The Economic and Fiscal Update

December 6, 1995

Department of Finance Canada
Ministère des Finances Canada

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Introduction and Overview

Agenda: Jobs and Growth

This document is designed to facilitate the dialogue among Canadians on how best to continue the process of restoring the federal government's finances. It provides an update on the economic and fiscal situation and sets out the deficit target for 1997-98. It also explains the key linkages between the fiscal strategy and the government's top priority: ensuring that job creation and economic growth continue.

Economic growth resumed in the third quarter of 1995, after a pause in the first half of the year. This growth was led by strong export demand. While overall employment growth has been slow and volatile, 173,000 new jobs have been created in the private sector in the past 12 months.

To support its jobs and growth objectives, the Government will continue to pursue the strategy outlined in *A New Framework for Economic Policy* (October 1994).

As the "Framework" made clear, resolving Canada's debt and deficit problems is an integral part of the government's jobs and growth strategy. The creation of jobs and growth is hindered by the high real interest rates and economic uncertainty that accompany high levels of debt in relation to the size of the economy – the debt-to-GDP ratio. Indeed, the benefits that Canada has reaped from creating and maintaining a low inflation environment have been offset by the effects of the high debt-to-GDP ratio.

Efforts to sustain job creation and improve the standard of living, therefore, will be hamstrung until this issue has been brought under control.

Implementing the Fiscal Agenda

With its first budget, the government began the process of restoring Canada's finances and restoring credibility to the government's fiscal policy after years of missed deficit targets. By setting credible two-year rolling deficit targets, by using prudent economic assumptions for fiscal planning purposes, and by establishing Contingency Reserves to handle the impact of unforeseen economic developments on the achievement of the deficit targets, credibility is being restored to the nation's finances. The 1994 and 1995 budgets secured savings to begin turning around the deterioration in Canada's fiscal position. These budgets announced a series of policy reviews – most notably the comprehensive Program Review – charged with ensuring that federal programs were effective, cost-efficient and appropriate to the federal role in the Canadian federation.

1995 budget introduced major reform of government operations ...

The 1995 budget followed through on major government reform, based on the fiscal context set in the 1994 budget, and the policy themes elaborated in the "Framework" and its companion documents.[1] The budget set out the strategy for securing the government's interim deficit target of 3 per cent of GDP by 1996-97. It put in place $29 billion in cumulative fiscal actions over three years with expenditure reductions exceeding tax revenue increases by a ratio of seven to one.

... notably through Program Review ...

The expenditure reductions were based largely on the fundamental reform of government programs undertaken in Program Review. The Review directed government resources to the highest priorities, allowing for significant fiscal savings. As a result, the government took steps to get out of a

[1] These companion documents were: *Improving Social Security in Canada*, *Creating a Healthy Fiscal Climate*, and *Building a More Innovative Economy*.

number of areas where the private sector could deliver services more effectively and efficiently – notably transportation – and where government involvement has been found to have perverse effects – principally in subsidizing business. As the Organization for Economic Cooperation and Development (OECD) concluded:

> "Subsidies tend to operate in exactly the opposite way from what is needed: they slow rather than stimulate adjustment; they discourage rather than encourage innovation; and they tend to become permanent."

The 1995 budget also introduced reforms to the federal-provincial transfer system. It introduced the Canada Health and Social Transfer (CHST), which replaced transfers to provinces under the Canada Assistance Plan (CAP) and Established Programs Financing (EPF). The CHST provides the provinces more flexibility in allocating these transfers to areas of highest priority in their particular jurisdictions, while protecting medicare and residency requirements.

The budget also reduced tax preferences and increased the fairness of the tax system, while ensuring that taxes already owed are collected. Personal income tax rates were not raised in either the 1994 or 1995 budgets.

… which will ensure that the 1995-96 and 1996-97 fiscal targets are met

As a result of the actions in the last two budgets, real progress is being made in restoring Canada's fiscal health. The 1994-95 deficit target of $39.7 billion set out in the February 1994 budget was more than met. The deficit for 1994-95 was $37.5 billion, $2.2 billion below the February 1994 budget target. And despite an unexpected slowing in economic growth this year, the deficit targets for 1995-96 and 1996-97 will be met. The actions contained in the 1994 and 1995 budgets will reduce the deficit in relation to the size of the economy by 1996-97 to its lowest level in over 20 years.

Table 1.1
Federal deficit

	Actual		Forecast	
	1993-94	1994-95	1995-96	1996-97
$ billions	42.0	37.5	32.7	24.3
Per cent of GDP	5.9	5.0	4.2	3.0

The expenditure reductions on which the 1994 and 1995 budgets were based were structural in nature. Savings contained in the 1995 budget mature, for the most part, in 1997-98 and continue thereafter. Thus, decisions already made in the 1994 and 1995 budgets, as well as the recently announced unemployment insurance reform, will ensure that program spending – and the deficit – will continue to decline in 1997-98.

Ensuring Continued Progress

Previous governments set long-term deficit targets that were never realized. This government's approach to budgeting is to set credible two-year rolling deficit targets. By setting two-year deficit targets, discipline is maintained to ensure that the targets are met. The government is held accountable on an ongoing basis.

The government is proposing to set the 1997-98 deficit target at two per cent of GDP, or about $17 billion. This target will result in a permanent reduction in the debt-to-GDP ratio – the first time Canada's debt-to-GDP ratio has been on a sustained downward track since 1974-75. It is another important step toward the ultimate goal of a balanced budget.

Outline of the Paper

The remainder of this paper is organized as follows:

- **The Economic Assumptions** presented in the 1995 budget is updated in Chapter 2.

- **The Fiscal Implications of the Economic Assumptions** are discussed in Chapter 3

- **Creating a Healthy Monetary and Fiscal Climate** and in particular, why Canada's debt burden needs to be reduced, is discussed in Chapter 4.

- **Meeting the Challenge** posed by the large federal debt-to-GDP ratio and the changes in the economic environment since the 1995 budget is discussed in Chapter 5.

- **Conclusions and Main Issues** are presented in Chapter 6, including a number of specific questions on which the Finance Committee will be asked to provide advice.

As in last year's *Economic and Fiscal Update*, detailed descriptions of government spending and revenues are provided in the Annexes.

2

Economic Assumptions

Introduction – The Need for Prudence

This chapter begins with a review of recent economic developments and then presents private sector views on the prospects for 1996. Continuing with the approach used since the 1994 budget, a prudent alternative for fiscal planning is also presented. This prudent alternative was developed following the recommendation of the House of Commons Standing Committee on Finance that the fiscal forecast be based on interest rates above the average of private-sector forecasts, with consequential impacts on nominal GDP.

The use of prudent assumptions does not mean, however, that the government takes a gloomy view of Canada's economic prospects. Fiscal consolidation, structural reforms and a commitment to low inflation will lead to a strong economy. But the government's fiscal plan must allow for the possibility that the economic situation will be less favourable to fiscal consolidation than assumed, because of the high cost of failing to achieve deficit-reduction targets. Indeed, the use of prudent economic assumptions, backed by visible progress in reaching announced targets, offers the best hope of bringing forward the benefits of fiscal consolidation in the form of lower interest rates and hence better economic performance.

Recent Economic Developments

Growth paused in the first half of 1995

After growing strongly throughout 1994, the Canadian economy suffered a sharp decline in demand in the first half of this year. While some weakness was expected in the budget outlook for 1995, it came much sooner and was more pronounced than expected. Real GDP rose 1.4 per cent in the first quarter and then shrank 0.6 per cent in the second (annual rates).[1] The weakness would have been even more pronounced had there not been a large inventory accumulation in both quarters.

Both exports and domestic demand weakened dramatically. The weakness in exports followed growth of over 6 per cent in the second half of 1994. U.S. demand for Canada's exports fell sharply as U.S. industrial production trended down from January to June. Moreover, two key determinants of Canada's exports, U.S. motor vehicle sales and housing starts, fell 12 and 16 per cent respectively in the first half of the year.

Domestic demand also weakened in the face of rising interest rates, flagging consumer confidence and stagnant labour markets. Short-term interest rates rose more than 200 basis points from mid-1994 to early 1995, reflecting rising U.S. interest rates and heightened concerns about public sector debt. Further, the Conference Board's index of consumer confidence fell 12 per cent in the first half of the year. Finally, total employment was virtually stagnant through July after rising approximately 400,000 in the 12 months ending November 1994. As a result, consumer spending on goods and services stalled in the first half of the year and housing starts weakened substantially, falling to a 13-year low in July.

The weakness in overall employment, however, masked continued strong growth in the private sector offset by declining public sector employment. From November 1994 to July 1995, public sector employment fell 210,000 while private sector employment rose a healthy 206,000.

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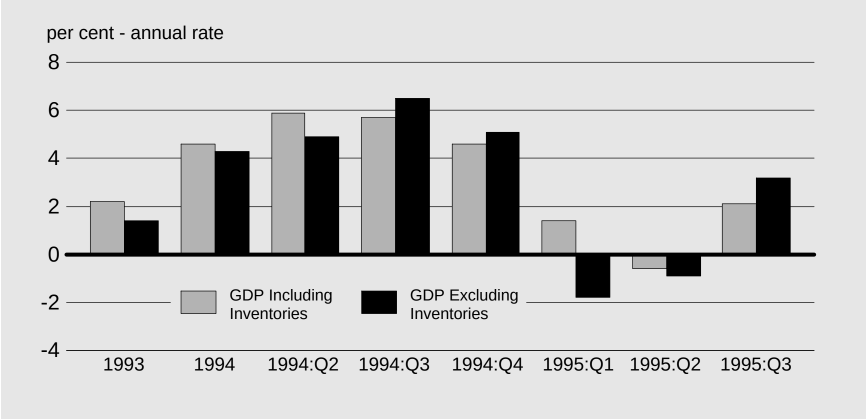
1 Growth rates in this chapter are period-to-period changes calculated using seasonally adjusted data. The growth rates are not annualized unless explicitly noted.

Chart 2.1 **Growth in GDP including and excluding inventory investment**

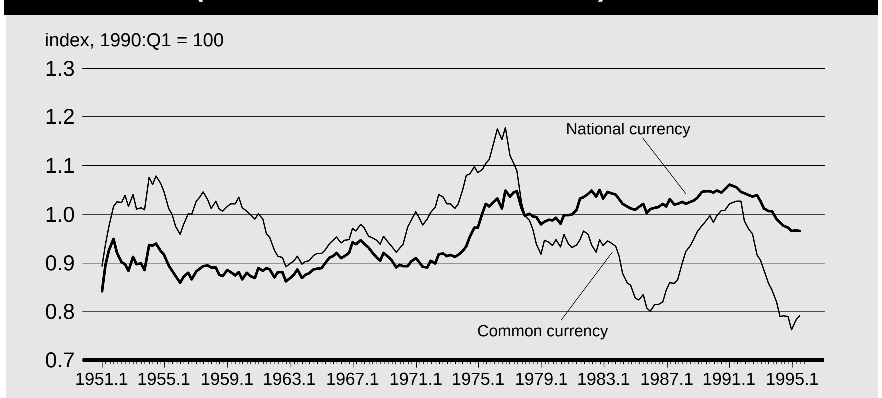


Inflation remains low

The 12-month rate of CPI inflation peaked at 2.9 per cent in May. The increase was largely due to temporary factors such as the pass through of the past depreciation of the dollar, rising indirect taxes, and increases in energy prices. The CPI was virtually unchanged from May to October, pushing the 12-month rate down to 2.4 per cent.

Inflation should ease further in the coming months given the amount of spare capacity in the economy, the virtual absence of domestic cost pressures and a relatively stable exchange rate. Wage settlements have averaged just under 1 per cent so far this year. Although the temporary weakness in output caused productivity to slip in the first half of the year, Canada's unit

Chart 2.2 **Total economy relative unit labour costs (Canada relative to the United States)**



labour cost performance over the past three years remains quite remarkable. While U.S. costs rose through this period, Canada's unit labour costs *fell* from the beginning of 1993 to the fall of 1994. An exchange rate depreciation pulled Canada's costs down much more sharply on a common currency basis and Canada's cost position relative to the U.S. remains at the lowest level in the 45 years the data are available.

Recent indicators are more promising

After plummeting from January to July, real merchandise exports surged almost 9 per cent in August and remained at this high level in September. This extraordinary performance caused the current account deficit to fall to $13.6 billion, equivalent to 1.7 per cent of GDP. This is down from 2.5 per cent of GDP in the first half of 1995 and is the lowest level since the second quarter of 1985. The prospects for continued export growth are good as U.S. economic activity has picked up after its own pause in the first half of the year.

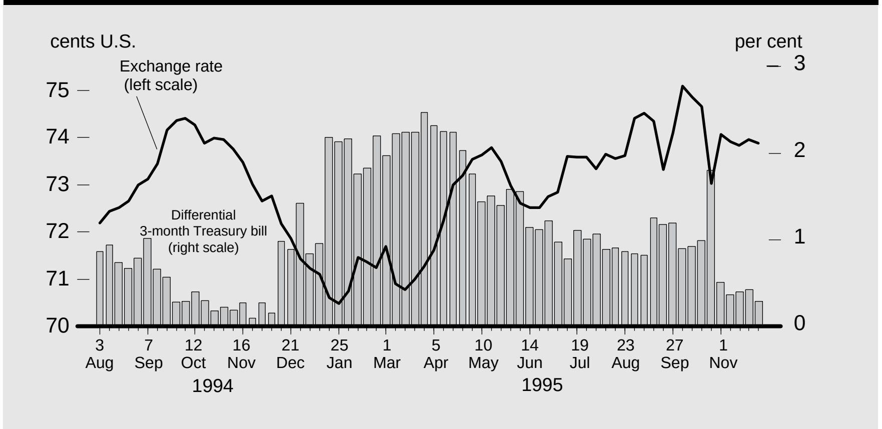
On the domestic side, household spending in the third quarter showed signs of recovering from its first-half slump as real consumer spending rose at an annual rate of 2.5 per cent, largely on the strength of car sales, and house resales picked up. The strength in consumption was not sufficient to offset weakness elsewhere and final domestic demand edged down in the third quarter. Nevertheless, real output rose 2.1 per cent (annual rate) in the quarter, faster than expected by most analysts.

While some weakness is evident in the most recent data, particularly employment in November, this is due in part to the financial market volatility and general uncertainty caused by the referendum.

Financial market sentiment has improved substantially

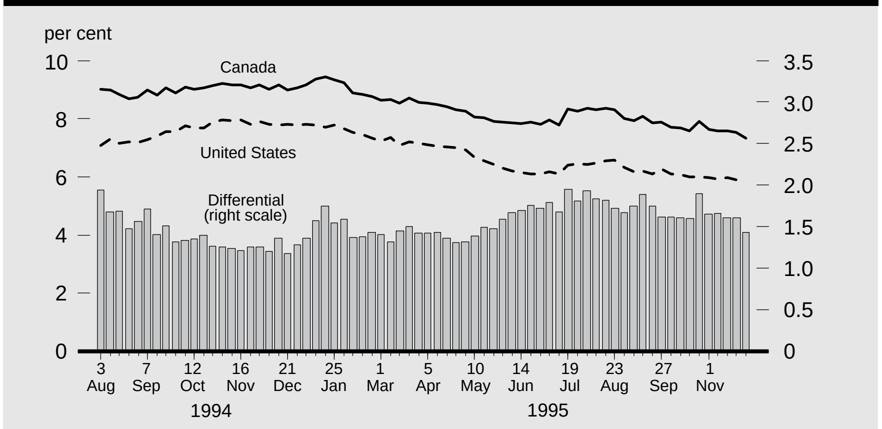
Financial market concerns reached a recent peak early in 1995 when the exchange rate fell to a nine-year low and Canada-U.S. short-term interest rate differentials rose above 200 basis points. Sentiment improved substantially over the spring and summer, due in part to the favourable reception given to the federal budget and the budgets of many provincial governments as well. Financial market concerns resurfaced in the late stages of the referendum campaign, causing a short-lived spike in interest rates and temporary weakness in the dollar.

Chart 2.3 Canada-U.S. exchange rate and the short-term interest rate spread



Since early 1995, the dollar has trended up and interest rates have fallen about 250 basis points. The short-term differential with the U.S. has fallen to under 50 basis points. Interest rate differentials on 10-year government bonds have also declined substantially since the referendum but remain high, suggesting ongoing concerns about public sector deficits and political uncertainty.

Chart 2.4 10-year bond rate



The External Economic Environment

Major overseas economies

Overseas growth performance has been markedly less favourable thus far in 1995 than expected at the time of the February budget. The rise in the value of their currencies against the U.S. dollar earlier this year hurt the export performances of Japan and Germany. At the same time, Japan continues to suffer from financial sector instability.

Japan is now expected to see its fourth consecutive year of almost no growth. The Japanese economy is expected to pick up gradually through 1996 but growth will remain below potential. Growth in the major European countries should be at, or perhaps slightly below, potential rates both this year and next.

All of the major overseas economies have spare capacity at present and this is expected to persist in 1996. This implies that inflation in most of the major overseas economies should remain around current low rates or even ease somewhat.

The United States

The U.S. economy looks well-placed to experience a soft landing rather than the more usual boom and bust expected at the time of the 1995 budget. Demand growth slowed in the first half of 1995 due to policy-induced rises in interest rates last year and weakness in foreign markets. This caused excessive inventories to accumulate and production to slow. Real growth fell from 5.1 per cent in the fourth quarter of last year to 1.3 per cent (annual rate) in the second quarter of this year. Employment growth slowed from 3.0 per cent to 1.0 per cent (annual rate) over the same period.

The slowing, however, served to ease capacity pressures and keep inflation pressures relatively low. As a result, CPI inflation excluding food and energy has stabilised at about 3 per cent.

Growth rebounded to an annual rate of 4.2 per cent in the third quarter, but this reflected a number of special factors that are not likely to recur in the fourth. These special factors included a jump in government spending and a surge in motor vehicle sales in August in response to end-of-model-year rebates and incentives. As a result, most private sector forecasters expect growth to slow to about the economy's potential growth rate (approximately 2½ per cent) in the fourth quarter. Growth is then expected to remain near potential through next year.

Table 2.1
Economic assumptions for the United States – Private sector average

	Actual	Forecast	
	1994	1995	1996
Real GDP growth	4.1	3.2	2.6
CPI inflation rate	2.6	2.9	2.9
Unemployment rate (%)	6.1	5.6	5.7
90-day Treasury bill[1] (%)	4.4	5.7	5.5
10-year government bond rate[2] (%)	7.1	6.6	6.2

Source: Blue Chip Economic Indicators, November 10, 1995. This is a survey of 50 U.S. private sector forecasters.

[1] True yield, adjusted from discount basis by the Department of Finance.

[2] Based upon Blue Chip Consensus for the corporate AAA rate.

The stable inflation outlook allows short-term interest rates to remain near their end-November level of 5.5 per cent. The 10-year bond yield, however, moves up slightly through next year from just under 6.0 per cent. In the budget, short and long-term interest rates were assumed to peak well above these levels, at 7½ and 8¼ per cent respectively.

The Economic Assumptions for Canada

Private sector views

Private sector views on the economic outlook for Canada are summarised in Table 2.2. Although some of these forecasts were prepared quite recently, the majority were prepared from mid-September to mid-October. They are consistent with the views of the 10 private sector economists that appeared before the House of Commons Finance Committee on November 9. The forecasts do not, however, reflect the most recent data, particularly the national income and expenditure accounts for the third quarter, and the labour market data for October and November. On balance, these data suggest that real growth in 1995 is likely to be closer to 2½ per cent than the 2.2 per cent reported in the survey.

Private sector forecasters generally expect economic performance to improve in 1996 due to a favourable external environment and interest rates that are lower than in 1995 As a result, both exports and domestic demand are expected to make solid contributions to growth. Since most forecasts were prepared with the expectation of a solid "no" vote in the referendum, the survey does not take account of the potentially damaging effect of heightened political uncertainty on confidence and growth.

