The Economic and Fiscal Update

October 30, 2002

Department of Finance Canada
Ministère des Finances Canada

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Table of Contents

Presentation

by the
Honourable John Manley, P.C., M.P.

to the
House of Commons
Standing Committee on Finance

October 30, 2002
CHECK AGAINST DELIVERY

Introduction

Allow me to thank you, Madam Chair, and all of the members of this committee for inviting me today.

We meet here at one of Canada's great historic landmarks – Pier 21. From 1928 to 1971 more than 1 million immigrants and refugees from all corners of the world passed through these buildings on their way to a new life in Canada.

Their reasons for choosing Canada were as different as the people themselves. Some came fleeing political and religious persecution in their homelands. Others came to escape poverty or the ravages of war to search for new opportunities in a country that promised fertile land, clear skies and freedom from fear. For hundreds of thousands of new Canadians, Pier 21 stood as a symbol of hope – and a starting point for opportunity.

All of them shared a dream – to build a better life in Canada for themselves and their families. It is the same dream that brings succeeding generations of newcomers to our shores every year. It nourishes and enriches our country, because it brings with it not only the traditions of the past, but the spirit, talent and drive of the present and the future. That dream built the Canada we cherish. It will help build the Canada we all want in the 21st century.

Consulting With Canadians

Madam Chair, this is my second appearance before this committee as Minister of Finance.

In the four months since I last spoke to you, Canada has continued to post strong economic growth, surprising many analysts with our resilience and leading major economic forecasting agencies to predict that our nation will continue to lead the Group of Seven (G-7) in growth.

But we are also very cognizant of the global risks we face, both now and in the future. Global uncertainties have been rising. Economic growth is turning out to be weaker than expected in a number of industrialized countries. The decline in equity markets, the impacts of corporate scandals in the US, the possibility of armed conflict in Iraq and anxieties over global terrorism – these have all further increased the level of global uncertainty.

Against this backdrop, I am here today to provide an overview of Canada's economic and fiscal forecast for the next five years, which the Government will use for planning purposes and will help frame pre-budget consultations.

Madam Chair, this committee's deliberations have played a key role in establishing the Government's fiscal and economic agenda. Your report, based on consultations held across the country, provides the Government and myself, as Finance Minister, with a clear sense of the fiscal and economic issues that Canadians find important and which we, as parliamentarians, must address.

Over the coming weeks you and I will hear from a wide range of individuals and organizations, all with their own specific ideas about what the upcoming budget should contain.

We know that Canadians are not shy in bringing their views to their elected officials, particularly when it comes to their economic well-being.

Canadians told us to eliminate the deficit and get the nation's finances in order. This government listened. We balanced the budget in 1997-98 for the first time in 28 years and we have kept the books balanced ever since.

Canadians told us to pay down the national debt. Over the past five years we have reduced the debt by $46.7 billion.

Canadians told us they wanted governments to work together to improve health care. In the September 2000 health accord the federal government provided an additional $23.4 billion to the provinces for health care and early childhood development.

Canadians told us to reduce their tax burden. In October 2000 we delivered a five-year, $100-billion tax cut package for both personal and corporate taxes.

Canadians have made it clear that they want a policy of balanced books and a balanced approach to our nation's finances. We agree, because we know – and Canadians know – that sound fiscal management and a prudent approach to spending are the surest path to a better standard of living for our citizens and a higher quality of life for every Canadian. It is how we ensure that Canada is a society of prosperity and opportunity for all. It is how we realize our potential as a "Northern Tiger."

Sound Fiscal Management

Madam Chair, when I met with the Finance Committee in June, I stated that Canada would not deviate from the fiscal and economic policies that have created the most rapidly growing economy in the G-7.

We will stay on course and on target. We will manage the hard-earned tax dollars of Canadians with care and caution. Our approach must be no different from that of Canadian families balancing their household budgets. We must spend wisely and live within our means.

The reasons are convincing and compelling. Sound fiscal management has allowed Canada to record five consecutive budget surpluses and pay down $46.7 billion of our national debt. In simple dollar terms, our debt reduction efforts mean we are now paying almost $3 billion less annually in interest payments, money that is now being used to address the priorities of Canadians. Our debt-to-GDP (gross domestic product) ratio has now fallen from its peak of 71 per cent in 1995-96 to its current level of 49 per cent, the largest decline recorded by any G-7 country in the same period.

This remarkable progress has been recognized by two leading international credit rating agencies. Earlier this year Moody's Investors Service and Standard & Poor's restored Canada's credit rating to Triple-A, the highest rating these agencies give to a country.

Our clear commitment to fiscal responsibility, through economic ups and downs, is paying dividends. It protected the historic October 2000 personal and corporate income tax cuts as well as the new funding under the September 2000 health accord. Coupled with Canada's excellent track record on inflation, it allowed the Bank of Canada to sharply reduce interest rates last year. And our prudent approach kept the Government's finances in surplus during the recent economic downturn.

Canadians' accomplishments in the area of fiscal responsibility are all the more remarkable when you consider the situation in the United States. Less than two years ago the US government forecast a budget surplus of $231 billion for the fiscal year that ended in September 2002. Now, figures released recently show the final result was a deficit of $159 billion, with no early return to surplus in sight.

