ECONOMIC VIEWPOINT

2022 Canadian Budget Overview

Government Revenue Windfall: Who Saved it and Who Spent It

By Randall Bartlett, Senior Director of Canadian Economics

Canada's 2022 budget season has come to a close. Across the board, revenues were much stronger than expected on the back of higher inflation and economic growth. Spending was more mixed, but pandemic-related expenditures were generally lower than anticipated. As a result, the federal and provincial governments all saw an improvement in their 2021–2022 deficit estimates and starting points for the rest of their fiscal forecast. But what they did with this fiscal windfall varied greatly. Some chose to set a portion of it aside for a rainy day, while others spent it all. Importantly in this context, we expect economic activity to come in weaker than most governments currently project for 2023 and beyond. If that happens, some governments could be in a more challenging fiscal situation than they anticipated when they published their more recent fiscal plans.

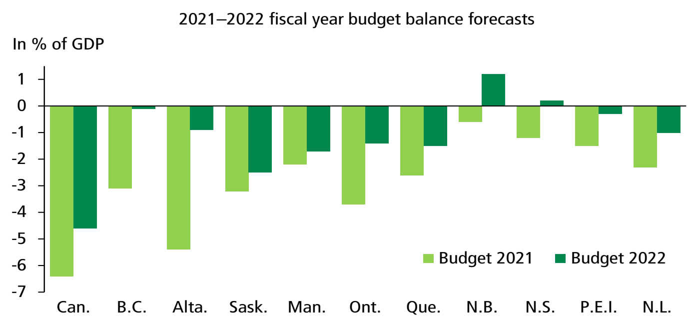
Canada's 2022 budget season has been quite a ride. With all governments seeing revenues come in better than expected on higher growth and inflation, much of the interest has focused on what they will do with the windfall. Some plan to run budget surpluses this year. Others plan to spend some of their good fortune but still run smaller deficits than in the 2021–2022 fiscal year. Still another group plans to run even larger deficits in the 2022–2023 fiscal year than a year earlier. But that may not be as concerning as it first appears for every province in this last group.

Fiscal Positions Universally Improved Last Year

Christmas came early for the federal and provincial governments this budget season. With real GDP growth, inflation and labour market indicators topping early 2021 expectations, it came as little surprise that revenues outperformed. Spending also came in lower than expected, albeit more modestly, particularly in those areas most closely linked to the economy such as COVID-19-related measures.

As a consequence of the fiscal boost provided by this economic tailwind, budget deficits in the 2021–2022 fiscal year are now universally estimated to be smaller than was expected during the 2021 budget season (graph 1). Some provinces, such as Nova Scotia and New Brunswick, are even anticipating a return to surplus. The other jurisdictions continued to run deficits, but some, notably Alberta, British Columbia (BC) and Ontario, saw a meaningful improvement in their in-year deficit estimates as a share of GDP.

GRAPH 1
Governments reported better-than-expected budget balances last year



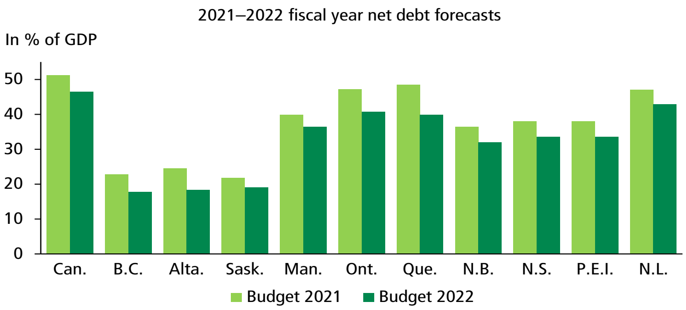
Sources: Federal and provincial departments of finance and Desjardins, Economic Studies

With deficits having bested expectations in the 2021–2022 fiscal year, it's no surprise that net debt-to-GDP ratios last year also outperformed earlier forecasts. Across the board, federal and provincial governments benefitted from both smaller deficits adding less to the debt stock and a higher level of nominal GDP further reducing the net debt-to-GDP ratio (graph 2 on page 2).

