



TD Economics

Special Report

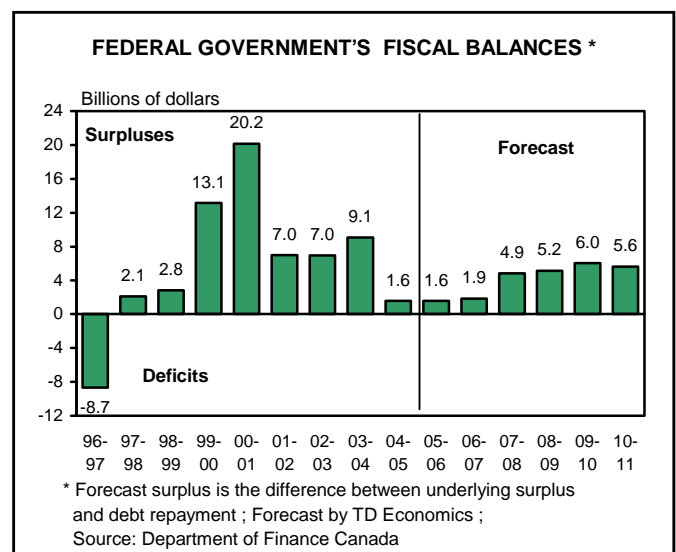
February 15, 2006

OUTLOOK FOR FEDERAL FISCAL POLICY

With a new federal government installed in Ottawa, it is only natural to ask where federal fiscal policy is headed. One should acknowledge that this is inherently an exercise in speculation, as election promises do not always translate into implemented policies and the narrow minority government situation complicates matters, with the passage of future policies requiring the support of at least one opposition party. Having said that, none of the political parties will want to force Canadians back to the polls immediately and the Liberal party will no doubt want to complete a leadership race before attempting to force an election. As result, the Conservatives have a window of opportunity to introduce much of their election platform. Parliament is scheduled to resume sitting on April 3, 2006 and the new government's first order of business will be to outline its objectives in a speech from the throne. This will likely be followed by a budget in mid-April, with a goal of getting a budget omnibus bill passed before the House of Commons rises for the summer recess.

While the spring budget is likely to cover the vast majority of the election platform, three key policy proposals are unlikely to be tabled. The deferral of taxes on capital gains that are reinvested within six months, the commitment to addressing the fiscal imbalance with the provinces and the promise to reduce hospital waiting times are all expected to be delayed, due to their complexity, cost and – for the final two measures – the need to negotiate the terms with the provinces.

Progress on these initiatives may also be hampered by the limited fiscal room available. Based on the estimated cost of the rest of the Conservative plan, and after removing the contingency reserve, the government is projected to run modest surpluses of \$1.9 billion in FY2006 and



around \$5 to \$6 billion in each of the following four years. This does not provide much in the way of additional funds to implement the remaining policies – but there are options. For example, the capital gains deferral might be capped to a lifetime limit, while dealing with the fiscal imbalance could be revenue neutral if the federal government shifts taxation to the provinces, but simultaneously reduces federal transfers. And, it might be possible to free up funds through restricting spending in other areas that are assigned a lower priority.

Regardless, the overall stance to fiscal policy will remain slightly restrictive to the economy and even if the projected modest surpluses are exhausted, the kick to economic growth would be meagre. As a result, given the government's commitment to running at least balanced budgets, the prospects for fiscal policy should not alter the conduct of monetary policy by the Bank of Canada.

And, while the cut in the GST will temporarily lower the rate of inflation, the central bank will see past this.

Finally, once the government has implemented much of its election platform, it is our hope that attention will be shifted to addressing Canada's ailing productivity performance. The country needs a coherent and focused strategy to shift the economic culture away from consumption and borrowing and towards saving and investment. The challenge is that there does not appear to be much fiscal room to deliver much in the way of new policies. However, this issue is pressing and cannot be ignored. At a minimum, the new government is encouraged to do a comprehensive review of its existing programs and policies, with an eye to finding savings and creating opportunities to introduce productivity-enhancing initiatives.

Expectations for the spring 2006 budget

For guidance on the prospects for federal fiscal policy, we turn to The Conservative Fiscal Plan that was released during the election. We expect that the bulk of these initiatives, as outlined in the accompanying tables, will be passed in the spring 2006 budget.

