Federal Fiscal Forecast: In Forecasting as in Life, All Good Things Must Come to an End

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This report was prepared under the supervision of Kevin Page, President & CEO of the Institute of Fiscal Studies and Democracy (IFSD).

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Canada's sesquicentennial year has been a very good one for the Canadian economy, and the federal government in particular. Upon taking the reins of power in November 2015, the Canadian economy was sputtering thanks to an oil prices shock, and the fiscal prospects looked to be coming up short relative to Budget 2015. So, the feds turned on the taps, with plans to run substantial deficits announced in Budget 2016 in the hope of kick-starting the economy.

Unfortunately, things did not go quite as planned. It turns out that government institutions don't turn on a dime, no matter who is behind the wheel. As a result, the federal government overpromised and under-delivered on its massive infrastructure program. Indeed, the Bank of Canada was forced to backpedal on its overly enthusiastic adoption of the Government of Canada's fiscal impact forecasts. As it turns out, history still matters, and the delays that restrained infrastructure approvals from showing up in actual economic activity were the same that plagued the prior government during the 2008-09 recession.

However, these impediments look to be a thing of the past. For instance, in Q2 2017, real general government investment in engineering structures (e.g. roads) experienced its strongest quarterly advance since 2014, at 9.9% annualized. Real repair construction was also way up in the first half of 2017. Of course, some of this boost can also be chalked up to infrastructure spending by the provinces funded from their own-source revenues, but the federal government undoubtedly made a significant contribution. When combined with the impact of the increased Canada Child Benefit in mid-2016 and other policies, there is little doubt that expansionary policy measures have had a positive contribution to the recent strong economic performance observed in Canada. However, the exact size and timing of this impact are difficult to know, and therefore credit taken for any individual data release should be taken with a grain of salt.

The recent economic potency has been particularly notable in its strength relative to the Budget 2017 survey of private-sector forecasters (see the IFSD's September 2017 Canadian Economic Forecast). This is especially true for 2017, where the real GDP growth forecast used in the budget was 1.9%, as compared to the 3.1% currently being forecast by the IFSD and many other Canadian forecasters (Table 1). GDP inflation has also come in stronger-than-expected at the time of the budget, albeit less so. This means that 2017 growth in nominal GDP—the broadest measure of the tax base—should be roughly 1.7 percentage points (ppts) higher, at 5.7%, than was forecast in Budget 2017. This forecast error is largely the result of growth that was well beyond the expectations of forecasters at the time, including the IFSD. However, it also reflects the fact that the forecasts used for Budget 2017, which was published in March 2017, were based on a survey undertaken in December 2016. As a result, it was several months outdated by the time Budget 2017 was released, and an upside fiscal surprise was generally expected once Fall 2017 rolled around, and still is.

This superior economic outperformance, particularly in 2017, will undoubtedly lead to an improved fiscal forecast for both the 2016-17 and 2017-18 fiscal years relative to Budget 2017 (see Tables A through C for fiscal forecast details). To quantify the fiscal impact, one can look at the differences in the 2017 economic forecasts of the IFSD and Budget 2017, and then apply the fiscal impact estimates from Budget 2017 (see Table D). In doing this, it is estimated that the budget balance should improve by roughly $6.5 billion in fiscal 2017-18 based on the differences in the economic forecasts alone (Table 2). This better fiscal performance is almost entirely due to a higher projected path for revenues.

