

FISCAL MEASURES

Québec Budget



Office of the vice-president, Taxation
www.desjardins.com

May 24, 2007

This afternoon, Minister of Finance Monique Jérôme-Forget tabled her new 2007-2008 budget at the National Assembly. Let us first point out that this budget confirms all the measures presented in the previous February 20 budget. In addition, this budget introduces some new measures, the two main ones being an additional personal income tax cut for 2008 and the elimination of the corporate tax on capital as of January 1, 2011. Accordingly, this document does not reintroduce the fiscal measures presented in the *Budget Express* document of February 20, but outlines the new measures announced in today's budget.

Highlights

| Measures affecting Desjardins – Corporate | Measures affecting individuals | Measures affecting businesses |
|--|---|--|
| <ul style="list-style-type: none">. Gradual elimination of the tax on capital. Establishment of the Registered Disability Savings Plan. Harmonization measures with the federal budget | <ul style="list-style-type: none">. Personal income tax cuts. Establishment of the Registered Disability Savings Plan. Harmonization measures with the federal budget | <ul style="list-style-type: none">. Gradual elimination of the tax on capital. Remittance of payroll withholdings. Increase of the QST yearly remittance threshold. Refundable tax credit for resource regions. Harmonization measures with the federal budget |

May 24, 2007



MEASURES AFFECTING DESJARDINS - CORPORATE

Gradual Elimination of the Tax on Capital

Québec had already announced that it would gradually cut the tax on capital. In this budget, the government announces the elimination of this tax as of January 1, 2011, both for financial institutions and other corporations. By then, the cuts will also occur at a quicker than anticipated pace:

Tax on Capital Rate – Financial Institutions (%)

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|-------------|------|------|------|------|------|
| Pre Budget | 0.98 | 0.72 | 0.58 | 0.58 | 0.58 |
| Post Budget | 0.98 | 0.72 | 0.48 | 0.24 | 0.00 |

Note: The rate cuts will come into effect on January 1 of each year.

This elimination does not apply to the tax on capital of insurance companies.

Establishment of the Registered Disability Savings Plan

As outlined in the section of the measures affecting individuals, Québec is announcing that it is harmonizing with the federal government with respect to the establishment of the Disability Savings Plan.

Harmonization measures with the federal budget

The following measures, announced in the federal budget of March 19, 2007, are taken on by Québec:

- elimination of the annual limit on registered education savings plan (RESP) contributions;
- increase of the RESP lifetime limit from \$42,000 to \$50,000;
- increase of the basic RESP grant announced in the February 20, 2007 budget. Accordingly, the maximum Québec annual grant increases from \$200 to \$250;
- recognition of part-time studies for RESP purposes;
- increase of the capital cost allowance rates for some tax categories (mainly buildings and computer equipment)

MEASURES AFFECTING INDIVIDUALS

Personal Income Tax Cuts

As anticipated, the government is announcing interesting personal income tax cuts, but taxpayers will have to wait until 2008 to take advantage of them. Accordingly, the income bracket thresholds as well as the amount used to calculate the basic credit allowance will be increased as of 2008, as shown in the following table:

Taxable Income Brackets and Amount Used to Calculate the 2007-2008 Basic Credit Allowance

| Marginal Rate (%) | Taxable Tax Bracket | 2007 (\$) | 2008 (\$) <u>PreBudget</u> | 2008 (\$) <u>PostBudget</u> |
|-------------------|---|------------------|----------------------------|-----------------------------|
| 16 | Not exceeding | 29,029 | 29,875 | 37,500 |
| 20 | Over but not exceeding | 29,029 58,595 | 29,875 59,765 | 37,500 75,000 |
| 24 | Over | 58,595 | 59,765 | 75,000 |
| | Amount used to calculate the basic credit allowance | 9,745 | 9,940 | 10,215 |

(1) The thresholds and limits were indexed based on an index estimated at 2%.

For an individual, these increases will cut Québec income tax as follows:

| Reduction of the income tax paid to Québec (\$) | | | |
|---|--------------|--------------|---------------|
| Taxable Income | 25,000 | 50,000 | 75,000 |
| Tax paid 2007 | 2,051 | 6,879 | 12,535 |
| Tax paid 2008 | <u>1,957</u> | <u>6,457</u> | <u>11,457</u> |
| Cut | <u>94</u> | <u>422</u> | <u>1,078</u> |

Establishment of the Registered Disability Savings Plan

The Québec government is harmonizing with the federal government with respect to the establishment of a Registered Disability Savings Plan (RDSP). In general, the rules will be similar to those of the federal plan announced in the previous budget of March 19. However, no grant and no “disability savings bond” will be paid out by Québec.

