Briefing Note

Budget 2009 Economic and Fiscal Outlook – Key Issues

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The *Federal Accountability Act* mandates the Parliamentary Budget Officer (PBO) to provide independent analysis to the Senate and House of Commons on the state of the nation's finances, government estimates and trends in the national economy.

In meeting the commitments of this mandate, this short note addresses some key questions regarding the Government of Canada's 2009 budget:

- *Do the economic assumptions presented to Parliament represent a reasonable basis for fiscal projections and are the economic risks adequately characterised?*
- *Do the status quo fiscal projections provided to Parliament represent a reasonable basis for planning and are the fiscal risks adequately characterised? Is the size of the fiscal stimulus appropriately measured?*
- *What is the Government's structural budget balance given the measures introduced in Budget 2009?*
- *Are the fiscal and implementation risks of measures proposed in Budget 2009 adequately characterised?*

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The purpose of this note is to provide parliamentary committees and parliamentarians with an overview of key issues arising from Budget 2009; to identify areas that may merit additional inquiry; and, some research topics that will form part of the PBO workplan. Fiscal and economic forecasting is fraught with risk and imprecision. The views expressed by the PBO are based on its own set of assumptions, analysis and judgment to provide an independent view of the budget, its impact and implementation. The objective of the analysis is to provide a view as to the reasonableness of the Government's assumptions, proposals and assertions as well as an additional framework for the scrutiny of the budget by parliamentarians.

Key Points

- In general, the 2009 budget economic assumptions based on the average private sector outlook appear reasonable; however, the adjustment for risk may be insufficient for budget planning over the medium term. Further, the assumptions underlying the medium-term forecast of corporate profits, and therefore corporate tax revenues, appear to be optimistic.
    - The economic outlook presented in Budget 2009 implies that the economic downturn may be more severe than either of the last two recessions in terms of the cumulative amount of unrealized output.
    - The Government's downward risk adjustment to nominal GDP largely affects only the near term, leaving the level of nominal GDP essentially unchanged in the outer years of the projection period. That is, the Government has not made a complementary risk adjustment to the final years of the projection period which may increase the risk to attaining projected medium-term budget balances.
    - The experience of past recessions would suggest that corporate profits relative to nominal GDP would initially decline to a greater extent and then remain significantly below pre-recession levels for some time.

- Due in part to the economic risk and the treatment of that risk in Budget 2009, PBO judges that there is downside risk surrounding the Government's projected budget balances over the outer years of the projection period and, accordingly, a risk that the Government's budgetary balance will not return to a surplus position by 2013-14.
    - In addition to the economic risks, the return to a small surplus position is dependant on a rapid recovery in tax revenues as well as the effective implementation of planned contractionary measures – over and above the 'sunsetting' of temporary measures announced in Budget 2009.
        - The fiscal track assumes the Government will raise Employment Insurance (EI) premium rates while the economy remains well below estimates of its potential capacity.
        - The Government's fiscal track also continues to include just under $8 billion in yet-to-be-determined fiscal savings and gains from the sale of assets.

- PBO views the Budget 2009 $39.9 billion measure of the Government's stimulus as a maximum or 'gross' estimate (i.e., relative to existing or planned legislation and recently adopted spending cuts).
    - Adjusting for restraint measures proposed in the 2008 Economic and Fiscal Statement and the contributions to stimulus associated with maintaining current EI premium rates in 2010, PBO estimates that the total 'net' stimulus could be 20% smaller (at $31.8 billion) than reported in Budget 2009 over 2009-10 and 2010-11.
    - Further, a significant part – up to 25% – of the Government's $39.9 billion stimulus appears to be contingent on matching contributions from other levels of government.

- Largely as a result of the permanent personal income tax measures introduced in Budget 2009, the structural surplus has been reduced over 2009-10 to 2012-13 from an average of $5 billion annually (based on PBO's estimate following the 2008 Economic and Fiscal Statement) to just under $1 billion on average. The structural surplus is then projected to rise to $5 billion in 2013-14 as the CIT rate reductions are completed in 2012-13 and the annual growth in underlying program spending is held below 4%.
    - It would be useful for the Department of Finance Canada to publish their detailed Budget 2009 assumptions and projections of the income components of GDP, effective tax rates, estimates of potential output and estimates of structural and cyclical budget balances, to help parliamentarians and Canadians better understand the underlying fiscal position of the Government over the upcoming years.

- The impact of the stimulus package in influencing the economic recovery is predicated on the Government's ability to successfully implement the new budget measures. As a result, operational implementation of the proposed budget measures will need to be closely monitored.
    - PBO has begun working on an assessment of the targeted, timely and temporary nature of each of the proposed budget measures. This report will be published in the coming weeks.
    - In addition to this initial assessment, in keeping with the mandate of budget oversight, PBO is prepared to help develop an accountability framework based on OECD best practices to enable parliamentarians to exercise effective oversight of budget implementation.

