TD Bank Financial Group

TD Economics

The 2008 Federal Budget

Released on February 26, 2008

HIGHLIGHTS

- **FY 07-08 surplus estimated at $10.2 billion, used for debt pay-down**
- **Surplus projections and planned debt pay-down scaled back for FY08-09 and FY09-10**
- **Accelerated capital cost allowance (CCA) for manufacturers extended for 3 years, with a phase-down in the rate, at $1 billion cost**
- **Additional funding for public transit infrastructure, R&D in the auto industry and carbon capture & storage technology**
- **Creation of a Tax-Free Savings Account (TFSA) in 2009**

In the weeks leading up to today's Budget 2008, Finance Minister Jim Flaherty was busy managing expectations for the fiscal year to come. In light of tax relief measures already announced in October's Fiscal Update and the expected slowdown in economic activity, the emphasis was on prudence and frugality. Stating on Monday that "people ought not to expect any big spending items", Mr. Flaherty nonetheless admitted there would be "one or two surprises". Speculation was that one of these would be the partial fulfilment of an outstanding commitment, made during the 2006 election campaign, to allow investors to shelter their capital gains from taxes if those profits were reinvested within six months. Today's Budget didn't go that far, but the government did announce the creation of a new tax-free savings vehicle, the Tax-Free Savings Account (TFSA). Furthermore, along the lines of what was expected, further support for the manufacturing sector and new funding for infrastructure were announced.

$10.2 billion surplus and debt write-down for FY 07-08

The government's batting average at estimating surpluses might be improving. Indeed, Budget 2008 marks a departure from recent history in that its typical large undershooting of the surplus was more timid this time around. The previous two Budgets had recorded actual surpluses more than double the amounts projected in the fall Fiscal Update. The latest Update, however, had estimated the surplus would come in at $11.6 billion for FY 07-08. Before the impact of new measures announced today, the government's planning surplus was revised upward relatively modestly from that October estimate, to $12.9 billion. For the same fiscal year, the cost of measures proposed in today's Budget factor in at $2.7 billion, of which $1 billion will be devoted to supporting communities and traditional industries, $500 million will go towards public transit infrastructure, and $400 million towards a police officer recruitment fund. The remaining $800 million will be split among knowledge & research initiatives, carbon

FEDERAL GOVERNMENT FISCAL POSITION

(Billions of dollars, unless otherwise indicated)

	Actual	Estimate	Projection	
Fiscal Year	06-07	07-08	08-09	09-10
Budgetary revenues	**236.0**	**244.5**	**241.9**	**252.0**
% change	6.2	3.6	-1.1	4.2
% of GDP	16.3	16.0	15.3	15.3
Program spending	188.3	201.2	208.1	218.3
% change	7.5	6.9	3.4	4.9
% of GDP	13.0	13.2	13.1	13.2
Public debt charges	33.9	33.1	31.5	32.4
% change	0.3	-2.4	-4.8	2.9
% of GDP	2.3	2.2	2.0	2.0
Total expenditures	**222.2**	**234.3**	**239.6**	**250.7**
% change	6.3	5.4	2.0	4.9
% of GDP	15.4	15.3	15.1	15.2
Underlying budget balance	**13.8**	**10.2**	**2.3**	**1.3**
- Planned debt reduction	14.2	10.2	2.3	1.3
= Planning surplus		**0.0**	**0.0**	**0.0**
Federal debt:				
Accumulated deficits	**467.3**	**457.1**	**454.8**	**453.5**
% of GDP	32.3	29.9	28.7	27.5

Source: Department of Finance Canada.

ECONOMIC & FINANCIAL ASSUMPTIONS* FOR CANADA Annual average percent change, unless otherwise noted			
Calendar Year	**2007**	**2008**	**2009**
Real GDP			
2008 Budget	2.6	1.7	2.4
2007 Fiscal Update	2.5	2.4	2.7
TD Economics^	2.5	1.9	2.5
Nominal GDP			
2008 Budget	5.7	3.5	4.3
2007 Fiscal Update	5.9	4.8	4.7
TD Economics^	6.1	3.9	4.5
Unemployment rate (%)			
2008 Budget	6.0	6.3	6.4
2007 Fiscal Update	6.1	6.2	6.2
TD Economics^	6.0	6.0	6.1
3-Month T-Bill Rate (%)			
2008 Budget	4.2	3.2	3.8
2007 Fiscal Update	4.2	4.4	4.7
TD Economics^	4.1	3.7	3.9
10-Year Gov't Bond Yield (%)			
2008 Budget	4.3	3.6	4.2
2007 Fiscal Update	4.3	4.6	5.0
TD Economics^	4.3	4.1	4.4
U.S. real GDP			
2008 Budget	2.2	1.5	2.4
2007 Fiscal Update	1.9	2.2	2.9
TD Economics^	2.2	1.8	2.8

