OBSERVATION

TD Economics

January 13, 2015

HOW WILL LOWER OIL PRICES IMPACT FEDERAL FINANCES?
DOING THE MATH ON THE FEDERAL FISCAL OUTLOOK

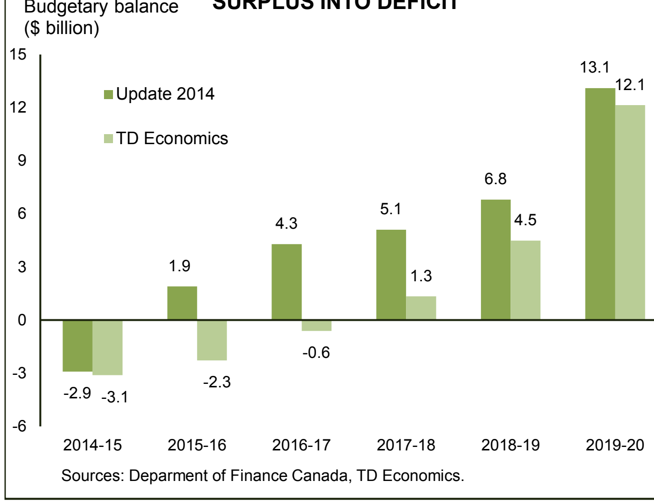
Highlights

- Since the release for the federal fiscal Update in November, oil prices have continued to plunge. Consequently, questions have been raised as to the impact that falling oil prices will have on the projected surpluses in fiscal 2015-16 and beyond.
- While there are a lot of numbers floating around, TD has developed a detailed federal fiscal model which it has used to evaluate the impact of oil prices on the federal fiscal outlook.
- The conclusion is unambiguous. In the absence of new measures to raise revenues or cut spending, TD is projecting budget deficits in fiscal 2015-16 and 2016-17 as opposed to the surpluses expected at the time of the Update. Beginning in fiscal 2017-18, we expect the government will continue to show surpluses over the remainder of the projection.
- Deficits over the next couple of years will leave no room to announce new measures, such as doubling the contribution limit of the Tax Free Saving Account or introducing the Adult Fitness Tax Credit.
- However, these expected deficits are less than the federal government's annual $3 billion set-aside for contingencies. As such, surpluses over the next couple of years cannot be ruled out.

The recent decline in oil prices has led to much analysis of their impact on the Canadian economy. Among the topics that has garnered a great deal of interest is the impact of falling oil prices on the federal fiscal outlook. This is particularly the case in 2015, as it is an election year and great political weight has been put on the fortunes of the economy and returning to surplus following years of deficits.

Using TD's detailed federal fiscal forecasting model, we have concluded that the federal fiscal outlook will be much weaker than that presented in the November fall fiscal Update (Chart 1). The cumulative total of the surpluses and deficits over the next 6 years is on track to reach a mere $12.0 billion – well down from the $28.3 billion expected at the time of the Update. Over the next couple of years, modest planning deficits of $1-$3 billion are projected. Keep in mind that our fiscal forecast includes the Department of Finance's convention of reducing revenues by $3 billion annually to safeguard against potential risks to the forecast. This status-quo analysis still implies that balanced budgets are likely but only by the thinnest of margins. Consequently, introducing significant new policy measures, such as enhancing the Tax Free Savings Account (TFSA), in the current fiscal environment will be a challenge.

CHART 1: OIL PRICES TO TIP THE FEDS FROM SURPLUS INTO DEFICIT



Sources: Deparment of Finance Canada, TD Economics.

Update refresh

The federal government's 2014 Update of Economic and Fiscal Projections (Update) was of particular importance for a couple

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of reasons. First, the government moved to incorporate a number of policy commitments that it had outlined in the Conservative Party of Canada's 2011 election platform. The second was the prudence added to the fiscal forecast beyond the typical $3 billion set-aside for contingencies in order to account for the falling price of oil. While these features to the Update were very different in nature they both had the effect of reducing the overall fiscal room available for the federal government to maneuver.

Regarding the policy measures, these included the Family Tax Cut (commonly referred to as income splitting), the expansion of the Universal Child Care Benefit, the increase in the Child Care Expense Deduction limit, and a doubling of the Child Fitness Tax Credit. Together, these measures are expected to cost nearly $27 billion in total from fiscal 2014-15 to 2019-20. These initiatives were in addition to the Small Business Job Credit announced in September 2014, which committed $550 million in 2015 and 2016, respectively, to support job creation by small business.

