



TD Economics

Special Report

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THE IMPACT OF SALES TAX HARMONIZATION IN ONTARIO AND B.C. ON CANADIAN INFLATION

The Government of Ontario and B.C. announced that effective July 1, 2010, the provinces will harmonize the provincial sales tax (RST) with the federal goods and services tax (GST). We estimate that the move to a harmonized sales tax (HST) will reduce the amount of taxes paid on inputs by business by a combined \$6.9 billion in British Columbia and Ontario, along with an additional \$650 million by reducing compliance costs under the current separate provincial and federal tax systems. By reducing the cost of doing business in the two provinces, the aim of the reform is to make businesses more competitive and to encourage business investment and future income growth for their economies, yet the policy has taken a lot of heat from critics for its impact on consumer prices.

In response to consumer concerns, we thought it would be worthwhile to highlight what implications the reform will have on Canadian households and inflation. In the past, consumers ultimately bore the burden of a large chunk of the \$6.9 billion tax bill as businesses likely passed the majority of this tax to consumers in the form of higher prices. As such, previous experience tells us that businesses won't pocket the \$6.9 billion in cost savings, but rather competitive pressures will cause them to pass along the bulk of those savings to consumers via lower prices. However, for the tax to be revenue neutral for governments, the tax burden will shift to consumers and apply to a broader base of goods and services. Yes it is true that the policy will have a positive permanent impact on overall consumer prices, but it will not be as much as many fear. We estimate that the reduction in prices will not be enough to fully offset the rise in the effective tax rate on consumption, and the net effect will be a permanent 0.7% increase in the consumer price index in Ontario and British Columbia. The com-

HIGHLIGHTS

- **Both Ontario and B.C. will harmonize the GST and RST with a single HST, as part of an effort to make businesses in these provinces more competitive by lowering the effective tax rate on business inputs**
- **We estimate that the move to a harmonized sales tax (HST) will reduce the cost of doing business by a total of \$6.9 billion in Ontario and British Columbia**
- **The majority of the cost savings will pass onto consumers in the form of lower prices, and consumers in both provinces could witness a 0.8% -0.9% drop in the pre-tax ticket prices on the purchase of goods and services**
- **However, the tax burden will shift from businesses to consumers, who will now pay the flat HST on a broader array of goods and services than before, and the effective tax rate on consumption will increase by 1.5 percentage points Ontario and B.C., and the overall price level will increase by 0.7 percentage points in both provinces**
- **The combined impact will lead to a permanent 0.4% increase in Canada's average annual consumer price level relative to where it would have been without harmonization.**

bined provincial impacts will lead to a 0.4% increase in Canada's average annual consumer price level relative to where it would have been had harmonization not occurred.

Table 1: List of Goods and Services for which the Tax Rate will be Affected By Harmonization (does not include the pass through of business cost savings)

			ON	BC
		↔ = no change		
		↑ = increase in tax rate		
		↓ = decrease in tax rate		
Expenditure Category			ON	BC
Goods	Food	Basic Groceries	↔	↔
		Prepared foods purchased at stores	↔	↑
		Restaurant Food	↔	↑
	Energy	Natural Gas	↑	↔
		Gasoline	↑	↔
		Fuel Oil and Other fuels	↑	↔
		Water	↔	↔
	Goods ex. Food and Energy	Clothing/footwear and accessories	↔	↔
		Children's clothing and footwear	↔	↔
		Household appliances	↔	↔
		Other household furnishings and equipment	↔	↔
		Recreational Equipment	↔	↔
		Autos/recreational vehicles	↔	↔
		Healthcare goods	↔	↔
Personal Care supplies		↔	↔	
Tobacco and Tobacco products		↑	↔	
Alcohol		↔	↔	
Services	Shelter/ Office Services	Rent/mortgage interest costs/insurance	↔	↔
		Maintenance and Repair	↔	↔
	Financial Services	Credit Application/Account Fees	↔	↔
		Purchase/Selling of Investments	↔	↔
		Portfolio Management Fees	↑	↑
		Advisory Fees	↑	↑
		Mergers and Acquisition Fees	↑	↑
	Fees related to RRSPs, RRIFs, RESPs, TFSA's	↑	↑	
	Other Non-Shelter Services	Telephone and Cable	↔	↑
		Internet Access Fees	↑	↔
		Postal Services	↔	↔
		Child care Services	↔	↔
		Other (cleaning, landscaping etc)	↑	↑
		Services related to installation of household equipment and furnishings	↔	↔
		Health care and Education Services	↔	↔
		Personal Care Services (eg. hair cuts, manicures/pedicures, and facials)	↑	↑
		Recreational Services	↑	↑
		Admission Charges	↓	↔
	Professional Services	↑	↑	
Transport Services	Registration ,drivers licences, and auto insurance	↔	↔	
	Taxis	↑	↑	
	Other Public transportation	↔	↔	

