
Finance Minister Jim Flaherty delivers the 2014 budget, to a standing ovation from his Conservative colleagues on February 11. "We're almost there," he said in terms of balancing the budget. But larger macro-economic issues remain for Canada. PMO photo

Budget 2014: Through a Telescope, not a Microscope

Kevin Lynch and Karen Miske

All government budgets matter. And in a federal system, it is the totality of federal and provincial budgets that should matter most to citizens and markets. The more these budgets are aligned, both fiscally and economically, the greater the leverage and impact they have on our economic and social future. As all governments look to a challenging global environment, will this be the season of greater budget cohesion in Canada?

How should we look at budgets—through a microscope, a telescope, or both? The perspective matters greatly because budgets typically have their structural impacts well beyond the short term, whereas media punditry and political calculation around budgets appear to be increasingly focused on the present. Short-termism has come to dominate so much of our lives, including budgets. Yet, the future is hiding in plain sight, shaped by the evident and disruptive trends in the world around us—increasing globalization, a more volatile and uncertain global economy, the demographics of aging, the unrelenting information revolution, the disruption of innovation, and the unbreakable link between productivity growth and rising living standards. We need to view budgets more through the lens of how well they are preparing us for this future, through the telescope, and not just through the microscope of how they are responding to the immediate.

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The centrepiece of the 2014 federal budget is its fiscal narrative. The fiscal books will return to balance in 2015-16 after seven consecutive years of deficits and an increase in federal debt of over $160 billion. The budget projects a debt-to-GDP ratio that peaked at roughly 33 per cent of GDP in 2013 and 2014 (up from a low of 28 per cent in 2008) and then begins a slow decline dictated by the pace of nominal income growth absent major new government initiatives. Compared to other G7 countries, and in the aftermath of the financial crisis, the ensuing recession and the weak global recovery, this is an impressive budgetary achievement.

A strong fiscal balance sheet is both a means and an end. In a volatile and uncertain global environment, having a relatively low debt-to-GDP ratio provides an element of "fiscal insurance". Clearly, the value of this insurance is higher if a declining debt-to-GDP at the federal level is not partially offset by rising debt ratios at the provincial government level. A healthy balance sheet also provides the fiscal means to deal with longer term economic and social priorities, and in particular, the under-appreciated impacts of a slowing rate of potential growth in Canada and all it implies for our future.

There is much emphasis on "good management" initiatives and "consumer-friendly" actions in the 2014 budget that, while not unimportant, will have limited impact on the longer term challenges of Canada's poor productivity performance, our weak innovation performance, our under-investment in capital, research and training in a knowledge intensive global economy, and our over-reliance on the US market, particularly in energy, in a world where emerging markets are driving growth and demand.

Our focus in this analysis will be more telescopic than microscopic, looking at how the budget is preparing Canada for these inescapable longer term trends we need to deal with. The structural issues we will examine more closely are: the size and tax-take of government, the evolution of federal debt on both a gross and net basis and associated debt servicing costs, the degree of harmony between federal and provincial fiscal frameworks, and the extent to which the budget is tackling Canada's declining potential growth challenge.

Concerns about the size of government can arise because of quite different priorities and pressures. It may be for fiscal affordability reasons, it may be for productivity and efficiency reasons, or it might be for ideological reasons. What Chart 1a shows rather clearly is that the size of the federal government today, at 13.5 per cent of GDP, is well below its average size of 16.1 per cent over the 1980-2000 period, although it is still above the size of the federal government before the massive stimulus spending introduced in the 2009 budget. We do not have a size of government problem judged by any historical benchmark.

