

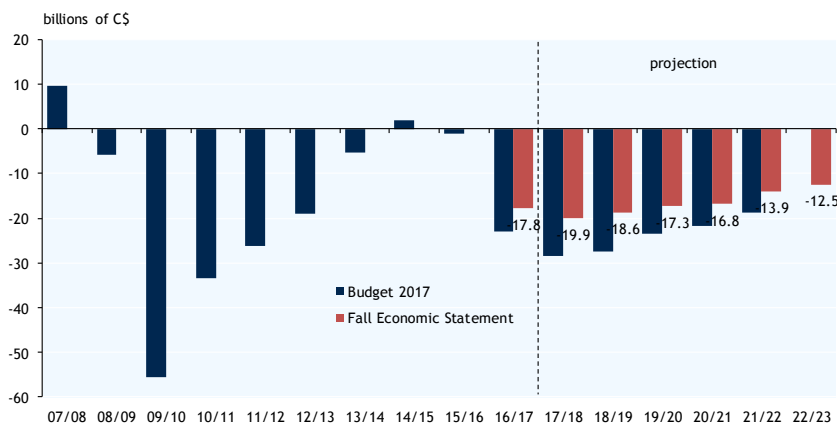


Fiscal dividend used to trim deficits, though boost spending as well

The federal government issued its fall economic statement today, providing an update on the state of its finances between official budgets. As noted in our [preview](#), the combination of a better-than-expected starting point from fiscal year 2016/17 and stronger GDP growth than was assumed in Budget 2017 provided a ‘fiscal dividend’—allowing the government to show smaller deficit projections, though also providing greater capacity to spend. In the end they opted for a combination of both, spending about a third of the \$46.6 billion fiscal dividend but still showing a deficit profile that is \$8.6 billion smaller in the current fiscal year and \$33 billion smaller cumulatively over the next five years. While a lower deficit profile is encouraging, it is still disappointing that the government doesn’t envision a return to balance by fiscal year 2022/23, when a \$12.5 billion deficit is expected. We think it would be prudent to commit to a return to balance—particularly at this stage in the business cycle when the economy is close to full capacity and the government should be looking to rebuild fiscal room ahead of any future economic slowdown. The lack of balanced budget anchor also raises the risk that the government further dips into their fiscal dividend in Budget 2018.

Two main factors contributed to the government’s stronger budget position. The first, a better starting point from fiscal year 2016/17, was already known with Department of Finance figures released in September showing a \$17.8 billion deficit last fiscal year, more than \$5 billion smaller than the estimate from Budget 2017. The other factor helping to shrink the deficit profile was stronger GDP growth this year. Canada’s economy emerged from the energy-driven slowdown of the last two years and now leads the G7 in growth. That was clearly reflected in the economic forecasts underlying the government’s budget projections as the consensus for 2017 real GDP growth was bumped up to 3.1% from 1.9% in Budget 2017. Economic assumptions beyond the current year were little changed with GDP growth expected to slow to 2.1% next year and 1.6% in 2019, compared with 2.0% and 1.7% previously. The forecast also incorporated higher interest rates, which raised debt servicing costs and tempered the improved deficit profile. With the Bank of Canada having raised rates twice this year—increases not expected at the time of Budget 2017—the profile for short-term interest rates was revised up by roughly 50 basis points over the projection horizon while longer-term interest rates are only forecast to be slightly higher than projected in Budget 2017.

Updated budget projections show smaller deficits than Budget 2017 but still no return to balance...



