

ECONOMIC VIEWPOINT

Federal Fiscal Outlook: Stimulus Cheques and Sanity Checks

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KEY TAKEAWAYS

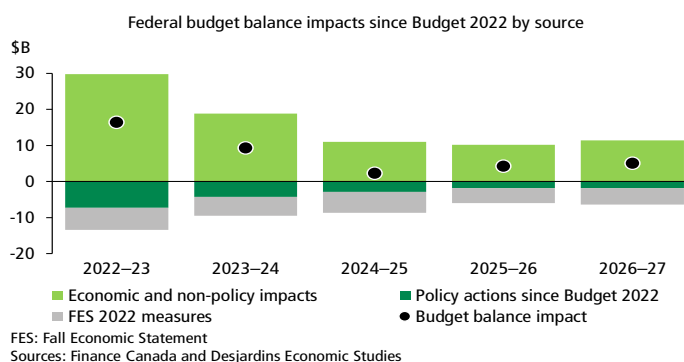
- **The Fall Economic Statement 2022 was like a frog prince: it had a few jewels but also some warts.** From questionable changes to program design and ongoing concerns about what's coming in Budget 2023, there are good reasons to be skeptical of the merits of the announced initiatives. Luckily, the affordability measures are unlikely to exacerbate inflation or hinder economic growth.
- **From a fiscal forecast perspective, the good news is the federal government set aside some of the revenue windfall for a rainy day. The bad news is it looks like it's going to need it.** Our forecasts suggest the economic and fiscal outlook will be weaker than projected in FES 2022, and the federal government's downside scenario is looking increasingly likely to become the baseline. The same is true for the Parliamentary Budget Officer's risk scenario. This will make it more difficult to fund the new energy transition measures expected in Budget 2023.
- **Fortunately, federal finances are currently on a sustainable path, with debt expected to continuously fall as a share of GDP.** It will be imperative for the federal government to keep it that way. But the Government of Canada does have some wiggle room. We estimate that the federal government could increase spending and/or reduce revenues by roughly 0.8% of GDP on average annually while keeping the debt-to-GDP ratio at or below last year's level (45.2%) through the 2027–28 fiscal year. That works out to over \$25B on average annually over the next five years.

They say absence makes the heart grow fonder, but that isn't always the case with fiscal forecasts and policy announcements. Now that the dust has settled on the federal Fall Economic Statement 2022 (FES 2022), some of the initiatives have raised eyebrows. And it's not just the sticker price. Additional fiscal forecasts have also been published by the Parliamentary Budget Officer (PBO) that let us better benchmark the federal government's fiscal baseline and downside scenarios as well as our own. And then there's the whole question of what this all means for fiscal sustainability.

Stimulus Cheques

Shortly after the embargo was lifted on FES 2022, we published our [early assessment](#) of the measures in it. We concluded that the measures were modest relative to the revenue windfall experienced by the federal government (Graph 1). The outcome would have been very different if the federal government had spent all of the unanticipated tax take, which would have driven the debt-to-GDP ratio higher (Graph 2 on page 2). This is because larger primary deficits would have raised the debt level and pushed up public debt charges, even assuming the

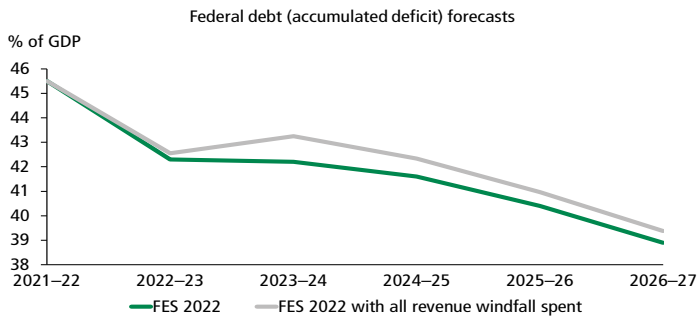
GRAPH 1
The improved fiscal outlook is all due to the recent revenue windfall



economic outlook in FES 2022 remains unchanged. However, higher inflation due to stimulative spending and deeper structural deficits could prompt the Bank of Canada to hike further, compounding the Government of Canada's challenges in this scenario.