But, while we have reason to be pleased with Canada's fiscal performance, I believe there is more for us to do. We must continue to pay down debt. Despite the paydowns of recent years, our national debt still stands at more than $536 billion. In the last fiscal year we paid $37 billion in interest charges on our debt. It is still the largest single expenditure item in our budget, costing us some 22 cents out of every revenue dollar taken in. This is money that I would rather see spent on the needs of Canadians.

Moreover, it also means that Canada is vulnerable to economic shocks outside our borders that drive up interest rates.

But beyond the arguments about the consequences of debt today, we must look to the future. We must not saddle our children and grandchildren with today's high debt burden.

Prudence in an Uncertain World

Prudent planning, coupled with the hard work and commitment to fiscal discipline by Canadians from all walks of life, have been crucial elements in our success.

In the past the Government's approach to budget planning has included setting aside a Contingency Reserve and additional prudence to guard against the risks of unforeseen circumstances.

In the 2001 federal budget the Government used the economic prudence and a portion of the Contingency Reserve to deal with the exceptional fiscal pressures caused by the September 11 terrorist attacks and the global economic downturn. At that time we said that we would restore the full Contingency Reserve as soon as possible.

Therefore, today I am pleased to announce that the Government has restored the $3-billion annual Contingency Reserve, effective this fiscal year. This money will provide a buffer against unforeseen circumstances. As usual, any year-end surplus goes to pay down debt. Further, we will provide an additional degree of economic prudence in our budget planning to help ensure that the Government will not return to deficit.

Managing Tax Dollars Wisely

But sound fiscal management means more than simply avoiding deficits and reducing debt. It also means managing tax dollars well and responsibly, and delivering cost-effective and efficient government services. This is why the Government must assess its programs on an ongoing basis.

This is more than just good management. It is good common sense. Just as Canadians adjust their budgets to stretch their hard-earned dollars, the Government must also reassess its spending to ensure it best meets the needs of Canadians.

So, what does this mean in practice?

It means that in preparing the next budget, we will find opportunities to realign existing spending and improve efficiency.

It means that, where appropriate, the Government will reallocate money to programs that meet the immediate needs of Canadians from those that have already served their purpose. Such reallocation will not be used for debt reduction; instead, monies freed up will be used to help address new, pressing needs.

I believe this approach is based on a straightforward premise: that governments at all levels must constantly reinvent themselves. This means we must always strive to find new ways to meet the needs of Canadians in a cost-effective and efficient manner, while supporting the programs and services that make us a caring and compassionate society.

Sound Economic Performance

Madam Chair, when I appeared before this committee in June, I stated that Canadians had good reason to be optimistic about their economic future and that of the country as a whole.

Despite global weakness and uncertainties, Canada has not only emerged from the slowdown of 2001, it now finds itself in the midst of a much better than expected recovery. Consider the facts:

- In the first half of this year the Canadian economy grew at an annualized rate of more than 5 per cent, strongest in the G-7.
- In the nine-month period from January through September the Canadian economy created 427,000 new jobs. The majority of these were full-time, with gains in every region of the country and across all age groups. In fact, 77,000 young Canadians found new jobs during this period.
- Not only are more Canadians working, but they are also seeing an improvement in their personal financial situation. Real personal disposable income per person has increased 2.9 per cent over the last 12 months. That means an average of $600 for each Canadian.

– Canada's net foreign debt as a share of GDP is now at its lowest level in 50 years, and is below that in the US for the first time in our history.
– Growth in business investment in machinery and equipment in Canada, a key element for sustained economic growth, has rebounded in 2002 and is outpacing the US.

To further illustrate our solid economic performance this year, let's compare how the Canadian and US economies have responded during previous economic slowdowns.

In the past, slowdowns tended to be more severe in Canada than in the US, and our recoveries weaker. Indeed, in the 1980s and 1990s Canada had longer and deeper recessions than the US.

But times have changed. For the first time in more than 20 years, the Canadian economy outperformed the US economy during a downturn. The US economy had three consecutive quarters of negative growth last year while Canada avoided recession.

Equally important, we are outpacing the US in the current recovery period. The growth in our economy was almost twice that of the US in the first half of this year. And our record of creating over 400,000 jobs so far this year compares with a loss of almost 40,000 jobs in the US.

Thus, while our economic performance remains closely dependent upon the health of the global economy, particularly the US, the progress we have made has improved the resilience and flexibility of our economy and given us considerable economic momentum.

Canadians should be proud of this accomplishment – namely because it is their own. The people of Canada made clear nine years ago that they wanted a change in how national finances were run. They have worked hard and sacrificed, and accepted difficult choices – making it possible for us to be in this position today. The credit belongs to them.

Economic Outlook

Madam Chair, let me now turn to the economic and fiscal outlook.

First, I would like to explain how we arrived at these figures.

To gauge Canada's growth prospects, the Department of Finance follows a rigorous and transparent process. It has surveyed a group of 20 private sector economists and used their average forecast of economic growth as the basis for our fiscal planning. Three macroeconomic modelling firms then use this economic forecast to generate fiscal projections over the next five years.

I have also met with a group of key private sector economists to seek their views on the projections, as well as the risks and uncertainties to the outlook. These private sector forecasters expect growth to average 3.4 per cent in 2002. This is more than double the 1.5-per-cent growth rate recorded in 2001. For 2003 private sector forecasters now expect economic growth of 3.5 per cent.