Source: Department of Finance, RBC Economics Research

Stronger GDP growth this year and a better starting point—the ‘fiscal dividend’ or what the Department of Finance refers to as ‘economic and fiscal developments’—trimmed the projected deficit in fiscal year 2017/18 by \$8.9 billion. Policy actions since Budget 2017 will cost \$1.8 billion in the current fiscal year although eliminating half of the \$3.0 billion risk

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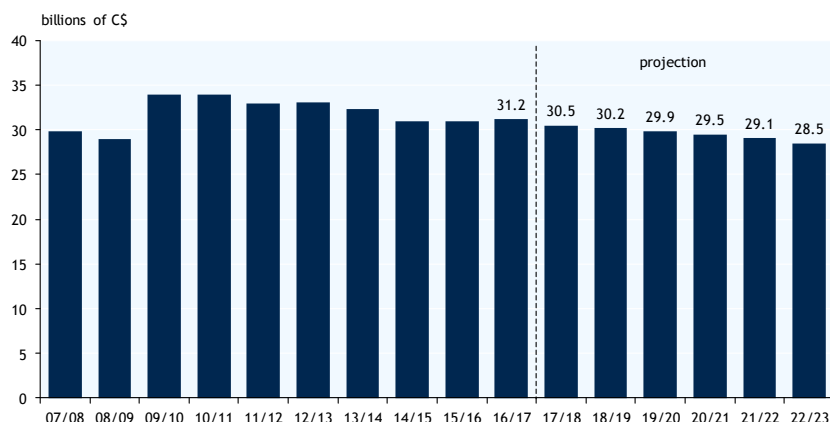
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adjustment (in this year alone—the \$3.0 billion adjustment remains in place further out) largely offset that increase. On balance, the projected deficit for fiscal year 2017/18 was lowered to \$19.9 billion from \$28.5 billion in Budget 2017. A smaller deficit profile was largely carried through over the projection horizon. Total deficits of \$86.5 billion from fiscal years 2017/18 to 2021/22 were down significantly from a \$119.8 billion cumulative shortfall projected in Budget 2017. That improvement was thanks to a \$46.6 billion in ‘economic and fiscal developments’—again, largely stronger growth this year alone that boosts revenues across the projection horizon. The federal government ate into that fiscal dividend to the tune of \$15 billion through policy actions since Budget 2017, including measures announced in today’s economic statement.

Much of the additional spending relative to Budget 2017 consists of policy actions taken prior to the release of today’s Fall Economic Statement. The most notable is the small business tax cut that was announced last week. Lowering the tax rate for small businesses from 10.5% currently to 10% on January 1, 2018 and 9% a year later costs \$2.9 billion over the projection period. Some of that tax cut is paid for by measures to limit income sprinkling. Other policy actions since Budget 2017 include investing in critical care services for Canadians at a cost of just over \$5 billion as well as ‘non-announced measures’ that amount to nearly \$3 billion over the projection horizon. The latter includes “provisions for anticipated Cabinet decisions not yet made and funding decisions related to national security, commercial sensitivity and litigation issues.”

Two measures announced in today’s Fall Economic Statement are set to cost a cumulative \$7.7 billion between fiscal years 2018/19 and 2022/23. The more significant is the earlier indexation of the Canada Child Benefit. Benefits from that program, which was introduced in Budget 2016 to replace the previous child benefit system, as well as the thresholds to qualify were previously scheduled to be indexed to inflation in fiscal year 2020/21. The government is moving ahead that timeframe, beginning indexation in July 2018 at an additional cost of \$5.6 billion. The other significant measure announced is enhancement to the Working Income Tax Benefit, a refundable tax credit that supports low-income workers. The government is boosting that program by \$0.5 billion annually starting in 2019.

...though Canada's federal debt-to-GDP ratio is now projected to fall over the forecast horizon



Source: Department of Finance, RBC Economics Research

With smaller projected budget deficits and a level of nominal GDP that is 1.4% higher this year than expected in Budget 2017, the federal debt-to-GDP ratio is expected to fall to 30.5% in the current fiscal year rather than the 31.6% ratio previously expected. The debt-to-GDP ratio continues to decline over the projection horizon, falling to 28.5% by fiscal year 2022/23—below the mark seen prior to the 2008/09 recession that pushed government deficits higher. The debt-to-GDP ratio is something of a fiscal anchor for the federal government, and it is encouraging to see the debt burden is projected to decline over time even as deficits persist. However, it remains disappointing that the government is not projecting a return to a balanced budget over the medium term.

