ECONOMIC VIEWPOINT

Road to Ruin or Fiscal Fearmongering? Busting Myths about Government Finance in Canada

By Randall Bartlett, Senior Director of Canadian Economics, Marc Desormeaux, Principal Economist, and Farjad Khan, Economics Intern

Highlights

Coming out of the 2023 budget season, there is no shortage of views about government spending, taxing and borrowing in Canada. Indeed, prognostications of impending fiscal demise in the Great White North are a dime a dozen. But is there any substance to the view that public finances in Canada are on a road to ruin, or is it fiscal fearmongering that is unsupported by the data?

This note explores several myths about government finance in Canada, explaining which claims are unsubstantiated or, in some cases, why they may contain a grain of truth.

- **Myth 1: Government debt is much higher in Canada than in other advanced economies.** *This is categorically untrue.* Canada has the lowest net government debt in the G7 and is middle of the pack when it comes to gross government debt.
- **Myth 2: Net government debt only looks good because of public pension plan assets.** *This isn't the case.* The federal government continues to have one of the lowest net debt-to-GDP ratios in the G7 even in the absence of social security funds.
- **Myth 3: Canadian governments are about in the same fiscal position they were in during the 1980s and 1990s.** *Not so much.* Government debt-to-GDP and interest-to-revenue ratios are below where they were in the 1990s and, given the very different rate and growth outlook, that doesn't look set to change.
- **Myth 4: Government of Canada debt is on an unsustainable trajectory.** *Not currently, but there are risks.* Both the Government of Canada and Parliamentary Budget Officer have determined that federal finances are sustainable. But this assumes everything goes according to plan and there is no substantial new spending. The risks are to the downside.
- **Myth 5: If you include the provinces, government debt in Canada looks much worse.** *No, not really.* Canadian provinces are more indebted than subnational jurisdictions elsewhere in the G7, but that partly reflects the unique role that provinces play in the federation. The upside surprises in the 2023 budget season will end up improving the sustainability math for some of them.
- **Myth 6: Canadian governments are running massive deficits.** *Wrong again.* When looking at all levels of government together, Canada has among the smallest budget and structural deficits in the G7. At the federal level, cyclically-adjusted budget deficits are near their historical averages.
- **Myth 7: All of the new spending in the 2023 budget season was inflationary.** *Some, but certainly not all of it.* At the federal level, most of the new spending announced in Budget 2023 is not especially inflationary. However, the provincial affordability measures may be more so.

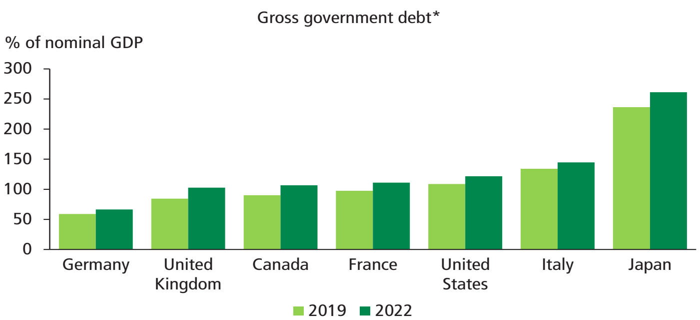
Desjardins Economic Studies: 514-281-2336 or 1-866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

Myth 1: Government debt is much higher in Canada than in other advanced economies

This is categorically untrue.

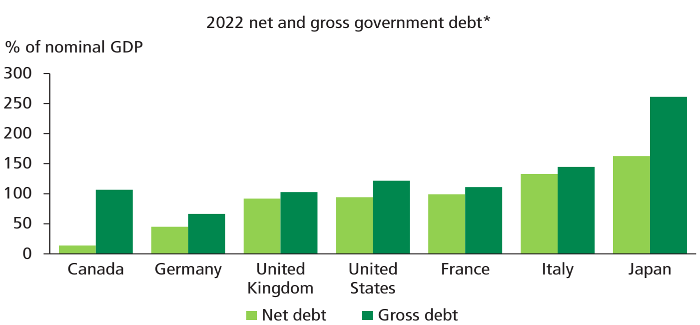
Gross government debt, which includes the total liabilities of federal, provincial and local governments as well as public pension plans, is middle of the pack in the G7 as a share of nominal GDP (graph 1). Net government debt, equivalent to gross government debt less public financial assets such as those held by public pension plans, is even lower as a share of GDP (graph 2). Indeed, international organizations such as the International Monetary Fund (IMF), World Bank and Organisation for Economic Co-operation and Development (OECD) universally recognize that Canada has the lowest net government debt-to-GDP ratio in the G7. This is important, given that this is what sovereign bond investors tend to focus on. Indeed, research by the IMF has found that net debt seems more appropriate than gross debt when evaluating the impact of indebtedness on spreads.