Table 1. Canadian Economic Forecast Comparison, 2016 to 2021

	2016	2017	2018	2019	2020	2021
			per cent, unless otherwise indicated			
IFSD Economic Forecast (September 2017)						
Real GDP growth	1.5	3.1	2.0	1.6	1.6	1.5
GDP inflation	0.6	2.6	2.3	2.4	2.4	2.4
3-month Treasury bill	0.5	0.8	1.6	2.3	2.8	3.5
10-Year GOC bond	1.3	1.8	2.2	2.6	3.0	3.6
Budget 2017 Average Private Sector Forecast (December 2016)						
Real GDP growth	1.3	1.9	2.0	1.7	1.7	1.8
GDP inflation	0.6	2.1	2.0	1.8	2.1	2.0
3-month Treasury bill	0.5	0.6	0.9	1.4	1.8	2.3
10-Year GOC bond	1.3	1.8	2.3	2.7	3.0	3.3
Difference (IFSD less Budget 2017)						
Real GDP growth (percentage points)	**0.2**	**1.2**	**0.0**	**-0.1**	**-0.1**	**-0.3**
GDP inflation	**0.0**	**0.5**	**0.3**	**0.6**	**0.3**	**0.4**
3-month Treasury bill	**0.0**	**0.2**	**0.7**	**0.9**	**1.0**	**1.2**
10-Year GOC bond	**0.0**	**0.0**	**-0.1**	**-0.1**	**0.0**	**0.3**

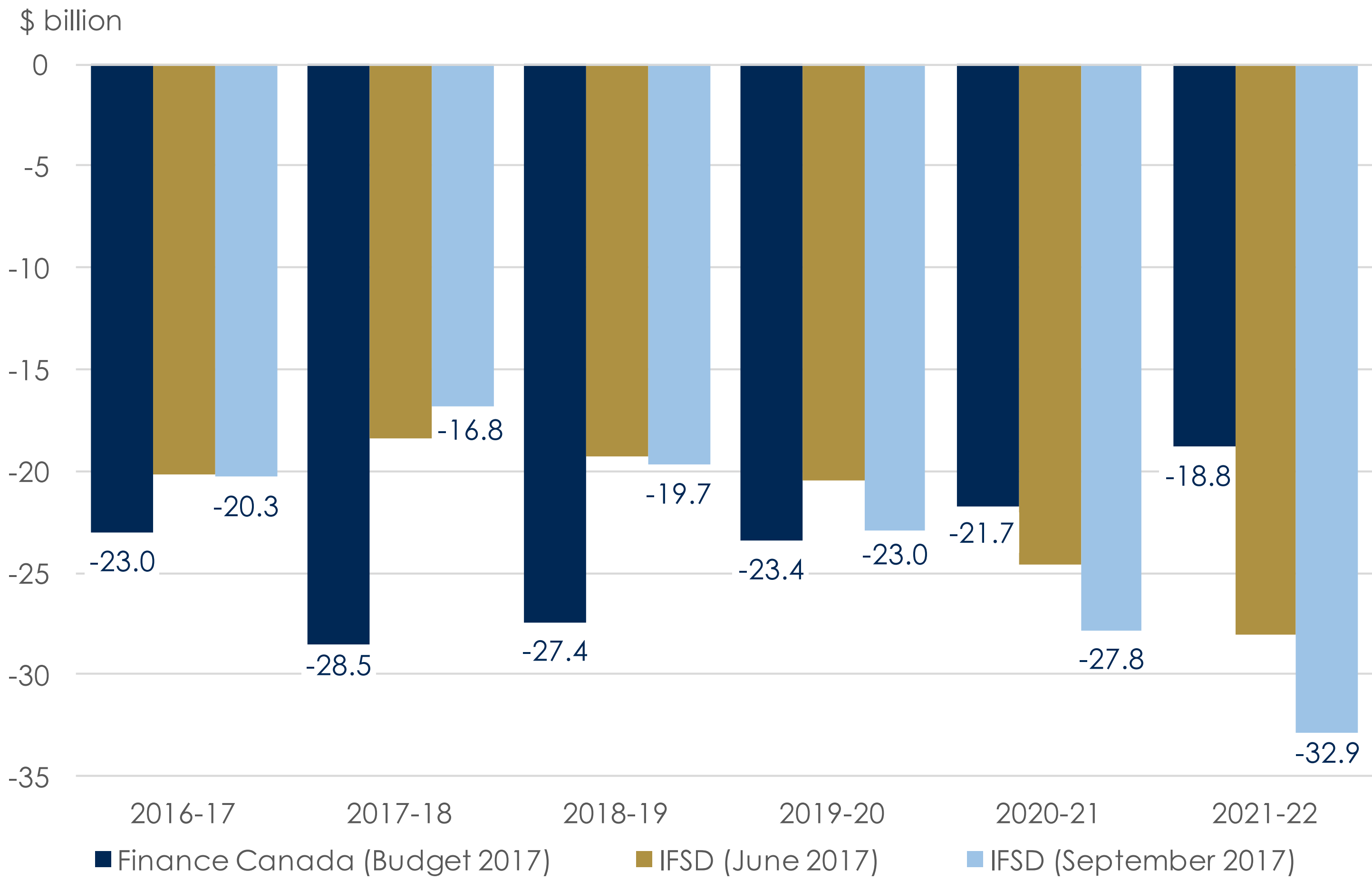
Sources: Finance Canada, Institute of Fiscal Studies and Democracy.
Note: All values are annual averages.

