Canadian Federal: A Balanced Budget Could Be Within Reach

SUMMARY

- **Fiscal year 2019 was a tumultuous one for growth in Canada with successive downward revisions over the course of the year. Federal government revenues, on the other hand, continued to surpass expectations by wide margins despite historically-tight co-movement between nominal GDP and federal revenues.**
- **While it would be hasty to proclaim a structural decoupling of economic growth and government revenues, revenues could plausibly continue to outperform over the near term, particularly as labour markets remain robust.**
- **With additional revenues potentially as high as $18.5 bn over the next two fiscal years under various upside scenarios, a balanced budget could conceivably be achieved within three years if expenditure growth does not deviate from current budgetary plans.**

MUCH ADO ABOUT NOTHING, OR LITTLE ADO ABOUT SOMETHING?

The Canadian federal Department of Finance quietly released a preliminary budget balance estimate for fiscal year 2018–19 (FY19) in the publication of its May 2019 *Fiscal Monitor* (FM) report. While still subject to revisions, the $11.8 bn* deficit—alongside considerably stronger projections for underlying revenue growth—suggests an improvement over the $14.9 bn shortfall predicted as recently as the March 20th, 2019 federal *Budget*.

The bottom-line improvement implied in the FM are by no means a game-changer in isolation. Even if the deficit were reduced by the full $3.1 bn, that would only account for about 0.1% of GDP, and have minimal impact on the modest downward debt trajectory targeted by the Federal Government. However, revisions over the course of the year were already significant (chart 1). Recall that *Budget 2019* disclosed an FY19 windfall of $5.9 bn relative to the November 2018 *Fall Economic Statement*, the bulk of which was directed to new policy initiatives.

Improvements in the Government's finances came against a backdrop of disappointing economic growth. Domestic and international factors knocked the wind out of the Canadian economy's sails in late 2018 and early 2019. A drop in global oil prices, along with oil egress challenges at home, put a serious dent in growth for oil-producing provinces, and for Canada as a whole, while heightened trade uncertainty added to the headwinds. Consequently, growth expectations were revised down progressively over the course of the year.

Successive upward revisions to revenue performance during a period of economic retrenchment and high uncertainty warrants exploration.

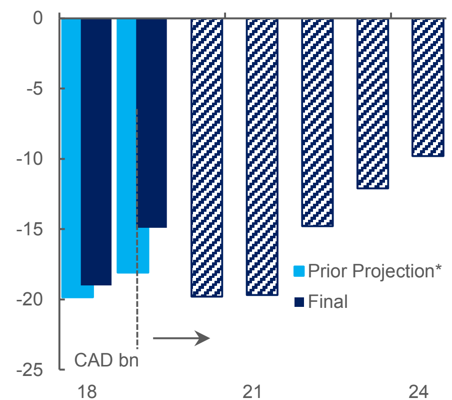
* Figures reported in Canadian dollars unless otherwise stated.

CONTACTS

Rebekah Young
Director, Fiscal & Provincial Economics
416.862.3876
Scotiabank Economics
rebekah.young@scotiabank.com

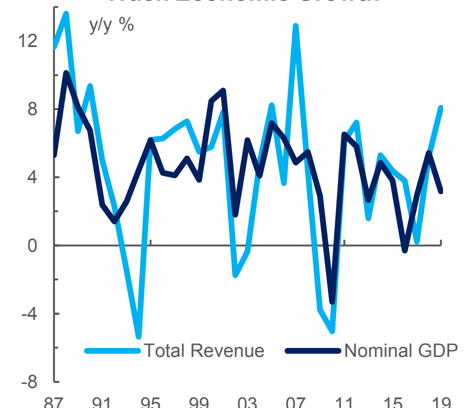
Marc Desormeaux, Provincial Economist
416.866.4733
Scotiabank Economics
marc.desormeaux@scotiabank.com

Chart 1



* Budget 2018 for FY18, 2018 *Fall Economic Statement* for FY19. Source: Scotiabank Economics, FinanceCanada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada, Finance Canada.

