Equity Research

Scotia Capital

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The 2003 Canadian Federal Budget

Economics

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General

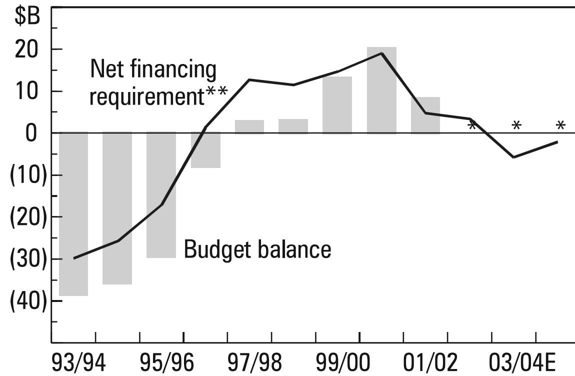
This was Finance Minister John Manley's first budget and, given the amount of leakage in the lead up to the speech, there was going to be little in the way of surprise. Nor should the market be shocked that this was the first major belt-loosening exercise in recent history, especially as the wide breadth of spending measures contained in this document essentially reflected the wish list of the prime minister. Manley's job therefore was to construct a budget that applied management to this wish list, such that Canada's reputation of being a stalwart role model of fiscal austerity could be maintained. This objective he achieved, but only in the sense of how Canada looks compared to its peers – the U.S. (bad), Europe (worse), and Japan (ugly). Some of the measures in this budget are front-loaded and non-committal (in the case of the lump-sum CHST transfer to provinces as part of the health care agreement), while others do not even show up for a few more years (additional funds to strategic infrastructure).

With the exception of health care, there is actually very little focus in terms of the announced spending initiatives. Markets may not view this positively, although, again, Mr. Manley still shines on a global comparison basis. That said, the measures outlined in the health agreement offered little in terms of additional operations money for the provinces. The key criticism of this budget, especially as we head into an even more uncertain economic climate, is that there was not enough done in terms of debt paydown, particularly in the current fiscal year. True, the budget forecasts a decline in the nation's debt to GDP ratio to 40% by F2005 from 46.5% last year but, by simply taking the Bank of Canada at its word, one has to assume that the days of steadily falling borrowing costs in Canada have come to an end and can no longer be relied upon to keep downward pressure on debt-servicing costs. And this places the onus on debt reduction. With the U.S. running massive deficits once again, Canada also faces the risk of seeing medium-term yields pressured higher by the combination of increased supply south of the border and wider spreads here against U.S. bonds. On net, the market will likely either ignore this budget in favour of more pressing geopolitical concerns or because it will be viewed as perhaps just a one-year change in policy before the prime minister steps down, or they may just give Mr. Manley a barely passing grade. Either way, the potential for significant market movements on the document is low. That said, in a world where one has to buy something at the expense of a short position in something else, Canada's superior fiscal position relative to the rest of the G7 still reinforces the view of outperformance in Canadian fixed income securities, at least to the United States.

Economic Backdrop

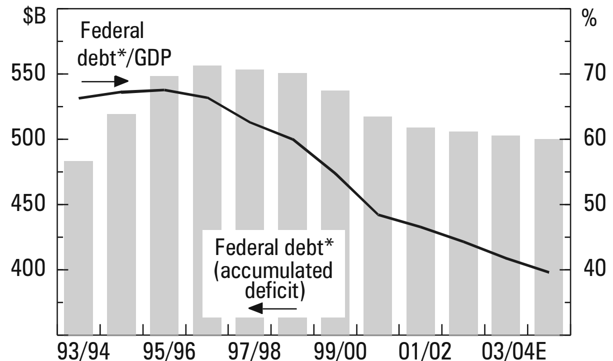
As much as Mr. Manley tried to be prudent and cautious in this gift-bag of spending initiatives, we still find some of the underlying assumptions a little on the high side. Canadian macro numbers have signalled moderation from the strong pace last year and will continue to show weakness for a while yet. This does not even account for the risks of potentially adverse effects from increased hostilities in the Middle East and a resumption of domestic terrorist activity in the U.S. and possibly in Europe. The budget assumes real growth this year of 3.2% after an estimated 3.3% in 2002 and a pickup to 3.5% in 2004. Our forecast calls for

Figure 1 – Balancing the Books



** Zero balances (after $3 billion contingency reserve) forecast for F02/03 through F04/05.*
*** Excludes foreign exchange requirements. A negative number indicates a need to raise cash and a positive number indicates a source of cash.*
Source: Federal Budget 2003.

Figure 2 – With Modest Debt Reduction



** Assumes $3 billion contingency reserve is used annually to reduce debt from F02/03 through F04/05.*
Source: Federal Budget 2003.

growth of 2.7% this year and 3.3% in 2004. On the deflator, the budget assumes a 2.2% rise this year and 1.9% next year, giving us nominal growth of 5.4% for both periods. We are a little more concerned with the 1.9% rise in employment forecast for 2004, following two years of hefty 2.2% increases. While strong job creation boosts PIT and EI receipts, it also casts a long shadow on productivity growth. In terms of the actual numbers, the feds cannot be faulted since they simply use the blue chip consensus and then rely on their own prudency reserves to keep them onside. Longer term is where the feds could have a problem. For one, an increased perceived security threat in the U.S. will make cross-border commerce with the U.S. even more problematic, and implementation of Kyoto will introduce its own governor on growth years down the road. The three-month bill rate is forecast at 3.3% for this year and 4.5% in 2004, while the 10-year GOC yield assumption is 5.4% this year and 5.9% next year.

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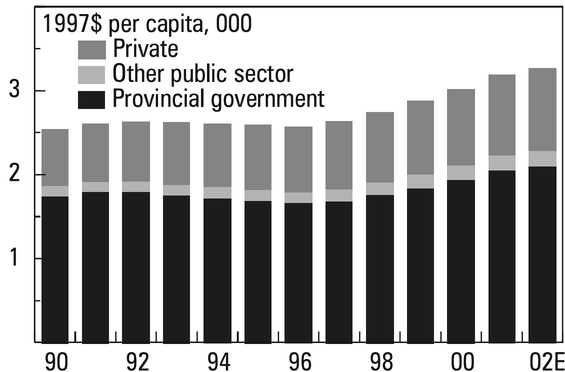
Fiscal Outlook

Back in the fall, the government was working with planning surplus assumptions of $1.0 billion in F2003, $3.1 billion in F2004, and $3.5 billion in F2005. Based on the change in economic conditions and forecasts, and initiatives taken in this budget, the feds would have been working with budgetary surpluses (after subtracting for contingency reserves and prudence) of $3.4 billion this year, and $4.2 billion and $5.7 billion in the next two fiscal years. That is, however, using the old method of modified accrual accounting. This budget makes the shift to full accrual accounting, and the net effect is to lift the budgetary surpluses to $9.4 billion, $8.8 billion, and $11.5 billion, respectively, for the three fiscal years. After subtracting contingency and prudency amounts, this leaves the government with planning surpluses of $6.4 billion, $4.8 billion, and $6.5 billion in these three fiscal years – a cumulative $17.7 billion, which is spent entirely on spending initiatives ($15.4 billion) and revenues ($2.3 billion). Under the full accrual methodology, accumulated deficits (federal debt) remain at $507.7 billion through to F2005, assuming contingency reserves are used. As with past budgets, any reserves left over at the end of each fiscal year will be applied to debt. Financial requirements in F2003 and F2004 will amount to $5.8 billion and $2.1 billion, respectively, following a source of funds of $3.4 billion this fiscal year.

