



Publication

BUSINESS ALERT

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FEDERAL BUDGET SIGNALS RESTRAINT...BUT LATER

The centrepiece of the March 4, 2010 Budget presented by Finance Minister Jim Flaherty is the plan to return to a balanced budget. According to the Minister, the deficit is slated to fall from \$53.8 billion this year to \$1.8 billion by 2014-15. Although focused on deficit reduction, the government opted to postpone the pain and to continue with year two of its stimulus program. Beyond 2010-11, the government will rely on a mix of economic growth, overall expenditure restraint, and specific spending cuts to close the fiscal gap. Budget 2010 also introduced targeted measures to stimulate investment as well as some additional funding for research, education, training and other items aligned with supporting economic growth.

As noted, the document reaffirms the government's commitment to follow through with the second year commitments made in Canada's Economic Action Plan. This provides \$25.1 billion in stimulus in the coming year, \$19 billion of which is federal funding plus an estimated \$6 billion in matched provincial spending. In our estimation, the government is wise to follow through with the second year of the Action Plan, even though the economy is on the mend. While the recovery is gaining traction, it remains fragile and there are a number of risks for the next year – including the fact that the European economy appears to be stalling and the possibility of a 'double dip' in the US.

Economic Setting

After being caught up in the global recession and contracting by an estimated 2.5% in 2009, Canada's economy is now rebounding, as evidenced by the 0.9% expansion in GDP in the third quarter, followed by a healthy 5.0% bounce in the final months of 2009. Employment, housing activity, and consumption are rising. Total economic activity, however, is still below pre-recession levels, and the unemployment rate remains quite high.

Table 1 Key Economic Assumptions for Canada				
	2009	2010	2011	2012
Real GDP Growth	-2.5%	2.6%	3.2%	3.0%
Nominal GDP Growth	-4.6%	4.9%	5.4%	5.3%
CPI Inflation rate	0.3%	1.7%	2.2%	2.1%
Unemployment rate	8.3%	8.5%	7.9%	7.4%
3-month T-bill rate	0.3%	0.7%	2.4%	3.8%
10-yr gov't bond rate	3.3%	3.7%	4.3%	4.9%
Exchange rate (US¢/C\$)	88.0	95.5	98.3	97.7

Source: Federal Budget 2010.



To some extent, Canada is being lifted by an upturn in the global economy, with the International Monetary Fund recently forecasting a 3.9% advance in global output in 2010, following a decline of almost 1% last year. But the Budget is careful to point out the “recovery remains fragile in advanced economies.” In many of these countries, domestic demand is weak with any recovery being led by exports. Canada is unusual among industrial countries in having fairly strong domestic demand growth, creating a stronger foundation for sustained recovery.

The average private sector forecast, or consensus view, is for the Canadian economy to grow 2.6% this year. Next year real GDP is expected to increase by 3.2%. We see no reason to quibble with the Budget’s forecast. But the downside risks, although acknowledged, may be understated -- especially with respect to the outlook for the US and Europe.

Fiscal Picture

The Conservative government states that it will balance the budget over time, and do so without raising taxes or cutting transfers to persons or other levels of government. This will be a tall order. The government plans to sharply restrict the growth of expenditures after 2010-11, while allowing an expanding economy and the associated gain in revenues to do the heavy lifting in slashing the deficit.

With weakness in both personal income tax (due mostly to tax relief measures and the now expired home renovation tax credit) and corporate income tax, federal revenue will be down 8.2% this fiscal year (2009-10). Next year, with the economy rebounding and the unwinding of temporary tax relief, revenues are expected to climb 8.1%, leaving the government’s take (in dollars) just slightly below the pre-recession level.

<u>Table 2</u>						
Federal Government Fiscal Projection						
(billions of dollars unless otherwise indicated)						
	<u>2009/10</u>	<u>2010/11</u>	<u>2011/12</u>	<u>2012/13</u>	<u>2013/14</u>	<u>2014/15</u>
Budgetary Revenues	213.9	231.3	249	266.5	282.7	296.5
(% change)	-8.2	8.1	7.7	7.0	6.1	4.9
Program Spending	237.8	249.2	241.4	245.2	251.4	257.7
(% change)	14.4	4.8	-3.1	1.6	2.5	2.5
Debt Charges	29.9	31.3	35.3	38.9	39.8	40.6
Total Expenditure	267.7	280.5	276.7	284	291.2	298.3
(% change)	12.1	4.8	-1.4	2.6	2.5	2.4
Budget Balance	-53.8	-49.2	-27.6	-17.5	-8.5	-1.8
Federal Debt	517.5	566.7	594.3	611.9	620.3	622.1
% of GDP	33.9	35.4	35.2	34.4	33.3	31.9

Source: Department of Finance Canada, 2010 Federal Budget.



