Canadian Federal: 2018–19 Budget

FOCUSED ON THE FUTURE BUT NOT ENOUGH ON RISKS

Budgetary outcomes are largely as laid out in the *Fall Economic Statement*. A deficit of about $20 billion is forecast for this fiscal year (fiscal 2017–18, FY18), falling to only $12.3 billion in FY23 (chart 1). The accumulated deficit-to-GDP continues to fall from its current level to 28.2% of GDP in FY23 (chart 2). From a markets perspective, this *Budget* should be of little consequence.

Spending levels are largely unchanged, but mask a very significant compositional shift. Developments since the *Fall Economic Statement* suggest that a significant budgetary improvement was within reach. Lower spending and stronger economic growth should have worked to shave $19.8 billion from the cumulative deficit through FY23. Instead of banking these savings and allowing them to flow through to the bottom line, the government proposes to implement a large number of investments to encourage, to a large degree, greater participation of females in the labour force (chart 3) as well as higher research and development activity across the country. The result is additional spending of $20.3 billion through FY23.

Was this the right thing to do? The economic benefits of higher participation by women in the workforce are undeniable, as are those from higher spending on research and development by the private sector. They can be a powerful driver of business investment, and we hope these policies will pay off in time.

A key challenge, however, is that this *Budget* does relatively little to comfort businesses given the range of challenges they currently face. We do not yet understand the full impact of US tax reform on Canadian competitiveness, nor the effects of the regulatory changes in the US that are moving in the opposite direction to Canada's, or the implications of potential changes to NAFTA, or the full effects of minimum wage increases in several provinces. In our view, it would have been more prudent to set some of the $19.8 billion in savings aside in the event that they are needed to deal with these challenges. Failure to do so, and failure to signal decisively that the Government stands ready to act in the event that some of these challenges have a material impact is a missed opportunity.

Moreover, we are now at a point in the cycle where we have to be more mindful of downside risks. The fiscal planning horizon runs five years. Over that time, we are likely to experience a significant economic slowdown, possibly even a recession. If this occurs, it will require a substantial fiscal response, as was the case in the previous recession. The cyclically adjusted deficit, also known as the structural deficit, increased last year and will almost certainly increase again this fiscal year (chart 4). Add to this the eventual cost of pharmacare and probable electoral goodies, and the risks appear tilted towards greater deficits than currently projected. All this will limit our flexibility to deal with the next downturn.

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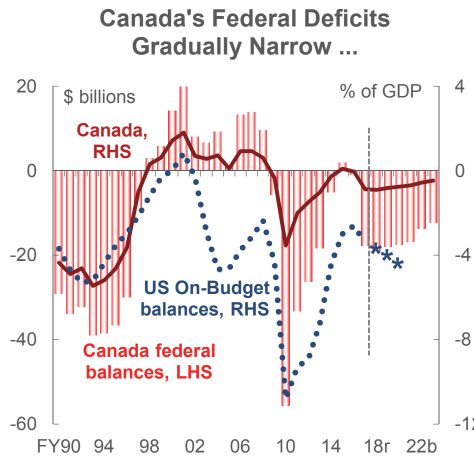
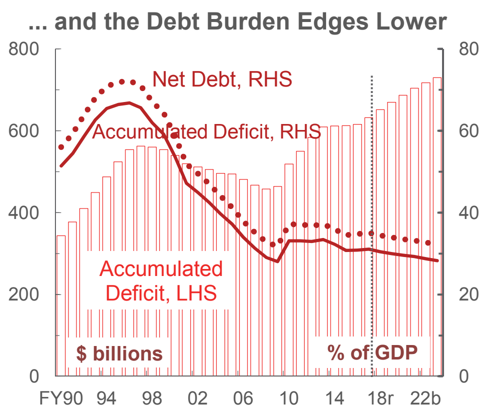
Chart 1



* Scotiabank forecast of US on-budget deficits.

Chart 2



Sources for charts: Finance Canada; Statistics Canada; OMB; BEA; budget & nominal GDP forecasts: Scotiabank Economics.

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REVENUE DETAILS

The $19.4 billion deficit now forecast for fiscal 2017–18 (FY18) represents a $1.6 billion widening from the $17.8 billion FY17 shortfall (table 1). Since the government's October update, FY18 revenues have been revised $1.1 billion lower, largely due to reduced net income through the Canadian Commercial Corporation. For FY18 program spending, the sizeable $4.3 billion downward revision since October is offset by subsequent policy actions that add a net $4.0 billion. Thus, keeping this year's deficit narrower than $20 billion depends upon the removal of the $1.5 billion Adjustment for Risk.

