



TD Economics

Special Report

October 31, 2007

2007 FEDERAL FALL ECONOMIC & FISCAL UPDATE

HIGHLIGHTS

- Focus shifts back to tax relief measures
- After adjusting for new measures, surplus projection below private sector forecasts
- Expected but regrettable cut to the GST
- Slight personal income tax relief
- Significant but back-end loaded move on corporate income taxes
- Further major tax relief in next Budget unlikely but not inconceivable

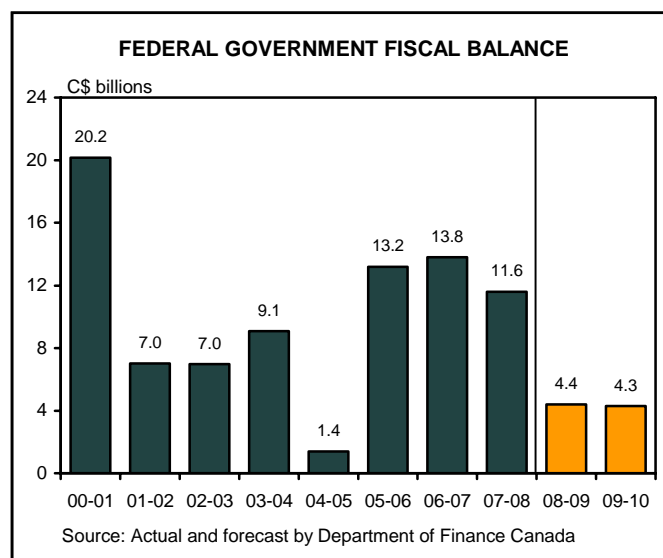
The chatter prior to the unveiling of this year's federal Economic & Fiscal Update was all about tax relief. Two weeks ago, in its Speech from the Throne, the Government had clearly signaled its intention to "bring forward a long-term plan of broad-based tax relief for individuals, businesses and families – including following through on its commitment to a further cut to the GST."

The latest economic outlook from Finance Canada doesn't differ significantly from that of TD Economics. We do note that Finance Canada is slightly more bearish than TD on U.S. real GDP growth prospects in 2008-09 (by 0.2 percentage points), and slightly more bullish on Canadian real GDP growth prospects in 2009 (by 0.3 percentage points). Overall though, these differences practically wash out when it comes to nominal GDP growth forecasts, which are more directly linked to the Government's revenue outlook.

In the absence of any action, the Government estimates the surplus for the current fiscal year would have been \$16.4 billion, just shy of the \$19.9 billion record from 2000-01.

When compared to *Budget 2007*, where the focus was on spending priorities, and in light of yet another larger-than-expected surplus for fiscal year 2007-08, attention shifted back to tax relief. Unanticipated surpluses can always be used to pay down the debt, but tax cuts require caution as they must be sustainable, to avoid having to raise them again if net revenue came up short sometime down the road. Fiscal projections by economists and the Department of Finance made it clear that the federal Government can be expected to have enough wiggle room to deliver permanent tax cuts without compromising the objective to reduce the debt-to-GDP to 25%. Debt-reduction measures include:

- \$10 billion payment this fiscal year
- Continued \$3 billion reduction per year afterwards
- 25% debt-to-GDP to be reached by FY 2011-12, one year ahead of *Budget 07* schedule



