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# ***Canada's economic challenges***

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**Background**

January 1994

**Canada**

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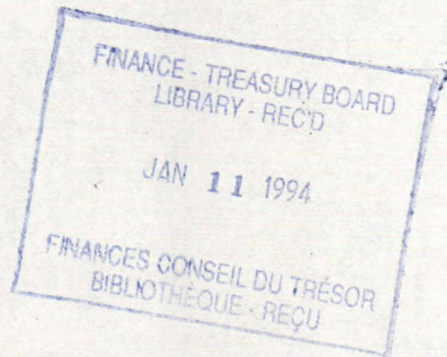
# *Canada's economic challenges*

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Background



January 1994



Department of Finance  
Canada

Ministère des Finances  
Canada



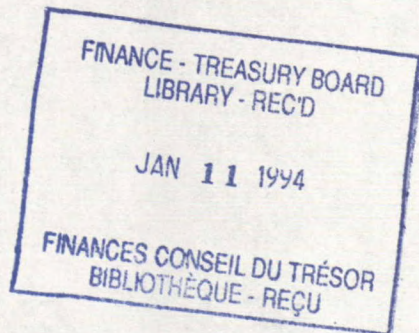
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# ***Section 1***

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Introduction



- In the wake of the economic boom of the late 1980s, Canada entered recession in 1990 and the recovery since 1991 has been very weak by historical experience.
- The impact of the recession and the slow recovery has been particularly severe on employment – the unemployment rate now stands at 11 per cent and employment is still below its pre-recession peak.
- The recession and weak recovery have had a negative impact on Canada's fiscal situation at both the federal and provincial government level.
- The economic recovery has been slow for a number of reasons:
  - Growth has been weak worldwide.
  - Restructuring by business in response to global competition has lowered consumer confidence.
  - Federal and provincial governments have had to implement restraint measures to contain their burgeoning deficits and debt burdens.
- Canada faces a number of economic challenges:
  - Promoting growth and reducing the cyclical component of unemployment;
  - Reducing the deficit and bringing the debt burden under control;
  - Reducing disincentives to work and reducing the structural component of unemployment;
  - Promoting adjustment to structural change and globalization;
  - Promoting R&D and adoption of new technologies so as to raise productivity and ultimately living standards.

- The purpose of this document is to provide background material on the economic challenges facing Canada today. The document is divided into a number of sections.
  - *The Economic Situation and Outlook:*
    - This section provides information on the state of the economic recovery.
  - *Structural Change:*
    - This deals with the structural changes facing Canada as well as structural unemployment.
  - *The Fiscal Challenge:*
    - This covers the problems of public sector deficits and debt.
  - *The Role of Government in the Economy:*
    - This section provides background information on government programs.



## ***Section 2***

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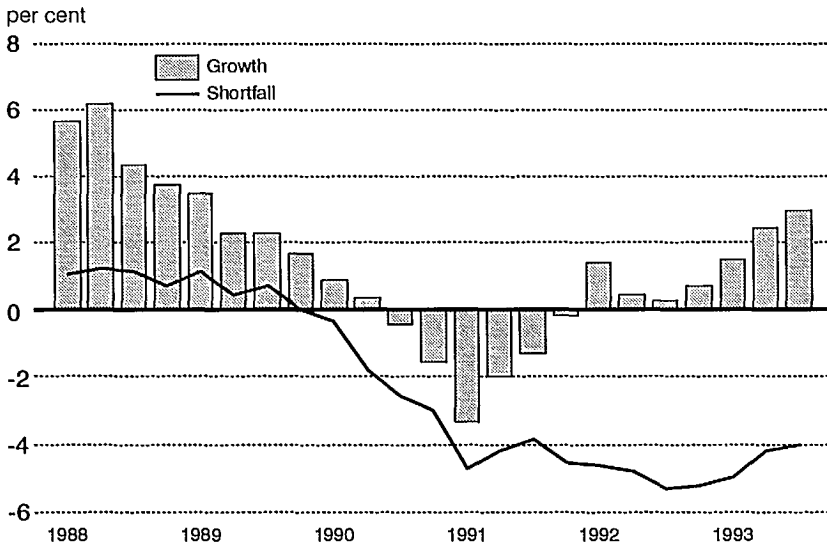
**The economic situation and outlook**



## THE RECESSION HAS DEPRESSED PRODUCTION

- The economy entered recession in 1990, and growth rates have been below normal since then.
- This slow growth has kept the level of production significantly below its potential or capacity level.
- Although growth has been positive since the first quarter of 1992, there is still a lot of slack in the economy.

### *Output growth (year-over-year) and shortfall of output below its normal level*



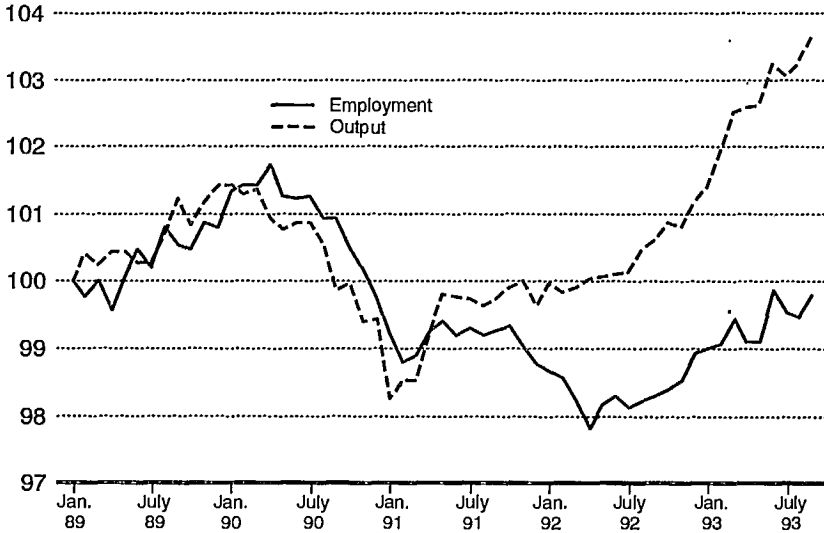
Source: National accounts and Department of Finance.

## FIRMS HAVE BEEN SLOW TO REHIRE WORKERS

- Employment has lagged output in this recovery, as firms seek to lower costs and raise productivity.
- Restructuring and associated uneasiness over job prospects has hurt consumer confidence and restrained consumer spending.

### *Levels of employment and output*

January 1989=100



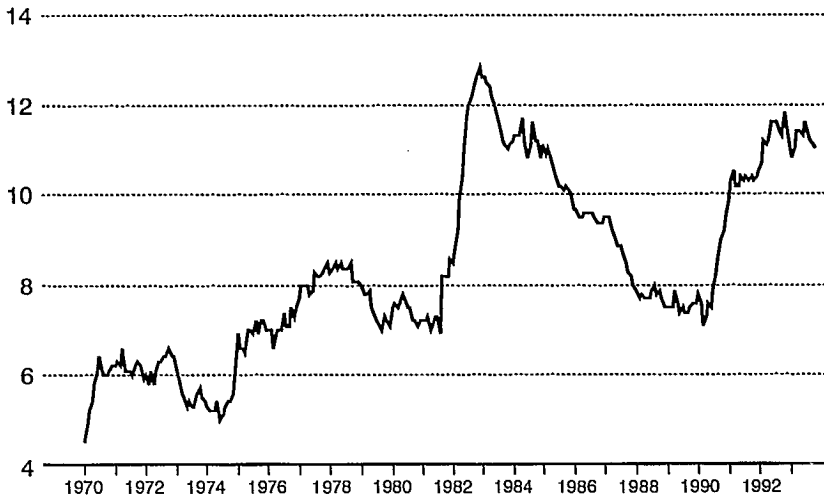
Source: Labour force survey.

## UNEMPLOYMENT REMAINS VERY HIGH

- The unemployment rate reached a peak of 11.6 per cent in 1992.
- Employment growth has barely kept up with labour force growth and as a result the unemployment rate has only declined slightly.

### *Unemployment rate*

per cent



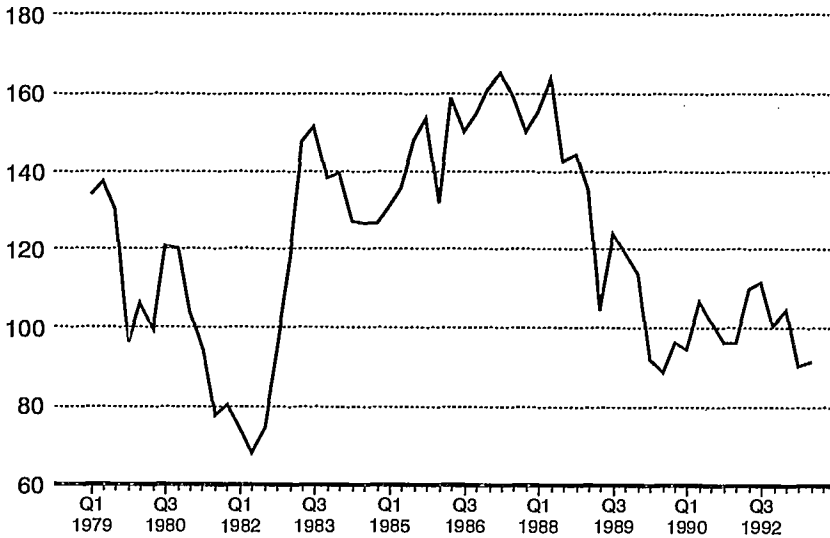
Source: Labour force survey.

## A KEY PROBLEM IS CONSUMER CONFIDENCE

- In the face of weak employment growth, household confidence remains very low.
- This is having an adverse impact on consumer spending and housing markets.

### *Conference Board Index of Consumer Confidence*

Index 1961=100

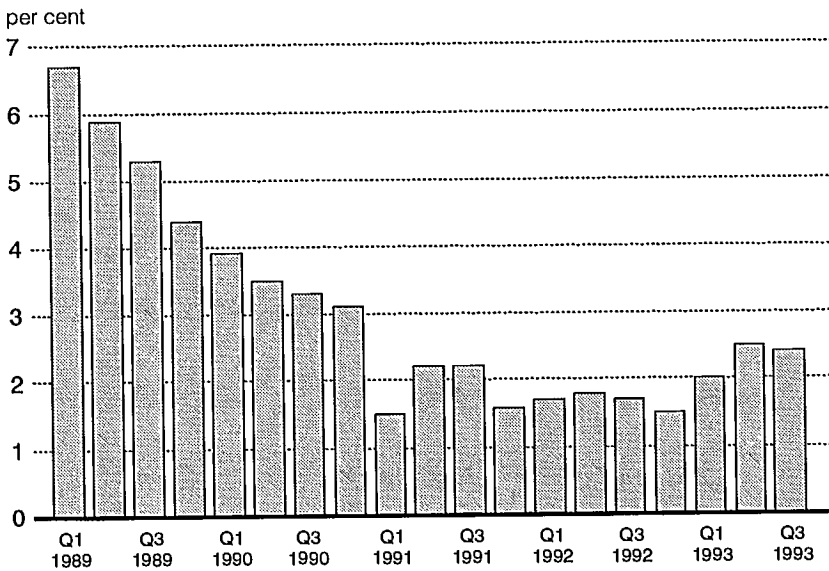


Source: Conference Board.

