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Fiscal Pulse

The U.S. Federal 2010 Budget

— *Embarking on Change, Alongside Significant Uncertainty*

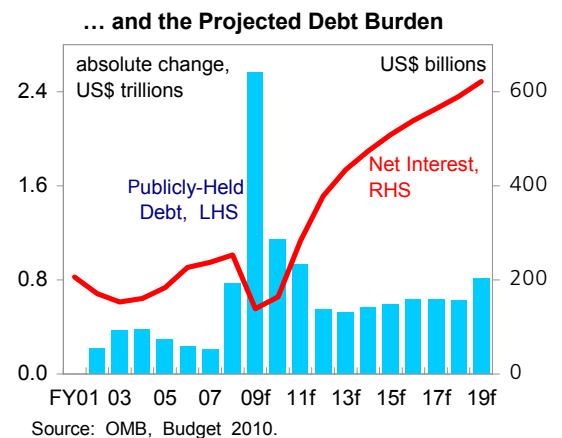
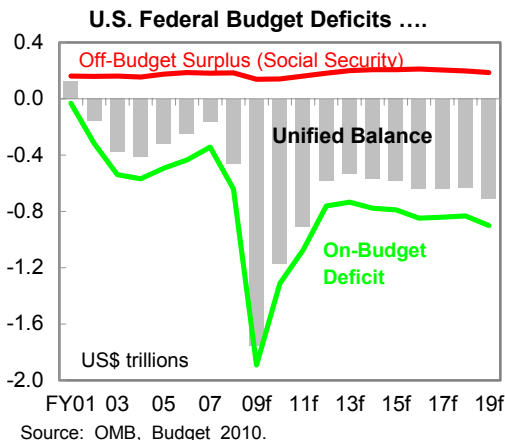
As promised, the 2010 Budget proceeds with major investments in health, education, clean energy and infrastructure. Juxtaposed with a sharp economic correction, unprecedented measures to support financial markets, major stimulus and two overseas military operations, the deficit is forecast to balloon from US\$459 billion¹ in fiscal 2008 (FY08) to \$1.75 trillion in FY09. Relative to the U.S. economy, at 12½% of GDP the FY09 shortfall will be the largest since the mid-1940s. Excluding the \$138 billion Social Security surplus, the on-budget deficit for FY09 is expected to approach \$1.9 trillion.

After FY09, projected deficits contract sharply from FY10 to FY13. The estimated shortfall in FY10 is \$1.17 trillion, and in FY11 \$912 billion, or 6.0% of GDP, though with current economic and financial market uncertainties, further policy adjustments will probably be required to avoid three years of trillion-dollar deficits. For FY13, the forecast \$533 billion shortfall meets the Administration's target of halving the inherited \$1.3 trillion deficit by the end of its first term. From FY14 to FY19, the deficit gradually widens back to \$712 billion, confirming an extended period of significant borrowing. Moreover, for large-ticket priorities such as health care, the funding in the *Budget* represents a hefty downpayment, but more financing likely will be needed.

The erosion of Washington's revenues will continue. For the first four months of FY09, revenues were 10.2% below the year-earlier period. For all of FY09, the *Budget* projects a 13.4% decline in receipts, while a range of issues is expected to elevate FY09 expenditures by a whopping 32% to a record 28% of GDP.

The Budget builds on the investments initiated in the recent \$789.5 billion stimulus package (the *American Recovery and Reinvestment Act of 2009*), balancing major new outlays with tax hikes and spending reforms. A \$634 billion reserve for health reform is established from FY10 through FY19 (see *text box on measures, pages 3-4*). Half of the reserve stems from planned savings within health care, including trimming payments to private-sector Medicare Advantage plans through competitive bidding, accelerating generic drug access, improving Medicare and Medicaid payment accuracy and decreasing hospital readmission rates. The other half of the health reserve results from dropping the rate to 28% at which itemized deductions (i.e., mortgage interest, charitable donations) reduce personal income tax for higher-income individuals.