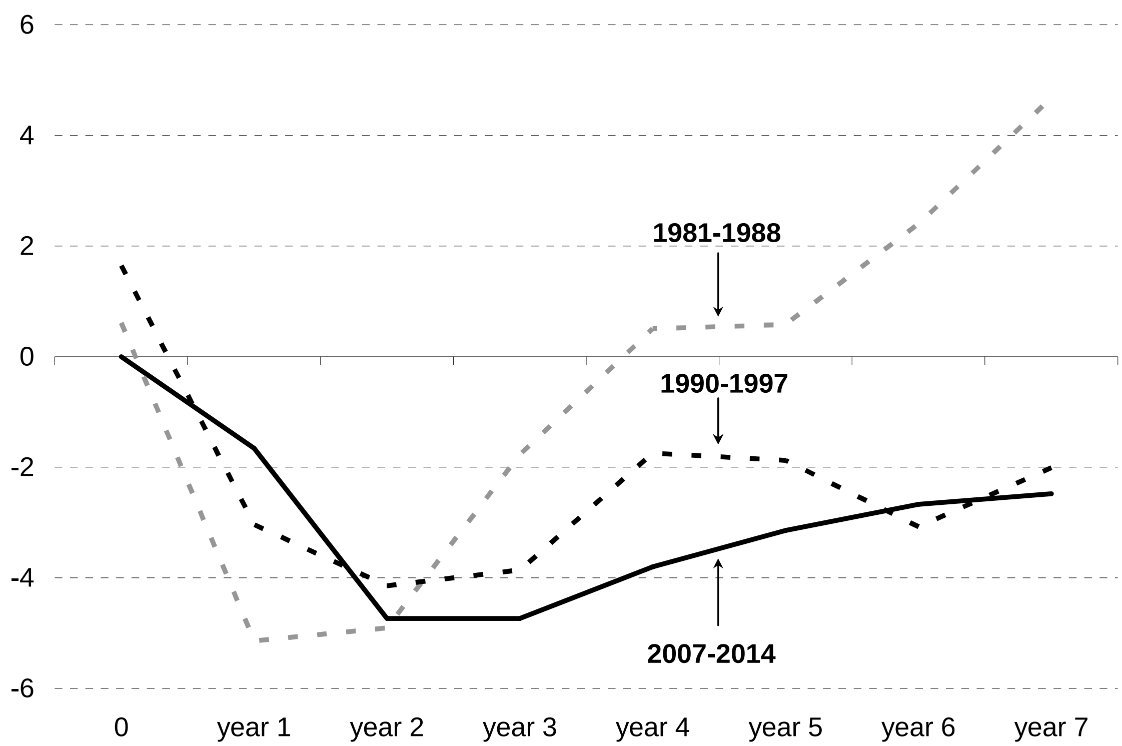
1. Economic Outlook and Risks

Do the economic assumptions presented to Parliament represent a reasonable basis for fiscal projections and are the economic risks adequately characterised?

In general, the 2009 budget economic assumptions based on the average private sector outlook appear reasonable; however, the adjustment for risk may be insufficient for budget planning over the medium term. Further, the assumptions underlying the budget forecast of corporate profits over the medium term risk being overly optimistic.

The average private sector forecast of real GDP in Budget 2009 is very much in line with the forecast in the January 2009 PBO average scenario through 2011 and is somewhat lower over 2012-2014.[1]

Figure 1: Projected Output Gap and Past Recessionary Periods (% of potential GDP)



Sources: Department of Finance Canada and Office of the Parliamentary Budget Officer.

The projected downturn (prior to the implementation of Budget 2009 measures) – as measured relative to an estimate of the economy's potential output i.e., the output gap – is more severe than either of the last two recessions in terms of the cumulative amount of unrealized output (Figure 1).[2]

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[1] See PBO's pre-budget briefing: http://www2.parl.gc.ca/Sites/PBO-DPB/documents/Pre-Budget_Briefing.pdf.

[2] In Figure 1, the output gap over 2008-2014 is projected using the forecast of real GDP growth in Table 2.1 in Budget 2009 and assuming potential GDP growth of 2.4% annually. Estimates of the output gap in 2007 and in past recessionary periods are Department of Finance Canada estimates. For further detail see http://www2.parl.gc.ca/sites/pbo-dpb/documents/CABB%20-%20E.pdf. In addition, consistent with PBO's pre-budget

Budget 2009 however characterises this projected downturn as 'milder than the last two Canadian recessions' based on quarterly year-over-year real GDP growth rates, which do not take into account the economy's performance relative to its potential capacity.

The outlook for nominal GDP based on the average private sector forecast in Budget 2009 is however somewhat higher over the entire projection period compared to the PBO average scenario (almost $17 billion higher on average over 2009-2010 and $13 billion higher on average over 2011-2014) as a result of a higher GDP inflation forecast.

Both PBO and the Government judge that the risks to their respective outlooks are tilted to the downside. Moreover, the Government judged it appropriate to adjust downward the private sector forecast of nominal GDP levels for budget planning assumptions. The Government's downward adjustment however largely affects only the near term (2009-2011) leaving the level of nominal GDP essentially unchanged in the outer years. As a result, the Government has made essentially no risk adjustment to the final years of the projection period.

An alternative treatment of risk could be to use a level of nominal GDP that is permanently lower compared to the average private sector forecast. This would better reflect the possibility that the downturn (particularly given its global and financial nature[3]) could be deeper and/or longer than expected by private sector forecasters, and/or that the improvement in commodity prices could be less pronounced. PBO illustrated this risk using the lowest private sector forecasts in its survey which resulted in a permanently lower level of nominal GDP over the entire projection horizon relative to the private sector average forecast. PBO believes that a more adequate risk adjustment to the private sector forecast of nominal GDP levels could have included a larger downward adjustment to the private sector forecast in the outer years.

