

A Case for Spending Restraint in Canada

How the Federal Government Can Balance the Budget

Grady Munro and Jake Fuss



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Executive Summary

Since 2015, there has been a deterioration in the federal government's fiscal situation. Annual nominal program spending has increased an estimated \$193.6 billion since 2014/15; adjusted for inflation and population growth this represents an extra \$2,330 per person. Prior to the COVID pandemic, spending increased faster than population, inflation, and other relevant economic indicators. These spending increases have resulted in a string of large budgetary deficits that have contributed to an estimated \$941.9 billion increase in gross federal debt from 2014/15 to 2023/24. This accumulation of debt, along with recent hikes in interest rates, has raised the cost of interest on the federal debt to one of the largest budget expense items.

Moving forward, the federal government plans to slow nominal spending growth, which will keep inflation-adjusted, per-person spending relatively constant to 2026/27. Despite this, the federal government will continue running budget deficits and accumulating debt. It is also uncertain whether the federal government's current estimates are truly reliable as the estimates do not incorporate expected spending on pharmacare or the level of defence spending to meet Canada's NATO commitment. Moreover, the federal government's track record of exceeding previous spending commitments calls into question the reliability of the current spending targets. Therefore, it is clear the federal government is not implementing the level of spending restraint necessary to reverse course towards a stable fiscal situation.

An approach to federal finances that continues to run budget deficits and accumulate debt is economically harmful to both current and future generations of Canadians. Research shows that significant increases in debt-financed spending harm economic growth by reducing capital accumulation and labour productivity. Furthermore, accumulating debt today increases the tax burden on future generations of Canadians, as they will be responsible for paying off this debt. Despite these effects, the federal government plans to continue running deficits and accumulating debt for the foreseeable future.

This need not be the case. The federal government can undertake decisive spending reform starting in 2024—similar to the reform by the Chrétien government in the 1990s—that balances the budget within a year or two. The federal government could balance the budget in 2026/27 by limiting annual growth in nominal program spending to 0.3% for two years. This would result in a 5.9% reduction in real per-person spending. Alternatively, the budget could be balanced in 2025/26 if the federal government reduces spending 4.3% for one year; the

next year, 2026/27, would see a budgetary surplus. In this scenario, inflation-adjusted per-person spending would decline by 7.5%. Key trade-offs between the two approaches include the extent of the spending reform and the speed of the return to balanced budgets. Balancing the budget in one year, as opposed to two years, would result in \$30.0 billion less debt accumulated by 2026/27.

Though it is beyond the scope of this study to discuss how such spending reforms should be implemented, there are three areas that might be considered for reform. Business subsidies are a significant expense, yet research suggests they have little if any economic benefit, and may actually harm economic growth when governments pick winners and losers in a free market. Reviewing business subsidies might provide opportunities to find savings. Aligning government-sector wages with those in the private sector would also provide savings, as government workers in Canada currently enjoy an 8.5% wage premium (on average) relative to comparable private-sector workers. Finally, studies show that government fiscal waste can be significant. From 1988 to 2013, more than 600 government failures cost the federal government between \$158.3 billion and \$197.1 billion. Moreover, more than 25% of all federal COVID spending was wasteful. Addressing inefficiencies within government might also reveal savings.

Introduction

For nearly a decade, there has been a marked deterioration in the finances of Canada's federal government. Large budget deficits have become the norm, public debt and debt interest costs are rising, and annual government spending has risen substantially. Furthermore, there does not appear to be an end in sight as higher spending, large deficits, and ever-growing debt are projected for the foreseeable future (Canada, Department of Finance, 2023a). The situation is concerning but the past shows that decisive government action can reverse this trajectory quickly, stabilize government finances, and improve economic conditions.

When Prime Minister Jean Chrétien was elected in 1993, the federal government was facing a worse fiscal situation than today. Poor fiscal management by predecessors meant the Chrétien government inherited federal finances that were heavily reliant on borrowing and a total level of debt that threatened to spiral out of control unless there was a change in course (Clemens, Lau, Palacios, and Veldhuis, 2017). The fiscal situation in the early 1990s was grim, yet in three years the Chrétien government was able to return the federal government to balanced budgets by implementing significant spending reform. This, along with similar reforms in the provinces, helped lay the foundation for the economic success that Canada experienced during the remainder of the 1990s and well into the 2000s.

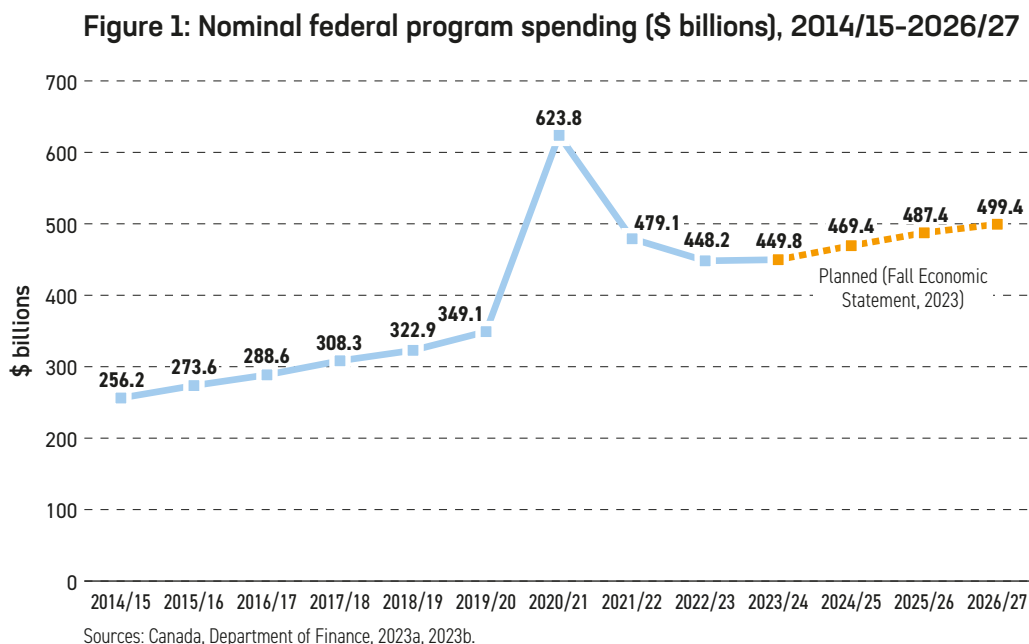
The objective of this study is to analyze the current state of Canada's federal finances, and calculate the level of spending restraint needed to return to a balanced budget within one or two years starting in 2024/25, similar to what was done in the mid-1990s.

Current Fiscal Plan

The Trudeau government’s tenure has been characterized by uninterrupted deficits leading to significant debt accumulation, primarily as a result of continued and often marked increases in program spending. To show this track record, the following series of charts display federal fiscal data since 2014/15. In addition, they display projected data until 2026/27 to show the government’s current fiscal plan for the coming years.

Figure 1 displays actual and planned nominal program spending (total spending minus debt interest costs) from 2014/15 to 2026/27. Total nominal program spending has risen substantially since 2014/15, and is projected to rise even further moving forward. From 2014/15 to 2023/24, annual program spending increased an estimated \$193.6 billion in nominal terms—a 75.5% increase. For reference, the population of the country increased by 11.4%, and cumulative inflation was 25%. In other words, program spending increased well in excess of the amount required to maintain the inflation-adjusted per-person spending levels of 2014/15.

