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Fiscal Pulse

Canada's 2010-11 Federal Transition Budget

Ottawa's near-term deficit reduction path is only slightly altered. The deficit for fiscal 2009-10 (FY10, ending March 31) is expected to be \$54 billion versus the \$56 billion September estimate. Sticking to its game plan of fully implementing the second year of its stimulus package, a \$49 billion shortfall is projected for FY11, \$4 billion higher than the September estimate. After deficits of \$28 billion, \$18 billion and \$9 billion in the following three years, a very minor \$2 billion shortfall is forecast for FY15, with balanced books assumed in FY16, just beyond Ottawa's forecast horizon.

As previously committed, the deficit reduction strategy involves no tax increases, Defence spending continues to rise albeit at a slower pace and the growth tracks of major transfers to individuals and other governments remain intact. The federal plan to trim the general corporate income tax rate to 15% by 2012 also remains in place.

The FY11 shortfall, at 3.0% of GDP, will remain the envy of our G7 partners as will Ottawa's net debt, peaking at just over 35% of GDP in FY11 and FY12. Relative to revenues, the debt service peaks at 14.6¢ of each revenue dollar in FY13. Nevertheless, in absolute terms, interest charges are forecast to climb from just less than \$30 billion this year to almost \$41 billion in FY15, limiting Ottawa's flexibility.

Ottawa's financial requirement will drop from an estimated \$71 billion in FY10 to \$45 billion in FY11. To lengthen term with the anticipation of rising rates, Ottawa plans gross bond issuance of \$95 billion for FY11, only slightly lower than the \$102 billion issuance in FY10.

A centre-piece of the Budget is making Canada a tariff-free zone for industrial manufacturers, a first among the G-20. All remaining tariffs on manufacturing inputs and machinery & equipment will be eliminated by January 1, 2015, with most removed immediately.

Ottawa's saving measures are expected to total \$0.8 billion in FY11, climbing to \$2.0 billion in FY12 and eventually to almost \$6 billion by FY15.

Part of this saving involves closing tax loopholes, with a number of measures affecting businesses and households, such as changes to the tax treatment of stock options.

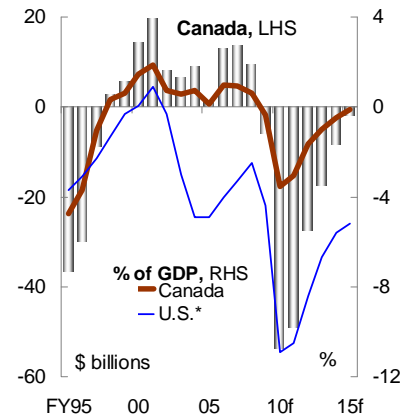
The risk in the Budget estimates is the ability to sharply cut the deficit from \$49 billion in FY11 to \$28 billion in FY12, and accomplish a further \$10 billion cut in red ink in each of the two following fiscal years. This dramatic deficit reduction occurs during 2011 and 2012 when Finance Canada assumes real growth averaging over 3% annually, a forecast that could prove optimistic, requiring Ottawa to undertake additional saving.

The market reaction to this Budget is likely to be muted, with many of the factors driving the near-term deficits already known. Canada's fiscal advantage relative to most of its trading partners is well known, and would allow some unexpected slippage in the deficit reduction path. There will, however, be significant impact on industry from the decision to make Canada a tariff-free zone, as well as from the measures to close perceived tax loopholes.

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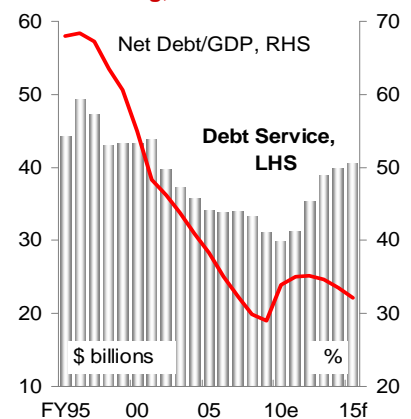
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Federal Budget Balances



* Excluding Social Security surplus.
 Source: Finance Canada, OMB;
 U.S. deficits and GDP forecasts:
 Scotia Economics.

A Moderate, But Rising, Debt Burden



Source: Finance Canada; GDP
 forecast: Scotia Economics.



