# BUDGET EXPRESS

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## FEDERAL BUDGET SPEECH OF FEBRUARY 18, 2003

1. Fiscal Comments

2. Economic Comments


Office of the Vice-president, Tax Service
Office of the Vice-president, Economic Studies


INFORMATION BULLETIN


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# FISCAL COMMENTS

Canada's Finance Minister John Manley tabled his budget this afternoon. This budget announces no personal tax cuts, the main point being an increase in RRSP and pension fund limits.

For businesses, there is an increase in the deduction for small businesses and a gradual reduction of the capital tax.

## MEASURES AFFECTING DESJARDINS - BUSINESSES

### Deduction for small businesses

In order to provide additional support to small businesses, the 2003 budget proposes that the annual amount of active business income eligible for the reduced 13.12% tax rate be increased by $100,000 to $300,000 as follows:

- for 2003, to $225,000,
- for 2004, to $250,000,
- for 2005, to $275 000,
- after 2005, to $300 000.

These small business limits will be pro-rated where the taxation year of the corporation does not coincide with the calendar year. In addition, there will continue to be a requirement to allocate these limits among associated corporations, and the limits will continue to be reduced on a straight-line basis for CCPCs having between $10 million and $15 million of taxable capital employed in Canada.

As a consequence of increasing the small business limit, some CCPCs with taxable income above $200,000, but below the proposed new limits, will now be able to pay the balance of theirs taxes at the end of the third month after the end of their taxation year.

### Capital Tax (Part 1.3)

In order to promote investment, the budget proposes to eliminate the federal capital tax over five years, starting January 1, 2004. This proposal will be implemented by increasing the threshold for application of the tax from $10 million to $50 million of capital, for taxation years ending after 2003, and by reducing the rate of tax over the period 2004 to 2008, as follows:

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| Rate (%) | 0.225 | 0.200 | 0.175 | 0.125 | 0.0625 |

Rates will be pro-rated for taxation years that do not coincide with the calendar year. The increased $50-million capital deduction will apply to all taxation years ending after 2003, and will not be pro-rated. However, this deduction will continue to be allocated among corporations within a related group.

### Various Administrative Measures

Currently, credit unions whose taxable income during a fiscal year were lower that $10,000 did not have to make instalments for the following fiscal year. This measure will be eliminated for the taxation years beginning after June 2003. However, the measure determining that no instalments are required when the total amount of tax is under $1,000 remains.

Several other administrative measures were announced in the budget and are mainly designed to change the time when interests become payable to taxpayers.

### Scientific Research Tax Credit

As a consequence of the proposal to increase the small business limit, the budget also proposes that the $2-million expenditure limit on scientific research and experimental development be phased out where taxable income in the previous years is between $300,000 and $500,000. This change will apply where the previous taxation year ends after 2002. The phase-out based upon taxable capital will not be changed.

## MEASURES AFFECTING INDIVIDUALS

***RRSP and RPP (registered pension plans) limits***

The budget proposes increasing the limits of RRSPs and RPPs according to the following table:

| (in dollars) | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| **RRSPs** | | | | | |
| *Annual contribution limit* | | | | | |
| Existing | 13,500 | 14,500 | 15,500 | Indexed | |
| **Proposed** | **14,500** | **15,500** | **16,500** | **18,000** | **Indexed** |
| **Defined benefit RPPs** | | | | | |
| *Maximum pension benefit (per year of service)* | | | | | |
| Existing | 1,722 | 1,722 | Indexed | | |
| **Proposed** | **1,722** | **1,833** | **2,000** | **Indexed** | |
| **Money purchase RPPs** | | | | | |
| *Annual contribution limit* | | | | | |
| Existing | 14,500 | 15,500 | Indexed | | |
| **Proposed** | **15,500** | **16,500** | **18,000** | **Indexed** | |

### Automobile Benefit

When an employer provides an employee with an automobile, the tax legislation determines how to calculate the taxable benefit that must be allocated to the employee. In general, the employee must be taxed for the benefit of a standby charge equal to two thirds of the lease payout or 2% per month of the original cost of the vehicle. Actually, this charge can be reduced to the extent that personal driving is less than 12,000 kilometres per year, but only if 90% of the driving is for business purposes.

