2019 FEDERAL BUDGET

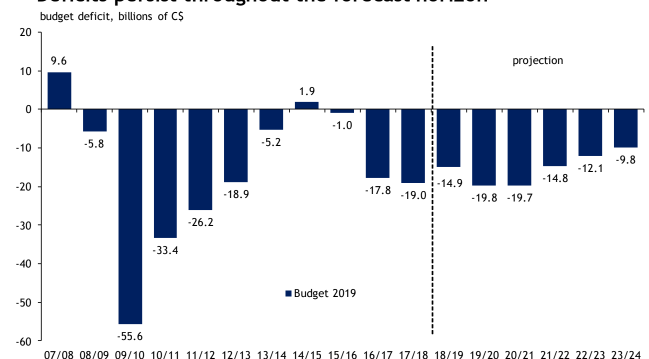
March 19, 2019

Voter-friendly grab bag leaves little room for error

The backdrop to today's budget was a familiar one: positive fiscal developments had given the government the option to plot a path of less borrowing, or more spending. Unsurprisingly, it went with the latter, announcing $21 billion in new expenditures over the next five fiscal years. It was hard to spot a centrepiece among these initiatives. Instead, the budget is a grab bag of voter-friendly measures (many telegraphed ahead of time) including funding for training and education, help for first-time homebuyers, early steps toward national pharmacare, and money for low-income seniors. The result is a little-changed deficit profile, including shortfalls of nearly $20 billion in each of the next two fiscal years. Those deficits are just small enough to push debt-to-GDP slightly lower in the near term. But a softening economic outlook for 2019 leaves little room for error. Persistent deficits also mean less fiscal flexibility should the economic outlook deteriorate more significantly. There are certainly some worthwhile initiatives in today's budget—funding for training and education in particular will help address very real challenges faced by workers and businesses. But we continue to be disappointed by the government's inability to prioritize spending and return to balance over its five-year forecast horizon.

Economic and fiscal projections

In our preview of today's budget, we noted that "March spending madness" often sees the government running a substantial deficit in the final month of the fiscal year. The current year will be no different. Despite tracking a small deficit over the first ten months of the current fiscal year, the government still expects to post a $14.9 billion deficit in FY 2018/19 excluding risk adjustment—only slightly below the $18.1 billion shortfall it estimated last fall including a $3 billion risk adjustment. Government revenues are tracking $5.7 billion higher than previously estimated. But rather than directing that money toward deficit reduction, the government is putting the money toward $5.6 billion in new policy actions. More than half of that is new infrastructure funding for local communities and funding to promote energy efficiency.



Positive economic and fiscal developments relative to the government's fall estimates continue in the years ahead. Higher revenues and lower debt-service spending gave the government an additional $22 billion in fiscal room over the next five fiscal years. As with the current fiscal year (and budgets past) that money went to $21 billion in new spending initiatives rather than deficit reduction. As a result, the deficit profile in the coming years is little changed from the fall—slightly higher in the near term and slightly lower further out. Deficits of $19.8 billion and $19.7 billion in FY 2019/20 and 2020/21 gradually shrink to $9.8 billion by FY 2023/24. That allows for a gradual reduction in the debt-to-GDP ratio, the government's fiscal anchor.

The projections don't fully take the recent deterioration in the economic outlook into account. Canada's economy lost momentum toward the end of last year with the energy sector facing new headwinds and the household sector slowing a bit more than expected. We have revised our 2019 real GDP growth forecast down to 1.5%, compared with the 1.8% assumed in today's budget. But the more significant impact comes from lower oil prices limiting nominal GDP growth, the broadest measure of the government's tax base. We see nominal growth slowing to 2.1% in 2019 rather than the 3.4% increase baked into today's projections. This more challenging economic backdrop could shave a few billion dollars off the government's bottom line in the upcoming fiscal year—potentially eating up all of the government's $3 billion risk adjustment for the year. A lower nominal GDP forecast would also adversely impact the government's debt-to-GDP estimates.

Key initiatives

Training and education

No single spending item stands out, but one of the more notable initiatives in today's budget is funding for training and education. In addition to support for work-integrated learning, we are pleased to see the government easing a path for workers at all career stages to pursue lifelong learning—something RBC called for in 2018's Humans Wanted report. The new Canada Training Credit will give

Craig Wright | SVP & Chief Economist | 416-974-7457 | **craig.wright@rbc.com**

Josh Nye | Senior Economist | 416-974-3979 | **josh.nye@rbc.com**

workers aged 25 to 64 $250 per year (up to $5,000 in a lifetime) in credits that can cover up to half the cost of a course or online training program. To qualify, workers must have at least $10,000 in earnings from work (including maternity and EI) and an annual income of less than $150,000. To facilitate use of this program, the Employment Insurance Training Support Benefit will give workers on training leave up to four weeks of income support through EI. The Canada Training Credit has a net cost of $700 million over the next five fiscal years, while the tab for EI enhancements is largely picked up by higher premiums. The government is also committing $800 million over five years to work-integrated learning, largely through expanding student work placements. Another $1.8 billion will go toward making student loans more affordable and accessible, mostly by lowering interest rates on those loans.

