EBD/86/56

March 4, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Discussion on Canada

The Secretary has received the following memorandum dated February 28, 1986 from Mr. Massé:

> As promised to the Executive Directors during the February 14 meeting on the Article IV Consultation on Canada, I am hereby attaching a statement summarizing the main measures of the Canadian Federal Budget of February 26, 1986. I would be grateful if you could circulate it to the Executive Directors.

Att: (1)

Other Distribution:
Department Heads

Statement by Mr. Massé on the Canadian Federal Budget of February 26, 1986

During the recent discussion in the Executive Board on the Article IV consultation with Canada, a number of Directors expressed concerns about the sharp increase in the fiscal deficit over past years and about the continuing high level of unemployment. Many Directors underlined the need for a substantial improvement in the federal fiscal position and in this context indicated that "while emphasis should be placed on expenditure restraint... measures on the revenue side might well be unavoidable". Directors also perceived the debt-to-GNP ratio as rising too fast, too high and advocated an earlier and more pronounced deceleration of federal debt.

In light, particularly, of the recent discussions in the Board on Fund surveillance, Directors will be interested to note some of the features of the recent Canadian Budget.

The budget presented by Finance Minister Wilson on February 26 announces "the most significant and far-reaching program of expenditure control ever undertaken by the Government of Canada". As a base, the deficit for 1985-86 will be within the target of $33.8 billion forecast last May. For fiscal year 1986-87, the Government is taking action to reduce the deficit to $29.5 billion, a reduction of 14 percent from the current year. By the end of the decade the deficit will be reduced to $22 billion. Similarly, financial requirements will fall to $22.6 billion in 1986-87 (a decline of 22 percent from the current year level) and fall further to $11 billion by 1990. Citing action taken in November 1984 and May 1985 in bringing federal expenditures under control, the budget introduces further measures to consolidate expenditure reduction and to control the increase of the national debt. While taxation increases will contribute to the reduction in the deficit, the emphasis has been placed on restraining Government expenditures even further. Fully 70 percent of the debt reduction that will result from these three sets of measures will have been achieved by spending cuts.

The budget announces, in particular, a $500 million special reduction in non-statutory spending for the 1986-87 fiscal year, *equivalent to 2 percent of the cost of all non-statutory Government* programs, with the exception of foreign aid and defence. After 1986-87, operating costs will not be permitted to rise by more than 2 percent per year. A further substantial reduction in reserves for workload increases will force Government Departments to absorb such increases by increasing productivity or re-allocating funds. These initiatives will result in savings of $850 million in 1986-87, rising to $2.8 billion in 1990-91.

Also the size of the public sector is being reduced. By 1990-91 the number of positions in the federal government will be 15,000 fewer than at present; 5,000 positions will be eliminated next year.

Overall, the reduction in planned program spending will total almost $1 billion in 1986-87, and grow to $3.1 billion annually by 1990-91. In 1984-85, spending on programs amounted to 20.6 percent of GNP. This will be reduced to 18.3 percent of GNP in 1986-87 and will fall further to 15.8 percent of GNP by 1990-91. By that latter date, spending on federal programs will account for the same share of the economy as it did in the early 1960s. (See Chart 1 attached)

The budget announced the following tax increases: a 3 percent surtax on federal personal income taxes commencing July 1, 1986; a 3 percent surtax on all corporations effective January 1, 1987; the rates of federal sales tax will be increased by 1 percent effective April 1, 1986; excise taxes and duties on alcohol and tobacco will also be increased immediately. The net effect of all tax measures announced in the budget will be to raise $1.5 billion in 1986-87 and $2.4 billion in the following year.

In sum, the measures announced in the budget continue the concrete steps that have been taken in November 1984 and May 1985 to correct Canada's fiscal imbalance. As a result of previous measures and those announced today, the deficit will decline a further $4.8 billion next fiscal year and another $3.5 billion in 1987-88 to reach a level of $25.9 billion (4.9 percent of GNP). By 1990-91, the deficit will have dropped to 3.5 percent of GNP, from 9.1 percent in 1984-85. (See Chart 2 attached)

The debt-to-GNP ratio which previously was continuing to rise after 1990-91, will now, as a consequence of the budget measures, stabilize and start to come down by the early 1990s: the national debt will have finally stopped growing faster than the national economy for the first time since 1974-75. (See Chart 3 attached)