Selected increases in program spending

On the spending side, the government has outlined \$30 billion in new initiatives over the next five years. The

CONSERVATIVE SPENDING PLANS	
5-Year Cumulative Cost (\$ millions)	
Apprenticeship incentive grant	400
Support for agriculture	2,500
Assistance to forestry industry to battle pine beetle	500
Measures for security, crime prevention and assistance to victims	500
National Cancer Strategy	260
New Choice in Child Care Allowance and funds to create workplace child care spaces	9,500
Support for students, research & development	600
Highways and Borders Infrastructure Fund	2,000
Reduce the Right of Landing Fee	500
Overseas development assistance	425
New funds for National Defence	5,325
New agencies and inquiries	285
Canada-Ontario Agreement	2,914
Pacific Gateway commitment	591
Immigration measures	1,257
C-66 Energy Assistance planned for 2006-07	400
Post-budget measures' such as operations in Darfur and Afghanistan	2,103
TOTAL	30,060

Source: Conservative Federal Election Platform 2006

CONSERVATIVE TAX RELIEF	
5-Year Cumulative Cost (\$ millions)	
Reduce GST from 7% to 6% to 5%	32,300
Corporate tax relief cancelled in NDP budget deal, and the Forestry-Bio-energy CCA measures announced in Nov. 2005	900
Raise the threshold and reduce small business tax rate	1,800
New tools tax deduction	150
New apprenticeship job creation tax credit	800
Exempt \$500,000 of capital gains from taxation when transferring fishing assets	150
Raise Seniors Pension Income Amount	2,235
Textbook tax deduction and raise scholarship income exemption	400
New physical fitness tax credit	650
New affordable housing tax credit	800
New transit pass tax credit	2,000
Eliminate capital gains tax on charitable contributions	250
Deliver dividend tax credit changes announced Nov. 2005	1,600
Jewelry excise tax relief announced	120
TOTAL (excluding capital gains deferral)	44,155

Source: Conservative Federal Election Platform 2006

largest financial commitment is the promise to provide a \$1,200 annual allowance to parents for each child under age 6 and to provide tax credits for employers and communities that create additional child care spaces. The government has already indicated their intention to implement this policy starting in July 2006 and to terminate the prior daycare funding commitments made by the Liberals effective March 31st 2007. As one would expect, many provinces are attempting to delay or reverse the reduction in federal funding.

Other big-ticket spending items that are likely to be tabled in the upcoming budget are additional money for national defence, agriculture, forestry, highways and border infrastructure. A number of Liberal commitments made since the 2005 budget are also expected to be maintained, such as the Pacific Gateway commitment to promote Asia-Pacific trade, the immigration measures included in The Economic and Fiscal Update to help facilitate the settlement and integration of new arrivals to Canada, and funding for operations in Darfur and Afghanistan.

In other areas not identified in the plan, there is likely to be significant fiscal restraint, with spending growth to be kept flat on a real per capita basis – in other words, limiting the increase to roughly 2.7% per annum over the next five years.

Moderate tax relief in the pipeline

On the tax side, the Conservative fiscal plan calls for more than \$44 billion in tax relief over the next five years. The commitment to cut the GST from 7% to 6% immediately and to eventually lower it to 5% is the single biggest measure, and this alone accounts for almost three quarters of the total tax reduction. In order to fund this policy, the personal income tax cuts announced by the Liberal government in late 2005 will have to be reversed, but this is likely to only occur for the 2006 tax year and beyond, so Canadians will get a temporary reduction in personal income taxes in 2005.

The other tax measures in the spring budget are expected to include the pledge to reduce the corporate tax rate from 21% to 19% by 2010, the elimination of the federal capital tax effective January 1st 2006, and the removal of the business capital surtax on January 1st 2008. These are all policies that the Liberals can support, since they had previously made similar commitments.

The Conservatives should also make good on their promise to match the Liberal proposal made in November to cut the taxation of dividends, in order to better level the playing field between dividend paying stocks and income trusts – although this will not make the issue disappear entirely. First, the tax treatment only becomes more even if the provinces follow suit and the federal government delivers its promised corporate tax cuts. Even then, pension funds, foreigners and individuals investing through RSPs will continue to have a tax advantage for income trusts over equities.

