

BUDGET

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FEDERAL BUDGET SPEECH OF MARCH 19, 2007

- Tax measures
- Economic Viewpoint



Desjardins

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

March 19, 2007

Minister of Finance Jim Flaherty tabled his 2007-2008 budget this afternoon. Contrary to what was expected, no announcements concerning personal or corporate tax rates were made.

However, this budget proposes some surprising measures like postponing to 71 years old the maturation of the Registered Retirement Savings Plan (RRSP), introducing a Registered Disability Savings Plan (RDSP), improving the Registered Education Savings Plan (RESP) and returning tax credit for minor children.

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- . Increase of the threshold of quarterly tax instalments on source deductions
- . Single administration of Ontario corporate tax

March 19, 2007

MEASURES AFFECTING DESJARDINS - CORPORATE

Changes to RESPs

Various changes are proposed to the Registered Education Savings Plans (RESPs):

- the annual \$4,000 limit is eliminated;
- the lifetime contribution limit is increased from \$42,000 to \$50,000;
- the annual maximum amount of the Canadian Education Savings Grant (CESG) is increased from \$400 to \$500 per child. However, the lifetime limit of \$7,200 remains;
- the minimum requirement for eligibility of part-time students is relaxed from 10 hours per week to 12 hours per month.

These changes apply to the 2007 and subsequent taxation years.

Introduction of a Registered Disability Savings Plan (RDSP)

As described in the section on measures affecting individuals, the federal government announced the introduction of a Registered Disability Savings Plan to help disabled Canadians. A program such as this one will operate like RESPs and will involve Desjardins Trust.

Withholding tax on the payment of interests to non-residents

Working with the United States, the government proposes to change the Canada – United States tax treaty to eliminate the 10% tax withholding on the payment of cross-border interests. The elimination of the withholding will take effect in the first year following the entry into force of the treaty.

In addition, once the treaty is adopted, it is proposed to eliminate the Canadian tax withholding regardless of the country of residency. This elimination would take effect at the same time as it takes effect with the United States.

Increase of the capital cost allowance rate

The budget proposes to change the capital cost allowance rate of certain assets. For goods purchased on or after March 19, 2007, the capital cost allowance rate for non residential buildings goes from 4% to 6%. To be entitled to this additional 2% deduction, at least 90% the building must be used for non residential purposes and be registered in a separate class.

As well, also for acquisitions on or after March 19, 2007, the capital cost allowance rate for computer equipment (category 45) goes from 45% to 55%.

Increase of the GST annual remittance threshold

To minimize compliance costs for small and medium-sized businesses, Budget proposes:

- to triple the taxable supplies threshold at or below which registrants can file a GST/HST return annually, to \$1,500,000 from \$500,000;
- to double the net tax threshold, below which annual GST/HST filers can make one tax remittance, to \$3,000 from \$1,500.

These measures will apply to fiscal years that begin after 2007.

Trust information returns

A number of taxpayers and tax professionals have expressed concern with the existing due-date for the issuance of Trust T3 information slips. The Government is working with the investment funds industry to develop a process that appropriately balances the desire of taxpayers for sufficient time to prepare their tax returns and the desire of commercial trusts (including income trusts) for sufficient time to compute their income and prepare their T3 information slips. It is expected that draft regulations to give effect to a more efficient process for 2007 T3 slips will be released in the near future.

MESURES AFFECTING INDIVIDUALS

Age limit for maturing RRSPs

The budget proposes to raise the age limit from 69 to 71 years old in 2007 for maturing Registered Retirement Savings Plans (RRSPs), Registered Pension Plans (RPPs) and Deferred Profit Sharing Plans (DPSPs).

The measure will also benefit individuals who turn 70 or 71 in 2007. If contribution room is available, RRSP contributions will be permitted to be made in 2007 and 2008 for the former, and in 2007 for the latter. In addition, the requirement that a specified minimum amount be withdrawn from a RRIF each year after the RRIF is established will be waived for 2007 and 2008 in the case of RRIF annuitants who turn 70 years of age in 2007, and for 2007 in the case of RRIF annuitants who turn 71 years of age in 2007. A RRIF annuitant who is 71 years of age or younger at the end of 2007 will be able to reconvert the RRIF to an RRSP, so long as the re-established RRSP is converted to a RRIF before the end of the taxation year in which the individual turns 71 years of age.

Existing registered plan annuities will be permitted to be amended, without adverse tax consequences, to reflect the later conversion age. As well, employers will be allowed to amend their RPPs to allow benefits to accrue, and contributions to be made, in respect of employed members who are 71 years of age or younger at the end of 2007, subject to any otherwise applicable adjustments to pensions in pay.

