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BUREAU DU DIRECTEUR PARLEMENTAIRE DU BUDGET

Fall Economic Statement 2017: Issues for Parliamentarians

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

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Executive Summary

To assist parliamentarians in their pre-budget deliberations, this report identifies key issues arising from the Government's Fall Economic Statement.

The economic outlook

Despite the $30 billion (average) annual upward revision to the private sector outlook for nominal GDP over 2017 to 2021, PBO judges that there remains some upside risk to the private sector outlook for nominal GDP over 2020 to 2022. Compared to the Fall Economic Statement, PBO's projected levels of nominal GDP are, on average, $11 billion (0.4 per cent) higher per year over 2020 to 2022.

The fiscal outlook

PBO is projecting budgetary deficits over 2017-18 to 2022-23 that are $2.2 billion lower, on average, compared to the Fall Economic Statement. This difference is broadly consistent with the Government's adjustment for risk. However, our outlook for the budgetary balance reflects both higher revenues and higher expenses.

Forecast performance

Given the uncertainty surrounding economic and fiscal projections, PBO has often been asked by parliamentarians how its forecast performance compares to Finance Canada.

To provide a high-level assessment of forecast performance, we have calculated average forecast differences for nominal GDP growth and the budgetary balance. On balance, PBO projections are less biased and are as accurate compared to Finance Canada's survey and budget forecasts.

Presentation of the fiscal plan

The Government continues to improve on the transparency and accessibility of its fiscal plan. That said, the Fall Economic Statement omitted the fiscal sensitivities that have been provided in past statements/updates and budget plans. These sensitivities show the impact on the budgetary balance of various economic shocks (that is, shocks to real GDP growth, GDP inflation and interest rates).

Further, the Fall Economic Statement establishes a fiscal provision of $1.9 billion for "future investments in critical programs and services" over 2020-21 to 2022-23. Parliamentarians may wish to seek further detail on these investments.

The Government's fiscal targets

Despite the commitments made by the Government in Budget 2016 to achieving federal debt-to-GDP and balanced-budget targets, the Fall Economic Statement does not mention these targets, nor does it set a timeline for balancing the budget as per the Government's commitment. Parliamentarians may wish to seek additional clarity regarding the status of the Government's fiscal targets and commitments.

Operating expenses

The Fall Economic Statement provisions for increases in operating expenses of 0.8 per cent annually, on average, over 2018-19 to 2022-23. However, collective agreements promise annual wage growth in excess of 0.8 per cent. Parliamentarians may wish to seek further detail on the Government's strategy to manage operating expenses. To better assist parliamentarians, PBO will produce a follow-up report with a more detailed analysis of the Government's operating expenses and its major cost drivers.

1. The economic outlook

The economic outlook presented in the Statement is based on Finance Canada's September 2017 survey of private sector forecasters. Table 1-1 compares the average private sector forecast of nominal GDP and PBO's October 2017 projection. Appendix B in our October Economic and Fiscal Outlook provides a more detailed comparison of the economic outlooks.[1]

Table 1-1 Nominal GDP outlook comparison

	2017	2018	2019	2020	2021	2022
Nominal GDP ($ billions)						
Fall Economic Statement	2,140	2,226	2,302	2,388	2,473	2,568
PBO October 2017	2,140	2,221	2,306	2,395	2,486	2,580
	0	5	-4	-7	-13	-12

Sources: Finance Canada and Parliamentary Budget Officer.

The Fall Economic Statement shows that the private sector outlook for nominal GDP was revised up from Budget 2017 by $30 billion per year, on average, over 2017 to 2021, bringing it closer in line with PBO's outlook. This revision supports PBO's April 2017 risk assessment that there was upside risk to the private sector outlook for nominal GDP in Budget 2017.[2]

That said, PBO judges that there remains some upside risk to the private sector outlook for nominal GDP over 2020 to 2022. Compared to the Fall Economic Statement, PBO's projected levels of nominal GDP are, on average, $11 billion (0.4 per cent) higher per year over 2020 to 2022, reflecting higher projected GDP inflation (2.1 per cent versus 1.9 per cent annually, on average, over 2020 to 2022).

The difference in GDP inflation projections likely reflects differences in views on the outlook for consumer prices. Over 2020 to 2022, PBO projects consumer prices (as measured by the Consumer Price Index (CPI)) to increase by 2.1 per cent annually, on average, compared to 1.9 per cent in the Fall Economic Statement.

In addition, over 2019 to 2022, 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 Fall Economic Statement.

