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CANADA

Economic and Fiscal Outlook Update 2014

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The mandate of the Parliamentary Budget Officer (PBO) is to provide independent analysis to Parliament on the state of the nation's finances, the government's estimates and trends in the Canadian economy; and upon request from a committee or parliamentarian, to estimate the financial cost of any proposal for matters over which Parliament has jurisdiction.

This report fulfils the September 29, 2011 Standing Committee on Finance motion that the PBO provide an economic and fiscal outlook to the Committee the fourth week of October and April of every calendar year. It provides PBO's economic and budgetary projections based on data up to and including September 30, 2014.

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The authors thank Mostafa Askari, Jason Jacques, Tim Scholz, and Duncan MacDonald for comments. Any errors or omissions are the responsibility of the authors. Please contact Mostafa Askari (email: mostafa.askari@parl.gc.ca) for further information.

Summary

Real GDP (gross domestic product) in Canada grew at 3.2 per cent in the second quarter of 2014. This was stronger than expected in the April 2014 EFO (Economic and Fiscal Outlook). This, together with an increase in projected external demand as a result of improvements in U.S. economic conditions, has led PBO to revise its projection of real GDP growth upward in 2014 to 2.3 per cent (Table S-1). Growth in Canada is expected to be roughly the same as in the April EFO over the medium-term.

Table S-1: Real GDP growth

%

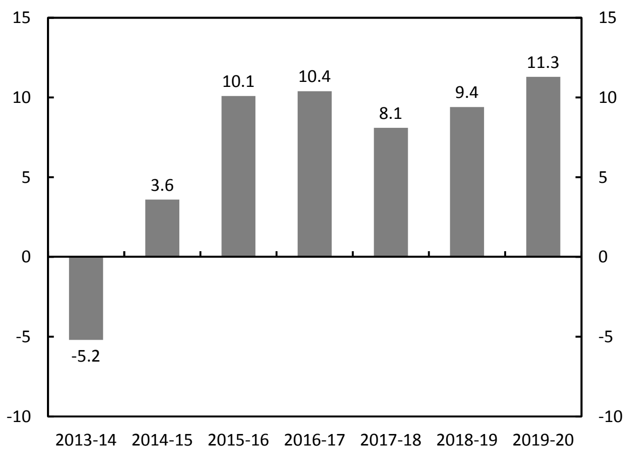
	2014	2015	2016	2017	2018	2019
October 2014	2.3	2.7	2.5	2.0	1.7	1.5
April 2014	2.1	2.7	2.5	1.9	1.5	-

Source: Parliamentary Budget Officer.

PBO forecasts that the budget will return to surplus in 2014-15 and remain in surplus over the medium term outlook (Figure-S-1).

Figure S-1: Projected budgetary balance

$ billions



Source: Parliamentary Budget Officer.

Surpluses are expected to reach as high as $11.3 billion. However, much of the projected fiscal room is a result of the economy growing faster than its potential, as well as the temporary effects of the EI premium rate freeze, planned asset sales, and adjustments to direct program expenses (Table S-2).

Policymakers should be wary of using surpluses to implement permanent tax relief or spending initiatives if they wish to avoid returning to deficits as economic growth subsides.

Table S-2: Temporary budget contributions

$ billions

	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020
Budgetary balance	3.6	10.1	10.4	8.1	9.4	11.3
Less:						
Asset sales	0.5	1.5	-	-	-	-
EI freeze	0.7	2.7	3.2	-0.9	-0.8	-0.7
DPE adjustments	2.7	2.5	2.3	1.0	0.9	-
Economic cycle	-4.2	0.7	4.9	6.9	7.5	7.7
Permanent policy room	3.9	2.7	0.0	1.1	1.8	4.3

Source: Parlimentary Budget Officer, Finance Canada.
Note: DPE adjustments include changes to defence capital funding and the accrual of changes to the public services health care plan.

Although operating budget room is limited, there is policy space under current economic conditions to increase capital spending over the outlook while maintaining a balanced budget and achieving the government's 25 per cent debt-to-GDP target in 2021. As suggested by recent research in the IMF's *World Economic Outlook*, if this spending goes toward public infrastructure investment, there is potentially even more policy room available as a result of associated medium- and long-term economic and fiscal benefits.

Finally, if the government takes a longer term perspective, there is policy room to permanently increase spending or reduce the tax burden by 1.4 per cent of GDP ($28.2 billion in 2014-15) while maintaining the stability of public debt over a 75-year horizon. This would involve sustained deficit financing, capital spending, or both. Borrowing could then be repaid as the demographic pressure of population ageing falls after 2033.

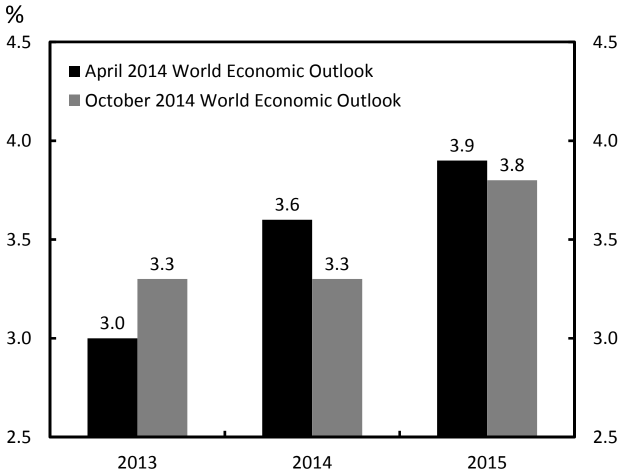
PBO's forecast is a balanced-risk outlook and is not adjusted to provide a fiscal cushion. However, in the past two years there have been unforeseeable year-end adjustments resulting in average budgetary improvements of $5.9 billion. A surprise of this size in 2014-15 could move the expected $3.6 billion surplus into a much larger surplus position. It would be good practice if policymakers commit in advance to the allocation of potential surpluses between debt reduction, tax reductions, or spending increases.