Both the International Monetary Fund and Organisation for Economic Co-operation and Development are in broad agreement with the views of the forecasts. They project that Canada will outperform all of its G-7 counterparts in economic growth, both this year and next.

Private sector forecasters expect solid job creation going forward, thanks to ongoing strength in business investment and consumer spending. Over the medium term they project that economic growth will average roughly 3 per cent.

But Madam Chair, they also stressed that, despite the positive Canadian outlook, there are clouds on the horizon. We face a period of global uncertainty in the months to come.

Outside of North America, European growth is forecast to be lower this year than last. Japan remains mired in a protracted slowdown. The fragile financial situation in emerging markets, especially in parts of Latin America, needs to be monitored closely. And most importantly for Canada, the US recovery has been very uneven. Corporate scandals, notably those involving Enron and WorldCom, have damaged investor confidence, not only in the US but globally, and contributed to large equity market declines. Finally, the continuing threat of terrorism and the growing possibility of conflict in Iraq add to global uncertainty. Taken together, these underscore the importance of remaining prudent in our budget planning.

Fiscal Situation and Outlook

Madam Chair, I would like to turn now to our fiscal situation and outlook.

As announced earlier this month in our Annual Financial Report, we have closed the books on fiscal year 2001-02. We realized a surplus of $8.9 billion, every single penny of which went to reduce Canada's debt. This is our fifth consecutive budget surplus, the first time this has happened in my lifetime. Moreover, Canada is the only G-7 country expected to achieve a surplus this year.

Looking ahead, the average private sector projections of the fiscal surplus for planning purposes are as follows:

2002-03: $1.0 billion

2003-04: $3.1 billion

2004-05: $3.5 billion

2005-06: $6.8 billion

2006-07: $10.5 billion

2007-08: $14.6 billion

These planning surpluses take into account the $3-billion annual Contingency Reserve and an additional degree of economic prudence.

These private sector fiscal-planning projections indicate relatively small surpluses in the near term. This is due to two main factors: first, the ongoing impact of last year's economic slowdown upon tax revenues; and second, the effect of previously announced policy initiatives, particularly the $100-billion Five-Year Tax Reduction Plan and the $23.4-billion health accord, both of which are still coming on stream.

Madam Chair, I should note that these figures were calculated using the Government's current modified accrual method of accounting. As indicated in the 2001 budget, and supported by the Auditor General of Canada, the Government will switch to the full accrual accounting system. We are planning that this will take place with the upcoming budget, provided we are able to verify the accrual accounting amounts with sufficient assurance.

Meeting Future Challenges

Canadians know that maintaining balanced budgets and reducing our debt burden are crucial to our long-term economic health, and thus to our broad, national aspirations. But they are not ends unto themselves. They are a very necessary means to achieve our fundamental goal: improving the standard of living and quality of life of Canadians. These efforts are important to all of us as Canadians, not only because improving our standard of living puts more money into our pockets, but also because it provides more people with greater choices and opportunities.

Our efforts in this area are yielding results. Since we eliminated the deficit we have made significant strides in boosting the growth in our standard of living. Over the past five years both employment and productivity growth have been important contributors to the improvement in our standard of living. From 1997 to 2001 Canada recorded the fastest rate of growth in GDP per capita – which represents the best measure of living standards – among the world's leading industrialized countries, including the US.

While we have made good progress, the message is clear: if we want the kind of long-term, durable economic growth that will continue to boost our standard of living and our quality of life, we must improve our productivity growth as a nation.

We have been talking about productivity for some time now. Some people might see it as an abstract economic term which has nothing to do with real people and their day-to-day lives.

I disagree. Improving productivity is about attaining that higher standard of living that we all want, and that our country deserves. It is not about people working harder and for less pay. That would defeat the purpose. Rather, it means working more effectively through improved skills, equipment and education.

Improved productivity does more than boost a company's bottom line. It means more income and better jobs for employees. It means that more and more Canadians, wherever they live, will have the chance to learn and have more opportunities for personal growth and development.

Recognizing this, the Speech from the Throne outlined initiatives that the Government will undertake to ensure that Canada's productivity growth continues to rise, and with it, the Canadian standard of living.

A key element in raising productivity growth will be to make Canada a magnet for talent and investment – a critical part of how we position ourselves as a Northern Tiger.

To encourage investment and entrepreneurship, we will review existing policies to ensure that our regulatory environment is as efficient, transparent and cost-effective as possible.

To protect the integrity and efficiency of our capital markets, we will work with all stakeholders and the provinces to implement new standards of corporate governance and to reform our current system of securities regulation.

But Canadians understand that investment in people is the intersection between our economic and social policies. And nowhere is this integration of economic and social policy more important than health care. This is why we will work with all stakeholders to ensure Canada's health care system can continue meeting the needs of Canadians in the 21st century, and provide Canadians with a distinct advantage in the world.

Last week Senator Michael Kirby and his colleagues released a wide-ranging report on options for health care in Canada. In the coming weeks the Commission on the Future of Health Care in Canada, led by former Saskatchewan Premier Roy Romanow, will table its report. Both reports will help governments in their future deliberations to develop a national approach to addressing Canada's health care needs.