Private sector forecasters expect short-term interest rates to average 6.3 per cent in 1996 while the interest rate on 10-year government bonds is expected to average 7.8 per cent. These are somewhat lower than on average in 1995, but they are about 50 basis points above end-November levels. Economic fundamentals and a sound policy framework suggest the current low interest rates are likely to be sustained in the near term and that further progress could be made in 1996:

- credible progress is being made by all levels of government in reducing budget deficits;
- the government and the Bank of Canada are committed to keeping inflation low, reinforcing Canada's excellent competitive position.

Table 2.2
Economic assumptions for fiscal planning[1]

	1995	1996
Real GDP growth (%)		
Private sector average	2.2	2.4
Prudent alternative	2.2	2.3
Nominal GDP growth (%)		
Private sector average	4.0	4.3
Prudent alternative	4.0	4.1
Nominal GDP ($ billions)		
Private sector average	780	814
Prudent alternative	780	812
CPI inflation		
Private sector average	2.3	2.2
Prudent alternative	2.3	2.2
91-day Treasury bill (%)		
Private sector average	6.9	6.3
Prudent alternative	6.9	6.8
10-year benchmark government bond rate (%)		
Private sector average	8.0	7.8
Prudent alternative	8.0	8.3

[1] The private sector average is based on 19 respondents for 1995 and 1996.

On the other hand, a loss of confidence in financial markets – perhaps due to increased political uncertainty – could put substantial upward pressure on interest rates.

Private sector analysts expect real growth will average 2.4 per cent in 1996, up slightly from this year. Growth from the end of this year to the end of 1996 is, however, expected to be substantially stronger at almost 3½ per cent. Employment is forecast to rise 1.4 per cent in 1996. This is not, however, sufficient to reduce the unemployment rate substantially from its level in November.

CPI inflation is expected to average about 2¼ per cent in 1996, virtually unchanged from 1995. Economy-wide inflation will be somewhat lower, but again little changed from this year.

A prudent alternative for fiscal planning

This government has adopted the approach of using economic assumptions that are prudent in the sense that they skew the risks in favour of reducing the deficit more than assumed. This does not mean that the government takes a pessimistic view of Canada's economic prospects. Economic performance is more likely than not to be better than set out in the planning assumptions *as the government makes credible progress meeting its fiscal targets*. If the targets are not met, economic performance is likely to be worse due to higher interest rates and lower confidence. It is important to stress that if the economy does perform better than assumed, the government will use the fiscal gain to achieve its long-run deficit target faster, which will reinforce the good economic performance.

In its report last fall, the House of Commons Finance Committee stressed that the large stock of outstanding debt made the interest rate planning assumptions crucial because of the extreme vulnerability of the deficit to interest rate swings. As a result, the Committee recommended that the economic assumptions for fiscal planning be based on interest rates that are 50 to 100 basis points higher than the private sector average. Given the substantial improvement in financial market sentiment since the private sector forecasts were prepared, it is appropriate to apply a 50 basis point prudence factor to the private sector average. This lowers nominal GDP growth about 0.2 percentage point in 1996, and reduces the level of nominal GDP by $2 billion. This impact on nominal GDP has been split evenly between real income and inflation.

The fiscal implications of using the prudent planning scenario are explored in the next chapter. The appropriate degree of prudence will, of course, be re-examined during the pre-budget consultations and revised if necessary for the budget.

Comparison with the budget economic assumptions

The outlook for real growth in 1995 has been reduced sharply since the budget, from 3.8 to 2.2 per cent. Although growth is assumed to pick up in 1996, the level of real GDP in the prudent alternative remains below the budget assumption. In contrast, the outlook for inflation has edged up since the budget. Overall, the 1996 level of nominal GDP, which is a reasonable proxy for the tax base, is about $9 billion lower in the prudent planning scenario than was assumed in the budget.

Interest rates in 1995 have come in much lower than expected in the budget, offsetting completely the impact of slower growth on the fiscal deficit. Interest rates in 1996 are now assumed to be 70 basis points lower than in the budget.

Table 2.3
Updated prudent economic assumptions for Canada

	Actual	Forecast	
	1994	1995	1996
Real output growth (%)			
Budget 1995	4.3	3.8	2.5
Fall update	4.6	2.2	2.3
GDP deflator increase (%)			
Budget 1995	0.6	1.6	1.8
Fall update	0.6	1.9	1.9
Nominal GDP growth (%)			
Budget 1995	4.9	5.5	4.3
Fall update	5.2	4.0	4.1
Nominal GDP ($ billions)			
Budget 1995	746	787	821
Fall update	750	780	812
91-day Treasury bill rate (%)			
Budget 1995	5.5	8.5	7.5
Fall update	5.5	6.9	6.8
10-year government bond rate (%)			
Budget 1995	8.4	9.7	9.0
Fall update	8.4	8.0	8.3

3

The Fiscal Implications of the Economic Assumptions

Final Deficit Outcome for 1994-95

The government's *Annual Financial Report*, released November 1, 1995, reported that the 1994-95 deficit was $37.5 billion, $2.2 billion below the target of $39.7 billion set out in the 1994 budget and $4.5 billion below the 1993-94 deficit outcome of $42.0 billion.

The deficit outcome for 1994-95 underscores the importance of basing the fiscal projections on prudent economic assumptions. Economic conditions changed significantly during the course of 1994 from what was expected at the time of the February 1994 budget. Economic growth turned out to be more robust than forecast, but interest rates were substantially higher. However, because the deficit forecast for 1994-95 was based on prudent economic assumptions, the net effect was that most ($2.2 billion) of the $2.4 billion Contingency Reserve established in the 1994 budget was not needed.

Fiscal Implications of Economic Assumptions

The key factor affecting the fiscal update is the changed economic outlook, as described in Chapter 2. That chapter provided an update of economic developments for 1995 and 1996 from those presented in the February 1995 budget. It also provided a prudent economic scenario for fiscal planning purposes for 1995-96 and 1996-97.

1995-96

The deficit target for 1995-96, as first put out in the February 1994 budget and restated in the February 1995 budget, is $32.7 billion.

As explained in Chapter 2, economic growth in 1995 will be substantially less than expected at the time of the February 1995 budget. Thus, tax revenue will be lower than had been expected. However, interest rates have also been much lower during 1995 than expected in the 1995 budget, thereby resulting in lower-than-expected public debt charges.

On balance, the impacts of lower growth and lower interest rates on the deficit are expected to be offsetting. This is supported by the financial results for the first six months of 1995-96. The deficit over the April to September 1995 period was $1.3 billion below the deficit for the same period last year. This improvement, coupled with the inclusion of a number of one-time restructuring costs in the 1994-95 deficit outcome, clearly indicates that the 1995-96 deficit target of $32.7 billion will be met.

Table 3.1
Changes to the 1995 budget deficit track

	1995-96	1996-97
	(billions of dollars)	
February 1995 budget deficit track	32.7	24.3
Changes:		
Revenues		
Personal income tax	0.5	1.0
Corporate income tax	1.2	0.6
Other	0.3	-0.3
Total revenue changes	2.0	1.3
Program spending		
U.I. benefits	-0.7	0.4
CHST	0.3	0.1
Other spending	0.1	0.2
Total program spending	-0.3	0.7
Public debt charges	-1.7	-1.5
Net impact of changes	0.0	0.5
Contingency Reserve	0.0	-0.5
Total changes	0.0	0.0
Revised deficit with unchanged policy	32.7	24.3

Note: Negative sign indicates a reduction in the deficit.
Positive sign means an increase in the deficit.

1996-97

The deficit target for 1996-97 of $24.3 billion, or 3 per cent of GDP, also remains on track, despite the changes in the economic planning assumptions since the February 1995 budget. Using the prudent economic planning assumptions, both the level of nominal income and interest rates are expected to be lower than forecast at the time of the February 1995 budget.

Budgetary revenues, especially personal and corporate income taxes, are now expected to be $1.3 billion lower than forecast in the 1995 budget. The Minister of Human Resources Development recently proposed major reforms to the unemployment insurance program, including changes to the earnings base used to calculate premium contributions. The premium rate equivalent to generate the premium contributions assumed in the 1995 budget would need to be $2.93 per $100 of insurable earnings (employee rate). The rate for 1996 has, therefore, been set at $2.95 per $100 of insurable earnings. This compares to a rate of $3.00 per $100 of insurable earnings in 1995.

Program spending is expected to be somewhat higher than forecast in the 1995 budget. This reflects the impact of higher cash transfers under the Canada Health and Social Transfer, slightly higher unemployment insurance benefit payments, and some adjustments to other program spending. The fiscal impact of the proposed changes to unemployment insurance benefits was included in the 1995 budget projections for 1996-97. The proposed changes, therefore, secure these savings. As a result, the operating surplus is expected to be $2.0 billion lower than forecast in the 1995 Budget.

Largely offsetting this deterioration in the operating balance are lower public debt charges, as interest rates for 1996 are expected to be lower than assumed in the 1995 budget.

Included in the fiscal projections is a Contingency Reserve. This is included in the deficit projections primarily to cover risks arising from (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. The contingency reserve provides an extra measure of back-up against adverse errors in the economic forecast. The contingency reserve is not a source of funding for new policy initiatives.

The Contingency Reserve for the first full fiscal year of the upcoming budget planning cycle is set at $2.5 billion, as per current budget practice. Future years' Contingency Reserves are set a $3.0 billion per year. In the 1995 budget, the Contingency Reserve for 1996-97 was $3.0 billion, as that was the second year of the planning horizon at that time. Lowering the Contingency Reserve for the first year of the budget planning cycle reflects the fact that the risks to the planning assumptions are lower than in succeeding fiscal years.

With the revisions outlined above, the deficit target of $24.3 billion for 1996-97 is met.

Financial requirements – a measure of net market borrowing – will decline sharply, from $24.9 billion in 1995-96 to $13.7 billion in 1996-97. This represents 1.7 per cent of GDP, the lowest requirement, relative to the size of the economy since 1974-75.

Table 3.2
Summary statement of transactions: status quo fiscal extension

	1994-95	1995-96	1996-97
	(billions of dollars)		
Budgetary revenues	123.3	131.2	136.1
Program spending	118.7	113.7	108.6
Operating balance	4.6	17.6	27.4
Public debt charges	42.0	47.8	49.2
Contingency Reserve	0.0	2.5	2.5
Deficit	-37.5	-32.7	-24.3
Non-budgetary transactions	11.6	7.8	10.6
Financial requirements	-25.8	-24.9	-13.7
Net public debt	545.7	578.4	602.6
GDP (calendar year)	750	780	812
Per cent of GDP			
Revenues	16.4	16.8	16.8
Program spending	15.8	14.6	13.4
Deficit	-5.0	-4.2	-3.0
Financial requirements	-3.4	-3.2	-1.7
Net public debt	72.8	74.2	74.2

Financial requirements form the basis for the amount of Borrowing Authority requested from Parliament for a fiscal year. The Borrowing Authority that would be associated with financial requirements of $13.7 billion in 1996-97 would be $17.7 billion. This is down sharply from the Borrowing Authority of $28.9 billion for 1995-96 shown in the 1995 budget.

Financial requirements are also a more comparable measure of the government's fiscal position on an international basis, in particular with respect to the United States. On this basis, Canada's fiscal performance in 1996-97 will be significantly better than in the United States and will be projected to be the lowest among central governments of G-7 countries.

Fiscal Outlook: Sensitivity to Economic Assumptions

Estimates of the main fiscal aggregates are sensitive to changes in economic assumptions - particularly the level of nominal income and interest rates. The following sensitivity estimates are intended to capture the direct fiscal impacts of changes, one economic variable at a time. These are partial calculations. For example, in the nominal income sensitivity estimate, there is no feed-through of the change in nominal income to other variables, such as interest rates and unemployment.

Sensitivity to changes in nominal income

A 1-per-cent increase in the level of nominal income leads to higher tax bases and therefore higher revenues. Expenditures are lower, primarily due to lower interest costs since the stock of debt is smaller than it otherwise would be.

The deficit impact would depend on the source(s) of the increase in nominal income. The most favourable impact on the fiscal situation would occur if all of the increase in nominal income was due to an improvement in productivity. Inflation and interest rates would not rise and indeed could decline. Revenues would be higher and borrowing costs lower.

If, however, the improvement were solely due to inflation, then some of the positive impact on government revenues would be offset by higher spending on those programs that are indexed to inflation. In addition, higher nominal GDP, caused either by higher inflation or stronger demand in the economy, would likely raise interest rates, thereby increasing public debt charges.

Assuming the increase in nominal incomes comes solely from an increase in real output, the deficit would be lower by $1.3 billion in the first year and would be lower by $1.7 billion after four years, as savings from lower debt charges begin to accumulate.

Table 3.3
Fiscal sensitivity analysis: 1-per-cent increase in the level of nominal income

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	1.2	1.3	1.4	1.6
Expenditure reductions	0.1	0.2	0.1	0.1
Deficit reduction	1.3	1.5	1.5	1.7

Sensitivity to changes in interest rates

In contrast to the uncertainties of the sensitivity of the deficit to changes in nominal GDP, the impact of interest rate changes on public debt charges can be calculated with considerable precision. A sustained 100 basis point decline in all interest rates causes the deficit to decline by $1.5 billion in the *first* year.[1] As longer-term debt matures and is refinanced at lower interest rates, the favourable impact on the deficit increases, such that by year four, the deficit is about $3.4 billion lower.

Table 3.4
Fiscal sensitivity analysis: 100-basis-point decline in all interest rates

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue decreases	0.3	0.3	0.4	0.4
Expenditure reductions	1.8	2.8	3.4	3.8
Deficit reduction	1.5	2.5	3.0	3.4

[1] This estimate is slightly lower than previous estimates as more of the debt is now being financed at longer maturities.

As the above clearly illustrates, an important consideration in managing the federal debt is the impact on debt charges of unexpected increases in interest rates. The potential for unexpected variations in debt charges, especially in the short run, can be modified by changing the structure of the outstanding debt. A larger proportion of fixed-rate debt reduces the sensitivity of debt charges to interest rates. Over the past year, the government has been moving to a higher portion of fixed-rate debt and has set out a target to increase its fixed-rate proportion from 55 per cent to 65 per cent by the end of 2004-05. For further details on the government's debt management strategy see *Debt Operations Report*, December 1995.

4

Creating a Healthy Monetary and Fiscal Climate

The government's strategy paper *A New Framework for Economic Policy*, released October 1994, set out the context and broad directions for the government's jobs and growth strategy. It argued the importance of creating a healthy monetary and fiscal climate, not just because it is fundamental to strong economic performance in its own right, but because it is also essential if the government is to have the public trust and the resources necessary to tackle its responsibilities in other areas.

This government remains committed to keeping inflation within a band of one to three per cent, which will contribute to a more stable and attractive business climate.

The government has also laid the groundwork for restoring fiscal health. The 1994 and 1995 budgets put in place reforms to achieve the interim deficit target of three per cent of GDP by 1996-97 – the lowest such ratio since 1974-75. Measures put in place in these budgets will ensure that the deficit continues to fall in relation to GDP in the future.

But the job of restoring health to Canada's public finances is not yet complete. This chapter will focus on the fiscal challenge posed by Canada's high debt-to-GDP ratio. This problem is not just a matter for businesses and financial markets. It affects all Canadians profoundly.

The Ongoing Challenge of Canada's High Debt-to-GDP Ratio

The government is focusing on the debt-to-GDP ratio because this is a measure of the country's ability to service the debt. GDP is an estimate of total income generated in the economy. It is akin to total income in a household. Just as a household with a larger income can support a larger mortgage, an economy with a larger GDP can support a larger public debt.

This government will reduce the debt-to-GDP ratio both by eliminating the source of that debt – ongoing deficits – and by increasing the growth potential of the economy. As the rest of this chapter explains, these two approaches are complementary. Lowering the deficit will soon put the debt-to-GDP ratio on a downward track. Lowering the deficit will also lower interest rates, which will bolster economic growth and, thus, further reduce both the deficit and the debt-to-GDP ratio. Structural changes to support and enhance economic efficiency will lead to more jobs and higher incomes. This, in turn, will result in higher revenues to the government and lower spending, thereby reducing the deficit further.

Achieving a significant reduction in the debt-to-GDP ratio involves difficult choices. Many of these choices were made in the 1994 and 1995 budgets, but more are still to come.

The urgency of reducing the debt-to-GDP ratio was clearly stated in the government's strategy paper *Jobs and Growth: A New Framework for Economic Policy:*

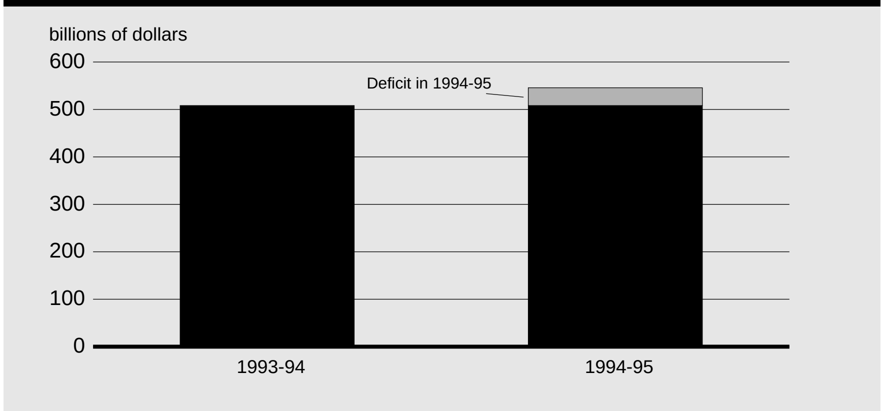
> "Increasing productivity and sustained job growth are the results of investment, of entrepreneurial vigor, and of consumer confidence. All are being undermined by a growing public debt that has led to higher taxes, higher real interest rates, and a diminished capacity of the Government of Canada to address the other vital issues of an economic strategy for the future."

The Auditor General has also drawn attention to the implication of the growing government debt-to-GDP ratio. In his 1995 report to the House of Commons *Deficits and Debt: Understanding the Choices,* the Auditor General writes:

> "Today when the debt-to-GDP ratio is four times higher than it was 20 years ago, the cost of stabilizing it is significantly higher, as is the cost of letting it continue to rise. In short, the choices available to us have become much more painful."

The federal debt-to-GDP ratio did not increase suddenly and its momentum will not be turned around quickly. The federal Government has been spending more than it collects in revenues *for 25 consecutive years*. In 1994-95, the government ran a deficit of $37.5 billion. As a result, the public debt increased by $37.5 billion that year (Chart 4.1). Persistent deficit financing has pushed the federal debt up from $20 billion in 1971 to over $545 billion as of March 31, 1995.

Chart 4.1 Net public debt



The debt has been increasing faster than the country's ability to pay for it. Chart 4.2 shows that since 1974-75, the stock of debt has grown faster than GDP. This is because deficits have ratcheted up in periods of economic weakness but failed to decline significantly in economic expansions. As a result, Chart 4.3 shows that the federal debt-to-GDP ratio has increased from 19 per cent in 1974-75 to 73 per cent in 1994-95.

