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ECONOMIC VIEWPOINT

Federal Government Spending: Neither the Sole Cause of, nor Solution to, Our Inflation Woes

By Randall Bartlett, Senior Director of Canadian Economics

The federal government has come under significant fire for the inflationary impacts of its pandemic spending. This has prompted calls for austerity from some quarters, particularly as expenditures are expected to remain elevated as a share of GDP for the foreseeable future. However, we think federal austerity would be a mistake. First, federal program spending is already rapidly declining and is forecast to advance in line with inflation over much of the outlook. Second, many of the spending categories that aren't already declining are transfers to low-income households or negotiated transfers to provinces. Third, provinces will collectively see spending fall more slowly than the federal government, suggesting they may have more room to reduce spending. Fourth, the government sector in Canada looks to be on a more sustainable path than the housing market and other interest rate sensitive parts of the economy. As tough as the adjustment is going to be, interest rates need to rise to restore balance to asset markets and bring down inflation. And the burden of responsibility for returning inflation to target falls squarely on the Bank of Canada.

There's been a lot of blame thrown around for Canada's current bout of high inflation. Chief among the accused are the Bank of Canada and the federal government. As the argument goes, each provided more stimulus than warranted during the pandemic and has been too slow to remove it now that the economy is running hot. As such, they're now behind the curve. The Bank of Canada has thus been forced to raise interest rates at the most aggressive pace in decades. In contrast, the federal government has let extraordinary programs roll off gradually as planned and has even enhanced some existing programs. It has also added new programs to the mix, such as a federal dental care program and early childhood education.

Some say this sustained federal spending is contributing to ongoing high inflation and have called for the Government of Canada to embark on an austerity program to help the Bank reign in inflation. While we don't disagree that previous and ongoing federal spending is contributing to inflation, we believe it would be a mistake for the federal government to slash spending relative to its current fiscal plan. In this note, we'll share our reasoning for this view.

What's the Relationship between Monetary and Fiscal Policy?

First, it's important to understand the historical interaction between monetary and fiscal policy in Canada. In a highly prescient 2016 speech, former Bank of Canada Governor Stephen Poloz said, "[…] there is a meaningful trade-off in the policy space between the medium-term consequences for debt of monetary and fiscal policies. An easy monetary/tight fiscal policy mix will lead to higher private sector debt and lower public sector debt, all other things being equal. Similarly, a tight monetary/easy fiscal policy mix will lead to lower private sector debt and higher public sector debt."

In part, this reflects the inflationary nature of expansionary fiscal policy. When the economy is operating below its potential level of output, government spending spurs demand and reduces the likelihood of deflation/disinflation in the process. When a downturn is particularly pronounced, expansionary monetary and fiscal policy can work hand in hand to provide an economic boost to blunt the worst of a crisis. This is what happened during the depths of the pandemic.

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However, when the economy is operating above its potential, expansionary fiscal policy can push demand further above what the economy can supply and drive inflation higher. This often forces the central bank to act more aggressively to rein in inflation than it would otherwise need to, thereby raising public and private borrowing costs.

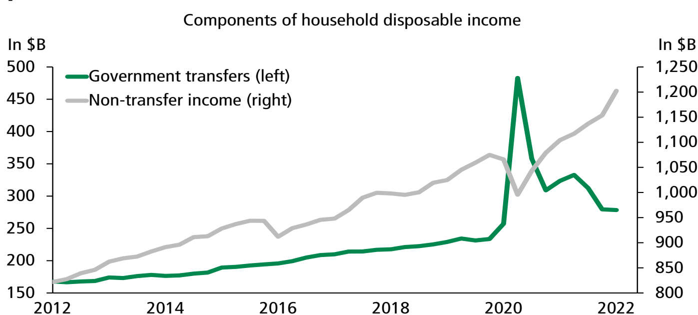
This is the crux of the argument for greater federal government austerity. As the argument goes, federal government spending today is contributing to ongoing inflation and leading to unnecessarily high borrowing costs. Slashing spending would therefore cool aggregate demand, ease inflationary pressure and reduce the Bank of Canada's eventual terminal rate in this hiking cycle.