Housing

Initiatives to support first-time home buyers took on a slightly different shape than we were expecting. Extended amortizations for insured mortgages aren't on offer, though the government did increase the withdrawal limit for the Home Buyers' Plan to $35,000 from $25,000 previously (this is money buyers can withdraw from RRSP savings). The major initiative here is the First-Time Home Buyer Incentive, which is available to first-time home buyers with annual household incomes of less than $120,000 and who have the minimum down payment for an insured mortgage (5%). This program will see CMHC financing a portion of the home purchase by taking an equity stake (10% for new homes and 5% for existing homes). A lower mortgage size for the home buyer results in lower monthly mortgage payments (in the budget's example, $228 lower per month on a $400,000 home purchase with 5% down).

The government expects up to 100,000 first-time home buyers will be able to benefit from this program over the next three years. But its impact will ultimately depend on uptake of what is quite a novel program. It's worth noting that with a borrowing limit of four times debt-to-income and a maximum household income of $120,000, a borrower putting 5% down wouldn't be looking at homes for much more than $500,000. So it's hard to see the program helping buyers in Canada's least affordable markets.

In a recent note we argued that there isn't an obvious problem with home-ownership rates, including among millennials. We also warned that any measures that support housing demand, unless accompanied by initiatives to improve supply, could exacerbate affordability issues for first-time homebuyers. The changes announced today may stimulate demand somewhat in the near term (again depending on uptake) but are also intended to prompt a longer-term supply response (by allowing for a greater CMHC equity stake in new homes). Meanwhile, expanding the Rental Construction Financing Initiative at a cost of about $400 million in the coming five fiscal years is intended to increase rental supply.

Advancing reconciliation

The government is committing $4.7 billion over six years (including $3.8 billion over the next five years) to advancing reconciliation with Indigenous peoples. That includes a number of initiatives to improve the standard of living in Indigenous communities, including over $700 million to eliminate boil water advisories on reserves and $1.4 billion to improve services for First Nations and Inuit children.

National pharmacare

The government's pharmacare announcement was light on details. It intends to create the Canada Drug Agency which will take a coordinated approach to negotiating prescription drug prices on behalf of Canadians, potentially yielding annual savings of up to $3 billion in the long term. One of the agency's key responsibilities will be to work with the provinces, territories and other key stakeholders to develop a new national formulary of prescribed drugs. In terms of current funding commitments, the most significant initiative is $500 million per year to cover drug costs for rare diseases, but this only begins in FY 2022/23.

Other initiatives

Starting in FY 2020/21, the government is committing $1.8 billion to improve income security of low-income seniors through enhancements to the Guaranteed Income Supplement. $700 million over five years is being put toward the goal of ensuring all Canadians have high-speed internet access. Finally, a variety of initiatives filed under "delivering real change" (funding for health and well-being, the arts, veterans, public safety, government services, tax compliance) cost $5.3 billion over five years.

Financing Requirements

Financial requirements are set to rise to $28.9B in FY19/20 (excluding the $3B risk cushion) from a downwardly revised $12.6B in FY18/19. In terms of Government of Canada bond issuance, a sizable increase to $119bn in FY19/20 from $100bn in FY18/19 is projected, with the treasury bill stock expected to repeat its $20bn increase in FY18/19 to hit $151bn by the end of FY19/20. Multiple tweaks across bond sectors should see an increase in 3-year, 5-year and 30-year nominal issuance, while one less auction each for 10-year bonds and Real Return Bonds suggest lower issuance there. The increase in 3-year issuance should be the largest, with this reinforcing the preponderance of short- and medium -term bond issuance in the program (estimated 84% in maturities 5-years and under vs 80% in FY18/19). Looking ahead, the government is projecting $152.6B in aggregate financial requirements from FY19/20 through FY23/24 (excluding risk cushions). This, along with rising bond maturities, should see Government of Canada bond issuance remain at or above the FY19/20 level for the projection horizon.

Economic assumptions	Budget 2019						RBC Forecast	
percent	2018	2019	2020	2021	2022	2023	2019	2020
Real GDP growth	1.9	1.8	1.6	1.7	1.9	1.9	1.5	1.8
GDP inflation	1.9	1.6	1.9	2.0	2.0	2.0	0.7	2.4
Nominal GDP growth	3.8	3.4	3.5	3.7	3.9	4.0	2.1	4.2
3-month treasury bill rate	1.4	1.9	2.2	2.3	2.4	2.5	1.9	2.2
10-year government bond rate	2.3	2.4	2.7	2.8	3.1	3.3	2.4	2.5

Source: Department of Finance, RBC Economics

Projections from the 2019 Federal Budget						
	Projection					
billions of dollars	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Budgetary transactions						
Budgetary revenues	332.2	338.8	351.4	366.7	380.7	395.5
Program expenses	323.5	329.4	339.7	348.3	358.4	369.1
Public debt charges	23.6	26.2	28.5	30.2	31.4	33.2
Total expenses	347.1	355.6	368.2	378.4	389.8	402.2
Adjustment for risk		*-3.0*	*-3.0*	*-3.0*	*-3.0*	*-3.0*
Budgetary balance	-14.9	-19.8	-19.7	-14.8	-12.1	-9.8
Federal debt	685.6	705.4	725.1	739.8	751.9	761.7
Per cent of GDP						
Budgetary revenues	14.9	14.7	14.8	14.9	14.8	14.8
Program expenses	14.6	14.3	14.3	14.1	14.0	13.8
Public debt charges	1.1	1.1	1.2	1.2	1.2	1.2
Budgetary balance	-0.7	-0.9	-0.8	-0.6	-0.5	-0.4
Federal debt	30.8	30.7	30.5	30.0	29.3	28.6

Source: Department of Finance, RBC Economics

The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.

®Registered trademark of Royal Bank of Canada.
©Royal Bank of Canada.