In terms of new initiatives besides the GST cut, the government is also likely to raise the threshold for the small business tax rate from \$300,000 to \$400,000, gradually reduce the small business tax rate from 12% to 11% over the next five years, raise the amount of pension income seniors can receive and the amount of scholarship income that students can receive before paying taxes, and provide a tax credit on public transit passes. Again, most parties can support these initiatives. The government is also highly likely to eliminate the capital gains tax on donations of publicly-traded stocks to public charities – as all political parties have already stated publicly that they are in favour of this policy.

3 key measures unlikely to be included in upcoming budget

There are three key policies that were in the Conservative platform that are unlikely to be tabled in the spring budget. First, the proposal to allow the deferral of capital gains taxes if the proceeds are reinvested within six months time is more complicated than it looks on the surface. The policy will take considerable time to design and the costs would likely far exceed the estimate in the Conservative fiscal plan. It will also be difficult to administer. As a result, there is probably insufficient time for the capital gains deferral to be included in the upcoming budget.

Second, the Conservative promise to address the fiscal imbalance will require consultations and negotiations with the provinces. And, as one might expect, this will not happen quickly.

Third, the commitment to reducing hospital waiting times similarly needs consultations and could prove costly to implement.

This is not to say that progress cannot be made on these matters and there is likely to be a commitment made to them in the speech from the throne, but the process is likely to be drawn out.

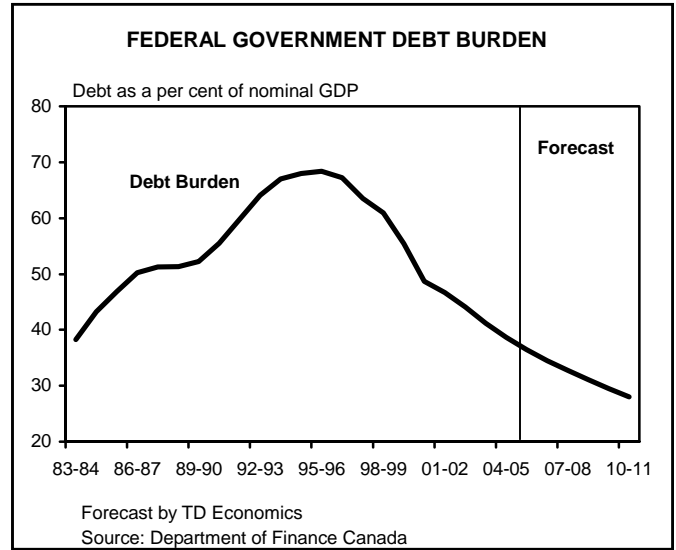
Furthermore, worries that the federal government could be forced into budget deficits in implementing these policies are overblown. The government is committed to running balanced budgets, so if the cost of these initiatives is greater than revenues allow, savings will be found in other areas to fund the policies or they will not be pursued. And, there are various options. For example, the capital gains deferral might be implemented by allowing individuals to set up a specific capital gains exempt account with a lifetime limit, say \$100,000 to \$500,000, which would facilitate the administration and restrict the costs. It would also constrain the benefit to extremely wealthy Canadians. Similarly, the fiscal imbalance could be addressed in a revenue neutral way, if the federal government sifted taxation towards the provinces, but simultaneously reduced the transfers to the provinces by a matching amount.

Spring budget should not be highly stimulative

So, putting all the pieces together, the overall assessment is that fiscal policy will remain mildly restrictive for the economy. This may seem counterintuitive, since the

platform calls for \$30 billion in new spending and \$44 billion in tax relief. However, even with these measures, the government is still projected to run modest surpluses. This is a testimony to Canada's high tax environment and declining debt burden. Indeed, these factors mean that the fiscal system is naturally geared to produce large surpluses year after year. This is why all of the political parties could promise considerable increases in spending and some tax relief during the election.

In terms of the details of the fiscal outlook under the Conservative platform, assuming that total income in the economy (i.e. nominal GDP) rises at an average annual pace of around 4.7% in the next five years, the proposed tax relief measures would slow the rate of growth in government revenues to around a 4% average annual pace in

