2023 Federal Budget

Spending in a Time of Uncertainty

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Highlights

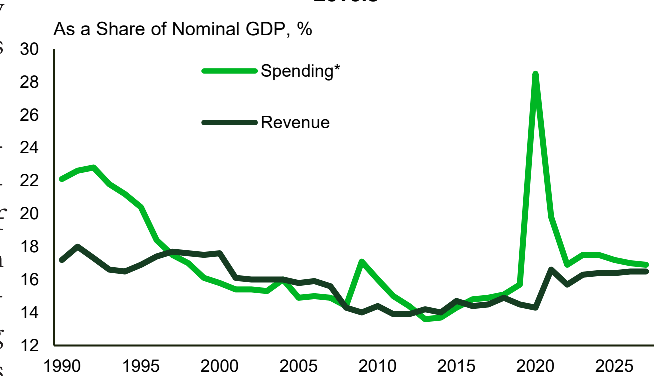
- In a budget intended to help Canada compete on a global stage during the energy transition, the government unveiled $67 billion in net new spending over the 5-year forecast horizon.
- About one-third was accounted for by the previously announced increase in health transfers, with the remainder focused on clean energy investment, dental care, and measures that were cited to address affordability in a high inflation environment.
- There will not be a return to fiscal balance. The deficit is expected to rise to $40 billion (1.4% of GDP) in the upcoming fiscal year, before shrinking but holding in the red at $14 billion (0.4%) by fiscal 2027-28. Accordingly, the debt-to-GDP ratio is slated to rise initially before heading lower to just below 40% by the end of the 5-year projection.
- The government's forecast is based on cautious near-term economic assumptions, but fiscal projections remain vulnerable should the economy hit a deeper recession or stagnate into 2024.

Thanks to a weaker economic outlook over the near term and increased spending commitments, the budget deficit has widened by nearly $10 billion (bn) in fiscal 2023-24. The deficit is estimated to be $40 bn, or 1.4% of GDP, up from 1.1% of GDP in the Fall Economic Statement (FES) back in November 2022 (Chart 1). The government unveiled $67 billion in new spending measures on priorities in a budget titled "A Made-In-Canada Plan: Strong Middle Class, Affordable Economy, Healthy Future". As expected, the key focus included support for the climate change transition, healthcare, and improving affordability.

Given the higher deficit, the Federal debt-to-GDP ratio rises in the 2023-24 fiscal year, before resuming its downward trajectory. At 39.9% in 2027-28, it is notably above the 37.3% estimated only a handful of months ago in the FES (Chart 2). It also remains above the 30% threshold of the prior business cycle.

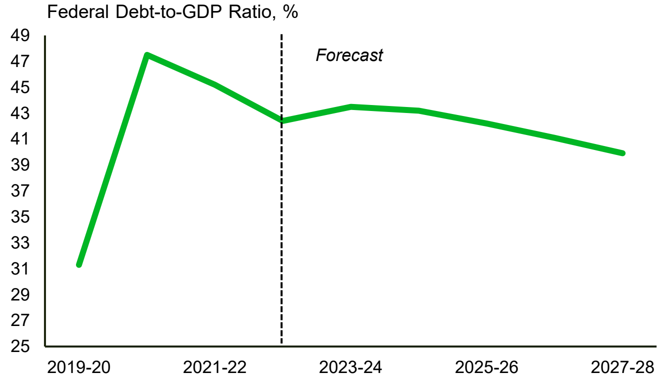
The main risk to this budget is the potential for a significant economic slowdown that could put government finances on an unsustainable path. But, it's hard to argue given that a portion of the new spending was already known and supportive of health transfers to provinces, while roughly one-third of spending initiatives are intended to address Canada's competitiveness during the climate change transition. On the margin, some initiatives could work at odds with the Bank of Canada's (BoC) attempt to bring down inflationary pressures.

Chart 1: Spending Remains Above Pre-Pandemic Levels



*Program spending + interest charges.
Source: Department of Finance Canada, TD Economics.

Chart 2: Near-Term Outlook for Fiscal Anchor Worsens



Source: Department of Finance Canada, TD Economics.

This budget is poised to pass in Parliament due to the existing partnership agreement between the Liberal minority government and the NDP.

