



TD Economics

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PEERING INTO THE CONSERVATIVE'S FISCAL PLAN: MORE SPENDING RESTRAINT REQUIRED THAN YOU MIGHT THINK

Conservative Platform Assumed Internal Spending Savings

Most of the emphasis in the Conservative Party's campaign document "Stand Up for Canada" was on initiatives they would introduce to cut taxes and raise spending in certain areas. TD Economics commented on these initiatives and overall federal fiscal prospects in a Special Report "Outlook for Federal Fiscal Policy", February 15, 2006 (available at www.td.com/economics). The campaign document is transparent that in order to achieve the Party's fiscal objectives, a 5-year cumulative total savings of \$22.5 billion would be required by lowering spending on grants and contributions and operating budgets of government departments and agencies relative to the track the previous Liberal Government had planned. This was to be on top of the \$6.8 billion cumulative 5-year savings from reallocating money out of the climate change fund and from the Liberal child care plan. "Stand Up for Canada" gave little indication how the savings from departmental budgets would be achieved and there has been almost no public attention to this aspect of the Conserva-

tive plan. This note attempts to put the required internal spending savings into perspective. The conclusion is that the savings required are heroic, far surpassing what was identified by the Expenditure Review Committee for the 2005 Budget but more modest than that of the watershed Program Review in the 1995 Budget.

The Conservative Plan did not specify an annual pattern for the cumulative \$22.5 billion savings in spending and there is not enough information to calculate it with precision. For the purpose of this note, we have made a guesstimate on the annual figures that come to this total. To put the savings into context, we have compared them to the total spending set in the November 2005 Economic & Fiscal Update for "direct program spending" (excluding the Liberal's new initiatives). This essentially matches the base from which the Conservative document says the internal spending savings are to be realized. It is the aggregate of departmental spending on grants and contributions and operating budgets. From another perspective, it is total government spending excluding direct transfers to individuals (such as Old Age Security and Employment

TABLE 1
REQUIRED SPENDING SURVEYS IN THE CONSERVATIVE FISCAL PLAN
(\$ Millions)

	2006-07	2007-08	2008-09	2009-10	2010-11	5 Year Total
Direct Program Spending	82755	86285	90335	93810	97350	450535
Spending Savings	2000	3000	4250	5750	7500	22500
Savings as % of Direct Program Spending	2.4	3.5	4.7	6.1	7.7	5.0
Direct Program Spending in Areas to be cut (75% of Total)	62066	64714	67751	70358	73013	337902
Savings as % of Direct Program Spending in Areas to be Cut	3.2	4.6	6.3	8.2	10.3	6.7

Source: TD Economics

Insurance Benefits), direct transfers to other levels of governments (such as the Canada Health Transfer and equalization) and interest on the public debt.

The Required Savings are Large Relative to the Spending Base

Over the 5-year period, the savings are 5 per cent of direct program spending, although by 2010-11 they amount to 7.7 per cent. This certainly seems large, but is not heroic. The perspective that direct program spending after the cuts is intended to grow along with population and inflation (in other words, to grow at around 3 per cent per year and hence be constant in real, per capita terms) similarly suggests the spending regime need not be terribly draconian. Yet there are a number of areas where the Conservatives will increase departmental spending. This has 2 ramifications. First, as some departments will see their spending rise faster than inflation and population, the budget of other departments will have to decline in real, per capita terms. Second, given the priority to increase some budgets, the pot from which spending can be cut is considerably smaller than the total direct program spending under the Liberal's fall 2005 Update. In other words, Departments that are to receive net increases in their budgets cannot be considered as areas to be cut. The budgets of defence, international assistance, Indian & Northern Affairs, Agriculture and the RCMP are to be increased. The Climate Change Fund is already tapped to be reduced to finance the promised tax credit for transit users and commitments have been made to protect other areas of the budget, such as certain infrastructure programs. We have calculated that at least 25 per cent of direct program spending will be off limits from the spending slashers given the various other campaign promises that have been made. So in Table 1 we also show the required savings as a portion of 75 per cent of direct program spending. Now the savings are 6.7 per cent of the relevant base on average over the 5 years and just over 10 per cent by the fifth year. The noose tightens.

Conservative Savings Would be Larger than Liberals Expenditure Review Committee

We now put these required savings into the context of 2 previous cost-cutting exercises. For the 2005 Budget, the Liberal's Expenditure Review Committee identified \$10.9 billion of savings over a cumulative 5 year period. Almost all areas of direct program spending were tapped.

