Fall 2018 Federal Fiscal and Economic Update

Competition in the Crosshairs

Brian DePratto, Senior Economist | 416-944-5069

November 21, 2018

Late today, Federal Finance Minister Bill Morneau delivered the government's annual fall update to its fiscal and economic outlook. In his discussions with business leaders earlier this fall, competitiveness issues were reportedly front and centre, and it appears that Minister Morneau has taken these concerns to heart. The update includes immediate expensing of equipment costs for a number of industries, through 2027. Government calculations suggest that this will lower the average overall tax rate on new business investment from 17% to about 14%. Other measures announced today include incentives for the media, notably news organizations, and plans to further increase exports via initiatives across a number of departments.

All these measures come with a price tag. Roughly $16 billion in net new spending is envisioned, with tax changes making up the bulk. Helping pay for these is a better-than-expected economic backdrop that generates a fiscal windfall (Table 1). Real GDP for 2019 has been upgraded to 2.0%, with a slowing envisioned thereafter. This narrows the deficit by roughly $4 billion per year through fiscal 2023/24, all else equal, and provides the starting point for today's announcements. Even with new spending measures added in, the result is a slightly lower deficit for this fiscal year than initially envisioned, of $18.1 billion (Budget 2018: $18.8 billion), and only modestly wider deficits thereafter. While deficits may be a hair higher, they are still expected to bend lower as time passes, alongside the debt-to-GDP ratio (Table 2).

Investment environment front and centre

This update was all about the investment environment, at least from a spending perspective. Of the $16 billion fiscal impact through 2023/24, more than $14 billion can be attributed to tax changes. The government's response to U.S. tax changes took the form of two major initiatives. The first allows firms to write off 100% of the cost of manufacturing equipment, clean energy equipment, and software. The allowance for spending on computers has also been increased significantly. The second part is broader, effectively tripling the speed at which businesses can write off capital costs not covered in the first change.

These changes will enter into immediate effect, and be in full effect through 2024, then entering a phase-out period before returning to previous levels by the end of 2027. A change of this magnitude entails significant costs. The net impact on fiscal 2019/2020 is to increase the budget deficit by roughly $5bn. This impact fades through time, leaving the average impact over the next five fiscal years at roughly $2.8 billion per year. While sizeable, this is less than the $3.5 billion the Office of the Parliamentary Budget Officer estimates that just a 2 percentage point cut to the corporate tax rate would have cost per year.

Beneath the headlines, tweaks around the edges

Changes to the tax code are likely to draw the most attention today, but a grab bag of small changes and spending measures were also on offer. The government will look to reduce barriers to interprovincial trade, and also committed to increasing Canada's overseas exports 50% by 2025, a task that will likely be made easier by the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) trade agreement that comes into effect at the end of this year.

Bottom Line

It took a bit longer than might have been expected, but these measures should help address the competitiveness challenge by incentivizing further investment. Indeed, the government's actions align closely with what we had counseled ahead of today's update. Temporary, targeted tax measures like those introduced today have the advantage of encouraging new investment at a relatively small fiscal cost, particularly when compared with more broad-based tax cuts. While difficult to assess immediately, we expect these changes should be at least marginally positive for business investment in Canada going forward. While it is not encouraging that the government seems to have made a habit of spending most (or in today's case, all) of its fiscal windfalls, today's response to competitiveness challenges is a welcome use of funds.

Table 1: Economic Assumptions
Annual, Per Cent Change (Unless Otherwise Indicated)

Calendar Year	2018	2019	2020	2021	2022
Real GDP					
Budget 2018	2.1	1.6	1.7	1.6	1.8
November 2018 Update	**2.0**	**2.0**	**1.6**	**1.6**	**1.9**
TD Economics Nov 2018	2.1	2.1	1.8	1.7	1.7
Nominal GDP					
Budget 2018	4.1	3.5	3.8	3.6	3.8
November 2018 Update	**4.2**	**4.1**	**3.3**	**3.7**	**4.0**
TD Economics Nov 2018	4.2	4.3	3.8	3.7	3.7
Unemployment Rate (%)					
Budget 2018	6.0	6.0	6.1	6.0	6.0
November 2018 Update	**5.9**	**5.8**	**6.0**	**6.1**	**6.0**
TD Economics Nov 2018	5.9	5.9	5.9	5.9	5.9
3-Month T-Bill Rate					
Budget 2018	1.4	2.0	2.3	2.5	2.5
November 2018 Update	**1.4**	**2.1**	**2.4**	**2.4**	**2.4**
TD Economics Nov 2018	1.4	2.2	2.5	2.5	2.5
10-Year Gov't Bond Yield					
Budget 2018	2.3	2.8	3.1	3.2	3.3
November 2018 Update	**2.3**	**2.8**	**3.0**	**3.1**	**3.2**
TD Economics Nov 2018	2.3	2.7	2.8	2.9	2.9

Source: Department of Finance Canada, Statistics Canada, Bank of Canada, TD Economics

Table 2: November 2018 Federal Fiscal Update Forecast Summary (C$ Billion, Unless Otherwise Specificed)						
	2018-19	**2019-20**	**2020-21**	**2021-22**	**2022-23**	**2023-24**
Budgetary Revenues	**328.9**	**339.2**	**352.1**	**367.9**	**382.1**	**396.7**
Program Expenses	320.2	328.3	337.3	348.2	359.0	370.8
Public Debt Charges	23.8	27.5	29.9	31.8	32.7	34.3
Total Expenses	344.1	355.8	367.2	380.0	391.7	405.1
Budget Balance	**-18.1**	**-19.6**	**-18.1**	**-15.1**	**-12.6**	**-11.4**
Federal Debt	687.7	707.3	725.5	740.6	753.2	764.7
Per Cent of GDP						
Budgetary Revenues	14.8	14.6	14.7	14.8	14.8	14.8
Program Expenses	14.4	14.2	14.1	14.0	13.9	13.8
Public Debt Charges	1.1	1.2	1.2	1.3	1.3	1.3
Budget Balance	-0.8	-0.8	-0.8	-0.6	-0.5	-0.4
Federal Debt	30.9	30.5	30.3	29.8	29.2	28.5

Source: Department of Finance Canada, TD Economics. Budget Balances Include $3bn Risk Adjustment.