ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

Sébastien Lavoie,
Chief Economist
LavoieS@vmbl.ca
514 350-2931

Dominique Lapointe, CFA,
Senior Economist
LapointeD@vmbl.ca
514 350-2924

April 8, 2022

Federal Budget 2022: Improved Fiscal Outlook as Revenues Outweigh New Spending

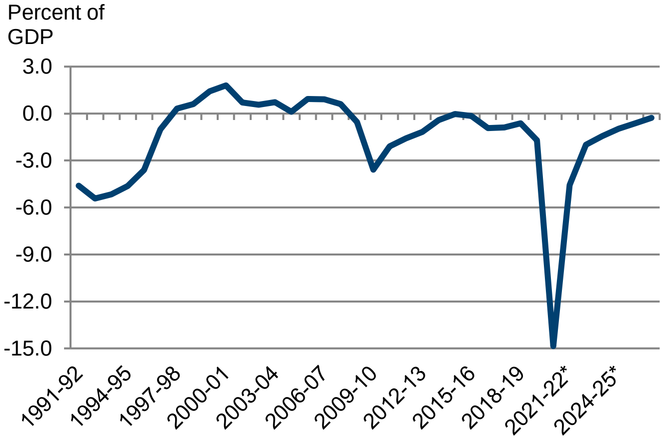
Finance Minister Chrystia Freeland can announce several measures related to housing, climate and military spending in her second budget due to better-than-expected economic fortunes filling the coffers in Ottawa. Indeed, revenues jumped in FY 2021-22 and are projected to stay above-trend (15% of GDP), thanks to the robust economic recovery, red hot commodity prices and the three-decade high CPI inflation.

Overall, the introduction of $30B in new spending over 5 years is a big number but remains smaller than previous COVID-related expenses. It makes sense to ease on the fiscal pedal considering that the Canadian economy runs at full throttle today. Federal spending represented a record-high 28% of GDP in FY 2020-21 and have now started to fall back to the more comfortable zone of 15% observed during most of the 2000s and 2010s.

Granted, public finances could have been closer to balance at this stage considering the revenue stream from commodities and where we are in the business cycle. However, issues related to housing affordability, the Russian invasion of Ukraine, and climate change call for action. Also, the federal government deliberately draws a line for spending, leaving aside the $28B in additional health care transfers provincial leaders repeatedly ask for. A national Pharmacare program was also left aside, a heavy spending item that could cost about $25B over 5 years. Although, the government intends to pass a Bill regarding the matter in 2023.

Altogether, the projection of a $53B deficit in FY 2022-23 (2.0% of GDP) means federal fiscal policy is still slightly in easing territory. Restraint in new expenditures gradually and a program review reduce the deficit to as low as 0.3% of GDP in FY 2026-27 (chart 1).

Chart 1: Federal Government Budgetary Balance



Source: Government of Canada, Statistics Canada.

New Housing Policies Addressing Supply and Demand

About one-third of new spending is dedicated to housing. The flagship measure is the Tax-Free First Home Savings Account (THSA). This new vehicle, to become effective in 2023, will allow first-time home buyers to save up to $40K to put towards their purchase later. Contributions will be tax-deductible, similar to an RRSP. The THSA is poised to become more popular than the Shared Equity Mortgage program launched in 2019 because of its simplicity. First-time home buyers represent half of home sales according to a recent Bank of Canada note. The government also doubles the first-time home buyers' tax credit to $10K, retroactive to January 1st, 2022. In addition, Ottawa proposes a ban on foreign homebuying for a period of 2 years. Non-residents own 3% of all residential properties in Toronto and 5% in Vancouver according to Statistics Canada. Also, investors (both domestic and from abroad) represent 19% of all home sales according to the Bank of Canada. In addition, flipping units or selling the same unit within a year will be subject to full income taxation.

On the supply side, CMHC will notably oversee a new program called the *Housing Accelerator Fund*. The objective is to provide flexible incentives to speed up housing planning and construction at the municipal level. Additional funding for CMHC's Rapid Housing Initiative also aims at building more affordable units. Overall, these supply-side policies are necessary but face labour and materials shortages. For instance, we notably expect a double-digit reduction in Canada's lumber production this year.

Another measure to improve affordability is the dental coverage program for children, costing $5.3B over five year to put in place and $1.5B per year to run thereafter.

Besides Housing, Climate Change and Military Responsibilities

The Russian invasion of Ukraine prompts several European countries to boost military spending. President Biden also recently asked for a 4% increase in U.S. military spending. Ottawa plans to spend more than $8B on the capabilities of the Canadian Armed Forces and cybersecurity to increase national defence. That significant investment constitutes a step toward reaching NATO's requirement of spending 2% of GDP on defence capabilities. By our calculations, in FY 2026-27, defence spending will be at 1.3% of GDP.

The new climate reduction plan announced last week by the federal government is backed up in Budget 2022 by multiple incentives: installation of emission-reducing technologies in buildings, supporting the purchase of zero-emission vehicles for businesses, etc. Budget 2022 also proposes a 50% tax credit to incentivize carbon capture utilization and storage (CCUS) projects, starting this year. The CCUS investment tax credit will benefit mostly the oil patch in Alberta, but also other industries including cement and mining producers.

