Global Economics

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Fiscal Pulse

Canadian Federal 2016-17 Budget

Jean-François Perrault, SVP & Chief Economist 416.866.4214
jean-francois.perrault@scotiabank.com

Mary Webb 416.866.4202
mary.webb@scotiabank.com

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The No-Surprise Budget

- **The Budget is largely as expected**, focused on the delivery of the government's election platform commitments.

- **Deficits of roughly $29 billion** (1.4% of GDP) are projected for each of the next two fiscal years, narrowing to a $14.3 billion shortfall (0.6% of GDP) by fiscal 2020-21 (FY21).

- **The federal debt** (narrowly defined as the accumulated deficit) is expected to rise from 31.0% of GDP as of March 2015 to a peak of 32.5% of GDP during FY16. The debt burden subsequently trends lower every year to FY21.

- **The government expresses a general commitment to regaining a balanced budget**, with a date for achieving this to be determined later.

- **There is a significant increase in program expenditures in the current plan.** From FY16 to FY18, the planned rise in program spending totals almost $51 billion, contrasting with the $5½ billion increase over the five years to FY15. Policy measures total $11 billion in FY17 and $13.5 billion in FY18.

- **More program spending is likely** as the Government develops plans to address its other policy imperatives.

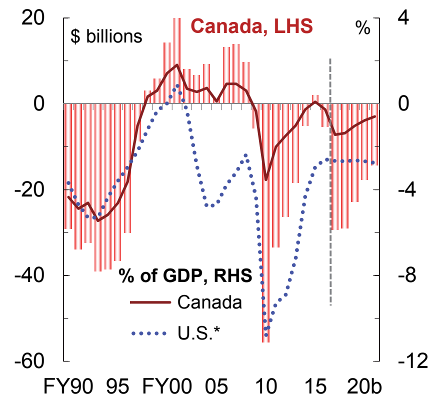
- **The Government's estimate of the growth impact of its Budget measures** is 0.5% per year for FY17 and FY18, is likely overly optimistic, but the effect is still probably substantial.

- **Bottom line**: the Budget is well designed to support the middle class and the economic impact may be important. That, and a stronger start to 2016 for the Canadian economy should reduce the odds of a cut by the Bank of Canada. We continue to believe that the next move will be a rise in interest rates, but only in mid-2017.

- **The government's market debt** is expected to rise by $37 billion in FY17, after a $20 billion increase this year. The rise in required financing is met through higher gross bond issuance, spread across the existing nominal bond sectors and the re-introduction of 3-year nominal bonds in FY17.

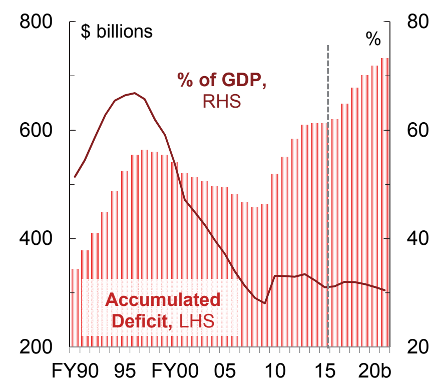
For additional debt strategy details, please see Fiscal Pulse: *Federal Debt Management Strategy, Fiscal 2016-17.*

Federal Budget Balances ...



* Ex. Social Security.

... and Accumulated Deficit



Source: Finance Canada; Statistics Canada; OMB; nom GDP fcst: Scotiabank Economics.

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Commentary on Package of Policy Initiatives

As expected, the federal Budget delivered on key aspects of the Liberal government's electoral platform, focused largely on measures to support the middle class. The signature policy is the introduction of the Canada Child Benefit, an income-tested transfer to help families with children.

Other key measures include the previously announced middle class tax cut and related measures, investments in a range of infrastructure projects, social housing, and additional support for low-income seniors. In addition, the Government is moving forward with an array of small measures designed to appeal to a range of stakeholders.

