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Securing Economic Renewal A Progress Report

Issued by
The Honourable Michael Wilson
Minister of Finance

November 1985

Canada



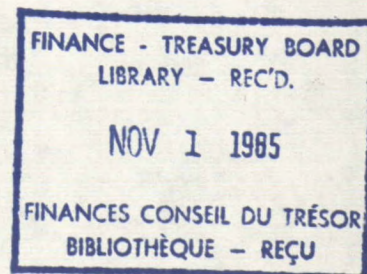
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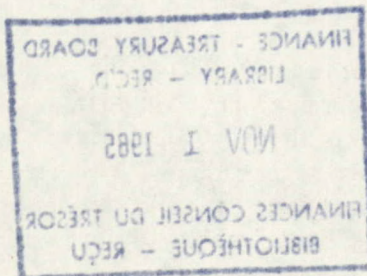
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Department of Finance
Canada

Ministère des Finances
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This document has been prepared as a background paper for the round of consultations between the government and the private sector in the period leading up to the 1986 budget.



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Preface

One year ago, the Government of Canada laid out a comprehensive strategy to secure lasting economic growth and to create jobs for Canadians. This strategy was designed to provide a stable and consistent framework for the initiatives that the government is undertaking over time to achieve a durable economic renewal.

The guiding principles and broad parameters of the strategy were clearly presented in the November 1984 Agenda for Economic Renewal and the first phase of major actions was initiated in last November's economic statement and in the May 1985 budget.

The strategy for economic renewal deals with the vital economic challenges facing the nation: the crucial importance of encouraging private initiative, higher investment, greater innovation and new enterprise in our economy; the need for government to be more effective by providing a better and more positive framework for growth and job creation; and the necessity to control the deficit and the national debt. These challenges must be met in a way that is as fair as possible and consistent with the basic sense of justice and compassion that is characteristic of Canadian society.

From the outset, the government has been committed to a broad, systematic process of consultation as the best means of achieving the economic renewal objectives. In the past year, the government has benefitted from the views and understanding of the economy – its problems and needs – that have been offered by Canadians from every sector and region, and from all walks of life. As Minister of Finance, I was immeasurably helped by the consultations that I had in the period leading up to and following the May budget. Our commitment to consultation will continue to be fundamental to this government's approach in the coming years.

Today, Canadians are beginning to see the first measurable benefits of the renewal strategy and the confidence that the strategy has instilled. The economic picture is much brighter today than it was a year ago. More Canadians have jobs and unemployment has fallen. Investment is up, interest rates are down, consumer confidence is improving. A more stable economic climate prevails. More opportunities are being created.

This document is intended both as a progress report on year one of the economic renewal strategy and as a preview of the challenges of the coming years. The first section reviews economic performance during the first year of the renewal strategy and considers the economic outlook for the years ahead. Section two summarizes the key challenges of economic renewal and identifies the initiatives taken by the government to meet these challenges. Finally, section three identifies the specific initiatives that will be the subject of my forthcoming round of pre-budget

consultations with the private sector. The implications of high deficits and debt for economic activity are reviewed in a separate background paper.

While this report shows clearly that the government has made substantial progress in implementing the first phase of the renewal strategy and that the economy is already responding with a more favourable performance, the long-term and enduring benefits to the economy and Canadians will only be fully realized if the government maintains its strategy on a stable and steady course. The economic renewal challenges remain no less important today than they were a year ago. The government is committed to meet these challenges creatively and vigorously, just as we remain committed to consultation with Canadians as the best way to achieve our common goals.

A handwritten signature in black ink, reading "Michael Wilson". The signature is written in a cursive, flowing style.

The Honourable Michael Wilson
Minister of Finance

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The Economic Outlook: Update

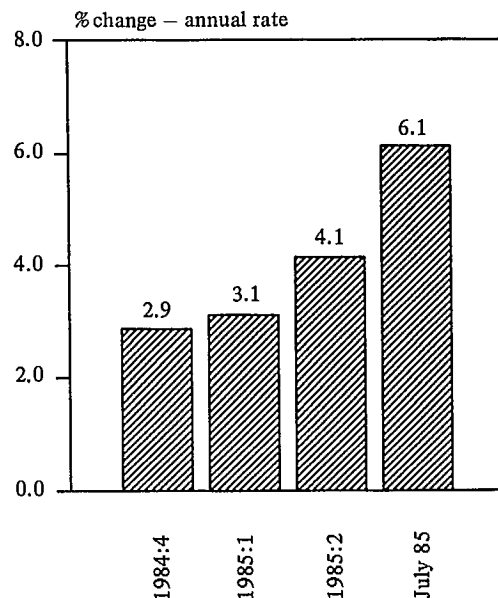
- When the government took office in September 1984, the unemployment rate exceeded 11 ½ per cent and investment was declining. Forecasters were predicting a slowdown in economic growth for the balance of 1984 and 1985; the unemployment rate was expected to remain close to 11 per cent through 1985. Consumers and business people alike had lost confidence in both the economy and the federal government's capacity to manage effectively.
- Canada's solid economic performance in the past year has restored the confidence of households and businesses. Economic growth has been much stronger than had been foreseen. About 300,000 more Canadians are working now than there were one year ago. Consumer spending, housing starts, and investment spending, both residential and non-residential, are all strengthening. While unemployment remains unacceptably high, it is steadily declining; the unemployment rate has fallen in eight of the last 12 months. Inflation is down and once again workers can look forward to a time when prices will not be rising faster than their wages. Export performance continues to be good and the competitive position of Canadian industry is improving. Both household and corporate balance sheets are in better shape today than they were a year ago. The foundation is being laid for a durable economic recovery.

Current Developments in Brief

- Real growth in the economy averaged an annual rate of 4.1 per cent in the first half of 1985 and is expected to continue at at least this rate during the second half of the year. Real gross domestic product rose 6.1 per cent (annual rate) in July relative to the second quarter level (Chart 1).

Chart 1

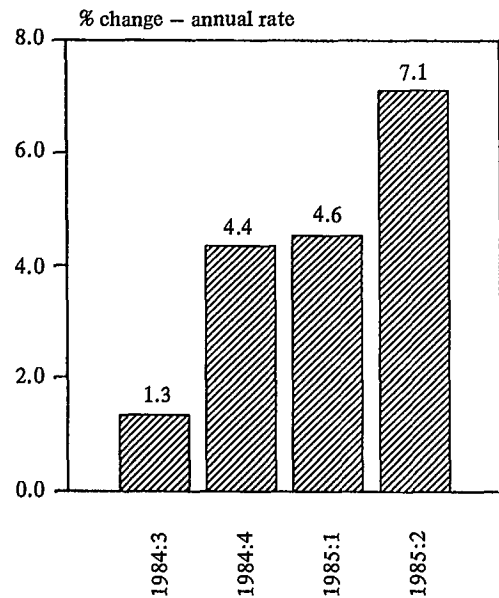
Real Gross Domestic Product



- Final domestic demand, a better indicator of developments in the domestic sector than total real gross national expenditure, has been gaining momentum during the past year and posted its best rate of growth of the current recovery in the second quarter of 1985 (Chart 2).

