

# Budget

## EXPRESS

March 25, 2008

### ONTARIO BUDGET SPEECH

- *Tax Measures*

*No changes for Corporate and  
for Personal Income Tax*

- *Economic Budget Analysis*

A Lacklustre Budget

The Economic Slowdown  
Could Result in Additional  
Action



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*Ontario's Minister of Finance, Dwight Duncan, tabled his 2008-2009 budget this afternoon. The budget has no tax increases or tax cuts and it eliminates Capital Tax for businesses involved in manufacturing and resources retroactively to January 1, 2007, one year earlier than planned. In addition, it extends some exemption measures in the retail sales tax and harmonizes measures with the Federal government.*

## **MEASURES AFFECTING DESJARDINS - ENTERPRISE**

### **Tax-Free Savings Account (TFSA)**

The Ontario government is fully harmonizing with the Federal TFSA rules.

Bear in mind that, starting in 2009, an individual will be able to make a maximum non deductible contribution of \$5,000 in an account whose investment income will be tax free. Unused room will be carried over for future years. Withdrawals from these accounts will regenerate the rights.

Like for RRSPs, Ontario is relying on the Federal government to manage any aspect of this account.

### **Flexibility with Regard to Life Income Funds (LIFs)**

The government is announcing that the improved characteristics of the new Ontario LIFs, established in the March 2007 budget, will also be applicable in 2008 to the old Ontario LIFs or locked-in retirement income funds (LRIFs). The measures are as follows:

- annuitants will be able to transfer amounts of up to 25% of the LIF amount to unlocked accounts;
- annuitants will be able to increase the maximum annual withdrawal depending on the fund's performance in the previous year.

### **Registered Education Savings Plan (RESP)**

The government is harmonizing with the changes proposed by the Federal government by extending for 10 years the maximum lifespan, maximum contribution period and contribution age limit for a family plan in 2008.

### **A Single Corporate Tax Administration**

In October 2006, Ontario and the Federal government signed a memorandum of agreement to transfer the collection and administration of certain Ontario corporate taxes to the federal government. As a result, the Canada Revenue Agency (CRA) will be able to collect and administer Ontario's Corporate Income Tax, Capital tax, Corporate Minimum Tax and Special Additional Tax on life insurers for taxation years ending after December 31, 2008.

Bear in mind that Ontario corporations will be filing a single tax return for taxation years ending after December 31, 2008. In addition, CRA has begun to collect instalments on Ontario corporate income tax for taxation years ending in 2009.

## MEASURES AFFECTING INDIVIDUALS

### Tax-Free Savings Account (TFSA)

As mentioned previously, the new TFSA will allow individuals to accumulate investment free of income tax.

### Harmonizing the Gross-up Factor of Eligible Dividends to Federal Rules

Like the Federal government, the budget provides that the gross-up factor for eligible dividends will be amended according to the following table. However, the tax credit rate for Ontario dividends will be maintained and presented hereunder.

	2008	2009	2010	2011	2012
Gross-up (%)	45	45	44	41	38
Credit rate (%)	7.0	7.4	7.7	7.7	7.7

### Senior Homeowners' Property Tax Grant

Starting in 2009, the budget provides for a new property tax grant for seniors with low or moderate income who own their own homes. The new grant could reach \$250 in 2009 and \$500 by 2010.

An eligible individual living alone with up to \$35,000 in annual income and paying property tax of \$500 or more will receive the maximum amount. The grant will be proportionately smaller for those whose income is between \$35,000 and \$50,000. Eligible couples with income between \$45,000 and \$60,000 would receive a proportionately smaller grant.

### Property and Sales Tax Credits for Seniors

In 2007, the property and sales tax credits for seniors were reduced to a threshold of \$23,820.

The new threshold for 2008 will be established when the Federal government finalizes the Old Age Security and the Guaranteed Income Supplement for 2008.

### Transfers from Family Farm Corporations

Currently, transfers of farmland between family members and transfers into a family farm corporation are exempt from Land Transfer Tax. Amendments will be proposed to expand the exemption to include transfers of farmland from family farm corporations to individual family members. The proposed measure would apply to qualifying transfers after March 25, 2008.

