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CANADIAN CENTRE
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FEDERAL FISCAL FORECASTING ROUND 3

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**For the House of Commons Standing
Committee on Finance**



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Federal Fiscal Forecasting Round 3

Ellen Russell

Introduction

This report is prepared as part of “Round 3” of the quarterly independent forecasts of the federal Public Accounts provided to the House of Commons Standing Committee on Finance. In addition to presenting an updated federal forecast, this Round 3 report will highlight two particularly notable developments that have occurred since the last round of the quarterly independent federal fiscal forecast: the agreement reached between the government and the NDP, and the publication of Tim O’Neill’s report on federal fiscal forecasting.

While Round 2 of the federal fiscal forecasting process included an analysis of the federal budget tabled by the Finance Minister in February, since that time an agreement has been negotiated with the New Democratic Party calling for \$4.6 billion in additional spending. This spending is conditional on the government’s ability to realize a budget surplus of \$2 billion or more. The conditionality of this additional program spending adds to the importance of ascertaining the likely size of the budget surplus in coming years. In addition, the agreement with the NDP removes the majority of the corporate income tax cuts put forward in the government’s 2005 budget.

A second important development was the release of the report conducted by Tim O’Neill on behalf of the Finance Minister. The report, enti-

tled “Review of Canadian Federal Fiscal Forecasting: Processes and Systems” (hereafter referred to as the O’Neill Report), examined the federal government’s fiscal forecasting accuracy to both explain and propose remedies for the persistent pattern of “surprise” federal budget surpluses. Because its findings are of such significance for the House of Commons Standing Committee on Finance’s ongoing inquiry into federal fiscal forecasting, certain highlights from the O’Neill Report will be considered in the CCPA’s Round 3 Report.

The O’Neill Report emphasized that “implicit prudence” is built into the government’s fiscal forecast. This unacknowledged buffer exists in addition to the explicit prudence reserves already incorporated into the government’s budget¹. The O’Neill Report argues that implicit prudence plays a large role in generating the repeated upside errors in the Finance Department’s estimates of upcoming budget surpluses. As we will discuss in the final section of this report, the O’Neill Report argues that this practice has been motivated by the government’s adherence to a no-deficit “fiscal rule”.

Determining the size and source of this implicit prudence is a complex undertaking even for fiscal forecasting experts. There are many ways to build implicit prudence into a forecast, and the Finance Department is fully capable of varying the manifestations of implicit prudence in differ-

ent budget years. While forecasters outside of the Finance Department may have strong suspicions that particular budget categories within the official forecast conceal implicit prudence, we cannot know this with certainty. It is always possible that the budget category in question merely reflects information known only to those with access to the full range of data available to the Finance Department.

However, meaningful participation in public policy debates requires that Parliamentarians (and all Canadians) have the most accurate possible understanding of the true state of the government's expected financial position. This need is made more pressing given that substantial spending commitments are now conditional on the outlook for the government's budget surplus.

Thus so long as the Department of Finance incorporates implicit — and invisible — prudence into its forecasts, observers of the federal budget are obliged to form opinions about the extent of this implicit prudence. In an effort to

assist Parliamentarians in their ability to assess the magnitude and location of implicit prudence, CCPA's Round 3 report discusses possible avenues through which implicit prudence can be incorporated into the government's estimates of its forthcoming budget surpluses.

The report is structured in four sections. Noteworthy assumptions or methodological issues are signaled in the relevant section. Section 1 presents the current macroeconomic forecast. Section 2 presents the federal fiscal forecast adjusted to reflect both current macroeconomic conditions as well as other new developments that affect government revenue, program expenditure and public debt charges. Section 3 discusses some of the ways in which implicit prudence may be incorporated in official fiscal forecasts. Finally, section 4 concludes with some comments on those findings of the O'Neill Report that have particular importance for the House of Commons Standing Committee on Finance.

1 Macroeconomic Forecast

The CCPA's Consensus Macroeconomic Forecast

Table 1 presents the CCPA's consensus macroeconomic forecast of key economic indicators. The CCPA arrives at this consensus macroeconomic forecast by reviewing the current expectations of ten forecasts or surveys of forecasts published during June and early July. In each case a median value is chosen for the consensus variable².

One methodological issue deserves specific emphasis. Beginning with this CCPA report, we will depart from one of the practices employed in CCPA reports for rounds #1 and #2 of this independent forecasting exercise. This current report will no longer convert macroeconomic variables and nominal dollar amounts expressed in calendar years into their fiscal year equivalents. This conversion was originally motivated to assure readers that important ratios (such as revenue/GDP) had a numerator and denominator that were expressed in comparable units. While we continue to maintain that mixing fiscal and calendar years in this manner is incorrect and misstates important indicators that shape public policy debate, we recognize that this practice is widely employed. Thus to enhance the comparability of our results with other forecasts, we have adopted this same manner of presentation.

The consensus forecast for real GDP growth became more pessimistic following the release of

the February budget (as measured at the time of CCPA's Round 2 report). More recently the economic outlook has improved slightly. Oil and gas prices have continued to climb, the Canadian dollar has regained some of the value it lost after the February budget, and employment growth in the second quarter was strong. Compared to the February budget, our current consensus forecast of nominal GDP growth for 2005 is 0.2 percentage points lower than was the case in the federal budget. For 2006 the CCPA consensus forecast of nominal GDP growth matches that of the February budget.

Compared to the CCPA's Round 2 consensus forecast for real GDP growth prepared in March, real GDP growth has improved slightly for 2005

TABLE 1 Consensus Macroeconomic Forecast prepared by CCPA

	2005	2006
Real GDP growth	2.7	2.9
GDP inflation	2.3	2.1
Nominal GDP growth	5.0	5.0
3 month Treasury Bill Rate	2.6	3.5
10 Year Government Bond Rate	4.3	4.5
Unemployment Rate	6.9	6.9
Employment Growth	1.3	1.2
US Real GDP growth	3.6	3.2

NOTE Median values of 10 published forecasts for 2005 and 2006.

