October 15, 1997

The Economic and Fiscal Update

strong economy strong society

SECURITY & OPPORTUNITY

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Introduction and Overview

The government's overarching economic goal is to foster strong economic growth and job creation. The first step in achieving this goal is to ensure that the government's own fiscal performance complements Canada's economic strengths. Restoring fiscal health to the nation's finances allows interest rates to come down and stay down to stimulate the economy. This is the path the government has followed since 1993-94; it is the path it will follow in the future.

The strategy is working:

- the deficit is down to its lowest level in 20 years and will continue to fall;
- Canadian interest rates have come down to their lowest levels in decades;
- the economy is now growing at a strong pace; and
- job creation is strong.

Today, the challenge for the federal government is to build on this progress by creating opportunity and security for all Canadians.

Economic and Fiscal Context Extremely Positive

The government's action plan of the past four years has focused on restoring fiscal health and modernizing the role of government. That plan recognized that fiscal health and economic growth go hand in hand – achieving strong and sustained economic growth was not possible without restoring Canada's fiscal health and, without a strong economy, there could be no sustained improvement in the nation's fiscal situation.

This strategy is paying off. The economy is now growing very strongly, and at no time in the past 25 years has the economic environment in Canada been more positive. The government's action plan to restore sound finances, combined with low and stable inflation, has contributed to a significant decline in interest rates. This has fuelled the recent strong growth that is creating jobs, and reflects a new optimism on the part of consumers and businesses about the future. Altogether, these positive developments provide a sound basis for continued strong growth.

The deficit for 1996-97 was $8.9 billion – down $19.7 billion from 1995-96.

The budget will be balanced by no later than 1998-99.

Just as the fiscal turnaround has directly contributed to the improvement in Canada's economic environment, stronger growth and job creation have reinforced the impact of the government's direct actions to reduce the deficit. The deficit for 1996-97 was $8.9 billion, down $19.7 billion from the 1995-96 outcome and the smallest deficit since 1976-77. This marks the third year in a row that the government's deficit targets have been surpassed. The deficit is continuing to decline and the government is committed to achieving a balanced budget no later than 1998-99.

Remaining Fiscal Challenge

As a result of the significant decline in the federal deficit in 1996-97, Canada's debt-to-GDP ratio fell to 73.1 per cent – the first meaningful decline in 25 years. With a balanced budget to be achieved no later than 1998-99, this ratio will continue to decline in the coming years. But the burden of public debt is still too high by both historical and international standards.

The debt-to-GDP ratio needs to be reduced.

Reducing the debt-to-GDP ratio is key to ensuring that the long-run benefits of improved health in the nation's finances are realized and maintained. In the short-run, this may require a reduction in the absolute level of the debt. Nevertheless, the debt-to-GDP ratio is the most appropriate indicator of the nation's ability to carry debt. Just as households and businesses with higher incomes can support higher debt, the larger a country's gross domestic product (GDP), the larger the *absolute level* of debt it can support. But there are clear limits to this carrying capacity.

In Canada's case, there are a number of factors that underscore the importance of achieving further significant reductions in the debt-to-GDP ratio.

- Currently, public debt charges absorb about 32 cents of every revenue dollar collected. Reducing the debt-to-GDP ratio will mean that some of the revenues now being absorbed by debt charges can be used for the nation's key priorities – for example, health care, education, pensions, lower taxes, etc.
- Reducing the debt-to-GDP ratio will reduce the vulnerability of Canada's fiscal situation to economic shocks, particularly interest rate increases.
- Reducing the debt-to-GDP ratio will improve economic efficiency and growth by providing an environment that is more conducive to entrepreneurship and investment. This occurs because a lower debt-to-GDP ratio brings with it the potential for permanently lower taxes and interest rates.
- Finally, it is also a matter of fairness to today's youth and future generations. Younger Canadians have received relatively less benefit from the build-up in Canada's debt. The debt-to-GDP ratio should be reduced now, while the generations that benefited most from its run-up are still in the labour force.

Prospering in a Knowledge-Based Economy

Fundamental changes are taking place in Canada's economy …

While the economic indicators are much healthier today than at any point in the past 25 years, other fundamental changes are taking place in Canada's economy that require ongoing adjustment. The development and use of information and knowledge are fast becoming the main engines of long-term growth in all industries. This change is raising educational and skill requirements throughout the economy and accelerating the integration of the world's economies.

Canadians believe that they can prosper in the economy of the 21st century. But they are also concerned about how these changes will affect them, their families and those who are unable to take advantage of the opportunities economic change will bring. They are concerned too about the future of health, education and social programs that serve and unite Canadians. That is why Canadians want a government that responds to economic change by providing leadership. The federal government is taking an active role in creating opportunities and building security for Canadians by:

- working with Canadians to build a strong, modern economy that will generate more and better jobs and raise living standards; and
- securing Canada's health, education and social programs so that the benefits of economic growth can be shared by all.

This document sets out the government's key roles and responsibilities in encouraging economic growth and translating it into a better quality of life for all Canadians.

Outline of *The Economic and Fiscal Update*

The rest of this document is organized as follows:

- **Chapter 2** reviews recent economic developments and their implications for the assumptions underlying the federal government's fiscal planning. It highlights the fact that the economy has strengthened considerably over the last year, translating into strong job gains.
- **Chapter 3** explains the final deficit outcome for 1996-97, states the government's fiscal guidelines for future years and discusses the challenge of putting the debt-to-GDP ratio on a permanent downward track to ensure sustained economic growth and more jobs for Canadians.
- **Chapter 4** describes the emerging global economy based on knowledge and skills. It also details the federal government's role in providing active leadership in several areas key to Canada's prosperity in this new environment.
- **Chapter 5** presents the conclusions and main issues, including a number of specific questions on which the House of Commons Standing Committee on Finance will be asked to provide advice.

In addition, there are two annexes. Annex 1 reviews the progress made at the provincial level. Annex 2 describes the fiscal sensitivity of changes in economic growth and interest rates.

2

A Growing Economy and Stronger Job Creation: The Payoff from Sound Policies[1]

Highlights

- Economic conditions have improved considerably over the past year.
- In the first eight months of the year, 263,000 jobs were created, all in the private sector and most of them full-time positions.
- The encouraging outlook reflects steep declines in interest rates resulting from restored fiscal health and continued low inflation.
- One-year mortgage rates have fallen over 400 basis points since January 1995, providing substantial interest rate relief for homeowners. Five-year mortgage rates are presently at their lowest levels in a generation.
- Private sector forecasters expect growth of about 3.7 per cent in both 1997 and 1998 – the strongest back-to-back growth in almost 10 years.

Introduction

Economic developments since the February 1997 budget have been very encouraging. Growth has strengthened, leading to strong employment gains and lower unemployment. The near-term outlook is also promising, as private sector economists forecast strong growth of 3.7 per cent in both 1997 and 1998. This outcome would be the best two-year performance of the economy in almost 10 years. Major international organizations, such as the International Monetary Fund (IMF) and the Organization for

[1] All statistical references are as of Thursday, October 2.

Economic Co-operation and Development (OECD), share this very favourable assessment of the Canadian economy's growth prospects.

The improved economic outlook results from a number of factors. Most important are the determined efforts by the federal and provincial governments to address the fiscal problems that seemed so intractable only a few years ago, and which threatened the country's long-term prosperity. Improved public finances have allowed interest rates to fall to historic lows, fuelling the economic growth that is creating jobs. Confidence on the part of households and businesses has improved enormously – *Canadians are once again starting to have confidence in their economic future*.

This chapter briefly reviews recent economic developments and discusses the factors accounting for the renewal of consumer and business confidence underlying the improved outlook, in particular the key role of improved financial management. It outlines the results of the latest survey of private sector forecasters, which will provide the basis for the near-term economic assumptions to be used for fiscal planning in the 1998 budget.

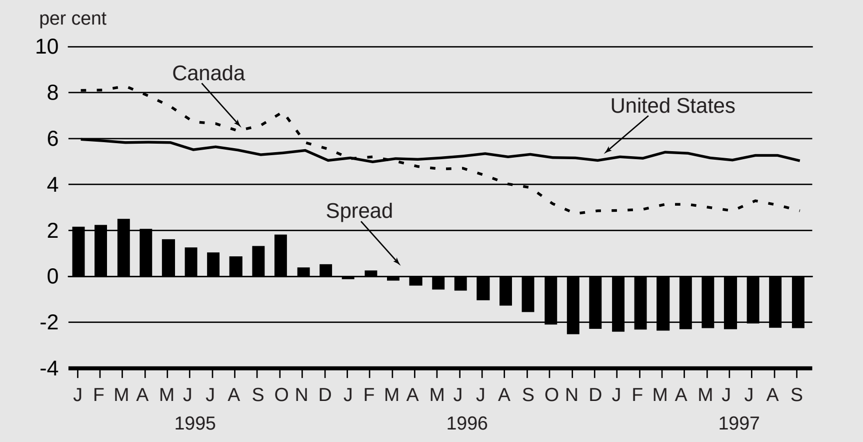
Recent Economic Developments

… fiscal progress has allowed monetary conditions to become and remain highly supportive of growth.

In 1993, the government recognized that the restoration of sound public finances would have to be a central element of its strategy to restore growth and create jobs for Canadians. Since that time, the progress made in terms of fiscal consolidation has allowed monetary conditions to become and remain highly supportive of growth. Indeed, the results have been better than anyone expected. As noted in the February budget, interest rates earlier this year were well *below* the average forecast among private sector forecasters one year earlier. And interest rates have remained at very low levels.

These low interest rates reflect, in part, reduced risk premiums attached to Canadian assets. This effect is most noticeable in the substantial negative spreads between comparable Canadian and U.S. interest rates. Negative spreads on short-term interest rates have prevailed for the past 19 months – the longest such period since the early 1970s (Chart 2.1).

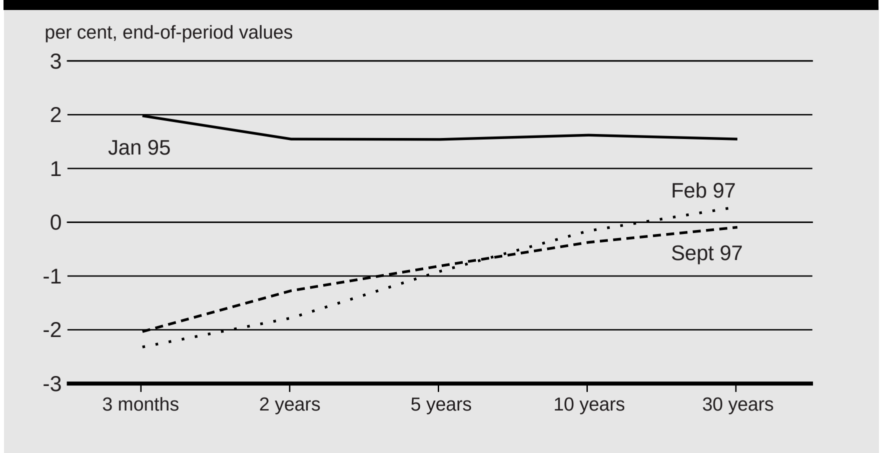
Chart 2.1 Canadian and U.S. three-month Treasury bill rates



Long-term Canadian interest rates have also fallen below U.S. rates. The rate on 10-year bonds has generally been below that in the U.S. since last fall and rates on 30-year bonds are now slightly below those in the U.S. (Chart 2.2).

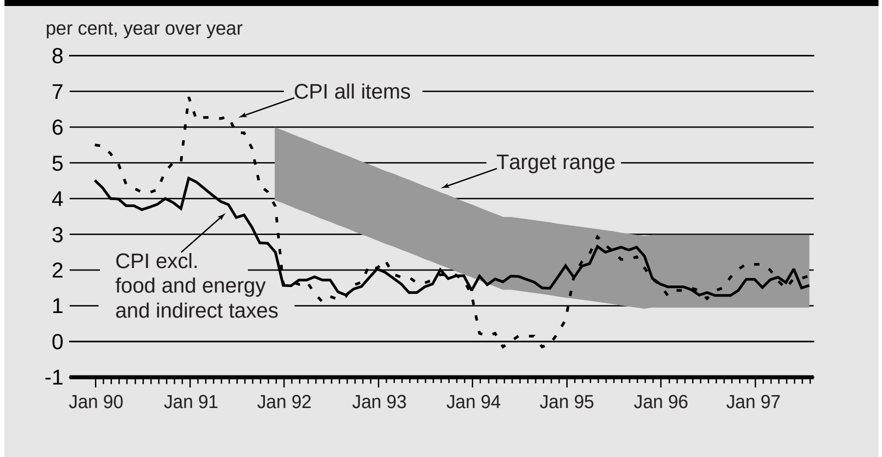
The current favourable interest rate environment would not have been possible without the substantial improvement in public finances. At the same time, Canada's commitment to low inflation – clearly demonstrated by the 1- to 3-per-cent inflation range established jointly by the government and the Bank of Canada – has also been important in supporting this improved financial environment. The range assures all investors that the government and the Bank of Canada are committed to containing cost and price pressures as the expansion continues. Consumer price inflation,

Chart 2.2 Canada-U.S. yield curve spreads



excluding the effects of changes in food and energy prices, has remained at or below the mid-point of the current range for the past 21 consecutive months (Chart 2.3).