What's the Outlook for Federal Government Spending?

There's little doubt that government spending has played a key role in the high inflation we're seeing in Canada. Much like in other developed economies, governments at all levels opened the spending floodgates during the pandemic to prevent the economy from falling into a depression. At the time, they were nearly unanimously applauded by economists and political rivals given the uncertainty around the depth and duration of the downturn. As former Governor Poloz said in a later interview, "[…] no one ever blames a firefighter for using too much water if, at the end of the day, you save the house."

With the benefit of hindsight, we now know that government transfers more than filled the aggregate income gap left by public health-mandated lockdowns (graph 1). The effects of these transfers were uneven, with some Canadians still barely able to scrape by and others receiving a windfall. But on the whole, the amounts transferred by governments to households drove demand for goods when supply was constrained, helping to push inflation higher. Housing and other asset prices also surged, and this continues to show up in current inflation despite more recent price declines.

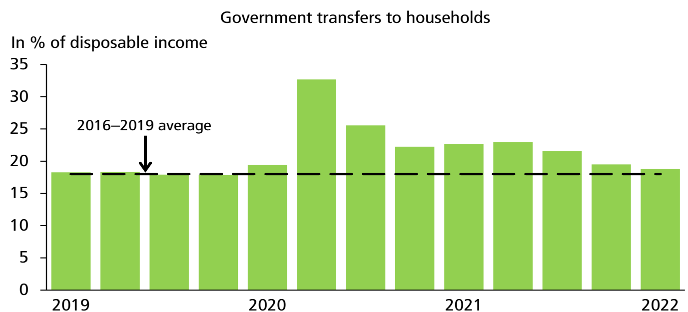
GRAPH 1
Government transfers supported household incomes in the pandemic



Sources: Statistics Canada and Desjardins, Economic Studies

Now that pandemic restrictions have been lifted, the world is opening back up. Households are consuming the services they've been deprived of for the past couple of years. To do that, Canadians are spending the solid income gains they're currently making in the tightest labour market in decades. They can also dip into the massive savings they racked up during the pandemic. However, unlike during the pandemic, government transfers are now playing a minor role in household income (graph 2). Government transfers now make up roughly the same share of disposable household income they did back in Q4 2019 and are trending lower.

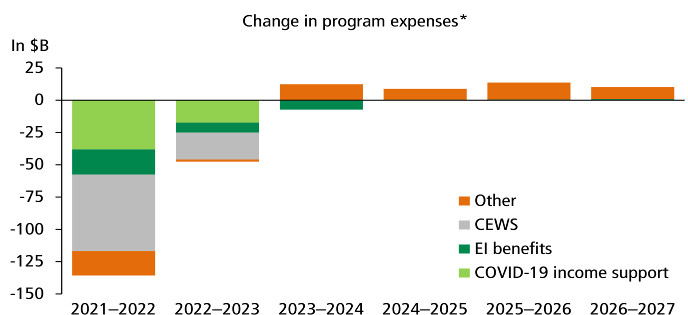
GRAPH 2
Government transfers are shrinking as a share of household income



Sources: Statistics Canada and Desjardins, Economic Studies

This decline in total government transfers to households doesn't just show up in the Statistics Canada numbers. The federal government's monthly data on program expenses indicate that COVID-related transfers to households and businesses are rapidly declining as demand for them falls and measures expire. Indeed, COVID-19 income support for workers is expected to be virtually zero in the current fiscal year (graph 3). At the same time, the Canada Emergency Wage Subsidy (CEWS) wrapped up last fiscal year. And with unemployment at record lows, Employment Insurance payouts are also falling rapidly from historically high