In addition, income that will be taxable under this plan will be included in the calculation of the taxable income and not the net income, which will allow recipients to keep benefiting from some tax relief calculated based on the net income.

Harmonization Measures with the Federal Budget

The following measures, announced in the federal budget of March 19, 2007, are taken up by Québec:

- Increase from 69 to 71 of the RRSP age limit and the resulting impact;
- rise of the lifetime capital gains exemption from \$500,000 to \$750,000;
- no-taxation of capital gains on donations of publicly-listed securities to private foundations. However, this rate will no longer be applied after the end of the first taxation year of the foundation beginning after March 18, 2012;
- measure facilitating phased retirement;
- increase from \$1,200 to \$1,800 of the threshold below which an individual need not make quarterly tax instalments;
- the deductibility of the meal allowance for truckers is gradually increased to 80%.

However, the measure with respect to the non-taxation of scholarships paid to elementary and secondary school students was not taken up by Québec.

MESURES AFFECTING BUSINESSES

Gradual Elimination of the Tax on Capital

As mentioned previously, the government is announcing the elimination of the tax on capital as of January 1, 2011. The cuts that had been announced are increased:

Tax on Capital Rate - Corporations Other than Financial Institutions (%)

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|-------------|------|------|------|------|------|
| Pre Budget | 0.49 | 0.36 | 0.29 | 0.29 | 0.29 |
| Post Budget | 0.49 | 0.36 | 0.24 | 0.12 | 0.00 |

Note: The rate cuts will come into effect on January 1 of each year.

For the various fiscal years of the calendar year, the applicable rate will be a rate weighted on the basis of the number of days in the fiscal year in each of the calendar years.

The elimination of the tax on capital also means the withdrawal on the same date of the capital tax credit for investments in manufacturing and processing equipment.

In addition, the budget announces technical changes for the purposes of the tax on capital in order to avoid inappropriate tax treatments:

- ✓ the non-consolidated financial statements of a corporation must be prepared according to the same accounting principles as those used for the purposes of consolidated financial statements of this corporation;
- ✓ a security issued by a government, other than a municipal government, cannot constitute investments covered by the reduction in paid-up capital;
- ✓ the notion of a bond issued by a corporation will be clarified to avoid treatments considered abusive.

Remittance of Payroll withholdings

Corporations whose annual remittances for payroll withholdings and employer contributions do not exceed \$1,200 can currently remit these amounts once per year. The budget proposes to increase this threshold to \$2,400 as of 2008.

In addition, as of 2008, the budget proposes a similar measure to the federal measure stating that if the annual remittances do not exceed \$3,000, they can be remitted on a quarterly basis rather than on a monthly basis.

Increase of the QST Yearly Remittance threshold

To further lighten the administrative burden for SMEs, the budget proposes:

- . to triple from \$500,000 to \$1,500,000 the threshold of taxable supplies up to which a registered taxpayer can produce an annual QST statement.
- . to double from \$1,500 to \$3,000 the threshold of net tax beyond which an annual QST filer can make a single tax payment.

These measures will apply to fiscal years beginning after 2007.

Refundable Tax Credit for Resource Regions

In short, the refundable tax credit for processing activities in resource regions is granted regarding the increase of payroll attributable to eligible employees of an eligible corporation operating in a resource region of Québec, until December 31, 2009. To determine their tax credit, corporations must currently compare the increase in payroll for such calendar year with that of their reference calendar year. Accordingly, the government is introducing a 2 % reducing factor on the 2008 payroll and 4 % on the 2009 payroll to avoid the fact that corporations benefit from a credit simply because they increased their wages without creating any new jobs.

Harmonization Measures with the Federal Budget

The following measures, announced in the federal budget of March 19, 2007, are taken up by Québec:

- increase of the capital cost allowance rates for some tax categories (mainly buildings and computer equipment);
- increase from \$1,000 to \$3,000 of the threshold above which corporations are required to make tax instalments;
- change in the frequency of instalments, from monthly to quarterly, for corporations with less than \$400,000 of taxable income. The condition for benefiting from the deduction for small businesses is replaced by the requirement to have an active business income and the notion of \$10 million in paid-up capital refers to the paid-up capital under Québec legislation.

