Canadian Fiscal and Economic Forecasts Series

In this issue: Things should get better before they get worse

Institute of Fiscal Studies and Democracy
at the University of Ottawa

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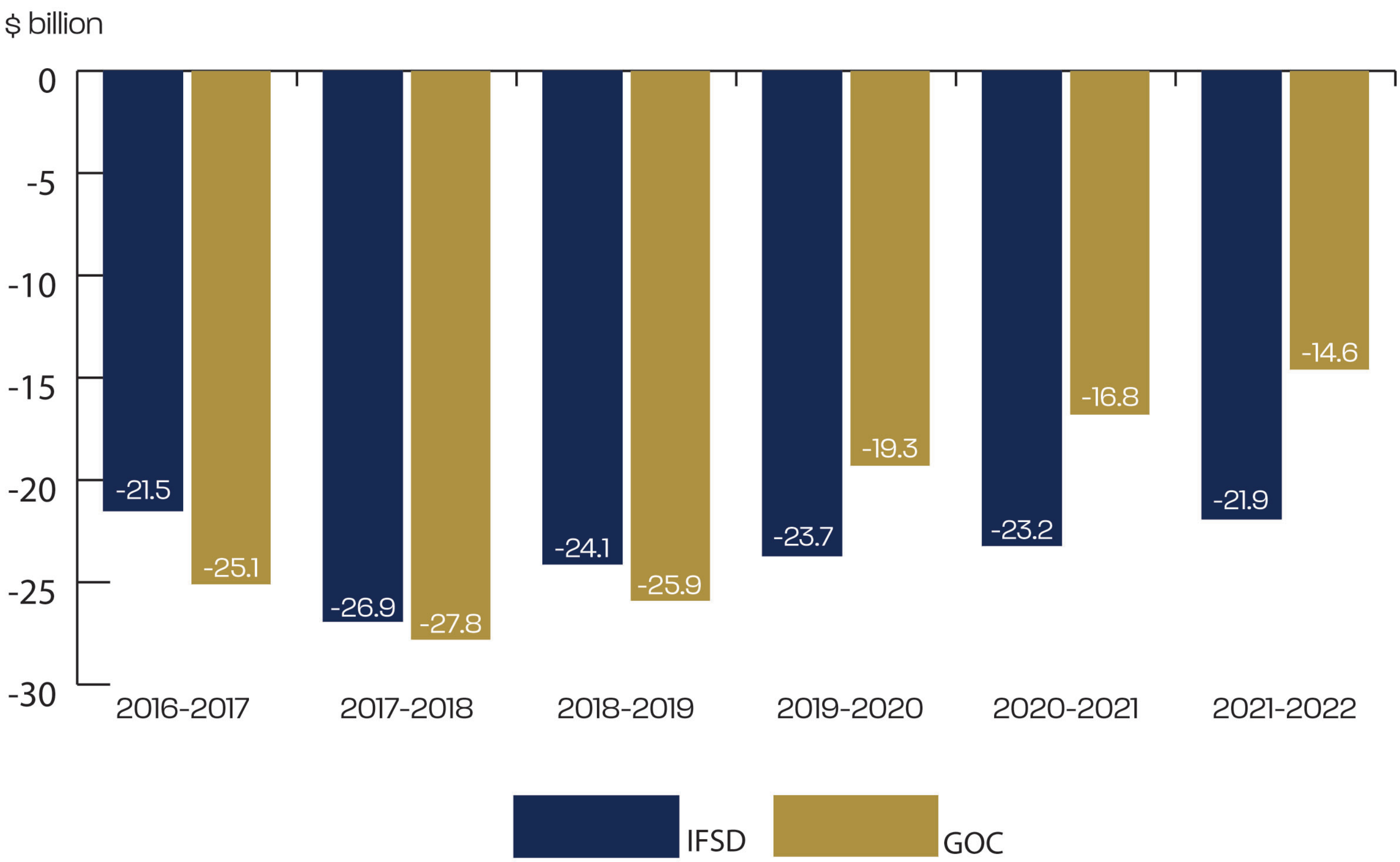
Federal Fiscal Forecast: Things Should Get Better Before They Get Worse