Source: TD Economics, produced with information provided by Canada Revenue Agency, the Ontario Ministry of Finance and the B.C. Ministry of Finance
 Note the table is meant to capture the general direction of changes for each category, however there may be different treatment for certain goods within each categories.

Understanding Harmonization

Before delving into the details of the policy, it is worthwhile to take some time to define harmonization and some of the key policy changes that come with it. Harmonization is the process in which the rules that govern the provincial retail sales tax (currently the RST) will be integrated with those of the federal goods and service tax (GST) to create one final tax – the HST. In Ontario, the HST will be 13%, and in B.C. it will be 12%. The provincial portions of the tax will be 8% and 7% respectively. Moreover, the provincial tax base will be broadened to include the same goods and services taxed by the GST (the federal tax base is currently much larger than that of the RST). Table 1 provides a detailed list of the goods and services that will be affected by the policy. Since services are much more broadly taxed under the GST than they are under the RST, the table shows that the largest impact of the policy will be a higher effective tax rate on services. This includes some financial services, all professional services and personal services consumed by households and businesses alike.

The Motivation for Harmonization

The HST is a value-added tax, which ensures that only the value added by the business providing the good or services is taxed. Thus, it attempts to avoid the situation where a product may have been taxed multiple times – at different stages of production – and in some cases earlier taxes may have been compounded by applying tax upon tax before ultimately being taxed one last time when purchased by the consumer. This process is commonly referred to as tax cascading. To prevent this, businesses can claim a tax credit for much of the HST they pay on non labour inputs, effectively reducing the amount of tax on many inputs to zero, with the tax just being paid on the final sale of the good or service. This makes a value added tax more efficient than a retail sales tax because it avoids the cascading tax effect, which is ultimately passed along as higher prices to consumers. To understand this in practice, Table 2 provides an example of how the RST creates tax cascading. Consider a firm that uses \$1000 of inputs, and has a price mark up of 30%. A good for which 100% of its inputs are currently subject to the RST, such as a renovation technician, for whom the majority of input costs include tools and supplies bought at the local hardware store, the total provincial tax paid is \$192. But, after the switch to the HST, the total provincial tax paid would be \$104 and the final cost to consumers is 7.4% below what it would be

TABLE 2: EXAMPLE OF POTENTIAL TAX SAVINGS

Example of a Firm with \$1000 in inputs and a 30% mark-up in Ontario

Proportion of Taxable Business Inputs

	For Goods and Services Taxable to the Consumer				For Goods and Services not Taxable to the Consumer		
	100%	50%	25%	0%	50%	25%	0%
RST	100%	50%	25%	0%	50%	25%	0%
GST	0%	50%	75%	100%	50%	75%	100%
Current Tax System							
Cost of Inputs before Tax	1,000	1,000	1,000	1,000	1,000	1,000	1,000
RST paid on Inputs	80	40	20	-	40	20	-
GST paid on inputs	-	25	38	50	25	38	50
Federal Input Tax Credit	-	25	38	50	-	-	-
Total Cost of Inputs	1,080	1,040	1,020	1,000	1,065	1,058	1,050
Ticket Price to Consumers	1,404	1,352	1,326	1,300	1,385	1,375	1,365
RST	112	108	106	104	-	-	-
GST	70	68	66	65	-	-	-
Final Price to Consumers	1,587	1,528	1,498	1,469	1,385	1,375	1,365
Total Tax paid	263	216	192	169	65	58	50
After Harmonization							
Cost of Inputs before Tax	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Provincial HST paid on inputs	-	40	60	80	40	60	80
Federal HST paid on inputs	-	25	38	50	25	38	50
HST Input Tax Credit	-	65	98	130	-	-	-
Total Cost of Inputs	1,000	1,000	1,000	1,000	1,065	1,098	1,130
Ticket Price to Consumers	1,300	1,300	1,300	1,300	1,385	1,427	1,469
Provincial HST	104	104	104	104	-	-	-
Federal HST	65	65	65	65	-	-	-
Final Price to Consumers if taxed	1,469	1,469	1,469	1,469	1,385	1,427	1,469
Total Tax paid	169	169	169	169	65	98	130
Final Cost to Consumer if Zero Rated Good	1,300	1,300	1,300	1,300	-	-	-
% Change in final price paid by consumers	-7.4	-3.8	-2.0	0	0	3.8	7.6

