

ECONOMIC VIEWPOINT

Public Finances Face Numerous Post-Pandemic Challenges

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Some provinces have already tabled their 2022 budgets; the federal government, Quebec and Ontario should do so within the next few weeks. Expectations are running high for these transitional budgets, which will act as a bridge between the turbulence arising from the pandemic and the coming years. The epidemiological situation is improving, so the time has come to look ahead and focus on the many challenges facing public finances.

The Pandemic's Onerous Legacy

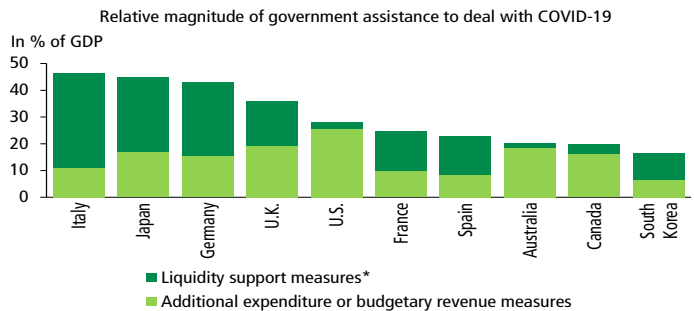
After two turbulent years, the pandemic situation finally seems to be on the right track. The vaccination rate is high, and individuals and businesses are doing better and better at dealing with the constraints that come with infections. However, the pandemic will have left scars in its wake and will take a heavy toll on public finances in industrialized countries, including Canada.

Firstly, budgetary revenues have declined as a result of the economic difficulties noted at the start of the pandemic. Secondly, fighting the pandemic triggered a sharp increase in public health spending to cover care for people who caught the infection as well as preventive measures such as equipment and vaccine purchases. Thirdly, governments introduced substantial measures to support individuals and businesses, pushing up spending considerably. Canada's federal government was very proactive in rapidly rolling out support measures. Most industrialized countries did the same. Taking into account liquidity support measures,¹ which were less used here, Canada ranks 9th amongst industrialized nations for government pandemic support (graph 1).

Together, the drop in revenue and surge in expenditures eroded the budget balances of all G7 public administrations (graph 2). Canada went from a slight surplus in 2019 to one of the biggest deficits in 2020.

GRAPH 1

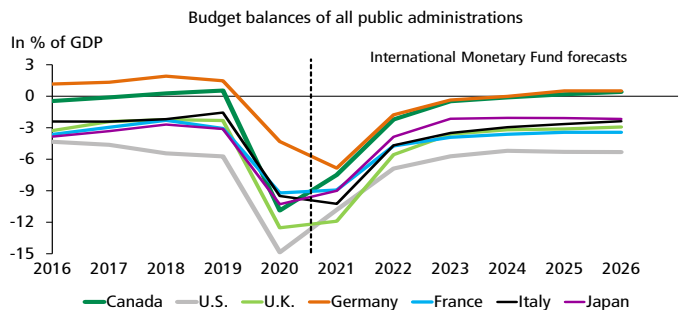
Canada provided fairly extensive support during the pandemic, particularly with spending and income measures



Sources: International Monetary Fund and Desjardins, Economic Studies

GRAPH 2

The budget balances of G7 countries declined during the pandemic



Sources: International Monetary Fund and Desjardins, Economic Studies

¹ Mainly liquidity injections, loans and asset purchases.

These deficits triggered a net increase in public administration debt (graph 3). This higher debt will be an additional burden in the coming years or even decades, as debt service will rise sharply. The anticipated interest rate hike will certainly aggravate the situation. It is likely to reduce government financial leeway for the next few years. To deal with that, some very tough choices will have to be made: either cut back on public spending or increase budgetary revenue more significantly through tax hikes. Economic growth could suffer either way. Governments could also opt for the status quo and grapple with the greater risk posed by higher debt. No matter what, the pandemic will clearly leave a lasting scar on public finances in industrialized countries.

The Challenges of the Coming Years

Attention is increasingly focused on what will happen after the pandemic, and it is becoming clear that Canada’s federal and provincial governments face many challenges. Expectations for the 2022 budgets are high.

Reduction in Budget Deficits

As the situation slowly normalizes, one priority of governments should be to fine tune their recovery plans for public finances. This is a matter of not losing the ground gained through the budgetary efforts made over the last few years and decades. Federally, the fall update was already showing a substantial decrease in the deficit by 2026–2027. In Quebec, last fall’s projections still featured a \$4B deficit in 2026–2027: a sharp contrast with the balanced budgets seen prior to the pandemic. Ontario’s fall update slightly reduced the projected future deficits, but 2023–2024 still included a \$12.9B deficit, showing how far there is to go in cleaning up public finances.

Combating Climate Change

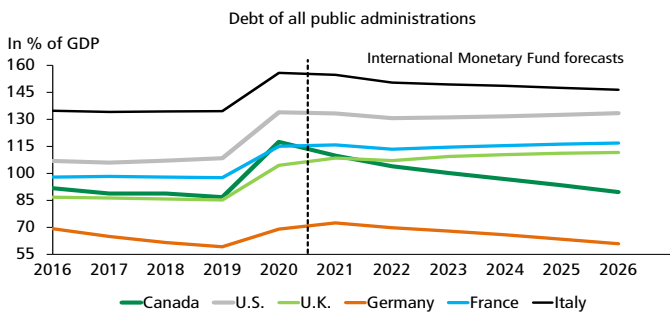
The federal and most provincial governments have taken various measures to support the fight against climate change. This issue remains critical, as the energy transition will require substantial investments in the coming years. Governments will have to develop new public infrastructures, including electrifying transportation and developing renewable energies; additional measures will also be needed to promote business investment in this area and support households through the transition.