Mixed Responses to a Better Fiscal Start

Headline numbers aside for the 2021–2022 fiscal year, the one thing every government has in common is that their starting point for future fiscal years has universally improved. But much

GRAPH 2
Government net debt positions have improved across the board

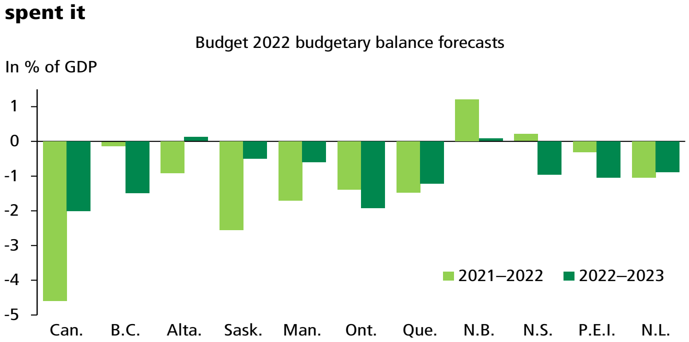


Sources: Federal and provincial departments of finance and Desjardins, Economic Studies

like individuals who win the lottery, some provinces squirreled away the windfall while others spent it and then some.

More specifically, there are three distinct groups of fiscal performers in Canada from a budget balance perspective. The first is the federal government, which, as the sovereign issuer, is a group unto itself. And to the surprise of many, including us, the Government of Canada exercised some fiscal discipline in Budget 2022. It spent some of the revenue windfall from higher real GDP growth and inflation but used the rest to reduce the deficit (graph 3). The second group of fiscal performers, consisting of Saskatchewan, Manitoba, Alberta, Quebec, and Newfoundland and Labrador, also saved some of their deficit windfalls for a rainy day. The third group includes Ontario, BC, Nova Scotia, and Prince Edward Island (PEI). In contrast to the other two groups, they plan to run larger deficits in the 2022–2023 fiscal year than they did the year before despite the better-than-expected starting point for their fiscal outlook.

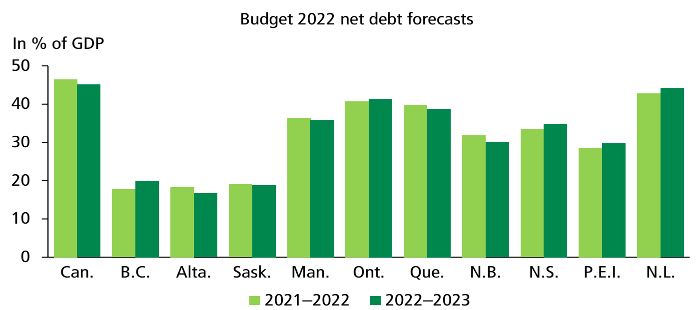
GRAPH 3
Some governments saved their revenue windfall while others spent it



Sources: Federal and provincial departments of finance and Desjardins, Economic Studies

Not surprisingly, the federal government and most of the provincial governments planning to run smaller deficits in the 2022–2023 fiscal year are also expected to see their net debt-to-GDP ratios decline (graph 4). Newfoundland and Labrador is the notable exception. Its net debt-to-GDP ratio is expected to rise in the 2022–2023 fiscal year despite an anticipated reduction in the budget deficit. (More on that later.) In contrast, those provinces that plan to run larger deficits this year than in the 2021–2022 fiscal year are also expected to post higher net debt-to-GDP ratios.