The budget proposes to allow the reduced standby charge to apply to the extent that annual personal driving does not exceed 20,000 kilometres, and to reduce the threshold of use for business purposes from 90% to 50%. For example, where a vehicle is driven 25,000 kilometres a year for business and 15,000 kilometres a year for personal driving, the employee will benefit from a reduction of his taxable benefit for personal use as he will satisfy the two conditions (i.e. less than 20,000 kilometres for personal use and over 50% for business purposes). To calculate the standby charge another way, the benefit is multiplied by the ratio of personal mileage (15,000 in the example) and 20,000.

This measure will apply to the 2003 and subsequent taxation years. The individuals affected by this measure should review the estimate of the taxable benefit for 2003.

### RRIF-type Payouts from Money Purchase RPPs

The budget proposes after 2003 to allow money purchase RPPs to pay pension benefits in the form of the same income stream currently permitted under a RRIF. This measure will allow money purchase plan members to choose to benefit from the flexibility a RRIF offers without having to assume greater responsibility for investment decisions. A member will be required to withdraw from his/her money purchase account a minimum amount each year determined in accordance with the existing rules that apply to RRIFs.

### Enhancements to the Child Tax Benefit (CTB)

The budget proposes to increase the CTB annual supplement by $150 per child in July 2003, by $185 in July 2005 and by $185 in July 2006.

In addition, realizing the special needs of low- and modest-income families with disabled children, the budget proposes the establishment of a child disability benefit of $1,600. This benefit will be added to the CTB paid for children eligible to the child disability benefit. This new benefit will be based on family income.

**Capital Gains Rollover with respect to investments in Small Business**

The 2000 federal budget introduced a measure allowing an individual to defer the taxation of a capital gain on investments in eligible small business shares if the proceeds of disposition are reinvested in other eligible small business shares, within 120 days of the transaction, up to a maximum investment of $2M.

This budget removes the $2M limit so that the capital gains taxation can be entirely deferred if the proceeds of the disposition are reinvested in another eligible small business. In addition, the purchase of eligible shares can be done at any time in the year of disposition or within 120 days after the end of the year.

These changes apply to dispositions occurring after February 18, 2003.

**Deceased RRSP/RRIF rollovers to an infirm child**

Currently, if a child or a grandchild is a dependent of a deceased annuitant due to a physical or mental disability, the proceeds of the RRSP or the RRIF can be transferred tax free to the child's RRSP or be used to purchase an immediate life annuity.

Starting in 2003, the budget proposes to increase from $7,634 to $13,814 the level of income used to determine the financial independence of an infirm child or grandchild.

**Eligibility Criteria for the Disability Tax Credit**

As regards the disability tax credit, the budget revised the definition of "feeding oneself" to make individuals with celiac disease who require a gluten-free diet ineligible to this credit.

However, starting in 2003, the incremental costs associated with the purchase of gluten-free food will be added to the list of medical expense tax credit for these individuals.

**Administrative Measure**

For income tax purposes, interest on a refund payable to an individual begins to accrue only on the later of the day that is 45 days after the taxpayer's balance due day, and the day that is 45 days after the return claiming the refund is filed. This period will be reduced to 30 days in 2003.

# ECONOMIC COMMENTS

## A budget that stays the course and focuses mainly on health care

### Highlights

No surprises in the budget Minister of Finance John Manley tabled. Despite Canada's economic prosperity, caution is what the minister is mainly concerned with as the main financial balances are still ensured. As expected, health care gets over 50% of the new expenditure measures. The budget also proposes that the government now adopt full accrual accounting, making its financial statements more comprehensive and transparent.

- The government's sound management and the resilience of the economy helped post six annual budget surpluses in a row and cut the federal debt by over 50B$.

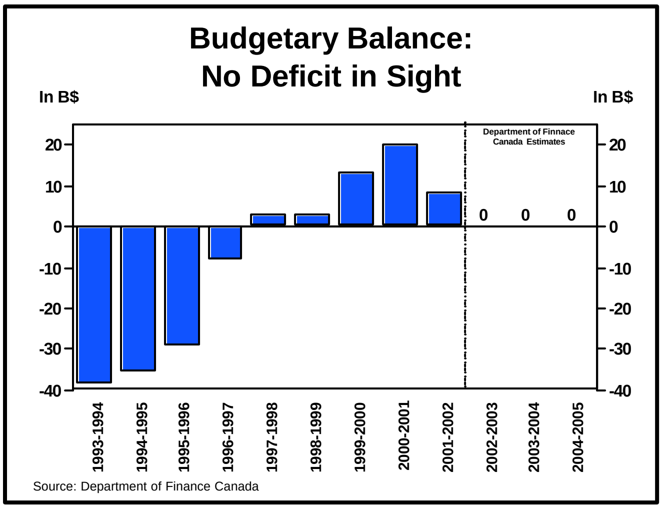
- Public finances will be balanced in each of the next two fiscal years.