Spending Initiatives

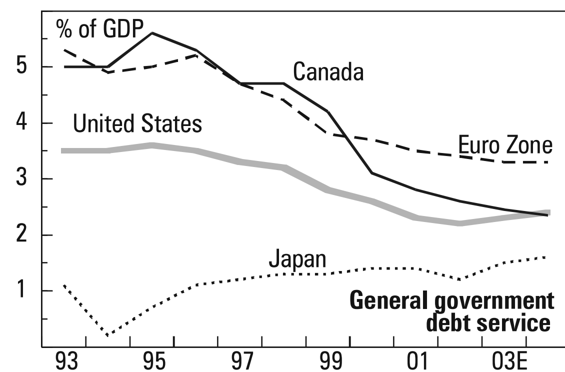
Health care initiatives represented the majority of the government's plans in this budget, accounting for $8.2 billion or 53% of all new expenditures during the next three fiscal years (that does not include $1.5 billion for the Diagnostic/Medical Equipment Fund and $600 million for the health information technology trust). The highlight of the health program is the one-time $2.5 billion CHST supplement that gets paid this fiscal year, while the Health Reform Fund gets $2.5 billion in fiscal years 2003 and 2004. Productivity-enhancing initiatives account for roughly $3.4 billion over three years or 22% of the total, while military and aid programs amount to $3.8 billion. Defence in particular picks up close to $1.9 billion over the period; however, there is an additional $325 million in contingency reserves added in for this fiscal year and next. As Finance Minister Manley promised, there was some reallocation of existing expenditures, freeing up $1 billion next year and another $1 billion in F2005.

Figure 3 – Canada's Health Care Spending



Source: Canadian Institute for Health Information.

Figure 4 – Canada Leads G7 in Fiscal Repair



Source: OECD; Scotia Economics.

Revenue Initiatives

This budget wasn't expected to be a tax budget – and it wasn't – and the government's own line would be that enough has been done in recent budgets anyway, beginning with the $100 billion package in the 2000 Budget. Over three years, total revenue initiatives amount to only $2.3 billion and the biggest contributors come from relief on corporate capital taxes, a further increase in annual RRSP contribution limits to $18,000 by 2006 from the current $13,500, and increased support for resource firms (reduction in corporate taxes from 28% to 21% over five years). On capital taxes, the proposal is for a complete elimination of federal capital taxes within five years and elimination of capital taxes on medium-sized business by 2004. This will be done in two steps – the first being an increase in the taxable threshold to $50 million from $10 million, and then a reduction in the rate of tax to zero by 2008. Note that the special capital tax on large financial institutions was not changed in this budget. Additional assistance was extended to persons with disabilities – $255 million over three years; unfortunately, this is still an income-tested relief. An increase in the National Child Benefit supplement pumps in $500 million over two years. As expected, the government lowered EI premiums to $1.98 per $1,000 of insurable earnings, representing $231 million worth of stimulus over three years.

Table 1 – Economic and Interest Rate Assumptions

Annual per cent change unless otherwise noted

		Finance Assumptions*		Scotia Economics	
	2002E	2003F	2004F	2003F	2004F
Real GDP	3.3	3.2	3.5	2.7	3.3
GDP deflator	1.1	2.2	1.9	2.5	1.8
Nominal GDP	4.4	5.4	5.4	5.3	5.2
3-month T-bills (%)	2.6	3.3	4.5	3.4	4.5
10-year Bonds (%)	5.3	5.4	5.9	5.3	5.8

** Private sector average.*
E = estimated; F = forecast.
Source: Federal Budget 2003.

*Table 2 – Ottawa's Pre-Budget Arithmetic**

	Actual	Forecast		
($B)	**01/02**	**02/03P**	**03/04F**	**04/05F**
Personal income tax	80.5	84.2	86.6	91.1
Corporate income tax	24.6	21.9	24.3	25.5
Employment ins. premiums	17.7	18.3	17.6	17.6
Sales & excise taxes	37.3	41.6	43.1	45.1
Other revenue	11.6	12.7	13.1	13.7
Total revenue	**171.7**	**178.7**	**184.7**	**192.9**
Transfers, persons	38.4	40.8	42.5	43.9
Transfers, provinces	26.6	32.8	31.0	33.2
Other program spending	59.3	65.0	69.5	72.4
Total program spending	**124.3**	**138.6**	**143.0**	**149.6**
Operating balance	47.4	40.1	41.7	43.4
Debt service	39.3	37.2	37.6	38.4
Contingency reserve	n/a	3.0	3.0	3.0
Economic prudence	n/a	0.0	1.0	2.0
Budget/planning surplus	**8.2**	**0.0**	**0.0**	**0.0**
Net financial balance*	**4.7**	**3.4**	**-5.8**	**-2.1**
Federal debt (accumulated deficit)**	**507.7**	**504.7**	**501.7**	**498.7**
Annual Percent Change				
Personal income tax	-6.2	4.5	2.9	5.2
Corporate income tax	-13.2	-10.7	10.9	4.9
Sales & excise taxes	4.2	11.5	3.6	4.6
Total revenues	**-5.8**	**4.1**	**3.3**	**4.5**
Transfers, persons	4.9	6.4	4.1	3.3
Transfers, provinces	7.7	23.1	-5.4	7.1
Program spending	**4.8**	**11.5**	**3.2**	**4.6**
Debt service	-10.0	-5.3	1.1	2.1
Memo items				
Revenue/GDP	15.7	15.7	15.4	15.2
Program spending/GDP	11.4	12.2	11.9	11.8
Net debt/GDP**	46.5	44.3	41.7	39.6
Debt service/revenue	22.9	20.8	20.4	19.9

** Components may not sum to totals because of rounding error.*
*** Assumes contingency reserve applied to debt reduction.*
P = preliminary; F = forecast.
Source: Federal Budget 2003.

