TD Economics

2021 Federal Budget

Big Spends for Big Times

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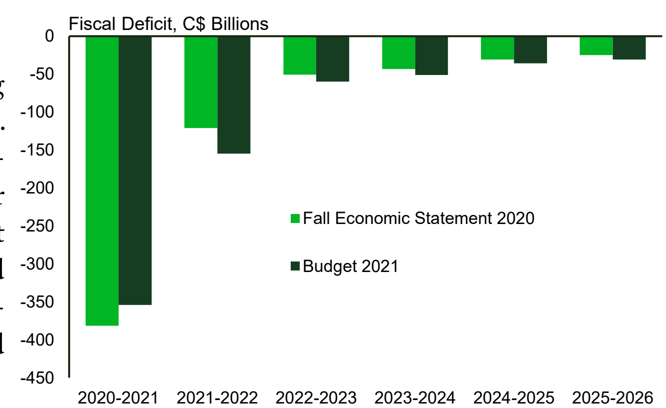
Highlights

- The federal government's fiscal plan put meat on the bones of their previously proposed $100 billion in spending over three years. The additional spending is relatively front loaded, with roughly half booked for the next fiscal year.
- Following a record breaking $354 billion in fiscal 2020-21, the deficit is anticipated to fall to $154.7 billion this fiscal year. Deficits will remain elevated relative to the pre-pandemic era, but gradually drift lower, hitting $30.7 by 2025-26, or a little over 1% of GDP.
- The debt-to-GDP ratio is expected to head higher over the next year, hitting 50.7%, but then move gradually lower to 49.2% by 2025-26. This is lower than the estimate provided in the Fall Economic Statement.
- The main headline spending item was $30 billion over five years for a national childcare program aimed at lowering average fees by 50% by 2022 and bringing the cost of regulated daycare to $10 a day within the next five years in all provinces outside Quebec (which already surpasses the benchmark).
- On the environmental front, the budget made additional commitments to invest in clean energy and infrastructure, with the aim of upping its goal of reducing green house gas emissions by 36% below 2005 levels by 2030 (from 30% previously).
- Economic assumptions are reasonable. However, the front-loaded nature of the stimulus may lead to stronger nominal GDP growth than currently projected, while achieving longer-term growth expectations will require the productivity enhancing measures in this budget to come to fruition.

After one of the largest deficits on record in the past year, the government introduced an ambitious budget, captured in just under 750 pages. Budget 2021 is split between near-term measures in response to the pandemic, as well as a pivot to several big-ticket long-term investments and spending measures.

For fiscal year 2020-2021, the budget revealed a better starting point on the deficit relative to the Fall Economic Statement (FES). However, a portion of this was redeployed. In the FES, the government telegraphed up to $100 billion in additional spending over the next three years but had not allocated those funds. The budget now lays out the path forward. Roughly half of it is front-loaded over the next fiscal year. Of this, there is a heavy lean on the extension of pandemic supports, including worker recovery benefits and wage and rent subsidies.

Chart 1: Better Starting Point but Bigger Deficits Thereafter



Source: Department of Finance Canada, TD Economics.

In terms of medium-term initiatives, the biggest item was additional funding for a national childcare program amounting to $39 billion over the next five years and ending in an annual commitment of $8.3 billion on a permanent basis. There is a little bit for everyone in this budget, with increased funding for women, seniors, students, low-wage workers, indigenous and racialized communities, as well as incentives for businesses to adopt digital technologies. Revenue increases were relatively minor, though a digital tax, luxury tax on yachts and private jets, as well as a tax on vacant homes owned by non-residents will surely grab headlines.

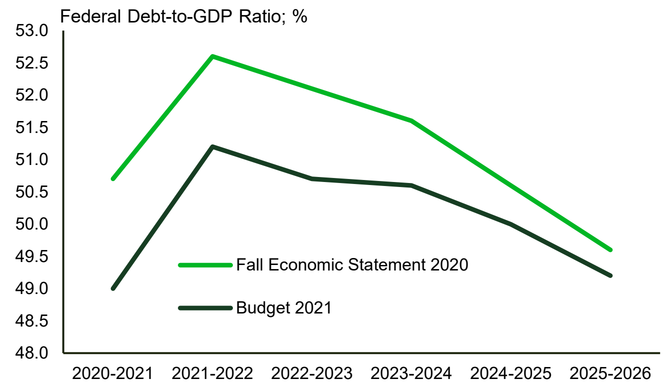
The government remained committed to a gradual decline in the debt-to-GDP ratio over the course of the next five years, but only to 49.6% in 2025-2026, from a 2021-2022 peak of 52.6%. In other words, debt will remain structurally above the 30% ratio that existed prior to the pandemic. Annual deficits are expected to fall to 1% of GDP by the end of the five-year period, lower than its pre-pandemic forecast for fiscal 2020-21, but notably higher than its longer-run expectations at that time. The document gives a nod to economic guardrails, noting their considerable improvement from early in the pandemic, but the government did not lay out any specific thresholds or targets in guiding their decisions.

