November 21, 2018

Business tax relief delivered, resulting in a bit of extra red ink

Highlights

- Ottawa's fall fiscal update took some non-trivial steps to address Canada's perceived tax competitiveness challenge. A stronger economy and the attendant uplift in federal revenue help to finance some (but not all) of this business tax relief, with the net result being some incremental budgetary red ink starting in 2019-20 vs a restated budget plan from February.
- The focus of today's update was a suite of business tax measures. Topping the list was immediate and full expensing of machinery and equipment used in the manufacturing/processing of goods. Businesses will also be allowed to immediately and fully write off the cost of clean energy equipment. An *Accelerated Investment Incentive* will allow businesses of all sizes to write off a larger share of the cost of newly acquired assets the year the investment is made. Elsewhere, incremental funding was allocated to a *Strategic Innovation Fund*. An export diversification strategy, increased internal (i.e., inter-provincial) trade and broad regulatory modernization also featured. There wasn't much for the middle class in terms of *net new* relief.
- Measures to accelerate business investment are worth a cumulative $14.4 billion over the six-year period ending 2023-24. This relief is front-end loaded, worth almost $5 billion in 2019-20 and nearly $4 billion in 2020-21, working out to ~0.2%-pts/year. That could spur a *modest* upgrade to the near-term economic forecast but doesn't appear sufficient to alter our thinking on the Bank of Canada.
- Economic and fiscal developments since budget have been positive, to the tune of $4.6 billion in 2018-19. Post-budget policy actions have a fiscal cost of $4.0 billion in 2018-19, the net result being an improvement in the current fiscal year's budget deficit to $18.1 billion (0.8% of GDP). There's still fully $3 billion in an "adjustment for risk", which could allow for a further improvement in the current year's deficit.
- Beyond 2018-19, the deficit profile has deteriorated *somewhat* relative to February's restated budget plan. For 2019-20, the government has added $1.8 billion to the projected deficit, bringing the shortfall to $19.6 billion (0.8% of GDP). There's a similarly scaled shortfall (i.e., 0.8% of nominal GDP) penciled in for 2020-21. By 2023-24, the deficit is expected to be down to $11.4 billion or 0.4% of GDP, although there's no definitive timeline for deficit reduction. As in 2018-19, there's a $3 billion reserve/buffer in each and every year of the fiscal framework.
- The profile for the debt-to-GDP ratio has been raised relative to budget, but that's a reflection of previously announced changes in the accounting/discount rate treatment for federal employee pension plans. An already lean net debt burden steps lower each year, to 30.9% in 2018-19, 30.5% in 2019-20 and on down to 28.5% by 2023-24. The interest bite is barely 7% in 2018-19, rising to a quite manageable 8.6% in five years' time, under the assumption of steadily rising interest rates.
- Canada's economy is churning out solid and relatively broad-based growth, with labour markets healthy and business investment recovering. Strictly speaking, the real GDP growth projection for 2018 was nudged down 0.1%-pt to 2.0%. However, a stronger outlook for 2019 helped maintain the 2018-22 real growth projection at annual average rate of 1.8%.
- Consistent with past practice, the *Fall Economic Statement* includes no update on net financing requirements and/or the related debt issuance strategy. On its own, the relatively modest adjustment to the 2018-19 budget balance would not imply a meaningful change to Ottawa's estimated current fiscal year borrowing needs.

Responding to competitiveness worries

As promised, Ottawa's fall fiscal update took some non-trivial steps to address Canada's perceived tax competitiveness challenge—most notably via more generous write-offs on business investment, particularly for manufacturers and processors. A stronger economy and the attendant uplift in federal revenue help to finance some (but not all) of this business tax relief, with the net result being some incremental budgetary red ink starting in 2019-20 vs the budget plan set down in February.

With today's action, Canada's revised marginal effective tax rate on new investment will certainly look better. The update crows that Canada will have "the lowest overall tax rate on new business investment in the G7, significantly lower than that of the United States". Granted, the overall magnitude of business tax relief doesn't fully compare to the deep tax cuts deployed south of the border, which included a significant step down in the US federal corporate tax rate. As such, some segments of the business community may view the government's response as inadequate given a hyper-competitive global backdrop, replete with its geopolitical risk factors. There's also the issue of personal income tax competitiveness, but that was never really meant to feature in this update.