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Quantitative & Portfolio Strategy

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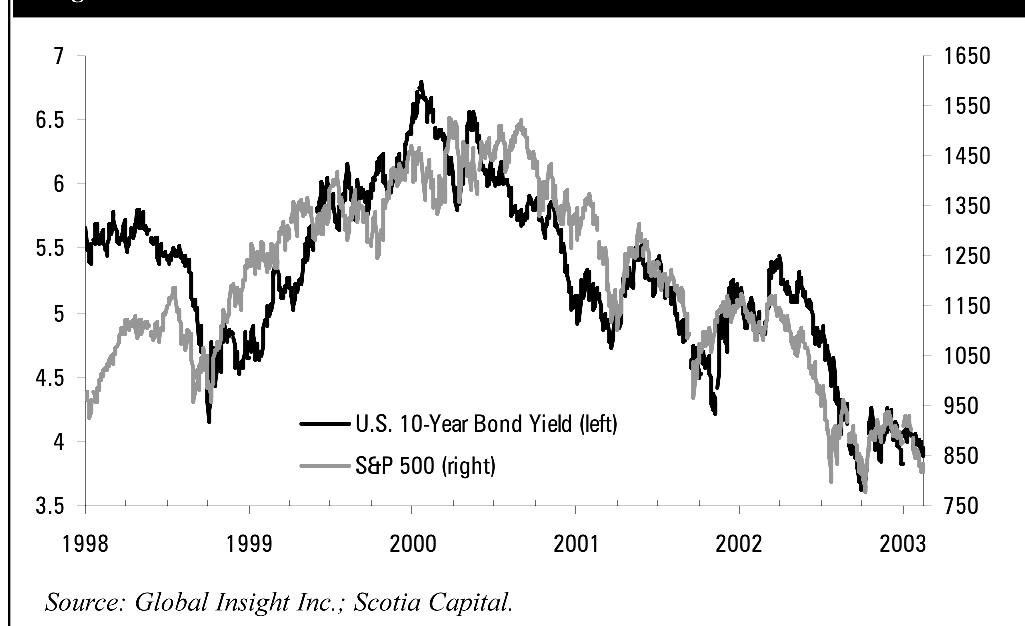
The Paul Martin Benefits Still Outweigh the Costs of the Jean Chrétien Legacy

The U.S. economy is on the mend and U.S. corporate profits are recovering. After nearly a 50% decline in North American stock indices over the last three years, and the anticipated new lows in U.S. bond yields, we now see S&P 500 ROE on the rise. This is far more significant than the recent budget. In fact, if the U.S. recovery were not taking shape, then the growth assumptions and spending plans in the budget would have no hope of being realized. Fortunately – and unfortunately – our growth depends on U.S. strength. Were it not for the threat of armed conflict and the possibility of further terrorist acts, then we could conclude that all the necessary pre-conditions for an equity market recovery had finally been met. After the worst equity market environment since the 1930s, it is easy to understand why these facts outweigh the budget. In this time of unprecedented consumer and Western government indebtedness, without a U.S. recovery, there is no Canadian government budget.

Figure 1 – U.S. 10-Year Bond Yield vs. S&P 500 Price



Source: Global Insight Inc.; Scotia Capital.

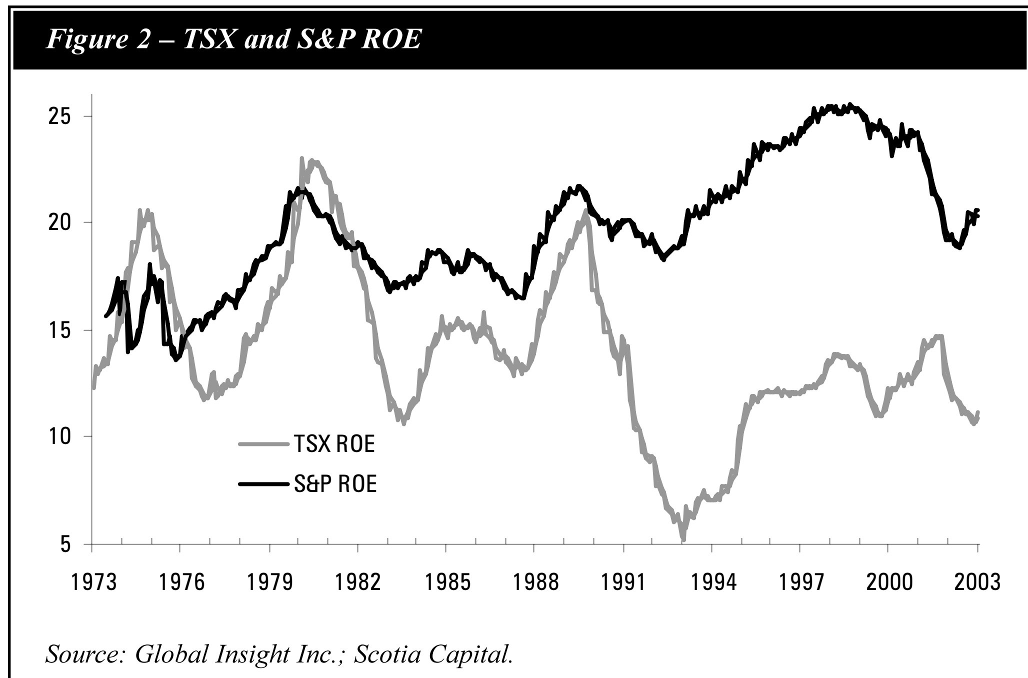
Since late 1998, U.S. bond yields and stock prices have been rising and falling in lockstep. This is a truly rare phenomenon. Over 130 years of U.S. history, this has consistently signalled a very weak economic environment and one that usually borders on or witnesses a generalized decline in prices (deflation). During these last few years, we have regularly pointed to interest rate ceilings. Simply put, if bond yields and stock prices rise at the same time, then the duration and magnitude of a stock market rally is limited by the bond yield ceiling. We will forgo all the technical details here but, suffice to say, these ceilings have been extremely accurate for years. The bond yield ceilings have also been falling for several years. For the first time, however, the combination of lower stock prices, lower bond yields, and rising S&P 500 ROE have pushed the ceiling **higher** to 5.7% (10-year U.S. treasury). Were it not for the threat of war and terrorism, the conditions are finally in place for an equity market recovery and this outweighs, by far, the significance of the recent budget.