1 UPDATE OF ECONOMIC PROJECTIONS

Weaker external outlook

Global economic growth in the first half of 2014 has been weaker than expected in the April 2014 Economic and Fiscal Outlook (EFO).[1] The International Monetary Fund (IMF) recently revised global growth downward for 2014 and 2015 in their *World Economic Outlook* (WEO) to reflect weaker global output in the first half of the year (Figure 1-1).

Figure 1-1: Global growth



Source: IMF World Economic Outlook.

The IMF indicates that the global economy is nonetheless expected to rebound in the coming quarters. The pickup in growth is expected to come from both advanced economies and emerging markets. For the former, the United States will play a leading role as economic conditions are expected to improve. For the latter, growth in emerging markets is expected to increase due to stronger domestic demand and recovery in external demand as growth in advanced economies strengthens.

The IMF believes that downside risks have increased since the spring, with heightened geopolitical risk due to conflicts in the Middle East and tensions around Russia and Ukraine. Other downside risks include the reestablishment of normal monetary policy conditions in the U.S., the risk of deflation in the euro zone, as well as lower than projected potential output growth in advanced and emerging economies.

For the U.S. economy, PBO has revised down its outlook for U.S. real GDP growth in 2014 from 2.7 to 2.2 per cent relative to the April EFO due to a sharper than expected contraction in the first quarter.

U.S. real GDP declined 2.1 per cent in the first quarter of 2014 as the severe winter weather dampened demand. Since the first quarter's weakness was largely due to temporary factors, economic activity rebounded in the second quarter, with real GDP growth reaching 4.6 per cent. The employment rate increased from 58.8 per cent in January to 59.0 in August. As the U.S. economic fundamentals continue to improve, PBO expects that real GDP growth in the U.S. will return to levels projected in the April 2014 EFO in 2015 and beyond.

PBO's projection of commodity prices has been revised downward relative to the April 2014 EFO largely due to a weaker projection for the Bank of Canada energy commodity price index.[2] Energy prices are expected to fall as indicated by futures prices. Particularly, futures prices for crude oil have dropped relative to the April 2014 EFO, reflecting a global excess supply of oil (Figure 1-2).

According to the Organization of the Petroleum Exporting Countries (OPEC), an agreement to open ports in Libya to increase export of crude oil put downward pressure on crude oil prices while low refinery runs and concerns for global economic growth have dampened demand.[3] Given this, PBO assumes the Bank of Canada energy commodity price index will decline by an average annualized rate of 1.7 per cent from the third quarter of 2014 to the fourth quarter of 2019.

In contrast, futures prices suggest that the Bank of Canada non-energy price index (BCPIXE) is projected to be slightly higher than the April 2014 EFO projection. PBO assumes that the BCPIXE will

[1] See PBO (2014a) available at http://www.pbo-dpb.gc.ca/files/files/EFO2014_EN.pdf

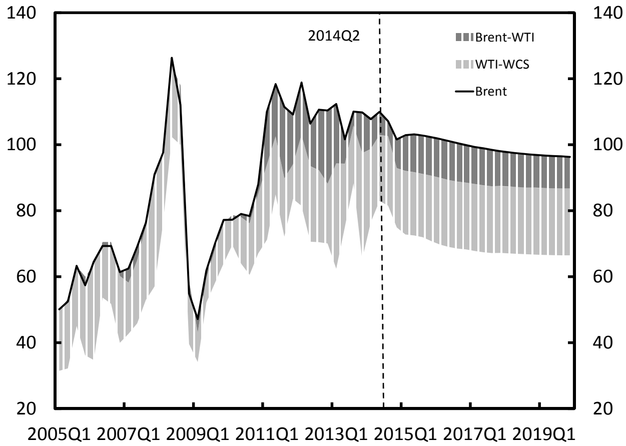
[2] Futures prices for commodities underlying the Bank of Canada commodity price index were collected from August 29th and September 12th, 2014.

[3] http://www.opec.org/opec_web/static_files_project/media/downloads/publications/MOMR_September_2014.pdf, p.7

increase by an average annualized rate of 1.8 per cent from the third quarter of 2014 to the fourth quarter of 2019.[4]

Figure 1-2: Crude Oil Historic and Futures Prices

U.S. dollars per barrel



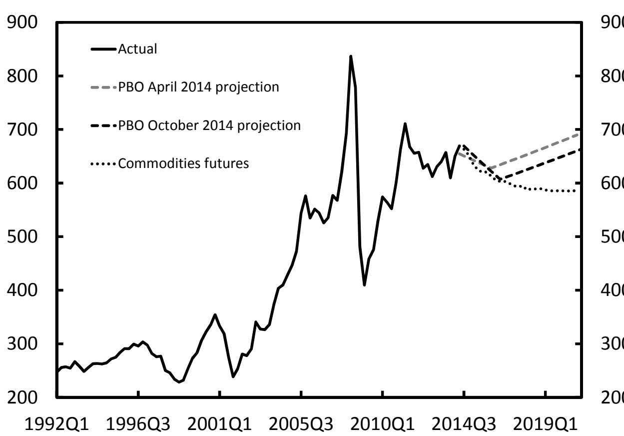
Sources: Parliamentary Budget Officer, Baytex Energy Corp, CME Group, Bloomberg L.P.

Note: WTI refers to West Texas Intermediate and WCS refers to Western Canadian Select.

