ECONOMIC VIEWPOINT

Federal Budget 2024 Preview:

At Risk of Losing Its Anchors, Federal Fiscal Credibility May Soon Be Set Adrift

By Randall Bartlett, Senior Director of Canadian Economics

Highlights

- Spring is in the air, and with it the promise of warmer weather and government budgets. But a lot has changed since the Government of Canada tabled its prior fiscal plan in November 2023.
- The federal government is tracking a larger deficit in the 2023–24 fiscal year than was projected in the FES 2023. In particular, the outsized pace of spending is highly concentrated in Direct Program Expenses (DPE)—the expenditure category where the federal government hoped to find the greatest savings and over which it has the most direct influence.
- The resulting higher path of DPE over the forecast should more than offset the benefit from our improved economic outlook, leading to larger deficits. Add to that the announcement of a new national pharmacare program and a possible increase in military spending, and suddenly the "fiscal anchors" announced in the FES 2023 look much harder to achieve.
- Despite this, the Government of Canada is in an enviable fiscal position internationally. That's because it's had the good fortune of standing on the shoulders of fiscal giants that came before. But it can't take that for granted. The federal government would be wise to fund any new measures from existing planned spending while looking for opportunities to generate permanent savings. At the same time, focus should be shifted to reducing barriers to business investment, thereby better supporting gains in productivity and the living standards of Canadians.

Spring is in the air, and with it the promise of warmer weather and government budgets. A smattering of provinces have already released their fiscal plans, and the federal government won't be far behind.

A lot has changed since the Government of Canada tabled its prior fiscal forecast in November. In what follows, we'll dig into the substantive measures announced since the Fall Economic Statement (FES 2023), the impact of changes in the economic outlook, and the risks to the projection for federal deficits and debt in Canada.

The Devil's in the Near-Term Details

As we've highlighted in the past, the federal government is tracking higher revenues and expenses in the 2023–24 fiscal year than were projected in the FES 2023 (graph 1 on page 2). The accelerated pace of spending is particularly notable, as it is well above the barely positive print projected by the Government of Canada in November of last year.

Unpacking the outsized pace of spending makes clear that it is highly concentrated in Direct Program Spending (graph 2 on page 2). That's the spending category that is most closely tied with the operations of the Government of Canada and, hence, over which it has the most discretion. Particularly disappointing is that this is the spending category where the federal government

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
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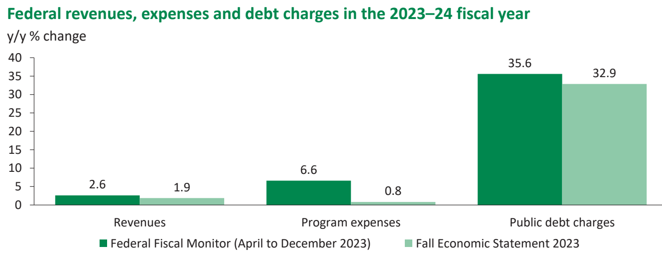
Graph 1
Federal Expenses Are Coming in a Lot Hotter than Expected

Federal revenues, expenses and debt charges in the 2023–24 fiscal year



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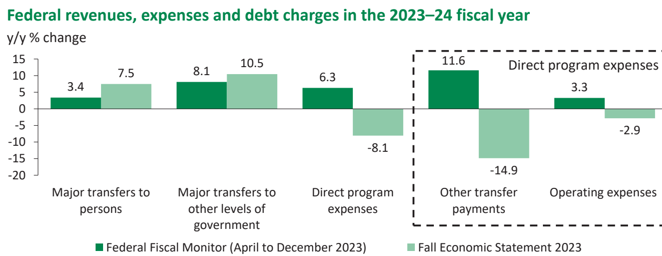
Graph 2
Higher Expenses This Year Are Driven by Government Operations