The second particularly noteworthy addition to the Update was the further prudence introduced to account for weak crude oil prices. According to the calculations in the Update, oil prices had fallen from US$98 per barrel of WTI in Q3 (the most recent price data to be included in the September 2014 survey of private-sector economists) to US$81 per barrel in mid-October – a US$17 per barrel decline. Assuming prices stayed unchanged at $81 per barrel over the forecast, the Department of Finance estimated that this would lead to a $16 billion annual reduction in the level of nominal GDP – the broadest measure of the tax base. This translates into the following rough rule-of-thumb: for every sustained US$1 per barrel decline in the price of WTI, Canadian nominal GDP for fiscal planning purposes will be about $1 billion lower over the projection.

Another well-known sensitivity for fiscal planning is that a $1 billion decline in the level of nominal GDP translates into a $150 million decline in the level of total federal revenues. As such, the $16 billion decline mentioned above translates into lost revenue of $2.4 billion annually. Tack on the $3.0 billion set-aside for contingencies and the downward adjustment to revenues in the Update totalled about $5.4 billion annually beginning in 2015 – certainly not chump change.

Developments since the Update

Since the Update, oil prices have continued to plummet, further reducing the fiscal room available to the federal government. After declining to about US$76 on average in calendar Q4, WTI prices have slumped to around US$49 so far in January. This is well below the US$81 per barrel assumed in the Update.

Beyond lower oil prices, the federal government also announced additional spending on infrastructure following the release of the Update. In total, this added up to about $1.3 billion in additional spending over the projection.

Table 1: TD Economics January 2015 Federal Fiscal Forecast Summary
(C$ billion, unless otherwise specificed)

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Budgetary Revenues	**276.9**	**289.9**	**302.6**	**314.7**	**328.8**	**343.7**
Program Expenses	252.7	263.7	273.1	281.2	291.9	299.4
Public Debt Charges	27.3	28.4	30.2	32.1	32.4	32.1
Total Expenses	**280.0**	**292.1**	**303.2**	**313.3**	**324.3**	**331.5**
Budgetary Balance	**-3.1**	**-2.3**	**-0.6**	**1.3**	**4.5**	**12.1**
Federal Debt	615.0	617.3	617.9	616.5	612.0	599.9
Per cent of GDP						
Budgetary Revenues	13.8	14.0	14.0	14.0	14.1	14.3
Program Expenses	12.6	12.8	12.7	12.5	12.6	12.4
Public Debt Charges	1.4	1.4	1.4	1.4	1.4	1.3
Budgetary Balance	-0.2	-0.1	0.0	0.1	0.2	0.5
Federal Debt	30.7	29.8	28.7	27.5	26.3	24.9

Sources: TD Economics, Department of Finance Canada.

The fiscal forecast, then and now

Table 1 provides a summary of TD's fiscal forecast (based on our December 2014 Quarterly Economic Forecast). This forecast includes our oil price forecast published in December 2014. The TD forecast assumes that oil prices will gain ground relative to its recent lows, averaging US$67.50 per barrel in 2015 and US$80.25 in 2016. However, the near-term profile will still remain significantly lower than the Update's assumption of US$81 per barrel.

Broadly similar to the approach taken by the Department of Finance, TD uses a detailed federal fiscal model to construct its fiscal forecast. As such, while lower oil prices feed into nominal GDP (through real GDP and, to a much larger degree, the GDP deflator), it has different effects on various types of tax bases, both in terms of timing and magnitude. For example, revenues from corporate income taxes are expected to take a bigger relative hit than revenues from either personal income taxes or the Goods and Services Tax (GST) in 2015. This said, for brevity, the detailed projections of revenues, expenses, and the Employment Insurance (EI) Operating Account are presented in Annexes A through C.

Table 2: Without the set-aside for contingencies, surpluses can be expected (C$ billion, unless otherwise specificed)						
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Budgetary Balance	**-3.1**	**-2.3**	**-0.6**	**1.3**	**4.5**	**12.1**
Set-aside for contingencies	3.0	3.0	3.0	3.0	3.0	3.0
Revised Balance	**-0.1**	**0.7**	**2.4**	**4.3**	**7.5**	**15.1**

Sources: TD Economics, Department of Finance Canada.