Further, based on the experience of past recessions, there could also be downside risk in the outer years to corporate profits underlying the budget forecast. Figure 2 contrasts PBO's projection of corporate profits as a share of nominal GDP (based on its January 2009 average scenario) with the 1981 and 1990 recessions. As noted in its pre-budget briefing, PBO characterised this assumption as 'relatively optimistic'. Indeed, the share of corporate profits in PBO's projection returns to its 1961-2007 historical high of 13.2% by the end of the forecast horizon.

The experience of past recessions however would suggest that corporate profits relative to nominal GDP would initially decline to a greater extent and then remain significantly below pre-recession levels for some time. Moreover, the share of corporate profits may in fact not return to its pre-recession level over the medium term and instead converge toward its long-term historical average. This was the case in the 1981 recession where – similar to the current situation – the

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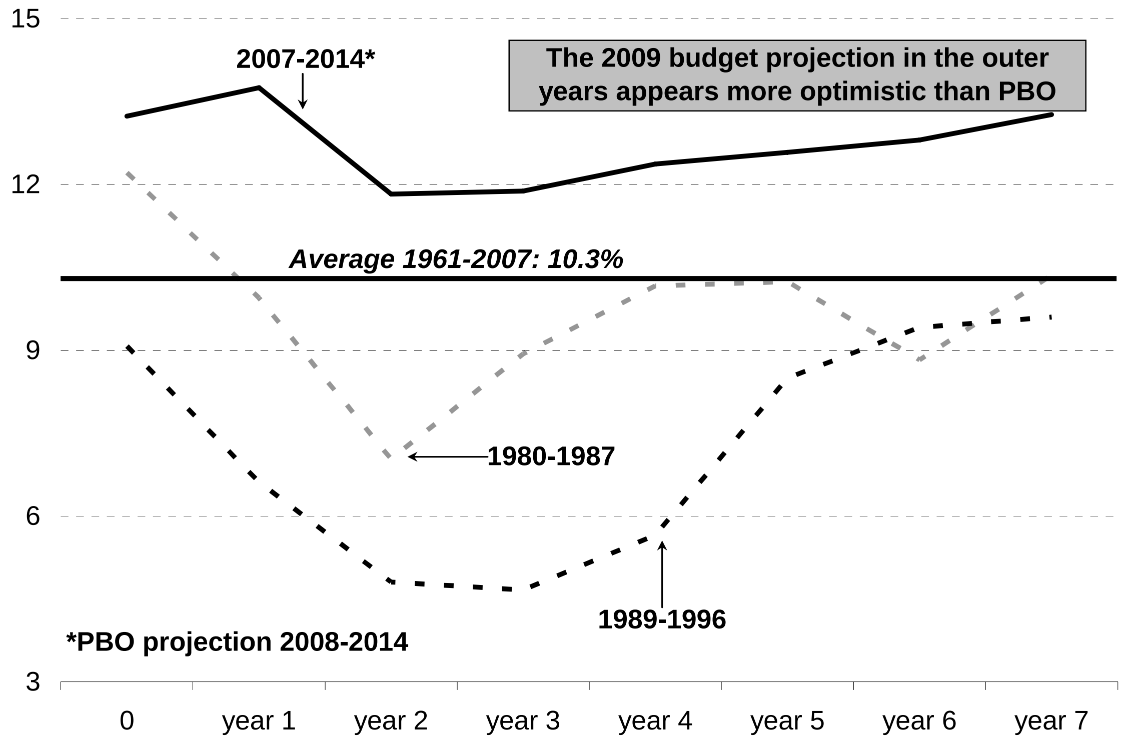
analysis, we have assumed that the average private sector forecast does not reflect the impact of anticipated Budget 2009 measures. If however these impacts have been included, then the projected economic downturn, prior to accounting for budget measures, would be even more pronounced.

[3] Recent research by the IMF Clasesens et al, *What Happens During Recession, Crunches and Busts?* (2008, WP/08/274) and academic economists Reinhart and Rogoff, *The Aftermath of Financial Crisis (2008)* both analyze the cross-country evidence and find evidence that financial, credit and housing related recessions tend to be longer and more severe.

share of corporate profits was initially above, but then ultimately converged to, its long-term historical average.

Figure 2: Corporate Profits relative to Nominal GDP (per cent)



Source: Office of the Parliamentary Budget Officer.

While Budget 2009 does not present its underlying assumptions about corporate profits, it would appear that a more optimistic assumption is maintained since the Budget 2009 forecast of corporate income tax revenues is significantly higher in the outer years compared to PBO's projection even after adjusting for differences in nominal GDP.[4]

2. Fiscal Outlook and Risks

Do the status quo fiscal projections provided to Parliament represent a reasonable basis for planning and are the fiscal risks adequately characterised?

The near-term status quo fiscal projections appear reasonable. However, the medium-term status quo fiscal projections contained in Budget 2009 may be optimistic.

[4] Based on Table 4.2 in Budget 2009, the Government's status quo corporate income tax revenues over 2011-12 to 2013-14 are projected at: $35.7 billion, $36.8 billion and $39.7 billion, respectively. Over the same period, PBO projected status quo corporate income tax revenues of $29.8 billion, $30.2 billion and $32.6 billion – almost $7 billion lower in each year. PBO's projection of nominal GDP was marginally higher (+$6 billion) than the adjusted budget forecast in 2011 but marginally lower in 2012 and 2013 (-$3 billion and -$7 billion respectively). This suggests that the share of corporate profits and/or the effective corporate tax rate underlying the Budget 2009 forecast are more optimistic than PBO's assumptions.

