Economics

FEDERAL BUDGET BRIEFS

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Federal budget 2024: buying on an installment plan

The lead-up to today's federal budget saw no shortage of new program initiatives, but staying close enough to fiscal targets, and avoiding inflationary stimulus, required many of these items to be bought on an installment plan. Increases in big ticket items like defence spending won't therefore kick in for a few years, but tax measures in the budget will bring in revenues right away.

Last year's budget projected a 2023/24 deficit of just over $40 bn, and pledged to scale that down to $35 bn in 2024/25 and to $26.8 bn in 2025/26. Developments by the fall fiscal update, including sluggish growth, had made a significant dent in the last of these projections, raising the 2025 fiscal year shortfall to $38.3 bn. Current estimates for 2023/24 are still close in line with those of the fall fiscal statement, with a deficit of roughly $40 bn in the last fiscal year and the one just started, and only marginally lower at $38.9 bn in 2025/26 (Table 1).

That's courtesy in part to an improved economic performance in the last couple of quarters, which would have lowered budgetary deficits over the forecast horizon. The government has essentially used more than all of that elbow room to add new policy initiatives, and had to add tax hikes, largely on individuals and corporates earning capital gains, to stay close to the fall update projections. Even then, the 2027/28 budget deficit, now estimated at $26.8 bn, is higher than the $14 billion projection from the March 2023 budget, although the debt-to-GDP ratio will decline as promised. Moreover, the coming year's deficit, at 1.3% of GDP, is still much lower than what we're seeing from other governments we track, which would still be the case if we looked at deficits at all levels of government.

Table 1: Fiscal outlook: (C$billions)

Fiscal measure	2022/23 Actual	2023/24 23 Budget	2023/24 24 Budget	2023/24 Change	2024/25 24 Budget	2025/26 24 Budget	2026/27 24 Budget	2027/28 24 Budget	2028/29 24 Budget
Budgetary revenue	447.8	456.8	465.1	8.3	497.8	514.6	535.7	561.4	586.3
• % Change		4.5	3.9	-0.6	7.0	3.4	4.1	4.8	4.4
Program Spending ex. Actuarial Losses	438.6	446.6	450.3	3.7	480.5	496.3	509.6	526.3	544.4
• % change		2.5	2.7	0.2	6.7	3.3	2.7	3.3	3.4
Public debt charges	35.0	43.9	47.2	3.3	54.1	54.9	57.0	60.9	64.3
Budgetary balance (Before Actuarial Losses)	-25.7	-33.7	-32.5	1.3	-36.8	-36.5	-30.8	-25.8	-22.4
Net Actuarial Losses	-9.6	-6.4	-7.6	-1.2	-3.1	-2.4	0.1	-1.0	2.4
Budgetary balance	-35.3	-40.1	-40.0	0.1	-39.8	-38.9	-30.8	-26.8	-20.0

Economic backdrop: waiting for better days

As is its practice, Ottawa built its budget projections on the consensus of private sector forecasts (Tables 2 and 3), and developments since economists were surveyed might leave some scope for pleasant surprises as a result. Real GDP growth of 0.7% in 2024, and nominal GDP of 3.8%, now look a bit on the low side after upgraded data on Q1 GDP and a climb in oil prices, with our latest outlook calling for 1.0% and 4.3% for real and nominal growth respectively.

Still, the economy hasn't been that friendly to governments of late, with generally soft per capita growth, and inflation that earlier boosted revenues from sources like sales taxes now pushing public service wage costs higher. That has served to elevate deficit projections in most Canadian provinces, and made the task of staying within federal fiscal guideposts more challenging.

In addition to the economy's impact on the budget, there's the budget's impact on the economy to consider. The Finance Minister has stressed that she wanted to avoid a plan that added an inflationary impulse and thereby delayed much desired interest rate relief. The Bank of Canada Governor noted that some of the upgrade to this year's growth forecast was tied to planned increases in provincial government spending.

But at the federal level, today's budget won't materially change the picture the BoC had in hand from the fall fiscal update, with policy actions adding a net $5.3 bn to the deficit in 2024/25, and $7.5 bn next year, or only 0.1% to 0.2% of GDP. That might somewhat understate the fiscal boost, since the drag from tax hikes hitting upper income earners and corporates might be less than the boost from other measures, although one could argue that there is a long-term disinflationary element to measures designed to stimulate housing supply or childcare spaces. On a cyclically adjusted basis, the federal fiscal stance does not look materially different from where it was in 2023.

Looking ahead, the fiscal plan benefits from better times in consensus forecasts for 2025 and beyond, with real GDP expected to average a bit over 2% and nominal GDP slightly above 4%. Cooler inflation will leave room for Bank of Canada rate reductions, with bill yields forecast to average 3.1% by 2025 and drop below 3% thereafter, will cushion the impacts of ongoing deficits on debt servicing costs on shorter dated bonds. But the budget assumes 10-year rates will be sticky near 3.3%, meaning that maturities of old long bonds will be rolled over at higher rates. Still, as a share of GDP, federal debt service costs aren't in scary territory relative to where we've been in the past, and deficits are also small to what we're seeing in the US. The need for restraint these days is more pressing at the provincial level, and as a way of avoiding any upward pressure on inflation in the near term.

