BUDGET ANALYSIS

Canada: Budget 2022

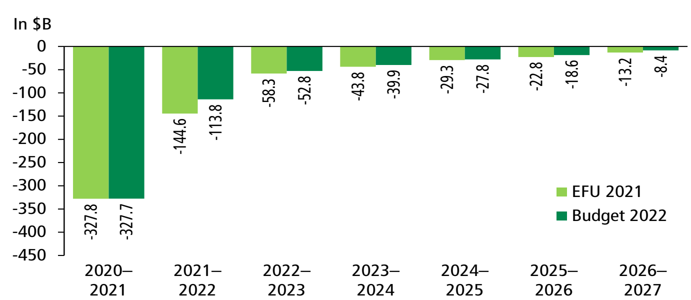
Economic Tailwinds and Modest New Spending Lead to Improved Fiscal Outlook

HIGHLIGHTS

- Higher real GDP, employment and inflation since the Economic & Fiscal Update 2021 (EFU 2021) have boosted federal government revenues significantly in Budget 2022 and contributed to lower spending in the near term, particularly on pandemic-related programs.
- The federal budget deficit is now projected to fall from 4.6% of GDP ($113.8 billion) in the 2021–2022 fiscal year to 0.3% of GDP ($8.4 billion) in the 2026–2027 fiscal year. Higher revenues explain the improved outlook, which was kept in check by only modestly higher, albeit still elevated, spending.
- But that doesn't mean there weren't any new measures. Big items in the window include a national dental care plan, a modest increase in spending on defense, a Housing Accelerator Fund to support municipalities increasing the supply of housing, an investment tax credit for carbon capture, utilization, and storage, the list goes on.
- On the revenue side of things, the federal government's focus is on generating revenues by taxing financial institutions and taxable income that Canadian companies earn abroad. There are also meaningful revenues and savings booked from beefing up the Canada Revenue Agency's capacity and the federal government finding efficiencies—ambitious goals for any administration.
- The result of this improved economic and deficit outlook is a debt-to-GDP profile that is comfortably falling over the forecast, from 47.5% in the 2020–2021 fiscal year to 41.5% six years later. Even in a more adverse scenario, the debt forecast is expected to fall to below where it was at the fiscal year that just ended, at 42.8% of GDP. This should keep fiscal hawks and rating agencies happy for now.

As goes the economy goes the federal balance, and there has been good news on both accounts. Higher-than-expected real GDP, employment, and inflation since December 2021 have led to a meaningful improvement not just in the deficit now but over the entire federal fiscal outlook through the 2026–2027 fiscal year (graph 1). A much higher outlook for revenues can be thanked for this, while less spending than was floated in the run up to Budget 2022 also made a helpful contribution. This adds up to a faster pace in the decline of the debt-to-GDP ratio than previously expected, which should appease most of the fiscal hawks out there for now.

GRAPH 1
Federal deficit improve again in Budget 2022



EFU: Economic & Financial Update
Source: Finance Canada

Economic Tailwinds Helped Shrink the Deficit

As a starting point for most budget forecasts, the government first lays out the impact of the changes in the economic outlook on the bottom line. In bad times, it can share some of the blame

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for weaker-than-expected budget numbers. But in good times, it can free up room in the government's fiscal framework for new spending or tax cuts.

And it's on the favourable side of the ledger where the federal government found itself in Budget 2022. As growth, employment, energy prices and, especially, inflation have surprised to the upside, so too have revenues. This has also helped to keep expenditures down, as people have rapidly returned to work following the pandemic. All in all, improvements in the economic outlook since the EFU 2021 have helped to boost the budget balance by roughly $85 billion over the six years to fiscal 2026–2027. That's nothing to sneeze at.

But it is also a cautionary tale. Protracted inflation also erodes peoples' real income if it isn't passed along through wages, ultimately hitting real GDP through lower household spending and, eventually, investment. It also risks prompting the Bank of Canada to increase interest rates more quickly, as we've seen market expectations suggest since the time the forecasts of private sector forecasters were collected in early-February. If interest rates rise quickly to combat higher inflation, as is the case in the federal government's "heightened impact scenario", this could lead to a more challenging economic and fiscal environment.

Revenues Are Doing a Lot of the Heavy Lifting

One of the big surprises from the federal budget was the increase in federal revenues. This improvement is expected to total over $100 billion from the 2021–2022 to 2026–2027 fiscal year inclusive. While part of this is a windfall from the better economic outlook, nearly $16.5 billion are expected to come from additional revenue raising measures.

