Canadian Fiscal and Economic Forecasts Series

In this issue: An Improved Outlook, but Deficits Persist for the Foreseeable Future

Institute of Fiscal Studies and Democracy
at the University of Ottawa

Randall Bartlett, Chief Economist

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

IFSD is a Canadian think-tank at the University of Ottawa that sits at the nexus of public finance and state institutions. It is at this dynamic intersection that the IFSD strives to research, advise, engage and teach.

IFSD undertakes its work at all levels of government in Canada and abroad, while helping to prepare its student researchers and volunteers to make their mark as practitioners and good citizens.

115 Séraphin-Marion Room 107

Ottawa ON K1N 6N5

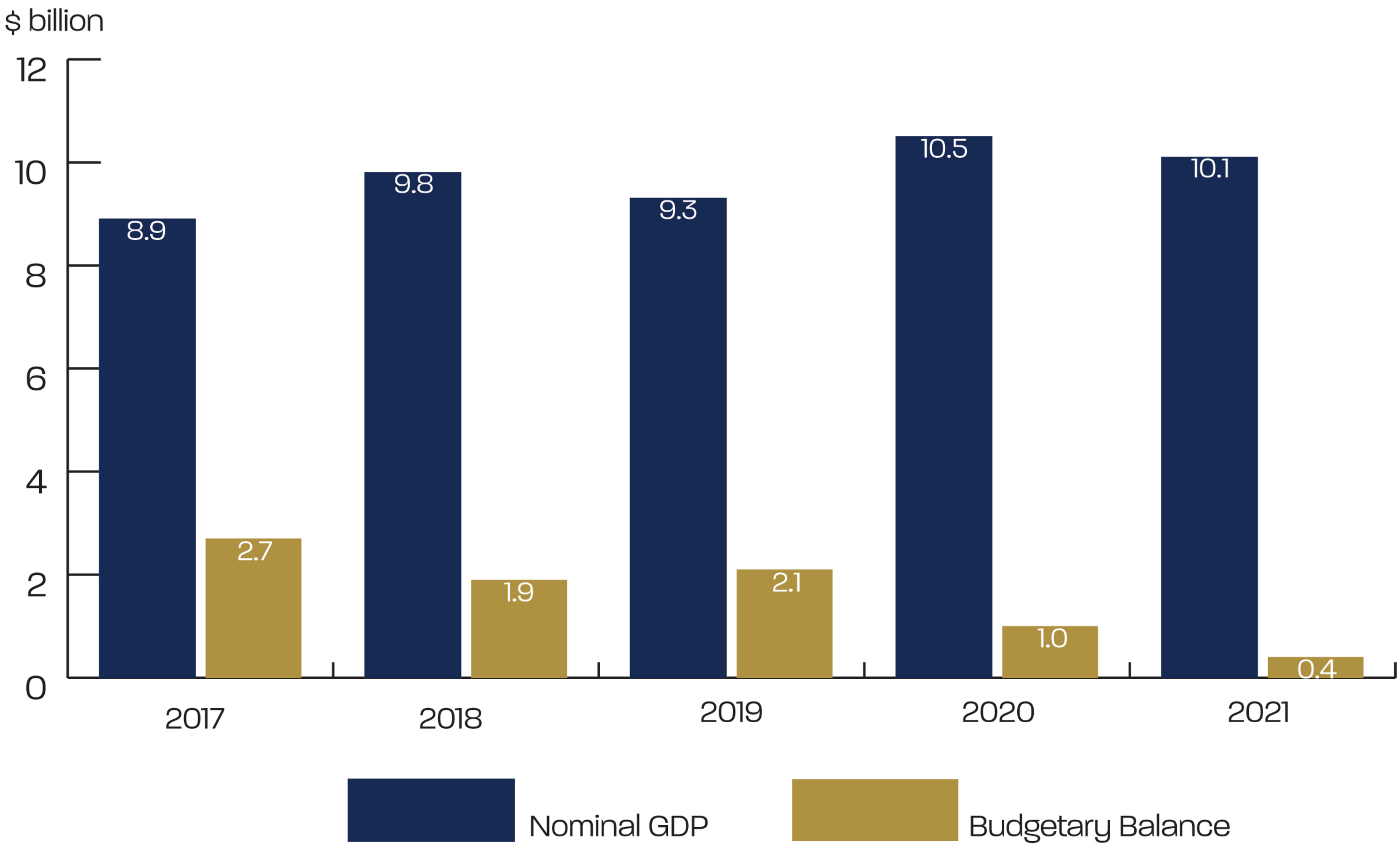
613-562-5800 x 5628

Ifsd.ca | info@ifsd.ca

While the last couple of years have been tough ones for the Canadian economy, things finally look to be turning a corner. Not only did real GDP growth in the final quarter of 2016 come in well ahead of expectations at 2.6% (annualized), but upward revisions to 2016 more broadly put annual real GDP growth at 1.4% for the year. While nothing to write home about in normal times, this is an upside surprise to the private-sector average forecast of 1.2% in the federal government's *Fall Economic Statement* (*FES*) 2016 (Government of Canada, 2016). It also bested the 1.3% anticipated by the