2. The fiscal outlook

PBO is projecting budgetary deficits over 2017-18 to 2022-23 that are $2.2 billion lower, on average, compared to the Fall Economic Statement (Table 2-1). This difference is broadly consistent with the Government's adjustment for risk.

However, our outlook for the budgetary balance reflects both higher revenues (personal income taxes, Employment Insurance premiums and other revenues) and higher expenses (children's benefits, Employment Insurance benefits and public debt charges). Appendix I in our October Economic and Fiscal Outlook provides a more detailed comparison of the fiscal outlooks.

Table 2-1 Budgetary balance comparison

$ billions	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022	2022-2023
Budgetary balance						
PBO (October 2017)	-20.2	-15.5	-14.2	-13.6	-12.5	-9.9
Fall Economic Statement	-19.9	-18.6	-17.3	-16.8	-13.9	-12.5
Difference	-0.3	3.1	3.1	3.2	1.4	2.6
Government's adjustment for risk	1.5	3.0	3.0	3.0	3.0	3.0

Sources: Finance Canada and Parliamentary Budget Officer.

In the Fall Economic Statement risk assessment, the Government judged that "[o]verall the risks to the September 2017 economic outlook appear broadly balanced". Nevertheless, and following the approach in Budget 2017, the Government included an adjustment for risk "to account for risks and uncertainty in the economic and fiscal forecast". In contrast to Budget 2017, the Government states that this adjustment is consistent with "prudent planning purposes". Further, the risk adjustment and changes to it since Budget 2017, as well as the unadjusted budgetary balance, are clearly identified in the Fall Economic Statement.

As PBO noted in its assessment of Budget 2017, this prudent planning approach means that the Government is understating its fiscal outlook with the expectation that fiscal outcomes will exceed its projections. Further, this approach contrasts with adjusting the private sector economic outlook to account for the balance of risks (either to the upside or downside).

The Fall Economic Statement introduced earlier indexation of the Canada Child Benefit and also included estimates of the net fiscal impact of reducing the small business tax rate to 9 per cent. Table 2-2 provides a comparison of Finance Canada and PBO estimates of these measures.

Table 2-2 Comparison of cost estimates

	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022	2022-2023
Earlier indexation of Canada Child Benefit ($ billions)						
PBO	-	0.5	1.2	1.5	1.6	1.6
Fall Economic Statement	-	0.4	1.1	1.3	1.4	1.4
Difference	-	0.1	0.1	0.2	0.2	0.2
Reducing the small business tax to 9 per cent ($ millions)						
PBO	-45	175	610	785	815	840
Fall Economic Statement	-45	90	685	855	655	675
Difference	0	85	-75	-70	160	165

Sources: Finance Canada and Parliamentary Budget Officer.

Note: The fiscal impact of small business tax reduction is shown as a net amount. Over 2019-20 to 2022-23, we estimate that corporate income tax revenues would decrease by $1.3 billion per year, on average. These revenues would be partially offset by $500 million annual increases to personal income taxes, owing to smaller deductions for non-eligible dividend income.

In the Fall Economic Statement, the Government accelerated the indexation of benefit amounts and phase-out thresholds for the Canada Child Benefit (CCB) by two years to July 2018. We estimate that this policy change will increase the fiscal costs of the CCB by $500 million in 2018-19, growing to $1.6 billion by 2022-23, slightly higher than Finance Canada's estimates.

On 16 October 2017 the Government announced the reduction in the small business tax rate to 10 per cent on 1 January 2018 and to 9 per cent on 1 January 2019. We estimate that these changes will increase federal revenues by $45 million in 2017-18 and then reduce them by $0.2 billion in 2018-19 and by $0.8 billion annually, on average, over 2019-20 to 2022-23, somewhat higher than Finance Canada's estimates.

