OBSERVATION

TD Economics

March 1, 2016

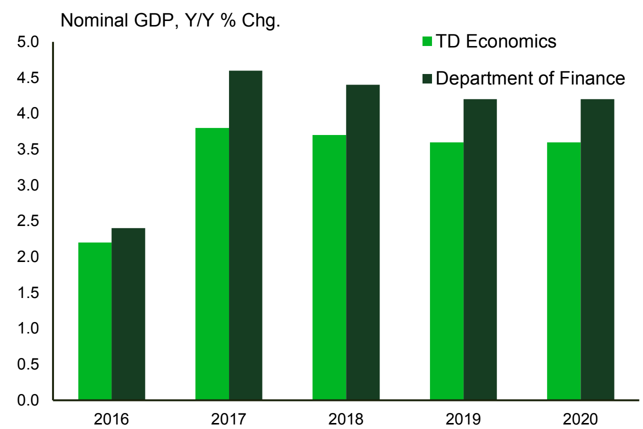
PERSISTENT FEDERAL DEFICITS ON THE HORIZON

Highlights

- The federal government made a splash last week by upgrading its budget deficit profile over the next two years to about $18 billion (1% of GDP). This shortfall excludes the cost of platform commitments or post-election promises, but builds in a $6 billion annual prudence amount to guard against weaker than expected growth.
- In this report, we re-calculate the projected path of deficits to include our below consensus assumptions on economic growth and to incorporate the cost of platform commitments. We also have extended the forecast horizon to 5 years.
- Our analysis yields steady deficits of around $30 billion per year (1.5% of GDP), or a cumulative $150 billion through fiscal year 2020/21. Even excluding the amount set aside for prudence, cumulative deficits are likely to reach nearly $120 billion.
- The persistence of the deficits over the medium term largely reflects our downgraded view of Canada's economic growth rate. Although projected revenue gains are likely to surpass those of spending by a slim margin, the large size of initial deficits means it will take some time to restore balance. Indeed, without tax increases or adjustments to the profile of spending, it would take more than a decade for the budget to return to balance.
- The debt-to-GDP ratio is on track to edge up to over 36% by FY 2020/21.
- The spending mix will be crucial in assessing the economic impact of this deficit spending. Projects that enhance long-term productivity and output should be emphasized to ensure the stimulus legacy is more than just higher debt.

On February 22, the Department of Finance published its updated economic and fiscal outlook, providing the 'starting point' ahead of the federal budget, set for release on March 22nd. The revised outlook caused a stir, as the deficit excluding the cost of platform commitments or any additional stimulus measures, was on track to reach at least $18.4 billion. Our analysis suggests that once platform commitments are included, near-term deficits are likely to come in at roughly $30 billion. But more importantly, with our assumptions on revenue and expenditure growth, deficits of $30 billion in magnitude are likely to persist over the next five years, resulting in cumulative deficits of $150 billion. While there is significant uncertainty surrounding the impact of deficit spending on growth, our analysis suggests that a modest growth boost is likely. There also remains an upside risk depending on the ultimate size and composition of the 2016 budget.

CHART 1. DEPARTMENT OF FINANCE GROWTH PROJECTIONS MAY BE OPTIMISTIC



Source: TD Economics, Department of Finance. Post-2017 figures from November update

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Updating the status quo

The revised growth outlook presented in last week's fiscal update by Minister Morneau shows what a difference a few months can make. Oil prices have remained stubbornly low, and growth was likely non-existent in the final quarter of 2015, sapping momentum heading into 2016. A weaker outlook hits government coffers from both sides, as revenues fall and expenditures rise. The Department of Finance uses an average of private sector forecasts (TD Economics included) to develop their growth outlook. Beyond 2016, the growth projections may be optimistic, with nominal GDP growth trending around 4.3%. In our view, the pace is more likely to be around 3.6% (Chart 1).

Differences in expected growth and their impact on government finances provide the starting point for our analysis of the 'status quo' fiscal outlook. As shown in Appendix Table 1, in the near term, we expect the baseline deficit (i.e., without the cost of platform commitments or additional stimulus measures) to be roughly in line with that revealed in the February update. We project a deficit of $19.4 billion ($13.4 billion excluding the $6 billion contingency), about $1 billion larger than what was presented in the February update. As we move forward in time, larger gaps emerge. We expect that the fiscal 2017/2018 deficit will reach about $18 billion, $3 billion larger than the government projections, largely the result of our weaker outlook for growth. The government's projection was carried out two years. However, by extending the projection horizon to 5 years, our estimates show deficits remain somewhat persistent, largely the result of our conservative view on long-term growth rates. Program spending estimates beyond next year are derived from the government's revised near-term outlook and the longer term profile included in its Fall update. In that update, status-quo spending growth is held at around 3% per year, on average, in the outlying years or roughly population growth plus inflation.