Instead, the government has opted for deficit-financed spending at a time when the economy is close to full capacity. This runs the risk of any additional pro-cyclical fiscal policy being offset by tighter monetary policy. Hopefully this reality will prevent Budget 2018 from backsliding further into spending more of the fiscal dividend.

| Economic assumptions | Fall Economic Statement 2017 | | | | | Budget 2017 | | | | | |
|------------------------------|------------------------------|------|------|------|------|-------------|------|------|------|------|------|
| | per cent | 2017 | 2018 | 2019 | 2020 | 2021 | 2017 | 2018 | 2019 | 2020 | 2021 |
| Real GDP growth | | 3.1 | 2.1 | 1.6 | 1.7 | 1.7 | 1.9 | 2.0 | 1.7 | 1.7 | 1.8 |
| GDP inflation | | 2.4 | 1.8 | 1.8 | 2.0 | 1.9 | 2.1 | 2.0 | 1.8 | 2.1 | 2.0 |
| Nominal GDP growth | | 5.5 | 4.0 | 3.4 | 3.7 | 3.6 | 4.1 | 4.0 | 3.5 | 3.8 | 3.8 |
| 3-month treasury bill rate | | 0.8 | 1.5 | 2.0 | 2.3 | 2.5 | 0.6 | 0.9 | 1.4 | 1.8 | 2.3 |
| 10-year government bond rate | | 1.8 | 2.5 | 2.9 | 3.1 | 3.3 | 1.8 | 2.3 | 2.7 | 3.0 | 3.3 |
| US real GDP growth | | 2.2 | 2.3 | 1.9 | 1.9 | 1.9 | 2.3 | 2.3 | 1.8 | 1.9 | 2.0 |

Source: Department of Finance, RBC Economics

Projections from the October 2017 Fall Economic Statement

| billions of dollars | 2016/17 | Projection | | | | | |
|-------------------------------|---------|------------|---------|---------|---------|---------|---------|
| | | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 |
| Budgetary transactions | | | | | | | |
| Budgetary revenues | 293.5 | 310.7 | 323.1 | 333.3 | 345.3 | 359.6 | 371.3 |
| Program expenses | 287.2 | 304.9 | 312.2 | 319.0 | 328.9 | 338.6 | 347.9 |
| Public debt charges | 24.1 | 24.2 | 26.6 | 28.7 | 30.2 | 31.9 | 32.8 |
| Total expenses | 311.3 | 329.1 | 338.8 | 347.7 | 359.1 | 370.5 | 380.7 |
| <i>Adjustment for risk</i> | | -1.5 | -3.0 | -3.0 | -3.0 | -3.0 | -3.0 |
| Budgetary balance | -17.8 | -19.9 | -18.6 | -17.3 | -16.8 | -13.9 | -12.5 |
| Federal debt | 631.9 | 652.8 | 671.5 | 688.8 | 705.6 | 719.5 | 732.0 |
| Per cent of GDP | | | | | | | |
| Budgetary revenues | 14.5 | 14.5 | 14.5 | 14.5 | 14.5 | 14.5 | 14.5 |
| Program expenses | 14.2 | 14.3 | 14.0 | 13.9 | 13.8 | 13.7 | 13.5 |
| Public debt charges | 1.2 | 1.1 | 1.2 | 1.2 | 1.3 | 1.3 | 1.3 |
| Budgetary balance | -0.9 | -0.9 | -0.8 | -0.8 | -0.7 | -0.6 | -0.5 |
| Federal debt | 31.2 | 30.5 | 30.2 | 29.9 | 29.5 | 29.1 | 28.5 |

Source: Finance Canada, RBC Economics

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