BUDGET ANALYSIS

# Federal Budget 2023

## Prudence Is in the Eye of the Beholder

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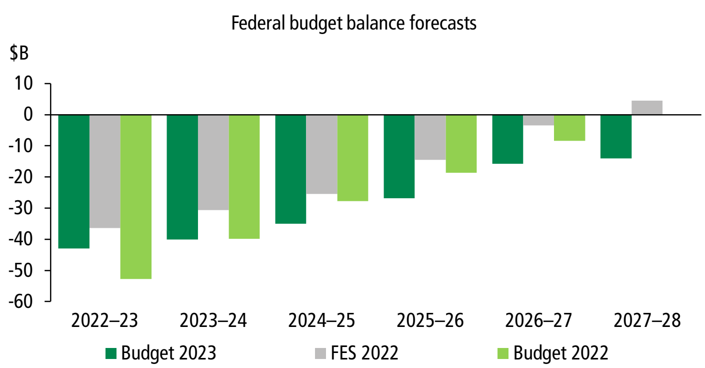
### HIGHLIGHTS

- As expected in our *Federal Budget 2023 preview note*, the Government of Canada plans to run larger deficits than anticipated in the Fall Economic Statement 2022 (FES 2022). In the 2023-24 fiscal year, the $43.0B deficit is now expected to be $6.6B greater than that published back in November of last year. After that, deficits are projected to be larger by $12.5B on average annually. Indeed, the federal government no longer expects to run a surplus at any point over the fiscal planning horizon.
- The larger deficits are entirely the result of more elevated spending. Program expenses are expected to be $39B higher over the coming five fiscal years than projected in the FES 2022. Most of this is related to measures to support the energy transition ($21B in total over 5 years). Beyond the $22B in new health care spending announced in February, other new measures were more modest, with a focus on improving affordability for vulnerable households.
- On the revenue side, the lower profile due to a weaker economic outlook is largely offset by tax hikes on high-income earners, financial institutions, and Canadian multinationals. Without these changes, revenues would have been much lower over the forecast horizon, to the tune of more than $11.6B over six years. That said, we believe the economic outlook in Budget 2023 is a reasonable starting point for fiscal planning, although risks remain tilted to the downside.
- Taken together, debt-to-GDP ratio is expected to increase from an estimated 42.4% in the 2022-23 fiscal year to a peak of 43.5% in 2023-24. After that, debt as a share of the economy is expected to track lower. This is likely to leave Canada the envy of the G7 from a net debt perspective, although gross debt should remain middle of the pack.

It came as a surprise to no one that the federal government's projected deficits are larger in Budget 2023 than they were at the time of the FES 2022 (graph 1). Indeed, next year's deficit projection now rivals the outlook in Budget 2022, which preceded the end of the COVID-19 pandemic and the tailwind to revenues that came as a result of decades-high inflation. While this partly reflects a weaker outlook for the Canadian economy than in November of last year, the primary reason for the more pessimistic deficit projection is the sharp increase in spending contained in this year's budget. Much of it was focused on keeping up with the Americans in the energy transition, but there was a little bit of spending for almost everyone. And while additional revenues are expected to be raised to pay for some of it, the debt-to-GDP ratio is likely to rise in the near term regardless. This is a trend that rating agencies will no doubt be watching closely, even as Canada remains in one of the best fiscal positions in the G7.

**GRAPH 1**
**Federal Budget Deficits Will Get Larger Before They Get Smaller**

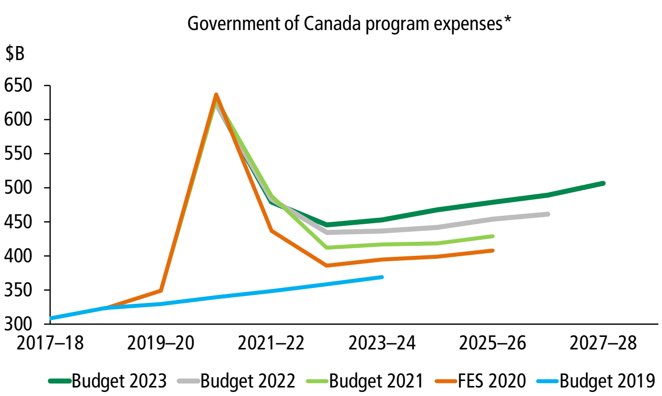



Note: 'FES' refers to Fall Economic Statement
Sources: Finance Canada and Desjardins Economic Studies