GRAPH 4
The outlook for net debt is generally in line with deficit forecasts



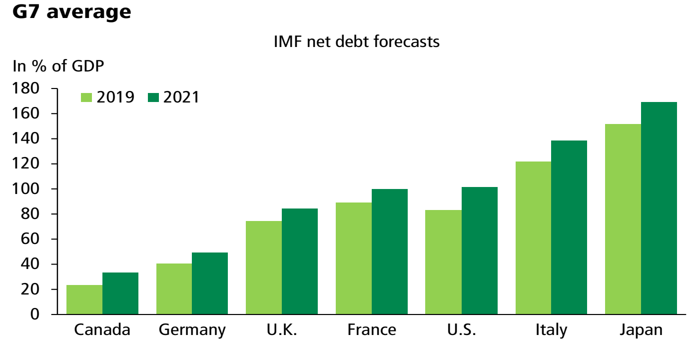
Sources: Federal and provincial departments of finance and Desjardins, Economic Studies

Keeping Up with Other Debt Issuers

Rising net debt-to-GDP ratios are an important consideration in any fiscal analysis because they're key to determining the long-term sustainability of public finances. But there's more to it than that.

Relevant comparators matter. In the context of total public debt outstanding, Canada has the lowest net debt-to-GDP ratio in the G7. And while higher than prior to the pandemic, Canada's total government debt position continues to compare very well to other major advanced economies (graph 5). This was reinforced

GRAPH 5
Canada's debt rose during the pandemic but is below the G7 average



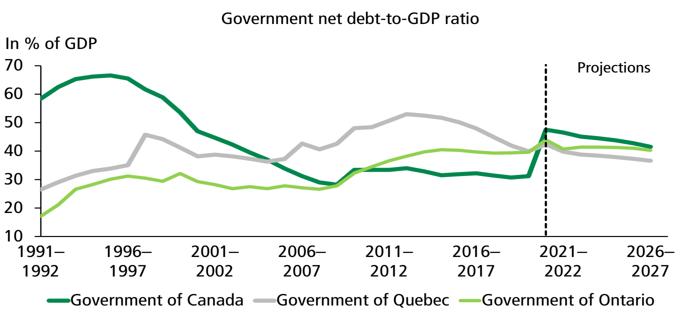
IMF: International Monetary Fund
Sources: IMF and Desjardins, Economic Studies

when Standard & Poor's re-affirmed the Government of Canada's AAA credit rating with a stable outlook at the end of April 2022.

At the provincial level, other provinces are the relevant comparators. And the provinces can be divided into at least three groups by net debt-to GDP. First, BC, Alberta and Saskatchewan all have much lower net debt-to-GDP ratios than the other Canadian provinces, and by a wide margin. So, while BC's net debt-to-GDP ratio is set to rise, it's starting from a low level and will remain below that of other provinces for the foreseeable future. Second are the Maritime Provinces, which exclude Newfoundland and Labrador. Their net debt-to-GDP ratios are higher than the first group's, but still below the group with the highest ratios. That higher net debt-to-GDP group includes Ontario, Quebec, Manitoba, and Newfoundland and Labrador.

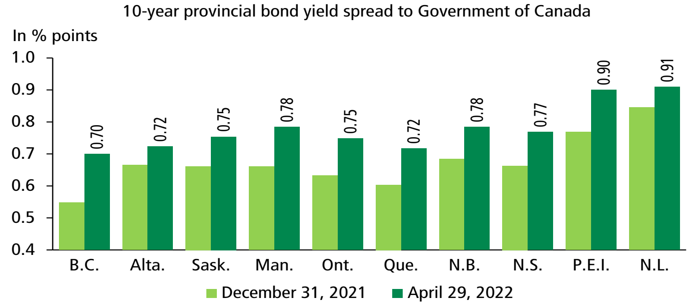
These differences in provincial net debt-to-GDP ratios help explain both provincial yield spreads and provincial-Canada yield spreads. And since the 2022 budget season has come to a close, there has been notable movement in relative yields across provinces. Ontario and Quebec are classic comparators, as they're the two largest provinces and subnational debt issuers in Canada. In terms of net debt-to-GDP, Quebec has dramatically closed the gap with Ontario over the past decade and is expected to have a better net debt-to-GDP ratio over the coming five fiscal years (graph 6). And Quebec has been rewarded for this fiscal discipline by paying a lower interest rate on government debt than Ontario has (graph 7). Indeed, the borrowing costs of all provinces can be evaluated through the lens of relative fiscal discipline (as measured by net debt-to-GDP) and economic size (as a proxy for potential revenue base).

