THE BUDGET PLAN 1999

Including Supplementary Information and Notices of Ways and Means Motions

Building today for a better tomorrow

Tabled in the House of Commons
by the Honourable Paul Martin, P.C., M.P.
Minister of Finance

February 16, 1999

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Canada

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1

Building Today for a Better Tomorrow

Introduction and Overview

Introduction

This budget extends the government's plan to build a strong economy and secure society – one which generates a higher standard of living for all Canadians and builds today to make Canada a better place to live.

To achieve this goal, the government has consistently followed a strategy designed to advance living standards by promoting well-paying jobs, productivity growth and equal opportunities for all and providing a safety net for those in need.

This is the strategy that was first set out by the Prime Minister in Québec City on September 18, 1994. It was outlined in the 1994 document entitled *A New Framework for Economic Policy* and it is the strategy behind the actions in each of the last five budgets and again in this budget.

The strategy entails action on three fronts:

- maintaining sound economic and financial management;
- investing in key economic and social priorities; and
- providing tax relief and improving tax fairness.

All three elements of this plan work together to improve Canadians' standard of living and quality of life. Strong economic growth and a reduced debt burden better enable the government to provide tax relief and make key investments. Investments in health care, in access to knowledge and skills training and in other key areas improve Canadians' ability to work and their quality of life. Tax relief engenders economic growth by increasing rewards to work, save and invest.

This strategy has produced unprecedented results. The deficit has been eliminated much faster than anyone expected. Interest rates are low and have remained low despite the volatility in global financial markets. Since December 1996, 909,000 new jobs have been created and the unemployment rate, although still too high, has declined to 7.8 per cent – its lowest level in almost nine years.

The actions taken to address the fiscal problem facing the nation were undertaken in a balanced and measured fashion. Even as fiscal order was being restored, targeted investments were undertaken to enhance job creation and growth and to address priorities in health care, knowledge and innovation and other programs that contribute to the well-being of Canadians. In addition, targeted tax actions were taken to enhance fairness and provide assistance to those most in need. Effective 1997-98, the cash floor under the Canada Health and Social Transfer was increased from $11 billion to $12.5 billion. In the 1998 budget, major strategic investments were made in access to knowledge and skills training through the Canadian Opportunities Strategy. That budget also began the process of providing general tax relief. This budget builds on those initiatives.

Budget Highlights

Strengthening health care for Canadians, and renewing federal transfers to provinces and territories

Canada's publicly-funded health care system is key to an improving quality of life. It reflects the fundamental values shared by all Canadians. Governments must work together to preserve and build on its strengths.

Medicare provides Canadians with access to health care irrespective of their financial means. It ensures that Canadians have the security of knowing that they have access to high quality care when they need it, not if they can pay for it. It ensures that there is a highly competent and devoted cadre of health care providers and researchers using the most up-to-date knowledge about preventive measures, treatments and cures. It ensures that health care coverage is portable from one province to another, while allowing health care providers to innovate and learn from each other to the benefit of all Canadians. Finally, medicare is not only good social policy, it is also good economic policy, ensuring that every public health care dollar in Canada is used to the greatest possible extent to deliver services.

The budget makes significant investments to help the provinces and territories deal with Canadians' immediate concerns about health care – waiting lists, crowded emergency rooms and diagnostic services. It also helps to build a stronger health care system that reflects the changing needs of Canadians and provides timely access to high quality health care. It proposes to do so by:

- *Investing in medicare* by increasing transfers to the provinces and territories. Over the next five years, the provinces and territories will receive an additional $11.5 billion specifically for health care. This represents the largest single new investment this government has ever made.
  - Of this amount, $8 billion will be provided through future-year increases in the Canada Health and Social Transfer (CHST) and $3.5 billion as an immediate one-time supplement to the CHST from funds available this fiscal year. Allowing for a gradual and orderly draw-down in the supplement over the next three years by the provinces and territories means that total support for health care would increase by $2 billion in 1999-2000 and in 2000-01 and by $2.5 billion in each of the following three years of the five-year commitment. However, individual provinces

and territories could draw down the supplement over the next three years in a pattern which best meets the needs of their health care systems.

- The $2.5 billion increases CHST cash from $12.5 billion to $15 billion and takes what is regarded as the health component of the CHST as high as it was before the period of expenditure restraint of the mid-1990s.
- Together with the growing value of CHST tax transfers, federal support is expected to reach a new high by 2001-02, surpassing where transfers stood prior to restraint.
- Significant increases in Equalization will also make more resources available to most of the less prosperous provinces for public services, including health care. Payments this year are expected to reach $10.7 billion, up $2.2 billion from the 1998 budget estimate, of which $1.6 billion remains to be paid this March. Legislation is now before Parliament to renew the Equalization program for the next five years. It is projected that payments will be $5 billion higher than over the previous five years, including technical improvements totalling an estimated $700 million over that period.
- The disparities in the way the CHST is allocated across provinces would, under current legislation, have been reduced by half over the next four years. This budget completely eliminates these disparities over the next three years. All provinces will then receive identical per capita CHST entitlements, providing equal support for health and other social services to all Canadians.
- All major transfers to provinces and territories will, for the first time, be placed on common five-year tracks, thus providing provinces and territories with greatly improved predictability.

The budget also strengthens the federal government's contribution to Canada's health system and the health of Canadians by investing close to $1.4 billion over the remainder of this fiscal year and the next three years in:

■ *Improving health information systems* to better meet the information needs of health care providers and patients, and to foster greater accountability to the public on how the health care system is serving them, consistent with the new Social Union Framework.

■ *Promoting health-related research and innovation* to improve diagnosis and treatment of diseases, promote best practices in health care delivery and enhance the health and well-being of Canadians.

- *Improving First Nations and Inuit health services* by strengthening home and community care in particular.
- *Doing more to prevent health problems from occurring* by building on efforts to improve prenatal nutrition, food safety and the control of toxic substances. Steps will also be taken to foster innovations in rural and community health, in partnership with the provinces, and to combat diabetes, the incidence of which is particularly high in Aboriginal communities.

Combined with the $6.5-billion cash increase in the CHST over the next three years, the $1.4 billion invested in these activities means a total of $7.9 billion in new resources for health over the remainder of this fiscal year and the next three years.

Building a strong economy by investing in knowledge and innovation

The creation and application of new technologies provides the value-added within the Canadian economy on which productivity growth and rising standards of living are based. This government is committed to the support of knowledge and innovation, as part of its plan to promote productivity growth and improve the standard of living for all Canadians.

To this end, the government established the Canada Foundation for Innovation in the 1997 budget and introduced the Canadian Opportunities Strategy in the 1998 budget.

This budget includes measures totalling over $1.8 billion over the remainder of 1998-99 and the next three years to build on the Canadian Opportunities Strategy, fostering innovation, productivity and job creation by:

- *Creating knowledge:* this budget provides an additional $200 million in 1998-99 to the Canada Foundation for Innovation. Based on awards in 1998, it is expected that about $100 million will support non-health-related research. This budget also provides $176 million in additional funding over the remainder of this fiscal year and the next three years to the Natural Sciences and Engineering Research Council, the Social Sciences and Humanities Research Council and the National Research Council, and provides support for bio-technology related research and development.
- *Disseminating knowledge:* As part of the government's plan to make Canada one of the most connected countries in the world by the year 2000, this budget provides $96 million over the next three years

to support the Geoconnections initiative, which makes geographic-related information more accessible, and the establishment of one "Smart Community" within each province, the North and in an Aboriginal community.

- *Commercializing knowledge:* For innovation to remain the driving force behind improving productivity and living standards, knowledge must be applied to creating new products, production processes and markets, thereby leading to economic growth and generating job opportunities. Over the next three years, an additional $150 million will be provided to the Technology Partnerships Canada program to help companies bring to market innovative products and processes. The Networks of Centres of Excellence program, which facilitates the transfer of knowledge among world-class researchers within Canada, will be provided with an additional $90 million over the next three years. Funding for the Canadian Space Agency is being increased by $430 million over the next three years and stabilized at $300 million per annum thereafter. The government will also inject a further $50 million as equity into the Business Development Bank of Canada, increasing its ability to provide financing for knowledge-based and export-oriented companies.

- *Supporting employment*: Two recently announced initiatives will provide a total of $795 million in funding for employment related issues over the next three years: the Youth Employment Strategy and the Canadian Jobs Fund.

As a result, over three-quarters of the new spending initiatives in the 1998 and 1999 budgets reflect two of the highest priorities of Canadians – increased funding for health care and for access to knowledge and innovation.

Providing tax relief and improving tax fairness

The government's objective is to provide substantial tax relief in the fairest way possible. The 1998 and 1999 budget measures follow a single broad-based tax-reduction plan. Separately, and in combination, the 1998 and proposed 1999 budget measures flow from the principle that such tax relief should not be provided with borrowed money. They provide affordable broad-based tax cuts to all Canadians and they provide proportionately greater reductions at lower income levels.

Tax reductions in the 1999 budget build on the tax reductions in the 1998 budget.

- The 1998 budget provided a $500 increase in the amount of income low-income Canadians can receive tax-free. The 1999 budget increases this amount to $675 and extends this tax relief to all taxpayers.
- The $675 increase more than offsets the effect of inflation on the value of the tax-free amount since 1992.
- The 1998 budget began the process of eliminating the 3-per-cent surtax by providing complete relief for taxpayers with incomes up to about $50,000 and reductions for those with incomes between $50,000 and $65,000. The 1999 budget completes this process by eliminating the surtax for all remaining taxpayers.
- The 1998 budget, on top of the $850 million provided in the 1997 budget, committed an additional $850 million to the Canada Child Tax Benefit (CCTB) targeted exclusively at low-income families.
- The 1999 budget sets out the design of this increased assistance, agreed to by federal and provincial governments, and also commits an additional $300 million to increase CCTB payments for modest- and middle-income families.

The 1998 and 1999 budgets provide Canadians with substantial tax relief.

- The 1998 budget actions will provide Canadians with $2.4 billion of tax relief in 1999-2000, $3.2 billion in 2000-01 and $3.3 billion in 2001-02 for a cumulative total of $8.8 billion over the three fiscal years.
- The 1999 budget actions will provide an additional $1.5 billion of tax relief in 1999-2000, $2.8 billion in 2000-01 and $3.4 billion in 2001-02. Cumulative tax relief from the 1999 budget totals $7.7 billion over the three fiscal years.
- The 1998 and 1999 budgets together provide tax relief of $3.9 billion in 1999-2000, $6.0 billion in 2000-01 and $6.6 billion in 2001-02, for a total of $16.5 billion over three years.
- In combination, the 1998 and 1999 budget actions, and the $800-million employment insurance premium rate reduction for 1999-2000 provide tax relief of $17.3 billion over the next three years.

The across-the-board tax relief in the 1999 budget is part of the government's commitment to fairness.

- The proposed measures provide the largest proportionate federal income tax reductions at the lowest income levels.
- As a result of the 1998 budget 400,000 low-income Canadians will no longer pay any federal income tax. The 1999 budget removes an additional 200,000 from the tax rolls for a total of 600,000.
- Single taxpayers earning $20,000 or less will have their federal income taxes reduced by at least 10 per cent as a result of the 1998 and 1999 budget measures.
- A typical Canadian one-earner family of four that receives income of $30,000 or less will pay no net federal income tax.
- Families with incomes of $45,000 or less will have their federal income taxes reduced by a minimum of 10 per cent and some will receive much larger reductions, as a result of the 1998 and 1999 budget measures.

This budget provides funding for a number of other initiatives, some of which have been announced earlier, including assistance for fishers and farmers; crime prevention; Aboriginal programs; and compensation and benefits in the Canadian military.

Maintaining sound economic and financial management

Canada's economic fundamentals remain strong and have helped it to weather the recent global economic turbulence. Interest rates remain low, despite the volatility in financial markets caused by the fallout of the Asian crisis. Employment soared, 453,000 jobs were created in 1998 on the heels of the already impressive gain of 368,000 jobs in 1997. This marks the best annual performance of the decade and outpaces the job performance of any other Group of Seven (G-7) country. This strong job performance has continued in January 1999, with 87,000 new jobs created. Almost 40 per cent of the new jobs created in the last 12 months went to Canada's youth, who posted their strongest yearly employment growth in over 25 years. This strong job performance pushed the unemployment rate down to 7.8 per cent in January 1999, its lowest level since June 1990.

This budget maintains sound economic and financial management:

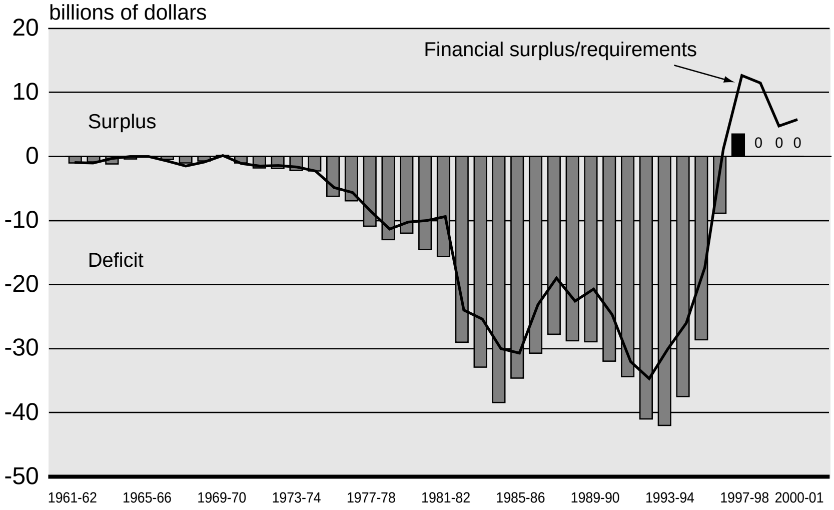
- A balanced budget, or better, is expected for 1998-99 – the second consecutive year in which the budget has been deficit-free. The last time this occurred was almost half a century ago, in 1951-52.
  - To the extent that the Contingency Reserve is not required for 1998-99, it will be used to reduce the public debt.
- The government is committed to balanced budgets or better in both 1999-2000 and 2000-01. This will mark four consecutive years in which the budget will be in balance or surplus.
- Program spending as a share of gross domestic product (GDP) is expected to decline from 12.6 per cent in 1998-99 to 12 per cent in 2000-01, the lowest level in 50 years.
- The Debt Repayment Plan and continued economic growth will ensure that the debt-to-GDP ratio remains on a permanent downward track.
- The debt-to-GDP ratio is expected to be 65.3 per cent in 1998-99 and then fall to just under 62 per cent by 2000-01. This compares to 71.2 per cent in 1995-96.
- By the accounting standards used in most other countries, the federal government will post a financial surplus for the third consecutive year in 1998-99 – the only G-7 country to do so.
- Market debt – the debt issued on credit markets – is expected to fall even faster than the public debt. Market debt is expected to decline to about $457 billion in 1998-99, down about $20 billion from its peak of $476.9 billion in 1996-97.

The budgetary deficit, which stood at $42.0 billion in 1993-94, was eliminated in just four years. In fact, a surplus of $3.5 billion, the first in 28 years, was recorded in 1997-98 (Chart 1.1). As a result, net public debt declined by this amount in 1997-98. Based on financial results for the first nine months of 1998-99, and including measures announced in this budget, a balanced budget or better is expected for 1998-99 – the second consecutive year in which the budget will be in balance or surplus. To the extent that the Contingency Reserve is not needed, it will be used to pay down debt.

The fiscal outlook presented in Table 1.1 includes all of the spending and tax measures announced since the 1998 budget – measures that will contribute to a stronger economy and a more secure society. Even taking these measures into account, total program

Chart 1.1

Federal budgetary balance and financial surplus/requirements
(Public Accounts basis)



spending as a percentage of the economy will decline to 12 per cent by 2000-01. This is down from 16.6 per cent in 1993-94 and marks its lowest level in 50 years.

With the era of deficit financing now over, Canada is entering the new millennium with its financial credibility restored. The Debt Repayment Plan, introduced in the last budget, will ensure that the government continues to build on the fiscal progress achieved to date.

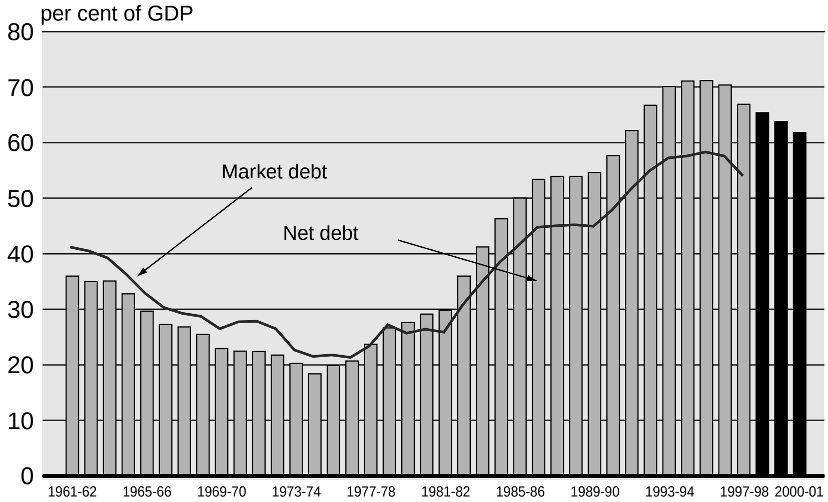
The Debt Repayment Plan is based on three key elements:

- two-year fiscal plans based on prudent economic planning assumptions;
- the inclusion in the fiscal plan of a Contingency Reserve in each year; and
- the use of the Contingency Reserve, when not needed, to pay down the public debt.

The debt-to-GDP ratio (the debt in relation to the total income generated in the economy) is expected to fall from its peak of about 71 per cent in 1995-96 to just under 62 per cent in 2000-01 (Chart 1.2).

While Canada has made significant fiscal progress by eliminating its deficit, the debt-to-GDP ratio remains high by Canadian historical and international standards.

Chart 1.2
Federal debt-to-GDP ratio
(Public Accounts basis)



Note: Forecasts of market debt have not been included due to the uncertainty involved in forecasting these amounts.

However, the Debt Repayment Plan, combined with sustained economic growth, will maintain the debt-to-GDP ratio on a permanent downward track. This will ensure that, in the future, the government's ability to deliver on economic and social priorities will not be hampered by the onerous costs imposed by a large debt, through the higher taxes and interest rates it entails.

The commitment to balanced budgets or better, in both 1999-2000 and 2000-01 also means that:

- there will be ongoing financial surpluses; and
- there will be a steady repayment of the federal government's market debt.

The measure of budget balance most consistent with that used in most other major industrialized countries is financial requirements/ surplus – the net cash flow from government operations. On this basis, the Canadian government recorded a $1.3-billion surplus in 1996-97, a $12.7-billion surplus in 1997-98, and is expected to record an $11.5-billion surplus in 1998-99 (Table 1.1). Among the G-7 countries, Canada is the only country to achieve surpluses three years in a row, at the central government level.

Table 1.1
Summary statement of transactions: fiscal outlook with budget measures

	1997-98	1998-99	1999-00	2000-01
		(billions of dollars)		
Budgetary transactions				
Budgetary revenues	153.2	156.5	156.7	159.5
Program expenditures	108.8	112.1	111.2	113.2
Operating balance	44.4	44.4	45.5	46.3
Public debt charges	40.9	41.4	42.5	43.3
Underlying balance	3.5	3.0	3.0	3.0
Contingency reserve		3.0	3.0	3.0
Budgetary balance	3.5	0.0	0.0	0.0
Net public debt	579.7	579.7	579.7	579.7
Non-budgetary transactions	9.3	11.5	5.0	7.0
Financial requirements/surplus (excl. foreign exchange transactions)	12.7	11.5	5.0	7.0
Percentage of GDP				
Budgetary revenues				
Including budget measures	17.7	17.6	17.2	17.0
Excluding 1998 &1999 budget measures/ EI rate reductions	17.7	17.9	17.8	17.7
Program spending	12.6	12.6	12.2	12.0
Public debt charges	4.7	4.7	4.7	4.6
Budgetary balance	0.4	0.0	0.0	0.0
Financial requirements/surplus	1.5	1.3	0.5	0.7
Net public debt	66.9	65.3	63.7	61.7

Financial requirements/surplus largely determine the government's net new borrowing requirements or debt retirement. Other factors influencing overall borrowing requirements or debt retirement are exchange fund transactions and changes in cash balances. With a financial surplus of $12.7 billion in 1997-98, the government was able to retire $9.6 billion of market debt – interest-bearing debt the government owes private sector lenders. It is expected that a similar amount will be retired in 1998-99, bringing the two-year decline in market debt to about $20 billion.

Summary of spending and tax actions

The net fiscal impact of the spending and tax actions proposed since the 1998 budget is summarized in Table 1.2. The fiscal cost of these proposed spending and tax initiatives amounts to $5.7 billion in 1998-99, $4.1 billion in 1999-2000, $5.6 billion in 2000-01 and $7.5 billion in 2001-02.

Over the four years, 1998-99 to 2001-02, the new fiscal cost of the spending and tax actions amount to $22.9 billion. Of this amount, $14.1 billion is for spending initiatives. Most of this is for increased spending initiatives related to “Building a Secure Society.” This includes the $6.5 billion to the provinces and territories for health care, $1.4 billion for other health initiatives and $2.3 billion for other initiatives, including increased funding for Aboriginal peoples, crime prevention, furthering international cooperation, renewing the Equalization program, official languages and for compensation and benefits in the Canadian military.

Over $1.8 billion is allocated for building on the Canadian Opportunities Strategy, for research and innovation and employment programs. As a result, over three-quarters of the spending initiatives announced in the 1998 and 1999 budgets reflect two of the highest priorities of Canadians – increased funding for health care and access to knowledge and innovation (see Annex 1).

Finally, funding has also been provided for economic adjustment in a number of sectors. These include the previously announced funding for the Canadian Fisheries Adjustment and Restructuring Program and the Agricultural Income Disaster Assistance Program.

The general tax relief and fairness measures, including the proposed increase to the Canada Child Tax Benefit, amount to $7.7 billion over the next three years. In addition, employment insurance premium rates were lowered in 1999. For employees, the rate dropped from $2.70 in 1998 to $2.55 in 1999, with corresponding declines for employers. The total impact of the tax relief measures amount to $8.8 billion over the remainder of this fiscal year and the next three years.

Table 1.2
Spending and tax initiatives since the 1998 budget

	1998-99	1999-00	2000-01	2001-02	Cumulative total
			(millions of dollars)		
Spending initiatives					
Building a Secure Society					
Strengthening health care for Canadians					
Increased CHST cash transfers			1,000	2,000	3,000
CHST supplement[1]	3,500				3,500
Total CHST	3,500		1,000	2,000	6,500
Potential cash flow to provinces					
Increased funding for health care					
Of which:		*2,000*	*2,000*	*2,500*	*6,500*
CHST			*1,000*	*2,000*	*3,000*
CHST supplement		*2,000*	*1,000*	*500*	*3,500*
Other health initiatives					
Improving health information systems	95	28	85	120	328
Promoting health-related research and innovation[2]	160	50	115	225	550
First Nations and Inuit health services		20	60	110	190
Preventive and other health initiatives		49	104	134	287
Total	255	147	364	589	1,356
Other initiatives	247	510	710	804	2,271
Total – Building a Secure Society	4,002	658	2,074	3,393	10,127

Table 1.2
Spending and tax initiatives since the 1998 budget (cont'd)

	1998-99	1999-00	2000-01	2001-02	Cumulative total
			(millions of dollars)		
Building a Stronger Economy					
Building on the Canadian Opportunities Strategy					
Creating knowledge					
Canada Foundation for Innovation[2]	100				100
Support for advanced research	16	50	55	55	176
Disseminating knowledge		27	42	27	96
Commercializing knowledge		121	232	317	670
Supporting employment		265	265	265	795
Total	116	463	594	664	1,837
Economic adjustment	1,241	645	152	69	2,107
Total – Building a Stronger Economy	1,357	1,108	746	733	3,944
Total spending initiatives	5,358	1,766	2,820	4,126	14,070
General tax relief and fairness measures					
General tax relief		1,530	2,555	2,965	7,050
Canada Child Tax Benefit			225	300	525
Tax fairness measures		15	25	100	140
Reduction in EI premiums	300	800			1,100
Total	300	2,345	2,805	3,365	8,815
Total spending and tax initiatives	5,658	4,111	5,625	7,491	22,885

[1] CHST supplement in 1998-99 will be paid to a third-party trust in 1999-2000, on passage of authorizing legislation. Expected drawdown by provinces and territories is described in Chapter 4.

[2] An additional $200 million is being allocated to the Canada Foundation for Innovation. It is expected that about half will be used to improve infrastructure for health research.

Outline of the budget plan

- Chapter 2 reviews recent economic developments and prospects. It establishes the economic planning assumptions that underlie the government's budget plan.
- Chapter 3 provides a detailed fiscal outlook through to 2000-01.
- Chapter 4 describes the government's strategy to strengthen health care for Canadians and to renew transfers to the provinces and territories.
- Chapter 5 identifies the challenges facing Canadians in ensuring sustained increases in their standard of living and other improvements in their quality of life. It then summarizes the action plan the government has been implementing to meet these challenges and the measures announced in this budget to support access to knowledge and innovation.
- Chapter 6 describes the tax relief provided in this budget and how it builds on the relief provided in the 1998 budget.

There are also a number of annexes.

- Annex 1 describes spending initiatives and tax actions undertaken since the February 1997 budget.
- Annex 2 describes and reconciles three different measures of the federal fiscal position – the budgetary balance, the financial requirements/surplus and the National Accounts budget balance.
- Annex 3 updates the fiscal situation of the total government sector in Canada.
- Annex 4 compares Canada's fiscal situation with that of other major industralized countries.
- Annex 5 describes the fiscal sensitivity of the federal budget to changes in economic growth and interest rates.
- Annex 6 outlines the government's response to the 1998 Report of the Auditor General and his "Observations" on the Government of Canada's financial statements.
- Annex 7 provides supplementary information on the tax measures contained in this budget.

2

Building Today for a Better Tomorrow

Economic Developments and Prospects

Highlights

- The global economic environment deteriorated significantly over the past year and a half due to the fallout from the Asian crisis. And while recent economic developments are more encouraging, the world outlook remains uncertain.
- Like many other economies, Canada's economy has not been immune to the "Asian flu." Indeed, global uncertainty slowed Canadian economic growth in 1998 from its strong pace in 1997.
- Despite these negative external developments, employment soared in 1998: 453,000 jobs were created following the already impressive gain of 368,000 jobs in 1997. This marks the best annual performance of the decade and exceeds the job performance of any other G-7 country in 1998.
- This strong job performance continued into 1999 with 87,000 jobs created in January, pushing the unemployment rate down to 7.8 per cent, its lowest level since June 1990.

Highlights *(cont'd)*

- Notably, almost 40 per cent of the new jobs created over the last 12 months have gone to Canada's youth, who posted their strongest yearly employment growth in over twenty-five years.
- Private-sector forecasters expect growth in Canada to moderate to 2.0 per cent in 1999, before picking up to 2.5 per cent in 2000.
- Both the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) expect Canada to be among the top performers in the G-7 countries in terms of growth and to lead in terms of job creation in 1999.
- Canada's relatively positive economic developments and prospects are clear evidence that strong economic fundamentals are helping us prosper despite global volatility.

Introduction[1]

After a year and a half of extraordinary uncertainty and turmoil on a global level, the crisis that originated in Asia in 1997 has left its imprint on Canada, as it has on all economies. As a result, Canadian economic growth slowed in mid-1998 from its strong pace in the second half of 1996 through to early 1998. Real growth is expected to have averaged 2.9 per cent in 1998, down from 3.8 per cent in 1997. The economy nonetheless ended 1998 on a strong note, much as the year began.

Global economic prospects also brightened toward the end of 1998, due to a shift toward economic policy stimulus in the major industrial countries, mainly through lower interest rates. Moreover, clear progress in implementing essential financial and economic reforms by countries first affected by the crisis, and the replenishment of IMF funds, also went a long way to fostering global financial market confidence and stability.

[1] All statistical references are as of Monday, February 1, 1999 unless otherwise noted.

Looking ahead, private-sector forecasters expect Canadian economic growth to continue to moderate to 2.0 per cent in 1999 before picking up to 2.5 per cent in 2000, reflecting the ongoing effects of weak world demand and expectations that global economic conditions will improve only slowly. Moreover, the U.S. economy, the largest single market for Canada's exports, is also expected to grow at a slower yet more sustainable pace than in 1998.

Canada's relatively positive economic prospects reflect our solid economic fundamentals, which have allowed for macroeconomic conditions that are favourable to growth. Canada's success in eliminating the deficit and keeping inflation low undoubtedly has been instrumental in keeping interest rates at historically low levels.

But risks remain to the world economic outlook. Indeed, the spillover effects of world economic developments on Canada since late 1997 make clear the ongoing need for fiscal planning to be based on prudent economic assumptions.

Recent Economic Developments

World economy

World economic growth fell from over 4 per cent in 1997 to 2.2 per cent in 1998 primarily because of financial market instability originating in Asia, which then spread to other regions including Russia and Latin America, weakening aggregate demand worldwide.

The resulting buildup of large, worldwide excess supplies of commodities put almost unprecedented downward pressures on world commodity prices. In fact, the U.S. dollar price of resource-based commodities has fallen about 35 per cent from its peak in December 1996.

The worsening of global financial turmoil in August and September 1998 posed serious risks of a global recession. This prompted central banks in major industrial countries to lower interest rates. This easing was successful because, in contrast to the situation in recent decades, industrialized countries, including Canada, have generally followed low inflation and deficit reduction policies in the 1990s. Central bank easing and declining global inflation have permitted long-term interest rates to fall to historical lows worldwide.

The move to policy stimulus was led by the U.S. Federal Reserve which responded by lowering interest rates beginning in late September. Monetary authorities in Europe also lowered interest rates prior to the move to a single currency, the euro, and the establishment of the European Central Bank on January 1, 1999.

World economic developments over the last year and a half underscore the importance of sound economic policies and financial market mechanisms, both at domestic and international levels. That is why Canada put forward a six-point program to address both the short-term problems raised by the recent financial crisis as well as the longer-term, underlying issues associated with open capital markets. Canada has also been working with other industrial and developing countries to put in place measures to address the financial crisis in many emerging market economies and to help prevent and manage future crises. This includes measures to strengthen countries' financial sectors and to ensure that the private sector plays an appropriate role in crisis prevention and resolution.

Reforming the International Financial Architecture

Canada has put forward a six-point program that addresses both the short-term problems raised by the latest financial crisis, as well as the longer-term underlying issues associated with open capital markets. The program includes:

- use of appropriate monetary policy through G-7 central banks, giving the appropriate weight to the risk of a further slowdown in the global economy;
- a renewed commitment by the emerging market economies to sound macroeconomic and structural policy;
- expeditious action to strengthen national financial systems and international oversight;
- development of a practical guide or "roadmap" for safe capital liberalization in developing countries;
- agreement to work urgently towards a better mechanism to involve private-sector investors in the resolution of financial crises; and
- greater attention to the needs of the poorest countries to ensure that they receive the resources and the support they need to reduce poverty and begin growing.

Although much remains to be done, lower interest rates, as well as progress made by countries affected by the crisis in implementing essential financial and economic reforms, have contributed to renewed financial market stability and improved global economic prospects.

Indeed, revived financial market confidence in the late fall of 1998 pushed equity prices higher in both advanced and emerging market countries.

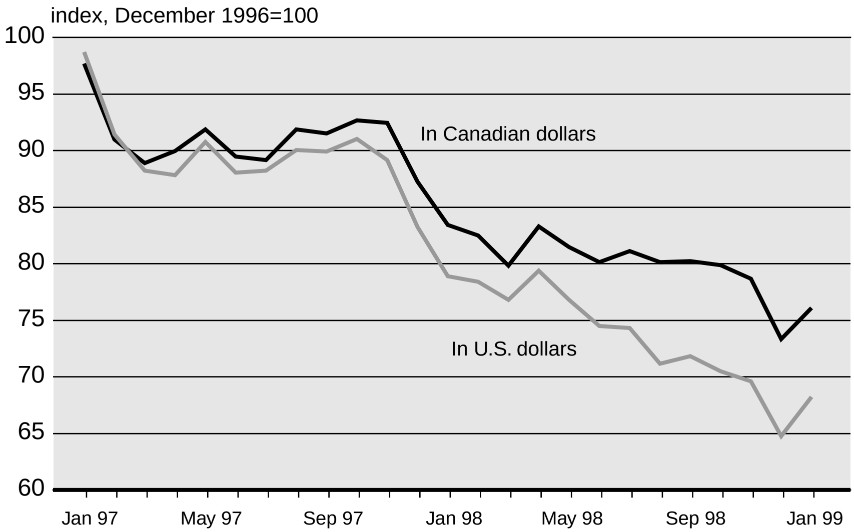
Nonetheless, the financial volatility that culminated in Brazil floating its currency last month underscores the difficulty of assessing whether or not contagion effects from the Asian crisis have fully run their course.

Canadian economy

Lower world commodity prices were the most significant channel through which the Asian crisis dampened Canadian economic growth in 1998 (Chart 2.1). Forestry, farming and mining in particular have suffered. Because Canada is a net exporter of commodities, this led to a decline in the price of Canada's exports relative to the price of our imports – otherwise described as a deterioration in the "terms of trade."

Chart 2.1

Commodity prices

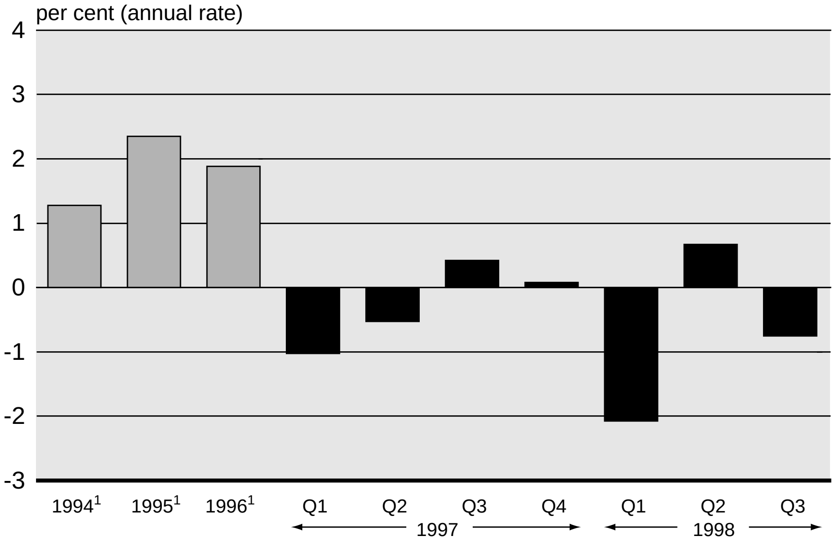


Source: Department of Finance Commodity Price Index.

This deterioration in our terms of trade put considerable downward pressures on the aggregate price of Canada's production or GDP. Indeed, the producer price level is expected to have actually declined during 1998, due mainly to a decline in commodity export prices (Chart 2.2). However, broad measures of prices on goods and services that are purchased by Canadians, such as consumer prices, are expected to have increased modestly in 1998. In fact, growth in the consumer price index (CPI) remained within the target band of 1 to 3 per cent set by the Bank of Canada.

Chart 2.2

GDP inflation



[1]Q4-over-Q4 growth.

Combined with slower real GDP growth in 1998, the decline in GDP prices further slowed growth in nominal GDP and thus in the overall tax base.

As typically happens when world commodity prices fall, the Canadian dollar also came under downward pressure last summer. This led to a temporary increase in short-term interest rates, which had been much lower than those in the U.S. at the beginning of last year. By August, when the Bank Rate increased by 100 basis points, Canadian short-term rates had moved above those in the U.S.

Short-term interest rates have since declined and are now virtually at parity with similar U.S. rates, which have also declined. As a result, at around 4.7 per cent, short-term interest rates are back to the levels seen early last year. Moreover, long-term rates continued to decline over 1998, and are also at historically low levels (Chart 2.3).

Chart 2.3

Canadian interest rates

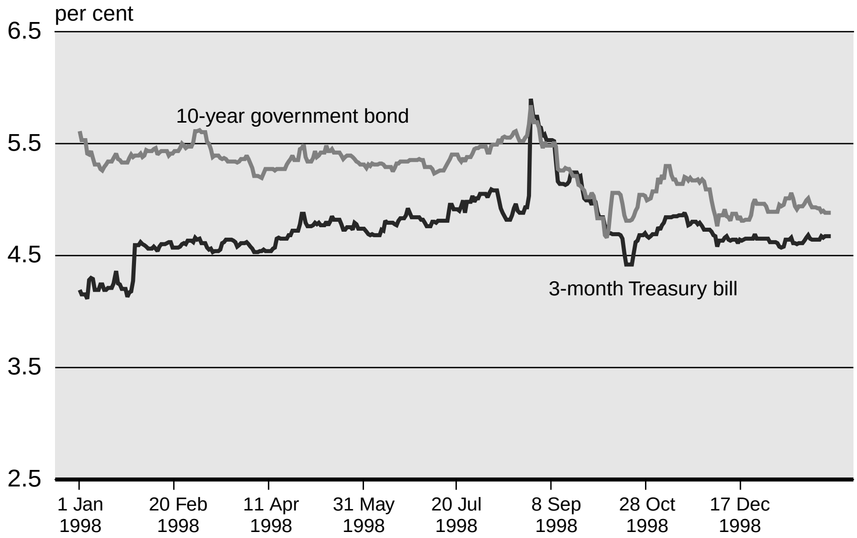
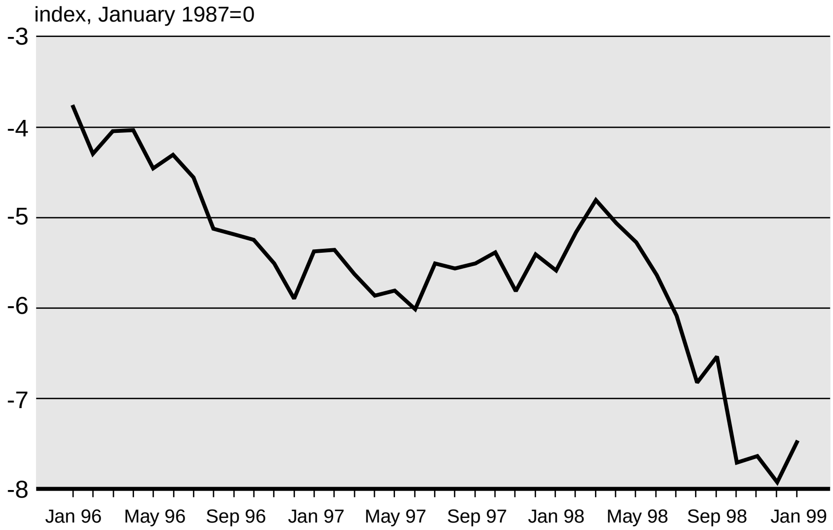


Chart 2.4

Monetary conditions index



Source: Bank of Canada.

With short-term interest rates roughly back to where they were in early 1998, a lower dollar means that overall monetary conditions have eased considerably over the past 12 months (Chart 2.4). Easier monetary conditions have been reinforced by lower long-term interest rates. By supporting growth, monetary conditions are offsetting and will continue to offset some of the negative impacts of the global crisis.

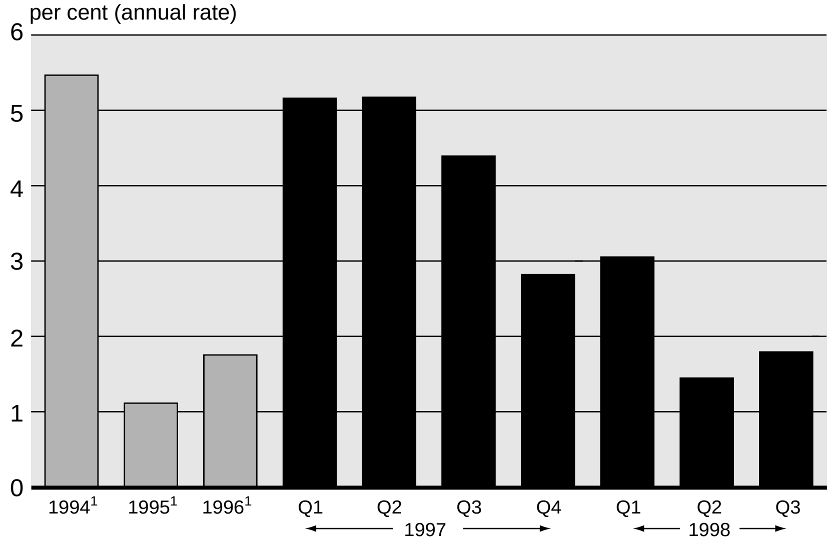
The impact of weaker world demand and lower commodity prices was also felt in profits and thus in stock markets. The Canadian stock market was particularly hard hit, given its heavy weighting in resource firms (more so than the economy as a whole). The TSE 300 fell more than 30 per cent between its peak in April and its trough in October. These developments clearly slowed growth and undermined confidence in late summer. The year ended on a stronger note, however, with renewed world financial market stability and restored confidence. According to the Conference Board of Canada, consumer confidence increased by 6.4 per cent in the fourth quarter, while business confidence rose by 2.8 per cent. Moreover, the TSE 300 rebounded strongly over the fall, ending the year only modestly lower than its January 1, 1998 level.

Real Canadian GDP growth slowed to an average annual rate of under 2 per cent in the second and third quarters of 1998, after averaging a robust 3.7 per cent in the seven-quarter period ending in the first quarter of 1998 (Chart 2.5). But the Canadian domestic economy still performed relatively well, considering the difficult international context and the impact of a number of major strikes. Indeed, recent economic indicators tend to suggest that real GDP growth rebounded in the fourth quarter of 1998. The relatively strong performance of the Canadian economy in 1998 reflects sound underlying economic policies that have allowed us to maintain generally stimulative macroeconomic conditions.

This resilience is clearly demonstrated by healthy job creation, which helped to generate income gains; these gains in turn sustained domestic demand. Jobs were created in all regions of the country in 1998; a total of 453,000 jobs were created last year, well above the robust pace set during 1997 (Chart 2.6). In fact, Canada even outpaced the U.S. in terms of job growth in both 1997 and 1998 (Chart 2.7). This strong job performance continued into 1999, with 87,000 jobs created in January. Moreover, almost 40 per cent of the new jobs created over the last 12 months have gone to Canada's youth, who posted their strongest yearly employment growth in over 25 years. Solid job growth pushed down the overall unemployment rate to 7.8 per cent in January, despite some recovery in the labour force participation rate. The unemployment rate, while still too high, is now at its lowest level since June 1990.

Chart 2.5

Real GDP growth



[1]Q4-over-Q4 growth.

Chart 2.6

Cumulative employment growth by region, 1998

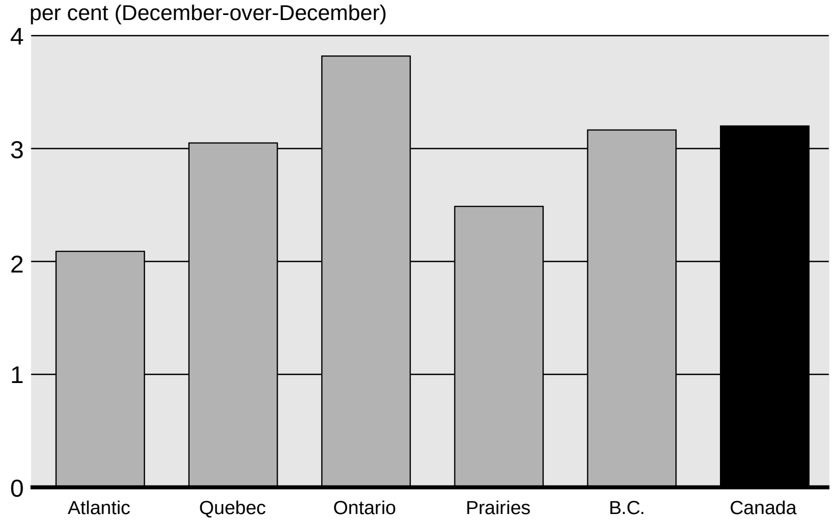
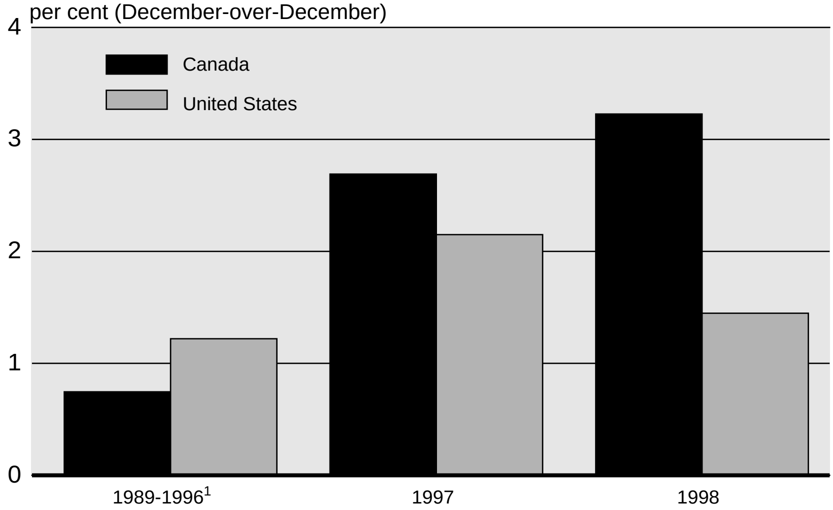


Chart 2.7

Employment growth: Canada vs. U.S.



[1]Average annual rates.

Among major categories of domestic demand, business investment slowed the most in 1998, albeit from a very strong pace of growth. The slowdown mainly reflected sharply weaker prices and falling profits in the resource sector. Investment nevertheless remained relatively strong, increasing over the first three quarters of 1998 by an average annual rate of around 7 per cent. Non-residential construction remained particularly strong, while the level of investment in machinery and equipment remained quite high and therefore generated robust growth in the capital stock.

Inventory accumulation also slowed during the course of 1998, but from high and possibly unintended levels. The current modest level of inventory stocks relative to sales bodes well for production growth in the near term.