### Expansion of the Medical Expense Tax Credit

The government will be harmonizing with the Federal government by expanding the list of eligible expenses for the Medical Expense Tax Credit.

### Exemption of Certain Elements in the Retail Sales Tax (RST)

The budget proposes to expand certain RST exemptions with respect to the following supplies:

- newspapers;
- admissions to live theatres of not more than 3,200 seats;
- energy-star household appliances and light bulbs;
- bicycles and related safety equipment;
- nicotine replacement therapies;
- destination marketing fees.

## MEASURES AFFECTING CORPORATIONS

### Elimination of Capital Tax for All Activities Involved in Manufacturing and Resources

It was proposed to eliminate the Capital Tax effective January 1, 2008, for Ontario companies primarily engaged in manufacturing and resource activities. In this Budget, the government is proposing to retroactively eliminate the Capital Tax one year earlier, effective January 1, 2007.

The proposed elimination would apply to corporations whose salaries and wages relating to manufacturing and processing (M&P), mining, logging, farming or fishing activities in Ontario represent 50 per cent or more of their total salaries and wages in Ontario. For corporations whose salaries and wages in Ontario for these activities comprise less than 50 per cent, but more than 20 per cent of their total salaries and wages in Ontario, the Capital Tax would be reduced proportionately.

As previously legislated, the Capital Tax deduction for other corporations increased to \$15 million on January 1, 2008, and the Capital Tax will be fully eliminated on July 1, 2010.

### Ontario Innovation Tax Credit (OITC)

The OITC is a refundable tax credit available to small and medium-sized corporations that carry on scientific research and experimental development (SR&ED) in Ontario. The OITC provides a refundable 10 per cent tax credit on a corporation's qualifying SR&ED in Ontario.

Currently, the OITC is applicable to the first \$2M in expenditures incurred each year. The \$2M limit is progressively reduced for corporations whose taxable income in the preceding taxation year is more than \$400,000 but less than \$600,000 and whose taxable capital used in Ontario in the preceding taxation year is greater than \$25M but less than \$50M.

In line with the Federal amendments announced on February 26, 2008, the budget proposes to extend the limit of eligible expenses and to expand the phase-out range applicable to taxable income. Ontario will not change its phase-out range of taxable capital, which is currently above the current and proposed Federal phase out range.

	Current	Proposed
Expenditure limit	\$2M	\$3M
Phase-out range		
Taxable income	From \$400,000 to \$600,000	From \$400,000 to \$700,000
Taxable capital	From \$25M to \$50M	From \$25M to \$50M

Like for the Federal government, the amendments proposed are applicable to taxation years that end after February 25, 2008, proportionately to the number of days from this date.

### Tax Exemption for Commercialization

The government is proposing a 10-year tax exemption from Ontario Corporate Income Tax and Corporate Minimum Tax for new corporations established in Ontario between March 24, 2008 and March 25, 2012 that commercialize intellectual property developed by qualifying Canadian universities, colleges or research institutes.

The exemption would generally apply to corporations that commercialize intellectual property in priority areas such as, but not limited to, bio-economy/clean technologies, advanced health technologies, and telecommunications, computer and digital technologies.

### Allowance for Manufacturing and Processing Equipment

The 2007 Federal budget proposed a temporary tax incentive in the form of a 50 per cent straight line CCA rate for M&P machinery and equipment acquired on or after March 19, 2007, and before 2009. The 2008 federal budget proposed to extend this incentive by allowing eligible assets acquired in 2009 to be depreciated on a 50 per cent straight-line basis and those acquired in 2010 and 2011 on a declining balance basis. Subject to enactment of the applicable federal regulations, the Ontario budget proposes to extend this tax incentive for manufacturers in line with the proposed federal rates and effective dates.

**Taxation Division****Instalments for Small Businesses**

Recent federal legislation has changed corporate tax instalment rules to generally permit small Canadian-controlled corporations to remit their instalments on a quarterly basis rather than on a monthly basis. The new federal legislation also allows corporations with current- or past-year federal tax of up to a new limit of \$3,000 (increased from \$1,000) complete relief from the requirement to pay instalments.