Weaker Economic Growth and Increased Spending Swell the Deficit

The outlook for the Federal budget has worsened since the 2022 FES. As has been the practice for nearly 30 years, the budget projections are based on an average of private sector forecasts captured in February. The survey average calls for a shallow recession this year, with a peak-to-trough decline in real GDP of 0.4%. After an 11% rise in nominal GDP growth – a key driver of overall government revenues – there will be a big step down in 2023, with a forecast of only 0.9% (versus 2.6% in the FES) (Table 1). Over the 2022-2027 period, nominal GDP is expected to average 4.6% versus 5% in the FES. Finance also outlined an upside and downside economic scenario reflecting the high degree of uncertainty in the current economic environment. The budget also reflects a higher interest rate environment and a lower commodity price environment relative to the FES.

As a result, budgetary revenues have been revised down by $5.7 billion for fiscal 2023-24 relative to the FES. The weaker nominal GDP forecast is expected to depress income tax receipts by $4.8 billion over the forecast horizon. Weaker revenues are responsible for more than half of the worsening in the deficit in the upcoming fiscal year. However, by the end of the budgetary horizon, the larger deficit is accounted for entirely by an increase in program spending.

Despite an uncertain economic outlook, the federal government eschewed restraint, delivering more than $67 billion in net new spending over 5 years with significantly more over a 10-year time horizon. Roughly one-third of that figure was accounted for by the previously announced increase in health care transfers to provinces – amounting to approximately $22 billion through 2028. Other major spending initiatives were split across dental

Table 1: Federal Budget 2023 Forecast Summary
(C$ Billion, Unless Otherwise Specificed)

Fiscal Year	21-22	22-23	23-24	24-25	25-26	26-27	27-28
Budgetary Revenues	**413.3**	**437.3**	**456.8**	**478.5**	**498.4**	**521.8**	**542.8**
Program Expenses	468.8	435.9	446.6	463.3	475.9	489.2	505.4
Public Debt Charges	24.5	34.5	43.9	46.0	46.6	48.3	50.3
Net actuarial losses	10.2	9.8	6.4	4.2	2.8	0.0	1.1
Total Expenses	**503.5**	**480.2**	**496.9**	**513.5**	**525.3**	**537.5**	**556.8**
Budget Balance	**-90.2**	**-42.9**	**-40.1**	**-35.0**	**-26.9**	**-15.7**	**-14.0**
Federal Debt	1,134.5	1,180.7	1,220.8	1,255.8	1,282.7	1,298.4	1,312.5
Per cent of GDP							
Budgetary Revenues	16.5	15.7	16.3	16.4	16.4	16.5	16.5
Program Expenses	18.7	15.7	15.9	15.9	15.7	15.5	15.4
Public Debt Charges	1.0	1.2	1.6	1.6	1.5	1.5	1.5
Budget Balance	-3.6	-1.5	-1.4	-1.2	-0.9	-0.5	-0.4
Federal Debt	45.2	42.4	43.5	43.2	42.2	41.1	39.9

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

care expansion, areas the government identified as cost-of-living measures for households and a continued focus on driving the clean energy transition.

Affordability measures take top billing

Two new spending initiatives stood out in this year's budget with respect to affordability. First, the government will be providing a one-time "grocery rebate", equal to double the existing GST tax credit. In practice, this represents a tripling of the GST tax credit households receive that quarter to a maximum of $230 per adult and $121 per child, with an equal tripling of phase-in/phase-out rates to ensure the rebate is distributed across the income spectrum in the same manner. Roughly 5 million households receive the GST tax credit, benefiting some 11 million Canadians. The initiative is expected to cost $2.5 billion.

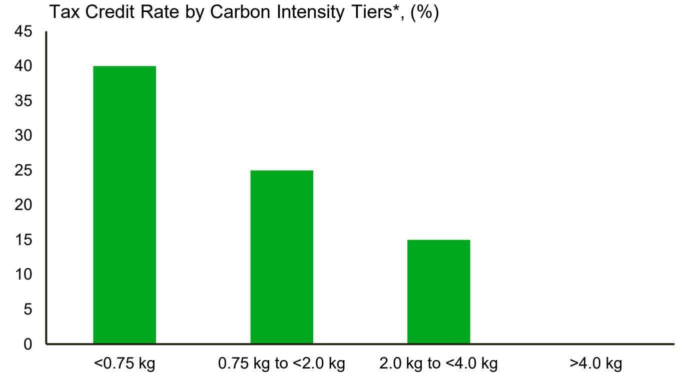
Second, the government is expanding public support for dental care for low and middle-income families. Introduced last year, the plan originally covered children aged 18 and under and people with disabilities. This year's expansion will include all uninsured individuals with household incomes below $90,000. Government estimates a cost of $13 billion over 5 years and $4.4 billion on an ongoing basis. Arguably, this is one area where the government could have done a more gradual phase in, perhaps focused on the lowest income households, in order to manage finances in the current uncertain economic environment.