A few additional observations on the outlook for revenue growth are warranted as hefty gains in tax collections are the cornerstone of the government's deficit reduction strategy. The Budget assumes revenues will grow by an average of 6.5% over the coming five-year period. Looking back over the five-year period between 2002-03 to 2006-07 (which includes a recovery from a mild recession), federal revenues grew by an average of 5.1%. This basic comparison suggests the revenue growth assumptions in Budget 2010 may be on the optimistic side. It is important to remember, however, that the earlier era was characterized by significant, multi-year tax cuts. This is less true for the period encompassed by the current fiscal plan. Allowing for this difference, the Budget's revenue projections are not as optimistic as they initially appear.

The estimates for Employment Insurance revenue are of interest to the employer community. EI premiums were frozen in 2009 and 2010 at \$1.73 per \$100 of insurable earnings (for workers; employers pay at a higher rate, 1.4 times the rate charged to workers). When the freeze is lifted, EI premiums will move higher, starting in 2011. The rate will be set by the independent Canada Employment Insurance Financing Board (CEIFB) such that EI premiums come into balance with outlays over time. According to the Budget, the deficits incurred by the EI program during the recent recession will be paid back by 2014. As outlined in last year's Budget, the CEIFB will not have to pay back the \$2.9 billion in benefit enhancements announced in 2009, but there is still a sizable gap to close.

The figures presented in the Budget show EI premium revenue rising 6% this year, mostly from job growth as rates are still frozen in 2010. EI revenue is then projected to increase by about 13% in each of the subsequent two years, then by 11.5% in 2013-14. Given that EI revenue is driven by job growth and premium increases (which will be determined by the CEIFB), the exact magnitude of future premium rate increases is unclear. What is clear, however, is that after many years of being stable or falling, payroll taxes are heading higher. While this may be inevitable, it certainly won't help to bring down the country's unemployment rate.

On the spending side of the ledger, a key step in restraining expenditure growth is allowing the temporary elements of the Canada Action Plan to wind down as scheduled. This alone is expected to trim the deficit nearly in half between 2009-10 and 2011-12. The remainder of the deficit is to be eliminated by restraining growth in defence spending, freezing outlays on international assistance, pruning administrative costs, reviewing government operations, and addressing tax loopholes. Together, these measures are reported to save \$2 billion in 2011-12 and up to \$5.7 billion in 2014-15. More than one-third of the targeted annual savings each year come from "containing the administrative cost of government," which will require controlling wage and benefit costs.

The restraint measures proposed in the Budget are tilted towards the latter years of the fiscal planning period. Indeed, given the commitment to follow through with the Canada Economic Action Plan, and the somewhat precarious nature of the recovery, the deficit for 2010-11 is only slightly lower than in 2009-10. With the winding down of the Canada



Economic Action Plan, total spending shrinks in 2011-12 and then rises by a modest 1.5% to 2.5% over the remainder of the budget projection period.

Driven by several years of substantial deficits, the federal debt is slated to jump to \$622 billion by 2014-15, up sharply from \$463 billion in 2008-09. While some commentators are alarmed at the increase, we see little reason to lose sleep. The ratio of total federal debt-to-GDP – which is the most relevant measure of debt load – has edged up from 29% in 2008 to roughly 34%

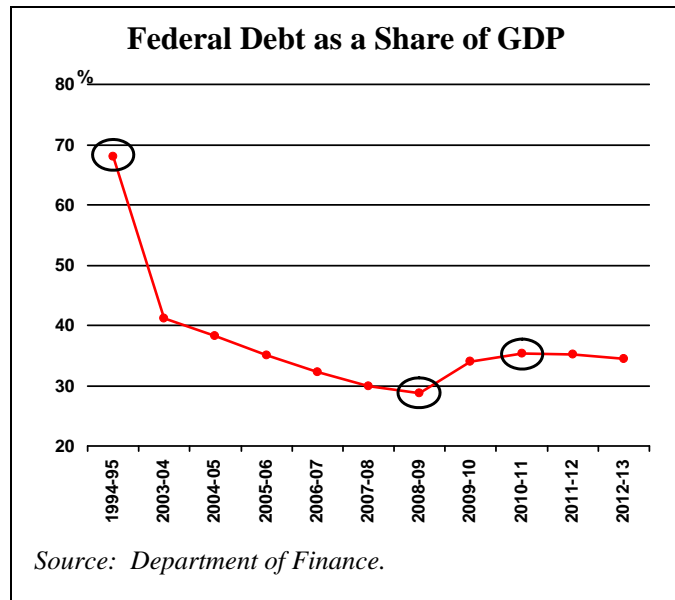
this fiscal year, and is projected to peak at 35.2% in 2012, before beginning a slow decline. Budget 2010 confirms that even with the return of large, recession-driven deficits, Canada is in excellent fiscal shape by international standards, with debt loads well below other OECD countries. As long as Ottawa presses ahead with its plan to stem the tide of red ink as the economy improves, the recent deficits can be seen as a result of reasonable discretionary fiscal policy choices made during the worst global economic downturn in more than six decades.