Introduction of a Registered Disability Savings Plan

To ensure the long-term financial security of a severely disabled individual, the budget proposes to introduce a new Registered Disability Savings Plan (RDSP) with a Canada Disability Savings Grant (CDSG) program and Canada Disability Savings Bond (CDSB) program.

The RDSP will be based generally on the existing Registered Education Savings Plan (RESP) design and take effect in 2008.

Generally, any person eligible for the disability tax credit (DTC) and resident in Canada, or their parent or other legal representative, will be eligible to establish a RDSP whose beneficiary shall be the person eligible for the DTC.

Contributions to an RDSP will be limited to a lifetime maximum of \$200,000 in respect of the beneficiary, with no annual limit. There will be no restriction on who can contribute to the plan. Contributions will be permitted until the end of the year in which the beneficiary attains 59 years of age.

Contributions to an RDSP will not be deductible. The investment income on contributions, CDSGs and CDSBs will accrue tax-free. Contributions will not be included in income for tax purposes when paid out of an RDSP. CDSGs, CDSBs, and investment income earned in the plan will be included in the beneficiary's income for tax purposes when paid out of an RDSP.

Canada Disability Savings Grants (CDSG)

RDSP contributions made in a year will qualify for CDSGs. The CDSG will equal 300% for the first \$500 of contributions and 200% for the next \$1,000 for families with a household income that does not exceed \$74,357. In such a case, an annual contribution of \$1,500 will entitle the individual to a \$3,500 CDSG. The CDSG will be 100% for the first \$1,000 for families whose income exceeds \$74,357. This \$74,357 amount will begin to be indexed in 2008.

There will be a lifetime limit of \$70,000 on CDSGs paid in respect of an RDSP beneficiary. An RDSP will be eligible to receive CDSGs until the end of the year in which the beneficiary attains 49 years of age.

Canada Disability Savings Bond (CDSB)

The maximum \$1,000 CDSB will be paid annually to an RDSP of a low-income beneficiary and family. The CDSB will not depend on RDSP contributions. The maximum CDSB amount (\$1,000) will be paid to the RDSP to the extent the family income does not exceed \$20,883. The CDSB will be phased out gradually for those with family net income between \$20,883 and \$37,178. These income thresholds are in 2007 dollars and will be indexed to inflation for 2008, when RDSPs become operational, and for subsequent taxation years.

There will be a lifetime limit of \$20,000 on CDSBs paid in respect of an RDSP beneficiary. An RDSP will be eligible to receive CDSBs until the end of the year in which the beneficiary attains 49 years of age.

Payments

Payments from an RDSP will be required to commence by the end of the year in which the beneficiary attains 60 years of age. Payments from an RDSP will be subject to a maximum annual limit determined by reference to the life expectancy of the beneficiary and the fair market value of the property of the plan.

To ensure that RDSP contributions, CDSGs and CDSBs are used to support the beneficiary, only the beneficiary or the beneficiary's legal representative will be permitted to receive payments from the RDSP. Contributors will not be entitled to receive a refund of contributions.

Repayments of CDSGs and CDSBs

There will be a requirement for an RDSP to repay to the government all CDSGs and CDSBs (and associated investment income) paid to the plan in the ten years preceding a payment from the plan, upon the cessation of the beneficiary's eligibility for the DTC or the death of the beneficiary.

Death or Cessation of Disability

Where the beneficiary of an RDSP either ceases to be eligible for the DTC or dies, the funds in the RDSP (net of repayments as described above) will be required to be paid to the beneficiary or pass to the beneficiary's estate. That amount (net of contributions) will be included in the income of the beneficiary for tax purposes.

Treatment of the RDSP for Means-Tested Benefits

Budget proposes that amounts paid out of an RDSP will not be taken into account for the purposes of calculating income-tested benefits delivered through the income tax system. In addition, RDSP payments will not reduce Old Age Security or Employment Insurance benefits.

New Minor Child Tax Credit

From 2007, Budget proposes to introduce a new non-refundable child tax credit for each child under the age of 18 years at the end of a taxation year. The credit will be based on an amount of \$2,000, indexed annually starting in 2008. For 2007, in Quebec, this credit represents a tax savings of \$259 per eligible child (\$310 in other provinces).

The credit amount would not be affected by the child's income.

Increase of the spousal tax credit

For 2007, the amount used for spouse or common-law partner credit purposes was to be \$7,581 (reduced when the spouse's income or common-law partner exceeds \$759) while the basic personal amount is \$8,929.

In line with the Quebec, this budget proposes that the two amounts be equivalent and stand at \$8,929. The amount upon which this credit is based is required to be reduced on a dollar-for-dollar basis by the dependant's net income in excess of a threshold.

