2022 Federal Budget

Inflation Gets the Assist on Deficit Reduction

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Highlights

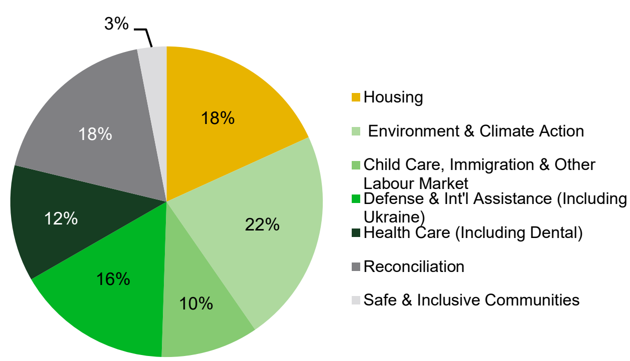
- The federal deficit is expected to fall to $53 billion (2% of GDP) in the upcoming fiscal year, before shrinking steadily to $8 billion (0.3%) by fiscal 2026-27. Accordingly, the debt-to-GDP ratio is slated to head lower to just over 40% by the end of the 5-year projection.
- The government's forecast is based on cautious near-term economic assumptions, which point to the potential for a near-term revenue overshoot.
- Close to $60 billion in gross new spending measures have been unveiled through 2026-27, with housing, climate change, health care, reconciliation and defense receiving the most attention.
- Some of these costs will be defrayed by around $20 billion in new revenue measures. Moreover, the government intends to secure around $9 billion in departmental savings by the end of the 5-year period, though details at this stage remain scarce.

In bold fashion, the government unveiled close to $60 billion in new spending measures through fiscal 2026-27 – or an average of around $10 billion per year – in Budget 2022 to incorporate much of its outstanding election platform spending commitments as well as some newer priorities. As was widely expected, key focal points include support for housing affordability, the climate change transition, healthcare, reconciliation with Indigenous peoples and defense, with a smattering of funding allocated in other areas.

Despite this active spending backdrop, the near-term deficit profile and debt burden hew quite closely with those presented in December's Fall Economic Statement (FES). In turn, the debt-to-GDP ratio is expected to still grind lower over the 5-year horizon, though remain well above its pre-pandemic level of under 30%.

Budget planners have been afforded some additional wiggle room due to an upgraded growth and inflation forecast – positive fiscal influences that are expected to carry over into the medium term. Moreover, the government plans to augment coffers through the introduction of some targeted new revenue sources – notably a tax on large financial institutions (FIs) as well as increased efforts to close tax loopholes – that is expected to generate around $17 billion over 5 years.

Chart 1: Net New Fiscal Outlays by Theme



Note: Based on total net new spending from fiscal 2021-22 to 2026-27.
Source: Department of Finance Canada, TD Economics.

If anything, both the dollar amount of revenue and tax measures came in on the light side of expectations. The tax on FIs came in below what had been telegraphed ahead of the budget. And despite some speculation in recent days of a potential hike in capital gains tax rates or other broad-based wealth levies, the government elected to stay its hand. Moreover, some of the spending in the outer years has been blunted by the expectation of cost savings secured through a forthcoming Strategic Spending Review.

A key risk to the fiscal plan is its reliance on a continued robust expansion continuing well into the middle part of the decade. It will take the adept touch of the Bank of Canada (and other central banks) to pull off a soft landing in the economy through rate hikes in the coming months. Yet, the significant new spending announced in Budget 2022 will complicate the central bank's task by pushing the economy deeper into excess demand compared to the status-quo. Some of this risk has been mitigated through gradual phase-in of some of the new spending programs. Still, it would have been our preference to see more of the current revenue windfall from growth deployed towards faster near-term deficit reduction, both to ease inflation risks and help protect Canada's fiscal position against the growing threat of a downturn over the medium-term.