GRAPH 1
Canada's Gross Government Debt Is Middle of the Pack in the G7



*2022 is a forecast for the US, France and Japan; estimates for all other countries.
Sources: International Monetary Fund and Desjardins Economic Studies

GRAPH 2
Canada Has the Lowest Net Government Debt in the G7



*2022 is a forecast for the US, France and Japan; estimates for all other countries.
Sources: International Monetary Fund and Desjardins Economic Studies

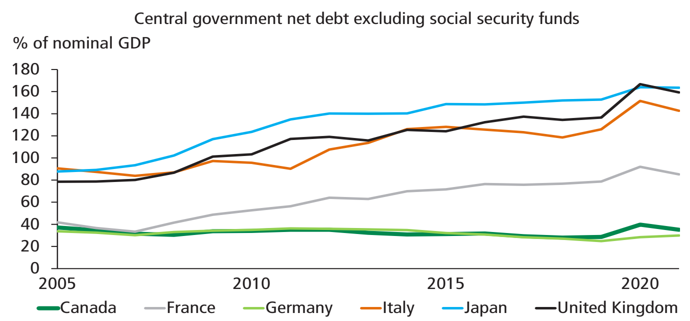
Myth 2: Net government debt only looks good because of public pension plan assets

This also isn't the case.

The IMF's Government Finance Statistics (GFS) allow for ready cross-country comparisons by level of government. At the federal or central government level, balance sheet data excluding social security funds are available for most countries. This comparison is important because these pension assets cannot be drawn on by the federal or any other level of government in Canada in the event of some sort of debt crisis. Unfortunately, balance sheet data excluding social security funds are not available for the US.

In the case of net central government debt excluding social security funds, the Government of Canada still fares well compared to other G7 central governments (graph 3). According to the IMF's GFS data, except for Germany, Canada ranks ahead of all other G7 countries (excluding the US).

GRAPH 3
Canada's Central Government Net Debt Is on Par with Germany's



Sources: International Monetary Fund and Desjardins Economic Studies

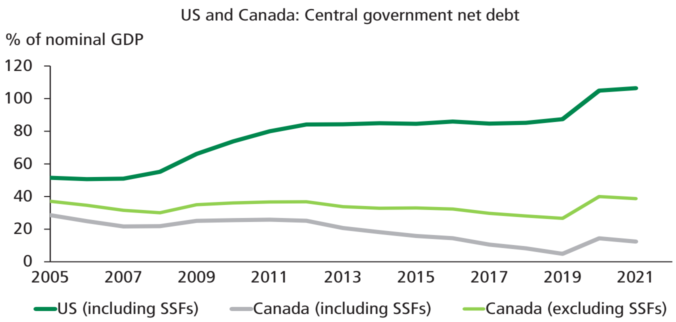
But maybe most importantly for Canadians, when you compare federal government net debt in Canada versus the US, it doesn't matter whether or not you include social security funds in the net debt calculation. Without exception, Canada comes in well below the US in terms of net federal debt as a share of national nominal GDP, and the gap has consistently widened in Canada's advantage over time (graph 4 on page 3).

Myth 3: Canadian governments are about in the same fiscal position they were in during the 1980s and 1990s

Not so much.

Starting with general government debt, the IMF estimates that the net debt-to-GDP ratio not only didn't come close to the peak of the 1990s during the COVID-19 pandemic, but is going to track lower going forward (graph 5 on page 3). However,

GRAPH 4
Federal Net Debt Is Much Lower in Canada than in the US



SSFs: Social security funds
Sources: International Monetary Fund and Desjardins Economic Studies

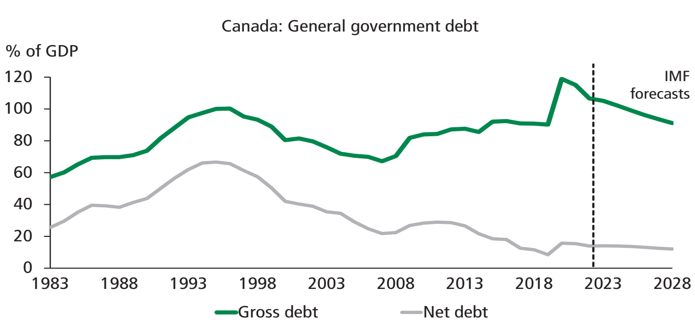
in 2020, gross government debt in Canada surpassed its pre-COVID peak of just over 100% of GDP reached in 1996. And while gross government debt has come down since as a share of the economy, it remains elevated. Fortunately, the IMF expects it to keep moving lower, ultimately returning to pre-COVID levels.

