OBSERVATION

TD Economics

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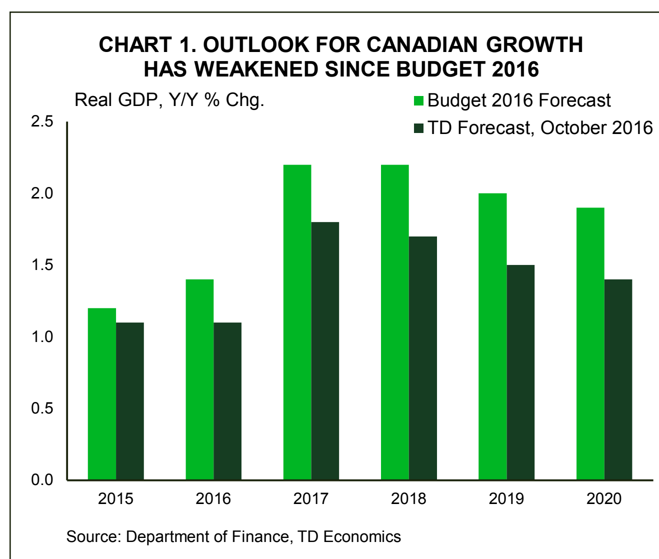
SOFT ECONOMY SETS THE STAGE FOR WIDER FEDERAL DEFICITS

Highlights

- The medium-term outlook for Canadian economic growth has weakened since the time of Budget 2016. Larger federal fiscal deficits are forecasted.
- Based on our calculations, the budget deficit is on track to reach $34 billion this fiscal year (1.7% of GDP), about $5 billion higher than shown in the March budget.
- This fiscal erosion extends through the entire 5-year horizon, leaving the cumulative deficit $16.5 billion above that forecasted in March.
- Despite this deficit upgrade, prospects for a modestly growing economy would likely cap the federal debt-to-GDP ratio close to its current level of 31-32% through fiscal 2020/21
- As the budget approaches the government will face growing calls for further stimulus, while pressure from the Provinces will build for additional health transfers.
- However, we caution against undertaking actions that would lift the deficit profile significantly above the “status-quo”. Maintaining a good degree of fiscal wiggle room is warranted in light of the unusually high uncertainty that persists around Canada’s economy and housing market.

The economic situation in Canada has deteriorated since Budget 2016, impacted not just by wildfires, but also by serially disappointing underlying momentum. This raises questions surrounding the longer-term trend pace of economic growth and the potential to hit federal coffers. A commensurate downgrade in the profile for interest rates will provide an offset in terms of lower debt service charges. But, lower rates will also act to increase pension liabilities, thus dampening their positive impact on the federal deficit. This note will examine how these factors are expected to net out on federal fiscal fortunes over the next five years.

Based on our calculations, the federal deficit is likely to come in at about $34 billion in fiscal 2016/17, roughly $5 billion higher than projected in the March budget. Recall that the government built in a $6 billion annual cushion into its numbers to protect against unforeseen events. This allotted cushion is poised to be absorbed, and then some. The erosion extends through the entire fiscal horizon, leaving the combined shortfall some $16.5 billion higher than that projected in March. Despite this widening in the status-quo budget gap, debt as a share of GDP is expected to remain broadly stable through the forecast period.



Beata Caranci, VP & Chief Economist, 416-982-8067
Derek Burleton, VP & Deputy Chief Economist, 416-982-2514
Brian DePratto, Economist, 416-944-5069