The projected $0.5 billion improvement in the FY19 deficit to $18.1 billion (including a $3.0 billion annual Adjustment for Risk which extends from FY19 to FY23) relies upon stronger revenue growth of 4.5% next year and holding the program spending increase to 2.5% (table 3).

The *Budget's* underlying assumptions for economic growth are little changed from the *Fall Statement* (table 2) with nominal GDP growth slowing from an estimated 5.2% in 2017 to an average 3.7% from 2019 to 2022. Total revenues from FY20 to FY23 rise by an average 3.7%, while average program spending hikes are held to 2.9%. The result from FY18 to FY23 is a cumulative deficit that is a modest $0.5 billion lower than the *Fall Statement* estimates.

Combined, the tax measures in the *Budget* assist the bottom line by $565 million in FY19 and over $600 million the following year. Income tax initiatives affecting businesses, including the taxation of passive income in Canadian controlled private corporations, boost revenues by $0.4 billion in FY19 and $0.9 billion in FY20. Closing tax loopholes remains a major source of new revenues, with additional receipts of more than $0.5 billion annually anticipated from FY20 through FY23.

The increase in the tobacco tax and the tax revenues generated on legalized cannabis sales add $0.4 billion in FY19, with the latter subsequently expected to double from $100 million in FY20 to $220 million by FY23.

For middle- and lower-income individuals, tax relief totals $253 million in FY19, growing to more than $700 million annually as of FY20. The lower tax burden for households is anchored by enhancements to the *Working Income Tax Benefit*, introduced in 2005 as a refundable tax credit to supplement low-income workers' earnings. This *Benefit* will be renamed the *Canada Workers Benefit* and, as of 2019, the maximum benefit will be raised, the disability supplement increased and eligibility expanded at a total revenue cost of $0.7 billion for the first full year in FY20.

Table 1

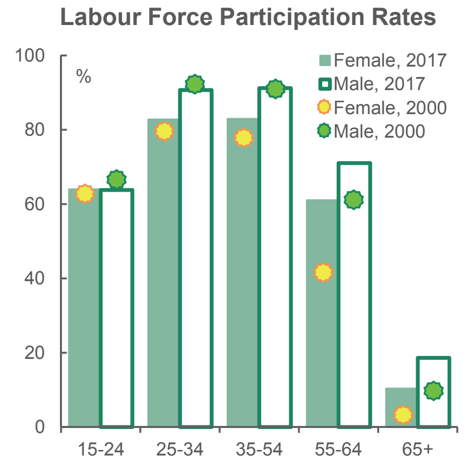
Comparing Federal Deficit Projections

excluding Adjustment for Risk, $ billions

	FY17	FY18	FY19	FY20	FY21	FY22	FY23
Budget 2016	-23.4	-23.0	-16.8	-11.7	-8.3	n.a.	n.a.
Budget 2017	-23.0	-25.5	-24.4	-20.4	-18.7	-15.8	n.a.
Fall Update 2017	-17.8*	-18.4	-15.6	-14.3	-13.8	-10.9	-9.5
Budget 2018	-17.8*	-19.4	-15.1	-14.5	-13.9	-10.8	-9.3

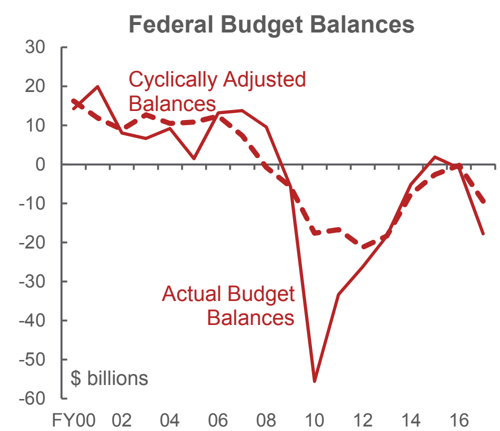
* Final. Source: Finance Canada.

Chart 3



Source: Statistics Canada.

Chart 4



Source: Finance Canada.