Chart 2

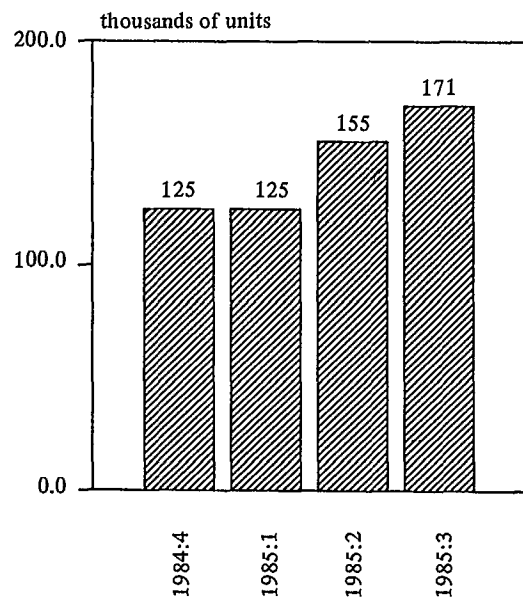
Growth of Final Domestic Demand



- Housing starts averaged 171,000 units in annual terms in the third quarter, an increase of 10 per cent from the second quarter which had already witnessed a solid 24-per-cent increase over the first quarter performance (Chart 3). Residential investment spending rose at an annual rate of 38 per cent in the second quarter.

Chart 3

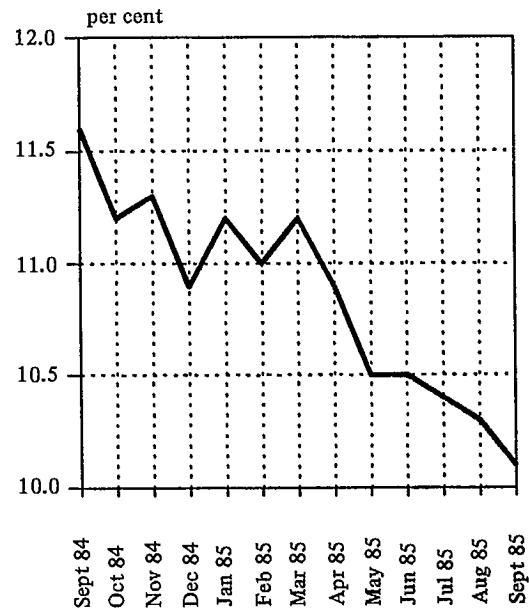
Housing Starts



- Investment has begun to increase vigorously after a decline of more than 20 per cent from the 1981 peak. Investment rose 17 per cent on an annual basis in the second quarter.

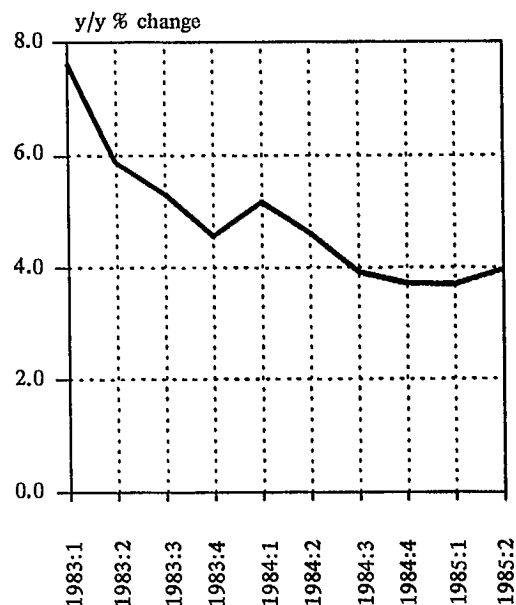
- The Canadian economy has created 300,000 new jobs during the past year and the number of unemployed is down by 170,000. The unemployment rate has declined 1.5 percentage points during the past year to 10.1 per cent in September after showing relatively little movement during the year before (Chart 4). The unemployment rate is now the lowest it has been in the past three years.

Chart 4
Unemployment Rate



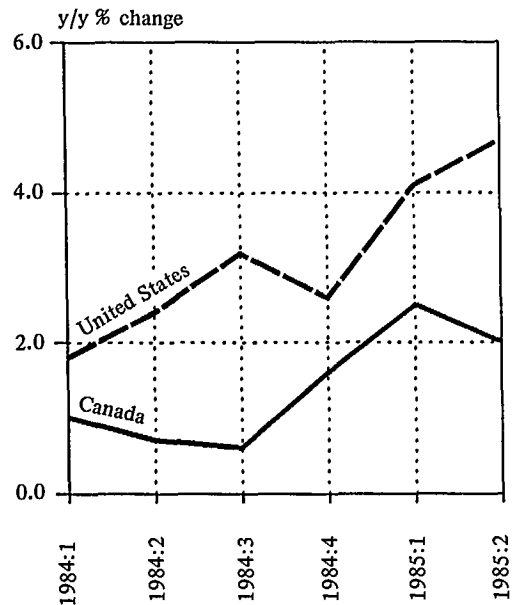
- The recovery has become more balanced during the past year with all major sectors of the economy contributing to growth. This is in contrast to the previous two years when growth came mainly as a result of inventory accumulation and exports to an expanding U.S. economy.
- Inflation has remained subdued at about 4 per cent or lower in the past year (Chart 5).

Chart 5
CPI Inflation



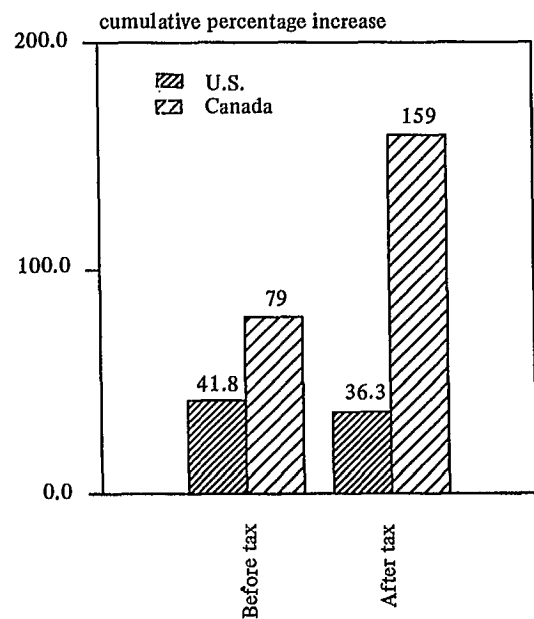
- Unit labour costs are increasing at a rate that is one of the lowest among major industrialized countries. Canada's competitive position is improving (Chart 6) .

