

ECONOMIC VIEWPOINT

Federal Budget 2026 Preview

Running Short on Fiscal Room as Commitments Pile Up

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HIGHLIGHTS

- ▶ Canada's economy has been hit by multiple geopolitical shocks since the start of 2025. In response, the Government of Canada leveraged its strong fiscal position to support households and businesses while investing in long-term economic growth. We expect new planned spending since the Spring Economic Update 2026 to top \$50B over the coming decade while tax cuts and deductions could reach around \$90B over the same period.
- ▶ Gaps in federal fiscal disclosure have made the Government of Canada's annual deficits more difficult to forecast than in the past. Despite that, our analysis suggests the federal government may not meet its commitment to a declining deficit-to-GDP ratio, a conclusion also reached by the Office of the Parliamentary Budget Officer. Discretion in classifying operating and capital expenses limits the operating budget anchor's usefulness as a measure of fiscal sustainability. That said, the federal debt-to-GDP ratio should improve over the next year or so due to a higher level of nominal GDP. Elevated oil prices and inflation are to thank for that. But as oil prices gradually return to normal, the tailwind to the deficits and debt will fade as well, leading to a weaker federal fiscal outlook compared to the SEU 2026.
- ▶ Despite the deteriorating long-term federal fiscal outlook, Canada's absolute and relative debt position and path are broadly in line with maintaining a triple-A sovereign credit rating. However, a re-escalation in the US-Canada trade war or continued rise long-term interest rates could put the Government of Canada's fiscal sustainability at risk. Preserving fiscal room would help the federal government respond to unforeseen economic and financial shocks.

As a tidal wave of turbulence has washed up on Canada's shores in the form of trade disruptions, high oil prices and rising interest rates, the Government of Canada opened the fiscal taps in the hope of meeting the moment. Greater spending on defence and infrastructure has been coupled with tax cuts for individuals and deductions for businesses. All of this has pushed deficits to levels not seen outside of recessions or the pandemic, shelving the previously planned decline in the federal debt-to-GDP ratio. While it's tough to determine what the federal government's deficit and debt track will look like given the reduced transparency around federal finances since the start of 2025, the outlook for fiscal sustainability over the long term has become more precarious. The Government of Canada would be well advised to keep some powder dry for an unexpected deterioration in economic or fiscal conditions.

Gaps in Disclosure Complicate the Fiscal Assessment

Before going into detail on the federal fiscal forecast that may be presented in Budget 2026, it's important to outline the challenges faced by external observers in trying to pin down the outlook. The Government of Canada has been increasingly opaque when providing annual cost projections for new tax and spending measures. And capital spending estimates have become scant, forcing analysts to look to documents provided by industry and other levels of government to get a sense of what the federal government intends to spend and when. The West Coast Oil Pipeline (now Pacific Link), recently designated a national interest project by the Major Projects Office, is a striking example. The province of Alberta has provided projected costs and benefits, which we examined in detail in [recent analysis](#). However, the Government of Canada has not publicly provided

the economic or financial analysis underpinning its planned contribution to this project.

This adds to the concerns around transparency we and other federal fiscal analysts have raised previously. These include the classification of operating and capital expenses, which still doesn't conform to national or international best practices and isn't subject to independent external validation (PBO, 2026a). Indeed, the discretion of the federal government in determining what is and is not an operating expense limits the usefulness of the operating budget fiscal anchor—balance operating spending with revenues by the 2028–29 fiscal year (FY29)—when evaluating the sustainability of federal finances (PBO, 2026b). Even the International Monetary Fund (IMF) has raised concerns regarding the Government of Canada moving away from the debt-to-GDP ratio as its primary fiscal anchor. According to the IMF, reinstating it would “strengthen discipline, transparency, and credibility while preserving fiscal space for high-return investment.” (IMF, 2026) To quote the Parliamentary Budget Officer (PBO), “Federal borrowing will significantly exceed cumulative budgetary deficits over the projection period, because under accrual accounting, capital expenses and loans to Crown corporations are recorded as assets rather than liabilities. This obscures the realities of cash debt and raises questions about whether the current fiscal framework provides a complete and transparent picture of Canada’s fiscal sustainability.” (PBO, 2026c)

More complete and consistent fiscal disclosure would allow independent analysts to reconcile new commitments with the government’s deficit, borrowing and debt projections. Clearer costing and classification would strengthen confidence in the fiscal framework and help distinguish changes in the underlying outlook from changes in accounting treatment.