Federal revenues, expenses and debt charges in the 2023–24 fiscal year



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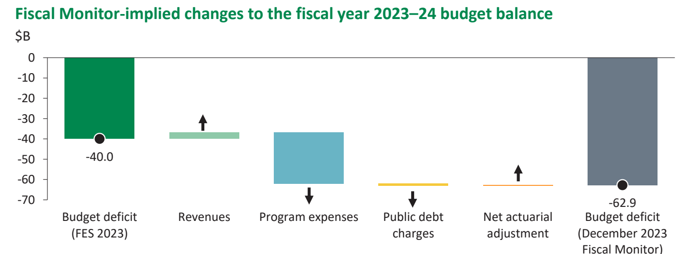
Graph 3
The Fiscal Monitor Points to a Much Larger Deficit This Year

Fiscal Monitor-implied changes to the fiscal year 2023–24 budget balance



FES: Fall Economic Statement
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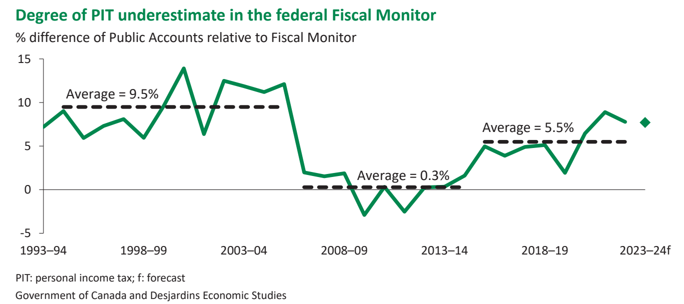
Graph 4
The Fiscal Monitor Has Underestimated PIT Revenues Recently

Degree of PIT underestimate in the federal Fiscal Monitor



PIT: personal income tax; f: forecast
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expected to find substantial savings. Drilling down deeper, it's evident that much of the difference stems from "Other transfer payments," which include items such as increased disbursements for the Housing Accelerator Fund and higher payments with respect to Indigenous Peoples. But "Other transfer payments" aren't the only thing going up. Operating expenses are also coming in hot, reflecting things like higher-than-expected spending on personnel expenses.

Extrapolating the in-year tracking to the full 2023–24 fiscal year points to a substantially larger deficit this year, increasing to $62.9B from $40.0B in the FES 2023 (graph 3). This is almost entirely the result of higher program spending. And while higher interest payments also play a role, this is more than offset by the faster-than-anticipated pace of revenue growth.

That said, we think there is some upside risk to the dour Fiscal Monitor-implied deficit outlook. Specifically, personal income tax (PIT) revenues have come in well above those suggested by the Fiscal Monitor when the Public Accounts of Canada are eventually released (graph 4). As such, we think PIT revenues could come in as much as $16B better than they are currently tracking in-year, likely bringing the federal deficit this year closer to $47B.

Longer-Term Costs Keep Piling Up

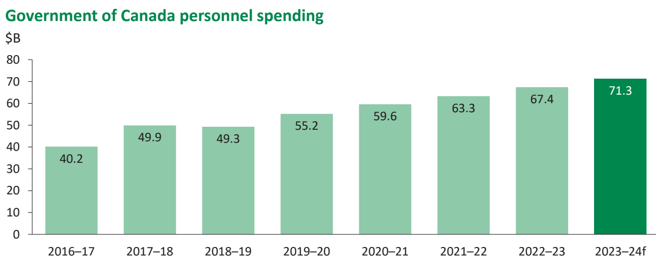
Overall, the starting point for the updated federal fiscal forecast is likely to be worse than projected in the FES 2023. But the Government of Canada's troubles don't end there. Spending is likely to see sustained upward pressure beyond just this year.

Operating expenses

Operating expenses are expected to be higher than projected in the FES 2023 not only for the current fiscal year, but for every year of the forecast. The poor starting point is one reason. Another is the ongoing increase in spending on personnel (graph 5 on page 3) resulting from a sustained rise in hiring along with the negotiated wage increases last year. Together, these have combined to ensure federal government operating expenses are likely to overshoot the expectations laid out in the FES 2023.