Other measures also contribute to a more progressive tax code. President Bush's personal income tax (PIT) rate reductions are extended after 2010 for all individuals except the top two income brackets. For higher-income individuals, the tax rate on capital gains and dividends will rise from 15% to 20%. In contrast, for low-



¹ Fiscal years end September 30; financial data are in US dollars; and calculations relative to GDP use Scotia Economics' forecast data for calendar years, which are significantly lower than the *Budget* assumptions.

and middle-income families, the *Budget's* measures to make tax credits more generous offer \$770 billion of additional tax relief from FY11 to FY19.

For corporations, the *Budget* expands the extended loss carryback that was limited to smaller firms in the stimulus package. One targeted measure is making the research and experimentation tax credit permanent. The closure of tax "loopholes" for the oil & gas and other sectors, however, is estimated to cost companies more than \$350 billion through FY19. The largest change relates to tightening the current practice of deferring corporate income tax on multinationals' overseas earnings. For both corporations and higher-income individuals, the proposed tax increases are largely delayed for two years, when the worst of the economic downturn is assumed to be over.

A cap-and-trade system to curtail greenhouse gas emissions, scheduled for implementation in 2012, is a major plank in the Administration's plans to transform the U.S. energy supply and slow global warming. The *Budget's* proposal to auction all the permits to avoid windfall profits among major industrial emitters makes cap-and-trade a major source of new revenue, generating estimated receipts of \$646 billion from FY12 to FY19. From this revenue, \$120 billion will be dedicated to clean energy development, while \$526 billion will finance the refundable Making Work Pay Tax Credit. Any additional receipts also will be returned to households, especially vulnerable families, and to businesses to smooth their transition to clean energy, recognizing that a significant implicit price on carbon will impact corporate competitiveness and consumer prices. While federal leadership will be welcome to limit the fragmented policy that has resulted from State associations each pursuing their own climate change strategies, the administrative framework is formidable, as Europe's Emissions Trading Scheme illustrates. As well, adopting a price for carbon is difficult when key global competitors, notably the developing countries, are not expected to follow.

Raising fiscal accountability began with a stimulus package relatively free of earmarks, and continues in the *Budget* with the termination of a diverse group of expenditures now considered low priority. To help constrain future deficits, the Administration commits to working with Congress to re-introduce pay-as-you-go budgeting rules for all non-emergency measures. The *Budget* attempts to make future spending estimates as complete as possible, including supplemental appropriations of \$76 billion for FY09 and \$130 billion for FY10 for the Iraq and Afghanistan operations, and inserting placeholder amounts to cover potential but unspecified outlays. An example of the latter is the \$50 billion annual allocation for overseas defense operations as of FY11.

In addition to the Troubled Assets Relief Program (TARP) and the new Financial Stability Plan, the *Budget* incorporates a \$250 billion contingent reserve for further financial market support. With only the net cost of financial assets recorded on the books and the government's assumption of eventually recouping two-thirds of its outlays, this reserve would allow another \$750 billion of financial asset purchases. To protect taxpayers' money, beyond requirements such as dividend payments, a fee or assessment on financial institutions or financial activity, after the financial system has stabilized, is being considered.

Debt held by the public is forecast to rise by \$2.56 trillion in FY09, \$1.14 trillion in FY10 and another \$5.86 trillion by September 2019. From under 41% of GDP in September 2008, the publicly held debt outstanding is expected to top 65% of GDP by September 2010, and remain between 65% and 70% of GDP for the following nine years. Net interest, at just over 9¢ of each revenue dollar in FY07, is forecast to approach, and probably exceed, 15¢ by FY15, posing a significant limitation on U.S. federal fiscal flexibility.

