

## Federal Budget

### Comments on the 2006 Federal Budget

**A budget patterned  
on the Conservative campaign promises**



**Gilles Soucy**  
VP and Chief Economist

**François Dupuis**  
Director, Deputy Chief Economist and Strategist

**Benoit P. Durocher**  
Economist

**Francis Généreux**  
Economist

Phone: 514 281-2336 or 1 866 866-7000, ext. 2336

E-mail: [desjardins.economics@desjardins.com](mailto:desjardins.economics@desjardins.com)

## A budget patterned on the Conservative campaign promises

### Highlights

The first budget of the Conservative government of Stephen Harper and Finance minister James Flaherty introduces a new type of involvement for the federal government in comparison with previous governments. While trying to please a wide range of Canadians, this budget is also in line with the promises made by the Conservative Party during the last election campaign. Many measures to cut the tax burden of businesses and individuals have been introduced. It is also an ambitious budget with over \$35B in new initiatives over 2 years. Like the budgets tabled by the Liberals, it aims to be balanced and to reduce the government's debt. Moreover, it sets the stage for a dialogue along with immediate measures aimed at rectifying the fiscal imbalance.

- Over 2 years, the budget proposes close to \$20B in tax relief for individuals, including a cut of one percentage point on the goods and services tax. However, in comparison with the current 15% rate, the first tax bracket will increase to 15.5% next July.
- To stimulate employment, growth and competitiveness, the Conservative government is proposing several initiatives to cut corporate taxation.
- The federal government is determining a specific approach to rectify the fiscal imbalance in Canada.
- The budget earmarks \$8B for debt reduction in 2005-2006 and \$3B during the next fiscal years. The debt-to-GDP ratio should decrease from 38.7% in 2004-2005 to 31.7% in 2007-2008.
- The budget plan is based on realistic and conservative economic assumptions. However, Minister Flaherty is dropping the contingency reserve and the reserve for economic prudence.

<b>SUMMARY OF BUDGETARY TRANSACTIONS</b>					
In billions of \$	2003-2004	2004-2005	2005-2006f	2006-2007f	2007-2008f
Budgetary transactions:					
<b>Budgetary revenues</b>	<b>198.9</b>	<b>211.9</b>	<b>220.9</b>	<b>227.1</b>	<b>235.8</b>
- Variance (%)	4.4	6.6	4.2	2.8	3.8
<b>Program spending</b>	<b>-154.2</b>	<b>-176.3</b>	<b>-179.2</b>	<b>-188.8</b>	<b>-196.5</b>
- Variance (%)	5.5	14.4	1.6	5.4	4.1
<b>Operating balance</b>	<b>44.7</b>	<b>35.6</b>	<b>41.7</b>	<b>38.3</b>	<b>39.3</b>
<b>Public debt charges</b>	<b>-35.8</b>	<b>-34.1</b>	<b>-33.7</b>	<b>-34.8</b>	<b>-34.8</b>
- Variance (%)	-4.0	-4.6	-1.2	3.3	0.0
<b>Projected reduction of the debt</b>	---	<b>-1.5</b>	<b>-8.0</b>	<b>-3.0</b>	<b>-3.0</b>
<b>Budgetary balance</b>	<b>8.9</b>	<b>0.0</b>	<b>0.0</b>	<b>0.6</b>	<b>1.4</b>
Non-budgetary transactions					
Financial source and requirements	-2.6	3.3	-2.7	-6.0	1.7
Ratio of program spending to GDP (%)	6.2	4.8	5.3	-3.0	4.7
Ratio of budgetary balance to GDP (%)	12.7	13.7	13.1	13.0	13.0
Ratio of debt charges to budgetary revenues (%)	0.7	0.1	0.0	0.0	0.1
Debt representing accumulated deficits	18.0	16.1	15.3	15.3	14.8
Debt-to-GDP ratio (%)	495.9	494.4	486.4	483.4	480.4
	40.8	38.3	35.5	33.3	31.7
f: forecasts					
Source: Departement of Finance of Canada					

## Budget analysis

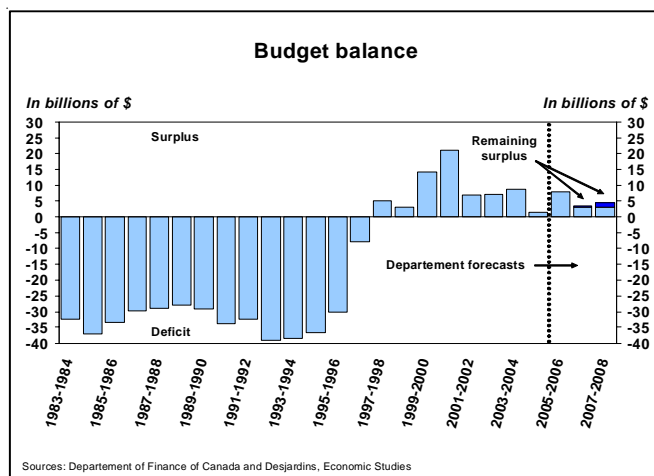
### The tradition of prudence is maintained

