2015 FEDERAL BUDGET

TD Economics

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2015 FEDERAL BUDGET: A BALANCE IN HAND IS WORTH TWO IN THE BUSH

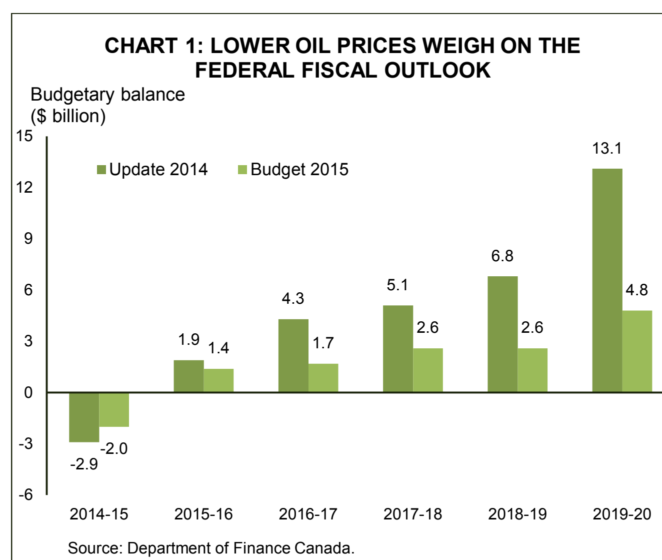
Highlights

- Oil prices have dominated the headlines throughout the 2015 budget season. And with national income growth expected to be soft in the near term, the coffers of federal government were not able to escape without a few scratches.
- Despite this setback, the federal government appears poised to balance the budget in each year of the projection, partly through a combination of one-time revenue raising measures, a lower set-aside for contingencies, and ongoing spending restraint. That said, the Feds also found room to provide some extra goodies in the form of tax cuts and new spending.
- Looking to revenues, some of the eye-catching tax breaks introduced in Budget 2015 are the increase of the TFSA contribution limit to $10,000 annually, a reduction in the minimum withdrawal rate for Registered Retirement Income Funds, and a reduction in the small business tax rate to 9%.
- The outlook for expenditures is more mixed, with new measures including additional spending on veterans' benefits and more money for defense and public safety. On the other hand, spending on public services disability and sick leave benefits are expected to generate additional savings.
- In light of the outlook for modest surpluses, the federal debt-to-GDP ratio is projected to decline to 25.5% by the end of the 5-year projection. This would put the government on track to meet its 25% debt-to-GDP target by 2021.

Oil prices have continued to dominate the economic and fiscal narrative as we find ourselves knee-deep in budget season. Unlike the big oil-producing provinces, federal government revenues are not directly tied to the fortunes of oil. However, with national income growth expected to be soft in the near term, its coffers have not escaped without a few scratches. This can largely be attributed to a decline in revenues, most specifically corporate income tax revenues, as low for long oil prices weigh on corporate profits.

Despite this setback, the federal government appears headed for a balanced budget in fiscal 2015-16, albeit a smaller one than was expected at the time of the Fall Update (Chart 1). Indeed, partly through a combination of asset sales, a lower set-aside for contingencies, and spending restraint, the federal government has managed to eke out a modest surplus while even providing some extra goodies for Canadians.

Beyond fiscal 2015-16, the federal government expects surpluses as far as the eye can see. However, these are much reduced from the levels expected in Update 2014. Indeed, from fiscal 2015-16 through 2019-20, the cumulative surplus is expected to



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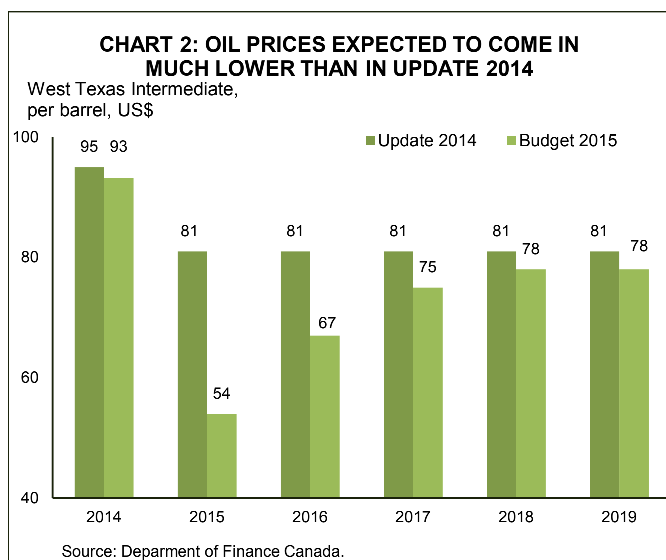

be $13.1 billion, down from $31.2 billion at the time of the Update. Nonetheless, the government fully expects to reach its debt-to-GDP target of 25% by 2021.

