Scotiabank Group

Global Economic Research

Fiscal Pulse

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The 2007-08 Canadian Federal Budget … A Very Broad Agenda

Highlights

- **Federal fiscal stimulus continues** with spending initiatives and tax cuts since the 2006 *Budget* totalling $5.8 billion in fiscal 2006-07 (FY07) and $9.0 billion in each of FY08 and FY09. Of this $23.9 billion total, spending measures approach a 60% share.

- **The revised *Budget* forecast indicates a hefty $9.2 billion surplus for FY07**, up substantially from the $3.6 billion *Budget* estimate. With the $13.2 billion surplus in FY06, debt retirement of $22.4 billion over the two years is expected to lower the net debt relative to GDP by 5.5 percentage points to 32.8% by March 2007. This raises the possibility of accomplishing the 25% debt-to-GDP target before the scheduled FY13.

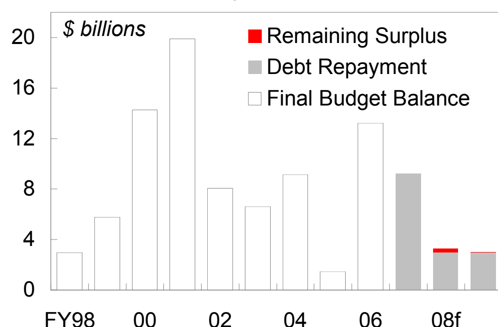
- **Budgeting for the future is tighter.** For FY08 and FY09, the underlying surplus covers the $3 billion annual debt repayment commitment, but a remaining surplus exists only for FY08 and is just $0.3 billion. However, Ottawa remains committed to strictly monitoring its fiscal performance to keep it on track and accomplish debt reduction of at least $3 billion annually. With its debt retirement promise, Canada will retain fiscal leadership among its G7 partners. Reinforcing this leadership is the aggregate provincial surplus, now projected to be $10 billion in FY07.

- **The debt service continues to contrast** with historically low interest rates and the debt reduction accomplished to date. In FY08, interest charges are expected to absorb just 14.3¢ of every revenue dollar, down from 18¢ just four years ago. Moreover, the government's **Tax Back Guarantee,** that directs savings in the debt service to personal income tax (PIT) reduction will contribute $1.1 billion in FY08 to the proposed PIT relief and $1.3 billion in FY09.

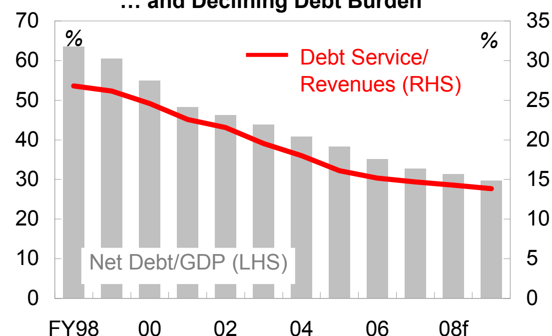
- **Personal income tax relief for FY08, including the Working Income Tax Benefit and new Child Tax Credit, totals $2.7 billion.** Corporate tax relief totals just $0.3 billion next year, but picks up to $0.9 billion by FY09 as firms take advantage of the enhanced two-year write-off allowed for manufacturing machinery and equipment over the next two years, as well as more generous Capital Cost Allowances (CCAs) for specific assets such as computers and an accelerated CCA for clean-energy generation.

- **Program spending climbs almost 14% over FY07 and FY08, or 7.6% on a real per capita basis. Relative to GDP, however, program spending at 13.3% of GDP in FY08, is still less than the recent 13.7% peak in FY05.** Key to the expenditure surge in FY08 is a $6.1 billion increase in total payments to the Provinces and Territories, the first stage of a seven-year plan representing the government's answer to Canada's fiscal imbalance.

Ottawa's Projected Black Ink…

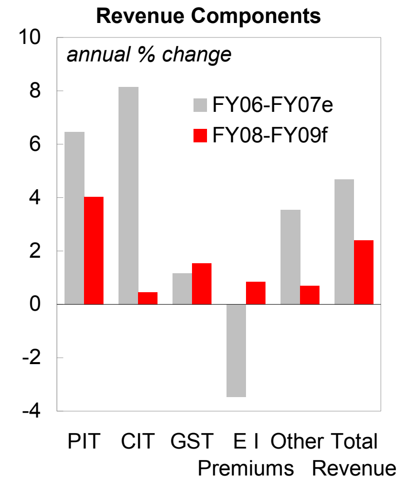


… and Declining Debt Burden



Fiscal Highlights

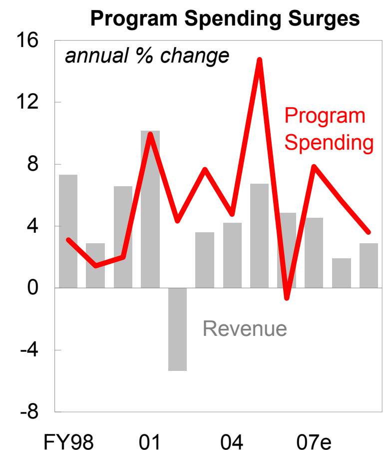
Before the Budget 2007 measures, the FY07 surplus is now forecast to be $14.1 billion, up from the $7.2 billion estimate in the November *Update*. Ottawa in FY07 continues to be blessed with hefty revenue surprises on the upside. Since November, FY07 revenues have been revised up by $3.4 billion, doubling projected FY07 revenue growth from the Budget estimate of 2.2% to 4.5%. Program expenses for FY07 are now expected to be $3.0 billion lower than the November *Update* estimate, and the saving on the debt service is now projected to be $0.5 billion. The underlying revenue strength is particularly notable in light of the major tax relief introduced last year.



Budget measures will trim $4.9 billion from the FY07 surplus, with $3.1 billion going to other governments, a $1.3 billion increase in federal programs and $0.6 billion in tax cuts. Program spending for FY07 thus increases to almost 8%.

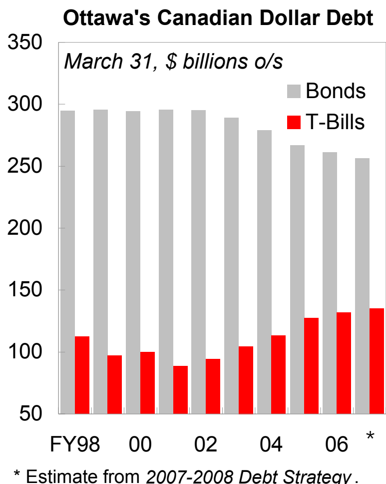
Revenue growth of only 1.9% is forecast for FY08, reflecting in part the cumulative impact of tax cuts introduced in past *Budgets* and this *Budget.* Tax relief introduced by the government since the *2006 Budget* totals $4.0 billion, of which $1.0 billion is the Age Credit increase and Pension Income Splitting provisions of the *Tax Fairness Plan,* $2.7 billion is personal income tax (PIT) relief, and $0.3 billion stems from corporate tax cuts. **For the Tax Fairness Plan,** booked in the November *Update* estimates, legislation will be introduced with the *Budget* legislation.

Central in the PIT relief is the new Child Tax Credit that provides a $1.4 billion saving to families in FY08. To help lower-income workers surmount the welfare wall, a Working Income Tax Benefit (WITB) is introduced for 2007, offering a refundable annual tax credit of $500 for individuals and $1,000 for families. A supplement is offered to the WITB for disabled workers. For parents of a severely disabled child, a Registered Disability Savings Plan is introduced, to be topped up by Canada Disability Savings Bonds and the Canada Disability Savings Grants. Enhancement of the spousal amount offers a further $270 million PIT saving for FY08.



Household savings are encouraged through a couple of measures. RESP enhancements include raising the annual contribution qualifying for the Canada Education Savings Grant from $2,000 to $2,500. Capital gains taxes, eliminated for donations to public charities in May 2006, will be removed for donations to private foundations when appropriate self-dealing rules are developed. The age limit for maturing Registered Pension Plans and RRSPs will be raised from 69 to 71 and the definition of RRSP qualified investments will be broadened to include any debt obligation with an investment grade rating and a minimum $25 million issuance and any security other than futures contracts listed on a designated stock exchange. Missing was a measure allowing some deferral of capital gains taxes — a 2006 election promise of the Conservatives that was expected in this *Budget* to take some of the sting out of the planned tax changes for income trusts.

