SPECIAL REPORT

TD Economics

March 21, 2012

CHIPPING AWAY AT THE FEDERAL DEFICIT

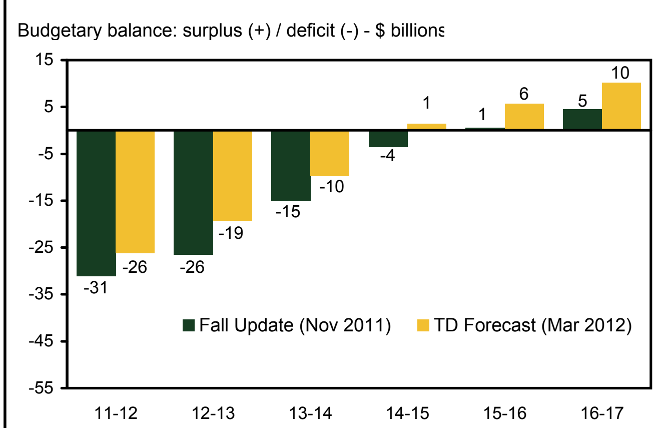
A Bit More Room to Manoeuvre

Highlights

- Upgraded economic assumptions and spending coming in well below target puts the federal government on track to record a deficit of around $26 billion for fiscal year 2011-12, nearly $5 billion better than estimated in the November Fall Update.
- In TD Economics' revised 'status-quo' fiscal projection, we assume that a good part of the positive momentum will carry forward to future years, putting the government in a position to record a modest planning surplus in 2014-15, one year earlier than previously forecast. These projections, which show surpluses building to about $10 billion (0.5% of GDP) in 2016-17 assume that the government achieves the program spending and administrative efficiency targets as highlighted in the Fall Update.
- Despite this good news, austerity will remain the key theme in the 2012 budget. Still, in recent weeks, senior federal officials have said that only a high level of detail will be provided in the budget on where spending restraint will be secured.
- Rather than accelerate the pace of deficit reduction, any additional wiggle room due to a stronger starting point could be used to incorporate more prudence into the budget plan, cancel the need to find up to $4 billion in annual spending efficiencies, raise the program spending profile and/or implement new targeted and limited tax measures.
- Based on our calculations and assuming spending efficiencies have been secured, the government could keep its 2015-16 balanced budget target and raise program spending growth by roughly a half a percentage point per year relative to that shown in the Update. However, such a boost would not dramatically alter the difficult restraint challenge at hand.
- Governments across the country are balancing deficit reduction plans with a need to plan for the future given only modest long-term economic growth. This two-pronged mission statement was the undercurrent in the Drummond Report and we expect a similar give-and-take to play out later this month in the 2012 federal budget.

While Canadians are braced for a tough 2012 federal budget, one nugget of good news surrounds the progress being made in slaying the deficit. Improved economic assumptions and lower than-anticipated spending numbers suggest that the federal government is enjoying a brighter fiscal outlook than just a few months ago – the deficit is now estimated at $26 billion (1.5% of GDP) for fiscal 2011-12. TD Economics projects that if the economy unfolds as expected and spending efforts laid out in the Fall Update are achieved, the government would return to a modest surplus in 2014-15. Looking beyond 2014-15, the budgetary surplus is projected to blossom to roughly $10 billion in 2016-17 as revenue

A RETURN TO THE ORIGINAL DEFICIT REDUCTION TIMETABLE – SURPLUS IN FY 14-15



Source: Department of Finance Canada - 2011 November Update on Economic and Fiscal Projections. Forecasts by TD Economics as at March 2012.

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growth exceeds that of spending. It is important to stress that our numbers are less a forecast but more a status-quo projection. Put another way, we assume no additional tax or spending changes beyond those measures already announced.

The improved starting point should provide the government with some wiggle room as its shifts its attention towards the difficult job of restraint. In particular, the government has taken revenue raising initiatives off the table and in turn, is relying on holding spending growth down substantially to get federal books to balance. This restraint comes in two forms: (1) reining in program spending growth to 2.2% per year over six years; and (2) securing permanent administrative efficiencies in the current plan. With Ottawa's comprehensive spending review (led by Treasury Board President Tony Clement) now complete, we were hoping that more details would be released in the upcoming budget regarding both of these plans. Yet, expectations have been tempered in recent communications by senior federal officials about how much detail will be included.

As we saw with the Drummond exercise in Ontario, structural reform is required to keep Canadian government income statements in the black over the long-term. With discussions surrounding innovation and pensions already seeping into the public arena, it seems that the federal budget will be tackling some of these meaty issues as well.