For taxation years ending after 2008, Ontario proposes to amend the corporate tax instalment rules to parallel the new federal corporate tax instalment rules.

# Budget Analysis

March 25, 2008

## ONTARIO: 2008 BUDGET

### A lacklustre budget

*The economic slowdown could result in additional action*

It is increasingly obvious that Ontario will be going through a short recession in early 2008. It will be small in scope and will be coming in through the United States. Yet, Minister Duncan does not seem to believe it. His budget presents rather optimistic economic forecasts and does not introduce any anticyclical measure that would mitigate the harmful effects of an economic slowdown. Only his Skills to Jobs Action Plan indicates that the government has understood that significant job losses in the manufacturing sector will require major investments in training so that workers can be recycled in other sectors.

**Table 1**  
**Summary statement of transactions**

In \$M	Actual		Projection		
	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011
<b>Own source revenues</b>	<b>76,361</b>	<b>79,663</b>	<b>80,420</b>	<b>83,600</b>	<b>86,100</b>
- Variation (%)	7.6	4.3	1.0	4.0	3.0
<b>Federal transfers</b>	<b>14,036</b>	<b>16,900</b>	<b>16,500</b>	<b>17,000</b>	<b>17,700</b>
- Variation (%)	5.9	20.4	-2.4	3.0	4.1
<b>Total budgetary revenues</b>	<b>90,397</b>	<b>96,563</b>	<b>96,920</b>	<b>100,600</b>	<b>103,800</b>
- Variation (%)	7.3	6.8	0.4	3.8	3.2
<b>Program spending</b>	<b>-79,297</b>	<b>-86,997</b>	<b>-87,279</b>	<b>-90,600</b>	<b>-93,400</b>
- Variation (%)	5.9	9.7	0.3	3.8	3.1
<b>Debt charges</b>	<b>-8,831</b>	<b>-8,966</b>	<b>-8,891</b>	<b>-9,000</b>	<b>-9,100</b>
- Variation (%)	-2.1	1.5	-0.8	1.2	1.1
Reserve	---	---	-750.0	-1,000.0	-1,200.0
<b>Budgetary balance</b>	<b>2,269</b>	<b>600</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Net debt</b>	<b>141,100</b>	<b>142,839</b>	<b>146,232</b>	<b>n.a.</b>	<b>n.a.</b>

n.a.: not available

Sources: Ontario Ministry of Finances and Desjardins, Economic Studies

**François Dupuis**  
Vice-President and Chief Economist

**Benoit P. Durocher**  
Senior Economist

**Yves St-Maurice**  
Director and Deputy Chief Economist

**Mathieu D'Anjou**  
Senior Economist

514-281-2336 or 1 866 866-7000, ext. 2336  
E-mail: [desjardins.economics@desjardins.com](mailto: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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### A "PLAN B" IN THE WINGS

It seems that some governments have had considerable difficulty in adequately anticipating their revenues during 2007-2008 and Ontario is no exception. In comparison with the 2007 budgetary plan, the government missed its target by \$5.1B in revenues, i.e., a 5.5% mistake. Total revenues will reach \$96.6B rather than the \$91.5B anticipated in March 2007. This discrepancy is mainly due to corporate and personal income tax overshooting their targets by \$2.1B and \$1.4B respectively. Faced with this windfall, the government used the opportunity to increase its expenditures by almost \$4.8B, which allowed it not to use the contingency reserve and as a result generate a surplus of \$600M. Thanks to stronger than anticipated economic growth, the government should count its blessings.

However, the environment may well change for fiscal 2008-2009 as the province will probably be facing a recession. Revenue growth will be that much more weakened. In fact the Minister anticipated revenue growth of only \$357M (+0.4%) for 2008-2009. This is relatively small given that, according to his document, economic growth will reach 1.1% in 2008. As for expenditures, the government intends to increase them by a mere \$282M (+0.3%). The health and education sectors will be benefiting from some of its generosity: their respective budgets will be increasing by 6.0% and 5.6%. However, all other expenses will be taking a 7.9% cut, which should spread fear in some ministries that will see some programs ending.

