

Canada's Federal Fiscal 2018–19 Fall Statement

- The Fall Statement is clearly focused on raising Canadian competitiveness, though spending increases in a number of other areas result in a widening deficit relative to Budget 2018 through the fiscal planning horizon as spending outpaces the revenue windfall associated with stronger than expected revenue growth (chart 1).
- The key policy announcement is a move to accelerate the pace at which businesses can depreciate capital investments. We strongly support these measures, even though they are costly. Supports for Canadian competitiveness and investment accounted for the bulk of the new policy measures announced.
- Policy actions in this Statement result in a large increase in the deficit relative to Budget 2018, though the debt-to-GDP ratio continues to fall throughout to planning horizon.
- The Canadian dollar is little affected in the post-update aftermath thus far, though at the margin the stimulus announced in this update should be constructive toward our expectations for Bank of Canada rate hikes over 2019.

ECONOMIC OUTLOOK

The Government's economic outlook is improved versus the *Budget* forecast. Real GDP in 2019 is now projected to advance 2%—a marked improvement versus the 1.6% assumed in Budget—while nominal GDP growth was revised 60 basis points higher. This mirrors upward revisions to private sector forecasts that include economic data surprising on the upside since February, as well as expectations that the recent USMCA signing will remove the dampening effects of uncertainty on business investment after uncertainty related to NAFTA negotiations weighed on Canadian growth for close to two years. The economic expansions expected in 2018 and in the outer years are largely in line with Budget forecasts.

Key risks to the outlook included an extended blowout of the light-heavy oil price discount, slower-than-expected growth in the US that spills into financial markets as a result of excessive fiscal stimulus, and the global rise of protectionism. The Government also cited easing concerns related to housing market overheating given signs of cooling in Toronto and Vancouver.

NEW POLICY MEASURES

As foreshadowed in previous months, the signature measure of this Statement is altering taxation rules for machinery and equipment (M&E) outlays to counter US tax reform implemented in January. Full expensing will apply to eligible assets acquired after November 20, 2018, M&E used in Canada for the manufacturing and processing of goods, with a gradual phase-out beginning in 2024. For eligible clean energy equipment investment, the same rules will apply on the same timeline.

The new *Accelerated Investment Incentive*, in force for tangible and intangible capital assets, complements these measures. It triples the existing first year

CONTACTS

Marc Desormeaux, Provincial Economist
416.866.4733
Scotiabank Economics
marc.desormeaux@scotiabank.com

Chart 1

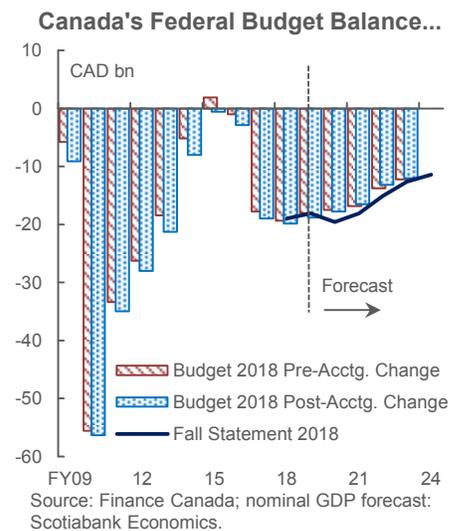
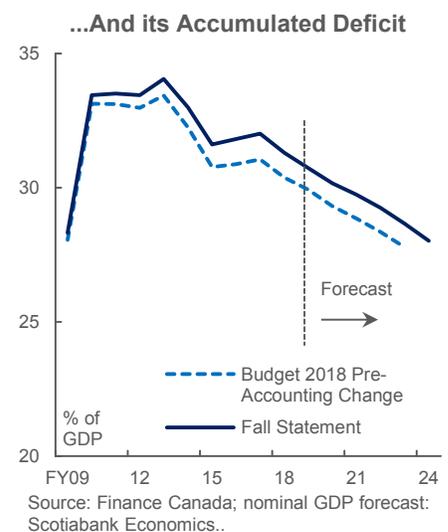


Chart 2



deduction rate for eligible capital investments, and is estimated to lower Canada's overall marginal effective tax rate on new investment from 17% to just 13.8%. Alongside these measures, the 15% Mineral Exploration Tax Credit, which had been scheduled to expire on March 31 2019, was extended until March 31, 2024.

