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FEDERAL BUDGET SPEECH OF DECEMBER 10, 2001

1. Fiscal Comments
2. Economic Comments

Audit and Tax Services
Taxation Department
Economic Studies

INFORMATION BULLETIN



Desjardins

Fédération des caisses
Desjardins du Québec

FISCAL COMMENTS

Canada's Minister of Finance, Paul Martin, tabled his budget this afternoon. As expected, the budget does not announce any significant tax measures. The majority of the fiscal texts restate the measures announced over the past five years. The fiscal comments on the budget will then be some of the briefest in a long time.

MEASURES AFFECTING DESJARDINS - BUSINESSES

Deferral of 2002 first-quarter tax instalments for SMEs

Like the provincial government, the Federal Department of Finance announces measures that are designed to defer the payments of the January to March 2002 instalments.

These measures apply to all corporations whose taxable capital for tax purposes under section 1.3 is below \$15 million. These measures affect almost all the caisses.

In general, the corporations affected will be able to defer the payments of January, February and March 2002 by six months.

In addition, corporations whose fiscal year ends between January and March 2002 will be able to pay their Federal balance due no later than six months after the end of their year and those whose fiscal years end between April and June will be able to pay the balance due on September 30, 2002.

More information will be sent to the caisses in a new Fiscalité Express.

Venture Capital – Eligibility of Limited Partnerships

Currently, pension funds and other tax-exempt investors may be unwilling to choose a limited

partnership, because interests in limited partnerships are generally treated as foreign property for the purposes of the income tax rules that limit the amount of foreign property that a deferred income plan can hold.

One of the proposed measures in the budget involves removing the 30-per-cent ownership limitation in limited partnerships as a condition for eligibility.

Accordingly, a limited partnership may be eligible even though a limited partner, either alone or as part of a non-arm's-length group, has more than a 30-per-cent ownership interest in the partnership. However, for the purpose of the foreign property rules, any limited partner or group that holds more than a 30-per-cent interest in a limited partnership will be treated as owning a proportionate interest of each property owned by the partnership, including any foreign property.

An ownership interest of 30 per cent or less in a limited partnership will remain exempt from treatment as foreign property.

This measure will apply after 2001.

MEASURES AFFECTING INDIVIDUALS

Quarterly Reassessment of the GST Credit

The GST credit is paid out quarterly over a twelve-month period (the benefit year) beginning each July. Currently, the credit is calculated on the basis of the income and family information provided at the end of the previous calendar year, six months before the beginning of the benefit year.

This budget announces that starting with the benefits payable for July 2002, an individual's entitlement to the GST credit for a quarter will be based on the individual's family situation at the end of the previous quarter. This will help to respond more rapidly to the changes in family situations, such as births, deaths and marriages.

Deduction for Tools – Apprentice Mechanics

The budget proposes to provide an income tax deduction for the extraordinary portion of the cost of new tools acquired by apprentice vehicle mechanics after 2001 and used by them during their apprenticeship.

The amount of the deduction will be the total cost of new tools acquired in a taxation year, less the greater of \$1,000 and 5 per cent of the individual's apprenticeship income for the year. Any part of the eligible deduction that is not taken in the year in which the tools are acquired can be carried forward and deducted in subsequent taxation years.

Deduction for Tuition Assistance

Some adult students who take basic education to upgrade their skills receive direct financial assistance from governments to pay their tuition fees. This tuition assistance must be included in the income, and the tuition fees do not qualify for any tax relief.

The budget proposes that individuals may deduct, in computing their taxable income, the amount of tuition assistance received for adult basic education that has been included in their income. In order to be eligible, the tuition assistance must be provided under certain programs, such as the Employment Insurance or other similar provincial programs.

This measure will apply to eligible tuition assistance received **after 1996**. Administrative procedures will be established over the coming months for the assistance received before 2001.

Extending the Education Tax Credit

Currently, students who receive financial assistance for post-secondary education under the government training programs cannot claim the tax credit for education.

Starting in 2002, the budget proposes to extend access to the education tax credit to students who receive taxable assistance for post-secondary education under some programs, such as

Employment Insurance or other similar provincial programs.

However, those whose tuition fees are paid by the employer are not eligible for the credit.

Donations of Some Securities to Charities

Under a special measure, the amount included in the income of a donor for capital gains tax purposes arising from donations of publicly traded securities is cut by half. Accordingly, the capital gains inclusion rate is reduced to 25%.