What about the planned savings? Upon close inspection, it's possible to see reduced spending in the Fiscal Monitor associated with "Information" and "Utilities, materials and supplies" over the prior year. But these areas of expenditure pale in comparison to what's spent on personnel. Indeed, the Parliamentary Budget Officer found that none of the planned $500M in savings will come from a reduction in personnel levels. Instead, reducing spending on professional services and travel will be the source. Further savings could also come from lapsed spending, which

Graph 5
Personnel Spending Is Expected to Push Operating Expenses Higher



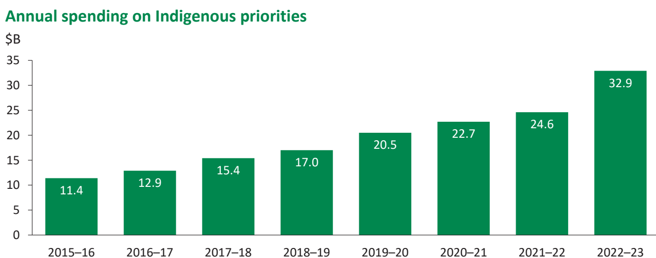
f: forecast; The value for 2023–24 is based on the rate of growth in personnel spending from the December 2023 Fiscal Monitor
Parliamentary Budget Officer, Government of Canada and Desjardins Economic Studies

is just money departments planned to spend but didn't, as opposed to true, permanent savings. Government officials have suggested that this money, roughly $10.5B over three years, will be redirected to other priorities, such as national pharmacare. As such, this lapsed spending isn't likely to help bring the 2023–24 federal deficit closer to the $40.0B in the FES 2023.

Other transfer payments

But it's not just operating expenses that are driving Direct Program Expenses higher. "Other transfer payments" have also regularly surprised to the upside. Part of the reason cited in both the FES 2023 and the most recent Fiscal Monitor is higher payments with respect to Indigenous Peoples to support the advancement of reconciliation. In the 2022–23 fiscal year, for example, the federal government spent $32.9B on Indigenous priorities (graph 6). For comparison, the Government of Canada ran a $35B deficit that same year. The $23B First Nations child welfare compensation agreement reached in October 2023 is expected to add to this total in the current fiscal year.

Graph 6
Federal Spending on Indigenous Priorities Is Likely to Increase



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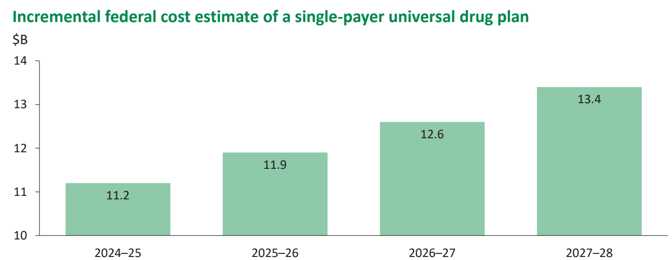
National pharmacare plan

In February 2023, the Liberal and New Democratic Parties of Canada reached a pharmacare deal as part of their Supply and Confidence Agreement. While the coverage is limited so far, the enabling legislation will likely create a framework that will open the door to an expanded set of drugs. Indeed, the development of a national formulary could rapidly accelerate the pace of expansion. As such, the program that is currently estimated to cost about $800M annually could quickly approach the PBO's estimated additional cost to the federal government of $10B to $15B annually (graph 7).

