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FISCAL AND TAX POLICY

The Fiscal Update the Government Should Have Produced and the Budget Canada Needs

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Introduction: No Budget, No Plan

The federal government has said it will not release a budget until the fall. Delaying a budget until the fiscal year is more than half over is never good, but Canada's current high spending trajectory makes this delay especially bad. The government is making costly commitments without showing us the key numbers: how much more tax it expects to collect; how far its new spending will exceed its revenues; and what the resulting higher deficits imply for interest costs and our debt burden.

To fill in at least some of the information the government should be providing, we present our own fiscal update: the outlook that provides a context for the next federal budget. We then discuss possible measures the next budget could contain to address runaway spending, perpetually high deficits and debt, and vulnerabilities Canada should avoid at a time of severe economic challenge.

A Deteriorating Fiscal Outlook

To calculate the federal government's bottom line in the current fiscal year, 2025/26, and the three following years, we followed the steps summarized in Table 1 (on page 3):

1. We started with the Liberal Party's costing document for its election platform (Liberal Party of Canada 2025). Based on a March 2025 economic scenario from the Parliamentary Budget Office (PBO), it did not reflect the impact of US tariffs or Canada's countermeasures (PBO 2025).
2. We updated the economic assumptions based on the Bank of Canada's April 2025 Monetary Policy Report, using the more optimistic of the two scenarios examined by the Bank, both regarding the severity of tariffs and resulting economic damage (Bank of Canada 2025).

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3. We calculated a revised baseline fiscal projection by including policy initiatives that appear firm – either because of definitive statements, such as the cancellation of the proposed changes to capital gains taxation and the June 2025 plans to first accelerate defence spending to 2 percent of GDP and then gradually increase it to 5 percent by 2035, or because legislation is currently before Parliament, as is the case for cuts to the bottom personal income tax rate, the GST break for first-time homebuyers under Bill C-4,[1] and the government's announcement that it will not proceed with the digital services tax (DST).
4. We added the spending measures from the Liberal platform's costing document that were not included in the previous step.
5. We added platform proposals for increasing revenue from higher fines and penalties and, more significantly, for reducing spending through a review of public sector operations to boost productivity. We show these as a memo item, since the lack of concern about the bottom line evident in the platform and subsequent announcements, and the lack of urgency evident in the government's decision to delay the budget, makes it reasonable to doubt that these savings will materialize.

The resulting bottom line represents a marked deterioration, as Table 1 shows. As recently as the April 2024 budget, the government projected the deficit to decline to $20 billion by 2028/29.[2] With this baseline, and even if the imagined fines and savings were realized in full, the deficit that year would be more than three times that level. Even in this optimistic scenario, the deficit would average $78 billion annually over the four years, and the net debt-to-GDP ratio would rise to 45 percent. Excluding the speculative savings, the cumulative deficit would be almost $350 billion over four years – or an annual average of $86 billion – and the net debt-to-GDP ratio would increase to 46 percent. Further, the baseline deficit without any of the non-implemented initiatives in the electoral platform is still elevated at $66 billion per year on average.

These projections include our estimates of the potential impact of the new defence spending commitments made at the recent NATO summit. At that summit in The Hague, Canada joined a pledge to raise defence and security-related spending to 5 percent of GDP by 2035 (3.5 percent for direct military needs and 1.5 percent for security-related investments).

No details on the year-to-year increases have been announced, but countries are expected to submit multi-year roadmaps by mid-2026. Prime Minister Mark Carney also indicated that some of the 1.5 percent for security-related investments – such as critical mineral infrastructure, ports, telecommunications, and cyber – could be counted from existing budget envelopes.

In Table 2, we present a hypothetical scenario where annual defence spending rises gradually from 2 percent of GDP to 5 percent of GDP over 10 years, with half of the spending allocated to depreciable capital assets. Under this scenario, we estimate the direct military component of the pledge would add $2.3 billion to the deficit this fiscal year, rising to $11.8 billion in four years. Assuming half of the new spending on security-related investments comes from existing envelopes, the deficit would be $17.8 billion higher in four years. These amounts continue to grow over the 10-year period as the 5 percent target approaches and the stock of amortized capital outlays increases. By year 10, new defence commitments could add a staggering $68.4 billion to the deficit under this scenario.

1 Parliament of Canada. 2025. *Bill C-4: Making Life More Affordable for Canadians Act.* 45th Parliament, 1st Session. May 26. https://www.parl.ca/legisinfo/en/bill/45-1/c-4.

2 Department of Finance Canada. 2024. *Budget 2024: Fairness for Every Generation.* Ottawa: Government of Canada. April 16. https://www.budget.canada.ca/2024/home-accueil-en.html.