*If you spend it, the green investment will come (it's hoped)*
As was widely expected, new spending to bolster investment in Canada's energy transition was the show piece of Budget 2023. The federal government doubled down on investment tax credits (ITC) for capital investments to support the clean energy transition. The largest among the many measures was a 15% refundable ITC for clean electricity, which is expected to clock in at $6.3B over five years. It is complemented by additional financial support for clean electricity projects ($1.1B over five years). Another measure telegraphed in the FES 2022 was $5.6B over five years for an ITC for clean hydrogen, which will range between 15% and 40% of eligible project costs depending on the carbon intensity equivalency of the project—the lower the carbon intensity, the higher the ITC rate. A further $4.5B is planned for a 30% ITC for clean technology manufacturing that can be used for investment in machinery and equipment where eligible. Finally, Budget 2023 also announced its intent to begin broad-based consultations on development of carbon contracts for differences. In total, the federal government plans to increase spending for the energy transition by nearly $21B over the coming five years.

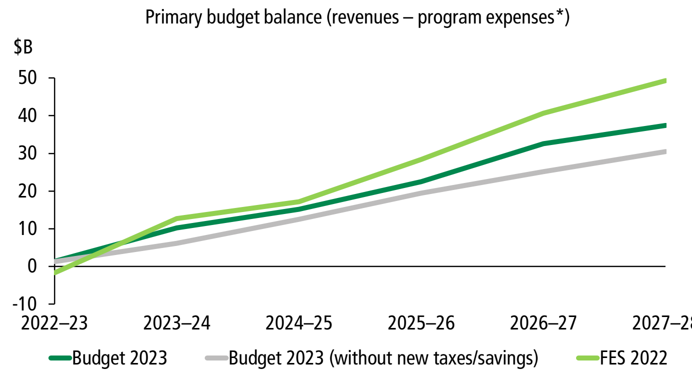
New measures to become a cleaner, greener Canada weren't the only new spending in the budget. To meet its commitments in the Supply and Confidence Agreement with the New Democratic Party, the federal government expanded the Canada Dental Benefit, which is now expected to cost $2.5B annually when fully up and running starting in 2027-28. A widely anticipated one-time grocery rebate for Canadians, to the tune of $2.5B in the 2022-23 fiscal year, was also rolled out, matching was what spent on the GST rebate announced in September last year. There was also the usual smattering of smaller measures, with notably higher spending on supporting Indigenous people. However, housing advocates will be very disappointed by the bare cupboards to address affordability in Budget 2023.

**GRAPH 2**
**Size of the Federal Goverment has Permanently Increased**




Note: 'FES' refers to Fall Economic Statement; program expenses include net actuarial losses
Sources: Finance Canada and Desjardins Economic Studies

**GRAPH 3**
**More spending will only be only partly offset by higher revenues**

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Sources: Finance Canada and Desjardins Economic Studies

Just as importantly as the measures themselves is the impact they are having on the Government of Canada's spending profile. While an increase in federal government expenditures was necessary during the pandemic, it was also expected to be temporary. The program spending forecast in FES 2020 illustrated as much (graph 2). However, with each successive budget, the profile for spending gets incrementally higher even as COVID-19 has become endemic, and Budget 2023 is no exception.

*Higher spending to be offset by tax hikes*
Unlike what we've seen at other levels of government, federal revenues before new measures came in weaker than expected back in November 2022 due to the downwardly revised economic forecast. This is particularly true for income taxes, but the weakness was broad based. We believe this provides a more prudent starting point for fiscal planning.