The Economic Cost of Using Borrowed Money

Canada still labours under too much accumulated debt and too much taxation – the latter, in large part, to service the former. If the goal of overtaxing was to create surpluses for debt reduction, thereby, cutting our country's enormous interest costs, then that would make some economic sense. For example, an individual in the 50% tax bracket would probably see a reduction to a 40% tax rate if the current accumulated debt were eliminated. Roughly 20% of tax revenues are currently spent on interest costs associated with this debt. Similarly, if the goal were to cut taxes and enjoy greater GDP growth so that, bond markets willing, we grow more rapidly out of our debt/GDP, then this too makes some sense. Overtaxing to create surpluses for substantial social spending is risky business. It is worth noting that, in the budget's 27-page summary, only half a page was dedicated to tax reform and reduction. In general terms, less fiscally responsible policies have, for years, brought us to the point where the federal government's accumulated debt is half a trillion dollars!

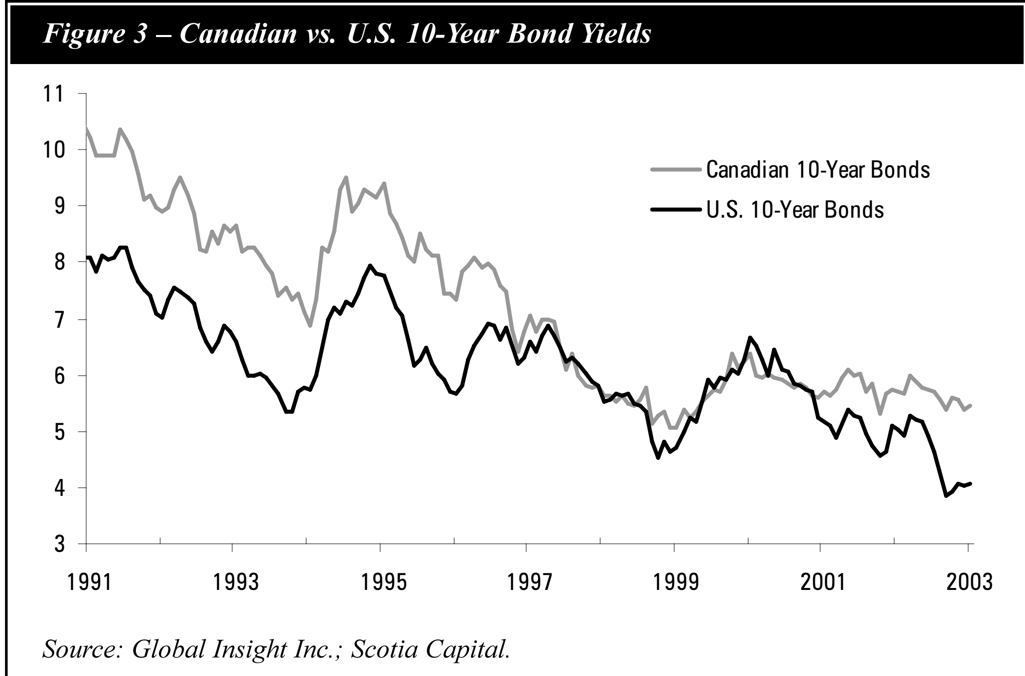
Canadians have paid an enormous price and it is unambiguous – no more mincing words. For example, since 1972, Canadian real GDP growth in currency adjusted terms is 1.6 %, nearly half that of the United States. The Canadian dollar has also been devalued by 40% over this time. Excessive indebtedness, overtaxation, and a weaker economy are the reasons that Canadian 10-year bond yields are still 140 bp higher than in the United States. Canadian businesses and Canadian consumers across the country pay a real and substantial price every day based on this interest rate differential. If we need more evidence of the economic costs, then its worth noting that TSX return on equity is 11% compared with the weighted-average operating ROE of 20% for the S&P 500!

Figure 2 – TSX and S&P ROE



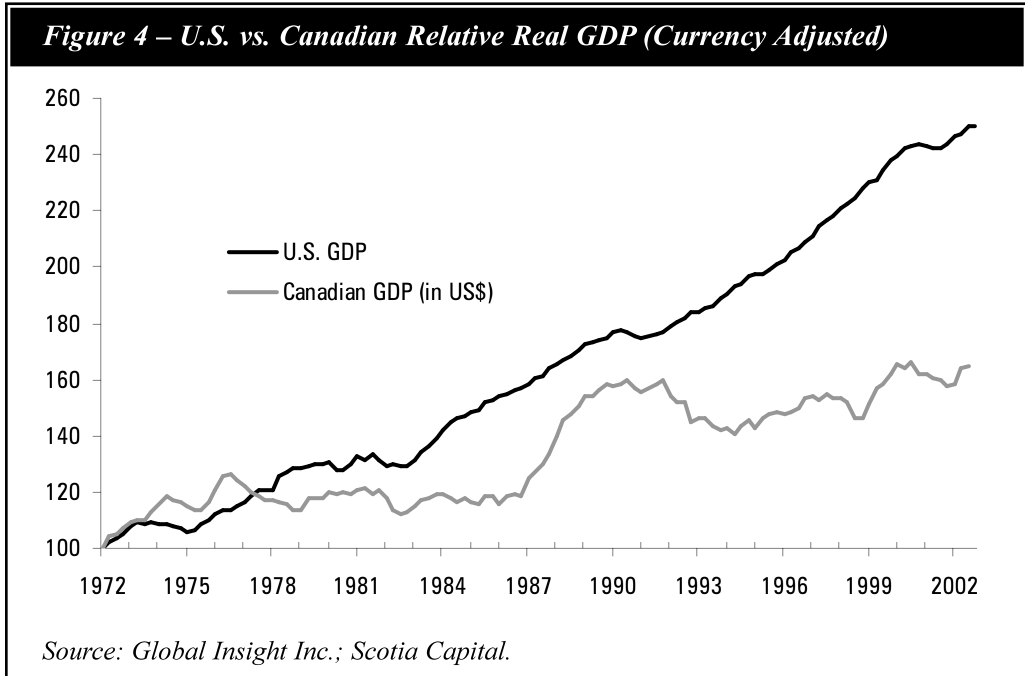
Source: Global Insight Inc.; Scotia Capital.

Figure 3 – Canadian vs. U.S. 10-Year Bond Yields



Source: Global Insight Inc.; Scotia Capital.

