ECONOMIC VIEWPOINT

Canada: Federal Fall Economic Statement Preview

The Known Knowns, Known Unknowns and Unknown Unknowns of Federal Spending Plans

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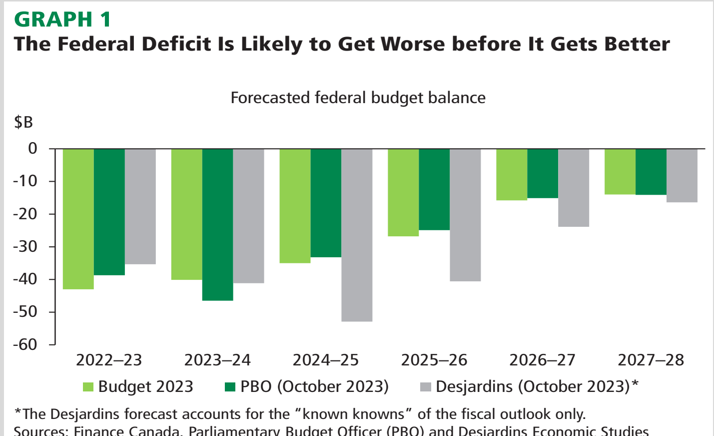
Highlights

- Channelling the late Donald Rumsfeld, former US Secretary of Defense, in this note we lay out the known knowns, known unknowns and unknown unknowns of the federal fiscal forecast in the run-up to the Fall Economic Statement 2023 (FES 2023).
- The known knowns—the things we know we know—are well known. For instance, the starting point for the federal fiscal forecast is much improved over the Budget 2023 estimate. The economy also outperformed expectations in early 2023. But this is likely to be short-lived. Indeed, the budget balance so far during the current fiscal year has underperformed. Add to this wage agreements with public servants reached before the House rose for the summer, and the known knowns of the federal fiscal forecast suggest a larger deficit in every year of the forecast (graph 1).
- Then there are the known unknowns—measures about which we know we don't know everything we need to know. These include measures from unplanned industrial subsidies and booked but unrealized revenues and savings, to the possibility of a national pharmacare plan and the fiscal impact of recent carbon tax relief. Together, these have helped to further erode the federal government's fiscal room, but by how much we can't be certain.

GRAPH 1
The Federal Deficit Is Likely to Get Worse before It Gets Better



*The Desjardins forecast accounts for the "known knowns" of the fiscal outlook only.
Sources: Finance Canada, Parliamentary Budget Officer (PBO) and Desjardins Economic Studies

- Add to this the likely unknown unknowns coming in the FES 2023—the measures we don't know we don't know—and federal fiscal room will be further chipped away at. That said, the federal government has sufficient fiscal room to keep the debt-to-GDP ratio from rising consistently over the outlook. But this shouldn't be taken for granted as rising interest rates are helping to push the debt service ratio ever higher, although it remains well below the level reached in the 1990s. As such, while the federal government would be wise to outline fiscal anchors and stick to them, one shouldn't exaggerate the current state of federal finances, which remain in better shape than in our G7 peers.

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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In the lead-up to the War in Iraq that began in 2003, then-US Secretary of Defense Donald Rumsfeld took questions from reporters on the lack of evidence of weapons of mass destruction (WMDs) in the hands of Saddam Hussein's regime. To address their concerns, he cited three types of knowledge that are relevant to making any decision: known knowns (things we know we know); known unknowns (things we know we don't know); and unknown unknowns (things we don't know we don't know). Saddam Hussein's supposed WMDs fell into the latter category. But as the world very quickly discovered, there was no evidence of WMDs because there were none, obviating the entire rationale for the invasion of Iraq. As a result, this expression has come to represent the sort of convoluted thinking used to justify unjustifiable actions.

However, there is a lot of value in this framework for categorizing information. This is particularly true in fiscal forecasting. That's because there are plenty of known knowns (e.g., measures that have been announced and are easily costed), known unknowns (e.g., measures that have been announced or considered but for which costing is difficult or non-existent) and unknown unknowns (e.g., measures that haven't been leaked by politicians and are only made public in the budget documents). There are plenty of all of these measures being bandied about by the federal government currently. This note will explore some of these measures that may be included in the federal Fall Economic Statement 2023 (FES 2023) and what they mean for Government of Canada debt and deficits.