## CORPORATE PROFITS HAVE BEEN DEPRESSED

- In this recession, corporate profits fell sharply as a share of GDP.
- 1993 has so far seen renewed growth in profits, though the level is still low.
- Low profitability has reduced the ability of firms to hire workers.

### *After tax corporate profit as a share of GDP*

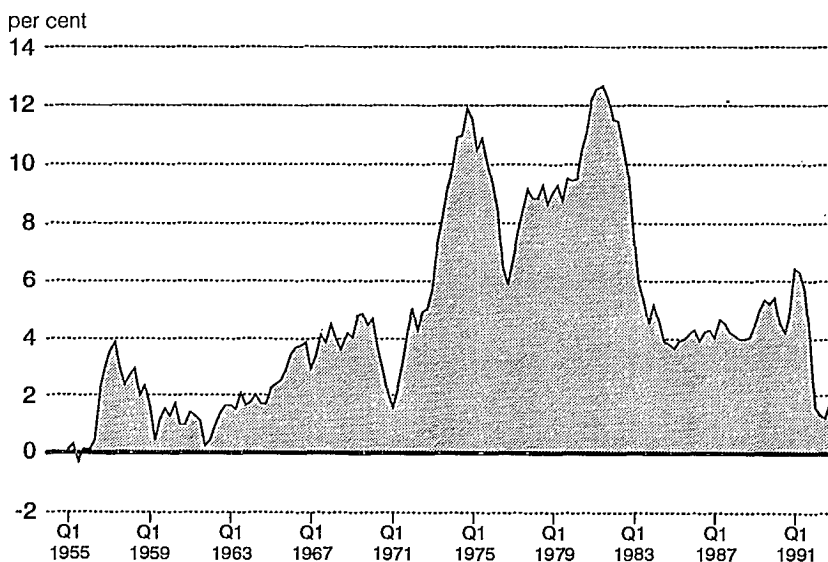


Source: National accounts.

## INFLATION IN CANADA HAS FALLEN SHARPLY

- The rate of inflation has fallen to levels not seen since the 1950s and early 1960s.
- Canada now has one of the lowest inflation rates in the OECD.
- The low inflation environment and continued slack in labour markets have kept wage settlements low, averaging below 2 per cent recently.

### *CPI year-over-year inflation rate*



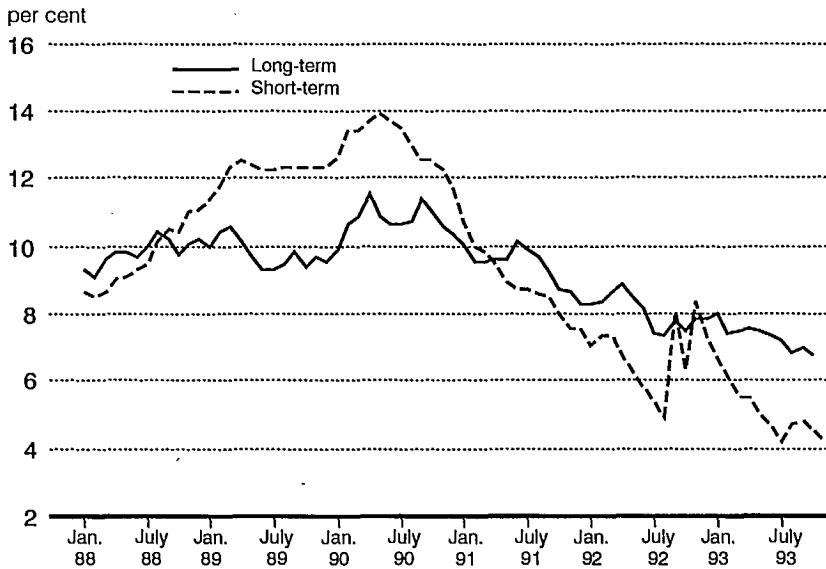
Source: Statistics Canada.



## INTEREST RATES HAVE COME DOWN

- As inflation has fallen, interest rates have come down.
- Short-term interest rates have fallen sharply.
- Long-term rates have come down in nominal terms, but remain high in real terms.

### *Long-term and short-term nominal interest rate*



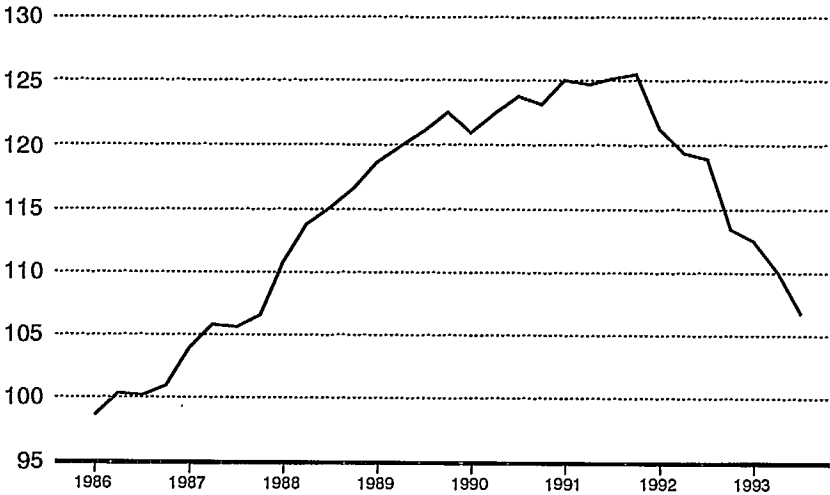
Source: Statistics Canada.

## CANADA'S COST COMPETITIVENESS HAS IMPROVED

- The drop in inflation has been associated with a sharp decline in unit labour cost growth.
- Even without considering movements in the exchange rate, much of the loss in our relative cost position vis-a-vis the United States over the second half of the 1980s has been regained.
- Lower growth in labour costs, combined with the recent decline in the Canadian dollar, has lowered costs relative to our trading partners.
- With the recent decline in the Canadian dollar, the reversal in the loss of competitiveness has been even more marked.

### ***Canada-U.S. unit labour cost ratio (common currency)***

1986=100

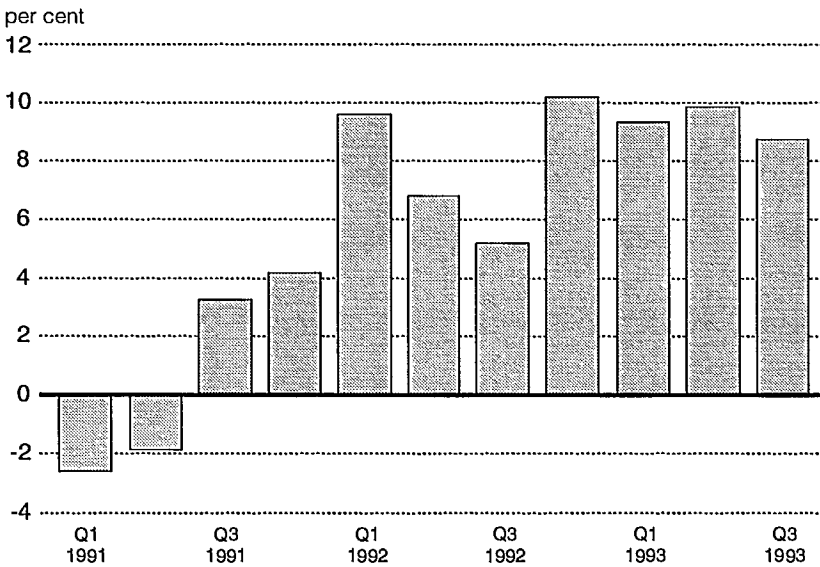


Source: Department of Finance.

## EXPORTS HAVE BEEN STRONG

- Our exports are being boosted by the recent improvement in our competitiveness.
- A strengthening U.S. economy is also helping.

### *Exports of goods and services growth (real terms, year-over-year)*



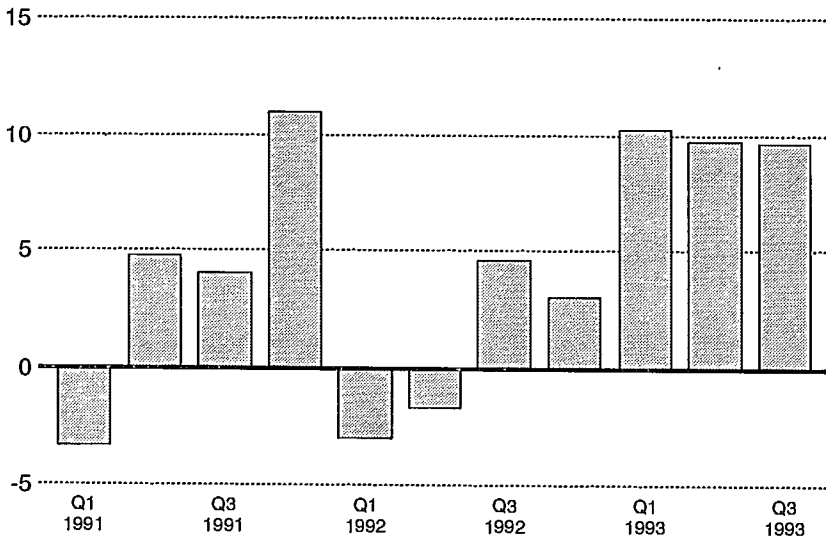
Source: National accounts.

## INVESTMENT SPENDING IS GROWING

- Low interest rates and improved competitiveness are leading to higher investment.
- The strength in machinery and equipment investment – which typically embodies technology improvements – augurs well for future productivity performance.

### *Growth of investment in machinery and equipment (real terms, year-over-year)*

per cent



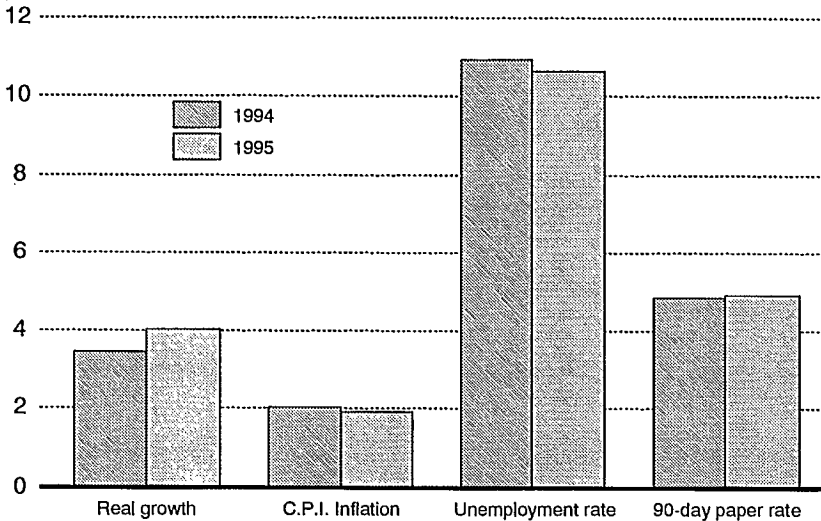
Source: National accounts.

## A MODEST RECOVERY IS FORECAST

- Output growth is expected to gradually pick up:
  - low interest rates should boost consumption and investment;
  - improved competitiveness and a faster U.S. recovery should raise exports.
- Unemployment is forecast to come down slowly as firms seek to raise their profit margins by keeping their labour costs down.
- The large amount of slack should keep inflationary pressures subdued.

