SPECIAL REPORT
TD Economics
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GOVERNMENT BUDGET SEASON COMES A KNOCKIN’ AGAIN
10 themes expected to play out

Highlights

• It has been a roller coaster ride for government deficits in Canada in fiscal 2012-13. Using publicly-available data, the cumulative deficit for federal and provincial governments sits at $45.8 billion, or about $6 billion more than anticipated at the time of the 2012 budget. In addition, the combined federal-provincial debt burden remained on an upward track.

• We do not expect the aggregate deficit to exacerbate much further as the federal government is poised to post an improvement, effectively offsetting Alberta’s expected deterioration.

• This report outlines ten themes that we expect to play out during the upcoming budget season. While each government faces different challenges, the high-level themes presented should be relevant for most 2013 budgets.

• British Columbia, Alberta, Nova Scotia and Québec plan to return to a balanced budget in fiscal 2013-14. Saskatchewan hopes to hold onto to its surplus as well.

• The economic momentum heading into the upcoming budget season is weak. In turn, no jurisdiction should experience a revenue windfall. There is also little appetite for tax increases. As a result, additional belt-tightening may be required to keep deficit elimination dates unchanged. There is also the risk that some governments will push back their timelines in light of the challenges present.

Somewhat surprisingly given the time of year, the 2013 budget season is already underway – Québec was the first out of the gate last November. The remaining provinces and the federal government should table their budgets over the next few weeks. The fiscal momentum coming out of 2012-13 is poor – the cumulative deficit for federal and provincial governments is estimated to be $45.8 billion, or about $6 billion more than anticipated in 2012 budget documents. The economic growth environment will be mixed for fiscal 2013-14. In this budget preview piece, we briefly outline the fiscal developments in 2012-13 and quickly move on to the ten themes we think will prevail this budget season.

Deterioration in government deficits in fiscal 2012-13

During fiscal 2012-13, a global economic slowdown became entrenched. There was unease about the European sovereign debt crisis. Economic indicators coming out of the United States and China were also concerning and worries about a double-dip recession were beginning to emerge. With confidence levels among businesses and consumers lacklustre, global demand tempered and commodity prices faced significant downward pressure. The subdued economic climate filtered down to Canada largely through export and resource channels. The domestic engines of economic growth also let up, as households curbed their pace of debt accumulation and the resale housing market softened on the heels of tighter mortgage lending regulations.

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Lower-than-expected nominal economic growth performance trickled through to fewer own-source revenues for government coffers. A case in point, when the 2012 federal budget was tabled, Canadian nominal GDP growth was assumed to be 4.6% for 2012. The current tracking is now 3.1%.

Resource-reliant provinces have been particularly affected because of lower commodity prices and fewer resource royalties. This revenue source has also been hit by the wider spread between West Texas Intermediate (WTI) and Western Canada Select (WCS) prices. Alberta and Saskatchewan expect to record $6 billion and $300 million fewer in resource royalties, respectively.

With expenditure restraint a high priority across governments, public sector program spending has come in close to the original estimates presented in 2012 budgets.

Partially offsetting the negative revenue developments has been reduced debt servicing costs. Governments are benefitting from the lower and longer interest regime and this line item has, for the most part, been positive for Canadian government’s fiscal plans.

With the economic backdrop, every government in Canada, except Ontario, has seen its deficit stay the same as in the case of Prince Edward Island or deteriorate as fiscal 2012-13 has unfolded. The Ontario government’s outperformance was due primarily to one-time savings and one-time revenue windfalls. Nationally, the aggregate debt burden as a share of GDP increased from 61.9% in fiscal 2011-12 to 62.5% in fiscal 2012-13.

Now that we have a review of the fiscal deterioration in fiscal 2012-13 in hand, we turn our attention to the upcoming budget season. Based on our own fiscal analysis, and reading pre-budget consultations and media reports, we believe the following ten themes should emerge over the course of the season.

1. There is no economic boom on the near-term horizon

TD Economics expect real economic growth in Canada to be 1.7% in 2013. In nominal terms, we are tracking economic growth of 3.6%. This is lower than the 4.0% forecast published just a few months ago. A lower expansion in nominal GDP relative to our prior estimate will be felt disproportionately by resource-reliant provinces.