Institute of Fiscal Studies and Democracy (IFSD) as recently as mid-January 2017 (Bartlett, 2017c). Additionally, the IFSD's forecast for real GDP growth in 2017 was also revised higher, to 2.3% from 2.0% in January 2017.

Not only was real GDP growth higher than expected in 2016, but so was the level of nominal GDP—the broadest measure of the tax base—by about $2 billion. While this may not seem like a lot, much of this was back loaded to the end of 2016, meaning it starts the forecast off on a much stronger footing than expected just a couple of months ago. Indeed, starting in 2017, the level of nominal GDP is projected to be nearly $10 billion better on average for every year of the forecast. This translates into increased average annual revenue of over $1.5 billion relative to the IFSD's February 2017 federal fiscal forecast (see Chart 1) (Bartlett, 2017b). While this will have positive impact on the budget balance, it is important to remember that this boost to revenues is just a drop in the bucket when compared to projected budget deficits in the range of $20 to $30 billion. Besides, given that the Department of Finance surveyed private-sector forecasters in mid-January 2017, this upside surprise will not be reflected in the budget numbers anyway, despite many forecasts having been similarly revised higher in the interim.

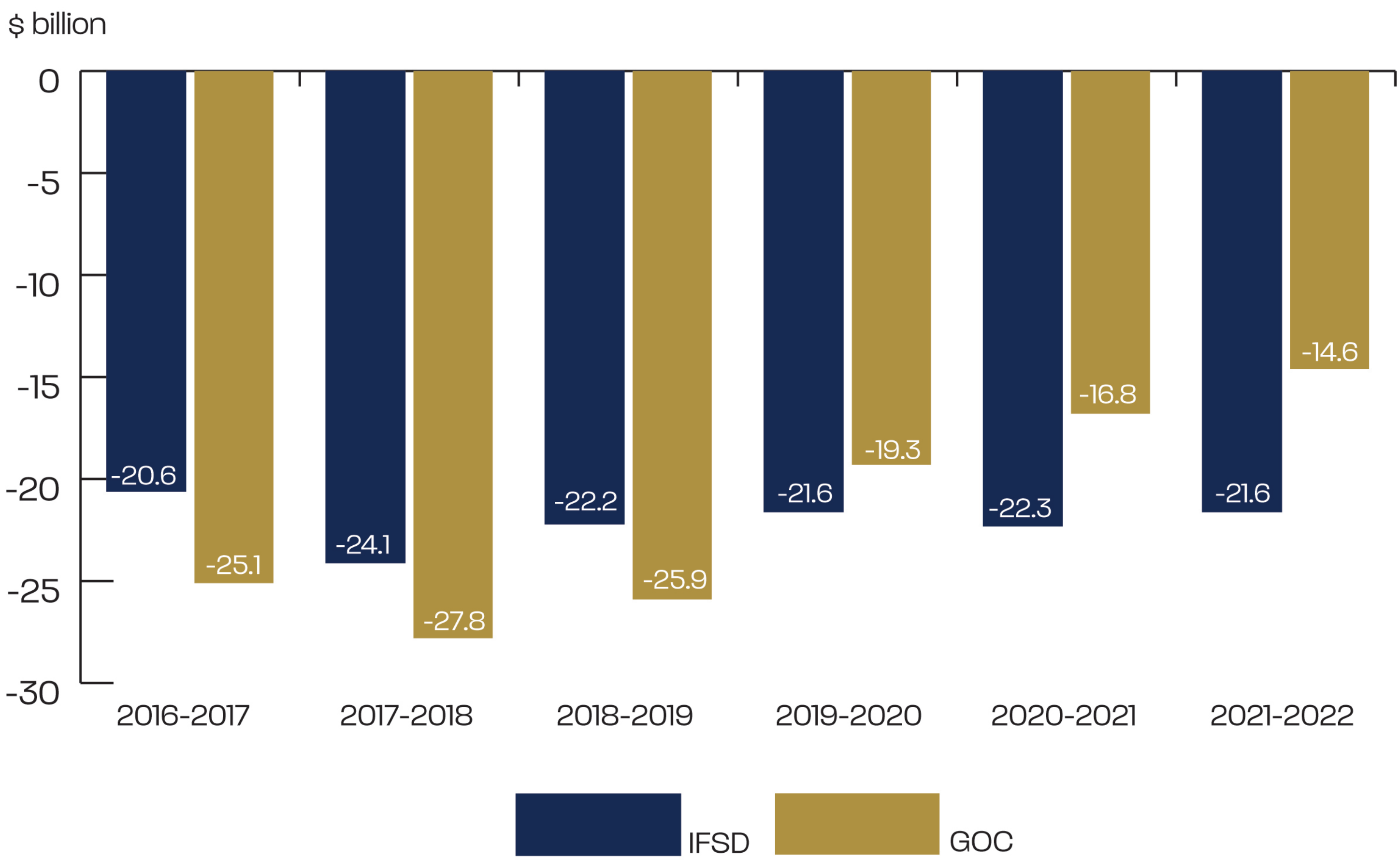
Chart 1: Changes to Economic and Fiscal Forecasts