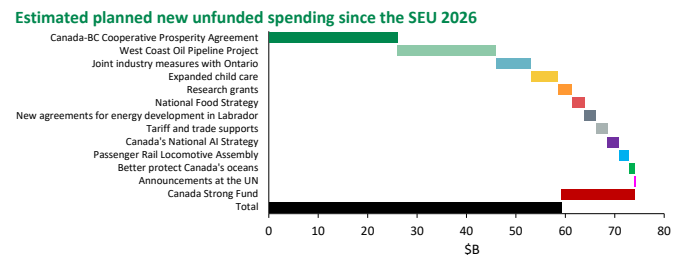
Numerous New Spending Commitments Since the Spring Update

Since the publication of [Spring Economic Update \(SEU\) 2026](#) in April, federal spending announcements—from capital investments to transfers to households and other levels of government—have continued to stack up. The challenge is distinguishing measures already included in prior fiscal forecasts from what is new money. And for new capital expenses—defined as a non-financial asset held on the Government of Canada’s balance sheet—should it be added to the debt or have existing financial assets been put against it, such as \$25B provisioned for the [Canada Strong Fund](#)?

[We sought to address](#) some of these questions back in July. At that time, we estimated that new federal spending measures since the SEU 2026 totalled more than \$40B through 2035. Subsequent announcements have added over \$10B more to the total over the next decade, for a total of over \$50B in new spending since the SEU was published in April (graph 1).

Graph 1

New Unfunded Spending Measures Since SEU 2026 Total Nearly \$60B



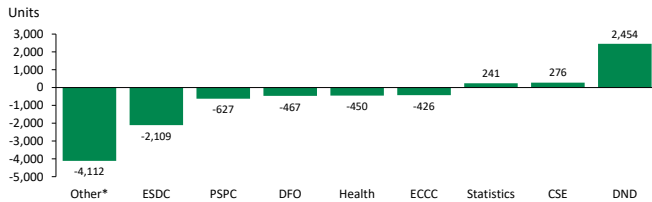
SEU: Spring Economic Update; AI: Artificial Intelligence; UN: United Nations
Provincial governments, Government of Canada and Desjardins Economic Studies

The largest spending announcements since the spring were by far the Canada-BC Cooperative Prosperity Agreement and West Coast Oil Pipeline Project, the federal portion of which we estimate could add up to about \$26B and \$20B over the next decade, respectively (graph 1). However, some of this will likely be offset by existing funds allocated to the Canada Strong Fund, although how much remains highly uncertain. The same is true for the new passenger rail locomotive assembly. But other spending for expanded childcare, extending the fuel tax cut to March 2027, Canada’s National AI and Food Strategies, increased research grants and other more modest measures should largely be considered operating expenses, as there will be no associated asset on the Government of Canada’s balance sheet. Finally, the \$7.5B committed to support Canadian households and businesses impacted by the re-escalation of the trade war in August and September of this year may not be fully utilized if trade tensions de-escalate, as expected in our baseline economic outlook. Besides, given this support is mostly in the form of expanded loan programs, the impact on the federal deficit and net debt should be minimal.

It’s important to keep in mind that this substantial increase in planned spending comes while the Government of Canada is looking to reduce its operating expenses, primarily through payroll reductions. Federal full-time equivalents (FTEs) have fallen substantially since Budget 2025 outlined plans to reduce Government of Canada payrolls. The federal public service posted a net decline of roughly 5,220 FTEs so far in calendar year 2026 compared with 2025. Under the hood, Employment and Social Development Canada (ESDC) accounted for the largest reduction, shedding 2,110 FTEs, followed by Public Services and Procurement Canada (-627), and Fisheries and Oceans Canada (-467) (graph 2 on page 3). Most other departments either reduced their workforces or saw little change. In contrast, the Department of National Defence (DND) added roughly 2,454 FTEs amid Canada’s push to meet its NATO defence-spending commitments. Twenty-seven smaller departments saw a combined increase of 776 FTEs.