It's not our intention to scoff at the $4.5-5.3 billion/year of primarily business tax relief coming in fiscal 2019-20 and 2020-21… it's welcome support, equivalent to ~0.2%-pts of GDP, which may be sufficient to prompt a *modest* upgrade to our national economic forecast. Despite deeply discounted Canadian crude, which is causing its own set of headaches (particularly in Alberta), Canada's economy has proven resilient enough to support monetary policy normalization. With little to no slack in the national economy, it's hard to justify a continuation of negative real interest rates. Still, given the household sector's unprecedented sensitivity to higher interest rates, the Bank of Canada could well be looking for the monetary policy off-ramp in as little as a year from now… on this, our view hasn't really changed.

Fiscal hawks (you know who you are) might cringe at the larger deficits beyond 2018-19 and no doubt decry the lack of a definitive timeline for deficit reduction. Really, though, the adjustment to the deficit profile amounts to less than $1 billion a year (on average, over a six-year period), which barely registers as a percent of GDP in today's $2.2 trillion economy. To us, Ottawa remains in a relatively envious and much more secure fiscal position vs any number of advanced sovereigns, a message reinforced in the latest *Fiscal Sustainability Report* from the non-partisan Parliamentary Budget Officer.

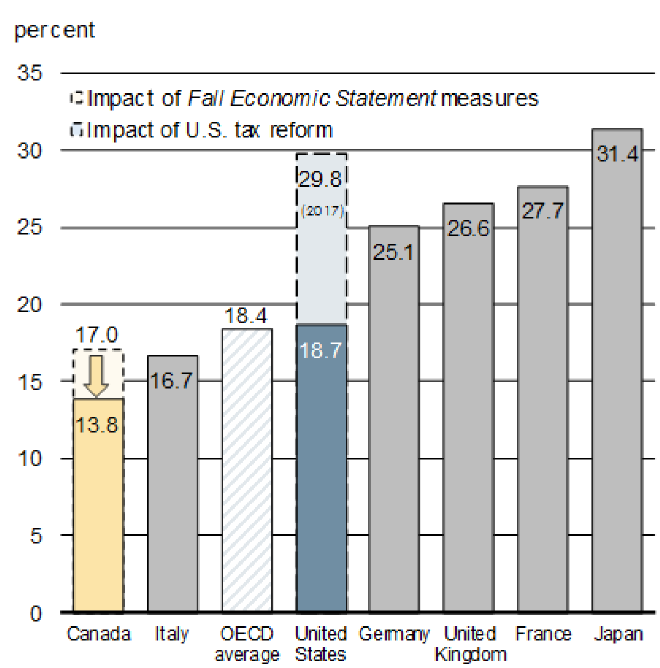
A couple of other things to keep in mind. Today is hardly the last word from this Liberal government. Indeed, there's a pre-election budget coming down the pike in spring 2019, providing another (perhaps more natural) opportunity to: provide additional relief, including for Canadian households; take action on persistent/perceived threats to the economic outlook; and fund/address certain other strategic priorities. Saying that, unless (or until?) the federal government is prepared to abandon its so-called "fiscal anchors", including a declining debt-to-GDP ratio, there's not going to be a tremendous amount of *additional* near-term room for marginal stimulus at the federal level… barring a big-time economic surprise to the upside of course.

In the end, no one should be terribly surprised by this report, which delivered a well-telegraphed set of business tax measures (mainly write-offs on business investments). Rather than a full-on tax/fiscal overhaul akin to that undertaken in the US, it amounts to a targeted/focused response to competitiveness worries, limited in scope/magnitude by a generalized desire to keep the federal government on a relatively prudent debt track.

Writing off business investment

As expected, the big focus of today's update was a suite of business tax measures. Topping the list was immediate and full expensing of machinery and equipment used in the manufacturing/processing of goods—a move clearly designed to spur new investment. Businesses will also be allowed to immediately and fully write off the cost of clean energy equipment. An *Accelerated Investment Incentive* "will allow businesses of all sizes and in all sectors of the economy to write off a larger share of the cost of newly acquired assets in the year the investment is made".