Source: Institute of Fiscal Studies and Democracy.
Note: Years are calendar years for nominal GDP and fiscal years for the budgetary balance.

What hasn't changed relative to the IFSD's latest forecast is the view that, while deficits may be smaller in the next few years than the dour prognostications of the federal government in the *FES* 2016, they are likely to be larger in the outer years (see Chart 2). Indeed, the IFSD is forecasting budget deficits in excess of $20 billion annually in each year of the outlook (see Table 1). This can largely be tied to two different pieces of the federal fiscal forecast—direct program expenses and public debt charges (see Annex Tables A, B, and C for more details).

Chart 2: IFSD and GOC Budget Balance Forecasts



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

First, the Government of Canada's outlook for direct program expenses (DPE) seems very optimistic given its track record on spending. Indeed, the federal government is expecting DPE to advance at an average annual pace of just 1.1% starting in fiscal 2018-19, well below the torrid pace of 7.2% anticipated in the first two years of the current government's mandate. But, without detailed spending plans, there is little information available to support the government's outlook. Instead, if the federal government were to assume DPE advance at the rate of Consumer Price Index (CPI) inflation forecast by the IFSD—about 2% per year—that would add nearly $19 billion to the federal debt over the last four fiscal years of the outlook relative to the *FES* 2016. If DPE were assumed to increase at the rate of inflation and population growth—roughly 3% per year—this gap would widen further still to over $33 billion by the end of fiscal 2021-22.

The second important consideration in the federal fiscal forecast is public debt charges. Since the *FES* 2016 was published on November 1st, the U.S. Treasury yield curve has steepened sharply, due to the anticipation of higher growth and inflation resulting from President Trump's proposed policies. And as

Table 1: Federal Fiscal Forecast Summary

$ billion	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
Total Budgetary Revenues	**295.5**	**294.4**	**307.2**	**320.3**	**332.9**	**344.8**	**358.0**
Total Program Expenses	270.8	290.1	305.6	315.2	324.9	334.9	344.6
Public Debt Changes	25.6	25.0	25.8	27.2	29.5	32.1	35.1
Total Expenses	**296.4**	**315.0**	**331.3**	**342.4**	**354.4**	**367.1**	**379.6**
Final Budgetary Balance	**-1.0**	**-20.6**	**-24.1**	**-22.2**	**-21.6**	**-22.3**	**-21.6**
Federal Debt	616.0	636.6	660.7	682.9	704.5	726.7	748.3
Percent of GDP							
Total Budgetary Revenues	14.9	14.5	14.4	14.5	14.5	14.5	14.5
Total Program Expenses	13.6	14.3	14.3	14.2	14.2	14.1	14.0
Public Debt Changes	1.3	1.2	1.2	1.2	1.3	1.4	1.4
Final Budgetary Balance	-0.1	-1.0	-1.1	-1.0	-0.9	-0.9	-0.9
Federal Debt	31.0	31.4	31.0	30.8	30.7	30.6	30.4

