

# THE 2006 FEDERAL BUDGET: A QUANTITATIVE APPRAISAL

By Peter Dungan  
Steve Murphy  
Tom Wilson

Institute for Policy Analysis, University of Toronto

## **Separating the Fiscal Impacts of Budget 2006 from the Fiscal Impacts of the November 2005 Update**

- The documentation in Budget Plan 2006 includes most of the fiscal changes proposed last November (and earlier).
- Table 1 provides estimates of total fiscal changes since Budget 2005 (as laid out in Budget Plan 2006) and our estimates of the fiscal impacts of the new measures introduced in the 2006 budget.

**Table 1. Budget Plan 2006 and Net Impacts of New Measures (\$ Millions) - Public Accounts Basis**

<b>REVENUES</b>	<b>Budget Plan 2006</b>			<b>New Measures</b>		
	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>
<b>Total PIT</b>	4,965	5,150	5,110	-140	280	330
<b>Total Sales and Excise</b>	0	3,580	5,225	0	3,580	5,225
<b>Total Business measures</b>	0	1,080	620	-230	500	375
<b>Total Other Revenues</b>	0	134	90	0	134	90
<b>TOTAL REVENUE CHANGES</b>	<b>4,965</b>	<b>9,944</b>	<b>11,045</b>	<b>-370</b>	<b>4,494</b>	<b>6,020</b>

**Table 1. Budget Plan 2006 and Net Impacts of New Measures (\$ Millions) - Public Accounts Basis (cont'd)**

<b>EXPENDITURES</b>	<b>Budget Plan 2006</b>			<b>New Measures</b>		
	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>
<b>Total Transfers to Persons</b>	0	1,857	2,832	0	1,482	2,318
<b>Total Transfers to Non-Residents</b>	320	0	0	320	0	0
<b>Total Transfers to OLG</b>	3,300	880	21	3,300	880	21
<b>Total Subsidies</b>	755	1,703	703	755	1,700	700
<b>Total Goods and Services</b>	1,400	805	1,547	-2,092	-1,954	-1,683
<b>TOTAL EXPENDITURE CHANGES</b>	<b>5,775</b>	<b>5,245</b>	<b>5,103</b>	<b>2,283</b>	<b>2,108</b>	<b>1,356</b>
<b>TOTAL BUDGET BALANCE IMPACT</b>	<b>10,740</b>	<b>15,189</b>	<b>16,148</b>	<b>1,913</b>	<b>6,602</b>	<b>7,376</b>

- As is apparent the fiscal impacts of the fiscal initiatives introduced in the 2006 budget are substantially smaller than the fiscal impacts presented in Budget Plan 2006.
- On the revenue side, Table 1 shows that the only new major tax cut is the 1% point reduction in the GST.
- The \$5.2 billion reduction in sales tax revenues is accompanied by some small net reduction in PIT and business tax revenues, with an overall revenue reduction of \$6.0 billion.
- On the spending side, identifying the new initiatives introduced reveals that there is a net reduction in federal spending on goods and services.
- However there are significant increases in transfers to persons and transfers to the provinces; As a result overall program spending increases by \$ 2.1 billion in 2006-7 and by \$1.4 billion in 2007-08.
- Taking into account both sides of the budget, Budget 2006 is stimulative, with a net fiscal impact of \$6.6 billion in 2006-7 and \$7.4 billion in 2007-8.
- Table 2 provides our allocation of the various fiscal measures on a national accounts basis. The main change involves the allocation of spending pre-booked to fiscal 2005-6, but to be spent in 2006-7.