Apparently, Ontario's budgetary policy is to underestimate its revenues, as a precaution, and to do the same with its expenditures. In this way, if revenues are coming in more quickly than anticipated, the government can increase expenses to the same extent. In this way it makes sure that it is maintaining its budgetary balance and gives itself the

flexibility of announcing additional expenses or tax cuts in the middle of the financial year. With the additional \$750M budgetary reserve for fiscal 2008-2009, it is clear that the government of Ontario is being very cautious.

In the current context, when uncertainties as to where the financial crisis is going remain very present, which could lead the U.S. economy even more astray, the government should be congratulated for acting responsibly. It must however keep in mind that Ontario's economy could be going through a slight recession and that the establishment of the measures aimed at improving the productivity of the economy should mitigate its effects while favouring its structuring effects over the long term. However, the government preferred to wait for clearer indications on where Ontario's economy is going before acting in this way. There could be a Plan B waiting in the wings.

### THE GOVERNMENT MIGHT BE CAUGHT OFF GUARD BY A RECESSION IN 2008

If the Ontario government had been clearly cautious in establishing its economic forecasts in last year's budget, the situation has now changed in 2008. For instance, real GDP growth in 2007 was evaluated at only 1.6% in last year's budget, i.e., close to 0.5 percentage points lower than the result expected now (2.1%). The 2008-2009 budget now anticipates that the growth rate of Ontario's economy should slow down in 2008 and an increase of only 1.1% of real GDP is anticipated.

In our view, the slowdown of Ontario's economy could be even more severe this year. Bear in mind that most of the forecasts used by the Ministry of Finance were established early in the year. The economic outlook for Canada and especially in Ontario had now deteriorated significantly. The signs indicating that economic activity in the United States

**Table 2**  
**Economic and financial forecasts**

	2007			2008 <sup>f</sup>			2009 <sup>f</sup>		
	Budget 2007	Budget 2008	Desjardins Group	Budget 2007	Budget 2008	Desjardins Group	Budget 2007	Budget 2008	Desjardins Group
Variation in %									
Real GDP	1.6	2.1 <sup>e</sup>	2.1 <sup>e</sup>	2.8	1.1	0.5	3.1	2.1	1.5
Nominal GDP	3.1	5.1 <sup>e</sup>	5.3	4.7	2.8	3.0	4.7	3.9	2.9
Employment	1.1	1.6	1.6	1.4	1.0	1.2	1.6	1.1	0.7
U.S. real GDP	2.7	2.2	2.2	3.0	1.7	1.0	3.1	2.6	2.0
Canadian dollar (US¢)	86.0	93.1	95.0	87.5	100.0	99.0	88.0	98.0	101.0
Treasury bills – 3-month	4.1	4.2	4.1	4.3	3.3	3.0	4.5	3.8	3.7
Federal bonds – 10-year	4.2	4.3	4.3	4.7	3.9	3.9	5.1	4.5	4.4

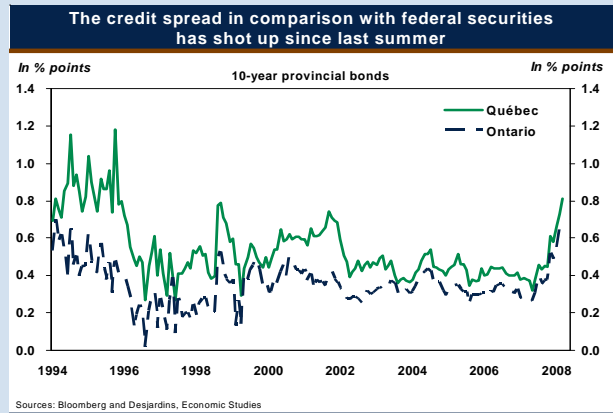
e: estimates; f: forecasts

Sources: Statistics Canada, Bank of Canada, U.S. Bureau of Economic Analysis, Blue Chip Economic Indicators, Ontario Ministry of Finances and Desjardins, Economic Studies

**IMPACT ON FINANCIAL MARKETS**

Today's budget should not impact financial markets significantly. The interest rate spread between provincial and federal bonds will continue to reflect the evolution of the credit crisis over the next few months. The major financial turbulence since last summer has led to a widespread reappraisal of risk premiums and, despite almost no probability of defaulting, provincial bonds were not spared. The spread between Ontario and Federal bonds has recently reached levels that had not been seen in over ten years and no quick return to normal is expected.