May 24, 2007

Québec Budget

Comments on the 2007-2008 Québec Budget

**First Jérôme-Forget budget:
Almost everything on the promised tax cuts**



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Highlights

It is quite obvious that when this budget was worked out, the attention of the new minister of Finance Monique Jérôme-Forget was mainly focused on personal tax cuts. Aside from the cuts and announcing the elimination of the corporate tax on capital by the end of 2010, we feel that the new measures are quite timid. Government spending is also accelerating while, as tax cuts are granted, own-source revenues decelerate. The Québec government seems to be increasingly dependent on the generosity of the federal government and to a lesser extent on the revenues of its government corporations or even the sale of some assets. The Charest government manages nevertheless to maintain some kind of balanced budget and allocate some money to the Generations Fund. On the other hand, the steady increase of the government's debt is cause for concern.

- As announced by the Premier when the session of parliament opened, the new minister of Finance Monique Jérôme-Forget is proceeding with tax cuts. Over one year, a \$700M reduction in personal tax overall is added to the \$250M already promised before the election campaign.
- Despite the tax cuts, the government is maintaining a balanced budget, closing the fiscal 2008-2009 gap anticipated in February and putting money into the Generations Fund. To do so, it is allocating the additional amounts that come from the federal government and amounts already allocated in 2006-2007 to a temporary budgetary reserve.
- Given the balanced budgets anticipated between now and 2008-2009, the debt level that represents the accumulated deficits remains stable. However, the total debt and the net debt keep increasing. The net debt will increase by \$3.3B, an amount equal to what had been announced in February. In proportion to GDP, the

Summary of budgetary transactions

| In millions of \$ | 2005-2006 | 2006f-2007f | 2007f-2008f | 2008f-2009f |
|--|----------------|----------------|----------------|----------------|
| . Own-source revenue | 45,743 | 49,290 | 47,842 | 48,152 |
| - Ann. var. in % | 3.1 | 7.8 | -2.9 | 0.6 |
| . Federal transfers | 9,969 | 11,015 | 13,174 | 13,117 |
| - Ann. var. in % | 8.0 | 10.5 | 19.6 | -0.4 |
| . Total Budgetary Revenues | 55,712 | 60,305 | 61,016 | 61,269 |
| - Ann. var. in % | 3.9 | 8.2 | 1.2 | 0.4 |
| . Operational Expenditures | -49,229 | -51,769 | -53,802 | -55,393 |
| - Ann. var. in % | 3.3 | 5.2 | 3.9 | 3.0 |
| . Public Debt Charges | -6,875 | -6,967 | -7,244 | -7,158 |
| - Ann. var. in % | 0.3 | 1.3 | 4.0 | -1.2 |
| . Total Budgetary Expenditures | -56,104 | -58,736 | -61,046 | -62,551 |
| - Ann. var. in % | 2.9 | 4.7 | 3.9 | 2.5 |
| . Budgetary Reserves | --- | -1,300 | 200 | 1,100 |
| . Generations Fund | --- | -500 | -200 | --- |
| . Net Results of Consolidated Organizations | 429 | 260 | 30 | 182 |
| . Budgetary Balance | 37 | 29 | 0 | 0 |
| . Non Budgetary Surplus | -246 | -1,585 | -1,091 | -972 |
| . Net Results of the Generations Fund | | 578 | 653 | 740 |
| . Net Financial Requirements | -209 | -978 | -438 | -232 |
| . Debt Representing the Accumulated Deficits | 91,699 | 91,670 | 91,670 | 91,670 |
| . Net Debt | 104,683 | 106,048 | 108,028 | 109,316 |
| . Net Debt to GDP Ratio (%) | 38.3 | 37.3 | 36.5 | 35.7 |

Source: Ministère des Finances du Québec

---: not available; f: forecasts

Québec government's net debt will go from 37.3% to 35.7% between 2006-2007 and 2008-2009.