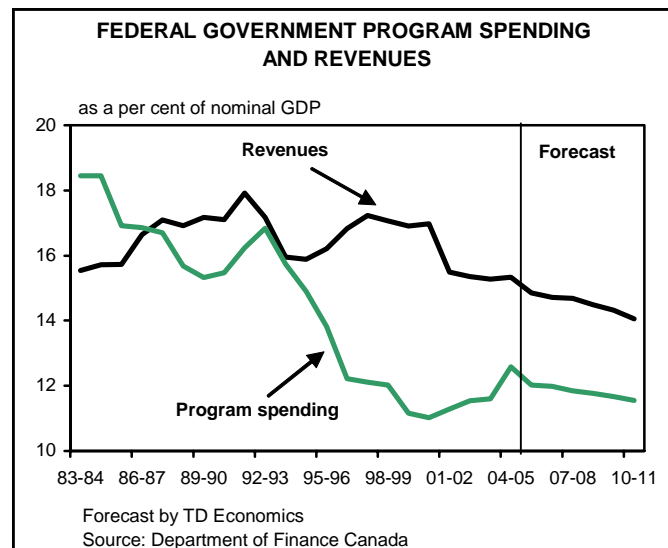
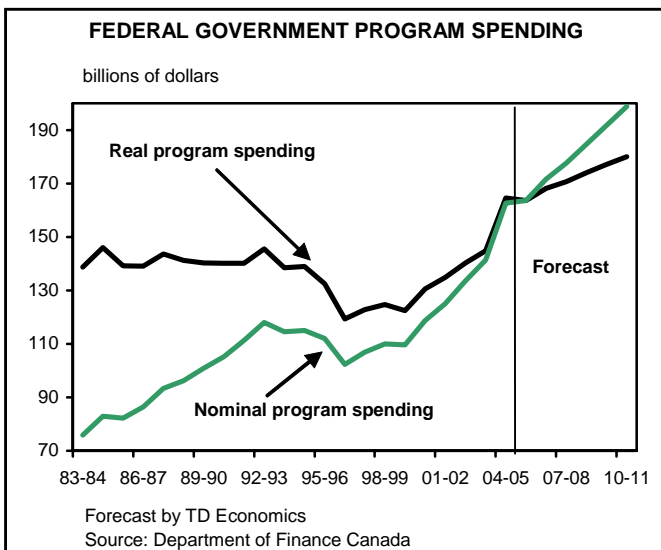


FY2006-2010. This would result in a modest decline in the nation's tax burden, with the ratio of revenues to nominal GDP edging down from 14.9% in FY2005 to 14.1% in FY2010.

Meanwhile, budgetary expenditures would rise slower than revenues, with a 3.4% average annual increase. This would reflect a rise in program spending that keeps pace with revenues, while debt service costs remain relatively flat. As a result, program spending would decline as a share of GDP, edging down from 12% in FY2005 to 11.5% in FY2010, while debt service costs would fall from 2.5% of GDP to 2% over the same time frame.

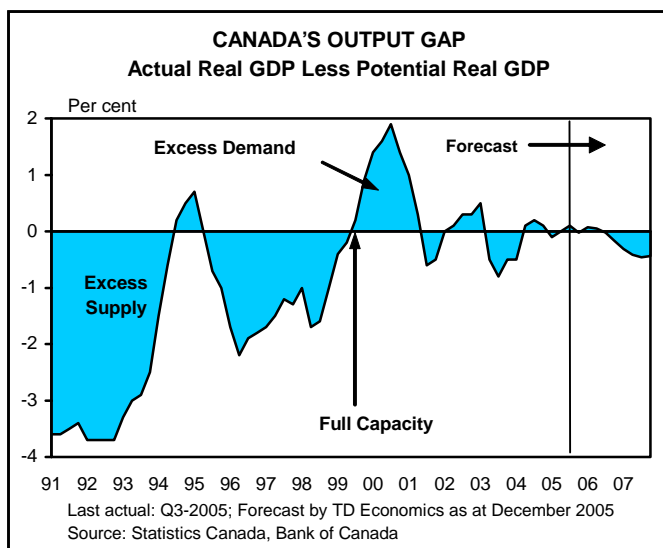
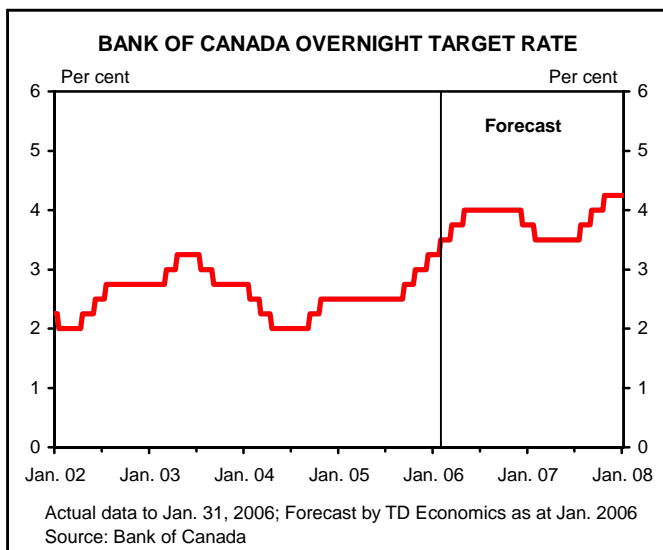
The implication is that the underlying budgetary balance would come in at around \$4.9 billion in FY2006, before rising and hovering at around \$8 to \$9 billion in FY2007-2010. However, \$3 billion of those surpluses would be the contingency reserve, which is earmarked for debt reduction. Assuming no economic slump, the projected debt reduction implies that Canada's debt-to-GDP ratio would continue to decline in the years ahead, falling to 28% by FY2010.

