ECONOMIC VIEWPOINT

Spending Promises Will Have an Impact on the Federal Fiscal Outlook

By Randall Bartlett, Senior Director of Canadian Economics

Recent economic developments in Canada have benefitted the bottom lines of provincial governments. The same is expected to be true of the federal budget in the near term. But major spending commitments during and since the 2021 federal election raise questions about the long-term sustainability of federal finances, with upside risk to the federal government's most recent debt-to-GDP outlook.

Spring budget season is upon us, and the torrent of provincial budgets will soon be followed by the latest federal fiscal forecast. Though the pandemic recovery is well underway, the federal government has kept us guessing about what goodies it will add to the December deficit outlook. With outstanding spending promises and the war in Ukraine added to the mix, the federal fiscal outlook remains highly uncertain.

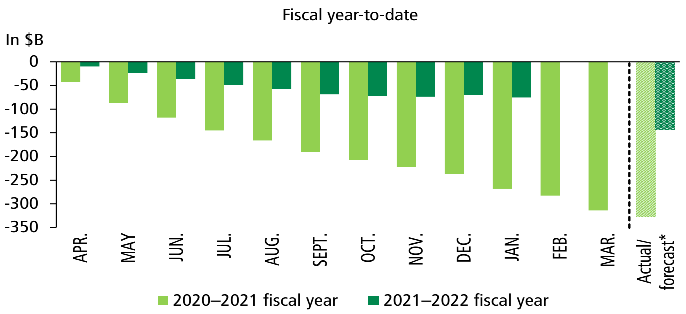
A Blast from Monthly Deficits Past

Much like recent provincial budgets, the federal budget deficit for the 2021–2022 fiscal year (FY22) is shaping up to be smaller than projected in the December 2021 Economic and Fiscal Update (2021 EFU). So far, incoming monthly data on the federal fiscal position point to an improved fiscal situation on both better revenues and lower pandemic-related spending (graph 1). This suggests the FY22 deficit could come in well below the nearly $145 billion shortfall projected in the 2021 EFU.

For Deficits and the Economy, It's Complicated

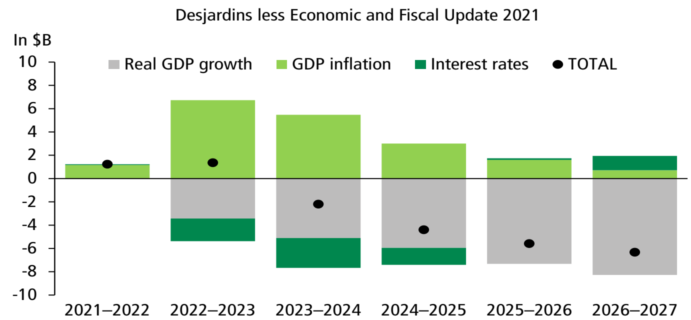
Some but not all of the decline in the FY22 deficit estimate is due to changes in the economic outlook. The economic-driven improvement in the near-term deficit is set to continue in FY23, based on Desjardins's latest *Economic & Financial Outlook* relative to the average of private sector forecasts published in the 2021 EFU. This is primarily the result of higher inflation, which is largely offset by weaker real GDP growth and higher interest rates (graph 2). But the further you look into the future, the more the revisions to the economic outlook weigh

GRAPH 1
Year-to-date federal fiscal numbers point to a smaller deficit this year



* Projected annual budgetary balance.
Source: Finance Canada

GRAPH 2
Inflation is improving the federal deficit in the near term



Sources: Finance Canada and Desjardins, Economic Studies

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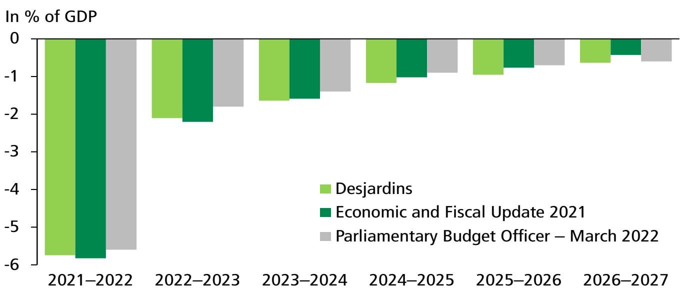
on the deficit projection in the 2021 EFU. Because of the updates to the economic forecast, Desjardins's federal deficit outlook is slightly worse than, albeit broadly in line with, those of the Government of Canada in the 2021 EFU and the Parliamentary Budget Officer (PBO) (graph 3).

