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Backgrounder

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The 1998 Budget: Falling Behind on Debt Reduction

by

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The February 24, 1998, federal budget has properly been hailed as a landmark. It ends 30 years of profligate spending, irresponsible deficits, and rising interest costs. This is an achievement worth celebrating. We should not, however, let the celebrations of the present detract us from setting a clear and prudent course for the future.

The Fiscal Plan: A Missed Opportunity

The fiscal plan presented to Canadians on February 24 promised a three-year string of balanced budgets. Bringing the budget finally into balance was indeed a laudable goal, but continuing with a string of zeros, rather than surpluses, is a missed opportunity to chart a prudent course for future debt reduction.

One such strategy was outlined by William Robson and William Scarth in a C.D. Howe Institute Commentary, *Out Front on Federal Debt Reduction: Programs and Payoffs*. They showed that debt reduction offered a key payoff: a fiscal dividend as lower interest payments make room for spending or tax cuts. That fiscal dividend would grow to $6,000 annually per family of four if the debt were lowered from its current 70 percent of gross domestic product (GDP) to 20 percent by 2021.

The best route to such a target would be a front-loaded one, with significant surpluses paying down debt in the early years. Robson and Scarth proposed that the budget move within two years to surpluses of 2 percent of GDP (about $15 billion in fiscal year 1999/00) and maintain that level for six years. This plan would produce lower interest rates, higher economic growth, and more certain and lasting fiscal dividends than either a constant surplus or a back-loaded plan.

Finance Minister Martin's 1998 budget, by failing to present some modest future surpluses, did not give him an opportunity to present, explain, and defend sizable annual debt paydowns as a prudent fiscal strategy. The budget is silent about the importance of

running consecutive surpluses to reduce the debt burden and bring future fiscal dividends.

The Debt Plan: Meager Minimums

The absolute minimum that the budget pledges for debt reduction is the annual contingency reserve. This means that, instead of budget balances, Canada will experience $3 billion surpluses for the next two years — clearly not enough to execute a desirable front-loaded strategy. The point is not to quarrel with the presence of the contingency reserve itself — it has a defensible purpose and is part of any prudent fiscal plan — but the budget guarantees surpluses that only amount to one-third of 1 percent of GDP for the next few years.

Nudge Nudge, Wink Wink: Underneath the Artificial

Of course, nearly everyone can see through the budgetary plastic surgery — a little padding here, a little tuck there — all designed to make the fiscal situation appear worse than it really is. The padding in the budget comes from the prudent assumptions. How much is this worth? If one assumes that the consensus forecast turns out to be right and applies the sensitivity tables in the budget, this padding amounts to $1.45 billion in fiscal year 1998/99 and $5.31 billion in 1999/2000. The tuck is some strange projections for employment insurance (EI) benefits: they are projected to grow by $1.2 billion by 1999/2000 despite falling unemployment levels and positive growth; and the sensitivity tables mysteriously exclude EI operations. These two factors mean additional surpluses of $0.69 billion in 1998/99 and $1.39 in 1999/2000. All of these together provide "prudence factors" of $2 billion next year and $7 billion the year after.

With the contingency reserves (which also reduce interest costs in 1999/2000 over the budget baseline), the budget produces underlying surpluses of about $5 billion next year and $10 billion the following year, or about 0.5 percent of GDP next year and 1 percent of GDP the year after. These do not quite reach the levels for a prudent out-front strategy, but they do signal important possibilities.

Will these possibilities become realities? There are three reasons for concern.

The first, noted above, is the budget's failure to present, explain, and defend surpluses as a crucial strategy to retire debt.

The second comes from the budget itself: last year's budget projected a $17 billion dollar deficit, while the 1998 budget shows that revenues came in $9.7 billion above, spending $3 billion below, and interest costs $4.5 billion below 1997 forecasts. These three items produce a balanced budget. What happened to the contingency fund that still must be accounted for? New spending and tax cuts of $3.2 billion in the 1998 budget took care of that — last year's "prudence factor" did not reduce debt in 1998. This is a worrying example for the future. Will next year's $2 billion "prudence factor" be added to the $3 billion in contingency to reduce the debt? The budget does not say explicitly, but it sets a poor example.

A final reason for concern has to do with the strength of the economy. Canada is currently enjoying tremendously strong economic growth, which ought to translate into some reduction in social program costs, such as for EI. Yet total spending for fiscal year 1997/98 is increasing. In a period of strong growth, spending should be going down, not up. Holding the line on spending during a period of strong growth is not something to celebrate; it is, in fact, worryingly reminiscent of an era we supposedly left behind with this budget.

Getting Back Out Front

In defending his budget, Finance Minister Martin would do well to emphasize that better-than-anticipated results in coming years will not be used to finance spending. Prudence in economic assumptions is not a

good idea if it merely gives the government an annual slush fund from which to dole out tax cuts and new spending. This prudence worked in the past because everyone knew that the proceeds would be used to lower deficits. The same must now happen with debt.

This year's budget is truly historic. But Canadians can afford to dwell on the present for only so long. To repeat the success of the past few years, future efforts should follow a prudent, out-front strategy on debt reduction.

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