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Moving Targets: Re-estimating Federal Deficits and Debt-to-GDP through 2020/21

by Niels Veldhuis, Milagros Palacios, and Charles Lammam

Summary

- The federal government has repeatedly shifted the goal posts on its own "fiscal anchors." This bulletin examines the robustness of the current "fiscal anchor" to reduce the debt-to-GDP ratio by the government's first mandate.
- The 2016 federal budget confirmed the government's plan to run long-term deficits–$113.2 billion over the five-year plan.
- Budget 2016 increases program spending by 7.6% in 2016/17, following a 6.7% increase in 2015/16.
- A closer look at the government's spending plan reveals a major slowdown in spending growth during the last three years. Specifically, the federal government is proposing to reduce spending as a share of the economy and per-person spending (inflation-adjusted) from 2017/18 to 2020/21.
- Decreasing the size of the federal government does not square with the government's view that government spending drives economic growth.
- Using three alternative spending scenarios from 2017/18 to 2020/21, we estimate the potential impact on the five-year deficit plan and debt-to-GDP assuming:
  - Program spending increases at the rate of population growth plus inflation
  - Program spending increases at the rate of economic growth
  - Program spending increases by 6.0% annually (the average growth rate of first two years of the 5-year budget plan)
- We estimate that over the course of the government's fiscal plan the cumulative federal deficit could reach up to $196.0 billion.
- We find that the debt-to-GDP ratio under three different spending scenarios would be greater in 2020/21 than in 2015/16. The federal government is therefore unlikely to meet its latest target of reducing the federal debt-to-GDP by the end of its first mandate.

Introduction

During the 2015 federal election, the Liberals campaigned on two core fiscal positions: (1) to balance the budget and (2) to reduce the federal debt-to-GDP ratio to 27%, both by 2019/20.[1] While the Liberals proposed annual deficits of approximately $10 billion in each of the first two years, Canadians were assured that they had a responsible plan to balance the budget within the government's mandate. The Liberal platform specifically noted:

> With the Liberal plan, the federal government will have a modest short-term deficit of less than $10 billion in each of the next two fiscal years… After the next two fiscal years, the deficit will decline and our investment plan will return Canada to a balanced budget in 2019/20. Combining fiscal prudence with investments in economic growth, we will end the Harper legacy of chronic deficits and reduce Canada's federal debt-to-GDP ratio each year. (Liberal Party of Canada, 2015: 76)

Within months of being elected, the new government distanced itself from the first of the two core fiscal anchors—the promise to balance the budget by 2019/20—and began to focus exclusively on its second core fiscal policy—to reduce the federal debt-to-GDP ratio. For example, in December 2015, Prime Minister Trudeau noted: "We will continue to decrease (the debt-to-GDP ratio) every single year because that's important for the fiscal health of our country" (Blatchford, 2015, Dec. 14).

[1] The Liberal Party platform states, "We have two fiscal anchors that guide our overall fiscal framework. In 2019/20, we will: Reduce the federal debt-to-GDP ratio to 27% [and] Balance the budget" (Liberal Party of Canada, 2015: 75).

The focus on the second core anchor was also short-lived. The federal government's recently released 2016 budget proposed a notable increase in the federal debt-to-GDP ratio in 2016/17. The budget clearly moved away from the prime minister's promise to reduce debt-to-GDP "every single year." Instead, the finance minister promised that "By the end of our first mandate, Canada's debt-to-GDP ratio will be lower than it is today" (Canada, 2016b).

