Canada's Upcoming 2019–20 Federal Budget … To Spend or Not to Spend?

- **The Government is on track to achieve a substantially lower deficit than predicted in the Fall Economic Statement owing to spectacular revenue growth. A fiscal windfall of roughly $10b is expected in the current fiscal year, falling to roughly $7b in 2019/20.**

- **Improvements in the budgetary balance will be less than implied by this windfall owing to weaker growth and our assumption that much of it will be spent ahead of the Federal election.**

The 2018/19 deficit is on track be less than half the $18.1b forecast in the Fall Economic Update, if expenditure growth doesn't accelerate through the end of March. The much improved budgetary situation comes on the back of significantly stronger-than-expected federal revenue growth. Expenditure growth is thus far only modestly outpacing that planned in the Fall Economic Statement. If the current pace for revenue and expenditure growth is maintained for the remainder of this fiscal year, the deficit for 2018/19 should be much smaller than forecast in the fall. While we can expect some drag on revenues and expenditures from the slowdown in growth late last year to materialize in next year's numbers, the deficit should still show a substantial improvement in 2019/20, trimming about a third off the $19.6b forecast from the Fall Update (table 1).

Budget 2019 will paint a cautiously optimistic view on the economic outlook. While real GDP for 2019 will take a hit following a soft fourth quarter—coming in around 1.6%[1] from an expected 2%—the underlying factors will be painted as transitory due to the impact of oil curtailment in Alberta and a delay in business investment pick-up. There are plenty of reasons that warrant optimism: stronger US growth, dissipating trade uncertainty, robust job creation, an oil price rebound, decent business sentiment, stabilizing housing markets, and more generally accommodative government policies.

Table 1

Federal Deficit Projections
$ billions, with risk adjustment

	FY19	FY20
Fall Update 2018 budgetary balance	**-18.1**	**-19.6**
Total budgetary revenues	**340.9**	**351.6**
*Revised growth rate y-o-y, % **	*8.7*	*3.1*
Total expenses	**345.6**	**357.3**
Plus risk adjustment	3.0	3.0
*Projected growth rate y-o-y, % **	*3.9*	*3.4*
Preliminary budgetary balance	***-7.7***	***-8.8***
Impact of real GDP shock		-1.8
Impact of GDP deflator shock		-1.7
Projected budgetary balance	**-7.7**	**-12.2**

**Ytd growth rates assumed for FY19, shock deflators applied to FY20 (from Budget 2018)*

Source: Finance Canada, Scotiabank Economics.

[1] Scotiabank's forecast for calendar year 2019 is 1.5%.

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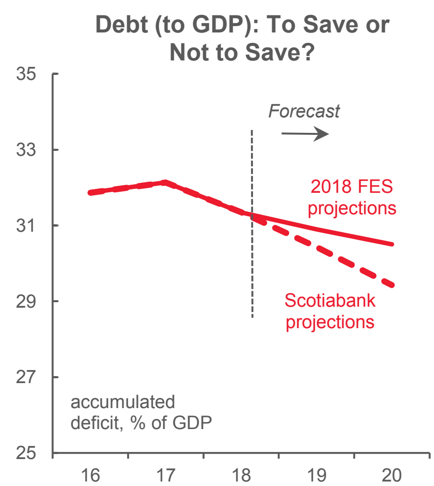
Chart 1



Sources: Scotiabank Economics, Finance Canada.

However, caution is the operative word. The government will no doubt stress the downside risks to its outlook as the economy works through what we still consider to be a temporary soft patch early this year. With the economy now operating below its potential, the government will use this backdrop to make the case for the continuation of a supportive policy environment.

Strong budgetary performance in 2018/19 will provide room to manoeuvre. Numbers at the end of the fiscal third quarter (December 2018) show the balance in modest surplus, whereas it was close to $9b in deficit at the same time last year. It is a revenue-side story: despite slowing growth, tight labour markets have supported robust growth in personal income taxes and EI premiums, while corporate income tax revenues have also jumped.