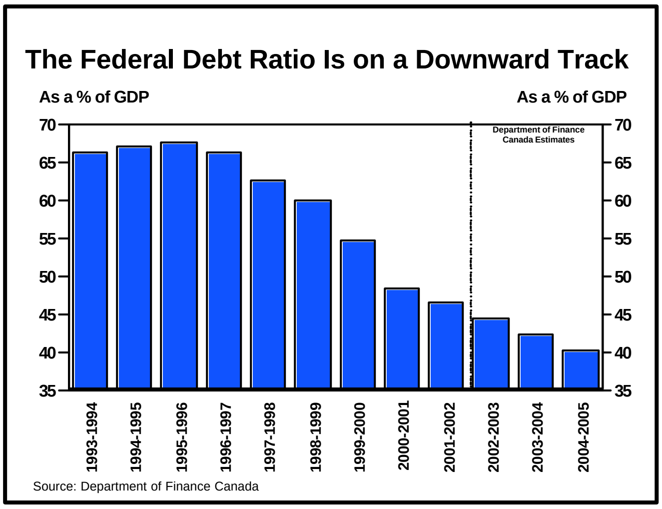
- After reaching a high of 67.5% in 1995-1996, the federal government's net public debt-to-GDP ratio will be under 40% in 2004-2005.

- In 2002-2003, federal program spending will increase by 11.5% due mainly to new health initiatives. However, during the 2003-2004 and 2004-2005 fiscal years, the spending will maintain a more modest growth rate, i.e. approximately 4%.

- In total, the new expenditure measures will total 15.4B$ from 2002-2003 to 2004-2005, including 8.2B$ in health and 3.7B$ for defence and international assistance.

- Because the tax cuts had already been decided, budgetary revenues will reach 15.7% of GDP in 2002-2003, their lowest share in the economy since the late 70s.



**Economic Assumptions and Budgetary Situation: Caution and Commitment to Transparency**

With respect to budgetary management and economic assumptions, John Manley's first budget perfectly stays the course established by his predecessor, Paul Martin, during the 1994-2001 period. This budget smacks of prudence and a strong commitment to keep improving the government's budgetary situation.

Canada posted the strongest growth among large industrialized countries and this approach again provided the federal government with a lot more budgetary room to manoeuvre than expected in fiscal 2002-2003. It can now involve itself more fully in the financing of health care, all the while improving its financial ratios.

The fiscal projections are based on credible, reasonable and even relatively conservative economic forecasts. More specifically, the budget is based on real GDP growth of 3.2% in 2003 and 3.5 % in 2004, which is slightly lower than our own forecasts. The forecasting with respect to short and long term interest rates is almost identical to our own. We believe that the foundation of the Canadian economy is solid enough to support the geopolitical uncertainties that are currently overshadowing the North American and global economic climate.

In any event, the federal government is determined to protect itself against deficits in case the economic situation deteriorates. To do so, John Manley is re-establishing the practise established by Paul Martin by giving himself a contingency reserve in addition to an additional economic prudence measure, all of which will total 4B$ for fiscal 2003-2004 and 5B$ for fiscal 2004-2005. If these amounts are not used, they will be entirely allocated to debt reduction.

So, the federal government's financial ratios keep improving. For instance, the dept-to-GDP ratio, which reached a high of 67.5% in 1995-1996, fell to 44.3% in 2002-2003 decreasing slightly below 40% at the end of fiscal 2004-2005. The public debt charges, which accounted for 37.0% of the government's total revenues in 1995-1996, declined to 20.8% in 2002-2003. They will keep going down and reach 19.9% in 2004-2005. The sound management of the last seven years has then greatly helped the government giving it more room to manoeuvre and as a result huge amounts to cover new priorities.