Our government will do its part. The Prime Minister has indicated that we will work with the provinces and territories to agree on a long-term plan to modernize medicare, with a First Ministers Meeting early in the new year. We will provide resources to support implementation of that plan in the upcoming budget.

Madam Chair, our future depends on providing the best possible opportunities for our children. As a society, we must strive to ensure that every Canadian child, no matter where they live, has the best possible start in life and the chance to achieve their full potential.

This is why we have committed to further increase the National Child Benefit for low-income families, building on our reinvestments in recent years. Our challenge is nothing less than to equip our children with what they need to succeed in a rapidly changing world. Nowhere is this need more urgent than with Canada's Aboriginal children.

Our challenge is also to invest in our nation's infrastructure, building, for ourselves and our children, competitive cities and healthy, safe communities.

But that is not all.

Madam Chair, in the interest of future generations, it falls to this generation of Canadians to confront the issue of improving our environment. Canadians want clean air and clean water and they are concerned about the impact of climate change. On this, our government is working with the provinces and industry to ensure that Canada lives up to its international responsibilities on climate change, as embodied in the Kyoto accord.

These are important steps in what must be a continuous effort to shape our economy to meet the needs of both today's citizens and future generations.

Conclusion

Statistics and percentages can shed a lot of light on where we stand as an economy, but we must never allow them to obscure what we stand for as a government and as members of Parliament. And that is to make the lives of individual Canadians and their families better and more secure than ever.

Madam Chair, there is a whole new generation of Canadians ready to take on the challenge of building an even stronger, more prosperous and more generous Canada. Their view is global and their dedication to this country and the values it stands for is inspiring.

People like Carla MacQuarrie of West Chezzetcook, Nova Scotia, who has combined the sciences of aquaculture and agriculture to create a successful farming operation that produces high-quality hydroponic vegetables and herbs.

Carla and her husband Peter Lenihan and their other partners, Dave and Joanne Roberts, own and operate Future Aqua Farms Limited. This company has attracted worldwide attention for its unique use of aquaculture technology, and Carla herself was one of 18 young business people between the ages of 19 and 30 who were recently awarded the Business Development Bank of Canada's (BDC's) Young Entrepreneur Award.

This award recognizes outstanding young Canadian entrepreneurs in every province and territory who, through hard work and determination, have overcome the odds to develop successful and innovative new businesses.

Carla and the other BDC award winners are just some of the young leaders who are helping to shape Canada's future. These young Canadians – confident, well-educated, globally sensitive and technologically savvy – are our best hope for making Canada represent not only what is good, but what is best in the world.

Madam Chair, Canadians will be asked by this committee to offer their views on the priorities the Government should focus on in its next budget. Over the coming weeks you will hear from groups and individuals across Canada who will have a wide range of opinions. Like you, I will be travelling across the country in the days ahead to hear the views of Canadians. Undoubtedly, you and I will hear many good ideas.

But you know, just as I know, that the business of government is about making choices. If all of the ideas that we will hear over the coming weeks were to be implemented, our small surpluses would rapidly become large deficits once again. We cannot allow this to happen. And so, choices will have to be made.

With this in mind, I would ask the committee to provide input to the Government on the following questions:

- In June I asked for the committee's views on how the Government can best control expenditures and focus priorities. Further to this issue, I would seek the committee's input on how the Government can best realign its spending to meet the highest priorities of Canadians.

- As I mentioned earlier, the Government has restored the $3-billion annual Contingency Reserve. To further guard against going back into deficit, what additional amount of economic prudence should be included in the upcoming budget?
- The idea of making Canada a Northern Tiger has captured the imagination of citizens across the country. What policies do Canadians think we need to make our country a magnet for investment, for skilled knowledge workers, and for cutting-edge research and innovation?

Madam Chair, the consultations this committee is pursuing with Canadians are not just about what should be contained in the next budget – they are also about the kind of Canada we want.

I believe the Canada we want is fiscally healthy, so that we are free to choose our own path and to shape our own destiny.

It is a Canada where economic and social policies work hand in hand.

It is a Canada that is more productive, more innovative and more competitive than ever, so we can generate the resources needed to invest in our future priorities – health care, the environment and our children.

It is a Canada that embraces a fair and competitive tax system.

It is a Canada that plays an important role on the world stage, helping to build a more stable and more just global community.

It is a Canada that is a magnet for talent and investment, a Northern Tiger, confident it can take on the world and win.

In short, it is a Canada that strives to give its citizens not only a better standard of living, but the best standard of living in the world.

Not only a better quality of life, but the best quality of life in the world.

A Canada that continues to earn its reputation as one of the most compassionate, inclusive and progressive nations on earth.

Madam Chair, I began my remarks today by referring to the debt that the present generation of Canadians owes to those who passed through this building on their way to a new life in a new land.

Just like the hundreds of thousands of Canadians who came through Pier 21 believing that tomorrow can be better than today, I, too, believe in the great potential of this great place called Canada.

Annexes

Annex 1

Canada's Recent Economic Developments and Outlook[1]

[1] Incorporates data available up to October 21, 2002.