The annual growth forecasts mask in-year trends: the economic performance in the first half of the year should be substantially weaker than the second half of the year. Over the next six months, external developments will keep a lid on Canada’s economic growth. Europe will continue to muddle through its sovereign debt crisis, with structural and political reform proceeding at a painstakingly slow pace. Fiscal discussions are also ongoing in the United States. Economic growth in Canada is poised to pick up in the second half of the year as improved global demand lifts exports and drives stronger business investment.
Most major commodity prices will end 2013 higher than where they were in 2012. The price of WTI crude oil should average between US$92-95 per barrel over the course of the year. The improvement in prices will be driven by stronger global economic growth, firmer global demand, and continued stimulus from central banks around the world. The resource sector in Canada will benefit from the ameliorated price conditions. However, an oil supply excess in the U.S. Midwest will remain a challenge for Western Canada’s oil and gas sector for much of 2013.

Economic planning assumptions are highly tied to the pace of nominal GDP growth. With the annual profile described here, government revenue growth is expected to be modest. Offsetting some of this pressure will be smaller debt servicing costs – the Bank of Canada is poised to leave rates unchanged until the first quarter of 2014. Under this interest rate profile, governments will likely record fewer debt servicing costs over the near term. We have seen this trend materialize in fall updates and Fiscal Monitor publications and it should persist for a few more years.

In light of the risk-filled environment and modest economic backdrop, we expect governments to continue to adopt more prudent economic assumptions than the private sector consensus. It has also been confirmed that the British Columbia government has appointed an external economist to review the revenue projections and planning assumptions for its 2013 budget. The Alberta government also recently hosted an economic summit while it enters the home stretch of budget preparation.

2. Some provinces to cross over into surplus territory

British Columbia, Alberta, Nova Scotia and Québec plan to return to a balanced budget in fiscal 2013-14. Saskatchewan hopes to hold onto its surplus as well. The provinces lucky enough to be in this group will find themselves confronting the following realities:

- Any surplus posted will be small in dollar terms and as a share of the economy.
- The deficit deteriorations in fiscal 2012-13 are a stark reminder of how difficult it is to meet fiscal targets in this highly uncertain economic environment. A budgetary surplus can easily turn into a deficit if complacency sets in and/or spending restraints are removed altogether.
- The modest economic growth backdrop should mean that an expenditure restraint mindset endures. Rein in health care and education spending growth, and identifying and eliminating spending inefficiencies will

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**Nominal GDP Growth Has Disappointed Expectations Across Canada in 2012**

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Note: *TD Economics tracking as at February 2013. 2012 nominal GDP for PEI has been estimated by TD Economics.
Source: Government Budgets.

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**Combined Federal-Provincial Government Deficits**

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still be required.

- Once surplus is realized, the next challenge will be on the medium-term fiscal plan. This might include boosting long-term savings, spending on long-term projects like infrastructure (which can be amortized over several years) or reducing debt levels.

3. Significant tax changes to be few and far between

Another factor that will limit revenue gains will be policymakers’ hesitancy to raise taxes. In a recent speech, the Federal Finance Minister ruled out any new taxes in the forthcoming budget. With this mindset in mind, the provincial tax changes in the upcoming budget season will likely be imposed on the sales tax, health tax, and user fee front. These policy instruments are economically less dampening on growth than income and capital taxes. Alberta may be an outlier from the rest of the group in this regard – tweaks to personal income and/or corporate income tax rates are thought to be under consideration.

The Prince Edward Island government will harmonize its provincial sales tax with the federal Goods and Services Tax on April 1, 2013. This tax move was announced in last year’s budget. British Columbia also returns to its provincial sales tax on this same date, after their referendum struck down the proposal for a Harmonized Sales Tax (HST).

In pre-budget consultations, New Brunswick Finance Minister Higgs has stated that the government may hold a referendum to gauge public appetite for a higher HST and greater user fees such as tolls. The province is also contemplating a health care levy, like the ones adopted in Ontario and British Columbia. Québec also has a similar tax in place. In its 2013 budget, the government chose to make the tax rate progressive along the income scale.

Sin taxes (tobacco and liquor taxes) are another popular move as they curb less-than-optimal behaviour and, at the same time, higher rates help pad government coffers. In its 2013 budget, Québec increased these rates; other provinces are likely to follow suit.

4. Need for additional belt-tightening if deficit reduction timetables are not changed

With modest momentum on the revenue front, clamping down on spending will be an important factor to successful deficit elimination. With the larger deficit tally recorded in fiscal 2012-13, the hill towards budgetary balance is much steeper than it was just a year ago. Additional belt tightening will have to be relied upon to meet the deficit slaying objective. In these instances, a greater amount of fiscal drag would be felt in the economy to accomplish the feat.