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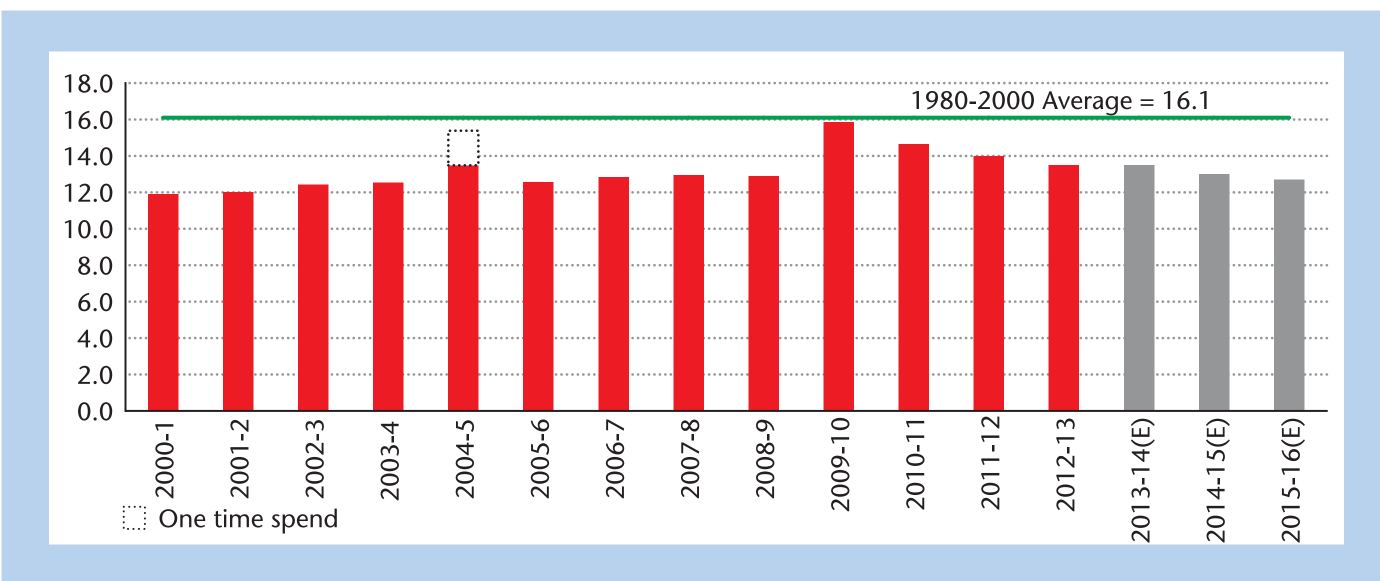
CHART 1A: Size of Government (program spending, % of GDP)



Sources: 2013 Fiscal Rererence Tables, Economic Action Plan 2014

What about on affordability grounds? Clearly, deficits are neither always bad, and the global recession of 2008-09 is a recent case in point, nor are they always good, and Canada's own experience in the 1980s and early 1990s is a stellar example. Deficit sustainability can never be judged independently of the stock of debt, which has unfortunately skyrocketed over the past seven years. Part of the rise in the deficit was government stimulus spending, part was the automatic stabilizers, part was a cyclical decline in tax revenues, and part was a structural decline in tax revenues. Spending reductions were inevitable and needed to rein in the deficit. Given the structural decline in revenues, from cuts in the GST, reductions in corporate tax rates, numerous new tax expenditures and lower potential output, it does raise the longer term issue of the size and sustainability of the federal tax take.

A glance at Chart 1b suggests that the federal tax take in Canada, at 14.1 per cent of GDP today, is substantially below its average of 17.1 per cent over the 1980-2000 period and quite a bit lower than it was before the recession and the structural tax cuts. The trend in the tax take has been downward, not upward, for some time.

Independent of the size of government is the important issue of the efficiency or productivity of government. Just as Canada has a substantial "productivity deficit" in the business sector, with distressingly little progress in well over a decade, there is no reason to think that the government sector cannot be more productive as well. The state of government productivity is even harder to measure than the private sector, and what is difficult to measure is challenging to manage.

