INVESTING IN GROWTH

BACKGROUND DOCUMENT TO THE ECONOMIC AND FISCAL STATEMENT

December 2, 1992

Canada

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Department of Finance
Canada

Ministère des Finances
Canada

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PREFACE

Most of the world is wrestling with economic problems. Following the widespread economic weakness beginning in 1990, the recovery has been weak. Growth in the major industrial countries has been hesitant and much lower than expected a year ago.

Canada is only slowly recovering from a painful and prolonged world recession. The economy remains weak and people and businesses everywhere are deeply worried about what the future holds.

In these difficult times, Canadians look to government at all levels to help build solutions. This document is part of that process. It has three goals:

- First, to highlight the real nature of our economic dilemmas and how the federal government is responding to this weakness;
- Second, to discuss the limits to what the government can do given a taxpayer burden that is already very heavy; and
- Third, to explain why the best route out of our current problems must be based on policies that look ahead to Canada's medium-term needs, rather than short-term "quick fixes".

To create jobs and boost our standard of living – and to assure real opportunities for the next generation – we must make sure that the actions we take today do not leave us weaker tomorrow.

This means investing in productivity. Productivity is a measure of how efficiently the economy produces goods and services. Since the late 1970s, Canada's productivity growth has been weak. When productivity grows, real incomes grow.

Stronger productivity growth is essential if we are to meet the challenges of an increasingly competitive world economy this decade and beyond. Without a recovery in productivity growth, we won't be able to sustain strong growth in our standards of living. Raising Canada's productivity growth requires that all stakeholders in the economy work together so we can invest more in capital, technology, education and worker skills. Governments can play a role in helping this happen:

- By establishing a climate that supports and rewards productive investment;
- By helping Canadian workers and businesses adjust to the economic restructuring that is now taking place; and
- By creating the secure trading opportunities that allow Canada to increase its sales to world markets.

The government is doing all these.

- It is improving the climate for investment by getting inflation down, creating the conditions for sustainably lower interest rates and controlling government spending.
- It has reformed the tax system.
- It is reorienting its labour-market support towards provision of training and help in adjusting.
- It is getting government out of markets through deregulation and privatization.

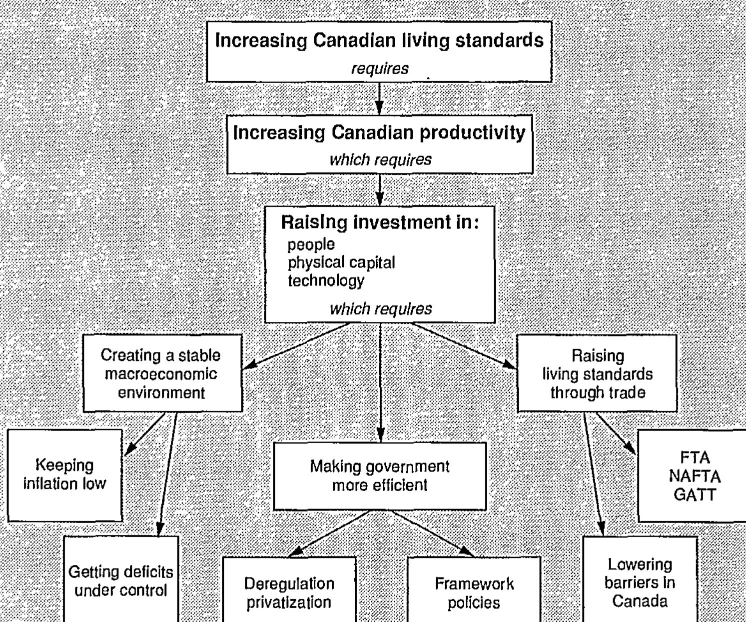
- And it is entering into trade agreements that secure Canada's access to its export markets.

In the following pages, this document:

- Identifies the very serious nature of our poor productivity performance of the past two decades;
- Explains how increasing investment – in people, capital and technology – is the key ingredient in the recipe for higher productivity (Chart 1);
- Highlights the role of the government's policies in creating an environment which favours investment.
  - First, government must create a stable environment of low inflation and low budget deficits.
  - Second, government must become more efficient and less costly. This means working to reduce the direct costs shouldered by taxpayers, and also the indirect costs imposed by unnecessary rules and regulations – including "disincentives" that discourage investment or work.
- Third, government must create the trade opportunities, both outside of Canada and within our own economy, for businesses to expand their production.

With these policies Canadians can expect to see a steady improvement in their standard of living. And we will retain our status as the best country in the world to live in – and one that can offer us and our children outstanding potential for a prosperous, secure future into the 21st century.

Chart 1
Policies for sustainable growth



LOOKING AHEAD FROM TODAY'S ECONOMY

THE NEED TO FOCUS ON PRODUCTIVITY GROWTH

Main issues in brief

Productivity growth based on working smarter is the key to a rising standard of living. It improves our quality of life by expanding our range of social and economic choices. Canada's productivity performance deteriorated in the late 1970s, and the improvement in our living standards consequently slowed. To improve this performance, Canada will have to invest in growth. This means investing in people and creating a favourable economic environment for that investment.

Productivity growth from working smarter is the basis for rising living standards

Productivity growth through working smarter and more efficiently is the key to generating growth in the living standards of Canadians and our national quality of life. This can be done in two ways:

- We can have more Canadians in the labour force, work longer hours, and invest in new capital rather than consume. This is working harder.
- Or, we can improve the efficiency of our production, the quality of our capital and the skills of our workers. This is working smarter.

Working smarter is the key to the kind of productivity growth that will improve our real incomes – both salaries and profits, and our living standards. High living standards reflect more than just high levels of consumption. They also reflect a good quality of life.

Increases in living standards do not just happen, they have to be earned through increases in productivity.

What is total factor productivity?

It is the most comprehensive measure of how efficiently our economy produces goods and services. It measures how effectively we use available labour and capital inputs to produce goods and services. Growing total factor productivity is a sign that we are working smarter, not just harder.

Benefits of productivity growth

Productivity growth expands the range of choices available to us as individuals and as a society.

It gives us the option of consuming more goods and services, or working less and having more leisure time.

It enables us to devote more resources to the environment, the arts and the social safety net.

Social and economic problems become easier to solve when productivity is growing. Without productivity growth, one person's gain must be another's loss, leading to a greater possibility of social tensions and conflict. Productivity growth enables everyone to achieve gains without costly and divisive conflict.

Canada's recent record is one of poor productivity growth

Canada owes its high living standard to its high level of productivity.

In the 1970s and 1980s, however, Canada experienced a significant slowdown in the growth of its standard of living. The reasons for this slowdown are not fully understood.

The slowdown is apparent in a slower growth of real net national income per capita, which is the income left after servicing our foreign debts. The sharp slowdown in total factor productivity growth (see box below) since the late 1970s was the main cause of this slowdown in growth of living standards. In the 1980s, we produced more only because we had more people, worked harder and spent more on capital, not because we were more productive and more efficient.

Real wage growth (the growth of wages adjusted for inflation) requires growth in productivity. This is because growth in real wages unmatched by growth in labour productivity would cause a deterioration in competitiveness, and could not be sustained.

The slowdown in total factor productivity growth since the late 1970s has translated into weaker labour productivity and real wage growth.

Canada must do better than it did in the 1980s to succeed in an increasingly tough and competitive world. Without ongoing productivity growth, our living standards and real wages will stagnate and continue to fall behind those of our trading partners.

Productivity growth raises real wages

The record shows the close relationship between labour productivity and real wages. Growing real wages depend upon growing labour productivity, which in the long run depends upon growing total factor productivity.

From 1963 to 1978, labour productivity grew strongly. So did real wages, by an average of 2.7 per cent a year. Workers in the 1960s could expect their real wages to double every 26 years.

Since 1978, labour productivity and real wages have grown at an average rate of around one per cent. At this rate, real wages would take over two and a half times as long to double – 70 years. Workers would not see their real incomes double during their working lives.

How Canada can improve its productivity growth

Improving Canada's productivity and living standards will require that Canada invest in growth. Investing in growth means investing more resources in technology and physical capital, and, especially, in people.

This will only occur if the economic environment is favourable to productivity-enhancing investment. Macroeconomic stability and appropriate structural policies are key to developing such an environment. Without them, it is difficult for both households and businesses to plan, save and invest.

- Macroeconomic stability requires low inflation and fiscal prudence.
- Appropriate structural policies are those that expand the opportunities for people to work, invest and innovate. They do this by creating a level economic playing field and enhancing, rather than stifling, incentives. Macroeconomic stability and appropriate structural policies reinforce each other in creating a favourable economic environment for investment in growth.

Progress is being made in improving the environment for investment

The 1984 *Agenda for Economic Renewal* showed that such policies were necessary if Canada were to improve its productivity performance. It stressed the need to act quickly as the payoff from such fundamental reforms could take considerable time to be achieved. Since the 1984 Agenda was set out much has been achieved in providing the basis for an improved economic environment.

- Inflation has been lowered, and the underlying structural fiscal deficit brought under control.
- A number of structural initiatives like tax reform, deregulation, etc. are now in place.
- The expansion of trade opportunities through the NAFTA, the FTA and the GATT, tax reform, deregulation and privatization will encourage efficiency.
- The resulting productivity payoff will enhance our living standards by increasing the range of choices available to us as individuals and as a society.

CHARTING THE CHANGES

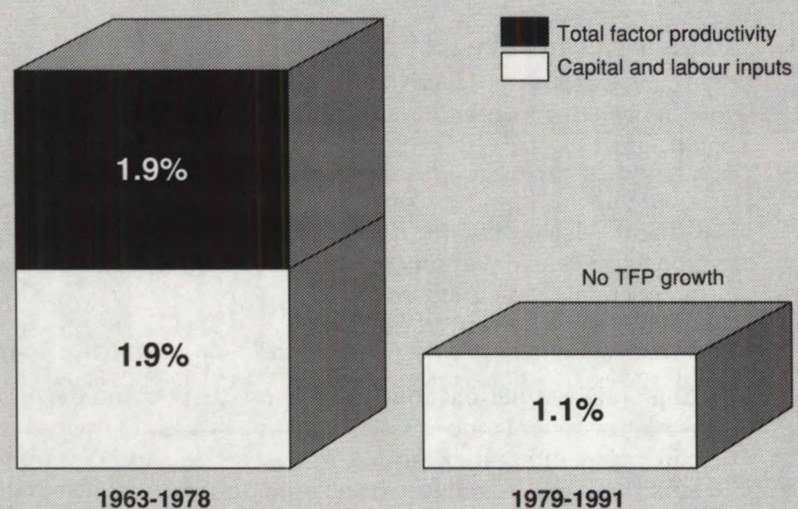
Slow productivity growth leads to slow income growth

- From 1963 to 1978, real net national income per capita (the income we have left after servicing our debts to foreigners) grew at a rapid pace of 3.8 per cent per year. By the 1980s this pace was cut by more than two-thirds.
- The slowdown was almost entirely due to the disappearance of total factor productivity growth. Indeed, after 1979, net national income per capita rose only because Canadians worked more and invested more. We worked harder, not smarter.

Chart 2

The growth of real net national income per capita has fallen since 1979 as total factor productivity growth has slowed

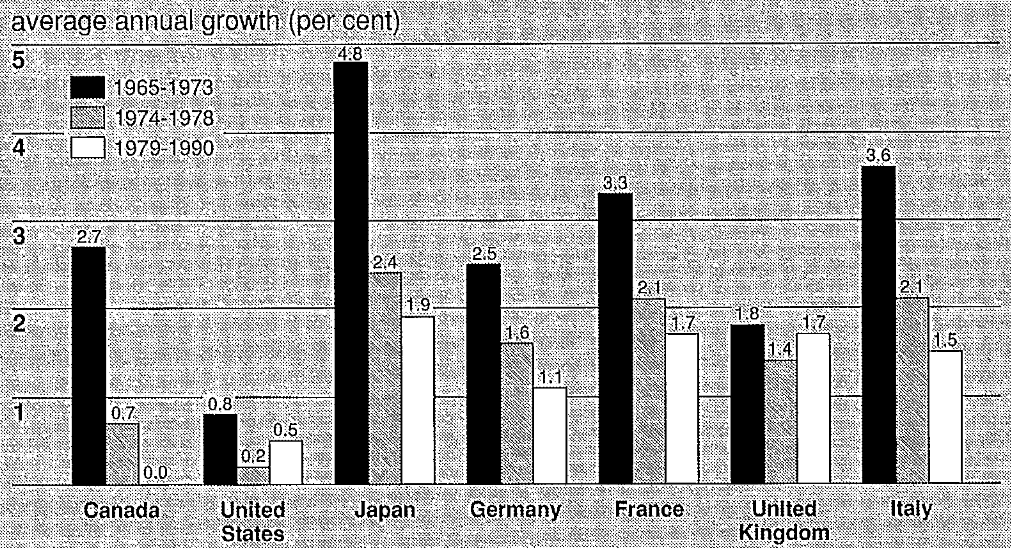
per cent growth per capita



Source: Department of Finance estimates.

- Over the past decade, Canada's total factor productivity growth has been among the worst in the G-7.
- A consequence of this growth slowdown is that, since 1980, every other G-7 country has achieved a gain in the level of its productivity relative to that of Canada.
- If Canada were to stand still, then other countries will surpass us in productivity and living standards.

Chart 3
Canada's total factor productivity growth has fallen behind the other G-7 economies



Sources: OECD and Department of Finance.

INVESTMENT: THE KEY TO PRODUCTIVITY GROWTH

INVESTING IN PEOPLE

Main issues in brief

The most advanced technology is useless without people who have the knowledge and skill to use it. To be competitive, Canada must invest heavily in its people as well as its capital. Canada requires highly-skilled, technically-competent workers to use its capital efficiently and to develop and use new technologies. Since much of Canada's future labour force has already been through the school system, those skills will have to be learned on the job or through retraining.

Why education and training are important

Competitive firms in the global economy are demanding more and more skilled and flexible personnel. To attract domestic and international investors, Canada requires skilled workers capable of adapting to a changing work environment.

Numerous reports have criticized Canada's education system for failing our students, since many Canadians are unable to read or do simple arithmetic. This is despite Canada spending one of the highest shares of GDP in the industrialized economies on education.

Older Canadians will constitute a larger proportion of the labour force in the decade ahead. About two-thirds of those who will be in the labour force a decade hence are in the labour force now. Many are sure to need retraining or on-the-job training to meet the changing needs of Canadian firms.

Firms must focus more on training

The Conference Board of Canada reported in a recent study that almost three-quarters of companies surveyed believed they had a significant problem with functional illiteracy in some part of their organization. Yet only 24 per cent of them had developed a systematic human resource policy to deal with this problem, even though it slowed the adoption of new technologies.

Private sector spending in Canada on training and education as a proportion of GDP is well below that of our major competitors.

What government has done

The federal government commits substantial funds to labour market programs, chiefly for income support known as "passive" programs.

A number of our major competitors direct a greater proportion of resources to "active" programs such as apprenticeship and training programs.

As part of its *Labour Force Development Strategy*, in 1990, the federal government modified the unemployment insurance system to move from "passive" towards more-effective, "active" support for unemployed workers.

- The *Unemployment Insurance Act* was amended to reduce work disincentives by making it harder to qualify for benefits – especially for those who quit their jobs – and decreasing the duration of benefits.
- Most of the savings from these amendments were redirected into developmental programs which help retrain workers and upgrade skills.

In total in 1992-93, the federal government will spend $3.55 billion for worker adjustment, over 50 per cent more than the $2.3 billion spent in 1990-91.

The Canadian Labour Force Development Board was established to review and make recommendations on all labour-market matters including strategies for using unemployment insurance funds for training Canada's unemployed.

More needs to be done

The federal government seeks to build on the *Labour Force Development Strategy* in two ways.

- Funds for "active", developmental purposes will be increased from $1.95 billion to $2.1 billion in 1993.
- Small businesses that increase employment will be entitled to a one-year holiday from their unemployment insurance contributions for those new jobs.
- Sectoral training councils will be put in place to help workers and firms develop and implement training practises which will take advantage of new opportunities.

Provinces also generally recognize that their social assistance programs could be improved by emphasizing retraining those on social assistance who need new skills to get good jobs.

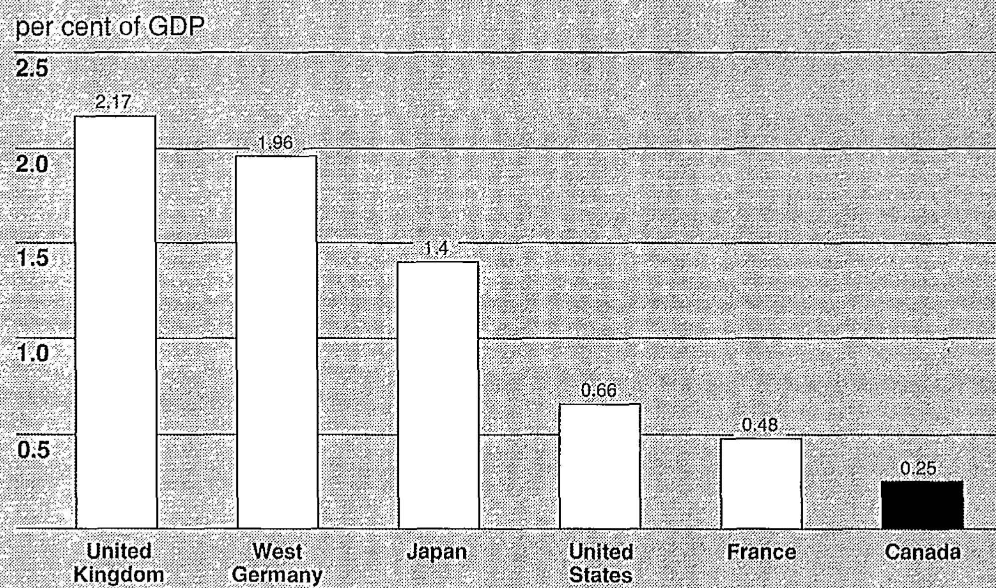
The welfare reform experiments developed jointly by the federal government and the governments of New Brunswick and British Columbia represent a first step in this direction. They will supplement the earnings of low-income families or build on existing mechanisms to improve education and skill levels.

