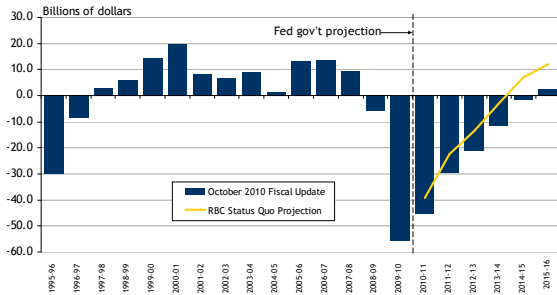


2011 FEDERAL BUDGET PREVIEW

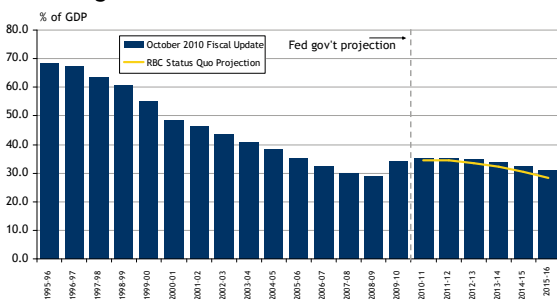
March 16, 2011

Federal government budgetary balance



Source: Department of Finance, RBC Economics Research

Federal government debt



Source: Department of Finance, RBC Economics Research

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Overview

Looking ahead to the upcoming 2011 Federal Budget we see an opportunity for the government to present an improved fiscal outlook, namely one with smaller deficits, a return to a downward trend in the debt-to-GDP ratio in the current fiscal year and a balanced budget a year ahead of plan. This improved path reflects a better-than-expected outcome over the first nine months of FY2010/11, reflecting a stronger economic environment and low interest rates. While economic uncertainty remains high, we suggest that the government seize the opportunity presented and book the good news now. The earlier deterioration in the fiscal measures through FY2009-10 reflected the economic downturn which warranted a timely and targeted response from fiscal authorities to prevent some of the worse-case outcomes. As the crisis environment is now behind us, it is time to put the fiscal books back on a sustainable path.

Given the data for the first nine months of FY2010/11, we estimate the shortfall for the current fiscal year could come in as low as \$39.2 billion. This would represent an improvement from the earlier fiscal projection of a \$45.4 billion deficit as well as the \$55.6 billion deficit recorded last year. The better-than-expected deficit alongside a stronger-than-expected reading for nominal GDP would imply a debt-to-GDP ratio of 34.4% in the current fiscal year, which would mark the peak in the ratio given our projections. This peak would be a year earlier and almost a percentage point lower than that projected in the October 2010 Fiscal Update. Our estimates would also translate into a trend improvement in this ratio, dropping below the pre-crisis mark of 30% by FY2014/15.

These projections reflect a number of assumptions. The key assumption is that the better-than-expected year-to-date readings for FY2010/11 are booked and not spent in the final months of the fiscal year. This assumption is a key risk given what has lately been a fairly consistent trend towards last minute spending increases, reminding us of the old adage that good politics and good policy are not always aligned. From the favourable starting point, we then assume the growth trajectory for both revenues and expenditures are the same as were presented in the October 2010 Fiscal Update. Effectively, we are assuming the fiscal plans presented in that Update are maintained in the upcoming budget. This assumption implies no major new initiatives will be undertaken through FY 2015/16. As a result, the scope for news in the budget will largely be limited to providing details in terms of how the government expects to achieve their expenditure and revenue growth profiles. Of particular interest will be the details underlying the expenditure path, which would require a prolonged period of government restraint that hasn't been seen since the fiscal consolidation episode of the mid 1990's.

Analysis

The starting point for the upcoming March 22 federal budget will be the fiscal update provided by the federal government in October 2010, as shown in Table 1. That update projected a steady improvement in the deficit from the actual FY2009-10 deficit of \$55.6 billion to a surplus of \$2.6 billion in FY2015-16.