GRAPH 6
Quebec's lower net debt-to-GDP ratio explains its lower yield spread



Sources: Finance Canada, Quebec Ministry of Finance, Ontario Ministry of Finance and Desjardins, Economic Studies

GRAPH 7
Rates are lower for provinces that are larger and/or have less debt



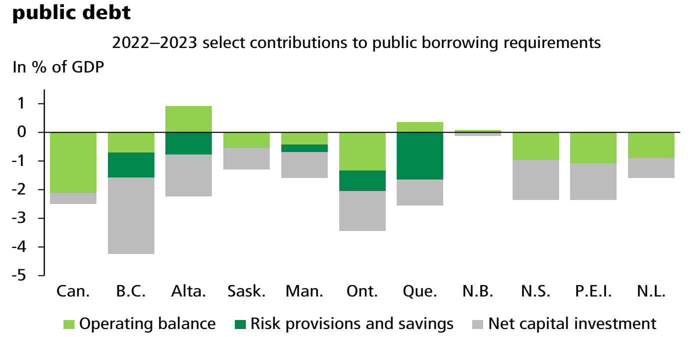
Sources: Bloomberg and Desjardins, Economic Studies

Not All Borrowing Is Created Equal

Most provinces break out their total funding requirement into at least three primary underlying drivers: borrowing to fund the budget or operating balance (revenues less program expenses and debt services charges), borrowing for net capital investment (capital expenses less amortization of capital assets), and debt maturities and redemptions. Borrowing for capital investment is generally considered "good" debt, particularly if it's invested in productivity-enhancing infrastructure that supports higher long-term economic growth. In contrast, borrowing to fund operating deficits is generally considered "bad" debt, as program spending and borrowing costs are best funded with revenues in normal times. Otherwise, the burden of paying for today's deficits risks falling on future taxpayers. There is also debt, which is used to fund operating deficits that are well outside of what is warranted by the state of the economy (and, therefore, structural in nature) or used to fund capital investments that are of questionable economic or social value.

Net capital investment, risk provisions and savings make up a substantial share of some provinces' planned borrowing requirements for the 2022–2023 fiscal year (graph 8). Most

GRAPH 8
Net capital investment makes a key contribution to projected public debt

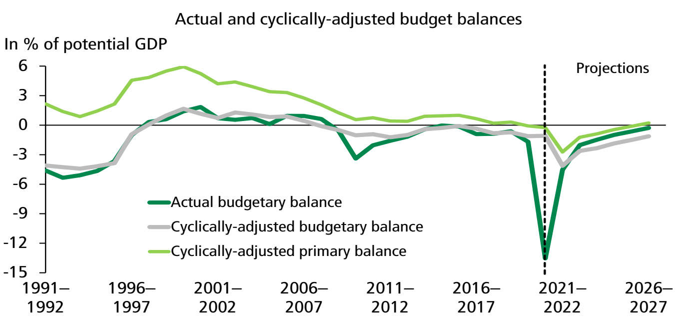


Sources: Federal and provincial departments of finance and Desjardins, Economic Studies of the borrowing requirements in BC, for example, are for significant net capital investment (2.7% of GDP) following the floods late last year. At the same time, a substantial 0.9% of GDP is also set aside for pandemic recovery contingencies and forecast allowance, meaning the operating deficit is responsible for only a modest increase in the net debt-to-GDP ratio.

Meanwhile, Ontario has set aside 0.7% of GDP for net capital investment and COVID-19-related contingencies and reserves. It also intends to run a province-leading 1.3% of GDP operating deficit in the 2022–2023 fiscal year. Newfoundland and Labrador, PEI and Nova Scotia are also planning to run relatively large operating deficits as a share of GDP, while Manitoba and Saskatchewan will have much smaller operating deficits.