Targeted clean energy industrial policy, or race to the bottom?

Budget 2023 provides $21 billion in net new spending to support the clean energy transition over 5 years with most of the key initiatives providing billions more beyond the budget's 2028 forecast horizon. New announcements include:

- $6.3 billion through 2028 and an additional $19.4 billion through 2035 in a 15% refundable investment tax credit for clean electricity. This is separate from the 30% refundable investment tax credit for clean technologies from budget 2021, which was primarily aimed at industry investing in zero-carbon electricity systems, stationary electricity storage, low-carbon heat equipment, and zero-emissions vehicles. For the new investment tax credit, eligibility extends to crown corporations and publicly-owned utilities, corporations owned by indigenous communities, and pension funds taking direct positions in projects.

Chart 3: Proposed Tax Credit Incentive Structure for Carbon



*kg of carbon per kg of hydrogen. Source: Government of Canada, Budget 2023.

- $3 billion over 13 years in recapitalization of the smart renewables and electrification pathways program aimed at supporting transmission projects and indigenous-led projects.
- $4.5 billion through 2028 and $6.6 billion through 2035 in a 30% refundable investment tax credit for clean technology manufacturing, targeting extraction and processing of critical minerals, nuclear energy equipment and fuel, electricity storage, zero-emissions vehicles, and battery components.
- $5.6 billion through 2028 and $12.1 billion through 2035 in a 40% clean hydrogen investment tax credit (Chart 3). Announced in last year's budget, the credit is scaled up based on the emissions intensity of production with <0.75 kg of carbon produced per kg of hydrogen needed to reach the full 40% credit. Both green and blue hydrogen production are eligible, so long as emissions intensity falls below the thresholds. However, captured carbon is required to be stored geologically or in concrete production and cannot be used for enhanced oil recovery.
    - A separate 15% tax credit is available for equipment to convert hydrogen to ammonia for transportation purposes, details of which were not yet available.
- $1.3 billion over 6 years to several government agencies such as the Impact Assessment Agency of Canada to expedite project assessments and approvals.

- $520 million over 5 years to expand the Carbon Capture, Utilization and Storage (CCUS) tax credit to include relevant heat, power and water use equipment, expanding geological storage projects to BC, among other considerations.
- $1.3 billion through 2035 to extend the small business tax and general CIT rate by 50% for zero-emission technology manufacturers. The special tax rate is set to expire in 2029 and will be extended through to the 2034 tax year.
- $500 million over 10 years to top up for Strategic Innovation Fund – a key funding tool that the federal government has used to collaborate with industry and subsidize new investments.
- Details were also provided for the $15 billion Canada Growth Fund in delivering on carbon contracts-for-difference (CCFDs). In fall economic statement, the federal government had already indicated that the CGF would be used to provide CCFDs, with confirmation that the fund will now be run by the Public Sector Pension investment board and will begin operations in the first half of this year.

Heading into the budget, it has been an open question how the federal government would respond to the clean energy components of U.S. Inflation Reduction Act (IRA). The U.S. Congressional Budget Office estimates the legislation to cost its government a whopping $370 billion, but likely to even surpass that given the IRA's uncapped investment and production tax credits now acting as a gravity well for both domestic and foreign investment in clean energy, technology, and manufacturing. Indeed, the IRA put all advanced countries on the defensive as evidenced by the EU's recent green deal industrial strategy specifically lifting rules on individual state subsidies and allowing them to match foreign subsidies in a direct call out to the competitiveness challenge posed by the IRA.

However, Canada's investment strategy is perhaps not quite as simple as treating clean energy investments as a zero-sum game and competing to offer the biggest subsidy. There is certainly some sense of that. As the budget notes, "the recent passage of the United States' Inflation Reduction Act (IRA) poses a major challenge to our ability to compete in the industries that will drive Canada's clean economy." But Canada stands to leverage the IRA given concessions in domestic content requirements that include Canada and Mexico. In a convoluted way, the IRA represents both opportunity and challenge. And the maturation of climate policy in Canada is clearly reacting to where the government sees those opportunities that ought to be supported, or where challenges exist that require more support.