GRAPH 3
Federal budget deficits are expected to steadily improve



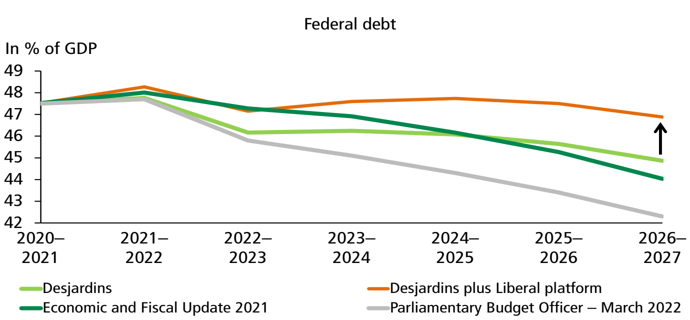
Sources: Finance Canada, Parliamentary Budget Officer and Desjardins, Economic Studies

More Promises, More Problems

But the monthly in-year data and change in the economic outlook are only part of the story. Specifically:

- The 2021 EFU didn't include the vast majority of the promises the federal Liberal Party made in the 2021 election, which amounted to about $25 billion in new revenues and $80 billion in new spending over five years. That's in addition to funds set aside in Budget 2021, such as for $10 a day child care. Accounting for these revenue and spending measures could increase the federal deficit by $13 billion (or 0.4% of GDP) on average annually from FY22 through FY26. This would raise the federal debt-to-GDP ratio starting in FY24 after an inflation-led improvement in FY23 (graph 4).

GRAPH 4
New spending promises could stall the decline in debt-to-GDP



Sources: Finance Canada, Liberal Party of Canada, Parliamentary Budget Officer and Desjardins, Economic Studies

- The Liberals and NDP reached *A Supply and Confidence Agreement* on March 22 to keep the federal government in power until 2025 in exchange for the Liberals acting on key NDP priorities, including national pharmacare and dental care. The PBO costed the NDP's pharmacare proposal in the run-up to the 2021 federal election. It concluded that a national pharmacare program would cost about $11 billion (or 0.4% of GDP) annually and more once fully implemented in FY24. Together with the measures in the Liberal Party's election platform, it would keep the federal debt-to GDP ratio roughly constant at around 48.5%. But when you layer on the cost of a national dental care program, which was neither costed by the PBO nor included in the 2021 NDP election platform, the federal debt-to-GDP ratio would gradually increase, which could raise concerns about long-term fiscal sustainability. And this doesn't include any increase in the Canada Health Transfer (CHT) escalator—the annual pace of growth in the CHT—which has been a long-time ask of Canadian Premiers.

- Moreover, in January 2022, the federal government agreed in principle to providing $40 billion in compensation to Indigenous children and families for the historical removal of children and underfunding of services. However, there has been no guidance so far on how the federal government will distribute these funds.

- Finally, the war in Ukraine has put additional pressure on all Western governments, including Canada, to increase military spending. NATO countries are supposed to spend at least 2% of GDP on defense, but most spend much less. That means closing the gap will be no small task. According to 2021 NATO estimates, Canada would need to increase its defence spending by about 50% to meet the NATO target, ballooning the federal budget deficit by about $15 billion to $20 billion, or just shy of 1% of GDP, annually.

Conclusion

Given all the recent spending commitments, any near-term drop in the federal deficit from today's improved economic outlook could be fleeting. As such, we feel the risks to our baseline debt-to-GDP forecast are very much skewed to the upside.

It's an open question whether spending can be restrained or sufficient revenues raised to keep the federal debt from growing faster than the economy. If the debt rises too quickly on the back of continued large deficits, federal fiscal sustainability could come to be questioned. Inflation is currently doing the heavy lifting on that front, though that too is not sustainable. But with another election now unlikely before 2025, we'll have plenty of time to see how this turn to more expansionary fiscal policy plays out.