The Economic and Fiscal Update

October 9, 1996

Department of Finance
Canada

Ministère des Finances
Canada

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1

Introduction and Overview

The ultimate objectives of the government's economic policy are to foster growth and the creation of well-paying jobs, within a fair and caring society. To achieve this, the government has focused on three basic building blocks:

- getting the economic foundation right – a key element of which is restoring health to the nation's finances;
- reforming social programs to ensure their sustainability; and
- providing Canadians and Canadian business with the support they require to take full advantage of the opportunities in the modern economy.

Reducing the deficit and the debt-to-GDP ratio (the size of the government's debt in relation to the economy ... this is a measure of the country's ability to pay) has been only one part of an overall jobs and growth strategy. But it has been an essential part. Three years ago, the federal government's finances were out of control. Expenditures had exceeded revenues for more than 20 years. Interest costs were eating up one-third of each revenue dollar. Debt in relation to GDP had surpassed 70 per cent and was continuing to rise unabated.

This untenable situation required determined and immediate action.

The last three budgets have put in place the measures necessary to achieve lasting deficit reduction and to reverse the rise in the debt-to-GDP ratio. This fiscal strategy has been based on reducing government spending rather than increasing taxes, improving the way government operates and refocusing spending and revenues to priority areas.

Taking stock

The strategy is on track …

This Update is being published concurrently with the *Annual Financial Report of the Government of Canada – Fiscal year 1995-96*. The Report shows that the federal deficit for 1995-96 came in at $28.6 billion. This means that the government has bettered its deficit target for a second year in a row and is on track to hit its deficit target of $24.3 billion for 1996-97 and $17 billion for 1997-98.

The provinces have also achieved significant fiscal improvement. As a result, Canada's total government deficit will decline from among the highest in the G-7 in the early 1990s to the lowest by 1997.

The transition to a healthier fiscal situation has entailed difficult adjustments that have sometimes obscured underlying progress. This is the nature of the early stages of fundamental change.

Structural reform in Canada's large public sector is recent, and no easier than it was for the resource sector in the mid-1980s or the manufacturing or commercial services sectors earlier this decade. The downsizing of the public service sector across Canada has, however, obscured the more vibrant performance of the private sector.

But this reform was necessary and fiscal policy is now working to *complement* monetary policy and other reforms to get the economy on track to meet the challenges of the 21st century.

… and the payoff is starting to emerge

Canada is already experiencing the benefits of its fiscal actions. Investor confidence has strengthened, reflecting the country's excellent inflation performance and fiscal progress. This renewed confidence has resulted in a historic decline in interest rates. Indeed, Canadian interest rates are now well below those in the U.S., on maturities up to five years. The last time short-term interest rates in Canada were lower than in the U.S. was in 1983.

The reduction in the deficit is also contributing to a sharp reversal in the country's reliance on foreign borrowing. In the second quarter of 1996, Canada lent more to non-residents than it borrowed from them. The last time this happened was in 1984.

Buoyed by declining interest rates and an extremely competitive export sector, economic growth is expected to strengthen in the remainder of this year and through 1997. Indeed, the International Monetary Fund (IMF) has recently announced that it expects real GDP growth in Canada to be the strongest in the G-7 next year.

Ensuring continued progress

Although the deficit has been put on a steady downward track, the debt-to-GDP ratio will remain unacceptably high for a number of years to come. The debt ratio will have to be lowered to a more manageable level if Canada is to benefit fully from the difficult decisions that have had to be taken in recent years.

To build on the progress achieved in the last three budgets – and in line with the measured pace of deficit reduction established to date – the deficit target for 1998-99 will be set at $9.0 billion, or about 1 per cent of GDP. Achieving this goal will be a major milestone for Canada. The new deficit target means that Canada's net new borrowing in private credit markets will be eliminated.

The government is committed to continuing reform to make the federal public sector more efficient, effective and flexible. Resources will continue to be reallocated to highest priorities. And the government will continue to strengthen its role in fostering employment growth.

Together these steps will lead to sustained growth and job creation, reduced financial vulnerability and increased policy flexibility.

Outline of *The Economic and Fiscal Update*

This Economic and Fiscal Update reviews, in **Chapter 2**, the costs to Canada of its high debt-to-GDP ratio and the challenges that have had to be overcome in turning it around.

Chapter 3 describes recent economic developments and their implications for the economic assumptions used in budget planning. It stresses that, while the restructuring of the government sector in Canada has been difficult, there are signs that the economy is beginning to respond to the significantly lower interest rates that have resulted from better fiscal performance at all levels of government. As a result, the economy is expected to strengthen in the latter part of this year and through 1997 as well.

Chapter 4 describes the fiscal implications of the updated economic planning assumptions. The government is on track to meet or better its deficit target for 1996-97. Other fiscal indicators are improving dramatically and the deficit target for 1997-98 will also be achieved. However, even then the debt-to-GDP ratio will still be extremely high, in both an historical and an international context. Correcting these imbalances is necessary to strengthen growth and job creation, and requires the government to keep its finances firmly under control.

Chapter 5 returns to the *Jobs and Growth* agenda – the government's top economic priority. Deficit reduction has always been only one part of a broader strategy to foster sustained strong job creation. While the private sector is the engine of job creation, the government still has a key role to play. The chapter reviews the measures the government has already put in place to support job creation in the private sector.

Chapter 6 presents the conclusions and main issues, including specific questions on which the Finance Committee will be asked to provide advice.

Background material on a number of issues raised in the document is provided in Annexes.

Annex 1 provides analyses of the sensitivity of the deficit to changes in interest rates and GDP.

Annex 2 explains the various measures of the government's fiscal position.

Annex 3 provides an international comparison of Canada's fiscal situation.

2

Creating a Healthy Fiscal Climate: Taking Stock

The fiscal challenge

When the government came to office in late 1993, the fiscal situation was clearly not sustainable. The deficit was $42 billion, almost 6 per cent of GDP. The debt-to-GDP ratio was over 70 per cent and growing, having risen virtually without interruption for the previous 20 years (Chart 2.1). The effect of compounding interest on the existing stock of debt meant that, without significant fiscal action, the deficit would have continued to rise from its already crippling level.

Indeed, by 1994-95 Canada's deficit was due solely to debt interest as revenues exceeded program spending (the operating balance was in surplus). The vicious circle of compounding debt is a powerful dynamic to counter. Consider, for example, that if the government had continued to run a policy allowing program spending to equal revenues so that the operating balance were zero (rather than generating substantial operating surpluses under the current policy), then within only five years:

- the stock of debt would have increased by *almost 50 per cent* – to about $800 billion; and
- public debt charges would be approaching $60 billion annually, rather than about $50 billion under current policy.[1]

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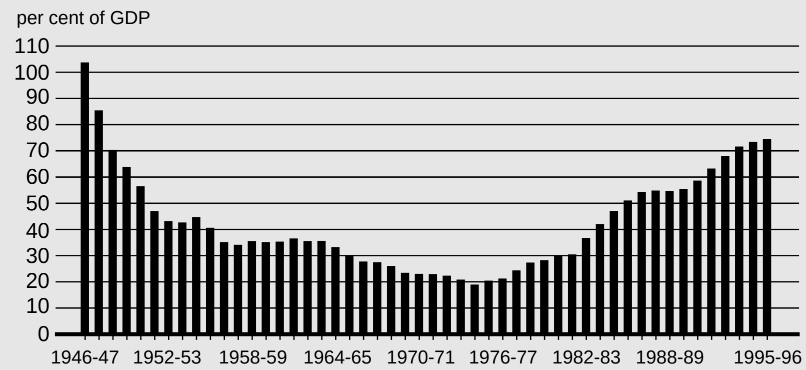
1 This assumes that the average effective interest rate on the debt remains at its current level of about 8 per cent.

Chart 2.1 **Federal net debt (Public Accounts basis)**



The loss of investor confidence associated with such a run-up in the debt would have caused a dramatic increase in interest rates, undermined consumer and investor confidence and increased unemployment. The economic and social consequences of delaying fiscal action would have been profound and eventually, even greater action than has been taken would have been needed to restore fiscal order.

The level and growth in the debt-to-GDP ratio are the crux of the fiscal problem. The debt-to-GDP ratio is the most appropriate measure of the country's ability to service the debt. Just as a household with a higher income can support a larger mortgage, so a country with a higher GDP has the capacity to support a higher public debt.

The challenge posed by the high debt ratio is to generate operating surpluses that are sufficient to fully offset interest charges on the debt and then to maintain these large surpluses until the debt-to-GDP ratio is substantially reduced. This implies maintaining control over program spending and the revenue share of GDP.

The rest of this chapter reviews the consequences of a high debt-to-GDP ratio and then explains the actions that the government has taken to ensure that it is reduced.

The consequences of a high debt-to-GDP ratio

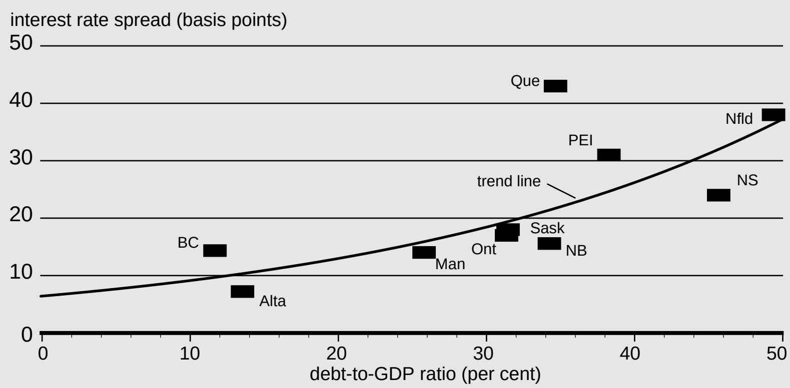
A high debt-to-GDP ratio brings with it a number of adverse economic consequences.

High interest rates

A run-up in the debt-to-GDP ratio can result in high and volatile interest rates. This is because financial markets demand an interest rate risk premium from highly indebted governments.

In Canada, the relationship between the debt-to-GDP ratio and interest rates is most apparent in the different rates of interest paid by provincial governments (Chart 2.2). The higher a province's debt-to-GDP ratio, the higher the interest rate demanded by financial markets. The lower a province's debt-to-GDP ratio, the lower the interest rate it pays. With little variation, this relationship holds across all provinces. A similar relationship can be observed across G-7 countries.

Chart 2.2 **Debt-to-GDP ratios and interest rates by province**



Interest rate spreads relative to 10-year Government of Canada bond rate as of Sept 26, 1996.
Debt/GDP ratios are 1995-96 Department of Finance estimates.

Because federal government securities are the benchmark for Canadian interest rates in money and capital markets, the rate of interest paid by the federal government sets the standard for all other borrowers. Reducing the high federal debt-to-GDP ratio, therefore, will also reduce interest costs throughout the economy. For example, the lower interest rates achieved between January 1995 and June 1996 have provided provincial governments with cumulative savings of about $1.3 billion (Table 2.1). As a share of their expenditures, Quebec and Alberta have benefited most to date from this decline in interest rates because a larger portion of their debt is in short-term securities. Others will benefit more as they refinance their existing stock of debt.

Table 2.1
Estimated cumulative savings in debt charges by province
18 months starting January 1995

	Millions of dollars	Per cent of expenditures[1]
Newfoundland	10	0.3
Prince Edward Island	2	0.3
Nova Scotia	15	0.3
New Brunswick	25	0.6
Quebec	625	1.5
Ontario	315	0.6
Manitoba	45	0.8
Saskatchewan	35	0.7
Alberta	165	1.2
British Columbia	75	0.4
Total Provincial	1,312	0.8

[1] Calculated as cumulative interest cost savings divided by total expenditures in 1995.

Source: Department of Finance estimates.

The more general economic benefits that flow from lower interest rates – in terms of higher investment and consumer spending – are well known to many Canadians. To take but one example, the reduction in interest rates since 1995 has resulted in a 15-per-cent increase in housing starts.

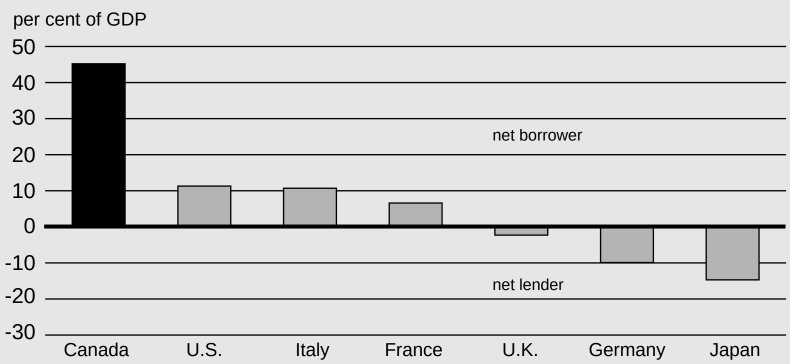
High net foreign debt

Persistently high government deficits soak up domestic savings and force a country to borrow abroad.

For example, in 1995 total private savings in Canada were $144.2 billion (Chart 2.3). This was more than sufficient to cover total investment of $123.5 billion. However, because the total government deficit that year was $31.9 billion (on a National Accounts basis), the country had to borrow $11.2 billion abroad. As a result, the stock of debt held by non-residents (the sum of annual net foreign borrowings) increased $11.2 billion. Ongoing deficit financing over the past 20 years has resulted in a run-up in the stock of foreign debt, with the result that Canada now has the highest external debt-to-GDP ratio in the G-7 (Chart 2.4).

Chart 2.3 Sources and uses of savings in Canada (1995)

Chart 2.4 G-7 net international indebtedness (1994)



Source: Canada, Department of Finance; rest of the G-7, OECD Economic Outlook, June 1996.

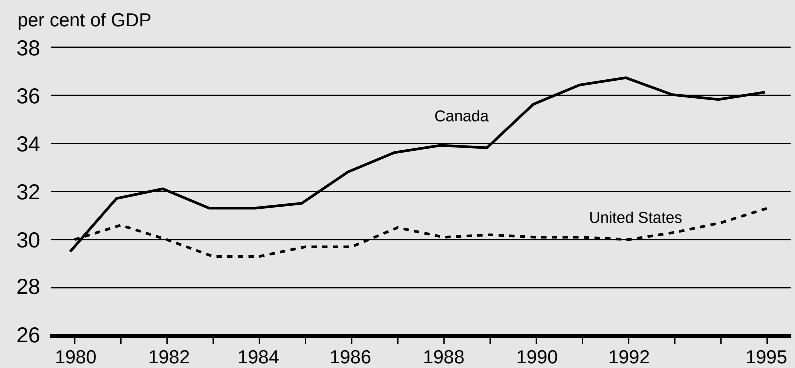
To service the foreign debt, a rising share of income generated in Canada has been flowing abroad. These payments represent a permanent deterioration in the country's standard of living. That creates a situation where non-residents are indirectly exercising a substantial influence over economic decisions made in Canada.

High taxes

A high debt-to-GDP ratio tends to result in heavy tax burdens. This is because highly indebted governments often push up taxes in order to generate the large operating surpluses needed to keep the debt-to-GDP ratio from rising.

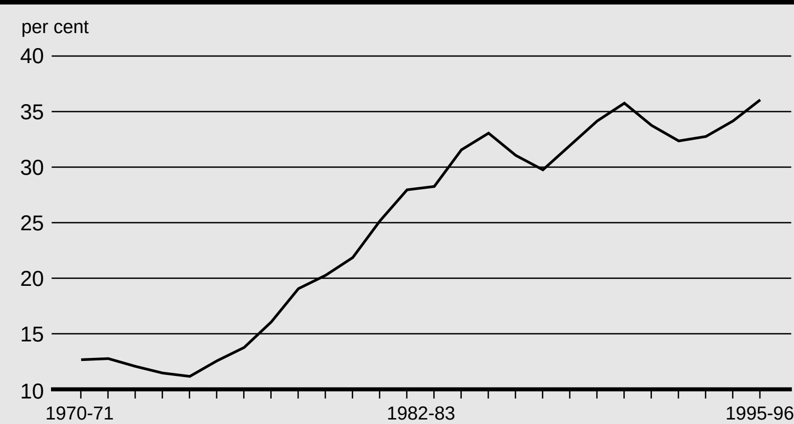
For example, since the early 1980s, the tax burden in Canada increased significantly and much more rapidly than in the United States – our largest trading partner (Chart 2.5). In the past, higher overall taxes in Canada always reflected a higher level of public services. However, particularly over the 1980s, taxes were raised just to help pay for the mounting interest costs on the public debt, rather than to pay for programs and services that could have improved economic performance (Chart 2.6). High taxes are detrimental to employment and output growth and undermine Canada's attractiveness as an investment location.