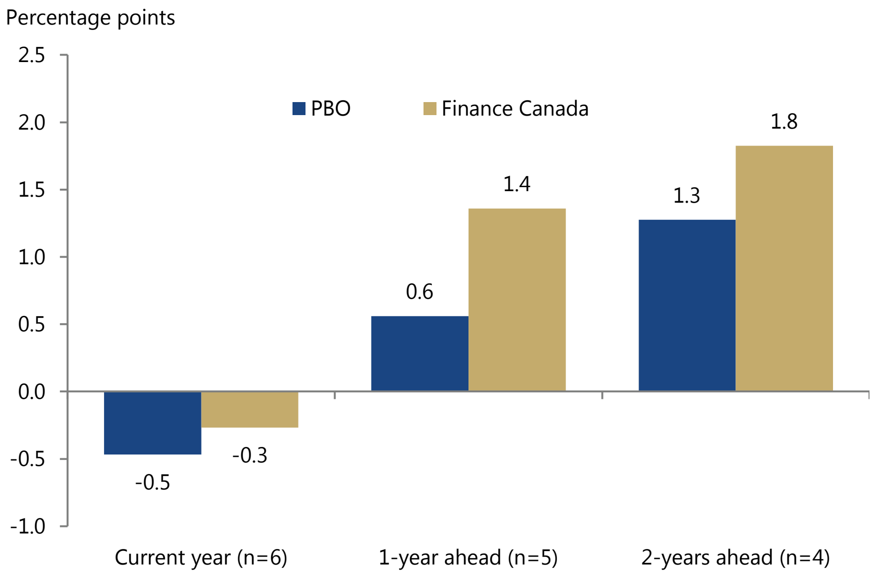
3. Forecast performance

PBO produced its first independent economic projection in June 2011. Prior to its June 2011 projection—and similar to Finance Canada—PBO based its economic outlook on the average private sector forecast from its own survey of forecasters. PBO constructed its own economic projection to enhance its independent analysis of the state of the nation's finances and trends in the national economy.

Given the uncertainty surrounding economic and fiscal projections, PBO has often been asked by parliamentarians how its forecast performance compares to Finance Canada. To provide a high-level assessment of forecast performance, and controlling for timing issues and forecast horizons, we have calculated average forecast differences for nominal GDP growth and the budgetary balance. It is important to note that these indicators are based on a small number of observations and, statistically speaking, the differences observed may not be meaningful. PBO will provide a more detailed evaluation of its forecast performance in a future report.

On balance, our projections of nominal GDP growth over 2011 to 2016 have been less biased compared to the average private sector forecast based on Finance Canada surveys (Figure 3-1).[3] While PBO's current-year projection has tended to underpredict nominal GDP growth to a greater extent than the Finance Canada survey-based forecast, our 1- and 2-year ahead projections have tended to overpredict nominal GDP growth to a lesser extent than the survey forecasts.[4]

Figure 3-1 Average projection errors: nominal GDP growth (2011 to 2016)



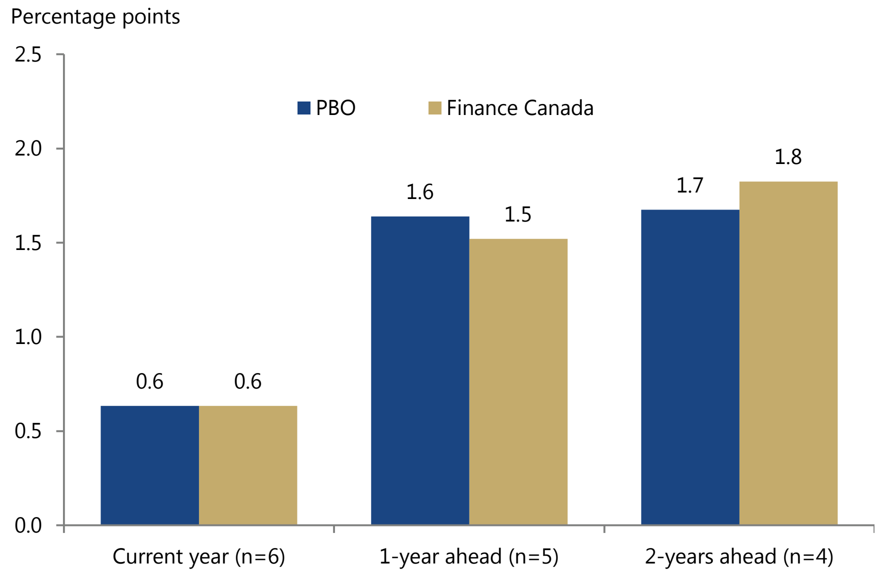
Sources: Finance Canada and Parliamentary Budget Officer.

Note: Projections are based on fall outlook vintages. "n" refers to the number of observations. The current vintage of nominal GDP growth is used for actual values. Projection errors are calculated as the projected value minus the actual value.

On balance, the accuracy (as measured by average absolute projection errors[5]) of our nominal GDP growth projections over 2011 to 2016 has been in line with the average private sector forecast based on Finance Canada surveys (Figure 3-2).