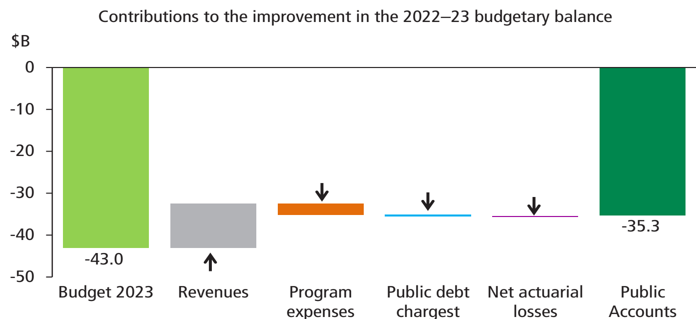
Known Knowns

There are a few "known knowns" that will be front and centre of the changes in the federal fiscal forecast since Budget 2023 was published in the spring. These include the improved starting point, the worse-than-expected economic data so far this fiscal year, changes to the economic forecast and the wage agreements reached with federal public servants through June 2023.

Improved Fiscal Starting Point

Budget 2023 projected the federal government would run a $43B deficit in the 2022–23 fiscal year. But the shortfall came in at a more modest $35.3B when the numbers were tallied up in the Public Accounts of Canada 2023. The improved outturn was entirely the result of much better-than-expected revenues—over half of which came from corporate income tax—offsetting slightly higher program expenses and public debt charges than anticipated in the budget (graph 2).

GRAPH 2
The Improvement in Last Year's Budget Balance Is Due to Revenues

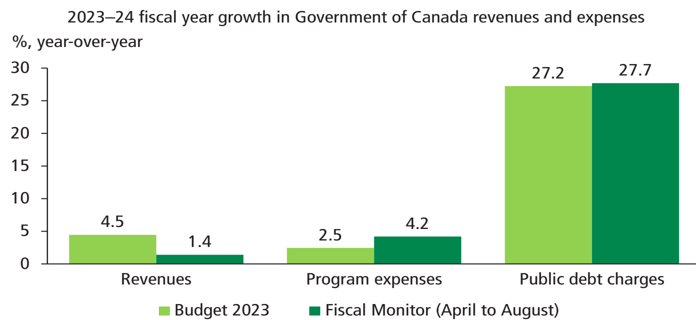


Sources: Finance Canada and Desjardins Economic Studies

The Current Fiscal Year Is Starting Off Soft

But the good times don't look as if they'll last. The first five months of the 2023–24 fiscal year are starting off softer than expected in Budget 2023. Monthly data from April through August 2023 point to cooler revenue growth, hotter program expenses and public debt charges that are broadly in line with the most recent budget projections (graph 3). Together, this is a recipe for a larger budget deficit for the current fiscal year than anticipated in the spring.

GRAPH 3
Federal Government Expenses Are Growing Faster than Revenues

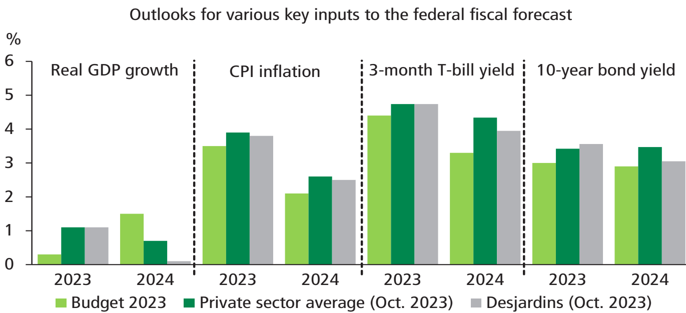


Sources: Finance Canada and Desjardins Economic Studies

Changes to the Economic Outlook Worsen the Deficit Forecast

A lot has changed since private sector economists were surveyed in the lead-up to Budget 2023. Growth has come in much stronger than expected in the first half of this year, leading to upward revisions to the forecast for real GDP growth in 2023 (graph 4 on page 3). But much of this is a Q1 story, with growth having contracted in the second quarter of the year. When combined with weak quarterly growth through the end of this year and into early 2024, real GDP is expected to advance at a materially weaker pace in 2024 than expected back in the spring.

