



# TD Economics

## Special Report

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### OOPS THEY DID IT AGAIN: THE FEDERAL SURPLUS HAS BEEN UNDER-PREDICTED

Despite taking some steps that should have improved the accuracy of federal government fiscal projections, it appears that like their Liberal predecessors, the Conservative Government has under-predicted the size of the budget surplus. In the Fall 2006 Economic & Fiscal Update the surplus for 2006-07 was predicted to be \$7.2 billion. After the first 8 months of the year it sits at \$6.1 billion, down only \$0.5 billion from the same period of 2005-06 when the full year result came in at \$13.2 billion. The surplus over the remaining 4 months and supplementary period of 2006-07 should be lower than in the previous year, in good part because of the initiatives in the 2006 Budget. However, the results over the remainder of the year should be sufficiently favourable to lift the 2006-07 surplus to \$9-10 billion, or \$1.8 - \$2.8 billion higher than the Government last publicly predicted. This is before any year-end bookings such as the recent announcement of a \$1.5 billion trust fund for provincial environmental initiatives. To the extent the favourable outcome for 2006-07 is carried forward, the Government will have room to introduce additional or more expensive initiatives in the 2007 Budget than previously anticipated.

#### Revenues up \$1-\$2 billion from Fall Forecast

In the Fall Update the Government projected budgetary revenue growth of 3.3 per cent for 2006-07. Over the first 8 months growth sits at 4.6 per cent. Personal income tax revenues are up 9.2 per cent relative to a full fiscal year projected growth rate of 7.7 per cent. Corporate income tax revenue is up 9.5 per cent whereas the Fall Update predicted full year growth of only 3.3 per cent.

#### HIGHLIGHTS

- **Before taking into account any year-end bookings, federal surplus for FY 06/07 headed for \$9-\$10 billion ...**
- **... or \$1.8-\$2.8 billion above the Fall estimate**
- **Future years could also be revised up**
- **A number of commitments have been made that will easily eat up all the room**
- **The only way Minister Flaherty could deliver significant personal income tax relief would be to throw caution into the wind**

Other income tax revenue is up a whopping 28.8 per cent, whereas the Update predicted a decline for the full year. Other revenues, in particular the GST, are running a bit behind the Update's prediction.

Personal income tax revenues are increasing at double the pace of personal income as measured by Statistics Canada. In the Department of Finance's language, this gives a personal income tax elasticity of 2 (the percentage change in tax collections divided by the percentage change in the proxy for the tax base). This has puzzled Finance because the elasticity is normally around 1.2 (the progressivity of the rate structure lifting the elasticity above 1). Without fully understanding why the elasticity is so high they have been reluctant to conclude that it will continue. The reconciliation may be that Statistics Canada is understating personal income growth. Indeed, the personal income figures are ultimately benchmarked to the

tax data. A significant upward revision to personal income may also be part of the reconciliation between the apparent dichotomy between weak output growth recently and strong employment gains.

In Finance's November 2006 Fiscal Monitor there was a caution that corporate income tax revenues can be very volatile over the final months of the year. While true, the corporate tax workhorses, being the financial services and energy sectors, appear to be continuing to turn out favourable financial results. It is unlikely corporate tax collections will drop off soon.

Even if GST revenues fall short of the Fall Update mark, it is quite likely revenues will be at least \$1 billion higher, and possibly \$2 billion higher than predicted in the Fall Update for 2006-07.

### Program spending down \$0.5-\$1 billion

The Fall Update predicted 7.1 per cent growth in program expenses while over the first 8 months of the year the increase was 6.4 per cent. Aside from special year-end bookings, it is likely that program expenses will come in \$0.5 – 1.0 billion lower than the last official forecast. Some of the shortfall may be due to programs coming on stream more slowly in a minority government era. With the greater certainty under majority governments departments typically had everything ready to go by the time Parliament authorized the spending. Under less certainty they may hold back some elements of planning until approval is received, making the spending slower off the mark. There are also rumours that tougher procedures from the Treasury Board Secretariat may be clamping down on spending increases. It is difficult to say how much of any under-spending in 2006-07 should be carried forward. If there is an election in 2007-08 Parliament will not be sitting for an extended period and that always leads to larger-than-normal spending lapses. So if the Conservatives wished to take a bit of a chance in their budget planning, they could knock down the 2007-08 spending projections.