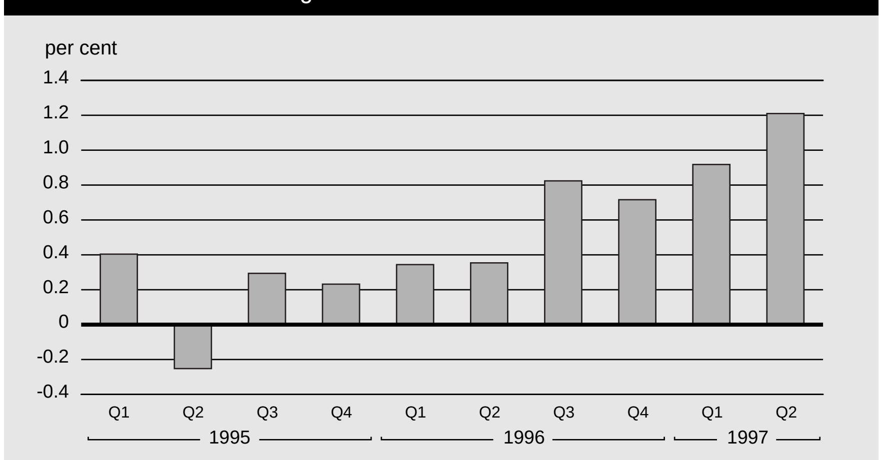
Chart 2.3 CPI inflation



The Payoff: Stronger Growth and Job Creation

There is little question that economic prospects have improved considerably over the past year. The economy has grown at an average annual rate of 3.7 per cent over the four quarters to mid-1997. And the pace of economic activity has been accelerating over this period, as real gross domestic product (GDP) was up 1.2 per cent (an annual growth rate of 4.9 per cent) in the second quarter (Chart 2.4).

Chart 2.4 Real GDP growth



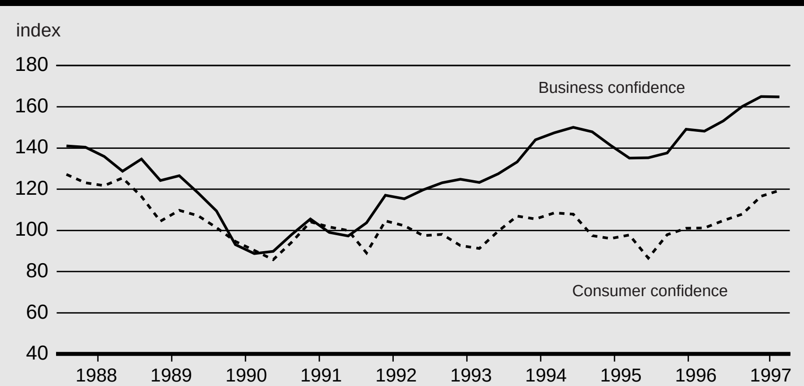
The stronger growth that has been recorded over the past four quarters reflects the effect of significant interest rate declines from the peaks reached in 1995. Looking ahead, the further interest rate declines in the fall of 1996 provide a sound base for continuing growth through 1998. The declines in long-term interest rates are particularly significant, both because they show that financial markets expect short-term interest rates to remain at low levels for some time, and because many firms finance their capital investment at long-term rates.

… the further interest rate declines of last fall provide a sound base for continuing growth through 1998.

Low interest rates and the successes achieved by the federal and provincial governments toward putting their fiscal houses in order have translated concretely into improved household and business confidence. Consumer confidence, as measured by the Conference Board of Canada, has improved markedly in recent months, and stands at its highest level in eight-and-a-half years, while business confidence remained at the highest level on record (Chart 2.5). It should not be surprising in this environment that sales of durable consumer goods have been very strong in recent months. There are also clear signs of strength in the housing sector, with housing starts in the first eight months of 1997 up 24 per cent over the same period last year. And real business investment in machinery and equipment surged in the second half of 1996 and the first half of 1997, rising by 25 per cent.

There is also evidence that the strong business investment performance witnessed in recent months will continue and become more broadly based. The July Survey of Public and Private Investment Intentions indicates that firms expect to increase their investment by some 14 per cent in 1997, a

Chart 2.5 Consumer and business confidence



Source: Conference Board of Canada.

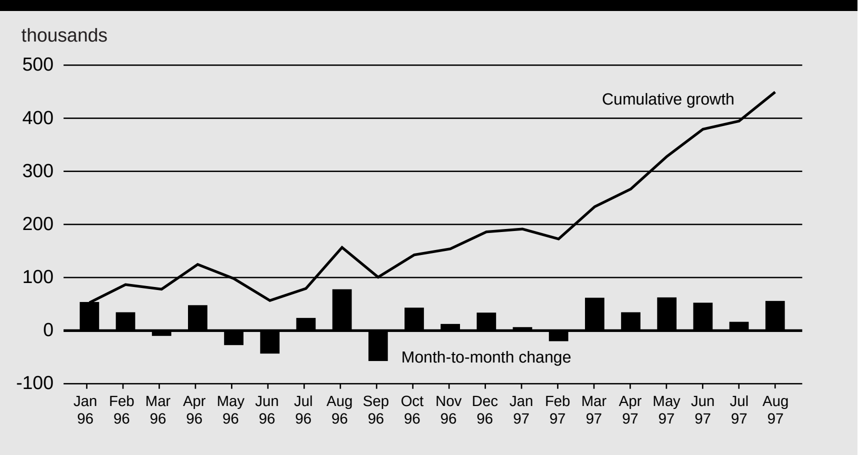
marked upward revision from their intentions only six months earlier. Moreover, the survey suggests that investment spending will broaden from machinery and equipment, much of which is imported, to non-residential construction, which has much more of a direct impact on domestic activity and job creation. Evidence of this trend emerged in the second quarter.

Another positive development is the trend improvement in the current account which, in late 1995, posted its first surplus in 11 years. This decline in Canada's reliance on foreign savings resulted from sharply reduced borrowing by federal and provincial governments. A corresponding decline has emerged since 1993 in Canada's net foreign debt as a share of GDP, from 45.4 per cent in 1993 to 41.7 per cent in 1996. Although the current account has moved back into a modest deficit position in the last several quarters, these recent deficits are well below those of the early 1990s. Moreover, one of the main factors behind the re-emergence of small current account deficits is a surge in investment spending that is boosting the Canadian economy's long-run growth and export potential.

Strong growth is creating employment opportunities for Canadians across the country.

Strong growth is creating employment opportunities for Canadians across the country. This has always been the ultimate goal of the government's economic strategy, which is now coming to fruition. Employment growth began to strengthen in the second half of 1996, when 130,000 jobs were created. Job creation has continued to strengthen since the end of last year, with employment having increased for six consecutive months through August (Chart 2.6). Indeed, during the first eight months of this year, 263,000 new jobs were created, all of them in the private sector and

Chart 2.6 Employment growth



most of them full-time positions. The economy is well placed to exceed the threshold of the 300,000 new jobs figure that many economists had forecast for this year at the time of the budget. Also encouraging is the clear evidence that Canada's youth are sharing in this strong job creation: 52,000 of the 121,000 jobs created over the May to August period have been filled by young people. Most important of all, the strong employment growth witnessed in recent months has the potential to generate a "virtuous circle" in which higher household incomes and improved confidence lead to stronger consumer spending, higher growth and even stronger job creation.

The Near-Term Outlook

These positive domestic developments have led private sector forecasters to expect strong growth in both 1997 and 1998. While much of this reflects the payoff from good Canadian economic policy, it also reflects an international environment that is supportive of growth in Canada.

The External Environment

The economic environments in both the United States and the major overseas economies are expected to remain conducive to growth and job creation in Canada, although there are risks that need to be taken into consideration in our fiscal planning.

The United States

Developments in the U.S. economy demonstrate clearly that strong and steady growth with low unemployment can be achieved together with stable inflation. At the same time, a major policy debate is underway in the U.S. with respect to the near-term prospects for the economy. Over the past year, the U.S. economy has expanded at a robust pace that some analysts believe may have pushed the economy beyond its maximum sustainable output. Other analysts, in contrast, believe that potential output growth has in fact increased in the U.S. economy as a result of sustained capital expansion, particularly in information technologies. They argue that the application of new technologies may have unleashed productivity improvements that have raised the productive capacity of the economy, or will soon raise it as firms become more adept with that technology. They also contend that the development *and* adoption of information technology in recent years has made physical capital more flexible than it once was, enabling firms to adapt more quickly than in the past to shifting demands.

These effects are believed to be assuming greater importance. But the available evidence on their impact on the overall economy is inconclusive. And, while the nature of capital may be changing, the economy can still face capacity constraints in labour markets that could put upward pressure on wages and, ultimately, prices.

The most likely development in the view of most private sector economists is for the U.S. economy to grow at a more moderate pace in the quarters ahead (Table 2.1). Indeed, growth slowed somewhat in the second quarter (albeit to a still-strong 3.3 per cent). The appreciation of the U.S. dollar over the last several quarters is expected to help ensure that growth moderates further and, thus, that inflation pressures stay contained. There is, nonetheless, an expectation that short-term interest rates could rise in the coming months.

Table 2.1
U.S. economic outlook – private sector consensus

	1996	1997	1998
		(per cent)	
Real GDP	2.8	3.6	2.4
CPI	3.0	2.5	2.7
3-month Treasury bill rate	5.1	5.2	5.4
10-year government bond rate	6.4	6.5	6.4

Source: *Blue-Chip Economic Indicators*, September 10, 1997. This is a survey of approximately 50 private sector forecasters of the U.S. economy.

Major Overseas Economies

Private sector forecasters expect that growth in the major overseas economies will strengthen modestly in 1997 and into 1998. One of the most positive factors shaping the economic situation in these countries is the virtual absence of inflationary pressures. This provides monetary authorities considerable scope to maintain interest rates at their present accommodative levels, a stance that supports both growth and deficit reduction.

But there are risks to this outlook. Concerns have emerged that the moderate economic recovery underway in Japan may be curtailed if domestic demand fails to strengthen. In Europe, unemployment remains high and there is considerable uncertainty about prospects for domestic demand and sustained growth.

Private Sector Assessment of the Economic Outlook for Canada

Canadian private sector forecasters have become more optimistic since the 1997 budget, significantly revising upwards their forecasts for growth in both 1997 and 1998. The consensus among private sector forecasters surveyed by the Department of Finance is that the Canadian economy will grow by 3.7 per cent in both 1997 and 1998. Prior to the 1997 budget, these forecasters expected 3.3 per cent growth for 1997 and only 2.9 per cent growth for 1998 (Table 2.2).

Canadian forecasters have become more optimistic since the 1997 budget.

Other aspects of the private sector consensus have changed little from the very positive outlook prevailing at the beginning of the year. Short-term interest rates are expected to remain very low by historical standards, although private sector forecasters now expect rates to rise by somewhat more in 1998, reflecting in part, expectations of higher interest rates in the U.S. The higher interest rates expected by private sector forecasters in 1998 also reflect their view that interest rates will rise as the economy nears its productive potential. Forecasters also expect strong growth will fuel job creation sufficient to reduce further the unemployment rate over the course of 1998.

Strong growth will fuel job creation sufficient to reduce Canada's high unemployment rate.

Major international organizations share this very favourable assessment of Canada's growth prospects. The most recent forecasts by the IMF and the OECD project that Canada's economy will achieve the strongest economic growth in the Group of Seven (G-7) countries on average over the 1997 to 1998 period.

Table 2.2
Evolution of private sector forecast survey results

	1996*	1997	1998
Real GDP growth (%)			
February 1997	1.5	3.3	2.9
September 1997	1.5	3.7	3.7
Nominal GDP growth (%)			
February 1997	2.8	4.9	4.7
September 1997	2.8	4.7	5.2
Nominal GDP ($ billion)			
February 1997	798	837	876
September 1997	798	835	879
CPI inflation (%)			
February 1997	1.6	1.6	1.8
September 1997	1.6	1.8	2.0
Unemployment rate (%)			
February 1997	9.7	9.3	8.8
September 1997	9.7	9.2	8.6
Employment growth (%)			
February 1997	1.3	2.0	2.0
September 1997	1.3	2.0	2.4
3-month Treasury bill rate (%)			
February 1997	4.2	3.2	3.7
September 1997	4.2	3.2	4.1
10-year govt. bond yield (%)			
February 1997	7.2	6.6	6.6
September 1997	7.2	6.3	6.3

*1996 values are actual data.

Prudent Assumptions for Fiscal Planning

The prudence factors for fiscal planning adopted at the time of the 1997 budget were for short-term interest rates 80 basis points higher than the private sector average in 1997 and 1998, and long-term rates 50 basis points higher than forecast by the private sector.