### *Private sector consensus forecast for Canada*

per cent



Source: Department of Finance.



# ***Section 3***

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**Structural change**



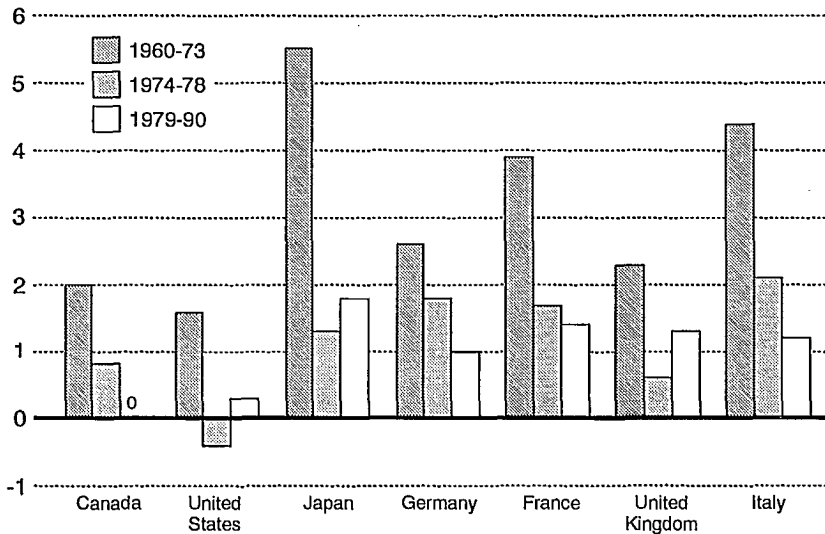


## PRODUCTIVITY GROWTH HAS SLOWED...

- Canada's total factor productivity (TFP, productivity accounting for both labour and capital inputs) has not increased since the late 1970s.
- This is a sharp slowdown from the 1960s and 1970s.
- Other countries have also experienced a slowdown.
- But they have all continued to experience growth.
- Labour productivity has increased in Canada, but only because we have more capital per worker.

### *Growth in TFP in the G-7 economies<sup>1</sup>*

average annual growth – per cent



Source: OECD.

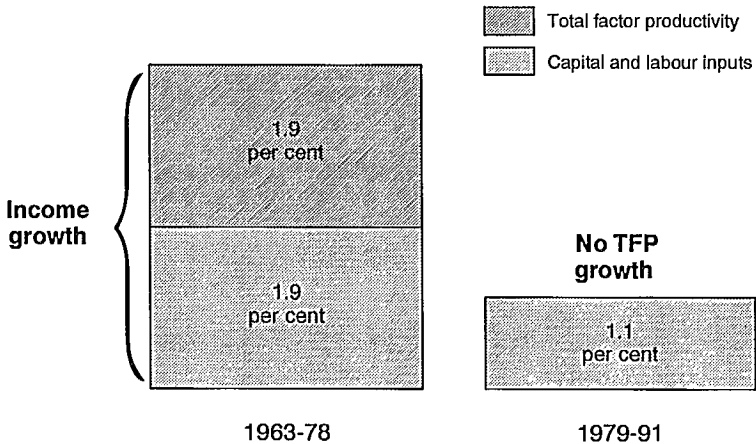
<sup>1</sup>1966-73 for Canada; 1961-73 for U.K.; 1962-73 for Japan; 1963-73 for France.

**... WITH MAJOR CONSEQUENCES FOR INCOMES**

- Growth in productivity is what causes living standards to rise.
- Since the late 1970s, growth in Canada's net national income per capita (the broadest measure of our living standard) has slowed dramatically.
- Slow growth in incomes exacerbates all our economic problems – e.g. it has had a major impact on our ability to finance government programs.
- Boosting productivity growth is one of the most important challenges facing Canadians.

***Growth in real net national income per capita***

per cent – annual rate



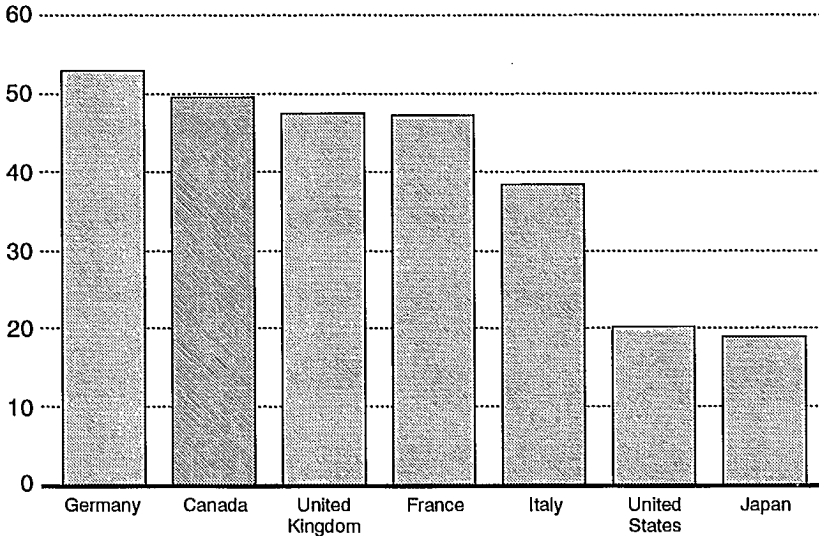
Source: Department of Finance, Statistics Canada.

**CANADA IS VERY DEPENDENT ON TRADE...**

- There is a worldwide trend towards freer trade and open markets.
- Canada is one of the most open economies in the world.
- Globalization and the drive to improve competitiveness has resulted in:
  - Freer trading arrangements with less protection (FTA, NAFTA and now the MTN);
  - The opening up of previously closed economies (China, Russia, etc).

***Trade flows (goods and services) in 1991***

as a percentage of GDP



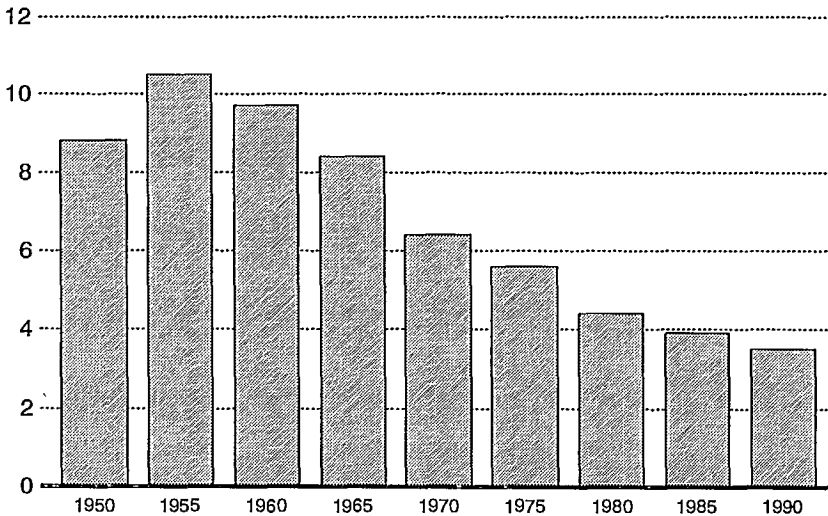
Source: IMF.

**... AND TARIFF WALLS HAVE TUMBLLED**

- Successive bilateral and multilateral trade agreements have led to a steady reduction in tariffs on Canadian imports.
- The Free Trade Agreement (FTA) provides for total elimination of tariffs between Canada and the United States by 1998.
- The recent GATT agreement will reduce remaining tariffs by a third by the end of the decade.
- Worldwide emphasis has necessarily shifted from industry protection through subsidies to encouragement of competitiveness.

***Canadian duties as a percentage of imports***

per cent

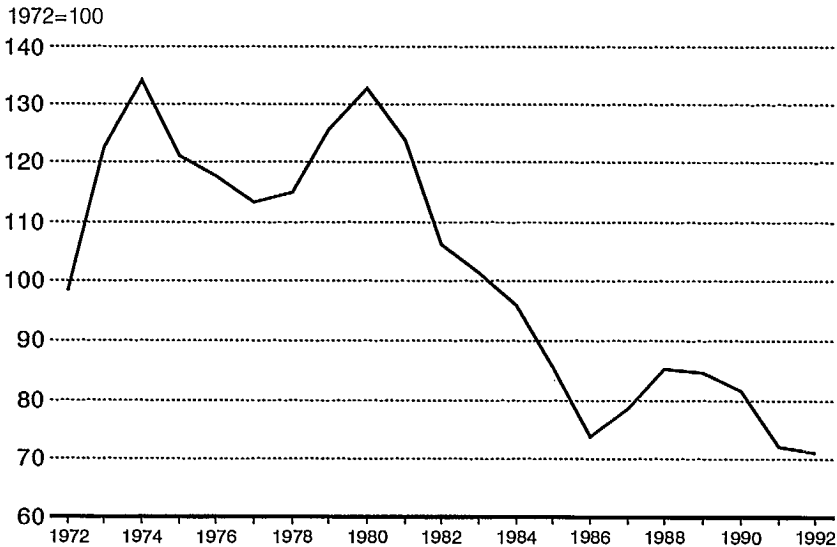


Source: Department of Finance.

## COMMODITY PRICES ARE WEAK

- Commodity prices in real terms (i.e. relative to other prices in the economy) are in a long-term downward trend.
- As a result, Canadians can no longer depend as heavily as in the past on primary products for improvements in their standard of living.
- Canada will have to rely more on increased value-added exports.

### *Real commodity price index*

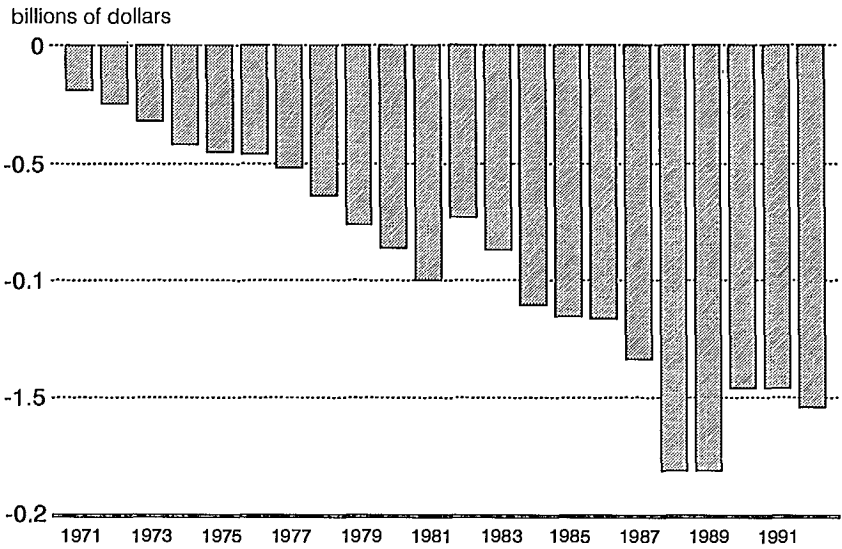


Source: Bank of Canada commodity price index deflated by the GDP deflator.

## CANADA RUNS A DEFICIT IN HIGH-TECH GOODS

- Successful countries are concentrating on high-technology goods.
- Canada, however, is lagging in the export of high-technology goods.