GRAPH 4
Growth Is Down but Inflation and Rates Are Up since Budget 2023

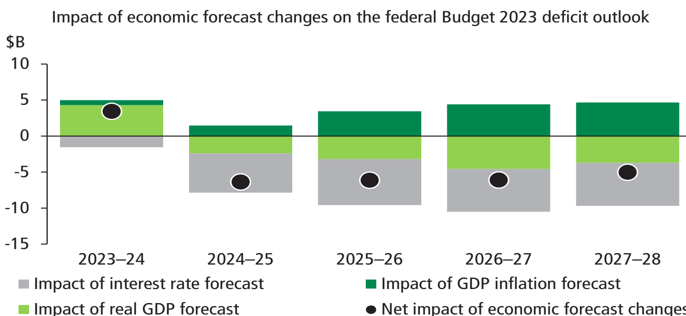


Sources: Finance Canada, Bloomberg, Statistics Canada, Bank of Canada and Desjardin Economic Studies

At the same time, inflation hasn't come down as quickly as hoped, and interest rates have moved higher—and are expected to remain higher—than projected in Budget 2023.

Together, the near-term benefit from higher growth and inflation should offset the impact of more elevated interest rates. Using the federal government's fiscal sensitivities in Budget 2023, this should reduce the deficit by around $2.5B in the 2023–24 fiscal year (graph 5). However, this benefit should fade over the medium term, as weaker real GDP growth in 2024 weighs on nominal GDP—the broadest measure of the tax base—over the remainder of the forecast. Starting in the 2024–25 fiscal year, the weaker economic outlook should drag down the federal deficit by roughly $3B on average annually. That said, we use the federal government's fiscal sensitivities as a guide only, preferring to go deeper into the outlook for changes to various tax bases and their impact on specific revenue categories. (See our most recent Economic and Financial Outlook for more information.)

GRAPH 5
Changes to the Economic Outlook Point to Larger Deficits Ahead

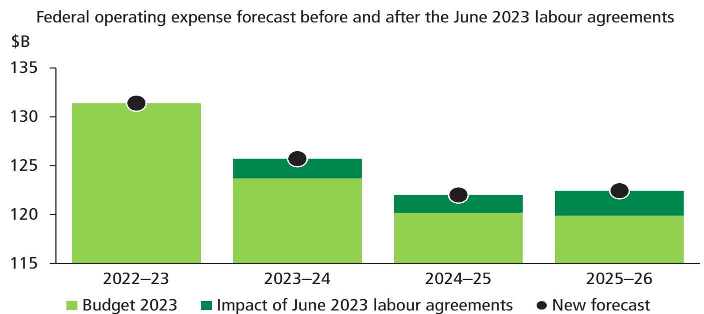


Sources: Government of Canada, Statistics Canada and Desjardins Economic Studies

Public Service Compensation Agreements Increase Expenses

Through the end of June 2023, the Government of Canada approved eight collective agreements representing 138,000 public service employees. In our extensive analysis of the fiscal impact of these agreements, we assumed that the initial offers extended by the Treasury Board to Public Service Alliance of Canada members were budgeted for. As such, the difference between the initial offers made and the final agreements would be the additional contribution to federal operating expenses. When just accounting for the public service employees covered by these collective agreements, this amounts to $2B in the current fiscal year, ultimately reaching $2.5B annually (graph 6). If the terms of these new agreements are ultimately applied to the full federal public service, then the impact on the personnel bill would be substantially larger, reaching about $6B annually starting next year. Notably, a modest amount of this increase in compensation will be offset by greater personal income tax revenues, meaning the net fiscal impact will be less than the increase in operating expenses.

