

# Dispelling Some Fiscal Myths

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With sovereign credit concerns tearing through Europe like an out-of-control brush fire, analysts have divided into two solitudes on Canada's fiscal position. In one camp are those who fret that today's record budget deficits and the prospect of red ink lingering five years down the road could cast Canada back into a fiscal quagmire, just a few steps removed from Greece. The other camp appears to believe that our fiscal backdrop is so healthy that the biggest challenge will be dealing with an impending wave of capital inflows attracted by Canada's pristine fundamentals. Of course, the reality is somewhere in between.

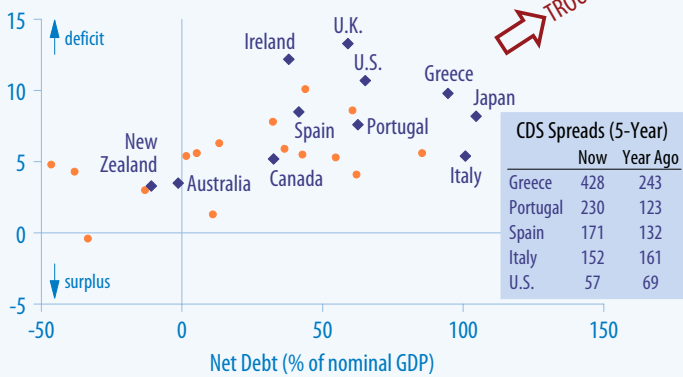
**Myth #1:** Canada's finances are in need of urgent repair: The heightened sensitivity of global financial markets to sovereign risk has suddenly turned the spotlight from the weak economy to weak government finances. Canada has no doubt suffered some serious fiscal bruising in the downturn, but entered the recession in much better shape than most other major economies and will emerge much healthier (*Charts 1-3*). With the recovery still in its infancy, it is simply premature to focus on withdrawing the fiscal stimulus measures, particularly at the federal level.

**Myth #2:** Canada's finances are wildly superior: While Canada's fiscal position stands tall next to the weaklings in Europe, as well as Japan, the U.S. and Britain, it is by no means extraordinary (*Chart 1, again*). Many smaller European nations (and even Italy) are now running total government deficits similar in size to Canada, while Australia and New Zealand's gaps are smaller. In contrast to other OECD nations, Canada has significant budget shortfalls at the sub-national level, so focusing solely on Ottawa's relatively healthy finances can give a misleading impression of the overall position. Indeed, the provinces are projected to run a combined \$38 bln deficit in FY09/10, widening the national shortfall to more than 6% of GDP versus 3.7% if the provinces are excluded (*Chart 4*).

Righting the fiscal ship will be tough for some provinces, particularly in Central Canada. Ontario's deficit weighs in at a record 4.3% of GDP, while Quebec's eventual return to balance hinges on \$5 bln of yet-to-be-found annual cost

**CHART 1**  
**OECD FISCAL LANDSCAPE**

Deficit vs Debt (% of nominal GDP, 2010)

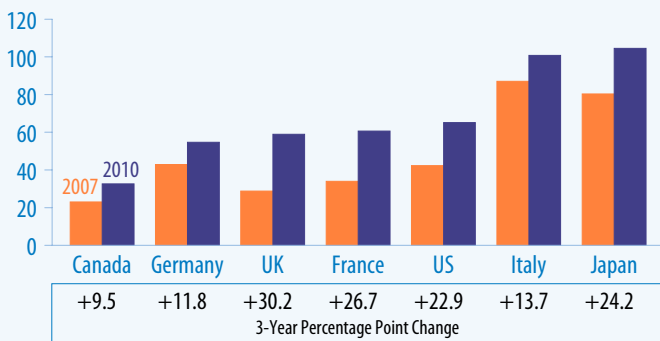


Dots represent countries in the OECD; except Norway, which has huge assets

**CHART 2**  
**CANADA'S FISCAL FITNESS**

(% of GDP)

Net Government Debt

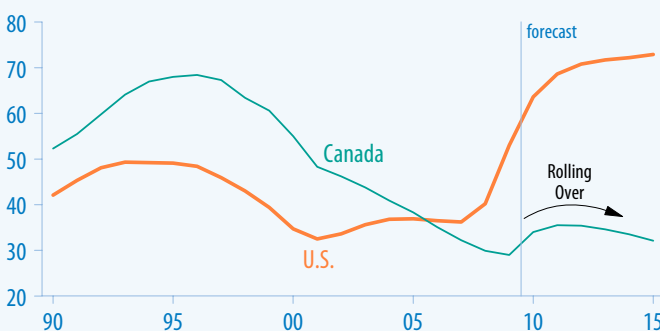


Source: OECD, December 2009 Economic Outlook

**CHART 3**  
**OTTAWA VERSUS WASHINGTON: CROSSOVER**

(% of GDP)