GRAPH 2

Federal debt would be even higher if the revenue windfall were spent



FES: Fall Economic Statement

Sources: Finance Canada and Desjardins Economic Studies

But this doesn't mean these new measures aren't without sin. We knew before FES 2022 that the federal government planned to [double the GST tax credit for six months](#) and [top up the Canada Housing Benefit](#). These measures were limited and targeted towards low-income households. The [Canada Dental Benefit](#) is similarly targeted but was already included in Budget 2022. The remaining affordability measures were more questionable, if not in desired impact than in design. The automatic advance for the Canada Workers Benefit has come under particular scrutiny. In its most recent [Issues for Parliamentarians](#), the PBO took issue with the changes. Specifically, that eligibility will be based on qualifying in the prior tax year, with the federal government not requiring repayment of ineligible benefits based on the current year's income. This adds around \$800 million to the cost of the program annually. It also marks "a pronounced departure from the existing federal tax and transfer system." As such, it could be a canary in the coal mine for future transfer program redesigns, as it may result in higher and more poorly targeted income supports. And while eliminating interest on federal student and apprentice loans is equally questionable in terms of its targeting, it shouldn't come as a surprise as it was a commitment made in the [Liberal Party of Canada's 2021 federal election platform](#). Maybe most importantly, the impact of these new affordability measures on growth and inflation is expected to be modest. Together, they should add less than 0.05 percentage points to annual Canadian real GDP growth and inflation in each of this year and next—clearly contributing to inflation but not by much. This is also less than the combined stimulus shelled out by the provinces in 2022. (See our [analysis](#).)

Other measures in FES 2022 were more likely to be criticized due to their scope and scale. Take policies meant to close the gap with those in the US Inflation Reduction Act (IRA). The IRA earmarked nearly \$400B in new spending for decarbonization in the form of corporate and consumer tax incentives, grants and loans, and federal operations. Meanwhile, the flagship measure in FES 2022—an investment tax credit for clean technologies—fell well short of achieving equivalence with the IRA. Other

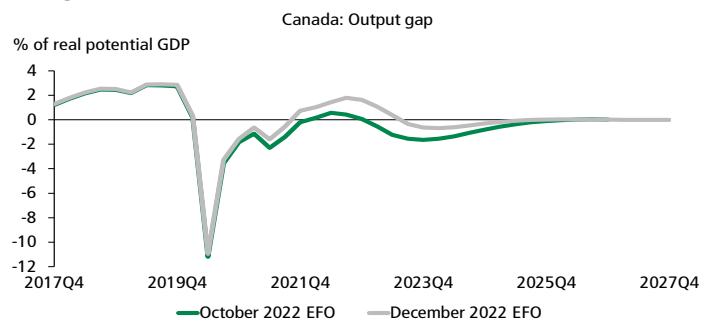
similar measures related to the energy transition suffered the same fate. That said, federal officials have been clear that FES 2022 was just a "down payment" and that "significant additional actions will be announced in Budget 2023." But with a recession likely around the corner, we'll need to see what the spring budget brings, as there could be less cash in the kitty for these promised initiatives. One area of opportunity we'll be tracking closely that didn't receive much attention in FES 2022 is carbon, capture and storage (CCS). According to [Desjardins Capital Markets](#), "2023 is likely to be a critically important year for the advancement of CCS projects in Canada. The federal government has signalled its intention to create a level playing field between Canada and the US [...]. The bottom line is that the achievement of supportive policies around CCS in 2023 will likely enable the launch of large-scale investments in projects that will play a key role in decarbonizing the economy."

Sanity Checks

In a lot of ways, FES 2022 is old news. Instead, we need to look ahead to Budget 2023. And the outlook is decidedly mixed. The latest monthly fiscal data point to a better outturn for revenues in the 2022-23 fiscal year than we previously expected. However, recent upward revisions to historical real and nominal GDP suggest that the economy is running hotter than previously expected (Graph 3). This means high interest rates could stick around for longer to close Canada's output gap and bring inflation to heel. A deeper economic contraction could therefore be in store. Moreover, the revisions mean that the ratio of revenues to nominal GDP was lower over the past few years than estimated in FES 2022. That should lower the revenue-to-income ratios used to forecast government revenues over the long term.