Looking at the most recent estimates and forecasts for federal debt in Budget 2023, the debt-to-GDP ratio is estimated to have peaked in the 2020–21 fiscal year. This squares with the Government Finance Statistics published by Statistics Canada. Since then, it has moved lower and is estimated to have fallen even faster in the 2022–23 fiscal year (graph 6). Beyond that, Finance Canada's outlook is for a slight increase in the 2023–24 fiscal year before gradually declining again.

Most importantly for this myth is the fact that at no time during or since the COVID-19 pandemic did any measure of the federal debt as a share of GDP surpass the peak of the 1990s. This has been reflected in Government of Canada credit ratings, which have by and large remained unchanged for the past two decades (graph 7).

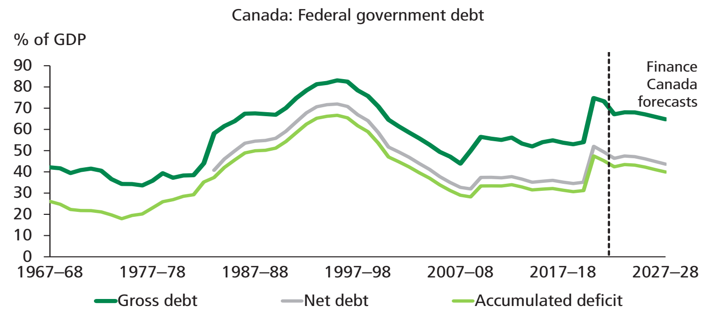
Additionally, the causes of the increase in federal debt were very different in recent years than in the past. In the 1980s and 1990s, high interest rates drove a substantial amount of the debt accumulation. Indeed, at one point nearly 40 cents of every dollar in federal revenue went to pay interest on the debt (graph 8). Today, that number is closer to 8 cents on the dollar, slightly higher than it was pre-pandemic. It is expected to rise further to a peak of just short of 10 cents for every dollar of revenue based on the interest rate forecasts of private sector economists and Finance Canada calculations.

GRAPH 5
Gross Debt Remains Elevated, but Net Debt Has Stayed Low



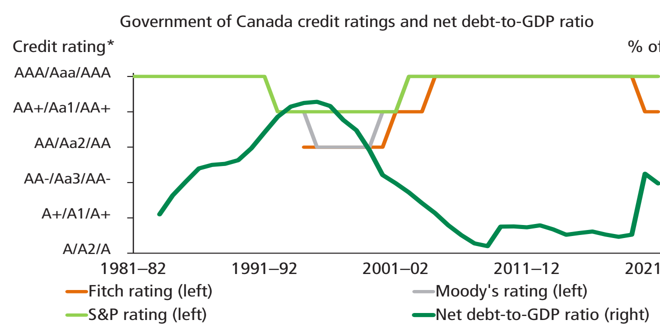
Sources: International Monetary Fund and Desjardins Economic Studies

GRAPH 6
After Rising Sharply, Federal Debt-to-GDP Is on the Decline



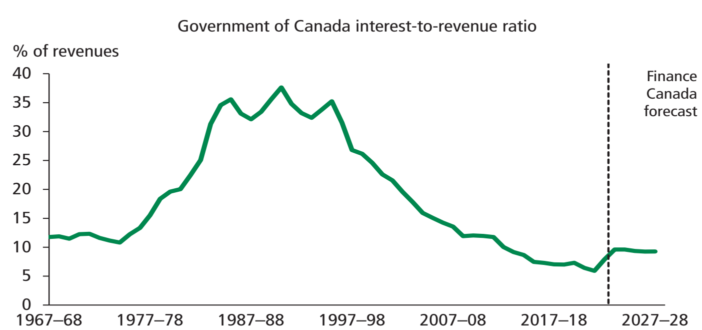
Sources: Finance Canada and Desjardins Economic Studies

GRAPH 7
The Government of Canada's Credit Quality Remains High



*End of fiscal year
Sources: Bloomberg, Finance Canada and Desjardins Economic Studies

GRAPH 8
Federal Interest Costs Are Rising but Should Remain Modest

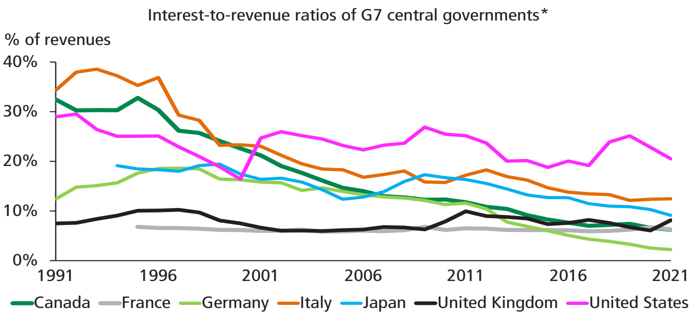


Sources: Finance Canada and Desjardins Economic Studies

When we compare the Government of Canada's interest-to-revenue ratio to that of other G7 central governments, both the extent of the improvement over the past 30 years and the recent relative outperformance are clear (graph 9). Indeed, the IMF found that in 2021—the most recent year for which data is available—Canada had the lowest interest-to-revenue ratio of any G7 central government except Germany.