### *Trade balance in high technology goods*

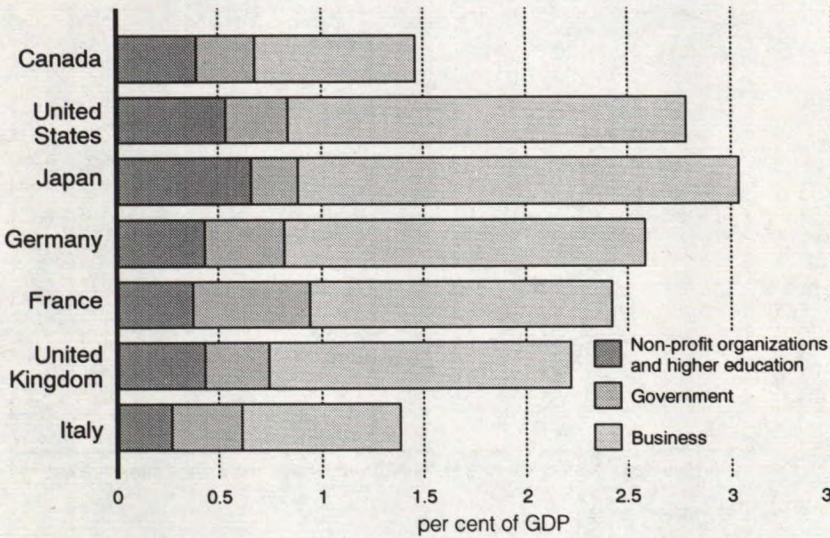


Source: Statistics Canada.

## R&D EXPENDITURE CONTINUES TO LAG

- A key to raising productivity growth is innovation, and research and development of new products.
- Canada is one of the lowest spenders on research and development in the G7 when measured as a share of GDP.
- R&D spending by business in Canada is particularly weak.
  - This is despite generous tax incentives for R&D.

### *Spending on research and development G-7 countries – 1991*



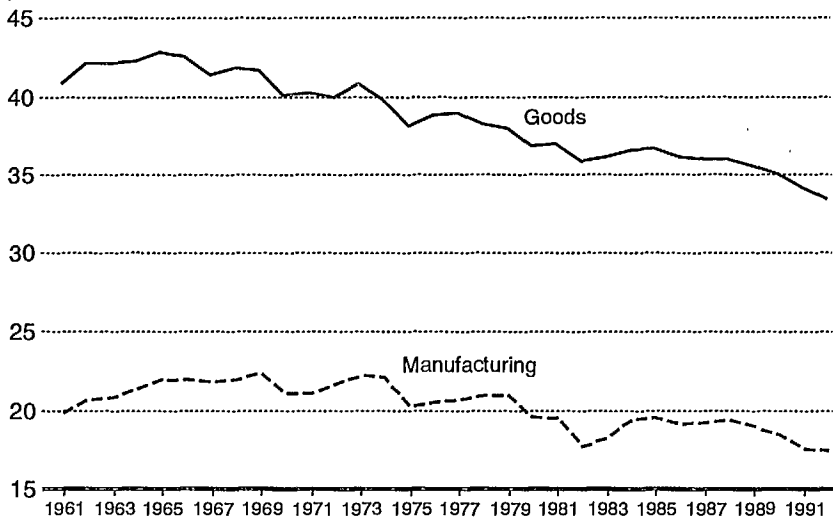
Source: OECD.

## THE STRUCTURE OF THE ECONOMY IS CHANGING

- There has been a long-term trend shift from goods to services.
- Within the goods sector, manufacturing displays the same declining trend.
  - The share of manufacturing in GDP has declined from 22 per cent in 1965 to about 17 per cent today.

### *Share of goods and manufacturing production in the economy*

per cent of GDP at factor cost



Source: National accounts.

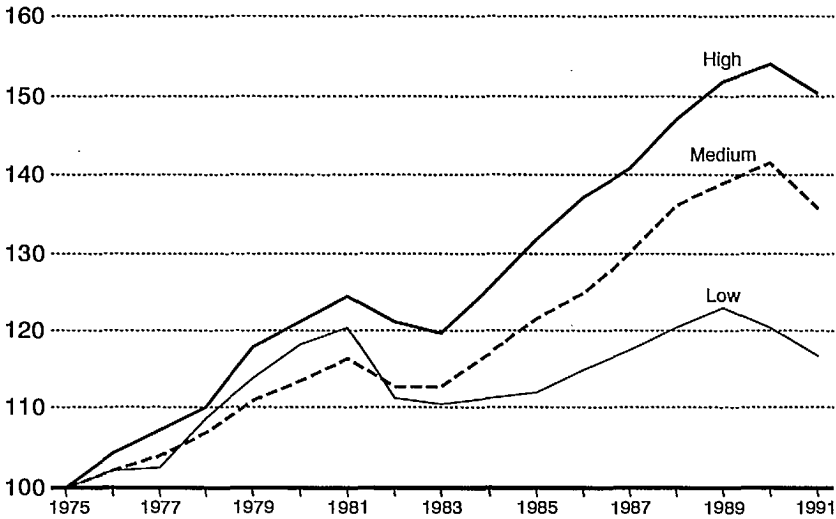


## THE HIGH TECHNOLOGY SECTOR IS GROWING

- Employment in high-technology industries has been growing fastest.
- Almost simultaneously, there has been a shift from low-skilled to high-skilled labour.

### *Business sector employment growth in high, medium, and low technology industries*

1975=100



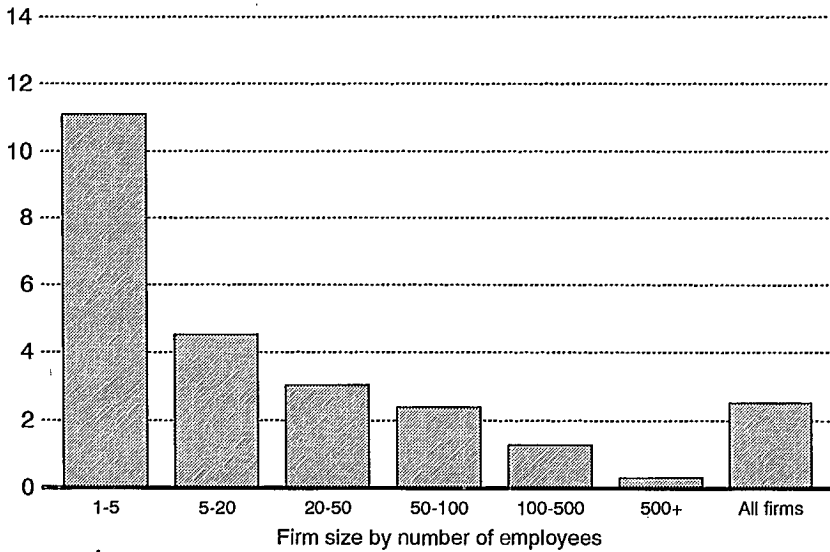
Source: Small Business and Special Surveys Division, Statistics Canada.

## **SMALL AND MEDIUM SIZE BUSINESSES CREATE MOST NEW JOBS**

- Small businesses show higher rates of job growth than large businesses.
- As a result, small business is playing an increasing role in the economy.

### ***Employment growth from 1978 to 1990***

annual average – per cent



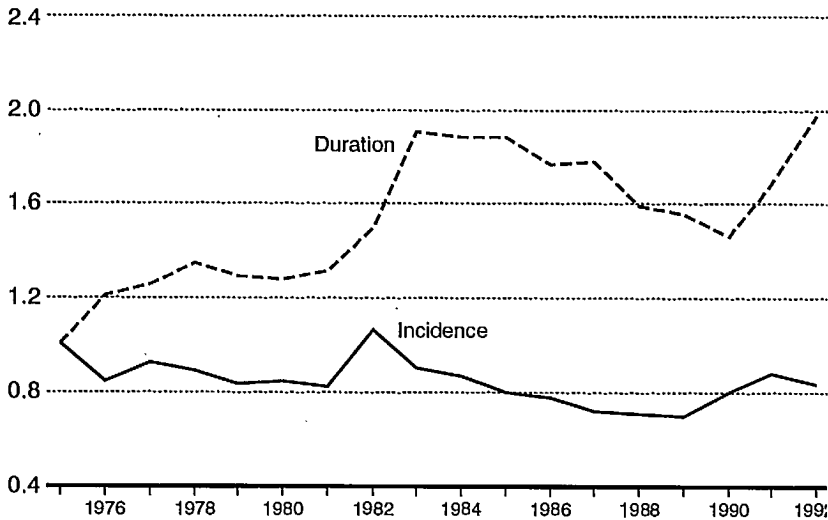
Source: Labour Force Survey

## PEOPLE ARE UNEMPLOYED FOR LONGER PERIODS

- Unemployment is comprised of the risk that a person will be unemployed (the incidence) and the length of time spent unemployed (the duration).
- Most of the increase in the unemployment rate over time is due to higher duration of unemployment.
  - Once unemployed, people are finding it harder to get a job because their skills do not match the shifting requirements.
  - Social programs which discourage work may also be playing a role.

### *Duration and incidence of unemployment*

index: 1975=1

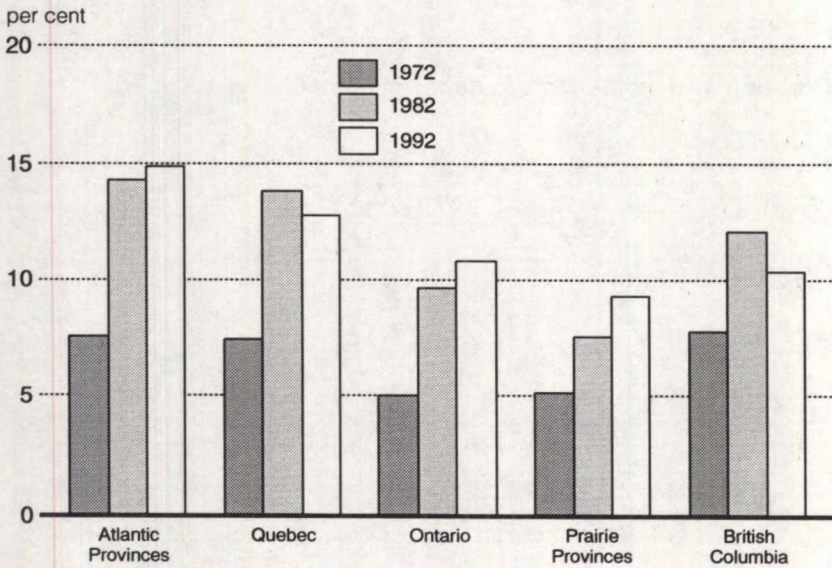


Source: Labour force survey.

## THERE ARE BIG VARIATIONS IN UNEMPLOYMENT RATES ACROSS CANADA

- The Atlantic provinces and, to a lesser extent Quebec, experience chronically above average unemployment.
- Ontario's unemployment rate has approached the Canadian average in the last recession.