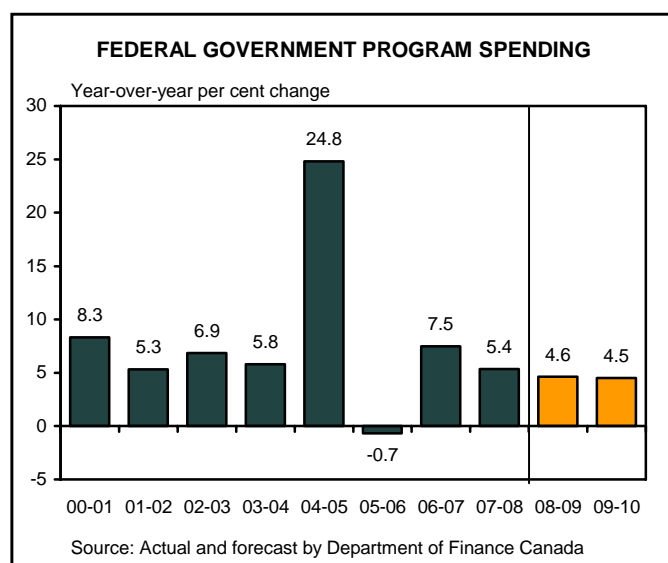
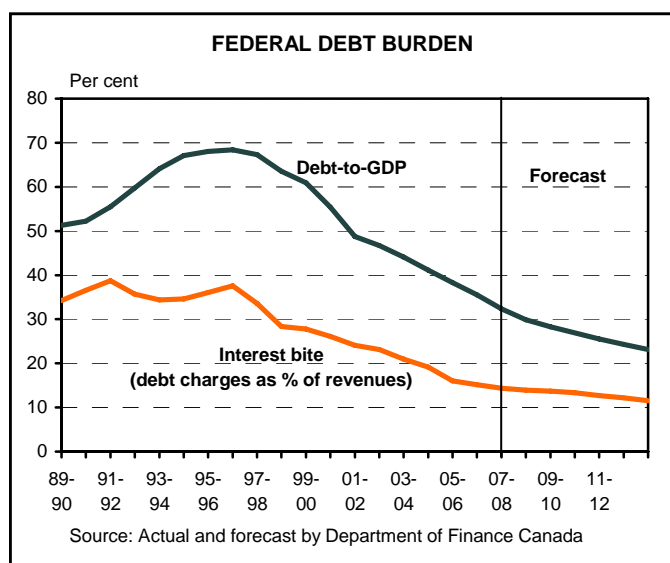
Anticipation of broad-based tax relief then quickly becomes an issue of specifics: what taxes will be cut, when (and for how long) will this occur, and by how much?

As widely expected but despite almost universal admonition from economists to the contrary, the Government will stick to its promise to cut the GST to 5% on Jan. 1st 2008 from its current 6%. This measure alone is estimated to cost \$5.5 billion per annum. Economically speaking, the only redeeming quality to this move would have been to tie this reduction in the GST rate to harmonization of provincial sales taxes to the GST. The latter move would substantially reduce taxes on investment in those five provinces whose sales taxes are not harmonized with the GST. The Update makes reference to the Government's intent in addressing harmonization, but for the second time the incentive of a rate cut has been lost, i.e. provinces who would suffer a revenue loss from harmonization could have raised their rate without increas-

ing the overall hit on their consumers. We therefore cannot help but feel that an important opportunity was missed to help make Canada more competitive on that front. At the margin, the GST cut – by boosting consumption – increases the likelihood that the next direction for the Bank of Canada's overnight rate will be up rather than down.

On a positive note, the broad-based nature of the announced tax relief measures contrasts with a recent history of more targeted measures. Employment Insurance (EI) premiums will be reduced by 10 cents per \$100 of insurable earnings for employers and 7 cents for employees. Personal Income Tax (PIT) measures include:

- Retroactive this fiscal year, the basic personal amount (exemption) will increase by \$671, from \$8,929 to \$9,600. It will increase by another \$500 in 2009, bringing it to \$10,100
- Lowest income bracket PIT rate down to 15.0% from



FISCAL PROJECTIONS OF UNDERLYING SURPLUS*						
(C\$ Billions)						
Fiscal Year	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Conference Board of Canada	15.3	10.8	11.8	14.2	15.9	17.2
University of Toronto	11.5	2.4	0.7	2.3	3.0	2.3
Global Insight	11.0	2.8	2.6	3.9	5.4	5.0
Centre for Spatial Economics	13.6	7.7	6.0	8.3	11.5	14.1
Average of private sector projections	12.9	5.9	5.3	7.2	9.0	9.7
Finance Canada	11.6	4.4	4.3	7.5	10.2	12.8
TD Economics	9.7	6.6	7.2	11.3	12.4	12.8

* On a Public Accounts basis. Source: Department of Finance Canada, TD Economics.