The economic assumptions are reasonable, though the front-loaded nature of the fiscal stimulus may lead to upgrades in nominal GDP over the near-term. Achieving longer-term growth expectations will require the productivity enhancing measures in this budget to come to fruition (Table 1).

Near-term Measures Account for Half of the $100 Billion Boost

The economy has performed better than expected over the past several months, reducing the deficit this fiscal year by an estimated $35.2 billion relative to the baseline projected in the FES. Illustrating the sea change in the magnitude of deficit projections, this improvement is almost as big as the entire deficit recorded in fiscal 2019-20. From this better starting point, the government has allocated an additional $7.7 billion, bringing the total deficit to $354.2 billion (Chart 1), versus a projected $382 billion deficit in the fall. As a result, the debt-to-GDP ratio is expected to come in about one percentage point lower at 49.0% of GDP (Chart 2).

Chart 2: Better Starting Point For Debt-to-GDP Ratio



Source: Department of Finance Canada, TD Economics.

Making good on its promise to spend an additional $100 billion over the next three years, the government now describes the form this will take. Spending is front loaded, with $49 billion in the next fiscal year, $28.3 billion in 2022-23, and $23.8 billion in the following year. Deficits will also be slightly larger than previously projected through fiscal 2025-26 relative to the FES.

Roughly half of the upfront spending is in supports to see Canadians through the recovery, split roughly evenly between direct supports for workers and those for businesses. The government had already announced in February an extension of the Canadian Recovery Benefit (CRB) to 38 weeks and the extension of EI benefits up to a maximum 50 weeks. In this budget, they further extend CRB by another 12 weeks, with a key nuance. The final 4 weeks would be at a reduced benefit of $300 a week (from $500 per week) for all claims made after July through September. The government reserved the right to extend the program again if economic conditions warrant. Combined with the February announcement, this amounted to roughly $14.6 billion in expenditures.

On the business side, the Canadian Emergency Wage Subsidy and Canadian Emergency Rent Subsidy were both extended through September, but also at a lower rate starting in July. The government announced a new program, the "Canada Recovery Hiring Program," which would provide

Table 1: Economic Assumptions Annual,Percent Change (Unless Otherwise Indicated)						
Calendar Year	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
Real GDP						
Fall Economic Statement	-5.5	4.8	3.2	2.3	2.1	1.9
Budget 2021	**-5.4**	**5.8**	**4.0**	**2.1**	**1.9**	**1.8**
TD Economics Forecast	-5.4	6.0	3.9	1.7	1.6	1.7
Nominal GDP						
Fall Economic Statement	5.4	7.0	5.3	4.4	4.3	4.0
Budget 2021	**-4.6**	**9.3**	**6.0**	**4.0**	**4.0**	**3.8**
TD Economics Forecast	-4.6	10.6	6.1	3.7	3.5	3.6
Unemployment Rate (%)						
Fall Economic Statement	9.8	8.2	7.1	6.4	6.1	6.1
Budget 2021	**9.6**	**8.0**	**6.5**	**6.2**	**6.0**	**5.9**
TD Economics Forecast	9.6	7.2	6.1	5.9	5.8	5.7
3-Month T-Bill Rate						
Fall Economic Statement	0.4	0.2	0.3	0.5	1.1	1.5
Budget 2021	**0.4**	**0.1**	**0.2**	**0.5**	**1.1**	**1.6**
TD Economics Forecast	0.4	0.1	0.2	0.3	0.7	1.3
10-Year Gov't Bond Yield						
Fall Economic Statement	0.7	0.9	1.2	1.6	2.0	2.4
Budget 2021	**0.7**	**1.5**	**1.8**	**2.1**	**2.5**	**2.7**
TD Economics Forecast	0.8	1.5	1.8	2.0	2.1	2.1

Source: Department of Finance Canada, Statistics Canada, Bank of Canada, TD Economics.

a subsidy of up to 50% of the cost of new workers between June and November of this year. The program is expected to cost $595 million.

