Red is the New Black: Deficits as Far as the Eye Can See

Douglas Porter and Robert Kavcic

After nearly a decade of relentless focus—sometimes borne out, sometimes not—on balancing the budget by the Harper government, the change of fiscal regime produced by October's election results is overwhelmingly evident in the Trudeau government's first budget. BMO's Douglas Porter and Robert Kavcic break down the swing to a $29.4 billion deficit.

Finance Finance Minister Bill Morneau's first budget projected a string of deficits as far as the eye can see, with even fiscal year 2015-16 ending with a small deficit (after a small $1.9 billion surplus the prior year). This comes as little surprise, as it was well-advertised ahead of time that we would be looking at years of red ink, especially in light of a weaker-than-expected economic backdrop, loaded on top of the government's election pledge to crank up spending and run $10 billion shortfalls.

The two major areas of uncertainty heading into the budget were: 1) How much net new stimulus would be planned for the coming fiscal year; and 2) How aggressively would it be wound down in coming years, if at all?

As mostly expected, Ottawa will stick to the initial election plan of injecting just over $10 billion of net new stimulus in the coming year (equivalent to 0.5 per cent of GDP), which will push the expected deficit to $29.4 billion. Deficits in excess of $20 billion then persist for two more years, and a $14 billion shortfall still remains by FY 2020-21—in other words, there is no plan to balance the books, even beyond the first mandate. This scenario would see the closely-watched debt-to-GDP ratio rise again this coming fiscal year, to 32.5 per cent, before grinding back down to 30.9 per cent by 2020-21, essentially back to where it started when the government took office.

Note that above and beyond the headline-grabbing $29 billion deficits over the next two years, arguably the bigger story in the budget plan is the notable lack of a serious reversal of stimulus in the ensuing years. Recall that this government was elected on a pledge to run deficits for two years (at that time, just under $10 billion), and then bring finances back to balance over the next two years.

That plan has gone out the window, and not just because the economy is more challenging in the near-term. Indeed, the budget includes net new fiscal measures of $7 billion per year as far out as 2020-21, leaving the

Chart 1: Deficits Persist

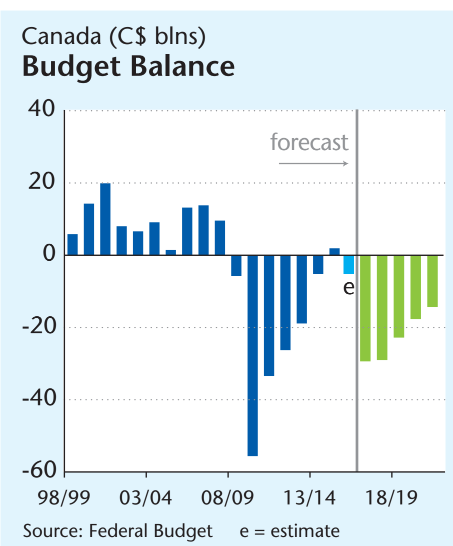


Chart 2: Revenues Grow with GDP

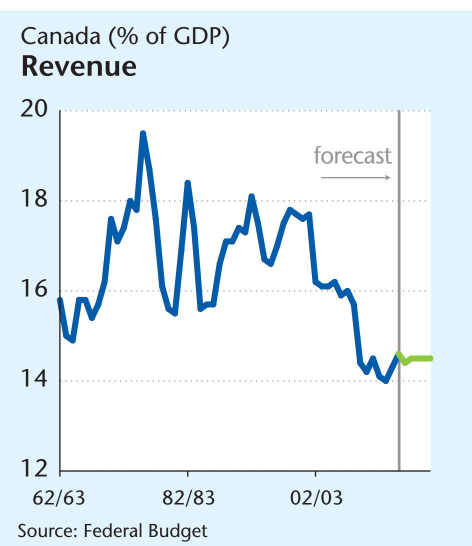
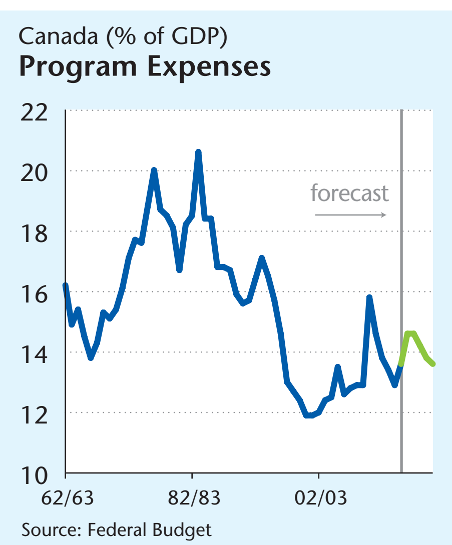