TABLE 2 CCPA Consensus Macroeconomic Forecast Compared to 2005 Federal Budget and Round 2 CCPA Report

(Per Cent)	2005	2006
Real GDP growth		
February 05 Budget	2.9	3.1
March CCPA Report	2.6	3.0
Current CCPA Consensus	2.7	2.9
GDP inflation		
February 05 Budget	2.0	1.9
March CCPA Report	2.1	2.0
Current CCPA Consensus	2.3	2.1
Nominal GDP growth		
February 05 Budget	4.9	5.0
March CCPA Report	4.9	5.1
Current CCPA Consensus	5.0	5.0
3 month Treasury Bill Rate		
February 05 Budget	2.7	3.5
March CCPA Report	2.5	3.0
Current CCPA Consensus	2.6	3.5
10 Year Government Bond Rate		
February 05 Budget	4.6	5.1
March CCPA Report	4.6	4.8
Current CCPA Consensus	4.3	4.5
Unemployment Rate		
February 05 Budget	7.2	7.0
March CCPA Report	7.1	7.0
Current CCPA Consensus	6.9	6.9
Employment Growth		
February 05 Budget	1.4	1.5
March CCPA Report	1.4	1.5
Current CCPA Consensus	1.3	1.2
US Real GDP growth		
February 05 Budget	3.6	3.4
March CCPA Report	3.5	3.4
Current CCPA Consensus	3.6	3.2

but declined slightly for 2006. In both years, the forecast indicates that GDP inflation is projected to be higher than was the case in March. Projected nominal GDP growth has been increased slightly for 2005, and decreased slightly for 2006.

The CCPA consensus forecast indicates that short term interest rates are expected to climb over the period relevant to this forecasting exercise (in a manner fairly similar to the short term interest rate outlook presented in the 2005 budget).

However, the current CCPA consensus forecast indicates that long term interest rates will not increase as much as was previously assumed. The CCPA's projections for the 10 year bond rate have fallen since both the February budget and the publication of CCPA's round 2 report.

On July 14, Bank of Canada Governor David Dodge stated that "some reduction in the amount of monetary stimulus would be required in the near term to keep aggregate demand and supply in balance and inflation on target." While virtually all forecasters expect increases in short term interest rates, the Governor's statement was particularly definitive. As Governor Dodge stated, the risks over the near term (through to 2006) appear to be balanced, but possible weaknesses in the global economy over the medium term (2007 to 2009) are more of a concern. In effect, the Bank of Canada is planning to raise short-term interest rates over the next year so that it will have flexibility to lower the rates later if necessary to counteract possible medium term weaknesses.

The component forecasts of our CCPA consensus forecast were generated prior to these remarks. Despite these comments, we regard substantial upward pressure on interest rates to be unlikely. The Bank of Canada, in its recent Monetary Policy Report Update, confirmed that the outlook for inflation has not changed since the

Bank's April report. Moreover, we expect that under current circumstances the Bank would be unwilling to subject the Canadian dollar to further upward pressure. Thus we do not believe that the outlook for interest rates depicted in the CCPA

consensus report will be substantially altered. In any case, moderately higher interest rates are not likely to have dramatic impact on the debt service charges estimated in the CCPA fiscal forecast, as is explained below.

2 The Federal Fiscal Forecast

Important Assumptions Pertaining to the Federal Fiscal Forecast

The federal fiscal forecast presented here reflects both CCPA's current consensus macroeconomic forecast as well as recent developments that inform our assessment of the foreseeable government revenue, program spending and debt service charges. Apart from explicitly discussed developments, the CCPA's federal fiscal forecast reflects a "status-quo" policy base case.

On the revenue side, the agreement between the government and the NDP has caused the government to withdraw much of the corporate income tax reductions proposed in the budget tabled by the Finance Minister in February. The government has signaled its intention to reintroduce these measures at a later time, but our status quo assumptions require that we assume that these corporate tax cuts will not proceed. However, both the corporate surtax and general corporate income tax rate reductions originally announced by the Finance Minister were to take place in fiscal year 2007/08 and beyond. Thus the status of these tax reductions has no direct bearing on the forecast projections that extend only until fiscal year 2006/07.

All new spending announcements (as announced on the Department of Finance's website as of July 10, 2005) have been included in program spending estimates. The media release pre-

pared by the Finance Department assesses the net new cost of these announcements at \$2.4 billion in the current fiscal year and \$2.7 billion in the upcoming fiscal year³. Since there are a number of difficulties posed in attempting to assess the extent to which these spending announcements genuinely represent an increase in spending over status quo government spending, we accept the Finance Department's assessment of their net new cost.

Bill C-48 implements the NDP-government agreement to increase spending by \$2.25 billion in each of the current and upcoming fiscal years. Thus Bill C-48 constitutes the bulk of the cost of recent spending announced by the Finance Department. The spending contained in Bill C-48 is conditional, in that it will take place only so long as it does not reduce the government's budget surplus below \$2 billion. For the purposes of this forecasting exercise, we have elected to assume that this spending will in fact proceed. However, it is presented as a separate line item to enhance its visibility.

We assume that only the \$3 billion contingency fund is used to repay federal debt each year. This assumption is made despite the fact that our forecasted surpluses exceed \$3 billion per year, and the government normally allocates its full surplus to debt repayment. This assumption imparts caution into our forecast. If the government continues its practice of allocating

more than \$3 billion annually to debt repayment, then the public debt charges would be lower than those indicated in this forecast.

