FEDERAL BUDGET 2008

February 26, 2008

Highlights

▲ In contrast to the October 2007 Economic Statement, the 2008 Budget put greater emphasis on increased spending rather than tax reductions. As well, the overall fiscal stimulus of $5.9 billion over the next three fiscal years is much smaller relative to the $23.5 billion announced last October.

▲ The ratio of program spending to GDP is now forecast to be higher over the next three fiscal years relative to that forecast in the October 2007 Economic Statement.

▲ This budget increases the risk of incurring deficits to the highest level since the transition away from deficits towards surpluses began a decade ago.

▲ No contingency reserves, and no forecast planning surpluses, result in precious little room for downside surprises to revenue growth or unanticipated expenses.

▲ Planned debt reduction declines from $14.2 billion in FY2006-07 to $10.2 billion in the now closing fiscal year, and then only $2.3 billion in 2008-09 and $1.3 billion in 2009-10. By the following year, planned debt reduction of at least $3 billion per year is restored.

▲ The potential sleeper effect in this budget is a rapidly escalating loss of future tax revenues via a new personal Tax Free Savings Account. Within five years, this program alone is estimated to cost a cumulative $0.9 billion.

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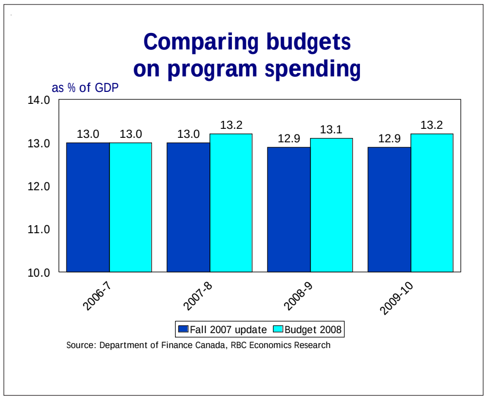
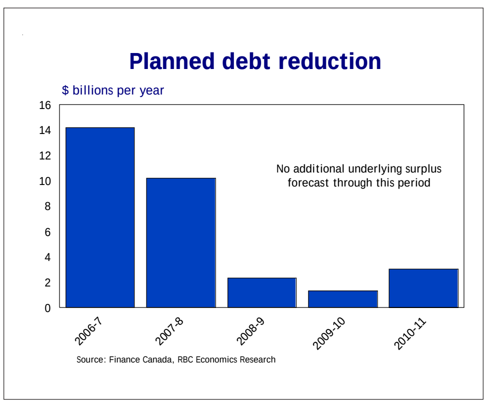
Today's budget confirmed expectations of relatively modest new initiatives particularly compared to the October 2007 "mini-budget." In that earlier document, the Conservative government introduced a sizeable $23.5 billion of stimulus over the next three fiscal years through FY 2009-10 (almost $60 billion over the next six fiscal years). All of the stimulus introduced last October was in the form of tax reductions with more than half attributable to the 1 percentage point reduction in the GST rate to 5%. In contrast, today's 2008 Budget provides a decidedly more modest $5.9 billion in fiscal stimulus. As well, there is a decided shift towards increased spending to the tune of $5.4 billion as lower taxes account for only $0.4 billion of additional fiscal stimulus. The increase in expenditure announced today is occurring across a myriad of areas. In many ways this resurrects the earlier criticism of fiscal policy under the Harper government that appears surprisingly inclined, for a Conservative administration, towards expenditure increases.

This higher expenditure is occurring despite a downward revision to the "underlying surpluses" (i.e., the calculated surpluses prior to accounting for the various budget initiatives) that have resulted from a much weaker economic environment. Overall economic growth for 2008 and 2009 has been lowered to 1.7% and 2.4%, respectively, from increases forecasted last October of 2.4% and 2.7% over the same period. One channel from which the increased spending is being financed is by a lowered contribution to debt reduction through the forecast. For example, over the next two fiscal years, the planned debt reduction of $2.3 and $1.3 billion is down from $3.0 billion allocated in each year in the October 2007 Economic Statement. By 2010-11, however, the government plans to return to $3 billion annual debt reductions such that the next two fiscal years represent a short-term hiatus from the more aggressive debt pay down schedule. A second channel to finance the higher expenditure is that the government has eliminated planning surpluses of between $1.0 to $1.5 billion that have been projected in the October 2007 Economic Statement for each of the next three fiscal years. In so doing the government has increased the odds of possible deficits occurring in the face of a further deterioration in economic activity. This higher expenditure and lowered growth results in the ratio of program spending to GDP rising from 13.0% in FY 2006-07 to 13.2% in FY 2009-10. In October this ratio was expected to fall to 12.9%. Despite the increased spending, the government reiterated that it remains on track to meeting its medium-term target of reducing the debt-to-GDP ratio to 25% by 2011-12.

