Canadian Federal: 2018–19 Final Results

ECONOMIC GROWTH DRIVES ANOTHER DEFICIT UNDERSHOOT

SUMMARY

- **The federal fiscal deficit for the 2018–19 fiscal year (FY19) came in at $14.0 bn, as reported in today's *Annual Financial Report of the Government of Canada*. This is a modest improvement from the $14.9 bn shortfall anticipated as of Budget 2019 (chart 1).**
- **A largely unchanged budget balance masks important opposing trends: exceptionally strong—but likely temporary—revenue performance against expenditure growth that continues to exceed nominal GDP growth.**
- **The deficit stood at 0.6% of GDP, modest in isolation, particularly as the output gap widened over the course of the year, owing in part to the government spending less than planned on infrastructure.**
- **A declining debt-to-GDP ratio continues to be the Government's operational anchor at 30.9% in FY19, down from 31.3% in FY18.**

ECONOMIC MIGHT PROPELS FURTHER REVENUE GAINS

Total revenue advanced a healthy 6.7% in FY19 to complete the first instance of two consecutive years of revenue growth over 6.5% since FY99–00. The increase was roughly in line with Budget 2019 estimates. Underlying that jump was a commensurate 6.7% rise in personal income tax receipts—a result largely expected given the robust job creation witnessed in the closing months of 2018 and in early 2019. By the same token, employment insurance premiums rose 5.5% versus FY18—the best one-year gain since FY13—though 2018 premium rate increases also contributed to that rise.

Corporation income tax revenues climbed a healthy 5.4%—the second-strongest single-year gain since the 2008–09 recession and trailing only FY18. That climb—the Government attributed the increase to robust corporate earnings growth across multiple sectors—came in spite of accelerated depreciation measures that took effect in November 2018. Strength in the corporate sector also contributed to a surge in taxes paid by non-residents on Canadian-sourced income.

WHILE EXPENDITURES CONTINUE TO CLIMB

Total expenditures grew by 4.8% in FY19, just below the 5.1% anticipated as of *Budget*. Major transfers to persons rose 2.5%, with elderly benefits expanding 5.4% as employment insurance payments fell 4.2% in a reflection of the strong labour market. Transfers to other levels of government gained 7.7%, in line with *Budget* plans. Key cost reductions of $2.3 bn versus the prior fiscal blueprint were found in the other transfers category.

Public debt charges increased 6.3%—in line with Budget expectations—which was attributed to a higher average effective interest rate on the stock

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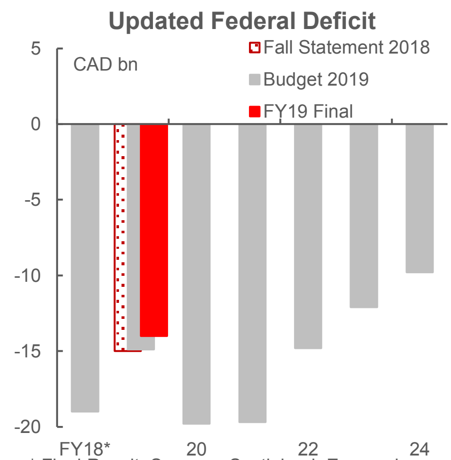
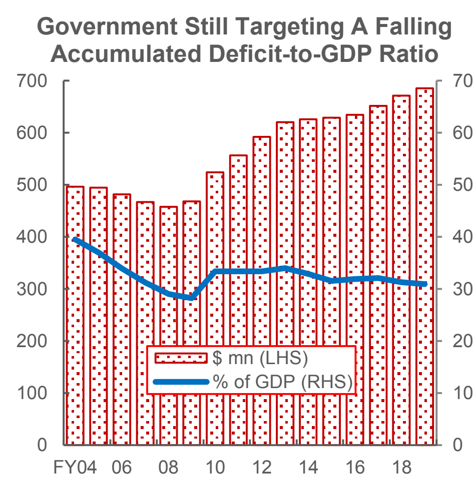
Chart 1



* Final Result. Sources: Scotiabank Economics, Finance Canada.

Chart 2



Sources: Scotiabank Economics, Finance Canada.

of interest-bearing debt. The Government highlighted the gradual historical decline in its debt servicing costs as a share of revenues, from a peak near 38% in the early 1990s to about 7% in FY19.

DEBT AND BORROWING

The modestly narrower FY19 deficit translated into a modestly lighter debt burden. As a share of nominal GDP, the federal accumulated deficit was 30.9%; that represented a small decrease from the 31.3% registered in FY18. The Government continues to target a declining debt-to-GDP ratio as its fiscal anchor, and emphasize its small debt burden relative to G7 peers.

With a $1.2 bn net source of funds from non-budgetary transactions, the Government's net financial requirement was $12.7 bn in FY19. That followed a $9.4 bn net financial requirement in FY18, with borrowing related to the acquisition of the Trans Mountain Pipeline drawing down the $9.5 bn net source of funds via non-budgetary transactions in that year. The Government financed its $12.7 bn requirement, and also increased its cash balances and unmatured debt by $3 bn and $15.7 bn, respectively.

OUR TAKE: LUCK OR FORESIGHT?

The economic outlook deteriorated substantially over the course of the year. As of *Budget 2018*, nominal GDP growth for calendar year 2018 was estimated at 4.1%; actual results came in at 3.6% by year-end. In retrospect, a deficit of 0.6% of GDP is relatively modest as the economy shifted from above- to below-potential. This was arguably more by luck than design.

Bottom line improvements stem largely from revenue windfalls. This is likely a temporary phenomenon that will run its course over the next year or two. Meanwhile, expenditure growth continues to climb. Built-in escalators to several large transfers, along with demographic pressures on others, will continue to exert upward pressure on expenditures without additional constraints. Achieving a downward debt-to-GDP target as GDP growth slows will be more challenging in the years ahead.

While the modest deficit is not concerning in and of itself, its composition is wanting. Deficit spending has largely spurred temporary growth in consumption, but has stalled on building productive capacity. Notably, there is a chronic underspend in infrastructure against plans. While data is opaque, approximately only two-thirds of funds allocated under the *Investing in Canada Plan* for FY19 was spent. This trickles down to the provincial level: Ontario, for example, recently reported an underspend of $1.5 bn in its FY19 *Public Accounts* due to re-profiled federal infrastructure program transfers.

With interest rates expected to decline, deficits will be all the more tempting. If savings are not applied against the debt stock outside a serious downturn, spending should be concentrated on productivity-enhancing investments.