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Canadian Fiscal Policy and Infrastructure Spending: Navigating the Tariff Troubled Waters?

- **The ongoing trade war, along with the associated uncertainty, has clouded the economic outlook.** Our most recent published **forecast** shows that Canada's economic activity slows significantly owing to tariffs on our exports to the U.S., weaker growth in our southern neighbour, and deteriorating uncertainty and confidence. Consequently, growth slows markedly in Canada from 2024 to 2026. This outlook assumes these higher tariffs are maintained permanently, consistent with our convention to not speculate on future policy developments.

- **Our June outlook assumes some discretionary support by governments in Canada, but not sufficient to fully offset the impact from the headwinds hitting the economy.** This discretionary support is relatively modest, at 0.8% of Canada's nominal GDP at its peak, which is slightly more than half the estimated peak economic impact from the higher tariff environment. The combined positive impact on GDP from this discretionary fiscal support and from the automatic fiscal stabilizers is not sufficient to offset the negative effect from increased tariffs.

- **We estimate that the magnitude of the fiscal support that would largely offset the effect from increased tariffs while preventing significant inflationary pressures and a rise in the monetary policy rate should reach 1.25% of GDP at its peak**. This proposed fiscal package has two components; the first one aims to support the economy when it needs it the most—in the form of a **temporary increase in transfers or tax rebates to individuals**—and, the second component, helps to offset the negative long-term impact from the higher tariff landscape on potential GDP by **an important permanent increase in public infrastructure expenditures (i.e. +0.5% of GDP)**. This infrastructure stimulus increases potential GDP, which substantially reduces the inflationary effect of the entire proposed discretionary fiscal support package.

- **The side effects from this proposed fiscal package are relatively limited and manageable in our view.** The scenario with fiscal support leads to an inflation profile well within the monetary policy's inflation control range of 1–3%, indeed converging rapidly near the mid-point of this range, and a policy rate within the 2.25–3.25% neutral—or equilibrium—range estimate by the Bank of Canada. The proposed fiscal package also avoids a rise of the policy rate over the 2025–2027 horizon.

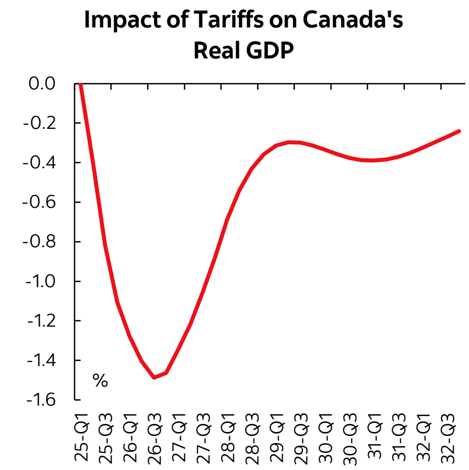
- **The fiscal position deteriorates with this tariff-offsetting fiscal package, but governments would still be able to bring it to a sustainable path with minimum harm to the economy thanks, in part, to the positive effect of public infrastructure spending on potential GDP.** Eventually, fiscal positions would need to tighten to reach a sustainable path, but real GDP will still grow in line with its potential pace. Indeed, fiscal balances in this scenario would achieve magnitudes below those observed during the Great Recession.

- **A change in the future tariff landscape should only affect the temporary transfer support component, making it larger with higher tariffs and smaller with reduced tariffs.** Notwithstanding what looms ahead for this trade landscape, the proposed permanent increase in public investment in infrastructures should be maintained.

The Canadian economy is slowing from the effects of the U.S. trade war. This is true because of the direct impacts on Canada of trade actions targeting our country, but it is also a function of the self-harm to the U.S. economy from their actions against virtually all trading nations. Our June outlook assumes a 10% effective tariff rate on total imports (goods and services) by the U.S. and a 4% effective tariff rate on Canada's total exports (all destinations). This note analyzes potential fiscal options in Canada for dealing with the consequences of this economic disturbance. We consider the following questions: is there a role for fiscal policy in managing the trade shock? What is the magnitude and timing of the fiscal support that would broadly offset the impact from the tariff war on Canada's economy, if so desired? Would it lead to inflationary pressures strong enough to trigger a rise in the monetary policy rate, rather than staying constant at its current 2.75% level before it starts declining in early 2026 as per our current outlook? Would it crowd out private investment? And could it put Canada's fiscal position on an unsustainable path?