Once again, today's budget shows to the degree of financial leeway that the federal government has. Economic growth that is more solid than anticipated, strong corporate profits and soaring revenues from fuel taxes generated higher than anticipated budget revenues. So, even when taking into account the new initiatives announced today, the minister of Finance is anticipating a surplus of approximately \$8B for the fiscal year ended last March 31. If the final results that will be published next fall are similar to these forecasts, the federal government's debt should go down by \$8B in 2005-2006.

In general, the first Conservative government budget maintains the tradition of prudence adopted by the Liberals over the last few years. The economic assumptions used in drawing up the budget are realistic, although the forecasts on the growth of nominal GDP are slightly lower than our own and anticipated interest rates in 2006 and 2007 are slightly higher. Accordingly, the minister of Finance's scenario probably underestimates budgetary revenues and overestimates the costs related to the debt, which shows some prudence on the part of Minister Flaherty.

Even if the outlook for the Canadian economy is relatively good, one must keep in mind that some risks are still present and as a result, we are not completely sheltered from economic setbacks. The existence of global imbalances, the uncertainty in the American real estate market, a strong appreciation of the loonie, the increase in energy costs and the prices of other raw materials are so many factors that could lead to a slowdown in the global and Canadian economy in 2006 and 2007.

Following a 14.4% increase in 2004-2005 due mostly to higher transfers to provinces, and growth of only 1.6% in 2005-2006, the progress of program spending should now match that of the economy, i.e. 5.4% in 2006-2007 and 4.1% in 2007-2008. With respect to budgetary revenues, the many initiatives included in this budget (like the GST cut for instance) should curb their increase in such a way that the Department anticipates that it will show significantly lower growth than that of the economy.



As for debt service charges, the anticipated increase in interest rates, according to the budget plan, should lead to a slight increase in 2006-2007 and in 2007-2008. Bear in mind that public debt charges have decreased markedly over the past few years due to the combined effect of the lower interest rates and the gradual repayment of the federal debt. Even so, the ratio of debt charges to budgetary revenues should keep going down and reach 14.8% in 2007-2008 compared with 35.2% in 1995-1996 when it peaked at 35.2%.

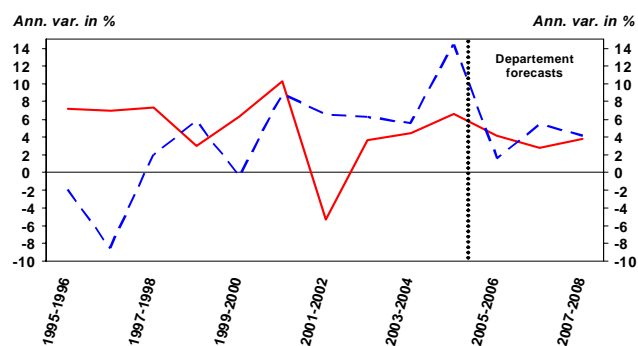
### Economic and financial forecasts

	2005	2006 Forecasts		2007 Forecasts	
		Budget	Mouvement Desjardins	Budget	Mouvement Desjardins
Nominal GDP Canada (%)	6.1	6.0	6.3	4.6	5.1
Real GDP Canada (%)	2.9	3.0	3.0	2.7	2.8
GDP deflator Canada (%)	3.2	3.0	3.2	1.9	2.2
Treasury bills 3-month (%)	2.70	4.00	3.90	4.10	3.60
Canadian bonds 10-year (%)	4.10	4.40	4.20	4.50	4.10
Unemployment rate (%)	6.8	6.6	6.6	6.6	6.6

Note: For all indicators, the data represents annual averages.

Sources: Departement of Finance of Canada and Desjardins, Economic Studies

### Growth of program spending and budgetary revenues



It should also be noted that minister Flaherty is replacing the contingency reserve established by the Liberals with an announced reduction of the federal debt. However, the size of the anticipated repayment is identical to the former Liberal contingency reserve, i.e. \$3B per year, so that in the end, these 2 ways of doing things are similar and meet, as it were, the same objective. Unlike the Liberals, the Conservative government is dropping the reserve for economic prudence. This measure is not as necessary since minister Flaherty's projections only apply for two budget years, in comparison with five during the Liberal years.