Chart 4.2 Annual growth in federal debt and GDP

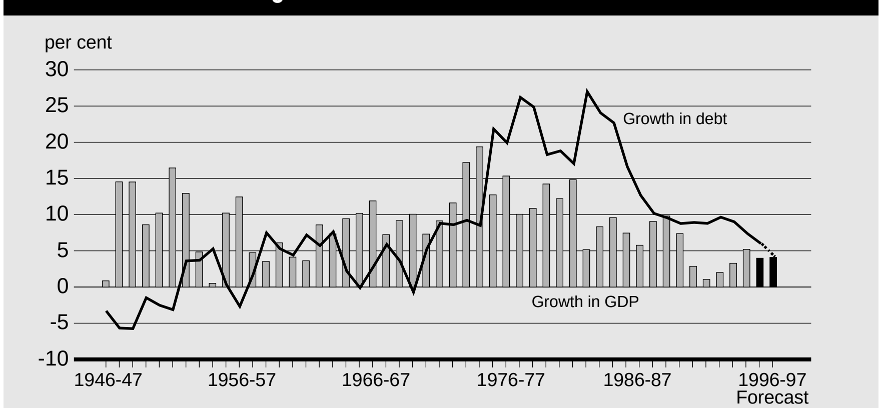
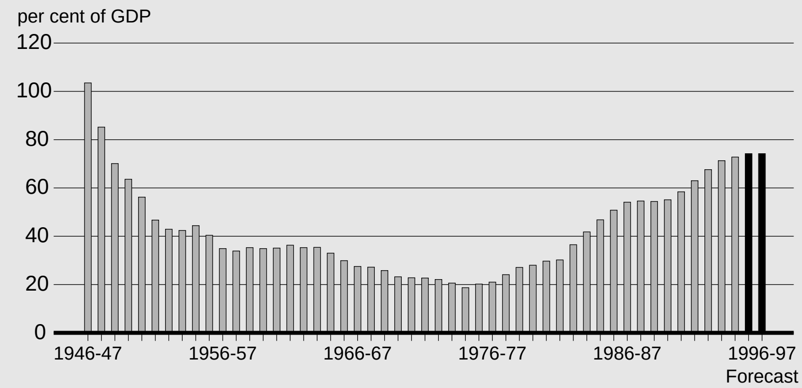


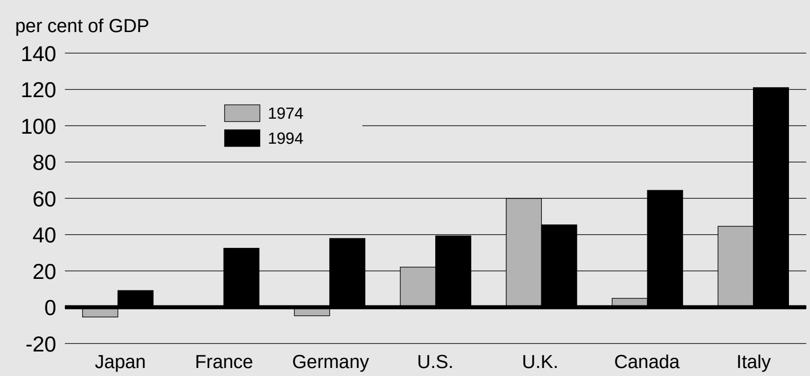
Chart 4.3 Federal government net debt (Public Accounts basis)



Other countries have also experienced increases in their debt-to-GDP ratios over this period. However, few have experienced as pronounced an increase as Canada. Chart 4.4 shows that in a little over twenty years, Canada has moved from having a relatively low debt-to-GDP ratio to having the second highest debt burden of the world's seven largest economies (G-7). (Debt-to-GDP ratios by country are reported on a National Accounts basis as only these data are consistent across countries. The debt-to-GDP ratio on a National Accounts basis is significantly smaller than on a Public Accounts basis.)

In addition, many countries with markedly lower debt-to-GDP ratios than Canada are now concerned that their own debt is excessive. France, Germany and the United Kingdom all have lower debt-to-GDP ratios than Canada, but have put in place reforms to lower their ratios even further.

Chart 4.4 Total governement net fiscal debt – G-7 countries
(National Accounts basis)



Source: Statistics Canada for Canada OECD estimates for other countries.

Germany is well on the way to meeting the Maastrich requirement of a deficit-to-GDP ratio of 3 per cent by 1997 and a gross general government debt-to-GDP ratio of below 60 per cent. France too is committed to meeting these objectives, while the United Kingdom is committed to eliminating its borrowing requirements by 1998-99.

The cost of servicing Canada's debt is crowding out all other spending. Roughly 30 per cent of total spending is now going to pay debt charges, with the remaining 70 per cent devoted to programs (Chart 4.5). This is in sharp contrast to the mid-1970s when only 10 percent of spending was on debt charges. By next year, public debt charges will equal all spending by federal departments other than transfers to persons and to other levels of government (Chart 4.6). The vicious circle of compound interest is crowding out programs that Canadians want and need.

Chart 4.5 **Composition of total budgetary expenditures**

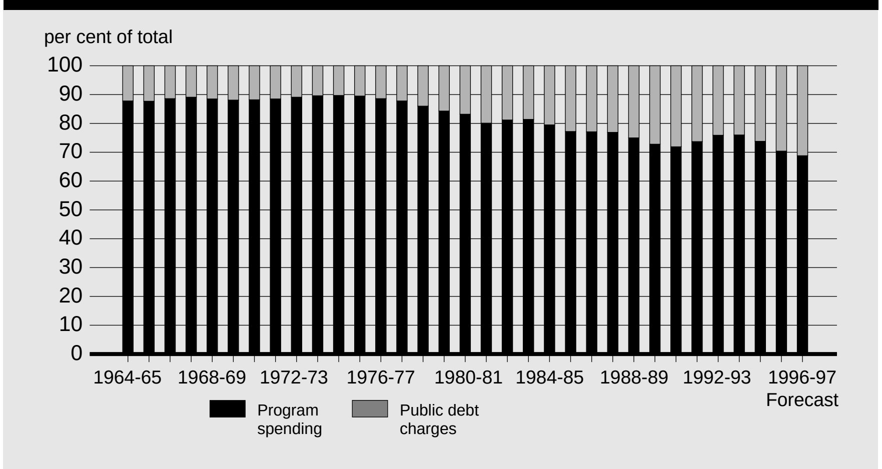
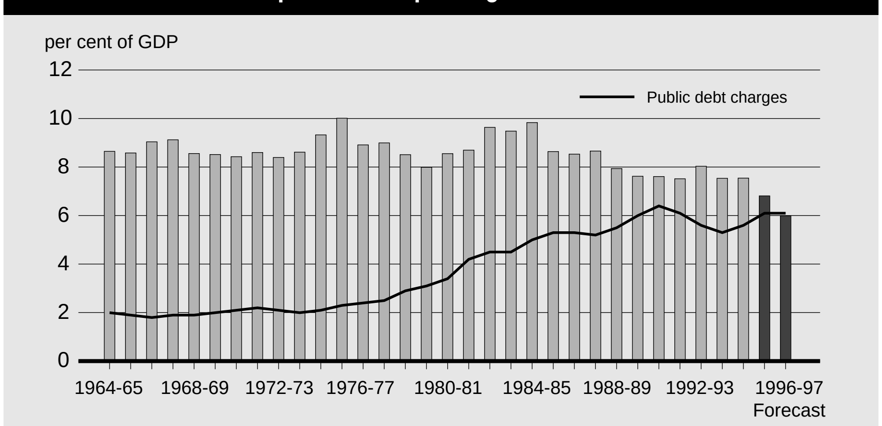
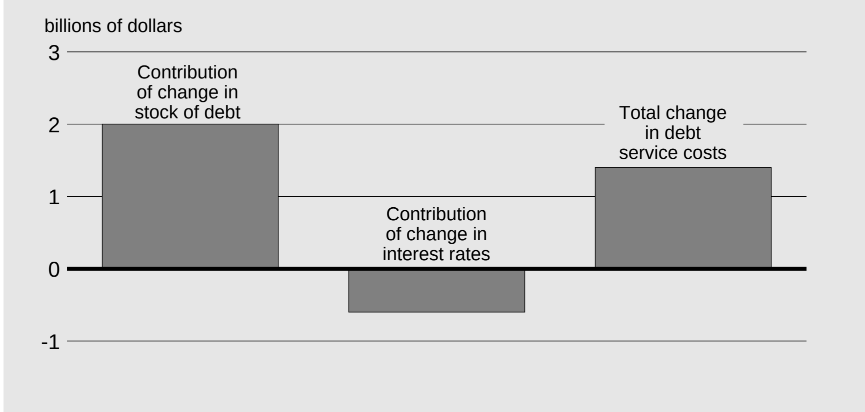


Chart 4.6 **Total departmental spending**



Debt servicing costs are largely increasing because of the rising stock of debt. Lower interest rates alone will not be sufficient to reduce the debt-to-GDP ratio. For example, by 1996-97 the effective interest rate on the debt is expected to decline, which will lower debt servicing costs in that year by $600 million. However, this decline will be offset by the effect of the deficit, which is expected to raise debt servicing costs by $2 billion. Thus, total debt servicing costs are expected to increase $1.4 billion in 1996-97.

Chart 4.7 **Contribution to change in debt service costs 1996-97**



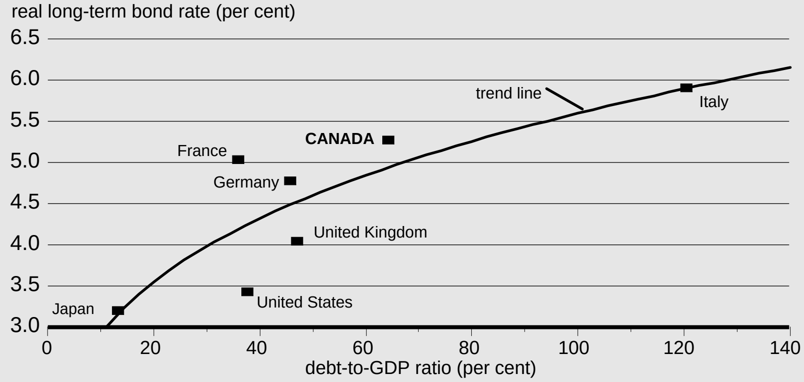
The Consequences of a High Debt-to-GDP Ratio

Canada's high debt-to-GDP ratio ultimately threatens to slow job creation and growth. In terms of its impact on the economy, the debt build-up represents one of the most significant – albeit dubious – developments of recent times, alongside the globalization phenomenon, the development of the information economy and the emergence of dynamic newly industrialized (and industrializing) countries. Unlike these positive developments that offer tremendous economic opportunities, the high debt-to-GDP ratio has brought with it a number of severe economic consequences which threaten the Canadian standard of living.

High interest rates

Canada's high debt-to-GDP ratio is keeping interest rates high. Interest rates rise and fall virtually every day, but comparing interest rates and government debt-to-GDP ratios across countries and provinces clearly suggests that debt and interest rates are linked.

Chart 4.8 Real interest rates and debt-to-GDP ratios in G-7 countries



Real interest rates calculated using interest rates on November 22, 1995 and the October 1995 year-over-year change in the CPI.

Debt/GDP ratios are for 1994.

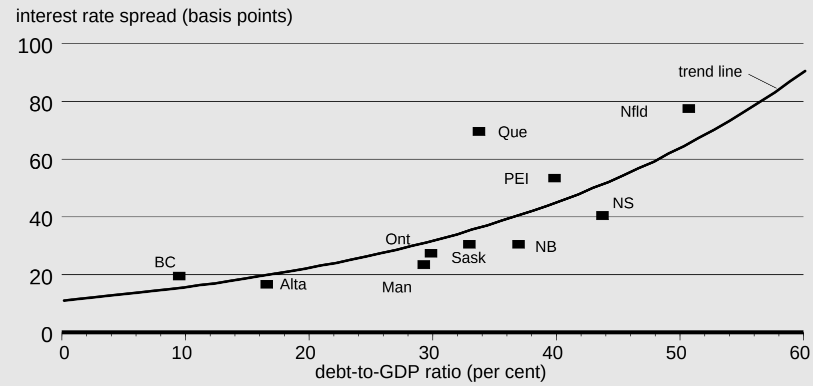
Canada and Italy have the highest debt-to-GDP ratios and the highest real rates of interest (adjusted for inflation) in the G-7 (Chart 4.8). Japan, on the other hand, has the lowest debt-to-GDP ratio and the lowest interest rate.

Of course, differences in interest rates across countries are not just determined by debt burdens. Other factors, such as the degree of political stability and average rates of taxation, also come into play. However, excessive debt is now clearly among the primary factors keeping interest rates high in Canada. Research by the Organization for Economic Co-operation and Development and the International Monetary Fund suggests that high government debt has offset much of the reduction in interest rates that should have resulted from Canada's excellent inflation performance.

The relationship between debt-to-GDP ratios and interest rates is even more apparent in the different rates of interest paid by provincial governments (Chart 4.9). The higher a province's debt-to-GDP ratio, the higher the interest rate demanded by financial markets. British Columbia and Alberta, which have relatively low debt-to-GDP ratios, pay the lowest interest rates. Newfoundland and Nova Scotia are among the most indebted provinces and also face the highest interest rates.

As the rate of interest paid by the federal government sets the standard for all other borrowers, the high federal debt-to-GDP ratio raises interest rates throughout the economy. These high interest rates are lowering consumer demand and making it more costly to invest and produce in Canada.

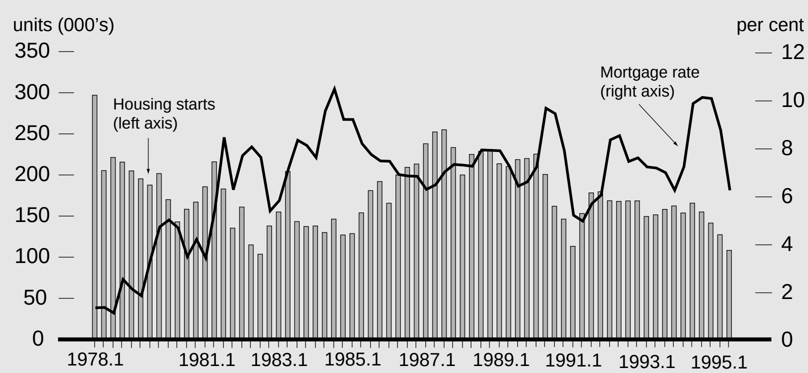
Chart 4.9 Debt-to-GDP ratios and interest rates by province



Interest rate spreads relative to 10-year Government of Canada bond rate as of Nov.'95.
Debt/GDP ratios are 1994-95 Department of Finance estimates.

Canadians have first-hand experience with the effects of high interest rates. For example, a 200 basis point increase in mortgage rates increases the cost of a $100,000 mortgage by $135 per month, or $1,624 per year. When mortgage rates rise, housing starts fall. A similar relationship holds for purchases of such items as automobiles, consumer appliances and furniture (Chart 4.10).

Chart 4.10 Real 5-year mortgage rate and housing starts



Housing starts are lagged two quarters.

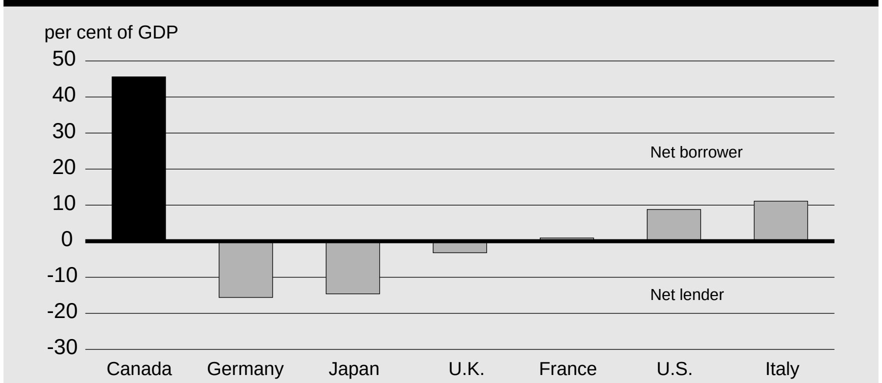
Small and medium-sized businesses – a key engine of growth in the Canadian economy – are particularly affected by high interest rates because they have few alternative sources of financing. With a 200 basis point increase in interest rates, the cost of a $2,000,000 loan to a small business increases by $28,000 per year.

Indeed, the effects of high interest rates are felt throughout the economy. The Department of Finance estimates that a sustained 200 basis point increase in interest rates lowers real GDP by 2¼ per cent and employment by 140,000 after four years. Estimates of the impact of interest rates by other organizations show similar results.

High foreign debt

Persistent government deficits also lower investment spending by soaking up money that could be used for productive investments. Many investments by Canadian firms now must be financed by borrowing from foreigners. As a result, Canada has the highest external debt-to-GDP ratio in the G-7 (Chart 4.11).'

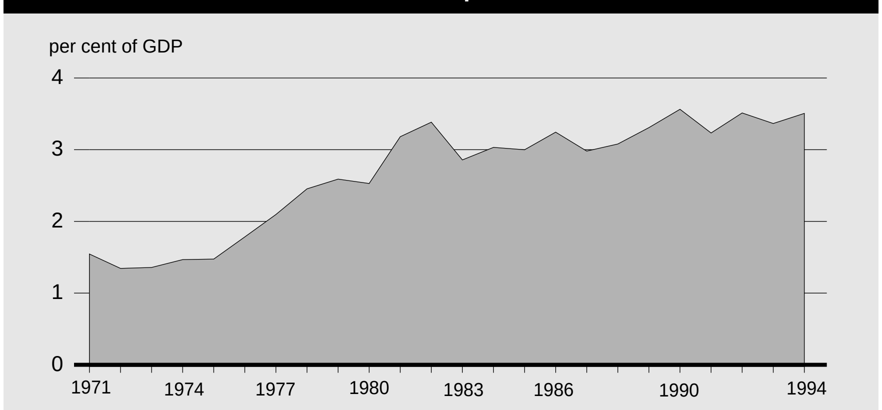
Chart 4.11 G-7 countries' net international investment position[1]



[1]1994 for Canada. 1993 for France, Germany, Japan, the United States and the United Kingdom. 1992 for Italy.

Accordingly, a rising share of income generated in Canada has been flowing abroad to pay for the debt (Chart 4.12). This represents a permanent deterioration in the country's potential standard of living. And it means that non-residents are indirectly exercising greater influence over economic decisions made in Canada.

Chart 4.12 Net investment income paid to non-residents

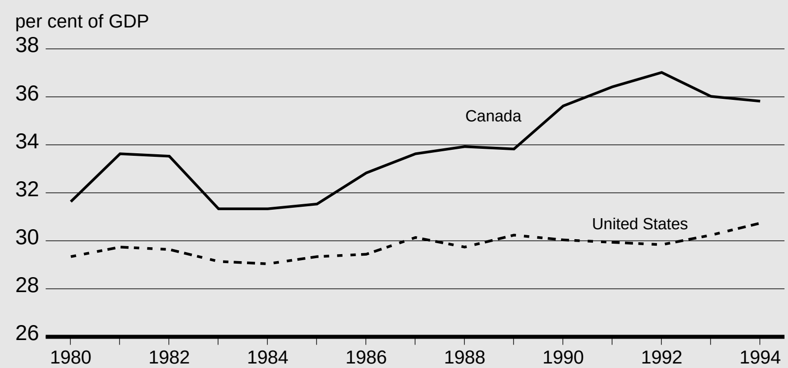


High taxes

Since the early-1980s the tax burden in Canada has increased significantly, and much more rapidly than that in the United States – our largest trading partner (Chart 4.13). Higher overall relative taxes in Canada have always reflected a higher level of public services, many of which have contributed to the fairness and quality of Canadian life. But over the last decade, as the cost of servicing the debt has risen, taxes were raised and program spending cut in order to service the rising debt.

These tax increases are detrimental to employment and output growth. The rising debt-to-GDP ratio also increases the risk of future tax increases, which further erodes Canada's attractiveness as an investment location.

Chart 4.13 **Canada and U.S. – Total tax revenue**



Source: OECD *Revenue Statistics of OECD Member Countries,1968-1993.*

Deficit vulnerable to recessions and high interest rates

The high federal debt-to-GDP ratio has also left the fiscal situation extremely vulnerable to economic slowdowns and increases in interest rates. Although the low inflation that Canada now enjoys reduces the risk of "boom and bust" economic cycles, no economy is recession-proof. This is especially true of an open economy like Canada, which is directly affected by developments in the economies of its major trading partners.

In particular, one cannot rule out interest rate shocks in response to financial market pressures in the world's largest economies or trading blocs. The increase in U.S. rates in 1994, due to inflation fears, and the increases in rates in late 1994 and early 1995, due to the Mexican currency crisis, are two examples of how developments in other countries affect interest rates in Canada.

To miminize the short-term negative effects of interest rate increases on the deficit, the government has been lengthening the term structure of its debt. Yet a 100 basis point increase in interest rates still raises the deficit by $1.5 billion in the first year and by $3.4 billion after four years. This large impact would upset even the best-laid budget plans. A more complete discussion of fiscal sensitivities to changes in income growth and interest rates is provided in Chapter 3.

Just as importantly, high deficits and a high debt-to-GDP ratio have eroded much of the government's policy flexibility – including its ability to buffer the economy from the negative effects of recessions. In 1990-91 the rising debt-to-GDP ratio forced the federal government to cut spending during a recession.

