2018 FEDERAL BUDGET PREVIEW

February 2018

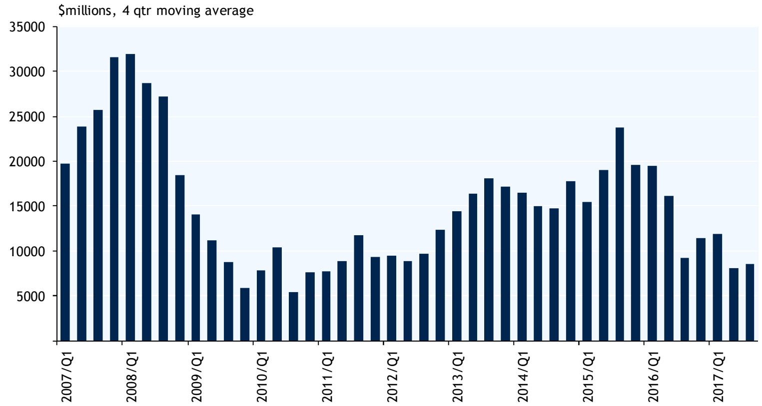
Eroding Canadian competitiveness is a Made-in-Canada problem

What a difference a year makes. The primary concern heading into last year's federal budget was how much damage the new U.S. administration would do to Canada's relative competitiveness, by lowering taxes and dismantling regulation. We did indeed witness a significant erosion in Canadian competitiveness, but it turns out to have been a Made-in-Canada effort. At various levels of government we saw the introduction of higher personal and corporate taxes, a move to carbon pricing in some provinces, and minimum-wage hikes.

As another federal budget looms, the existential risk of U.S. policy changes has become a reality. The U.S. tax overhaul wiped out Canada's corporate tax advantage, and the regulatory and environmental touch there is only expected to get lighter. These changes will threaten Canadian economic growth both in the short and long term. The Canadian consumer has been carrying the economy for a long period, building up substantial debt along the way. Economic growth in the years ahead will increasingly depend on investment and exports, both of which are on the defensive given Canada's weakened competitive position and threats to NAFTA. A more competitive Canadian economy would help stem the decline in foreign direct investment into Canada, which last fall hit lows not seen since the global financial crisis. Against this backdrop we would suggest the federal government look at any budget initiative through a competitive lens: if it further harms our competitive position it should be tossed out.

Canada Foreign Direct Investment inflows

$millions, 4 qtr moving average

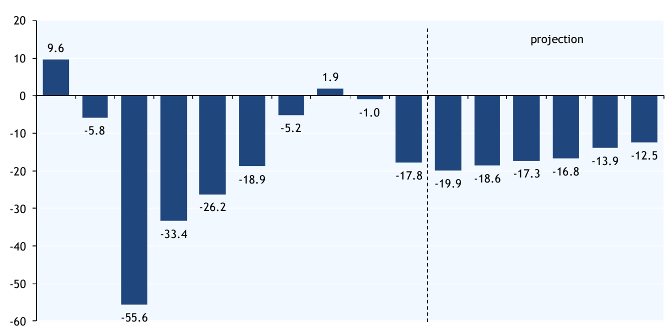


Source: Statistics Canada, RBC Economics Research

In the spirit of do no harm, the federal government has options to help stem the erosion in competitiveness. One—smarter regulation—would be relatively inexpensive to implement but could have real positive effects on economic performance. Other initiatives, including tax relief, would cost more but should also be considered. The recent tax changes in the U.S. included the full expensing of capital investment, something that in Canada would help accelerate the investment cycle needed for the next leg of expansion.

Fall Economic Statement 2017 deficit projections

billions of C$



Source: Department of Finance, RBC Economics Research

There are indications the budget will focus on gender and skills, both areas that deserve some policy attention. Female participation in the workforce in Canada is the highest among G7 countries, and further narrowing the gap with the male participation rate would yield substantial returns, including boosting GDP by up to 4%. And a focus

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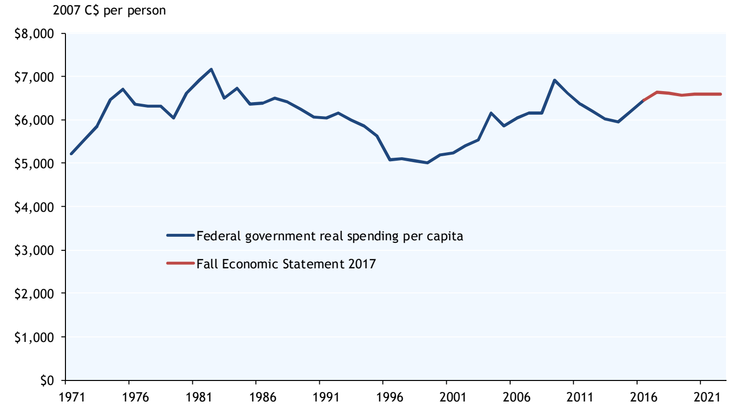
on skills comes just as many young people head into a labour market being significantly disrupted by technology. As Canada is a leader in post-secondary education attainment within the OECD, we are well positioned for a skills-based economy, though some rethinking is needed in how we are preparing our youth for this transition.

Unfortunately, the scope for a substantial improvement in our competitiveness is limited. The federal government has tossed aside an early promise of small deficits followed by a return to balance in favour of running deficits for as far as the eye can see. The current period offers the government the runway to regain some fiscal freedom by running surpluses so that it can respond when shocks come–be they changes to trade agreements, competitive policy changes by neighbouring countries, aging demographics, recessions, etc.

One area of opportunity would be to look for savings and efficiencies in the overall federal spend of over $300 billion. A modest cut of 5% would open up $15 billion for tax relief, a reallocation of spending to priority areas and/or a bigger step towards balancing the budget. The year-to-date tracking for the FY2017/18 shows that spending has been coming in lower than expected, which is one of the reasons the budget shortfall for the current fiscal year will likely come in below the $19.9 billion target and perhaps even under the FY2016/17 deficit of $17.8 billion.

Federal government real program expenses per capita



Source: Department of Finance, Statistics Canada, RBC Economics Research