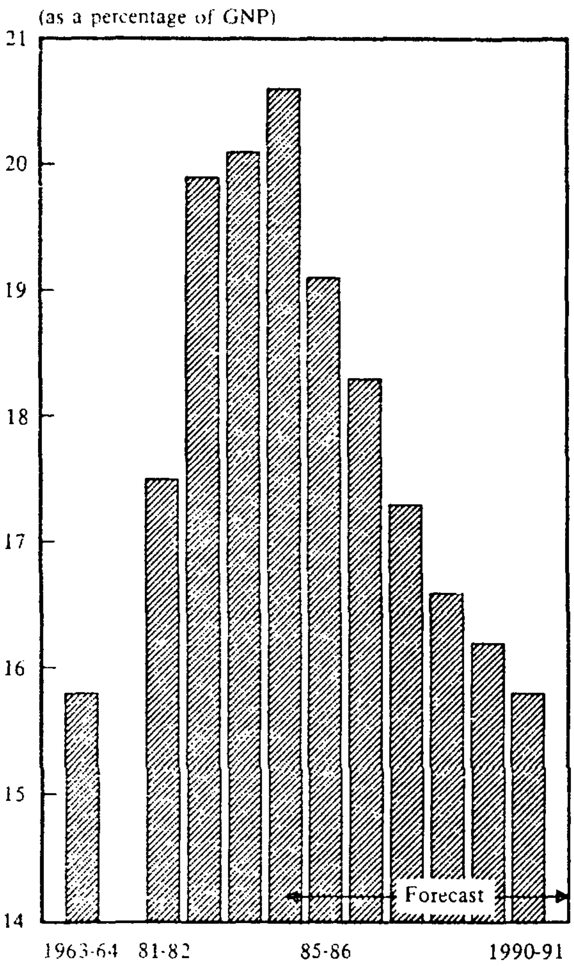
As for the factors influencing unemployment, the budget forecasts real growth in the economy of 3.7 percent for 1986, one of the highest rates of growth among the industrialized countries, and a further 3 percent in 1987. Job creation has been vigorous recently (580,000 new jobs in the last 18 months) such that unemployment for that period has fallen from 11.7 to 9.8 percent. While growth has been strong, inflation has been stable and is expected to remain steady around 4 percent. Because of strong labour force growth, progress in reducing the unemployment rate will be steady but less dramatic. An unemployment rate of 9.6 percent is expected by the end of the year, falling to 9.0 percent by the end of 1987 and to between 6 3/4 and 7 3/4 percent (i.e. close to the equilibrium rate) by 1990-91.

To assist workers in adapting to a changing labour market, the budget allocates $800 million to the Canadian jobs strategy in 1987-88. This program is targeted at building the skills necessary to help young people obtain a first job and to assist women re-entering the labour market. The budget also announces federal funding of up to $115 million over a four-year period to finance a new program for older worker adjustment.

Growth in Canada's foreign aid to developing countries will average 8.7 percent per year over the remainder of the decade, which will keep foreign aid at 0.5 percent of GNP. The Government has now set 1995 as the date for reaching the 0.6 percent target. It should be noted that Canada will remain one of the most generous international aid donors ($2.4 billion in 1986-87) with an aid/gnp ratio of 0.5 percent compared with the OECD average of 0.36 percent and with donors such as the United States at 0.24 percent. Furthermore, relative to other federal program expenditures, the yearly increases in the aid program remain large.

Chart 1

PROGRAM EXPENDITURES

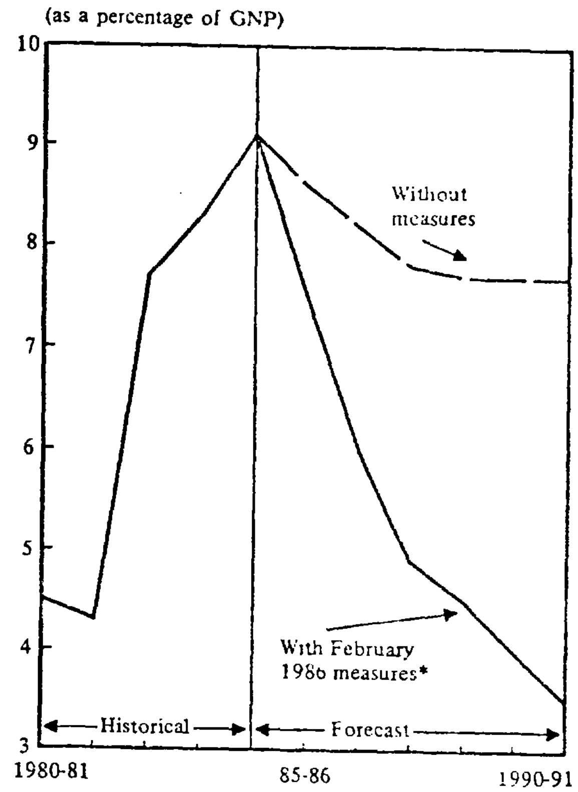


The amount of money the Government spends on all programs has been reduced this year for the first time in over 20 years. By 1990-91, spending on federal programs will account for the same share of the economy as it did in the early 1960s.