The choice of these prudence factors reflected two main considerations:

- With the U.S. economy generally considered to be operating at its productive capacity, there was a risk that stronger-than-expected economic growth or signs that upward pressure on inflation was materializing, could lead the U.S. Federal Reserve to raise interest rates by more than expected. This could then spill over into Canada.

- The smaller prudence factor applied to long-term interest rates reflected the unusually steep slope of the Canadian yield curve. As long-term interest rates were already high compared to short-term rates, the view was that they might not rise commensurately with any future increase in short rates.

An issue to be addressed in the months ahead is what economic assumptions to use for the 1998 budget. These assumptions should reflect the consensus view of private sector forecasters for 1998 and 1999 with appropriate prudence factors applied in light of the perceived risks.

3

Maintaining a Healthy Fiscal Climate: Eliminating the Deficit

Highlights

- Deficit for 1996-97 at $8.9 billion: smallest deficit since 1976-77 and down $19.7 billion from 1995-96.
- Budget to be balanced no later than 1998-99.
- Financial requirements eliminated in 1996-97 – in other countries, including the United States, this would be a balanced budget.
- Net public debt-to-GDP ratio declined to 73.1 per cent in 1996-97 – the first meaningful decline since 1974-75.

Restoring health to the nation's finances has been a key element of the government's strategy to build a stronger economy and create jobs for Canadians. This chapter reviews the progress achieved to date in restoring fiscal health and highlights the challenges that remain.

- It reviews the fiscal progress made since 1993-94 and the major factors contributing to the decline in the deficit over the 1993-94 to 1996-97 period.
- It compares the deficit outcome for 1996-97 to the February 1997 budget estimate.
- It puts Canada's progress in restoring fiscal health in the international context.

■ It sets out the fiscal guidelines that the government will follow in planning future budgets.

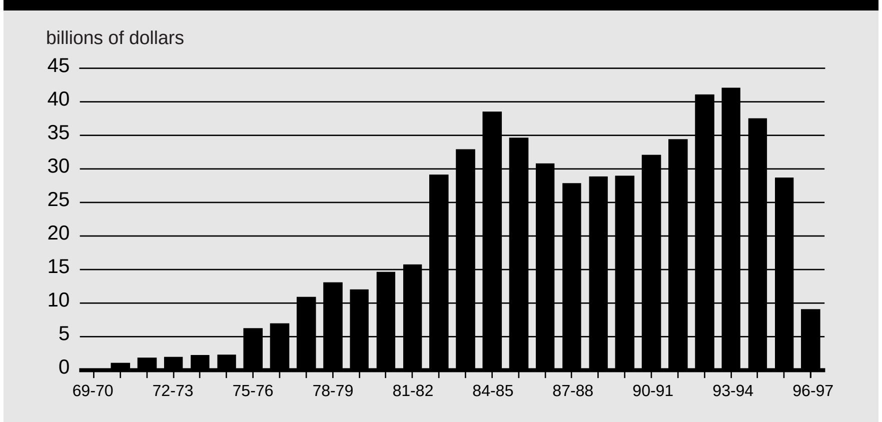
■ It highlights the need to ensure that the debt-to-GDP ratio is put on a permanent downward track.

Deficit Reduction Since 1993-94

The 1996-97 deficit was $8.9 billion, the smallest deficit recorded since 1976-77.

The 1996-97 deficit was $8.9 billion – the smallest deficit recorded since 1976-77 (Chart 3.1). The deficit was down $19.7 billion from 1995-96 – the largest one-year change in the budget balance. Relative to the size of the economy, the deficit was 1.1 per cent of gross domestic product (GDP) – the lowest level since 1970-71.

Chart 3.1 Budgetary deficit



This decline was attributable to:

■ the impact of restraint measures introduced in the 1994 and 1995 budgets, primarily affecting federal program spending;

■ the impact of economic growth; and

■ the effect of major one-time factors affecting budgetary revenues.

Detailed information on the 1996-97 outcome is provided in the *Annual Financial Report of the Government of Canada – Fiscal Year 1996-97*.

This section provides an overview of the major factors responsible for the unprecedented turnaround in the federal government's fiscal position since 1993-94.

In 1993-94, the deficit was $42.0 billion, or 5.9 per cent of GDP. Since the 1981-1982 recession, the deficit had never been lower than $27.8 billion. Without fiscal action, the debt dynamic in place in the early 1990s meant that the deficit would have remained stuck at a very high level. The continued uncertainty about Canada's financial future that would have ensued would have seriously eroded the economy's growth potential and put in jeopardy the sustainability of Canada's most valued programs.

The government's strategy for achieving its fiscal objectives was based on two-year rolling deficit targets, backed by prudent economic planning assumptions and a sizeable Contingency Reserve. However, deficit reduction was not viewed as an end in itself. The pursuit of deficit reduction at any cost would have had an unduly negative impact on the economy and Canadians. Moreover, economic growth is an essential element of fiscal health. As such, the government has pursued its fiscal strategy in a balanced and sustained manner, recognizing the need to address critical economic and social concerns.

The government has pursued its fiscal strategy in a balanced and sustained manner …

The deficit targets set for each of the last three years have been bettered.

- The target for 1994-95 was $39.7 billion – the final outcome was $37.5 billion.
- The target for 1995-96 was $32.7 billion – the final outcome was $28.6 billion.
- The target for 1996-97 was $24.3 billion – the final outcome was $8.9 billion.

Since 1993-94, the deficit has been reduced by $33.1 billion, from $42.0 billion to $8.9 billion (Table 3.1). This reduction in the deficit has been due to higher budgetary revenues, primarily from a growing economy, and a reduction in program spending, largely as a result of the restraint measures introduced in the 1994 and 1995 budgets.

Since 1993-94, the deficit has been reduced by $33.1 billion …

Table 3.1
Evolution of fiscal situation since 1993-94

	1993-94	1994-95	1995-96	1996-97	Change 1993-94 – 1996-97
			(billions of dollars)		
Budgetary revenues					
Personal income tax	51.4	56.3	60.2	63.3	11.9
Corporate income tax	9.4	11.6	16.0	17.0	7.6
EI premiums	18.2	18.9	18.5	19.8	1.6
GST	15.7	16.8	16.4	18.1	2.4
Other excise and sales tax	10.9	10.3	10.2	11.0	0.1
Other revenues	10.4	9.4	9.0	11.7	1.3
Total	116.0	123.3	130.3	140.9	24.9
Program spending					
Major transfers to persons	37.5	35.3	34.5	34.0	-3.5
Major cash transfers: other levels of government					
CHST	18.6	19.2	18.6	14.8	-3.8
Fiscal arrangements	10.5	9.3	9.8	9.8	-0.7
Alternative Payments for Standing Programs	-1.8	-1.8	-1.9	-2.0	-0.3
Total	27.4	26.7	26.5	22.6	-4.8
Reference:					
Total entitlements	37.4	38.2	38.7	35.7	-1.7
CHST entitlements	29.0	29.3	29.6	26.9	-2.1
Direct program spending	55.2	56.7	51.0	48.2	-6.9
Total	120.0	118.7	112.0	104.8	-15.2
Public debt charges	38.0	42.0	46.9	45.0	7.0
Deficit	-42.0	-37.5	-28.6	-8.9	33.1

One-time revenue factors contributed $5.6 billion to deficit cut.

Between 1993-94 and 1996-97, budgetary revenues increased $24.9 billion. Of this increase, $5.6 billion was attributable to one-time factors. Budgetary revenues were depressed in 1993-94 due to transitional costs associated with the introduction of the child tax benefit ($1.2 billion) and the faster processing of personal income tax returns resulting in higher refunds ($1.2 billion). In contrast, one-time factors inflated budgetary revenues by $3.2 billion in 1996-97. This was attributable to the sale of the Air Navigation System ($1.5 billion), the change in remittance procedures for employment insurance (EI) premium revenues ($1 billion) and the reclassification of the air transport tax from program spending to budgetary revenues ($0.7 billion). Prior to April 1996, receipts from the air transport tax were netted against the costs of running airports and, therefore, program spending. With the sale of the Air Navigation System, these receipts were classified as part of budgetary revenues, effective April 1996. Since this reclassification affects both revenues and program spending, the deficit is unaffected by this change.

About $2.6 billion of the increase in budgetary revenues between 1993-94 and 1996-97 was attributable to the net impact of revenue-raising measures introduced since 1993. These measures were primarily designed to increase the fairness of the tax system and to remove or reduce a number of tax preferences. Over this time period, there were no increases in personal income tax rates.

Table 3.2
Tax measures from 1994 to 1996

	1994-95	1995-96	1996-97
	(billions of dollars)		
Tightening measures			
Eliminate $100,000 capital gains exemption	0.0	0.4	0.3
Extend taxation of employer-provided life insurance benefits	0.1	0.2	0.2
Income test the age credit	0.0	0.2	0.3
Reduce deduction for business meals and entertainment expenses	0.2	0.2	0.3
Eliminate deferral of tax on business income			0.2
Action plan against smuggling	-0.4	0.0	0.2
Other	1.0	0.9	0.6
Total	0.9	1.9	2.1
Rate increases			
Large corporation tax		0.2	0.2
Corporate surtax		0.1	0.1
Temporary capital tax increase for large deposit-taking institutions		0.1	0.1
Gasoline excise tax		0.5	0.5
Other	-0.1	-0.4	-0.4
Subtotal	-0.1	0.5	0.5
Total	0.8	2.4	2.6

The remainder, $16.7 billion, was attributable to economic growth. Between 1993 and 1996, nominal income (the overall tax base for budgetary revenues) increased by about $85 billion. As the economy expands, more people work and pay income taxes; increased consumer spending generates more sales tax revenues; while higher corporate profits result in higher corporate income tax collections.

Program spending has declined by $15.2 billion …

Since 1993-94, program spending has declined by $15.2 billion, from $120.0 billion to $104.8 billion. This reduction primarily reflects the impact of the restraint measures introduced in the 1994 and 1995 budgets. These included the Program Review measures to restructure direct program spending, reforms to the employment insurance program, and the restructuring of the major transfers to other levels of government.

Among the major components of program spending, major transfers to persons declined by $3.5 billion. Employment insurance benefits were down $5.2 billion, but this was partially offset by an increase in elderly benefits of $1.7 billion. The decline in employment insurance benefits reflected the impact of the reform measures introduced in the 1994 budget and in December 1995, together with improvements in the labour market.

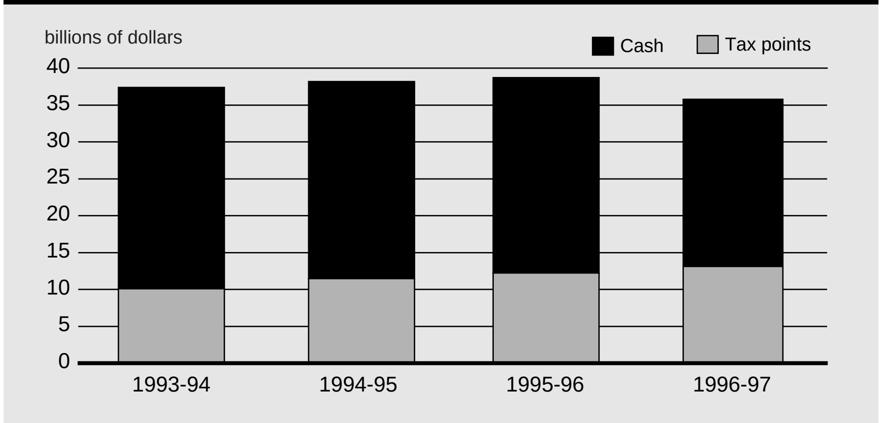
The most appropriate measure of federal transfers to other levels of government is not cash transfers but total entitlements.

Major cash transfers to other levels of government were $4.8 billion lower in 1996-97 than in 1993-94. However, this overstates the net impact on the finances of other levels of government. The most appropriate measure of federal transfers to other levels of governments is not cash transfers but total entitlements. Total entitlements consist not only of cash transfers but also tax point transfers. The tax point transfer represents the value of the "tax room" which the federal government has made available to provincial governments, by reducing federal tax rates so that provinces can increase their tax rates by an equivalent amount, with no impact on the taxpayer.

The value of these tax point transfers fluctuates with changes in the applicable tax bases – personal and corporate income taxes. As these taxes increase due to the growth in the economy, the value of the tax point transfer also increases. Therefore, even with no change in entitlements, cash transfers would decline as the value of the tax point transfers grows.

Total entitlements, including both cash and tax point transfers, declined from $37.4 billion to $35.7 billion, a decrease of $1.7 billion, substantially less than the $4.8 billion decline in cash transfers (Chart 3.2). This difference reflects the growth in the value of tax point transfers and the inclusion of one-time liabilities in 1993-94 under the stabilization program related to the 1990-1991 recession.

Chart 3.2 Transfers to other levels of government



Transfers to other levels of government …

Cash transfers under the Canada Health and Social Transfer (CHST) were down $3.8 billion. However, only $2.1 billion was due to the reduction in entitlements. The remainder of the decline was attributable to the effect of growing tax bases on the value of the CHST tax point transfer ($1.6 billion) and recoveries related to overpayments made in previous years ($0.1 billion).

