



March 10, 2011

HIGHLIGHTS

- The government will release its 2011 budget on March 22nd.
- We prepared a status quo fiscal forecast that does not take into account any possible budget items. Even so, the fiscal outlook is considerably brighter than last profiled in the fall update, due to a better-than-anticipated starting point.
- Status quo deficits of \$39.5 billion in FY 10-11 and \$21.7 billion in FY 11-12 are estimated.
- On track to return to a surplus position in FY 15-16.
- Will be a 'stay the course' budget that does not include any significant new spending, tax measures or cuts to transfers.
- An improved near-term economic and fiscal outlook creates a bit more wiggle room for the government to listen to other federal party demands. Examples of some of the items on the wish list include enhancements to the GIS and increased support for older workers.
- In the absence of any revenue measures, expenditure restraint will be increasingly relied upon to balance the federal books. Enhanced credibility would be given to the medium-term fiscal plan if further spending restraint details were presented in the 2011 budget.

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LOOKING AHEAD TO THE 2011 FEDERAL BUDGET

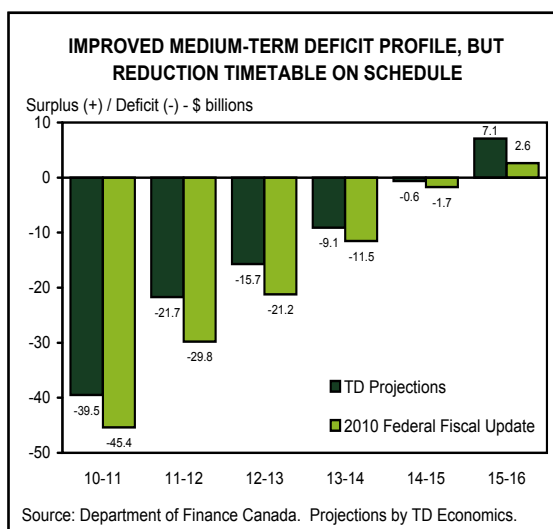
Helped in part by a better-than-anticipated starting point, the federal government is enjoying a considerably brighter fiscal outlook heading into its March 22nd budget than was the case in the fall of 2010. Indeed, from our status quo projections (e.g., excluding any 2011 budget items), we estimate the government is on track to report a \$39.5 billion deficit in FY 10-11. This would be a hefty \$5.9 billion improvement relative to the number included in the fall update. An \$8.1 billion upward revision is also anticipated for FY 11-12, leaving a \$21.7 billion deficit target. The positive momentum heading into 2011 will wane in the medium-term, but not enough to change the deficit reduction timetable and the plan to return to surplus in FY 15-16.

Despite this improved leeway, the government faces significant medium-term fiscal challenges. For one, the government's minority status in Parliament will likely necessitate some additional spending that will erode off a bit of the fiscal room. We discuss some of the speculated announcements and their costs in the final section of this report. Second, since the government continues to rule out tax increases, the revenue line can only inch up so much. To achieve budgetary balance then, the medium-term fiscal plan hinges on its ability to wrestle annual program spending growth down to an average 1.1% per year through FY 15-16. Such a feat would represent one of the most prolonged periods of federal fiscal restraint in the Post War era and coincides with a time when age-related spending pressures are intensifying. As such, providing more detail as to how the medium-term plan will be achieved – and especially how government will achieve its spending targets – is encouraged.

A Better Fiscal Starting Point for FY 10-11

The Canadian economy ended 2010 on a high note, with 3.3% annualized real growth posted in the fourth quarter. Growth upside came primarily from exports, helped in large part by robust foreign demand and strong commodity prices. Domestically, households also continued to shell out. With the solid end to 2010, we have upgraded our annual real GDP growth forecast to 3.0%. The nominal GDP growth number was bumped up accordingly and sits at 6.2% in 2010. The positive momentum generated in the fourth quarter should carry forward to the first half of 2011. As such, we have also upgraded our 2011 nominal GDP forecast to 5.9%, about 0.7 percentage points higher than what was assumed in the fiscal update.