Remaining spending measures are split between a range of programs discussed in further detail below. All told, the increase in the new budget items over the next fiscal year amount to close to 2% of GDP. This suggests some upside risk to our economic forecast for 2021 and 2022, as well as the consensus forecasts within the budget.

A Down Payment on National Childcare Tops the List of Major Investments

As expected, the main headline grabbing item was a down payment on a national childcare program aimed at lowering average fees by 50% by 2022 and bringing the cost of regulated care to $10 a day on average within the next five years in all provinces outside Quebec (which already hits this benchmark). To do so, the government will spend $30 billion over the next five years and $8.3 billion ongoing. When combined with previous commitments, the annual ongoing spending (i.e. run rate) would be a minimum of $9.3 billion annually. This represents a significant commitment to supporting parents, but with a particularly positive outcome of attracting women into the workplace.

Although specific details remain to be seen and negotiations with the provinces could prove challenging, the federal government would commit to funding 50% of the cost with the provinces as part of initial five-year agreements. If successfully implemented, the program could go along way to raising the participation of women in the labour force. Quebec offers a useful example. Since the program was introduced, the labour force participation of women went from below the rest of the country to well above. The gap between core working-age male and female participation in Quebec is roughly half of that within the rest of the country. If labour market outcomes can be replicated, it would mean an additional 250 thousand women in the workforce, lifting the economy's potential. The benefits would also accrue through the potential for children to gain access to quality early learning.

Spending on childcare wasn't the only major social initiative in this budget. The budget committed to significant additional funding for students, including a doubling of the Canada Student Grant for the next school year, at a cost of over $3 billion over the next two fiscal years.

Enhancements to the Canada Workers Benefit were also laid out to provide a higher threshold before benefits are reduced. This amounted to a sizeable $8.9 billion over six years, with expenditures persisting at $1.7 billion annually thereafter. The government estimates this will lift 100,000 people out of poverty. In addition, the budget will increase the federal minimum wage to $15 an hour, impacting an estimated 26,000 workers who currently make less than this in the federally regulated private sector.

Significant income supports were provided for seniors, budgeting an additional $12 billion over five years and $3 billion per year ongoing thereafter to provide a one-time payment of $500 to Old Age Security (OAS) beneficiaries

Table 2: Federal Budget 2021 Forecast Summary (C$ Billion, Unless Otherwise Specificed)						
Fiscal Year	**20-21**	**21-22**	**22-23**	**23-24**	**24-25**	**25-26**
Budgetary Revenues	**296.2**	**355.1**	**377.9**	**396.4**	**417.9**	**437.7**
Program Expenses	614.5	475.6	403.0	409.2	414.4	426.7
Public Debt Charges	20.4	22.1	25.7	30.5	35.4	39.3
Net actuarial losses	15.4	12.2	8.9	7.7	3.9	2.4
Total Expenses	**650.3**	**509.9**	**437.6**	**447.4**	**453.7**	**468.4**
Budget Balance	**-354.2**	**-154.7**	**-59.7**	**-51.0**	**-35.8**	**-30.7**
Federal Debt	1,079.0	1,233.8	1,293.5	1,344.5	1,380.3	1,411.0
Per cent of GDP						
Budgetary Revenues	13.4	14.7	14.8	14.9	15.1	15.3
Program Expenses	27.9	19.7	15.8	15.4	15.0	14.9
Public Debt Charges	0.9	0.9	1.0	1.1	1.3	1.4
Budget Balance	-16.1	-6.4	-2.3	-1.9	-1.3	-1.1
Federal Debt	49.0	51.2	50.7	50.6	50.0	49.2

Note: Totals may not add due to rounding.
Source: Department of Finance Canada, TD Economics.

and raise OAS payments by 10% on an ongoing basis as of July 2022.

Perhaps the one item in which there was little additional funds allocated was for a national pharmacare program, with just the previously announced $500 million to cover high-cost drugs for rare diseases.