CHARTING THE CHANGES

- Older Canadians will constitute a larger proportion of the labour force in the decades ahead.
- In fact, about two-thirds of the labour force in the year 2000 are in the labour force now. To upgrade their skills will require on-the-job training or retraining programs.
- Private sector spending on training and education in Canada is low by international standards. It will have to be improved if the workers already in the labour force are to become more productive.

Chart 4

Canada's private sector spends less on training and education



Source: Economic Council of Canada, *Employment in the Service Economy*, 1991.

INVESTING IN TECHNOLOGY AND PHYSICAL CAPITAL

Main issues in brief

Canada's productivity and high standard of living are partly due to our substantial investment in both people and the capital stock. But with growth in productivity stagnating, more and more effective investment is clearly required. Canada devotes a smaller share of our GDP to public investment, machinery and equipment investment and research and development (R&D) than in our major competitors. The record must be improved. Government's main role in improving that record is to provide a stable environment for productive private sector investment: one of low inflation, with a low cost of capital, and low government deficits. It is also to provide a tax system which encourages both a high quantity of investment and a high quality of investment. The federal government has taken many measures to make the tax system supportive of investment. As well, the federal government plans to co-operate with the provinces in increasing investment in Canada's transportation and communications infrastructure.

How government can encourage investment

Government can play an important role in encouraging productive investment.

- General economic policy should be aimed at creating a stable business environment. Otherwise, businesses will not risk investing in projects whose return is in the distant future. Reducing inflation and controlling the deficit are the cornerstones of such a stable environment.
- Tax and structural policies should be aimed at making investment in Canada as attractive as investment in our trading partners.
- Policies should also ensure that investments are undertaken because they provide a payoff for the economy, not just a tax advantage.

The Canadian government has established a stable, supportive investment environment. Inflation is down to its lowest level in decades, lowering the capital costs of investment. Tax reform has reduced distortions in the tax system, made investment more attractive, and levelled the playing field for Canadian businesses.

Government can also encourage investment in those areas where the private sector cannot do the job alone. Examples are direct government investment to improve public infrastructure, such as transportation and communications systems, and to promote private sector investment when the benefits are substantial but only to be realized over a long time.

Recent tax measures encouraging investment

The federal Manufacturers' Sales Tax (MST), which taxed some capital purchases and placed domestic manufacturers at a disadvantage both in export markets and when competing against imports, was replaced by the Goods and Services Tax.

The capital cost allowance for eligible machinery and equipment was increased from 25 per cent to 30 per cent in the 1992 federal budget to encourage investment.

The federal corporate tax rate applicable to Canadian manufacturing was also reduced in the 1992 budget.

Canada's system of R&D tax incentives, already one of the most generous in the world, is being enriched and made more effective.

Canada's investment record

In the second half of the 1980s, investment increased significantly as a share of output. The increase is most evident in machinery and equipment, which embodies new technologies. But, Canada continues to lag behind other major industrial countries in the share of GDP spent on machinery and equipment investment.

Public investment as a share of total output is also typically lower in Canada than in other major industrial countries, especially Japan. Canada's lower investment was, in part, because it had invested heavily in infrastructure in the 1960s and other countries have been catching up. But we may now be falling behind.

Spending on R&D is too low

Canada's research and development is also lagging.

- Despite the low after-tax cost of R&D in Canada (Canada has the most generous system of R&D tax incentives in the G-7), private expenditures on R&D continue to be significantly lower than in other major industrial countries relative to GDP.
- Government and the not-for-profit sector R&D expenditures are also somewhat lower as a proportion of GDP than in other countries.
- Combined R&D expenditures in the private and public sectors accounted for 1.4 per cent of GDP in 1990 in Canada, the lowest among all major industrial countries except Italy, which spent the same. In contrast, Japan spent 3.1 per cent of GDP on R&D in 1990.

Canada's low spending on R&D is reflected in our less intensive use of advanced technologies. Canadian companies do not use advanced technologies such as computer-aided design and local area networks to the same extent as companies in the United States.

What next?

Clearly, more needs to be done to improve Canada's investment record. The private sector must provide most of this increased investment. The government must continue to act in a fiscally responsible manner to ensure that businesses have the confidence and funds to invest in Canada's future.

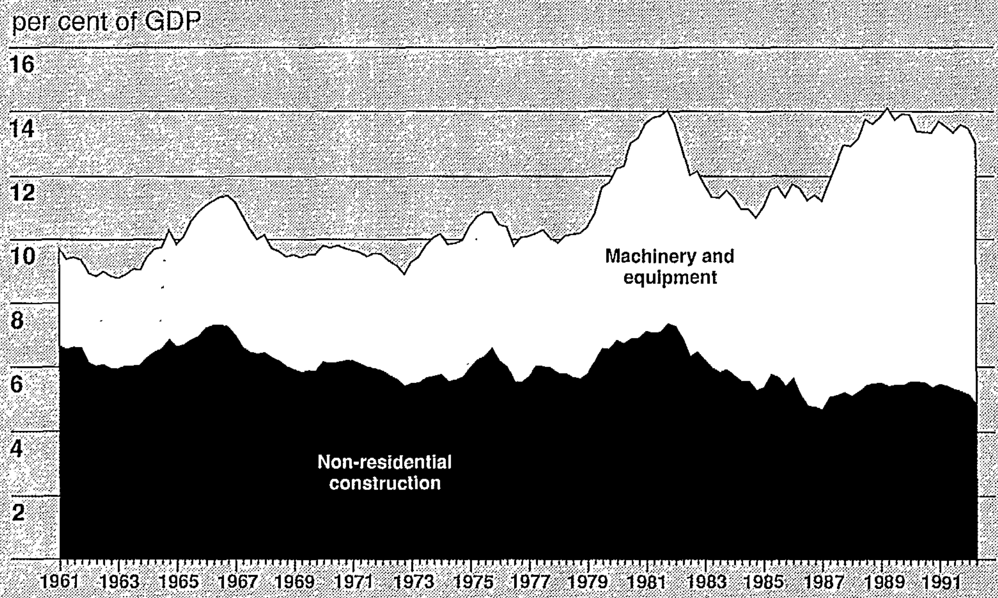
- To encourage more R&D in the private sector, the federal government has enriched the scientific research and experimental development (SR&ED) tax credit system.
- The government is considering the recommendations of the Steering Group on Prosperity to bring depreciation allowances on high technology purchases into line with their short service lives.
- Governments should examine closely the opportunities for further public investment. The federal government, in co-operation with the provincial governments, plans to intensify its efforts to improve Canada's transportation and communications infrastructure. As noted in the action plan from the Steering Group on Prosperity, improving Canada's infrastructure will make the economy more efficient and industry more competitive.

CHARTING THE CHANGES

Investment increases as a share of GDP, but is still low by G-7 standards

- Total investment, as a share of output, increased significantly in the late 1980s.
- The increase was most evident in investment in machinery and equipment.

Chart 5
Investment share of GDP is growing



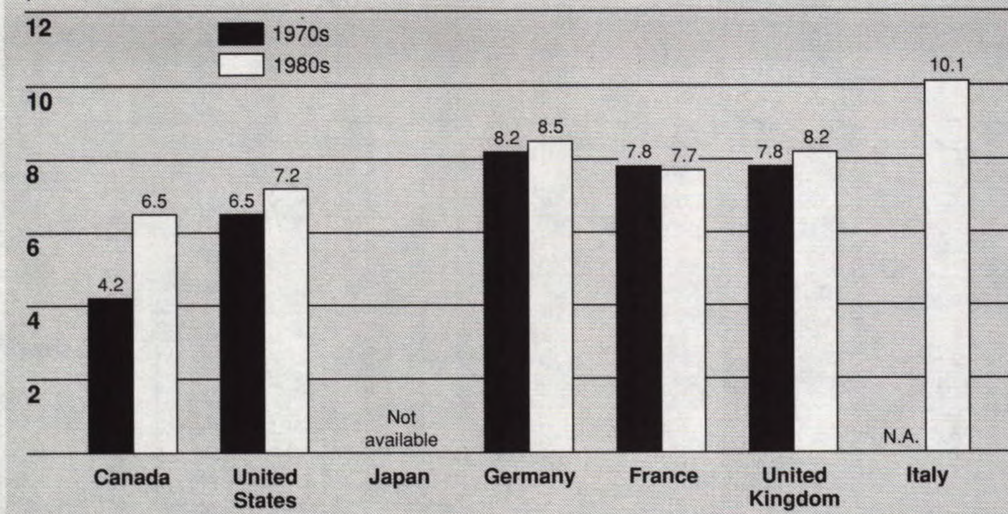
Source: Statistics Canada.

- Compared with other major industrial countries, however, Canada lags behind in investment in machinery and equipment.

Chart 6

Private investment in machinery and equipment is lower in Canada than in other G-7 economies

per cent of GDP

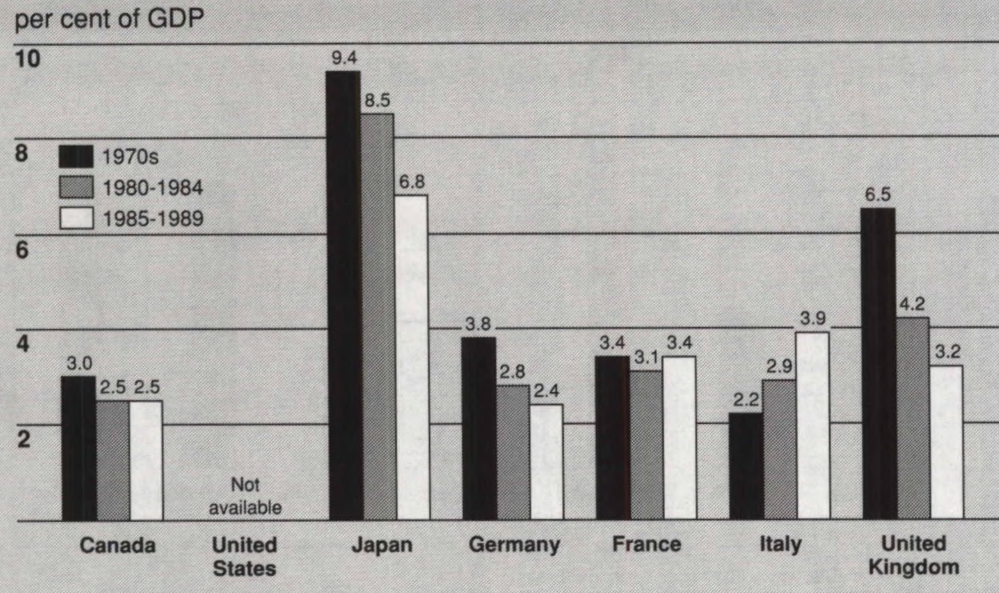


Source: OECD Main Economic Indicators.

Public investment is also low compared to other G-7 countries

- Public sector investment in Canada as a share of total output is somewhat lower than in other major industrial countries.

Chart 7
Public investment in Canada compared with other G-7 countries

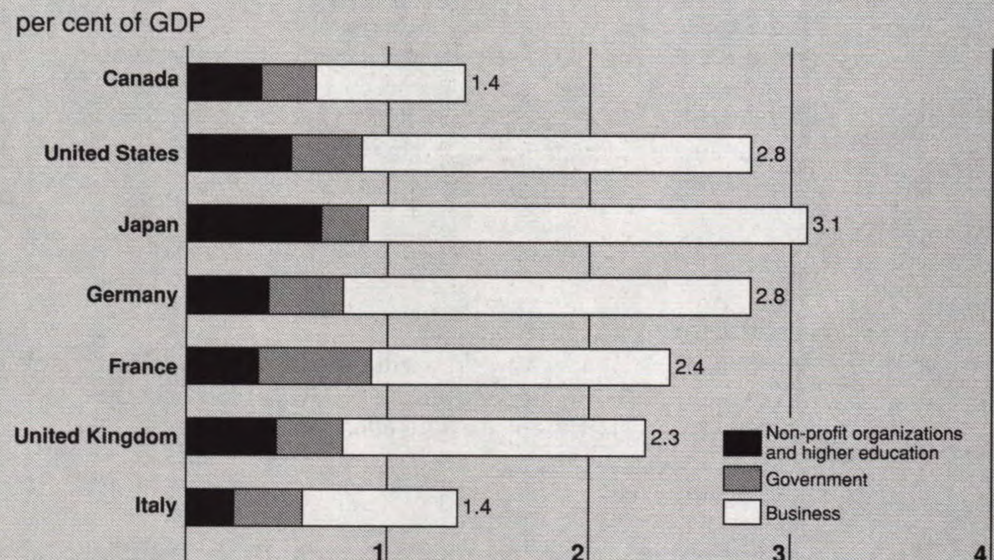


Source: OECD Economic Outlook.

R&D spending falls far behind Canada's competitors

- Canada's record of spending on research and development needs improvement.
- Spending on R&D in both the private and public sectors lags behind that of other major industrial countries.

Chart 8
Canada is behind other G-7 countries' spending on research and development, 1990



Source: OECD Main Science and Technology Indicators.

CREATING A MORE STABLE ECONOMIC ENVIRONMENT

KEEPING INFLATION LOW

Main issues in brief

By the end of the 1980s, Canada's competitiveness was deteriorating rapidly as inflation and labour cost increases, especially in the manufacturing sector, greatly exceeded those of our major competitors. To restore Canada's competitiveness, the government determined to lower inflation and bring price stability to Canadians. The policy has already achieved impressive results in lower inflation and set the stage for a strong economic performance in the 1990s. Low inflation will benefit Canadians in many different ways: further declines in interest rates, more investment, more jobs, higher standards of living and a more stable economy.

Why low inflation is important

Some Canadians wonder how they will benefit from lower inflation. Was the government right to make price stability its policy objective? To answer these questions, it is important to understand the harmful effects of inflation.

Inflation hurts in many different ways.

- Inflation hurts a country's competitiveness. By the late 1980s, Canada's competitiveness was deteriorating rapidly as inflation and labour cost increases, especially in the manufacturing sector, greatly exceeded those of our major competitors.
- Inflation causes interest rates to rise as investors require compensation for the erosion of the purchasing power of their capital through high nominal interest rates. As international and historical experience unequivocally demonstrate, low interest rates can only be maintained if inflation is kept low.
- Inflation creates uncertainty. And uncertainty creates risks for businesses, risks which raise the real cost of capital, curbing investment and consequently employment and production.
- Inflation reduces incentives for businesses to make long-term productive investment. Instead, inflation causes investment to be geared toward speculative gain – often real estate. The switch reduces our productivity and standard of living.
- Inflation redistributes income unfairly. It penalizes most those who are vulnerable in our society: people on fixed incomes, like pensioners; small savers who lose on the real after-tax return on their savings when inflation is high; homeowners who lose their homes because they cannot afford to pay high, inflationary mortgage rates; and workers who see the purchasing power of their hard-earned wages melt away.

- Low inflation is, however, the surest way of getting the unemployment rate down on a sustained basis. This is certainly the experience in other economies. Those countries with the lowest inflation rates tend to have the lowest unemployment rates.

The government has acted to lower inflation

Because inflation is unfair and bad for the economy, the government has pursued a determined policy to replace inflation with price stability.

These are some of the anti-inflation policies the government has adopted:

- monetary policy aimed at lowering inflation and ultimately achieving price stability;
- inflation targets to ease the process of reducing inflation and achieving price stability;
- providing wage leadership through a two-year wage program in the federal public sector.

Inflation has fallen sharply in Canada

Inflation has declined considerably in Canada. Indeed, the October year-over-year rate of consumer price inflation of 1.6 per cent is lower than the average annual rate of inflation recorded in any single year since 1962 and the lowest among the G-7 countries. Despite a fall in the Canadian dollar, which adds to inflation because it raises import prices, inflation will be below the targets for 1992 set out in the 1991 budget.

Progress against inflation has been impressive compared to Canada's past record with inflation and compared to the achievements of our competitors around the world.

The payoff from lower inflation is already evident in lower interest rates. In August of this year, Canadian short-term and long-term interest rates were at their lowest average monthly levels since the mid-1970s. But recent turbulence in financial markets and investor uncertainty about future policies have caused interest rates to rise.

Low inflation makes borrowing more affordable

Low inflation provides more-affordable home ownership. On average, one-year mortgage rates of chartered banks fell to 6¼ per cent in September 1992, compared to about 14½ per cent in the first half of the 1980s. Such a drop saves a homeowner with an outstanding mortgage of $100,000 and an amortization period of 25 years $548 per month or $6,576 per year.

