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## Federal Budget

### **Analysis of the Canada's 2007 Budget**

**A clever and generous budget that is a good step  
in resolving fiscal inbalanced issue**



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## Highlights

This is the second budget of Minister of Finance James Flaherty and the Conservative government and it is in line with the one tabled last year. With nearly \$20B in new initiatives over 3 years, this budget is again trying to please a wide range of Canadians while remaining true to the Conservative Party's program. More particularly, it partially resolves the fiscal imbalance issue and implements a host of new measures to make the Canadian economy more competitive, especially by lessening the tax burden on individuals and corporations. Moreover, many other initiatives are being introduced with respect to the environment, health, education, culture as well as national and international security.

- Program spending is growing by 5.6% in 2007-2008, which is a growth rate that is unmistakably higher than that of the economy.
- Some factors are undeniably slowing down increases of the government's revenues: slower economic growth in Canada this year, the many measures announced today and those mentioned in the last few years.
- The government's financial leeway remains relatively sizeable.

- The debt-to-GDP ratio could go down from 35.1% in 2005-2006 to 29.7% in 2008-2009. The government is then well on the way to reach its objective of bringing this ratio down to 25% by 2012-2013.
- Taking into account the other initiatives, all the new measures aimed at cutting the fiscal imbalance could reach just under \$1B in 2007-2008 for Québec.

## Realistic economic forecasts

Since the private sector forecasts used by the Department of Finance come from a survey conducted just a few days ago, i.e., at the beginning of March, the projections included in the budget are relatively consistent with the recent changes in Canada's economic conditions. Domestic demand should remain relatively firm, mostly due to a strong labour market, while foreign trade will continue to suffer from a high Canadian dollar and stiffer international competition. So real GDP could, according to the Department's survey, grow by 2.3% in 2007 and by 2.9% in 2008. These forecasts are close to our own, which anticipate a 2.2% increase in 2007 and a 2.8% one next year.

**Table 1**

### Summary of budgetary transactions

In billions of \$	2003-2004	2004-2005	2005-2006	2006-2007f	2007-2008f	2008-2009f
<i>Budgetary transactions</i>						
<b>Budgetary revenues</b>	<b>198.6</b>	<b>211.9</b>	<b>222.2</b>	<b>232.3</b>	<b>236.7</b>	<b>243.5</b>
- Variation (%)	4.2	6.7	4.8	4.5	1.9	2.9
<b>Program spending</b>	<b>-153.7</b>	<b>-176.4</b>	<b>-175.2</b>	<b>-189.0</b>	<b>-199.6</b>	<b>-206.8</b>
- Variation (%)	4.8	14.8	-0.7	7.9	5.6	3.6
<b>Operating balance</b>	<b>44.9</b>	<b>35.6</b>	<b>47.0</b>	<b>43.3</b>	<b>37.1</b>	<b>36.7</b>
<b>Public debt charges</b>	<b>-35.8</b>	<b>-34.1</b>	<b>-33.8</b>	<b>-34.1</b>	<b>-33.8</b>	<b>-33.7</b>
- Variation (%)	-4.0	-4.6	-0.9	0.9	-0.9	-0.3
<b>Projected reduction of the debt</b>				<b>-9.2</b>	<b>-3.0</b>	<b>-3.0</b>
<b>Budgetary balance</b>	<b>8.9</b>	<b>1.5</b>	<b>13.2</b>	<b>0.0</b>	<b>0.3</b>	<b>0.0</b>
Non-budgetary transactions	-1.5	5.1	-6.5	-0.8	-7.7	0.5
Financial source and requirements	7.6	6.6	6.7	8.4	-4.7	3.5
Ratio of program spending to GDP (%)	12.7	13.7	12.8	13.1	13.3	13.2
Ratio of budgetary balance to GDP (%)	0.8	0.1	1.0	0.0	0.0	0.0
Ratio of debt charges to budgetary revenues (%)	18.0	16.1	15.2	14.7	14.3	13.8
Debt representing accumulated deficits	496.2	494.7	481.5	472.3	469.3	466.3
Debt-to-GDP ratio (%)	40.9	38.3	35.1	32.8	31.4	29.7