Table 1: Deficit Estimates, 2025/26 to 2028/29 ($ millions)						
	2025/26	**2026/27**	**2027/28**	**2028/29**	**Cumulative Total**	**Source/Note**
PBO/Liberal Baseline	-46,800	-32,700	-33,100	-29,100	-141,700	PBO March 24 updated deficit projection used by Liberal platform
Adjustments						
Bank of Canada (BoC) April Monetary Policy Report	-4,236	-3,563	-1,927	0	-9,726	Lower GDP (BoC Scenario 1)
Cancellation of the Capital Gains Tax Hike	-1,243	-2,970	-3,897	-4,456	-12,566	Liberal platform
Cut Tax Rate to 14%	-4,214	-5,754	-5,948	-6,077	-21,993	Liberal platform
Cut GST for First-Time Home Buyers	-383	-378	-391	-413	-1,565	Liberal platform
Cancel the Digital Services Tax	-1,207	-1,169	-1,158	-1,200	-4,734	PBO October 2023 Report (Sourang 2023)
Counter Tariffs	6,000	0	0	0	6,000	Est. $500M/month for one year
Defence Spending	-11,759	-13,302	-20,627	-27,267	-72,956	RBC Economics Defence Spending Analysis (Leach and Zanzana 2025) and Our Estimates in Table 2
Additional Debt Charges		-488	-1,315	-2,402	-4,205	Authors' calculations
Total Adjustment	-17,043	-27,625	-35,263	-41,816	-121,746	
Adjusted Baseline	**-63,843**	**-60,325**	**-68,363**	**-70,916**	**-263,446**	
Net Debt, % of GDP	**42.5%**	**43.0%**	**43.4%**	**43.7%**		
Liberal Platform: Policy Initiatives	-28,348	-20,458	-13,340	-12,912	-75,058	Excludes penalties, fines, and productivity savings
Additional Debt Charges		-812	-1,460	-1,936	-4,208	Authors' calculations
New Deficit Baseline	**-92,191**	**-81,595**	**-83,163**	**-85,764**	**-342,712**	
Net Debt, % of GDP	**43.4%**	**44.5%**	**45.3%**	**46.0%**		
Note: Liberal Platform's Penalties, Fines and Savings		6,750	10,250	14,750	31,750	Liberal platform
Deficit, Including Uncertain Savings	-92,191	-74,845	-72,913	-71,014	-310,962	
Net Debt, % of GDP	43.4%	44.3%	44.8%	45.1%		

Source: As noted, and authors' calculations.

Table 2: Potential Impact of New Defence Commitments on the Federal Deficit ($ billions)										
	2026	**2027**	**2028**	**2029**	**2030**	**2031**	**2032**	**2033**	**2034**	**2035**
Core Military Needs										
Baseline Spend (NATO), Cash Basis	61.5	64.5	66.7	69.2	71.8	74.7	77.7	80.8	84.0	87.4
Increase to Reach 3.5% Target										
Cash Basis (NATO)	4.6	9.7	15.0	20.8	26.9	33.6	40.8	48.5	56.7	65.5
Budget Accounting Basis (Accrual, See Notes)	2.3	5.1	8.2	11.8	16.0	20.7	25.9	31.8	38.3	45.6
Total Cash Spend (NATO), % of GDP	*2.15*	*2.3*	*2.45*	*2.6*	*2.75*	*2.9*	*3.05*	*3.2*	*3.35*	*3.5*
Security-Related Investments										
Increase from 3.5% to 5% Target										
Cash Basis (NATO)	4.6	9.7	15.0	20.8	26.9	33.6	40.8	48.5	56.7	65.5
Budget Accounting Basis (Accrual, See Notes)	1.2	2.5	4.1	5.9	8.0	10.3	13.0	15.9	19.2	22.8
Total Impact on Deficit	**3.5**	**7.6**	**12.3**	**17.8**	**23.9**	**31.0**	**38.9**	**47.7**	**57.5**	**68.4**
Total Cash Spend (NATO), Percent of GDP	*2.3*	*2.6*	*2.9*	*3.2*	*3.5*	*3.8*	*4.1*	*4.4*	*4.7*	*5.0*

Notes: The last five years of defence cash spending are estimated assuming 4 percent annual GDP growth. Budget accounting basis (accrual) estimated assuming a 50 percent capital share and a 10-year straight-line amortization schedule. The budget basis for security-related investments assumes that half of the new spend comes from already budgeted amounts, and that half of the non-budgeted amounts are federal capital expenses.

Separating Operating and Capital Spending is Unhelpful

The large deficits projected in this update cannot be downplayed or disguised by dividing the budget into two new categories – operating and capital – and targeting a balanced operating budget only, as proposed in the election platform. No firm details have been released about what each category will include, but logically, the operating budget will consist of whatever does not fall under the new capital category.

The rationale for introducing a capital budget is unclear. Under Public Sector Accounting Standards, the federal government, like all Canadian governments, uses accrual accounting. So its capital costs are amortized over the useful life of the assets. As a result, the government's Statement of Operations already shows costs related to capital investments: depreciation (about $7 billion per year) and interest on debt incurred when the outlays occur. As more capital assets are added – such as ports or defence equipment – amortization expenses will rise. But amortization reflects the current consumption of capital assets and should remain part of the bottom line. Excluding it would disconnect the federal budget presentation from the audited financial statements – a serious blow to transparency and accountability.