Lifetime Capital Gains Exemption (LCGE)

Budget proposes to increase from \$500,000 to \$750,000 the eligible amount to the LCGE realized by an individual on dispositions of agricultural property, fishing property or eligible shares of small businesses that occur on or after March 19, 2007

Working income tax benefit

The government recognizes that the taxation system sometimes discourages some individuals from finding a job. Accordingly, it is introducing the Working Income Tax Benefit (WITB), which is similar to the working premium introduced in Quebec in 2006.

The WITB will be equivalent to a refundable tax credit of 20% of the earned income over \$3,000, up to \$500 for an individual living alone without dependents and up to \$1,000 for families (couple and single-parent family). This credit will be reduced by 15% of the net family income exceeding \$9,500 in the case of an individual living alone and exceeding \$14,500 for families.

A parallel plan will be provided for Canadians with disabled individuals benefiting from the disability tax credit. These individuals must have earned at least \$1,750 and the maximum credit will be \$250. The supplement will be reduced by 15% of the net family income exceeding \$12,833 for someone living alone and \$21,167 for families.

In general the individuals eligible will be people who live in Canada during the entire taxation year and who, at the end of the taxation year, are at least 19 years old. In addition, it is specified that students without dependent children who are studying full-time during more than three months of the taxation year are not entitled to the WITB.

This measure will apply in the 2007 and following taxation years. An advance payment mechanism for the WITB will be set up beginning in 2008. As a result, GST beneficiaries who would have been entitled also to the WITB (based on anticipated annual earned income) will be able to apply to the Canada Revenue Agency to receive, in the form of an advance payment, half of their estimated WITB for the year.

Public transit tax credit

Budget 2006 introduced a non refundable tax credit for the cost of monthly public transit passes as of July 1, 2006.

In 2007, this credit will be strengthened.

Electronic Payment Cards

Since the introduction of this credit, several transit authorities have developed proposals for the introduction of cost-per-trip electronic payment cards. Under this proposal, the cost of an electronic payment card will be eligible for the credit if:

- . the cost relates to the use of public transit for at least 32 one-way trips during an uninterrupted period not exceeding 31 days, and
- . that transit usage, and cost of those trips, are recorded and receipted to the purchaser by the relevant transit authority, in sufficient detail as to allow the Canada Revenue Agency to verify eligibility for the credit.

Weekly Passes

There may be instances where low-income individuals are unable to afford the financial outlay associated with purchasing a monthly pass. Even though they are regular transit riders, they may purchase a series of weekly passes.

Budget 2007 proposes to extend eligibility for the public transit tax credit to accommodate weekly passes where an individual purchases at least four consecutive weekly passes.

Capital gains and charitable donations to private foundations

To better encourage charitable giving, Budget 2006 eliminated capital gains tax on donations of publicly-listed securities to public charities.

Also, a non arm's length employee who acquired publicly-traded securities under an option granted by the employer and who donates the securities to a public charity within 30 days can be entitled to a special reduction, which will essentially exempt from tax the employment-related benefit. The budget also proposes to grant such an exemption to eligible donations to private foundations.

This no gains income inclusion rate with respect to publicly-traded securities will apply to donations made on or after March 19, 2007.

Phased retirement under a defined benefit registered pension plan

Budget 2007 proposes to allow employers, starting in 2008, to offer eligible employees the opportunity of getting up to 60% of the benefits from a Defined Benefit Registered Pension Plan and to keep working and accumulate further pension benefits.

For this measure to have a positive effect on labour supply, this measure will target employees aged 55 and over eligible to an unreduced pension. The partial pension need not be based on a reduction of the hours worked or a matching cut in wages.

This approach will give employers greater latitude in designing personnel retention programs for senior employees who satisfy specific needs.

Levy on fuel-inefficient vehicles

For vehicles purchased after March 19, 2007 and consuming 13 litres or more per 100 kilometres, the federal government proposes a levy based on the amount of fuel the vehicle consumes:

- at least 13 but less than 14 litres / 100 kilometres: \$1,000;
- at least 14 but less than 15 litres / 100 kilometres: \$2,000;
- at least 15 but less than 16 litres / 100 kilometres: \$3,000;
- 16 litres or more per 100 kilometres: \$4,000.

Rebate on new fuel-efficient vehicles

To encourage consumers to buy more fuel-efficient vehicles, the budget proposes a rebate performance-based program, to a maximum of \$2,000, on the purchase of a new fuel-efficient vehicle after March 19, 2007.

Tax instalments

Currently, individuals who reside in Quebec are required to make instalment payments for federal income tax when they reach the \$1,200 threshold. Starting in 2008, this threshold will be raised to \$1,800. For residents of other provinces, the threshold is raised from \$2,000 to \$3,000.