The British Columbia and Alberta Premiers have stated that their deficit reduction timetable of fiscal 2013-14 will remain in tact, despite the talk order. Saskatchewan Premier Brad Wall has indicated that his government’s budget will remain balanced. The Québec budget tabled late last year had a balanced budget objective for fiscal 2013-14, but it is unknown whether the province is on track to meet this target.

Some policymakers have argued that the date of deficit reduction is a moving target. It is the path to fiscal restoration that matters, not necessarily the end date. In other words, these policymakers would argue that deficit reduction should not be accomplished at any cost – public services are needed and cutting too much, too soon, would generate unnecessary harm to an already fragile economic recovery. Some governments have already announced or have begun to test the waters on delaying their deficit timetables.

- Nova Scotia Finance Minister Maureen MacDonald has said her government’s deficit reduction timetable may be delayed by one year.
- In its fall update, the federal government announced that its deficit reduction timetable would be postponed one year to fiscal 2016-17. However, in later comments, Federal Finance Minister Flaherty remarked that fiscal 2015-16 remains the working assumption.

In announcing the fiscal setbacks, policymakers argued that they need to strike the right balance between slaying their deficits and investing in the key drivers of economic growth. When the 2013 budget season is done, we would not be surprised to see two or three provincial governments
set their original timetables back one year.

5. Leaner health care and education, but both to reign supreme

The need for belt-tightening is nowhere as stark as in health care and education. All of the platforms that won in last year’s election cycle stated that health care and education will continue to be of upmost importance for governments over the medium-term. Speeches from the Throne, pre-budget consultations and media reports argue that education and health care are public services which should be preserved. That being said, health care and education spending growth are not going to be returning to their historical trends over the next few years – governments cannot simply afford to do so at the moment.

Spending in these two areas have been labelled strategic priorities, and in turn, the departments are typically assigned a greater-than-average spending growth target. Yet, both of these areas eat up approximately seventy per cent of total spending for most provinces. Such a large portion crowds government’s ability to pay for many other services. Add in debt servicing costs and the available dollars get squeezed further.

With such a significant amount of the total spending pot at stake, governments in the upcoming budget season will continue to look for ways to streamline services, consolidate programs and, in the case of health care, improve patient-delivery outcomes and reduce the incidence and the health care burden of chronic illnesses. Manitoba’s plan to streamline regional health authorities and Ontario’s plan to consolidate some school boards are good examples of the type of initiatives likely to find their way into budgets.

6. Enduring need to articulate a credible, medium-term fiscal plan

While the specific date of deficit elimination is less headline-worthy, the same cannot be said for a credible, medium-term fiscal plan. Saskatchewan is the only government in Canada who does not regularly publish a medium-term plan, although it has the distinct advantage of being the only province currently in a surplus position.

For those governments in deficit, the medium-term plan is what the credit rating agencies use in their assessment and evaluation of government finances. Last year, Standard & Poor’s downgraded New Brunswick to A+ and put Ontario in a negative outlook position. Moody’s placed British Columbia on a negative outlook as well in December.

In making these decisions, the credit rating agencies were not satisfied that sufficient progress was being made and/or the government did not put in place the necessary policies to achieve their specified targets. However, Ontario recently beat their 2012-13 deficit target by $3 billion, a development which should provide some comfort to the rating agencies for the time being. Credit rating agencies will also look for prudent economic assumptions and contingency reserves, as both signal some wiggle room for governments in the event of an unexpected need and/or emergency.

The general public is also an important element to building and communicating the fiscal plan. Pre-budget consultations are used to help solicit advice, respond to feedback, frame expectations and to receive the necessary buy-in. Another medium which has popped up on several government websites is a deficit fighting calculator. This tool allows the public to understand the difficult decisions required. It also helps underscore the notion that dramatic
action is required and to achieve deficit reduction, priorities will have to be identified and inherent social trade-offs made. What’s more, participatory decision making usually leads to less resistance to the savings objectives. More of these Town Halls will undoubtedly be in store, especially as governments run out of low-hanging fruit to pick.

7. Public sector compensation and labour negotiation file to remain active

Since governments have embarked on spending restraint, public sector and broader public sector labour negotiations have been quite active. In the Commission on the Reform of Ontario’s Public Services, Don Drummond and his fellow commissioners stated that wages, salaries and benefits represent about half of all Ontario’s program spending. Roughly the same statistic likely prevails across Canada. To curb the pace at which labour costs rise, the following measures have been implemented across the country:
- Freezing the number of employees in the public sector (or broader public sector) or eliminating positions either through layoffs or attrition;
- Compensation restraint measures for public sector employees and/or elected officials – these include pension changes, salary freezes, or limiting salary growth to the pace of inflation;
- Improved management of sick leave usage; and
- Reduced dependency on consultations and travel.