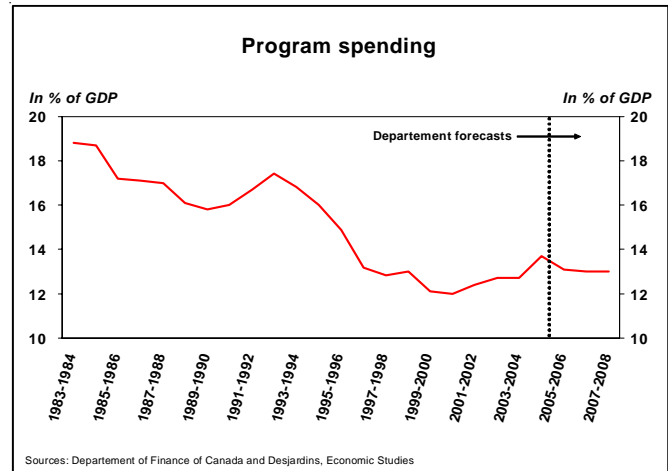
### A range of new measures targeting both businesses and individuals

Most new measures presented by the minister of Finance are in line with the campaign promises of Stephen Harper and the Conservative Party. There are in fact very few real surprises and most measures are aimed at easing the tax burden of individuals and businesses.

For individuals, the goods and services tax (GST) will, as promised, be cut from 7% to 6% effective July 1, 2006. By 2007-2008, this measure will have cost \$8.7B to the federal government. Minister Flaherty is also committed to creating a new \$500 employment credit effective July 1, that will increase to \$1,000 on January 1, 2007. However, he finances part of these measures by raising the lowest tax rate to 15.5% in July. Bear in mind that it had been cut to 15% by the Liberals for 2005 and 2006 in the fall 2005 Budget update. The new government is also cutting back part of the increase in the basic personal amount announced by minister Goodale: after increasing considerably in January, this amount will be cut by \$400 on July 1. Other more minor and targeted measures are also included in this budget, namely for pensioners, students and public transit users.

The budget introduces a Universal Child Care Benefit that will provide \$100 per month to all families for each child under age 6 effective July 1. Over 2 years, this measure will cost \$3.7B. The government is also setting aside \$250M to create daycare spaces.

For businesses, the budget tabled by Minister Flaherty is definitely looking to increase their competitiveness by significantly easing their tax burden. Accordingly, the general tax rate on corporate income will go down from 21% to 19% by 2010. While the corporate surtax was slated to be eliminated in 2008 for SMEs, it will in fact be eliminated for all corporations. Federal capital tax will also be eliminated, but two years earlier than what had been announced by the former government, i.e. retroactively to January 1, 2006.



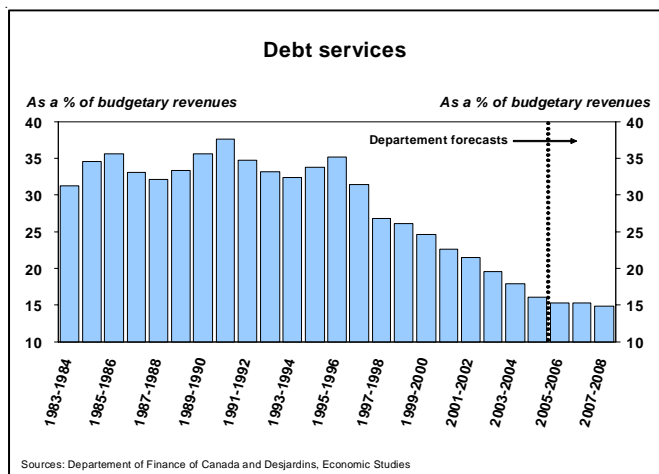
More specific measures are aimed at small businesses, such as the \$100,000 increase in the amount of business income eligible for the reduced tax rate and the lower tax rate. In addition, the Conservatives renewed the Liberal measure aimed at eliminating double taxation of large corporation dividends. Assistance programs and tax credits for specific economic sectors were also introduced.

National security and strengthening Canada's role in the world are major concerns of the new government. It is allocating an additional \$2.6B over 2 years for these concerns, in particular to hire RCMP officers, secure borders and increase pandemic preparedness. Over \$5B will be allocated to the Canadian Forces in the next 5 years.