GRAPH 6
Operating Expenses Will Be Higher as a Result of Wage Increases



Sources: Public Service Alliance of Canada, Government of Canada and Desjardins Economic Studies

Known Unknowns

The "known unknowns" of the federal fiscal plans are piling up and add a great deal of uncertainty to the outlook for deficits and debt. These include, but are not limited to, newly negotiated industrial subsidies for electric vehicle manufacturing, recent housing announcements, modifications to the repayment schedule for Canada Emergency Business Account (CEBA) loans, changes to how the carbon tax is applied to home heating fuel and the increase in support to rural households, future Indigenous claims, the ongoing negotiations around a national pharmacare plan, taxes on high-net-worth individuals and Canadian multinationals, and savings in the fiscal framework.

You Get a Subsidy, and You Get a Subsidy

Much as Oprah famously gave away cars to her studio audience, the federal government has been very generously doling out investment subsidies to companies it hopes will form the foundation of an electric vehicle manufacturing ecosystem in Canada. In June, we attempted to estimate the difference between what had been announced to that point and what had been enumerated in past budget documents. However, while we know the federal subsidies for Volkswagen and Stellantis exceeded what was budgeted for, we can't be certain when and for how much that new spending will be booked. As such, forecasting unplanned industrial subsidies is a bit of a mug's game that has become increasingly challenging, particularly as additional subsidies have been announced over the summer and fall. We should get some clarification in the FES 2023, although there is a strong likelihood that these numbers will be overly optimistic. Indeed, analysis by the Parliamentary Budget Officer (PBO) has made clear that it is likely to take much longer for the federal government to break even on its investments in Volkswagen and Stellantis than it currently expects (around 20 years as opposed to less than 5 years).

Measures to Accelerate Homebuilding

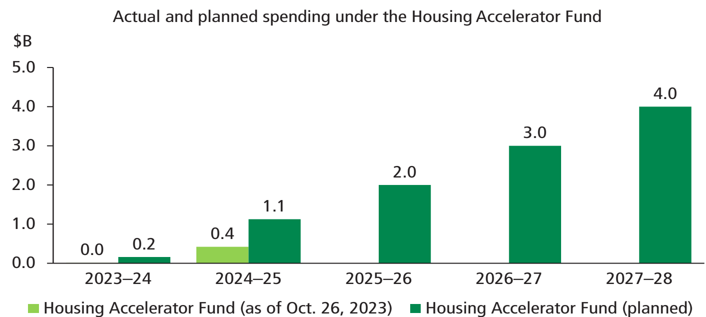
The recent move by the Government of Canada to forego the federal portion of the HST/GST on purpose-built rental construction was widely recommended, including in our research, and we applaud that decision. However, we have yet to see the price tag. But if the estimate from the recent Ontario Economic Outlook and Fiscal Review is any indication, it shouldn't break the bank.

At the same time, according to the Government of Canada, "[t]hrough Housing Accelerator Fund negotiations, cities like London, Calgary, Hamilton, Halifax, Kitchener, and Vaughan have recently made progress to end exclusionary zoning. Others are proactively changing their zoning rules and permitting process in anticipation of a decision on their Housing Accelerator application." Initially intended to provide $4B over five years starting in the 2022–23 fiscal year, the long-delayed rollout has compressed the period to four years. Funds have started to flow but remain well short of what has been budgeted for, although many more announcements are expected in the coming weeks and months (graph 7).

To Repay or Not to Repay CEBA Loans in Full by the Deadline

The CEBA program offered interest-free loans of up to $60,000 to small businesses and not-for-profits via financial institutions in Canada. Repaying the balance of the loan by January 18, 2024, would result in loan forgiveness of up to $20,000. On September 14, 2023, the federal government announced changes to the program, the most important of which was to roll the total amount for those businesses not able to repay

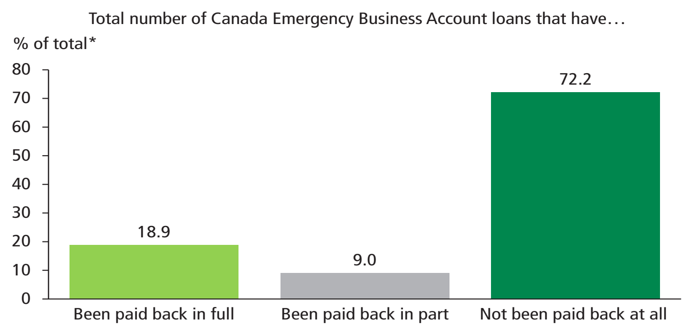
GRAPH 7
Housing Accelerator Fund Spending Is behind Schedule for Now