Chart 2.5 Canada and U.S. total tax revenue



Source: Canada, Department of Finance; U.S.A., OECD Economic Outlook, June 1996.

Chart 2.6 Interest on the debt as a per cent of budgetary revenues



Yet even the increases in taxes over the past decade have not stopped the debt-to-GDP ratio from rising. The debt-to-GDP ratio increased from less than 20 per cent in 1974-75 to over 70 per cent by 1993-94. As a consequence, in 1974-75, about 11 cents of each revenue dollar went to servicing the debt. By 1993-94, this was up to 33 cents. Despite the fiscal actions taken to date, the debt-to-GDP ratio stood at 74.0 per cent at the end of 1995-96 while interest costs amounted to 36 cents of each revenue dollar.

Deficit vulnerable to recessions and high interest rates

A high debt-to-GDP ratio can also leave a country extremely vulnerable to increases in interest rates and economic slowdowns.

In Canada's case, a 100-basis-point increase in interest rates raises the federal deficit by $1.3 billion in the first year and by $3.0 billion after four years. (A more complete discussion of fiscal sensitivities to changes in income growth and interest rates is provided in Annex 1.)

Indeed, high deficits and a high debt-to-GDP ratio have eroded much of the federal government's policy flexibility – including its ability to use discretionary policy to buffer the economy from the negative effects of recessions. This became abundantly clear in the 1990-1991 recession when the government was forced to offset the negative impact of the automatic stabilizers on the deficit to prevent the debt-to-GDP ratio from rising.

The inequities of high debt

The imperative of lowering a high debt-to-GDP ratio is not only a matter of economics and fiscal accounting. It is also a matter of fairness toward future generations.

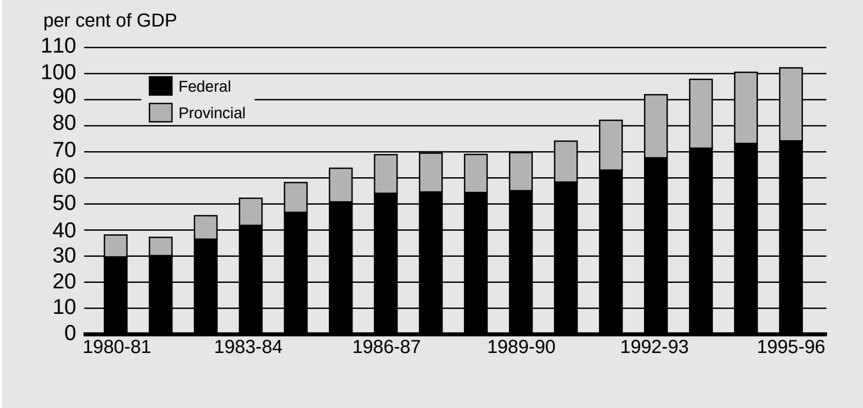
Canada, in particular, will face major demographic changes in the next century. Over the next 40 years, the percentage of the population over 65 will almost double to 22 per cent, from 12 per cent today. At the same time, the share of the population of working age will decline. Thus the ratio of dependants – both elderly and children – to the working-age population will increase, from about 48 per cent now to over 60 per cent.

Adjusting to these changes alone will pose a considerable challenge. The additional burden of having to act to reduce the debt-to-GDP ratio should not be imposed on future generations as well. Those working now should not leave an enormous debt for future generations to pay.

Federal fiscal situation more severe than at provincial level

Since the early 1990s, the deterioration in federal finances was compounded by a similar deterioration in provincial finances. The all-province debt-to-GDP ratio increased from under 15 per cent to 28 per cent between 1989-90 and 1995-96 (on a Public Accounts basis). This meant that the combined federal-provincial debt-to-GDP ratio exceeded 100 per cent in 1995-96 (Chart 2.7).

Chart 2.7 **Net debt: federal and provincial governments (Public Accounts basis)**

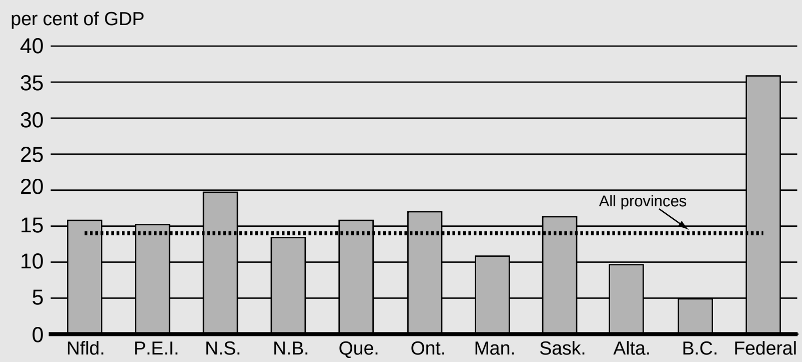


However, the combined provincial fiscal situation is not as difficult as that at the federal level. Although the provincial debt-to-GDP ratio has nearly doubled in the past five years, its level in 1995-96 is still only about one-third of the federal ratio. The provincial debt-to-GDP ratio now is similar to the level that the federal ratio was in 1980-81.

The much lower debt-to-GDP ratio for the provinces means that less of their revenues must go to paying debt servicing costs (Chart 2.8). On an aggregate basis, debt servicing costs amounted to 14 cents of each revenue dollar that the provinces received in 1995-96 (which includes revenues received from the federal government). It ranged from about 5 cents in British Columbia to 20 cents in Nova Scotia. This compares to 36 cents for the federal government.

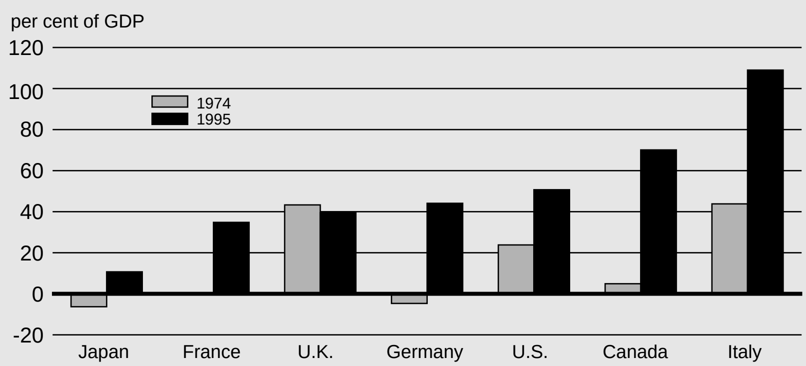
The run-up in the debt-to-GDP ratio in Canada was not unique among G-7 countries. Other countries also experienced increases in their debt-to-GDP ratios over this period. But few were as pronounced as in Canada (Chart 2.9). Canada moved from having a relatively low debt-to-GDP ratio in 1974 to having the second highest among the world's seven largest economies in 1995. (Debt-to-GDP ratios by country are traditionally reported on a National Accounts basis in order to allow comparability across countries. The debt-to-GDP ratio on a National Accounts basis is significantly smaller than on a Public Accounts basis but the trends are broadly consistent. See Annex 2.)

Chart 2.8 Interest on debt as a per cent of budgetary revenues: provinces and federal government (1995-96)



All-province total includes territories.

Chart 2.9 Total government net fiscal debt – G-7 countries (National Accounts basis)



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

Meeting the challenge

The government's top priority is to ensure strong and sustained job creation and economic growth, while protecting the most vulnerable in Canada.

To achieve this overarching goal, the government has focused on three key objectives:

- creating a healthy fiscal and economic climate by eliminating the deficit and reducing the debt-to-GDP ratio;
- reforming Canada's social programs in order to ensure that they are sustainable over the long run; and
- providing Canadians and Canadian business with the support they require to take full advantage of the opportunities in the modern economy.

These objectives are mutually reinforcing:

- cleaning up the nation's finances will lead to lower interest rates, which will bolster economic growth and job creation and, in turn, further improve the fiscal situation;
- structural changes to support and enhance the economy's growth potential will lead to more jobs and higher incomes. This, in itself, lowers the debt-to-GDP ratio by increasing GDP. But in the longer run, it also increases revenues to the government which reduces the deficit, providing another source of downward pressure on the debt ratio. (The government's strategy to enhancing economic growth is explained in Chapter 5.)

Anchored by a healthy fiscal and monetary climate

Creating a healthy fiscal and monetary climate is a prerequisite for achieving the government's economic and social objectives.

Governments by themselves cannot ensure ongoing job creation – the private sector is the engine of economic growth. If the economic foundation is weak, due to high interest rates or a lack of competitiveness or other forces that diminish risk taking, then no amount of government employment initiatives would be successful enough to offset the shortfall in job creation in the private sector.

The *approach* to restoring fiscal health has been two-track: reducing expenditures and fostering economic growth. There have been no personal tax rate increases in any of the last three budgets. Tax measures have been targeted largely at closing loopholes and increasing tax fairness.

Budget planning has been based on:

- setting two-year rolling deficit targets as a step to achieving its ultimate objective of a balanced budget. In the past, the fact that fiscal targets were set for the long term played a role in delaying the implementation of needed fiscal reforms;
- using prudent economic planning assumptions, that are somewhat more conservative than the average of private sector economic forecasts; and
- including a Contingency Reserve, as an additional amount of prudence to ensure that the deficit targets will be met.

The contingency reserve is included in the deficit projection 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 also 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 fiscal actions

The 1994 budget created savings to put the deficit on a downward path. It was the first of a two-step process that culminated with the 1995 budget, that introduced the most far-reaching reform of federal spending in the postwar era. The 1996 budget extended and consolidated the savings achieved in the previous two budgets.

Together, the three budgets put in place savings that will build to $29 billion annually by 1998-99, of which close to 90 per cent are the result of expenditure reductions (Table 2.2). These savings will result in a 14-per-cent decline in program spending between 1992-93 and 1998-99. In relation to the size of the economy, program spending by 1998-99 will be at its lowest level since 1949-50.

Table 2.2
Direct budget savings

	1994-95	1995-96	1996-97	1997-98	1998-99	Cumulative effect on net debt
			(billions of dollars)			
1994 budget	1.5	8.0	10.9	11.9	12.6	44.9
1995 budget		5.0	10.6	13.3	13.8	42.7
1996 Employment Insurance (EI) reform[1]				0.7	0.8	1.5
1996 budget				0.2	1.7	1.9
Total	1.5	13.0	21.5	26.1	28.9	91.0
of which:						
expenditures	0.7	10.6	18.9	23.3	25.6	79.0
revenues	0.8	2.4	2.6	2.8	3.4	12.0

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

Resulting in a more effective federal government …

The cornerstone of the 1995 and 1996 budgets was *Program Review* – a comprehensive review of departmental spending whose objective was to bring about a more effective and cost-efficient way of delivering programs and services to Canadians. This Review will fundamentally change what government does and how it operates. The changes have already begun.

A new *Expenditure Management System* has been introduced to better control government spending by ensuring better accounting of cost and risk and that new policy initiatives are now funded through spending reallocation.

Program delivery has also been reformed to increase efficiency and effectiveness. For example, the 1996 budget announced the creation of a Single Food Inspection Agency to consolidate food inspection and quarantine-related services currently provided in three federal departments into one single agency. The federal government has also been discussing with the provinces the establishment of a federal-provincial border and revenue service to eliminate existing overlap and duplication in tax administration.

The government is privatizing or commercializing services that the private sector is better positioned to deliver. For example, all of the government's shares in Canadian National Railways and a substantial portion of the government's interest in Petro-Canada have been sold.

The government is also getting out of activities that have been shown to impede adaptation and innovation. By 1998-99, subsidies to business will have declined 61 per cent from their level in 1994-95. The structure of remaining subsidies will be shifted away from direct production subsidies toward income stabilization and economic adjustment in Canadian agriculture, support for small business development and promoting technological advancement and the competitiveness of Canadian industry. Program assistance directed to business development will be on a more commercial basis, including more risk sharing by the private sector and repayable forms of assistance.

These and other changes are bringing about a sharp drop in departmental spending. By 1998-99, departmental spending will be 21.5 per cent lower than in 1994-95 (Table 2.3).

However, Program Review has not only reduced spending, it has reallocated spending to the government's highest priorities. Reductions in departmental spending have been less severe in departments dealing with *social*, *justice* and *legal* issues – reflecting the priority given to issues related to justice, health care and aboriginals.

… and a more affordable and sustainable transfer system

Departmental spending accounts for less than half of federal program spending. No spending reform could be sufficient without an examination of the transfer system to individuals and to other levels of government – these latter transfers represent about 23 per cent of program spending. The government's three budgets have reformed transfer programs to make them more sustainable over the long run and more suited to the needs of the current and future generations:

- significant changes have been made to Canada's Employment Insurance (EI) system;
- the proposed reform of seniors benefits will take effect in 2001 in order to be mature when the "baby boomers" reach retirement. In addition, the proposed reform will fully protect the benefits of all current and near seniors;
- the federal government and the provinces are currently discussing reform of the Canada Pension Plan (CPP) system to ensure that the system is sustainable for the future; and

Table 2.3
Departmental spending

	Spending levels		Change	
	1994-95	1998-99	$ million	Per cent
	(millions of dollars)			
Natural resource-based programs	5,524	3,564	-1,960	-35.5
Agriculture	2,080	1,455	-625	-30.1
Fisheries and Oceans	1,307	1,037	-269	-20.6
Natural Resources	1,422	592	-830	-58.4
Environment	716	480	-236	-32.9
Transport	2,273	704	-1,569	-69.0
Industrial, regional and scientific-technological support programs	3,822	2,760	-1,062	-27.8
Industry	2,940	2,052	-888	-30.2
Regional agencies	882	708	-174	-19.7
Justice and legal programs	3,375	3,140	-236	-7.0
Justice	752	719	-33	-4.5
Solicitor General	2,623	2,421	-202	-7.7
Heritage and cultural programs	2,906	2,051	-855	-29.4
Foreign affairs and international assistance	4,374	3,232	-1,142	-26.1
Foreign Affairs and International Trade	1,464	1,320	-143	-9.8
International Assistance Envelope	2,910	1,912	-998	-34.3
Social programs	12,641	11,664	-971	-7.7
Citizenship and Immigration	658	615	-43	-6.5
Health	1,818	1,682	-136	-7.5
Human Resources Development	2,415	1,452	-964	-39.9
Indian and Northern Affairs	3,786	4,268	481	12.7
Canada Mortgage and Housing	1,988	1,808	-180	-9.0
Veterans' Affairs	1,975	1,840	-136	-6.9
Defence/Emergency Preparedness	11,801	9,252	-2,549	-21.6
Parliament and general government services	4,635	3,979	-656	-14.1
Central agencies	369	248	-122	-32.9
Total	51,720	40,593	-11,127	-21.5

Source: 1996 budget estimates.

- transfers to provinces for health, social welfare and post-secondary education have been reduced to be more affordable and restructured to be more predictable and more flexible. The five-year financing arrangement announced in the 1996 budget will take effect in 1998-99, and includes the assurance of a minimum $11-billion cash transfer. Provincial transfer entitlements will begin to increase by the turn of the century. Territorial transfers have also been reformed to increase the incentives for economic development within the territories.

The results: dramatic improvement in the federal deficit

The fiscal results for 1994-95 and 1995-96 show that the prudent approach to budget planning is paying off. The deficit targets were bettered in both years (Chart 2.10).

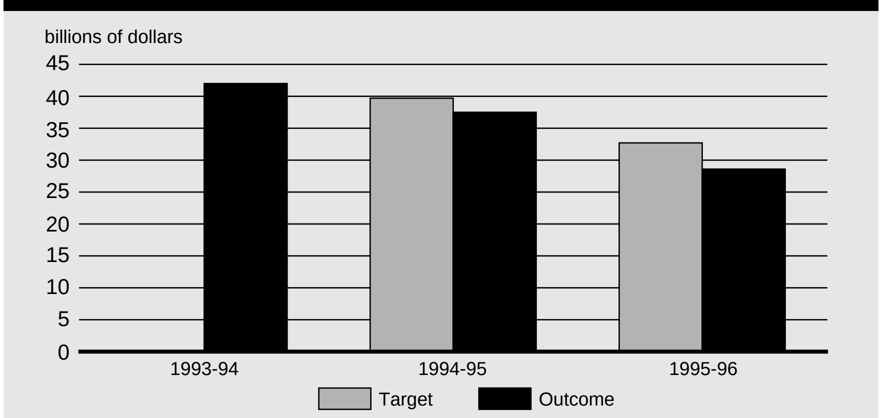
1994-95

The deficit for 1994-95 was $37.5 billion – $4.5 billion lower than the deficit in the previous year and $2.2 billion below the target of $39.7 billion set out in the 1994 budget.