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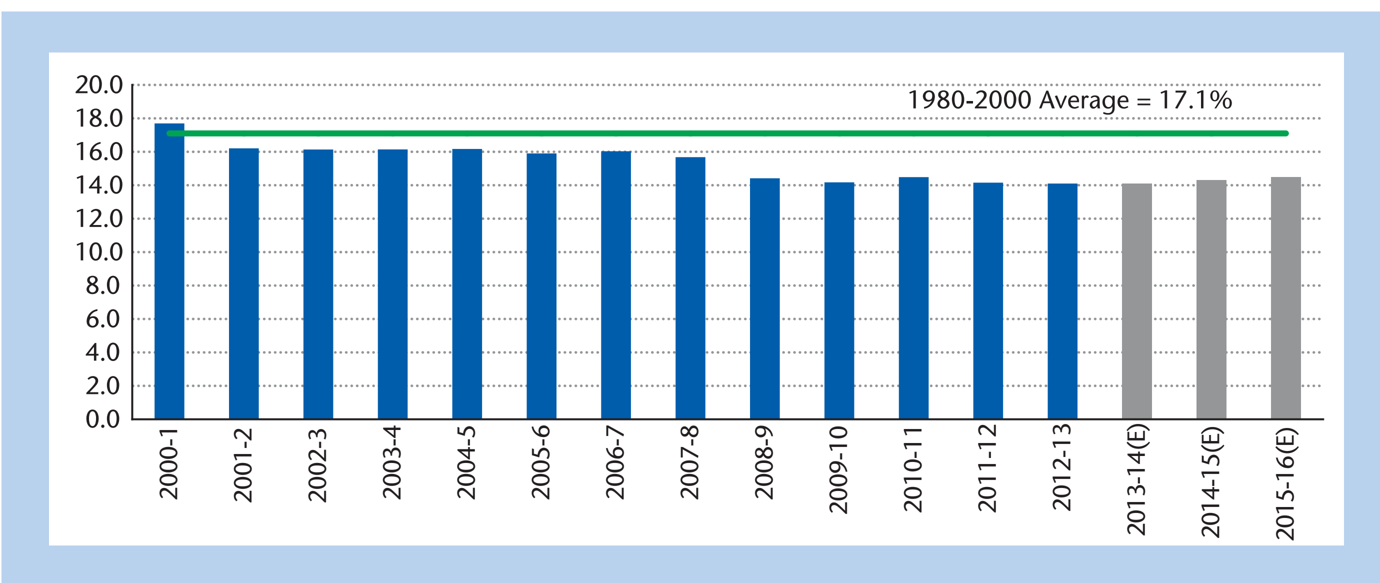
Too often the default option is across-the-board cost cutting that, as numerous examples in the private sector in many countries have amply demonstrated, is likely to reduce long term productivity growth while raising short-term efficiency levels. Despite the many challenges, the government sector, both federal and provincial, seems ripe for a concerted productivity initiative that draws on many of the "big data" and "data analytics" technology revolutions that are transforming how companies like Google serve customers.

While much of the budget commentary has been on when, and with what confidence, the budget will move back into the black, there has been less discussion of the longer term issue of the significant rise we have experienced in federal debt, both gross and net, its implications for debt servicing costs when interest rates return to more normal levels, and whether we should have a longer term target for debt-to-GDP to provide guidance to markets and tax-payers.

Debt levels matter both absolutely and relatively. Relative debt levels affect how rating agencies view countries, and how investors and markets evaluate country risks in a volatile and changing global economy. As Chart 2a indicates, gross federal debt is considerably higher than net debt, and both have risen from their pre-financial crisis lows. Compared to the United States, Canadian federal debt levels compare favourably but much of the credit is due to poor US fiscal and debt policies for the better part of a decade and to the legacy of excellent fiscal and debt policies in Canada reaching back to the late 1990s. While Canada compares well to G7 countries, Canada does not stand out as clearly against a

CHART 1B: Tax-Take of Government (revenue, % of GDP)



Note: Budgetary revenues and program expenses in 2011-12 have been adjusted to reflect the new accounting standard for tax revenues issued by the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants

Sources: 2013 Fiscal Rererence Tables, Economic Action Plan 2014 number of like countries such as Australia, Denmark, Norway, Sweden and Finland.

Debt levels matter because they are indicative of the country's ability to absorb shocks when they occur and to make national investments when they are needed. Here, as Chart 2b shows, federal debt servicing costs consume just over 11 per cent of federal revenues today, compared to the 38 per cent in the mid-1990s that helped trigger the extraordinary, and successful, deficit elimination policies introduced in the 1995 budget. But before we take too much comfort from today's debt servicing ratios, we need to remember that interest rates are at record low levels and they will eventually return to normal levels as global recovery strengthens and quantitative easing (QE) programs in the US, Europe and Japan unwind. Comparing short term interest rates (90-day T-Bill yield) today, at 0.88 per cent, with the 15-year average (1992-2007) before the onset of the financial crisis, at 4.27 per-cent, shows the scope for upward pressure on debt servicing costs.