Overall, as a result of the weaker outlook for energy commodity prices, PBO's projection of the Bank of Canada commodity price index is lower relative to April 2014 EFO (Figure 1-3).

Figure 1-3: Commodity price outlook

index, 1972 = 100



Sources: Parliamentary Budget Officer, Bank of Canada, Bloomberg L.P.

[4] Annex A of the April 2013 EFO provides a detailed description of PBO's approach to projecting the Bank of Canada's energy commodity price index. A similar approach is applied to the Bank of Canada's non-energy commodity price index.

Stable Canadian economic outlook

Like the U.S., the Canadian economy had a weak start to the year with real GDP growth of 0.9 per cent in the first quarter of 2014. However, real GDP in Canada grew at 3.2 per cent in the second quarter of 2014, which was stronger than PBO's projection in the April 2014 EFO. Therefore, PBO has revised the projected growth of real GDP in 2014 upward to 2.3 per cent, compared to 2.1 per cent in the April 2014 EFO (Table 1-1).

Table 1-1: Real GDP growth

%

	2014	2015	2016	2017	2018	2019
October 2014	2.3	2.7	2.5	2.0	1.7	1.5
April 2014	2.1	2.7	2.5	1.9	1.5	-

Source: Parliamentary Budget Officer.

PBO expects the Bank of Canada to maintain its policy interest rate at 1 per cent until the second quarter of 2015.

Long-term interest rates have fallen since the first quarter of 2014, which forms a lower starting point for the interest rate projection relative to the April 2014 EFO (Table 1-2). Given the recent drop in long-term interest rates, PBO judges that the future increase in interest rates will be more gradual than expected in the April 2014 EFO.

Consequently, the PBO revised long-term interest rates downward relative to the April 2014 EFO. Combined with the weaker outlook for commodity prices, this places downward pressure on the U.S.-Canada exchange rate.

Table 1-2: 10-year government bond interest rates

%

	2014	2015	2016	2017	2018	2019
October 2014	2.3	2.7	3.4	4.2	4.9	5.3
April 2014	2.7	3.6	4.4	5.1	5.3	-

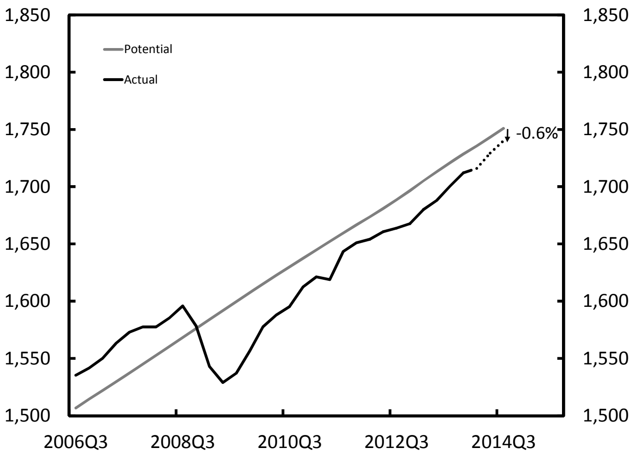
Source: Parliamentary Budget Officer.

Going forward, improved U.S. economic conditions are expected to lead to stronger demand for Canadian exports. The upward revision in economic growth in 2014 pushes the economy closer to potential (Figure 1-4) and inflation closer to the 2 per cent target. Although weakness in employment and commodity prices could potentially act as drag to economic growth going forward, PBO expects the

Canadian economy to grow at roughly the same rate as predicted in the April 2014 EFO after 2014, averaging 2.1 per cent over the 2015-2019 period.

Figure 1-4: Real and Potential GDP

billions of chained (2007) dollars

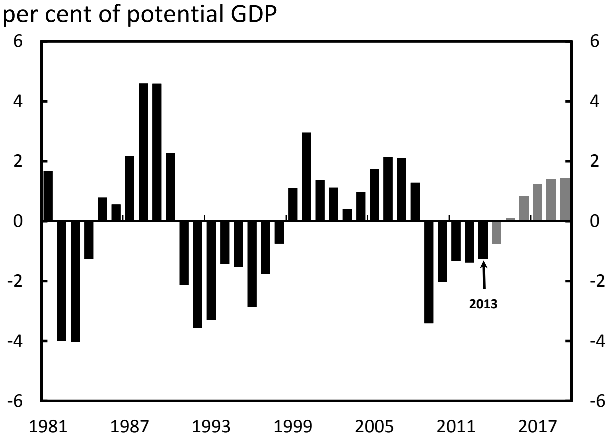


Source: Parliamentary Budget Officer, Statistics Canada.

As a result, the level of real GDP returns to its potential level and the output gap closes by the third quarter of 2015 (Figure 1-5).

Figure 1-5: Output gap

per cent of potential GDP



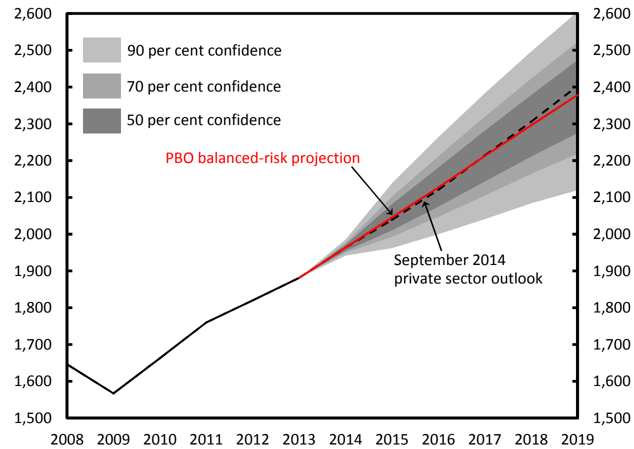
Sources: Parliamentary Budget Officer, Statistics Canada.