GRAPH 3
Three programs explain most of the decline in federal spending

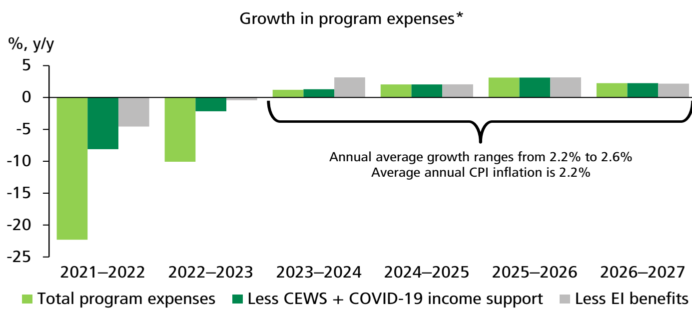


* Excludes net actuarial losses.
Sources: Finance Canada and Desjardins, Economic Studies

levels. Even those areas of spending that are more indirectly linked to the state of the economy given the progressive nature of their payouts, such as the Canada Child Benefit (CCB), are on a downward trend.

It's therefore clear that extraordinary pandemic spending has run its course and future growth in program spending will be modest as a result. After rapidly declining again this year, spending is expected to increase around 2.2% on average annually over the next few years (graph 4). So, in real inflation-adjusted terms, federal spending is projected to be flat, while real per-capita spending is forecast to decline.

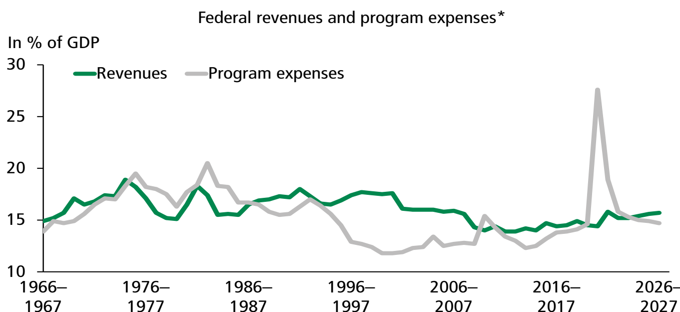
GRAPH 4
Program expense growth is set to slow to roughly the rate of inflation



* Excludes net actuarial losses.
Sources: Finance Canada and Desjardins, Economic Studies

This begs the question: Where would austerity advocates cut federal spending? Spending as a share of GDP isn't expected to return to pre-COVID levels until the end of the 2026–2027 fiscal year (graph 5). But with COVID-related spending rapidly fading in the rear-view mirror, that leaves the usual spending categories—major transfers to persons, major transfers to other levels of government and direct program expenses (DPE)—on the chopping block.

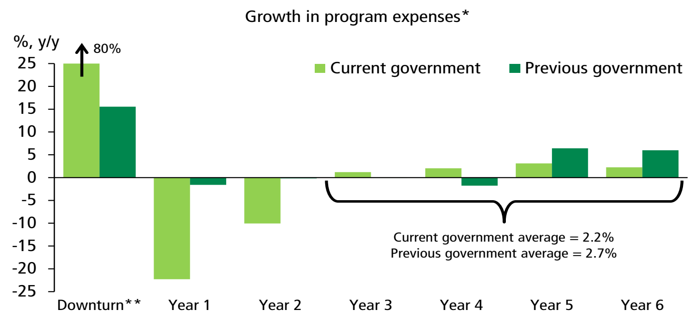
GRAPH 5
Revenues and expenses are set to remain higher than pre-COVID



* Excludes net actuarial losses.
Sources: Finance Canada and Desjardins, Economic Studies

