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BUREAU DU
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Follow-up Information for the Standing Committee on Finance

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The mandate of the Parliamentary Budget Officer (PBO) is to provide independent analysis to Parliament on the state of the nation's finances, the government's estimates and trends in the Canadian economy; and upon request from a committee or parliamentarian, to estimate the financial cost of any proposal for matters over which Parliament has jurisdiction.

This report provides information requested by the Standing Committee on Finance (FINA) at Meeting No. 85 on October 30, 2012 as well as additional information related to issues raised. PBO would be pleased to meet with members of the Standing Committee on Finance, or any parliamentarians, to further discuss PBO's analysis and provide additional information.

Prepared by: Randall Bartlett and Chris Matier*

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* The authors thank Mostafa Askari, Scott Cameron, Helen Lao and Stephen Tapp for helpful comments. Any errors or omissions are the responsibility of the authors. Please contact Chris Matier (email: chris.matier@parl.gc.ca) for further information.

Overview

This note provides information requested by Mrs. Shelly Glover at the October 30, 2012 meeting of the Standing Committee on Finance (FINA). Specifically, Mrs. Glover requested that PBO provide a comparison of G-7 countries' fiscal structures over the long term, identifying which countries are fiscally sustainable.

Recent fiscal gap[1] estimates (presented below) by the Organisation for Economic Co-operation and Development (OECD) and Alan Auerbach indicate that the fiscal structures of G-7 governments are not sustainable over the long term.

Although PBO's latest fiscal gap estimates[2] indicate that the current federal fiscal structure is sustainable over the long term, its estimates also indicate that the total government sector in Canada (i.e., the combined federal, provincial-territorial and local governments as well as the public pension plans) is not sustainable over the long term. There is, however, a significant difference between PBO's fiscal gap estimate for Canada and the estimates in recent studies, likely reflecting differences in medium-term outlooks, long-term economic and fiscal assumptions, as well as the inclusion of recent policy changes from the Government's 2012 budget. Reconciling the differences in fiscal gap estimates is beyond the scope of this note.

PBO is also providing additional information related to the Chair's (Mr. James Rajotte's) question at the same FINA meeting regarding the recent labour market performance in Newfoundland and Labrador. The additional information provided shows that despite having the largest increase in the employment rate from the third quarter of 2008 to the third quarter of 2012, as well as the strongest employment growth, the employment rate in Newfoundland and Labrador remains the lowest of any province, while the unemployment rate remains the highest – consistent with historical trends.

1 Total Government Sector Results from PBO's 2012 Fiscal Sustainability Report

In its September 2012 Fiscal Sustainability Report (FSR), PBO concluded that the Government of Canada's fiscal structure was sustainable over the long term given recent policy changes.[3] Based on its 75-year projection horizon, PBO estimated that the federal government would have fiscal room amounting to 1.4 per cent of gross domestic product (GDP), that is a fiscal gap of -1.4 per cent, to reduce taxes, increase spending on programs or some combination of both while maintaining fiscal sustainability.

PBO's FSR also provided an assessment of the sustainability of the provincial-territorial-local government and public pension plan sectors. PBO assessed that the fiscal structure of the provincial-territorial-local government sector was not sustainable and estimated that addressing the provincial-territorial-local fiscal gap would require permanent policy actions of 2.0 per cent of GDP. PBO's fiscal gap estimates indicated that the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) were sustainable over the long term, with fiscal room amounting to 0.1 per cent of GDP.

For the government sector as a whole, which is used for cross-country comparisons, PBO's fiscal gap estimates and debt-to-GDP projections indicated that the total government sector was not fiscally sustainable over the long term due to the unsustainable fiscal structure of the provincial-territorial-local government sector. PBO's

[1] The fiscal gap measures the degree to which a government's fiscal structure is not sustainable over the long term. It is calculated as the immediate and permanent change in a government's projected operating balance (i.e., revenue less program spending) relative to GDP that is required to achieve the level of the current debt-to-GDP ratio over the long term.