For nominal GDP, the broadest measure of the government's tax base, PBO's forecast is higher than the average private sector forecast from 2014 to 2016. Beyond 2016, PBO's forecast of nominal GDP is lower than that of the private sector.

To illustrate the uncertainty and balance of risks to the private sector projection of nominal GDP, PBO constructs a fan chart based on the historical forecast performance of the average forecasts from Finance Canada's survey of private sector economists (Figure 1-6). This shows that the risk to the private sector nominal GDP forecast is roughly balanced.

Figure 1-6: Nominal GDP Projections

$ billions



Sources: Parliamentary Budget Officer, Finance Canada, Statistics Canada.

2 UPDATED FEDERAL FISCAL OUTLOOK

PBO's fiscal outlook reflects the latest economic projections, as well as the latest fiscal data from the Annual Financial Report and the national accounts. The outlook is also adjusted for the fiscal impact of policy measures announced since EFO 2014.

Positive surprise in 2013-14 year-end results

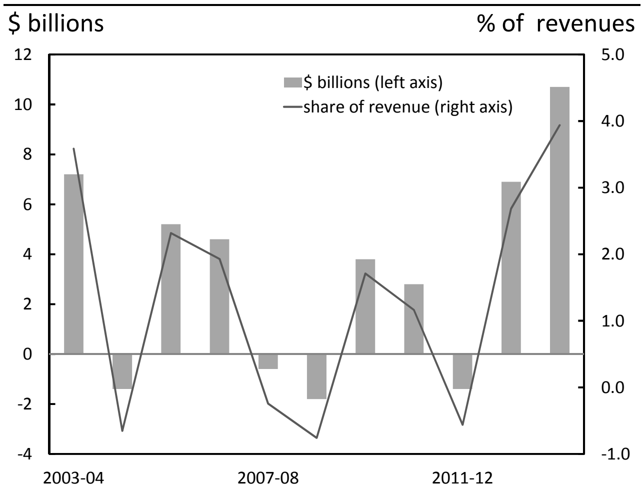
The budget deficit in 2013-14 was $5.2 billion.[5] This is $10.7 billion lower than the government's forecast in Budget 2014 and $5.7 billion lower than PBO's forecast in EFO 2014.[6]

This unanticipated improvement is the largest since the introduction of accrual accounting, both in nominal terms and as a share of revenues (Figure 2-1).

[5]Reported in Finance Canada's latest Annual Financial Report, available at: http://www.fin.gc.ca/purl/afr-eng.asp.

[6] Expenses forecast by Finance Canada in Budget 2014 and PBO in EFO 2014 must be adjusted for a change in the accounting treatment of government bond buybacks, which reduced public debt charges in 2013-14 by $0.7 billion.

Figure 2-1: Unanticipated budget improvements



Source: Annual Financial Reports of the Government of Canada.
Note: The unanticipated improvement is calculated relative to the Budget forecast preceding the release of the Public Accounts of Canada.

A breakdown of the improvement is given in Table 2-1. Unexpected one-time adjustments explain some of the difference between PBO's forecast and the outcome. One-time adjustments include a reduction in the estimated liability for disaster financial assistance resulting from the Alberta flood and higher revenues arising from tax assessments. Other improvements are a result of ongoing items of uncertainty that PBO identified in April, such as continued overestimation of departmental spending in the planning framework. This is discussed further in Box 1.

Announcement of new measures

On September 11, 2014 the government announced the new Small Business Job Credit. On October 10, 2014 the government announced that the Children's Fitness Tax Credit will be doubled and made refundable. The expected impact of new measures is given in Table 2-2.

The Small Business Job Credit was announced at a cost of $550 million over calendar years 2015 and 2016. This reduces revenues over the first three fiscal years of the outlook, but increases revenues in 2017-18 and beyond, as the EI premium break-even rate is increased to cover the losses incurred in the EI Operating Account to fund the credit. The Small Business Tax Credit is assessed in greater detail in PBO (2014b).

The Children's Fitness Tax Credit was announced at a cost of between $25 and $35 million per year over the outlook.

Together, measures announced since Budget 2014 have only a small fiscal impact in 2015-16 and 2016-17, and a negligible impact going forward.

Box 1: The problem with prudency

Positive forecast errors are partly a result of transparent risk adjustments to protect the public finances against unexpected economic and fiscal underperformance relative to expectations. These prudency assumptions are described in the budget papers and are part of a responsible fiscal planning framework.

However, federal budget forecasts demonstrate a consistent and substantial prudency bias beyond these risk adjustments. This mostly affects revenues and direct program expenses.

Cautious fiscal assumptions in excess of transparent risk adjustments could result in a large unforeseen surplus in 2014-15. PBO has two concerns with the result of these additional prudency assumptions:

- The allocation of year-end surprises is not subject to normal scrutiny by Parliament.
- Overly conservative planning assumptions limit the range of available measures that parliamentarians can consider when setting the course of fiscal policy.

To limit the impact of these concerns, it would be good practice if policymakers commit in advance to the allocation of potential surpluses between debt reduction, tax reductions, or spending increases.

Parliamentarians may also wish to review whether more balanced fiscal assumptions would provide a more useful forecast for planning the path of fiscal policy.

Table 2-1: Unanticipated 2013-14 budget improvements

$ billions

		Finance Canada	PBO
Deficit forecast (restated)		15.9	10.9
Deficit (Annual financial report)		5.2	5.2
Improvement		10.7	5.7
Less:			
Risk adjustment		1.5	-
Unanticipated improvement		9.2	5.7
Of which:			
Lower Alberta flood assistance	1.2		
DPE planning assumption	1.6		
Non-recurring tax assessments	1.0		
		3.8	3.8
Residual forecast error (mainly higher than expected revenues)		5.4	1.9

Sources: Budget 2014, EFO 2014, Annual Financial Report.
Notes: Deficit forecasts have been restated for the revised accounting treatment of government bond buy-backs. This change reduced public debt charges by $0.7 billion in 2013-14.