Fiscal Details

The Second Year of Ottawa's Economic Action Plan Stimulus

- ❑ The government is proceeding to fully implement the second year of its two-year stimulus package, with few changes from last year's *Budget* and the government's updates. At \$19.2 billion, plus assumed provincial/territorial participation of \$6.0 billion, a \$25.1 billion boost is planned, 31% less than last year's \$36.5 billion assist. With the recovery still at an early, fragile stage, the gradual withdrawal of monetary stimulus, and importantly for Canada's small open economy, the winding down of stimulus around the world, maintaining some economic support for our businesses and households should help private-sector growth regain sustainable traction.
- ❑ A couple of the *Plan's measures* should have important pay-offs this year. As business sees demand picking up, the measures allowing full expensing of computer equipment purchased before February 2011 and, for manufacturers and processors, the 50% straight-line depreciation allowed on machinery & equipment purchases before January 1, 2012, should become increasingly attractive. Alongside the removal of all tariffs on capital imports, the strength of the Canadian dollar, reducing their effective price, should support productivity growth.

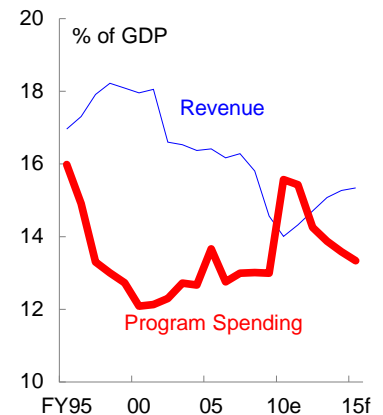
Positioning Canada for the Future

- ❑ The government's key initiative is the removal of tariffs on machinery & equipment and manufacturing inputs for the manufacturing sector. The government estimates that more than \$5 billion in imports will be liberalized, eventually providing Canadian business with \$300 million in annual duty savings. This also reduces custom compliance costs, eliminates the administrative burden of origin and drawback regulations and simplifies Canada's tariff structure.
- ❑ For the telecommunications sector, the existing restrictions on foreign ownership of Canadian satellites will be removed.
- ❑ The *Budget* measures to specifically support growth add to \$900 million in FY11 and \$600 million in FY12. They include an additional \$178 million for education and internships, increased research grants, and funding for a broad array of specific projects such as Genome Canada, a Canadian High Arctic Research Station, developing new avenues for medical isotope production and the RADARSAT Constellation Mission, the next generation of advance radar remote sensing satellites. As a two-year pilot, a Small- and Medium-Sized Enterprise Innovation Commercialization Program will be launched to demonstrate innovative products. The Next Generation Renewable Power Initiative will support the development of green energy technology for the forest sector.
- ❑ A commitment to reducing regulation includes creating a Red Tape Reduction Commission to review federal regulations and streamlining the Northern Regulatory Regime to facilitate new resource projects in the North.
- ❑ A number of international tax adjustments are intended to facilitate investment in Canada and assist Canadian corporations abroad.

A Start on Expenditure Restraint

- ❑ Program spending in FY10 is expected to jump 14.4%, less than budgeted, followed by a 4.8% rise in FY11. From FY12 to FY15, the government plans to limit annual program spending growth to just 0.8%, reflecting the successful unwinding of the temporary measures in the stimulus package and Ottawa's saving plan.
- ❑ In the near-term, the government proposes to freeze politicians' salaries and allow no increase in departmental administration costs from FY11 through FY13.

Revenue and Expenditure Paths



Source: Finance Canada; GDP forecast: Scotia Economics.

Economic Assumptions* annual % change except where noted

	Scotia Economics		
	2009	2010f	2011f
Canada: Real GDP	-2.6	3.2	2.8
Nominal GDP	-4.5	5.7	4.8
CPI - All Item	0.3	1.8	2.2
Unemploy. Rate,%	8.3	8.2	8.0
Oil Price, US\$/bbl	61.78	83	87
3-Month T-Bills,%	0.4	1.0	2.2
10-Year Bonds,%	3.2	4.0	4.6
Cdn Dollar, US¢/C\$	88.1	101	104
U.S.: Real GDP	-2.4	3.6	2.6

	Finance Canada**		
	2010f	2011f	2012-14f
Canada: Real GDP	2.6	3.2	2.8
Nominal GDP	4.9	5.4	5.0
CPI - All Item	1.7	2.2	2.1
Unemploy. Rate,%	8.5	7.9	7.0
3-Month T-Bills,%	0.7	2.4	4.2
10-Year Bonds,%	3.7	4.3	5.1
Cdn Dollar, US¢/C\$	95.5	98.3	98.5
U.S.: Real GDP	2.7	3.0	3.1

* All data: annual averages. ** Private-sector survey.