A better starting point

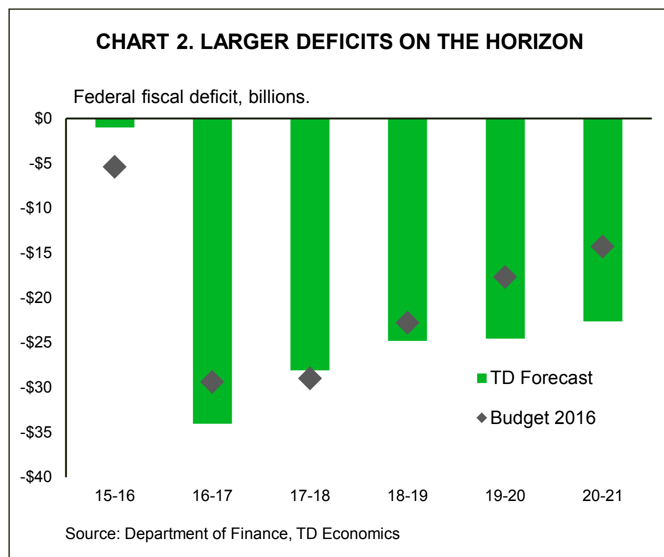
From the outset, it should be acknowledged that when it comes to the federal fiscal situation since Budget 2016 was brought down, it is not all bad news. To begin with, the federal government will enjoy a better-than-expected starting point. Last week, the Federal Department of Finance released the 2015/16 Public Accounts, which revealed a shortfall of $1.0 billion, roughly $4.4 billion smaller than what had been predicted in Budget 2016.

Secondly, expectations surrounding interest rates have continued to come down in tandem with growth. This reduces the longer-term fiscal impacts of new borrowing, and results in lower public debt charges as existing debt matures and is rolled over at lower interest rates. Longer-term rates have been marked down by about 1.5 percentage points since the budget, sufficient to reduce public debt charges by as much as $5 billion by fiscal 2020/2021, even when larger deficits are taken into account.

Slow growth drags deficits wider

Despite these positives, larger deficits are likely. First, lower interest rates are something of a double-edged sword: although helpful in reducing public debt charges, they also create a challenge for government pensions. Lower interest rates make it harder for these programs to achieve their return targets, creating shortfalls that must be met. Using Department of Finance sensitivities, we expect this effect to result in additional costs of roughly $3 billion per year, offsetting a large portion of the public debt charge savings.

Most important, however, is the economic backdrop. Canadian growth prospects have weakened since Budget 2016 was introduced. Much of the near-term weakness has been unforeseeable, as the tragic May wildfires in Alberta dragged the overall economy into a second-quarter contraction. More concerning was the lack of 'underlying' momentum in economic activity. Even absent the wildfires, the economy has barely grown since the early part of 2015. We see somewhat better times ahead as the impact of resource cuts diminish. Still, with elevated housing and debt-loads to keep consumer spending in check and demographic pressures intensifying, the Canadian economy seems poised for a significant period of only modest 3-3.5% nominal GDP growth through fiscal 2020/21. This is roughly one percentage point lower than Budget 2016 estimates.



This annual increase would leave the level of nominal GDP – a good proxy for the tax base – at $2.305 trillion by fiscal 2020/21. By comparison, the 2016 Budget assumed a 5-year out nominal GDP level of $2.368 trillion – and that was after downwardly adjusting the private sector average forecast by $40 billion as a risk buffer. Based on a crude revenue yield of 15 cents for each dollar of GDP, that differential would translate into a lower revenue intake relative to budget of about $10 billion by the final year of the 5-year forecast horizon.

The softer income gains would hit personal tax revenues (the lion's share of federal revenues). Corporate tax takes are forecast to grow only slowly, in line with overall economic growth and only modest gains in oil prices. It is a similar story for excise taxes and other duties.

While less impacted than revenue, program spending would also be impacted by a slower profile of nominal GDP. Several expenditure categories – notably the Canada Health Transfer and Canada Social Transfer – are governed by present formulae. As a result, we expect only modestly higher expenditures over the forecast, with the largest driver being the previously discussed pension liability resulting from lower interest rates. EI benefit expenditures are also expected to be somewhat higher in the near term, reflecting recent qualification changes and a soft labour market backdrop.

Putting it all together, Canadians can expect to see larger and more persistent federal budget deficits than those contained in Budget 2016 (Chart 2 and Appendix B). Our analysis suggests that the $6bn downward adjustment to the deficit forecast in the budget may not have been large enough. Admittedly, our medium-term GDP growth forecast has, for some time, been at the low end of consensus. However, the general tendency of forecasters has been to trim their growth projections, at least over the near term.

