OBSERVATION

TD Economics

November 12, 2014

THE PRODIGAL SURPLUS IS RETURNED

SOME HIGHLIGHTS FROM THE NOVEMBER 2014 FEDERAL FISCAL UPDATE

Highlights

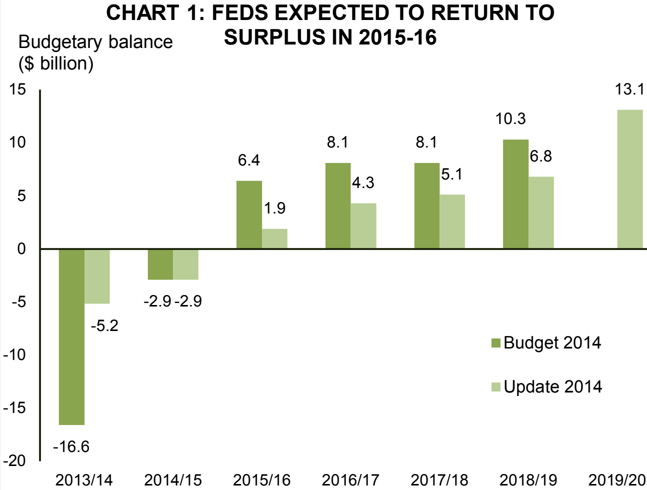
- With an election year looming, the release of the federal fiscal update has provided Canadians with renewed clarity as to the expected path of the nation's finances over the next few years.
- Overall the outlook is positive, with stronger economic growth expected to keep revenues buoyant while spending remains low relative to the size of the economy. That said, lower oil prices and a weaker global growth environment has led the government to scale back its fiscal forecast relative to Budget 2014.
- The government is projecting a $2.9 billion deficit for the current fiscal year. However, surpluses over the next 4 years are excepted to come in at a much reduced cumulative $18.1 billion when compared to the $32.9 billion projected in Budget 2014.
- The lower fiscal forecast largely reflects the adjustment for risk and tax relief provided to families in October 2014. As a result, there will be little room left to increase spending or cut taxes going forward. Given the modest amount of room available, tough choices will be required.

With the release of the federal government's Update of Economic and Fiscal Projections 2014 (the Update), Canadians now have a clearer picture of state of the nation's finances in the run-up to the 2015 election year. Overall, today's report confirmed that there is light at the end of the tunnel, with surpluses expected in each fiscal year beginning in 2015-16. At $2.9 billion, the estimated deficit in fiscal 2014-15 is modest and identical to that expected in February 2014 Budget (Chart 1). Beyond fiscal 2014-15, about $18.1 billion in surpluses are projected over the next five years, just over half of that contained in the government's 4-year outlook in Budget 2014.

Fiscal 2013-14 reaps $11.4 billion windfall

Since bringing down the 2014 budget, the government's fiscal outlook has changed significantly. Ahead of today's Update, Canadians had already received news from the release of the 2014 Annual Financial Report (AFR) that last year's budget deficit came in considerably lower than projected in the spring budget. The budget deficit came in at $5.2 billion in 2013-14, a marked improvement of $11.4 billion over the $16.6 billion shortfall projected in Budget 2014. Much of the outperformance reflected higher revenues than projected at the time of the budget (+$7.7 billion). At the same time, both program expenses (-$2.6 billion) and public debt charges (-$0.4 billion) came in lower than expected. The lower program expenses projection was due to $2.8 billion in savings from direct program expenses (i.e.,

CHART 1: FEDS EXPECTED TO RETURN TO SURPLUS IN 2015-16



Source: Deparment of Finance Canada.

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all programs excluding transfer payments to individuals, businesses and other governments) – one of the few remaining areas of discretionary spending. This said, some of the better revenue and expenditure numbers were the result of one-time factors, such as asset sales, which will not flow through to later fiscal years.

