



## ***Fiscal imbalance is still with us!***

### **The federal government has had flexibility of at least \$22.5B per year, on the average, over the last 10 years**

The Government of Canada's public finances have been subjected to a great deal of analysis, commentary and criticism over the past 10 years. For a number of years, even decades, the federal government accumulated deficit after deficit as the Department of Finance was not able to meet its forecasts and systematically underestimated its deficits. In 1995, the government announced its firm intentions to balance its budget, and this led to a first surplus in almost 40 years of \$3B for the 1997-1998 fiscal year. This surplus gradually accumulated until it reached almost \$20B by the end of the 2000-2001 fiscal year.

This environment of repeated budgetary surpluses brought with it a change of attitude toward public finances. When a deficit is incurred, there is a need to borrow to settle the bill. The action that needs to be taken is simple and doesn't provoke any particular debate, unless the debt is excessive. On the other hand, when there's a surplus, a different sort of problem arises, and it's an even bigger problem if the surplus is large and chronic. How are we going to use this surplus? Who is going to benefit from this new-found wealth? In short, decisions have to be made concerning the use of these surpluses.

This is an enviable situation for the federal government from several of points of view. In the short term, priority has been given to debt reduction. Then, accumulated surpluses opened the door to other initiatives such as income and sales tax reductions and increased financing for certain programs. It was clear that these types of paybacks would indeed be welcome, even more so when the government's budget remained in surplus.

The size of the 2000-2001 surplus (\$19.9B) scandalized a lot of people and resulted in some serious pressure to correct a

situation that had become unacceptable. Evidence of a significant *fiscal imbalance* between the provinces and the central government appeared at this time and actions had to be taken. The amassing of surpluses had to be curbed and a more balanced financial situation had to be found.

This present analysis summarizes how the government has tried, over the last few years, to absorb these surpluses or at least slow their growth. It shows that the government has benefited from an exceptional \$22.5B room for manoeuvre over the last 10 years, and that this situation has every chance of continuing into the future. It would seem that the problem of *fiscal imbalance* is not completely settled and could very well return to the agenda, particularly in light of the current cyclical slowdown.

#### **SPECTACULAR TAX REDUCTIONS**

One of the reasons that the federal government has been chalking up one surplus after another is assuredly the systematic underestimation of growth in its budgetary revenues compared to its forecasts (Graph 1). This is probably the result of a faulty evaluation of the sensitivity of budgetary revenues to economic growth. On the other hand, it is true that the oil and gas manna from western Canada and the strength of company profits have also resulted in an inflation of federal budgetary revenues.

Theoretically, we could expect that growth in the government's tax revenues would keep pace in the medium term with the rate of growth in the economy. If this is the case, we can fairly safely assume that revenues should increase at the same rate as the advance in the economy (taking inflation into account). If not, the relative weight of the government in the economy would have a tendency to increase, which is not truly desirable. Moreover, in a situation

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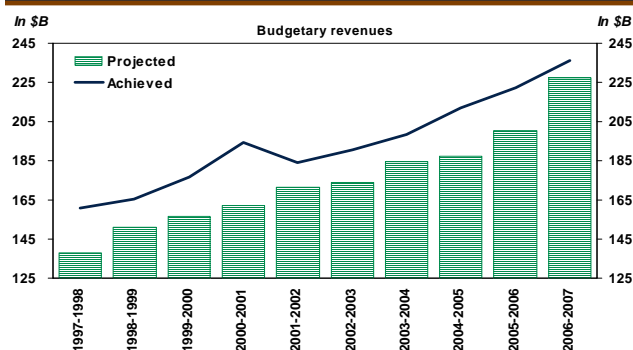
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**Graph 1 – The Department of Finance systematically underestimates its revenues**



Sources: Department of Finance of Canada and Desjardins, Economic Studies

of budgetary equilibrium, if overall budgetary revenues and expenses increase at the same rate as the nominal GDP, budgetary equilibrium is preserved. The government will declare a surplus if growth in revenue is greater and a deficit, if it is less.

Table 1 shows the evolution of budgetary revenues between the 1997-1998 and 2006-2007 fiscal years. We have shown growth in budgetary revenues at the same rate as the nominal GDP so as to compare them with the actual and we have calculated the difference between the two. If revenues are superior to those that would have been received if they had followed nominal GDP, in principle, the difference can be found in the surplus. However, if they increase less rapidly, it's probably because there has been a decrease in income or sales taxes. In fact, this is what happened during the 2001-2002 fiscal year. The budgetary revenues dropped in

this period by 5.4%. We must remember that it was at this time that the Canadian Government announced income tax cuts of around \$100B.