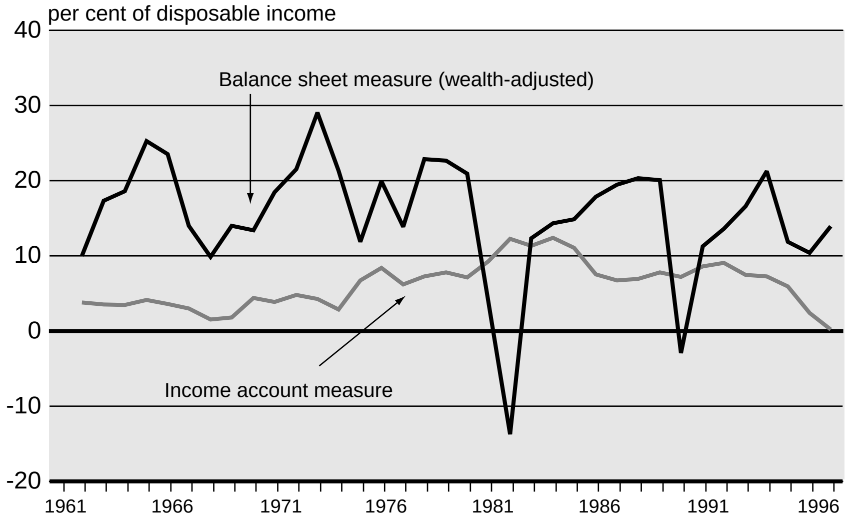
Consumption growth has also slowed in recent quarters from its previously strong rate but was still solid at an average annual rate of 2.7 per cent over the first three quarters of 1998. This indicates strong confidence in Canada's economic prospects and reflects solid growth in personal net wealth. Personal net wealth is not accounted for in standard measures of income and therefore has led to an underestimation of the personal savings rate in the conventional National Accounts measure.

National Accounts measure of income and the savings rate

- A significant part of what individuals or families normally consider as income and savings is not included in the National Accounts measure of the personal savings rate.
- Specifically, capital gains from investments in stocks, bonds, mutual funds or real estate are not part of income or savings in the National Accounts because the Accounts measure only the income generated from production of new goods and services, not the effects of higher prices for existing assets.
- A more comprehensive measure of savings that accounts for these wealth gains shows that the real personal savings rate has remained healthy in the 1990s, and is close to its historical average (Chart 2.8).

Chart 2.8

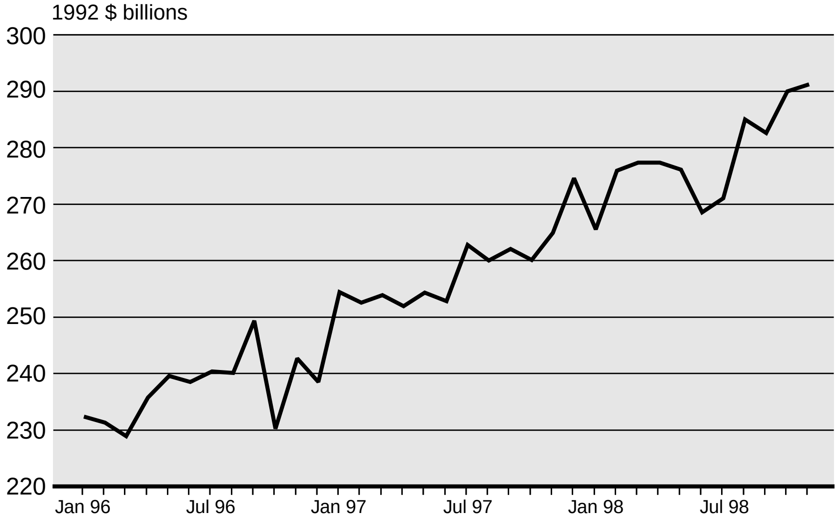
Personal savings rates



The Canadian economy is also exhibiting strength in the continued ability of firms to boost their exports despite the Asian crisis and the deteriorating external environment. In fact, real exports increased by $12.5 billion, or over 5 per cent at an average annual rate, over the first three quarters of 1998 (Chart 2.9).

Chart 2.9

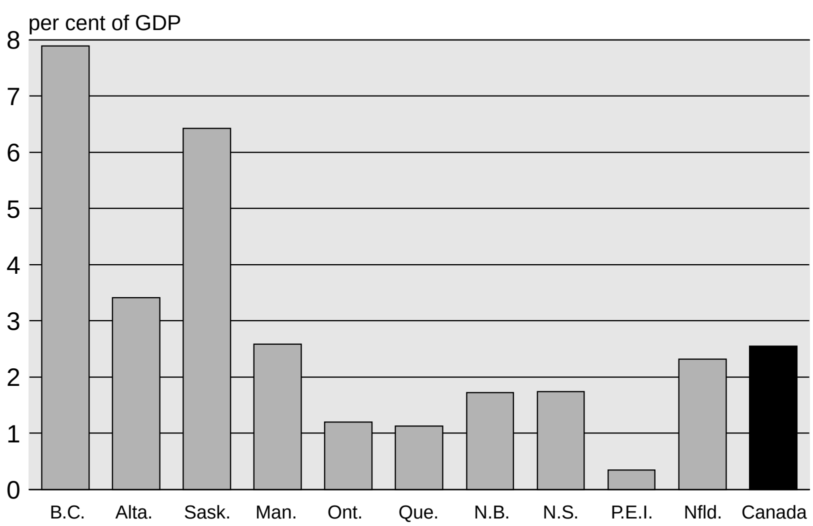
Real merchandise exports



That said, exports did decline to countries affected directly or indirectly by the crisis. Canada's western provinces, especially British Columbia, were particularly hard hit as they rely heavily on trade with Asia (Chart 2.10). At the same time, imports from Asian countries increased, as depreciation in their currencies made their products more competitive both within Canada and in Canada's export markets.

Graphique 2.10

Exports to Southeast Asia in 1997 by province



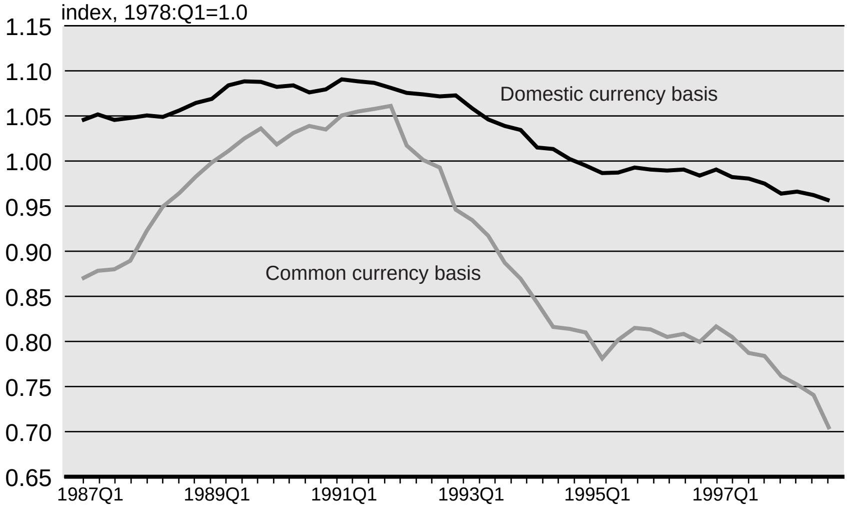
However, the trade impact was small for the country as a whole as exports to Southeast Asia (which includes many of the countries affected by the crisis) account for only 2½ per cent of Canada's GDP. Moreover, overall export growth over this period was fuelled by continued strong demand growth in the U.S., our largest trading partner, as well as ongoing increases in the competitiveness of Canadian firms.

In contrast, imports were virtually unchanged over the first three quarters of 1998, due in part to a slowdown in the growth of the components of aggregate demand that have a particularly large import content, such as machinery and equipment investment and consumption of durables. Near-zero import growth was also due to improved competitiveness, which has resulted in the substitution of domestic for imported goods.

Increased competitiveness reflects not only a lower dollar but also lower relative costs per unit produced, which are a direct payoff for Canada's success in maintaining low inflation and improving productivity growth (Chart 2.11).

Chart 2.11

Canada-U.S. relative unit labour costs



The Economic Outlook and Risks

External environment

The global economy is expected to recover only slowly over the next two years. The IMF's December 1998 projection is for it to grow a modest 2.2 per cent in 1999, rising to 3.5 per cent in 2000 (Table 2.1), although the IMF believes the risks remain predominantly on the downside. As a result, global commodity prices are expected to recover only moderately over the next two years.

Overseas economies

Among the major industrial countries, Japan will continue to suffer the greatest economic weakness over the near term (Table 2.1). Japan still faces serious domestic challenges as it reforms its financial system and attempts to lift its economy out of recession. In fact, the second largest economy in the world is expected to begin to recover only later in 1999, leaving Japanese real GDP virtually stagnant on a year-over-year basis.

Table 2.1
Global economic outlook

	1998	1999	2000
		(per cent)	
World	2.2	2.2	3.5
Japan	-2.6	0.2	0.7
Germany	2.7	2.2	2.5
France	3.1	2.4	2.6
United Kingdom	2.7	0.8	1.5
Italy	1.5	2.1	2.6

Sources: December 1998 *OECD Economic Outlook* for G-5 countries, IMF December 1998 *World Economic Outlook* for world.

Following good performances in 1998, most major European countries are expected to post fairly solid albeit more moderate growth in 1999, with the exception of the United Kingdom, where a substantial slowdown is expected.

United States

The U.S. economy continued to exceed expectations in 1998, despite being at the limit of its productive capacity as conventionally estimated, and despite the adverse impact of the elevated U.S. dollar and reduced Asian and Latin American demand on U.S. trade. In fact, U.S. real GDP is now estimated to have grown 3.9 per cent last year, the same robust pace as in 1997.

Despite the strong performance of the economy at the end of 1998, the consensus forecast continues to call for a significant slowing of U.S. growth through 1999 (Table 2.2). This reflects mainly an expected slowing in consumption and business fixed investment.

Table 2.2
U.S. economic outlook – private-sector consensus

	1998[1]	1999	2000
		(per cent)	
Real GDP	3.9	2.4	2.3
CPI	1.6	2.0	2.4
3-month Treasury bill rate	4.8	4.3	4.4
10-year government bond rate	5.3	4.9	5.1

Source: January *Blue Chip Consensus*.

[1] Preliminary or final estimates for 1998.

Canada's economic prospects

For Canada, the global economic situation will likely continue to be a drag on growth in 1999 and 2000 for two main reasons. First, slower U.S. growth will clearly dampen Canadian exports. Second, a slow recovery in global economic growth over the next two years will likely result in only a mild recovery in commodity prices and a modest restoration of profits and incomes in Canada.

These developments will be partly offset by continued stimulative monetary conditions; indeed, U.S. interest rates are likely to remain at low levels given slower growth and quiescent U.S. inflation. In this environment, the Canadian economy is expected to continue to grow moderately.

Moreover, because of the success in restoring Canada's fiscal health, most Canadian governments are now in a position to directly support growth without jeopardizing their hard-won fiscal health and credibility. Half of governments have balanced their budgets and all have put their debt-to-GDP ratios on a downward track. The total government sector deficit, which stood at $66 billion – or 9.5 per cent of GDP – in 1992-93, was eliminated by 1997-98.

Monetary and fiscal policy can therefore now work together to strengthen the economy and make it better able to withstand adverse global economic developments. Moreover, the healthy job growth already achieved will favour a virtuous circle of strong income gains, growing consumer demand, higher business investment and further job creation.

Despite these strengths, fiscal planning must account for the fact that nominal GDP growth – which drives nominal incomes and thus the tax base – is likely to remain modest because commodity prices, and therefore producer prices, are expected to remain weak.

Private-sector consensus

Consistent with deteriorating global economic prospects, private-sector forecasters have become steadily more pessimistic over the last year about Canada's growth prospects, although they continue to expect the Canadian expansion to remain self-sustaining over the next two years. The January 1999 private-sector consensus calls for real growth to slow to 2.0 per cent in 1999 from the 2.9 per cent now expected for 1998, and then to recover somewhat to 2.5 per cent in 2000 (Table 2.3).

Over the last year, private-sector forecasters have lowered their projections for price increases in Canada to an even greater degree. They now expect GDP prices to have fallen 0.4 per cent on average during 1998, and to increase only 0.7 per cent in 1999 and 1.4 per cent in 2000.

As a result of lower forecasts for both real GDP growth and GDP inflation, the January consensus calls for growth in nominal GDP to reach only 2.5 per cent in 1998 and 2.7 per cent in 1999, just over half of what had been expected at the beginning of 1998.

Private-sector forecasters, on average, expect that slowing global growth will lead to further modest declines in U.S. and Canadian short-term interest rates from current levels. In particular, Canadian short rates are expected to fall to an average of 4.4 per cent in 1999 and 4.5 per cent in 2000. Longer-term rates are, in contrast, expected to drift up somewhat from current levels.

Table 2.3
Evolution of the private sector consensus[1]

	1998	1999	2000
Real GDP growth (%)			
January 1998	3.5	2.9	
September 1998	2.9	2.2	2.6
January 1999	2.9	2.0	2.5
GDP inflation (%)			
January 1998	1.2	2.0	
September 1998	0.1	1.3	1.6
January 1999	-0.4	0.7	1.4
Nominal GDP growth (%)			
January 1998	4.7	4.9	
September 1998	3.0	3.5	4.2
January 1999	2.5	2.7	3.9
CPI inflation (%)			
January 1998	1.5	1.7	
September 1998	1.2	1.6	1.6
January 1999	1.0	1.4	1.6
Unemployment rate (%)			
January 1998	8.5	8.2	
September 1998	8.4	8.3	8.2
January 1999	8.4	8.2	8.1
Employment growth (%)			
January 1998	2.3	2.1	
September 1998	2.4	1.6	1.8
January 1999	2.7	1.9	1.6
3-month Treasury bill rate (%)			
January 1998	4.6	4.6	
September 1998	5.0	5.2	5.2
January 1999	4.8	4.4	4.5
10-year govt. bond yield (%)			
January 1998	5.9	6.0	
September 1998	5.4	5.4	5.7
January 1999	5.3	5.1	5.4

[1] The January 1999 consensus is based on 19 respondents to a survey of private-sector forecasters conducted between late December and early January.

Risks to the Canadian outlook

In light of continued uncertainty surrounding the world economy, the greatest downside risk to Canada's growth prospects is the possibility of further significant and negative global economic developments, most notably developments occurring in emerging economies as a result of the Asian crisis. A related risk is that the ongoing effects on major industrial nations of the world turmoil over the last year and a half could be more severe than expected. Either of these developments could lead to even slower U.S. growth, especially when considered in the context of possibly unsustainable structural imbalances in the corporate and household sectors in that country.

That said, the private-sector forecasters surveyed in January who anticipate lower real growth in Canada relative to the consensus also expect interest rates to be lower. This expectation is supported by developments in world interest rates over the last year in response to lower growth prospects. Lower interest rates would partly offset some of the unexpected adverse effects of world developments on Canadian domestic demand, as well as lower-than-expected U.S. growth on Canadian exports.

Canada's economic prospects are balanced by some upside potential. Both the Canadian and U.S. economies ended the year with considerably more momentum than most economists expected in mid-1998. Indeed, with a healthy virtuous circle of strong job creation and income growth, economic performance in Canada and the U.S. may exceed expectations in 1999 and beyond. Stronger U.S. growth would favour Canadian exports. However, it would also likely put upward pressure on U.S. interest rates. Any ensuing upward pressure on Canadian interest rates would moderate growth in Canadian domestic demand.

Prudent Economic Assumptions for Fiscal Planning

Ongoing uncertainty about the full impact of the Asian crisis, nearly a year and a half after it began, shows the wisdom of basing fiscal planning on prudent assumptions.

The economic outcome for 1998 is an example of the importance of being prudent. The prudence factors used in the 1998 budget were generally larger than in previous budgets, particularly for nominal GDP, given:

- the relatively optimistic view of the private-sector at the time with respect to GDP inflation and, to a lesser extent, real GDP growth, given the extraordinarily high downside risks posed by the Asian crisis and unprecedented downward pressure on commodity prices; and
- the unusually high upside risks to interest rates due to the large negative spreads between Canadian and U.S. rates at a time when the Canadian dollar was at risk of being adversely affected by weakening commodity prices.

As it turned out, the nominal GDP downside risks highlighted in the last budget were fully realized in 1998. As a result, private-sector forecasters have substantially revised downward their expectations for nominal GDP for 1998 and 1999.

The latest private sector projections assume very low GDP inflation in 1999 and only a moderate rebound in 2000. Overall, the January 1999 private sector consensus is a much better base for fiscal planning than was the January consensus last year. As a result, a return to normal prudence – similar to that used in earlier budgets – is appropriate for nominal GDP in 1999 and 2000. The rate of nominal GDP growth used for budget planning purposes is 0.2 percentage point lower in 1999 than the January private-sector consensus and 0.6 percentage point lower in 2000.

Normal prudence is also warranted for interest rates since Canadian rates are now slightly above U.S. rates and the probability of a substantial increase in worldwide interest rates in the short to medium run is low. The short-term interest rate used for budget planning purposes is 0.7 percentage point higher than the January private-sector consensus for the average yield on 3-month Treasury bills in both 1999 and 2000. The long-term interest rate used for budget planning purposes is 0.5 percentage point higher than the January private-sector consensus for the average yield on 10-year government bonds in both 1999 and 2000.

Under the current circumstances, the prudence factors on nominal GDP and interest rates actually combine to provide an extra buffer against economic outcomes adverse to the fiscal targets. This is because, given the risks outlined above, interest rates and nominal GDP are likely to move in the same direction, which will tend to dampen the overall fiscal impacts. Thus, in the event of lower-than-expected growth, interest rates would most likely also be lower than expected.

Table 2.4
Prudent planning assumptions

	1998	1999	2000
Nominal GDP growth (%)			
1998 budget	4.1	3.9	
1999 budget	2.5	2.5	3.3
Nominal GDP ($ billions)[1]			
1998 budget	902	937	
1999 budget	887	910	940
3-month Treasury bill rate (%)			
1998 budget	5.4	5.6	
1999 budget	4.8	5.1	5.2
10-year govt. bond yield (%)			
1998 budget	6.4	7.0	
1999 budget	5.3	5.6	5.9

[1] In order to be consistent with the 1999 budget numbers, nominal GDP levels for the 1998 budget have been adjusted to reflect the recent upward National Accounts revisions and are therefore not the same as previously published.

3

Building Today for a Better Tomorrow

Maintaining Sound Financial Management

Highlights

- A balanced budget, or better, is expected for 1998-99 – the second consecutive year in which the budget has been deficit-free. The last time this occurred was almost half a century ago, in 1951-52.

  – To the extent that the Contingency Reserve is not required for 1998-99, it will be used to reduce the public debt.

- The government is committed to balanced budgets or better in both 1999-2000 and 2000-01. This will mark four consecutive years in which the budget will be in balance or surplus.

- Program spending as a share of gross domestic product (GDP) is expected to decline from 12.6 per cent in 1998-99 to 12 per cent in 2000-01, the lowest level in 50 years.

- The Debt Repayment Plan and continued economic growth will ensure that the debt-to-GDP ratio remains on a permanent downward track.

Highlights *(cont'd)*

- The debt-to-GDP ratio is expected to be 65.3 per cent in 1998-99 and then fall to just under 62 per cent by 2000-01. This compares to 71.2 per cent in 1995-96.
- By the accounting standards used in most other countries, the federal government will post a financial surplus for the third consecutive year in 1998-99 – the only G-7 country to do so.
- Market debt – the debt issued on credit markets – is expected to fall even faster than the public debt. Market debt is expected to decline to about $457 billion in 1998-99, down about $20 billion from its peak of $476.9 billion in 1996-97.
- The fiscal position of provincial-territorial governments has also improved. From a peak of $25.0 billion in 1992-93, the provincial-territorial government sector deficit declined to $3.2 billion in 1997-98. With a surplus of $3.5 billion at the federal government level, the total federal-provincial-territorial government sector was in a slight surplus in 1997-98.

Introduction

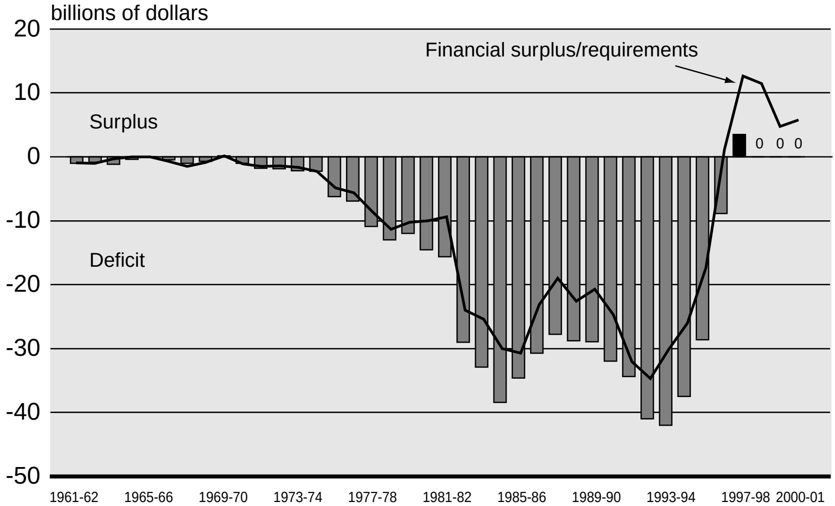
Over the past five years, Canadians and their governments have made tremendous fiscal progress, measured by both domestic and international standards. In 1993-94, the federal deficit was $42 billion and the debt-to-GDP ratio was rising. Including the provinces and the territories, the total government sector deficit was $62 billion and the debt-to-GDP ratio was fast approaching 100 per cent, second highest among the G-7 countries. High deficits and rising interest rates were pushing up the debt burden, depressing economic growth and job creation, which in turn further aggravated the debt burden. At risk was Canada's standard of living.

Canadians wanted their governments to act. The federal government responded with a measured and responsible plan to eliminate the deficit. That plan was based on a fundamental reform, with accompanying reductions of program spending, complemented by a prudent approach to budget planning.

The plan has worked. A budgetary surplus of $3.5 billion was recorded for 1997-98 – the first surplus since 1969-70 (Chart 3.1). A balanced budget or better is expected for 1998-99. As well, the government is now committing to balanced budgets or better for both 1999-2000 and 2000-01. This will mark four consecutive years of balanced budgets or surpluses. On only two other occasions since Confederation has the Government of Canada recorded balanced budgets for at least four consecutive years – in the 1920s and during the World War II demobilization in the late 1940s – early 1950s. Moreover, with a balanced budget in 1998-99, this marks the first time that the federal government has recorded back-to-back balanced budgets since 1951-52, almost half a century ago.

Chart 3.1

Federal budgetary balance and financial surplus/requirements
(Public Accounts basis)



The combined budgetary balance of the federal government and the provinces was a small surplus in 1997-98, as the federal surplus of $3.5 billion offset the consolidated provincial-territorial deficit of $3.2 billion. Based on current plans, the total provincial-territorial government sector is expected to be in balance, if not surplus, by 2000-01. (Additional information on the combined federal-provincial-territorial government balance is presented in Annex 3.)

Financial requirements/surplus

The budgetary deficit/surplus – the budgetary balance – is the most comprehensive measure of the government's financial situation as it includes liabilities incurred by the government regardless of when the actual cash payment is made. It is largely presented on an accrual basis of accounting. However, it is only one measure of the government's financial position.

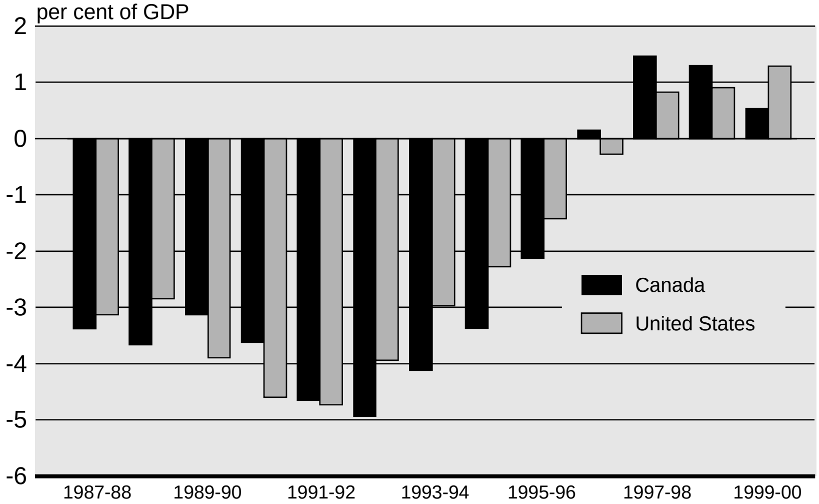
Another important measure is financial requirements/surplus. This measures the difference between cash coming into the government and cash payments made for programs and public debt charges during the year. Thus, financial requirements do not include any liabilities incurred by the government during the year for which no cash payment has been made during that year. Canada recorded a financial surplus of $1.3 billion in 1996-97, $12.7 billion in 1997-98 and, on the basis of the current budget plan, is expected to record a surplus of about $11.5 billion in 1998-99.

Financial requirements/surplus are broadly comparable to the measures of the budgetary balance used by most other major industrialized countries, including the United States. Within the G-7, Canada was the first country to record a financial surplus in this decade, and only Canada and the United States are expected to continue to record financial surpluses over the near term (Chart 3.2).

Financial requirements/surplus provide a broad indication of the change in market debt actually outstanding and held by investors in the form of Government of Canada bonds, Canada Savings Bonds and Treasury bills.

In 1997-98, the government retired $9.6 billion of market debt and, based on results to the end of December 1998, is expected to retire a similar amount in 1998-99, for a total paydown of about $20 billion over two years. With a commitment to a balanced budget or better in each of the next two years, which will result in financial surpluses, the stock of outstanding market debt is expected to continue to decline. However, the actual decline will depend not only on the government's financial surplus but also on foreign exchange transactions and changes in the government's cash balances.

Chart 3.2
Federal government budgetary balance in Canada and the United States
(Public Accounts basis)



Notes: Financial requirements are used for Canada and the Unified Budget Basis (UBB) balance is used for the United States. Fiscal years ending March 31 and September 30 of the same year are used for Canada and the U.S. respectively.

Sources: Canada, Department of Finance; United States, *Budget of the United States Government, Fiscal Year 2000* and the Office of Management and Budget.

Market debt relative to GDP has fallen from its peak of about 58 per cent in 1995-96 to about 54 per cent in 1997-98. It is expected to be about 52 per cent of GDP in 1998-99, depending on foreign exchange transactions and changes in the government's cash balances.

Improvement in the federal fiscal situation since 1993-94

The federal budget balance has swung from a deficit of $42 billion in 1993-94 to a surplus of $3.5 billion in 1997-98. For 1998-99, a balanced budget or better is expected. To the extent that the Contingency Reserve is not required, it will be used to pay down the public debt.

This dramatic turnaround in federal finances is attributable to both a decline in program spending, largely as a result of the restraint measures introduced in the 1994, 1995 and 1996 budgets, and higher budgetary revenues, primarily from a growing economy. Partially offsetting these positive developments were somewhat higher public debt charges. In addition, the 1998-99 budget balance estimate includes the $3-billion Contingency Reserve (Table 3.1).

Table 3.1
Sources of changes in the federal budgetary balance

	1993-94 to 1998-99
	(billions of dollars)
Factors increasing the balance	
Reduction in program spending	15.4
Higher revenues due to economic growth	37.8
One-time revenue adjustments	2.7
Net impact of revenue actions	0.0
Subtotal	55.9
Factors reducing the balance	
Spending actions in 1998 and 1999 budgets	7.5
Increase in public debt charges	3.4
Inclusion of Contingency Reserve in 1998-99	3.0
Subtotal	13.9
Net improvement in federal budgetary balance	42.0

Program spending is expected to decline from $120.0 billion in 1993-94 to $112.1 billion in 1998-99 – a reduction of $7.9 billion. This reduction is more than accounted for by the impact of the restraint measures taken since 1993-94. However, growth in some programs unaffected by restraint (for example, elderly benefits and Equalization) and policy initiatives have offset some of the impact of the restraint measures. Since the February 1997 budget, policy initiatives, directed primarily to health and access to knowledge and skills training, have totalled $7.5 billion in 1998-99. This includes an additional $4.4 billion in CHST cash transfers to provinces and territories (of which $0.9 billion was attributable to raising the CHST cash floor to $12.5 billion and $3.5 billion reflects the CHST supplement), $1.1 billion for other "Building a Secure Society" initiatives, (primarily for health-related initiatives), $0.8 billion for the Canadian Opportunities Strategy and $1.2 billion for economic adjustments ($0.6 billion each for the Canadian Fisheries Adjustment and Restructuring Program and the Agricultural Income Disaster Assistance Program).

The decline in program spending is more pronounced when it is viewed in relation to the size of the economy over this period. In

1993-94, total program spending as a percentage of GDP was 16.6 per cent. By 1998-99, it is expected to be 12.6 per cent. Over the next two years, it is expected to continue to decline to about 12 per cent of GDP by 2000-01.

Between 1993-94 and 1998-99, budgetary revenues are estimated to have increased by $40.5 billion. Of this increase, $2.7 billion was attributable to certain one-time factors. Transitional costs associated with the introduction of the Child Tax Benefit ($1.2 billion) and the faster processing of personal income tax refunds ($1.2 billion) depressed revenues in 1993-94. In contrast, budgetary revenues in 1998-99 include the Air Transportation Tax ($0.3 billion) which in 1993-94 was netted against the cost of running airports and, therefore, against program spending.

Policy actions since 1993 have had no net impact on budgetary revenues. Some revenue-raising measures were introduced in earlier budgets, primarily designed to increase the fairness of the tax system and reduce the number of tax preferences. However, by 1998-99, the financial impact of these measures has been offset by general tax relief initiated in the 1998 budget and the cumulative impact of reductions in employment insurance (EI) premiums.

This implies that most of the remaining increase in budgetary revenues (about $38 billion) since 1993-94 is attributable to economic developments and the interaction of the tax system with the growth in the economy. Between 1993 and 1998 nominal income, the applicable tax base for budgetary revenues, is estimated to have increased by over $160 billion, with over 1.6 million more Canadians employed. More companies have returned to profitability following the recession of the early 1990s and consumer demand has rebounded from the depressed levels of the early 1990s.

The impact of economic growth on budgetary revenues is best illustrated by looking at budgetary revenues as a percentage of the economy (Table 3.2). Between 1993-94 and 1998-99, the revenue-to-GDP ratio has increased by 1.6 percentage points, of which 0.3 percentage point is due to the impact of the one-time factors. In comparison, the program spending-to-GDP ratio declined by almost 4 percentage points. The increase in the revenue-to-GDP ratio reflects the interaction of the tax system with economic growth and changes in the composition of income. In addition, there are some components of income that are subject to taxation, such as capital gains and pension income from trusteed pension plans, that are not included in the definition of nominal GDP, thereby overstating the effective revenue-to-GDP ratio.

Table 3.2
Sources of change in the federal budgetary balance

	1993-94	1998-99	Change
Per cent of GDP			
Budgetary revenues	16.0	17.6	1.6
Program spending	16.6	12.6	-3.9
Operating balance	-0.6	5.0	5.6
Public debt charges	5.2	4.7	-0.6
Contingency Reserve		0.3	0.3
Budgetary balance	-5.8	0.0	5.8

Note: Numbers may not add due to rounding.

As shown in Table 3.2, the improvement in the fiscal balance, as expressed as a percentage of GDP, from a deficit of 5.8 per cent of GDP in 1993-94 to a balanced budget in 1998-99, comes much more from spending restraint than from revenue gains.

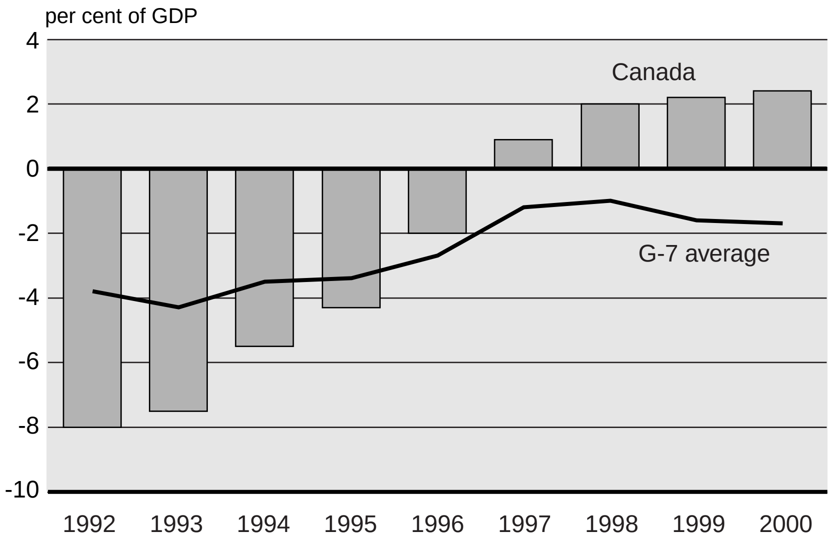
Canada’s fiscal progress best among G-7 countries

When making comparisons across countries, adjustments must be made for differences in accounting practices and in the distribution of responsibilities among the various levels of government in each country. For international comparisons, the most appropriate measure is the total government budget balance on a National Accounts basis. The total government sector includes federal, provincial and local governments and the Canada/Quebec Pension Plans.

Canada’s budgetary position has improved from being among the worst in the G-7 in the early 1990s, to the best. In 1992, Canada’s total government sector deficit (based on National Accounts) reached a high of 8 per cent of GDP, compared to the G-7 average deficit-to-GDP ratio of 3.8 per cent (Chart 3.3).

Since then there has been improvement in each and every year and Canada has become the G-7 leader in this area. The OECD predicts that by 2000, (on the basis of current programs and policies) Canada and the U.S. will be the only G-7 countries to have achieved four consecutive annual surpluses. (Detailed international comparisons are shown in Annex 4).

Chart 3.3
Total government deficit (-)/surplus (+)
(National Accounts basis)



Source: *OECD Economic Outlook*, December 1998.

The Debt Repayment Plan

After too many years of optimistic revenue forecasts and missed budget targets, the record since 1993-94 has restored the credibility of the federal government's budget making. For the first time in a generation, Canadians can plan now for the future, secure in the knowledge that the interest rates and tax rates that they pay will not be pushed up because of missed fiscal targets and a continued build-up of debt.

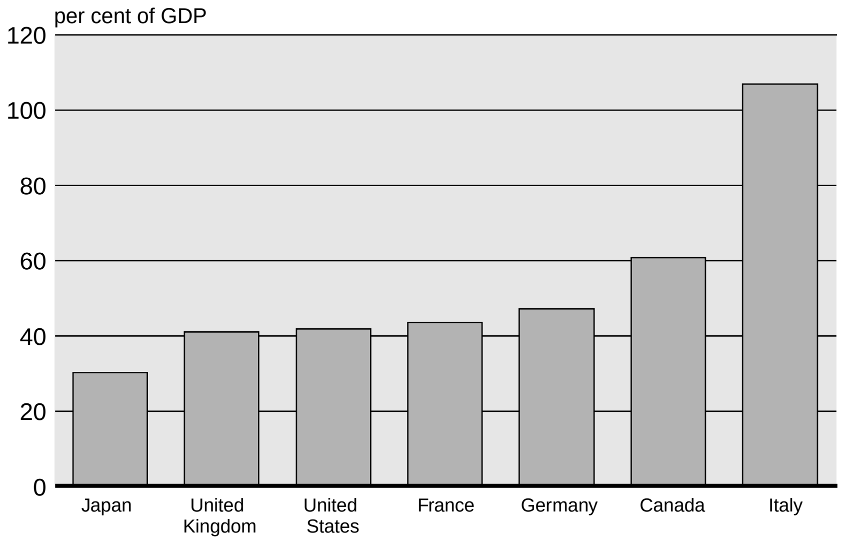
The federal government is not prepared to risk a return to deficits. The gains from maintaining sound public finances – low interest rates, falling tax rates and the ability to make investments in key strategic programs – will not be put at risk.

One of the most important actions that the federal government can undertake towards enhancing the living standards of Canadians is to continue this restoration of fiscal health. While the deficit has been eliminated, the level of debt in relation to the ability to service the debt (the debt-to-GDP ratio) is still too high – both by historical Canadian and international standards (Charts 3.4 and 3.5). This ratio is generally recognized as the most appropriate measure of the debt burden since it measures debt relative to the ability of the government and the country's taxpayers to finance it. Reducing the debt-to-GDP ratio must remain a key objective of the government's fiscal policy.

Chart 3.4

Total government net debt in G-7 countries, 1998

(National Accounts basis)



Source: *OECD Economic Outlook,* December 1998.

For these reasons, the government will continue to follow the prudent approach to budget planning as contained in The Debt Repayment Plan set out in the 1998 budget.

The Debt Repayment Plan consists of three key elements:

- two-year fiscal plans based on prudent economic planning assumptions;
- the inclusion in the fiscal plan of an annual Contingency Reserve; and
- the use of the Contingency Reserve, when it is not needed, to pay down the public debt.

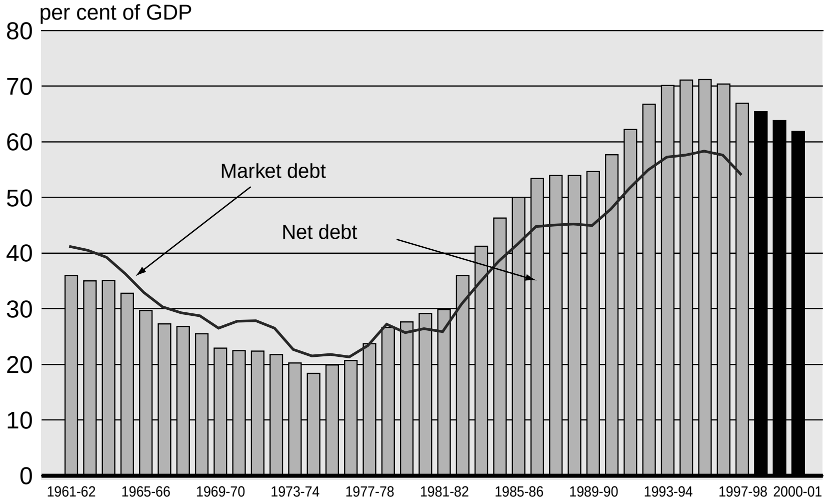
The Contingency Reserve is included in the budget projections primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and unpredictable events. The Contingency Reserve also provides an extra measure of backup against adverse errors in the economic forecast. The Contingency Reserve is not a source of funding for new policy initiatives.

The prudent economic planning assumptions, described in Chapter 2, provide an additional buffer to ensure that the fiscal targets will be met. In years where the economic prudence is not required, that is, when the economy performs better than the prudent assumptions, the resulting gains to the fiscal track form part of future years' dividends.

Central to this planning approach is the notion that spending initiatives and tax cuts will be introduced only when the government is reasonably certain that it has the necessary resources to do so. This protects against the risk of having to make hasty, and potentially damaging, corrections to the budget plan, such as announcing tax relief one year and then having to raise taxes the following year.

Clearly, The Debt Repayment Plan is working. The absolute level of debt declined in 1997-98. To the extent that the Contingency Reserve is not used in 1998-99, it will fall again. Based on current planning assumptions, the debt-to-GDP ratio is expected to fall to just under 62 per cent by 2000-01 (Chart 3.5). Assuming nominal GDP growth averages 3.5 per cent annually and an annual balanced budget, the debt-to-GDP ratio would fall to about 57 per cent within five years. If the Contingency Reserve is not required, and therefore goes to paying down the debt, the ratio would be close to 55 per cent.

Chart 3.5
Federal debt-to-GDP ratio
(Public Accounts basis)



Note: Forecasts of market debt have not been included due to the uncertainty involved in forecasting these amounts.

Fiscal Outlook to 2000-01

Overview

Despite the uncertainty in the world economies, the fiscal outlook remains positive (Table 3.3).

■ A balanced budget or better is expected for 1998-99. To the extent that the Contingency Reserve is not required, it will be used to pay down the public debt.

■ The government is committed to maintaining balanced budgets or better in 1999-2000 and 2000-01. This will mark four straight balanced budgets or better and will be only the third time since Confederation that this has happened.

Table 3.3
Summary statement of transactions: fiscal outlook with budget measures

	1997-98	1998-99	1999-00	2000-01
	(billions of dollars)			
Budgetary transactions				
Budgetary revenues	153.2	156.5	156.7	159.5
Program expenditures	108.8	112.1	111.2	113.2
Operating balance	44.4	44.4	45.5	46.3
Public debt charges	40.9	41.4	42.5	43.3
Underlying balance	3.5	3.0	3.0	3.0
Contingency reserve		3.0	3.0	3.0
Budgetary balance	3.5	0.0	0.0	0.0
Net public debt	579.7	579.7	579.7	579.7
Non-budgetary transactions	9.3	11.5	5.0	7.0
Financial requirements/surplus (excl. foreign exchange transactions)	12.7	11.5	5.0	7.0
Percentage of GDP				
Budgetary revenues				
Including budget measures	17.7	17.6	17.2	17.0
Excluding 1998 &1999 budget measures/ EI rate reductions	17.7	17.9	17.8	17.7
Program spending	12.6	12.6	12.2	12.0
Public debt charges	4.7	4.7	4.7	4.6
Budgetary balance	0.4	0.0	0.0	0.0
Financial requirements/surplus	1.5	1.3	0.5	0.7
Net public debt	66.9	65.3	63.7	61.7

- These targets continue to be based on prudent economic planning assumptions and include a Contingency Reserve of $3 billion each year. If the Contingency Reserve is not needed, it will be used to pay down the debt in those years.

- With sustained economic growth and The Debt Repayment Plan, the net public debt-to-GDP ratio will continue to decline. By 2000-01, it is expected to fall to just under 62 per cent, compared to just over 71 per cent in 1995-96.

- A financial surplus of $11.5 billion is expected in 1998-99. This means that for the third consecutive year, the government is taking in more cash than is needed to pay for current operations and interest on the public debt. With a commitment to balanced budgets, or better in each of the next two fiscal years, the government will continue to be in a net financial surplus position.

- With ongoing financial surpluses, the government will continue to pay down its market debt. In 1997-98, $9.6 billion of market debt was retired. A similar amount is expected to be paid down in 1998-99, for a total of about $20 billion over two years.

Changes since the 1998 budget forecast

For 1997-98, a budgetary surplus of $3.5 billion was recorded. This marked the first federal government budgetary surplus since 1969-70. In the February 1998 budget, a balanced budget was estimated for 1997-98.

Most of this better-than-expected outcome was attributable to higher revenues, up $5.7 billion from the February 1998 budget estimate. This primarily reflected higher personal and corporate income tax revenues in the final quarter of 1997-98 and recoveries, at year-end, related to previous fiscal years. Public debt charges were $0.6 billion lower. In contrast, program spending was up $2.8 billion, reflecting higher-than-expected liabilities at year-end.

Financial results for the first nine months of the 1998-99 fiscal year report a cumulative budgetary surplus of $11.7 billion (see *The Fiscal Monitor* for December 1998). However, caution must be exercised in using the monthly fiscal results to derive an estimate for the potential budgetary balance for the year as a whole.

For example, over the remaining three months of the fiscal year and the end-of-year accounting period, the effect of economic developments and technical factors is expected to lower the budgetary surplus recorded to date by $3.2 billion (Table 3.4, Panel B). First, corporate income tax revenues are expected to be $1 billion lower in the February/March settlement period, reflecting the decline in corporate profits in 1998. As noted in *The Fiscal Monitor*, the monthly corporate income tax results to date are more reflective of the monthly remittance procedures for corporations than of their actual tax liability for the current taxation year. The latter occurs when corporations file their returns. This usually results in a substantial amount of corporate income tax collections being received in the months of February and March, ranging from 25 to 40 per cent of total collections for the year as a whole. With corporate profits lower in 1998 than in 1997, it is expected that the settlement payments in February and March 1999 will be lower than those in the same period last year.

Table 3.4
Fiscal outlook for 1998-99

	(billions of dollars)
A. Budgetary surplus to December 1998	11.7
B. Economic developments over balance of fiscal year	
Corporate income tax collections	-1.0
Equalization transfers[1]	-1.7
Other	-0.5
Total	-3.2
C. Impact of initiatives announced prior to 1999 budget	
Canadian Fisheries Adjustment and Restructuring Program[2]	-0.4
Agricultural Income Disaster Assistance Program	-0.6
EI premium rate reduction	-0.3
Total	-1.3
D. Implied surplus	7.2
E. Less Contingency Reserve	3.0
F. Underlying surplus (before budget measures)	4.2
G. Impact of 1999 budget policy actions	
Increased health cash	-3.5
Other health initiatives	-0.2
Canada Foundation for Innovation	-0.2
International assistance	-0.2
Other	-0.1
Total	-4.2
H. Planning outcome (excluding Contingency Reserve)	0.0

[1] Total change since the 1998 budget is estimated at $2.2 billion of which $0.5 billion has been paid through December 1998.

[2] Total assistance is $0.6 billion of which a total of $0.2 billion has been paid through December 1998.

Second, data revisions for the 1996-97 to 1998-99 period, based on tax data which only became available recently, have resulted in large upward adjustments to Equalization entitlements, totalling $2.2 billion from what was estimated at the time of the February 1998 budget. To the end of December 1998, only $0.5 billion of this amount had been reflected in the financial results. The remainder will be paid to the provinces before the end of this fiscal year. Finally, the timing of revenues and spending at year-end also serves to reduce the budgetary balance.

In addition to these factors, there have also been a number of policy decisions since the February 1998 budget, the full impact of which has yet to be reflected in the financial results to date (Table 3.4, Panel C). To the end of December 1998, only $0.2 billion of the $0.6 billion had been paid out under the Canadian Fisheries Adjustment and Restructuring Program. In December 1998, the government announced the Agricultural Income Disaster Assistance Program. The cost to the federal government is expected to be up to $0.6 billion in 1998-99, which under generally accepted accounting principles must be recorded in this fiscal year. Finally, the impact of the reduction in employment insurance premiums, effective January 1, 1999, will lower premium revenues in the final quarter of 1998-99. In total, these policy announcements will reduce the surplus to date by an additional $1.3 billion.

Together, the anticipated developments over the remainder of the 1998-99 fiscal year and the policy initiatives announced prior to the 1999 budget reduce the surplus from $11.7 billion to $7.2 billion. From this, $3 billion needs to be set aside for the Contingency Reserve, resulting in an underlying surplus of $4.2 billion (Table 3.4, Panel F).