Graph 2
Federal Public Service Jobs Have Been Cut Almost Everywhere but DND

Calendar year-to-date average of FTEs in 2026

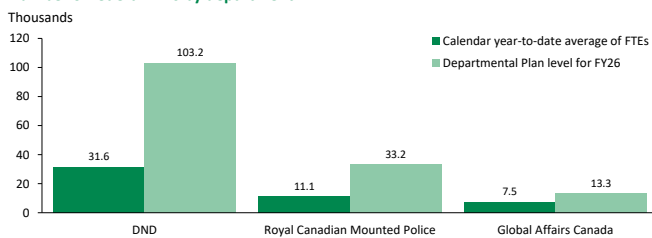


DND: Department of National Defence; FTE: Full-time equivalents; ESDC: Employment and Social Development Canada; PSPC: Public Services and Procurement Canada; DFO: Department of Fisheries and Oceans Canada; ECCC: Environment and Climate Change Canada; CSE: Communications Security Establishment; * Refers to the remaining 86 other departments in the public service. Government of Canada, Office of the Parliamentary Budget Officer and Desjardins Economic Studies

Progress across departments when it comes to meeting the FY27 departmental plans (DPs) remains uneven. So far for calendar year 2026, the year-to-date average of FTEs at Fisheries and Oceans Canada have fallen short of planned level reductions for FY26, followed by ESDC, and Agriculture and Agri-Food Canada. In contrast, the year-to-date average of level of FTEs at the DND (31.6k) is far below the planned 103.2k for FY26 (up from 29.1k last year). The workforce size in some other departments, such as the Royal Canadian Mounted Police and Global Affairs Canada, are also currently below what is planned in their respective DPs (graph 3).

Graph 3
Despite Sizeable Growth, DND Is Far from Reaching Its Planned Hiring

Number of federal FTEs by department



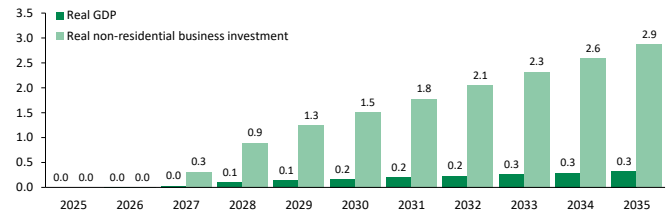
DND: Department of National Defence; FTE: Full-time equivalents; FY26: 2026–27 fiscal year. Government of Canada, Office of the Parliamentary Budget Officer and Desjardins Economic Studies

The Mega Deduction Carries a Larger Fiscal Cost

While an additional \$50B or more in spending over the next 10 years would have raised eyebrows just a couple of years ago, it pales in comparison to the likely cost of the Productivity Mega Deduction (PMD). This should come at a cost of \$36B over five years, starting in FY27. And since it is a permanent tax change, it is likely to persist after FY31, adding up to a total of around \$85B in lost tax revenue over the next decade. By our estimate, the PMD should boost the level of real GDP by 0.2% by 2030 and 0.3% by 2035 (graph 4), almost

Graph 4
Productivity Mega Deduction Should Have a Positive but Modest Impact on Canada's Economy
Impact of the Productivity Mega Deduction on real GDP and business investment

% change from pre-policy level



Government of Canada, Office of the Parliamentary Budget Officer, Statistics Canada and Desjardins Economic Studies

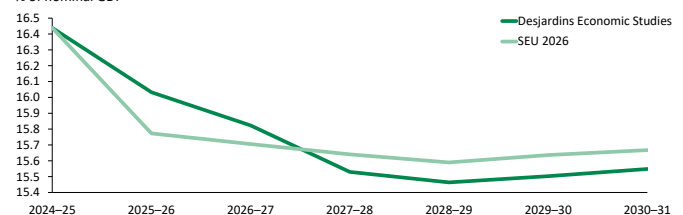
all of that coming from higher productivity. While laudable as a measure to help accelerate business investment in Canada, the economic tailwind will probably not offset the cost, at least over the next decade.

Two other revenue measures have been announced since the SEU 2026. Extending the fuel excise tax cut through March 2027 should cost around \$2.9B this fiscal year. However, this should be more than offset by the revenue from counter tariffs applied to \$28B of imports from the US starting on September 8. The tariffs could generate roughly \$7B in revenues if maintained for a full year, although we expect trade tensions to ease in early 2027. Overall, we anticipate revenues to decline as a share of GDP over the coming five fiscal years, broadly in line with the SEU 2026, but stay permanently lower thereafter (graph 5).