**Table 2. Net Impacts of New Measures (\$ Millions) - National Accounts Basis**

**REVENUES**

	<b>2006-07</b>	<b>2007-08</b>
<b>Total PIT</b>	140	330
<b>Total Sales and Excise</b>	3,580	5,225
<b>Total Business measures</b>	270	375
<b>Total Other Revenues</b>	134	90
<b>TOTAL REVENUE CHANGES</b>	<b>4,124</b>	<b>6,020</b>

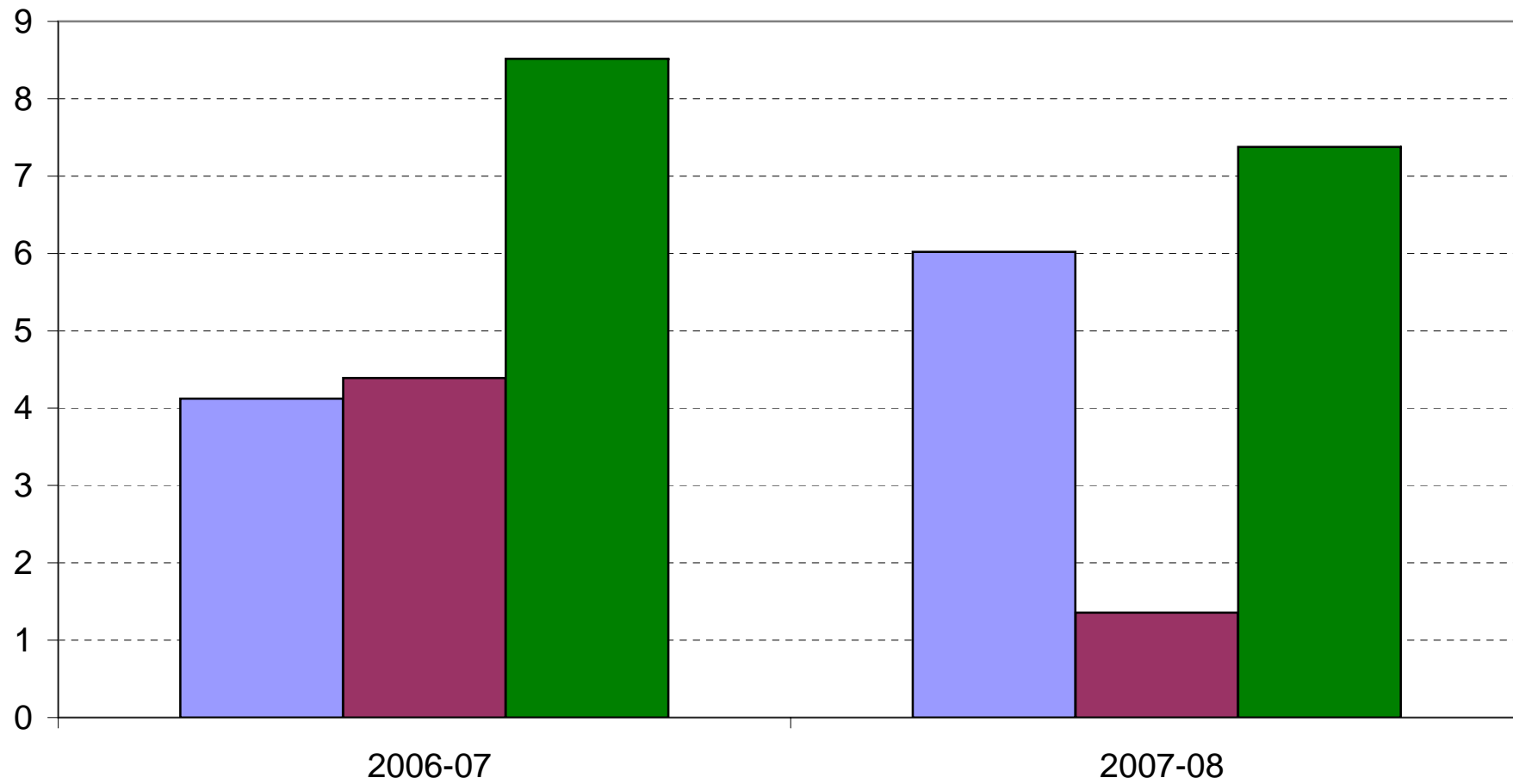
**Table 2. Net Impacts of New Measures (\$ Millions) - National Accounts Basis (cont'd)**

