FALL ECONOMIC STATEMENT 2018

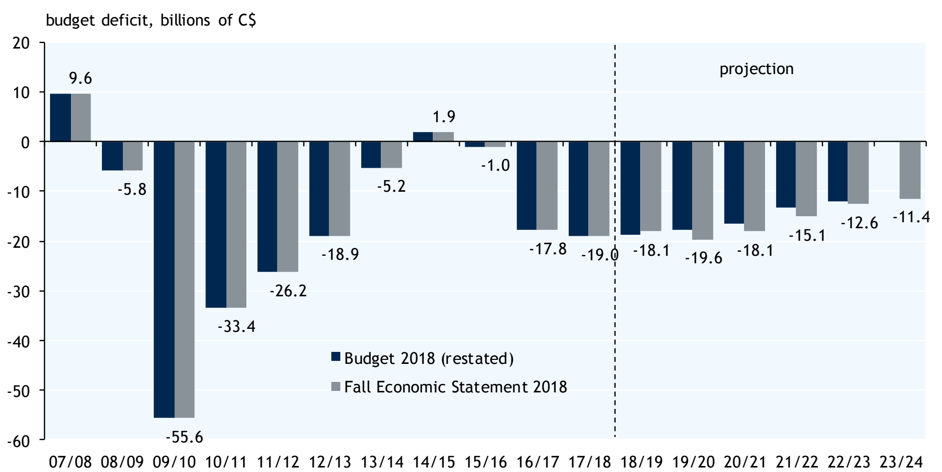
November 21, 2018

A more business-friendly Fall Economic Statement, but persistent deficits a concern

After receiving criticism for scant mention of competitiveness in Budget 2018, Finance Minister Morneau promised in March that the issue would be "Job 1" over the following six months. That culminated in today's Fall Economic Statement that was billed as addressing some of Canada's competitiveness challenges, including a relatively less attractive corporate tax regime following sizeable tax cuts in the United States. Few expected an across-the-board cut in Canada's corporate rate—instead, expectations were for less costly tax incentives to encourage business investment. That's exactly what was delivered today with an accelerated capital cost allowance that permits immediate expensing of qualifying capital goods, letting businesses recover the cost of new investment more quickly. That measure provides an additional incentive for firms facing growing capacity pressures to invest.

Unfortunately, the foregone revenue from that initiative was not offset by program spending efficiencies. Instead, it absorbed the additional fiscal room generated by Canada's solid economic performance. As noted in our preview of today's statement, federal government revenues have been tracking above plan over the first five months of the fiscal year, while program expenses have been in line with Budget 2018. "Economic and fiscal developments" would have allowed the government to trim their deficit projections by billions of dollars per year. Instead, measures announced since Budget 2018 (including today) have raised the cumulative deficit projection by more than $5 billion. Even in fiscal year 2023/24 the deficit is projected to remain above $10 billion. We continue to believe the government should be taking advantage of a strong economy by targeting a return to balance and saving up fiscal room for an eventual downturn.

The Fall Economic Statement shows even larger deficits than Budget 2018



Source: Department of Finance, RBC Economics Research

Additional fiscal room goes to spending rather than deficit reduction…

The budget deficit for the current fiscal year (2018/19) is now projected at $18.1 billion, down slightly from last year's $19.0 billion shortfall and an $18.8 billion deficit forecast in Budget 2018. That is despite $4.6 billion in positive "economic and fiscal developments", the majority of which reflects stronger income tax revenue. Most of that additional fiscal room went toward $3.5 billion in policy actions since Budget 2018. That includes more than $300 million over the next two years to support the steel and aluminum industries which have been hit with US import tariffs. The timing of Climate Action Incentive payments (i.e. carbon tax rebates) also represents a net fiscal cost in the near-term, though all proceeds from fuel charges will ultimately be returned to the provinces, resulting in no longer-term fiscal hit.

Deficits for the following fiscal years were revised higher. Again, that is despite an average $4.4 billion per year in additional fiscal room relative to Budget 2018. The majority of that fiscal room will be eaten up by foregone tax revenues from accelerated depreciation

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(detailed below). The result is persistent budget deficits throughout the projection horizon. The deficit is expected to increase to $19.6 billion in fiscal year 2019/20 (previously $17.8) and decline only gradually to $11.4 billion in fiscal year 2022/23. Cumulative deficits from fiscal year 2018/19 to 2022/23 total $83.5 billion, up from $78.3 billion in Budget 2018.

…mostly in the form of a new incentive to encourage business investment

The centrepiece of today's Fall Economic Statement is a new tax incentive designed to encourage business investment. The government will allow immediate expensing of qualifying capital goods purchased after November 20, 2018. The incentive applies to machinery and equipment purchased by manufacturers and processors, as well as clean energy investments. For other sectors, an Accelerated Investment Incentive will allow for faster write-downs of other types of capital assets, particularly for computers and software. The total cost of the initiative (in foregone revenue) is $14.4 billion, with more than half of that hit in the next two fiscal years. These incentives will be gradually phased out beginning in 2024. The government estimates that new expensing rules lower Canada's marginal effective tax rate on new investment from 17% to 13.8%. That compares to an 18.7% rate in the US, which also allowed for accelerated depreciation alongside last year's corporate tax cut.

Other business-friendly initiatives include $1.2 billion over five years to help access new markets for Canadian exports. An additional $800 million is allocated to the Strategic Innovation Fund which supports Canada's industrial and tech sectors. Some of that funding will come from revenues collected through countermeasures in response to US steel and aluminum tariffs.

Persistent deficits still a cause for concern

While we are encouraged that the government has taken some steps to address Canada's competitiveness challenges, we remain concerned by persistent deficits. Canada's economy is operating at capacity and unemployment is at multi-decade lows. In the past, governments have taken advantage of a strong economic backdrop to return to a balanced budget or even run a surplus. Instead, the federal government is focusing on the debt-to-GDP ratio as their fiscal anchor. That encourages pro-cyclical fiscal policy, allowing the government to run deficits during good economic times and leaving little ammunition should the economy falter. Running a balanced budget at this point in the economic cycle would build up more fiscal room, allowing the government to stimulate the economy in the event of a slowdown without jeopardizing the longer-term sustainability of their finances. It would also give households and businesses greater confidence that additional revenue sources won't be needed to close a structural deficit.

Projections from the 2018 Fall Economic Statement

	Projection					
billions of dollars	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Budgetary transactions						
Budgetary revenues	328.9	339.2	352.1	367.9	382.1	396.7
Program expenses	320.2	328.3	337.3	348.2	359.0	370.8
Public debt charges	23.8	27.5	29.9	31.8	32.7	34.3
Total expenses	344.1	355.8	367.2	380.0	391.7	405.1
Adjustment for risk	*-3.0*	*-3.0*	*-3.0*	*-3.0*	*-3.0*	*-3.0*
Budgetary balance	-18.1	-19.6	-18.1	-15.1	-12.6	-11.4
Federal debt	687.7	707.3	725.5	740.6	753.2	764.7
Per cent of GDP						
Budgetary revenues	14.8	14.6	14.7	14.8	14.8	14.8
Program expenses	14.4	14.2	14.1	14.0	13.9	13.8
Public debt charges	1.1	1.2	1.2	1.3	1.3	1.3
Budgetary balance	-0.8	-0.8	-0.8	-0.6	-0.5	-0.4
Federal debt	30.9	30.5	30.3	29.8	29.2	28.5

Source: Department of Finance, RBC Economics

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