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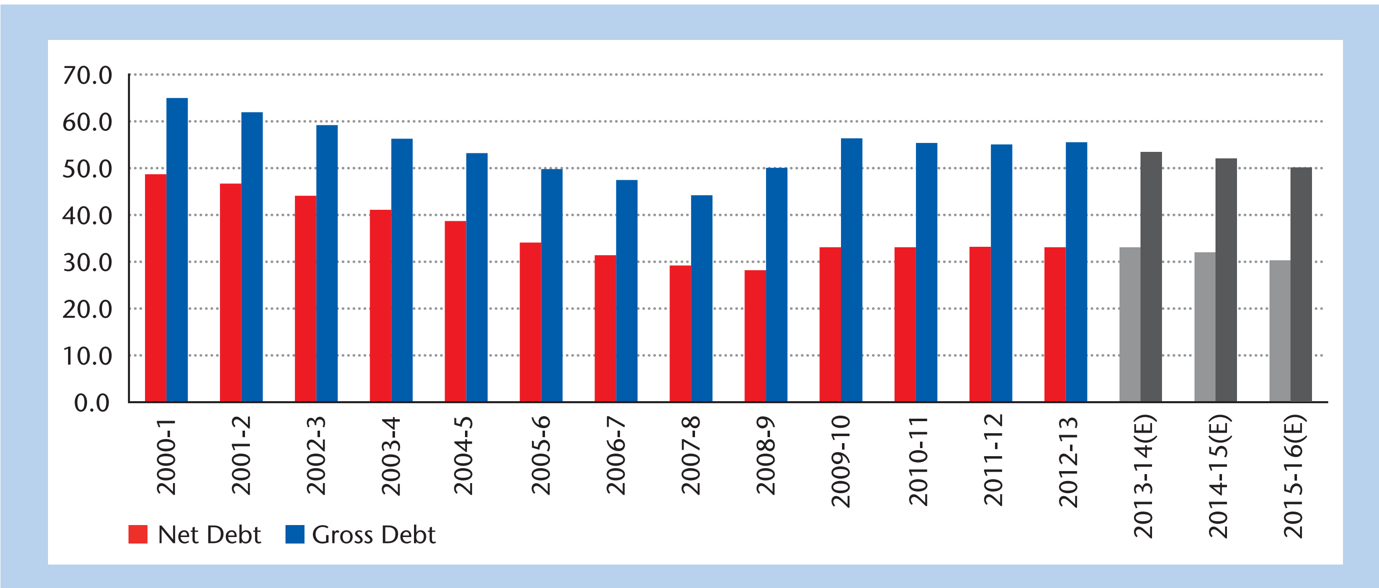
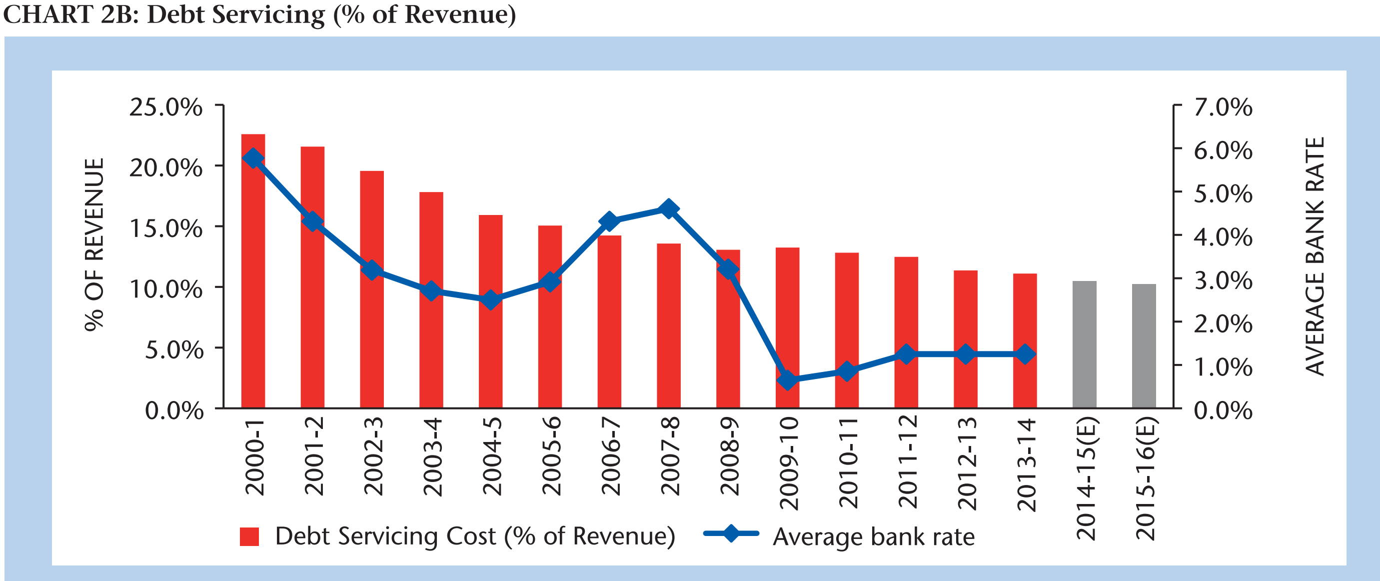
The effectiveness of the federal government's fiscal and economic strategies depends, in part, on the degree of federal-provincial harmonization. At the structural level, governments in Canada have made distressingly little progress in strengthening the economic union at a time when globalization is connecting markets all around us.