Table 2: Average private sector forecasts - economic assumptions

Economic assumptions (Y/Y % unless stated)	2023	2024	2025	2026-28
Real GDP	1.1	0.7	1.9	2.1
Nominal GDP	2.7	3.8	3.9	4.1
Jobless rate (%)	5.4	6.3	6.3	5.8
CPI	3.9	2.5	2.1	2.0
US real GDP	2.5	2.2	1.6	1.9

Table 3: Average private sector forecasts - financial assumptions

Financial assumptions	2023	2024	2025	2026-28
WTI (US$/bbl)	78	78	78	78
3-month T-bills (%)	4.8	4.5	3.1	2.7
10-year GoC bonds (%)	3.3	3.3	3.2	3.3
Exchange rate (US¢/C$)	74.1	74.4	76.4	78.0

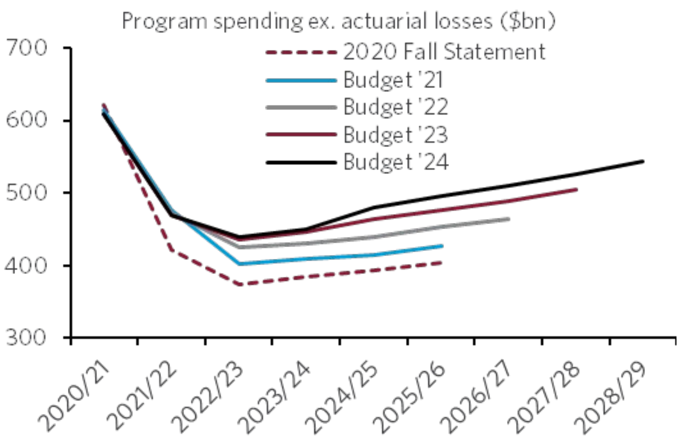
Dance of the seven veils: the final act

Budget secrecy has long ago been dropped in favour of a dance of the seven veils, in which new spending programs are revealed one at a time in the days leading up to the budget. For the final act on budget day, that leaves only tax items, economic-driven changes to spending, and any spending reductions, to be undressed for the public.

In this budget's spending plan, there's a pattern we should be familiar with by now. Each federal budget adds only a modest amount to program costs in the first year, but then phases in larger sums further out. The result is that no budget looks like a significant boost, unless you focus on those out years. But of course, we're now bearing the costs of some programs that are ramping up from past budgets, and election platforms in 2025 could bring forth fresh ideas.

Even with some phasing in of new measures, program spending excluding actuarial losses is set to grow by 6.7% in 2024/25, although thereafter the plan has it slowing to 3.3% the following year and beginning to ease off as a share of GDP that year and further out. But we'd note that's off a 2023/24 base that is nearly $66 bn higher than what was envisaged in the fiscal plan of the 2020 fall statement (Chart 1) due to measures announced in previous budgets. So one budget at a time, spending has been ratcheted up on a cumulative basis from what was once anticipated, although some of that could reflect a growing population and higher-than-expected inflation.

Chart 1: Program spending on a higher trajectory



Source: Finance Canada

In terms of the new initiatives, many are directed at housing, clearly a worthy cause given the shortage of affordable housing these days. Some of these don't entail outright expenditures, but are captured in low interest loans and tax measures that will enable larger tax free withdrawals from first-time homebuyer accounts, or accelerate depreciation allowances, the latter a potential game changer in greenlighting projects that would otherwise offer too little return given current financing costs. Support for the infrastructure needed to open up land for housing was another large measure.

All told, the initial fiscal cost will be roughly $1 bn this year, but given the lags entailed in getting activity off the ground from some of these measures, the fiscal cost will double by 2027. Further ahead, two more powerful tools to address the current housing crunch should also offer some relief for renters: lower interest rates that will boost construction and help some become home owners, and much slower population growth under new caps on foreign students and temporary foreign workers.

Costs for new programs in some other areas are also spread out over several years, including those tied to a jolt in defense spending, or are offered as loans, as is partly true for initiatives to expand child care spaces. The budget's spending envelopes will also cover the costs for previously announced government pharmacare offerings that are fairly narrow in terms of their reach at this point, but could grow if their coverage is expanded. New support for Indigenous communities is one of the areas where upfront costs will be larger, with a nearly $3 bn fiscal cost to the current year, and easing off thereafter.