EXPENDITURE DETAILS

In a highly competitive, knowledge-based global economy, this *Budget* offers a historic investment in research that includes over five years more than $1.7 billion for researchers through granting councils and research institutes and over $1.3 billion for laboratories and other research infrastructure. The latter includes $573 million to deliver more equitable access to advanced computing and big data resources.

On Innovation, measures include shifting the *Strategic Innovation Fund* to support larger projects and modernizing the Trade Commissioner Service. Significant new assistance will be provided to women entrepreneurs, partly through the Business Development Corporation and the Export Development Corporation.

An Advisory Council on the Implementation of National Pharmacare is created, to be chaired by the former Ontario Minister of Health. It will explore both domestic and international models in its recommendations to the government.

The *Budget* targets specific issues to assist the middle class. To help protect workers impacted by innovation, the *Wage Earner Protection Program* is improved and financial assistance for adult students is increased. A new pre-apprenticeship program is proposed. Recognizing the shortage of moderate-rent units, low-cost loans available for rental construction over the next three years are raised from $2.5 billion as of April 2017 to $3.75 billion. The Employment Insurance *Working While on Claim* pilot allowing claimants to keep 50 cents of their EI benefits for each dollar earned to 90% of the weekly insurable earnings will be made permanent as of FY19, representing a $352 million five-year benefit.

Substantial reprofiling is announced for infrastructure. For the infrastructure announced in *Budget 2016,* $2.2 billion and $1.0 billion are deferred from FY18 and FY19, after a $0.6 billion reduction in FY17. In FY20 and FY21, $2.3 billion and $1.6 billion are added to the FY20 and FY21 totals, confirming that activity under this program remains substantial over the next three years. Investment also is deferred on the longer-term plan stretching to FY28, with $1.5 billion now expected to be delayed from FY19 through FY22.

For the financial sector, the *Budget* proposes changes to the tax code that affect equity-based financial transactions and the stop-loss rules on share repurchase agreements. Both come at considerable cost to the sector, for a cumulative impact of roughly $2.5 billion through 2022–23.

OTTAWA'S FISCAL PLAN: BY THE NUMBERS

Table 2

Federal Budget's Economic Assumptions

annual % change except where noted

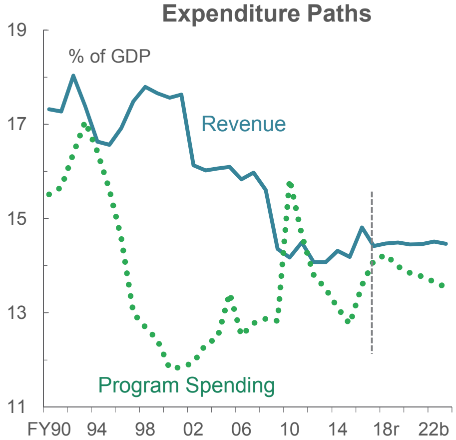
Scotiabank Economics, February 6, 2018	2017e	2018f	2019f
Canada: Real GDP	2.9	2.3	1.7
Nominal GDP	5.1	4.3	4.0
CPI - All Items	1.6	1.9	2.1
Unemployment Rate*,%	6.3	5.9	5.9
3-month T-bills*,%	0.7	1.6	2.3
10-year Bonds*,%	1.8	2.5	2.7
Cdn Dollar*, US¢	77.1	79.1	81.0
U.S.: Real GDP	2.3	2.5	1.8
WTI Oil Price*, US$/bbl	51	57	60

Finance Canada February 2018 Budget**	2017e	2018f	2019f	2020-22f
Canada: Real GDP	3.0	2.2	1.6	1.7
Nominal GDP	5.2	4.0	3.5	3.7
CPI - All Items	1.6	1.9	2.0	1.9
Unemployment Rate*,%	6.4	6.0	6.0	6.0
3-month T-bills*,%	0.7	1.4	2.0	2.4
10-year Bonds*,%	1.8	2.3	2.8	3.2
Cdn Dollar*, US¢	77.2	79.0	79.6	80.7
U.S.: Real GDP	2.3	2.4	1.9	1.9
WTI Oil Price*,US$/bbl	51	56	57	59

*Annual averages. ** Based on private-sector survey, Dec. 2017. Source: Finance Canada, Statistics Canada, US Bureau of Economic Analysis, Scotiabank Economics.

Chart 5

Federal Revenue and Expenditure Paths



Sources: Finance Canada; Statistics Canada; nominal GDP forecasts: Scotiabank Economics.