- By 2008-2009, the Québec government's budgetary expenditures are increasing by 6.5% while own-source revenues (including the government's corporations) are decreasing by 2.3%. Federal transfers will grow by 19.1%, a \$2.1B increase since fiscal 2006-2007.
- For fiscal 2007-2008, the overall increase in program spending will reach \$2,033.2M (\$2,075.2M in the Audet budget of February 2007). Two thirds of the new expenditures are allocated to health and social services.
- For businesses, the government is announcing that it will phase out the tax on capital by December 31, 2010 for all corporations. Meanwhile, manufacturing businesses will be able to benefit from additional measures to assist in their adjustment to a higher Canadian dollar. In addition, more measures, all in all timid, aimed at stimulating investments are also implemented.
- The government anticipates spending \$30B in infrastructure investments (renovations of schools, hospitals and roads) within the next 5 years.
- The Québec government is setting up a task force on the future of health care.
- Minister Jérôme-Forget is announcing that she will be initiating jointly with the Auditor General a major reform of government accounting.

Conservative yet unsure economic and financial forecasts

The forecasts issued by the ministère des Finances in this second version of the 2007-2008 budget are not very

different that those that had already been anticipated in the last Audet budget. The government is still anticipating that real GDP will be growing by 1.8% in 2007 and 2.5% in 2008. In both instances, these estimates are above our own (1.3% for 2007 and 2.3% for 2008). This difference can be explained by the fact that the government is more optimistic with respect to the recovery of Québec's external sector. Indeed, it anticipates that real exports will increase by close to 3% in 2007 while our own estimates are much more timid, at only 1.3%. Bear in mind that the ministry is counting on a low Canadian dollar in 2007 (US 86.0 cents on average), a bold forecast given the recent trend of the dollar (the loony is trading at US 92.5 cents today). In addition, the American economy keeps expanding modestly, the Chinese competition does not seem to be waning and the energy costs remain very high. In these circumstances, the problems encountered by Québec's manufacturing sector could very well continue and undermine to some extent the economic growth anticipated by the government.

However, we feel that these challenges that Québec businesses are facing will motivate many of them to invest more and modernize equipment and machinery. This will help them increase their productivity and competitiveness. In this regard, we are expecting that business investments will grow at a quicker pace. This anticipated acceleration of business expenses should cause the strength of domestic demand to offset part of the weakness of net exports.

As for households, the pay equity retroactive settlement and wage increases and the healthy state of the labour market in Québec are bringing about a strong expansion of consumption. In fact, the most recent labour statistics,

| Economic and Financial Forecasts | | | | | | | |
|---|----------|-----------------|------------|----------------------|-----------------|------------|----------------------|
| Annual average | 2006 | 2007 | | | 2008 | | |
| | Realized | Forecasts | | | Forecasts | | |
| | | February Budget | May Budget | Mouvement Desjardins | February Budget | May Budget | Mouvement Desjardins |
| Real Gross Domestic Product (%) | 1.7 | 1.8 | 1.8 | 1.3 | 2.5 | 2.5 | 2.3 |
| Nominal Gross Domestic Product (%) ¹ | 3.9 | 4.3 | 4.2 | 3.3 | 3.5 | 3.5 | 4.6 |
| GDP Deflator (%) ¹ | 2.2 | 2.5 | 2.4 | 2.0 | 1.0 | 1.0 | 2.3 |
| Real Consumption (%) ¹ | 3.0 | 3.2 | 3.1 | 2.8 | 2.4 | 2.4 | 2.7 |
| Business Investments (%) ¹ | 6.5 | 2.8 | 4.0 | 7.6 | 2.3 | 1.6 | 5.2 |
| International Exports (%) ¹ | 2.6 | 2.9 | 2.8 | 1.3 | 5.2 | 5.2 | 3.2 |
| Employment (%) ¹ | 1.3 | 1.1 | 1.3 | 1.2 | 1.1 | 1.0 | 1.5 |
| Unemployment Rate (%) | 8.0 | 8.0 | 7.8 | 7.8 | 7.9 | 7.8 | 7.6 |
| 3-month Treasury Bills (%) | 4.00 | 4.00 | 4.20 | 4.20 | 4.00 | 4.20 | 4.50 |
| 10-year Bonds (%) | 4.30 | 4.50 | 4.30 | 4.40 | 4.90 | 4.70 | 4.85 |
| Canadian Dollar (US¢) | 88.2 | 86.1 | 86.0 | 90.0 | 86.2 | 86.2 | 92.5 |

¹ Average Annual Growth
Sources: Ministère des Finances du Québec and Desjardins, Economic Studies

with the lowest unemployment rate in over 30 years, have brought the government to revise its unemployment rates downwards for 2007 and 2008.