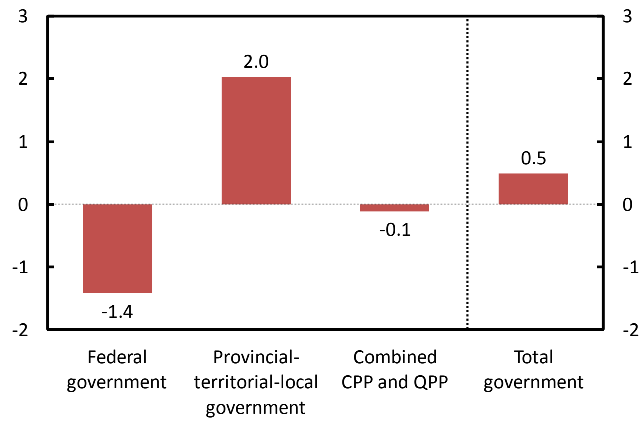
[2] Available at: http://www.pbo-dpb.gc.ca/files/files/FSR_2012.pdf.

[3] Recent policy changes include: the reduction in growth in the Canada Health Transfer (CHT) beyond 2016-17; reductions in direct program expenses; and, the increase in the age of eligibility for the Old Age Security (OAS) program. Long-term fiscal projections prepared by PBO and Finance Canada both indicate that prior to the reduction in the growth of the CHT the federal fiscal structure was not sustainable over the long term and that as a result of this policy change, the federal fiscal structure was rendered sustainable.

estimates indicate that there is a fiscal gap of 0.5 per cent of GDP for the government sector as a whole (Figure 1-1). Thus, if each sector eliminated its fiscal gap accordingly, total government net debt would return to 53.5 per cent of GDP (its 2011 level) in 2086.

Figure 1-1

PBO Fiscal Gap Estimates – 75-year Horizon

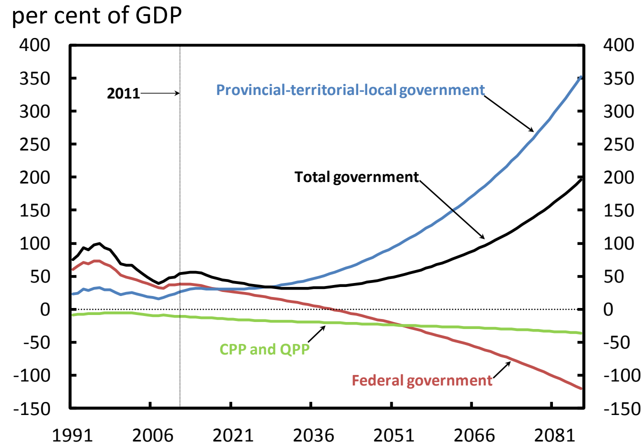


Source: Office of the Parliamentary Budget Officer.

For the total government sector, PBO projected its net debt would first decline from 53.5 per cent of GDP in 2011 to 31.6 per cent in 2033 but then climb steadily, reaching just over 195 per cent of GDP by 2086 (Figure 1-2).

Figure 1-2

Government Sector Net Debt-to-GDP, 1991 to 2086



Sources: Office of the Parliamentary Budget Officer; Statistics Canada.

2 G-7 Fiscal Sustainability Assessments

Given differences in the constitutional allocations of taxation and expenditure powers across G-7 countries, it is appropriate to compare their long-term fiscal positions for the government sector as a whole. PBO has identified recent reports by the OECD[4] and Alan Auerbach[5] that provide estimates of total government fiscal gaps.

OECD Fiscal Gap Estimates

The OECD study calculates fiscal gaps for (illustrative) total government gross and net debt-to-GDP targets in 2050. The long-term projections are built on the OECD's 2011 *Economic Outlook* and take into account the economic and fiscal impacts of population ageing. Table 2-1 summarizes the fiscal gap estimates for G-7 countries presented in the OECD study.

[4] Sutherland, D., P. Hoeller and R. Merola (2012), "Fiscal Consolidation: Part 1. How Much is Needed and How to Reduce Debt to a Prudent Level?", OECD Economics Department Working Papers, No. 932, OECD Publishing. Available at: http://dx.doi.org/10.1787/5k9h28rhqnxt-en.
[5] Auerbach, A.J. (2011), "Long-term fiscal sustainability in major economies", Bank of International Settlement (BIS) Working Papers No. 361. Available at: http://www.bis.org/publ/work361.pdf.