This measure was supposed to end on December 31. As announced in the October 12, 2001 release, this measure is now made permanent.

The measure also applies to corporations.

Also, a similar measure that applied to donations of securities purchased within a stock option scheme is also extended indefinitely.

Promoting Sustainable Woodlot Management

Currently a taxpayer may make an intergenerational transfer of farm property by deferring tax, if the property was principally used in a farming business in which the taxpayer or a family member was actively.

The operation of a woodlot can in some cases be considered a farming business. The tax-exempt intergenerational deferral cannot be used given the requirement for active involvement.

The budget proposes to facilitate the intergenerational rollovers of woodlots that are farming businesses. For transfers occurring after December 10, 2001, a new test will allow the intergenerational rollovers where the conditions of other rollovers are met and where the transferor or a family member is actively involved in managing the woodlot to the extent required by a prescribed forest management plan.

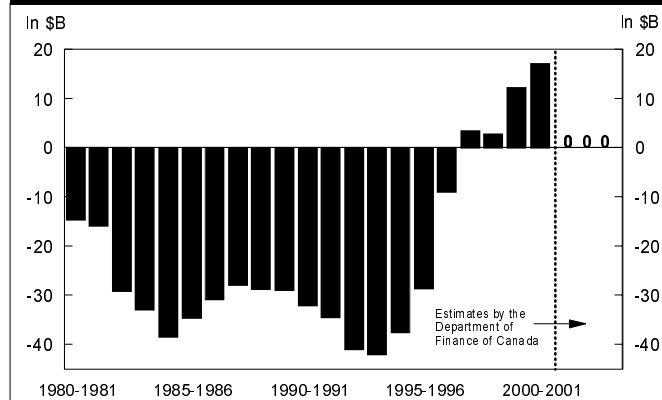
ECONOMIC COMMENTS

2001 Federal Budget: An unremarkable budget that focuses on caution and national security

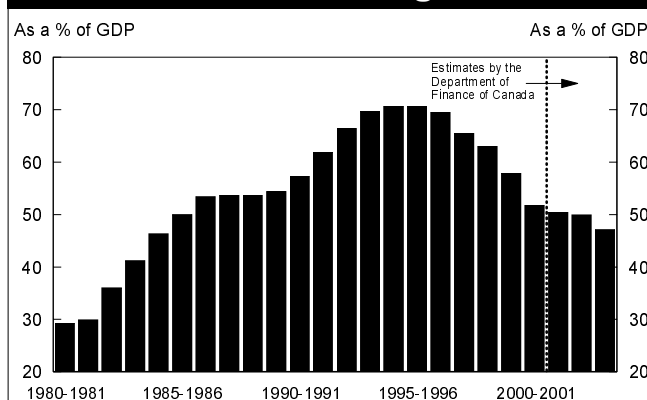
Highlights

- Paul Martin's 2001 Budget is based on two major concerns: 1) the economic slowdown and uncertainty worldwide; 2) the security of Canadian citizens.
- In the 2000-2001 fiscal year, the government brought down a budget surplus of \$17.1 billion. This was the fourth consecutive year in which a surplus was recorded and in relative terms, the best performance in the G-7.
- Budgets anticipated in 2001-2002 and for the next two fiscal years will be balanced or have a small surplus.
- As a result of the shift in the public finances, the net public debt-to-GDP ratio, which peaked to 70.7% in 1995-1996, should fall below 50% in 2002-2003, i.e. the lowest level since 1985.
- Federal program expenditures, expressed in per cent of the GDP, fell from 16.4% in 1993-1994 to 11.3% in 2000-2001. However, they will increase substantially during the next two years, reaching 12.4%, mainly because of the increases in provincial transfer payments for health and social programs.
- The deferral for six months of tax instalments for small businesses and the tax cuts already announced will bring budget revenues down by 4.1%.
- The budget earmarks \$7.7 billion for the improvement of national security in the next five years: \$6.5 billion for air-travel security and the armed forces and \$1.2 billion for border security.
- The budget also designates amounts for investments in strategic infrastructures (\$2 billion), learning and research (\$1.1 billion) and health to a lesser extent. In addition, the government will increase international assistance (\$1 billion).