Economic news has been mixed

The lower-than-expected deficit in fiscal 2013-14 generated a better starting point for the current fiscal year. However, developments in the economy since the spring have been decidedly mixed. Notably, as Table 1 reveals, the government's expectations for the economy this year (which are based on the latest private-sector forecasts) have been revised up relative to the budget, while interest rates have been adjusted downward. Both of these developments pointed to an upgrade in this year's fiscal outlook. However, two recent developments have eroded this outperformance. First, crude oil prices have tumbled since September. Moreover, the government announced significant new tax relief for families that will take be effective in 2014, absorbing about $3.2 billion in revenues this fiscal year alone. Lower oil prices and a more modest economic outlook for the U.S. have put a modest chill on the Canadian growth outlook going forward.

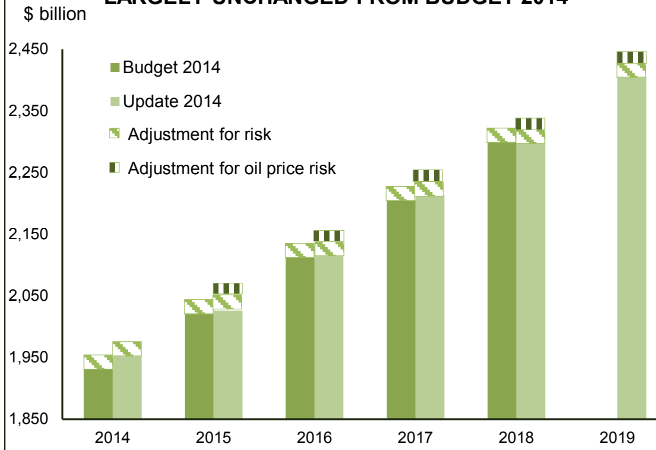
Since much of the oil price developments had occurred after private-sector forecasts were locked down, the government has chosen to augment its typical adjustment for risk with additional prudence related to the impact of the lower prices (for the views of TD Economics, see Of Oil and Output: An Overview of the Impacts of Falling Oil Prices on the Canadian Economy). This adjustment conservatively assumes Canadian crude oil prices remain unchanged at $70 per barrel. Together, these adjustments equate to $5.4 billion dollars in lower revenues each fiscal year from 2015-16 and beyond than would be the case using the economic projections alone (Chart 2). These adjustments offset the better starting point, leaving the level of nominal GDP for fiscal-planning purposes broadly unchanged from Budget 2014. However, the growing cost of the tax cuts will put a dent into surpluses over the full horizon.

Table 1: Economic Assumptions for Canada
Annual, percent change (unless otherwise indicated)

Calendar Year	2014	2015	2016	2017	2018	2019
Real GDP						
February 2014 Budget	2.3	2.5	2.5	2.3	2.2	--
November 2014 Update	2.4	2.6	2.4	2.3	2.2	2.1
Nominal GDP						
February 2014 Budget	3.9	4.5	4.5	4.4	4.2	--
November 2014 Update	4.4	4.3	4.4	4.4	4.2	4.1
Nominal GDP ($ billion)						
February 2014 Budget	1,952	2,040	2,132	2,226	2,320	--
November 2014 Update	1,977	2,062	2,153	2,249	2,345	2,442
3-Month T-Bill Rate						
February 2014 Budget	1.0	1.5	2.7	3.6	4.0	--
November 2014 Update	0.9	1.2	2.1	2.9	3.4	3.6
10-Year Gov't Bond Yield						
February 2014 Budget	3.0	3.5	4.1	4.6	4.8	--
November 2014 Update	2.3	3.0	3.6	4.1	4.3	4.4

Sources: Department of Finance Canada, Statistics Canada, Bank of Canada.

CHART 2: RISK-ADJUSTED NOMINAL GDP LARGELY UNCHANGED FROM BUDGET 2014



Source: Department of Finance Canada.

Fiscal projections

Putting it all together, while the 2013-14 and 2014-15 fiscal years were better overall relative to Budget 2014, the cumulative surplus over the remainder of the projection is notably lower. Specifically, the cumulative surplus from fiscal year 2015-16 to 2018-19 published in the November 2014 Update ($18.1 billion) is expected to be lower than the $32.9 billion surplus expected in Budget 2014 (Table 2).