Graph 7
A National Pharmacare Plan Could Dramatically Increase Expenses

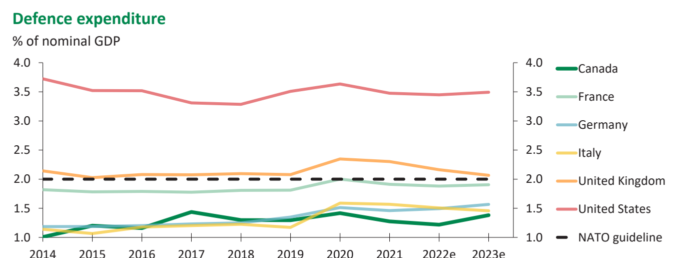


Parliamentary Budget Officer and Desjardins Economic Studies

Increased military spending

Another possible big expenditure commitment on the horizon is military spending, particularly in support of Ukraine's defence against Russian aggression. Currently, Canada's annual defence spending tallies up to 1.4% of GDP. And while spending has inched closer to NATO's 2% guideline since 2014 (graph 8), it remains a far cry from that commitment. To reach 2% of GDP in 2024 based on our nominal GDP forecast, military spending would need to increase from $39.3B in 2023 (NATO, 2024) to $59.0B this year—an amount that would increase annually.

Graph 8
Canada Is a Far Cry from Meeting Its NATO Commitment



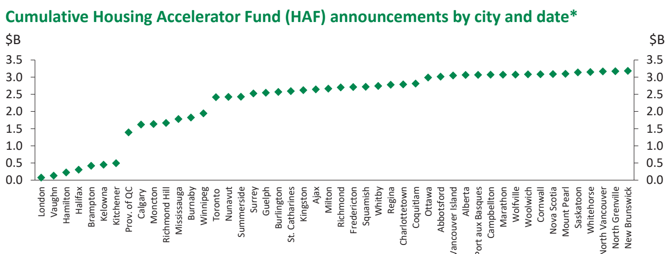
e: estimate
North Atlantic Treaty Organization (NATO) and Desjardins Economic Studies

Measures to improve housing affordability

Housing is also among the key priorities for the federal government. To date, it has introduced a number of measures that our analysis suggests will help increase the supply of housing in Canada. These include scrapping the federal portion of the HST on purpose-built rentals and encouraging a change in municipal behaviour through the Housing Accelerator Fund. Regarding the latter, the vast majority of the original envelope of $4B over five years has now been committed (graph 9). And given the perceived success of the program, more funds may be on the way.

Graph 9
More than Three Quarters of the HAF Funding Has Been Announced

Cumulative Housing Accelerator Fund (HAF) announcements by city and date*



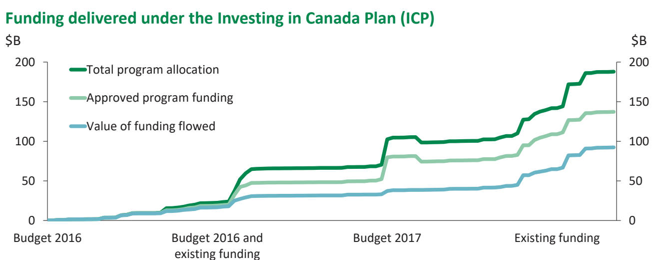
*As of March 1, 2024
Canada Mortgage and Housing Corporation and Desjardins Economic Studies

Infrastructure

Capping off the measures frequently discussed by the punditariat in the run-up to Budget 2024, big city mayors in Canada are hoping funding for infrastructure will take centre stage. If we think back to the early days of the current government's mandate, infrastructure was front and centre of the 2015 election campaign and subsequent policy push. There were high hopes that the Investing in Canada Infrastructure Program (ICP) and the launch of the Canada Infrastructure Bank would be game-changing developments. Unfortunately, they weren't (graph 10). And now cash-strapped cities with revenues hobbled by the knock-on impacts of the pandemic are looking to the federal government for financial support. Canadians will need to wait and see if the rubber meets the road on a substantive infrastructure deal that will help municipalities, even as it adds to the federal government's fiscal woes.