Source: *Departement of Finance of Canada*

f: forecasts

**Table 2**
**Economic and financial forecasts**

Annual average in % (except if indicated)	2006	2007f		2008f	
		Budget	Desjardins Group	Budget	Desjardins Group
Real gross domestic product <sup>1</sup>	2.7	2.3	2.2	2.9	2.8
Nominal gross domestic product <sup>1</sup>	4.9	3.9	3.3	5.0	5.1
Gross domestic product deflator <sup>1</sup>	2.2	1.6	1.1	2.1	2.3
Final domestic demand <sup>1</sup>	4.5	2.6	3.2	2.9	3.2
Employment <sup>1</sup>	1.9	1.5	1.8	1.3	1.9
Unemployment rate	6.3	6.3	6.3	6.4	6.1
Treasury bills—3-month	4.00	4.20	4.15	4.20	4.35
Federal bonds—10-year	4.20	4.10	4.15	4.50	4.80
Canadian dollar (US¢)	88.2	87.4	85.4	88.4	91.5
WTI* oil (US\$)	66.0	63.1	59.0	61.2	72.0

<sup>1</sup> Average annual growth; \* West Texas Intermediate.

Sources: Department of Finance of Canada, Statistics Canada and Desjardins, Economic Studies

f: forecasts

We generally believe however that price increases could be a little lower than expected in the budget projections, especially the energy prices. We believe that the rise of the GDP deflator expected by the government could be slightly lower in 2007, which could mean a weaker increase of nominal GDP and as a result less budgetary revenues.

As for interest rates, the budget projections are also similar to our own, although the improvement of the North American economic outlook from mid-2007 could pave the way to a gradual rate increase. In this context, we feel that the 10-year federal bond rate could be slightly higher than what the Department expects in 2008. This difference could obviously generate slightly higher than expected charges on the public debt as well as lower budgetary revenues.

### Budgetary revenues are not growing as quickly as spending

The budget tabled today by Minister Flaherty anticipates a 5.6% program spending increase in 2007-2008, which is a growth rate that is unmistakably higher than that of the economy. The host of measures proposed in the budget is visibly weighing heavily on the government's expenditures. Of course, the reduction of the debt charges, which is the result of repayments made over the last few years and low interest rates, is partly offsetting the growth in program spending.

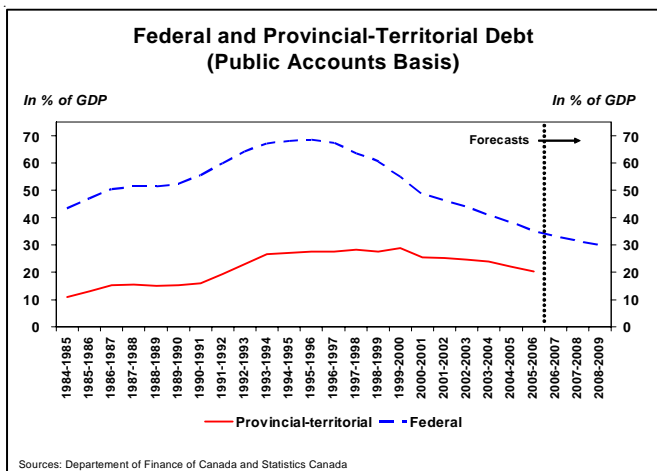
The growth of budgetary revenues has clearly been slower in the last few years. Following respective

increases of 6.7% in 2004-2005 and 4.8% in 2005-2006, the Department of Finance forecasts are anticipating a 4.5% increase in 2006-2007 and only 1.9% in 2007-2008. It is undeniable that Canada's slower rate of economic growth and the many measures announced today and over the last few years are slowing down the increase of government revenues. Moreover, the full effect of the goods and services tax (GST) cut last July will be in effect in 2007-2008.

Even so, the federal government's financial leeway remains relatively significant. The current fiscal year should close with a surplus of \$9.2B according to Department of Finance projections while a surplus of approximately \$3B is still anticipated for the next fiscal years.

### The debt keeps going down

After a \$13.2B cut in the debt taken from the 2005-2006 budgetary surplus, the federal government's forecasts anticipate that an additional amount of \$9.2B will be allocated to the debt in 2006-2007. In addition, the Department of Finance is maintaining its commitment to repay a minimum of \$3B per year for the next fiscal years. So, the ratio of debt to GDP could go down from 35.1% in 2005-2006 to 29.7% in 2008-2009. The government is then well on the way to reach its objective of cutting down the ratio to 25% by 2012-2013. The benefits of the lower debt are obvious as the public debt charges as a percentage of budgetary revenues have decreased significantly over recent years. The federal government must however keep at it as the weight of its debt is still



relatively high compared to that of the provinces and territories.