Prior to the 2001-2002 fiscal year, growth in revenues had more or less followed the nominal GDP. Most of the time, revenues earned were slightly greater and we can assume that the difference was in the surplus. On the other hand, the reductions that were given in income taxes constitute an actual reduction in room to manoeuvre that was at that time released by the government. These reductions in taxes were intended to redistribute the money that had been over collected from the taxpayers and to reduce the surplus which would easily have exceeded \$20B for the 2000-2001 fiscal year. For the complete period analyzed, the sum of the differences amounted to \$114.4B. This means that the government would have benefited from \$114.4B in room to manoeuvre that they could have used on income and sales tax reductions. This estimation is on the low side since, in reality, it is known that budgetary revenues generally increase more rapidly than nominal GDP.

#### INCREASED TRANSFERS TO PROVINCES

Budgetary expenditures vary in accordance with multiple factors and not just growth in nominal GDP. It makes no economic sense, for example, if transfers to persons (primarily OAS and employment insurance benefits) evolve in line with the nominal GDP. Such transfers should instead follow demographic trends—namely, evolution of the population aged 65 and over in the case of OAS benefits and evolution of the labour market in the case of employment insurance benefits. From fiscal 1997-1998 to fiscal 2006-2007, transfers

**Table 1**  
**The federal government's room to manoeuvre**

In \$M	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	Total
<b>Budgetary revenues</b>	<b>160,864</b>	<b>165,520</b>	<b>176,408</b>	<b>194,349</b>	<b>183,930</b>	<b>190,570</b>	<b>198,590</b>	<b>211,943</b>	<b>222,203</b>	<b>235,966</b>	
Ann. var. in %	7.3	2.9	6.6	10.2	-5.4	3.6	4.2	6.7	4.8	6.2	
Growth in terms of GDP	157,601	163,434	177,587	193,334	195,839	207,530	216,189	231,532	247,096	258,248	
<b>Variance</b>	<b>---</b>	<b>---</b>	<b>1,179</b>	<b>---</b>	<b>11,909</b>	<b>16,960</b>	<b>17,599</b>	<b>19,589</b>	<b>24,893</b>	<b>22,282</b>	<b>114,412</b>
<b>Total budgetary expenditures</b>	<b>-157,905</b>	<b>-159,741</b>	<b>-162,150</b>	<b>-174,458</b>	<b>-175,882</b>	<b>-183,949</b>	<b>-189,445</b>	<b>-210,480</b>	<b>-208,985</b>	<b>-222,214</b>	
Ann. var. in %	-0.4	1.2	1.5	7.6	0.8	4.6	3.0	11.1	-0.7	6.3	
Transfers to the provinces	-20,504	-25,523	-23,243	-24,724	-26,616	-30,645	-29,392	-41,955	-40,815	-42,514	
Ann. var. in %	-7.5	24.5	-8.9	6.4	7.7	15.1	-4.1	42.7	-2.7	4.2	
Growth in terms of GDP	-23,302	-24,165	-26,257	-28,586	-28,956	-30,685	-31,965	-34,233	-36,535	-38,184	
<b>Variance</b>	<b>---</b>	<b>---</b>	<b>---</b>	<b>---</b>	<b>---</b>	<b>---</b>	<b>---</b>	<b>7,722</b>	<b>4,280</b>	<b>4,330</b>	<b>16,332</b>
Interest charges	-43,120	-43,303	-43,384	-43,892	-39,651	-37,270	-35,769	-34,118	-33,772	-33,945	
Ann. var. in %	-8.8	0.4	0.2	1.2	-9.7	-6.0	-4.0	-4.6	-1.0	0.5	
<b>Surplus (+) or deficit (-)</b>	<b>2,959</b>	<b>5,779</b>	<b>14,258</b>	<b>19,891</b>	<b>8,048</b>	<b>6,621</b>	<b>9,145</b>	<b>1,463</b>	<b>13,218</b>	<b>13,752</b>	<b>95,134</b>
Debt repayment	1,839	4,291	12,750	18,379	6,425	5,742	8,568	1,415	12,641	13,041	
<b>Total flexibility</b>	<b>2,959</b>	<b>5,779</b>	<b>15,437</b>	<b>19,891</b>	<b>19,957</b>	<b>23,581</b>	<b>26,744</b>	<b>28,774</b>	<b>42,392</b>	<b>40,364</b>	<b>225,878</b>

Sources: Department of Finance of Canada and Desjardins, Economic Studies

to persons grew at an annual pace of 3.7%, compared with 5.6% for nominal GDP. We accordingly believe that these expenditures reflect reality and that no flexibility was used to increase them.