1995-96

The deficit for 1995-96 was $28.6 billion – $8.9 billion less than the 1994-95 deficit. In relation to the size of economy, the deficit in 1995-96 was 3.7 per cent – its lowest level since 1976-77.

Chart 2.10 **Federal deficit: outcome and target (Public Accounts basis)**



The deficit was about $4 billion lower than the target of $32.7 billion set out in the 1994 budget. Budgetary revenues were marginally lower than assumed in the 1996 budget, while public debt charges were relatively unchanged. However, departmental spending was reduced more quickly than anticipated in the 1996 budget. As a result, the operating surplus was $18.3 billion. For the second consecutive year, the contingency reserve was not required.

Details on the deficit results for 1995-96, are provided in the *Annual Financial Report of the Government of Canada – Fiscal year 1995-96*.

Federal improvement has been complemented by the provinces

Federal progress has been complemented by the actions of the provinces in addressing their deficit situations. By the end of 1995-96, 7 of the 12 provincial/territorial jurisdictions had balanced their budgets or were running surpluses, while the remaining provinces have all committed to balancing their budgets by the end of the decade, if not earlier.

Table 2.4
Provincial / territorial deficits
(millions of dollars and as a per cent of GDP)

	1993-94		1994-95		1995-96	
	Dollars	Per cent of GDP	Dollars	Per cent of GDP	Dollars	Per cent of GDP
Nfld.	205	2.2	127	1.3	-4	0.0
P.E.I.	71	3.1	1	0.0	-4	-0.2
N.S.	547	3.0	235	1.3	201	1.1
N.B.	290	2.0	64	0.4	-51	-0.3
Que.	4,894	3.0	5,710	3.4	3,966	2.3
Ont.	11,202	3.9	10,129	3.4	8,726	2.8
Man.	430	1.8	196	0.8	-156	-0.6
Sask.	272	1.3	-128	-0.6	-18	-0.1
Alta.	1,384	1.8	-958	-1.2	-1,132	-1.3
B.C.	910	1.0	446	0.5	235	0.2
Yukon	-15	-1.8	-29	-3.4	-1	-0.1
N.W.T.	36	1.8	26	1.2	31	1.3
Total	20,228	2.8	15,819	2.1	11,793	1.5

Note: a negative number indicates a budgetary surplus.

Source: Provincial budgets; Public Accounts.

3

The Economic Payoff and Planning Assumptions

Introduction

The government has been pursuing monetary and fiscal policies aimed at achieving low and stable interest rates as the basis for renewed growth and job creation. The payoffs from this strategy are now beginning to appear: interest rates have come down substantially in the last 18 months and the economy is beginning to respond.

Continued low inflation, the progress that all levels of government have made in addressing their fiscal problems and the turnaround in the current account from deficit to surplus have allowed the Bank of Canada to ease monetary conditions substantially since the 1995 budget. Short-term interest rates have dropped over 450 basis points since the spring of 1995 and, in fact, have been below those in the U.S. since March.[1]

Low interest rates spurred the economy on to a strong performance in 1994. The pace of economic activity weakened significantly, as interest rates moved sharply higher in 1995 when U.S. rates rose and the Canadian dollar came under severe pressure in foreign exchange markets. The effects of higher interest rates continued to impair economic growth in early 1996. But the interest rate declines that have been recorded since 1995 should again provide a strong boost to the economy's performance in 1997.

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1 All numbers as of Friday, October 4, 1996.

The improved outlook is already evident in the data. The housing sector is beginning a healthy recovery with house resales very strong and housing starts up well above last year's level. Business confidence is up sharply and, as a result, investment intentions for 1996 have been revised up. Consumer confidence has improved since the beginning of the year. Real GDP rose 0.5 per cent in July alone.

For fiscal planning purposes, the government will continue its practice of adopting prudent economic assumptions. This approach was developed following the advice from the Round Table of private sector economists held in December 1993, and the recommendations of the House of Commons Standing Committee on Finance. They recommended that budget planning be based on interest rate assumptions above the average of private-sector forecasts and, as a result, lower nominal GDP. The purpose of this approach was to guard against the possibility that a less favourable economic environment might derail the government's fiscal plan.

Recent developments in Canada: the payoff to date

Strong foundations

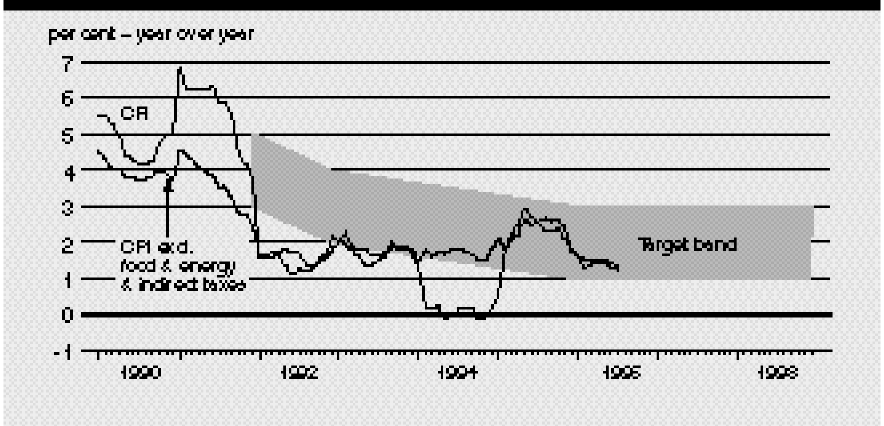
The fundamentals for a resumption of healthy growth – particularly low interest rates – are now coming into place. The substantial declines in Canadian interest rates reflect Canada's low inflation and improved trade and current accounts performance, in addition to the substantial progress on the fiscal front at all levels of government.

Inflation remains low

As expected, inflation has come down sharply since 1995, despite some pressure from a temporary rise in energy prices in early 1996. Since December 1995, the Consumer Price Index (CPI) inflation rate has been in the lower half of the Bank of Canada's target range of 1 to 3 per cent (Chart 3.1). In part, this reflects continued modest wage growth. This has restrained unit labour costs, which have grown by less than one-half per cent per year since the beginning of 1991.

The other major factor contributing to the slowdown in inflation has been a sharp reduction in the growth of import prices over the last year. Commodity prices have eased significantly after a strong run-up in 1993 and 1994, easing the pressures on producer prices. As well, the depreciation of the dollar between late 1991 and early 1995 which contributed to strong increases in the prices of imported goods has been followed by a year of stability for the Canadian dollar. Over the past year, the dollar has traded in a fairly narrow band of between 72½ and 74½ cents U.S. As a result, the prices of imported consumer goods have remained relatively stable.

Chart 3.1 Consumer Price Index



Canada's trade performance has improved sharply

Low inflation, combined with the depreciation in the dollar since the early 1990s, has improved Canadian competitiveness enormously. This has led to a sharp improvement in the merchandise trade surplus – from one-half per cent of GDP in 1991 to roughly 5.0 per cent of GDP in the second quarter of 1996.

Improvements in the trade sector are broadly based. Growth in merchandise exports has been exceptionally strong (Chart 3.2). Only about a quarter of the rise is attributable to commodity exports. Growing exports of manufactured goods, including autos and machinery and equipment, accounted for the rest. In dollar terms, exports of machinery and equipment are now almost as important as automotive exports.

Tourism has also benefited from the improvement in Canadian competitiveness. The balance on the travel account has improved significantly since the beginning of 1991 (Chart 3.3).

Chart 3.2 Merchandise trade surplus

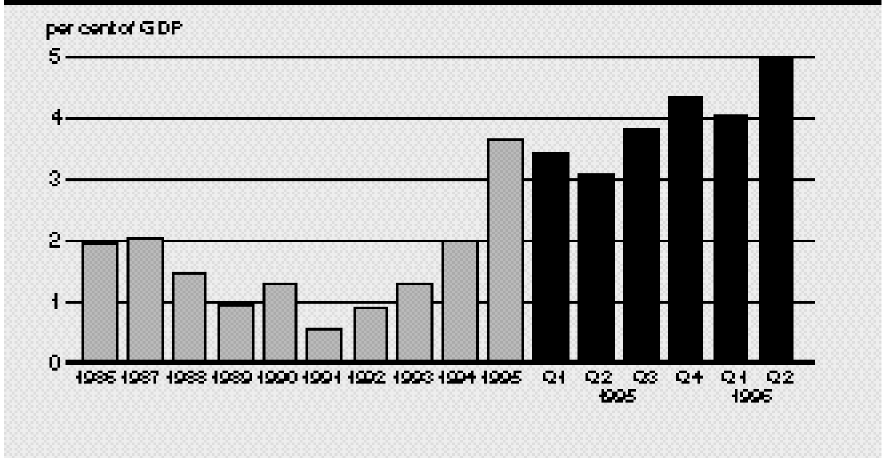
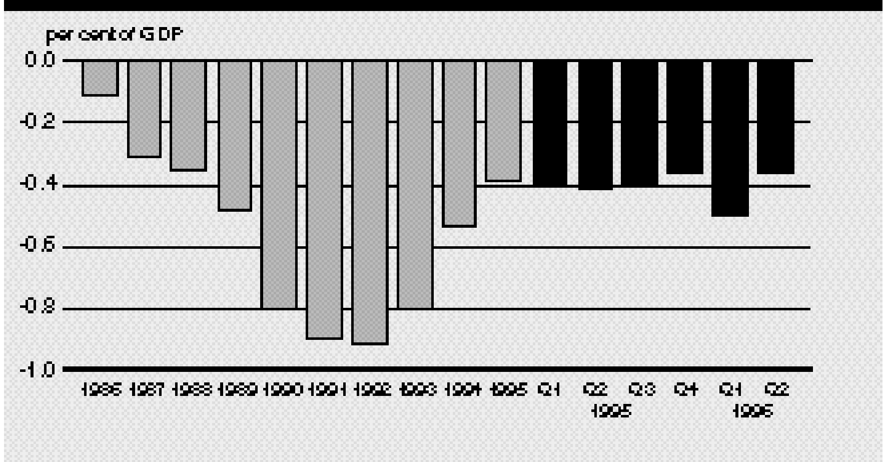
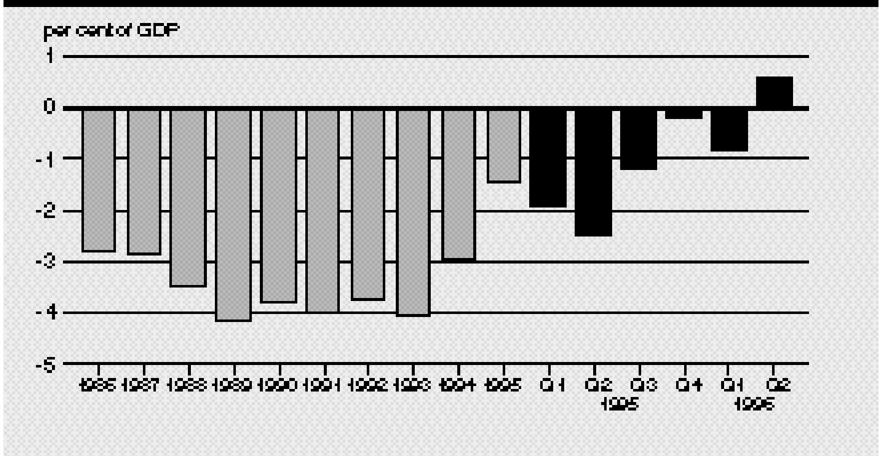


Chart 3.3 Travel balance



The strong performance of the trade sector over the past few years has led to a huge turnaround in the current accounts balance (Chart 3.4). The current account has moved from deficits averaging around 4 per cent of GDP in the early 1990s to a surplus of about 0.6 per cent of GDP in the second quarter of 1996, the first surplus that the current account has registered in 12 years.

Chart 3.4 Canada's current account balance



Interest rates are down substantially

Getting the fundamentals right has helped to boost financial market confidence. This has allowed the Bank of Canada to pursue a substantial easing of monetary conditions, with 17 reductions in the Bank Rate over the past 17 months. Although short-term U.S. interest rates increased modestly over the spring and summer, owing to concerns about re-emerging U.S. inflation pressures, these rates have since fallen back to their January levels. Short-term Canadian interest rates, meanwhile, have declined steadily over the year (Chart 3.5). They have been below those in the U.S. since late March, the first sustained period of negative spreads since 1983 (when the negative spreads were not as large and lasted for only 14 weeks) (Chart 3.6).

Chart 3.5 3-month Treasury bills

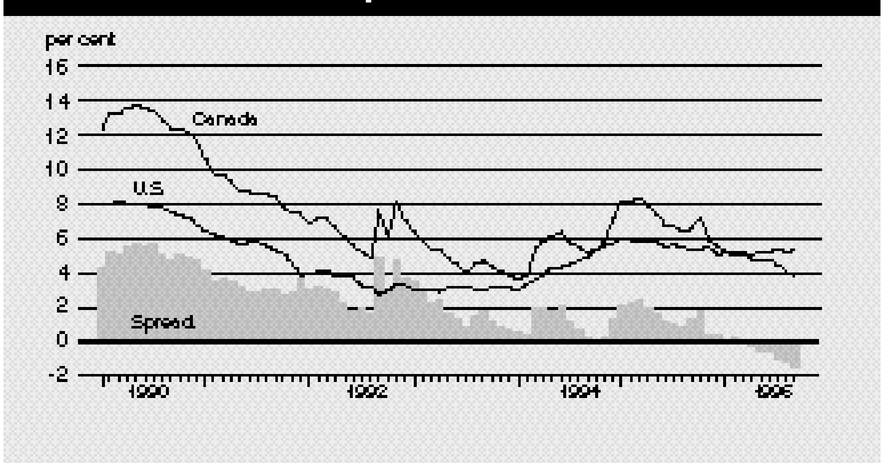
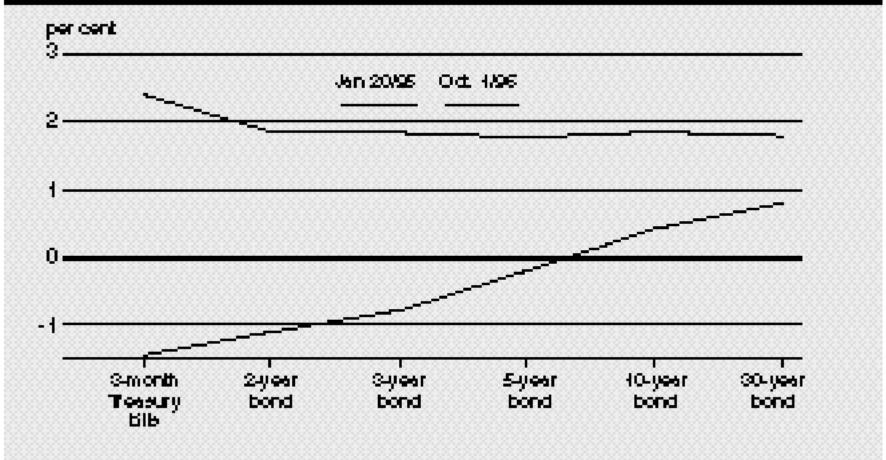
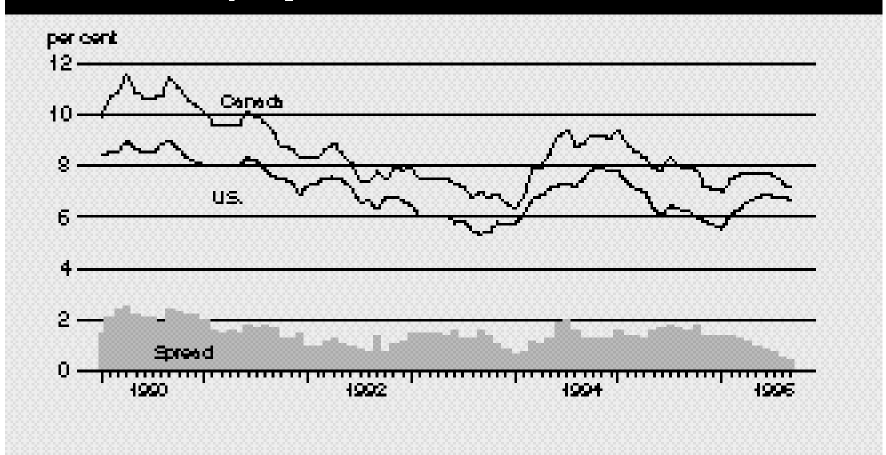


Chart 3.6 Canada-U.S. interest rate spreads



In the U.S., yields on 10-year government bonds, which had been declining since early 1995, have risen about 110 basis points since the beginning of 1996 (Chart 3.7). Rates on Canadian bonds also initially moved upward early in the year, but fell subsequently, with the result that Canadian rates are now roughly where they were at the start of the year. The spread between Canadian and U.S. long-term rates is now less than one quarter a percentage point ... 150 basis points less than one year ago. Nonetheless, the Canadian yield curve is unusually steep by historical standards. The difference between 3-month Treasury bills and 10-year benchmark government bonds is currently around 350 basis points, well above its historical average of about 90 basis points.