### The new tax cuts target low-income households and manufacturing businesses

Keeping the momentum of the previous budget, Canada's Minister of Finance is proposing again this year many measures that provide tax relief to individuals and businesses. This relief will total \$5.8B by fiscal 2008-2009.

As for individuals, rather than directly cutting the tax rate, the Minister chose to provide more support to low-income households and families. The government proposes a new tax benefit for earned income totalling \$550M per year. This measure is designed as an incentive to work by lowering the "welfare wall" for unemployed Canadians. It also introduces a new \$2,000 child tax credit, tax adjustments for single-income families and a host of smaller measures directed at public transit users, education savings plans, pension plans, assistance for disabled Canadians etc. Proposed also is a higher cumulative tax exemption of capital gains.

According to the Department of Finance, half of the tax relief anticipated in the budget is aimed at lower income taxpayers, i.e., those whose annual personal income is under \$37,178. Taking into account the measures implemented since the beginning of the Conservative government's term (with the exception of the GST cut), the proportion is leaning a bit more towards middle-income families.

In addition, the government is reaffirming its commitment to dedicate on an annual basis \$1B to

### Distribution of Tax Relief for Canadians: Budget 2007

The Tax Fairness Plan and Budget 2006		
Individual Income	Budget 2007 (1)	Budget 2007, (1) Tax Fairness Plan and Budget 2006 (2)
Under \$37,178	50.1%	29.7%
\$37,178 - \$74,357	33.1%	44.7%
\$74,358 - \$120,887	12.6%	17.3%
\$120,888+	4.2%	8.3%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>

(1) Includes increase in spousal and equivalent amount, new child tax credit and Working Income Tax Benefit.

(2) Broad-based personal income tax reductions from Budget 2006 and the 2006 Tax Fairness Plan (does not include the 2006 GST reduction).

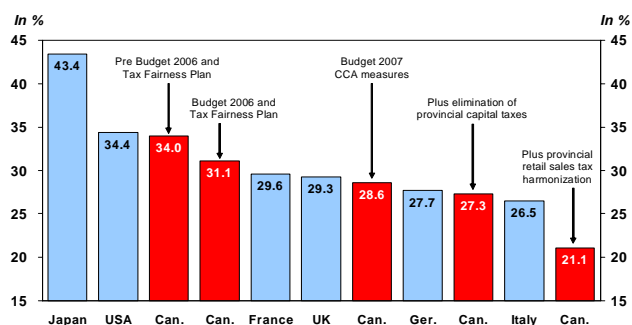
Source: Department of Finance of Canada

cutting personal income tax rates and fund it with the cut in interest charges on the debt.

For corporations, the government is staying the course on its objectives expressed last year, like the cut in the corporate tax rate by 2011 and the elimination of the corporate surtax in 2008 (corporate tax on capital was eliminated in January 2006). This year, the Harper government clearly wanted to help manufacturing businesses, as this industry has particularly suffered in the current economic conditions. By 2008-2009, \$735M will be allocated to assistance provided as investment incentives (accelerated capital cost allowance). In addition, the capital cost allowance of many assets will be increased to align them with their useful life (a cost of \$205M by 2008-2009).

These policies announced in the new budget, coupled with what was announced last year, are designed to increase the competitiveness of Canadian businesses. According to the government, by 2011, Canada would jump from 5<sup>th</sup> to 1<sup>st</sup> among G7 countries for its fiscal competitiveness towards new investments.

### Overall Tax Burden on New Investment (METR) in 2011\*



\* Includes all legislated policy initiatives that will be effective by 2011 and, in the case of Germany, also includes recently proposed changes. Excludes resource and financial sectors and research and development assets.

Source: Department of Finance of Canada

## Correcting the fiscal imbalance

As expected, the federal government's 2007-2008 budget proposes many measures to correct the fiscal imbalance with the provinces, the territories and the municipalities. Moreover, there are significant changes to the transfers to the provinces and territories, which come mainly from 3 separate programs. On the one hand, the Equalization payments are amounts allocated to have-not provinces<sup>1</sup>. The transfers are unconditional and can be allocated to whatever the provinces want to. The provinces that will benefit from Equalization in 2007-2008 are Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba and Saskatchewan. On the other hand, the two other transfer programs are the Canada Health Transfer and the Canada Social Transfer. All provinces and territories of Canada benefit from these transfers, but they are aimed at specific programs, i.e., health care and social programs.

