



# **ECONOMIC AND FISCAL UPDATE 2019: ISSUES FOR PARLIAMENTARIANS**



The Parliamentary Budget Officer (PBO) supports Parliament by providing economic and financial analysis for the purposes of raising the quality of parliamentary debate and promoting greater budget transparency and accountability.

To assist parliamentarians in their pre-budget deliberations, this report highlights key issues arising from the Government's Economic and Fiscal Update 2019.

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To assist parliamentarians in their pre-budget deliberations, this report identifies key issues arising from the Government's Economic and Fiscal Update published on 16 December 2019.

### Economic outlook

PBO judges that there is downside risk to the private sector outlook for nominal GDP over 2021 to 2024.

The economic outlook presented in the Economic and Fiscal Update (EFU) is based on Finance Canada's September 2019 survey of private sector forecasters.<sup>1</sup> Table 1 compares the private sector forecast of nominal GDP and PBO's November 2019 projection. Appendix A provides a more detailed comparison to our economic outlook.

**Table 1** Nominal GDP outlook comparison

	2019	2020	2021	2022	2023	2024
<b>Nominal GDP (\$ billions)</b>						
Economic and Fiscal Update	2,304	2,388	2,479	2,574	2,675	2,778
PBO November 2019	2,304	2,380	2,464	2,553	2,647	2,745
	0	8	15	21	28	33

Sources: Finance Canada and Parliamentary Budget Officer.

Note: For comparability, PBO's nominal GDP projection has been restated to reflect Statistics Canada's historical revisions to the Canadian GDP series released on 29 November 2019.

The private sector outlook for nominal GDP is \$21 billion higher per year, on average, over 2020 to 2024 compared to PBO's Economic and Fiscal Outlook (EFO). This reflects PBO's lower projection for GDP inflation in 2020 as well as slower real GDP growth from 2021 to 2024 (Table 2). The latter likely reflects, in part, the private sector outlook for employment growth, which is 0.2 percentage points higher each year, on average, over 2021 to 2024 compared to our November 2019 projection.<sup>2,3</sup>

**Table 2** Real GDP growth outlook comparison

	2019	2020	2021	2022	2023	2024
<b>Real GDP growth (%)</b>						
Economic and Fiscal Update	1.7	1.6	1.8	1.8	1.9	1.9
PBO November 2019	1.7	1.7	1.6	1.6	1.6	1.7
	0.0	-0.1	0.2	0.2	0.3	0.2

Sources: Finance Canada and Parliamentary Budget Officer.

Note: For comparability, PBO's real GDP projection has been restated to reflect Statistics Canada's historical revisions to the Canadian GDP series released on 29 November 2019.

Another possible reason for the difference could be that private sector forecasters project higher potential GDP growth over 2021 to 2024. In addition, over 2021 to 2024, we are projecting higher short- and long-term interest rates (approximately 50 basis points higher on average) compared to the private sector outlook in the EFU.

### Fiscal outlook

When put on a comparable basis, projected budgetary deficits in PBO's November EFO are \$2.6 billion (0.1 per cent of GDP) larger per year, on average, over 2019-20 to 2024-25 compared to the Government's EFU 2019. Incorporating the Government's annual risk adjustment narrows this difference to \$0.1 billion.

**Table 3** Budgetary balance outlook comparison

\$ billions	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024	2024-2025
<b>Budgetary balance in EFU</b>	-26.6	-28.1	-22.1	-18.4	-16.3	-11.6
Policy actions since Budget 2019	4.1	2.5	3.2	4.1	5.0	5.0
Adjustment for risk	1.5	3.0	3.0	3.0	3.0	3.0
<b>(A) EFU budgetary balance, without policy actions and risk adjustment</b>	<b>-21.0</b>	<b>-22.6</b>	<b>-15.9</b>	<b>-11.3</b>	<b>-8.3</b>	<b>-3.6</b>
<b>PBO budget balance in EFO</b>	-21.1	-23.3	-19.0	-14.6	-12.5	-11.1
Policy actions accounted for in EFO	2.5	0.2	0.1	0.1	0.1	0.1
<b>(B) PBO budgetary balance, without policy actions</b>	<b>-18.6</b>	<b>-23.1</b>	<b>-18.9</b>	<b>-14.5</b>	<b>-12.4</b>	<b>-11.0</b>
<b>Forecast differences owing to economic and fiscal factors (A – B)</b>	<b>-2.3</b>	<b>0.5</b>	<b>3.0</b>	<b>3.2</b>	<b>4.1</b>	<b>7.4</b>

Sources: Finance Canada and Parliamentary Budget Officer.

Note: The bottom line of Table 3 contrasts differences in fiscal outlooks owing only to differences between PBO and Finance Canada's economic and fiscal models and assumptions. To make this comparison, PBO has removed from both forecasts all policy actions taken after Budget 2019, as well as the Government's adjustment for risk.