**EXPENDITURES**

	<b>2006-07</b>	<b>2007-08</b>
<b>Total Transfers to Persons</b>	1,482	2,318
<b>Total Transfers to Non-Residents</b>	320	0
<b>Total Transfers to OLG</b>	4,180	21
<b>Total Subsidies</b>	2,455	700
<b>Total Goods and Services</b>	-5,446	-1,683
<b>TOTAL EXPENDITURE CHANGES</b>	<b>4,391</b>	<b>1,356</b>
<b>TOTAL BUDGET BALANCE IMPACT</b>	<b>8,515</b>	<b>7,376</b>

**Chart 1**  
**2006 Budget - Net Impacts of New Measures**

\$ Billions



■ Total Revenue Impact ■ Total Expenditure Impact ■ Budget Balance Impact



## **Modeling the Economic and Fiscal Effects of the 2006 Budget**

- With the exception of the GST rate cut all of the budget measures are implemented in the FOCUS macro-econometric model by changes to exogenous variables, or by add factors to revenue equations.
- The Provincial/Local spending response is spread out over the two fiscal years.
- The model was initially solved with no Bank of Canada reaction.
- Note that as the GST cut accounts for a significant part of the net fiscal stimulus, the budget generates a favourable supply price shock which tends to reduce prices initially.

## Model Simulation Results

### Table 3. Economic and Fiscal Effects of the 2006 Federal Budget

(Impacts are percentage changes unless otherwise indicated)

	2006(F)	2007(F)
Real Output and Components		
Real Gross Domestic Product	0.26	1.11
Consumption	0.53	1.52
Government	-0.48	-0.02
Residential Construction	0.27	1.99
Non-Residential Construction	0.07	0.57
Machinery and Equipment	0.02	0.68
Exports	0.06	0.22
Imports	0.00	0.35

## Model Simulation Results

**Table 3. Economic and Fiscal Effects of the 2006 Federal Budget (cont'd)**

(Impacts are percentage changes unless otherwise indicated)

	2006(F)	2007(F)
<b>Prices, Wages and Unemployment</b>		
Implicit Deflator for GDP	-0.38	-0.53
Consumer Price Index	-0.48	-0.65
CPI - Inflation Rate (% Points)	-0.48	-0.18
Average Wage	-0.15	-0.02
Unemployment Rate (% Pts)	-0.11	-0.57
<b>Interest Rates and Exchange Rate</b>		
90-day Paper Rate (% Pts)	0.01	0.08
Exchange Rate (US\$/C\$)	-0.15	-0.37

## Model Simulation Results

**Table 3. Economic and Fiscal Effects of the 2006 Federal Budget (cont'd)**

(Impacts are percentage changes unless otherwise indicated)