New Measures

While not a new announcement, we again draw attention to the Canada Action Plan's measures allowing businesses to fully depreciate computer equipment purchased before February 2011 and to use 50% straight-line depreciation for machinery and equipment purchased before January 1, 2012. With the domestic economy gaining traction, these previously announced changes should have a positive impact on business investment this year.

Budget 2010 builds on the investment stimulus theme by eliminating all remaining tariffs on machinery and equipment as well as on goods that are imported for further manufacturing. This welcome initiative will ultimately save business \$300 million annually.

Minister Flaherty has confirmed that the government is on course to lower the basic federal corporate income tax rate to 15% by 2012 – a key step in making Canada a globally competitive location for investment and high-value business activity. Unfortunately, the government did not see fit to extend the two-year write-off for investments in manufacturing and processing equipment beyond 2011. The Business Council continues to believe that an extension of this measure is necessary.





Turning to jobs, training, innovation, and education, the Budget contains a number of new proposals, including:

- Extension of work sharing agreements by 14 weeks, to a maximum of 52 weeks. Budget 2010 further extends the benefit period another 26 weeks, to a maximum of 78 weeks. This measure is estimated to cost \$106 million over two years.
- \$60 million is allocated for 2010-11 to “assist young Canadians while the labour market recovers.”
- There is additional funding for post-doctoral fellows.
- The budgets of the federal research granting councils are boosted by \$32 million per year, plus \$135 million over two years for the National Research Council’s regional innovation clusters program.
- There is also \$30 million over two years to support better education outcomes for First Nations.

In addition are a few items of particular interest to British Columbia:

- The most significant is the announcement of \$222 million in funding over five years to strengthen research at the TRIUMF facility at UBC.
- Genome BC, one of six Genome Canada centres, should benefit from \$75 million in additional funding for Genome Canada.
- The government is streamlining the income tax rules in respect of reporting requirements for foreign venture capital investments. This has been a key issue for the local advanced technology sector. The proposed changes were recommended by the BC Technology Industry Association and endorsed by the Business Council.
- BC will see a portion of the \$49 million in annual funding for regional development agencies to support innovation.
- With the country’s largest forestry sector, the Next Generation Renewable Power Initiative, which provides \$100 million to support the development and commercialization of clean energy technologies in the forestry sector, is welcome news for BC.
- Canada’s Action Plan included \$1 billion over five years for a Green Infrastructure Fund. The federal government committed (in advance of the Budget) \$130 million from this fund to help build the Highway 37 transmission corridor. This is a vital piece of infrastructure that will open up new opportunities in the north western region of the province.

Conclusion

As we noted in our comments on the recent provincial Budget, the federal Budget has been judged in the context of today’s unusual times. While the 2008-09 recession has ended, it has left a painful legacy. The economic environment is still uncertain and the recovery remains somewhat fragile. We agree with the stay-the-course approach that characterizes



the new federal Budget. While the Budget was short of major new announcements it managed to include a number of relatively low cost measures to improve competitiveness and help spur business investment and productivity over time. The government deserves credit for keeping “competitiveness” on the agenda – and also for reaffirming the plan to lower the basic federal corporate income tax rate to 15% by 2012. Coupled with falling tax rates in many provinces, including BC, this will give Canada an increasingly competitive business tax regime at a time when many countries are likely to be raising taxes as they move to address their fiscal problems.

If we do have a concern with Budget 2010, it relates to whether the government can find the cost savings that are integral to its plan to balance the books by 2014. Most of the relevant administrative and program cost reductions are to be identified in the years ahead. Whether the current or a future government will stay on this path cannot be known in advance.

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