The ECONOMIC and FISCAL UPDATE

Presentation by
the Honourable Ralph Goodale, P.C., M.P.

to the House of Commons
Standing Committee on Finance

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Mr. Chairman and members of the House of Commons Standing Committee on Finance:

I am pleased to be back before you once again—this time to present the 2004 fall Economic and Fiscal Update. I appreciate this opportunity to discuss the Government's assessment of where our country is headed in the next five years, based upon what we have accomplished to date.

Building on a Sound Foundation

In brief, Canada's impressive social and economic progress over the past decade, including a world-calibre and history-making fiscal performance, should fuel genuine optimism about what lies ahead.

Because Canadians had the collective courage to make some tough choices back in the mid-1990s and because we have had the discipline to stay our fiscal course ever since, we are now reaping significant economic and social dividends.

Canadians are among only a very few in the world who now have the fiscal freedom to consider how best to allocate successive budgetary surpluses. Ten years ago the debate was about something quite different. It was about whether the annual federal deficit would be $43 billion or maybe just $34 billion, and how much that burden would further suffocate jobs and growth.

Many other countries are still struggling with stubborn deficits and escalating debt—including all of our partners in the G-7 group of nations. All except Canada! And I will never hesitate to defend and celebrate the underlying principles and the operating behaviour that have produced the best fiscal record of any government since Confederation and the strongest fiscal position among the world's leading economies.

That includes seven consecutive surplus budgets, $61 billion in reduced federal debt, $3 billion saved each and every year on debt-servicing costs, consistently low interest rates, more than $100 billion in cumulative tax cuts (tax cuts in every budget since 1996, with a primary focus on middle- and low-income families), 10 consecutive reductions in employment insurance (EI) premiums, and more than $200 billion for investments in Canadians' highest social and economic priorities—like health care and equalization; the well-being of children and families; learning, skills and innovation; affordable housing, community infrastructure and the environment.

Sometimes, after initial goals have been attained, it is easy to forget how far we had to come to reach them, or why it was so crucial to do so. In fact, what Canada has accomplished—economically, fiscally and socially—over this past decade is nothing short of astonishing.

And the best is yet to come. While our progress thus far is gratifying, it is even more important as an "enabler" for what we still seek to achieve. In short, our fiscal responsibility has made our social and economic ambition possible.

An Active Agenda

The most recent Speech from the Throne laid out our agenda, noting—to begin with—two flagship achievements for Canada in just the past two months.

First, in September, the $41-billion, 10-year agreement with provinces and territories to bolster health care.

All governments have signed on. It includes key elements of systemic reform and the best terms ever for reporting and accountability. By meeting and surpassing every financial standard identified in the landmark report of Commissioner Roy Romanow, it turns the corner on the annual intergovernmental feud about health funding.

The health accord puts everybody's focus where it should be—on shortening waiting times, getting more health care professionals and better equipment, improving primary care, home care and drug coverage, better services in the North and for Aboriginal people, more health research and innovation, and improved public health and wellness.

Secondly, in October, to help alleviate fiscal disparities among provinces and territories, we launched the most far-reaching improvements in the equalization system since it first began in 1957.

Through two years of transition arrangements, which have already been agreed upon among First Ministers, the available federal funding to assist Canada's less wealthy jurisdictions will rise initially to match the highest level equalization has ever generated, and then it will continue to grow at an annual rate of 3.5 per cent. Territorial Formula Financing will benefit in similar fashion.

The best expert advice about future distribution issues will be sought, with provincial and territorial collaboration. With a new approach and incremental federal funding of some $33 billion over 10 years, we are directly addressing prime provincial/territorial concerns about clarity, predictability and adequacy.

We also continue to work diligently and in good faith on specific related issues affecting Nova Scotia and Newfoundland and Labrador, the two provinces with offshore oil and gas revenues.