In light of the fact that the government is still on track to post surpluses, and since the economy is pretty much running at full capacity, the assessment must be that fiscal policy is mildly restrictive. This reflects the fact that budgetary surpluses imply that the government is collecting more revenues than it is spending or investing. However, in order to assess whether fiscal policy is become more or less restrictive and its impact on economic growth, one must compare the projected surpluses with those in the past.



If the Conservative platform was implemented – with the exception of the policies associated with the capital gains deferral, fiscal imbalance and hospital waiting times – the fiscal surpluses after deducting the contingency reserve would be \$1.9 billion in FY2006 and then hover at between \$5-6 billion over the next four years. This would represent a slightly more restrictive stance in policy, since the surpluses would be higher than the \$1.6 billion in FY2005.

However, this is a status quo view and there is a good chance that the surpluses could be directed to the outstanding campaign promises or to new initiatives, as yet unidentified. Consequently, it is useful to inquire what would happen if the surpluses were fully exhausted, taking for granted that the government will not entertain deficits.



Even under this scenario, the boost to GDP would be limited. Indeed, assuming that the economy is currently operating at full capacity, the fiscal kick to economic growth from using up the available surpluses would be only 0.1 percentage points in FY2006, 0.2 percentage points in FY2007 and a negligible impact thereafter.

Fiscal policy should not alter the path of interest rates

This is good news for the Bank of Canada. With the national unemployment rate running at close to a 30-year low, manufacturing capacity usage at a record high and the output gap estimated to be closed, the central bank is justifiably concerned about the possibility of inflationary pressures should economic growth exceed the economy's estimated potential pace of 2.8%. If fiscal policy added significant fuel to economic growth at this time, the Bank would be forced to run a tighter monetary policy than otherwise would have been the case. But, this seems unlikely given the magnitude of the future projected surpluses. Furthermore, the TD Economics base case forecast incorporates an expected slowdown in the U.S. economy in response to cooling housing markets that would, in turn, dampen economic growth in Canada. Accordingly, even if the surpluses are used for spending or tax cuts, fiscal policy is unlikely to lead to an overheating of the economy.