Chart 3.7 10-year government bond



Demand is strengthening and production growth will follow ...

The unexpected weakness in both foreign and domestic demand at the beginning of 1995 had left businesses with unusually large stocks of unsold goods. Over the second half of 1995 and the first half of 1996, overall demand was recovering, but output growth lagged the demand increases as businesses sought to reduce inventories to more normal levels. This slowed employment growth and, hence, growth in personal incomes and household expenditures.

This period of slow growth appears to be behind us, however, and growth should strengthen considerably in the rest of 1996 and into 1997.

- First, lower interest rates are boosting both consumer and business confidence and there are signs that a robust recovery is beginning in the interest-sensitive sectors of the domestic economy. The rebound is particularly evident in the housing market where sales of existing homes are up, unsold inventories are down and housing starts and building permits are rising. Business investment intentions for 1996 have also been revised upwards. Businesses now expect private non-residential investment spending to rise 4.4 per cent in 1996, a much stronger performance than the 2.3-per-cent decline they were expecting at the beginning of the year.

- Second, the inventory clearance now appears largely complete, particularly after the large inventory reduction in the second quarter of 1996. As a result, production growth should follow more closely the growth in demand in the coming months.

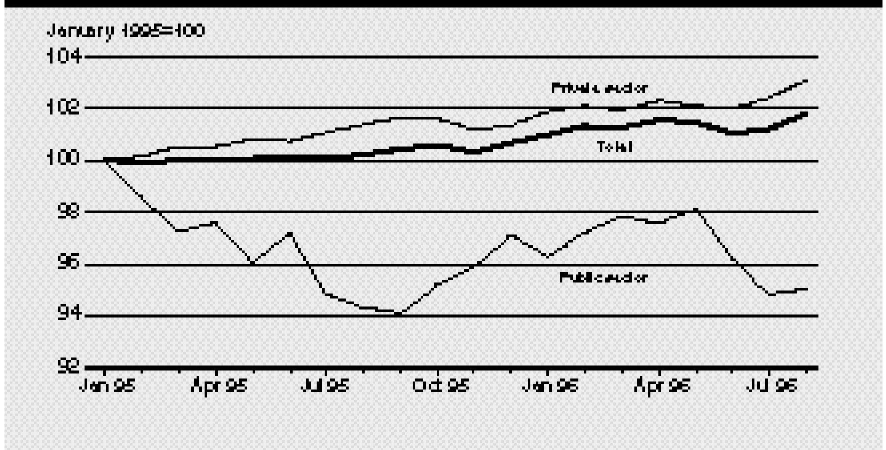
... and stronger growth will support job creation

The weakness in overall employment growth masks a fairly strong job-creation performance by the private sector. Since last November, 220,000 jobs have been created in the private sector. This was partly offset by a loss of 19,000 jobs in the public sector (Chart 3.8).

The shift of jobs from the public to private sector reflects a major restructuring of the domestic economy. The government sector has shrunk 2.2 per cent since the end of 1994, while the business sector has grown 2.2 per cent.

Despite this restructuring, overall GDP growth has picked up to around 1¼ per cent at an annual rate so far in 1996. Recent indicators support the view that the economy will strengthen in the second half of 1996.

Chart 3.2 Employment growth by sector



The outlook: updating the planning assumptions

The external environment

Major overseas economies

Growth in the main European countries in 1996 is expected to be below the levels registered in 1995, especially in France and Germany. Europe's sluggish economies are expected to pick up in response to both the easing in monetary conditions to date and an assumed further easing over the remainder of 1996. In Japan, the signs of strength now evident in the economy are expected to be a harbinger of better economic performance: real GDP is projected to grow 2.8 per cent in 1996 and 2.4 per cent in 1997, about three times the pace registered last year. Despite the pick-up in growth, inflationary pressures are expected to remain well contained in the major overseas economies.

The United States

After a period of sluggish growth through most of 1995, the U.S. economy rebounded in the first half of 1996. Real GDP grew 2.0 per cent in the first quarter despite the GM strike, the severe January weather, and the government shutdown, and 4.7 per cent in the second quarter. Clearly, the

U.S. economy cannot continue to grow at this unsustainable pace. The rise in long-term interest rates earlier this year, the stronger dollar, higher consumer debt, and fiscal restraint are operating in the direction of a slower pace of growth. The consensus view is that economic activity will moderate to near its long-run potential growth rate of just over 2 per cent by the end of this year, a rate that is also expected to prevail in 1997 (Table 3.1).

The consensus view is, however, that the momentum evident in the economy will likely lead to the Federal Reserve increasing the federal funds rate 25 basis points from its current level of 5.25 per cent by the end of the year. The federal funds rate is then assumed to remain unchanged.

Because of the slowdown in economic activity in the second half of this year and growth at around potential rates in 1997, CPI inflation is forecast to stay near its current level of 3 per cent.

Table 3.1
Economic assumptions for the U.S. – Private sector average

	1995	1996	1997
Real GDP	2.0	2.4	2.2
CPI	2.8	3.0	3.0
90-day Treasury bill rate (true yield)	5.7	5.3	5.5
10-year government bond rate	6.6	6.5	6.6

Source: Blue Chip Economic Indicators September 10, 1996. This is a survey of approximately 50 U.S. private sector forecasters. The 90-day bill rate has been adjusted from a discount basis by the Department of Finance.

The economic assumptions for Canada

Private sector sees low inflation and strong growth ahead

Private sector forecasters expect that Canada's advantageous competitive position will keep export growth healthy over the remainder of this year and next year even as the U.S. economy slows to a more sustainable pace of growth. Just as importantly, the substantial declines in domestic interest rates are expected to help strengthen domestic demand considerably in the second half of 1996. This will help stimulate job creation, growth in household incomes and consumer confidence, further boosting dometic demand.

As a result, private sector forecasters expect that the level of output will be about 2¾ per cent higher at the end of 1996 than it was at the end of 1995 – a sharp improvement relative to the 0.7-per-cent expansion during 1995 (Table 3.2). This implies that the average level of real GDP in 1996 will be 1.5 per cent above that in 1995.

Private sector forecasters expect that this momentum will carry through 1997, leading to stronger employment growth and a fall in the unemployment rate. They expect the CPI inflation rate to rise slightly in 1997 to just under the mid-point of the Bank of Canada's target inflation range. They also expect short-term Canadian interest rates will move up somewhat in 1997 with U.S. rates.

Table 3.2
Change in the average private sector forecast

	1995	1996	1997
Real GDP growth (%)			
February 1996	2.5	1.9	2.8
September 1996	2.3	1.5	3.1
Nominal GDP growth (%)			
February 1996	4.3	3.5	4.6
September 1996	3.9	2.7	4.6
Nominal GDP ($ billion)			
February 1996	782	809	846
September 1996	776	797	834
CPI inflation rate (%)			
February 1996	2.2	1.7	2.1
September 1996	2.2	1.5	1.7
Unemployment rate (%)			
February 1996	9.5	9.4	9.1
September 1996	9.5	9.5	9.2
Employment growth (%)			
February 1996	1.6	1.3	1.8
September 1996	1.6	1.4	1.9
91-day Treasury bill (%)			
February 1996	7.1	5.3	5.8
September 1996	7.1	4.5	4.5
10-year benchmark government bond rate (%)			
February 1996	8.1	7.2	7.4
September 1996	8.1	7.6	7.5

The February private sector average is based on 20 respondents for 1996 and 18 for 1997; it was carried out before the release of the Canadian Income and Expenditure Accounts for the fourth quarter 1995. The September survey is based on 15 respondents for both years, a somewhat smaller sample than usual as it includes only forecasters who have updated their forecasts since the release of the second quarter National Accounts data on August 30.

The changes in private sector views since the 1996 budget range from the small to the substantial. The smaller changes are that the outlook for real growth in 1996 has been marked down slightly but that for 1997 has been marked up and that the private sector now expects lower inflation this year and next. Historical data revisions and lower inflation forecasts also contribute to the lower level of nominal GDP in current private sector forecasts. The substantial changes are the major downward revisions to the outlook for short-term interest rates, revisions which help explain why forecasters now expect even stronger real growth in 1997. In contrast to the outlook for short-term rates, longer-term rates are expected to be slightly higher than projected at the time of the 1996 budget, reflecting the increases in the first half of the year that were primarily attributable to higher U.S. rates.

The favourable assessment of Canada's economic prospects underlying private sector forecasts is shared by major international organizations. The International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) both expect strong growth in the second half of 1996, followed by sustained robust growth in 1997 and beyond. Indeed, the IMF recently released its *World Economic Outlook* showing that Canada is expected to outgrow all the G-7 economies in 1997.

Prudent assumptions for fiscal planning

In the prudent planning alternative, short-term interest rates are assumed to be 80 basis points higher than the private sector average in 1997. Long-term interest rates, meanwhile, are assumed to be 50 basis points higher than the private sector forecast. These assumptions result in lower growth in nominal GDP in the prudent planning alternative, with nominal GDP growth 0.2 per cent lower than the private sector average (Table 3.3).

The prudence factors on interest rates reflects two key considerations.

- There remains a risk that continued strong growth expected in the U.S. will elicit a greater-than-expected tightening of monetary conditions by the Federal Reserve Board, and hence, higher U.S. interest rates by year end or early 1997, which could spill over to Canada. Prudent planning therefore dictates that we provision for short-term interest rates well above those expected by the private sector.

- However, the prudence factor on long-term interest rates is somewhat smaller than that applied to short-term rates. The Canadian yield curve is unusually steep; that is long-term rates are much higher than short-term rates than is usually the case. This may reflect some lingering worries on the part of investors concerning the sustainability of our low inflation performance of the past couple of years, especially as growth strengthens. While the unusual steep slope of the yield curve is consistent with the view that short-term rates could move higher in the near term, it offers the prospect that Canadian long rates may not rise commensurably with short-term rates as investors revise downward their expectations of future inflation. As a result, a somewhat lower prudence factor is appropriate.

Table 3.3
Change in prudent economic assumptions for fiscal planning

	1995	1996	1997
Real GDP growth (%)			
1996 budget	2.2	1.8	2.6
October update	2.3	1.5	3.0
Nominal GDP growth (%)			
1996 budget	4.0	3.3	4.3
October update	3.9	2.7	4.4
Nominal GDP ($ billion)			
1996 budget	780	806	841
October update	776	797	832
91-day Treasury bill (%)			
1996 budget	7.1	5.8	6.6
October update	7.1	4.5	5.3
10-year benchmark government bond rate (%)			
1996 budget	8.1	7.7	8.2
October update	8.1	7.6	8.0

1996 budget assumptions for 1995 interest rates are actual data.

Relative to the planning assumptions in the 1996 budget, short-term interest rates are lower, while long-term interest rates are broadly unchanged in 1996 and 1997. The level of nominal GDP, however, is down by about $9 billion in 1996 and 1997. This is due in part to historical data revisions, which should have relatively little impact on the fiscal outlook. The rest reflects a downward revision to the real growth outlook for 1996, although this is mostly offset by a stronger growth for 1997, and slightly lower inflation outlook.

4

Creating a Healthy Fiscal Climate: Continuing the Progress

Fiscal implications of the economic assumptions: changes to the 1996 budget track

Chapter 3 provided an update of the economic developments in the past year and sets out the economic assumptions that could be used in planning the 1997 budget. This chapter describes the fiscal implications of these economic assumptions, showing that the government is on track to meet its deficit targets and to set the debt-to-GDP ratio on a steady downward path. This chapter also describes in more detail the significant improvement that is underway in Canada's fiscal situation and the challenges that will have to be met to keep this improvement continuing.

1996-97

The deficit target for 1996-97, as first announced in *Creating Opportunity*, is 3 per cent of GDP, or $24.3 billion. This has been a major anchor in the government's strategy of achieving a balanced budget.

Nominal income in 1996 – the tax base for budgetary revenues – is now expected to be lower than assumed in the 1996 budget. This is because of revisions to the historical level of nominal GDP in 1995 and lower-than-assumed real growth and inflation in 1996.

The revisions to the historical estimates of nominal income for 1995 have no fiscal counterpart, as revenues for 1995-96 are already known. However, the lower-than-expected real growth and inflation outcome in the first half of 1996 and the consequent impact on nominal income will reduce forecast revenues. This is especially true for personal income taxes and excise taxes and duties.

In contrast, corporate income tax collections are expected to be higher-than-projected in the March 1996 budget, largely because of the much higher-than-expected outcome for 1995-96.

On balance, budgetary revenues are expected to be about $1.6 billion lower in 1996-97 than projected at the time of the 1996 budget. Program spending is now projected to be $0.3 billion lower.

Interest rates for 1996, especially short-term interest rates, have been much lower than assumed in the 1996 budget. As a result, public debt charges are now estimated to be $1.3 billion lower than projected in the 1996 budget.

Table 4.1
Changes to the 1996 budget deficit track

	1995-96	1996-97	1997-98
	(billions of dollars)		
March 1996 budget deficit track	-32.7	-24.3	-17.0
Changes:			
Revenues			
Personal income tax	0.3	0.9	0.7
Corporate income tax	-1.6	-1.0	-0.6
Excise taxes and duties	1.0	0.7	0.7
Other	0.7	0.9	1.0
Total revenue changes	0.3	1.6	1.9
Program spending			
Transfers to persons	-0.2	-0.1	-0.1
Transfers to other levels of government	-0.3	-0.2	-0.3
Other spending	-1.3	–	–
Total spending changes	-1.7	-0.3	-0.4
Public debt charges	-0.1	-1.3	-1.5
Contingency Reserves	-2.5	0.0	0.0
Total changes	-4.1	0.0	0.0
Revised deficit with unchanged policy	-28.6	-24.3	-17.0

Note: Negative sign indicates a reduction in the deficit. Positive sign means an increase in the deficit. Numbers may not add due to rounding.

Overall, lower public debt charges and program spending offset the lower budgetary revenues, leaving the deficit target of $24.3 billion on track.

Financial results to date support this conclusion. The deficit over the April to August 1996 period was $5.4 billion lower than in the same period in 1995-96. About $1.8 billion of this improvement was the result of developments unique to the first quarter of 1996-97. This includes higher tax remittances related to the 1995 taxation year, the timing of Goods and Services Tax collections and the manner in which some of the budget restraint measures are being implemented. These special factors mean that an assessment of the possible outcome for the year as a whole cannot simply be extrapolated from the improvement in the results to date.

Nevertheless, the results to date clearly indicate that the 1996-97 deficit target will be met and possibly bettered.

1997-98

The deficit target for 1997-98 of $17 billion, or 2 per cent of GDP, set out in the 1995 *Economic and Fiscal Update* and restated in the 1996 budget, also remains on track. Expenditure savings required to ensure the achievement of this target were contained in actions announced in both the 1995 and 1996 budgets.

Budgetary revenues are now expected to be $1.9 billion lower than forecast in the 1996 budget – entirely due to the lower forecast of nominal income. Within budgetary revenues, lower personal income tax collections, excise taxes and duties, and non-tax revenues more than offset higher corporate income tax collections. For planning purposes, the employee employment insurance premium rate in 1997 is assumed to be $2.90 per $100 of insurable earnings – the same as in the 1996 budget. In 1996, the rate was $2.95 per $100 of insurable earnings.