Finally, a number of initiatives in this budget will have an impact in 1998-99. A one-time supplement of $3.5 billion is being provided to the Canada Health and Social Transfer. Incremental funding is also being provided to the Canada Foundation for Innovation ($0.2 billion), the Canadian Institute for Health Information and the Canadian Health Services Research Foundation, to be used for health information and for research and innovation ($0.2 billion) and for humanitarian and new international initiatives, including the acceleration of payments of international subscriptions ($0.2 billion).

Final audited results will be published in the *Annual Financial Report*, which is released in the fall of each year.

Table 3.5 shows the changes in the major fiscal estimates since the 1998 budget. Revenues were significantly higher in the final quarter of 1997-98 than anticipated at the time of the 1998 budget and this has carried over into 1998-99 and 1999-2000. This has more than offset the negative impact of the downward revisions to nominal income, the applicable tax base for budgetary revenues, since the 1998 budget (see Chapter 2).

In addition, employment growth during 1998 was much stronger than expected, resulting in higher personal income tax revenues. As a result, budgetary revenues, excluding the impact of policy initiatives, are now expected to be $5.8 billion higher in 1998-99 and $4.0 billion higher in 1999-2000 than estimated in the February 1998 budget.

Table 3.5
The fiscal outlook: changes since the 1998 budget

	1997-98	1998-99	1999-00
		(billions of dollars)	
1998 budget budgetary balance	0.0	0.0	0.0
Impact of economic factors			
Revenues			
Personal income tax	2.4	2.7	3.0
Corporate income tax	2.5	1.5	-0.1
Sales and excise taxes and duties	-0.4	-0.6	-0.4
Other tax revenue	0.6	0.6	0.5
Employment insurance premium revenues	0.2	1.0	0.1
Non-tax revenues	0.5	0.8	0.9
Total	5.7	5.8	4.0
Program spending			
Major transfers to persons	0.1	0.6	-0.1
Major transfers to other levels of government	-0.1	-2.4	-0.9
Direct program spending	-2.8	-0.4	-1.4
Total	-2.8	-2.2	-2.4
Public debt charges	0.6	2.1	2.5
Net impact of economic factors	3.5	5.7	4.1
Net impact of policy changes			
Affecting budgetary revenues		-0.3	-2.3
Affecting program spending		-5.4	-1.8
Net impact		-5.7	-4.1
Net changes since 1998 budget	3.5	0.0	0.0
1999 budget budgetary balance	3.5	0.0	0.0

Note: (+) indicates an increase in the balance
(-) indicates a reduction in the balance

Excluding the impact of policy initiatives, program spending is expected to be $2.2 billion higher in 1998-99 and $2.4 billion higher in 1999-2000 than the levels estimated in the 1998 budget. Data revisions have resulted in substantially higher Equalization entitlements for 1998-99 and prior years, resulting in much higher than expected cash transfers in 1998-99 (up $2.2 billion) and 1999-2000 (up $0.6 billion). In addition, higher take-up under the Canada Education Savings Grant and measures to address the Year 2000 computer problem in government departments have resulted in an increase in direct program spending. In contrast, expenditures under *Major transfers to persons* are somewhat lower in 1998-99, primarily reflecting lower-than-expected EI benefit payments, due to a decline in the number of unemployed.

Public debt charges are estimated to be $2.1 billion lower in 1998-99 and $2.5 billion lower in 1999-2000 than estimated in the 1998 budget. For 1998, both short-term and long-term interest rates turned out to be lower than the rates assumed for prudent planning purposes in the 1998 budget. Short-term rates were 60 basis points lower while long-term rates were 110 basis points lower. Although, for planning purposes, interest rates are assumed to be higher in 1999 than in 1998, they are still below those estimated in the 1998 budget.

As a result, economic factors increased the budgetary balance by $5.7 billion in 1998-99 and $4.1 billion in 1999-2000.

Initiatives announced since the 1998 budget or proposed in this budget total $5.7 billion for 1998-99 (see Annex 1). The largest component of this is the one-time supplement of $3.5 billion to the CHST. In addition, two economic adjustment programs, totalling $1.2 billion for 1998-99, were announced during 1998 – the Canadian Fisheries Adjustment and Restructuring Program and the Agricultural Income Disaster Assistance Program. Incremental funding is also being provided to a number of private sector agencies for research and information initiatives. For 1999-2000, the fiscal cost of the policy initiatives amounts to $4.1 billion, of which over half ($2.3 billion) is being provided for general tax relief.

Outlook for budgetary revenues

The revenue outlook to 2000-01 is summarized in Table 3.6.

Through the first nine months of 1998-99, budgetary revenues were up 2.9 per cent over the same period last year. Over the balance of the year, revenues are expected to be lower than in the same period last year. This primarily reflects lower corporate tax revenues in the February/March settlement period, given the reported decline in corporate profits in 1998, and the elimination of the Air Transportation Tax. In addition, EI premium rates were lowered effective January 1, 1999. For the year as a whole, budgetary revenues are expected to be up only 2.2 per cent from 1997-98.

Table 3.6
The revenue outlook

	1997-98	1998-99	1999-00	2000-01
		(billions of dollars)		
Income tax revenue				
Personal income tax	70.8	73.7	75.0	76.2
Corporate income tax	22.5	22.0	20.9	21.1
Other	3.0	2.9	2.9	2.9
Total income tax	96.3	98.5	98.7	100.2
Employment insurance premium revenues	18.8	19.2	18.3	18.5
Sales and excise taxes/duties				
Goods and services tax	19.5	20.6	21.6	22.4
Customs import duties	2.8	2.5	2.5	2.5
Other	8.6	8.3	8.2	8.3
Total	30.9	31.4	32.3	33.2
Non-tax revenue	7.2	7.5	7.5	7.6
Total budgetary revenues	153.2	156.5	156.7	159.5
Per cent of GDP				
Including budget measures	17.7	17.6	17.2	17.0
Excluding 1998 and 1999 budget measures and EI premium rate reductions	17.7	17.9	17.8	17.7

For 1999-2000, total budgetary revenues are expected to be up slightly, reflecting the overall weakness in nominal income growth projected for 1999, further reductions in EI premium rates, and the impact of the 1998 and 1999 budget tax relief measures. For 2000-01, budgetary revenues are expected to grow by 1.8 per cent.

As a per cent of GDP, budgetary revenues are expected to decline steadily over the outlook period, from 17.7 per cent in 1997-98 to 17 per cent in 2000-01. This decline in the revenue-to-GDP ratio is primarily attributable to the tax relief measures announced in the 1998 and 1999 budgets and the decline in EI premium rates. Excluding the impact of these measures, the revenue-to-GDP ratio would be relatively stable at around 17.8 per cent.

Among the major components of revenues, personal income tax revenues traditionally increase somewhat faster than the growth in the economy, given the progressivity of the tax system, the indexation of tax brackets and credits only when inflation exceeds 3 per cent, and the fact that assessed income for taxation purposes includes some components of income that are not included in Statistics Canada's definition of nominal income. However, most other components either grow in line with the growth in the economy or more slowly. The growth in GST revenues is dependent on domestic demand and is not affected by increases in exports. EI premium revenues are affected by changes in premium rates, the growth in employment and increases in average wages up to maximum insurable earnings. The latter has been frozen since 1996. Other excise taxes and duties and non-tax revenues increase by considerably less than the growth in the economy. As a result, in the absence of major policy actions, the revenue-to-GDP ratio should be relatively stable.

Personal income tax collections, the largest single source of federal revenues, are expected to rise by 1.8 per cent in 1999-2000, following an estimated increase of 4.0 per cent in 1998-99. The slowdown in revenue growth is the result of the tax relief measures introduced in the 1998 and 1999 budgets – the increase in amount of income that can be earned tax-free, the elimination of the 3 per cent surtax and the increase in the Canada Child Tax Benefit. These measures will also limit the growth of personal income tax revenues in 2000-01.

Over the first nine months of 1998-99, corporate income tax collections were up 3.4 per cent. However, collections are expected to drop off markedly during the balance of the fiscal year, and for the year as a whole they are expected to be down 2.4 per cent. This decline reflects a prior-year adjustment that increased revenue in 1997-98 and the weakening of corporate profits in 1998. For 1999-2000, corporate income tax collections are expected to decline by about 5.0 per cent, reflecting a further decline in corporate profits and the payment of refunds due to the overpayment of instalments for the 1998 tax year. A slight increase is expected in 2000-01.

For 1999, the EI premium rate has been lowered to $2.55 (employee rate) per $100 of insurable earnings, from $2.70 in 1998. The government is planning its budget on a premium rate of $2.55 (employee rate) for 2000. The increase in EI revenues in 1998-99 is attributable to prior-year adjustments relating to underpayments for the 1997 taxation year. In 1999-2000, the reduction in the premium rates more than offset the gains from higher employment.

Goods and services tax (GST) revenues are expected to increase by 5.6 per cent in 1998-99, in line with the growth in consumption of goods and services subject to the tax. Weaker growth in consumer spending subject to the GST will lower the growth of GST receipts to 4.9 per cent in 1999-2000 and 3.7 per cent in 2000-01. Other excise tax collections are expected to decline in 1998-1999, largely due to the phase-out of the Air Transportation Tax.

Non-tax revenues include returns on investments, most notably Bank of Canada profits and exchange fund earnings, and other non-tax revenues. Non-tax revenue is expected to be relatively stable over the outlook period.

Outlook for program spending

Table 3.7 provides the major elements of program spending through to 2000-01. The profile of program spending reflects the impact of new initiatives announced since the 1998 budget.

For 1998-99, total program spending is expected to be $112.1 billion, up $3.3 billion, or 3.0 per cent from 1997-98. This increase reflects the impact of the new initiatives announced since the 1998 budget, especially the one-time $3.5 billion supplement to the CHST.

Table 3.7
The outlook for program spending

	1997-98	1998-99	1999-00	2000-01
	(billions of dollars)			
Major transfers to persons				
Elderly benefits	22.2	22.8	23.5	24.1
Employment Insurance benefits	11.8	12.1	13.4	13.8
Total	34.1	34.9	36.9	37.9
Major transfers to other levels of government				
CHST cash[1]	12.6	16.0	12.5	13.5
Equalization	8.9	10.7	9.3	9.7
Other fiscal transfers	1.1	0.9	0.9	0.8
Alternative Payments for Standing Programs	-2.1	-2.2	-2.3	-2.3
Total cash transfers	20.5	25.4	20.4	21.7
Direct program spending				
Subsidies and other transfers				
Agriculture	0.8	1.6	1.1	0.7
International assistance envelope[2]				
Base funding	2.1	1.9	2.0	2.0
One-time adjustment	0.1	0.2		
Health	0.9	1.2	1.2	1.3
Human Resources Development	2.1	2.5	2.5	2.5
Indian and Northern Development	4.0	4.1	4.2	4.3
Industry and Regional Development	2.2	2.4	2.3	2.1
Other	10.3	5.1	5.3	5.2
Total	22.5	19.0	18.6	18.1
Crown corporations	2.5	3.8	3.9	3.8
Defence	8.9	8.3	8.7	8.7
Other	20.3	20.7	22.7	23.0
Total direct program spending	54.2	51.8	53.9	53.6
Total program spending	108.8	112.1	111.2	113.2

[1] Reflects profile of CHST cash as accounted for by the federal government (see Chapter 4).

[2] The 1998 budget provided one-time additional funding to IAE of $90 million in 1997-98 and $50 million in 1998-99. The 1999 budget provides one-time funding of $187 million in 1998-99 for humanitarian assistance and the acceleration of additional payments of international subscriptions.

Reflecting the impact of a number of one-time initiatives in 1998-99, program spending is expected to fall to $111.2 billion in 1999-2000 and then increase to $113.2 billion in 2000-01. The increase in 2000-01 is roughly in line with inflation and population growth, but less than the expected increase in nominal GDP. By 2000-01, program spending is still expected to be about $6.8 billion lower than it was in 1993-94. As a share of GDP, this is expected to be 12 per cent in 2000-01, the lowest level in 50 years.

Program spending falls into three components: major transfers to persons, major transfers to other levels of government and direct program spending – the latter referred to as departmental spending.

Major transfers to persons

Major transfers to persons consist of elderly benefits – Old Age Security, the Guaranteed Income Supplement and the Spouse's Allowance – and EI benefits.

Elderly benefits are expected to rise steadily over the outlook period, reflecting the growth in the senior population and average benefits, which are fully indexed, each quarter, to changes in consumer prices.

EI benefits were up slightly in 1998-99, the first increase in five years. This increase reflected higher special benefits, such as sickness and employment and support benefits. Over the next two years, benefits are expected to increase. With an improving economy, the number of beneficiaries relative to the number of unemployed typically increases. In addition, increases in average wages result in increased individual benefits, since benefits are calculated as a percentage of insurable earnings up to a maximum of $39,000. Since not all workers are at the maximum, the average benefit will continue to rise.

Major transfers to other levels of government

The three major programs under which the federal government transfers funds to other levels of government are the Canada Health and Social Transfer (CHST), Equalization and other fiscal transfers, primarily Territorial Formula Financing.

These transfers are being put on common five-year funding tracks for the first time. This will provide provinces and territories with improved predictability in funding.

The CHST, the largest of these transfers, is a block-funded transfer which supports health care, post-secondary education and social services. CHST is delivered in the form of tax and cash transfers. The tax transfer component reflects a transfer of personal and corporate income tax room made to the provinces in 1977.

This budget builds on the actions already taken to increase the CHST cash floor from $11.0 billion to $12.5 billion, effective 1997-98. This budget proposes to provide provinces and territories with increased funding of $11.5 billion over the next five years as follows:

- A one-time CHST supplement of $3.5 billion, which will be accounted for in 1998-99. However, these funds will be paid into a third-party trust on passage of amendments to the relevant legislation. Individual provinces and territories could draw down the supplement over the next three years in a pattern which best meets the needs of their health care systems.
- Cash payments under the CHST will be increased by $1 billion in 2000-01, $2 billion in 2001-02 and $2.5 billion in 2002-03 and in 2003-04, for a total of $8 billion over five years.

Equalization provides transfers to provinces with below-average capacities to raise revenues. This allows these provinces to provide public services that are reasonably comparable to those found elsewhere in the country without imposing above average tax rates.

Data revisions, primarily resulting from much stronger growth in Ontario than in the Equalization-receiving provinces, have resulted in large upward revisions to Equalization entitlements. Thus, relative to the 1998 budget, Equalization payments have been revised up by $2.2 billion in 1998-99 and $0.6 billion in 1999-2000.

Equalization legislation expires every five years. Legislation now before Parliament provides for the renewal of the program for the period 1999-2000 to 2003-04 and proposes a number of technical changes, which improve the ability of the program to measure fiscal disparities between provinces.

The federal government also provides transfers to territories under Territorial Formula Financing. This reflects the reality that territories are in a unique situation due to the special challenges of providing public services in the north.

The Alternative Payments for Standing Programs represent recoveries of federal tax point abatements under contracting-out arrangements. Provinces were given the option in the mid-1960s to accept tax points in lieu of cash transfers. The value of these tax points are netted against total entitlements, and accordingly from the cash transfers. Quebec was the only province to choose these arrangements. The recoveries have no impact on net federal transfers or on Quebec’s net receipts.

Direct program spending

Direct program spending consists of total program spending excluding the major transfers to persons and to other levels of government. It includes transfer programs administered by departments, expenditures related to Crown corporations and the operating, maintenance, and capital costs of departments, including defence.

Total subsidies and other transfers are expected to total $19.0 billion in 1998-99, $18.6 billion in 1999-2000 and $18.1 billion in 2000-01. However, subsidies and other transfers are higher than estimated in the 1998 budget, reflecting the impact of a number of initiatives announced since then.

- The increase in agricultural transfers in 1998-99 reflects the impact of the Agricultural Income Disaster Assistance Program, a 60:40 federal-provincial cost-shared program over two years. The cost to the federal government is expected to be up to $600 million in 1998-99 and up to $285 million in 1999-2000, based on the decline in producers' 1998 and 1999 incomes, respectively. An amendment will be proposed to clarify the scope of loan guarantees to financial institutions under the *Agricultural Marketing Programs Act*.
- Transfers under the International Assistance Envelope (IAE) are distributed between Official Development Assistance (ODA) and assistance to countries in transition in Central and Eastern Europe. As part of the government's overall program of controlling expenditures, IAE spending was reduced to a base level of $2,061 million in 1997-98 and to $1,911 million thereafter. As fiscal circumstances have permitted, one-time adjustments have been made to the base level spending to provide additional resources and greater flexibility to the aid program. In 1997-98, additional funding of $90 million was provided to accelerate payments for international obligations, which increased IAE to $2,151 million. In 1998-99, one-time adjustments totalling $237 million have been provided for humanitarian and new international initiatives as well as for accelerated payments of international obligations. The accelerated payments will free up an equivalent amount for Canadian International Development Agency bilateral programs in 1999-2000. In addition, IAE spending will be increased by $50 million in 1999-2000 and $75 million thereafter. This increase will mark a step by the government towards meeting the official development target of 0.7 per cent of gross national product. Amendments are being proposed to facilitate financial operations relating to international financial institutions. The poorest countries are particularly vulnerable to turmoil in the world economy and financial markets.

The government believes that more needs to be done to help them with their debt burdens. Canada will be working closely with other G-7 countries and international financial institutions, with a view to securing agreement on more generous and timely debt relief.

- Additional funding is being provided to Health Canada in this budget (see Chapter 4) to improve health information systems, promote health research, improve First Nations and Inuit health services, and for preventive and other health initiatives.

- Transfers administered by Human Resource Development Canada are about $500 million higher in 1998-99 than in 1997-98. This reflects funding for the Canadian Fisheries Adjustment and Restructuring Program and for initiatives under the Canadian Opportunities Strategy announced in the 1998 and 1999 budgets (see Chapter 5).

- Transfers administered by the Department of Indian and Northern Affairs are expected to rise over the outlook period. Spending levels incorporate incremental funding provided in this budget for Gathering Strength initiatives.

- Industry and regional development transfers support a wide range of programs, such as advanced research, technology adoption and support for small businesses. Transfers are higher than those included in last year's budget, reflecting a number of measures proposed in this budget which build on the Canadian Opportunities Strategy (see Chapter 5). This includes incremental funding for the granting councils, Technology Partnerships Canada, Networks of Centres of Excellence and the Canadian Space Agency (see Chapter 5).

The Department of Canadian Heritage will strengthen official languages support programs, including increased funding for minority and second language education. Parks Canada will receive additional funding in 1998-99 to support the development and upgrading of parks and historic sites.

A secure society is one that provides Canadians with a safe place to live and work. This budget provides funding for a number of crime prevention initiatives. The Department of Justice will receive funding for renewal of the youth justice system, including replacement of the *Young Offenders Act* with a new legislative framework. Funding is being provided for the implementation of measures to provide law enforcement agencies in Canada with more effective tools to meet Canada's international commitments to combat crime.

Canadians value a clean and healthy environment. Last year the government set in motion a process to develop a national climate change strategy to reduce greenhouse gas emissions. The process involves environmental groups, industry and different levels of government in a dialogue through a series of Issue Tables. Later this year, the Issue Tables will make recommendations on options that will be considered in the development of the national strategy.

The Government of Canada will lead by example. All departments of government are being asked to develop baseline data and forecasts to 2010 for greenhouse gas emissions, with a view to subsequently determining departmental reduction targets and monitoring mechanisms.

The tax system includes incentives, such as accelerated capital cost allowance and flow through shares, to encourage the use of energy efficient and renewable energy equipment. A number of tax proposals to further encourage these investments are being reviewed in the context of the work of the Issue Tables. A change in this budget will provide a more favourable tax deduction for the purchase of equipment used to generate electricity from solution gas that would otherwise be flared during the production of crude oil.

Further, funds are being provided in this budget to help the Federation of Canadian Municipalities initiate a program to help municipalities identify opportunities for energy savings in their operations. The government also continues to support alternative energy development. For instance, the Atlantic Wind Test Site of Prince Edward Island, which contributes to the development of wind energy technology for use in domestic and export markets, will continue to receive federal funding in the coming fiscal year. This is an example of efforts between the federal and provincial governments to diversify the Atlantic economy.

On the international climate change front, negotiations in Buenos Aires this past November resulted in an Action Plan. Canada is continuing to play a leadership role in the development and implementation of key features of the Kyoto Protocol such as international emissions trading and the Clean Development Mechanism.

Climate change, though important, is not the only environmental issue facing Canadians. For example, the government has set aside up to $12 million to support the establishment of a UNESCO Biospheric Reserve in Clayoquot Sound, and in response to the risk of future flooding in the Red River Basin, the federal government will be investing $50 million over four years to cost share a flood protection program with Manitoba for the Red River Valley south of Winnipeg.

Expenditures on Crown corporations consist of direct expenditures made to appropriation-dependent Crown corporations and the annual profits and losses of enterprise Crown corporations. In 1997-98, extraordinary earnings from enterprise Crown corporations restrained the overall level of expenditures in this area. The government will continue to review its equity holdings in Crown corporations and other assets and divest those that no longer serve a public policy objective.

Defence spending has declined significantly since 1993-94, reflecting the impact of the restraint measures introduced in the 1994 and 1995 budgets. In addition, the 1996 budget imposed a further one-time reduction in defence spending levels for 1998-99. Defence expenditures will increase in 1999-2000 as the one-time reduction ends, and incremental funding is being provided in this budget to address compensation and benefit issues in the military.

All other spending includes departmental operating costs and centrally held funds to assist departments in managing unavoidable cost pressures. The operating budgets of federal government departments have been reduced significantly since 1993-94 as a result of Program Review measures. Total departmental spending is now rising gradually in order to deal with wage and salary pressures and increasing workloads within departments.

The Expenditure Management System (introduced in the 1995 budget) will ensure that departments continue to operate in the most efficient and cost-effective manner possible. The government will continue, to the greatest possible extent, to fund new cost pressures by internal reallocation and increased efficiencies.

Legislative changes are being proposed relating to collective bargaining in various public sector organizations. This will enable the government to pursue important human resources reforms while keeping related expenditures at a reasonable level. The government will also be undertaking amendments to the public sector pension plans.

Public debt charges

Based on the financial results for the first nine months of 1998-99, public debt charges are estimated at $41.4 billion for 1998-99, up $0.5 billion from 1997-98, as a somewhat higher average effective interest rate on the government's interest-bearing debt more than offsets the effect of a decline in the overall stock of debt. The higher interest rates, embedded in the prudent budget planning assumptions, result in an increase in public debt charges over the planning horizon (Table 3.8).

Table 3.8
Public debt charges

	1997-98	1998-99	1999-00	2000-01
	(billions of dollars)			
Public debt charges	40.9	41.4	42.5	43.3

In 1995-96, debt servicing costs absorbed about 36 cents of each dollar of revenue collected by the federal government. In 1998-99, this is down to about 27 cents.

Prudent and effective debt management is required to ensure that debt service costs are kept to a minimum. Greater cost stability has been achieved over the past several years by increasing the share of the government's interest-bearing debt issued at fixed rates from about 50 per cent in 1992-93, to about two-thirds currently. A higher proportion of fixed-rate debt provides protection against unexpected changes in interest rates and brings the term structure of the debt into line with other major sovereign borrowers. In the early 1990s, the impact of a 100-basis-point increase in interest rates was estimated to raise public debt charges $1.8 billion in the first year. Today the same increase in interest rates would increase debt charges by only $0.9 billion in the first year. The government is committed to maintaining a prudent debt structure.

Well-functioning capital markets are required to ensure that the government, and other creditworthy borrowers in Canada, can raise funds at stable and low costs. As the market debt declines, the debt management priority is the maintenance of a well-functioning market for Government of Canada securities. Gradual adjustments to the federal debt programs will continue in consultation with market participants, emphasizing the maintenance of a liquid and transparent Government of Canada debt market.

To maintain liquidity and market integrity, the government has undertaken a number of actions in 1998-99, such as: changes to the issuance of Treasury bills and 30-year bonds; revisions of auction rules for Government of Canada securities; the launch of a pilot bond buyback program; and support for the development by the Investment Dealers Association of a Code of Conduct governing trading in the secondary market.

For 1999-2000, consultations are underway with market participants on a possible restructuring of the Treasury bill program to maintain liquidity in this market. As well, the pilot bond buyback program will be extended into next fiscal year.

To enhance the effectiveness of debt and risk management, a number of amendments will be proposed to the *Financial Administration Act* (FAA). The FAA amendments will be made to modernize the federal government's debt and risk management capabilities and clarify borrowing authority and the authority for setting the terms of distribution of federal government securities. More detail on the government's debt strategy can be obtained from the *Debt Management Strategy: 1999-2000*, published with the 1999 budget.

Financial surplus

The financial balance (requirements/surplus) provides a measure of the net cash requirements needed to fund the government's programs and debt charges. The difference between the financial balance and the budgetary balance is due to a number of non-budgetary transactions that provide funds to the government. Non-budgetary transactions convert the accrual-based spending and revenue concepts in the budgetary balance to the cash-based financial requirements. The largest of the non-budgetary transactions are the government employees' pension accounts. Other smaller sources of funds include loans, investments and advances, cash in transit and accounts payable.

In 1997-98, the financial balance was in surplus by $12.7 billion (Table 3.9). The financial surplus is expected to be $11.5 billion in 1998-99, $5.0 billion in 1999-2000 and $7.0 billion in 2000-01. The 1998-99 estimate includes the impact of a number of initiatives which, on a budgetary basis, are included as expenditures in 1998-99, but for which cash payments will be made in 1999-2000 and subsequent years, thereby contributing to the lower source of funds in those years. These include the $3.5-billion CHST cash transfers for 1998-99 and costs associated with the Agricultural Income Disaster Assistance Program.

Table 3.9
Budgetary balance, non-budgetary transactions and financial surplus

	1997-98	1998-99	1999-00	2000-01
	(billions of dollars)			
Budgetary balance	3.5	0.0	0.0	0.0
Non-budgetary transactions				
Loans, investment and advances	2.0	1.0	0.2	0.1
Pension and other accounts	3.8	4.5	4.9	5.3
Other	3.4	6.0	-0.1	1.6
Total	9.3	11.5	5.0	7.0
Financial surplus (excluding foreign exchange transactions)	12.7	11.5	5.0	7.0

With a balanced budget or better expected in each year over the outlook period, the financial surplus, excluding foreign exchange transactions, mirrors the source of funds in non-budgetary transactions. To the extent that the Contingency Reserve is not required, the financial surplus will be correspondingly higher.

4

Building Today for a Better Tomorrow

Strengthening Health Care for Canadians

Highlights

The budget makes significant investments to help the provinces and territories deal with Canadians' immediate concerns about health care – waiting lists, crowded emergency rooms and diagnostic services. It also helps to build a stronger health care system that reflects the changing needs of Canadians and provides timely access to high quality health care. It proposes to do so by:

- **Investing in medicare** by increasing transfers to the provinces and territories. Over the next five years, the provinces and territories will receive an additional $11.5 billion specifically for health care. This represents the largest single new investment this government has ever made.

  – Of this amount, $8 billion will be provided through future-year increases in the Canada Health and Social Transfer (CHST) and $3.5 billion as an immediate one-time supplement to the CHST from funds available this fiscal year. Allowing for a gradual and orderly draw-down in the supplement over the next three years by the provinces and territories means that total support for health care would increase by $2 billion in 1999-2000

Highlights *(cont'd)*

and in 2000-01 and by $2.5 billion in each of the following three years of the five-year commitment. However, individual provinces and territories could draw down the supplement over the next three years in a pattern which best meets the needs of their health care systems.

- The $2.5 billion increases CHST cash from $12.5 billion to $15 billion and takes what is regarded as the health component of the CHST as high as it was before the period of expenditure restraint of the mid-1990s.

- Together with the growing value of CHST tax transfers, federal support is expected to reach a new high by 2001-02, surpassing where transfers stood prior to restraint.

- Significant increases in Equalization will also make more resources available to most of the less prosperous provinces for public services, including health care. Payments this year are expected to reach $10.7 billion, up $2.2 billion from the 1998 budget estimate, of which $1.6 billion remains to be paid this March. Legislation is now before Parliament to renew the Equalization program for the next five years. It is projected that payments will be $5 billion higher than over the previous five years, including technical improvements totalling an estimated $700 million over that period.

- The disparities in the way the CHST is allocated across provinces would, under current legislation, have been reduced by half over the next four years. This budget completely eliminates these disparities over the next three years. All provinces will then receive identical per capita CHST entitlements, providing equal support for health and other social services to all Canadians.

- All major transfers to provinces and territories will, for the first time, be placed on common five-year tracks, thus providing provinces and territories with greatly improved predictability.

Highlights *(cont'd)*

The budget also strengthens the federal government's contribution to Canada's health system and the health of Canadians by investing close to $1.4 billion over the remainder of this fiscal year and the next three years in:

- **Improving health information systems** to better meet the information needs of health care providers and patients, and to foster greater accountability to the public on how the health care system is serving them, consistent with the new Social Union Framework.
- **Promoting health-related research and innovation** to improve diagnosis and treatment of diseases, promote best practices in health care delivery and enhance the health and well-being of Canadians.
- **Improving First Nations and Inuit health services** by strengthening home and community care in particular.
- **Doing more to prevent health problems from occurring** by building on efforts to improve prenatal nutrition, food safety and the control of toxic substances. Steps will also be taken to foster innovations in rural and community health in partnership with the provinces, and to combat diabetes, the incidence of which is particularly high in Aboriginal communities.
- Combined with the $6.5-billion cash increase in the CHST over the next three years, the $1.4 billion invested in these activities means a total of $7.9 billion in new resources for health over the remainder of this fiscal year and the next three years.

Building on the Strengths of Canada's Publicly-Funded Health Care System

Canada's publicly-funded health care system is key to the quality of life we enjoy. It reflects the fundamental values we share as Canadians. Governments must work together to preserve and build on its strengths.

First and foremost, medicare provides Canadians with access to health care irrespective of their financial means. All Canadians have the security of knowing that they have access to high quality care when they need it, not if they can pay for it. This is no small accomplishment. In many countries, basic health care services are subject to user fees and some leave part of their population with little or no health care coverage.

Second, Canadians are fortunate to have a highly competent and devoted cadre of health care providers and researchers working on their behalf. Physicians, nurses, dentists, pharmacists, home care workers and health researchers, to name only a few, play a key role in ensuring that Canadians receive appropriate and high quality health care based on the most up-to-date knowledge about preventive measures, treatments and cures.

Third, provinces and territories each deliver their own health care services assisted by federal financial support, within the common framework of the *Canada Health Act*. This offers two advantages to Canadians: they have the security of knowing that their health care coverage is portable from one province to another; and it allows provincial health administrators to innovate and learn from each other to the benefit of all Canadians.

Finally, medicare is not only good social policy; it is good economic policy. Canada's "single payer" health care system significantly increases efficiency and reduces costs. This ensures that every health dollar in Canada is used to the greatest possible extent to deliver services. As a result, Canada's health care system imposes considerably less cost on the economy than in the case of our largest trading partner, the United States.

Today, Canadians are among the healthiest people in the world. Life expectancy at birth has reached 81 years for women and 76 years for men. Canada's rate of infant mortality is low and death rates for most of the major diseases are declining. These impressive results can be attributed to the availability and high quality of health care services, as well as to improvements in other key determinants of health such as living and working conditions, the physical environment and personal health practices.

As Canadians' health care needs change and as the delivery of health care services evolves to better meet those needs, Canadians must have the security of knowing that high quality health care services will be available when and where they are needed. Federal and provincial governments will work together to maintain the confidence of Canadians in medicare.

Health care in transition

Health care has undergone a profound transformation over the past decade.

First, it is increasingly being delivered in different settings. More and more services are being provided in the community and in the home rather than in hospitals.

Second, Canadians are receiving their health care from an increasingly diverse cadre of health care providers, including doctors, nurses, midwives, physiotherapists, home care workers, pharmacists, practitioners of alternative medicines and informal caregivers.

Third, the breadth of health care interventions is expanding with new technologies and medical treatments. Improvements in surgical techniques and treatments have considerably shortened hospital stays. Health care is increasingly reliant on drug therapy – many ailments that previously required surgery or extended stays in hospital can now be treated effectively with drugs.

As a result of these changes, the composition of health expenditures has changed significantly. As shown in Table 4.1, hospital expenditures declined from 39.3 per cent of total health expenditures in 1990 to 33.4 per cent in 1998. Public home care expenditures increased from 2.2 per cent to 4 per cent of public health spending. Spending on drugs increased from 11.3 per cent of total health expenditures in 1990 to 14 per cent in 1998.

Table 4.1
Facts and figures about Canada's health system

	1990	1994	1998
Total health expenditures as a share of GDP	9%	9.6%	9.1%
Per capita total health expenditures	$2,203	$2,508	$2,613
Public health expenditures	$45.7B	$52.9B	$55.8B
Per capita public health expenditures	$1,643	$1,808	$1,821
Total health expenditures by use of funds (share of total)			
– Hospitals	39.3%	36.2%	33.4%
– Home care[1]	2.2%	3.1%	4.0%
– Physicians	15.1%	14.6%	14.4%
– Drugs	11.3%	12.7%	14.0%

[1] Public home care spending as a share of aggregate public expenditures. Estimates of private home care spending are not available.

Sources: Canadian Institute for Health Information, Health Canada.

The changes in health care over the past decade have taken place at the same time as governments restored order to the nation's finances by restraining growth in expenditures. Between 1990 and 1994, public health spending grew moderately from $1,643 to $1,808 per person, but has exhibited little growth over the past four years. In real per capita terms, public funding for health has actually declined since 1994.

Total public and private health spending is now $2,613 per person, up from $2,203 in 1990. Expressed as a share of GDP, total health expenditures last year were 9.1 per cent – down from 9.6 per cent in 1994, but slightly higher than the 9.0 per cent registered in 1990.

As these changes continue to unfold, governments must reassure Canadians of their unwavering commitment to Canada's public health care system by taking the necessary steps to ensure that it continues to adapt to serve Canadians well.

Laying the groundwork – recent federal health initiatives

The early to mid-1990s were a period of government restraint. To restore order to the nation's finances, both orders of government reduced spending. Provincial health expenditures – and federal transfers which support these provincial services – were restrained. More recently, provinces have begun to allocate increased resources to health care. Over the past three years, the federal government has also made significant investments in health care.

- *Stable funding for medicare* – Effective 1997-98, the cash floor of the CHST was increased from $11 billion to $12.5 billion, as recommended by the National Forum on Health.
- *Meeting pressing health-related needs* – Measures include increased funding for community-based projects to improve the health of children; renewal of strategies to address HIV/AIDS and breast cancer; increased funding for public education about tobacco; Head Start programs for Aboriginal children; reform of the blood system; and a tax credit for caregivers.
- *Promoting research and innovation* – Measures include increased funding for health services research, health care pilot projects, health information systems, medical research and health research infrastructure.

As shown in Table 4.2, these investments will increase annual federal health-related funding by $2 billion in each of the next two years. Most of this is the result of the increase in CHST cash transfers to provinces and territories.

Table 4.2
Previous federal health initiatives[1]

	1998-99	1999-00	2000-01
	(millions of dollars)		
Stable funding			
CHST cash floor increase (effective 1997-98)	900	1,500	1,500
Health-related needs			
Community Action Program for Children and Canada Prenatal Nutrition Program	33	33	33
National HIV/AIDS Strategy	41	41	41
Canadian Breast Cancer Initiative	7	7	7
Tobacco Demand Reduction Strategy	20	20	20
Aboriginal Head Start (on-reserve)	15	33	27
Aboriginal Health Institute	1	7	7
Caregiver tax credit	30	120	125
Deductibility of private insurance for self-employed		90	110
Blood agency	30	30	
Blood regulation and surveillance	25	25	25
Research and innovation			
Cdn Health Services Research Foundation	13	13	13
Health Transition Fund	50	50	
Canada Health Information System	17	17	5
Canada Foundation for Innovation ($800M in 1996-97)[2]			
Increase to Medical Research Council	40	44	50
Total	1,222	2,030	1,963

[1] Initiatives announced since 1996 but prior to this budget. Estimates and funding profiles for some initiatives may have changed.

[2] Funding not exclusively for health. In 1998, about half the funding awarded by the Canada Foundation for Innovation was for infrastructure related to health research.

Strengthening Health Care for Canadians

Building on a common vision

In 1997, provincial and territorial Ministers of Health agreed on a common vision of Canada's health system[1], including:

- A new partnership between the federal and provincial governments to ensure the maintenance of a national health system with a reasonably comparable range of services based on the five principles of medicare.

[1] This paper was released without the participation of Quebec.

- Access to a more integrated, effective and appropriate system of health care to ensure that prevention of illness, promotion of healthy lifestyles, as well as assessment, diagnosis and treatment services, are better matched to peoples' needs.

This vision is consistent with the 1997 report of the National Forum on Health, which emphasized the need to improve the quality of, and access to, health care services by providing Canadians with the right care, when it is needed, in the right setting, and by the most appropriate provider.

At a First Ministers' meeting on February 4, 1999, all provincial premiers and territorial leaders confirmed undertakings they had previously given in an exchange of correspondence with the Prime Minister. They confirmed their commitment to the five principles of medicare; to spending any additional funds made available from the Government of Canada through the CHST on health services in accordance with health care priorities within their respective jurisdictions; and to making information about the health system available to Canadians.

The federal government welcomes these commitments as a demonstration of a constructive willingness on the part of provinces and territories to work with the federal government to ensure that the health needs of Canadians are met.

Investing in Medicare: the Canada Health and Social Transfer (CHST)

Building on these commitments and shared objectives, this budget invests in medicare through the CHST.

The $12.5 billion in cash currently transferred to the provinces and territories through the CHST will be increased – and this increase will be designated specifically for health care. This increase will be allocated to provinces and territories on an equal per capita basis.

Provinces and territories will receive funding over the next five years so that support for health care can increase by $2 billion in 1999-2000 and in 2000-01 and by $2.5 billion in each of the three following years of the five-year commitment, as Table 4.3 illustrates. This $2.5 billion increase takes what is regarded as the health component of the CHST as high as it was before the period of expenditure restraint in the mid-1990s.

Cash payments under the CHST will be increased by $1 billion in 2000-01, $2 billion in 2001-02, and $2.5 billion in 2002-03 and in 2003-04, for a total of $8 billion over five years.

Table 4.3
Canada Health and Social Transfer

	1999-00	2000-01	2001-02	2002-03	2003-04	5 years
			(billions of dollars)			
Increased funding						
for health care	2.0	2.0	2.5	2.5	2.5	11.5
Of which:						
CHST		1.0	2.0	2.5	2.5	8.0
CHST supplement[1]	2.0	1.0	0.5			3.5
Existing CHST cash	12.5	12.5	12.5	12.5	12.5	62.5
Total CHST cash	14.5	14.5	15.0	15.0	15.0	74.0
CHST tax transfers	13.9	14.4	15.0	15.6	16.4	75.3
Total CHST	28.4	28.9	30.0	30.6	31.4	149.3

[1] The $3.5-billion CHST supplement will be accounted for in 1998-99 by the federal government. Payments will be made in a manner that treats all jurisdictions equitably, regardless of when they draw down funds.

In order to provide provinces and territories with the growing and predictable funding they are seeking for their health care systems as quickly as possible, an additional $3.5 billion in funds from this fiscal year will be paid into a third-party trust upon passage of amendments to the CHST legislation for 1998-99, and will be made available to provinces and territories over the next three years. It is anticipated that they will draw down this one-time CHST supplement in a gradual and orderly manner such that total support for health care would increase as set out in Table 4.3. This means that the provinces and territories would draw down the supplement by $2 billion next year, $1 billion in 2000-01 and $500 million in 2001-02.

However, the pattern of payments from the supplement may be varied over the three-year period to best meet health care needs as requested by individual provinces and territories.

In terms of cash alone, the new funding means provinces and territories will receive $11.5 billion in additional cash over the next five years to strengthen access to high quality health care. It represents the largest single new investment this government has ever made.

This investment will help the provinces and territories deal with immediate concerns of Canadians about health care – waiting lists, crowded emergency rooms and diagnostic services. It will also help to build a stronger health care system – a system that reflects the changing health needs of Canadians and which is based on timely access to high quality health care.

Together with the value of CHST tax transfers, which will also grow over the next five years, federal support is expected to grow to $31.4 billion in 2003-04. A new high for CHST transfers will be reached by 2001-02 – surpassing where transfers stood prior to the expenditure restraint of the mid-1990s.

Over the five-year period, provinces and territories will receive transfers projected to total nearly $150 billion, with the cash portion making up $74 billion of this.

Predictable and stable funding for the CHST

These investments in health care will be provided in proposed amendments to the CHST legislation, which will give provinces and territories stable and predictable funding for health care and other social services over the next five years.

All major transfers to provinces and territories – CHST, Equalization and Territorial Formula Financing – will for the first time be placed on common five-year tracks, thus providing provinces and territories with greatly improved predictability.

Renewing Equalization and territorial financing

Under the Equalization program, the federal government transfers additional funds to the less prosperous provinces so that they can provide their residents with services comparable to those in other provinces without having to resort to higher taxation than other provinces. In recognition of its role, Equalization was one of the few federal programs that was exempted from restraint measures over the past five years.

Equalization legislation is renewed every five years. Legislation has recently been introduced in Parliament to renew the program for the period 1999-2000 to 2003-04.

Federal and provincial governments have worked together over the past two years to review the program so that it continues to measure differences in provinces' abilities to raise revenues as accurately as possible. Improvements will be made which will provide an estimated $48 million in additional funding to provinces in 1999-2000, rising to $242 million by 2003-04. These improvements mean that over the next five years, an additional estimated $700 million will be transferred to Equalization-receiving provinces.

It should be noted that Equalization estimates are updated twice annually as new and better data become available, reflecting economic developments and their impacts on provinces' revenues. For 1998-99, official estimates at the time of the last budget indicated that the federal government would be providing receiving provinces with $8.5 billion in Equalization payments. In response to economic changes – in particular strong economic growth in Ontario – the latest data revisions for both 1997-98 and 1998-99 indicate that payments made this year, including adjustments with respect to 1997-98, will total $10.7 billion.

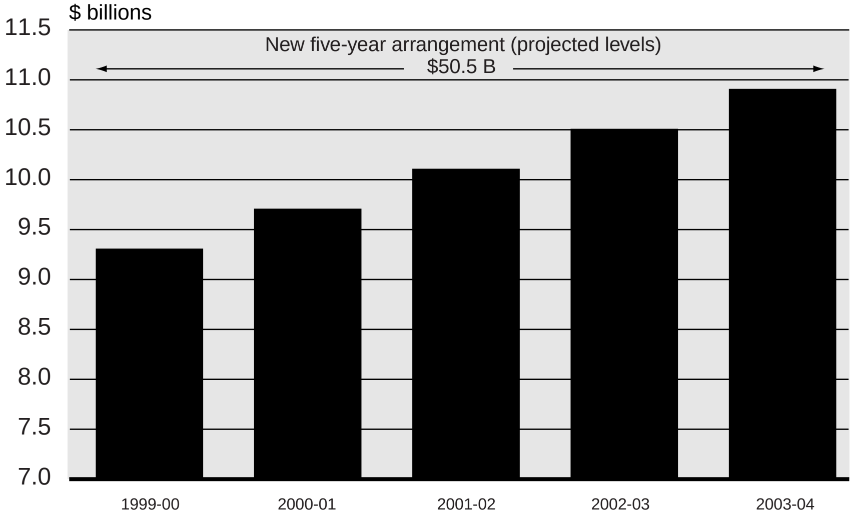
Of this $2.2-billion increase, $1.6 billion is over and above the official estimates provided to provinces this past October, and will be provided as a one-time supplementary cash payment which the provinces will receive before the end of the current fiscal year. The remaining $600 million of the increase has already been paid to receiving provinces.

These data revisions mean the projections of Equalization payments for 1999-2000 are also $600 million higher than projected in the last budget.

Equalization normally increases to reflect economic growth. Together with the $700-million increase from technical improvements, it is currently projected that Equalization will reach $10.9 billion by 2003-04. Equalization is projected to provide more than $50 billion for provinces over the new five-year arrangement. This is $5 billion more than they received over the past five years (Chart 4.1).

Chart 4.1

Equalization: new five-year arrangement



As a result, significant new resources will be available to most of the provinces which receive Equalization for public services, including health care.

The federal government is also putting in place new five-year funding arrangements for the territories. This funding, called Territorial Formula Financing (TFF), ensures that the territorial governments can provide public services, including health care, comparable to those of the provinces. Territories will also benefit from increases to the CHST.

In 1999-2000, the federal government will transfer close to $1.3 billion to the three territorial governments. Over the next five years, these transfers are projected to total approximately $6.9 billion, ensuring that the territorial governments have the revenue they need to provide northern Canadians with health and other public services.

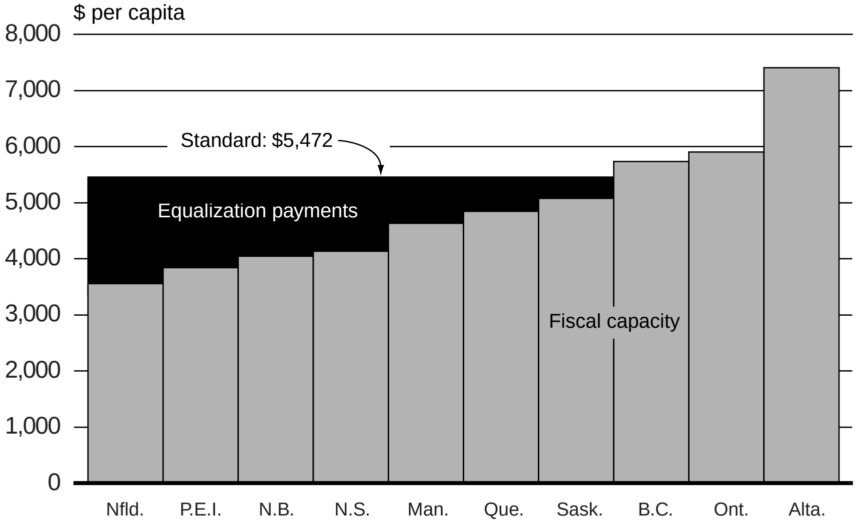
How the Equalization program works

Provinces with revenue-raising capacity below a standard receive Equalization transfers from the federal government to bring their per capita fiscal capacity up to the standard.