Highlights of the CCPA Federal Fiscal Forecast

The CCPA expects federal revenues as a share of GDP to be 15.3% during the 2004/05 fiscal year, but we expect revenue/GDP to remain virtually stable at 15.2% for the remainder of the forecast period. This outlook continues to contrast sharply with federal government's February 2005 Budget, which had revenue/GDP sinking to 14.7% by 2006/07.

Federal revenues are separately projected in several major categories (personal and corporate income taxes, GST revenues, EI premiums and other) in Table 3. These projections are formed on the basis of the consensus macroeconomic forecast and on the demonstrated historical relationships between revenue categories and selected macroeconomic variables, as well as new information that may cause us to reassess these behavioral relationships. Now that we have the benefit of the full twelve months data for 2004/05 in the Fiscal Monitor, we can compare our projections with this preliminary data, recognizing of course that year-end adjustments and reconciliation's can produce substantial variations between the Fiscal Monitor and the final year end results.

Expressed as a percentage of GDP, our estimated personal income tax revenue is slightly higher than the Finance Department's for both 2004/05 and 2005/06. Our perspective is that the underlying increase in personal incomes (as well as the impact resulting when real personal incomes increase, which pushes more Canadians into higher tax brackets) more than outweighs any remaining downward pressure from the final

phase of the 2000 tax cuts as well as the impacts of the initial implementation of the changes in the basic personal exemption announced in the 2005 federal budget.

However, our perspective on corporate income tax revenues differs more sharply from the Finance Department's. We believe that the budget has significantly underestimated corporate income tax revenues—even after adjusting for the value of forthcoming corporate tax reductions (both those announced in previous budgets and still being enacted, and the small amounts relating to Capital Cost Allowance that were introduced in the 2005 budget and have not been withdrawn). Corporate profits have reached record levels (in both dollar terms and as a share of GDP). Private sector forecasts consulted in preparation of CCPA's consensus economic forecast saw the surge in growth of corporate profits (which increased almost 19% for 2004) continuing at a declining but still rapid rate in 2005. Thus our forecast of corporate income tax is higher than is the government's, implying that corporate income taxes would continue to constitute 2.3% of GDP for the period until 2006/07.

Our spending estimate (\$156.5 billion) for 2004/2005 comes in considerably below the \$158 billion projected by the Finance Department. This perspective is consistent with the preliminary program spending estimates contained in the Fiscal Monitor indicating that program spending prior to year-end adjustments stands at about \$153 billion for the 2004/2005 fiscal year.

CCPA's program spending estimates for 2005/2006 and 2006/2007 are lower than the government's despite the inclusion of the spending announcements made since the February 2005 budget. This implies that the net new cost of the spending promises made both via the agreement with the NDP and via other announcements are

TABLE 3 Budgetary Revenues (billions of dollars)

Tax Revenues	2003-04 (actual)	2004-05	2005-06	2006-07
Income tax				
Personal Income Tax	84.9	89.7	94.3	99.6
Corporate Income Tax	27.4	29.8	31.3	32.7
Goods and Services tax	28.3	31.1	31.7	33.3
Other	28.1	29.7	31.2	32.7
Employment Insurance Revenues	17.5	17.2	17.1	17.2
Total Budgetary Revenues	186.2	197.4	205.5	215.5
Per Cent of GDP				
Personal Income Tax	7.0	7.0	7.0	7.0
Corporate Income Tax	2.3	2.3	2.3	2.3
Goods and Services tax	2.3	2.4	2.3	2.3
Other	2.3	2.3	2.3	2.3
Employment Insurance Revenues	1.4	1.3	1.3	1.2
Total Budgetary Revenues	15.3	15.3	15.2	15.2

NOTE Numbers may not add due to rounding

funded from the implicit prudence built into the official estimates of program spending.

In our estimation, the government's debt service charges for 2004/05 are likely on the high side at \$34.7 billion (compared with the Fiscal Monitor's \$34.1 billion). We diverge from the Finance Department's perspective more sharply in future years. We believe that the cost savings implied by the government's debt management strategy (see below) will continue to produce savings in the debt service category. Thus even in an environment of rising interest rates, we believe that debt service charges will be substantially below those forecast in the 2005 budget.

The CCPA forecasts a federal surplus of \$6.8 billion for the 2004/05 fiscal year (see Table 4). In coming fiscal years, we project surpluses of \$9.5 billion in 2005/06 and \$11.3 in 2006/07. This forecasted surplus ("underlying surplus" in the par-

lance of the Finance Department) far exceeds the official budget surplus estimate presented in the 2005 budget.

Note that this surplus projection has already incorporated the full spending negotiated between the NDP and the Liberal government. Despite the inclusion of this spending, CCPA projects surpluses that are still far in excess of the \$2 billion required to implement that agreement.

Vis à vis the Round 2 report of the CCPA (authored by Jim Stanford), our current surplus estimate for 2004/05 is higher than the estimate made in March 2005, although our surplus estimates are somewhat lower in later years (in large part because Bill C-48 spending is now included in CCPA program spending estimates). Discrepancies between CCPA's Round 2 and Round 3 reports are the result of several factors, many of which have enhanced the magnitude of