Program spending is expected to be $0.4 billion lower than in the 1996 budget.

Offsetting the weaker revenues are lower public debt charges, related to lower short-term interest rates than assumed at the time of the 1996 budget.

Table 4.2
Summary statement of transactions: status quo fiscal extension

	1995-96[1]	1996-97	1997-98
	(billions of dollars)		
Budgetary revenues	130.3	133.5	139.1
Program spending	112.0	108.8	105.6
Operating balance	18.3	24.7	33.5
Public debt charges	46.9	46.5	47.5
Underlying deficit	-28.6	-21.8	-14.0
Contingency Reserve	–	2.5	3.0
Deficit	-28.6	-24.3	-17.0
Net public debt	574.3	598.6	615.6
Non-budgetary transactions	11.4	10.6	11.0
Financial requirements	-17.2	-13.7	-6.0
GDP (calendar year)	776	797	832
Per cent of GDP			
Revenues	16.8	16.8	16.7
Program spending	14.4	13.7	12.7
Operating balance	2.4	3.1	4.0
Public debt charges	6.0	5.8	5.7
Deficit	-3.7	-3.0	-2.0
Financial requirements	-2.2	-1.7	-0.7
Net public debt	74.0	75.1	74.0

[1] Actual.

Continuing the progress

The government's ultimate objective is job creation and growth. The government's two-track approach – cleaning up the nation's finances, and ongoing structural reforms and strategic investments to further enhance the growth potential of the economy – will ensure increased confidence in Canada's economic future.

The pace that the government has chosen to achieve this result is measured, deliberate and responsible. Responsible fiscal action requires careful planning, appropriate time for adjustment to policy changes (both inside and outside government), and consideration of the economic impact of reductions in government spending.

Central to the government's fiscal strategy has been a two-year planning horizon. This strategy recognizes that the fiscal projections are simply too sensitive to economic developments to warrant a longer time frame.

Just as importantly, the two-year horizon is short enough to maintain the government's focus on ensuring that the targets are achieved; the costs of missing the deficit targets are simply too high.

This strategy is working. The deficit has been brought down from $42.0 billion, or 5.9 per cent of GDP in 1993-94, to $28.6 billion in 1995-96, or 3.7 per cent of GDP. The fiscal targets for 1996-97 and 1997-98 clearly remain on track.

Consistent with the two-year fiscal planning horizon, it is now appropriate to establish the deficit target for 1998-99.

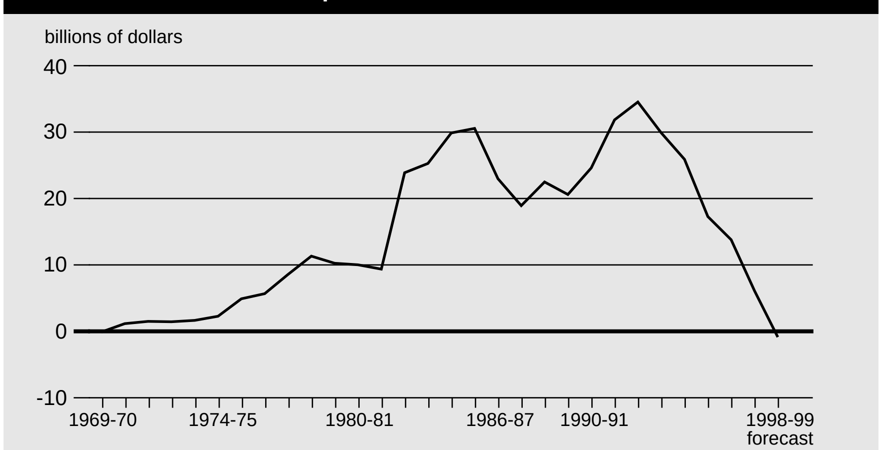
To build on the progress made to date and in line with the measured pace of deficit reduction established in the last three budgets, the deficit target for 1998-99 will be $9 billion or about 1 per cent of GDP. The last time the federal deficit was under $10 billion was 1976-77. The last time the deficit in relation to the size of the economy was about 1 per cent was in 1970-71.

The structural reforms that were put in place in the last three budgets will keep program spending on a downward track, and together with prudent economic planning assumptions mean that the deficit target in 1998-99 can be achieved.

Financial requirements eliminated by 1998-99

A deficit target of $9 billion for 1998-99 will mean that the government will not have to go to the private credit markets for new borrowing, other than that required to roll over the existing stock of debt (Chart 4.1). The last time this occurred was in 1969-70.

Chart 4.1 **Financial requirements**



Financial requirements, which measure the amount by which cash going out from the government exceeds cash coming in – and which is more comparable to how most other G-7 countries calculate their deficits – will be in a small surplus position by 1998-99.

The Deficit and Financial Requirements

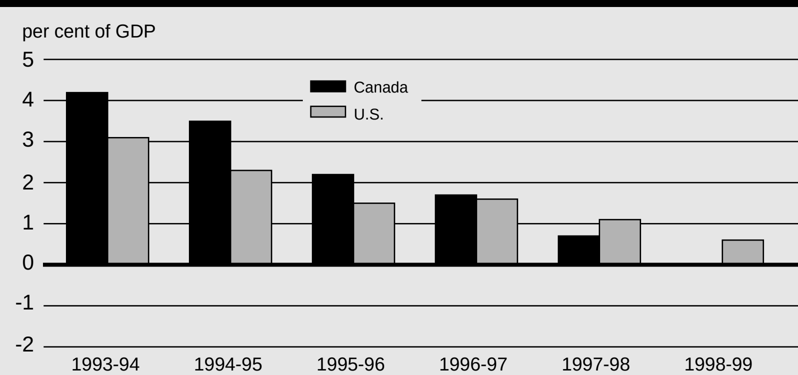
The difference between the deficit and financial requirements is due to a number of non-budgetary transactions that provide funds to the government. The largest of these is the government's employees pension accounts. Other small sources of funds include loans, investments and advances, cash in transit and accounts payable. These differences are explained in detail in Annex 2.

Fiscal position improving faster in Canada than in the United States

Financial requirements are more comparable to the way most central governments in major economies measure their *deficits*. For example, the United States deficit on a unified budget basis (UBB) is more comparable to Canada's financial requirements than the Canadian budgetary deficit.

Comparisons with the United States are particularly important for Canada because of the substantial interdependence between the two economies. In addition, the capital markets within the two countries are highly integrated, with the result that fiscal policies in the U.S. can have financial repercussions for the Canadian economy.

Chart 4.2 **Financial requirements: Canada and U.S.**



Note: Financial requirements for Canada; United Budget Basis deficit for the U.S.
Source: U.S. forecast from Mid-Season Review of the 1997 Budget (OMB).

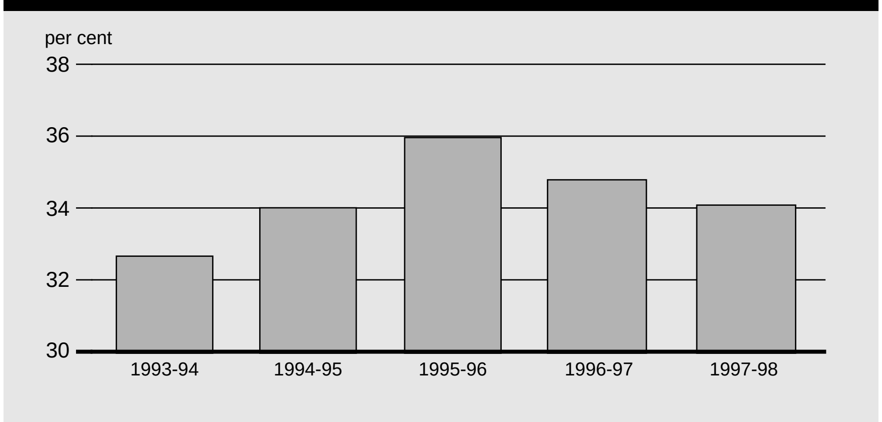
Canada's deficit, as measured by financial requirements in relation to GDP, has been falling much more rapidly than the U.S. government deficit in recent years (Chart 4.2).

Federal debt-to-GDP ratio will stabilize then fall

As noted in Chapter 2, declining deficits are only one measure of fiscal recovery. The crux of the fiscal problem in Canada is high debt, and the most appropriate indicator of this is the debt-to-GDP ratio. A key milestone on the road to restoring Canada's fiscal health will be reached in 1997-98. Following two consecutive decades of virtually uninterrupted increases, the debt-to-GDP ratio will start to decline. And the target of reducing the deficit to $9 billion in 1998-99 will ensure that the ratio will continue to decline after 1997-98.

As the debt-to-GDP ratio declines, the share of federal revenues needed to pay debt charges will also decline (Chart 4.3). However, the burden of the debt on the economy will remain high by historical Canadian and international standards. A sustained period of operating surpluses will be required before the debt-to-GDP ratio declines significantly.

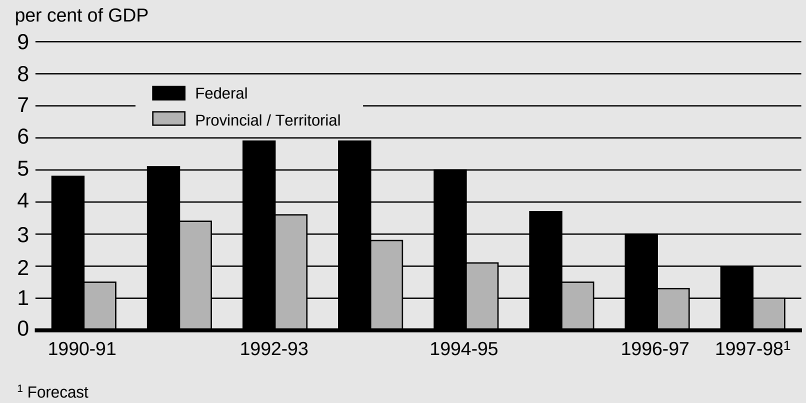
Chart 4.3 **Interest on the debt as a per cent of budgetary revenues**



Federal fiscal improvement complemented by provincial-territorial sector

The improvement in federal finances is being complemented by a similar effort at the provincial level. The combined provincial-territorial deficit has declined since 1992-93, from 3.6 per cent of GDP to 1.6 per cent of GDP in 1995-96 (Chart 4.4).

Chart 4.4 **Federal and provincial-territorial budgetary deficits (Public Accounts basis)**



Further progress is anticipated for 1996-97, with seven provinces expected to report balanced budgets or budgetary surpluses. Like the federal government, many provincial governments have also focused on reducing spending to achieve their fiscal targets.

However, because the federal fiscal imbalance was more serious than that of the provinces, the federal government has had to take significantly more fiscal action. For example, between 1993-94 and 1996-97, the percentage decline in federal program spending will be about three times larger than the percentage decline in total provincial program spending.

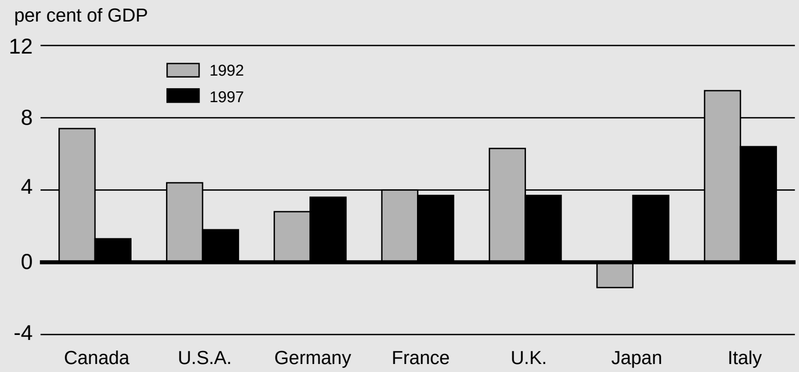
The coherence between federal and provincial fiscal strategies has resulted in an impressive decline in the total government deficit. From a peak of 9.6 per cent of GDP in 1992-93, the total government sector deficit is forecast to decline to some 3 per cent of GDP in 1997-98 (Public Accounts basis).

Fiscal improvements in total government sector also compare very favourably internationally

Among G-7 countries that have undergone fiscal consolidation over the last two decades, the improvement in Canada's total government fiscal balance on a National Accounts basis will have been the most substantial. From 1992 to 1997, the total government deficit in Canada will have moved from being the second highest among the G-7 countries to the lowest, at 1.3 per cent of GDP (Chart 4.5).

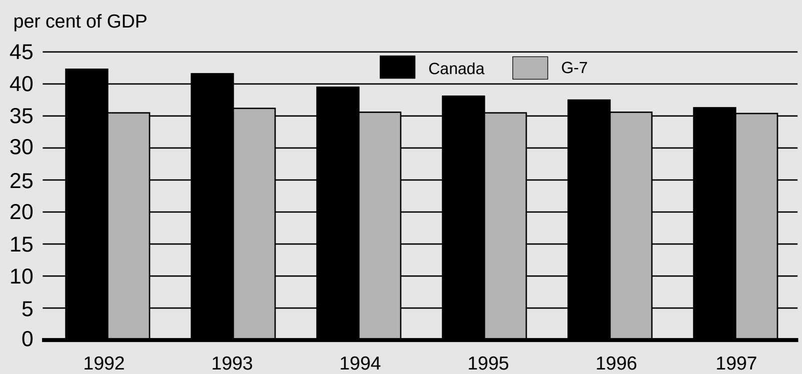
This improvement primarily reflects the impact of reductions in program spending. In 1992, program spending by all levels of government in Canada, as a share of GDP, was about 5 percentage points above the G-7 average (Chart 4.6). By 1997, it will be similar to the G-7 average.

Chart 4.5 Total government deficit in G-7 countries (National Accounts basis)



Source: Department of Finance for Canada, OECD Economic Outlook Data for other G-7 countries.

Chart 4.6 Total government program spending (National Accounts basis)



Source: Department of Finance, G-7 Average, OECD Economic Outlook Data, 1996.

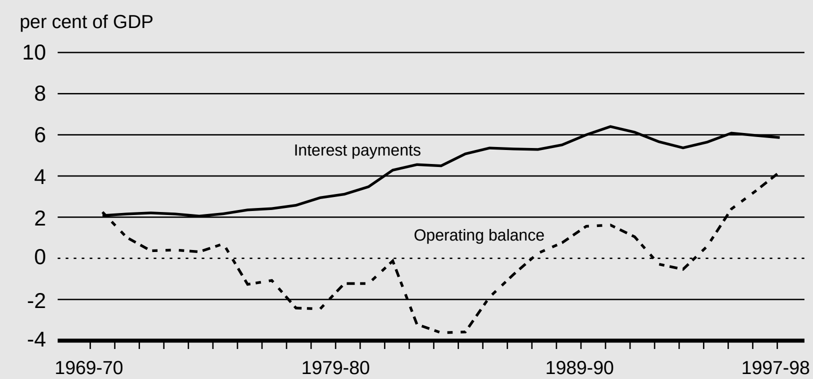
The ongoing challenge of restoring fiscal sovereignty

The fiscal actions already put in place will result in a sharply lower deficit. However, the federal debt-to-GDP ratio will remain high by historical and international standards. Prudent fiscal management will be required for some time yet if the government's ultimate fiscal objectives – a balanced budget and a significant reduction in the debt-to-GDP ratio – are to be achieved.

The operating reserve required to lower the debt-to-GDP ratio will depend on the evolution of interest rates and the growth in the economy. For illustration, suppose that from now on the government were to achieve and maintain an operating surplus equivalent to 5 per cent of GDP. This is higher than the surplus expected in 1997-98 of about 4 per cent of GDP (Chart 4.7). Under prudent economic assumptions, an operating surplus of 5 per cent of GDP would lower the debt-to-GDP ratio by 10 percentage points after 5 years – from 74 per cent to 64 per cent.[1] This would be a significant drop, but it would leave the debt ratio at about its level in 1991-92. Sustained large operating surpluses will be required before the debt-to-GDP ratio is reduced to a more manageable level.

The policy decisions necessary to eliminate financial requirements have now been taken and have put the government on track toward eliminating the deficit. The challenge now and for the future is to reduce significantly the debt-to-GDP ratio.

Chart 4.7 **Public debt charges and operating balance**



[1] This example assumes that nominal GDP growth is 3.5 per cent and the effective interest rate on the debt is 8 per cent.

