Following Through: No Surprises Federal Budget Moves to Surplus

Highlights

- Budget 2014 confirms that the federal government is on course to return to surplus in 2015-2016. The deficit for the coming fiscal year is projected to be a slim $2.9 billion. But in our view it's likely the deficit will be eliminated in 2014-15.
- The move back to surplus is achieved mostly through tight expenditure management, with a two year spending freeze for all departments, a deferral of defence procurement, and reforms to public employee benefit programs.
- The only notable tax change in Budget 2014 is higher taxes on tobacco.
- Asset sales are also part of the balancing equation and are expected to add $500 million to the government's bottom line this year and $1.5 billion in 2015-16.
- The economic assumptions underpinning the Budget foresee the Canadian economy growing by 2.3% (in real terms) this year and by 2.5% in 2015, in line with private sector projections.
- Spending priorities are in the areas of labour market development and skills training as well as innovation and some funding for infrastructure.

Getting back to surplus remains the cornerstone of federal budgeting. With the deficit having swelled to more than $55 billion in the aftermath of the 2008-09 global recession and financial crisis, Finance Minister Jim Flaherty delivered a budget that has the government on the cusp of returning to the black. This is a notable accomplishment, one achieved without any significant tax increases and involving a hefty dollop of restraint after spending had been ramped up during and after the recession.

The Economic Setting

Budget 2014 is built around a consensus view that Canada's economy will grow by 2.3% this year, followed by a slightly stronger advance (2.5%) in 2015. This is an improvement over the 1.7% expansion in 2013 and helps to explain the stronger revenue growth projected in Budget 2014.

Much of the risk that overshadowed the global economy in recent years has dissipated, making it more likely the government will meet its deficit targets in the hold-the-line budget tabled on Tuesday. Private sector forecasters, however, still judge the balance of risks to be on the downside, due to high levels of Canadian household debt, softer global commodity markets, and slower growth in emerging economies. On the upside, the weaker Canadian dollar will support stronger economic growth via a boost to net exports. As a cushion, the Finance Minister adjusted the nominal GDP target downwards by $20 billion and included a $3 billion contingency

Table 1
Budget 2014 Economic Assumptions and Forecasts for Canada
(annual per cent change unless otherwise indicated)

		Forecast				
	2013	**2014**	**2015**	**2016**	**2017**	**2018**
Real GDP	1.7	2.3	2.5	2.5	2.3	2.2
GDP inflation	1.4	1.6	2.0	2.0	2.0	2.0
Nominal GDP growth	3.2	3.9	4.5	4.5	4.4	4.2
Unemployment rate (%)	7.1	6.8	6.6	6.4	6.3	6.2
Cdn 3-month T-bill (%)	1.0	1.0	1.5	2.7	3.6	4.0
Cdn 10 year gov't bond (%)	2.3	3.0	3.5	4.1	4.6	4.8
US GDP growth	1.7	2.7	3.1	3.0	2.9	2.6

Source: 2014 Federal Budget.

reserve to guard against potential downside revenue surprises.

Fiscal Outlook

Budget 2014 delivered few changes to Ottawa's fiscal profile and essentially solidifies the Harper government's commitment to return to balance by 2015-16. The plan calls for a deficit of just $2.9 billion this year and then a surplus of $6.4 billion in 2015-16, with further annual surpluses out to 2018-19.

The return to balance will be achieved by a healthy but in our view not unreasonable amount of spending restraint coupled with revenue growth driven by a stronger economy. On the spending side, federal program expenses are slated to decline slightly (-0.4%) in 2014-15. Departmental budgets are frozen for two years, and savings will be realized through managing compensation costs. The government is looking to trim costs associated with sick leave and disability for public employees; it is also working to transition to paying 50% of health care benefit costs for retired employees rather than 75% today. On the government's watch, program spending as a share of GDP will fall back to around 12.5%, where it stood in the early 2000s.

Targeted Spending Initiatives

In an environment where restraint and cost savings are dominant themes, it is not surprising to see few new spending announcements. With the funding that was available, however, the government chose to target workforce development, training and innovation as priorities in Budget 2014.

To help address skill shortages, the Budget is putting $40 million towards supporting internships in high-demand fields. It also provides additional support for apprenticeship training. Recognizing that older workers are part of the solution to emerging labour shortages, Budget 2014 introduces $75 million over three years for a targeted initiative to help train more older workers.