ECONOMIC ASSUMPTIONS* FOR CANADA
Annual, percent change (unless otherwise noted)

Calendar Year	2011	2012	2013	2014	2015
Real GDP					
2011 November Update	2.2	2.1	2.5	2.5	2.5
TD Economics*	2.5	2.2	2.4	2.2	2.1
Nominal GDP					
2011 November Update	5.3	4.1	4.5	4.5	4.5
TD Economics*	5.8	4.8	4.3	4.2	4.2
Nominal GDP ($ billions)					
2011 November Update	1,711	1,781	1,861	1,945	2,032
2011 November Update (planning assumption)	1,691	1,751	1,841	1,935	2,022
TD Economics*	1,719	1,802	1,878	1,958	2,039
Unemployment rate					
2011 November Update	7.5	7.2	7.0	6.8	6.6
TD Economics*	7.5	7.4	7.1	6.8	6.6
3-Month T-Bill Rate					
2011 November Update	0.9	1.2	2.0	2.9	3.5
TD Economics*	0.8	1.0	2.1	2.6	3.3
10-Year Gov't Bond Yield					
2011 November Update	2.8	2.7	3.2	3.9	4.5
TD Economics*	1.9	2.9	3.4	3.9	4.7

* Forecasts as at March 2012.
Source: 2011 November Update on Economic and Fiscal Projections.

Improved fiscal starting point for 2011-12

In the federal fall update released last November, the government forecast a deficit of $31 billion for 2011-12. At the time, there were significant worries about the economic recovery and as a result, the government had built in additional prudence in the event that unanticipated spending was needed and/or revenues came in below expectations.

The government's Fiscal Monitor publication allows us to gauge how the federal fiscal plan has performed for 2011-12 as a whole and since the fall update. We have data from April-December 2011, or three quarters of the fiscal year, with which to make our assumptions. In the first nine months of the year, the government has run a deficit of $17.7 billion, significantly lower than the $27.4 billion reported during the same period in 2010-11. What's more, the monthly deficits since the fall update have actually shown marked year-over-year improvement. The ameliorated bottom line for the fiscal year as a whole can be chalked up to better-than-expected revenue growth and lower-than-targeted spending:

- Revenues are up across most major categories including personal and corporate income taxes from April-December 2011, helped in part by upgraded economic assumptions. For corporate tax revenues, the government notes that it is experiencing a 3.5% increase in receipts and a 9.7% decrease in the tax refunds paid. Employment Insurance (EI) revenues are also up so far in 2011-12, reflecting growth in insurable earnings and a higher premium rate of $1.78 per $100 of insurable earnings.
- On the expense front, program expenditures are coming in lower-than-budgeted due to reduced EI benefit outlays and fewer transfers to certain departments like Aboriginal Affairs and Northern Developments, and Foreign Affairs and International Trade. By contrast, transfer outlays to other levels of government are up in large part due to legislated growth rate increases for many of the major programs (Equalization, Canada Health Transfer, and Canada Social Transfer).
- Treasury Board President Tony Clement has sent a directive to bureaucrats to forego the 'March Madness' spending binge that is often recorded in the last three months of the year. This should help keep 2011-12 spending in line with year-to-date Fiscal Monitor estimates, as bureaucrats avoid allocating funds towards new furniture, promotional items, stockpiling of IT hardware and other purchases as the fiscal year comes to a close[1].

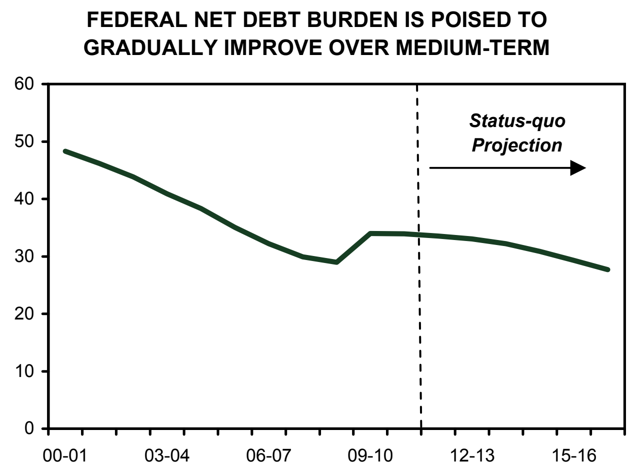
In coming up with a revised estimate for 2011-12, it is not as simple as taking the nearly $18 billion figure, dividing it by the number of months (in this case nine) and then inferring the annual total (in this case, $24 billion). While this methodology is straightforward, it is also rough, as year-end re-statements are almost always applied to Fiscal Monitor monthly numbers. In most years, these adjustments are typically in the $2.0-2.5 billion range and in turn, we feel comfortable placing the federal deficit for the current fiscal year at $26.1 billion (or 1.5% of GDP). If it materializes, it would be well below the 3.6% federal deficit to GDP burden recorded at the height of the 2008-09 recession.

