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HIGHLIGHTS

- The federal budget was tabled earlier today. With all three opposition parties indicating that they intend to vote against the budget, the government will fall on the budget. Under this scenario, Canada will have a federal election this Spring unless there is a change of course.
- In the meantime, the budget reflects the economic and fiscal policy intent of the Government of Canada.
- To summarize, today's release was a stay-the-course budget with a smattering of small measures.
- Highlights include a temporary hiring credit for small businesses and renewed funding for the ecoEnergy retrofit program.
- Return to budgetary balance on schedule in FY 15-16. Surplus one year earlier is within striking distance.

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ALL SIGNS POINT TO A SHORT SHELF-LIFE FOR TODAY'S FEDERAL BUDGET

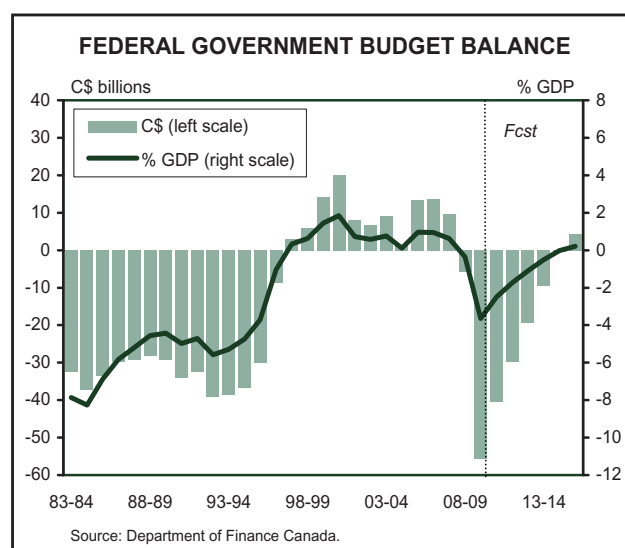
The federal government released its budget earlier today. Included in this publication was a smattering of small measures such as a temporary credit for small businesses and renewed funding for the ecoEnergy retrofit program. However, given the Conservative government's minority status in Parliament, the budget requires the support of at least one other party. All three opposition party leaders have declared that they will vote the budget down. Under this scenario, all of the new spending and tax items announced today would not be implemented.

With the political uncertainties lingering and the fate of the budget unknown, we still provide an in-depth summary of what was included in today's publication. While the specific initiatives may not be implemented, the budget also presents an economic and fiscal outlook for the country. What's more, the political discourse surrounding specific government priorities may provide a sense of the material to be played out on the campaign trail.

Stronger economy pays dividends

Rewind back to the October 2010 Fall Update. At the time, deficits were projected to narrow to \$45.4 billion (3% of GDP) in FY 2010-11 and just under \$30 billion (2% of GDP) in FY 2011-12, as stimulus measures lapsed, before the shortfall was to be gradually expunged in the following four years.

Since that time, the economy has enjoyed some renewed momentum, owing in part to strengthening commodity markets and a firming in U.S. economic growth. In today's budget, the government confirmed that it would raise its forecast for real GDP growth in 2011 by about a half percentage point to near 3%. Although the moderate economic growth forecasts for future years were left largely intact compared to the Update, the stronger hand-off from FY 2011-12 leaves revenues about \$3 billion higher per year and helps bring the government close to recording black ink by FY 2014-15 – a year ahead of schedule.



The economic assumptions used for budget planning look reasonable. Notably, the Department of Finance shaved an amount off private-sector expectations for nominal GDP in order to build in a reserve cushion amounting to \$1.5 billion per year in order to protect the budget plan against unforeseen circumstances. In com-

parison to our view, the budget applies growth assumptions that are considerably lower than ours in the near term, but higher over the medium term, effectively cancelling out the risks over the 5-year planning timeframe.

Not all of the upside surprise to revenues flowed through to an improved bottom line. The government used some of the fiscal room for new measures. As expected, the government followed through with its pledge not to introduce major spending hikes, tax increases or cuts to personal or provincial transfer payments. In addition, the government will stay the course on earlier measures, including the previously announced cuts to the corporate income tax rate. To recall, this was slated to be reduced from the current 16.5% to 15.0% on January 1, 2012. In terms of new measures, the government has announced about \$1.5 billion per year over the next 5 years, with a slight front-end loading to FY 2011-12. This is well below the \$25 billion per year in stimulus measures provided in the last two budgets and lower than the \$6-8 billion per year in the 2007 and 2008 budgets. Still, today's release may have surpassed those previous budgets in terms of sheer quantity of relatively modest measures. Key highlights are as follows:

- Enhancing the Guaranteed Income Supplement (GIS) for low-income seniors. This measure will provide a new annual top-up benefit of up to \$600 per year for single seniors and \$840 per year for couples. The price tag is estimated at \$300 million annually.
- Providing a one-time Hiring Credit for Small Business of up to \$1,000 against a small firm's increase in its 2011

Employment Insurance (EI) premiums over those paid in 2010 to encourage hiring. The estimated cost is \$165 million.

