Prime Minister Stephen Harper and Finance Minister Jim Flaherty going over a final draft of the 2014 budget, which came very close to being in balance, with a surplus of $6.4 billion forecast for 2015—an election year. PMO Flickr photo

Ottawa's Deficit: Making a Mogul out of a Mountain

Douglas Porter

The headline from the 2014 budget was really more about 2015: that we are one budget away from balance. Otherwise, the Conservative government tabled what Finance Minister Jim Flaherty happily admitted was a boring budget, but it included a range of measures aimed at labour enhancement, infrastructure and pocketbooks, all as a prelude to next year.

The finish line is clearly within sight for Canada's long quest to return to balanced budgets after a seven-year deficit detour. Ottawa's measured pace of restraint continues with the 2014 fiscal plan, but the emphasis looks set to change in 2015. The budget was a self-proclaimed "stay-the-course" affair—with little in terms of major new measures from a macroeconomic standpoint. Much of the document's 419 page-heft was devoted to renewed support for skills training, infrastructure and the consumer.

All told, the deficit trajectory is again running better than expected, with a $2.9 billion shortfall now forecast for this coming fiscal year before a $6.4 billion surplus is expected in FY15/16—and that continues to include $3 billion per year in wiggle room should the economy underperform. In other words, if the economy performs as ex-

pected, we could be looking at a balanced budget this coming fiscal year (*Chart 1*). The FY13/14 shortfall was also trimmed to $16.6 billion from November's $17.9 billion projection.

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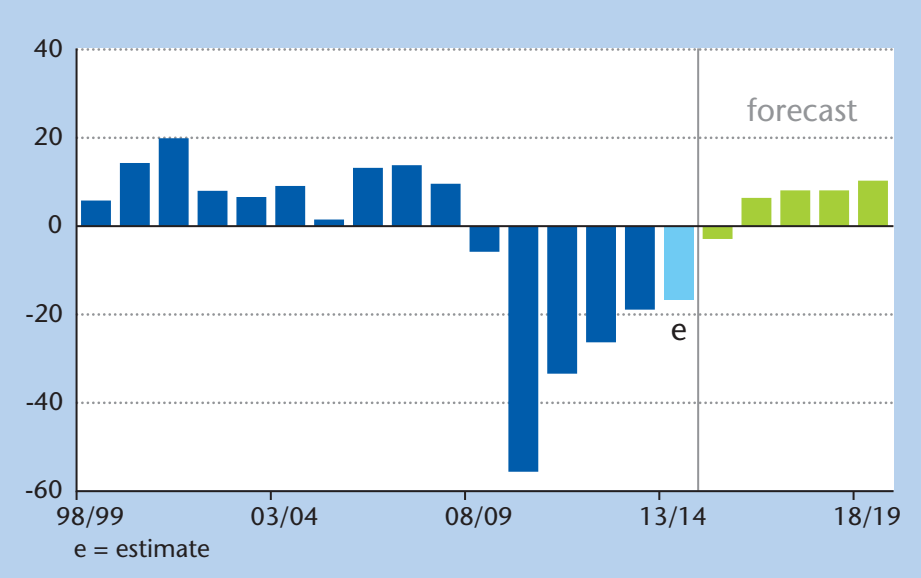
The challenge after hitting the fiscal goals will be ensuring the recovery stays on track and that spending remains largely under control (*Chart 2*). Program spending will dip slightly (0.5 per cent) in the coming fiscal year after an estimated 2 per cent rise in FY13/14. Even with planned restraint measures and next year's drop, program spending still rises at a 2.7 per cent annualized clip over the next five years, or a bit above inflation. As a share of GDP, program spending is expected to drop to pre-recession levels of just below 13 per cent by mid-decade from 13.5 per cent in FY13/14 and the recent peak of 16 per cent. Starting from FY13/14, revenues are projected to grow at a 4.7 per cent average annual rate over the next five years, a bit faster than nominal GDP growth, which is not out of line with historic norms.

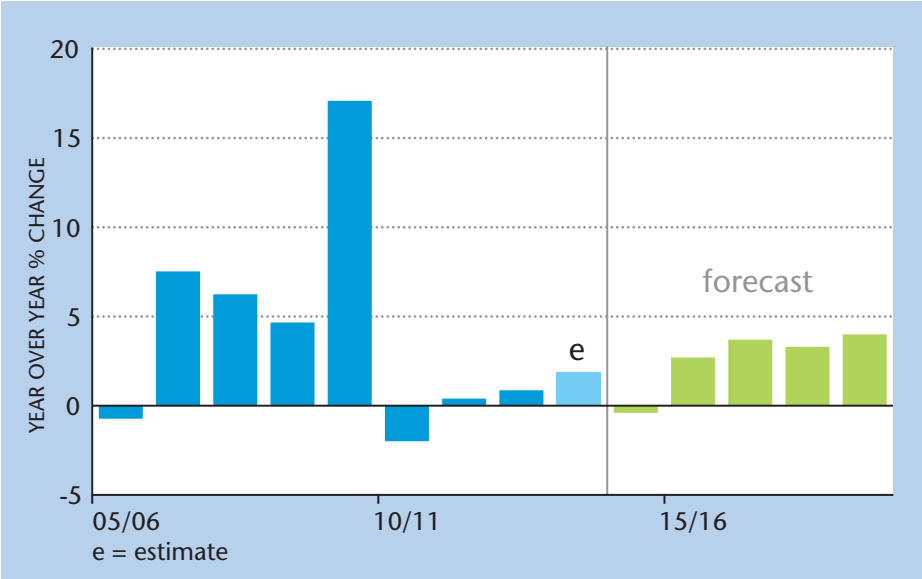
Digging into the details, there were a few noteworthy measures announced in this year's budget, but they are not surprising and come at minimal net fiscal cost. Here is a quick recap of the largest new initiatives:

CHART 1: Surplus in Reach (C$ blns)



Source: Federal Budget

CHART 2: Spending Restraint



Source: Federal Budget

Consumers-First Agenda—Minding the (Price) Gap:

Arguably the most surprising element in this year's budget was the proposed step to address the Canada/US price gap. Instead of broadening last year's tariff cuts, Ottawa has instead chosen to legislate against "unjustified" country price differences, providing the Competition Bureau with powers to address the issue. While we will await the legislation before passing judgement, this is a surprising tack for a variety of reasons. First, with the Canadian dollar sagging 10 per cent in a year, the price gap has already largely vanished as a widespread issue. Second, the price gap is fundamentally an issue between consumers and business, and not primarily a public policy issue. Finally, it is highly questionable how effective legislation could possibly be in helping reduce the price gap.

Beyond that tidbit, Ottawa also unveiled a grab-bag of proposals to help consumers. The government proposes capping wholesale domestic wireless roaming rates. They will also seek to make credit card charges more transparent. Finally, the government will provide $305 million over five years to enhance broadband access in rural areas (some 280,000 households). A handful of other very small-ticket items net out to a fiscal cost of $18 million in this coming fiscal year, and $138 million in FY15/16—everything from tax treatment of charitable contributions, food inspection, adoption expense credits and continued funding for Own the Podium.

Measures to Support Jobs and the Economy:

This budget is titled "*The Road to Balance: Creating Jobs and Opportunities*", and contains an array of minor mea-

sures to support the economy. But the measures are very much aimed at the microeconomic level, not the macro side. Net new spending totals $730 million in FY14/15, rising to just over $1 billion in FY15/16. Top billing goes to addressing the nation's skills shortage, though the fiscal cost is relatively small. This is done through the roll-out of the Canada Job Grant in 2014, with employers required to contribute, on average, one-third of training costs of up to $15,000. Note that in jurisdictions where agreements are not secured by April, the program will be run directly through Service Canada. Ottawa is also creating a Canada Apprentice Loan (which will build on the student loans program) which will create access to over $100 million in funding for prospective skilled trades.

Meanwhile, the more meaningful fiscal impact comes from investments in areas like the Windsor-Detroit crossing ($497 million over the coming two years) and the auto sector ($500 million). Additional targeted measures include an extension of the Mineral Exploration Tax Credit for junior miners for an additional year; continued support for forestry; and a removal of the duty on equipment used in Canadian offshore drilling.

The days of Ottawa having to borrow from capital markets to finance its deficit, above and beyond refinancing requirements, are over.

Spending Restraint Ongoing:

The cost of the aforementioned measures is more than paid for by two major measures: public-sector compensation costs and an excise duty increase on tobacco. First, the operating budget freeze continues through FY15/16 as previously announced, and goes a few steps further this year with measures to contain long-term compensation costs. The biggest savings will come from changes to the Public Service Health Care Plan—the government will shift from funding 75 per cent of retiree benefit costs to a split-cost formula, as well as increasing the number of years to become eligible for the plan. This will generate savings down the road, but accounting adjustments (i.e., a lower future liability) will reduce the deficit by roughly $1.5 billion per year over the next two years. Some National Defence funding will be shifted to future years, averaging just over $700 million per year.

The excise duty on tobacco will be raised by roughly 23 per cent, which will generate a noteworthy $685 million in FY14/15, making it one of the biggest-ticket items in this budget. For smokers, this tax increase works out to roughly 2 cents/cigarette.

