Budget Analysis

Desjardins Economic Studies
www.desjardins.com/economics

April 21, 2015

2015 CANADIAN BUDGET

A balanced budget ahead of the fall election

HIGHLIGHTS

- The budget is still slated to be balanced in 2015–2016.
- The surpluses forecast for upcoming fiscal years are slightly smaller due to the impact of new initiatives in the fall 2014 update and the 2015 budget, as well as the erosion of economic conditions.
- The contingency fund has been slashed for upcoming periods, making budget projections shakier in the context of numerous substantial economic and financial uncertainties.
- Several new measures were announced in the 2015 budget, with only a slight total financial impact. The budget documents put more of an emphasis on the balance sheet over the last few years.
- Among other things, the 2015 budget announced an increase to the annual TFSA contribution ceiling, as well as a change to the RRIF minimum withdrawal factors.

Table 1
Summary statement of transactions

	Actual	*Projections*					
In $B	2013–2014	2014–2015	2015–2016	2016–2017	2017–2018	2018–2019	2019–2020
Budgetary revenues	**271.7**	**279.3**	**290.3**	**302.4**	**313.3**	**326.1**	**339.6**
- Change (%)	5.9	2.8	3.9	4.2	3.6	4.1	4.1
Program spending	**-248.6**	**-254.6**	**-263.2**	**-274.3**	**-282.7**	**-293.0**	**-302.6**
- Change (%)	1.0	2.4	3.4	4.2	3.1	3.6	3.3
Debt charges	**-28.2**	**-26.7**	**-25.7**	**-26.4**	**-28.0**	**-30.5**	**-32.1**
- Change (%)	-2.3	-5.3	-3.7	2.7	6.1	8.9	5.2
Adjustment based on risk[1]	**0.0**	**0.0**	**-1.0**	**-1.0**	**-1.0**	**-2.0**	**-3.0**
Budgetary balance	**-5.2**	**-2.0**	**1.4**	**1.7**	**2.6**	**2.6**	**4.8**
Federal debt[2]	**611.9**	**616.0**	**617.0**	**615.3**	**612.6**	**610.1**	**605.2**
- Change (%)	0.4	0.7	0.2	-0.3	-0.4	-0.4	-0.8
In % of GDP							
Budgetary revenues	14.3	14.1	14.5	14.4	14.3	14.3	14.3
Program spending	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

[1] Reserve contained in budget revenues; [2] Debt representing the accumulated deficits including other comprehensive income.
Sources: Department of Finance of Canada and Desjardins, Economic Studies

François Dupuis
Vice-President and Chief Economist

Benoit P. Durocher
Senior Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

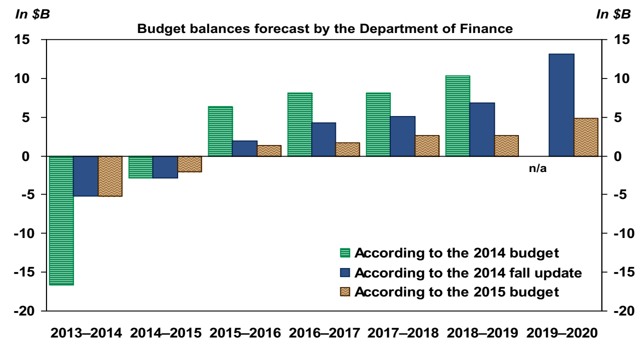
THE BUDGET IS STILL SLATED TO BE BALANCED IN 2015–2016

The federal government's 2015 budget confirms that the books are balanced for fiscal 2015–2016. The forecast deficit for 2014–2015 is now $2.0B, slightly under the $2.9B set out in the fall update. For the 2016–2017 to 2019–2020 fiscal years, the Department of Finance is still projecting budget surpluses, but the amounts have been downgraded. The adjustment is primarily due to the negative impacts of eroding economic conditions. Under the circumstances, the fiscal leeway for introducing new budget measures was fairly limited.

To help it reach its balanced budget target, the Government of Canada also sold some assets. Among other things, the government sold off its last GM shares on April 6, 2015, for a net gain of $2.1B.

In addition to smaller projected budget surpluses in upcoming fiscal years, the Department of Finance also reduced the contingency fund (included with budget revenue) to $1.0B for the 2015–2016 to 2017–2018 fiscal years from the $3.0B contained in prior projections. This makes budget assumptions more vulnerable to economic and financial ups and downs, and gives the Government of Canada less leeway for future action. However, in our opinion, the economic environment is still littered with major risks, both internal and external.

