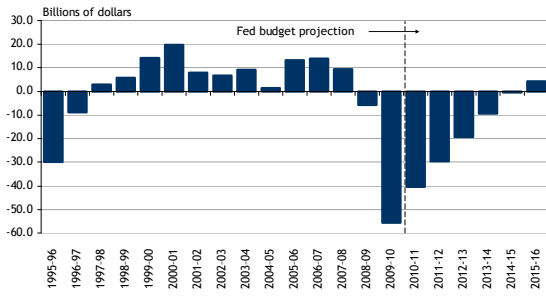


2011 FEDERAL BUDGET MARCH 22, 2011

Federal government budgetary balance



Source: Department of Finance, RBC Economics Research

Overview

Budget 2011 presented today allows the federal government to argue that it has been able to maintain the deficit reduction agenda introduced in last spring's Budget 2010 (and reaffirmed in the October 2010 Fiscal Update). Broadly, this initiative entailed a steady reduction in the deficit from its ballooning in FY2009-10 to \$55.6B, which occurred in the wake of the recent recession, to a surplus position in FY2015-16 (as articulated in the October 2010 fiscal update). Such remains the case with a surplus of \$4.2B being projected by that terminal year that in fact represents almost a doubling from the \$2.6B surplus projected last October. As well, the deficit profile in the intervening years is lower in every year relative to that projected in October. The continued downward trajectory of the deficit is attributable to the federal government being able to adhere to its three-point deficit reduction program specified in Budget 2010 (winding down of the Economic Action Plan, restraining growth in government spending and strategic reviews of spending going forward). As well it continues to be the case that this restraint does not rely on any tax increases (as long as you do not count another round of "closing tax loopholes" as such). The lower deficit profile (and higher surplus in the terminal year) largely reflects better fiscal numbers in the current fiscal year (FY2010-11) as 2010 economic growth has come in better than expected.

Our analysis prior to the budget suggested that a so-called "status quo" projection (incorporating the recent better fiscal numbers and assuming unchanged fiscal policy) could yield a FY2014-15 surplus of \$6.9B rising to \$12.1B in FY2015-16. Today's budget projections fell short of this with the elimination of the deficit continuing to be projected for FY2015-16. A lion's share of this dissipation of savings was attributable to a number of spending initiatives undertaken by the federal government in today's budget particularly in FY2011-12. This spending totalled \$7.6B over five years and reflected a myriad of small initiatives. Though this spending has slowed the pace of deficit reduction, the prospect of a federal election had raised the risk of an even greater surge in spending. There is the possibility that this budget will not be passed by parliament. Such will result in this budget reverting to the Conservative Party's economic platform in a federal election.

Tempering this disappointment about a more modest pace of deficit reduction is the fact the government is within a hair's breadth of achieving fiscal balance in FY 2014-15 given a current projected deficit of only \$0.3B. As well, the budget does indicate success in achieving savings from the strategic initiatives. Specifically, the strategic review savings incorporated in this year's budget yielded \$2.1B over five years and compares to a savings of \$1.3B booked last budget. Going forward, today's budget offers the prospect of achieving additional saving from ongoing strategic reviews that could offer "at least \$4 billion in ongoing annual savings by 2014-15." Such presents the prospect of eventually achieving a faster pace of improvement in the overall fiscal balance.

Craig Wright
Chief Economist
(416) 974-7457
craig.wright@rbc.com

Paul Ferley
Assistant Chief Economist
(416) 974-7231
paul.ferley@rbc.com

Analysis

Going into Budget 2011, there had been considerable optimism that stronger-than-expected economic growth through 2010 had contributed to, and would continue to yield, better fiscal numbers. This was confirmed by today's projection with the FY2010-11 deficit lowered to \$40.5B from the \$45.4B projected in the October Fiscal Update. This savings reflected \$2.9B in higher revenues and \$2.0B in lower expenditures.

Going forward, despite this encouraging start, the undershoot on the deficit was not projected to continue. The projected deficit for FY2011-12 of \$29.6B was only slightly below the \$29.8B projected in October. This was the case despite the assumption that revenues would likely be \$2.9B higher for a second straight year. What happened to these savings? About \$1.0B was attributed to various one-off expenditures that have emerged since the October 2010 fiscal update. Examples provided in the budget included: "transfer protection payments [e.g. health transfers, equalization] to the provinces" along with provisions for the training of the Afghan National Security Forces. However the bigger \$2.3B offset in FY2011-12 came from new program spending introduced in today's budget. There were two main components of this additional spending that were titled in the budget: "A Low-Tax Plan for Jobs and Growth" and "Supporting the Recovery." The former included numerous expenditures grouped into three main areas: "Supporting Job Creation" "Supporting Families and Communities" and "Investing in Innovation, Education and Training." This included initiatives like improving tax support for caregivers that were projected to cost \$200 million over the next two years. "Supporting the Recovery" reflected programs such as enhancing employment insurance and a hiring credit for small businesses. Expenditures in these areas continue through 2015-16 though with the level of spending moderating to \$1.2B by that terminal year. Over the five fiscal years, there is a cumulative \$7.6B in additional spending.