### *Unemployment rate by region 1972 to 1992*



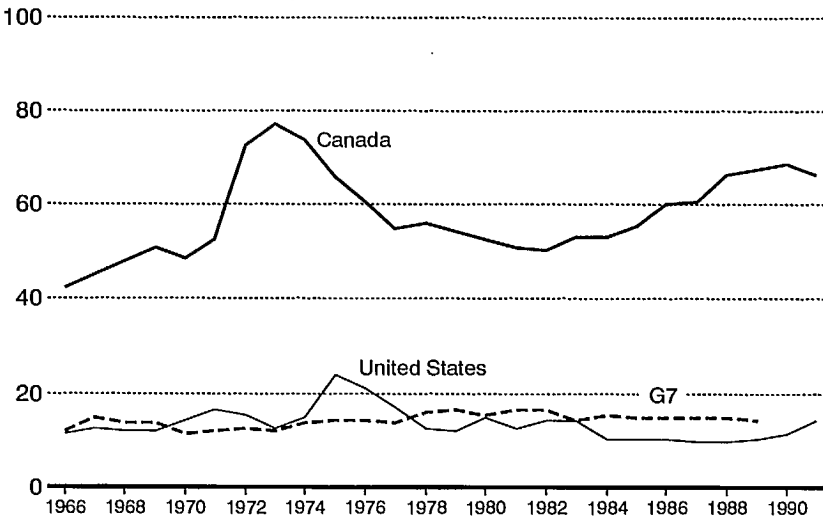
Source: Labour force survey.

## CANADA HAS A RELATIVELY GENEROUS UNEMPLOYMENT INSURANCE SYSTEM

- Canada's unemployment insurance system is more generous than those of the U.S. and the G7 average.
- Studies indicate that our UI system contains important disincentives to work.

### *Generosity of unemployment benefits in the G-7*

per cent of private sector compensation

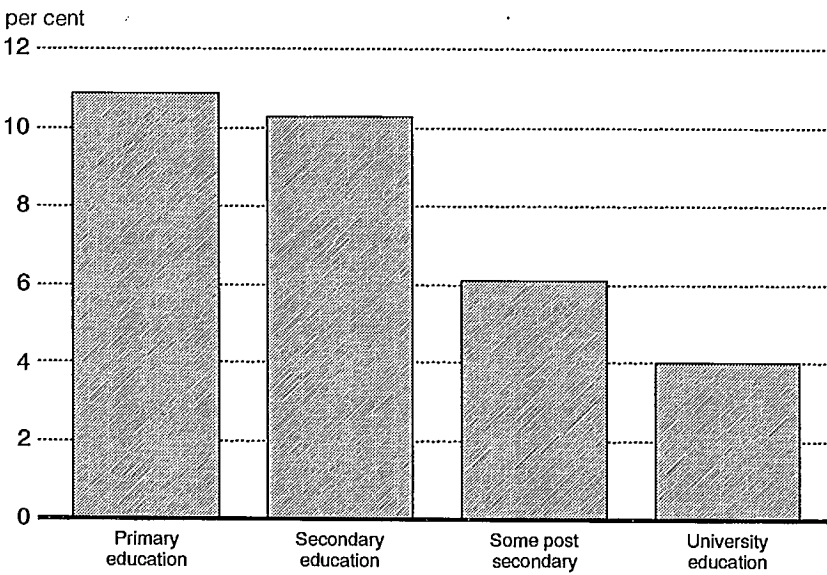


Source: OECD.

## EDUCATION AFFECTS EMPLOYMENT PROSPECTS

- Higher education tends to translate into lower risk of unemployment.
- The trends in demand for various occupations is reflected in unemployment rates.

***Average unemployment rates by educational attainment  
1975 to 1991***

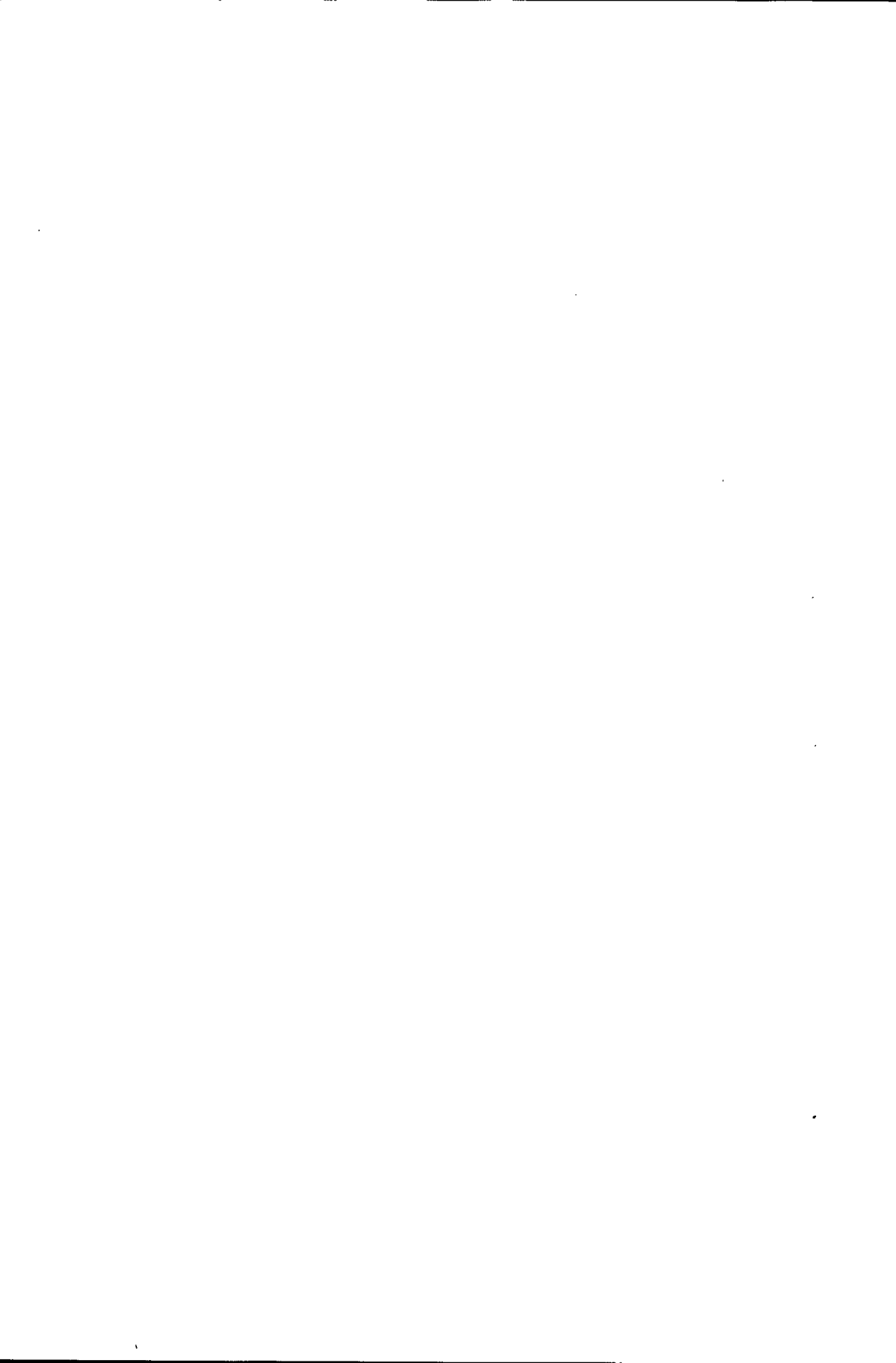


Source: Labour force survey.

# ***Section 4***

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**The fiscal challenge**



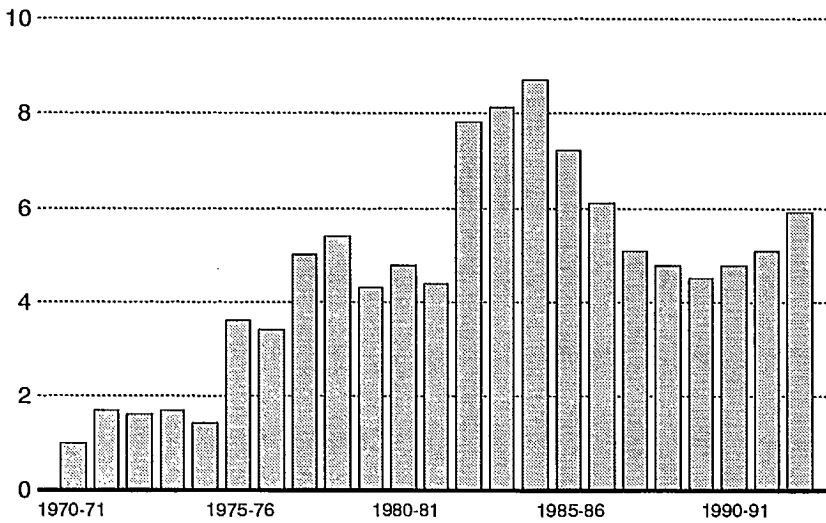


## THE FEDERAL DEFICIT REMAINS VERY HIGH

- The federal government has been consistently running a deficit on a public accounts basis since the beginning of the 1970s.
- While improvement was made in lowering the deficit during the second half of the 1980s, not enough was done.
- The deficit never got below 4.5 per cent of GDP even when the economy was performing at full utilization of its resources. It has since risen again with the recession but not to the same extent as occurred coming out of the recession of 1981-1982.

### *Deficit to GDP ratio*

per cent



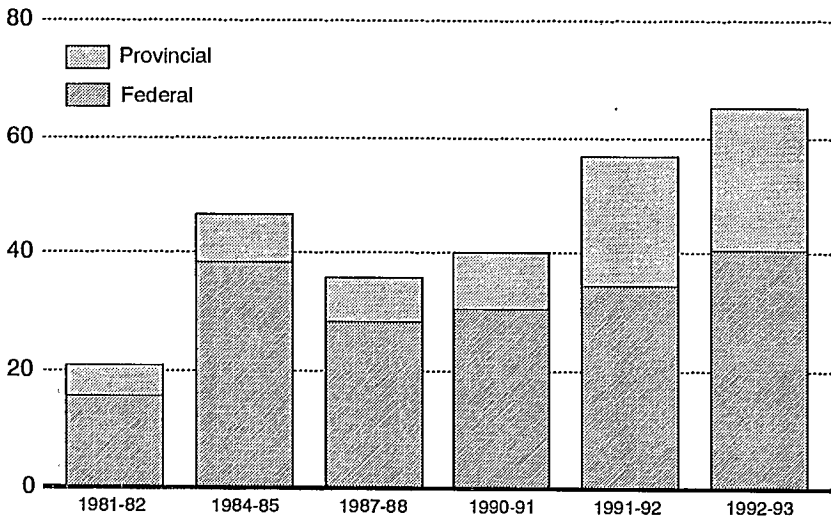
Source: Public accounts and Department of Finance.

## DEFICITS ARE A NATIONAL PROBLEM

- Deficits are no longer just a federal problem. Provincial governments now account for a large and growing portion of the total government deficit.
- In 1992-93 provincial deficits totalled \$25 billion.
- The combined federal and provincial deficits totalled over \$65 billion (on a public accounts basis) – 9.5 per cent of Canada's GDP.