- The revenue-raising capacity of each province is measured by examining its ability to raise revenues from over 30 revenue sources – including personal income tax, corporate income tax, sales taxes, property tax and many other sources.
- The standard measures the revenue raising-capacity of the five "middle income" provinces – Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.
- Equalization payments are made to raise the less prosperous provinces up to the standard (Chart 4.2).

Chart 4.2

The Equalization formula
1998-99



Providing equal per capita support under the CHST

When the CHST was introduced in the 1995 budget, it replaced Established Programs Financing (EPF) for health and post-secondary education and the Canada Assistance Plan (CAP) for social assistance and social services.

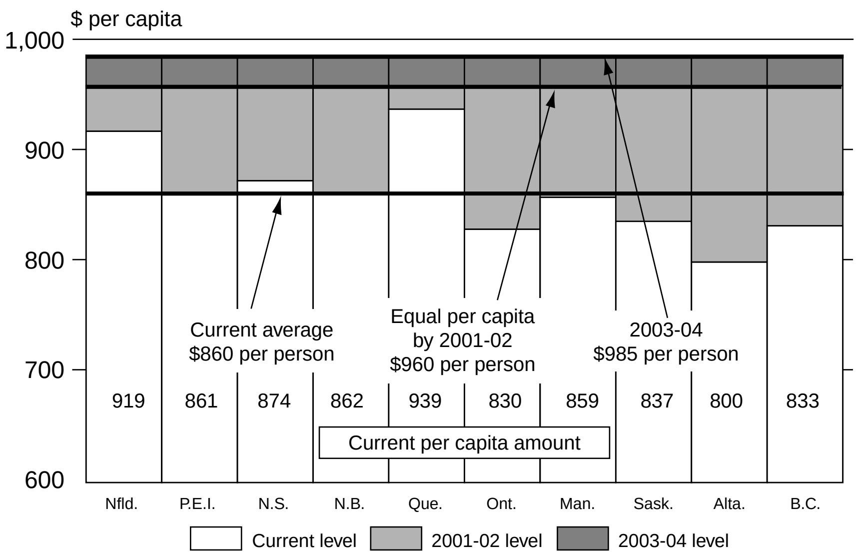
EPF provided identical per capita federal support to all provinces. CAP did not – in large part due to the cost-sharing limits imposed on certain provinces by the previous government beginning in 1990-91. The provincial distribution of the CHST in its initial year was based on its predecessors – EPF and CAP. As a result, the initial allocation of the CHST among provinces reflected the per capita disparities that were in CAP.

The 1996 budget announced that the per capita disparities in the distribution of the CHST among the provinces would gradually be reduced by half by 2002-03 – four years from now.

This budget provides for the complete elimination of these disparities three years from now – by 2001-02. All provinces will then receive identical per capita CHST entitlements, providing equal support for health and social services to all Canadians.

Chart 4.3

Provincial CHST entitlements



At present, support to the provinces varies from a high of $939 per capita in Quebec to a low of $800 per capita in Alberta, as shown in Chart 4.3. By 2001-02, all provinces will receive equal per capita entitlements of $960. The disparities in funding among provinces which exist today will be entirely eliminated.

Strategic Federal Investments: Health Information, Research, and Prevention

In addition to transferring funds to provinces and territories, the federal government makes important contributions to the health of Canadians and to the quality of the health system through several means.

This budget provides close to $1.4 billion over the remainder of this year and the next three years to strengthen these important roles. The quality, timeliness and availability of health information will be significantly enhanced. Research and innovation in the diverse fields that contribute to health will be augmented and given a more integrated focus. Health services provided to First Nations and Inuit will be improved. Programs designed to prevent health problems from occurring will be expanded or reinforced. And funding will be provided to continue exploring with the provinces innovative approaches in rural and community health.

Combined with the $6.5-billion cash increase in the CHST that will be made available to provinces and territories over the next three years, the $1.4-billion investment in these federal roles means a total of $7.9 billion in new resources will be spent on health care over the remainder of this year and the next three years.

Improving health information systems

Making better use of health information is central to moving towards a more integrated, effective and appropriate system of health care. Better health information systems will improve the delivery of health services and the health and well-being of Canadians.

Information is a powerful tool in the hands of doctors, nurses, hospital administrators, health researchers and others whose work underpins Canada's health care system. It can provide up-to-date knowledge about best practices so that health care providers can make decisions based on the best possible evidence.

Information can also be a powerful tool in the hands of Canadians themselves as they seek to know more about their own health or health problems.

Moreover, information can help Canadians understand how their health dollars are being spent, by whom, and with what results. Today, Canadians have limited information to assess the performance of the health system. They can reflect on their own experiences, turn to a friend or family member, or they can refer to various reports produced by governments, stakeholders, researchers and the media.

To maintain the confidence of Canadians in their health system, governments will continue to work together to provide Canadians with information to assess its performance. The new Social Union Framework provides for governments to monitor and measure outcomes of social programs and to report regularly on the performance of these programs.

The 1997 budget invested $50 million over three years towards the development of a national health information system, as recommended by the National Forum on Health.

On February 3, 1999, the Minister of Health's Advisory Council on Health Info-structure issued its final report, calling for further strategic investment in Canada's Health Infoway, based on the following vision:

> "The Canada Health Infoway empowers individuals and communities to make informed choices about their own health, the health of others and Canada's health system. In an environment of strengthened privacy protection, it builds on federal, provincial and territorial infostructures to improve the quality and accessibility of health care and to enable integrated health services delivery. It provides the information and services that are the foundation for accountability, continuous improvement to health care and better understanding of the determinants of Canadians' health."

This budget allocates a total of $328 million over the remainder of this fiscal year and the next three years to improve the quality and availability of health information and to further develop health information systems across the country. These funds will be used as described below. In all of this, the government is committed to engaging the provinces, health providers and interested Canadians in a manner consistent with the Social Union Framework.

The Canadian Institute for Health Information

The Canadian Institute for Health Information (CIHI) was established in 1994 to improve the quality and availability of health information in Canada. With an annual budget of about $13 million, the CIHI is now well established as an arm's length body governed by a board with private, provincial and federal representation. The Institute has worked closely with governments and health stakeholders to fulfil its mandate but more needs to be done, given the size and complexity of Canada's health care system.

This budget provides $95 million to the CIHI. The over-arching objective is to strengthen its capacity to report regularly on the health of Canadians and the functioning of the health care system. This will enable the CIHI to provide comprehensive and reliable health information for the use of Canadians, health care providers and all orders of government. It will also foster greater accountability to the public on how the health care system is serving them.

This funding will be used by the CIHI over the next three to four years to build a consensus on which health indicators to measure, to develop data standards, to fill key data gaps and to build capacity to analyze data and disseminate information. The need for funding beyond this period will be assessed as this work proceeds.

Using modern information technology to meet health needs

Modern information technology enables networks of people and institutions to communicate important health information with increasing speed and efficiency.

This budget allocates $75 million over the next three years to implement two health-related networks that have been tested as pilot projects.

The National Health Surveillance Network will link laboratories and public health officers across the country so they can communicate electronically with each other. This will provide, for example, for earlier identification of outbreaks of serious illness such as salmonella and tropical diseases, so that preventive measures can be taken more quickly to minimize their impact.

The Canadian Health Network will provide Canadians with access to up-to-date information on a host of health issues – from nutrition and the common cold to breast cancer and diabetes. Canadians will be able to access this information via the Internet and a 1-800 telephone line.

Modern information technology can also improve access to health services, particularly in rural and remote areas and in home care settings. "Telehealth" uses communications technologies to deliver health information, services and expertise over short and long distances. For example, "Telehealth" will enable doctors and nurses in rural areas to communicate directly with the best specialists anywhere in the country. "Telehomecare" will assist home care patients and caregivers by using the latest technologies to transfer information needed for diagnosis and treatment between the patient's residence and health care facilities.

This budget provides $115 million over the next three years to test pilot projects and develop large-scale applications of technologies such as "Telehealth" and "Telehomecare", in consultation with provinces.

Improving accountability for federal health programs

The federal government delivers health services and programs in several areas, including health protection, health promotion, disease prevention and Aboriginal health care. These programs help ensure the safety of food, water and drugs; address issues such as AIDS, breast cancer, smoking and substance abuse; and provide health services to First Nations and Inuit.

This budget allocates $43 million over the next three years to improve health information systems in Health Canada to better inform Canadians on the performance of federal health programs, consistent with the Social Union Framework.

Promoting health-related research and innovation

This budget provides $550 million over the remainder of this fiscal year and the next three years for health-related research and innovation.

Research is vital to improving the health of Canadians through improvements in the prevention and diagnosis of disease, the discovery of new therapies and cures, the development of innovative approaches to health care delivery and health promotion. A strong and vibrant health research community can also be a major contributor to innovation and productivity in Canada. For these reasons, it is important to ensure that Canadian researchers and clinicians continue to view Canada as an attractive and rewarding place in which to carry out their research.

Health research in Canada is carried out in a complex network of those who do research and those who fund it. Research is conducted in universities, hospitals, research institutes and centres, industrial laboratories and government facilities. It is funded by the federal government, provincial governments, donations to hospitals and health charities and the private sector.

At the federal level, the Medical Research Council is the main source of funding for biomedical and health research. Health services research is funded by the Canadian Health Services Research Foundation. Social and population health research is funded by the Social Sciences and Humanities Research Council. The Natural Sciences and Engineering Research Council and the National Research Council fund life science research. Health Canada's National Health Research and Development Program funds research on a range of national health issues.

Special federal programs, such as the National HIV/AIDS Strategy, the Canadian Breast Cancer Initiative and the Networks of Centres of Excellence, direct funds for research to targeted health areas. Health research infrastructure is funded by the Canada Foundation for Innovation.

Promoting health research is a key element of the budget plan to strengthen health care. New research can offer our doctors, nurses and other caregivers the tools they need to improve the diagnoses and treatment of diseases, and to find new cures and more effective therapies. There is a clear link between research, high quality health care, and the good health that all Canadians desire. Yesterday's discoveries in research laboratories lead to new and more effective medical treatments today.

The Canadian Institutes of Health Research

The evolution of health research over the past years has produced a research capacity across Canada that is internationally recognized. Canada's health researchers have a proud tradition of achievement and are dedicated to improving the health of Canadians. Past investments in health research have resulted in many of the major Canadian discoveries and breakthroughs that have enhanced the health and well-being of Canadians and people throughout the world.

To be a world leader in health research, Canada needs to develop a broader understanding of the underlying determinants of health and disease, recognizing that the nature of health research is changing.

Health research is critical to a number of social and environmental issues, including aging, food safety, pollution and infectious diseases.

Today health research encompasses fields from genetics to nutrition, molecular biology to microelectronics to social determinants of health. Because science has changed and the questions being posed are more challenging, the management of health research must also change. Increasingly, research groups are interdisciplinary in focus, interactive in nature, networked across Canada and around the world, and more focused on shared health priorities. Canada's health researchers, and the people and communities they serve, recognize that they can learn from one another and can work together in pursuit of shared goals.

Over the past year, a national task force representing the health research community has come together to develop an exciting new approach to health research in Canada. Its vision, reflecting the views of leaders drawn from the granting councils, teaching hospitals, universities, health charities, provincial health research agencies and health institutes, as well as the views of business leaders, is to create a new organization, the Canadian Institutes of Health Research (CIHR) in the year 2000. The government is prepared to support and invest in this proposal.

The CIHR would create networks – not brick and mortar institutions – which would draw together investigators and institutions to coordinate and provide national focus to Canada's research efforts, and to better integrate research into Canada's health care system. It would be an umbrella for 10 to 15 health institutes each dedicated to a particular theme.

For example, it is currently envisaged that there would be institutes on aging, child and maternal health, women's health, arthritis and musculo-skeletal research, and cancer and developmental biology. Each institute would be supported by a small secretariat and guided by a board representative of the institute's constituencies.

The mandate of the CIHR would be to:

- promote the creation of new knowledge and its translation into improved health for Canadians, more effective health services and economic development;
- forge an integrated health research agenda across disciplines, sectors and regions that reflects the emerging health needs of Canadians and the evolution of the health system;

- encourage interdisciplinary, integrative research through the creation of thematic institutes that will encompass the disciplines of basic science, applied clinical science, health services and population health, and foster collaboration with stakeholders in the voluntary, community and private sectors and others with complementary research interests;
- create a robust research environment in Canada based on excellence as determined by peer review to ensure the best and the brightest have opportunities to contribute to improved health in Canada;
- anticipate emerging health threats and challenges and accelerate discovery of cures, prevention and wellness strategies;
- promote economic growth and job creation by encouraging innovation and enhancing commercialization of Canadian research; and
- ensure transparency and accountability to the taxpayer for the federal investment in health research.

The Minister of Health will establish a transition team to work with a task force representing the health community to further develop this proposal over the coming weeks and months. Following further consultations, legislation establishing the CIHR could be introduced as soon as this fall.

While the CIHR proposal is being further developed, the budget provides an increase of $150 million over the next three years for health-related research. On an annual basis, the $50-million increase in funding will be allocated as follows:

- $27.5 million to the Medical Research Council;
- $7.5 million to the Social Sciences and Humanities Research Council;
- $7.5 million to the Natural Sciences and Engineering Research Council;
- $5 million to the National Research Council; and
- $2.5 million to Health Canada's National Health Research and Development Program.

This funding reflects the multidisciplinary nature of health research. It will provide more opportunities for health researchers to carry out advanced research in Canada. This is in addition to the funding provided in the 1998 budget.

This budget also provides an additional $35-million endowment in 1998-99 to the Canadian Health Services Research Foundation to support its participation in the CIHR. An initial endowment of $65 million was provided in the 1996 budget to create the Foundation. It supports research to identify what works in Canada's health care system, what does not work, and what procedures and interventions require further evaluation.

These funds will be used by the councils, the Canadian Health Services Research Foundation and Health Canada to support CIHR objectives. The MRC would become part of the CIHR once it is constituted in the year 2000.

To support the new CIHR, this budget sets aside an additional $65 million in 2000-01, its initial year of operation. The government is prepared to increase this funding to $175 million in its second year.

The increased funding in this budget for existing federal research organizations, together with funding being set aside for the CIHR, will effectively make $225 million of new resources available for the objectives of the CIHR by the year 2001-02.

This initiative is one means of ensuring that Canada continues to offer opportunities for its best medical scientists and other health researchers, and attracts the best scientists from abroad. It has the potential to move Canada to the forefront of the global health research community.

Canada Foundation for Innovation

The 1997 budget allocated $800 million to the Canada Foundation for Innovation with a mandate to help modernize Canada's research infrastructure in several areas, including health. Awards from the Foundation are expected to be about $420 million in 1999. In 1998, approximately 45 per cent of awards were made to improve infrastructure for health-related research in hospitals and universities.

As described in Chapter 5, this budget provides an additional $200 million to the Foundation in 1998-99. It is expected that about half this amount will be available for health research infrastructure across Canada.

NURSE Fund

Health care restructuring is affecting the nursing profession. The nature of work nurses perform and the environment within which they practise is changing.

The government will create a NURSE Fund – Nurses Using Research and Service Evaluations – to support a ten-year research program to develop solutions to the challenges facing nursing over the next decade. The objective is to develop a knowledge base to better enable nurses to deliver quality care in an environment of health care restructuring to identify approaches to retrain/retool the existing workforce, and to attract new members to the profession.

An endowment of $25 million will be made available to the Canadian Health Services Research Foundation in 1998-99 for this purpose.

First Nations health services

The federal government provides health services to First Nations and Inuit. This budget allocates $190 million over the next three years to better meet the needs of these communities.

This will provide a more integrated continuum of services, by strengthening home and community care in particular. It will also improve case management and other support services.

As well, health information systems will be developed with First Nations communities and better linkages made with provincial systems and public health surveillance programs.

First Nations will also benefit from the diabetes initiative described below.

Preventive and Other Health Initiatives

This budget invests $287 million over the next three years to build on a number of other federal initiatives in the health field, with a particular focus on measures which help prevent health problems.

Prenatal nutrition

The federal government's current prenatal program provides $23 million per year in food supplementation, nutrition counselling, support, referral and lifestyle counselling to pregnant women to help ensure they have healthy babies. Pregnancies put at risk by alcohol or drug abuse, family violence or other factors can have serious effects on children's prospects.

This budget allocates an additional $75 million to the Canada Prenatal Nutrition Program over the next three years to reach many more pregnant women at high risk of having unhealthy pregnancies and babies. It is expected that this program will now reach a majority of these women.

Food safety

Canada is regarded as having one of the safest food systems in the world. However, infectious foodborne illness remains a public health problem with an estimated 2.2 million cases each year. As new foodborne pathogens emerge, as new products come to market and as processing and packaging technologies change, steps must be taken to ensure that Canada's food system remains safe.

This budget allocates $65 million over the next three years to modernize and strengthen Health Canada's food safety program. These funds will be used to enhance surveillance systems, improve scientific capacity and increase regulatory activities.

Toxic substances

Toxic substances in the environment, in food and in drinking water present significant risks to the health of Canadians. Children are especially vulnerable, as exposure to toxics can impair fetal, infant and childhood development.

In response to the recommendations of the Standing Committee on the Environment and Sustainable Development, the government has recently introduced amendments to the *Canadian Environmental Protection Act*. Upon passage of legislation, screening within seven years of all potentially harmful substances currently in the Canadian market and prompt action on substances found to be toxic, will be required.

This budget provides $42 million over the next three years to Environment Canada to meet the government's responsibilities under the new legislation. These funds will serve to accelerate screening and assessment of new and existing substances, improve management and control of toxic substances, and track progress.

Innovations in rural and community health

Provinces face unique challenges posed by health care delivery in rural and remote areas. For example, access to health services must be maintained over large sparsely populated areas. Attracting and retaining physicians and other health professionals can also be a challenge.

Health care restructuring also entails a greater role for community-based services, including home care. All provinces have taken steps to expand the availability of these services, using different models of service delivery. This presents an ideal opportunity to work in partnership with provinces to evaluate these models and build on lessons learned to ensure that Canadians continue to have access to a cost-effective and responsive system of community-based services.

Over the last two years, the federal government has worked in partnership with provinces to develop innovative approaches to health care and health care delivery, through a Health Transition Fund. Building on this, this budget allocates $50 million over the next three years to continue exploring with the provinces innovative approaches in the area of rural and community health.

Diabetes

Diabetes is a chronic health condition affecting many Canadians. The prevalence of this disease is particularly high among Aboriginal people – three times that of the general population.

This budget provides $55 million over three years to combat diabetes. Surveillance and research will be carried out to find better ways to prevent this disease and enhance treatment and care. This should lead to a better understanding of why it has become such a serious problem in Aboriginal communities and what can be done about it, including an enhancement of services on reserves.

Table 4.4
Other 1999 budget health initiatives

	1998-99	1999-00	2000-01	2001-02	Total
		(millions of dollars)			
Improving health information systems					
Canadian Institute for Health Information	95				95
Other health information initiatives		20	70	100	190
Accountability for federal health programs		8	15	20	43
Subtotal	95	28	85	120	328
Promoting health-related research and innovation					
Canadian Institutes for Health Research			65	175	240
Increased health funding for research councils/organizations	35	50	50	50	185
Canada Foundation for Innovation[1]	100				100
NURSE Fund	25				25
Subtotal	160	50	115	225	550
First Nations health services		20	60	110	190
Preventive and other health initiatives					
Prenatal nutrition		10	30	35	75
Food safety		15	20	30	65
Toxic substances		14	14	14	42
Innovations in rural and community health		5	20	25	50
Diabetes		5	20	30	55
Subtotal		49	104	134	287
Total	255	147	364	589	1,356

[1] Funding will be increased by $200 million. Based on awards in 1998, it is expected that about half this amount will be allocated to support health-related research infrastructure.

5

Building Today for a Better Tomorrow

Building a Strong Economy Through Knowledge and Innovation

Highlights

- The government has been implementing a plan to promote productivity growth and job creation to improve the standard of living and quality of life of all Canadians.
- A key element of the plan lies in advancing knowledge and encouraging innovation, both of which are increasingly important in our more open knowledge-based economy.
- The government plays an important role in fostering access to education, knowledge and skills, and in encouraging businesses to innovate.
- This budget includes measures totalling over $1.8 billion in 1998-99 and over the next three years to build on the Canadian Opportunities Strategy and foster innovation.

Highlights *(cont'd)*

- Key additional investments will be made in the Canada Foundation for Innovation, the Natural Sciences and Engineering Research Council, the Social Sciences and Humanities Research Council, the National Research Council, biotechnology research, the Networks of Centres of Excellence program, Technology Partnerships Canada, the Business Development Bank of Canada, the Canadian Space Agency, new information highway initiatives and in employment programs.

Introduction

Several powerful forces are reshaping modern economies. Rapid technological innovation is transforming the skills and knowledge required for competing domestically and abroad. At the same time, the world is becoming increasingly integrated as goods, services and workers move much more freely across borders.

In the new economy, individuals and businesses must be able to quickly adapt to change by seizing the opportunities that arise from technological improvements and globalization. The ability of businesses to compete domestically and abroad increasingly depends on their capacity to create new products and implement innovative technologies. This will require individuals who understand new technologies and use them effectively. Developing a highly skilled workforce is therefore crucial.

In short, Canada's potential for strong economic growth and job creation will increasingly depend on knowledge and innovation.

The Policy Challenge

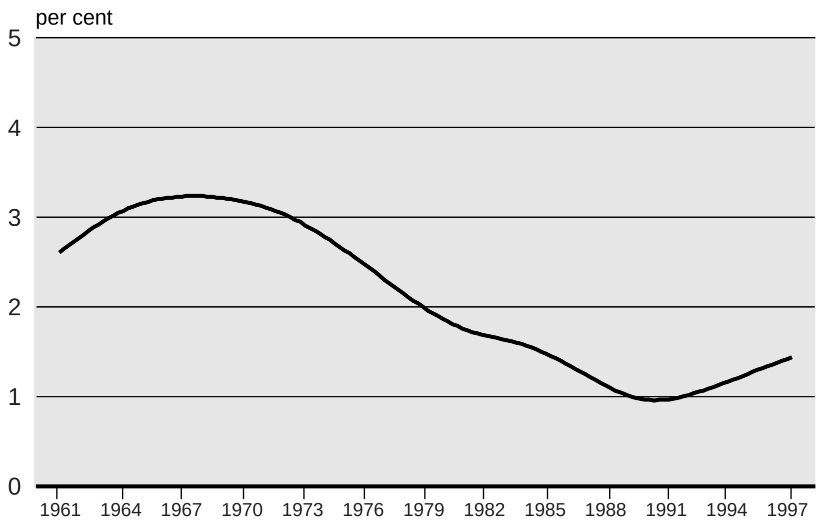
Building a strong economy for the 21st century

The ultimate goal of the government's economic policies over the past five years has been to build a strong economy – one which generates well-paying jobs and a higher standard of living for Canadians – while ensuring that all Canadians share in the prosperity.

Real GDP per capita is a commonly used measure of living standards. While Canada's real GDP per capita has been growing, the trend growth rate declined substantially from the early 1960s to the early 1990s before improving slightly in recent years (Chart 5.1). In order to continue this improvement over the longer term, we must increase our potential for economic growth.

Chart 5.1

Trend growth in real GDP per capita



Note: Trend calculated using the "Hodrick-Prescott filtering" technique.

There are two ways to expand the economy's potential and hence real GDP per capita: by getting more people working and by increasing the amount that each employed person produces. Employment growth and productivity growth are thus the two main elements that determine the potential growth rate of our economy.

Employment growth was an important source of the increase in living standards in the 1970s and 1980s. During those decades, members of the baby boom generation entered their working years, and women entered the labour force in unprecedented numbers.

However, we cannot count solely on employment growth to improve our standard of living over the long term. Indeed, as the baby boom generation retires, the proportion of Canadians that are of working age will decline, and this will be felt most strongly after the year 2010.

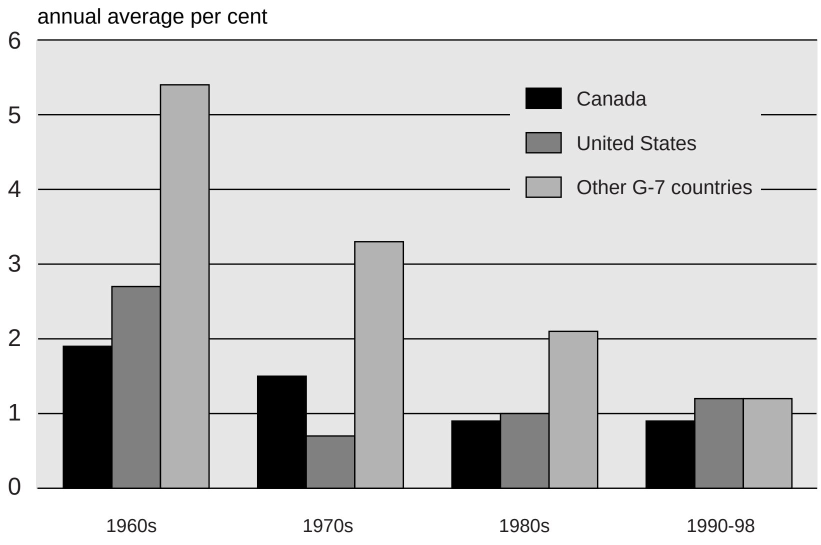
The key to achieving sustained increases in our standard of living over the long term thus lies in advancing productivity growth. Growth in wages and salaries tends to move in line with productivity growth. Even a small but sustained increase in productivity growth would have a major influence on our living standard over time.

Unfortunately, Canada's productivity performance over the past two decades has been disappointing by historical, domestic as well as international, standards. Productivity growth has slowed from an average annual rate of 1.9 per cent in the 1960s to 0.9 percent in the 1980s and so far this decade. A similar slowdown in productivity growth has occurred in all industrialized countries (Chart 5.2). But productivity growth has been particularly slow in Canada.

Clearly Canada can, and should, do better.

Chart 5.2

Productivity growth in G-7 countries



The role of knowledge and innovation

There is no simple explanation for the productivity growth slowdown nor is there a single policy measure that will ensure stronger productivity performance in the future. Productivity growth can, however, be encouraged in a variety of ways. That is why the government is acting on several fronts.

One way to encourage productivity growth is through business investment. Investment provides workers with more capital equipment, which enables each worker to produce more output. Moreover, investments that allow businesses to increase the scale of their operations often lead to increased productivity.

Productivity is also influenced by the flexibility of the economy in adjusting to structural changes. Productivity growth is encouraged when capital, workers and other resources are allowed to move to their most productive use.

In the modern economic environment, knowledge and innovation are crucial for advancing productivity growth. Businesses must continually innovate in order to compete successfully in the global marketplace. Innovation is essential not only for businesses creating new products and services in high technology sectors, but also for businesses in traditional sectors. To be able to create and adopt new technologies and develop new products and production processes requires people with leading-edge research skills and a modern, sophisticated infrastructure.

The Policy Framework

The government has been implementing a plan to promote productivity growth and job creation in order to improve the standard of living of all Canadians.

Sound economic and financial management

A key element of the plan has been to restore health to the country's fiscal situation and to maintain an economic environment that is conducive to investment and job creation.

The elimination of the deficit and the fact that the debt-to-GDP ratio has been put on a clear downward track have contributed to the current low and stable interest rate environment and improved business and consumer confidence. This has created a healthy environment for business investment, which is a key ingredient for raising productivity growth and supporting job creation over the longer term.

Lowering the debt burden will provide government more scope to make key economic and social investments and to provide needed tax relief in the future. Tax relief increases the reward from working, saving and investing, thereby advancing productivity growth and job creation.

The current low and stable inflation environment has also contributed to achieving low and stable interest rates. The inflation targets were extended to the end of 2001 in the 1998 budget. Inflation targets will remain the cornerstone of monetary policy to ensure that strong non-inflationary economic growth continues into the future.

Investing in knowledge and innovation

Another key element of the government's plan to improve productivity has been to invest in knowledge and innovation.

Federal spending on science and technology (S&T) activities makes a key contribution to creating knowledge and fostering innovation. In 1998-99 federal S&T spending is estimated to be $5.4 billion, of which $3.3 billion is on research and development (R&D). About half of this federal R&D spending is on transfers to businesses and universities to finance basic and applied research. The federal government currently funds 22 per cent of all R&D performed in Canada. The federal scientific research and experimental development (SR&ED) tax credit, with claims amounting to $1.3 billion annually, is also an important federal instrument for encouraging private sector research.

The Canadian Opportunities Strategy

In the 1998 budget, the government introduced the Canadian Opportunities Strategy to expand, in a comprehensive way, access to knowledge and the skills needed for better job opportunities and higher living standards. The Strategy does so through strategic investments in seven key areas:

- providing financial assistance for students;
- providing support for advanced research;
- helping individuals manage their student debt;
- encouraging families to save for education;

- helping Canadians upgrade their skills;
- supporting youth employment; and
- connecting Canadians to information and knowledge.

The government is investing more than $1.2 billion to support Canadians in the acquisition of knowledge and skills through the Canadian Opportunities Strategy. In addition, the Canada Millennium Scholarship Foundation, starting in the year 2000, will provide an additional $300 million annually in awards to 100,000 students from low- and middle-income families. The Foundation was established in June 1998 with a $2.5-billion contribution from the federal government.

Another key measure of the Canadian Opportunities Strategy is the Canada Education Savings Grant (CESG). The CESG provides a 20-per-cent bonus on the first $2,000 in annual contributions to registered education savings plans (RESPs). The CESG makes it highly attractive for parents and grandparents to use RESPs to invest in the knowledge and skills that children will require to thrive in the economy of the next century.

The CESG has been a resounding success and most financial planners now agree that RESPs are the best way to save for a child's education. The number of institutions offering RESPs has risen from 30 to 80 since the CESG was announced, and with RESP products now readily available at most financial institutions, RESPs are now more accessible to all Canadians. The industry reports that the number of families using RESPs has increased by one-third to almost 1 million. In the 25 years from their inception in 1972 through to the end of 1997, there was a $2.5 billion net accumulation in RESPs. In 1998 alone, with the introduction of the CESG, the total soared to $4.0 billion.

Administrative arrangements are now in place and the government has started to make CESG payments into the plans which parents, grandparents and others have set up. RESPs are well on their way to becoming as essential to saving for education as registered retirement savings plans (RRSPs) are in saving for retirement.

Building on the Canadian Opportunities Strategy

This budget builds on the Canadian Opportunities Strategy by investing over $1.8 billion in 1998-99 and over the next three years in additional support for creating, disseminating and commercializing knowledge, and supporting employment.

Creating knowledge

The Canadian Opportunities Strategy complemented the 1997 budget investment of $800 million used to create the Canada Foundation for Innovation. The Foundation makes awards to universities, research hospitals and not-for-profit research institutions and organizations for the modernization of research infrastructure in the areas of health, environment, science and engineering. In 1998, the Foundation awarded $58 million. It expects to make awards of $420 million in 1999, leaving approximately $400 million for awards beyond 1999. The Foundation's awards lever investments from its partners including provincial governments, post-secondary educational institutions, research hospitals, the business community, the voluntary sector and individuals. Awards from the initial funding are expected to lever a further $1.2 billion in investment in research infrastructure.

In this budget, the government is investing an additional $200 million in the Foundation to help Canada to continue to meet the research infrastructure challenge through the acquisition of state-of-the-art equipment and facilities. Based on awards in 1998, it is expected that about $100 million of this additional investment will support research infrastructure in the areas of the environment, science and engineering. It will provide ongoing opportunities for young Canadians and other researchers to carry out their work in modern research facilities across Canada, including in smaller communities. The investment holds out the promise of new discoveries and spinoff products and services that will enhance and enrich the lives of Canadians.

The Canadian Opportunities Strategy also provided an additional $405 million over three years to the three federal granting councils – the Natural Sciences and Engineering Research Council (NSERC), the Medical Research Council and the Social Sciences and Humanities Research Council (SSHRC). This funding restored the budgets of the councils to their previous peak levels and helped them to raise the value and number of research grants and scholarships and to focus on key research priorities.

This budget will make available increased funding over three years of $75 million for NSERC and $15 million for SSHRC. This funding is in addition to increased support for health research to the granting councils and other federal entities, including the proposed Canadian Institutes for Health Research (see Chapter 4 for details).

For more than 80 years, the National Research Council (NRC) has been the principal science and technology agency of the federal government. The NRC is a major funder and performer of federal research spanning from basic to applied research, with annual spending of about $500 million. NRC researchers in 16 institutes, located in eleven major centres across Canada, make a significant contribution to regional economic innovation. This budget will make available $16 million in 1998-99 to the NRC to invest in leading-edge equipment and $15 million over three years to better support national and regional research objectives.

Biotechnology is one of the world's fastest growing technologies. It is changing our understanding of the basic "building blocks" of life processes and providing new ways of improving the quality of human life, ranging from improved health care products and procedures to advances in agriculture and the food system. Canada is committed to being a world leader in biotechnology. This budget builds on current federal investments in biotechnology with an additional $55 million over three years for biotechnology research and development by science-based departments and agencies.

Disseminating knowledge

"Connecting Canadians" is the federal government's vision and plan to make the information and knowledge infrastructure accessible to all Canadians by the year 2000, thereby making Canada the most connected country in the world. Considerable funding has been provided to date, including $205 million over three years in the 1998 budget to build on the success of the Community Access Program and SchoolNet, and to assist the voluntary sector in expanding its technological capacity through Voluntary Sector Network Supports. An additional $55 million was made available for the Canadian Network for the Advancement of Research, Industry and Education (CANARIE) to build the world's first national optical Internet – a next-generation Internet backbone for research and development.

This budget will invest $60 million over three years to establish one Smart Community Demonstration Project in each province, in the North, and in an Aboriginal community. These Demonstration Projects will show how information and communication technologies can be harnessed by communities to support economic development and to enrich community life for Canadians. Smart Communities will use information technology more effectively in such areas as education and lifelong learning, health, government services, business and industry, housing, employment, library and information services, transportation, culture and arts.

Canadian geographic information is a national asset that can be made more broadly available and useful to Canadians through the information highway. In this budget, the government will fund the "GeoConnections" initiative at $60 million over five years beginning in 1999-2000. This initiative will make critical Canadian geographic information accessible as a national resource in support of economic and social goals. It will transform geographic information into content for the information highway. GeoConnections will keep Canada at the forefront of mapping and will have applications from search and rescue to climate change.

Commercializing knowledge

The foregoing initiatives focus on supplying and transferring the initial research that creates ideas. For innovation to remain the driving force behind improving productivity and living standards, knowledge must be applied to creating new products, production processes and markets, thereby leading to economic growth and generating job opportunities.

The Networks of Centres of Excellence (NCE) program, renewed in the 1997 budget with a commitment of $47 million in annual funding, contributes to the transfer of knowledge by supporting partnerships between world class researchers across Canada and the private sector. The NCE program links 900 researchers from Victoria to St. John's in fourteen Networks. Networks focus on research areas of vital importance to Canada such as health, telecommunications, robotics and forestry. This budget will provide an additional $90 million over three years for the NCE program starting in 1999-2000. These new resources enable the program to initiate a competition for new Networks in 1999, rather than waiting for its next planned competition in 2001.

Technology Partnerships Canada (TPC) was created by the government with reallocated resources provided in the 1996 budget, together with existing Industry Canada resources, at a funding level which rose from $150 million in 1996-97 to $250 million in 1998-99. TPC makes strategic investments with companies to commercialize innovative products and processes. It operates on the basis of partnership agreements between the government and the private sector in which both the risks and the benefits are shared, and the conditions for repayment of investments are specified. Investments are focused on technologies in the aerospace and defence industries and the enabling and environmental technologies sectors, with broad-based benefits for Canada. In this budget, an additional $150 million over three years will be made available to TPC starting in 1999-2000. This investment will help to keep Canada at the forefront of technological innovation, opening new market opportunities and facilitating the emergence and growth of higher technology industries.

Small- and medium-sized enterprises (SMEs) continue to be the growth engine of the Canadian economy. The more than 2 million small businesses in Canada account for approximately 50 per cent of all private sector employment and over 40 per cent of private sector output. Access to capital is important to increase innovative activities in SMEs, thereby improving their productivity performance.

Parliament recently passed the new *Canada Small Business Financing Act* (replacing the *Small Business Loans Act*), which will provide guarantees to commercial lenders who loan approximately $2 billion to SMEs under this program every year. The Business Development Bank of Canada (BDC) has also been given an important role in this area. The Bank has substantially increased its lending and investment efforts to help businesses in knowledge-based sectors. In this budget, the government will inject an additional $50 million in equity to the BDC through a purchase of dividend-paying preferred shares. This capital will allow the BDC to provide additional financing for knowledge-based and export-oriented businesses.

The Canadian Space Agency (CSA) plays a leading role in the development and application of space knowledge for the benefit of all Canadians. In particular, the CSA has been instrumental in the success of Canadian space technology firms in the fields of space robotics, earth observation, satellite communications and science. In the past, the CSA has been funded largely on a project-by-project basis. This situation has created uncertainty for the Agency and its clients.

In this budget, the government is providing the CSA with additional resources of $430 million over three years and thereafter will stabilize funding for the CSA at $300 million per annum. These resources will support ongoing significant investments by the government in space projects, science and technology, consistent with Canadian needs and priorities.

In addition, the increased funding for health research announced in Chapter 4 will lead to the creation of new products and services in health industries. These fast-growing industries are an important part of the knowledge economy.

Supporting employment

In recognition of the important role of work experience in building skills and knowledge among Canada's youth, the government has announced the renewal of the Youth Employment Strategy with funding of $465 million over three years, which is 50 per cent higher than the previous three years. This funding will provide increasing numbers of young Canadians with opportunities for summer employment, internships, and career and labour market information services.

The Canada Jobs Fund will replace the Transitional Jobs Fund. The government will provide $110 million per year to create sustainable jobs in regions most directly affected by high unemployment. The Minister of Human Resources Development will work in close partnership with other levels of government, the private sector, regional development agencies and community organizations to stimulate employment in areas with high unemployment rates.

Table 5.1
Building on the Canadian Opportunities Strategy: knowledge and innovation

	1998-99	1999-00	2000-01	2001-02	Cumulative total
	(millions of dollars)				
Creating knowledge					
Canada Foundation for Innovation[1]	100	–	–	–	100
NSERC		25	25	25	75
SSHRC		5	5	5	15
National Research Council	16	5	5	5	31
Biotechnology		15	20	20	55
Disseminating knowledge					
Smart Communities		15	30	15	60
GeoConnections		12	12	12	36
Commercializing knowledge					
Business Development Bank of Canada[2]	50	–	–	–	50
Technology Partnerships Canada		50	50	50	150
Canadian Space Agency		41	152	237	430
Networks of Centres of Excellence		30	30	30	90
Supporting employment					
Youth Employment Strategy renewal		155	155	155	465
Canada Jobs Fund		110	110	110	330
Total	166	463	594	664	1,887

[1] Funding will be increased by $200 million. Based on actual awards in 1998, it is expected that about half this amount will support research infrastructure in areas other than health.

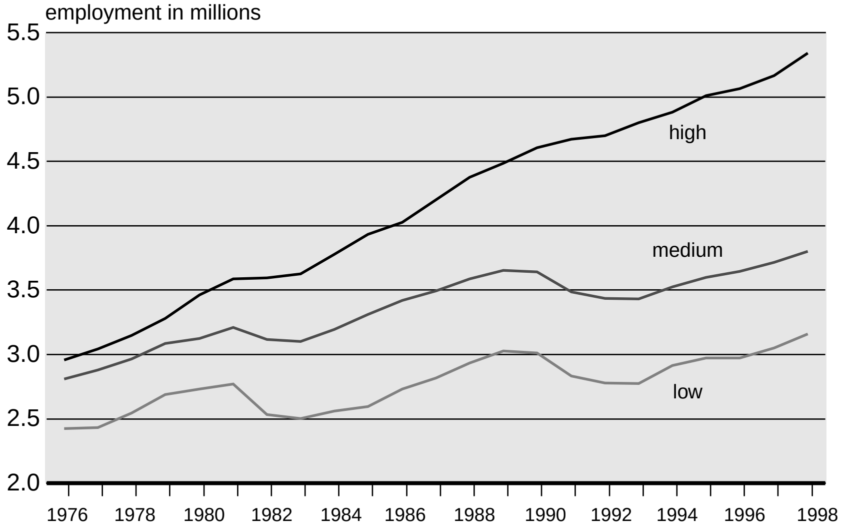
[2] Federal support for the Business Development Bank of Canada is in the form of an equity injection – i.e. the purchase of shares. As such, it is not counted as a budgetary expenditure.

Looking Ahead

Technological innovation and globalization will continue to transform modern economies as we progress into the 21st century. These changes have already had a substantial impact on the structure of the Canadian economy. Over the past few decades more and more Canadians have become employed in sectors that require a high level of knowledge (Chart 5.3). Moreover, Canada's reliance on trade has risen substantially, particularly over the past decade (Chart 5.4).

Chart 5.3

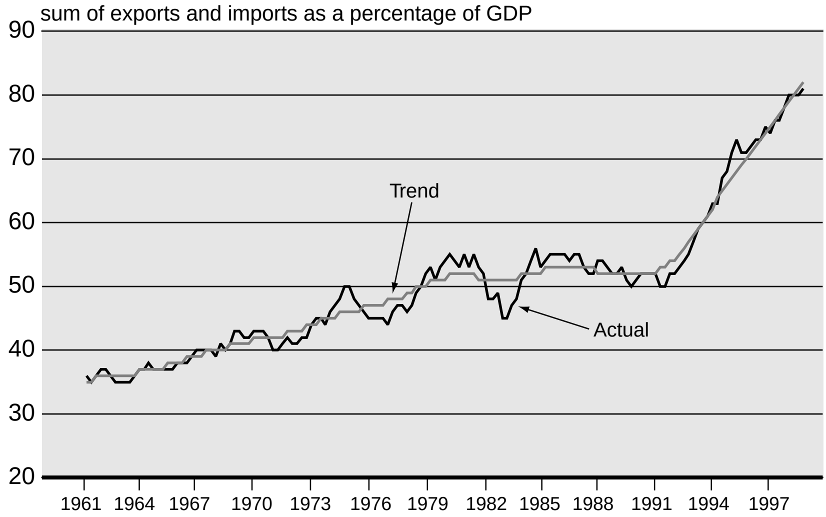
Employment by knowledge intensity[1]



[1]Knowledge intensity measured by educational attainment.

Chart 5.4

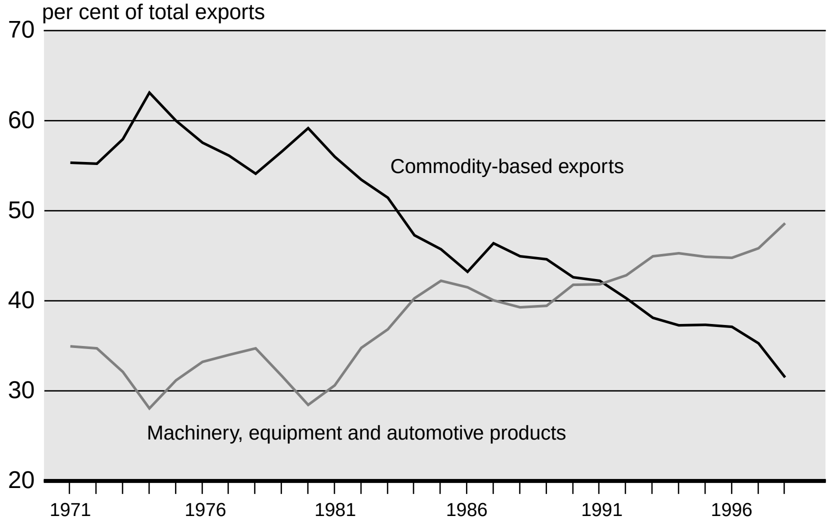
Canada's reliance on trade



Canada's international exports now account for over 40 per cent of GDP, making Canada the most trade-oriented of the G-7 countries. The ongoing diversification of the Canadian economy is reflected in the declining share of commodity-based products in our exports. The share of commodities in total exports has fallen from about 60 per cent in 1980 to about 30 per cent per cent in 1998. Since 1992, Canada's exports of automotive products and machinery and equipment have exceeded our commodity exports (Chart 5.5).

Canada is well placed to take on the challenge of building a 21st century economy. The proportion of Canadians enrolled in post-secondary education is one of the highest in the world. The strong rate of employment growth over the past few years has been highly concentrated in knowledge- and information-intensive sectors of the economy that require highly skilled workers. In addition, research and development expenditures by Canadian businesses increased by 38 per cent over the past five years. Canadian businesses are actively involved in developing leading-edge technologies and implementing new technologies in more traditional sectors such as resources and manufacturing.

Chart 5.5
Canadian exports of commodities and machinery, equipment and automobiles



Building a strong economy for the 21st century will require steady, firm commitment from individuals, businesses and government. The government will continue to invest in key priorities by supporting knowledge and innovation.

6

Building Today for a Better Tomorrow

Providing Tax Relief and Improving Tax Fairness

Highlights

- The government's objective is to provide substantial tax relief in the fairest way possible.
  - Each of the government's budgets has provided targeted tax relief to achieve key social and economic objectives. Areas of support included education, low-income families with children, charities and Canadians with disabilities.
  - With the elimination of the deficit in 1997-98 the government began to provide broad-based tax relief not paid for with borrowed money – the first time since 1965.
  - The government's tax strategy is to continue to provide as much tax relief as possible within its fiscal means.
- Tax reductions in the 1999 budget build on the tax reductions in the 1998 budget.
  - The 1998 budget provided a $500 increase in the amount of income low-income Canadians can receive tax-free. The 1999 budget increases this amount to $675 and extends this tax relief to all taxpayers.

Highlights *(cont'd)*

- The $675 increase more than offsets the effect of inflation on the value of the tax-free amount since 1992.

- The 1998 budget began the process of eliminating the 3-per-cent surtax by providing complete relief for taxpayers with incomes up to about $50,000 and reductions for those with incomes between $50,000 and $65,000. The 1999 budget completes this process by eliminating the surtax for all remaining taxpayers.

- The 1998 budget, on top of the $850 million provided in the 1997 budget, committed an additional $850 million to the Canada Child Tax Benefit (CCTB) targeted exclusively at low-income families.

- The 1999 budget sets out the design for this increased assistance, agreed to by federal, provincial and territorial governments, and also commits an additional $300 million to increase CCTB payments for modest- and middle-income families.

■ The 1998 and 1999 budgets provide Canadians with substantial tax relief.