The inequities of high debt

The imperative of lowering the debt-to-GDP ratio is not only a matter of economics and fiscal accounting, however. It is also a matter of fairness towards future generations of Canadians and the legacy left to them.

Canada will face major demographic changes in the next century. Within forty years, the share of the population over 65 will almost double from its current level of 12 per cent to 23 per cent. There will be three workers to support every retired person, compared to five now. Adjusting to these changes alone will pose a considerable challenge. The additional challenge of coming to grips with the current debt load should not be imposed on future generations as well. Those working now should not leave an enormous debt for their children and grandchildren to pay.

The Need for a Sustained Reduction in the Debt-to-GDP Ratio

Ongoing deficit financing has not worked in the past

The lesson of the past 20 years of fiscal policy is, clearly, that ongoing deficit financing eventually becomes unsustainable. In virtually all of these years the federal government pursued a stated objective of balancing its budget at some time in the future, based largely on the hope that it could grow out of its deficit. However, even after adjusting for the impact of cyclical factors, persistent deficits were incurred throughout this period. Such large structural deficits can only be eliminated by discretionary fiscal actions.

Canadians have clearly indicated to their governments that it is time to get back on track – to reduce the federal debt-to-GDP ratio while preserving the essential qualities of Canada's social programs. This requires decisive actions, to reverse the course of federal finances, before mounting debt threatens the country's ability to act on its social commitments.

Sustainable balance in the federal budget is the solution

The only viable solution to the high federal debt-to-GDP ratio is to pursue policies that will *permanently* boost economic growth and *to ensure that the budget remains roughly in balance over the economic cycle*. In periods of economic boom – when the level of activity is straining the economy's capacity to produce – the budget should be in surplus. In periods of economic slack, when unemployment rises and income growth is weak, the federal budget may be in deficit. But, abstracting from the cyclical position of the economy, the budget should be clearly in balance.

The payoff from a lower debt-to-GDP ratio will be large

Reducing the debt-to-GDP ratio and balancing the federal budget over the economic cycle raises the prospect of a substantial payoff. It will lower debt servicing costs, which will make it possible for the government to pursue other interests of strategic importance.

A lower debt-to-GDP ratio will also put downward pressure on interest rates. This will provide additional relief from debt servicing costs. More importantly, it will be a significant stimulus to investment and job creation. Permanently lower interest rates will provide a much greater stimulus to job creation than any government spending program possibly could.

Reducing the debt-to-GDP ratio will lower Canada's international indebtedness and, hence, the share of Canadian income going abroad to service that debt. This will amount to a permanent increase in the standard of living in Canada.

Reducing the debt-to-GDP ratio will also lower the risks to the fiscal situation posed by high interest rates and economic weakness. Indeed, a sustainable balance in the federal budget over the economic cycle opens the possibility of allowing government fiscal balances to play a counter-cyclical role in the economy.

But achieving this balance will not be easy

Interest on the debt is now compounding more rapidly than the economy is growing. In other words, the simple compounding of interest payments is putting upward pressure on the debt-to-GDP ratio.

As a result, the federal government has taken actions in the 1994 and 1995 budgets to bring about increasing operating surpluses – the difference between total revenues and total program spending. The operating surplus is projected to increase to 3.4 per cent of GDP ($27.4 billion) in 1996-97, from 0.6 per cent or $4.6 billion in 1994-95. As a percentage of the economy, the 1996-97 operating surplus will be the largest since the post-war demobilization of the late 1940s and early 1950s. More importantly, this operating surplus will be sufficient to stabilize the debt-to-GDP ratio.

Beyond 1996-97, a sustained operating surplus of 3.4 per cent per year would put the debt-to-GDP ratio on a firm *gradual* downward track. To bring about a larger reduction, the operating surplus will have to rise above 3.4 per cent.

Increasing operating surpluses involve difficult choices. The Auditor General has recently expressed this in the following terms:

> "... Parliament and the public need information to help them understand fully the stark reality that there is a momentum to debt that makes it costly to control the larger it becomes, and consequently more difficult to rein in through just one or two budgets."

To put this in context, consider that maintaining an operating surplus of 5 per cent of GDP for 10 years is required to reduce the federal debt-to-GDP ratio from 73 per cent to about 50 per cent – the level reached in 1985-86.[1] At 5 per cent of a growing economy, the operating surplus in ten years in this scenario would approach $60 billion.

[1] This calculation assumes nominal economic growth of 4 per cent and an average interest rate on the debt of 7.5 per cent.

The Next Milestone for Fiscal Progress

The government's ultimate fiscal objective is a balanced budget. This will ensure that the debt-to-GDP ratio is put on a firm and steady downward track. A key consideration is how fast to move to a balanced budget.

This involves difficult choices. It also requires that the consequences of the choices be fully understood and taken into consideration. Mindless cuts – without concern for the consequences or the need for adaptation – may yield short-term fiscal savings. But they can also result in substantial long-term costs. To achieve a balanced budget and an ongoing reduction in the debt-to-GDP ratio requires a strategy that is measured, thoughtful and responsible.

The government's fiscal strategy has been to implement a significant and persistent, but orderly, reduction in the deficit, based on structural changes in spending. This means allowing departments sufficient lead time to properly plan their program reforms, while fostering adjustment throughout the economy.

The government's deficit reduction strategy has been to focus on a two-year fiscal planning horizon. The two-year horizon recognizes that fiscal projections are simply too sensitive to as yet uncertain economic developments to warrant a longer time frame. But just as importantly, the two year horizon is short enough to maintain the government's focus on actions required to reduce the deficit, while providing sufficient lead time to achieve the targets.

As planning proceeds for the 1996 budget, it is now appropriate to establish a target for the deficit for 1997-98. The government is proposing a deficit target of 2 per cent of GDP.

The deficit target of 2 per cent for 1997-98 also means that the government's financial requirements will be within the range of ½ to 1 per cent of GDP or less than $7 billion. Financial requirements represent the amount the government has to borrow from outside sources. It is less than the deficit to the extent the government is able to borrow from internal sources – principally the public service pension account. By 1997-98, therefore, the government will be close to no longer having to go to credit markets for new borrowings.

5

Meeting the Challenge

The 1994 budget announced $20.4 billion of savings over three years. Actions taken in the 1995 budget totalled an additional $29 billion over three years, including $13.4 billion in 1997-98. Most of the savings in both budgets came from spending reductions rather than tax increases. The unemployment insurance reform proposals recently tabled by the Minister of Human Resources Development will provide for net additional savings of $0.7 billion in 1997-98.

Table 5.1
Budget savings

	1994-95	1995-96	1996-97	1997-98
		(billions of dollars)		
Feb. 1994	1.5	8.0	10.9	11.9
Feb. 1995		5.0	10.6	13.4
UI reform[1]				0.7
Total	1.5	13.0	21.5	26.0

[1] Savings for 1996-97 were included in the 1995 budget measures.

These expenditure reductions are structural. The 1995 budget secured the savings required to meet the 1996-97 deficit target, but the savings *mature*, for the most part, in 1997-98, and *persist* thereafter. Thus the decisions already made in the 1994 and 1995 budgets and the recently announced unemployment insurance reform will ensure that program spending will continue to decline in 1997-98. Simply staying the course on decisions already made will ensure that the deficit falls further in 1997-98, even without further budgetary measures.

As noted in Chapter 4, the government's fiscal strategy has been to implement a significant and persistent, but orderly, reduction in the deficit, based on structural changes in spending. This means allowing departments sufficient lead time to properly plan their program reforms, while fostering adjustment. Budget planning, being undertaken in conjunction with ongoing Program Review, has allowed departments three-years in which to implement program reforms.

The 1995 budget, in announcing Program Review actions to 1997-98, has already contributed to meeting the deficit target now being established for that year. Similarly, the 1996 budget will announce Program Review decisions which will largely affect 1998-99 and subsequent years. This means that the 1996 budget will not only secure the 1997-98 deficit target, but will announce actions that will secure ongoing momentum for deficit reduction past 1997-98.

The government's overall fiscal actions since taking office have been based on a commitment to *fiscal health*, *social fairness* and ensuring the *sustainability* of Canada's social programs. These principles guided the difficult choices made in the 1994 and 1995 budgets and they will guide the decisions that will be made in the 1996 budget.

Past fiscal choices have also reflected the government's fundamental belief that deficit reduction is not an end in itself, but rather a necessary plank of the jobs and growth strategy.

Getting Government Right: Continuing the Process

The continuing evolution of the role of government

The role of government in Canadian social and economic life has never been static; rather it has changed, at times quite dramatically, in response to the emergence of new national and international challenges.

This era of fiscal restraint – both in Canada and in other countries – provides both a challenge and an opportunity. In order to meet the challenge of permanent fiscal reform, this government has, throughout its mandate, emphasized the importance of government renewal. This is a process to determine the role and priorities for the federal government in the Canadian economy and federation, and to implement reforms to undertake this role in the most efficient and effective manner possible.

It is precisely this priority which inspired the launching, in the 1994 budget, of a series of policy reviews, including the overall Program Review of federal departmental (non-statutory) programs, which formed the cornerstone of the 1995 budget.

The policy actions to date have secured the fiscal savings required to achieve the interim deficit target of 3 per cent of GDP in 1996-97. But they represent a more fundamental change in the vision for how the federal government should be conducting its business.

It is why there has been a focus on the federal government withdrawing from areas better left to the business, the voluntary sector, labour groups, or other levels of government. It is why future reforms to government programs will continue to focus on improving the functioning of markets – for products and services and for labour – thereby ensuring sustained growth and job creation.

Program review principles

The guidelines for assessing the role of government programs and policies were outlined in October 1994 in *Agenda Jobs and Growth: Creating a Healthy Fiscal Climate*. They have not changed.

- **Public interest test:** does the program area or activity serve a public interest?

- **Role of government test:** is there a legitimate and necessary role for government in the area or activity?

- **Federalism test:** is there a role for the federal government in the program area?

- **Partnership test:** what activities or programs should or could be transferred in whole or in part to the private or voluntary sector?

- **Efficiency test:** if the program is to continue, how could its efficiency be improved?

- **Affordability test:** is the program affordable in light of the current fiscal situation?

The results of this assessment formed the cornerstone of the 1995 budget, and the process is ongoing.

Changing what the federal government does

The 1995 budget announced two major changes to the focus of government activities, which cut across all federal departments.

First, the federal government is moving away from the direct ownership or provision of services, where these can better be provided by the private sector or by other agents, or in partnerships with these groups if appropriate.

The government announced the privatization and commercialization of a number of activities formerly undertaken by government departments. This year has seen the recent successful high-profile privatizations of *Petro Canada* and *Canadian National Railway*. In addition, the government is now engaged in privatizing the *Air Navigation System*. But all departments are looking at commercialization opportunities, including moving some activities to Special Operating Status, where activities operate basically on a commercial basis (such as geomatic activities in Natural Resources). Other commercialization opportunities announced in the 1995 budget include recreational harbours and some meteorological activities.

Second, the 1995 budget announced a 60 per cent decline in business subsidies. In the agriculture sector, for example, transportation subsidies are bring eliminated, and farm safety net programs are being focused on a "whole farm" approach rather than being product-specific. Notably, federal involvement in mega projects will also end.

The change in federal program orientation has also meant a fundamental change in federal government activities in regional development. The federal government is moving away from the direct provision of subsidies and other programming through its Regional Agencies. Regional Agencies will instead facilitate the access of small business to private sector financing and provide single points of contact in the different regions for federal programming aimed at the small business sector. Further, regional development agreements in mining and forestry are bring discontinued.

Streamlining and consolidating programs

In almost all departments, actions have been taken to restructure programs and services within smaller budgets. A major example is the creation of the *Human Resources Investment Fund*, which consolidates a myriad of labour market programs under a single umbrella, ensuring more effective use of government resources and supporting better employment opportunities for Canadians.

Reforming program delivery

Federal departments have instituted a number of new options for service or program delivery, which are aimed at increased effectiveness and efficiency, while delivering substantial fiscal savings. In many cases this means new partnerships with the private sector, other levels of government or both. Examples are numerous.

For instance, new partnerships are being developed with provinces and community groups for the delivery of settlement services for new immigrants. First steps in this new type of partnership have already been put in place with the government of British Columbia.

Another example is the new *Service Delivery Network* in Human Resources Development Canada, where clients can more easily access HRDC's programs through a variety of informal means.

In the agriculture and agri-food sector, existing and new initiatives in trade and market development are being integrated into a single-window approach, providing a single point of contact for the sector in the provinces. Inspection and regulation services in this sector are being streamlined, and responsibility will be shared with the agri-food industry.

Reforms announced in the 1995 budget have not only been undertaken for departmental programs, but also for some transfers. The introduction of the new block-funded Canada Health and Social Transfer (CHST) in the 1995 budget ended cost-sharing rules with the provinces, allowing provinces more scope to allocate resources to areas of highest priority within their jurisdictions.

Reducing overlap and duplication

As a result of Program Review, departments have already moved to eliminate overlap and duplication with other levels of government. For example, airport operations are being transferred to municipalities. But other departments have been involved as well.

Efforts to reduce overlap and duplication have also involved efforts to harmonize joint programs with the provinces and territories. For instance, federal and provincial student assistance programs have been harmonized. With respect to Yukon forestry, the Department of Indian Affairs and Northern Development has updated regulations to be more in line with those of the provinces, as well as establishing a reforestation program to be paid for by harvesters.

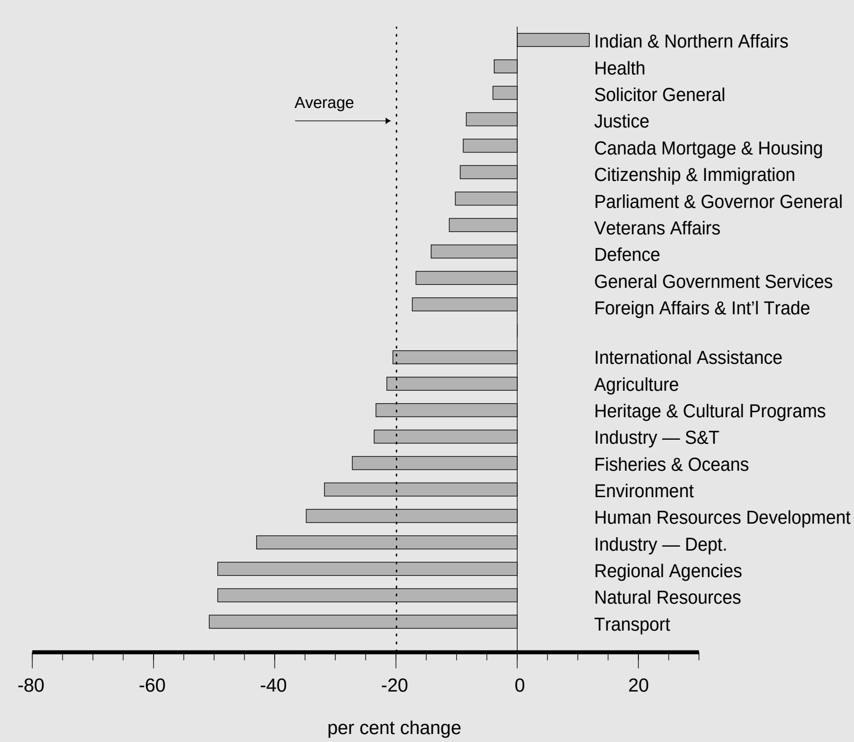
Increasing efficiency through better management

Departments all across the government have announced plans to rationalise their operations – including joint operations – and to assure administrative efficiencies. The most notable reform is the introduction of the new *Expenditure Management System*, to ensure that the scrutiny of government spending undertaken in Program Review becomes a permanent feature of federal government management.

Getting Government Right Means Permanent Fiscal Savings

As a result of these and other actions, Program Review has reduced federal government spending considerably (Chart 5.1). Even without further budgetary action, the 1995 budget announced that by 1997-98 departmental spending will be almost 19 per cent lower than in 1994-95. This

Chart 5.1 **Changes in federal department spending 1997-98 relative to 1994-95**



will put total departmental spending, in nominal dollars, back to its 1985-86 level. And as a share of the economy, departmental spending will be much lower than at any other time in the past 30 years (Charts 5.2 and 5.3).

The implementation of Program Review I therefore has allowed the government to achieve many of its economic and social objectives. However, there remains unfinished business. These issues are currently being addressed in Program Review II.

The government will continue to assess its role in the economy and federation, including identifying how federal government activities can best be restructured to continue the process of government renewal. Such decisions will guide actions taken in the 1996 budget.

Chart 5.2 **Total departmental spending**

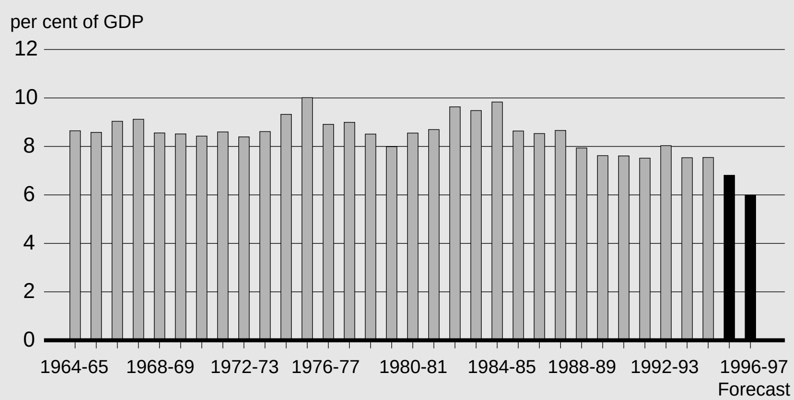
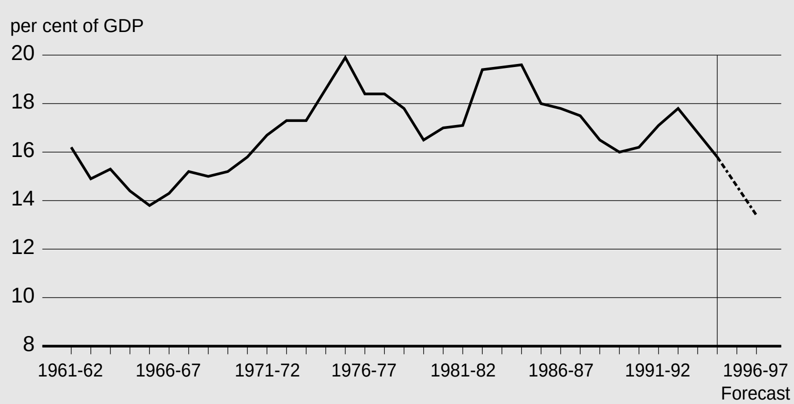


Chart 5.3 **Program spending**



6

Conclusions and Main Issues

The government's main priority is to create more and better jobs and sustained economic growth. All of the government's economic policy actions will continue to support this goal.

The government has always understood that returning Canada to fiscal health is a prerequisite to realizing the economic strategy. Debt that has grown faster than the economy has led to higher taxes, higher real interest rates, increased uncertainty, and a diminished government capacity to address other issues of strategic importance.

The 1994 and 1995 budgets made substantial progress in putting the deficit on a strong downward path. These actions assured that the 1996-97 deficit target of 3 per cent of GDP will be met.

But there is still more to be done. There is simply too much at risk to avoid taking the additional steps necessary to meet the 1997-98 deficit target. That step will put the debt-to-GDP ratio on a firm downward track. Ultimately, a balanced budget will ensure that the debt-to-GDP ratio falls rapidly to a point at which the country's debt will be consistent with our ability to pay for it.

The decisions taken in the 1995 Budget were consistent with messages clearly and strongly delivered in the process of consultations undertaken last year as part of a new open budget process. As last year, the Finance Committee will be asked to advise on:

1) Are the updated economic assumptions for 1995 and 1996 prudent – particularly with respect to interest rates and nominal income – and what should the economic assumptions for these two variables be for 1997?

2) What should be the ratio between expenditure reductions and revenue increase?

3) To meet the deficit target of reducing the deficit to 2 per cent of GDP, should programs be reduced or eliminated? If so, which ones?