The net result of these measures is to raise deficit projections to roughly $29 billion during the next two fiscal years (1.4% of GDP). There is no immediate return to balance, as the deficit is projected to be $14.3 billion by FY21 (0.6% of GDP). The Government indicates it is committed to returning to balance, but will only commit to a date once "growth is forecast to remain on a sustainably higher track". This could be interpreted as a weak commitment to budgetary balance, but in our view, this is a reasonable approach given the uncertainty in the outlook.

The federal debt (on an accumulated deficit basis), is projected to peak at 32.5% of GDP in FY17, an increase of 1.5 percentage points from FY15 level. The debt/GDP ratio is projected to fall every year subsequent to that, even as deficits remain. Market debt is expected to rise by more than $150 billion through 2020/21.

The outlook for expenditures is likely to increase as the Government identifies how it will address other policy imperatives. Examples of these include consultations to improve the Labour Market Development Agreements, the proposals of the Council of Economic Advisors, the development of its Innovation Agenda, and a review of Canada's international assistance policy framework. Absent a significant increase in economic growth, it is likely that a return to balance will require additional revenue at some point over the fiscal planning horizon.

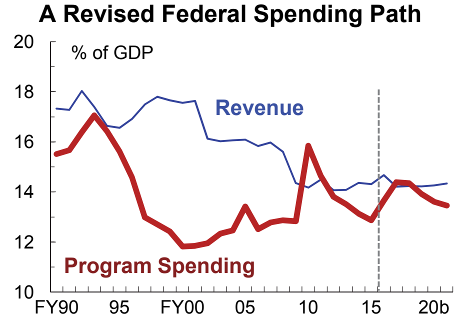
Economic Assumptions*
annual % change except where noted

Scotiabank Economics, March 2, 2016	2015	2016f	2017f
Canada: Real GDP	1.2	1.3	2.5
Nominal GDP	0.6	2.0	4.8
CPI - All Items	1.1	1.7	2.2
Unemployment Rate,%	6.9	7.2	7.1
3-month T-bills,%	0.5	0.5	0.8
10-year Bonds,%	1.5	1.5	2.2
Cdn Dollar, US¢	78	72	76
U.S.: Real GDP	2.4	2.2	2.7
WTI Oil Price, US$/bbl	49	35-40	40-45

Finance Canada March 2016 Budget*	2015	2016f	2017f	2018-20f
Canada: Real GDP	1.2	1.4	2.2	2.0
Nominal GDP	0.7	2.4	4.6	4.2
Nom. GDP, Assumed	0.7	0.4	4.7	4.3
CPI - All Items	1.1	1.6	2.0	2.0
Unemployment Rate,%	6.9	7.1	6.9	6.4
3-month T-bills,%	0.5	0.5	0.7	2.2
10-year Bonds,%	1.5	1.6	2.3	3.3
Cdn Dollar, US¢	78.3	72.1	75.9	81.2
U.S.: Real GDP	2.4	2.3	2.4	2.2
WTI Oil Price, US$/bbl	49	40	52	62

* Annual averages. Finance: Private-Sector Survey; "Nom. GDP, Assumed" includes annual risk adjustment of $40 bn from 2016 to 2020.
Source: Finance Canada; Statistics Canada; Scotiabank Economics.

A Revised Federal Spending Path



Source: Finance Canada.

A modest amount of assistance is provided to regions and workers most affected by the decline in commodity prices. The key element is an extension of Employment Insurance benefits in the 12 regions that have experienced the sharpest increase in unemployment.

Though the cash stimulus provided in the Budget is at the low end of projections, the Government believes the budgetary measures will add 0.5 percentage points to growth in each of the next two fiscal years. This is likely to be overly optimistic, but the actual boost to the economy should be in line with, or slightly above, our expectations which assumed twice the level of stimulus.