For FY11, this means that Departments, except for Defence, must make cuts to accommodate the 1.5% public service wage increase. Scheduled growth in the Defence department will be slowed, saving \$1 billion by FY15. In addition, International Assistance, slated to rise 8% annually, will be capped after it reaches \$5 billion in FY11. By FY15, this represents a saving of almost \$2 billion.

- ❑ A number of strategic reviews are expected to trim costs by \$100 million in FY11 and \$250 million by FY12. These reviews include a reassessment of overhead costs, the ongoing Corporate Asset Management Review and a reduction in Governor-in-Council positions, with more effective governance of agencies, boards, commissions and Crown corporations planned. The government will examine ways in which all compensation costs, including benefits, could be better managed.
- ❑ Of major significance are the government's plans to close tax loopholes, broadly echoing Quebec's actions to limit aggressive tax planning. For example, increased reporting is proposed for certain tax avoidance practices. Another measure would deny claims for foreign tax credit generators incurred for the tax years starting after March 4, 2010.
- ❑ A further measure, as part of its efforts to close tax loopholes, is a range of tax changes for stock options, including repealing the tax deferral election and requiring employers to remit at least part of the tax owing. Increased reporting is proposed for certain tax avoidance practices.
- ❑ For income trusts transitioning to SIFT trusts owning a corporation, the subsequent use of that corporation's losses is restricted.

The Downsized Revenue Base

- ❑ Ottawa estimates an 8.2% drop in FY10 revenues, dragged down by a 24% plunge in corporate income taxes. For FY11, an optimistic 8.1% rebound in tax receipts is assumed and for the following four years, taxes are expected to advance by a healthy 6.1% annually.
- ❑ The Budget estimates assume that EI premium rates, beginning in 2011, will be raised to the maximum limit of 15¢ per \$100 of insurable earnings, with the EI account balanced by 2014.

Financial Sector Measures

- ❑ The opportunity to expand Canada's financial services, given this sector's strong performance through recent turmoil, is recognized with federal interest in Toronto's proposed Global Integrative Risk Management Institute. To help federally regulated financial institutions diversify their funding sources, Ottawa will introduce legislation setting out a framework for low-cost source of funds — covered bonds, debt instruments secured by high-quality assets such as residential mortgages.
- ❑ Most of the measures under the Extraordinary Financing Framework have expired or will expire this March 31. An

Ottawa's Budget Arithmetic*

\$ billions except where noted

	FY10	FY11	FY12	FY15*
	Rev.	Bud.	Bud.	Bud.
Personal Income Tax (PIT)	108.2	117.0	124.5	150.6
Corporate Income Tax (CIT)	22.3	25.5	28.9	33.2
Goods & Services Tax (GST)	25.8	27.3	28.8	33.7
Employ. Insurance (EI) Premiums	16.6	17.6	20.0	26.6
Other Revenue	41.0	43.9	46.8	52.4
Total Revenue	213.9	231.3	249.0	296.5
Total Transfers to Persons	69.7	72.0	71.4	77.1
EI Benefits	22.4	22.6	19.6	18.4
Other Transfers to Persons	47.3	49.4	51.8	58.7
Transfers to Other Cdn Gov'ts	51.4	56.8	56.3	62.4
Direct Program Expenditures	116.8	120.4	113.7	118.2
Total Program Spending**	237.8	249.2	241.4	257.7
Debt Service	29.9	31.3	35.3	40.6
Total Expenditure	267.7	280.5	276.7	298.3
Budget Balance	-53.8	-49.2	-27.6	-1.8
Non-Budgetary Transactions	-17.3	4.6	4.6	11.5
Financial Source/Requirement	-71.1	-44.6	-23.0	9.7
Net Debt	517.5	566.7	594.3	622.1
Annual Change, %				
Personal Income Tax (PIT)	-6.7	8.1	6.4	6.5
Corporate Income Tax (CIT)	-24.3	14.3	13.3	4.7
Goods & Services Tax (GST)	0.4	5.8	5.5	5.4
Total Tax Revenue	-8.8	8.1	6.9	5.8
EI Premiums	-1.7	6.0	13.6	10.0
Total Revenue	-8.2	8.1	7.7	6.0
EI Benefits	37.4	0.9	-13.3	-2.1
Other Transfers to Persons	4.4	4.4	4.9	4.3
Transfers to Other Cdn. Gov'ts	10.5	10.5	-0.9	3.2
Direct Program Expenditures**	17.0	3.1	-5.6	1.3
Total Program Spending	14.4	4.8	-3.1	2.2
Memo Items, %				
Total Revenue / GDP	14.0	14.3	14.7	15.3
Program Spending** / GDP	15.6	15.4	14.3	13.3
Budget Balance / GDP	-3.5	-3.0	-1.6	-0.1
Net Debt / GDP	33.9	35.1	35.1	32.2
Debt Service / Revenue	14.0	13.5	14.2	13.7