- Dedicating \$65 million per year to extend the temporary accelerated capital cost allowance rate for investment in machinery and equipment by the manufacturing and processing sector for two additional years.
- Extension of work-sharing agreements by up to 16 weeks to mitigate the risk of layoffs by offering EI benefits to workers willing to work a reduced week. This amounted to \$10 million in foregone revenues.
- \$400 million allocated in FY 2011-12 to renew funding for the ecoENERGY Retrofit program.
- The introduction of a new Family Caregivers Tax Credit – a 15% non-refundable credit on an amount of \$2,000 to assist those caring for infirm dependants.
- Introducing legislation to make permanent the annual investment of \$2 billion in the Gas Tax Fund for municipal infrastructure.

In sum, there were no clear winners in today's budget as the host of additional measures crossed many segments of the population and multiple sectors. Efforts to help the country deal with the demographic challenge were a notable theme – such as the GIS enhancement, elimination of mandatory retirement for federally regulated employees, and the caregiver's credit. Another is the extension of several programs initially intended to be temporary, such as Retrofit, work-sharing agreements, and capital cost allowance accel-

FEDERAL GOVERNMENT FISCAL POSITION											
(C\$ billions, unless otherwise indicated)											
Fiscal Year	Actual					Est.	Budget				
	05-06	06-07	07-08	08-09	09-10	10-11	11-12	12-13	13-14	14-15	15-16
Budgetary revenues	222.2	236.0	242.4	233.1	218.6	235.6	249.1	264.4	281.2	296.8	309.2
% change	4.8	6.2	2.7	-3.8	-6.2	7.8	5.7	6.1	6.4	5.5	4.2
% of GDP	16.2	16.3	15.8	14.6	14.3	14.5	14.6	14.8	15.0	15.1	15.1
Program expenses	175.2	188.3	199.5	207.9	244.8	245.2	245.7	247.3	252.0	257.7	265.6
% change	-0.7	7.5	6.0	4.2	17.8	0.2	0.2	0.7	1.9	2.3	3.1
% of GDP	12.8	13.0	13.0	13.0	16.0	15.1	14.4	13.8	13.4	13.1	12.9
Public debt charges	33.8	33.9	33.3	31.0	29.4	30.8	33.0	36.5	38.6	39.4	39.4
% change	-1.0	0.5	-1.8	-7.0	-5.1	4.7	7.1	10.6	5.8	2.1	0.0
% of Revenues	15.2	14.4	13.7	13.3	13.5	13.1	13.2	13.8	13.7	13.3	12.7
Total expenditures	209.0	222.2	232.8	238.8	274.2	276.0	278.7	283.8	290.7	297.2	305.0
% change	-0.7	6.3	4.8	2.6	14.8	0.7	1.0	1.8	2.4	2.2	2.6
% of GDP	15.2	15.3	15.2	14.9	18.0	17.0	16.3	15.8	15.5	15.1	14.8
Budgetary balance	13.2	13.8	9.6	-5.8	-55.6	-40.5	-29.6	-19.4	-9.5	-0.3	4.2
% of GDP	1.0	0.9	0.6	-0.4	-3.6	-2.5	-1.7	-1.1	-0.5	0.0	0.2
Federal debt*	481.5	467.3	457.6	463.7	519.6	556.4	586.0	605.4	614.9	615.2	611.0
% of GDP	35.0	32.2	29.9	29.0	34.0	34.3	34.4	33.8	32.7	31.3	29.7

* Accumulated deficits. Source: Department of Finance Canada.

eration. This underscored the challenge of letting temporary measures elapse.

