Competitiveness: Your Move, Canada

Robert Kavcic, Senior Economist • robert.kavcic@bmo.com • 416-359-8329

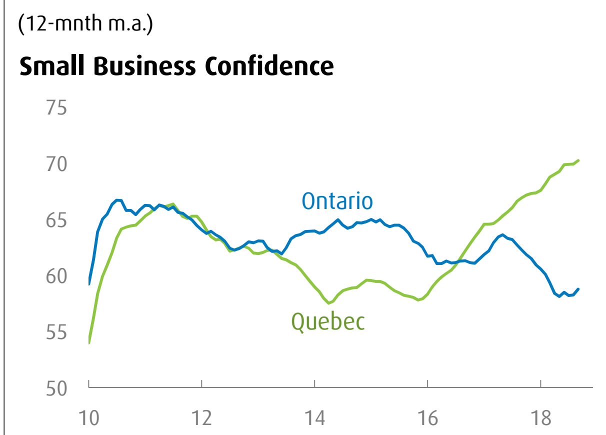
Positive economic news has been flowing for Canada recently. The ink is drying on the USMCA deal, a record infrastructure project has been announced in Western Canada, our growth forecast revisions have been consistently to the upside, and the Bank of Canada is only gradually normalizing interest rates. Against that backdrop, the federal and provincial governments will begin to roll out their mid-year fiscal updates in the coming weeks, and some meaningful policy moves could be on offer.

The **USMCA deal** removes a thick cloud of uncertainty from the Canadian business sector, particularly in Ontario where business confidence has been depressed (*Chart 1*). To be sure, some of the downdraft in Ontario reflects displeasure with prior-provincial-government policy (i.e., energy costs, minimum wages, etc.), which helps explain the divergence versus Quebec, where that (also now prior) government took a more pro-business approach. The wheels are already in motion for a shift in Ontario (e.g., scrapping of cap-and-trade, minimum wage freeze), and more moves could be coming in the next few months. Ontario was also by far the most heavily-exposed province to a negative trade outcome, so business confidence should get a natural lift from the USMCA.

Still, even with the uncertainty cleared, **competiveness issues remain for Canada broadly**. Last year's record FDI outflow has been well documented. Also, consider that M&E investment has been plumbing record lows as a share of GDP in recent years, in stark contrast to a record high for residential investment (*Chart 2*). With the latter likely to stagnate amid recent policy changes and higher interest rates, the former will be needed to pick up some of the slack. This is set against a backdrop of U.S. tax relief that has only further eroded Canada's relative position, with the 2018 round of provincial and federal budgets doing little to address competiveness—perhaps policy will now shift in this direction.

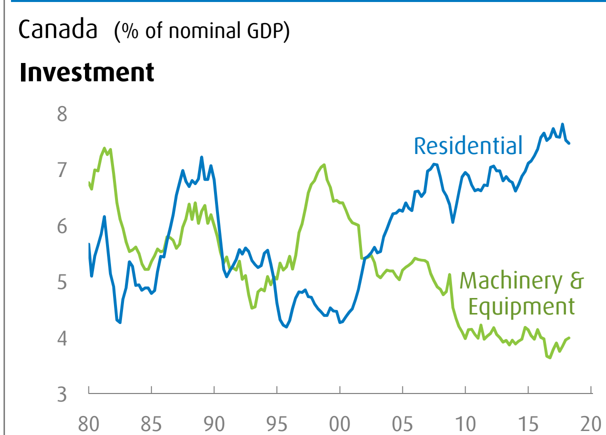
Accelerated depreciation (or full expensing) of capital investment is one idea that has been floated and could be implemented almost immediately to match the U.S. move, though this could be costly and somewhat narrow (i.e., benefiting capital-intensive businesses that are mature enough to have a heavy tax burden). More broadly, Canada's corporate tax rate advantage has effectively eroded versus the U.S. in one fell swoop. Recall that Canada had been cutting corporate tax rates steadily since the early-2000s, with many provinces taking additional steps to harmonize taxes. At one point, Canada had a 13 ppt gap on combined corporate tax rates—that is now fully gone (*Chart 3*). At the personal level, while relatively competitive through the low and middle income brackets, Canada

Chart 1
Better Business Confidence Ahead?