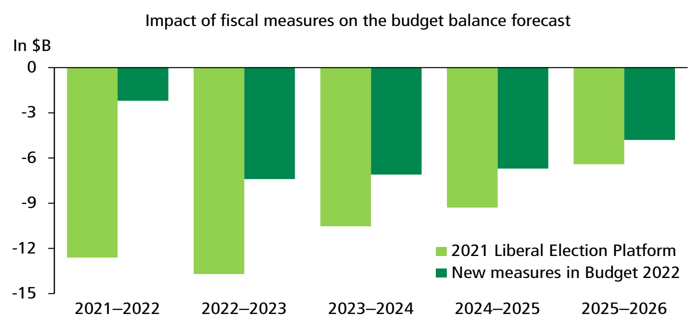
Major transfers to persons include EI benefits and the CCB, both of which are expected to shrink over the next couple of years in dollar terms and even faster as a share of GDP. The same is true for non-COVID-related DPE, such as operating expenses and other transfers. Of course, operating expenses—largely comprised of labour costs—could decline faster, as was the case during the Harper years. But [2018 research](#) from the Institute of Fiscal Studies and Democracy found that operating expenses were restrained only slightly following the Global Financial Crisis (GFC) and only for a short time. And in Budget 2022, the federal government presented plans to grow spending less than the previous government did when we emerged from the GFC (graph 6). Of course, this doesn't include the many measures like a national pharmacare program that have been put in the window but have yet to be included in the fiscal forecast (graph 7). As such, the question remains: Can the federal government even achieve this parsimonious projection let alone something more austere?

GRAPH 6
Keeping spending growth below nominal GDP growth is a challenge



* Excludes net actuarial losses; ** Refers to the 2009–2010 and 2020–2021 fiscal years.
Sources: Finance Canada and Desjardins, Economic Studies

GRAPH 7
New spending is more modest than was proposed in the 2021 election



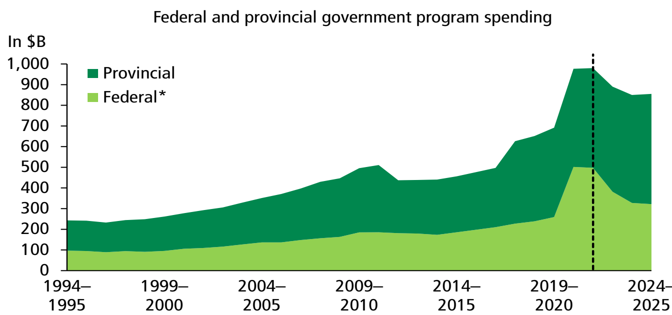
Sources: Liberal Party of Canada, Finance Canada and Desjardins, Economic Studies

This leaves options like rolling back the recent enrichment of elderly benefits, which is disproportionately targeted toward low-income seniors, or cutting transfers to other levels of government. The trouble with the latter is that transfers to provinces often reflect negotiated agreements, some of which are enshrined in legislation. This is the case of the Canada Health Transfer, Canada Social Transfer, and Equalization—the three largest transfers to other levels of government.

What's the Fiscal Mix in Canada?

While the federal government often draws the ire of fiscal hawks given its central role in Canada's fiscal framework, the provinces tend to be the bigger spenders in aggregate. This makes sense, as the provinces administer health care, education and other major programs. And going forward, provinces are expected to keep spending closer to pandemic levels, whereas federal government spending is projected to decline (graph 8).

GRAPH 8
Federal spending is likely to fall quickly as pandemic measures expire



* Federal program spending excludes transfers to other levels of government.
Sources: Federal and provincial departments of finance and Desjardins, Economic Studies

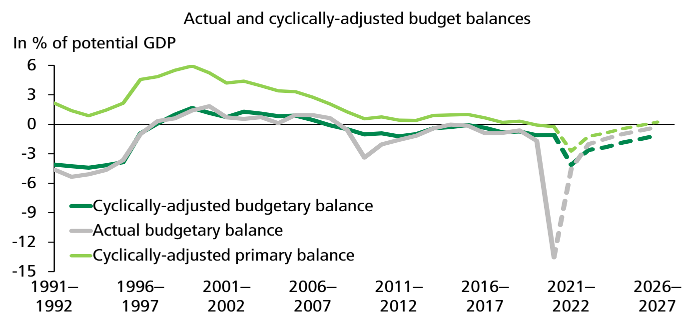
High revenues have allowed lower levels of government to maintain elevated spending while still generally running smaller-than-anticipated deficits. But like the federal government, they're also somewhat constrained in what they can cut in the near term. For instance, the backlog of surgeries postponed during the worst of the pandemic will require higher-than-usual health spending over the next couple of years. Many provinces have also laid out ambitious capital spending plans after deferring work for two years.[1]

Of course, cutting spending isn't the only form of austerity. Governments could also raise revenues by increasing taxes and/or fees. This is something that is squarely in the wheelhouse of the federal government. To some extent, Canada Emergency Response Benefit and Canada Emergency Business Account loan repayments will also act as a brake on spending growth this year. However, provinces have recently shown a proclivity for cutting taxes and fees, particularly as it applies to transportation. As such, this avenue for austerity appears to be closed for subnational governments.