As a result of the lower revenue track due to the economic outlook, the decision was made to raise revenues in order to offset the new spending announced in Budget 2023 (graph 3). The federal government looks to increase taxes on the highest-income Canadians to meet the shortfall by raising the Alternative Minimum Tax (AMT). It expects to pull in $3.0B with this measure in the next five fiscal years. It also plans to generate more than $3B in revenue over five years by treating "dividends received on Canadian shares held by financial institutions in the ordinary course of their business as business income." Additionally, in implementing a Global Minimum Tax (GMT), the federal government expects to generate an average of over $2.5B annually starting in the 2026-27 fiscal year from Canadian multinationals.

Other revenue-raising measures in Budget 2023 were more modest. However, the federal government continued to increase its expectations for savings it can find under the fiscal couch cushions. It now hopes to discover a total of $6.2B in additional savings over the coming five fiscal years relative to what was previously telegraphed. We have some reservations on whether these savings will be realized, as it's easier said than done to restrain spending.

Together, the anticipated ramp up in revenues and savings are anticipated to offset around 20% of the new spending in the budget. However, these estimates are often at risk of being overly optimistic. The tax increases in Budget 2016 didn't bring in nearly as much revenues as expected, and the outcome of the proposed tax hikes in Budget 2023 may suffer a similar fate. Savings in the fiscal framework can be even harder to find. As such, deficit and debt projections could be larger than currently anticipated.

*The economy is no longer playing nice*

While the federal government is planning to raise revenues to pay for a portion of their new spending, the big surprise was how quickly the economic tailwinds have faded. Part of this is due to a modest markdown in 2023 real GDP growth, but arguably more important for Budget 2023 is the oft-overlooked substantial downward revision to GDP inflation (table 1). An all-encompassing measure of prices in the economy, the GDP inflation makes up half of the growth in nominal GDP—the broadest measure of the tax base. This weakness over the projection is largely the result of the anticipated downturn in oil prices relative to 2022, which has weighed on export prices and the Canadian dollar. But despite this slowing in GDP inflation and the broadly unchanged outlook for Consumer Price Index (CPI) inflation, the projection for the Bank of Canada policy rate has been raised relative to FES 2022, which is showing up in higher-than-expected public debt changers.

Now, it isn't all bad news. The unemployment rate is forecast to come in lower than in the FES 2022, which should keep a lid on Employment Insurance benefits while boosting revenues. But that's somewhat cold comfort when almost every other economic indicator looks as though it will make the fiscal plan more challenging than just a few short months ago.

While the baseline economic projection in Budget 2023 isn't an unreasonable starting point for fiscal planning, we believe

**TABLE 1**
**Economic and financial forecasts**

| AVERAGE ANNUAL GROWTH IN % (EXCEPT IF INDICATED) | 2022 | 2023f | | | 2024f | | |
|---|---|---|---|---|---|---|---|
| | Actual | Budget 2023 | FES 2022 | Desj. Group | Budget 2023 | FES 2022 | Desj. Group |
| Real GDP | 3.4 | 0.3 | 0.7 | 0.6 | 1.5 | 1.9 | 0.9 |
| GDP deflator | 7.4 | 0.6 | 1.9 | -0.8 | 2.0 | 1.8 | 1.6 |
| Nominal GDP | 11.0 | 0.9 | 2.6 | -0.3 | 3.6 | 3.7 | 2.6 |
| Treasury bills—3-month | 2.2 | 4.4 | 3.6 | 4.3 | 3.3 | 2.8 | 3.0 |
| Federal bonds—10-year | 2.8 | 3.0 | 3.1 | 2.7 | 2.9 | 2.8 | 2.7 |
| Unemployment rate | 5.3 | 5.8 | 6.1 | 6.0 | 6.2 | 6.2 | 6.7 |
| Exchange rate (US¢/C$) | 76.8 | 74.7 | 77.1 | 72.4 | 76.8 | 77.9 | 78.0 |
| Real GDP—United States | 2.1 | 0.8 | 0.6 | 0.9 | 1.4 | 1.7 | 1.4 |

