



TD Economics

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THE STATUS QUO FEDERAL FISCAL OUTLOOK: NOT MUCH ROOM HERE

While the federal government's 2006 Budget was only 3 months ago, planning for the 2007 Budget will soon begin with a meeting with private sector economists in late September or early October, followed by release of a Fall Economic & Fiscal Update and then hearings by the House of Commons Standing Committee on Finance. Many unofficial fiscal planning exercises are likely already underway. The Conservative Party may have turned its attention to crafting a new platform. The Liberal Party leadership contenders are no doubt examining the interplay between their positions and fiscal realities. Various interest groups are preparing to engage in the planning processes.

A difficulty all fiscal actors will encounter is that there are no official fiscal projections available beyond 2007-08, the last year covered in the 2006 Budget. As some policy measures take several years to mature and the Government has set a longer-term objective for the debt burden, a much longer time horizon is needed for planning. And as some decisions may be made well before next year's Budget, such as for transfers to the provinces, there is utility in having a longer-term view fairly soon. However, the last official longer-term projection, extending through 2010-11, was in the Fall 2005 Update by the Liberal Government. But many of the underlying policies have since been altered, undermining the usefulness of that document.

This note takes a stab at a highly unofficial longer-term projection of the federal government's books. The period extends to 2012-13 to give 5 years following the 2006 Budget's horizon. The figures for 2006-07 and 2007-08 have been left unchanged from the 2006 Budget. Subsequent data suggest some tweaking of components is in order, but

ECONOMIC ASSUMPTIONS (per cent)					
	2008	2009	2010	2011	2012
Real GDP growth	2.9	2.9	2.9	2.8	2.8
GDP inflation	1.7	1.7	1.7	1.7	1.7
Nominal GDP growth	4.7	4.7	4.7	4.6	4.6
3-month treasury bill rate	4.2	4.2	4.2	4.2	4.2
10-year Gov't of Canada bond rate	5.4	5.4	5.4	5.4	5.4
Source: TD Economics					

in aggregate the Budget still appears to be a reliable representation of the near-term fiscal situation. The projections for the later years borrow liberally (excuse the pun) from last year's Fall Update, with appropriate corrections for policy changes. The Conservatives promise of a second point cut to the GST rate has not been incorporated into the status quo outlook.

No adjustments have been made to reflect differences in view between the Budget assumptions and internal projections by TD Economics. In a sense, this exercise could be viewed as an attempt to forecast what the federal government will show in the 2006 Fall Update.

Planning surpluses are modest

Under the key assumptions of continuing sound economic performance and implementation of the policy agenda set out in the 2006 Budget, budget surpluses would continue to accrue. But they would be quite modest. The 2006 Budget projected that on top of paying down \$3 billion of debt each year, there would be remaining surpluses of \$0.6 billion this year and \$1.4 billion next year. These remaining surpluses would not change much over the next 2 years at \$1.9 billion and \$2.0 billion. The surpluses above and beyond the \$3 billion annual debt payments would then grow in the final 3 years.

Over the 5 years 2008-09 to 2012-13 the surpluses on top of the committed debt payments average \$6.2 billion per year for a cumulative total of \$31.2 billion. On the surface these may appear to be significant figures. But they are not large beside the cost of initiatives in recent budgets. The Liberal's 2005 Budget had \$41.8 billion of initiatives over 5 years and the Conservative's 2006 Budget had \$35.1 billion over 3 years. Further, consider that a single point reduction (or transfer to the provinces) in all 4 personal income tax rates would cost more than \$6.5 billion per year by 2010. Of greater relevance for the Conservatives is that by 2010 a point cut in the GST rate will also cost about \$6.5 billion per year. The cut could not even be accommodated in this status quo projection by 2010 without compromising the commitment to pay down \$3 billion of debt each year. If the 3-year cost of a point GST rate cut is applied to the final years, the 5-year cumulative remaining surplus above debt paydown is only \$11 billion or an average of just over \$2 billion per year.

A number of conclusions seem evident from this unofficial projection. First, the federal government's books should remain in a healthy state. In particular, the debt-to-GDP ratio falls below 25 per cent by 2012-13, one of the lowest in the world and just over one-third where it stood in Canada in the mid-1990s. This milestone is reached one year earlier than the objective set in the 2006 Budget. Second, while respecting the commitment to pay down at least \$3 billion of debt per year, there isn't a lot of room for

new initiatives short of cutting existing programs and services. This of course has great relevance in the current debate over federal-provincial transfers. It may also serve as a bitter reality check for politicians and advocates alike who may be contemplating schemes with significant costs.