WHAT GOES UP MUST COME DOWN

Co-movement between economic growth and government revenues has historically been tight (chart 2, p.1). Theory suggests that slowing growth leads to lower production and higher unemployment, which in turn drives down household consumption and further erodes residential and non-residential investment. Automatic stabilizers—including employment insurance—provide a first line of defense to offset the impacts. Governments can resort to direct intervention in the form of new stimulus should conditions call for a stronger response.

Revenues nevertheless continued to grow last year as the economy slid. Not only did they hold throughout this turmoil, they actually outperformed expectations by wide margins. *Budget 2018* projected revenue gains of 4.4% for FY19, slightly above economic growth forecasts of 4.1% nominal GDP growth (2.1% real) for 2018. With the fiscal year-end fast approaching, *Budget 2019* penciled in 6.7% revenue growth for FY19—$8.8 bn higher than initially anticipated—but expected nominal GDP gains of only 3.4% (1.6% real). By the time of the publication of the FM released in May, nominal economic growth for FY19 had come in at 3.2% (1.7% real), while preliminary revenues jumped 8.1% (chart 3) with gains across almost all categories. This is a considerable departure from previous slowdowns in the Canadian economy (chart 4).

JOB MARKET, POPULATION GAINS TURBO-CHARGING REVENUES

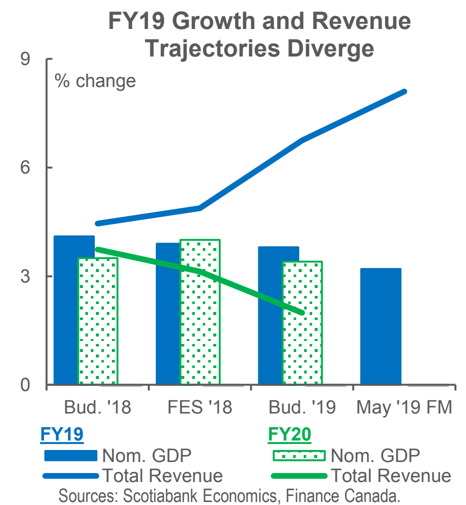
Extraordinary labour market performance could partially account for the decoupling. Historically, personal income tax revenue has declined during slowdowns in economic activity as employment drops (chart 5), though the correlation has not been as strong as that between total revenues and economic growth. In the recent economic lull, job creation has remained robust by all metrics. Unemployment steadily declined to historic lows during this period. More than a million new jobs have been created since 2015 (chart 6, p.3), wages are growing modestly above inflation, and labour force participation is gradually strengthening.

Consequently, personal income tax receipts advanced by a robust 6.5% in FY19. This is particularly striking given the 2015 middle-income tax cuts were expected to lead to net revenue losses in the order of $1.5 bn per year beginning in FY17. Foregone tax receipts via a cut to the second tax bracket (from 22% to 20.5% for annual incomes of approx. $45–$90k) had been forecast to dominate gains vis-a-vis the new fifth high-income tax bracket.

In fact, revenues declined only marginally for the second bracket in 2016 (latest available data) by less than 1% ($0.4 bn). About half of all new tax filers fell within this tax bracket (growing at 1.5% versus 0.7% for all tax filers). In light of recent job growth numbers, that trend can be expected to continue (chart 7, p.3). So while the individual tax burden may have dropped, the number of tax payers grew. This would also have a compounding effect on corporate income tax revenues, as a growing workforce also translates into higher corporate payroll taxes and employment insurance premiums.