Our near-term economic growth forecasts appear broadly



in line with the private sector consensus average. This is important as it is this latter measure that the government uses in its fiscal planning process. Relative to the numbers included in the federal fiscal update, upgraded growth projections, particularly nominal GDP, should translate into additional revenues for the government's coffers. These benefits are indeed noted in the year-to-date Fiscal Monitor numbers. These show revenue gains across most categories, particularly personal and corporate income tax receipts.

Aside from the boost generated from economic growth, the FY 10-11 revenue tally should be improved by some recent events. First, Daimler reached a tax settlement in March with the federal, Ontario and Alberta governments in the amount of \$1.5 billion. A breakdown of allocations for each government was not provided, but a sizeable portion should be directed towards federal coffers and would likely be applied to FY 10-11. Second, the General Motors Initial Public Offering (IPO) that took place in November resulted in a \$600 million revenue gain for the government, according to Fiscal Monitor estimates.

Based on the first nine months of the fiscal year, as presented in this same publication, spending appears to be mostly on track. When combining both sides of the ledger then, the deficit tally for FY 10-11 is estimated to be \$39.5 billion or 2.4% of GDP. This would be \$5.9 billion better than what was estimated last fall. The FY 10-11 accumulated deficit is also improved and should represent 34.5% of GDP. All told, the government has a better starting point

with which to plan its 2011 budget.

Moderate Medium-Term Economic Prospects

With respect to the near-term outlook, we expect economic growth to moderate, particularly after 2012. This is evident from the table on the next page comparing our current forecasts to those included in the fall fiscal update. Admittedly though, TD's projections have tended to be on the low side relative to the private sector average in 2013 and onwards. That said, the moderation in growth is slated to come as a result of several domestic headwinds including the impacts of a high Canadian dollar, dampened housing activity and high household debt levels. Headwinds abroad also remain on the horizon some of which include the repercussions of inflation control measures in emerging markets and possible debt restructuring in parts of Europe.

But Deficit Reduction Timetable Remains Unchanged

In generating our status quo forecast, we use our economic assumptions to derive budgetary revenues. For federal-provincial-territorial fiscal arrangements, we have assumed that current legislated growth rates prevail beyond FY 13-14. Overall, the revenue profile is helped by the economic lift generated in the recovery phase, but this boost wanes over the medium-term.

On the expenditure front, we have decreased year-over-year program expenditures by \$7.3 billion or 3.0% in FY 11-12. This is slightly less than the spending cut reported