Highlights

- *The Canadian economy has emerged from the slowdown of 2001 into a solid recovery, outpacing the United States and other Group of Seven (G-7) countries in both gross domestic product (GDP) and employment growth.*

- *Canada's resilient economic performance during the global slowdown reflected the turnaround in the fiscal situation and the achievement of sustained low inflation, which enabled the Government and the Bank of Canada to provide timely support to the economy through lower taxes and interest rates.*

- *Strong fundamentals have led to robust employment gains of 427,000 over the first nine months of this year, which have been distributed across all regions and reflected in the continued growth of real disposable income of Canadians.*

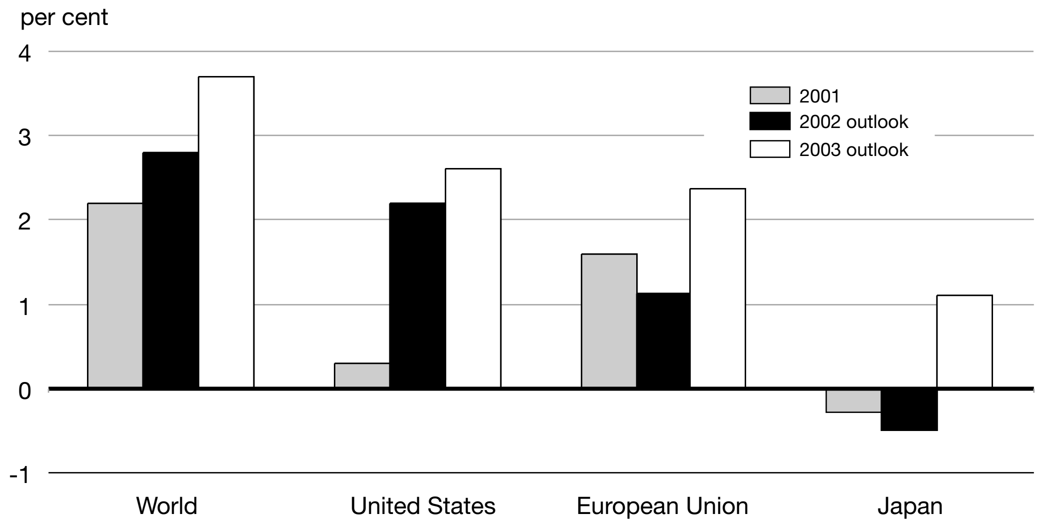
- *Private sector forecasters expect continued solid growth in the Canadian economy. The Department of Finance survey of private sector economists in September shows a moderation in growth in the second half of this year from the strong pace exhibited in the first half, leading to forecast growth of 3.4 per cent for 2002 as a whole. For 2003 they expect growth to average 3.5 per cent.*

- *While the economic outlook has improved substantially since the December 2001 budget, there are significant risks to the outlook, stemming mainly from uncertainty about the near-term momentum of the US recovery. US growth has been uneven so far this year, and forecasters expect only a modest pickup in growth in the second half of the year.*

- *Accounting and corporate scandals and the decline in equity markets, combined with the threat of war in Iraq, pose significant risks to the US economic outlook.*

A global economic recovery has been underway since late 2001

World Real GDP Growth

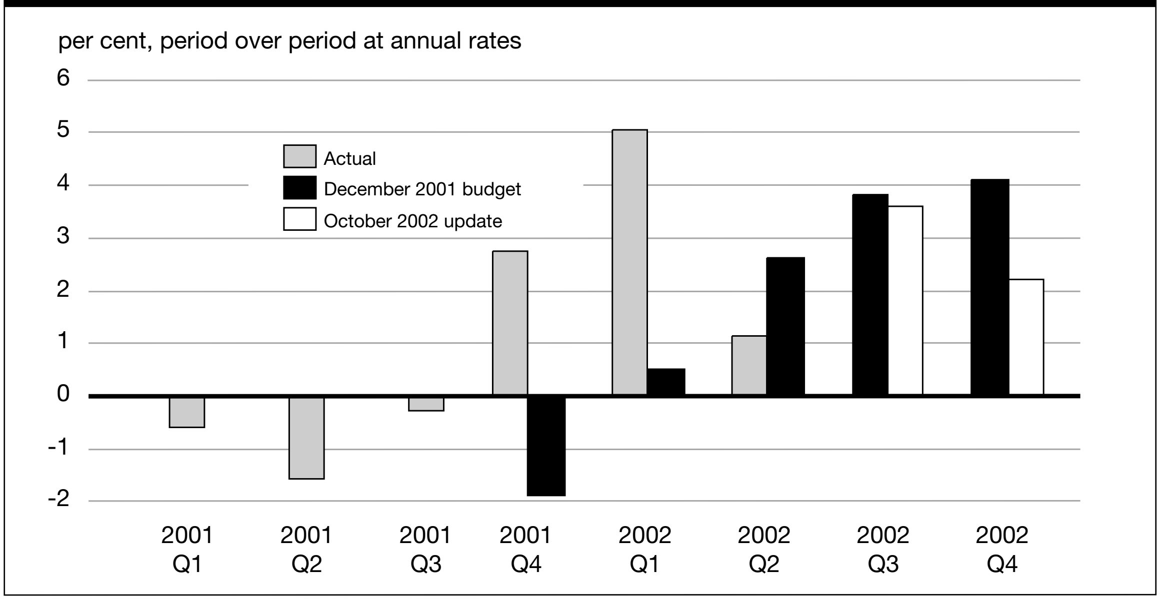


Source: International Monetary Fund, *World Economic Outlook*, September 2002.