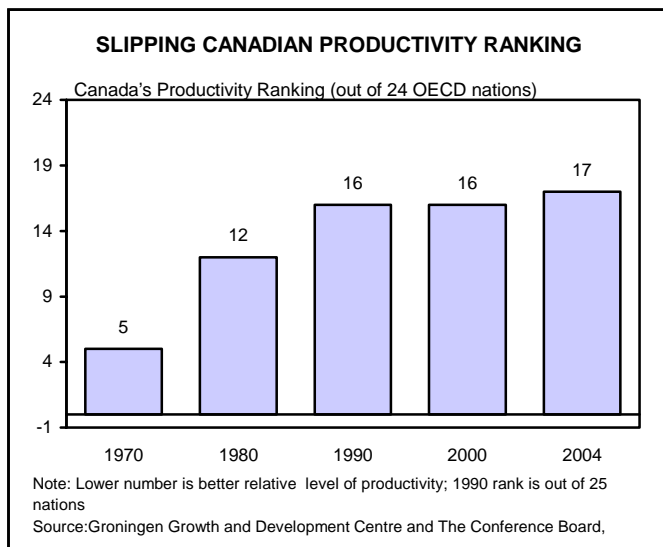
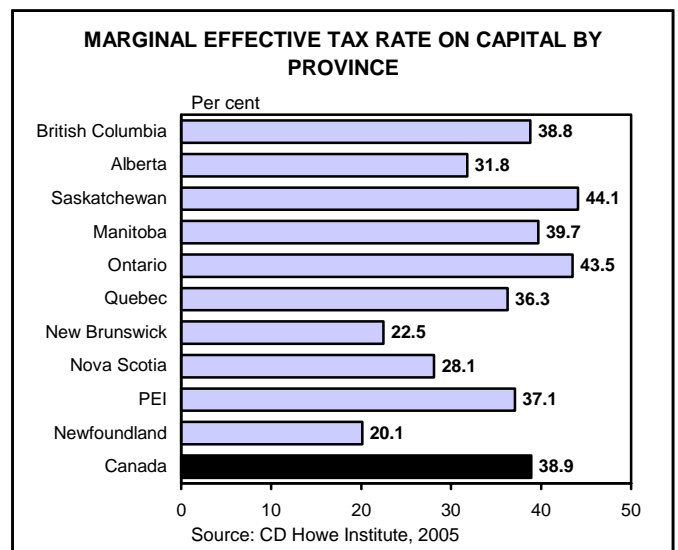
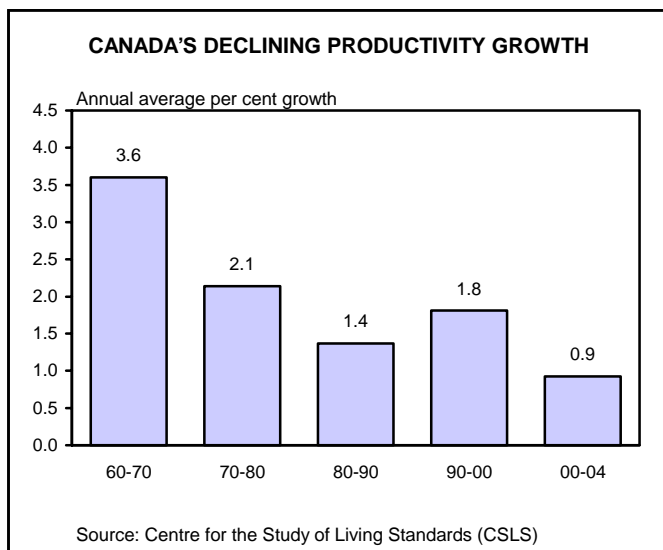
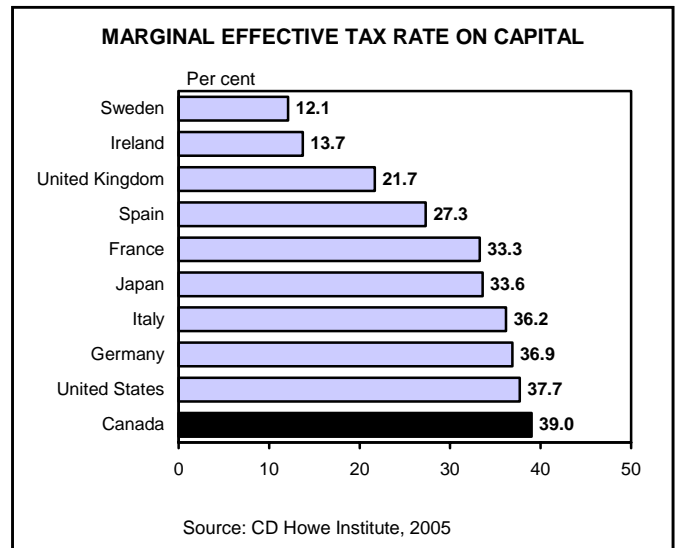
The cut in the GST will impact the profile for inflation for the first twelve months after the reduction. However, this will be fully anticipated by the central bank and will be viewed as a temporary distortion. The explanation is simple. Many of the products and services in the basket of goods that make up the Consumer Price Index have GST on them, so the immediate 1 percentage point reduction in the consumption tax will lower the prices paid by individuals. Since some consumer items are excluded from the GST, it is estimated that the reduction in the tax will lower the annual pace of inflation by a lesser 0.6 percentage points. However, once 12 months have passed, the impact of the tax cut will fall out of the year-over-year calculation of inflation. As a result, the Bank will not react and will focus on their preferred measure of core inflation, which excludes the eight most volatile items and indirect taxes – such as the GST.