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

**TABLE 2**
**Economic and financial forecasts**

| AVERAGE ANNUAL GROWTH IN % (EXCEPT IF INDICATED) | 2022 | 2023f | | | 2024f | | |
|---|---|---|---|---|---|---|---|
| | Actual | Budget 2023 | Down. Scen. | Desj. Group | Budget 2023 | Down. Scen. | Desj. Group |
| Real GDP | 3.4 | 0.3 | -0.2 | 0.6 | 1.5 | 1.0 | 0.9 |
| GDP deflator | 7.4 | 0.6 | -0.2 | -0.8 | 2.0 | 1.9 | 1.6 |
| Nominal GDP | 11.0 | 0.9 | -0.4 | -0.3 | 3.6 | 3.0 | 2.6 |
| Treasury bills—3-month | 2.2 | 4.4 | 4.6 | 4.3 | 3.3 | 3.6 | 3.0 |
| Unemployment rate | 5.3 | 5.8 | 6.0 | 6.0 | 6.2 | 6.7 | 6.7 |

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

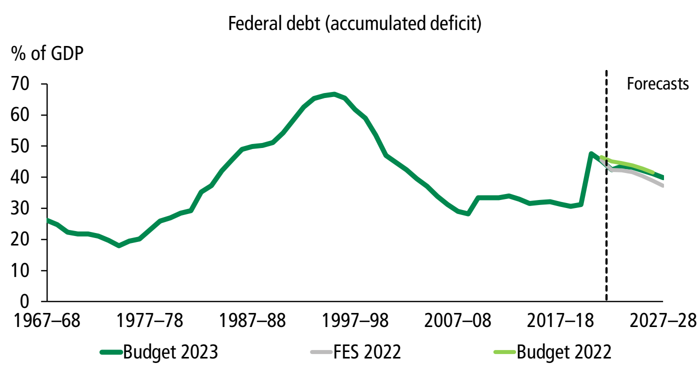
the risks are titled to the downside. Indeed, Desjardins' baseline economic forecast, published in our most recent [Economic and Financial Outlook](), is for weaker nominal GDP growth this year and next. That forecast falls somewhere between the baseline and downside economic scenarios in Budget 2023 (table 2). As such, we think the fiscal planning assumptions presented in the budget are reasonable but likely somewhat optimistic based on the economic outlook alone.

*Deficits and debt move higher in a time of plenty*

As a result of the increase in spending exceeding that of revenues, the Government of Canada plans to run larger deficits than anticipated in the FES 2022. In the 2023-24 fiscal year, the $43.0B deficit is now $6.6B greater than that published back in November of last year. After that, deficits are projected to be larger by $12.5B on average annually. Indeed, the federal government no longer expects to run a surplus at any point over the fiscal planning horizon. And this is in the absence of any sort of contingency for risk, which looks to be a thing of the past.

This string of deficits has resulted in a more elevated profile for the debt-to-GDP ratio over the projection when compared to past fiscal plans (graph 4). It is now expected to increase from an estimated 42.4% in the 2022-23 fiscal year to a peak of 43.5% in 2023-24, before tracking lower thereafter. After that, the profile

**GRAPH 4**
**Federal Debt Should Rise Before Declining as a Share of GDP**

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Sources: Finance Canada and Desjardins Economic Studies

is for a falling debt-to-GDP ratio over the medium term, and is very much in line with the profile published in Budget 2022. This is likely to still leave Canada the envy of the G7 from a net debt perspective, although gross debt should remain middle of the pack. However, if Finance Canada's downside economic scenario materializes, the debt would not only increase more than in the baseline but stay permanently higher as a share of the economy.

*A smaller (but not small) bond issuance program*

For 2023-24, the debt management strategy includes a debt issuance program of $414B, up from the estimated $387B raised in 2022-23. The size of the program is determined by both maturing debt ($358B) and the projected financial requirement ($63B). In addition to the impact of the deficit increase, the financial requirement is influenced by non-budgetary transactions, which include repayments to Canada Emergency Business Account (CEBA) loans. Reimbursements expected by year-end should help mitigate the rise in financing requirements to the tune of $21B in 2023-24.