Table 2-1

OECD Fiscal Gap Estimates for G-7 Countries

per cent of GDP

	Gross debt/GDP				Net debt/GDP	
	2007*	**75%**	**50%**	**25%**	**25%**	**0%**
Canada	2.18	2.03	2.52	3.07	1.93	2.46
France	2.69	2.64	3.13	3.69	2.85	3.44
Germany	1.24	1.38	1.79	2.26	1.55	2.05
Italy	0.00	0.00	0.14	0.55	0.07	0.52
Japan	7.63	9.16	9.60	10.06	4.93	5.74
United Kingdom	5.81	5.28	5.75	6.29	5.56	6.15
United States	6.65	6.40	6.90	7.47	6.95	7.59

Source: Sutherland, Hoeller and Merola (2012).
Note : * indicates that for each country the target level is equal to its level of gross debt-to-GDP observed in 2007.

OECD fiscal gap estimates indicate that the fiscal structures of the G-7 countries are not sustainable over the long term, with the exception of Italy for certain gross debt-to-GDP endpoint targets. In all cases considered, OECD estimates show that Canada ranks behind Italy and Germany in terms of having the smallest fiscal gap.

Auerbach (2011) Fiscal Gap Estimates

The study by Auerbach calculates fiscal gaps for total government net debt-to-GDP targets in 2060. For the medium term, Auerbach uses the IMF's April 2011 *World Economic Outlook* projections of revenue and program spending. For the long term, Auerbach constructs projections using IMF estimates of spending on health care and public pensions and for remaining components assumes that they return to their averages (relative to GDP) observed over 2002 to 2007. Table 2-2 summarizes the fiscal gap estimates for G-7 countries presented in the Auerbach study.

Table 2-2

Auerbach (2011) Fiscal Gap Estimates for G-7 Countries

per cent of GDP

	Net debt/GDP	
	2010*	**45%**
Canada	2.52	2.32
France	5.24	5.70
Germany	3.53	3.67
Italy	2.31	3.17
Japan	7.88	9.02
United Kingdom	7.88	8.26
United States	8.05	8.37

Source: Auerbach (2011).
Note : * indicates that for each country the target level is equal to its level of net debt-to-GDP observed in 2010.

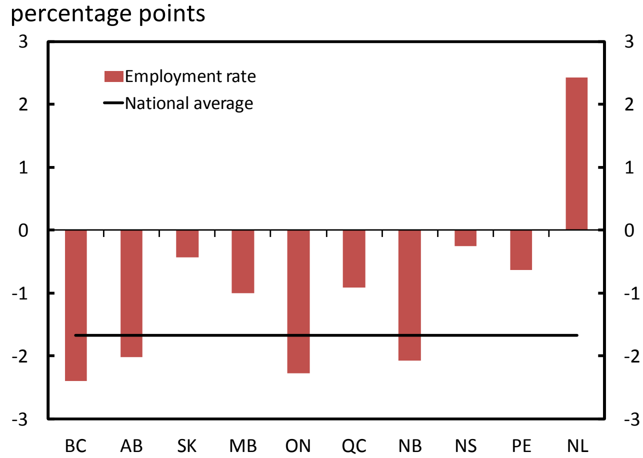
Auerbach's fiscal gap estimates also indicate that the fiscal structures of the G-7 countries are not sustainable over the long term. In the baseline case where the net debt-to-GDP endpoint target is set equal to the 2010 level, Canada ranks behind Italy in terms of the having the smallest fiscal gap. However, in the case where the net debt-to-GDP endpoint target is set equal to 45 per cent, Canada ranks first in terms of having the smallest fiscal gap.

3 Labour Market Performance in Newfoundland and Labrador

Through the 2008-2009 recession and the subsequent recovery, employment conditions have differed across provinces. Newfoundland and Labrador, in particular, has stood out as the only province to currently have a higher employment rate than prior to the recession (Figure 3-1)[6].