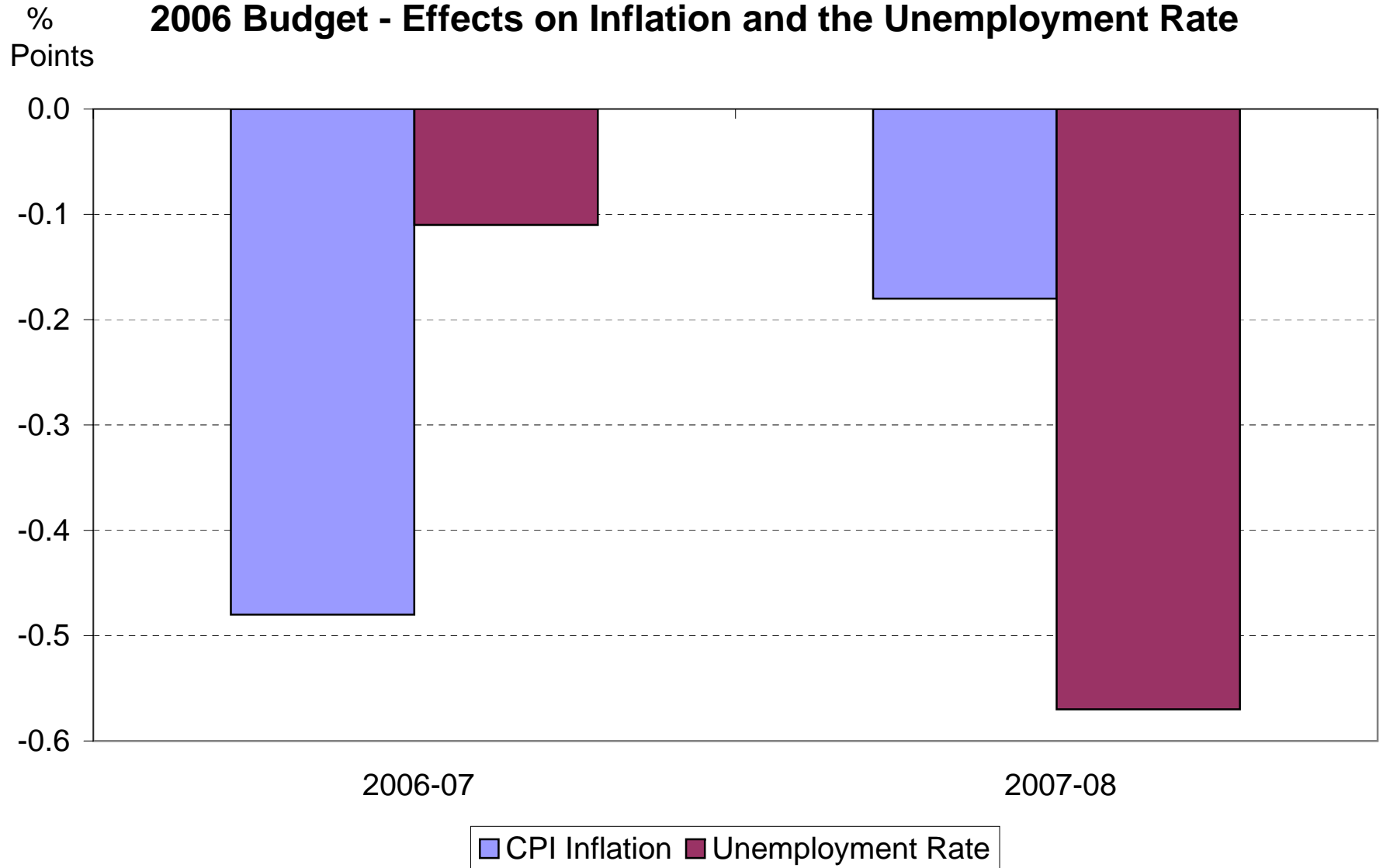
	2006(F)	2007(F)
Government Fiscal		
Federal Balance(\$ Bill)	-8.42	-4.52
Ratio of Federal Debt to GDP (% Pts)	0.38	0.59
OLG Balance (\$ Bill)	2.68	2.26

## **Model Simulation results**

- If there were no monetary policy adjustment, the model results indicate that the 2006 Budget would stimulate real aggregate demand, while reducing prices.
- Real GDP would increase by 0.3 percent in 2006-7 and by 1.1 percent in 2007-8.
- CPI inflation would be lowered by 0.5 percentage points in the current fiscal year and by a further 0.2 percentage points in 2007-8.
- The unemployment rate would be reduced by 0.6 percentage points by 2007-8