Foreign Convention and Tour Incentive GST Program

On September 25, 2006, the Government of Canada announced that it would eliminate the Visitor Rebate Program effective April 1, 2007. Budget proposes a new Foreign Convention and Tour Incentive Program that will replace the Visitor Rebate Program. This program will provide GST relief in respect of certain property and services used in the course of conventions held in Canada and the accommodation portion of tour packages for non-residents.

Increase of the over 48-hour travellers' exemption

Budget proposes to increase the travellers' exemption to \$400 from \$200 for returning Canadian residents who are out of the country for 48 hours or more. Increasing the 48-hour exemption will make it more convenient for travellers to clear customs and will reduce the amount of processing at the border.

Tax exemption for some scholarships

Starting in 2007, the budget proposes to exempt some scholarships paid to elementary and secondary school students.

Meal expenses of truck drivers

The budget proposes to gradually increase from 50% to 80% the deductibility of food and beverage expenses of truck drivers during eligible travel periods. The increase is planned over 5 years and will reach 80% by 2011.

MEASURES AFFECTING BUSINESSES

Increase of the accelerated capital cost allowance rate

In addition to the changes in the capital cost allowance rate mentioned in the Desjardins – Corporate section, manufacturing or processing buildings, acquired on or after March 19, 2007, will benefit from a 10% rather than a 4% capital cost allowance rate.

Tax credit for the creation of child care spaces

The federal government proposes to introduce a tax credit to encourage businesses to create licensed child care spaces for the children of their employees and, potentially, for children in the surrounding community.

The measure will provide eligible taxpayers with a non-refundable investment tax credit equal to 25 per cent of eligible expenditures incurred on or after March 19, 2007, to a maximum credit of \$10,000 per child care space created.

Corporate income tax instalments

Currently, corporations are required to make tax instalments when they reach the \$1,000 threshold. For fiscal years beginning after 2007, the threshold is raised to \$3,000.

In addition, for fiscal years beginning after 2007, the frequency of instalment payments by Canadian-controlled private corporations will be reduced from monthly to quarterly if:

- . the taxable income of the corporation for either the current or previous year does not exceed \$400,000;
- . the corporation qualified for the small business deduction for either the current or previous year;
- . the taxable capital employed in Canada of the corporation does not exceed \$10 million in either the current or previous year.

Increase of the threshold of quarterly tax instalments on source deductions

Currently, an employer is entitled to remit source deductions in respect of employees' income tax, Canada Pension Plan contributions and Employment Insurance premiums by quarterly instalment, instead of monthly instalment, if the average monthly withholding amount for either of the two preceding calendar years is less than \$1,000 and the employer has perfect compliance history. Budget 2007 proposes to triple this threshold amount to \$3,000.

Single administration of Ontario corporate tax

The federal government currently collects corporate income tax for all of the provinces and territories, other than the provinces of Alberta, Ontario and Quebec. On October 6, 2006, the governments of Canada and Ontario signed a Memorandum of Agreement regarding the collection and administration, by the Government of Canada, of Ontario's corporate tax for taxation years that end after 2008. The agreement will reduce compliance costs for businesses and enable the Canada Revenue Agency (CRA) to streamline service and reduce overall administrative costs. With respect to this agreement, the federal government announces that it will pay \$400M to the Ontario government.

March 19, 2007

Federal Budget

Analysis of the Canada's 2007 Budget

**A clever and generous budget that is a good step
in resolving fiscal inbalanced issue**



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Highlights

This is the second budget of Minister of Finance James Flaherty and the Conservative government and it is in line with the one tabled last year. With nearly \$20B in new initiatives over 3 years, this budget is again trying to please a wide range of Canadians while remaining true to the Conservative Party's program. More particularly, it partially resolves the fiscal imbalance issue and implements a host of new measures to make the Canadian economy more competitive, especially by lessening the tax burden on individuals and corporations. Moreover, many other initiatives are being introduced with respect to the environment, health, education, culture as well as national and international security.

- Program spending is growing by 5.6% in 2007-2008, which is a growth rate that is unmistakably higher than that of the economy.
- Some factors are undeniably slowing down increases of the government's revenues: slower economic growth in Canada this year, the many measures announced today and those mentioned in the last few years.
- The government's financial leeway remains relatively sizeable.

- The debt-to-GDP ratio could go down from 35.1% in 2005-2006 to 29.7% in 2008-2009. The government is then well on the way to reach its objective of bringing this ratio down to 25% by 2012-2013.
- Taking into account the other initiatives, all the new measures aimed at cutting the fiscal imbalance could reach just under \$1B in 2007-2008 for Québec.

Realistic economic forecasts

Since the private sector forecasts used by the Department of Finance come from a survey conducted just a few days ago, i.e., at the beginning of March, the projections included in the budget are relatively consistent with the recent changes in Canada's economic conditions. Domestic demand should remain relatively firm, mostly due to a strong labour market, while foreign trade will continue to suffer from a high Canadian dollar and stiffer international competition. So real GDP could, according to the Department's survey, grow by 2.3% in 2007 and by 2.9% in 2008. These forecasts are close to our own, which anticipate a 2.2% increase in 2007 and a 2.8% one next year.