Fiscal arrangements, consisting of Equalization, transfers to the territories, stabilization and other smaller statutory transfers, declined $0.7 billion over the period. Liabilities of $1.5 billion were incurred in 1993-94 under the stabilization program, due to the impact of the 1990-1991 recession on provincial revenues. This program provides compensation if economic conditions caused a province's revenues to decline from one year to the next. No such liabilities have been incurred since that time. In addition, as part of Program Review, the Public Utilities Income Tax Transfer was eliminated, resulting in a net saving of $0.2 billion between 1993-94 and 1996-97.

Equalization cash transfers increased by $1 billion between 1993-94 and 1996-97 …

Equalization cash transfers increased by $1 billion between the 1993-94 to 1996-97 period, while transfers to the territories were up $0.1 billion. The Fiscal Equalization Program provides unconditional transfers that enable less well-off provinces to provide their citizens with reasonably comparable levels of public services at reasonably comparable levels of taxation relative to the national standard.

Table 3.3
Source of change in cash transfers to other levels of government: 1993-94 to 1996-97

	(billions of dollars)
Change in cash transfers	-4.8
Of which:	
CHST entitlements	-2.1
CHST cash due to higher value of tax points	-1.7
Elimination of PUITTA	-0.2
Stabilization liabilities	-1.5
Equalization	1.0
Other	-0.3

Direct program spending declined $6.9 billion.

Direct program spending – that is, total program spending excluding major transfers to persons and to other levels of government – declined $6.9 billion between 1993-94 and 1996-97. This understates the underlying decline ($7.6 billion) as, prior to 1996-97, the air transport tax was netted against program spending.

The decline in direct program spending was attributable to the reform of federal departmental programs.

The decline in direct program spending was attributable to the reform of federal departmental programs. In the February 1994 budget, restraint measures were introduced which significantly reduced defence spending, extended the federal public sector wage freeze and reduced transfer payments. In the February 1995 budget, the government announced the results of Program Review – a comprehensive examination of federal departmental spending. The actions taken resulted in a major decline ($5.7 billion) in this component in 1995-96, one year earlier than the decline in transfers to other levels of government, with a further $2.8 billion decline in 1996-97.

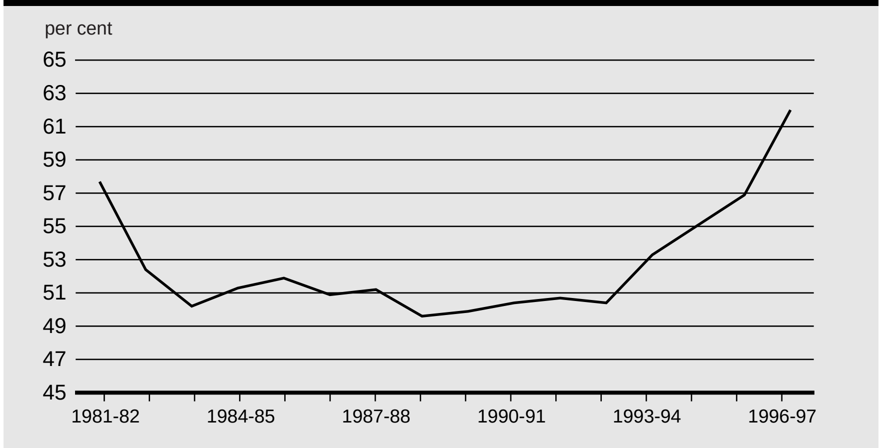
In contrast, public debt charges increased $7 billion over the 1993-94 to 1996-97 period. This increase reflected both the effect of higher average effective interest rates on the stock of the government's debt and increases in that stock due to the deficits that occurred over the entire time period.

Reforms to the structure of the debt stock have reduced the sensitivity of public debt charges to changes in interest rates.

Just as structural changes to program spending have reduced the deficit, reforms to the structure of the debt stock have reduced the sensitivity of public debt charges to changes in interest rates. The reduction in interest rate risk exposure has been a central feature of the government's debt strategy. In 1992-93, half the debt was at fixed rates (one-year maturities and over). By 1995, this proportion had increased to about 55 per cent (Chart 3.3). In that year, the government set a medium-term target of increasing its fixed-rate debt to 65 per cent of the total. With the much lower-than-expected borrowing requirements in 1996-97 and to date in 1997-98, that target has been met. As a result, the government has gained an additional margin of prudence through which it can better manage adverse interest rate developments. For example, a 100-basis-point increase in interest rates would now raise debt by $1 billion in the first year. In the 1995 budget, the first year impact of a 100-basis-point increase was estimated at $1.8 billion.

The government and market participants have undertaken a number of initiatives in recent years to improve the efficiency of the domestic bond markets. As a result, Canada has one of the most efficient bond markets in the world and this has helped reduce the government's debt servicing costs.

Chart 3.3 Fixed-rate share of total debt, 1981-82 to 1996-97



In conclusion, the growth in revenues over the 1993-94 to 1996-97 period was largely attributable to a growing economy. The decline in program spending reflected the combined impacts of the restraint measures and a growing economy.

Deficit Significantly Below Target

The original deficit target for 1996-97, as set out in the March 1996 budget, was 3 per cent of GDP, or $24.3 billion.

In the February 1997 budget, the government indicated that the deficit outcome for 1996-97 would be no higher than $19 billion. This downward revision of $5.3 billion, primarily reflected the impact of the one-time measures (sale of the Air Navigation System and the acceleration of EI premium revenues) and the fact that the Contingency Reserve of $2.5 billion, included in the March 1996 budget deficit target of $24.3 billion, was not needed. The government has committed not to use the Contingency Reserve to finance new policy initiatives; if it is not needed to offset the impact of adverse economic developments, it goes to reduce the deficit.

The final deficit of $8.9 billion was $10.1 billion below the February 1997 budget estimate of $19 billion (Table 3.4). Of this difference:

- budgetary revenues were $5.4 billion higher;
- program spending was $4.2 billion lower; and
- public debt charges were $0.5 billion lower.

All components of budgetary revenues were higher with the exception of personal income tax collections. Corporate and other income tax collections, primarily non-resident withholding taxes, were $1.9 billion higher than estimated in the 1997 budget. About 30 per cent of corporate income tax collections for the year as a whole are received in February and March, reflecting the settlement period for most large corporations. This makes estimating the results for the year as a whole extremely difficult. As corporate profits were relatively unchanged in 1996 from 1995, relatively weak settlement period collections were expected. However, settlement period collections were much stronger than expected, reflecting a different distribution of profits among industries, together with the effect of different effective tax rates paid by those industries. Goods and services tax (GST) collections were $1.2 billion higher, as collections were extremely strong in the final quarter of 1996-97, reflecting the strength in consumer demand. Non-tax revenues were up $1.2 billion, primarily reflecting end-of-year accounting adjustments.

Table 3.4
Changes since February 1997 budget

	(billions of dollars)
February 1997 budget deficit target	19.0
Budgetary revenues	-5.4
Personal income tax	0.0
Corporate and other income tax	-1.9
EI premiums	-0.2
GST	-1.2
Other excise and sales taxes	-0.9
Other revenue	-1.2
Program spending	-4.2
Major transfers to persons	-0.7
Major transfers to other levels of government	0.0
Direct program spending	-3.4
Public debt charges	-0.5
1996-97 outcome	8.9

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

Most of the lower program spending (down $4.2 billion) was attributable to much lower direct program spending (down $3.4 billion), primarily attributable to lower-than-expected end-of-year accounting adjustments. Changes in operating procedures in recent years have permitted departments to carry forward a portion of unused but committed funding, thereby providing more cost-effective management of resources and reducing the previous incentive to end-of-year spending. In addition, accounting adjustments at year-end to recognize liabilities incurred by departments and Crown corporations were much lower than in previous years. Transfers to persons were $0.7 billion lower, primarily reflecting lower-than-expected employment insurance benefit payments.

As reported in the March 1997 *Fiscal Monitor*, the deficit for the April 1996 to March 1997 period was $9.6 billion. These results did not include the regular end-of-year accounting adjustments. Consistent with government accounting principles, these end-of-year accounting adjustments largely reflect increases to program spending to include the costs of liabilities incurred during the fiscal year for which no payments were made during the year. Some adjustments are also made to budgetary revenues, primarily reflecting cash-in-transit at year-end.

These end-of-year accounting adjustments have traditionally resulted in large deficits. Since 1988-89, there has only been one year (1991-92) in which these adjustments amounted to less than $4 billion. In other years, they have ranged between $4 billion and $6½ billion. Based on these results, it was indicated in the March 1997 *Fiscal Monitor* that the final deficit for 1996-97 would be no higher than $16 billion.

However, the end-of-year accounting adjustments resulted in a surplus of $0.7 billion. Revenues (primarily non-tax revenues) in the end-of-year period were significantly higher than in previous years, while program spending adjustments (especially those affecting direct program spending) were considerably lower.

Financial Requirements Eliminated

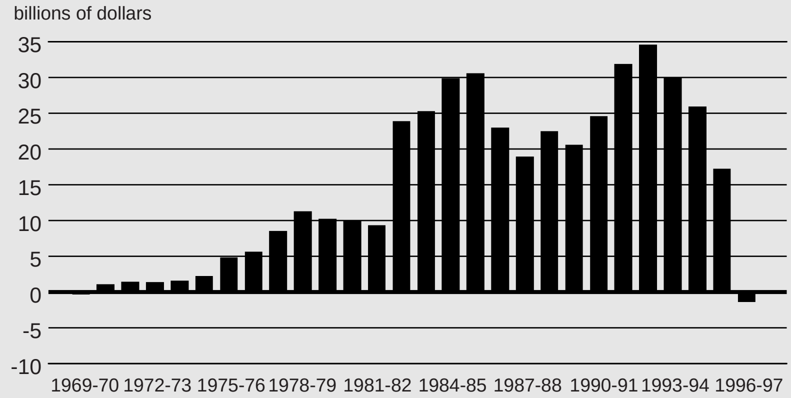
The budgetary deficit includes liabilities incurred during the fiscal year for which no cash payment was made during the course of the year. It is the most comprehensive measure of the government's financial situation.

Another measure of the government's financial performance is financial requirements. It is the difference between cash coming in to the government and cash going out. Financial requirements are usually less than the deficit as the former includes funds from internally held accounts, such as the federal employee pension accounts. Financial requirements closely approximate the amount of money that the government has to borrow in the private credit markets to finance its current operating activities. Excluding the net requirement relating to the Exchange Fund Account, there was a net financial surplus of $1.3 billion. This was the first financial surplus since 1969-70 (Chart 3.4).

There was a net requirement by the Exchange Fund Account of $7.8 billion, primarily reflecting the 1996 budget announcement to increase Canada's official reserves because of the increased flows and potential volatility in foreign exchange markets, and to bring these reserves more in line with those in other countries.

The prime objective of the Exchange Fund Account is to promote orderly conditions in the foreign exchange market for the Canadian dollar. Although the Account is consolidated within the government's financial statements, the activities of the Account are not reflective of the government's underlying financial position.

Chart 3.4 Financial requirements/surplus



As a result, total financial requirements, including the transactions of the Exchange Fund Account, amounted to $6.5 billion, down from a net requirement of $21.9 billion in 1995-96.

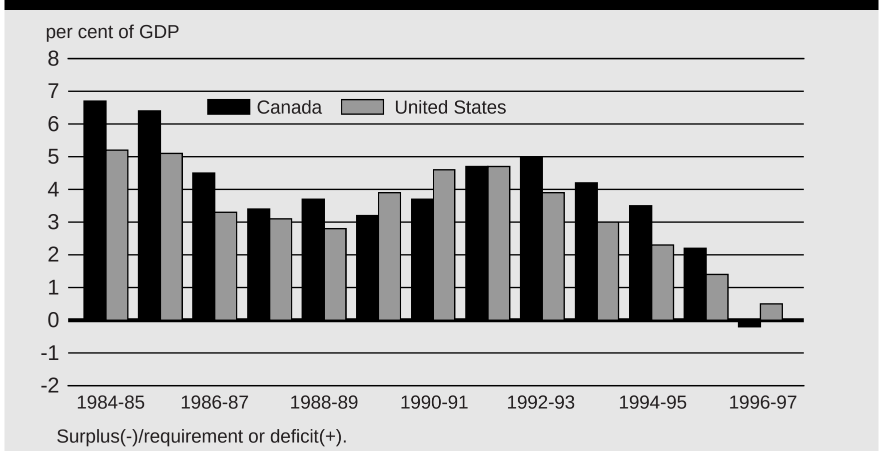
A financial surplus can be used to retire some of the government's marketable debt and/or increase cash balances. The government's net public debt stood at $583.2 billion at the end of fiscal year 1996-97. Of this amount, $476.9 billion consisted of unmatured debt issued by the federal government largely in the form of marketable bonds, Treasury bills and Canada Savings Bonds. Most of the rest was in the form of non-market liabilities related to federal employee pension accounts.