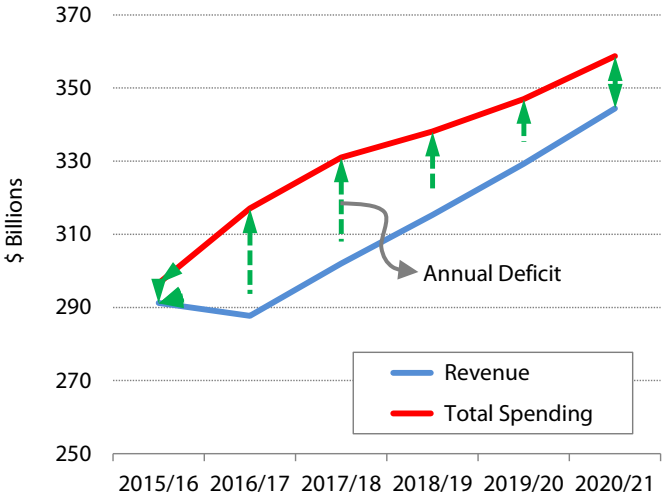
Given the rapidly evolving deficit and debt targets, this bulletin provides a detailed examination of the government's deficit plan. Most importantly, it examines the robustness of the current "fiscal anchor" to reduce the federal debt-to-GDP by the end of the government's first mandate.

Budget 2016: Long-term deficit spending

The 2016 federal budget confirmed the government's plan to run long-term deficits. Specifically, the budget calls for a $29.4 billion deficit this year (2016/17) and total deficits amounting to $113.2 billion over the five-year plan. It is important to note that the budget does not provide a strategy for bringing the budget back to balance during the government's current mandate, nor does it set any future target date for a balanced budget. In other words, the budget leaves the task of balancing the books to the government's next mandate or a future government.

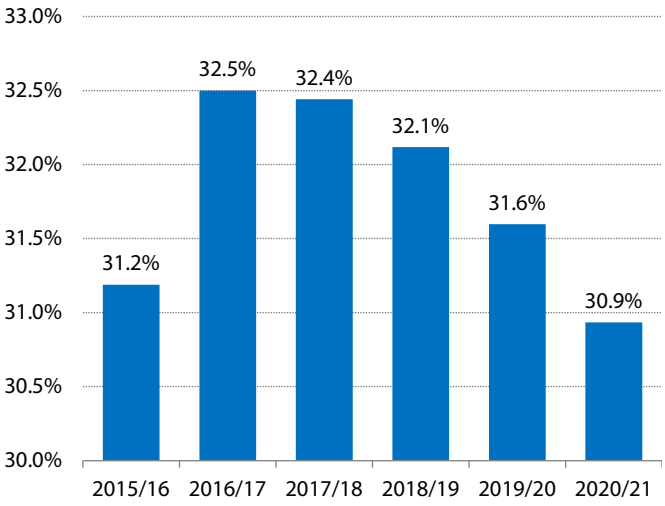
Figure 1 shows the five-year fiscal plan (2015/16 to 2020/21) presented in Budget 2016. As depicted, revenues are projected to decrease slightly (-1.2%) in 2016/17, after which they are expected to increase robustly over the remaining four years of the fiscal plan. More specifically, revenues are expected to increase at an average rate of 4.6% from 2017/18 to 2020/21,

Figure 1: Federal Fiscal Plan, *Budget 2016*



Source: Canada, 2016a.

Figure 2: Debt-to-GDP Projections, *Budget 2016*



Source: Canada, 2016a.

slightly outpacing expectations of economic growth (averaging 4.4% over the period).[2]

Given the robust revenue growth expected from 2017/18 to 2020/21, it is clear from figure 1 that it is significant spending increases that are driving federal deficits.[3]

In 2016/17, total federal spending is projected to increase by 6.9%, significantly above expected economic growth of 0.5%. This increase is even more dramatic considering that spending in 2015/16 is up 5.8% from the previous year. That means total spending will increase 13.1% over just two years. Over the five-year plan, total government spending is set to increase by $62 billion or 20.9%.

As a result of the spending-induced deficits, the federal government is proposing to increase its debt-to-GDP ratio in 2016/17 (see figure 2), a clear reversal of the prime minister's promise to reduce debt-to-GDP "every single year." Instead, the government is proposing to stabilize the debt-to-GDP ratio in 2017/18 before reducing it over the final three years of its plan.[4] As noted above, by 2020/21, the government has committed to reducing the debt-to-GDP ratio to slightly below its 2015/16 level.