A word on fiscal anchors

Reflecting both economic and political reasons, the outlook for federal deficits has changed significantly over the last two years. With this comes a rekindling of the debate over what fiscal anchor, if any, should bind the federal budget. There a number of challenges in making this determination. A frequently mentioned target that tends to gather fairly broad support is a zero deficit target over a medium-term horizon. But, in this economic environment, achieving that goal would generate significant fiscal drag in an economy already struggling to grow.

More focus has shifted to targeting a certain level of the debt ratio. However, there is no consensus on what an optimal debt ratio would look like – past research has landed in the massive range of about 60% of GDP to a net asset position. So setting a debt target becomes somewhat arbitrary.

In general, the benefits of introducing a binding fiscal anchor or rule are largest for economies with ballooning deficits and debt, as an anchor and credible path may help reassure markets. Fortunately, the Canadian federal government is not in that situation, boasting a relatively low and stable debt burden. Moreover, so long as the government continues to target a positive gap between revenue and expenditure growth – and remains both credible and accountable for achieving those targets through its annual budget exercise – an implicit fiscal anchor remains (as deficits will thus shrink over time in both absolute and relative terms).

Caution on deficits is warranted

But, while a formal anchor may not be currently warranted, we do share concerns that the federal deficit will prove to be stubbornly hard to rein in. Canadian experience shows that running budget shortfalls can be a slippery slope. Imagine the federal fiscal position if the economy were to hit a severe speedbump, which is far from out of the question.

The federal government is also facing pressures to introduce new measures above and beyond the commitments incorporated in Budget 2016 (and thus included in our fiscal forecast). Some, such as increased spending on Aboriginal reconciliation and rights recognitions, as well as spending on veterans, are likely to be modest in size, and would represent the keeping of promises made by the government. Other government commitments, such as extending compassionate care employment insurance benefits, may prove more costly.

One of the larger risks is in relation to health care transfers to provinces. As mentioned previously, these transfers are governed by a set growth formula. This means that after expanding by 6% in the current fiscal year, fiscal 2017-2018 will, in our forecast, see growth of 3% (the formula calls for these transfers to expand by nominal GDP growth, with a floor at 3%). Given population aging will place increased strains on healthcare systems, pressure to re-evaluate the funding formula will likely increase. This could prove quite costly: while the initial impact of maintaining growth at 6% per year would be an increase of only about $1 billion in fiscal 2017-2018, compounding growth means that the costs quickly rise. The potential cumulative impact would be (by 2020-2021) nearly $10 billion, and expanding thereafter.

Confronting these pressures with a firm eye on keeping the deficit from rising significantly above the status-quo will mean tough choices. For those pushing for additional stimulus, keep in mind that the measures included in Budget 2016 have just begun to make themselves felt in the economy. Only about $4.3 billion of $11.7 billion planned for 'phase one' of Budget 2016 has been allocated to date.

Limited wiggle room means that care must be put into prioritizing actions in Budget 2017. Given that much of the downshift in the pace of economic growth has to do with structural issues, focus should be on investments that will provide a lasting boost to growth by enhancing productivity.

Beyond spending, the government should also continue advocating for fiscal stimulus globally. Canada is a small, open economy, which means that domestic stimulus may leak beyond our borders, reducing its effectiveness. Were our stimulus to take place alongside increased government spending globally, this effect will be reduced, enhancing the growth impacts of existing stimulus without requiring any additional funds.

Bottom Line

The economic outlook for Canada has weakened, putting a significant dent in the outlook for revenues. Lower interest rates will provide only a partial offset as they also drive up pension liabilities. The net result will likely be larger than planned federal fiscal deficits. Despite the widening of forecasted deficits, federal debt as a share of GDP is expected to remain effectively stable, as the deficit is forecast to begin slowly shrinking after the current fiscal year. Canada is thus likely to remain in an enviable fiscal position, relative to its advanced economy peers. This position should not be taken for granted, however. We would caution against implementing additional measures that would drive the deficit profile significantly above the status-quo.

