The 2018 Federal Budget

Federal Finance Minister Bill Morneau tabled his third budget today, the third chapter of the inclusive growth agenda.

Let us start by reviewing the 5-year fiscal outlook, essentially unchanged in comparison to the fall's fiscal update. The stronger-than-expected economic momentum increases excise taxes and duties. The ultra-low unemployment rate lowers EI benefits. Altogether, the budgetary balance improves by approximately $4B per year. The federal government will use this money to finance new initiatives strengthening the economic well-being of low-income workers, women and indigenous peoples. Consequently, deficits projected in the medium-term are virtually unchanged. The deficit for FY 2018-19 is projected at $18.1B compared to $18.6B last November. The path of the debt-to-GDP ratio remains intact, softly declining from 30.4% in FY 2017-18 to 28.4% in FY 2022-23.

The *Debt Management Strategy* contains valuable information for market participants. First, gross bond issuance is projected at $115B in FY 2018-19, a significant reduction in issuance size relative to the previous two years caused partly by lower financial requirements ($138B in FY 2017-18, $135B in FY 2016-17). Lower 2-yr, 3-yr and 5-yr benchmark sizes are expected; the number of 2-yr (16) and 3-yr (6) auctions are projected to stay the same, but the number of 5-year auctions is reduced (from 9 to 8). Benchmarks and auctions of 10-yr and 30-yr bonds are expected to stay the same. Ultra-long bond issuance appears less likely given the federal government's preference to have a higher stock of treasury bills. The stock of T-bills is projected to increase to a 3-year high of $138B in FY 2018-19. The objective is to support liquidity, following a lower-than-expected $125B in T-bills stock registered in FY 2017-18.

New fiscal measures: mostly promoting the equality + growth agenda

There are several new fiscal measures in this budget. The total cost of these measures, about $4B per year, is relatively small compared to program spending ($312B in FY 2018-19) and the size of the federal debt ($670B). Here are some of the new policies that caught our attention:

- Slower phase-out of the working income tax benefit, a sound policy that will allow low-income workers to receive more financial assistance while they work and earn more labour income. The Canada Revenue Agency will determine if an individual is eligible to receive the refundable tax credit since many miss out on claiming this benefit. This enhancement will cost $0.5B annually.
- Initiatives to improve the labour force participation of women and families. Notably, a new EI parental sharing benefit will allow parents to receive up to an additional five weeks of leave, making it easier for women to return to work sooner. The Province of Quebec, which already has its own program, will receive some form of financial compensation although the federal budget does not include details.
- Extension eligibility for the 15% mineral exploration tax credit for an additional year, to flow-through share agreements entered before the end of March 2019.
- Measures to limit tax deferral advantages on passive investment income earned in small private corporations. Notably, access to the lower small business tax rate will phase out gradually between $50K and $150K generated annually in passive investment income. More precisely, the small business deduction will be reduced by $5 for every $1 of passive investment income, effective for the taxation year 2018.

- The federal government plans to remove the legal tender status of some old bank notes no longer issued by the Bank of Canada ($25, $2, $1, etc.). The Bank of Canada will exchange them at their face value.
- The federal government proposes to undertake a review of the merits of open banking platforms, reflecting fintech developments.
- The federal government intends to modernize the Canada Deposit Insurance Corporation Act, following public consultations held since late 2016.
- Amounts dedicated to infrastructure investments are revised down by a cumulative $2.5B over the next five years, likely reflecting delays before some projects go underway. This implies a slightly smaller positive impact from public infrastructure investments on economic growth. The budget proposes to compensate with additional investments in the long run, beyond FY 2022-23.
- Creation of an advisory council on the implementation of universal prescription drugs program called National Pharmacare, which could ease financial pressures for Canadian provinces. No fiscal impact is included in the 5-year federal fiscal outlook.

Conclusion: Solid economic momentum today, uncertainty still surrounding the fiscal outlook

Benefitting from a strong economic momentum, Finance Minister Bill Morneau does not find it necessary at this stage to respond to Trump's tax reform. The gradual reduction of the small business tax rate announced last fall remains intact: 10.5% in 2017, 10% in 2018 and 9% in 2019 for the first $500K in corporate income, the lowest rate in the G7 countries. However, the budget does not provide further tax relief to the business community. The federal government prefers to see how NAFTA will evolve before assessing if additional tax relief will be necessary. Similar to the previous two budgets, this third act is oriented to improve the well-being of the middle class. The fiscal outlook presented today is very similar to last fall's fiscal update. However, an unfavorable new trade deal with the US post-NAFTA and a possible new round of spending initiatives in the 2019 federal budget could alter the fiscal outlook.

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