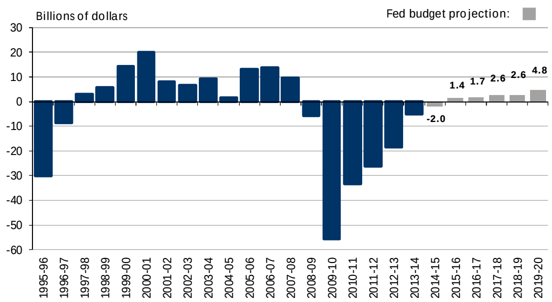
ECONOMICS | RESEARCH

2015 FEDERAL BUDGET

April 21, 2015

Federal government budgetary balance



Source: Department of Finance, RBC Economics Research

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Goals Achieved Though Risks Remain

With a federal election slated for later this year, it has been widely speculated that Budget 2015 was intended to demonstrate the current government's responsible handling of fiscal issues. In other words, the government would be able to provide tangible benefits to the Canadian electorate after enduring a number of years of fiscal restraint. The success of this plan came under threat with the recent slide in oil prices and attendant negative implications for federal government revenue flows. However, this downside hit was countered by a number of offsetting factors. The government has benefitted from better-than-expected fiscal returns prior to the onset of the oil price shock. As well, revenues are poised to receive a one-off boost from various initiatives such as the sale of the government's holding of the GM stocks acquired as a result of the stresses incurred during the last recession. However, it is also the case that much of the cumulative projected surplus has been achieved by reducing the contingency reserves by a cumulative $10B between FY2014/15 and FY2019/20. Putting this reduction in context, it can almost fully fund the cumulative $13.8B in total budget measures contained in Budget 2015. Lower contingency reserves help keep the government in a surplus position in the near term. A lowering of contingency reserves has occurred despite the government warning that downside risks to the economy persist in the form of continuing low or declining oil prices leaving the fiscal projections more vulnerable to an economic shock going forward.

Fiscal Balance Projections

As long promised, Budget 2015 shows the federal government returning to a surplus in FY2015/16 of $1.4B after seven consecutive years of deficits including the $2.0B shortfall projected for FY2014/15. A surplus position is maintained over the projection period rising gradually to $4.8B in FY2019/20. The 2015/16 surplus is down slightly from the $1.9B projected in the 2014 Fall Update. It is generally the case that the profile of surpluses has been lowered since last fall through the medium term. Cumulatively the fiscal balance position of the federal government has been lowered by $17.2B between FY2014/15 and FY2019/20 compared to the 2014 Fall Update. The lower surplus profile has mainly reflected revenues being lowered a cumulative $33.7B, prior to accounting for new measures in the 2015 budget, that in large part reflected a lower oil price assumption weighing on nominal GDP growth. The revenue hit was tempered in part by various assets sales that boosted revenues a cumulative $2.0B with $1.0B coming in the current fiscal year. This mainly reflected the sale of both GM shares and spectrum licences. Measures introduced in Budget 2015 represented a net cost to the government of a further cumulative $13.8B. Factors lowering the projected surpluses were tempered by three main upside factors. Public debt charges were lowered a cumulative $18.7B that mainly reflected lower forecasted interest rates. As well, the reduction in contingency reserves also provided a $10.0B offset. A final, and much smaller, $1.5B in offsets was provided by lower program expenses that reflected "economic and fiscal developments" that occurred in the intervening period between the 2014 Fall Update and Budget 2015. Though direct program spending increased it was offset by lower transfers to individuals.

Initiatives

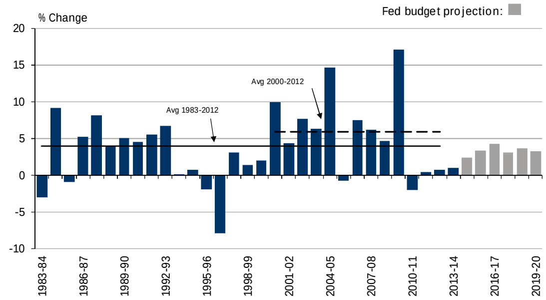
The return to positive fiscal footing in Budget 2015 saw the government build upon earlier announced initiatives, with many of the key proposals alluded to ahead of the budget release. The bulk of the $13.8B in proposed new spending is targeted at supporting the government's overarching goals of creating jobs and supporting economic growth, at $9.1B. Accordingly, the manufacturing sector is set to be a beneficiary of this stimulus with the 2015 expiration of the accelerated capital cost allowance to be replaced with a new 10-year incentive. The proposed 50% accelerated capital cost allowance on a declining basis accompanied $100M in funding over five-years in support of auto part suppliers, rounding out the $1.2B in total support for the sector. The government also announced $1.3B will be allocated over a six-year period beginning in 2017/18 to fund the non-profit Canada Foundation for Innovation to further promote innovation and support advanced research infrastructure investment.