### *Federal and provincial deficits*

billions of dollars



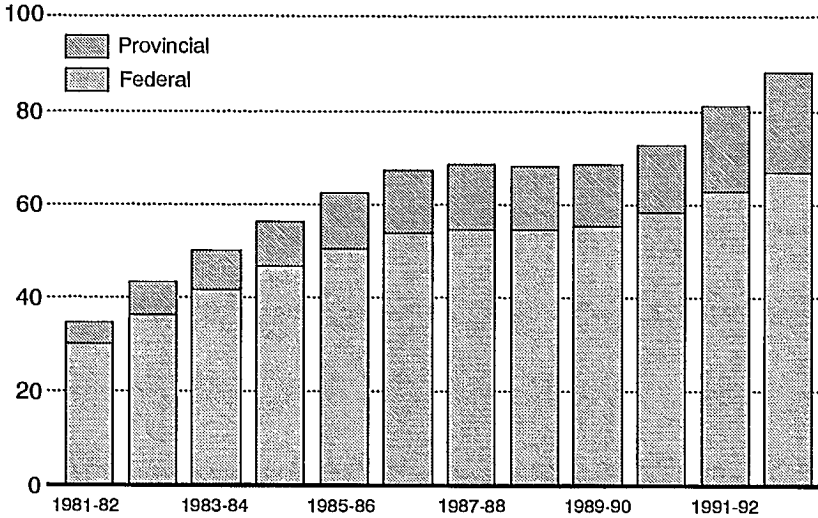
Source: Public accounts and Department of Finance.

## THE PUBLIC DEBT BURDEN CONTINUES TO RISE

- Relative to GDP, Canada's combined federal and provincial debt (public accounts basis) has increased 2 ½ times since 1981-82.
- The combined net debt in 1992-93 was over \$22,000 for every man, woman and child in Canada.

### *Federal and provincial public debt in Canada*

per cent of GDP



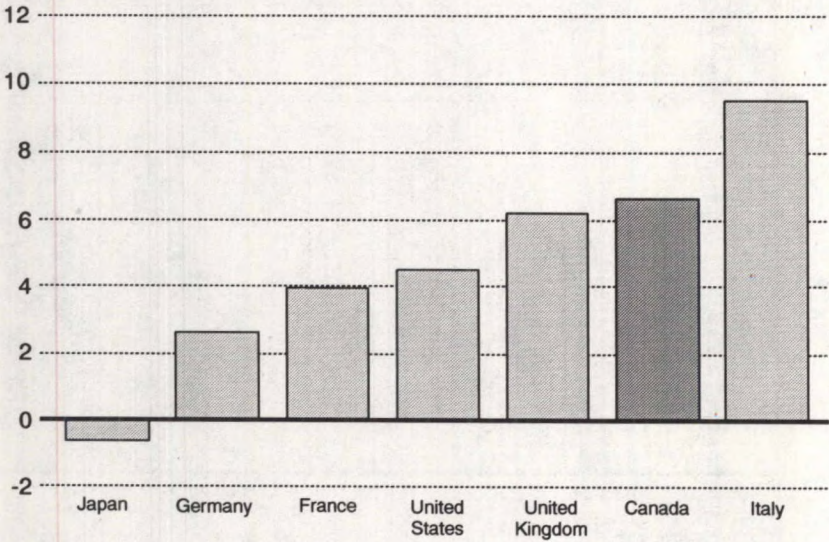
Source: Public accounts.

**CANADA'S DEFICIT IS VERY HIGH BY INTERNATIONAL STANDARDS**

- To make international comparisons, fiscal data must be put on a national accounts basis which are lower than Canada's data on a public accounts basis.
- Canada's total government fiscal deficit was 6.6 per cent of GDP in 1992, on a national accounts basis.
- Only Italy and the UK. had higher deficits in the G-7.

**Total government budget deficits in G-7 economies**

per cent of GDP in 1992



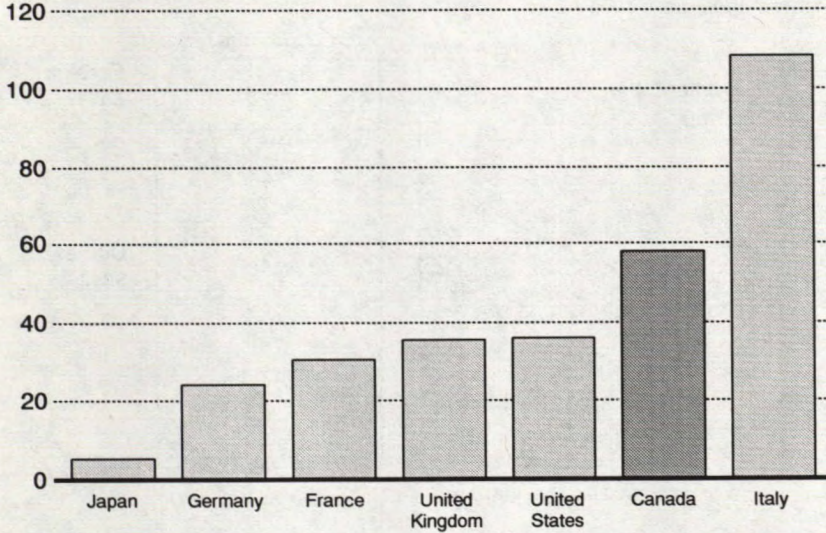
Source: OECD.

## OUR DEBT IS HIGH IN INTERNATIONAL TERMS

- Canada's total public debt of 55.9 per cent of GDP in 1992, on a national accounts basis, is the second worst among the G-7 economies.
- Such high debt levels make Canada very vulnerable to interest-rate developments.

### *Total government net debt in G-7 economies*

per cent of GDP in 1992



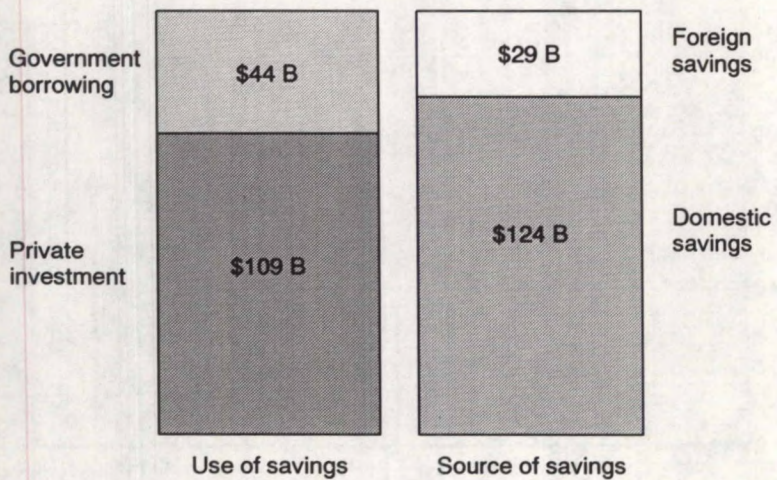
Sources: OECD and Department of Finance.

## DEFICITS ABSORB SAVINGS

- Canadians' savings are high enough to finance private investment, but not enough to finance the extent of government borrowing.
- Therefore, the large government deficits force us to borrow as a nation from foreigners.
- This competition for savings may also be putting upward pressure on real interest rates, further damaging Canada's economic performance.

### *Deficits absorb savings*

billions of dollars in 1992



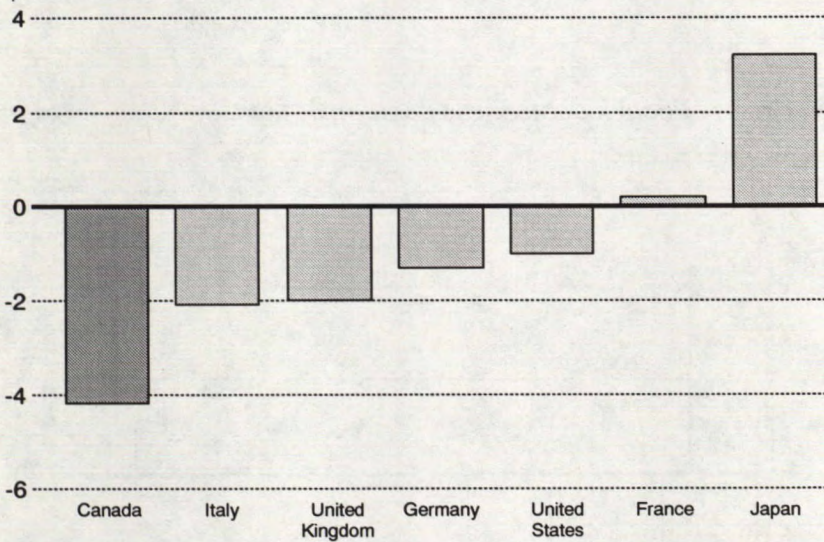
Source: Statistics Canada.

## CANADA'S CURRENT ACCOUNT IS THE WORST IN THE G7

- The current account deficit is a measure of how much we rely on foreign savings.
- Canada has the worst current account deficit, relative to GDP, in the G-7.

### *Current account deficits as a share of GDP in G-7 countries*

per cent of GDP in 1992



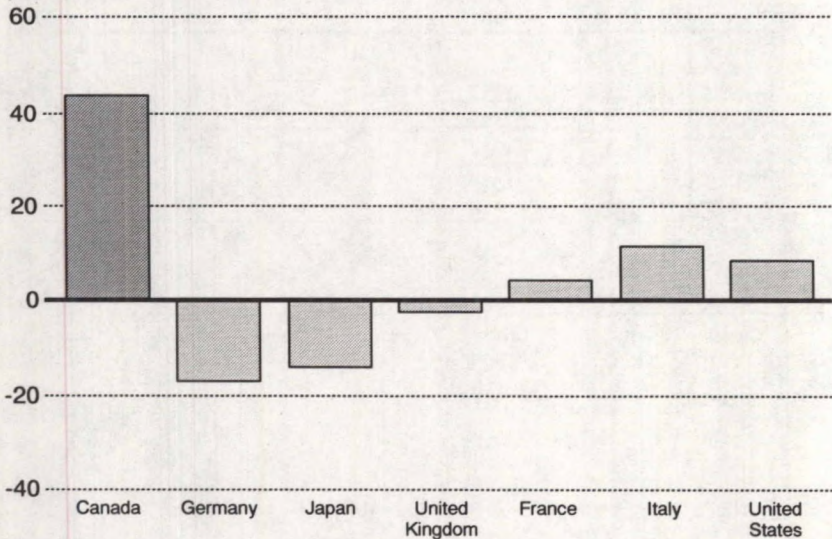
Source: OECD.

## CANADA'S FOREIGN DEBT IS THE WORST IN THE G7

- Canada has the highest level of foreign debt relative to GDP of all the G-7 countries.
- This foreign debt includes debt issued by governments and private corporations and direct foreign investment in Canadian companies.
- Borrowing to finance productive investment can improve the performance of the Canadian economy. However, most of the debt incurred has been going to finance current consumption.
- Unlike borrowing to finance high yielding investment, borrowing to finance consumption will mean that foreign debt will be more difficult to pay back in the future, with possible harmful effects on the future of the economy.

### *Net international indebtedness position of the G-7*

per cent of GDP in 1992



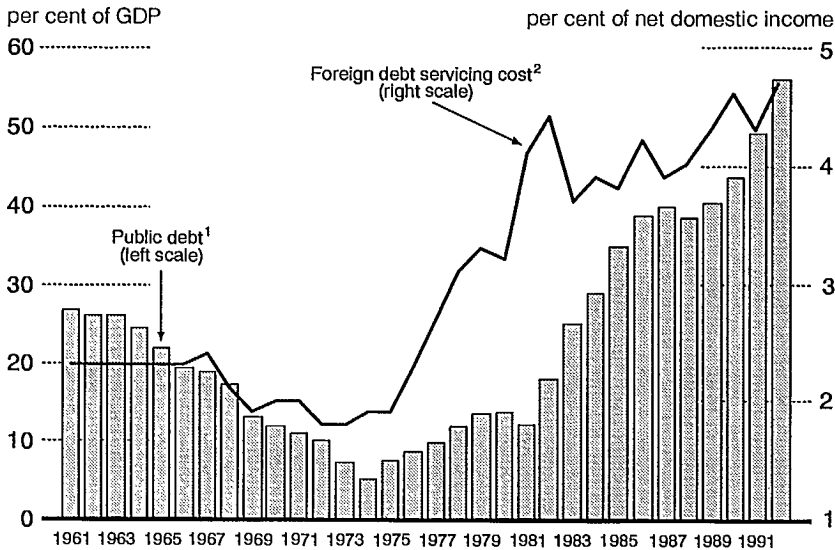
Source: IMF.