5

Supporting Job Creation

Introduction

The federal government's top economic priority is clear: more and better jobs for Canadians. However, in a modern economy, sustained job creation must be generated by the private sector. That does not mean government has no role to play. On the contrary, government has a *critical* role to play in supporting job creation. The federal government has embraced that role through its Jobs and Growth Strategy as outlined in the 1994 *Agenda: Jobs and Growth* documents. This strategy addresses both immediate and long-term job creation needs through several key components:

■ setting the appropriate macro-economic conditions to keep interest rates low and encourage investment;

■ getting government right to ensure that government programs and policies contribute to a more productive economy (which is discussed in Chapter 2);

■ creating opportunities for Canadian businesses to grow by selling in the world economy;

■ investing in growth through strategic investments in new technology, in worker skills, and in capital, such as infrastructure; and

■ helping Canadians adapt by encouraging them to adjust to the changing economy, helping small businesses grow and prosper, reducing the regulatory burden on business and ensuring that Canada has an efficient, secure and competitive financial sector.

Canada is not alone in adopting such a strategy. Indeed, the Organization for Economic Co-operation and Development (OECD) recommended, in its own *Jobs Study*, that all industrialized economies adopt this approach.

Setting healthy macro-economic conditions

The issue

No economy can perform well without healthy macroeconomic conditions. In particular, strong growth – which leads to strong job creation – plays an essential role in helping the economy adapt to the major structural changes that are occurring.

A healthy macroeconomic climate is one where inflation is low and stable, where fiscal deficits and debt are under control, and where interest rates – that is the cost of capital – are low and stable. A healthy macroeconomic climate enhances consumer and business confidence, encourages domestic and foreign businesses to expand their activities in Canada and to undertake investments in new capital and technologies. It also encourages both businesses and workers to invest in needed education and skills.

It is the responsibility of governments to establish a healthy economic climate by keeping inflation low and stable, and by getting and keeping their fiscal house in order.

The policies

Low Inflation

Canadian economic policy has led to a sustained period of low inflation. Inflation has averaged under 2 per cent in the last three years – its lowest sustained level in three decades and less than one-third of its average during the 1980s.

Canada has not been alone in pursuing the benefits of low inflation. In 1995, inflation in the G7 countries averaged 2.4 per cent, compared to 5.6 per cent in the 1980s. The record shows that – in the long-run – economies with low and stable inflation perform better than economies with high and variable inflation. In particular, countries with sustained low inflation tend to have lower unemployment.

Getting government finances in order

For several years, however, Canada's fiscal situation prevented the full benefits of our excellent inflation performance from being realized. For instance, short-term interest rates were over 1 percentage point higher in Canada than in the U.S. in 1994, although inflation in Canada was about 2½ percentage points below that in the U.S. This was, in large part, because of investors' concerns about governments' abilities to meet their financial commitments if they continued to build up debt by running high fiscal deficits.

This kept interest rates high for all borrowers in Canada. Those high real interest rates discouraged business investment and consumer spending. One only has to look at Canada's depressed housing market in 1995 to see the impact. High real rates also worsened the fiscal situation. The weakened economy slowed revenue growth while interest costs rose. This vicious circle had to be broken by a determined effort to cut fiscal deficits.

This shows that deficit reduction and debt control is not an end to itself but rather *an integral part of the government's jobs and growth strategy*. All Canadian governments recognize the importance of fiscal prudence and have been successfully reducing their deficits.

The payoff

The payoff is already evident. Investors' confidence in Canada has substantially improved and, as a result, the risk premium in Canadian interest rates has been reduced. For example, in 1994, many investment firms were recommending that their clients reduce their Canadian investments. But, by 1996, they were reversing their positions and telling investors to substantially increase their holdings of Canadian assets.

The resulting declines in interest rates since early 1995 have pushed Canadian short-term rates well below those in the U.S. These lower interest rates encourage consumers to buy and businesses to invest by lowering the cost of borrowing or raising capital. The decline in mortgage rates has contributed to more than a 15-per-cent increase in housing starts and almost a 50-per-cent increase in existing housing sales since their troughs in 1995. The payoff is also evident in business confidence, which is also up strongly to one of its highest levels since the end of the 1970s, and in the recent increases in investment intentions.

Creating opportunities for growth through trade

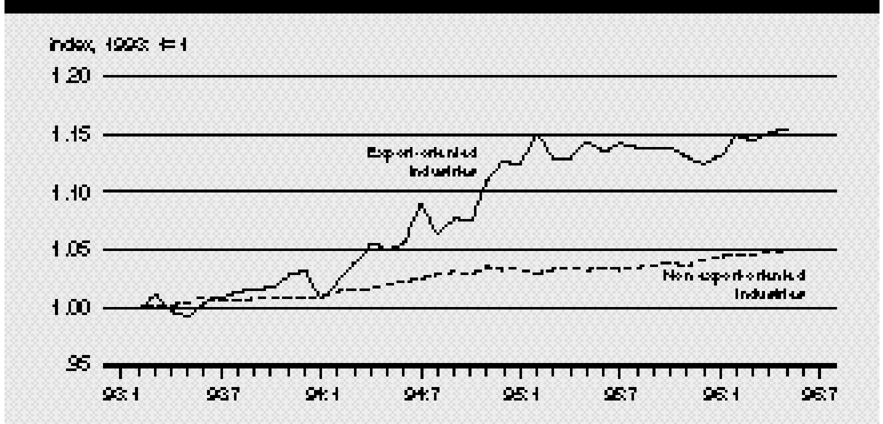
The issue

Creating and sustaining a positive macroeconomic environment is vital for creating more and better jobs. But it is only part of the story. Improving access to foreign markets, as has been achieved under NAFTA and the World Trade Organization (WTO), and capturing the expanded export opportunities, are also vital for job creation.

Canadians have always been trade oriented. Selling our products and services around the world has generated jobs, increased wealth, and brought all Canadians a higher standard of living. *This is as true today as it has been throughout Canada's history*. In fact**,** the dramatic growth in exports in recent years has been the strongest single contributor to Canada's economic growth and job creation.

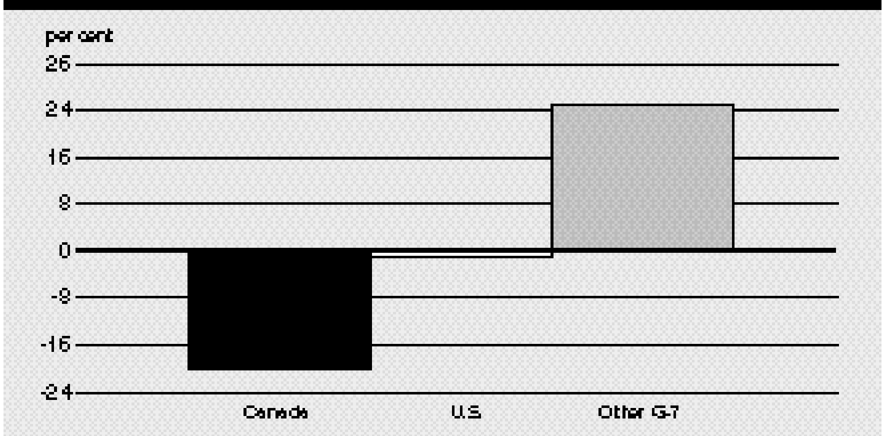
However, many Canadians remain concerned that freer trade increases competition, and that this threatens job security. There is no doubt that the growth in world trade has had adverse effects on some businesses and some workers. This is the nature of change and has been part of Canada's economic development for decades. While imports have at times displaced production in Canada, the resulting job losses have been more than offset by the employment gains from increased exports (Chart 5.1). Trade liberalization has consistently been positive for the overall Canadian economy, and it is the export-oriented industries which have seen the healthiest rate of job creation.

Chart 5.1 Employment growth by trade orientation



Most of Canada's foreign trade, and most of the recent growth in our trade, is with other industrialized countries that have wages and other costs similar to or even higher than those in Canada. For example, in 1995, 80 per cent of Canada's exports went to the U.S. and 75 per cent of our imports came from our southern neighbour. In the same year, 12 per cent of our exports went to, and 16 per cent of our imports came from other OECD countries, almost all of which are highly industrialized. Declines in Canada's unit labour costs relative to these countries since 1991 have improved Canada's competitiveness, and contributed both to export growth and job creation (Chart 5.2).

Chart 5.2 Change in manufacturing unit labour costs since 1991 (measured in a common currency)



Only 9 per cent of Canada's imports come from other areas, most of which are lower-wage developing countries. While competition from these countries can lead to job losses in some firms and companies, on balance Canada has been more than able to compete with these countries. With the advantages of our increasingly skilled work force, our use of technology and our physical and social infrastructure, Canadian workers are significantly more productive than workers in lower wage developing countries. For example, studies have shown that, although wages in Canada are as much as seven times higher than those in Mexico, Canadian workers, because of their higher productivity, remain very competitive with Mexican workers.

Furthermore, the liberalization of international trade gives Canadian producers access to larger markets. That allows them to specialize in what they do best and to become both more efficient and more competitive. In turn, Canadians have access to better-quality goods and services at lower prices, which also raises our standard of living.

The policies

To preserve and increase this key source of growth and job creation, governments must support the private sector in securing and expanding Canada's access to world markets for its goods and services. This includes pursuing trade liberalization through multilateral and bilateral trade agreements, implementing measures to assist companies develop and expand their export business, and bolstering awareness of Canada's advantages as a location for investment.

Trade agreements

Canada has been, and remains, at the forefront of efforts to strengthen the global rules-based trading system and to liberalize trade. Canada was a key participant in the recent Uruguay Round of multilateral trade negotiations which resulted in the establishment of the World Trade Organization to oversee and guide the expansion of world trade. The OECD has estimated that the WTO agreement will increase the national incomes of those participating by about $320 billion. This increased income creates new demand for goods and services, leading to higher employment. For Canada, it is estimated that real annual incomes of Canadians from the WTO agreements will increase by $3 billion in perpetuity.

Following the conclusion of the Uruguay Round, a WTO agreement in financial services was reached under the auspices of the *General Agreement on Trade in Services* (GATS). The agreement involves over 90 countries. Canadian financial institutions, many of which are important exporters, will benefit from the agreement as a result of its provisions for broad-based trade disciplines and as a result of the enhanced trade liberalization commitments by other countries to open their financial markets. This will provide greater opportunities for Canadian financial institutions to offer competitive financial services worldwide.

Canada has also signed a free-trade agreement with Israel and has undertaken negotiations to establish an agreement with Chile to expand access to each others' markets. In addition to pursuing further avenues for trade liberalization and strengthening the rules-based trading system, the government will continue to act vigorously to challenge unfair trade practices by others and defend Canadian trade interests in disputes about Canadian practices, such as in softwood lumber.

Team Canada trade missions

A key part of the focus on trade is the Team Canada trade missions. The two Team Canada missions plus the trade mission to Latin America in the past year and a half have brought home some $20 billion worth of business deals for Canadian companies and created or sustained thousands of jobs. As a result of this success, more Team Canada missions are planned for the future.

Helping Canadian Business Export

The Jobs and Growth Strategy is helping prepare companies for export opportunities through initiatives such as:

- the ***International Business Opportunities Centre***, established last fall, has already helped almost 6,000 Canadian companies access new business opportunities from around the world;
- a market research centre has been established to provide market intelligence and other information to exporters to strengthen our ability to compete in foreign markets;
- twenty-three national sector teams of public and private sector representatives are working together to devise action plans to target international business development more effectively;
- the federal government has reduced tariffs on a wide range of goods to reduce costs and help Canadian manufacturers become more competitive in domestic and world markets. (In 1996, the reductions in tariffs since 1994 will save Canadians $1.9 billion.) Other tariff-related measures have provided administrative and cash-flow savings to Canadian exporters.

More export financing

Access to competitive export financing often determines whether or not a firm can export. In the 1996 budget, the Export Development Corporation (EDC) was provided with $50 million of additional capital to support new approaches to export financing and to create new partnerships with exporters and commercial banks.

In September, the EDC committed an additional $1.5 billion in new export financing to support sales of Canadian goods and services to foreign customers in 50 higher-risk emerging markets worldwide. This is only the latest in a series of steps to help exporters to successfully break into international markets.

Other EDC Initiatives

- Since 1993, the EDC has opened or reopened nearly 20 new markets in which it provides export financing.
- The EDC recently announced less restrictive coverage for short-term credit insurance for exporters to 33 markets.
- The EDC has also created specialized teams which focus on small- and medium-sized enterprise (SME) exporters and have developed a number of specialized products and services for them.

Attracting international investments

More than one job in 10 and more than half of Canada's exports are directly due to international investment in Canada. The Jobs and Growth Strategy is helping to attract high quality, technology-rich international investments to Canada. In particular, Canada's improved macroeconomic climate and much improved competitive position has made the country one of the *top ranked* countries in the world in which to invest.

Tax policy also plays an important role in maintaining Canada as an attractive location for investment and job creation. It is of particular importance that Canada maintains a competitive tax regime in relation to its major trading partner, the United States. All levels of government have a role to play here.

The payoff

Businesses are increasingly finding that Canada is a cost-effective place to invest in and produce from. As a result, Canadian exports have grown much faster than imports. The payoff is obvious in the numbers.

- In 1995, foreign direct investment as a per cent of GDP reached its highest level since 1980.
- The volume of Canada's exports has soared, up 28 per cent since the end of 1993. In 1995, 42 per cent of the real value of Canadian production was exported, making Canada the most export-oriented of the G-7 economies.
- As a result, Canada has experienced a dramatic $19-billion improvement in its real trade balance since the end of 1993, an improvement which led to a current account surplus in the second quarter of 1996 – the first since 1984.
- This improvement in Canada's international trade balance has created about 275,000 jobs for Canadians in the past 2½ years.

Investing in growth

A healthy macroeconomic climate and expanding opportunities for trade are both key ingredients for a strong economy. But, the role of government does not end there. There is also a key role for governments in helping businesses and their workers seize the opportunities for growth created by growing world trade and advances in technology. Canada's success at world trade has not been built on a foundation of low wages. Instead, it has been built on a foundation of up-to-date technology, an educated and skilled workforce, and a high level of investment to make the economy more productive. Together these factors allow Canada to be competitive with high wages, even by the standards of most industrialized economies. Further productivity growth in Canada will sustain and increase these wages.

Thus, no job strategy would be complete without the government acting to ensure that Canada retains and enhances its competitive advantages in technology, worker skills and capital. The government has been targeting its assistance on strategic investments that promise the greatest long-run benefits. Reflecting the primary role of businesses in creating jobs, many initiatives are in partnership with the private sector.

Investing in technology

The issue

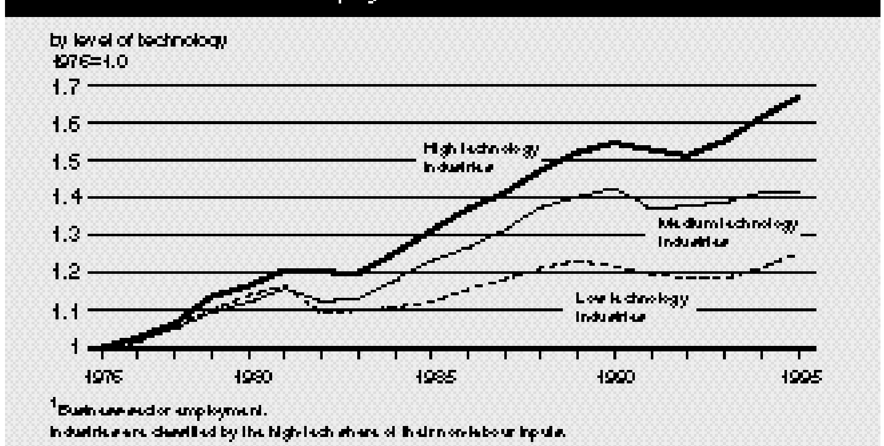
One of the key goals of the Jobs and Growth Strategy is the development of technology. Technology enhances competitiveness. It delivers new products and services, more product choice and lower prices. This creates new demand for goods and services, both in Canada and abroad, creating more and better paying jobs.

People are often concerned that improvements in technology result in the replacement of workers by machines. While new technology does tend to reduce the amount of labour needed to create a given product, there is overwhelming evidence that the resulting higher quality of products and lower production costs leads to a net increase in jobs. As the OECD *Jobs Study* states:

> *"Empirical analysis based on cross-country comparisons tends to confirm the fact that the employment record has been better in those countries which have experienced the best performance in terms of pace of structural change, technological specialization, investment rates and productivity gains."*

In other words, those who willingly embrace technology and use it create more jobs. This has been very evident in Canada, where, from 1976 to 1995, employment in industries that used high-technology inputs intensely grew more than twice as fast as employment in low-technology industries and 60 per cent faster than in medium-technology industries (Chart 5.3).