### Debt interest down \$0.5-\$1 billion

The Fall Update predicted a rise in interest on the public debt of \$0.8 billion from 2005-06 to 2006-07. Through the first 8 months of the year interest charges are down \$0.1 billion. So there could be a savings here of \$0.5 to 1.0 billion.

Possible Status Quo				
Fiscal Update for 2007 Budget				
	2006-07	2007-08	2008-09	2009-10
Underlying Surplus	9.0	9.3	8.4	8.1
Year-End Trust Funds	-1.5			
Net Surplus	7.5	9.3	8.4	8.1
Planned Debt Reduction	3.0	3.0	3.0	3.0
Interest Savings Dedicated to Personal Income Tax Reductions:				
\$13.2 Billion Debt Reduction in 2005-06		0.7	0.7	0.7
\$7.5 Billion Debt Reduction in 2006-07		0.4	0.4	0.4
\$3.0 Billion Debt Reduction Starting in 2007-08			0.2	0.3
Planning Surplus	4.5	5.2	4.1	3.7
Planning Surplus in Fall Update	4.2	3.5	2.4	2.0
Change	+0.3	+1.7	+1.7	+1.7

### \$9-\$10 billion surplus for 06-07 (before year-end bookings) a conservative call

Putting the 3 elements of the budget identity together, revenues could be up \$1-2 billion from the Fall Update prediction for 2006-07, program expenses could be down \$0.5 – 1.0 billion and interest on the public debt could be down \$0.5 – 1.0 billion. In total these ranges would give a lift to the predicted surplus of \$2.0 – 4.0 billion, bringing it to \$9.2 – 11.2 billion for the fiscal year, again before any year-end special bookings. It is unlikely Finance would completely abandon their traditional caution, and there are legitimate uncertainties over the numbers for the remaining months. Hence, is not all of the customary Finance caution has worn off, the budget prediction for 2006-07 is more likely to be \$9-10 billion range.

### Some carry forward to future years likely

With some weak real output numbers recently and interest rates being flat since the Fall Update, Finance is likely to be a bit cautious as well in the extent to which they carry the surplus lift from 2006-07 forward into the projection period. For the purposes here let us assume that they raise the surplus projections for 2007-08 and 2008-09 \$2 billion each. As shown in the accompanying table, once adjusting for the implied personal income tax cuts flowing from the anticipated debt paydown for 2006-

07 (the Fall Update established a mechanism whereby the interest savings of debt payments are dedicated to personal income tax cuts), the planning surpluses for the 2007 Budget could be \$5.2 billion in 2007-08, \$4.1 billion in 2008-09 and \$3.7 billion for 2009-10, up in each year by \$1.7 billion relative to the Fall Update predictions. The Budget will not extend to 2009-10 but we include it here just to monitor whether the Budget might be building a fiscal hole for that year that would need to be addressed subsequently.

### **Government initiatives easily eat up room**

These planning surpluses may seem to give the Government considerable latitude to introduce new initiatives. However, they have made a number of commitments that could easily eat up all the room. First, they have promised to reveal their “solution to the fiscal balance” issue with the provinces. If they adopt something along the lines that the O’Brien Task Force recommended for equalization and territorial financing (with a likely tweaking of the proposed cap so it does not amount to 100 per cent tax back of non-renewable resource revenues), that would be at least \$1 billion per year. The O’Brien report also recommended eliminating “associated equalization” whereby Alberta and Ontario get lower per capita transfers than other provinces. Chalk up another billion per year for that. The Government has hinted that it will increase transfers to the provinces for post-secondary education (under the Canada Social Transfer). You don’t go far for less than \$1 billion there either. So even if the Government didn’t touch the Canada Health Transfer or infrastructure transfers (other than bundling up its transfers to the provinces and municipalities and labeling that a new, fourth major transfer), the bill could be \$3 billion per year. Mind you, some elements, such as eliminating associated equalization, could be phased in.