Helping offset some of the impact is the current low interest rate environment. While overall debt service costs are projected to rise as a result of increased borrowing, the current interest rate environment will help provide some offset. Blended borrowing costs are lower than the outstanding rate on current government debt, producing sizeable savings as the debt stock rolls over (but creating longer term pressures as low rates impact pension and benefit liabilities). This effect persists well into 2018/2019.

The impact of the election platform

Our updated baseline fiscal outlook results in modest but persistent deficits that are likely to fade away only slowly. This is not the end of the story however. During the election campaign, the Liberal Party of Canada communicated a platform that included deficit-funding spending promises, alongside significant changes to the tax system and other changes to federal revenues and expenditures. The election platform promised sizeable spending on infrastructure, changes to employment insurance, and other priorities. The net impact was forecast to be a near-term deficit of approximately $10bn. Recent reports have suggested that an even larger spending package may be incorporated in the March 22nd budget.

As helpful as it would be to know exactly what the budget will look like, we will have to wait until the 22nd. For this reason, we've chosen to focus on the election platform promises, which we consider the likely starting point for any stimulus package. Taking platform projections at face value government revenues are increased from 2016/2017 onwards, with a sharp jump of more than 6% in the first year. At the same time however, program expenses climb even more dramatically, nearly 17% in fiscal 2016/2017. The net result is a deficit of nearly $29 billion. Even taking into account the positive growth impacts of stimulus spending, this represents nearly 1.5% of GDP, as shown in Appendix Table 2. Cumulative deficits total more than $120bn over the projection, with the debt to GDP ratio reaching 35% by fiscal 2019/2020, from the current ratio of 31%.

Keep in mind that our projected figures also include the government's new practice of embedding some $6 billion annually in economic prudence to guard against unforeseen revenue surprises. If these amounts are ultimately not required, the deficit profile is on track to come in closer to $25 billion annually, but 'persistence' would remain the watchword. Under that scenario, the debt-to-GDP ratio would still edge up, but reach a lower peak, and sooner, declining from 2019/2020 onwards.

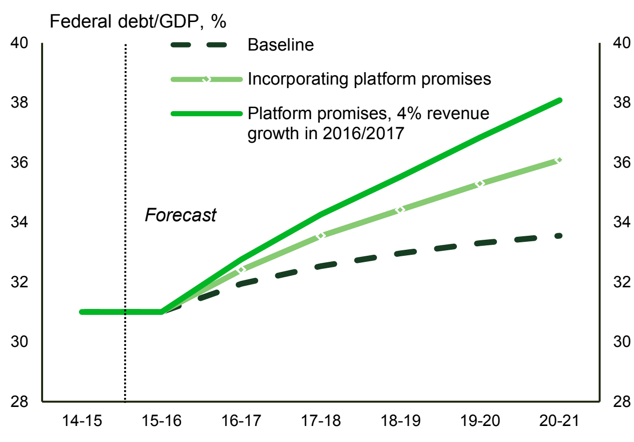
As in all things, risks abound

A key takeaway from our analysis is that absent additional revenues or adjustments to spending relative to the status-quo, the federal deficit is poised to remain stubbornly elevated over the medium term. Afforded by a relatively favourable debt ratio and ultra-low interest rates, the government has significant wiggle room to run deficits over the next several years. And, deficits on the order of 1.5% of GDP appear manageable. However, to the extent that persistent deficits are run, federal finances would be more exposed in the event of a severe economic shock. The government needs to be mindful of these risks as it lays out its medium-term plan.

A challenge that most industrialized economies are confronted with is a likely slower rate of longer term economic growth, which is the key driver of revenues. Our analysis indicates that over the longer term, growth in real economic activity in Canada is likely to average only around 1.6%, reflecting an aging population and relatively soft productivity growth. This is somewhat weaker than many other analysts are predicting; as a result, the government (which uses consensus expectations) is likely to base its outlook on a more optimistic average forecast for economic growth. In our more pessimistic projections, the wedge between revenue gains (3.7%) and spending (3.0%) is quite small. Based on this only slight outperformance, without changes in taxes or spending adjustments, it would take about 13 years for the budget to reach balance.