Sources: Government of Canada and Desjardins Economic Studies

what they owe into a 3-year, low-interest loan. This changed the nature of the repayment profile for the federal government, likely increasing the odds of repayment but over a longer period of time. However, we'll need to wait for the FES 2023 to get a better sense of the overall fiscal impact and its timing. What we do know with some certainty thanks to numbers tabled in the House of Commons on November 1 is that only a small fraction of Canadian businesses have repaid all or part of their CEBA loans as of June 30, 2023 (graph 8). To put that in perspective, nearly three quarters of the $49.2B in CEBA loans approved had yet to see even a minimal amount of repayment as of the middle of 2023.

GRAPH 8
Most CEBA Loans Haven't Been Paid Back, Even in Part



*As of June 20, 2023
Sources: Government of Canada, The Globe and Mail and Desjardins Economic Studies

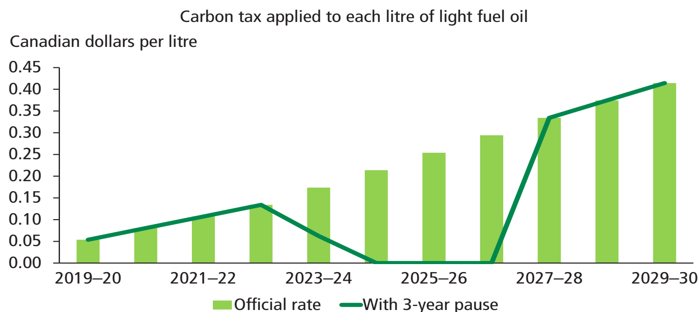
Carbon Taxes for Some but Not for All

On November 9, 2024, the federal government will begin a temporary, three-year pause on the federal carbon tax on deliveries of heating oil in all jurisdictions where the federal fuel charge is in effect. This "would save a household that uses heating oil $250 at the current rate, on average," according to the Government of Canada. At the same time, the federal government will double "the pollution price rebate (Climate

Action Incentive Payment) rural top-up rate, increasing it from 10 to 20 per cent of the baseline amount starting in April 2024." Finally, the Government of Canada is increasing incentives for installing electric heat pumps by providing an up-front payment of $250 for low- and median-income households and increasing the amount of federal funding available to homeowners from $10,000 to $15,000.

According to Statistics Canada, about 0.2% of Canadian consumer spending goes to home heating fuel. That's less than the 0.6% and 1.5% of consumer spending going to gas and electricity, respectively. As such, while pausing the federal carbon tax will weigh on headline inflation, the contribution is likely to be modest. For instance, scrapping the carbon tax on home heating fuel entirely for the next three years would only revise headline inflation lower by around 0.02 percentage points in 2024. And while this tax change will reduce "proceeds from the pollution pricing framework" in federal government revenues, it is very likely to be offset by a reduction in the climate action incentive payment. That said, this tax cut will be difficult to reverse at a later date, as a return to plan will dramatically push up the cost of home heating oil (graph 9).

GRAPH 9
Today's Carbon Tax Cut Will Be Challenging to Reintroduce Later



Sources: Government of Canada, Canada Revenue Agency and Desjardins Economic Studies

In contrast to the broadly budget-balance-neutral changes to the carbon tax, the doubling of the rural top-up rate and augmented subsidy for electric heat pumps will both exacerbate the federal deficit. In Budget 2023, the federal government projected the "Oil-to-Heat Pumps Affordability Grant" would cost nearly $250M over 4 years. The Minister of Natural Resources has now confirmed this amount will increase to $750M over the same period—a tripling in the cost but still a relatively small spend overall. Estimates of the aggregate cost of the supplement for residents of small and rural communities remain more elusive.