Program spending rose significantly during the COVID-19 pandemic and, though spending partially returned to normal levels as emergency spending wound down, it still remained

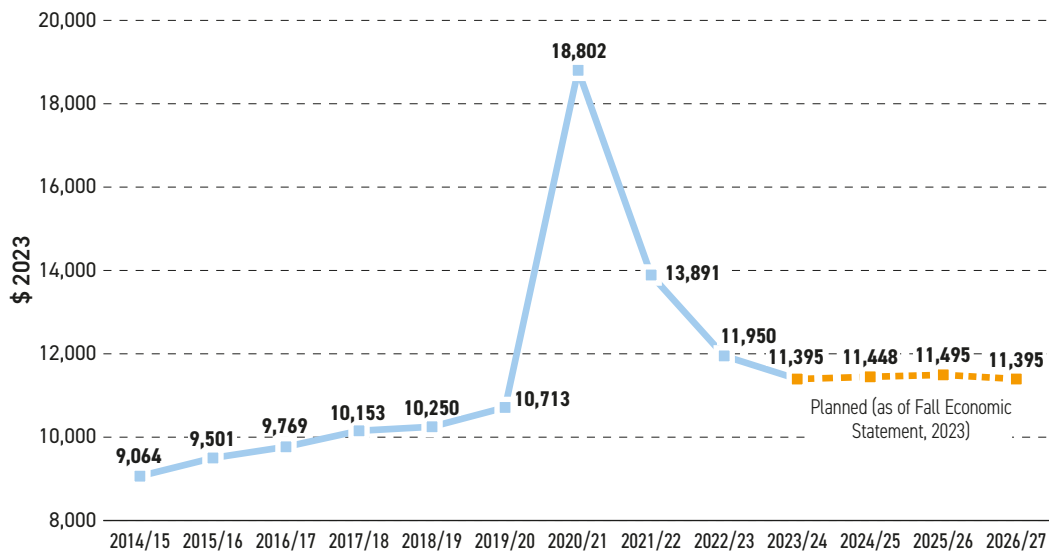


elevated after the pandemic. More specifically, nominal program spending reached \$349.1 billion in 2019/20 but was \$448.2 billion in 2022/23 when no COVID-related spending was incurred, indicating a permanent and sizeable increase in nominal spending by the federal government during the COVID years. Areas driving this permanent spending increase include expanded elderly benefits, the introduction of national child care and dental care, and increased climate financing (Canada, Department of Finance, 2021, 2022).

As part of the federal government’s fiscal plan going forward, nominal annual program spending is expected to reach \$499.4 billion by 2026/27, an extra \$49.6 billion (or 11.0% increase) in annual spending from current (2023/24) levels.

Figure 2 displays actual and planned annual per-person program spending from 2014/15 to 2026/27, adjusted for inflation. Again, it shows the federal government has increased program spending since first being elected, even after adjusting for population growth and inflation. Per-person spending is budgeted to increase 25.7% from \$9,064 in 2014/15 to an estimated \$11,395 in 2023/24. As with total spending, per person spending rose significantly during COVID, yet only partially returned to normal levels following the pandemic. Specifically, per-person federal program spending was \$10,713 in 2019/20, spiked to \$18,802 in 2020/21, and fell to \$11,395 for 2023/24. This still remains 6.4% above 2019/20 levels, even after the pandemic has ended. This increase in spending, unrelated to COVID, has contributed to the Trudeau government’s recording the five-highest years of inflation-adjusted, per-person spending in Canadian history (Fuss, 2023).

Figure 2: Annual federal per-person program spending (\$2023), inflation-adjusted, 2014/15-2026/27

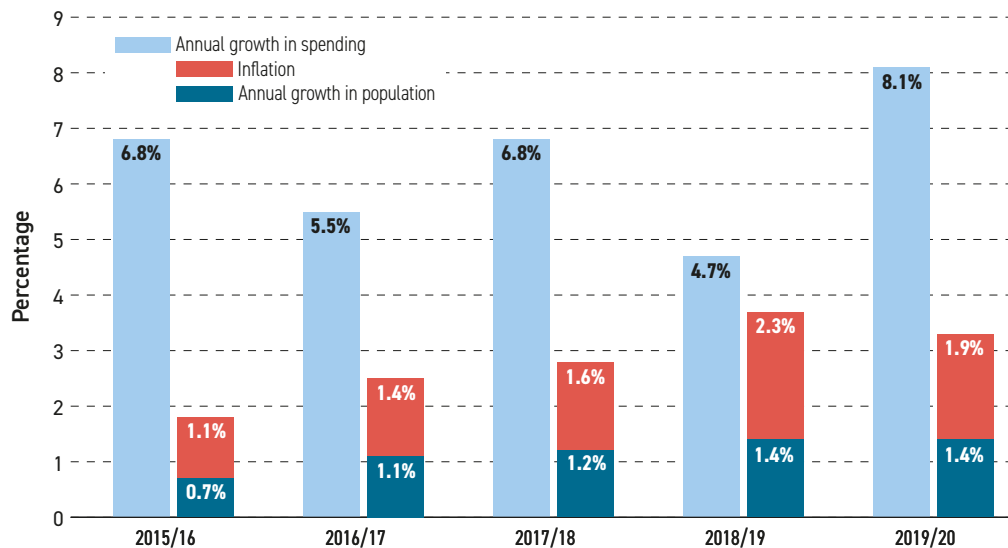


Sources: Canada, Department of Finance, 2023a, 2023b; Statistics Canada, 2022a, 2022b, 2023a; calculations by authors.

Looking ahead, the federal government plans to slow growth in inflation-adjusted, per person spending. In fact, planned per-person spending is essentially flat over the next several years, rising only slightly in 2024/25 and 2025/26, before falling back to \$11,395 per person in 2026/27. This shows an important nuance when interpreting government spending, which is that the change in real per-person spending will not match the change in overall spending.

Inflation-adjusted, per-person spending (as shown in figure 2) is driven by three key factors: program spending, population, and inflation. Accordingly, **figure 3A** displays annual growth rates for those three variables from 2015/16 to 2019/20, in order to further analyze federal spending prior to the pandemic. The graph shows that growth in program spending prior to COVID outpaced that of inflation and population, individually and combined, in every year. At its smallest in 2018/19, annual spending growth (4.7%) still exceeded population growth (1.4%) plus inflation (2.3%) by 1.0 percentage point. For all other years, the gap was roughly three to five times that.

Figure 3A: Annual growth (%) in nominal federal program spending and population; and annual inflation, 2015/16–2019/20



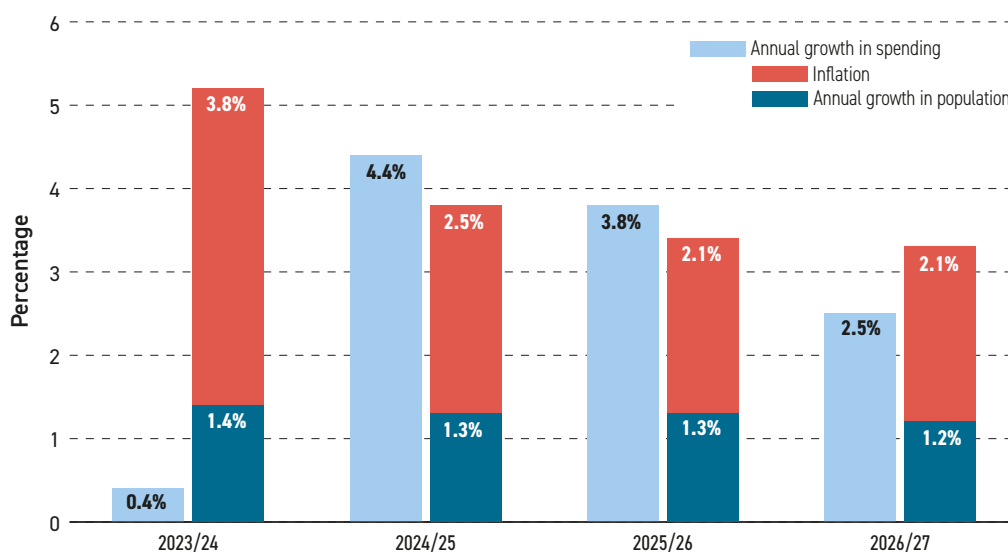
Sources: Canada, Department of Finance, 2023b; Statistics Canada, 2022a, 2023a; calculations by authors.