Although the Québec government adjusted itself since the budget tabled last February, it anticipated a status quo in the mid term for key interest rates (the last Audet budget seemed to anticipate lower key rates for the Bank of Canada during the year). According to the ministry forecasts, this period of status quo will continue until the end of 2008. As for us, we are counting on a few increases in key interest rates and the mid- and long-term rates, especially next year. In these circumstances, but only marginally, the charges associated with debt servicing could be a little higher than what the minister is anticipating.

Over a longer term, the government seems to believe that the measures aimed at lightening the tax burden of individuals and businesses as well as the increasing public investments announced since 2003 will provide faster growth for the Québec economy. Over some 15 years, the ministère des Finances estimates that the cumulative gains of real GDP associated with these various measures will reach 4.1%, which should create 47,000 jobs. So, the government believes that eventually the gap between GDP per capita in Québec and that of the rest of Canada will go down by close to 18%.

| Effects of the Government Actions on the Main Macroeconomic Variables (approximate 15-year horizon) | | |
|---|-----|---------------|
| Cumulative Variation | (%) | (M\$ of 2005) |
| Real GDP | 4.1 | 11,247 |
| Investments | 2.9 | 1,291 |
| Capital Stock | 3.2 | 12,221 |
| Employment (in thousands) | 1.2 | 47 |
| Real Disposable Income | 4.7 | 7,840 |
| Productivity of Labour | 2.9 | -- |

Source: Ministère des Finances du Québec

Tax cuts: A questionable choice

The federal government introduced a major reform of its transfers to provinces and territories in its last budget in March as amounts allocated to the transfers increased significantly in a year. These changes, which mean higher transfers of approximately \$2B over the next two budgetary years for Québec, were the federal government's partial

Personal Income Tax Cuts Announced by Other Provinces (in millions of dollars)

| | Budget date | Amount of the tax cut announced by the province | Value of the tax cut if applied to Québec (1) |
|---------------------------|-------------------|---|---|
| Newfoundland and Labrador | April 26, 2007 | 155 | 2,971 |
| British Columbia | February 20, 2007 | 515 | 1,200 |
| Prince Edward Island | April 10, 2007 | 11 | 638 |
| Manitoba | April 4, 2007 | 186 | 455 |
| Alberta | April 19, 2007 | 197 | 455 |
| Saskatchewan | March 22, 2007 | 40 | 300 |
| Ontario | March 22, 2007 | 176 ⁽²⁾ | 137 |
| Nova Scotia | March 23, 2007 | 33 | 111 |

Source: Ministère des Finances du Québec

(1) The value in Québec of the tax cuts announced by the other provinces is estimated by applying the tax structure of other provinces to Québec taxpayers.

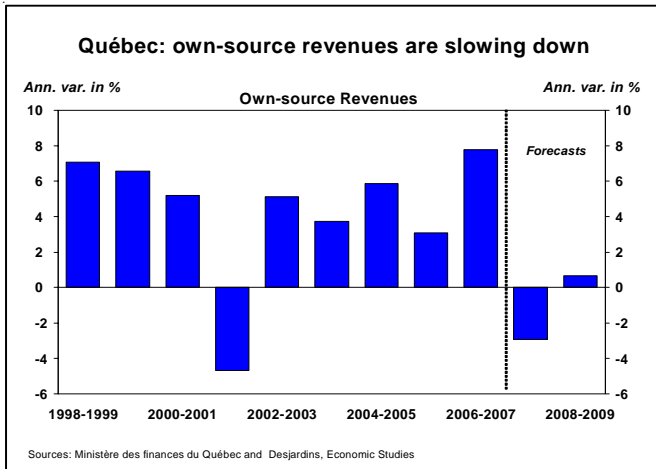
(2) In addition to the tax cuts, the Ontario budget provides for the gradual establishment of a tax benefit for children, in the form of a refundable tax credit valued at \$765 million.

solution to the issue of fiscal imbalance. Bear in mind that the fiscal imbalance refers to the disparity between the large financial flexibility of the federal government and the shaky budgetary situation of most Canadian provinces.

The government of Québec is announcing today that it will use a good share of the \$2B increase in federal transfers to cut personal taxes by \$950M per year (including \$250M that had already been announced in the first version of the 2007-2008 budget last February). These tax cuts will be in the form of a 25% increase in the tax table and an additional \$275 in basic personal exemptions. Many other tax cutting measures are also proposed in today's budget totalling \$298M over one year. Ultimately, Québec taxpayers will be benefiting from an overall tax reduction of \$295M for fiscal 2007-2008 and \$1,300M for 2008-2009. It should be noted that most of these measures will only come into effect in January 2008, which explains the higher impact on the 2008-2009 budget.