Corporate tax relief is focused on reducing the marginal effective tax rate (METR) on new business investment. The longer-term enhancements to CCAs for several classes of assets including computer equipment, buildings used for manufacturing and processing and other non-residential premises, will trim Canada's METR by 2.5 percentage points by 2011. While clean energy is promoted, the accelerated CCA for oil sands projects — both mining and *in-situ* — will be phased out from 2011 to 2015, with projects begun before March 19, 2007, grandfathered. To further reduce the METR, Ottawa will return to any Province the federal income tax gain stemming from that province's reduction of its capital tax. Ottawa continues to pursue non-tax measures to make Canada more attractive for small and large businesses. The paperwork burden for small business is to be trimmed by 20% by November 2008, and a renewed effort to streamline regulations is promised this spring, including a Major Projects Management Office to act as the 'single window' for federal regulation. A shift to more principles-based regulations recommended for capital markets with a further call to establish a common securities regulator for Canada.



* Estimate from *2007-2008 Debt Strategy*.

International tax changes are proposed to increase the availability of capital to Canadian business and lower its cost. For instance, assuming that the updated

Canada-U.S. Tax Treaty eliminates non-resident withholding tax on interest payments, Ottawa plans to remove the withholding tax from arm's-length interest payments to other countries.

Program spending growth of close to 8% in FY07 and a further 5.6% in FY08 significantly exceeds the government's original intention to hold program spending to roughly the pace of population growth and inflation. Next year's spending increase is dominated by increased payments to the Provinces and Territories, but a broad range of initiatives are also introduced. Health measures, for example, include $400 million of new funding for Canada Health Infoway and for post-secondary education, enhanced support for graduate students proposed.

Total payments to Provinces and Territories, including infrastructure and the environment, will climb by $6.1 billion in FY08 and a plan to FY14 is mapped out. As anticipated, Equalization reform to a formula-driven system broadly follows the O'Brien Panel recommendations, shifting to a 10-Province standard, including 50% of provincial natural resource revenues and introducing a fiscal capacity cap. For the Canada Social Transfer (CST), beyond the $300 million legislated increase for FY08, $687 million is added to facilitate the shift to equal per capita cash support across the Provinces. Beginning in FY09, an additional $800 million annually will be directed to the Provinces for post-secondary education and, in FY10, an automatic 3% escalator for the CST begins. For the Canada Health Transfer (CHT), equal per capita cash across the Provinces is not implemented until after FY14 when the current agreement expires. The final result varies sharply across the Provinces with Quebec receiving an additional $2.3 billion in FY08, Ontario ahead by $1.1 billion and Alberta gaining $0.7 billion.

The government's commitment to predictable infrastructure support, from FY08 to FY14, starts with the base of the gas tax transfer and the 100% GST rebate for municipal purchases. Expanding on the funding from last year's *Budget,* a Building Fund is added for highway, transit and other major projects, a national fund for gateways and borders and another for public-private partnerships are created and the Asia-Pacific Gateway and Corridor Initiative is enriched. For the important Windsor-Detroit crossing, the federal government will be responsible for the Canadian portion of the new international bridge. The seven-year total for Ottawa's infrastructure program is $37.1 billion, including a number of funds such as the Strategic Infrastructure Fund that will be sunsetted.

While we await the revised *Clean Air Act* , further measures are introduced including a performance rebate for energy-efficient car purchases totaling $160 million over the next two years and a Green Levy on gas guzzler purchases. To encourage renewable fuel production, $2 billion is allocated over the next seven years. The Conservatives' commitment to secure a prosperous future for Canadian agriculture continues with a $400 million immediate payment to farmers to address their rising costs and $600 million to kick start producer savings accounts that will replace the top tier of the current Canadian Agriculture Income Stabilization Program.

Potential short-term risks include the possibility that the revenue surprises on the upside diminish. The budget estimates are very sensitive to a shortfall in growth, with the government calculating that a one percentage point shortfall in real GDP growth subtracts $2.6 billion from the bottom line. However, the government's 2.3% GDP forecast for 2007 appears reasonable, and prudent assumptions are used to translate the economic forecast into revenue projections.

Ottawa's Budget Arithmetic
$ billions unless otherwise noted

	FY07		FY08	FY09
	Bud.	**Rev.**	**Bud.**	**Bud.**
Personal Income Tax (PIT)	109.3	111.6	115.2	120.8
Corporate Income Tax (CIT)	35.3	35.0	36.3	35.4
Goods & Services Tax (GST)	29.8	30.5	30.1	31.4
Employment Insurance Premiums	16.1	16.1	16.2	16.4
Other Revenue	36.6	39.0	39.0	39.6
Total Revenue	**227.1**	**232.3**	**236.7**	**243.5**
Transfers: Persons	56.3	55.8	58.5	60.2
Transfers: Other Cdn Gov'ts*	40.1	41.6	43.5	45.6
Other	92.4	91.5	97.6	100.9
Total Program Spending*	**188.8**	**189.0**	**199.6**	**206.8**
Debt Service	34.8	34.1	33.8	33.7
Total Expenditure	**223.6**	**223.1**	**233.4**	**240.5**
Underlying Surplus	**3.6**	**9.2**	**3.3**	**3.0**
Planned Debt Reduction*	**3.0**	**9.2**	**3.0**	**3.0**
Remaining Surplus	**0.6**	**0.0**	**0.3**	**0.0**
Non-Budgetary Transactions	-6.0	-0.8	-7.7	0.5
Financial Source/Requirements	**-3.0**	**8.4**	**-4.7**	**3.5**
Net Federal Debt	**478.5**	**472.3**	**469.3**	**466.3**
Annual Change, %				
Personal Income Tax (PIT)	*5.4*	*7.7*	*3.2*	*4.9*
Corporate Income Tax (CIT)	*11.4*	*10.4*	*3.7*	*-2.7*
Goods & Services Tax (GST)	*-9.6*	*-7.8*	*-1.2*	*4.4*
Total Tax Revenue	*3.4*	*5.6*	*2.0*	*2.9*
Total Revenue	***2.2***	***4.5***	***1.9***	***2.9***
Transfers: Persons	*7.1*	*6.0*	*4.9*	*2.9*
Transfers: Other Cdn. Gov'ts*	*-1.8*	*2.0*	*4.5*	*4.9*
Total Program Spending	***7.8***	***7.9***	***5.6***	***3.6***
Memo Items, %				
Tax Revenue / GDP	13.4	13.6	13.4	13.1
Total Revenue / GDP	15.8	16.1	15.8	15.5
Program Spending / GDP	13.1	13.1	13.3	13.2
Net Debt / GDP	33.2	32.8	31.4	29.7
Debt Service / Revenue	15.3	14.7	14.3	13.8

* Includes Bill C-48 third-party trusts totalling $3.3 billion.

Economic and Interest Rate Assumptions
annual percent change unless otherwise noted

	Scotia Economics			Finance	
	2006	2007f	2008f	2007f	2008f
Canada					
Real GDP	2.7	2.3	2.7	2.3	2.9
GDP Deflator	2.2	1.7	2.0	1.5	2.0
Nominal GDP	4.9	4.0	4.7	3.9	5.0
Employment	1.9	1.8	1.2	1.5	1.3
T-bills 3-mos*, %	4.0	4.0	3.8	4.2	4.2
Bonds 10-yr*, %	4.2	3.9	4.2	4.1	4.5
U.S. Real GDP	3.3	2.4	2.7	2.5	2.9

** Average, not end of period.*

Debt Management

For FY07, the larger-than-expected $9.2 billion surplus and a much smaller non-budgetary transactions requirement results in a hefty $8.4 billion source of funds. Actuarial adjustments in the government's pension liabilities related to prior-year service result in a $4.7 billion source of funds. For some expenses booked in FY07 cash payments are not due until FY08. With cash payments also due next year for liabilities recorded in previous years, a $4.7 billion financial requirement is forecast for FY08, reversing to a $3.5 billion financial source the following year.

This year's *Budget* includes the *2007-2008 Debt Strategy.* The planned reduction in the share of fixed-rate debt from two-thirds in FY03 to 60% by FY08 will be accomplished. Treasury bills outstanding are projected to climb by about $3 billion during FY08 to $138 billion. Gross issuance of domestic marketable bonds is expected to be $35 billion, about $1.5 billion higher than FY07. Long bond issuance will expand by about $1 billion. Given maturities, however, the stock of bonds is forecast to fall by about $2 billion to $254 billion. Real Return Bond issuance will be slightly over $2 billion. Similar to FY07, two auctions will be foregone, in FY08 the adjusted timing is removing a five-year auction in Q3, and a two-year auction in Q4.