So, additional payments for Equalization and the territorial financing as part of the settlement of the fiscal imbalance should total \$1.2B in 2007-2008 and \$0.9 in 2008-2009. Moreover, a new approach in the treatment of natural resources is proposed. Provinces producing natural resources would keep additional tax benefits thanks to a 50% exclusion of the revenues arising from these resources in calculating Equalization. The old formula excluding all the revenues arising from natural resources could however be kept for the provinces whose transfers would be higher under this method.

Many amendments are also brought to the social transfer. The main objective of the government is obviously the increase of these transfers for each of the provinces, but also greater transparency so that it will be easier for the provinces to anticipate over the long term the amounts that they will be getting. On the health front, the amounts transferred are exactly what had been established. Taking into account other programs, including infrastructure funding, the cumulative amount of the new transfers that are designed to settle the fiscal imbalance will reach \$39.4B between 2007-2008 and 2013-2014, including \$3.2B for fiscal 2007-2008. With the current programs, all the transfers of the federal government to the provinces and territories should then total \$51.5B in 2007-2008, an increase of \$6.0B compared with the previous year.

For Quebec, the budgetary documents do not make it possible to precisely establish the additional transfers that will be allocated to the province as part of the fiscal imbalance. Even if the Equalization transfers will increase by \$1.6B in 2007-2008, it is only a bit less than half the increase that really comes from the settlement of the fiscal imbalance, i.e., \$695M. Taking into account the other initiatives, all the new measures aimed at cutting the fiscal imbalance could reach about \$1B in 2007-2008. Visibly, the measures announced today could prove to be below the expectations of many stakeholders on the political scene in the province. In short, the second budget of Minister Flaherty is a good step to reduce the fiscal imbalance, but it would be unrealistic to believe that the problem is definitely solved. In fact, a permanent solution should rather be through a transfer of tax points to the provinces.

<sup>1</sup> The territories benefit from amounts under the Territorial Formula Financing.

**Tableau 3**

**Fiscal Balance New Investments: \$39 Billion Over Seven Years**

In millions of \$	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014	Total
Equalization	1,092	833		Formula Driven	→			1,925
Territorial Formula Financing	87	75		Formula Driven	→			162
<b>Subtotal</b>	<b>1,178</b>	<b>908</b>						
Canada Social Transfer	937	1,737	2,053	2,379	2,714	3,059	3,415	16,295
Transition—CST-CHT Protection	226	24	17	11	4			282
Labour market training		500	500	500	500	500	500	3,000
Infrastructure	325	325	325	2,425	3,899	4,342	4,625	16,266
Canada ecoTrust	506	506	506					1,519
<b>Subtotal</b>	<b>1,994</b>	<b>3,092</b>	<b>3,402</b>	<b>5,314</b>	<b>7,117</b>	<b>7,901</b>	<b>8,540</b>	<b>37,361</b>
<b>Total</b>	<b>3,172</b>	<b>4,000</b>	<b>3,402</b>	<b>5,314</b>	<b>7,117</b>	<b>7,901</b>	<b>8,540</b>	<b>39,448</b>

Source: *Department of Finance of Canada*

## The conservative government is now sensitive to the environment

Up to now, one could not say that the Harper government was known for its environmental tendencies. Apparently, this budget is trying to adjust the aim. Aside from the measures on tax cuts and the resolution of fiscal imbalance with the provinces, announcements associated with environmental conservation are now very important in the government plans. In terms of new allocated amounts, those that involve environmental measures will total \$806M by 2008-2009. These new programs provide a rather ill-assorted collection, going from tax incentives for the production of clean energy to programs encouraging cleaner means of transport (rebates on the purchase of energy efficient vehicles, fuel strategy) and measures to protect Canada's natural heritage, namely the conservation program for natural areas.

In addition, for environmental issues, the government wants to dedicate over \$1.5B over 3 years to Canada ecoTrust for air quality and climate change, to help provinces and territories reach their environmental objectives. The moneys in the trust will be allocated to the provinces over a three-year period based on an amount per individual with a minimum of \$15M per province and \$5M per territory.