TABLE 4 Summary Statement of Transactions

	2003-04 (actual)	2004-05	2005-06	2006-07
Budgetary Transactions (billions of dollars)				
Revenue	186.2	197.4	205.5	215.5
Total Expenses				
Program Spending				
status quo		156.5	159.8	168.3
NDP-government deal			2.3	2.3
Total Program Spending	141.4	156.5	162.1	170.5
Debt Service	35.8	34.1	33.9	33.7
Total Expenses	177.1	190.6	196.0	204.2
Underlying Budget Surplus	9.1	6.8	9.5	11.3
Prudence				
Contingency Reserve		3.0	3.0	3.0
Economic Prudence			1.0	2.0
Total	0.0	3.0	4.0	5.0
Budgetary Balance	9.1	3.8	5.5	6.3
Federal Debt (accumulated deficit)				
Balanced budget (no debt Reduction)	501.1	501.1	501.1	501.1
Apply Contingency Reserve to debt	501.1	498.1	495.1	492.1
Percent of GDP				
Budgetary Revenues	15.3	15.3	15.2	15.2
status quo		12.1	11.8	11.8
NDP-government deal		0.0	0.2	0.2
Total Program Expenses	11.6	12.1	12.0	12.0
Public Debt Charges	2.9	2.6	2.5	2.4
Underlying Budget Surplus	0.7	0.5	0.7	0.8
Federal Debt (assuming Contingency Reserves applied to debt)	41.1	38.6	36.5	34.6

NOTE Numbers may not add due to rounding

the 2004/05 surplus projections. Our revenue projections are somewhat more optimistic for 2004/05, but less optimistic in subsequent years, in part because we have revised our outlook on the impact of the shifting composition of federal revenues under conditions of high but declining forecasted corporate profitability. In addition, more recently available Fiscal Monitor data has compelled us to revise downwards our expectations about 2004/05 program spending and debt service estimates. In subsequent years, our cur-

rent perspective on the impact of debt management strategies under the prevailing interest rate forecasts has caused us to anticipate lower debt service charges than was previously reported in Round 2. Some information contained in the Round 3 Report (such as the ratios of the various budget categories to GDP) is not directly comparable with Round 2 results because of a change in methodology in which we no longer convert calendar year data to its fiscal year equivalents.

3 Implicit Prudence In Federal Fiscal Forecasts

The CCPA's forecasts of the major components of the federal budget differ from those of the Department of Finance in several respects. Given the O'Neill Report's analysis of the pervasiveness of implicit prudence in generating "surprise" budget surpluses, the CCPA is always alert to the possibility that discrepancies between our forecast and that of the Finance Department highlights the impact of this implicit prudence. However, given that this prudence is implicit, it is not possible to know conclusively what the sources of those discrepancies are.

So long as implicit prudence lurks behind the forecasts generated by the Finance Department forecasters, the general public is forced to decode official forecasts to assess the magnitude and location of this implicit prudence. To assist readers of the official federal fiscal forecast in this task, this section of the report provides some guideposts to enable critical readers of the federal fiscal forecast to detect the possible evidence of implicit prudence.

Implicit Prudence in Macroeconomic Forecasting

Forecasters can build in "implicit prudence" by employing macroeconomic forecasts that are pessimistic. Since no one can truly know what will happen in the future (especially the distant future), pessimistic macroeconomic forecasts

can usually be justified by citing some sort of negative potential economic development

The most straightforward way to understate future budget surpluses is to employ a pessimistic projection of nominal GDP growth (or either of its component parts, real GDP growth and GDP inflation). Since tax revenue rises with nominal GDP growth, pessimistic economic growth assumptions will contribute to underestimating taxation revenue. Jim Stanford's analysis of macroeconomic forecasting errors performed for the House of Commons Standing Committee on Finance (see Table 5) indicates that nominal and real GDP growth have been underestimated more often than not. Over a 10 year average, actual nominal GDP growth was 5.3%, while the government's forecasted growth was 4.3%. Similarly, actual real GDP growth averaged 3.5% over this period, while the government's forecasted real GDP growth averaged 2.9%.

Overly cautious estimates of other macroeconomic variables can also downplay the likely size of the forthcoming surplus. For example, forecasts that overstate the degree to which interest rates are expected to rise add implicit prudence that will diminish expected tax revenue (to the extent that higher interest rates dampen economic growth) and elevate expected debt servicing costs. As Table 5 shows, the federal government's forecast of both short and long term interest rates have, on average, been too high over the last 10

TABLE 5 Macroeconomic Indicators: Forecast and Actual, 1994-2004

Fiscal Years	Nominal GDP Growth		Real GDP Growth		90-day T-bill Rate		10-yr Benchmark Bond	
	Forecast	Actual	Forecast	Actual	Forecast	Actual	Forecast	Actual
1994/95	3.9	6.5	3.0	5.1	4.5	6.5	6.4	8.9
1995/96	5.5	4.0	3.8	1.8	8.5	6.2	9.7	7.7
1996/97	3.5	4.2	1.9	2.4	5.3	3.7	7.2	7.0
1997/98	4.9	5.1	3.3	4.5	3.2	3.6	6.6	5.8
1998/99	4.7	3.7	3.5	4.1	4.6	4.8	5.9	5.2
1999/2000	2.7	8.7	2.0	5.8	4.4	4.8	5.1	5.8
2000/01	5.7	8.9	3.5	4.6	5.2	5.4	6.2	5.7
2001/02	2.6	1.4	1.3	1.7	3.8	3.1	5.5	5.5
2002/03	4.6	6.4	3.4	3.6	2.6	2.8	5.3	5.2
2003/04	5.4	4.0	3.2	1.7	3.9	2.7	5.5	4.7
10-year Average	4.3	5.3	2.9	3.5	4.6	4.4	6.3	6.1

SOURCE Jim Stanford, CCPA Round 1 Report.

Includes forecast for first budgeted fiscal year from each year's budget, with the exception of 2002 (for which first budget year forecast from October *Economic and Fiscal Update* is used). Forecasts are unadjusted for "prudence." Economic data are averages for fiscal years.

years for which we have final data. There are also macroeconomic variables that the federal budget does not report on, but will nonetheless affect their forecasted surpluses. Projections about pre-tax corporate profitability shape the likely size of corporate income tax revenues, thus pessimistic assumptions in this category will also contribute to understating foreseeable budget surpluses.