- The 1998 budget actions will provide Canadians with $2.4 billion of tax relief in 1999-2000, $3.2 billion in 2000-01 and $3.3 billion in 2001-02 for a cumulative total of $8.8 billion over the three fiscal years.

- The 1999 budget actions will provide an additional $1.5 billion of tax relief in 1999-2000, $2.8 billion in 2000-01 and $3.4 billion in 2001-02. Cumulative tax relief from the 1999 budget totals $7.7 billion over the three fiscal years.

- Together, the 1998 and 1999 budgets provide tax relief of $3.9 billion in 1999-2000, $6.0 billion in 2000-01 and $6.6 billion in 2001-02, for a total of $16.5 billion over three years.

Highlights *(cont'd)*

- In combination, the 1998 and 1999 budget actions, and the $800-million employment insurance premium rate reduction for 1999-2000, provide tax relief of $17.3 billion over the next three years.

■ The across-the-board tax relief in the 1999 budget is part of the government's commitment to fairness.

- The proposed measures provide the largest proportionate federal income tax reductions at the lowest income levels.
- As a result of the 1998 budget 400,000 low-income Canadians will no longer pay any federal income tax. The 1999 budget removes an additional 200,000 from the tax rolls for a total of 600,000.
- Single taxpayers earning $20,000 or less will have their federal income taxes reduced by at least 10 per cent as a result of the 1998 and 1999 budget measures.
- A typical Canadian one-earner family of four that receives income of $30,000 or less will pay no net federal income tax.
- Families with incomes of $45,000 or less will have their federal income taxes reduced by a minimum of 10 per cent, and some will receive much larger reductions, as a result of the 1998 and 1999 budget measures.

Introduction

Tax reduction plays a key role in helping to build Canada today for a better tomorrow and is one of the highest priorities of the government. Lower taxes mean higher disposable income and therefore improved living standards. Lower taxes also provide increased rewards for work, saving and investment. These effects enhance job creation and productivity and further increase disposable income.

Tax policy, however, must be developed within the overall fiscal, economic and social policy context. Tax revenues are required to finance the important government programs that Canadians want (for example, for health care and education). Taxes also provide the revenue required to pay the interest on the public debt.

Consequently, tax policy must strike a balance between keeping taxes low and providing a source of revenue for vital social and economic programs.

Tax Policy Principles

Tax policy is an important pillar of economic and social policy. The tax policy of the government is based on three fundamental principles.

First, taxes must be fair. Tax reductions must benefit first those who need them the most – low- and middle-income Canadians. Taxes must reflect an ability to pay, and ongoing efforts are required to ensure that taxes that are due are indeed paid.

Second, broad-based tax relief should focus initially on personal income taxes. That is the area where the Canadian tax burden is greatest and most out of line with that of our major trading partners.

Third, because the debt burden is so high, broad-based tax relief should not be financed with borrowed money. To do otherwise would reverse the process of debt reduction and result in even higher tax burdens in the future.

Targeted Tax Relief

Each of this government's budgets has provided targeted tax relief in priority areas to achieve key social and economic objectives. Actions in these areas could not wait as the potential benefits outweighed the associated fiscal costs.

There have been more than 40 major targeted tax relief actions including support provided for students, charities, persons with disabilities, and children in families with low incomes. Examples include:

- In the area of education, the 1997 budget increased the education tax credit amount to $200 per month of full-time attendance, and broadened the fees eligible for the tuition tax credit. The 1998 budget built on these measures by providing tax relief for interest on student loans, tax-free withdrawals from registered retirement savings plans for lifelong learning, and education credits and child care tax deductions for part-time students. The 1998 budget also made tax-assisted registered education savings plans more attractive by providing a 20 per cent top-up to contributions through the Canada Education Savings Grant.

- To assist persons with disabilities, the medical expense tax credit was broadened in the 1997 and 1998 budgets and the Home Buyers' Plan was modified in the 1998 budget to allow persons with a disability to buy a home more suited to their needs. The 1998 budget also provided a new caregiver credit of up to $400 to benefit those providing care to an elderly parent or grandparent or an infirm dependent relative.
- The Canada Child Tax Benefit was increased for low-income families with children by a total of $1.7 billion in the 1997 and 1998 budgets and the 1998 budget increased the limit under the child care expense deduction.

Broad-Based Tax Relief: Tax Measures in the 1998 and 1999 Budgets

The 1998 and 1999 budget measures follow a single broad-based tax-reduction plan. Separately, and in combination, the 1998 and proposed 1999 budget measures flow from the principle that such tax relief should not be provided with borrowed money. They provide affordable broad-based tax cuts to all Canadians and they provide proportionately greater reductions at lower-income levels.

Increasing the Amount of Income Canadians Can Receive Tax-Free

The 1998 budget provided a $500 supplement to the amounts used to determine basic personal tax credits, including the spousal and equivalent-to-spouse tax credits. These supplementary amounts were reduced at a rate of 4 per cent and completely disappeared at an income level of about $20,000 for singles and $40,000 for one-earner families.

Effective July 1, 1999, the 1999 budget proposes that the tax relief provided by the $500 supplementary amounts be extended to all taxpayers. This measure benefits all Canadian taxpayers, with the largest proportionate benefits accruing to low-income Canadians who did not fully benefit from the 1998 budget measure because of the targeting by income. For example, taxpayers earning $15,000 only benefited from about $200 of the $500 supplement provided in the 1998 budget. The extension announced in this budget will allow them to use the full $500 increase in the amount of income that can be received tax-free.

Also effective July 1, 1999, the amounts of income that can be received tax-free will be increased by a further $175 for all taxpayers. All taxpayers will then benefit from personal amounts that are $675 higher than they were prior to the 1998 budget. With these increases, the basic personal amount will rise to $7,131 and the spousal and equivalent-to-spouse amounts will rise to $6,055. The increase in basic amounts more than offsets the erosion in the value of these credits caused by inflation since 1992.

The 1998 budget increase in the amount of income low-income Canadians can earn tax-free eliminated the federal income tax liabilities of 400,000 Canadians, effectively removing them from the tax rolls. The increases in basic amounts provided in the 1999 budget will remove an additional 200,000 taxpayers from the tax rolls and provide tax reductions to all Canadian taxpayers.

Eliminating the General Surtax for All Taxpayers

The general (3-per-cent) surtax was introduced in the 1986 budget as a temporary deficit fighting measure. With the books in balance, the 1998 budget provided relief from this surtax. Taxpayers with incomes of up to about $50,000 benefited from the total elimination of the surtax, while those with incomes above $50,000 but below $65,000 received some benefit. The 1999 budget completes this process by eliminating the 3-per-cent surtax for all remaining taxpayers as of July 1, 1999. An additional 2.7 million Canadians will benefit from the complete elimination of the surtax.

Other Potential Areas for Broad-Based Tax Relief

The amount of tax relief, and the areas in which action has been taken, have both been limited by the amount of fiscal resources available. The government will provide further tax relief in future budgets as resources become available.

Many commentators have recommended areas for further tax reductions. The following lists some of these and provides estimates of their respective costs. These will need to be carefully evaluated for action in future budgets.

- Further increases in the amount of income Canadians can earn tax-free (the amounts used as the basis for calculating the basic personal, spousal and equivalent-to-spouse credits). These amounts effectively increase the threshold at which the 17 per cent tax rate applies. Increasing personal amounts by an additional $100 would cost $290 million per year.
- Increases in the thresholds at which the 26 per cent ($29,590) and 29 per cent ($59,180) tax rates become effective: increasing these two thresholds by $1000 would cost $700 million per year.
- Reductions in the middle tax rate of 26 per cent: each percentage point reduction in the rate would cost $1.1 billion per year.
- Increases in limits for registered retirement savings: increasing the dollar limits on registered pension plan (RPP)/RRSP contributions by $1,000 from the current level of $13,500 would cost $200 million per year. The RPP limit is currently scheduled to increase to $14,500 in 2003 and to $15,500 in 2004 while the RRSP limit will rise to $14,500 in 2004 and $15,500 in 2005.
- More comprehensive offset of the effect of inflation on the tax system: restoring full indexation of the tax system would cost approximately $850 million in the first year with the cost rising cumulatively in subsequent years, e.g. $4.5 billion annually in the fifth year.
- Elimination of the 5-per-cent surtax or an increase in the income threshold at which it becomes applicable: reducing the 5-per-cent surtax rate by one percentage point would cost $130 million per year; raising its threshold from $65,000 to $100,000 would cost $300 million per year.
- Reduction in the taxation of capital gains: for example, a five percentage point reduction in the inclusion rate for capital gains from 75 per cent to 70 per cent would cost $135 million.
- Reductions in corporate tax rates: reducing the general corporate tax rate by one percentage point, leaving other rates unchanged, would cost $375 million per year.

Improving Tax Fairness

The 1999 budget proposes a number of other measures that will improve the fairness of Canada's tax system.

- Currently, some low-income single parents may not fully benefit from the supplement under the GST credit. Changes are being proposed that would ensure that all low-income single parents receive the maximum amount under the GST credit supplement.
- Currently, it can take over a year before GST credit payments are adjusted to reflect changes in family situations – changes are being proposed that would shorten the response time.
- To provide increased assistance for people with disabilities, the list of expenses eligible for the medical expense tax credit is being expanded. For the 1999 and subsequent tax years, eligible expenses will include: tutoring for persons with learning disabilities; therapy for persons with severe and prolonged disabilities; and costs for the care and supervision of such persons in a group home.
- Changes are being proposed that would increase the fairness of the rules governing investments in foreign investment funds and transfers to non-resident trusts to ensure that Canadians keeping their money in Canada are not disadvantaged relative to those taking their money abroad.
- Changes are being proposed that would prevent high-income individuals from reducing their taxes by income splitting with minor children.
- To alleviate hardship when a parent of a child dies, the favourable treatment of the disposition of RRSP proceeds on death will be extended to include distribution to financially dependent children even when the annuitant has a surviving spouse.

These measures are described in detail in Annex 7.

Canada Child Tax Benefit

Investing in children is one of the best investments a government can make. The Canada Child Tax Benefit (CCTB) is the primary federal instrument for providing financial assistance to families with children and delivering federal investments to build the National Child Benefit system. This budget contains two measures aimed at fostering equality of opportunity for children. It sets out the design of the commitment in the 1998 budget to provide an $850-million increase in the CCTB payments to low-income families. It also provides $300 million to extend benefit enhancements to modest- and middle-income families.

Building on the National Child Benefit System

The government committed $850 million in the 1997 budget to create a simplified and enriched CCTB as its initial investment in the National Child Benefit (NCB) system. The NCB system is central to the government's strategy for supporting low-income families and reducing child poverty. It is also a strong example of how governments can work together to improve the lives of Canadians.

The NCB system represents a significant modernization of our welfare programs and income benefits for low-income families in Canada. Traditionally, families that moved from welfare to work had to give up a range of income supports and services for their children because such supports were tied to the welfare system. The prospect of losing benefits for their children stood as a substantial barrier to employment for many low-income families and limited their opportunities to earn income. In 1996 federal, provincial and territorial leaders agreed that this system had to change, and in doing so, established the NCB.

Since July 1998, the government's first $850 million investment in the CCTB – the federal portion of the NCB system – has allowed low-income families to keep a growing portion of their child benefits when they move from welfare to work. In addition, the provinces and territories have added new income supports and services such as dental and vision care to assist these families. The combination of new federal, provincial and territorial supports are bringing down barriers to employment and improving the lives of many families, but more must be done and is being done.

The 1998 budget committed an additional $850-million federal contribution to the NCB, to be delivered in two $425 million investments in July 1999 and July 2000, bringing the federal investment in the NCB to $1.7 billion. The 1999 budget sets out the design for the $850-million increase in assistance, agreed to by federal, provincial and territorial governments. Under this design, low-income families will receive an increase of $350 per child in the NCB supplement. The design also increases the maximum level of income at which the NCB supplement benefits are provided from $25,921 to $29,590. This will allow for a more gradual phase-out of benefits and will provide more money to modest-income families to support their children.

Enhanced benefits for modest- and middle-income families

The 1999 budget also proposes to allocate an additional $300 million in July 2000 to enhance CCTB benefits for modest- and middle-income families. Currently, families with incomes up to $25,921 receive the full amount of the base benefit. The benefit is reduced for families with incomes above this threshold and, for a two-child family, the benefit completely disappears at an income level of $66,721.

This budget proposes to increase the income threshold at which CCTB base benefits start to be reduced from $25,921 to $29,590. Increasing the threshold results in higher CCTB payments for modest- and middle-income families by reducing the amount of family income subject to income-testing. This measure will provide increased child benefits to 2 million modest- and middle-income families.

As a result of the 1998 and 1999 budget CCTB increases, the maximum CCTB benefits will reach $1,975 for the first child and $1,775 for each additional child in the year 2000. A typical two-child family with family income of $20,000 will receive $3,750 in CCTB benefits, compared to $2,540 in 1996, an increase of $1,210 or 48 per cent. A family with two children and an income of $50,000 will receive $1,020 in CCTB benefits, compared to $836 in 1998, an increase of $184 or 22 per cent.

The CCTB and the budget actions relating to it are described in detail in Annex 7.

Reductions in Employment Insurance Premiums

The personal income tax reductions are in addition to the 15-cent reduction in the employment insurance (EI) premium rate to $2.55 per $100 of insurable earnings for 1999. The reduction in EI premiums provides progressive relief in the burdens of contributors, as lower-income workers receive a proportionately larger cut than those with higher incomes. It provides reductions in the premiums paid by employees of up to $58; it also provides employers with reductions of up to $82 per employee. The premium cut will reduce the cost to Canadians of paying EI premiums by $1.1 billion in 1999.

Since 1994 EI premium rates have been reduced by 52 cents, saving the average employee as much as $200 in 1999. Together, employers and employees will pay about $3.5 billion less in 1999 than they would have if premium rates had remained at the 1994 levels.

Tax Relief Impacts on Individuals and Families

Tables 6.1 to 6.4 provide the impacts of the proposed 1999 budget package on typical individuals and families by income levels as well as the fiscal cost of the package. They also show the combined impacts of the 1998 and proposed 1999 budget measures.

The 1998 budget actions will provide Canadians with $2.4 billion of tax relief in 1999-2000, $3.2 billion in 2000-01 and $3.3 billion in 2001-02 for a cumulative total of $8.8 billion over the three fiscal years.

The 1999 budget actions will provide Canadians with additional tax relief of $1.5 billion in 1999-2000, $2.8 billion in 2000-01 and $3.4 billion in 2001-02. Cumulative tax relief totals $7.7 billion over the three fiscal years from 1999-2000 to 2001-02. In combination, the 1998 and 1999 budget actions and the $800 million EI premium rate reduction for 1999-2000 provide tax relief of $17.3 billion over the next three years.

The proposed 1998 and 1999 budget measures in combination will provide tax reductions for all 15.7 million Canadian taxpayers.

The measures particularly benefit low- and modest-income Canadians and their families. As a result of the 1998 budget 400,000 low-income Canadians will no longer pay any federal income tax, effectively removing them from the tax rolls altogether. The 1999 budget removes an additional 200,000 from the tax rolls for a total of 600,000.

Single taxpayers earning $20,000 and less will have their federal income taxes reduced by at least 10 per cent.

Typical families with two children that receive income of $30,000 or less will pay no net federal income tax. The taxes of a family earning $30,000 will fall by $169 while their CCTB payments will rise by $184 for a total benefit of $353. This is more than the $306 that the family would have paid in net federal income tax without the measures.

Families with incomes of $45,000 or less will have their federal income taxes reduced by a minimum of 10 per cent and some will receive much larger reductions.

The effects of the general tax relief measures and CCTB enhancements on Canadians and Canadian families are provided in a number of tabular examples in the following pages.

- A typical one-earner family of four earning $30,000 received $145 in federal income tax relief from the 1998 budget. The 1999 budget provides an additional $353 to this family, $169 through the increase in personal credits and $184 in increased CCTB benefits.
- A typical two-earner family of four earning $50,000 received $183 in federal income tax relief from the 1998 budget. This budget provides an additional $373 to this family, $189 through the increase in personal credits and $184 in increased CCTB benefits.

Many Canadians, depending on their circumstances, are benefiting from targeted tax reductions announced in the government's previous budgets. These tax reductions should be added to the broad-based federal income tax relief being provided in the 1998 and 1999 budgets to get a complete picture of tax relief. The following are some examples of targeted federal income tax relief provided in the 1998 budget.

- An individual who pays $1,000 per year in interest on a student loan benefits from an annual reduction in federal and provincial income tax of $250 because of the tax credit for interest on student loans provided in the 1998 budget.
- A parent earning $45,000 and paying $14,000 for the care of two pre-school children receives $1,600 in additional federal and provincial income tax relief as a result of the increase in the deduction limits for child care expenses provided by the 1998 budget.
- As a result of the 1998 budget, a part-time student may now be eligible for an education tax credit based on an amount of $60 per month. If this student is also a parent, he or she may also be eligible for the child care expense deduction. A single parent with two children who is a part-time student enrolled in two eligible courses for eight months may now benefit from an education credit amount of $480 (federal and provincial tax saving $120) and a child care expense deduction of up to $2,200 for a total tax saving of $670.

Federal tax relief for Jane
Single parent with one child and an income of $20,000

	Net federal relief	
	(dollars)	
Pre-1998 budget federal tax[1]		-1,496
1998 budget tax reduction		
Increased tax-free income	-104	
3% surtax reduction	-19	
Total	-123	
1999 budget tax reduction		
Increased tax-free income	-126	
3% surtax elimination	0	
Total	-126	
Canada Child Tax Benefit[2]	-350	
Total relief[3]	-599	-599
Post-1999 budget federal tax[1] (net benefit)		-2,095

[1] Negative values indicate that Jane receives more in federal refundable credits (CCTB & GST credit) than she pays in federal income tax.

[2] 1998 and 1999 budget increases. Negative values indicate an increase in benefits and thus a reduction in tax.

[3] Full-year impact.

Federal tax relief for Edward
Single with an income of $30,000

	Net federal relief	
	(dollars)	
Pre-1998 budget federal tax		3,746
1998 budget tax reduction		
Increased tax-free income	0	
3% surtax reduction	-112	
Total	-112	
1999 budget tax reduction		
Increased tax-free income	-115	
3% surtax elimination	0	
Total	-115	
Total relief[1]	-227	-227
% of federal income tax	-6.1%	
Post-1999 budget federal tax		3,519

[1] Full-year impact.

Federal tax relief for Louis & Marie

One-earner couple with two children and an income of $30,000

	Net federal relief	
	(dollars)	
Pre-1998 budget federal tax		451
1998 budget tax reduction		
Increased tax-free income	-60	
3% surtax reduction	-85	
Total	-145	
1999 budget tax reduction		
Increased tax-free income	-169	
3% surtax elimination	0	
Total	-169	
Canada Child Tax Benefit[1]	-184	
Total relief[2]	-498	-498
% of federal income tax	-110.4%	
Post-1999 budget federal tax[3] (net benefit)		-47

[1] 1999 budget increases. Negative values indicate an increase in benefits and thus a reduction in tax.

[2] Full-year impact.

[3] Negative values indicate that Louis and Marie receive more in federal refundable credits (CCTB & GST credit) than they pay in federal income tax.

Federal tax relief for Don & Jenna

Two-earner couple with two children and an income of $50,000

	Net federal relief	
	(dollars)	
Pre-1998 budget federal tax		3,716
1998 budget tax reduction		
Increased tax-free income	-41	
3% surtax reduction	-142	
Total	-183	
1999 budget tax reduction		
Increased tax-free income	-189	
3% surtax elimination	0	
Total	-189	
Canada Child Tax Benefit[1]	-184	
Total relief[2]	-556	-556
% of federal income	-15.0%	
Post-1999 budget federal tax		3,160

[1] 1999 budget increases. Negative values indicate an increase in benefits and thus a reduction in tax.

[2] Full-year impact.

Table 6.1
Impact on taxpayers – mature system

General tax relief and Canada Child Tax Benefit (CCTB)	Number of taxpayers 1998 and 1999 budgets	1998 budget	1999 budget
Changes to personal amounts[1]			
Number with tax reductions[2]	15,700,000	5,000,000	15,300,000
Number removed from the tax rolls	600,000	400,000	200,000
Elimination of 3% surtax			
Number with tax reductions[3]	15,100,000	14,000,000	2,700,000
Increase to CCTB			
Number of families with CCTB increases[4]	3,300,000	1,400,000	2,000,000
Number of families added to CCTB eligibility[5]	100,000	–	100,000

[1] Includes extension of $500 supplement to all taxpayers and $175 increase in tax-free income.

[2] The 1999 budget provides tax reductions to all 15.3 million taxpayers remaining after the 1998 budget removed 400,000 from the tax rolls. Consequently all 15.7 million taxpayers receive tax reductions from the two budgets combined.

[3] The 1999 budget eliminates the surtax for the 2.7 million taxpayers who remained liable for the surtax following the 1998 budget measures. This number includes taxpayers who received only partial relief from the surtax in the 1998 budget.

[4] The total number of families receiving CCTB benefits following the full implementation of the 1999 budget measures will be 3.3 million. Some families gain from benefit increases provided by both the 1998 and 1999 budgets.

[5] As a result of the 1998 budget, the number of families eligible for the NCB supplement will increase by 175,000. However, the number of families eligible for the CCTB remains unchanged as these families were already receiving the base benefit.

Table 6.2
Impact on federal revenues

General tax relief and Canada Child Tax Benefit (CCTB)	1999-2000	2000-01	2001-02	Three-year cumulative impact
	(millions of dollars)			
Measures effective July 1, 1999				
Extension of $500 supplement to all taxpayers	-665	-1,110	-1,290	-3,065
$175 increase in tax-free income	-270	-450	-525	-1,245
Elimination of 3% surtax	-595	-995	-1,150	-2,740
Total	-1,530	-2,555	-2,965	-7,050
Tax fairness measures	-15	-25	-100	-140
Increase to CCTB for middle-income families[1]	0	-225	-300	-525
Total-1999 budget	-1,545	-2,805	-3,365	-7,715
Memorandum item: 1998 budget				
General and tax fairness measures	-2,070	-2,405	-2,425	-6,900
Increase to CCTB for low-income families[2]	-320	-750	-850	-1,920
Total-1998 budget	-2,390	-3,155	-3,275	-8,820
Total-1998 and 1999 budgets	-3,935	-5,960	-6,640	-16,535

[1] Effective July 2000. The amount is in addition to the cumulative $1.7-billion increase in CCTB in the 1997 and 1998 budgets.

[2] $425 million effective July 1999 and an additional $425 million effective July 2000.

Table 6.3
Typical one-earner family of four
Full-year impact of proposed measures

			1999 budget tax relief measures							
Total income	Federal tax[1] pre-1998 budget	1998 budget impacts	Extending the $500 supplement	$175 increase to basic amounts	Surtax elimination	Canada Child Tax Benefit[2]	Total 1999 budget	Total 1998 and 1999 budgets	Total 1998 and 1999 as a % of federal tax[3,4]	Federal tax post-1999 budget
$	$	$	$	$	$	$	$	$	$, %	$
13,500	-3,708	-163	0	0	0	-700	-700	**-863**	**-863**	-4,571
15,000	-3,462	-174	-7	-60	0	-700	-767	**-941**	**-941**	-4,403
20,000	-2,643	-164	-41	-60	0	-700	-801	**-965**	**-965**	-3,608
25,000	-1,000	-154	-75	-60	0	-719	-854	**-1,008**	**-1,008**	-2,008
30,000	451	-145	-109	-60	0	-184	-353	-498	-110.4%	-47
35,000	2,233	-149	-143	-60	0	-184	-387	-536	-24.0%	1,697
40,000	3,938	-160	-170	-60	0	-184	-414	-574	-14.6%	3,364
45,000	5,527	-199	-170	-60	0	-184	-414	-613	-11.1%	4,914
50,000	7,116	-238	-170	-60	0	-184	-414	-652	-9.2%	6,464
55,000	8,705	-197	-185	-65	-60	-184	-494	-691	-7.9%	8,014
60,000	10,319	-117	-185	-65	-179	-184	-613	-730	-7.1%	9,589
65,000	12,063	-30	-185	-65	-310	-184	-744	-774	-6.4%	11,289
75,000	15,469	0	-184	-64	-440	0	-688	-688	-4.4%	14,781
100,000	23,299	0	-184	-64	-658	0	-906	-906	-3.9%	22,393

[1] Includes federal income tax, refundable Canada Child Tax Benefit (CCTB) and the goods and services tax (GST) credit. Does not include provincial income tax. Negative values indicate that refundable CCTB and GST credits received are greater than income tax paid.

[2] Design change announced in the 1999 budget – includes the effect of the $850-million increase announced in the 1998 budget as well as the $300-million increase announced in the 1999 budget.

[3] Negative values indicate a reduction in net tax paid to the federal government.

[4] Typical one-earner families of four at incomes of about $25,000 and less receive more in federal refundable credits (CCTB and GST credit) than they pay in federal income tax. The federal tax reduction indicated in bold therefore represents the increase in the net benefits they receive from the tax and transfer system. Percentages are not meaningful so the dollar amounts are repeated.

Table 6.4
Typical single individual
Full-year impact of proposed measures

Total income	Federal tax[1] pre-1998 budget	1998 budget impacts	1999 budget tax relief measures: Extending the $500 supplement	$175 increase to basic amounts	Surtax elimination	Canada Child Tax Benefit	Total 1999 budget	Total 1998 and 1999 budgets	Total 1998 and 1999 as a % of federal tax[2,3]	Federal tax post-1999 budget
$	$	$	$	$	$	$	$	$	$, %	$
7,500	-98	-85	-4	-30	0	0	-34	**-119**	**-119**	-217
10,000	262	-80	-21	-30	0	0	-51	-131	-50.0%	131
15,000	1,047	-70	-55	-30	0	0	-85	-155	-14.8%	892
20,000	1,866	-63	-85	-30	0	0	-115	-178	-9.5%	1,688
25,000	2,685	-87	-85	-30	0	0	-115	-202	-7.5%	2,483
30,000	3,746	-112	-85	-30	0	0	-115	-227	-6.1%	3,519
35,000	5,128	-149	-85	-30	0	0	-115	-264	-5.1%	4,864
40,000	6,429	-187	-85	-30	0	0	-115	-302	-4.7%	6,127
45,000	7,768	-226	-85	-30	0	0	-115	-341	-4.4%	7,427
50,000	9,107	-219	-93	-32	-35	0	-160	-379	-4.2%	8,728
55,000	10,446	-141	-93	-32	-152	0	-277	-418	-4.0%	10,028
60,000	11,810	-62	-93	-32	-272	0	-397	-459	-3.9%	11,351
65,000	13,324	0	-92	-32	-384	0	-508	-508	-3.8%	12,816
75,000	16,456	0	-92	-32	-471	0	-595	-595	-3.6%	15,861
100,000	24,286	0	-92	-32	-689	0	-813	-813	-3.3%	23,473

[1] Includes federal income tax and the goods and services tax (GST) credit. Does not include provincial income tax. The negative value indicates that refundable GST credit received is greater than income tax paid.

[2] The negative value indicates a reduction in net tax paid to the federal government.

[3] Typical singles at incomes of about $7,500 and less receive more in federal refundable credit (GST credit) than they pay in federal income tax. The federal tax reduction indicated in bold therefore represents the increase in the net benefits they receive from the tax and transfer system. Percentage is not meaningful so the dollar amount is repeated.

Annex 1

Spending and Tax Initiatives Since the 1997 Budget

Table A.1
Spending and tax initiatives: 1999 budget

	1998-99	1999-00	2000-01	2001-02
		(millions of dollars)		
Building a Secure Society				
Strengthening Health Care for Canadians				
Canada Health and Social Transfer[1]	3,500		1,000	2,000
Other health care initiatives				
Improving health information systems	95	28	85	120
Promoting health-related research and innovation[2]	160	50	115	225
First Nations health services		20	60	110
Preventive and other health initiatives		49	104	134
Total	255	147	364	589
New partnerships with Aboriginal peoples		49	144	159
Crime prevention	13	95	128	159
Furthering international co-operation	187	55	80	80
Addressing environmental challenges	12	18	17	17
Other				
Equalization – technical improvements		48	97	145
Official languages in education		70	70	70
Parks Canada	35			
Compensation and benefits in the military		175	175	175
Total	4,002	658	2,074	3,393
Building a Strong Economy				
Building on the Canadian Opportunities Strategy				
Creating knowledge				
Canada Foundation for Innovation[2]	100			
Support for advanced research	16	50	55	55
Disseminating knowledge		27	42	27
Commercializing knowledge		121	232	317
Supporting employment		265	265	265
Total	116	463	594	664
Economic adjustment				
Canadian Fisheries Adjustment and Restructuring Program	600	355	116	48
Agriculture Income Disaster Assistance Program	600	285	15	
DEVCO	41	5	21	21
Total	1,241	645	152	69
Total spending initiatives	5,358	1,766	2,820	4,126

Table A.1 *(cont'd)*
Spending and tax initiatives: 1999 budget

	1998-99	1999-00	2000-01	2001-02
		(millions of dollars)		
Targeted and general tax actions				
Building a Secure Society				
Increase in Canada Child Tax Benefit			225	300
General tax relief and fairness measures				
Extension of $500 supplement to all taxpayers		665	1,110	1,290
Increase in tax-free income by $175		270	450	525
Elimination of 3% surtax		595	995	1,150
Tax fairness measures		15	25	100
Reduction in 1999 EI premiums	300	800		
Total	300	2,345	2,580	3,065
Total tax initiatives	300	2,345	2,805	3,365
Total spending and tax initiatives	5,658	4,111	5,625	7,491

[1] The 1998-99 CHST supplement will be paid into a third-party trust in 1999-2000, on passage of authorizing legislation.

[2] An additional $200 million is being allocated to the Canada Foundation for Innovation. It is expected that about half will be used to improve infrastructure for health research.

Table A.2
Spending and tax initiatives: 1998 budget

	1997-98	1998-99	1999-00	2000-01	2001-02
	(millions of dollars)				
The Canadian Opportunities Strategy					
Canada Millennium Scholarship Foundation	2,500				
Canada Study Grants		100	100	100	100
Increased funding for granting councils		120	135	150	150
Canada Student Loans Program		50	145	150	158
Canada Education Savings Grant[1]		325	385	560	735
Connecting Canadians to information and skills	55	60	70	75	75
Supporting youth employment		50	75	100	100
Total	2,555	705	910	1,135	1318
Building a Secure Society					
Increase in CHST cash floor	200	900	1,500	1,500	1400
Other health initiatives					
National AIDS Strategy		41	41	41	41
Canadian Breast Cancer Initiative		7	7	7	7
Sustaining Canada's blood system[1]		55	55	25	25
Hepatitis C[1]	800				
Tobacco Demand Reduction Strategy		10	10	10	10
Total	800	113	113	83	83
Total	1,000	1,013	1,613	1,583	1,483
Support for families					
Increased funding for employability assistance for persons with disabilities		15	20	20	20
New partnership with Aboriginal People	350	126	126	126	126
Promoting Canadian culture and sports	43	103	153	153	153
Strengthening communities		42	67	67	67
Environmental efficiency & innovation		94	94	94	94
Furthering international co-operation	90	70	20	20	20
Total	1,483	1,463	2,093	2,063	1,963
Total spending initiatives	4,038	2,168	3,003	3,198	3,281

Table A.2 *(cont'd)*
Spending and tax initiatives: 1998 budget

	1997-98	1998-99	1999-00	2000-01	2001-02
	(millions of dollars)				
Targeted and general tax actions					
The Canadian Opportunities Strategy					
Credit for interest on student loans		80	130	145	155
Lifelong learning (RRSPs)		15	40	45	50
Part-time education tax credit (includes part-time child care expense deduction)		25	90	90	90
EI premium holiday for youth			100	100	
Total		120	360	380	295
Building a Secure Society					
Deductibility of health/ dental insurance premiums			90	110	125
Caregiver credit		30	120	125	130
Canada Child Tax Benefit			320	750	850
Child care expense deduction		20	45	45	45
Disability measures		5	5	5	5
Alternative Min. Tax & RRSPs		70	20	20	20
Emergency services		5	10	10	10
Total		130	610	1,065	1,185
General tax relief and fairness measures					
Eliminate surtax for taxpayers up to $50,000		710	1175	1,365	1,430
Tax relief for low-income taxpayers		170	270	315	330
Reduction in EI premiums	235	465			
Tax fairness measures		-5	-25	30	35
Total	235	1,340	1,420	1,710	1,795
Total targeted and general tax actions	235	1,590	2,390	3,155	3,275
Total spending and tax actions	4,273	3,758	5,393	6,353	6,556

[1] Revised from February 1998 budget.

Table A.3
Summary of spending and tax actions in 1998 and 1999 budgets

	1997-98	1998-99	1999-00	2000-01	2001-02	Cumulative total
	(millions of dollars)					
Spending initiatives						
Building a Secure Society						
Strengthening Health Care for Canadians						
Canada Health and Social Transfer	200	4,400	1,500	2,500	3,400	12,000
Other health initiatives	800	368	260	447	672	2,546
Other	483	697	991	1,190	1,284	4,645
Total	1,483	5,465	2,751	4,137	5,356	19,191
Building a Strong Economy						
Canadian Opportunities Strategy	2,555	821	1,373	1,729	1,982	8,460
Economic adjustment		1,241	645	152	69	2,107
Total	2,555	2,062	2,018	1,881	2,051	10,567
Total spending initiatives	4,038	7,527	4,769	6,018	7,407	29,758
Targeted and general tax relief						
Canadian Opportunities Strategy		120	360	380	295	1,155
Building a Secure Society		130	610	1,290	1,485	3,515
General tax relief		880	2,975	4,235	4,725	12,815
Tax fairness measures		-5	-10	55	135	175
EI premium reductions	235	765	800			1,800
Total	235	1,890	4,735	5,960	6,640	19,460
Total spending and tax initiatives	4,273	9,417	9,504	11,978	14,047	49,218

Annex 2

The Budgetary Balance, Financial Requirements / Surplus, and the National Accounts Budget Balance

There are three basic measures of the federal government's fiscal position in Canada – two measures based on the Public Accounts (the budgetary balance and financial requirements/surplus) and one based on the System of National Accounts, as prepared by Statistics Canada. Corresponding to each measure are indicators of the debt of the federal government.

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

The fundamental purpose of the Public Accounts is to provide information to Parliament on the government's financial activities as required under the *Financial Administration Act*. The Public Accounts permit parliamentary control of public funds into and out of the Consolidated Revenue Fund. The accounting conventions employed in the Public Accounts are based on generally accepted accounting principles for the public sector (as recommended by the Public Sector Accounting and Auditing Board) and are audited by the Auditor General of Canada.

The financial requirements/surplus, excluding exchange fund transactions, measures the difference between cash payments by the government and cash receipts. Over time it is roughly equivalent to the amount of money that the government has to borrow in credit markets or the amount of market debt that the government is repaying. However, in any one year, changes in the government's cash balance and foreign reserve position can also have an effect on the level of market debt.

- Practically speaking, the main difference between the budgetary balance and the financial requirements/surplus relates to the treatment of federal government employee pension accounts. The budgetary balance includes the total annual pension-related obligations (the government's contribution as an employer for current service costs plus interest on its borrowings from the pension accounts) while the financial requirements/surplus includes only the benefits paid out in that year less employee premiums paid.
- In addition, the budgetary balance includes all other obligations incurred by the federal government during the course of the year, while the financial requirements/surplus only includes the actual cash outlay related to these obligations.

Most industrialized countries present their budgets on a basis that is more comparable to the financial requirements/surplus than to the Public Accounts measure of the budgetary balance. The financial requirements/surplus corresponds closely to the Unified Budget Balance in the United States.

The primary objective of the National Accounts is to measure current economic production and income. The government sector in the National Accounts is treated on the same basis as other sectors of the economy. As such, only tax revenues collected on income generated in the current year are included as revenues, and only spending which relates to economic activity in the current year are included as expenditures. The current National Accounts' treatment of the transactions of federal government employee pension accounts is similar to that in the Public Accounts measure of the financial requirements/surplus.

- National Accounts balances are used for international fiscal comparisons by the Organization for Economic Cooperation and Development and the International Monetary Fund.

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

The budgetary balance (deficit or surplus) is the most comprehensive of the three measures. It includes all financial transactions between the government and outside parties. It also includes liabilities incurred during the year for which no cash payment has been made.

Each of the three measures provides important complementary perspectives on the government's fiscal position. Although the measures differ in their levels, their trends are broadly similar (Chart A2.1 and Table A2.1).

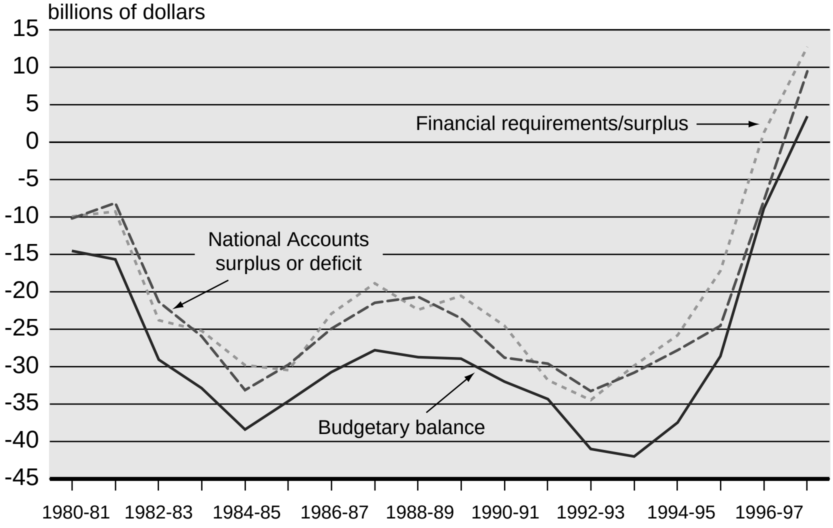
Table A2.1
Alternative measures of the federal balance[1]
1980-81 to 1997-98 (fiscal years)

Year	Budgetary balance		Financial requirements/surplus (excluding foreign exchange transactions)		National Accounts balance	
	(millions of dollars)	(per cent of GDP)	(millions of dollars)	(per cent of GDP)	(millions of dollars)	(per cent of GDP)
1980-81	-14,556	-4.6	-9,917	-3.1	-10,219	-3.2
1981-82	-15,674	-4.3	-9,264	-2.6	-8,168	-2.3
1982-83	-29,049	-7.6	-23,819	-6.3	-21,323	-5.6
1983-84	-32,877	-8.0	-25,219	-6.1	-25,957	-6.3
1984-85	-38,437	-8.6	-29,824	-6.6	-33,128	-7.4
1985-86	-34,595	-7.1	-30,510	-6.3	-29,725	-6.1
1986-87	-30,742	-6.0	-22,918	-4.5	-24,934	-4.9
1987-88	-27,794	-5.0	-18,849	-3.4	-21,511	-3.9
1988-89	-28,773	-4.7	-22,424	-3.7	-20,704	-3.4
1989-90	-28,930	-4.4	-20,530	-3.1	-23,571	-3.6
1990-91	-32,000	-4.7	-24,538	-3.6	-28,801	-4.2
1991-92	-34,357	-5.0	-31,800	-4.7	-29,638	-4.3
1992-93	-41,021	-5.9	-34,497	-4.9	-33,290	-4.8
1993-94	-42,012	-5.8	-29,850	-4.1	-30,804	-4.2
1994-95	-37,462	-4.9	-25,842	-3.4	-27,809	-3.6
1995-96	-28,617	-3.5	-17,183	-2.1	-24,531	-3.0
1996-97	-8,897	-1.1	1,265	0.2	-7,819	-0.9
1997-98	3,478	0.4	12,729	1.5	9,468	1.1

[1] A positive number denotes a surplus; a negative number denotes a deficit.

Chart A2.1

Alternative measures of the federal budget balance



As the deficits or surpluses derived from these three measures are different, so are the measures of debt (Table A2.2).

- The accumulation of annual budgetary deficits and surpluses since Confederation is the net public debt.
- For financial requirements/surplus, the relevant measure is the stock of market debt that the government has outstanding (Table A2.2).
- Another important debt measure in the Public Accounts is interest-bearing debt. This measure includes all interest-bearing liabilities of the Government of Canada. As such, this is the measure that is most appropriate for calculating the average effective interest rate. Interest-bearing debt is larger than market debt because it includes liabilities which have not been issued on markets – notably the government's liabilities to its employee pension accounts. Interest-bearing debt is larger than the net debt because it includes the government's liabilities only, while the net debt is net of financial assets.
- The National Accounts debt represents the government's total liabilities minus its financial assets.

Table A2.2

Alternative measures of the federal debt 1980-81 to 1997-98 (fiscal years)

Year	Net debt		Interest-bearing debt		Market debt		National Accounts debt[1]	
	(millions of dollars)	(per cent of GDP)	(millions of dollars)	(per cent of GDP)	(millions of dollars)	(per cent of GDP)	(millions of dollars)	(per cent of GDP)
1980-81	91,948	29.2	112,418	35.7	83,138	26.4	45,880	14.6
1981-82	107,622	29.9	126,684	35.1	93,167	25.8	51,908	14.4
1982-83	136,671	36.0	154,221	40.6	116,562	30.7	72,293	19.0
1983-84	169,549	41.2	184,849	45.0	142,901	34.8	102,754	25.0
1984-85	207,986	46.3	219,458	48.8	172,719	38.4	130,864	29.1
1985-86	242,581	50.0	253,381	52.2	201,229	41.5	170,428	35.1
1986-87	273,323	53.4	286,034	55.9	228,611	44.7	192,455	37.6
1987-88	301,117	54.0	313,948	56.3	250,809	44.9	211,563	37.9
1988-89	329,890	53.9	345,057	56.4	276,301	45.2	237,174	38.8
1989-90	358,820	54.7	370,104	56.4	294,562	44.9	255,478	38.9
1990-91	390,820	57.6	406,475	59.9	323,903	47.8	281,704	41.5
1991-92	425,177	62.2	440,181	64.4	351,885	51.5	303,335	44.4
1992-93	466,198	66.7	477,034	68.3	382,741	54.8	340,220	48.7
1993-94	508,210	70.1	514,510	71.0	413,975	57.1	380,115	52.4
1994-95	545,672	71.1	550,192	71.7	440,998	57.5	410,141	53.4
1995-96	574,289	71.2	586,387	72.7	469,547	58.2	437,595	54.2
1996-97	583,186	70.3	600,557	72.4	476,852	57.5	445,081	53.7
1997-98	579,708	66.9	594,825	68.7	467,291	53.9	439,685	50.8

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

Annex 3

Fiscal Outlook for the Canadian Government Sector

Introduction

This annex provides a brief overview of the fiscal performance of the federal and provincial-territorial governments. The performance is assessed on a Public Accounts basis according to the evolution of budget balances, debt-to-GDP ratios, debt servicing costs, program spending and operating balances.

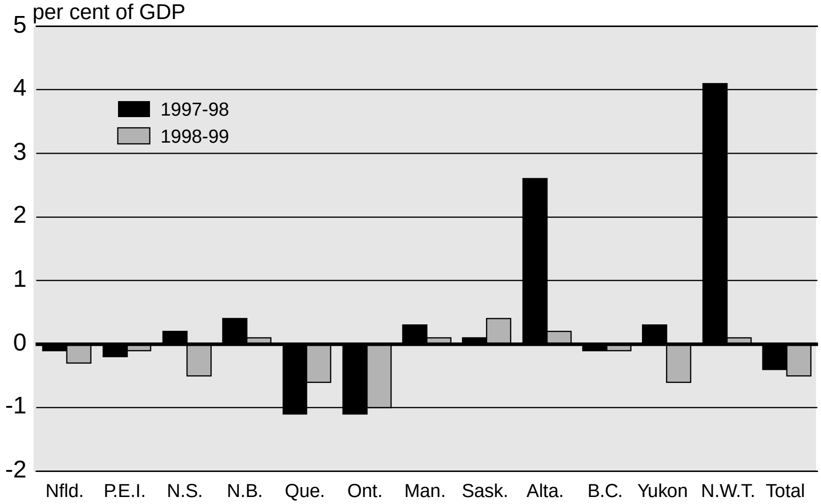
Maintaining Balanced Budgets

Recent years have witnessed a significant restoration of the fiscal health of the total government sector. For example, the total government sector deficit of $66 billion in 1992-93 was completely eliminated by 1997-98, with the federal surplus of $3.5 billion offsetting a deficit of $3.2 billion at the provincial-territorial level.

However, the rate of fiscal improvement is expected to pause in 1998-99. A number of provinces have been adversely affected by the Asian crisis and its contagion effects, which have led to slower economic growth, lower commodity prices, and a weaker Canadian dollar. As a result, a deficit of $4.5 billion is expected in 1998-99 for the provincial-territorial government sector. Five jurisdictions are expected to be in balance or surplus, compared to seven in 1997-98 (Chart A3.1).

Chart A3.1

Provincial-territorial budgetary deficits (-)/surpluses (+)
(Public Accounts basis)

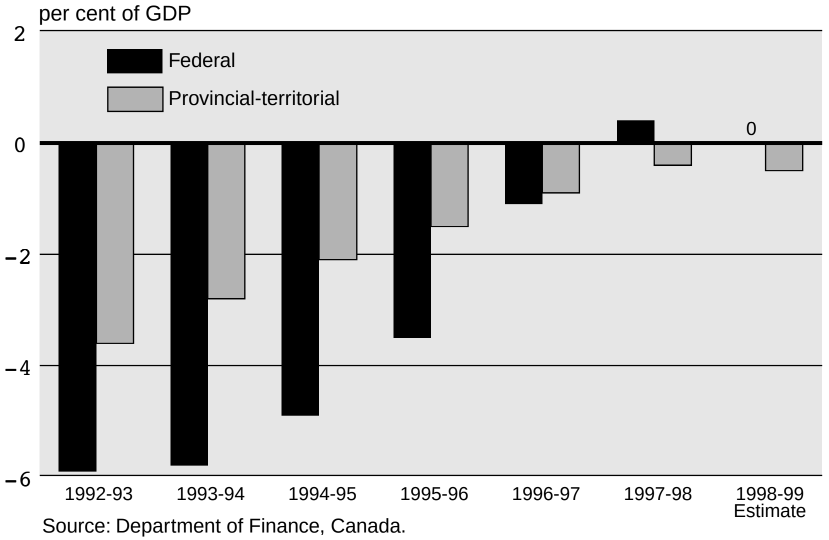


Source: Department of Finance, Canada.

