Economic Viewpoint

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Should we be worried about major Canadian government budget deficits?

According to Budget 2016's projections, the federal government's budget balance will worsen substantially in the coming fiscal years. There could even be a $14.3B deficit at the end of the forecast horizon, that is, in 2020–2021. This raises some concern about the federal government's ability to deal with contingencies, or the vagaries of economic growth. The risk involves lapsing into spiralling budget deficits. However, the federal government does have some leeway. For one thing, the current projections are very cautious in that they artificially worsen the government's financial picture. For another, Finance Canada has some options for repairing the public finances, if necessary. Under these conditions, the federal government seems fairly well equipped to deal with any contingencies that arise in the next few years without compromising its solid position in terms of its debt load.

On March 22, Canada's new government tabled its first budget since the fall 2015 election. The budgetary projections set out in Budget 2016 not only incorporate the impact of the new measures introduced by the Trudeau government, but also factor in the impact on Canada's public finances[1] of the erosion of economic conditions seen in recent quarters. The outcome was a projection for the bottom line that was substantially worse for coming fiscal years. For example, Budget 2015 forecast a surplus of $1.7B for 2016–2017, while the new projections in Budget 2016 forecast a deficit of $29.4B for the period. Major deficits are also anticipated in later years, until the end of the federal government's forecast horizon, 2020–2021, for which a $14.3B deficit is projected. Aggregated, the deficits should total almost $118B from 2015–2016 to 2020–2021.

Given this, we may wonder whether the federal government will be able to get the budget balanced sooner or later. The situation raises a number of concerns. For example, does the federal government still have enough financial leeway to tackle the unexpected, or the vagaries of economic cycles? The Canadian government's budgetary projections are established over a 5-year horizon, and many events could alter the economic and financial forecasts during that time. Among other things, if we exclude the 2015 technical recession, the current growth cycle began at the end of the 2008–2009 recession, nearly seven years ago now. Sooner or later, a steeper slowdown will materialize, leading to much slower Canadian economic growth and major repercussions for public finances. We got a glimpse of this problem with 2015's economic difficulties and their repercussions on the public finance. Our long-term scenario calls for such a cyclical slowdown around 2020, as the global and, in particular, the U.S. economies could lose steam. This could result in weaker economic growth in most industrialized countries, including Canada, as a result of the importance of its international trade.

GETTING READY FOR THE NEXT CRISIS

Given the $24.3B deficit projected for 2020–2021, Finance Canada's current financial projections suggest that the federal government will not be in the best position to cope with an eventual economic slowdown or even a recession. If such an event occurs, it could substantially increase the deficit, which could easily go above $30B. In short, all of the pieces would be in place to trigger a rising trend for deficits, with a risk of relapsing into the bad habits in place in the early 1990s, an observation that is, of course, worrisome at first glance, because it seems to jeopardize all the hard, painful work done over the last few years to clean up the federal government's public finances.

[1] The November 2015 Budget Update and February 2016 information document also provided important information on the impacts on the public purse of worsening economic conditions.

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However, some factors suggest that the federal government showed great caution in developing its financial projections. As a result, the budget deficits will likely be much smaller than forecast in the next few years.

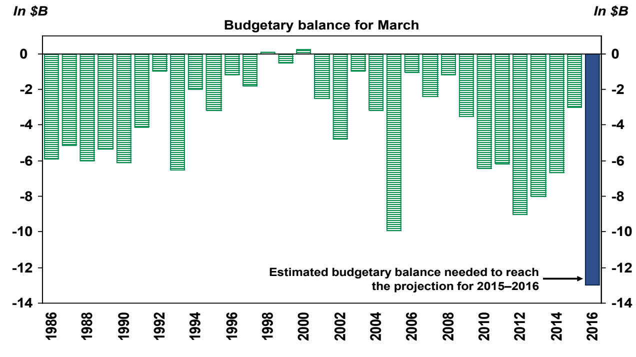
For one thing, Finance Canada's projected budget deficits include a cushion of $6B per year; the cushion comes deducting $40B from the nominal GDP numbers projected by private sector forecasters. This new padding is twice the leeway the Canadian government has used in the last few years. If the padding remains unused, as often happens, the deficits could be much smaller. For example, the 2020–2021 deficit could drop to $8.3B. This doesn't mean that these types of adjustments for risk should not be made. Given the many uncertainties, it is important to acquire some leeway. On the other hand, we must be aware that this move artificially swells the forecast deficits.