Chart 2

IMPACT ON BUDGETARY DEFICIT OF FISCAL MEASURES SINCE NOVEMBER 1984

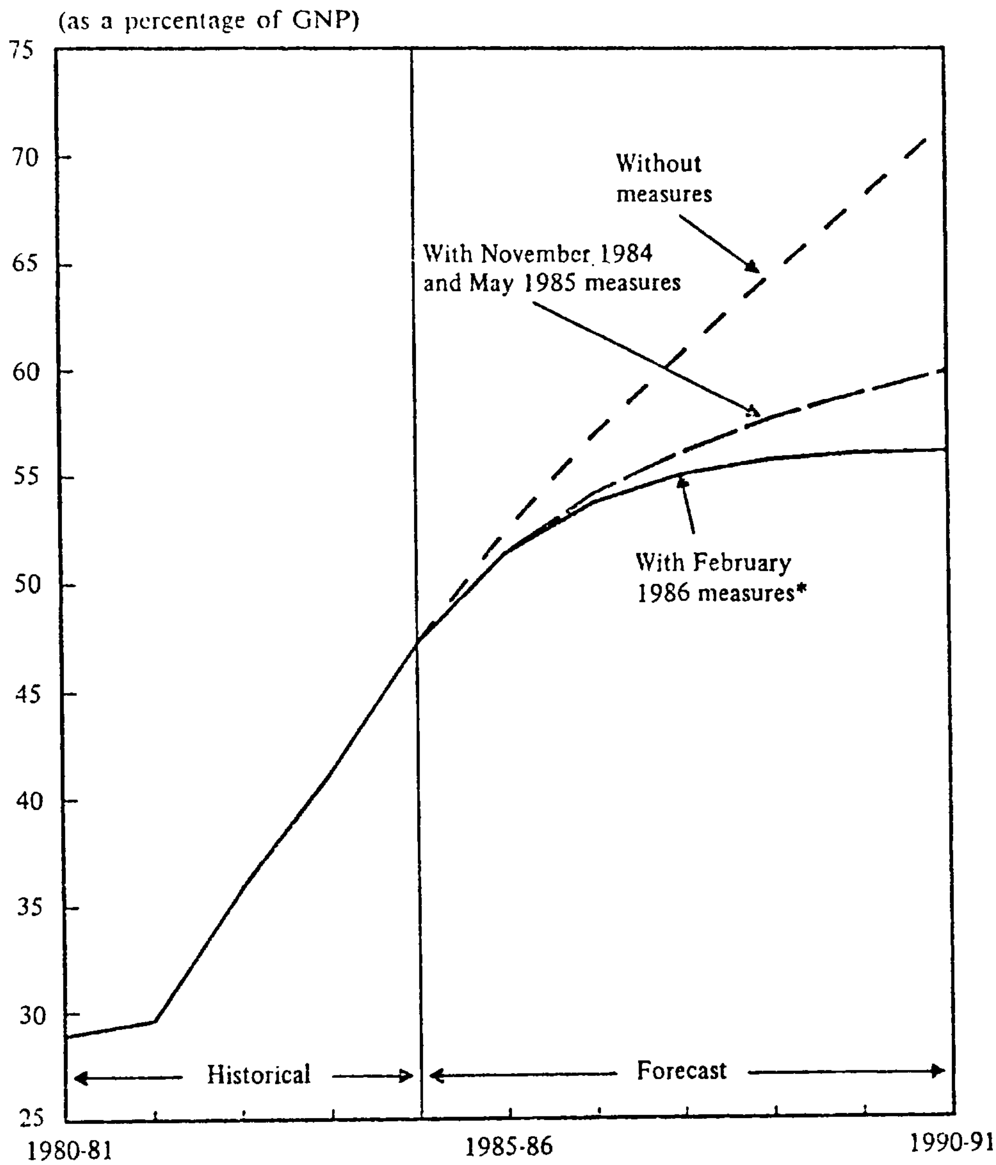
With the actions now in place, the deficit is projected to drop from 9.1 percent of national income in 1984-85 to 3.5 percent in 1990-91.



*Based on the mid-range economic outlook

Chart 3

Debt-to-GNP Ratio
With and Without the Fiscal Measures
Since November 1984



*Based on the mid-range economic outlook.

The debt-to-GNP ratio will now stabilize and start to come down by the early 1990s.