With a balanced budget, or better, expected for the federal government in 1998-99, the total government position is expected to be in a small deficit position in 1998-99 (Chart A3.2).

Chart A3.2

Federal and provincial-territorial budgetary deficits (-)/surpluses (+)
(Public Accounts basis)



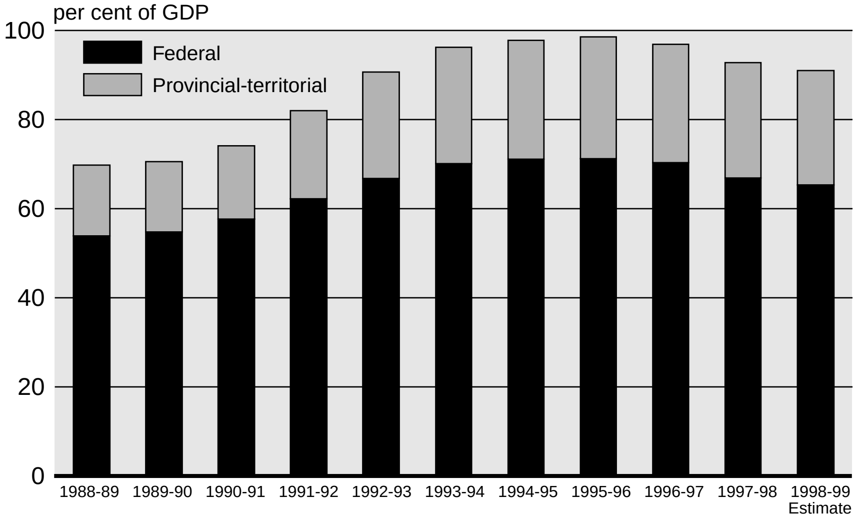
Source: Department of Finance, Canada.

The federal government is committed to balanced budgets or better, for both 1999-2000 and 2000-01. Moreover, all jurisdictions are expected to balance their budgets by 2000-01.

Leading to a Lower Net Debt Burden

After peaking in 1995-96 at 98.5 per cent of GDP, the total government sector net debt-to-GDP ratio is forecast to fall to 91.0 per cent in 1998-99 (Chart A3.3). The improvement in overall fiscal balances, coupled with moderate GDP growth, has enabled both the federal and provincial-territorial sectors to reduce their debt burdens.

Chart A3.3
Federal and provincial-territorial net debt
(Public Accounts basis)



Source: Department of Finance, Canada.

The federal debt burden will decline from its peak of 71.2 per cent of GDP in 1995-96 to about 65.5 per cent of GDP in 1998-99.

The provincial-territorial debt burden has also fallen during this period. However, the pace of decline will slow in 1998-99. The total net debt burden of the provinces and territories is expected to decrease marginally in 1998-99, to 25.7 per cent of GDP, and to continue its decline in the medium term. Similar to the federal Debt Repayment Plan, several provincial jurisdictions have debt reduction plans, some of which are legislated.

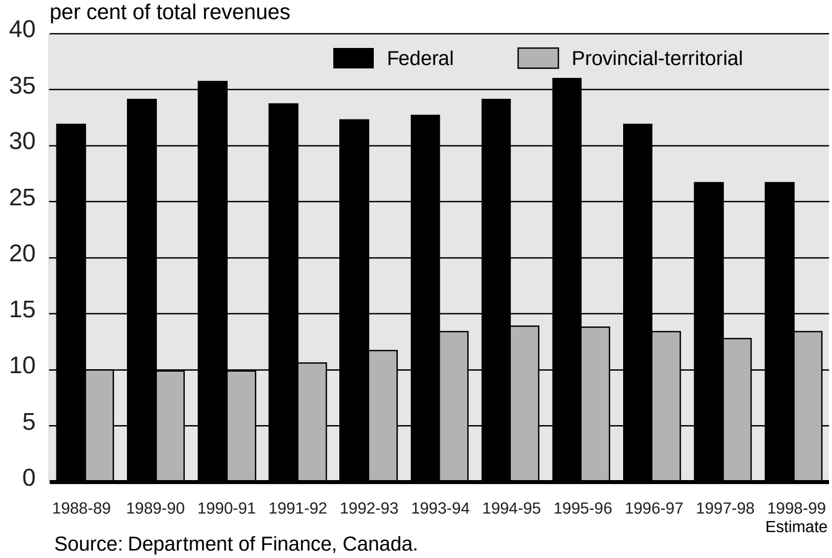
Lowering Interest Charges as a Share of Revenues

Largely as a result of deficit elimination, federal debt charges declined from 36 per cent of revenues in 1995-96 to about 27 per cent in 1998-99. The debt charges burden of the provincial-territorial sector declined marginally during this period, from 13.8 per cent of revenues in 1995-96 to 13.4 per cent in 1998-99 (Chart A3.4).

Chart A3.4

Federal and provincial-territorial debt charges

(Public Accounts basis)

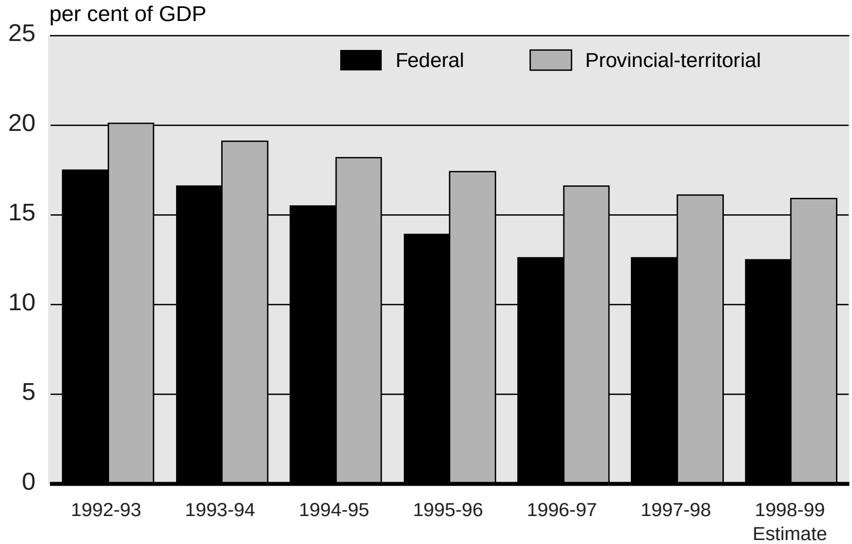


Source: Department of Finance, Canada.

Program Spending Relative to the Size of the Economy Continues to Decline

Although new spending initiatives have been announced, total government program spending as a percentage of GDP will continue to decline in 1998-99. Federal program spending will fall to 12.6 per cent of GDP in 1998-99, from a peak of 17.5 per cent in 1992-93. Likewise, provincial-territorial program spending is expected to decrease from 20.1 per cent of GDP in 1992-93 to 16.0 per cent for 1998-99 (Chart A3.5).

Chart A3.5
Federal and provincial-territorial program spending
(Public Accounts basis)



Source: Department of Finance, Canada.

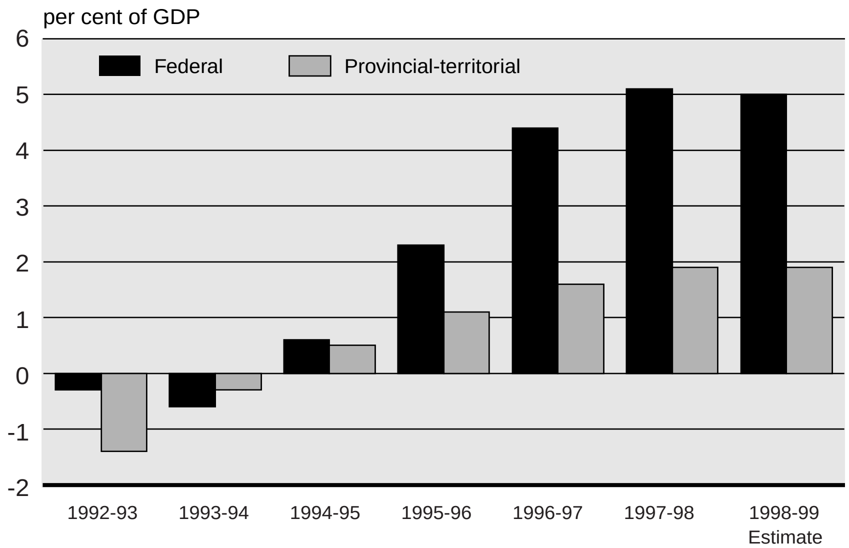
Growing Operating Surpluses

Fiscal consolidation strategies pushed operating balances, defined as the difference between total budgetary revenues and program spending, from a deficit to a significant surplus position. The federal government's operating balance evolved from a deficit of 0.3 per cent of GDP in 1992-93 to a surplus of 5.1 per cent in 1997-98. Over the same period, the provincial-territorial operating balance improved from a deficit of 1.4 per cent of GDP to a surplus of 1.9 per cent. At the combined federal and provincial-territorial government level, the improvement in operating balances was primarily achieved through expenditure reductions.

As shown in Chart A3.6, the federal operating surplus will remain at approximately 5 per cent of GDP in 1998-99, while the provincial-territorial operating surplus is forecast to remain at slightly under 2 per cent of GDP.

Chart A3.6

Federal and provincial-territorial operating balances
(Public Accounts basis)



Source: Department of Finance, Canada.

Annex 4

Canada's Financial Progress in an International Context

Introduction and Overview

This appendix compares Canada's financial position with that of the other Group of Seven (G-7) countries.

Two factors tend to complicate international financial comparisons. First, differences in accounting practices between countries reduce the comparability of the data. Second, financial responsibilities are distributed differently among the various levels of government in each country. That is why System of National Accounts definitions and data, which are fairly uniform among countries, are used for the government sector when making fiscal comparisons. The Organization for Economic Co-operation and Development (OECD) produces a complete series of comparable estimates based on the System of National Accounts. The data presented here are based on OECD's December 1998 projections, and as such, do not include the policy initiatives announced in this budget.

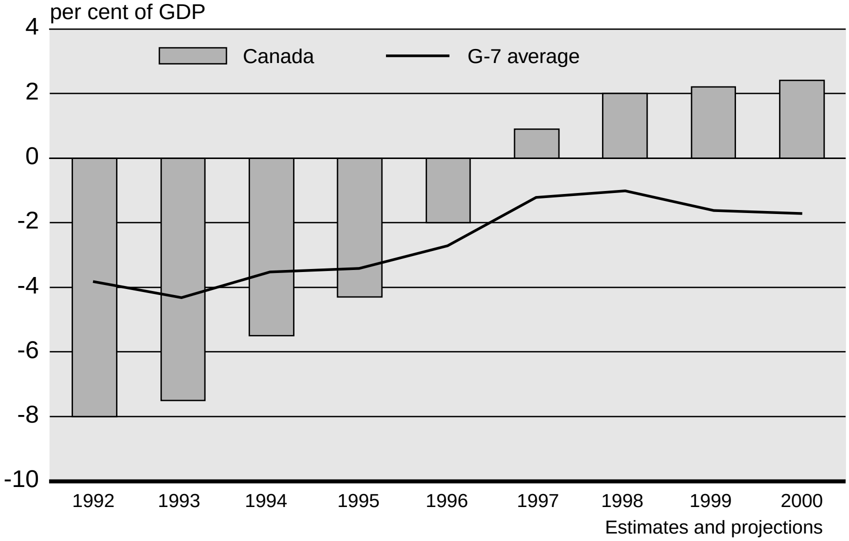
Increase in Canada’s Budget Surpluses

In the wake of the recession early this decade, Canadian governments’ total deficit (on a National Accounts basis, it includes federal, provincial and local governments, and the balances in the Canada and Quebec Pension Plans) reached a high of 8 per cent of GDP in 1992, compared to the G-7 average deficit-to-GDP ratio of 3.8 per cent that same year.

However, deficit reduction efforts by all levels of government resulted in a budget surplus in Canada in 1997. Canada’s budgetary improvement over the 1992-97 period surpassed all other G-7 countries. The deficit-to-GDP ratio in the G-7 countries averaged 1 per cent in 1998 (Chart A4.1) compared to a surplus of 2 per cent in Canada.

Chart A4.1

Total government deficit(-)/surplus(+)
(National Accounts basis)

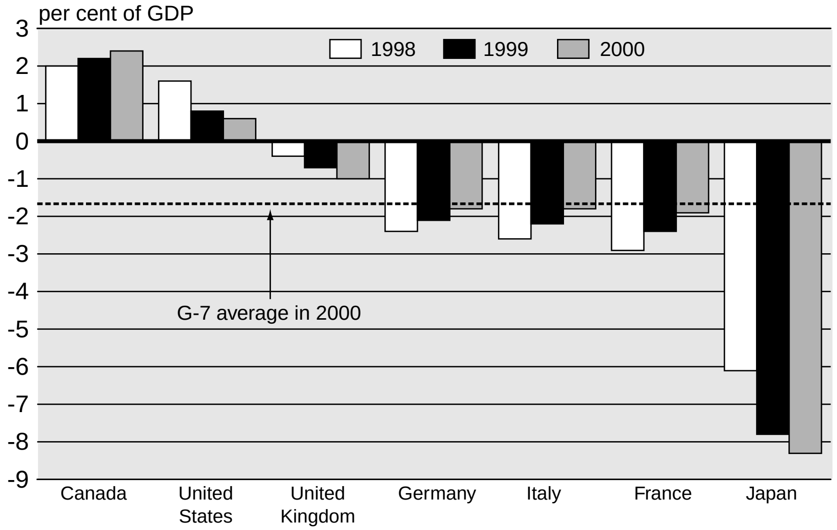


Source: *OECD Economic Outlook,* December 1998.

According to the OECD, Canada's budget surpluses are expected to grow steadily in the years to come if no new tax or spending initiatives are undertaken. Canada is expected to continue to outperform every other G-7 country (Chart A4.2). Among the G-7 countries, the U.S. is the only other country expected to report a budget surplus in 1999 and 2000.

Chart A4.2

Total government deficit(-)/surplus(+) in G-7 countries
(National Accounts basis)



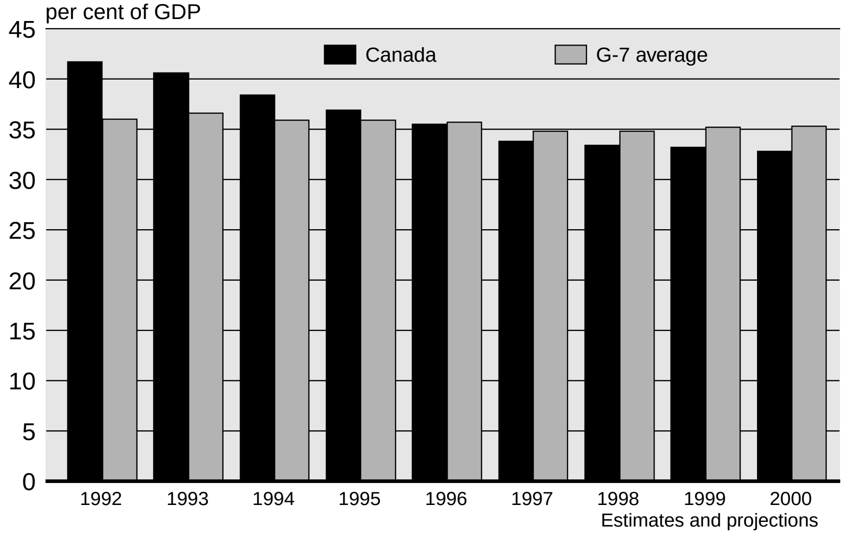
Source: *OECD Economic Outlook,* December 1998.

A More Rapid Decline in Program Spending

Sharp cuts in program spending have enabled Canada to quickly put its fiscal house in order. Between 1992 and 1997, Canada had the largest reduction in program spending of any G-7 country as a share of GDP: program spending dropped 7.9 percentage points, compared to an average of 1.2 points for the G-7 countries. In relation to the size of the economy, Canada's program spending is now below the G-7 average, a trend that is expected to continue (Chart A4.3).

Chart A4.3

Total government program spending
(National Accounts basis)

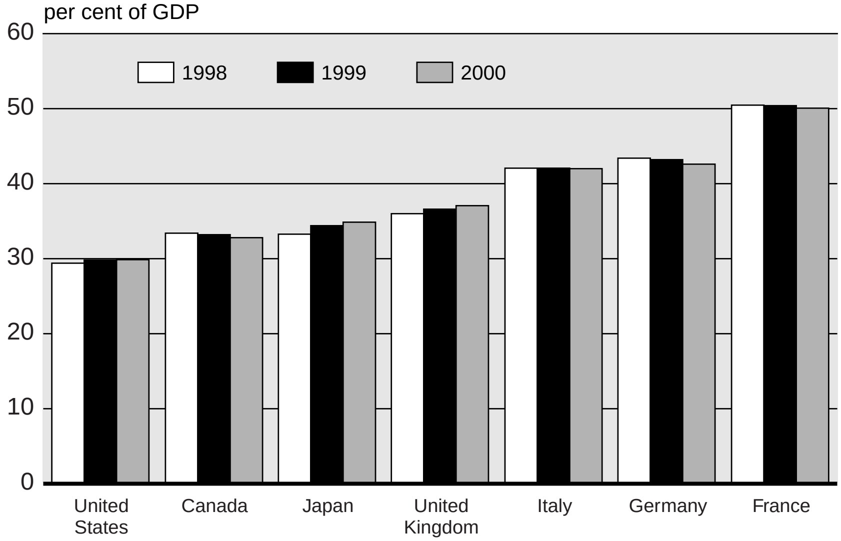


Source: *OECD Economic Outlook,* December 1998.

In 1999 and 2000, the ratio of program spending to GDP will place Canada second lowest among the G-7 countries, above only the United States (Chart A4.4).

Chart A4.4

Total government program spending in G-7 countries
(National Accounts basis)



Source: *OECD Economic Outlook*, December 1998.

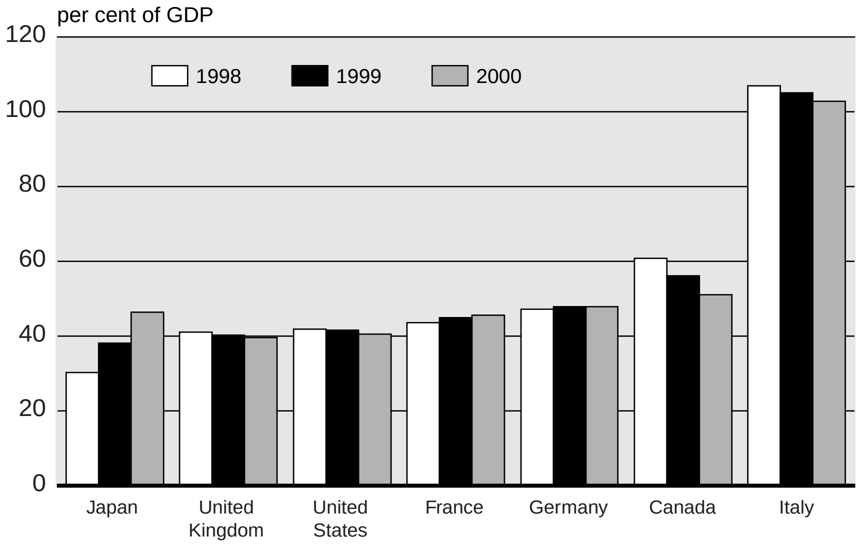
Rapid Decline in Canada's Net Debt-to-GDP Ratio

Canada's debt-to-GDP ratio remains high, both in an international and an historical context. Reducing the debt-to-GDP ratio must remain a key objective of the government's fiscal policy.

Indeed, the debt-to-GDP ratio is now on a sustainable downward track. The OECD projects that Canada's debt-to-GDP ratio will decline almost 10 percentage points between 1998 and 2000, the sharpest decline among the G-7 countries (Chart A4.5). This will reduce the gap between Canada's net debt-to-GDP ratio and the G-7 average from about 20 percentage points in 1997 to just over 3 percentage points in 2000.

Chart A4.5

Total government net debt in G-7 countries
(National Accounts basis)



Source: *OECD Economic Outlook,* December 1998.

Annex 5

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 GDP and interest rates. The following sensitivity estimates capture the direct fiscal impacts of changes in these variables. These are partial calculations that capture the impact of the changes one economic variable at a time. 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.

Sensitivity to changes in nominal income

A 1-per-cent increase in the level of nominal GDP leads to higher tax bases and thus higher revenues. In turn, the higher revenues result in a lower stock of interest-bearing debt, thereby lowering debt servicing costs.

The ultimate budgetary impact would depend on the source of the increase in nominal income. The most favourable impact on the fiscal situation would occur if all of the increase in nominal GDP resulted from increased real output. Revenues would be higher, while interest rates would be relatively stable.

If, however, the improvement in nominal GDP were solely due to inflation, then higher spending on those programs indexed to inflation would offset some of the positive impact of government revenues. Higher inflation would also likely raise interest rates, which would result in higher debt servicing costs.

Assuming the increase in nominal income comes solely from an increase in output, with no net impact on the employment insurance (EI) program (premium rates would be lowered to offset the impact of lower benefits), the budgetary balance would improve by $1.5 billion in the first year, rising to $1.8 billion after four years (Table A5.1). The fiscal impact of a change in nominal income is somewhat larger than that presented in last year's budget, reflecting the increase in the level of nominal income since that time.

Table A5.1
Fiscal sensitivity analysis: 1-per-cent increase in nominal income

	Estimated changes in fiscal position			
	Year 1	Year 2	Year 3	Year 4
	($ billions)			
Budgetary transactions				
Revenue increases	1.4	1.4	1.5	1.6
Expenditure reductions	0.1	0.1	0.2	0.2
Deficit reduction	1.5	1.5	1.7	1.8

For a 1-per-cent decline in nominal income, the adverse impact on the budgetary balance is somewhat larger. Assuming that EI premium rates would not be increased, a decline in nominal income growth would result in an increase in the number of unemployed, higher EI benefit payments and lower EI premium revenues. As a result, the fiscal balance would deteriorate by an additional $0.6 billion per year.

Sensitivity to changes in interest rates

Changes in market interest rates, all other things remaining equal, result in changes in public debt charges and revenues from interest-bearing assets. The ultimate budgetary impact will depend on the magnitude of the change in market rates, the composition of the debt stock and the amount of interest-bearing assets.

A sustained 100-basis-point increase in all interest rates would cause the budgetary balance to deteriorate by $0.9 billion in the first year (Table A5.2). As longer-term debt matures and is refinanced at the higher interest rates, the negative impact on the budgetary balance goes up, reaching $2.3 billion by year four.

Table A5.2
Fiscal sensitivity analysis: 100-basis-point increase in interest rates

	Estimated changes in fiscal position			
	Year 1	Year 2	Year 3	Year 4
	($ billions)			
Budgetary transactions				
Revenue increases	0.3	0.3	0.4	0.4
Expenditure increases	1.2	1.9	2.3	2.7
Deficit reduction	0.9	1.6	1.9	2.3

These estimates are somewhat lower than those presented in the 1998 budget. This is partly due to the fact that the stock of interest bearing debt is now estimated to be lower than at the time of the 1998 budget. In addition, the lower estimates reflect a slight increase in the proportion of fixed-rate debt (i.e. debt with an effective term of greater than twelve months) to about two-thirds, compared to 65 per cent at the time of the 1998 budget.

Annex 6

The Government's Response to the Auditor General's Observations on the 1998 Financial Statements

The 1998 *Public Accounts of Canada* contains the Auditor General's opinion of the government's financial statements for 1997-98. As well, the Auditor General raises a number of accounting issues in his "Observations" on the government's financial statements. These are:

- the use of foundations as vehicles through which the government carries out its objectives;
- recorded and contingent liabilities for Aboriginal claims;
- accounting for environmental liabilities and contingencies;
- accounting for enterprise Crown corporations; and
- the Financial Information Strategy: the move to full accrual accounting.

The government's response to the Auditor General's opinion and observations on the 1998 financial statements are discussed in this annex. This annex also reviews a recommendation of the Auditor General, still outstanding from the 1996-97 Public Accounts, for a review of the need and usefulness of the Debt Servicing and Reduction Account.

Audited opinion of the government's financial statements

After having expressed a clean opinion on the government's financial statements for five consecutive years, spanning 1991-92 to 1995-96, in the past two years the Auditor General has expressed a qualified opinion. For both 1996-97 and 1997-98, the Auditor General claims that the financial statements overstated expenditures.

With respect to the 1996-97 financial statements, the Auditor General argued that the federal deficit was overstated by $800 million, relating to the recording of a transaction to the Canada Foundation for Innovation. For the 1997-98 financial statements, he claimed that the surplus is understated by $2.5 billion, due to the government's recording of the liability related to the Canada Millennium Scholarship Foundation.

With reference to the 1997-98 financial results, the Auditor General claimed that since legislation establishing the Canada Millennium Scholarship Foundation did not receive Royal Assent until June 18, 1998 and the funding agreement was not signed until July 3, 1998, the government should not have recorded the liability in 1997-98.

The government disagrees with this interpretation. It believes its decisions to provide funding to arm's-length organizations such as the Canada Millennium Scholarship Foundation establish liabilities that should be recorded in the year in which the decisions are made. Furthermore, transparency and accountability to Parliament and Canadians are enhanced by recording liabilities in the year in which they are incurred. This is good public policy. The government has been consistent in this practice over the last years and will continue to be so in the future. As such, non-recurring liabilities will continue to be recognized in the year in which the decision to incur the expenditures is made, provided the enabling legislation or authorization for payment receives Parliamentary approval before the financial statements for that year are finalized.

A commitment was made in the 1998 budget to provide funding of $2.5 billion, and legislation establishing the Canada Millennium Scholarship Foundation received Royal Assent well before the financial statements for 1997-98 were completed. Therefore, consistent with the government's accounting policy, the liability was recorded in 1997-98.

Although the Auditor General notes that the recording of the liability is consistent with the government's stated accounting policy, he not only disagrees with the policy, but also claims that the government "changed its stated accounting policies so that the recording of the transaction does comply." However, the government's policy for such transfers has been consistently applied over the last three years. The accounting treatment for the Harmonized Sales Tax adjustment payments in 1995-96, the Canada Foundation for Innovation in 1996-97 and the Canada Millennium Scholarship Foundation in 1997-98 are all consistent with this policy.

Substance of the foundations

In his observations on the financial statements of the Government of Canada, the Auditor General raised a number of matters which, in his view, require continued attention. One of these concerns relates to the use of independent foundation-type entities to deliver government programs. Current standards issued by the Public Sector Accounting and Auditing Board (PSAAB) state that such independent agencies should not be consolidated with the government for financial reporting purposes. Nevertheless, the Auditor General questions whether these entities are, in substance, part of government. Accordingly, he recommends that the government, in consultation with other governments in Canada, their auditors and the PSAAB, consider whether objective accounting standards should be revised to address this new situation.

Both the Canada Foundation for Innovation and the Canada Millennium Scholarship Foundation were established as arm's-length organizations for sound public policy reasons. As arm's-length organizations, these foundations operate outside the influence of political considerations and can attract funding from the private sector to pursue their objectives. The government is committed to ensuring that these foundations operate at arm's-length, without government interference. As such, the government believes the financial affairs of these entities should not be consolidated with those of the government.

Accounting for contingent liabilities for Aboriginal claims

The Auditor General has also expressed concern that the government is not yet capable of providing in its financial statements a full and fair accounting and disclosure of Aboriginal claims. Specifically, the Auditor General recommends that:

> *"the government needs to develop an appropriate accounting policy that fully addresses both the quantification of contingent liabilities for Aboriginal claims and the point in time at which they should be recognized in the financial statements as actual liabilities. In order to do this, the government's systems and processes that are used to monitor and provide management information on Aboriginal claims need to be improved on a priority basis."*

The government shares the concerns of the Auditor General in this area. It is currently examining its accounting policies for Aboriginal claims, both with respect to the quantification of contingent liabilities and the point in time at which such liabilities should be recognized in the financial statements as actual liabilities. In addition, the government is taking the steps required to improve its systems and processes for monitoring information on Aboriginal claims.

Accounting for environmental costs and liabilities

The Auditor General has recommended that the government finalize its accounting policy with respect to environmental liabilities and that it provide departments with detailed instructions so that the policy can be fully implemented in 1998-99.

The draft accounting policy will be finalized shortly, and the government is committed to developing a complete estimate of its liabilities from applicable departments consistent with that policy. Environmental liabilities will be included in the financial statements once the implications of such an accounting change have been fully assessed. The government will work closely with the Office of the Auditor General to ensure that all concerns are adequately addressed.

Enterprise Crown corporations

The Auditor General recommends that the government accept the PSAAB recommendation and report the modified equity value of enterprise corporations in its financial statements. The government currently reports investments on a cost basis with adjustments to the allowance, when applicable. The two methods yield similar results on an annual basis. However, the government only began using this method of accounting in 1992-93 and did not make any prior-year adjustments. As a result, the Auditor General claims that the net debt is $4.2 billion higher than it would otherwise be. As announced in the 1998 budget, the government will change its accounting for enterprise Crown corporations when other accounting changes are implemented.

The Financial Information Strategy (FIS): the move to full accrual accounting

Currently, the government records most of its expenditures and non-tax revenues on an accrual basis of accounting. In contrast, tax revenues and capital assets are recorded on a cash basis of accounting. The government has indicated its intention to move to full accrual accounting in previous budgets and the Auditor General has supported this move but cautions that such changes represent significant challenges.

The Auditor also raised this issue in his September 1998 Report, Chapter 18, "The Financial Information System: A Key Ingredient in Getting Government Right." He notes that FIS is critical to the government's continuing ability to produce Public Accounts and his ability to audit them. He plans to devote sufficient resources to monitor this project carefully.

The government recognizes the challenges that adopting full accrual accounting will present. To that end, it will continue to work closely with the Office of the Auditor General to implement full accrual accounting in an appropriate manner.

Debt Servicing and Reduction Account

In his observations on the 1996-97 financial statements, the Auditor General recommended that the government re-examine the need and usefulness of the Debt Servicing and Reduction Account (DSRA). He raised this again in his opening statement to the House of Commons Standing Committee on Finance in July 1998.

The DSRA was established by statute in June 1991. Under that legislation, all goods and services tax (GST) revenues, net of applicable input tax credits, rebates and the low-income credit, along with the net proceeds from the sale of Crown corporations and gifts to the Crown explicitly identified for debt reduction, must be deposited into this Account. The funds in this Account are earmarked to pay interest on the public debt and ultimately to reduce the debt. In 1997-98, net revenues, primarily from the GST, amounted to $19.6 billion.

In contrast, public debt expenditures chargeable to the Account were nearly twice this amount. It will be some time before these revenues match the public debt expenditures chargeable to the Account.

The Auditor General notes that, "given the fundamental concept of the Consolidated Revenue Fund (CRF) underlying the government's accounting system, the Account is an internal mechanism that may not be necessary." All revenues received by the government must be deposited in the CRF and any disbursements from the CRF must be authorized by Parliament. Therefore, the specific revenues of the DSRA must be deposited in the CRF and the public debt expenditures chargeable to the Account must be appropriated from the CRF by Parliament. As all of the information relating to the DSRA is already reported in other parts of the government's financial statements, there is no requirement for a separate financial statement.

The government has asked the Finance Committee to review this recommendation and is awaiting its response.

Annex 7

Tax Measures: Supplementary Information and Notices of Ways and Means Motions

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Tax Measures: Supplementary Information

Overview

The 1998 budget provided a $500 supplement to the basic personal, spousal, and equivalent-to-spouse amounts for low-income Canadians. The 1998 budget also eliminated the 3-per-cent general surtax for many taxpayers and reduced it for some others.

This budget proposes to expand on this general tax relief by: extending to all taxpayers the tax relief provided by the $500 supplements to the personal credit amounts; further increasing these amounts by $175 for all taxpayers; and eliminating the 3-per-cent surtax for all remaining taxpayers. These measures will come into effect on July 1, 1999.

The budget proposes a $300-million increase in the Canada Child Tax Benefit (CCTB) for children in modest- and middle-income families. This is in addition to the $1.7-billion increase in the CCTB provided to low-income Canadians in the 1997 and 1998 budgets.

The budget also proposes a number of measures designed to enhance the fairness of the Canadian tax system and to achieve social and economic objectives. The appendix to this annex provides a summary table of these measures and those announced in the five previous budgets.

Table A7.1
Federal revenue impact of new measures

	1999-00	2000-01	2001-02
	(millions of dollars)		
General tax relief and Canada Child Tax Benefits (CCTB)			
Extension of $500 supplement to all taxpayers	-665	-1,110	-1,290
$175 increase in tax-free income	-270	-450	-525
Elimination of the 3-per-cent surtax for all taxpayers	-595	-995	-1,150
Increase to CCTB for middle-income families	–	-225	-300
Tax fairness measures			
Income splitting with minor children	–[1]	–	–
Non-resident trust and foreign-based investment fund rules	–	–	–
The goods and services tax credit	-20	-20	-20
Retroactive lump-sum payments	–	-10	-10
Communal organizations	–	–	–
Civil penalties for misrepresentations of tax matters by third parties	–	–	–
RRSP/RRIF proceeds on death	–	–	–
Medical expense tax credit (METC) – persons with disabilities	-10	-15	-20
First Nations taxation	–	–	–
Temporary capital tax surcharge on large deposit-taking Institutions	25	50	–
M&P tax rate reduction extended to electricity generating sector	-10	-30	-50
Offsetting of interest on corporate tax overpayments and underpayments	–	–	–
Non-resident investment funds that engage Canadian service providers	–	–	–
Capital cost allowance (CCA) for the productive use of flare gas	–	–	–
Tobacco contraband	–	–	–
Tax administration	–	–	–
Labour-sponsored venture capital corporations (LSVCCs)	–	–	–
Total tax measures	-1,545	-2,805	-3,365

[1] Small, non-existent or prevents revenue loss.

Personal Income Tax Measures and the Canada Child Tax Benefit

General income tax relief

The budget proposes three measures that provide general tax relief to Canadians:

- an extension to all taxpayers of the $500 supplements provided to low-income Canadians in the 1998 budget;
- a further increase in the personal amounts of $175 for all taxpayers; and
- the elimination of the 3-per-cent surtax for all those taxpayers whose surtax remained following action in the 1998 budget.

These measures will come into effect on July 1, 1999.

Increasing the amount of income that Canadians can receive tax-free

The income tax system currently provides a basic personal credit and spousal and equivalent-to-spouse ("spousal") credits to allow individuals and families to receive a basic amount of income on a tax-free basis. The amount used to establish the basic personal credit is $6,456 while the spousal credit amount is $5,380. The spousal credit amount is reduced on a dollar-for-dollar basis by income in excess of $538 of the dependant individual in respect of whom the credit is claimed. The federal credits are established at 17 per cent of these amounts.

Extending the $500 supplement

The 1998 budget provided a $500 supplement for low-income Canadians to each of the amounts used to determine basic personal and spousal tax credits. These supplementary amounts are phased out at a rate of 4 per cent of income in excess of $6,956. This budget extends to all taxpayers the tax relief provided by the $500 supplementary amounts by increasing the personal credit amounts by $500 and eliminating the supplements. The effect of applying this change as of July 1, 1999 is that, for 1999, most taxpayers will be entitled to one-half of the supplement that would be determined under the 1998 budget rules for 1999, plus $250. The proportionate benefit of this measure is the largest for those in the income range of about $8,000 to $20,000 in the case of single taxpayers.

Increasing the basic amounts by $175 for all taxpayers

This budget also proposes to increase these personal amounts by a further $175 effective July 1, 1999. Applying this change as of July 1, 1999 means that taxpayers will be entitled to one-half of the amount (rounded up to $88) for the 1999 tax year.

Once the two measures are fully implemented, all taxpayers will benefit from a basic personal amount of $7,131 – $675 higher than in 1997. The maximum amount for the spousal credit will also be increased by $675 to $6,055. The threshold at which the spousal credit amount begins to be reduced on a dollar-for-dollar basis by the income of the dependant will be increased from $538 to $606.

Eliminating the 3-per-cent surtax for all taxpayers

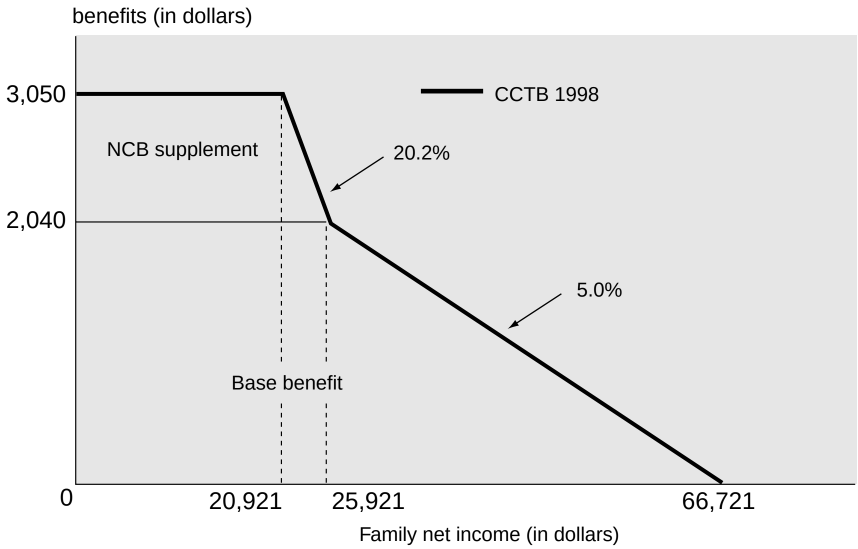
The general (3-per-cent) surtax was introduced in the 1986 budget. All taxpayers were liable for the surtax. The 1998 budget eliminated this surtax for those with incomes under $50,000 and reduced it for those in the $50,000 to $65,000 income range. This budget eliminates the 3-per-cent surtax completely, effective July 1, 1999. For 1999, a taxpayer will benefit from a surtax reduction by an amount equal to one and one-half per cent of federal tax plus one-half of the surtax reduction for which he or she was eligible as proposed in the 1998 budget.

In combination, the 1998 and 1999 budget measures remove 600,000 Canadians from the tax rolls and provide tax reductions to all 15.7 million Canadian taxpayers. While these measures benefit all taxpayers, the greatest proportional benefits accrue to those with low incomes. For example, a typical single filer with $15,000 in employment income will pay 15 per cent less federal tax as a result of the general tax relief provided in the 1998 and 1999 budgets while a similar individual earning $30,000 will pay 6 per cent less tax. Typical families earning less than $30,000 will pay no net federal tax. A typical family with income of $30,000 has its federal income tax reduced by 110 per cent – that is, it becomes a net recipient of federal benefits as a result of the 1998 and 1999 budget actions. A typical family earning $40,000 will enjoy a 15 per cent reduction in federal income tax.

Canada Child Tax Benefit (CCTB)

The Canada Child Tax Benefit (CCTB) currently provides close to $6 billion in annual assistance to 3.2 million families with children. It includes two key components: the base benefit and the National Child Benefit supplement (NCB supplement). As shown in Chart A7.1, the full amount of the NCB supplement is provided to families with

Chart A7.1
CCTB
Family with two children – July 1998



incomes up to $20,921 while the maximum amount of the base benefit is provided to families with incomes up to $25,921. Beyond these thresholds the benefits are gradually phased out.

The National Child Benefit system

The NCB supplement to the CCTB is the instrument through which the federal government delivers its contribution to the National Child Benefit system. The National Child Benefit (NCB) is a federal, provincial and territorial initiative designed to combat child poverty by helping to protect benefits for low-income parents who enter and stay in the workforce. Under the previous set of uncoordinated welfare and federal child benefits, parents could face a significant drop in benefits when deciding to accept a job and leave welfare.

In the 1997 budget, the federal government committed $850 million to create a simplified and enriched CCTB. As a first step, the Working Income Supplement (WIS) was enriched and restructured in July 1997. The maximum amount provided under the WIS was increased from $500 per family to $605 for the first child, $405 for the second child and $330 for each subsequent child. In July 1998, the WIS was replaced by the NCB supplement. The NCB supplement provided the same maximum benefit as the WIS but was not limited to low-income families with earnings. It is phased out based on family net income in excess of $20,921. The phase-out rates are 12.1 per cent for a one-child family, 20.2 per cent for a two-child family and 26.8 per cent for larger families.

Under the NCB, low-income families also receive increased assistance from provinces and territories. As part of the NCB, these governments agreed to adjust their welfare programs by the amount of the NCB supplement increase and to reinvest the savings in programs and services better targeted at low-income families with children. Provinces and territories have reinvested in a wide range of programs including child care, health benefits, early childhood services and income support.

In the 1998 budget, the federal government announced an additional annual contribution of $850 million to the NCB to be phased in over the years 1999 and 2000. Last year's budget indicated that the details of these enrichments would be announced following discussions with the provinces and territories.

After discussion, the provinces and territories have generally endorsed the following design:

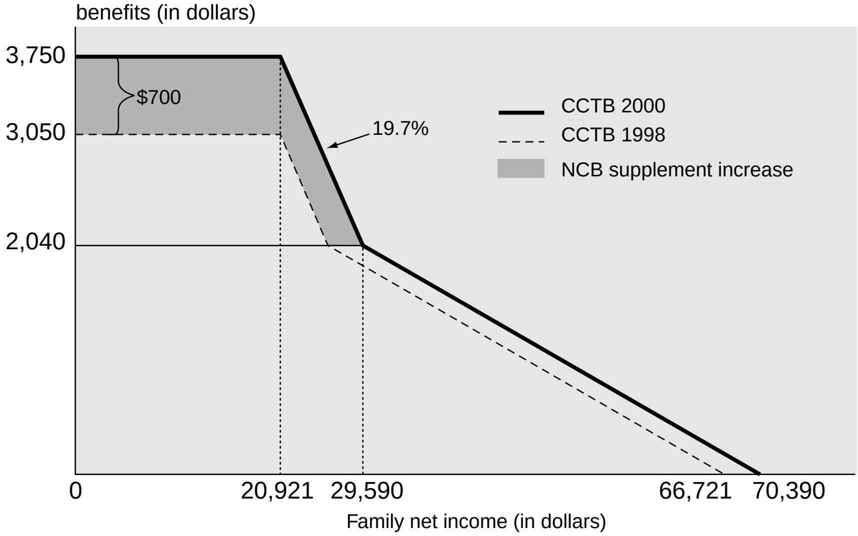
- Effective July 1999, the maximum NCB supplement will increase by $180 per child to reach $785 for the first child, $585 for the second child and $510 for each subsequent child. The income level at which the NCB supplement is fully phased out will be increased from $25,921 to $27,750. This will allow the increased benefits to be reduced more gradually over a wider income range. The phase-out rates will be 11.5 per cent for a one-child family, 20.1 per cent for a two-child family and 27.5 per cent for larger families.
- Effective July 2000, the NCB supplement will increase by an additional $170 per child to reach $955 for the first child, $755 for the second child and $680 for each subsequent child. The threshold at which the NCB supplement is fully phased out will be increased from $27,750 to $29,590. The phase-out rates will be 11.0 per cent for a one-child family, 19.7 per cent for a two-child family and 27.6 per cent for larger families.

As of July 2000, the maximum CCTB benefits will be $1,975 for the first child and $1,775 for each subsequent child. As shown in Chart A7.2, the maximum annual benefit for a two-child family will be $3,750, an increase of $700 since July 1998. This maximum benefit of $3,750 represents an increase of 48 per cent over the maximum benefit of $2,540 in 1996.

Chart A7.2

NCB supplement

Family with two children – July 2000



The proposed enrichment of the NCB supplement will provide increased federal benefits to 1.4 million families with 2.5 million children. It will also provide scope for significant targeted reinvestments by provinces and territories in programs for low-income families. By the year 2000, the $1.7 billion federal investment in the NCB supplement and the additional support provided by provinces and territories will have significantly reduced barriers for parents of low-income families entering the work force.

The budget also proposes to amend the *Children's Special Allowances Act* to provide benefit increases of $180 per child in July 1999 and an additional $170 per child in July 2000 to provincial agencies for children in care.

Enhancement to the base benefit under the CCTB

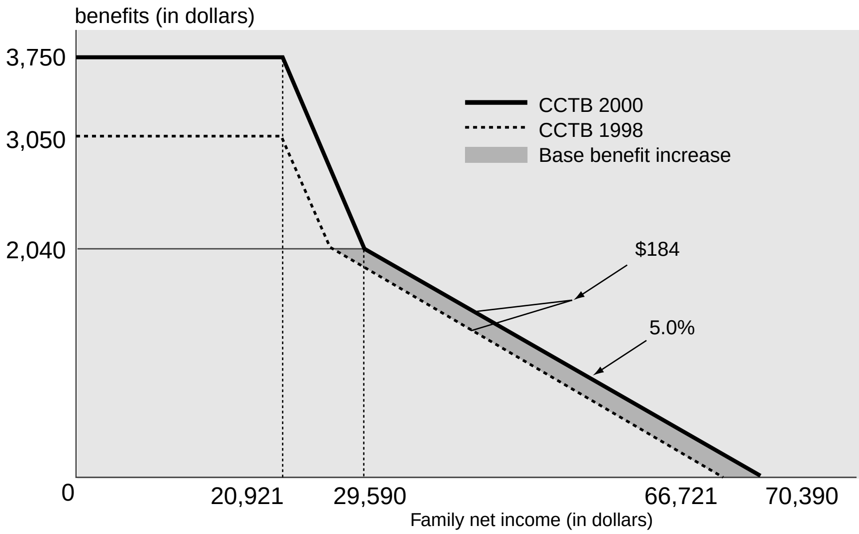
The base benefit currently includes a basic amount of up to $1,020 per child, a supplement of $75 for the third and each subsequent child, and an additional supplement of $213 for each child under age seven for whom no child care expenses are claimed. The base benefit is reduced by 5 per cent of family net income in excess of $25,921 (2.5 per cent for one-child families).

The budget proposes to enrich annual payments under the base benefit of the CCTB by $300 million starting in July 2000. As shown in Chart A7.3, this will be achieved by increasing the income threshold at which the base CCTB begins to be phased out to $29,590 from its current level of $25,921. This measure will provide increased child benefits to 2 million families with incomes over $25,921. A typical two-child family with family income of $50,000 will receive $1,020 in CCTB benefits, compared to $836 in 1998, an increase of $184 for that family.

