



Publication

BUSINESS ALERT

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SPENDING THE FISCAL DIVIDEND: COMMENTS ON THE 2007 FEDERAL BUDGET

In a now familiar refrain, stronger-than-expected revenue growth allowed Finance Minister Jim Flaherty to present a budget featuring hefty spending increases accompanied by some modest and targeted tax reduction measures. Families with dependent children, lower-income workers and the elderly will receive most of the tax benefits at the individual level. For business, the budget offered no broad-based tax cuts but did announce significant, albeit temporary, tax relief for Canada's beleaguered manufacturing sector. Business will also welcome the stepped up federal focus on investing in transportation and border infrastructure. Not surprisingly, the environment figured prominently as the Conservative government boosted funding to address climate change, support renewable energy and fuels, and improve water quality. The single largest budget item is a plan to achieve "fiscal balance" under which Ottawa will hand over an additional \$8.2 billion to the provinces and territories over the next two years, rising to a cumulative \$39 billion over seven years.

Although Budget 2007 referenced the virtues of fiscal restraint, the government's hearty spending appetite points to different priorities. This year's 7.9% surge in program spending will be followed by a 5.6% increase in 2007/08, and then a more moderate 3.6% advance in 2008/09. Table 1 provides the details. The government's assumption of

<u>Table 1</u>				
Federal Government Fiscal Projection				
(billions of dollars unless otherwise indicated)				
	<u>2005/06</u>	<u>2006/07</u>	<u>2007/08</u>	<u>2008/09</u>
Budgetary Revenues	222.2	232.3	236.7	243.5
(% change)	4.9	4.5	1.9	2.9
Program Spending	175.2	189.0	199.6	206.8
(% change)	-0.7	7.9	5.6	3.6
Debt Charges	33.8	34.1	33.8	33.7
Total Expenditure	209.0	223.1	233.4	240.5
(% change)	-0.7	6.7	4.6	3.0
Budget Balance				
planned debt reduction	13.2	9.2	3.3	3.0
Planning Surplus				
Federal Debt	481.5	472.3	469.3	466.3
% of GDP	35.1	32.8	31.4	29.7

Source: 2007 Federal Budget

slower revenues growth in part reflects the impact of tax cuts introduced in this and previous budgets as well as softer economic conditions in 2007.

The overall federal fiscal picture remains healthy, however. Federal debt continues on its now decade-long downward trajectory. Upside revenue surprises and lower-than-forecast outlays



allowed the government to put another \$9.2 billion toward the debt in the current fiscal year, on the heels of a \$13 billion paydown in 2005/06. Going forward, the updated fiscal plan envisages annual debt reduction of at least \$3 billion for 2007/08 and 2008/09. With the debt falling in absolute terms, the federal debt/GDP ratio is shrinking rapidly. It is now expected to reach 29.7% of GDP by 2008/09, compared to roughly 70% in the mid-1990s. The government is on course to make its 25% debt/GDP target by 2012/13.

Tax Measures

Although tax cuts took a back seat to spending initiatives in this budget, there were a few well-targeted tax measures.

- A new 50% depreciation allowance for manufacturers on new machinery and equipment purchased before 2009. This should provide much-needed assistance to the struggling factory sector and stimulate investment in machinery, equipment and technologies.
- Budget 2007 proposes to better align capital cost allowance deductions with the economic life of business assets. New, more generous CCA rates will apply to buildings used for manufacturing/processing; other non-residential buildings; computer equipment; and natural gas distribution lines. There is also an accelerated CCA for investment in equipment used for a wider range of “clean energy” generation. Less welcome is the government’s plan to scale back accelerated CCAs for oilsands projects.
- Minister Flaherty has proposed major changes to the manner in which Canadian companies that do business abroad are taxed. Eliminating withholding tax on interest paid between persons in Canada and the US under the Canada-US tax treaty should improve Canadian companies’ access to global capital markets. On the other hand, disallowing the deduction of interest on borrowed money that Canadian firms use to make investments in foreign affiliates will have negative fiscal implications for many Canadian multinationals and lead to a more complex and costly tax reporting and compliance regime.
- For individuals, the tax relief in Budget 2007 is mainly targeted to families and the elderly. Parents will applaud the new, non-refundable \$2,000 tax credit for each child under the age of 18. This is projected to yield tax savings of \$1.4 billion for Canadian families. Families putting aside savings for their children’s post-secondary education will benefit from higher contribution limits and enhanced flexibility in managing Registered Education Savings Plans. The new budget also eliminates the so called marriage penalty by raising the tax credit for low-income spouses to the same level as the basic personal amount. Taxpayers will now be able to contribute to RRSPs and registered pension plans up to age 71 (compared to age 69 today). Workers nearing retirement will be able to continue accruing pension benefits for work performed with the same employer after retirement. Budget 2007 also proposes to increase the age



credit by \$1,000 to \$5,066 per year and to allow pension income splitting. The government is introducing a new Working Income Tax Benefit of up to \$500 for individuals (\$1,000 for families) to strengthen work incentives for 1.2 million low-income Canadians. Finally, the current \$500,000 lifetime capital gains exemption for small business owners and farmers rises to \$750,000. The budget is silent on the Conservatives' earlier promise to provide broadly-based capital gains tax relief.