In 1996-97, the financial surplus, excluding the Exchange Fund Account, was primarily used to retire some marketable debt and to increase cash balances, to ensure that the government had sufficient cash to manage its operations in the first few months of 1997-98.

In the first five months of 1997-98 (April to August), the government retired $11.0 billion of its marketable debt, primarily Treasury bills. This retirement of marketable debt resulted from a reduction in cash balances of $5.7 billion, a net change in Exchange Fund Account transactions of $3.9 billion and a financial surplus, excluding exchange fund transactions, of $1.5 billion. Cash balances can exhibit wide fluctuations, especially at the beginning and end of each fiscal year. However, with the improvement in the overall budgetary situation, the government should be in a position in the future to continue to retire its marketable debt – a major milestone in Canada's fiscal recovery.

Most industrialized countries present their budgets on a basis that is more comparable to financial requirements than to the public accounts measure of the budgetary deficit. For example, the Unified Budget Balance for the United States' federal government is broadly comparable to financial requirements. Whereas there was a financial surplus of $1.3 billion in 1996-97 for Canada, in the U.S. the deficit is estimated to be $37 billion (0.5 per cent of GDP) by the Office of Management and Budget (Chart 3.5).

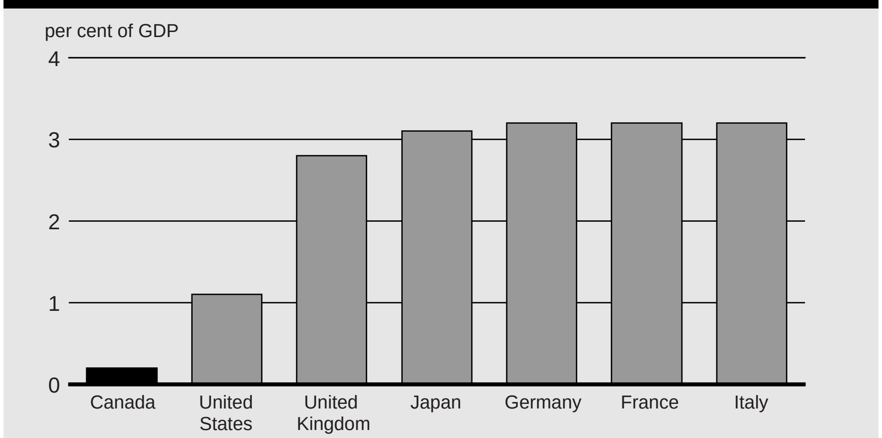
Chart 3.5 Canadian financial requirements / surplus and U.S. deficit



The federal government's main fiscal measure – the public accounts deficit – is not only the most comprehensive but is also more strict than the financial requirements measures adopted by other countries. This means that Canada's fiscal performance on a public accounts basis is not strictly comparable to that in other countries. In addition, international fiscal comparisons are complicated by the fact that fiscal responsibilities of each country can be shared differently among the various levels of government. It is for these reasons that national accounts data for the total government sector (federal, provincial-local-hospital, and the Canada and Quebec pension plans) are often used for international fiscal comparisons, as these data are broadly consistent across countries. These are the data used by international organizations, such as the Organization for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF), when presenting and commenting on international fiscal developments.

In its June 1997 Economic Outlook, the OECD estimated that Canada will have the best fiscal performance in 1997 among all Group of Seven (G-7) countries (Chart 3.6). This stands in sharp contrast to the situation in 1992, when Canada's total government deficit stood at 7.4 per cent of GDP, almost double the G-7 average of 4.0 per cent and the second highest in the G-7.

Chart 3.6 Total government deficit in G-7 countries – 1997



Fiscal Guidelines and Ongoing Challenges

Since first coming to office in 1993, the government's ultimate fiscal objective has been to restore fiscal health by balancing the budget. As an interim step to this objective, it set as a target the reduction of the deficit to 3 per cent of GDP by 1996-97. Implicit in this objective was the need to halt the rise in the debt-to-GDP ratio and to put it on a permanent downward track.

The better-than-expected outcome for 1996-97, together with the financial results for the first five months of 1997-98 (see *Fiscal Monitor* for August 1997), clearly indicate that the deficit will continue to decline in 1997-98. The government is now committed to the achievement of a balanced budget no later than 1998-99. Updated projections for 1997-98 and 1998-99 will be provided in the 1998 budget.

With a commitment to a balanced budget no later than 1998-99, deficit reduction targets are no longer relevant. However, the government remains committed to the pursuit of sound public finances as a basis for sustained economic growth. To this end, the government will continue to adhere to the fiscal guidelines that have proven to be so successful to date:

- budget planning will continue to be based on prudent economic assumptions; and
- budget projections will continue to include a sizeable Contingency Reserve.

A two-year planning horizon will continue to be used but these projections will be presented in the annual budget.

The Contingency Reserve

The Contingency Reserve is included in the deficit projections primarily to cover risks arising from (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. The Contingency Reserve 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. In the past, any portion of the Contingency Reserve that was not required was applied to the deficit. In the future, once the budget is balanced, if it is not required for the purposes stated above, it will be used to pay down the debt of the federal government.

The better-than-expected deficit outcome for 1996-97 means the government has now reached another important milestone in its efforts to improve Canada's financial position. The federal government's net debt burden – the level of net debt relative to the size of the economy – fell to 73.1 per cent from 74 per cent in 1995-96. This marks the first significant reversal after 25 years of virtually uninterrupted increases in the debt ratio.

The fiscal challenge for Canada remains the reduction in the debt-to-GDP ratio.

These fiscal guidelines and the commitment that the budget will be balanced no later than 1998-99 will ensure that the decline in the debt-to-GDP ratio that is now underway continues. This remains the central fiscal challenge for Canada. While declining, the burden of the debt on the economy will remain high for some time, both by historical Canadian and by international standards (Charts 3.7 and 3.8).

Chart 3.7 Federal government net debt (public accounts basis)

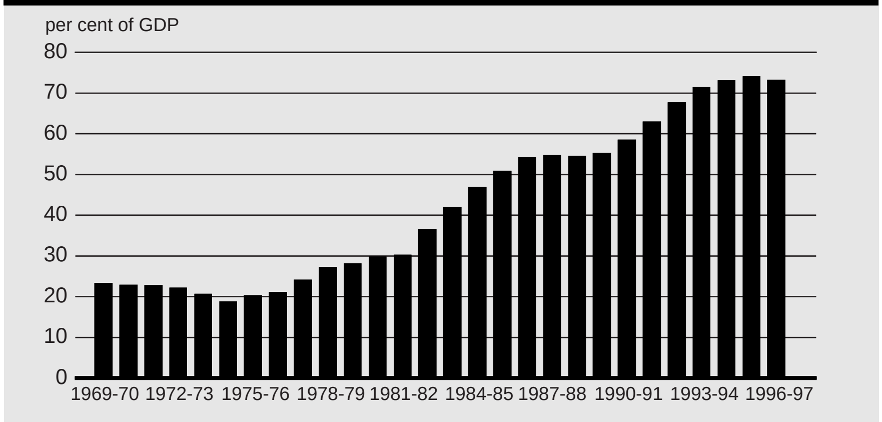
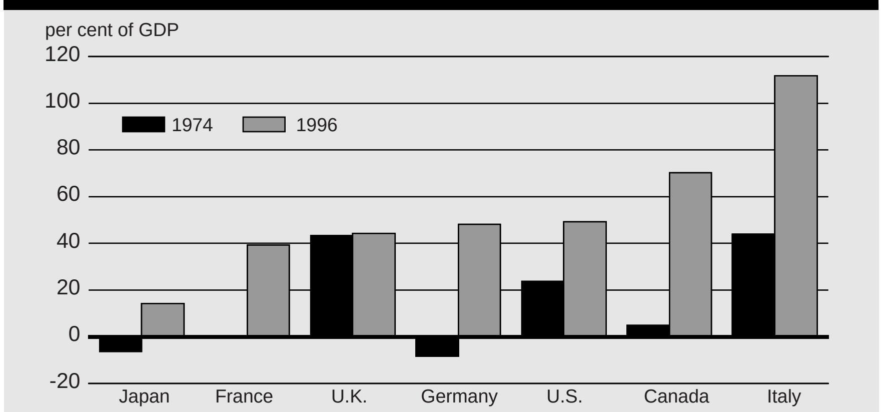


Chart 3.8 Total government net fiscal debt – G-7 countries (national accounts basis)



There is no optimal level for the debt-to-GDP ratio. What is clear is that the current level is too high and must be reduced to a more manageable level.

In the mid-1970s, less than 15 cents of each revenue dollar received by the federal government went to pay interest on the public debt. In 1996-97, however, 32 cents of each revenue dollar received was used to pay interest on the public debt. With such a large portion of every revenue dollar going to pay interest on the debt, the ability of the government to address national priorities is significantly reduced.

Moreover, the current high debt-to-GDP ratio also leaves Canada's fiscal situation extremely vulnerable to economic shocks, especially those associated with a possible run-up in interest rates or prolonged slowdowns

The current high debt-to-GDP ratio also leaves Canada's fiscal situation extremely vulnerable to economic shocks …

in economic activity. This vulnerability means that a sustained decline in the debt-to-GDP ratio in the coming years will be necessary if the federal government is to buffer the economy from the negative effects of future economic downturns.

… the legacy left to future generations is one of sound social and economic programs …

Reducing the debt-to-GDP ratio will ensure that the legacy left to future generations is one of sound social and economic programs, not one of high debt and high taxes. Younger Canadians have received relatively less benefit from the build-up in Canada's debt, as much of the increase has been related to past consumption of goods and services rather than spending on investments in the economy. To ensure that younger Canadians do not pay an unduly large portion of the debt, the debt-to-GDP ratio must be reduced while the generations that benefited most from its run-up are still in the labour force.

However, the demographic story does not end there. Within 40 years, the share of the population over age 65 will almost double from its current level of 12 per cent to 23 per cent. This will naturally put upward spending pressure on retirement income and health care programs. To deal with these pressures effectively, the government needs to reduce significantly the debt-to-GDP ratio ahead of time.

Finally, a high debt-to-GDP ratio restrains economic efficiency and hinders growth, thus adversely affecting the well-being of all Canadians. This is because the high levels of taxation, and concerns over even higher levels, associated with the need to service the debt discourage investment and entrepreneurship. Moreover, high levels of debt tend to push up interest rates, as a risk premium is demanded, which again discourages the investment needed to sustain growth.

Bringing the debt-to-GDP ratio down, therefore, is key to ensuring sustained long-term growth and job creation.

Bringing the debt-to-GDP ratio down, therefore, is key to ensuring sustained long-term growth and job creation. However, it will take time to achieve a signification reduction in this ratio. For example, if a balanced budget was maintained over a 10-year period, coupled with moderate economic growth and average effective real interest rates of about 5 per cent, the debt-to-GDP ratio would be about 45 per cent – the level last witnessed in the early 1980s.

The budget will be balanced no later than 1998-99. If economic performance turns out better than assumed for budget planning purposes and the Contingency Reserve is not needed, then it will be used to pay down the debt and the debt-to-GDP ratio would decline that much faster.

But this prudence in budget making will also mean that the emerging fiscal dividend will only be small at first and then grow slowly. This means that the government will be able to address a limited set of its highest priority initiatives; otherwise, it will risk putting the budget back into a deficit.

The Fiscal Dividend

The fiscal dividend is the projected surplus of total revenues over total spending that would arise in the absence of any new tax and spending actions since the 1997 budget.

The 50:50 allocation of the fiscal dividend, among expenditures to address economic and social needs and among tax cuts and debt reduction, will be used as a guiding principle for planning purposes. The annual allocation will vary from year to year. The final allocation can only be assessed after totalling all of the spending, tax and debt reduction actions undertaken in all of the budgets during the mandate and the year-end audited outcomes.

4

Building a Strong Economy and a Strong Society

Highlights

Knowledge and information are increasingly becoming the keys to economic success, presenting both challenges and opportunities.

The government is committed to building a strong economy and a strong society for Canadians in the global knowledge-based economy:

- first, by working with Canadians to build a strong economy based on knowledge, learning and innovation; and
- second, by preserving and enhancing Canada's valued education, health and social programs that have provided security and equality of opportunity for all Canadians, ensuring that no one is left behind by economic change.

Introduction

Canadians are no strangers to economic change. Canada has attained one of the highest standards of living in the world by transforming an economy focused on producing primary goods to one based on manufacturing and services. Today, Canada's economy is going through another fundamental change. The development and use of information and knowledge are increasingly becoming the principal engines of long-term growth.

The development and use of information and knowledge are fast becoming the principal engines of long-term growth.

This is not only true for what are widely considered to be "high-tech industries" such as computer software, or "high-tech jobs" like electrical engineering. Advances in knowledge are becoming increasingly important in all industries and in all jobs.

No one knows exactly how these changes will ultimately affect the economy and society. But it is clear that profound changes are underway. This transformation can be the source of major economic and societal benefits if Canadians, and their governments, make the right choices.