To support a well-functioning bond market and trim overall financing costs, beginning in 2008, the borrowing requirements of the Business Development Bank of Canada, Canada Mortgage and Housing Corporation (not including Canada Housing Trust) and Farm Credit Canada will be met through direct lending from the government. The government in turn will borrow to fund these operations under amended borrowing authority legislation. Annual bond issuance from these three corporations is estimated at up to $10 billion. This will add an additional 30% or so on to the projected gross issuance in 2007-08 of about C$35 billion. Currently these Crown corporations issue their own debt, some of which carries a higher interest cost than Government of Canada securities. The corporations also pay fees and commission on their borrowing, while the Government directly distributes its debt through an auction process. The estimated total reduction in borrowing costs from this change is estimated at up to $90 million over five years. Outstanding debt of the three corporations plus its 2007 issuance will remain outstanding in the marketplace. The Export Development Corporation that requires funding primarily in foreign currencies will continue to borrow on a stand-alone basis, as will the Canada Wheat Board and the Canada Housing Trust (that administers the Canada Mortgage Bond program).

Adjustments to the *Financial Administration Act* would remove the existing statutory limit on borrowing to offer greater flexibility in debt management, but at the same time would require greater disclosure on anticipated borrowing and the use of funds in the *Debt Management Strategy* as well as greater detail in the *Debt Management Report.* More detailed information on outcomes would be included in the *Public Accounts* for the Auditor General's review.

Market Implications

Carolyn Kwan & Mary Webb

From a financial market perspective, the first level of uncertainty has been removed, with the early media reports indicating that the Bloc Quebecois would support the passing of the budget. The government's commitment to annual debt reduction of at least $3 billion appears realistic with reasonably prudent underlying assumptions on the government revenues and economic growth assumptions.

In the end, there was little immediate market reaction to the debt management strategy or to any specific measures contained in the *Budget*. Many of the measures were already communicated before today's release, lessening the surprise for markets. In aggregate, the annual C$3 billion debt repayment in subsequent years is unlikely to change the Bank of Canada's projections or its current policy stance. This is especially true given that the economic growth assumptions align quite closely with those of the BoC. The direct influence on fixed income markets from the addition of agency bonds into the overall market beginning in 2008 will help to enhance liquidity going forward, a positive for a market facing declining bond supply since 2002-03.

With respect to general fixed-income markets, the inclusion of maple bonds (a C$26.8 billion market in 2006, accounting for two-thirds of the aggregate foreign bond investment) in the securities allowed to go into pensions and RSPs will also increase demand on the margin.

Industry Initiatives

Patricia Mohr & Carlos Gomes

In view of public interest in environmental issues, the proposed measures affecting industry lean heavily towards environmental initiatives, many of which had already been announced prior to the Budget:

$1.5 billion Canada EcoTrust for Clean Air and Climate Change — providing financial support to provinces and territories identifying major projects that will result in reductions in greenhouse gas emissions and air pollution. Projects could include the development of technology and infrastructure enabling carbon sequestration in Alberta and clean coal and electricity generation across Canada.

Biofuels Development — to promote the development of a biofuels industry in Canada (mostly grain-based ethanol as well as canola oil-based biodiesel) and help to reduce greenhouse gas emissions as well as pollution, the Budget provides $2 billion in funding over seven years to achieve a national biofuel content requirement of 5% in gasoline by 2010 and 2% in diesel and heating oil by 2012 (regulations have yet to be developed for the latter). This funding consists of $1.5 billion for ongoing operating incentives and $500 million for 'Sustainable Development Technology Canada' for production of next-generation renewable fuels. R&D into new varieties of canola (producing more oil) or cellulosic ethanol based on forest 'waste' could put Canada at the forefront of technology in this rapidly expanding global industry. Excise tax exemptions for ethanol and biodiesel will be eliminated as of April 1, 2008.

The United States currently imports 60% of its crude oil & petroleum products and is highly vulnerable to 'geopolitical supply risks'. As a result, mandated requirements for the use of ethanol additives in gasoline (mostly based on corn) have been implemented, resulting in near-record corn prices in early 2007. An expected doubling of U.S. corn-based ethanol production over the next several years will likely pull more planted acres from soybeans and wheat in the United States — tightening U.S. and international supply/demand conditions for oilseeds and wheat. These developments — combined with rapidly growing production of biodiesel in Europe (based on rapeseed or canola oil) have already contributed to higher international prices for Western Canada's canola (+ 37% yr/yr) and wheat (14% yr/yr) – leading to a 'new day' for Canadian farmers. Canada's grain-handling companies and fertilizer producers are also benefitting.

Levies/Credits to promote fuel-efficient vehicles — Ottawa also unveiled plans for rebates of up to $2,000 on the purchase of new fuel-efficient vehicles consuming 5.5 litres or less per 100 kilometres, while imposing levies on vehicles with fuel consumption in excess of 13 litres per 100 kilometres. This means that a buyer of a Toyota Prius — which has seen its sales level off at roughly 2,000 units in each the past three years, due to high sticker prices — would receive a $2,000 rebate.

At the other end of the spectrum, new passenger vehicles that consume more than 13 litres of fuel per 100 kilometres will be hit with a $1,000 levy. The levy will rise to $4,000 for vehicles that consume at least 16 litres of fuel per 100 kilometres — such as some large SUVs. The rebate plan is expected to cost about $160 million over the next two years, while Ottawa expects to collect $215 million from the levy over those years. These measures favour Japanese manufacturers over the traditional Big Three.

The Budget also sets aside up to $36 million over the next two years to provide incentives to replace high pollution-emitting older vehicles built before the 1995 model year. Estimates suggest that these vehicles account for about 35% of the entire Canadian vehicle fleet.

Major Industry Tax Measures

Enhanced Capital Cost Allowances for Manufacturing — to assist the competitive position of the manufacturing sector, which faces intense pressure due to the appreciation of the Canadian dollar and increased global competition, the Budget provides manufacturers with an incentive to invest in new machinery and equipment. All machinery and equipment purchased between March 19, 2007 and the end of 2008 will benefit from an accelerated 50% depreciation rate, up from the current 30%. Ottawa also plans to develop a 'global commerce strategy' and a Canadian advantage in global capital markets.

Phase-out of ACCA for Oil Sands Investment — the accelerated capital cost allowance (ACCA) for mining investment — which was extended to 'in-situ' oil sands in 1996 — will be phased out for both new 'in-situ' bitumen and oil sands 'mining' projects between 2011 and 2015. While the ACCA for projects already under construction will be grandfathered and the phase-out will be fairly long, in our view this is a disappointing measure in view of the importance of oil sands development for the Canadian economy — not only in Alberta but across Canada — and escalating capital costs in an uncertain longer-term oil price environment. The regular 25% CCA rate will remain in place.

Major Revenue and Expenditure Highlights

Mary Webb & Karen Cordes

Revenues *(FY08 impact in brackets where available)*

Personal Income Tax (PIT): As part of a **new Working Families Tax Plan** effective January 1, 2007, a non-refundable **Child Tax Credit** is created, for $2,000 annually (indexed) for each child under the age of 18 calculated at the lowest PIT bracket rate (15.5% for 2007). Currently, it will offer parents annual tax relief of up to $310 per child *($1,445 million).* This is in addition to the Universal Child Care Benefit established last year at an annual $2.4 billion cost, providing $100 per month for each child under six years. **For low-income couples or single individuals supporting dependents** the spousal or other personal amount allowing income on a tax-free basis will be raised by $1,348 to match the basic personal amount of $8,929, with future increases matching the latter's growth *($270 million)*.

A Working Income Tax Benefit (WITB) to encourage individuals 19 and older to opt for employment rather than social assistance will consist of a refundable tax credit equal to 20% of earned income over $3,000, to a maximum credit of $500 for single individuals and $1,000 for families. The benefit is effective for 2007, with payments beginning in 2008. Application for an advance payment of one-half the estimated entitlement can be made in 2008 and thereafter. **An additional disability supplement to the WITB** will be calculated at 20% of earned income over $1,740 for a maximum additional credit of $250 *($550 million)*.

Registered Education Savings Plans (RESPs) will be enhanced as of 2007 by removing the $4,000 annual contribution limit, raising the lifetime contribution limit from $42,000 to $50,000 and lifting the annual amount eligible for the 20% Canada Education Savings Grant from $2,000 to $2,500 *($15 million).*

Registered Disability Savings Plans (RDSPs) will be introduced with a Canada Disability Savings Grant and a Canada Disability Savings Bond as soon as possible in 2008 to help family and friends save for the long-term financial security of a child with a severe disability *($25 million)*.

As part of the *Tax Fairness Plan* announced on October 31, 2006, **the Age Credit** will be raised by $1,000 to $5,066 for lower-income seniors (65+) starting in 2006 *($345 million)* and **pension income splitting** will be introduced as of 2007 *($675 million)*.