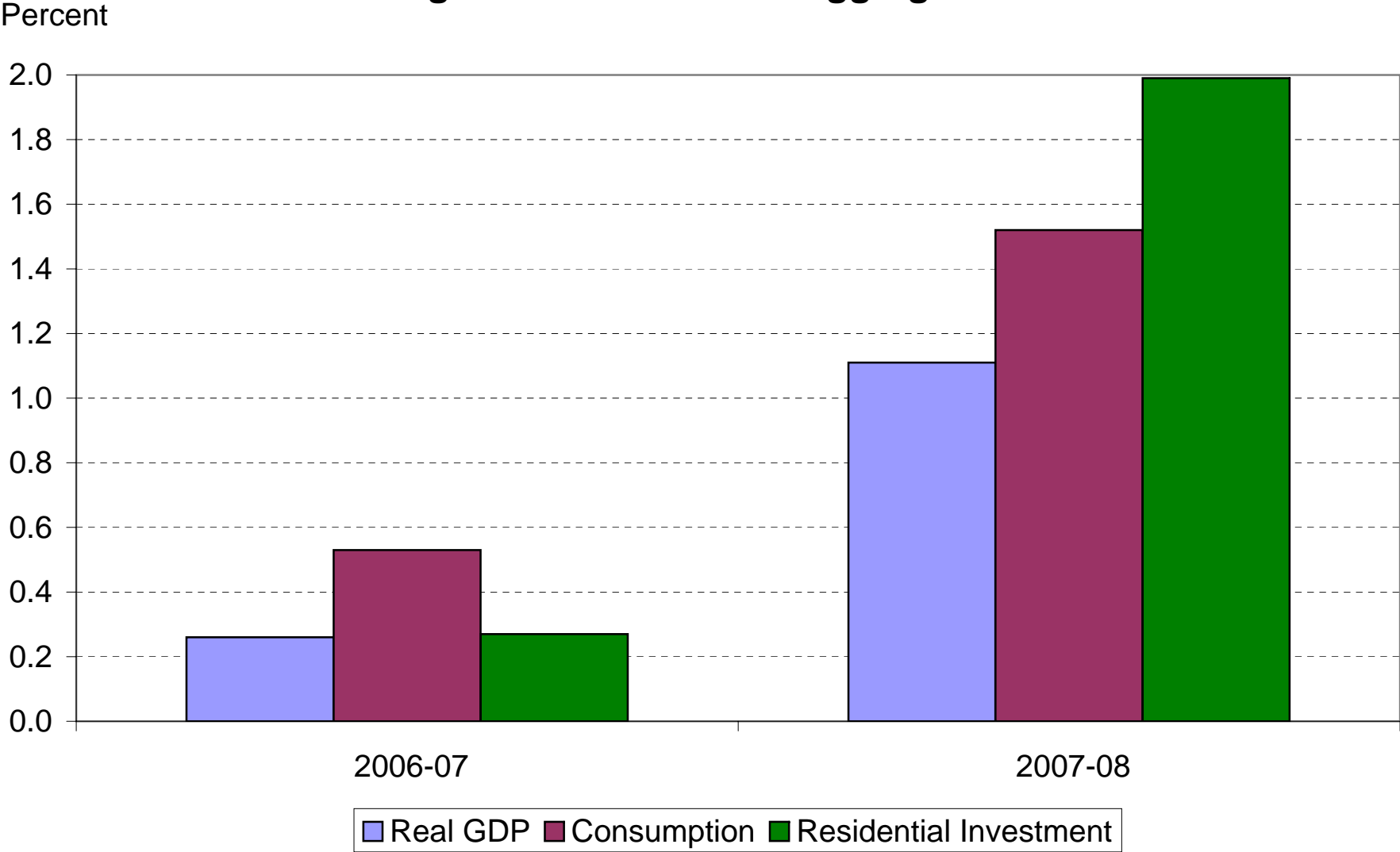
### Chart 2

## 2006 Budget - Effects on Inflation and the Unemployment Rate



- Among the components of aggregate output, consumption and residential construction have the greatest increases, but all components of domestic demand would increase, except for government spending on goods and services.