Some of these new tax measures have been long discussed by the federal government. These include the Canada Recovery Dividend ($4.1 billion over five years), which is a temporary, one-time 15% tax on the taxable income of banking and life insurers' groups above $1 billion for the 2021 tax year. It will be payable in equal installments over five years. These same companies will also be subject to a permanent increase in the corporate income tax rate of 1.5 percentage points—from 15.0% to 16.5%—on taxable income above $100 million ($2.1 billion over five years). Putting our economist hats on, we believe the practice of targeting specific industries or companies with higher corporate income tax rates is questionable for any jurisdiction, including Canada. If revenues are scarce, the better approach is to work to make the tax system more neutral and broad-based across all businesses as opposed to targeting a subset.

Beyond these new taxes that were already in the policy window, there are new measures that target income held by Canadian companies in foreign corporations as well as tax changes applied to insurance contracts starting in 2023. While we're not tax experts, it is an open question as to whether these new tax measures will generate the amount of tax revenue that is being forecasted. Indeed, we've seen meaningful shortfalls in this regard in the past. Further, additional funding for the Canada Revenue Agency is expected to pull in an extra $2.75 in revenue for every dollar spent, for a total net increase in revenues of $2.2 billion in revenues over five years. Much like some of the other proposed new tax measures, the proof of the tax revenue pudding will be in the tasting.

Spending Was More Constrained than Expected

In contrast to the sharp increase in revenues, program spending is expected to increase by a more modest $42.5 billion over the outlook. Again, some of this comes from the improved economic environment in the near term. Nearly $9 billion will also come from savings and a more "effective government"—a challenging proposal for any government.

But this level of spending also means that the federal government left some of the windfall it's expecting on the revenues side in the bank. Indeed, relative to the size of proposed spending that was being bandied around prior to Budget 2022 related to 2021 election platforms, Supply & Confidence agreements, hitting NATO targets in defense spending, national pharmacare and dental care programs, etc., the spending cupboard looked to be relatively bare.

Housing Measures Will Likely Come Up Short

Housing was expected to be a central topic of Budget 2022, and it took the coveted spot as the first chapter. Totalling roughly $9.5 billion over the next five fiscal years, the keynote measure was the launching of a new Housing Accelerator Fund ($4 billion), which will support communities increasing the housing supply in the hope of creating 100,000 net new housing units over the next five years. However, how the federal government will deliver on this remains vague on details. While other measures to increase the housing supply were more modest, new funds are dedicated to rapidly building new affordable housing ($1.5 billion over the next two years) and some funds are being repurposed for speeding up housing construction and repairs for vulnerable Canadians as well as increasing housing construction around transit stations.

On the demand side of the housing market, the federal government reiterated its plan to move forward on a Home Buyers' Bill of Rights and examine the role of large corporate investors in treating real estate as an asset class. It also plans on making anyone who sells a property they have held for less than 12 months pay the full tax rate on their profits as business income. And then, of course, there is the pre-announced ban on foreign investment in Canadian housing for the next two years. For first-time homebuyers, the federal government will also introduce a Tax-Free First Home Savings Account as well as double the First-Time Home Buyers' Tax Credit.

All in all, while we believe these measures will help to provide some relief in the housing market, they will be challenged to meet the need for increased supply that plagued the Canadian real estate sector even prior to the pandemic.

Other Spending Was a Mixed Bag of Measures

Another big line item in Budget 2022 was the increase in defense spending. However, this too may leave advocates wanting more, as by the 2026–2027 fiscal year total defense spending is expected to by roughly 1.5% of GDP—still well below the NATO target of 2%. And the measures themselves—focusing on modernizing NORAD and beefing up the federal government's ability to contend with cyber threats—may seem a little pedestrian to those expecting fighter jets.

Climate change was of course a big focus of the budget, and in particular the federal government's new 2030 Emissions Reduction Plan. Net new funding totalled nearly $12.5 billion over the five years to the 2026–2027 fiscal year. This included $2.6 billion for a new investment tax credit for carbon capture, utilization, and storage. Notably, the federal government is also phasing out flow-through shares for oil, gas, and coal activities.

Health care and Indigenous advocates may walk away from Budget 2022 disappointed. On health, while a costed dental care plan was presented ($5.3 billion over the next five years), a national pharmacare plan barely warranted a mention. That said, additional funds tied to the Canada Health Transfer (CHT) will meet some of the calls from Premiers as will funds to address surgery backlogs. Meanwhile, remuneration to Indigenous people for past injustices and support for First Nations children through Jordan's Principle seems to have come up short of amounts agreed to in principle. This despite investing nearly $4 billion over the next five years in Indigenous housing.