Forecasts can be wrong, policies can be changed

As to forecast accuracy, consider that this exercise assumes a continuation of solid economic performance with modest interest rates for another 6 years. Anyone caring to give a thought to the upside should also ponder that things could be worse. After 2007-08, program expenses rise at an average annual rate of 4.1 per cent. It would certainly be feasible to lower that. But difficult decisions would be required.

The projection for program expenses already implicitly assumes that the internal cost-cutting exercise announced in the 2006 Budget will be successful in meeting its objective and then keeping spending to the lower track. Second, much of the growth in spending comes from programs that in recent times have been considered "untouchable". For example, driven by indexation to the CPI and the rising growth rate of the population over the age of 65, elderly benefits rise at an annual average rate of 4.9 per cent beyond 2007-08. If the Conservative Government follows the plan legislated by the Liberals for transfers to the provinces for health and other programs then this component will grow at an annual rate of 5.3 per cent.

SUMMARY STATEMENT OF TRANSACTIONS							
(\$ billions)							
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Budgetary revenues	227.2	235.8	244.0	253.4	264.8	277.4	290.6
Program expenses	188.8	196.5	204.5	214.0	222.5	231.3	240.7
Public debt charges	34.8	34.8	34.6	34.4	34.2	34.0	33.8
Total expenses	223.6	231.4	239.1	248.4	256.7	265.3	274.5
Planned debt reduction	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Remaining surplus	0.5	1.4	1.9	2.0	5.1	9.1	13.1
Federal debt	483.4	480.4	477.4	474.4	471.4	468.4	465.4
Per cent of GDP							
Budgetary revenues	15.7	15.5	15.4	15.2	15.2	15.2	15.3
Program expenses	13.0	13.0	12.9	12.9	12.8	12.7	12.6
Public debt charges	2.4	2.3	2.2	2.1	2.0	1.9	1.8
Total expenses	15.4	15.3	15.1	14.9	14.7	14.6	14.4
Debt reduction	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Federal debt	33.3	31.7	30.1	28.5	27.1	25.7	24.4
Nominal GDP (billions of dollars, calendar year)	1451	1517	1588	1663	1741	1821	1905

Source: Department of Finance Canada, TD Economics

The current equalization scheme is indexed through legislation to 3.5 per cent growth. All the recent proposals for reform would raise the cost above what is contained in this status quo projection. Further, the federal government has said it is considering the provinces' request to increase transfers with respect to post-secondary education.

Direct program expenses, being the total of all non-major transfers to persons or other levels of government, is projected to grow at an annual rate of 3.9 per cent beyond 2007-08. This is dramatically lower than in recent years, (program expenses averaged 8.2 per cent annual growth from 1999-00 to 2004-05) but could certainly be lowered further. But again there would be real implications. Key factors keeping the growth rate up are the real increases in the budgets to defense and Overseas Development Assistance and rising depreciation charges reflecting the increases in infrastructure spending of recent years. The civil service wage bill, which comprises one-quarter of this spending category, is assumed to grow 3 per cent per year to reflect wage increases slightly higher than inflation (so a small real wage gain) and very modest in-

creases in employment levels.

Budget planning will be more restrained

If the Government's Fall Update projection bears any resemblance to this unofficial cut, then the days of "easy" budget planning are gone. Recent years have been easy on budget planners because a natural "wedge" had developed between revenues and spending that automatically generated growing planning surpluses. With the growth rate of budgetary revenues above that of total spending, the "wedge" produced larger surpluses as each new budget extended the planning period. But the "wedge" has been flattened. In the projections presented here budgetary revenues grow more slowly than program expenses because tax cuts have slowed revenue growth and new initiatives have ramped up spending growth. Now even with slightly declining public debt charges total spending (program expenses together with public debt charges) only increases modestly less rapidly than revenues. The elimination of the economic prudence factor in the 2006 Budget closed the door on \$1 billion of fiscal room that was automatically opened with each new fiscal year. The practice