**Chart 3**  
**2006 Budget - Effects on Real Aggregate Demand**



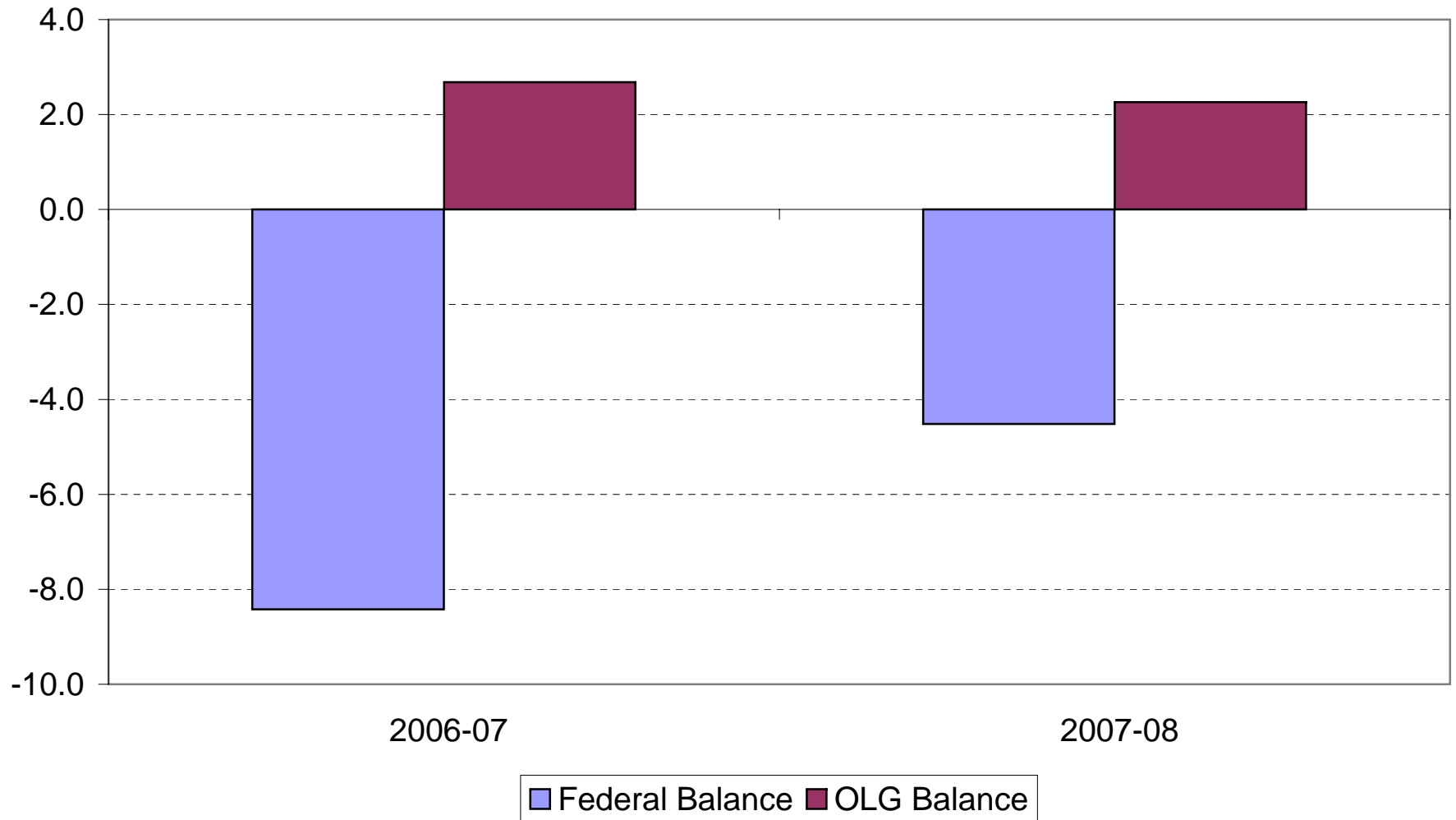


- With the increase in real output, tax recaptures increase in 2007-8. The Federal budget balance declines by only \$4.5 billion that year (whereas the net fiscal impact from Table 2 was \$7.8 billion )