Table 1

Summary of budgetary transactions

In billions of \$	2003-2004	2004-2005	2005-2006	2006-2007f	2007-2008f	2008-2009f
<i>Budgetary transactions</i>						
Budgetary revenues	198.6	211.9	222.2	232.3	236.7	243.5
- Variation (%)	4.2	6.7	4.8	4.5	1.9	2.9
Program spending	-153.7	-176.4	-175.2	-189.0	-199.6	-206.8
- Variation (%)	4.8	14.8	-0.7	7.9	5.6	3.6
Operating balance	44.9	35.6	47.0	43.3	37.1	36.7
Public debt charges	-35.8	-34.1	-33.8	-34.1	-33.8	-33.7
- Variation (%)	-4.0	-4.6	-0.9	0.9	-0.9	-0.3
Projected reduction of the debt				-9.2	-3.0	-3.0
Budgetary balance	8.9	1.5	13.2	0.0	0.3	0.0
Non-budgetary transactions	-1.5	5.1	-6.5	-0.8	-7.7	0.5
Financial source and requirements	7.6	6.6	6.7	8.4	-4.7	3.5
Ratio of program spending to GDP (%)	12.7	13.7	12.8	13.1	13.3	13.2
Ratio of budgetary balance to GDP (%)	0.8	0.1	1.0	0.0	0.0	0.0
Ratio of debt charges to budgetary revenues (%)	18.0	16.1	15.2	14.7	14.3	13.8
Debt representing accumulated deficits	496.2	494.7	481.5	472.3	469.3	466.3
Debt-to-GDP ratio (%)	40.9	38.3	35.1	32.8	31.4	29.7

Source: *Departement of Finance of Canada*

f: forecasts

Table 2
Economic and financial forecasts

Annual average in % (except if indicated)	2006	2007f		2008f	
		Budget	Desjardins Group	Budget	Desjardins Group
Real gross domestic product ¹	2.7	2.3	2.2	2.9	2.8
Nominal gross domestic product ¹	4.9	3.9	3.3	5.0	5.1
Gross domestic product deflator ¹	2.2	1.6	1.1	2.1	2.3
Final domestic demand ¹	4.5	2.6	3.2	2.9	3.2
Employment ¹	1.9	1.5	1.8	1.3	1.9
Unemployment rate	6.3	6.3	6.3	6.4	6.1
Treasury bills—3-month	4.00	4.20	4.15	4.20	4.35
Federal bonds—10-year	4.20	4.10	4.15	4.50	4.80
Canadian dollar (US¢)	88.2	87.4	85.4	88.4	91.5
WTI* oil (US\$)	66.0	63.1	59.0	61.2	72.0

¹ Average annual growth; * West Texas Intermediate.

Sources: Department of Finance of Canada, Statistics Canada and Desjardins, Economic Studies

f: forecasts

We generally believe however that price increases could be a little lower than expected in the budget projections, especially the energy prices. We believe that the rise of the GDP deflator expected by the government could be slightly lower in 2007, which could mean a weaker increase of nominal GDP and as a result less budgetary revenues.

As for interest rates, the budget projections are also similar to our own, although the improvement of the North American economic outlook from mid-2007 could pave the way to a gradual rate increase. In this context, we feel that the 10-year federal bond rate could be slightly higher than what the Department expects in 2008. This difference could obviously generate slightly higher than expected charges on the public debt as well as lower budgetary revenues.

Budgetary revenues are not growing as quickly as spending

The budget tabled today by Minister Flaherty anticipates a 5.6% program spending increase in 2007-2008, which is a growth rate that is unmistakably higher than that of the economy. The host of measures proposed in the budget is visibly weighing heavily on the government's expenditures. Of course, the reduction of the debt charges, which is the result of repayments made over the last few years and low interest rates, is partly offsetting the growth in program spending.

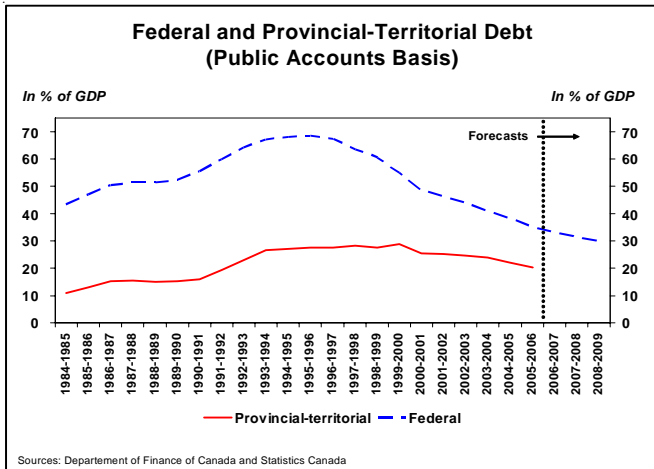
The growth of budgetary revenues has clearly been slower in the last few years. Following respective

