TD Bank Financial Group

Special Report

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TD Economics
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HIGHLIGHTS

- **We believe that some of the recent strength in consumer spending and housing construction reflects households bringing purchases forward to beat the HST. As such, we anticipate some payback for the recent strength in the months following harmonization.**
- **However, even as overall Canadian consumer prices are expected to rise permanently by 0.4%, trend consumer spending is not expected to be greatly affected as tax relief programs in Ontario and British Columbia largely offsets the higher consumer tax burden.**
- **Housing activity, particularly new residential construction, will experience a larger-than-average impact given its big-ticket nature and the stage of the cycle. However, the majority of new homes in Ontario are priced under $400,000 and will not be subject to additional tax on the selling price.**
- **In contrast, business capital spending will receive a permanent boost, as the HST and other tax cuts for businesses reduce the effective cost of investment. As a result, we anticipate solid gains of 10-15% annualized in overall Canadian business investment in machinery and equipment during the four quarters directly following harmonization.**

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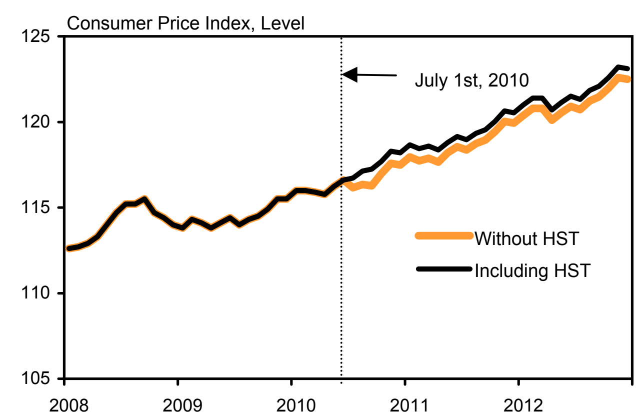
THE ECONOMIC IMPACT OF HST REFORM

On July 1st 2010, the Ontario and British Columbia governments blended the provincial sales tax (PST) with the federal government goods and services tax (GST) to create one harmonized sales tax (HST) to be 13% in Ontario and 12% in British Columbia. Major tax changes like harmonization can have significant macroeconomic implications. And since these provinces make up 50% of overall Canadian economic activity, any impact harmonization may have on their performance will ripple through to the national headline economic figures. Therefore, with the implementation date now behind us, we thought it worthwhile to outline some of the near-term (1-2 year) impacts harmonization will have on Canada's economic performance.

Overall level of consumer prices to rise moderately

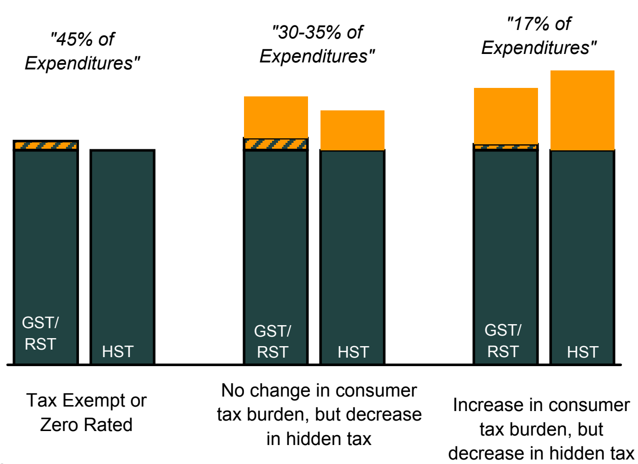
Tax changes influence economic activity through their impact on prices. In a recent TD Economics special report titled "Sales Tax Harmonization and Consumer Prices in Ontario and B.C. ", we calculated the impact on consumer prices. The majority of goods purchased by households on a daily basis will not cost a penny more, and some may cost less. First, households in these provinces already pay a total tax of 13% in Ontario and 12% in B.C. on roughly 30% of the goods and services they purchase. Second, important purchases like basic groceries, prescription drugs, and medical devices are "zero rated", meaning that consumers do not have to pay the sales tax on the final purchase. However, providers of these goods and services can now claim the input tax credit available with the HST. For these goods, prices may actually fall. Meanwhile, some goods and services are "tax exempt", like education, health care, day care, dental, residential rent, most basic financial services, public transit and legal aid. For these services, consumers do not pay the tax, but businesses cannot claim the input tax credit. For these services, the price will likely be largely unchanged. HST will tack on an additional tax of 8% in Ontario and 7% in B.C. on roughly 17% of household expenditures. Since services are more heavily taxed at the federal level, the bulk of expenditures being affected by harmonization include services such as those related to purchasing and maintaining a home, personal care (i.e.