Not to be outdone, the federal government plans to run a larger operating deficit as a share of GDP than any individual province and, hence, more than that of all provinces combined. This is expected to lead to the largest and longest string of structural deficits since the early 1990s (graph 9). However, the net debt-to-GDP ratio will likely decline gradually over the forecast period given the high level of projected nominal GDP. At the same time, almost every province is expected to engage in more net capital investment than the federal government, although some of this subnational infrastructure spending likely includes an element of federal transfers which are difficult to disentangle. For this and other reasons, it's important to be cautious when comparing federal and provincial deficits and debt.

GRAPH 9
The federal government is likely to run sustained structural deficits



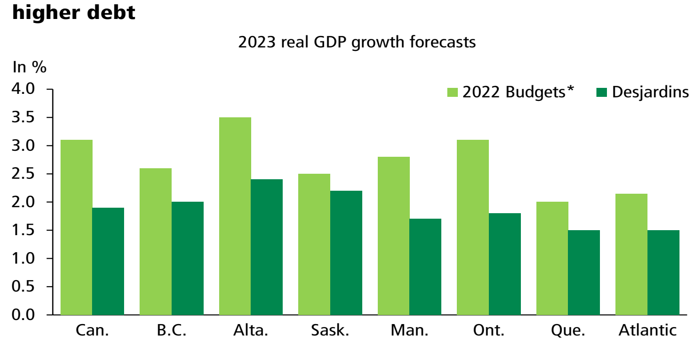
Sources: Department of Finance Canada, International Monetary Fund and Desjardins, Economic Studies

Finally, three provinces—Alberta, Quebec and New Brunswick—plan to run operating surpluses in the 2022–2023 fiscal year after accounting for amounts set aside for risk provisions and savings. This helps to explain why these provinces are projected to see the smallest increase in net debt-to-GDP ratio in the 2022–2023 fiscal year. Quebec in particular stands out for the substantial level of funds set aside for "COVID-19 support and recovery measures," "provision for economic risks and other support and recovery measures," as well as "deposits of dedicated revenues in the Generations Fund."

Risks to the Fiscal Outlook Are Economic

Beyond the fiscal outlook numbers provided by each government, there's also the question of the economic forecasts underpinning these projections. Almost universally, our [most recent forecasts] for real GDP growth and inflation are weaker starting in 2023 than those used by the federal and provincial governments as inputs into their fiscal forecasts (graph 10). This implies that the risks are tilted toward lower revenues, larger deficits and higher debt than are currently baked into the fiscal forecasts of governments in Canada. As we discussed above, some governments have accounted for this by building a reserve into their fiscal forecast. Others, however, have not or have not built in a sufficient reserve to capture the risk. As such, those provinces with additional fiscal buffers may be better positioned to withstand an economic downturn or sharp rise in interest rates.

GRAPH 10
A weaker economic outlook may mean larger deficits and higher debt



* Bloomberg average of private-sector forecasters is used in place of missing 2022 budget data.
Sources: Federal and provincial departments of finance, Bloomberg and Desjardins, Economic Studies

Conclusion

Taken together, the federal and provincial governments all ended the 2021–2022 fiscal year in a much better financial position than expected a year earlier. However, what they plan to do with this windfall varies significantly. Some provinces, such as Alberta, Quebec and New Brunswick, plan to run operating surpluses layered on top of contingencies for risk and savings. Others like Manitoba, Saskatchewan and Newfoundland and Labrador also intend to run smaller deficits in the 2022–2023 fiscal year than the year that preceded it. These deficits are divided between financing for operating deficits and capital investments. Finally, Ontario, BC, Nova Scotia and PEI all intend to run larger budget deficits as a share of GDP this year than in the 2021–2022 fiscal year, leading to an increasing net debt-to-GDP ratio. However, these provinces will see higher net capital investment make a substantial contribution to rising debt levels, particularly in BC.