More troubling is the pledge to recharacterize as capital spending "new incentives that support the formation of private sector capital (e.g., patents, plants, and technology) or which meaningfully raise private sector productivity" (Liberal Party of Canada 2025). Governments like to call many categories of spending "investment." Would the new classification mean the government would exclude subsidies for housing construction or incentives for first-time homebuyers from the bottom-line target? Would it reclassify other subsidies – for clean technology, artificial intelligence, or training programs, for example – as capital? What qualifies as capital under this framework appears open to subjective interpretation, undermining accountability. Without clear standards audited by independent sources, this approach is ripe for abuse.

And for what purpose? The government appears intent on showcasing how much it is doing for growth. But this does not require a new accounting convention. Their efforts could be highlighted through words and dedicated tables – not by altering the definition of the bottom line.

What Canada Needs in the Next Federal Budget

Notwithstanding rhetoric about transforming Canada's economy in the face of US trade threats and prioritizing growth, federal fiscal policy and promises do not support the transformation of Canada's trade relations or promote investment over consumption. Adding $300 billion in federal debt while doing nothing to raise investment and productivity will make Canada more vulnerable, not less. The new 5-percent defence commitment, even if its fiscal impact will be felt mostly in the later years, further highlights the need for difficult tax and spending trade-offs. Given the scale of the new defence commitment, on top of the fiscal challenges created by the old one, it is all the more important for the government to ensure proper accountability.

For that reason, the next federal budget – which should come as soon as possible – should have the following features:

1. **Dropping more costly platform initiatives**. Recent developments, including diminished US support for environmental action and related impacts on Canada, suggest that some potential spending items may cost less or be delayed. Still, it seems surreal to contemplate introducing another $28.3 billion in deficit-increasing platform measures this fiscal year, when the projected deficit would already be close to $60 billion. One of the more straightforward options for the government in the 2025 budget is to forgo implementing some of its platform commitments or fund them through existing envelopes. The list is extensive. For example, the platform proposes to allocate over $10 billion to various infrastructure transfer funds, including nation-building initiatives, trade corridors, digital infrastructure, rural transit, critical healthcare, and community development. In addition, more than 64 small-scale platform measures, each costing under $200 million, collectively amount to over $3.1 billion. These areas clearly present opportunities for reallocation or funding within existing envelopes.
2. **Finding deeper savings from existing operating spending**. The C.D. Howe Institute's 2025 Shadow Budget contemplates $97 billion in non-defence direct program expense savings over the budget horizon (Robson, Drummond, and Laurin 2025). Such savings are possible, but not achievable without strong leadership from the very top.
3. **Rely more on less damaging taxes**. Canada's personal income tax rates are already high – the top rate is over 50 percent in most provinces – and our corporate income taxes are uncompetitive, undermining the investment we need to become more productive and raise workers' wages. Those rates should come down: if

the federal government is determined to fund spending that requires higher revenues, the least damaging option is to raise the GST rate, as proposed in the Institute's Shadow Budget.

4. **Cut federal transfers to provinces and territories**. The Institute's latest Shadow Budget also proposed cuts to transfers that fund programs that are not in the federal government's jurisdiction (Robson, Drummond, and Laurin 2025). Provinces and territories would not welcome such a move – indeed, many might raise their own consumption taxes in response – but deficit-financed federal transfers are less consistent with fiscal sustainability and accountability than tax-financed ones, and the Canadian federation will be healthier if provinces and territories become more fiscally self-sufficient.

The Need for Clarity and Serious Choices

It is widely accepted that Canada's economy is at a critical crossroads. So are Canada's public finances. Beyond the economic drag of high deficits and rising debt, it is unfair to pass these burdens onto the current young and future generations.

The fact that the 2025/26 Main Estimates are before Parliament does not mean that the government has made itself accountable to the legislature for its fiscal plans.[3] The Estimates support the appropriation bills through which Parliament authorizes funding for program spending not already provided for in existing legislation. They exclude any forward-looking policy initiatives typically included in a budget. They omit revenues and only account for a subset of expenses. They are prepared on a different basis of accounting than regular budgets and financial statements, making direct comparisons difficult. And, they cover only a single fiscal year, making it impossible to assess the medium-term outlook.

The federal government itself should release full economic and fiscal projections to enable a proper national debate. But in their absence, this informal update will have to suffice.

Canada is on a troubling path. We need Parliament and the public to discuss the best way forward – economically and fiscally. The next federal budget should launch us on that path.

3 See: Treasury Board of Canada Secretariat. 2025. *2025–26 Main Estimates for the Government of Canada*. Ottawa: Government of Canada. May 27. https://www.canada.ca/en/treasury-board-secretariat/news/2025/05/treasury-board-president-tables-in-parliament-the-2025-26-main-estimates-for-the-government-of-canada.html.

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