Source: TD Economics

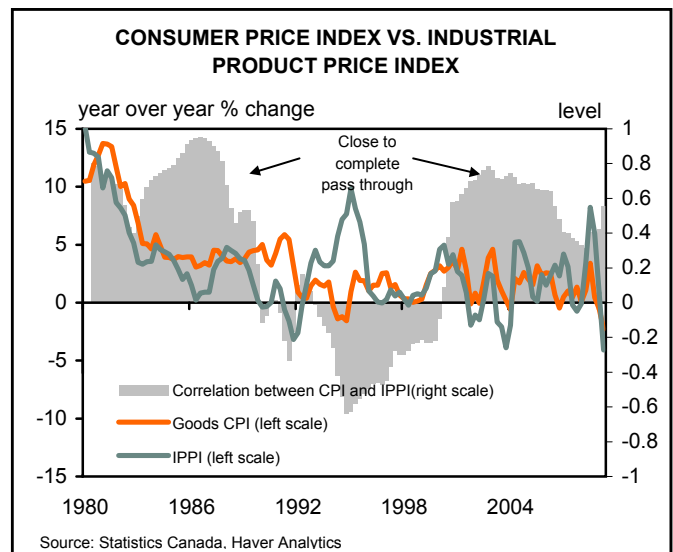
*Note the example does not take into account the embedded retail sales tax in the purchase of the inputs

provincial portion of the harmonized sales tax paid on these items.

More importantly, Table 2 also shows that a move to a value added tax is more efficient because it avoids distortions. What this means is that certain goods and services are more heavily taxed simply because they use more inputs that are taxable at the retail sales tax level. As a majority of tax is passed through to consumers, they end up paying more tax (hidden and direct) on these products. Under the HST, most goods and services will be treated fairly, in that consumers will pay the exact same amount of tax per dollar consumed.

However, there is a small portion of goods and services that will not benefit from the reform. Namely, goods and services that are tax exempt for the consumer, but for which businesses have already paid a value added tax on the inputs. Because the business is the final taxpayer (no one after them is required to pay the GST), they cannot claim the input tax credit. Table 2 shows that a good or service for which a large chunk of its inputs are already GST taxable, but not RST taxable (0% RST, 100% GST), will experience a significant rise in taxes – as the 5% GST becomes a 13% HST for many of its inputs in Ontario and a 12% HST in B.C. For example, much of the services provided by financial and insurance institutions are GST exempt. But, 22% of the inputs are services that will

under the RST. Now imagine the amount of tax cascading that goes on in manufacturing – an industry which has multiple stages of production. The manufacturing of a tire alone has up to 8 stages. Depending on whether these stages are done in-house or contracted out, there is the potential to have the RST cascading through all 8 stages, before the tire is taxed one last time as part of the final purchase of a motor vehicle. Moreover each stage uses inputs likely purchased from an outside supplier such as, bolts, and office equipment. But manufactured goods are not the only area where input tax credits will help ease the cost to consumers. A significant amount of tax cascading also goes on in the service sector as they pay the retail sales tax on many of their inputs – both operating and capital – such as machinery and equipment, mobiles, computers and software, office equipment, and office supplies. Many service providers such as personal care services and professional services (such as lawyers, accountants, and investment managers) will now be able to claim an input tax credit for the 8%