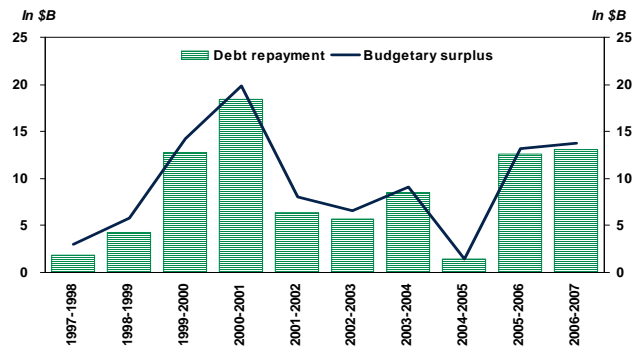
The same rule applies to transfers to the provinces. Such transfers should, in principle, have evolved at the same (or at least a similar) pace as growth in nominal GDP. This was the case, for example, until about 2003-2004. In fiscal 2004-2005, transfers to the provinces climbed considerably (42.7%) as a result of the 10-Year Plan to Strengthen Health Care and increased funding allocated to fiscal equalization and territorial financing. The additional support granted to the provinces and territories served to considerably increase the amount of money received by the provinces, largely exceeding our target based on growth in nominal GDP. For the three fiscal years affected by these new commitments, the federal government spent \$16.3B more than it would have if the transfers had evolved at the same pace as growth in nominal GDP since fiscal 1997-1998. This amount could be viewed as additional flexibilities that were reallocated to payments of transfers to the provinces. However, despite this substantial growth in the level of transfer payments to the provinces, the federal government has always managed to achieve a surplus at the end of its fiscal year.

### ACCELERATED DEBT REPAYMENT

From fiscal 1997-1998 to 2006-2007, the federal government posted surpluses totalling \$95.1B. The government managed to achieve this large amount, which was not returned in the form of lower income or other taxes (or simply spent). The government has, in fact, decided to allocate 90% of this figure to repayment of the federal debt (Graph 2). In so doing, the government substantially reduced the burden of future annual interest payments. For this reason, as well as decreased interest rates, the federal government paid some \$9B less in interest payments during fiscal 2006-2007 than it had in 1997-1998. This choice thus resulted in substantial savings for all Canadians.

If we add up all of the surpluses achieved, money redistributed in the form of lower income taxes and additional funding transferred to the provinces, we arrive at a tidy little sum of \$225.9B over the past decade: a flexibility that benefited the federal government, while drawing the envy of certain provincial governments, such as those of Ontario and Québec, which have only managed to make ends meet with the greatest difficulty. These governments must constantly contend with an increasing demand for such first-line services as healthcare and education, accompanied by rapid aging of the population, which amplifies such needs, particularly in Québec. This is all the more the case when you consider that the estimate of flexibility used is minimal and in fact could be much higher.

**Graph 2 – Almost all budgetary surpluses are assigned to debt repayment**



Sources: Department of Finance of Canada and Desjardins, Economic Studies

### DOES FISCAL IMBALANCE STILL APPLY?

The term *fiscal imbalance* still generates much passion within political circles and the general population. It must be said, however, that this expression is inappropriate if not altogether wrong. A situation does exist, however, that cannot be ignored. The federal government's tax revenues have been and remain more than it needs to carry out its responsibilities. The federal government has enjoyed flexibility of some \$226B over the past 10 years. However, the federal government continues to post surpluses: \$13.8B for fiscal 2006-2007, which is equivalent to a bit more than the amount that would have been necessary to reduce the Goods and Services Tax (GST) from 5% to 3%. According to its last Economic Statement of October 30, 2007, the government anticipates another surplus of \$11.6B, of which another \$10B will be assigned to the debt.

Debt reduction is a worthy goal and all Canadians will draw significant benefits from such an effort. The debt service has been reduced by more than \$9B over the past decade. This money could easily find a better use elsewhere. However, we might consider if debt repayment has not become an overriding priority and if this effort is not being made to the detriment of a more efficient and competitive economy and the quality of services obtained by citizens for the taxes they pay. Ultimately, isn't the debt-to-GDP ratio—which will drop to less than 30% over fiscal 2007-2008—close enough to the government's target of 25%? We firmly believe that a search for balance should always guide the central government's decisions.

In its budget forecasts, for example, the government set a goal of cutting the debt by an annual \$3B. Any surplus above and beyond this objective should be returned to our economy to boost our competitiveness and to help not only the provinces but the municipalities pay their first-line services, or be placed directly back into the pockets of taxpayers who have overpaid the services they have used. If debt repayment prevents us from making productive expenditures or

producing the investments required for supporting our international competitiveness and ensuring the future prosperity of our economy, such a goal becomes less laudable.

We have, in fact, arrived at the point where the harmful effects of the *fiscal imbalance* could trigger excessive collateral damage for the other levels of government. Canada's leading cities are also experiencing intolerable financial situations in terms of their needs. Balance must under such circumstances soon be restored. Canada still seems to be in an unfortunate adjustment phase with respect to *fiscal imbalance*. This issue should be closely monitored with the next budget from the Harper government, which will probably be tinged with caution in view of current economic circumstances. The federal government will however finish fiscal 2007-2008 with almost \$12B in its pockets to deal with the economic slowdown! Furthermore, issues with major budgetary implications (such as the environment, the war and poverty) also require responses. Surplus money that is allocated to debt repayment could also quickly find uses in other equally important fields.

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