The status quo fiscal planning track indicates large deficits in the first two years of the projection period, with the budgetary balance moving to a small surplus position by the final year of the projection period. The status quo cumulative deficit over the five-year period is estimated to be $35 billion. Though more optimistic, this is within a reasonable range of the $46B cumulative deficit contained in the PBO's pre-budget 2009 briefing note based on similar economic assumptions.

Due in part to the economic risk and the treatment of that risk in Budget 2009, as well as for reasons outlined below, PBO judges that there is downside risk surrounding the Government's projected budget balances over the outer years of the projection period and therefore a significant risk that the Government's budgetary balance will not return to a surplus position by 2013-14. However, a slower improvement in the budgetary balance would not necessarily be indicative of a structural deficit, as the economy may remain well below its potential over the entire projection period.

Fiscal Risks

In addition to the economic risks outlined above, the return to a small surplus position on a status quo basis is dependant on a relatively rapid recovery in tax revenues as well as the effective implementation of significant planned contractionary measures beginning in 2011-12. The required, and planned, contractionary measures are in addition to the 'sunsetting' of the short-term fiscal stimulus package announced in the 2009 budget (discussed in the next sub-section).

With respect to budgetary revenues, Figure 3 shows the Government's income tax revenues as a share of nominal GDP indexed to the year immediately prior to the onset of each of the past two recessions as well as for the Budget 2009 projection (indexed to 2007-08) adjusted for the effects of the implementation of the reductions in statutory corporate income tax (CIT) rates (see box below).[5]

As can be seen in Figure 3 below, the adjusted Budget 2009 status quo revenue projection includes a more rapid decline in revenues as a share of GDP in the first two years than had been experienced in past recessions, likely reflecting the effects of significant losses in financial markets that occurred in 2008 as well as refunds of past corporate taxes paid. However, the trough and subsequent level recovery in income tax revenues are both considerably more optimistic than those that occurred in the each of the past two recessions, once adjusted for the impact of corporate income tax statutory rate declines detailed in the October 2007 Economic Statement. In addition, the recovery of income tax revenues following the 1991 recession was aided by personal income tax brackets and basic exemption amounts that were not indexed to inflation, as is the case under the current personal income tax structure, which could very well further dampen revenue growth during the recovery period, relative to the 1990s track.

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[5] The CIT statutory rate adjustment is calculated using the impact values Table 3.1 and an estimate of nominal GDP contained in the October 2007 Economic Statement. This ratio (impact value as a share of GDP) is added to the income tax revenues as a share of GDP prior to the series indexation to 2007-08.

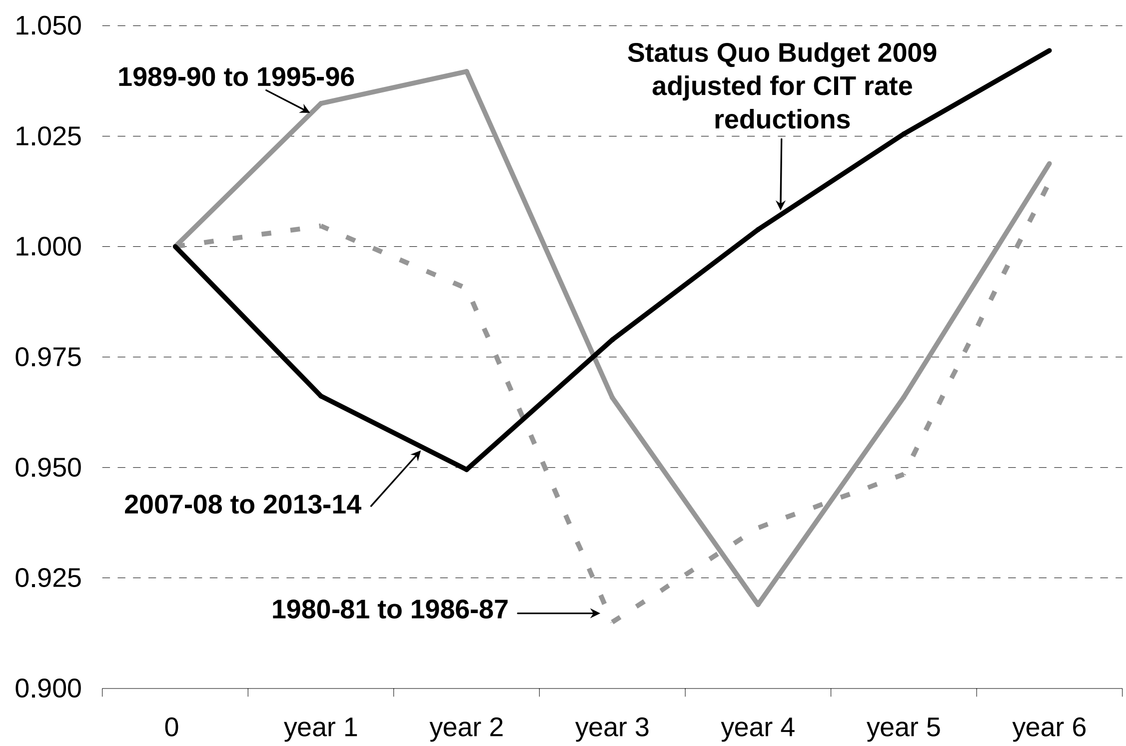
Adjustment for Statutory Corporate Income Tax Changes

Beginning with Budget 2006 and most recently in the 2007 Economic Statement, the Government introduced significant reductions in corporate income tax rates, lowering them from about 22% (including the corporate surtax) in 2007, to 15% by 2012. As a result there are two factors affecting the Government's CIT revenues over the Budget 2009 forecast period: 1) declining income tax rates; and, 2) fluctuations in corporate profits and losses. Since we are only interested in the latter, we have removed the impact of the declining income tax rates using the Government's estimates of the value of those measures as published in Table 3.1 of the Government's October 2007 Economic Statement. The table below details the planned reduction in corporate income tax rates over the projection period.