Source: Statistics Canada, Haver Analytics

Making businesses more lean and competitive

The majority of businesses—both small and large— in Ontario and B.C. will benefit from harmonization. The move to a value added tax in combination with other tax reforms will save businesses billions of dollars in taxes paid on inputs and business investment, as well as \$650 million in compliance costs. We have estimated that the effective tax rate on business input costs will be lowered by 0.9% and 0.8% in Ontario and B.C. respectively – for a combined total annual savings of \$6.9 billion. Ontario and B.C. are very open economies – with imports accounting for 62% of GDP in Ontario and 55% in B.C. As a result, businesses must contend with outside competitive pressures. In competing with over 130 countries² around the world which already use a value added tax, the RST imposes a huge competitive disadvantage on these provinces.

The tax change is thus intended to help Ontario and B.C. businesses, particularly exporters gain a competitive edge. In order for businesses to generate an increase in demand for their products they will have to pass those savings onto consumers. This in turn should help spur business investment, employment and income growth. Businesses may emerge from the recession lean, but the tax policy will ensure they are ready to compete.

experience a rise in the effective tax rate due to harmonization. That's not to say that these goods will not benefit from tax savings on inputs. There is embedded retail sales tax in the inputs they purchase, such as computers, and office supplies and equipment. The reduction in input taxes on these goods and services will feed through to these businesses as lower input costs, helping to offset some of the increase in the effective tax rate on their inputs. Other

Effective Tax Rate=Official Tax Rate x Proportion of Goods and Services taxed

Table 3: Proportion of Consumer Expenditures Being Affected By the HST (%)

CPI Category	Ontario	British Columbia
Headline Inflation	19.3	21.4
Food	--	8.7
Energy	8.4	0.0
Goods ex. Food and Energy	1.7	0.6
Services ex Shelter	9.2	12.1

Source: TD Economics, Statistics Canada

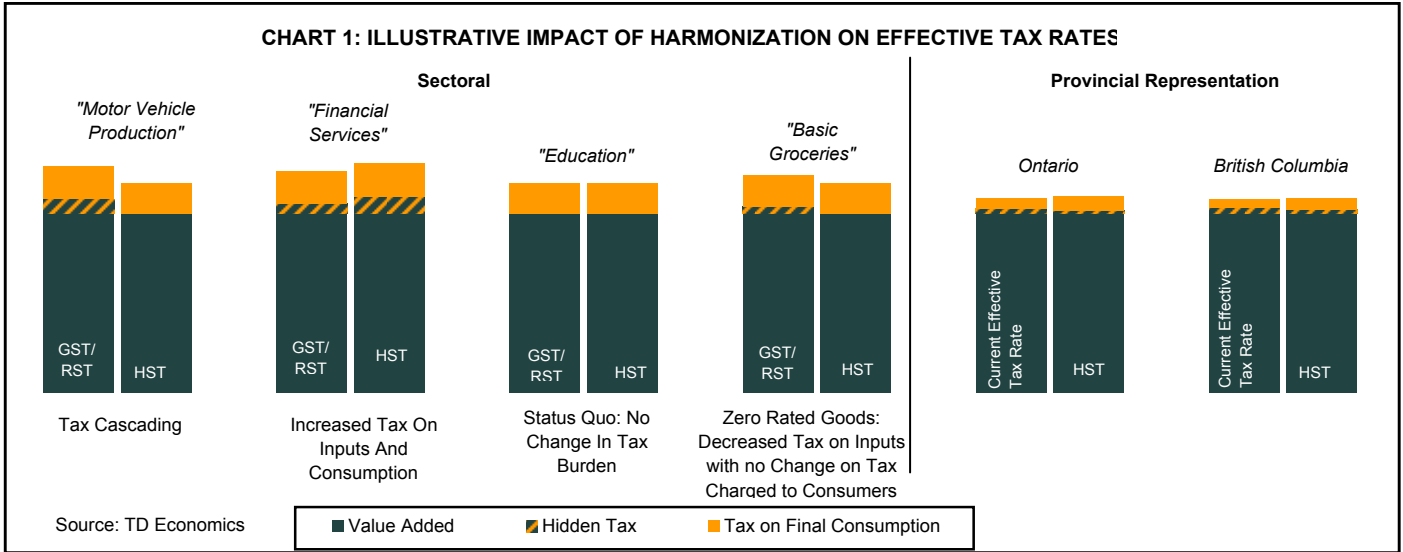
providers of exempt goods and services, including health and dental services, and child services, generally cannot claim input tax credits.