Chart: Marginal effective tax rates on new investments



How much relief are we really talking about? Measures to accelerate business investment are worth a cumulative $14.4 billion over the six-year period ending 2023-24. This relief is front-loaded, worth almost $5 billion in 2019-20 and nearly $4 billion in 2020-21. That works out to ~0.2%-pts/year, which could spur a modest upgrade to the near-term economic forecast but doesn't appear sufficient to alter our thinking on the Bank of Canada.

An incremental $800 million over five years was earmarked for the *Strategic Innovation Fund*, to support innovative business investment. (A portion of that funding commitment comes via surtaxes applied on certain US goods, part of the countermeasures adopted in response to American tariffs on our steel and aluminum.

In the ongoing search for deeper overseas trade ties, Ottawa is launching an *Export Diversification Strategy*. Via enhanced trade corridors to Asia and Europe, company supports and enhanced services for exporters, the government aims to vault overseas exports 50% higher by 2025. Internal trade likewise remains a focus, where harmonized regulations and standards are looked at as a means to free up the flow of goods and services across provincial borders. Specific areas of focus include: harmonized trucking requirements, more standardized food/inspection regulations, better alignment of building codes, and greater inter-provincial trade in alcohol. An overhaul/modernization of federal regulations has also been flagged, with a view to freeing up the ability of Canadian businesses to grow without unduly jeopardizing health and safety. That would include immediate action on a series of existing business recommendations, establishment of an external advisory committee, a new *Centre for Regulatory Innovation*, and an annual modernization bill to keep federal regs more up-to-date.

On carbon taxes, the federal government reiterated its intention to fully recirculate proceeds from prospective federal fuel charges (in non-compliant jurisdictions) and the "output-based pricing system" for greenhouse gas emissions.

There wasn't really much for the middle class here, just $1.1 billion over six years with the bulk (75%) of that coming in supports for Canadian journalism ($595 million) and wild fish stocks ($242 million).

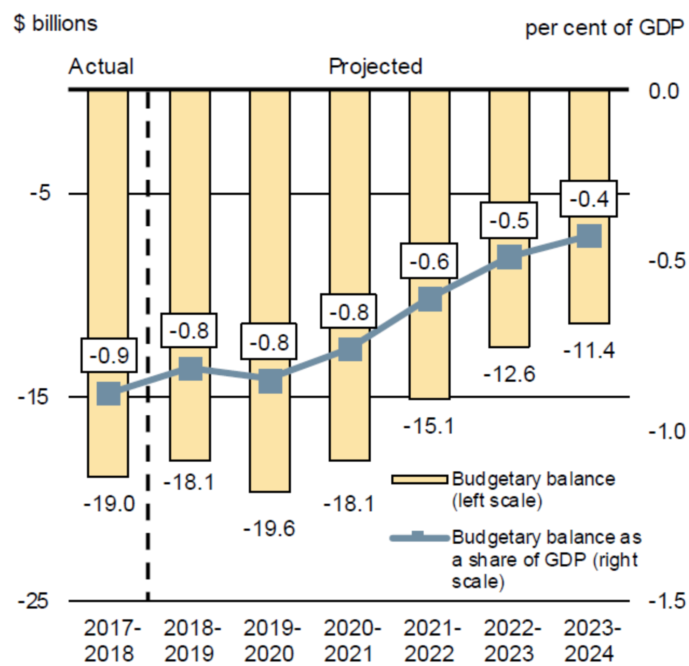
Updated fiscal profile adds some extra red ink beyond 2018-19

Pledged business tax relief means forgone revenue and, at the margin, larger deficits over the medium term relative to what was laid in February's budget. There are always a number of moving parts when it comes to adjusting the fiscal framework and here's what has transpired since Budget 2018:

Economic and fiscal developments since budget are clearly positive, to the tune of $4.6 billion in 2018-19 (and >$22 billion over the five-year period to 2022-23). That's mainly via an upgraded outlook for income tax and consumption tax revenue.

On the other hand, policy actions have a fiscal cost of $4.0 billion in 2018-19. The result is a net improvement in the current fiscal year's budget deficit, which has been shaved from a budgeted $18.8 billion (on a restated basis) to $18.1 billion today (equivalent 0.8% of GDP). We'd note that there's still fully $3 billion set aside in an "adjustment for risk", which could allow for a further improvement in the current year's deficit… assuming, of course, that unused prudence goes directly to the bottom line, which is our strong preference.