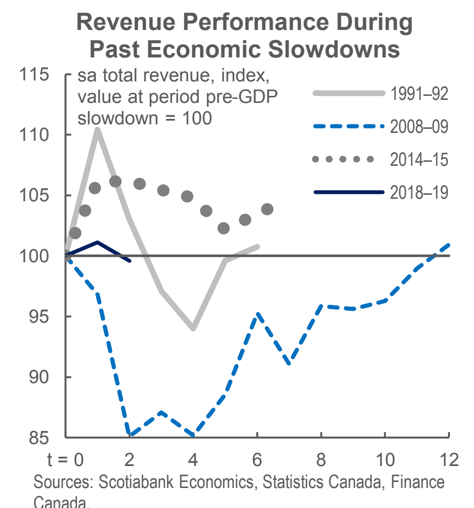
The recent surge in population growth, anchored by stepped-up immigration, supported job creation and likely also padded federal government coffers. During 2016–18, net international immigration to Canada grew by an annual average of 29% —more than in any prior three-year period for which data are available—and the national population rose by a cumulative 3.7%—the steepest three-year climb since 1990–92. The distribution of those gains is of particular note. As interprovincial

Chart 3



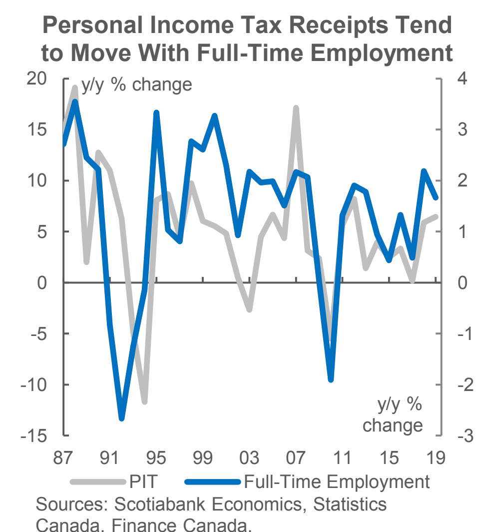
Sources: Scotiabank Economics, Finance Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada, Finance Canada.

Chart 5



Sources: Scotiabank Economics, Statistics Canada, Finance Canada.

migration to Western Canada eased during the 2014–15 commodity price correction, Montreal, Ottawa, and cities near Toronto and Vancouver witnessed post-recession high population growth (chart 8, p.3).

Even with record numbers of newcomers to Canada, labour force integration has improved. Only in Saskatchewan did the employment rate for prime working-age immigrants fall relative to 2014–16 during the last two years, and it nevertheless maintained the highest such rate—at nearly 83%—of any province last year.

BANKING ON BUSINESS

Strong corporate tax revenue performance is more complicated. Pre-tax corporate profits surged by almost 15% (y/y) in the first half of FY19, but declined sharply in the second half, closing out the year down by 10%. Meanwhile, corporate income tax receipts grew by 11.3%.

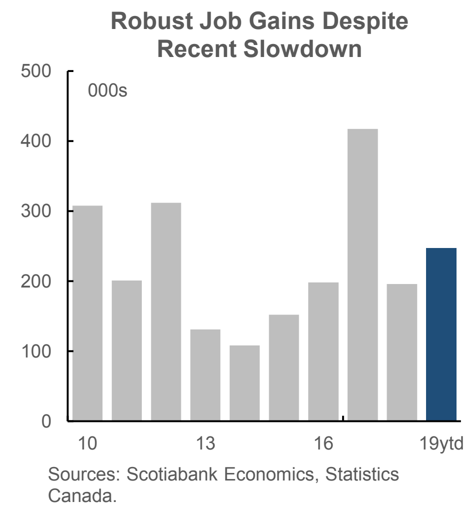
Pre-tax profitability of corporations tends to follow the economic cycle tightly over the long term (chart 9, p.4); however, the correlation between profitability and corporate income tax receipts has been less clear-cut in recent years (chart 10, p.4). Major tax cuts exaggerate the apparent correlation as the marginal effective tax rate (METR) has steadily declined over recent history, coming down from almost 40% in 2005 to less than 14% today (chart 11, p.4). While corporate profitability has been relatively volatile since the 2008–09 downturn, fluctuations in corporate tax revenues have been much less pronounced with the METR effectively halved in this period, reducing the sensitivity.