Economic conditions change with the passage of time, so it is notoriously difficult to provide meaningful forecasts of macroeconomic variables in time periods more than 2 years hence. The convention among federal fiscal forecasters is to assume a middle-of-the-road scenario for more distant years, rather than speculating on the possible timing of future economic cycles. In the absence of other information, a good benchmark is a nominal GDP growth of 5% in future years. It conforms to the commonly-estimated rate of growth of potential output in Canada (3%) and the midpoint of the Bank of Canada's

target band for inflation (2%). While the Department of Finance has sometimes employed a 5% long-run nominal GDP growth estimate (in the 2004 budget, for example), the 2005 budget assumes a long run average nominal GDP growth rate of 4.8%. The CCPA regards this as a form of implicit prudence.

Implicit Prudence in Revenue Forecasts

Underestimation of revenues is another way to build implicit prudence into the federal fiscal forecast. Since so many economic and other factors shape the dynamics of taxation and other revenues, it can be difficult to distinguish excessive caution in revenue estimates from a variety of other the impacts. As the CCPA Round 1 report points out (Table 6), revenues have been under-forecast for 8 of the last 10 fiscal years by an average of 3.7%. On average, the difference between the Finance Department's forecasted rev-

TABLE 6 Liberal Budgeting Errors by Category, 1994-2004

	Revenues			Program Spending			Debt Service			Budget Balance		
	Budget	Actual	%Error	Budget	Actual	%Error	Budget	Actual	%Error	Budget	Actual	\$bError
1994/95	123.9	123.3	-0.5%	122.6	118.7	-3.2%	41.0	42.0	+2.4%	-39.7	-37.5	+2.2
1995/96	133.2	130.3	-2.2%	114.0	112.0	-1.8%	49.5	46.9	-5.3%	-32.7	-28.6	+4.1
1996/97	135.0	140.9	+4.4%	109.0	104.8	-3.9%	47.8	45.0	-5.9%	-24.3	-8.9	+15.4
1997/98	137.8	153.5	+11.4%	105.8	108.8	+2.8%	46.0	40.9	-11.1%	-17.0	3.8	+20.8
1998/99	151.0	155.9	+3.2%	104.5	111.4	+6.6%	43.5	41.4	-4.8%	3.02	3.1	+0.1
1999/2000	156.7	166.1	+6.0%	111.2	111.8	+0.5%	42.5	41.6	-2.1%	3.0	12.7	+9.7
2000/01	162.0	179.6	+10.9%	116.0	119.3	+2.8%	42.0	42.1	+0.2%	3.0	18.1	+15.1
2001/02	171.3	173.3	+1.2%	130.5	126.7	-2.9%	39.2	37.7	-3.8%	1.5	8.9	+7.4
2002/03 ¹	173.9	177.6	+2.1%	134.3	133.3	-0.7%	35.6	37.3	+4.8%	3.0	7.0	+4.0
2003/04	184.7	186.2	+0.8%	143.0	141.4	-1.1%	37.6	35.8	-4.8%	3.0	9.1	+6.1
Average			+3.7%			-0.1%			-3.0%			+\$8.5 b

SOURCE Jim Stanford, CCPA Round 1 Report. Full accrual accounting since 2002/03 only; partial accrual accounting in prior years.

¹ No formal budget was delivered for 2002/03; budgeted items are as reported in 2002 *Economic and Fiscal Update*.

² Beginning in 1998, the government pledged to use its contingency fund (equal to \$3 billion in most years) for debt repayment if not needed to cover budgetary shortfalls; this table assumes that the contingency fund is thus the targeted balance (rather than the officially stated zero balance). If the official budget balance target were utilized (instead of the planned contingency fund) as the target, then the average annual error over the 10 budgets would have equalled over \$10 billion.

venues and actual revenues was \$6.3 billion. The dollar magnitude of these errors was greatest in the time preceding the introduction of the 2000 tax cuts, but even in the last 3 fiscal years the discrepancy between forecasted and actual revenues has averaged \$2.4 billion.

Non-experts wishing to scrutinize the government's revenue forecasts face an immense task if they wish to apprise themselves of the many factors that shape each form of government revenue. For the purposes of an initial reference point, we suggest the following: look at revenues as a percentage of GDP. Unless tax cuts or increases are being implemented, we would expect that revenue would form a roughly constant share of GDP (or even move upward slightly over time because of income tax bracket creep.)

Of course, this is only a first approximation. Also be aware that a one-time change in revenue

(such as the one-time revenue generated by the sale of Petrocan shares) will produce a temporary blip in the revenue/GDP ratio. Tax cuts or tax increases produce an ongoing shift in the revenue/GDP ratio.

For the purpose of forming an initial opinion about how various developments affect the revenue/GDP ratio, it is important to have a sense of how a given dollar amount (say the projected expense of a tax cut) can be expressed as a percentage of GDP. Canada's GDP is currently over \$1.3 trillion dollars in today's dollars, so a reduction of 1 percentage point in the revenue/GDP ratio this year is roughly equivalent to \$13 billion less in revenues

In 2003/2004, the last year for which we have actual figures, revenue/GDP was 15.3%. Yet for 2004/2005 revenue/GDP is projected by the Finance Department to be 15.1%. This low ratio

causes us to pause, particularly since 2004/05 is a time of good economic growth and high corporate profitability, as well as the period in which a one-time windfall relating to the Petrocan sale was realized. The difference between a 15.3% vs. 15.1% revenue/GDP ratio amounts to over \$2.6 billion — which, if not justified, would constitute quite a substantial amount of implicit prudence. This is not of course a conclusive analysis, for revenues are subject to many other influences. But it does provide a reference point to scrutinize the plausibility of official revenue forecasts.