Perhaps more important than the longer term outlook are pressures and risks in the near term. A few key issues merit discussion. To begin with, including election platform promises results in a very strong uptick in revenue in fiscal 2016/2017. Growth of more than 6% reflects planned changes to the tax system, including the phase-out or replacement of a number of tax credits, and a sizeable uptick in oil prices. While not unprecedented, particularly given policy changes, this kind of growth rate is typically

CHART 2. REVENUE SLIPPAGE PUSHES DEBT/GDP HIGHER



Source: Department of Finance, TD Economics.

associated with boom periods, such as the 1999/2000 and 2005/2006 periods. Were revenue to grow at a more typical rate of around 4%, an even steeper debt/GDP profile would emerge, with stabilization pushed back even further (Chart 2).Given these risks, the government's use of a wider margin for prudence seems reasonable in our view.

Stimulus spending provides a growth boost

Although the estimated impact will change as budget details are revealed, our forecasts nevertheless incorporate the impacts of growth from government spending plans. This works to reduce the impact of spending on the debt-to-GDP ratio by boosting its denominator. There is considerable debate and uncertainty, both in Canada and other economies, notably the U.S., on exactly what the impacts of stimulus are likely to be. The impacts are captured by 'fiscal multipliers', which express how much GDP is likely to expand as a result of government spending. In our analysis, we've employed multipliers that are in line with Department of Finance estimates. The result is a boost to GDP growth of about 0.1 p.p. in 2016, and 0.3 p.p. in 2017, with only a very small impact on growth thereafter. These impacts will likely be larger should a more aggressive stimulus package be on offer, though this will also depend on the spending mix.

A few risks exist to these impacts. Beyond the composition of spending, the multipliers themselves may be lower than what we've assumed. For instance, the Bank of Canada estimates multiplier effects that are between one tenth and one half the size of Department of Finance estimates (Table 1). Should fiscal multipliers prove to be smaller than assumed, the result would be slower economic growth and a higher debt-to-GDP ratio, further impinging on fiscal sustainability.

Even ignoring multiplier effects, there remains the issue of the timing of the impact. The 2009 Economic Action Plan stimulus provides a valuable example of how stimulus spending works its way through the economy. Changes to transfer payments, such as EI, and taxes, have a nearly immediate impact, showing up in the data roughly a month after the budget was passed. In contrast, infrastructure spending takes much longer to make itself felt – typically about a year. This is because the lion's share of infrastructure falls under provincial and municipal control. As a result, projects often must be co-ordinated, and so it takes some time for the money to flow. Moreover, these projects require ramping up of employment, purchasing supplies, approving contrac-

Table 1. Comparison of Fiscal Multipliers Estimates		
Fiscal Measure	**Dept. of Finance Estimates**	**Bank of Canada Estimates**
Spending	1.05 – 1.25	0.53 – 0.65
Taxes	0.15 – 0.65	0.025 – 0.03
Transfers	0.35 – 1.15	0.025 – 0.05

Note: Average of Year 1 and Year 2 impacts presented. Multipliers by year are only available for Department of Finance figures. "Measures for low-income households and the unemployed" included as transfer measures in Dept. of Finance column.

tors, etc. All of these processes take time. This timing effect is largely why we expect the bulk of the growth impact to hit in 2017. Despite deficits rising in 2016, presumably to address near term weakness, the practicalities of getting projects going, and ensuring that the selected projects are likely to actually provide a long-term boost to the economy, push the impacts into 2017.

Bottom Line

The government has laid out its new starting point from which the March 22 budget will be derived. Our analysis suggests that sizeable, persistent deficits are likely on offer and absent tax changes or spending adjustments, finances are likely to rebalance only very gradually. Given the relatively lacklustre growth outlook, some additional stimulus, in line with Liberal election promises, is likely warranted. It is important that the government receive 'bang for its buck', however, and projects should be emphasized that will be likely to result in growth dividends over their lifetime. Regardless of the size of any stimulus package, Canada's debt-to-GDP ratio is likely to be on an upwards trajectory over the medium term. This underscores the need for a credible long-term anchor on spending and revenue that helps keep the budget on a sustainable track in a low-growth world.