GRAPH 3

The output gap is estimated to be higher than we previously thought

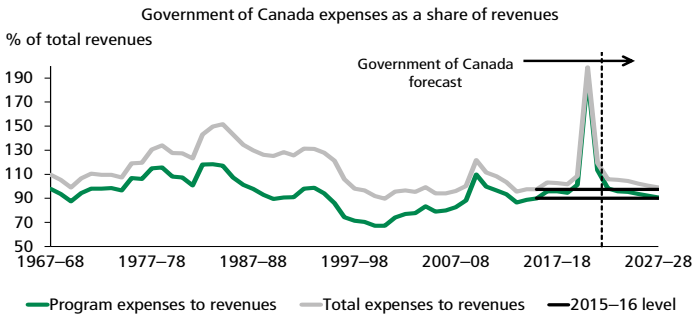


EFO: Economic and Financial Outlook

Source: Desjardins Economic Studies

Due to this more lacklustre economic outlook, revenues should advance at a slower pace and expenses remain more elevated than predicted in the latest federal fiscal plan. At that time, the federal government expected to see spending continue to fall as a share of revenues over the outlook, ultimately reaching the level of the 2015-2016 fiscal year (Graph 4 on page 3). That now seems like wishful thinking. Indeed, after the 2022-2023 fiscal

GRAPH 4
The federal government expects revenues to well outpace expenses

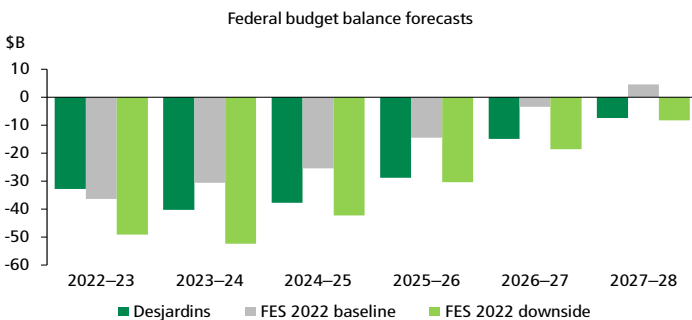


Sources: Finance Canada and Desjardins Economic Studies

year, our updated federal deficit projection looks a lot more like the federal government's downside scenario than its baseline (Graph 5). It isn't far off the [PBO's downside risk scenario](#) either (Graph 6).

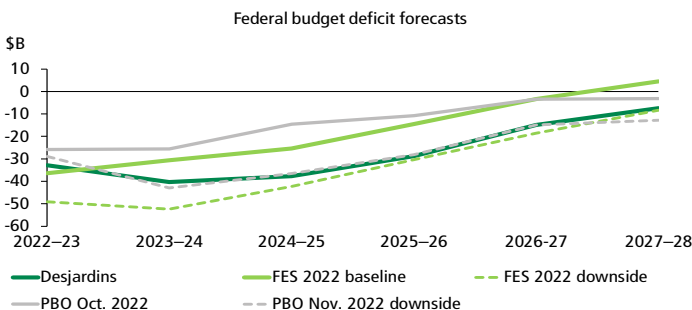
There's an important caveat to this outlook. We continue to forecast that the federal government will eventually return to running structural primary surpluses (Graph 7). This means

GRAPH 5
Federal budget deficits should get larger before they get smaller



FES: Fall Economic Statement
Sources: Finance Canada and Desjardins Economic Studies

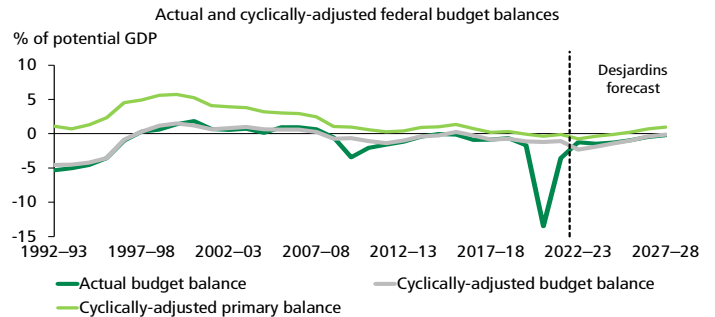
GRAPH 6
Our deficit outlook is close to other forecasters' downside scenarios



FES: Fall Economic Statement
Sources: Finance Canada, Parliamentary Budget Officer (PBO) and Desjardins Economic Studies

revenues will ultimately exceed program expenses even after the impact of the business cycle is removed. When the impact of the business cycle on interest rates is accounted for, the outlook doesn't look to be nearly as rosy. But even the structural budget deficit is expected to nearly disappear along with the actual budget deficit by the 2027-28 fiscal year.