Figure 3-2

Average absolute projection errors: nominal GDP growth (2011 to 2016)



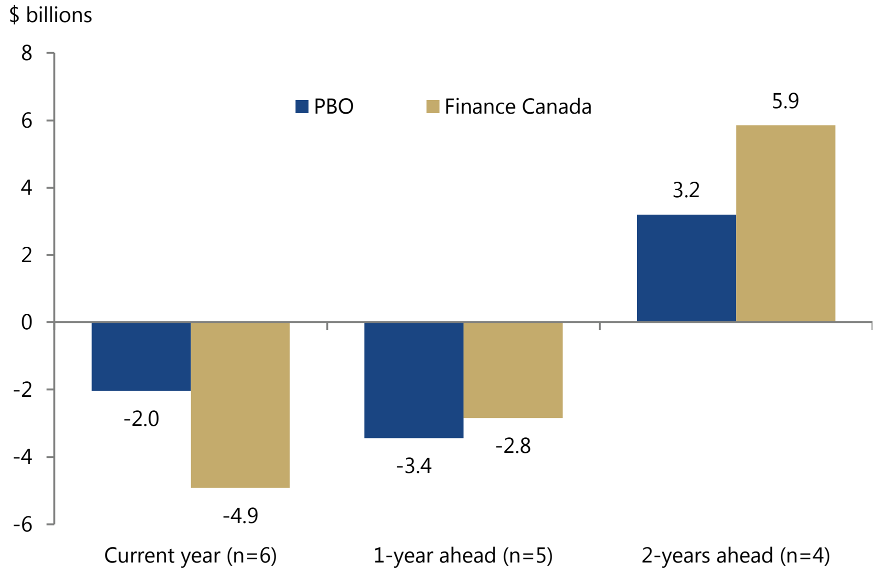
Sources: Finance Canada and Parliamentary Budget Officer.

Note: Projections are based on fall outlook vintages. “n” refers to the number of observations. The current vintage of nominal GDP growth is used for actual values. Projection errors are calculated as the projected value minus the actual value.

On balance, our projections of the budgetary balance over 2011-12 to 2016-17 have been less biased compared to Finance Canada forecasts (Figure 3-3). Both PBO and Finance Canada have tended to underpredict the budgetary balance in the current year and 1 year ahead but have overpredicted the budgetary balance 2 years ahead.[6]

Figure 3-3

Average projection errors: budgetary balance (2011-12 to 2016-17)



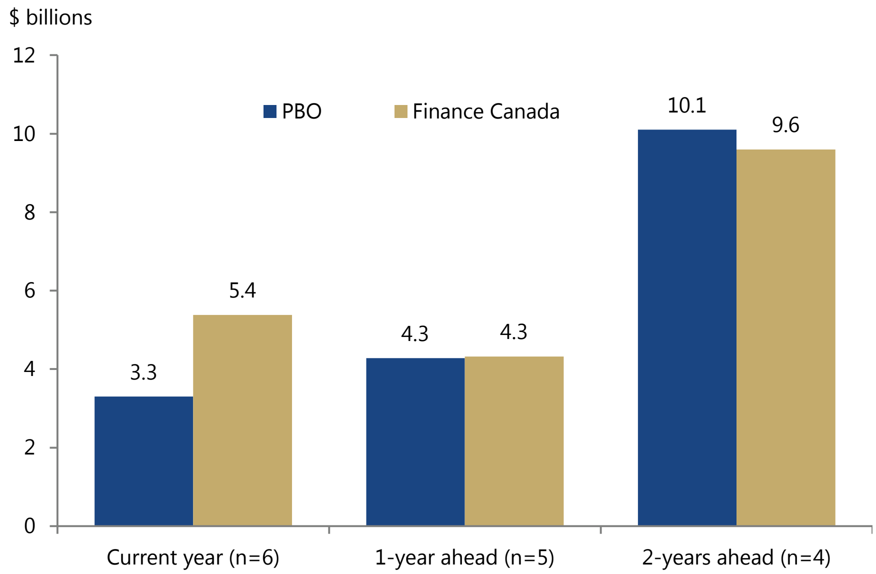
Sources: Finance Canada and Parliamentary Budget Officer.

Note: Projections are based on budget and April PBO outlooks. "n" refers to the number of observations. Projection errors are calculated as the projected value minus the actual value (unadjusted for new policy measures). Risk adjustments have been removed from the Government's budget projections.

On balance, the accuracy (as measured by average absolute projection errors) of our projections of the budgetary balance over 2011-12 to 2016-17 has been in line with Finance Canada's projections (Figure 3-4).

Figure 3-4

Average absolute projection errors: budgetary balance (2011-12 to 2016-17)



Sources: Finance Canada and Parliamentary Budget Officer.

Note: Projections are based on budget and April PBO outlooks. "n" refers to the number of observations. Projection errors are calculated as the projected value minus the actual value (unadjusted for new policy measures). Risk adjustments have been removed from the Government's budget projections.

