September 14, 2023

The fine art of fiscal finger pointing

By Warren Lovely

As a defensive or divisionary tactic, placing the blame on others is a commonly used strategy. Politicians of varying persuasions have been blaming their opponents since time immemorial, even if the specific criticisms (and the platforms used to voice displeasure) have evolved with the times. And as a potential point of contention, is there anything more basic than the budgetary policy of the government of the day—its relative heft, orientation, intrusiveness, progressivity, etc?

Nor are central bankers off limits when it comes to assigning blame for perceived economic ills. If anything, monetary policies and those responsible appear to be a source of growing ire. Perhaps that's not too surprising given the current combination of acute affordability worries and legitimately restrictive policy interest rate settings.

In the wake of the pandemic—as extraordinary/unconventional monetary accommodation saw central bank balance sheets balloon—some openly questioned central bank independence. Once the shoe was on the other foot and the monetary screws began to tighten, some political leaders—with ultimate responsibility for fiscal policy—took issue with the conduct/stance of monetary policy. Most recently, this has been on display in Canada, as certain voices across this fair land have made direct appeals to the Bank of Canada. 'No more hikes' has generally been the plea. This is something of a novel strategy and speaks to the rather extreme pressure households (and prospective voters) are under. Perhaps most ironically (or is it insensibly?), others have even blamed Bank of Canada rate hikes for elevated inflation, since mortgage interest costs appear to be making such an outsized contribution to headline CPI. Don't get us started.

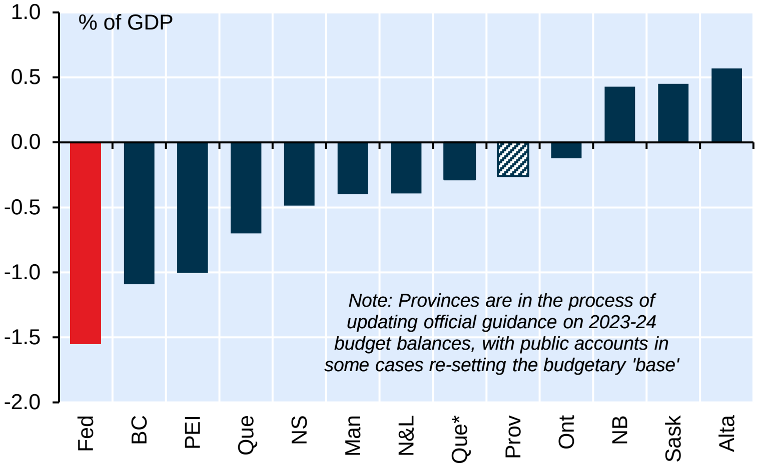
For their part, central bankers have been willing and able to turn the attention back onto fiscal policy makers. 'Blame' might not necessarily be the word directly applied but the extent to which government fiscal policies are complicating the successful conduct of monetary policy is no trivial concern, attention having recently swiveled to unsustainably loose budget policies south of the border. In light of this growing debate, we explore just how problematic and/or inappropriate fiscal policies are in Canada. There may well be some blame to apportion, but perhaps not as much or where or how one might think.

A final caution/warning: We've packaged this analysis as an *In Focus* report. Just the same, there's a fair degree of editorial comment/opinion expressed herein. Readers may not, in all cases, fully agree with us. That's to be expected. We have, however, endeavored to present our points in an intellectually honest fashion, relying on/leveraging factual information, including more than a few sets of publicly available, reliable, frequent and reasonably current data. Those wishing to further the debate are encouraged to reach out directly.

The government footprint & fiscal impulse in today's Canadian economy: How big & how perilous?

Chart 1: Running deficits while in excess demand. Hunh?

Fed-prov budget balance: 2023-24 (based on latest official projections)

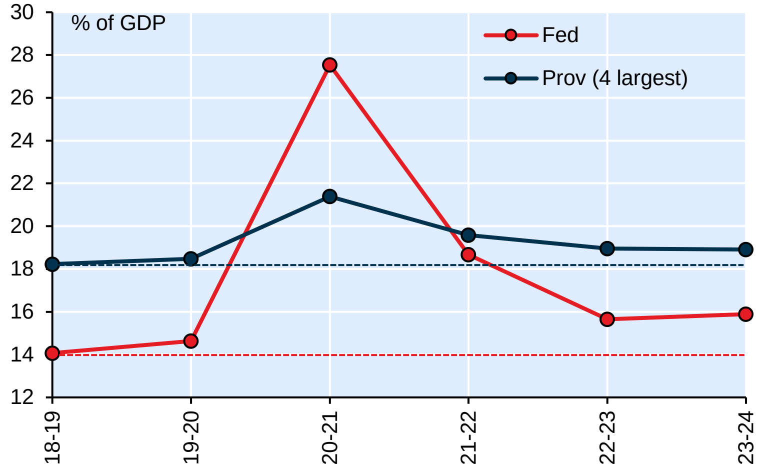


Source: NBF, GoC, prov gov'ts | Note: Que before GF; uses NBF est for nominal GDP

As an initial point, let's acknowledge that many governments in Canada—federally and in the majority of the provinces—officially planned for budget deficits in fiscal 2023-24. That's despite an economy operating with little to no slack (i.e., in excess demand). That has led some to question: 'If you can't run a surplus when there's full employment, when can we reasonably expect black ink?' We can understand this point of view, although we'd draw a distinction between the federal and provincial records. Collectively, the provinces spent the past two fiscal years in the black and possess scope to better official targets in 2023-24 too. As for Trudeau's federal deficit, at 1½% of GDP, it's not exactly excessive. That's not an apology or a free pass. We are, however, mindful of the platform the federal government ran on, which wasn't exactly centred on real fiscal austerity/restraint.

Chart 2: Size of gov't off peak but above pre-COVID level

Fed-prov program spending (public accts basis) relative to size of economy

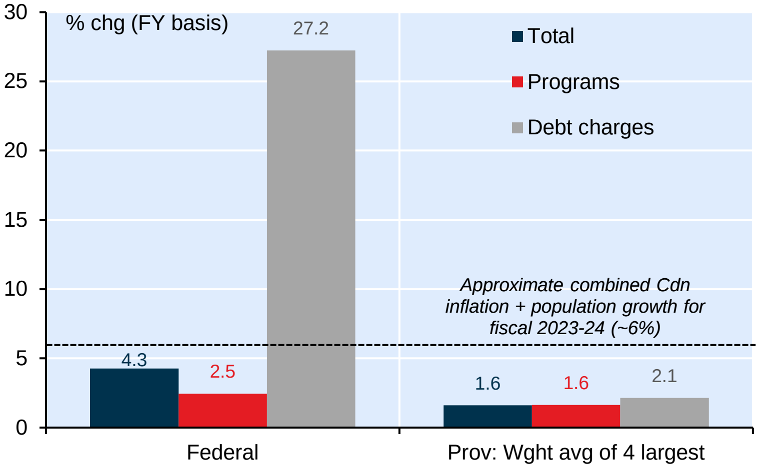


Source: NBF, GoC, prov gov'ts | Note: Based on official Bud23 plans

As most appreciate, Canadian governments hardly shied away from supporting the economy (and all those in need) when the pandemic hit and mandated shutdowns bit. International comparisons suggest Canada's fiscal response was relatively large vs. many peers. It was the feds that picked up the lion's share of the fiscal tab, easing pressure on the provinces (all else equal). As growth returned and the economy healed, many extraordinary supports were wound down and/or expired. You can see this in the overall arc of program spending, although relative to GDP, planned outlays for 2023-24 are still relatively larger than in the pre-COVID era. Is this the proverbial 'smoking gun' for those despairing of ultra-loose fiscal policy? Not necessarily, but it does hint at/imply a relatively larger government footprint in today's economy.