Table 2-2: Fiscal impact of announced measures

$ billions

	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020
Small Business Job Credit	-70	-275	-170	150	120	75
Children's Fitness tax Credit	-25	-35	-35	-35	-35	-35
Total	-95	-310	-205	115	85	40

Source: Finance Canada; Parliamentary Budget Officer.

Larger surpluses over the medium-term

PBO forecasts that the budget will return to surplus in 2014-15 and will remain in balance for the remainder of the outlook. For 2015-16 and beyond, there will be an average annual surplus of roughly $10 billion to be allocated to debt repayment, tax reductions, or spending increases. A summary of PBO's budget outlook is given in Table 2-3. A detailed fiscal outlook is provided in Annex B and Annex C.

Table 2-3: Budgetary balance outlook

$ billions

	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020
October 2014	3.6	10.1	10.4	8.1	9.4	11.3
April 2014	-0.5	7.8	9.1	7.5	9.1	-

Source: Parliamentary Budget Officer.

Budgetary revenues have been revised upward slightly over 2014-15 to 2016-17, and downward beyond 2017-18 (Table 2-4). Corporate income taxes are expected to be higher as a result of higher than expected receipts in 2013-14 and a stronger corporate profits tax base projection.

Table 2-4: Changes to the outlook for revenues

$ billions

	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
Income taxes					
Personal income tax	0.3	-0.1	-0.9	-1.2	-1.0
Corporate income tax	3.2	2.2	1.6	1.2	1.4
Non-residents income tax	0.1	-0.1	-0.4	-0.3	-0.3
Total	3.5	2.1	0.4	-0.2	0.1
Excise taxes/duties					
Goods and Services Tax	0.1	-0.1	-0.1	0.0	0.2
Customs import duties	0.0	-0.1	-0.1	0.0	0.0
Other excise taxes/duties	0.0	0.0	0.0	0.0	0.0
Total excise taxes/duties	0.1	-0.2	-0.1	0.0	0.3
EI premium revenues	-0.1	0.0	-0.2	0.0	0.0
Other revenues	0.8	0.2	-0.1	-0.5	-0.8
Total budgetary revenues	4.3	2.1	0.0	-0.7	-0.5

Source: Parliamentary Budget Officer.

Several one-time factors led to higher other revenues in 2013-14.[7] These included gains on the sale of General Motors shares ($0.7 billion), higher than usual tax re-assessment revenues ($1.5 billion), and unexpected foreign exchange gains ($0.5 billion). These are not expected to affect future years of the outlook. Going forward, government revenues generated from Crown Corporations are estimated to grow more slowly than in recent years, leading to a slight decrease in the outlook relative to the April 2014 EFO.[8]

Program expenses are roughly unchanged since EFO 2014, with the exception of elderly benefits (Table 2-5). The forecast for spending on elderly benefits is higher compared to the April 2014 EFO as a result of Statistics Canada's latest population projection, which shows an older population than assumed in the April 2014 EFO. Average benefit payments are also expected to be higher as a result of higher expected CPI inflation relative to the April outlook.

[7] Other revenues consist of income from Federal Crown corporations (45 per cent); sales of government goods and services (30 per cent); and interest, penalties, and exchange rate gains (25 per cent).

[8] This revision is a result of a review of Crown Corporations' Corporate Plan Summaries tabled in Parliament in 2013 and 2014.

Table 2-5: Changes to the outlook for expenses

$ billions

	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
Major transfers to persons					
Elderly benefits	0.4	0.4	0.5	0.6	0.5
EI benefits	-0.4	-0.6	0.0	0.1	0.1
Children's benefits	0.0	0.0	0.0	0.0	0.0
Total	0.0	-0.2	0.5	0.7	0.6
Transfers to other levels of government	0.1	0.2	0.3	0.4	0.3
Direct program expenses	0.1	0.1	0.1	0.1	0.1
Public debt charges	0.0	-0.3	-2.2	-2.6	-1.9
Total expenses	0.2	-0.2	-1.4	-1.4	-0.8

Source: Parliamentary Budget Officer.

Employment Insurance benefits are projected to increase at a slower rate than forecast in the April 2014 EFO. The projection of beneficiaries was revised downward again, as a result of persistently low coverage of unemployed workers (See PBO 2014b).

PBO uses Finance Canada's Budget 2014 outlook for direct program expenses, adjusted for subsequent spending commitments. This has remained relatively unchanged since April. Overly prudent forecasts for direct program expenses remain a significant area of uncertainty in PBO's projection of the budgetary balance.

Public debt charges are projected to be lower as a result of lower forecast medium-term real interest rates relative to the April 2014 EFO.

PBO has updated our forecast of the **EI Operating Account** with the latest information in the Annual Financial Report and Statistics Canada surveys. This estimate has been updated from the estimate that appeared in PBO's October 2014 report *Response on the financing of Employment Insurance and recent measures* (PBO 2014b).[9]

PBO's latest projection of the breakeven rate is given in Table 2-6. The forecast breakeven rate for 2015 is lower than PBO (2014b) as a result of lower monthly unemployment and the latest public accounts information for 2013-14 outcomes.

Table 2-6: Latest breakeven rates

dollars per $100 of insurable earnings

	2015	2016	2017	2018	2019
Budget 2014	1.88	1.88	1.47	1.47	-
Breakeven (PBO)	1.71	1.59	1.58	1.58	1.58
Difference	0.17	0.29	- 0.11	- 0.11	na

Sources: Parliamentary Budget Officer, Budget 2014.