Moreover, Washington's projected bottom line could well prove optimistic. A relatively immediate positive impact from the stimulus package is assumed to limit the 2009 drop in real GDP to 1.2%, followed by robust output growth of 3.2% growth in 2010 and annual gains averaging over 4.0% for the following three years. Scotia Economics' outlook is far less buoyant. In addition, the Administration's proposed spending reforms, tax hikes and the cap-and-trade framework will face compromises in Congress.

For Canada, entering the downturn in a far stronger fiscal position than the U.S., with its financial sector less pressed, an opportunity exists to significantly increase our North American competitiveness. A major emerging issue is climate change policy. Canada also faces fragmented environmental measures. Ottawa has suggested to Washington a continental system of emissions caps and market-based permit trading, but the proposals in the U.S. *Budget* are ambitious and would represent substantial change for both Canadian households and businesses.

Economic and Interest Rate Assumptions
annual % change except where noted

	09f	10f	11-13f
Real GDP			
2010 Budget	-1.2	3.2	4.3
CBO, January 2009	-2.2	1.5	4.2
Scotia Economics	-2.6	1.7	n.a.
Nominal GDP			
2010 Budget	0.1	4.3	6.0
CBO, January 2009	-0.4	2.5	5.8
Scotia Economics	-1.9	3.1	n.a.
CPI			
2010 Budget	-0.6	1.6	2.0
CBO, January 2009	0.1	1.7	2.0
Scotia Economics	-0.6	1.5	n.a.
Unemployment Rate, %			
2010 Budget	8.1	7.9	6.1
CBO, January 2009	8.3	9.0	6.9
Scotia Economics	8.7	9.1	n.a.
T-bill, 3-month¹, %			
2010 Budget	0.2	1.6	3.8
CBO, January 2009	0.2	0.6	3.6
Scotia Economics	0.2	0.8	n.a.
Treasury, 10-year, %			
2010 Budget	2.8	4.0	5.0
CBO, January 2009	3.0	3.2	4.6
Scotia Economics	2.4	2.9	n.a.

¹ Annual averages.

Source: OMB, 2010 Budget and Scotia Economics.

Budget 2010 Major Revenue and Expenditure Measures

Revenues

Personal Income Tax (PIT, aggregate revenue impact from FY11 to FY19 follows in brackets)

PIT rate cuts from the Bush administration will not lapse, except for individuals in the top two brackets.

In addition, enhancing and extending tax credits will offer \$770 billion of tax relief through FY19, largely focused on low- and middle-income families. The refundable **Making Work Pay Tax Credit**, equal to 6.2% of earned income to a maximum of \$400 per individual (\$800 per couple) to help offset Social Security payroll taxes, was introduced in the *Recovery Act* for 2009 and 2010 and is made permanent in the *Budget* (\$537 billion). Phasing out of the Credit begins at incomes of \$75,000 and the Credit is eliminated for incomes of \$95,000 and over. Also made permanent from the stimulus package are the expansion of the **Child Tax Credit** for low-income families (\$70 billion) and the \$2,500 **American Opportunity Tax Credit** for college students (\$75 billion). The Administration proposes working with Congress to reform the outdated asset rules that, combined with the new refundable tax credits, would disqualify individuals from federal programs such as Medicaid and Food Stamps. **The Earned Income Tax Credit** will be enhanced (\$33 billion) and the **Saver's Credit** will be made fully refundable, with government matching 50% of the first \$1,000 of retirement savings for families earning less than \$65,000. Longer term, **automatic workplace pensions** are promised for the 75 million workers (about half the workforce) without occupational pension plans. Alongside Social Security, employers without pension plans would enroll their employees in direct-deposit IRA accounts (*together with the Saver's Credit, \$55 billion*).