	2007	2008	2009	2010	2011	2012	2013
CIT rates[1]	22.12	19.5	19.0	18.0	16.5	15.0	15.0

1. 2007 Includes 1.12% corporate surtax which was eliminated as of 2008

Figure 3: Income Tax Revenues relative to Nominal GDP (year prior to recession = 1.0)



The Budget 2009 status quo fiscal track also includes substantially higher Employment Insurance (EI) premium revenues in the final two years of the projection period compared to the 2008 Economic and Fiscal Statement (EFS), as the program begins to recover the cost associated with deficits in the account arising from the rise in unemployment in 2009 and 2010 as well as to recoup the cost of maintaining the premium rates at 2009 levels in 2010. As a result, EI premium revenues are expected to be $1.7 billion higher in 2013-14 than they were in the 2008 EFS. In summary, the status quo fiscal track assumes the Government will raise EI premium rates while the economy remains well below estimates of its potential capacity.[6]

Table 1 below shows the changes in the EI program in the 2009 budget compared to the 2008 EFS. As can be seen in the table, relative to the 2008 EFS, the EI program is assumed to adopt a more contractionary stance in the final three, and in particular the last two, years of the projection period.

Table 1: Budget 2009 Employment Insurance Projections versus the 2008 EFS ($ billions)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Change in Revenues						
Due to Economic Impacts (as reported)	0.1	0.3	1.3	0.7	1.6	1.7
Stimulus Measure (as reported)	0.0	-0.8	-1.6	0.0	0.0	0.0
Total	**0.1**	**-0.6**	**-0.4**	**0.7**	**1.6**	**1.7**
Change in Expenses						
Due to Economic Impacts (as reported)	0.2	0.9	1.2	0.4	0.1	-0.3
Stimulus Measure (as reported)	0.0	1.4	1.4	0.0	0.0	0.0
Total	**0.2**	**2.3**	**2.6**	**0.4**	**0.1**	**-0.3**
Total	**-0.1**	**-2.9**	**-3.0**	**0.3**	**1.5**	**2.0**

The Government's status quo fiscal track also continues to include just under $8 billion in yet-to-be-determined fiscal savings and gains from the sale of assets that have been incorporated into the Government's planning projections related to ongoing reviews. Budget 2009 provides details on the savings that have been realized under the 2008 Strategic Reviews. Savings identified rise from net savings of just over $300 million in 2009-10 to about $500 million (assumed) ongoing as of 2011-12. Table 2, below, shows the annual profile of remaining savings/revenues required to be identified by the Government. The as-yet-to-be-identified asset sales and savings pose a near-term downside risk to the budget deficit projections as half of the planned savings/revenues are required to be identified and realized within the next fiscal year.

Table 2: Savings and Revenues from Reviews included in the Fiscal Plan ($ billions)

	2009-10	2010-11	2011-12	2012-13	2013-14
Reallocation					
Savings recorded in EFS 2008	2.3	1.9	1.6	1.1	1.1
2008 Strategic Reviews	0.3	0.4	0.5	0.5	0.5
Remaining to be identified	**2.0**	**1.5**	**1.1**	**0.6**	**0.6**
Gains from Asset Sales	**2.0**				
Total remaining to be identified	**4.0**	**1.5**	**1.1**	**0.6**	**0.6**

[6] In the PBO January 2009 projections, the normative assumption with respect to the Employment Insurance program was that the Government maintained rates at 2009 levels throughout the projection period.

Is the size of the fiscal stimulus appropriately measured?

The 2009 budget estimate of the Government's stimulus totalling $39.9 billion over 2009-10 to 2010-11 appears to be somewhat overstated due for example to the inclusion of the budgetary impacts ($2.4 billion) of maintaining Employment Insurance premiums at 2009 levels in 2010, the re-allocation of $5.4 billion in previously-planned expenditures to stimulus initiatives, as well as the inclusion of a small amount of funding for the continuation of existing programs at current levels.

In PBO's January 2009 projections, the normative assumption with respect to the Employment Insurance program was that the Government maintained contributions rates at 2009 levels throughout the projection period, essentially choosing not to raise rates while the economy remained well below its estimated potential capacity. As such, relative to its status quo outlook, PBO views the Budget 2009 $39.9 billion measure of the federal stimulus as a maximum or 'gross' estimate (i.e., relative to existing or planned legislation and recently adopted spending cuts). Adjusting for the above-raised issues, PBO estimates that the total 'net' stimulus would be 20% smaller than reported in Budget 2009 over 2009-10 and 2010-11 (see Table 3). Further, a significant part – up to 25% – of the Government's $39.9 billion measure of fiscal stimulus appears to be contingent on matching contributions from other levels of government.