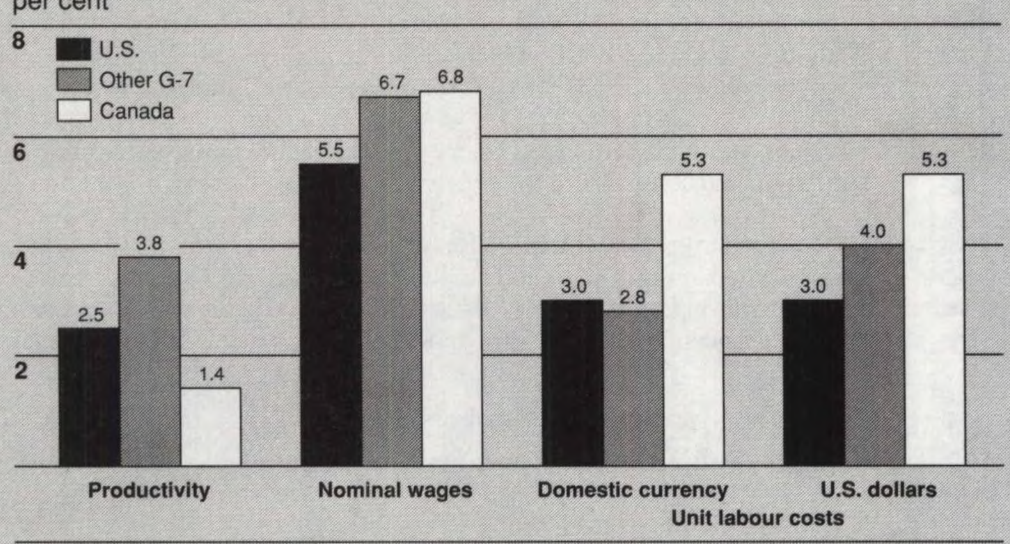
In September, the owner of a small business with a loan of $100,000 and an amortization period of ten years would have paid $480 per month (or $5,760 per year) less than at average rates prevailing over the 1980-1984 period.

CHARTING THE CHANGES

Inflation reduces competitiveness

- Over the 1980s, Canada's competitive position was deteriorating rapidly.
- Growth in our manufacturing productivity was trailing that of our major competitors, yet our wages were growing faster than theirs.
- As a result, our unit labour costs grew way out of line.
- A strong Canadian dollar *was not* the culprit, since the value of our currency (vis-à-vis the U.S. dollar) was basically the same at the end of the period as it was at the beginning.

Chart 9
Canadian competitiveness declined in the 1980s (average annual growth rate, 1980-1990)



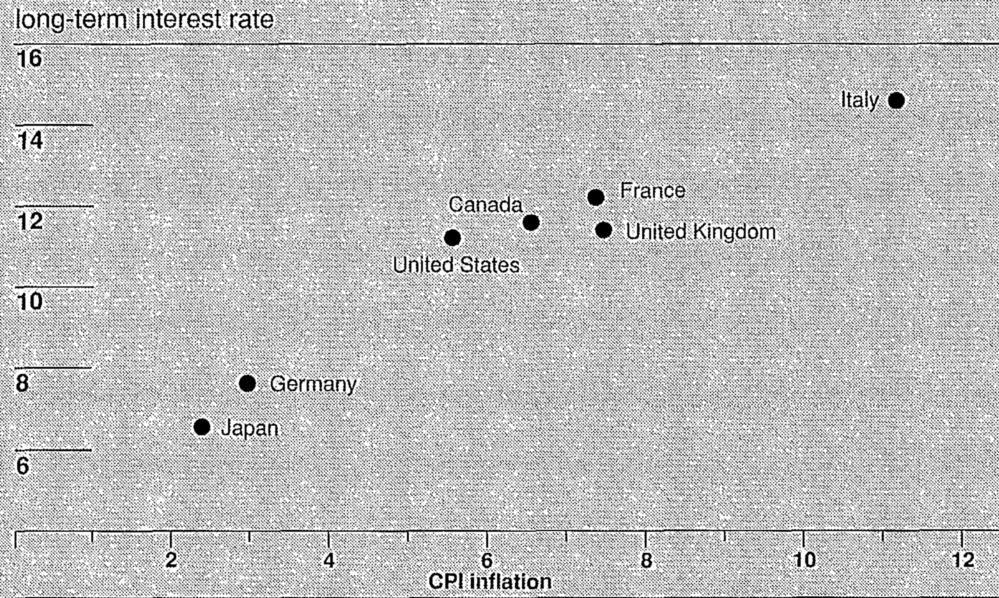
Sources: United States Bureau of Labor Statistics and Department of Finance.

Inflation raises interest rates and capital costs

- Low-inflation countries, such as Japan and Germany (lower left in the chart), have had low interest rates and conversely high-inflation countries, such as Italy (upper right), have had the highest interest rates.

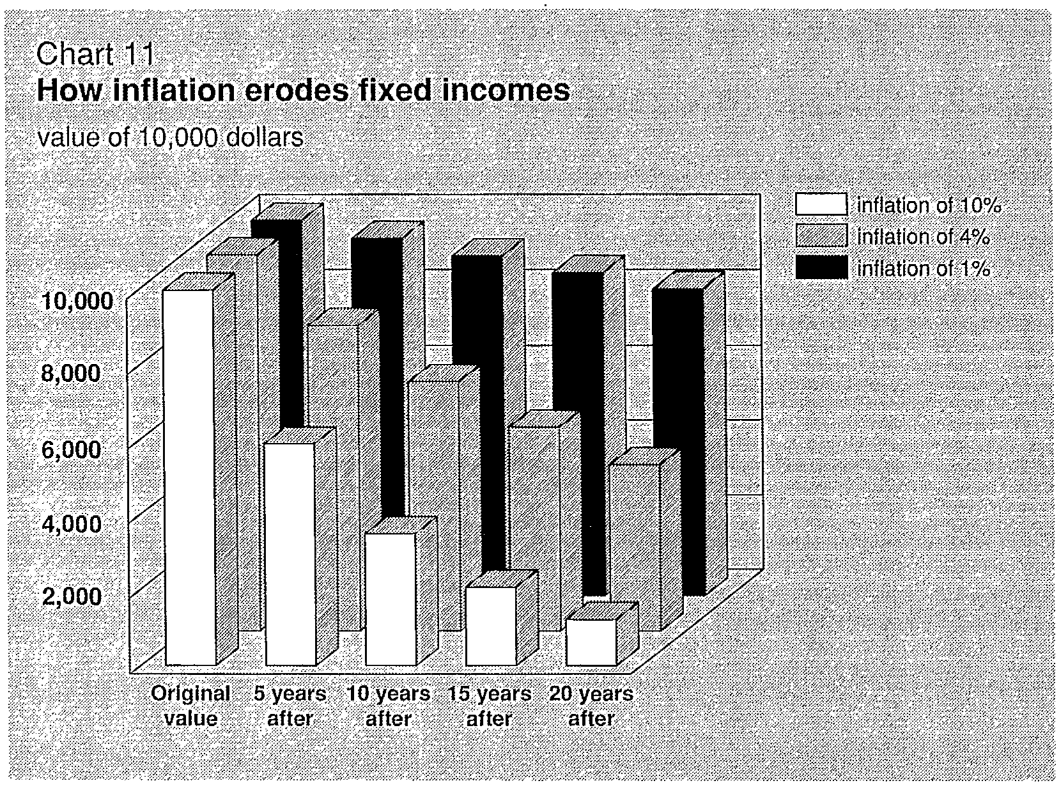
- The real cost of funds for business investment rises with inflation because of the uncertainties and business costs that inflation creates. This is devastating for investment.

Chart 10
Long-term interest rates reflect inflation, 1980-1989 average



Inflation is unfair

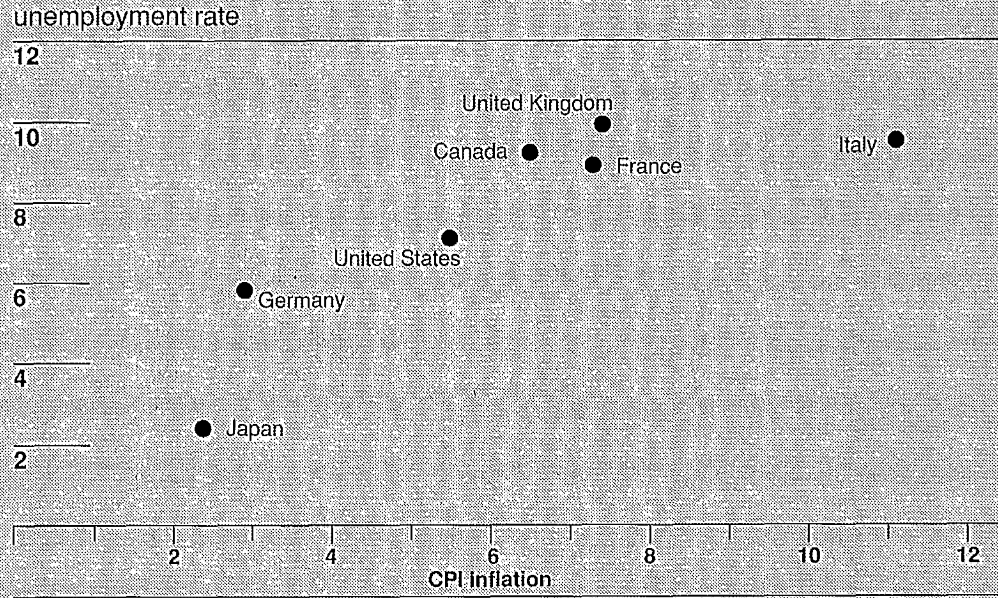
- Inflation redistributes income unfairly. Low inflation means better and more equitable protection of standards of living for every Canadian.
- What would happen to the income of a retired individual who must get by on a fixed pension of $10,000 a year? After 20 years of inflation, that income would be worth:
    - $1,220 after average annual inflation at 10 per cent;
    - $4,420 at 4 per cent;
    - $8,180 at 1 per cent.



Inflation does *not* lead to more jobs

- Low inflation and low unemployment go hand in hand.
- This experience is not unique to Canada. Look at France, the United Kingdom and Italy, at the top of the unemployment stakes with Canada; look at low-inflation Japan at the bottom. Low-inflation countries had the best unemployment performance while high inflation countries had the worst.

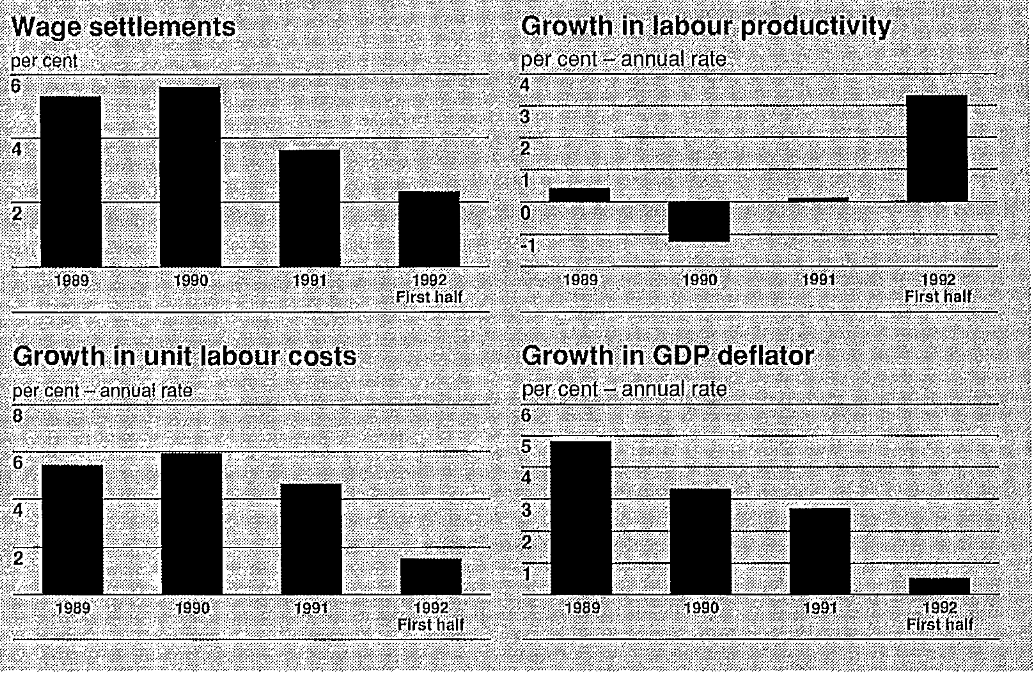
Chart 12
How inflation and unemployment go hand in hand, 1980-1989 average



Canada's competitiveness has improved remarkably

- Inflation pressures have fallen sharply in Canada in the past two years.
- Growth in labour productivity is up sharply while wage increases have slowed. As a result, growth in unit labour costs is now almost a quarter of what it was in 1990.
- Inflation, as measured by the CPI, is now at levels not seen consistently this low since the early 1960s.

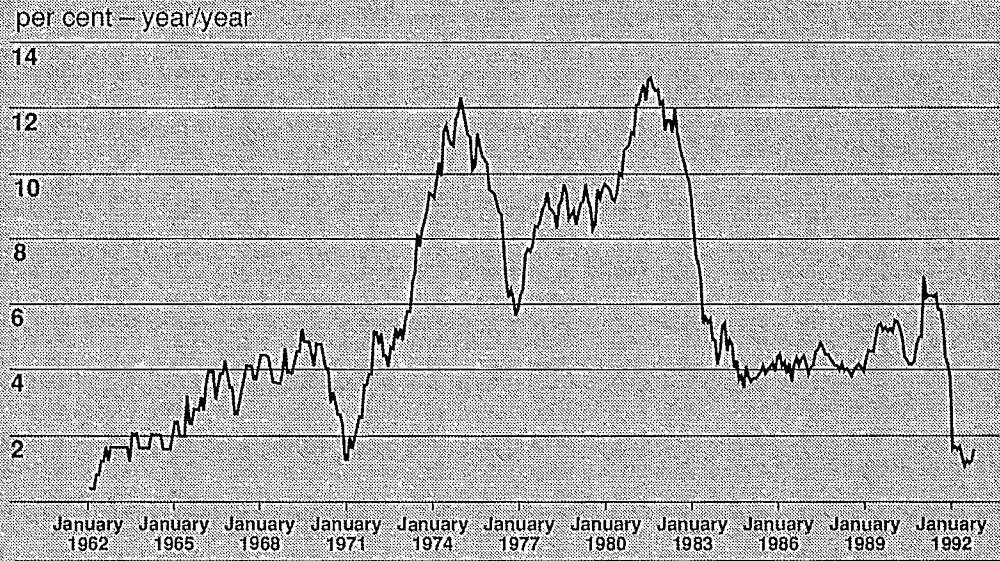
Chart 13
Production cost increases in Canada have been cut sharply



Inflation has declined markedly

- Canada has made great progress in getting inflation down.
- In October, CPI inflation was 1.6 per cent and inflation has been near or below this all year. Today's CPI inflation rate is lower than the average annual rate of inflation recorded in any single year since 1962.

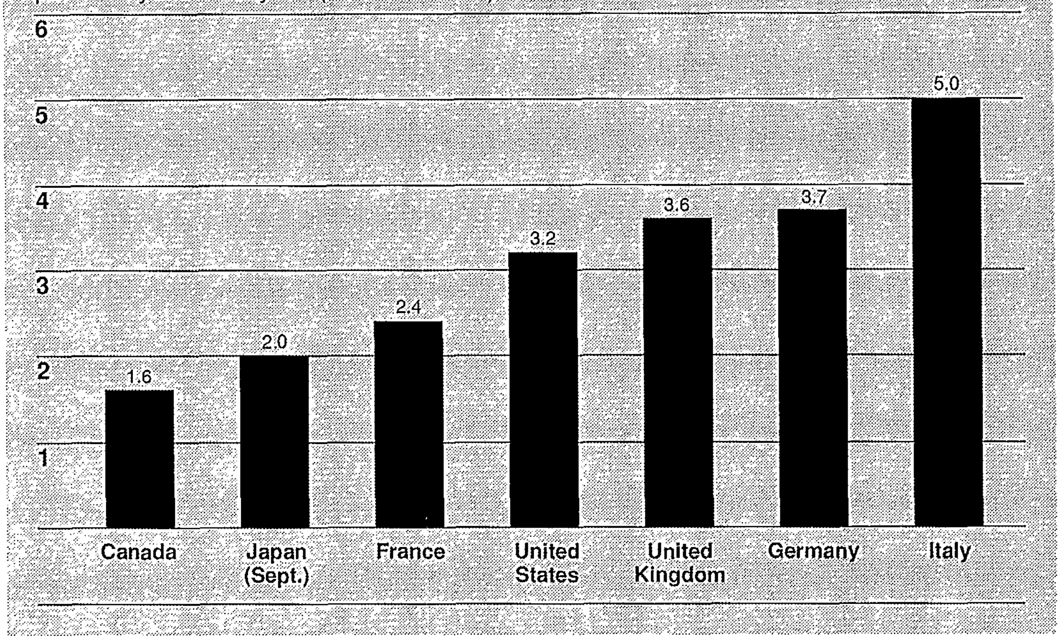
Chart 14
CPI inflation in Canada at lowest level since 1960s



Source: Statistics Canada.

- Canadian CPI inflation is now the lowest among the G-7 countries.