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

U.S. yields, so go Canadian. This is particularly true at the longer end of the yield curve, where interest rate decisions by the Bank of Canada have less influence. Consequently, the cost of servicing Canadian debt is expected to increase at a faster pace than was projected by the Government of Canada in November 2016. This phenomenon is exacerbated by the fact that the federal government chose to fund its deficit spending by issuing debt at relatively short maturities instead of capitalizing on investor appetite for longer-dated sovereign bonds.

Notwithstanding the higher deficits over the medium term in the IFSD outlook, the federal debt-to-GDP ratio remains relatively stable, turning down modestly as we approach the end of the decade. This path is consistent with the federal fiscal policy medium target to not increase the debt-to-GDP ratio from current levels. IFSD projects nominal debt to increase by about $130 billion over the next six years—more than 20 percent. This is a large increase in nominal debt and highlights the weakness of the federal debt target as a budgetary constraint.

But the upcoming budget is not only about debt and deficits (for more details on considerations for Budget 2017, please see the IFSD's February 2017 Federal Fiscal Forecast).

- Budget 2017 is anticipated to be a skills and innovation budget. However, as was discussed at length in recent analysis by the IFSD, spending on skills and innovation by the federal government is already in the range of $23 billion annually (Gaspard, 2017). The current failing on the part of the federal government actually appears to lie in the fact that only a small number of the associated program activities have strong performance metrics.

- As was discussed at length in the IFSD's February 2017 federal fiscal forecast, the IFSD also hopes Budget 2017 will provide more clarity on the government's approved and planned infrastructure investments, as well as the expected role that the Canada Infrastructure Bank will play. To date, little information is available on either.

- Another item on the IFSD's radar is the impending change to the Canada Health Transfer (CHT). Currently, Manitoba is the only remaining hold-out province after Alberta, Ontario, and Quebec inked deals with the federal government early March 2017. In signing on to the federal government's CHT offer, the provinces and territories have exchanged certainty and a small sweetener for declining federal health funding as a share of costs over the long term (Bartlett, 2017a). At the same time, the logic behind the federal government's stinginess on health care funding while engaging in fiscal largesse in almost all other areas remains a mystery. Indeed, the additional cost of increasing the CHT by 5.2% annually—the December 2016 ask by the provinces and territories—is forecast to be a cumulative $3 billion (or roughly 3% of the cumulative deficit) from fiscal 2017-18 through 2021-22. This is well below the increase in forecasted revenues resulting from the upwardly revised economic forecast since January 2017.

- Further, to prevent a vicious cycle of ever-greater deficits on the back of rising public debt charges, it is the view of the IFSD that the federal government should commit to a Canadian Fiscal Charter. This Fiscal Charter would set out the fiscal management objectives of the government, its commitments on transparency and accountability, and how it will work with Parliament and officers like the Parliamentary Budget Officer.

- Finally, an important issue that also requires attention in Budget 2017 is the proposed legislation to make the Parliamentary Budget Officer an independent Officer of Parliament. The

IFSD expects to see legislative improvements on the appointment, tenure, and provision of information. The federal government has indicated that it wants the Office of the PBO to have the capacity to cost party platforms in the next election. It will be essential that the PBO have a budget consistent with the expanded mandate.