So, the proposed fiscal policies do not alter the path for interest rates, which we believe will consist of only two more quarter point hikes in the overnight rate.

Next steps: need for a productivity agenda

The basic conclusion is that the Conservative government has the scope to implement the vast majority of its election platform and at the same time continue to run balanced budgets and pay down debt at a gradual pace. However, the election commitments do little to address the greatest economic challenge facing Canada today – its dismal productivity performance. It is our hope that the new government will turn its attention to this issue in the months ahead, as Canada urgently needs a coherent and comprehensive productivity strategy that aims at boosting the incentives to work, save and invest.

Having said that, the government has little fiscal flexibility to introduce significant new spending or tax relief. Accordingly, Canada’s punitively high marginal effective



personal income tax burden will continue to constrain the ability of households to save and to act as a barrier for many low income Canadians trying to leave government income-support programs in order to enter the labour force. And, while the cut in dividend taxation and the possible deferral of capital gains could boost personal disposable income and encourage saving, these measures will be a greater boon to high income Canadians.

On the business front – even with the proposed corporate tax cuts, small business tax relief, elimination of the federal capital tax and business surtax – Canada will continue to have extremely high marginal effective tax rates on capital, which act as a deterrent for investment, innovation and entrepreneurial activities. However, in fairness, it should be remarked that much of the capital tax burden is at the provincial level.

Nevertheless, the main recommendation is that the new government should do a rigorous review of the current use of revenues for program spending, with a focus on cutting costs and increasing efficiency. There is also a fundamental misperception that so long as the government runs balanced budgets, it is running a prudent and positive fiscal policy. But, the true acid test of any government program should be whether the productivity and societal payoff is greater than the advantage that would have been received from lowering taxes by the cost of the initiative.

This does not necessarily imply cutting back on government services, but it does mean trying to make fiscal policy more effective in boosting productivity. For exam-

ple, while the federal government has many programs to support research and development and promote small business growth and investment, it appears that many of the opportunities are not being fully accessed. An effort at streamlining the process and promoting these programs could prove advantageous.

Finally, it is our opinion that all existing and future fiscal policies should be geared towards shifting Canada's economic culture away from consumption and borrowing and towards saving and investment.

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FEDERAL GOVERNMENT FISCAL PROJECTION									
(Billions of dollars unless otherwise indicated)									
Fiscal years	02-03	03-04	04-05	05-06e *	Projections				
					06-07	07-08	08-09	09-10	10-11
BUDGETARY REVENUES	177.8	186.2	198.4	202.3	210.9	220.3	227.5	235.4	241.9
% change	3.6	4.7	6.5	2.0	4.2	4.5	3.3	3.5	2.8
PROGRAM SPENDING	133.6	141.4	162.7	163.7	171.6	177.6	184.7	191.8	198.8
% change	6.9	5.8	15.1	0.6	4.8	3.5	4.0	8.0	7.6
PUBLIC DEBT CHARGES	37.3	35.8	34.1	34.0	34.4	34.8	34.6	34.5	34.4
% change	-6.0	-4.0	-4.7	-0.3	1.2	1.2	-0.6	-0.3	-0.3
TOTAL EXPENDITURES	170.9	177.1	196.8	197.7	206.0	212.4	219.3	226.3	233.2
% change	3.8	3.7	11.1	0.5	4.2	3.1	3.2	3.2	3.0
UNDERLYING BUDGET BALANCE	7.0	9.1	1.6	4.6	4.9	7.9	8.2	9.0	8.6
CONTINGENCY RESERVE	---	---	---	3.0	3.0	3.0	3.0	3.0	3.0
PLANNING SURPLUS/DEFICIT (-)	7.0	9.1	1.6	1.6	1.9	4.9	5.2	6.0	5.6
% of GDP	0.6	0.7	0.1	0.1	0.1	0.3	0.3	0.4	0.3
FEDERAL DEBT:									
ACCUMULATED DEFICIT	510.6	501.5	499.9	496.9	493.9	490.9	487.9	484.9	481.9
% of GDP	44.1	41.1	38.8	36.8	34.5	32.7	31.1	29.5	28.0

* e = estimate ; Forecast by TD Economics, Source: Department of Finance Canada

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