Chart 3: Spending Jumps



above-noted $14 billion gap at that point. Thus, even five years out, the fiscal plan now includes deficits well above the previously pledged maximum limit of $10 billion. Has the long-term economic outlook changed that dramatically in the past five months? In a word, no.

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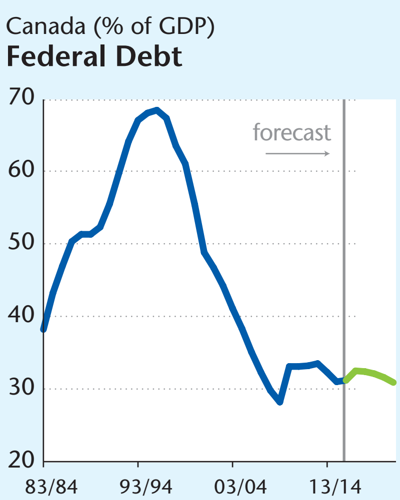
While we fully agree that a moderate dose of stimulus was an entirely appropriate response to current economic realities, we counseled caution in minding the dosage, for two distinct reasons: First, the growth restraints on Canada look to be structural in nature (a reset lower on commodity prices), and not a short-term cyclical phenomena that can be countered with a quick fiscal boost. Second, an overly aggressive fiscal boost could do lasting damage to Canada's finances, casting doubt on the country's hard-won triple-A credit rating, especially at a time when provincial credit has been steadily deteriorating.

In other words, we believe that, barring a much more serious slowdown in the economy, $30 billion should be the absolute ceiling for deficits, and certainly not the floor. Note that the latest deficit estimate includes a fattened $6 billion contingency, which means that if the economy performs broadly as expected, there will be plenty of scope to beat fiscal targets. In reality, we might see a page taken from the Ontario playbook—that is, part of the cushion gets backfilled with more spending, while the finance minister still reports better-than-expected bottom lines through the forecast horizon.

New measures announced in this year's budget net out to roughly $11.6 billion in 2016-17. Here is a quick recap of the largest of the many new initiatives:

- **Infrastructure spending:** This budget will famously "invest" in a wide range of infrastructure projects. That said, the total amount delivered in 2016-17 will be somewhat less than previously expected at $4.0 billion, but a much larger $7.3 billion in 2017-18. Infrastructure is loosely defined to include transportation, social and green infrastructure, each accounting for roughly a third of the spending pie. Public transit infrastructure will actually be relatively modest at $852 million this coming fiscal year, rising to $1.7 billion in 2017-18.
- **Program spending** will rise a hefty 7.6 per cent in 2016-17, the strongest clip since 2010 (post-recession stimulus), and a further 4.5 per cent in 2017-18. As a share of GDP, program spending will rise from just under 13 per cent in 2014-15, to 14.6 per cent by 2017-18. This is back above the 30-year average of 14.2 per cent. Notably, program spending will begin to decline in real per-capita terms by 2018-19 in order to reduce the size of the deficit further out in the forecast horizon.
- **Canada Child Benefit:** The new benefit replaces a trio of programs (the Universal Child Care Benefit, the Canada Child Tax Benefit and National Child Benefit Supplement), and tops them up with an additional $4.5 billion per year. The new plan is a tax-free benefit starting at $6,400 per child under the age of 6, and $5,400 per child between 6 and 17, phased out gradually based on income. Benefit payments get fattened meaningfully in the low-to-middle income range

Chart 4: Debt to Edge Up



Source: Federal Budget

Table 1: Fiscal Outlook

(C$ blns, except where noted)

	Est. 15/16	Forecast 16/17	Forecast 17/18	Forecast 18/19
Revenues	291.2	287.7	302.0	315.3
Expenditures	296.6	317.1	331.0	338.0
Program Spending	270.9	291.4	304.6	308.7
Public Debt Charges	25.7	25.7	26.4	29.4
Budget Balance	(5.4)	(29.4)	(29.0)	(22.8)
Federal Debt	619.3	648.7	677.7	700.5
As a percent of GDP:				
Budget Balance	(0.3)	(1.5)	(1.4)	(1.0)
Federal Debt	31.2	32.5	32.4	32.1

Note: totals may not add due to rounding ( ) = deficit Source: Federal Budget at the expense of those in the middle-to-upper income ranges. The change will take place on July 1, and be based on prior-year income.