Chart 6
Unit Labour Costs



- Canadian corporate profits have grown strongly, and this growth has exceeded that in the U.S. on both a pre- and after-tax basis during the current recovery (Chart 7).

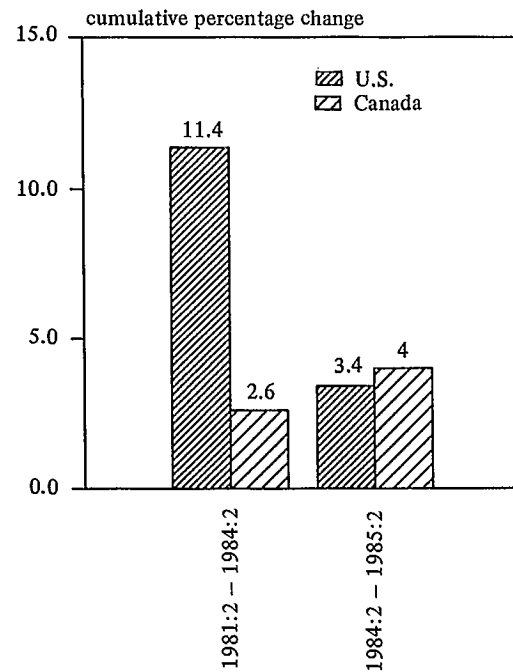
Chart 7
Corporate Profits
During the Current Recovery:
Canada vs. U.S.



- Real personal disposable income rose 4.0 per cent last year, outstripping the 3.4-per-cent rise in the U.S. and much improved over the 2.6-per-cent cumulative increase in the previous three years (Chart 8).

Chart 8

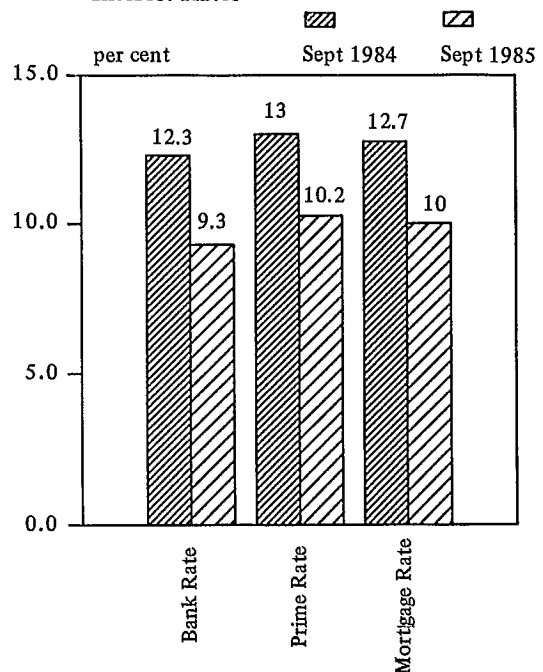
**Real Personal Disposable Income
Canada and the U.S.**



- Interest rates during the past year have dropped by about 3 percentage points (Chart 9).

Chart 9

Interest Rates



- Reinforcing this trend of improved performance is the fact that some major leading indicators of economic activity are now growing at rates greater than in recent months and much greater than in the U.S. The OECD's leading indicator for Canada rose 8.4 per cent in July, the fourth consecutive month of increase above 8 per cent (the U.S. index rose 3.6 per cent). The U.S. Conference Board's leading indicator for Canada rose 8 per cent in May, its best gain in 15 months.

Outlook for 1986

- The outlook for 1986 has improved significantly from what it was a year ago. At that time forecasters were anticipating growth of about 2 per cent for 1986 – and some were even predicting a recession. Since the spring, the outlook has brightened considerably.
- While growth of consumption is expected to slow somewhat in 1986 and government demand for goods and services should remain restrained, most forecasters now anticipate total domestic demand to grow by about 3 per cent due to strengthening investment.
- This 3-per-cent growth expected next year is somewhat slower than the growth anticipated for 1985, but still relatively good by international standards.
- For the U.S., forecasters generally believe real GNE will grow by 2 to 3 per cent next year. With only moderate U.S. growth, Canadian net exports are likely to remain relatively flat in 1986 as imports rise and exports to the U.S. grow more slowly. However, a number of forecasters are anticipating a stronger U.S. performance next year which – if this improvement does materialize – would result in greater Canadian exports and stronger Canadian economic growth.
- Employment is expected to continue to grow substantially although a commensurate decline in the unemployment rate is not likely because of the anticipated growth in the labour force.
- Inflation is expected to remain very near its current rate of about 4 per cent. Moderate rates of inflation are predicted, despite increasing capacity utilization and lower unemployment rates, because of continued favourable cost performance.
- Many forecasters are anticipating continued moderation of interest rates in the United States and a narrowing of Canada/U.S. interest rate differentials. This bodes well for interest-sensitive sectors such as housing and investment (see Table 1).

Table 1
September Survey of 18 Private Sector Forecasts

		Low	Average	High
Real GNE growth	1985	3.5	4.0	4.2
	1986	1.9	3.0	4.4
	1987	2.4	3.6	5.6
Inflation (CPI)	1985	3.8	4.0	4.6
	1986	2.0	4.1	5.1
	1987	1.3	3.6	5.2
Unemployment rate	1985	10.5	10.6	10.7
	1986	9.7	10.1	10.7
	1987	8.6	9.4	10.0
90-day commercial paper rate	1985	9.1	9.5	9.7
	1986	7.5	8.8	10.1
	1987	6.5	8.5	9.9

The Medium-Term Outlook for 1987 and Beyond

- The farther one looks into the future, the more difficult it is to forecast with any degree of accuracy. While the basis for continued recovery is being laid within Canada, great uncertainty persists about the course of the world economy. In particular, there is concern that budget deficit problems may not be adequately resolved and that this may result in real interest rates remaining high. There also is concern over protectionist pressures on the trade front, particularly in the U.S.
- On balance, however, world economic growth is expected to be stronger in 1987 than in 1986. U.S. economic growth is expected to pick up.
- The Canadian domestic sector should witness continued strength as consumer spending increases and investment remains strong.
- Beyond 1987, the outlook becomes more uncertain and depends even more critically on the resolution of fiscal and economic imbalances. Real interest rates become a key factor conditioning the medium-term outlook. In turn, the interest rate outlook is conditional on confidence in the economy and the ability of governments, both domestic and abroad, to reduce their budgetary deficits.