Graph 5
Federal Revenues Are Expected to Decline as a Share of GDP

Government of Canada revenue forecasts

% of nominal GDP

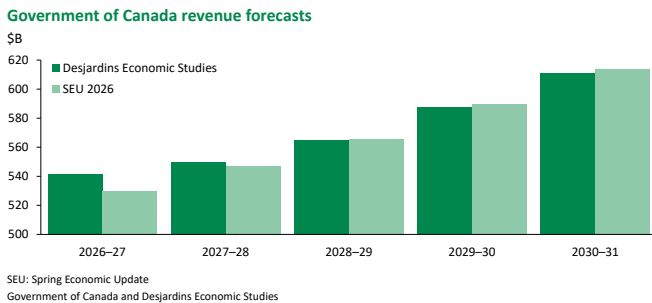


SEU: Spring Economic Update. Government of Canada and Desjardins Economic Studies

High Oil Prices Provide a Temporary Revenue Offset

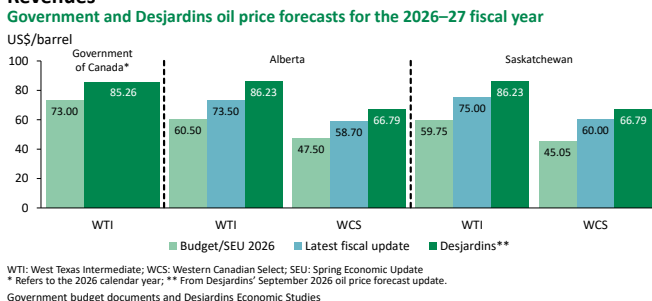
With new spending and tax measures tallying up to nearly \$140B over the next decade, the fiscal outlook would normally point to substantially larger deficits. Stronger-than-expected tax receipts are offsetting part of that pressure in the near term. Tax revenues will likely remain above the SEU 2026 projection next year as well, although that tailwind should subsequently weaken (graph 6 on page 4).

Graph 6
Higher Near-Term Federal Revenues Should Fade over Time

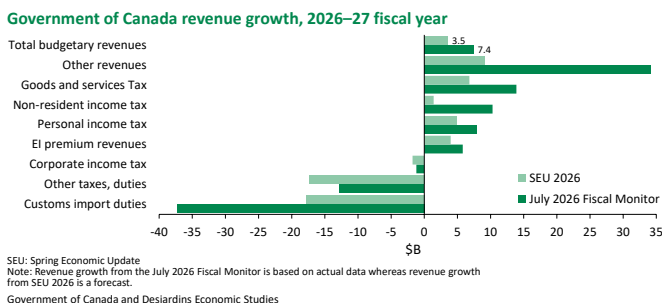


The federal government [has sustained high oil prices](#) to thank for [surging tax revenues](#) (graph 7). According to the July 2026 Fiscal Monitor, fiscal year-to-date revenues are up 7.4% than a year ago, well above the 3.5% pace projected in SEU 2026 (graph 8). Growth in Goods and Services Tax revenues have risen particularly sharply, as prices at the pump have spiked, despite taxes per average litre being nearly half their early 2025 level (see [our recent research](#) on the Canadian consumer for more information). Personal income tax revenues are also poised to exceed expectations, likely supported by surging capital gains on investments among higher-income households.