Closing the Gaps in the Health Care System

The pandemic highlighted certain shortcomings in the country’s health care system, and Quebec’s in particular. The limited number of hospital beds as well as shortages of medical staff are major issues that resurfaced during the crisis. This lack of capacity suggests that difficulties could persist over the coming years. We are not specialists in this matter, so it is hard to point to specific solutions. However, it seems clear that we will have to change how we approach health care. Overall, the problem does not seem to be coming from substantial underfunding; adding financial resources will not necessarily guarantee a better result. According to the Organisation for Economic Co-operation and Development (OECD), health spending² as a ratio of GDP in Canada is 10.8%, putting it in 7th place among industrialized nations and well ahead of the average of 8.8% (graph 4 on page 3).

² Health spending measures final consumption of health care goods and services (i.e., current health expenditures), including individual health care (curative care, rehabilitation treatment, long-term care, auxiliary services and medical goods) and collective services (prevention and public health services as well as health administration), but excludes capital spending.

GRAPH 3
The size of the public debt could decrease further in Canada in the years to come

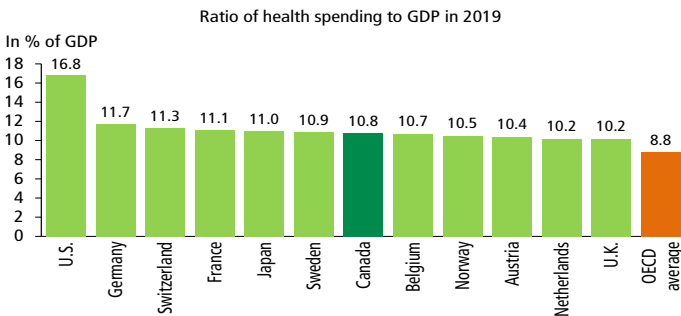


* With a disproportionate ratio of 254.1% in 2021, Japan was excluded from the graph. Sources: International Monetary Fund and Desjardins, Economic Studies

International Monetary Fund (IMF) projections, however, are fairly encouraging for Canada, as the balance for all public administrations could once again close in on equilibrium as of 2023. Canada could thus be one of the few G7 nations to see the relative size of its public debt gradually decline. This could give Canada a competitive edge internationally on its public finances, potentially leading to lower interest rates compared to other countries, among other things.

However, these estimates for Canada seem quite uncertain given the substantial residual deficits that the federal government and a number of provinces still project for the coming years. The 2022 budgets soon to be released by the federal government and the provinces will allow us to take stock of the situation. Economic growth has been robust in the last few quarters, and tax revenues are expected to accelerate given the strong price growth, so there is room to hope that the upcoming government budget projections will include an improvement to the estimated budget balances for the years to come. For example, Alberta recently released its 2022 budget, which shows a net improvement in the budget balance that takes it back into the black in 2022–2023, ending a run of seven consecutive deficit years. Clearly, rising energy prices are giving the province’s public finances a lot of support.

GRAPH 4
Canada's health spending is relatively high



OECD: Organisation for Economic Co-operation and Development
 Sources: OECD and Desjardins, Economic Studies

Combating High Inflation

Another pandemic legacy: major supply and demand imbalances have emerged for some goods and services, pushing up growth in consumer prices. Canada's total annual inflation rate rose to 5.1% in January as a result. At first glance, this is good news for governments, as price growth boosts their revenue from the various sales taxes. The results for consumers are not so good, however. Wages are more rigid, so most households are seeing their purchasing power decline.

Under these circumstances, governments could be tempted to introduce compensatory measures to help consumers deal with higher prices. Caution is in order, however. Support measures such as lowering sales taxes or income tax or increasing transfers to individuals could swell consumers' disposable income, further stimulating demand and ultimately intensifying upside pressures on prices, which works against the desired goal. Strongly targeted measures focusing on households that are the most vulnerable to price increases should be favoured in order to minimize distortion. That said, governments have other levers to use to get inflation back to more normal levels, which brings us to the next challenge.

Supply Problems

The pandemic also shone a spotlight on the vulnerabilities in the supply and transportation chains, while putting again the labour shortage front and centre. These difficulties have had a lot to do with the acceleration of inflation in recent months. Helping resolve these problems indirectly helps reduce inflationary pressures. Governments have carte blanche on this front and could introduce some measures to mitigate the situation. Among others, action plans to promote business investment, increase productivity, modernize transportation infrastructures, improve workforce training and facilitate the integration of newcomers are keenly anticipated.

Canada and Global Trade

Canada's economy is very open to international trade, and it will have to make a place for itself in the new global scene. Rising protectionism, Canada's position in global value chains and greater instability due to the war in Ukraine, for example, are substantial challenges that Canada will have to overcome in the years ahead. The federal government, together with the provinces, will have its work cut out for it to secure Canada's competitive position in global trade.

Transition Budgets

After two turbulent years, expectations are running high for the upcoming federal and provincial budgets, particularly Quebec's and Ontario's. These will be transitional budgets that will act as a bridge between the pandemic and the coming years. Major challenges lie ahead, but doing nothing is not an option, as that could have serious consequences over the long run.