Funding to implement the new Expression of Interest System for economic immigrants is now secured. The Budget provides $14 million over the next two years and ongoing

Table 2 **Canadian Government Financial Position** (billions of dollars unless otherwise indicated)							
	2012-13	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**
Revenues	256.6	264.0	276.3	293.3	306.8	317.7	332.4
% change	3.0	2.9	4.7	6.2	4.6	3.6	4.6
Program expenses	246.4	251.2	250.2	256.9	266.5	275.2	286.3
% change	0.9	1.9	-0.4	2.7	3.7	3.3	4.0
Public Debt Charges	29.2	29.3	29	30	32.1	34.4	35.8
Total Expenses	275.6	280.5	279.2	286.9	298.7	309.7	322.1
% change	0.2	1.8	-0.5	2.8	4.1	3.7	4.0
Budgetary Balance	-18.9	-16.6	-2.9	6.4	8.1	8.1	10.3
Federal Debt	602.4	616.0	618.9	612.4	604.3	596.2	586.0
% of GDP	33.1	33.0	32.0	30.3	28.6	27.0	25.5
Source: 2014 Federal Budget.							

funding of $4.7 million for the new system. There is also new money to strengthen the Labour Market Opinion process necessary to bring in some temporary foreign workers.

Budget 2014 also earmarks an additional $40 million over four years for the Canada Accelerator and Incubator Program to help entrepreneurs in the advanced technology sector.

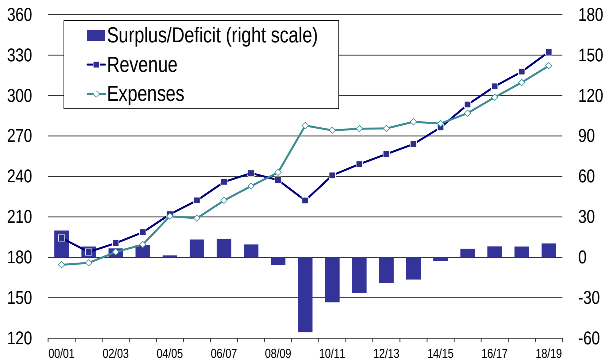
Research and innovation is also a priority area. The Budget provides $1.5 billion over ten years to help advance university research that is relevant to developing a more competitive Canadian economy. An additional $46 million annually will flow to granting councils to fund other post-secondary research. While BC institutions will garner a share of the above funding, we are pleased that the Budget also specifically directs $8 million to enable Mitacs to expand its Elevate program. The TRIUMF facility in BC is also slated to receive an additional $126 million in new funding. When combined with existing funding of $96 million, federal support for TRIUMP's core operations will total $222 million.

BC should also benefit from $90 million over four years directed to supporting innovation and transformation in the forest industry. Some of this funding is earmarked to fight the spread of the Spruce Budworm in eastern Canada, but presumably a portion of the $90 million will flow to our province.

Ontario's automotive industry will benefit from $500 million for the Automotive Innovation Fund which is intended to make Ontario more competitive as a North American location for auto-related manufacturing.

There are significant new funds for transportation infrastructure across the country, but no specific projects were delineated for BC.

Federal Revenue and Expenditures
billions $



Source: Federal Fiscal Reference Tables and 2014 Federal Budget

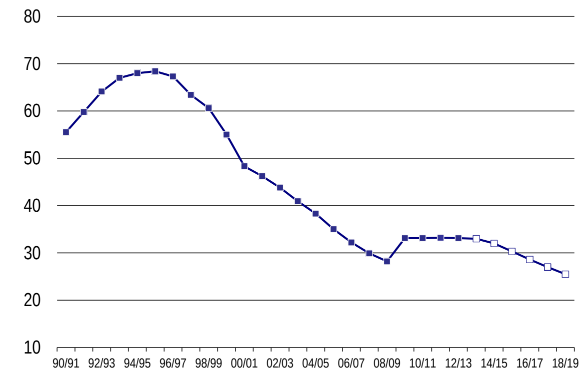
Consistent with the stay-the-course tone permeating the Budget, there was little in the way of new revenue proposals, other than a $4 per carton increase in cigarette excise tax. A number of enforcement measures are being instituted to close tax loopholes and broaden the business and personal income tax bases.

The government previously announced that EI premiums will be frozen at $1.88 per $100 of insurable earnings in 2013 and 2014. Budget 2014 assumes this rate will continue through 2016-17, which should be enough to eliminate the accumulated deficit in the EI operating account. Stable EI premiums are goo news for employers

Debt

As evident in Table 2, the federal debt is set to peak in 2014-15 at $619 billion. The debt-to-GDP ratio – will begin to decline this year. Canada is in excellent fiscal shape by OECD standards. Our shrinking federal debt-to-GDP ratio stands in contrast to most other advanced countries. [The provinces, however, are facing bigger fiscal challenges than Ottawa.] Outlining and sticking to a prudent fiscal plan and debt

Federal Debt-to-GDP Ratio
per cent



Source: Federal Fiscal Reference Tables and 2014 Federal Budget

reduction strategy is something the government deserves credit for.

Conclusion

Tuesday's effort was a no surprise Budget that delivered on the government's promise to balance the budget. In today's world of relatively slow growth and unsettled global economic conditions, this is a worthwhile accomplishment, especially since it was done without hiking personal or business tax rates and leaves Canada with a relatively competitive tax structure. In a fiscally constrained environment, targeting innovation, skills development and infrastructure makes sense, as investing in these areas is apt to produce the biggest economic dividends over time.

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