Table 3: Estimates of the Federal Fiscal Stimulus ($ billions)

	2009-10	2010-11	Total
Budget 2009 reported stimulus measures	**22.7**	**17.2**	**39.9**
Spending reductions recorded since Budget 2008			
Implications of reviews	2.3	1.9	4.2
Actions to reduce compensation expenses	0.6	0.9	1.5
Total	**2.9**	**2.8**	**5.7**
Estimated cost of maintaining EI premiums at 2009 levels in 2010	**0.8**	**1.6**	**2.4**
Total net stimulus measures	**19.0**	**12.8**	**31.8**

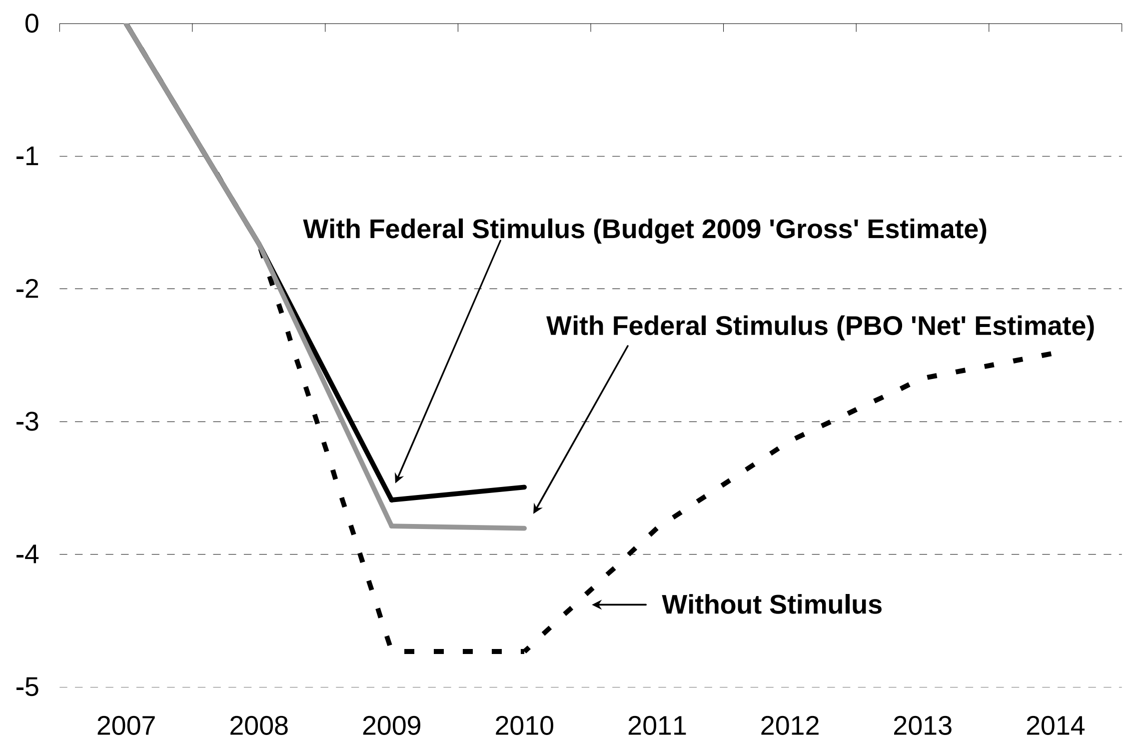
As PBO highlighted in earlier work,[7] in assessing fiscal stimulus measures, the economic impact of policy actions can be measured against the degree to which such action closes or narrows the output gap. Figure 4 shows the potential impact of the stimulus on the economy during this economic downturn based on estimates of the economic impacts presented in Annex 1 of Budget 2009 and based on PBO's measure of the 'net' stimulus.[8] Based on Department of Finance estimates of the economic impacts in 2009 and 2010 and the Budget 2009 'gross' measure, the federal stimulus would be expected to narrow the output gap by 1.1 percentage points in 2009 and 1.2 percentage points in 2010.

[7] http://www2.parl.gc.ca/sites/pbo-dpb/documents/CABB%20-%20E.pdf

[8] We have assumed that the private sector forecast of real GDP growth presented in Budget 2009 does not reflect anticipated impacts of the Government's fiscal stimulus measures. If however these impacts were incorporated into private sector projections then the impact of the Budget 2009 stimulus on the output gap would be less pronounced. We have also assumed that the federal stimulus in 2009 and 2010 would not impact potential output. Higher potential output would reduce the impact on the output gap.

Based on the Government's measure of fiscal stimulus provided by other levels of government (measured at $11.7 billion or 23% of the total $51.6 billion stimulus over 2009-10 to 2010-11) and Department Finance Canada estimates, the additional fiscal stimulus would be expected narrow the output gap further by approximately 0.4 percentage points in 2009 and 0.5 percentage points in 2010.

Figure 4: Potential Economic Impacts of the Federal Stimulus in 2009 and 2010 (% of potential GDP)



That said, the size of the stimulus package, whether measured in gross or net terms, is significant, and its ultimate economic impact, compared to that presented in Budget 2009, will more likely be determined by what is achievable in terms of meaningful stimulus investment in a short period than the above-mentioned factors. Specifically, the largest portion of the stimulus package is focused on infrastructure, due to its high multiplier and positive effect on long-run productivity. Historically, however, the Government has experienced significant delays in delivering funds related to planned infrastructure investments.[9]

[9] For example, in 2007-08, the last year for which data is available, Infrastructure Canada lapsed 50% ($1.1 billion of $2.3 billion) of its non-gas-tax related funding.

3. Structural and Cyclical Budget Balances

What is the Government's structural budget balance given the measures introduced in Budget 2009?