The lifetime capital gains exemption for small business owners, farmers and individuals in the fishery will be increased from $500,000 to $750,000 as of March 19, 2007 *($85 million).*

For Registered Retirement Savings Plans (RRSPs), Registered Pension Plans (RPPs) and Deferred Profit Sharing Plans (DPSPs), the age limit for maturing plans will be raised from 69 to 71 after which no further contributions or benefit accruals will be permitted and benefits must begin to be paid out *($130 million)*. To promote phased retirement, as urged by the Province of Quebec, *Income Tax Regulations* will be amended to allow an employee to simultaneously receive pension benefits from a defined benefit RPP while accruing further benefits through part-time work.

Corporate Income Tax (CIT): As part of the *Tax Fairness Plan*, the CIT rate will drop from 19% to 18.5% in 2011.

A temporary two-year enhancement for Capital Cost Allowances (CCAs) for manufacturing and processing machinery & equipment, shifting to a 50% straight-line rate, for purchases after March 18, 2007, and before 2009 *($170 million)*.

Further adjustments to bring CCA rates closer to the actual costs of depreciable assets will be made for manufacturing or processing buildings (4% to 10%), other non-residential buildings (4% to 6%), computer equipment (45% to 55%), natural gas distribution pipelines (4% to 6%) and liquefied natural gas facilities (4% to 8%) for investments after March 18, 2007 *($60 million)*. **A 50% accelerated CCA** will be introduced for energy generation equipment purchased after March 18, 2007, that uses a renewable energy source, waste fuel or a highly efficient use of fossil fuels such as high efficiency co-generation *($10 million).*

The Mineral Exploration Tax Credit will be extended one year from its scheduled expiry in March 2007.

A non-refundable Investment Tax Credit for child care spaces will be created, equal to 25% of eligible expenditures after March 18, 2007, up to a maximum of $10,000 per space. This is in addition to Ottawa's proposed annual $250 million transfer to Provinces and Territories to create new child care spaces starting in FY08.

International Taxation: Agreement in principle has been achieved on major elements for an updated Canada-U.S. Tax Treaty. After ratification by both governments, cross-border interest payments will no longer be subject to a tax of up to 10% by the source country. For arm's-length transactions, elimination of the withholding tax on interest is effective for the calendar year following the treaty changes; for non-arm's-length contracts, the removal will be phased in over three years. Once this is accomplished for both types of transactions, Ottawa proposes removing the Canadian withholding tax on interest paid for all arm's-length arrangements to all non-residents.

An International Tax Fairness Initiative is planned to review the taxation of Canadian residents' foreign-source business income, including foreign affiliate earnings, to update measures and ensure that Ottawa collects a fair share of potential tax.

Major Revenue and Expenditure Highlights (continued)

For example, the deductibility of interest expense will be eliminated on debt to finance non-taxable foreign affiliate earnings from a treaty country, effective for taxation years after 2008. Also proposed is a new condition allowing passive income of a foreign affiliate to be treated as active income only if an economic interest of at least 10% exists. All new tax treaties and revisions must abide by the new OECD standards for tax information exchange. To encourage Tax Information Exchange Agreements (TIEAs) with non-treaty jurisdictions, the existing exemption for dividends from active business income of foreign affiliates resident in treaty countries will be extended to countries agreeing to a TIEA with Canada. Similarly, the exempt surplus will be extended to active business income from non-treaty countries that agree to a TIEA.

Definition of a "Prescribed Stock Exchange" will be amended to a three-tier system that will be more responsive to evolving market needs and the incidence of new or restructured exchanges, lowering the tax barriers for domestic investors in international markets and international investors in Canadian companies. Canada is pursuing free trade in securities with the U.S. and its other G7 partners.

Mary Webb & Adrienne Warren

Expenditures *(Primarily items not discussed in main text, FY08 impact in brackets where available)*

Health: As part of the ongoing effort to establish **patient wait time guarantees**, $30 million will be allocated over three years to support pilot projects. A **Patient Wait Times Guarantee Trust** will be created with $612 million paid into a third-party trust in FY08 to support the Provinces and Territories that make wait time commitments prior to April 2007. Each Province will receive $10 million, each Territory $4 million and $500 million will be allocated on a per capita basis.

A Canadian Mental Health Commission will be established with $10 million over the next two years and $15 million annually as of FY10. An immunization program to prevent cancer of the cervix will receive $300 million.

Post-secondary education and training: The Canada Graduate Scholarship program will receive an additional $35 million over two years. A review of the Canada Student Loan Program will be conducted in consultation with stakeholders, the Provinces and the Territories to streamline the program and make it more effective.

For Employment Insurance Part II employment benefits and support measures, to clarify roles and responsibilities, full transfer Labour Market Development Agreements will be negotiated with P.E.I., Yukon, Nova Scotia, B.C. and Newfoundland and Labrador to replace co-management agreements. Ottawa will provide $500 million annually as of FY09 for a new labour market program for individuals not qualifying for the EI program through bilateral arrangements with each Province/Territory. The federal government will explore transferring its existing labour market programs for under-represented groups through bilateral arrangements with each Province/Territory, potentially transferring the current annual funding of over $500 million.

The Aboriginal Skills and Employment Partnership, with a current $85 million budget for six years, will receive an additional $105 million over five years.

Ottawa will now allow foreign students with a Canadian credential and skilled work experience and skilled temporary foreign workers already in Canada to apply for permanent residence without leaving the country, raising applications by an estimated 25,000 annually that will be accommodated within current immigration levels. To support improvements in the **Temporary Foreign Worker Program**, enabling a more effective response to regional labour shortages, Ottawa will invest an additional $51 million over the next two years.

Infrastructure: For the Greater Toronto Area, FLOW is the new federal long-term transportation plan, with $962 million allocated for the subway extension to Vaughan, rapid transit in the surrounding regions and highway expansions.

Environment: Recent measures include a $1.5 billion Canada ecoTrust for Clean Air and Climate Change with per capita allocations to each Province and Territory, a $100 million ecoTransport program focused on urban, vehicle and freight transport emission reductions, a $220 million ecoEnergy Retrofit to assist homeowners and SMEs, a $230 million new ecoEnergy Technology initiative, a $1.5 billion ecoEnergy for Renewable Power initiative offering ten-year incentives to eligible projects constructed over the next four years providing up to 4,000 MW of power and a $34 million ecoEnergy for Renewable Heat for water and space heating. A National Water Strategy is proceeding and $225 million is directed to conserving ecologically-sensitive land.

Economic Development: The mandate for **Technology Partnerships Canada** was not renewed in December 2006. The Mountain Pine Beetle Program will direct $200 million to minimize infestation consequences and limit the eastward spread.

Research and development initiatives include $510 million for the Canada Foundation for Innovation to modernize institutional research infrastructure, $120 million in FY07 for CANARIE Inc. that manages a sophisticated health research broadband network and $350 million from FY07 to FY09 for seven Centres of Excellence in Commercialization and Research. Over the next year, Ottawa has committed to reviewing and improving the Scientific Research & Experimental Development program to encourage private-sector R&D.

Restructured and Expanded Federal-Provincial Fiscal Arrangements — Highlights

Ottawa has mapped out a seven-year plan for its major intergovernmental transfers — Equalization, the Canada Health Transfer (CHT) and the Canada Social Transfer (CST) — and payments for other key areas, giving the Provinces and Territories primary responsibility for putting the key programs under their jurisdiction on a sustainable track.

Equalization is returned to a formula-driven, principles-based program, broadly following the O'Brien Panel's recommendations. A major benefit of this shift is that the program can contract if differences among Provincial per capita fiscal capacities narrow.

- The new Equalization formula shifts from a five- to a ten-Province standard.
- A Province will receive the greater amount of the transfer calculated with 50% resource revenues included and the payment excluding resource receipts.
- The 50% resource revenue inclusion may result in a Province with resource receipts gaining a higher post-Equalization per capita fiscal capacity than a non-recipient Province. To prevent this situation, a fiscal policy cap will be implemented.
- The Equalization calculation will be simplified, narrowing the 33 tax bases referenced in the prior formula to five — PIT, CIT, consumption tax, property tax and natural resource receipts. The previous system, with seven revisions over a four-year period, contributed to Provincial uncertainty. Consequently a single-point estimate is introduced, based on a three-year weighted average of fiscal capacity with a two-year data lag.
- Newfoundland and Labrador and Nova Scotia must choose between the old system that upholds the *2005 Offshore Accords* and the new Equalization system.
- The revised Equalization amounts for FY08 relative to the previously announced floors indicated a further $600 million rise for Quebec for a total $1.6 billion increase over FY06 and Saskatchewan's return to "have not" status.
- To promote economic development, the reform of Territorial Formula Financing (TFF) allows each Territory to keep 30% of any increase in its own-source receipts. Building on the additional federal payments to each Territory announced last year, this year's *Budget* introduces $25 million annual payments for infrastructure for each Territory, with an extra $23 million for Nunavut.
- The *Ten-Year Plan to Strengthen Health Care* legislates the CHT to FY14, delaying the shift to an equal per capita cash basis.
- After a $250 million transitional payment to the CST in FY08 for new child care spaces, $250 million annual payments will start in FY09.
- In FY08, $687 million will be allocated to the CST to move Ontario, Alberta and the Northwest Territories to the same per capita cash support as other jurisdictions, removing the "Equalization" bias that was introduced to offset Provincial differences in the value of a tax point transfer. The federal guarantee that this reform shall cause no jurisdiction to receive a lower cash CHT or CST transfer is expected to cost about $226 million in FY08 and $56 million over the remaining four years.
- Ottawa's outstanding commitments under the Canada-Ontario Agreement of $574 million for Ontario and on training agreements for Manitoba and Saskatchewan of $21.6 million and $18.5 million, respectively, will be provided through third-party trusts.