On the other side of the spectrum, there are goods that are zero rated, such as basic groceries and health care – so that consumers are not taxed on the final consumption of the good – but that businesses can still claim the input tax credits. As such, harmonization will mean a decreased tax burden on the inputs to production, with no change in the tax charged to consumers.

Cost savings within firms will likely shift to consumers...

Despite these exemptions, the majority of businesses (both large and small) in both Ontario and B.C. will benefit from the shift to a value-added tax and save a combined annual total of \$6.9 billion in taxes paid. There are good reasons to believe the majority of the tax savings by businesses will be passed on to consumers in the form of lower prices. As such, consumers in B.C. and Ontario could witness a 0.8-0.9% drop in the pre-ticket price in their purchases of goods and services. The move to HST by Ontario and B.C. is not uncharted territory. A number of other regions and countries have also gone through the experience. A study by Michael Smart and Richard Bird (2009) looked at the effect on consumer prices from HST tax reform undertaken in 1997 by New Brunswick, Nova Scotia and Newfoundland and Labrador. The authors found that with a few exceptions (i.e. shelter, clothing/footwear), consumer prices in harmonizing provinces fell, thus supporting the notion that tax changes are fully shifted forward¹. There are a number of reasons why we believe that the experience in Ontario and B.C. will be similar. First, the adjacent graph demonstrates that there is a strong correlation between consumer prices in Canada and business costs, indicating that price changes eventually filter down to consumers. Second, profit margins for manufacturers in Canada are responsive to relative price changes in domestic-made versus foreign-made goods. Since Ontario and B.C. export and import a significant portion of their GDP (see text box: Making businesses more competitive), firms in these regions face a high degree of competition from foreign suppliers. Therefore, in order to attract more demand and increase profitability, firms will have to pass the majority of these savings forward to consumers.

In addition, the policy will also remove provincial taxes on exports of goods and services shipped outside of

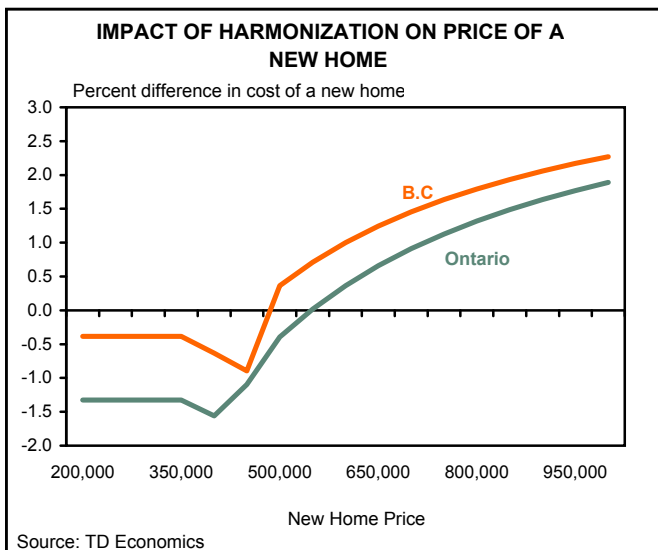


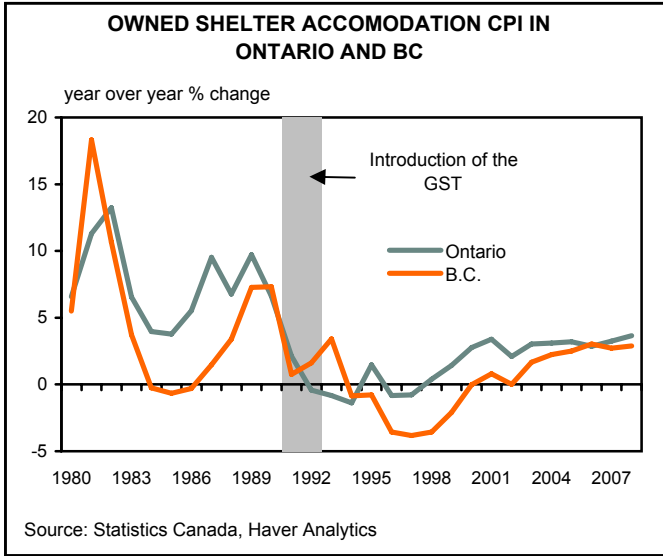
Canada, which will help increase the foreign competitiveness of B.C. and Ontario companies with a reduction in the effective tax rate on exports. Even within Canada there will be distributional benefits. Ontario exports about 19% of its production to the rest of Canada, while B.C. exports roughly 16% of its production to other provinces, resulting in cost savings at the national level.