The lower tax burden on Québec citizens obviously has a significant impact on the government's revenues. What is gained on one side with the increase in federal transfers is then lost in great part with the lower own-source revenues stemming from the tax cuts. For instance, consider fiscal 2008-2009 when all the new measures will be in effect. The initiatives announced in the 2007-2008 budget (including \$1.3B in personal tax cuts and \$208M in corporate tax cuts) take \$1.5B out of own-source revenues for fiscal 2008-2009. The increase in federal transfers for the same period being \$1.9B, nearly 80% of the new flexibility has then been allocated to new measures, so that the government of Québec finds itself today practically in the same financial situation as before.

Bear in mind the establishment of the \$1.3B budgetary reserve from the 2006-2007 revenues that will be used in 2007-2008 (\$0.2B) and 2008-2009 (\$1.1B) to counteract



the reduction in own-source revenues and maintain a balanced budget. Since the tax cuts are recurrent, the own-source revenues will also be cut by \$1.3B in 2009-2010. However, the budgetary reserve created in 2006-2007 will be completely spent and we can only wonder what the government will do to finance and maintain the tax cuts. Obviously, a shortfall of many hundreds of millions of dollars may well arise in 2009-2010, particularly as the total effect of the elimination of the tax on capital will cost another billion per year at that point. We must wonder if the government will not be forced to increase taxes again, levy new taxes and increase some rates (power, tuition fees, care expenses etc.) to make up for the shortfall. This situation reflects some short-sightedness in the budget preparation.

In that case, why cut taxes? Beyond the Liberal campaign promise, we can see that most other provinces have also brought down their tax burden recently. On a comparable basis with the Québec tax structure, the 8 other provinces have also announced tax cuts last winter and this spring and on average have made \$0.8B reductions, i.e., a lower level than the \$1.3B cut proposed in Québec. The tax cuts announced today will then allow Québec to remain in the middle of the pack with respect to its tax burden, the provinces of British Columbia, Alberta, Ontario and Saskatchewan having charges per taxpayer lower than Québec while that of the other provinces being slightly higher. Keeping Québec in the middle of the pack is undoubtedly the main reason for the tax cuts today.

Nevertheless, from a long-term financial and strategic standpoint, the increase in federal transfers constitutes a lost opportunity. In our view, it would have been better that the government begin by first and foremost cleaning up and stabilizing public finances before proceeding with any tax cuts. The real increase in public health expenditures and the need to invest in infrastructures and education, coupled with the aging population, are bringing more and more pressure to bear on a balanced budget. In addition, we are deeply concerned once again by the absence of a real contingency reserve, which results in making public finances vulnerable to unforeseen events and chance factors in economic conditions. Yet, the other provinces and the federal government already have such a reserve. In addition, despite maintaining a balanced budget and creating a Generations Fund, the net debt of the province keeps growing, i.e., from \$2.0B in 2007-2008 and \$1.3B in 2008-2009. We can also wonder about the relevance of cutting taxes with Québec's debt continuing to rise. Admittedly, the balance of the Generations Fund should total \$1.2B at the end of the current fiscal year thanks to an additional payout of \$653M in 2007-2008. This is however an amount that is clearly insufficient to stem the growth of the net debt. Yes, the debt-to-GDP ratio is gradually going down, but the same is going on for most other provinces, so that our comparative position is not improving and we still remain the province with the highest debt with respect to the size of its economy.

One way of reducing the financial impact of the tax cuts would have been to include an equivalent increase of the sales tax (QST), i.e., approximately 1% with a countervailing action for those who benefit from a QST return. Of course, this would result in practically no tax cuts for individuals, which is more in line with the fact that the government does not really have any flexibility to allow itself recurrent cuts in its own-source revenues. Replacing an income tax cut with an increase in the sales tax has however some advantages. A consumption tax is usually

| Changes to personal income tax - 2008 | | | |
|--|---------------------------|----------------------------|----------|
| 2007 taxation year | 2008 taxation year | | Tax rate |
| | Pre budget ⁽¹⁾ | Post budget ⁽²⁾ | |
| Taxable income threshold of the tax table | | | |
| From \$0 to \$29,290 | From \$0 to \$29,875 | From \$0 to \$37,500 | 16% |
| From \$29,290 to \$58,595 | From \$29,875 to \$59,765 | From \$37,500 to \$75,000 | 20% |
| \$58,595 and up | \$59,765 and up | \$75,000 and up | 24% |
| Basic Amount⁽³⁾ | | | |
| \$9,745 | \$9,940 | \$10,215 | |

Source: Ministère des Finances du Québec

(1) Anticipated amounts, including the indexation at the 2% rate in 2008. The indexation value is \$355 million.