Export diversification forms another pillar of the government's strategy to support business, with emphasis on increasing exports to the Asia-Pacific region and Europe plus development of new markets in services, digital products, health and technology and e-commerce. Key to this objective is the *Export Diversification Strategy* aiming to increase Canada's overseas exports by 50% by 2025, which will invest \$1.1 bn over the next six years starting in FY19. The establishment of the *National Trade Corridors Fund*, providing targeted infrastructure investments for marine ports and the busiest rail and highway corridors via \$773.9 mn over the next five years forms another plank of the Strategy. Additional support of \$184 mn will be provided over the same period to enhance the Canadian trade commissioner service. Alongside these announcements, the Government reaffirmed its commitment to reducing internal trade barriers, citing the steps made via signing of the Canadian Free Trade Agreement.

To attract high-quality and innovative business investment, the Government has allocated an additional \$800 mn for the *Strategic Innovation Fund*. Some \$100 mn of this funding earmarked to support the forest sector, with \$250 mn sourced from countermeasures to the US steel and aluminum tariffs.

A focus on reducing red tape was another element of the updated plan. The Government will review existing legislation with a view towards aligning regulators' mandates with efficiency and economic growth, and introduce a bill requiring annual reviews of existing federal regulations to remove outdated rules and duplication. It further cited progress on the first round of targeted regulatory reviews in high-growth sectors such as agri-food & aquaculture, health/bio-sciences and transportation & infrastructure.

With respect to carbon pricing, the Government reiterated previously announced details on its plan, namely that all proceeds from charges will be returned to the regions from which they originated. It continues to explore approaches for returning proceeds to provinces whose pricing models do not meet the federal standards.

FISCAL OUTLOOK

The stronger profile for income tax receipts that stems in part from a higher-than-previously-anticipated economic growth forecast is expected to improve the bottom line by nearly \$9bn over FY19-20. Increases in direct program expenses attributable to the prior changes in discount methodology eroded some of these gains. Recall that in October, the government lowered the discount rates used to value unfunded pension liabilities to align with industry practice, resulting in higher program expenses and wider deficits from FY09-17. The new methodology pushes program spending \$4.3 bn higher than the Budget projection over FY19-20, with more modest effects in later years.

Changes to capital expenditure taxation are expected to reduce the government's bottom line by nearly \$5 bn in FY20 alone. A further \$3.9 bn in foregone revenues is forecast for FY21 with another \$5.1 bn hit to the government's bottom line anticipated over FY22-24. This contributes to widening deficit versus Budget from FY20-23.

Debt estimates reflect changes to the budget balance outlook. Net debt and accumulated deficit figures for FY19 are higher than *Budget* estimates in every year of the forecast period. The Government continues to tout its favourable fiscal position relative international peers, as well as target a reducing debt-to-GDP ratio, rather than a balanced budget. It foresees a gradual decline in accumulated deficit-to-nominal GDP ratio from over 30% in FY19 to a number approaching 28% in FY24 (chart 2, p.1).

CONCLUSION

The spirit of the measures in today's Statement is appropriate in our view but we will monitor any further details as they are released. Efforts to boost Canadian business competitiveness are worthwhile as economic growth rotates towards exports and investment, and the recent US tax reform eroded Canada's longstanding advantage with respect to business taxation. Yet the new measures come at a significant cost and the evidence is somewhat unclear as to how past business tax rates influenced Canadian investment patterns and productivity.

It is clear, however, that we are entering the advanced stage of the economic cycle, and downside risks are becoming more prevalent. Our preference would have been for the government to be more cautious in raising expenditures, though

we fully support its measures to boost competitiveness. While growth was revised upward from *Budget* estimates and Canada looks to have forestalled NAFTA-related downside, we are increasingly likely to experience a material economic slowdown at some point during the forecast period. With costly promises such as pharmacare on the horizon and the potential for further pre-election stimulus, the balance of risks leans towards greater deficits and debt levels than those currently projected. Should a downturn occur, these factors will constrain the government's ability to offer the necessary fiscal support, regardless of the chosen fiscal anchor.