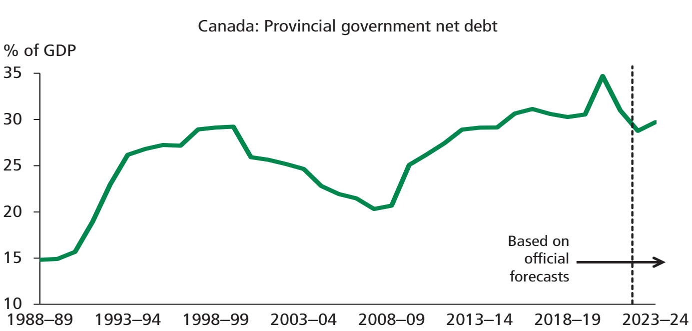
The federal government wasn't the only level of government to take on additional debt during the pandemic. The provinces also piled on borrowing, albeit to a lesser extent (graph 10). Total net debt-to-GDP has fallen more quickly at the provincial rather than the federal level since though, likely coming in below the pre-pandemic share of GDP in the 2022–23 fiscal year. And while the net debt-to-GDP ratio is expected to pick up slightly in the current fiscal year, this is more a reflection of weak nominal GDP growth than rapidly rising debt among the provinces. The outlook is more mixed and province-specific going forward.

GRAPH 9
Canada Has One of the Lowest Interest-to-Revenue Ratios in the G7



*Excluding social security funds
Sources: International Monetary Fund and Desjardins Economic Studies

GRAPH 10
Provincial Net Debt-to-GDP Has Fallen to below Pre-COVID Levels



Sources: Provincial budget documents, Finance Canada and Desjardins Economic Studies

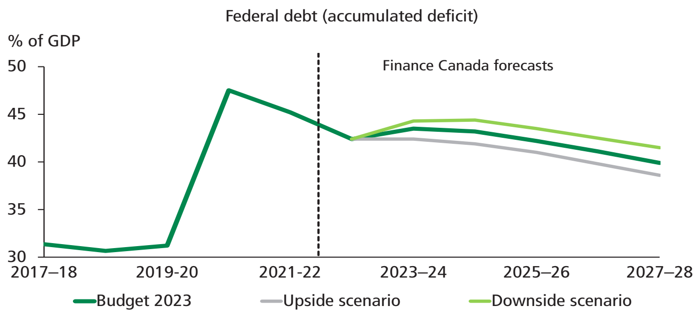
Myth 4: Government of Canada debt is on an unsustainable trajectory

Not currently, but there are risks.

While it's one thing to unpack where Canada's government debt stands relative to that of other countries, it's another thing entirely to get a sense of where it's going. As such, this myth isn't as easily busted.

One can start by looking at the recent federal Budget 2023. In it, the Government of Canada provided a baseline forecast as well as upside and downside scenarios based on alternative economic outcomes. In each of these scenarios, the federal debt-to-GDP ratio is expected to rise or remain constant in the 2023–24 fiscal year before returning to a declining path over the medium term (graph 11). Federal debt here is defined as the "accumulated deficit," or total liabilities less financial and nonfinancial assets.

GRAPH 11
Federal Debt Should Rise before Declining as a Share of GDP

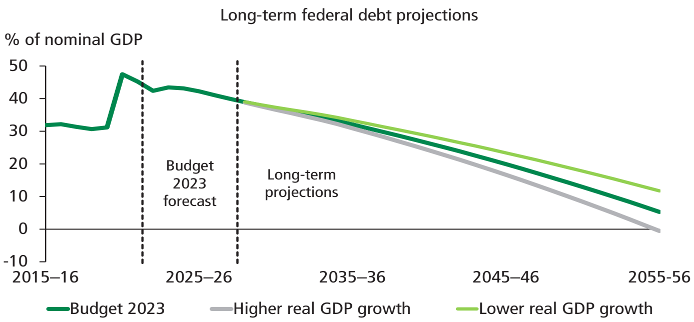


Sources: Finance Canada and Desjardins Economic Studies

Way in the back of Annex 1 of Budget 2023, the federal government also provides projections for the long-term path of federal debt under different economic assumptions. Without exception, these different scenarios point to a falling debt-to-GDP ratio over the coming decades (graph 12 on page 5).