- At the time of the December 2001 budget the International Monetary Fund (IMF) projected global growth of 2.4 per cent in 2002. By September this had been revised up to 2.8 per cent as a result of stronger-than-expected growth in late 2001 and early 2002.
- The IMF expects global growth to improve in 2003, although developments in recent months have led to some downward revisions to growth prospects for next year, largely in the US.
- Going forward, risks to the global outlook have increased, particularly stemming from uncertainty about the pace of the US recovery.
- While US growth at the beginning of this year was greater than expected, concerns about the pace and sustainability of the recovery have risen. Indeed, recent indicators suggest that the recovery is weakening in the US. Moreover, European growth is expected to be weaker in 2002 than in 2001, and Japan remains in recession. A sharp spike in oil prices resulting from a possible war in Iraq and continued equity market weakness could slow global growth. Also, financing conditions in emerging markets remain fragile, particularly in South America.
- Nonetheless, the IMF expects all three major economic blocs to experience positive growth next year.

Growth in the US in late 2001 and early 2002 was stronger than anticipated, but has been uneven more recently

US Real GDP Growth

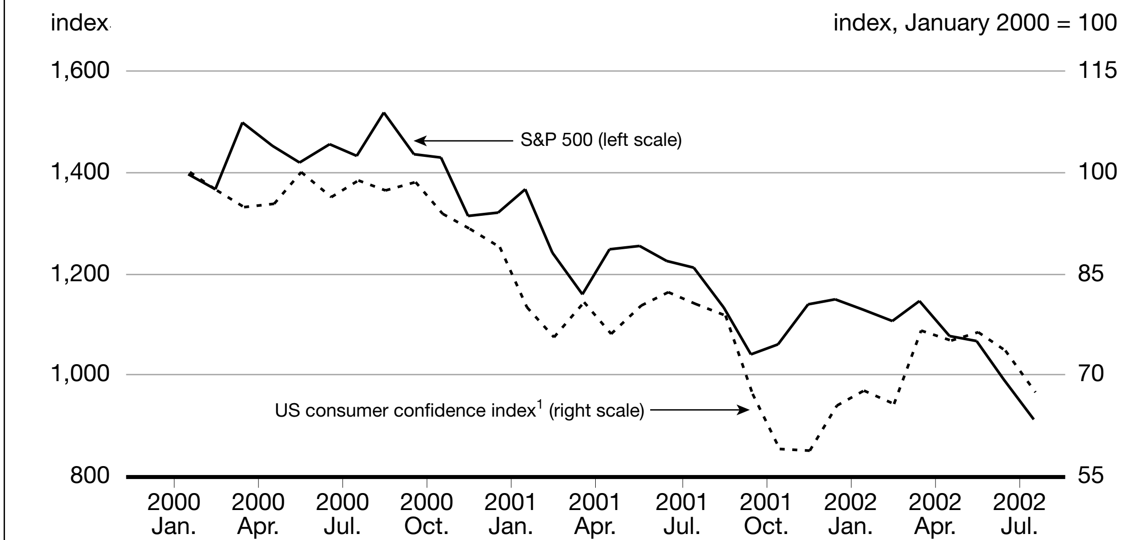


Souces: *Blue Chip Economic Indicators*, November 2001 and October 2002.

- Following strong growth in the late 1990s and 2000, the US economy experienced a recession in 2001, with three consecutive quarters of negative real GDP growth.
- This downturn was largely the result of a sharp correction in US business investment in information and communications technology goods (accompanied by a steep decline in equity prices), which was exacerbated by a weakening in global demand conditions.
- US growth in the last quarter of 2001 and first quarter of 2002 was much stronger than expected at the time of the December 2001 budget due to fiscal measures and the impact of low interest rates on household demand. Also, special factors such as zero-per-cent financing on new automobile purchases and a need by firms to replenish depleted inventories tended to bring forward future expenditures.
- As the impact of these special factors faded, US growth slowed to just above 1 per cent in the second quarter of 2002.
- Although forecasters expect growth to rebound in the third quarter, uncertainty about the pace of the recovery has risen.