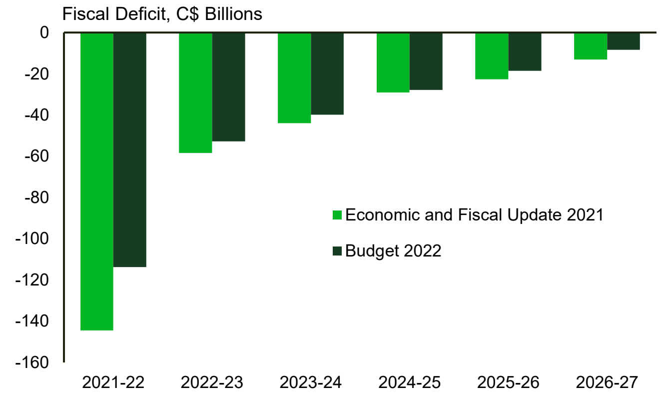
Lastly, this budget is almost assured to pass in Parliament following the recent partnership deal between the minority Liberal government and the NDP that committed to incorporate some of the latter party's budget priorities, such as a national dental program, in exchange for support.

Improving fiscal picture provides some wiggle room

The budget outlook has improved since the release of December's FES. Recall then that the government had modestly downsized its deficit estimate for fiscal 2021-22 to \$144.5 billion or 5.8% of GDP compared to the prior year's pandemic-driven \$328 billion in red ink (14.8% of GDP). With pandemic programs expected to be wound down, the government anticipated a narrowing in the shortfall to \$58.4 billion (2.2%) in the upcoming year and to gradually fall to \$13.1 billion (0.4%) by fiscal 2026-27.

The major economic development since December has been an unexpectedly sharp acceleration in inflation and Canadian near-term nominal growth prospects (see table). For 2021, gains in nominal GDP – the best proxy for underlying revenues – came in at 13.1% versus the 12.5% assumed in the FES. The government also upgraded its view for 2022 from 6.6% to 7.7%.

Chart 2: Fiscal Deficits Set to Improve



Source: Department of Finance Canada, TD Economics.

Keep in mind that because the government's survey of private-sector forecasts preceded the Russian invasion of Ukraine, they don't fully reflect up-to-date views. Inflation and nominal GDP expectations have further migrated higher in recent weeks post-war as commodity prices have soared. (Each point in GDP inflation drives up revenue by \$4 billion, partly offset by 1.7 ppts in higher spending linked to the rising prices).

Given the importance of Russia-Ukraine developments, Finance Canada has provided two alternative economic scenarios in the budget (I.e., moderate and high impact). The moderate scenario, which assumes a de-escalation in tensions and a moderately more favourable nominal GDP outlook than the government's baseline, is more akin to TD Economics March baseline outlook.

Interest rate expectations have also been adjusted steadily higher, suggesting an offsetting upside risk on debt service charges relative to budget assumptions. Each percentage point rise in interest rates boosts the deficit by just \$1 billion in the first year, rising to \$2.5 billion in year two. But even there, higher rates are not all bad news, since the government's pension liabilities fall as obligations are discounted at a higher rate (i.e., lower actuarial losses).

Table 1: Economic Assumptions Annual Percent Change (Unless Otherwise Indicated)						
Calendar Year	2021	2022	2023	2024	2025	2026
Real GDP						
Economic and Fiscal Update 2021	4.5	4.2	2.8	2.0	1.8	1.8
Budget 2022	**4.6**	**3.9**	**3.1**	**2.0**	**1.9**	**1.8**
TD Economics Forecast	4.6	3.9	3.0	2.0	1.7	1.5
Nominal GDP						
Economic and Fiscal Update 2021	12.8	6.7	4.3	3.9	3.7	3.8
Budget 2022	**13.1**	**7.7**	**4.8**	**3.9**	**3.8**	**3.7**
TD Economics Forecast	13.1	9.7	5.0	4.0	3.7	3.6
Unemployment Rate (%)						
Economic and Fiscal Update 2021	7.6	6.1	5.7	5.7	5.6	5.7
Budget 2022	**7.4**	**5.8**	**5.5**	**5.5**	**5.5**	**5.5**
TD Economics Forecast	7.4	5.4	5.4	5.7	5.9	5.9
3-Month T-Bill Rate						
Economic and Fiscal Update 2021	0.1	0.5	1.2	1.6	1.9	2.0
Budget 2022	**0.1**	**0.8**	**1.7**	**2.0**	**2.1**	**2.1**
TD Economics Forecast	0.1	1.2	2.0	1.8	1.8	1.8
10-Year Gov't Bond Yield						
Economic and Fiscal Update 2021	1.4	1.9	2.3	2.5	2.7	2.9
Budget 2022	**1.4**	**2.0**	**2.4**	**2.6**	**2.8**	**3.0**
TD Economics Forecast	1.4	2.1	2.3	2.1	2.1	2.1