4) Are there specific ways the government could alter its spending and taxation which would increase jobs and lead to stronger, sustained economic growth?

Annex 1

Where the Government Spends

This section provides details on government spending. The government spent $160.8 billion in 1994-95. Twenty six per cent of that spending was for interest payments on the debt. This the government has to pay. Interest payments on the debt accounted for 34 cents of every revenue dollar the government collected in 1994-95.

Annex Table 1
Structure of spending: 1994-95

	Billions of dollars	Per cent of total
Total spending	160.8	100.0
Interest on debt	42.0	26.2
Program spending	118.7	73.8

Program spending in 1994-95 was $118.7 billion (Table 2). Major transfers to persons totaled $36.7 billion. Cash transfers to other levels of government amounted to $26.7 billion. Total transfers to persons and other levels of government in 1994-95 were over $63 billion. Program spending other than major transfers consisted of: subsidies and other transfers ($18.6 billion); payments to crown corporations ($5.0 billion); defence spending ($10.7 billion) and other program spending ($21.0 billion).

In 1992-93, program spending totaled $122.6 billion. It fell to $120.0 billion in 1993-94 and to $118.7 billion in 1994-95. With the actions taken in the 1994 and 1995 budgets, it is projected to continue to fall in each of the next two years. By 1996-97, program spending is expected to amount to only $108.6 billion, $14 billion less than the level in 1992-93 and $10.1 billion below the level for 1994-95.

Annex Table 2
Program spending

	1994-95	1995-96	1996-97
		(billions of dollars)	
Total program spending	118.7	113.7	108.6
Major transfers to persons			
Elderly benefits	20.5	21.3	21.9
Unemployment insurance	14.8	13.6	14.1
Veterans' pensions/allowances	1.4	1.5	1.4
Total	36.7	36.4	37.4
Major transfers to other levels of government[1]			
EPF/CAP – CHST	17.4	16.7	13.0
Fiscal transfers[2]	9.3	9.8	10.0
Total	26.7	26.5	23.0
Subsidies and other transfers			
Business subsidies	3.7	2.8	1.9
Indians and Inuit	3.7	4.0	4.1
International assistance	2.9	2.2	2.2
Canada Infrastructure Works	0.4	0.9	0.3
Other transfers and subsidies	7.9	5.7	5.2
Total	18.6	15.6	13.7
Crown corporations			
Canadian Broadcasting Corporation	1.1	1.1	1.1
Canada Mortgage and Housing Corporation	2.0	2.0	2.0
Other	1.9	1.4	1.1
Total	5.0	4.5	4.2
Defence	10.7	10.3	9.8
All other spending	21.0	20.4	20.5

[1] Transfers under EPF/CAP – CHST to other levels of government are made as a combination of cash and a transfer of tax points. Total transfers, including cash and tax transfers, were an estimated $38.7 billion in 1995-96.

[2] Includes Equalization, Stabilization payments, PUITTA, Territorial Formula Financing, Youth Allowances Recovery, statutory subsidies and grants in lieu of taxes.

This reduction is the result of the most far-reaching reform of federal program activity since post-war demobilization 50 years ago. The 1995 budget announced actions which will result in cumulative savings of $29 billion (Table 3). These savings will come overwhelmingly from expenditure reductions, with expenditure cuts exceeding revenue increases by a ratio of nearly seven to one over three years. The decline in program spending comes mainly from lower departmental spending, and somewhat from lower transfers to other levels of government. Transfers to persons will increase slightly, as a result of increasing transfers to the elderly.

Annex Table 3
Budget savings

	1994-95	1995-96	1996-97
		(billions of dollars)	
February 1994	1.5	8.0	10.9
February 1995		5.0	10.6
UI reform[1]			
Total	1.5	13.0	21.5

[1] Savings for 1996-97 were included in the 1995 budget measures.

The cornerstone of the actions taken in the 1995 budget was Program Review I, conducted during the fall and winter of 1994.[1] This departmentally driven review of federal government responsibilities and spending programs will lead to long-lasting structural changes in federal government spending. Its key objective was to promote jobs and growth by more clearly defining the federal role in various program areas in relation to the private and voluntary sectors and other levels of government, and by determining the most effective and cost-efficient way of providing remaining federal programs and services to Canadians. The budget also announced a new Expenditure Management System, which, by formalizing the process of resource allocation from lower to higher priorities, ensures that the scrutiny of programs undertaken in Program Review becomes a permanent feature of federal financial management.

[1] In its efforts to continue to reform goverment spending, the government launched this fall a second phase of the review of departmental spending called Program Review II.

The Program Review underlay the government's overall fiscal strategy of a significant and persistent, but orderly, reduction in the deficit, based on structural changes in spending that will make savings permanent. Departments have been allowed sufficient lead time to properly plan their program reforms, while fostering adjustment throughout the economy. Thus, this year's budget announced Program Review decisions to 1997-98, although savings will persist beyond that date. These savings will thus contribute to the attainment of the 1997-98 deficit target. Program Review decisions underlying the 1996 budget will thus focus mainly on 1998-99, with savings persisting, as well, into the future.

Departments have used six tests to determine their departmental spending priorities and program design: serving the public interest; necessity of government involvement; appropriate federal role; potential for public sector/private sector partnerships; scope for increased efficiency; and affordability. The 1995 budget announced that, as a result of last year's Program Review I, departmental spending will be cut by $3.9 billion in 1995-96, $5.9 billion in 1996-97 and $7.2 billion in 1997-98 relative to what would have been the case otherwise. By 1997-98, departmental spending will be 18.9 per cent lower due to actions taken in last year's Program Review I.

Significant shifts in the pattern of departmental spending are occurring as a result of Program Review (Table 4). The share of spending by economic and resource departments is shrinking, reflecting the government's decision to move away from the direct ownership or provision of services, where these can better be provided by the private sector or by other agents.

Spending by social departments, Justice and Corrections and Defence are rising. The significant rise in social departmental spending (i.e. excluding transfers such as unemployment insurance) is due, in large part, to the increasing resources being devoted by the government to Aboriginal spending.

The remainder of this Annex provides detailed information on federal spending patterns for the fiscal years 1994-95 through 1996-97. For 1994-95, the figures shown are consistent with the *Public Accounts of Canada*. The 1995-96 figures are generally based on the *Main Estimates* for 1995-96, but are adjusted for supplementary estimates and decisions which have been taken since their tabling last February. Figures for 1996-97 are only available on an aggregate basis at this time and will be revised and shown on a more disaggregated basis with the release of the 1996-97 *Main Estimates*. This is consistent with the presentation in the October 1994 *Economic and Fiscal Update*.

Annex Table 4
Evolution of departmental spending

	1984-85	1994-95	1996-97
		(per cent of total)	
Economic programs	34.2	22.4	17.9
Natural Resource Sector	18.9	10.4	8.3
Transportation	8.8	5.3	3.4
Industry/Regional/S&T	6.5	6.7	6.2
Social programs	19.5	25.0	28.2
Aboriginal	5.7	9.4	12.1
Heritage and Culture	5.8	5.5	5.5
Justice and Corrections	4.5	6.4	7.1
Foreign Affairs and Int'l Trade Assistance	6.0	8.3	7.7
Defence	21.2	22.3	23.0
General Government Services	8.9	10.1	10.6
Total[1]	100.0	100.0	100.0

[1] Components may not add to total due to rounding.

Departmental Spending

Natural Resource-Based Programs

Federal spending on natural resource-based programs applies to agriculture, energy, mines, forestry, fisheries and the environment.

Total spending in 1994-95 was $5 billion, and is expected to be $3.8 billion in 1996-97. Nearly 50 per cent will be in the form of transfers, primarily to the agricultural sector. Spending on operations in this sector is largely directed to a wide range of scientific and technological research and inspection services.

The overall objective is to support the orderly development of natural resources in ways that maximize economic benefits to Canadians while ensuring that the quality of the environment is protected and enhanced.

Annex Table 5
Natural resource-based programs

	1994-95	1995-96	1996-97
		(millions of dollars)	
Agriculture	2,080	1,928	1,762
Natural Resources	1,423	1,145	757
Fisheries and Oceans	778	897	653
Environment	716	664	550
Total	4,997	4,634	3,772

Agriculture

Agriculture and Agri-Food Canada programming focuses on the following areas: farm income stabilization, grains policy and transportation, supply management, inspection and quarantine, research, trade and market development, environmental sustainability, adaptation and rural development, as well as policy and economic analysis.

A core aim of the department is encouraging the Agriculture and Agri-food industry to increasingly provide its own financial security in the event of income fluctuations. This financial security will help stabilize farm incomes while promoting increased efficiency in production. The department is promoting the transition to higher value-added and technologically sophisticated production through the development of new mechanisms for providing access to capital investment. Mechanisms are being implemented to bolster export market development.

As a result of last year's Program Review I, the 1995 budget announced that the farm safety net system will move to a "whole farm" support, from the traditional emphasis on support of individual commodities. In addition, the 1995 budget terminated the Western Grain Transportation Act as well as the Feed Freight Assistance transportation subsidy. Federal resources devoted to inspection and regulations were also reduced, helping to reduce overlap with the provinces and share the costs of these programs with industry.

Annex Table 6
Agriculture

	1994-95	1995-96	1996-97
		(millions of dollars)	
Transfer payments			
Farm Income Protection Act			
Crop Insurance	162	180	
GRIP	400	200	
NISA	163	245	
Other	20	69	
Dairy	227	208	
Other	259	196	
Total	1,231	1,098	
Operating and capital	847	827	
Canadian Dairy Commission	3	3	
Total[1]	2,080	1,928	1,762

[1] Excludes the Western Grain Transportation Act.

Natural Resources

The Department of Natural Resources emphasizes mining, forestry and energy policy to promote sustainable development and international competitiveness of resource sectors. The department places particular emphasis on cooperation with provinces and partnerships with industry in R&D, technology development and diffusion, and policy emphasis on energy efficiency and alternative energy sources. The Minister of Natural Resources is also responsible for Atomic Energy of Canada Ltd., the Crown Corporation which researches and develops nuclear technology, as well as three regulatory agencies: the Atomic Energy Control Board, the National Energy Board, and the National Pipeline Agency.

As a result of last year's Program Review I, the Department will keep a presence in forestry, mining and other energy sectors, but it has discontinued the direct support for megaprojects, federal-provincial forestry and mineral agreements and traditional resource development activities. A significant initiative towards reducing the federal government's direct involvement in the resource sector, was the recent successful privatization of Petro-Canada.

Annex Table 7
Natural Resources

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfer payments			
Hibernia project	330	172	
Interprovincial Pipeline	6	26	
Provincial revenue agreements	5	29	
Forestry	98	70	
Other	174	51	
Total	613	348	
Operating and capital	562	550	
Atomic Energy of Canada Ltd.	180	173	
Atomic Energy Control Board	41	44	
National Energy Board	27	30	
Total	1,423	1,145	757

Fisheries and Oceans

The Department of Fisheries and Oceans (DFO) is the lead department through which the Government of Canada exercises its jurisdiction over Canada's freshwater and oceans resources, and fulfills its responsibilities to ensure that they are managed in a viable and sustainable manner. These resources include those of the sea bed and the subsoil of the Continental shelf.

Significant developments over the past year have resulted in a fundamental reshaping of the role and activities of DFO. On April 1, 1995, DFO merged with the Canadian Coast Guard, consolidating the Government's main civilian marine assets and operational programs into one strengthened department. DFO is now reoriented to perform as the Government's principal agent for the fulfillment of its responsibilities with regard to oceans and major inland waterways.

The Department is also undergoing major reductions as a result of last year's Program Review I: there will be a significant decline in departmental spending over the three years 1995-96 through 1997-98. Six major business lines have been established to achieve its vision of being a world leader in oceans and marine resource management:

- understanding the oceans;
- manage and protect the fisheries resource;
- manage and protect the marine environment;
- maintain ship safety;
- facilitate marine trade, commerce and ocean development; and
- advance Canada's international fisheries and oceans interests.

The major thrusts to meet its Program Review I targets and achieve the fulfillment of its business lines include: devolution of responsibilities to the provinces, the development of government-industry partnerships, and the implementation of comprehensive organizational streamlining.

Annex Table 8
Fisheries and Oceans

	1994-95	1995-96	1996-97
		(millions of dollars)	
Transfer payments			
Special Groundfish Programming			
NCARP License Retirement Program	105	11	
Atlantic Groundfish Strategy (TAGS)	0	196	
Aboriginal Fisheries Strategy (AFS)	0	28	
Other	2	10	
Total	107	245	
Operating and capital	671	652	
Total spending[1]	778	897	653

[1] Total spending excludes the transfer of resources from Transport Canada to Fisheries and Oceans for Canadian Coast Guard and Corporate Services (approximately $545 million in 1995-96 and $547 million in 1996-97).

Environment

Programs under Environment Canada include: reducing risks to the environment and human health caused by human activities, minimizing the danger to life and property from severe weather and other environmental hazards and encouraging sustainable development. Other priorities include contributing to a competitive economy by focusing on providing international and national leadership on key environmental issues. The Department's funding amounted to $664 million in 1995-96.

Federal spending on environmental-related programs also takes place under other departments. For example, Environment Canada only manages 35 per cent of spending under the Green Plan.

Decisions made in last year's Program Review I were intended to streamline and modernize its activities at the community level while sustaining the department's science, policy and enforcement capabilities as the foundations of its leadership.

Annex Table 9
Environment

	1994-95	1995-96	1996-97
		(millions of dollars)	
Transfer payments	72	55	
Operating and capital	644	608	
Total	716	664	550

Transport

The federal government supports transport primarily through programs of Transport Canada and the National Transportation Agency.

Transport Canada sets the regulatory and policy framework for all transportation sectors, through legislation/regulation development, compliance (inspection and testing), certification, licensing and education programs relating to transportation safety, security and environmental protection in the marine, aviation, rail, and motor vehicle modes. Transport Canada is moving away from being a direct provider of services to being a policy maker and regulator. It will, however, continue to ensure reasonable service to remote communities and for Canadians with disabilities.

Annex Table 10
Transport

	1994-95	1995-96	1996-97
	(millions of dollars)		
Department			
Transfer payments			
Ferry and coastal service	64	51	
Strategic Capital Investment Initiative	132	114	
Highway agreements[1]	84	93	
Municipal airports	12	12	
Rail crossing improvements	8	8	
Payment to Canada Wheat Board	19	15	
VIA Rail	301	288	
Marine Atlantic	112	107	
Airports	9	30	
Other	11	42	
Total	752	760	
Operating and capital			
Gross[2]	2,225	2,176	
Revenues	(1,002)	(1,079)	
Net operating	1,223	1,097	
Total	1,974	1,857	1,547
National Transportation Agency			
Transfers			
Western Grain Transportation Act	644	210	
National Transportation Act	17	10	
Atlantic Region Freight Assistance Act	98	40	
Maritime Freight Rates Act	9	3	
Railway Act	10	8	
Total[3]	778	271	
Operating and capital	32	32	
Total National Transportation Agency	810	303	
Other Agencies			
Civil Aviation Tribunal	1	1	
Grain Transportation Agency Administrator	13	8	
Total	2,798	2,169	1,579

[1] Includes ERDAs, Nfld. regional trunk, TransCanada, Fixed Link and P.E.I. co-op.

[2] Operating figures include amounts for Crown Corporations (Jacques Cartier and Champlain Bridges, Canada Ports Corporation, Atlantic Pilotage Authority, Laurentian Pilotage Authority and St. Lawrence Seaway Authority).

[3] Figures do not reflect impending transfer of Canadian Coast Guard to the Department of Fisheries and Oceans.

As determined in Program Review I, and announced in the 1995 budget, Transport Canada reduced or eliminated most transportation subsidies, including subsidy programs for grain farmers (in conjunction with Agriculture Canada) under the Western Grain Transportation Act and for transportation companies under the Atlantic and Maritime Region Freight Assistance Acts.

Transport Canada is commercializing many of its current operations, including the transfer of airports to local authorities and the commercialization of the Air Navigation System. In addition, Transport Canada is privatizing Canadian National Railways.

Transport Canada also integrated its Coast Guard operations with the fleet of the Department of Fisheries and Oceans, and introduced various cost-recovery measures and increased existing fees to balance operating costs and revenues. For example, en route air navigation services to aircraft that traverse Canadian airspace will be cost-recovered. Over one-third of Transport Canada's total expenditures (including subsidies) are recovered through user fees.

Industrial, Regional and Scientific-Technological Support Programs

These programs are designed to foster regional and industrial development and to enhance Canadian industrial competitiveness by stimulating private sector investment across Canada. Industry Canada supports programs to promote international competitiveness, increased investment in Canada, regional development in northern Ontario, and to assist aboriginal people to realize their economic potential. The regional development agencies – Atlantic Canada Opportunities Agency, Federal Office of Regional Development in Quebec, and the Department of Western Economic Diversification and Industry Canada for FedNor – support the development of each region's economic potential, deliver assistance programs to entrepreneurs and small businesses, ensure the fair access of regional businesses to federal programs and services and procurement opportunities, and ensure that federal policies and programs are sensitive to regional concerns. ACOA also includes the Enterprise Cape Breton Corporation.

Annex Table 11
Industrial, Regional, and Scientific-Technological Support Programs

	1994-95	1995-96	1996-97
		(millions of dollars)	
Industry Department			
Transfer payments[1]			
Defence Industry Productivity Program	141	102	
Aboriginal Economic Program	56	42	
Canada Scholarships Program	21	23	
Sector Campaigns	30	21	
Strategic Technologies	19	22	
Other	290	203	
Total	557	413	
Gross operating and capital	586	668	
Revenues Credited to Vote	(52)	(60)	
Total net operating and capital	534	608	
Total Industry Department	1,091	1,021	748
Regional Agencies[1]			
Atlantic Canada Opportunities Agency	289	281	
Federal Office of Regional Development Quebec	175	230	
Western Economic Diversification	155	216	
Enterprise Cape Breton Corporation	16	18	
Total	635	745	630
Other Programs/Boards/Agencies and Councils			
Canada Infrastructure Works Program	415	931	293
Cape Breton Development Corporation	25	–	
Competition Tribunal	1	1	1
Copyright Board	1	1	1
Standards Council of Canada	5	5	5
Business Development Bank of Canada	14	14	14
Canadian Space Agency	318	302	212
National Research Council	448	413	382
Natural Sciences and Engineering Research Council	493	470	450
Social Sciences and Humanities Research Council	101	100	91
Total	1,821	2,237	1,449
Total	3,547	4,003	2,827

[1] Excludes funding for Canada Infrastructure Works Program, which is shown separately.

The National Research Council and the three Granting Councils (MRC, SSHRC and NSERC) support a wide range of science and technology activities.

Following Program Review I, regional industrial programming and service delivery were rationalized to reduce overlap and duplication among Industry Canada and the regional agencies. Federal industrial and business development programs will progressively be consolidated in a single point of contact. As well, departments and agencies moved away from providing business subsidies to assisting small business in obtaining access to commercial financing .

Transfer payments constitute about two-thirds of spending on Industrial, Regional and Scientific-Technological Support Programs including contributions under the Canada Infrastructure Works Program (shown separately), contributions to businesses under the Defence Industry Productivity Program, and contributions under the Aboriginal Economic Program.

Justice and Legal Programs

Programs in this sector provide for the administration of justice and law enforcement. They support a fair and equitable justice system and maintain law and order through policing and custodial activities.

The Department of Justice provides a range of services to the Government of Canada including legislative drafting, legal advice, recommendations and opinions as well as representation in the enforcement of federal law in litigation matters involving the federal government. The department is also responsible for managing the development, testing, promotion and implementation of justice policy, and ensures fair, effective and responsible public administration by managing the government legal framework. The portfolio also includes the Supreme Court, the Federal and Tax Courts of Canada, the Canadian Human Rights Commission, and the Offices of the Commissioners for Federal Judicial Affairs, Information, and Privacy.

