CANADA: 2014 BUDGET

A balanced budget by fiscal 2014–2015?

The Department of Finance is on track to balance the budget for 2015–2016. The target date could even be moved up a year if the amounts allocated for risk are not needed. To hit the target, the federal government is relying on tight control of program spending, which should even decline 0.4% in 2014–2015. Among other things, the measures introduced in the 2014 budget will help save $2.1B in 2014–2015, for a total of nearly $10B over six years. In this context, the new expenditures and investments put forward are, of course, quite small. Still, funds have been earmarked for infrastructures, research, workforce training and communities.

Table 1
Summary statement of transactions

	Actual	*Projections*					
In $B	**2012-2013**	**2013-2014**	**2014-2015**	**2015-2016**	**2016-2017**	**2017-2018**	**2018-2019**
Budgetary revenues	**256.6**	**264.0**	**276.3**	**293.3**	**306.8**	**317.7**	**332.4**
- Change (%)	3.0	2.9	4.7	6.2	4.6	3.6	4.6
Program spending	**-246.4**	**-251.2**	**-250.2**	**-256.9**	**-266.5**	**-275.2**	**-286.3**
- Change (%)	0.9	1.9	-0.4	2.7	3.7	3.3	4.0
Debt charges	**-29.2**	**-29.3**	**-29.0**	**-30.0**	**-32.1**	**-34.4**	**-35.8**
- Change (%)	-6.1	0.3	-1.0	3.4	7.0	7.2	4.1
Adjustment based on risk[1]	**0.0**	**-1.5**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**
Budgetary balance	**-18.9**	**-16.6**	**-2.9**	**6.4**	**8.1**	**8.1**	**10.3**
Federal debt[2]	602.4	616.0	618.9	612.4	604.3	596.2	586.0
- Change (%)	3.2	2.3	0.5	-1.1	-1.3	-1.3	-1.7
In % of GDP							
Budgetary revenues	14.1	14.1	14.3	14.5	14.5	14.4	14.4
Program spending	13.5	13.5	13.0	12.7	12.6	12.5	12.4
Public debt charges	1.6	1.6	1.5	1.5	1.5	1.6	1.6
Budgetary balance	-1.0	-0.9	-0.1	0.3	0.4	0.4	0.4
Federal debt	33.1	33.0	32.0	30.3	28.6	27.0	25.5

[1] Reserve contained in budget revenues; [2] Debt representing the accumulated deficits including other comprehensive income.
Source: Department of Finance of Canada

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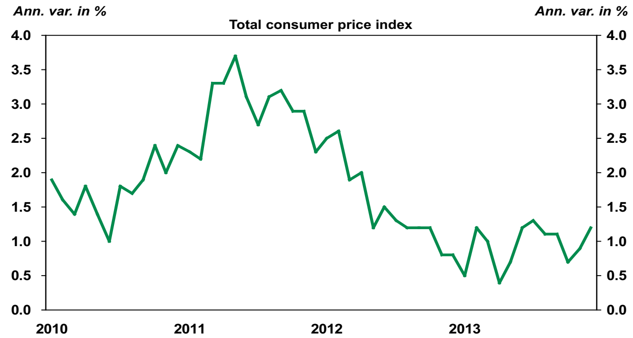
ECONOMIC PROJECTIONS: SUBSTANTIAL RISKS PERSIST

Overall, the economic and financial projections upon which Budget 2014 is built are fairly consistent with our forecasts; the time is right for a slight improvement to the economic outlook. Note that movement by Canadian economic indicators has been somewhat encouraging in the last few months. For example, the annual change in real GDP by industry was 2.6% in November 2013, substantially faster than last June's 1.3%. Most forecasters therefore think that economic conditions will continue to improve somewhat in 2014 and 2015.

That said, the risks that growth will come in below expectations are fairly high. The main assumptions for the next two years call for a stronger contribution from international trade, thanks to improved global demand and faster non-residential investment. Yet, these two factors are slow to take off. Canadian exporters face heavy competition in international markets, thus impacting their confidence levels and, in turn, their investment spending. In contrast, the housing market is sending out clear signs of slowing and Canadian households seem increasingly prudent about taking on debt, reining in potential growth by consumer spending.

The federal government's revenues will also be impacted by the weak inflation we have been seeing for some time. Forecasts for price growth have been downgraded several times in recent months, while 2013 ended with an inflation rate of just 0.9%. Inflation is expected to accelerate to about 1.5% in 2014, but the risks will remain tilted to the downside in coming months, as a number of disinflationary pressures will continue to have an influence. All in all—for both economic growth and inflation—the risks for the

Graph 1 – Total inflation has been fairly soft in recent months



Sources: Statistics Canada and Desjardins, Economic Studies

coming months remain sizable; accordingly, there will be substantial uncertainty about the federal government's financial performance.