(2) Amounts including the \$950 million tax cuts and the indexation at the 2% rate, valued at \$355 million, for a total cost of \$1,305 million for the government.

(3) As of 2008, the amount for recognized basic needs and the minimum supplementary amount will be merged into the basic amount used to calculate the basic tax credit. For the pre budget plan, the two amounts were added together. The taxpayer is entitled to a non refundable tax credit equivalent to 20% of this amount.

considered more effective from an economic standpoint, especially if it comes with countervailing measures for the have-nots. In contrast, higher income taxes deter job creation and savings, which in the end has a stronger impact on economic growth.

Aside from personal tax cuts, the new measures announced are timid

Compared with had already been announced last February when minister Audet tabled his last budget, the budget worked out by Monique Jérôme-Forget offers few new elements aside from the personal income tax cuts and the complete elimination of the tax on capital for businesses in a few years. The financial impact of the tax and budgetary measures for 2007-2008 and 2008-2009 totals respectively \$640M and \$1,750M. From these amounts, \$423M and \$879M had already been announced in February. Accordingly, the \$150M for 2007-2008 and \$700M for 2008-2009 linked to the additional tax reduction represent most of the financial impact of this budget.

Here are the main measures proposed in the budget (other than the one already announced before the election campaign):

- The government announces an additional reduction of personal income tax totalling \$700M over a full year.
- Many measures totalling \$84M are also designed to reduce personal taxes. From a monetary standpoint, the two main measures are the rise of the lifetime capital gains exemption on the shares of small businesses and on farm or fishing property as well as the increase from 69 to 71 of the age limit for maturing RPPs and RRSPs.
- Minister Jérôme-Forget indicated that she wanted to phase out the tax on capital for all businesses by 2010. The government had already planned to cut by more than half this tax by 2009. The following table represents the new plan to eliminate the tax on capital. Bear in mind that all other provinces already announced that they will be eliminating their own tax on capital in a few years, if it has not already been done. As mentioned previously, ultimately and over a full year, the elimination of the tax on capital represents a \$889M shortfall for the government of Québec.

| Elimination plan for the tax on capital | | | | | | | |
|---|------|-------|------|------|------|------|----------------|
| General rate of the tax on capital (%) | | | | | | | |
| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| Current plan for the reduction of the tax on capital | 0.6 | 0.525 | 0.49 | 0.36 | 0.29 | 0.29 | 0.29 |
| New budget 2007-2008 elimination plan for the tax on capital | 0.6 | 0.525 | 0.49 | 0.36 | 0.24 | 0.12 | Tax eliminated |
| Source: Ministère des Finances du Québec | | | | | | | |
| Note: Rate in effect on January 1 st of each year. For financial institutions, the applicable rate is double the general rate. | | | | | | | |

- The government increases the capital cost allowance rates on investments for manufacturing and processing equipment in the manufacturing industry and on the capital cost for building, computer equipment and other property. The government increases the threshold at which businesses are required to pay tax instalments.

Impact on financial markets

Like last February's budget, the second version of the 2007-2008 budget tabled today should not have any immediate impact on financial markets. The balanced budget is maintained and the growth of the debt is approximately the same as the one anticipated last February. For instance, the projections of the ministère des Finances indicate today that the net debt of the province will reach \$109.3B in 2008-2009 while last February's estimates indicated a net debt of \$109.4B for the same period. So, despite the additional amounts allocated to the Generations Fund, Québec's debt level remains generally the same and its relative position compared to the other provinces is practically unchanged.

