2018 Federal Budget Recap: High Times


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The third budget of the current federal government arrived with little fanfare and subdued expectations, and reinforces Ottawa's underlying priorities. Against a backdrop of aggressive U.S. tax reform and NAFTA uncertainty, Finance Minister Morneau played it safe with a largely stand-pat fiscal plan, allowing recent economic strength, deferred infrastructure spending and some tax increases (yes, including a pot tax) to fund yet another spending boost. Ottawa is again projecting a string of double-digit budget deficits as far as the eye can see, narrowing somewhat in the coming fiscal year, while the now-key debt/GDP ratio still gradually drifts lower. This outlook comes as little surprise, as a fading debt ratio has become the de facto anchor for policy. Last year's firmer-than-expected economic backdrop has provided a big tailwind for finances, although that favourable trend looks to have run its course. Two areas of uncertainty heading into budget day were: 1) would there be any significant response to the competitive challenge from U.S. tax reform; and, 2) would there be any new spending measures in the year before the next election? The short answers are: No; and, every last dollar subject to keeping the deficit path unchanged. This is set against what could quite possibly be the high point for economic and fiscal conditions in Canada. Consider what likely lies ahead:

- Economic growth is bound to slow after a powerful upside surprise last year, and as we get deep into an already long cycle (witness today's soggy Q4 GDP result);
- Profound uncertainty around the NAFTA talks; and a possible U.S. steel tariff;
- Debt interest costs are poised to edge higher after years of consistent positive surprises, rising as a share of GDP for the first time in decades;
- There is little fiscal room to stimulate the economy further, assuming the fiscal anchor holds, and short of a major re-profiling of the infrastructure program; and
- U.S. tax reform is a tough new competitive challenge, to which the budget is nearly silent in response.

Meantime, the deficit profile closely follows the update laid out in the 2017 Fall Statement, which is no surprise, given that the current economic outlook is little changed since that point. Recall, that update incorporated a much stronger-than-expected 2017 economic growth backdrop into the fiscal plan, reducing average deficits from FY18/19 through FY21/22 by an average of $6.5 billion per year. Similarly, the updated outlook in this budget calls for an $18.1 billion deficit this fiscal year, before shrinking modestly to $13.8 billion by FY21/22—there is still no plan to balance the books within the forecast horizon. Below the surface, **some re-profiling of the infrastructure program, lower EI benefit payments (stronger labour market), more favourable Crown expenses and some tax increases have allowed chunky new spending measures to go through without impacting the bottom line**.

A contingency of $3 billion per year remains in place through the forecast horizon, offering some wiggle room should the economy

Table 1
Fiscal Outlook

(C$ blns, except where noted)

	Est. 17/18	— Forecast — 18/19	19/20	20/21
Revenues	309.6	323.4	335.5	348.0
Expenditures	329.0	338.5	350.0	361.9
Program Spending	304.6	312.2	321.5	331.5
Public Debt Charges	24.4	26.3	28.6	30.3
Adjustment for Risk	—	(3.0)	(3.0)	(3.0)
Budget Balance	(19.4)	(18.1)	(17.5)	(16.9)
Federal Debt	651.5	669.6	687.1	704.0
As a percent of GDP:				
Budget Balance	(0.9)	(0.8)	(0.8)	(0.7)
Federal Debt	30.4	30.1	29.8	29.4

Source: Federal Budget ( ) = deficit

slow further (NAFTA risks, for example). Also, the debt-to-GDP ratio will fade from 30.1% this coming fiscal year, to 28.4% by FY22/23. We'd just reiterate that we are observing late-cycle conditions in North America, often a period that governments should build fiscal capacity—after all, a stable debt-to-GDP ratio will deteriorate overnight as the next downturn hits.

Major Policy Measures: A Shade of Pink

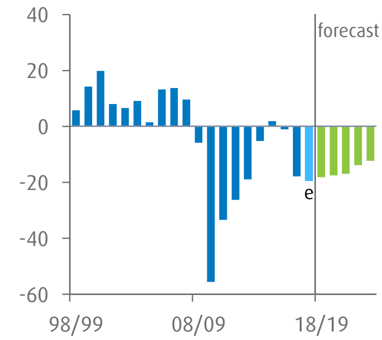
The net fiscal impact of new measures detailed in this year's budget is $5.4 billion (or 0.2% of GDP), fading to average $2.5 billion per year in the subsequent four fiscal years—not big, but not immaterial. Here's a recap of some key measures:

- ***Program spending*** *will rise 2.5% in FY18/19 after at 6.1% surge in FY17/18. As a share of GDP, program spending will dip slightly to 14%, but that remains up from the recent low of just under 13% in FY14/15. Notably, program spending as a share of GDP will drift very modestly lower over the forecast horizon.*
- ***Infrastructure spending:*** *Further re-profiling of the infrastructure plan, pushing some investment into future years. Since the Fall Statement, Ottawa has moved more than $2 billion out of FY18/19, with a meaningful chunk landing in FY19/20—an election year.*
- ***EI Parental Sharing Benefit:*** *Additional 5 weeks of parental leave for a family where the second parent agrees to take a minimum of 5 weeks. This will start in June 2019, and is expected to cost roughly $300 million per year, funded through the EI account.* ***EI premiums will rise by 3 cents*** *in FY18/19, to $1.66 (announced earlier). This will likely fall short in increasing female workforce participation.*
- *Other measures to promote* ***gender equality*** *include pay equity legislation in the federal sector and recognition for companies with gender equality on their board.*
- ***Tax loopholes:*** *Various changes to business taxes aim to raise $1.2 billion by FY20/21. This includes taxation of* ***passive income*** *in private corporations, where the business limit (income that triggers the higher general corporate rate) is reduced from $500,000 as passive investment income increases. A business would need at least $50,000 of investment income to be affected. Other targets include* ***limiting refundable taxes larger companies can obtain on dividend distribution****; and a few measures targeting* ***artificial losses generated by financial instruments*** *and* ***share buybacks*** *(measures which will mostly affect banks).*
- ***Pot tax:*** *Ottawa outlines a cannabis tax framework and raises tobacco taxes immediately. Combined, these will raise more than $400 million in FY18/19.*
- ***Canada Workers Benefit:*** *Revamped Working Income Tax Benefit, made more generous and easier to access. Funding was accounted for in the Fall Statement.*
- *Creation of an advisory council to look at a* ***national pharmacare*** *program. This could be the big-ticket item in next year's budget.*
- ***Debt management strategy*** *calls for gross issuance of $115 billion in FY18/19, down from $138 billion in FY17/18. Net borrowing requirements are pegged at $35 billion in the coming fiscal year, with cash balances unchanged.*

Chart 1
Deficits Persist

Canada (C$ blns)

Budget Balance

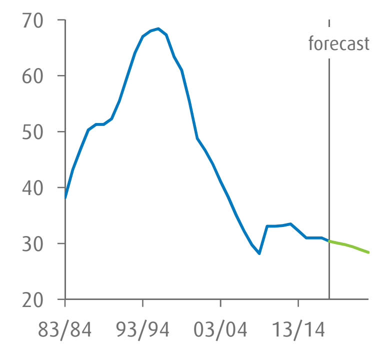


Source: Federal Budget e = estimate

Chart 2
Debt Ratio Tracking Lower

Canada (% of GDP)

Federal Debt



Source: Federal Budget