Reaction to the 2016 Federal Budget

Eric Lascelles, Chief Economist, shares his thoughts on the 2016 Federal Budget release, and provides a closer look at the impact on Canadian investors.

The 2016 Federal Budget put forth by the new Liberal Government contained few surprises relative to campaign promises, but nevertheless represents an abrupt shift in Canadian fiscal policy. It is an expansionist, progressive budget, meaning considerably more spending and deficits, while providing assistance to low and middle-class earners. On the back of a substantial 7% rise in projected government spending over the next year, the deficit is set to balloon to $29.4 billion. While other governments around the world look to squeeze juice from monetary policy, Canada is swinging in a slightly different direction by also encouraging growth through fiscal policy.

The tone and economic impact of this year's budget

Both the International Monetary Fund (IMF) and the G-20 have lately advocated for more expansionary fiscal policy at the global level. In Canada's specific case, the attraction comes from the combination of ultra-low borrowing costs, an underperforming economy and obvious infrastructure needs. In this environment, one can credibly argue that a dollar of government spending – prudently dispensed – should yield more than a dollar of economic gain.

However, in an unorthodox move, the government does not project that the budget returns to balance by the next election in 2019-2020. Perhaps the one major surprise is the extent of fiscal expansion in the outer years. Worryingly, this leaves Canada with considerably less fiscal wiggle room in the event of a surprise recession or global financial crisis over the next several years. On the other hand, the budget assumes a slower rate of economic growth than the private sector consensus, and the anticipated deficit is small enough that Canada's federal debt-to-GDP ratio should continue to edge lower. Canada's pristine AAA sovereign debt rating does not look to be seriously in jeopardy, though this shift in stance may not please the ratings agencies.

The logic behind the substantial deficit reflects much of Prime Minister Trudeau's campaign last fall: making smart investments in infrastructure and helping the middle class, all with the aim of paving the way towards better economic growth. As such, the government estimates that the overall boost to GDP would amount to 0.5% in 2016-17, and 1.0% in 2017-18 as a result of the proposed spending and changes.

Making up a large percentage of the purposed spending, this year's budget outlines a massive infrastructure growth plan worth more than $120 billion over the next decade that will create jobs, and help Canada become a leader in environmental change.

A closer look at the impact on investors

In addition to the robust spending plan put forth, this year's budget will implement several changes that will affect the tax and retirement planning of individual investors. Generally speaking, these measures are aimed at tightening perceived loopholes or inequalities in various aspects of the tax system and providing additional benefits to the middle class.

Elimination of tax deferred switching for mutual funds held within a corporate structure

Starting October 1, 2016, switching between mutual funds held within a corporate structure – which many mutual fund firms refer to as "corporate class" funds – will be treated as a taxable event in the hands of the investor. This change will essentially bring the tax treatment of corporate class funds on par with the more widely available mutual fund trusts.

Since the new tax treatment will affect transactions made after September 2016, existing investors have a six month window to take action before the tax-deferred switching opportunity is lost. Investors that have assets in these funds should speak with their advisor to discuss whether any action needs to be taken. At RBC Global Asset Management, we are working through the implications of this announcement and will continue to communicate any relevant information.

Old age security (OAS) eligibility will return to 65, from 67

From an investor and quality-of-life perspective this is good news, as it will enhance retirement income, and in many cases may enable Canadians to retire sooner. From an economic perspective, it is less optimal as it reduces the potential size of the country's workforce, and adds to fiscal strains at a time when the proportion of seniors is growing and longevity is rising.

Changes to personal tax legislation that began in January

A few of the changes to the personal tax legislation were previously announced, and were implemented on January 1, 2016. This includes a reduction in the TFSA maximum annual contribution amount from $10,000 to $5,500**.** Tempering this hit to investors, the budget now indexes the TFSA contribution limit to inflation, which means that the limit will rise with time, in $500 increments.

One of the many progressive moves of the Liberal government in this year's budget was formally lowering taxes on middle-income earners by 1.5%, and raising taxes by 4% for those earning C$200,000 and above. Both changes will also apply to eligible capital gains and the dividend tax rate and were broadly aimed at benefitting the middle class.

Other new policies include more generous guaranteed income supplements for some seniors, increased funding for post-secondary institutions and directly to students in the form of grants, and enhanced employment insurance payments to the recently unemployed in regions of the country particularly affected by the recent commodity shock.

A final note

This year's budget represents a notable shift in fiscal stance, with wide-ranging implications for workers and investors alike. The budget arguably scratches several itches. Most notably, it helps to address Canadian economic weakness, infrastructure needs and rising inequality. The Liberals plan to release an innovation agenda over the next year that they hope will boost Canada's rate of economic growth in a sustainable fashion.

Of course, implementation is everything, and only time will determine the real-world success of these new policies. Meanwhile, this budget certainly isn't for everyone: investors must grapple with a lower TFSA limit, top income earners are confronting higher income and investment tax rates, and the country itself will be juggling a materially larger debt load by 2020. Depending on each individual's personal situation, these changes could have negative or positive implications, and prior to implementing any strategies, individuals should consult with a qualified tax advisor, legal professional or other applicable professional.

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