This comparison adjusts for policy actions and the Government's risk adjustment to demonstrate the differences in fiscal outlooks owing only to economic and fiscal forecast differences. PBO's lower outlook for nominal GDP is the key reason for larger medium-term deficits. Our lower outlook for nominal GDP leads to a weaker outlook for tax revenues throughout the forecast horizon.<sup>4</sup>

### The Government's fiscal anchors

The Government has re-affirmed its commitment to reduce the federal debt relative to GDP and PBO will continue to monitor the Government's fiscal outlook relative to this fiscal anchor.

The fiscal outlook presented in EFU 2019 **does not meet** the Government's commitment to reducing debt relative to GDP, as the Government is forecasting a 31.0 per cent debt-to-GDP ratio in 2019-20 and 2020-21, higher than 30.8 per cent in 2018-19. A combination of additional spending restraint, revenue increases or faster economic growth would be needed prior to March 31, 2020 to put the debt-to-GDP ratio on a declining path in 2019-20.

Sustained economic growth and employment gains over the past several years have contributed to higher-than-forecast government revenues. In successive budgets and fiscal updates, the Government has repeatedly used unexpected fiscal space for new measures while maintaining short-term deficits between \$18 and \$28 billion, a range which may act as an implicit fiscal anchor.<sup>5</sup> Deficits in this range permit limited fiscal flexibility in the event of an economic downturn to maintain a declining debt-to-GDP, and limited fiscal room to implement additional electoral commitments in the near term.

### Incomplete information on sources of fiscal savings

EFU 2019 confirms that the Government will launch a comprehensive review of government spending and tax expenditures to generate \$1.5 billion of annual savings starting in 2020-21. No details have been published regarding the process or the criteria that will be used to assess programs, making it difficult to determine the viability of these savings. Parliamentarians may wish to request details on the specific mix of tax policies and operational actions the Government plans to introduce to reach the \$1.5 billion annual target.

### Pensions and other employee future benefit expenses

In EFU 2019, the Government has, for the first time, provided detailed projections for pensions and other employee future benefit expenses. This is an important improvement in fiscal transparency and begins to address an issue PBO has highlighted in past analysis.<sup>6</sup>

The change in presentation has three clear benefits.

- **Added transparency.** By breaking out pensions and other employee future benefit expenses from other operating expenses, the Government details a major driver for operating expenses. Budgets and financial statements are to provide predictive value, which is enhanced if abnormal items (such as actuarial gains or losses) are separately disclosed.<sup>7,8</sup>

- **Delineates costs outside of the Government's control.** Unlike most operating expenses, medium-term pension and other employee future benefit expenses are broadly outside the Government's direct control. These charges are based on predetermined accounting principles, as well as economic and actuarial forecasts. Separating discretionary charges from non-discretionary charges provides parliamentarians with a clearer illustration of how policy changes impact specific expense categories, and hence, the budgetary balance.
- **Preserves historical consistency with key fiscal aggregates.** The presentation in EFU 2019 permits full historical comparability without requiring a historical restatement of program spending, a key category in fiscal analysis. This consistency is important to users of federal financial data doing time-series analysis and comparisons.

Related to these new disclosures, the Government proposed in EFU 2019 to create an *operating balance*, which would separate actuarial gains or losses from program expenses.<sup>9</sup> As discussed above, presenting a distinct projection for actuarial gains or losses is an improvement upon prior presentation. Yet the Government's proposed operating balance meets only the first two benefits of the presentation in EFU 2019 and introduces other potential drawbacks.<sup>10,11</sup>

First, the Government already reports an operating balance defined differently, so introducing an alternative operating balance concept could reduce users' comprehension of federal financial reporting.<sup>12,13</sup> Next, it would require a historical restatement of program expenses and create greater discontinuity between historically restated fiscal aggregates and the corresponding details in historical Public Accounts (not generally restated). Lastly, it risks creating a perception that the Government has engineered a more favourable balance definition, which could possibly undermine the public's confidence in the presentation of the Government's fiscal bottom line.<sup>14</sup>

Irrespective of whether the Government maintains the EFU presentation, or adopts an alternative approach, parliamentarians may wish to ensure that the Government continues to consistently present its forecasts for actuarial gains and losses (and current service costs) in future budgets and updates. Parliamentarians may wish to request that data presented in budget forecasts fully aligns with data reported *ex post* in the Public Accounts.

