ECONOMIC VIEWPOINT

Federal Fiscal Forecast: The Road to Higher Debt Is Paved with Good Intentions

By Randall Bartlett, Senior Director of Canadian Economics

Highlights

- A lot of announcements have been made and new data released since Budget 2023 was published. They haven't meant much individually, but together they reinforce the narrative that the federal fiscal outlook is headed in the wrong direction.
- Specifically, despite some movement under the topline budget balance, the monthly data for the 2022–23 fiscal year was broadly a wash for the forecast. And the outsized move in real GDP growth to start 2023 should provide a bit of a tailwind to the current fiscal year. But that's where the good news ends. Notably, the wage increases resulting from the federal public service strike and new industrial subsidies will add to the deficit in the current and subsequent fiscal years.
- Taken together, these factors would result in a debt-to-GDP forecast that is broadly in line with that published in Budget 2023. However, this assumes the federal government is able to garner the revenues and find the savings it hopes to. Given past experience, we believe this is unlikely. As a result, we expect the rise in the debt-to-GDP ratio to exceed the outlook in Budget 2023.

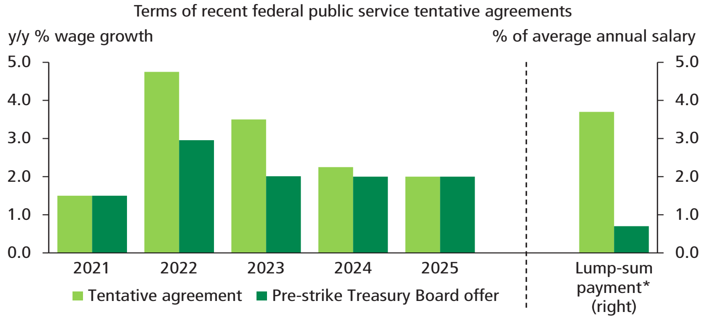
Well, the preliminary data is out for the 2022–23 fiscal year, and it was greeted with a collective shrug. The deficit came in slightly better than estimated in Budget 2023 but not by much, still rounding to 1.5% of GDP. And while the details of individual revenue and spending lines may differ, a detailed accounting here would do more to cure insomnia than to inspire interest in the federal government's finances.

So, assuming the starting point for the fiscal outlook is broadly in line with the estimate in Budget 2023, what's changed? Well, a lot actually.

PSAC's a Smooth Negotiator

The agreements on wage increases made in May 2023 following the federal public service strike (see the tentative agreements here and here) will undoubtedly put upward pressure on operating expenses. Applying to 155,000 federal public servants, the agreements committed to a 3.0% average annual increase in wages and salaries from 2021 through 2024 (graph 1). And that is in addition to a one-time lump-sum payment of $2,500 paid to each striking public servant. These agreements alone could cost the federal government as much as an additional $2.3B in the 2023–24 fiscal year, assuming none of it is booked in prior fiscal years. But these 155,000 workers are just north of 35% of federal public servants. If the agreements were to apply to all federal government workers, the additional cost would be more than $6B in the current fiscal year.

GRAPH 1
The Federal Public Service Strike Led to Larger Wage Gains

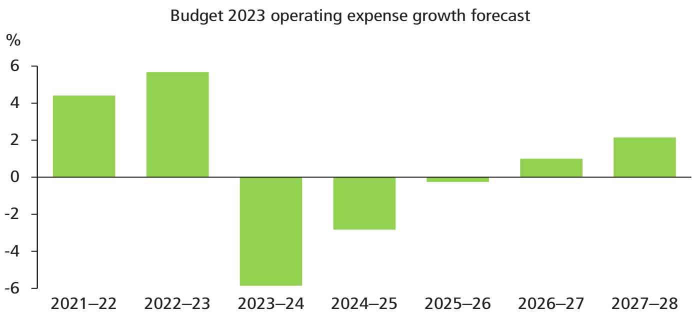


*Based on an average annual salary of $67,300 for PSAC members at Treasury Board
Sources: Public Service Alliance of Canada (PSAC) and Desjardins Economic Studies

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

This 3.0% average annual increase in wages and salaries stands in stark contrast to the 4.4% average annual contraction in operating expenses in the 2023–24 and 2024–25 fiscal years projected in Budget 2023 (graph 2). However, we have very little information on what is behind this operating expense forecast. According to the Government of Canada in Budget 2023, the decline in operating expenses is "due in part to tapering of COVID-19 related spending, such as for procurement of vaccines, therapeutics, and test kits. Growth in operating expenses over the outer years of the horizon is driven in part by wages for federal employees and capital amortization expenses, which is offset in part by the results of expenditure reduction actions announced in Budget 2022 and in this budget."