4. Presentation of the fiscal plan

The Government continues to improve on the transparency and accessibility of its fiscal plan. For example, the Fall Economic Statement detailed economic and fiscal developments by budgetary component (see Table A1.2). In addition, the fiscal impact of future non-announced measures related to Transport Canada funding (in aggregate), amounting to $2.9 billion over 2017-18 to 2022-23, is identified in Table A1.3.

That said, the Fall Economic Statement omitted the fiscal sensitivities that have been provided in past statements/updates and budget plans. These sensitivities show the impact on the budgetary balance of various economic shocks (that is, shocks to real GDP growth, GDP inflation and interest rates).

Further, the Fall Economic Statement establishes a fiscal provision of $1.9 billion for “future investments in critical programs and services” over 2020-21 to 2022-23. Parliamentarians may wish to seek further detail on these investments.

5. The Government’s fiscal targets

In Budget 2016, the Government committed to achieving two fiscal targets, namely:

i. to reducing the federal debt-to-GDP ratio to a lower level over a five-year period, ending in 2020-21.

ii. to returning to balanced budgets.

Given the audited financial results for 2015-16 and Statistics Canada’s current estimate of nominal GDP in 2015, the first fiscal target translates into a federal debt-to-GDP ratio of 31.0 per cent, or lower, in 2020-21. Based on the Government’s forecast provided in the Fall Economic Statement, the federal debt-to-GDP ratio in 2020-21 will be 29.5 per cent of GDP.

Despite the commitment made in Budget 2016, the Fall Economic Statement does not mention the Government’s debt-to-GDP target.

In terms of the balanced-budget target, in Budget 2016, the Government committed to “set a timeline for balancing the budget when growth is forecast to remain on a sustainably higher track”. However, the Fall Economic Statement does not mention the balanced-budget target, nor does it set a timeline for balancing the budget, contrary to the Government’s commitment in Budget 2016 to set such a timeline.

Parliamentarians may wish to seek additional clarity regarding the status of the Government’s fiscal targets and commitments.

6. Operating expenses

Lower operating expenses account for most of the reduction in the budgetary deficit over the medium term. The Fall Economic Statement provisions for increases in operating expenses of 0.8 per cent annually, on average, over 2018-19 to 2022-23, which is lower than projected inflation.[7] Moreover, collective agreements promise annual wage growth in excess of

0.8 per cent, so other sources of savings must underpin the Government's forecast of operating expenses.

The sources of planned consolidation in direct program expenditure (which includes operating expenses) have not been fully demonstrated. In Budget 2017, the Government highlighted plans for comprehensive reviews of inefficient, wasteful and obsolete government initiatives but additional detail on these plans has not been made public.

Parliamentarians may wish to seek further detail on the Government's strategy to manage operating expenses. To better assist parliamentarians, PBO will produce a follow-up report with a more detailed analysis of the Government's operating expenses and its major cost drivers.

Notes

1. Available at: http://www.pbo-dpb.gc.ca/en/blog/news/EFO_Oct_2017.
2. In its April 2017 assessment of the economic outlook in Budget 2017, PBO indicated to parliamentarians that there was upside risk to the private sector outlook for nominal GDP (available at: http://www.pbo-dpb.gc.ca/en/blog/news/EFO_April_2017). We noted that PBO's projected levels of nominal GDP were, on average, $34 billion higher per year over 2017 to 2021 compared to the Budget 2017 private sector outlook.
3. Average projection errors indicate the extent to which a projection is biased, that is, there is a tendency to overpredict or underpredict. Unbiased projections would have an average projection error of zero.
4. The current-year projection of nominal GDP growth corresponds to the same calendar year in which the projection was made. For example, the current-year projections of nominal GDP growth in 2011 are taken from PBO's October 2011 outlook and Finance Canada's September 2011 survey of private sector forecasters. The 1- and 2-year ahead projections from those outlooks correspond to nominal GDP growth in 2012 and 2013 respectively.
5. Absolute projection errors are calculated by taking the absolute value of the projection error. The average absolute projection error represents the average size or magnitude of the projection error, without regard to the direction of the error.
6. The current-year projection of the budgetary balance corresponds to the fiscal year ending at the time of the budget. For example, the current-year projections of the budgetary balance for 2011-12 are taken from PBO's April 2012 Economic and Fiscal Outlook and Budget 2012. The 1- and 2-year ahead projections from those outlooks correspond to the budgetary balance for 2012-13 and 2013-14 respectively.
7. Based on Finance Canada's September 2017 survey of private sector forecasters, over 2018 to 2022, CPI inflation is projected to average 1.9 per cent annually.