Further, the current fiscal projection continues to ensure that the federal government will meet the debt-to-GDP target of 25% by 2021 it set for itself in September 2013. With a projected debt-to-GDP level of 24.3% in fiscal 2019-20, the federal government is expected to comfortably meet its debt target.

Table 2: November 2014 Federal Fiscal Update Forecast Summary (C$ billion, unless otherwise specificed)						
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Budgetary Revenues	**277.6**	**294.5**	**307.6**	**318.6**	**332.8**	**347.9**
Program Expenses	252.7	263.9	273.0	281.3	292.2	299.6
Public Debt Charges	27.7	28.7	30.4	32.3	33.8	35.2
Total Expenses	**280.5**	**292.6**	**303.3**	**313.6**	**326.1**	**334.8**
Budgetary Balance	**-2.9**	**1.9**	**4.3**	**5.1**	**6.8**	**13.1**
Federal Debt	615.8	613.9	609.5	604.4	597.6	584.5
Per cent of GDP						
Budgetary Revenues	14.2	14.5	14.5	14.4	14.4	14.5
Program Expenses	12.9	13.0	12.9	12.7	12.7	12.5
Public Debt Charges	1.4	1.4	1.4	1.5	1.5	1.5
Budgetary Balance	-0.1	0.1	0.2	0.2	0.3	0.5
Federal Debt	31.5	30.3	28.8	27.3	25.9	24.3
Source: Department of Finance Canada.						

New measures introduced since Budget 2014

The government built in the cost of the previously-announced tax measures into the 5-year fiscal plan. The initiatives include new tax breaks for families with dependent children, which come in just shy of $27 billion over 6 years. Further, the Small Business Job Credit will come in to affect in 2015 and 2016, although it will have a more modest impact of $550 million. Beyond these measures, there were no new policies announced in the Update.

The following tax breaks for families with dependent children under the age of 18 were introduced in October 2014:

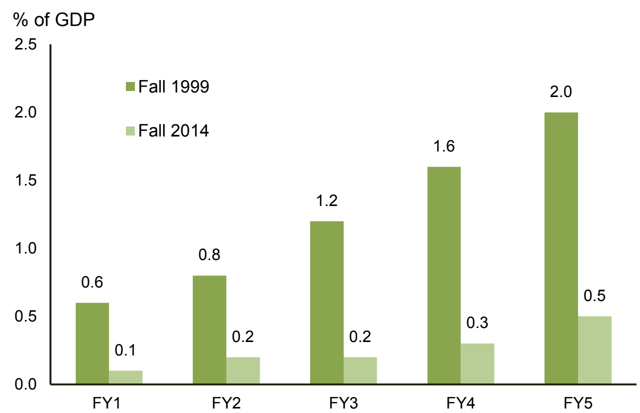
- Family Tax Cut – Equivalent to $12.7 billion over 6 years, the Family Tax Cut is a modified version of the income-splitting proposal contained in the Conservative Party of Canada 2011 Election Platform. The modification to the original proposal relates to the $2,000 cap on taxable benefits. This change was introduced to address the criticism that high-income families would benefit disproportionately from the proposal. Additionally, the Family Tax Cut will be provided in the form of a tax credit, thereby not affecting the federal or provincial tax base.
- Child Care Expense Deduction – The federal government also increased the maximum amount that could be claimed under the Child Care Expense Deduction by $1,000. The maximum limit now ranges between $4,000 and $11,000, depending on the child's age and eligibility for the Disability Tax Credit. In total, this measure is valued at $0.4 billion over 6 years.
- Universal Child Care Benefit – The numbers are a bit messier in regard to the Universal Child Care Benefit (UCCB), as the federal government eliminated the Child Tax Credit at the same time. Further, the UCCB is taxable, thereby reducing some of the benefit. As a result, the $26.2 billion increase in spending from the enhanced UCCB will be somewhat offset by $3.0 billion in taxes on the UCCB and $9.5 billion from the elimination of the Child Tax Credit.
- Doubling the Child Fitness Tax Credit – On October 9, the federal government announced it would be doubling the Child Fitness Tax Credit (CFTC) and making it refundable, meaning that those that don't pay sufficient tax to claim the credit against will still get something back. In TD Economics' initial fiscal forecast, we projected the cost of this measure to be at least $0.4 billion over 6 years.