Even so, the spread between the Québec government bonds and the equivalent ones of the federal government has closed significantly over the last few months. For instance, the spread between a 10-year government of Québec bond and that of the federal government is currently only 30 basis points approximately while it was 44 basis points a year ago and 51 points in the spring of 2005. Québec is however not the only province to benefit from smaller spreads in its interest rates since all Canadian provinces are showing a slight tightening over the past two years. This trend can be explained by a strong demand for quality fixed-interest securities in a context where the federal government, the largest issuer in the country, is reducing its debt, which limits the number of new securities in the markets. The recent craze for Maple bonds is another example of the strong demand for fixed-interest securities in the country. Even so, the tightening of the spread of Québec government securities, which has occurred over the last two years, is more significant than for all the other provinces. The establishment of the Generations Fund helped improve the credit rating of the government of Québec, which made Québec securities more attractive

for investors. Due to its high debt, Québec needed to catch up to close the gap with the other provinces. Today still, the spread between a Québec 10-year bond compared to an equivalent federal government security means of course higher charges on the public debt.

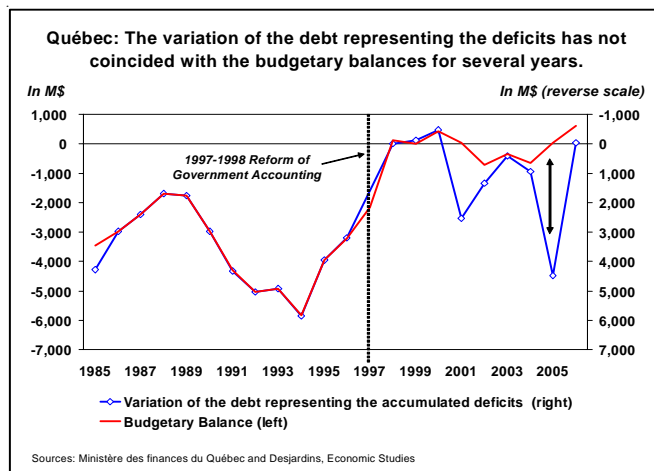
Conclusion: A longer-term vision is required

If the tax cuts announced in today's budget should please most electors, this nevertheless constitutes a lost opportunity to stabilize the province's public finances. Despite the significant increase in federal transfers, Québec finds itself today with a flexibility that is as limited and with a debt that increases almost as much as anticipated last February. Despite any temporal reallocation of \$1.3B through a budgetary reserve, fiscal 2006-2007 would have ended with a surplus of \$1,329M while the anticipated results for fiscal 2007-2008 and 2008-2009 would respectively show a deficit of \$200M and \$1,100M. Bear in mind that the federal government's budgetary policy provides that any budgetary surplus is allocated to repaying the debt. Québec has obviously made another choice, i.e., that of financing future tax cuts. In our view, it would have been much better for the long-term future of the province to set up a contingency reserve and a more robust action plan for repaying the debt for the Generations Fund.

So, the government is focusing once again on a short-term perspective of a few years and the absence of a long-term strategy is blatant. Yet, Québec will have important challenges to take up over the coming decades with the aging of its population and the erosion of its infrastructures. To this effect, the absence of measures designed to provide meaningful support to the city of Montreal as the economic generator of the province is cause for concern.

However minister Jérôme-Forget's initiative to come to an agreement with the Auditor General and proceed with a major reform of the government's accounting must be noted. Among others, there are proposals to include the school boards, the CEGEPs and the hospitals in the government's accounting perimeter, one of our demands over recent years. Hopefully, these reforms will bring to an end to the creative accounting that has been observed for some time. For instance, the debt representing the accumulated deficits increased by \$9.2B between March 31, 2000 and March 31, 2007 while all budgetary balances over these years show an accumulated deficit of only \$0.7B. However, these 2 measures should be similar in principle.

The set-up of a task force chaired by Claude Castonguay on the financing of health care is also a good initiative on the part of the government, which could lead to mid- and long-term solutions to improve the quality of services. This task force will examine the possibility of creating a health account for the financing of health care, which could enhance transparency. The role of the private sector would be clarified and new sources of financing would also be suggested.



Although the idea of lightening the tax burden of Québec citizens is a good one, we feel that it is somewhat reckless to proceed, come wind or high tide, with the promised personal income tax cuts. There is no real flexibility to do so and the policy proposed is mainly financed by the federal transfers or an increase in the debt. In these circumstances and without a better long-term strategy, we feel that the third minister of Finance of the Liberal government missed an opportunity, as this new term begins, to provide some real flexibility to the Québec government.

In addition, at the time these lines are written, the opposition parties have announced that they will vote against the budget in its current form. Will we be entitled to a third version of the 2007-2008 budget or will the various parties come to an agreement? To be continued over the coming weeks.