How Imbalanced Is the Government Sector?

Government spending is undoubtedly elevated in Canada and is expected to remain elevated as a share of the economy for the foreseeable future. As has already been discussed, this is less of an issue at the federal level than in the provinces, although the outlook for the federal cyclically-adjusted budget balance suggests there may be room for additional deficit reduction (graph 9). And while the Parliamentary Budget Office has yet to release its 2022 Fiscal Sustainability Report (FSR), economic and fiscal developments since the 2021 FSR suggest improved fiscal sustainability almost across the board for federal and provincial governments.

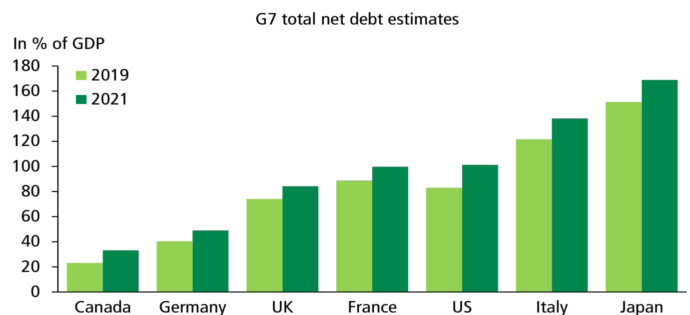
GRAPH 9
The federal government is likely to run sustained structural deficits



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

Another important consideration is the level of government debt relative to our international peers. On a total government basis, net debt (total gross debt minus financial assets) remains very low compared to that of other members of the G7 (graph 10). On a

GRAPH 10
Canada's debt remains well below the G7 average



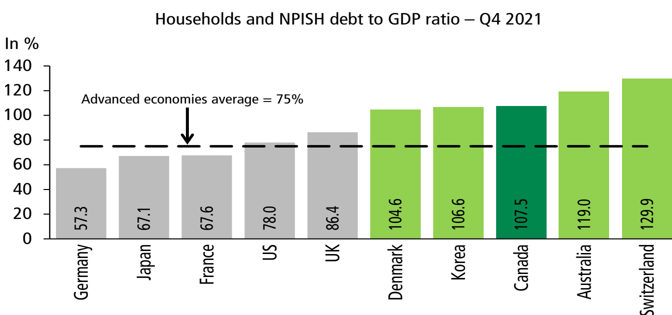
Sources: International Monetary Fund and Desjardins, Economic Studies

[1] For more detail, see: *2022 Canadian Budget Overview*, Desjardins, Economic Studies, *Economic Viewpoint*, May 10, 2022, 4 p.

gross debt basis, Canada's total government debt is only higher than Germany among G7 economies. This is important because credit ratings are a relative concept intimately linked to debt levels and profiles, and Canada's AAA credit rating was recently reaffirmed by multiple rating agencies.

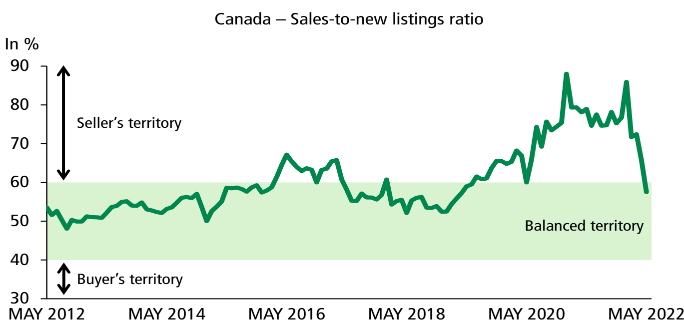
In contrast, certain areas of Canada's household and business sectors currently look to be running a lot hotter than the government sector. Take housing, for example. Canada's housing market is unquestionably one of the most unaffordable on the planet, leading households to become highly leveraged (graph 11). At the national level, the Canadian housing market has only recently begun to return to balance due to a broad-based decline in home sales and prices on the back of higher borrowing costs (graph 12). This is a correction that needs to happen to improve housing affordability and reduce vulnerabilities in the Canadian economy. But we anticipate this correction to be modest relative to the gains posted during the pandemic.[2]