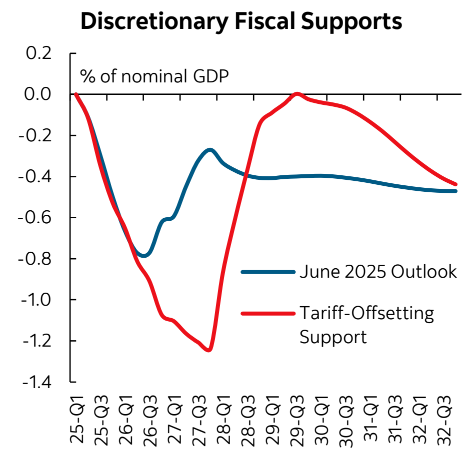
We find that the magnitude of the fiscal support package that would largely offset the impact from the higher tariff landscape without creating excessive inflation pressures is near 1.6 times the one assumed in our latest published outlook, reaching 1.25% of GDP at its peak at the end of 2027. This support package includes temporary measures—through increased transfers or tax rebates to individuals—and a permanent rise in public investment expenditures. The former helps to support the economy when it needs it the most and is phased out to avoid generating undesired inflation pressures as the economy recovers and needs less support. The latter helps to offset the permanent supply-side impact from the trade war on Canada's GDP and lifts its potential in the longer term by increasing both public and—through crowding-in effects—private capital. The impact on inflation and the monetary policy rate from this tariff-offsetting fiscal support is broadly modest and the short-term deterioration in fiscal position is also manageable in our view, reaching magnitudes below those observed for the federal government during the Great Recession and much smaller than the structural deficit era of the 1980s to the mid-1990s.

Chart 1



Source: Scotiabank Economics.

Chart 2



Source: Scotiabank Economics.

Chart 1 shows the estimated impact on the level of Canada's real GDP from the assumed effective tariff rates mentioned above. This, and other impacts in this study, are estimated with our macro-econometric model of the Canadian and U.S. economies. The GDP decline is more important in the short term as demand-side effects from the trade shock dominate. Over this period, the economy is pulled down by reduced external demand for Canada's products—including commodities—which is also spilling over to domestic demand. Increased uncertainty and deteriorating confidence further reduce domestic demand and real GDP. With both monetary and fiscal policies reacting to support the economy, and as uncertainty declines and confidence improves, real GDP starts recovering in the last quarter of 2026. However, the economy does not recover fully to its expected pre-tariff shock path because of the permanent negative supply-side effects from supply-chain disruption from the trade war—which also raises the price of non-tariffed imports—and Canada's retaliatory tariffs on imports from the U.S.

In this context, our view is that an appropriate discretionary fiscal package to offset the impact from the trade war should meet three objectives:

- First, provide economic support when the economy needs it the most. It is true that monetary policy is expected to react towards this objective, but its impact is delayed and not meant to help workers and industries affected the most. Income support measures—in the form of increased transfers or tax rebates—would help fill this objective but should be temporary and fully phased out as economic conditions improve. Their impact will diminish greatly and generate unnecessary inflationary pressures if they come too late in the cycle and/or are unduly maintained. Most advanced economies played in this movie coming out of the pandemic, which **led** inflation to multi-decade highs.
- Second, an appropriate fiscal package should also aim at mitigating the negative supply-side effects from higher tariffs with initiatives that promote productivity and potential GDP. This point is often made by the Governor of the Bank of Canada. Raising expenditures in public infrastructures would help achieve this objective as it will raise the return on private investment projects. From this channel, increased public investment could crowd in—rather than crowd out—private investment if infrastructure projects are wisely selected. And it would also help to improve and expand the infrastructure stock, **much needed in Canada**, and help redirect a larger share of Canada's exports to non-U.S. markets.