OUTLOOK FOR BUDGETARY REVENUES (\$ Millions, <i>Per cent change in italics</i>)								
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2008-09 to 2012-13*
Tax revenues								
Income tax								
Personal income tax	109,275	115,530	121,045	126,529	133,801	141,319	149,253	
		5.7	4.8	4.5	5.7	5.6	5.6	5.3
Corporate income tax	35,345	36,805	36,535	37,346	38,242	40,001	41,842	
		4.1	-0.7	2.2	2.4	4.6	4.6	2.6
Other income tax	4,370	4,240	4,439	4,648	4,866	5,090	5,324	
		-3.0	4.7	4.7	4.7	4.6	4.6	4.7
Total income tax	148,990	156,575	162,019	168,523	176,909	186,410	196,419	
		5.1	3.5	4.0	5.0	5.4	5.4	4.6
Excise taxes/duties								
Goods and services tax	29,845	29,760	31,159	32,623	34,156	35,727	37,371	
		-0.3	4.7	4.7	4.7	4.6	4.6	4.7
Customs import duties	3,610	3,920	3,998	4,078	4,160	4,243	4,328	
		8.6	2.0	2.0	2.0	2.0	2.0	2.0
Other excise taxes/duties	9,965	10,095	10,297	10,503	10,713	10,927	11,146	
		1.3	2.0	2.0	2.0	2.0	2.0	2.0
Total excise taxes/duties	43,420	43,775	45,454	47,204	49,029	50,897	52,845	
		0.8	3.8	3.9	3.9	3.8	3.8	3.8
Total tax revenues	192,410	200,350	207,473	215,727	225,938	237,307	249,264	
		4.1	3.6	4.0	4.7	5.0	5.0	4.5
Employment insurance premium revenues	16,125	16,420	17,058	17,722	18,411	19,127	19,870	
		1.8	3.9	3.9	3.9	3.9	3.9	3.9
Other revenues	18,615	18,990	19,465	19,951	20,450	20,961	21,485	
		2.0	2.5	2.5	2.5	2.5	2.5	2.5
Total budgetary revenues	227,150	235,760	243,996	253,400	264,799	277,395	290,619	
		3.8	3.5	3.9	4.5	4.8	4.8	4.3

*Average annual growth rate; Source: Department of Finance Canada, TD Economics

of the Liberals and Conservatives to back-end load the cost of new initiatives has to eventually catch up with policy makers.

The end of “easy” budget planning is not necessarily to be lamented. It did, after all, lessen the need for discipline in all aspects of fiscal management. And we should not lose sight that Canada is in great fiscal shape relative to its own history and the record of almost every other country.

Further, the projections contained in this report do not need to spell the end of policy activism. But difficult trade-offs will need to be managed in order to introduce changes with large budget costs. Finally, many of the things that ail the country and economy can be creatively tackled without incurring significant costs. As productivity is enhanced, growth will rise and that will raise revenues and open more choices.

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OUTLOOK FOR PROGRAM EXPENSES (\$ Millions, <i>Per cent change in italics</i>)								
	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2008-09 to 2012-13*
Major transfers to persons								
Elderly benefits	30,625	32,030	33,471	35,011	36,622	38,416	40,645	
		<i>4.6</i>	<i>4.5</i>	<i>4.6</i>	<i>4.6</i>	<i>4.9</i>	<i>5.8</i>	<i>4.8</i>
Employment insurance benefits	14,580	15,205	15,813	16,446	17,104	17,788	18,499	
		<i>4.3</i>	<i>4.0</i>	<i>4.0</i>	<i>4.0</i>	<i>4.0</i>	<i>4.0</i>	<i>4.0</i>
Children's benefits	11,140	11,795	11,913	12,032	12,152	12,273	12,397	
		<i>5.9</i>	<i>1.0</i>	<i>1.0</i>	<i>1.0</i>	<i>1.0</i>	<i>1.0</i>	<i>1.8</i>
Total	56,345	59,030	61,197	63,489	65,878	68,477	71,541	
		<i>4.8</i>	<i>3.7</i>	<i>3.7</i>	<i>3.8</i>	<i>3.9</i>	<i>4.5</i>	<i>4.1</i>
Major transfers to other levels of government								
Federal transfers in support of health and other programs	28,640	30,150	31,680	33,590	35,325	37,091	38,946	
		<i>5.3</i>	<i>5.1</i>	<i>6.0</i>	<i>5.2</i>	<i>5.0</i>	<i>5.0</i>	<i>5.3</i>
Fiscal arrangements	13,055	13,175	13,636	14,113	14,607	15,119	15,648	
		<i>0.9</i>	<i>3.5</i>	<i>3.5</i>	<i>3.5</i>	<i>3.5</i>	<i>3.5</i>	<i>3.1</i>
Alternative Payments for Standing Programs	-2,870	-3,065	-3,300	-3,445	-3,625	-3,806	-3,997	
		<i>6.8</i>	<i>7.7</i>	<i>4.4</i>	<i>5.2</i>	<i>5.0</i>	<i>5.0</i>	<i>5.7</i>
Early learning and child care	650	0	0	0	0	0	0	
		<i>-100</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	
Canada's cities and communities	600	800	1,000	2,000	2,000	2,000	2,000	
		<i>33.3</i>	<i>25.0</i>	<i>100.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>26.4</i>
Total	40,075	41,060	43,016	46,258	48,307	50,404	52,597	
		<i>2.5</i>	<i>4.8</i>	<i>7.5</i>	<i>4.4</i>	<i>4.3</i>	<i>4.4</i>	<i>4.6</i>
Total for all major transfers	96,420	100,090	104,213	109,747	114,185	118,881	124,138	
		<i>3.8</i>	<i>4.1</i>	<i>5.3</i>	<i>4.0</i>	<i>4.1</i>	<i>4.4</i>	<i>4.3</i>
Direct program expenses	92,385	96,455	100,255	104,205	108,311	112,373	116,587	
		<i>4.4</i>	<i>3.9</i>	<i>3.9</i>	<i>3.9</i>	<i>3.8</i>	<i>3.8</i>	<i>4.0</i>
Total program expenses	188,805	196,545	204,468	213,952	222,496	231,254	240,725	
		<i>4.1</i>	<i>4.0</i>	<i>4.6</i>	<i>4.0</i>	<i>3.9</i>	<i>4.1</i>	<i>4.1</i>