Federal Payments to the Provinces and Territories[1]

	FY07	FY08	FY09
Canada - Equalization	11,282	12,768	12,918
Offshore Accord Offsets[2]	386	624	983
Territorial Formula Financing[3]	2,106	2,221	2,285
Canada Health Transfer (CHT)	20,140	21,348	22,629
Transition CHT Protection		118	
Canada Social Transfer	8,500	9,737	10,537
Transition CST Protection		108	24
New Labour Market Funding			500
Infrastructure[2]	900	1,997	2,551
Canada ecoTrust		506	506
Total	**43,314**	**49,427**	**52,933**
Annual Absolute Change	*438*	*6,113*	*3,506*
NL - Equalization	632	477	197
Offshore Accord Offsets[1]	329	494	757
Total	**1,453**	**1,529**	**1,554**
Annual Absolute Change	*-100*	*76*	*25*
P.E.I. - Equalization	291	294	310
Total	**426**	**470**	**498**
Annual Absolute Change	*12*	*44*	*28*
N.S. - Equalization	1,386	1,308	1,294
Offshore Accord Offsets[1]	57	130	226
Total	**2,343**	**2,441**	**2,602**
Annual Absolute Change	*57*	*98*	*161*
N.B.- Equalization	1,451	1,477	1,492
Total	**2,173**	**2,286**	**2,363**
Annual Absolute Change	*91*	*113*	*77*
Quebec - Equalization	5,539	7,160	7,622
Total	**12,900**	**15,214**	**16,348**
Annual Absolute Change	*684*	*2,314*	*1,134*
Ontario - Total	**11,652**	**12,762**	**13,971**
Annual Absolute Change	*425*	*1,110*	*1,209*
Manitoba - Equalization	1,709	1,826	2,003
Total	**2,863**	**3,084**	**3,365**
Annual Absolute Change	*116*	*221*	*281*
SK - Equalization	13	226	0
Total	**1,105**	**1,414**	**1,246**
Annual Absolute Change	*1*	*309*	*-168*
AB - Total	**2,394**	**3,056**	**3,363**
Annual Absolute Change	*38*	*662*	*307*
B.C. - Equalization	260	0	0
Total	**4,404**	**4,742**	**5,116**
Annual Absolute Change	*-339*	*338*	374
Territories- TFF	2,106	2,221	2,286
Total	**2,206**	**2,425**	**2,496**
Annual Absolute Change	*67*	*219*	71

[1] Ex Patient Wait Times Guarantee Trust ($610mn) and Immunization Trust ($300 mn).
[2] Assumes NL and N.S. will opt for previous Equalization program.
[3] Excludes municipal GST rebate, the two National Funds, the Asia-Pacific Gateway and Corridor Initiative and sunsetting programs.

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Fiscal Pulse

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November 23, 2006

Federal 2006-07 Economic and Fiscal Update … An Ambitious Act II

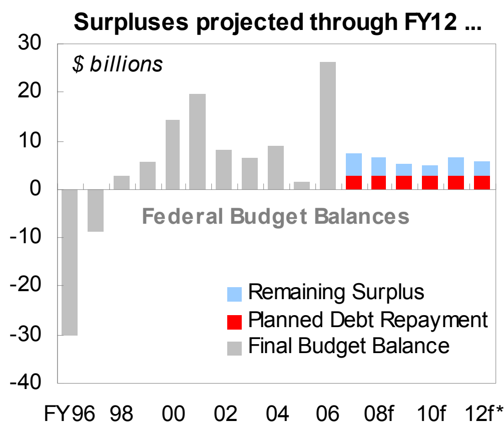
Highlights

- *The projected surplus for fiscal 2006-07 (FY07) is now $7.2 billion, double the $3.6 billion Budget estimate. For the following five years to FY12, the underlying surpluses average $8.6 billion annually.*
- *Following action on a number of election promises, the Conservative government has tabled a new strategic plan with the Update. It focuses on debt and tax reduction, alongside commitments to enhance Canada's infrastructure, the knowledge and skills of its work force and its competitive business environment.*
- *The federal government has renewed for five years the agreement with the Bank of Canada to target inflation at the 2% mid-point of the 1%-3% inflation-control range.*

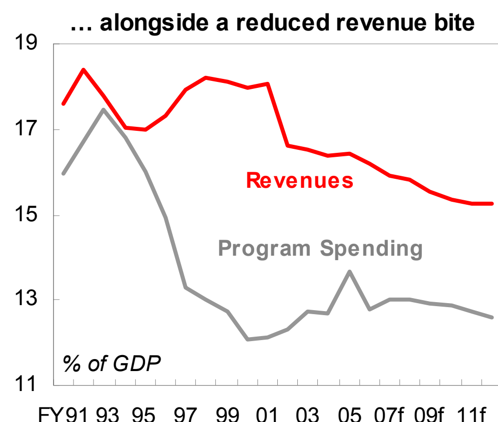
As anticipated, Ottawa's fall update points to a healthier bottom line for FY07. Even after the scheduled annual debt reduction of $3 billion, the remaining FY07 surplus available for new measures is $4.2 billion. The FY07 and FY08 revised budget balances incorporate measures announced since the May *Budget,* including the *Tax Fairness Plan*, that represent a net cost of $790 million this year and $1.2 billion next. Propelled by stronger personal income tax (PIT) receipts, total FY07 revenues are now forecast to climb 3.3%, compared with the 2.2% *Budget* estimate. Given the tax relief for FY07 introduced in last May's *Budget* totalling almost $10 billion, this year's underlying revenue growth is expected to surpass 7½%. In addition, program spending is now expected be $1.2 billion below *Budget.*

Surpluses for planning from FY08 through FY12 average $2.9 billion, after subtracting a $3.0 billion annual debt repayment, the promised one percentage point reduction in the GST (from 6.0% to 5.0%) by 2011 and the government's proposed "tax back guarantee" that dedicates the effective saving on interest charges from debt repayment to PIT reduction. Based on its survey of private-sector forecasts, the government's economic outlook is quite upbeat, assuming real GDP growth of 2.8% this year, 2.7% next, and an annual average of 3.0% from 2008 to 2011. Relative to average annual nominal GDP gains of 4¾% through 2011, total revenues over the six years to FY12 are forecast to climb 3.7% per year, reflecting this government's goal of narrowing the revenue bite relative to GDP. For the same period, program spending increases average 4.5%, just under projected nominal GDP growth. With the debt service expected to stabilize at $34.6 billion, however, the annual increase in total outlays averages just 3.9%.

The Conservative government, after moving forward on many aspects of its election platform, has rolled out, as promised, a new strategic plan, with important debt and corporate tax reduction targets. The near-term target of reducing the federal net debt from 35% of GDP at the end of FY06 to 25% has been



*Assumes a cut in the GST rate from 6% to 5% in 2011.



advanced one year to March 2013, recognizing the head start from last year's outsized $13.2 billion debt repayment. As well, the suggestion in the May *Budget* to devote year-end excess surpluses to the Canada and Quebec Pension Plans (CPP/QPP) is dropped in favour of using unanticipated surpluses to accelerate debt retirement and PIT reductions. Longer-term, the Conservatives' new blueprint for growth, titled "Advantage Canada", outlines the objective of eliminating Canada's general government net financial liabilities, as defined by the OECD, by 2021. This assumes that the Provinces and Territories maintain balanced budgets, the CPP and QPP remain on track to accumulate assets as currently projected, and Ottawa trims its debt by $3 billion annually. Achieving this goal would move Canada into the select club of nations claiming net financial asset positions that currently includes Australia, New Zealand, Norway and Finland. A key benefit of this goal is the increased visibility of the progress possible if Canadian governments retain their commitment to fiscal repair.