- Finally, this stimulus package should not lead to excessive inflation pressures that would require the Bank of Canada to tighten its policy rate beyond its estimated neutral range.

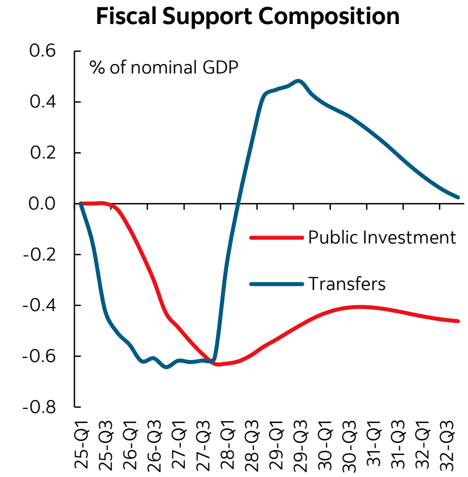
With these objectives in mind, we used our macro-econometric model to estimate the fiscal support that would largely offset the negative impact from increased tariffs on Canada's GDP (both the supply and demand elements) while preventing a significant rise in inflation pressures and the Bank of Canada policy rate. Chart 2 shows the estimated magnitude and profile of this support in % of nominal GDP, along with the one in our most recent published outlook. The fiscal support indicator in this chart reflects the combined primary fiscal balance across levels of government, with a negative figure showing a deficit. The more negative this indicator, the larger the fiscal support. This chart shows that the needed support to largely offset the economic impact from increased tariffs is about 1.6 times larger than the one assumed in our latest outlook. It is also largest at the beginning when demand-side pressures from the trade war are most acute and is gradually reduced as monetary and fiscal policies succeed in bringing the economy on a recovery path.

Chart 3 shows the contribution (in % of nominal GDP) to this tariff-offsetting support from the temporary measures—transfers/tax rebate to individuals—and from the permanent increase in public investment in infrastructures. We see that the heavy lifting in the shorter term mostly comes through increased transfers/tax rebates to individuals. These income support measures are eventually removed as the economy recovers. The permanent rise in the GDP share of public investment—by 0.5 percentage point in the long-term, compared to a posted 3.8% average share over 2015–2024—is permanently raising potential GDP as mentioned previously.

Chart 4 shows the contribution from the three levels of government to this tariff-offsetting support in % of Canada's nominal GDP. These contributions borrow from their historical shares for these expenditures. Given this, and as assumed in our latest outlook, the discretionary temporary income support package mostly comes from the federal government. However, our estimated economic and inflation impacts would be unaffected if we were to assume a larger share of these initiatives would come from provinces but fully financed by the federal government through increased transfers to other levels of government. This chart also reflects the fiscal stance of the federal government improving after temporary income support is removed and eventually reduced from the baseline scenario for the reason mentioned just above. For provincial and local governments, the permanent change in the fiscal stance reflects the permanent increase in the public infrastructure expenditure share of GDP. In the long-term—beyond the horizon showed in the chart—the fiscal stance of the federal government eventually converges near those of provincial and local governments once its debt has returned on a sustainable path, at which point this new stance would simply reflect higher public investment expenditures from the federal government.