*Average annual growth rate; Source: Department of Finance Canada, TD Economics

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Annex

Explanatory Notes to Status Quo Federal Fiscal Projection

All assumptions referenced below apply to the period post 2007-08. All figures for 2006-07 and 2007-08 have been taken from the 2006 Budget.

Budgetary Revenues

1. **Personal Income Tax** - Assumed an elasticity of 1.2 per cent with respect to personal income which is in turn assumed to grow with nominal GDP. Cost of post-2007 increases in basic amount are then deducted at \$300 million per \$100. That lowers revenues \$1 billion in 2008-09 and \$2.4 billion per year after.
2. **Corporate Income Tax** - Assumed an elasticity of 1 with respect to profits which in turn are assumed to grow with nominal GDP. The tax cuts in the 2006 Budget are then applied.
3. **Other Income Tax** - Assumed a match with nominal GDP growth.
4. **Goods and Services Tax** - Assumed to grow with nominal GDP.
5. **Customs Import Duties** - Applied growth of 2 per cent per annum – the average growth rate in the Fall Update for 2008-09 to 2010-11
6. **Other Excise Taxes/Duties** - Same assumption as for customs import duties.
7. **Employment Insurance Premiums** - Assumed to grow to keep the EI account in the same balance as in the 2006 Budget forecast for 2007-08. EI administration costs assumed to be \$1.5 billion in 2007-08 and grow 2% a year.
8. **Other Revenues** - Assumed to grow at an annual average rate of 2.5 per cent – similar to the average growth for 2008-09 to 2010-11 in the Fall Update.

Program Expenses

1. **Elderly Benefits** - Projected to grow with CPI inflation (2 %) and population 65 plus.
2. **Employment Insurance** - Projected to grow with average wages (3 ½ per cent – note the freeze in maximum insurable earnings is assumed to no longer be in effect after 2007) and the number of unemployed (which should trend modestly up with labour force growth) for total growth of 4 per cent.
3. **Children Benefits** - The Universal Child Benefit is not indexed so should decline at the rate of shrinkage of the population under the age of 6. The Child Tax Benefit should increase at a modest pace because payments are indexed, but the population under the age of 18 will decline and real income gains will squeeze payments due to the tax back provisions.
4. **Federal Transfers in Support of Health and Other Programs** - Applied the post 2007-08 growth rates from the Fall 2005 Update and extended at that pace.
5. **Fiscal Arrangements** - Applied the 3.5 per cent escalator in the current equalization regime.
6. **Alternative Payments for Standing Programs** - Applied growth rates from the Fall Update.
7. **Canada's Cities and Communities** - Applied levels from Fall Update and kept at \$2.0 billion per year beyond 2010-11.
8. **Direct Program Expenses** - Wages and benefits (one-quarter of total) projected to grow 3 per cent per annum.

Assuming no further amortization of pension account surpluses. The remainder is projected to grow 4.25 per cent per annum through 2010-11 reflecting commitments to increase real funding to areas such as defense and Overseas Development Assistance and the pick-up in depreciation allowances reflecting recent infrastructure investments. The growth rate for the non-wage component is assumed to be 4 per cent post 2010. The overall growth rates are thus 3.94% to 2010-11 and 3.75% after that.

Public Debt Charges

Assuming \$3 billion of debt is paid down each year, the stock of debt declines 0.6 per cent per annum. With flat interest rates that should lower public debt charges about \$0.2 billion each year (they could fall a bit more because some old, higher interest bonds would be turning over).