**ECONOMIC AND FINANCIAL ESTIMATES**

| | 2003 | | 2004 | |
|---|---|---|---|---|
| | Federal Budget* | Mouvement Desjardins | Federal Budget* | Mouvement Desjardins |
| Nominal GDP (%) | 5.4 | 5.7 | 5.4 | 5.8 |
| Real GDP (%) | 3.2 | 3.4 | 3.5 | 3.7 |
| 3-month Canada Treasury Bills (%) | 3.3 | 3.5 | 4.5 | 4.6 |
| 10-year Canadian Bonds (%) | 5.4 | 5.3 | 5.9 | 5.8 |

(*): Canadian private sector average consensus estimates
Sources: Department of Finance Canada and Economic Studies, Mouvement Desjardins

**SUMMARY OF BUDGETARY TRANSACTIONS**

| In billions of $ | 2000-2001 | 2001-2002 | 2002-2003e | 2003-2004e | 2004-2005e |
|---|---|---|---|---|---|
| **Budgetary Transactions:** | | | | | |
| Revenues | 182.3 | 171.7 | 178.7 | 184.7 | 192.9 |
| - Variation (%) | 10.0 | -5.8 | 4.1 | 3.4 | 4.4 |
| Program Spending | -118.5 | -124.3 | -138.6 | -143.0 | -149.6 |
| - Variation (%) | 8.3 | 4.9 | 11.5 | 3.2 | 4.6 |
| **Operating Balance** | **63.8** | **47.4** | **40.1** | **41.7** | **43.3** |
| Public Debt Charges | -43.6 | -39.3 | -37.2 | -37.6 | -38.4 |
| - Variation (%) | 1.2 | -9.9 | -5.3 | 1.1 | 2.1 |
| Contingency Reserve | --- | --- | -3.0 | -3.0 | -3.0 |
| Economic Prudence Measures | --- | --- | --- | -1.0 | -2.0 |
| **Budgetary Balance** | **20.2** | **8.2** | **0.0** | **0.0** | **0.0** |
| Debt Reduction | 20.2 | 8.2 | 0.0 | 0.0 | 0.0 |
| Resources of Financial Requirements | 19.0 | 4.7 | 3.4 | -5.8 | -2.1 |
| Program Spending to GDP Ratio (%) | 11.1 | 11.4 | 12.2 | 11.9 | 11.8 |
| Budgetary Revenues to GDP Ratio (%) | 17.1 | 15.7 | 15.7 | 15.4 | 15.2 |
| Dept to GDP Ratio (%) (no debt reduction) | 48.4 | 46.5 | 44.5 | 42.2 | 40.1 |
| Debt to GDP Ratio (%) (with 3 B$ reduction per year) | 48.4 | 46.5 | 44.3 | 41.7 | 39.6 |

e: estimates
Source: Department of Finance Canada.

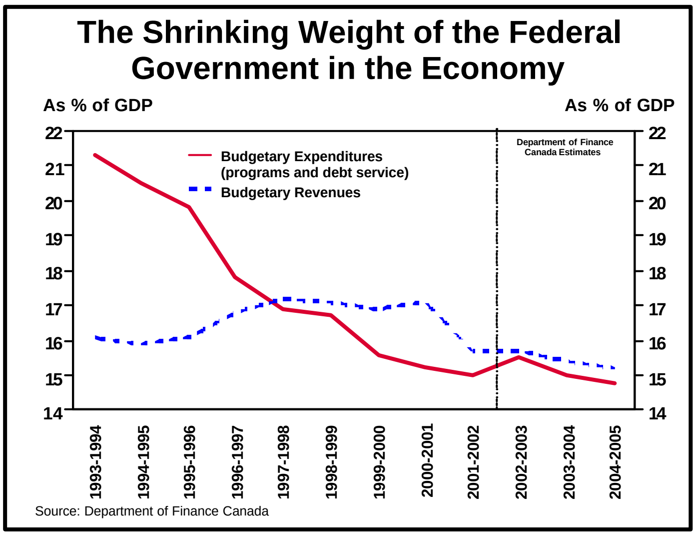
### A Budget Focusing on the Needs of Canadians

As expected, health is an important part in the fiscal policy tabled by the Department of Finance today. Federal initiatives in the field of health cumulatively account for approximately half of the new budgetary measures between fiscal 2002-2003 and 2004-2005. Taking into account the other social measures that were also announced in the budget, one must recognize that the federal government has been leaning a bit more to the left in its new budget policies. Thus, following the large tax cuts announced previously and the massive investments to improve the competitiveness of the Canadian economy, today's budget constitutes the third phase, all of which stems from the improvement of public finances: improving services to citizens.