Chart 3: Spending growth captures expanded interest bill

Fed-prov planned spending growth (public accts basis): 2023-24

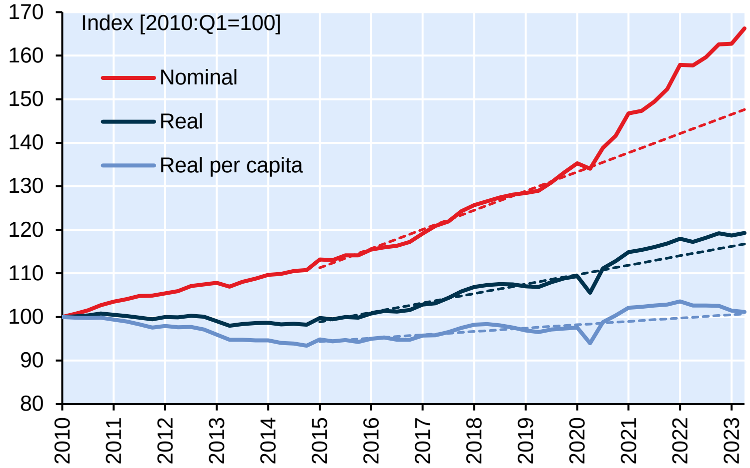


Source: NBF, GoC, prov gov'ts

So government spending has comprised a larger share of GDP than before our world was turned upside down by COVID-19. And what of planned growth in government outlays for fiscal 2023-24? Looking at official plans set down in 2023 budgets, the feds slotted in 2.5% nominal growth in total program spending. Where Ottawa's expenditures are really exploding is on public debt service. That's what happens when you run meaningful interest rate reset risk during an aggressive tightening cycle. As for the four largest provinces—with a combined GDP or population weight surpassing 85%—program spending was projected to edge up just 1.6% in 2023-24 on a public accounts basis. Not for nothing, the adjustment to (or budgetary hit from) a higher interest rate environment is much slower to arrive in provi land, since more of the sector's outstanding debt has been locked in for longer.

Chart 4: GDP data show 'G' component on the rise... or is it?

Gen gov't consumption & fixed capital investment (national accts basis)

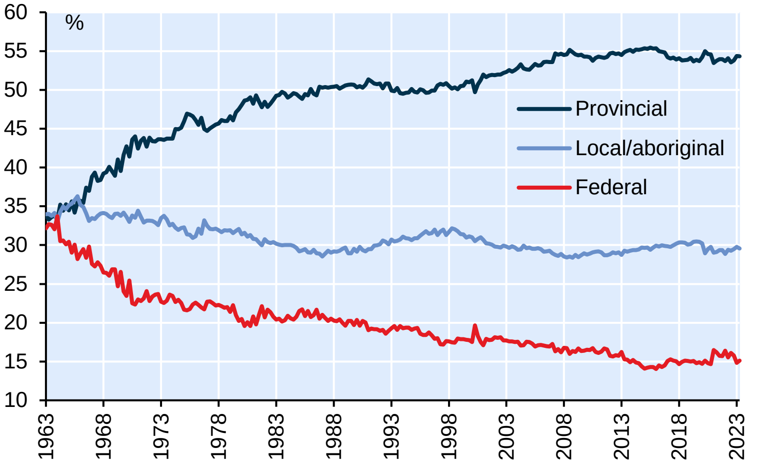


Source: NBF, StatCan

While budgets provide important direction, public sector accounting standards can blur the impact/timing of actual outlays. So let's turn to a fresh installment of the quarterly national accounts data. Here we have details on government final consumption expenditure and fixed capital investment, jointly comprising the 'G' in the basic expenditure-based GDP identity we all learned in Macro 101. No question, the nominal value of government consumption has moved sharply higher, implicit price indices rising every bit as fast as at the household level. In real terms, government spending is closer to, although still above, the pre-COVID trendline. Control for the fact that governments have more and more people to support, however, and *real per capita* consumption/investment is contracting. We'll come back to this population surge a few times, including in Chart 26.

Chart 5: Feds account for less direct consumption spending

Share of gen gov't nominal final consumption

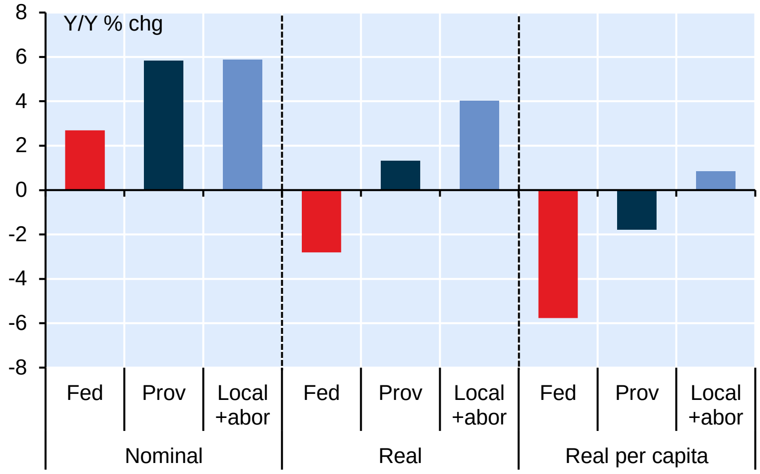


Source: NBF, StatCan

As we regularly note/caution, Canada has a relatively decentralized government model. Full or partial responsibility for some of the most vital public services rests with regional and local governments. Consider: Of the ~$600 billion in annualized final consumption expenditure currently undertaken by the general government sector, the feds account for just 15%. The provinces have generally accounted for at least half of all direct consumption for decades, the precise share equating to 54% as of Q2. Local governments deliver any number of vital services. There's clearly more to control for than direct consumption when gauging a government's impact on the economy (and its implications for monetary policy). But where and how regional and local governments spend matters more in Canada than many other advanced economies.