* Department of Finance Canada. ^ As at Dec.. 2007.

capture & storage technology, and support for more vulnerable Canadians. All told, this leaves a new estimated surplus of $10.2 billion which will be entirely directed towards debt reduction, or $200 million higher than planned in the Fall Update.

Managed expectations

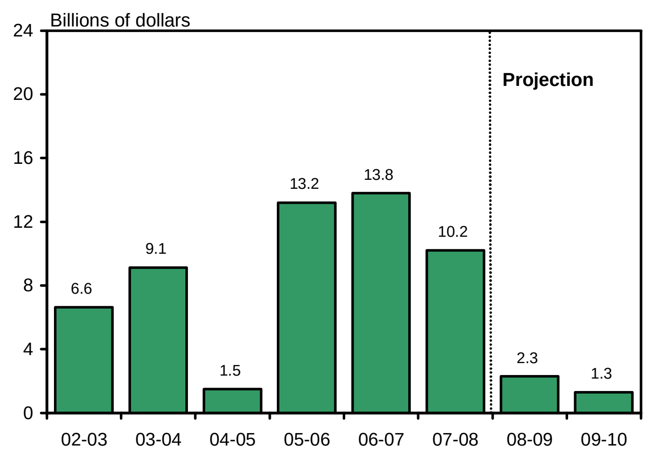
The economic outlook has weakened since the Fall Update, mostly in the United States, with its inevitable repercussions into Canada. Real GDP for the U.S. is forecast to grow by only 1.5% this calendar year, in line with TD Economics' expectations. As a consequence, the Canadian economy, while expected to fare better, should also experience slower growth of about 1.7% in real terms 2008, translating into fairly weak nominal GDP growth of 3.5% or so according to Finance Canada. In turn, the government has therefore had to scale down its projected revenues by $3.7 billion for FY 08-09. On the flip side, spending is now forecast to be lower by about $3.1 billion, mostly due to reduced public debt charges.

The net adjustment for FY 08-09 – when compared to the Fall Update – is therefore a weaker bottom line to the tune of $0.6 billion, bringing the expected surplus (before deducting the impact of new measures) down to $3.8 billion. While economic activity is expected to pick up the pace in 2009, growth forecasts are nonetheless currently more conservative than they were back in October. For FY 09-10, the revenues forecast has been revised down by $3.2 billion, with a $1.7 billion downward adjustment in program expenses only providing a partial offset, The net revision for FY 09-10 implies a "status-quo' planning surplus of $3 billion, down $1.3 billion from the Fiscal Update.

In light of the limited fiscal room, the government has opted to discontinue its customary strategy of allocating $3 billion to planned debt reduction. Under the former government, this amount was set aside as a contingency reserve along with another buffer for economic prudence, which together provided the budget with significant protection against unforeseen negative revenue surprises. When the Harper government took office, it discontinued the economic prudence cushion, but kept the $3 billion buffer, changing the label to 'planned debt reduction'. In today's budget, this amount has been lowered to only $2.8 billion in FY 08-09 and $1.3 billion in FY 09-10 in order to make way for new measures, albeit ones that are still quite limited in scope. In total, the new measures announced for FY 08-09 and 09-10 are expected to cost $1.5 billion and $1.7 billion, respectively.

Certainly, this smaller debt target raises the risk of returning to deficit. While the government's choice to reduce it may be disappointing to some, the budget is considerably less vulnerable now than in years passed, given the sharp decline in the debt burden and falling interest costs. Furthermore, the government's pace of debt reduction has