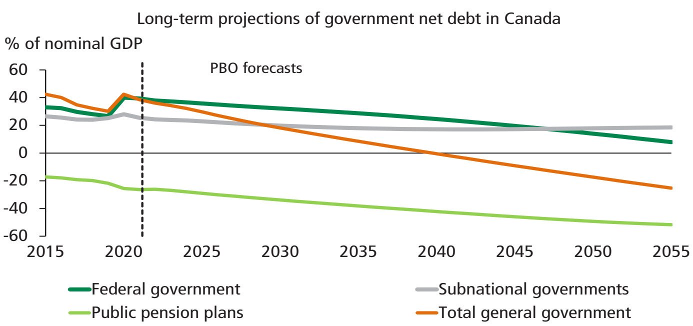
This echoes the work of the Parliamentary Budget Officer (PBO) in his latest Fiscal Sustainability Report (FSR). In it, the PBO concluded that, "Current fiscal policy at the federal level is sustainable over the long term." Indeed, the PBO projected that the federal net debt-to-GDP ratio would fall precipitously from current levels (graph 13 on page 5). Of course, it's important to point out that the FSR 2022 was published in July 2022, and so doesn't include new economic data or measures introduced in either Budget 2023 or the Fall Economic Statement (FES) 2022. That said, the path of the federal debt-to-GDP ratio projected in Budget 2023 is very similar to that in Budget 2022, and so we wouldn't expect the conclusion to change materially.

GRAPH 12
Finance Canada Is Projecting Federal Debt to Remain Sustainable



Sources: Finance Canada and Desjardins Economic Studies

GRAPH 13
The PBO Is Projecting Federal Debt to Remain Sustainable

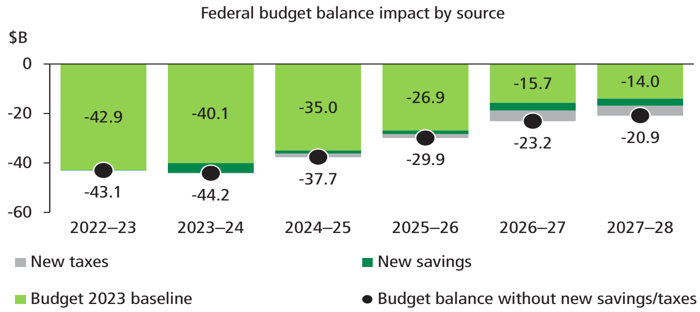


Sources: Parliamentary Budget Officer (PBO) and Desjardins Economic Studies

Taken together, what's clear is that both the PBO and Finance Canada believe federal finances are on a sustainable trajectory. However, long-term fiscal forecasts hinge materially on the assumptions that underlie them. And in each of these cases, there is an assumption that nominal GDP and revenue growth will exceed both growth in program spending and the level of interest rates. While these assumptions are par for the course in long-term fiscal forecasting, it takes a lot of resolve to rein in spending. If history is a guide, there is a risk that federal program expenditures increase materially even as the economy and revenues underperform. Indeed, this was the case in Budget 2023, hence the flat or rising debt-to-GDP ratio in the 2023–24 fiscal year in all forecast scenarios it presented. It is also why we are of the view that the risks are toward larger deficits and higher debt than presented in the recent federal budget (graph 14).

This said, completely eliminating government debt shouldn't be a goal in and of itself. Some level of government debt is required to ensure that debt markets continue to function well by having ample liquidity, particularly in times of crisis. Borrowing to

GRAPH 14
The Rosy Federal Fiscal Forecast Needs a Lot to Go Right, Especially in the Outer Years



Sources: Finance Canada and Desjardins Economic Studies

invest in growth-boosting public assets like infrastructure is also warranted and even necessary at times.

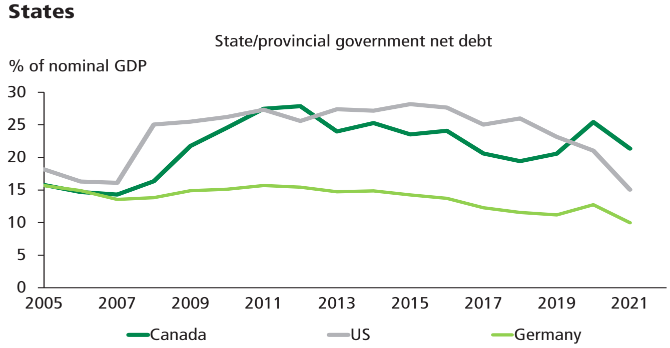
Myth 5: If you include the provinces, government debt in Canada looks much worse

No, not really.