As a result of last year's Program Review I, the Department of Justice will be focusing its activity on helping to modernize and simplify the justice system, including sentencing reform in order to reduce incarceration rates, and on implementing existing commitments such as firearms legislation and its part of the government's Safe Home/Safe Streets agenda. Further efficiencies are to be achieved through the restructuring of federal-provincial cost-sharing agreements under the Criminal Legal Aid and Young Offender Program agreements. The Department will also continue to examine ways of controlling the rising cost of the justice system.

Annex Table 12
Justice and Legal Programs

	1994-95	1995-96	1996-97
	(millions of dollars)		
Justice			
Transfer payments			
Young Offenders Act	156	156	
Legal aid	90	88	
Other	31	21	
Total	276	265	
Operating and capital	199	194	
Total Justice	475	458	426
Solicitor General			
Transfer payments			
Indian Policy Program	28	48	
Other (including RCMP, CSC)	43	45	
Total	71	93	
Operating and capital			
Correctional Service Canada	1,039	1,098	
RCMP	1,242	1,167	
Department	34	24	
Total	2,315	2,289	
Total Solicitor General	2,386	2,382	2,341
Federal Judicial Affairs	201	210	216
Supreme Court of Canada	15	16	14
Federal Court of Canada	28	31	30
Tax Court of Canada	10	11	11
Office of Information and Privacy Commissioners	7	6	6
Canadian Human Rights Commission	17	17	16
Canadian Security Intelligence Service	206	187	166
National Parole Board	25	26	24
RCMP External Review Commission	1	1	1
RCMP Public Complaints Commission	4	4	4
Office of Correctional Investigator	1	1	1
Total	3,376	3,351	3,256

The Solicitor General has responsibility for the federal corrections, policing and national security. Eight organizations report to Parliament through the Solicitor General, including the department, the RCMP, Correctional Service Canada, the National Parole Board, CSIS, and three small review agencies.

Ministry priorities include the advancement of the government's Safe Home/Safe Streets agenda, sentencing reform, and the development of new policy measures to deal with high-risk, violent offenders. Sentencing and corrections reform will be aimed at containing the rate of growth of the inmate population and associated correctional costs. Other initiatives being advanced include community policing and expanded crime prevention, intensified efforts to combat organized crime and effective and efficient law enforcement.

Heritage and Cultural Programs

Canadian Heritage promotes the development of Canada's culture, including public broadcasting, a strong sense of Canadian identity based on shared values and goals through citizen participation and multi-cultural programs, official languages support, amateur sport and the preservation of parks and historical sites.

Annex Table 13
Heritage and Cultural Programs

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Canadian Broadcasting Corporation	1,094	1,121	
Canadian Film Development Corporation	122	110	
National Film Board	85	76	
Canada Council	98	96	
National Museums	134	125	
National Arts Centre	22	19	
National Capital Commission	101	83	
National Archives	58	61	
National Library	37	34	
Advisory Council – Status of Women	3	3	
Status of Women – Office of Coordinator	5	15	
Official Languages	302	255	
Amateur sports	69	57	
Postal subsidy	78	69	
Other	172	134	
Total	2,380	2,258	2,040
Parks Canada	343	349	308
National Battlefields Commission	5	5	2
Canadian Radio-television and Telecommunication Commission	22	21	20
Operating and capital	157	138	134
Total	2,906	2,771	2,505

With fewer financial resources available to support its activities, the portfolio will have to balance financial and policy imperatives. Canadian Heritage is committed to pursuing initiatives to restructure and streamline its activities, to make better use of technology, to develop innovative mechanisms of co-operation with its partners, and to use a more entrepreneurial approach.

Foreign Affairs, International Trade, and International Assistance

The purpose of this program is to carry out Canada's foreign policies, represent Canada's interests abroad, and provide assistance to developing countries.

These programs are carried out by the Department of Foreign Affairs and International Trade (FAIT), the Canadian International Development Agency (CIDA), the Department of Finance, and other agencies such as the International Development Research Centre (IDRC).

Foreign Affairs and International Trade Canada's (FAIT) primary responsibilities include promoting Canadian exports and encouraging foreign investment in Canada, protecting Canada's international security interests, projecting Canadian culture and values abroad, and defending Canada's interest in a rules-based international trading system. The department also provides consular assistance to Canadians traveling or living abroad.

The core priority of the International Assistance Envelope (IAE) is the maintenance of a comprehensive aid program, which maintains Canada's presence and programs in needy regions of the world. The largest part of this funding is managed by the Canadian International Development Agency (CIDA). This program provides bilateral and multilateral aid, food, special development programs and international emergency relief.

Through the Foreign Policy Review and last year's Program Review I, IAE expenditures are to focus on core roles through reduced administrative costs and overhead, reduced program activities, and over time, lower contributions to international financial institutions to a level that balances Canada's international interests with fiscal capability.

Annex Table 14
Foreign Affairs and International Assistance

	1994-95	1995-96	1996-97
	(millions of dollars)		
Foreign Affairs			
Transfers	349	336	
Operating and capital	938	966	
Total	1,287	1,302	1,142
International Assistance			
Transfers			
CIDA Partnership Programs	671	495	
CIDA National Initiatives	994	959	
Countries in transition	–	116	
International Financial Organizations (CIDA)	336	141	
International Financial Organizations (Finance)	486	249	
Loan repayments	(60)	(60)	
Other[1]	233	125	
Total	2,660	2,024	
Operating and capital	153	105	
International Development Research Centre	112	96	
Total	2,925	2,225	2,220
Other Repayments	2	10	0
Agencies			
NAFTA Secretariat	2	2	2
International Joint Commission	4	5	4
Export Development Corporation	152	148	135
Total	4,372	3,692	3,503

[1] Figure includes international assistance grants and contributions made by Foreign Affairs, scholarship program, and administrative costs related to Foreign Affairs programs under international assistance envelope.

Social Programs

Federal *departmental* spending on social programs applies to immigration, health, labour market programs, aboriginal programs, housing and veterans programs. Federal spending on the major statutory social programs (i.e. elderly benefits, unemployment insurance benefits and the CHST) are dealt with below in the sections entitled “Major Transfers to Persons” and “Major Transfers to Other Levels of Government”.

Total spending in 1994-95 was $13.2 billion and is expected to be $12.9 billion in 1996-97. Spending on all major programs will decline in the next two fiscal years, save for aboriginal spending. However, the *share* of spending on total social programs in total departmental spending will rise.

Federal social programs meet a number of objectives, including protecting low-income Canadians, facilitating labour market adjustment, safeguarding and promoting the physical health of Canadians and supporting aboriginal Canadians and veterans.

Annex Table 15
Social Programs

	1994-95	1995-96	1996-97
	(millions of dollars)		
Citizenship and Immigration	659	670	665
Health	1,818	1,908	1,854
Human Resources Development	2,983	3,028	2,296
Indian Affairs and Northern Development	3,785	4,078	4,138
Canada Mortgage and Housing Corp.	1,988	2,026	1,968
Veterans' pensions and allowances	1,975	1,998	1,935
Total	13,208	13,708	12,856

Citizenship and Immigration

The Department of Citizenship and Immigration is responsible for promoting the values of Canadian citizenship, for managing immigration, for managing the entry of visitors and temporary workers, for the refugee determination system, for ensuring proper enforcement of the Immigration Act, and for assisting newly arrived immigrants to adapt and settle. The Immigration and Refugee Board of Canada determines refugee claims, hears immigration appeals and adjudicates immigration inquiries and detention reviews.

As a result of last year's Program Review I, the department is reshaping Canada's immigration and citizenship policies to better serve the interest of Canadians by:

- extending the multi-phase user fee strategy to put the program on a secure financial footing with gradual increases to all existing citizenship fees and the introduction of the new Right of Landing and the Right of Citizenship fees;

- achieving a better balance between family and economic immigration, strengthening selection criteria for independent immigrants and redesigning the Business Immigration Program;

- developing new eligibility and financial criteria in order to reduce the incidence of sponsorship default;

- establishing single-member panels to conduct Immigration and Refugee Board hearings and directing resulting savings to help settle refugees from abroad;

- putting in place a new removal strategy with the emphasis on the enforcement of removal/deportation orders; and,

- working with provinces to strike new immigration agreements which will give them more control over immigration selection and to eliminate overlap and duplication in the delivery of settlement services.

These reforms will shift the balance of immigration toward those who exhibit the capacity to settle quickly and contribute to the economy. In addition, reforms should also help relieve the pressure on federal settlement services and provincial social services.

Annex Table 16
Citizenship and Immigration

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Canada-Quebec Accord	90	90	
Language instruction	91	106	
Adjustment assistance	46	43	
Settlement and adaptation	14	14	
Other	4	3	
Total	245	256	
Operating and capital	337	336	
Total	582	593	589
Immigration and Refugee Board of Canada	77	77	76
Total	659	670	665

Health

Health Canada's role encompasses a broad range of activities aimed at protecting, preserving and improving the health of Canadians, including disease prevention and health promotion. The department administers the Canada Health Act which ensures that all residents of Canada have reasonable access to basic health care services paid for by the public sector. A significant proportion of its activities entails collaboration with provincial and territorial governments.

Health Canada also provides Status Indians and Inuit with health services in areas such as community health, hospital and treatment services and non-insured health benefits.

The Medical Research Council, the Patent Medicine Prices Review Board and the Hazardous Materials Information Review Commission fall under the mandate of the Minister of Health Canada.

Although overall program spending was reduced under last year's Program Review I, some of the savings have been redirected to other priorities. These include:

- the National Forum on Health, which was created to promote a dialogue with Canadians about their health and examine the issues relating to health system renewal;
- enhancements to the capabilities of the federal government to monitor and control disease;
- recognition of women's health issues such as breast cancer research and the establishment of Centres of Excellence for Women's Health;
- the implementation of the Canada Prenatal Nutrition Program; and
- assistance to Aboriginals through implementation of the Aboriginal Head Start Program.

Annex Table 17
Health

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Indian and Northern Health Services	312	336	
Other	148	192	
Total	460	528	
Operating and capital	1,089	1,124	
Total[1]	1,549	1,652	1,607
Medical Research Council	265	251	242
Patent Medicine Prices Review Board	3	3	3
Hazardous Materials Information Review Commission	1	1	1
Total	1,818	1,908	1,854

[1] These transfers do not include EPF health payments as these are now included in the new Canada Health and Social Transfer.

Human Resources Development Canada

Human Resources Development Canada (HRDC) is responsible for income security programs for the elderly, the disabled, the unemployed and families with children, for student loans, for labour market adjustment programs to develop and support the use of Canada's human resources. It provides funds to the provinces for social assistance and services, for post-secondary education, and for vocational rehabilitation of persons with disabilities. It also facilitates and sustains stable industrial relations and a safe, fair and equitable workplace.

Excluding the major transfer programs, which are discussed separately, and operating costs, the department will streamline and restructure its programs and services into a unified Human Resources Investment Fund which will focus on actively helping unemployed people find and keep jobs, combating child poverty and providing assistance to those who need help most. A portion of savings from unemployment insurance reform will be combined with funds previously committed to these purposes. Decision making will be pushed down to the local level and service delivery will better reflect community priorities.

Annex Table 18
Human Resources Development

	1994-95	1995-96	1996-97
	(millions of dollars)		
Transfers			
Employment programs	1,115	903	
Atlantic Groundfish Strategy	316	414	
Labour adjustment benefits	37	25	
Workers' Compensation benefits	60	48	
Vocational Rehabilitation of Disabled Persons	201	189	
Canada Student Loans	529	521	
Children's Special Allowance	39	43	
Strategic Initiatives	24	115	
Older Worker Adjustment	60	46	
Other	156	82	
Total	2,537	2,386	1,830
Operating and capital	434	631	455
Total	2,971	3,017	2,285
Canada Labour Board	9	9	9
Canadian Centre for Occupational Health and Safety	3	2	2
Total[1]	2,983	3,028	2,296

[1] HDRC spending is higher than shown in the 1995 budget because it includes transfers under the Canada Student Loans and the Children's Special Allowance programs. These two programs were included as transfers in the 1995 budget, but not as departmental spending.

Aboriginal Programs

Federal funding for Aboriginal people is currently about $5 billion. In addition to the Department of Indian Affairs and Northern Development (DIAND) and the Department of Health, 10 other departments have programs directed to aboriginal people, including Industry Canada and the Canada Mortgage and Housing Corporation.

Last year's Program Review I made no major changes to DIAND's existing mandate, but growth in program spending (excluding land claims, northern programming and other adjustments including post-secondary education) was restricted to 6 per cent in 1995-96 and 3 per cent for the following two years. Growth in the department's spending has averaged over 8 per cent per year over the last decade.

Annex Table 19
Indian Affairs and Northern Development

	1994-95	1995-96	1996-97
		(millions of dollars)	
Transfers			
Education	1,000	1,077	
Social Assistance	864	965	
Capital (including housing)	786	856	
Local and self government	309	310	
Claims	302	331	
Economic development	53	51	
Northern Affairs	79	55	
Other	25	62	
Total	3,418	3,707	
Operating and capital	367	371	
Total	3,785	4,078	4,138

Canada Housing and Mortgage Corporation

Through the Canada Mortgage and Housing Corporation (CMHC), the federal government helps Canadians to obtain affordable, adequate and suitable shelter. The bulk of federal transfers to the Corporation is to subsidize the cost of shelter for lower-income families.

Over 90 per cent of CMHC's spending on social housing is used to meet existing subsidy obligations for housing. CMHC is currently working with provinces and others to identify avenues to secure greater efficiencies in the management of the existing housing portfolio.

Annex Table 20
Canada Mortgage and Housing Corporation

	1994-95	1995-96	1996-97
		(millions of dollars)	
Social housing	1,896	1,928	
Other	91	97	
Total	1,988	2,026	1,968

Veterans' Pensions and Allowances

A range of benefits and services are provided to veterans and their dependents, to survivors of veterans and to eligible civilians. They include disability pension benefits, income support, and health care benefits.

Cost pressures in this area primarily relate to health care expenses and the provision of services under the Veterans Independence Program, which provides home support to veterans who might otherwise be institutionalized. Neither the War Veterans' Allowance nor disability benefits are taxable.

Annex Table 21
Veterans' Pensions and Allowances

	1994-95	1995-96	1996-97
		(millions of dollars)	
Transfers			
Pensions	1,113	1,139	
Health care	190	188	
Income Support	142	144	
Total	1,445	1,471	1,449
Other Health Purchased Services	320	321	291
Operating and capital	210	206	195
Total	1,975	1,998	1,935

Defence

The *1994 Defence White Paper* called for the preservation of multi-purpose, combat-capable forces to meet Canada's security needs at home and abroad. Greater emphasis will be placed on supporting Canada's peacekeeping efforts. Following the policy mandate set out in the *White Paper*, the Department of National Defence has identified four major capital projects it is currently working on: armored personnel carriers, search and rescue helicopters, maritime helicopters, and conventionally-powered submarines.

The 1995 budget reduced the planned level of defence spending by $2.8 billion between 1994-95 and 1998-99. As a result, defence spending will decline by almost 5 per cent each year through to 1997-98, a decline of more than 14 per cent from 1994-95.

Annex Table 22
Defence / Emergency Preparedness Canada

	1994-95	1995-96	1996-97
		(millions of dollars)	
Defence			
Capital	2,769	2,604	
Operating	7,998	7,484	
Pensions	798	747	
Other	209	175	
Total	11,774	11,010	10,479
Emergency Preparedness Canada	27[1]	68[1]	15

[1] Includes payments under the Disaster Financial Assistance Arrangements.

General Government Services

The departments and agencies that support and coordinate the operation of the federal government are shown in Table 23.

Annex Table 23
General Government Services

	1994-95	1995-96	1996-97
		(millions of dollars)	
Parliament/Governor General[1]	410	366	335
Central Agencies	272	237	196
National Revenue	2,286	2,179	2,073
Public Works and Government Services	1,814	1,783	1,594
Statistics Canada	275	288	406
Canada Post[2]	14	14	14
Canadian Commercial Corporation	13	12	12
Agencies			
Canadian Centre for Management Development	11	11	9
Canadian Intergovernmental Conference Secretariat	3	3	3
Canadian Transportation Accident and Safety Board	26	25	23
Commissioner of Official Languages	12	12	10
Public Service Staff Relations Board	6	6	6
Security Intelligence Review Committee	1	1	1
Public Service Commission	124	128	113
Canadian International Trade Tribunal	8	8	8
Office of the Superintendent of Financial Institutions	1	3	3
Purchase of domestic coinage	48	34	32
Total	5,324	5,110	4,838

[1] Includes Chief Electoral Officer and Auditor General.

[2] Canada Post receives $14 million per year in appropriations to provide free mail services for Parliament and literature for the blind.

Parliament/Governor General

The Parliament of Canada consists of the Senate, the House of Commons and the Library of Parliament. In 1994-95, the cost of operating Parliament was about $305 million, including the salaries of Members, Senators and staff. The budget of the House of Commons is not determined by the government but is solely determined by its Board of Internal Economy. Any options for budgetary savings must be decided upon by the Board.

The Governor General spends about $10 million each year on duties as the representative of the British Monarch in Canada.

The Office of the Chief Electoral Officer provides general direction and supervision over the administrative conduct of federal elections and referendums, while the Auditor General of Canada audits the operations of federal departments, agencies and Crown corporations for the review of the Parliament of Canada. As a result of last year's Program Review I, the Office of the Auditor General improved the efficiency of its support services and reduced the number of value-for-money audits.

Annex Table 24
Parliament

	1994-95	1995-96	1996-97
		(millions of dollars)	
Senate	42	42	41
House of Commons	246	224	217
Library of Parliament	17	16	15
Total	305	282	273
Governor General	11	10	10
Chief Electoral Officer	36	23	4
Auditor General	57	51	49
Total[1]	410	366	335

[1] Components may not add to total due to rounding.

Central Agencies

The Treasury Board is responsible for the general management of the government's financial, human and materiel resources. In addition, it contributes – as the "employer" – to employee health, income maintenance and life insurance plans and makes payments relating to provincial payroll taxes and provincial health insurance plans. As a result of last year's Program Review I, the Treasury Board is focusing its efforts on providing a more efficient management framework for the public service. In particular, it is implementing the government's new Expenditure Management System.

The Department of Finance provides general policy advice on Canada's economic and financial affairs. It is also responsible for administering the Fiscal Transfer Payments Program and the Public Debt Program in co-operation with the Bank of Canada. Actions taken in last year's budget resulted in departmental efficiency improvements and reductions of operations in a number of areas.

The Privy Council Office is responsible for advice and support to the Prime Minister and ensures the smooth operation of the government decision-making process. As a result of the 1995 budget, the Privy Council Office introduced a number of streamlining initiatives to improve the efficiency of its operations.

Annex Table 25
Central Agencies

	1994-95	1995-96	1996-97
		(millions of dollars)	
Treasury Board	88	83	78
Finance	66	71	56
Privy Council Office	118	83	62
Total	272	237	196

National Revenue

The core responsibilities of the Department of National Revenue are to administer Canada's personal and corporate income taxes, excise taxes and duties, and employee and employer contributions to the Canada Pension Plan and the Unemployment Insurance program. It also enforces Canadian laws and sovereignty at the border and is responsible for trade-policy administration.

As a result of actions taken in last year's Program Review I, Revenue Canada implemented improvements in the efficiency of a number of its existing programs. It also has placed greater emphasis on audit and other enforcement activities.

Annex Table 26
National Revenue

	1994-95	1995-96	1996-97
		(millions of dollars)	
National Revenue	2,286	2,179	2,073

Public Works and Government Services

Public Works and Government Services Canada (PWGSC) provides central and common services to the federal government. These services range from real property management and procurement of goods and services to auditing, banking, cash management and the provision of translation services. The department is concentrating on improving its services to business, through building partnerships with the private sector and reducing small business paper burden.

As a result of last year's Program Review I, the department is pursuing alternative mechanisms for the delivery of administrative and common services. This includes privatizing all or part of the printing, publishing and information services of the Canada Communications Group.

Annex Table 27
Public Works and Government Services

	1994-95	1995-96	1996-97
		(millions of dollars)	
Services Program	5	1	
Real Property Program	1,142	1,245	
Supply and Services Program	654	529	
Other (Crown corporations)	13	8	
Total	1,814	1,783	1,594

Statistics Canada

Statistics Canada's core responsibilities include the collection and analysis of statistical information on Canada's economic, financial and social structure. As a result of 1995 budget actions, Statistics Canada cut the frequency of certain programs and streamlined its operations. Funding for Statistics Canada is expected to be flat during the next two years except for a temporary top-up for the 1996 Census.