Ongoing tax reduction is also a priority. To address the personal income tax burden, a "tax back guarantee" is introduced, that will begin by trimming the PIT by close to $0.7 billion in FY07, using the effective reduction in interest charges from the $13.2 billion debt retirement in FY06. As this $0.7 billion reduction is carried forward, it will be supplemented each year by the interest savings from the scheduled $3 billion annual debt repayment. The resulting PIT cut escalates from $0.8 billion in FY08 to $1.4 billion by FY12, and possibly more if additional debt retirement is accomplished from unanticipated surpluses. As well, a number of measures are proposed to address emerging labour shortages, including in the upcoming *Budget* a Working Income Tax Benefit to help modest-income Canadians rejoin the work force. The importance of making Canada's tax treatment of savings more competitive with other nations' was reiterated, referencing RPP limits and capital gains as examples, but specific measures await future *Budgets.*

Corporate tax reduction receives attention, with the *Advantage Canada* plan setting a goal of dropping Canada's marginal effective tax rate on capital below its G7 partners. While federal initiatives are outlined, such as more closely aligning capital cost allowances to the useful life of capital, the onus for achieving this goal appears to largely rest with the Provinces who have not yet eliminated their capital taxes and still retain their provincial sales tax. Replacing a provincial sales tax with a value-added tax or harmonizing it with the GST would remove the sales tax on business inputs and capital goods. For Ontario, Finance Canada estimates that this change

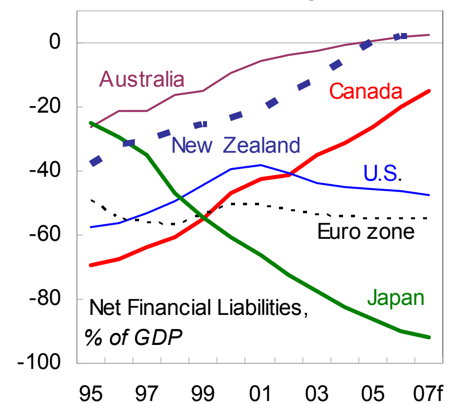
Economic and Interest Rate Assumptions

annual percent change unless otherwise noted

	Scotia Economics			Finance Assumptions			
	2005	2006e	2007f	2006e	2007f	2008f	2009-11f
Canada							
Real GDP	2.9	2.8	2.5	2.8	2.7	3.0	3.0
GDP Deflator	3.2	1.7	1.3	2.1	1.9	1.9	1.7
Nominal GDP	6.2	4.5	3.8	5.0	4.6	4.9	4.7
Employment	1.4	1.9	1.3	1.8	1.2	1.2	1.2
T-bills 3-mos*, %	2.7	4.0	3.8	4.1	3.9	4.2	4.3
Bonds 10-yr*, %	4.1	4.2	3.9	4.3	4.3	4.6	5.0
U.S. Real GDP**	3.2	3.3	2.4	3.4	2.6	3.1	3.0

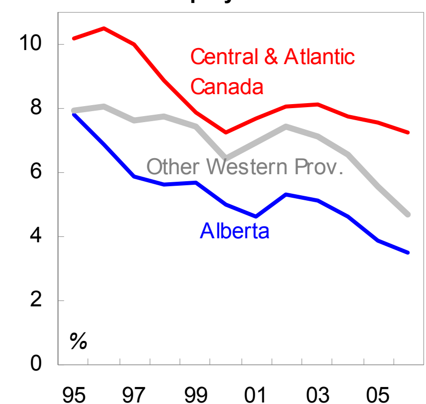
* *Average, not end of period.* ** *October 2006 Blue Chip Econmic Indicators.*

Canada's Diminishing Net Debt*

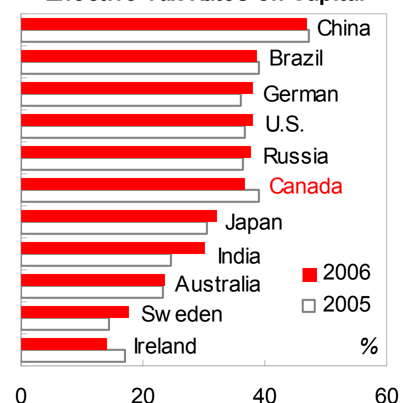


* General government. Source: OECD, June 2006.

Unemployment Rates



Effective Tax Rates on Capital



Source: J.M. Mintz, The 2006 Tax Competitiveness Report, C.D. Howe Institute.

alone would lower the province's METR by 9 percentage points. One specific change announced in this *Update* is a decrease in the Employment Insurance premium from $1.87 per $100 of insurable earnings to $1.80 as of January 2007.

The government's economic and fiscal projections are not without risk. In 2007, nominal GDP growth may not top 4½% if the rise in the GDP deflator does not approach 2.0%. Finance Canada's sensitivity estimates indicate that a half percentage point shortfall in the GDP deflator would trim the surplus by close to $1 billion in the first year. The surge in commodity prices that has bolstered corporate income tax (CIT) receipts has likely peaked, and gains in PIT receipts may ease to more closely match the labour income trajectory. The *Update* acknowledges the uncertainty of commodity prices, the possibility of a slower U.S. expansion and a renewed appreciation of the Canadian dollar. Interestingly, the average underlying surplus projected by four private-sector organizations is $0.7 billion lower for FY07 and a sizeable $1.8 billion lower for FY08, largely reflecting their assumption that recent high tax yield conditions may not persist.

The ambitious path laid out in the *Advantage Canada* plan raises the stakes for government discipline. The plan assumes that savings from debt repayment or expenditure management are directed to additional debt or tax reduction or new program initiatives that are ongoing, not one-time. In the wings are additional costs, including the substantial price tag likely attached to addressing Canada's fiscal imbalance. This one item could make it difficult to hold program spending growth below nominal GDP gains. While tighter budgeting offers more room for new measures, it places greater reliance on the government's commitment to closely monitor results and pull back expenditures, if necessary. To maintain expenditure control, the Treasury Board will present a new Expenditure Management System in the near future, reflecting the goal of a smaller, more focused federal government.

Ottawa's Budget Arithmetic
$ billions unless otherwise noted

	FY07		FY08	FY12
	Budget	Rev.	Rev.	Fcst.
Personal Income Tax	109.3	111.6	117.4	144.4
Corporate Income Tax	35.3	32.8	35.0	35.4
GST & Excise Taxes	43.4	44.7	44.9	51.3
Employment Insurance Premiums	16.1	16.2	16.1	18.4
Other Revenue	23.0	24.2	24.7	27.3
Total Revenue	**227.2**	**229.4**	**238.0**	**276.8**
Transfers: Persons	56.3	56.1	59.0	67.4
Transfers: Other Cdn Governments*	40.1	40.1	41.1	49.3
Other	92.4	91.4	95.9	111.8
Total Program Spending	**188.8**	**187.6**	**196.1**	**228.6**
Debt Service	34.8	34.6	34.7	34.6
Total Expenditure	**223.6**	**222.2**	**230.8**	**263.1**
Planned Debt Reduction	**3.0**	**3.0**	**3.0**	**3.0**
Reduce GST Rate to 5%				6.4
Interest Savings for PIT Reduction			0.8	1.4
Planning Surplus	**0.6**	**4.2**	**3.5**	**2.9**
Net Federal Debt	478.5	478.5	475.5	463.5
Annual Change, %				
Personal Income Tax	*5.4*	*7.7*	*5.2*	*5.3*
Corporate Income Tax	*11.4*	*3.3*	*6.8*	*0.3*
GST & Excise Taxes	*-5.9*	*-3.2*	*0.4*	*3.4*
Total Revenues	*2.2*	*3.3*	*3.8*	*3.8*
Transfers: Persons	*7.1*	*6.7*	*5.2*	*3.4*
Transfers: Other Cdn. Gov'ts	*-1.8*	*-1.8*	*2.6*	*4.6*
Total Program Spending	*7.8*	*7.1*	*4.5*	*3.9*
Memo Items, %				
Total Revenues / GDP	15.8	15.9	15.8	15.3
Program Spending / GDP	13.1	13.0	13.0	12.6
Net Debt / GDP	33.2	33.2	31.6	25.6
Debt Service / Revenues	15.3	15.1	14.6	12.5

* Includes Bill C-48 third-party trusts totalling $3.3 billion.
Source: Finance Canada

The immediate market reaction was minimal. Much of the good news on the near-term budget projections was already anticipated and most of the proposals in *Advantage Canada* will be formally implemented in subsequent Budgets. Existing investor confidence in the Bank of Canada limited the impact of the five-year extension of the inflation-targetting agreement. Going forward, evidence that the government is on track to achieve its longer-term objectives of stronger economic growth, tax cuts and debt reduction should be positive for domestic financial markets and the Canadian dollar.