Beyond these upfront agenda items, the Government is also focused upon the delivery of its other key commitments to Canadians, including:

- high-quality, universal, affordable and developmental child care;
- a powerful New Deal for Cities and Communities, including a share of the federal excise tax on gasoline;
- enhanced support for seniors, the disabled and their caregivers;
- meaningful action on the disparities that impede opportunities for Aboriginal Canadians;
- the protection of our rich natural environment;

- meeting the imperatives of national defence and national security; and
- ensuring Canada a place of respect and influence in global affairs.

As the Throne Speech emphasized, such an ambitious agenda must be founded upon a robust, competitive and innovative economy—growing and thriving in a knowledge-based, technology-driven and highly skilled world. And it must be rooted in fiscal policy that is prudent and disciplined.

The Transformation From "Vicious" to "Virtuous"

For 27 years prior to 1997, Canada was caught in a "vicious circle" of large chronic deficits and rising debt, leading to high interest rates, high taxes, sluggish economic growth and lost jobs, leading in turn to more deficits and even higher debt...and on and on it went.

With both the federal government and all the provinces in deficit positions, Canada chalked up the second highest total government debt-to-GDP (gross domestic product) ratio among the G-7.

Just servicing the federal debt alone was soaking up 38 cents out of every dollar the Government of Canada took in. It was hard to deal with the things that mattered the most to Canadians when creditors had first claim on more than a third of government revenues.

The situation was unsustainable. Canada needed to change course. And together, we did. It demanded tough decisions, and we would not have succeeded without the remarkable support of citizens and taxpayers.

But step by step, we made progress. The federal books were balanced in 1997. Canada's debt-to-GDP ratio began to improve, relying not just on economic growth but also actual debt reduction.

On a total government basis, we moved ahead of Japan in 1999. Ahead of Germany in 2001. Ahead of France in 2002. Ahead of the United States in 2003. And now, according to the Organisation for Economic Co-operation and Development (OECD), we are about to overtake the United Kingdom for top spot.

With seven consecutive federal surpluses now under our belts, the old vicious circle of economic failure has been replaced by a "virtuous circle" of sustained economic success—further declining debt, a solid credit rating, low interest rates, lower taxes, remarkable economic growth, and the best employment record in the G-7.

And the result is more than just bragging rights. It translates into tangible benefits for Canadians.

For example, in addition to funding major social and economic investments, tax cuts and debt reduction since 1997, our robust fiscal position has also enabled Canada to deal with some nasty external surprises (like the sudden impact of security threats, the SARS outbreak and BSE), without being driven off our fiscal track and back into the red.

A triple-A Canadian credit rating means lower costs every day for all Canadian borrowers—all levels of government, but also consumers buying homes and cars, small business owners investing in their enterprises, and farmers paying off their operating loans.

And significantly, since Canada moved into a surplus budget position, we have ranked first in the G-7 for growth in living standards. In fact, the average standard of living of Canadians has increased more in the past 7 years than in the previous 17.

But it behooves us to acknowledge that the fruits of a virtuous circle of economic success are not preordained.

There is nothing "automatic" about it. To continue to benefit from the new paradigm, we need to continue to respect its principles—living within our means, planning carefully, behaving prudently, staying consistently in the black.

Accordingly, our commitment is to balanced budgets or better, year after year, using the average of independent private sector forecasters to set our fiscal framework, setting aside an annual Contingency Reserve of $3 billion, and providing an extra measure of economic prudence on top.

I will continue to look to this committee to help ensure that, in the midst of all the pressures of a minority situation, we do not erode the fundamentals that have brought us such a long way forward from 1997. We here, together, must be the defenders of the fiscal integrity that Canadians have so carefully and meticulously built. No one would want it to be squandered.

Improving How We Do Things

I know that this committee agrees with the point that government spending plans must be based on money we *know* we have, not on what we just *hope* to have. Wishful thinking causes deficits, as many other countries around the world today know only too well.