Canadians see many opportunities in the knowledge-based economy. New technologies are making workers of all skill levels more productive. Workers and young people are raising their levels of schooling and training because they see good skills as essential to their future economic success. Canadian businesses in all sectors of the economy are increasingly developing and adopting new ideas and techniques, thereby creating new products and services or finding new, more efficient ways of producing existing goods and services.

But Canadians are concerned that such profound economic change may undermine their economic and social well-being. Some Canadians are anxious about finding a job, or about losing their current job, or about seeing that their children acquire the education and skills that they will need to secure rewarding employment. Many people worry that the less fortunate will be left behind, ultimately increasing income inequality among Canadians. Too many Canadians are also uncertain about whether Canada's health care and retirement income systems will be there for them and their families when they need them.

The federal government is taking an active role in building a strong economy and a strong society for Canadians:

- first, by working with Canadians to build a strong economy based on knowledge, learning and innovation that will generate more and better jobs and raise living standards; and
- second, by building a strong society – through preserving and enhancing Canada's valued education, health and social programs – so that all Canadians can participate in and benefit from economic growth.

These two goals are mutually reinforcing. A strong economy builds a solid foundation of security by creating employment opportunities throughout the economy and by generating the resources needed to maintain and enhance programs that contribute to a strong society. A strong society, in turn, provides Canadians with the sense of security that allows them to adjust with confidence to the changes that are inevitable in a modern economy.

The chapter begins by reviewing the changes that are now occurring in the Canadian economy. It then describes the leadership role government must play in encouraging economic growth and translating it into a better quality of life for all Canadians.

The Growing Economic Role of Knowledge

What drives growth and creates prosperity in a modern economy? Canada has long thrived on its rich endowment of natural resources. But, in fact, the amount and nature of our raw materials has changed very little over time. What has changed, and changed dramatically, is our knowledge of how to use those resources. For example, the first known human use of iron oxide was as a pigment in cave paintings. Today, centuries later, this document is available worldwide, via the Internet, through computers that use iron oxide on their disk drives to store information. (Connect to the Internet address http://www.fin.gc.ca to access this document.)

While advances in knowledge have always been important in generating economic growth, the relative importance of new ideas has increased steadily in recent years and is reshaping the economy and society. Raw materials are still valuable, but new ideas about how to use those materials can be even more valuable, and that value can be shared more widely.

Many Canadian industries have been leaders in the development and adoption of technology …

Many Canadian industries have been leaders in the development and adoption of technology, not just the so-called "high-tech" industries such as software, electronics and aviation. For example, new methods for managing inventories, and new technologies that have been developed to implement those ideas, are changing the way that retailers operate and the skills needed by sales personnel. Canada's resource industries are also being transformed by advances in knowledge, such as the use of satellite-generated images in resource exploration and development. Biotechnology is being used in the agricultural sector to enhance product quality, as well as to improve crop yields and disease resistance.

People are often concerned that advancements in knowledge will result in workers being replaced by computers and machines. At a time when job creation is a central concern, Canadians also worry about the ability of a knowledge-based economy to create jobs for all members of society, not just the highly skilled. New technology does tend to reduce the number of workers needed to produce specific products. Nonetheless, there is overwhelming evidence that advances in knowledge ultimately result in a net increase in jobs. This is because new technologies lead to new products and services, a higher quality of existing products and lower production costs, all of which stimulate economic growth and job creation.

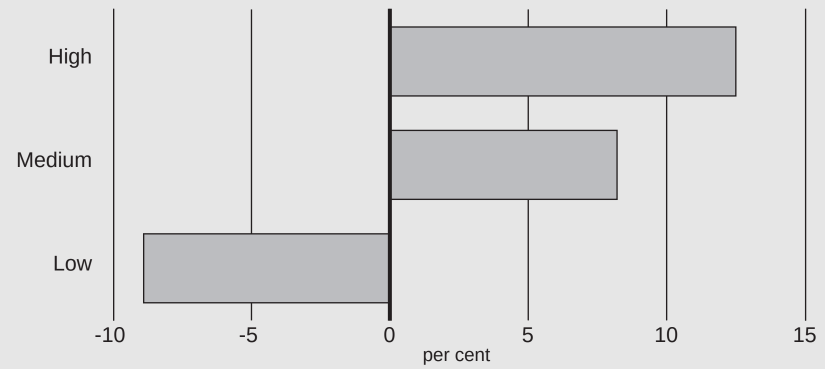
For example, the United States has enjoyed the benefits of a boom in the development and application of technology in the 1990s. This has allowed the U.S. economy to grow rapidly and to create many jobs without reigniting inflation.

Adaptation to the knowledge-based economy is a worldwide challenge. Although Canada's innovation performance has improved substantially in recent years, our major competitors have also moved forward. The key to Canada's success is for businesses, workers and governments to work together to accelerate the adoption of innovative technologies in all sectors of the economy.

That is happening. Businesses in Canada have increased their spending on research and development (R&D) by an estimated 80 per cent since the end of the 1980s. The share of manufacturers using advanced technology has increased from under 60 per cent in 1989 to almost three-quarters recently. A sign of this increased technological orientation is that the value of Canadian machinery and equipment exports is now almost as large as our automotive exports.

While Canada has only recently emerged from a difficult period over the 1990s, the benefits of this growing commitment to technology are already evident. This was reaffirmed in a recent Conference Board of Canada study entitled *Jobs in the Knowledge-Based Economy*, which found that firms that have purchased and used information technology have outperformed others in both output growth and job creation over the past decade (Chart 4.1). A study by Industry Canada entitled *Employment Performance in the Knowledge-Based Economy* also found that employment growth in Canada is increasingly related to the use and production of knowledge.

Chart 4.1 Employment growth by information technology intensity, 1986-1995



Source: Statistics Canada; The Conference Board of Canada.

As well as stimulating job creation, advances in knowledge also lead to higher real incomes. Learning to produce more, or more valuable products with the same amount of effort, raises productivity. Those productivity gains drive real income growth and a consequent improvement in living standards. Indeed, higher real incomes and the myriad of new products and services made possible by ongoing innovation afford Canadians today a standard of living their grandparents could hardly imagine.

The rise in the importance of knowledge has been accompanied by increasing integration of the world's economies. Globalization has, of course, been fostered by a worldwide move towards liberalization of trade and investment policies, but has been made possible by advances in the speed and efficiency of communications and transportation.

Globalization has added many new consumers of Canada's goods and services.

Globalization has added many new competitors in world trade. But it has also added even more potential consumers of Canada's goods and services, thereby increasing the rewards to the successful application of new ideas. By providing improved access to larger markets, trade liberalization has not only allowed Canadian producers to specialize in what they do best, it has also given Canadian firms and consumers access to new and better quality products and services at lower prices.

With the distance barriers between countries effectively diminishing and the importance of knowledge as an input to production increasing, economic activities are becoming less tied to geography and natural resource endowments and more tied to human resource endowments. The end result is not only that world demand for skilled workers is increasing, but also that the economic fortunes of Canada's regions will increasingly hinge on their ability to provide an environment conducive to growth. Indeed, Canada's traditional appeal of plentiful natural resources is no longer sufficient on its own to attract investment, by either Canadians or foreigners. What has become all the more important to attracting new investment and production is an attractive business, work and social environment. And especially important is having a skilled, productive workforce. Indeed, a recent study by the Conference Board of Canada entitled *What Makes Technopoles Tick? A Corporate Perspective* found that, for high-tech companies, a skilled workforce was the most important influence on the decision of where to locate.

Leadership in a Global Knowledge-Based Economy

Canadians want governments that provide active leadership.

Canadians want active governments that respond to economic change by providing leadership. They do not want governments that try to turn back the clock on change because that will deny them the opportunity to benefit from economic growth. Nor do they want governments that retreat from their responsibilities to build security for Canadians and expand opportunities for everyone.

While the importance of government has not diminished, the amount of money that governments can spend on programs has decreased. How can governments do more with their limited resources? The answer is to work more effectively by focusing on key areas. Governments can no longer be all things to all people.

An effective government works with the economy and markets, not against them. For example, the privatization of Canadian National (CN) not only resulted in fiscal savings, it also freed CN to pursue new business opportunities on an equal footing with its competitors, and allowed CN to modernize and provide customers with improved services at reduced costs. In another example, to help exporters reach new markets, the government provides competitive export financing through the Export Development Corporation (EDC). By working with financial markets, EDC is able to operate on a commercial basis.

Working effectively also means recognizing that 'going it alone' is rarely good policy. That is why the federal, provincial and territorial governments have been developing a more collaborative approach to strengthening Canada's social union – work on the new National Child Benefit is an early result of this approach. The federal government now also has agreements with eight provincial and territorial governments to take full or shared responsibility for active labour market programs. Building on this teamwork approach, partnerships between the federal and provincial governments have been broadened to include the private sector in ventures such as the Canada Foundation for Innovation – an arm's length foundation investing in Canada's universities, colleges, and research hospitals.

Providing effective, focused government is essential to creating opportunities and building security for Canadians, but it is not enough. As first outlined in the 1994 *Agenda: Jobs and Growth* documents, the federal government must also provide leadership in the four areas discussed below, which are key to Canada's prosperity in the global knowledge-based economy.

Building a Sound Economic Framework

Sound fiscal management and low and stable inflation are key to a healthy economy.

A sound economic framework is an essential ingredient for sustained prosperity. A healthy economy – by fostering consumer and business confidence – is key to encouraging business investment and major consumer purchases. That requires sound fiscal management and low and stable inflation. Strong business investment ultimately stimulates growth of the productive capacity of the economy and the adoption of new technologies embodied in capital goods.

The tax system also affects the health of the economy.

Tax laws and regulations, which affect the investment and spending decisions of businesses, workers and consumers, can also have a major effect on the health of the economy. The government must therefore ensure that it develops a fair and efficient tax system to raise its revenues. This implies that: taxes reflect the ability to pay; taxes are collected in a manner that is conducive to creating jobs and growth; and taxes that are owed are indeed paid. This government has a long-standing commitment to tax fairness, which it elaborated in the 1996 and 1997 budgets.

The federal government's approach to improving Canada's tax system will continue to be guided by two principles. First, the government will continue to provide targeted tax relief to deal with the most pressing social and economic stresses. Second, as fiscal room becomes available, the tax burden will be reduced in ways that not only ensure fairness, but that also will yield significant benefits in improving jobs and growth.

Building Opportunity Through Knowledge and Innovation

A sound economic framework is the foundation of any prosperous economy, but building a strong economy based on knowledge and information also requires the active participation of individuals, businesses *and* governments. Businesses obviously are motivated to develop and apply knowledge through investment in research and development. However, the returns from advancements in knowledge not only accrue to the businesses that make the investment, but can also spill over to the rest of the economy – for example, through better quality products and services at lower prices – thereby benefiting society as a whole.

The government therefore has a leadership role to play in promoting knowledge and innovation in several ways.

- First, laws and regulations can have a profound influence on the generation and use of knowledge. For example, intellectual property laws strike a balance between encouraging the development of new ideas and promoting their diffusion throughout the economy. This works particularly well for encouraging late-stage research and development.

- Second, federal government programs are needed to encourage the earlier stages of research when openness and collaboration are essential to progress and patent protection may not be possible. The federal government currently spends just over $5 billion annually on science and technology-related activities. Many programs are run in co-operation with the private sector, such as in the area of space technology development. The federal government currently funds 21 per cent of all R&D performed in Canada, including transfers to businesses and universities to finance basic and applied research. The federal scientific research and experimental development (SR&ED) investment tax credit – with claims amounting to

$1.3 billion annually – is also an important federal contribution to encouraging private sector research in Canada.

World-class research facilities have become key to attracting investment.

■ Third, world-class research facilities have become key to attracting investment in areas of high growth potential and to training and retaining highly skilled research personnel in Canada. The federal government's endowment of the Canada Foundation for Innovation – in partnership with the private sector, provincial governments and universities – is helping modernize research facilities at Canadian post-secondary education institutions and research hospitals in the areas of science and engineering, health and the environment.

■ Finally, the federal government has a role to play in supporting the generation and, especially, the diffusion of knowledge throughout Canada's diverse industries and regions. In particular, Canada's small and medium-size businesses can benefit by improving their access to leading-edge technology, financing and markets.

The growing importance of the Internet prompted the government to develop programs to assist rural and aboriginal communities, schools, libraries and businesses to connect to the information highway. For example, the SchoolNet program is providing young Canadians with vital access to, and training and experience in, new information technologies. Making Canada the most connected nation in the world will provide Canadians with new opportunities for learning, interacting, transacting business and developing their economic and social potential.

Multilateral agreements ensure that fair rules govern trading relationships.

Improved access to international markets is also key to the development of knowledge by encouraging Canadian firms to specialize in what they do best. It also encourages the use of new and better quality inputs at lower prices to take advantage of new market opportunities. The federal government's primary role in this area is to ensure that a fair set of rules governs economic relations with all of Canada's trading partners. To that end, formal trade agreements are very important in safeguarding the interests of smaller open economies like Canada's. In particular, the federal government is continuing to pursue multilateral and bilateral trade agreements such as the negotiations that resulted in the creation of the World Trade Organization (WTO) to oversee and guide the expansion of world trade.