Chart: Federal government budget balance



Beyond 2018-19, the deficit profile has deteriorated *somewhat* relative to February's restated budget figures. That because the annual cost of new policy actions (including the business tax relief noted above) in all cases exceeds the fiscal uplift from the stronger underlying economic/revenue base.

For the coming fiscal year, 2019-20, the government has added $1.8 billion to the projected deficit, bringing the shortfall to $19.6 billion. Interestingly, that once again works out to 0.8% of GDP. And there's a similarly scaled shortfall (i.e., 0.8% of nominal GDP) penciled in for 2020-21. In this way, Ottawa can effectively argue that the deficit, at least relative to the size of the national economy, isn't really getting much larger.

There's a steady, annual $3 billion risk adjustment as far as the eye can see—not inconsiderable insurance against unwelcome economic developments and/or unforeseen fiscal pressures. (Our summary of the revised economic outlook and key risks follows at bottom.)

As for that oft-cited fiscal anchor—the federal debt-to-GDP ratio—the updated profile has been raised relative to budget. Mind you, that's more a reflection of revised accounting/discount rate treatment for federal employee pension plans, a change previously announced and one we highlighted at the time of the *Annual Financial Report* back in October. Fact is, you'll still see an already lean net debt burden stepping lower each and every year of the fiscal plan, to 30.9% in 2018-19, 30.5% in 2019-20 and on down to 28.5% way out in 2023-24 (although you must always treat ultra-long-term fiscal projections with caution).

To us, the relative size of Ottawa's budgetary shortfall (amounting to less than 1% of GDP) isn't exactly alarming in an advanced economy context. Bond investors, it seems, tend to agree with this assessment. Moreover, it's not the federal level of government, but rather some provincial jurisdictions that still have work to do to bolster long-term fiscal sustainability. Debt affordability is understandably a hot topic in today's higher interest rate environment. True, Ottawa has issued a lot of shorter-term bonds, some of which will be rolled over at higher rates now that the Bank of Canada is hiking its policy rate. But the federal government's interest bite (calculated as the share of revenue consumed by public debt charges) is barely 7% in 2018-19, rising to a still quite manageable 8.6% in five years' time… under the assumption, it should be noted, of steadily rising interest rates.

There's still no timeline for deficit reduction, which irks some that would prefer to see Ottawa march swiftly back into the black. It should be noted, however, that a rapid fiscal consolidation at the federal level could, all else equal, stress parts of the economy and complicate efforts in some provinces undertaking needed fiscal repairs. Moreover, it's not necessarily obvious that a leaner deficit would translate into significantly lower borrowing costs for the federal government, which is one of the few remaining gold-plated sovereigns around (as judged by its proud collection of 'AAA' long-term ratings and universally "stable" outlooks).

Revised economic outlook

In a nutshell, Canada's economy is churning out solid and relatively broad-based growth, with labour markets healthy and, interestingly enough, business investment recovering. Technically, the real GDP growth projection for 2018 was nudged down 0.1%-pt to 2.0% in the *Fall Economic Statement* relative to budget. However, a notably stronger outlook for 2019 (2.0% vs. 1.6% in the 2018 budget) helped maintain the 2018-22 real growth projection at annual average rate of 1.8%. An upward revision on GDP inflation resulted in an average annual increase in the level of nominal GDP of $9 billion.

The outlook for interest rates remains largely unchanged near-term, though out the forecast horizon, expected GoC T-bill and bond yields were revised down slightly (by 0.1%-pt). There's a bit more Canadian dollar weakness projected through 2022, relative to the 2018 budget, as the average exchange rate over the next five years fell to 78.9 (US¢/C$) from 80.1 previously. Despite, recent weakness in the price of oil, the outlook for WTI over the forecast horizon is higher by an average of $8.4/barrel relative to the 2018 budget (US$66.6 vs US$58.2). There may well be downside risk here, at least judging from current market levels, but don't lose sight of the $3 billion annual fiscal buffer built into the financial framework.