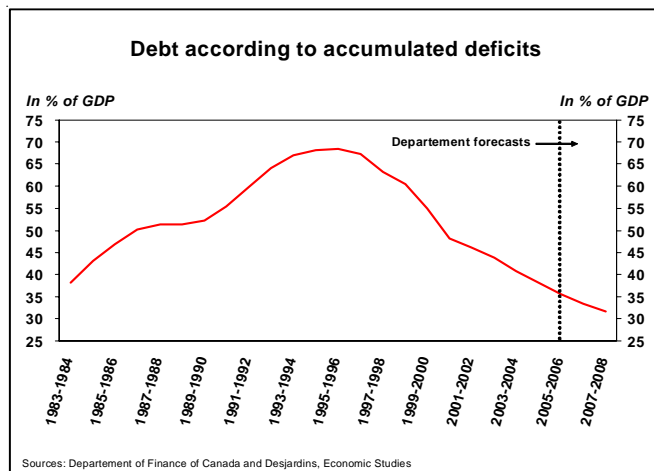
While the Chrétien and Martin governments did not recognize it, the fiscal imbalance is a real challenge for the current administration. It is pointing out in its budget documents that it is determined to find an overall solution to this issue. The Harper government is also committed to taking immediate measures to this effect. In the short term, the minister of Finance will pay \$3.3B to the provinces and territories through 5 trusts associated with specific urgent needs: post-secondary education (\$1,000M), public transit (\$900M), affordable housing (\$800M), affordable housing in the North (\$300M) and off-reserve Aboriginal housing (\$300M). Québec should get approximately \$671M of the total amount. The federal government is also committed to paying an additional \$255.4M to some provinces for equalization in 2006-2007 (including \$185M for Québec). In the coming year, the Harper government is aiming to take other measures with the provinces to develop new approaches in the allocation of federal budgetary surpluses to the renewal of equalization, long-term support for post-secondary education and training and the funding of infrastructure programs.

## Impacts on capital markets

Given that the new government is maintaining a balanced budget and that the Minister of Finance will tackle the debt through \$3B payments every year, the capital markets should be satisfied with this first Conservative budget. With respect to its overall financial situation, Canada should keep performing well in comparison with other leading economies.



Investors will also appreciate that a number of new measures are tackling the corporate tax burden while limiting growth in program spending. Given that one of the main risks weighing on the Canadian economy is the strong appreciation of the Canadian dollar, the measures dealing with increased competitiveness for local businesses are well received. Applying the measure already announced by the previous government on eliminating the double taxation of large corporation dividends should also please shareholders of Canadian corporations.



## Conclusion: A budget that will please Canadian voters

In short, the Harper government's first budget respects the main Conservative direction with a host of new measures and initiatives affecting both individuals and businesses. With this budget, the Conservatives are obviously looking to increase their support among Canadian voters, especially in Québec.

Yet, the economic efficiency of the GST cut can be questioned. It should be noted that most economists believe that consumption taxes are more effective than income taxes. Not only is Canadian income tax relatively high, but it is often considered as a work disincentive. High income taxes are also less effective from the standpoint of productivity as it curbs savings, investment and job creation up to a point.

### Impact of the GST cut

- The 7% to 6% cut in the GST will come into effect on July 1, 2006. Under the transitional rules, if a purchase is made by June 30, the 7% rate will apply if the tax is paid or becomes payable before July 1.
- The Department of Finance believes that this measure will cost \$3.5B in year 2006-2007, as the GST cut will only come into effect in the fourth month of this fiscal year and to \$5.2B in fiscal 2007-2008.
- Since the amounts subject to the Québec sales tax include GST payments, its cut to 6% should bring a shortfall of approximately \$100M per year for the government of Québec. However, the Charest government could decide to recover part of the tax room made available by the federal government by adjusting its own sales tax. Accordingly, a 1% increase in the QST would add approximately \$1.5B per year to Québec's budgetary revenues. An alternate solution with a 0.5% increase in the QST would increase Québec's tax revenues by a little over \$600M per year.
- According to Statistics Canada estimates, the 1% cut in the GST should bring down the consumer price index by 0.6% next July. So, the overall annual inflation rate could temporarily fall under the 2% level, i.e. the median target of the Bank of Canada. However, the decrease in the overall annual inflation rate should be limited by the increase in energy prices observed in the last few months.

In this context, we can only disapprove the decision to cut the GST rather than to bring down personal income tax. The GST cut could also be ineffective when compared to other consumption taxes in effect around the world. According to OECD data, the Canadian consumption tax level is similar to that of most industrialized countries even when considering the taxes in effect in some provinces. However, the income tax is much higher here than in most other countries.

Sales rate in effect in some countries		
	National administrations	Provinces/localities
Germany	16%	---
Australia	10%	---
Canada	6% (starting July 2006)	0 to 10%
Spain	16%	---
United States	---	0 to 7.25%
France	19.6%	---
Italy	20%	4.50%
Japan	5%	---
United Kingdom	17.5%	---

Source: OECD, United States Congress and Desjardins, Economic Studies

In the end, most Canadians should even so come out winners from this first Conservative budget. Indeed, the increase of the first tax rate is largely offset by the benefits from the GST cut, the \$1,200 family allowance payment for children under 6 and the employment credit.

In closing, the decision of the Harper government to begin discussions with the provinces on the fiscal imbalance should be applauded. Not only is the Harper government announcing a \$3.3B financial assistance for provinces from the 2005-2006 surplus, but it is considering a new approach to allocate part of the unplanned federal surpluses, an improvement to equalization, a new framework for the long-term funding of infrastructures and a new approach for the funding of training and post-secondary education.