Topping Up the Government's Climate Commitments

On the environmental front, the government had already previously announced significant commitments to reduce emissions and combat climate change, including its December 2020 commitment of $15 billion in new investments to reduce Canada's Green House Gas (GHG) emissions by 30% from 2005 levels by 2030. Additional measures in this budget aim to up the goal to 36% below 2005 levels.

Toward that end, the budget includes $17.6 billion in investments in the green economy. In addition to funds for energy audits and interest free loans for home retrofits, this includes $8 billion over seven years for its "Net Zero Accelerator", supporting the commercialization of decarbonization and clean energy projects, $1 billion in co-investments in clean technology development, and a proposal for a special 50% reduction of the general corporate income and small business tax rate specifically for clean technology manufacturers.

Notably, the Budget also commits $319 million to support the development of Carbon Capture, Utilization and Storage (CCUS) technology, while proposing to introduce a tax credit for related capital investments, similar to the 45Q tax credit that was recently expanded in the U.S.

Up to this point, climate policy in Canada has focused more on market-based mechanisms to incent decarbonization. This budget, in concert with the updated climate strategy from December, represent a small but increasing shift towards direct supports for actions aimed at reducing greenhouse gas emissions. The retrofit program provides a useful example. Residential and commercial buildings represent more than 12% of Canada's greenhouse gas emissions through HVAC systems and other appliances that burn natural gas or other hydrocarbons. Replacing the entire inventory those appliances is an expensive endeavor, warranting a dedicated program to support that transition. Similarly, many carbon-intensive industries, face significant carbon abatement costs due to a lack of green infrastructure that could support the shift away from producing and burning fossil fuels. These new programs thus represent important new tools for the government to kickstart the clean energy transition.

Headline-grabbing Tax Changes, But Little Revenue Increases Overall

On the revenue side, there were relatively few items of note. The digital services tax, which was floated before the budget, was formalized. The tax is set at 3% of the revenue of large digital service providers and is expected to raise $3.4 billion over the next five years, which makes it one of the larger items on the revenue side.

Smaller, but perhaps more tangible is a luxury tax of 10% tax on luxury cars, personal aircraft and boats. This is expected to earn just $604 million over five years.

Finally, the budget introduced a 1% tax on the value of vacant residential properties owned by non-residents. Non-residents will have to file a declaration of their use of the property. This is estimated to raise $700 million over four years.

Extending the Maturity of Government Borrowing

Canada came into this crisis on a sound fiscal footing, with one of the lowest net debt-to-GDP ratios among advanced economies. It will continue to have lower ratios than most of its peers, which have also increased their debt burdens to fight the pandemic.

The government's issuance will fall from the unprecedented level in fiscal 2020-21, still it will issue a planned $532 billion, including $332 billion in refinancing requirements and $155 billion to cover the deficit. The government's debt management strategy is to increase the maturity of its borrowing, raising the share of issuance at the long end of the curve (over the 10-year maturity spectrum) to 42% next year from 29% this year. This is prudent and reduces rollover risk by locking in low interest rates before they inevitably head higher.

The budget's interest rate projections are reasonable, and in line with our own (Table 1), though this is admittedly a source of considerable uncertainty. Still, higher interest rates will not break the bank. The budget documents the sensitivity of the deficit to higher interest rates, noting a permanent 100-basis point increase over the baseline would raise the deficit by $4.6 billion after five years, or roughly 0.2% of GDP.

Bottom Line

The 2021 Budget is an historic document. After one of the largest deficits in its history, the government will maintain significant spending initiatives in both the near-term to address the pandemic, as well as maintain structurally higher spending via a number of new and adjusted initiatives. By extension, absent any major revenue-raises, this lends itself to a sticky debt-to-GDP ratio.

The pivot to more long-term investments is welcomed, given the need for higher economic growth to deal with the increase in debt load. Funding for childcare is a worthwhile social investment and will likely pay for itself over the medium term via increased female labor force participation.

However, there is a note of caution on the structurally elevated debt-to-GDP ratio, which leaves Canada susceptible to investor scrutiny in the event of deviation to debt level commitments or another domestic revenue shock. We deem the economic assumptions behind the budget as reasonable, but the outlook still carries more than usual uncertainty, as does the future course of interest rates. A commitment to put any positive revenue surprises during periods of economic expansion toward debt reduction could give investors greater confidence in the government's commitment to sustainability and push against any notions that the debt-to-GDP ratio will be prone to serial upward revisions or stickiness.