Chart 6: Little to no growth in real, per capita terms

Growth in gen gov't final consumption: 2023:Q2

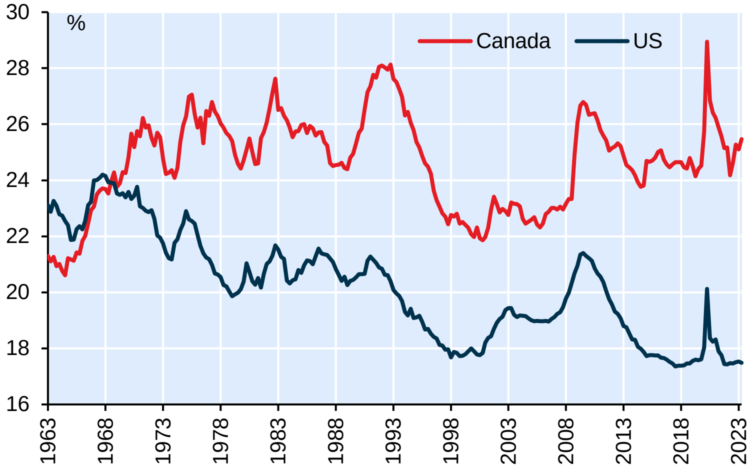


Source: NBF, StatCan

Canada's subnational governments have hardly been immune to inflation pressures, prices for the goods and services they consume on the rise here too. In real terms, provincial and local/aboriginal governments also spent more in 2023:Q2 than in the prior year. Considering the explosive growth in the population, however, final consumption expenditure in *real per capita* terms was noticeably lower at the federal level, was contracting provincially and was barely growing at the local level of government. Whether you can dub this legitimate 'restraint' is something of an open question. But direct spending by Canada's general government sector may not be all that excessive when you consider the rapidly growing number of bodies the public 'system' is required to support. We're thinking health care, education, social services, transit, transportation, other infrastructure... the list goes on.

Chart 7: Canada has long had larger government footprint…

Gen gov't consumption/investment share of nominal GDP

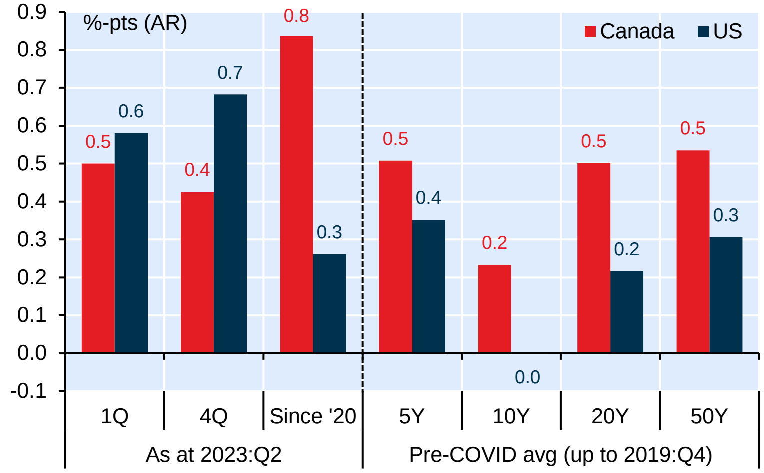


Source: NBF, StatCan, BEA

A word if we could on comparisons between the public sector model in Canada vs. the U.S.: Setting aside big differences in military strategy, Canada has long adopted a more hands-on approach to providing government services, this most easily understood/observed in the realms of health care and education. Measure the 'G' component of each nation's output and it's north of 25% in Canada. Interesting fact: Not for the first time, the government share of Canadian GDP surpasses the combined weight of private interest rate-sensitive demand components (consumer durables consumption, residential construction and business investment). South of the border, government expenditure accounts for a noticeably smaller share of GDP (currently 17% or more like 14% excluding sizeable defense outlays). But that's not the most interesting element… *<continued>*

Chart 8: … but gov't contributing more to growth stateside

Gen gov't consumption/investment contribution to real GDP growth

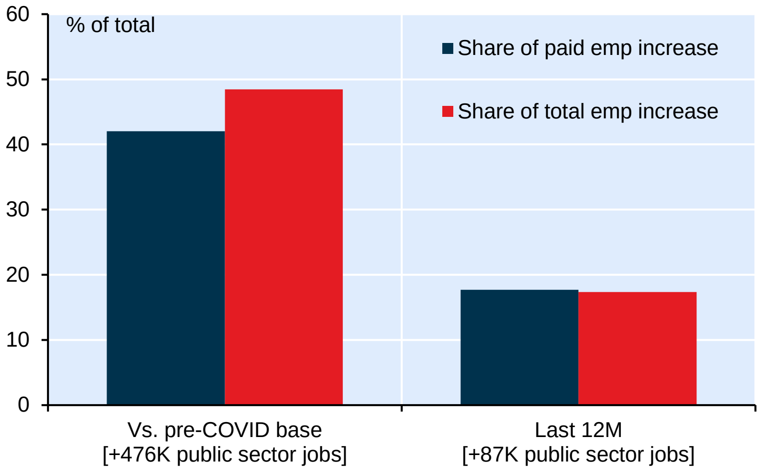


Source: NBF, StatCan, BEA

Contrasting with the government's historically lighter touch stateside, public sector outlays have made a larger direct contribution to growth in the U.S. than in Canada of late. We're not saying governments are taking away from growth in Canada; far from it. During the second quarter alone, StatCan identified a 0.5%-pt contribution to top-line real GDP growth. Although genuinely misleading, one could even say that 'all' of the growth in Canada's real final domestic demand over the past year came from government spending/investment, but that's really a function of collapsing residential construction activity. As an aside: The BoC's September 6th rate statement made note of government support for FDD. Still, when it comes to direct government outlays, today's contribution to Canadian growth is more or less in line with longer-term pre-COVID trends.