| FEDERAL GOVERNMENT FISCAL POSITION - TD ECONOMICS STATUS QUO FORECAST VS. FEDERAL FALL UPDATE | | | | | | | | | | | |
|---|--------|-------|-------|-------|-------|---------------------------|-------|-------|-------|-------|-------|
| (C\$ billions, unless otherwise indicated) | | | | | | | | | | | |
| Fiscal Year | Actual | | | | | Projection - TD Economics | | | | | |
| | 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 | 236.8 | 250.0 | 263.7 | 277.7 | 292.0 | 306.7 |
| % change | 4.8 | 6.2 | 2.7 | -3.8 | -6.2 | 8.3 | 5.6 | 5.5 | 5.3 | 5.1 | 5.0 |
| Program expenses | 175.2 | 188.3 | 199.5 | 207.9 | 244.8 | 245.0 | 237.7 | 243.1 | 249.0 | 254.0 | 261.1 |
| % change | -0.7 | 7.5 | 6.0 | 4.2 | 17.8 | 0.1 | -3.0 | 2.3 | 2.4 | 2.0 | 2.8 |
| Public debt charges | 33.8 | 33.9 | 33.3 | 31.0 | 29.4 | 31.3 | 34.0 | 36.3 | 37.8 | 38.6 | 38.5 |
| % change | -1.0 | 0.5 | -1.8 | -7.0 | -5.1 | 6.5 | 8.6 | 6.8 | 4.1 | 2.1 | -0.3 |
| Total expenditures | 209.0 | 222.2 | 232.8 | 238.8 | 274.2 | 276.3 | 271.7 | 279.4 | 286.8 | 292.6 | 299.6 |
| % change | -0.7 | 6.3 | 4.8 | 2.6 | 14.8 | 0.8 | -1.7 | 2.8 | 2.6 | 2.0 | 2.4 |
| Budgetary balance | 13.2 | 13.8 | 9.6 | -5.8 | -55.6 | -39.5 | -21.7 | -15.7 | -9.1 | -0.6 | 7.1 |
| % of GDP | 1.0 | 0.9 | 0.6 | -0.4 | -3.6 | -2.4 | -1.3 | -0.9 | -0.5 | 0.0 | 0.4 |
| Federal debt* | 481.5 | 467.3 | 457.6 | 463.7 | 519.1 | 558.6 | 580.3 | 596.0 | 605.1 | 596.6 | 598.0 |
| % of GDP | 35.0 | 32.2 | 29.9 | 29.0 | 34.0 | 34.5 | 33.8 | 33.2 | 32.5 | 30.8 | 29.6 |
| Projection - 2010 Federal Fall Update | | | | | | | | | | | |
| Budgetary revenues | 222.2 | 236.0 | 242.4 | 233.1 | 218.6 | 232.5 | 246.3 | 261.2 | 277.7 | 293.2 | 305.9 |
| % change | 4.8 | 6.2 | 2.7 | -3.8 | -6.2 | 6.4 | 5.9 | 6.0 | 6.3 | 5.6 | 4.3 |
| Total expenditures | 209.0 | 222.2 | 232.8 | 238.8 | 274.2 | 277.8 | 276.1 | 282.5 | 289.2 | 295.0 | 303.3 |
| % change | -0.7 | 6.3 | 4.8 | 2.6 | 14.8 | 1.3 | -0.6 | 2.3 | 2.4 | 2.0 | 2.8 |
| Budgetary balance | 13.2 | 13.8 | 9.6 | -5.8 | -55.6 | -45.4 | -29.8 | -21.2 | -11.5 | -1.7 | 2.6 |
| % of GDP | 1.0 | 0.9 | 0.6 | -0.4 | -3.6 | -2.8 | -1.8 | -1.2 | -0.6 | -0.1 | 0.1 |
| Federal debt* | 481.5 | 467.3 | 457.6 | 463.7 | 519.1 | 564.5 | 594.2 | 615.5 | 627.0 | 628.7 | 626.1 |
| % of GDP | 35.0 | 32.2 | 29.9 | 29.0 | 34.0 | 34.9 | 35.3 | 34.8 | 33.7 | 32.3 | 30.8 |

* Accumulated deficits. Source: Department of Finance Canada; Projections by TD Economics.

| ECONOMIC & FINANCIAL ASSUMPTIONS FOR CANADA (Annual Average Percent Change Unless Noted) | | | | |
|---|------|-------|------|---------|
| | 2010 | 2011 | 2012 | 2013-15 |
| Real GDP Growth | | | | |
| 2010 Federal Fall Update | 3.0 | 2.5 | 2.8 | 2.7 |
| TD Economics Forecast | 3.1 | 3.1 | 2.5 | 2.2 |
| Nominal GDP Growth | | | | |
| 2010 Federal Fall Update | 5.9 | 4.6 | 5.2 | 4.7 |
| TD Economics Forecast | 6.2 | 5.9 | 4.5 | 4.1 |
| Canadian Dollar (USD/CAD) | | | | |
| 2010 Federal Fall Update | 95.8 | 96.7 | 98.2 | 97.5 |
| TD Economics Forecast | 97.5 | 103.5 | 99.3 | 90.0 |
| 3-month Treasury Bill Rate | | | | |
| 2010 Federal Fall Update | 0.6 | 1.6 | 2.7 | 3.8 |
| TD Economics Forecast | 0.7 | 1.4 | 2.7 | 3.5 |
| 10-year Government Bond Rate | | | | |
| 2010 Federal Fall Update | 3.2 | 3.3 | 4.0 | 4.8 |
| TD Economics Forecast | 3.1 | 3.8 | 4.3 | 4.7 |