Corporate tax revenue growth is likely underpinned by a variety of factors other than corporate profitability. Corporate tax reassessments have also padded government revenues. The Canada Revenue Agency (CRA) estimates that Canada's annual tax gap could be as high as $26 bn from tax avoidance, evasion, and compliance issues across personal, corporate, and sales income tax categories. Recent federal budgets have provided an additional $1 bn in operating costs to the CRA over five years to close these gaps. CRA recently indicated it expects to recoup over half of the $9–$11 bn attributed to corporations alone. While low-hanging fruit may have already been realised, we should expect continued additional revenues across all tax revenue categories from these on-going efforts.

Other more speculative factors could also be providing a lift to corporate tax revenues. The increase to the top personal income tax bracket in 2015 could have induced some migration to corporate tax structures. The jury is still out on whether the new personal income tax bracket will deliver its forecasted revenue boost (by more than $2 bn annually), but early data is not promising. The 11% surge from this tax bracket in 2015—attributed by the Parliamentary Budget Office to high earners who shifted income forward to benefit from a more favourable tax rate—was subsequently unwound in 2016 with a drop in the total number of filers along with a 10% revenue drop. Tax planning may have been underestimated, which in this case would lead to a decline in personal income tax revenues, coupled with a (more modest) increase in corporate income tax revenues.

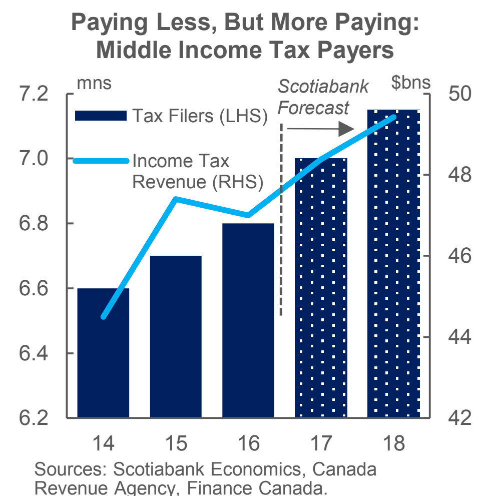
The new business investment incentives introduced in the fall of 2018 are also expected to impact fiscal revenues. Finance Canada estimated revenue losses in the order of $5 bn and $4 bn in FY20 and FY21, respectively, but expect the increased investment to deliver stronger growth over time. The uptake of these incentives was initially undone by uncertainty in late 2018, however a 40% surge in investment (machinery and equipment) in the first quarter of 2019 is promising (chart 12, p.5).

Chart 6



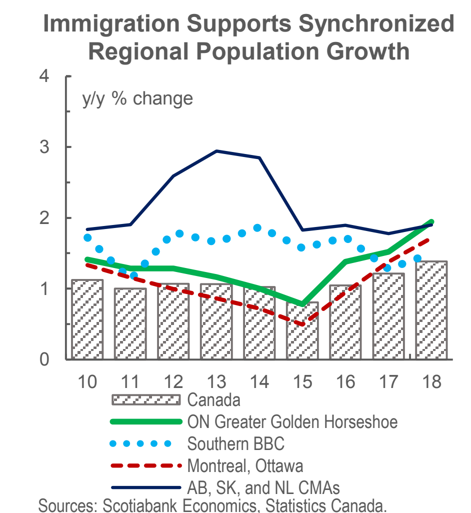
Sources: Scotiabank Economics, Statistics Canada.

Chart 7



Sources: Scotiabank Economics, Canada Revenue Agency, Finance Canada.

Chart 8



Sources: Scotiabank Economics, Statistics Canada.

Sustained growth is needed to realise the full potential of these measures but their sensitivity to uncertainty poses a real downside risk.