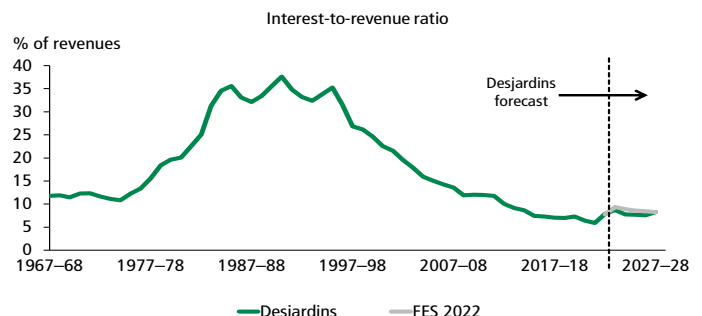
GRAPH 7
The federal government is likely to eventually run structural surpluses



Sources: Finance Canada and Desjardins Economic Studies

An important contributor to this gradually improving outlook is the anticipated decline in the effective interest rate after the 2023-24 fiscal year. This is the result of falling interest rates across the yield curve, which should then stabilize government borrowing costs at lower levels than today. Consequently, public debt charges are expected to fall over time as a share of revenues (Graph 8). Revenue growth is expected to outpace the advance in program expenses as well. Consequently, we expect the debt-to-GDP ratio to move gradually lower and at only a slightly slower pace than the government has forecast in FES 2022 (Graph 9 on page 4). This should keep the federal debt on a sustainable path in spite of the expected weakness in the Canadian economy going forward. Indeed, we estimate that the federal government could increase spending and/or reduce revenues by roughly 0.8% of GDP on average annually while keeping the debt-to-GDP ratio at or below last year's level

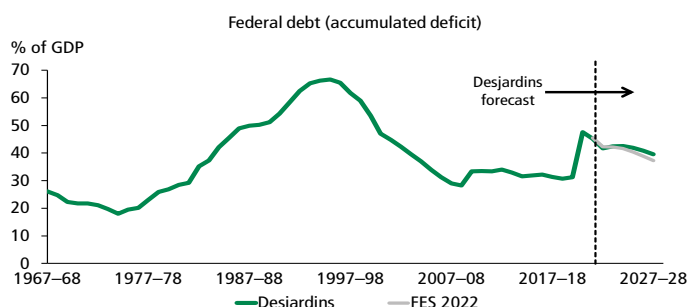
GRAPH 8
Federal interest costs are rising quickly but should remain modest



FES: Fall Economic Statement
Sources: Finance Canada and Desjardins Economic Studies

GRAPH 9

The federal debt is expected to gradually decline as a share of GDP



FES: Fall Economic Statement

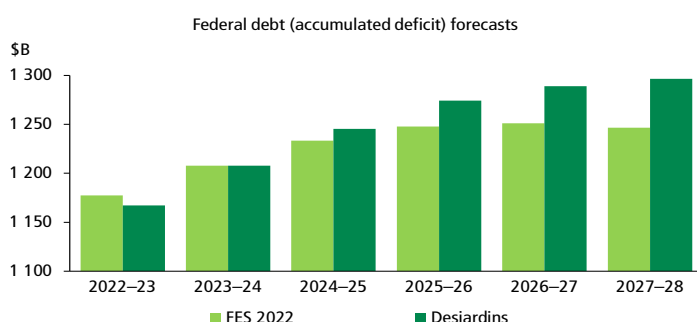
Sources: Finance Canada and Desjardins Economic Studies

(45.2%) through the 2027–28 fiscal year. That works out to over \$25B on average annually over the next five years. This isn't nearly as optimistic as the [PBO's Fiscal Sustainability Report 2022](#), but the different time horizons of the forecasts mean it's not an apples-to-apples comparison.