* TD Projections as of March 2011.

in the government's main estimates tabled in early March. The discrepancy between the numbers reported in the main estimates and the budget document lies primarily in different accounting standards. Estimates in the first publication are presented on a cash accounting basis, whereas the budget numbers are presented on an accrual basis. Nevertheless, the government has signaled that program spending will decrease year-over-year and we have incorporated such a cut into our projections. In deriving debt service costs, we have aligned our numbers based on the revised budgetary balance and average effective interest rates. Annual total spending growth beyond FY 11-12, that is program spending plus debt servicing costs, is in line with the profile presented in the fall update. Put simply, in our projections, we have taken the government's spending profile as given – an assumption other bodies like the Parliamentary Budget Office have called into question. Further detail regarding how the expenditure restraint plan will be achieved will undoubtedly add further credibility to the fiscal plan as outlined.

Higher-than-anticipated revenue intake along with the spending cuts generates a deficit projection of \$21.7 billion in FY 11-12. This represents an \$8.1 billion improvement relative to the estimate included in last year's fall update. Even with our lower nominal GDP level forecasts in the later years relative to those in the government's plan, we still project a higher surplus in FY 15-16. The out-performance in the later years is a result of revenues growing at a rate higher than nominal GDP growth. We have made this assumption as EI premiums will need to increase by their legislated maximum until the EI Account shortfall is made up by roughly FY 15-16. This assumption is consistent with what was included in the federal fiscal update.

What we Know About the Upcoming Budget

The projections that we have prepared for this report do not take into account items or measures that will be included in the 2011 budget. At this point, we only have speculation to go on as to what will be announced. Furthermore, cost estimates for these measures would likely be imprecise. Still, from statements made by federal Finance Minister Flaherty or press releases issued by the Department of Finance, here is what we know about the contents of the March 22nd budget:

- The next phase of the Economic Action Plan will focus on “strengthening the economy and creating good jobs”;
- The government plans to return to a surplus position in FY 15-16, on schedule;
- No big spending projects, tax increases or cuts to transfers will be announced;
- The government will continue its previous plan to lower general corporate tax rates;
- No funding will be made available to subsidize the building of professional sporting arenas; and
- No new stimulus measures will be announced and only a handful of previously announced stimulus items will continue beyond March 31, 2011.

What Might be Included

With a pretty good sense of what will not be in the budget from the list above, what might it actually include? The media have speculated that additional funding will be allocated to security and public safety programs as well as justice and legal programs. Owing to the drop-off in stimulus, infrastructure programs will likely see the biggest spending cut. Several cultural and social programs could also see year-over-year funding decreases.

The Minister of the Environment has indicated that the budget will extend the life of several environmental programs. These would be existing government programs whose funding allocations are close to running dry.

With the government's minority position in Parliament, the other federal party leaders have publicly stated their wish lists for the 2011 budget. For low-income seniors, the budget could include an expansion of the Guaranteed Income Supplement (GIS), at the request of both the Bloc and the NDP. The NDP have estimated that this initiative would cost \$700 million per year and would ensure all seniors are above the poverty line. Additional income support for those seniors without pension plans and older workers is also being considered by the Finance Minister. However, an

expansion to the Canada Pension Plan (CPP) does not appear to be in the works, due to the significant inter-governmental negotiations that such an undertaking would require and the tight timelines remaining till budget release.

