

BUDGET

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October 30, 2007

Federal economic statement

- Tax measures
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Desjardins

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



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Federal Finance Minister Jim Flaherty this afternoon tabled an economic statement designed to extend tax relief to individuals and business.

GENERAL MEASURE

GST cut as of January 1, 2008

The federal government has announced a cut to the GST rate, taking it from 6% to 5% as of January 1, 2008. Transitional measures are planned for implementing the cut; in general, the measures are the same as those implemented when the GST rate was lowered from 7% to 6% on July 1, 2006.

Briefly, if the GST is not payable or paid prior to January 1, 2008, the applicable rate will be 5%; the rate will be 6% if the tax is paid or payable prior to that date. In general, the tax is payable on the date the invoice is produced.

Desjardins' entities, which are financial institutions, do not generally recover the GST they pay on purchases. Considering the cut, it would be better to defer certain acquisitions of goods and services until after December of 2007.

For businesses that are not financial institutions and usually claim the GST on their purchases, the main impact of the measure will be that they have to modify their invoicing systems for January 1, 2008.

For individuals, unless the Québec government decides to use the tax base the federal government has freed up, the decrease will have a net impact of 1.075% as the Québec sales tax (QST) is applied to the GST.

MEASURE AFFECTING DESJARDINS – BUSINESS AND THE OTHER COMPANIES

Reduction to corporate tax rate

The government intends to accelerate the previously announced cuts to corporate tax. The following changes

have been announced for the general corporate tax rate and reduced rate for the next few years.

Corporate income tax rate (%)

	2007	2008	2009	2010	2011	2012
General rate						
Current rate	22.12 ¹	20.5	20.0	19.0	18.5	18.5
Proposed rate	22.12 ¹	19.5	19.0	18.0	16.5	15.0
Reduced rate						
Current rate	13.12 ¹	11.5	11.0	11.0	11.0	11.0
Proposed rate	13.12 ¹	11.0	11.0	11.0	11.0	11.0

¹ The rates 13.12% and 22.12% above include the 1.12% corporate surtax. This surtax will be eliminated in 2008.

The reductions will be prorated to the number of days in the year for tax years that run over December 31.

Note that the reduced tax applies to income eligible for the small business tax deduction or the additional deduction for credit unions.

The tax reductions will also cover the new tax on distributions which will, in general, apply as of 2011 for income trusts and publicly traded companies.

MEASURES AFFECTING INDIVIDUALS

Cut to the lowest tax rate

Currently, the tax rates that apply to personal taxable income range from 15.5% to 29.0% (12.9% to 24.2% for a Québec resident). The minimum rate, 15.5%, applies to the bracket of taxable income that does not exceed \$37,178.

Retroactive to January 1, 2007, the rate of 15.5% drops to 15.0% (12.5% for a Québec resident). The rate will also be generally used to calculate non-refundable tax credits and the alternative minimum tax as of 2007. The \$37,178 threshold remains, however.

Increase in the basic personal amount

The basic personal amount, which is currently \$8,929 for 2007, will go to \$9,600 for 2007 and 2008, and up to \$10,100 in 2009. Starting in 2010, the amount will be indexed each year.

The amounts for a spouse or equivalent to spouse will go up similarly.

A Québec resident's tax savings as a result of the two measures announced will be in the order of \$200 for 2007, tax that will be recovered when the 2007 tax return is filed in 2008.

Budget analysis

October 30, 2007



CANADA: ECONOMIC STATEMENT

Everyone's a winner, although some of the decisions are questionable

At mid-term, the federal government is taking stock of its budget situation and tabling its economic update. The document provides the latest Department of Finance projections for the results of the current budget year (2007-2008), as well as for the next five fiscal years. The new measures announced focus on reducing the tax burden on individuals and business. The debt will also be reduced substantially during the current fiscal year.

With an enviable financial situation, it was easy for Finance Minister Jim Flaherty to meet public and financial market expectations. Without compromising on debt reduction, the Conservative government stepped up some of its election promises and political goals. As widely expected, the Finance Minister announced that he will be cutting the GST again. He is also easing the tax burden on individuals and

businesses. However, unlike most budgets, these measures clearly are not designed to target specific taxpayers or industry sectors. Among the positives, the update is primarily made up of five simple measures for achieving laudable goals to lighten the tax burden on households and increase business competitiveness. However, the government can still be criticized for opting to cut a consumption tax rather than