Implicit Prudence in Program Spending Forecasts

Identifying implicit prudence in the government's program spending estimates is extremely difficult for a number of reasons. In addition to the possibility that the government may overestimate its likely expenses outright, there may be institutional reasons that projected expenditures are on the high side. For example, allocations are made to cover the costs of certain expenditures such as those undertaken in partnership with other jurisdictions, despite the high likelihood that some of these allocated funds will not be taken up. While the projected cost savings anticipated from the expenditure review process have been made explicit beginning with the 2005 federal budget, it is possible that the cost savings actually realized by the process may exceed the targets. Matters are made more difficult still by the lack of information, such as interim data on program expenditures or detailed intra-year program spending budgets, which are not available to those outside Finance Canada. The estimation of program expenditures is made still more difficult in the case of items that are subject to formulae to which the public is not privy.

In addition to the factors discussed above, there are pitfalls in assessing the government's historical record vis à vis program spending. A cursory examination shows that the difference between actual versus projected program expenditures varied between \$1 and \$3.8 billion during the last three fiscal years. However, this historical discrepancy between forecasted and actual program spending does not indicate the full magnitude of implicit prudence buried in the Finance Department's program spending estimates. This is because the government often makes spending announcements before the fiscal year end which 'soak up' some of the implicit prudence that had been built into the original estimates of program spending. These dynamics are assuming greater importance in the context of a minority government in which the pressures for new spending announcements have intensified.

Implicit Prudence in Debt Service Charges

The overestimation of debt service charges is another way to add implicit prudence to the fiscal forecast. Debt service charge estimates that increase over the forecast period are often justified as the result of forecasted increases in interest rates. However, in our judgement the overstatement of the impact of anticipated interest rate increases is a way of concealing implicit prudence.

Even in an environment of rising interest rates, debt services charges may continue to decline. To understand this point, it is necessary to realize that government debt is constantly rolled over. Currently the government borrows money long term (for 10 years) at an interest rate of about 4.5%, and our consensus macroeconomic forecast indicates that this is not expected to increase very much. But government debt that was financed in the past generally carried higher

interest rates. On this point, the Debt Management Report of 2003/04 provides a useful table that has unfortunately not been updated in subsequent debt management reports. It illustrates that the average interest rate on the government's so-called "marketable debt" (treasury bills, Canada Savings Bonds and so on) has been dropping steadily since the time of high interest rates in the 1980s. For example, the 2003/04 Debt Management Report indicates that the average interest rate on this marketable debt was 7.34% in 1995/96. The government realizes considerable savings when bonds that were issued at higher interest rates in the 1990s are rolled over at today's lower interest rates. Even if prevailing interest rates increase moderately, debt service costs will still decrease if the interest rate at which the debt is refinanced is lower than was the previous interest rate the debt carried.

In addition, the government is currently in the late stages of a planned shift in the composition of Canada's debt from 2/3 long-term 1/3 short-term to 60% long-term 40% short-term. Since

our CCPA consensus forecast indicates that short term rates are expected to be considerably below long term rates, this generates savings on debt service costs. Based on the current outlook for interest rates, this shift will continue to generate savings until it is completed in fiscal year 2006/7.

This background on some of the dynamics that produce savings on debt service cost savings allow us to scrutinize the government's debt service projections more critically. During the past several years, debt service costs have been declining by a minimum of \$1.5 billion per year. Yet the Department of Finance projections have debt service costs rising for years 2005/06 and beyond. Even with the federal government's budget projection that the 10 year bond rate will increase to 5.6% by 2007 and beyond (see Federal Budget 2005), this is still well below the relevant average interest rate for debt that is coming due for refinancing. We should still be enjoying savings as higher-yield securities mature and are replaced by lower-yield securities, and as the shift from long-term to short-term debt continues.

4 Response to the O’Neill Report

The Search for a Better Fiscal Rule

The O’Neill Report provides an important contribution to federal fiscal forecasting debates by explaining how adherence to the no-deficit fiscal rule has undermined the accuracy of the federal government’s official forecast. Because of this effective prohibition on incurring a budget deficit, forecasters in the Department of Finance have an incentive to build inordinately pessimistic biases into their forecasts. This implicit prudence in turn contributes to persistent upside surprise surpluses.

Not only has this fiscal rule compromised the quality of our official forecast, the O’Neill Report notes that the “no-deficit” rule has pro-cyclical implications. Rigid adherence to the “no-deficit” rule could exacerbate an economic downturn if it compels the government to run a surplus during a period of economic weakness.

The O’Neill Report rejects continued adherence to the no-deficit fiscal rule and proposes a new regime of two tandem fiscal rules. It recommends that the “no-deficit” rule be replaced with a fiscal rule directing the government to achieve a surplus, on average, over the economic cycle. In addition, the O’Neill Report recommends that the target for reaching a debt to GDP ratio of 25% by 2014 be lowered to 20%, or even 15% within an unspecified time frame.

This new regime of fiscal rules would have the virtue of enabling the government to engage in some degree of counter-cyclical stabilization. The CCPA is so supportive of moving away from the dictates of the no-deficit fiscal rule that we are almost hesitant to critique the alternatives proposed by O’Neill, lest this be interpreted as justification for continued adherence to the no-deficit rule.

However, we are struck with the rather superficial justification for the new fiscal rules advanced by the O’Neill Report. Given that the O’Neill Report eloquently illustrates the pervasive and deleterious consequences of adherence to an inappropriate fiscal rule, it is incumbent on advocates of new fiscal rules to provide a sound case for their adoption.