IMPACT OF HARMONIZATION ON NATIONAL CONSUMER PRICES



Source: Statistics Canada, Forecasted by TD Economics as of June 2010

ILLUSTRATIVE IMPACT OF HARMONIZATION ON PRICES



Source: TD Economics

haircuts, manicures, pedicures and massages), certain financial services (particularly related to management fees), new housing construction and home renovations. These tend to be purchases made less frequently by households in general, and account for a small proportion of spending by low-to-medium income families. Services that most households use and pay for on a regular basis for which the cost will undoubtedly rise include, some telecommunication services (internet in Ontario, and cable and home phone services in B.C.), recreation fees like gym memberships, lawn care and snow removal, and subscription magazines. In Ontario, fuel used both in motor vehicles and homes, and electricity and heating gets added to the list. Meanwhile, in B.C. newspapers, restaurant food, and snack food purchased from stores are included.

Immediately following the implementation of harmonization, overall consumer prices in Ontario and B.C. are expected to rise by 1.5 percentage points (0.9 percentage points nationally). However, within the first three years under the new tax, about half of this initial surge is expected to be offset by businesses passing down cost savings associated with the use of input tax credits under the new system (similar to that for GST, and done under a single filing). About 80% of this offset from pass-through is assumed in the first year. Once pass-through occurs, the average consumption basket in Ontario and B.C. is projected to be about 0.9 percentage points higher (0.4 percentage points nationally) than had the tax reform not occurred.

While, consumers are skeptical over whether this pass-through will actually occur, businesses in both the Ontario and B.C. economies face a highly competitive environment, in which firms typically compete for market share on price. The only way to take advantage of the HST is to pass the cost savings onto consumers, or risk losing market share. Even if it takes time to realize the cost savings associated with the input tax credit, businesses know that sometime down the road profitability will improve. Businesses can get ahead of the curve, and beat out competitors, by sharing these benefits with consumers sooner rather than later.

Consumer spending to be left largely unaffected

While a higher cost of living results in reduced purchasing power for households and a lower profile of spending, the Ontario and B.C. governments have moved to soften the blow. As part of a comprehensive tax package that includes significant income tax relief for businesses, the Ontario government will deliver to households a total of $11.8 billion in temporary and permanent tax relief (for details, see text box on the next page). According to government estimates, in the near-term (1-2 years), the tax reform is expected to provide a net savings to households in Ontario – meaning that on average, households will be better off. And once the temporary support expires, on average households will see a net increase in the cost of living of a slight $75 per year. As the temporary credit expires, the economic benefits of the HST, which include stronger employment and income gains, are expected to help offset the rise in these extra costs.

The B.C. government will provide a tax benefit worth up to $230 per family member, for low and modest income families which will help to offset the majority of the additional costs, along side an increase of $1,627 to the basic personal income tax credit. However, since B.C. residents have been benefiting more significantly than their counterparts in Ontario from cuts to personal income taxes over the last several years, the Province is not providing the same degree of transition support as Ontario. Even if benefits do not accrue to specific taxpayers in the near-term, this policy is not without benefits. Reducing the deficit lowers both the province's debt issuance needs and debt-service costs, which ultimately benefits the taxpayer. Still, the net government

Average Overall Annual (Saving)/Cost by Household Income

Annual Income	(Saving)/Cost ($)	
	Year 1	Year 3
$4,000-$40,000	-510	-205
$40,000-$80,000	-435	-25
$80,000-$125,000	-260	200
$125,000-$300,000	30	405

* Source: Ontario Ministry of Finance, Technical Report "Ontario's Tax Plan for Jobs and Growth", June 2010

support flowing to households in British Columbia is $611 million over the next three years. And, even without the transition benefits, studies have shown that the tax reform will be income neutral for B.C. residents.

That is not to say that there won't be consumption impacts from the HST. While most Canadians appreciate the social benefits supported by the tax system, nobody likes paying taxes, and many will time their consumption behaviour to avoid paying more taxes. Indeed, incentive programs with "beat the HST" themes have become popular among businesses to encourage households to buy now and avoid paying the HST later. Even though there are limitations to what extent services and smaller-ticket goods (i.e., fuel) can be pre-bought, households were given sufficient lead-time in order to bring forward certain purchases, thus mitigating the impact on overall demand. Thus, in the immediate months following harmonization, we do expect some payback in the form of lower purchases for those goods where pent-up demand was satisfied in advance of implementation. This payback effect will likely hold back consumer outlays to a meager pace in Ontario and B.C. in the third quarter on the heels of rapid gains earlier this year. Nationally, the third-quarter rate of real consumer spending growth is projected to subside to a modest 2.5% from more than 4% in the first half of 2010.