Table 1
Summary statement of transactions

In \$B	Actual		Projection				
	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013
Budgetary revenues	236.0	243.9	245.8	255.4	266.7	277.8	288.9
Program expenses	188.3	198.4	207.6	217.0	225.1	233.7	242.9
Public debt charges	33.9	34.0	33.7	34.2	34.0	33.9	33.3
Total expenses	222.2	232.3	241.4	251.1	259.2	267.6	276.2
Underlying surplus	13.8	11.6	4.4	4.3	7.5	10.2	12.8
Planned debt reduction	---	10.0	3.0	3.0	3.0	3.0	3.0
Planning surplus¹	---	---	1.6	1.4	1.3	4.6	7.3
Federal debt ²	467.3	457.3	454.3	451.3	448.3	445.3	442.3
Per cent of GDP³							
Budgetary revenues	16.3	15.9	15.3	15.2	15.2	15.1	15.1
Program expenses	13.0	13.0	12.9	12.9	12.8	12.7	12.7
Public debt charges	2.3	2.2	2.1	2.0	1.9	1.8	1.7
Total expenses	15.4	15.2	15.0	14.9	14.7	14.6	14.4
Federal debt	32.3	29.9	28.3	26.9	25.5	24.3	23.1

¹ The remaining surplus of \$1.6 billion in 2007-08 will be used to reduce federal debt or fund priorities; ² Based on planned debt reduction; ³ Per cent of GDP calculations do not include the commitment to dedicate interest savings to personal income tax reductions.

Source: Department of Finance of Canada, October 2007

François Dupuis
Vice-President and Chief Economist

Benoît P. Durocher
Senior Economist

Yves St-Maurice
Director and Deputy Chief Economist

Francis Généreux
Senior Economist

514-281-2336 or 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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Table 2
Changes in the fiscal outlook since March 2007 budget

In \$B	Actual			Projection		
	2006-2007	2007-2008	2008-2009	2006-2007	2007-2008	2008-2009
March 2007 budget underlying surplus	9.2	3.3	3.0			
Impact of economic and fiscal developments						
Budgetary revenues						
Personal income tax	-1.2	1.8	2.3			
Corporate income tax	2.7	5.2	4.0			
Other income tax	-0.5	1.2	1.2			
Goods and services tax	0.8	1.6	2.1			
Other revenues	1.8	2.2	2.0			
Total revenues	3.7	12.0	11.6			
Program expenses ¹						
Major transfers to persons	0.2	0.1	-0.4			
Major transfers to other levels of government	0.4	0.0	-0.1			
Direct program expenses	0.1	1.1	-0.3			
Total program expenses	0.7	1.3	-0.8			
Public debt charges	0.2	-0.2	0.0			
Total economic and fiscal developments	4.6	13.1	10.8			
Measures announced in this Economic Statement	---	-4.8	-9.4			
Revised underlying surplus	13.8	11.6	4.4			
Planned debt reduction	---	-10.0	-3.0			
Planning surplus	---	1.6	1.4			

¹ A positive number implies a decrease in spending and an improvement in the budgetary balance. A negative number implies an increase in spending and a deterioration in the budgetary balance.

Source: Department of Finance of Canada, October 2007

choosing a bigger cut to personal income tax, a decision that is less economically effective.

THE CANADIAN ECONOMY'S STRENGTH DELIVERS FURTHER FISCAL LEEWAY

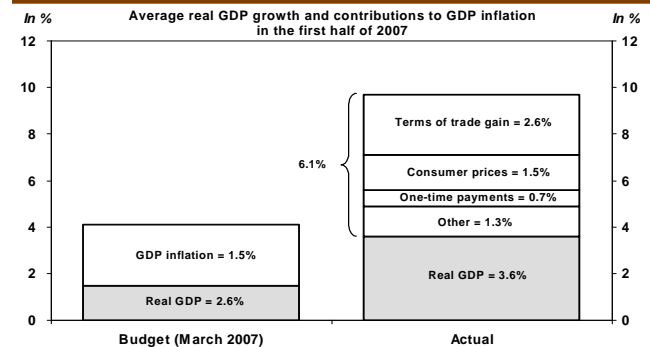
Canada's economic growth was much stronger than had been forecast in the first half of 2007. Not only did real GDP growth outstrip the forecast by 1%, but the GDP deflator increase is close to four times higher than expected due to greater improvement to the terms of trade and faster consumer price growth. Nominal GDP, the measure with the most impact on budgetary revenues, thus rose 9.7% in the first half of 2007. When the budget was tabled last March, the Department's projections were for growth of only 4.1%.

Given the latest developments, budgetary revenues should exceed last March's budget projections by \$12.0B for fiscal 2007-2008. This fresh financial leeway, combined with the \$13.8B payment on the debt in 2006-2007, illustrate the magnitude of the current disjunction between the federal government's revenues and program spending. Everything was thus in place to immediately move to reduce the tax burden on individuals and business. Otherwise, for the

current year, the budget surplus would have climbed to heights many deem to be excessive.