Total government debt does include the provinces, and Canada has the lowest net debt-to-GDP ratio in the G7. This is in large part the result of significant pension plan assets, but also relatively low federal government net debt. In contrast, total provincial government net debt in Canada is higher than comparable debt levels in other advanced economies where data is available, such as the US and Germany (graph 15).

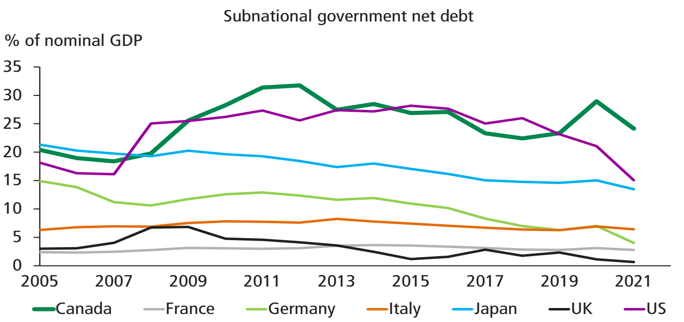
This is in part because of the role that the provinces play in delivering public services in Canada. In other advanced economies, some of these services are delivered at the local level, suggesting that the better comparison is total net debt of all subnational governments. But even when all subnational governments are included, Canada stands out for the outsized importance of the provinces relative to other G7 countries (graph 16 on page 6).

GRAPH 15
Net Debt-to-GDP Is Now Higher in Canada's Provinces than in US States



Sources: International Monetary Fund and Desjardins Economic Studies

GRAPH 16
Subnational Governments Play a Unique Role in Canada

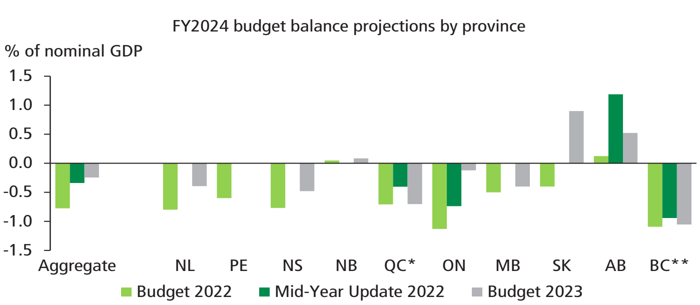


Sources: International Monetary Fund and Desjardins Economic Studies

However, it is important to highlight that all Canadian provinces individually have lower levels of net debt relative to their respective economies than the federal government does. And this is even more so the case after the 2023 budget season, as provinces saw their fiscal positions in the 2022–23 fiscal year improve across the board while the federal government's worsened (graph 17). This should have the impact of reducing the total debt-to-GDP ratio of subnational governments, thereby improving the starting point for the long-term projections.

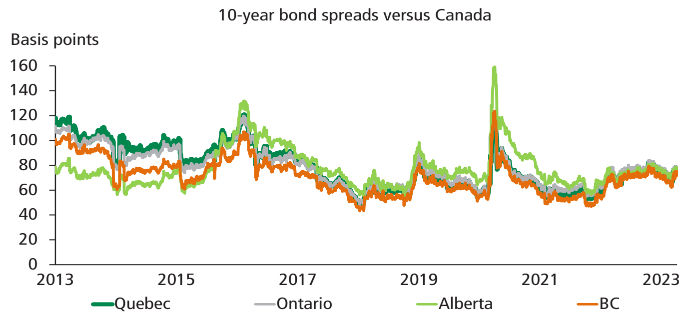
But as the PBO pointed out in the FSR 2022, provincial government debt wasn't on a sustainable path in 2022 (graph 18). There were a few reasons for this that are just as relevant today. The first is rising healthcare costs due to an aging population. While the recent increase in healthcare transfers from the federal government should help to blunt this impact, the provinces will continue to be left holding the bag as their populations age. Besides the near-term increase, the size of federal transfers to the provinces is expected to decline over time, further exacerbating budgetary pressures. And finally, the debt of every Canadian province trades at a spread to Government of Canada bonds, making their borrowing costs higher. This suggests the recent good fiscal news may not last forever.

GRAPH 17
Provincial Budget Balances Have Improved since Last Year



* Before deposits into the Generations Fund and use of the Stabilization Reserve
** Q1 FY2023 forecast
Sources: Provincial budget documents and Desjardins Economic Studies

GRAPH 18
It's More Expensive to Service Provincial than Federal Debt



Sources: Bloomberg and Desjardins Economic Studies

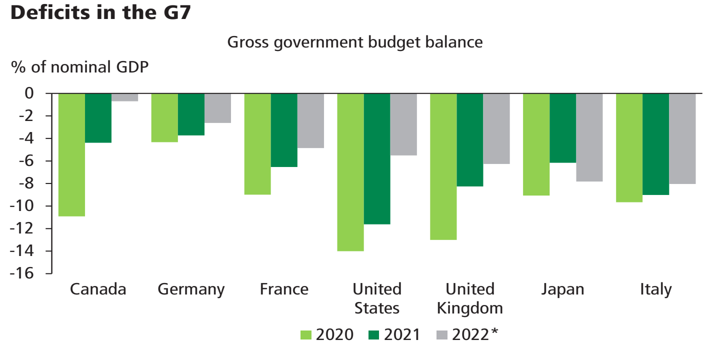
Myth 6: Canadian governments are running massive deficits

Wrong again.