* Average annual growth, FY13-FY15. ** Includes *Economic Action Plan*.
Source: Finance Canada; Nominal GDP forecasts: Scotia Economics.

exception is the Business Credit Availability Program, that in January 2010 reached its target of providing more than \$5 billion in loans and other financing at market rates through private lenders, the Export Development Corporation and the Business Development Bank. As part of this Program, the government will introduce a Vehicle and Equipment Financing Partnership with an initial \$500 million for asset-based financing in partnership with private lenders and investors.

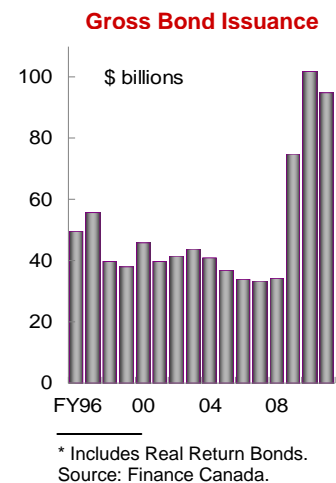
- ❑ *Budget* initiatives related to financial services for consumers include: an expanded mandate for the Financial Consumer Agency of Canada to provide the government with timely information; reduction of the maximum cheque hold period; additional financial institution disclosure requirements on items such as mortgage prepayment penalties, and; the Code of Conduct for the Credit and Debit Card Industry will be released shortly with a framework to monitor compliance. The government proposes that banks belong to an approved third-party dispute handling body and an independent Task Force will review the Canadian payments system.
- ❑ Ottawa will introduce a new legislative framework to enable credit unions to incorporate, continuing their operations as federal entities.

The Risks That Still Exist

- ❑ Canada remains closely linked to the struggling U.S. economy, our strengthening Canadian dollar represents a hurdle for all our producers, and the global unwinding of both fiscal and monetary stimulus may not be smooth. As a small, open economy, Canada depends upon continuing solid global growth. The government acknowledges the continuing high levels of uncertainty, indicating that further saving will be undertaken if necessary.

The Debt Management Strategy

- ❑ The government's financial requirement for FY10 is expected to fall to \$71 billion from \$90 billion in FY09. Lowering this requirement below expectations was the diminished borrowing of just \$63 billion for the Insured Mortgage Purchase Program. In total, the financing required for non-budgetary transactions shrinks from \$84 billion in FY09 to \$17 billion in FY10.
- ❑ In FY11, non-budgetary transactions actually represent a \$5 billion source of funds, trimming the financial requirement to \$45 billion.
- ❑ The government will be lengthening the term of its debt. After gross bond issuance in FY10 of \$102 billion, the government, even with its reduced financial requirement, still plans to issue \$95 billion, raising marketable bonds outstanding from \$295 billion in March 2009 to \$428 billion by March 2011.
- ❑ Conversely, Treasury bills outstanding will drop by \$28 billion during FY11 to \$150 billion by year-end, compared with outstanding bills of \$190 billion in March 2009. The average size of bi-weekly Treasury bill auctions will decrease for the 3-month, 6-month and 1-year terms.
- ❑ To help smooth the cash flow profile of upcoming maturities, the government is considering adjusting the maturities of certain benchmarks but will consult on possible changes first.





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