Spending growth during the pandemic is omitted as it represents significant outliers from the rest of the series. For example, spending growth in 2020/21 was 78.7%, while in 2021/22 spending decreased by 23.2% and, in 2022/23, by 6.5% (Canada, Department of Finance, 2023b). The 78.7% single-year increase in spending was unprecedented, and is not representative of normal government spending. Additionally, observed spending decreases can be attributed entirely to winding down temporary emergency spending for COVID as opposed to spending reform.

Figure 3B displays planned growth in annual program spending and forecast population growth and inflation from 2023/24 to 2026/27. Expected spending growth in 2023/24 is outweighed by both population growth and inflation, resulting in the observed decline in inflation-adjusted, per-person spending (figure 2). However, the following years show that spending growth essentially matches population growth plus inflation. This is why planned per-person spending is relatively flat from 2024/25 to 2026/27.

For more context, consider the growth in nominal program spending alongside other relevant factors. Figures 4A and 4B display the average annual growth of federal program spending compared to the average annual growth in revenue, nominal GDP, and population plus inflation. Like figures 3A and 3B, figure 4A measures average rates over the pre-COVID period of 2015/16 to 2019/20, and figure 4B shows planned average growth rates over the post-COVID period from 2023/24 to 2026/27. For the same reasons as before, data from 2020/21 to 2022/23 is omitted because of the distortionary effects of emergency spending for COVID.

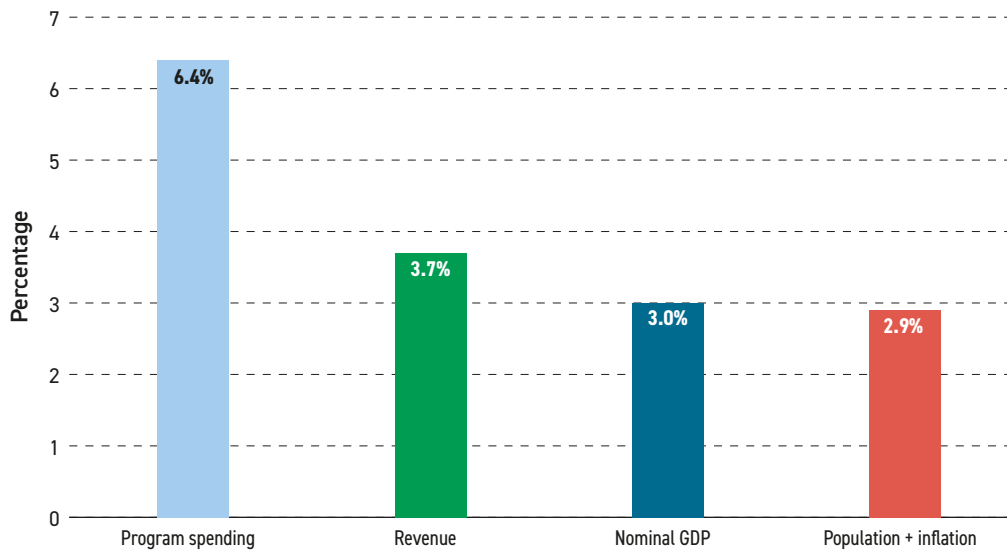
Figure 3B: Planned growth (%) in nominal federal program spending and expected increase in population; and annual inflation, 2023/24-2026/27



Sources: Canada, Department of Finance, 2023a; Statistics Canada, 2022a, 2023a; calculations by authors.

Figure 4A shows that the average annual growth rate of federal program spending from 2015/16 to 2019/20 outpaced growth in government revenue, nominal GDP, and population plus inflation. Average spending growth (6.4%) was 2.7 percentage points higher than growth in revenues (3.7%). Additionally, program spending also increased at more than twice the rate of economic output (3.0%), as measured by growth in nominal GDP, as well as the rate needed

Figure 4A: Average annual growth rate (%) in nominal federal program spending, revenue, and economic indicators, 2015/16–2019/20



Sources: Canada, Department of Finance, 2023b; Statistics Canada, 2022a, 2022b, 2023a, 2023b; calculations by authors.

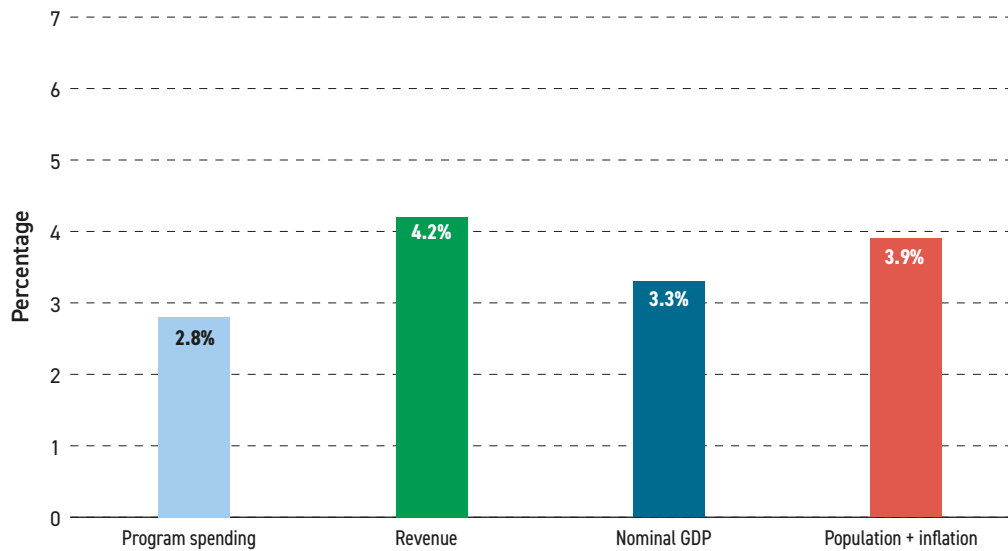
to keep up with a growing population and rising prices (2.9%). Figure 4A shows that prior to the pandemic, nominal program spending grew faster than several other key economic indicators.

Figure 4B shows the federal government's plans to slow spending growth relative to other variables during the coming years. Average annual growth in program spending is expected to be 2.8% from 2023/24 to 2026/27, compared to 4.2% for revenue, 3.3% for nominal GDP, and 3.9% for population plus inflation. While slowing spending growth is a step in the right direction, there are several important caveats that should be considered when interpreting the planned spending data presented in figures 1 to 4B.