Budget Balance: No Deficit on the Horizon



The Federal Debt Ratio Is Decreasing



Economic Assumptions and Budgetary Position: Paul Martin's Legendary Prudence Is the Dominant Factor

Once again, the Minister of Finance takes his lead from his caution and sticks with his mid- and long-term budget objectives that aim to improve the efficiency and productivity of the Canadian economy. He tabled a cautious unremarkable budget providing nearly nothing to offset in the immediate future the negative impact of the events of September 11 and the recession that Canada is currently experiencing.

The economic assumptions on which his budget projections are based are both realistic and moderately conservative. He anticipates real GDP growth in Canada of 1.3% and 3.9% respectively in 2001 and 2003. As this chart indicates, these projections are essentially comparable to those of the Mouvement Desjardins. They anticipate a rebound in economic activity in the second half of 2002, which will continue in 2003. Given the string of monetary and fiscal measures implemented since the beginning of 2001, which intensified following the attack on September 11, this scenario is very credible.

The Minister of Finance does not under any circumstance want to return to the deficit years, which may explain the apparent lack of proactivity with regard to the deteriorating conditions and the recession in effect since the middle of the year. So, he maintains a conservative and balanced budget for fiscal 2001-2002, 2002-2003 and 2003-2004. However, he confirms his previous commitments with respect to the tax cuts for 2002 and the subsequent years, as well as his September 2000 commitments that are designed to increase provincial transfer payments in the area of health.

At the same time, the government's budgetary position deteriorated because of the economic slowdown and the recession. To finance the new budget measures, particularly those aimed at improving security, the Minister must draw on his reserve. So the entire economic-prudence reserve of \$1 billion in 2001-2002 and of \$2 billion in 2002-2003 anticipated in the October 2000 statement was used, while the Contingency Reserve, created to protect the government against economic setbacks, fell to \$1.5 billion in 2001-2002 and \$2 billion in 2002-2003 rather than the \$3 billion, as was the case in previous years.

However, the government's financial ratios keep improving all across the board. For instance, in 2002-2003, the Federal debt as a per cent of GDP will fall just under 50% for the first time in 17 years.

Economic and Financial Estimates

| | 2001 | | | 2002 | | | 2003 | | |
|--------------------------------------|----------------|----------------|------------|----------------|----------------|------------|----------------|----------------|------------|
| | Private Sector | Federal Budget | Desjardins | Private Sector | Federal Budget | Desjardins | Private Sector | Federal Budget | Desjardins |
| Nominal GDP (%) | 4.1 | 2.6 | 2.6 | 3.1 | 1.3 | 1.1 | 5.9 | 5.9 | 5.6 |
| Real GDP (%) | 1.5 | 1.3 | 1.4 | 1.5 | 1.1 | 1.3 | 3.9 | 3.9 | 3.6 |
| Canadian Treasury Bills 3 months (%) | 4.0 | 3.8 | 3.9 | 3.2 | 2.4 | 2.4 | 4.7 | 4.0 | 4.5 |
| Canadian Bonds 10 years (%) | 5.5 | 5.5 | 5.5 | 5.5 | 5.5 | 5.8 | 5.9 | 5.9 | 6.0 |

SUMMARY OF BUDGETARY TRANSACTIONS (billions of dollars)

| | 1997-1998 | 1998-1999 | 1999-2000 | 2000-2001f | 2001-2002f | 2002-2003f | 2003-2004f |
|-----------------------------------|---------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Budgetary transactions | | | | | | | |
| Revenues | 153.2 | 155.7 | 165.7 | 178.6 | 171.3 | 174.7 | 180.7 |
| - Change (%) | 8.7 | 1.6 | 6.4 | 7.8 | -4.1 | 2.0 | 3.4 |
| Program spending | -108.8 | -111.4 | -111.8 | -119.3 | -130.5 | -136.6 | -140.2 |
| - Change (%) | 3.8 | 2.4 | 0.4 | 6.7 | 9.4 | 4.7 | 2.6 |
| Operating balance | -108.8 | 44.3 | 53.9 | 59.2 | 40.7 | 38.2 | 40.4 |
| Public debt charges | -40.9 | -41.4 | -41.6 | -42.1 | -39.2 | -36.3 | -38.1 |
| - Change (%) | -9.1 | 1.2 | 0.5 | 1.2 | -6.9 | -7.4 | 5.0 |
| Contingency Reserve | --- | --- | --- | --- | 1.5 | 2.0 | 2.5 |
| Budgetary balance | -149.7 | 2.9 | 12.3 | 17.1 | 0.0 | 0.0 | 0.0 |
| Debt paydown | 3.5 | 2.9 | 12.3 | 17.1 | 0.0 | 0.0 | 0.0 |
| Financial requirements/source | 12.7 | 11.5 | 14.6 | 19.0 | -1.9 | -1.0 | 1.2 |
| Program spending-to-GDP ratio (%) | 12.3 | 12.2 | 11.5 | 11.3 | 12.0 | 12.4 | 12.1 |
| Debt-to-GDP ratio (%) | 65.5 | 63.0 | 57.9 | 51.8 | 50.5 | 49.9 | 47.1 |