Securing Economic Renewal: A Progress Report

Introduction

- Canadians agree that economic growth and the creation of meaningful jobs are the basis of individual and collective well-being and economic security. The federal government has set itself the task of achieving these goals as its first and most important economic challenge.

What conditions are necessary for growth and jobs?

- Strong business investment to increase the nation's productive capital stock and to ensure a rising standard of living.
- Competitive export industries that are positioned to take advantage of existing and new markets, markets much larger than the Canadian domestic market.
- Secure access to these growing foreign markets.
- Consumer confidence – confidence in the prospects for stable inflation, lower interest rates and increased employment – as a reflection of economic well-being and expressed by growth in consumer spending, the personal counterpart of strong business investment.

How can government policies foster growth and jobs?

- By making markets work more effectively so that resources will be allocated efficiently and productively.
- By promoting productivity to improve living standards and to ensure international competitiveness.
- By generating the investor and consumer confidence required for innovative, productive risk-taking.
- By ensuring that government policies promote price stability.

In short, the government must create and maintain a stable policy framework that contributes to international competitiveness, dynamism, and confidence.

What are the key policy elements of this framework?

- Policies to encourage greater private sector investment.
- Positive foreign investment policies to attract foreign capital.

- Policies to enhance trade.
- Labour market policies that facilitate adjustment and flexibility through new training and job development programs.
- Improved government regulatory mechanisms in such sectors as energy, transportation and communications.
- An improved competition policy framework.
- Tax policies which ensure that taxpayers are paying their fair share without unduly complicating the tax system.
- Prudent fiscal and financial management to achieve medium-term stability in the debt/GNP ratio.
- A stable monetary policy consistent with non-inflationary conditions.
- Efficient public administration to deliver government programs effectively at minimum cost.

In the November 1984 Agenda paper and in the May budget, the government established the three broad thrusts of its strategy for economic renewal:

- encouraging private initiative
- improving government effectiveness
- controlling the national debt.

Over the past year the government has undertaken policy actions to implement each of these three major thrusts. Many of these initiatives have been discussed over the past year with provincial governments and private sector groups to obtain their insights and assistance in developing new attitudes as well as new policies. The following pages outline the real progress that is now being achieved.

1. Actions to Encourage Private Initiative

- As Canadians we save a substantial fraction of our incomes. Too often, however, we are unwilling to invest these savings in the kinds of new ventures that spur growth and create jobs.
- On balance, many government programs have discouraged rather than encouraged the risk-taking and productive investment Canada needs.
- To encourage private initiative the government must provide a framework within which Canadians will choose to invest in productive enterprises.

- In the past year, a number of measures have been introduced which are helping to create a stronger investment outlook.

Incentives to undertake productive new investments are being put into place.

- A lifetime capital gains tax exemption of \$500,000 encourages risk-taking and investment.
- A more receptive and aggressive foreign investment policy encourages new productive investment from abroad. The Foreign Investment Review Agency has been replaced by Investment Canada, giving foreign investors a clear message that they are welcome.
- The new tax credit to encourage long-term investment by individuals in labour-sponsored venture capital organizations will help to create jobs.

Robust private sector R&D spending is a very important factor in a vibrant economy.

- Research and development spending will be encouraged by the capital gains tax measure, by the removal of restrictions in the definition of R&D that qualifies for tax incentives, and by an increase in the amount of tax credit for current R&D that is refundable directly to non-taxable small businesses.

As investment increases, funding for new projects also has to be available at reasonable cost.

- New rules will encourage pension funds to invest in equity capital of small and medium-sized businesses.
- The extension of the non-resident withholding tax exemption for interest payments on certain long-term debt obligations ensures continued access to long-term debt financing at competitive rates.

An effective corporate tax system that minimizes market distortions while properly rewarding risk is also an important element in encouraging private initiative.

- Discussion has begun on the development of a more efficient corporate tax system with the tabling of the May budget discussion paper entitled *The Corporate Income Tax System: A Direction for Change*.
- The discussion paper *A Corporate Loss Transfer System for Canada* examines the possibility of allowing the transfer of losses among member corporations of a commonly owned group. The proposal would help reduce unproductive corporate restructuring based purely on tax considerations.

The Western and Atlantic Energy Accords are allowing private enterprise to take the initiative once again in the energy sector. Since the Accords were signed there have been many welcome signs of revival in the petroleum industry.

- Oil price deregulation clears the way for producers to respond to market signals, to undertake exploration and investment based on market prices.
- A more market-oriented energy sector will result from the phase-out of the Petroleum and Gas Revenue Tax (PGRT) and the repeal of the Natural Gas and Gas Liquids Tax (NGGLT), the Incremental Oil Revenue Tax (IORT) and the Canadian Ownership Special Charge (COSC).

Enhanced access to larger export markets is essential to healthy economic performance. All avenues to secure such increased access are being examined, including bilateral trade options with the U.S. and multilateral trade negotiations.

- The Prime Minister has announced Canada's willingness to engage in discussions with the U.S. on the options for further trade liberalization between our two countries. Extensive consultations are underway with the private sector and with the provinces on this issue and on the prospective next round of multilateral trade negotiations.
- Trade promotion services and export financing are being reoriented to provide for a more active private sector role in the penetration of new markets and in the improvement of our competitive exporting efforts.

A healthy economy is also marked by efficient labour markets where unemployment is low and skills of the labour force respond to job requirements.

- The new Canadian Jobs Strategy is a cooperative effort among federal and provincial governments and the private sector. The new strategy will ensure that training and job development programs are more responsive to the real demands of the labour market and are delivered in a more flexible and decentralized way. The federal government has committed a total of \$1.9 billion in 1986-87 for all job creation and training programs.
- By skills upgrading and retraining, these programs will address the urgent needs of workers whose jobs are threatened by new technology. New opportunities will also be offered to the long-term unemployed.
- Women and young people will be assisted in entering the labour market by programs that teach them essential skills.
- The Forget Commission's review of the Unemployment Insurance program is underway. The review should lead to improvements in the operation of labour markets by ensuring that the U.I. program is more effective in helping individuals and the economy adjust to changing conditions at a reasonable cost.
- U.I. premium rates for 1986 are being held at 1985 levels, thus avoiding any further tax increases on employment.