Table 2. Federal Fiscal Impacts of 2017 Economic Forecast Differences			
billions of dollars, unless otherwise indicated	Year 1	Year 2	Year 5
Difference in the 2017 Economic Forecasts (IFSD less Budget 2017)			
Real GDP growth (percentage points)	**1.2**		
GDP inflation	**0.5**		
3-month Treasury bill	**0.2**		
10-Year GOC bond	**0.0**		
Estimated Impact of the Difference in Real GDP Growth Forecasts			
Total revenues	4.9	4.3	4.8
Total expenses	-0.7	-0.7	-0.7
Budgetary balance	**5.6**	**5.0**	**5.5**
Estimated Impact of the Difference in GDP Inflation Forecasts			
Total revenues	1.7	1.3	1.4
Total expenses	0.6	0.5	0.7
Budgetary balance	**1.0**	**0.8**	**0.6**
Estimated Impact of the Difference in Interest Rate Forecasts			
Total revenues	0.1	0.1	0.2
Total expenses	0.2	0.3	0.4
Budgetary balance	**-0.1**	**-0.1**	**-0.2**
Total Fiscal Impact of 2017 Economic Forecast Differences			
Total revenues	6.7	5.8	6.4
Total expenses	0.1	0.1	0.4
Budgetary balance	**6.5**	**5.7**	**5.9**

Sources: Finance Canada, Institute of Fiscal Studies and Democracy.

Taking into account the impact of the improved economic outlook and assuming no $3 billion adjustment for risk (a reasonable assumption given it has changed in every budget document released by the current government), the federal government should expect a budget deficit of $19 billion in fiscal 2017-18, all else equal. Meanwhile, the IFSD's projected budget deficit is $16.8 billion for the 2017-18 fiscal year (Chart 1). This puts the IFSD's budget deficit forecast much closer to an updated federal fiscal forecast (using the Government of Canada's fiscal impact estimates) than the deficit forecast published in Budget 2017 ($28.5 billion).