Chart A7.3

Base benefit

Family with two children – July 2000



The following table summarizes the key changes to the CCTB in the 1997, 1998 and 1999 budgets.

SUMMARY OF CHANGES TO THE CANADA CHILD TAX BENEFIT

1997 budget

July 1997 The Working Income Supplement (WIS) was enriched and restructured. The maximum WIS increased from $500 per family to $605 for the first child, $405 for the second child and $330 for each subsequent child.

$195-million increase in annual benefits

July 1998 The National Child Benefit supplement (NCB supplement) replaced the WIS. The maximum NCB supplement was fixed at $605 for the first child, $405 for the second child and $330 for each subsequent child.

$655-million increase in annual benefits

1998 budget

July 1999 The NCB supplement will increase by $180 per child, to reach $785 for the first child, $585 for the second child and $510 for each subsequent child. The threshold at which the NCB supplement is fully phased out will be extended to $27,750 from $25,921.

$425-million increase in annual benefits

July 2000 The NCB supplement will increase by $170 per child, to reach $955 for the first child, $755 for the second child and $680 for each subsequent child. The threshold at which the NCB supplement is fully phased out will be extended to $29,590 from $27,750. This enrichment will provide increased benefits to 1.4 million families with 2.5 million children.

$425-million increase in annual benefits

1999 budget

July 2000 The income threshold at which the base CCTB begins to be phased out will be increased to $29,590 from its current level of $25,921. This will provide increased benefits to 2 million families with incomes over $25,921.

$300-million increase in annual benefits

Table A7.2
Impact on taxpayers – mature system

	Number of taxpayers		
General tax relief and Canada Child Tax Benefit (CCTB)	1998 and 1999 budgets	1998 budget	1999 budget
Changes to personal amounts[1]			
Number with tax reductions[2]	15,700,000	5,000,000	15,300,000
Number removed from the tax rolls	600,000	400,000	200,000
Elimination of 3% surtax			
Number with tax reductions[3]	15,100,000	14,000,000	2,700,000
Increase to CCTB			
Number of families with CCTB increases[4]	3,300,000	1,400,000	2,000,000
Number of families added to CCTB eligibility[5]	100,000	–	100,000

[1] Includes extension of $500 supplement to all taxpayers and $175 increase in tax-free income.

[2] The 1999 budget provides tax reductions to all 15.3 million taxpayers remaining after the 1998 budget removed 400,000 from the tax rolls. Consequently all 15.7 million taxpayers receive tax reductions from the two budgets combined.

[3] The 1999 budget eliminates the surtax for the 2.7 million taxpayers who remained liable for the surtax following the 1998 budget measures. This number includes taxpayers who received only partial relief from the surtax in the 1998 budget.

[4] The total number of families receiving CCTB benefits following the full implementation of the 1999 budget measures will be 3.3 million. Some families gain from benefit increases provided by both the 1998 and 1999 budgets.

[5] As a result of the 1998 budget, the number of families eligible for the NCB supplement will increase by 175,000. However, the number of families eligible for the CCTB remains unchanged as these families were already receiving the base benefit.

Table A7.3

Typical single individual

Full-year impact of proposed measures

			1999 budget tax relief measures							
Total income	Federal tax[1] pre-1998 budget	1998 budget impacts	Extending the $500 supplement	$175 increase to basic amounts	Surtax elimination	Canada Child Tax Benefit	Total 1999 budget	Total 1998 and 1999 budgets	Total 1998 and 1999 as a % of federal tax[2,3]	Federal tax post-1999 budget
$	$	$	$	$	$	$	$	$	$, %	$
7,500	-98	-85	-4	-30	0	0	-34	**-119**	**-119**	-217
10,000	262	-80	-21	-30	0	0	-51	-131	-50.0%	131
15,000	1,047	-70	-55	-30	0	0	-85	-155	-14.8%	892
20,000	1,866	-63	-85	-30	0	0	-115	-178	-9.5%	1,688
25,000	2,685	-87	-85	-30	0	0	-115	-202	-7.5%	2,483
30,000	3,746	-112	-85	-30	0	0	-115	-227	-6.1%	3,519
35,000	5,128	-149	-85	-30	0	0	-115	-264	-5.1%	4,864
40,000	6,429	-187	-85	-30	0	0	-115	-302	-4.7%	6,127
45,000	7,768	-226	-85	-30	0	0	-115	-341	-4.4%	7,427
50,000	9,107	-219	-93	-32	-35	0	-160	-379	-4.2%	8,728
55,000	10,446	-141	-93	-32	-152	0	-277	-418	-4.0%	10,028
60,000	11,810	-62	-93	-32	-272	0	-397	-459	-3.9%	11,351
65,000	13,324	0	-92	-32	-384	0	-508	-508	-3.8%	12,816
75,000	16,456	0	-92	-32	-471	0	-595	-595	-3.6%	15,861
100,000	24,286	0	-92	-32	-689	0	-813	-813	-3.3%	23,473

1 Includes federal income tax and the goods and services tax (GST) credit. Does not include provincial income tax. The negative value indicates that refundable GST credit received is greater than income tax paid.

2 The negative value indicates a reduction in net tax paid to the federal government.

3 Typical singles at an income of about $7,500 and less receive more in federal refundable credit (GST credit) than they pay in federal income tax. The federal tax reduction indicated in bold therefore represents the increase in the net benefits they receive from the tax and transfer system. Percentage is not meaningful so the dollar amount is repeated.

Table A7.4

Typical one-earner family of four
Full-year impact of proposed measures

Total income	Federal tax[1] pre-1998 budget	1998 budget impacts	1999 budget tax relief measures: Extending the $500 supplement	$175 increase to basic amounts	Surtax elimination	Canada Child Tax Benefit[2]	Total 1999 budget	Total 1998 and 1999 budgets	Total 1998 and 1999 as a % of federal tax[3,4]	Federal tax post-1999 budget
$	$	$	$	$	$	$	$	$	$, %	$
13,500	-3,708	-163	0	0	0	-700	-700	**-863**	**-863**	-4,571
15,000	-3,462	-174	-7	-60	0	-700	-767	**-941**	**-941**	-4,403
20,000	-2,643	-164	-41	-60	0	-700	-801	**-965**	**-965**	-3,608
25,000	-1,000	-154	-75	-60	0	-719	-854	**-1,008**	**-1,008**	-2,008
30,000	451	-145	-109	-60	0	-184	-353	-498	-110.4%	-47
35,000	2,233	-149	-143	-60	0	-184	-387	-536	-24.0%	1,697
40,000	3,938	-160	-170	-60	0	-184	-414	-574	-14.6%	3,364
45,000	5,527	-199	-170	-60	0	-184	-414	-613	-11.1%	4,914
50,000	7,116	-238	-170	-60	0	-184	-414	-652	-9.2%	6,464
55,000	8,705	-197	-185	-65	-60	-184	-494	-691	-7.9%	8,014
60,000	10,319	-117	-185	-65	-179	-184	-613	-730	-7.1%	9,589
65,000	12,063	-30	-185	-65	-310	-184	-744	-774	-6.4%	11,289
75,000	15,469	0	-184	-64	-440	0	-688	-688	-4.4%	14,781
100,000	23,299	0	-184	-64	-658	0	-906	-906	-3.9%	22,393

[1] Includes federal income tax, refundable Canada Child Tax Benefit (CCTB) and the goods and services tax (GST) credit. Does not include provincial income tax. Negative values indicate that refundable CCTB and GST credits received are greater than income tax paid.

[2] Design change announced in the 1999 budget – includes the effect of the $850-million increase announced in the 1998 budget as well as the $300-million increase announced in the 1999 budget.

[3] Negative values indicate a reduction in net tax paid to the federal government.

[4] Typical one-earner families of four at incomes of about $25,000 and less receive more in federal refundable credits (CCTB and GST credit) than they pay in federal income tax. The federal tax reduction indicated in bold therefore represents the increase in the net benefits they receive from the tax and transfer system. Percentages are not meaningful so the dollar amounts are repeated.

Table A7.5

Typical two-earner family of four
Full-year impact of proposed measures

			1999 budget tax relief measures							
Total income	Federal tax[1] pre-1998 Budget	1998 budget impacts	Extending the $500 supplement	$175 increase to basic amounts	Surtax elimination	Canada Child Tax Benefit[2]	Total 1999 budget	Total 1998 and 1999 budgets	Total 1998 and 1999 as a % of federal tax[3,4]	Federal tax post-1999 budget
$	$	$	$	$	$	$	$	$	$, %	$
20,000	-3,345	-173	-18	-60	0	-700	-778	**-951**	**-951**	-4,296
25,000	-2,687	-165	-45	-60	0	-700	-805	**-970**	**-970**	-3,657
30,000	-1,368	-156	-77	-60	0	-712	-849	**-1,005**	**-1,005**	-2,373
35,000	-8	-117	-85	-30	0	-344	-459	**-576**	**-576**	-584
40,000	1,311	-161	-102	-60	0	-184	-346	-507	-38.7%	804
45,000	2,609	-171	-116	-60	0	-184	-360	-531	-20.4%	2,078
50,000	3,716	-183	-129	-60	0	-184	-373	-556	-15.0%	3,160
55,000	5,063	-201	-143	-60	0	-184	-387	-588	-11.6%	4,475
60,000	6,410	-219	-157	-60	0	-184	-401	-620	-9.7%	5,790
65,000	7,764	-238	-170	-60	0	-184	-414	-652	-8.4%	7,112
75,000	10,437	-304	-170	-60	0	-95	-325	-629	-6.0%	9,808
100,000	16,498	-199	-178	-62	-272	0	-512	-711	-4.3%	15,787

[1] Includes federal income tax, refundable Canada Child Tax Benefit (CCTB), and the goods and services tax (GST) credit. Does not include provincial income tax. Negative values indicate that refundable CCTB and GST credits received are greater than income tax paid.

[2] Design change announced in the 1999 budget — includes the effect of the $850 million increase announced in the 1998 budget as well as the $300 million increase announced in the 1999 budget .

[3] Negative values indicate a reduction in net tax paid to the federal government.

[4] Typical two-earner families of four at incomes of about $35,000 and less receive more in federal refundable credits (CCTB and GST credit) than they pay in federal income tax. The federal tax reduction indicated in bold therefore represents the increase in the net benefits they receive from the tax and transfer system. Percentages are not meaningful so the dollar amounts are repeated.

Table A7.6
Typical single parent with one child
Full-year impact of proposed measures

Total income	Federal tax[1] pre-1998 budget	1998 budget impacts	1999 budget tax relief measures: Extending the $500 supplement	$175 increase to basic amounts	Surtax elimination	Canada Child Tax Benefit[2]	Total 1999 budget	Total 1998 and 1999 budgets	Total 1998 and 1999 as a % of federal tax[3,4]	Federal tax post-1999 budget
$	$	$	$	$	$	$	$	$	$, %	$
10,000	-2,273	0	0	0	0	-350	-350	**-350**	**-350**	-2,623
15,000	-2,128	0	0	0	0	-350	-350	**-350**	**-350**	-2,478
20,000	-1,496	-123	-66	-60	0	-350	-476	**-599**	**-599**	-2,095
25,000	-772	-114	-95	-60	0	-351	-506	**-620**	**-620**	-1,392
30,000	648	-104	-129	-60	0	-397	-586	-690	-106.5%	-42
35,000	1,973	-97	-163	-60	0	-92	-315	-412	-20.9%	1,561
40,000	3,648	-129	-170	-60	0	-92	-322	-451	-12.4%	3,197
45,000	5,112	-168	-170	-60	0	-92	-322	-490	-9.6%	4,622
50,000	6,579	-207	-170	-60	0	-92	-322	-529	-8.0%	6,050
55,000	8,040	-246	-170	-60	0	-92	-322	-568	-7.1%	7,472
60,000	9,504	-181	-185	-65	-83	-92	-425	-606	-6.4%	8,898
65,000	11,024	-99	-185	-65	-205	-92	-547	-646	-5.9%	10,378
75,000	14,216	0	-184	-64	-405	0	-653	-653	-4.6%	13,563
100,000	22,046	0	-184	-64	-623	0	-871	-871	-4.0%	21,175

1 Includes federal income tax, refundable Canada Child Tax Benefit (CCTB) and the goods and services tax (GST) credit. Does not include provincial income tax. Negative values indicate that refundable CCTB and GST credits received are greater than income tax paid.

2 Design change announced in the 1999 budget – includes the effect of the $850-million increase announced in the 1998 budget as well as the $300-million increase announced in the 1999 budget.

3 Negative values indicate a reduction in net tax paid to the federal government.

4 Typical single parents with one child at incomes of about $25,000 and less receive more in federal refundable credits (CCTB and GST credit) than they pay in federal income tax. The federal tax reduction indicated in bold therefore represents the increase in the net benefits they receive from the tax and transfer system. Percentages are not meaningful so the dollar amounts are repeated.

Table A7.7
Typical elderly single
Full-year impact of proposed measures

			1999 budget tax relief measures							
Total income	Federal tax[1] pre-1998 budget	1998 budget impacts	Extending the $500 supplement	$175 increase to basic amounts	Surtax elimination	Canada Child Tax Benefit	Total 1999 budget	Total 1998 & 1999 budgets	Total 1998 & 1999 as a % of federal tax[2,3]	Federal tax post-1999 budget
$	$	$	$	$	$	$	$	$	$, %	$
12,500	-30	-55	-38	-30	0	0	-68	-123	**-123**	-153
15,000	407	-51	-55	-30	0	0	-85	-136	-33.4%	271
20,000	1,283	-46	-85	-30	0	0	-115	-161	-12.5%	1,122
25,000	2,158	-72	-85	-30	0	0	-115	-187	-8.7%	1,971
30,000	3,383	-101	-85	-30	0	0	-115	-216	-6.4%	3,167
35,000	4,953	-144	-85	-30	0	0	-115	-259	-5.2%	4,694
40,000	6,424	-187	-85	-30	0	0	-115	-302	-4.7%	6,122
45,000	7,894	-230	-85	-30	0	0	-115	-345	-4.4%	7,549
50,000	9,341	-206	-93	-32	-56	0	-181	-387	-4.1%	8,954
55,000	10,877	-132	-93	-32	-167	0	-292	-424	-3.9%	10,453
60,000	12,765	-66	-93	-32	-266	0	-391	-457	-3.6%	12,308
65,000	14,785	0	-92	-32	-375	0	-499	-499	-3.4%	14,286
75,000	18,947	0	-92	-32	-449	0	-573	-573	-3.0%	18,374
100,000	28,007	0	-92	-32	-651	0	-775	-775	-2.8%	27,232

1 Includes federal income tax, refundable goods and services tax (GST) credit. Does not include provincial income tax. Negative values indicate that refundable GST credit received is greater than income tax paid.

2 The negative value indicates a reduction in net tax paid to the federal government.

3 Typical elderly singles at an income of about $12,500 and less receive more in federal refundable credit (GST credit) than they pay in federal income tax. The federal tax reduction indicated in bold therefore represents the increase in the net benefits they receive from the tax and transfer system. Percentages are not meaningful so the dollar amount is repeated.

Table A7.8
Typical elderly couple
Full-year impact of proposed measures

			1999 budget tax relief measures							
Total income	Federal tax[1] pre-1998 budget	1998 budget impacts	Extending the $500 supplement	$175 increase to basic amounts	Surtax elimination	Canada Child Tax Benefit	Total 1999 budget	Total 1998 and 1999 budgets	Total 1998 and 1999 as a % of federal tax[2,3]	Federal tax post-1999 budget
$	$	$	$	$	$	$	$	$	$, %	$
20,000	-307	-91	0	0	0	0	0	-91	**-91**	-398
25,000	453	-119	-87	-60	0	0	-147	-266	-58.7%	187
30,000	1,498	-110	-121	-60	0	0	-181	-291	-19.4%	1,207
35,000	2,705	-105	-155	-60	0	0	-215	-320	-11.8%	2,385
40,000	4,176	-122	-182	-60	0	0	-242	-364	-8.7%	3,812
45,000	5,646	-164	-182	-60	0	0	-242	-406	-7.2%	5,240
50,000	7,116	-207	-182	-60	0	0	-242	-449	-6.3%	6,667
55,000	8,566	-249	-182	-60	0	0	-242	-491	-5.7%	8,075
60,000	10,094	-177	-198	-65	-89	0	-352	-529	-5.2%	9,565
65,000	11,982	-111	-198	-65	-188	0	-451	-562	-4.7%	11,420
75,000	16,044	0	-196	-64	-386	0	-646	-646	-4.0%	15,398
100,000	25,626	0	-196	-64	-582	0	-842	-842	-3.3%	24,784

[1] Includes federal income tax, refundable goods and services tax (GST) credit. Does not include provincial income tax. Negative values indicate that refundable GST credit received is greater than income tax paid.

[2] The negative value indicates a reduction in net tax paid to the federal government.

[3] Typical elderly couples at an income of about $20,000 and less receive more in federal refundable credit (GST credit) than they pay in federal income tax. The federal tax reduction indicated in bold therefore represents the increase in the net benefits they receive from the tax and transfer system. Percentages are not meaningful so the dollar amount is repeated.

Tax Fairness Measures

Income splitting with minor children

Progressivity of tax rates is one of the principles of the Canadian personal income tax system. High-income individuals are considered to be better able to bear a higher rate of income taxation than are lower-income individuals. This progressivity is reflected in the three different federal marginal tax rates of 17 per cent, 26 per cent and 29 per cent, which apply depending on income levels. Further, with the implementation of the changes announced in this budget, the basic personal tax credit will allow the first $7,131 of an individual's income to be earned tax-free. Income-splitting tax planning techniques seek to avoid the rules which embody the principle of progressivity by causing income earned by high-income individuals to be taxed in the hands of low-income individuals (generally the family members of the high-income earner). The tax benefits of income splitting can generally only be accomplished by high-income individuals with dependants.

Currently, the income tax system uses attribution rules to reduce the opportunities for income splitting. These rules apply in certain cases to attribute to a taxpayer income from property that has been provided directly, or indirectly (for example, through a trust or corporation), to an individual by the taxpayer. Generally these rules apply in the family context. However, several tax planning techniques have developed over time to avoid the application of the attribution rules or to take undue advantage of exceptions provided in those rules. In addition, recent case law has provided support for income-splitting techniques contrary to policy intent.

In order to improve the fairness and integrity of the Canadian tax system, this budget proposes a targeted measure to discourage income splitting with minor children. The new measure constitutes a special tax, at the top marginal tax rate instead of the normal graduated rates, to be imposed on certain income of individuals age 17 or under. The types of income which will be taxed under this new measure are:

- taxable dividends and other shareholder benefits on unlisted shares of Canadian and foreign companies (received directly or through a trust or partnership); and
- income from a partnership or trust where the income is derived by the partnership or trust from the business of providing goods or services to a business carried on by a relative of the child or in which the relative participates.

Income that is subject to this tax will not be eligible for any deductions or credits other than the dividend tax credit and foreign tax credit. An offsetting deduction in computing taxable income will be introduced to ensure that income that is subject to the new tax is not also subject to ordinary income tax. In addition, income that is taxed under this new measure will not be subject to the attribution rules.

Income that is not received as dividend income, partnership income or trust income is not subject to the new measure. Accordingly, income from employment or personal services of the minor will not be subject to this measure. Dividends received on any listed shares will not be subject to these rules, since the income flow is less susceptible to manipulation. Further, income from property acquired on the death of a parent of the individual will be exempt from the measure, as will income from any property inherited by individuals with disabilities who are eligible to claim the disability tax credit or by individuals who are in full time attendance at a post-secondary institution. Individuals who have no parent resident in Canada for tax purposes in the year will also be exempted from the application of the new tax.

The scope of this new measure is narrow; it targets those structures that are primarily put in place to facilitate income splitting with minors. The government will monitor the effectiveness of this targeted measure, and may take appropriate action if new income-splitting techniques develop.

This proposal will apply to the 2000 and subsequent taxation years. This delay in the application of the new measure will allow time for consultation with taxpayers regarding the details of its implementation.

Non-resident trust and foreign-based investment fund rules

Canadians have significantly increased their holdings of investments in foreign countries over the past ten years. This reflects the globalization of capital markets and recognizes the benefits of portfolio diversification. However, tax planning techniques have developed to create advantages from using foreign-based investment funds and non-resident trusts in comparison with Canadian-based investment vehicles.

The *Income Tax Act* contains provisions that are designed to prevent the use by taxpayers of foreign-based investment funds and non-resident trusts to avoid Canadian tax. The purpose of the rules is to ensure that an appropriate amount of Canadian tax is paid on the foreign investment income earned by taxpayers through such vehicles in order to provide a level playing field with Canadian-based investment vehicles.

There is growing evidence that the objectives of the current provisions of the Act are not being fully met and that high-income individuals are able, in some cases, to avoid Canadian tax by investing in foreign-based investment funds and by contributing property to non-resident trusts. Such an outcome is inconsistent with a fair and neutral tax system, erodes the Canadian tax base and is contrary to the policy intent of the current rules.

Taxation of investment funds

Background

Canadian investment funds are taxed annually on the income and capital gains accumulated in the funds but not allocated to investors. Investors in such funds are taxed annually on the income and capital gains of the funds allocated to them, as well as on any taxable capital gains arising on the disposition of their interest in the fund. As a result, the Canadian tax base is protected.

Investment funds located outside Canada are generally not subject to tax in Canada. Where such funds face little or no tax in their country of residence, Canadian investors holding interests in such vehicles may benefit from a significant deferral of tax on income and realized capital gains retained in the funds over the years. Furthermore, on the disposition of their interest in a foreign-based investment fund, investors may also be able to convert ordinary income to capital gains, which are taxed at a lower rate. These tax advantages have resulted in a growing number of Canadians investing in foreign-based funds.

Issue

The *Income Tax Act* contains rules that attempt to eliminate these tax advantages. Where a Canadian makes an investment in a foreign-based investment fund and one of the main reasons for acquiring, holding or having the interest in such property is to avoid Canadian tax, a notional annual allocation of income is imputed to the taxpayer and subject to tax. This notional amount is determined by multiplying the cost of the taxpayer’s interest in the fund by a prescribed interest rate.

The current provision, however, has rarely been applied. Revenue Canada has had difficulty in enforcing this provision because of the frequent lack of information and the challenge of establishing that the interest in the foreign-based investment fund was acquired primarily to avoid Canadian tax. Although the provision may have been effective when first introduced in 1984, its impact has weakened over the years. When the provision has been applied, it has been criticized as subjecting to tax an arbitrary amount that may bear no relationship to the actual income accruing in the fund.

These deficiencies and the resulting erosion of the Canadian tax base necessitate the actions that the government is proposing in this budget.

Taxation of trusts

Background

Trusts that are resident in Canada are subject to tax in Canada annually on their undistributed income.

Beneficiaries of resident trusts are taxable on distributions received from such trusts, to the extent that the distributions are made out of the income of the trust. Distributions made out of the capital of the trust are tax-free. As a result, the Canadian tax base is protected.

Generally, non-resident trusts are not taxable in Canada and income can be accumulated in such trusts on a tax-deferred basis. When such trusts pay little or no foreign tax on their accumulated income and capital gains, taxpayers making use of such trusts may benefit either from a deferral of tax or complete avoidance of tax. Avoidance occurs where the accumulated income is transformed into the capital of the trust, which is distributed to the Canadian beneficiaries tax-free.

Issue

The anti-avoidance rules in the Act attempt to tax income earned by non-resident trusts in certain circumstances in order to ensure that they are not used to defer Canadian tax on the income accumulating in the trusts. Current rules apply only to non-resident trusts with a Canadian beneficiary. However, these rules are not fully effective and relatively little of such income is taxed in Canada.

Canadian residents are able to transfer funds to non-resident trusts under circumstances designed to circumvent the application of existing anti-avoidance rules. The trust regimes in several tax-haven jurisdictions have been specifically modified in an attempt to permit Canadians to avoid the application of the anti-avoidance rules. A feature of such schemes is to disguise the fact that the non-resident trust has a Canadian resident beneficiary. A number of tax-haven jurisdictions have modified their trust laws so that no beneficiaries need to be designated, thus facilitating tax planning by Canadians in order to defer the taxation of the income accumulating in the non-resident trust. Arrangements between the Canadian transferors and the trustee ensure that the Canadian transferors retain effective control of the trust, or are able to designate who may ultimately receive capital of the trust, including its accumulated income.

Non-resident trusts can therefore offer higher-income Canadians the opportunity to defer or avoid Canadian tax on investment income that would otherwise be taxable in Canada.

Proposal

The budget sets forth an approach to address the deficiencies in the current rules governing foreign-based investment funds and non-resident trusts. The objective of the proposals is to enhance fairness in the tax system in relation to the taxation of income earned from investing in foreign-based investment funds and contributing property to non-resident trusts on the one hand, and income earned from investing in similar entities resident in Canada. These proposals would not prevent Canadians from investing in foreign-based investment funds or from contributing property to non-resident trusts, but are intended to ensure that there is no tax advantage in doing so.

Consultations will be initiated on the following proposed modifications to the tax rules governing foreign-based investment funds:

■ That the proposed rules apply to interests in a foreign-based investment fund, subject to a number of exceptions noted below. Taxpayers would be subject, annually, to tax on their pro-rata share of all the undistributed income of the foreign-based investment fund where they have access to sufficient information about the income of the fund (the income accrual approach that applies in respect of controlled foreign affiliates of Canadian taxpayers), subject to a foreign tax credit for foreign income taxes paid by the fund. Alternatively, taxpayers would be required to add to or deduct from their income, as the case may be, the annual increase or decrease in the market value of their interest in the fund (the “mark-to-market” approach). These rules would replace the tax motivation test that “one of the main reasons for the taxpayer acquiring, holding or having an interest in a foreign-based investment fund was to avoid Canadian taxation". The rules would not apply where the foreign-based investment fund annually distributes or allocates to Canadian investors all of the fund's income to which those investors are entitled.

- That a foreign-based investment fund be defined as any non-resident corporation, trust, fund or other entity where more than 50 per cent of the cost of the entity's assets are investment properties. Look-through rules would apply in respect of significant investments in other entities for the purpose of making this determination. Where trusts are subject to the proposed non-resident trust rules, such trusts would not be subject to these rules.

- That investment funds situated in the United States not be subject to these rules since tax avoidance and deferral opportunities are not a concern through the use of such vehicles.

- That a five-year exception for temporary residents and new immigrants apply. Additional exemptions could be contemplated to remove from the rules foreign-based investment funds that are clearly not used to avoid or defer Canadian tax.

- That the proposed rules apply to any taxation year commencing after 1999, with respect to any interest in a foreign-based investment fund (in which the taxpayer does not already own an interest) not covered by the exceptions, acquired by a Canadian resident on or after February 16, 1999. All interests in any foreign-based investment fund not covered by the exceptions would be subject to the proposed rules for taxation years commencing after 2000.

Consultations will also be initiated on the following proposed modifications to the tax rules governing non-resident trusts:

- That where a Canadian resident transfers or loans property to a non-resident trust, the trust be treated as being resident in Canada and be taxed on all of its undistributed income, subject to a number of exceptions noted below. The Canadian resident transferor would be jointly (with the trust) liable for tax. Where a foreign income tax is imposed in respect of the undistributed income of the trust, a foreign tax credit would be provided. The proposed rules would apply whether or not the trust has a Canadian-resident beneficiary, since in practice it may not be possible to determine whether the property in the trust will be distributed to Canadian beneficiaries.

- That the proposed changes also deal with the distributions from trusts. Distributions out of current income of the trust would be taxed in the hands of the beneficiaries. As well, distributions out of any previously untaxed accumulated income of the trust would be subject to tax.

- That the following trusts be excluded from the application of the proposed rules:
  - trusts resident in the United States and subject to United States tax provisions;
  - non-resident trusts set up prior to immigrants' arrival in Canada, for a five-year period after immigration; and
  - non-resident trusts set up for the benefit of individuals with disabilities or children of divorced parents where the trust and beneficiaries are resident within the same country.
- Additional exceptions could be contemplated to remove from the rules non-resident trusts that are clearly not used to avoid or defer Canadian tax, such as *bona fide* foreign charitable trusts.
- The proposed rules would apply to any taxation year commencing after 1999, with respect to non-resident trusts to which a Canadian resident transfers or loans property on or after February 16, 1999, subject to the exceptions noted above. Other non-resident trusts to which a transfer or a loan of property was made by a Canadian resident before February 16, 1999, would be subject to the proposed rules for taxation years commencing after 2000.

The proposed changes are consistent with Revenue Canada devoting more resources to the audit of taxpayers whose investment activities extend beyond Canada.

Further details on the proposed legislative changes will be released soon to enhance the consultation process.

The goods and services tax credit (GSTC)

The goods and services tax credit (GSTC) was introduced in 1991 to help offset the impact of the goods and services tax (GST) on low- and modest-income Canadians. Depending on income levels, the GSTC provides a refundable tax credit of up to $199 for each adult and $105 for each child. The GSTC also provides a supplement of up to $105 for singles (including single parents) that is phased in at a rate of 2 per cent of net income over $6,456. The government is proposing two changes to the GSTC in this budget.

GSTC single supplement

The first proposed change will affect the supplement for single-parent families. Effective July 1, 1999, the budget proposes to eliminate the phase-in of the GSTC supplement for single parents, and to provide them with the full value of the supplement as part of their core GSTC benefits. The recovery rate and threshold for GSTC benefits will remain unchanged at 5 per cent of net income over $25,921, while the phase-in of the supplement for singles without children will also remain unaffected. This measure will provide additional annual benefits of $20 million to 300,000 single-parent families with incomes under $12,000.

Removing the phase-in requirement for the single supplement in the case of single parents will complement the National Child Benefit's objective of providing greater benefits to low-income families with children.

GSTC responsiveness

The second proposed change to the GSTC will make the credit more responsive to changing family circumstances. Currently, the amount of GSTC for an individual or family in any given year is calculated on the basis of income and family information provided in the previous year's income tax return. As a result, the credit does not respond to changes in family circumstances that occur in the current taxation year. In some circumstances, such as the birth of a child, the amount of GSTC paid to the individual or family may not reflect these changes for as long as 18 months.

The Department of Finance will work with Revenue Canada to improve the responsiveness of the credit and to streamline its administration. The goal of this initiative is to significantly reduce the amount of time it takes to reflect a change in personal and family circumstances in the amount of GSTC benefits. To allow for the implementation of necessary system changes at Revenue Canada, this measure is proposed to apply in 2001.

Retroactive lump-sum payments

For individuals, income from many sources is taxable in the year in which it is received. This generally applies to employment and pension income, and to spousal and taxable child support payments. As a result, individuals are generally taxable on retroactive lump-sum payments in the year they are received, even though a significant portion may relate to prior years.

An individual's tax liability on retroactive lump-sum payments may be higher than it would have been if payments had been made, and taxed, year by year as the income arose. This is due to the progressivity of the income tax system.

Although this higher tax liability represents increased revenue for governments, it is also the case that governments incur financing costs because they receive tax revenues later than if the payment had been made earlier, when due. However, where these financing costs are more than offset by the higher tax liability on the lump-sum payment, governments benefit from the delay in payment at the taxpayer's expense.

This budget proposes that individuals receiving qualifying retroactive lump-sum payments be allowed to use a special mechanism to compute the tax on those payments. These taxpayers will be able to request that Revenue Canada determine if the special mechanism is advantageous to them. The payor of the lump-sum amount will be required to provide information on the payment and each year to which it relates.

Qualifying retroactive lump-sum payments

A qualifying retroactive lump-sum payment is the principal portion of a payment received in a year and relating to a preceding taxation year throughout which the taxpayer was a Canadian resident. The mechanism will be available where the total of those qualifying retroactive lump-sum payments in a particular year is $3,000 or more. For an amount to be eligible, the right to receive the income must have existed in a previous year. Eligible income sources will be:

- income from an office or employment or income received because of termination of an office or employment, received under the terms of a court judgement, arbitration award or in settlement of a lawsuit;
- superannuation or pension benefits, other than non-periodic benefits;
- spousal or child support amounts; and
- employment insurance and other benefits that may be prescribed.

The interest portion of the lump-sum payment will continue to be taxed in the year in which it is received.

Mechanism

Under the proposed mechanism, the federal tax relief on a retroactive lump-sum payment will be the excess of A over B where:

A is the federal tax liability on the lump-sum payment under the current system; and

B is the amount that would be the sum of the federal tax liability, plus interest, on each qualifying retroactive lump-sum payment if it had been taxed in the year to which it relates.

Interest will be added to reflect the delay in payment of tax on the retroactive lump-sum payment. Interest will be calculated using the prescribed interest rate for tax refunds. Interest will begin to apply as of May 1 of the year following the year to which the qualifying lump-sum payment relates, and cease to apply at the end of the year preceding that in which the retroactive lump-sum payment is received.

In recomputing the notional tax liability for prior years, no adjustments will be made to the income tax returns for those years. That is, individuals will not be able to modify items such as RRSP contributions and tax credits. Similarly, the government will not recapture income-tested benefits paid in prior years. Any reduction in federal tax through this measure will also have the effect of reducing provincial tax liability in those provinces that are part of the tax collection agreements. Quebec has a similar mechanism for income tax purposes. These changes do not affect the current provisions applying to retroactive lump-sum CPP/QPP benefits.

These changes will apply to qualifying lump-sum payments received after 1994.

Communal organizations

Hutterite colonies carry on farming and other related businesses in Western Canada as “communal organizations” and as such are governed by the rules in section 143 of the *Income Tax Act*. In these communal organizations, the members of a religious congregation live and work together, none of the members owns property in his or her own right, and the members are required to devote their working lives to the activities of the congregation. The congregation as a whole owns property and typically operates one or more businesses.

Allocation of income by communal organizations

The purpose of section 143 is to provide a level of taxation for communal organizations that is roughly comparable to the general tax treatment of other families in the farming community. Each communal organization is treated for tax purposes as an *inter vivos* trust and may elect each year to make a deemed distribution of its income to its members, in whose hands the distribution is taxed. This allows for the taxation of the distribution at the income tax rates of the members, rather than at the top personal tax rate applied to the trust. In computing the income of the trust, no deduction may be made in respect of salaries, wages or other benefits paid to members of the congregation.

Under the election, 80 per cent of a congregation's income is divided by the number of adult members of the congregation. In the case of an unmarried adult, this quotient is the adult's mandatory share of the congregation's income. In each case where there are two married adults in a family, twice the amount of the quotient is allocated to the adult spouse designated by the congregation. The remaining 20 per cent of the congregation's income must be allocated to unmarried adults and designated spouses, but the congregation has the discretion to divide this remainder among these individuals in unequal shares. Each of these individuals may claim a basic personal credit and such other credits as may be available (including a married credit). Once the standard schedule of tax rates is applied, any resulting tax liability is paid by the congregation on behalf of these individuals.

The allocation of income required for communal organizations has remained largely unchanged since it was introduced in the mid-1970s. Since that time, however, provisions of the *Income Tax Act* have changed to permit the deductibility of wages and salaries paid to employed spouses, provided that the amounts are reasonable in the circumstances. In a typical communal organization, spouses contribute to income-generating farming activities. Therefore, to maintain a roughly equivalent level of taxation between communal organizations and other farming operations, the budget proposes to amend section 143 to allow allocations of income to both spouses in a family. Under the amendment:

- one designated spouse in each family will be allocated one full share of income;
- each non-designated spouse will be allocated a one-half share; and
- each unmarried adult will also be allocated a full share of income.

Example

A colony consists of 20 married couples, 10 single adults and has $900,000 in income. At present, 80 per cent of income is allocated in 50 equal pro-rata shares (two to each designated adult in each of the married couples, and one to each single adult). Each mandatory share is $14,400 (i.e., .8*900,000/50). Accordingly, each designated spouse is allocated $28,800 of income, and each unmarried adult is allocated $14,400. Each adult to whom any of the pro-rata shares has been allocated may claim a basic personal credit, and each designated married adult may also claim a married credit. The remaining 20 per cent of income is allocated in the proportions chosen by the colony among these 30 adults.

Under the proposed amendment, there would be one "full share" allocated to each of the 20 designated adults and 10 unmarried adults, and one "half share" allocated to each of the 20 non-designated spouses. As there are the equivalent of 40 "full shares," each mandatory full share is $18,000 (i.e., .8*900,000/40), and each half share is $9,000. Accordingly, each designated spouse and single adult is allocated $18,000 of income, and each non-designated spouse is allocated $9,000. The remaining 20 per cent of income is allocated as the colony chooses among the 50 adults. Each adult may claim a basic personal credit and, if the income of the non-designated spouse is sufficiently low, the designated spouse may claim the married credit in respect of the non-designated spouse.

It is proposed that this measure apply to the 1998 and subsequent taxation years.

Technical changes affecting communal organizations

Late filing of election

As described above, a communal organization is treated as a trust for income tax purposes. The income tax return of a trust is due 90 days after the end of a calendar year. The election to allocate income to congregation members is due at the same time.

For the 1998 and subsequent taxation years, it is proposed to add this election to the list of elections for which the filing deadline may be extended pursuant to the fairness rules under section 220 of the *Income Tax Act*.

Business investments with third parties

In some cases, a communal organization may have the effective management or control of a corporation in which other investors have a significant minority interest. The existing rules provide, in this case, that all of the income of the corporation is deemed to be the organization's income.

In order to increase the flexibility of business structures, it is proposed to allocate a corporation's income for a taxation year to a communal organization only where all of the issued shares of the corporation are owned throughout the year by the organization. In all other cases, the ordinary rules for computing corporate tax payable apply. This proposal applies in respect of corporate taxation years that begin after February 1999.

Civil penalties for misrepresentations of tax matters by third parties

Canadian tax law includes both criminal and civil penalties that may apply to misrepresentations of tax matters to ensure that all taxpayers pay their fair share of taxes.

Criminal penalties may apply where a person participates in tax evasion in respect of their or another person's taxes. Civil penalties may apply where taxpayers are shown to have knowingly, or in circumstances amounting to gross negligence, made false statements or omissions in the filing of the taxpayer's own tax information. However, Canadian tax law does not provide clear rules for assessing civil penalties for making or counselling false statements in respect of another taxpayer's tax liability. Noting this, the Auditor General, the House of Commons Standing Committee on Public Accounts and the Technical Committee on Business Taxation have made separate but similar recommendations that the tax law be revised to provide civil penalties against those who knowingly, or in circumstances amounting to gross negligence, make false statements or omissions in respect of another person's tax matters.

The budget proposes to apply civil penalties to third parties that make false statements or omissions in relation to tax matters. In particular, two new penalties are proposed.

Tax shelter and other tax planning arrangements

This penalty will apply to a person who plans, promotes or sells an arrangement that the person knows or would have known, but for circumstances amounting to gross negligence, includes a false statement or omission that may be used for tax purposes. This penalty also will apply to a person who provides false information for use in an arrangement. The penalty will be the greater of $1,000 and 100 per cent of the gross revenue derived by the person in respect of the arrangement.

Example

- *Promoter X* approaches individual taxpayers with an arrangement that involves each taxpayer acquiring one piece of art for its fair market value of $100. There are 1,000 pieces of art and *Valuator Z* has agreed to appraise the art at $1,000 per piece as part of the arrangement.
- Concurrently, Promoter X solicits *Charity Y*, which agrees to accept the art from the 1,000 taxpayers, as charitable donations. Charity Y also agrees to issue each taxpayer a charitable donation receipt in the amount of $1,000 per piece of art. Charity Y immediately auctions off the art to the highest bidder, and the price paid reflects the $100 value per piece. Charity Y and Promoter X split the auction proceeds.
- Each taxpayer claims a charitable donation of $1,000 on their tax return, which generates a tax reduction of $500 each (assume $1,000 x .50 top marginal tax rate). As each taxpayer paid only $100 for his or her art, each taxpayer receives a net benefit of $400.
- **Application of Proposed Penalty:** *Promoter X* is liable for the penalty because it organized an arrangement that it knew included a false statement (e.g., about the value of the art and about the allowability of a $1,000 charitable donation amount). *Valuator Z* is liable for the penalty for furnishing false valuations in respect of the arrangement. If *Charity Y* knew or would have known, but for circumstances amounting to gross negligence, that the valuations were incorrect, it would be liable for the penalty for issuing false receipts. As well, registration of Charity Y as a charity may be subject to revocation in such circumstances.

Advising or participating in a false filing

This penalty will apply to a person who makes (or participates in the making of) a statement or omission that the person knows or would have known, but for circumstances amounting to gross negligence, is a false statement or omission that may be used for tax purposes by or on behalf of another person in a return, form, certificate, statement or answer filed or made by or on behalf of that other person. In such circumstances, the penalty will be the greater of $1,000 and 50 per cent of the amount of tax sought to be avoided or refunded.

Example

- *Accountant X* receives a box of personal and business receipts from *Client Y* and agrees to prepare a business expense statement for Y. Accountant X includes the $5,000 cost of Y's family vacation, which X knew to be a non-deductible personal expense, as a business expense in Y's tax return.
- Accountant X finalizes Y's tax return and advises that Y will be receiving a $2,000 tax refund. The tax return is filed by Y.
- Revenue Canada conducts a compliance audit and discovers the $5,000 of personal expenses deducted in Y's tax return.
- **Application of Proposed Penalty:** *Accountant X* is liable because he or she knew of the false statement included in Y's tax return. On the facts, Accountant X may also be subject to criminal prosecution.

Revenue Canada would have the burden of proof of establishing the facts necessary to apply these civil penalties. Consultations will be held on the merits of requiring a person, who has been shown by Revenue Canada to have made a valuation of property that deviates significantly from the property's fair market value, to establish that the representation was reasonable in the circumstances and made in good faith.

It is proposed that these penalty provisions be added for the purposes of the *Income Tax Act* and the Goods and Services Tax/Harmonized Sales Tax and apply after Royal Assent.

RRSP/RRIF proceeds on death

When an annuitant under a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF) dies, the existing income tax rules generally provide that the value of the RRSP or RRIF is included in computing the deceased's income for the year of death. However, if the deceased has a surviving spouse, this income inclusion is offset by RRSP or RRIF distributions made after death to the surviving spouse. If there is no surviving spouse, the same offset is available in connection with distributions made to the deceased's financially dependent children or grandchildren. In both cases, these distributions are included in the income of the recipients, but a number of different mechanisms generally allow spouses and minor or infirm children to defer the taxation on these distributions. The deferral mechanisms involve transfers to acquire annuities, RRSPs and RRIFs for surviving spouses and infirm children, as well as transfers to acquire short-term annuities for minor children.

As noted above, the relief for the deceased's estate resulting from RRSP and RRIF distributions being made to financially dependent children and grandchildren is restricted to cases where there is no surviving spouse. The budget proposes to remove this restriction. This measure responds to cases of deaths of individuals with surviving spouses, where the deceased individuals' RRSPs are left to their dependent children. In these cases, the measure generally allows any resulting income inclusions to be borne by the dependent children rather than the estates of the deceased individuals.

The measure is proposed to apply in connection with deaths that occurred after 1998. It is also proposed to apply this measure in connection with deaths that occurred after 1995, but only when the deceased's estate and the recipient of an RRSP or RRIF distribution so elect. If the distribution in question was made before 1999 and the recipient was entitled to defer the taxation on the distribution by making a transfer under one of the deferral mechanisms described above, a transitional measure will allow the transfer to be made before March 2000. In these circumstances, the amount of the transfer will be available to offset the recipient's income for the taxation year in which the related RRSP or RRIF distribution was received. The deadline for a transfer in respect of an RRSP or RRIF distribution made after 1998 will remain the 60^{th} day following the taxation year in which the distribution is made.

Medical expense tax credit (METC) – persons with disabilities

The government is committed to continue helping Canadians with disabilities by building on the significant level of tax assistance that is already available. In the last two years, a number of tax relief measures were introduced to better recognize disability-related costs. These included the introduction of a tax credit for caregivers, a refundable tax credit for low-income earners with high medical expenses, and the addition of new expenses eligible for relief under the METC. These measures have provided significant additional tax assistance for persons with disabilities.

The METC recognizes the burden of above-average medical expenses by providing tax relief for eligible medical expenses. For 1999, the METC reduces the federal tax of a claimant by 17 per cent of qualifying unreimbursed medical expenses in excess of the lesser of 3 per cent of net income and $1,614.

The budget proposes to further improve tax assistance for the care and education of persons with disabilities by extending the METC to expenses in respect of the remuneration for:

- the care and supervision of persons with severe and prolonged disabilities living in a group home;
- therapy for persons with severe and prolonged disabilities; and
- tutoring for persons with learning disabilities (or other mental impairments).

The budget also proposes to expand the list of eligible equipment for persons with disabilities.

These measures will apply to the 1999 and subsequent taxation years.

Persons with disabilities living in a group home

Group homes are often established within communities for persons with severe mental and physical disabilities. This budget extends tax relief under the METC to include amounts paid on account of remuneration for persons providing care and supervision in a group home for those with severe mental or physical disabilities who are eligible for the disability tax credit (DTC).

Therapy for persons with disabilities

The METC currently provides tax relief for amounts paid to a qualified therapist or other medical practitioner for therapy. However, there are medical therapies that may be prescribed that do not require a qualified therapist or medical practitioner to administer. This measure provides tax relief for amounts paid for therapies administered by a person other than a qualified therapist or medical practitioner to persons with a severe and prolonged mental or physical disability. This measure will be available only in respect of an individual who is eligible for the DTC. The therapy must be prescribed by, and administered under the general supervision of, a medical doctor (or a psychologist in the case of a mental disability or an occupational therapist in the case of a physical disability).

Tutoring for persons with learning disabilities (or other mental impairments)

While tax assistance is already provided for education, individuals with learning disabilities may have a need for supplementary educational services. This budget provides tax relief for amounts paid on account of remuneration for such tutoring services for persons with learning disabilities (or other mental impairments). The need for tutoring services, because of a learning disability, must be certified by a medical practitioner.

Expanding the list of eligible equipment for persons with disabilities

The Income Tax Regulations contain a list of medical devices and equipment eligible for tax relief under the METC. This list will be expanded to include talking textbooks prescribed by a medical practitioner in connection with an individual's enrolment at an educational institution in Canada, where the individual has a perceptual disability.

First Nations taxation

In the 1997 and 1998 budgets, the federal government indicated its willingness to put into effect taxation arrangements with interested First Nations. Since that time, Parliament has passed legislation that enables the Cowichan Tribes, the Westbank First Nation and the Kamloops Indian Band to levy a tax on sales of certain products on their reserves. In addition, personal income tax collection and sharing agreements with the seven self-governing Yukon First Nations came into effect on January 1, 1999. The federal government is once again expressing its willingness to discuss and to put into effect arrangements in respect of direct taxation with interested First Nations.