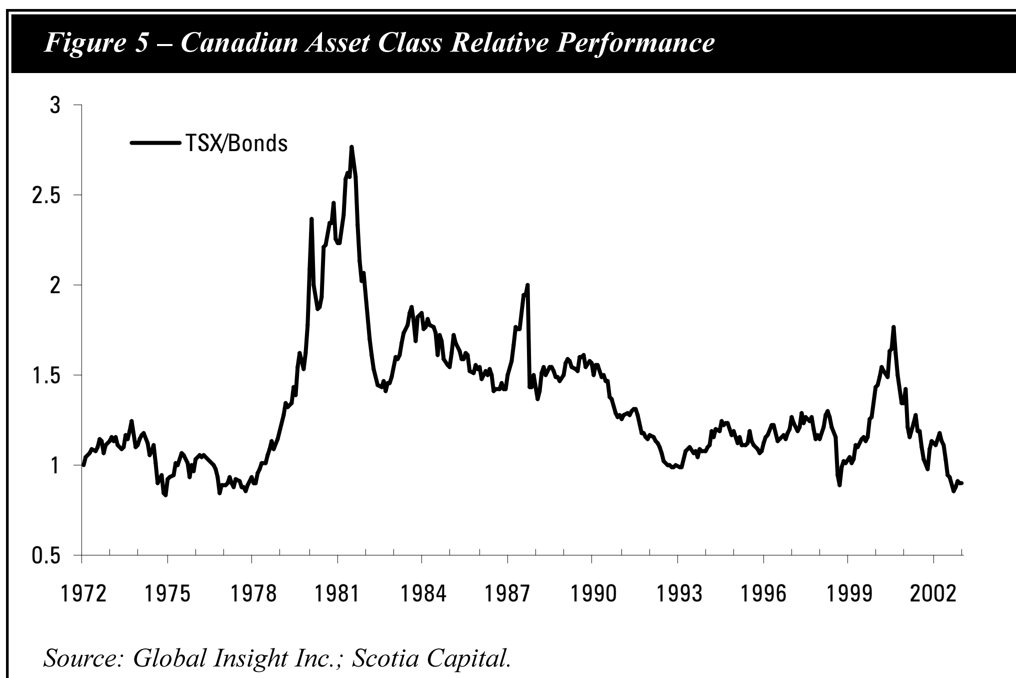
Figure 4 – U.S. vs. Canadian Relative Real GDP (Currency Adjusted)



Source: Global Insight Inc.; Scotia Capital.

By far, the most startling fact is that since 1973, the TSX has, on average, underperformed Canadian government bonds on a total return basis. In fact, over the same time frame, Canadian equities have barely outperformed T-bills. Better than any other anecdotal evidence, this demonstrates conclusively the economic costs of borrowing money to spend it and overtaxing to service debt. Without a doubt, the most fundamental premise of capital markets is that, in the longer term (e.g., over a two- to five-year period), stocks should outperform bonds in a healthy economy. Yet, this has not been the case over the last 30 years in Canada. This situation is reversed in the United States: despite the worst equity market collapse since the 1930s, the S&P has still outperformed bonds by 1.45 times and outperformed T-bills by 3.08 times over this time frame!

Figure 5 – Canadian Asset Class Relative Performance



Source: Global Insight Inc.; Scotia Capital.

Pension funds and individual Canadians own the majority of shares in publicly traded companies. Pension funds are the savings of individual Canadians and Canadian jobs depend on the health of Canadian corporations. The underperformance in the TSX relative to government bonds is a fundamental breakdown in sound economic principles. Whose legacy are we talking about?

Now, the Good News in the Budget

First, if the U.S., and therefore, Canadian recoveries are on track, then health care spending and spending on the environment may provide some economic stimulus. In addition, there is likely a small benefit to large companies in the reduction of unemployment insurance premiums. The initial benefit here in 2003/2004 will help smaller businesses. It might also be argued that the reduction in tax rates for resource companies is a partial offset to the costs of implementing the Kyoto Accord. Further, the higher RRSP contribution limits will help, but their positive impact is reserved for those making more than $75,000 to $100,000 per year; the government estimates a loss of $300 million in revenue over the next three years. Even if this contributed to an additional $1 billion of capital finding its way into equity markets, it would only represent 0.2% of the current market capitalization of the TSX.

The budget forecast also continues to project surpluses. One point of contention might be the average of private sector growth forecasts. In general, these forecasts are for real GDP growth of over 3.2%. We would only point out that there is considerable evidence to suggest that future growth will be weaker than this, perhaps closer to 2.5%. The budget then predicts that program spending will dip back below 12% as a proportion of GDP in 2003/2004 and 2004/2005. This will only occur if spending increases trail off in these years (as implied) **and** the GDP growth assumptions are also met. It is highly improbable that this budget will contribute to narrowing permanently the considerably higher interest rate structure in Canada relative to that of the United States.

Mr. Martin's Impact

This is a budget about massive spending increases rather than tax cuts or debt reduction. The most striking and positive feature of this budget is clearly the stamp of Paul Martin. As Minister of Finance, Mr. Martin implemented a five-year plan of tax reduction. Under this plan, corporate tax rates were expected to fall to 35% by 2006. If current Finance Minister

John Manley ensures that this budget is fully implemented by 2007/2008, then, after the elimination of the federal capital tax, the corporate tax rate should be 33.4%. This level is currently projected to be 6.6% lower in Canada than in the United States. If we consider the terrible economic costs of years of deficit spending and excessive indebtedness, then at least we can say that Mr. Martin's five-year tax reduction plan is still helping to reverse some of these costs.

The question is to what extent will this boost the current level of TSX return on equity (corporate profitability). Without taking into account any multiplier effect for real economic growth, its impact should be equal to a permanent increase of 150 bp in TSX ROE by 2008, all other things being equal. In truth, this would be an increase in ROE attributed to financial factors rather than operating factors such as rising margins or volume increases.

Nonetheless, this rise in TSX ROE should result in either increased stability in the future TSX P/E or perhaps even a slight expansion in multiples.

Our TSX and S&P targets are based on several important assumptions. First, the positive correlation between bond yields and stock prices does at the very least imply weaker growth in 2003/2004 than that forecast in the budget. Second, even with an economic recovery in 2003/2004, price/earnings multiples will compress slightly (after an enormous decline from 2000 to 2003) as earnings grow slightly faster than prices rise. In general, as we have argued for a couple of years, multiples are in a longer-term downward trend. It is hoped that this resembles the early 1900s rather than the path of P/Es in the 1930s (see Figure 6). Third, earnings will also grow at a slower-than-normal rate so that overall returns in the equity market should average 8%-10%. These rates of return resemble the averages of the last 100 years but not the anomalous returns witnessed during the 1980s and 1990s. It is the returns of the last two decades that were unusual not the return prospects going forward. Investors, however, still appear to be having trouble adjusting to the lower, historically more normal, rate of return expectations. If all goes well, P/Es should remain volatile for two years, but temporarily stabilize around the 20x level. The next significant development in the next few years will likely be the devaluation of the U.S. dollar, perhaps in the 2005/2006 time frame. For more details, please see our December 2002 publication *Au-Inconceivable*.

