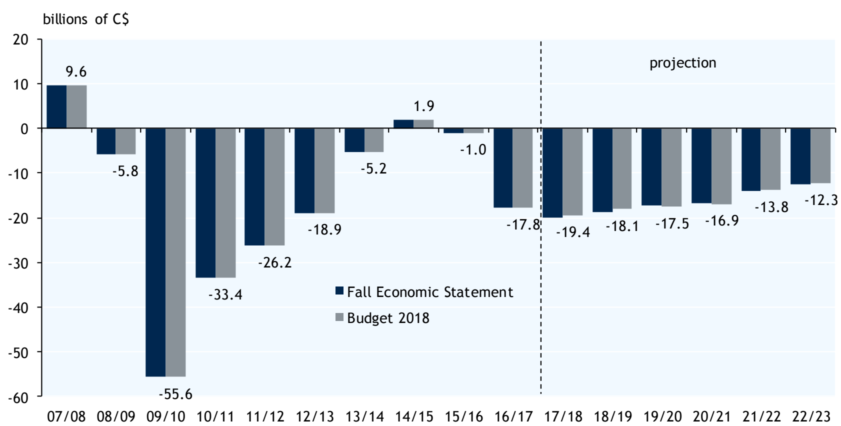
2018 FEDERAL BUDGET
February 27, 2018

Overview

Budget 2018 was expected to focus on gender equity, research and skills. It largely delivered in those areas, with important initiatives that will increase the Canadian economy's capacity to grow in the longer run. But as we noted in our budget preview, we would have liked to see measures to address the challenges facing Canadian businesses. There was little mention of improving competitiveness. We were also disappointed that the government continues to project average deficits of more than $15B per year over the next six years. With Canada leading the G7 in growth last year, our economy is now operating at full capacity and unemployment is close to 40-year lows. The budget maintained a $3B per-year 'adjustment for risk' beyond the 2017/18 fiscal year, but the economic outlook is not without storm clouds — including the potential for a bad outcome from NAFTA negotiations. Now is the time to return to a balanced budget in order to better deal with any future negative shock to the economy.

Budget 2018 indicates negligible change to the bottom-line fiscal position of the federal government, with the deficit profile largely copied from the 2017 Fall Economic Statement. This is the case despite the expectation that stronger revenues, and to a lesser extent lower program expenditures, will provide greater fiscal savings over the coming years. The federal government once again opted to spend those savings rather than banking them. Spending on initiatives related to improving gender equity in the workforce and investment in skills and research have the potential to benefit both individual Canadians and the economy as a whole. Indeed, some of these initiatives are paid for with higher revenue from expected stronger economic growth. But with the Canadian economy approaching capacity limits, future fiscal savings will likely be harder to come by, and the federal government will have fewer opportunities to rein in persistent deficits.

Updated budget projections show similar deficits to Fall Economic Statement with still no return to balance...



Source: Department of Finance, RBC Economics Research

Fiscal Balance Projections

The government continues to project deficits through FY22/23 with no indication of a return to balance. Improvement in the fiscal position is only evident in the deficit steadily dropping from $19.4B in FY17/18 to $12.3B in FY22/23, which contributes to the federal debt-to-GDP ratio dropping from 31.0% to 28.4% over this period. The cumulative shortfall of $98B over six years as outlined in Budget 2018 is little changed from the cumulative $99B shortfall projected last fall. That is despite subsequent positive "economic and fiscal developments" that provide $19.8 B in savings over the six-year period. The lion's share of these savings are coming from stronger projected revenue growth. But rather than using these positive fiscal developments to get closer to balancing its budget, the government is spending these savings across a number of new programs. Though initiatives such as equality in the workforce and skills development are laudable and of ben-

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efit to the economy over the longer run, it is disappointing that there has not been more of an attempt to fund them by reducing expenditures elsewhere.