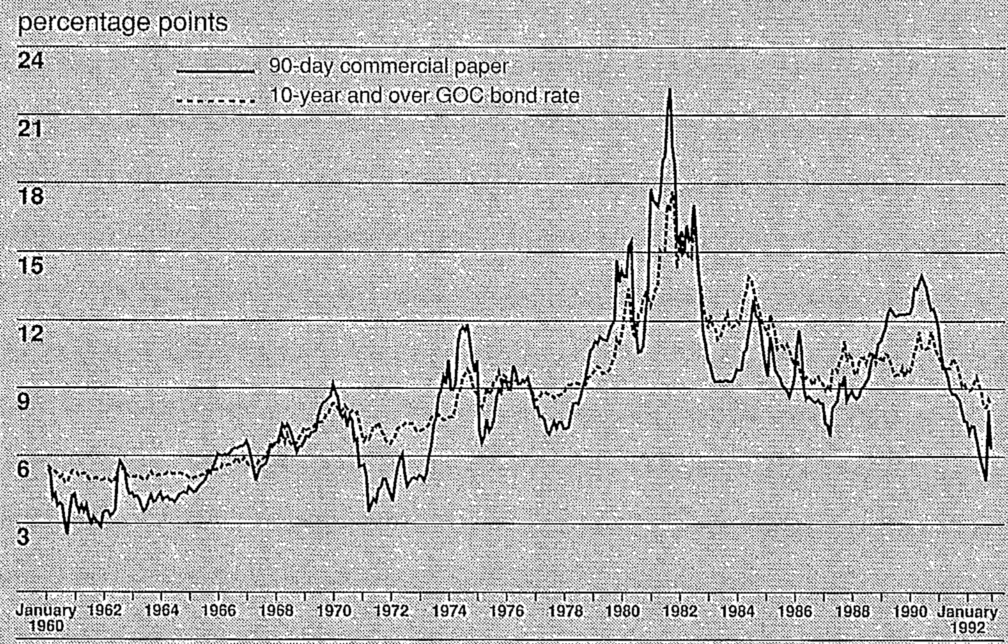
Chart 15
Canadian CPI inflation now the lowest in the G-7
per cent year-over-year (October 1992)



Low inflation is starting to pay off

- Over the past two years, Canadian interest rates have fallen faster than those in the United States and most other G-7 economies.
- In August of this year, Canadian short-term and long-term interest rates reached their lowest levels since the mid-1970s.
- Since then, a weak dollar has reversed some of the decline but rates remain well below their levels of two years ago.
- Low inflation is paving the way for interest rates to resume falling. But the benefits will be only fully realized as fiscal deficits and debt are controlled.

Chart 16
Canadian interest rates



GETTING DEFICITS UNDER CONTROL

Main issues in brief

Government debt is one of the largest burdens on the Canadian economy. The problem dates from the 1970s when government program expenditures grew so fast that they far exceeded revenues. Deficits rose rapidly and with them debt and interest costs. Interest payments have become the largest cost of the federal government. Indeed, without interest payments there would be no deficit.

The deficit has to be dealt with because of the huge costs it imposes. It competes with investment for the use of the limited flow of Canadian savings. That competition drives up real interest rates and results in heavy dependence on foreigners for investment funds. Deficits also rob governments of the ability to respond to emerging problems and opportunities.

Dealing with the deficit will not get easier. Compound interest makes the debt grow faster than incomes. The only way to control the growth of the debt is to get program spending (spending excluding interest) down below revenues. The government has begun this task but further effort is necessary.

How we got where we are

Most of the current federal debt and deficit resulted from the excess of expenditures over revenues that developed during the 1970s and early 1980s. In that period, accelerating expenditures outstripped the growth rate of both the economy and the tax base.

For the 15 years before 1984-85, program spending increased by an average of almost 14 per cent a year, nearly 2 percentage points faster than the growth of the economy. At the same time, the tax base deteriorated because of tax exemptions.

By 1984-85, the government was not paying its way. Program spending exceeded revenues by $16 billion a year. The government was spending $1.33 on programs for every dollar of tax revenue. Interest payments to service an exploding debt amounted to an additional $22.5 billion a year. Canada could not continue going with this ever-widening imbalance.

The growth of government debt had become self-perpetuating: every year the debt went up and every year more interest had to be paid. Delay was not an option. The compounding nature of the debt ensured that it would only be harder to deal with in the future.

Getting into debt is easy, getting out hard. The debt changed the rules of the game: keeping the debt from growing requires that revenues exceed expenditures by the growing amount of interest payments on the debt. This could not be accomplished overnight. A situation that had taken 15 years of fiscal imbalance to create was going to take considerable time to correct.

As the debt grew, it became more unmanageable. Interest payments absorbed more and more revenue, so important expenditures had to be forgone and the ability to meet emergencies was lost. In those circumstances, borrowing more money is not an option: it only increases the problem in the future.

The scale of interest costs

Debt service is now the single largest cost for government in Canada. Interest payments on the federal debt were \$41.2 billion in 1991-92, or about \$3,250 per worker. Over one dollar in every three of federal revenue is needed just to make these payments. In 1991-92, federal interest costs were larger than the combined expenditures on all major transfers to individuals, including unemployment insurance, family allowances and old age security.

The economic costs of deficits and debt

Deficits create very large, long-run costs for the economy because government borrowing competes with private investors for the use of Canadian savings.

If domestic savings cannot satisfy both needs, the competition forces business or government or both to borrow abroad, as happened in Canada. The increases in private investment and government borrowing of the 1980s outstripped the increases in domestic savings. As a result, Canada became highly dependant on foreign borrowing. While most of this borrowing was by the private sector, an increasing and significant part is now government borrowing at both the federal and provincial levels. At the end of 1991-92, nearly a quarter of federal debt was held abroad.

Are deficits always bad?

In many ways debt imposes the same restrictions on governments that it does on households. If it is kept in manageable proportion relative to earnings, it can be used to smooth out fluctuations in income so that important spending priorities can be met. In addition, it can also be used to finance important investments whose payoff will cover the cost of borrowing.

In the 1950s and 1960s, the federal government used debt in this manner. Years of deficit were offset by years of surplus. The end result was a fall in debt relative to GDP. Yet, a considerable amount was invested in infrastructure in those years.

Reliance on foreign savings makes both the Canadian government and businesses vulnerable to the vagaries of foreign financial markets. It also means we pay interest to foreigners. In 1991, 4.4 per cent of Canada's net domestic income went to service foreign debt.

In addition, competition in borrowing markets puts upward pressure on interest rates, which can put upward pressure on the Canadian dollar. This stifles economic growth in two ways:

- the high interest rates discourage Canadian investment; and
- a high dollar reduces the competitiveness of our exports.

Burgeoning deficits at the provincial level are now compounding the costs of government debt. In 1991-92, provincial deficits were about $21 billion, so the combined federal-provincial deficit was over $55 billion.

What the government has done

The government has made restraining expenditures to control the deficit a top priority since 1984-85.

To re-enforce this objective spending limits were established in the Expenditure Control Program, and then legally mandated in the *Spending Control Act*. These limits called for maintenance of spending on needed services and established programs, but for reductions in the growth of discretionary expenditures. The *Spending Control Act* is unprecedented within industrialized countries in fixing spending targets by law.

The federal government is now paying its own way on programs. In 1991-92 the government had a substantial operating surplus, $6.6 billion. This represented a $22.7 billion improvement since 1984-85. About three-quarters of this improvement was due to expenditure restraint.

As a result of spending restraint, Canada had the lowest growth of real program expenditures of central governments among the G-7 countries between 1984-85 and 1990-91.

Are Canadians getting less service for their tax dollars?

Some feel that they are now getting less service for their tax dollar than in the past. They are right. But there is no choice.

Through the 1970s and early 1980s, government program expenditures consistently exceeded its revenues. This is why the deficit grew.

Now, to make the interest payments on the accumulated debt, revenues must exceed program expenditures. In 1991-92, the government ran an operating surplus (the difference between revenues and program expenditures) of $6.6 billion, but debt service charges left it with a $34.6 billion deficit, so the federal debt still kept growing faster than the economy.

In essence, the bills are coming due for services already provided.

Furthermore, Canada's deficit performance compares favourably with that of the United States. In 1984-85, Canada's operating deficit was twice as large, relative to GDP, as the United States'. By 1991-92, Canada had increased its operating balance by 2.7 per cent of GDP to reach a surplus of one per cent of GDP. The improvement in the U.S. operating balance was markedly less pronounced, rising only 0.8 per cent of GDP.

Despite these achievements, however, the fiscal imbalances of the 1970s and early 1980s still linger on. Rapid growth of debt charges has absorbed much of the fiscal gains from program spending restraint.

Despite a cumulative operating surplus of $20 billion since 1984-85, the national debt has more than doubled since that time to $423 billion by 1991-92. The entire increase in the debt is due to the compounding interest on the debt already owed in 1984-85.

What still needs to be done

Even further expenditure reductions are needed. Although the government has achieved substantial operating surpluses, this is still insufficient to stop debt from growing faster than GDP.

Expenditures will come down sharply as a share of GDP if kept within the limits established in the *Spending Control Act.*

To meet pressing new needs in higher-priority areas such as investment in training, technology, and infrastructure, the government will have to reduce existing spending commitments.

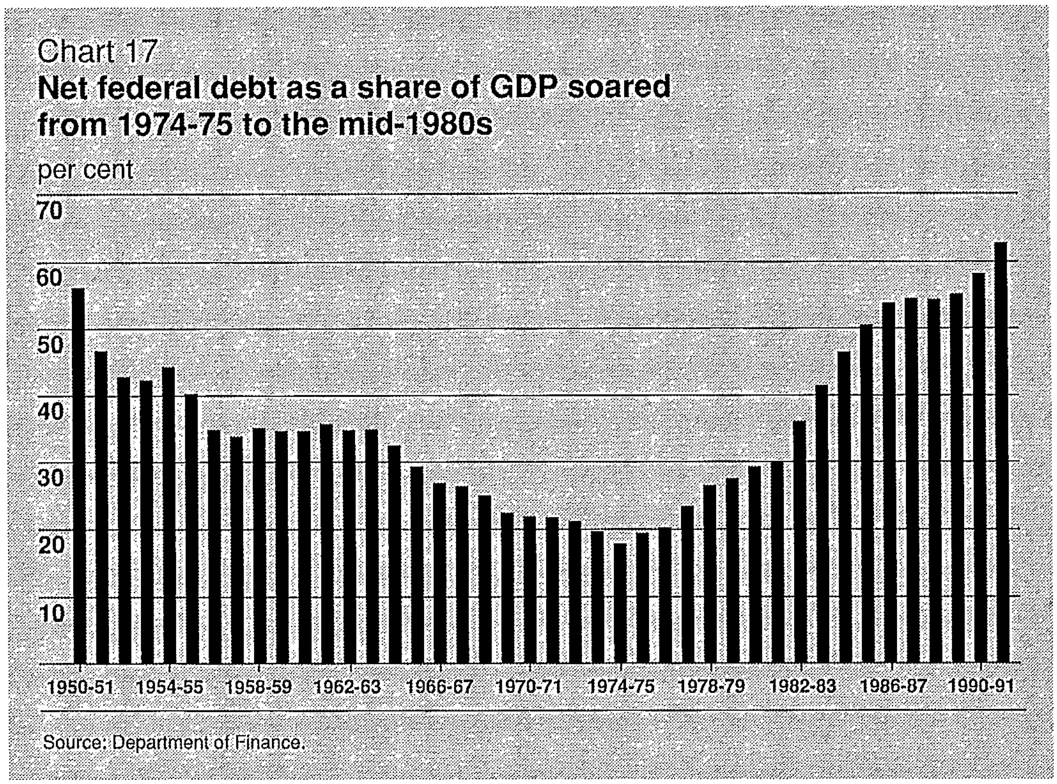
As the economy strengthens, government revenues will increase. The progress that has already been made on reducing the deficit will be renewed.

Those who call for more government spending are simply inviting a repeat of the mistakes made in the 1970s and early 1980s. The experience of those years has demonstrated that debt financing of government spending simply increases future tax burdens because higher government spending must *always* be paid for by higher taxes.

Charting the Changes

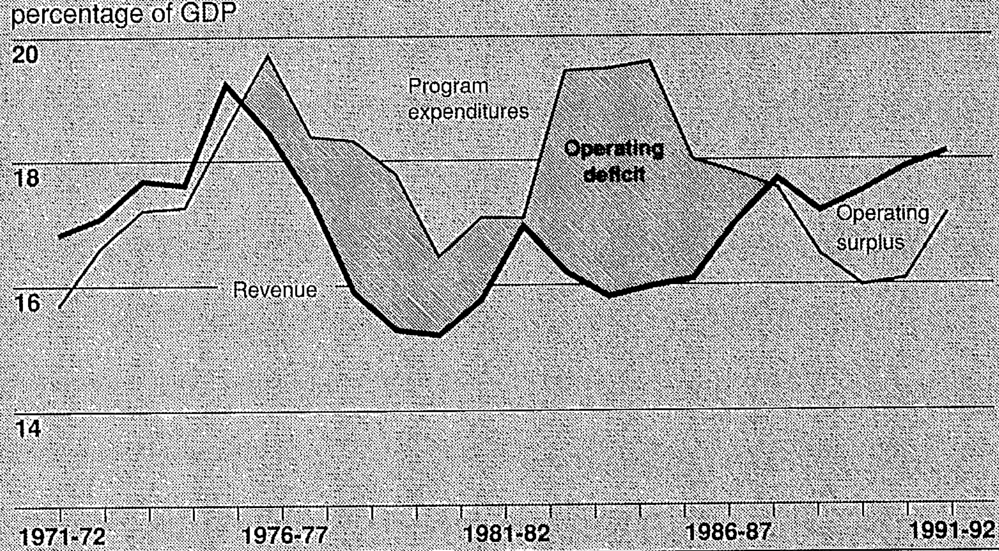
Deficits in the 1970s and early 1980s led to burgeoning debt

- Federal debt piled up rapidly in proportion to GDP over the mid-1970s and early 1980s. This undid the good job of running it down after the large deficits caused by the 1939-1945 war effort.
- The growth of debt slowed markedly after the mid-1980s.



- The growing debt came about when structural imbalances between expenditures and revenues developed during the 1970s and early 1980s.
- By 1984-85, the government was spending on programs $1.33 for every dollar of tax revenue.
- As a result of this imbalance, deficits soared.

Chart 18
How deficits arose – letting expenditures grow faster than revenues

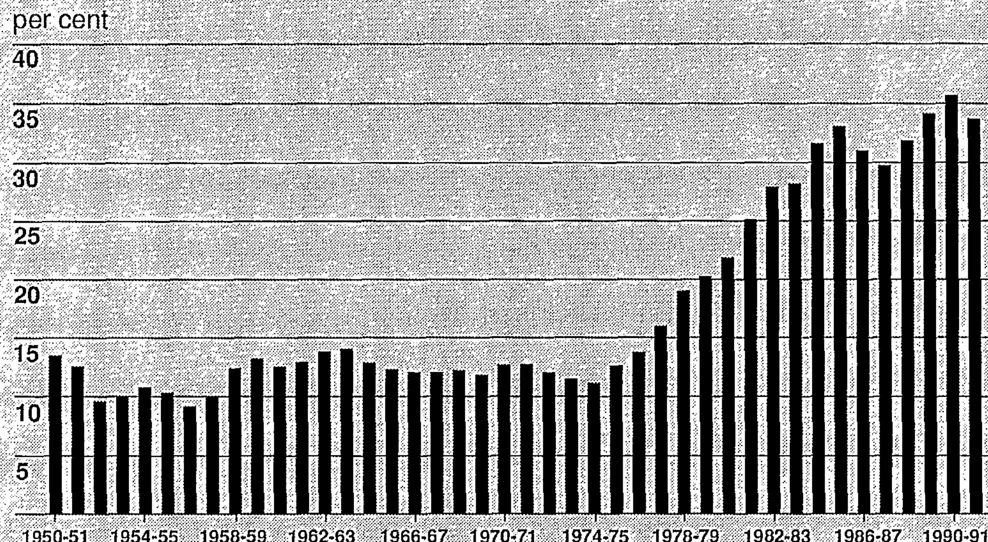


Source: Department of Finance.

Rising debt means rising interest payments

- After 1974-75, deficits developed a strong momentum, as interest payments used up more and more of the available revenues.
- Interest payments on the debt became the largest costs of government – larger than the cost of all major transfers to individuals.

Chart 19
The share of federal interest payments in total revenue also soared from 1974-75 to the mid-1980s

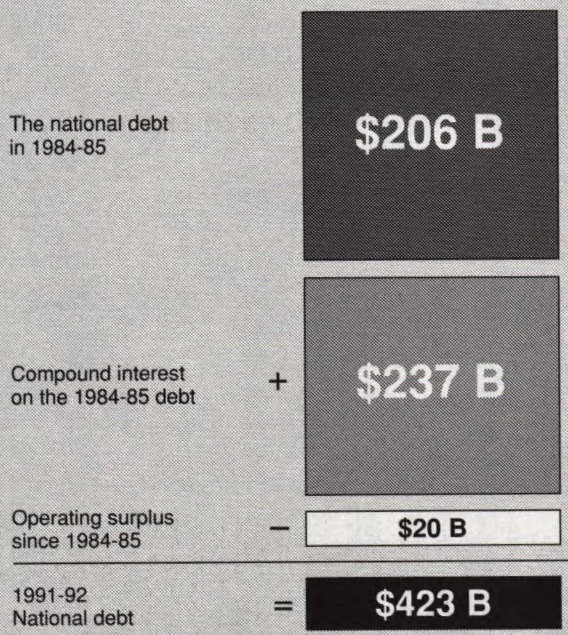


Source: Department of Finance.