Graph 7
Oil Prices Have Surpassed Government Expectations, Boosting Revenues

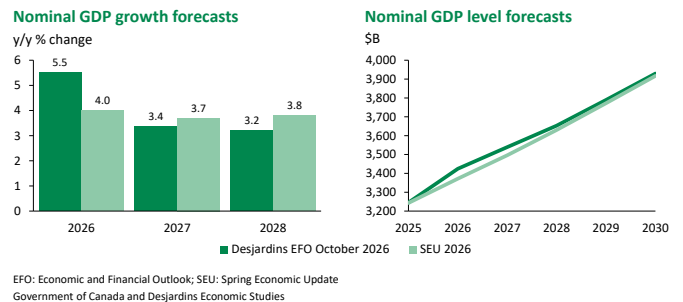


Graph 8
Federal Revenues Are Coming in Faster than Expected in the SEU 2026

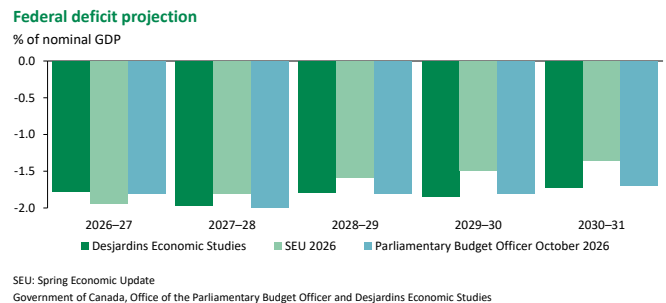


Higher-for-longer oil prices should extend the near-term revenue boost as nominal GDP—the broadest measure of the tax base—remains elevated, entirely due to heightened inflation (graph 9). However, this support is expected to fade, while the fiscal effects of permanent spending increases and tax reductions persist. Consequently, our analysis suggests that the federal government's other fiscal anchor—maintaining a declining deficit-to-GDP ratio—may be at risk despite a better starting point than in the SEU 2026 (graph 10). In its [October 2026 Economic and Financial Outlook](#), the PBO reached the same conclusion.

Graph 9
Elevated Oil Prices Have Pushed Nominal GDP Growth Higher in 2026

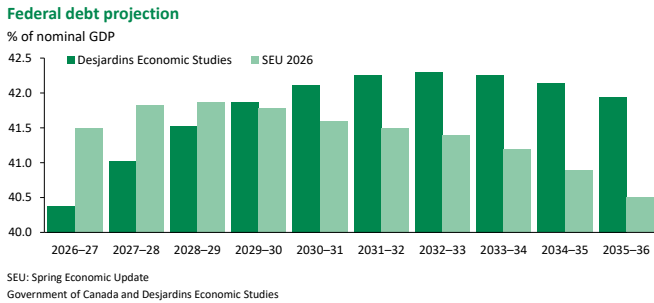


Graph 10
A Smaller Federal Deficit Now Should Give Way to Bigger Deficits Later



The federal debt outlook is more complicated. Deficits similar to those projected in SEU 2026, along with planned pre-borrowing for capital investment, should keep debt broadly on its spring forecast path over the next few years. But the higher-than-expected nominal GDP should nevertheless lower the debt-to-GDP ratio relative to that forecast through FY29 (graph 11 on page 5). Beyond then, permanent spending increases and tax cuts will outlast the boost from elevated energy prices, pointing to larger deficits and a higher debt-to-GDP ratio of the longer term than projected in SEU 2026.

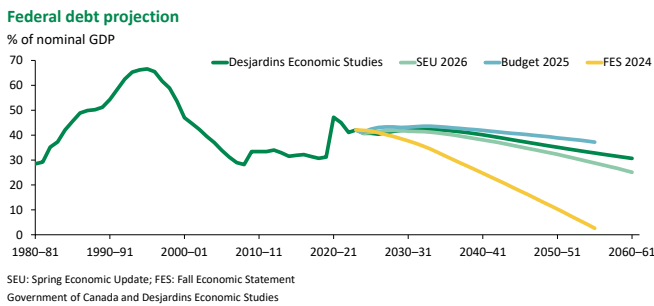
Graph 11
Improved Federal Debt Ratios on Higher Nominal GDP Won't Last Long



Fiscal Room has Narrowed, but a Debt Crisis Isn't Imminent

The sustainability of federal finances is generally measured by the long-term path for the debt-to-GDP ratio. We expect this ratio to decline over the long term after rising for five years starting in FY28 (graph 12), broadly consistent with the PBO's assessments based on [Budget 2025](#) and [SEU 2026](#). Even so, fiscal room has narrowed markedly since the end of 2024, largely because of increased planned defence spending.

