ECONOMIC VIEWPOINT

Federal Budget 2023 Preview: Champagne Taste on a Beer Bottle Budget

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- As with every federal budget, there is a lot of anticipation in the lead up to Budget 2023. But we think the federal government would be wise to err on the side of keeping new spending to a minimum given the uncertainty around the economic outlook.
- Our baseline fiscal forecast suggests that federal finances are sustainable in the absence of new spending, even after including the recently-announced health care transfers. A similar finding was also reached by the Parliamentary Budget Officer (PBO). However, our outlook is for much larger deficits and a higher debt-to-GDP track based largely on our more conservative economic projection, particularly for the pace of nominal GDP growth.
- Even if the federal government has less fiscal room than they may like, there will be new spending announced in Budget 2023. The federal government needs to better position Canada to compete with the US for investment in the energy transition, particularly in areas where we have a competitive advantage. It is also expected to meet its unmet commitments laid out in the Supply and Confidence Agreement with the NDP.
- But it's not difficult to imagine federal fiscal sustainability changing course if the economy slows sharply at the same time spending ramps up significantly. While our scenarios suggest this isn't a repeat of the fiscal fiasco that was the 1980s and 1990s, they illustrate that the path ahead could be very challenging for the federal government. The risk is that excess spending today could lead to spending cuts and/or tax hikes down the road.

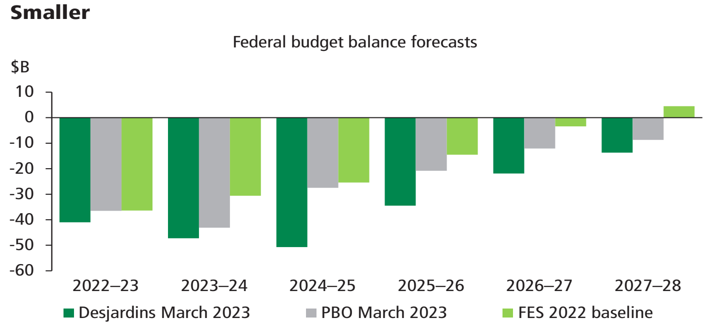
It's that time of year again, when economists are called upon to opine on the outlook for federal finances. But how much fiscal room does the federal government have to ramp up spending? What might they allocate the scarce resources toward? And could this push the federal debt track onto an unsustainable trajectory? We answer these and other questions in this note.

What is the starting point for budget planning?

To answer this question, we build a bottom-up federal fiscal projection tied to our Canadian economic forecast, most recently published in our [March 2023 Economic and Financial Outlook] (EFO). This helps to give us greater confidence that the budget projections we publish are well-informed and grounded in longstanding empirical relationships.

Our current tracking is for a federal budget deficit of $41.0B in the 2022–23 fiscal year (Graph 1), which is modestly higher than

GRAPH 1
Federal Budget Deficits Should Get Larger Before They Get Smaller



Note: 'FES' refers to Fall Economic Statement
Sources: Finance Canada, Office of the Parliamentary Budget Officer (PBO) and Desjardins Economic Studies

that published in the Fall Economic Statement 2022 (FES 2022). This includes the recently-announced $46.2B increase in federal health transfers to the provinces, which committed an additional $2B for health spending before the current fiscal year is out. However, the recent health accord just reinforced our view that the budget deficit will increase in the 2023–24 fiscal year, to $47.3B. This is much larger than the baseline deficit forecast published by the federal government in the FES 2022, but broadly in line with the recent outlook in the Parliamentary Budget Officer's (PBO's) March 2023 Economic and Fiscal Outlook.

Indeed, where we differ markedly from the PBO is on our outlook for the medium term. We are expecting federal deficits to be larger than other forecasters in every year of the projection starting in the 2024–25 fiscal year. This is particularly true relative to the seemingly optimistic forecasts presented by the federal government back in the fall. Much of this story is the economic outlook, as our forecast is more conservative than either the PBO's or the average of the private-sector forecasters published in the FES 2022 (Table 1). Different profiles for the health care transfers no doubt play a role as well.

