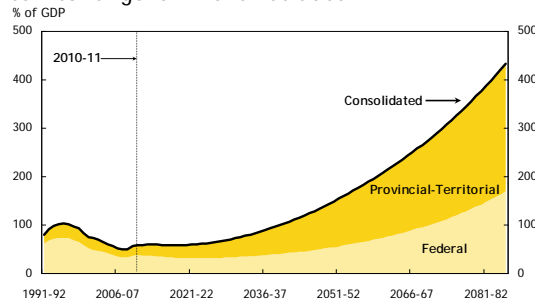


CURRENT ANALYSIS

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Kirsten Cornelson  
Economist  
(416) 974-8593  
kirsten.cornelson@rbc.com

Projected consolidated federal and provincial-territorial government net debt



Source: Office of the Parliamentary Budget Officer, Statistics Canada

**PBO Fiscal Sustainability Report**

Yesterday, a report released by the Office of the Parliamentary Budget Officer concluded that Canada’s current fiscal situation is unsustainable. Specifically, it examined the path of provincial and federal debt-to-GDP over the next 80 years, based on the current system of revenues and expenditures. The results suggest that while there is no immediate fiscal crisis, debt levels may be poised to rise rapidly in the very longer term.

**Projection assumptions**

The PBO’s report used data on both federal and provincial finances to project the path of revenues and expenditures over the next 80 years. The goal of the exercise is to determine whether, based on the current fiscal structure, debt-to-GDP levels are likely to increase, decrease or remain stable in the long run. Naturally, this kind of exercise requires a number of assumptions about economic and demographic conditions, as well as their potential effects on revenues and expenditures. In the baseline projections, GDP is expected to grow at 1.8% on average, while the dependency ratio is expected to rise to more than 40% by the end of the forecast period. Revenues and some expenditures are expected to grow in line with nominal GDP; other large expenditures, like health care and transfers to the elderly, are also expected to depend on demographics and other variables. Of course, as with all very long-term projections, the results depend heavily on the specific assumptions used, and are subject to a great deal of uncertainty. Because of this, the exercise is not meant to generate predictions about the future, but rather to ascertain whether the current path is sustainable.

**Debt to rise rapidly in the longer term**

The results of the analysis suggest that based on current trends, Canada’s debt levels could increase substantially in the long run. Although the projections show debt-to-GDP growing reasonably slowly in the medium term (10 to 15 years), the pace of growth picks up rapidly in the out-years. In the baseline scenario, debt-to-GDP would rise from its current 57.9% to over 100% by the mid-2040’s, before expanding to more than 400% by 2081-82. Of course, no one expects that this kind of debt growth could occur without invoking some sort of future policy response. However, the exercise does highlight the extent to which our current structure of revenues and expenditures is not poised to handle the demographic aging and slower GDP growth that is anticipated in the future. It should also be noted that the report does not include a feedback mechanism from debt-to-GDP

to GDP growth. There is substantial evidence that debt-to-GDP can have a significant negative effect on growth, once it reaches high levels. While this is unlikely to affect the estimates in the early years of the projection period, it suggests that the long run debt growth may be understated.

**Required restraint: large, but not unmanageable**

What kind of action would be required to put Canada's on a sustainable fiscal path? If action were taken today, a combination of spending cuts and revenue increases equivalent to 2.7% of GDP would be needed (the "fiscal gap".) To put this in perspective, the report notes that cutbacks in the mid-1990's were equivalent to 6.2% of GDP (although these turned out to be only temporary; in order to assist with future debt levels, new budget initiatives would have to be permanent.)

**Sensitivity analysis: health care and elderly spending pose the biggest risk**

The report also contains a number of alternative projections, to examine the sensitivity of the results to key assumptions. Increasing long run GDP growth from 1.8% per year to 2.3% per year lowers the fiscal gap to 2.4% of GDP; lowering GDP growth has a similar, but opposite effect. Using more optimistic demographic assumptions lowers the gap to 2.1%, while more pessimistic assumptions increase it to 3.0%. However, the biggest changes in the fiscal gap by far come from altering the assumptions about health care and spending on the elderly. The baseline projections assume that "enrichment" in health care and transfers to the elderly (that is, growth in spending beyond that explained by demographics or GDP growth) remains relatively muted. Enrichment in health care is projected to push up health care spending by 0.4% per year (its 35-year average), while enrichment in transfers to the elderly is negative. This means that per capita, real transfers are expected to grow more slowly than real GDP. However, if we assume that transfers to the elderly grow in line with nominal GDP and that health care enrichment follows its more recent path of 1.7% of GDP annually, we get a much scarier picture. In this case, the fiscal gap rises to 9.4% of GDP. Alternatively, assuming no real growth in elderly transfers and no enrichment in health care yields a fiscal gap of just 0.9% of GDP.

**Conclusion: the time for action is later**

The results of the PBO report suggest that while there is likely a structural deficit, it is not yet out of control: if policy makers acted immediately, the required restraint would be relatively manageable at 2.7% of GDP. However, given recent global uncertainty and lower-than-expected economic growth, it seems unlikely that new austerity measures will be put into place in the near term. What are the costs associated with waiting? Fortunately, the report indicates that these are fairly small at this stage. Waiting five years to act, until 2016-17, increases the size of the required restraint to 3.0% of GDP; waiting ten years increases the gap to 3.4%. While the situation should be addressed as soon as it is practical, these numbers suggest that the government does have some breathing room, should downside risks to the economy materialize.

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