HEADING FOR A BALANCED BUDGET IN 2014–2015?

Weaker nominal GDP growth due primarily to slower price growth has had a substantial impact on budgetary revenues, which were $1.3B less in 2013–2014 than projected in last fall's update. The shortfall will be $1.7B in 2014–2015, and $1.6B in 2015–2016; by March 2019, this means a total of $8.4B less in government coffers.

This has not kept the federal government from staying on track for a budget surplus of $6.4B in 2015–2016, $2.7B more than projected in fall 2013. Debt service costs will be a little smaller because interest rates (especially short-term rates) will stay extremely low for an extended period; in addition, the Department of Finance has taken steps to further curb budgetary expenditures. The annual growth by program spending forecast for fiscal 2013–2014 is now

Table 2
Economic and financial forecasts

	2013*			2014f			2015f		
Average annual growth in %	Nov. '13 update	2014 Budget	Desjardins Group	Nov. '13 update	2014 Budget	Desjardins Group	Nov. '13 update	2014 Budget	Desjardins Group
Real GDP	1.7	1.7	1.8	2.4	2.3	2.3	2.6	2.5	2.6
GDP deflator	1.3	1.4	1.5	1.8	1.6	1.7	2.0	2.0	2.0
Nominal GDP	3.0	3.2	3.3	4.2	3.9	4.0	4.6	4.5	4.6
Treasury bills – 3-month	1.0	1.0	1.0	1.1	1.0	1.0	1.8	1.5	1.9
Federal bonds – 10-year	2.3	2.3	2.3	3.1	3.0	3.0	3.5	3.5	3.6
Unemployment rate	7.1	7.1	7.1	6.9	6.8	7.0	6.6	6.6	6.7
Exchange rate (US¢/C$)	97.3	96.8	96.8	96.8	93.7	92.0	97.2	95.3	95.0
U.S. real GDP	1.6	1.7	1.9	2.9	2.7	2.9	3.1	3.1	3.0

f: forecasts; * Forecasts for real GDP, the deflator and nominal GDP.
Sources: Department of Finance of Canada, Statistics Canada and Desjardins, Economic Studies

just 1.9% against the previously projected rise of 2.9%. For 2014–2015, the federal government still projects that program spending will drop slightly, a clear indication of its drive to balance the budget. All in all, a deficit of $16.6B is forecast for 2013–2014, while the deficit anticipated for 2014–2015 is now just $2.9B.

If we assume that the $3.0B negative adjustment to budgetary revenue to account for risk is not used in 2014–2015, the slight budgetary deficit anticipated for this fiscal year could well turn into a surplus, making it possible for the federal government to move its target for balancing the budget ahead one year. However, for that to happen, economic and financial conditions must not deteriorate and the government would have to manage to cut program spending in 2014–2015, an ambitious goal, to say the least.

TIGHTER COST CONTROL

Overall, the new measures announced by the Canadian government today will help save $2.1B in 2014–2015, for a total of nearly $10B over six years. Firstly, increasing the excise duty on tobacco products and eliminating the preferential excise tax that applies to duty-free tobacco products will deliver another $685M in revenue in 2014–2015. The additional revenue will finance much of the new spending to support employment and growth, which totals $730M for that year. A variety of measures were also announced to deal with international aggressive tax avoidance, enhance the system's integrity, improve compliance with the rules, and make the tax system fairer. These measures will have little impact in 2014–2015 ($44M) and will primarily be felt as of 2015–2016, when the revenues stemming from these measures should increase by $389M. Over six years, their total impact is assessed at $1.8B.

The government knows very well that labour costs are one of its biggest operational expenditures. In an environment of austerity and tighter control over the civil service, it is pointless to think that the workforce and working conditions will be spared. Against this backdrop, the government will tackle the upcoming round of collective bargaining in 2014, with the aim of overhauling the disability and sick leave management system to better meet the needs of employees and the government. However, before taking on this thorny issue, it is starting with retired public servants. The government wants a better distribution of the costs of the Public Service Health Care Plan, with pensioners and the government paying equal shares. The government now pays 75% of the cost. Although the agreement remains to be negotiated, it is factored into the budget projections. The revaluation of the liability for future health care expenses will result in savings of $7.4B over six years, including $1.5B in 2014–2015. This is the biggest retrenchment in the government's budget in the next six years, but it is still to be negotiated, meaning that the estimates could be revised. Among the other savings listed in the budget, the government is postponing the $3.1B allocated to National Defence funding for major capital procurement projects from the 2013–2014 to 2016–2017 period to future years.