Chart 5.3 Growth in employment[1]



The policies

The Jobs and Growth Strategy is helping Canadian businesses become more adept at developing and using technology. Many of these initiatives involve partnerships with the private sector and other levels of government.

Helping to Develop Technology

- Businesses are encouraged to create new technology and processes with one of the most generous tax treatments of research and development in the world.
- Through ***Technology Partnerships Canada***, the federal government will invest approximately $250 million by 1998-99 to lever additional investment from the private sector in strategic high-tech sectors of the economy. Under this initiative, the government treats its funding as a key strategic investment rather than a grant. The funds are to be reimbursed when the products in which they were invested are a success. The reimbursements are returned to the fund to help finance additional projects.
- In the 1996 budget, the government injected almost $50 million into the ***Business Development Bank of Canada***. This funding will leverage an additional $350 million in bank loans to Canadian small business and growing knowledge-based, export-oriented businesses.
- The development of the ***Information Highway*** is another critical link in the Jobs and Growth Strategy, crucial to the competitiveness of Canadian businesses and their ability to create jobs. The government is actively promoting the development of the Canadian portion of the global information highway and working to ensure Canadians get access to the Information Highway through programs such as the ***Community Access Program***.
- The ***Industrial Research Assistance Program*** (IRAP) provides professional advice, technological know-how and financial support to small- and medium-sized companies that want to strengthen their R&D capabilities.
- ***Sectoral Partnerships*** bring together business, labour and government to promote standards for workers' skills and training to meet the needs of the dynamically evolving market.

Investing in education and skills

The issue

Educated and skilled workers are also an essential part of the Jobs and Growth Strategy. Without a qualified workforce, it is hard to generate or even use the latest in technology. There are two ways governments can help Canadians get the education and skills they need for the modern economy.

- The first is to invest in the education of Canada's young people and help them with the all-important transition from school to work.
- The second is to help those who are in the labour force to upgrade their education and skills, especially those who have lost their jobs and are having difficulties getting reintegrated into the labour market.

The policies

Investing in youth

One of the priorities of the Jobs and Growth Strategy is ensuring that Canada's youth have the education and opportunity to participate in building Canada's future by finding meaningful jobs – especially that critical first job that bridges the gap between school and work.

Loans and Tax Assistance for Education

- Under the Canada Student Loans Program, the government supports more than $1 billion in new student loans each year to help students to advance their post-secondary education. On August 1, 1995, the government made a series of major reforms to this program which provided $85 million in additional assistance to students who most need it.
- In the 1996 budget, the federal government provided an additional $80 million a year in tax assistance to help students and their families deal with the rising costs of higher education:
  - the amount on which the education credit is based was increased from $80 to $100 per month;
  - the limit on the transfer of tuition and educational amounts was increased from $4,000 to $5,000;
  - the annual limit on registered education savings plan contributions was increased from $1,500 to $2,000.
- The eligibility for the Child Care Expense Deduction was expanded to allow single parents or both parents who attend school full time to claim the deduction against all forms of income.

The first step is to help young people get a good education. That's why the government has set aside additional funding to help young Canadians to finance their education and get summer jobs.

The second step is to help young Canadians find work and make the transition from school to work. To do so the government allocated an additional $315 million, over three years, for youth programs in the 1996 budget.

■ The government doubled – to $120 million in 1996-97 – the assistance provided for student Summer Career Placements. In total, about 60,000 summer jobs were created this year.

Assisting the Transition to Work

■ Since 1994, ***Youth Service Canada*** has funded over 360 projects, involving over 5,200 young people in community service activities.

■ ***Youth Internship Canada*** has helped almost 26,000 young people make the transition from school to work.

■ The ***Student Connection*** program has 2,000 students responsible for training managers at 50,000 Canadian companies on how to use the Internet as a business tool.

Helping existing workers retrain

The vast majority of people who will be in the Canadian workforce in the year 2000 has already passed through the formal education system. Many of them will, however, need further education and skills upgrading. In many cases, the best way for them to get those skills will be through on-the-job training, as designed and implemented by the provinces in partnership with the private sector.

Governments have both the obligation and responsibility to help these people upgrade their skills. The Government of Canada has offered to negotiate agreements with interested provinces and territories to allow them to take responsibility for active employment measures funded through the Employment Insurance (EI) Account. These arrangements will focus on achieving mutually agreed labour market results in a manner reflecting the concerns of the provincial or territorial government. Negotiations with the provinces and territories are now underway led by the Minister of Human Resources Development. This proposal offers an unprecedented opportunity for new federal-provincial partnerships in developing labour-market arrangements that are tailored to reflect regional and local needs.

For the first time, all active measures funded through the EI account will be subject to consistent and rigorous results-based measurements. As a result, governments will be able to ensure active measures are well targeted to address the unique employment challenges and requirements of specific groups, such as youth. Further, Human Resources Development will work to expand the national labour market information and exchange system.

Employment Initiatives with EI Reform

Approximately $2 billion will be made available in discussions with provinces and territories for results-oriented employment measures which could include:

- *targeted wages subsidies* that encourage hiring and provide on-the-job experience that will lead to long-term employment or re-employment;
- *targeted earnings supplements* that will make work pay for individuals making the transition back into employment;
- *self-employment assistance* that helps start businesses and create jobs for others;
- *job-creation partnerships* between the provinces, the private sector and communities that will create work opportunities where there is high unemployment; and
- *skill loans and grants* to let individuals make their own choices about what skills they need.

Investing in infrastructure

The issue

Another important role for government is to support initiatives and activities where the benefits are so widespread that no individual firm or government would undertake the activity alone because they would not get all the benefits. Infrastructure investment is such a case.

The policies

The $6-billion *Canada Infrastructure Works* partnership between federal, provincial and municipal governments was launched on December 21, 1993 in response to the widespread need to upgrade and renew municipal infrastructure. A recent evaluation report estimates that about 80,000 additional person years of work will be created over the duration of the program.

Other Infrastructure Initiatives

- The ***First Nations Infrastructure Initiative*** which addresses infrastructure priorities in First Nations communities and creates jobs for Aboriginal peoples.
- The ***Federal Buildings Initiative*** which is an innovative program to encourage federal departments to improve energy efficiency. Private-sector firms pay the up-front costs of energy-saving retrofitting and the government then repays them out of its initial energy savings. The end result is greater energy efficiency and lower government energy bills, at no up-front cost to the government.
- The ***Western Grain Transportation Act Adjustment Fund***, which provides $140 million in 1996-97 and 1997-98 to develop infrastructure supporting western agricultural producers affected by the removal of the transportation subsidy for grain.

Helping Canadians adapt

Helping workers adjust to change

The issue

In addition to having education and skills, Canadians also need help adapting to the changing economy. In some cases, the help consists of increasing incentives to look for, find, and keep jobs. In many cases, the help must be more direct, through programs which ease adjustment.

The policies

The recent changes to the EI system will increase incentives to work. Rather than simply provide income support, the new system will offer unemployed Canadians the incentives and tools to find new opportunities. It represents the most fundamental restructuring of the system since the existing structure was introduced in 1971.

- Benefits will be more closely tied to work effort. They will be assessed in terms of total hours worked and total earnings over a fixed period, rather than the number of weeks worked. This will encourage people to work as much as possible.

As well, changes in EI premium rates and the maximum insurable earnings for EI since 1994 will effectively reduce employee and employer contributions by $1.8 billion in 1996. This is a significant reduction in payroll taxes that will lead to lower labour costs and increased employment.

The 1996 budget also increased the incentives to work through a substantial rise in the *Working Income Supplement* (WIS) from $500 to $750 in July 1997 and to $1,000 in July 1998. The WIS helps low-income parents enter and stay in the labour force by helping to defray some of the extra costs related to working. When fully phased in, the higher WIS will provide an additional $250 million annually to an estimated 700,000 low-income working families.

Other Programs to Help Canadians Adjust

- The ***Sectoral Partnerships Initiative***, which brings together employers, workers, educators and governments to address the challenges of a changing economy on a sector-by-sector basis.
- The ***Community Development Program***, which helps to create jobs in communities with severe labour market problems.

Helping small business grow

The issue

Small- and medium-sized enterprises (SMEs) are a critical element of the federal government's plan for Jobs and Growth. Small firms (with fewer than 50 employees) and self-employed entrepreneurs now make up 97 per cent of the businesses in Canada. Adding in firms with up to 300 employees covers over 99 per cent of the businesses in Canada. SMEs account for 55 per cent of Canada's employment and 60 per cent of Canada's output.

Initiatives to Help SMEs

- The ***Small Business Loans Act*** (SBLA) is designed to help new and existing small businesses obtain term loans from chartered banks and other lenders, to finance the purchase and improvement of fixed assets.
- The ***Business Development Bank of Canada*** (BDC) provides financial and management services to help create and develop small- and medium-sized businesses. Through it, a wide spectrum of specialized business counselling, training and mentoring services and financing options are made available to commercially viable business projects. BDC financing complements that of commercial financial institutions.
- The ***Canada Community Investment Plan*** (CCIP) will provide small businesses across Canada with the skills and resources to access the risk capital required to finance growth.
- ***Canada Business Service Centres*** (CBSC) provide Canadian business people with a wide range of information on government services, programs and regulations. Each CBSC offers a variety of products and services to help clients get quick, accurate and comprehensive business information.
- Small business especially can be hobbled by regulatory burdens. As a result, a variety of initiatives are underway with the private sector to reduce the regulatory and paper burden on businesses, especially small- and medium-sized businesses, and to set standards that will make it easier and less costly to conduct business in Canada.
- ***The $500,000 lifetime capital gains exemption*** for shares of qualifying small businesses encourages investment in small business, and can help small business owners to accumulate assets for retirement.
- ***Labour Sponsored Venture Capital Corporations*** (LSVCCs) facilitate access to capital for SMEs. The federal government, and most provincial governments, provide tax credits with respect to the acquisition of shares by individuals in LSVCCs, which has helped them accumulate a large pool of capital. LSVCCs are required over a number of years to invest most of these funds in SMEs.
- The ***Federal Income Tax System*** for small business is one of the most favourable in the world. It contains many provisions that benefit small businesses including a reduced corporate income tax rate, enhanced refundable research and development tax credits, and a $500,000 exemption for capital gains resulting from investments in small corporations. These measures provide additional funds to small businesses for reinvestment and increase their ability to access additional external financing.

While SMEs are a key source of job creation in this country, there are also important linkages between SMEs and larger firms in Canada which warrant attention. Restructuring of large corporations and governments has contributed to the rise in small businesses, as activities once done in-house are increasingly purchased from SMEs. As a result, Canada's large firms are the prime consumers of many of the services and products of Canadian SMEs, particularly in the export sector. In this context, the health and prosperity of Canada's large firms is also very important to the success and survival of Canadian SMEs.

The policies

The most appropriate policies are those which help small firms in areas where they have difficulty competing because of their size. This can include promoting international competitiveness through trade and investment, as well as through technology adoption, adaptation and development.

Financial sector policies

The issue

An efficient, secure and competitive financial sector is a critical component of job creation and growth. Canadians now enjoy one of the strongest financial systems in the world, and one which, with over 500,000 employees, is itself an important source of jobs. However, global and technological developments are posing complex challenges to this sector that must be addressed as we go forward.

The policies

The federal government has introduced proposals which call for important adjustments to the legislation for the financial sector. In addition, the government is establishing a *Task Force on the Future of the Canadian Financial Services Sector* with a broad mandate to make recommendations to enhance the contribution of the sector to job creation, economic growth and the new economy.

The payoff from the jobs and growth strategy

Clearly, there is no single "magic bullet" solution which can solve all Canada's economic problems at once. The solution lies in pursuing many policies – all with the one goal of more and better jobs. The Jobs and Growth Strategy has been doing that. It has put in place a process that has begun to reduce the cost of capital and will lead to improved productivity of Canadian businesses and workers by building a more dynamic and adaptive economy with a better-educated, better-skilled workforce. Such an economy will generate the growth and jobs Canadians need.

As a long-term strategy, much of the employment and growth gains from the strategy have yet to be realized. But the most recent numbers show the policy has already begun to pay off as Canadian interest rates come down and growth strengthens.

- About 670,000 jobs have been created since the end of 1993.
- Private sector job growth has been even stronger with nearly 770,000 jobs created over the same period of time.
- Since the fourth quarter of 1993, employment growth in Canada has been faster than in any other G-7 country except the U.S., where growth has been about the same.
- In fact, Canada has created more jobs than the combined total of Germany, France, Italy and the U.K. over this period, despite major restructuring of the public sector in Canada.

But this employment growth is still not good enough. The job gains in the private sector have been somewhat overshadowed by public sector losses as a result of the major restructuring of the federal and provincial sectors. As this restructuring matures, continued lower interest rates and a strong competitive private sector can be expected to strengthen total employment growth further. This is reflected in the June 1996 *OECD Outlook*, which forecasts that Canada will have the highest rate of job growth of any G-7 country in 1996 and 1997.

6

Conclusions and Main Issues

Considerable progress has been made in recent years in restoring fiscal health. The fiscal deficits, at both the federal and provincial levels, which seemed so intractable for many years, are now on a clear downward path. The actions taken in the last three budgets by the federal government will halt the rise in the federal debt-to-GDP ratio, and put it on a firm downward path. These achievements have created the necessary conditions for a substantial reduction in interest rates and for stronger economic growth and job creation.

The actions in the last three budgets restored credibility to federal government budget making. These actions addressed the immediate fiscal problem in a determined and measured way. But they went beyond the short term, ensuring that future spending pressures were being addressed now in a manner that ensures the sustainability of important social programs.

The government's economic and fiscal strategy is beginning to pay off and there are signs that the economy is now gaining strength. A rebound is particularly evident in the housing market and business investment intentions for 1996 have been revised up significantly.

This document is designed to facilitate the dialogue among Canadians on how best to continue the progress in restoring the federal government's finances – a key condition for sustained economic growth and job creation.

The public consultations that took place leading up to the last three budgets were instrumental in determining the strategy and measures that formed those budgets. Due to these measures, the necessary actions are now being implemented to achieve the announced deficit targets.

The House of Commons Standing Committee on Finance will be asked to consult with Canadians and advise on:

- First, are the updated economic assumptions for 1996 and 1997 prudent – particularly with respect to interest rates and nominal income – and what should the economic assumptions for these two variables be for 1998?

- And second, although focus has primarily been placed in recent years on the Public Accounts deficit, there are other complementary measures of the federal government's fiscal position – net public debt, interest-bearing debt, financial requirements, National Accounts deficit. The Auditor General, in his 1995 report to the House of Commons, *Deficits and Debt: Understanding the Choices*, recommended that more attention be paid to the debt-to-GDP ratio. How should these different fiscal measures be used by the government to improve understanding of the government's overall fiscal health and how should they be used in setting the future course of fiscal policy?

Annex 1

Fiscal Outlook: Sensitivity to Economic Assumptions

Sensitivity to changes in economic assumptions

Estimates of the main fiscal aggregates are sensitive to changes in economic assumptions – particularly to the level of nominal income and interest rates. The following sensitivity estimates 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 one-per-cent increase in the level of nominal GDP leads to higher tax bases and thus higher revenues. The ultimate deficit impact would depend on the source of the increase in nominal incomes. The most favourable impact on the fiscal situation would occur if all of the increase in nominal GDP resulted from increased productivity. Inflation and interest rates would not rise and indeed could decline. Revenues would be higher and borrowing costs lower.

If, however, the improvement in nominal GDP was solely due to inflation, then some of the positive impact of government revenues would be offset by higher spending on those programs indexed to inflation.

Higher nominal GDP, caused either through 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 productivity, the deficit would be lowered by $1.3 billion in the first year, rising to $1.7 billion after four years, as savings from lower debt charges begin to accumulate (Annex Table A1.1).

Table A1.1
Fiscal sensitivity analysis: 1-per-cent increase in 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 direct 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 would cause the deficit to decline by $1.3 billion in the first year (Annex Table A1.2). As longer-term debt matures and is refinanced at the lower interest rates, the favourable impact on the deficit increases, such that by year four, the deficit is about $3.0 billion lower.