First, current spending forecasts do not include spending on national pharmacare. The Trudeau government currently has an agreement with the New Democratic Party that promised legislation for a universal national pharmacare program by March 1, 2024 (Aiello, 2023). It can be expected that pharmacare legislation will be introduced within the coming year. If a national pharmacare program is implemented, according to estimates by the Parliamentary Budget Officer (PBO) it would cost the federal and provincial governments a combined \$11.2 billion in its first year, rising to \$13.4 billion in 2027/28 (PBO, 2023).

Similarly, in 2023 the federal government reaffirmed its commitment to the North American Treaty Organization (NATO) to spend 2% of GDP on national defence (NATO, 2023). In 2022, Canada spent 1.29% of GDP on defence and the PBO estimated that, if the federal government is serious in its commitment, it would take a cumulative \$41.6 billion in additional spending to meet the 2% target from 2024/25 to 2026/27 (PBO, 2022). Should the

Figure 4B: Average expected annual growth (%) in nominal federal program spending, revenue, and economic indicators, 2023/24-2026/27



Note: Spending and revenue data represent planned values presented in the Fall Economic Update 2023.

Sources: Canada, Department of Finance, 2023a; Statistics Canada, 2022a, 2022b, 2023a, 2023b; calculations by authors.

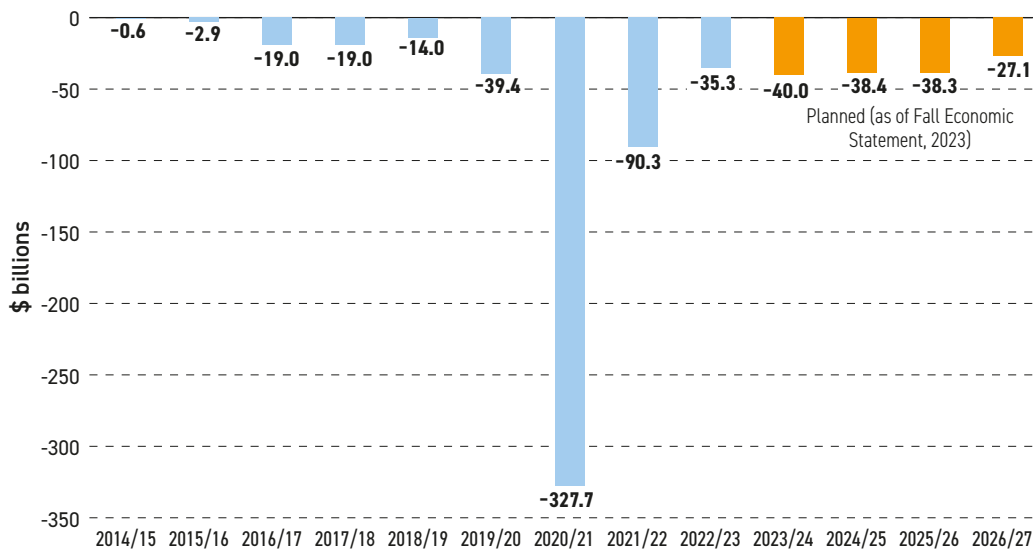
federal government raise defence spending to meet its NATO target or introduce a universal pharmacare system, expected spending until 2026/27 would increase by tens of billions past what was forecast in the most recent fiscal update.¹

Finally, the federal government also has a track record of exceeding its own spending targets. For example, consider estimates of program spending for the 2023/24 fiscal year. As presented in *Budget 2021*, planned federal program spending in 2023/24 was \$416.9 billion (Canada, Department of Finance, 2021). The following year, in *Budget 2022*, planned program spending for 2023/24 was \$436.5 billion, or \$19.6 billion higher than estimated in *Budget 2021* (Canada, Department of Finance, 2022). As part of the 2023 *Fiscal Update*, current spending estimates for 2023/24 now exceed the *Budget 2021* estimates by \$32.9 billion. Future spending estimates provided by the current federal government have consistently been lower than actual spending. The federal government's track record, along with the potential for new spending on pharmacare or defence, suggest it is unlikely the government will stick to its projections of slowed spending growth.

As part of its election platform, the Trudeau Liberals campaigned on running a series of small deficits (under \$10 billion) before returning to a balanced budget in 2019/20 (Liberal Party of Canada, 2015). **Figure 5** displays the annual budgetary balance from 2014/15 to 2026/27, and shows the government abandoned its campaign commitments very quickly.

¹ See Clemens, Fuss, and Munro, 2023 for additional discussion of the effects that additional defence spending and pharmacare would have on federal finances.

Figure 5: Annual federal budgetary balance (\$ billions), nominal, 2014/15–2026/27

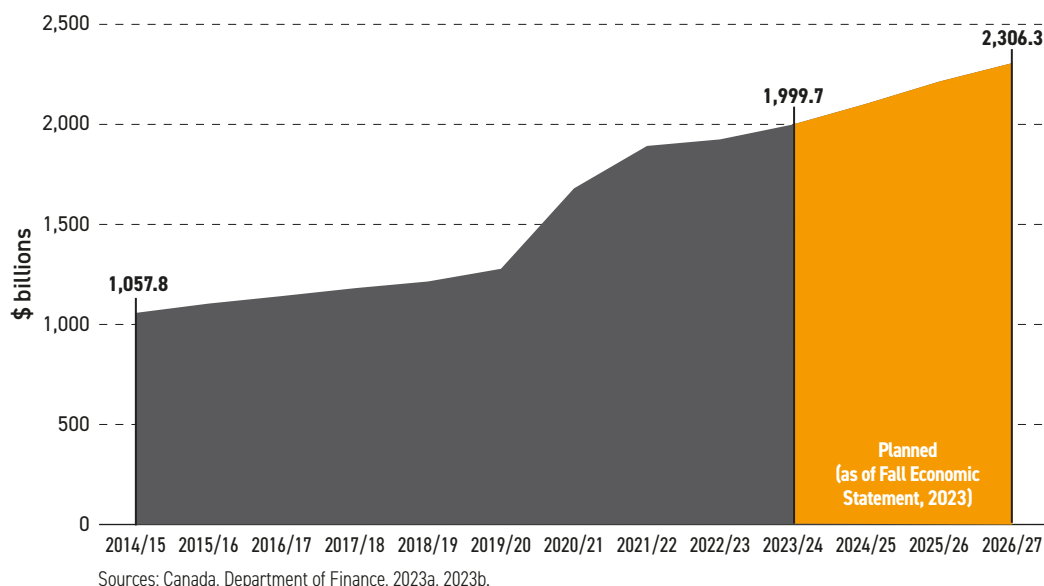


Sources: Canada, Department of Finance, 2023a, 2023b.

Instead, the Trudeau government has run deficits every year since first elected, with the last five deficits (2019/20–2023/24) all exceeding \$35 billion per year. Moreover, the federal government intends to continue running similarly large deficits in the coming years, with no indication of when the government will return to a balanced budget.

These deficits have resulted in a substantial accumulation of debt, which increases even further over the coming years. **Figure 6** shows federal gross debt from 2014/15 to 2026/27. Since 2014/15, gross debt has nearly doubled from \$1.06 trillion to an estimated \$2.0 trillion in 2023/24. As a share of the economy, the gross debt-to-GDP ratio is expected to reach 69.7% in 2023/24 (Canada, Department of Finance, 2023a). Over the next three years, debt is expected to grow a significant \$306.6 billion, up to \$2.3 trillion in 2026/27. Relative to the economy, gross debt is projected to rise to 72.0% of GDP by 2026/27.