Chart 9: Public sector share of recent hiring not outsized

Public sector share of net employment change

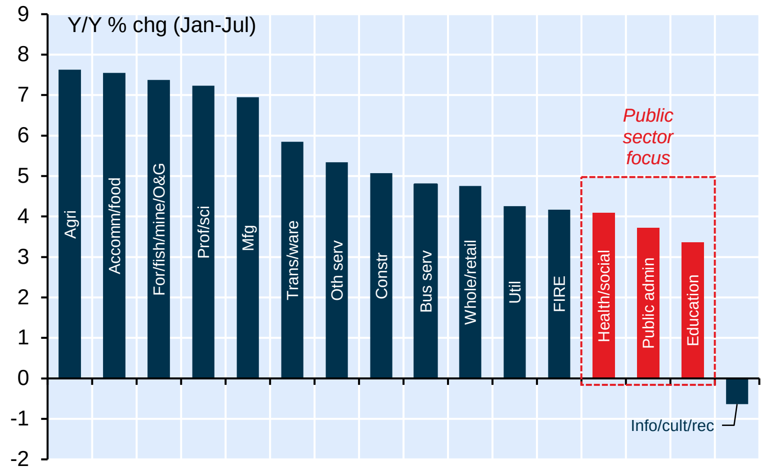


Source: NBF, StatCan

What of the government sector's role in spurring marginal job creation in an already tight labour market? As with most everything, some perspective is useful. Given pronounced private sector layoffs at the onset of the pandemic, the public sector technically accounts for a disproportionate share of the net employment change vs. pre-COVID/early 2020 levels. Today, the public sector's share of total employment—while well off its peak—is higher than what had once been the norm. And our governments continue to add to their headcount. Incorporating recent data for August, total public sector employment was up 87,000 (+2.1%) in the latest 12-month period. You may be reluctant to label public sector payrolls as 'lean and mean', but private paid employers have recently been staffing up even faster (these positions up 3.1% year-on-year as of August).

Chart 10: Wage growth in gov't sectors more controlled

Growth in average hourly wage rate by industry

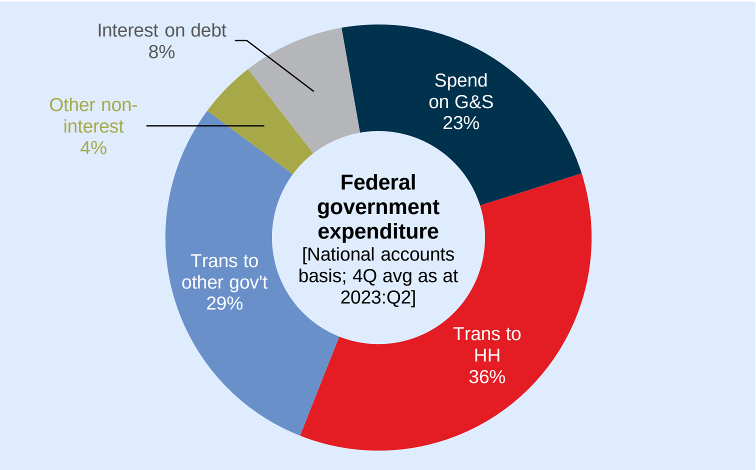


Source: NBF, StatCan

As for wage growth—an area the Bank of Canada would have us focus on—it might be unfair to place outsized blame on governments. Sure, average hourly wage rates are rising in public sector-dominated industries like health care, social assistance, public administration and education. But the heftiest wage growth has been reserved for private sector-centric industries. Yes, we're aware of the odd high-profile public sector collective bargaining agreement, whereby government(s) acceded to material cost of living demands advanced by unions. But as with the average wage rates illustrated above, detailed wage settlement data consistently reveal more controlled pay increases in the public sector ranks vs. what private sector employers have granted to their unionized workers.

Chart 11: Feds direct spending only part of picture...

Share of total nominal federal gov't expenditure

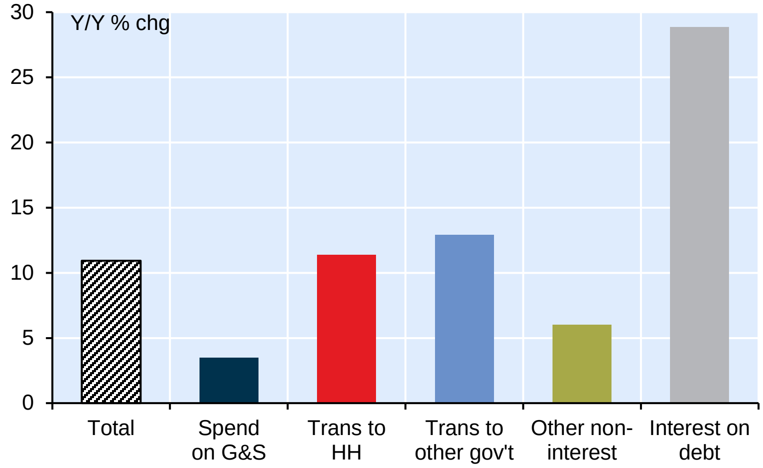


Source: NBF, StatCan

Lest anyone accuse us adopting a narrow/simplistic view of the government sector's contribution to economic activity and inflation, let's state clearly: There's a lot more to the public sector impulse than direct spending on goods and services and/or related payrolls. StatCan's detailed sector accounts show the bulk of current federal government expenditure takes the form of transfers to households and other levels of government, to say nothing of debt servicing charges (an increasingly hot topic given elevated borrowing rates). U.S. data likewise remind us of the serious role tax policy can play in spurring economic activity, although it would be fair to say that Canada has not really observed the type of policy fueled business investment bonanza that has recently featured south of the border.

Chart 12: ... and many expenditure categories soared in Q2

Growth in nominal federal gov't expenditure: 2023:Q2

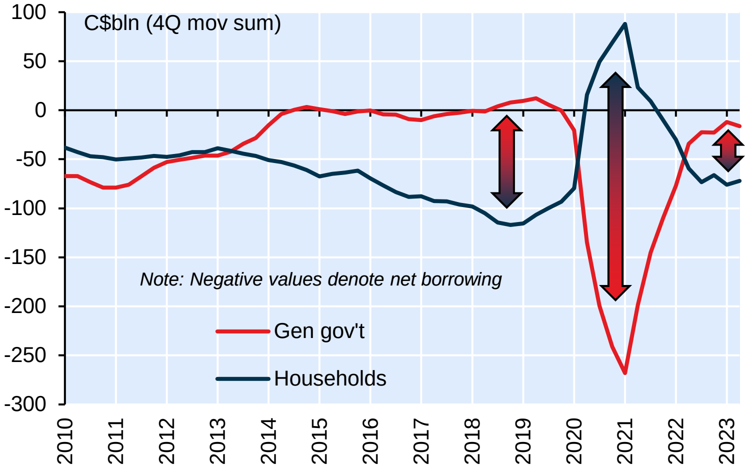


Source: NBF, StatCan

While growth in direct federal government spending may not, on its own, look particularly explosive, transfers can be another story. We've seen fresh affordability measures and extraordinary relief for stretched households, support that gets funneled back into the economy. Premiers may not be fully appeased, but some of Ottawa's major transfer envelops are linked to past nominal GDP growth and are thus expanding rapidly. A discussion of inter-government transfers can get a bit nuanced, but in one sense, enhanced federal transfers to the provinces can help to redistribute the nation's excess fiscal capacity and need not spur above-target inflation (all else equal). While we're on the subject, the strategically important local government sector could perhaps benefit from incremental flexibility and upper government support. This topic deserves its own treatment.