The expected impact of the Budget will feature prominently in the Bank of Canada's next decision. If the economic impacts are as large as those put forward by the Government, the output gap could well be closed by the end of 2017. This, in conjunction with a stronger start to the year and higher commodity prices, should eliminate the odds of a cut in the Bank of Canada's policy rate going forward. This could provide some support to the Canadian dollar. We have long held the view that the Bank of Canada was done easing monetary policy.

The persistence of deficits through FY21 was well telegraphed and should not have a significant impact on bond markets. The one area of potential concern is the Government's ongoing work to identify how to meet other policy imperatives. This will undoubtedly come at some cost. The extent of these measures could lead to a further delayed return to balance, or may require additional revenue.

FY16 Recap

The projected FY16 deficit of $5.4 billion contrasts with the monthly Fiscal Monitor reporting a cumulative surplus for the first ten months of $4.3 billion. Revenue growth is expected to slow from the 7.0% y/y rate through January to 3.1%. A major contributing factor is the expected correction in corporate income tax receipts as corporations carry back losses to request refunds of taxes paid in the last three years.

Pushing up FY16 program spending is the accrued $3.7 billion commitment to increased Veterans' support. Over the five years to FY15, program spending growth was held to an average of 0.4% annually to help narrow the deficit. That trend ends in FY16 with a projected 6.7% increase.

Federal Budget Arithmetic

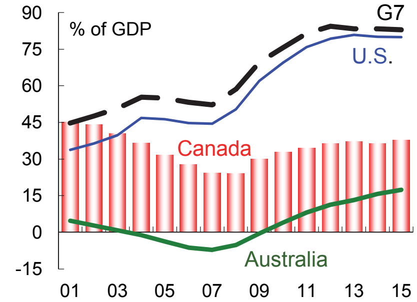
$ billions except where noted

	FY16 Rev.	FY17 Bud.	FY18 Bud.	FY21* Bud.
Personal Income Tax (PIT)	142.70	143.90	153.70	176.97
Corporate Income Tax (CIT)	38.80	37.90	39.90	44.50
Goods & Services Tax (GST)	33.10	33.50	35.20	40.00
Employ. Insurance (EI) Premiums	23.00	22.40	21.00	23.49
Other Revenue	53.60	50.02	52.20	59.40
Total Revenue	**291.20**	**287.72**	**302.00**	**344.35**
Elderly Benefits	45.60	48.40	51.10	60.10
Employ. Insurance (EI) Benefits	19.40	21.10	21.60	22.10
Children's Benefits	18.10	21.90	22.80	21.80
Major Transfers to Persons	**83.10**	**91.40**	**95.50**	**104.00**
Transfers to Other Levels of Gov't	65.80	68.65	70.30	78.10
Direct Prog. Spending (Incl. Defense)	122.00	131.33	138.80	141.07
Total Program Spending	**270.90**	**291.37**	**304.60**	**323.17**
Debt Service	25.70	25.70	26.40	35.48
Total Expenditure	**296.60**	**317.07**	**331.00**	**358.65**
Budget Balance	**-5.40**	**-29.35**	**-29.00**	**-14.30**
Non-Budgetary Transactions	-15.95	-7.85	-14.35	-14.65
Fin.Source(+) / Requirement(-)	**-21.35**	**-37.20**	**-43.35**	**-28.95**
Net Debt (Accumulated Deficit)**	**619.3**	**648.7**	**677.7**	**732.5**
Annual Change, %				
Personal Income Tax (PIT)	*5.1*	*0.8*	*6.8*	*4.8*
Corporate Income Tax (CIT)	*-1.6*	*-2.3*	*5.3*	*3.7*
Goods & Services Tax (GST)	*5.6*	*1.2*	*5.1*	*4.4*
Total Tax Revenue	***3.9***	*-2.6*	*-6.2*	*4.3*
EI Premiums	*1.9*	*-6.7*	*4.4*	*3.8*
Total Revenue	***3.1***	*-1.2*	*5.0*	*4.5*
Elderly Benefits	***3.4***	*6.1*	*5.6*	*5.6*
Employ. Insurance (EI) Benefits	***7.5***	*8.8*	*2.4*	*0.8*
Children's Benefits	***26.5***	*21.0*	*4.1*	*-1.5*
Major Transfers to Persons	***8.7***	*10.0*	*4.5*	*2.9*
Transfers to Other Levels of Gov't	***4.3***	*4.3*	*2.4*	*3.6*
Direct Prog. Spending (Incl. Defense)	***6.8***	*7.6*	*5.7*	*0.5*
Total Program Spending	***6.7***	*7.6*	*4.5*	*2.0*
Total Expenditure	***5.8***	*6.9*	*4.4*	*2.7*
Memo Items, %				
Tax Revenue / GDP	12.0	11.7	11.8	11.9
Total Revenue / GDP	14.7	14.2	14.2	14.3
Total Program Spending / GDP	13.6	14.4	14.4	13.5
Budget Balance / GDP	-0.3	-1.4	-1.4	-0.6
Accumulated Deficit** / GDP	31.2	32.0	31.9	30.5
Debt Service / Revenue	8.8	8.9	8.7	10.3