Table A1.2
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 decrease	0.3	0.4	0.4	0.4
Expenditure reductions	1.7	2.6	3.0	3.4
Deficit reduction	1.3	2.2	2.6	3.0

Annex 2

The Budgetary Deficit, Financial Requirements, and the National Accounts Deficit

There are three basic measures of the federal government's fiscal position in Canada – the budgetary deficit/surplus, financial requirements/sources, and National Accounts deficit/surplus. Corresponding to each of these measures are indicators of the net debt position of the federal government.

Differences in the measures arise because the accounting frameworks are designed for different purposes.

The fundamental purpose of the first two measures (budgetary deficits and financial requirements – Public Accounts measures) is to provide information to Parliament on the government's financial activities as required under the *Financial Administration Act*. The purpose of the Public Accounts is to permit parliamentary control of public funds into and out of the Consolidated Revenue Fund. The results are based on generally accepted accounting principles and are audited by the Auditor General of Canada.

Financial requirements/sources primarily measure the amount by which net cash going out from the government exceeds cash coming in – the amount of money that the government has to borrow in private credit markets. The budgetary deficit/surplus includes all transactions with outside parties which enter into the calculation of the deficit or surplus of the government. The budgetary deficit/surplus is a more comprehensive measure as it includes liabilities incurred during the year for which no cash payment has been made and only those revenues and program spending over which Parliament has control.

■ The main difference between the budgetary deficit and financial requirements relates to the treatment of the federal government's employee pension accounts. The budgetary deficit only includes the government's annual pension-related costs (the contribution as an employer plus interest on its borrowings from the pension accounts) while financial requirements include the net difference between premiums and benefits paid out.

■ In addition, the budgetary deficit includes all of the federal government's obligations made during the course of the year while financial requirements only include the actual cash outlay related to these obligations.

Most industrialized countries present their budgets on a basis that is more comparable to financial requirements than to the budgetary deficit.

The primary objective of the National Accounts is to measure economic production and income. Thus, the government sector is treated on the same basis as other sectors of the economy. The primary objective of measuring economic activity means that certain transactions are recorded on an accrual basis in order to measure when revenues and expenditures are incurred. The National Accounts treats the transactions of federal government employee pension accounts similar to the financial requirements. The National Accounts estimates are produced by Statistics Canada.

■ The National Accounts deficits/surpluses are largely used for international fiscal comparisons by the Organization for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF).

■ The National Accounts also provide a consistent framework for aggregation and comparison of the fiscal positions of the various levels of government in Canada.

Each measure provides important complementary perspectives on the government's fiscal position.

■ Although the levels are different, the trends are broadly similar (Table A2.1).

■ Financial requirements and the National Accounts deficit are broadly similar in level and both are considerably lower than the Public Accounts deficit, reflecting the inclusion of the net amount of the federal government's employees' pension funds.

Table A2.1
Alternative measures of the federal balance
1980-81 to 1995-96 (fiscal years)

	Budgetary surplus or deficit (-)		Financial requirements (excluding foreign exchange transactions)		National accounts surplus or deficit (-)	
Year	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP
1980-81	-14,556	-4.7	-9,917	-3.2	-9,604	-3.1
1981-82	-15,674	-4.4	-9,264	-2.6	-9,062	-2.5
1982-83	-29,049	-7.8	-23,819	-6.4	-23,486	-6.3
1983-84	-32,877	-8.1	-25,219	-6.2	-25,957	-6.4
1984-85	-38,437	-8.6	-29,824	-6.7	-32,584	-7.3
1985-86	-34,595	-7.2	-30,510	-6.4	-27,872	-5.8
1986-87	-30,742	-6.1	-22,918	-4.5	-24,089	-4.8
1987-88	-27,794	-5.0	-18,849	-3.4	-19,510	-3.5
1988-89	-28,773	-4.7	-22,424	-3.7	-20,592	-3.4
1989-90	-28,930	-4.4	-20,530	-3.2	-22,253	-3.4
1990-91	-32,000	-4.8	-24,538	-3.7	-27,416	-4.1
1991-92	-34,357	-5.1	-31,800	-4.7	-28,702	-4.2
1992-93	-41,021	-5.9	-34,497	-5.0	-31,060	-4.5
1993-94	-42,012	-5.9	-29,850	-4.2	-35,077	-4.9
1994-95	-37,462	-5.0	-25,842	-3.5	-28,560	-3.8
1995-96	-28,617	-3.7	-17,183	-2.2	-25,747	-3.3

Source: Public Accounts of Canada.

As the deficits/surpluses derived from these three measures are different, so are the measures of debt. The accumulation of annual budgetary deficits and surpluses since Confederation is the net public debt. This represents the total liabilities of the government less its financial assets. For financial requirements, the relevant measure is unmatured debt (market debt). Interest-bearing debt is the summation of unmatured debt outstanding from private credit markets as well as the borrowings from public sector pension accounts and other internal funds held for third parties. It is greater than net debt as the latter includes financial assets. The National Accounts debt represents the net financial liabilities of the federal government (Table A2.2).

Table A2.2
Alternative measures of the federal debt
1980-81 to 1995-96 (fiscal years)

	Net debt		Interest-bearing debt		Unmatured debt		National accounts debt[1]	
Year	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP	Millions of dollars	Percentage of GDP
1980-81	91,948	29.7	112,418	36.3	83,138	26.8	49,609	16.0
1981-82	107,622	30.2	126,684	35.6	93,167	26.2	57,817	16.2
1982-83	136,671	36.5	154,221	41.2	116,562	31.1	79,547	21.2
1983-84	169,549	41.8	184,849	45.6	142,901	35.2	105,765	26.1
1984-85	207,986	46.8	219,458	49.3	172,719	38.8	136,620	30.7
1985-86	242,581	50.8	253,381	53.0	201,229	42.1	169,619	35.5
1986-87	273,323	54.1	286,034	56.6	228,611	45.2	195,919	38.7
1987-88	301,117	54.6	313,948	56.9	250,809	45.5	215,613	39.1
1988-89	329,890	54.4	345,057	56.9	276,301	45.6	236,708	39.1
1989-90	358,820	55.1	370,104	56.9	294,562	45.3	262,021	40.3
1990-91	390,820	58.4	406,475	60.7	323,903	48.4	287,618	43.0
1991-92	425,177	62.9	440,181	65.1	351,885	52.0	309,189	45.7
1992-93	466,198	67.6	477,034	69.1	382,741	55.5	340,699	49.4
1993-94	508,210	71.3	514,510	72.2	413,975	58.1	366,494	51.4
1994-95	545,672	73.3	550,192	73.6	440,998	59.0	401,815	53.8
1995-96	574,289	74.0	586,387	75.5	469,547	60.5	428,976	55.3

[1] National Accounts debt figures represent net financial liabilities on a calendar year basis.

Source: Statistical Canada, *National Balance Sheet Accounts* (Cat. 13-214, category 2000).

Annex 3

Fiscal Progress in an International Context

Introduction and overview

This annex provides an assessment of the public sector financial situation in Canada in contrast with that in other G-7 countries.

For fiscal comparisons between countries, Public Accounts figures may not be consistent due to differences in accounting practices and possible differences in the shared fiscal responsibilities among levels of government within individual countries.

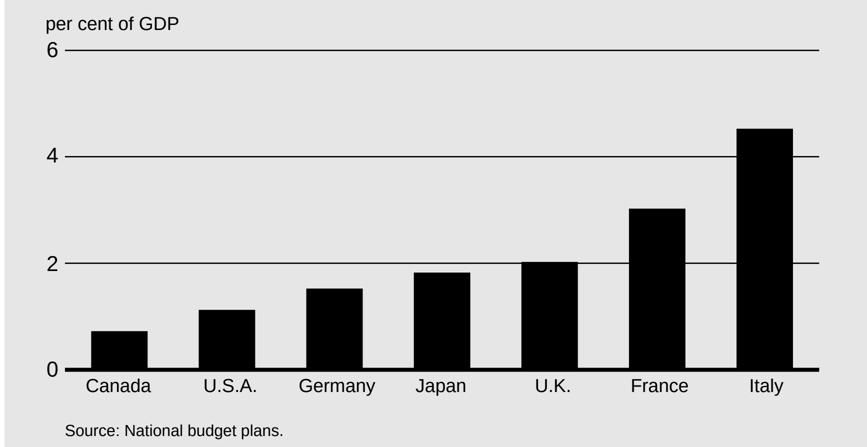
To overcome these obstacles, the majority of the following charts present Canada and the other G-7 countries on a more consistent basis using National Accounts figures at the total government level.

Canadian governments have undertaken consistent fiscal consolidation measures, making significant progess in deficit reduction, predominantly through program spending reduction. By 1997, the total government sector will be on a secure path to lower levels of public debt relative to GDP and an increasingly secure fiscal environment.

Lowest financial requirements among G-7

Financial requirements measure the amount by wich cash going out from the government exceeds cash coming in and is a good indication of net direct government borrowing on credit markets. In 1997, Canada will have the lowest ratio of financial requirements to GDP among all central governments in the G-7 countries (Chart A3.1).

Chart A3.1 **Projected 1997 central government financial requirements**



Total government deficit lowest among G-7

The total government deficit on a National Accounts basis records the difference between total receipts and total outlays. In 1992, the total government deficit in Canada, at 7.4 per cent of GDP, was nearly double the G-7 average.

However, as a result of deficit reduction efforts in recent years, governments in Canada have closed the gap with respect to G-7 countries. The total government deficit as a share of GDP in Canada will fall *below* the G-7 average (Chart A3.2) in 1996, with the gap in favour of Canada widening further in 1997.

By 1997, Canada's total government deficit as a share of GDP will be the lowest among the G-7 countries (Chart A3.3).

Chart A3.2 **Total government deficit (National Accounts basis)**

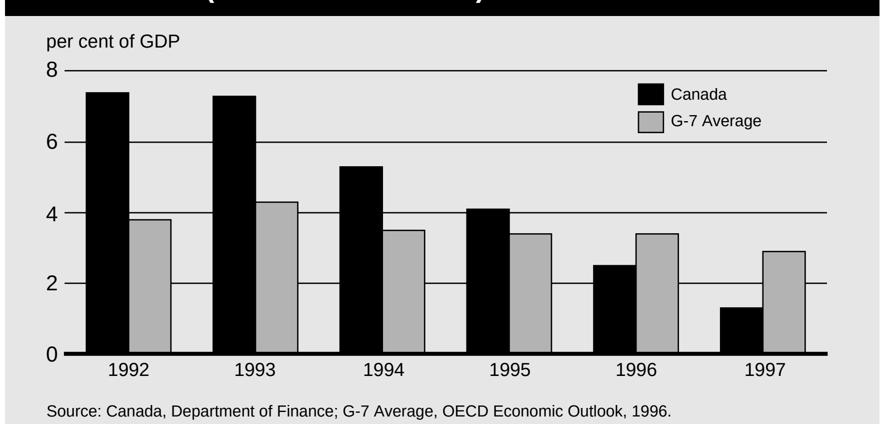
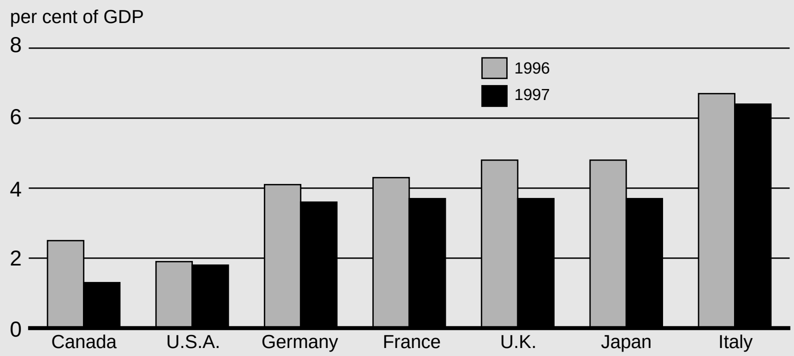


Chart A3.3 **Total government deficit in G-7 countries (National Accounts basis)**



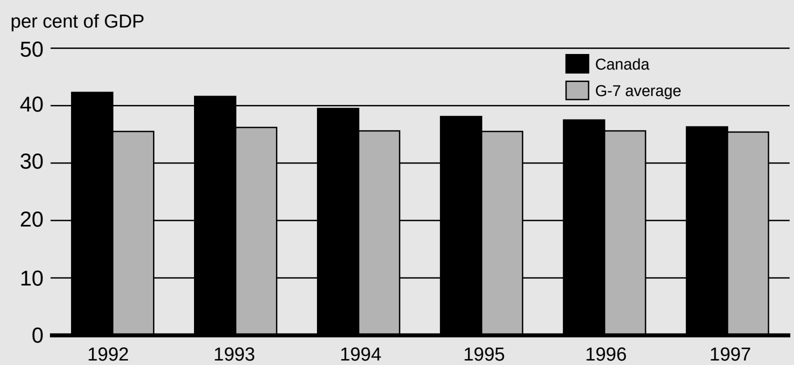
Sources: Canada, Department of Finance; G-7, *OECD Economic Outlook*, 1996.

Program spending reduced sharply

The bulk of fiscal consolidation in Canada has been achieved through program spending restraint. Canada's program spending as a share of GDP has been steadily declining since 1992. As a result, while Canadian program spending as a percentage of GDP was significantly above the average for the G-7 countries in 1992, by 1997, it will be only marginally higher (Chart A3.4).

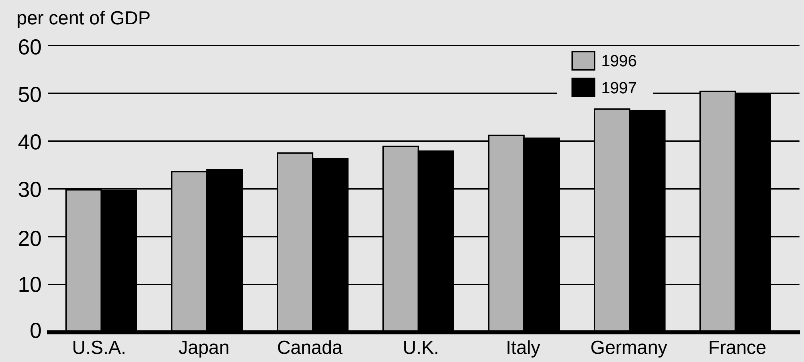
The ratio of program spending to GDP in Canada will be the third lowest in 1996, behind the United States and Japan (Chart A3.5). Total government program spending in Canada will continue to fall relative to GDP in 1997.

Chart A3.4 **Total government program spending (National Accounts basis)**



Source: Canada, Department of Finance; G-7 Average, *OECD Economic Outlook*, 1996.

Chart A3.5 **Total government program spending in G-7 countries (National Accounts basis)**



Source: Canada, Department of Finance; G-7 Average, *OECD Economic Outlook*, 1996.

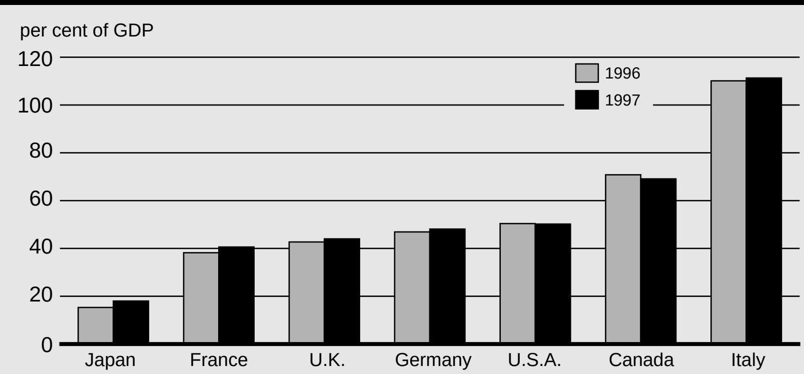
Net debt-to-GDP ratio declining more rapidly

Successful deficit reduction in Canada has led to a declining net debt-to-GDP ratio.

In 1997, the Canadian net debt-to-GDP ratio will decline by almost two percentage points, while increasing in a majority of other G-7 countries (Chart A3.6).

Canada's success in reducing the net debt-to-GDP ratio will ultimately bring about a sustainable level of public debt and an increasingly secure fiscal environment.

Chart A3.6 **Total government net debt in G-7 countries (National Accounts basis)**



Source: Canada, Department of Finance; G-7 Average, *OECD Economic Outlook*, 1996.