increases of 6.7% in 2004-2005 and 4.8% in 2005-2006, the Department of Finance forecasts are anticipating a 4.5% increase in 2006-2007 and only 1.9% in 2007-2008. It is undeniable that Canada's slower rate of economic growth and the many measures announced today and over the last few years are slowing down the increase of government revenues. Moreover, the full effect of the goods and services tax (GST) cut last July will be in effect in 2007-2008.

Even so, the federal government's financial leeway remains relatively significant. The current fiscal year should close with a surplus of \$9.2B according to Department of Finance projections while a surplus of approximately \$3B is still anticipated for the next fiscal years.

The debt keeps going down

After a \$13.2B cut in the debt taken from the 2005-2006 budgetary surplus, the federal government's forecasts anticipate that an additional amount of \$9.2B will be allocated to the debt in 2006-2007. In addition, the Department of Finance is maintaining its commitment to repay a minimum of \$3B per year for the next fiscal years. So, the ratio of debt to GDP could go down from 35.1% in 2005-2006 to 29.7% in 2008-2009. The government is then well on the way to reach its objective of cutting down the ratio to 25% by 2012-2013. The benefits of the lower debt are obvious as the public debt charges as a percentage of budgetary revenues have decreased significantly over recent years. The federal government must however keep at it as the weight of its debt is still



relatively high compared to that of the provinces and territories.

The new tax cuts target low-income households and manufacturing businesses

Keeping the momentum of the previous budget, Canada's Minister of Finance is proposing again this year many measures that provide tax relief to individuals and businesses. This relief will total \$5.8B by fiscal 2008-2009.

As for individuals, rather than directly cutting the tax rate, the Minister chose to provide more support to low-income households and families. The government proposes a new tax benefit for earned income totalling \$550M per year. This measure is designed as an incentive to work by lowering the "welfare wall" for unemployed Canadians. It also introduces a new \$2,000 child tax credit, tax adjustments for single-income families and a host of smaller measures directed at public transit users, education savings plans, pension plans, assistance for disabled Canadians etc. Proposed also is a higher cumulative tax exemption of capital gains.

According to the Department of Finance, half of the tax relief anticipated in the budget is aimed at lower income taxpayers, i.e., those whose annual personal income is under \$37,178. Taking into account the measures implemented since the beginning of the Conservative government's term (with the exception of the GST cut), the proportion is leaning a bit more towards middle-income families.

In addition, the government is reaffirming its commitment to dedicate on an annual basis \$1B to

Distribution of Tax Relief for Canadians: Budget 2007

The Tax Fairness Plan and Budget 2006		
Individual Income	Budget 2007 (1)	Budget 2007, (1) Tax Fairness Plan and Budget 2006 (2)
Under \$37,178	50.1%	29.7%
\$37,178 - \$74,357	33.1%	44.7%
\$74,358 - \$120,887	12.6%	17.3%
\$120,888+	4.2%	8.3%
Total	100.0%	100.0%

(1) Includes increase in spousal and equivalent amount, new child tax credit and Working Income Tax Benefit.

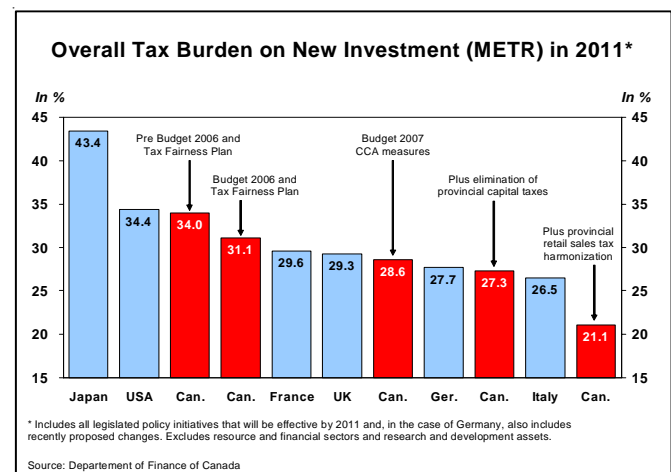
(2) Broad-based personal income tax reductions from Budget 2006 and the 2006 Tax Fairness Plan (does not include the 2006 GST reduction).

Source: Department of Finance of Canada

cutting personal income tax rates and fund it with the cut in interest charges on the debt.