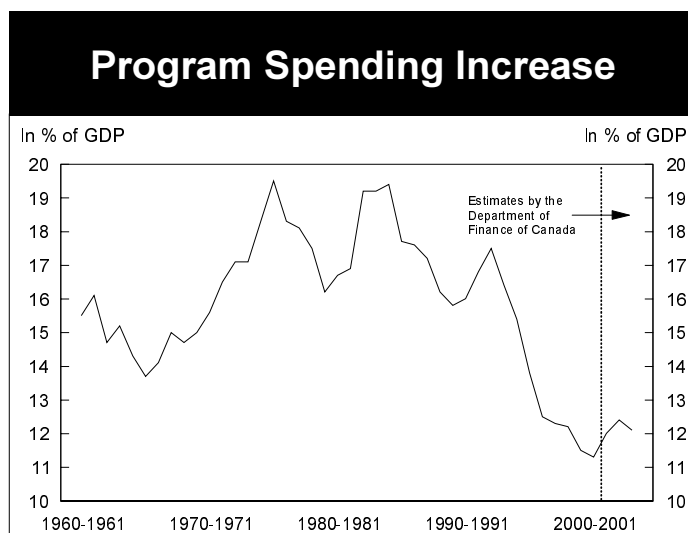
f: forecasts

Security and Infrastructures, Front and Centre in the Budget Initiatives

The terrorist attacks of last September in the United States not only changed the economic environment in which public finances evolve, but also the Federal government's priorities. As a result, Minister Martin is for a time putting aside his debt-reduction plan in order to significantly increase public expenditures, as the security of Canadians is the core of the main budget initiatives. The program expenditures will increase by 9.4% in the current year (2001-2002), as opposed to the 6.7% in 2000-2001 and 0.4% in 1999-2000.

The new budget announces an injection of \$7.7 billion during the next five years to improve the security of Canadians. The main measures in this program are as follows:

- Injection of \$1.6 billion to improve intelligence and law-enforcement services. From this amount, \$1.2 billion will be earmarked for the training of officers in intelligence and policing and to new equipment.
- Nearly \$1 billion will go to improving controls of entrants to Canada.
- Emergency preparedness will benefit from an extra \$1.6 billion, \$510 million of which will be allocated to the Canadian Armed Forces for Canada's participation in the international military campaign against terrorism and the purchasing of material.
- The Federal government earmarks \$1.2 billion in order to ensure that its borders with the United States are secure, open and efficient. This includes \$646 million to improve the security and the seamlessness of the border and \$600 million for new infrastructures.
- Lastly, \$2.2 billion will go to finance a new air security approach. This includes the set-up of a new organization in charge of air-travel security, help for transporters in limiting access to cockpits and increased security in airport work areas.
- A new air-traveller security charge will be levied starting April 1, 2002. The \$12 fee for a one-way fare and \$24 for a return trip will bring a little over \$2.2 billion over the next five years and will cover all the costs associated with the new component in air-travel security.



Other measures are also proposed to build a strong economy and improve the quality of life of Canadians. The strategic investments will account for a little over \$5.1 billion by 2003-2004 if all the commitments are carried out. The initiatives are designed to strengthen the Federal government's contribution in the field of research in health to promote the learning and acquisition of skills, to invest in research, especially in the academic community, in the set-up of a state-of-the-art Internet network, in strategic infrastructures and the environment, such as the \$680 million over five years to provide investments in social housing, and to improve the assistance programs for Aboriginal children. A commitment of at least \$2 billion is also proposed to finance a foundation for strategic infrastructures. The Foundation, in cooperation with provincial and municipal authorities, will provide shared-cost assistance within the framework of large infrastructure projects, such as highways and public utilities. This amount is separate from the \$2.6 billion programs announced in the February 2000 budget. In addition, the government will also increase its international assistance with close to \$1 billion over the next three years, including \$100 million to Afghanistan in a few months.