Accumulating debt comes with consequences because, just as a household must pay interest on a loan, governments must pay interest on debt. All else equal, as the total amount of government debt rises, so does the amount of interest that must be paid on that debt. Indeed, from 2019/20 to 2023/24, annual interest costs on debt nearly doubled from \$24.4 billion up to an expected \$46.5 billion. By 2026/27, interest costs will reach \$55.1 billion per year. These are government expenditures that do not go towards any government services such as health-care or defence. The majority of this increase in interest costs on debt has occurred in the last two years, as the effects of massive debt accumulation during the pandemic along with rising interest rates have begun to show up in actual interest payments.

Figure 6: Federal gross debt (\$ billions), nominal, 2014/15–2026/27

Figures 1 to 6 demonstrate the federal government has increased annual program spending since 2014/15, relying largely on debt to finance its spending habits. Furthermore, despite a tentative move towards slowed spending growth and constant per-person spending, continued large deficits and an ever-growing debt burden still appear to be a part of the federal government's fiscal plan moving forward.

Reasons for concern

This approach to fiscal policy is a concern for several reasons. Growing the level of government spending through continued debt increases means higher interest costs, which strain government finances as more money must be devoted towards servicing debt, leaving less for programs and services. For example, in 2023/24 the federal government expects to pay roughly \$46.5 billion interest on debt, which is nearly as much as it expects to pay out through the Canada Health Transfer (\$49.4 billion) and much more than it will spend on childcare benefits (\$31.2 billion) (Canada, Department of Finance, 2023a).

Growing debt interest costs as a share of the budget can create a vicious cycle whereby the government is pressured to take on more debt to maintain spending for other programs, which then helps grow interest costs even further and can ultimately result in a downgrading of the quality of government debt, which also results in higher interest rates. While interest costs as a share of the budget fell from 8.6% of total revenues in 2014/15 to 7.3% in 2019/20, the recent increase in interest costs mean they are now expected to reach 10.2% of revenues

in 2023/24 (Canada, Department of Finance, 2023a, 2023b). Although this value alone is not cause for alarm, it is important to recognize it has reversed a decade-long decline, since 2009/10, in interest costs as a share of total government revenues.

Additionally, when the government runs deficits it increases the tax burden on future generations because they are ultimately responsible for paying off debt accumulated today. Some argue that, as long as the economic growth rate is higher than the interest rate on debt, governments can accumulate debt indefinitely without needing to eventually raise taxes to pay it off (see Mian, Straub, and Sufi, 2022). However, this argument does not always hold. A number of studies² show that increasing government debt slows economic growth and raises interest rates, so there comes a point where the interest rate is higher than economic growth and that level of debt becomes unsustainable. At that point, the government will need to pay down its debt, likely through higher taxes. Dahlby, Ferede, and Fuss (2022b) explain that these future tax increases could exceed the initial increase in spending, meaning that one dollar borrowed today would need to be paid back by more than one dollar in future tax revenue (adjusting for inflation). As a result, not only do deficits today expand the tax burden on future generations, but they do so disproportionately.

Finally, the effect of high and increasing public debt on economic growth should not be understated. When governments borrow significant amounts, it creates uncertainty around future tax increases, which reduces incentives to work and save (Puonti, 2022). This, combined with the crowding out of private investment, acts to slow business investment and gains in labour productivity (Ardagna, Caselli, and Lane, 2004; Woo and Kumar, 2014). Since capital and labour productivity are key drivers of an economy's output, high levels of public debt act to slow economic growth and, consequently, reduce living standards. Considering its many impacts, it is clear continued increases in debt-financed spending is an economically harmful policy that is detrimental to both current and future generations of Canadians, as well as threatening the sustainability of government finances.

2 See Puonti, 2022, Eberhart and Presbitero, 2015, and *Woo and Kumar, 2014* for discussions on the negative relationship between public debt and economic growth. Additionally, see Ardagna, Caselli, and Lane, 2004, Kinoshita, 2006, and Jiang, Lustig, Van Nieuwerburgh, and Xiaolan, 2022 for discussions on the positive relationship between the public debt and interest rates.

Plans to Achieve a Balanced Budget

While the current approach to government finances is concerning and existing plans promise more of the same, decisive action from the federal government can reverse course and avoid further deterioration of public finances. The following section presents a model demonstrating that, by exercising spending restraint starting in 2024/25, the federal government can—depending upon how much spending is restrained—balance the budget within one or two years.

Past history shows that spending restraint is an effective tool to reverse deteriorating government finances. In the early 1990s, nearly one third of federal spending was funded by debt and accumulated net federal debt amounted to 70.9% of GDP. Moreover, the cost of interest on this debt as a share of government revenues amounted to over 30% in 1993: roughly one in three dollars collected in revenue was spent on debt interest.³ Federal government debt threatened to spiral out of control yet, through a reexamination of federal spending that resulted in a 9.7% reduction,⁴ over two years along with limited spending growth in the third year, the Chrétien government was able to balance the budget and help usher in a period of strong economic growth and prosperity (Clemens, Lau, Palacios, and Veldhuis, 2017).

Multiple studies make the case for using spending reductions to balance a government's budget, rather than the alternative of raising taxes. Alesina and Ardagna (2010) examine a number of large fiscal adjustments in OECD countries from the 1970s until 2007, and find that adjustments based on spending reductions, with no tax increases, were more effective at stabilizing debt and avoiding a recession. More recently, Alesina, Favero, and Giavazzi (2018) examined the recent body of literature on the effects of multi-year fiscal plans for deficit reduction, and find that reductions based on spending cuts are far less economically costly than those based on tax adjustments. In some instances, spending reductions

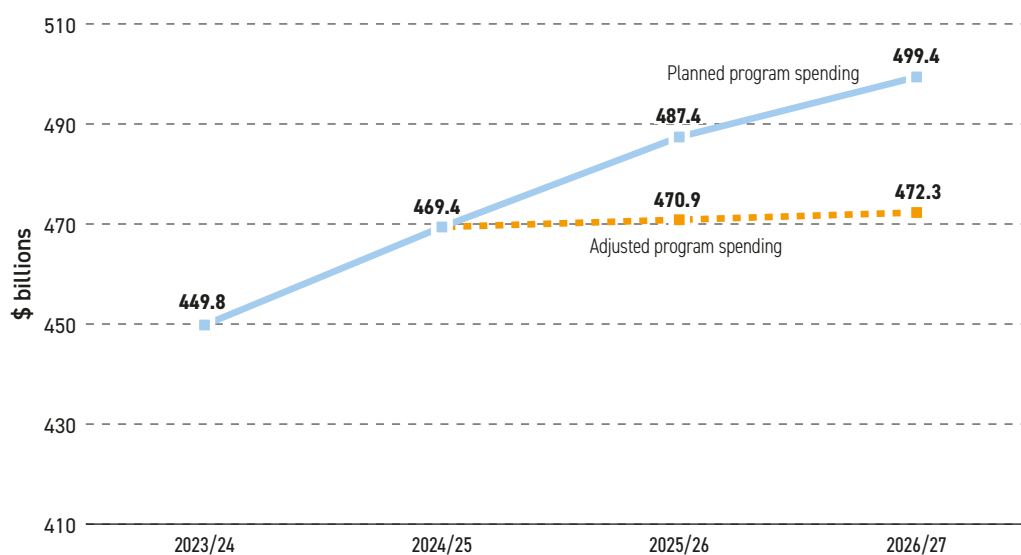
3 For perspective, the current net debt-to-GDP ratio is estimated at 46.4%, while federal debt interest costs account for 10.2% of revenues (Canada, Department of Finance, 2023a).