Annex Table 28
Statistics Canada

	1994-95	1995-96	1996-97
		(millions of dollars)	
General Statistical Information	244	236	
Census Related	31	52	
Total	275	288	406

Major Transfers to Persons

The federal government spent $36.7 billion in 1994-95 on direct income support for individuals. Expenditures in this category are comprised of payments to the elderly, the unemployed and veterans. These payments account for about 31 per cent of total program spending – the single largest category of spending. The largest and increasing share of payments go to the elderly and the unemployed.

Elderly Benefits

Direct federal spending on elderly benefits, which includes the Old Age Security (OAS), the Guaranteed Income Supplement (GIS) and Spouses' Allowance (SPA) programs is projected to be $21.3 billion in 1995-96:

- Old Age Security (OAS) is paid monthly (maximum benefit of $394.76 – October 1995) to Canadians aged 65 and over. OAS payments are taxable and recovered from high-income seniors upon tax filing. Payments are currently recovered at a rate of 15 per cent of individual income over $53,215, which means that the benefit is fully recovered at an income of about $84,500. This recovery will yield about $400 million in 1995-96. The 1995 budget introduced further measures to recover OAS payments from high-income persons. Effective July 1996, OAS benefits will be paid out net of high-income recovery amounts, while OAS recipients no longer residing in Canada will have to submit a statement of their world-wide income in order to continue to receive OAS benefits.

- Guaranteed Income Supplement (GIS) is a non-taxable monthly benefit (maximum single benefit of $469.13 per month – October 1995) paid to lower-income OAS recipients on the basis of family income. The maximum income, including OAS, below which GIS is payable is about $16,000 for a single pensioner and about $24,200 for married pensioners. More than 40 per cent of OAS/GIS benefits go to the low-income seniors who qualify for GIS.

- Spouses' Allowance (SPA) is a non-taxable benefit (maximum widowed benefit of $773.16 per month – October 1995) paid to low-income individuals aged 60 to 64 who are spouses of OAS pensioners or are widow(er)s. Like GIS, this benefit is based on net family income.

Payments to the elderly are one of the fastest growing areas of program spending. Elderly benefits now account for just less than 20 per cent of program spending, up from 14.5 per cent just a decade ago. This growth reflects increases in the elderly population and the fact that benefits are fully indexed to inflation. Elderly payments will continue to grow at a steady rate through 2010. After 2010 elderly payments will rise sharply as the "baby boom" generation starts to retire. The proportion of elderly people in the population will almost double in the next 40 years.

Annex Table 29
Elderly Benefits

	1994-95	1995-96	1996-97
	(billions of dollars)		
Expenditures			
Old Age Security	15.5	16.2	16.7
Guaranteed Income Supplement	4.6	4.7	4.8
Spouse's Allowances	0.4	0.4	0.4
Total	20.5	21.3	21.9
Tax Measures			
Age Credit	1.5	1.4	1.3
Pension Income Credit	0.3	0.3	0.4
Taxation of OAS benefit	-1.9	-2.0	-2.1
OAS repayment	-0.4	-0.4	-0.5
Total	-0.5	-0.7	-0.9
Total assistance	20.0	20.6	21.0

In addition to the three spending programs, elderly Canadians are also eligible for two tax credits, which lower income tax payable.

- Individual taxpayers aged 65 or over are entitled to claim a maximum federal tax credit of 17 per cent of $3,482. Beginning with the 1994 taxation year, the age credit is income-tested. The credit is reduced based on the amount by which an individual's net income exceeds $25,921.

- Individual taxpayers are entitled to claim a federal tax credit of 17 per cent on the first $1,000 of private pension income. About three-quarters of those claiming the credit are age 65 or over and one-quarter are under 65.

The following table shows the distribution, by household income, of net elderly benefits, on an after-tax basis. Nearly three-quarters of the benefits go to households with incomes less than $30,000.

Annex Table 30
Distribution of Net Federal Elderly Benefits[1] by Household Income 1995

Household income[2]	Number of households[3]	Net benefit
(dollars)	(thousands)	(millions of dollars)
Less than 15,000	810	7,050
15,000 to 20,000	390	2,840
20,000 to 25,000	370	3,110
25,000 to 30,000	240	1,670
30,000 to 40,000	350	2,320
40,000 to 50,000	190	1,230
50,000 to 60,000	130	770
60,000 to 75,000	90	500
Over 75,000	130	630
Total	2,700	20,120

[1] OAS (net of taxes), GIS, SPA, pension income and age credit. (Does not include pension income credit and SPA received by non-elderly families.)

[2] Total income of head and spouse including OAS, GIS, and SPA received by them.

[3] Households with at least one person age 65 or older.

The Canada Pension Plan (CPP) is a contributory, earnings-related social insurance program which ensures a measure of income protection to a contributor and his and her family against the loss of income due to retirement, disability, or death. The plan operates throughout Canada except in the province of Quebec, where a similar program – the Quebec Pension Plan (QPP) is in effect.

Canada Pension Plan premiums and benefits are not part of the federal government's revenues or expenditures and therefore do not affect the federal government's deficit.

Unemployment Insurance Benefits

Benefits under the Unemployment Insurance Program are paid from the Unemployment Insurance Account. In 1994, payments for unemployment insurance and developmental uses amounted to $15.4 billion. On average, about 1.1 million Canadians received unemployment insurance benefits each month in 1994. Administrative and other expenses amounted to $1.7 billion, bringing total program costs to $17.1 billion.

Since 1990, all expenses incurred by the account are to be financed through employee and employer contributions. Employers pay 1.4 times the employee premium rate. Unemployment insurance premium contributions by employers and employees totaled $19.3 billion in 1994. Another $82 million was received from penalties.

As a result, there was an *annual* surplus of $2.3 billion in 1994. This helped to reduce the *accumulated deficit* in the account to $3.6 billion by the end of 1994.

Premium contributions to the account form part of the federal government's overall budgetary revenues. Likewise, costs of the program are part of overall program spending. Annual deficits or surpluses in the account therefore directly affect the federal government's financial situation.

Unemployment insurance benefits are taxable as income and unemployment insurance premiums give rise to a tax credit. Claimants whose annual net income (including unemployment insurance benefits) is more than a prescribed limit ($61,230 in 1994) must repay 30 per cent of benefits in excess of the prescribed limit. Benefit repayments from higher-income claimants were estimated at $48 million in 1994. These repayments are credited to the account and help finance program expenses.

Annex Table 31
The Unemployment Insurance Account – 1994

	(billions of dollars)
Revenues	
Premiums	19.3
Penalties	0.1
Total	19.4
Expenses	
Benefits	
Regular	11.8
Maternity/parental	1.2
Sickness	0.4
Fishing	0.2
Total	13.6
Developmental Uses Program	1.8
Total benefits	15.4
Administration costs	1.3
Other (interest, doubtful debts)	0.4
Total expenses	17.1
Surplus for the year	2.3
Cumulative deficit at year end	-3.6

Important structural changes were recently announced by the Minister of Human Resources Development. The proposed reform strengthens incentives to get Canadians back to work. Benefits will be more closely tied to previous work, as they will be assessed in terms of “hours worked” rather than “weeks worked”, while total earnings will be covered up to an annual maximum. Seasonal workers will be encouraged to work in the off-season by averaging insurable earnings. Frequent users of unemployment insurance will face a reduction in their benefit rate. Coverage will be focused on those with lower earnings, by reducing maximum insurable earnings and reducing the threshold at which benefits are clawed back from high-income persons.

Annex Table 32
Unemployment Insurance Benefits

	1994-95	1995-96	1996-97
		(billions of dollars)	
Regular benefits	11.3	9.8	10.0
Special uses benefits	1.9	1.9	2.0
Development uses	1.8	1.9	2.1
Total[1]	15.0	13.6	14.1

[1] Components may not add to total due to rounding.

Unemployment insurance reform will also re-invest in people by promoting self-sufficiency and employment. Under a fully mature system, about $800 million will be redeployed within Human Resources Development Canada to set up adaptable employment programs to get unemployed Canadians back to work.

Major Transfers to Other Levels of Government

The provinces, territories and municipalities receive transfers from the federal government to support Canada’s health care system, post-secondary education, social assistance and provision of general public services.

In 1995-96, provincial, territorial and municipal governments will receive about $39 billion in financial transfers – both cash and tax point transfers. Of this amount, $26.4 billion will be cash, while more than $12.6 billion will take the form of tax transfers. A tax transfer consists of co-ordinated action by the federal government to reduce its taxes, allowing provinces to increase their taxes. In this way, revenues that would have otherwise gone to the federal government flow to the provinces.

Annex Table 33
Major Transfers to Other Levels of Government

	1994-95	1995-96	1996-97
		(millions of dollars)	
EPF/CAP – CHST			
Total entitlements	29,930	29,839	26,900
Cash transfer[1]	17,443	16,707	12,993
Tax point transfer	12,487	13,132	13,907
Equalization	8,543	8,512	8,895
Transfers to territories	1,196	1,155	1,116
Total			
Total entitlements[2]	38,869	38,702	36,096
Cash	27,182	26,374	23,004

[1] Figures include prior year adjustments.

[2] Equalization associated with EPF/CHST tax points appears in both Equalization and EPF/CHST entitlements. It has been subtracted from “Total entitlements” to avoid double counting.

EPF/CAP – CHST

A fundamental change was made to provincial and territorial transfers with the introduction of the Canada Health and Social Transfer (CHST) in the 1995 budget. The new block transfer will replace Established Programs Financing (EPF) and the Canada Assistance Plan (CAP) starting in 1996-97.

The CHST will provide funding for Canada’s major health and social programs.

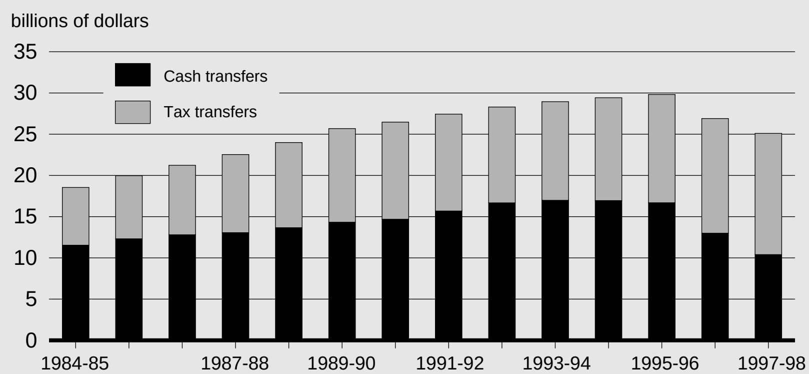
Unlike the old programs, such as CAP, the CHST will provide more scope for provinces to innovate and reform their programs, thus allocating resources where they are most needed, ending the intrusiveness of current cost-sharing arrangements.

The CHST will not be totally unconditional, however. The federal government will continue to enforce the Canada Health Act.

EPF/CAP – CHST entitlements are set to decline from $29.9 billion in 1994-95 to $25.1 billion in 1997-98, with cash transfers declining somewhat faster. The government has pledged to maintain a sustainable level of cash payments under the CHST.

The total CHST entitlement for 1996-97 is set at $26.9 billion. To provide provinces with certainty, CHST transfers will be allocated among provinces that year in the same proportion as provincial entitlements under combined CAP and EPF transfers in 1995-96. The Minister of Finance will be consulting with provinces shortly on how the allocation of the CHST could be made for years after 1996-97.

Annex Chart 1.1 **EPF/CAP – CHST**



Equalization

Equalization is unique in that its purpose is enshrined in the Constitution. Following discussions with the provinces, Equalization has been renewed for a five-year period beginning in 1994-95, providing stable financing for this program to the end of the century.

Equalization provides unconditional financial assistance to provinces that have below-standard revenue-raising capacities. It enables the less well-off provinces to provide Canadians with comparable levels of public services at comparable levels of taxation.

Equalization entitlements are calculated on the basis of a formula set out in federal legislation. Under this formula, each province's revenue-raising capacity is compared to the average fiscal capacity of a five-province standard. On a per-capita basis, any province whose revenue is below the five-province standard receives Equalization. The program is subject to a ceiling which limits the growth in Equalization entitlements to the growth in the Gross National Product (GNP) from a 1992-93 base. It also has floor provisions which protect each receiving province against a sharp annual decline in its Equalization.

Annex Table 34
Equalization Entitlements

	1994-95	1995-96	1996-97
		(millions of dollars)	
Newfoundland	958	926	977
Prince Edward Island	201	202	211
Nova Scotia	1,146	1,095	1,141
New Brunswick	887	945	983
Quebec	3,716	3,806	3,994
Manitoba	1,080	1,074	1,113
Saskatchewan	554	464	476
Total[1]	8,543	8,512	8,895

[1] Totals not exactly equal to sum of components due to rounding.

Territorial Formula Financing

The governments of the Northwest Territories and Yukon receive Formula Financing assistance to enable them to provide a range of public services comparable to those offered by the provinces. Transfers to the territories are calculated as the difference between territorial governments' expenditure requirements and their revenue means.

The 1995 budget announced that for 1995-96, entitlements for each territory are frozen at 1994-95 levels. In the subsequent fiscal year, the Gross Expenditure Base used in the formula will be cut by 5 per cent for each territory.

On October 4, 1995, the federal government and the governments of the territories announced a renewal of the Territorial Formula Financing Agreements for four years effective from April 1, 1995. The new agreements will expire on April 1, 1999 to coincide with the creation of Nunavut.

Annex Table 35
Transfers to Territories

	1994-95	1995-96	1996-97
		(millions of dollars)	
Current funding	1,196	1,155	1,116

Other Transfers

Apart from the major transfer programs, other smaller transfers also play an important role in providing financing to the provinces and territories.

■ Grants in lieu of taxes are paid by the federal government to municipalities in respect of municipal services provided to federal facilities. The 1994 budget froze payments under this program in 1993-94 and 1994-95 at 1992-93 levels as part of overall fiscal restraint.

■ To compensate for revenues lost on joining Confederation, the federal government provides statutory subsidies to the provinces.

■ Fiscal Stabilization provides financial assistance to any provincial government faced with a year-over-year decline in its revenues due to other than tax rate changes (i.e. due to a severe economic downturn). Payments to provinces totalling $1.1 billion were made to compensate them for revenue declines during the recent recession. Starting in 1995-96, compensation will only be provided for year-over-year revenue declines exceeding 5 per cent.

■ Youth Allowances Recovery: The federal government in the 1960s offered to the provinces an alternative method of financing for certain federal-provincial programs. The financing arrangement permitted any province to assume the administration of these programs by receiving “tax room” from the federal government. The Quebec government was the only province to choose this arrangement. One of the programs financed by this new arrangement was Youth Allowances. The federal government reduced personal income taxes in Quebec by three points to finance this program. Subsequently, the program was discontinued and now a payment is made each year by Quebec to the federal government to recover the value of the tax points.

Annex Table 36
Other Transfers

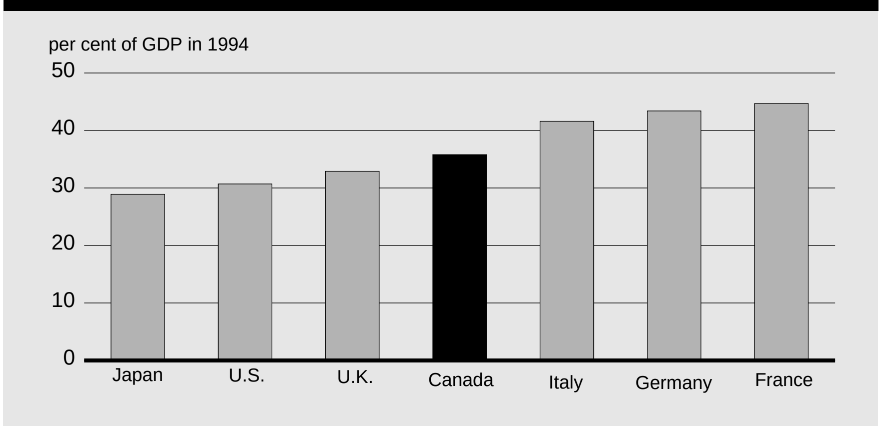
	1994-95	1995-96	1996-97
		(millions of dollars)	
Municipal grants	408	426	426
Statutory subsidies	38	38	38
Stabilization	0	0	0
Youth Allowances Recovery	-393	-422	-449
Total	53	42	15

Annex 2

Overview of Government Revenues

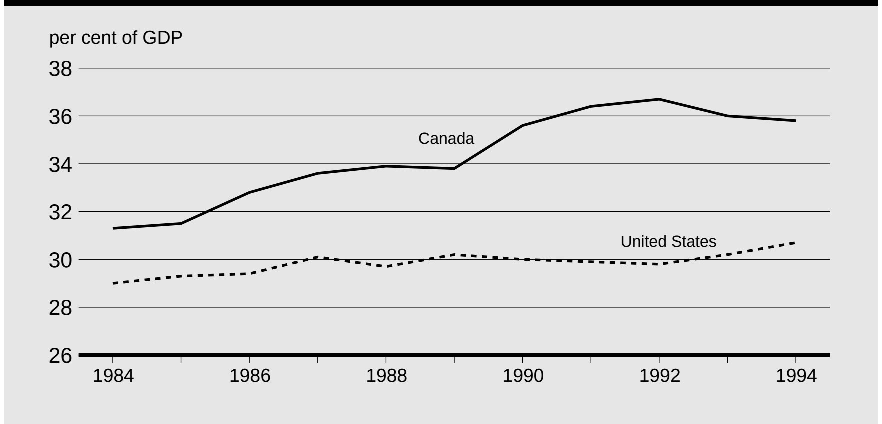
This section provides background on government tax revenues in Canada. In 1994, total tax revenues on a national account basis stood at $268.6 billion, which represented about 35.8 per cent of GDP. This placed Canada above the U.S. (for which tax revenues represented 30.7 per cent of GDP) and in the middle of the G-7 countries.

Annex Chart 2.1 **Comparison of total tax revenues – G-7**



In Canada, tax revenues have grown significantly relative to GDP. Between 1980 and 1994, tax revenues as a percentage of GDP increased from 29.5 per cent to 35.8 per cent (a 21.5 per cent increase). In comparison, tax revenues in the U.S. as a percentage of GDP increased from 29.8 per cent to 30.7 per cent (a 3.3 per cent increase) over the same period.

Annex Chart 2.2 **Comparison of government tax revenues – Canada-United States**



Federal Revenues

On a public accounts basis, as reported in the *Annual Financial Report* for 1994-95, federal government revenues amounted to $123.3 billion in 1994-95. Personal income tax is the most important revenue source for the federal government, at 46 per cent of total revenues. Sales and excise taxes, which include the Goods and Services Tax, customs import duties, motive fuel excise taxes and other excise taxes and duties, are the second largest federal revenue source, at 22 per cent of the total, followed by unemployment insurance premiums (15 per cent), and corporate income tax (9 per cent). Other revenues (8 per cent) include items such as return on investment (Bank of Canada profits, interest income, etc.) and other miscellaneous tax and non-tax revenues.