Over time, there are actions households can take to help mitigate the rise in the consumer tax burden. Consumers can opt for relatively cheaper goods and services to maintain their welfare. For instance, in British Columbia, restaurant food will be subject to an additional 7% tax, but basic groceries will remain exempt from both provincial and federal sales tax. In light of the additional tax on restaurant food, households may choose to purchase more food at the grocery store and eat in more often. Or, when out at a restaurant, they may choose either restaurants with lower cost menus, or continue going to their favourite restaurant but choose lower cost items, mitigating the negative impact of the rise in the effective tax rate.

Once the short-term adjustment has taken place – likely by the fourth quarter of this year – personal consumption expenditure growth should move back in line with underlying fundamentals such as employment, interest rates and household debt levels.

Harmonization and the housing sector

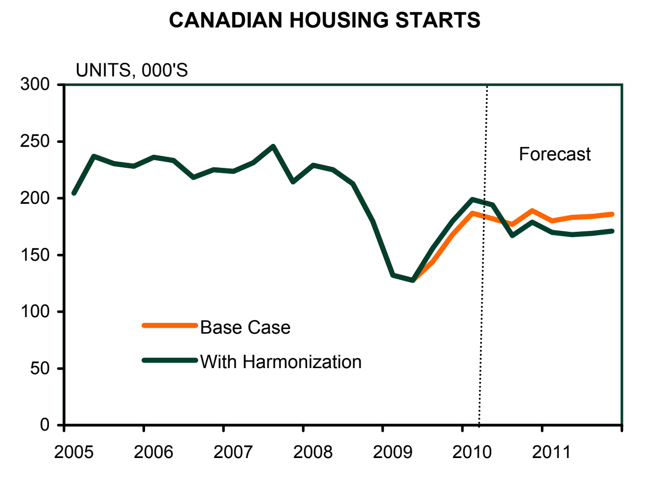
Admittedly, some sectors will feel the pinch from harmonization more than others. Housing is one example. An additional tax of 8% in Ontario and 7% in B.C. will be levied on everything from the purchase price of a new home, the renovation of an existing home, to the closing costs (commissions, legal fees, inspections, etc.) faced by the seller and buyer of new and existing homes. Tax rebates will help offset the majority of the additional tax on new housing with purchase prices under $400,000 in Ontario and $525,000 in British Columbia. As well, there's pass-through of lower input costs in the order of 3.2 percentage points– that will help to more than offset any rise in taxes on homes under $550,000 in Ontario and $580,000 in British Columbia. Nonetheless, for purchases over $600, 000 the cost of buying a new home will rise in both provinces. For example, a house with a purchase price of $650,000 would cost about $4,500 more in Ontario and $2,000 more in B.C., while for a $750,000 new home, the tax impact would grow to $8,800 in Ontario and $6,420 in British Columbia. Moreover, the HST could tack on an additional $3,000 (or 0.6%) to the cost of services tied to the purchase of a new or existing home with a price tag of $400,000.

In order to avoid paying this additional cost, it is likely that many Ontario and British Columbian households that

ONTARIO'S COMPREHENSIVE TAX REFORM PACKAGE

- Lowering the provincial tax rate on the lowest income tax bracket ($1 to $37,106) from 6.05% to 5.05% as of January 1st, 2010;
- Over $1 billion per benefit year of permanent sales tax relief – an increase of $800 million per benefit year. This support will flow primarily to low and medium income households through a permanent tax benefit of up to $260 per family member per year;
- Over $1.2 billion annually in proposed energy and property tax relief to low- to middle-income families and people – an increase of $455 million compared to tax relief provided in 2009, due to the enhancements announced in the 2009 Budget;
- Transitional payments in June 2010, December 2010 and June 2011, totaling $300 for eligible single individuals with net incomes of up to $80,000 and $1,000 for eligible families (including single parents) with net incomes of up to $160,000 (the maximum benefit will be reduced or eliminated for incomes over these thresholds);
- The general Corporate Income Tax (CIT) rate will be lowered from 14 per cent to 12 per cent and then to 10 per cent over three years;
- The CIT rate on income from manufacturing and processing, mining, logging, farming and fishing will be lowered from 12 per cent to 10 per cent;
- The small business CIT rate will be cut from 5.5 per cent to 4.5 per cent;
- The small business deduction surtax of 4.25 per cent will be eliminated;