Debts and deficits can become almost self-perpetuating

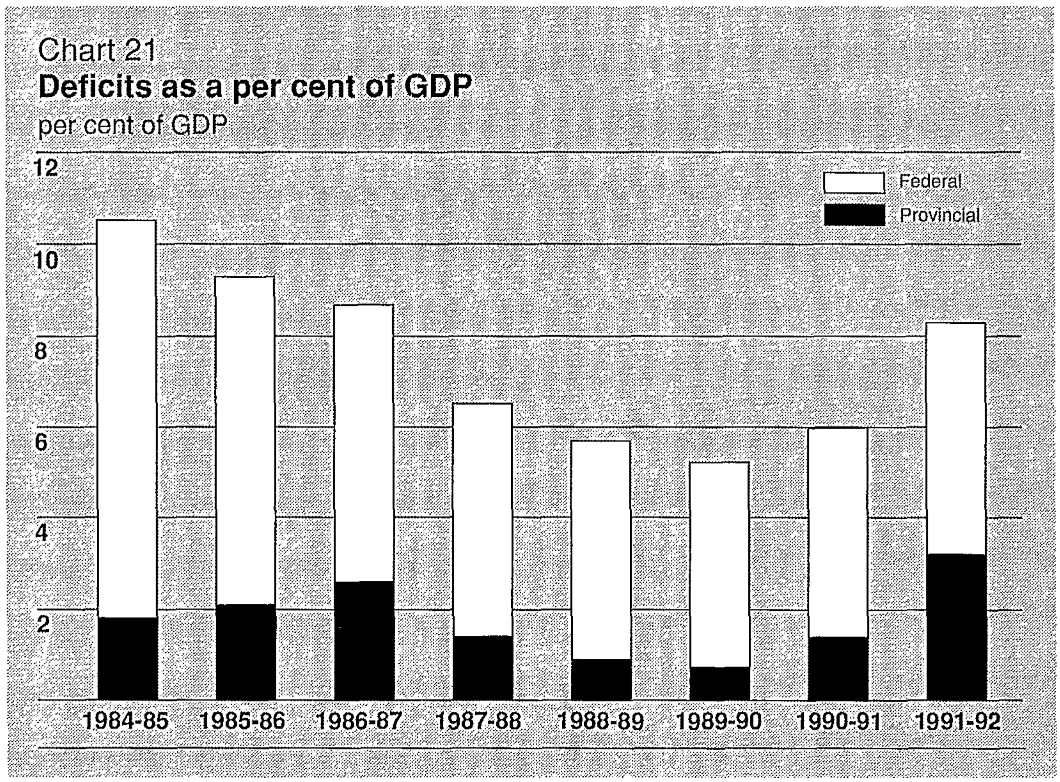
- The federal debt more than doubled as a result of compounding interest.

Chart 20
How compound interest pushed up the debt



All levels of government have deficit problems

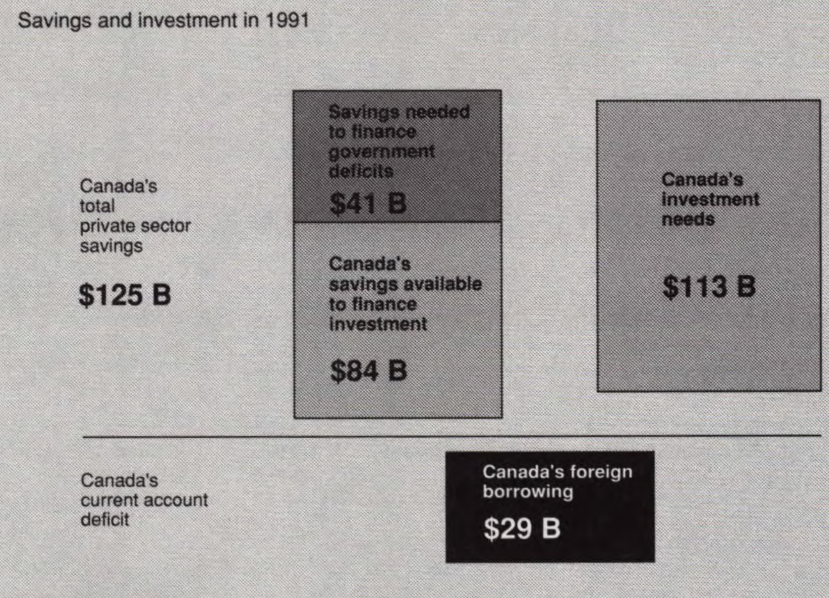
- Provincial governments now make a large contribution to the total government deficit.
- In 1991-92 provincial deficits will be about $21 billion.



Government deficits force Canadians to borrow abroad

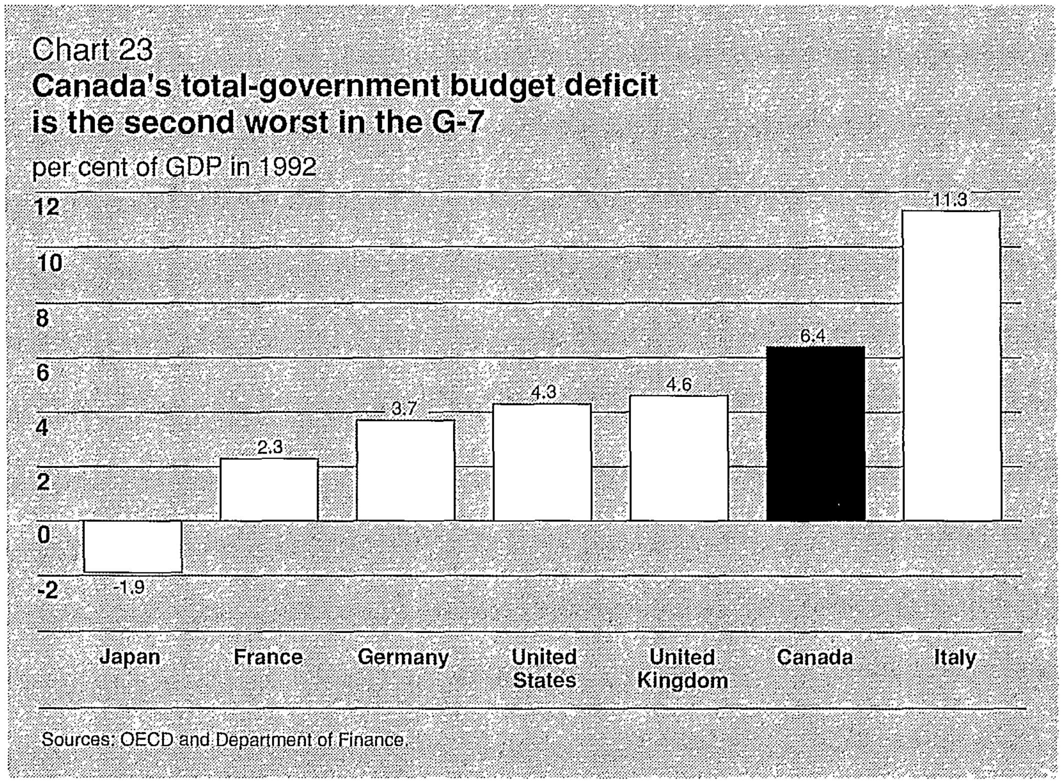
- Domestic savings could completely satisfy Canada's private investment needs if there were no government deficits. Instead, governments soak up about a third of the savings. To continue investing, we are pushed to a heavy reliance on foreign savings.

Chart 22
Foreign savings are needed because government borrowing uses too much savings



Canada's fiscal position is second-worst in the G-7

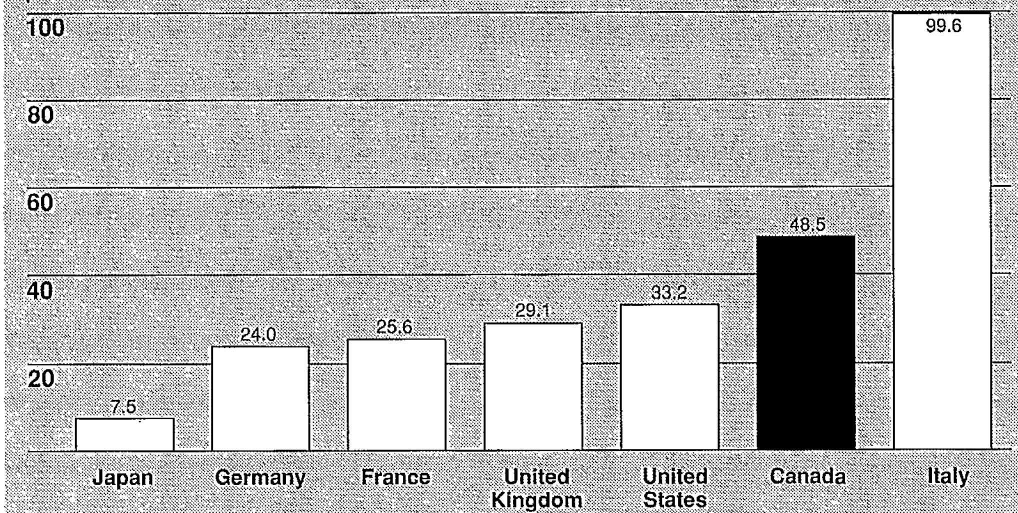
- In 1992, Canada's total government deficit was 6.4 per cent of GDP on a national accounts basis. Only Italy was higher among the G-7 countries.



- Canada's total public debt of 48.5 per cent of GDP, on a national accounts basis, is also the second largest among the G-7 countries.
- This high debt level makes Canada very vulnerable to interest-rate developments.

Chart 24
Canada's total-government net fiscal debt is also the second worst in the G-7

per cent of GDP in 1991

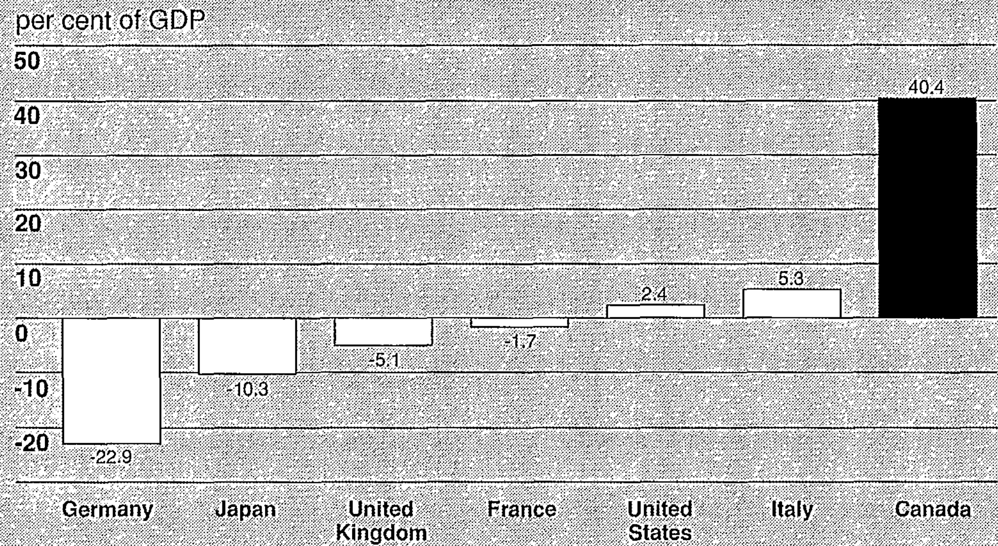


Sources: OECD and Department of Finance.

Large deficits have led to a high foreign indebtedness

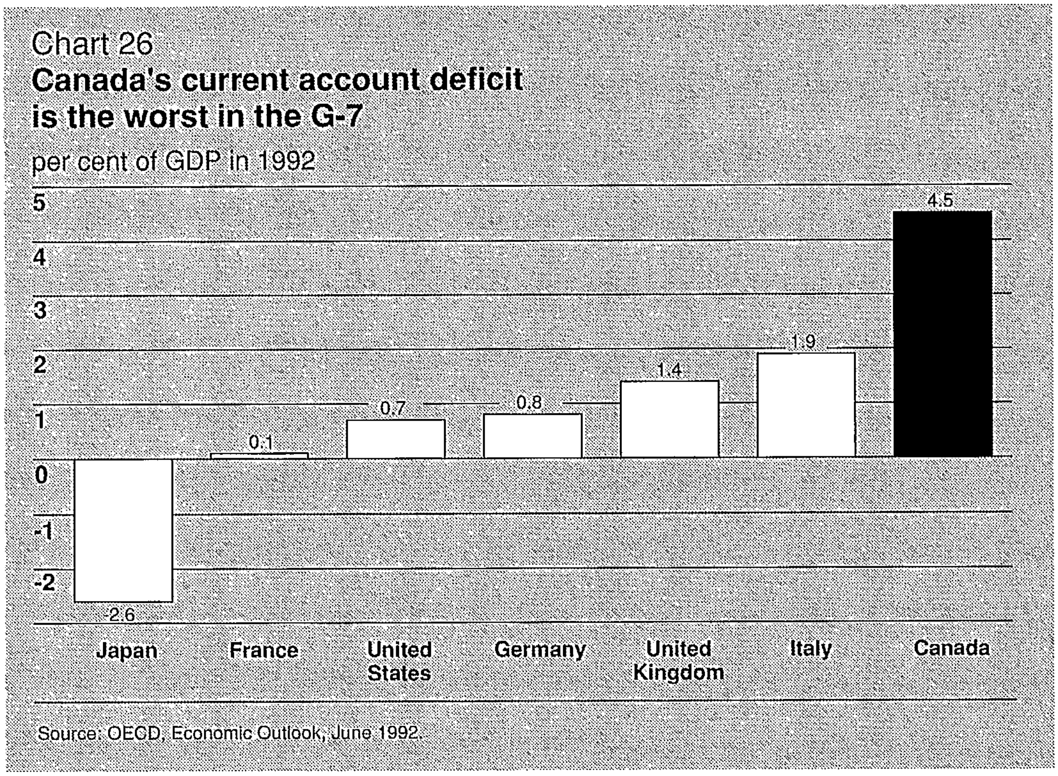
- High investment demand during the mid-1980s coupled with large government deficits has resulted in Canada having the highest level of foreign debt (both public and private) relative to GDP of all the G-7 countries.

Chart 25
Canada's total (public and private) international indebtedness is the highest in the G-7



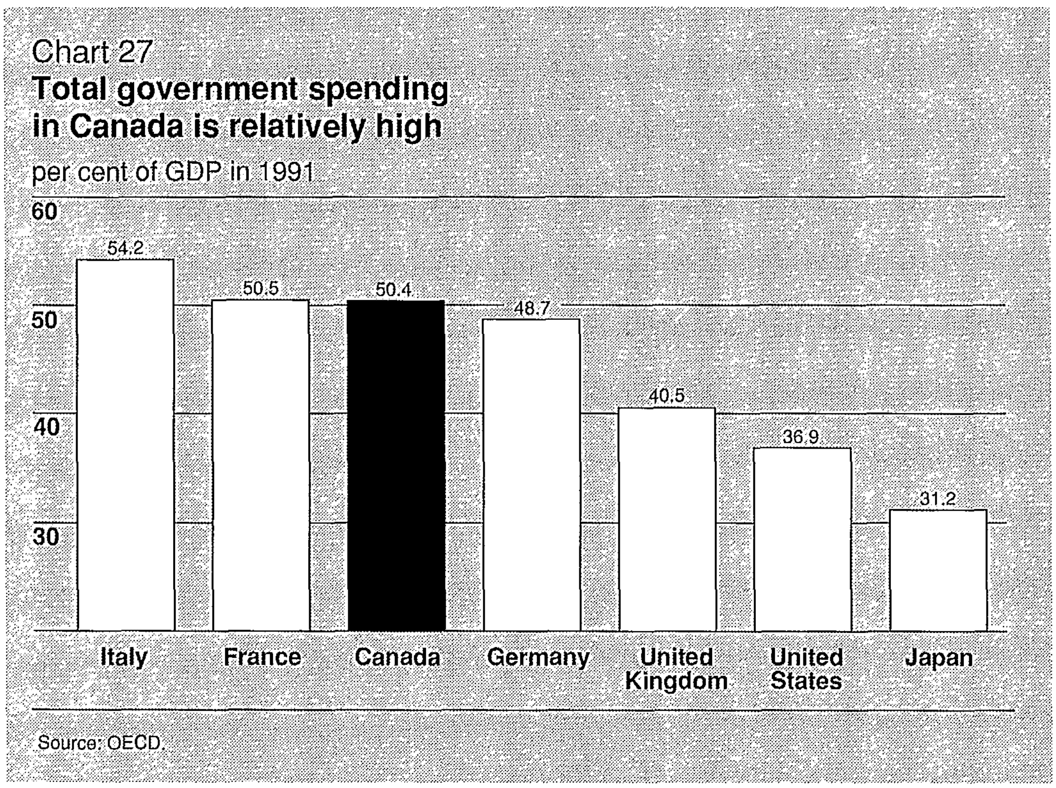
1991 for Canada and U.S.; 1990 for Germany, Italy, United Kingdom and Japan; 1989 for France.

- Interest payments on Canada's total foreign debt are a major contributing factor to Canada's large current account deficit, the worst in the G-7 relative to GDP.