Success of the fiscal plan rests on spending restraint

Arguably, the number one risk to the fiscal plan rests in the government's expenditure restraint plan. In this budget, program spending is expected to grow by merely 1.6% per year on average between FY 2011-12 and FY 2015-16. This would mark one of the most prolonged periods of fiscal restraint in decades. Furthermore, restraint would come at a time when age-related spending such as health care and pensions are intensifying. The flat reading on spending from FY 2010-11 to FY 2011-12 is largely due to the expiry of stimulus programs. The bigger challenge lies beyond next year.

In last year's budget, the government got the ball rolling by booking some \$17.6 billion in savings from freezing operating budgets, carrying out strategic reviews of departmental spending between 2007 and 2009, reductions in spending growth in defence and international aid as well as closing tax loopholes. In today's budget, the government indicated that these restraint measures are on track and hopes to double these savings through further actions on these fronts, including undertaking a one-year comprehensive Strategic and Operating Review.

Financial market implications

As some budget details had been intentionally leaked to the media the day prior and actual contents align with what was anticipated, we do not expect any marked financial markets reaction. Foreign appetite for Government of Canada securities will continue to be markedly larger than debt issuance requirements over the medium-term fiscal horizon, helping to contain overall borrowing costs. This

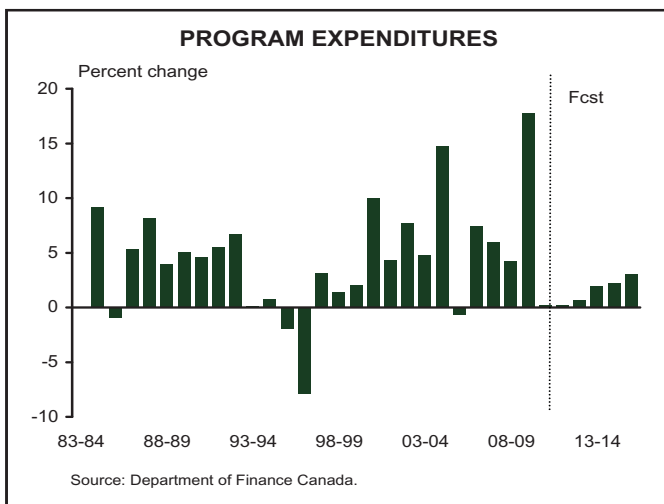
ECONOMIC ASSUMPTIONS* FOR CANADA			
Annual, percent change (unless otherwise noted)			
Calendar Year	2011	2012	2013-15
Real GDP			
October 2010 Update	2.5	2.8	2.7
2011 Budget	2.9	2.8	2.6
TD Economics [^]	3.0	2.5	2.2
Nominal GDP			
October 2010 Update	4.6	5.2	4.7
2011 Budget	5.8	5.0	4.6
2011 Budget (planning assumption)	5.2	5.0	4.7
TD Economics [^]	5.9	4.5	4.0
Unemployment rate, %			
October 2010 Update	7.7	7.4	6.8
2011 Budget	7.5	7.2	6.7
TD Economics [^]	7.7	7.4	6.9
3-Month T-Bill Rate, %			
October 2010 Update	1.6	2.7	3.8
2011 Budget	1.3	2.5	3.8
TD Economics [^]	1.4	2.7	3.7
10-Year Gov't Bond Yield, %			
October 2010 Update	3.3	4.0	4.8
2011 Budget	3.5	4.0	4.8
TD Economics [^]	3.8	4.3	4.7
U.S. real GDP			
October 2010 Update	2.4	3.0	2.9
2011 Budget	3.1	3.1	3.2
TD Economics [^]	3.0	3.0	3.5

should be the case whether or not the budget passes.

The government is planning on \$102 billion in gross bond issuance in FY 2011-12, roughly in line with issuance seen over the previous two fiscal years. The new medium-term debt management strategy will hone in on short- and medium-term issuance (2-, 3-, and 5-year maturities). Moreover, four new maturity dates will be introduced to the mix in order to reduce rollover risk. The regular bond buyback program will be about \$3 billion higher than in FY 2010-11, reaching about \$8 billion in FY 2011-12. Also, buyback operations on a cash basis will be reintroduced for longer-dated bonds.

Bottom Line

Today's modest budget contained no surprise of substance. The five-year plan is based on reasonable economic assumptions, and if the economy continues to grow at a moderate rate, balance will likely be reached by FY 14-15 – a year ahead of schedule. The fate of the budget and the shelf-life of its initiatives largely rest in the hands of the opposition parties. If the budget is voted down, a spring election would take place, and another 2011 budget would be tabled. All told, it will be an eventful week and likely next few months.





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