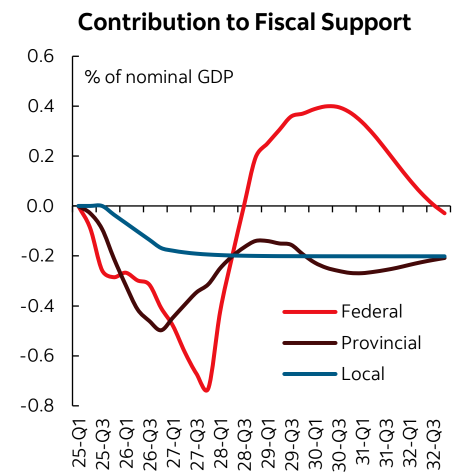
Chart 5 shows the individual impacts on Canada's real GDP from the increased tariffs, essentially the same profile as in chart 1. It also shows the impact from our proposed tariff-offsetting support package and from each of its components (transfers/tax rebates and public investment). Again, the support from transfers/tax rebates is temporary and its peak effect on GDP—at 0.5%—occurs when the economy needs it the most, meaning when the tariff shock reaches its peak impact. This positive GDP effect declines as income support is being phased out, and eventually becomes negative as transfers/tax rebates are reduced below their baseline path to bring fiscal positions back on a sustainable path. The permanent increase in public investment expenditures is pushing real GDP up permanently by about 0.6%. Back to chart 5, we see that the short-term GDP impact from public investment is larger (peaking above 0.8%) than in the long-term as businesses ramp up their investment

Chart 3



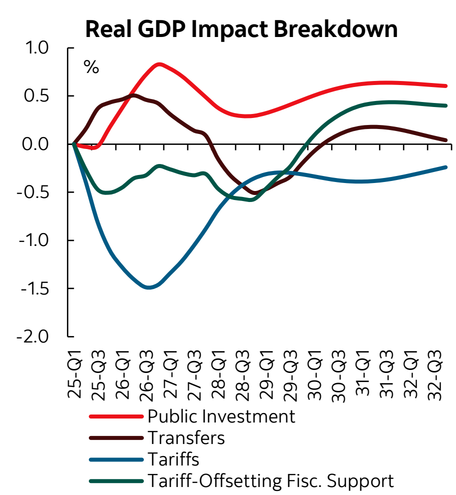
Source: Scotiabank Economics.

Chart 4



Source: Scotiabank Economics.

Chart 5



Source: Scotiabank Economics.

expenditures to bring their level of capital in line with the new higher potential level of economic activity, therefore potential sales. All these individual effects on GDP—from increased tariffs, transfer/tax rebates and public investment—combine to generate the real GDP profile showed by the green line in chart 5. This profile shows the net impact of the support measures on GDP once the tariff impact is considered. This combination succeeds at smoothing the GDP cycle from the trade war and even at more than offsetting its long-term decline from the increased tariffs landscape.

The sole impact from the infrastructure support on private investment is shown in chart 6. Increased public investment—and capital—raises the expected rate of return on private investment projects. In our model, as often the case for empirical macroeconomic models, this rise in public investment affects private investment by raising multi-factor productivity and this relationship is estimated in our model. Of course, public investment projects must be selected wisely to maximize their impact on private investment and potential GDP. The higher the complementarity between public and private capital, the higher the impact. From chart 6 we see that, by itself, the public investment stimulus leads to a long-term rise in private investment. There is nevertheless a short-lived negative impact from 2028Q1 to 2029Q1 as the policy rate stays at its current 2.75% level for a longer period with this infrastructure support (chart 8).

A key question now is if this proposed fiscal support package leads to undesirable inflationary pressures. Chart 7 shows that despite stronger economic activity—hence less economic slack—and associated inflation pressures with the fiscal support package, core inflation—defined here as the average of the CPI-trim and CPI-median indicators from the Bank of Canada—still converges to and stays near the mid-point of the 1–3% inflation control objective for monetary policy. Indeed, this fiscal support scenario generates a more stable inflation profile than for the scenario with increased tariffs only and for our latest (June 2025) published outlook.

And from chart 8 the monetary policy rate still needs to decline from its current 2.75% level but later than in the scenario with only increased tariffs to offset the negative impact on the economy from the above-mentioned reversal of the transfers/tax rebates component of the stimulus package. In both reported scenarios, the profile for the policy rate is the one needed to keep inflation near its target, but they both stay within the estimated neutral range by the Bank of Canada.