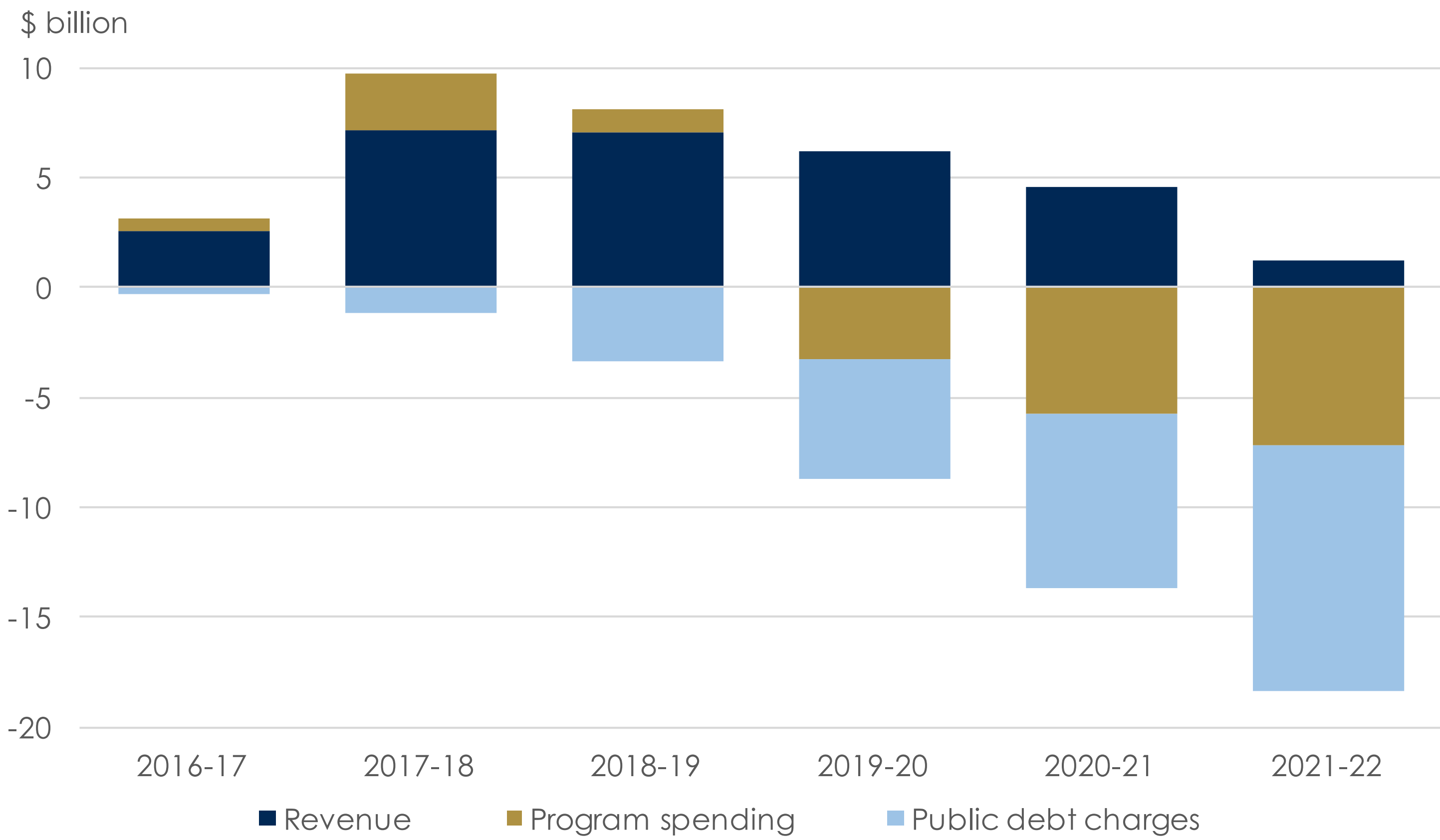
Chart 1: Federal Budget Balance Forecast Comparison



Sources: Finance Canada, Institute of Fiscal Studies and Democracy.

Beyond fiscal 2017-18, the outcome becomes more mixed. The budget deficit is projected to be both much smaller in the 2018-19 fiscal year than was projected in Budget 2017, again largely thanks to higher-than-expected revenues, and similar in fiscal 2019-20. But that is where the good news ends. Starting in the 2020-21 fiscal year, higher-than-projected expenses and rising interest rates, particularly at the short end of the yield curve, are expected to catch up with the federal government. So, as the recent revenue boost begins to fade as the economy converges to its potential, higher-than-expected program expenses and public debt charges are likely to begin weighing more heavily on the outlook (Chart 2). This should lead to much larger budget deficits in fiscal 2020-21 and beyond than were anticipated in Budget 2017.