Appendix A: Economic Assumptions

FORECAST ASSUMPTIONS						
	2015	**2016**	**2017**	**2018**	**2019**	**2020**
	Real GDP Growth, %					
Budget 2016	1.2	1.4	2.2	2.2	2.0	1.9
TD October 2016 Forecast	1.1	1.1	1.8	1.7	1.5	1.4
Difference		**-0.3**	**-0.4**	**-0.5**	**-0.5**	**-0.5**
	Nominal GDP Growth, %					
Budget 2016	0.7	2.4	4.6	4.3	4.2	4.1
TD October 2016 Forecast	0.5	1.4	3.3	3.6	3.4	3.5
Difference		**-1.0**	**-1.3**	**-0.7**	**-0.8**	**-0.6**
	Nominal GDP Level, $bns					
Budget 2016	1,988	2,036	2,129	2,221	2,313	2,408
Budget 2016, with adjustment	1,988	1,996	2,089	2,181	2,273	2,368
TD October 2016 Forecast	1,983	2,011	2,078	2,153	2,227	2,305
Difference (from adjusted)		**15**	**-11**	**-28**	**-46**	**-63**
	10 Year Government Bond Rate, %					
Budget 2016	1.5	1.6	2.3	3.0	3.4	3.6
TD October 2016 Forecast	1.5	1.2	1.3	1.6	1.9	2.1
Difference		**-0.4**	**-1.0**	**-1.4**	**-1.5**	**-1.5**
	Crude Oil Prices (WTI, US$ per barrel)					
Budget 2016	49	40	52	59	63	63
TD October 2016 Forecast	49	44	53	57	59	61
Difference		**4.0**	**1.0**	**-2.0**	**-4.0**	**-2.0**
Sources: Department of Finance, Statistics Canada, Bloomberg, TD Economics.						

Appendix B: Fiscal Projections

FEDERAL GOVERNMENT FISCAL POSITION (C$ billions, unless otherwise indicated)						
	Actual	TD Economics Projections				
Fiscal year	15-16	16-17	17-18	18-19	19-20	20-21
Budgetary Revenues (A)	**295.5**	**290.2**	**306.1**	**317.4**	**328.6**	**341.4**
% change	4.7	-1.8	5.5	3.7	3.6	3.9
% of GDP	14.9	14.4	14.7	14.7	14.8	14.8
Total Expenditures (B)	**296.4**	**324.2**	**334.1**	**342.2**	**353.2**	**364.0**
% change	5.7	9.4	3.1	2.4	3.2	3.1
% of GDP	14.9	16.1	16.1	15.9	15.9	15.8
of which,						
Program Expenses	**270.8**	**299.1**	**309.0**	**315.7**	**325.6**	**334.9**
% change	6.7	10.5	3.3	2.2	3.1	2.9
% of GDP	13.6	14.9	14.9	14.7	14.6	14.5
Public Debt Charges	**25.6**	**25.1**	**25.1**	**26.4**	**27.6**	**29.1**
% change	-3.8	-1.9	0.0	5.3	4.5	5.4
% of debt (t-1)	4.2	3.7	3.6	3.6	3.5	3.5
% of revenues	8.7	8.7	8.2	8.3	8.4	8.5
Budget Balance (A - B)	**-1.0**	**-34.0**	**-28.1**	**-24.8**	**-24.6**	**-22.6**
% of GDP	0.0	-1.7	-1.3	-1.1	-1.1	-1.0
Difference from Budget 2016*	4.4	-4.6	0.9	-2.0	-6.9	-8.3
Federal Debt (Accumulated Deficit)	**616.0**	**650.0**	**678.1**	**702.9**	**727.5**	**750.1**
% of GDP	31.0	32.0	32.3	32.4	32.4	32.3

Source: Department of Finance via HAVER, Statistics Canada, TD Economics.

*: Difference from Budget 2016, including the 6bn 'planning adjustment'

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