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THE FEDERAL *ECONOMIC AND FISCAL UPDATE:* ANALYSIS AND COMMENTS



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An update with no surprises on the whole and an ambitious plan to eliminate the debt

As is the custom at this period of the year, the Federal government is taking stock of its budgetary situation midway through its term, tabling its 2006 *Economic and Fiscal Update* today. This document provides the latest Department of Finance projections on the results of the current fiscal year (2006-2007) and those of the five subsequent years (2007-2008 to 2011-2012). The Conservative government also took the opportunity to publish a second document entitled *Advantage Canada* that described its long-term vision of the main challenges facing the Canadian economy (see box on page 4).

It should first be noted that in last May's budget, Minister of Finance Jim Flaherty was anticipating a \$3.6B budget surplus for the current year and a \$4.4B surplus for 2007-2008. However, robust consumer spending fueled by strong job creation and increased personal income helped bring in higher than expected budgetary revenues. By contrast, program spending was lower than expected and the Department of Finance is planning to maintain the rate of increase under that of nominal economic growth (including the inflation rate). As a result, the surplus of the current year could exceed the government's initial estimates by \$4.4B. So, taking into account the net impact of the measures already announced in last spring's budget, the surplus could

add up to \$7.2B for 2006-2007. The expected surplus now stands at \$7.3B for next year (compared with \$4.4B initially). In the end, the Department of Finance projections show that the surpluses could total nearly \$50B over the next five fiscal years if no new initiatives are taken in the meantime.

A plan focused on debt reduction

Of course, the Harper government is not even considering the status quo. It is already developing the outlines that will guide the management of public finances over the coming years. As he had announced in last May's budget, Minister Flaherty is proposing to allocate an initial \$3B yearly to pay

Table 1

Summary Statement of Transactions

In billions of \$	Actual	Projection					
	2005-2006	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012
Budgetary revenues	222.2	229.4	238.0	245.4	253.9	264.6	276.8
. Program expenses	175.2	187.6	196.1	204.4	213.1	220.7	228.6
. Public debt charges	33.8	34.6	34.7	34.6	34.7	34.6	34.6
. Total expenses	209.0	222.2	230.8	239.1	247.8	252.2	263.1
Underlying surplus	13.2	7.2	7.3	6.4	6.1	9.4	13.7
Government fiscal commitments							
. Planned debt reduction	---	3.0	3.0	3.0	3.0	3.0	3.0
. Reduce GST to 5 per cent	---	---	---	---	---	1.5	6.4
. Interest savings dedicated to personal income tax reductions							
. \$13,2-billion debt reduction in 2005-2006	---	---	0.7	0.7	0.7	0.7	0.7
. \$3-billion-per-year debt reduction starting in 2006-2007	---	---	0.2	0.3	0.5	0.6	0.8
. Total	---	---	0.8	1.0	1.1	1.3	1.4
Planning surplus	---	4.2	3.5	2.4	2.0	3.6	2.9
Federal debt	481.5	478.5	475.5	472.5	469.5	466.5	463.5

Source: Department of Finance of Canada, November 2006

Table 2
Summary of Changes in the Fiscal Outlook Since the May 2006 Budget

In billions of \$	Actual	Projection	
	2005-2006	2006-2007	2007-2008
May 2006 budget underlying surplus	8.0	3.6	4.4
Impact of economic and fiscal developments			
. Budgetary revenues			
. Personal income tax	0.7	2.9	2.9
. Corporate income tax	-2.8	-2.6	-1.8
. Goods and services tax	1.1	1.1	1.1
. Other revenues	2.3	0.4	0.6
. Total revenues	1.3	1.9	2.8
. Program expenses			
. Transfer payments	0.0	0.2	0.0
. Direct program expenses	3.9	2.2	1.2
. Total program expenses	3.9	2.4	1.2
. Public debt charges	-0.1	0.2	0.2
Total economic and fiscal developments	5.2	4.4	4.1
Impact of policy changes			
. Net impact of measures announced since the budget	---	-0.8	-1.2
Revised underlying surplus	13.2	7.2	7.3

Source: Department of Finance of Canada, November 2006

down the federal debt (i.e. the cumulated deficits). This amount could even be increased, should higher than expected budget surpluses occur, as was the case in 2005-2006 when \$13.2B was allocated to debt repayment. The Federal government is also aiming to gradually eliminate the net debt by 2021. As opposed to the Federal debt, the net debt is the gross debt of the government (debt instruments, pension plans and accruals) less its financial assets. In fact, the Conservatives would like the other levels of government to agree on adopting measures to make it a national objective and as a result, eliminate the net debt of all public administrations in one generation. In so doing, Canada would position itself in the select group of countries that have positive net assets (negative net debt).