Labour negotiations and compensation agreements will still be on top of many government agendas in the year ahead. The Alberta government recently set physician fees after negotiations with the provincial medical association stalled. The British Columbia government hopes to secure a 10-year labour deal with teachers. With a new Premier in place, there has also been growing calls in Ontario for some changes to Bill 115 which implements restraint measures in the provincial education sector.

8. Infrastructure: one of the elephants in the room

There was a significant boost to public infrastructure projects as a result of federal-provincial stimulus programs. This injection of cash stopped a declining trend of public investment in infrastructure in Canada since the 1950s. Stimulus funds have now been spent and governments are paring back their capital budget plans to help repair their fiscal positions. Previously-announced projects have been put on hold. In other cases, multi-year projects have been extended to minimize the annual impact to the fiscal plan.

A long-term infrastructure plan has the ability to contribute economic growth under the right circumstances. It represents another balancing act between deficit reduction and starving the very spending that is meant to drive economic growth. In this context, the federal government is negotiating a sequel to Building Canada which expires in 2014. Recent media reports have signalled that infrastructure will be a key theme in the upcoming federal budget. Other governments also have infrastructure on their mind.

The usual instruments to pay for these projects are being tossed around: public-private partnerships and industry loan guarantees. Alberta Premier Redford also mentioned that social infrastructure bonds could be an effective tool to pay for the items needed. As her province intends to borrow to fund some of these large endeavours, Alberta might be
the first in the country to explore this funding instrument.

9. Political uncertainty lingers under the surface

Any budget document represents a blend of politics and policy. While 2013 is not the year of the election that marked 2012, political uncertainty always lingers in any budget setting. In the case of British Columbia, the upcoming budget will represent Premier Clark’s last before voters head to the polls in May. While pre-election spending promises are likely to be minimal given the fiscal 2012-13 deterioration, the tone of the budget speech and document could provide signals as to what might be included in an election platform. Speeches from the Throne may also give glimpses to government’s agenda and priorities for fiscal 2013-14.

A budget represents a confidence vote and Ontario and Québec have minority governments in place. The Québec budget passed the National Assembly last year. In Ontario’s case, newly appointed Premier Wynne may work with the opposition parties to garner enough support for the budget to pass the legislature. If this does not occur, Ontarians could be headed to the polls for the second time in two years.

10. Long-term visions continuing to emerge

We suspect that budgets in the upcoming season will increasingly have a two-pronged agenda: (1) to restore fiscal order over the medium-term; and (2) to put policies and measures in place to foster economic prosperity and fiscal prudence over the longer-term. The federal government began this discussion with its 2012 budget titled “Jobs, Growth and Long-Term Prosperity.” We anticipate that the 2013 federal budget will drive forward some of these long-run priorities.

 Provincial governments are also increasingly talking about long-run challenges. In Alberta, for instance, there have been questions about savings policies and the exploration of other fiscal planning methods to fight resource booms and busts. For those governments (e.g., Alberta) who did tap into their rainy day funds, policies will likely be announced either this year or next to replenish these reserves.

Paring down net debt is also a challenge over the longer-term. This is because governments will encounter a debt overhang long after deficits are eliminated. In a recent speech, former Ontario Finance Minister Dwight Duncan labelled the province’s debt as a ticking-time bomb that needs to be addressed. The same sentiment could be applied to government debt across the country if it continues to climb amid modest economic growth.

Final thoughts and bottom line

This report highlights the overarching themes which should prevail in the 2013 budget season. In putting together this list, we noted that each government is in a different position. Inherent differences stem from politics, but also because governments are at different stages of their economic and fiscal cycle. At this juncture, there is a fork in the road for the path ahead. Governments now in surplus mode could switch the discussion to hanging onto their good fortunes, but also spark conversations about longer-term challenges. For those wanting to make good on previous deficit timeliness, additional belt tightening might be warranted. Others have a ‘we’ll get there when we get there approach’, stating that there is a careful balancing act between fiscal retrenchment and promoting economic growth.

With all these scenarios possible, it is difficult to put all Canadian governments in the same bucket. However, the common denominators across the country are the economic challenges present and the downside risks to the forecast.

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