Modest economic growth to reign over medium term

Federal Finance Minister Flaherty has indicated that the late budget this year stems from having to wait out what happens in the euro zone. Since the November Update, there has been a mild improvement in our global and Canadian economic outlook. While the rosier picture abroad is certainly not set in stone, there are less negative downside risks than were present just a few months ago. As a result, we have upgraded our real GDP growth forecast for Canada versus our December call to 2.2% in 2012 (up from 1.7%) and 2.4% in 2013 (up from 2.2%). Our nominal growth profile has also benefitted from a similar bump up. The sources for the more positive view are as follows:

- a milder recession in the euro zone given recent progress to avoid a Greek default and the lower risk we now attach to global financial market contagion;
- a better economic trajectory than we last forecast for the U.S. as the job picture and consumer spending continue to improve and for China, as the impacts of monetary policy work their way into the economy;
- commodity prices staying firm, with crude oil hovering at around US$100 per barrel; and
- a lower for longer interest rate profile such that the Bank of Canada is not expected to lift its overnight rate until mid-2013, giving support to the Canadian housing market and consumer spending in the interim.

The budget uses an average of the private sector consensus for its planning assumptions. While private sector economists met earlier this month to share their thoughts on the economic outlook, the survey results were not published. This is because the forecasts needed updating, in light of revised Statistics Canada data. In the past several surveys, TD Economics has come in at the lower end of the private sector forecasts. However, we believe that our numbers are reflective of what will ultimately be published in the budget as the government will likely continue its practice of shaving off a small amount of the level of private sector nominal GDP.



Source: 2011 Federal Fiscal Reference Tables and November Update on Economic and Fiscal Projections. Status-quo projections by TD Economics as at March 2012.

Better start to carry through the forecast horizon

The better economic assumptions described in the last section positively impact the medium term revenue plan in all fiscal years. For 2012, we have nominal GDP $51 billion higher than the government's planning assumption, which translates into approximately $4-5 billion in more revenue for government coffers. Out-performance on the nominal GDP vis à vis the Fall Update persists again in 2013. Positive momentum wanes in the later years, as this is when we believe the Canadian economy will begin to deal with higher interest rates, record household debt levels and a gradual unwinding of the Canadian real estate market. Still, come 2016-17, our status-quo revenues are $2.6 billion higher than those presented in the Fall Update.

For program spending, we have assumed that roughly half of the spending savings achieved this year are permanent in nature. While this is imprecise, we have little information to go on and we feel that it is conservative to assume that only some of the savings carry forward. Otherwise we have largely kept the medium term profile included in the Fall Update unchanged. Case in point, we have assumed that the government is able to secure up to $4 billion in annual permanent spending efficiencies come 2014-15. In turn, despite the better fiscal starting point, we have kept this line in the federal fiscal plan.