What quickly becomes apparent is that our current forecast for the budgetary balance is much weaker than that which was presented in the November 2014 Update. This largely reflects the impact of lower oil prices on the economy and, ultimately, revenues. It also includes the new infrastructure spending announced after the Update was released. In total, the cumulative surplus of the federal government over the fiscal period 2014-15 to 2019-20 is expected to be $12.0 billion, well down from the $28.3 billion expected at the time of the Update. In 2015-16 specifically, the federal government is now expected to post a deficit of $2.3 billion, well below the $1.9 billion surplus published in the Update.

However, while these deficits may look ominous, an important consideration is that TD's revised fiscal outlook also includes the annual $3 billion downward adjustment to revenues for contingencies. If this contingency amount were to go unused, small planning surpluses would still be in the cards in fiscal 2015-16 and beyond (Table 2).

What if oil prices stay low for longer?

If the government were to use the same planning approach as adopted in the Update and assume that oil prices remain at current levels over the forecast horizon, then the future small surpluses would effectively be wiped out. Case in point, taking the expenses profile that was published in the Update, a flat oil price assumption of $50 (roughly the average price recorded so far in January) would yield larger planning deficits of $3.2 billion in fiscal 2015-16 and $0.9 billion in 2016-17. Similarly, if the price of WTI were to fall to US$40 per barrel and remain at that price over the projection, the deficit could be as large as $4.7 billion in fiscal 2015-16 and $2.4 billion in 2016-17.

New measures left in limbo

In short, the current fiscal environment would make introducing additional policy measures difficult. Two measures that the federal government had committed to introducing once the budget was balanced were the doubling of the contribution limit of the Tax Free Savings Account (TFSA) and introducing an Adult Fitness Tax Credit. Together, if they were to be introduced in the upcoming budget, TD has estimated the cost of these two measures to be about $3.2 billion over the 5-years beginning in fiscal 2015-16. (See The Trouble with Surpluses: An Examination of the Federal Fiscal Outlook for more information on the costs of various policies.)

However, if the federal government still wants to introduce these measures, some room could be found. Assuming that the government sticks to its vow not to introduce significant new revenue-raising initiatives, there is the possibility for the government to further reduce program expenses, particularly direct program expenses (which include the cost of operations). That said, operating expenses are currently at an all-time low as a share of the economy, and history has shown that a prolonged low level of program spending is generally unsustainable and ultimately leads to rapid spending growth down the road.

Bottom line

Falling oil prices are expected to have a significant impact on federal coffers. Using TD's economic and oil price projections and assuming that the usual $3 billion annual set-aside for contingencies is maintained, planning deficits – albeit modest ones – can be expected over the next few years. With not much cash left in the kitty, further tax reductions or additional spending will likely be difficult to come by.

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Annex A: Overview of Federal Revenue Outlook

Table A: Federal Revenue Outlook (C$ billion)	Actual / Estimated		Projection					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Income taxes								
Personal income tax	125.7	130.8	133.2	142.8	150.5	158.3	165.3	173.6
Corporate income tax	35.0	36.6	38.3	37.6	40.2	42.4	44.8	47.2
Non-resident income tax	5.1	6.4	6.4	6.5	7.0	7.5	7.9	8.3
Total income tax	165.8	173.8	177.9	186.9	197.7	208.2	218.0	229.2
Excise taxes and duties								
Goods and Services tax	28.8	31.0	32.4	33.4	34.7	36.0	37.4	38.7
Custom import duties	4.0	4.2	4.4	5.0	4.7	4.9	5.1	5.4
Other excise taxes/duties	10.8	10.9	11.5	11.5	11.5	11.5	11.5	11.5
Total excise taxes/duties	43.6	46.1	48.3	49.9	51.0	52.5	54.0	55.5
Total tax revenues	**209.3**	**219.9**	**226.2**	**236.8**	**248.7**	**260.7**	**272.0**	**284.7**
Employment Insurance premiums	20.4	21.8	22.3	23.1	22.9	20.6	21.3	22.0
Other revenues	26.9	30.0	28.4	30.0	31.0	33.4	35.5	37.0
Total budgetary revenues	**256.6**	**271.7**	**276.9**	**289.9**	**302.6**	**314.7**	**328.8**	**343.7**
Share of GDP								
Personal income tax	6.8%	6.8%	6.7%	6.9%	7.0%	7.1%	7.1%	7.2%
Corporate income tax	1.9%	1.9%	1.9%	1.8%	1.9%	1.9%	1.9%	2.0%
Non-resident income tax	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Total tax revenues	11.3%	11.5%	11.3%	11.5%	11.5%	11.6%	11.7%	11.8%
Employment Insurance premium	1.1%	1.1%	1.1%	1.1%	1.1%	0.9%	0.9%	0.9%
Other revenues	1.5%	1.6%	1.4%	1.4%	1.4%	1.5%	1.5%	1.5%
Total budgetary revenues	13.9%	14.2%	13.8%	14.0%	14.0%	14.0%	14.1%	14.3%