The government is also supporting the private sector in securing and expanding Canada's access to world markets for its products and services, through an aggressive international trade promotion strategy led by the Team Canada trade missions.

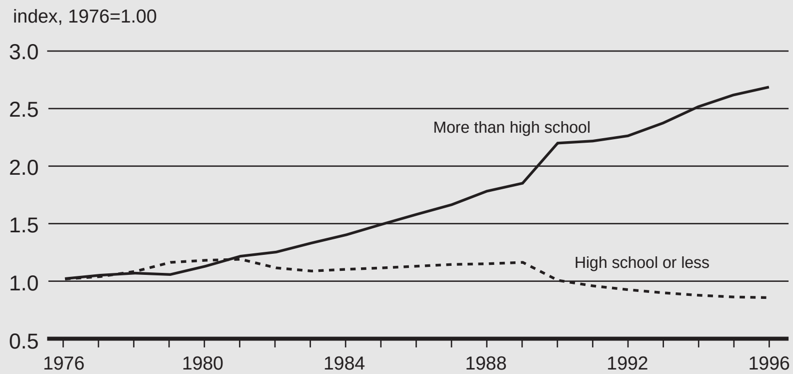
Building Opportunity Through Learning

The changes that are taking place in the economy are altering the way Canadians work and the skills they need to find and keep a job. Although this has been a fact of life for more than a century, the fortunes of workers turn increasingly on the skills they already possess or are prepared to acquire. Canada cannot afford to leave people behind while the rest of the economy moves forward. History has proven that education and training are important not only to the economy, but to people as well. Most importantly, education and training are the best tools to reduce income inequality, by giving people the skills needed to seize the opportunities available in a strong, modern economy. In this way, they provide both a solid foundation for a strong economy, and a society that is fairer and more inclusive.

Job growth has been faster for those with higher skills.

The premium that the knowledge-based economy has placed on skills is reflected in Canada's employment statistics. Over the past two decades, job growth has been faster for those with higher skills (Chart 4.2). With the number of jobs for persons with less than high school education shrinking rapidly, their unemployment rate is now double that of persons with a university degree. Moreover, given the relatively weak demand for low-skilled workers, their employment earnings are falling behind those of more educated and skilled workers, risking a polarization of incomes that could damage the social fabric. The rising importance of education and skills is only partly due to the creation of new "high-skill" jobs in "high-tech" industries. There has also been a steady increase in skill requirements in all sectors of the economy and in most types of jobs – from machinists to warehouse workers, from farmers to loggers.

Chart 4.2 Employment growth by educational attainment, 1976-1996



Source: Statistics Canada.

Canada's young people are particularly affected by the transition to a knowledge-based economy. Economic change has increased the advantage that young people can gain from education. As a result, many young people are staying in school longer. That is why today's young Canadians are, on average, the best educated, most literate and most technologically adept in Canada's history.

But today's young people face real challenges. Too many still do not even complete high school. Many more do not have the financial resources to enter into post-secondary education or face the prospect of graduating with difficult debt loads. Moreover, just as technological change has increased the value of education, it has also increased the value of on-the-job experience. This has made it particularly difficult for young people, who typically lack work experience, to find and keep their first jobs.

In order to realize their economic and social goals, governments must support education, skills development and the acquisition of work experience to help Canadians of all ages. A more educated and skilled workforce is better at developing, diffusing and adopting the advances in knowledge that are the key to economic growth. Better skills are also a powerful force for improving income equality and ensuring that all Canadians can participate in, and benefit from, economic growth. This is especially crucial to a shared prosperity when that growth is increasingly dependent on the application of knowledge.

No single sector of society or any one order of government has all the answers to meet this challenge successfully. All must contribute. The provincial governments are responsible for the delivery of education services and much of skills training. The federal government provides assistance to Canadian students and their families in coping with the rising cost of education. This help is not limited to young people; it increasingly will promote life-long learning, in recognition that many workers who have left the formal education system will need to enhance their skills or learn new ones.

- First, the federal government helps the post-secondary students of today face the substantial costs of post-secondary education.
- Second, the federal government helps recent graduates cope with the burden of repaying their student loans.
- Third, the federal government helps the families of the post-secondary students of tomorrow to save for the post-secondary education of their children.

This help is provided through several channels.

- First, the federal government provides tuition and education credits, which may now be carried forward indefinitely until students have sufficient income to make use of them. In the 1997 budget, the education credit was doubled from $100 to $200 per month of full-time study.
- Second, the Canada Student Loans Program helps to ensure the widest access to higher education by providing more than $1 billion in new student loans each year for post-secondary education. The loan limits were increased to reflect the rising costs of education. More recently, changes were made to the program to expand interest relief for borrowers encountering difficulty in repaying their loans. Scholarships made available by the federal granting councils provide financial assistance to students to complete their studies and add to their research experience.
- Third, resources and flexibility are provided through the tax system to encourage parents to save for their children's post-secondary education in registered education savings plans (RESPs). These were recently enriched in the 1997 budget.

More will be done. The government will be introducing special grants for needy students with dependants. The government is also exploring with the provinces and other interested parties the option of introducing income-related repayment schemes and other changes for student loans. Most recently, the Prime Minister announced the creation of the Canada Millenium Scholarship Endowment Fund to reward academic excellence and provide thousands of scholarships for low- and middle-income Canadians.

The federal government is also helping young people who face difficulties in making the transition to a career-oriented job. Through its recently expanded youth employment strategy, the federal government promotes work experience for young Canadians in partnership with aboriginal communities, the private sector and community organizations. For example, the federal public sector Youth Internship Program will invest $90 million over three years to provide, in partnership with Career Edge and the YMCA, essential work experience and skills to 3,000 young Canadians who are underemployed or “at risk” of unemployment.

The government will work with the provinces, the private sector and communities to develop a new mentorship program, and to introduce a new community-based program for those young Canadians who are most at risk of unemployment because of their lack of skills and low education. Internship programs will be expanded and aboriginal youth centres will be created to help off-reserve aboriginal young people who are unemployed.

Building Security Through a Strong Society

Canada’s future prosperity depends as much on our valued education, health and social programs as it does on our economic policies. Good public services and strong social programs are key to ensuring that Canadians have a sense of security and confidence in their well-being and future prospects and to helping them to pursue their economic objectives. While substantial progress has been made in invigorating our economy and in securing our social programs, more needs to be done in several areas.

Helping Canadian families give their children a good start in life is one of the most important investments Canada can make in its social and economic future. Most Canadian children are doing well and are physically, emotionally and socially healthy. But the fact remains that opportunity denied in childhood too often means chances lost as an adult. The experiences of Canada’s children, especially in the early years, influence their health, their

Helping Canadian families is one of the most important investments Canada can make.

well-being, and their ability to learn and adapt throughout their entire lives. The 1997 budget allocated $100 million to expand the Community Action Program for Children and the Canada Prenatal Nutrition Program.

Unfortunately, some government programs aimed at providing essential support to low-income families have inadvertently formed a "welfare wall" so that some parents may be financially worse off in the workforce than remaining on social assistance. This affects the opportunities available to their children.

To break down the welfare wall, the federal and provincial governments are developing a National Child Benefit System, designed to help prevent and reduce child poverty and ensure that families will always be better off by working. The foundation for this system is an enriched and redesigned Canada Child Tax Benefit and Working Income Supplement. The federal contribution to this benefit was increased by $850 million a year in the 1997 budget, bringing the total annual federal contribution to $6 billion. The federal contribution will increase at least $850 million during this government's mandate. In turn, provinces and territories will invest in complementary programs to improve work incentives and services for low-income families with children.

The federal and provincial governments will also continue to work together on a National Children's Agenda. As part of this, the government has committed in the Speech from the Throne to undertake three new initiatives: the creation of Centres of Excellence on Children's Well-being, the extension of the Aboriginal Head Start Program on reserve, and monitoring and reporting on the readiness to learn of Canadian children.

The government is firmly committed to preserving the health care system and ensuring that it meets the needs of the future. Canada has one of the best health care systems in the world, an achievement of which Canadians are justifiably proud. Under medicare, high quality health care services are available to all Canadians based on need, not ability to pay. Canadians do not have to fear catastrophic financial losses due to illness in the family. Medicare also makes a significant contribution to the competitiveness of Canadian firms, which do not have to fund expensive hospital and medical coverage for their employees as is the case in some countries.

The federal government is committed to ensuring universal and accessible medicare.

Since the 1990s, provincial governments in Canada have had to restrain the growth of health care costs, and likewise the federal government has had to cut its transfers to the provinces. This has lead to an increasing anxiety among Canadians about the present state and future of Canada's medicare system. The federal government recognizes that this restructuring has been difficult for Canadians and therefore it will be raising the cash floor of the Canada Health and Social Transfer (CHST) from $11.0 billion to $12.5 billion. Over five years, this will provide an additional $6 billion of funds to the provinces for health care and other social priorities. It will also ensure that the federal government has the means to enforce the principles of universal and accessible medicare for all Canadians. The 1997 budget allocated $300 million for new health initiatives and will be pursuing further health initiatives as recently outlined in the Speech from the Throne.

The retirement income system is working well, but it is under stress.

Ensuring that Canada's seniors have an adequate retirement income is one of the most important initiatives ever undertaken in this country. Although Canada has a sound and comprehensive retirement income system, it will increasingly come under stress as the baby-boom generation retires. While there are more than five working-age Canadians for every retired person today, by 2030 there will be only three.

To ensure that the retirement income system remains affordable and sustainable, the government has recently introduced legislation to change the Canada Pension Plan (CPP) by: moving to fuller funding now so that contribution rates will not exceed 10 per cent for future generations; improving the return on the CPP fund through a new investment strategy; and slowing the growth in costs by changing how some benefits are calculated and administered. The government is currently consulting Canadians on a new Seniors Benefit that would better target government support and moderate the growth of costs. Canadians can now have confidence benefits will be there for them when they retire.

Conclusion

As we move towards the 21st century, the growing importance of knowledge offers all Canadians great challenges and great opportunities. Modern communications have caused distance to lose much of its economic meaning, and skills are becoming the most important raw materials of all. This transformation can be the source of a widespread increase in living standards if individuals, businesses and governments make the right choices.

That is why the federal government is committed to providing leadership in helping Canada succeed as a knowledge-based economy and society. The government understands that a country with a rich natural resource base can be truly successful only if it also develops a rich base of knowledgeable and skilled workers. Yet, a country with a rich base of knowledgeable and skilled workers will succeed only if its economy creates the opportunities needed to develop and apply those skills in an innovative workplace. And these opportunities will only be fully seized if Canadians have the security needed to make the necessary adjustments confidently. This means ensuring that Canada's valued health, education and social programs are there for those who need them. The federal government is determined to build a society of skills, innovation and security, where each element reinforces the other, creating and sustaining jobs and raising the Canadian standard of living.

5

Conclusions and Main Issues

Over the last four years, the federal government has pursued a strategy of restoring Canada's fiscal health as a means to creating the conditions for stronger economic growth and job creation and sustaining the long-term viability of Canada's health, education and social programs.

The payoff to this strategy is clearly evident. The federal deficit has declined sharply, and the government is committed to achieving a balanced budget no later than 1998-99. The economy is now growing at a strong pace. Canada's overall economic prospects are better than at any time in the past 25 years.

The challenge now is to build on these achievements so as to assure Canadians of a strong economy and strong society for the future. The key lies in maintaining fiscal health while at the same time making strategic investments to build opportunity and security for all Canadians.

The improvement in economic conditions will make the government's other strategic investments more effective. For example, investments in skills training are more effective when participants find better job opportunities when they graduate. Similarly, programs to assist businesses to acquire new technologies are made more effective when low interest rates make it less costly for firms to make new investments.

The government's strategy of improving economic conditions and making strategic investments complements the investments being made by businesses and individuals. Collectively, these efforts will increase the capacity of the economy to grow, and the capacity of Canadians to adapt to the changes brought on by the knowledge-based economy. The end result will be more and better jobs.

The public consultations that took place over the last four years were instrumental in determining the government's economic and fiscal strategy, and its unquestionable success. In preparing the first budget of its second mandate, the government is seeking the views of Canadians on ways to consolidate the fiscal progress achieved, and what government can do to help Canadians prosper in the new economy.

The House of Commons Standing Committee on Finance will be asked to consult with Canadians and advise on the following questions.

- First, what economic assumptions, including prudence factors, should be used for 1998 and 1999 in planning for the 1998 budget?

- Second, what are the appropriate new strategic investments and changes to the tax system that would allow the government to best achieve its priorities?

- Third, what is the best way that the government can help to ensure that there is a wide range of job opportunities in the new economy for all Canadians? Areas of discussion could include how government can best support Canadians in acquiring the education and skills needed to thrive in a knowledge-based economy, and how government can best foster the application of knowledge across the economy.