4 It should be noted that the Chrétien government did incorporate some tax increases as part of its fiscal plan although spending reductions remained the primary mechanism to reduce the deficit. Furthermore, at the same time as the Chrétien government was balancing the federal budget, Alberta's Klein government was successfully balancing its budget, using no tax increases but instead relying solely on spending reform and reductions (Clemens, Lau, Palacios, and Veldhuis, 2017).

can even contribute to the expansion of the economy, with Alesina and colleagues (2018) pointing to Canada's efforts in the 1990s as an example where such action led to a faster growing economy.

In line with the literature, and past Canadian history, figures 7, 8, and 9 display a model of spending restraint by which the federal government can balance the budget by 2026/27. **Figure 7** displays currently planned federal program spending, overlaid with the adjusted nominal program spending, and **figure 8** shows the corresponding real per-person spending values. **Figure 9** displays planned budgetary balances compared with those resulting from the spending adjustments.⁵ The figures show that rather than cutting overall spending, the federal government would be able to balance the budget in 2026/27 by slowing growth in program spending to just 0.3% per year from 2024/25 to 2026/27.

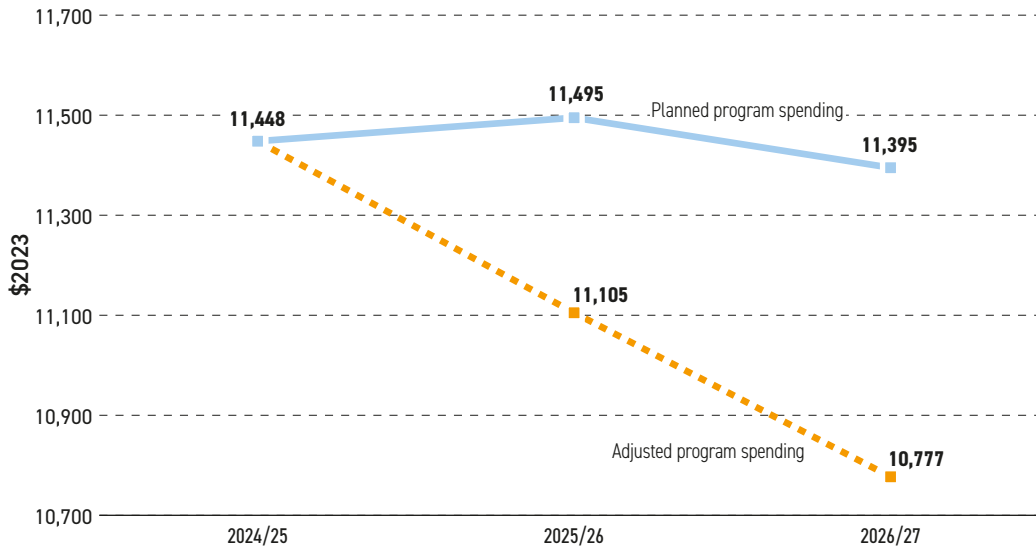
Figure 7: Planned federal program spending (\$ billions), nominal, and program spending adjusted to achieve a balanced budget by 2026/27



Sources: Canada, Department of Finance, 2023a; calculations by authors.

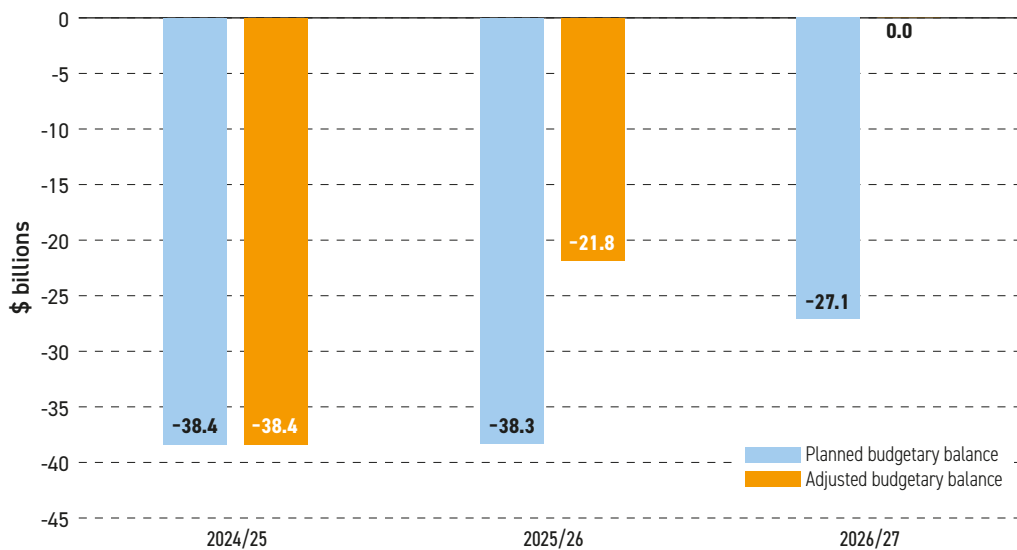
5 There are several assumptions incorporated into this model. First, it is assumed that federal revenue and the cost of interest on debt will remain the same as projected in Canada, Department of Finance, 2023a. As a result of this assumption, the spending reductions necessary to balance the budget likely represent overestimates, as debt interest costs in these scenarios will likely be lower than currently projected as a result of less accumulated debt. It is also assumed that population growth will remain consistent with estimates provided by Statistics Canada (2022a, 2022b). Finally, it is assumed that expected GDP growth and inflation will remain consistent with projections in Canada, Department of Finance, 2023a. These assumptions are consistent across both the two-year and one-year balanced-budget scenarios.

Figure 8: Planned federal per-person program spending (\$2023) and per-person program spending adjusted to achieve a balanced budget by 2026/27, inflation-adjusted



Sources: Canada, Department of Finance, 2023a; Statistics Canada, 2022a, 2022b, 2023a; calculations by authors.

Figure 9: Planned budgetary balances (\$ billions) versus adjusted budgetary balances with slower growth in program spending, nominal, 2024/25-2026/27



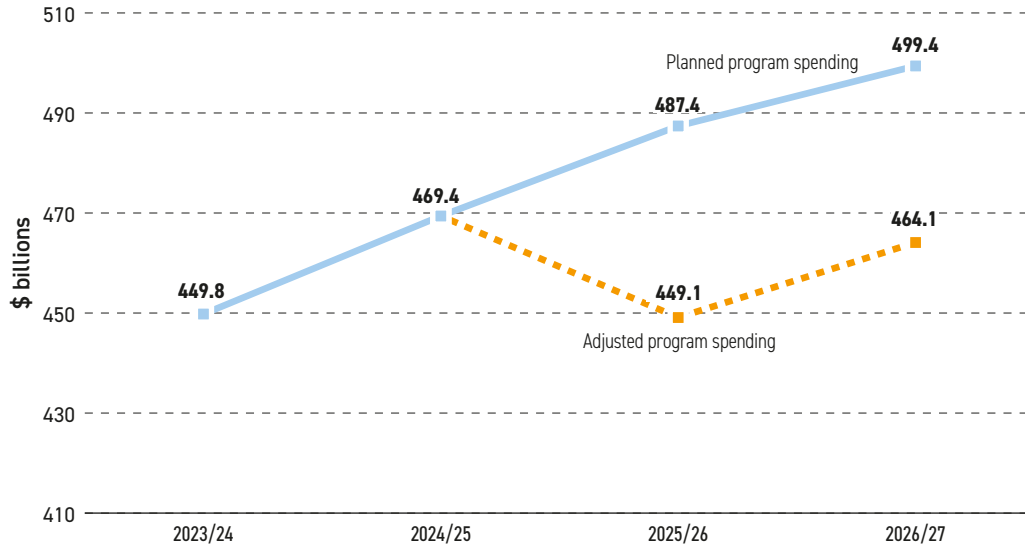
Sources: Canada, Department of Finance, 2023a; calculations by authors.