Since the release of its *Fall Economic Statement* (*FES*) 2016 on November 1, 2016, the federal government's planning environment has changed considerably (Government of Canada, 2016). As the Institute of Fiscal Studies and Democracy (IFSD) pointed out in its January 2017 economic forecast, U.S. political uncertainty is paired with solid economic fundamentals both here at home and south of the border (Bartlett, 2017b). Given the uncertainty is political in nature, it is difficult to plan for all eventualities. There are no priors to point to for guidance. As a result, the IFSD's fiscal forecast, much like its economic forecast, assumes a relatively benign planning environment. What is not benign, however, is the current interest rate environment, which is expected to prove somewhat more challenging than the Government of Canada (GOC) believed only a few short months ago. In addition, heated negotiations around proposed changes to the Canada Health Transfer (CHT) remain unresolved and the Finance Minister's Advisory Council on Economic Growth has released more recommendations, some of which are likely to find their way into Budget 2017.

Chart 1: IFSD and GOC Budget Balance Forecasts



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

Table 1: Federal Forecast Summary

$ billion	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022
Total Budgetary Revenues	**295.5**	**293.6**	**304.6**	**318.4**	**331.1**	**343.5**	**357.3**
Total Program Expenses	270.9	290.2	305.8	315.1	324.6	334.4	343.9
Public Debt Changes	25.6	25.0	25.6	27.5	30.2	32.3	35.4
Total Expenses	**296.4**	**315.1**	**331.5**	**342.6**	**354.7**	**366.7**	**379.3**
Final Budgetary Balance	**-1.0**	**-21.5**	**-26.9**	**-24.1**	**-23.7**	**-23.2**	**-21.9**
Federal Debt	616.0	637.5	664.4	688.5	712.1	735.4	757.3
Percent of GDP							
Total Budgetary Revenues	14.9	14.5	14.4	14.4	14.5	14.5	14.6
Total Program Expenses	13.6	14.3	14.4	14.3	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	-1.1	-1.3	-1.1	-1.0	-1.0	-0.9
Federal Debt	31.0	31.5	31.3	31.2	31.1	31.1	30.9

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

Fiscal 2016-17: A Sunnier Budgetary Outlook on Better Revenues

For the federal government, the 2016-17 fiscal year has been shaping up pretty well from a revenue standpoint. Both personal income tax (PIT) and Goods and Services Tax (GST) revenues have been tracking above the federal government's expectations, as have Employment Insurance (EI) premiums. Unfortunately, corporate income tax (CIT) revenues are not expected to fare as well after their unusually strong showing in the prior fiscal year. Meanwhile, major transfers to persons are estimated to have come in at about $1.2 billion less than was estimated in *FES* 2016, while public debt charges are on track to be roughly in line with Finance Canada's November forecasts. All in, this puts the IFSD's projected budget deficit for fiscal 2016-17 at $21.5 billion, a nearly $4 billion improvement over Finance Canada's Fall outlook (see Chart 1 and Table 1; see Annex for detailed projections). As sunny as the IFSD's outlook for fiscal 2016-17 is, it is still not as rosy as that of the Parliamentary Budget Officer. The PBO recently reported an anticipated deficit of $20.5 billion for the current fiscal year (Parliamentary Budget Officer, 2017b).

Fiscal 2016-17 to 2018-19: First, the Good News

The IFSD forecasts that this trend toward smaller-than-expected budget deficits will continue for the next couple of years. Starting in the 2016-17 fiscal year, the two subsequent fiscal years are also likely to have a better showing than was forecast in *FES* 2016. In large part, this is once again the result of improved revenues supported by an outperformance in most income categories when compared to the view of Finance Canada. Over this period, total program expenses are also forecast to come in roughly in line on average with the outlook in *FES* 2016. However, the same cannot be said about public debt charges. Indeed, the sharp steepening of the Treasury yield curve in the United States has spilled over to Canada, pushing yields on Canadian sovereign bonds similarly higher. And given the relatively short-term maturity of recent Canadian debt issues, there can be little doubt that the cost of servicing this debt will soon begin to climb.