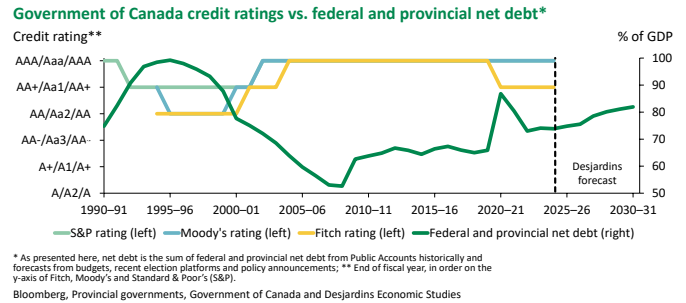
Graph 12
Government of Canada Debt Is Still Sustainable, If Only Barely



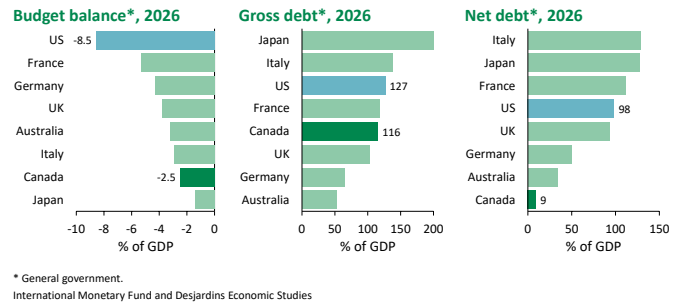
Based on [our research](#) digging into the methodologies of the three main credit rating agencies, concerns that the Government of Canada's credit rating may be at risk seem overblown. That's because sovereign credit ratings are both absolute and relative. In absolute terms, the outlook for combined federal and provincial net debt as a share of GDP is likely to remain below the threshold that has historically triggered a credit downgrade (graph 13). In relative terms, Canada is one of the best fiscal performers among peer countries, specifically the G7 plus Australia (graph 14).

This said, our better economic and financial outlook than that in SEU 2026 isn't guaranteed. In particular, sovereign bond yields have risen rapidly, including the Government of Canada's, albeit

Graph 13
The Government of Canada's Credit Quality Remains High for Now

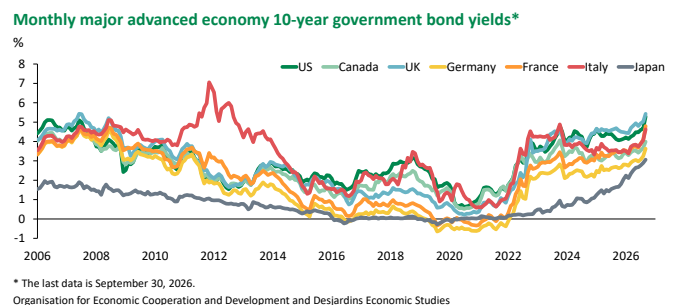


Graph 14
Canada Is One of the "Cleanest Fiscal Dirty Shirts" Among Its Peers



less so than most of its peers (graph 15). [Our Macro Strategy team](#) estimated that if interest rates remain at their recent high levels for the duration of the 5-year fiscal forecast, the annual gross interest cost could be more than \$3B higher on average annually starting FY28. Increases in short- and long-term interest rates from here would exacerbate the drag on the federal government's bottom line. Just a 50-basis point increase in our forecast for long-term interest rates from the start of 2027 onward could set the federal debt-to-GDP ratio on a sustained upward trajectory, putting current fiscal sustainability at risk (graph 16 on page 6). A permanent increase in long-term interest rates beyond that would be even more damaging.

Graph 15
Longer-Term Government Bond Yields Have Hit Multidecade Highs

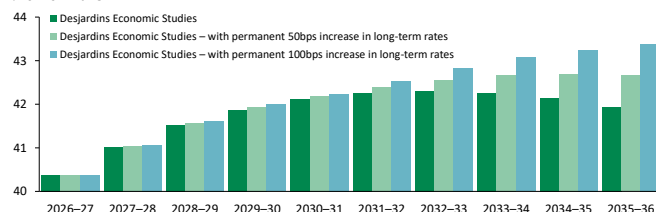


Graph 16

Federal Debt Sustainability May Be at Risk If Long-Term Rates Rise More

Federal debt projection

% of nominal GDP



bps: basis points

Government of Canada and Desjardins Economic Studies

Conclusion

To conclude, the Government of Canada may be in better fiscal shape than many of its advanced economy peers, but that advantage is not guaranteed. Significant cuts to revenues and increases in spending have put Canada's long-term fiscal sustainability at greater risk than in the past, particularly against the backdrop of sharply higher and rising interest rates. Maintaining some fiscal flexibility could help the federal government respond to unforeseen circumstances, including higher public debt charges. Budget 2026 should clarify the costing and financing of spending and revenue measures announced so far, and demonstrate the fiscal framework's robustness to adverse shocks.