Graph 10
Less than Half of ICP Infrastructure Funds Have Yet to Flow

Funding delivered under the Investing in Canada Plan (ICP)



Infrastructure Canada and Desjardins Economic Studies

CEBA loans

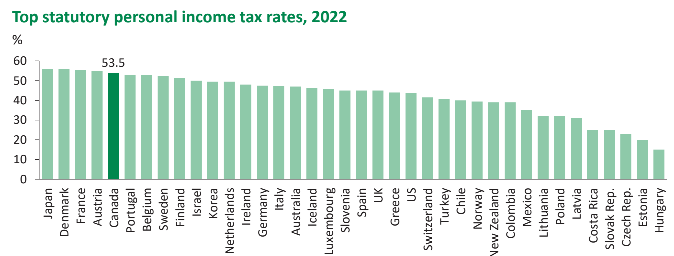
It hardly received a mention in the FES 2023, but repayment of Canada Emergency Business Account (CEBA) loans also poses a challenge for the federal government. As of the January 18, 2024, repayment deadline, about three quarters of the $49.2B in outstanding loans had been repaid in full, making those loan holders eligible for the grant portion. As we outlined in a note ahead of the repayment deadline, the remaining outstanding CEBA loans—roughly $12.5B—are considered an asset on the Government of Canada's balance sheet. These are now expected to be repaid in full plus interest. However, some of these loans will go unpaid, and the federal government will need to book this loss as a reduction in revenues. But we don't know how much the revenue impact will be as the repayment assumptions used for prior fiscal forecasts were never disclosed. That said, the revenue reckoning may not come for several years, with the latest repayment deadline falling after the next federal election.

Revenues

While the list above is by no means exhaustive, it helps to illustrate the scale of the challenge faced by the federal government. Everything points to a risk of higher spending, and revenue reinforcements aren't likely to come to the rescue. Canada already has one of the highest top statutory personal income tax rates in the OECD (graph 11). Increasing business taxes should be a non-starter as well, given the crippling state of business investment, productivity and real GDP per capita in Canada.

Graph 11
Canada Has among the Highest Top Marginal Tax Rates in the OECD

Top statutory personal income tax rates, 2022



Organisation for Economic Co-operation and Development and Desjardins Economic Studies

It's the Economy to the Rescue Again

But it's not all bad news for the federal fiscal outlook. We've revised up our economic forecast following the recent GDP release, and it is now more bullish than the baseline used by the federal government for fiscal planning in the FES 2023 (table 1). Indeed, our forecast for 2024 growth in nominal GDP—the broadest measure of the tax base—is in line with the federal government's upside scenario published in the FES 2023.

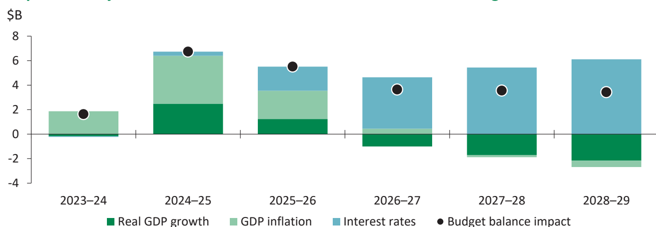
TABLE 1
Economic and financial forecasts

AVERAGE ANNUAL GROWTH IN % (UNLESS OTHERWISE INDICATED)	2022	2023f			2024f		
	Actual	FES 2023	Upside Scen.	Desj. Group	FES 2023	Upside Scen.	Desj. Group
Real GDP	3.8	1.1	1.3	1.1	0.4	1.5	0.9
GDP deflator	7.7	0.8	1.1	1.6	2.0	2.2	2.7
Nominal GDP	11.8	2.0	2.4	2.7	2.4	3.7	3.7
Treasury bills – 3-month	2.3	4.8	4.8	4.8	4.3	4.2	4.2
Unemployment rate	5.3	5.4	5.4	5.4	6.4	5.9	6.4

f: forecast
NOTE: Data may not add up to totals due to rounding.
Department of Finance Canada, Statistics Canada and Desjardins Economic Studies