Table 1 shows the annual profile for indicators of economic activity in the scenario with tariff-offsetting fiscal support. In this scenario, GDP growth still weakens in 2026, but the additional support from the proposed fiscal stimulus contributes to raise it by 0.3 and 0.8 p.p. in 2025 and 2026 respectively compared to the scenario with tariffs only. This helps to bring GDP closer to potential and mitigate the economic slack generated by increased tariffs. Compared to our latest published outlook, GDP growth in this fiscal support scenario is respectively 0.1 and 0.2 p.p. stronger for 2025 and 2026.

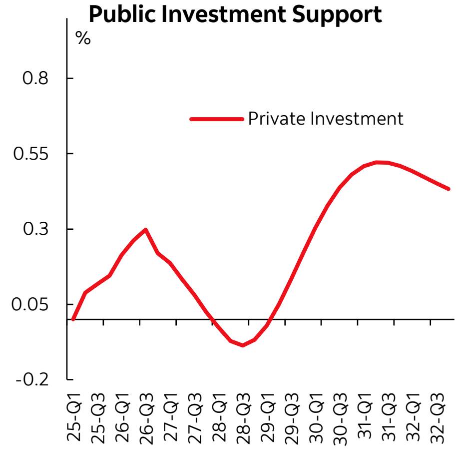
Table 1: Canada - Economic Indicators - Tariff-Neutralizing Scenario (Annual averages)

	2025	2026	2027	2028	2029	2030
Real GDP ($G, Chained-Fischer)	2459	2492	2534	2588	2650	2708
% Growth	1.5	1.3	1.7	2.1	2.4	2.2
Potential GDP (% Growth)	1.8	1.2	1.9	1.9	2.0	2.0
Output Gap (% of potential GDP)	-0.5	-0.4	-0.7	-0.5	-0.1	0.2

Source: Scotiabank Economics.

Chart 6

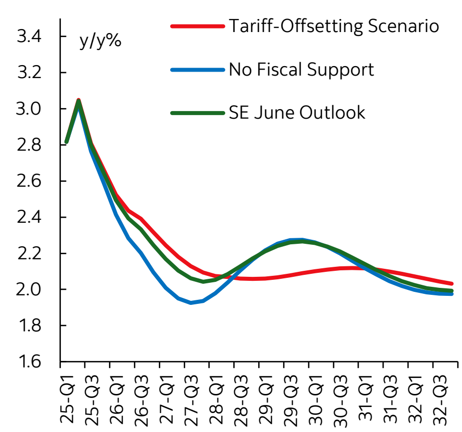
Private Investment: Impact from Public Investment Support



Sources: Scotiabank Economics, Bank of Canada.

Chart 7

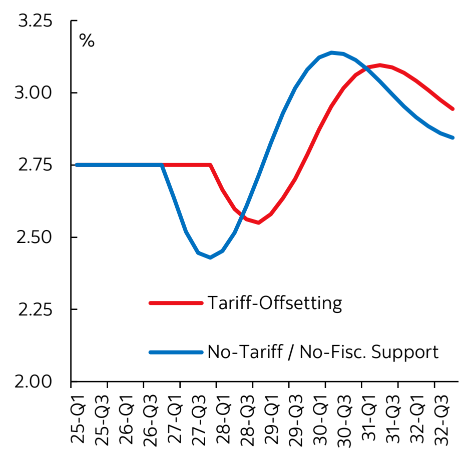
Average of BoC Core Inflation Rates



Sources: Scotiabank Economics, Bank of Canada.

Chart 8

Monetary Policy Rate



Sources: Scotiabank Economics, Bank of Canada.

Table 2: Canada - Federal Deficit ($G)*		
	FY2025	FY2026
Baseline (Pre-Tariffs and Pre-Fiscal Support)	44	41
Impact from:		
Tariffs	20	14
Tariff-Offsetting Support	13	41
Tariff-Neutralizing Scenario	77	96
% of Nominal GDP	*2.4*	*2.9*

* Assuming fiscal support entirely financed by the federal government.
Source: Scotiabank Economics.