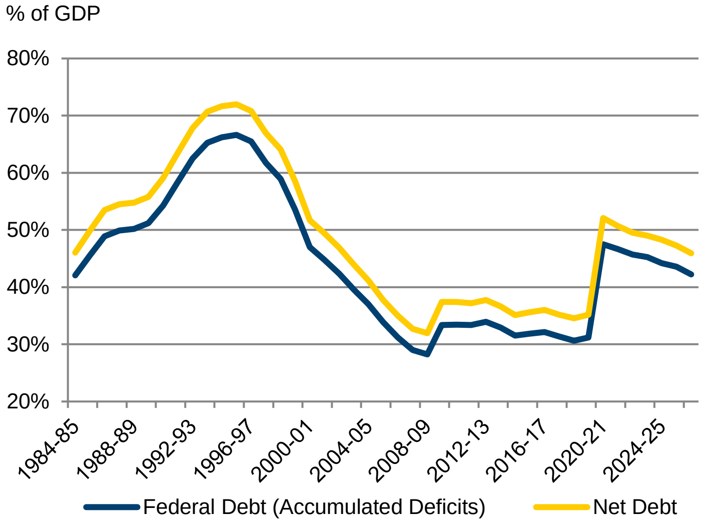
Tax Changes and Spending Review

In terms of tax policies, the low 9%corporate income tax rate available to small businesses will now be phased out more slowly as a function of revenue: between $10M to $150M in taxable income instead of $10M-$15M before. At $150M, the general corporate tax rate of 15% will kick in. Budget 2022 also includes a one-time 15% tax rate on the 2021 tax year income of banks and life insurers, and a permanent 1.5% increase of their corporate income tax rate (from 15% to 16.5%). The federal government also plans to look at a new minimum tax regime for high-income earners and make changes to limit companies that use tax haven and loopholes. This review could be announced in the Fall Fiscal Update. Also, a strategic review of existing spending programs will be conducted. The objective is to save $6B over 5 years.

The question of fiscal sustainability

The first criterion for fiscal sustainability as defined by the Parliamentary Budget Officer (PBO) is that the debt as a share of GDP should not increase indefinitely. In that regard, the downward trajectory for net debt-to-GDP, from 52% to 46%, between FY 2022-23 and FY 2025-26 suggests a sustainable path for public finances. That being said, it should not be the only criterion. While we support the financial hit that the federal government took in FY 2020-21 to provide necessary COVID-19 relief to households, businesses, provinces, and municipalities, it also led to sizeable debt accumulation. Between FY 2018-19 and FY 2025-26, total liabilities of the Government of Canada, almost all interest-bearing, will have increased by a whooping $764B, or 64%. With interest rates rising, this debt load becomes a vulnerability. It can also become a heavier burden for the delivery of public policy when it takes up a large share of revenue. At 1.3% of GDP and 8.4% of revenue in FY 2025-26, public debt charges should remain low by historical standards. However, the probability of another idiosyncratic negative event such as COVID-19 or a war, entailing large deficits, has increased. It therefore reinforces the needs to prioritize new spending initiatives in future budgets and respect the fiscal anchor (declining federal debt-to-GDP).

Chart 2: Government of Canada Debt



Source: Government of Canada, Statistics Canada.

Transition Year for Debt Management Strategy

Over the past two years, in order to finance record-high spending due to COVID-19 and to take opportunity of record-low interest rates across the yield curve, the Department of Finance oriented its debt management strategy toward the long-run. This led to an unprecedent increase in 10-year and 30-year bond issuances, along with the return of 50-year (ultra-long) bond deals. The 2022-23 Debt Management Strategy continues to focus on long-term debt, albeit at a reduced pace. Now that the endemic phase seemingly gets closer and that extraordinary COVID-19 spending is no longer required, the government proposes a debt management strategy transitioning out of ultra high reliance on 10-year+ funding, allocating a higher share of borrowing to the short-term. Additionally, the steep and rapid increase in bond yields experienced over the past 8 months raises the probability that, within 3-7 years, many bonds will mature in a lower interest rate environment, reducing the cost-benefit to lock-in current interest rates for a long time.

Green and ultralong bonds on the menu, no additional RRBs

Because of elevated refinancing needs for bonds ($182B) and Treasury Bills ($187B) and the annual deficit ($53B) total domestic borrowings in FY 2022-23 remain elevated at $425B, including a $28B cash drawdown, versus $442B last year. While the share of 3-year and 5-year bonds issued remains constant at 11% and 16%, respectively, 2-year bonds increase to 35% between 26% last year and 42% before the pandemic (table 1). Issuances of 10-year and 30-year bonds drop to 25% and 8%, respectively, both still significantly higher than in FY 2019-20. The Department of Finance plans to issue $4B equivalent of ultra-long bonds maturing in 2064 in FY 2022-23, unchanged from last year. The government projects a $5B green bond program although the DMS mentions that the size, timing and tenor will be subject to further considerations. Interestingly, despite multi-generational high inflation, the real return bond programs remain at $1.0B, potentially reflecting investors' demand or market liquidity.