With respect to our $9.1-billion surplus last year, surely that was a good thing—light years better than the opposite alternative, which so often persisted in previous governments. Paying down debt is nothing to apologize for. The vast majority of Canadians support it. It means, by one small step, we stop taking from our kids—by one small step, we strengthen our chances of beating the unexpected.

Still, I share this committee's desire to have more and better financial information available earlier, so the best informed and deliberate decisions can be made about how to dedicate available resources.

Economic modelling and fiscal forecasting are far from exact sciences. But inherent uncertainties notwithstanding, we need to work very hard to make our data and analyses as precise and transparent as humanly possible.

The way we go about our projections has been lauded by international observers, but we still want to do better.

To that end, I have announced a comprehensive review of how we do our economic and fiscal forecasting, under the able direction of Dr. Tim O'Neill, Chief Economist and Executive Vice-President of BMO Financial Group.

That review will, among other things, compare the average private sector economic forecasts used in previous budgets with the actual outcomes. It will also compare the fiscal projections presented in past budgets with actual results and assess the reasons for any discrepancies. And it will evaluate the changes that have been made over the past decade to the forecasting process to assess their impact on the accuracy of results.

As part of the overall review, I have also asked the International Monetary Fund (IMF) to compare our practices and experiences with those of other countries and ensure that the systems we use and the methods we employ are the very best in the world.

The IMF will review how Canada's fiscal environment compares to that of other countries, including the structure of revenues and spending as well as the fiscal rules and targets. It will compare our forecasting process to that of other nations and provide statistical analysis of the quality of our forecasts as well as of the factors which might affect that quality.

The results of the IMF analysis will be shared with Dr. O'Neill and contribute to his own review which, in turn, will be submitted to this committee for your careful consideration.

Also on the topic of improving how we do things, I am pleased to report to this committee that several of the operational initiatives that I mentioned in the budget last March are now underway.

The Office of the Comptroller General of Canada is up and running under the distinguished leadership of Mr. Charles-Antoine St-Jean (formerly of Cap Gemini). As promised, we are also bolstering the internal audit function across government, improving real-time information systems and enhancing the automatic disclosure of contracting activities.

With respect to the government-wide expenditure review process under the leadership of my Cabinet colleague, the Honourable John McCallum, the effort is well advanced—rigorously examining all the ways in which the Government of Canada spends money.

Expenditure review is not about cutting. It's about reallocation.

We are testing for excellence and for relevance. Looking for areas in which existing spending can be rejigged to shift money from lower to higher priorities. To get more value. To address the new and emerging needs of today and tomorrow, instead of just duplicating the way things were done 15 or 20 years ago.

It's about building fiscal space from within.

Minister McCallum's goal is to find some $12 billion of such internal fiscal space over a five-year time frame.

The Global Environment

Before turning to the economic outlook for Canada, let me touch just briefly on the international environment in which we find ourselves.

Overall, the global economic outlook is more positive and more evenly balanced than it was six or eight months ago. The IMF expects world GDP growth to accelerate to 5 per cent in 2004, the highest rate in nearly 30 years. Next year, growth is projected to average 4.3 per cent.

The economic situation in Japan improved markedly in 2004, thanks to strong demand in China and healthy business investment.

China's surging growth has also helped stimulate activity in other Asian countries, such as Korea and Singapore, while spurring strong demand for Canadian and other resources.

In Europe the recovery is gaining a firmer footing but remains uneven.

In the United States growth slowed in the second quarter of 2004, but advance estimates indicate that the American economy picked up in the third quarter. These fluctuations in growth have largely stemmed from swings in U.S. consumer spending, while business investment has posted strong gains throughout 2004. Private sector forecasters now expect the U.S. economy to grow by 4.4 per cent in 2004 and 3.5 per cent next year.

For a trading nation such as ours, continued economic strength in our major export markets, particularly the United States, is vitally important to our future prospects.

Economic Developments in Canada

Let me turn now to a description of recent economic developments here in Canada.