- **Income splitting (for families) eliminated:** The ability of families with children under the age of 18 to effectively split their income will be eliminated for the 2016 tax year, saving roughly $2 billion per year (and offsetting part of the cost of expanded child care benefits). The maximum benefit was $2,000.
- **Tax avoidance:** Ottawa aims to find $450 million by 2017-18 through a variety of measures aimed at eliminating tax evasion and avoidance, and collecting outstanding tax debts.
- **Targeted tax measures:** A few smaller-ticket items such as the children's fitness and arts credits are eliminated; others such as school supply credit for teachers are introduced.
- **Canada Student Grant:** A 50 per cent increase in Canada Student Grant amounts—the maximum grant for a full-time student rises to $3,000 from $2,000 currently. Cost will be roughly $750 million per year; increase in the income threshold at which students have to repay loans to $25,000.
- **Employment Insurance changes:** The waiting period for EI benefits (after a lost job) will be reduced to one week from two; accumulated hour requirements will be relaxed for new entrants; benefit period will be extended by five weeks in the hardest-hit areas. All told, changes to the EI system will cost $602 million this coming fiscal year.
- **GIS/OAS changes:** The Guaranteed Income Supplement will receive a 10 per cent boost, and OAS/GIS will be indexed to a new Seniors Price Index. The eligibility age for OAS will be returned to 65 after being raised to 67 for those born April 1, 1958 or later. Total cost is roughly $775 million in 2016-17.
- **What didn't change:** The capital gains inclusion rate (which was widely speculated); the treatment of stock options, and the small business tax rate.

Ottawa's economic assumptions are based on the latest private sector consensus, as has been the convention for more than a decade. We are slightly below the average on real GDP growth at 1.3 per cent this year, and at 2.1 per cent in 2017. Our call assumes that growth firms slightly through 2016 to eventually north of 2 per cent next year, with the extra fiscal spending accounting for some of the growth pick-up (note that our GDP growth forecast had already factored in about $10 billion of net new spending from the budget). The consensus expects that WTI oil prices have found a bottom, and will average around $40 this year before rising to $52 in 2017. Importantly for revenues, this will drive a rebound in nominal GDP growth to 4.6 per cent next year (consensus view), after a very sluggish 0.6 per cent pace in 2015 and 2.4 per cent this year.

Note that the nominal GDP projection for this year is less than half of the assumption in last year's budget of 4.9 per cent. In light of that huge misfire by forecasters, Ottawa has built in a much larger cushion for error. To factor in additional risks related to oil prices or economic underperformance, the government has based its projections on a nominal GDP undershoot of a honking $40 billion (equal to about 2 per cent of GDP), which translates into $6 billion per year in fiscal wiggle room (this is $3 billion above the norm and $5 billion higher than last year's budget). Thus, if the economy performs as we expect, the deficit would theoretically be $5-to-$6 billion lower than Ottawa projects in the coming year.

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Table 2: Economic Assumptions

(percent)	Ottawa 2015	Ottawa 2016	Ottawa 2017	BMO Capital Markets 2016	BMO Capital Markets 2017
GDP Growth					
Real	1.2	1.4	2.2	**1.3**	**2.1**
Nominal	0.7	2.4	4.6	**2.2**	**4.3**
Yields					
3-month T-Bill	0.5	0.5	0.7	**0.5**	**0.6**
10-yearGoC	1.5	1.6	2.3	**1.4**	**1.8**

The Bottom Line: The 2016 budget may well be remembered as a crucial turning point for federal finances. Deficits that were initially billed as moderate, temporary stimulus suddenly look large and structural in nature. Should the economy face serious headwinds in the next few years, Canada's fiscal position will be left in much weaker standing. P

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