Temporary capital tax surcharge on large deposit-taking institutions

The capital tax surcharge on large deposit-taking institutions, which was introduced in the 1995 budget, and extended in subsequent budgets, will be further extended to October 31, 2000.

This surcharge applies to financial institutions as defined under Part VI of the *Income Tax Act* except life insurance companies. The surcharge will continue to apply at a rate of 12 per cent of the capital tax imposed under Part VI, calculated before any credit for income taxes and with a capital deduction of $400 million. The surcharge is not eligible to be offset by tax payable under Part I of the Act.

The surcharge will be prorated for taxation years that straddle October 31, 2000.

Manufacturing and processing (M&P) tax rate reduction extended to electricity generating sector

Since 1972, the federal government has provided a tax credit to reduce the top rate of corporate tax applicable to manufacturing and processing profits earned in Canada.

The definition of manufacturing and processing specifically excludes the production or processing of electrical energy or steam, for sale. In the early 1970s the production of electrical energy for sale was carried on generally by Crown corporations. Furthermore, electricity markets were highly regulated and there were relatively few sales in Canada of imported electricity.

The M&P tax credit is currently 7 per cent, thereby reducing the federal corporate tax rate on profit from such activity from 28 per cent to 21 per cent. The credit does not apply to income which already benefits from the low 12 per cent rate applied to the first $200,000 of active business income of Canadian-controlled private corporations. At least 10 per cent of a corporation's gross revenue must be derived from manufacturing and processing activities in Canada in order for any of the corporation's profits to be eligible for the credit.

The electricity generating industry is currently undergoing significant change and restructuring throughout North America. Privatization is an important part of the restructuring, and taxpaying corporations will become more important participants. While the pace of change varies considerably among jurisdictions, the general direction of restructuring is to transform electricity markets from regulated markets to more competitive ones. The Canadian electricity supply sector is a major component of the overall energy system in North America, and Canada is becoming increasingly integrated with the U.S. market. These developments have put increased competitive pressure on Canadian producers of electricity.

The production or processing of electrical energy or steam used directly or indirectly by a taxpayer in a manufacturing process is generally eligible for the M&P tax credit. Thus companies that generate electricity for their own use may already benefit from the lower M&P tax rate.

This budget proposes to extend the M&P tax credit to corporations that produce electrical energy or steam for sale. Access to the credit would be phased in beginning January 1, 1999, with a one percentage point reduction. In each of the three subsequent years there will be additional two percentage point reductions. The full seven percentage point phase-in will be completed in 2002. These rate reductions will be pro-rated for taxation years that straddle calendar years.

Offsetting of interest on corporate tax overpayments and underpayments

A taxpayer who has made an overpayment of income tax in respect of a taxation year may be entitled to receive refund interest from the government on the overpayment. Refund interest is included in income for tax purposes, in the same manner as interest from other sources.

If, on the other hand, a taxpayer has failed to pay an amount of income tax when due, the taxpayer is required to pay arrears interest to the government. Arrears interest is not deductible in computing the taxpayer's income from business or property because it is not an expense incurred for the purpose of earning income. Also, arrears interest is charged at a rate two percentage points higher than refund interest, adding a further incentive to pay tax on time and discouraging use of tax payment deferrals as a source of operating funds.

The taxation of refund interest and the non-deductibility of arrears interest can produce inappropriate results to the extent that a taxpayer owes interest on unpaid tax from one taxation year and is concurrently owed interest on a tax overpayment of an equal amount from a different taxation year. In this circumstance, the cost of the non-deductible interest payable by the taxpayer exceeds the after-tax value of the taxable interest receivable by the taxpayer. In most instances, this difference results chiefly from the non-deductibility of interest paid and the inclusion in income of interest received. The difference in the rates of interest exacerbates the discrepancy.

This situation is most commonly encountered by corporations with complex tax returns, where multiple taxation years may be reassessed at the same time and items of income and expense may be reallocated from one taxation year to another.

The budget proposes a relieving mechanism. For any period of time for which interest is calculated both on an amount owed by a corporation in respect of an underpayment of income tax and on an amount owed by Revenue Canada to the corporation in respect of an overpayment of income tax, the corporation may request that the two amounts be offset for interest calculation purposes. Eligible amounts include tax (other than instalments), interest accrued prior to the period of overlapping balances, and penalties. Interest will only be payable on the net balance owing, with the rate of interest depending on whether there is a net overpayment or underpayment.

The offset will be achieved by reallocating the refund amount (as of the time from which refund interest was calculated) as if it were a payment against the arrears amount. If the refund has already been paid, the reallocation will be conditional on repayment by the taxpayer of the refund and refund interest received. Arrears interest will be charged for the period of time that the corporation had the use of these funds.

The taxpayer will be required to apply in writing for an interest offset between any two taxation years within 90 days of the date of the notice of assessment that sets out one of the two tax amounts (refund or arrears) sought to be offset. If the taxpayer has filed an objection or appeal, the deadline will be extended to the date 90 days after the date of the notice of confirmation or 30 days after the date of the final court decision, as the case may be. The request for offsetting must specify the amounts, dates and taxation years of the reallocation requested. If a reallocation results in the creation of a new refund, the corporation will not be entitled to have the new refund reallocated under this rule unless that request is contained in the request for the original reallocation.

This income tax provision will be available to corporations for any period or part thereof that is after 1999 in respect of which refund interest and arrears interest are calculated concurrently, regardless of the taxation year to which the amounts relate.

Non-resident investment funds that engage Canadian service providers

Both in Canada and abroad, millions of individuals have chosen to invest through mutual funds and other collective investment vehicles. The growth of such investment funds has contributed to the expansion of Canada's investment services industry, which provides advice and administrative support to both domestic and foreign funds. Under current tax rules, however, Canadian service providers are concerned that foreign funds which engage them may become taxable in Canada as a result. The budget proposes to clarify the rules to ensure that the Canadian investment services industry is able to compete effectively in international markets.

As a general matter, and subject to any applicable tax treaty, a non-resident is taxable in Canada on any income earned from carrying on business in Canada. However, there is a concern that a non-resident fund may be considered to be carrying on business in Canada, and therefore become taxable here, simply as a result of retaining a Canadian firm to provide investment management or advisory services or to perform certain administrative (so-called "back office") functions.

This concern could make it difficult for Canadian service providers to attract foreign funds as clients. The situation is exacerbated by the fact that the United States and the United Kingdom – both home to significant investment services industries – have statutory rules that specify circumstances in which foreign funds and other foreign investors are not subject to domestic taxation.

The budget proposes that, subject to conditions, a non-resident investment fund will not be considered to be carrying on business in Canada solely by reason of engaging a Canadian firm to provide portfolio management services, dealer services, or back office services in relation to investments in securities. If this rule does not apply to a particular foreign fund, the determination of whether or not the fund is carrying on business in Canada will be made under the existing law.

This rule is not a tax exemption. In cases where the rule applies, the Canadian firms that serve the offshore client will continue to pay tax in Canada on their profits. Likewise, non-resident funds that receive income such as dividends, interest or capital gains from Canadian sources will continue to be subject to Canadian tax under existing provisions.

There are two main conditions to the application of this rule. First, the non-resident fund must not sell units to investors resident in Canada. This will ensure that no incentive is created to serve Canadian investors from offshore, thereby displacing the domestic Canadian fund industry. Second, the fund must establish that it meets at least one of two tests:

(a) the Canadian resident firms that service the fund deal at arm's length with it (and to the extent that such firms are agents of the fund, they are independent agents); or

(b) the fund's annual rate of investment turnover is low.

The requirement that the Canadian service provider be independent of the fund provides assurance that the fund is not carrying on business through its own operations in Canada or those of a related party.

The alternative turnover test is applicable only in cases where the arm's length test is not met. If the rate of turnover of the investments held by the fund is low, it is presumed, for the purposes of this rule only, that the fund's investment activity is primarily passive in nature and does not constitute an active business. The rate of investment turnover is measured annually as the volume of sales of securities by the fund, net of sales required in order to provide cash for net redemptions by unitholders, relative to the average value of securities held by the fund during the year. For the purpose of calculating turnover, sales of securities due to redemption at maturity or unilateral redemption by the issuer will not be counted. The turnover rate will be calculated for all of the fund's investments, Canadian and foreign, regardless of whether or not they are administered in Canada. Subject to consultations, it is proposed that the low turnover threshold will be met if the turnover rate for the year is less than three.

This rule will apply to non-resident funds for the 1999 and subsequent taxation years.

Capital cost allowance (CCA) for the productive use of flare gas

The government is continually reviewing CCA rates to ensure that these rates reflect the economic life of assets. A number of proposals have been made to further encourage investments in energy efficiency and renewable energy projects by, for example, providing accelerated CCA to such assets. These proposals will be reviewed as the national climate change strategy to reduce Canada's greenhouse gas emissions is developed.

This budget proposes to allow electrical generating equipment using solution gas that would otherwise be flared during the production of crude oil to be eligible for CCA Class 43.1. The economic life of this electricity generation equipment is expected to be more consistent with the 30 per cent CCA rate, calculated on a declining balance basis, applicable to that class. The measure will be implemented by:

- including such solution gas in the list of eligible waste fuels that may be consumed in an electrical generating system eligible for CCA Class 43.1; and

- excluding this solution gas from the definition of fossil fuel for the purposes of the heat rate calculation for such electrical generation systems. (Qualifying systems must have a heat rate attributable to fossil fuels of less than 6000 BTU per kilowatt-hour of electrical energy generated by the system.)

A reduction in the flaring of solution gas offers a means of improving local air quality and reducing greenhouse gas emissions.

The CCA change for electrical generating equipment using solution gas that would otherwise be flared will apply to property acquired after February 16, 1999.

Tobacco contraband

The budget proposes two measures to assist in the government's efforts to reduce tobacco contraband.

Export tax

In 1994, as part of the National Action Plan to Combat Smuggling, the government imposed an excise tax on Canadian tobacco exports. To ensure that Canadian tobacco manufacturers were not denied access to legitimate export markets, several exemptions were provided, including an annual exemption for exports up to 3 per cent of a manufacturer's production in the preceding year.

While the 3 per cent exemption threshold facilitates legitimate exports by Canadian tobacco manufacturers, inherent in that threshold is an administrative latitude for some exports where the ultimate destination is unknown. Reducing this threshold could reduce the availability of low-cost Canadian tobacco products to smugglers. Caution needs to be exercised, however, to ensure that adequate exemptions from the export tax are provided to enable Canadian manufacturers to continue to meet the legitimate demand for their products in export markets.

Since implementation of the National Action Plan, smuggling of Canadian cigarettes has declined substantially. In order to further reduce the potential supply of exported Canadian tobacco products for illegal re-importation into Canada, the budget proposes that the annual exemption from the excise tax on exports be reduced from 3 per cent to 2.5 per cent of the manufacturer's production in the preceding year. On balance, this reduced exemption threshold, along with the other existing exemptions from the excise tax on tobacco exports, will be sufficient to enable domestic manufacturers to continue to meet the legitimate demand for their products outside Canada, while minimizing the potential availability of these products on the contraband market.

It is proposed that the reduced exemption threshold apply to exports after March 31, 1999.

Tobacco stamps

The *Excise Act* requires that all tobacco products for sale in Canada be packaged and stamped to indicate that excise duties have been paid. The absence of the proper stamp provides evidence to enforcement agencies that federal excise levies imposed on tobacco products have not been paid.

The Minister of National Revenue will be making changes to the requirements for stamping and packaging of tobacco products under the Tobacco Departmental Regulations to further improve enforcement. The security features of tear strips, which are used as stamps under the *Excise Act* to provide evidence of payment of excise duties, will be improved. In addition, a province-specific identifier will be required on each package containing tobacco products. These changes will ensure that the identification of the intended province of sale cannot be altered and will assist enforcement agencies in controlling the illegal movement of tobacco products from provinces with reduced rates of federal tobacco taxes to other provinces.

The Minister of National Revenue will be continuing consultations with his provincial counterparts on the merits of additional requirements to ensure the security of tear strips.

The proposed changes to the export tax and tobacco stamps outlined above are designed to improve enforcement and facilitate continuation of the government's coordinated federal-provincial strategy for the restoration of tobacco taxes in a gradual and sustainable manner.

Tax administration

The government has recently tabled legislation before Parliament to transform Revenue Canada into the Canada Customs and Revenue Agency (CCRA). The purpose of the new agency is to serve Canadians better, notably through an enhanced partnership with provincial governments. In this context, Revenue Canada and Nova Scotia are developing a joint initiative to modernize and streamline the administration of that province's workers' compensation program. This initiative will facilitate compliance for businesses, reduce government overlap and duplication and improve fairness. The budget proposes changes to allow Revenue Canada to share limited taxpayer information required to implement this initiative.

Labour-sponsored venture capital corporations (LSVCCs)

The federal government provides generous tax assistance in respect of amounts invested by individuals in LSVCCs. This assistance is provided in the form of a tax credit equal to 15 per cent of the cost of an individual's investment in an LSVCC, up to a maximum credit per year of $750. Many provinces provide similar assistance.

Measures were announced in August 1998 to help LSVCCs continue to be important suppliers of venture capital to small- and medium-sized businesses. This budget proposes further measures to encourage LSVCCs to focus more on small-business investments. The budget also proposes changes consequential to the Quebec government's decision to allow funds invested in LSVCCs to be used under the Home Buyers' Plan and the Lifelong Learning Plan. Other changes dealing with LSVCC share capital attributes, amalgamations and mergers are also proposed.

Measures to encourage investment in small business

Currently, federally-registered LSVCCs are subject to a federal business investment requirement that obligates them to invest 60 per cent of their shareholders' equity in eligible small businesses. These businesses are generally defined as Canadian corporations that have assets of up to $50 million and up to 500 employees. To encourage LSVCCs to focus more of their investments in smaller businesses, investments in businesses that have $10 million or less in assets are counted one and one-half times towards the federal business investment requirement. This budget proposes further measures to encourage LSVCCs to make investments in smaller business.

Community small business investment funds (CSBIFs)

CSBIFs are funds registered under Part III.1 of the Ontario *Community Small Business Investment Funds Act*. CSBIFs are required to invest in businesses with not more than $1 million in assets. The investments in CSBIFs of an LSVCC registered in Ontario count towards that province's business investment requirement. It is proposed that 150 per cent of the cost of such LSVCC investments count towards the federal business investment requirement.

Failure of a CSBIF to meet its investment requirement can result in a tax being levied on the CSBIF's investors. Under existing rules, where such a tax is payable by an LSVCC that is registered in Ontario but not federally, an equal tax is payable to the federal government by the LSVCC. It is also proposed to extend the matching of the Ontario tax for failure to meet a CSBIF's investment requirements to federally-registered LSVCCs.

These proposals apply to the 1999 and subsequent taxation years.

Early-stage financing

Very small businesses, particularly in the knowledge-based sector, report that they are having difficulty obtaining venture capital financing. To encourage LSVCCs to continue to be active participants in the early-stage financing market, this budget proposes that every $1 of eligible investment made by an LSVCC after February 16, 1999 in an eligible business with $2.5 million or less in assets be counted as $2 towards the LSVCC's federal business investment requirement.

Five-year start-up period

An LSVCC is currently not required to meet the federal business investment requirement until the expiry of a five-year period that begins when the LSVCC first issues Class A shares. During this period, there is a requirement that at least 80 per cent of the consideration received for Class A shares be invested in any combination of liquid reserves and eligible businesses.

While the five-year length of this period may have been appropriate when the LSVCC program was initiated because of the time needed for LSVCCs to address securities regulation issues and gain greater public acceptance, the five-year start-up period now can have the effect of delaying investments in eligible businesses.

It is therefore proposed that, for LSVCCs that first issue Class A shares after February 16, 1999, the five-year period be shortened to two years. The two-year period provides sufficient start-up time for new federally-registered LSVCCs and is more consistent with provincial LSVCC rules.

It is also proposed that an LSVCC be allowed to elect to shorten the period. As a result, an LSVCC will be able to elect to be subject to the federal business investment requirement, rather than subject to a requirement to have 80 per cent of consideration it has received for Class A shares be invested in a combination of liquid assets and eligible businesses. This amendment applies to the 1999 and subsequent taxation years.

RRSP withdrawals under the Home Buyers' Plan (HBP) and the Lifelong Learning Plan (LLP)

The HBP and the LLP allow a qualifying individual to withdraw RRSP funds on a tax-free basis to purchase a home or to pay for education. HBP withdrawals are repayable over a 15-year period, while LLP withdrawals are repayable over a 10-year period. To the extent that a scheduled repayment for a year is not made, it is added in computing the participant's income for the year.

The Quebec government has proposed to allow individuals to withdraw proceeds from the redemption of provincial LSVCC shares held within an RRSP, without the provincial LSVCC credit being recovered if the withdrawal is made under the HBP or the LLP. Under existing law, the federal credit will not be recovered in these circumstances. Individuals making such withdrawals are expected to acquire replacement shares in annual amounts determined under the existing HBP and LLP repayment schedules. These replacement purchases are not eligible for the Quebec LSVCC credit. Where an individual fails to acquire LSVCC replacement shares, a special Quebec tax of 15 per cent of the shortfall is imposed on the individual to recover the LSVCC credit that Quebec provided on the purchase of the redeemed shares.

The budget proposes that purchases of replacement shares in Quebec LSVCCs likewise not be eligible for the federal LSVCC credit. In addition, where an individual fails to acquire a replacement share, it is proposed to levy a federal penalty tax that matches the special 15 per cent Quebec tax. These proposals will apply from the date the corresponding Quebec proposals apply.

Similar changes are not contemplated for federally-registered LSVCCs or LSVCCs registered in other provinces. Because shares in Quebec LSVCCs are not normally redeemable until retirement, amounts on which an LSVCC credit was paid will be available for small business investment for a considerable period of time even if withdrawn under the HBP or the LLP for part of that time. In contrast, because shares in federally-registered LSVCCs or in LSVCCs registered in other provinces may generally be redeemed without a recovery of the federal credit after eight years, it would be inappropriate to allow the amounts invested in these shares not to be available for small business investment for any length of time in that period.

Other measures on LSVCCs

For business reasons, some LSVCCs may wish to combine with other LSVCCs and continue in the LSVCC regime. Other LSVCCs may opt to no longer qualify for participation in either the federal or a provincial LSVCC regime, or cease to meet requirements for continuing to qualify. The budget proposes a number of new measures to clarify the application of the LSVCC rules in these circumstances. These proposals apply only to federally-registered LSVCCs.

Changes of attributes of LSVCC shares

The share capital of a federally-registered LSVCC must satisfy registration conditions specified in the LSVCC rules, including conditions restricting the redemption and transfer of Class A shares on which the LSVCC tax credit has been earned.

If share attributes of the capital stock of an LSVCC (including a revoked LSVCC) are changed in a manner which is inconsistent with the registration requirements for LSVCCs, the budget proposes that:

- the subsequent acquisition of any share of the capital stock of the LSVCC will not give rise to any entitlement to the LSVCC tax credit;
- the LSVCC will become subject to a new penalty, calculated in the manner described below;
- the LSVCC's subsequent monthly deficiencies under subsection 204.82(2) of the *Income Tax Act* will be nil – there will no longer be penalties levied for the LSVCC failing to meet the federal business investment requirement; and
- LSVCC investors will not be liable for recovery of the LSVCC tax credit under Part XII.5 of the Act on subsequent dispositions of shares issued by the LSVCC.

These proposals will also apply in the event that the LSVCC begins to wind up, and to mergers and amalgamations (other than qualifying mergers and amalgamations, which are explained below) involving LSVCCs.

The new penalty will approximate a recovery of the federal LSVCC tax credit for outstanding Class A shares, assuming a 20 per cent federal tax credit for Class A shares issued before March 6, 1996 and a 15 per cent federal tax credit for other Class A shares. However, full relief will be provided from the penalty in connection with shares held beyond the required five-year holding period for shares issued before March 6, 1996 or beyond the eight-year holding period for other Class A shares. In addition, relief will be provided on a pro-rated basis to reflect the portion of the required holding period throughout which a share has been held.

These new rules apply to changes in share attributes, amalgamations, mergers or windings-up after February 16, 1999.

Qualifying amalgamations and mergers

The existing LSVCC rules are largely silent on the consequences for new corporations established as a result of an amalgamation or merger involving a federally-registered LSVCC. Where the new corporation meets the conditions for LSVCC registration to which its predecessor was subject and Class A shareholders of the predecessor receive comparable shares of the new corporation on the amalgamation, the new corporation may continue to operate within the LSVCC regime. In these circumstances:

- the new corporation will be treated for the purposes of the LSVCC rules as a continuation of each of the predecessors; and
- the new corporation will immediately become subject to the federal business investment requirement.

Voluntary de-registration

Currently an LSVCC's registration may be revoked if it fails to comply with certain rules. Revocation does not, by itself, affect a former LSVCC's obligations to invest in eligible businesses, nor does it provide any relief for investors from recovery of the LSVCC credit if they redeem their shares before the minimum holding period has passed. There is currently no provision under which an LSVCC can voluntarily de-register.

The budget proposes that LSVCCs may voluntarily de-register and, as a consequence, be treated for tax purposes in the same manner as revoked corporations. An LSVCC may voluntarily de-register by providing the Minister of National Revenue with a certified copy of a directors' resolution indicating the LSVCC is seeking to have its LSVCC registration withdrawn.

This measure will apply after Royal Assent.

Appendix

Measures to enhance tax fairness and achieve economic and social objectives

The budget reiterates the government's commitment to enhance fairness in the tax system and to provide targeted tax relief to achieve economic and social objectives. As explained in the 1997 budget, and reiterated in the 1998 budget, revenues must be raised in accordance with the following key principles:

- taxes must reflect the ability to pay – those with similar incomes and in similar circumstances should pay similar taxes, but those with higher incomes must pay more in absolute terms. Furthermore, when feasible, those with higher incomes should pay progressively more taxes. Corporations must also pay taxes in Canada on their profits;
- those who need help get it – the tax system must recognize special circumstances that affect the ability to pay tax and should be capable of actually providing assistance to, rather than levying taxes on, those in greatest need; and
- taxes that are owed must be paid – this involves compliance with the tax system. The government must ensure that Canadians clearly understand their legal obligations and that Revenue Canada collects taxes that are owed in a fair and efficient manner both for the government and taxpayers.

Maintaining tax fairness requires a constant monitoring of the tax system. The measures that were appropriate when introduced may no longer be suitable due to changes in the economy, new social priorities, aggressive tax planning or a need to improve compliance.

Since 1994, the government has introduced a number of tax measures to enhance fairness and achieve economic and social objectives. The following table summarizes measures taken in previous years and in this budget.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999)

Families and seniors

1996

- introduced new tax treatment of child support payments with payments non-deductible for the payer and non-taxable for the recipient.
- announced two-step enrichment of the Working Income Supplement (WIS) of the Child Tax Benefit (CTB) of $250 million.
- replaced the seven-year limit by an unlimited carry-forward of unused RRSP room.

1997

- announced a $6-billion Canada Child Tax Benefit (CCTB) by simplifying and enriching the current CTB, starting July 1998, with an $850-million supplement for low-income families.
- enriched the WIS in July 1997 from the $125 million announced in the 1996 budget to $195 million and restructured from a per-family to a per-child basis.

1998

- increased the limits to $7,000/$4,000 under the child care expense deduction.
- enriched the supplement under the CCTB by another $425 million on July 1, 1999 and a further $425 million on July 1, 2000.
- removed contributions to registered retirement savings plans (RRSPs) and registered pension plans (RPPs) from the base for the alternative minimum tax.

1999

- set the design for the $850-million increase in the CCTB supplement amount in the 1998 budget.
- proposing to enrich the CCTB by $300 million in July 2000 to enhance benefits for modest- and middle-income families.
- proposing to improve the responsiveness of the goods and services tax (GST) credit.
- proposing to ensure that the maximum GST credit supplement is provided to low-income single-parent families.
- proposing to allow greater flexibility to transfer RRSP proceeds to financially dependant children upon the death of the RRSP owner.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

Education

1996

- increased the amount used to establish the education credit from $80 to $100 per month.
- raised the annual limit on the transfer of the tuition fee and education amounts to those who support students from $4,000 to $5,000.
- increased the annual limit on contributions to registered education savings plans (RESPs) from $1,500 to $2,000, and the lifetime limit from $31,500 to $42,000.
- broadened eligibility for the child care expense deduction to assist parents who undertake education or retraining.

1997

- doubled the amount used to establish the education credit over two years to $200 per month.
- made ancillary fees eligible for the tuition credit.
- allowed a carry-forward of unused tuition and education credits.
- increased annual contribution limits for RESPs from $2,000 to $4,000.
- allowed transfers of RESP funds to an RRSP or to the contributor.

1998

- provided a Canada Education Savings Grant of 20 per cent on annual contributions of up to $2,000, along with carry-forward flexibility.
- introduced a tax credit for interest on student loans.
- allowed RRSP withdrawals for lifelong learning.
- enhanced tax support for part-time education through the education credit and the child care expense deduction.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

Tax assistance for charities and public institutions

1994

- lowered the threshold at which charitable donations begin to earn the 29-per-cent tax credit from $250 to $200.

1995

- removed the income limit for tax credits on donations of ecologically sensitive lands.

1996

- increased the limits on charitable donations eligible for tax credits from 20 per cent to 50 per cent of net income, and to 100 per cent of net income in the year of death and the preceding year.
- expanded zero-rating of hospital beds to all health care facilities, including long-term care facilities.
- allowed most charitable and public organizations to raise funds without collecting and remitting GST on sales.
- extended GST relief on purchases of vehicle modifications necessary to serve individuals with disabilities.
- provided a 100-per-cent GST rebate on books purchased by public libraries, educational institutions and other specified bodies.

1997

- reduced the inclusion rate on capital gains arising from the donation of publicly listed securities from 75 per cent to 37.5 per cent.
- changed the income limit for donations to 75 per cent.
- included 25 per cent of capital cost allowance (CCA) recapture in the net income limit.
- sanctioned a new method of valuation for easements of ecologically sensitive lands.
- increased resources for Revenue Canada to enhance information and compliance from charities.
- simplified GST accounting, reporting and remittance requirements for charities.

1998

- increased tax-free allowances for emergency service volunteers.
- allowed designated charities to treat certain services they supply to business customers as GST/HST taxable, thereby competing on an equal footing with other suppliers.
- provided equivalent GST/HST treatment to charities operating authorized bottle return depots vis-à-vis commercial operators.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

Persons with disabilities

1996

- expanded zero-rating of orthopaedic and orthotic devices under GST.
- enriched the tax credit for infirm dependants.

1997

- broadened the medical expense tax credit.
- removed the limit on the attendant care deduction.
- introduced a refundable medical expense credit for earners.
- broadened the definition of preferred beneficiary for trusts benefiting people with disabilities.

1998

- introduced a new tax credit for caregivers who care for related seniors and persons with disabilities.
- extended the Home Buyers' Plan to persons with disabilities.
- included training expenses for caregivers for the medical expense tax credit.
- allowed certification for the disability tax credit by occupational therapists and psychologists.
- exempted respite care services from GST/HST.

1999

- proposing to expand the medical expense credit to provide enhanced tax assistance for persons with disabilities.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

Personal income tax measures to better target tax preferences

1994

- eliminated the $100,000 lifetime capital gains exemption.
- extended the base for the alternative minimum tax.
- restricted the use of tax shelters.
- extended the taxation of employer-paid life insurance premiums to the first $25,000 of coverage.
- introduced income-testing of the age credit.

1995

- eliminated tax advantages available through trusts.
- reduced the over contribution allowance for RRSPs from $8,000 to $2,000.
- capped the money purchase RPP and RRSP dollar limits at $13,500 through 2002 and 2003 respectively.
- eliminated the retiring allowance roll-overs for years of service after 1995.
- eliminated double claims of personal credits in year of personal bankruptcy.

1996

- announced new rules on taxpayer migration to ensure that gains that accrue while a taxpayer is a resident of Canada are subject to Canadian tax.
- capped the maximum pension limit for defined benefit RPPs at $1,722 per year of service until 2005 (only affecting individuals earning over $75,000).
- reduced the maximum age limit for deferring tax on savings in RRSPs and RPPs from age 71 to 69.
- further constrained tax shelters relying on a mismatch of income and expenses.

1998

- allowed deductibility of health and dental premiums for the self-employed.
- expanded the remote worksite concept.
- clarified the tax treatment of relocation expenses.
- strengthened the integrity of the certified cultural property regime.
- expanded rules regarding employee options to allow the acquisition of units of mutual fund trusts.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

1999

- proposing to prevent income splitting with minors.
- proposing to address deficiencies in the rules governing the taxation of income earned through investments in foreign-based investment funds and transfers to non-resident trusts.
- proposing special rules for the treatment of retroactive lump-sum payments.
- proposing to provide more equitable treatment of income earned by communal organizations.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

Business income tax measures to better target tax preferences

1994

- eliminated both the small business deduction and the enhanced scientific research and experimental development (SR&ED) benefits for large private corporations.
- reduced the deduction for business meals and entertainment expenses from 80 per cent to 50 per cent to better reflect the personal consumption element of these expenditures.
- increased the rate of tax on corporate dividends received by private investment corporations.
- implemented measures to ensure that the income of financial institutions is measured appropriately for tax purposes.
- eliminated the preference for sole-purpose SR&ED performers.
- reduced regional investment tax credits.
- modified the basis upon which insurance companies may claim reserves for income tax purposes.
- eliminated "purchase butterflies."
- tightened the rules applicable to foreign affiliates.
- tightened the rules applicable on forgiveness of debt.

1995

- increased the large corporations tax (LCT) and corporate surtax.
- introduced temporary surcharge on banks and other large deposit-taking institutions.
- eliminated the deferral of tax on unincorporated business income.
- eliminated the deferral advantage for investment income earned by private holding companies.
- replaced film tax shelter mechanism for certified Canadian films with a tax credit.
- tightened rules relating to non-arm's-length contract SR&ED.
- introduced voluntary measure for construction industry reporting.
- tightened rules concerning superficial losses.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

1996

- extended capital tax surcharge on large deposit-taking institutions.
- reduced tax assistance for labour-sponsored venture capital corporations (LSVCCs).
- tightened the resource allowance rules.
- repealed joint exploration corporation rules.
- restricted eligibility of various expenses for flow-through share treatment.
- enhanced incentives to invest in renewable energy.
- limited SR&ED benefits for non-arm's-length salaries and wages.

1997

- extended capital tax surcharge on large deposit-taking institutions.
- replaced tax shelters used to finance non-Canadian films with a tax credit.

1998

- extended capital tax surcharge on large deposit-taking institutions.
- allowed deductibility of countervailing duties and anti-dumping charges.
- allowed more time for year-end distributions for mutual fund trusts.
- harmonized financial institution designation for LCT and other purposes.
- allowed earthquake reserve deduction.
- prevented unintended benefits under the SR&ED regime.
- improved a range of international taxation rules.

1999

- proposing to extend capital tax surcharge on large deposit- taking institutions.
- proposing to ensure that electricity generating activities are taxed equitably.
- proposing to clarify tax status of non-resident funds that retain Canadian service providers.
- proposing to update rules governing LSVCCs to ensure consistency with provincial programs, and address issues relating to corporate restructuring.
- proposing improved capital cost allowances to encourage the productive use of flare gas.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

Sales tax measures to better target tax preferences

1996-97

- tightened the GST rules governing the claiming of input tax credits and rebates by large businesses and exempt entities.
- reinforced the GST rules relating to trusts, estates and partnerships to ensure fair and consistent treatment of similar businesses that are organized differently.
- refined the criteria for businesses to be treated for GST purposes as being in competition with financial institutions.
- permitted warranty companies to recover GST paid on reimbursements to warranty holders.
- extended the GST accommodation rebate for visitors to Canada to non-resident businesses.
- expanded zero-rating and rebate provisions for exported goods and services.
- tightened the GST real property rules to ensure that all builders of multiple-unit residential buildings are treated equitably.

1998

- enhanced the GST/HST Visitors' Rebate Program.
- enhanced alternate collection mechanism for direct sellers.

Simplifying tax administration and improving enforcement

1994-97

- strengthened outreach and education programs.
- enhanced easy-to-understand automatic telephone information systems.
- met with special taxfiler groups such as senior citizens and immigrants to help them comply.
- established a single Business Number for streamlining registration for GST remitters, employers, corporations and importers/exporters.
- new "Business Window" initiative to provide one-stop service for small businesses.
- simplified payroll reporting for small businesses.
- reduced compliance costs for small- and medium-sized businesses by co-ordinating GST, income tax and excise tax audits.
- streamlined procedures to simplify and expedite Customs clearance.

Measures to enhance tax fairness and achieve economic and social objectives (1994-1999) (cont'd)

- implemented a new approach to large business audits including audit protocol.
- reinforced measures to target the underground economy.
- earlier identification of abusive tax avoidance and tax shelter schemes.
- continued improvement of sophisticated risk models to identify areas of high risk and a sector approach to compliance for small- and medium-sized businesses.
- forgiveness of penalties on voluntary tax disclosures to encourage taxpayers to comply voluntarily.
- included exchange of information provisions to help deal with tax havens.
- new rules requiring residents of Canada to file an information return when they own foreign assets in excess of $100,000 in value.
- required adequate documentation of transactions relating to transfer pricing and introduced new penalty provisions related to Revenue Canada reassessments.
- increased resources for Revenue Canada for transfer pricing audits.

1998

- introduced mandatory reporting of federal and construction contracts.

1999

- proposing to allow corporations to offset interest on corporate tax overpayments and underpayments.
- proposing to provide for civil penalties for misrepresentations of tax matters by third parties.
- proposing to improve tax administration by sharing limited information with provinces.
- proposing measures that will reduce tobacco contraband.

Notices of Ways and Means Motions

Notice of Ways and Means Motion to Amend the *Income Tax Act*

That it is expedient to amend the *Income Tax Act* to provide among other things:

Basic and spousal amounts

(1) That, for

(a) the 1999 taxation year,

(i) the basic personal amount be increased to $6,794 from $6,456,

(ii) the spousal and equivalent-to-spouse amounts be increased to $5,718 from $5,380,

(iii) the supplementary personal amount for each of an individual and the person in respect of whom the individual is entitled to a spousal or an equivalent-to-spouse credit be one-half of the amount otherwise determined, and

(iv) the income threshold beyond which the spousal and equivalent-to-spouse amounts are reduced be increased to $572 from $538, and

(b) the 2000 and subsequent taxation years,

(i) the basic personal amount be increased to $7,131,

(ii) the spousal and equivalent-to-spouse amounts be increased to $6,055,

(iii) the supplementary personal amount be eliminated, and

(iv) the income threshold beyond which the spousal and equivalent-to-spouse amounts are reduced be increased to $606,

and that these amounts be adjusted to reflect the portion of the annual increases in the Consumer Price Index in excess of 3 per cent.

Individual surtax

(2) That the 3-per-cent surtax required to be paid by an individual

(a) for the 1999 taxation year be one-half of the amount of that surtax that would be otherwise determined for that year, and

(b) be eliminated for the 2000 and subsequent taxation years.

Canada Child Tax Benefit

(3) That the provisions of the Act relating to the base benefit and National Child Benefit supplement payable under the Canada Child Tax Benefit be modified in accordance with proposals described in the budget documents tabled by the Minister of Finance in the House of Commons on February 16, 1999.

Income-splitting tax

(4) That, for the 2000 and subsequent taxation years, an individual under 18 years of age at the end of a calendar year be required to add to tax otherwise payable under Part I of the Act an income tax computed at the top marginal rate of tax applicable under that Part for the year on

(*a*) taxable dividends received directly or through a trust or partnership in respect of shares of a corporation (other than shares of a class that are listed on a prescribed Canadian or foreign stock exchange),

(*b*) amounts that are included in the individual's income because of section 15 of the Act as a consequence of the ownership by any person of shares described in subparagraph (*a*), and

(c) income from a partnership or trust if the income is derived by the partnership or trust from the provision of goods or services to a business

(i) carried on by a person related to the individual,

(ii) carried on by a corporation of which a person related to the individual is a specified shareholder, or

(iii) carried on by a professional corporation of which a person related to the individual is a shareholder.

(5) That income subject to the special tax described in paragraph (4) be deductible in computing the individual's taxable income and that the only deductions permitted in calculating income, taxable income or tax payable for the purposes of the special tax be the dividend tax credit and the foreign tax credit.

(6) That a parent of an individual liable for tax under paragraph (4) be jointly and severally liable for that tax if the parent was active in the business from which the income that is subject to that tax was derived.

(7) That paragraphs (4) to (6) not apply to

(*a*) individuals who have no parent who is resident in Canada at any time in the year,

(*b*) income from property inherited by an individual from a parent of the individual, and

(*c*) income from property inherited by an individual if, during the year in which the individual receives the income, the individual is

(i) in full-time attendance at a post-secondary educational institution, or

(ii) an individual in respect of whom the disability tax credit may be claimed.

Non-resident trusts and foreign-based investment funds

(8) That the provisions of the Act governing the taxation of

(*a*) trust beneficiaries and non-resident trusts, and

(*b*) taxpayers resident in Canada who hold interests in foreign-based investment funds

be modified in accordance with proposals described in the budget documents tabled by the Minister of Finance in the House of Commons on February 16, 1999.

Goods and Services Tax Credit (GSTC)

(9) That, with respect to payments for months after June 1999, the full GSTC single supplement be extended to any eligible individual who has one or more qualified dependants and whose income does not exceed $25,921 (as indexed).

Retroactive lump-sum payments

(10) That the provisions of the Act relating to the taxation of certain lump-sum payments received after 1994 by an individual (other than a trust) be modified in accordance with proposals described in the budget documents tabled by the Minister of Finance in the House of Commons on February 16, 1999.

Communal organizations

(11) That section 143 of the Act be modified in accordance with proposals, governing the taxation of communal organizations, described in the budget documents tabled by the Minister of Finance in the House of Commons on February 16, 1999.

Civil penalties for misrepresentations of tax matters by third parties

(12) That, after Royal Assent to any enactment giving effect to this paragraph, a person (including a partnership)

(*a*) who

(i) plans, promotes or sells an arrangement that the person knows or, but for circumstances amounting to gross negligence, would have known includes a false statement or omission that may be used for tax purposes, or

(ii) makes (or participates in the making of) a statement or omission that the person knows or, but for circumstances amounting to gross negligence, would have known is a false statement or omission that may be used for tax purposes,

pay a penalty equal to the greater of $1,000 and 100 per cent of the gross revenue derived, or to be derived, by the person from the activity, or

(*b*) who makes (or participates in the making of) a statement or omission that the person knows or, but for circumstances amounting to gross negligence, would have known is a false statement or omission that may be used for tax purposes by or on behalf of a taxpayer in a return, form, certificate, statement, or answer filed or made by or on behalf of the taxpayer, pay a penalty equal to the greater of $1,000 and 50 per cent of the amount of the tax sought to be avoided or refunded to the taxpayer,

and for the purposes of this paragraph,

(*c*) a person who is liable to a penalty under both subparagraphs (*a*) and (*b*) in respect of the same false statement or omission, pay only a penalty equal to the greater of those penalties, and

(*d*) a statement made by a person as to the value of a property or a service be deemed to be a statement that the person knows or, but for circumstances amounting to gross negligence, would have known is false where the value so stated is less than a prescribed percentage or more than a prescribed percentage of the fair market value of the property or service unless the person establishes that the valuation was reasonable in the circumstances and made in good faith.

RRSP/RRIF proceeds on death

(13) That the rules applying on the death of an annuitant under a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF)

(a) be modified for deaths that occur after 1998, by providing in all cases that an amount included in the annuitant's income on death in respect of an RRSP or RRIF be offset to the extent of the amount distributed from the RRSP or RRIF to a financially dependent child or grandchild of the annuitant, and

(b) be similarly modified for deaths that occurred after 1995 and before 1999, where the annuitant's estate and the recipient of the distribution so elect.

Medical expense tax credit

(14) That, for the 1999 and subsequent taxation years, there be added to the list of expenses eligible for the medical expense tax credit

(a) remuneration paid for the care, or supervision, in a group home in Canada of an individual in respect of whom the disability tax credit may be claimed, where the home is maintained exclusively for the benefit of individuals who have a severe and prolonged impairment,

(b) remuneration paid for therapy administered to an individual in respect of whom the disability tax credit may be claimed if

(i) the therapy is prescribed by, and administered under the general supervision of,

(A) a medical doctor or a psychologist, in the case of a mental impairment, and

(B) a medical doctor or an occupational therapist, in the case of a physical impairment, and

(ii) the payee is neither the payor's spouse nor under 18 years of age, and *(c)* remuneration paid for tutoring services that are rendered to, and are supplementary to the primary education of, an individual who

(i) has a learning disability or a mental impairment, and

(ii) has been certified by a medical practitioner to be a person who, because of that disability or impairment, requires those services,

where the payee is ordinarily engaged in the business of providing such services to persons unrelated to the payee.

Part VI surtax

(15) That the 12-per-cent surtax on financial institutions (other than life insurers) be extended to October 31, 2000, pro-rated for taxation years that end after October 2000.

M&P rate for electrical generating sector

(16) That, for the purpose only of applying the manufacturing and processing profits tax rate reduction in section 125.1 of the Act for the 1999 and subsequent taxation years, the producing or processing of electrical energy, or steam, for sale be considered manufacturing or processing except that, in its application to profits from such activity, the reference to 7% in that section be read as 1% for 1999, 3% for 2000, and 5% for 2001, pro-rated for taxation years that straddle a calendar year end.

Offsetting of interest on corporate tax overpayments and underpayments

(17) That a mechanism be introduced to allow for an offset in respect of refund interest on overpayments of income tax and interest owing on unpaid income tax in accordance with proposals described in the budget documents tabled by the Minister of Finance in the House of Commons on February 16, 1999.

Non-resident investment funds that engage Canadian service providers

(18) That, for the 1999 and subsequent taxation years, a non-resident investment fund not be considered to be carrying on business

in Canada in a taxation year solely by reason of engaging a corporation or trust resident in Canada or a Canadian partnership (the "service provider") to provide designated services in relation to investments in securities if

(*a*) the fund has not, directly or through its agents, directed any promotion of investments in the fund principally at, or sold such investments to, persons that the fund knew or ought to have known after reasonable enquiry were resident in Canada, and

(*b*) the fund has not filed any document with a government or public securities regulatory body in Canada in order to permit the distribution of investments in the fund to persons resident in Canada,

and either

(*c*) the service provider deals with the fund and the fund's promoters at arm's length, or

(*d*) the fund's investment turnover rate for the year is less than 3.

(19) That, for the purposes of the rules described in pargraph (18),

(*a*) a non-resident investment fund be a non-resident corporation, a non-resident trust or a partnership other than a Canadian partnership

(i) the only undertaking of which is the investing of its funds in property (other than real property in Canada or an interest in real property in Canada), and

(ii) that has at least one class of investment units of which there are no fewer than 150 holders, each of whom holds units of the class with a fair market value of $500 or more,

(*b*) designated services be

(i) investment management and advice, whether or not the manager has discretionary authority to direct trading,

(ii) securities dealing, and

(iii) investment administration services, namely: custody of securities, calculation and reporting of asset values, executing portfolio transactions and transactions with investors, communication with investors, record keeping, accounting, auditing, and marketing, (*c*) the fund's promoter be any person or partnership that initiates or directs the founding, organization or substantial reorganization of the fund, or any person or partnership affiliated with such a person or partnership, and

(*d*) the investment turnover rate for the fund for a year be equal to the total value of property disposed of by the fund during the year (other than securities redeemed at their maturity and securities redeemed unilaterally by their issuers), less the value of net redemptions of investment units in the fund by investors during the year, all divided by the average value of property held by the fund during the year.

Exchange of taxpayer information

(20) That specified taxpayer information may be provided to an official of the government or an agency of a province for the purpose only of the administration or enforcement of the province's workers' compensation program.

Labour-sponsored venture capital corporations

(21) That the provisions of the Act governing labour-sponsored venture capital corporations be modified in accordance with proposals described in the budget documents tabled by the Minister of Finance in the House of Commons on February 16, 1999.

Notice of Ways and Means Motion to Amend the *Excise Tax Act*

That it is expedient to amend the *Excise Tax Act* to provide among other things:

Civil penalties for misrepresentations of tax matters by third parties

(1) That, for the purposes of Part IX of the Act, where a person

(*a*) plans, promotes or sells an arrangement that the person knows or, but for circumstances amounting to gross negligence, would have known includes a false statement or omission that may be used for tax purposes, or

(*b*) makes (or participates in the making of) a statement or omission that the person knows or, but for circumstances amounting to gross negligence, would have known is a false statement or omission that may be used for tax purposes,

the person pay a penalty equal to the greater of $1,000 and 100 per cent of the gross revenue derived, or to be derived, by the person from planning, promoting or selling the arrangement or making (or participating in the making of) the false statement or omission, as the case may be.

(2) That, for the purposes of Part IX of the Act, where a particular person makes (or participates in the making of) a statement or omission that the person knows or, but for circumstances amounting to gross negligence, would have known is a false statement or omission that may be used for tax purposes by or on behalf of another person in a return, application, form, certificate, statement, invoice or answer made by or on behalf of that other person, the particular person pay a penalty equal to the greater of $1,000 and 50 per cent of the amount of the tax or net tax sought to be avoided or refunded to the other person.

(3) That, for the purposes of any enactment founded on paragraph (1) or (2), a statement made by a person as to the value of a property or service be deemed to be a statement that the person knows or, but for circumstances amounting to gross negligence, would have known is false if the value so stated is less than a prescribed percentage, or more than a prescribed percentage, of the fair market value of the property or service, unless the person establishes that the valuation was reasonable in the circumstances and made in good faith.

(4) That, where a person is liable to a penalty under both an enactment founded on paragraph (1) and an enactment founded on paragraph (2) in respect of the same false statement or omission, the person pay only a penalty equal to the greater of those penalties.

(5) That enactments founded on any of paragraphs (1) to (4) come into force on Royal Assent.

Excise tax on tobacco exports

(6) That the annual exemption from the excise tax on exports of tobacco products by a manufacturer be reduced for each category of tobacco product from 3 per cent to 2.5 per cent of the manufacturer's total production of that category of tobacco product in the previous calendar year, effective for tobacco products exported after March 31, 1999, and pro-rated for the 1999 transitional year.