For higher-income individuals, rates for the top two PIT brackets, after the Bush tax cuts expire in December 2010, will rise from 33% and 35% to 36% and 39.6%, respectively, in 2011 (\$339 billion). **The rate at which itemized deductions** (such as mortgage interest deductibility and charitable donations) reduce PIT will be trimmed to 28% (\$318 billion). **The tax rate on capital gains and dividend income** will rise from 15% to 20% (\$118 billion). **For managers of hedge funds, private equity and other investment funds**, a major portion of their income, carried interest, will be treated as ordinary income subject to PIT rates, ending the current application of lower capital gains tax rates (\$24 billion). **The estate tax**, instead of disappearing in 2010 as previously scheduled, will be extended at 2009 rates, with a 45% top rate and a \$3.5 million exemption.

Corporate Income Tax (CIT, aggregate revenue impact from FY11-FY19 follows in brackets)

The net operating loss carryback, providing cash rebates by allowing losses to be carried back five years instead of two, was expanded in the *Budget* beyond the *Recovery Act's* small business limitation, offering \$64 billion of additional tax relief for FY09-FY10. **The Research & Experimentation Tax Credit** will be made permanent (\$71 billion). Several **aviation taxes** will be replaced with user fees, tilting some of the Federal Aviation Administration financing away from hard-pressed corporate airlines. For **smaller businesses** with annual receipts up to \$50 million, the capital gains tax will be removed on the sale of stock.

U.S. multinationals, currently allowed to indefinitely defer the 35% CIT on overseas earnings, face tightening provisions, possibly alongside additional restrictions on tax havens. Greater funding is allocated for international tax compliance initiatives.

A number of corporate tax provisions applying to domestic earnings also will be tightened, such as eliminating LIFO accounting for tax purposes. Similar to other PIT and CIT increases, the changes will be largely implemented after 2010.

Tax and fee changes for the oil & gas sector will total \$31½ billion from FY11 to FY19. As of 2011, a new excise tax on offshore oil & natural gas production in the Gulf of Mexico will be levied to close "loopholes" presently providing royalty relief. On Federal lands, revised royalties for oil & gas production will raise taxpayers' return. Other changes include repealing the tax credits for enhanced oil recovery and marginal wells and disallowing the expensing of intangible drilling assets. In addition, **excise taxes** that expired in 1995, largely related to oil, will be reinstated as of 2011, with annual revenues rising to \$2.3 billion by FY19 to clean up toxic, contaminated sites under the Superfund program.

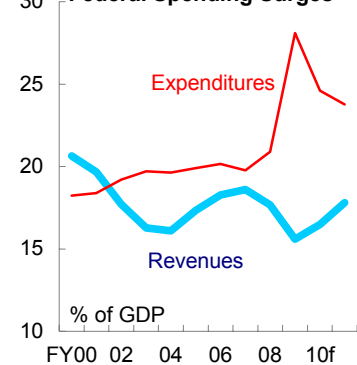
Expenditures

Credit measures include \$17½ billion under the Guaranteed Loan program for small business.

Health care reform will be driven by eight principles: protecting families' financial health (including bankruptcy from catastrophic illness); making the health system affordable; aiming for universality; safeguarding portability of coverage (and coverage cannot be refused because of medical conditions); guaranteeing choice of health plans and physicians; investing in prevention and wellness; improving patient safety and the quality of care and; maintaining long-term fiscal sustainability. The Administration will support comprehensive, fiscally responsible reform of physicians' payment formula that incents quality as well as quantity of care. The *Budget* includes over \$6 billion for the National Institutes of Health as a starting point for doubling funding for cancer research.

The **Children's Health Insurance Program (CHIP)** has been extended to 2013 with \$44 billion above the \$25 billion baseline funding to help States provide coverage for an additional four million children.

Federal Spending Surges



Source: OMB, 2010 Budget; GDP forecasts: Scotia Economics.

Budget 2010 Major Revenue and Expenditure Measures — continued

Post-secondary student aid will be restructured, eliminating the subsidies to private-sector financial institutions for government-guaranteed student loans. (Over the past year, approximately 100 lenders have abandoned the federal guaranteed-loan program.) New student loans now will be originated in Washington's direct lending program, saving more than \$4 billion annually for reinvestment in student aid. Competitive private providers will be retained to service the loans. **The Pell Grant** program will be made mandatory to ensure regular funding, with the Grants indexed to the CPI plus 1%. **The Perkins Loan program**, offering campus-based, low-interest loans, will be updated and the overall student aid application process will be simplified.