2. Actions to Improve Government Effectiveness

- Government has a pervasive influence on the private-sector decision-making process. The influence of government often distorts decisions in a variety of ways that lead to slower economic growth and lower employment.
- When interventionist policies have been in place for a long period of time, market signals are stifled, inefficient resource allocation occurs, prices and wages become inflexible and the private sector is unable to adjust as market conditions change; under these circumstances decision makers respond to government policies rather than to economic signals.
- Proposals for modified regulation of various industries, privatization of Crown corporations and fewer government subsidies to noncompetitive enterprises, are ways in which government can be more effective in helping foster sustained economic growth.

Improving effectiveness must start with a review of government's own program management.

- The Ministerial Task Force on Program Review was appointed in September 1984. Its mandate is to review all government programs with a view to making them simpler, more understandable and more accessible to the public. While the work of the Task Force continues, a number of study teams have already made their recommendations. The May budget set out the decisions that the government has taken in response to these recommendations. For example:
 - The government has taken measures to reduce the undesirable effects of undue stacking of federal benefits to investment projects.
 - The sales tax has been broadened, as recommended, to eliminate competitive distortions among manufacturers.
 - Measures are being considered to strengthen and consolidate export marketing programs.
 - Business framework legislation such as bankruptcy and competition legislation is being updated.
 - New commodity development strategies for agriculture are being considered.
 - A detailed accounting of the cost of tax expenditures has been released, as recommended by the study teams, to provide a basis for further discussion of the value of various tax incentives.
- A further progress report on the work of the Task Force will be released in the near future.

In addition, the government has identified a number of measures to manage its internal resources better.

- The Prime Minister and the members of Cabinet have taken a pay cut for 1985.
- The guarantee of full indexation for pensions of Members of Parliament and Senators is being ended, effective January 1, 1986.
- The public service is being reduced. By 1990-91, 15,000 fewer employees will be on staff.
- Government operating and capital budgets are being reduced in real terms.
- An aggressive program to improve the government's management of its cash and real property is being implemented.
- The guarantee of automatic indexation for public service pensions will be replaced by a new formula that will eliminate financial risk to taxpayers in the future.
- Programs in the areas of agriculture, energy, fisheries and oceans, overseas development assistance, regional industrial expansion, training and transportation are also being modified to make them more efficient and less costly.
- For example, transportation, industrial and agricultural subsidies are being capped or reduced.
- As a result of the November and May initiatives, transportation expenditures are being reduced by \$75 million this year and \$200 million next year. The operations of VIA Rail are being put on a full cost recovery basis where feasible. Industrial subsidies are being lowered by \$300 million this year and \$350 million next year by reducing planned spending under the Industrial and Regional Development Program and the Defence Industry Productivity Program. Agricultural subsidies will be reduced by \$50 million a year.
- In the energy sector, subsidy programs such as the Canadian Home Insulation Program (CHIP) and the Canadian Oil Substitution Program (COSP) are being phased out, as is the costly Petroleum Incentives Program (PIP).
- Nuclear research and heavy water production are being reduced by cutting research expenditures and by closing the heavy water plants in Cape Breton.

The privatization of Crown corporations that have no ongoing public policy purpose is a high priority.

- In the May budget, the government announced that it would be rationalizing the current structure of Crown corporations by putting up for sale those corporations with a commercial value but no ongoing public purpose.
- The government's shares in the Canada Development Corporation (CDC) have been sold. The Northern Transportation Company Limited has also been sold. The sales of Teleglobe and Canadian Arsenals Limited are expected in the next few months.
- A number of other Crown corporations are being reviewed with the objective of identifying further candidates for sale or absorption within existing departments.

Government regulation of major sectors such as transportation, communications and energy is being reviewed to reduce the regulatory burden and promote efficiency.

- In the July discussion paper *Freedom to Move* a number of substantial reforms were proposed to the regulatory regime governing transportation. These proposals are now being discussed with the private sector.
- A comprehensive review of telecommunications policy is underway.
- Substantial regulatory changes have already been made in the energy sector with the Western and Atlantic Accords. The issue of natural gas price deregulation is also being examined.

Many changes have also been introduced to improve the fairness and effectiveness of social programs.

- The eligibility for the spouse's allowance for the elderly has been extended to an additional 85,000 widows and widowers aged 60-64.
- Progressive changes have been made to the child benefit system, most notably the proposed increases in the child tax credit by \$70 in taxation year 1986 and \$35 in each of the following two years.
- The first steps have been taken to achieve employment equity in the work force by offering new training programs and by requiring the implementation of employment equity in federally regulated businesses.
- Discrimination has been removed from the Indian Act by ensuring equality between men and women and by restoring Indian status and band membership to those who lost them because of discrimination.

- A number of important bills have been introduced to amend the Criminal Code and other key social legislation such as the enforcement and maintenance of custody orders.
- Changes to the tax system have been proposed which are of assistance to the disabled, charitable organizations and artists.
- The government has made significant progress on the acid rain issue and on dealing with toxic chemical pollution.
- Task forces have been created to review both broadcasting policy and the funding of the arts.

The pension system is being reformed to make it fairer, more comprehensive and more in tune with today's needs.

- Veterans' pensions have been modified to benefit some 51,000 disability pensioners and 6,000 widows and widowers of veterans.
- Discussions are underway with the provinces on the financing of the Canada Pension Plan and the level of benefits provided.
- Amendments to the Pension Benefits Standards Act have been proposed to deal with portability, access, vesting and inflation protection. These changes will be of particular benefit to women and to part-time workers.
- Tax incentives for retirement savings are being introduced to deal with fair access, flexibility in the timing of contributions, profit sharing and greater equality between employees and the self-employed.

The fairness of the tax system is being enhanced.

- A minimum personal income tax will be introduced beginning in 1986.
- The tax-shelter financing of certain types of property including yachts, recreational vehicles and hotels, has been curtailed.
- The tax advantages of income splitting through interest-free or low-interest loans among family members will be ended.
- The investment tax credit will be changed to ensure that it is based on the taxpayer's actual costs.
- The Scientific Research Tax Credit is eliminated in favour of more cost-effective credits for small business research and development.

- Limited partnerships and other similar tax shelter arrangements are being reviewed.

Technical changes have improved the fairness of tax administration.

- Additional protection is being provided for taxpayers in the area of search and seizure, audits and examinations and demands for tax information.

The federal budgetary process is being reviewed.

- The federal budget has an important bearing on the planning and decision making of other levels of government and of the private sector.
- Proposals to improve the budgetary process will provide greater certainty throughout the economy, and will make the budget process more orderly and systematic.