Debt Management Strategy: All Downhill from Here... For Debt/GDP

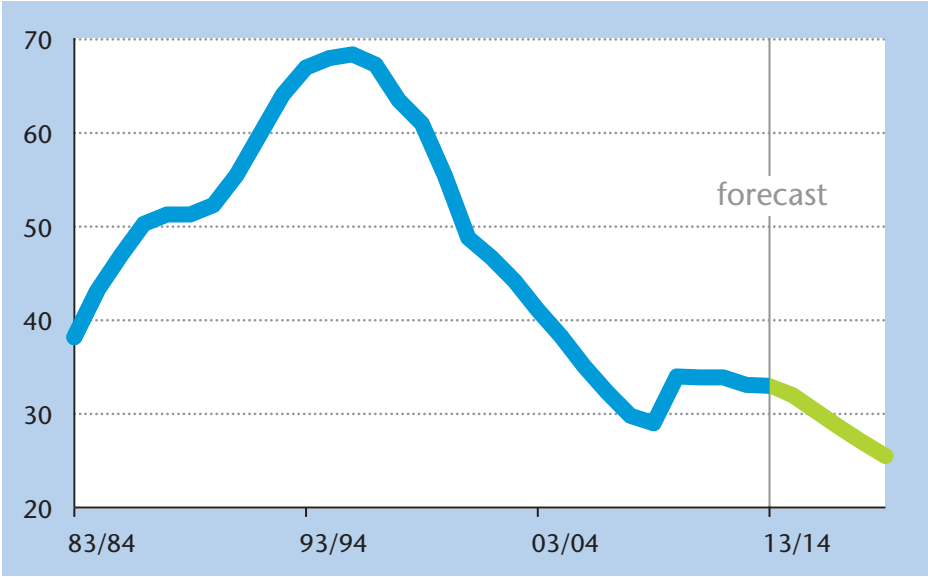
The days of Ottawa having to borrow from capital markets to finance its deficit, above and beyond refinancing requirements, are over. Mortgage-backed securities purchased under the Insured Mortgage Purchase Program (IMPP) in 2008 and 2009 began to mature last October, all but eliminating the need for net new borrowings this year and next, and then the emergence of surpluses in the following years will take care of the rest. Net new bond issuance will continue next year, however, as the government takes advantage of historically low interest rates. Gross marketable bond issuance will total $95 billion, up from $88 billion in FY13/14. After accounting for maturities, buybacks and other adjustments, the net increase in bonds will be $23 billion in FY14/15, versus just $5 billion this year (with the stock of bonds ending next fiscal year at almost $500 billion). The government is now considering issuing bonds with a maturity of 50 years in the coming year (last year they looked at 40-year bonds). The stock of treasury bills, which will absorb the impact of IMPP flows and net new bond issuance, is projected to drop from $152 billion to around $130 billion.

Reflecting the above, Ottawa is projecting net new borrowing requirements of a grand total of $1 billion in the coming fiscal year. In turn, total federal debt/GDP is projected to begin declining in FY14/15 to 32.0% (or in absolute dollar terms, the year after). The debt ratio is projected to drop consistently further to 25.5% by FY18/19, or below the pre-recession low of 28.2% (*Chart 3*).

Economic Assumptions Look Reasonable:

Ottawa based the economic assumptions on the latest private sector con-

CHART 3: Federal Debt (% of GDP)



Source: Federal Budget

TABLE 1: Fiscal Outlook (C$ blns, except where noted)

	Estimate 13/14	14/15	— Forecast — 15/16	16/17
Revenues	264	276.3	293.3	306.8
Expenditures	280.5	279.2	286.9	298.7
Program Spending	251.2	250.2	256.9	266.5
Public Debt Charges	29.3	29	30	32.1
Budget Balance	**(16.6)**	**(2.9)**	**6.4**	**8.1**
Federal Debt	**616**	**618.9**	**612.4**	**604.3**
As a percent of GDP:				
Budget Balance	-0.9	-0.1	0.3	0.4
Federal Debt	33	32	30.3	28.6

Source: Federal Budget Note: totals may not add due to rounding ( ) = deficit

TABLE 2: Economic Assumptions (%)

	— Ottawa — 2013	2014	2015	BMO Capital Markets 2014	2015
GDP Growth					
Real	1.7	2.3	2.5	2.3	2.5
Nominal	3.2	3.9	4.5	3.9	4.5
Yields					
3-month T-Bill	1	1	1.5	0.9	1.1
10-year GoC	2.3	3	3.5	2.8	3.7

sensus, as has been the convention for more than a decade (*Table 2*). We are right in line with the average on real GDP growth at 2.3 per cent this year and 2.5 per cent in 2015. Given that fiscal restraint will remain in force in many provinces and, to a lesser extent, in Ottawa, the growth assumptions may even be seen as a tad optimistic, but we can't quibble since the budget forecast is effectively our forecast. To factor in additional risks, the government has based its projections on a nominal GDP undershoot of $20 billion (equal to about 1.1 per cent of GDP), which translates into $3 billion per year in fiscal wiggle room. Three-month interest rates are expected to average 1.0 per cent this year and 1.5 per cent next year, only slightly above our call of 0.9 per cent and 1.1 per cent.

The bottom line on the fiscal front is that Ottawa can achieve its target—policy is mildly restrictive and achievable, there is a degree of prudence, and the starting point is slightly better than expected. Now we await the real budget show, in 2015. P

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