Appendix: Fiscal Projections

Table 1. Weaker Economic Outlook Means Persistent Deficits							
FEDERAL GOVERNMENT FISCAL POSITION - February Update (C$ billions, unless otherwise indicated)							
	Actual	**TD Economics Projections**					
Fiscal year	**14-15**	**15-16**	**16-17**	**17-18**	**18-19**	**19-20**	**20-21**
Budgetary Revenues	**282.3**	**290.8**	**285.4**	**296.1**	**306.8**	**317.8**	**329.3**
% change	3.9	3.0	-1.8	3.7	3.6	3.6	3.6
% of GDP	14.3	14.6	14.2	14.5	14.7	15.0	15.4
Program Expenses	**253.8**	**267.4**	**279.0**	**288.2**	**298.5**	**305.8**	**314.6**
% change	2.1	5.4	4.3	3.3	3.6	2.4	2.9
% of GDP	12.9	13.4	13.9	14.1	14.3	14.4	14.7
Public Debt Charges	**26.6**	**25.8**	**25.9**	**26.3**	**28.8**	**30.9**	**31.5**
% change	-5.7	-3.2	0.4	1.5	9.5	7.5	1.8
% of debt (t-1)	4.3	4.2	4.2	4.1	4.4	4.6	4.5
% of revenues	9.4	8.9	9.1	8.9	9.4	9.7	9.6
Total Expenditures	**280.4**	**293.2**	**304.8**	**314.4**	**327.3**	**336.7**	**346.1**
% change	1.3	4.5	4.0	3.2	4.1	2.9	2.8
% of GDP	12.9	14.7	15.2	15.4	15.7	15.9	16.2
Budget Balance	**1.9**	**-2.3**	**-19.4**	**-18.3**	**-20.5**	**-18.8**	**-16.8**
% of GDP	0.1	-0.1	-1.0	-0.9	-1.0	-0.9	-0.8
Federal Debt	**612.3**	**616.2**	**635.6**	**653.9**	**674.3**	**693.2**	**710.0**
% of GDP	31.0	31.0	31.9	32.5	33.0	33.3	33.5
Source: Department of Finance, TD Economics. Note: GDP figures include $40bn adjustment							

Table 2. Incorporating Election Promises Results In Sizeable Deficits							
FEDERAL GOVERNMENT FISCAL POSITION - February Update + Promises (C$ billions, unless otherwise indicated)							
	Actual	TD Economics Projections					
Fiscal year	14-15	15-16	16-17	17-18	18-19	19-20	20-21
Budgetary Revenues	**282.3**	**290.8**	**309.4**	**320.5**	**332.0**	**344.0**	**356.4**
% change	3.9	3.0	6.4	3.6	3.6	3.6	3.6
% of GDP	14.3	14.6	15.4	15.6	15.9	16.2	16.7
Program Expenses	**253.8**	**267.4**	**312.2**	**324.1**	**333.3**	**340.8**	**350.7**
% change	2.1	5.4	16.8	3.8	2.8	2.2	2.9
% of GDP	12.9	13.3	14.9	14.7	14.4	14.2	14.3
Public Debt Charges	**26.6**	**25.8**	**25.9**	**26.6**	**30.0**	**33.6**	**34.5**
% change	-5.7	-3.2	0.4	3.1	12.7	11.9	2.7
% of debt (t-1)	4.3	4.2	4.2	4.1	4.4	4.8	4.7
% of revenues	9.4	8.9	8.4	8.3	9.0	9.8	9.7
Total Expenditures	**280.4**	**293.2**	**338.1**	**350.8**	**363.4**	**374.4**	**385.2**
% change	1.3	4.5	15.3	3.8	3.6	3.0	2.9
% of GDP	12.9	14.5	16.1	15.9	15.8	15.6	15.7
Budget Balance	**1.9**	**-2.3**	**-28.7**	**-30.3**	**-31.3**	**-30.4**	**-28.8**
% of GDP	0.1	-0.1	-1.4	-1.4	-1.4	-1.3	-1.2
Federal Debt	**612.3**	**616.2**	**644.9**	**675.1**	**706.5**	**736.8**	**765.6**
% of GDP	31.0	31.0	32.4	33.5	34.4	35.3	36.1
Source: Department of Finance, TD Economics. Note: GDP figures include $40bn adjustment							