Although some emphasis has been put on the environment, the cost of these measures (including ecoTrust) will only add up to 12% of the new budget initiatives by 2008-2009. Bear in mind that a good share of the new measures (aside from the tax cuts and the fiscal re-balance) are also going to other fields of activity, such as health care, education (knowledge) and to a lesser extent, culture and security.

As for health care, \$400M are earmarked for the use of information technologies (Canada Health Infoway), \$612M to helping the provinces that will have committed to guarantee reasonable wait times for patients and \$300M for the introduction of an immunization program against cervical cancer.

For farmers, James Flaherty proposes a new income stabilization program that will cost \$1,155M by 2008-2009. The government is also announcing that it will invest \$158M in projects associated with culture, including \$52M to organize the *Sommet de la Franco-*

*phonie* in Quebec City. Among other measures, the government will invest \$904M on research assistance in science and technology and \$209M on post-secondary education and manpower training.

Overall, including a host of other smaller measures or measures that are less structuring for the economy, the total of the government's new commitments will reach \$19.7B by fiscal 2008-2009. The large part of this is going to tax relief, totalling \$8.2B. The second place goes to the provinces, while the fiscal re-balancing project will cost \$6.9B to the federal government during the current fiscal year and the following two.

## Impact on financial markets

The investors will be able to appreciate the current rate of repayment of the Canadian debt. Between fiscal 2005-2006 and 2008-2009, the debt will be cut by \$28.4B according to the forecasts. As a percentage of GDP, the ratio will go down from 35.1% to 29.7% during this period. A ratio under 30% has not been seen at the federal level since the early 80s. The current financial health of the federal government should definitely satisfy financial markets. In addition, the assistance provided to provinces through the transfers associated with fiscal balance could relieve some of the budgetary pressure on provincial governments, which could in turn borrow less.

As for the measures announced by Minister Flaherty, some could however have an impact on investors. First, like in 2006-2007, the Canadian government will forgo 2 new bond auctions, i.e., the 5-year bond in the third quarter and the 2-year bond in the fourth quarter. In addition, starting in 2008, the Canadian government will take over the loans associated with crown corporations, i.e., the Canada Development Bank, the Canada Mortgage and Housing Corporation and Farm Credit Canada. The government will borrow itself to fund these operations. The debt of these corporations will remain outstanding in the market, including the 2007 issues.

The federal government is also proposing a new securities regulation method with a common regulatory board, i.e., nationwide, and a modernization of the statutory framework as it applies to financial operations. Setting up a national regulatory board will be a measure that will undoubtedly be challenged by

many provinces, as it means a loss of autonomy for them. The protection of investors also needs to be strengthened with higher governance standards and stricter adherence to the law. Also proposed is a free trade in securities with the United States and other G7 countries.

### **Conclusion: A skilled budget in the current situation**

The country's economic growth, especially domestic demand, and the government's management allowed Minister Flaherty to keep his financial commitments and maintain a balanced budget. Moreover, the debt anticipated for 2008-2009 will go below 30% of GDP, a first in over 25 years. Of course, continuing the good financial health of the federal government should please the financial world. In addition, in case of impacts, the government's leeway remains considerable and it will surely know how to meet the risks that might occur.

Minister Flaherty is using this fiscal year to introduce a host of new initiatives that total over \$19B in 3 years. So, the 2007 budget of the Harper government addresses health care, education, the fiscal imbalance, the environment and the competitiveness of Canadian businesses around the world. Many structuring measures are incorporated in the budget that can be qualified as generous. It lessens the tax burden for individuals and corporations.

What Stephen Harper and James Flaherty are proposing is not above criticism. Given the challenges to be met with respect to the environment, the measures proposed seem timid. It cannot be said either that the discussions, negotiations and disagreements with the provinces are over. The settlement of the fiscal imbalance still seems partial, and a definitive solution is still yet to be found. Incidentally, the way in which the federal government proposes to alleviate the tax burden leaves little room to provincial governments to recover the space left by the central government. In addition, Ottawa seems to still occupy a lot of space in the jurisdictions that are exclusive to the provinces, especially in health care, education and manpower training.

Nevertheless, Minister Flaherty's budget is a feat that can definitely be called clever given the current political context in Quebec but also on the federal scene.

Keeping in mind that the Harper government is in a minority situation in the House of Commons, the budget proposed clearly indicates that the Conservatives are ready to go to the polls and get an eventual majority.