There are significant risks to the US outlook

S&P 500 Index and Consumer Confidence



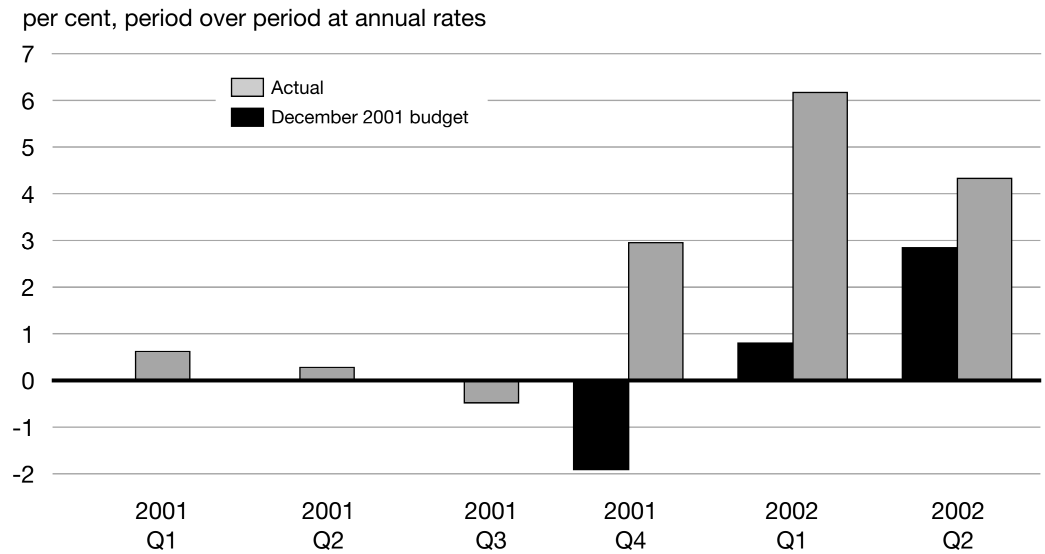
[1] The Conference Board's Consumer Confidence Index.

- Since March of this year US equity markets have declined sharply, exacerbated by accounting and corporate scandals. This continues a trend decline in US stock markets since mid 2000, which has been reflected in similar drops in consumer confidence. If stock price weakness persists, it could further erode consumer and business confidence and slow the US economy.

- Continued uncertainty regarding developments in the Middle East, particularly with regard to Iraq, and the impact such developments could have on world oil prices and consumer and business confidence, present additional downside risks to the US outlook.

Canada's economy has emerged from the slowdown of 2001 into a robust recovery

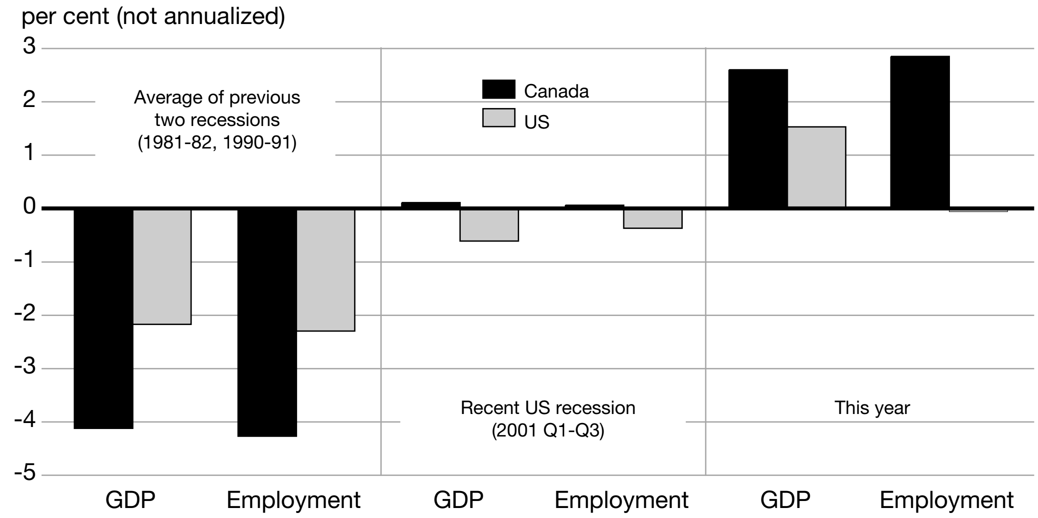
Canadian Real GDP Growth



- While Canada did experience one negative quarter of growth in 2001, it avoided the recession that hit the US.
- The Canadian economy has rebounded earlier and more strongly than expected at the time of the December 2001 budget. During the first half of this year the economy grew over 5 per cent at an annual rate.
- Growth has been solid in the broad categories of domestic demand: consumer spending, housing construction and, more recently, business investment.
- The Canadian economy outperformed the US economy during the downturn, and so far this year in both output growth and job creation. The elimination of the deficit and the restoration of fiscal and monetary policy credibility in Canada have underpinned that solid economic performance.

The Canadian economy outperformed the US economy during the 2001 global downturn and again so far this year

