Intelligence MEMOS

From: Colin Busby

To: Parliament Watchers

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Re: **The Three Big Challenges Facing Parliament Next Week**

Three big policy issues will be the focal point when Parliament resumes next week.

The government faces a challenging balancing act as it works against the backdrop of a weakening economy – the unemployment rate is at 7.1 percent and the working-age employment rate fell for the first time since the pandemic this summer.

Success hinges on delivering: 1) a fall budget that is both transformative yet fiscally credible; 2) trade negotiation progress that calms business uncertainty over the medium term; and 3) major infrastructure projects to foster economic growth and transformation.

The State of Federal Finances and the Fall Budget

The April 2024 budget foresaw a federal deficit of $18.4 billion in 2028/29, and more recent figures at the end of 2024 showed a baseline deficit of $23 billion by that time. Recent estimates by the C.D. Howe Institute suggest, once taking into account additional spending on defence and election promises, that number today could be closer to $60 billion.

On top of election promises, there will be more than $8 billion in additional funds devoted to national defence this fiscal year, and a commitment of more than $70 billion in additional military spending over the next 10 years to reach NATO targets. It is unclear how the federal government will plan for for this increased cost on its bottom line – or if it will simply finance it by issuing debt.

The fall budget must also tackle the pledge to split capital and operating budgets. And as of right now, what should be labelled capital investment is unclear. The Liberal platform pledged to "recharacterize as capital spending new incentives that support the formation of private sector capital (e.g., patents, plants, and technology) or which meaningfully raise private sector productivity," which leaves a lot of room for interpretation.

Plus, the early summer announcement for a federal spending review aims to cut targeted program expenses by 15 percent by 2028/29. But the review, since it excludes transfers to individuals and the provinces, only encompasses 33 percent of total program spend. That is limited space to investigate inefficiencies, and probably not enough to get overall spending down to a better level, let alone accommodate the defence boost over the next decade. The fall budget will be a major test for this government and a thorny balancing act.

US Trade Negotiations and Trade Diversification Progress

A trade and security deal with the United States remains elusive. And on top of that, the government must factor in the 2026 renewal of Canada-US-Mexico Agreement (CUSMA). Anticipate the July 2026 review should make for a smoother renewal. Given that around 90 percent of Canadian exportable goods are currently exempt from tariffs under CUSMA, the government will want to ensure that this required review of the agreement is included or at least foreseen.

The C.D. Howe Institute's trade crisis working group, rightly, favours a "temporary suspension of Canadian retaliatory tariffs, and supports Canada offering to make additional pledges around restricting transshipments from third countries through Canada into the United States, critical minerals developments, and even providing guarantees of Canadian direct investments in the United States or purchases of US government securities – in addition to those commitments Canada already made around defence spending and border security – as part of the mix that could facilitate a framework agreement that would underpin the renewal and extension of CUSMA favourable to all three countries."

Our integrated supply chains, however, do give us significant bargaining strength. For example, Canada supplies more than half of US aluminum imports. And that level of integration gives Canadian negotiators strong footing to not settle for tariff rates of around 10-15 percent that the EU-UK-and Japan recently negotiated.

The growing concern, however, is that companies are starting to reconsider the location of their investments as trade disputes linger. Do businesses view the state of conflict as more permanent or temporary? The answer to this question is material. This could be a very troubling situation for Canadian policymakers and is critical to business confidence and investment decisions going forward.

Major Infrastructure Projects and Bill C-5

Bill C-5, which became law in the final days of the house's pre-summer session, is poised to be the major pillar of economic policy for this government, and it has tremendous potential, even if progress on certain projects is uncertain. All signs point to a renewed sense of optimism among private businesses interested in major infrastructure projects, with the five projects announced yesterday.

It will become a point of contention to understand which projects are selected and why, which further begs the biggest question: Can the government attract sufficient private capital to join in?

This is going to be a critical and momentous fall session for the federal government. How it acts against a weakening economic backdrop and delivers a credible fall budget, advancements on major infrastructure projects, and some trade certainties, are three central priorities that are key for success.

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