A year ago, as we prepared our economic and fiscal forecasts in November of 2003, we were bedevilled by the consequences of several major shocks that had hit Canadians throughout that year—the SARS outbreak, a major power blackout in Ontario, borders closed to our cattle and beef exports as a result of a single case of BSE in Alberta, massive forest fires in British Columbia, a devastating hurricane across Atlantic Canada, and the accelerating challenge for exporters of a soaring dollar that had appreciated some 20 per cent against the U.S. dollar in a very short span of time.

All in all, Mr. Chairman, a trying set of circumstances filled with downside risks. Most private sector forecasters concluded that the economy would take a substantial hit. And when the figures were all in for 2003, they showed our GDP growth slipped to only 2 per cent. Since then, however, Canada rebounded strongly, with GDP growth of close to 3.4 per cent in the first half of 2004—much better than was evident at the time of my budget in March.

Significantly, this strong economic performance also produced a dramatic improvement in the labour market, which has generated nearly 400,000 new jobs since it started to grow again in August 2003. This is a remarkable pace of job creation—more than 25 per cent higher than in the previous 14 months. Overall, the unemployment rate has fallen from 8 per cent in August 2003 to 7.1 per cent in October of this year, while the share of the working-age population with a job has now reached an all-time high.

A healthy labour market helps to bolster consumer confidence which, together with historically low interest rates, fuels strong consumer spending.

Business confidence, too, has been strong, as reflected in increased investments in new machinery and equipment, which rose by nearly 9 per cent during the past year.

Exports recovered well from the rapid rise of the Canadian dollar in 2003—a testimony to the resiliency and resourcefulness of Canadian companies. Indeed, exports grew at an annual rate of over 21 per cent in the second quarter of this year, the third straight quarter of solid growth.

Together with a significant rise in commodity prices, Canada's export growth led to an increase in the current account surplus to $42 billion in the second quarter—the second highest ever. As a result, Canada's net foreign indebtedness now stands at 13.7 per cent of GDP—down from a peak of nearly 45 per cent in 1993—and the lowest level in almost half a century. This means more money in the hands of Canadians and less in the hands of foreign creditors.

Because Canada's fiscal house was in order and our underlying fundamentals were strong, we were able to get through last year's shocks and rebound more successfully than many of the experts had dared to expect.

Economic Outlook

Let me turn now from the current state of the economy to what lies ahead.

Once again, the Finance Department has surveyed private sector economists to obtain their outlook for the Canadian economy.

According to their forecasts, Canada will enjoy stronger growth in both 2004 and 2005. On average, they expect growth of 3 per cent in 2004—up from the 2.7 per cent predicted at the time of the last budget. For next year, 2005, they are forecasting that growth will reach 3.2 per cent, close to the 3.3 per cent reported in Budget 2004.

These projections again speak to Canada's remarkable resiliency and strength. But, as always, there are risks and uncertainties which could affect the forecasts. After all, forecasts only tell us what *can* happen, they do not determine what *will* happen.

While it appears that exporters adjusted well to the Canadian dollar in 2003, it is not clear how the further 10-cent increase since May will affect the economy. Furthermore, it is very difficult to predict where the dollar will go next. In the near term, this uncertainty about the direction of the Canadian dollar, as well as the magnitude and timing of the resulting impacts, poses a significant risk to the outlook for growth.

In addition, higher oil prices could lower consumer demand both here and in the United States, as high energy prices constrain the purchasing power of consumers. Lower consumer demand, in turn, could have a negative effect on growth in the short term. On the other hand, higher oil prices stimulate new investment and production in the Canadian energy sector, which will contribute to growth over time. So the impact of high world oil prices is mixed for Canada.

Looking further down the road, the U.S. fiscal deficit could put upward pressure on interest rates, and that could slow growth in our largest and most important export market.

Moreover, the geopolitical risks posed by uncertain international situations could affect our forecasts in ways that cannot presently be foreseen or quantified.