PBO's projection of the EI Operating Account is given in Table 2-7. As a result of the rate freeze in 2015 and 2016, the EI Operating Account will need to run an annual deficit in 2017, 2018, and 2019, and possibly beyond, to eliminate the surplus that will accumulate.

Table 2-7: EI Operating Account

$ billions

	2014	2015	2016	2017	2018	2019
Annual balance	3.7	3.4	3.5	-1.5	-0.5	-0.3
Cumulative balance	-1.3	2.1	5.6	4.1	3.6	3.3

Sources: Parliamentary Budget Officer.

Fiscal implications of economic uncertainty

To estimate the sensitivity of the outlook to economic uncertainty, PBO constructs a probability distribution around its budgetary balance projection. The probability distribution is estimated using the historical errors of the average private sector forecast, an assessment of the balance of risks to the average private sector forecast in Budget 2014, and the sensitivity of budgetary revenues and expenses to economic shocks published by Finance Canada.[10]

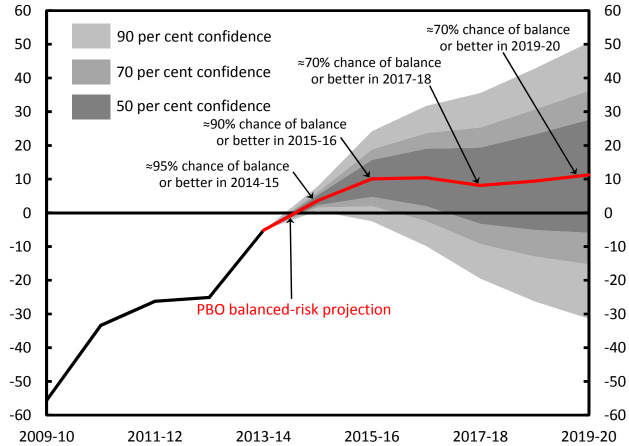
PBO estimates that the likelihood of realizing a balanced budget or better is approximately 95 per cent in 2014-15. This drops to 70 per cent in 2017-18 with the removal of temporary measures and increased economic uncertainty as the forecast moves to outer years (Figure 2-2).

[9] See www.pbo-dpb.gc.ca/files/files/EI_response_EN.pdf.

[10] See Budget 2014, p. 287.

Figure 2-2: Budgetary balance outcomes given economic uncertainty

$ billions



Sources: Parliamentary Budget Officer; Finance Canada.

Adjusting the surplus for the economic cycle

The budgetary surpluses projected over the outlook are a result of both structural factors (tax policy being fundamentally sufficient to cover a given level of spending when the economy is growing at trend) and cyclical factors (revenues are high as a result of the economy growing faster than trend). Structural surpluses are permanent (barring any changes to tax policy), while cyclical surpluses are transitory and will fall when the economy returns to trend.

This distinction is particularly important when planning to use the projected fiscal room to fund new program spending or tax reductions. If policy is funded out of cyclical surpluses, there is a risk that deficits could return when economic growth returns to its potential.

PBO estimates that the Government's structural budgetary balance will improve from a deficit of $2.8 billion in 2013-14 to a surplus of $7.8 billion in 2014-15 (Table 2-8), and to remain in surplus thereafter. The structural surplus falls in 2017-18 when the EI premium rate is reduced to the 7-year breakeven rate.

Table 2-8: Updated structural balance

$ billions

	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020
Budget balance	-5.2	3.6	10.1	10.4	8.1	9.4	11.3
Structural balance	-2.8	7.8	9.4	5.5	1.2	1.9	3.6

Source: Parliamentary Budget Officer.

Operating room for new policy measures

The improvement in the Government's budgetary balance from 2013-14 to 2016-17 is mainly the result of temporary factors (Table 2-9). As the budget contributions from the EI premium rate freeze and planned assets sales come to an end and constraints on operating budgets are relaxed in 2016-17 and beyond, both the structural balance and budgetary balance are expected to stabilize.

Although there will be minor growth in fiscal room beyond 2019-20 as a result of bracket creep and certain transfers such as CST and the Gas Tax Fund being indexed below the rate of nominal GDP growth,[11] future public spending plans cannot count on the significant growth in fiscal room that has been the experience following Economic Action Plan stimulus spending and the subsequent fiscal consolidation.

Table 2-9: Temporary budget contributions

%

	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020
Budgetary balance	3.6	10.1	10.4	8.1	9.4	11.3
Less:						
Asset sales	0.5	1.5	-	-	-	-
EI freeze	0.7	2.7	3.2	-0.9	-0.8	-0.7
DPE adjustments	2.7	2.5	2.3	1.0	0.9	
Economic cycle	-4.3	0.7	4.8	6.9	7.6	7.7
Permanent policy room	3.9	2.7	0.1	1.3	1.7	4.3

Source: Parliamentary Budget Officer.
Note: DPE adjustments include changes to defence capital funding and changes to the Public Service Health Care Plan.

PBO has, however, identified two significant areas of uncertainty in the budgetary outlook that could contribute to higher fiscal room in the future.

[11] The structural growth in tax revenues as a result of bracket creep is the result of thresholds, credits, and deductions not being fully indexed to real income growth and inflation.

First, rates on government bonds are at a historical low. The Bank of Canada's policy rate has been held constant at 1 per cent for 16 quarters. Increasingly, researchers are arriving at the possibility that rates could be lower for longer.[12] A more permanent low-interest rate environment could create fiscal room for new policy measures by reducing public debt charges, already at a historic low as a share of revenue.

Second, the 2013-14 Annual Financial Report shows that departments once again underspent by more than was assumed in Budget 2014.