Figure 3-1

Change in Provincial Employment Rates, 2008Q3 to 2012Q3

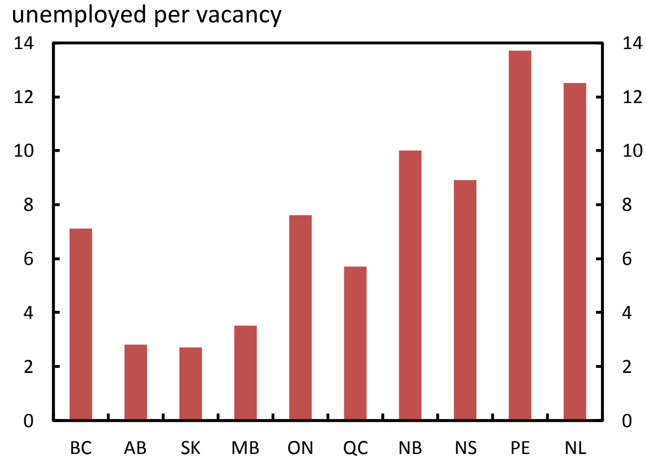


Sources: Office of the Parliamentary Budget Officer; Statistics Canada.
Note: The pre-recession peak is assumed to be 2008Q3 for all provinces, as this was the employment peak nationally.

While the change in the employment rate has been marked in Newfoundland and Labrador, the number of unemployed persons per job vacancy remains elevated (Figure 3-2)[7]. The change in the number of unemployed persons per job vacancy cannot be compared over the period 2008Q3 to 2012Q3 as the *Job Vacancy Survey* began in January 2011.

Figure 3-2

Labour Market Tightness by Province, 2011 Annual Average

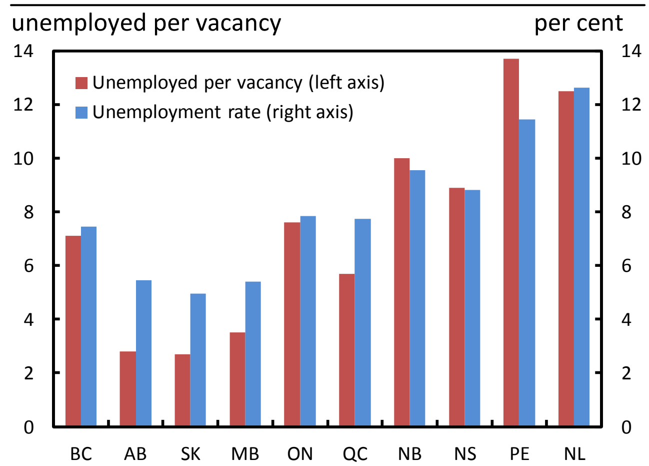


Sources: Office of the Parliamentary Budget Officer; Statistics Canada.

Complementing the number of unemployed persons per job vacancy, the unemployment rate also provides a measure of labour market tightness. As indicated in Figure 3-3, in 2011, these measures of labour market tightness generally show similar results. This is particularly true for Newfoundland and Labrador, which had the highest unemployment rate and the second highest number of unemployed persons per job vacancy among Canadian provinces in 2011.

Figure 3-3

Indicators of Labour Market Tightness by Province, 2011 Annual Average



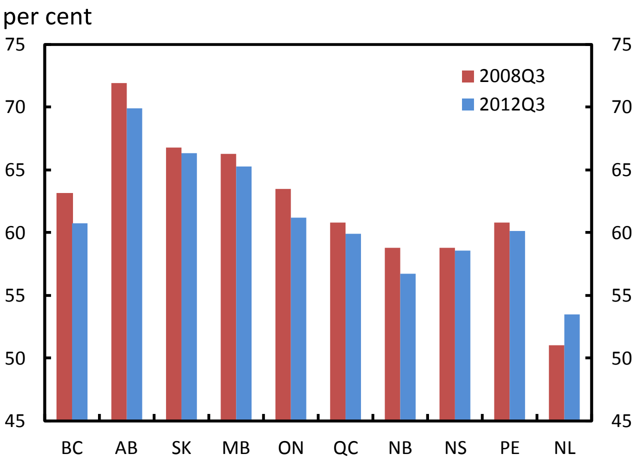
Sources: Office of the Parliamentary Budget Officer; Statistics Canada.

[6] See Figure B-13 in PBO's "An Assessment of Canada's Labour Market Performance". Available at: http://www.pbo-dpb.gc.ca/files/files/Labour_Note_EN.pdf.
[7] See Figure 3-5 in PBO's "An Assessment of Canada's Labour Market Performance".

Despite having the largest increase in the employment rate from 2008Q3 to 2012Q3, as well as the strongest employment growth, the employment rate in Newfoundland and Labrador remains the lowest of any province in Canada (Figure 3-4), while the unemployment rate remains the highest (Figure 3-5).