According to the federal government's latest projections for budget transactions, the debt (representing cumulative deficits) should be reduced by a further \$10.0B at the end of fiscal 2007-2008, taking it to \$457.3B. This constitutes a decrease of more than \$105B from the \$563B peak reached in 1996-1997. The debt to GDP ratio should thus drop below

Graph 1 – Economic growth is stronger than forecast



Source: Department of Finance of Canada

Table 3
Economic and financial forecasts

	2007			2008f			2009f		
	March budget	October stat.	Mouv. Desjardins	March budget	October stat.	Mouv. Desjardins	March budget	October stat.	Mouv. Desjardins
Average annual growth in %									
Real GDP	2.3	2.5	2.6	2.9	2.4	2.8	3.1	2.7	3.0
GDP deflator	1.5	3.3	3.2	2.0	2.4	2.8	2.0	2.0	2.5
Nominal GDP	3.9	5.9	5.9	5.0	4.8	5.6	5.2	4.7	5.5
Treasury bills – 3-month (1)	4.2	4.2	4.2	4.2	4.4	4.6	4.3	4.7	5.0
Federal bonds – 10-year (1)	4.1	4.3	4.3	4.5	4.6	4.7	5.2	5.0	5.2
Unemployment rate (1)	6.3	6.1	6.0	6.4	6.2	6.0	6.3	6.2	6.0
U.S. real GDP	2.5	1.9	1.9	2.9	2.2	2.5	3.3	2.9	3.0

f: forecasts; (1) Annual average in %.

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

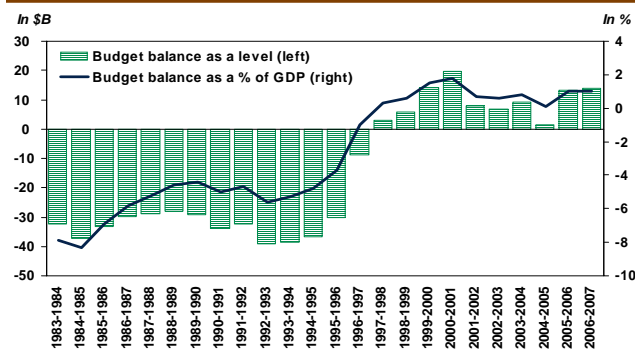
the 30% mark this year, reaching the target of 25% in 2011-2012, three years earlier than forecast.

Along with the improvement to economic conditions in the first half of 2007, the Finance Minister's new projections also factor in a degree of darkening of the economic outlook for the remainder of 2007 and 2008. Like most of the private sector forecasters, Finance Minister Jim Flaherty is stressing the downside risks to Canada's economic growth. The American real estate market's struggles and their impact on U.S. demand, the loonie's lively appreciation, as well as tightening of credit conditions by the financial institutions are among the factors that could curb economic growth in the coming quarters. The Department of Finance's latest projections for real and nominal GDP have thus been trimmed for 2008 and 2009. They are, in fact, similar to our projections, although our latest economic scenario features a slightly greater real GDP increase for next year.

measure, to be implemented on January 1, 2008, will take the GST rate to 5% and trim about \$6B year from the federal government's budget revenues. While the GST rate is being cut again, the tax credit for low income earners is staying at its current level.

The government is also announcing that the base amount tax payers can earn without paying income tax is being increased. The minimum tax rate has also been cut (retroactive to January 1, 2007) from 15.5% to 15.0%. The last Liberal government had, in fact, announced the decrease at the end of 2005, which was then cancelled in the first Conservative budget (May 2006). Jim Flaherty is giving Canadians back the tax cut he took back a year and a half ago. The increase in the base amount and drop in the minimum tax rate constitute a \$3.5B shortfall for the government in fiscal 2007-2008. The cost to the public coffers then becomes smaller (\$1.9B in 2008-2009, and about \$1.4B after that). The measures to cut personal income tax will thus primarily have a very short-term fiscal impact. The cost to the government is also well below that of the GST cut.

Graph 2 – Budget surplus follow one another

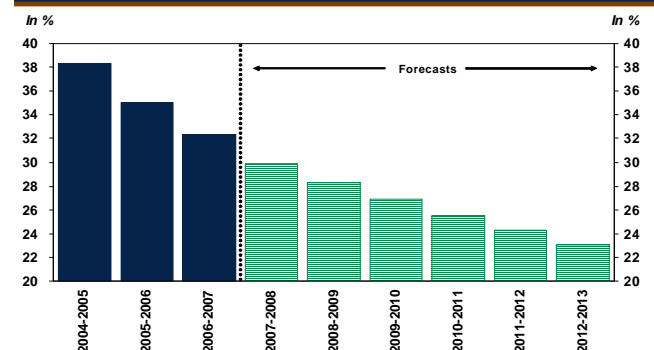


Source: Department of Finance of Canada

DECREASE IN PERSONAL INCOME TAX: MEASURES THAT AFFECT ALL CANADIANS

As expected, the federal government has come back with a further 1% cut to the Goods and Services Tax (GST). The