While this is admittedly a bit circular, a noted risk to the economic outlook is the outsized fiscal stimulus introduced in the United States, which could prompt the US Federal Reserve to raise interest rates faster than expected. That, in turn, could hamper American economic activity, causing negative spillover effects for an interconnected Canadian economy. Additionally, trade tensions could ultimately impair trade and investment in Canada. On the upside, tight labour market conditions might just drive stronger-than-expected household spending and business investment. Finally, the government pointed to major international investments in Canada announced recently, the most notable being the $40 billion joint investment in an LNG export facility in British Columbia—an undoubtedly positive story on the West Coast and big enough to trigger positive adjustments to the national outlook across much of the Canadian economic forecasting community.

A final note: Consistent with past practice, the *Fall Economic Statement* includes no update on net financing requirements and/or the related debt issuance strategy. On its own, the relatively modest adjustment to the 2018-19 budget balance (the deficit is just $0.7 billion removed from the restated budget plan) would not imply a meaningful change to Ottawa's underlying borrowing needs. Note that the government has actively consulted with the dealer community and a variety of domestic/international fixed income investors to help guide the development of its *2019-20 Debt Management Strategy*, to be presented in next year's budget. For now then, we continue to get fairly steady diet of 2- to 5-year GoC bonds, the cornerstone of 2018-19's $113 billion gross bond issuance program, which is being well absorbed by the market. Meanwhile, a scarcity of long sovereign product—alongside well-cemented inflation expectations and a relatively mature economic expansion—contributes to Canada's flat yield curve and relatively rich valuations (on a fully hedged basis) vs virtually all of the advanced economy sovereign bond markets we monitor.

Warren Lovely & Taylor Schleich

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Fiscal Projections

Changes to the Fiscal Outlook Since Budget 2018

Table A1.2
Economic and Fiscal Developments Since Budget 2018
billions of dollars

		Projection					
	2017–2018	2018–2019	2019–2020	2020–2021	2021–2022	2022–2023	2023–2024
Budget 2018 budgetary balance[1, 2]	**-19.9**	**-18.8**	**-17.8**	**-16.5**	**-13.2**	**-12.0**	**n/a**
Adjustment for risk from Budget 2018		3.0	3.0	3.0	3.0	3.0	
Budget 2018 budgetary balance (without risk adjustment)	**-19.9**	**-15.8**	**-14.8**	**-13.5**	**-10.2**	**-9.0**	
Economic and fiscal developments since Budget 2018	0.9	4.6	5.3	4.5	3.8	4.1	
Revised budgetary balance before policy actions and investments	**-19.0**	**-11.2**	**-9.5**	**-9.0**	**-6.4**	**-4.9**	**-3.2**
Policy actions since Budget 2018[3]		-3.5	-1.7	-1.5	-3.0	-2.4	-3.3
Investments in 2018 *Fall Economic Statement*							
Continued Progress for the Middle Class		-0.0	-0.1	-0.2	-0.2	-0.2	-0.3
Confidence In Canada's Economic Future		-0.5	-5.3	-4.4	-2.5	-2.1	-1.7
Total investments in 2018 *Fall Economic Statement*		-0.5	-5.5	-4.7	-2.7	-2.3	-1.9
Total policy actions and investments since Budget 2018		**-4.0**	**-7.1**	**-6.2**	**-5.7**	**-4.7**	**-5.2**
Budgetary balance	**-19.0**	**-15.1**	**-16.6**	**-15.1**	**-12.1**	**-9.6**	**-8.4**
Adjustment for risk		-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
Final budgetary balance (with risk adjustment)	**-19.0**	**-18.1**	**-19.6**	**-18.1**	**-15.1**	**-12.6**	**-11.4**

Note: Totals may not add due to rounding.

1 A negative number implies a deterioration in the budgetary balance (lower revenues or higher spending). A positive number implies an improvement in the budgetary balance (higher revenues or lower spending).

2 Budget 2018 budgetary balance has been restated based on the change to the discount rate methodology for unfunded pension benefit obligations, described in the *Annual Financial Report of the Government of Canada—2017–2018*.

3 Table A1.7 provides a detailed list of policy actions since Budget 2018.

Federal • Fiscal Update

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