In the slowed-growth scenario, nominal program spending would increase from \$469.4 billion in 2024/25 to \$472.3 billion in 2026/27 rather than the \$499.4 billion that is currently projected. Although total federal program spending will still increase in this scenario, real per-person spending will decrease as spending growth falls behind projected population growth and inflation. Specifically, real program spending per person will fall from \$11,448 in 2024/25 to \$10,777 in 2026/27. This is a 5.9% decline in inflation-adjusted per-person spending, as opposed to the current fiscal plan which projects a 0.5% decline. By slowing growth in program spending, the federal government would run a budget deficit in 2025/26 that is \$16.6 billion smaller than it currently plans to run, and would achieve a balanced budget in 2026/27 as opposed to a \$27.1 billion deficit.

The slowed-growth scenario represents a conservative approach to spending restraint and deficit reduction, which carries risks. For example, the *Ontario Budget 2015* presented a fiscal plan that projected a return to balanced budgets by 2017/18, based on slower spending growth averaging 0.5% over three years (Ontario, Department of Finance, 2015). Following the budget's release, the province's own Financial Accountability Office highlighted the risks of this approach, namely that such a commitment came with no explicit plan on how to limit growth in spending, and hinged on overly optimistic revenue projections to achieve a balanced budget (Ontario, Financial Accountability Office, 2015). Indeed, history shows the province failed to achieve this goal and the Ontarian government ran uninterrupted deficits until 2021/22 (Canada, Department of Finance, 2023b). An approach based on slowed growth by the federal government would carry similar risks. Therefore, figures 10 to 12 present an alternative path to a balanced budget, one that increases the likelihood of success by front-loading active spending reductions for a more deliberate approach to a balanced budget. Specifically, the figures illustrate spending reductions, starting in 2024/25, that would balance the budget within one year and result in a subsequent budgetary surplus in 2026/27.

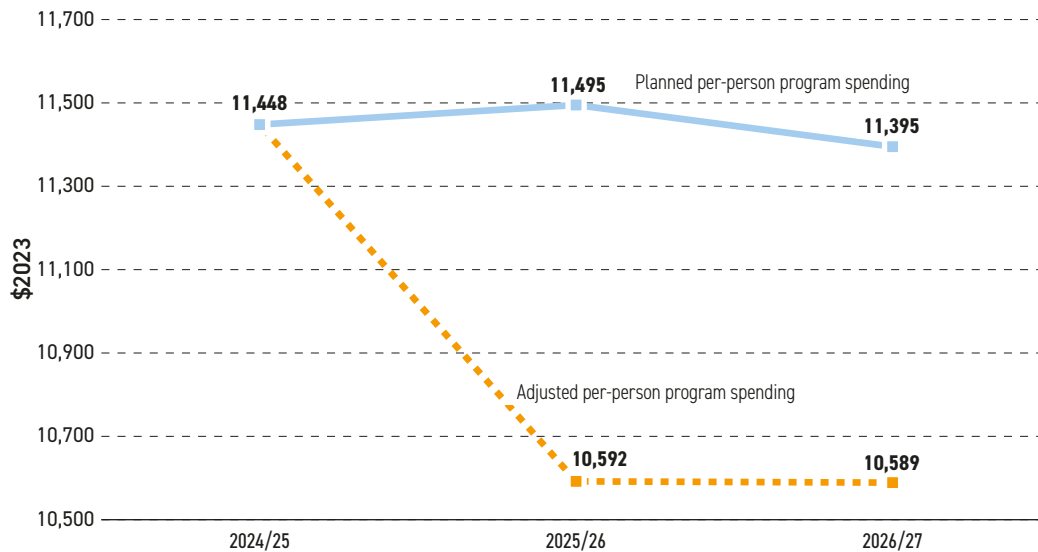
Figure 10 displays currently planned federal program spending along with adjusted program spending. **Figure 11** shows the corresponding real per-person spending values, while **figure 12** displays planned budgetary balances compared with those resulting from the alternative spending plan that includes actual reductions in 2025/26. The figures show that, if nominal program spending is decreased by 4.3%, from \$469.4 billion in 2024/25 to \$449.1 billion in 2025/26, the federal government can move from a \$38.4 billion deficit in 2024/25 to a balanced budget in 2025/26. Per person, the spending reduction becomes more substantial as real per-capita spending would fall 7.5% from 2024/25 to 2025/26. However, once the budget is balanced the federal government could resume increasing program spending at the same rate as population growth plus inflation (3.3%). This is higher than the 2.5% increase currently planned by the federal government in that year. Following the spending increase in 2026/27, the federal government would run a \$8.2 billion surplus in the spending-reduction scenario, as opposed to the \$27.1 billion deficit that is currently projected.

Figure 10: Planned federal program spending (\$ billions), nominal, and program spending adjusted to achieve a balanced budget by 2025/26



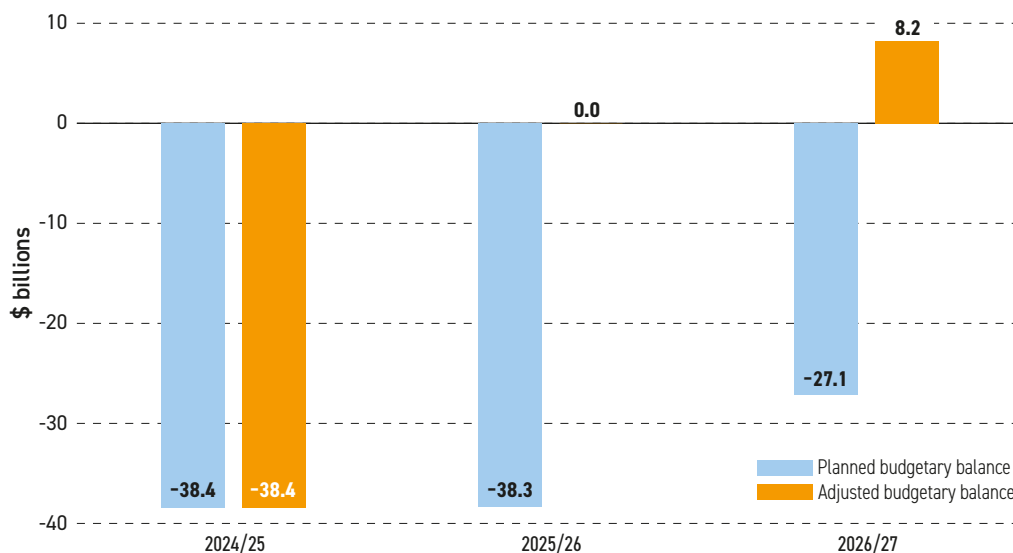
Sources: Canada, Department of Finance, 2023a; calculations by authors.