Tax cuts... next year

As far as new budgetary initiatives are concerned, today's update offers no immediate measures. It will be necessary

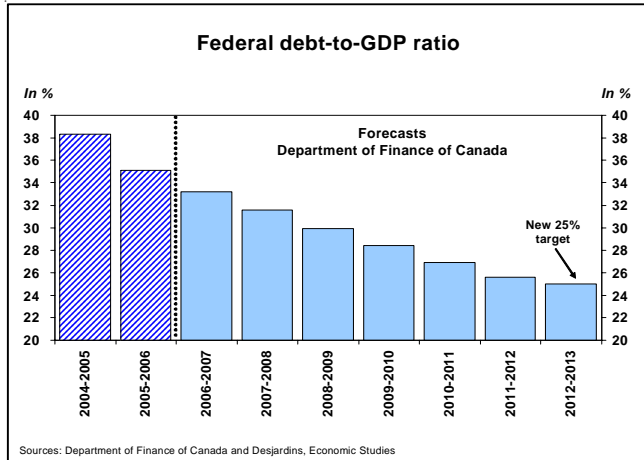
to wait until the next Federal budget to get more details on what will be put forward. Nevertheless, a \$0.8B cut in personal income tax is announced for 2007-2008, which will be funded by the savings in interest charges resulting from the repayment of the debt in 2005-2006 and 2006-2007. The gradual reduction of the debt should help to continue the cuts in personal income tax over the next fiscal years. However, it should be noted that the annual savings will total a maximum of \$1.4B in five years, which, once distributed among all taxpayers, represent relatively limited tax cuts. In addition, the Conservatives are intent on another GST (goods and services tax) cut to 5%, but this measure will only come into effect on January 1, 2011.

Once again, it should be underlined that another GST cut is not the best alternative from the standpoint of economic efficiency. Indeed, income tax cuts are more efficient than consumer tax cuts, because the high taxation of income is a great disincentive to work. Particularly as, according to Organisation for Economic Co-operation and Development data, the consumer tax level in Canada is not significantly higher than that of other industrialized countries, which is not the case for income tax. These issues, which many criticized ever since the GST cut was announced last July, could explain in part why the Conservatives delayed putting in place the second cut to 5%. In addition, the

Table 3
Sales rate in effect in some countries

	National administrations	Provinces/localities
Australia	10.0%	---
Canada	6.0% (since July 2006)	0.0 to 10.0%
France	19.6%	---
Germany	16.0%	---
Italy	20.0%	4.50%
Japan	5.0%	---
Spain	16.0%	---
United Kingdom	17.5%	---
United States	---	0.0 to 7.25%

Sources: Organisation for Economic Co-operation and Development, United States Congress and Desjardins, Economic Studies



lightening of the tax situation for individuals could also be more advantageous to the minority government in Ottawa.

As far as the debt is concerned, the determination of the Conservatives to repay all the net debt by 2021 can be surprising. On the one hand, cleaning up public finances does not necessarily imply the complete disappearance of the net debt. In fact, there are very few countries in the world whose net debt is equal to zero or even negative. On the other hand, the concept of net debt is rather unclear, since

this calculation does not include the government's non financial assets, such as public infrastructures and government buildings. To this effect, the measure of the net debt could underestimate the net assets of the government.

In today's update, the "government believes that our country should be aiming to eliminate to net debt from all public administrations in less than a generation". The Federal government is even giving the example with its ambitious repayment plan. Despite this national objective, Ottawa cannot force the other governments to follow its lead and prioritize the elimination of debt in the country. In fact, most provinces have a hard time balancing their budgets and in this context, debt is not their sole concern. It must be recognized that, as long as the issue of fiscal imbalance is not settled, it will always be easier for the Federal government to repay its debt thanks to its large financial leeway. All in all, this national policy on the repayment of the debt of public administrations may well be seen as another attempt by the Federal government to "interfere" politically in the management of public finances of provinces and municipalities. Stay tuned...

A new long-term economic and strategic plan: Advantage Canada

Today, the Minister of Finance of Canada tabled a new economic and strategic plan that aims to improve the country's prosperity. The goal of the government is to create competitive advantages to meet the challenges the country will be facing, improve the quality of life of Canadians, support economic growth and help Canada become a world leader.

Here are the highlights:

- Reducing taxes for all Canadians
- Establishing the lowest tax rates on new business investment in the G7
- Eliminating the net debt of the Federal government and all public administrations in Canada in less than a generation
- Reducing regulations and red tape to promote entrepreneurship
- Improving training for the workforce and increasing labour force participation
- Building a modern infrastructure of international stature that will improve the quality of life and trade flows