FEDERAL GOVERNMENT FISCAL POSITION (C$ billions, unless otherwise indicated)									
	Actual			TD Economics' Projections - March 2012					
Fiscal Year	08-09	09-10	10-11	11-12	12-13	13-14	14-15	15-16	16-17
Budgetary revenues	**233.1**	**218.6**	**237.1**	**244.5**	**256.7**	**271.6**	**287.4**	**300.6**	**313.2**
% change	-3.8	-6.2	8.5	3.1	5.0	5.8	5.8	4.6	4.2
% of GDP	14.6	14.3	14.6	14.2	14.3	14.5	14.7	14.7	14.7
Program expenses	**207.9**	**244.8**	**239.6**	**238.6**	**244.4**	**249.5**	**254.5**	**262.1**	**269.0**
% change	4.2	17.8	-2.1	-0.4	2.4	2.1	2.0	3.0	2.6
% of GDP	13.0	16.0	14.8	13.9	13.6	13.3	13.0	12.9	12.7
Public debt charges	**31.0**	**29.4**	**30.9**	**32.0**	**32.5**	**33.8**	**35.5**	**36.8**	**38.0**
% change	-7.0	-5.1	5.1	3.4	1.7	4.0	5.0	3.7	3.3
% of Debt (t-1)	6.8	6.3	6.0	5.8	5.6	5.7	5.9	6.1	6.4
% of Revenues	13.3	13.5	13.0	13.1	12.7	12.4	12.4	12.2	12.1
Total expenditures	**238.8**	**274.2**	**270.5**	**270.6**	**276.9**	**283.3**	**290.0**	**298.9**	**307.0**
% change	2.6	14.8	-1.3	0.0	2.3	2.3	2.4	3.1	2.7
% of GDP	14.9	18.0	16.7	15.7	15.4	15.1	14.8	14.7	14.4
Deficit reduction action plan savings target	--	--	--	**0.0**	**1.0**	**2.0**	**4.0**	**4.0**	**4.0**
Budgetary balance	**-5.8**	**-55.6**	**-33.4**	**-26.1**	**-19.2**	**-9.7**	**1.4**	**5.7**	**10.2**
% of GDP	-0.4	-3.6	-2.1	-1.5	-1.1	-0.5	0.1	0.3	0.5
Federal debt	**463.4**	**519.1**	**550.3**	**576.4**	**595.6**	**605.3**	**603.9**	**598.1**	**587.9**
% of GDP	29.0	34.0	33.9	33.5	33.1	32.2	30.8	29.3	27.7
				2011 Fall Federal Update of Economic/Fiscal Projections November 2011					
Budgetary revenues	233.1	218.6	237.1	243.5	251.8	268.8	285.1	298.4	310.6
% change	-3.8	-6.2	8.5	2.7	3.4	6.8	6.1	4.7	4.1
Total expenditures	238.8	274.2	270.5	274.5	279.2	285.8	292.6	301.8	310.1
% change	2.6	14.8	-1.3	1.5	1.7	2.4	2.4	3.1	2.8
Budgetary balance	**-5.8**	**-55.6**	**-33.4**	**-31.0**	**-26.4**	**-15.0**	**-3.5**	**0.6**	**4.5**
% of GDP	-0.4	-3.6	-2.1	-1.8	-1.5	-0.8	-0.2	0.0	0.2
Federal debt*	**463.4**	**519.1**	**550.3**	**585.2**	**612.7**	**629.7**	**637.2**	**640.6**	**640.0**
% of GDP	29.0	34.0	33.9	34.6	35.0	34.2	32.9	31.7	30.3

Source: Department of Finance Canada. Projections by TD Economics as of March 2012.

For debt servicing costs, our interest rate profile is similar to that assumed in the federal fall update. As we propagate the assumption of lower interest rates for longer through the fiscal plan, we yield $2.2 billion in cumulative savings over a five year period.

Under these assumptions, the federal government could see a return back to surplus by 2014-15, which would be in line with the Conservatives' election platform. By 2016-17, the black ink is projected to rise to about $10 billion, as the federal debt-to-GDP ratio falls back to an estimated 28%, about six percentage points below the 2011-12 peak.

As we argued in our last federal fiscal analysis report, changes in the government's bottom line should always be placed in context so that appropriate conclusions can be made[2]. Case in point, the small surplus projection could easily change with just a minor revision to our underlying economic assumptions or the program spending profile.

Speculation on what might be in the 2012 budget

One of the key aims of a status-quo fiscal projection is to estimate the budget balance path under a certain set of economic assumptions and/or to provide a sense for how much scope there is for additional measures and maintain a certain path. While we wait patiently for the 2012 budget, the media have reported on several measures and initiatives that could find their way in the document. The speech made by Prime Minister Stephen Harper in Davos, Switzerland in January served the same purpose as a 'Speech from the Throne' as the Prime Minister used the opportunity to outline some of his government's key near term priorities[3]. Here is a list of what has been speculated about the contents of the upcoming budget. We have separated out initiatives that are highly likely to be included in the document from those which remain speculation up until this point.

What we know or what is likely to be included:

- We expect to see a plan that shows a balanced budget by 2015-16, with no new taxes or revenue-raising measures on tap. This places the burden of deficit reduction purely on the back of spending restraint. However, this does not preclude new small spending items, particularly if some additional fiscal room is available. For example, last month, Prime Minister Harper announced $27 million for adult education in the North, with the funds for three colleges spread over five years[4]. The money will be targeted at improving the job opportunities and education access for Northern residents. Although details are known, we expect the budget to reference this new initiative.