All of these actions taken together are resulting in significant progress towards the goal of fairer and more effective government and a healthier, more dynamic economy. If progress is to continue, however, determined action will be required to achieve the third thrust of the strategy for economic renewal, control of the national debt.

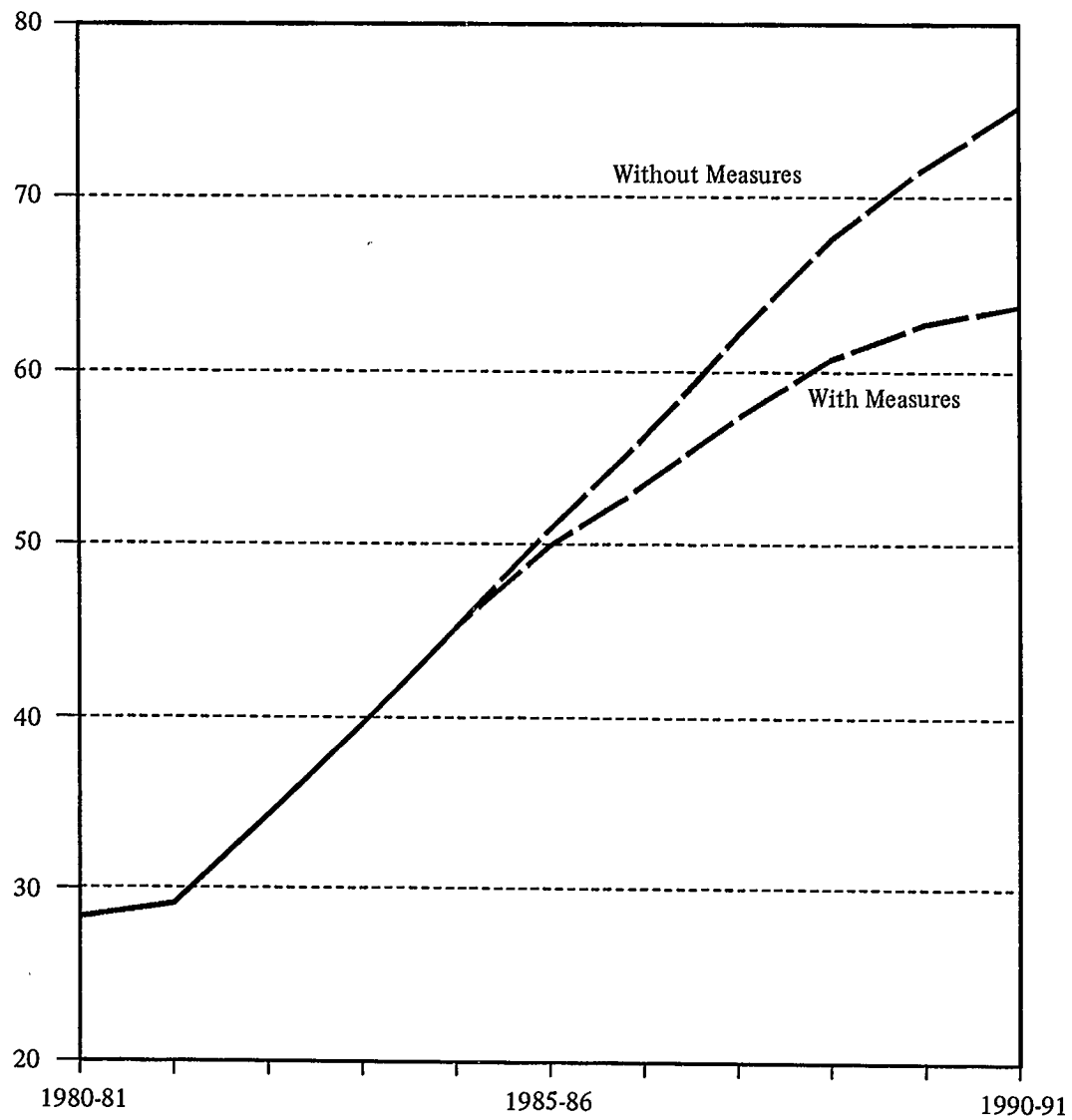
3. Actions to Control the National Debt

- The dangers of a growing public debt-to-GNP ratio are clear.
- High deficits, growing debt and escalating debt charges will ultimately undermine economic growth and will put severe constraints on the government's scope for policy initiatives.
- Canada cannot reasonably expect the economy to grow its way out of this difficulty, nor would a sudden and dramatic decline in interest rates in itself fully solve the problem.
- In the absence of remedial action, given prudent economic assumptions, the fiscal situation that confronted the country one year ago could easily have generated deficits of \$50 billion or more by the early 1990s.

Steps had to be taken to lower the deficit.

- As a result of all measures introduced in November and May, the deficit will be \$4 billion lower than it would otherwise have been in 1985-86 and \$8 billion lower in 1986-87.

**Debt-to-GNP Ratio With and Without
the November and May Measures*
Mid-Range Case**



*Consistent with the June 27 announcement.

- By 1990-91 the deficit will be \$19 billion lower than it otherwise would have been and the stock of debt will be \$70 billion lower. With these measures there is greater certainty that the debt-to-GNP ratio will stabilize by the early 1990s and turn down thereafter (see the chart on page 18).