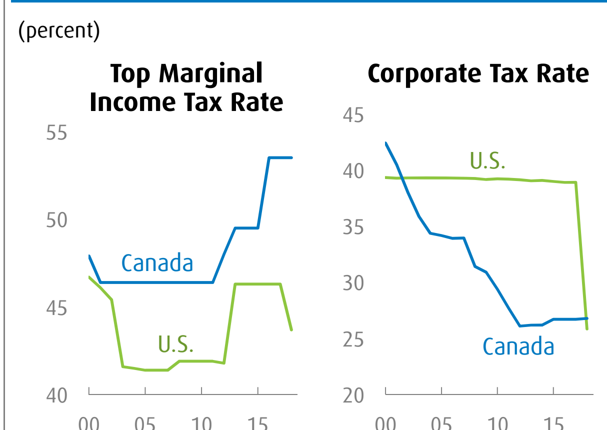
Sources: BMO Economics, CFIB

Chart 2
Rotation Coming?



Sources: BMO Economics, Haver Analytics

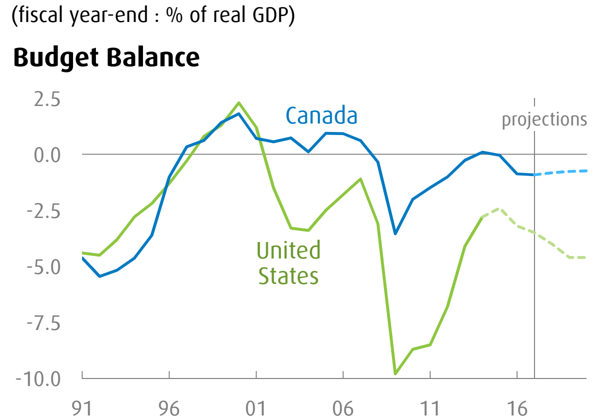
Chart 3
Competitiveness Challenged



Sources: BMO Economics, OECD

loses competiveness quickly as incomes push higher up the scale. Indeed, Canada still suffers one of the highest top marginal income tax rates in the OECD (6th highest, with 7 of 10 provinces above 50%), it has seen that position deteriorate steadily versus the U.S., and the top rate kicks in at a relatively low income threshold. This could pose a much bigger longer-term issue as the economy evolves to one driven more by innovation, technology and services, requiring talent and skilled labour.

Chart 4
The Deficit: It's All Relative



Sources: BMO Economics, Cdn federal budget; CBO

With that in mind, we've consistently made two major arguments with respect to **fiscal policy in Canada**. First, fiscal stimulus is not ideal near the peak of the business cycle, when the economy is rolling on its own and governments could be shoring up fiscal capacity. Second, if such a move is absolutely necessary, tax relief to address some of the above issues would provide a more lasting benefit than ramped-up government spending—to date, we've mostly seen the latter. Keep in mind, too, that 2019 is an election year, so the Fall update and Budget 2019 will serve as important blueprints. And, some meaningful policy could be prodded by the fact that **a wave of change is well underway at the provincial level**—three prominent Liberal governments have fallen in Ontario, Quebec and New Brunswick, with voters in each case shifting to the right.

At any rate, **Ottawa likely has sufficient wiggle room in its fiscal plan to accommodate some new policy measures** in the Fall update and/or Budget 2019. The FY17/18 deficit looks to come in roughly in-line with the $19.4 billion estimate after accounting for some benefit programs. Year-to-date through July 2018, the bottom line is running about $4.5 billion better than a year ago, and our current economic outlook suggests that FY18/19 is, at a minimum, tracking in-line with Ottawa's estimate, leaving the $3 billion contingency free (though dairy compensation could eat up some). Additionally, next fiscal year could see that room doubled (i.e., roughly $6 billion including the contingency) with our 2.1% 2019 real GDP growth forecast now fully 0.5 ppts above Ottawa's budget assumption. For argument's sake, a 1 ppt reduction in the corporate tax rate (closing the U.S. gap) would cost roughly $1.7 billion per year according to the PBO; a 4 ppt reduction in the top marginal income tax rate (bringing all provinces at or below 50%, as they were in 2014) would cost just under $2 billion. **On a relative basis, Canada's fiscal position looks even better**. Although many have scoffed at the move back into deficit, the shortfall this year, at 1% of GDP, pales in comparison to the $1 trillion (4.7% of GDP) U.S. gap expected in the fiscal year that began this week (*Chart 4*). While we wouldn't recommend Washington as a blueprint for fiscal responsibility, the point is that Canada is still in a position of strength at the federal level.

In the meantime, the record $40 billion **LNG Canada** announcement has provided a ray of optimism that private-sector capital spending can pick up some of the slack. With pipeline construction expected to begin in 2019, we've revised up our real GDP forecast by a tick, and the boost could rise to two-ticks as construction ramps up further in 2020. The massive discount for **Canadian oil prices** versus WTI, however, suggests there is much work to be done in the energy sector. We now await the next steps for fiscal policy.