BEARISH BUDGET BIAS

The old adage of "under-promise, over-deliver" applies to fiscal forecasting by public office. It is harder to plug a hole in overly optimistic forecasting than it is to announce a windfall. A prudent approach to budgeting is all the more critical at the present juncture with considerable downside risks both domestically and globally. The federal government rightly introduced a fiscal buffer (e.g., $3 bn) as a tool to mitigate against downside risks in its annual budgeting exercise.

But an exclusive focus on the downside comes with its own risks. Windfalls take the system by surprise, often resulting in a high propensity to spend this 'found money'. With little time to consider its best use, timeliness can trump other policy objectives when the year-end is fast approaching.

What could an upside scenario look like? It is plausible that public revenues could remain solid over the next couple of years despite waning growth. Labour-related tax income could credibly continue to exceed nominal growth levels in line with employment and immigration trends. Corporate income tax revenues are more of a wild card. Waning corporate profitability in line with growth expectations would likely moderate the exceptionally strong revenue growth of the past year, but further corporate reassessments could continue to deliver in the near term. Additionally, a more modest fiscal impact from the depreciation measures could also yield improvements in the budget balance over the baseline.

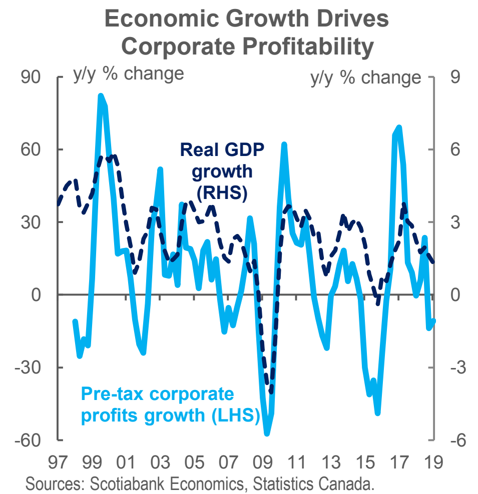
We run several scenarios where revenues outperform expectations (table, p.5). For this exercise, we hold expenditure growth forecasts constant. While expenditure restraint is another legitimate means to balance the budget, this exercise focuses on windfall potential with no policy change. These scenarios yield substantial additional revenues over the next two years ranging from $6–18 bn. At about 0.3-0.6% of GDP, these numbers start to put a serious dent in the federal debt-to-GDP trajectory if applied against debt. A balanced budget could reasonably be achieved within three to five years under these upside scenarios (chart 13, p.5).

This would strengthen the fiscal firepower to respond to any future serious downturn in the economy. It would potentially relieve some of the near-universal pressure on monetary policy to support a recovery, a pertinent consideration when household debt levels are already high.

Alternatively a revenue windfall could provide a substantial down payment on future growth. Public infrastructure investment is still facing disbursement bottlenecks so it is an unlikely candidate, but the federal government has yet to make substantive in-roads in closing the female labour force participation gap. A more comprehensive childcare program would require substantial upfront investments, but would pay for itself over time.

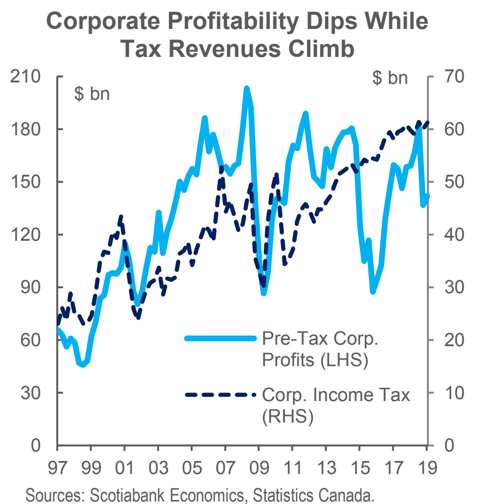
So while conservative fiscal forecasting may be the prudent thing to do, it may not be the most productive. End-of-year rushes to spend 'surprise' windfalls quickly add up; effective fiscal planning might include commitments to apportion higher-than-anticipated revenues towards deficit management or debt repayment. Ultimately, a deliberate and methodic approach to also considering upside scenarios can engender a more balanced and fulsome debate on options that would pay off in the longer run.