If our economic forecast comes to fruition, revenues should be stronger in the next couple of years than anticipated in the FES 2023 due to the rosier outlook. Program expenses should also be higher in the near term, albeit less than revenues, largely because of higher inflation relative to government projections. As a result, the net impact of the revised economic outlook on the primary balance (revenues less program expenses) should be positive through the 2025–26 fiscal year. However, this will change in the outer years as we expect the economy to underperform FES assumptions over the medium term. But the resulting lower interest rates in the latter half of the forecast should provide a meaningful offset to the fiscal drag coming from weaker growth and inflation. All told, using our economic forecast and the fiscal sensitivities outlined in Budget 2023 would cause deficits to be smaller than in the FES 2023 by about $4B on average annually from the 2023–24 through 2028–29 fiscal years (graph 12).

Graph 12
Higher-than-Expected Inflation Should Again Provide a Tailwind to Revenues
Impact of Desjardins's latest economic forecast on the federal budget balance



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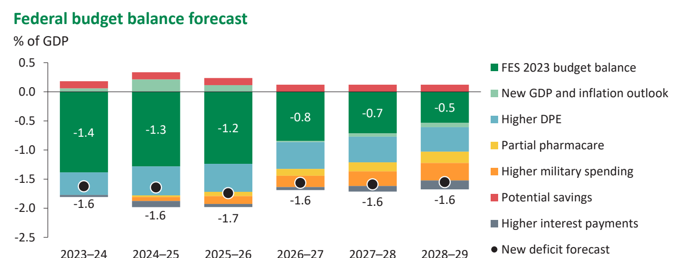
No Deficit of Federal Deficit Prognostications

Not only would accounting for the improvement in the economic outlook help to shrink the deficit in the 2023–24 fiscal year, the budget balance improves further when adding in the better-than-expected revenue tracking so far this year. Yet barring any unforeseen lapses in spending in the current fiscal year, surging Direct Program Expenses to date should offset all the tailwind coming from the economy. Consequently, we've assumed a deficit placeholder of $47.0B for the 2023–24 fiscal year, as per the Fiscal Monitor, in line with the PBO's March 2024 fiscal forecast. This would violate the first "fiscal anchor" outlined in the FES 2023: maintaining the 2023–24 deficit at or below the Budget 2023 projection of $40.1B. However, this stands in sharp contrast to recent statements made by the Minister of Finance that the federal government will meet its fiscal targets, suggesting there may be some unexpected savings coming in Budget 2024.

Given how far out of line the Fiscal Monitor suggests Direct Program Expenses are with the FES 2023 projection for the current fiscal year, we've assumed that some of this higher discretionary spending carries over into later years. Add to this some modest expansion of the national pharmacare plan beyond what's already announced and a partial closing of the NATO commitment gap, and the deficit outlook only gets worse (graph 13). This deficit profile would violate the second "fiscal anchor" outlined in the FES 2023: maintaining a declining deficit-to-GDP ratio in 2024–25 and keeping deficits below 1% of GDP in 2026–27 and future years. This doesn't really change even if the recently telegraphed savings of $10.5B over three years is found and consulting and travel spending is cut by $500M as promised.

Graph 13
Federal Deficits Are Expected to Be Larger than in the FES 2023
Federal budget balance forecast

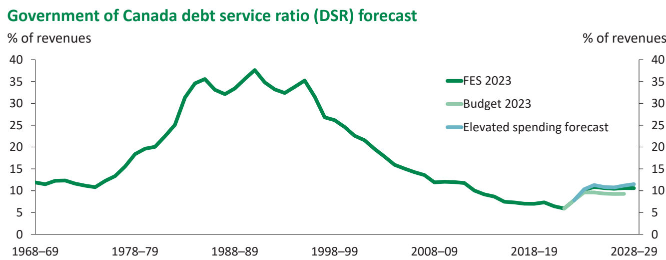


FES: Fall Economic Statement; DPE: Direct Program Expenses
Government of Canada and Desjardins Economic Studies