Chart 13: Looking back, gov't clearly financed excess savings

Net lending/(borrowing): Gen gov't vs. households

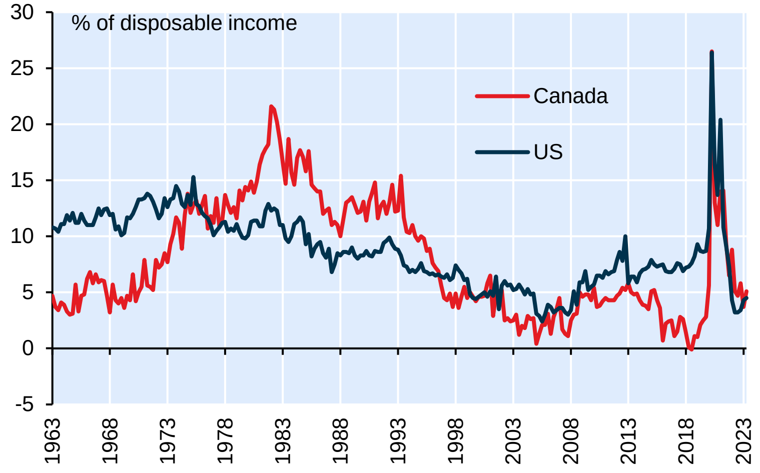


Source: NBF, StatCan

Taking a closer look at household finances, there's no question that governments engineered an unprecedented financial transfer during the height of the pandemic. You can quantify this any number of ways, but simply look at the level of net borrowing/lending at the household and government levels. Massive government support programs—financed via aggressive/record government borrowing—earlier saw Canadians accumulate abundant excess savings, the ultimate deployment of which contributed to growth and inflation. But things look/feel quite a bit different in mid-2023 than they did one or two or three years ago. Average general government net borrowing, if not quite fully normalized, has receded significantly, particularly at the sub-national level of government.

Chart 14: Do saving rates hint at too generous gov't support?

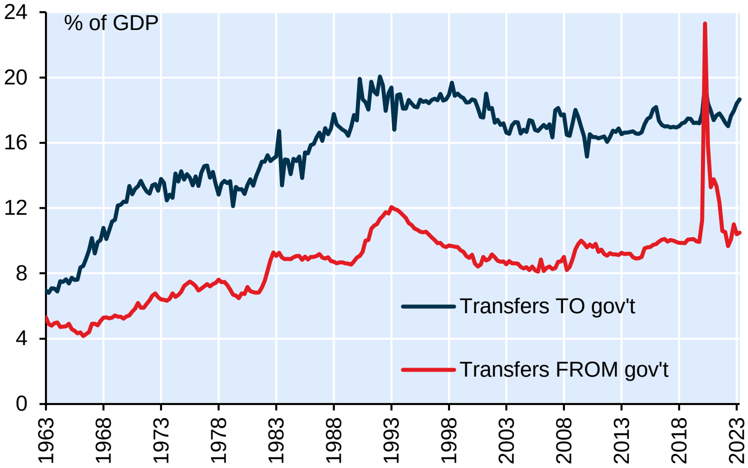
Household saving rate: Canada & U.S.



Source: NBF, StatCan, BEA

Canadians still set aside ~5% of their disposable income in Q2. That might sound a bit high relative to the ~2½% saving rate averaged in the half-decade prior to the pandemic, although rapid wealth creation back then may have dampened the perceived need to save. Our Economics and Strategy colleagues can fill your boots with detailed household financial analysis, but from our vantage point, more recent savings look to have been fueled as much by robust employment compensation as generous government handouts. Not surprisingly, our political leaders and budget makers remain sensitive to the acute affordability concerns flagged in seemingly every public opinion poll. Marginal supports have been on offer, but we would suggest that there's more to the story... *<continued>*

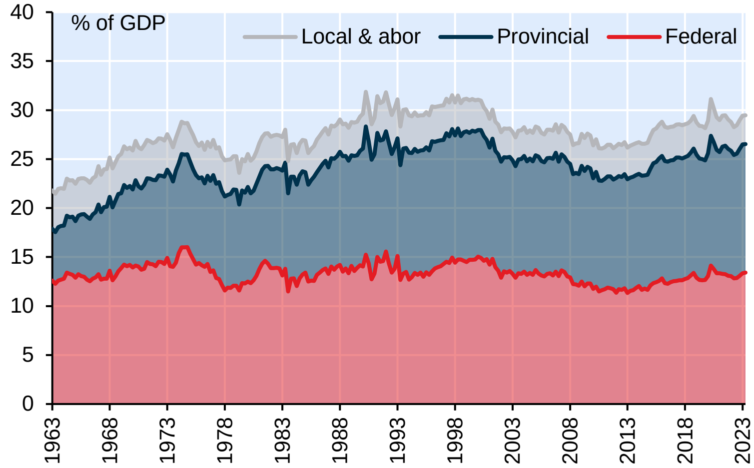
Chart 15: Don't lose sight of transfers *TO* gov't
Household transfers to/from gen gov't



Source: NBF, StatCan

As discussed, government transfers (in one form or another) can help colour household spending behaviour. Relative to GDP, transfers *from* governments are more elevated today than prior to the pandemic. But on the other side of the ledger, transfers *to* governments have also grown. This might not be a fully neutral fiscal proposition in every jurisdiction across Canada, but the extra taxes being remitted have help offset the financial cost of an enlarged public sector footprint. Political parties are always going to argue over the appropriate mix/balance between tax and spend policies. One presumes this will feature prominently in Canada's next federal election. We're not offering a political endorsement here, but would argue that this nation's budgetary policy, across all levels of government, is less imbalanced than some appreciate.

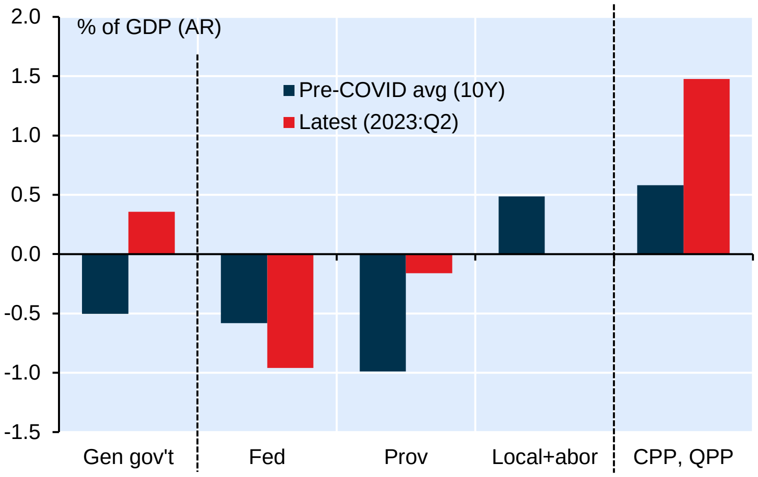
Chart 16: Frothy taxes finance outlays
Gen gov't taxes on income, production, imports



Source: NBF, StatCan

This pronouncement—of general government fiscal sustainability—may strike some as counterintuitive, given the perceived largesse currently on offer. But here again, it's vital to control for the revenue being collected. Following from Chart 15, Canada's tax bill has generally grown. Personal and corporate income taxes blossomed during the economic recovery. Ditto for consumption tax revenue. Even if commodity prices are off their 2022 peaks, material royalties have been clipped in more resource-leveraged jurisdictions. In general, economic resilience has meant a positive revenue base effect. Having parsed the numbers, we'd argue that a number of provinces deserve credit for allocating more of their above-plan revenue windfall not to new spending but to the deficit reduction/debt containment. Where possible, we would encourage a continuation of this strategy.