Graph 3 – Federal debt-to-GDP ratio



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

The tax measures affecting individuals announced by Finance Minister Jim Flaherty are less focused than the measures contained in previous budgets. For example, there is no specific focus on families or public transit users. Only households with modest incomes will see any notable difference in their financial circumstances under the terms of the announcement. We have already criticized the government's approach, which is to opt for cuts to GST rather than income tax. Note that a sales tax cut, which encourages consumption, has fewer economic benefits than an equivalent dollar cut to personal income tax. Domestic demand, consumption and consumer confidence are doing very well in Canada at this time, while savings is growing rather slowly.

FASTER, DEEPER TAX RELIEF FOR BUSINESS

Finance Minister Flaherty has understood that improving our international competitiveness also involves an advantageous tax system. He had mentioned it when he tabled his economic plan (Advantage Canada) last fall. A smaller tax bite on business encourages investment, improves productivity and secures long-term prosperity for the country.

Previously announced measures had taken the general corporate tax rate from 22.12% in 2007 to 18.5% in 2011. The Finance Minister is going further with this economic update, accelerating planned cuts and reducing the rate to 15% in 2012. A cut of 1 percentage point will be added to the cut scheduled for 2008, bringing the rate down to 19.5%. The Minister is also seeking the cooperation of provinces and territories in achieving a combined federal-provincial-territorial tax rate of 25% which, in 2012, would give Canada the lowest general corporate tax rate of G7 nations.

We often see programs that focus on stimulating investment in specific sectors of the economy. The Minister is trying to get us to overlook the standard recipe by seeking instead to create a more competitive tax environment for all businesses,

leaving the market free to decide which sectors are the most promising in terms of investment. This makes it possible to give the weakest sectors a boost by easing their tax burden, while encouraging the strongest sectors to develop further. It does give small business some extra help by moving up the implementation of cuts to the small business tax rate. In all, business will get a further \$14.4B in tax relief for the 2008-2009 to 2012-2013 fiscal years.

AN UPDATE THAT SHOULD PLEASE THE FINANCIAL MARKETS

In addition to reducing the tax burden on individuals and business, the federal government is moving ahead with its plan to repay the debt. Following an expected reduction of about \$10B this year, the Finance Minister will move ahead with a minimum reduction of \$3B a year until 2012-2013. The measure will increase the scarcity of federal government debt securities on the financial markets, which will be conducive to maintaining narrow interest rate spreads between Canada and the United States. The federal government's sound financial health should also make many investors happy, which could bolster the loonie, already thoroughly buoyed by the weak greenback and surge by raw materials prices. With the expected U.S. Federal Reserve cut to the target rate for federal funds on October 31, everything appears to be in place for the Canadian dollar to close in on its August 20, 1957 peak (US\$1.0613).

THE GST CUT COULD BE AN OPPORTUNITY FOR THE PROVINCES

The federal government's comfortable financial situation is prompting it to make some decisions in allocating the surplus. In our view, the three main criteria that should govern its decisions are effectiveness, equity and competitiveness. Overall, we believe these criteria have been broadly met. A lighter corporate tax burden makes business more competitive in relation to other nations and ensures the Canadian economy's potential develops over the medium and long term. The tax system's progressiveness has been maintained as well, meaning that the equity goal has been respected. Tax cuts for individuals and business also meet our efficiency criterion.

In fact, only the GST cut is questionable, because it fails to meet the efficiency criterion. Moreover, in a study,¹ the Department of Finance itself concluded that a GST cut has half as many positive effects on the economy as a decrease in personal or business tax. In exchange, it leaves the door open for provinces that want to improve their tax situations by taking over the terrain abandoned by the federal GST and increasing their sales tax.

Table 4
Statutory General Corporate Income Tax Rates
in G7 Countries, 2012

	<i>In %</i>
Canada	25.0 - 27.7
Federal statutory rate	15.0
Provincial-territorial statutory rate*	10.0 - 12.7
United Kingdom	28.0
Germany	29.8
France	33.3
Italy	37.3
United States	40.0
Japan	41.9

* Federal Government targets a 10% provincial rate, but provincial weighted average rate will remain at 12.7% without further provincial action.
Source: Department of Finance of Canada, October 2007

¹ Baylor, Maximilian and Louis Beauséjour, "Taxation and Economic Efficiency: Results from Canadian CGE models." Department of Finance Canada. 2004.