For corporations, the government is staying the course on its objectives expressed last year, like the cut in the corporate tax rate by 2011 and the elimination of the corporate surtax in 2008 (corporate tax on capital was eliminated in January 2006). This year, the Harper government clearly wanted to help manufacturing businesses, as this industry has particularly suffered in the current economic conditions. By 2008-2009, \$735M will be allocated to assistance provided as investment incentives (accelerated capital cost allowance). In addition, the capital cost allowance of many assets will be increased to align them with their useful life (a cost of \$205M by 2008-2009).

These policies announced in the new budget, coupled with what was announced last year, are designed to increase the competitiveness of Canadian businesses. According to the government, by 2011, Canada would jump from 5th to 1st among G7 countries for its fiscal competitiveness towards new investments.



Correcting the fiscal imbalance

As expected, the federal government's 2007-2008 budget proposes many measures to correct the fiscal imbalance with the provinces, the territories and the municipalities. Moreover, there are significant changes to the transfers to the provinces and territories, which come mainly from 3 separate programs. On the one hand, the Equalization payments are amounts allocated to have-not provinces¹. The transfers are unconditional and can be allocated to whatever the provinces want to. The provinces that will benefit from Equalization in 2007-2008 are Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba and Saskatchewan. On the other hand, the two other transfer programs are the Canada Health Transfer and the Canada Social Transfer. All provinces and territories of Canada benefit from these transfers, but they are aimed at specific programs, i.e., health care and social programs.

So, additional payments for Equalization and the territorial financing as part of the settlement of the fiscal imbalance should total \$1.2B in 2007-2008 and \$0.9 in 2008-2009. Moreover, a new approach in the treatment of natural resources is proposed. Provinces producing natural resources would keep additional tax benefits thanks to a 50% exclusion of the revenues arising from these resources in calculating Equalization. The old formula excluding all the revenues arising from natural resources could however be kept for the provinces whose transfers would be higher under this method.

Many amendments are also brought to the social transfer. The main objective of the government is obviously the increase of these transfers for each of the provinces, but also greater transparency so that it will be easier for the provinces to anticipate over the long term the amounts that they will be getting. On the health front, the amounts transferred are exactly what had been established. Taking into account other programs, including infrastructure funding, the cumulative amount of the new transfers that are designed to settle the fiscal imbalance will reach \$39.4B between 2007-2008 and 2013-2014, including \$3.2B for fiscal 2007-2008. With the current programs, all the transfers of the federal government to the provinces and territories should then total \$51.5B in 2007-2008, an increase of \$6.0B compared with the previous year.

For Quebec, the budgetary documents do not make it possible to precisely establish the additional transfers that will be allocated to the province as part of the fiscal imbalance. Even if the Equalization transfers will increase by \$1.6B in 2007-2008, it is only a bit less than half the increase that really comes from the settlement of the fiscal imbalance, i.e., \$695M. Taking into account the other initiatives, all the new measures aimed at cutting the fiscal imbalance could reach about \$1B in 2007-2008. Visibly, the measures announced today could prove to be below the expectations of many stakeholders on the political scene in the province. In short, the second budget of Minister Flaherty is a good step to reduce the fiscal imbalance, but it would be unrealistic to believe that the problem is definitely solved. In fact, a permanent solution should rather be through a transfer of tax points to the provinces.

¹ The territories benefit from amounts under the Territorial Formula Financing.

Tableau 3

Fiscal Balance New Investments: \$39 Billion Over Seven Years

In millions of \$	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014	Total
Equalization	1,092	833		Formula Driven	→			1,925
Territorial Formula Financing	87	75		Formula Driven	→			162
Subtotal	1,178	908						
Canada Social Transfer	937	1,737	2,053	2,379	2,714	3,059	3,415	16,295
Transition—CST-CHT Protection	226	24	17	11	4			282
Labour market training		500	500	500	500	500	500	3,000
Infrastructure	325	325	325	2,425	3,899	4,342	4,625	16,266
Canada ecoTrust	506	506	506					1,519
Subtotal	1,994	3,092	3,402	5,314	7,117	7,901	8,540	37,361
Total	3,172	4,000	3,402	5,314	7,117	7,901	8,540	39,448

Source: *Department of Finance of Canada*

The conservative government is now sensitive to the environment

Up to now, one could not say that the Harper government was known for its environmental tendencies. Apparently, this budget is trying to adjust the aim. Aside from the measures on tax cuts and the resolution of fiscal imbalance with the provinces, announcements associated with environmental conservation are now very important in the government plans. In terms of new allocated amounts, those that involve environmental measures will total \$806M by 2008-2009. These new programs provide a rather ill-assorted collection, going from tax incentives for the production of clean energy to programs encouraging cleaner means of transport (rebates on the purchase of energy efficient vehicles, fuel strategy) and measures to protect Canada's natural heritage, namely the conservation program for natural areas.