The savings targets of the Conservative Government is more than double what the Expenditure Review Committee achieved and the base to extract savings from is narrower. Clearly the Conservatives have the more difficult task. Further, the Liberals already implemented many of the "painless" cuts such as efficiencies in procurement.

Conservative Savings Would Still Fall Short of Program Review

The Program Review for the 1995 Budget is considered a watershed event in Canadian fiscal policy for the magnitude of savings, the breadth of savings and the fact it went way beyond simply slowing the growth rate of program spending, but drove the actual levels down. This has been the rarest of occurrences in any country outside of post-war experiences. Yet much of the savings from Program Review came out of the major statutory payments such as Employment Insurance and transfers to the provinces. As these are off limits for the Conservative's exercise, we need to examine the Program Review results for direct program spending only. Program Review extracted savings from virtually all areas of the \$52 billion (65 billion in today's dollars) that comprised total program spending excluding the major statutory programs.

Table 2 summarizes the results from Program Review for direct program spending. On average over the first 3 years, the savings from Program Review were 10.9 per cent of direct program spending. So clearly that exercise went deeper than the Conservatives will need to. It must be remembered that Program Review was not just a simple exercise of nips and tucks to departmental budgets. Much of the savings came about through transformational changes in government. For example, the relatively small Transportation budget accounted for 15 per cent of all direct program savings as subsidies under the Western Grain Transportation Act, the Atlantic Region Freight Assistance

TABLE 2
1995 PROGRAM REVIEW SAVINGS FROM
DIRECT SPENDING PROGRAM
(\$ Millions)

	1995-96	1996-97	1997-98	3 Year Total
Savings - 1995 \$	3867	5869	7217	16953
(-2006 \$)	(4810)	(7300)	(8975)	(21085)
% of Direct Program Spending	7.4	11.3	13.9	10.9

Source: TD Economics

Act and the Maritime Freight Rates Act were scrapped. A heavy upfront price for transitional assistance was paid to end these subsidies and that cost is not netted against the savings in Table 2. In total, including personnel downsizing, restructuring charges of \$2.6 billion were booked against 1994-95. Further, a good number of the Program Review cuts did not materialize or were reversed in subsequent years.

Conservatives Must Find the Savings to have Budget Flexibility

The conclusion from this analysis is that it will be a difficult, but not unprecedented exercise, to generate the internal spending savings the Conservatives need to achieve their fiscal plan. No doubt the new Government is seized with this issue internally. It may appear from the plan that there is some wiggle room if the full extent of the assumed savings is not realized. After all, on top of the \$3 billion annual contingency reserve, the plan does show a surplus remaining of \$1.7 billion in 2006-07 and roughly \$5 billion per year thereafter. But there are many pressures against these sums. To name just a few:

- Nothing was allocated in the plan against the commitment to address the (federal-provincial) “fiscal imbalance”;
- Nothing was allocated to reduce “waiting times” in healthcare;
- Transitional funding has now been promised to the provinces through 2006-07 before the Liberal’s daycare scheme is scrapped;
- It seems to us that the cost of the proposal to defer capital gains taxation on investment roll-overs has been grossly understated;
- It is certainly possible that the elimination of the Liberal’s personal income tax cuts might not kick in as

early as January 2006 because that would mean that personal income taxation would go up before the GST rate cut could kick in;

- The Conservative Plan underestimates the cost of cutting the GST by almost \$500 million per percentage point (as they do not plan to cut the GST low-income credit, the cost per point is one-seventh of gross GST collections whereas the cost in the Plan seems to have been derived by taking one-seventh of net collections – in other words, after netting the low-income credit); and
- Unlike the Liberal’s Budgets, no amounts have been set aside in the Conservative Plan for “economic prudence”.

If the Conservatives want to maintain flexibility to act on these remaining commitments and pressures, they will need to secure at least the internal spending savings assumed.

Hard to Imagine the Savings Being Identified by a Spring Budget

Looking at the assumed savings in the context of the pot that can be trimmed and putting the exercise into the context of the previous 2 rounds of expenditure cuts makes it clear that savings of the magnitude identified in the Conservative Plan will not be easy to secure. It will certainly take more time than is available before the first Conservative Budget, which we believe is likely to be in mid-to-late April. That suggests that this budget will either plug in the assumed savings without identifying details, or the budget will only have a short timeframe, perhaps 2 years rather than the tradition in recent years of extending to 5 years.

*Don Drummond, SVP & Chief Economist
416-982-2556*