FEDERAL BUDGET PREVIEW

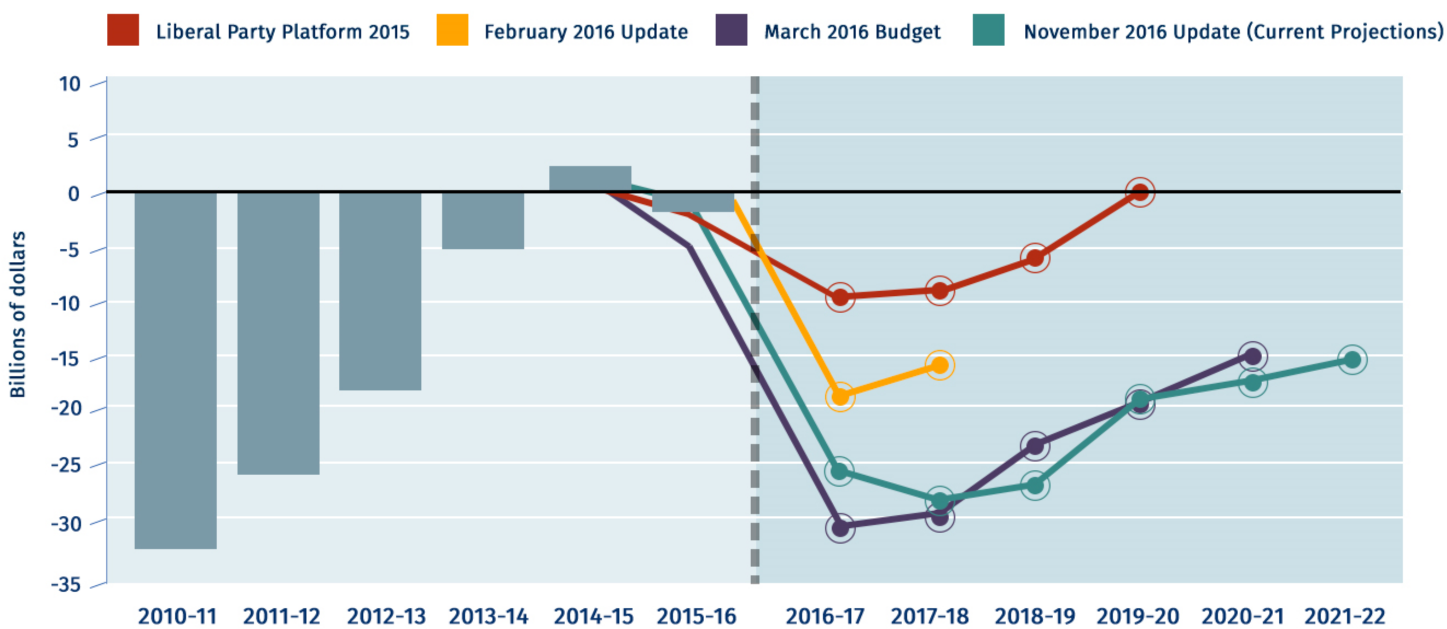
March 2017

The fiscal plan: first, do no harm

The March 22nd federal budget will mark the first look at Ottawa's fiscal plans following the U.S. election. While there are many unknowns, it appears Canada will be facing a U.S. economy with lower taxes and fewer regulations in the years ahead. There are also potential risks on the trade front, with "tweaks" coming to NAFTA and a potential border-adjustment tax. In this challenging environment, the government should ensure that the budget does not disadvantage the Canadian economy. This implies staying away from tax increases while mapping out a credible medium-term plan back to a balanced budget. Ottawa's biggest challenge comes from its robust spending plan, which results in deficit forecasts over the entire fiscal planning horizon, and poses the risk of higher taxes. Our view is that the government should reintroduce a target for balancing the budget, as the commitment to lowering the debt-to-GDP ratio that replaced the balance target is more difficult to control and less stringent.

Deeper in the red, and for longer

As Budget Day looms, a look at Ottawa's shifting budgetary balance projections



Source: Department of Finance, RBC Economics Research

What to look for:

Deficits, and more deficits: The government campaigned on a pledge to run small deficits for a few years and then return to a balanced budget. That plan evaporated soon after the election, as Ottawa greatly expanded its spending program. The new budget is expected to show deficits in the $25-$30 billion range over the next couple of years, before easing to around the

Craig Wright
Chief Economist | 416-974-7457 | craig.wright@rbc.com

Laura Cooper
Economist | 416-974-8593 | laura.cooper@rbc.com

$15 billion mark in FY2021/22. Those deficits would add $130 billion to the federal debt load. While the federal debt-to-GDP ratio will remain low relative to other G7 countries, Canada compares less favourably to the handful of other AAA-rated countries. Ottawa is basing its projections on the assumption that nominal interest rates will remain below nominal GDP growth. That bet will face longer odds as rates rise and the economic expansion ages.

The return of the fiscal cushion: Canadian federal budgets typically include a risk adjustment to protect the government against unforeseen costs, but Ottawa dropped the cushion in last fall's economic update. Expect to see it reinstated in this budget, a move that would push the deficit profile up an additional $6 billion or so throughout the forecast horizon relative to what was tabled in the fall. If reinstated, we would want the budget to explicitly state that, if the cushion is not needed, the funds will go towards debt reduction rather than turn into a slush fund for future spending.

Stay the course on taxes: Ottawa appears to have little room to raise taxes, given challenges to its tax competitiveness and its own previous initiatives targeting the middle class. Nonetheless, a lack of spending restraint has made additional revenue measures more pressing. On the tax front, there has been speculation the budget will increase taxes on capital gains. That move could be hard to square with the government's billing of the document as an innovation budget, given that some sectors use stock-based compensation to attract talent.

At last, details on spending: Having significantly ramped up spending since taking office, the government should provide some details behind its many initiatives. Over the medium term, the largest share of that spending will be on infrastructure, and we anticipate the budget will shed more light on intended projects as well as flesh out the structure of Ottawa's proposed infrastructure bank.

Fiscal lift: The government assumed last year's budget would lift GDP growth by about half a percentage point in each of 2016 and 2017. Given scant evidence that this occurred, the budget may say that more of the growth will come this year, or spill into next. That lag underscores how difficult it is for a government to use fiscal policy to support growth given time lapses in implementation.

Projections from the November 2016 Fiscal Update (billions of dollars)

		Projection					
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Budgetary transactions							
Budgetary Revenues	295.5	291.1	303.3	313.2	326.2	339.5	355.0
Program Expenses	270.8	291.3	306.5	313.2	317.2	326.0	336.5
Public debt charges	25.6	24.9	24.6	25.9	28.2	30.3	33.1
Total Expenses	296.4	316.1	331.0	339.1	345.4	356.3	369.6
Budgetary Balance	-1.0	-25.1	-27.8	-25.9	-19.3	-16.8	-14.6
Federal Debt	616.0	642.0	669.8	695.7	715.0	731.8	746.4
Per cent of GDP							
Budgetary revenues	14.9	14.4	14.4	14.3	14.4	14.4	14.5
Program Expenses	13.7	14.4	14.6	14.3	14.0	13.8	13.7
Public Debt Charges	1.3	1.2	1.2	1.2	1.2	1.3	1.3
Budgetary Balance	0.0	-1.2	-1.3	-1.2	-0.8	-0.7	-0.6
Federal Debt	31.1	31.8	31.8	31.9	31.5	31	30.4

The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.

®Registered trademark of Royal Bank of Canada.