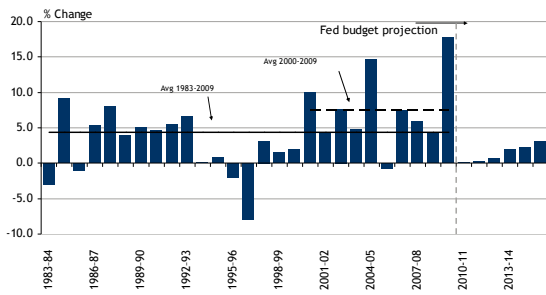
These spending initiatives saw some modest offset in FY2011-12 from the various savings measures including the "booking" of the 2010 strategic review and another round of "closing tax loopholes." This only provided a modest \$0.4B in savings in FY2011-12, though these savings were projected to grow through FY2015-16 rising to \$1.5B by that terminal year. Over the five fiscal years, there is a cumulative savings of \$6.2B. As the cost savings start to rise relative to a moderation in increased expenditures beyond FY2011-12, the projected fiscal balance starts to show greater improvement relative to that projected in October. (Specifically, -\$19.4B, -\$9.5B, -\$0.3B and +\$4.2B versus -\$21.2B, -\$11.5B, -\$1.7B and \$2.6B for FY2012-13 through FY2015-16, respectively.)

These deficit projections imply that the debt-to-GDP ratio now rises in FY2011-12 to 34.4% from 34.3% the previous year. However, this is a smaller ratio in FY2011-12 relative to that projected in October of 35.3%. The ratio is now projected to drop to 29.7% by FY2015-16 compared to the 30.8% projected in October.

Financial requirement

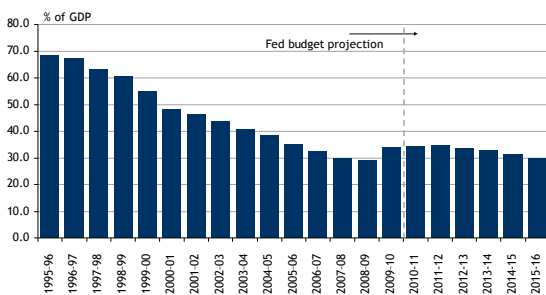
The federal government implied a slowing in financial requirements to \$34B for FY2011-12 which is down from the \$45B projected in Budget 2010 for FY2010-11. This slowing in the financing requirement is consistent with the downward trend in the fiscal deficit over these two years.

Federal program spending



Source: Department of Finance, RBC Economics Research

Federal government debt



Source: Department of Finance, RBC Economics Research

Summary statement of transactions (billions of dollars)

	<u>2010-11</u>	<u>2011-12</u>	<u>2012-13</u>	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>
Budgetary transactions						
Budgetary Revenues	235.6	249.1	264.4	281.2	296.8	309.2
Program Expenses	245.2	245.7	247.3	252.0	257.7	265.6
Public debt charges	30.8	33.0	36.5	38.6	39.4	39.4
Total Expenses	<u>276.0</u>	<u>278.7</u>	<u>283.8</u>	<u>290.7</u>	<u>297.2</u>	<u>305.0</u>
Budgetary Balance	-40.5	-29.6	-19.4	-9.5	-0.3	4.2
Federal Debt	556.4	586.0	605.4	614.9	615.2	611.0
Per cent of GDP						
Budgetary revenues	14.5	14.6	14.8	15.0	15.1	15.1
Program Expenses	15.1	14.4	13.8	13.4	13.1	12.9
Public Debt Charges	1.9	1.9	2.0	2.1	2.0	1.9
Budgetary Balance	-2.5	-1.7	-1.1	-0.5	0.0	0.2
Federal Debt	34.3	34.4	33.8	32.7	31.3	29.7

(Year-over-year % change)

	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Real GDP growth	3.1	2.9	2.8	2.7	2.5	2.5
GDP Inflation	3.0	2.8	2.1	2.1	2.0	2.0
Nominal GDP growth	6.2	5.8	5.0	4.9	4.5	4.5
3-month Treasury bill rate*	0.6	1.3	2.5	3.4	3.9	4.1
Ten-year government bond rate*	3.2	3.5	4.0	4.6	4.8	5.0
Unemployment rate	8.0	7.5	7.2	7.0	6.7	6.5
U.S. real GDP growth	2.8	3.1	3.1	3.2	3.3	3.2

*%, end of period

Source: Statistics Canada, Bureau of Economic Analysis, RBC Economics Research

The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.