GRAPH 11
Canadian households are among the most indebted in the world



NPISH: Non-profit institutions serving households
Sources: Bank for International Settlements and Desjardins, Economic Studies

GRAPH 12
The housing market is rapidly returning to balanced territory



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Does the Government of Canada Have a Responsibility to Fight Inflation?

Another issue is what responsibility the federal government has in bringing inflation to heel. Starting in the mid-1990s, the federal government shifted this responsibility to the Bank of Canada with great success. But that changed with the December 2021 *Monetary Policy Framework Renewal*. According to the Joint Statement of the Government of Canada and the Bank of Canada on the Renewal of the Monetary Policy Framework, "[…] recognizing the limits of monetary policy, the Government and the Bank also acknowledge their joint responsibility for achieving the inflation target and promoting maximum sustainable employment." For many people, this has put the federal government on par with the Bank of Canada in fighting inflation, hence the calls for austerity.

For further guidance on what this means, the Joint Statement says that "[…] the Government of Canada and the Bank of Canada believe that the best contribution of monetary policy to the well-being of Canadians is to continue to focus on price stability." Further, we can look to the speech Governor Tiff Macklem gave following the mandate renewal. In it he said, "[…] the Government and the Bank agree that well-anchored inflation expectations are critical to achieving both price stability and maximum sustainable employment. So the primary objective of monetary policy is to maintain low and stable inflation over time."

So, we have clarity on the central role of monetary policy in Canada—maintaining low and stable inflation over time. However, we don't have clarity on the relative responsibility of the Government of Canada versus the Bank of Canada in achieving this objective. This is a significant omission from the Monetary Policy Framework Renewal. That said, Finance Minister Chrystia Freeland provided some clarification on this in a recent speech: "For more than three decades, it has been the Bank's responsibility to tackle inflation here in Canada. I reaffirmed this central mandate in December. The Bank has begun the work of bringing inflation back within target, and it has the tools and the expertise it needs to keep inflation from becoming entrenched." While helpful, this should have been unnecessary. It's also woefully insufficient, as the preeminent role of the Bank of Canada in fighting inflation should be enshrined in the Mandate Renewal.

Conclusion

Federal government spending is coming down quickly. Pandemic-related programs are ending, and traditional programs to shore up household incomes are going unused in Canada's red-hot labour market. It leaves you wondering where the fiscal hawks calling for greater austerity would like the federal government to cut. If the rationale for austerity is to reduce domestic demand to keep interest rates lower than they would be otherwise, how would this help restore balance to the Canadian housing market?

[2] For more detail, see: *Canada's Housing Market Correction Has Begun. Is It a Good or a Bad Thing?*, Desjardins, Economic Studies, *Economic Viewpoint*, June 14, 2022, 5 p.; *Canadian Residential Real Estate Outlook*, Desjardins, Economic Studies, *Economic Viewpoint*, June 8, 2022, 6 p.

Rising borrowing costs are removing some of the excess froth in housing and reducing financial system vulnerabilities. Other highly valued risky assets are also feeling the squeeze of higher rates and returning to more typical valuations.

As such, we're of the view that the federal government should stay the course. It should follow its current plans to gradually lower spending and let the Bank of Canada do its job on the front lines of the fight against inflation. Additional new spending would be a mistake, but measures to mitigate the eroding purchasing power of vulnerable households during this period of high inflation and rising interest rates are welcome.