Fiscal 2019-20 to 2021-22: And, Now, the Bad News

Looking beyond the next couple of fiscal years, rising public debt charges are expected to increasingly become problematic for the federal government's bottom line. Indeed, despite besting Finance Canada's budget balance forecast in the 2018-19 fiscal year, the fiscal deficit is projected to come in even larger than the bleak prognostications in *FES* 2016 thereafter. This is largely the result of a steeper GOC yield curve over the fiscal forecast, and of the IFSD's view that the Bank of Canada will begin raising the overnight rate in the second half of 2018. Borrowing costs are therefore likely to be increasing at a time when the Government of Canada will be rolling over some of the short-term debt it recently issued to fund its fiscal largesse. Indeed, given the IFSD is projecting primary surpluses (total revenues less total program expenses) over the forecast, it is public debt charges alone that are expected to keep the federal government in deficit. The IFSD's outlook for Direct Program Expenses (DPE) also differs from that of the GOC over the final years of the forecast. With no departmental spending plans having been advanced by the federal government that are consistent with Budget 2016 initiatives, the IFSD has assumed that DPE will grow at the rate of Consumer Price Index (CPI) inflation (roughly 2% annually) beginning in the 2018-19 fiscal year. As a result, by the end of fiscal 2021-22, the IFSD's forecast of DPE adds over $18 billion to the federal debt relative to the federal government's DPE forecast. If the IFSD assumed DPE increased by population growth in addition to CPI inflation, DPE would instead add an additional $32.5 billion to the federal debt by the close of fiscal 2021-22 relative to Finance Canada's outlook.

One could say it's like watching *Back to the Future*, with the federal fiscal quagmire of the late-1980s and early-1990s in the starring role. The exception this time is that the deficits were not inherited from past governments, they were in large part avoidable, and that interest rates are much, much lower than three decades ago. With that said, the federal government has some wiggle room, as the IFSD is forecasting the annual effective interest rate on federal debt to be as much as 20 basis points higher than in *FES* 2016. Only time will tell how interest rates will continue to evolve but caution on the part of the federal government is certainly warranted. While federal finances are currently considered to be fiscally sustainable (Department of Finance Canada, 2016; Parliamentary Budget Officer, 2016), many provinces and territories can attest to how quickly that tide can reverse.

IFSD Recommendation: Canadian Fiscal Charter

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. It could have at least five major components (which could apply equally to any province or territory), including:

1. Fiscal Policy Statement
    a. Presented with every budget
    b. Includes the government's fiscal goals, including deficit targets, debt-to-GDP ratios, spending rules, and approaches to fiscal adjustment
    c. Discloses fully all measures of debt, including accumulated deficits, gross liabilities, and contingent liabilities

2. Quarterly Budget Update
    a. Presented on the first of day of each fiscal quarter
    b. Presents progress in achieving the goals of the Fiscal Policy Statement

3. Departmental Spending Report
    a. Presented quarterly online
    b. Includes progress against budget for both financial and performance targets (including variances for both)

4. Fiscal Sustainability Report
    a. Presented annually
    b. Includes long-term projections for public spending and tax revenues
    c. Describes the public sector balance sheet and sets out summary indicators of the long-term sustainability of public finances
    d. Highlights sustainability implications for major measures in the budget and implications for other levels of government

5. Intergenerational Report

   a. Presented every four years
   b. Examines international fiscal fairness through the calculation of net fiscal benefits accruing to different generations from current and planned government spending and revenue.

Other Things to Look for in Budget 2017 Besides Big Deficits

As newsworthy as federal budget balances are, there are also likely to be major policy planks announced in Budget 2017 that have been repeatedly hinted at throughout 2016. Those discussed here include 1) skills and innovation, 2) the Advisory Council's recommendation to encourage broader workforce participation, 3) infrastructure investment and the Infrastructure Bank, 4) the CHT negotiation with the provinces and territories, and 5) impending legislation to make the PBO an independent Officer of Parliament.

There are some positive recommendations in the recent batch of reports prepared by the Finance Minister's Advisory Council on Economic Growth. The first is the focus on building a skilled and resilient workforce. While the IFSD sees merit in the development of a FutureSkills Lab that would bring together positive energies to improve labour market information, planning, and programming (Advisory Council on Economic Growth, 2017a), the IFSD strongly supports the need for a full review of existing skills and innovation development and training programs (Gaspard, 2017). The IFSD will release a report prior to Budget 2017 outlining the 180 programs and $23 billion annual spending. It is essential that Canada look at opportunities to get more value for money on existing spending.