## FOREIGN DEBT SERVICING REDUCES OUR NATIONAL INCOME

- As a result of rising fiscal and national indebtedness, more and more of Canadian income must go to foreigners to service Canada's foreign debt.
- The cost of servicing this debt measured as a per cent of our net domestic income has risen steadily over the years with the rise in fiscal debt.
- What this means in simple terms is that less and less of Canada's income is available to Canadians because more and more goes to servicing foreign indebtedness.
- This is a direct hit on our standard of living.

### *Foreign debt servicing reduces our national income*



<sup>1</sup>Total government debt on a national accounts basis as a share of GDP.

<sup>2</sup>Difference between net domestic and national income as a share of NDI.

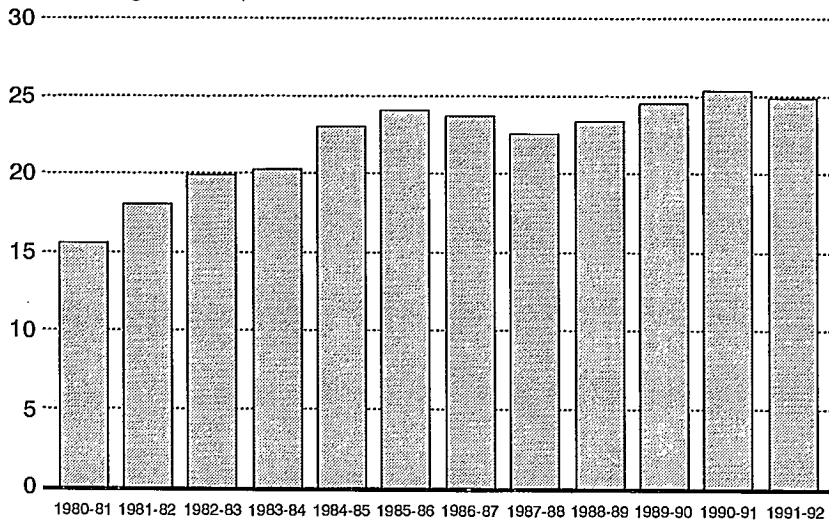
Source: *National Accounts* and Department of Finance.

## RISING INTEREST COSTS REDUCE FISCAL FLEXIBILITY

- The high and rising levels of debt have also robbed the federal and provincial governments of fiscal flexibility.
- In 1991-92, almost 25 cents of every dollar of federal and provincial revenue went to pay interest on the existing debt rather than for needed programs. For the federal government, over 32 cents of every dollar of revenue goes to servicing the debt.
- In 1980-81, only 15 cents of every dollar of revenue was used to service the debt. By 1991-92, an additional 10 cents from each revenue dollar are needed to pay interest on public debt.
- As a result, governments have less room to respond to economic challenges and difficulties and less opportunity to provide services Canadians need.

### *Rising interest costs reduce fiscal flexibility*

debt servicing cost as a per cent of federal revenue

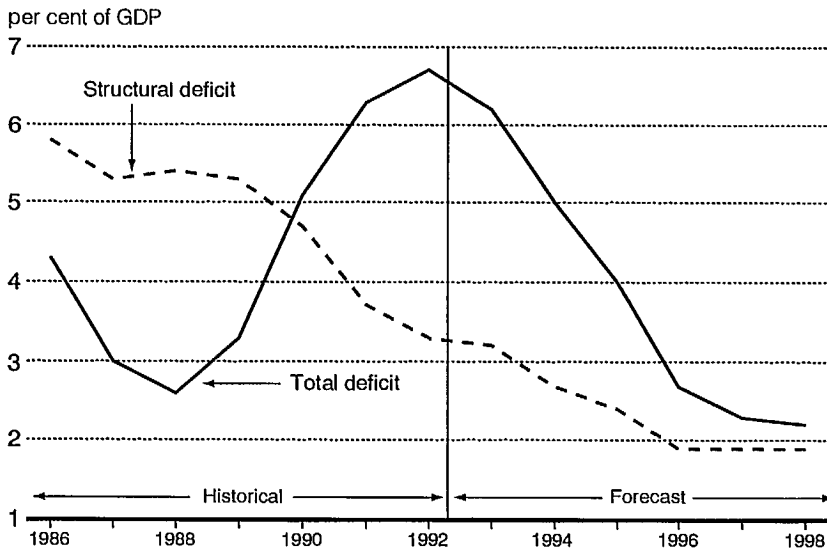


Source: Public accounts.

## A LARGE SHARE OF THE DEFICIT IS STRUCTURAL – NOT CYCLICAL

- The recession and the drop in inflation have contributed to the deficit situation.
- However, according to the IMF the structural deficit – that part which will not go away as the economy moves to its potential – is currently at 3 per cent.
- By 1998, the structural deficit is still at 2 per cent of GDP.
- This estimate of the structural deficit is split evenly between the federal and provincial governments.

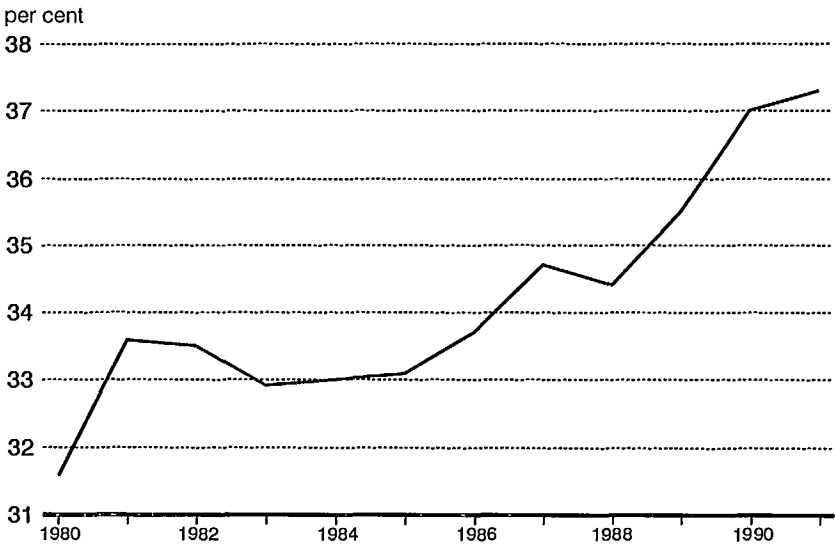
### *A large share of the deficit is structural – not cyclical*



## **CANADA'S TAX BURDEN HAS BEEN STEADILY INCREASING**

- Since the early 1980s total government taxes as a share of GDP have risen significantly.
- Deficits have risen sharply despite the rise in the overall tax burden.

### ***Canada's total tax revenue as a per cent of GDP – 1980 to 1991***



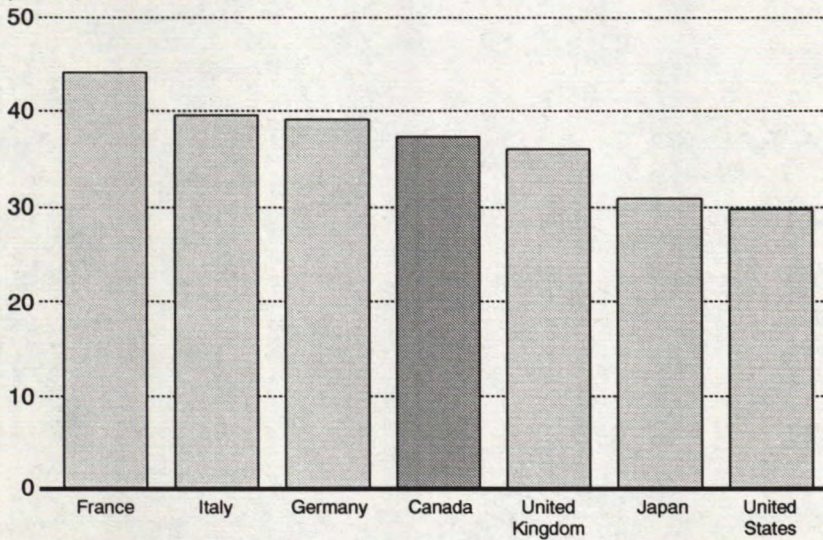
Source: OECD.

## INTERNATIONAL COMPARISON OF THE TAX BURDEN

- The tax burden in Canada is significantly higher than in our major trading partners – the United States and Japan.
- High taxes, in addition to acting as a significant drag on the economy, impede Canada's competitiveness.

### *The G-7 tax burden as a share of GDP*

per cent



Source: OECD.



# ***Section 5***

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The role of government in the economy



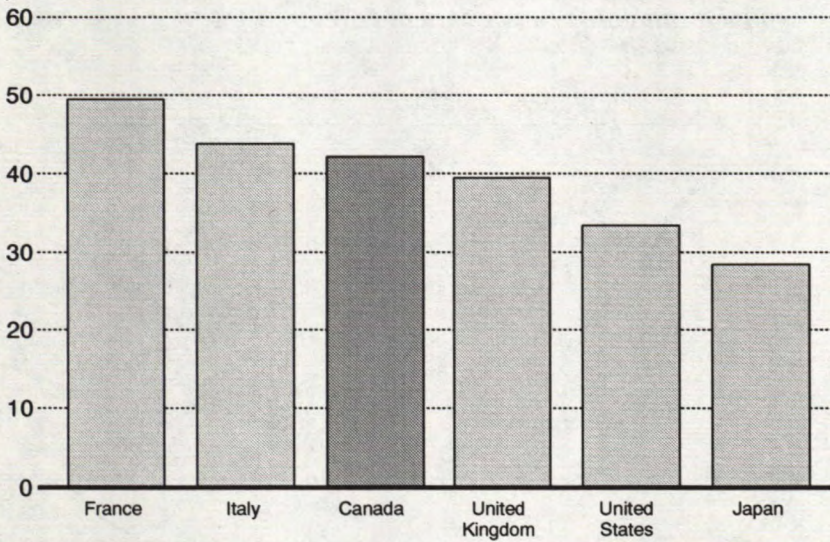


## CANADA HAS A LARGE PUBLIC SECTOR

- The size of Canada's government sector relative to GDP is large.
- Canada's government expenditure on goods and services is one of the highest in the G-7 as a proportion of GDP.