TABLE 1
Economic and financial forecasts

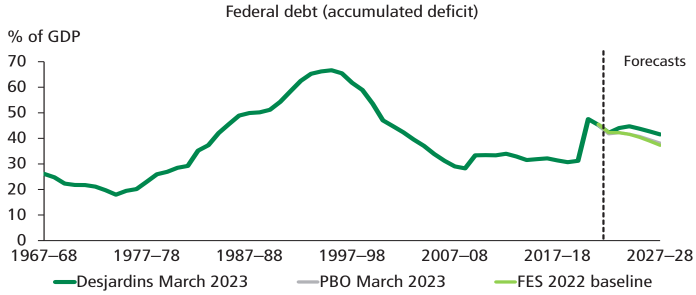
	2022	2023f			2024f		
AVERAGE ANNUAL GROWTH IN % (EXCEPT IF INDICATED)	Actual	FES 2022	PBO 2023	Desj. Group	FES 2022	PBO 2023	Desj. Group
Real GDP	3.4	0.7	1.0	0.6	1.9	1.6	0.9
GDP deflator	7.4	1.9	1.5	-0.8	1.8	2.1	1.6
Nominal GDP	11.0	2.6	2.6	-0.3	3.7	3.8	2.6
Treasury bills—3-month	2.2	3.6	4.4	4.3	2.8	3.2	3.0
Federal bonds—10-year	2.8	3.1	3.4	2.7	2.8	3.3	2.7
Unemployment rate	5.3	6.1	5.5	6.0	6.2	5.9	6.7
Exchange rate (US¢/C$)	76.8	77.1	76.7	72.4	77.9	79.2	78.0
Real GDP—United States	2.1	0.6	0.7	0.9	1.7	1.3	1.4

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

Importantly, the federal debt-to-GDP ratio is expected to be stable or gradually decline over time in all these forecasts (Graph 2). Consequently, absent any new measures, the federal debt-to-GDP ratio would likely remain below the latest official accounting of this often-touted 'fiscal guardrail'. This implies the federal fiscal position as it stands today is sustainable—a conclusion also reached prior to the latest health care announcement in the FES 2022 and by the PBO in its Fiscal Sustainability Report 2022. That said, the path isn't expected to see the debt-to-GDP ratio move consistently lower, with a modest increase expected in the 2023–24 fiscal year even if no new spending were to be announced in Budget 2023. This is in large part due to weak nominal GDP growth.

We've estimated that the Government of Canada could permanently increase spending and/or reduce revenues by about $10B annually starting in the 2023–24 fiscal year and still keep the debt-to-GDP ratio below the 45.2% posted in the most recent fiscal year. This wiggle room is down from our prior

GRAPH 2
Federal Debt Should Rise Before Gradually Declining as a Share of GDP



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estimates, reflecting the substantial downward revision to our nominal GDP forecast since we last published a federal fiscal outlook.

What measures could we see in Budget 2023?

Of course, this is only the starting point for Budget 2023 planning, as the federal government is widely expected to introduce new measures. These are likely to focus on increasing the competitiveness of our energy transition policies relative to the IRA enacted in the US. Other measures are expected to be more modest to avoid stoking inflationary pressures.

Keeping up with the Americans

The energy transition has been central to federal government policy since 2015, as Canada stands to gain greatly from the economic growth fuelled by increased investment in the energy transition. But the need for further policy support has become much more urgent since the Inflation Reduction Act (IRA) was passed in the United States in 2022. It provides substantial financial incentives for investment in technologies that will help the US reach net zero emissions by 2050. In response, the Government of Canada introduced modest new measures to support the energy transition in the FES 2022, promising more to come in Budget 2023.

Other measures on the federal fiscal wish list

An additional measure we are looking for in Budget 2023 is an expansion of the Canada Dental Benefit. Only the first phase of the program laid out in the Supply and Confidence Agreement (Agreement) between the federal Liberal Party and New Democratic Party was included in FES 2022. Covering children under 12 years old, this program is expected to be expanded to Canadians under 18 years old as well as "seniors and persons living with a disability in 2023, then full implementation by 2025." While we have yet to see the full price tag for this program, the PBO has costed it at around $2B annually once fully implemented.

The federal government has also said it will extend the GST rebate introduced in 2022, although details remain scant. Finance Canada costed the doubling of the GST credit for six months at $2.5B in the 2022–23 fiscal year. We could possibly see a repeat of this next year. A extension to the top-up to the Canada Housing Benefit is possible as well, although it has not been announced.

Another program the federal government has perennially placed in the window is a national pharmacare plan. The proposal laid out in the Agreement is a much watered-down version of what was in the 2021 NDP election platform, which the PBO costed at $11.5B annually by the 2025–26 fiscal year.

On the revenue side, speculation is rife that there may be tax increases in Budget 2023 to help offset the cost of new spending. But if that's the case, the federal government is keeping its cards close. Hence, we don't have any estimates of potential tax changes outside of those already announced, such as increases in carbon and alcohol taxes. That said, we've had some questions from members and clients related to the introduction of a Global Minimum Tax, which is something we'll be keeping an eye out for in Budget 2023.

Risks to the federal fiscal forecast

To assess the risks to the federal fiscal forecast, we examine alternative economic and fiscal scenarios that could cause the deficit and debt train to go off the rails. Federal and provincial governments, as well as the PBO, often do the same when assessing the risks to their forecasts.