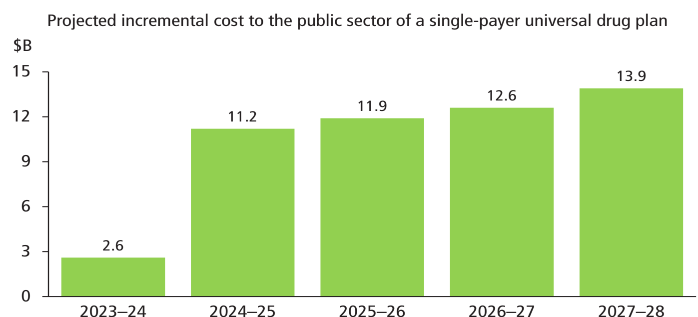
Indigenous Claims Are Adding Up

The resolution of Indigenous claims was highlighted early and prominently in the Public Accounts of Canada 2023, contributing $26B to the roughly $35B deficit. This means the deficit would have been about $9B in the absence of these expenditures. According to the Public Accounts, "The government is committed to advancing reconciliation, supporting Indigenous Peoples' right to self-determination, and addressing historical wrongs and systemic racism. Acknowledging and resolving past injustices through the resolution of Indigenous claims is an important part of renewing the relationship between the Government of Canada and Indigenous Peoples." As such, we expect to see a similar-sized contribution to federal spending going forward, albeit with significant uncertainty from year to year.

The Debate over National Pharmacare Continues

The debate over a national pharmacare plan in Canada is like watching Bill Murray's classic film Groundhog Day. It has been on the table since 2015 but the needle hasn't really moved despite much ink being spilled. However, adding to the discussion recently has been the PBO, which published an updated cost estimate of a single-payer universal drug plan in mid-October. It now estimates that if the program were to be introduced this year, the incremental cost to the public sector would gradually rise to nearly $14B annually in the 2027–28 fiscal year, which would be borne all or in part by the federal government (graph 10).

GRAPH 10
A National Pharmacare Plan Would Come with a Big Price Tag

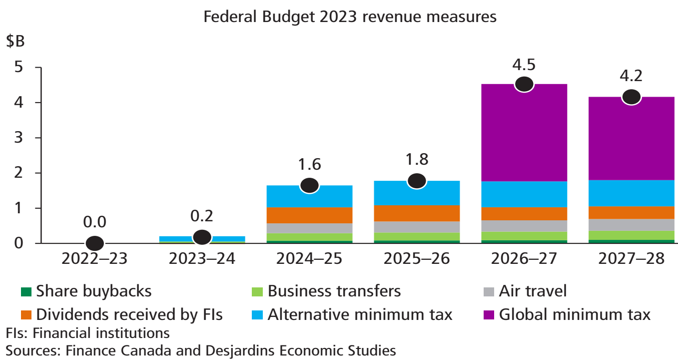


Sources: Parliamentary Budget Officer and Desjardins Economic Studies

The Taxman with the Tax Plan

The federal government booked a lot of new revenue measures in Budget 2023 that it has begun to move ahead on. These include a global minimum tax, an alternative minimum tax, and new taxes on air travel, business transfers, share buybacks, and dividends received by financial institutions from other financial institutions (graph 11 on page 6). While projected to pull in an

GRAPH 11
The Revenue Expectations for New Tax Measures Are Optimistic



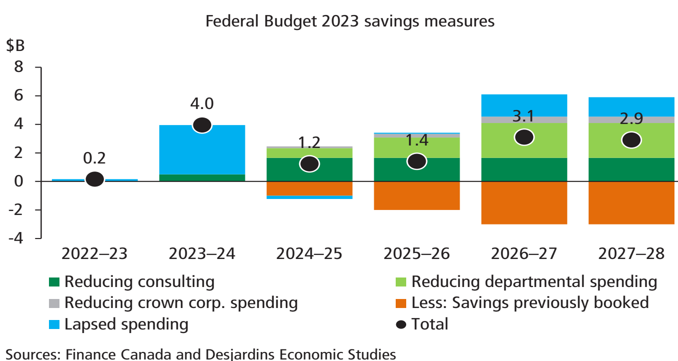
FIs: Financial institutions
Sources: Finance Canada and Desjardins Economic Studies

additional $4B annually by the end of the fiscal forecast period, the Government of Canada has already started to walk some of this back. Add to that the likely behavioural changes that made these optimistic from the start, and the ultimate tax take is likely to come in below the tally in the spring budget.