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

Looking through these crosscurrents, the government's underlying deficit (before any new measures in Budget 2022) was on track to pull back to around $108 billion in fiscal 2021-22, before dropping further to a mere $6 billion by fiscal 2026-27.

Deficits to gradually narrow over time

Enter the new budget measures that are poised to absorb this additional room – and then some. Gross new spending laid out in the budget amounts to around $56 billion over the next 5 years. A part of this spending – around $2 billion for immediate provincial health-care support to address surgery backlogs – has been booked into the previous fiscal year ended March 31st, with roughly $10 billion allocated for the upcoming year.

The table shows the overall budget picture that includes all new outlays and those previously announced. Actual program spending is still poised to drop for the second straight year in fiscal 2022-23, as pandemic programs are discontinued. The new measures are poised to cushion the drop somewhat, before program spending resumes an upward track (though in GDP terms, program spending is expected to edge down). Keep in mind that the government is assuming some $9 billion in savings by fiscal 2026-27 through a combination of planned spending cuts and a forthcoming Strategic Policy Review. Since these savings have not yet been found, this presents an upside risk to the spending outlook.

Overall federal spending will rise faster due to a steady increase in the debt-load and the effective government borrowing rate. By the end of the projection period, the government is expecting to shell out roughly $43 billion to service its debt by fiscal 2026-27, compared to $41 billion at the time of the FES.

The new revenue measures will help to support relatively brisk overall revenue growth and in turn fund about 1/3 of the gross new program spend. More than half of that amount is simply addressing tax gaps through increasing CRA oversight and clamping down on tax avoidance. There is a general tendency for forecasters to overstate the tax collection returns through this sort of clampdown. This is thus an offsetting downward risk to a revenue forecast that as is based on cautious near-term growth assumptions.

Highlights of key measures

Here's a run-down of key budget measures, though not an exhaustive list.

Taxes on banks, small business tax cut

- A 1.5% surtax on Canadian banks and insurance companies on profits over $100 million, raising around $2 billion over 5 years.
- A one-time Canada Recovery Dividend of 15% on taxable income above $1 billion on the same institutions. This will be paid in equal installments over 5 years and is expected to yield $4 billion.
- Support to small businesses through pushing out the phase-out schedule around which companies can take advantage of the lower 9% corporate rate (vs a 15%

Table 2: Federal Budget 2022 Forecast Summary (C$ Billion, Unless Otherwise Specificed)						
Fiscal Year	**21-22**	**22-23**	**23-24**	**24-25**	**25-26**	**26-27**
Budgetary Revenues	**394.4**	**408.4**	**429.5**	**450.8**	**475.1**	**496.0**
Program Expenses	473.0	425.4	430.4	439.2	453.1	463.3
Public Debt Charges	24.9	26.9	32.9	37.0	39.8	42.9
Net actuarial losses	10.3	8.9	6.1	2.4	0.8	-1.8
Total Expenses	**508.2**	**461.2**	**469.4**	**478.6**	**493.7**	**504.4**
Budget Balance	**-113.8**	**-52.8**	**-39.9**	**-27.8**	**-18.6**	**-8.4**
Federal Debt	1,160.8	1,213.7	1,253.6	1,281.4	1,300.0	1,308.4
Per cent of GDP						
Budgetary Revenues	15.8	15.2	15.2	15.4	15.6	15.7
Program Expenses	18.9	15.8	15.3	15.0	14.9	14.7
Public Debt Charges	1.0	1.0	1.2	1.3	1.3	1.4
Budget Balance	-4.6	-2.0	-1.4	-0.9	-0.6	-0.3
Federal Debt	46.5	45.1	44.5	43.8	42.8	41.5

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

general rate) on the first $500,000 of active business income. Under the new rules, full phase out will occur at $50 million of taxable capital, up from $15 million.