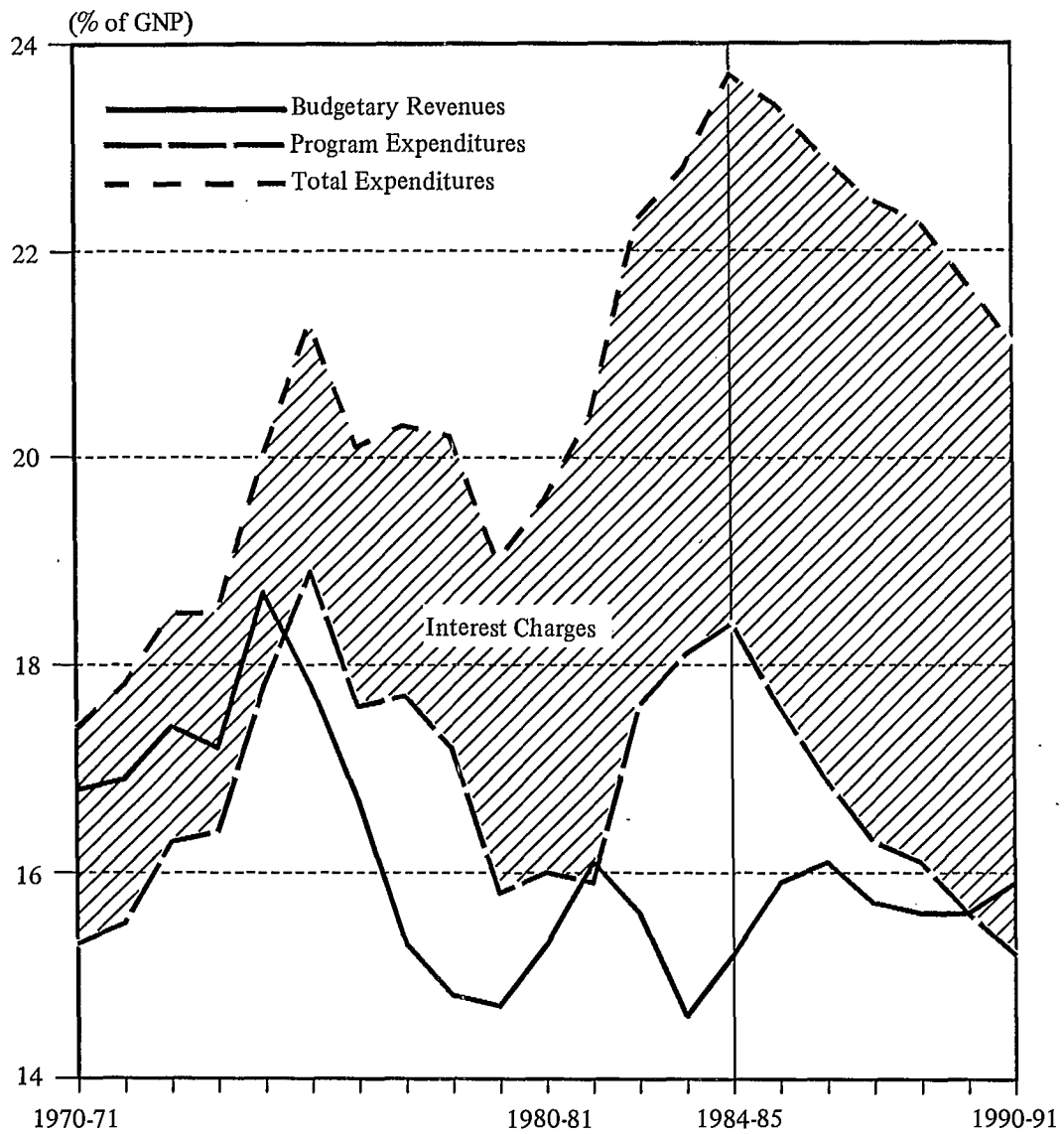
The fiscal outlook

- As the past 12 months have shown, the deficit can be influenced by many unforeseen factors. Unanticipated developments such as those associated with the two bank failures can easily throw the deficit off course, although improvements in the economy such as those seen so far this year can help compensate.
- With relatively little change in the economic picture for 1986 and 1987 since the May budget, the fiscal outlook for 1986-87 and 1987-88 also remains similar to that expected at the time of the budget.
- If the U.S. economy weakens, there will be some slowdown in Canada's export-related industries and an increase in the cyclical component of the deficit. In addition, revenue growth is likely to slow in 1987-88 as a consequence of the phasing of some taxes, such as the temporary income surtaxes and the PGRT.

The medium-term fiscal strategy

- The government's fiscal strategy aims for fiscal stability over the medium term.
- The medium-term strategy that is now in place ensures that program expenditures – equal to total expenditures less public debt charges – will fall steadily in relation to GNP through to the end of the decade. At the same time the strategy ensures that the tax structure will generate a stable share of revenues that is sufficient to pay for federal program expenditures by 1990-91 (see the chart on page 20). Much progress has been made in both these areas.
- Even with this strategy, however, the deficit remains high because of the heavy burden of interest payments required to service the large stock of debt.
- Although substantial actions have already been taken to ensure that expenditures and revenues move into greater balance over the medium term, the fiscal problem is not yet solved.
- Further initiatives will be necessary.

Budgetary Revenues and Expenditures



Where can further changes be made?

- This question will be under serious consideration as the government prepares the next budget.
- As background for discussions on this issue it is instructive to examine in more detail the initiatives of the November 1984 economic statement and the May budget.
- As can be seen in Table 2 the expenditure reductions announced in November and May were broadly based, although the largest reductions were in the area of economic programs, notably energy and industrial programs.
- New management initiatives, such as reductions in the size of the public service and improved cost recovery, generate substantial savings.
- To spread the burden of expenditure reduction fairly, the government will also seek to limit the rate of growth of transfers to provinces to yield annual savings of \$2 billion by the end of the decade.
- As a result of the expenditure and revenue measures of the last year, the level of public debt will be substantially lower than it otherwise would have been and public debt charges will also be lower, as shown in the table.

Table 2
The Expenditure Reductions

	1985-86	1986-87	1990-91
	(\$ billions)		
Transfers to persons	—	0.1	0.4
Transfers to other levels of government	—	—	2.0
Other program reductions	2.7	3.6	4.0
Management initiatives	2.8	2.8	4.2
Total expenditure reductions	5.5	6.5	10.6
Less: expenditure increases	-1.7	-1.4	-0.9
Plus: reductions in public debt charges	0.2	0.8	4.5
Budgetary expenditures	4.1	6.1	14.1

Note: Totals may not add due to rounding.

- Yet even after these reductions, budgetary expenditures are projected to rise to \$105 billion this fiscal year and \$110 billion in 1986-87. (see Table 3)
- Of the 1986-87 total budgetary expenditures, about one quarter will go to pay public debt charges. A further 11 per cent is for defence, external affairs and foreign aid, areas where the government has international commitments to its allies. Another 40 per cent is for transfers to persons and other levels of government, both priorities of the government. The remaining "other" component of government spending is under severe restraint and will decline in absolute terms by about \$1 billion both this year and next.
- These figures clearly indicate that further expenditure reductions will not be easy to realize.
- Nevertheless, additional reductions will be necessary over time if the growth in the debt is to be slowed.
- Table 4 shows the projected growth rates of the spending categories over time. All spending categories show substantially lower projected growth than was recorded in the first half of the decade.
- Over the 1986-87 to 1990-91 period, program expenditures are projected to grow roughly in line with inflation, while the economy and the population receiving government services continue to expand in real terms. Transfers to persons and transfers to other levels of government are also expected to grow

Table 3
The Expenditure Base⁽¹⁾

	1985-86	1986-87	Per cent of base in 1986-87
	(\$ billions)		(per cent)
Transfers to persons	19.0	19.9	18.1
Transfers to other levels of government	19.7	21.1	19.2
Defence, external affairs and foreign aid	11.4	12.3	11.2
Other program expenditures	29.0	27.8	25.3
Program expenditures	79.1	81.1	73.7
Public debt charges	26.0	28.9	26.3
Budgetary expenditures	105.0	109.9	100

(1) The fiscal data are drawn from the May budget and adjusted for the impacts of the June 27 announcement concerning old age security payments.