Budget balances have been trimmed



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

That being said, the budget surpluses forecast for upcoming fiscal years will reduce the federal government's debt, which could go from $616.0B on March 31, 2015 to $605.2B on March 31, 2020. The 2015–2016 financing program should therefore include total gross bond issues of $90B (in addition to the $70B in maturing bonds), down $9B from 2014–2015.

The drop in oil prices is hurting the economic outlook

Economic conditions have deteriorated substantially in the last few months. Oil prices dropped significantly between the summer of 2014 and winter 2015, hitting Canada's energy sector especially hard. Although the oil and natural gas industry represents less than 6% of GDP, it accounted for about 30% of total business investment in 2014. The drop in energy prices has triggered a slide by Canadian non-residential investment; the outlook there remains lacklustre. Increasing contagion effects are also being seen in other sectors. For example, the volume of manufacturing sales is down 5.8% since last July, the real estate market is seeing some difficulties in Alberta, and retail sales were off substantially in December and January. Clearly, the effects are not uniform across Canada. Alberta, Newfoundland and Labrador and Saskatchewan will be especially hard hit; their economies could even see a recession in 2015. In contrast, Ontario and, to a lesser extent, Quebec will benefit from the Canadian dollar's depreciation and lively U.S. demand (although the first quarter of 2015 was disappointing in this respect).

In this context, our latest economic scenario calls for Canadian real GDP growth of just 1.9% in 2015. This projection is much lower than it was at the time last year's budget was tabled, when a gain of 2.5% was forecast for 2015. In terms of nominal GDP, the most important variable for budget parameters, the gap is even bigger due to the impact on the deflator of the drop in oil prices. We now expect nominal GDP to rise just 1.5% in 2015, a substantial erosion from the increase of about 4.5% forecast at the time of last year's budget.

However, these major gaps have been incorporated into the 2015 budget, as the economic assumptions used by the government were fairly similar to our forecasts. This also has a big impact on the budgetary balance forecast for the upcoming fiscal years. According to the Department of Finance, the evolution of the economic and budgetary situation since last fall's update has a total impact of -$2.1B on the 2015–2016 balance, -$3.4B for 2016–2017, and -$2.1B for 2017–2018.

Table 2
Economic and financial forecasts

Average annual growth in %	2014			2015f			2016f		
	2014 Budget	2015 Budget	Desjardins Group	2014 Budget	2015 Budget	Desjardins Group	2014 Budget	2015 Budget	Desjardins Group
Real GDP	2.3	2.5	2.5	2.5	2.0	1.9	2.5	2.2	2.1
GDP deflator	1.6	1.8	1.8	2.0	(0.4)	(0.4)	2.0	2.6	2.8
Nominal GDP	3.9	4.4	4.4	4.5	1.6	1.5	4.5	4.9	4.9
Treasury bills – 3-month	1.0	0.9	0.9	1.5	0.6	0.6	1.5	1.0	1.0
Federal bonds – 10-year	3.0	2.2	2.2	3.5	1.7	1.6	3.5	2.5	2.2
Unemployment rate	6.8	6.9	6.9	6.6	6.7	6.8	6.6	6.6	6.6
Exchange rate (US¢/C$)	93.7	90.5	90.5	95.3	79.2	78.2	95.3	80.8	82.3
U.S. real GDP	2.7	2.4	2.4	3.1	3.1	3.0	3.1	2.9	3.0

f: forecasts
Sources: Department of Finance of Canada, Statistics Canada and Desjardins, Economic Studies

RESTRAINED BUDGET MEASURES

The 2015 budget takes stock of all of the measures the federal government has put forward in the last few years. In this context, it may at first be difficult to distinguish between measures that are new 2015 budget initiatives and measures that were announced in the past. All in all, although numerous, the new measures introduced in the budget are fairly restrained, fiscally speaking. All of the new measures announced today yield a net budgetary cost of $1.4B in 2015–2016 and $1.9B in 2016–2017; the amounts are higher for subsequent fiscal periods. Note that the government did not have much leeway given the goal of balancing the budget and the price tag of the various measures announced in last fall's budget update, particularly certain tax credits for families. Here is an overview of the primary new measures contained in the 2015 budget:

- When the TFSA was launched in 2009, the annual contribution ceiling was set at $5,000 per person, and indexed to inflation in $500 increments. The annual TFSA contribution ceiling rose to $5,500 on January 1, 2013 due to indexation. The 2015 budget proposes to raise the annual TFSA contribution ceiling to $10,000. The increase applies as of January 1, 2015, so that a single annual TFSA contribution ceiling will apply to the 2015 and later calendar years. The annual TFSA contribution ceiling will no longer be indexed to inflation. For now, the Department did not think it necessary to set a maximum amount that an individual could amass within a TFSA.
- Before the end of the year in which an RRSP holder turns 71, a Registered Retirement Savings Plan (RRSP) must be converted into a Registered Retirement Income Fund (RRIF) or the savings accumulated in the RRSP must be used to purchase an eligible annuity. RRIF contributions are prohibited and a minimum amount must be withdrawn each year as of the year following the year in which the RRIF is set up (i.e. as of the year in which the RRIF holder turns 72). The 2015 budget proposes a change to the minimum withdrawal factors applicable to plan holders aged 71 to 94, basing the factors on a nominal return rate of 5% and an indexation rate of 2%. These assumptions are more in line with the historic long-term rates of return for a securities portfolio and forecast inflation. The new factors will allow RRIF holders to retain more of their RRIF savings, to provide income when they are older.
- Two percentage point cut to the tax rate on small business, now 11%. The cut will be implemented as follows:
  - The rate will be reduced to 10.5% as of January 1, 2016.
  - The rate will be reduced to 10.0% as of January 1, 2017.
  - The rate will be reduced to 9.5% as of January 1, 2018.
  - The rate will be reduced to 9.0% as of January 1, 2019.
- In 2007, the government instituted an accelerated capital cost allowance to promote investment in machinery and equipment used in manufacturing and processing operations. This measure, which provides a rate of 50% for the deduction for straight line depreciation, expires at the end of 2015. To support ongoing investment in machinery and equipment, and to help boost productivity, the 2015 budget proposes to offer manufacturers a deduction for accelerated 50% straight line depreciation for eligible assets acquired after 2015 and before 2026.
- The 2015 budget proposes to give the Canada Foundation for Innovation an additional $1.33B over six years as of 2017–2018. The investment will strengthen Canada's capability in highly competitive technological research and development by supporting the following: cutting-edge research equipment and facilities, including digital research infrastructure; industry-relevant research infrastructure in colleges through the College-Industry Innovation Fund; ongoing operational and maintenance needs of national research establishments.
- The Finance Department plans to give $750M over two years to major public transit projects as of 2017–2018, followed by $1B per year through a new Fund.

- The 2015 budget proposes taking the annual escalator for the National Defence budget to 3% as of 2017–2018; this would increase that department's budget by $11.8B over 10 years. National Defence will receive a total of $360.3M in 2015–2016 to combat the Islamic State in Iraq and Syria.
- The government has announced that it intends to establish the Development Finance Initiative, with capitalization to reach $300M over the first five years. The initiative, to be run by Export Development Canada, will support effective international development by offering financing, technical assistance, and consulting to private sector businesses so as to facilitate and promote investment in developing nations.

A BALANCE SHEET BEFORE THE NEXT ELECTION

The federal budget tabled today will likely be the last budget before the next election, slated for the fall. The budget documents released today are therefore intended to take stock of the government actions in recent years that could serve as a reference for future discussion. In terms of new items, the 2015 budget contains a plethora of announcements, but, overall, their financial impact is slight for the federal government.

Note that the Department of Finance had very little leeway given the negative impacts of the erosion of economic conditions and the budget impact of last fall's announcements, particularly the announcements concerning tax credits for families. Minister Oliver therefore opted to stay focused on balancing the books. In the 2015 budget, the Government of Canada also confirmed that it plans to introduce balanced budget legislation, whereby the only acceptable deficit would be one that responds to a recession or extraordinary circumstances like a war or natural disaster. Within 30 days of tabling a deficit budget, regardless of the reason, the Finance Minister would have to appear before the House of Commons Standing Committee on Finance and set out a plan featuring a concrete schedule for getting the budget balanced. If the deficit was due to a recession, the plan would include a freeze on operations spending, as well as a freeze on the wages of ministers and deputy ministers, effective as of the start of the recovery.

That being said, numerous significant uncertainties surround the budget projections. Economic and financial conditions remain shaky throughout the world. In Canada, the expected upswing by oil prices could take longer to materialize than anticipated, magnifying the adverse impacts on the economy. Yet, the contingency fund is smaller than it has been historically. The possibility that the budgetary balance will come in below projections in upcoming fiscal years therefore cannot be completely ruled out, especially as the forecast surpluses until 2019–2010 have been lowered. Balancing the books cannot be a goal we can take for granted for these years.