...but the burden of tax will shift to consumers

The tax savings for businesses is lost revenue for the Ontario and B.C. governments, and the tax revenue needed to support hospitals, schools, and social programs has to come from somewhere. And in this case, it will come from increasing the tax burden on consumers. Although we anticipate that consumers will pay lower pre-tax prices on

average, they will have to pay the flat HST on a broader array of goods and services than before, therefore increasing their effective tax rate on consumption. Chart 1 shows that consumers will be made better off for goods and services for which RST cascading occurs heavily through the supply chain, despite a rise in the effective tax rate. Depending on whether the final purchase of a good and service is currently charged the RST, consumers could see no change in the final price of the good or service. The obvious exception is in cases where inputs and/or consumption are currently taxed only at the Federal level, and not the provincial level – such as personal care services. In such circumstances, the tax rate jumps from 5% to 13% in Ontario and to 12% in B.C. Given the list of goods and services that will be affected by the new tax, we have estimated that Ontario consumers will experience an 8 percentage point increase in the posted tax rate on approximately 19% of their expenditures. In B.C., consumers will be subject to a 7 percentage point increase on the tax rate on 21% of their expenditures. In Ontario and B.C., this will lead to a 1.5 percentage point increase in the effective tax rate. Just to clarify, these estimates represent the estimated impact on the effective tax rate on consumption, and exclude the impact from the pass through of business cost savings to consumers. The difference in the two estimates lies in the treatment of energy and food, two consumption categories on which households spend a significant amount of their income. B.C. is making the move from not taxing any food consumed by persons at the provincial level, to taxing prepared and packaged food purchased at stores, and restaurants. Ontario imposes the





provincial sales tax on the majority of food products taxed under the GST, with the exception of prepared food purchases under \$4, which are exempted from the RST, but will be taxed under the HST. Meanwhile, Ontario will now tax energy items such as gasoline and fuel oils at 8%, while B.C. will exempt these goods from the HST. It should be noted that Ontario currently charges a fixed \$0.147 per litre on gasoline. This tax will not be removed, but the 8% will now apply on top of the old tax. B.C also applies a per litre carbon tax on all fossil fuels such as gasoline.

Concerns over Housing

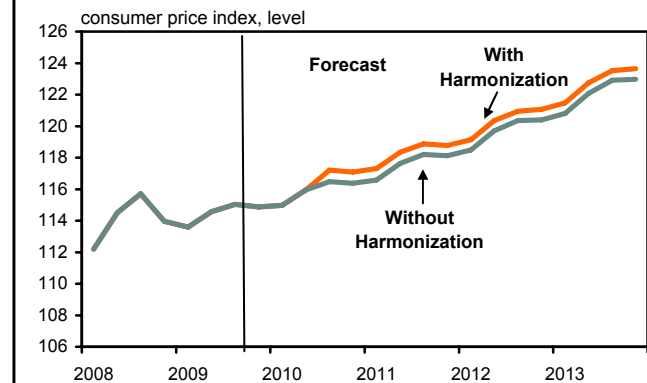
Arguably the most controversial aspect of the tax reform is the treatment of new housing, which under harmonization will be taxed an additional 8% in Ontario, and 7% in B.C. The concern is not only that this will lead to a significant increase in the overall cost of purchasing a home, but that it will also drive prices of existing homes up as demand shifts to the resale market as homebuyers attempt to avoid paying the additional tax. However, analogous to the previous discussion, there are some mitigating factors that may result in the drop of the purchase price of a new home valued under \$500,000.