### **Capital gains roll-over may surface in some form**

The Government promised in the Fall Update to introduce a Working Income Tax Benefit in the 2007 Budget to help people in low-paying employment. When it first raised this idea in the 2006 Budget the notion was that the provinces would also participate. That doesn’t seem likely. So if the federal government is going to go it alone, the initiative would likely cost \$0.5 – 1.0 billion. One of the few promises the Government made in the 2006 election

campaign that hasn’t been acted upon yet is deferral of capital gains taxation on investment roll-overs. As described (albeit very generally) in the election campaign, the cost would likely be at least \$1 billion a year and its administration, for both the Government and taxpayers, would be cumbersome. In the context of allegations they misled people about taxing income trusts, they will be reluctant to let this promise slide. Let us assume they introduce some stripped down version (such as allowing deferral up to a lifetime limit within a dedicated investment account) costing \$0.3-0.5 billion. Finally, while it is not likely the Government will reveal a definitive environment plan in the Budget, it is hard to believe there won’t be any measures. Let’s assume \$0.3 – 0.5 billion there. Adding up the list so far gives \$4.1 – 5 billion per year, with the proviso that this would be the “mature cost” and some of the measures could be phased in. But, phasing in doesn’t avoid the day of reckoning for 2009-10.

### **What about new personal income tax relief?**

The list of possible measures so far entirely exhausts the planning surplus room available from the above speculation on what the Government might show in the 2007 Budget. And we haven’t yet discussed what might be done regarding Minister Flaherty’s musings about personal income tax cuts. Mind you, the Minister will be laying out in the Budget how the personal income tax cuts flowing from the debt pay downs for 2005-06 will be specified. This will probably be done by establishing a consistent model for all subsequent pay downs. For example, the Minister may say that all these proceeds will go toward raising the income thresholds for the various tax rates. This would be consistent with his recent statements that he believes Canadians get kicked into higher tax brackets too quickly as their income rises. Such an announcement would certainly go toward satisfying the musings about personal income tax cuts. But not likely very far. The tax cut stemming from the 2005-06 debt pay down is \$0.7 billion, which works out to about \$35 per tax filer. If the 2006-07 debt retirement is \$7.5 billion that would add another \$20 per tax filer eventually.

How could the 2007 Budget deliver larger tax savings? It could cut down on the increases in transfers to the provinces (or phase them in slowly, but as indicated, that still leaves a problem for 2009-10 that must be confronted one day) and other initiatives already promised. Or it could

boost the projected surpluses above the assumptions set out above. Throwing considerable caution to the wind, it could raise the projected surpluses \$4.0 billion per year above the Fall Update predictions, leaving another \$2 billion available for personal income tax relief (at the cost of greater risk of missing fiscal targets). But still, \$2 billion only works out to \$100 per tax filer. Such a calculation would no doubt launch an internal debate in Finance whether it would be better to have one broad-based tax cut (such as going further in raising the income thresholds) or spreading the money across several targeted tax cuts in the hope they might attract political credit above their fiscal weight. In other words, follow the model of

the 2006 Budget where the personal income tax cuts were targeted.

### **Conclusion**

In conclusion it is hard to see how the Government could deliver on everything that has been discussed in the context of the 2007 Budget and remain fiscally responsible. The only way it could deliver a significant dose of personal income tax relief would be to take a pretty risky stance on the fiscal projections and greatly up the anticipated surpluses from the numbers presented just a few months ago in the Fall Update. And even then the amount of tax relief per filer would be rather modest.

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