Restoring Fiscal Balance

Consistent with past political promises, the Conservative government is taking action to address the so-called “fiscal imbalance” between Ottawa and the provinces by giving the latter billions in additional funding for health care, education, social services, environmental programs, labour market training, and infrastructure. Taken together, new investments to restore fiscal balance will cost the federal government \$3.2 billion in 2007/08 and \$4.0 billion the following year. By 2013/14, the annual cost is pegged at \$8.5 billion.

As part of its promise to restore fiscal balance, the Conservative government has also overhauled and increased equalization transfers to the “have-not” provinces by an additional \$2 billion over the next two years, after which a new “formula-based” approach to determining eligibility for equalization will apply. In the meantime, Ottawa is guaranteeing that no equalization-receiving province will get less under the new program.

There is also more money for the provinces for post-secondary education under the Canada Social Transfer. Infrastructure spending will now be bundled together as a new infrastructure transfer, amounting to a sizable \$16 billion over seven years, roughly half of which is an extension of the previous gas tax transfer to municipalities.

Some Implications for BC

A number of items in Budget 2007 can be seen as positive for British Columbia. One is more funding for the Asia-Pacific Gateway and Corridor Initiative. Budget 2007 builds upon previous federal commitments by allocating another \$410 million over the next seven years. This takes total federal support for the Gateway initiative to \$1 billion – an amount that is likely to increase further as more Gateway projects are developed in the coming years. Some of the additional federal funding directed to the environment, alternative energy, post-secondary education, research, and commercialization will also find its way into BC. Also welcome is the extension of the 15% federal mineral exploration tax credit, introduced in Budget 2006, for another year, a step that will further spur exploration activity in the province.

The Budget includes tax relief to support the 2010 Olympic Games. This recognizes a long-standing tradition for host countries to provide tax relief to help support the Games. Ottawa will waive non-resident withholding tax payable by the International Olympic Committee and the International Paralympic Committee and income tax payable by non-resident participating athletes. The federal government will also forgo all or a portion of applicable customs and excise duties and GST/HST on goods imported into Canada in connection with the Games.



Some of the tax savings attributable to the tax relief measures in Budget 2007 will accrue to individuals and businesses in British Columbia. We estimate that the new child tax credit will benefit BC by \$150 million per year and the new Working Income Tax Benefit by \$55 million per year. With an increasing number of retirees, BC will garner a disproportionate share of the tax savings flowing to the elderly as a result of pension income-splitting and the increased age amount announced in the Budget. BC manufacturers – at least those that are in a position to undertake new investments – will be able to take advantage of accelerated capital cost allowances on purchases of new machinery and investment made before the end of 2008. Many other BC companies will benefit from the government's plan to introduce more generous capital cost allowances for certain types of business assets.

But the news is not all good. For one thing, Budget 2007 provides no new funding to deal with the pine beetle crisis in the BC interior – although, to be fair, Ottawa did set aside substantial monies for this purpose in last year's budget. Of greater concern, the rules for determining provinces' fiscal capacity under the revamped Equalization program are distinctly disadvantageous to British Columbia. Specifically, the federal government's decision to adopt a market-value base for residential property taxes will make it exceptionally difficult for BC ever to qualify for equalization transfers in the future, even though the province has been in receipt of such transfers for the past several years. Contrary to what Ottawa claims, high residential property values do not imply that BC residents (or the BC government) are in a stronger financial position than their counterparts in other provinces where property values are lower. Quebec appears to be the big winner under the new Equalization formula.

Adding it all up, Budget 2007 proposes approximately \$20 billion in new spending/tax measures between fiscal 2006/07 and 2008/09. Two-thirds of this consists of increased spending, the rest of tax relief. We estimate that BC's share of this \$20 billion in incremental fiscal stimulus will be in the vicinity of \$2.5 billion – an amount that will have little impact on the province's overall economy, but that should provide a slight boost to our underlying growth rate.

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