The financial turbulence is affecting securities in all provinces but the marked darkening of the economic outlook in Ontario could disadvantage it even more. Budget 2008 confirms the fragile financial situation of the Ontario government, as maintaining a budgetary balance appears to be hazardous, and the important



investments announced will increase the province's financing needs and its bond issues. In this context, it is possible that Ontario bonds underperform slightly in comparison with other securities in provinces that are not as affected by the U.S. economic slowdown.

**Table 3**  
**Some elements that are affecting the offer of Ontario bonds**

ln \$M	2007-2008	2008-2009	2009-2010	2010-2011
Deficit / (surplus)	-0.6	0.0	0.0	0.0
Investments in property, plant and equipment	3.6	4.9	6.0	7.1
Maturing debt	13.5	20.5	14.6	10.4
Total financing requirements	19.8	26.9	20.6	18.9
Total long term public borrowing requirements	18.0	24.3	20.9	19.4

Source: Ontario Ministry of Finances

is declining have multiplied, which points towards greater foreign trade difficulties in Canada. Since Ontario is the Canadian province that is the most dependent on trade with the United States, the negative effects of an U.S. economic slowdown will be important. In fact, our most recent economic scenario anticipates a slight decline of Ontario real GDP in the first half of 2008, which in fact means a technical recession. So Ontario's real GDP could grow by only 0.5% in 2008, i.e., projections that are less than half the assumption of a 1.1% increase used in the budget. As for nominal GDP, the Ministry of Finance forecasts a sharp drop in 2008 and 2009. According to our forecasts, a downside risk remains present for next year.

The negative impact of this overestimation of economic growth on the budgetary balance will however be offset, at



least in part, by lower interest rates. If economic growth is below Ministry of Finance forecasts, interest rates should, as circumstances dictate, be lower than anticipated for the Ontario government.

#### **BUDGETARY MEASURES THAT DISREGARD A POSSIBLE RECESSION**

Budget 2008-2009 may include many new measures, but the lack of any significant action to offset the economic slowdown is somewhat disappointing. It must be recognized that the Ministry of Finance's assumptions are rather optimistic and seem to disregard the possibility of an economic decline. As mentioned previously, we feel that the risks of a recession for the Ontario economy in the first half of 2008 are relatively high. Should that be the case, it is possible that the Ontario government will be forced to react by announcing additional measures during the year. This could however be too late to really prevent a production decline in the province.

Among the measures announced today, the \$1.5B investment in worker training and knowledge must be mentioned. New expenditures of \$1B are also expected for municipal infrastructures in 2007-2008. The Ministry of Finance is also

proposing to introduce close to \$300M in new investments to promote and support Ontario's assets in innovation. Lastly, partnerships with private businesses and other levels of government will be set up to strengthen Ontario by implementing significant economic development initiatives.

#### **CAUTION OR SLUGGISHNESS?**

The 2008-2009 budget is reinforced in the sense that caution ensures that the budgetary balance will be respected. The Minister is rather optimistic as to economic growth for 2008, but he seems to have a lot of leeway to deal with the problems, should Ontario's economy get drawn into a recession. A \$750M reserve is anticipated to face the contingencies while the growth of budgetary revenues seems to be underestimated.

In this way, the caution that the government is showing may be slightly exaggerated. A better balance could have been struck between stronger fiscal stimulation measures and a calculated risk of declaring a slight deficit. Despite less flexibility and a higher debt level, the Québec government has managed to implement an impressive infrastructure program and grant significant tax cuts. These actions will probably allow the province to avoid an economic slowdown.