For another thing, although Canada's economic situation is still very uncertain, especially with the forest fires in Alberta, the change in the situation since the beginning of 2016 is encouraging in some regards. Thus, the latest consensus forecast suggests that Canada's real GDP growth could be 1.7% in 2016 while the projection was just 1.4% in the last budget. The difference could not only result in a lower deficit for this year, but also for later years, due to recurring effects.

The preliminary numbers for fiscal 2015–2016 also speak eloquently to this matter. According to Finance Canada, the cumulative results from April 2015 to February 2016 include a $7.5B surplus. March should record a substantial deficit given the high charges posted that month, some year-end adjustments, and the costs of the veteran benefit measures announced in Budget 2016. That being said, March would have to end with a deficit of about $13B to reach the target, a budget balance of -$5.2B for fiscal 2015–2016. A deficit that large for a single month has never been seen since the historical data started in 1985 (graph 1). Under these conditions, fiscal 2015–2016 could, finally, end close to budgetary balance. This would then change the starting point for later years, which could, accordingly, post smaller deficits.

The Parliamentary Budget Officer (PBO) seems to be of this opinion, as well. In an analysis released April 19,[2] he indicates that "the Budget 2016 planning assumption for nominal GDP in 2016 and 2017 is excessive." Also,

Graph 1 It would take a record deficit in March to hit Finance Canada's projection for fiscal 2015 2016



Sources: Finance Canada and Desjardins, Economic Studies

"other factors include economic data that has exceeded expectations in the February survey of private sector economists and higher expected revenues from Crown corporations." According to the PBO's estimates, budgetary deficits could be much smaller than anticipated between 2015–2016 and 2020–2021. For example, the deficit for fiscal 2016–2017 could be just $20.5B, $8.9B less than projected by Finance Canada. Even if the difference declines slowly after that, the combined difference could be $28.5B by March 31, 2021, giving the federal government substantial leeway.

If we consider all of these factors, it is clear that the federal government could achieve budgetary balance by 2020–2021, a fact that eases many fears in this area. Moreover, we must not forget that the federal government has some other tools with which to confront potential difficulties and replenish the public purse, if needed.

Among other things, the government could reverse some of the tax relief provided in the last few years once economic conditions have improved enough. For example, the goods and services tax (GST) was lowered twice in the last few years, going from 7% to 6% on June 30, 2006, and from 6% to 5% on January 1, 2008. In a statement released in the fall of 2007, the federal government had put the cost of the cuts at nearly $15B a year. Reversing the cuts would put substantial funds in government coffers. Many analysts think that a potential sales tax increase would be the way to go, as it is more efficient than raising income tax.

The government could also opt to maintain somewhat of a deficit, even if doing so takes it further into debt. Note that the relative size of the federal government's debt, as shown by the debt-to-GDP ratio, has declined substantially in recent years (graph 2 on page 3). Thanks to the decrease, the debt load carried by Canadian public administrations compares favourably to that of most industrialized nations.

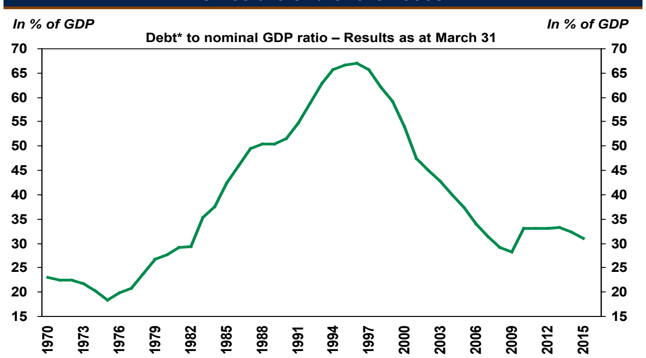
[2] Office of the Parliamentary Budget Officer, "Economic and Fiscal Outlook – April 2016", *Economy*, April 19, 2016, www.pbo-dpb.gc.ca/web/default/files/Documents/Reports/2016/EFO%20April%202016/EFO_April_2016_EN.pdf.