GRAPH 2
Operating Expenses Are Expected to Contract This Year and Next



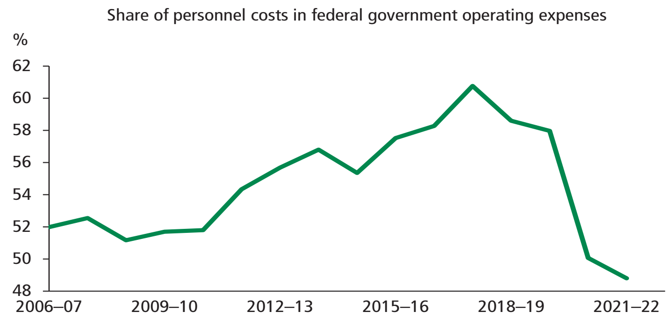
Sources: Government of Canada and Desjardins Economic Studies

Prior to the pandemic, between 50% and 60% of federal operating expenses were personnel costs (graph 3). According to analysis by Bartlett and Reeves (2018), these were composed of mostly wages and salaries, but also benefits and pension contributions. However, in the most recent Public Accounts of Canada 2022, personnel costs made up less than 50% of operating expenses in the 2021–22 fiscal year. But this historically low share isn't due to less spending on personnel. Instead, it's the result of a sharp increase in pandemic-related spending. As such, the recent compensation agreements and end of pandemic-era measures point to personnel costs again becoming the primary driver of federal operating expenses.

In addition to individual compensation, the size of the federal public service has also increased since the start of the pandemic. The number of full-time equivalents (FTEs) in the federal public service has risen from 368,000 in the 2018–19 fiscal year to 413,000 in the 2021–22 fiscal year (graph 4). This is an increase of over 45,000 FTEs, or more than 12%. In contrast, between the 2015–16 and 2018–19 fiscal years, the increase in the number of FTEs was closer to 25,000.

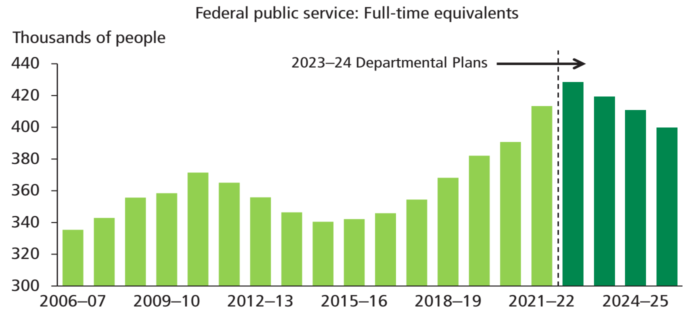
According to data assembled by the Parliamentary Budget Officer from the 2023–24 Departmental Plans, the number of FTEs is expected to have peaked in the 2022–23 fiscal year at 428,000.

GRAPH 3
Personnel Costs Were Rising as a Share of Spending Pre-pandemic



Sources: Government of Canada and Desjardins Economic Studies

GRAPH 4
The Number of Federal Public Servants Is Expected to Have Peaked



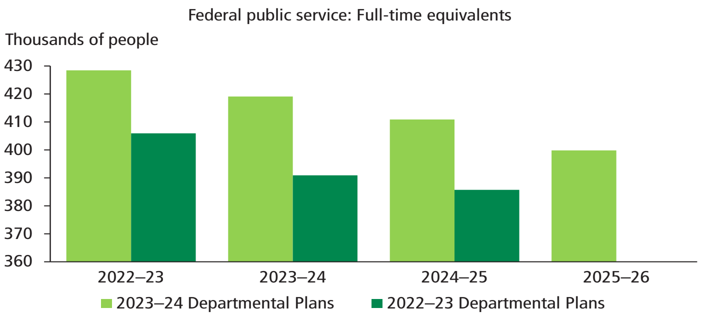
Sources: Parliamentary Budget Officer, Government of Canada and Desjardins Economic Studies

After that, it's projected to fall gradually, eventually dipping to just below 400,000 in the 2025–26 fiscal year. That's an annual decline of 2.3% from the high until the end of the forecast, but would still leave the size of the federal public service well above its pre-pandemic level.