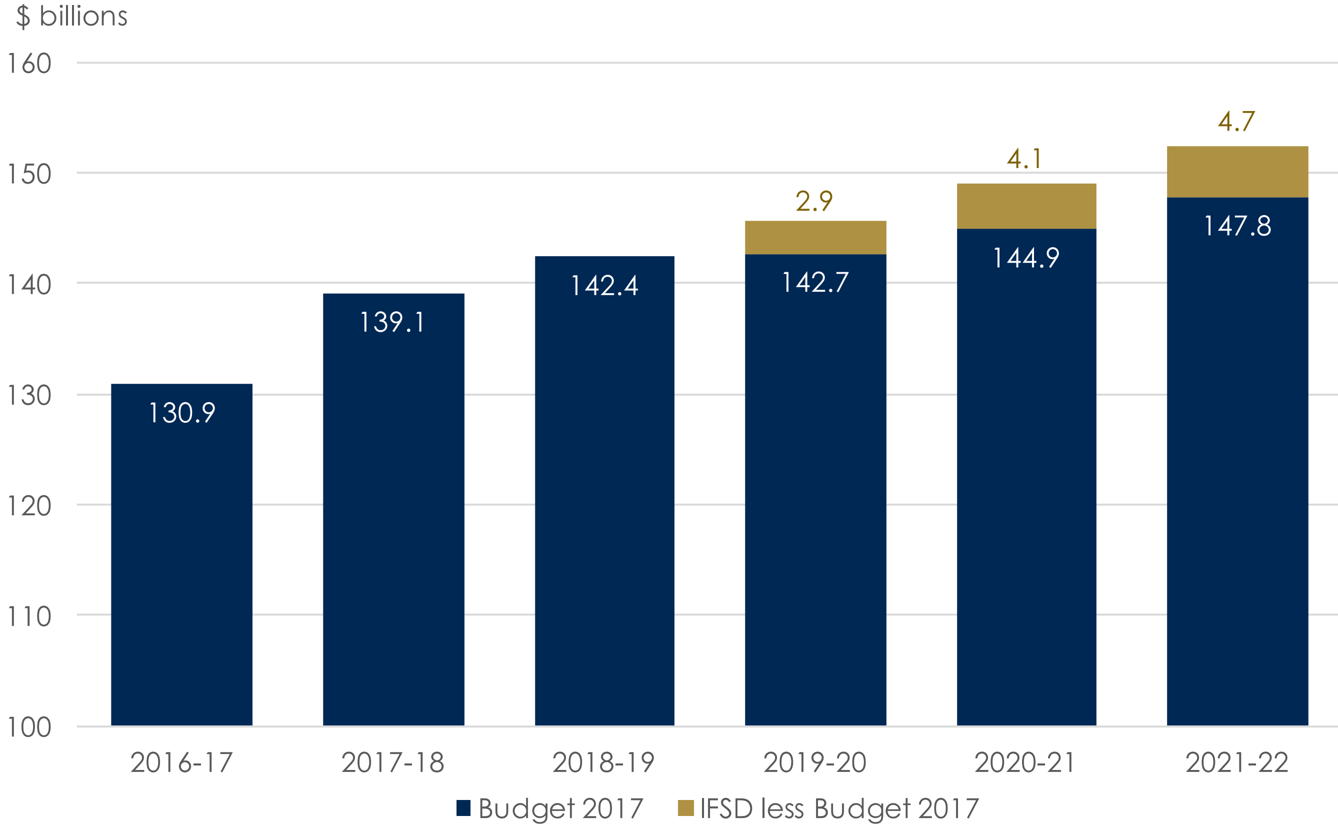
Chart 2: Causes of IFSD and GOC Forecast Differences



Sources: Finance Canada, Institute of Fiscal Studies and Democracy.
Note: The bars represent the contributions to the difference in the budget balance forecasts of the IFSD in Sept. 2017 and the Government of Canada (GOC) in March 2017, reflecting economic and other forecast differences.