According to the IMF, Canada had one of the smallest general government budget deficits as a share of nominal GDP in the G7 in the 2021–22 fiscal year (graph 19). This followed a substantial borrowing binge during the pandemic. Going forward, the IMF expects Canada to lead the G7 in keeping its budget deficits under control. That said, the deterioration in the outlook for the federal budget balance (graph 14 on page 5) will be at least partly offset by the aggregate improvement in the provinces (graph 17).

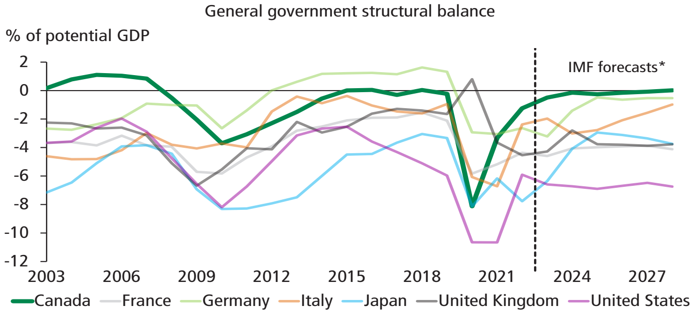
Canada also had one of the smallest general government structural deficits as a share of potential GDP in the G7 in the 2021–22 fiscal year (graph 20 on page 7). "The structural budget balance refers to the general government cyclically adjusted balance adjusted for nonstructural elements beyond the economic cycle." (IMF, 2022) It is designed in part to provide an indication of the medium-term orientation of fiscal policy. As in the case of general government debt, this estimate includes the structural deficits of all levels of government. Importantly, after

GRAPH 19
Canada Has among the Smallest Gross Government Budget Deficits in the G7



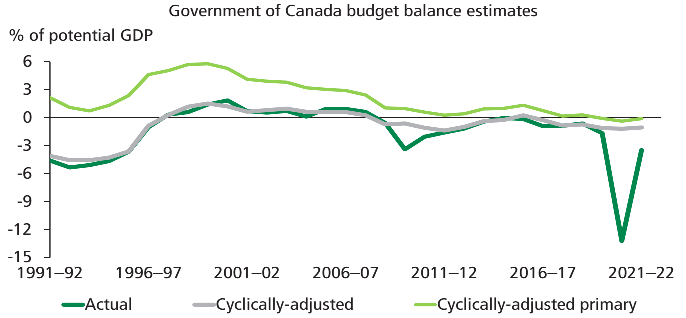
*2022 is a forecast for the US, France and Japan; estimates for all other countries
Sources: International Monetary Fund and Desjardins Economic Studies

GRAPH 20
Canada Has the Smallest Structural Deficit in the G7



*2022 is a forecast for the US, France and Japan; estimates for all other countries
Sources: International Monetary Fund and Desjardins Economic Studies

GRAPH 21
The Federal Structural Deficit Is Estimated to Have Been Small



Sources: Finance Canada and Desjardins Economic Studies

widening substantially during the pandemic, Canada's structural deficit is estimated to have shrunk considerably as the economy recovered. And the IMF projects Canada to post the smallest structural deficits in the G7 in the coming years.

While estimates of the structural deficit are scarce at the provincial level, Finance Canada helpfully publishes one for the federal government in its annual Fiscal Reference Tables. This shows that the federal budget deficits adjusted for the stage of the business cycle and one-time measures were much smaller in recent years than the headline deficit would suggest (graph 21). This implies that the size of the federal deficits during the pandemic were not unwarranted given the extent of the economic downturn. But with the Canadian economy currently operating in a state of excess demand, it is imperative that the federal government work to minimize its cyclically-adjusted budget balances.

Myth 7: All of the new spending in the 2023 budget season is inflationary

Some but certainly not all of the newly announced spending is inflationary.