Expenditures lead the way

As indicated above, today's budget proposals are largely skewed towards increased spending. Of the $5.9 billion of increased stimulus introduced through FY 2009-10, $5.4 billion is in the form of higher spending with the remainder reflecting various tax initiatives. The increased spending is spread across a myriad of expenditure areas. The increase was led by the earlier announced $1.0 billion for the "Community Development Trust" that was allocated to the current FY 2007-08. This fund was set up to help communities vulnerable because of a dependence on a single employer or sector. As well $0.5 billion was allocated to public transit. There were a limited number of spending initiatives on the environment. For example, $300 million was allocated to "investing in nuclear energy" while $250 million was provided for carbon capture and storage.





Revenue measures — little room for anything new

Budgetary revenues came in $7.8 billion higher than projected for FY2008-09 in the 2007 budget, but only slightly higher than projected in the October statement (+$600 million). This suggests that the scope for upside revenue surprises may be faltering in line with IMF warnings to governments around the world. Going forward, revenues are forecast to decline by 1.8% in FY2008-09, and then bounce back by 4.2% in FY2009-10. The government is forecasting significant drops in revenue from corporate income taxes in a challenged economy, but continued strength in personal income tax revenues.

Most of the major revenue initiatives were pre-announced in the October 2007 Economic Statement in which a total of $60 billion in tax relief was offered to households and businesses over the next six fiscal years. Three quarters of that amount went to personal relief, and in turn three quarters of that amount went towards funding a one percentage point drop in the GST rate. The Tax Back Guarantee, which allocates interest savings on debt reductions to ongoing personal tax reductions, offers $2 billion in tax savings by FY2009-10. Corporate income tax rates remain on schedule with the October 2007 promise to reduce them by 1% in 2008, and ultimately take the federal rate down to 15% by 2012 from 22% in 2007. Beyond this, although the 2008 Budget contains many small initiatives, only a few stand out.

A new Tax Free Savings Account

One is that the government delivered on rumoured plans for a more flexible form of tax free savings via the introduction of a Tax Free Savings Account (TFSA). This will allow Canadians to contribute up to $5,000 per year, with no limitations on both carry-forward for unused room and lifetime contributions. No tax credit will be provided up front, so in a sense it is a tax pre-paid form of saving since contributions come out of after-tax earnings, but all forms of investment income will be tax exempt. There will be no restrictions on the ability to withdraw such funds, or on how they may be utilized. This initiative results in only a modest revenue hit of $55 million through FY 2009-10 though the impact grows to $920 million by FY 2012-13.

On the plus side, anything that potentially stimulates more saving is helpful. Furthermore, TFSAs could help to avoid problems with RRSPs whereby some savers may have inefficiently withdrawn savings for non-retirement purposes and then paid punitive tax penalties. This new plan also allows the federal government to claim a victory by way of delivering on its plans for sheltering investment income including capital gains.

Criticisms, however, include the fact that TFSAs are likely to be utilized more by middle- and upper-income cohorts than lower-income earners. As well, whether TFSAs materially boost saving is open to debate. One likely outcome is that contribution room may well be used up by gradually sweeping non-tax sheltered savings across to this new tax sheltered account and thereby have no material impact on saving tendencies. The other reason why it may not boost savings over the long haul is that no restrictions on when and how funds can be redeployed make it more of a deferred consumption vehicle subsidized by tax revenue dollars. The incidence of the tax savings is also open to debate. Not only is it more likely to be the case that lower income households are unlikely to make use of TFSAs, financial institutions are much more likely to market them to middle- and upper-middle income cohorts.