We expect the government will spend part of this windfall while protecting the bottom line. The current political challenges facing the Trudeau government make it more likely in our view that the Government will use the budgetary windfall to increase their odds of re-election. While there will be room to do this and still meet, or come in below, the deficit predicted for 2019/20 in the Fall Economic Statement, it remains important for the Government to continue to gradually reduce the debt-to-GDP ratio.

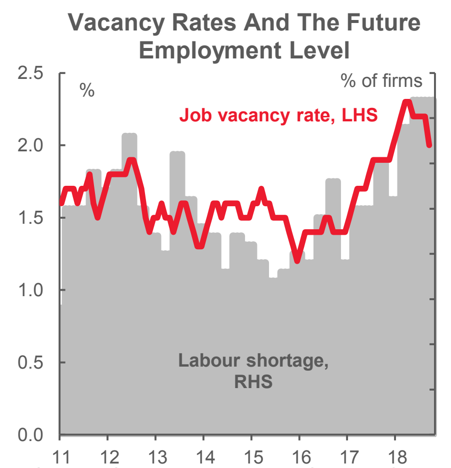
What should the government do with the fiscal windfall?

- **Our preference would be to bank the higher than expected revenue so that the Government is in better fiscal shape to deal with the next downturn. We do not think this is likely.**
- If the Government is to introduce policy measures to take advantage of this budget space, **we think policy action should focus on key economic obstacles to a sustained expansion.** The job vacancy rate is near record levels and firms consistently note availability of labour as the key challenge they face. Part of this reflects a skills mismatch between those looking for work and the available jobs, but part of this also reflects the strength of the economy which is compounded by a significantly lower participation rate of women in the economy than observed for men. From the household perspective, a key challenge is housing affordability.
- **It is possible to hit two birds with one stone.** Measures to increase the affordability of child care, such as an increase in the Canada Child Benefit or an increase in the deduction limit for child care expenses, would increase female participation in the labour market, possibly dramatically. In Quebec, where childcare is heavily subsidized, male and female participation rates are nearly identical. Moreover, more affordable child care will effectively raise disposable income, and in so doing increase housing affordability, particularly if it incents more women to work.
- We have no reason to believe the Government is considering such action, but this would provide a timely boost to household finances if it were to occur before the election.

What will the Government do?

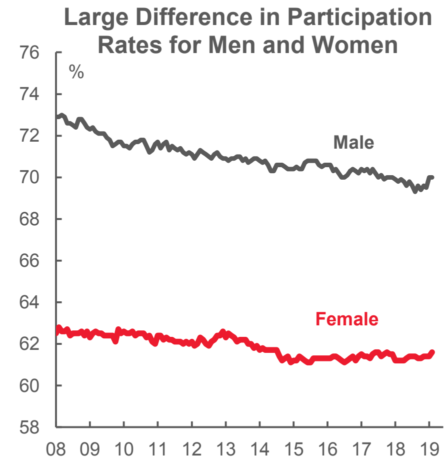
- **The Government is more likely to tinker with programs seeking to better match skills to opportunities**, as previous governments have done repeatedly.

Chart 2



Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

- **On housing affordability, Minister Morneau has clearly indicated that the Government will put forward measures to improve affordability.** Speculation revolves around increasing the generosity of the Home Buyers Plan, or extending maximum amortizations, possibly only for first time homebuyers. These measures, designed to boost demand, will do nothing to increase the supply of housing, which is the ultimate reason for still-high house prices in various cities. In fact, they may make the problem worse, as the impact of measures to raise demand get capitalized in the price of homes. In the absence of measures to boost supply (such as tax incentives for purpose built rentals), which are largely in the wheelhouse of municipal and provincial governments, housing affordability is unlikely to be affected over a longer period.

- Of course, a key challenge in Canada remains lack of egress capacity for western Canadian oil. We do not anticipate any major developments in pipeline progress in the Budget, but the Government will want to be seen to be doing something on this file. This could take the form of financial assistance to Alberta as it purchases rail cars to move oil to market.