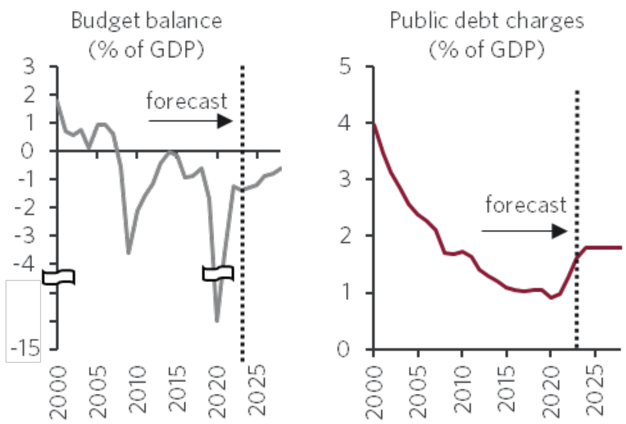
On the revenue side, what the government is giving in terms of tax relief for the likes of apartment builders and entrepreneurs, it's more than taking back in a tax hike designed to avoid hitting middle-income Canadians. Two-thirds of capital gains earned by corporates and trusts, and capital gains in excess of $250K earned by individuals, will be included as income for tax purposes, up from a 50% inclusion rate previously. The budget argues that current rules result in an unfairly low marginal rate on high income earners, but some might note that capital gains income is earned by those taking risks with money that they may have originally saved from income that was already taxed. The lower inclusion rate was deemed to be an incentive for Canadians to take such risks in order to finance business capital spending that helps growth and productivity over time.

On the corporate side, the government did not act on rumors of a targeted tax hike on particular sectors, as had been recommended by a parliamentary committee. Overall, the capital gains tax hike, less some reductions elsewhere (including some changes to alternative minimum tax reforms) will reap $6.5 bn this year, but a more modest $3 bn in 2025/26.

Living within guardrails

Taken together, the spending and tax measures will still have debt to GDP ratios on a gradually declining path, if still well above where they were projected to run prior to the pandemic. Debt service costs, while up from their lows, remain well below historical norms (Chart 2).

Chart 2: Deficit expected to shrink relative to GDP (l); debt service charges contained as a share of GDP (r)



Source: Finance Canada

Canada's fiscal balances, whether at the federal or total government level, might be judged as a case of a missed opportunity, in the sense that a greater degree of belt tightening could accelerate the pace of much-needed interest rate relief. Moreover, from an overall government perspective, we face rising costs for health care, and old age supplements tied to an aging population, making it important to keep a better lid on government debt while more of that burden still lies ahead.

That said, the federal deficit, at 1.3% of GDP, stands in stark contrast to a projected US federal shortfall of 5.6% of GDP this year, particularly given that the American economy is in greater need of an anti-inflation cooling. Even adding in the provinces, Canadian deficits will pale relative to those of most other major economies. It’s in the household sector where our larger burden lies, and efforts to contain housing costs are relevant in slowing that accumulation, which has largely been tied to sharply rising mortgage sizes.

In terms of gross government debt as a share of GDP, Canada looks a bit high relative to some other AAA-rated countries, while still at the lower end of most large economies, and is a clear winner on net debt, even when including provinces. So while bond supply will be ramping up, and thereby acting as a headwind to an easing in longer term rates, its likely that heavy US federal borrowing will have a larger impact in steepening Canada's yield curve as the Bank of Canada eases up on short-term rates.

More bonds, if less than feared

While the increase was not quite as large as our FICC strategists had feared, owing to less of a need to cover non-budgetary transactions (e.g. loans), we're still facing an increase in bond supply in the coming year. We're getting into the days of heavy maturities of the debt used to finance the pandemic period deficit. Some of the government program spending is in the form of loans that won't be adding much to deficits but will need financing, as will its plan to buy Canada Mortgage Bonds.

The small projected decline in the deficit will be more than countered by an increase in non-budgetary transactions, so net financing requirements are expected to climb (Table 4). Add to that a heavier schedule for maturities, and gross borrowing needs will grow to $523.4 bn, from $447.4 bn the prior year. That won't entail as much of a change in the pace for gross Canadian dollar domestic bond issuance, with the expected $228 bn in C$ bonds coming in at the lower end of the range our strategists had been expecting, although we will still be adding a further $60 bn to the stock of such bonds outstanding after maturities (Table 5). Some of the increase in requirements will instead be met by reducing cash holdings and by an increase in treasury bills outstanding, including the addition of a 1-month to help fill in the gap previously filled by BAs.

Table 4: Borrowing requirement (C$billions)

Borrowing requirements	2023/24E	2024/25F
Budgetary (Surplus)/Deficit	40.0	39.8
Non-budgetary transactions[1]	49.4	62.6
Net Financial Requirement/(Source)	89.4	102.4
Domestic Maturities, Adj. & Buybacks	358	421
Gross Borrowing Requirement	447.4	523.4

Table 5: Sources of funding (C$billions)

Funding requirements	2023/24E	2024/25F
Cash & Other (net)	-30.6	15.4
Treasury Bills (net)	267	272
Canadian Dollar Bonds	204	228
Retail (net)	0	0
Foreign Currency Debt (net)	7	8
Total	447.4	523.4
Change in stock of domestic bonds	48	60

Table 6: Gross issuance (C$billions)

$bn	2022/23A	2023/24 E	2024/25 F
Treasury bills	202	267	272
2yr	67	86	88
3yr	20	6	0
5yr	31	47	60
10yr	52	47	60
30yr	14	14	16
Green bonds	-	4	4
Total bonds	185[2]	204	228
Total Gross Issuance	387	471	500

[1] Non-budgetary transactions comprise loans/advances to Enterprise Crown Corporations, pension costs & other

[2] Total issuance includes real-return bonds and ultra-long bonds.

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