Economic developments since Update 2014

Much has changed on the economic front since the release of Update 2014. On November 12th, the day Update 2014 was published, West Texas Intermediate (WTI) closed at US$77 per barrel and the Canadian dollar was sitting at 88 US cents. Today, WTI is trading for roughly US$55 per barrel. Consequently, the government has lowered its expectation for the per barrel price of WTI from US$81 for 2015 and beyond in the Update to US$54 in 2015 and US$67 in 2016, after which it is forecast to begin rising more gradually (Chart 2).

As a result of softer oil prices, the Feds are now expecting that real GDP growth will be 2.0% in 2015, marked down from the 2.6% growth forecast in Update 2014 (Table 1). Most importantly to the fiscal outlook, nominal GDP – the broadest measure of the tax base – is projected to advance by a more modest 1.6% in 2015, about one-third of the 4.3% assumed in the Update. As oil prices are likely to rebound in 2016, the prospects for the economy are expected to rise along with them. Indeed, the government anticipates nominal GDP to advance by nearly 5% in 2016, and to gradually decelerate thereafter.

Another important consideration on the economic front are the lower interest rate projections, which are in part a reflection of the Bank of Canada's surprise interest rate announcement in January 2015. Indeed, the outlook for interest rates has been revised down dramatically across the yield curve, which is expected to contribute to lower public debt charges over the outlook.

Oil prices pull down revenues but tax relief is still in the cards

Partly owing to the sharp decline in oil prices observed since mid-2014, budgetary revenues are expected to be lower over the outlook than was forecast at the time of the Update (Table 2).

This is despite a better-than-expected starting point in fiscal 2014-15, where higher Other Revenues due to the transfer to Ontario of one-third of the Fed's holdings of shares of GM boosted the overall take by $0.6 billion. This helped to offset the broader weakness in revenues that can be chalked up to lower oil prices.

It is fiscal 2015-16 where the negative impact of lower oil prices is really going to be felt. Specifically, the oil price shock is showing up more dramatically in the government's outlook for corporate income tax (CIT) revenues, which have been marked down to $36.8 billion in fiscal 2015-16 from $40.4 billion. However, the government has taken steps to mitigate the income hit and ensure that they meet their commitment to reach budgetary balance in 2015. Most importantly, the federal government sold its remaining shares of GM shares on April 6, booking proceeds of $1.0 billion (see Box 1 for more information on the proceeds from the sale of GM shares).

Table 1: Economic Assumptions for Canada
Annual, percent change (unless otherwise specified)

Calendar Year	2014	2015	2016	2017	2018	2019
Real GDP						
November 2014 Update	2.5	2.6	2.4	2.3	2.2	2.1
April 2015 Budget	2.5	2.0	2.2	2.3	2.2	2.0
Nominal GDP						
November 2014 Update	4.5	4.3	4.4	4.4	4.2	4.1
April 2015 Budget	4.4	1.6	4.9	4.7	4.3	4.2
Nominal GDP ($ billion)						
November 2014 Update	1,978	2,063	2,155	2,251	2,347	2,444
April 2015 Budget	1,976	2,008	2,106	2,204	2,299	2,396
3-Month T-Bill Rate						
November 2014 Update	0.9	1.2	2.1	2.9	3.4	3.6
April 2015 Budget	0.9	0.6	1.0	2.0	2.7	3.0
10-Year Gov't Bond Yield						
November 2014 Update	2.3	3.0	3.6	4.1	4.3	4.4
April 2015 Budget	2.2	1.7	2.5	3.2	3.7	3.9

Sources: Department of Finance Canada, Statistics Canada, Bank of Canada.

Box 1: Background on proceeds from the sale of GM shares

On April 6, 2015, the Government of Canada sold its remaining 73.4 million General Motors common shares. The closing price on the day of the sale was US$35.61, equivalent to roughly $44.70 Canadian dollars, for an estimated market value of $3.3 billion (US$2.6 billion). However, $1.1 billion is subtracted for the book value of the GM shares previously on the federal government's books. Further, as the federal government had already booked $1.2 billion in unrealized asset sales in 2015-16, revenues from the sale of these shares by this amount is also reduced by this amount. All told, a gain on the sale of the remaining GM common shares of $1.0 billion was included in the projection for revenues in fiscal 2015-16.

Also boosting prospects for fiscal 2015-16, and much of the remainder of the projection, is the lower set-aside for contingencies relative to Update 2014 (Table 3). Indeed, over the next five years, the set-aside for contingencies is expected to add up to a cumulative $8 billion as opposed to the $15 billion dollars included in the Update.