In addition, for environmental issues, the government wants to dedicate over \$1.5B over 3 years to Canada ecoTrust for air quality and climate change, to help provinces and territories reach their environmental objectives. The moneys in the trust will be allocated to the provinces over a three-year period based on an amount per individual with a minimum of \$15M per province and \$5M per territory.

Although some emphasis has been put on the environment, the cost of these measures (including ecoTrust) will only add up to 12% of the new budget initiatives by 2008-2009. Bear in mind that a good share of the new measures (aside from the tax cuts and the fiscal re-balance) are also going to other fields of activity, such as health care, education (knowledge) and to a lesser extent, culture and security.

As for health care, \$400M are earmarked for the use of information technologies (Canada Health Infoway), \$612M to helping the provinces that will have committed to guarantee reasonable wait times for patients and \$300M for the introduction of an immunization program against cervical cancer.

For farmers, James Flaherty proposes a new income stabilization program that will cost \$1,155M by 2008-2009. The government is also announcing that it will invest \$158M in projects associated with culture, including \$52M to organize the *Sommet de la Franco-*

phonie in Quebec City. Among other measures, the government will invest \$904M on research assistance in science and technology and \$209M on post-secondary education and manpower training.

Overall, including a host of other smaller measures or measures that are less structuring for the economy, the total of the government's new commitments will reach \$19.7B by fiscal 2008-2009. The large part of this is going to tax relief, totalling \$8.2B. The second place goes to the provinces, while the fiscal re-balancing project will cost \$6.9B to the federal government during the current fiscal year and the following two.

Impact on financial markets

The investors will be able to appreciate the current rate of repayment of the Canadian debt. Between fiscal 2005-2006 and 2008-2009, the debt will be cut by \$28.4B according to the forecasts. As a percentage of GDP, the ratio will go down from 35.1% to 29.7% during this period. A ratio under 30% has not been seen at the federal level since the early 80s. The current financial health of the federal government should definitely satisfy financial markets. In addition, the assistance provided to provinces through the transfers associated with fiscal balance could relieve some of the budgetary pressure on provincial governments, which could in turn borrow less.

As for the measures announced by Minister Flaherty, some could however have an impact on investors. First, like in 2006-2007, the Canadian government will forgo 2 new bond auctions, i.e., the 5-year bond in the third quarter and the 2-year bond in the fourth quarter. In addition, starting in 2008, the Canadian government will take over the loans associated with crown corporations, i.e., the Canada Development Bank, the Canada Mortgage and Housing Corporation and Farm Credit Canada. The government will borrow itself to fund these operations. The debt of these corporations will remain outstanding in the market, including the 2007 issues.

The federal government is also proposing a new securities regulation method with a common regulatory board, i.e., nationwide, and a modernization of the statutory framework as it applies to financial operations. Setting up a national regulatory board will be a measure that will undoubtedly be challenged by

many provinces, as it means a loss of autonomy for them. The protection of investors also needs to be strengthened with higher governance standards and stricter adherence to the law. Also proposed is a free trade in securities with the United States and other G7 countries.

Conclusion: A skilled budget in the current situation

The country's economic growth, especially domestic demand, and the government's management allowed Minister Flaherty to keep his financial commitments and maintain a balanced budget. Moreover, the debt anticipated for 2008-2009 will go below 30% of GDP, a first in over 25 years. Of course, continuing the good financial health of the federal government should please the financial world. In addition, in case of impacts, the government's leeway remains considerable and it will surely know how to meet the risks that might occur.

Minister Flaherty is using this fiscal year to introduce a host of new initiatives that total over \$19B in 3 years. So, the 2007 budget of the Harper government addresses health care, education, the fiscal imbalance, the environment and the competitiveness of Canadian businesses around the world. Many structuring measures are incorporated in the budget that can be qualified as generous. It lessens the tax burden for individuals and corporations.

What Stephen Harper and James Flaherty are proposing is not above criticism. Given the challenges to be met with respect to the environment, the measures proposed seem timid. It cannot be said either that the discussions, negotiations and disagreements with the provinces are over. The settlement of the fiscal imbalance still seems partial, and a definitive solution is still yet to be found. Incidentally, the way in which the federal government proposes to alleviate the tax burden leaves little room to provincial governments to recover the space left by the central government. In addition, Ottawa seems to still occupy a lot of space in the jurisdictions that are exclusive to the provinces, especially in health care, education and manpower training.

Nevertheless, Minister Flaherty's budget is a feat that can definitely be called clever given the current political context in Quebec but also on the federal scene.

Keeping in mind that the Harper government is in a minority situation in the House of Commons, the budget proposed clearly indicates that the Conservatives are ready to go to the polls and get an eventual majority.