Figure 3-4

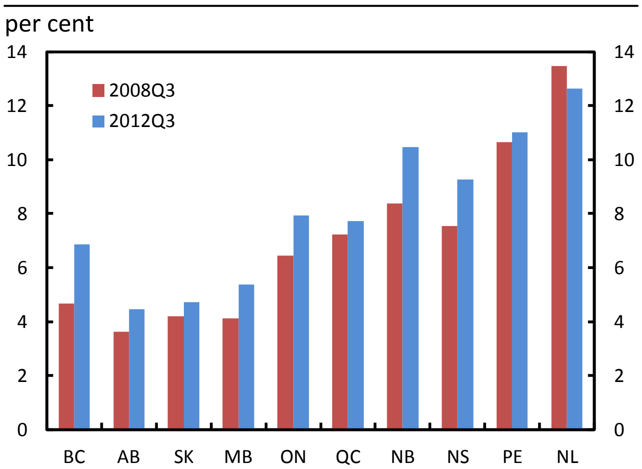
Provincial Employment Rates, 2008Q3 and 2012Q3



Sources: Office of the Parliamentary Budget Officer; Statistics Canada.
Note: The pre-recession peak is assumed to be 2008Q3 for all provinces, as this was the employment peak nationally.

Figure 3-5

Provincial Unemployment Rates, 2008Q3 and 2012Q3

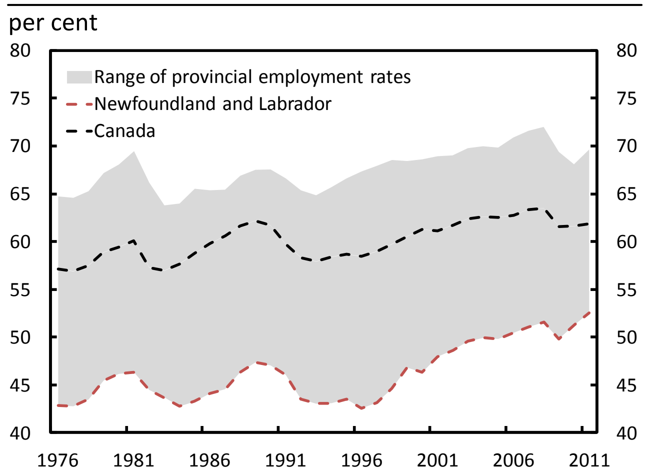


Sources: Office of the Parliamentary Budget Officer; Statistics Canada.
Note: The pre-recession peak is assumed to be 2008Q3 for all provinces, as this was the employment peak nationally.

Newfoundland and Labrador's position relative to other provinces in 2012Q3 is consistent with long-term trends. On an annual basis, the employment rate in Newfoundland and Labrador has been consistently the lowest (Figure 3-6), and the unemployment rate consistently the highest (Figure 3-7), among all provinces over the past 35 years. That said, the difference between the employment and unemployment rates of Newfoundland and Labrador and Canada as a whole in 2011 were at their lowest levels on record (at 9.3 and 5.2 percentage points, respectively).

Figure 3-6

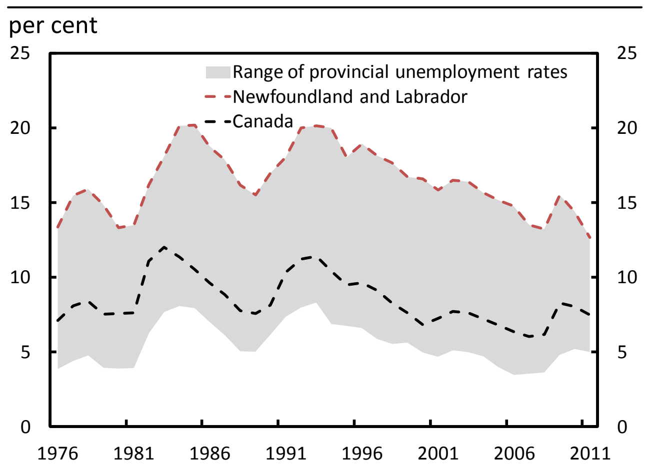
Employment Rates, 1976 to 2011



Sources: Office of the Parliamentary Budget Officer; Statistics Canada.

Figure 3-7

Unemployment Rates, 1976 to 2011



Sources: Office of the Parliamentary Budget Officer; Statistics Canada.