Sources: Department of Finance Canada, TD Economics.

Annex B: Overview of Federal Expenses Outlook

Table B: Federal Expenses Outlook (C$ billion)								
	Actual / Estimated		Projection					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Major transfers to persons								
Elderly benefits	40.3	41.8	44.2	46.4	49.0	51.7	54.6	57.6
Employment Insurance benefits	17.1	17.3	17.3	17.9	18.6	19.3	20.2	21.2
Children's benefits	13.0	13.1	14.5	18.3	18.5	18.7	18.9	19.1
Total	70.3	72.2	76.0	82.6	86.2	89.8	93.7	98.0
Major transfers to OLG								
Canada Health Transfer	28.6	30.5	32.1	34.0	36.1	37.4	38.8	40.4
Canada Social Transfer	11.9	12.2	12.6	12.9	13.3	13.7	14.1	14.6
Fiscal arrangements	19.7	19.8	19.4	20.1	20.9	21.8	22.6	23.5
Gas Tax Fund	2.0	2.1	2.0	2.0	2.1	2.1	2.2	2.2
Other major transfers	1.5	0.0	0.2	0.2	0.1	0.1	0.0	0.0
Alternative payments for Standing programs	-3.4	-4.2	-3.7	-3.9	-4.1	-4.3	-4.5	-4.7
Total	58.4	60.5	62.6	65.4	68.4	70.9	73.2	76.0
Direct program expenses	117.7	115.9	114.1	115.7	118.5	120.6	125.0	125.5
Total program expenses	**246.2**	**248.6**	**252.7**	**263.7**	**273.1**	**281.2**	**291.9**	**299.4**
Public debt charges	28.9	28.2	27.3	28.4	30.2	32.1	32.4	32.1
Total expenses	**275.1**	**276.8**	**280.0**	**292.1**	**303.2**	**313.3**	**324.3**	**331.5**
Share of GDP								
Major transfers to persons	3.8%	3.8%	3.8%	4.0%	4.0%	4.0%	4.0%	4.1%
Major transfers to other levels of government	3.2%	3.2%	3.1%	3.2%	3.2%	3.2%	3.1%	3.2%
Direct program expenses	6.4%	6.0%	5.7%	5.6%	5.5%	5.4%	5.4%	5.2%
Total program expenses	13.3%	13.0%	12.6%	12.8%	12.7%	12.5%	12.6%	12.4%
Public debt charges	1.6%	1.5%	1.4%	1.4%	1.4%	1.4%	1.4%	1.3%
Total expenses	14.9%	14.4%	14.0%	14.1%	14.1%	14.0%	13.9%	13.8%

Sources: Department of Finance Canada, TD Economics.

Annex C: Overview of the Employment Insurance Operating Account Outlook

Table C: Employment Insurance Operating Account Projections (C$ billion)								
	Actual / Estimated		Projection					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
EI premium revenues	20.4	21.8	22.3	23.1	22.9	20.6	21.3	22.0
EI benefits	17.1	17.3	17.3	17.9	18.6	19.3	20.2	21.2
	2012	2013	2014	2015	2016	2017	2018	2019
EI Operating Account annual balance	1.0	2.7	3.3	3.6	3.8	-0.3	-0.3	-0.7
EI Operating Account cumulative balance	-8.1	-5.4	-1.9	1.7	5.4	5.2	4.8	4.1
Projected premium rate (per $100 of insurable earnings)	1.83	1.88	1.88	1.88	1.88	1.57	1.57	1.57
Sources: Office of the Chief Actuary, Department of Finance Canada, TD Economics.								