Dental care program leads health measures

- A $2 billion one-time top up to the provinces to help them address pandemic-related pressures and reduce surgery backlogs.
- $5.3 billion over 5 years to fund a gradual ramp up of a national dental care program beginning in 2022. Children 12 and under will receive coverage this year, to be gradually expanded to those under 18 years, seniors and people with disabilities in 2023 before being fully implemented by 2025 for low- income families.

An $8 billion boost for defense

- $8 billion over 5 years to raise defense outlays from around 1.4% of GDP to 2.0% of GDP as per NATO objectives.

$11 billion to support Indigenous peoples and communities

- To support and healthy communities and moving forward with reconciliation.

Housing measures totaling just over $10 billion over 5 years

- Several new measures to address housing supply, including $4 billion over 5 years to CMHC in a Housing Accelerator Fund to support the construction of 100k net new homes by 2027, tying infrastructure and transit funding to provincial/territorial and municipal actions to increase housing supply, and a second $1.5 billion expansion of the Rapid Housing Initiative.
- First-time homebuyer support through a $40,000 tax-free savings account in which contributions would be tax-deductible and withdrawals tax-free, a doubling of the first-time homebuyer's tax credit from $5,000 to $10,000, and an extension of the first-time homebuyer's incentive.
- An additional $475 million to provide a $500 one-time top up to the Canadian Housing Benefit.
- Up to $7,500 in a multi-generational tax credit that would allow those renovating or building a secondary suite for a dependent with a disability to claim 15% of renovation costs up to $50,000.
- Efforts to clamp down on housing speculation and foreign investment through a two-year ban on foreign buyers from purchasing residential property, a move to recognize capital gains on real estate held for less than 12-months as business income, and making assignment sales subject to GST/HST.
- A commitment to a Homebuyers' Bill of Rights that would include a ban on blind bidding and a legal right to a home inspection.

While the housing measures have been put together with the aim of improving affordability, it is questionable, at this point, whether demand-side measures can really move the needle given a fundamentally supply-constrained environment in major urban centres where household formation has generally outpaced new construction. The new first-time buyer measures may, in fact, lead to a deterioration in affordability in the near-term given knock-on effects to the rest of the housing market and the lag with which supply measures result in more completed construction.

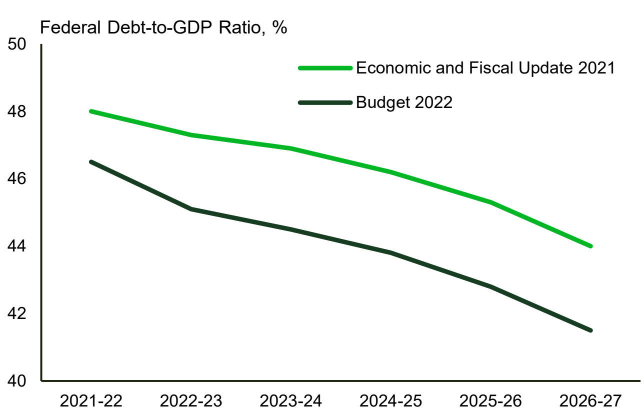
More impactful are likely to be the measures aimed at investors, with the ban on foreign purchases likely to make the biggest wave. However, data from BC where foreign purchases are tracked show that the share of real estate transactions with 'foreign involvement' fell from 6.6% in 2016 to 1.7% in 2019 prior to the pandemic owing mostly to the tax on foreign purchases implemented in 2016. In other words, the ban is also unlikely to move the needle in isolation, given the relatively small share of purchases.

More interesting, however, is how the ban would interact with the upcoming findings of the Cullen Commission on money laundering in Canadian real estate transactions. A resulting public beneficial ownership registry could reveal more foreign involvement in transactions and a wider impact on housing, but this remains to be seen.

