

Capital Strategy

Special Report

January 24, 2006

Canadians Opt For Change But Continued Commitment to Balanced Books

Canadians today elected a minority Conservative government, elevating the profile of Western Canada in Ottawa and bringing to power for the first time a party drawn from Reform/Canadian Alliance and Progressive Conservative roots. Conservative momentum was not sufficient at the end of the day to deliver a majority, with only 124 seats compared to 99 in the June 2004 election. The 32-seat loss for the Liberals (to 103) was not as significant as some had expected in the wake of the *Gomery Report*. Surprises were not limited to the two front-runner parties. The NDP increased its seat count to 29 from 19 in the 2004 election, and the Bloc Québécois ended up losing 3 seats from the 54 tally they received in 2004.

The New Parliament

With the seat spread between the Conservatives and Liberals smaller than with the past minority Liberal government, the Parliamentary dynamics will be no less interesting. The Conservatives' slim mandate is challenging, but conversely, the Liberals and the NDP, together, do not command a majority (see *table, page 2*). It's worth pointing out that the key shift in this Parliament is that rural seats make up the bulk of the governing minority against a largely urban opposition. The decline in Bloc support in Quebec resulted from a smaller-than-anticipated loss in Liberal seats (13 from 21) as well as an unexpected recovery in the Conservatives' showing (10 seats from 0). This will be viewed positively by markets from the perspective of a reduced separatist vote, though attention on the upcoming Quebec provincial election will continue.

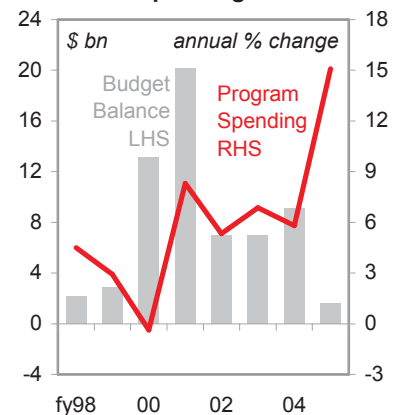
The eight minority governments from Confederation to 2003 survived, on average, only eighteen months, but Canadians have just emerged from one short-lived minority administration, raising the stakes for the Conservatives to make their minority government as effective as possible. A number of the Conservatives' policy initiatives have broader support, such as their proposed *Federal Accountability Act* that would introduce changes in a number of areas such as federal political party financing, lobbying activity and government appointments.

Fiscal Implications

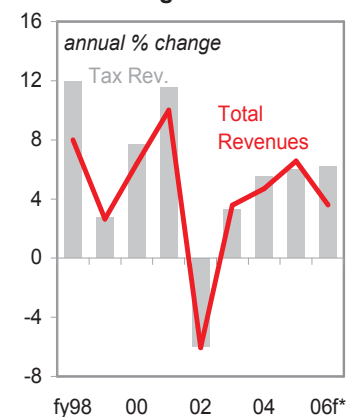
The slim minority demands that the Conservatives, to advance their program, must rely upon support among the other parties. The most notable common ground with the Liberals is the Conservatives' pledge to keep the federal books balanced, earmarking at least \$3 billion for annual debt repayment. Consequently, Ottawa should remain on track to lower net debt relative to GDP to the revised target of 20% by 2020.

In terms of spending plans, the Conservatives echo some Liberal priorities, such as post-secondary education, emphasize other areas such as defence, and propose significantly different approaches for a number of programs such as child care. Critical to the Conservatives' work-

Less fiscal flexibility given recent spending initiatives ...



... and moderating revenue gains



* Data from April to November, 2005.

ing relationship with the Bloc Québécois is their pledge to revisit federal-provincial financial arrangements and address the current fiscal imbalance. The Conservatives' plan to hold the line on real per capita departmental and agency outlays is expected to free up funds for this exercise and the report from the independent Expert Panel on Equalization and Territorial Formula Funding due this spring will offer a starting point.

The Conservatives have indicated that they will deliver the corporate tax reductions outlined in the *Fiscal and Economic Update* last November. This includes removing the capital tax for larger non-financial corporations in 2006, two years ahead of schedule, eliminating the corporate surtax in January 2008 and trimming the general corporate income tax rate from the current 21% to 19% from 2008 to 2010. The Conservatives and the Bloc Québécois both support the enhanced dividend tax credit introduced last November and the Conservatives have waived new taxes on income trusts, identifying them as important retirement savings vehicles. Assessing the impact of the Conservatives' suggestion to defer the capital gains tax for individuals on the sale of assets if the proceeds are reinvested within six months requires further definition of the measure.

Trade-offs are likely as the Conservatives implement a key plank in their election platform — dropping the Goods and Services Tax (GST) rate from 7% to 6% in the near-term, and eventually to 5% over the next five years. The immediate cost of the GST relief will be difficult to afford given the expense of the personal income tax (PIT) reductions introduced in the November *Update*, retroactive to 2005. The PIT relief — cutting the lowest bracket tax rate from 16% to 15% and accelerating increases in the basic personal amount by \$500 for 2005 and a further \$100 (\$100 was already specified in the February *Budget* plan) for 2006 — was estimated to cost \$5.1 billion for fiscal 2005-06 (FY06). Incorporating these changes for the first eleven months of the 2005 taxation year scaled back the year-over-year increase in federal tax receipts from 11.2% for the April-to-October period to 6.2% for April to November. Drafting a first *Budget* will undoubtedly involve some careful balancing. Since 1944, only three governments have moved from election to the first sitting of Parliament within 42 days, but this still leaves open the possibility of a budget this spring.

Growth, Rates and Currencies

Even if the election outcome had delivered a majority Conservative or Liberal government, there would not have been any material impact on Canada's near-term economic growth. The next important juncture will be the upcoming federal *Budget*. Tax cuts remain on the table and will continue to provide some insulation for domestic consumption in the face of continuing headwinds, though not enough to produce overheating conditions. Hence, the climate is also one of status quo for the Bank of Canada, which is expected to remain on course for additional tightening beyond today's much-anticipated quarter-point hike. Ditto for the Canadian dollar. While immediate reaction by the market was negative on the news that there would not be a majority government, the impact of the election is swamped by other more important fundamentals. Rising oil prices, on the back of heightened Middle East tensions, a shift by foreign investors away from the US dollar and the potential uncertainty accompanying this month's change in Chairmanship at the Federal Reserve will have a greater influence on currency direction in the weeks and months to come. Again, with the popular support for the Bloc down well below 50%, foreign exchange markets are expected to deem this a positive over the medium term.

House of Commons Party Standings							
	Bloc						
	Conservatives	Liberals	Québécois	NDP	Independent	Vacant	Total
January 2006 (Preliminary)							
B.C.	17	9		10			36
Alberta	28						28
Sask./ Man.	20	5		3			28
Ontario	40	54		12			106
Quebec	10	13	51		1		75
Atlantic	9	20	0	3			32
Territories		2		1			3
Canada	124	103	51	29	1	0	308
December 2005							
B.C.	22	8		5		1	36
Alberta	26	1			1		28
Sask./ Man.	20	4	0	3	1	0	28
Ontario	23	74		7	2		106
Quebec		21	53			1	75
Atlantic	7	22	0	3	0	0	32
Territories		3					3
Canada	98	133	53	18	4	2	308

Source: Elections Canada.