



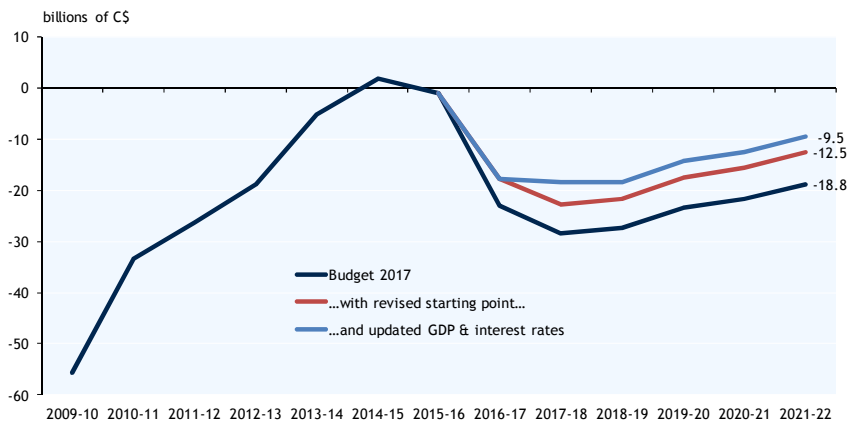
‘Fiscal dividend’ expected to trim budget deficits

The federal government will issue its fall economic statement on October 24th. Thanks to a smaller-than-expected deficit in fiscal year 2016/17 and stronger economic growth in the current calendar year, **the government’s finances are in better shape than it projected in Budget 2017**. That should put an end to the recent trend of ever-deeper deficit projections. In fact, the government has scope to trim the projected deficit by \$10 billion in the current fiscal year, and to lower cumulative deficits by nearly \$50 billion over the projection horizon. **The big question is whether the government will choose to spend some, or all, of this fiscal dividend**. We think it should exercise restraint. A return to smaller deficits or even a balanced budget would be a welcome development—particularly at this point in the business cycle when the economy is near full capacity and the government should be using higher revenues to create some fiscal room ahead of any economic downturn.

Recent federal budgets have included sizeable, deficit-financed spending in areas such as infrastructure and housing. Budget 2017 projected a \$28.5 billion deficit in the current fiscal year, widening from a previously estimated \$23.0 billion shortfall in fiscal 2016/17 and a deficit of just \$1.0 billion in the prior year. Deficits were projected to persist over the six-year forecast horizon although narrowing to \$18.8 billion by 2021/22. **The government will be taking into account a better starting point when it refreshes these projections**. Department of Finance figures show a \$17.8 billion deficit in fiscal 2016/17, more than \$5 billion smaller than the earlier estimate thanks to slower expenditure growth and higher revenues.

The other major development the government will take into account is stronger-than-expected GDP growth. **Canada’s economy leads the G7 this year and our forecast for 2017 real GDP growth of 3.1% is well above the 1.9% increase projected in Budget 2017**. According to the government’s sensitivity analysis, an upside surprise of 1 percentage point on real GDP growth boosts the bottom line by about \$4.5 billion a year thanks to stronger revenue growth and a slight reduction in expenses. There will be some offsetting impact, however, from higher interest rates. Given the economy’s impressive performance, the Bank of Canada has raised its benchmark interest rate by 50 basis points this year—increases that were not expected at the time of Budget 2017. That increase would add about \$0.5 billion to the deficit this year and more than \$1.5 billion five years out. **Overall, stronger growth and higher interest rates should trim the projected deficit by about \$4 billion in the current fiscal year and \$3 billion annually over the next four fiscal years.**

Canada's federal government could come closer to balancing their books by 2021-22



Source: Department of Finance, RBC Economics Research

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Combining the better starting point from fiscal 2016/17 and updated economic forecasts, the projected deficit for the current fiscal year would be about \$10 billion smaller than the \$28.5 billion shortfall set out in Budget 2017. If the \$3.0 billion risk cushion is removed, the deficit could be closer to \$15 billion. Indeed, the government's fiscal monitoring for the first four months of the current fiscal year is tracking a deficit close to that mark if not slightly smaller. **We think the updated deficit for fiscal year 2017/18 should fall somewhere in the \$10-20 billion range rather than \$28.5 billion.** The budget shortfall by 2021/22 could come in below \$10 billion rather than the \$19 billion deficit previously shown.