Given the government's evolving deficit and debt targets over the past six months, should Canadians have faith in the government's plan to reduce the debt-to-GDP ratio over its mandate? The remainder of this Bulletin addresses this important question.

[2] Economic growth refers to nominal growth in gross domestic product (GDP).

[3] For more on this topic, see Lammam and Eisen, 2016, March 24.

[4] Federal debt in this Bulletin is defined as net debt minus non-financial assets.

A closer look at the federal government's spending plans

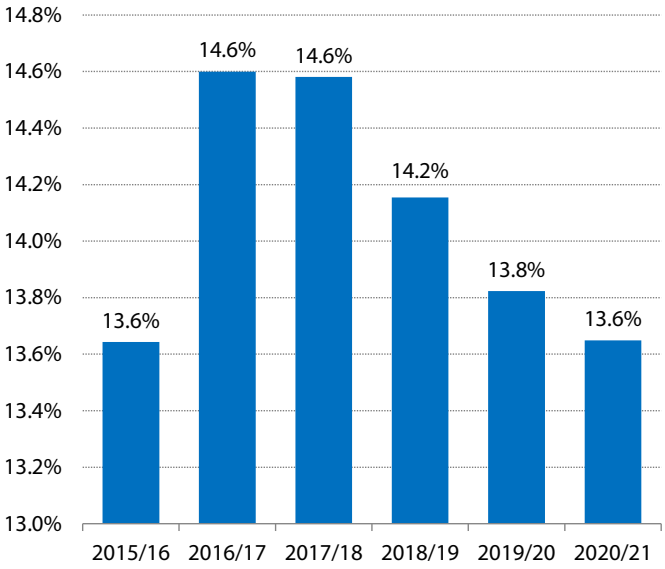
It is clear from both the government's rhetoric and actions in *Budget* 2016 that it is committed to significant increases in spending. Program spending (total spending minus interest charges on the federal debt and the portion of spending that the government can most directly control) is projected to increase by 7.6% in 2016/17, following a 6.7% increase in 2015/16. That means program spending will increase by nearly 15% over just two years.

While program spending is projected to increase significantly in 2015/16 and 2016/17, *Budget* 2016 proposes a major slowdown in spending growth from 2017/18 to 2020/21. Specifically, program spending growth will average 2.6% from 2017/18 to 2020/21, well below the average rate of economic growth forecasted over this period (4.4%), and average population growth plus inflation (3.0%).

With program spending set to grow at a slower rate than the economy and inflation plus population growth, the federal government is proposing a reduction in the size of the federal government (measured by program spending as a share of the economy) from 2017/18 to 2020/21 and a decrease in inflation-adjusted per person spending. Figure 3 presents program spending as a percent of GDP while figure 4 presents program spending per person from 2015/16 to 2020/21.

Canadians should view the proposed spending plan from 2017/18 to 2020/21 with skepticism. A decrease in the size of the federal government does not evidently square with the current government's view that government spending drives economic growth. Indeed, Budget 2016 includes an entire Appendix on

Figure 3: Program spending as a percent of GDP, *Budget 2016*

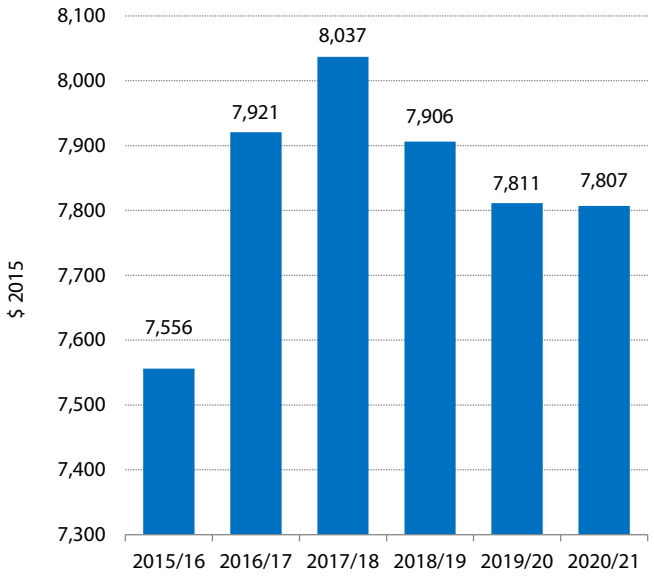


Source: Canada, 2016a.