If the trends of low interest rates and overestimated direct program expenses continue, there could be extra fiscal room over the budget outlook.

Balance sheet room for new policy measures

While policy room in the operating budget is limited, it can be leveraged through measures that expand the government's balance sheet with capital spending. Capital spending, for example federal investment in public infrastructure, can be an important tool of public policy in supporting economic growth, which in turn improves future fiscal outcomes.

The government is projected to achieve its federal debt target of 25 per cent of GDP in 2021 with a comfortable margin. There is considerable room for increasing capital spending while achieving both the government's debt target and budget surpluses over the medium term.

To illustrate this point we consider a case where the government decides to undertake further capital investment (Table 2-10). The government's federal debt target is defined in terms of the *accumulated deficit*. The accumulated deficit definition of debt offsets any liabilities incurred to finance capital investment with the value of the assets acquired. Therefore, any amount of higher capital spending would only affect the government's debt target by the amount it increases annual capital amortization expenses (the cost of the capital investment divided across its useful life) and interest charges.

[12] See, for example, Mendes (2014).

PBO estimates that the government has fiscal room for one-time capital investment of $50 billion in 2015-16, or $10 billion annually over the medium-term. This investment can be undertaken while still achieving balanced budgets and achieving the government's 25 per cent debt-to-GDP ratio target in 2021.

Table 2-10: Fiscal room in the Financial Position

$ billions, unless noted

	2015-2016	2017-2018	2019-2020
Initial budgetary balance	10.1	8.1	11.3
Federal debt-to-GDP (%)	30.9	26.2	23.6
Capital acquisition ($b)	50.0	-	-
Resulting budgetary balance	6.0	2.2	4.1
Federal debt-to-GDP (%)	30.6	28.0	25.4

Source: Parliamentary Budget Officer.
Note: Annual amortization expenses are calculated by using the average depreciation rate for federal tangible capital assets.

Research in the IMF's October 2014 World Economic Outlook 2014 showed that debt-financed public investment in advanced countries can significantly contribute to expanding economic output in both the medium and long term. The IMF's research also showed that under current economic conditions and borrowing rates, this spending can result in a net improvement in the budgetary balance.[13] The actual fiscal room available is likely to be much larger than presented above when these factors are considered.

Fiscal sustainability and policy room

The fiscal policy room is even greater if a longer horizon is considered in a debt sustainability framework. In PBO's annual Fiscal Sustainability Report, we estimate an alternative measure of fiscal capacity that examines policy in terms of its long-run impact on the path of public debt calculated over 75-years.[14]

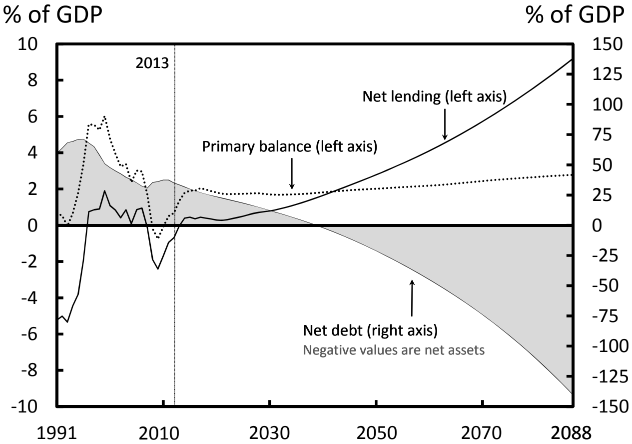
PBO projects that under current policy the federal government's net debt will decline over the long-term, reaching a net asset position in 2040 (Figure 2-3). If the government instead chooses to maintain debt at existing levels, it could introduce

[13] The IMF's research shows that a 1 per cent increase in debt-financed public infrastructure investment can lead to a 3 per cent *decrease* in a country's debt-to-GDP ratio.

[14] See PBO (2014c), available at: http://www.pbo-dpb.gc.ca/files/files/FSR_2014.pdf.

new programs, expand existing programs, or reduce taxes permanently by 1.4 per cent of GDP ($28.2 billion in 2014). This would require net borrowing over the medium-term, which could be accomplished with operating deficits, balance sheet expansion, or a combination of both. This borrowing would be repaid when the fiscal impact of the demographic pressures of population ageing falls after 2033.

Figure 2-3: Federal long-term debt outlook



Sources: Parliamentary Budget Officer; Statistics Canada.