Table 1: Projections from the October 2010 Fiscal Update

| | 2009-10 | Projection | | | | | |
|---------------------|---------|-----------------------|---------|---------|---------|---------|---------|
| | | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 |
| | | (billions of dollars) | | | | | |
| Budgetary revenues | 218.6 | 232.5 | 246.3 | 261.2 | 277.7 | 293.2 | 305.9 |
| Program expenses | 244.8 | 246.6 | 242.7 | 246.1 | 251.7 | 257.2 | 265.4 |
| Public debt charges | 29.4 | 31.3 | 33.4 | 36.4 | 37.5 | 37.8 | 37.8 |
| Total expenses | 274.2 | 277.8 | 276.1 | 282.5 | 289.2 | 295 | 303.3 |
| Budgetary Balance | -55.6 | -45.4 | -29.8 | -21.2 | -11.5 | -1.7 | 2.6 |
| Federal debt | 519.1 | 564.5 | 594.2 | 615.5 | 627 | 628.7 | 626.1 |
| Per cent of GDP | | | | | | | |
| Budgetary revenues | 14.3 | 14.4 | 14.6 | 14.8 | 14.9 | 15 | 15 |
| Program expenses | 16 | 15.3 | 14.4 | 13.9 | 13.5 | 13.2 | 13 |
| Public debt charges | 1.9 | 1.9 | 2 | 2.1 | 2 | 1.9 | 1.9 |
| Budgetary balance | -3.6 | -2.8 | -1.8 | -1.2 | -0.6 | -0.1 | 0.1 |
| Federal debt | 34 | 34.9 | 35.3 | 34.8 | 33.7 | 32.3 | 30.8 |

Source: Update of Economic and Fiscal Projections October 2010, Government of Canada

The first modification that federal government will likely make to these earlier estimates is to update the FY2010-11 numbers. Actual data through the first nine months of the fiscal year (April to December 2010) are indicating a budgetary deficit of \$27.4 billion and compares to a \$39.4 billion shortfall over the comparable period for FY2009-10. If we apply the year-to-date growth rates for both expenditures and revenues as indicated in the data for the first nine month, it implies a full year deficit for FY2010-11 of \$39.2 billion, as shown in Table 2. Moving forward, we use this new starting point and apply the growth rates used in the October 2010 Fiscal Update, which implies a deficit of \$22.3 billion in FY2012/13. This compares to the \$29.8 billion deficit projected last fall. Beyond the next two fiscal years, the deficit continues to trend lower and is projected to return to surplus in FY2014-15. This is a year earlier relative to October 2010 projections, which did not show a surplus until FY2015-16. The initial surplus is also anticipated to be larger than initially projected, at \$6.9 billion instead of \$2.6 billion.

Table 2: RBC's "Status Quo" Projections

| | 2009-10 | Projection | | | | | |
|-------------------|---------|-----------------------|---------|---------|---------|---------|---------|
| | | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 |
| | | (billions of dollars) | | | | | |
| Budgetary Balance | -55.6 | -39.2 | -22.3 | -13.4 | -3.1 | 6.9 | 12.1 |
| Federal Debt | 519.1 | 558.3 | 580.6 | 594 | 597.1 | 590.2 | 578.1 |
| Per cent of GDP | | | | | | | |
| Budgetary Balance | -3.6 | -2.4 | -1.3 | -0.7 | -0.2 | 0.3 | 0.6 |
| Federal Debt | 34.0 | 34.4 | 33.8 | 32.9 | 31.5 | 29.6 | 27.6 |

The above fiscal projections are based on the assumption of unchanged fiscal policy. This in fact may be not too far off what actually emerges after the budget presentation as we are not assuming any major new initiatives. A myriad of small new spending initiatives is possible, given the likelihood of a near-term election, though we expect, and hope, that the main focus of the 2011 federal budget will be to provide an update on eliminating the sizeable deficit. In terms of the actual dimensions of the fiscal challenge, this balance was last in surplus of \$9.6 billion in FY2007-08 but then deteriorated to a deficit of \$5.8 billion in FY2008-09. This was then followed by a ballooning of the deficit to \$55.6 billion in FY 2009-10 in the midst of the Canadian, and global, recession. A return to a surplus will be slightly less of a challenge in the face of a lower deficit this year, as suggested above, though a significant degree of restraint will still be required.