Major Measures in the Mid-Year Update

Measures Announced Since the May Budget

Additional expenditures, including the Afghanistan mission and the extension of EI pilot projects total $432 million for FY07 and $788 million for FY08, less funding in the fiscal framework of $218 million and $603 million, respectively.

Revenue measures total $576 million and $1.0 billion this year and next, primarily reflecting the Tax Fairness Plan — notably a $1,000 rise in the PIT age credit to $5,066 for modest-income seniors as of 2006, and the introduction of pension income splitting, starting in 2007. Higher revenues and expenses for the Softwood Lumber Agreement are offsetting.

The EI premium rate will be cut from $1.87 per $100 of insurable earnings this year to $1.80 for 2007. Maximum insurable earnings, frozen at $39,000 from 1996 to 2006, will rise to $40,000 in 2007 and thereafter climb in line with the average industrial wage, affecting both premiums and benefits ($420 million estimated net saving for employers/employees in 2007).

Advantage Canada — Opportunities for Individuals

To address skilled labour shortages, proposals include reviewing and eliminating barriers to labour force participation for under-represented groups, stepping up the Temporary Foreign Worker Program and encouraging non-resident students and temporary foreign workers to become Canadian citizens.

To modernize current financial assistance for post-secondary students, Ottawa will work with the Provinces and Territories.

To raise labour mobility within Canada, additional federal assistance will be provided to accelerate the Provinces' and Territories' agreement to recognized credentials from other places within Canada by April 1, 2009.

Advantage Canada — Investing for Sustainable Growth

Canada leads the G7 in public-sector R&D as a share of GDP and funds 85% of primary research in Canada. To raise the effectiveness of these expenditures, consolidating the range of funding mechanisms is recommended and Industry Canada will review the current allocation process for funding through the federal granting councils. Proposals to expand private-sector linkages include exploring the benefits of transferring the management of some federal laboratories to universities.

A performance-based, efficient environmental regulatory regime will be developed that supports new technologies and pursues market-based approaches, with long-term predictability for industry and harmonization across jurisdictions. A more streamlined environmental assessment process will be implemented. Municipal waste water effluents will be more closely monitored.

A predictable multi-year funding framework is promised to support a core national highway system, large-scale projects in areas such as transit and border crossings and small-scale municipal projects. A pre-condition will be consideration of alternative financing such as public-private partnerships. For the Windsor-Detroit corridor that accommodates 28% of all Canada-U,S. trade in goods, the spring *Budget* will outline a financing strategy, working towards a new crossing no later than 2013.

Advantage Canada — A More Competitive Business Environment

Regulatory reform will include reducing the federal government's paperwork burden on business by at least 20%.

To support a globally competitive financial services sector, Ottawa will continue to urge a common securities regulator and pursue changes such as allowing more foreign experts on an institution's board as long as the majority of directors remain Canadian residents. Canadian retail investors will be provided with a wider access to investment products such as "Maple bonds", issued in Canadian dollars by foreign borrowers.

Barriers to international capital flows will be reduced, updating, for example, the Canada-U.S. Tax Treaty.

A Global Commerce Strategy is proposed that would build on the NAFTA advantage through improved border efficiency and regulatory convergence. Ideally with our NAFTA partners, Canada would pursue regional and bilateral trade, investment and science & technology agreements.

The Investment Canada Act, not significantly amended since its introduction in 1985, will be reviewed to maximize the benefits of foreign investment for Canadians while retaining Canada's ability to protect national interests.

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Fiscal Pulse

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September 26, 2006

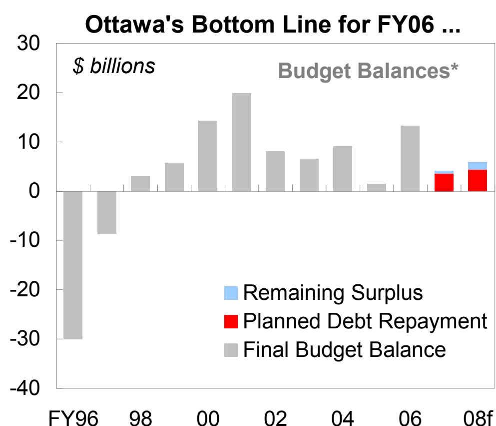
Canada's Federal 2005-06 Final Results … A Further Downpayment on Fiscal Repair

Fiscal 2005-06 (FY06) was a good year for Canadian governments. Ottawa has announced a $13.2 billion surplus that should be roughly matched by the aggregate Provincial balance given the audited results already released by six Provinces. Driving the good news are robust income tax receipts and natural resource revenues. Across all levels of government, Canada stands out as the only G7 nation to post a surplus in 2005, and its governments' debt service, at just 1.1% of GDP, is now considerably less than the OECD average of 1.8%.

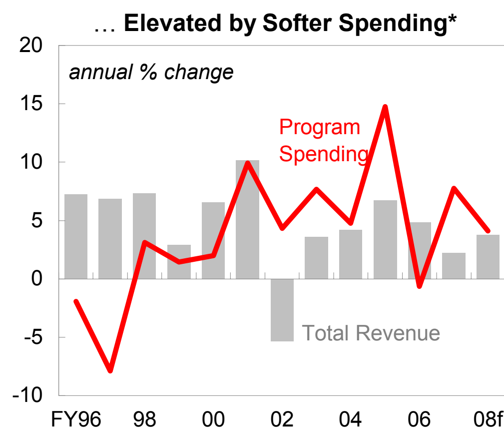
With Ottawa's entire $13.2 billion surplus devoted to debt reduction, the federal net debt was reduced to $481.5 billion as of March 31, 2006, down $81.4 billion from its FY97 peak, and now just 35.1% of GDP. Debt issued to investors has dropped by $56 billion over the past nine years. With a $33 billion decline in Canadian dollar marketable bonds outstanding since March 2002, and the outlook for further black ink, maintaining a well-functioning domestic market will require continuing adjustments. With its liabilities declining and historically low interest rates, the federal government's interest charges since FY96 have fallen by $15.6 billion to $33.8 billion, absorbing just 15.2¢ of each revenue dollar, a major improvement from the record of nearly 38¢ in FY91.

The underlying federal surplus for FY06 actually exceeded $21½ billion, after adding back in the $5 billion of personal income tax reductions and the allocations under Bill C-48 of $3.3 billion to five third-party trusts and $0.3 billion for additional international assistance (see table p. 3). Final revenues for FY06 were almost $22 billion (10.9%) ahead of the February 2005 *Budget* estimate. The government has the authority to allocate an additional $0.9 billion under Bill C-48 if the audited FY07 statements report a surplus over $2 billion.

Relative to the revised FY06 forecast in the May 2006 *Budget,* year-end accrual adjustments accounted for $3.5 billion of the $5.2 billion jump in the surplus. Program spending was $3.9 billion less than the May estimate and $1.1 billion (0.7%) below FY05, the first annual decline since FY97 and a major departure from the 9.0% average annual increase over the prior three years. Year-end spending by Departments and Crown corporations was $1.4 billion less than the May forecast. Spending for FY06 was also trimmed by two sets of accrual adjustments — one totalling $1.5 billion resulting from a rise in the estimated creditworthiness of debt owed to the government and a second equal to $1 billion from adjusted valuation allowances and liability provisions, including including provisions for pension and other employee future benefits. The final FY06 revenue and debt service were much closer to the May forecast. Of the $1.3 billion gain in receipts, $1.0 billion resulted from a change in the accounting treatment of the Government's subscriptions to the IMF. Compensating for the pronounced $2.8 billion shortfall in



* The Q1 *Update* indicated an FY07 surplus greater than the $3.6 billion May *Budget* forecast.



* FY07-FY08 forecasts from May 06 *Budget*.

corporate income tax receipts from the May forecast were higher-than-projected GST, personal income tax (PIT) and non-tax revenues.

For FY07 onward, without a $3 billion annual contingency reserve and economic prudence, the Conservative government intends tighter budgeting, avoiding large amounts of excess revenues emerging at year-end without clear *Budget* direction. The government hopes to approve a specific plan for allocating any surplus beyond the $3 billion annual debt reduction commitment. The suggestion in the May *Budget* was contributions to the Canada and Quebec Pension Plans (CPP and QPP) to eventually lower the contribution rate for younger Canadians who will pay considerably more for their retirement benefits given the present 9.9% steady state contribution rate. A key disadvantage of the proposal is the substantial contributions required to allow a significant decline in the per capita contribution rate.