All of these unknowns again speak to the need for prudent fiscal planning—for staying on course and staying in the black. This we will do, implementing the agenda set out in the Speech from the Throne as quickly as our resources will allow, while carefully and deliberately building the economic strength which makes possible everything else that Canadians want to do.

Fiscal Situation

Let me turn now to the fiscal outlook. In developing our fiscal projections, we have continued to rely on the independent analysis and advice of leading private sector economists. I have met personally with a group of 15 economists representing all regions of the country to discuss their forecasts and ensure that we are using the best possible economic assumptions in our planning.

As in the past, we have asked four of the leading econometric modelling firms in the country to use these agreed-upon economic assumptions to generate five-year fiscal projections.

This year we are increasing the transparency of our process by publishing, for the first time, the individual results of the four econometric models rather than simply presenting the average, as had been the practice in the past.

I should also point out that these projections are prepared originally on a National Accounts basis—the common statistical approach used by the OECD for international comparisons. Again for transparency, we are also providing details this year of how the National Accounts forecasts are translated into a Public Accounts format, which is how we present our budgets.

These projections were prepared before taking into account the cost of the most recent intergovernmental accord on health care, the new framework for equalization and Territorial Formula Financing, as well as other spending decisions since the last budget.

The cost of the health accord and equalization and Territorial Formula Financing together amount to $3.6 billion this year, $4.8 billion in 2005–06, rising to $6.7 billion by 2009–10, for a cumulative total over the six-year period of $33 billion.

After subtracting the costs of all these commitments, and after providing $3 billion for our usual Contingency Reserve and additional prudence, the budget balance for planning purposes shows the following: a surplus of $5.9 billion this year, then small but positive balances of $500 million in 2005–06 and $900 million in 2006–07, with the surplus rising to $3.2 billion in 2007–08, $7.5 billion in 2008–09 and $11.5 billion in 2009–10—for a cumulative total of $29.5 billion over the six-year period.

I should point out that these figures do not include any savings from the expenditure review process currently underway. I hope this exercise will be largely completed in time for the next budget, but until savings have been clearly identified, it would not be prudent to assume them in the projected surplus for the purpose of budget planning.

I also want to note that the $5.9-billion surplus expected this year reflects a number of special factors, including the $2.6-billion net proceeds realized from the very successful sale of the Government's stake in Petro-Canada, lower debt charges due to lower interest rates in 2004, and the release of the $1 billion of economic prudence, which had been set aside in Budget 2004 for this year.

Meeting the Challenges Ahead

Mr. Chairman, this country has come a long way in overcoming the legacies of the past, but there is still much that remains to be done to prepare ourselves for the challenges of the future. One such challenge is the impending impact of an aging population.

Here in Canada, the real force of this demographic trend will hit when the big baby boomer generation begins to retire around 2010—a little over five years from now. This will have a significant effect on our workforce.

At the present time, there are more than five people of working age in Canada for every person of retirement age. Within the next 15 years, that ratio will fall to four working people compared to those 65 years of age and older. And the ratio will keep falling until it is ultimately cut in half.

This huge development will have at least two profound effects on our society.

First, there will be greater demand for social programs, particularly health care and public pensions. The Government of Canada has already taken significant steps to address both these issues.

As I mentioned earlier, we have reached a historic and far-reaching agreement on health care with all the provinces and territories which helps to provide the wherewithal to ensure that all Canadians will have access to the high-quality health services they need, when they need them.

Working with the provinces, we have also revamped the Canada Pension Plan so it is now actuarially sound for at least the next half century—making Canada one of the few countries in the world with a rock-solid public pension system.

And, as noted, we have substantially reduced the level of federal debt. Instead of paying 38 cents of every dollar of revenue collected just to carry the debt, today we pay about 19 cents. And if we are successful in meeting our objective of a debt-to-GDP ratio of 25 per cent within 10 years, that debt cost will fall to about 12 cents—roughly a third of what it was 8 years ago.