Table 3

Federal Budget Arithmetic

$ billions except where noted

	FY17 Final	FY18 Rev	FY19 Bud	FY20 Bud	FY23* Bud
Personal Income Tax (PIT)	143.7	152.3	161.4	168.6	190.0
Corporate Income Tax (CIT)	42.2	48.2	47.3	47.9	52.2
Goods & Services Tax (GST)	34.4	36.5	37.7	39.2	43.5
Total Tax Revenue	**244.3**	**262.3**	**272.3**	**281.7**	**313.1**
Employ. Insurance (EI) Premiums	22.1	20.6	21.7	22.6	25.0
Other Revenue	27.1	26.8	29.4	31.3	35.8
Total Revenue	**293.5**	**309.6**	**323.4**	**335.5**	**373.9**
Elderly Benefits	48.2	50.9	53.6	56.7	67.0
Employ. Insurance (EI) Benefits	20.7	20.1	20.7	21.7	24.0
Children's Benefits	22.1	23.4	23.7	23.9	25.1
Major Transfers to Persons	**90.9**	**94.4**	**98.1**	**102.3**	**116.1**
Transfers to Other Levels of Gov't	68.7	70.5	73.6	76.5	84.7
Direct Program Spending	127.6	139.7	140.5	142.7	149.3
Of which: Other Transfers	41.6	44.1	47.5	50.4	52.0
Total Program Spending	**287.2**	**304.6**	**312.2**	**321.5**	**350.1**
Debt Service	24.1	24.4	26.3	28.6	33.1
Total Expenditure	**311.3**	**329.0**	**338.5**	**350.0**	**383.2**
Adjustment for Risk		0.0	3.0	3.0	3.0
Budget Balance	**-17.8**	**-19.4**	**-18.1**	**-17.5**	**-12.3**
Non-Budgetary Transactions	-9.7	-4.1	-16.7	-15.8	-17.4
Fin.Source(+) / Requirement(-)	**-27.5**	**-23.5**	**-34.8**	**-33.3**	**-31.2**
Accumulated Deficit	**631.9**	**651.5**	**669.6**	**687.1**	**730.1**
Net Debt	**714.5**	**736.7**	**757.8**	**778.5**	**831.5**
Annual Change, %					
Personal Income Tax (PIT)	*-0.8*	*6.0*	*6.0*	*4.5*	*4.1*
Corporate Income Tax (CIT)	*1.9*	*14.2*	*-1.9*	*1.3*	*2.9*
Goods & Services Tax (GST)	*4.3*	*6.2*	*3.3*	*4.0*	*3.5*
Total Tax Revenue	***0.7***	***7.4***	***3.8***	***3.4***	***3.6***
EI Premiums	*-4.1*	*-6.9*	*5.4*	*4.1*	*3.4*
Total Revenue	***-0.7***	***5.5***	***4.5***	***3.7***	***3.7***
Elderly Benefits	*5.9*	*5.7*	*5.3*	*5.8*	*5.7*
Employ. Insurance (EI) Benefits	*6.7*	*-3.0*	*3.0*	*4.8*	*3.4*
Children's Benefits	*22.4*	*6.1*	*1.3*	*0.8*	*1.6*
Major Transfers to Persons	***9.7***	***3.8***	***3.9***	***4.3***	***4.3***
Transfers to Other Levels of Gov't	*4.3*	*2.7*	*4.4*	*3.9*	*3.5*
Direct Program Spending	*4.4*	*9.5*	*0.6*	*1.6*	*1.5*
Total Program Spending	***6.0***	***6.1***	***2.5***	***3.0***	***2.9***
Total Expenditure	***5.0***	***5.7***	***2.9***	***3.4***	***3.1***
Memo Items, %					
Tax Revenue / GDP	12.0	12.3	12.2	12.6	12.1
Total Revenue / GDP	14.4	14.5	14.5	14.5	14.5
Total Program Spending / GDP	14.1	14.2	14.0	13.8	13.5
Budget Balance / GDP	-0.9	-0.9	-0.8	-0.8	-0.5
Accumulated Deficit / GDP	31.0	30.4	30.0	29.6	28.2
Net Debt / GDP	35.1	34.4	33.9	33.5	32.2
Debt Service / Revenue	8.2	7.9	8.1	8.5	8.9

*Average annual growth for FY21-FY23. Source: Finance Canada; Statistics Canada; nominal GDP forecasts: Scotiabank Economics.