Take the federal government's Budget 2023. Much of the new spending was related to health and dental care and the energy transition, neither of which are likely to stoke short-term inflation. This is because the fiscal multipliers associated with these types of measures are relatively small (table 1), thereby providing little additional boost to real GDP, employment, wages and, ultimately, inflation. The extension of the GST credit masquerading as a new grocery rebate may have a larger impact on inflation for every dollar spent, but it should still be minor given that the measure is modest, targeted and time-limited. Indeed, we've estimated that it will add much less than 0.1 percentage points to CPI inflation in 2023. At the same time, the federal government has also said it is raising taxes on high-income earners, financial institutions and Canadian multinationals, which should be disinflationary.

Planned spending cuts should act to have an offsetting impact on new expenditures as well, if they materialize.

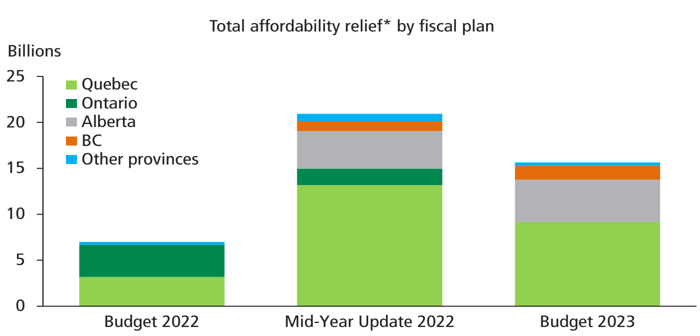
The broad-based nature of some policies implemented at the provincial level still risks inflaming consumer demand (graph 22), but we're somewhat encouraged by a trend towards more modest and targeted measures. We noted this in our recaps of provincial mid-year updates and 2023 budgets. Of course,

TABLE 1
Fiscal Multipliers Suggest Little Impact of Federal Spending on Inflation

	Fiscal multipliers by type of measure				
Impact on real GDP in $	Year 1	Year 2	Year 3	Year 4	Year 5
Housing investment measures	1.0	1.1	1.3	1.5	1.6
Infrastructure investment measures	0.9	1.0	1.2	1.3	1.5
Business investment measures	0.7	0.8	0.9	1.0	1.1
Measures for modest- and low-income households	0.8	1.0	1.2	1.3	1.3
Personal income tax measures	0.2	0.5	0.7	0.9	1.0
Corporate income tax measures	0.1	0.3	0.4	0.5	0.5

[1] Debt representing the accumulated deficits including other comprehensive income
Sources: Parliamentary Budget Officer and Desjardins Economic Studies

GRAPH 22
Provinces Scaled Back Affordability Relief, but Quebec Didn't

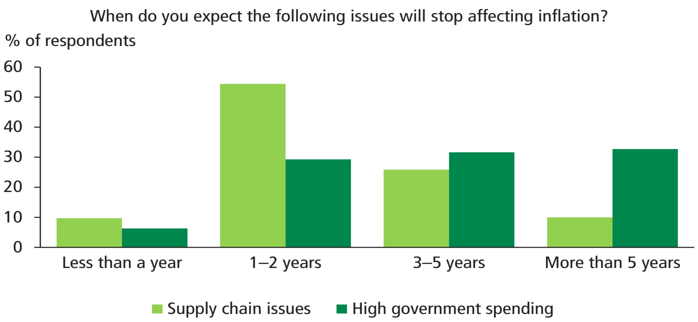


* Includes current and future fiscal year estimates
Sources: Provincial budget documents and Desjardins Economic Studies

there are some exceptions. For instance, cuts to the lowest income tax brackets could very well stimulate consumer demand higher up the income chain. Nonetheless, these should provide some assistance to households of modest means that are most impacted by inflation.

Notably, while the size of the impact of recent federal and provincial spending on inflation is debated by economists, the direction of the impact is not. It will be inflationary, if only at the margins. Canadians look to have internalized this message, as evidenced by the recent Q1 2023 Canadian Survey of Consumer Expectations from the Bank of Canada. In it, consumers said they think higher government spending will affect inflation for longer than supply chain issues will (graph 23). So, regardless of the actual impact on inflation, governments should be aware of the impact their policy measures are having on inflation expectations, thereby making the Bank of Canada's job more difficult.

GRAPH 23
Consumers Think High Government Spending Will Keep Inflation Elevated



Sources: Bank of Canada and Desjardins Economic Studies

Conclusion

Fiscal mythmaking is alive and well in Canada. Some of this stems from past deficit and debt struggles that remain part of our cultural DNA. But many of the statements that are presented as fact have become little more than fiscal fearmongering, at times trumpeted by old generals eager to fight past battles.

The truth is that Canada is in a very enviable fiscal position globally and is not on the brink of experiencing a debt sustainability crisis. And while the size of government has increased materially since before the COVID-19 pandemic with questionable benefit for Canadians, this in and of itself does not signal our impending fiscal demise. It's time we all start working from the same data and leave the Canadian debt doomsday prophesizing to fiction writers.