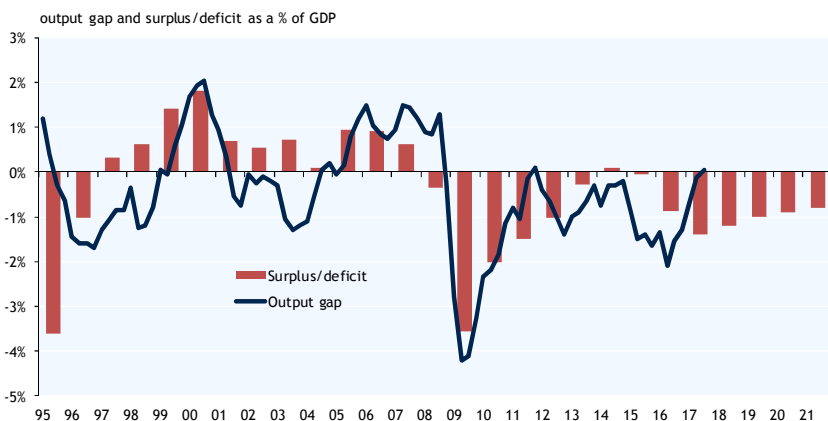
The question is whether the federal government will spend some or all of the room freed up by this stronger-than-expected fiscal position. **It has already announced a tax cut for small businesses that will lower the current 10.5% rate to 10% on January 1, 2018 and 9% a year later.** That change will cost \$2.9 billion over the next five fiscal years. Some offset could come from other changes to small business taxes. **Given its relatively small size, the small business tax cut isn't likely to provide a noticeable boost to the economy**—particularly if proposed US tax cuts erode Canada's relative advantage.

The government has so far not announced any new spending measures that would eat into the fiscal dividend. We think that is prudent, as even with an improved deficit profile, **the government won't return to balanced budgets over the next five years in the absence of greater fiscal restraint.** It is unusual for the federal government to not be at least aspiring to eliminate the deficit by some specified date—particularly at this stage in the economic cycle when fiscal buffers are normally being rebuilt. While it is the case that the debt-to-GDP ratio remains manageable and is set to decline over the projection horizon, deficits as far as the eye can see are a concern when fiscal headwinds from an aging population are intensifying. Persistent deficits suggest future tax hikes will be needed to close the gap. That would certainly be unwelcome when the Canadian economy is already facing competitiveness issues related to carbon taxes, electricity prices and minimum wage hikes.

With the economy near full capacity, any fiscal stimulus is likely to be inflationary—prompting an offsetting response from the Bank of Canada.

The central bank has already raised interest rates by 50 basis points since July, a move that will likely trim about 1/2 percentage point from GDP growth over one to two years. For perspective, the government estimates that new spending measures announced in Budget 2016 boosted growth by 0.4 percentage points in the first year of implementation. Granted, infrastructure spending has the potential to boost longer-run productivity growth, lifting capacity and resulting in less inflationary pressure. But higher spending won't translate one-to-one into productivity growth, meaning stimulus is likely to push the economy beyond full capacity and prompt a more aggressive tightening in monetary policy from the Bank of Canada. It

No end in sight for budget deficits when the economy is nearing full capacity and should be rebuilding fiscal room



wouldn't take much in terms of further rate hikes to fully offset any near-term fiscal lift. **We think the government's improved fiscal position would be put to better use by returning to a balanced budget.** That would leave room to respond if the currently enviable trend in Canada's economy deteriorates down the road.

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