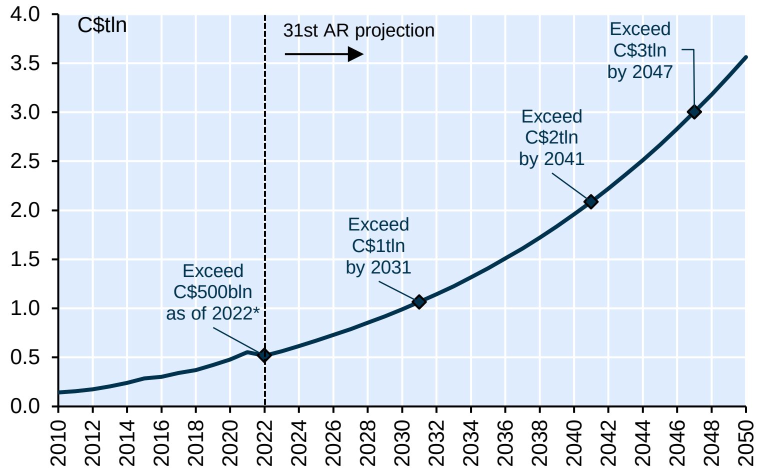
Chart 17: Factor in CPP/QPP and gen gov't sector in black...
Gen gov't surplus/(deficit)



Source: NBF, StatCan

Where does this leave us when it comes to government balances? Going back to Chart 1, Ottawa's 2023 budget pledged a shortfall of roughly 1½% of GDP (public accounts basis). As of 2023:Q2, the shortfall on a national accounts basis was closer to 1% of GDP. As for the provinces, public accounting and national accounts data reveal the smallest of combined deficits. Local governments aren't impervious to fiscal pressures or COVID scarring, but stringent legislative requirements mean balanced operating budgets here. Nothing new in that. Then there's the not-so-subtle issue of Canada's social security system, something we would label as a core strategic advantage for this country. While their investment returns are sensitive to market conditions, CPP and QPP jointly make a very positive contribution to Canada's general government fiscal health... *<continued>*

Chart 18: ... with social security a strategic edge for Canada
CPP net assets, incl. latest actuarial projection

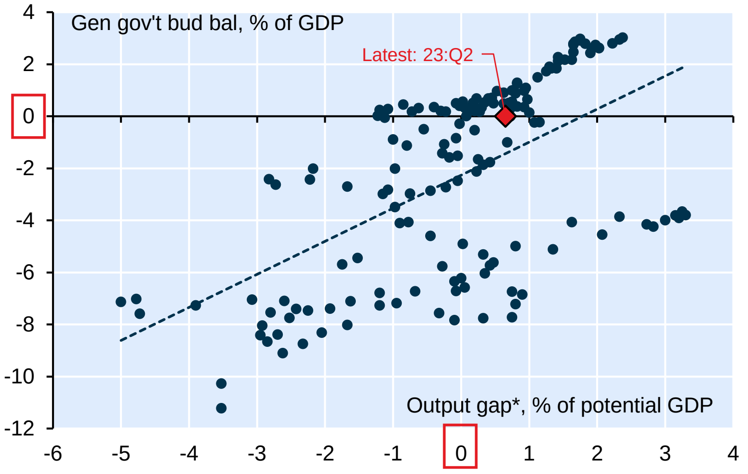


Source: NBF, OSFI

As if ever in doubt, possessing a sound social security system can/will pay handsome dividends. Factoring in CPP/QPP net income, Canada's general government sector was in surplus—not deficit—in Q2. Believe it or not, this country's general government income statement (inclusive of CPP/QPP) is today as strong or stronger than what routinely prevailed prior to the pandemic. Yes, this is a broad(er) way to measure 'government', but a legitimate approach in our opinion. After all, the rapidly growing pool of financial assets in the social security system provide bedrock income support for Canadians in retirement and will thus lessen the ultimate pressure on central and regional governments relative to an underfunded or purely pay-as-you-go system. Really, Canada's social security advantage vs. an arguably dysfunctional U.S. model is about as striking as one can get.

Chart 19: So more structurally sound then

Gen gov't budget balance vs. national output gap: 1983 to current

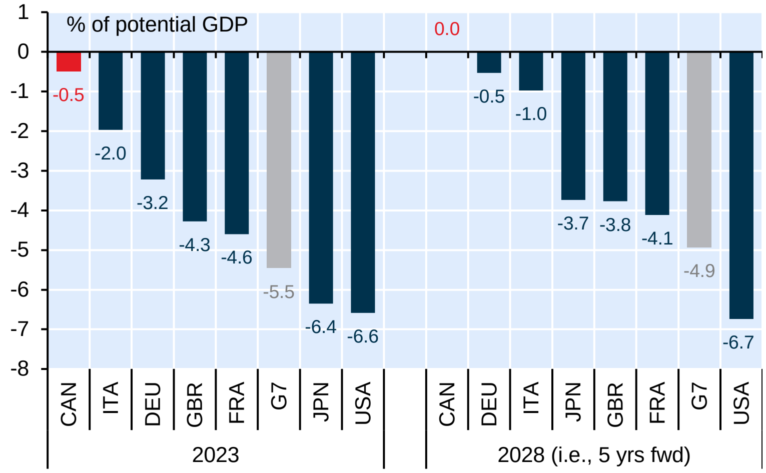


Source: NBF, StatCan, BoC | Note: 40Y of qtrly observations, using 4Q avg for smoothing

So here we are, with a moderate/modest federal government, with an all-but-balanced provincial sector (in aggregate), with local governments precluded from running operational deficits and with a social security system adding to an already sizeable pool of assets. Overall, that leaves Canada with a fully balanced general government fiscal position. You might argue that's a necessary position to be in given the economy has been in excess demand. Fair enough. And we won't pretend that Canadian fiscal policy is perfectly aligned to every challenge or a still-evolving/highly uncertain economic backdrop. A lackluster productivity record remains a noted sore spot and energy transition policies are a work-in-progress (to name two focal areas). But to us, Canada is better positioned than most of its key peers, something the IMF has likewise acknowledged… *<continued>*