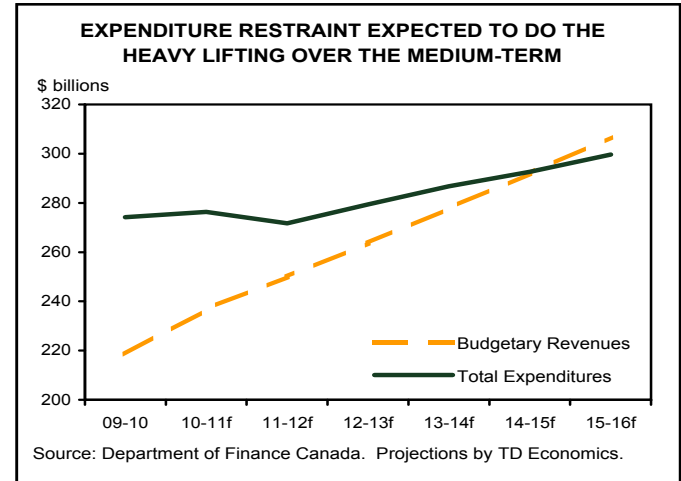
The Bloc have demanded that Québec be compensated in the amount of \$5 billion, including \$2.2 billion for harmonizing its provincial sales tax in the late 1990s. The Finance Minister has stated that negotiations between federal and provincial counterparts are underway and progressing, but that a deal in time for the budget is unlikely. Still, the government could choose to book this expense in FY 11-12 in the event such an agreement is reached later on in the year.

Given the lingering economic and geo-political uncertainties both domestically and abroad, particularly for the medium-term, the government could choose to apply additional prudence to its economic assumptions. Contingency of this sort was built into the fall fiscal update and served to provide a cushion in the event of unanticipated economic developments or spending pressures.

Key Risks and Bottom Line

With any multi-year fiscal plan, underlying risks on both the economic and fiscal front could derail deficit reduction timetables and plans at a moment's notice. The primary risk to the fiscal plan rests in the government's expenditure restraint plan. The spending profile included in last year's fiscal update limited annual program spending growth to an average 1.1% per year through FY 15-16. If the profile was achieved as outlined, it would be 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 is intensifying. With the vast majority of stimulus expiring in FY 11-12, year-over-year spending declines are much easier to secure. This feat will become increasingly difficult over the medium-term when there is less fat to trim. As such, we anticipate that the upcoming budget will include details as to how the government will achieve its spending targets. This, in turn, would add further credibility to the government's fiscal plan.

The Parliamentary Budget Officer, Kevin Page, has raised concerns about the government's planned operating freeze. Through a variety of measures such as constraining the size of the civil service and freezing departmental budgets, the government's existing fiscal plan includes \$6.8 billion in savings over five years. Through his analysis, Page questioned whether the planned freeze was on track and feasible given the restraint measures identified. He has also publicly called on the federal government to provide



further details as to how these savings will be realized.

On the upside, if the British Columbia public votes down its Harmonized Sales Tax come June 24th, the government would see a return of the \$1.6 billion in transition payments it previously dispersed. If assigned to FY 11-12, this could further upgrade the deficit tally. For federal-provincial-territorial fiscal arrangements, legislation currently expires in FY 13-14. Changes to the funding formula could have both upside and downside risk to the fiscal plan in FY 14-15 and onwards.

Despite the growing confidence in the recovery, there continue to be a number of economic risks that could impede the deficit reduction plan over the next three to four years. Many are international in nature, including the potential for an inflation-induced hard landing in emerging markets, further troubles in Europe, and a spike in oil prices that would drive up the Canadian dollar and trigger a global recession. A number of key risks are domestic, such as high household debt and concerns about excess housing market valuations, although recently-announced changes to the mortgage rules should help to mitigate the likelihood of a problem forming on those fronts. In addition, the impact of an ageing population on Canada's longer-term growth performance remains open to debate.

As federal party leaders state their budget wish lists, we are reminded of the fact that the budget will be a confidence vote in the House. If voted down, an election could be triggered; under this scenario, some are calling for an election as early as May. With the higher-than-expected economic growth numbers for 2010 and 2011, the government appears to have more wiggle room to listen to the demands being made. We will have to wait till release day to assess whether these demands were met and in turn, get a real sense of the budget's staying power.



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