Chart 9



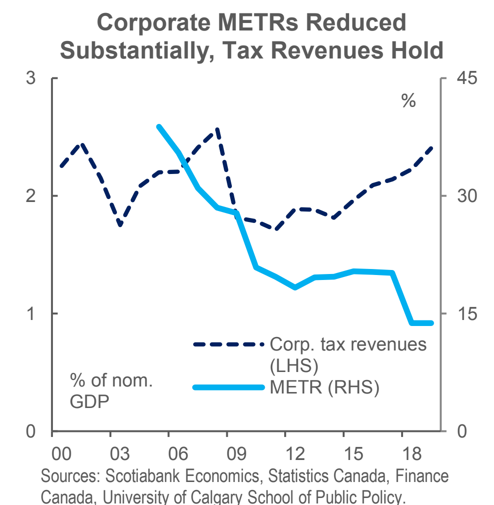
Sources: Scotiabank Economics, Statistics Canada.

Chart 10



Sources: Scotiabank Economics, Statistics Canada.

Chart 11



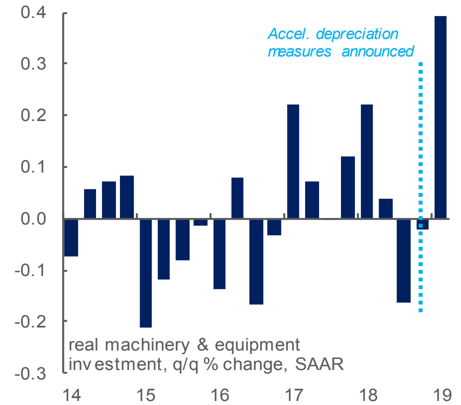
Sources: Scotiabank Economics, Statistics Canada, Finance Canada, University of Calgary School of Public Policy.

Alternative Revenue Scenarios
y/y % change except where noted

	FY20	FY21	Additional Revenues
Baseline: Pullback in PIT revenues; deep ST cuts to CIT revenue with uptake of CCA (Budget 2019)			
PIT revenues	4.5	4.5	
CIT revenues	-7.6	3.9	
Total revenues ($ bn)	339	351	
Scenario 1: Continued strength in PIT revenues; deep ST cuts to CIT revenue with uptake of CCA			
PIT revenues	6.5	6.5	
CIT revenues	-7.6	3.9	
Total revenues ($ bn)	339	357	**5.9**
Scenario 2: Continued strength in PIT revenues; modest ST cut to CIT revenue with uptake of CCA			
PIT revenues	6.5	6.5	
CIT revenues	0	3.9	
Total revenues ($ bn)	343	361	**14.2**
Scenario 3: Continued strength in PIT revenues; modest growth CIT revenue			
PIT revenues	6.5	6.5	
CIT revenues	3.9	3.9	
Total revenues ($ bn)	345	363	**18.5**

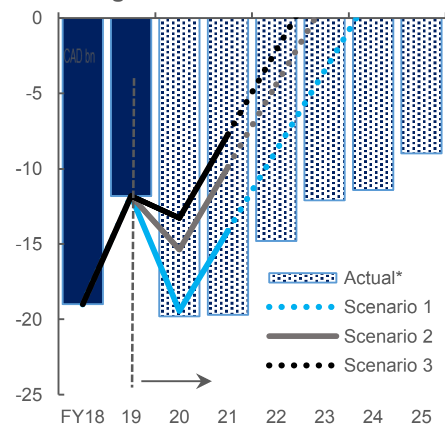
Sources: Scotiabank Economics, Finance Canada.

Chart 12



Sources: Scotiabank Economics, Statistics Canada.

Chart 13



* Based on Finance Canada long-term projections. Sources: Scotiabank Economics, Finance Canada.

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a "call to action" or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.