In the case of program expenses specifically, the bulk of the difference between the IFSD and Budget 2017 forecasts in the second half of the forecast period can be linked to different assumptions around direct program expenses (DPE). DPE is the component of expenditures over which the federal government has the most discretion from year to year. The IFSD assumes the program expenses advance by the rate of inflation starting in the 2019-20 fiscal year, whereas the Government of Canada assumes they will advance by a mere 1.3% on average annually. This is well below the average annual pace of 5.3% forecasted in Budget 2017 for the first three fiscal years of the current government's mandate. As a result of these different growth assumptions, the IFSD expects DPE is likely to be $4.7 billion higher in fiscal 2021-22 than was forecasted in Budget 2017 (Chart 3).

Chart 3: Finance Canada and IFSD DPE Forecasts



Sources: Finance Canada, Institute of Fiscal Studies and Democracy.
Note: The IFSD takes the Budget 2017 forecast through 2018-19, then assumes DPE grows by CPI inflation thereafter.

A further point of departure between Budget 2017 and the IFSD is in regard to interest rates. This is particularly true with regard to bonds of short maturities, known as Treasury bills. The reason is that the Bank of Canada was expected to keep interest rates unchanged for the foreseeable future when private-sector economists were surveyed in December 2016. However, a lot can change in the span of a year, and indeed a lot has. As a result of the unexpectedly strong growth experienced over the past year, the Bank of Canada undertook its first interest rate hike since 2010 in July 2017, and its second in September 2017. And, given the continued strength of the economy, future rate hikes are anticipated. As a result, short-term interest rates are likely to rise much more quickly than expected almost a year ago (see Table 1), pushing the effective interest rate forecasted by the IFSD significantly higher than in Budget 2017.

But more importantly than the budget deficit of any one individual year is what this outlook means for the fiscal sustainability of the federal government. And, in that respect, there is good news. Certainly, higher budget deficits by the end of the 5-year forecast would result in a slightly higher debt-to-GDP ratio than the federal government projected in Budget 2017 (Table 3). However, the IFSD's forthcoming very-long-run fiscal forecast supports the conclusion, reached by the Parliamentary Budget Officer and supported by Finance Canada forecasts, that the federal government is in a fiscally sustainable position when examined over the next 50-odd years. With that said, while this conclusion holds true under a variety of economic scenarios, the federal government is, by its own measure, very likely running a structural deficit in a time of plenty. As such, if the federal government continues to run structural deficits without showing restraint, it could be sacrificing this hard-won sustainability in order to meet short-term political commitments.

Table 3. IFSD Federal Fiscal Forecast

billions of dollars	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Total revenues	**294.7**	**311.9**	**322.6**	**333.9**	**344.9**	**357.2**
Total program expenses	290.4	302.8	312.6	323.0	334.3	345.7
Public debt charges	24.6	25.9	29.7	33.8	38.4	44.4
Total expenses	**315.0**	**328.7**	**342.3**	**356.9**	**372.7**	**390.1**
Budgetary balance	**-20.3**	**-16.8**	**-19.7**	**-23.0**	**-27.8**	**-32.9**
Federal debt	**636.3**	**653.1**	**672.8**	**695.8**	**723.6**	**756.5**
percent of GDP	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Total revenues	**14.5**	**14.5**	**14.4**	**14.4**	**14.3**	**14.2**
Total program expenses	14.3	14.1	14.0	13.9	13.8	13.8
Public debt charges	1.2	1.2	1.3	1.5	1.6	1.8
Total expenses	**15.5**	**15.3**	**15.3**	**15.4**	**15.4**	**15.5**
Budgetary balance	**-1.0**	**-0.8**	**-0.9**	**-1.0**	**-1.1**	**-1.3**
Federal debt	**31.4**	**30.5**	**30.1**	**29.9**	**29.9**	**30.1**

Source: Institute of Fiscal Studies and Democracy.