Tilting policy to leverage competitive positioning

The new clean hydrogen tax credit is an example of this delicate balancing act by the federal government. The U.S. IRA offers an extremely generous $3/kg for clean hydrogen production, essentially putting green hydrogen in a similar levelized cost playing field as blue hydrogen and natural gas. This will no doubt act as a foghorn for attracting green hydrogen producers. Whether or not Canada's investment tax credit can compete purely on a cost basis is uncertain for now. However, Canada has already seen significant development in the clean hydrogen front. This is reflected in signing both a hydrogen trade agreement with Germany following Chancellor Olaf Schulz's visit last summer, and a memorandum of understanding to export clean hydrogen to Europe through the Port of Rotterdam, which is hoping to establish itself as a primary storage and trading hub for the region. The investment tax credit may never have been intended to compete with the U.S., but rather build on the optimism among several east coast provinces hoping to take advantage of the trade agreement.

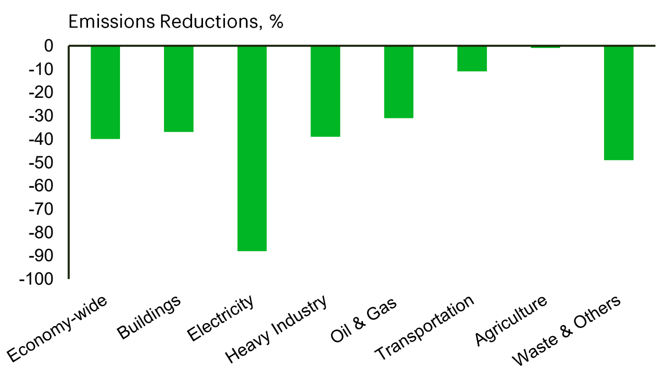
The additional 15% investment tax credit for conversion into ammonia (necessary for marine transport of hydrogen) is the clearest signal yet that the federal government is leaning in to support that specific development. And to the extent that a clean hydrogen supply chain emerges in the U.S., Canada should be well-placed to benefit.

A similar conclusion can be drawn by taking a holistic view of new spending on expediting project assessments, the new clean electricity investment tax credit that provinces and public utilities are eligible for, and the new manufacturing tax credit that specifically calls out the extraction and refining of critical minerals – particularly when combined with the recent announcement by Volkswagen to locate their first EV battery plant in St. Thomas, Ontario. In VW's communications following the announcement, the company cited not only the generous support of both the federal and provincial government in helping to locate the plant, but also its proximity to the resources necessary to create the EV battery supply chain – likely referring to the ample critical minerals located in Ontario and in neighbouring provinces. No doubt, these new initiatives are intended to both expedite the adoption of clean electricity as a competitive advantage for firms looking to tamp down scope 2 emissions, while also expediting the development of critical minerals extraction and refining.

One critical missing element from this year's climate section is the notable lack of a reference to a hard cap on oil & gas sector emissions. This was a highly contentious issue in the past several years with environmental groups calling for the government to legislate absolute emissions reductions in the sector (which likely would have necessitated a decline in production). Instead, we see an expansion of the CCUS tax credit to include heat and water equipment used in CCUS processes. This is likely in the hopes that a hard cap won't be necessary in an already energy-constrained world. Note that in the 2030 emissions reduction plan, the government is looking to the oil & gas sector to contribute a significant share of emissions reduction (on the order of 31% from 2005 levels) in order for Canada to reach 40-45% emissions reduction by 2030 (Chart 4). A hard cap would get us there, but likely threaten the already tenuous economic situation wrought by 40-year highs in inflation and interest rates.

All said, taking stock of this year's budget when it comes to climate policy is a difficult task. Early estimates from the Canadian Climate Institute indicate that emissions in 2021 are expected to be lower than 2019, even after considering the effects of the pandemic. Given the recent spate of new clean energy investments, particularly in the EV and battery sectors, it is likely that our existing climate policy framework is seeing some success. The uncertain economic environment represents a major roadblock but confronting challenges while leaning into opportunities is likely to be the status quo.

Chart 4: Notional Pathway for Sectoral Emissions Reductions to Reach 2030 Emissions Reduction Plan Target



Source: Government of Canada, 2030 Emissions Reduction Plan.

Revenue Measures and Government Expense Controls Partially Offset New Spending

There were a few new revenue-raisers targeted at higher income taxpayers and corporations. In totality, revenue measures are estimated to raise $11.6 billion through 2027-28, although about $2.7 billion had been previously provisioned in the fiscal framework.