*Source: Ontario Ministry of Finance



Source: Statistics Canada/Haver Analytics, Forecasted by TD Economics as of June 2010

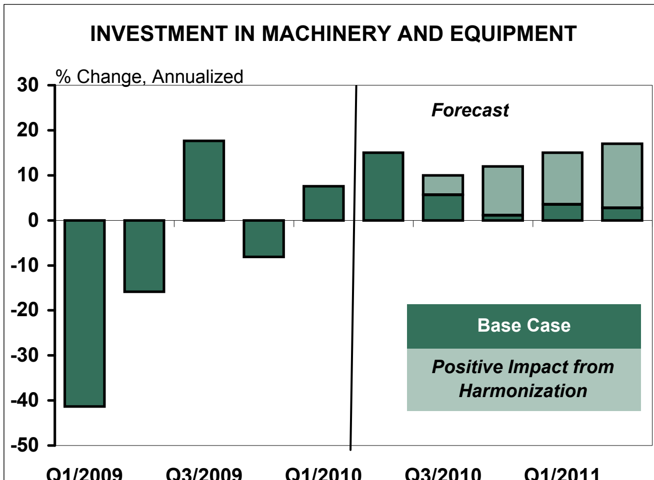
had planned to purchase over the next year have already brought the purchase of new and existing homes ahead of the July 1st implementation date. This accounts for some of the strength in the housing market over this last year.

Case in point is the new housing market, where the HST impact will be more significantly felt than in either the resale market or the home renovations market. Housing starts peaked in October of last year in Ontario and in February of this year in British Columbia. Because it takes roughly 4-6 quarters to complete a single-detached house once started, this peak in starts is consistent with builders and buyers trying to get ahead of paying the new tax. We estimate that as much as 10% of housing starts over the last year can be attributed to households and builders bringing forward demand for new housing to beat the HST. As a result, we expect Canadian housing starts to fall back to 167,000 units annualized in the third quarter of 2010 from an average of almost 200,000 units in the first half of the year.

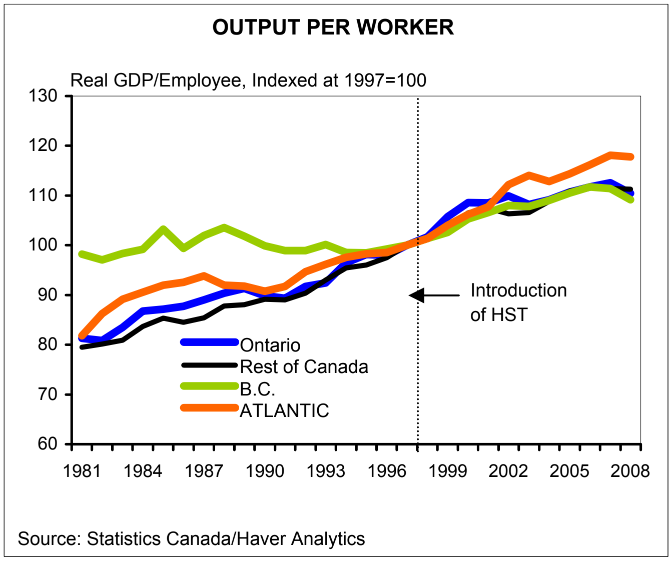
Outside of the near-term payback in activity, we do expect a negative longer-term impact on new home construction. But, the impact will likely be minor as the majority of new homes in Ontario (75%) are currently priced under $400,000. New home construction in B.C. may endure a slightly larger adjustment as homes in that province are more pricey than in Ontario. Looking back to harmonization in three Atlantic regions – New Brunswick, Nova Scotia and Newfoundland – there was a clear slowing in the pace of growth in new housing construction once harmonization was implemented on April 1997. Housing starts were on average 2,000 units lower in the two years following harmonization than they were in the two years prior. This time around, what could exacerbate the slowdown in housing more broadly is the timing of the move given the stage of the housing cycle. The higher cost from HST will be among several factors weighing down new home construction, including an over-valued market, an absence of pent-up demand, higher interest rates and this year's changes to mortgage regulations. Due to the combination of all these factors, TD Economics predicts average resale prices will fall by 7% over the next 4-5 quarters, while housing starts are projected to decline to 170,000 units in 2011 from this year's 185,000 tally.