so-called "fiscal multipliers," a concept that assumes governments can spend one dollar and generate more than one dollar's worth of economic activity. Specifically, the budget states that "new spending stimulates employment growth, which in turn yields a further boost to real GDP" (Canada, 2016c.) In addition, the government's spending proposals in the latter half of its fiscal plan do not square with the finance minister's own budget speech: "Of course, this is only the beginning. Today we have taken some big steps in a long journey" (Canada, 2016b).

Finally, the proposed slowdown in spending growth from 2017/18 onwards is at odds with the long-term nature of many of the initiatives proposed in *Budget* 2016. Put differently, many initiatives are not one-offs and will be built into future federal spending. A recent

Figure 4: Program spending per person ($ 2015), *Budget 2016*



Sources: Canada, 2016a; calculations by authors.

report by the Parliamentary Budget Officer criticized the government for not providing the full annual cost of many of its *Budget 2016* initiatives beyond 2017/18. Specifically, there is $10.9 billion in new initiatives delineated within the budget for 2016/17, whose costs (also separately delineated) increase to $13.3 billion in 2017/18. Thereafter, only the annual cumulative costs of the new initiatives are provided and are assumed to decrease from $13.3 billion in 2017/18 to $6.2 in 2020/21 (PBO, 2016).

The federal deficit and debt-to-GDP under three alternative spending scenarios

If indeed the significant spending increases of 2015/16 and 2016/17 are only the beginning and the federal government is unable or unwilling to restrain the growth in spending from 2017/18 to 2020/21, how would this affect the government's deficit and debt-to-GDP projections?

This section offers three alternative spending scenarios:

1. Program spending increasing at the rate of population growth plus inflation from 2017/18 through 2020/21, which would stabilize per-person spending from 2017/18 onwards
2. Program spending increasing at the rate of economic growth from 2017/18 through 2020/21, which would stabilize spending as a percent of GDP from 2017/18 onwards
3. Program spending increasing by 6.0% annually (the average growth rate of the first two years of the 5-year budget plan) from 2018/19 to 2020/21