In opting for the “balance with structural surplus over the cycle” fiscal rule, the O’Neill Report concedes that there are substantial advantages and disadvantages to both this fiscal rule and other contenders (such as achieving a balanced budget over the cycle). Ironically the fiscal rule that the O’Neill Report rejects (the “balance over the cycle” fiscal rule) is depicted as having “well-established analytical support from most macro-economists (as economists and not as political economists)” (p. 96). Meanwhile arguments marshaled in favour of the O’Neill Report’s preferred fiscal rule include considerations that should be irrelevant for the purposes of those seeking to

enhance the accuracy of fiscal forecasting. The Report claims that its preferred fiscal rule can be explained and justified to a Canadian public conditioned to persistent surpluses (p. 98). When fiscal rules are justified on their public relations merits *vis à vis* the perceived sensibilities of Canadians, we are clearly well outside the boundaries of debate based in economic criteria.

The O’Neill Report’s rationale for adopting a fiscal rule calling for more aggressive debt reduction is even more insubstantial. Given Canada’s low federal indebtedness compared to other G-7 countries, the adoption of this fiscal rule is worthy of debate. Yet the O’Neill Report provides no substantive justification for its proposed fiscal rule of targeting these particular debt/GDP ratios, except for a very minimal reference to fiscal pressures of demographic origin. (p.12). (This is in keeping with recent federal budgets, which allude to pressures associated with an aging population without acknowledging factors such as the deferred taxes payable on the retirement savings of aging Canadians, which provide a substantial offsetting impact to the fiscal pressure of this demographic trend.)

Perhaps the most pernicious aspect of this proposed new regime of tandem fiscal rules is that they could potentially create a situation with precisely the same incentive problems that have undermined the credibility of the Finance Department’s fiscal forecasts under the no-deficit rule. If the government is required to reach a debt/GDP ratio as low as 15% in any expedited way, this could compel the government to continue to seek “surprise” surpluses in order to achieve ambitious debt repayment goals. This in turn would perpetuate the “implicit prudence” which has made official federal forecasting so unreliable. Moreover, rigid adherence to this rule could force the government to pursue policies that are just as illogical as those that accompany the “no-

deficit rule”—such as dampening aggregate demand by accelerating debt repayment during a time of impending economic slowdown.

A Better Way to Handle the No-Deficit Fiscal Rule?

Despite the O’Neill Report’s conclusion that the no-deficit fiscal rule should be abandoned, the Report provides a recommendation for dealing with the surprise surpluses that are likely to persist if this fiscal rule remains in place. The Report suggests the creation of a formal and structured process for dealing with the surprise surpluses to allow Parliamentary debate on the contingent allocation of forthcoming surpluses.

If we must live with the repeated pattern of “surprise” budget surpluses, certainly a process to debate the allocation of these surpluses is preferable to the surprise allocation of surprise surpluses. Under current circumstances, this process would be a reasonable (if not ideal) way to extend democratic debate to a broader range of government spending decisions.

Unfortunately, this process would bias the allocation of forthcoming budget surpluses towards measures that do not have multi-year implications. This removes the possibility of considering a whole range of public policy priorities which cannot be meaningfully funded with one-time bursts of surprise money.

However suggestions for managing the consequences of fiscal forecasting inaccuracy should not eclipse the central objectives of the O’Neill Report—namely to improve fiscal forecasting accuracy. It is preferable to fix the problem rather than cope with symptoms, particularly since the O’Neill Report has identified the source of the problem. The goal should remain that Parliamentarians and the Canadian public must be provided with fiscal forecasts that are as accurate

as possible, for the entire public policy process is affected when we tolerate official fiscal forecasts that are misleading.

The Dilemmas Posed by Fiscal Rules: Mixing Economic With Politics

The no-deficit rule (or any fiscal rule) is not a necessity. Canada is not obliged to adopt any particular fiscal rule because of any economic, legal or other compulsion. Indeed the O'Neill Report confirms that various countries subscribe to different fiscal rules, and they adhere to them with varying degrees of stringency.

While this fiscal rule may have the appearance of an economic dictum, the no-deficit rule is actually a political rather than an economic choice. As the O'Neill Report states:

One argument against retaining the [no-deficit] rule is that it has no solid grounding in financial or economic analysis but is based on what are essentially political economy considerations.... That is, there is no analytical or empirical support for a no-deficit target as an optimal fiscal target for a government. (p. 95)

The no-deficit rule imbues the forecasting process with political considerations under the guise of a fiscal rule that appears to be animated by objective economic considerations. Not only does this permeate government forecasting with political considerations, it does so without taking full responsibility for the political imperatives motivating the fiscal rule. It distances these political considerations from public scrutiny, since they are not articulated as political choices but as arcane fiscal rules.

The CCPA believes that this is an objectionable blurring of the distinction between economics and politics. Important decision-making tools such as the federal fiscal forecast should be pre-

pared so as to provide the most accurate possible information to our elected representatives. What political criteria decision-makers subsequently apply as they interpret and act on this information should not be the concern of those preparing the forecast. Let us have our politics out in the open where we can all debate them, and shield the forecasters from the pervasive influence of politics imported under the guise of fiscal rules.

If forced to adhere to a fiscal rule, we prefer "balanced budget over the cycle" as the fiscal rule that is most defensible in terms of economic theory and most congruent with our argument below. But in general we believe that elevating any fiscal rule to inviolable status is a mistake. Certainly, the Finance Minister can and does keep multiple (and sometimes mutually conflicting) desiderata in mind. This is as should be in the midst of complex, uncertain and changing circumstances. But rather than concealing these choices behind the purported inviolability of a fiscal rule, we believe that the Finance Minister should inform Canadians of her or his priorities and how they are evolving over time, and face the political consequences of these choices in the political arena. Not only does this enhance democratic accountability, it avoids the possibility of inappropriate government action resulting from the rigid adherence to simplified, all-purpose fiscal rules without reference to the prevailing economic context.