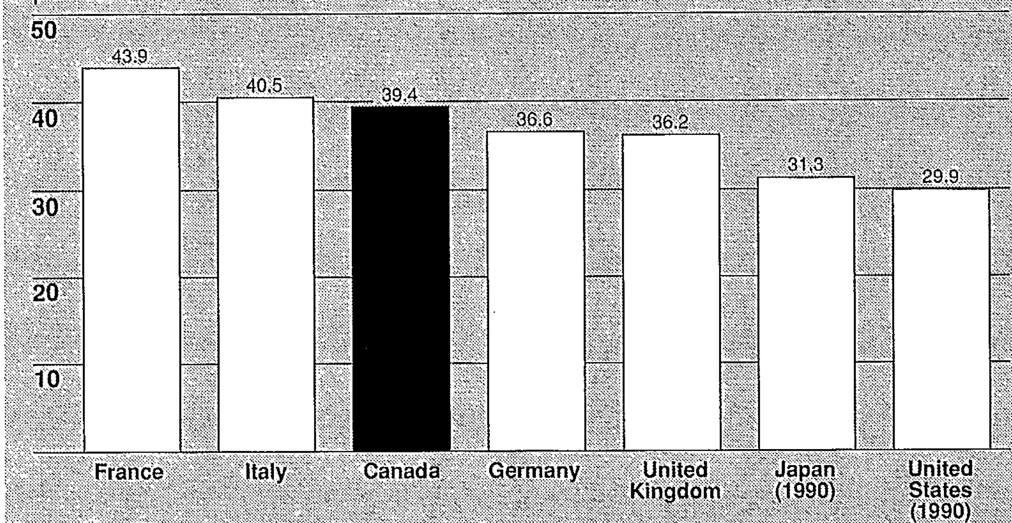
Spending must be controlled to keep taxes down

- Canadian governments' total spending, relative to GDP, exceeds that in most other G-7 countries.
- Total spending of all levels of government, relative to GDP, was 13.5 percentage points higher in Canada than in the U.S. in 1991.



- High spending has meant high taxes. These taxes impede Canadian competitiveness. Raising them more to fund new spending is not an option.
- The February 1992 budget introduced measures to reduce personal income taxes by $7.5 billion in the following five years.
- Furthermore, taxes on Canadian businesses will also be reduced by $2 billion over five years.

Chart 28
Canada has a high tax burden relative to many other G-7 countries
per cent of GDP in 1991

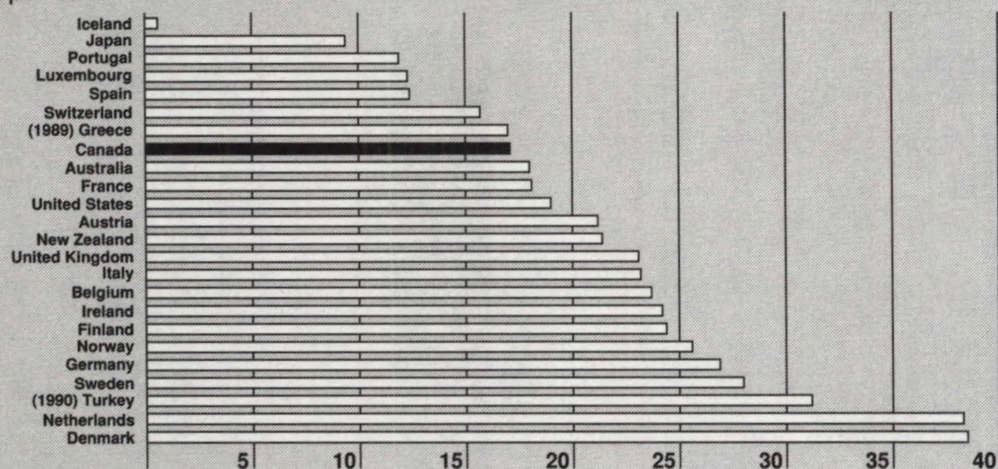


Source: OECD.

THE TAX BURDEN ON FAMILIES HAS BEEN KEPT MODERATE

- The tax burden – income taxes and employee contributions to social security plans – facing an average Canadian production worker with a two-child family in 1991 is lower than in most modern, industrialized countries, including the U.S.
- This is because Canada has a more progressive income tax system and relies more on sales taxes than many other economies.

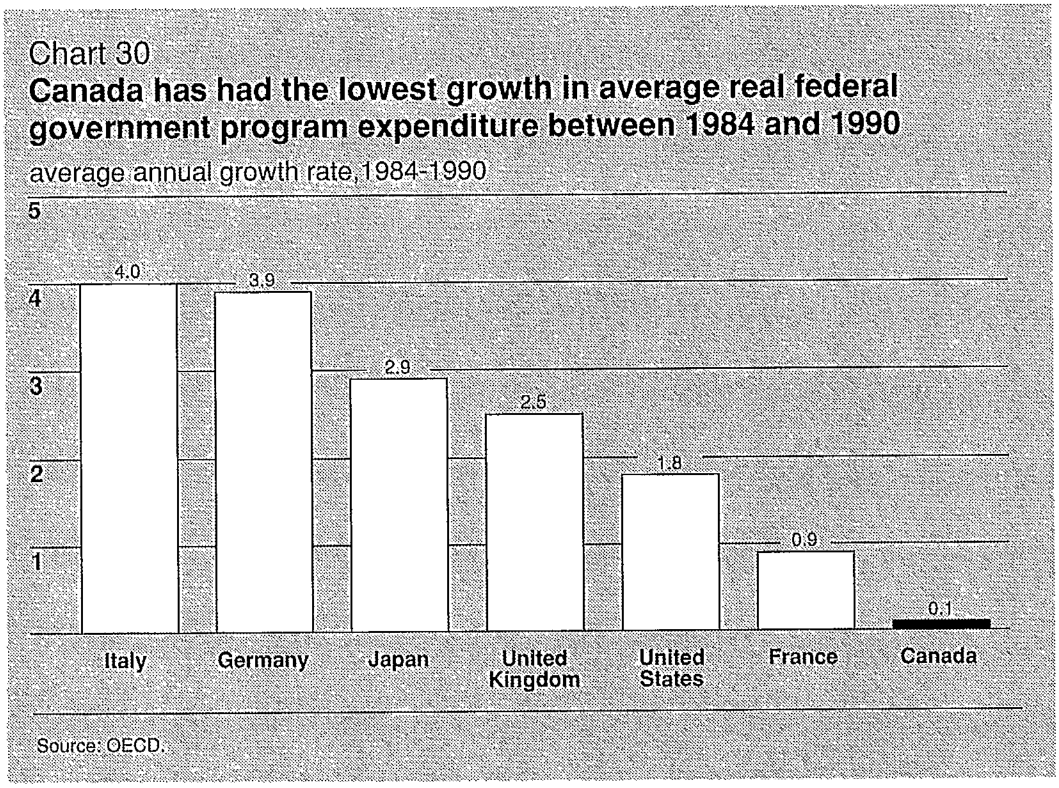
Chart 29
Income and social security taxes on an average production worker in OECD economies
Personal income tax and employee social security contributions on an average production worker with a family of two children in 1991
per cent



Source: OECD, Tax/Benefit Position of Production Workers, 1988-1991.

The federal government has controlled program expenditures

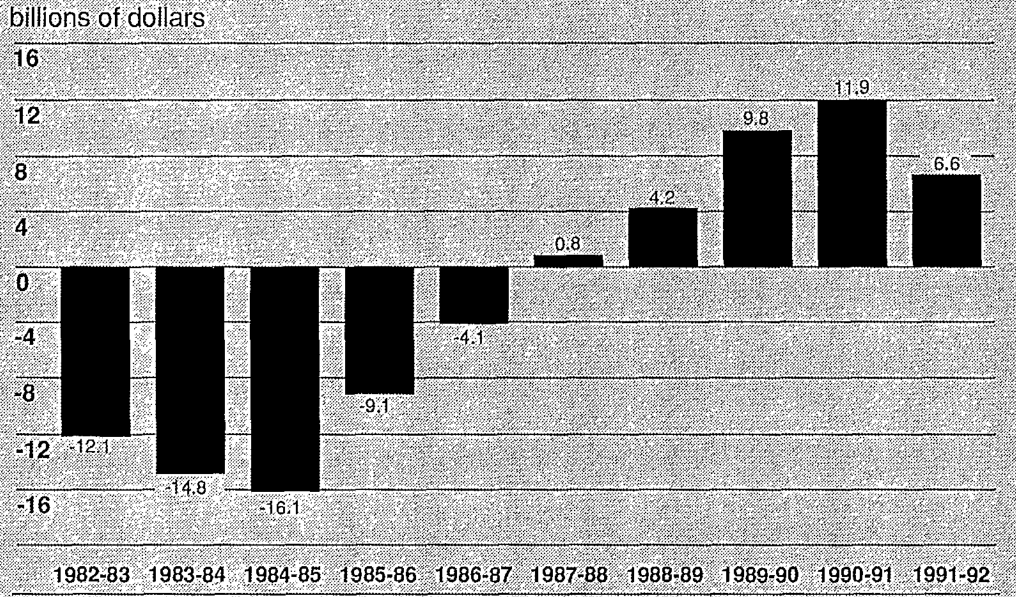
- The Canadian record of restraining the growth of real federal government program expenditures has been the best in the G-7 countries since 1984.



- As a result, the large operating deficits (the difference between revenues and program expenditures) of the early 1980s have been turned into large operating surpluses.

Chart 31

The operating balance has moved from large deficits to large surpluses

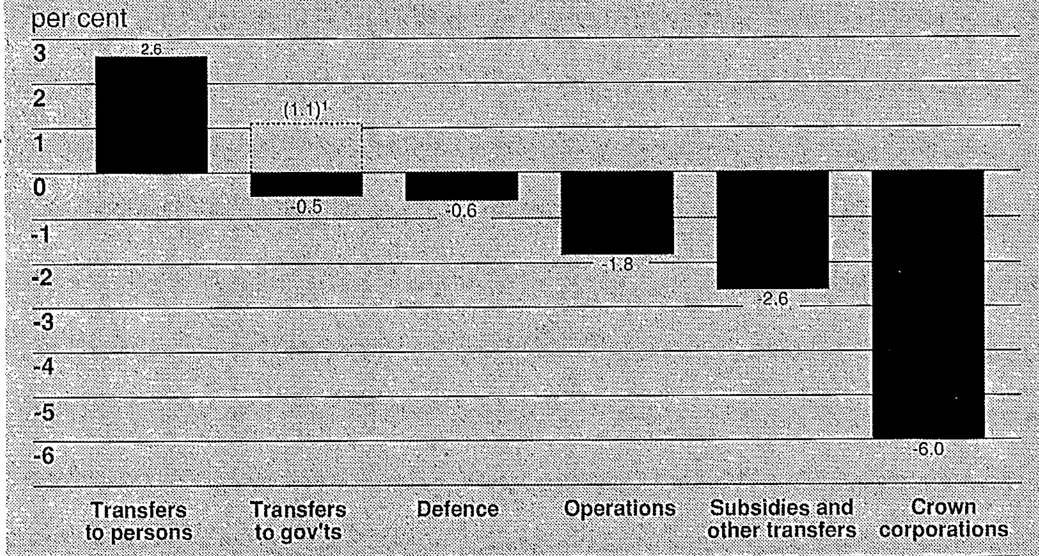


Expenditure growth is highest for major transfers to people

- The largest growth in spending has been transfers to people. After adjustments for inflation, spending on government operations has actually fallen.

Chart 32

Between 1984-85 and 1991-92, the big increases in program spending have been in transfers to people (constant dollars)



[1] Total entitlements (cash payments plus tax points).

- Major transfers to people and transfers to governments are also the largest areas of program spending.
- Combined they represented 55 per cent of total program spending in 1991-92.

Chart 33
More than half of federal program spending is for transfers

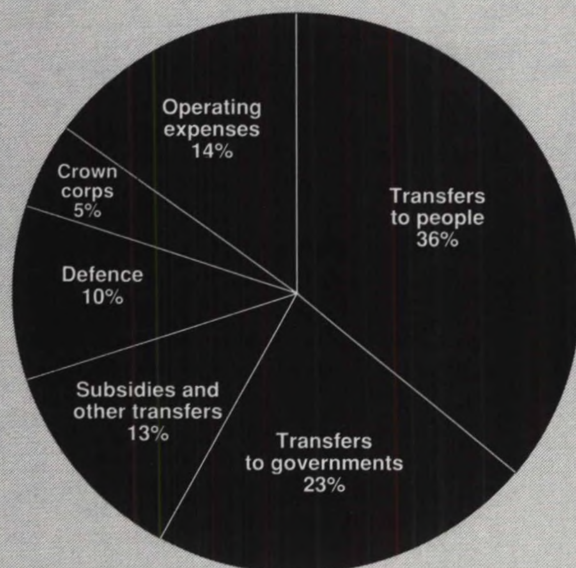


Table 1
Distribution of program expenditures

	1984-85	1991-92	Absolute change	Annual average change
		(billions of dollars)		(per cent)
A. Transfers to:				
1. Persons				
OAS/GIS/SA	11.4	18.3		
U.I. benefits	10.1	18.4		
Family allowances	2.4	2.8		
Veterans benefits and allowances	1.1	1.4		
Other	0.5	0.2		
Total	25.5	41.1	15.6	7.0
2. Governments				
Established Programs Financing	8.6	8.8		
Equalization	5.4	8.0		
Canada Assistance Plan	3.7	6.1		
Territories	0.5	1.0		
Other	1.8	2.1		
Total	20.0	26.1	6.1	3.9
Cash plus tax transfers[1]	24.6	36.8	12.2	5.9
3. Subsidies and other transfers	12.5	15.1	2.7	2.8
4. Total transfers	58.0	82.3	24.3	5.1
B. Payments to Crown corporations	6.2	5.3	-0.9	-2.3
C. Defence	8.8	11.5	2.7	4.0
D. Government operations	14.1	16.4	2.3	2.2
F. Total program expenditures	87.1	115.5	28.4	4.1

[1] Certain transfers to provinces are made as a combination of cash and a transfer of tax points.

MAKING GOVERNMENT MORE EFFICIENT

Main issues in brief

All programs have administrative, compliance and efficiency costs in addition to the program expenditures themselves. These costs must be kept low to reduce the economic distortion caused by government intervention. In other words, governments must be efficient. The goals of reforms undertaken since 1984 have been to: reform the tax system and ensure that it keeps Canadian businesses on an equal footing with their competitors; encourage adjustment to new economic circumstances; promote key investments in training, advanced education, research and development, and infrastructure; reduce the role of government in the economy; and establish more secure and open trading relationships for Canada.

HOW GOVERNMENT CAN BE EFFICIENT

The government's drive to increase efficiencies over the past eight years has included many vital elements:

- Framework policies have been redirected toward promotion of sustainable, medium-term growth, including reform to ensure that the tax system keeps Canadian businesses on an equal footing with their competitors.
- Policies have been adopted to ease and encourage adjustment of the work force and industries to new economic challenges.
- Key investments have been made in training, advanced education, research and development, and economic infrastructure.
- The government has become leaner.

EFFICIENCY POLICIES YIELD BENEFITS

Tax reform increases Canadian competitiveness

- **Personal income tax reform**: The old system of personal income tax with ten tax brackets was replaced by three tax rates. The top marginal tax rate was reduced from 34 per cent to 29 per cent. The base was broadened by eliminating special provisions and converting personal exemptions into tax credits.
- **Corporate income tax reform**: The corporate tax base was broadened to permit lower tax rates. The new system is fairer, less distortionary, and helps Canadian corporations compete.
- **Sales tax reform**: The Good and Services Tax (GST) replaced the archaic, anti-competitive, Manufacturers' Sales Tax. This removed significant distortions in the tax structure, particularly ones that disadvantaged Canadian firms in exporting or competing against imports.

Pension reform

The government has reformed Canada's private pension system to give employees more equitable access to tax-sheltered savings for retirement and encourage higher savings.

Human and physical capital improved

In labour market policies, the government moved from passive income support towards active measures to help workers get lasting jobs by modifying the unemployment insurance system in 1990.

- Unemployment insurance reform has maintained the safety net for Canadians in need of work but increased incentives to take available jobs.
- Support for unemployed workers has been partly redirected to training and skills development through various programs.

Programs for worker adjustment

The federal government's labour market policies comprise two main thrusts.

The **Labour Force Development Strategy** embodies training and retraining programs both through the Developmental Uses of Unemployment Insurance and through elements (much of which was formerly delivered by the Canadian Job Strategy) such as information and special initiatives, employability improvement, labour-market adjustment, and community development.

The **Program for Older Worker Adjustment**, administered by Labour Canada, provides special assistance to workers faced with difficult adjustment circumstances because of their age.

Investment in R&D encouraged

The government is streamlining the administration of the Scientific Research and Experimental Development (SR&ED) tax credit system. As a result, the SR&ED tax credit system will be enriched by about $230 million over the next five years.

Government made leaner

The government has reduced its role in the economy, an important contribution to creating a more competitive environment.

The government has become much leaner and more efficient:

- While GDP grew at an annual rate of 6.3 per cent between 1984-85 and 1991-92, federal operating expenditures on items like salaries, travel and accommodation grew at only 2.2 and program expenditures at only 3.9 per cent – well below the rate of inflation. In 1991-92 only 14 cents of every dollar of revenue went to operating costs of government, compared with 21 cents in 1984-85.

- Twenty-three privatization initiatives have been undertaken. Through productivity gains, privatization and rationalization, the number of employees of Crown corporations has been reduced by 86,000 since 1984-85.
- In 1992 alone, the government eliminated or consolidated a total of 46 separate government entities.

Competition encouraged

The government introduced a modern *Competition Act* in 1986 to spur enterprise.

Federal regulation governing financial institutions has been reformed to allow greater competition among them.

The government has modernized delivery of support for regional development.