All things considered, the goal of reversing 30 years of economic damage from decades of deficit spending and accumulated debt must remain the government's highest priority. In Mr. Manley's own words, the European and Japanese economies are "subdued" and the U.S. recovery is "uneven." There are great social benefits from some of these spending plans if they are implemented efficiently. Canada, however, will not grow if the global economy, and particularly the U.S. economy, languish. Fortunately, Mr. Martin's five-year tax reduction plan from an earlier budget remains the most positive feature of fiscal prudence in this budget. This, coupled with the evidence of a more fairly valued U.S. stock market and ROE growth have finally, at long last, set the stage for an equity market recovery. On a long-term historical P/E valuation basis, the U.S. equity market is still expensive; however, the combination of ROE and prevailing low interest rates suggest valuations that are attractive. The returns will not be spectacular, and the stock market's positive correlation with bond yields should continue. The unfortunate trading nature of this equity market should remain pronounced and volatility should remain at levels comparable to a much earlier time. In general, however, equities should generate an average 8%-10% annual return for 2003/2004. In this environment, internal growth for companies based on high and rising ROE levels is the best source of superior returns.

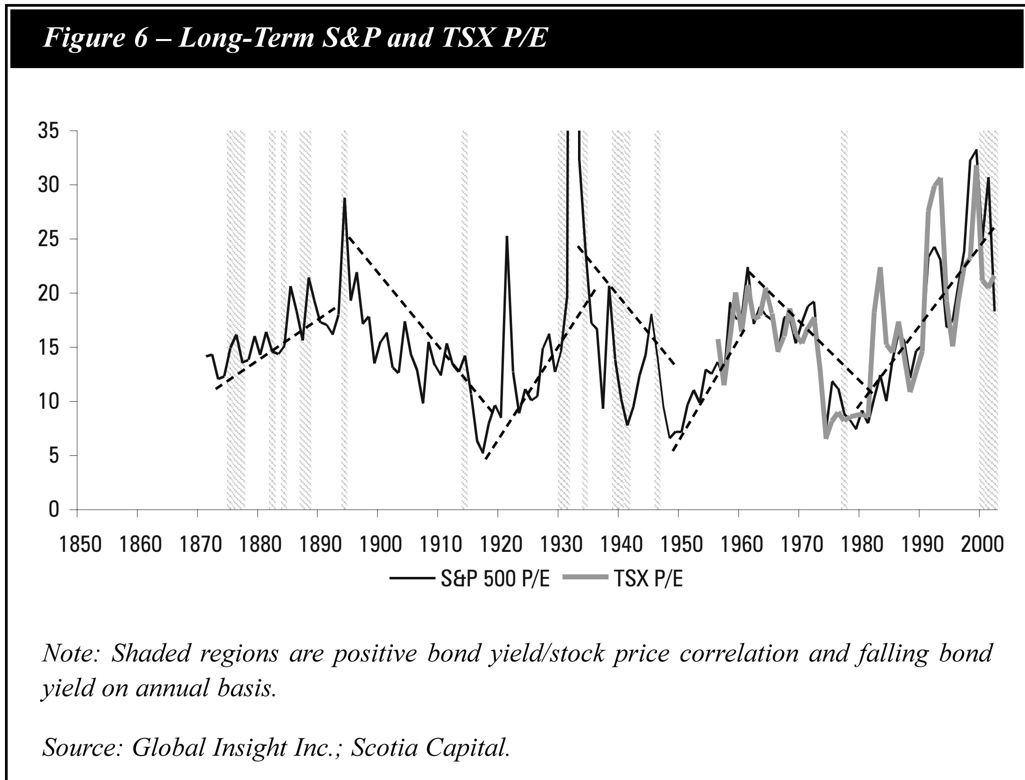
Table 1 – Market Estimates and Earnings

	Recent	Year-End 2003E
Canada		
TSX Composite	6592	8000
Earnings	324	368
Dividends	130	130
Earnings Yield	4.92%	4.60%
Long Canada 30-Year Bond Yield[1]	5.53%	5.90%
Earnings Yield minus Bond Yield	-0.61%	-1.30%
Dividend Yield	1.97%	1.63%
Valuation P/E (Normalized)[2]	20.3	21.7
3-Month T-Bills[1]	2.83%	4.10%
10-Year Bond Yield[1]	5.05%	5.60%
United States		
S&P 500	851	1030
3-Month T-Bills[1]	1.17%	2.80%
10-Year Treasury Yield[1]	3.95%	5.00%

[1] *Scotia Economics estimates.*
[2] *Please see three* Weekly EDGE *articles: 1) "What Is the Market's True P/E"; 2) "Stress Testing P/Es"; 3) the June 28, 2002 Strategy Update.*

Source: Global Insight Inc.; Scotia Capital.

Figure 6 – Long-Term S&P and TSX P/E



Note: Shaded regions are positive bond yield/stock price correlation and falling bond yield on annual basis.

Source: Global Insight Inc.; Scotia Capital.

Health Care

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As was expected following the findings of the Romanow Commission on the Future of Health Care in Canada, this year's budget played to the widespread public demand for increased spending on the Canadian health care system. The budget provides for an additional $17.3 billion in funding over three years and $35 million over the next five years. While the overall numbers look impressive, it should be noted that the bulk of the spending is weighted to the near term, with a significant portion going toward health care reform initiatives. According to the budget, the breakdown by spending category is as follows.

- $9.5 billion in increased transfer payments to the provinces plus a $2.5 billion supplement.
- $16 billion for a Health Reform Fund, which will provide additional funds for primary care, home health care, and catastrophic drug coverage.
- $1.5 billion to improve publicly funded diagnostic services.
- $600 million to accelerate the development of electronic health records.
- $1.6 billion in direct Health Accord initiatives.
- $1.4 billion for other health reform initiatives and $1.3 billion for First Nations health care services.

As with all aggregate funding measures, it is difficult to assess the ultimate impact on our universe of Canadian health care stocks, let alone on any individual company. Nevertheless, it is useful to examine which companies have the most exposure, if any, to certain budget items. Our universe of stocks includes Biovail Corporation, MDS Inc., Angiotech Pharmaceuticals, Axcan Pharmaceuticals, and Patheon Inc.