For better or worse, it is necessary for governments to exercise judgment rather than submit to formulaic rules. There is no escape from the reality that government budgets are ultimately about choices. "One-size-fits-all" rules cannot substitute for informed analysis of prevailing conditions. Experts supply their analyses and recommendations to elected officials (including the fiscal objectives that they deem appropriate), but it is possible that the exigencies of the mo-

ment will be such that the recommendations of the experts may be disregarded. Such possibilities are an inevitable consequence of the democratic process, and we should not attempt to preempt democratic debate by devising arbitrary “fiscal rules” that compel Parliamentarians to abandon discussion of any alternatives that are deemed incongruent with the prevailing fiscal rules. If we foreclose democratic debate in this manner, Parliamentarians may be left to exercise discretion on only those relatively minor fiscal issues that have not been predetermined by the implementation of the fiscal rule.

The Role of Independent Forecasting Advice

The O’Neill Report rejects both the formation of a separate fiscal forecast agency (analogous to the U.S. Congressional Budget Office), and the recent practice instituted by the House of Commons Finance Committee of securing access to independently prepared quarterly reports on federal fiscal forecasting (i.e., the process of which this report is a part).

The O’Neill Report links its rejection of outside fiscal forecasting analyses to its critique of the “no-deficit” fiscal rule:

Finally, if the real culprit in the story of surprise surpluses is the predictable response of the system to a no-deficit fiscal rule, hiring outside economists to monitor and produce fiscal forecasts in conjunction with Finance will not resolve that either. Instead what is required is a change in the fiscal target which affects the incentives driving behavior in the forecasting process.

More generally, it is difficult to see how an institutional change that involves transferring some of the forecasting responsibility to

an independent agency would make much of a difference to short-term forecasting accuracy. (p. 13)

This is a puzzling conclusion. If the culprit is the no-deficit rule, then forecasting accuracy would be enhanced by seeking out forecasters who are not constrained by this rule. Yet several pages later in the O’Neill Report, the argument is made that adherence to the no-deficit rule is pervasive in the Finance Department. Abundant forecasting prudence in the interests of avoiding a deficit at all cost is described as a “habit bred into the Finance Department by Paul Martin” (p. 25) and deficits are regarded as (in the words of one interviewee) a “cloak of shame.” If the no-deficit rule is so pervasive in the internal culture of the Finance Department, then greater reliance on forecasters outside of the Department of Finance is imperative. Given that the Finance Minister has provided no public indication of any intention to relax his commitment to the no-deficit rule since the publication of the O’Neill Report, we can only conclude that this fiscal rule continues to be firmly entrenched.

If, according to the O’Neill Report, the “culprit” explaining poor forecasting accuracy is the no-deficit rule, then forecasters who have not been inculcated by that rule should be able to work with the same raw data available to the Finance Department and achieve greater forecast accuracy. Thus we come to a conclusion that is diametrically opposite to that of the O’Neill Report: we believe that it is desirable to provide Parliamentarians (and Canadians more generally) with access to independent fiscal forecasting information, since the O’Neill Report presents no incentive for forecasters unaffiliated with present government forecasting processes to subscribe to the no-deficit rule. This point appears to have eluded the O’Neill Report⁴.

The fact remains, however, that forecasters located outside the Finance Department do not have access to the data available within the Department. Thus, Canadians face a quandary: the entity with privileged information is so captured by the no-deficit rule that its interpretation of this information is suspect. Yet forecasters who are not subject to the Finance Department's biases do not have access to the range of information available to the Finance Department. Presumably, the creation of an entity that has access to the detailed information available to Finance Department yet is insulated from the Finance Department's fiscal rules would be a means of improving the reliability of the fiscal forecasting information. Establishing an independent body to provide objective and unbiased forecasts of the nation's finances — and of budgetary proposals — would be the best way of increasing transparency and accountability in this aspect of the budget process.

In the absence of an entity that embodies the best of full insider access to information and

unbiased outsider perspective, the exercise performed by the independent forecasters' report to the House of Commons Standing Committee on Finance provides one indispensable service to Parliamentarians. This exercise provides a point of comparison to enable Members of Parliament to develop informed opinions on the plausibility of the forecasts generated by the Department of Finance. Given the lack of any evidence that the government wishes to reconsider its adherence to the no-deficit rule, independent fiscal forecasting advice supplies a useful reality check that may at least generate critical scrutiny of official federal fiscal forecasting. And the fact that public debate is informed by perspectives other than those of the Finance Department may to some degree counteract the incentive structure within the Finance Department. For by making the evidence of implicit prudence more visible, the Finance Department may be made more accountable for the consequences of its allegiance to a fiscal rule which biases their forecasting.

5 References

- 1 Explicit prudence reserves consist of the yearly \$3 billion “Contingency Reserve”, as well as an “Economic Prudence” reserve which varies from \$1 billion in the upcoming fiscal year to \$7 billion in the most distant fiscal year budgeted.
- 2 Not all of the forecasts report each of the variables reported in Table 1, hence the sample size for some variables is smaller than 10. In some cases, even though some forecasts do not report on particular variables, it is possible to derive those estimates from the variables that are forecast. For example, nominal GDP is derived when forecasts present estimates of GDP inflation.
- 3 www.fin.gc.ca/news05/05-035e.html
- 4 For example, after pointing out that the Finance Committee could be briefed more frequently by finance officials if it feels it is not receiving enough information, the report goes on to say “If members of the Committee don’t trust the information provided currently by the Department [of Finance], it is not clear why their trust would be much enhanced by having the same information filtered through external economists. (p.13)” Yet if the O’Neill report subscribes to the position that the Finance Department is systematically biased in its interpretation of the information at its disposal, surely having external economists provide a different perspective on this information would be beneficial for Parliamentarians.