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Quick Hit — Cyclical fiscal improvements mask structural gaps

Here's a fairly basic public finance concept for you: economic performance begets fiscal traction. The theory goes something like this: when your economy is hot, extra revenue flows in the door, providing an opportunity for governments to run a healthy budget balance and consolidate debt. On the flip side, when the economic lights dim (or go out completely), revenue wilts and fiscal stabilizers kick in, oftentimes sparking rapid fiscal deterioration and related debt accumulation.

It's easy enough to test this economic-fiscal dynamic and scrubbing decades of data confirms (both federally and provincially) a positive and largely contemporaneous correlation between changes in economic growth and shifts in budget balances. Granted, the fit isn't perfect, breaking down for stretches. Nor does each individual government exhibit uniform fiscal sensitivity to changing economic conditions, owing to differences in demography, industrial make-up, tax-spending policies, federal transfer eligibility, etc.

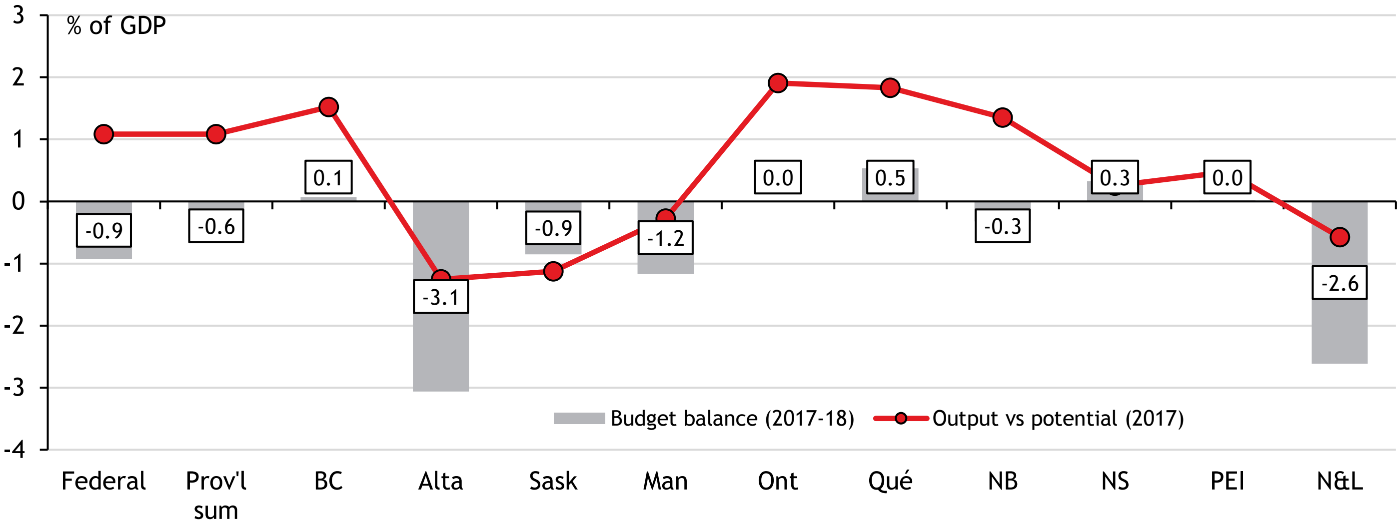
So a strong and/or strengthening economy historically produces fiscal dividends. And so it was in 2017-18… at least in Ottawa. The pick-up in 2017 real GDP growth—to a decidedly better-than-expected and above-potential 3%—saw the federal government cut its 2017-18 deficit projection by $8.6 billion in October's fall statement, with an equivalent amount of red ink erased from the 2018-19 deficit too. (The final tally for the outgoing year will likely look even better when all is said and done.) Things have been a little more complicated at the provincial level, however. Despite a positive base effect and provincial growth rates that generally topped budget assumptions, there's been no real improvement in the aggregate provincial budget balance vs plan… for either 2017-18 or 2018-19. Really, were it not for draws on reserves and other contingencies, the province-wide budget balance would actually be looking worse today than in the spring… despite fairly stellar economic results. We don't want to paint every jurisdiction with the same "provincial" brush and offer up Table 1 (on page 2), which explores the shifting fiscal sands (vs Budget 2017) for each individual province.

But wait you say: "a number of provinces are already balanced, so what's the big deal if they're not making much incremental progress here?" Well, it is true that half of our 10 provinces have achieved budgetary balance, including the three most populous provinces of British Columbia, Ontario and Québec. Some others in deficit are making budgetary progress. So are our expectations simply too high? Not really, assuming you control for where we are in the economic cycle. Enter our take on the output gap. For the record, this *Quick Hit* is not designed to provide a hyper-detailed breakdown of the non-inflationary speed limit from coast-to-coast. Rather, drawing on excellent work done by our colleagues in Economics, we've applied our estimate of individual output gaps to current fiscal positions at the federal and provincial levels of government. The result is the chart at bottom.