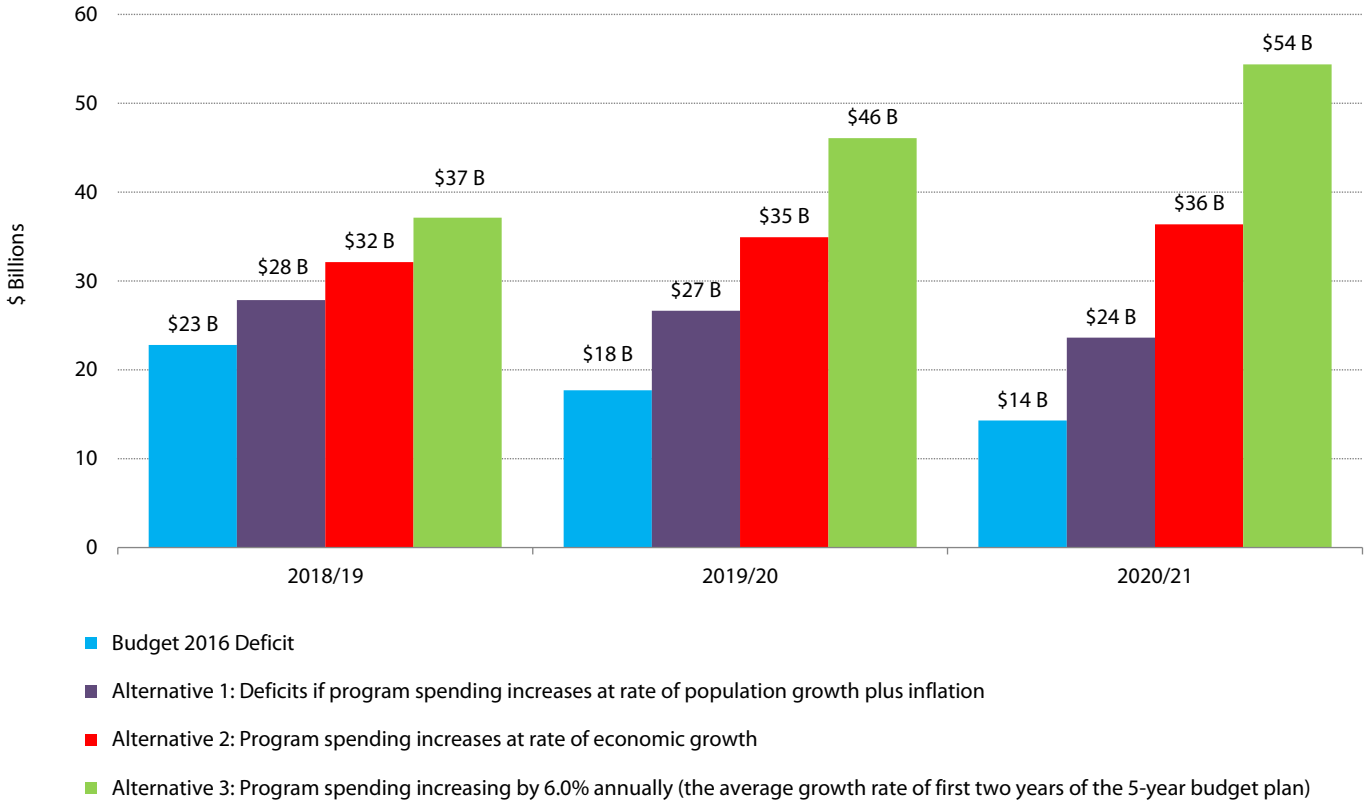
Annual deficits and debt-to-GDP ratios are also calculated for each scenario.

Figure 5 presents projected federal deficits under the three spending scenarios mentioned above and compares them to the deficits presented in *Budget 2016*.

In the first scenario, the federal government follows through with its 2016/17 and 2017/18 spending plans and thereafter increases program spending at the rate of population growth plus inflation. This would stabilize per-person spending from 2017/18 onwards. Under this scenario, annual federal deficits would be substantially larger than forecasted in *Budget 2016*. Over the five-year plan, total deficits would amount to $136.5 billion, some $23.3 billion more than projected in *Budget 2016*.

If program spending is increased by the rate of projected economic growth from 2017/18 onward, resulting in the federal government sta-

Figure 5: Federal Deficits Under More Realistic Spending Assumptions



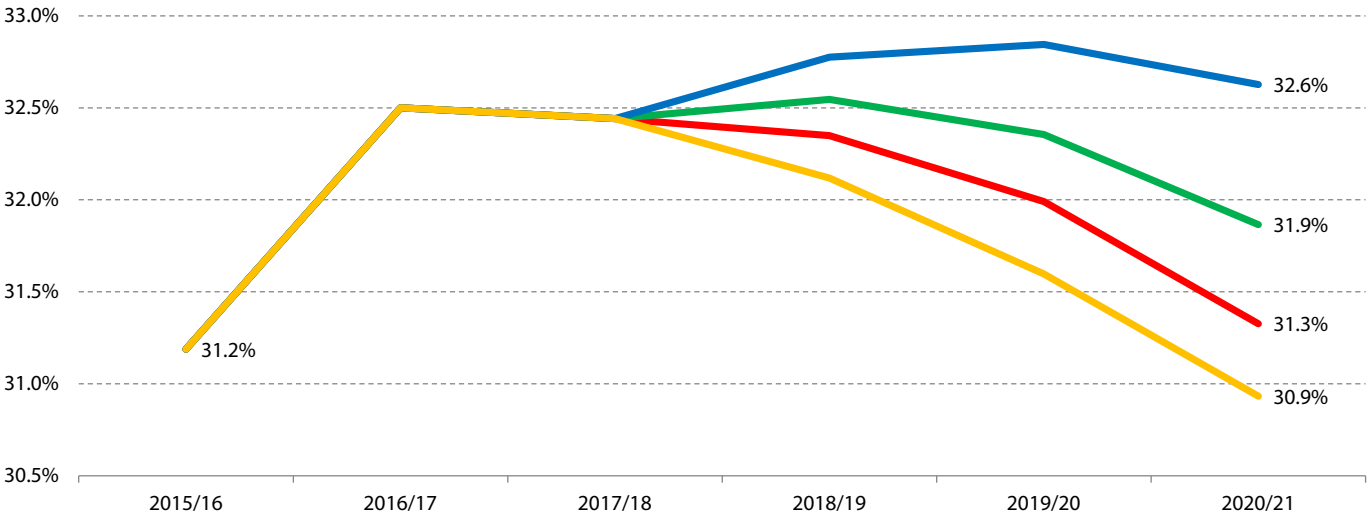
Sources: Canada, 2016a; calculations by authors.