Of the companies that have direct exposure to pharmaceutical spending – Biovail, Angiotech, Axcan, and Patheon – none have a significant portion of their revenue tied to the Canadian market. Axcan and Patheon both derive about 13% of their business from domestic sources and Biovail only 8%. Angiotech will see its first product revenue come from Europe shortly, followed by the U.S. in 2004, but will not likely see any Canadian sales for some time. The United States is, without a doubt, the most important pharmaceutical market in the world, representing nearly 50% of worldwide pharmaceutical revenue ($364 billion in 2001). Additionally, the liberal environment with respect to drug pricing has made it by far the most profitable market in which to operate. Canada, in contrast, makes up only a small portion of the total market and its heavily regulated prescription drug coverage does not provide much profit incentive. **Therefore, the budget items that relate to drug spending and new drug approval will have only a minor effect if any on these companies.** Furthermore, since companies in the Canadian pharmaceutical sector have relatively small drug portfolios, they are more highly leveraged to the fate of individual drugs than to aggregate pharmaceutical spending levels.

The company most highly levered to overall health care spending in Canada is MDS, which sees about 37% of its revenue come from the domestic market. The majority of MDS' revenue comes from its diagnostics and health care distribution businesses. The diagnostics business provides laboratory services to provincial health care plans on a tightly regulated contract basis (contracts are renegotiated every two years). The company has recently renewed its deal with British Columbia (the second-largest market) and will begin negotiations with Ontario (the largest market) shortly. Any increase to provincial health care budgets is

certainly an advantage at the bargaining table, but since each individual province is responsible for apportioning the funding increases based on regional program need, it is impossible to determine what the overall impact will be to MDS. The budget does establish a $1.5 billion pool for diagnostics services; however, the money appears to be set aside for spending on medical equipment, so there appears to be no direct benefit to diagnostic service companies such as MDS. The same holds true for the distribution business, which provides medical supplies to hospitals across the country. While any increase in aggregate funding and the funding to global hospital budgets is a good thing for the medical supply business, it is too soon gauge what the overall impact will be.

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Several items proposed in the budget directly affect Canadian resource companies operating in mining (base metals and gold) and paper & forest products. Although we believe the immediate impact on earnings appears minimal, the trend set in place by the budget for declining tax rates over the next five years will be positive for the resource group as a whole. We do not anticipate material changes to our earnings forecasts or share price targets based on proposals set out in this budget. In addition, we do not expect any material increase in exploration or investment in the resource sector as a result of the latest budget, as it pertains to mid- to large-sized resource companies. The government proposes to improve the taxation of resource income by phasing in, over a five-year period, the following initiatives.

1) **Positive impact:** Resource companies will now be included in the five-year tax reduction plan that was established by the 2000 budget. As a result, income generated from resource activities will be subject to a declining federal statutory corporate income tax rate. This rate is scheduled to decline from 28% to 21% over a period of five years. Most Canadian resource companies have been actively managing their corporate structure to make it as tax-effective as possible and may not get the full benefits suggested by the tax rate decrease. We note that the Department of Finance will review these changes to the tax structure for the resource sector with industry, provinces, and interested parties prior to the finalization and tabling of the implementing legislation. A technical paper to be released by the Department of Finance shortly is expected to set out the proposed changes in greater detail.
2) **Positive impact:** A reduction in stages of the federal capital tax (approximately 0.225%) over a period of five years so that, by 2008, the tax will be completely eliminated. We note that at present, the capital tax is reduced by the income surtax paid by a corporation. In addition, a proposed increase in the capital threshold from $10 million to $50 million in 2004 will have minimal impact on overall tax paid by Canadian mining companies.
3) **Positive impact:** A deduction for actual provincial and other Crown royalties and mining taxes paid. This deduction appears to apply to the calculation of resource income and was not quantified. At this point, it is unclear if stumpages paid to the provinces to harvest trees on Crown land will qualify for this deduction and, if so, what would be the impact on the current negotiations aiming at solving the Canada-U.S. softwood lumber trade dispute.
4) **Positive impact:** For the smaller investor, the budget extends the existing temporary mineral exploration tax credit provided to individuals who purchase eligible flowthrough shares until December 31, 2004.
5) **Positive impact:** A new tax credit for qualifying mineral exploration expenditures. This new credit appears to target the smaller exploration companies and/or prospectors.
6) **Negative impact:** The elimination of the existing 25% resource allowance that is currently used as a deduction in determining taxable income.

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Energy Utilities

The additional spending introduced for advancing Canada's climate change plan (i.e., Kyoto) is $2 billion over five years. A further $34 million will be spent over two years for other sustainable development commitments (i.e., federal contaminated sites) and a further $600 million over five years for water and wastewater systems on reserves.

The federal budget made no specific reference to new or higher pollution penalties for high-emission coal-fired and/or oil-fired power plant owners. This is a mild relief for shareholders in publicly traded TransAlta Corporation (TA-T; 1-Sector Outperform), ATCO Ltd. (ACO.X-T; 1-Sector Outperform), Canadian Utilities Limited (CU-T; 3-Sector Underperform), and Emera Incorporated (EMA-T; 3-Sector Underperform). Higher pollution penalties would be passed through to the owners of the coal-based Alberta Power Purchase agreements, while the Nova Scotia Regulator would have to allow higher federal pollution costs to be passed through into Nova Scotia rates. Kyoto costs per CO_2 tonne emitted by Canadian companies have been previously capped by the federal government at C$15 per tonne of CO_2 emissions until 2012.

Chemicals

Canadian farmers will receive $5.2 billion of federal support over the next six years (previously announced in June 2002). A further $0.5 billion was allocated to agricultural policy initiatives, including $220 million for the Crop Reinsurance Fund, which ensures farmers will receive future payments. This should mildly support Canadian focused fertilizer producer Agrium Inc. (AGU-T; 1-Sector Outperform) that supplies a majority of Alberta's farmer nitrogen and phosphate fertilizer needs.

The reduction of the Federal Resource Tax to 21% over five years is gradually supportive of the Saskatchewan potash producers that had an effective tax rate of over 30% when the Resource Tax was at 28% in 2002. Additional provincial royalties were not deductible for federal tax purposes and, for now, continue to be non-tax deductible. This should mildly support Potash Corporation (POT-T; 1-Sector Outperform), as the company is Canada's largest potash producer.

The federal government's $2 billion spending on climate change referenced support for ethanol fuel, but not methanol or MTBE fuel. Canada's only methanol-based MTBE plant is being converted to producing alkylate gasoline components for California-based Chevron (50% owner of the Edmonton-based MTBE plant) due to California's decision to eliminate MTBE. Canada's existing ethanol is produced from corn, but could be produced from wheat, barley, or other cellulosic or food-based byproducts. This would be slightly supportive for Agrium through the providing of a new revenue source for Canada's farmers. It is slightly negative for methanol producer Methanex Corporation (MX-T; 2-Sector Perform) due to the loss of methanol demand for the world-scale Edmonton MTBE plant.