- Changes to transfers to other levels of government and individuals are off the table.
- National employment growth has stalled over the past six months. With this trend likely in mind, Prime Minister Harper has said that the budget will contain several measures targeted at 'job creation.'
- Coming out of the comprehensive spending review, some federal departments will likely experience greater austerity than others. Departments thought to be more vulnerable in this regard include National Defence, Veteran Affairs, Public Works and Foreign Affairs. We will likely to have to wait a while before we learn the details behind the broad brush strokes of austerity and expenditure restraint. Treasury Board President Clement has said that details will be released in several stages – between the budget and Fall Update – as information becomes available and supplementary estimates are published[5].
- Details should be provided on the long-run outlook of Canada's retirement income system. Human Resources and Skills Development Canada Minister Diane Finley has said that any changes announced in the budget will not impact the Canada Pension Plan (CPP) or anyone who is currently aged sixty-five and older. New criteria will also not affect any individual who will become eligible for Old Age Security (OAS) in the next few years. The media have speculated that the forthcoming changes will increase the eligibility age for OAS to 67 years, from the current age of 65, effective in or around 2020.
- Prime Minister Harper's speech in Davos spoke about putting increased emphasis on business innovation. We anticipate that the government will move to implement many of the recommendations put forth by a recent research and development commission led by Tom Jenkins. Highlights include enhancements to the Scientific Research and Experimental Development program and the creation of an Industrial Research and Innovation Council.
- New rules are expected to expedite the environmental approval process for energy-related projects[6].

Other moves that could be included:

- Civil service cuts are rumoured, with some reports putting the figure at 30,000 positions over three years (roughly 10% of the total federal civil service)[7]. But, the government has neither confirmed nor denied that such a move is coming, except to say that the public sector must also do its part. Wages and salaries represent a large share of all program costs and in turn, this entry in the spending ledger must have been reviewed. However, if these types of cuts are pursued, they will provide long-term savings for the federal fiscal plan. In the interim, however, the government will need to book sizeable expenditures related to severance packages and buy-outs.
- Other areas where spending restraint might be announced include agricultural support, border infrastructure, public safety, infrastructure renewal and official languages programs.
- The speech in Davos also mentioned a need to overhaul the immigration system in Canada. We echoed concerns about the current immigration system in an in-depth report last month[8]. However, given their comprehensive nature, we believe that any policy changes on this front will be announced outside of the budget process.
- At the meeting with private sector economists earlier this month, unease was raised about the overvaluation incorporated in the Canadian housing market. Based on media reports, members and Minister Flaherty also discussed possible policy changes that could be tabled to mitigate this concern. With no impact to the federal treasury, the government could choose to lower the maximum amortization period for mortgages to 25 years (from 30 years) or other action in the upcoming budget, as a first step to reining in home prices and personal borrowing.

What we are looking for come March 29th

Based on recent public remarks by senior federal officials, we fully expect that the government will maintain the same deficit elimination timetable as that shown in the November Update: 2015-16. While this fiscal year will remain the target, the small deficit in 2014-15 could easily turn into a surplus if, for example, the economy outperforms. Given that budget planning assumptions have likely improved to some extent since the Fall, maintaining the same budget timetable suggests that the government might have some additional resources at its disposal. Based on our status-quo projection, this might amount to as much as

$4-5 billion per year – that could be used to (1) modestly soften the pace of spending restraint; (2) cancel the need to find annual permanent spending efficiencies; (3) build in more prudence into the fiscal plan in light of the substantial longer term economic uncertainty; or (4) pursue modest and targeted tax relief that helps to improve the economy's longer-term growth and innovation potential. With the government appearing steadfast in its desire to achieve its spending restraint targets, the probability of (3) and (4) are considerably higher than (1) and (2).

We fully recognize that austerity is never easy and can have marked regional, industrial and households impacts. However, moving to eliminate the deficit as an economy recovers – albeit gradually – is responsible fiscal policy. With nerves on alert given the austerity talk and what it could all mean, there has been growing debate about whether now is the right time for spending restraint or whether significant cuts could tip the economy into recession. Unfortunately, there is never a right time to implement restraint – short-term pain is required for long-term gains. Forecasters continue to predict moderate economic growth over the next several years despite plans both federally and provincially to slay deficits. Accommodative monetary policy during some of this period will help to insulate the economy, but these same low rates are raising concerns about growing debt levels. In that vein, the implementation of further measured changes to mortgage insurance rules could help to mitigate the risks of a severe correction in housing activity and household debt deleveraging down the road.

Given that we are still in the recovery phase, it is easy to be myopic about the economic challenges present and the inherent risks to the forecast. However, the long-term challenges such as growing health care costs and an ageing population are equally as important. With so much talk about growth enhancing measures, we hope the budget lays out a more comprehensive plan for improving the economic outlook over the long run. We saw this type of framework tabled in 2006 with the government's Advantage Canada action plan. The building blocks are probably still relevant today. However, we are in a period of restraint and will be for some time to come. As a result, we will need an augmented plan which takes these recent developments into account.

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