CHART 2A: Federal Debt (Gross and Net) (% of GDP)



Sources: Fiscal Reference Tables, 2013, Annual Financial Reports of the Government of Canada 2000-2012, Economic Action Plans 2013-2014, Department of Finance Canada

CHART 2B: Debt Servicing (% of Revenue)



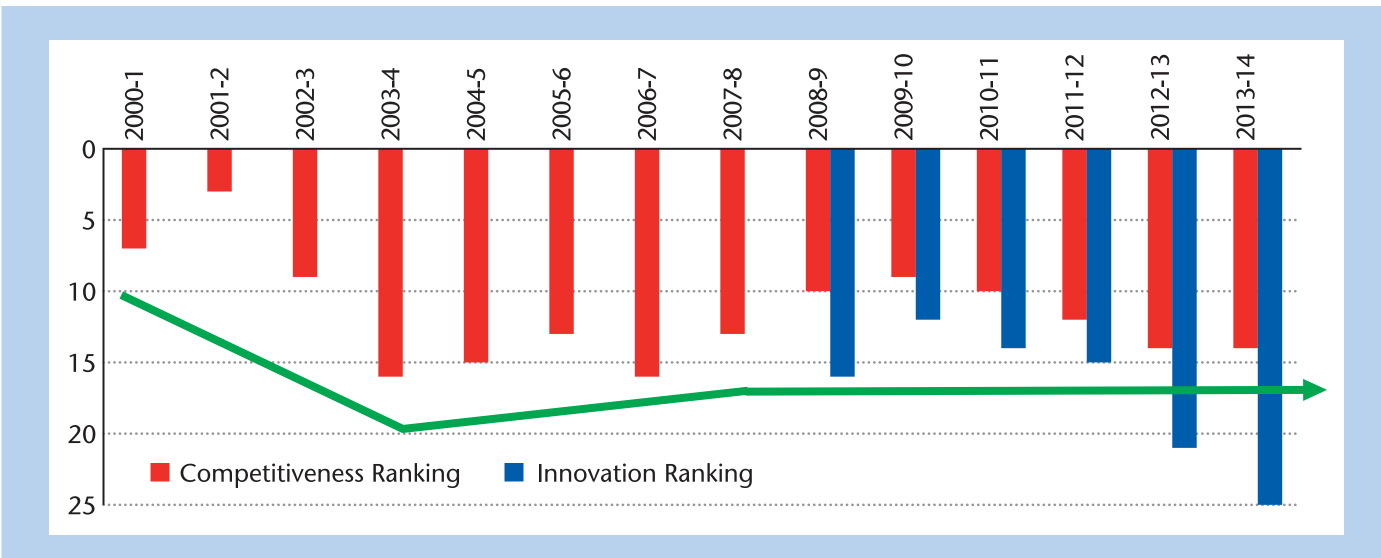
Sources: 2013 Fiscal Rererence Tables, Economic Action Plan 2014; Bank of Canada

Attempts stretching back well over a decade to establish a national securities regulator are a case in point of the triumph of parochialism over building a bigger and stronger Canadian securities market to take on global competitors. The need for, but absence of, a national strategy for energy diversification and energy transportation infrastructure if we are to pivot successfully to the growing energy markets in Asia is another example of lack of coordination that risks constraining our future growth and income prospects for decades.