It should be noted that despite our lower interest rate profile than the one in the FES 2023, higher primary deficits resulting from more elevated spending would increase public debt charges. This should push the debt service ratio (DSR) higher, although better revenues on an improved economic outlook will limit the rise (graph 14 on page 6). In none of these scenarios

Graph 14
Despite Elevated Spending, Higher Revenues Should Stabilize the DSR

Government of Canada debt service ratio (DSR) forecast



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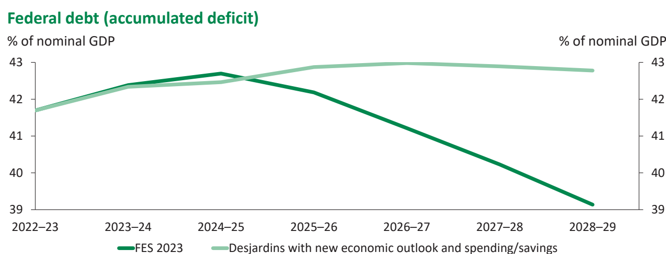
does the DSR top 12%, remaining well below the peak of 38% reached in the 1990–91 fiscal year. That said, if interest rates begin to rise beyond our forecast due to higher federal deficits and debt, the increase in the DSR would be expected to accelerate.

Bigger Deficits Mean Higher Debt

The third and final "fiscal anchor" outlined in the FES 2023 is also put at risk by these spending trends. That anchor is lowering the debt-to-GDP ratio in 2024–25 relative to the FES 2023 and keeping it on a declining track thereafter. But after incorporating the possible spending measures being bandied about, no fiscal room would remain to further increase spending going forward while maintaining this fiscal anchor (graph 15)—without raising further revenues and/or cutting spending elsewhere, that is. And this outlook is assuming that only half of the PBO's forecast for the full incremental cost of a national pharmacare plan is implemented by the 2028–29 fiscal year. A roughly similar share of Canada's NATO military funding gap is assumed to close over the same period. Further funding for these initiatives would accelerate the increase in the debt-to-GDP ratio even more.

Graph 15
New Spending Risks Pushing the Federal Debt Gradually Higher

Federal debt (accumulated deficit)



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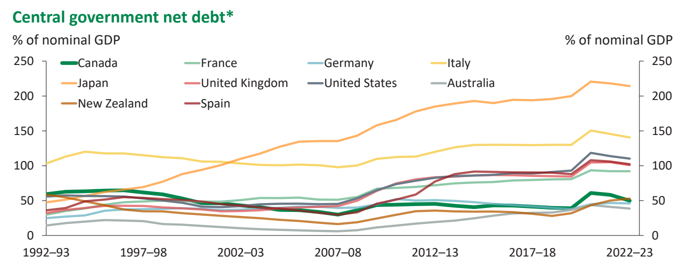
Despite this pessimistic prognostication, it is important to mention that the Government of Canada remains in a better fiscal position than most central governments in comparable countries. Whether from a deficit or net debt position, our research has found that Canada's central government remains favourably situated relative to its international peers (graph 16). This has played out in lower yields on Government of Canada bonds than on the outstanding obligations of the central governments of similar countries like the UK, Australia and New Zealand.

Graph 16
Canada's Central Government Net Debt Is Comparatively Low

Central government net debt*



*Estimates of central government net debt do not include the assets and liabilities of public pension plans
International Monetary Fund and Desjardins Economic Studies

Conclusion

The Government of Canada is in an enviable fiscal position internationally. But it can't take that for granted. Consistently running deficits to fund operating expenses, accumulating debt and pushing up against fiscal anchors puts Canada's fiscal credibility and triple-A credit rating at risk. As such, the federal government would be wise to fund any new measures from existing planned spending while looking for opportunities to generate permanent savings. At the same time, focus should be shifted to reducing barriers to business investment, thereby better supporting gains in productivity and the living standards of Canadians.