Following the introduction of the Small Business Job Credit in September 2014, Budget 2015 took further measures to support this segment of the economy by means of a tax cut at a cost of $2.7B. A reduction in the current 11% small business tax rate will be phased in over the projection period, declining by 0.5pp at the beginning of each calendar year beginning in 2016, settling in at 9% on January 1, 2019. Rounding out the measures geared towards job creation and long-term prosperity was the introduction of a $1.8B New Public Transit Fund as well as underlying details of an earlier announced $5.8B investment in infrastructure. With respect to the former, the government will guarantee payments over the useful life of a public transit asset, which in turn, would provide a stream of funds to which a provincial or municipal government could borrow against to raise sufficient funds for the project in the near-term. For the latter $5.8B investment, the spending will be spread out over a six-year period (initially announced as a three-year initiative), with a focus on renewing existing infrastructure within national historic sites and national parks. As a result of the accounting for this initiative, the fiscal cost of this program is reflected in a $1.6B reduction over through fiscal year 2019/20 to the government's bottom line.

As the cornerstone of the fiscal initiatives announced leading up to the November update, most notably the $12.7B Family Tax Cut initiative, Canadian families continued to be a prominent beneficiary of Budget 2015, with measures totalling $7.8B. As was largely expected leading up to the budget's release, the government fulfilled its 2011 election commitment to increase the annual contribution to Tax Free Savings Accounts from its current $5.5K. Effective in the current 2015 tax year, the limit will be raised to $10K, resulting in an estimated reduction to federal revenues of $1.1B over the entirety of the fiscal plan. A further $0.9B in measures aimed at preserving the retirement savings of Canadian seniors was pledged by the government. This included an adjustment to the minimum withdrawal requirements for Registered Retirement Income Funds, which is set to see Canadian seniors benefit from capital preservation as under the new framework, the percentage of assets that are required to be withdrawn on an annual basis will decline. This is projected to yield savings to this age cohort of $670 million over the 2015/16 to 2019/20 period.

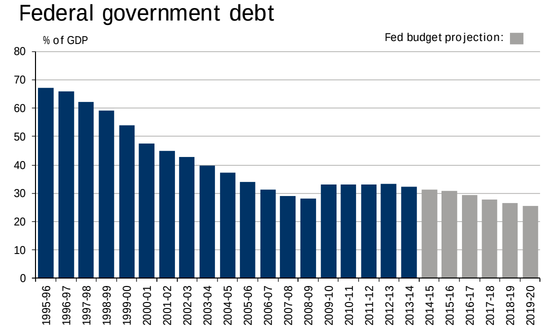
Heightened awareness to national security threats prompted the government to pledge $360M in FY2015/16 for the specific purpose of countering the Islamic State of Iraq and Levant (ISIL). In addition, the government expanded its support for the Canadian Armed Forces by increasing National Defence funding by a total of $11.8B over a 10-year period. By increasing the annual escalator for the National Defence budget to 3% beginning in 2017/18, a $184M boost to the department's spending in 2017/18 is set to

Federal program spending



Source: Department of Finance, RBC Economics Research

Federal government debt



Source: Department of Finance, RBC Economics Research rise to $2.3B by 2026/27 and accounts for a total cost over the five-year fiscal plan of $1.1B. Additional measures to support Canada's military emanated from the government's pledge to amend veterans' benefit plans. This $2.5B initiative incorporates the accrual of future benefit payments with the majority of the cost booked in FY 2014/15 (at $1.6B). Beginning in 2015/16, the funds will gradually be dispersed ($86M over the next five years) through increased benefits and services.

Additional fiscal initiatives proposed in Budget 2015 are limited in fiscal costs although are noteworthy nonetheless. The government affirmed its earlier proposal to provide the Liquefied Natural Gas industry with an accelerated capital cost allowance. It further expanded its support by extending the life of a LNG export license to 40 years from its current 25 years.