Annex 1

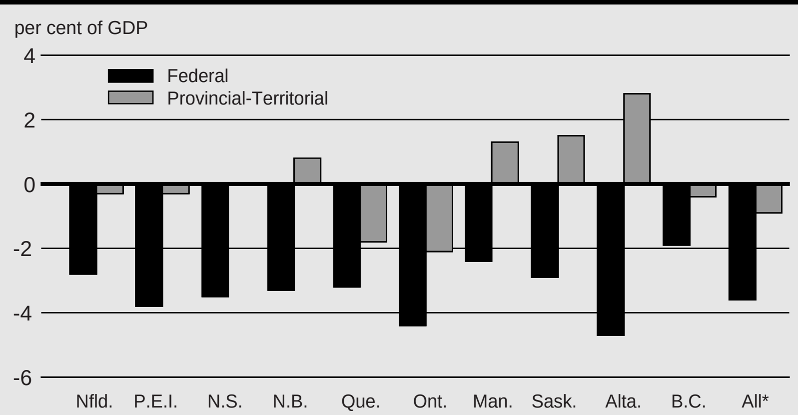
Improvement in Provincial Finances

The fiscal turnaround at the federal level is critical to Canada's financial health. But this represents only one element of the more general improvement in the overall fiscal situation of governments in Canada.

This annex provides an assessment of the fiscal progress made at the provincial-territorial level.

The provincial-territorial budgetary balance deteriorated very rapidly in the early 1990s, reaching a peak deficit of $25.2 billion in 1992-93, compared to a deficit of less than $5 billion prior to the 1990-1991 recession. However, since the recession, provinces have introduced medium-term fiscal plans to address their fiscal balances.

Chart A1.1 Surplus/deficit (-)
(public accounts basis)



*Includes the Yukon and Northwest Territories.

These plans have met with considerable success. Five provinces are expected to report budgetary surpluses in 1996-97. The aggregate provincial-territorial deficit in 1996-97 is estimated to be $7.2 billion, a decline of over 70 per cent from its peak in 1992-93. Moreover, all jurisdictions are committed to eliminating their deficits by the end of the current decade.

Various fiscal consolidation strategies have been adopted at the provincial level. British Columbia targeted a reduction in real per capita spending. Alberta cut program spending without introducing any new taxation initiatives. Other jurisdictions, such as Saskatchewan, implemented program spending reductions in conjunction with some revenue-enhancing measures. Ontario reduced both program spending and personal income taxes.

Reflecting the accumulation of deficits since the beginning of the 1990s, the net debt-to-GDP ratio of the provincial-territorial sector increased from 16 per cent prior to the last recession to a peak of 28.4 per cent in 1995-96. However, the aggregate provincial-territorial debt burden declined in 1996-97 for the first time since 1988-89.

The federal net public debt-to-GDP ratio rose from about 55 per cent prior to the last recession to 74.0 per cent in 1995-96, before declining to 73 per cent in 1996-97. As a result, the combined federal-provincial-territorial debt-to-GDP ratio rose from about 70 per cent prior to the 1990-91 recession to over 100 per cent by 1995-96.

The much higher debt-to-GDP ratio faced by the federal government underscores the much more difficult fiscal challenge facing the federal

Chart A1.2 The evolution of the net debt-to-GDP ratio (public accounts basis)

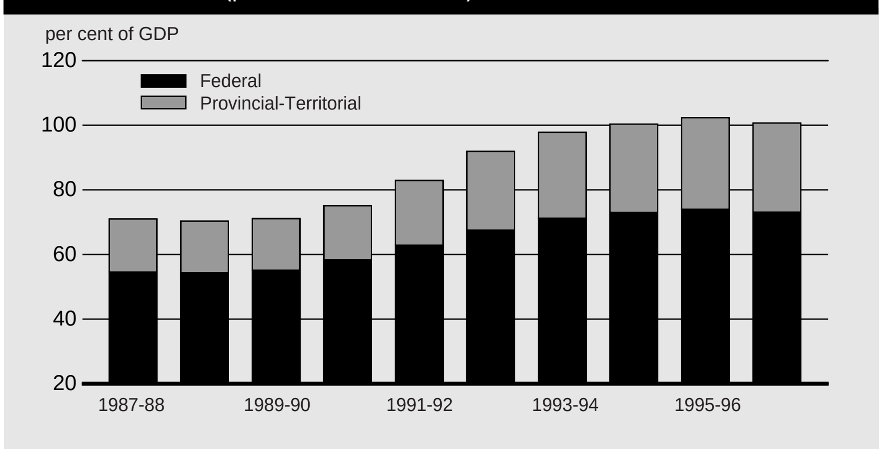
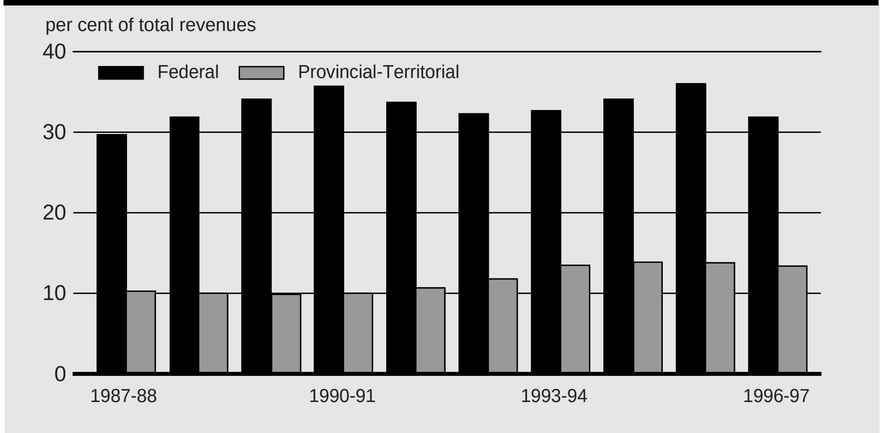


Chart A1.3 Debt charges as a proportion of total revenues (public accounts basis)

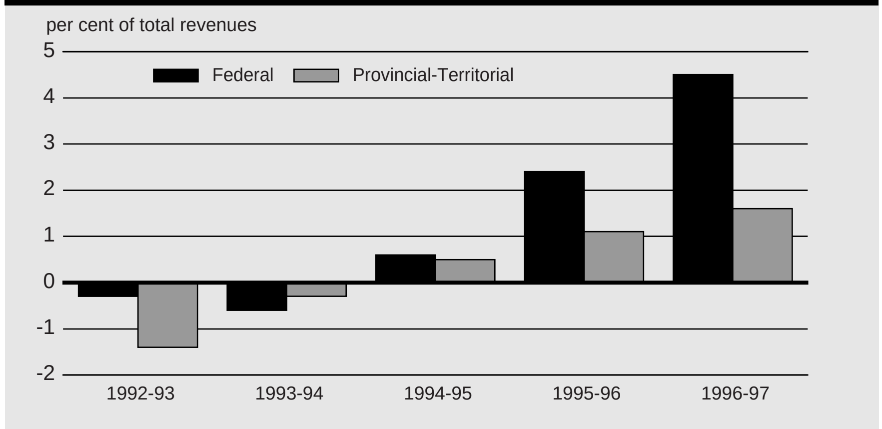


government compared to that of the provinces and territories. For example, debt charges at the federal level absorbed about one-third of every dollar collected in revenues, sharply higher than the 14 cents of each dollar at the aggregate provincial-territorial level.

In order to break the vicious cycle of debt dynamics, all Canadian governments had to engineer increasing operating surpluses – the difference between total revenues and program spending. In 1993-94, the federal government had an operating deficit of equivalent to 0.6 per cent of gross domestic product (GDP). By 1996-97, the federal government had generated an operating surplus of 4.5 per cent of GDP. Provincial-territorial governments also implemented measures that led to the realization of significant operating surpluses. From a deficit position of 1.4 per cent in 1992-93, the provincial-territorial operating balance reached a surplus of 1.6 per cent in 1996-97. The higher level of indebtedness and debt servicing costs of the federal government mean that it has had to generate operating surpluses almost three times as large as those of the provinces and territories in order to achieve a similar deficit outcome.

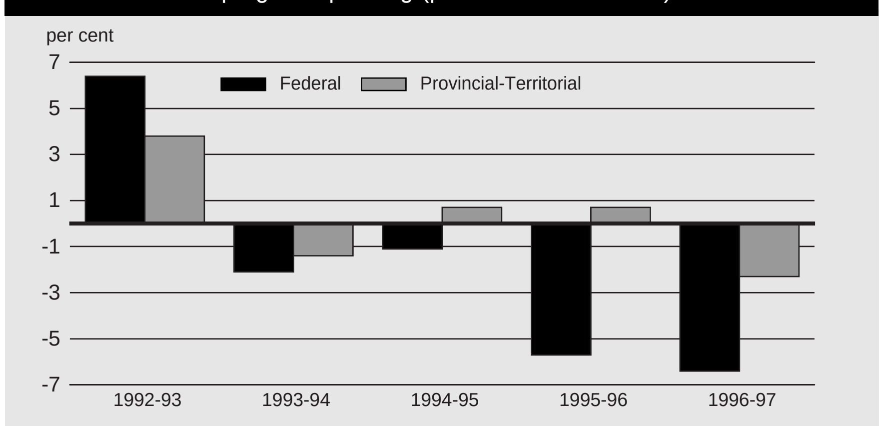
Collectively, program spending at the aggregate provincial-territorial level is larger than program spending at the federal government level. From a peak of $140.2 billion in 1992-93, the aggregate provincial-territorial program spending fell to $137.1 billion in 1996-97, a decline of $3.1 billion, or 2.2 per cent. In contrast, federal program spending has declined in each of the last four fiscal years, falling from $122.6 billion in 1992-93 to $104.8 billion in 1996-97, a decline of $17.8 billion, or 14.5 per cent.

Chart A1.4 Federal and provincial-territorial operating balances (public accounts basis)



Given the amount of fiscal action required to address the federal fiscal situation, federal transfers to provinces could not be exempt from restraint. Cash transfers to the provinces and territories amount to over 20 per cent of federal program spending. However, as demonstrated in Chapter 3, the reduction in total entitlements to the provinces and territories over the 1993-94 to 1996-97 period was considerably less than the reduction in federal direct program spending. Furthermore, the reductions in transfers to the provinces and territories primarily occurred in 1996-97, a full year later than the reductions to federal direct program spending. This delay was put in place to allow provinces and territories time to adjust to the reduction in total entitlements.

Chart A1.5 Annual growth in federal and provincial-territorial program spending (public accounts basis)



Furthermore, the improvement in the federal fiscal situation has generated positive benefits for all provinces in the form of lower debt servicing costs. The interest rates paid by the provinces and territories cannot be lower than that charged to the federal government. The dramatic turnaround in federal finances has played an important part in getting interest rates down for all borrowers in Canada. These low interest rates benefit both the private sector and governments, which have new borrowing requirements or must refinance their debt.

Annex 2

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 gross domestic product (GDP) and interest rates. The following sensitivity estimates capture the direct fiscal impacts of changes, one economic variable at a time. These are partial calculations. For example, in the nominal income sensitivity estimate, there is no feed-through of the change in nominal income to other variables, such as interest rates and unemployment.

Sensitivity to Changes in Nominal Income

A 1-per-cent increase in the level of nominal GDP leads to higher tax bases and thus higher revenues. The ultimate deficit impact would depend on the source of the increase in nominal 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 and borrowing costs lower. Interest rates would be relatively stable.

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

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

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

Assuming the increase in nominal income comes solely from an increase in output with no impact on interest rates, the deficit would be lowered by $1.3 billion in the first year, rising to $1.7 billion after four years (Table 1).

Sensitivity to Changes in Interest Rates

In contrast to the uncertainties of the sensitivity of the deficit to changes in nominal GDP, the direct impact of interest rate changes on public debt charges can be calculated with considerably more precision.

A sustained 100-basis-point increase in all interest rates would cause the deficit to increase by $1.0 billion in the first year (Table 2). As longer-term debt matures and is refinanced at the higher interest rates, the negative impact on the deficit increases, such that by year four, the deficit is about $2.6 billion higher.

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

	Estimated changes to fiscal position			
	Year 1	Year 2	Year 3	Year 4
	(billions of dollars)			
Budgetary transactions				
Revenue increases	0.5	0.5	0.5	0.5
Expenditure increases	1.5	2.4	2.8	3.1
Deficit increase	1.0	1.9	2.3	2.6

These estimates are somewhat lower than estimates contained in previous years. This is because the government has increased the fixed-rate portion of the debt (the percentage of the gross debt issued as longer-term fixed-rate instruments) from about 50 per cent in the late 1980s and early 1990s to 65 per cent today.

The establishment of a prudent debt structure that has more stable long-term financing is one of the key steps to putting Canada's financial house in order, and is essential to maintaining investor and credit rating agency confidence. Canada's past reliance on short-term debt was noted by market participants and credit rating agencies – a concern which, if unaddressed, could have raised Canada's overall cost of debt. By ensuring the government meets its objective of raising stable, low-cost funding, a prudently structured debt stock benefits all taxpayers and brings Canada into line with international standards. For further information, refer to the *Debt Operations Report*, Department of Finance, November 1996.