Over the remainder of the forecast, revenues are expected to ramp-up, although remain below the projection in Update 2014. This is almost entirely the result of lower projected CIT revenues, thanks in large part to the government's prudent oil price forecast. Indeed, by fiscal 2019-20, CIT revenues are expected to be $5.7 billion lower than was forecast in the Update.

However, the federal government did find room to introduce some new tax goodies. For instance, the federal government is proposing to (cumulative fiscal impact through fiscal 2019-20 in parentheses):

- Increase the Tax-Free Savings Account annual contribution limit to $10,000, effective for 2015 and subsequent years ($1.1 billion in foregone revenues);
- Reduce the minimum withdrawal factors for Registered Retirement Income Funds ($0.7 billion);
- Reduce the small business tax rate to 9% from 11% by 2019 ($2.7 billion); and
- Accelerate Capital Cost Allowance for manufacturers ($1.1 billion).

Table 2: April 2015 Federal Fiscal Forecast Summary (C$ billion, unless otherwise specified)						
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Budgetary Revenues	**279.3**	**290.3**	**302.4**	**313.3**	**326.1**	**339.6**
Program Expenses	254.6	263.2	274.3	282.7	293.0	302.6
Public Debt Charges	26.7	25.7	26.4	28.0	30.5	32.1
Total Expenses	**281.3**	**288.9**	**300.7**	**310.7**	**323.5**	**334.7**
Budgetary Balance	**-2.0**	**1.4**	**1.7**	**2.6**	**2.6**	**4.8**
Federal Debt	616.0	617.0	615.3	612.6	610.1	605.2
Per cent of GDP						
Budgetary Revenues	14.1	14.5	14.4	14.3	14.3	14.3
Program Expenses	12.9	13.2	13.1	12.9	12.8	12.7
Public Debt Charges	1.4	1.3	1.3	1.3	1.3	1.4
Budgetary Balance	-0.1	0.1	0.1	0.1	0.1	0.2
Federal Debt	31.1	30.8	29.3	27.9	26.7	25.5

Source: Department of Finance Canada.

Despite lower revenues, the federal government still finds room for some new spending

Overall, the Feds are expecting expenses to come in broadly in line with their expectation in Update 2014. However, there is more happening under the surface than the headline numbers would suggest.

First, the federal government introduced new measures through enhancing benefits for veterans, $1.6 billion of which will be booked in fiscal 2014-15, for a cumulative total of $2.7 billion by fiscal 2019-20. Additionally, the government has announced it will be investing $750 million over two years starting in 2017-18, and $1 billion per year thereafter, in a new Public Transit Fund. This equates to new spending on infrastructures totalling a cumulative total of $1.75 billion through fiscal 2019-20. The government also plans to spend an additional $1.5 billion through fiscal 2019-20 on National Defense funding and $0.4 billion on enhancing national security. Finally, many Canadians will be pleased to see the extension of compassionate care benefits, which is forecast to total $0.2 billion through 2019-20.

That said, with what one hand giveth, the other taketh away. Specifically, in working to ensure a healthier and more productive public service, the expenditure outlook includes cumulative savings of $1.5 billion through the modernization of the disability and sick leave management system. These savings are based on the federal government's latest

Table 3: Set-aside for contingencies (C$ billion, unless otherwise specificed)						
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Update 2014	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**
Budget 2015		**1.0**	**1.0**	**1.0**	**2.0**	**3.0**

Source: Department of Finance Canada.

proposal to federal public service bargaining units, with 60% of the savings being booked in fiscal 2015-16.

Balanced budgets lead to lower debt

Beginning in fiscal 2015-16, the federal government expects that it will post budgetary surplus every fiscal year, thereby meeting the terms of its soon-to-be-introduced balanced budget legislation. That said, this legislation will give the government sufficient wiggle room to run a deficit during a recession or an extraordinary circumstance.

As a result of the surpluses forecast over the projection, the debt-to-GDP ratio is expected to fall from a recent peak of 33.0% in fiscal 2012-13 to 25.5% in fiscal 2019-20. This is well within sight of the government's 25% debt-to-GDP by 2021 target it set for itself in 2012; thus reinforcing Canada's position as having one of the lowest debt-to-GDP ratio among the G-7 nations.

Bottom line

The federal government has done it. They have met their promised target of reaching budgetary balance in 2015. This is despite being hit with a sharp, downward revision to revenues resulting from the collapse in oil prices since mid-2014. Cobbling together revenue from various sources, combined with a modernization of the public service disability and sick leave management system, the government managed to deliver some moderate new spending measures and tax relief while positioning itself to meet its long-term debt target too.

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