In a nod to the long-term economic outlook, there are a few notable proposals. Immigration is always central to any federal budget and this was no exception. Indeed, additional funds will be set aside to support the processing and settlement of the planned over 1 million new permanent residents to Canada ($2.1 billion). To spur investment in commodities related to the low-carbon transition, the federal government plans to make about $850 million in infrastructure investments linked to the Canadian Critical Minerals Strategy. Finally, in yet another attempt to spur productivity and innovation, the federal government will create a Canadian Innovation and Investment Agency, although past experience suggests we'll wait to see how this venture goes before ruling on its merits.

Shrinking Deficits Push Debt-to-GDP Lower

Taking the substantial increase in expected revenues together with a modest increase in planned spending, the federal government's fiscal numbers look to be in pretty good shape (table 1). Indeed, given the uncertain economic environment over the next few years, the Finance Minister seems to have baked some prudence into the outlook. When comparing the deficit and debt outlooks from Budget 2022 with the EFU 2021,

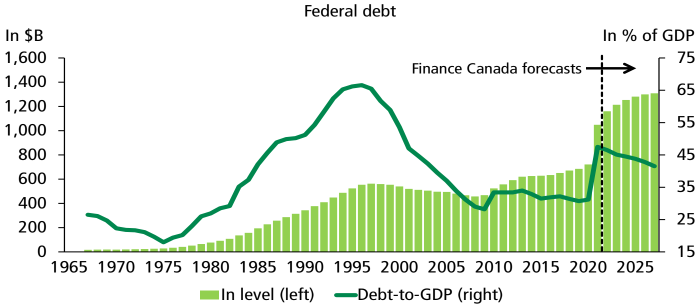
TABLE 1
Summary of transactions

	ACTUAL	PROJECTIONS					
IN $B (EXCEPT IF INDICATED)	2020–2021	2021–2022	2022–2023	2023–2024	2024–2025	2025–2026	2026–2027
Budgetary revenues	316.5	394.4	408.4	429.5	450.8	475.1	496.0
Variation (%)	*-5.3*	*24.6*	*3.5*	*5.2*	*5.0*	*5.4*	*4.4*
Program spending	-608.5	-473.0	-425.4	-430.4	-439.2	-453.1	-463.3
Variation (%)	*79.8*	*-22.3*	*-10.1*	*1.2*	*2.0*	*3.2*	*2.3*
Debt charges	-20.4	-24.9	-26.9	-32.9	-37.0	-39.8	-42.9
Variation (%)	*-16.7*	*22.3*	*8.0*	*22.3*	*12.5*	*7.6*	*7.8*
Net actuarial losses	-15.3	-10.3	-8.9	-6.1	-2.4	-0.8	1.8
Budgetary balance	-327.7	-113.8	-52.8	-39.9	-27.8	-18.6	-8.4
Federal debt[1]	1,048.7	1,160.8	1,213.7	1,253.6	1,281.4	1,300.0	1,308.4
Variation (%)	*45.4*	*10.7*	*4.6*	*3.3*	*2.2*	*1.5*	*0.6*
Budgetary revenues (% of GDP)	14.3	15.8	15.2	15.2	15.4	15.6	15.7
Program spending (% of GDP)	27.6	19.0	15.8	15.3	15.0	14.9	14.7
Public debt charges (% of GDP)	0.9	1.0	1.0	1.2	1.3	1.3	1.4
Budgetary balance (% of GDP)	-14.9	-4.6	-2.0	-1.4	-0.9	-0.6	-0.3
Federal debt (% of GDP)	47.5	46.5	45.1	44.5	43.7	42.8	41.5

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

it would have been tough for the fiscal hawks to ask for much more. Even under the most adverse economic scenario of high interest rates along with low growth and inflation, the Government of Canada is expected to see a falling debt-to-GDP ratio (graph 2).

GRAPH 2
The federal debt-to-GDP ratio is expected to fall more quickly than previously expected



Sources: Finance Canada and Desjardins, Economic Studies

However, while the federal government will issue less debt than was previously expected, new issuance will not be as long-term as was planned in the EFU 2021. This should be considered a missed opportunity. That said, the debt issued will continue to be at a longer maturity than was the norm prior to the pandemic, which is a trend we hope will continue.

The Feds Choose Prudence in Uncertain Times

We live in very uncertain economic and geopolitical times. And in the face of that, the federal government opted to hold back on some of the promises it has put in the window. It was the right decision. If the projected revenue boost materializes, there may be room to spend when skies are clearer. But if the economic outlook takes a turn for the worse, the federal government has put sufficient savings aside to weather the storm better than it might have otherwise.