To help smaller businesses face their immediate cashflow needs during this economic slump, the government is deferring for six months the payment of tax instalments for the months of January, February and March 2002. All in all, some \$2 billion will be taken out of the 2001-2002 year and deferred to the next budget year.

Federal Budget 6

Aside from the new measures, one must also take into account the tax relief on personal income that began in the last budget and the October 2000 statement. So, in 2004-2005, once all the measures announced are implemented, personal income tax will have decreased on average by 21%, i.e. a total of \$100 billion. In 2002, taxpayers will also benefit from a 3% indexation of the tax system.

The Federal government also confirms its \$23.4 billion commitment towards the provinces made in September 2000 with respect to health and social programs. Over 70% of this amount have already been granted to the provinces during the 2000-2001 budget year. The provinces should then receive \$6.9 billion by the 2005-2006 budget year.

| Proposed Expenditures and Revenue in the December 2001 Budget | | | | | | | |
|--|--------------|-------------------------|--------------|--------------|--------------|--------------|---------------|
| (In millions of \$) | 2001-2002f | 2002-2003f | 2003-2004f | 2004-2005f | 2005-2006f | 2006-2007f | Total |
| Security | | | | | | | |
| Intelligence and Law Enforcement | 273 | 253 | 276 | 279 | 275 | 278 | 1,634 |
| Entrant Control | 143 | 186 | 184 | 157 | 165 | 165 | 1,001 |
| Emergency Preparedness and Military Deployment | 535 | 316 | 204 | 201 | 192 | 192 | 1,638 |
| Air Security | 115 | 462 | 573 | 367 | 366 | 306 | 2,189 |
| Border Measures | 72 | 306 | 260 | 257 | 201 | 151 | 1,246 |
| Health | 105 | 78 | 78 | | | | 261 |
| Skills, Learning and Research | 429 | 318 | 318 | | | | 1,065 |
| Strategic Infrastructures and Environment | 207 | 181 | 234 | | | | 622 |
| Strategic Infrastructure Foundation | | Commitments for 2,000 M | | | | | 2,000 |
| Aboriginal Children | | 90 | 95 | | | | 185 |
| International Assistance | 215 | 0 | 285 | | | | 500 |
| Africa Fund | | Commitments for 500 M | | | | | 500 |
| Ministerial Events | 569 | 361 | 198 | | | | 1,128 |
| Total of Announced Spending | 2,664 | 2,551 | 2,703 | 1,260 | 1,199 | 1,092 | 13,969 |
| Deferral of Tax Instalments | 2,000 | -2,000 | | | | | 0 |
| Tax-Expenditure Measures | 10 | 40 | 60 | | | | 110 |
| Air-travel Security Charge | | -430 | -445 | -445 | -445 | -445 | -2,210 |
| Cost Recovery | | -50 | -50 | -30 | -25 | -25 | -180 |
| Total Revenue | 2,010 | -2,400 | -435 | -475 | -470 | -470 | -2,280 |

f: forecasts

In Short, a Conservative and Cautious Budget, but Few Measures to Offset the Recession and the Current Uncertainties

The Federal budget of December 10, 2001 is in line with the customary Paul Martin tradition. The Minister stuck with his budget strategy of the past six years that focuses on the improvement of government's financial situation and the commitment to improve Canada's competitive position on the long term on the North-American and international scenes, e.g. by promoting research and development, innovation, technological investments, improving the health system and consolidating the government's financial situation.

The better part of the new money goes to strengthening the security of Canadians in the aftermath of the events on September 11, 2001. The government renewed the tax cuts announced previously in the February 2000 budget and the pre-election budget statement of October 18, 2000. However, the Minister of Finance has not introduced many measures to offset the prevailing recessionary context or to alleviate

uncertainties. There is nothing for consumers, except for the tax cuts and the indexation of the tax system announced last year. The government could have been more proactive and send a clear message to economic actors to prevent the economic situation from worsening even more.

However, this budget should satisfy financial markets and put their minds at ease. There is no deficit on the horizon. Several financial ratios will keep improving. The government maintained the principle of a contingency reserve to protect itself against unfavourable conditions, although the reserve has decreased. In short, unless circumstances turn really bad, i.e. if consumer and business confidence worsens even more, Paul Martin's prudence should safeguard the government from slippage, which would cancel the gains achieved with great sacrifice over the last six years.