Economic Forecast Assumptions annual % change except where noted					Fiscal Summary \$ billion except where noted				
	<u>18f</u>	<u>19f</u>	<u>20f</u>	Average <u>21-23f</u>		FY18	FY19	FY20	FY24
						<u>Final</u>	<u>Rev.</u>	<u>Rev.</u>	<u>Fcst.</u>
CANADA - Real GDP									
Finance: 2018 Budget*	2.1	1.6	1.7	n.a	Personal Income Tax (PIT)	153.6	161.9	170.2	188.1
2018 Fall Statement	2.0	2.0	1.6	1.8	Corporate Income Tax (CIT)	47.8	49.5	45.7	50.4
Scotiabank Oct.15, 2018	2.1	2.2	1.8	n.a	Other Tax Revenue	61.7	65.7	66.7	70.1
GDP Deflator					Total Tax Revenue	263.1	277.1	282.6	309.5
Finance: 2018 Budget*	2.0	1.9	2.0	n.a.	Employ. Insurance (EI) Premiums	21.1	22.0	22.4	24.5
2018 Fall Statement	2.2	2.1	1.7	2.0	Other Revenue	29.4	29.8	31.9	35.9
Scotiabank Oct.15, 2018	2.2	2.4	2.2	n.a.	Total Revenue	313.6	328.9	339.2	374.7
Nominal GDP					Elderly Benefits	50.6	53.4	56.5	65.1
Finance: 2018 Budget*	4.1	3.5	3.8	n.a	Employ. Insurance (EI) Benefits	19.7	20.1	21.3	23.8
2018 Fall Statement	4.2	4.1	3.3	3.9	Children's Benefits	23.4	23.9	24.2	25.4
Scotiabank Oct.15, 2018	4.3	4.6	4.1	n.a	Major Transfers to Persons	93.8	97.5	102.0	114.3
Unemployment Rate, %					Transfers to Other Levels of Gov't	70.5	73.8	76.7	83.9
Finance: 2018 Budget*	6.0	6.0	6.1	n.a	Direct Program Spending	146.4	149.0	149.6	155.7
2018 Fall Statement	5.9	5.8	6.0	6.0	Total Program Spending	310.7	320.2	328.3	353.8
Scotiabank Oct.15, 2018	5.9	5.8	5.8	n.a	Debt Service	21.9	23.8	27.5	32.2
T-Bills**, 3-month, %					Total Expenditure	332.6	344.1	355.8	386.0
Finance: 2018 Budget*	1.4	2.0	2.3	n.a	Adjustment for Risk	0.0	3.0	3.0	3.0
2018 Fall Statement	1.4	2.1	2.4	2.5	Budget Balance	-19.0	-18.2	-19.6	-14.3
Scotiabank Oct.15, 2018	1.5	2.4	3.0	n.a	Accumulated Deficit	671.3	687.7	707.3	746.0
Bonds**, 10-year, %					Annual Change, %				
Finance: 2018 Budget*	2.3	2.8	3.1	n.a	Personal Income Tax (PIT)	6.9	5.4	5.1	4.1
2018 Fall Statement	2.3	2.8	3.0	3.2	Corporate Income Tax (CIT)	13.2	3.5	-7.7	3.9
Scotiabank Oct.15, 2018	2.4	2.8	3.2	n.a	Total Tax Revenue	7.7	5.3	2.0	3.7
Canadian Dollar**, US\$/C\$					EI Premiums	-4.5	4.1	1.8	3.7
Finance: 2018 Budget*	79.0	79.6	80.3	n.a	Total Revenue	6.9	4.9	3.1	4.0
2018 Fall Statement	77.6	78.4	78.7	80.3	Elderly Benefits	5.2	5.4	5.8	5.7
Scotiabank Oct.15, 2018	77.9	81.0	82.0	n.a	Employ. Insurance (EI) Benefits	-4.8	2.0	6.0	3.9
U.S. - Real GDP					Children's Benefits	6.2	2.0	1.3	1.9
Finance: 2018 Budget*	2.4	1.9	1.9	n.a	Major Transfers to Persons	3.1	4.0	4.6	4.5
2018 Fall Statement	2.8	2.5	1.8	1.9	Transfers to Other Levels of Gov't	2.7	4.7	3.9	3.5
Scotiabank Oct.15, 2018	2.9	2.4	1.7	n.a	Direct Program Spending	11.2	1.8	0.4	1.9
WTI Oil, US\$/barrel					Total Program Spending	6.7	3.1	2.5	3.1
Finance: 2018 Budget*	56	57	57	n.a	Total Expenditure	6.4	3.5	3.4	3.3
2018 Fall Statement	67	68	65	68	Memo Items, %				
Scotiabank Oct.15, 2018	68	72	69	n.a	Tax Revenue / GDP	12.3	12.4	12.1	12.0
					Total Revenue / GDP	14.6	14.7	14.5	14.5
					Total Program Spending / GDP	14.5	14.3	14.0	13.7
					Budget Balance / GDP	-0.9	-0.8	-0.8	-0.6
					Accumulated Deficit / GDP	31.3	30.7	30.2	28.9
					Net Debt / GDP	35.4	33.9	33.2	31.6
					Debt Service / Revenue	7.0	8.6	9.7	10.4

**Annual averages. Sources: Finance Canada, Statistics Canada, BEA, Bloomberg, Scotiabank Economics.

* Average annual growth for FY21-24. Sources: Finance Canada; Statistics Canada; nominal GDP forecasts: Scotiabank Economics.

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