Bibliography

Bartlett, R. (2017a). *CHT Conundrum: Ontario case study*. Ottawa, ON: Institute of Fiscal Studies and Democracy. Retrieved from http://ifsd.ca

Bartlett, R. (2017b). *Federal Fiscal Forecast: Things should get better before they get worse*. Canadian Economic Forecasts series No. 17005, Vol. 2. Ottawa, ON: Institute of Fiscal Studies and Democracy. Retrieved from http://ifsd.ca

Bartlett, R. (2017c). *U.S. political uncertainty is paired with solid economic fundamentals*. Canadian Economic Forecasts series No. 17001. Ottawa, ON: Institute of Fiscal Studies and Democracy. Retrieved from http://ifsd.ca

Gaspard, H. (2017). *Skills and innovation: Where's the money?* Ottawa, ON: Institute of Fiscal Studies and Democracy. Retrieved from http://ifsd.ca

Government of Canada. (2016). *A plan for middle class progress: Fall economic statement 2016* [Cat No.: F1-52E-PDF]. Ottawa, ON: Department of Finance Canada. Retrieved from http://www.budget.gc.ca

Annex 1: Table A – Federal Revenue Forecast

$ billion	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
Personal Income Tax	144.9	144.0	153.1	159.6	166.3	173.3	179.5
Corporate Income Tax	41.4	42.5	44.7	46.6	48.1	49.4	51.5
Non-resident Income Tax	6.5	6.3	6.7	6.9	7.1	7.4	7.6
Total Income Tax	**192.8**	**192.9**	**204.5**	**213.1**	**221.5**	**230.1**	**238.6**
Goods and Services Tax	33.0	34.6	35.3	36.8	38.3	39.8	41.4
Custom Import Duties	5.4	5.1	4.6	4.6	4.7	4.8	5.0
Other Excise Duties/Taxes	11.5	11.6	11.8	12.0	11.9	12.0	11.9
Total Excise Taxes/Duties	**49.9**	**51.4**	**51.8**	**53.4**	**54.9**	**56.6**	**58.4**
EI Premium Revenues	23.1	23.0	21.4	22.6	23.7	24.4	25.0
Other Revenues	29.7	27.2	29.5	31.3	32.8	33.7	36.0
Total Budgetary Revenues	**295.5**	**294.4**	**307.2**	**320.3**	**332.9**	**344.8**	**358.0**

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

Annex 2: Table B – Federal Program Expense Forecast

$ billion	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
Major Transfers to Persons							
Elderly Benefits	45.5	47.9	50.6	53.5	56.5	59.8	63.1
EI Benefits	19.4	20.7	21.3	22.0	22.6	23.1	23.1
Children's Benefits	18.0	21.4	21.9	22.6	23.2	23.8	24.4
Total	**82.9**	**90.0**	**93.9**	**98.0**	**102.3**	**106.6**	**110.6**
Major Transfers to Other Levels of Government							
CHT	34.0	36.1	38.2	39.9	41.5	43.0	44.5
CST	12.9	13.3	13.7	14.1	14.5	15.0	15.4
Fiscal Arrangements	17.3	17.9	18.3	18.9	19.6	20.4	21.2
Gas Fund	2.0	2.1	2.1	2.2	2.2	2.2	2.2
Territorial Formula Financing	3.6	3.6	3.7	3.8	3.9	4.0	4.1
Alternative Payments for Standing Programs	-4.0	-4.5	-4.8	-5.0	-5.3	-5.5	-5.8
Total	**65.8**	**68.5**	**71.3**	**73.9**	**76.5**	**79.1**	**81.6**
Direct Program Expenses	**122.1**	**131.6**	**140.4**	**143.3**	**146.2**	**149.2**	**152.3**
Total Program Expenses	**270.8**	**290.1**	**305.6**	**315.2**	**324.9**	**334.9**	**344.6**

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

Annex 3: Table C – Federal Employment Insurance Program Forecast

$ billion	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
EI Premium Revenues	23.1	23.0	21.4	22.6	23.7	24.4	25.0
EI Benefits	19.4	20.7	21.3	22.0	22.6	23.1	23.1
EI Administration and Other Expenses	1.8	1.8	1.7	1.7	1.7	1.7	1.7
	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2024**
EI Operating Account Annual Balance	2.6	1.2	-1.8	-1.3	-0.5	-0.3	-0.2	**1.1**
EI Operating Account Cumulative Balance	0.9	2.1	0.3	-1.0	-1.6	-1.9	-2.1	**0.0**
Projected Premium Rate	1.88*	1.88*	1.63*	1.68	1.73	1.74	1.74	**1.74**

Sources: Finance Canada, Office of the Chief Actuary, Institute of Fiscal Studies and Democracy. Note: * refers to legislated EI premium rates.