CHARTING THE CHANGES

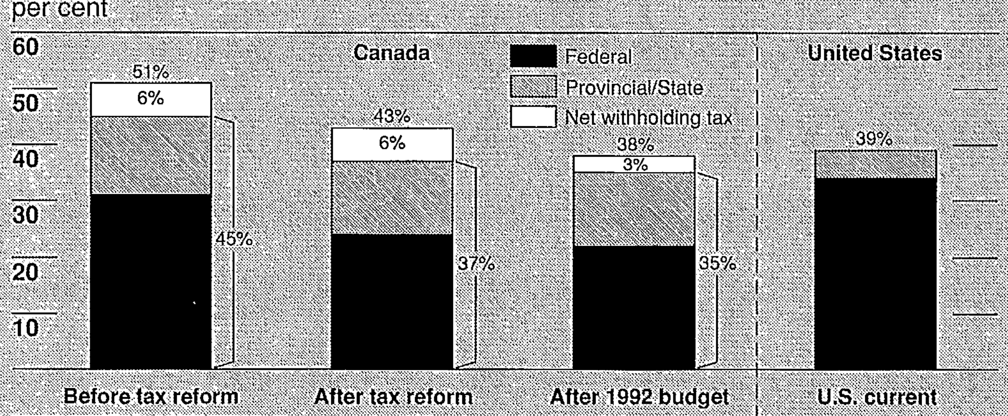
Tax reform increases competitiveness of Canadian firms

- Corporate income tax reform and the 1992 budget proposals greatly increase the competitiveness of Canadian firms by putting them on an equal tax footing with U.S. firms.

Chart 34

Tax rates for the manufacturing and processing sector are now lower in Canada than in the United States

Corporate income tax rates for the manufacturing and processing sector

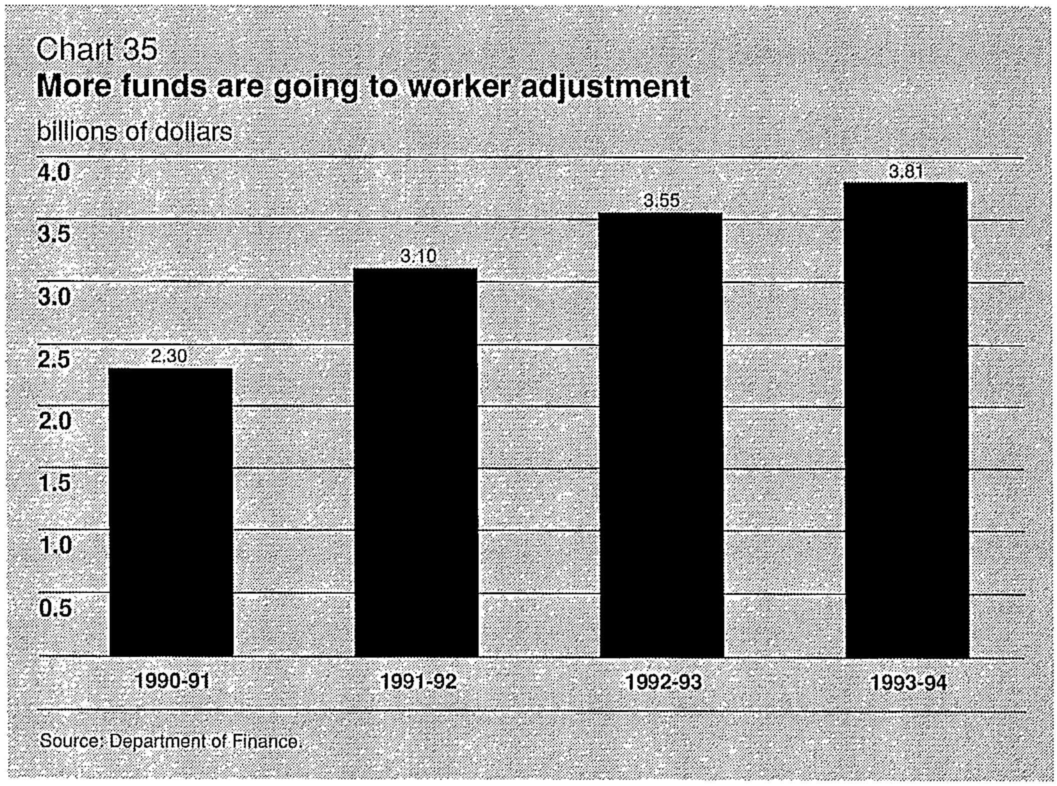


Note: The withholding tax reduction will be implemented when a new Canada-U.S. tax treaty is ratified.

Source: Department of Finance (1992).

Labour market policies improve human capital

- "Active" labour market programs to improve people's skills – and hence their employability and earning power – grew rapidly after the 1990 unemployment insurance reform. In 1990-91, the government spent $2.3 billion on worker adjustment. In 1993-94, the total will be $3.8 billion.



RAISING LIVING STANDARDS THROUGH TRADE

CANADA'S INTERNATIONAL TRADE

Main issues in brief

Improving trading opportunities is essential to maintain and promote Canada's standard of living. Exports create jobs and allow firms to reduce production costs. Imports provide consumers with a wide range of goods at low cost. In a two-track strategy of trade liberalization, Canada has worked for liberalization of world trade through the General Agreement on Tariffs and Trade (GATT) and freer trade arrangements with our regional trading partners. Canada's exports and imports have grown faster than the economy as a whole, creating jobs and increasing productivity. The next steps will be a successful conclusion of the latest round of GATT negotiations and ratification of the North American Free Trade Agreement (NAFTA). NAFTA improves the gains made in the Canada-U.S. Free Trade Agreement and makes us part of the largest free trade area in the world in both population and production.

Why Canada needs trade and trade agreements

Canada depends more than most other industrialized countries on trading opportunities and exports for its high standard of living.

- Because it is a small economy, Canada must drive for expansion of export markets to create jobs and economic growth.
- Canada exports over a quarter of domestic output; one in every three of the country's jobs (or 4.1 million jobs) depends on exports.
- Imports are equally important to the health of the economy. They provide both production inputs and a wide choice of goods and services not otherwise available to Canadian consumers.

Without large export markets, Canada could not gain the economies of scale required to reduce production costs and compete for consumers both at home and abroad.

Canada consequently has more to lose from trade barriers than larger economies, and is more vulnerable to an unstable trading environment.

These problems can only be attacked by negotiating trade agreements.

- Reducing barriers by agreement opens opportunities for the gains from trade which develop as firms learn to meet competition by improving products and reducing costs.
- Agreements provide mechanisms for settling disputes, making trade relationships secure and more stable.

What Canada has done to expand trade

Since the end of the Second World War, Canada has adopted a two-track approach to trade liberalization.

First, it engaged in multilateral trade liberalization through the General Agreement on Tariffs and Trade (GATT). Successive GATT negotiating rounds have lowered our tariffs on imports and improved our access to export markets.

Second, Canada has established regional trading arrangements consistent with the GATT.

- The first major agreement was the Canada-U.S. Auto Pact in 1965. It allowed the automobile industry to rationalize operations and specialize in its most efficient product lines.
- The Canada-U.S. Free Trade Agreement (FTA) negotiated in 1989 represented a continuation and expansion of this strategy. The FTA has lowered tariff as well as non-tariff barriers and provided a mechanism for settling disputes, ensuring more stable access to Canada's largest export market. In 1991, our exports to the U.S. accounted for 18 per cent of our production.

Canada has also undertaken other structural reforms with important trade-related benefits. One example is the Goods and Services Tax (see box).

How the GST helps Canada compete

The Goods and Services Tax (GST) has also been a boon to competitiveness. The old Manufacturers' Sales Tax (MST) treated imports more favourably than domestically produced goods. It exempted advertising and distribution costs on imports, but not on domestic goods, from taxation. Previously, the effective tax rate on domestic products had been an average 33 per cent higher than on competing imports. Replacing the MST with the more equitable GST has ensured that Canadian goods do not suffer from a competitive disadvantage in our own markets.

In addition, the GST helps us to compete by reducing taxes on the inputs used to produce exports. Under the MST as under provincial sales taxes, many business inputs were taxed, even for exported goods and services. The GST reduced these hidden taxes on exports from 3.4 to 1.8 per cent, according to the Canadian Export Association. The majority of the remaining tax is provincial.

Payoffs from freer trade

Postwar trade liberalization spurred Canada's exports and imports to faster growth than the economy as a whole. This has provided greater prosperity for Canadians. Although Canada ranks 31st in the world in population, its economy is the seventh in production; Canada has the second highest standard of living among G-7 countries.

The FTA has also paid off handsomely.

- In spite of the recent North American recession and the appreciation of the Canadian dollar, Canada has significantly improved its balance of trade with the U.S. since the start of the FTA.
- A recent study by the C.D. Howe Institute showed that in the 1989-1991 period Canada's exports did best in sectors liberalized by the FTA, particularly the non-resource-based manufacturing sector.
- The study also suggested that the U.S. continues to offer the largest and most dynamic market for Canadian exports of high-value-added goods and services. This is an invaluable opportunity to expand and diversify Canada's exports beyond the traditional resource base and promote highly paid, technology-intensive jobs.
- Trade liberalization under the FTA has also attracted more foreign investment to Canada.

Like trade, investment is critical to Canada's prosperity. It raises output and productivity, and provides more high-skilled, high-paid jobs. The FTA has been crucial in enabling Canada to compete effectively for foreign investment.

Building on success in trade strategy

By pursuing the trade liberalization strategy, Canada will promote its international competitiveness and high living standards.

We must persist in the GATT process to successfully conclude the Uruguay Round. Successful conclusion of the Uruguay Round will bring sizeable benefits to Canada and the world and avert the escalation of trade disputes.

We must ensure the ratification of NAFTA. The North American Free Trade area will be the largest in the world, with a population of 361 million and a gross domestic product of $7 trillion.

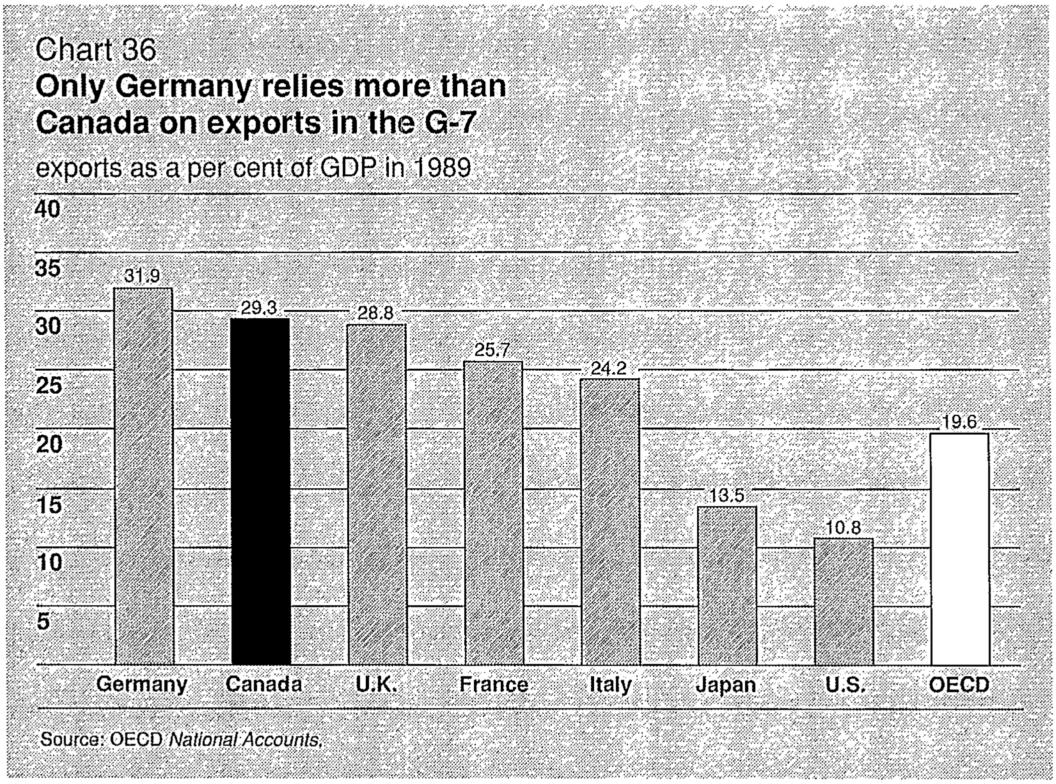
NAFTA meets three main objectives for Canada.

- It gains better access to the rapidly growing Mexican market.
- It safeguards and improves the gains made in the FTA. The value of trade between Canada and Mexico is small, but Canada is increasingly in direct competition with Mexico in the large and rich U.S. market.
- It ensures that Canada and the United States participate in the North American market on the same terms and that Canada remains an attractive location for foreign investment. Had the NAFTA been negotiated without Canada, the U.S. would have been the main beneficiary, being the only country with privileged access to both Canadian and Mexican markets.

CHARTING THE CHANGES

Canada relies more on trade than other countries

- Well over a quarter of Canada's GDP comes from exports.
- The chart shows that among G-7 countries, only Germany is more reliant on exports than Canada.

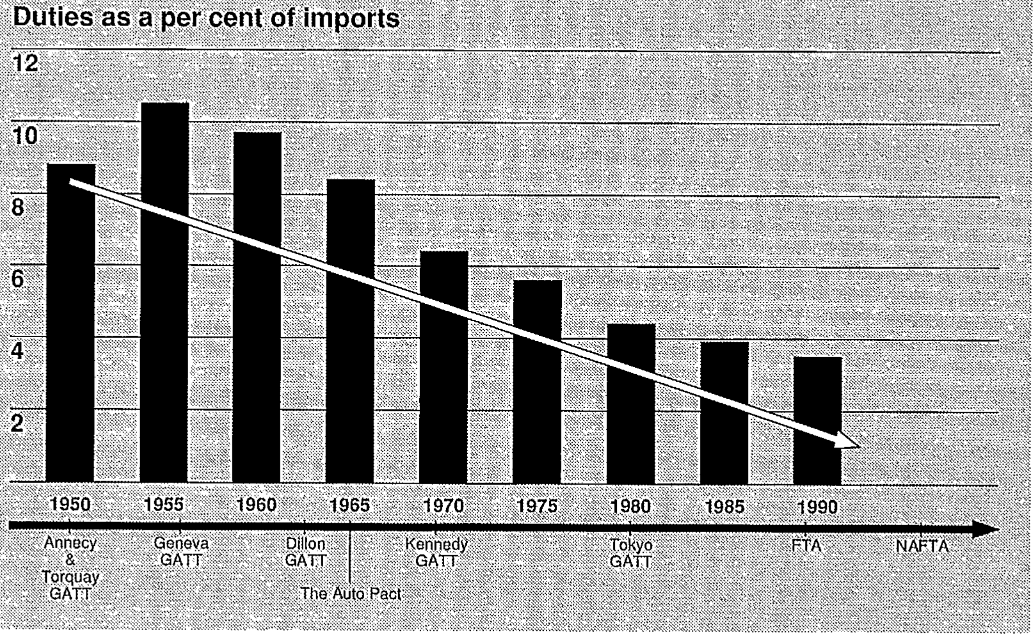


Trade agreements expand access to export markets

- Successive bilateral and multilateral trade agreements have led to the steady reduction in tariffs on Canadian imports. As a proportion of the value of imports, they dropped from a peak of 10 per cent in 1955 to less than 4 per cent in 1990.

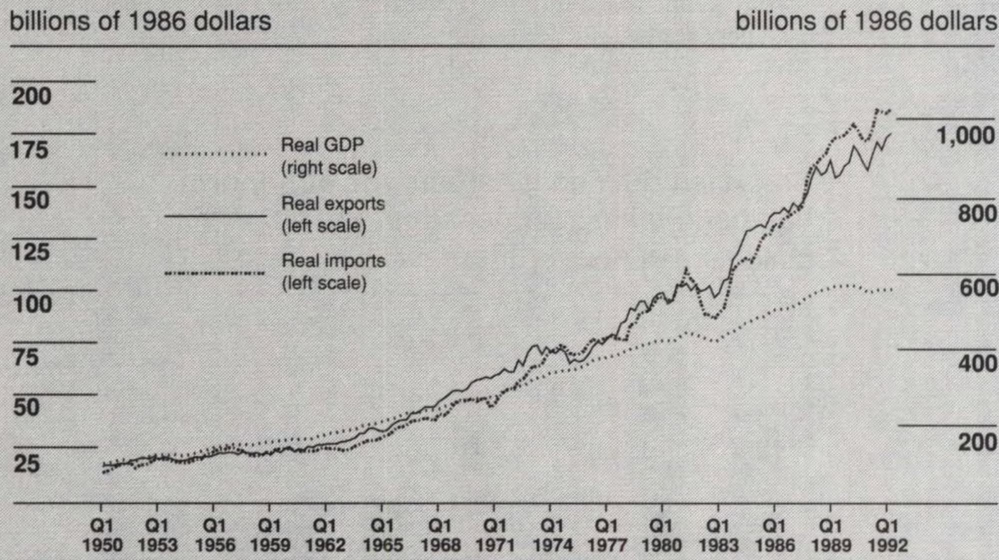
- The trade agreements have also expanded Canada's access to export markets. According to GATT, the average weighted tariff on manufactured products in the world's nine major industrial markets fell from about 40 per cent in the late 1940s to 4.7 per cent in 1987.

Chart 37
Canadian duty as a percentage of imports has been falling for decades



- As a result of these trade agreements, the growth of exports and imports has outstripped all other components of Canada's production.