In addition, the Advisory Council provided recommendations on increasing workforce participation in Canada, particularly regarding underrepresented groups (Advisory Council on Economic Growth, 2017b). This is a laudable goal and this yet-to-be-tapped well of potential could unquestionably boost long-term economic output in Canada. Interestingly, among the recommendations was increasing the ages of eligibility for both the Old Age Security (OAS) program and Canada Pension Plan (CPP). The Advisory Council cited the trend internationally toward raising the age of eligibility age for such programs resulting from concerns around fiscal sustainability. However, according to both Finance Canada and the PBO, the federal fiscal position has been eroding but remains sustainable (Department of Finance Canada, 2016; Parliamentary Budget Officer, 2016). Indeed, the impact of returning the age of eligibility to 65 years in 2016 only delayed returning to budget balance by a few years. The PBO also found that the CPP is in a fiscally sustainable position as recently as 2016. Hence, the argument that raising the age of eligibility for both OAS and CPP is necessary to ensure fiscal sustainability does not hold up. It would also require a complete reversal of the current government's stated policy. However, if encouraging older workers to remain engaged in the workforce is the intended outcome of this recommendation, that is a different story entirely. In this context, the Advisory Council's recommendation to find ways to make pension deferrals more attractive would be a better place to start.

Regarding infrastructure investment, as the IFSD noted in its January 2017 economic forecast, projects were approved quickly in the latter three quarters of 2016 but money appears to have been slow to get out the door. This has been further corroborated by recent analysis on the part of the PBO (Parliamentary Budget Officer, 2017a; Parliamentary Budget Officer, 2017c). To those who watched the rollout of infrastructure spending that followed Budget 2009, this comes as no surprise. Indeed, project approvals are not the same as outlays and there is a notable time lag between the two, with outlays often peaking several years after federal projects are approved (Press, 2016). However, this has come as a shock to the federal government and the Bank of Canada, the latter having adopted the former's assumptions without qualification. Fortunately for the GOC and the Bank, history suggests that these dollars should begin to materially find their way into the Canadian economy beginning in the 2017 construction season, thereby supporting above-potential real GDP growth.

But even as infrastructure investment makes its way into the economy, it is worth noting that the gap between the need for, and supply of, infrastructure in Canada remains a big question mark. The Advisory Council for instance puts Canada's 'infrastructure gap' at somewhere between $150 billion and $1 trillion (Advisory Council on Economic Growth, 2016). In other words, the Council has no idea what the size of the infrastructure gap is in Canada. This is because Canadian governments do not have a good grasp of a) what the existing level of public assets is, b) what the condition of those assets is, c) where those assets are in their life cycle, and d) what Canada's future infrastructure needs are going to be. Indeed, according to a report by the McKinsey Global Institute published in June 2016, Canada had sufficient infrastructure funding in the pipe to meet its infrastructure needs through 2030 (Woetzel, Garemo, Mischke, Hjerpe & Palter, 2016). This suggests all of the extra funds being shovelled out the door may be for naught, although there remains too large a data gap to reach a definitive conclusion.

It is worth noting that the infrastructure investment discussed above is only Phase 1 of the federal government's plan. Of the $81 billion in infrastructure investment as part of Phase 2, the federal government is setting up a Canada Infrastructure Bank (CIB) to invest at least $35 billion in the hope of using these funds to leverage additional private-sector investment. And while it's still early days, it remains unclear how the CIB will achieve some of its objectives. For instance, it is unclear which asset classes the federal government currently considers to be investable for the private sector. As institutional investors and asset managers are looking for opportunities to increase their returns relative to their total portfolio risk, it seems that some types of investments may be considered essentially uninvestable as they may have little or no associated stream of revenues. As an example, it is difficult to see where revenues will be generated from wastewater treatment, drinking water, recreation, housing for low-income Canadians, etc. despite the fact that these are important public assets. Instead, investable assets are more likely to be found in public transit, airports, ports, and highways and roads. However, while user fees can be easily attached to the former three asset classes, highways and roads may pose a greater problem due to Canada's thin history of using tolls to raise revenues. Indeed, the recent discussion between the City of Toronto and Province of Ontario around this issue highlights the political sensitivity around tolls. And this includes only those highways and roads that have sufficient consistent volume to lend itself to revenue-generating tolls.