The Take Away

All in all, federal government finances should look better in the near term, but should begin to erode toward the end of the 5-year forecast. But, with the federal government likely to remain in a fiscally sustainable position regardless of the economic scenario, it is difficult to see what might persuade it to stray from their course. That said, as the economy advances and interest rates rise, it is likely to become increasingly difficult for the federal government to avoid running structural deficits. This is a cautionary tale, as the hard-won fiscal sustainability of past governments could be lost if fiscal largesse is not kept in check today, meaning a disproportionate burden could be borne by future generations.

Looking ahead to Budget 2018, the open question is whether the federal government will use this short-term economic windfall to increase spending or will it take the opportunity to lay out a plan to return to balance at some point in the foreseeable future? With Budget 2017 having fallen somewhat flat given a lack of 'cash in the kitty' at the time, Budget 2018 holds renewed political promise given commitments around housing and homelessness and smaller-than-expected budget deficits in the near term. And then there is still the innovation agenda and planned tax reform. But this remains against the backdrop of rising debt, deficits, and interest rates. Taken all together, this should make the next six months very interesting in Ottawa.

Table A. Federal Revenue Forecast

billions of dollars	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Personal income tax	144.3	156.1	161.4	166.9	172.8	179.0
Corporate income tax	41.9	44.9	45.8	47.1	48.6	49.9
Non-resident income tax	6.8	7.0	7.2	7.7	8.0	8.2
Total Income Tax	**193.0**	**208.0**	**214.4**	**221.6**	**229.4**	**237.1**
Goods and Services Tax	34.2	35.9	37.3	38.7	40.1	41.5
Custom import duties	5.3	5.1	5.2	5.4	5.6	5.8
Other excise duties/taxes	11.6	11.8	11.9	12.0	12.1	12.1
Total Excise Taxes/Duties	**51.1**	**52.9**	**54.5**	**56.1**	**57.7**	**59.3**
EI premium revenues	23.0	21.5	22.7	23.5	24.2	24.8
Other revenues	27.5	29.5	31.0	32.7	33.6	36.0
Total Budgetary Revenues	**294.7**	**311.9**	**322.6**	**333.9**	**344.9**	**357.2**
percent of GDP						
Personal income tax	7.1	7.3	7.2	7.2	7.1	7.1
Corporate income tax	2.1	2.1	2.1	2.0	2.0	2.0
Non-resident income tax	0.3	0.3	0.3	0.3	0.3	0.3
Total Income Tax	**9.5**	**9.7**	**9.6**	**9.5**	**9.5**	**9.4**
Goods and Services Tax	1.7	1.7	1.7	1.7	1.7	1.6
Custom import duties	0.3	0.2	0.2	0.2	0.2	0.2
Other excise duties/taxes	0.6	0.6	0.5	0.5	0.5	0.5
Total Excise Taxes/Duties	**2.5**	**2.5**	**2.4**	**2.4**	**2.4**	**2.4**
EI premium revenues	1.1	1.0	1.0	1.0	1.0	1.0
Other revenues	1.4	1.4	1.4	1.4	1.4	1.4
Total Budgetary Revenues	**14.5**	**14.5**	**14.4**	**14.4**	**14.3**	**14.2**

Source: Institute of Fiscal Studies and Democracy.