*Investing in Health Care*

In early February 2003, the Prime Minister and the premiers met to renew the Accord on Health Care Renewal. Under this agreement, which is largely based on the Romanow Commission, the federal government is committed to injecting cumulatively 34.8B$ in the health care system over the next five years. In light of this agreement, this budget provides an increase of 12B$ in the transfers to provinces, including 2.5B$ paid to a trust and accounted by the federal government in 2002-2003. In other words, the increase in transfers to provinces account for a little under 35% of the new federal health initiatives.

As regards other federal health initiatives, the government specifically expects to invest 16B$ cumulatively in a health reform fund. This fund will help provinces and territories accelerate reform in priority sectors (primary care, home care and prescription medication) mentioned in the February accord. Without getting into a political controversy, this situation is somewhat disappointing when considering that health care is a provincial jurisdiction. The table below indicates federal support for health care in the coming years.




**FEDERAL SUPPORT FOR HEALTH CARE**

| In millions of $ | 2003-2004e | 2004-2005e | 2005-2006e | 2006-2007e | 2007-2008e | Total |
|---|---|---|---|---|---|---|
| **Canada Health and Social Transfer (CHST)** | | | | | | |
| Cumulative Increases - 2000(1) | 700 | 1,300 | 1,900 | 2,500 | 3,100 | **9,500** |
| CHST Supplement(2) | 1,000 | 1,000 | 500 | | | **2,500** |
| **Healt Reform** | | | | | | |
| Health Reform Fund | 1,000 | 1,500 | 3,500 | 4,500 | 5,500 | **16,000** |
| Diagnostic/Medical Equipment | 500 | 500 | 500 | | | **1,500** |
| Health Information Technology | 200 | 200 | 200 | | | **600** |
| Research Hospitals | 100 | 100 | 200 | 100 | | **500** |
| Direct Health Accord Initiatives | 221 | 336 | 341 | 341 | 346 | **1,585** |
| **Other Health Initiatives in Support of Reform** | 337 | 253 | 258 | 258 | 258 | **1,364** |
| **First Nations and Inuit Health** | 180 | 230 | 280 | 280 | 280 | **1,250** |
| **Cumulative Funding Increases** | | 17,336 over 3 years | | | 34,800 over 5 years | |

e: estimates
(1): Includes a 1.8B$ increase for 2006-2007 and 2007-2008 (respectively 600M$ and 1.2B$).
(2): The 2.5 billion dollars will be paid to a third-party trust and accounted for in 2002-2003 by the federal government (based on a assumed drawdown by the provinces and territories).

*Investing in Families and Communities*

Minister Manley also proposes to invest in Canadian families and communities. The minister of Finance will gradually increase the National Child Benefit supplement in order to provide greater support to low-income families. The first increase is anticipated in July 2003 and the supplement will be increased to 965M$ by 2007. Several additional measures that cover affordable housing, support for the homeless and public infrastructures are planned. In this budget, the federal government indeed announces an extra 3B$ to improve infrastructures over the next ten years.

*Investing in a Sustainable and Productive Economy*

To improve the competitiveness of the Canadian economy, the government of Canada will invest several billion dollars over the next years in research and innovation. For instance, a 500M$ investment in the Canada Foundation for Innovation is announced for fiscal 2002-2003. This foundation will increase its assistance to state-of-the-art health research facilities. In addition, several measures aimed at advancing sustainable development, improving the environment and helping agriculture will also be implemented.