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Annex A

Detailed economic outlook

	2014	2015	2016	2017	2018	2019
Real GDP growth (%)						
October 2014 EFOU	2.3	2.7	2.5	2.0	1.7	1.5
April 2014 EFO	2.1	2.7	2.5	1.9	1.5	
difference	0.2	0.0	0.0	0.1	0.2	
GDP inflation (%)						
October 2014 EFOU	2.2	1.3	1.5	2.0	2.1	2.1
April 2014 EFO	1.5	1.6	1.8	2.0	2.0	
difference	0.7	-0.3	-0.3	0.0	0.1	
Nominal GDP growth (%)						
October 2014 EFOU	4.5	4.1	4.0	4.0	3.8	3.6
April 2014 EFO	3.6	4.3	4.3	4.0	3.6	
difference	0.9	-0.3	-0.3	0.1	0.2	
Nominal GDP level (billions of dollars)						
October 2014 EFOU	1,966	2,046	2,128	2,213	2,297	2,379
April 2014 EFO	1,948	2,032	2,120	2,204	2,282	
difference	18.5	13.5	7.8	9.3	14.4	
3-month treasury bill rate (%)						
October 2014 EFOU	0.9	1.3	2.4	3.4	3.9	4.2
April 2014 EFO	1.0	1.4	2.5	3.5	4.2	
difference	0.0	-0.1	-0.1	-0.2	-0.3	
10-year government bond rate (%)						
October 2014 EFOU	2.3	2.7	3.4	4.2	4.9	5.3
April 2014 EFO	2.7	3.6	4.4	5.1	5.3	
difference	-0.5	-0.9	-1.0	-1.0	-0.4	
Exchange rate (US cents/C$)						
October 2014 EFOU	91.7	94.1	94.9	94.1	93.0	93.0
April 2014 EFO	90.8	93.5	94.6	94.5	93.6	
difference	0.9	0.6	0.3	-0.4	-0.7	
Unemployment rate (%)						
October 2014 EFOU	7.0	6.8	6.5	6.2	6.1	6.0
April 2014 EFO	7.0	6.8	6.4	6.1	6.0	
difference	0.0	0.0	0.1	0.1	0.1	
Core CPI inflation (%)						
October 2014 EFOU	1.7	2.0	2.0	2.1	2.1	2.1
April 2014 EFO	1.5	2.0	2.0	2.0	2.0	
difference	0.2	0.0	0.0	0.1	0.1	
US real GDP growth (%)						
October 2014 EFOU	2.2	3.5	3.6	3.1	2.7	2.4
April 2014 EFO	2.7	3.5	3.6	3.1	2.5	
difference	-0.5	0.0	-0.1	0.1	0.2	

Source: Parliamentary Budget Officer.

Annex B

Detailed fiscal outlook

$ billions

	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020
Income taxes							
Personal income tax	130.8	138.9	147.3	154.3	161.2	167.9	174.8
Corporate income tax	36.6	39.1	41.7	43.7	45.7	47.7	49.1
Non-resident income tax	6.4	6.1	6.4	6.7	7.0	7.3	7.5
Total income tax	173.8	184.2	195.4	204.7	213.9	222.8	231.5
Excise taxes/duties							
Goods and Services Tax	31.0	32.0	33.4	34.7	36.2	37.5	38.9
Custom import duties	4.2	4.6	4.8	4.5	4.7	4.9	5.1
Other excise taxes/duties	10.9	11.3	11.4	11.4	11.4	11.4	11.4
Total excise taxes/duties	46.1	47.9	49.6	50.6	52.3	53.8	55.4
EI premium revenues	21.8	22.6	23.7	23.3	20.6	21.4	22.3
Other revenues	30.0	29.6	30.5	31.8	32.8	34.0	35.2
Total budgetary revenues	**271.7**	**284.3**	**299.1**	**310.3**	**319.6**	**332.1**	**344.3**
Major transfers to persons							
Elderly benefits	41.8	44.4	47.0	49.7	52.6	53.2	53.9
Employment Insurance benefits	17.3	17.4	19.1	20.0	20.2	20.6	21.1
Children's benefits	13.1	13.2	13.3	13.5	13.7	13.8	13.9
Total	72.2	75.0	79.3	83.1	86.5	87.6	88.9
Major transfers to other levels of government	60.5	62.5	65.3	68.4	71.0	73.6	76.2
Direct program expenses	115.9	113.3	114.1	117.2	119.8	124.4	128.7
Public debt charges	28.2	29.9	30.2	31.1	34.2	37.0	39.2
Total expenses	**276.8**	**280.7**	**289.0**	**299.9**	**311.5**	**322.6**	**333.0**
Budgetary balance	**-5.2**	**3.6**	**10.1**	**10.4**	**8.1**	**9.4**	**11.3**
Federal debt	611.9	608.3	598.2	587.7	579.6	570.2	558.9

Source: Parliamentary Budget Officer, Finance Canada.

Annex C

Detailed fiscal outlook, changes since the April 2014 Economic and Fiscal Outlook

$ billions

	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
Income taxes						
Personal income tax	0.3	0.3	-0.1	-0.9	-1.2	-1.0
Corporate income tax	2.4	3.2	2.2	1.6	1.2	1.4
Non-resident income tax	0.2	0.1	-0.1	-0.4	-0.3	-0.3
Total income tax	2.9	3.5	2.1	0.4	-0.2	0.1
Excise taxes/duties						
Goods and Services Tax	0.1	0.1	-0.1	-0.1	0.0	0.2
Custom import duties	0.0	0.0	-0.1	-0.1	0.0	0.0
Other excise taxes/duties	0.3	0.0	0.0	0.0	0.0	0.0
Total excise taxes/duties	0.4	0.1	-0.2	-0.1	0.0	0.3
EI premium revenues	-0.4	-0.1	0.0	-0.2	0.0	0.0
Other revenues	0.6	0.8	0.2	-0.1	-0.5	-0.8
Total budgetary revenues	**3.4**	**4.3**	**2.1**	**0.0**	**-0.7**	**-0.5**
Major transfers to persons						
Elderly benefits	0.2	0.4	0.4	0.5	0.6	0.5
Employment Insurance benefits	0.3	-0.4	-0.6	0.0	0.1	0.1
Children's benefits	-0.1	0.0	0.0	0.0	0.0	0.0
Total	0.4	0.0	-0.2	0.5	0.7	0.6
Major transfers to other levels of government	0.1	0.1	0.2	0.3	0.4	0.3
Direct program expenses	-2.9	0.1	0.1	0.1	0.1	0.1
Public debt charges	-0.6	0.0	-0.3	-2.2	-2.6	-1.9
Total expenses	**-3.0**	**0.2**	**-0.2**	**-1.4**	**-1.4**	**-0.8**
Budgetary balance	**5.7**	**4.1**	**2.3**	**1.3**	**0.6**	**0.3**
Federal debt	-2.1	-6.3	-8.5	-9.8	-10.5	-10.7

Source: Parliamentary Budget Officer, Finance Canada.