The increase in overall issuance will largely be conducted via treasury bills. The target for the year-end stock of treasury bills for 2023-24 is $242B, up from the $202B estimated for March 31, 2023 (which was upwardly revised from the $192B projection in FES 2022).

Meanwhile, the bond program continues to shrink for the time being, with an expected $172B in 2023-24, down from $185B issued in 2022-23. This will be achieved primarily via the cancellation of the 3-year sector, but also reduced auction sizes in 10-year and 30-year sectors.

We would still observe that while smaller, the bond program is not small by any means. By way of comparison, pre-pandemic bond programs typically ranged between $95B and $100B. Moreover, with the Bank of Canada's quantitative tightening program not expected to cease before the end of the calendar year, private markets will need to digest a meaningful volume of duration in upcoming quarters. Should the Bank of Canada cut rates as we expect it to next year, issuing authorities could use the opportunity to roll some their money market debt into bonds. Large bond programs are here to stay.

*Conclusion*

Budget 2023 was another large spending plan, paid for by aspirational assumptions for raising revenues and finding savings in the fiscal framework. While we welcome the more conservative economic outlook than in the FES 2022, we are of the view that the risks remain to the downside. Taken together, larger deficits and higher debt levels than projected in Budget 2023 are more likely than not. And that's without assuming any new spending going forward. As such, the federal government would be wise to prepare for the worse instead of hoping for the best.

## TABLE 3
### Summary of transactions

| | ACTUAL | DESJARDINS PROJECTIONS | | | | |
|---|---|---|---|---|---|---|
| IN $B (EXCEPT IF INDICATED) | 2021–2022 | 2022–2023 | 2023–2024 | 2024–2025 | 2025–2026 | 2026–2027 |
| Budgetary revenues | 413.3 | 437.3 | 456.8 | 478.5 | 498.4 | 521.8 |
| *Growth (%)* | *30.6* | *5.8* | *4.5* | *4.8* | *4.2* | *4.7* |
| Program spending | -468.8 | -435.9 | -446.6 | -463.3 | -475.9 | -489.2 |
| *Growth (%)* | *-23.0* | *-7.0* | *2.5* | *3.7* | *2.7* | *2.8* |
| Debt charges | -24.5 | -34.5 | -43.9 | -46.0 | -46.6 | -48.3 |
| *Growth (%)* | *20.3* | *40.9* | *27.2* | *4.8* | *1.3* | *3.6* |
| Net actuarial losses | -10.2 | -9.8 | -6.4 | -4.2 | -2.8 | 0.0 |
| **Budgetary balance** | **-90.2** | **-43.0** | **-40.1** | **-35.0** | **-26.8** | **-15.8** |
| Federal debt[1] | 1,134.5 | 1,180.7 | 1,220.8 | 1,255.8 | 1,282.7 | 1,298.4 |
| *Growth (%)* | *8.2* | *4.1* | *3.4* | *2.9* | *2.1* | *1.2* |
| Budgetary revenues (% of GDP) | 16.5 | 15.7 | 16.3 | 16.4 | 16.4 | 16.5 |
| Program spending (% of GDP) | 18.7 | 15.7 | 15.9 | 15.9 | 15.7 | 15.5 |
| Public debt charges (% of GDP) | -1.0 | -1.2 | -1.6 | -1.6 | -1.5 | -1.5 |
| **Budgetary balance (% of GDP)** | **-3.6** | **-1.5** | **-1.4** | **-1.2** | **-0.9** | **-0.5** |
| **Federal debt (% of GDP)** | **45.2** | **42.4** | **43.5** | **43.2** | **42.2** | **41.1** |

[1] Debt representing the accumulated deficits including other comprehensive income.
Sources: Department of Finance Canada and Desjardins Economic Studies