*Improving the Tax System and Reducing Employment Insurance Premiums*

As expected, the 2003-2004 budget does not provide any new significant measures to reduce the tax burden of taxpayers and businesses. Keep in mind that the federal government already made a considerable effort when it tabled its five-year tax cut plan. Nevertheless, the February 2003 budget has some complementary measures that cumulatively account for a little over 2B$ between fiscal 2002-2003 and 2004-2005. Note the increase of RRSP and RPP contribution limits, which will increase to 18,000$ over four years, the elimination of federal capital tax in five years and the 50% small business deduction increase. The Department of Finance Canada also reduced the employment insurance premium rate. In fact, the employment insurance plan has a huge actuarial surplus and the Department of Finance will launch public consultations in the near future on a new rate-setting regime for premiums in 2005.

*Canada in the World*

Responding to the current geopolitical uncertainties and keeping in mind the terrorist attacks of 2001, the budget allocated to defence and security will be increased significantly during the next few years. With this in mind, the Canadian military capabilities will be increased by 800M$ during the next two fiscal years in addition to an immediate allocation of 270M$ to cover the most urgent needs. In addition, Canada also plans to provide an additional 1.4B$ in international assistance (cumulatively) by 2004-2005 to the poorest countries. In addition, the air traveller security charge will be reduced from 12$ to 7$ for a one-way trip. This measure will certainly be welcome news for air carriers that have been seriously hit by the sluggishness of the global economy and the current nervous climate.

## Impact on financial markets

Canada's financial picture has been steadily improving over the past years. Canada's strong economic performance, combined with the 50B$ decrease of the federal debt, up to now (at 508B$, it is at its lowest level in nearly 20 years), as well as the significant decrease of the debt-to-GDP ratio emphasize this trend even more. In addition, the vulnerability of the Canadian economy and of financial markets to external events keeps lessening. This explains in large part why Canada benefited from an improvement of its credit rating last year. It was brought back to the rating agencies' highest level, the AAA rating. This budget demonstrates the improvement of our public finances and can only be seen positively by financial markets.

**PROPOSED EXPENDITURES AND REVENUES IN THE FEBRUARY 2003 BUDGET**

| In millions of $ | 2002-2003e | 2003-2004e | 2004-2005e |
|---|---|---|---|
| Health Care | 4,720 | 1,369 | 2,095 |
| Canadian Families and Communities | --- | 886 | 1,065 |
| Sustainable and Productive Economy | 924 | 1,405 | 1,074 |
| Canada in the World | 748 | 1,301 | 1,701 |
| Expenditure Management and Accountability | 7 | 25 | 34 |
| Reallocating Resources | --- | -1,000 | -1,000 |
| **Total Spending Initiatives** | **6,398** | **3,986** | **4,969** |
| Health Care | --- | 30 | 55 |
| Canadian Families and Communities | --- | 295 | 460 |
| Sustainable and Productive Economy | --- | 5 | 5 |
| Improving the Tax System | 35 | 335 | 850 |
| Employment Insurance Rate Reduction | --- | 53 | 178 |
| **Total Revenue Initiatives** | **35** | **718** | **1,548** |

e: estimates
Source: Department of Finance Canada.

**Impact of Full Accrual Accounting**

To provide a better idea of the situation of Canada’s public finances, the federal government adopted the “full accrual accounting” method in this budget. According to this method, all tax revenues are accounted during the fiscal period they are recognized. In addition, as regards expenses, the depreciation of capital assets will now be accounted in the financial statements.

This accounting change obviously has some impact on the federal government’s past and future results. For instance, personal income tax increased in 2001-2002 due to the large capital gains of 2000. However, the following stock market slump meant higher tax refunds in 2002-2003. The impact of the accounting reform on the budgetary balance is relatively limited as the budgetary surplus in most cases increased or decreased by only a few hundred million dollars.

## Conclusion: a balanced, prudent budget … with a social bias

The February 18, 2003 budget is in many ways in keeping with the tradition of the Martin era: a budget that remains cautious, tries to avoid at all costs returning to deficits while improving the long term tax situation of the federal government. Canada has already been posting the best budgetary picture of the large industrialized countries and the Manley budget can only consolidate this position if everything turns out as expected. The financial ratios will keep improving over the next few years.

However, considering the importance of the commitments, this budget is shifting towards social spending, especially as far as health funding is concerned. After a first phase of deficit elimination and a second phase that emphasized cutting the tax burden, the government now wants to tackle Canadians’ top priority, improving the health system. So, close to 50% of the new expenditures by fiscal 2004-2005 will be allocated to health care funding, while 15.3% of the new moneys will be aimed at families and communities. This is only fair.