Chart 38
Both exports and imports have grown much faster than the economy as a whole



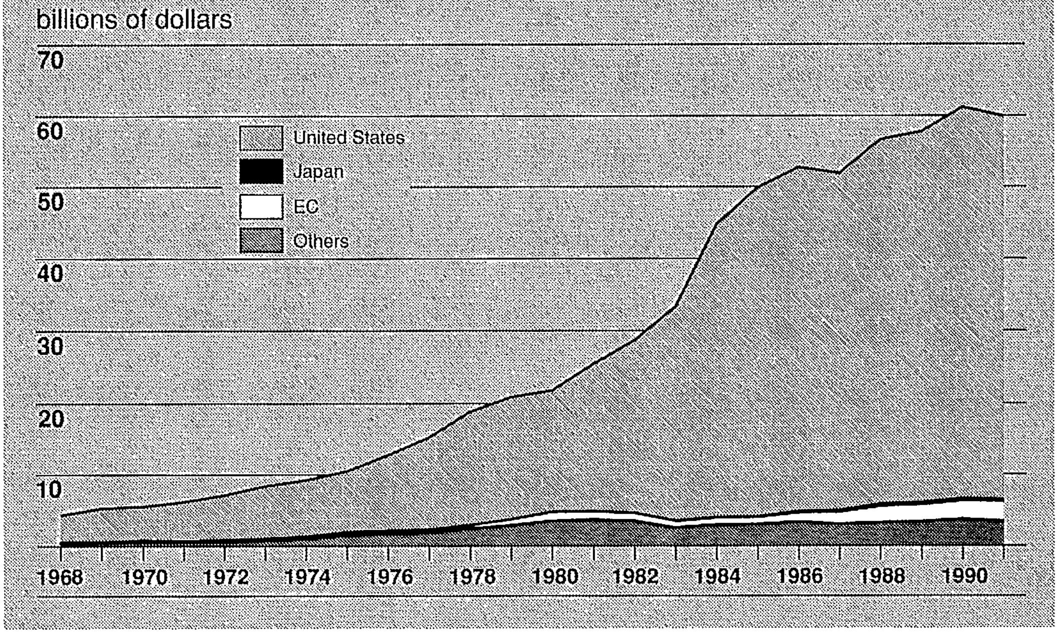
Source: Statistics Canada.

The United States is the key market for Canada's high-valued-added exports

- The U.S. is by far the dominant market for Canada's exports of finished goods.
- Canadian exports of finished goods to the U.S. took off in the 1980s. Between 1980 and 1991, they grew 212 per cent, increasing from $17.4 billion to $54.4 billion.
- In 1991, the U.S. purchased 89 per cent of the $60 billion of finished goods exported by Canada.
- Virtually all Canadian exports to Japan, and most to the European Community are still raw materials and semi-finished goods.

Chart 39

Canada's exports of finished goods to the U.S. have grown substantially since 1968



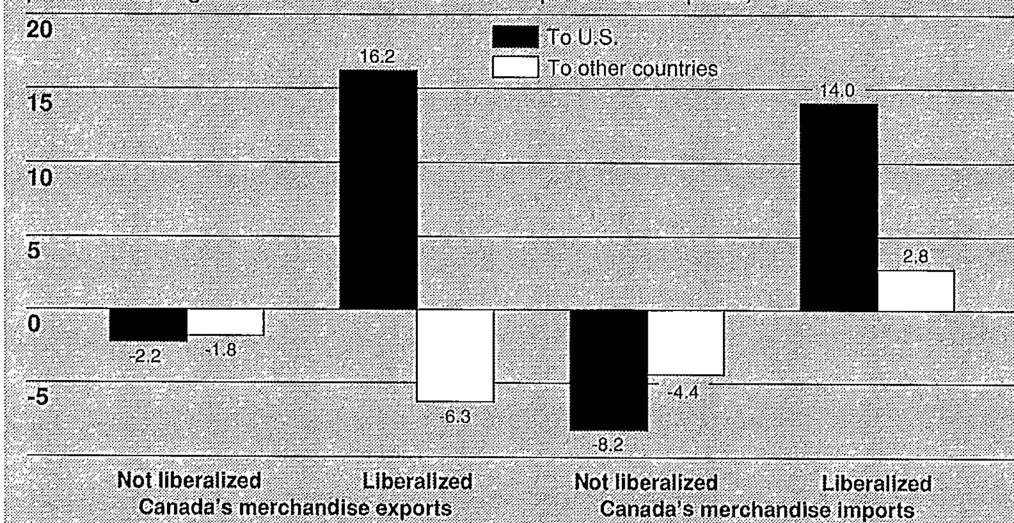
The Canada-U.S. Free Trade Agreement is paying off

- A recent study by the C.D. Howe Institute showed that the FTA is having the expected impacts.
- Canada's merchandise exports are rising fastest to the U.S. and rising fastest in the areas where the FTA liberalized U.S. trade barriers.
- Similarly, merchandise imports from the U.S. are rising faster than other imports and rising fastest in areas where we liberalized our trade barriers.

Chart 40

Changes in Canada's merchandise trade under the Canada-U.S. Free Trade Agreement

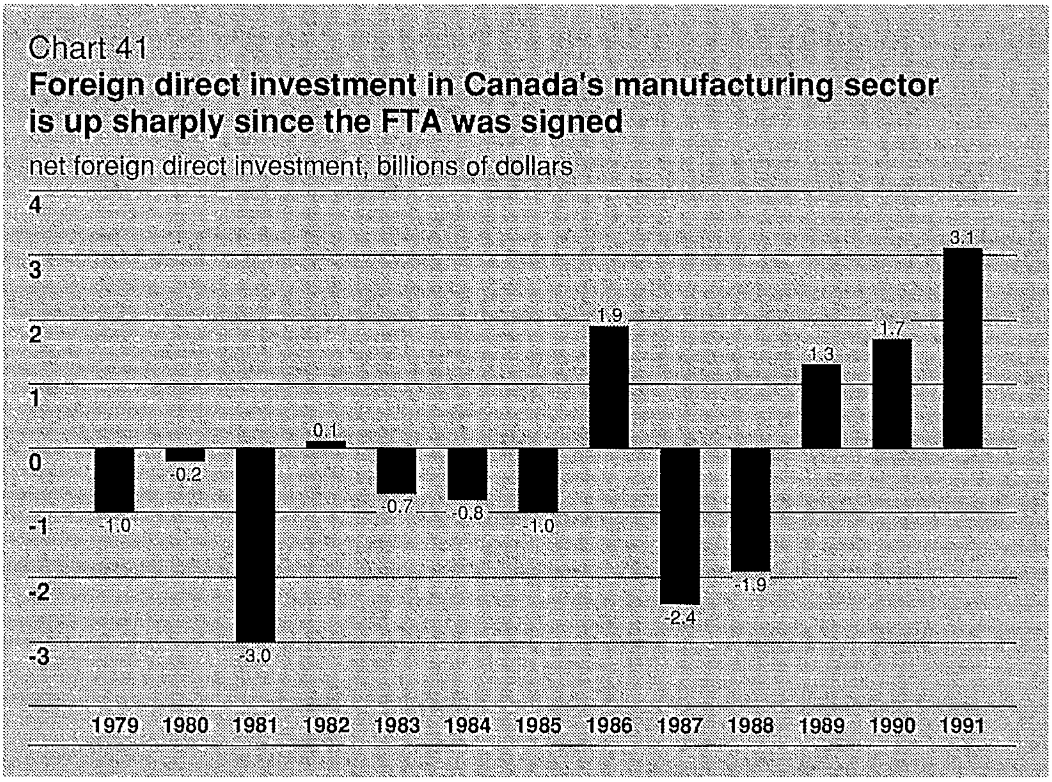
per cent change in value of merchandise exports and imports, 1989-1991



Source: C.D. Howe Institute.

Canada's attractiveness to investors has improved under the FTA

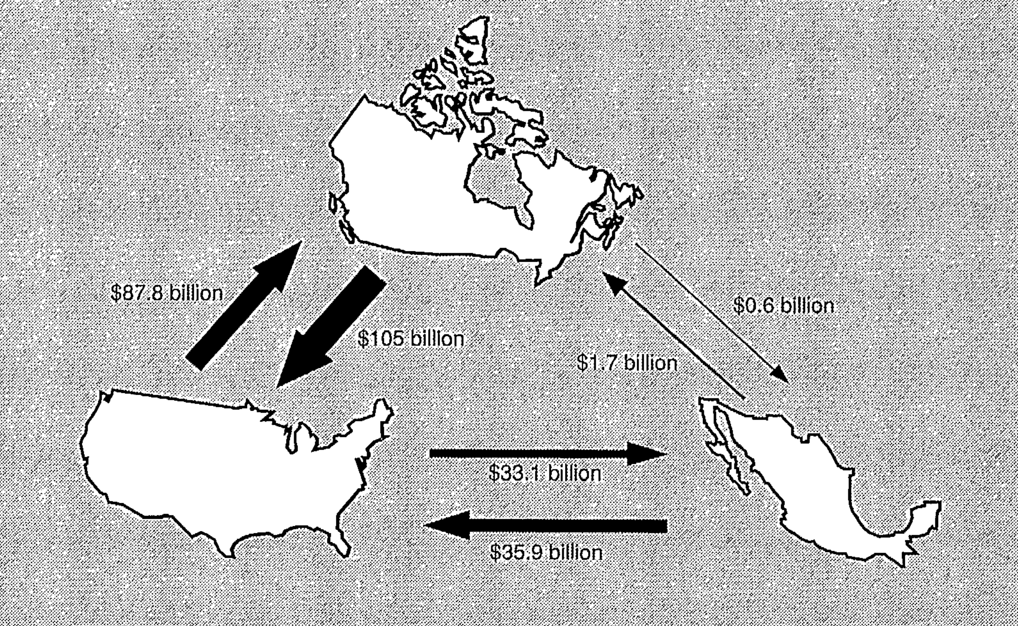
- Increased trade liberalization has been crucial in making Canada a more attractive place for foreign investment.
- Since the FTA, as this chart shows, foreign investment in Canada's manufacturing sector (net of Canadian investment abroad) increased from $1.3 billion (1989) to $3.1 billion (1991).



Canada and Mexico already compete in the U.S. market

- This chart shows the importance of direct competition in the U.S. market between Canada and Mexico despite their low level of trade between one another.
- In fact, Mexican exports to the U.S. are becoming increasingly similar to our own exports to the U.S.
- NAFTA ensures that Canada will continue to compete on an equal footing with Mexico in the U.S. market.

Chart 42
Canada-Mexico trade is low, but we compete in the U.S.
(Value of trade within North America, 1990)



THE STRONG CONTRIBUTION OF TRADE WITHIN CANADA

Main issues in brief

Trade within the country contributes powerfully to Canada's high standard of living. It is almost as important as international trade – more important in some provinces. Trade within Canada encourages firms to reduce costs and improve product quality, making consumers better off. It strengthens domestic firms for competition against international producers, both at home and abroad. But important barriers to trade within Canada still exist. They reduce the international competitiveness of domestic firms. In co-operation with the provinces, the federal government is committed to reducing interprovincial barriers .

Why trade within Canada is important

Since the Canadian provinces specialize in producing different kinds of goods, our standard of living depends on extensive trade within Canada as well as international trade.

Local producers gain access to markets larger than their own province, just as international trade gives them access to international markets. This is especially important for the smaller provinces.

Larger markets enable firms to take advantage of economies of scale, and produce more efficiently. Competition from elsewhere in Canada encourages firms to improve product quality and service and control costs, benefiting all consumers.

Almost as important as international trade

Economic linkages among the Canadian provinces are strong.

- Excluding Newfoundland and British Columbia, roughly 40 per cent or more of total provincial exports of goods are shipped to other provinces.
- Quebec, New Brunswick, Prince Edward Island, and Manitoba export as much to other provinces as they do to other countries, or more.

For the most part, the pattern of interprovincial and international trade did not change significantly from 1984 to 1988. In particular, there was no general shift towards north-south trade at the expense of east-west trade.

But not as free as it should be

Although economic links among the Canadian provinces are strong, harmful barriers to interprovincial trade still exist. They result in higher prices for consumers and reduce the competitiveness of domestic firms.

Freer internal trade would strengthen Canada's ability to attract investment and increase production.

- In a recent report, the Conference Board of Canada noted that internal barriers to trade reduce the ability of Canadian business to compete with international producers, both at home and in international markets.
- Since the Canada-U.S. Free Trade Agreement guarantees our access to the U.S. market, interprovincial barriers to trade imply that some Canadian firms may have easier access to the U.S. market than to other provinces in Canada. The trucking industry is one example of this problem. The beer and wine industries are another, although recent efforts have been made to solve this problem.

Disadvantaging Canada to the benefit of the U.S. in this way is intolerable and damages Canada's attractiveness as a place to invest.

If it makes no sense to allow the U.S. to become the only place with access to both the Canadian and Mexican markets, it especially makes no sense to give U.S. producers greater access than Canadian producers to the full Canadian market.

Trade barriers within Canada

Beer: Preferential treatment to local producers through provincial control of distribution has fragmented Canada's beer industry.

Government procurement: Preferential treatment and local-content requirements for purchases by provincial governments and Crown corporations reduce competition.

Marketing boards: Pricing and distribution policies of provincially regulated marketing boards (pork products, for example) can reduce interprovincial trade.

Health standards and regulations: Different provincial health standards and regulations can prevent companies from developing national marketing strategies in the food processing and pharmaceutical industries.

Licensing requirements: Differences in provincial licensing requirements and procedures in professional occupations (the accounting profession, for example) can prevent competition and mobility from other provinces.

What government can do

Benefits from liberalizing trade with other countries must not be negated by the harmful effects of barriers to trade within Canada.

In concert with efforts to liberalize trade between Canada and other countries, the federal and provincial governments must reduce barriers to trade within Canada. Unfortunately, attempts so far have met with only limited success.

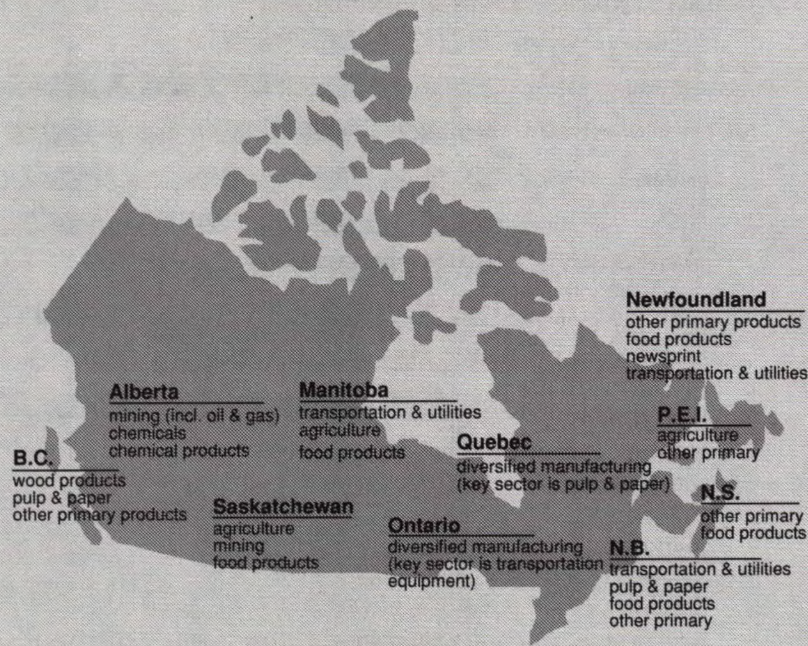
The federal government is committed to lowering these barriers and will be working with the provinces to make more progress than in the past.

CHARTING THE CHANGES

Trade among the provinces builds Canada

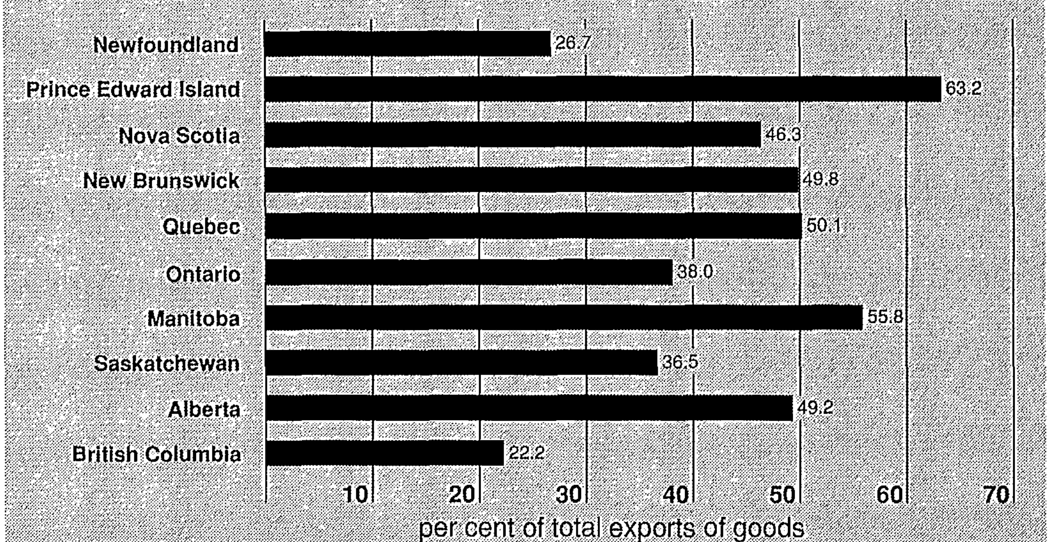
- Interprovincial trade is important since the Canadian provinces specialize in different areas of goods production, as illustrated by this chart.

Chart 43
Most provinces are highly specialized in what they produce



- Excluding Newfoundland and British Columbia, roughly 40 per cent or more of total exports of goods are to other provinces. This chart tells the story for each province.
- Quebec, New Brunswick, Prince Edward Island, and Manitoba export as much to other provinces as they do to other countries, or more.

Chart 44
Exports to other provinces are a large share of provinces' total exports



Source: Statistics Canada.