Figure 11: Planned federal per-person program spending (\$2023) and as adjusted to achieve a balanced budget by 2025/26, inflation-adjusted



Sources: Canada, Department of Finance, 2023a; Statistics Canada, 2022a, 2022b, 2023a; calculations by authors.

Figure 12: Planned budgetary balances (\$ billions) versus adjusted budgetary balances with spending reductions in 2025/26, nominal, 2024/25–2026/27



Sources: Canada, Department of Finance, 2023a; calculations by authors.

It is important to note that both balanced budget scenarios in this study represent modest fiscal adjustments relative to the reforms implemented by the Chrétien government in the 1990s. At that time, the federal government reduced overall program spending by 9.7% over two years, which translated to a 15.5% reduction in real per-person spending (Clemens, Lau, Palacios, and Veldhuis, 2017). For comparison, balancing the budget by 2026/27 allows for a 0.6% increase in federal program spending over two years, while per-person spending would fall 5.9%. To balance the budget in one year, by 2025/26, the federal government must reduce overall program spending by 4.3%, or 7.5% per person. Although the one-year balanced-budget scenario would require a more significant spending reduction than the two-year scenario, it is still less than half the reduction undertaken by the Chrétien government.

Slowing the growth of debt

Through efforts to restrain spending and balance the budget, the federal government would slow the growth in overall federal debt. **Table 1** displays planned gross debt levels from 2024/25 to 2026/27, along with gross debt that would be accumulated in each of the two balanced-budget scenarios. With planned spending and deficits, gross debt is forecast to increase 9.7% from 2024/25 to 2026/27. If the government balances the budget by 2026/27 gross debt would increase by 7.6% during that same period. If the federal government balances the budget in 2025/26, gross debt would increase by 6.2%.

Table 1: Accumulated federal gross debt (\$ billions), 2024/25-2026/27

	2024/25	2025/26	2026/27
Gross debt with planned deficits	2,102.8	2,213.8	2,306.3
Gross debt with balanced budget by 2026/27	2,102.8	2,197.3	2,262.7
Gross debt with balanced budget by 2025/26	2,102.8	2,175.5	2,232.7

Sources: Canada, Department of Finance, 2023a; calculations by authors.

In other words, a faster and more decisive move to balance the budget would enable Ottawa to accumulate less debt. By balancing the budget in two years the federal government would accumulate \$43.7 billion less debt than it currently plans. It would accumulate \$73.6 billion less than currently planned if it were to balance the budget in one year. This further illustrates an important trade-off between the two scenarios, whereby balancing the budget in one year would require stricter spending reform (that is, spending reductions as opposed to slowed growth) but allow the federal government to return to surpluses faster and accumulate less debt. However, both scenarios result in less debt accumulation, which would help slow the growth in the cost of interest on the debt and further improve the federal fiscal situation.⁶

From the models presented in figures 7 to 12 and table 1, it is clear the federal government can quickly return to a balanced budget as long as it takes decisive action to control spending. Furthermore, both paths to a balanced budget are modest compared to the actions taken by the Chrétien government in the 1990s. An important caveat is that the federal government would likely need to decrease spending further, or at least be more aggressive in limiting year-over-year growth, than presented in this study to create the fiscal room to introduce meaningful tax relief, as was done by the Chrétien government following its success in balancing the budget (Clemens, Lau, Palacios, and Veldhuis, 2017).

Where are savings to be found?

The question now becomes how to implement spending reform and from which areas of government spending should savings be found? The Chrétien government sought to answer this question by systematically evaluating all federal government spending using the following metrics (Canada, Department of Finance, 1994):

⁶ As mentioned, although decreased debt accumulation would help slow the growth in debt interest costs, this is not reflected in this model as debt interest costs are held constant across all scenarios.

1. serves the public interest;
2. necessity of government involvement;
3. appropriate federal role;
4. scope for public sector / private sector partnerships;
5. scope for increasing efficiency;
6. affordability.

The federal government could engage in a similar review process in 2024/25 to find targets for spending reforms, but it is beyond the scope of this study to discuss how these specific reforms could be implemented to achieve a balanced budget. However, research highlights a few general areas that could be targeted.

Business subsidies represent a significant expense for Canadian governments that produces little to no economic benefits for the broader economy. Hill and Emes (2023) explain that from 2007 to 2019, federal, provincial, and local governments spent roughly \$352.1 billion (inflation-adjusted) on business subsidies, more than the federal government spent on national defence (\$327.5 billion, inflation-adjusted) during the same period. Despite absorbing significant amounts of government resources, business subsidies generate little to no economic growth, and might actually have a negative economic impact as a result of the distortionary effects of governments' attempts to pick winners in the free market (Hill and Emes, 2023). Given the size of these expenditures, for little to no economic gain and potential for economic harm, business subsidies are a possible target for spending reform.

Another target for spending reform may be to align government-sector wages more closely with those in the private sector. A recent study showed that in 2021 government-sector workers in Canada enjoyed an 8.5% wage premium, on average, over their private-sector counterparts, even after controlling for a large number of relevant factors like sex, age, marital status, and education. In addition to higher wages on average, government-sector workers enjoyed more generous benefits and higher job security compared to their private-sector counterparts (Palacios, Li, and Eisen, 2023). Given the federal government currently employs over 350,000 workers (Canada, Treasury Board of Canada Secretariat, 2023), aligning government-sector wages more closely with the compensation provided to comparable private-sector workers might yield significant savings.

Finally, a third target is the general issue of government fiscal waste. Lammam, MacIntyre, Clemens, Palacios, and Veldhuis (2013) reviewed the Auditor General's reports from 1988 to 2013 and found more than 600 instances of government failure across multiple federal

governments. There were many types of failures including, but not limited to, cost overruns, over-/under-payment of benefits, or failure to achieve stated objectives. The cumulative cost of these government failures was estimated to have been between \$158.3 billion and \$197.1 billion. Alternatively, Fuss and Hill (2023) estimated that during the COVID-19 pandemic the federal government wasted at minimum 25% (\$89.9 billion) of its total COVID spending. Taken together, these studies point to billions of dollars in savings that could be found by the federal government if it engaged in a serious review of its own operations and sought to eliminate these inefficiencies.

Conclusion

Federal fiscal policy has included little to no restraint on spending for nearly a decade, which has resulted in a string of large deficits, a significant accumulation of debt, and rising costs for interest on the debt. This approach is economically harmful and imposes real costs on Canadian taxpayers, yet the federal government appears unwilling to take the necessary steps to change course. Instead, the current fiscal plan accumulates more debt and promises no return to balanced budgets for the foreseeable future. Despite government forecasts, however, a balanced budget is within grasp as long as the federal government commits to exercising genuine spending restraint.

As modeled in this study, the federal government has two options to balance the budget if it controls spending. The first option is a balanced budget in two years (by 2026/27), as long as growth in nominal program spending is limited to 0.3% each year. The second option is a balanced budget within one year (by 2025/26), as long as nominal program spending is reduced by 4.3% during that year. Each option comes with different benefits and drawbacks; however, both scenarios are modest compared to the spending reductions implemented by the Chrétien government during the 1990s. This study does not provide an in-depth analysis of how such savings should be found but three areas that could be targeted with spending reform are business subsidies, aligning government-sector wages with those in the private sector, and seeking to reduce government fiscal waste.

The federal government's challenges will not be solved overnight, and a balanced budget should be viewed as a starting point rather than the end goal of any fiscal reform. Therefore, in addition to the spending reform presented in this study, the federal government should pursue longer-term fiscal policies to help improve its finances.

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