Rise in business investment to offset any near-term potential drags

A significant boost to business investment will likely help offset any weakness that may stem from the housing market and consumer spending in the second half of 2010 and into 2011. In Ontario, as part of the tax reform, the government is providing a total of $4.6 billion in tax relief to businesses over three years. The combination of the move to a value added tax and lower corporate income taxes will leave B.C. and Ontario with some of the lowest tax rates on business capital investment relative to their peer jurisdictions. A study by Jack Mintz (2009) showed that the marginal effective tax rate on business investment will fall to 18.5% by 2013 in Ontario down from 33.6% in 2009, while that in B.C. will fall to 17.9%, from 29.5%[1]. We estimate that lowering the tax rate this significantly will boost business investment strongly in the four quarters following harmonization. As a result, we anticipate solid gains of 10-15% annualized in overall Canadian business investment in machinery and equipment during this period. By the second half of 2011 growth is expected to return to levels in-line with macroeconomic fundamentals, which is a still-healthy 8-10% annualized quarterly percent change.



Source: Statistics Canada, Haver Analytics, Forecasted by TD Economics as of June 2010



But, the level of investment will still be 11% above where it would have been had harmonization not been implemented.

Turning once again to the Atlantic region for a historical perspective, we saw business investment in both non-residential structures and machinery & equipment increase significantly after harmonization. The cost savings associated with lower taxes on business investment, production and income may also help to spark stronger demand for Canadian made goods.

On the international front, the strong Canadian dollar and rapidly rising unit labour costs have put Canadian exporters at a large disadvantage. While the export sector has experienced a very robust recovery so far, it has not been as strong as it could have been absent of the cost disadvantage. The cost savings associated with the tax reform will help exporters in Ontario and B.C. compete more competitively on price hopefully helping them regain some global market share.

Putting it all together, we anticipate that the HST impact will take a bite out of Canadian real GDP growth in the short term, but that will largely reflect a shift in the timing of expenditures to the first half of 2010, leaving average annual real GDP growth relatively unscathed from its rate had the HST not been implemented. In terms of the third-quarter payback, we anticipate that this will be less than 0.5 percentage points (annualized) as negative hits to consumers and housing are partially offset by stronger growth in business investment. Indeed, the experience of the 1997 harmonization of sales tax in the Atlantic Region was that the tax reform had a negligible impact on consumer spending, which was largely outweighed by strong gains in capital spending.

Impact on Monetary Policy

The implementation of the HST in Ontario and B.C. is not expected to materially impact monetary policy at the Bank of Canada. First, the increase in the effective tax rate on consumer spending will feed through to the overall consumer price index (CPI), but the Bank of Canada's core measure excludes price changes related to indirect taxes such as the HST. If anything, the pass-through of business cost savings is expected to put downward pressure on core CPI. Still, this influence is likely to be spread out over time and, in any event, the central bank has built into its expectations an estimate of these one-time impacts. Above all, as indicated, we don't believe the HST implementation will have a major effect on real economic activity or the Bank's estimate of the output gap. As such, harmonization is unlikely to alter their view on inflation past the first year of harmonization, nor the anticipated path of monetary policy. Our view is that the Bank of Canada will continue on a gradual path of 25 basis point rate hikes through 2010 and most of 2011, with an overnight rate of 1.5% and 3.0% at the end of the respective years.

Bottom Line

The bottom line is that we don't anticipate a significant near-term impact on consumption and overall economic growth from harmonizing the provincial sales tax with the federal sales tax. There may be a short-lived adjustment period as households have been bringing forward purchases to avoid paying the additional 7% or 8% and as they shift some of their purchases to goods not subject to a tax change. The strong positive benefits on business investment and the export sector will virtually offset the negative near-term adjustments that are likely to occur in consumer spending and in the housing market.

The true lasting benefits of harmonization will be indirect, in the form of higher employment, personal incomes, and overall standard of living. Most studies show that countries that have introduced a value-added tax have higher GDP per capita. Indeed, the sharp rise in business investment in the Atlantic region following harmonization was accompanied by a significant boost to labour productivity. Since the introduction of the HST in Newfoundland & Labrador, New Brunswick, and Nova Scotia, labour productivity in the Atlantic region has grown above that of the rest of Canada and has also been significantly better than that in Ontario and British Columbia. The fact that both Ontario and British Columbia have fallen behind their harmonized peers is of itself a valid reason to go ahead with the HST.

Endnotes

1. Mintz, Jack.. "Ontario's Bold Move to Create Jobs and Growth", School of Public Policy, University of Calgary, November 2009

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