Table 4 below presents PBO's rough estimates of structural and cyclical budgetary balances based on Budget 2009 fiscal projections. We continue to assume that underlying structural revenues in 2007-08[10] increase in line with our assumed growth in potential GDP of 2.4% and 2.1% inflation (resulting in nominal growth of 4.6%).[11] We then make adjustments to incorporate recent structural changes affecting revenues based on published Department of Finance Canada estimates presented in the 2008 EFS and 2009 budget. On the spending side, we maintain the 2008 EFS program spending forecast contained in Budget 2009, with an adjustment for EI benefits, the main cyclical component, the addition of assumed structural programs (those that continue to the end of the projection period) and removing the as-yet-to-be-identified proposed savings from spending reviews.[12] Public debt charges are assumed to remain at their 2007-08 level. Given our estimates of the structural budget balance and the Budget 2009 budget balance projection, the cyclical budget balance is determined residually (i.e., cyclical balance = budget balance – structural balance).

Table 4: Budget 2009 Structural and Cyclical Budget Balances ($ billions)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Budgetary balance (excluding assets sales/review savings)	+9.6	-1.1	-37.7	-31.3	-14.1	-7.9	+0.1
Structural budgetary balance	+9.6	+3.7	-1.7	+0.4	+1.5	+1.6	+5.0
Cyclical budgetary balance	0.0	-4.8	-36.0	-31.7	-15.6	-9.5	-4.9

Table 4 shows that the projected structural budget balance is essentially zero over the next four fiscal years. Largely as a result of the permanent personal income tax measures introduced in Budget 2009, the structural surplus has been reduced over this period from an average of $5 billion annually (based on PBO's estimate following the EFS) to just under $1 billion on average. The structural surplus is then projected to rise to $5 billion in 2013-14 as the CIT rate reductions are completed in 2012-13 and the annual growth in underlying program spending is reduced further to 3.7%, well below its 2000-01 to 2007-08 historical average of 6.8% annually. It is important to note that to a large extent we have simply adopted the Government's underlying program spending

[10] The September 2008 Fiscal Reference Tables (FRT) published by the Department of Finance indicate that in 2007 the actual budget balance (National Accounts basis) was almost identical to the estimate of the cyclically-adjusted budget balance (Table 45) which implies that actual GDP equals potential GDP and a zero output gap. We assume that on a Public Accounts basis, the actual budget balance equals the structural budget balance in the fiscal year 2007-08 and therefore revenues and expenditures in 2007-08 represent structural levels. For further detail about PBO's estimate of structural budget balances, see http://www2.parl.gc.ca/sites/pbo-dpb/documents/CABB%20-%20E.pdf.

[11] The assumption of 2.1% GDP inflation is based on the average of the annual forecasts of GDP inflation over the period 2008-2013 presented in the EFS (see EFS Table 1.1) which is in line with Budget 2009's average of 2.0% annually over 2008-2014 presented in Table 2.1.

[12] These actions have been excluded due to the uncertainty regarding their implementation/attainability.

projection to represent structural expenditures. Our structural surplus projection is therefore dependant on spending growth that averages less than 4% in the last four years of the projection period, well below historical rates and the projected (nominal) growth rate of the economy. Further, the projected return to structural surplus is of course also conditional on the Government ensuring that none of the planned stimulus measures become structural. Should some of these measures in fact become structural, all else being equal, this would likely result in structural budget deficits based on PBO estimates presented in Table 4.

Table 4 also shows a cyclical budget deficit of $4.9 billion in 2013-14, which would be consistent with the economy returning to slightly below potential (i.e., almost a zero output gap). Although our updated estimates suggest that the budgetary position remains structurally balanced, the residually determined cyclical balance, which is projected to improve rapidly beyond 2010-11, appears to be inconsistent with our estimates of potential output which suggest that the economy remains well below its potential beyond 2010. Based on the Budget 2009 outlook for real GDP and PBO estimates of potential output, the economy would still be 3.8% to 2.7% below its potential capacity over 2011 to 2013 respectively while the residually-determined estimate of the cyclical balance would essentially vanish by the end of the forecast horizon. Based on the January 2009 PBO projection of cyclical budget balances, this would suggest a cyclical deficit of about $16 billion, which would better reflect the performance of the economy relative to potential.[13] The 'vanishing' cyclical balance implied by the use of the Budget 2009 budgetary balance projection, however could be consistent with a number of explanations (see box below).

Explaining the 'vanishing' cyclical budget balance

First, if the PBO has overestimated potential growth and the output gap is essentially closed by 2013 then the cyclical balance shown in Table 3 would be more consistent with the revised output gap. This however would imply much slower potential output growth (of 1.9% annually, or 0.5 percentage points lower in each year than PBO's assumed growth) and, based on PBO's methodology, would also imply structural budget deficits since underlying revenue growth would be correspondingly significantly lower.

Second, it is possible that we have underestimated the size of the structural budget surplus in the outer years and therefore our residual-based calculations would result in larger cyclical deficits. Based on the above PBO estimate of a $16 billion cyclical deficit in 2013-14 (i.e., more in line with an output gap of -2.7% in 2013), this would imply a structural surplus of approximately $16 billion in 2013-14 based on the Budget 2009 projection of real GDP and our assumed potential growth rate of 2.4%.

Third, it is also possible that the revenue forecasts of the budgetary balance in the outer years in Budget 2009 may be too optimistic. For example, assumptions about corporate profits or other taxable income components of GDP in the outer years may not fully incorporate the negative impact of the economic cycle (i.e., the economy remaining below its potential capacity) and therefore overestimate the taxable income base.