Bottom Line

The fiscal outlook improved markedly since the December fiscal update even if important challenges led the federal government to introduce additional billions of dollars in new spending. Accordingly, other priorities including additional health care funding for provinces, a clearer pro-growth agenda and a nation-wide drug coverage program were left aside.

In summary, Budget 2022 constitutes the first small step towards the fiscal responsibility necessary to prevent debt stress. The current context involving higher interest rates and a slowing economy leaves no margin for error. Otherwise, federal deficits could inflate beyond what is proposed in the 5-year outlook and force the government to add structural spending, increase taxes and/or take additional marketable debt.

Sébastien Lavoie | Chief Economist
514 213-4571 | lavoies@vmbl.ca

Dominique Lapointe, CFA | Senior Economist
514 350-2924 | lapointed@vmbl.ca

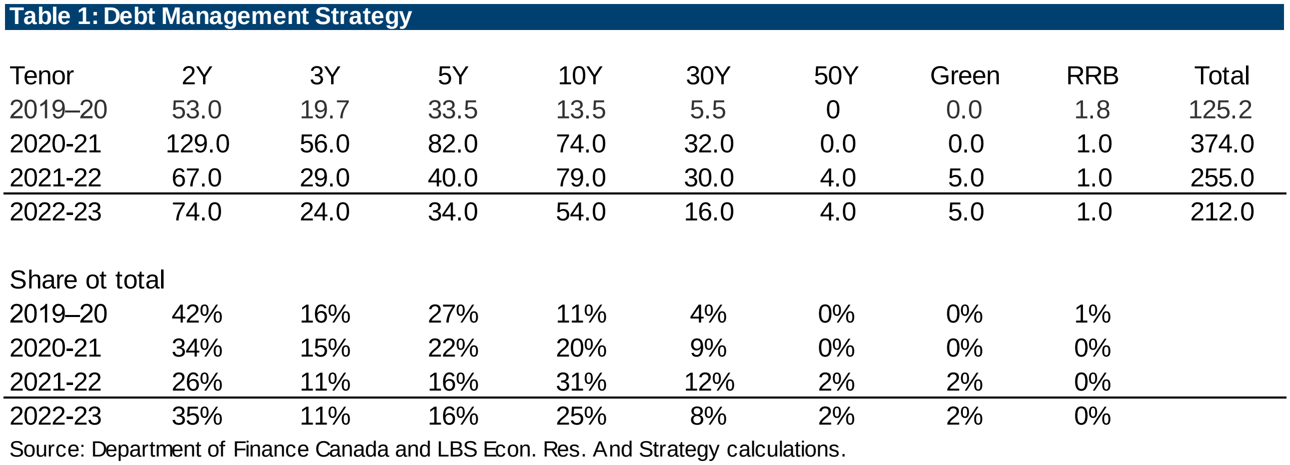


Table 1: Debt Management Strategy

Tenor	2Y	3Y	5Y	10Y	30Y	50Y	Green	RRB	Total
2019–20	53.0	19.7	33.5	13.5	5.5	0	0.0	1.8	125.2
2020-21	129.0	56.0	82.0	74.0	32.0	0.0	0.0	1.0	374.0
2021-22	67.0	29.0	40.0	79.0	30.0	4.0	5.0	1.0	255.0
2022-23	74.0	24.0	34.0	54.0	16.0	4.0	5.0	1.0	212.0
Share ot total									
2019–20	42%	16%	27%	11%	4%	0%	0%	1%	
2020-21	34%	15%	22%	20%	9%	0%	0%	0%	
2021-22	26%	11%	16%	31%	12%	2%	2%	0%	
2022-23	35%	11%	16%	25%	8%	2%	2%	0%	

Source: Department of Finance Canada and LBS Econ. Res. And Strategy calculations.

This document is intended only to convey information. It is not to be construed as an investment guide or as an offer or solicitation of an offer to buy or sell any of the securities mentioned in it. The author is an employee of Laurentian Bank Securities (LBS), a wholly owned subsidiary of the Laurentian Bank of Canada. The author has taken all usual and reasonable precautions to determine that the information contained in this document has been obtained from sources believed to be reliable and that the procedures used to summarize and analyze it are based on accepted practices and principles. However, the market forces underlying investment value are subject to evolve suddenly and dramatically. Consequently, neither the author nor LBS can make any warranty as to the accuracy or completeness of information, analysis or views contained in this document or their usefulness or suitability in any particular circumstance. You should not make any investment or undertake any portfolio assessment or other transaction on the basis of this document, but should first consult your Investment Advisor, who can assess the relevant factors of any proposed investment or transaction. LBS and the author accept no liability of whatsoever kind for any damages incurred as a result of the use of this document or of its contents in contravention of this notice. This report, the information, opinions or conclusions, in whole or in part, may not be reproduced, distributed, published or referred to in any manner whatsoever without in each case the prior express written consent of Laurentian Bank Securities.