First Book the Savings, Then Figure Out Where to Find Them

Budget 2023 had a lot of planned savings built into the fiscal forecast. However, outside of lapsed spending—planned expenditures that never make it out the door—and reduced expenditures on consulting, we have yet to get a good sense of where the savings will be found (graph 12). Indeed, given that the vast majority of federal spending is on labour costs, reducing spending by federal departments and crown corporations will be challenging. This is particularly true now that wage bills have gone up. As such, we remain highly skeptical that the federal government will hit the planned savings targets announced in Budget 2023.

GRAPH 12
The Federal Government Hopes to Find Some Savings Somewhere



Sources: Finance Canada and Desjardins Economic Studies

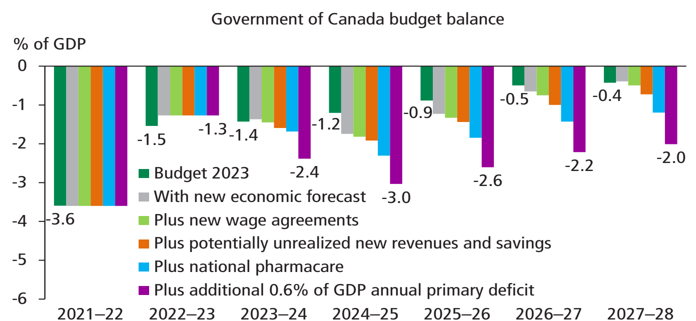
Unknown Unknowns

By definition, “unknown unknowns” are unknowable both in their nature and magnitude. But they always come, as governments want to maintain the element of surprise in their fiscal announcements to keep budget watchers on their toes. As a result of this uncertainty, it is helpful to get a sense of the potential fiscal room available to the federal government before it sets Canada on a track for the debt-to-GDP ratio to keep rising continuously.

Deficits as Far as the Eye Can See

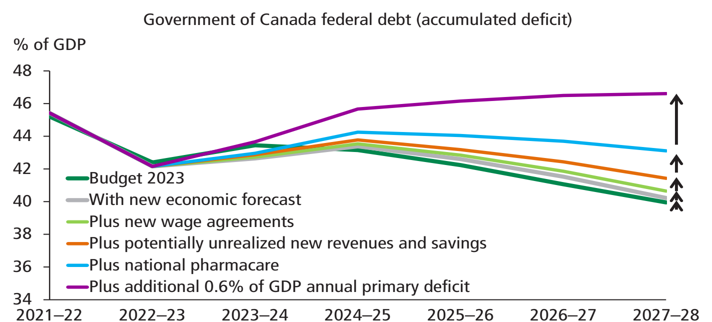
Outside of the pandemic, there have rarely been so many known unknowns (e.g., unplanned industrial subsidies and likely-to-be-unrealized tax revenues and savings) that will be included in the federal fiscal forecast. But even the known knowns (e.g., recently released fiscal numbers, updated economic forecasts, new public sector wage contracts) are stacking up. As we did in our federal fiscal forecast in September, we added up some of the more easily quantified measures (graph 13). But thanks to a smaller budget deficit in the 2022–23 fiscal year combined with our upwardly revised outlook for real GDP growth and inflation, modestly more fiscal room opened up than we previously estimated without leading to a sustained rise in the debt-to-GDP ratio (graph 14). However, much of

GRAPH 13
The Federal Deficit Will Likely Be Larger than in Budget 2023



Sources: Finance Canada and Desjardins Economic Studies

GRAPH 14
The Federal Debt Should Be Higher than Forecasted in Budget 2023



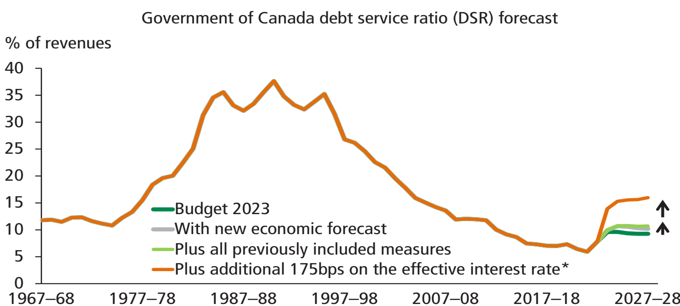
Sources: Finance Canada and Desjardins Economic Studies

this room has already been spent. We just don't know how much. But even then, we're likely a long way from federal finances being on an unsustainable track.