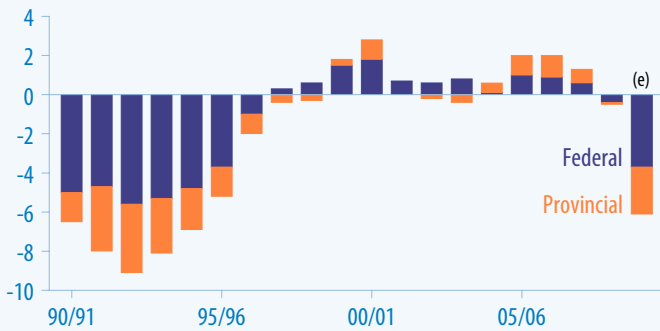
Federal Government Debt



Sources: [U.S.] OMB; [Canada] Federal Budget Update

**CHART 4**  
**THE PROVINCES COUNT**  
(% of GDP)

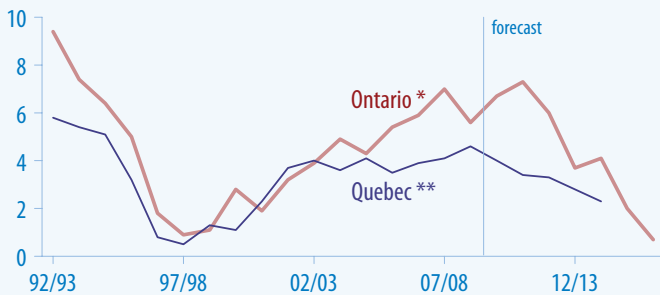
**Combined Budget Balances**



(e) = estimate

**CHART 5**  
**SPENDING RESTRAINT**  
(5-yr CAGR : %)

**Total Expenditures**



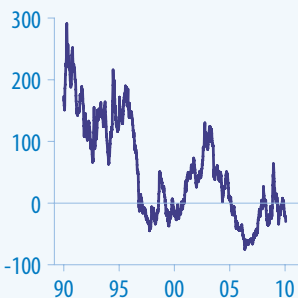
Source: Provincial Budgets

\* Excludes \$4 bln of auto-sector aid in FY2009/10

\*\* Assumes "measures to be identified" taken out of spending (FY2010/11-13/14)

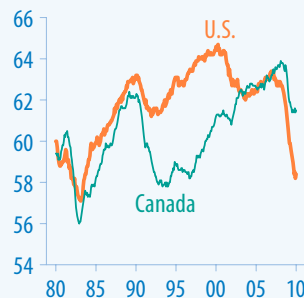
**CHART 6**  
**MIND THE GAP**

**Bond Yields \***  
(bps)



\* Canada-U.S. 10-year spread

**Employment / Population**  
(percent)



savings, even after accounting for the one point increase in the provincial sales tax rate in 2011. These provinces also face a revenue challenge, given their greater reliance on personal and corporate income taxes, and expected mild economic recoveries. Short of new revenue measures, the burden will thus land on spending, a tall order given that combined spending in these provinces grew at more than 5% annually in the past five years (Chart 5). All else equal, spending restraint akin to the mid-1990s will be needed to repair public finances in Central Canada over the next five years.

**Myth #3:** Tax increases are inevitable: Some jurisdictions will opt to lean on revenues to rein in deficits in the years ahead. We already know that Quebec will raise its sales tax. However, it is not at all clear that tax hikes are required or necessary to repair Canadian government finances more broadly. The combination of even a moderate economic recovery and real program spending growth held to 3% over a five-year period (i.e. 0.6% per year) would bring Ottawa's budget deficit down to 1% of GDP by mid-decade.

**Myth #4:** The budget must be balanced for a clean bill of fiscal health: Part of the reason why we believe tax increases are not inevitable is that we question whether the medium-term deficit target of policymakers should be zero. The debate around the fiscal outlook often assumes prima facie that the budget must be balanced. However, given that Canada's debt/GDP ratio is still low in both an international and historical perspective, it's highly debatable that we "must" balance the budget. The debt/GDP ratio would begin to fall again in the years ahead if Ottawa's budget deficit were to drop to around 1% of GDP or less. To some extent, investors are already giving Canada a relatively clean bill of fiscal health through the bond market (Chart 6): Canada/U.S. 10-year spreads are back into the red, despite the fact that Canada's economy has held up better (at least gauged by jobs) and the Bank of Canada is likely to start hiking rates ahead of the Fed.

**Bottom Line:** Ensuring that the economic recovery fully takes root should be policymakers' number one priority in the coming budget season, with the possible exception of Ontario and Quebec. However, looking beyond this year, the emphasis will (appropriately) shift to restraint, and the first order of business should be to reverse some of the hefty spending increases seen over the past year.

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