FEDERAL GOVERNMENT'S FISCAL BALANCE



Source: Department of Finance Canada

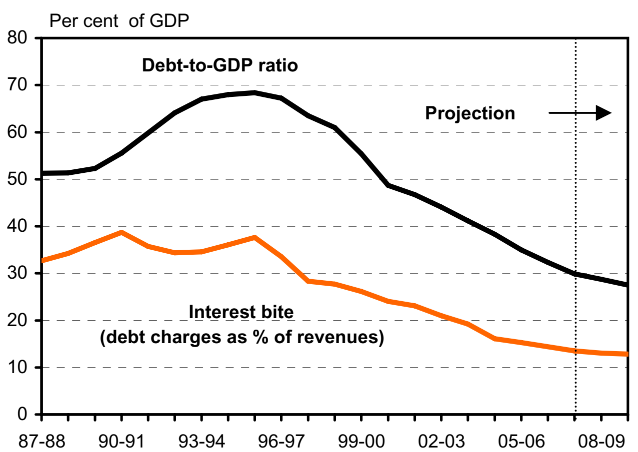
greatly exceeded $3 billion per year so far, and even with the more modest planned profile, the government is still on track to achieve the 25% debt-to-GDP ratio by FY 2011-12. Lastly, we would look for any potential upswing in revenues to flow straight to the bottom line.

New measures

While not the most costly in terms of foregone revenue – at least during its start-up phase – the measure that will have the largest impact for most Canadians over the long haul is no doubt the introduction of a new tax-sheltered savings vehicle or Tax-Free Savings Account (TFSA). Unlike an RRSP, contributions to this vehicle are not tax deductible nor are withdrawals subject to tax. But like an RRSP, earnings within the plan don't attract tax, making it a very useful way to supplement saving for retirement. Details of the proposed TFSA are provided in the accompanying textbox. While economic conditions and fiscal positions differ markedly in the U.S. and Canada, providing Canadians with the added flexibility of an incentive-based savings tool provides a stark and positive contrast to the spending stimulus the U.S. budget will provide. The initial foregone revenue from allowing the tax sheltering of investment income within the TFSA is estimated to be only $5 million in FY 08-09. As the asset base upon which the investment income grows expands, the foregone revenue ramps up significantly over time, to $290 million by 2011 and about $3 billion annually in twenty years.

Within the two-year forecast horizon of the Budget, the only new and significant tax relief measure is, as expected,

FEDERAL DEBT BURDEN



Source: Actual and Forecast by Department of Finance Canada

Tax-Free Savings Account (TFSA)

- Registered account starting in 2009, issued by financial institutions;
- Eligibility: Canadian residents aged 18 or older;
- No tax deduction on contributions, which are made with after-tax income;
- Contributions grow tax-free, withdrawals are tax-free and can occur anytime;
- Yearly contribution room of $5,000, to be indexed to inflation in $500 increments. Unused room will be carried forward indefinitely. There is no lifetime contribution limit;
- Withdrawals do not compromise accumulation of contribution room; they are added to contribution room for the following year;
- Eligible investments include all arm's-length RRSP qualified investments;

aimed at manufacturers. In Budget 2007, the federal government announced a 2-year accelerated capital cost allowance (CCA) program for manufacturers for machinery and equipment purchases before 2009. In today's budget, the government extended the two year write-off (or 50% per year) for an additional year. For the following two years, the accelerated treatment will continue, although at a declining rate. This extended measure is expected to cost $1 billion over the course of the 3-year period.

On the spending side of the ledger, significant initiatives in terms of total expenditures include:

For FY 07-08:

- $500 million trust funding in to be used for public transit infrastructure, and will be allocated on a provincial-territorial per capita basis
- $400 million set aside for a Police Officers Recruitment Fund

For FY 08-09:

- $350 million for a new consolidated Canada Student Grant Fund (CSGF)

Other notable measures include:

- Making the $2 billion annual Gas Tax Fund for municipal infrastructure permanent;

- An extension of the RESP account lifetime by 10 years to 35 years;
- Improved accountability for Employment Insurance (EI). The government announced the creation of an independent financing board for EI to insure rates are set on a break-even basis and that funds are not used for other purposes. An initial $2 billion cash reserve is established;
- Establishing a new crown corporation to work with the public and private sectors to support public-private-partnerships.

Bottom Line

As the fiscal noose tightens and we edge closer to a zero surplus in the coming years, we are reminded of Canada's enviable position among developed countries. Expectations were downplayed in the period leading up to this Budget, in light of the more difficult economic juncture we find ourselves in. Few people expected major new spending initiatives, and the measures that were announced were largely along the lines of strong recurring themes: knowledge, the environment, infrastructure, and help to the manufacturing sector. Significant tax measures and debt relief are mostly rearview mirror reflections, at least until the economy likely gets back on a faster growth track in 2009. Today's budget is almost certain to pass, as the opposition Liberals have already indicated that they will not vote against it.

Pascal Gauthier
Economist
416-944-5730