## Appendix A: Economic and Fiscal Update and PBO economic outlook comparison

% unless otherwise indicated	Projection					
	2019	2020	2021	2022	2023	2024
<b>Real GDP growth</b>						
PBO November 2019*	1.7	1.7	1.6	1.6	1.6	1.7
Economic and Fiscal Update 2019	1.7	1.6	1.8	1.8	1.9	1.9
<b>GDP inflation</b>						
PBO November 2019*	1.8	1.6	2.0	2.0	2.0	2.0
Economic and Fiscal Update 2019	1.9	2.0	2.0	2.0	2.0	2.0
<b>Nominal GDP growth</b>						
PBO November 2019*	3.6	3.3	3.5	3.6	3.7	3.7
Economic and Fiscal Update 2019	3.6	3.7	3.8	3.8	3.9	3.9
<b>Nominal GDP (\$ billions)</b>						
PBO November 2019*	2,304	2,380	2,464	2,553	2,647	2,745
Economic and Fiscal Update 2019	2,304	2,388	2,479	2,574	2,675	2,778
<b>3-month treasury rate</b>						
PBO November 2019	1.7	1.9	2.5	2.5	2.5	2.5
Economic and Fiscal Update 2019	1.6	1.5	1.6	1.9	2.2	2.4
<b>10-year government bond rate</b>						
PBO November 2019	1.7	2.0	3.1	3.3	3.3	3.3
Economic and Fiscal Update 2019	1.5	1.6	2.0	2.4	2.7	3.0
<b>Exchange rate (US\$/C\$)</b>						
PBO November 2019	75.4	75.7	75.7	75.8	76.0	76.0
Economic and Fiscal Update 2019	75.4	76.2	76.6	77.4	78.1	79.3
<b>Unemployment rate</b>						
PBO November 2019	5.7	5.7	5.6	5.5	5.4	5.3
Economic and Fiscal Update 2019	5.7	5.8	5.8	5.8	5.8	5.8
<b>CPI inflation</b>						
PBO November 2019	1.9	1.9	2.0	2.0	2.0	2.0
Economic and Fiscal Update 2019	2.0	2.0	1.9	2.0	2.0	2.0
<b>U.S. real GDP growth</b>						
PBO November 2019	2.3	1.7	1.7	1.8	1.8	1.8
Economic and Fiscal Update 2019	2.3	1.8	1.8	1.8	1.8	1.9
<b>WTI oil price (\$US)</b>						
PBO November 2019	57	55	56	57	58	59
Economic and Fiscal Update 2019	57	57	58	62	64	65

Sources: Statistics Canada, Finance Canada and Parliamentary Budget Officer.

Note: \* For comparability, PBO's projections have been restated to reflect Statistics Canada's historical revisions to the Canadian GDP series released on 29 November 2019.

# Notes

1. See: <https://www.fin.gc.ca/pub/psf-ppsp/2019/2019-09-eng.asp>
2. See: <https://www.fin.gc.ca/pub/psf-ppsp/2019/2019-09-eng.asp>
3. PBO's medium-term projections for employment growth reflect, in part, Statistics Canada's population projections published on 17 September 2019. See: <https://www150.statcan.gc.ca/n1/daily-quotidien/190917/dq190917b-eng.htm>
4. Our higher outlook for interest rates also contributes to our forecast for higher medium-term deficits than in EFU 2019.
5. The reference period includes the one- and two-years ahead budgetary balance outlook from seven budgets and fall updates, beginning with the Fall Economic Statement 2016 up to Economic and Fiscal Update 2019.
6. Past PBO analysis has repeatedly asserted that parliamentarians may wish to request additional data regarding pension and benefit expenses in Finance Canada's forecasts, most recently in our Economic and Fiscal Outlook – April 2019. A more detailed PBO explanation of pension and benefits accounting is available [here](#).
7. See Public Sector Accounting Standard 1000.28 for a more detailed discussion.
8. Expenses arising from actuarial losses are inversely related to movements in interest rates. Current and future rates are much lower than their historical averages and have hence put the medium-term path of federal finances on a flat or declining path despite increases in hiring, transfers and other expense.
9. The proposal does not address current service cost valuation adjustments, which increased spending by \$2.2 billion on average from 2019-20 to 2023-24 in EFU 2019.
10. In the EFU 2019, actuarial gains and losses are presented as a separate expense component *within* program expenses, as has been the longstanding accounting treatment. The alternative proposal would remove actuarial gains and losses from the program expense category in future federal budgets.
11. According to Public Sector Accounting Standard 1100.22, "the benefits expected to arise from providing information in financial statements should exceed the cost of doing so", and "the evaluation of the nature and amount of benefits and costs [to changing financial reporting options] is substantially a judgmental process."
12. As currently, defined: Operating balance = Revenues – Program expenses. See Fiscal Reference Tables – September 2019 – Table 1, <https://www.fin.gc.ca/frt-trf/2019/frt-trf-19-eng.asp>.
13. The terms operating balance and budgetary balance can also be used synonymously depending on the context. If reported side-by-side in the



Summary Statement of Transactions, the operating balance concept may confuse even well-versed readers of public finance data regarding which is the 'true' balance.

14. Although the budgetary balance remains unaffected by the proposal, based on current fiscal projections, the operating balance depicts federal finances as closer to a surplus than the budgetary balance throughout most of the forecast horizon.