For the Unemployment Insurance system, the *Budget's* reforms include making benefit payments available faster and reducing improper benefit payments, with more fundamental reform promised for the future.

Assistance for low-income families will include \$3.2 billion to help defray heating and cooling costs and plans for a trigger mechanism to provide automatic increases in aid when energy prices spike. The **Community Development Block Grant** will be modernized and receive \$5 billion to expand economic opportunities for low-income households.

Agriculture will receive increased funding for rural initiatives such as broadband services. It will also witness several spending cuts including phasing out direct payments (unrelated to crop or livestock prices) to farms with revenues exceeding \$500,000, reducing crop insurance subsidies for both farmers and insurance companies and scaling back overseas brand promotion. The *Budget* fully funds ten-year average forest fire suppression costs, and provides a \$282 million discretionary contingent reserve if the \$1.1 billion ten-year allocation is exhausted.

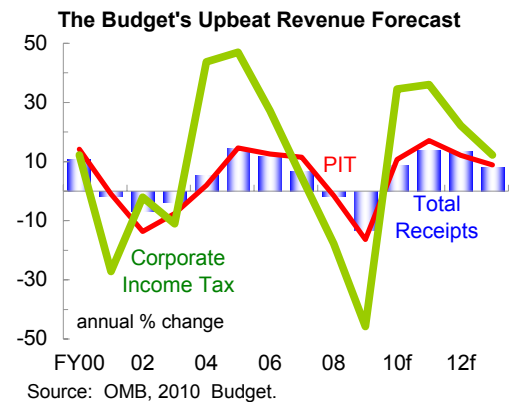
New climate change goals are proposed. Relative to 2005, a 14% cut in greenhouse gas emissions is suggested by 2020 and an 83% decrease by 2050. With an aim to double the nation's renewable energy capacity over the next three years, the *Budget* adds to the \$39 billion provided in the *Recovery Act* for clean energy and the \$11 billion for the smart grid with loan guarantees for renewable energy projects, transmission investments and carbon capture and storage projects. The *Budget* also provides for improved disposal and accountability for nuclear and other radioactive waste.

A National Infrastructure Bank is proposed to allow direct federal investment in challenging projects and facilitate co-ordination with State and municipal governments and private-sector co-investors. The *Budget* offers additional funding to the *Recovery Act*, including \$0.8 billion to modernize air traffic control, \$5 billion over 5 years for high-speed passenger rail corridors between major cities, and further funding for State clean water programs. **Surface Transportation Programs** will be revisited with Congress to provide a sustainable funding path and better-targeted investments. A recent report by the bi-partisan National Surface Transportation Infrastructure Financing Commission established two years ago suggested a 10¢ hike to the 18.4¢/gallon federal gasoline tax (and a 15¢ increase to the 24.4¢/gallon federal diesel fuel tax) measures to make it easier for States to levy tolls and more private-sector involvement.

For the IMF, the U.S. quota subscription will be raised as part of the 2008 agreement on the Fund's reform. Full funding is provided for all the 2010 payments to Multilateral Development Banks plus a portion of the outstanding arrears.

For the **Department of Defense**, a 4% increase in funding is proposed for FY10, beyond the monies provided by the *Recovery Act*, in part covering a permanent increase in the Army and Marine Corps. As part of the Administration's effort to provide more comprehensive accounting, items such as security assistance to foreign governments, previously funded in emergency supplementals, now will be included in base funding. Internal challenges include overhauling the costly and inefficient weapon development and acquisition process.

Spending constraints include a freeze on White House senior staff pay and a *Budget* proposal to limit the 2010 pay increase for federal civilian employees to 2.0% to bring their pay and benefits more in line with the private sector.



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