Chart 20: Canada to maintain large fiscal edge vs. G7 peers

Gen gov't budget balance, incl. latest IMF projection

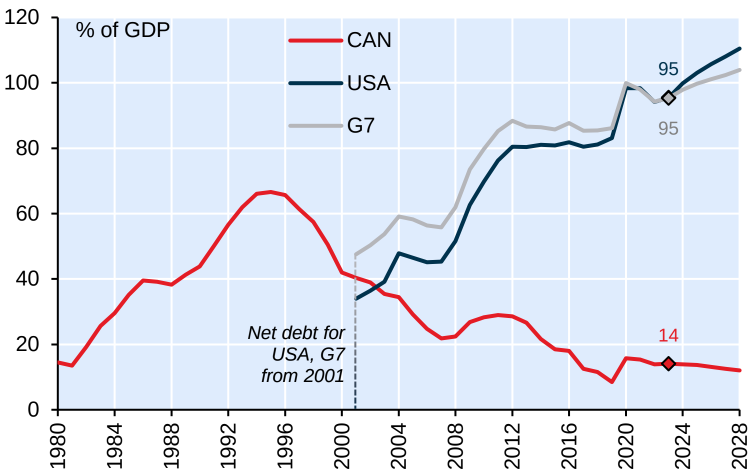


Source: NBF, IMF | Note: Based on Apr-23 WEO, with next update coming Oct-23

Explore the government-related statistics in the IMF's detailed international comparisons and you'll find Canada with the foremost fiscal flexibility in the G7. Consistent with our own view, the IMF has tended to see Canada with a negligible cyclically adjusted general government deficit. Canada can be expected to maintain (really build on) this sizeable fiscal advantage. As Chart 21 should make clear, you don't need too many years to pass by for a serious income statement edge to drive a growing wedge between relative balance sheet or debt metrics. And yes, if not plainly evident, status quo fiscal policy in the U.S. is far from sustainable. If you somehow needed convincing, recent CBO analysis helps drive the point home. Meantime, Fitch's early August downgrade of the U.S. sovereign drew further attention to America's structural budgetary shortcomings.

Chart 21: A much more favourable debt trajectory in Canada

Gen gov't net debt-to-GDP ratio, incl. latest IMF projection

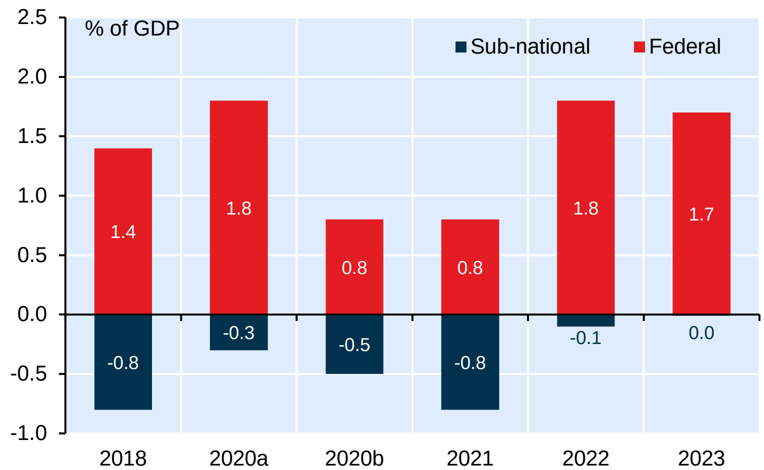


Source: NBF, IMF

To be fair, there's no shortage of *gross debt* in Canada's government sector. But when it comes to the general government *net debt* burden—net debt being a more common fiscal 'anchor', accounting as it does for the value of financial assets—Canada has been best in the G7 since 2005. Our nation's advantage over a more profligate U.S. (or the G7 as a whole) is expected to grow over time, a not-so-trivial consideration in an era when fresh debt is considerably more expensive. As a caution, an ever-expanding debt edge vs. others could prompt some to ask: 'Just how big of a balance sheet advantage does Canada really need?' That's ultimately for voters to decide. While Canadians supported and ultimately benefited from necessary fiscal repair back in the 1990s, opinion polling suggests deficits and debt are hardly top concerns today.

Chart 22: Still excess fiscal room in Canada

PBO estimate of excess fiscal capacity/(gap)



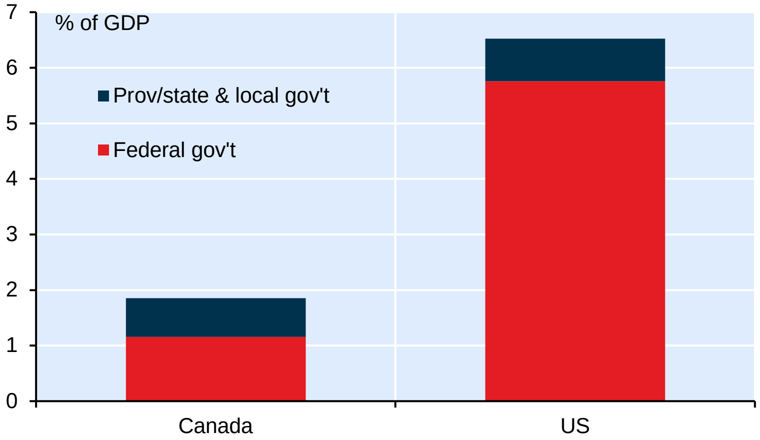
Source: NBF, PBO

If you are still uneasy with the fiscal path Canada appears to be walking, spare a moment for the Parliamentary Budget Officer's latest *Fiscal Sustainability Report*. It seems Canada's status quo fiscal policies aren't all that perilous after all. The PBO's baseline assessment suggests the feds actually have excess 'fiscal room' of 1.7% of GDP (~$50 billion/year in current dollars). In essence, that's the extra room Ottawa has to permanently increase spending and/or cut taxes without driving the debt burden higher over time. Equally important is the PBO's sustainability assessment for sub-national governments. While some regions have work to do, Canada's sub-national governments (in aggregate) are seen on a fully sustainable long-term path. Rating agencies have been encouraged too, a raft of ongoing positive adjustments bolstering average provincial credit quality.