bilizing in size (in terms of spending as a percent of GDP) thereafter, annual federal deficits would be even larger. Over the five-year plan, total deficits would amount to $161.8 billion, some $48.6 billion more than projected in *Budget 2016*.

Under the third scenario, the federal government would continue to grow spending at an average rate of 6.0% from 2017/18 through 2020/21 (6.0% is the average growth rate of first two years of the 5-year budget plan: 2016/17 to 2017/18). Total deficits over the five-year plan under this scenario would total $196.0 billion, $82.8 billion more than than projected in *Budget 2016*.

The addition of billions of dollars to federal debt, over and above that forecasted in *Budget 2016*, will place a significant burden on current and future Canadians. For instance, the federal government is currently paying $25.7 billion (or 8.9% of total revenue) in debt interest payments, more that it expects to spend on Employment Insurance or Child benefits. In addition, the spectre of rising interest rates poses a risk. If interest rates go up, the cost of carrying debt will increase and even more money will have to be re-directed to debt servicing costs. Specifically, *Budget 2016* estimates that a one percentage point increase in interest

Figure 6: Federal Debt-to-GDP Ratio Under More Realistic Spending Assumptions



Sources: Canada, 2016a; calculations by authors.

rates would increase the annual deficit by up to $3.3 billion (it would be lower initially as it takes time for debt to mature and be refinanced at higher rates).

Figure 6 presents the projected federal debt-to-GDP ratio under three spending scenarios and compares them to the debt-to-GDP presented in *Budget* 2016. In all three scenarios, the federal debt-to-GDP ratio in 2020/21 would be greater than in 2015/16.

Forecast adjustments built into *Budget 2016*

Some readers may question the above deficit calculations given the federal government's inclusion of a "forecast adjustment" of $6 billion a year over *Budget 2016*'s five-year planning horizon.

The $6 billion a year forecast adjustment to shield the fiscal plan from the various risks facing the Canadian economy is calculated through an annual $40 billion reduction in forecasted GDP.[5] That is, the federal government uses private sector forecasts of economic (GDP) growth but reduces GDP forecasts by $40 billion a year. With federal revenues totaling approximately 15% of GDP, the $40 billion reduction translates into roughly $6 billion in revenue.

[5] See *Budget 2016* (Canada, 2016a: 44-45) for a detailed description of the economic risks.

Putting aside the PBO's recent criticism that the $40 billion annual adjustment erodes the independence of the economic projections, there are several reasons to be skeptical of the cushion supposedly built into the budget.

First, as noted above, *Budget 2016* assumes aggressive revenue growth from 2017/8 to 2020/21. Specifically, average revenue growth is forecasted at 4.6% from 2017/18 to 2020/21, which outpaces average economic growth expectations of 4.4% over the period. It is unusual for the federal government to see revenue grow at a faster rate than nominal GDP over a four-year period.[6]

2016/17 is an exception as economic growth is projected at 0.5% while revenues are expected to decrease by 1.2%. The revenue decline is primarily due to one-time asset sales in 2015/16, the gains from which will not be repeated in 2016/17 (Canada, 2016a: 236).