On the provincial fiscal front, the issue is really how aligned will the provincial deficit and debt strategies be with the 2014 federal budget. While time will tell as the remaining provinces roll out their budgets, there is every reason to be concerned. The collective net debt of the provinces and territories in 2012-13 was 28 per cent of GDP, about 85 per cent of the federal net debt. Ontario is currently running a deficit of $11.7 billion, and the government is only aspiring to balance its books by 2017-18. Quebec has indicated intentions to balance its books by 2015-16 but is still running deficits of $2.5 billion. The Atlantic provinces have large deficits and vague reduction plans. Alberta, Saskatchewan and British Columbia are flirting with surpluses this year; though BC is relying heavily on LNG exports for its long-term fiscal health, and these have yet to materialize.

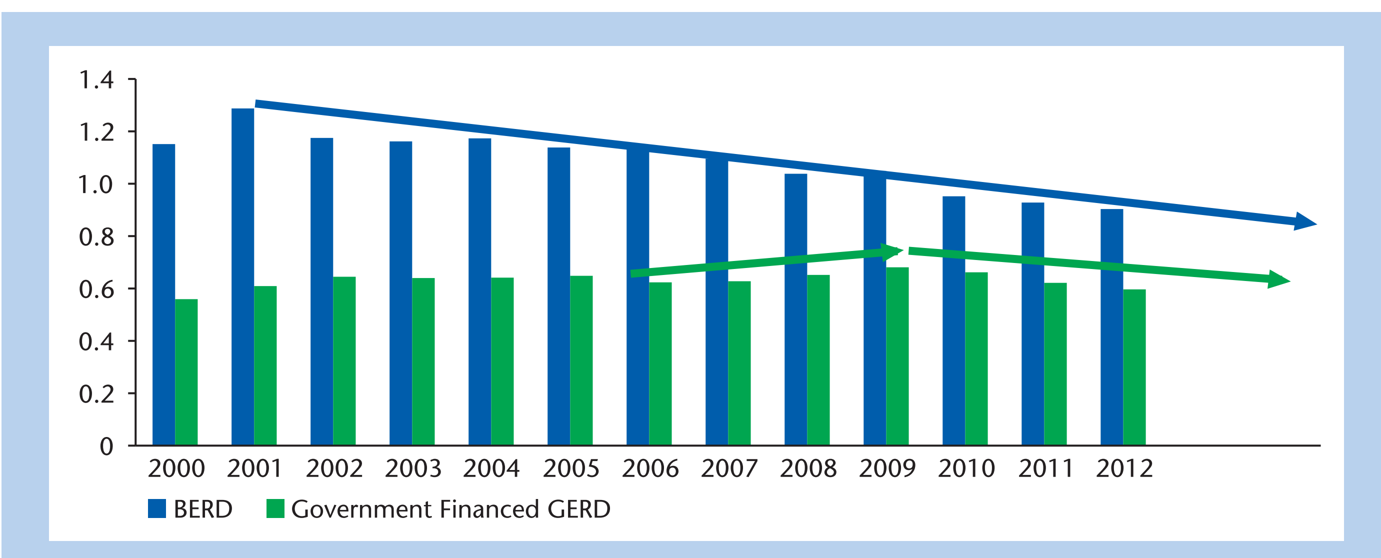
As important as spending policies and tax parameters are to the success of governments' fiscal policies, economic growth matters greatly because it is what drives the income bases that governments tax and the economic conditions that influence social safety net spending. So, looking ahead over the next decade, how is the economic growth potential of Canada shaping up?

CHART 3: World Economic Forum's Global Competitiveness Rankings



Source: World Economic Forum

CHART 4: Spending on Research and Development in Canada (% of GDP)



Source: OECD.stat. Extracted Jan 22, 2014

Managing economic growth is extraordinarily difficult in practice, but it is relatively simple in concept. As the Nobel Prize winner Paul Krugman has famously stated, "productivity is not everything, but in the long run it is almost everything." Not surprisingly, therefore, longer-term potential growth is dictated by productivity growth and labour force growth (plus terms-of-trade shifts). Neither is good news for Canada looking to the longer term.