First, there is large scope for the construction industry to benefit from the cost savings associated with the shift to a value added tax. Homebuilders pay a significant amount of provincial tax on inputs. This could include anything from the hammer to the lumber purchased at the local home depot. It has been estimated that the ability to claim an input tax credit for the provincial sales tax on these inputs will result in a 3.2% cost savings for builders. If homebuild-

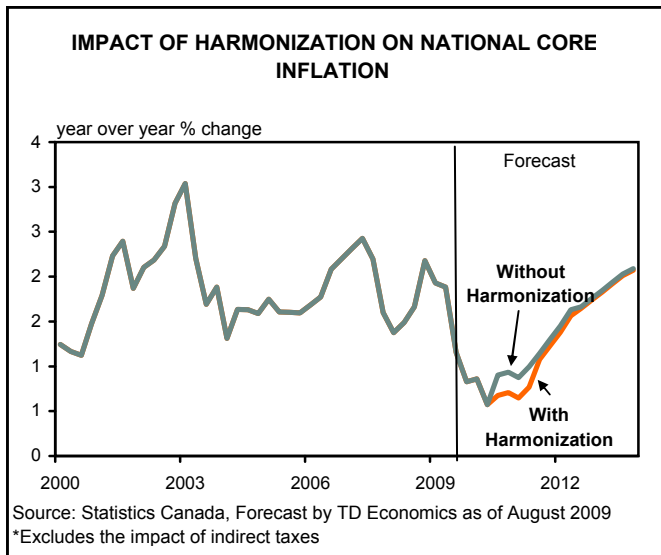
Government Support

While consumers will find themselves paying more tax on certain goods and services, the hope is that the higher costs will be offset by stronger sustainable income growth. But recognizing that the transition from the current tax system to the HST may have negative implications on households in the near term, especially lower income households, and particularly in the early transitional period, both the government of B.C. and Ontario in co-operation with assistance from the Federal Government have offered their support. The Government of Ontario has committed \$4 billion in support to help consumers transition into the new sales tax, paying out a sales tax transition benefit in three installments over the time period of June 2010 to June 2011. The transition benefit is higher for lower and middle income families and gets scaled back for singles with income over \$80,000 and for families (including single parents) with incomes over \$160,000. This will help offset the expected \$2.5-3 billion in additional costs that households will be paying. This benefit will be temporary, but Ontario and B.C. will also be paying out a permanent sales tax credit to lower income families. The Government of Ontario will issue an annual payment of up to \$260 per family member through quarterly installments. B.C will follow suit by providing lower income families a quarterly refund cheque, but to a maximum of \$230 per person per year. The Government of Ontario is also cutting the rate on the lowest personal income tax bracket which, together with higher tax credits, will offer nearly \$2.5 billion annually in permanent tax relief to help offset direct tax shifts to households.

IMPACT OF HARMONIZATION ON NATIONAL CONSUMER PRICES



Source: Statistics Canada, Forecast by TD Economics as of August 2009



ers pass the entirety of these savings onto homebuyers, the price of a new home will fall by the same scale – for example, a new home priced at \$400,000 today could cost as little as \$387,200 after July 1, 2010³.

In addition, new homebuyers can claim a tax credit for part of the provincial sales tax paid on the purchase of a new home. In Ontario, the tax credit is 75% of the provincial tax paid to a maximum of \$24,000. In B.C., the tax credit will be 5% of the home value up to a maximum of \$20,000. However, this means that the tax credit is maxed out once the price of a new home reaches \$400,000 in Ontario and B.C. The chart above illustrates that the higher the cost of the home, the higher the tax burden. Fortunately in Ontario (and in Toronto), about 90% of new homes are priced below \$500,000 (and 75% of new homes are priced under \$400,000)⁴, so the majority of new homebuyers will be affected at the lower range. B.C. will likely be hit harder by the tax, as home prices in the province are higher than those in Ontario. Existing homes are about 30% more expensive in B.C. than they are in Ontario.