Moving beyond the recommendations of the Finance Minister's Advisory Council on Economic Growth, another recent headline-grabbing issue is the ongoing dustup between the federal and provincial-territorial governments around federal funding for health care. Covered extensively in a recent report by the IFSD, the offer by the federal government around the future of the Canada Health Transfer was initially rejected by all of the provinces and territories, as they deemed it insufficient (Bartlett, 2017a). Instead, provincial and territorial governments wanted the CHT to increase by 5.2% annually to meet their health spending needs. However, cracks began to show in the resolve of the Canadian subnational governments soon after talks broke down; only Alberta, British Columbia, Manitoba, Ontario, and Quebec have yet to sign a deal. As such, the CHT outlook in this fiscal forecast assumes that the parameters of the deals made so far are what the federal government will assume in Budget 2017. With that said, it is worth noting that, if the federal government had increased the CHT by 5.2% annually starting in the 2017-18 fiscal year, the CHT would have been higher on average by $0.7 billion annually over five years. The total additional cost over that period would have been an additional $3.7 billion—that is, about 3.5% of the cumulative budget deficit from 2017-18 through 2021-22.

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. Finally, as was the case with the Fiscal Charter of the United Kingdom, we recommend that a Canadian Fiscal Charter outline how the government and public service will work with an independent Parliamentary Budget Officer. This should include the exchange of economic and financial information essential for fiscal analysis and accountability.

The Take-Away

Federal budgets are important political events. The federal government won the 2015 election on a mandate of modest fiscal expansion to help address significant policy challenges related to income distribution and economic opportunity, infrastructure, the environment, and better public services for First Nations and veterans. There were commitments to strengthen transparency and institutions like the Parliamentary Budget Officer. The challenges of tackling major policy files are becoming more apparent. Progress on policy reforms is slow. Budgetary deficits are much higher than anticipated.

The stage is set for Budget 2017. The IFSD strongly supports a strategy that strengthens innovation and skills. We encourage the government to undertake a full review of existing innovation and skills programs and to make that review available to Parliament and to Canadians. We encourage the federal government to return to the table with the provinces and territories and work out a new health accord that promotes better outcomes for citizens of all ages and fiscal sustainability for both levels of government. We encourage the federal government to strengthen its fiscal planning framework. Governments need budgetary constraints (targets, rules, and contingency measures) to ensure fiscal prudence, stability, and fairness to future generations.

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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	144.7	153.4	160.6	168.0	175.6	182.5
Corporate Income Tax	41.4	40.7	42.0	43.5	44.9	46.1	48.1
Non-resident Income Tax	6.5	6.3	6.6	6.9	7.0	7.3	7.6
Total Income Tax	**192.8**	**191.7**	**202.1**	**211.0**	**219.9**	**229.0**	**238.1**
Goods and Services Tax	33.0	35.2	35.3	36.8	38.4	39.9	41.6
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	11.9	11.9	11.9	11.9
Total Excise Taxes/Duties	**49.9**	**51.9**	**51.7**	**53.4**	**54.9**	**56.7**	**58.5**
EI Premium Revenues	23.1	22.9	21.3	22.9	23.6	24.2	24.8
Other Revenues	29.7	27.2	29.4	31.1	32.6	33.5	35.9
Total Budgetary Revenues	**295.5**	**293.6**	**304.6**	**318.4**	**331.1**	**343.5**	**357.3**

Source: 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	47.8	50.6	53.4	56.4	59.6	62.9
EI Benefits	19.4	20.8	21.5	21.9	22.4	22.9	22.9
Children's Benefits	18.0	21.4	22.0	22.6	23.2	23.8	24.4
Total	**82.9**	**90.0**	**94.1**	**97.8**	**101.9**	**106.2**	**110.2**
Major Transfers to Other Levels of Government							
CHT	34.0	36.1	38.2	39.8	41.4	42.9	44.4
CST	13.0	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	**65.9**	**68.5**	**71.3**	**73.8**	**76.4**	**79.0**	**81.5**
Direct Program Expenses	**122.1**	**131.6**	**140.4**	**143.3**	**146.1**	**149.0**	**152.0**
Total Program Expenses	**270.8**	**290.2**	**305.8**	**315.1**	**324.6**	**334.4**	**343.9**

Source: 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	22.9	21.3	22.9	23.6	24.2	24.8
EI Benefits	19.4	20.8	21.5	21.9	22.4	22.9	22.9
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	-2.3	-0.7	-0.5	-0.3	-0.2	**1.0**
EI Operating Account Cumulative Balance	0.9	2.0	-0.3	-1.0	-1.4	-1.8	-1.8	**0.0**
Projected Premium Rate	1.88*	1.88*	1.63*	1.73	1.73	1.73	1.73	**1.73**

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