ECONOMIC & FINANCIAL ASSUMPTIONS* FOR CANADA			
Annual average percent change, unless otherwise noted			
	2007	2008	2009
Real GDP			
2007 Budget	2.3	2.9	3.1
2007 Economic Statement	2.5	2.4	2.4
TD Economics^	2.6	2.3	2.4
Nominal GDP			
2007 Budget	3.9	5.0	5.2
2007 Economic Statement	5.9	4.8	4.7
TD Economics^	6.2	4.9	4.6
Unemployment rate (%)			
2007 Budget	6.3	6.4	6.3
2007 Economic Statement	6.1	6.2	6.2
TD Economics^	6.1	6.3	6.4
3-Month T-Bill Rate (%)			
2007 Budget	4.2	4.2	4.3
2007 Economic Statement	4.2	4.4	4.7
TD Economics^	4.2	4.8	4.9
10-Year Gov't Bond Yield (%)			
2007 Budget	4.1	4.5	5.2
2007 Economic Statement	4.3	4.6	5.0
TD Economics^	4.4	4.9	5.1

*Department of Finance Canada. ^ TD QEF, Oct. 2007

15.5%, also retroactive this fiscal year. This effectively restores the plan of the previous Liberal Government.

However, the implications of favoring a GST cut at the expense of larger PIT cuts are well highlighted by the fact that permanent PIT relief is only worth \$1.2 billion, spread across 20 million taxpayers. Although the revenue shortfall from reductions in the GST and PIT are more costly on a percentage point basis, the boldest move was on corporate income tax (CIT) measures, which include:

- General CIT rate down from 22.1% to 15% over the next 5 years, but only by 1 percentage point a year in the next 3 years
- Small business rate down to 11% effective January 2008, a year earlier than in *Budget 07*
- Aim to reach a combined federal/provincial 25% CIT rate

Mostly back-end loaded, these measures should nonetheless place Canada on a better competitive footing vis-à-vis other economies. Looking forward and factoring in the announced tax relief measures means the Government's planning surplus is unlikely to breach the \$2 billion mark before fiscal year 2010-11. As such, it would seem that the likelihood of further significant tax relief between now and then has diminished accordingly. But there is considerable and legitimate uncertainty surrounding fiscal projections, as can be seen in the accompanying table. First, history suggests that projected 4-5% increases in spending are rarely met after the fact. Furthermore, there is also considerable uncertainty concerning forecast revenues, for which, when compared to Finance Canada's projection, there is a large potential upside. All of which should sound familiar by now.

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FEDERAL GOVERNMENT FISCAL PROJECTION				
(Billions of dollars, unless otherwise indicated)				
Fiscal Year	Actual	Est.	Projection	
	06-07	07-08	08-09	09-10
Budgetary revenues	236.0	243.9	245.8	255.4
% change	6.2	3.3	0.8	3.9
% of GDP	16.3	15.9	15.3	15.2
Program spending	188.3	198.4	207.6	217.0
% change	7.5	5.4	4.6	4.5
% of GDP	13.0	13.0	12.9	12.9
Public debt charges	33.9	34.0	33.7	34.2
% change	0.3	0.3	-0.9	1.5
% of GDP	2.3	2.2	2.1	2.0
% of revenues	14.4	13.9	13.7	13.4
Total expenditures	222.2	232.3	241.4	251.1
% change	6.3	4.5	3.9	4.0
% of GDP	15.4	15.2	15.0	14.9
Underlying budget balance	13.8	11.6	4.4	4.3
- Planned debt reduction		10.0	3.0	3.0
= Planning surplus		1.6	1.4	1.3
Federal debt:				
Accumulated deficits	467.3	457.3	454.3	451.3
% of GDP	32.3	29.9	28.3	26.9

Source: Department of Finance Canada

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