Where will this additional restraint come from? In the 2010 budget, the government indicated additional savings via three main channels, that we expect will be reiterated in the 2011 budget. These channels include:

1. winding down of the Economic Action Plan
2. restraining growth in government spending
3. undertaking a comprehensive review of “government administrative functions and overhead costs in order to identify opportunities for additional savings”

The biggest component of the Economic Action Plan was the infrastructure spending initiative. In the 2010 Budget the federal government estimated spending of around \$16.0 billion over FY2009-10 and FY2010-11. The cessation of this spending will provide a sizeable contribution towards deficit reduction. In fact, the federal government stated in the 2010 budget that the projected drop in the deficit between FY2009-10 and FY2011-12 (estimated at the time as going from \$53.8 billion to \$27.6 billion though revised in October to \$55.6 billion to \$29.8 billion) reflected, “for the most part,” the winding down of the overall Economic Action Plan.

The second initiative to reduce the deficit, the restraining of growth in government spending, was estimated in the last budget as offering \$17.6 billion in savings over five fiscal years out to FY2014-15. The main components of these savings included: containing the administrative cost of government (\$6.8 billion), lowering spending for international assistance (\$4.5 billion) and restraining defence spending (\$2.5 billion). Savings of \$2.5 billion was also projected from closing various tax loopholes. The final \$1.3 billion was assumed to come from the “2009 strategic review.” These reviews were intended to reduce cost and improve efficiency of the operation of the federal government.

The third line of attack to eliminate the deficit was essentially an extension of the 2009 strategic reviews to the out years of the budget projection. This initiative was to be led by the President of the Treasury Board, Stockwell Day. The 2010 federal budget promised that “the Government will report on the results of this review in the 2011 budget.” Thus we are likely to see a number finally attached to this third initiative along with details as to where the savings are likely to be found.

This strategy for deficit reduction comes almost exclusively from lowering expenditures with any tax increases being limited to closing tax loopholes. In fact, the 2010 Budget clearly stated that “the Government will not raise taxes.” We are generally assuming that this promise will be maintained. As well, we are assuming that the earlier-promised corporate tax cuts will proceed. This entails maintaining the January 2011 reductions from 18% to 16.5% and implementing the further reduction next year to 15%.

The last budget also indicated that savings would not come on the back of reductions in transfers to persons and other levels of government. However, the current funding arrangements between the federal government and the provinces for health care and social programs as well as equalization payments lapse after FY2013-14. It is therefore conceivable that the federal government could opt to lower funding beyond this point and thus not, in principle, break its commitment on transfers. The October 2010 fiscal update clearly stated that “for planning purposes, major transfers to other levels of government are projected to grow at current legislated rates over the full forecast period. From 2014-15 onward, these growth rates have not yet been legislated and are therefore subject to change.” (Currently health transfers increase annually by 6%, equalization by nominal growth in the economy and “social programs” by 3%.) The dollar amounts are not insignificant. In FY2009-10 funding for federal transfers in support of health and social programs combined with equalization, totalled \$49.9 billion. Finance Minister Flaherty has mused in the past of tying growth in health transfers closer to nominal GDP growth. Thus the 2011 Budget will be scrutinized to see if a reduction in funding levels in FY2014-15 and beyond are component of the government’s deficit reduction program.

The current base case fiscal outlook as stated in the October 2010 update has revenues growing on average 5.6% per year from FY 2011-12 to FY2015-16. Program expenditures are expected to decline 1.6% in FY2011-12 as the infrastructure spending is wound down and then to rise 2.3% on average per year until FY2015-16. This implies a sustained period of very low government expenditure. Providing a credible strategy to achieve such will represent the main challenge confronting the 2011 Budget.

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