Table B. Federal Program Expense Forecast						
billions of dollars	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Elderly benefits	48.2	50.7	53.6	56.8	60.2	63.8
EI benefits	20.5	20.5	21.1	22.0	22.8	23.5
Children's benefits	22.1	22.3	22.6	23.0	23.9	24.8
Major Transfers to Persons	**90.8**	**93.5**	**97.3**	**101.8**	**106.9**	**112.0**
Canada Health Transfer	36.1	37.2	38.6	40.4	42.1	43.8
Canada Social Transfer	13.3	13.7	14.2	14.6	15.0	15.5
Fiscal arrangements	17.9	18.3	18.9	19.6	20.4	21.2
Gas Fund	2.1	2.1	2.2	2.2	2.3	2.3
Territorial funding formula	3.6	3.7	3.8	3.9	4.0	4.1
Alternative Payments for Standing Programs	-4.3	-4.7	-4.8	-5.1	-5.3	-5.6
Major Transfers to Other Levels of Government	**68.7**	**70.2**	**72.9**	**75.7**	**78.5**	**81.2**
Direct program expenses	**130.9**	**139.1**	**142.4**	**145.6**	**149.0**	**152.5**
Total Program Expenses	**290.4**	**302.8**	**312.6**	**323.0**	**334.3**	**345.7**
percent of GDP						
Elderly benefits	2.4	2.4	2.4	2.4	2.5	2.5
EI benefits	1.0	1.0	0.9	0.9	0.9	0.9
Children's benefits	1.1	1.0	1.0	1.0	1.0	1.0
Major Transfers to Persons	**4.5**	**4.4**	**4.4**	**4.4**	**4.4**	**4.5**
Canada Health Transfer	1.8	1.7	1.7	1.7	1.7	1.7
Canada Social Transfer	0.7	0.6	0.6	0.6	0.6	0.6
Fiscal arrangements	0.9	0.9	0.8	0.8	0.8	0.8
Gas Fund	0.1	0.1	0.1	0.1	0.1	0.1
Territorial funding formula	0.2	0.2	0.2	0.2	0.2	0.2
Alternative Payments for Standing Programs	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Major Transfers to Other Levels of Government	**3.4**	**3.3**	**3.3**	**3.3**	**3.2**	**3.2**
Direct program expenses	6.5	6.5	6.4	6.3	6.2	6.1
Total Program Expenses	**14.3**	**14.1**	**14.0**	**13.9**	**13.8**	**13.8**

Source: Institute of Fiscal Studies and Democracy.

Table C. EI Program Forecast							
billions of dollars	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**2021-22**	
EI premium revenues	23.0	21.5	22.7	23.5	24.2	24.8	
EI benefits	20.5	20.5	21.1	22.0	22.8	23.5	
EI administration and other expenses	1.8	1.7	1.7	1.7	1.7	1.7	
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2025**
EI Operating Account annual balance	1.2	-0.9	0.0	-0.1	-0.2	-0.4	0.0
EI Operating Account cumulative balance	2.1	1.2	1.2	1.1	0.9	0.5	0.0
Projected premium rate (per $100 of insurable earnings)	1.88*	1.63*	1.68	1.69	1.69	1.69	1.69

Sources: Institute of Fiscal Studies and Democracy, Office of the Chief Actuary.
* legislated EI premium rates

Table D. Federal Fiscal Impact Estimates of Economic Forecast Errors			
billions of dollars	**Year 1**	**Year 2**	**Year 5**
Estimated Impact of a One-Year, 1-Percentage-Point Decrease in Real GDP Gro			
Total revenues	-4.1	-3.6	-4
Total expenses	0.6	0.6	0.6
Budgetary balance	**-4.7**	**-4.2**	**-4.6**
Estimated Impact of a One-Year, 1-Percentage-Point Decrease in GDP Inflatio			
Total revenues	-3.6	-2.9	-3.0
Total expenses	-1.4	-1.1	-1.6
Budgetary balance	**-2.1**	**-1.8**	**-1.4**
Estimated Impact of a Sustained 100-Basis-Point Increase in All Interest Rates			
Total revenues	1.5	1.9	2.7
Total expenses	2.3	3.7	6.0
Budgetary balance	**-0.9**	**-1.8**	**-3.3**

Source: Finance Canada.
Note: Values are taken from Annex 1 of Budget 2017.

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