The impact of the change in the tax on the final cost of a new home will show up in the mortgage interest cost component of CPI, as the higher principal required to purchase the house means consumers will pay higher interest payments. Nevertheless, increases in home prices feed into CPI very slowly through the mortgage interest component, because they are amortized over 25 years in the calculation of the index. In fact, the introduction of the GST back in 1991 left home ownership prices unaffected in Ontario, while B.C. witnessed a short lived surge two years after the introduction of the tax. This was in large

part owing to the GST rebate offered on new homes. The rebate was (and still is) 36% of the GST paid for new homes purchased under \$350,000, and is phased out for homes between \$350,000 and \$450,000. At the time of the introduction of the GST, the majority of homes in Ontario and B.C. were below \$300,000, and as such the purpose of the rebate was to leave the cost of purchasing a new home unaffected by the tax. The difference this time around will be that the rebate is higher for the provincial sales tax than it was when the GST was introduced, and applies to homes in all price ranges. This should limit the impact the increase in the effective tax rate on new homes will have on the overall consumer price index.

Homebuyers of both new and existing homes can also count on a rise in the closing costs of purchasing a home. Some of these costs include legal fees, home inspection fees, realtor fees, and getting a survey. Closing fees aren't the only additional costs that households will face when purchasing a home. If the house needs renovation, they can also expect to pay the additional tax on the labour provided by the workers.

The Impact on National CPI

So what does this mean for consumer prices? On net, harmonization is expected to permanently lift the overall price level of consumer prices by 0.7% in both Ontario and B.C. The combined impact will be a 0.4% increase in average Canadian consumer prices, relative to where they would have been had the tax change not occurred.

While the overall price level will rise permanently, the rate of national headline inflation will experience a short-lived pop that will only last for 12 months. The change in the effective tax rate of 0.9% will occur immediately, and likely show up in Canadian headline inflation on July 1, 2010 (the day the policies take effect). However, the pass through of business cost savings will not be instantaneous. In both provinces, corporations with over \$10 million in taxable sales cannot claim input tax credits for five years, and thereafter the tax credits will be phased in over three years for certain items. These items include energy (except when used to produce a good), most telecommunication services, most road vehicles and fuel for those vehicles, and food and entertainment. Within these five years, the government can choose to pull back these restrictions. These firms account for a significant portion of revenues in Ontario and B.C., however it is believed that competitive pressures in a large market like Ontario and B.C. will likely

force these firms to pass through some of their eventual savings before credits can be claimed. Nonetheless, about 80% of the expected total cost savings will be passed along immediately in the first year the HST comes into effect, with that ratio eventually reaching 95% by year three, with the full cost savings of these firms to take up to 6 years to feed through to consumers. Since the impact from tax reform will be a one-time event related to the tax reform that will fall out of the data one year from implementation, it is not an inflationary pressure that the Bank of Canada would get concerned over.

In addition, harmonization will have very little impact on the Bank of Canada's preferred measure of core inflation, which excludes indirect taxes. As such, only the pass through of business cost savings will show up in core inflation. Given the amount of slack that has built in the Canadian economy, inflation will likely still be well below the Bank of Canada's target of 2% by the time harmonization is implemented in 2010 and any potential downward pressure on core prices from harmonization is likely to be small.

Bottom Line

Sales tax harmonization means an increase in the tax burden on consumers who will pay the flat HST on a broader array of goods and services than before. This will lead to an overall increase in the consumer price level, but not as much as some may fear and will not have an enduring effect on the inflation rate. The price impact will be muted by businesses passing forward their savings as retail sales taxes come off their inputs, including capital goods. The increase in the consumer price level needs to be put into the broader context of the widely-held view, with which we concur, that a value added tax is a more efficient tax than the provincial retail sales taxes currently in place in both Ontario and B.C. Thus, harmonization is an important step to increase the competitiveness of these provinces' economies and complements actions the two governments have taken on capital and corporate income taxes.

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Endnotes

- ¹ Smart, Michael, and Richard M. Bird. "The Economic Incidence of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience", Canadian Public Policy, 2009
- ² "Single Sales Tax Information Notice", Ontario Ministry of Revenue, <http://www.rev.gov.on.ca/english/notices/str/pdf/01.pdf>
- ³ The estimate for B.C. assumes that builders face a similar cost structure as those in Ontario and estimates were found in : Somerville, Robin. "Made In Ontario: The Case for Sales Tax Harmonization", The Centre for Spatial Economics, 2009. <http://www.c4se.com>
- ⁴ Calculated by TD Economics using CMHC 2008 housing completion data

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