RESEARCH AND INFRASTRUCTURES

Along with increases to revenue and savings on operating costs, the government has put forward new initiatives and maintained support for existing programs. More funding will go to research and innovation. The Automotive Innovation Fund will get $500M over the next two years to support new strategic research and development projects, as well as provide the sector with long-term investment. Atomic energy gets $117M for the same period to ensure a secure supply of medical isotopes. The budget also calls for the creation of the Canada First Research Excellence fund, to be used to help post-secondary institutions excel internationally in areas that deliver long-term economic advantages in Canada. The fund will receive $1.5B in financing over the next decade, receiving $50M in 2015–2016.

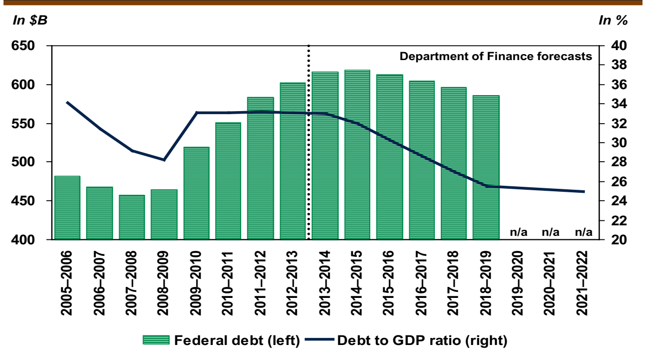
Today's budget did not overlook infrastructures. To foster trade with the United States, the government has earmarked $470M over the next two years for a new international crossing between Windsor and Detroit. Montreal is also benefited, with $165M in funding going to building a new bridge over the St. Lawrence. Moreover, the budget also sets aside $378M for Jacques-Cartier and Champlain Bridges Inc. to repair, run, and ensure the safety of federal bridges and infrastructures pertaining to Montreal. The government's other major expenditures deal primarily with communities and First Nations (drinking and waste water), and training and enhancing the workforce.

The government of Canada remains concerned about the housing market and is thus instituting additional measures to strengthen market discipline in the area of mortgage lending and reduce taxpayer exposure to the housing sector. For example, the Canada Mortgage and Housing Corporation (CMHC) will reduce the total value of its annual issuance of portfolio insurance from $11B to $9B. The government noted that it is keeping a close eye on the housing market and will adjust further, if needed. The federal government also plans to introduce regulatory measures governing virtual currency, such as Bitcoin, in the fight against money laundering and terrorist financing.

THE DEBT SHOULD START TO SHRINK AGAIN

Achieving a budget surplus by March 31, 2016 will allow the federal government's debt load to start decreasing once more. The debt, i.e. the accumulated deficits, had dropped to $457.6B in 2007–2008, or 29.2% of nominal GDP. Subsequently, the financial crisis and Great Recession had prompted the debt to trend up; it should peak at $618.9B as at March 31, 2015. It is then expected to fall slowly, reaching just $586.0B on March 31, 2019, or 25.5% of nominal GDP. According to the Department of Finance's projections, the debt to GDP ratio should drop to 25.0% by March 31, 2022.

Graph 2 – Federal debt should decline shortly



n/a: not available
Sources: Department of Finance Canada and Desjardins, Economic Studies

Federal government borrowings from financial markets should total $648B in 2014–2015, similar to the amount in 2013–2014. Marketable bonds will finance nearly 77% of this amount, with Treasury bills accounting for 20%. Foreign debt and retail debt (including savings bonds) will make up the rest of the borrowing. With the intent of further capitalizing on the current extraordinarily low interest rates, the federal government is contemplating the option of issuing 50-year bonds in 2014–2015 if market conditions are favourable.

CONTROLLED PUBLIC SPENDING

The financial projections tabled today by the Department of Finance show very tight control over program spending, as the results achieved since 2009–2010's record $55.6B deficit attest. In 2013–2014, program spending growth was once again softer than projected; a decline of 0.4% is forecast for 2014–2015. The government has therefore shown its ability to control public spending. What's more, it is not shy about declaring that the collective bargaining to come in 2014 will happen in the same spirit, to make the public service affordable, modern and high-performing. The government is therefore in a good position to balance the budget in 2015–2016 and, given slightly better conditions, perhaps even a fiscal year earlier. It could thus be able to announce tax cuts as of the next budget, as promised.