However, we've heard this lower FTE story before. The Departmental Plans perennially show a decline in FTE counts over the forecast (graph 5 on page 3). This is in part because some long-standing programs have their funding reviewed and renewed annually, and so these FTEs aren't assumed to be a sure thing.

But as Milton Friedman used to joke, there is nothing more permanent than a temporary government program. Indeed, the proposed reduction in FTEs would be roughly equivalent to the drop we saw in the last three years of the previous administration's mandate. As such, in the absence of a clear plan to reduce the number of FTEs, we assume the number of federal public servants will remain unchanged at the projected level in the 2022–23 fiscal year. However, even this assumption may be generous, as the sustained growth in federal public service payrolls prior to the pandemic suggests the direction is unlikely to change anytime soon.

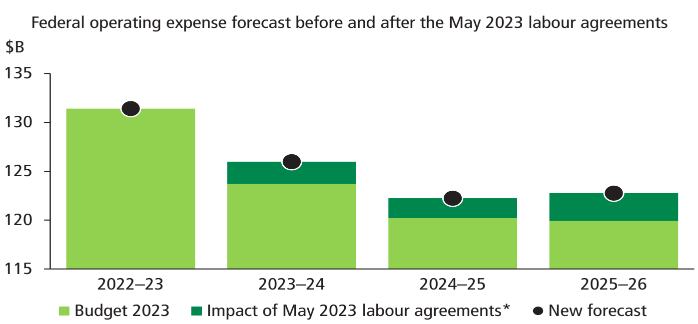
GRAPH 5
The Number of Federal Public Servants Is Always Forecast to Fall



Sources: Parliamentary Budget Officer, Government of Canada and Desjardins Economic Studies

Putting this all together, we expect federal public service wage increases will push operating expenses higher (graph 6). When just accounting for the 155,000 PSAC members that recently went on strike, this amounts to $2.3B in the current fiscal year and about $2.5B annually every fiscal year thereafter. This assumes that the original offer made by the Treasury Board was baked into operating expenses in Budget 2023. If it wasn't, then the budgetary impact will be even larger. And if the terms of these new agreements are ultimately applied to the full federal public service, then the personnel bill will be substantially larger, topping $6B annually starting next year.

GRAPH 6
Operating Expenses Will Be Higher as a Result of Wage Increases



*Impact if applied to the entire federal public service
Sources: Public Service Alliance of Canada, Government of Canada and Desjardins Economic Studies

Mega-Subsidies for Gigafactories

After Budget 2023 came the announcement of $13B over 10 years in subsidies for Volkswagen to build an electric battery manufacturing plant in Southwestern Ontario. According to Budget 2023, "[p]rojected costs of this agreement have been fully accounted for in Budget 2023. Further details and announcements will follow in the coming weeks after finalization of the agreement by Volkswagen." However, no details were provided in the budget as to projected costs. As such, we don't know if the final $13B was fully accounted for.

Further, the PBO recently released its own fiscal analysis of Canada's support for Volkswagen's electric vehicle battery manufacturing plant. In it, the PBO estimated that total federal fiscal support could be $2.8B higher than the federal government has assumed. This is because "the government would need to offer a tax adjustment to ensure an after-tax equivalency to the support offered under the IRA [Inflation Reduction Act] that it has publicly stated on numerous occasions."

But this isn't the end of the story. Following the announcement of the Volkswagen subsidies, Stellantis asked for additional subsidies for its new electric vehicle battery plant in Southwestern Ontario. We don't know what the amount of the subsidies will ultimately be, but we do know that they were not accounted for in Budget 2023. With one researcher putting the fiscal largesse at as much as $19B over 10 years, the bill taxpayers are being asked to pay could be substantial.