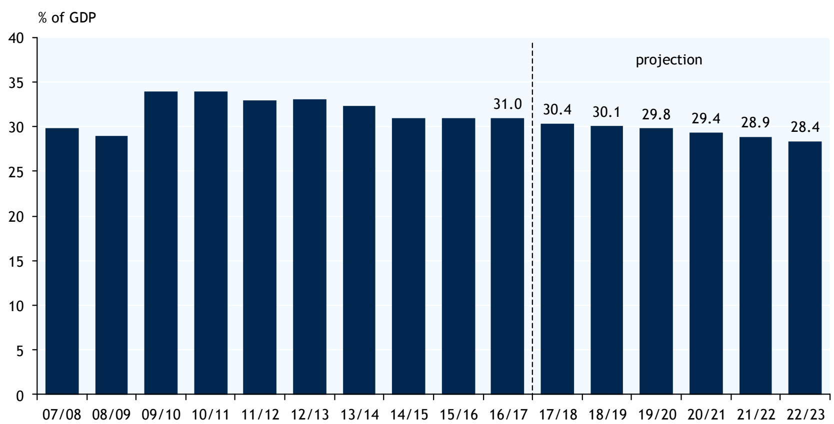
Near term, the FY17/18 deficit of $19.4B represents little change from the $19.9B projected in the 2017 Fall Economic Statement. A largely unchanged deficit occurs despite $3.0B in savings from economic and fiscal developments in the current fiscal year and elimination of a $1.5B risk adjustment. As well, a re-profiling of the infrastructure expenditure program is generating savings of $2.7B in FY17/18. These saving are largely being offset by an increase in support for veterans ($4.2B) and "non-announced" fiscal measures ($1.4B). Similarly, a delay of infrastructure spending previously allocated for FY18/19 results in that year's deficit being marginally lowered to $18.1B from the $18.6B projected last fall. This reallocation of infrastructure spending confirms anecdotal evidence that infrastructure dollars have been slow to get out the door. Nearly $5B in infrastructure spending previously planned for FY17/18 and FY18/19 has been delayed. About $3B of that will occur over the subsequent three fiscal years.

Initiatives

Gender equity: One of the policies floated ahead of Budget 2018 was enhancement of EI benefits to encourage female labour-force participation. As the budget points out, previous research from RBC Economics indicated closing the gender gap in labour force participation could add some 4% to Canadian GDP. With that in mind the government announced additional "use it or lose it" EI benefits, providing an additional five weeks of parental leave if both parents agree to share it. This measure, which is expected to cost $1.2B over five years, will be paid for by higher revenues in the EI program due to a projected better employment backdrop. In addition to a number of other measures promoting gender equity in the workforce, the government is committing $2.0B in funding for the Feminist International Assistance Policy.

Canada Worker Benefit: The government is replacing the Working Income Tax Benefit, which was bolstered in the 2017 Fall Economic Statement, with the Canada Worker Benefit. An additional $0.8B in funding for the CWB is committed over five years.

... with Canada's federal debt-to-GDP ratio still projected to fall over the forecast horizon



Source: Department of Finance, RBC Economics Research

Research and innovation: The government is committing $3.9B for Canadian scientists and researchers including NRCAN and $2.6B for the Innovation and Skills Plan. The latter funds a number of industrial research and development agencies.

Reconciliation: The government is committing $4.1B to achieve better results for indigenous peoples, including health, housing and child welfare. Skills and employment training is a pillar of the initiative, and one that partially pays for itself in delivering higher government revenues via stronger economic growth.

Support for veterans: The Pension for Life program unveiled last December, which broadens pension benefits with a focus on veterans with the most severe disabilities, costs $4.2B in FY17/18, reflecting the present value of future commitments.

Other initiatives: The government is committing additional funding for parks and environmental protection. $1.9B is being spent on enabling digital services—generally improving government IT services and infrastructure and enhancing cybersecurity.

Fiscal Savings

With most of the new expenditures being funded by positive economic and fiscal developments, Budget 2018 indicated only a small number of tax increases. The government is projecting an additional $2.6B in revenue from closing loopholes. An additional $2.3B comes from the controversial proposal to tax passive investment income of private corporations. The government believes it has addressed many business concerns by only taxing passive investment income over a $50K per year threshold. Investment income beyond that threshold will be taxed via a clawback of the small business tax deduction. With that threshold, the government expects less than 3% of Canadian controlled private corporations will be affected by this policy. Sin taxes, including an additional $1.5B in tobacco taxes, also bolster government revenue.

