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A Sleepy Budget for Busy Times

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No one thought that Canada's 2017 budget would match the punch of the 2016 edition given that the latter was the product of a newly minted Liberal government looking to put its mark on fiscal policy after a decade in the wilderness. Still, the 2017 budget is surprising in how little it delivers.

Few big changes

Budget 2017 appears to be one of the sleepier in recent memory. The largest speculated changes simply were not delivered:

- The expected headliner – innovation – saw only small measures deployed.
- The capital gains tax rate failed to rise – perhaps the most important good news for investors.
- More generally, after a brutal 2016 budget, wealthy Canadians were left mostly alone.
- There was little that addressed the new U.S. policy landscape or how to counter the threat of protectionism.
- There were no major measures to cool the country's hottest housing markets.
- There was no effort to increase Canada's military spending to meet NATO commitments.
- The government's infrastructure commitment remains unchanged at $81 billion over eleven years.

Some smaller actions

Of course, the budget was not completely devoid of action. A number of small- and medium-sized measures were undertaken.

On the government revenue side, employment insurance premiums will now rise by 3% on every dollar earned. Existing sin taxes will also be raised on tobacco and alcohol, and Uber rides will be taxed. The public transit tax credit has also been eliminated.

On the spending side, the government announced a net total of $4.4 billion of additional spending over the next six years – a distinctly restrained performance when compared to the largesse of the 2016 budget. However, because of prior commitments, government spending is still set to grow by a large 5% over the next year – materially faster than the underlying rate of economic growth or the pace of revenue growth. As a result, the federal deficit will now top $28 billion in 2017-18, higher than previously forecast. The increase isn't quite as large as it first looks given the reintroduction of a $3 billion "cushion" into the forecast, but it is still there.

Innovation got a small nod in the form of a few programs worth several hundred million dollars each, focused on creating economic "superclusters" and a new venture capital fund. But, for perspective, the federal government already spends $23 billion per year on innovation and skills training and so the addition is a mere drop in the bucket. For that matter, Canada's productivity woes are largely a function of a global productivity malaise, as opposed to a particular failure of Canadian public policy.

One subject that did receive a fair amount of attention was the family. Most notably, parental leave has been extended from 12 months to 18 months for new parents, though the benefits become stingier over the final six months. It will also be slightly cheaper to secure foreign nannies. Other efforts included $7 billion spread over eleven years for early learning and child care, and $11 billion over the same time frame for a national housing strategy. But to put these into perspective, each represents less than 0.25% of the overall government outlays that will occur over the relevant period. The childcare measures are intended to add 40,000 daycare slots – a welcome proposition though fairly small relative to the four million Canadian children under the age of ten. An effort to tame or otherwise improve Canada's housing market is also welcome, though the amount committed represents just 0.4% of the value of the Canadian housing stock. Statistics Canada has also been tasked with tracking the drivers of the Canadian housing market more closely.

In the realm of high finance, derivatives in Canada will now have to be marked to market – in other words, updated for their underlying value on a regular basis. Also, oil and gas companies will experience a slightly less favourable tax environment as exploration costs can no longer be fully deducted.

Fiscal shift

Although the deficit is set to be somewhat larger over the next year, the overall trajectory is for a very similar profile over the next six years. Technically, the cumulative deficit is now expected to be slightly smaller, but the change is trivial.

If projections are taken at face value, Canada does not have a federal debt problem despite deficits set to persist indefinitely into the future. The deficit as a share of GDP is barely more than 1% and the all-important debt-to-GDP ratio – a rough-hewn measure of debt sustainability – is low and set to decline slightly over the next few years as economic growth outpaces debt growth. Moreover, recall that deficits are not necessarily an evil when deployed on things like high-return infrastructure spending at a time of economic slack and low borrowing costs.

However, there is a risk of slippage in these forecasts:

- Recall that the Liberal government initially campaigned on a mere $10 billion deficit eighteen months ago whereas this now sits at $28 billion today.
- We also suspect their economic outlook may also be a bit too rosy – ours is somewhat dimmer given the threat of U.S. protectionism and a potentially wobbly housing market.
- Lastly, the spending profile assumes that the current trend of substantial increases will be tamed in subsequent years. This is certainly possible, but it may be hard to resist adding additional goodies as times passes.

Canada's sparkling AAA-rated debt rating seems safe for now, but if economic growth underperforms or program spending continues to bounce higher, the situation could become more precarious.

Economic implications

With this budget in hand, we maintain our assumption that the Canadian economy will grow about 0.5 percentage points faster than otherwise due to fiscal stimulus. This boost comes largely in the form of infrastructure spending, though that money has struggled to make its way out the door so far. Despite this, we only look for 1.5% GDP growth in both 2017 and 2018.

At the margin, efforts to increase access to child care could raise the labour force participation rate, though this is unlikely to be a large economic driver.

A key competitiveness risk for the Canadian economy remains the extent to which taxation and environmental wedges are opening up relative to the U.S. Canadian taxes rose last year and environmental rules have tightened. The U.S. seems set to push in the opposite direction under President Trump.

Financial market implications

How will financial markets take these changes?

The stock market will likely be pleased that the capital gains tax rate did not rise, and so may manage a mild rally. To the extent that the amount of fiscal stimulus isn't much different than before, the earnings outlook and central bank outlook are little altered.

Without a big change in central bank expectations or in the public debt trajectory, bond yields are unlikely to respond.

Finally, from a currency perspective, a slight rally is conceivable given the elimination of the capital gains tax increase and the positive implications this may have for prospective Canadian investors.

But let us not forget the main message of this budget: very little of substance has changed. There's nothing whatsoever wrong with that – change for its own sake is rarely advisable – but it does mean that the economic and market outlook will largely continue along their pre-budget trajectory.