Some combination of the above explanations could reconcile our results or we could have overlooked other potential explanations. In any case, it would be useful for the Department of Finance to publish their detailed Budget 2009 assumptions and projections of the income components of GDP, effective tax rates, estimates of potential output and estimates of structural and cyclical budget balances, to help Canadians better understand the fiscal position of the Government over the upcoming fiscal years.

[13] In PBO's recent pre-budget briefing (http://www2.parl.gc.ca/Sites/PBO-DPB/documents/Pre-Budget_Briefing.pdf) we projected an output gap of 2.2% in 2012 which coincided with a $13.3 billion cyclical deficit in 2012-13.

4. Fiscal Costs and Implementation Risks

Are the fiscal and implementation risks of measures proposed in Budget 2009 adequately characterised?

As discussed above, the impact of the stimulus package in influencing the economic recovery is predicated on the Government's ability to successfully implement the new budget measures. The operational effectiveness of the implicated departments to deliver the new measures and ensure the monies actually reach the recipients in a timely manner is likely the most critical factor in determining the ultimate effectiveness of the stimulus package. As a result, operational implementation of the proposed budget measures would need to be closely monitored. There are a number of factors that will affect the successful implementation of budget measures, including some key indicative factors noted below:

1. Size, nature and scope of the new measures;
2. The requirement for multiple-jurisdictional agreements;
3. Program requirements relative to current administrative structures of implementing departments – for example, time required to hire new people, the putting in place of new policies, procedures and a delivery vehicles;
4. Time required to ensure compliance with due processes, particularly due diligence prior to parliamentary approval of the appropriations through the Main and Supplementary Estimates.

Accountability Framework for Monitoring Budget Implementation

The IMF[14] and the OECD[15] have highlighted the need for monthly and semi-annual reporting for tracking budget implementation. These best practices have noted the need for an accountability framework that provides critical financial disclosures to ensure budget transparency and effective parliamentary oversight of expenditures.

Immediately following the tabling of the 2009 budget, PBO began working on an assessment of the targeted, timely and temporary nature of each of the proposed budget measures. This report will be published in the coming weeks. In addition to this initial assessment, in keeping with the mandate of budget oversight, PBO is prepared to help develop an accountability framework based

[14] IMF Code of Good Practices on Fiscal Transparency (2007).

[15] "The relationship between good governance and better economic and social outcomes is increasingly acknowledged. Transparency – openness about policy intentions, formulation and implementation – is a key element of good governance. The budget is the single most important policy document of governments, where policy objectives are reconciled and implemented in concrete terms. Budget transparency is defined as: the full disclosure of all relevant fiscal information in a timely and systematic manner." - OECD Best Practices for Budget Transparency. "First, not much can happen without information and transparency – timely, accurate, useful information. We mentioned three types of essential information above: disaggregated draft budgets, budget implementation data and audit findings. Information on draft budgets is obviously the first place to start, particularly information below the department level to enable a thorough discussion of departmental expenditures. Beyond this, quality and timely information on budget implementation is critical to help parliament improve the quality and effectiveness of expenditure." - Legislatures and Budget Oversight: Best Practices1 - Warren Krafchik, International Budget Project & Joachim Wehner, London School of Economics.

on OECD best practices to enable parliamentarians to exercise effective oversight of the budget implementation. In achieving this framework the PBO is prepared to develop an accountability framework that factors-in the above as well as the under-mentioned three pillars of OECD best practices.

- Budget reports that should be prepared, including both economic monitoring reports and progress implementation reports
- Specific disclosures that should be made
- Processes that should be in place to ensure their integrity

Questions Parliamentarians may wish to raise with Government Officials

In its pre-budget briefing PBO provided a number of questions for parliamentarians to consider (see Annex 1). Parliamentarians may wish to raise these questions with Government officials in the context of their scrutiny of the Budget 2009 and its implementation.

Annex 1: Key Questions for Parliamentarians to raise with Government Officials[16]

- In the US, a key goal has emerged to save or create 3 million jobs by end of 2010. While this may be difficult to measure in practice, the existence of a stated objective provides a useful lens to assess the impact of proposed policies.

  Is there a single, or set of over-arching fiscal policy objectives that the stimulus package will aim to achieve?

- Prior to the 2009 budget, the Government's fiscal policy framework has been based on a combination of several stated fiscal targets over differing time horizons:
  - *Short-term*: Balanced budgets or better annually;
  - *Medium-term*: 25% federal debt-to-GDP ratio by 2011-12, and non-increasing program spending relative to nominal GDP; and,
  - *Long-term*: Eliminate net total government debt by 2021.

  The fiscal and economic plan outlined in the 2009 budget indicates that, at a minimum, the short- and medium-term targets will not be met. Which of these targets will be reset, or replaced with new policy targets?

- The current economic slowdown is global. As such, there are many external influences beyond the control of Canadian policymakers that will impact Canadian economic growth and fiscal finances. Further, PBO analysis suggests that for the Government to return to a surplus position over the next five years is predicated in part on the Government undertaking contractionary measures (i.e., additional spending restraint and/or increased taxes) which would dampen the effectiveness of automatic fiscal stabilizers while the economy remains well below its potential capacity.

  Does the Government's fiscal plan adequately address the projected weakness in the economy and support a meaningful recovery towards the economy's potential level of activity without limiting the Government's fiscal capacity to respond to future spending pressures arising from population ageing?

[16] PBO's pre-budget briefing is available at http://www2.parl.gc.ca/sites/pbo-dpb/documents/Pre-Budget_Briefing.pdf.