One key point that should be evident: we see the national economy and a number of individual provinces operating above potential. And just to be clear, our 2018 growth forecasts generally see above-potential growth continuing for many provinces, dulling near-term fiscal threats. Notwithstanding this fairly constructive view of near-term growth, it might be fair to say that for many of our less resource-intensive regions, the so-called top of the economic cycle might not be that far off. Thus, we caution governments not to get lulled into a false sense of fiscal security. Cyclically-driven budgetary performance can mask structural pressure points. It's one thing to run a budget balance at the top of the economic cycle, but maintaining balance when a relatively hot economy inevitably cools could be tough, with elevated debt burdens in some corners limiting fiscal flexibility. But hey, that's a problem for another day, another generation, and in some cases, another government right?

Chart: Are federal-provincial fiscal results out of sync with economic cycle?

Federal-provincial budget balances (2017-18) vs NBF estimate national-regional output gaps (2017)



Source: NBF, federal-provincial governments | Note: Budget balances based on latest official estimates; Qué balance before Generations Fund/reserve transfers

Table: Federal-provincial fiscal scorecard

Federal & provincial budget balances (and related contingencies): Actual/latest vs Budget 2017 plan

Calendar year >>		2016			2017			2018		
Fiscal year >>		2016-17			2017-18			2018-19		
Reference document >>		Bud 2017	Actual	*Change*	Bud 2017	Latest	*Change*	Bud 2017	Latest	*Change*
Budget balance ($mln)										
Federal	GoC	-23,000	-17,800	*5,200*	-28,500	-19,900	*8,600*	-27,400	-18,600	*8,800*
Provincial total	Prov	-14,071	-9,778	*4,293*	-12,560	-12,457	*102*	-11,187	-11,282	*(95)*
– Most populous (Ont, Qué, BC)	Big-3	184	4,107	*3,923*	295	190	*(105)*	244	228	*(16)*
– Oil-levered (Alta, N&L, Sask)	Oil-3	-13,175	-13,150	*25*	-11,960	-11,845	*114*	-10,657	-10,657	*0*
– Remaining provinces	Oth-4	-1,080	-735	*345*	-895	-802	*93*	-774	-853	*(79)*
Ontario	Ont	-1,524	-991	*533*	0	0	*0*	0	0	*0*
Québec	Qué	250	2,361	*2,111*	0	0	*0*	0	0	*0*
– Underlying balance (excl GF, res)	QuéxGF	2,292	4,362	*2,070*	2,488	2,200	*(288)*	2,834	1,305	*(1,529)*
British Columbia	BC	1,458	2,737	*1,279*	295	190	*(105)*	244	228	*(16)*
Alberta	Alta	-10,806	-10,784	*22*	-10,497	-10,314	*183*	-9,709	-9,709	*NA*
Manitoba	Man	-872	-764	*108*	-840	-827	*13*	-698	-698	*NA*
Saskatchewan	Sask	-1,289	-1,218	*70*	-685	-679	*6*	-304	-304	*NA*
Nova Scotia	NS	41	150	*109*	136	139	*3*	36	28	*(8)*
New Brunswick	NB	-231	-119	*112*	-192	-115	*77*	-117	-189	*(72)*
Newfoundland & Labrador	N&L	-1,080	-1,148	*(68)*	-778	-852	*(74)*	-644	-644	*NA*
Prince Edward Island	PEI	-18	-1	*17*	1	1	*1*	5	5	*NA*
Contingencies / reserves ($mln)										
Federal: forecast adjustment	GoC	0	0	*0*	3,000	1,500	*(1,500)*	3,000	3,000	*0*
Provincial total	Prov	930	0	*(930)*	2,750	1,637	*(1,113)*	2,185	728	*(1,457)*
– Most populous (Ont, Qué, BC)	Big-3	930	0	*(930)*	2,065	1,447	*(618)*	1,250	-207	*(1,457)*
– Oil-levered (Alta, N&L, Sask)	Oil-3	0	0	*0*	800	250	*(550)*	1,050	1,050	*0*
– Remaining provinces	Oth-4	0	0	*0*	-115	-60	*55*	-115	-115	*0*

Notes: Compiled by NBF, the above table compares official/government fiscal assumptions from 2017 budgets vs latest estimates; where future-year forecasts have not been updated, change is denoted as "NA"

Shout out to…

… my colleagues in *Economics and Strategy*. If you've not read our economic analysis, you're missing an oftentimes unique and always insightful take on recent developments and the road ahead. Case in point, Senior Economist Matthieu Arseneau has done some great work on federal-provincial output gaps over the years, including a Sep-2016 *Special Report* that delved into regional drivers of potential growth. Today's *Quick Hit* draws on Matthieu's updated work, specifically fresh province-by-province estimates of where GDP resides vs potential. You can find our Economics work on the web at www.nbc.ca/en/rates-and-analysis/economic-analysis.html or via Bloomberg at NBFR <GO>.

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