On the personal side, the Alternative Minimum Tax (AMT) rate will be raised from 15% to 20.5% starting in the 2024 tax year. However, the income threshold at which the AMT kicks in has also been raised from $40k to $173k. The government estimates this will mean a tax cut for "tens of thousands of middle-class Canadians". This tax increase is estimated to raise $3 billion over 5 years.

The government fleshed out some details on its tax on share buybacks that was announced in the 2022 FES. The 2% tax will apply to the annual net values of repurchases of equity by public corporations and certain publicly traded trusts and partnerships. This will take effect as of Jan. 1st, 2024, and it will not apply to gross repurchases in a given tax year of less than $1 million. This is estimated to raise $2.5 bn over five years starting in 2023-24.

International tax reform, and more specifically pillar two (Global minimum tax), was a previous commitment but this budget banks an additional $5.1 billion into the fiscal framework starting in 2026-27. Finally, the budget announced that dividends received by financial institutions on Canadian shares will be treated as business income. This is estimated to raise $3.15 bn over five years starting in 2024-25.

The government also committed to a $12.8 billion net reduction in spending across management consultants, a 3% reduction in departmental budgets, and similar decreases among crown corporations.

Gross borrowing requirements to drop

Total gross issuance is expected to increase to $414 billion in fiscal 2023-24, up from $387 billion in fiscal 2022-23. In fiscal 2023-24, borrow reflects $358 billion in refinancing, and a projected financial requirement of $63 billion. The stock of total public market debt will just exceed $1.3 trillion by 2023-24. The government announced it will cease issuance in the 3-year term effective in the second fiscal quarter. 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 continues its quantitative tightening process. This has gone smoothly thus far, with over a third of the process completed.

Bottom Line

In Budget 2023, this minority government once again leaned into spending. Much of the increase in spending is accounted for by the increase in health transfers, which were previously known, and on programs aimed at securing Canada's competitiveness in the clean energy transition. The latter in particular might be viewed as being critical give the sprint Canada is doing to reach 40% emissions reductions below 2005 levels by 2030, on the way to net zero by 2050.

The near-term increase in the deficit can be partially blamed on the weaker economic backdrop, but in the out years, the lack of return to balance raises the debt burden relative to what was presented in the FES. The government cites international comparisons, which show that Canada's net debt relative to the size of its economy compares favourably to its G7 peers, but uncertainty in Canada is perhaps disproportionate given household debt-to-income ratios far exceed our peers.

Table 2: Economic Assumptions Annual Percent Change (Unless Otherwise Indicated)						
Calendar Year	2022	2023	2024	2025	2026	2027
Real GDP						
Economic and Fiscal Update 2022	3.2	0.7	1.9	2.3	2.1	1.9
Budget 2023	**3.4**	**0.3**	**1.5**	**2.3**	**2.2**	**1.9**
TD Economics Forecast	3.4	0.8	0.4	1.5	1.9	1.8
Nominal GDP						
Economic and Fiscal Update 2022	11.6	2.6	3.7	4.2	4.1	3.9
Budget 2023	**11.0**	**0.9**	**3.6**	**4.3**	**4.1**	**3.9**
TD Economics Forecast	11.0	2.2	3.0	3.6	3.9	3.8
Unemployment Rate (%)						
Economic and Fiscal Update 2022	5.4	6.1	6.2	6.0	5.8	5.7
Budget 2023	**5.3**	**5.8**	**6.2**	**6.0**	**5.7**	**5.7**
TD Economics Forecast	5.3	5.5	6.4	6.2	5.9	5.9
3-Month Treasury Bill Yield						
Economic and Fiscal Update 2022	2.2	3.6	2.8	2.3	2.1	2.1
Budget 2023	**2.4**	**4.4**	**3.3**	**2.6**	**2.4**	**2.4**
TD Economics Forecast	2.2	4.5	3.3	2.3	2.3	2.3
10-Year Gov't Bond Yield						
Economic and Fiscal Update 2022	2.8	3.1	2.8	2.8	2.9	3.0
Budget 2023	**2.8**	**3.0**	**2.9**	**3.0**	**3.1**	**3.1**
TD Economics Forecast	2.8	3.0	2.9	2.9	2.9	2.9
Source: Department of Finance Canada, Statistics Canada, Bank of Canada, TD Economics.						