Table 4
Expenditure Growth Rates⁽¹⁾

	Average 1981-82 to 1984-85	1985-86	Average 1986-87 to 1990-91
	(per cent)		
Transfers to persons	13.0	5.7	3.4
Transfers to other levels of government	12.3	4.2	3.7
Defence, external affairs and foreign aid	14.6	3.4	6.7
Other program expenditures	12.5	-1.7	2.2
Program expenditures	12.8	2.2	3.6
Public debt charges	20.5	15.1	6.9
Budgetary expenditures	14.4	5.1	4.4
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Gross national product ⁽²⁾			
Nominal	9.1	7.6	6.6
Real	1.7	4.1	2.9
Inflation	7.2	3.4	3.6

(1) The fiscal data are drawn from the May budget and adjusted for the impacts of the June 27 announcement concerning old age security payments.

(2) For 1980 to 1985 the growth rates reflect the latest information released by Statistics Canada. After 1985 the rates are as projected at the time of the May budget.

roughly in line with inflation. The defence category is projected to grow more quickly than inflation, again reflecting international commitments, while the "other" category grows less rapidly, the result of substantial cuts that have already been made.

- A number of changes have also been made to taxes over the past year in order to encourage greater initiative on the part of the private sector and also in an effort to reduce the deficit.
- The main tax changes are shown in Table 5.

- After allowing for these tax measures, budgetary revenues in 1990-91 are still projected to be less than 16 per cent of GNP, well below the peak level of 18.7 per cent of GNP reached in 1974-75.
- Together these revenue and expenditure measures reduce the budgetary deficit substantially by 1990-91, with most of the reductions attributable to expenditure reductions as opposed to tax increases.
- Nevertheless a fiscal problem remains. Three key questions regarding the deficit must be addressed:
 - How can further reductions be made?
 - How large should these reductions be?
 - How fast should they be made?

Table 5
Tax Measures

	1985-86	1986-87	1990-91
	(\$ billions)		
Personal income tax	-0.1	1.0	4.1
Corporate income tax	0.2	0.6	0.2
Sales and excise tax	0.6	1.7	3.2
Energy taxes	-0.4	-1.2	-2.5
Other	0.0	0.0	-0.3
Net change	0.3	2.1	4.7

Issues for Consultation

- Over the course of the past year the government has conducted extensive consultations with Canadians on many of the major policy questions that were first posed in the November 1984 Agenda paper.
- A highlight of this consultative effort was the bringing together of Canada's major economic players at the National Economic Conference in Ottawa in March 1985.
- The National Economic Conference represented an important milestone on the road to economic renewal. In a common forum Canadians shared their views on the country's economic and social problems and issues. While the diversity of participants and interests at the conference made clear consensus on solutions difficult to achieve, many of those present obtained a better understanding of the shared objectives of economic renewal and of the obstacles to achieving those objectives.
- The May 1985 budget benefitted from the discussions held at the National Economic Conference and from the extensive pre-budget consultations conducted across Canada. This government is committed to continuing these consultative efforts as it charts the next steps in the process of economic renewal.
- In the months ahead, consultations between the government and the private sector will focus on a number of general issues within the framework for economic renewal set out over the past year. Once again, we will be seeking contributions from the private sector on the problems and issues facing Canada's economy; the broad directions in which we must go to achieve effective and responsible solutions; and the options available to the federal government and the private sector.
- In the context of the three central thrusts of the renewal strategy, the forthcoming round of consultations will present opportunities for public discussion of a number of current major policy initiatives.

1. Encouraging private initiative

- (i) **Tax initiatives.** The May budget discussion papers invited comment on proposals for reform of the corporate tax system aimed at making the system fairer and more effective in supporting economic growth. With these and other initiatives, the government is continuing to move toward greater equity and efficiency in the tax system, making necessary changes in a responsible and moderate way. Private sector views on these proposals are welcomed.

- (ii) Initiatives to streamline the **regulatory regime** in the areas of transportation, energy, and financial services are now underway. In all of these areas, proposals are being put forward for public discussions.
- (iii) **New labour market** initiatives, including training and job creation programs, are being implemented after discussions between the federal government and the provinces. In addition, the Forget Commission on Unemployment Insurance, established in June 1985, is undertaking a comprehensive assessment of the unemployment insurance system to ensure that it promotes flexible adjustment in the labour market. The Commission is inviting private sector submissions on this issue. It is due to make its report in March 1986.
- (iv) **Trade policy** initiatives are also prominent on the government's agenda, including securing access to larger markets and the improvement of Canada's competitive position abroad. Following extensive consultations, the government has proposed discussions with the United States on the negotiation of an enhanced trade regime, and broad public debate is proceeding. In addition, Canada is participating in the preparatory process for a new round of multilateral trade negotiations. The government intends to continue to work closely with the provinces and with the private sector in developing these complementary initiatives.

2. Improving government effectiveness

Initiatives in this area include:

- (i) the ongoing work of the Ministerial Task Force on Program Review;
- (ii) rationalization of government programs;
- (iii) reform of the budgetary process.

Further actions in these areas are being undertaken to eliminate waste and duplication, to restrain government growth and to reduce government intervention. The private sector has already made valuable contributions to the work of the Ministerial Task Force. These contributions will continue to be sought as the government continues to implement the Task Force recommendations. Proposals for reform of the budgetary process have also been made in order to provide greater certainty for planning and decision making, both in government and in the private sector. Private sector comments on the proposals are invited.

3. Controlling the national debt

Deficit reduction and the control of government expenditures continue to be major priorities for the government. The fiscal problem confronting the government has been clearly outlined throughout the past year. Important questions remain to be answered as the government continues to pursue the economic renewal strategy, including the question of establishing appropriate levels for further deficit reduction, timing of new deficit reduction measures, and the balance to be struck between expenditure cuts and revenue increases. Private sector views on these issues will be important to the government as we prepare to take the necessary further steps towards controlling the national debt.

Conclusion

This paper is being distributed widely as background information to be used in conjunction with the November Agenda paper and the May budget discussion papers. The Minister of Finance is beginning a new round of pre-budget consultations with representative groups in the business, labour, social, and voluntary communities. Participants in the consultative process will be invited to comment on the policy directions and initiatives outlined in this document. The views and suggestions contributed through these consultations will be taken into account as the government begins to prepare the next budget.