It is imperative that the debt burden be kept on this steady downward track because even with all of the progress we have made, annual debt-servicing costs are still the largest single expense of the Government of Canada—close to what we spend on seniors' benefits and EI combined! By continuing to reduce the debt burden, we will build our flexibility to meet emerging demographic pressures—paying down debt today means more money for social programs tomorrow.

The second major impact of an aging population—the declining proportion of the population that is in the workforce—means that we will rely more and more on increasing productivity in order to ensure a continuing rise in our standard of living. Moreover, in the face of rising competition from countries such as India and China, it is imperative that Canada meet this productivity challenge.

That is why, in the Speech from the Throne, we presented an agenda aimed at making our economy more productive and competitive—the kind of 21st century economy that generates the wealth this nation will need and the kind of well-paying jobs our people deserve.

It starts with our human resources—investing in knowledge and learning, from basic literacy requirements to highly sophisticated workplace skills. It includes the faster and more successful integration of new Canadians into the workforce and strategic attention to opportunities for Aboriginal peoples.

We will build on our highly successful Innovation Agenda to advance Canadian excellence in scientific research and new technology development. Investing in both the discovery of new ideas and in their commercialization in the real marketplace fuels an upward spiral of brainpower and productivity.

The President of the Association of Universities and Colleges of Canada has described our multi-faceted Innovation Agenda as nothing short of a new, 21st century "National Dream" for Canada's future. And we must keep up our momentum.

We must also improve Canada's competitiveness by making our regulatory systems more efficient, transparent and predictable, by re-energizing the drive toward less inhibited interprovincial commerce, by bolstering the strength and efficiency of Canadian capital markets, by maintaining Canada's competitive tax system, by continuing to invest in sustainable high-quality public infrastructure, and by promoting trade and investment—including a determined fight for legitimate market access on behalf of Canadian producers of cattle and beef, softwood lumber and wheat.

And underpinning every aspect of our economic plans and our social objectives is an unshakeable dedication to careful prudence in how we plan and manage, coupled with a genuine sense of fairness and inclusion in how we balance competing demands.

Conclusion

In the coming weeks I will be consulting with Canadians on their priorities for the next budget and on the important choices we all must make in a world of limited resources.

I know this committee is also pursuing its own pre-budget consultations. I look forward to your report and recommendations.

And I would appreciate the committee's advice with respect to the following five specific issues:

First, how should the Government allocate any available surplus among such important but competing priorities as economic and social programs, tax cuts and debt reduction? And what considerations should guide those decisions?

Second, with respect to the items mentioned in the Speech from the Throne to enhance Canada's productivity and competitiveness in a global economy, what early steps could be taken in the next budget to best advance those goals?

Third, in the context of the challenges that an aging population will present in the years to come, what additional steps should the Government of Canada be taking now to prepare our economy for this significant change in demographics?

Fourth, as I indicated, the projections for the surplus presented in this Update include the $3-billion Contingency Reserve as well as additional economic prudence to provide a cushion against going back into deficit. What level of prudence does this committee feel should be included in the upcoming budget?

Fifth—and this final question is more about process—how can this committee contribute to fiscally responsible and coherent decision making in the particularly delicate context of a minority Parliament? There are accumulating pressures for specific new program expenditures and ad hoc tax reductions which, if all agreed to one by one, would quickly consume any available surplus and push the Government back into deficit. What could be done to ensure that all such proposed measures are examined objectively and in the necessary context of all the other priorities for possible budget action?

Mr. Chairman, as you consider these questions and others, you can do so on solid economic ground. The debilitating vicious circle of bygone years has been replaced by a virtuous circle of economic success that we can reinforce and enhance.

It's all a matter of never taking our progress for granted, never assuming that we achieved the strength we enjoy today by happenstance, never getting careless with the principles of fiscal responsibility.

This committee has always been a champion of those principles. With your ongoing discipline, judgment and hard work, collectively we can make certain that Canadians continue to be global leaders for economic strength, social progress and fiscal performance.