Other revenue initiatives

The manufacturing and processing sector also received extended capital cost allowance treatment for investment in machinery and equipment. The accelerated depreciation that was introduced in the 2007 budget and which applied to investments made within a two year horizon has now been extended out to include investments made up to the end of 2011. For the first additional year, a 50% straight-line accelerated CCA treatment will apply, but for 2010-11, an accelerated treatment will be provided on a declining basis.

Registered Education Savings Plans were liberalized by extending the maximum contribution period by ten additional years, and increasing the time they may remain open to 35 years from 25 years.

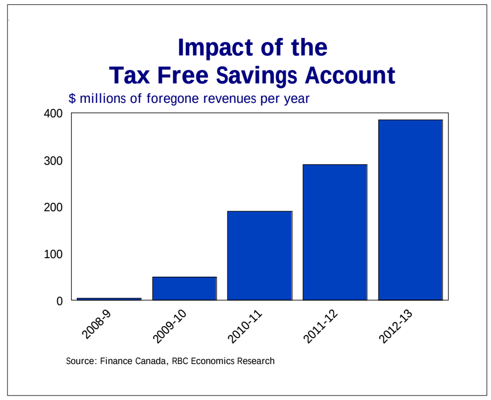
The Guaranteed Income Supplement has been changed by raising the current earned income exemption to $3,500 from its current maximum exemption of $500.

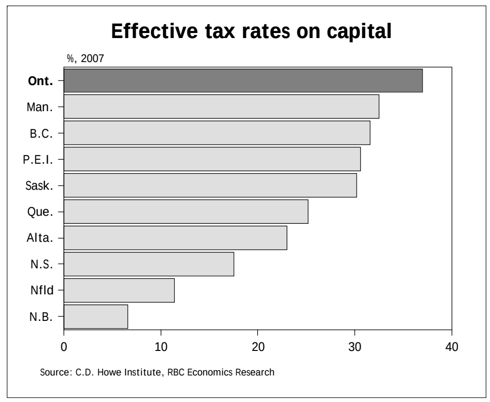
Municipalities will be pleased by the fact that the Gas Tax Fund has now become a permanent measure. It will be worth $2 billion by 2009-10.

Two new crown corporations

Of additional note is the introduction of two new significant Crown corporations. One will be called the Canada Employment Insurance Financing Board and will be an independent Crown corporation with a legislated structure consisting of its own independent board of directors and staffed with financial sector experts. This sounds similar to the CPP Investment Board, and it will be mandated to ensure that E.I. premiums are dedicated only to the E.I. program.

The second is a new crown corporation called PPP Canada Inc., perhaps not surprisingly oriented towards working with the public and private sectors to support public-private partnerships.





Fiscal plan and economic assumptions

Summary statement of transactions (billions of dollars)

	2006-07	2007-08	2008-09	2009-10
Budgetary transactions				
Revenues	236.0	244.5	241.9	252.0
Program spending	188.3	201.2	208.1	218.3
Public debt charges	33.9	33.1	31.5	32.4
Total expenditures	222.2	234.3	239.6	250.7
Planned debt reduction	14.2	10.2	2.3	1.3
Planning surplus	0.0	0.0	0.0	0.0
Net public debt	467.3	457.1	454.8	453.5
Per cent of GDP				
Budgetary revenues	16.3	16.0	15.3	15.3
Program spending	13.0	13.2	13.1	13.2
Public debt charges	2.3	2.2	2.0	2.0
Total expenses	15.4	15.3	15.1	15.2
Net public debt	32.3	29.9	28.7	27.5

Economic assumptions

(Year-over-year % change)

	2006	2007	2008
Real GDP growth	2.8	2.6	1.7
Nominal GDP growth	5.2	5.8	3.7
3-month Treasury bill rate*	4.2	3.8	3.4
Ten-year government bond rate*	4.1	4.0	4.1
CPI inflation	2.0	2.1	1.3
Unemployment rate	6.3	6.0	6.3
U.S. real GDP growth	2.9	2.2	1.4

* %, end of period

Source: Statistics Canada, Bureau of Economic Analysis, RBC Economics Research