APPENDIX: THE 2018–19 DEBT MANAGEMENT STRATEGY

The government's financial requirement for FY18 drops to $23.5 billion from last year's estimate of almost $39 billion. This reflects both a $9.1 billion narrowing of the deficit and a $6.1 billion reduction of the requirement stemming from non-budgetary transactions.

From FY19 to FY23, annual financial requirements rebound to more than $30 billion (chart A1), with non-budgetary requirements averaging $17.5 billion annually. Increased financing needs are now estimated for non-financial assets and Enterprise Crown corporations.

Aggregate borrowing of $258 billion is forecast for FY19. Treasury bills outstanding are expected to provide $138 billion. This follows an expected drop in bills outstanding to $125 billion from $137 billion a year earlier as FY18 financial requirements declined (chart A2). This is a traditional use of bills, to act as the main shock absorber to changing events. For FY19, however, the objective is a treasury bill stock sufficiently large to enable a liquid and well-functioning market, and this leads to a planned rebound in bills outstanding.

Cash management bond buybacks are expected to total $35 billion in FY19, slightly lower than the $42 billion FY18 plan. The pilot project to raise the flexibility in the maximum repurchase amount, introduced in January 2017, will remain in place.

Gross bond issuance in FY19 is expected to fall to $115 billion from $138 billion this fiscal year (chart A3).

With maturing bonds and adjustments in FY19 totaling $94 billion and $1 billion of bond buybacks on a switch basis anticipated, the net increase in Canadian dollar bonds outstanding is halved in FY19 to $20 billion. As of March 2018, bonds outstanding are expected to total $598 billion.

The government's planning assumption is that over the next decade, the share of domestic market debt outstanding with original terms to maturity of ten years or more is projected to remain at about the current level of 40%. Similar to last year, the average term-to-maturity is expected to stabilize at about 5.5 to 6.5 years.

The number of planned bond auctions for FY19 is 16 for two-year bonds, six for three-year issues, eight for five-year issues, five for ten-year bonds and four for Real Return Bonds. For the 30-year bond, the practice of three auctions per year will continue.

Ultra-long bond issues, similar to the recent past, will only be issued if market conditions are considered favourable and if these instruments are believed to add to the government's objective of stable, low-cost funding.

Chart A1

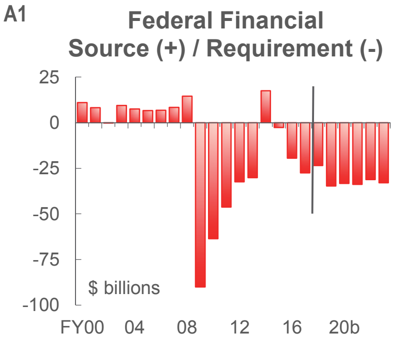


Chart A2

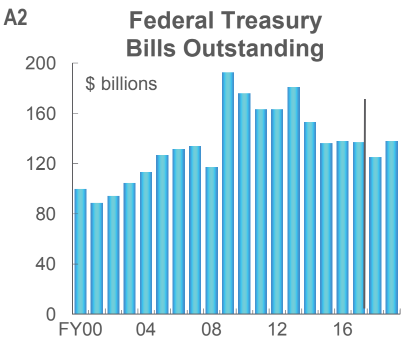
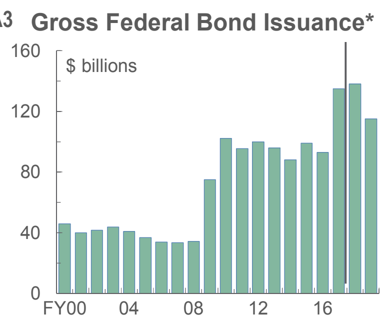
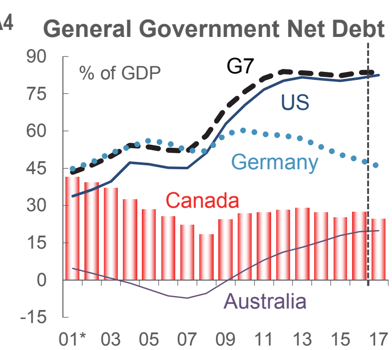


Chart A3



* Includes Real Return Bonds. Source for top three charts: Finance Canada.

Chart A4



* Calendar year. Source: IMF, October 2017.