



Economic Commentary

Ottawa's Bountiful Fall Harvest Of Revenues Produces A Cornucopia Of Tax Cuts



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The federal government announced hefty (\$60 billion) and broad-based tax cuts to individuals and businesses on October 30th, amounting to almost \$5 billion for the current fiscal year ending in March 2008, and averaging roughly \$11 billion in each of the next five years. Ways and means legislation has been introduced in Parliament, with a confidence vote set to take place today.

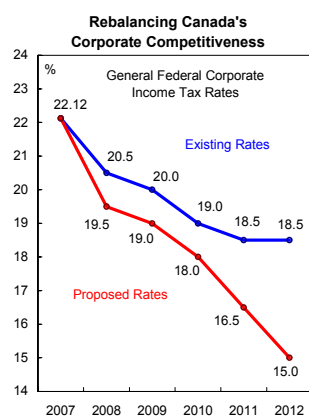
From a short-term perspective, the tax relief measures will provide much-needed support to the regions and sectors of the Canadian economy that are underperforming as a direct result of the intensifying housing and motor vehicle-led slowdown in the United States, and the financial market turbulence in the wake of the sub-prime mortgage crisis.

From a long-term perspective, the multi-year personal and corporate tax cuts will help to rebalance Canada's competitive landscape that has been severely tilted by mounting competitive pressures internationally, and the non-stop appreciation of the C\$ (up 22% vis-à-vis the US\$ this year alone).

The government's fall fiscal plan involves three major areas of tax relief that are being supported by a multi-year bonanza in revenues, largely from corporate coffers.

First, fulfilling their earlier pledge, an additional one percentage point reduction in the GST to 5% is slated for January 1, 2008. Retailers may have to bite the bullet over the next two months to prevent personal expenditures from being deferred into the new year.

Second, Canadians filing their 2007 income tax returns will get an up-front bonus with the first of two planned increases in the basic personal income exemption to \$9,600 retroactive to January 1, 2007 (with the second tranche planned to raise the exemption bar to \$10,100 on January 1, 2009). Retroactive to January 1, 2007 as well, Ottawa also plans to reduce the lowest personal income tax rate to 15% (from 15.5%). Combined, the first two measures have just given the holiday shopping season a good kick in the wallet.



And third, the corporate income tax rate will be reduced by a further one percentage point in 2008 to 19.5% (from 22.12% in 2007 that includes a 1.12% surtax that will be eliminated next year), with further cuts set to bring the federal tax rate component down to 15% by 2012. For many sectors, the reduced federal tax burden will help firms deal with higher operating costs, such as

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chronic labour shortages and rising municipal levies, and provide an increased incentive to pursue productivity-enhancing capital investments.

Absent a major setback in the U.S. economy, the macroeconomic forecast that underpins the fiscal projections is reasonable. Although a stronger first-half growth performance has raised this year's estimate for Canadian real GDP to 2.5%, Ottawa has chopped roughly ½ a percentage point from output growth in each of the next two years to 2.4% and 2.7% respectively for 2008 and 2009, a reflection of the persistent drag on key manufacturing-oriented export sectors of the domestic economy. However, Canada will more than likely keep its economic head above water in view of the important thrust provided by the resource-rich regions, the massive infrastructure-related construction boom underway, in addition to the newly added fiscal thrust.

Inflationary concerns are likely to remain on the front burner. However, while the resource-rich regions, primarily in the west, are straining the limits of capacity, the underemployed export-sensitive manufacturing centres in central Canada are far less inflation prone. Additionally, the deflationary pulse on retail prices emitted by the strong C\$ will only gather, not lose, momentum going forward. Downward price adjustments, reinforced by the continuing reductions in the cost of technology-related products, will be needed if further erosion in sales to cross-border U.S. shopping sites is to be avoided.

The budget's heavy focus on tax cuts, in addition to the continuing rapid paydown of debt that lays the seed of further fiscal improvement, are both important and timely fiscal initiatives. Ottawa's accelerated pace of corporate income tax relief, in conjunction with prior measures to accelerate depreciation on newly bought machinery & equipment, are fundamental to support the strategic investments required to bolster productivity and combat international competitive pressures. (The strong C\$ is a two-edged sword, raising the affordability of imported capital goods that are needed to fight the currency's heightened competitive stains.) Moving Canada's corporate tax rate to the low end of the G7 scale is key to attracting the growth-enhancing investments, both domestic and foreign, that are needed to support a faster pace of competitive restructuring.

More work must be done to facilitate these adjustments. Increased federal-provincial co-operation is imperative to enhance competitiveness through the harmonization of sales taxes (to lower the tax rate on business inputs that could bolster investments), as well as lowering the combined general corporate income tax rates.

In general, the reaction in domestic financial markets has been generally muted, with the tax cuts widely anticipated. If the minority Conservative government survives this week's confidence vote, equity markets will focus on the next round of targeted tax relief and spending measures that Finance Minister Jim Flaherty indicated would be forthcoming in the spring 2008 Budget. For the time being, U.S. and global events are shaping interest rates and the yield curve, with investors betting that the slumping U.S. economy will keep the Fed in rate-cutting mode, notwithstanding continuing US\$ weakness.

The C\$ may prove to be a more durable currency, with more upside than downside potential. Not only should Ottawa's latest fiscal fill-up help to underpin domestic growth, but the strength of Canada's fiscal finances, and its longer-term flexibility, will facilitate the ongoing pay down in debt. By 2011-12, Canada's G7-leading debt-to-GDP ratio — currently at 32.3% — will fall to 25%.

From an industry perspective, the reduction in corporate taxes and the GST should be supportive of Canada's struggling motor vehicle and parts producers. Although the GST reduction will likely give a modest boost to vehicle sales in early 2008, lower corporate taxes should provide an important assist to producers that have been battered by the U.S. sales slowdown, coupled with the C\$ surge. Job losses have totaled more than 10,000 over the past three years, mostly in the parts sector. Lower taxes should also help offset some of the impact of the recent contract agreements between the UAW and U.S. automakers. These removed retiree health care costs from the automaker's books, and significantly reduced Canada's traditional health care cost advantage over facilities in the United States.

Lower corporate tax rates will also be welcome news for Alberta's oil patch that is faced with higher royalties on oil sands and conventional oil & gas production starting in 2009. Nevertheless, higher prospective royalties are still expected to extend the current downturn in drilling activity.

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