Annex Chart 2.3 **Federal revenue mix: 1994-95**

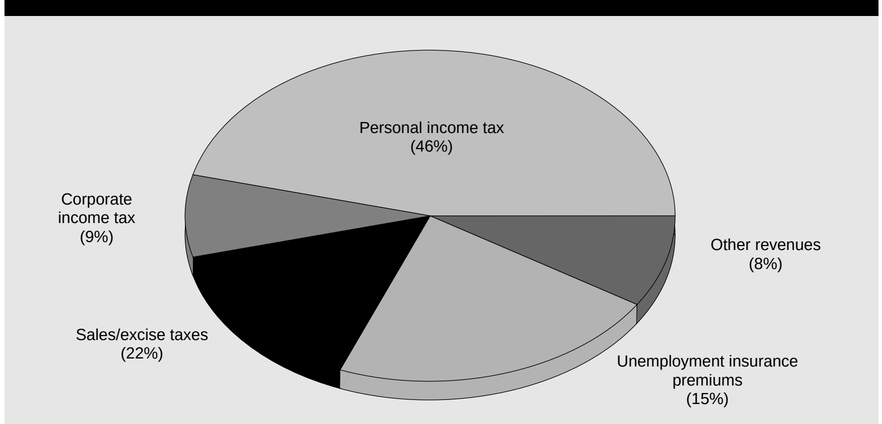


Table 37 provides an overview of the outlook for the major revenue components to 1996-97. Budgetary revenues are expected to increase to $131.2 billion in 1995-96, up 6.4 per cent from 1994-95. In 1995-96, revenues are expected to grow slightly faster than the economy, primarily due to the progressivity of the personal income tax system, with higher marginal tax rates at higher levels of taxable income, and the partial indexation of its parameters, as well as increased profitability of the corporate sector. In addition, measures introduced in recent budgets to tighten tax preferences and to increase certain excise tax rates contribute to the growth in revenues. In 1996-97, revenue growth slows to 3.8 per cent mainly due to lower unemployment insurance contributions and non-tax revenues.

Annex Table 37
Budgetary revenues

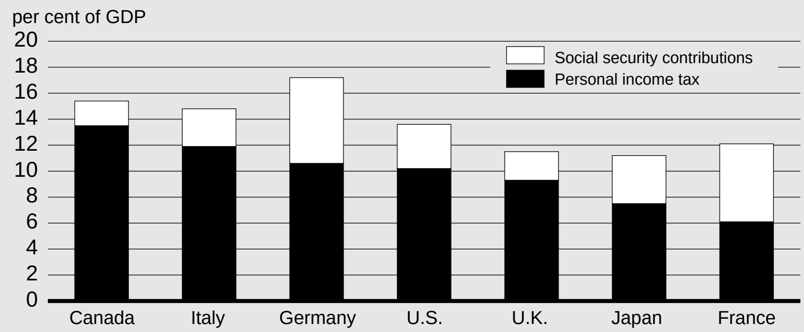
	1994-95	1995-96	1996-97
		(millions of dollars)	
Personal income tax	56,329	59,900	63,500
Corporate income tax	11,604	14,350	15,700
Unemployment insurance premiums	18,928	19,520	19,450
Goods and Services Tax	16,786	17,300	18,150
Excise taxes and duties	10,303	10,485	10,515
Other tax revenues	1,769	1,865	1,780
Non-tax revenues	7,604	7,740	6,990
Total revenue	123,323	131,160	136,085

Tax on Personal Income

In 1993, tax on personal income in Canada stood at 15.4 per cent of GDP on a national accounts basis, and was higher than in all other G-7 countries except Germany, which was at 17.2 per cent. It includes both personal income taxes and the employee portion of social security contributions (in Canada, these are primarily unemployment insurance premiums and Canada/Quebec Pension Plan contributions).

Relative to other G-7 countries, Canada relies to a much greater extent on personal income taxes, which were 13.5 per cent of GDP. Social security taxes represented 1.9 per cent of GDP, the lowest share among the G-7 countries.

Annex Chart 2.4 **Taxes on personal income in G-7 countries: 1993**



Tax Burden on Corporations

Canadian corporations pay a variety of taxes and other levies to the various levels of government in Canada:

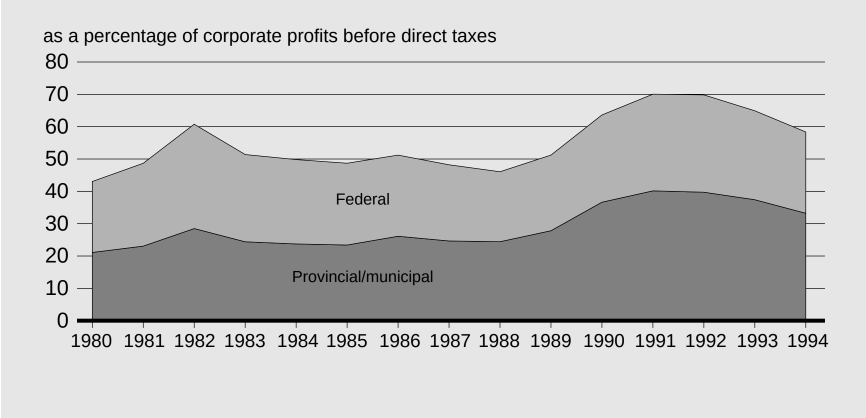
- corporate income taxes;
- capital and insurance premium taxes;
- payroll levies (e.g., health taxes, Unemployment Insurance, Canada Pension Plan, Quebec Pension Plan, Workers' Compensation);
- property taxes; and
- indirect taxes, such as sales and excise taxes, on business inputs.

With the exception of corporate income taxes, these taxes incurred by corporations do not vary with the level of profits and must be paid whether or not the corporation makes a profit. Direct taxes that are not based on profits represent approximately 70 per cent of all direct taxes paid by corporations.

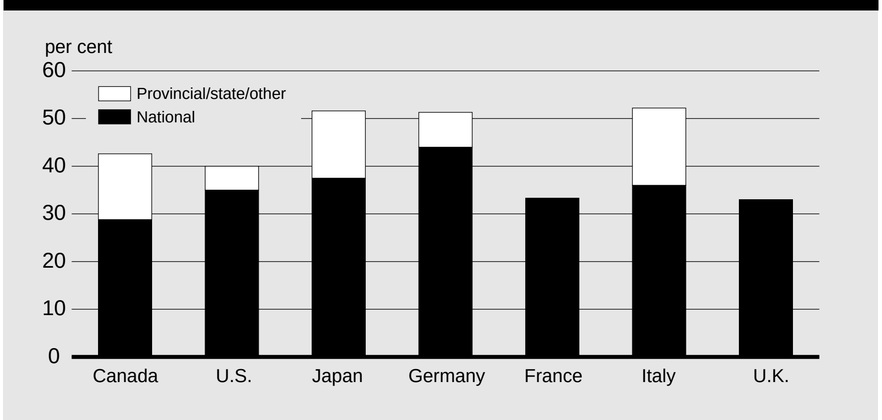
In 1994, Canadian corporations paid about $55 billion in direct taxes: about $24 billion to the federal government and $31 billion to provincial and municipal governments.[1] This amount is an increase from $36 billion (1994 dollars) in 1980. Measured as a percentage of pre-tax corporate

[1] Exact figures on the amount of indirect taxes paid by the corporate sector are unavailable. However, estimates suggest that these taxes represent a relatively small component of the total corporate tax burden.

Annex Chart 2.5 **Total corporate direct taxes**



Annex Chart 2.6 **International comparison of corporate income tax rates: 1994**



profits, direct taxes also increased significantly between 1980 and 1994 from 43.0 per cent to 58.4 per cent.

Income tax rates can be an important consideration in investment and location decisions by business, especially in the context of today's integrated global economy. Canadian rates are near the middle of the range in the G-7 countries.

Major Tax Expenditures

In raising revenues the tax system provides assistance or incentives to particular groups of individuals, businesses, or to certain activities. Tables 38 and 39 sets out some of these tax expenditures where the federal revenue foregone in each case likely exceeds $300 million. Short descriptions of the measures follow the table. It should be noted that the estimated cost of each tax expenditure takes no account of possible changes which could affect revenues, such as changes in taxpayer behaviour. Consequently, eliminating the measure would not necessarily increase revenues by the amount shown. Descriptions of all tax expenditures and the revenue foregone may be found in *Tax Expenditures*, published annually by the Department of Finance.

Annex Table 38
Major income tax expenditures[1]

	1992
	(millions of dollars)
Non-taxation of lottery and gambling winnings	
Education and tuition fee credits	365
Married/equivalent to married credit	1,725
Child tax benefit[2]	5,273
Partial inclusion of capital gains	745
Non-taxation of employer-paid health and dental benefits	1,125
Non-taxation of social assistance benefits	680
Non-taxation of workers' compensation benefits	610
Age and pension income credits	1,650
Tax assistance for retirement savings	13,600
$500,000 lifetime capital gains exemption on small business shares	785
Charitable donations credit	865
Low tax rate for small businesses	1,934
Low tax rate for manufacturing and processing	368
R&D investment tax credit	597

1 The elimination of a tax expenditure would not necessarily yield the full revenues shown in the above table. The actual increase in revenues would depend on the design of the tax change and resulting changes in behaviour. For instance, the theoretical yield from full taxation of lottery and gambling winnings is estimated to be $900 million. However, the actual potential revenues from such a tax would be much less if prizes under a certain value were excluded.

2 Estimate is for 1993, the first year of the program.

Lottery and gambling winnings

Lottery and gambling winnings are not subject to tax. The federal government has agreed to vacate the lottery field in return for payments by the provinces ($49.5 million was received in 1994-95). The forgone tax revenues from this tax expenditure were estimated at $900 million for 1992. This estimate reflects only lottery and horseracing gains; it does not include other types of gambling for which accurate data are unavailable. However the actual potential revenue from the taxation of these winnings would depend on design issues such as, whether there would be a threshold under which prizes would not be taxable.

Education and tuition fee credits

Tax assistance is provided to students enrolled at prescribed educational institutions such as universities and colleges. A 17-per-cent tax credit is available for tuition fees above $100 paid by students to prescribed educational institutions. In addition, students can claim an education tax credit of 17 per cent of $80 for every month of full-time attendance. Amounts not used by the student may be transferred to a supporting spouse, parent or grandparent, to a maximum of $4,000. The tax assistance provided to students through these federal tax credits amounted to $365 million in 1992.

Married and equivalent-to-married credits

A married taxpayer supporting a spouse is entitled to a tax credit of 17 per cent of $5,380 for taxation year 1995. This is reduced by 17 per cent of the amount by which the dependent spouse's income exceeds $538. Similarly, single parents can claim an equivalent-to-married tax credit in respect of a child. The amount of the credit and the limitation of the dependent child's income are the same as those for the married credit. These credits recognize that taxpayers in one-earner or single-parent families have a reduced ability to pay tax relative to taxpayers with the same income but without a financially dependent spouse or child to support. This tax expenditure cost the federal government $1.725 billion in 1992.

Child tax benefit

The child tax benefit was introduced in 1993, replacing the family allowance, the dependent credit for children under 18 years of age and the refundable child tax credit.

The child tax benefit is paid monthly and is non-taxable. The basic benefit is $1,020 per child annually, plus $75 for the third and each subsequent child. It also includes a supplement of up to $213 for each child under age 7. The combined total benefit is reduced by 5 per cent (2.5 per cent for one-child families) of family income over $25,921.

The child tax benefit also includes an earned income supplement for low-income working families. The supplement is equal to 8 per cent of the family earned income in excess of $3,750 (to a maximum supplement of $500). The supplement is reduced by 10 per cent of family net income in excess of $20,921.

In 1994, $5.3 billion was paid out in child tax benefits.

Partial inclusion of capital gains

Only three-quarters of net realized capital gains accrued since 1972 are included in income. The remaining one-quarter of the capital gain is tax free. This reduced income inclusion rate provides an incentive for individuals and corporations to invest by increasing the after-tax return on their investment and provides some recognition of the inflation-related portion of capital gains. This measure involved an estimated federal tax expenditure for 1992 of $745 million.

Non-taxation of employer-paid health and dental benefits

Approximately 8 million employees receive employer-paid health and dental benefits tax-free while other individuals without plans have to finance such expenses out of after-tax income. The non-taxation of these benefits is estimated to have cost the federal government $1.125 billion in forgone revenues in 1992.

Non-taxation of social assistance benefits

Social assistance benefits received by low-income Canadians are not taxable. These payments must be included in income but an offsetting deduction from net income is provided. The benefit levels are determined on the basis that benefits are non-taxable. The non-taxation of social assistance payments cost the federal government $680 million in forgone revenues in 1992.

Non-taxation of workers' compensation benefits

Workers' compensation benefits are not taxable even though contributions to Workers' Compensation Boards are deductible. Normally, where a deduction or credit has been allowed for premiums, benefits are taxable. Workers' Compensation Boards, established under provincial authority, set benefits levels on the assumption that benefits are not taxable. Generally, the benefit rate is 90 per cent of after-tax earnings, to a dollar maximum. The non-taxation of workers' compensation cost the federal government $610 million in forgone tax revenues in 1992.

Age and pension income credits

Individual taxpayers aged 65 or over are entitled to claim a maximum federal tax credit of 17 per cent of $3,482. Beginning with the 1994 taxation year, the age credit has been income-tested. The credit is reduced based on the amount by which an individual's net income exceeds $25,921. Individual taxpayers are also entitled to claim a federal tax credit of 17 per cent on the first $1,000 of private pension income. About three-quarters of those claiming the credit are age 65 or over and one-quarter are under 65. The age credit cost the federal government $1.355 billion in 1992. Income-testing the credit, which was announced in the 1994 budget, is estimated to reduce its 1995 cost by about $300 million. The pension income credit cost $295 million in 1992. Together these two credits for older Canadians cost the federal government $1.65 billion in 1992.

Tax assistance to retirement savings

The level of tax assistance provided to saving in registered pension plans, deferred profit sharing plans and registered retirement savings plans was estimated to be $13.6 billion at the federal level in 1992. This tax assistance results from the deferral of tax on income contributed to these plans, and on investment income earned inside the plans, until benefits are paid out. Each year, about nine to ten million individuals either claim deductions for contributions to retirement savings plans or receive benefits from them. Private saving for retirement plays a major role in the retirement income security of Canadians, and this role is increasing in importance as the "baby boom" generation moves towards retirement age.

$500,000 lifetime capital gains exemption for small business shares

A $500,000 lifetime capital gains exemption is available in respect of the disposition of small business shares. The exemption was designed to encourage investment in small business, provide retirement support and facilitate transfers. This tax expenditure cost the federal government $785 million in 1992.

Charitable donations credit

A tax credit of up to 20 per cent of net income is available in respect of donations by individuals to registered charities. Donations in excess of 20 per cent may be carried forward up to five years. The credit is 17 per cent on the first $200 of donations ($250 prior to taxation year 1994) and 29 per cent on the remaining portion. The purpose of the credit is to provide an incentive for charitable giving in recognition of the important work of charities. The estimated cost of this measure was $865 million for taxation year 1992.

Small business deduction

The small business deduction reduces the basic federal corporate tax rate on the first $200,000 of income earned by Canadian-controlled private corporations from 28 per cent to 12 per cent. This lower tax rate provides small corporations with more after-tax income for reinvestment and expansion to recognize the special financing difficulties they face. This measure had an estimated tax expenditure for 1992 of $1.934 billion and, in conjunction with other special tax measures for small business, provides Canadian small businesses with a more favorable income tax regime than in most other countries.

Manufacturing and processing profits deduction

The manufacturing and processing (M&P) profits deduction reduces the basic federal corporate tax rate on M&P income from the general rate of 28 per cent to a rate of 21 per cent. This lower tax rate provides M&P corporations with more after-tax income for reinvestment which increases their productivity and enhances their ability to compete in international markets. This measure had an estimated tax expenditure for 1992 of $368 million.

R&D investment tax credits

R&D investment tax credits are provided in recognition of the fact that the benefits of R&D accrue beyond the R&D performer to other participants in the economy. These credits are intended to encourage firms to perform R&D in Canada and are important given the key role of R&D in the emerging new economy. The current system of tax credits for R&D

provides significant tax relief (the estimated tax expenditure for 1992 is $597 million). Indeed, studies have shown that the Canadian system of R&D tax incentives is one of the most attractive in the world particularly when one includes the incentives offered by some provinces.

Other income tax expenditures

While the above list describes the major income tax expenditures, the publication *Tax Expenditures* provides a comprehensive listing of all tax expenditures. These range from those where the revenue forgone is relatively close to the $300 million cutoff, such as the deduction of limited partnership losses to lower cost ones such as the logging tax credit and the deduction for employee stock options.

Annex Table 39
Goods and Services Tax expenditures

	1992
	(millions of dollars)
Zero-rated goods and services	
Basic groceries	2,455
Tax exempt goods and services	
Long-term residential rent	1,015
Health care services	325
Education services (tuition)	305
Tax rebates	
Rebates for municipalities	500
Housing rebate	440
Tax credits	
GST credit	2,490

Zero-rated goods and services

Basic groceries

Basic groceries, which include the majority of foodstuffs for preparation and consumption at home, are zero-rated under the GST. However, the tax is charged on certain goods such as soft drinks, candies and confections, and alcoholic beverages.

Tax-exempt goods and services

Long-term residential rent

Rentals of a residential complex (such as a house) or a residential unit (such as an apartment) for a period of at least a month are tax exempt. Short-term accommodation is also exempt where the charge for the accommodation is not more than $20 per day.

Health care services

Health care services are exempt under the GST. These services include the following categories:

- institutional health care services provided in a health care facility. These include accommodation, meals provided with accommodation, and rentals of medical equipment to patients or residents of the facility. However, it excludes meals served in a cafeteria, parking charges, or haircuts for which a separate fee is charged.

- services provided by certain health care practitioners who must be licensed or otherwise certified to practise the particular profession in provinces. This category includes services such as dental, optometric, chiropractic, physiotherapy, chiropodic, podiatric, osteopathic, audiological, and psychological services. It also includes speech therapy and occupational therapy.

- services covered by a provincial health insurance plan. Most of these services are already covered by the previous two provisions.

All those exempt services which are covered by provincial health insurance plans are not considered as a tax expenditure because, constitutionally, the GST cannot apply to purchases made by provincial governments.

Education services (Tuition)

The GST provides an exemption for most educational services. The exemption includes tuition fees paid for courses provided primarily for elementary or secondary school students; courses leading to credits towards a diploma or degree awarded by a recognized school authority, university or college; and certain other types of training for a trade or vocation. In addition, the exemption covers meals supplied to elementary or secondary students as well as most meal plans at a university or public college.

The estimate is derived from the revenues that would be collected if tuition fees were taxed and input tax credits were allowed for taxable purchases. The estimate takes into account the fact that universities and public colleges currently receive a rebate of 67 per cent of the tax that they pay on their purchases.

Tax rebates

Rebates for municipalities

Recognized municipalities are entitled to a rebate of 57.14 per cent of the GST paid on their purchases used in the course of supplying exempt municipal services.

Housing rebate

Purchasers of newly constructed residential dwellings and substantially renovated houses are eligible for a rebate of the GST paid if the purchaser is acquiring the dwelling as a primary place of residence. For houses priced at or below $350,000, the rebate is 36 per cent of the total GST paid. The rebate is phased out for houses priced between $350,000 and $450,000.

Tax credits

The GST credit

As part of the introduction of the GST, a GST credit was established to provide sales tax relief to low- and modest-income families. The amount of the GST credit depends upon family size and income. The basic adult credit is $199 a year in 1995. Families with children 18 years and younger receive a basic child credit of $105 for each child. However, single parents can claim a full adult credit of $190 for one dependent child. In addition to their basic credit, single adults (including single parents) are eligible for an additional credit of up to $105. The value of the credit is reduced for families with income of over $25,921. Both the credit amounts and the income threshold are adjusted annually to increases in the consumer price index in excess of 3 per cent.

Revenue Impacts of Changes in Selected Tax Parameters

The sensitivity of revenue to illustrative changes in selected tax parameters is set out in the following table.

Annex Table 40
Estimated revenue impact of tax parameter changes (when mature)

	(millions of dollars)
Personal income tax	
Federal surtax (per percentage point)	
On total basic federal tax	660
On basic federal tax above $12,500	100
Change in marginal rates (per percentage point)	
Lowest rate (17 per cent)	1,950
Middle rate (26 per cent)	880
High rate (29 per cent)	420
All	3,250
$10 change in selected credits	
Basic personal credit	150
Married/equivalent to married credit	25
Age credit	25
Corporate income tax	
Rate changes (one percentage point)	
General income tax rate	315
Manufacturing and processing tax rate	110
Small business income tax rate	170
Surtax	120
Large corporation tax	
0.025 per cent change	160
Sales and excise taxes and duties	
GST (one percentage point change)	2,985
One cent per litre motive fuel	555
1 per cent in excise levies	
Spirits	5
Beer	6
Wine	1
Tobacco	20