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Personal Tax Initiatives

The 2003 Federal Budget proposes a number of personal tax initiatives. They are as follows.

1) An increase in RRSP and RPP contribution limits.

RRSP contribution limits will be as follows:

- $14,500 for 2003
- $15,500 for 2004
- $16,500 for 2005
- $18,000 for 2006

Registered Pension Plan contributions will be as follows:

- $15,500 for 2003
- $16,500 for 2004
- $18,000 for 2005

2) An increase in the defined pension benefit amount.

The current maximum defined benefit pension amount of $1,722 per year of service will be increased to $1,833 for 2004 and $2,000 for 2005.

3) RRIF-type payouts for defined contribution pension plans.

Currently, upon retirement, money purchase RPP members must either purchase a life annuity or transfer the funds to a locked-in RRSP. Beginning in 2004, the budget proposes to allow money purchase (defined contribution) pension plans to pay pension benefits in the form of the same income stream currently permitted under a RRIF.

4) An increase to the National Child Benefit.

The Canada Child Tax Benefit (CCTB) is an annual non-taxable payment made to low income families with children. The CCTB is phased out for families earning more than $33,487. The National Child Benefit is an additional payment made available to low-income families. Its phase-out begins at $22,755. Families earning over $33,487 do not qualify for the NCB.

The 2003 Federal Budget proposes to increase the NCB supplement as follows:

- $150 per child in 2003
- $185 per child in 2005
- $185 per child in 2006

5) The Child Disability Benefit.

This new income-tested benefit will be available to families with children who have a severe and prolonged mental and physical impairment. The eligibility criteria will be based on the same eligibility used for the disability tax credit. The full $1,600 benefit will be available to families receiving the National Child Benefit (incomes of less than $33,487).

6) RRSP/RRIF rollovers for an infirm child/grandchild.

The current RRSP/RRIF rollover provisions allow a financially dependent infirm child/grandchild to receive a tax-free rollover of a deceased parent's RRSP or RRIF. The 2003 Budget proposes to increase the level of income used to determine the financial dependence of the infirm child from $7,634 to $13,814, effective in 2003.

7) Medical expense tax credit.

For the 2003 taxation year, the budget proposes to expand the list of expenses eligible for the medical expense tax credit to include:

- the cost of real-time captioning and other similar services used by persons with an impairment and
- the incremental cost of gluten-free food products for individuals with celiac disease.

8) Capital gains rollover for small business investors.

The current rules allow an individual to defer having to pay tax on the disposition of common shares of an eligible small business corporation provided the proceeds are reinvested in commons shares of other eligible small business corporations. This deferral was capped at an individual's investment of $2 million.

As of February 18, 2003, the capital gains rollover measure will be expanded by:

- eliminating the $2 million limit on the amount of the original investment on which the deferral is allowed;
- eliminating the $2 million limit on the amount that can be reinvested; and
- allowing a reinvestment to be made at any time in the year of disposition or within 120 days after the end of the year.

9) An improved automobile standby charge.

The standby charge reflects the benefit of having an employer-provided vehicle available for personal use. For 2003 and subsequent taxation years, the budget proposes to:

- increase allowable personal driving kilometres from 12,000 to 20,000 and
- reduce the current requirement that 90% of driving is for business purposes down to 50%.

Corporate Tax Initiatives

The 2003 Federal Budget includes two significant corporate tax initiatives, which we highlight below.

1) A reduction in the small business tax.

The small business deduction reduces the basic federal corporate income tax rate to 12% for the first $200,000 of active business income of a Canadian Controlled Private Corporation (CCPC). The budget proposes to increase the $200,000 limit as follows:

- For 2003, to $225,000
- For 2004, to $250,000
- For 2005, to $275,000
- After 2005, to $300,000

2) The reduction/elimination of federal capital tax.

The federal capital tax is applied to a corporation's taxable capital at a rate of 0.225% on taxable capital in excess of $10 million. For taxation years ending after 2003, the budget proposes to increase the $10 million threshold to $50 million. As well, it is proposed to reduce the tax rate as follows:

- For 2004, to 0.200%
- For 2005, to 0.175%
- For 2006, to 0.125%
- For 2007, to 0.0625%

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Definition of Ratings and Risk Rankings

Ratings

1-Sector Outperform:	The stock is expected to outperform the average total return of the analyst's coverage universe over the next 12 months.
2-Sector Perform:	The stock is expected to perform approximately in line with the average total return of the analyst's coverage universe over the next 12 months.
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Risk Rankings

Low:	Low financial and operational risk, high predictability of financial results, low stock volatility.
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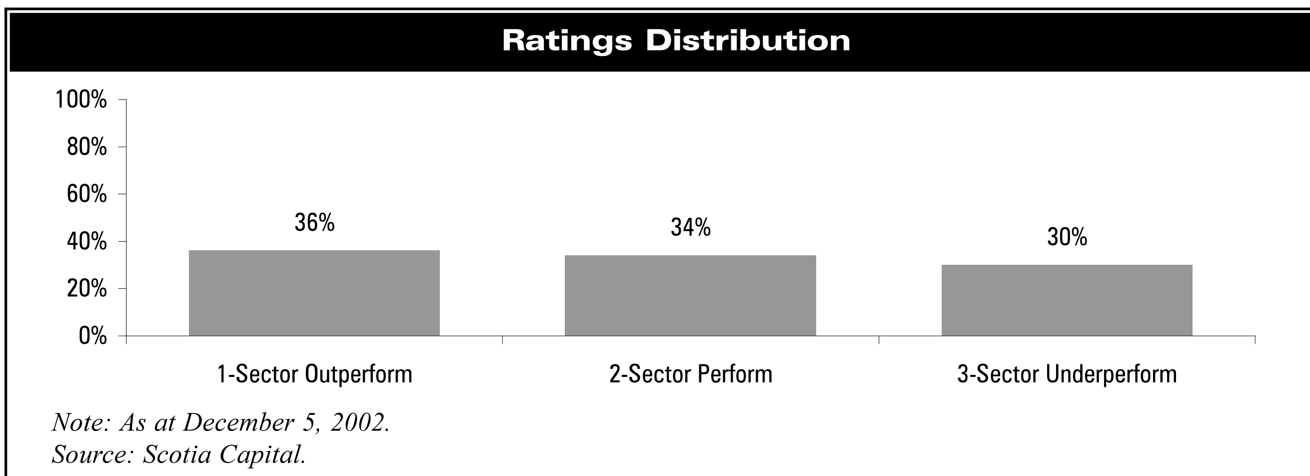
Source: Scotia Capital.

Ratings Distribution



Note: As at December 5, 2002.
Source: Scotia Capital.

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