Despite the inclusion of new spending initiatives, the government asserted its position as a strong fiscal steward by affirming its earlier announced balance budget legislation. Under the proposed rule, a government could record a deficit in cases of "extraordinary circumstance" such as a war or natural disaster or alternatively, if the shortfall was in response to an economic contraction. In the case of the latter, a freeze on operating spending and a freeze on the wages of Ministers and Deputy Ministers would take effect once the economy is on the path to recovery and in the early stages of the recovery. The lifting of the freeze is reportedly at the discretion of the government.

Fiscal Savings

Budget 2015 helps to partially fund the numerous initiatives by proposing $3.3B in various savings. About $1.8B is projected to be saved by a strengthening in the tax system. For example, measures were proposed "to prevent corporations from converting their taxable capital gains into tax-free dividends." As well, rules surrounding the shifting of income from insurance from Canada to lower-tax jurisdictions, so-called "insurance swaps", were strengthened from what had been introduced in 2014. An additional $1.5B in savings was projected to be achieved by the "modernization of the disability and sick leave management system within the federal public service." This is mainly intended to limit the practise of individual employees banking sick days and in essence better "pooling" this capacity to a level more in line with actual usage resulting in a reduced net cost to government. A lion's share of this savings ($0.9B) is projected to occur in FY2015/16.

Fiscal Overview

The steady rise in the federal government surplus from $1.4B in FY2015/16 to $4.8B in FY2019/20 is generally achieved via revenue growth outpacing growth in program expenses. Specifically, the average annual increase in revenues over the forecast horizon of 4.0% compares to growth in program expenses of 3.5%. Revenue growth is in line with the projected increase in nominal GDP of 3.9% which aligns with average real GDP gains of 2.2% and average annual inflation, on a GDP deflator basis, of 1.7%. Revenue growth projected in Budget 2015 is down from the projected increase of 4.4% projected in Budget 2014. This in turn in large part reflects nominal GDP growth being lowered from the previously-projected 4.3% resulting from lower oil prices in the near term. The rising surplus contributes to the federal debt, as a percentage of GDP, steadily falling from 32.3% in FY2013/14 to 25.5% in FY2019/20. It is of note that the relatively smaller surpluses over the forecast horizon results in a less rapid improvement in this measure. For example, the ratio for FY2018/19 of 26.7% compares to the 25.5% projected for the same fiscal year in Budget 2014.

Table 1

Summary statement of transactions (billions of dollars)							
		Projection					
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Budgetary transactions							
Budgetary Revenues	271.7	279.3	290.3	302.4	313.3	326.1	339.6
Program Expenses	248.6	254.6	263.2	274.3	282.7	293.0	302.6
Public debt charges	28.2	26.7	25.7	26.4	28.0	30.5	32.1
Total Expenses	276.9	281.3	288.9	300.7	310.7	323.5	334.7
Budgetary Balance	-5.2	-2.0	1.4	1.7	2.6	2.6	4.8
Federal Debt	611.9	616.0	617.0	615.3	612.6	610.1	605.2
Per cent of GDP							
Budgetary revenues	14.3	14.1	14.5	14.4	14.3	14.3	14.3
Program Expenses	13.1	12.9	13.2	13.1	12.9	12.8	12.7
Public Debt Charges	1.5	1.4	1.3	1.3	1.3	1.3	1.4
Budgetary Balance	-0.3	-0.1	0.1	0.1	0.1	0.1	0.2
Federal Debt	32.3	31.2	30.8	29.3	27.9	26.7	25.5

Table 2

Economics assumptions						
(Year-over-year % change)						
	2014**	2015	2016	2017	2018	2019
Real GDP growth	2.5	2.0	2.2	2.3	2.2	2.0
GDP Inflation	1.8	-0.4	2.6	2.3	2.1	2.1
Nominal GDP growth	4.4	1.6	4.9	4.7	4.3	4.2
3-month Treasury bill rate*	0.9	0.6	1.0	2.0	2.7	3.0
Ten-year government bond rate*	2.2	1.7	2.5	3.2	3.7	3.9
Unemployment rate	6.9	6.7	6.6	6.3	6.2	6.1
U.S. real GDP growth	2.4	3.1	2.9	2.6	2.4	2.4

* %, end of period

** Values for 2014 are actuals

Source: Statistics Canada, Bureau of Economic Analysis, Department of Finance, RBC Economics Research