And this is really just the beginning. It's difficult to get a sense from Budget 2023 what the federal government's ultimate plans are for industrial subsidies, and if there is a limit to what it is willing to spend.

The Economy to the Rescue, Again

Despite unquestionably higher spending in the hopper than was presented in Budget 2023, the news isn't all bad. The Canadian economy has continued to outperform expectations, particularly real GDP in the near term (table). But this isn't expected to last. Indeed, the change in the economic outlook looks as though it will be a net drag on federal finances in almost every year of the forecast (graph 7 on page 4). See our latest Economic and Financial Outlook for more information about our most recent forecast.

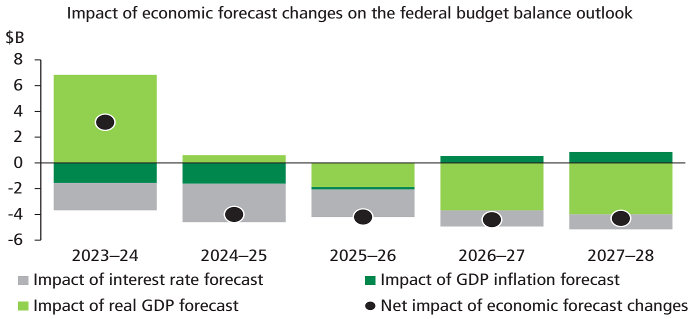
It's worth noting that we don't think the recent federal public service wage agreements will move the needle much on inflation. This is because the 3% average annual increase is broadly in line

TABLE
Economic and financial forecasts

AVERAGE ANNUAL GROWTH IN % (UNLESS OTHERWISE INDICATED)	2023f	2024f	2025f	2026f	2027f
Budget 2023					
Real GDP	0.3	1.5	2.3	2.2	1.9
GDP deflator	0.6	2.0	1.9	1.9	1.9
Treasury bills – 3-month	4.4	3.3	2.6	2.4	2.4
Federal bonds – 10-year	3.0	2.9	3.0	3.1	3.1
Desjardins (June 2023)					
Real GDP	1.7	0.3	1.7	1.8	1.9
GDP deflator	0.0	2.1	2.4	2.1	2.0
Treasury bills – 3-month	4.7	3.5	2.3	2.2	2.5
Federal bonds – 10-year	3.2	2.9	2.7	2.8	3.0
Difference (Desj. - B2023)					
Real GDP	1.4	-1.2	-0.6	-0.4	0.0
GDP deflator	-0.6	0.1	0.5	0.2	0.1
Treasury bills – 3-month	0.3	0.2	-0.3	-0.2	0.1
Federal bonds – 10-year	0.2	0.0	-0.3	-0.3	-0.1

f: forecast
NOTE: Data may not add up to totals due to rounding.

GRAPH 7
On Net, the Changes to the Economic Outlook Have Been Negative



Sources: Government of Canada, Statistics Canada and Desjardins Economic Studies

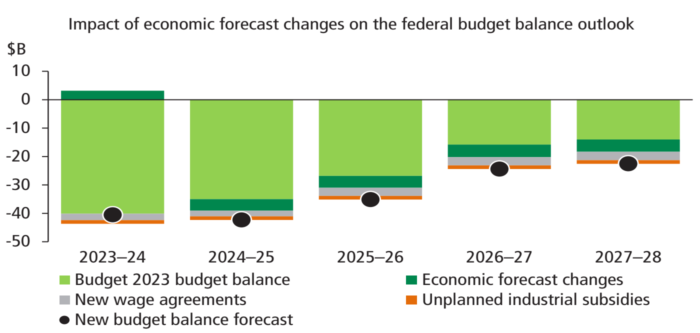
with what we've seen historically. Further, it's our impression that public service wage settlements tend to feed more gradually into general prices than those in the private sector. This is because the nature of the services provided does not lend itself as readily to passing wage increases on to consumers.