While debt is expected to rise more quickly over the forecast, we anticipate that it will come in below the level projected in FES 2022 in the current fiscal year (Graph 10). This is entirely the result of a smaller budget deficit forecast this year due to a solid revenue performance that is on track to outpace the FES 2022 projection. The question is: How will this near-term improvement in the federal debt impact the Government of Canada's Debt Management Strategy (DMS)? If recent history is any guide, the reduction in projected gross issuance in the 2022–23 fiscal year from Budget 2022 to FES 2022 was concentrated in shorter-term maturities, such as 2- and 3-year bonds (Graph 11). And this was complemented by a \$21B reduction in the projected gross issuance of Treasury bills. Exceptions to this pattern were the scrapping of the planned \$4B ultra-long bond auction and the decision to cease issuance of Real Return Bonds (RRBs) going forward. With Treasury bills making up half of total planned issuance in the 2022–23 fiscal year and 2-year GoC bonds expected to be the maturity with largest issuance, it seems like

GRAPH 10

The near-term improvement in federal debt will be short-lived

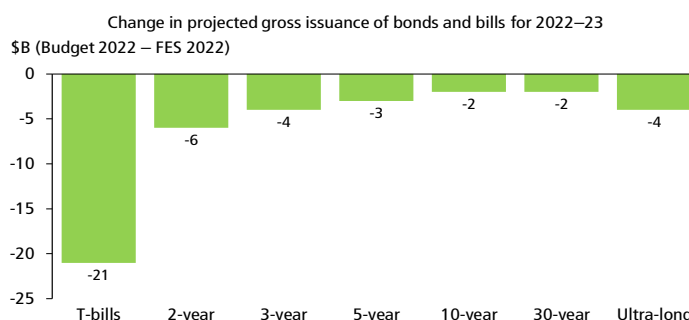


FES: Fall Economic Statement

Sources: Finance Canada and Desjardins Economic Studies

GRAPH 11

The government has reduced issuance in shorter-term maturities



FES: Fall Economic Statement

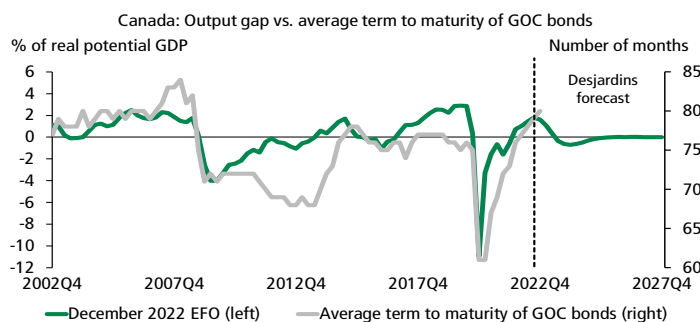
Source: Finance Canada

the short end of the curve is ripe for a smaller-than-planned issuance.

But the good times aren't expected to last. With a recession on the horizon, the federal budget deficit is expected to worsen. Consequently, gross issuance should increase again in the 2023–24 fiscal year. In the past, economic downturns have typically led to a lower average term-to-maturity of outstanding debt because of a larger increase in short-term debt issuance (Graph 12). However, as the economy rebounds in 2024 on the back of expected rate cuts as inflation continues to cool, the average maturity should again begin to move higher given the larger share of outstanding longer-term debt than before the COVID-19 pandemic.

GRAPH 12

The impending recession could see the average debt maturity fall



GOC: Government of Canada; EFO: Economic and Financial Outlook

Sources: Bank of Canada and Desjardins Economic Studies

Bottom Line

FES 2022 was like a frog prince: it had a few jewels but came with some warts. From questionable changes to program design and open questions about what's coming in Budget 2023, there are good reasons to be skeptical of the merits of the announced initiatives. Luckily, the impact on real GDP and inflation of the larger well-targeted affordability measures is expected to be modest. From a fiscal forecast perspective, the good news is

the federal government set aside some of the revenue windfall for a rainy day. The bad news is it looks like they're going to need it. Our forecasts suggest the economic and fiscal outlook will be weaker than projected in FES 2022, and the federal government's downside scenario is looking increasingly likely to become the baseline. The same is true for the PBO's risk scenario. This will make it more difficult to fund the new energy transition measures expected in Budget 2023. Fortunately, federal fiscal finances are currently on a sustainable path. It will be imperative for the federal government to keep it that way.