

February 16, 2012

Dear Senators and Members of Parliament,

I would like to take this opportunity to provide you with some additional information regarding recent Parliamentary Budget Officer (PBO) reports in order to enhance your understanding of the concepts and indicators used by the PBO; and, in order to clear up any confusion that may exist surrounding the PBO's assessments of fiscal sustainability that I have provided to you under the PBO's mandate to provide independent analysis on the state of nation's finances and trends in the national economy (*Parliament of Canada Act*, Section 79.2 (a)).

The PBO's analysis is based on widely-used concepts and indicators from the economics literature that are also used by budget offices such as the Congressional Budget Office (CBO) in the United States and the Office for Budget Responsibility (OBR) in the United Kingdom. The PBO regularly updates its analysis to reflect economic developments, policy actions and methodological changes. For example, following the Government of Canada's renewal of the Canada Health Transfer (CHT) announced on December 19, 2011, the PBO updated its September 2011 fiscal sustainability assessment to reflect this change and published its updated analysis on January 12, 2012.<sup>1</sup>

The PBO uses concepts and indicators that – while conventional in the economics literature – may be subject to misinterpretation by individuals without, and with, subject matter expertise. For example, the PBO's November 1, 2011 report<sup>2</sup> projected structural budget deficits over the medium term (to 2016-17) for the Government of Canada yet the PBO assessed the Government of Canada's fiscal structure to be sustainable over the long term in its January 12, 2012 analysis. As discussed below, projected structural budget deficits do not necessarily indicate that a government's fiscal structure is unsustainable over the long term. The PBO strives to explain and define in non-technical terms the concepts and indicators underlying its analysis and conclusions.

There are three topics that I would like to address in more detail:

- 1) The concepts of the structural, or cyclically-adjusted, budget balance and fiscal sustainability;
- 2) The evolution of the PBO's fiscal sustainability analysis; and,
- 3) Improving budget transparency and accountability.

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<sup>1</sup> Available at: [http://www.parl.gc.ca/PBO-DPB/documents/Renewing\\_CHT.pdf](http://www.parl.gc.ca/PBO-DPB/documents/Renewing_CHT.pdf).

<sup>2</sup> Available at: [http://www.parl.gc.ca/PBO-DPB/documents/EFO\\_November\\_2011\\_EN.pdf](http://www.parl.gc.ca/PBO-DPB/documents/EFO_November_2011_EN.pdf).

## 1) The structural (cyclically-adjusted) budget balance and fiscal sustainability

The PBO is committed to providing independent analysis for parliamentarians to enhance their understanding of the state of the nation's finances and trends in the national economy. The PBO uses indicators such as the "output gap" (i.e., gross domestic product (GDP) relative to its potential), the "structural budget balance" and the "fiscal gap" that are based on widely-used concepts in the economics literature and that are used by budget offices such as the CBO and the OBR.

The PBO regularly provides estimates of the Government of Canada's structural (cyclically-adjusted) budget balance, which is typically defined as the budgetary balance that would be observed if the economy were operating at its potential GDP, which itself can be defined as the amount of output that the economy can produce when capital, labour and technology are at their respective trends. An estimate of the structural budget balance helps to provide a *snapshot* of a government's underlying financial situation. Moreover, distinguishing between structural and cyclical components of a government's budget balance is crucial because, while the cyclical component may be expected to dissipate over a medium-term horizon (i.e., typically up to five years) as the economy returns to its potential, the structural component may necessitate policy actions.

The concept of fiscal sustainability is based on the notion that government debt cannot ultimately grow faster than the economy. To assess fiscal sustainability, PBO projects government debt relative to the size of the economy (i.e., the debt-to-GDP ratio) over a long-term horizon (up to 75 years) to ensure that the demographic transition in Canada is fully captured. More specifically, once the economy reaches its potential GDP, PBO assumes that government revenue grows in line with nominal GDP (i.e., that the tax 'burden' is constant); and, that the current structure of spending on programs, relative to nominal GDP, is maintained but adjusted to account for projected changes in the demographic structure of the population as well as assumed program enrichment. Further, PBO provides an estimate of the extent to which the fiscal structure is not sustainable using the fiscal gap, which is measured as the immediate and permanent increase in a government's operating balance (i.e., revenue less program spending) relative to GDP that is required to stabilize the debt-to-GDP ratio over the long term.

It is important to note that projections of structural budget deficits do not mean that a government's budget will *never* return to balance or – necessarily – that its fiscal structure is unsustainable. In the former case, it suggests that policy actions to increase revenue and or reduce program spending would be required to ensure that the budget is balanced once the economy returns to its potential. In the latter case, as the economy remains at its potential over the long term, structural budget deficits may persist even while a government's debt-to-GDP ratio *declines*.<sup>3</sup>

The PBO routinely revises its estimates of the Government of Canada's structural budget balance to reflect revised estimates of the economy's potential output/income, announced policy measures and changes to other assumptions and projections (e.g., public debt charges). The PBO's November 1, 2011 report to the Standing Committee of Finance (FINA) on the economic and fiscal outlook indicated on page iii that "the projected reduction in the budgetary deficit over the period 2011-12 to 2016-17 primarily reflects an improvement in the Government's structural balance." The PBO estimated that the Government of Canada's structural budget deficit, on a Public Accounts basis, would decline from \$25 billion in 2011-12 to \$1.6 billion in 2016-17, largely as a result of the PBO's assumed modest growth in direct program expenses. Further, the PBO cautioned on page iv that:

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<sup>3</sup> Over the long term, persistent structural budgetary deficits that are less than  $[g/(1+g)] \cdot D$  (where  $g$  is the growth of nominal GDP and  $D$  is the amount of government debt) would ensure that a government's debt-to-GDP ratio would continue to decline.