You Can't Spend Your Way to Debt Sustainability

The improved near-term economic outlook is good news for the federal government as it will help to provide some offset to the higher-than-planned spending in the current fiscal year. However, the deterioration in the economic outlook thereafter is expected to add to the more elevated spending in the next few fiscal years (graph 8).

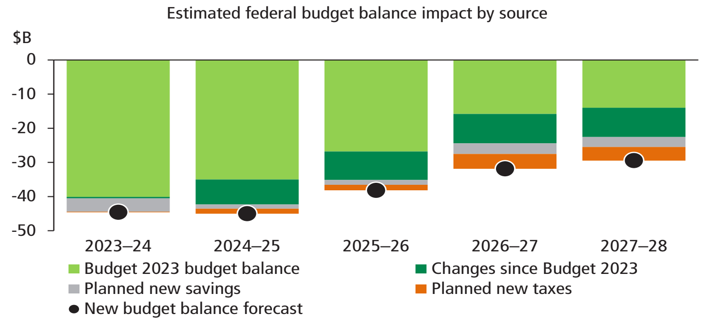
Further, this outlook assumes that the federal government raises the revenues and finds the savings it hoped to in Budget 2023. As we outlined in our overview of the budget, we think this is unlikely. New tax measures have consistently raised less revenue than anticipated. And as for finding efficiencies, we have yet to see a credible plan. (See Clark (2011) for the criteria that define a credible fiscal plan.) Consequently, the federal deficit could come in much larger than currently projected (graph 9).

GRAPH 8
The Federal Fiscal Outlook Should Get Worse in the Near Term



Sources: Government of Canada, Statistics Canada and Desjardins Economic Studies

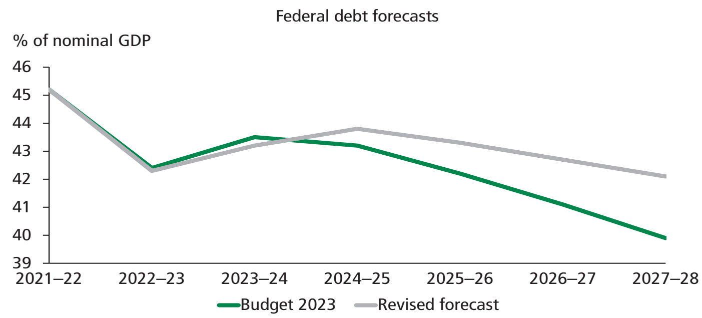
GRAPH 9
A Lot Could Still Go Wrong with the Federal Fiscal Outlook



Sources: Government of Canada and Desjardins Economic Studies

This will have material implications for the level of federal debt. Specifically, the debt-to-GDP ratio would rise in both the 2023–24 and 2024–25 fiscal years before gradually falling (graph 10). All told, the debt-to-GDP profile is likely to be higher than in Budget 2023 over much of the forecast. And if the debt-to-GDP outlook ultimately follows this higher path, it would be just the latest example of the federal government moving the goalposts of the fiscal plan.

GRAPH 10
Federal Debt-to-GDP Is Likely to Be Higher than in Budget 2023



Sources: Government of Canada and Desjardins Economic Studies

That said, the federal debt is not currently on an unsustainable trajectory. (See our note on the state of government finances in Canada.) Even if the debt-to-GDP ratio rises in the next couple of years, we expect it to gradually decline over the long term in the absence of new spending. It's also worth noting that if the federal government does manage to raise all the new revenues and find all the savings outlined in Budget 2023, the debt-to-GDP ratio would come in only modestly worse than the budget projection. However, our latest forecast demonstrates that the Government of Canada can't rely on economic activity to surprise on the upside forever, not least when the Bank of Canada is pressing on the brakes even harder. And with each new unplanned spending announcement, the credibility of the fiscal plan and sustainability of public finances get eroded further.

Conclusion

The economic and fiscal information released since Budget 2023 is cause for concern. Budget deficits are likely to be larger and debt higher than the federal government expected earlier this year. This is entirely the result of spending decisions made by the Government of Canada and comes despite an improved near-term economic backdrop. That's not to say those decisions weren't made with the best of intentions. But we all know where the road paved with good intentions leads, and the federal government would be wise to keep that in mind.