**Chart 4**

**2006 Budget - Fiscal Effects of New Measures**

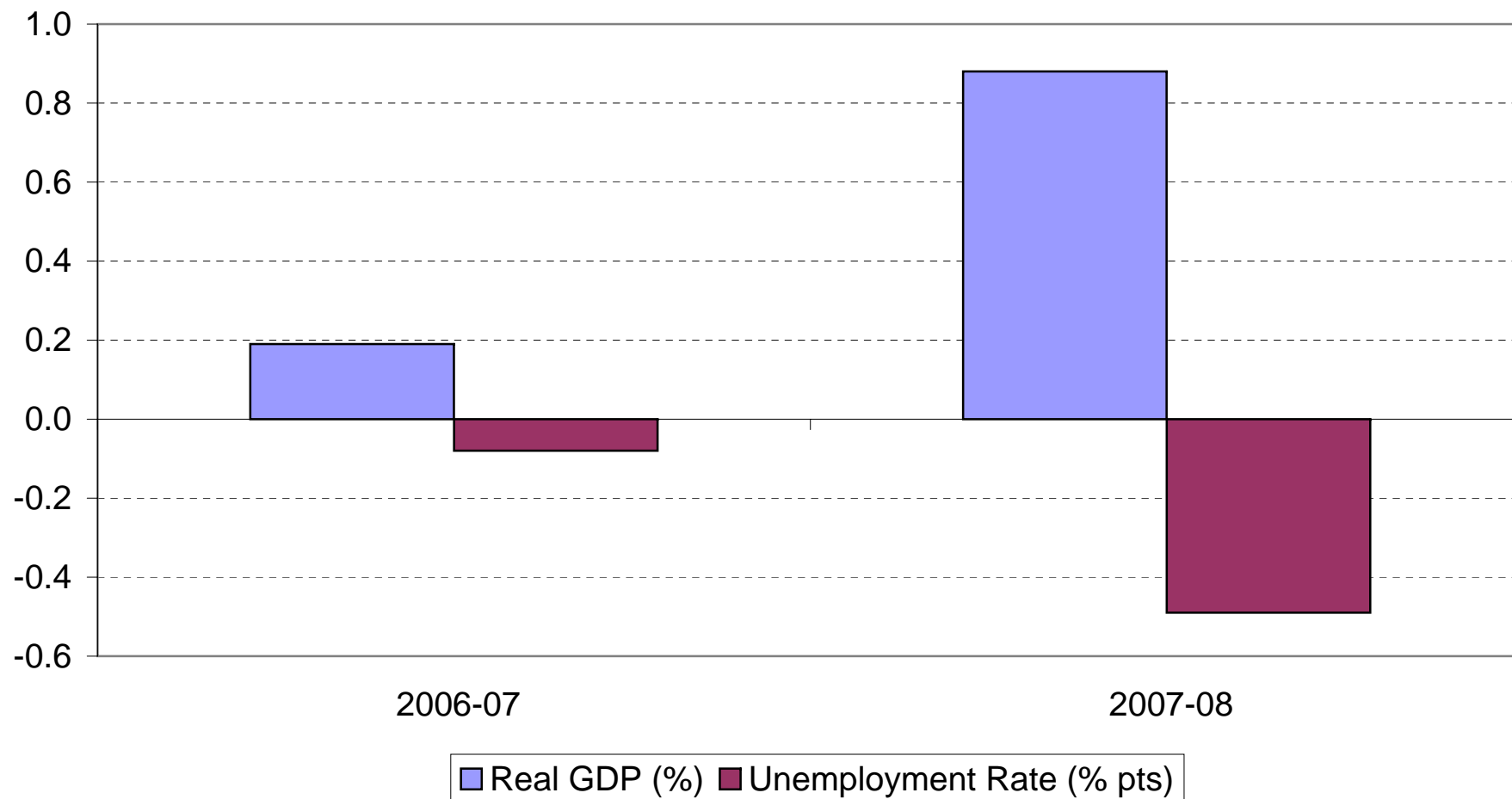
\$ Billion



- Although these results are consistent with the Bank of Canada's policy of targeting 'core' inflation, the Bank could well be concerned that the real demand stimulus in 2007-8 could generate inflationary pressures in future years.
- Our second model simulation incorporates a monetary policy response which offsets part of the real demand stimulus.
- In this simulation, the Bank acts to neutralize the exchange rate effects of the fiscal policies.
- The results indicate that the real demand stimulus is muted slightly, with a smaller reduction in the unemployment rate.
- With this monetary policy reaction real GDP is increased by 0.9% in 2007-8 and the unemployment rate reduced by 0.5 percentage points.

**Chart 5**  
**2006 Budget - Alternative Monetary Policy - Effects on Real Growth and the Unemployment Rate**

Percent



- Although the differences between the two simulations are small, they could reasonably represent the initial effects of the central bank choking off a possible future increase in inflation.