*Average annual growth for FY19 to FY21. **Includes Other Comprehensive Income.
Source: Finance Canada; Statistics Canada; nom.GDP forecasts: Scotiabank Economics.

Revenue Outlook

General Government Net Debt



Source: IMF.

Revenues in FY17 are expected to drop 1.2%, constrained by no anticipated increase in tax receipts as corporate income taxes decline again and the rise in Personal Income Tax and the Goods & Services Tax is limited to the 1.0% range. The one-time boost to other revenues in FY14 and FY15 from asset transactions is not repeated.

Doubling the adjustment for risk also constrains revenues. The government lowers nominal GDP for its *Budget* estimates by $40 billion annually from calendar 2016 to 2020 from the private-sector survey average, reducing annual revenues by $6 billion. The government cites multiple sources of uncertainty for Canada as it is a small, open economy and references the substantial downward revisions to national income forecasts over the past two years. Interestingly, for 2016, the assumed nominal GDP is in line with oil prices averaging US$25/barrel and real GDP growth of 1.0%. Events over the past month suggest a slightly better 2016 performance, which may assist the *Budget* bottom line.

With program spending in FY17 advancing a further 7.6%, the deficit widens to $29.4 billion. Limiting the red ink is the debt service, estimated to be unchanged in FY17 with the assistance of historically low interest rates.

For FY18 through FY21, revenue growth is expected to average 4.6% annually, as annual increases in the GDP deflator recover to a 2.1% average and annual real GDP gains rebound to roughly 2.2% in calendar 2017 and 2018 and then ease to 1.9% by 2020.

Among the revenue components, Employment Insurance (EI) premiums drop 8.7% over FY17 and FY18 as the seven-year break-even rate is introduced in calendar 2017. The expected drop in this rate, for employees from $1.88 per $100 of insurable earnings to $1.61 represents sizeable payroll tax relief for both employers and workers.

Expenditure Plans

Program spending, after a projected FY18 rise of 4.5%, eases to average annual growth of just 2.0%, awaiting the development of the government's longer-term commitments. Increases in several expenditures are expected to ease, such as EI benefits that are assumed to trend lower with the economy's stronger expansion. An offset are elderly benefits that are projected to climb by 5½% per year from FY18 to FY21.

The debt service, estimated to remain in the $26 billion range over the four years to FY18, is then expected to escalate to $35.5 billion by FY21. Relative to revenues, federal interest charges have steadily declined from 35¢ of each revenue dollar in FY96 to just below 9¢ in FY16 and FY17, before jumping to 10.3¢ in FY21. Policies with minimal or no cost still make a difference, Statistics Canada, long form Census, Seniors Price Index, Agreement on Internal Trade

Scotiabank Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: 416.866-6253 Fax: 416.866.2829
Email: scotia.economics@scotiabank.com