NATIONAL BANK OF CANADA FINANCIAL MARKETS

Chart 23: When it comes to net borrowing, it's no contest

Total government net borrowing (4Q sum as at 2023:Q2)

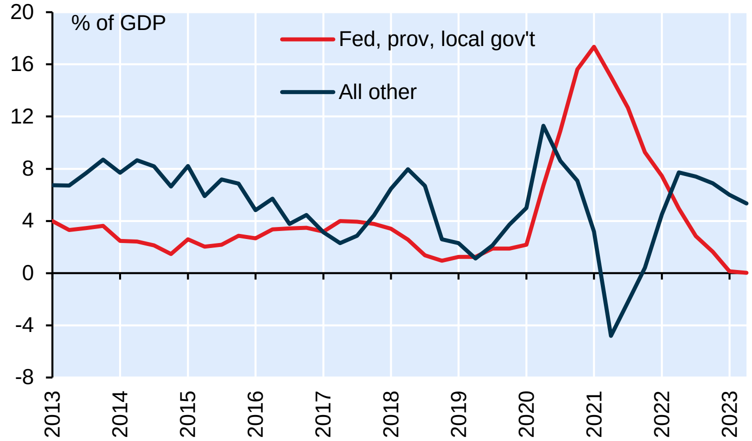


Source: NBF, StatCan, BEA

Time to put these theories to the test, and for that, we'll pivot to the nature and scale of net government borrowing. It comes as no surprise that Canadian governments borrow proportionately far less than their U.S. equivalents. You can observe this all across the yield curve, although it's in longer points (and related curves) where the policy rate trajectory holds less sway and where fiscal risk/term premia/supply technicals exert relatively greater influence. E.g., the relative gulf in 30Y sovereign supply is massive.

Chart 24: No net bond issuance in the general gov't sector

Net Cdn bond issuance (all currencies) as a share of GDP (4Q moving sum)

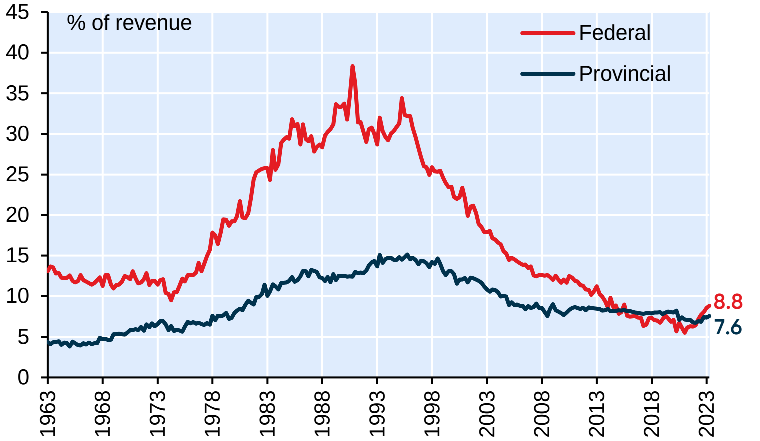


Source: NBF, StatCan

Beyond increasingly timely Canada-U.S. comparisons, consider another angle on the bond supply impulse: Canadian governments vs. all other issuers. As per StatCan's quarterly debt securities data, there's been essentially no net bond issuance across all currency markets by Canadian governments in the past year, whereas other issuing sectors collectively lifted a net $150 billion (CAD equivalent). This net supply distinction remains striking when isolating for purely domestic issuance.

Chart 25: Interest bites low but rising, particularly in Ottawa

Interest expense as a share of revenue by level of government

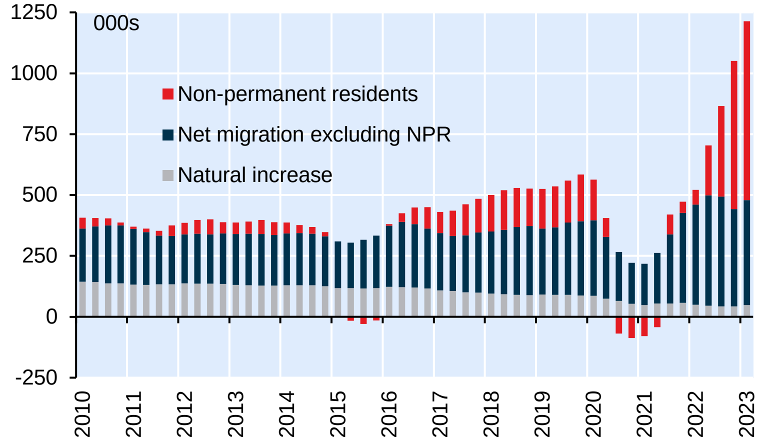


Source: NBF, StatCan

Just because the general government sector is essentially balanced doesn't mean it's everywhere inoculated against interest rate reset risk and debt servicing pressures. As noted, the feds are still running a deficit, the sovereign's debt load thus expanding. A larger share of that debt rolls quicker than at the provincial level. It stands to reason that debt servicing pressures are rising here, as flagged previously. We credit the provinces for limiting their immediate reset risk via years of longer-dated bond supply.

Chart 26: More than spending… look at population growth!

Decomposition of Canada population growth (4Q moving sum)



Source: NBF, StatCan

A last point: If there's inflationary public policy at play, at least in the short term, it's less to do with singular tax or spending initiatives and more a function of Canada's demographic direction. Heady immigration targets and a bevy of temporary entrants mean a burgeoning population—one increasingly hard to accommodate. Turns out, it's not the *size of government* out-of-whack with our near-term monetary policy objectives but the *size of our population*—the extra mouths to feed and bodies to house.

In conclusion… North Americans are increasingly practiced in the fine art of fiscal finger pointing. This is perhaps understandable, such is the extraordinary nature of the current economic condition, complete with above-target inflation and pronounced affordability concerns. You can observe frustration with the stance/slant/size/speed of government policy action. Unceasing party posturing will surely keep perceived fiscal policy follies front and centre, an influential vote looming in the U.S. next year and a Canadian federal election expected no later than 2025. Since emerging from our own fiscal crisis back in 1990s, Canadians have adopted an air of budgetary superiority. And while our governments can't claim policy perfection, it remains the case that Canada's fiscal framework, in the aggregate, is less perilous than some seem willing to accept. Measured broadly, our general government sector is balanced, leaving a relatively low aggregate net debt burden on a more favourable trajectory. True, federal debt continues to accumulate, the related interest bill consuming more financial resources. No longer is the central bank gobbling up this sovereign debt but just the opposite. Notwithstanding Ottawa's budget shortfall, non-partisan analysis shows current federal policy on a sustainable fiscal track, assuming potential GDP growth remains steady. Provincial finances, once a source of concern, have undergone an important transformation. Credit an economic recovery for some of this but structural pressures are being remediated. Rating agencies are taking notice. Meanwhile, an actuarially sound social security system remains an ace up our nation's fiscal sleeve. This is no theoretical discussion, with relative budgetary advantages fully reflected in debt capital markets, whether your focus is international, intra-government or cross-province. Canada's 'fiscal impulse' may not be as grave a direct threat to inflation then. Rather, it's another policy tactic—one centred on aggressive immigration and leading to rapid, hard-to-accommodate population growth—that increasingly looks out-of-whack with near-term inflation goals and is perhaps in need of revisiting.

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