Table 1
Change in the federal government's budget balance since Budget 2015

In $B	2014–2015	2015–2016	2016–2017	2017–2018	2018–2019	2019–2020	2020–2021
Budget 2015							
Budget balance	**-2.0**	**1.4**	**1.7**	**2.6**	**2.6**	**4.8**	**n/a**
Plus: adjustment to projections for risk	*0.0*	*1.0*	*1.0*	*1.0*	*2.0*	*3.0*	*n/a*
Balance before adjustment	**-2.0**	**2.4**	**2.7**	**3.6**	**4.6**	**7.8**	**n/a**
Update – November 20, 2015							
Impact of the change in the economic and budget situation since Budget 2015	3.9	-5.4	-6.6	-6.1	-6.0	-6.1	n/a
Balance before adjustment	**1.9**	**-3.0**	**-3.9**	**-2.4**	**-1.4**	**1.7**	**6.6**
Information document – February 22, 2016							
Impact of the change in the economic situation since the November 20, 2015 update	0.0	1.5	-6.2	-5.0	-4.7	-5.3	-6.4
Impact of the measures in the February 22, 2016 information document	0.0	-0.8	-2.3	-2.1	-1.8	-1.4	-1.4
Minus: adjustment to projections for risk	*0.0*	*0.0*	*-6.0*	*-6.0*	*-6.0*	*-6.0*	*-6.0*
Budget balance	**1.9**	**-2.3**	**-18.4**	**-15.5**	**-13.9**	**-11.0**	**-7.2**
Plus: adjustment to projections for risk	*0.0*	*0.0*	*6.0*	*6.0*	*6.0*	*6.0*	*6.0*
Balance before adjustment	**1.9**	**-2.3**	**-12.4**	**-9.5**	**-7.9**	**-5.0**	**-1.2**
Budget 2016							
Impact of Budget 2016 measures	0.0	-3.1	-11.0	-13.5	-8.9	-6.7	-7.0
Minus: adjustment to projections for risk	*0.0*	*0.0*	*-6.0*	*-6.0*	*-6.0*	*-6.0*	*-6.0*
Budget balance	**1.9**	**-5.4**	**-29.4**	**-29.0**	**-22.8**	**-17.7**	**-14.3**
Plus: adjustment to projections for risk	*0.0*	*0.0*	*6.0*	*6.0*	*6.0*	*6.0*	*6.0*
Balance before adjustment	**1.9**	**-5.4**	**-23.4**	**-23.0**	**-16.8**	**-11.7**	**-8.3**

n/a: not available; Numbers may not add up to the total indicated due to rounding.
Sources: Finance Canada, Office of the Parliamentary Budget Officer and Desjardins, Economic Studies

Graph 2 Federal government debt has decreased substantially since the end of the 1990s



* Debt representing accumulated deficits.
Sources : Finance Canada and Desjardins, Economic Studies

Under these circumstances, Finance Canada has some leeway in terms of budget deficits and the debt load. Note that the nominal GDP growth expected over the years makes it possible for federal government debt to rise without leading to an erosion of the debt-to-GDP ratio. For example, based on Finance Canada's projections for nominal GDP and debt, a budget deficit of about $25B to $30B in 2020–2021 would still make it possible to maintain a debt-to-GDP ratio similar to the ratio recorded on March 31, 2015 (31.0%).

THE FEDERAL GOVERNMENT IS WELL EQUIPPED

All in all, it is clear that the federal government's financial situation is not worrisome, even if major budget deficits are planned until 2020–2021. For one thing, the deficits could be much smaller than expected thanks to slightly better economic conditions than initially forecast and, in particular, due to the substantial leeway yielded by great caution. For another, the federal government has some options for repairing public finances, if necessary.

Under these conditions, Finance Canada should not have too much difficulty coping with an eventual slowdown by economic growth. That being said, the government would have to keep including the possibility of a substantial global economic slowdown in upcoming budget planning exercises. We have, in the last few months, seen how much harm an erosion in economic conditions can do to the budget balance.

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