We have shown that the impact on inflation and the policy rate from this tariff-offsetting fiscal support is manageable and tolerable. Inflation stays near the mid-point of the inflation target range and the policy rate within the 2.25%–3.25% neutral range estimated by the Bank of Canada. But the natural follow-up question is about the impact from this support on the sustainability of fiscal positions of governments. To simplify this discussion, we assume that the cost of all measures in this tariff-offsetting package is borne by the federal government. With this assumption, table 2 shows the resulting total federal deficit in $billion and in % of nominal GDP. This table also shows the individual contribution to the deficit from the increased tariff landscape and from the fiscal support. The baseline scenario—without the assumed increase in tariffs and discretionary fiscal support—would generate a federal deficit of $44 and $41 billion respectively for 2025 and 2026. The increased tariff scenario raises these deficit figures by $20 and $14 billion respectively, while the tariff-offsetting support package lifts them by an additional $13 and $41 billion. Consequently, the federal deficit rises to $77 and $96 billion for 2025 and 2026 respectively. These deficit figures respectively reach 2.4% and 2.9% of nominal GDP in 2025 and 2026, magnitudes lower than observed during the Great Recession in Canada and much less than the structural deficit era of the 1980s to mid-1990s. Therefore, we believe that the magnitude of these deficits would be manageable when assessed against the benefits this fiscal support package—at 1.25% of GDP at its peak—would provide[1].

Of course, the reasonableness of this tariff-offsetting fiscal support is dependent on our assumptions on the size and duration of the increase in tariffs facing Canadian exports, and retaliatory measures by Canada (and others). Again, these assumptions are effective tariff rates (on goods and services from all destinations) of 10% on U.S. total imports and 4% on Canada's total exports, and that this set of increased tariffs imposed by the U.S. is permanently held. This latter assumption is consistent with communications by the President and key advisers at the time our outlook was completed. Of course, any change in these assumptions will affect the appropriate fiscal support package that would offset the impact from tariffs on the economy. Higher tariff rates would increase the size of the appropriate transfer support component. Conversely, a more modest transfer support would be appropriate if these tariffs are reduced or reversed to their pre-2025 levels. As long as the composition—products and origins—of these tariffs and relative retaliation by Canada (and others) are unchanged, the results presented in this study could be used to scale down (or up) the estimated tariff-offsetting fiscal support consistent with a lower (or higher) tariff environment. This would not be the case however if the duration of the higher tariffs is temporary rather than permanent, or if some countries' bilateral tariffs with the U.S. are changed. We believe increased expenditures on public infrastructure should be unchanged notwithstanding what looms ahead for global trade since, as reflected in our results, it would benefit Canada's economic potential and productivity, and Canadians more generally. And increased productivity would better position Canada to diversify markets for its exports, a much-needed objective now.

There is one key lesson and consideration from the fiscal experience in the pandemic: If it becomes evident that inflation is on a worse track than modelled in our scenario, it would be critically important for governments to roll back these support packages expeditiously. It should prioritize cutting transfers if that was the case. This was a critical mistake made in the management of post-pandemic inflation that we cannot allow to be repeated. Indeed, there was a relatively broad agreement among economists and policy makers during and after the Great Recession that discretionary government support to smooth the economic cycle should be timely, targeted and temporary. This agreed principle was apparently ignored by policy makers during the pandemic period.

But despite this, even if tariffs are eventually reduced or removed, for reasons mentioned above, our results suggest that potential output would rise if well designed government investment were undertaken. Indeed, if we are serious about efforts to transform our economy given economic threats from the U.S., there is a strong argument in favour of significant public investments in **our trade infrastructure alone**, irrespective of the cyclical considerations noted in this note.

[1] We also do not consider the likely cost over-runs associated with government investment projects, which could inflate costs meaningfully in relation to initial budgeted estimates.