### **Total government program spending as a per cent of GDP in selected G-7 countries**

per cent in 1992

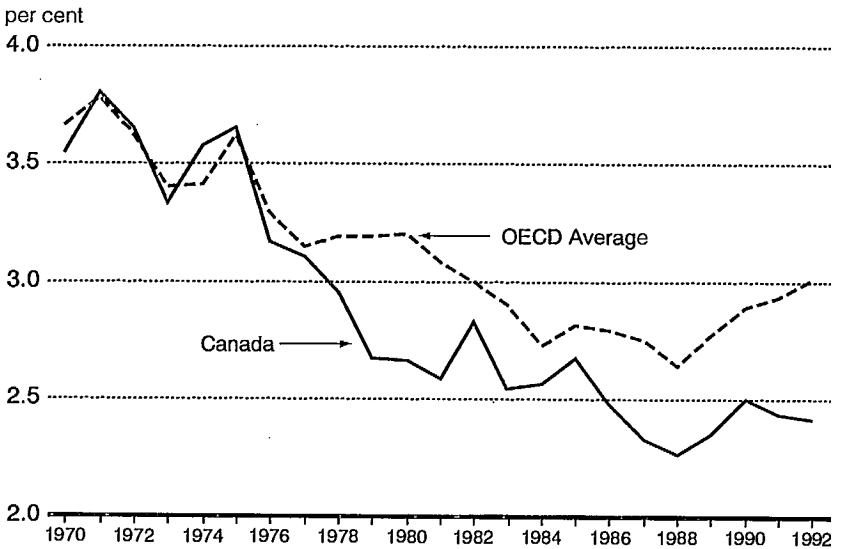


Source: OECD.

## GOVERNMENT HAS BEEN SPENDING LESS ON INFRASTRUCTURE

- There has been a marked declining trend in gross government investment spending in the OECD countries.
- This downward trend has been particularly evident in Canada, where government capital formation declined from over 3.5 per cent of GDP in the early 1970s to under 2.5 per cent in the 1990s.

**Total government gross fixed capital formation as a per cent of GDP – Canada and the OECD**

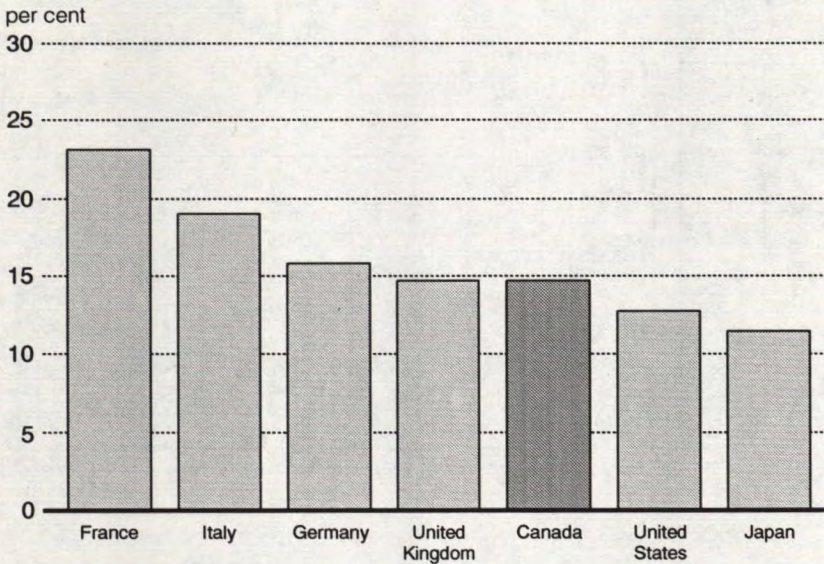


Source: OECD.

## CANADA'S SPENDS MORE ON SOCIAL ASSISTANCE THAN ITS MAJOR TRADING PARTNERS

- Canada spends less on total social security and other income support measures (including UI and welfare) as a share of GDP than most European countries.
- However, we spend more than our major trading partners: the U.S. and Japan.
- And our unemployment insurance program is one of the most generous in the world. This can create serious disincentives to upgrade skills, to work and to move to find work.

### **Total government social security and other income support measures as a per cent of GDP – Canada and the G-7, 1991**

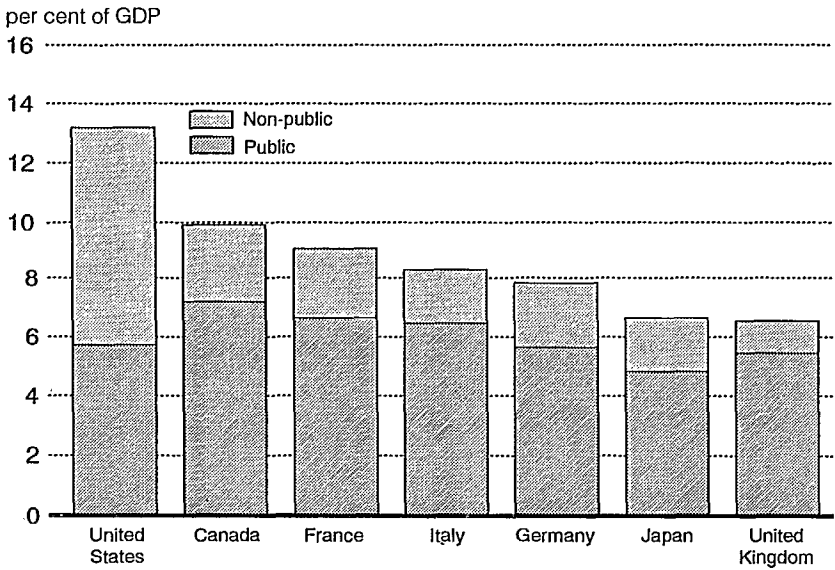


Source: OECD.

### CANADA SPENDS A LOT ON HEALTH CARE

- Canada spends much less than the U.S. on health care.
- However, compared to other countries, public expenditures on health care are higher in Canada.

**Total spending on health care  
Canada and the G-7**



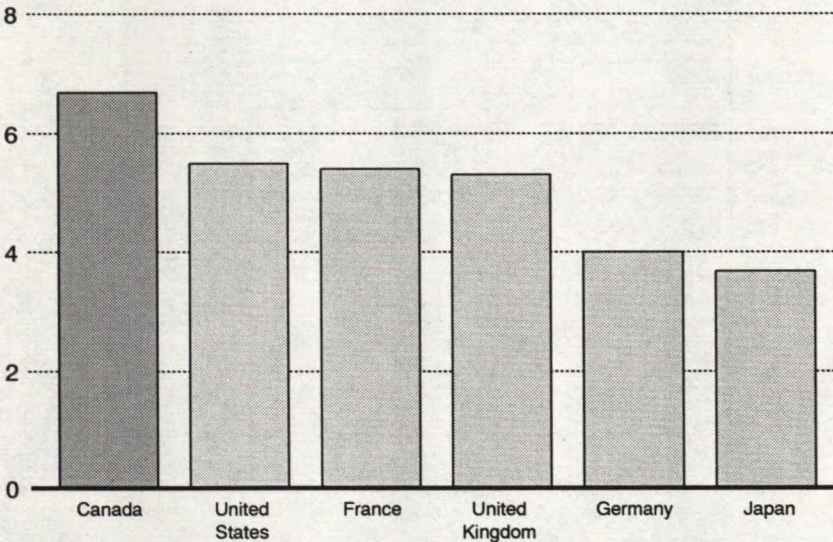
Source: OECD.

## CANADA SPENDS A LOT ON EDUCATION

- Education is critical for a country both to improve its competitiveness and to raise living standards.
- As a per cent of GDP, Canada spends more on education than any other G-7 country.
- But the results are less than spectacular. Canadian students typically do not perform well on international tests for basic mathematics and other skills that are considered critical to the new economy.

### *Public expenditure on education Canada and the G-7, 1991*

per cent of GDP

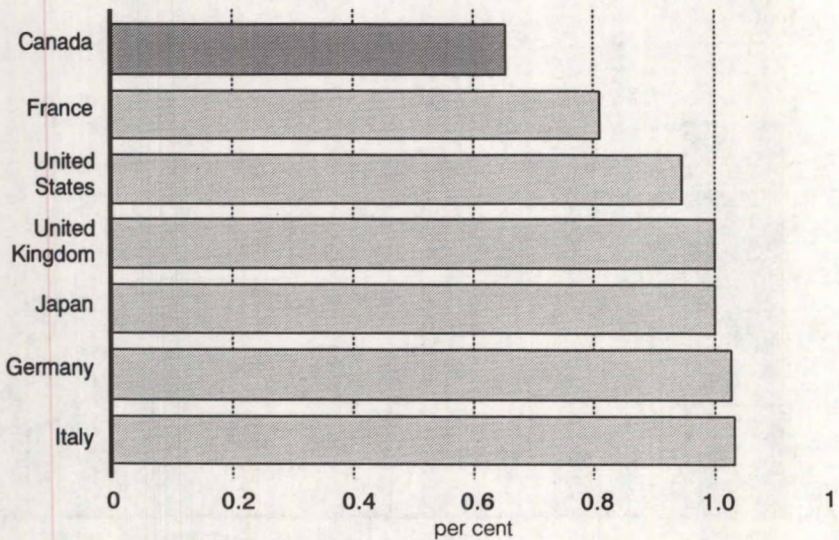


Source: OECD.  
Data for Italy not available.

## R&D TAX INCENTIVES ARE GENEROUS

- Research and development has been identified in a number of studies as a key to raising productivity.
- Canada has in place one of the most generous tax incentive systems to encourage R&D. The chart below shows that government support in Canada gives our firms a lower cost of doing R&D compared to our major trading partners.
- But, as noted above, Canada's R&D effort lags noticeably behind that of our major competitors.

*After-incentive cost per dollar of R&D  
in the G-7 countries, 1990*



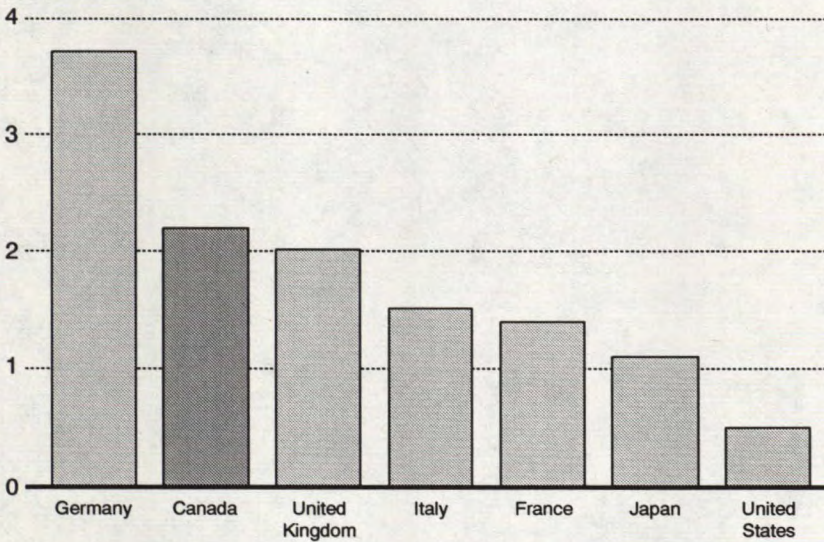
Source: Conference Board of Canada.

## GOVERNMENT ASSISTANCE TO BUSINESS IS QUITE LARGE IN CANADA

- This assistance typically takes the form of grants, subsidies or tax expenditures. It is delivered either directly or through government agencies (like our regional development agencies).
- Sometimes this support is not well targeted or is directed towards firms that would not survive if left to their own devices.
- Government has a role to play in providing assistance to business but it must be effective assistance.

### *Total government transfer to business Canada and the G-7, 1992*

per cent of GDP



Sources: Department of Finance, DRI, and the OECD.