Deficit Projections

The government's budget deficit is expected to narrow from $19.4B in FY17/18 to $12.3B in FY22/23 (the latter including a $3B risk adjustment that wasn't needed in the latest fiscal year). That narrowing reflects average revenue growth of 3.8% outpacing program expenditure growth of 2.8% and rising public debt charges. Revenue growth is supported by average real GDP growth of 1.8% over the next five years — much closer to the economy's longer-run potential than the 3.0% increase projected for 2017. Annual growth in program expenditures is optimistically projected to grow at less than half the rate of increase seen in FY17/18.

Even with persistent budget deficits, a growing economy is expected to gradually lower the federal debt-to-GDP ratio, which has become this government's fiscal anchor. Debt-to-GDP is expected to decline from 30.4% in FY17/18 to 28.4% in FY22/23. That projection is little changed from the 2017 Fall Economic Statement. While a shrinking debt burden relative to the size of the economy is a positive development, we are disappointed that the government is not targeting a balanced budget over its projection horizon. Persistent deficits raise the prospect that taxes will have to be increased down the road to close the gap. That uncertainty can affect current spending decisions of businesses and households.

Financing Requirements

Financial requirements are set to rise to $31.8B in FY18/19 (excluding the $3B risk cushion) from a downwardly revised $23.5B in FY17/18, with the former due to ~$10B in additional non-budgetary transactions versus the Budget 2017 estimate for FY18/19. In terms of Government of Canada bond issuance, a sharp decline from $138B in FY17/18 to $115B in FY18/19 is outlined, with the treasury bill stock slated to rise from its currently depressed level to $138B by the end of FY18/19. Sharp reductions in 2-year and 3-year bond issuance are expected given recent auction size reductions in the former and a large fall in benchmark sizes for the latter. Nevertheless, there is continued emphasis on short- and medium-term bond issuance in the program (81% in maturities 5-years and under vs 83% in FY17/18). Looking ahead, the government is projecting $151.1B in aggregate financial requirements from FY18/19 through FY22/23 (excluding risk cushions). This, along with rising bond maturities, should see Government of Canada bond issuance rise from the FY18/19 level in subsequent fiscal years.

Economic assumptions	Budget 2018						Fall Economic Statement 2017 (Restated)					
per cent	2017	2018	2019	2020	2021	2022	2017	2018	2019	2020	2021	2022
Real GDP growth	3.0	2.2	1.6	1.7	1.6	1.8	3.0	2.1	1.6	1.7	1.7	1.8
GDP inflation	2.2	1.8	1.9	2.0	2.0	1.9	2.4	1.9	1.8	2.0	1.9	1.9
Nominal GDP growth	5.2	4.0	3.5	3.8	3.6	3.8	5.5	4.1	3.4	3.7	3.6	3.8
3-month treasury bill rate	0.7	1.4	2.0	2.3	2.5	2.5	0.8	1.5	2.0	2.3	2.5	2.7
10-year government bond rate	1.8	2.3	2.8	3.1	3.2	3.3	1.8	2.5	2.9	3.1	3.3	3.5
US real GDP growth	2.3	2.4	1.9	1.9	1.8	1.9	2.2	2.3	1.9	1.9	1.9	1.9

Source: Department of Finance, RBC Economics

Projections from the 2018 Federal Budget						
	Projection					
billions of dollars	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Budgetary transactions						
Budgetary revenues	309.6	323.4	335.5	348.0	362.1	373.9
Program expenses	304.6	312.2	321.5	331.5	340.7	350.1
Public debt charges	24.4	26.3	28.6	30.3	32.2	33.1
Total expenses	329.0	338.5	350.0	361.9	372.9	383.2
Adjustment for risk		*-3.0*	*-3.0*	*-3.0*	*-3.0*	*-3.0*
Budgetary balance	-19.4	-18.1	-17.5	-16.9	-13.8	-12.3
Federal debt	651.5	669.6	687.1	704.0	717.8	730.1
Per cent of GDP						
Budgetary revenues	14.5	14.5	14.5	14.5	14.6	14.5
Program expenses	14.2	14.0	13.9	13.8	13.7	13.6
Public debt charges	1.1	1.2	1.2	1.3	1.3	1.3
Total expenses	15.4	15.2	15.1	15.1	15.0	14.9
Budgetary balance	-0.9	-0.8	-0.8	-0.7	-0.6	-0.5
Federal debt	30.4	30.1	29.8	29.4	28.9	28.4

Source: Department of Finance, RBC Economics