Meanwhile, at a cost of $550 million over two years, the Small Business Job Credit was introduced in September 2014 to support job creation by small businesses. While the federal government has not provided an estimate of the expected employment impacts of this measure, the labour market impact is expected to be modest but positive.

What to expect in the run up to Budget 2015

With the introduction of these additional measures, the federal government is now projected to have about $28.3 billion in cumulative surplus room available for new measures

CHART 3: FISCAL PROJECTIONS SHOW SURPLUSES AREN'T WHAT THEY USED TO BE



Sources: 1999 Economic and Fiscal Update, TD Economics.
Note: The horizontal axis refers to each fiscal year following the release of the Fall Update. For example, 'FY1' refers to both 2000-01 and 2015-16.

over the next five years. This is modest by any standard. For instance, in its 1999 Economic and Fiscal Update, the federal government issued status-quo projections that revealed a sea of surplus black ink that was expected to reach $23 billion, or 2% of GDP, by the end of the 5-year planning horizon (Chart 3). Fast forward to today. The cumulative total expected over the 5-year horizon at the time was $67 billion. The Update's 5-year cumulative surplus forecast beyond 2014-15 is slightly lower than that projected in the 1999 Economic and Fiscal Update. Specifically, it only amounts to about 0.5% of GDP 5 years out, or about one quarter of the expectation in the 1999 Update (Chart 3).

Beyond the measures currently announced, the federal government has also committed to introducing all of its 2011 election commitments prior to the next election. As such, the only remaining measures to be introduced are the doubling of the contribution limit for the Tax Free Savings Account (TFSA) from $5,000 to $10,000 and the introduction of an Adult Fitness Tax Credit (AFTC) of $500. Using information from a variety of official source, TD Economics estimated the costs of these measures in a recent report at about a cumulative $2.3 billion and $1.0 billion, respectively, from 2015-16 to 2019-20. This would reduce the cumulative surplus by an additional $3.3 billion over the projection. As a result, the cumulative surplus over the next 6 years would be lowered slightly to $25.0 billion.

According to TD Economics calculations, this leaves little room for additional tax relief or new spending measures (see The Trouble with Surpluses: An Examination of the Federal Fiscal Outlook). For instance, reducing the lowest marginal federal tax rate by one percentage point is estimate cost $15.5 billion, while cutting the corporate income tax rate could be expected to cost about $14.7 billion. Further reducing the Goods and Services Tax (GST) from 5% to 4%, all else equal, would have a cumulative fiscal impact of about $36.7 billion. Tax relief could also be provided through a reduction in Employment Insurance (EI) premiums, as the cumulative balance in the EI Operating Account is expected to reach $7.0 billion in 2016-17, before being gradually reduced.

Beyond tax measures, there will be pressure for the federal government to increase spending after a period of prolonged restraint. Historically, periods of spending restraint have been followed by periods of significant spending increases. The provinces may also be looking to share in the wealth, with an increase in the Canada Health Transfer (CHT) and Equalization transfers being a frequently heard call.

Finally, while the projected surplus in the Update will not leave much room available for new spending or tax cuts, this projection does not include funds set aside for general and oil price risk. This prudence is equivalent to roughly $31 billion over 6 years. In our view, this amount should be more than ample to address the external risks to government finances. As such, there may be scope to see higher surpluses and, as such, to provide additional room for new measures or pay down the debt more quickly.

Bottom line

Despite the recent drop in oil prices and the cost of tax relief announced recently, the federal government's books are on track to move into surplus and debt-to-GDP ratio to continue to fall towards 25% of GDP. As the government heads into an election, pressure to provide additional tax cuts and increase spending will intensify. However, given the modest amount of room available, tough choices will be required.

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