What this all adds up to is declining productivity growth. Combine this with the impacts of our aging demographics, which are leading to slowing labour force growth in Canada, and you have the recipe for a slowing rate of potential growth over the next decade, lower than anything we have experienced over the last half century.

In a world where competitiveness in higher cost economies is driven by innovation and productivity, Canada's innovation ranking today is 25th and on an apparent declining trend.

Why should we worry? Chart 3 presents the World Economic Forum's Global Competitiveness Index rankings for Canada over the last 15 years. By the early 2000s, Canada had slipped to around 14-15th place and, except for a blip during the global financial crisis where we moved up as others moved down with failing banking systems, there has been little change in a decade. Part of the reason is evident in the WEF's Innovation Index rankings for Canada — in a world where competitiveness in higher cost economies is driven by innovation and productivity, Canada's innovation ranking today is 25th and on an apparent declining trend.

Now you might query the validity of this particular innovation index, but a cross check with the OECD on spending on research and development across all OECD countries in Chart 4 validates the problem. Private sector spending on research and development in Canada has been on a declining trajectory for a decade, and we now rank 22nd among OECD countries for our business research and development effort.

We do see a bright spot with government-financed research and development in universities and government labs, which were prioritized by the public sector in the late 1990s after the restoration of fiscal balance. And this budget introduces an intriguing new research vehicle, the Canada First Research Excellence Fund, with $1.5 billion over 10 years but still undefined objectives and parameters. Notwithstanding, government research investments have flat-lined in real dollars in the short term; government spending in research and development as a share of the economy looks ready to decline, and this will have unintended longer term consequences.

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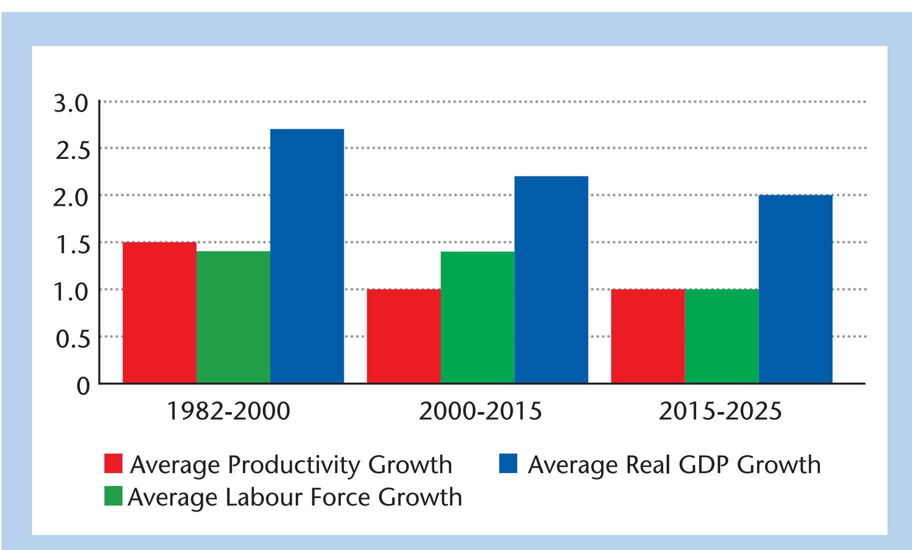
Chart 5 sets out the inescapable algebra. Real GDP growth averaged 2.7 per cent from 1982-to-2000; it has declined to 2.2 per cent over the 2000-to-2015 period, driven by weaker productivity growth; and, over the next 10 years, it will be hard pressed to grow even 2 per cent on average, held down by productivity growth under 1 per cent annually and labour force growth in the same range.

Looking at the budget through a telescope not a microscope reveals a number of longer term risks to our future well-being that deserve more attention by both the public and private sectors in Canada. What this argues for is a greater policy focus on raising Canada's declining potential growth in both federal and provincial budgets, an orientation commensurate with the long term economic risks inherent in a business-as-usual approach. Budgets have to shift to a greater structural and longer-term orientation if we are to avoid the perils of short termism. P

CHART 5: Potential Growth in Canada (%)



Source: StatsCanada
Note: Productivity growth is for 2000-2012, Real GDP forecast 2013-15, Labour Force forecast 2014-15

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