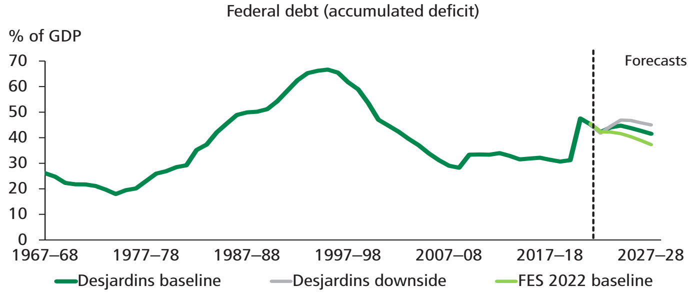
For this exercise, we take two different steps. The first is to see how the federal fiscal outlook would evolve under alternative economic scenarios. To do this, we use an updated version of our downside scenario published in November 2022 (Table 2). This alone would push the federal debt-to-GDP ratio higher to nearly 47% by the 2024–25 fiscal year. It would only return to the 45% of GDP number posted in the 2021–22 fiscal year by the end of the forecast (Graph 3). This would leave little to no room for new spending without putting fiscal sustainability in peril.

TABLE 2
Desjardins Baseline Forecast vs Downside Scenario

AVERAGE ANNUAL GROWTH IN % (UNLESS OTHERWISE INDICATED)	Scenario: March 2023 EFO 2023	March 2023 EFO 2024	Downside scenario 2023	Downside scenario 2024
Real GDP growth	0.6	0.9	-1.0	-1.4
GDP inflation	-0.8	1.6	-1.0	1.2
Nominal GDP growth	-0.3	2.6	-1.9	-0.3
Unemployment rate (%)	6.0	6.7	6.4	7.3
Policy rate (%, end of period)	4.3	2.50	3.8	1.8

Sources: Statistics Canada, Bank of Canda and Desjardins Economic Studies

GRAPH 3
A Deep Economic Downturn Would Push the Debt-to-GDP Ratio Higher



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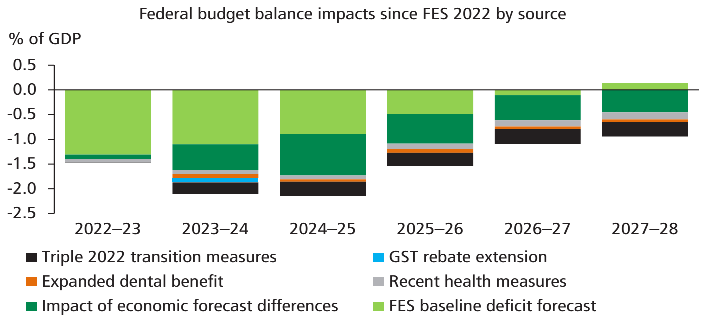
The second step is to then estimate the impact of additional discretionary spending that we could see in Budget 2023. Unfortunately, we don't have reliable estimates of program costs outside of the expanded Canada Dental Benefit from the PBO. As such, we apply a range of spending forecasts based on allocations toward energy transition measures in recent federal fiscal plans. Together, this suggests we could see spending increase by an average of between $6B and $10B annually (0.20% and 0.35% of GDP, respectively) relative to the planned spending in the FES 2022 (Graph 4).

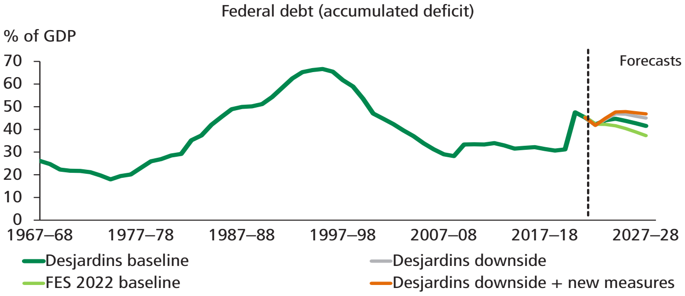
GRAPH 4
Potential New Spending Will Weigh on the Federal Deficit Outlook



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

Under these various scenarios, it is evident that federal fiscal sustainability would be at risk in the event of both a significant increase in spending and a sharp decline in economic activity (Graph 5 on page 4). However, the new measures alone would not be enough to put federal finances on an unsustainable path unless they well exceed the amounts estimated above.

GRAPH 5
The Fiscal Risks of an Economic Slowdown Dominate New Spending



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While this isn't a repeat of the fiscal fiasco that was the 1980s and 1990s, these scenarios illustrate that the path ahead could be very challenging for the federal government. The risk is that excess spending today could lead to spending cuts and/or tax hikes down the road. To avoid this cautionary tale, the federal government should exercise restraint in Budget 2023, particularly during this period of substantial uncertainty around the economic outlook.

Bottom Line

As with every federal budget, there is a lot of anticipation in the lead up to Budget 2023. But we think the federal government would be wise to err on the side of keeping new spending to a minimum. While its finances are currently sustainable, it's not difficult to imagine this quickly changing course if the economy slows sharply while spending ramps up significantly. Of course, the federal government needs to better position Canada to compete with the US for investment in the energy transition. But it can't break the bank to do it. Indeed, while the federal government may have champagne taste when it comes to spending, it's working with a beer bottle budget.