Over $12 billion for climate change initiatives

- Many of the new measures aimed at addressing climate change were already announced in the 2030 Emissions Reduction Plan (ERP) released last week. The budget added a number of new measures along with more specificity to previously announced initiatives, raising the ERPs $9.1 billion new spending figure to $12.5 billion.
- Support for the use of carbon capture, utilization and storage (CCUS) through 2040 by providing $2.6 billion over 5 years and $1.5 billion annually afterwards in a CCUS refundable tax credit.
- $120.6 million in support of small modular nuclear reactors in addition to making SMRs eligible for $250 million of previously announced funding and for CIB investments. These measures draw a deeper line in the sand of nuclear's role in Canada's energy transition.
- $15 billion in seed funding (not included in the $12.5 billion spending figure) for a Canada Growth Fund aimed at attracting private capital for green investments at a 3-1 ratio of private-to-public dollars. The aim of the fund extends beyond reducing emissions and growing low-carbon industries and includes restructuring of critical supply chains.

Chart 3: Improved Outlook for Debt Ratios



Source: Department of Finance Canada, TD Economics.

- $3.8 billion in support of a critical minerals strategy (also not included in the $12.5 billion spending figure) over eight years, including $1.5 billion in infrastructure investments and the introduction of a 30% critical mineral exploration tax credit.

The budget and ERP provide the most detailed picture yet of how government intends on reaching its 40% emissions reduction target by 2030 along the way to net zero by 2050. The combination of new policies and spending measures makes it clear that government intends on carving a path that attempts to balance demand-side measures to decarbonize major sources of emissions while addressing oil & gas sector emissions through technological means rather than mandating production declines. The budget adds further colour to this through the variety of investments the government intends on making to establish key supply chains and industries that will be critical to those decarbonization efforts.

Significant efforts are being made to reduce oil & gas demand in the major emissions sectors, including increasing zero-emissions vehicles adoption through new sales mandates, the new Canada Green Buildings Strategy, and the implementation of a Clean Electricity Standard. On oil & gas production where more than one-quarter of Canada's emissions are produced, the most impactful of the recent policy initiatives would have been the hard cap on the sector's emissions announced at COP26. However, no additional details were provided with the policy only receiving a passing mention in the budget. As noted in the ERP, "the intent of the cap is not to bring reductions in production that are not driven by declines in global demand." Instead, the strong focus on CCUS firmly suggests the government intends on supporting the sector, while aiming to reduce emissions through technological means – our recent report on CCUS discusses this precise issue. Yesterday's approval of the Bay du Nord offshore oil development project in Newfoundland & Labrador along with the recent commitment to increase oil & gas exports to Europe to support their delinking from Russian gas further cement this position.

Gross borrowing requirements to drop, but private sector to take up some of the slack

Gross issuance is expected to decline further in fiscal 2022-23 to $212 billion from last year's estimated $255. Despite a sizeable decline in the budget deficit, the total stock of public market debt will reach close to $1.3 trillion by 2022-23. The government will also be dealing with a heavy plate of maturities that will need to be financed in the coming years. Keep in mind that a large share of the bonds that will mature are currently held by the Bank of Canada due to QE, which in turn will need to be refinanced in the public market as the central bank engages in QT in the coming months. Accordingly, while a smaller deficit should translate into less government borrowing, a higher supply will need to be absorbed in public markets. Though Canadian bond yields have been rocketing higher in recent weeks, there was little market action post-budget.

Bottom Line

Like many others, we had some trepidation around the federal government's ambitious spending plans in this budget, especially during a period when the economy is overheating. While net outlays are lighter than we had expected, they are still set to grow at a solid pace, slowing improvement in the debt burden and applying another tailwind to inflation (even if modest) over the medium term. There are also questions raised around how new structural programs – such as dental, pharmacare and provincial demands for additional health transfers – will be funded over the longer term without a significant increase in the tax burden.

Having said that, there are mitigating factors that help to ease some of these concerns. First, Canada's still enjoys a decent fiscal standing relative to other major advanced economies, a fact that was touted again in today's budget. Moreover, the fact that some of the budget measures – notably to unlock private investment to push ahead with clean energy transition – should pay off to some extent in terms of raising longer-term economic growth.

The government's near-term budget plan is based on reasonably conservative assumptions that should allow for a near-term revenue overshoot. Hopefully, the government allows any windfall to flow through to an improved bottom line.