Ottawa's Budget Arithmetic

$ billions unless otherwise noted

	FY06		FY07
	May Budget	Actual	May Budget
Personal Income Tax	103.0	103.7	109.3
Corporate Income Tax	34.5	31.7	35.3
GST & Excise Taxes	45.3	46.2	43.4
Employment Insurance Premiums	16.9	16.5	16.1
Other Revenue	21.2	24.1	23.0
Total Revenue	**220.92**	**222.20**	**227.15**
Transfers to Persons	53.2	52.6	56.3
Transfers: Other Cdn Gov'ts*	37.5	40.8	40.1
Other	88.5	81.8	92.4
Total Program Spending	**179.2**	**175.2**	**188.8**
Debt Service	33.7	33.8	34.8
Planned Debt Reduction	**8.0**	**13.2**	**3.0**
Remaining Surplus	**0.0**	**0.0**	**0.6**
Non-Budgetary Transactions	-2.7	-6.4	-6.0
Financial Source/Requirements	**5.3**	**6.8**	**-3.0**
Net Federal Debt	486.4	481.5	478.5
Annual Change, %			
Personal Income Tax	*4.5*	*5.2*	*5.4*
Corporate Income Tax	*15.3*	*5.9*	*11.4*
GST & Excise Taxes	*5.7*	*7.7*	*-5.9*
Total Revenues	*4.2*	*4.8*	*2.2*
Transfers: Other Cdn. Gov'ts	*-10.7*	*-2.7*	*-1.8*
Total Program Spending	*1.6*	*-0.7*	*7.8*
Memo Items, %			
Total Revenues/GDP	16.1	16.2	15.7
Program Spending/GDP	13.1	12.8	13.0
Debt Service/Revenues	15.3	15.2	15.3

* Includes Bill C-48 third-party trusts totalling $3.3 billion.

Additional repayment of Ottawa's direct debt beyond the $3 billion annual objective should also be considered as an option, in light of the approaching retirement of the baby boom generation. The annual servicing costs for these obligations, though dramatically slashed, still absorb just over 15% of federal revenues, a share that is significantly higher than the Provincial average. Canada's fiscal repair is impressive relative to the G7, but its fiscal position falls short of several other trading partners, such as Sweden, Australia and New Zealand, whose governments have moved into a net financial asset position.

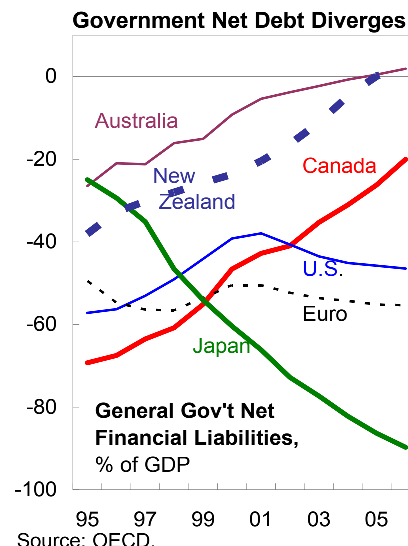
With the substantial debt reduction accomplished unexpectedly in FY06, Ottawa should update its debt reduction target. In the May *Budget,* the government's stated goal was to trim net debt to 25% of GDP by FY14, one year earlier than a previously announced target. Assuming moderate growth in Canada's real and nominal GDP, the 25% target can be achieved without any further debt repayment by FY13. With annual debt retirement of $3 billion, the 25% target is now within range by FY12.

The Conservatives have outlined some potentially high-ticket tasks for the fall, notably renewing and strengthening the Equalization and Territorial Formula Financing programs and creating new long-term federal funding frameworks for post-secondary education, training and infrastructure. Ottawa's Q1 *Update* for FY07 suggested that this year's surplus could be somewhat larger than the May *Budget* estimate of $3.6 billion. Subsequent events possibly offer a more mixed outlook.

Estimated FY07 revenues from the May *Budget* assume 6% nominal GDP growth this year, a forecast that may prove high, particularly for the deflator. The federal Finance Department estimates that a 1% decrease in GDP inflation would trim $2.0 billion from this year's bottom line, but the prospect of lower-than-forecast long-term interest rates could provide some offset. With corporate income taxes ending FY06 weaker than expected, the May forecast for FY07 is likely high. Conversely, GST revenues will probably exceed the May estimate and PIT receipts entered FY07 with some momentum. (When the $5 billion of tax cuts are added back in, PIT revenues in FY06 rose a hefty 10.3%.) Overshadowing these considerations is the possibility that the expansion of the U.S. economy is slowing more than anticipated, and could fall short of the 3.0% growth assumed for 2007 in the May *Budget.*

Reassuring are indications that Ottawa is closely monitoring its fiscal situation — as promised when the contingency reserve and economic prudence were removed. The government appears willing to make tough trade-offs, if necessary, to ensure its annual $3 billion debt reduction objective. Ottawa's update on its progress in making its expenditures more effective and efficient details $1 billion of cutbacks over FY07 and FY08 plus a further

two-year saving of $1 billion resulting from increased expenditure management. The latter includes tighter oversight from the Treasury Board. The May *Budget* estimates for FY07 and FY08 include this $2 billion of savings. Four categories of cutbacks are defined: the elimination of measures that do not provide good value for money ($256.1 million); unused funds from programs that have already achieved their objectives or had a lower-than-expected take-up ($379.6 million); streamlining programs ($99.6 million); and the consolidation or removal of non-core programs ($265.6 million). The government's new Expenditure Management System will be ongoing. Some of the significant savings include eliminating GST rebates for tourists ($79 million), a smaller Cabinet ($47 million), administrative efficiencies in CMHC programs ($45 million), removing excess funding for Public Service HR programs ($83 million), improved targetting of investments for youth employment ($55 million), and lower funding for industrial programs including Technology Partnerships Canada ($42 million). Program spending, after the 0.7% decline in FY06, dropped back to a more sustainable 12.8% of GDP, in contrast to 13.7% in FY05 when more than $10 billion of one-time expenditures were implemented. With the FY06 decline, projected program spending growth for FY07 rises to 7.8% (13% of GDP), a significant margin as the government begins its next round of stated objectives.



Source: OECD.

Trusts Created for Provinces and Territories* After Final FY06 Results, Further to Bill C-48
$ millions

	Total Allocation				Post-Secondary	Public Transit	Affordable	Off-Reserve Aboriginal	Northern Housing
	FY07	FY08	FY09	Total	Education Trust	Capital Trust	Housing Trust	Housing Trust	Trust
NL	20.1	20.0	10.5	**50.6**	15.8	14.1	12.6	8.2	—
P.E.I.	4.9	4.9	2.3	**12.2**	4.3	3.8	3.4	0.7	—
Nova Scotia	34.4	34.2	16.9	**85.4**	28.8	25.8	23.0	7.8	—
New Brunswick	27.7	27.5	13.7	**68.9**	23.1	20.7	18.4	6.7	—
Quebec	271.1	270.4	129.5	**670.9**	234.5	210.8	187.4	38.2	—
Ontario	455.2	456.3	222.5	**1134.1**	390.0	351.5	312.3	80.2	—
Manitoba	50.8	50.7	28.9	**130.4**	36.3	32.6	29.0	32.5	—
Saskatchewan	42.3	42.0	23.7	**108.1**	30.3	27.2	24.2	26.4	—
Alberta	127.4	127.7	67.0	**322.2**	101.3	91.3	81.1	48.4	—
British Columbia	162.3	162.7	83.4	**408.5**	132.3	119.3	106.0	50.9	—
Total: Provinces	**1196.2**	**1196.4**	**598.4**	**2991.3**	**996.7**	**897.1**	**797.4**	**300.0**	**0**
Yukon	17.7	17.7	17.1	**52.6**	1.0	0.9	0.8	—	50.0
NWT	18.1	18.2	17.3	**53.6**	1.4	1.2	1.1	—	50.0
Nunavut	67.7	67.7	67.1	**202.5**	0.9	0.8	0.7	—	200.0
Total: Territories	**103.5**	**103.6**	**101.5**	**308.7**	**3.2**	**2.9**	**2.6**	**0**	**300.0**
Total	**1300.0**	**1300.0**	**700.0**	**3300.0**	**1000.0**	**900.0**	**800.0**	**300.0**	**300.0**

Notes
1. Components may not sum to totals because of rounding error.
2. Allocations for the Post-Secondary Education, Public Transit and Affordable Housing were on an equal per capita basis.
3. For the Northern Housing Trust, each Territory received $50 million, with a further $150 million for Nunavut's urgent needs. Allocation of the Off-Reserve Aboriginal Housing Trust was by provincial share of the Aboriginal population living off-reserve.
4. The Post-Secondary Education Trust is notionally allocated over two years (FY07-FY08); the other Trusts are over three years (FY07-FY09).
5. The one-time funding included $320 million for international initiatives of which $250 million was directed to the Global Fund to Fight Aids, Malaria and Tuberculosis, $45 million to the Global Polio Eradication Initiative and $25 million to the IMF's Exogenous Shocks Facility.

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