*Although PBO estimates that the Government's structural deficit will essentially be eliminated by the end of the projection horizon [2016-17], assessing whether a government's fiscal structure is sustainable requires looking beyond projections of budgetary deficits and debt over a medium-term horizon to take into account the economic and fiscal implications of population ageing.*

## **2) The evolution of the PBO's fiscal sustainability analysis**

Over the period of time from the publication of the PBO's September 2011 *Fiscal Sustainability Report*<sup>4</sup> (FSR) to the publication of the PBO's February 2012 note *Federal Fiscal Sustainability and Elderly Benefits*<sup>5</sup> the PBO's assessment of the sustainability of the federal fiscal structure changed as a result of the Government of Canada's December 2011 renewal of the federal CHT – no other assumptions or long-term projections underlying the PBO's fiscal sustainability analysis have changed. The PBO's September 2011 FSR was based on the assumption that the federal CHT would continue to grow at 6 per cent annually beyond 2016-17. On December 19, 2011 the Government of Canada announced<sup>6</sup> that starting in 2017-18 the CHT “will grow in line with a three-year moving average of nominal gross domestic product (GDP) growth, with funding guaranteed to increase by at least three per cent per year. Based on long-term trends, it would be expected to grow in the range of four per cent annually.” Following the renewal of the federal CHT, the PBO updated its fiscal sustainability analysis and on January 12, 2012 provided you with the note *Renewing the Canada Health Transfer: Implications for Federal and Provincial-Territorial Fiscal Sustainability*.<sup>7</sup> To quote from page ii of the January 12, 2012 note:

*PBO's updated consolidated federal and provincial-territorial government net debt-to-GDP projection continues to indicate that the overall fiscal structure is not sustainable over the long term given projected demographic and economic trends. ... However, as a result of incorporating the new CHT escalator the fiscal structure at the federal level is now sustainable.*

On February 8, 2012 the PBO published the note *Federal Fiscal Sustainability and Elderly Benefits* that reiterated the updated federal results (published in January) and compared various projections of elderly benefits. The main contribution of the February note was to provide an analytical framework for assessing the sustainability of the federal elderly benefits program. With growth in the federal CHT beyond 2016-17 limited to nominal GDP growth, the PBO estimates that the federal fiscal structure now has sufficient room to absorb the cost pressures arising from the impact of population ageing on the federal elderly benefits program. However, the mirror image of the change to the federal CHT structure is reflected at the provincial-territorial level – the provincial-territorial long-term fiscal situation has deteriorated. It should be noted that the PBO's recent assessment that the consolidated (i.e., combined) federal and provincial-territorial fiscal structure is not sustainable over the long term remains unchanged from its September 2011 *Fiscal Sustainability Report*.

## **3) Improving budget transparency and accountability**

The PBO is committed to supporting Parliament in exercising its oversight role in the Government of Canada's stewardship of public funds by ensuring budget transparency and promoting informed public dialogue. The PBO uses an open and transparent operating model to ensure that its analysis is objective and non-partisan. In the interests of budget transparency and accountability, as the PBO, I would strongly encourage the Government of Canada to publish:

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<sup>4</sup> Available at: [http://www.parl.gc.ca/PBO-DPB/documents/FSR\\_2011.pdf](http://www.parl.gc.ca/PBO-DPB/documents/FSR_2011.pdf).

<sup>5</sup> Available at: [http://www.parl.gc.ca/PBO-DPB/documents/Sustainability\\_OAS.pdf](http://www.parl.gc.ca/PBO-DPB/documents/Sustainability_OAS.pdf).

<sup>6</sup> Available at: [http://www.fin.gc.ca/n11/data/11-141\\_1-eng.asp](http://www.fin.gc.ca/n11/data/11-141_1-eng.asp).

<sup>7</sup> Available at: [http://www.parl.gc.ca/PBO-DPB/documents/Renewing\\_CHT.pdf](http://www.parl.gc.ca/PBO-DPB/documents/Renewing_CHT.pdf).

- Its historical estimates and medium-term projections (i.e., five years ahead) of the economy's potential GDP (income), as well as the methodology and assumptions used;
- Its historical estimates and medium-term projections of the Government of Canada's structural budget balance, as well as the methodology and assumptions used; and,
- The assumptions, projections and methods used to translate the private sector economic forecasts into Finance Canada's fiscal projections.

As the PBO, I would also strongly encourage the Government of Canada to fulfill the commitment it made in Budget 2007<sup>8</sup> to publish a "comprehensive fiscal sustainability and intergenerational report". As noted in Budget 2007, this report would "provide a broad analysis of current and future demographic changes and the implication of these changes for Canada's long-run economic and fiscal outlook".

I would be pleased to discuss with you, and or your staff, in more detail the PBO reports and analysis. PBO staff and I are available to meet at your convenience.

It is an honour and privilege to serve you as the Parliamentary Budget Officer.

Yours truly,

[Signed]

Kevin Page  
Parliamentary Budget Officer

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<sup>8</sup> See p. 155 in *The Budget Plan 2007* available at: <http://www.budget.gc.ca/2007/pdf/bp2007e.pdf>.