Second, the government assumes (as do many private sector economic models) "multipliers" above 1.0, which means that if the government takes a dollar out of your pocket, or borrows it, and then spends it on someone else, it generates more than a dollar in economic activity (GDP). The concept of multipliers has been rigorously debated in economics and there is genuine debate about their validity. There is substantial evidence that the multipliers are actually less than 1.0, meaning that if government spending increases by one dollar, then GDP increases by less than a dollar (see Veldhuis and Lammam, 2010). If government spending is deficit-financed, as the current federal government's plan is, then increased government spending reduces other parts of GDP, such as consumer spending, private sector investment, and net exports. The net result is that the government spending actually reduces economic activity rather than expands it.

Given the difficultly of forecasting economic growth, particularly over longer periods of time, and the relatively robust revenue growth projected, Canadians should be skeptical of the $6 billion in annual "forecast allowance" built into *Budget 2016*.

The potential impact of a slowdown in economic growth

We also consider the implications of a 1 percentage point decline in inflation-adjusted economic (GDP) growth on the federal deficit. Such an economic shock may, for example, be caused by a slowdown in the US economy.

When a government runs deficits during recessions, it is understandable because revenues decline and certain spending increases. However, governments that prudently manage their finances ensure that they return to balance as soon as possible once the economy recovers. Failing to do so puts the country's finances at risk should the economy experience a slowdown or another recession.

The current federal plan includes deficits for the next five years (see figure 1) despite the fact that economic growth is expected to average 4.4% from 2017/18 to 2020/21. If Canada experiences an economic slowdown, not only will revenues be reduced, but federal spending will automatically increase (for employment insurance spending, for example). An economic

[6] For example, an analysis of rolling, four-year average growth rates for federal revenues and GDP since 2000/01 reveals only two cases out of 15 in which average revenue growth was greater than average GDP growth.

slowdown—or worse, a recession—would lead to a deficit that is much higher than currently planned. The government's own estimates reveal that the impact of a one year, 1 percentage-point decrease in inflation-adjusted GDP would result in an estimated $5.0 billion increase in the annual deficit.

The bottom line is that borrowing money to finance spending during good times (i.e., when the economy is growing) means that when the inevitable downturn occurs, our country's finances will be much worse than that forecasted above.

Conclusion

Over the past six months, the federal Liberals have repeatedly shifted the goal posts on their own "fiscal anchors." Canadians should therefore be skeptical of the government's plan to reduce the federal debt-to-GDP ratio to below 2015/16 levels by the end of its first mandate. Our estimates, using different spending assumptions from 2017/18 to 2020/21, reveal that the cumulative federal deficit over the course of the government's fiscal plan could reach up to $196.0 billion, significantly above that forecasted in Budget 2016. Using more realistic spending assumptions, the government is also unlikely to reduce the federal debt-to-GDP ratio below the 2015/16 level by the end of its first mandate. We find that debt-to-GDP under three different spending scenarios would be greater in 2020/21 than in 2015/16 and the federal government is therefore unlikely to meet its goal of reducing the federal debt-to-GDP by the end of its first mandate.

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Niels Veldhuis *is Fraser Institute President. He has written six books and more than 50 comprehensive studies on a wide range of economic topics as well as over 200 commentaries that have appeared widely in national and international newspapers. He holds a Master's Degree in Economics from Simon Fraser University.*

Milagros Palacios *is a Senior Research Economist at the Fraser Institute. She holds a BA in Industrial Engineering from the Pontifical Catholic University of Peru and a M.Sc. in Economics from the University of Concepción, Chile. Since joining the Institute, she has published or co-published over 100 research studies and over 80 commentaries on a wide range of public policy issues including taxation, government finances, investment, productivity, labour markets, and charitable giving.*

Charles Lammam *is Director of Fiscal Studies at the Fraser Institute. He has published over 70 studies and 260 original articles on a wide range of economic policy issues. He holds an MA in public policy and a BA in economics with a minor in business administration from Simon Fraser University.*

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