Mind the "Fiscal Guardrails"

A rising debt-to-GDP ratio is just one "fiscal guardrail" that should spur the federal government to get its fiscal house in order. Another that has been proposed is the debt service ratio (DSR), calculated as public debt charges as a share of revenues. In the most recent fiscal year, this came to 7.8%, the highest level since the 2014–15 fiscal year and well above the record low of 5.9% reached the prior year. Under every scenario presented so far, the DSR would stay below 12% if our interest rate projection holds true. That said, an aggressive run-up in yields alone could put the debt-to-GDP ratio on an unsustainable track even if the federal government tries to keep primary deficits under control. That's what happened in the 1990s when Canada was unquestionably on the road to fiscal ruin and nearly 40 cents of every dollar of revenue was going to service the debt. However, in the absence of larger primary deficits, an increase in the effective interest rate (e.g., this year's public debt charges over last year's federal debt) of roughly 175bps in each year of the projection would be required to keep pushing the debt-to-GDP ratio higher—a very unlikely development in the near term (graph 15). That said, a mix of modestly larger primary deficits (e.g., an additional 0.3% of GDP primary deficit in each year of the forecast) and a not-quite-as-aggressive run-up in yields (e.g., an additional 100bps in the effective interest rate in each year of the forecast) could also lead to a sustained rise in the debt-to-GDP ratio and is much more likely.

GRAPH 15
The DSR Would Need to Increase Sharply to Make the Federal Debt Unsustainable

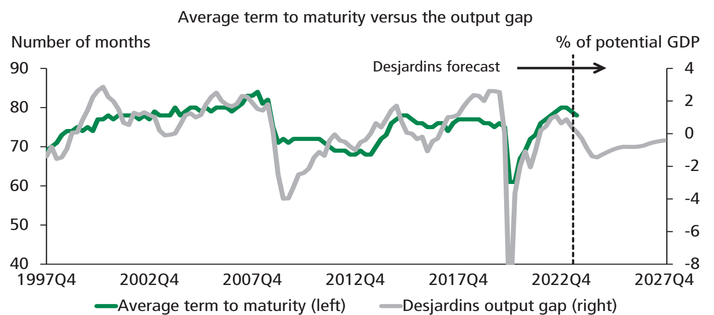


*Does not include the 0.6% of GDP primary deficit included in previous scenarios.
Sources: Finance Canada and Desjardins Economic Studies

What Could the Debt Management Strategy Look Like?

With higher deficits anticipated in the next couple of fiscal years, we expect the Government of Canada to issue a higher share of federal debt at shorter maturities. This is because greater deficits will in part be driven by a cooling of the economy and labour market, which has historically been correlated with a shorter average term to maturity (graph 16). Further, longer-term debt has tended to be less attractive to federal authorities than shorter-term debt during periods of high interest rates, as the latter has the hope of rolling over at lower rates when the debt matures. That said, there are no guarantees that future rates will be lower, so prudence had best be practiced.

GRAPH 16
More Short-Term Federal Debt Is Likely to Be Issued Going Forward



Sources: Bank of Canada and Desjardins Economic Studies

Conclusion

All told, there are a lot of unknowns when it comes to the current state of federal finances in Canada, of both the known and unknown variety. All we can be sure of is that there has been a lot more spending announced than has thus far been accounted for. As such, the FES 2023 is likely to show larger deficits starting in the 2023–24 fiscal year than were projected in Budget 2023, if not also those of the PBO and Desjardins Economic Studies more recently. Higher debt will follow. As such, the federal government would be wise to demonstrate some restraint.