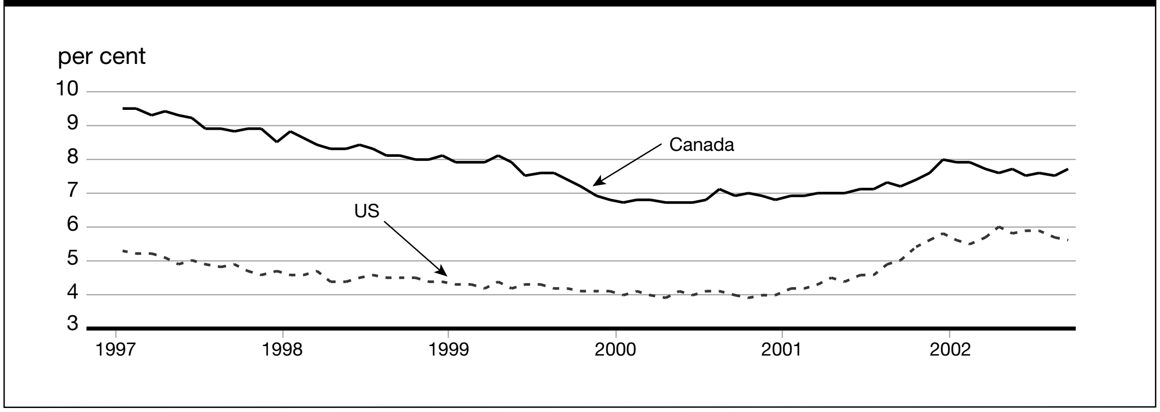
Change in Real GDP and Employment



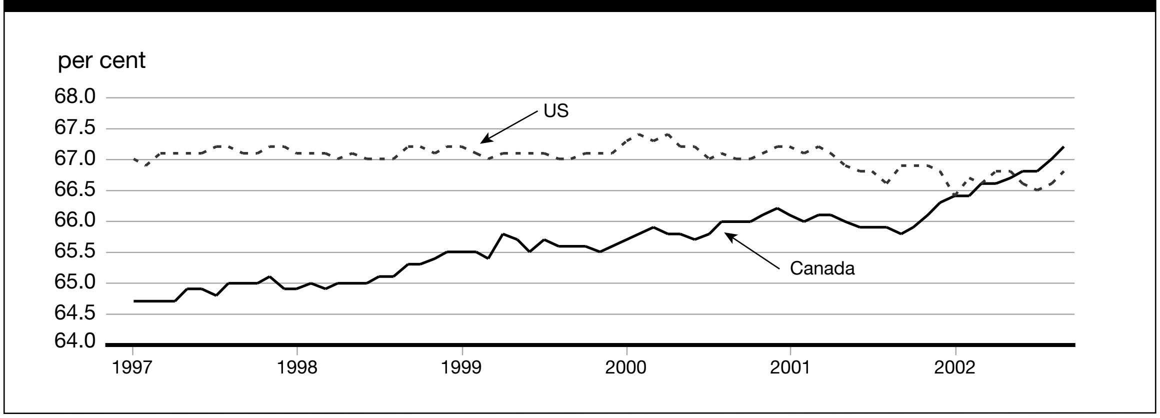
- Canada performed better than the US during the 2001 US recession. This stands in sharp contrast to our poorer performance in the recessions of the early 1980s and early 1990s.
- During these two recessions real GDP and employment in Canada declined more than in the US. In contrast, during the 2001 US recession real GDP and employment actually rose in Canada, while they declined in the US.
- The Canadian economy has continued to outperform the US economy during the recovery. In the first two quarters of 2002 Canadian real GDP growth averaged more than 5 per cent (annualized), compared to 3 per cent in the US. And over the first nine months of this year 427,000 jobs were created in Canada, compared with an employment decline of 36,000 in the US.

Canada’s unemployment rate gap with the US has narrowed significantly

Unemployment Rate



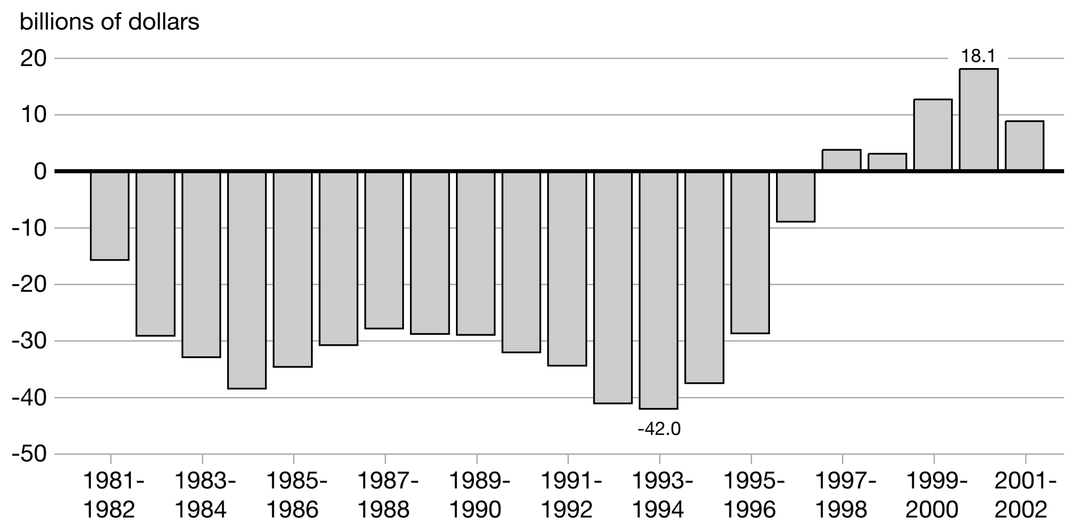
Participation Rate



- The Canadian unemployment rate has dropped from 8.0 per cent at the end of last year to 7.7 per cent in September.
- Canada has narrowed its unemployment rate gap with the US from almost 5 percentage points in late 1996 to about 2 percentage points in September. If the Canadian unemployment rate were to be measured according to the US definition, the gap would be only 1.5 percentage points.
- The fall in Canada’s unemployment rate comes despite a sharp increase in the participation rate (the share of the working-age population that is working or actively looking for work) to its highest level in 12 years – reflecting rising confidence in job market prospects. In contrast, the US participation rate has recently trended downward and is now below the Canadian rate for the first time since 1991.

Canada's solid economic performance reflects the substantial improvement in our fiscal position

Federal Budget Balance

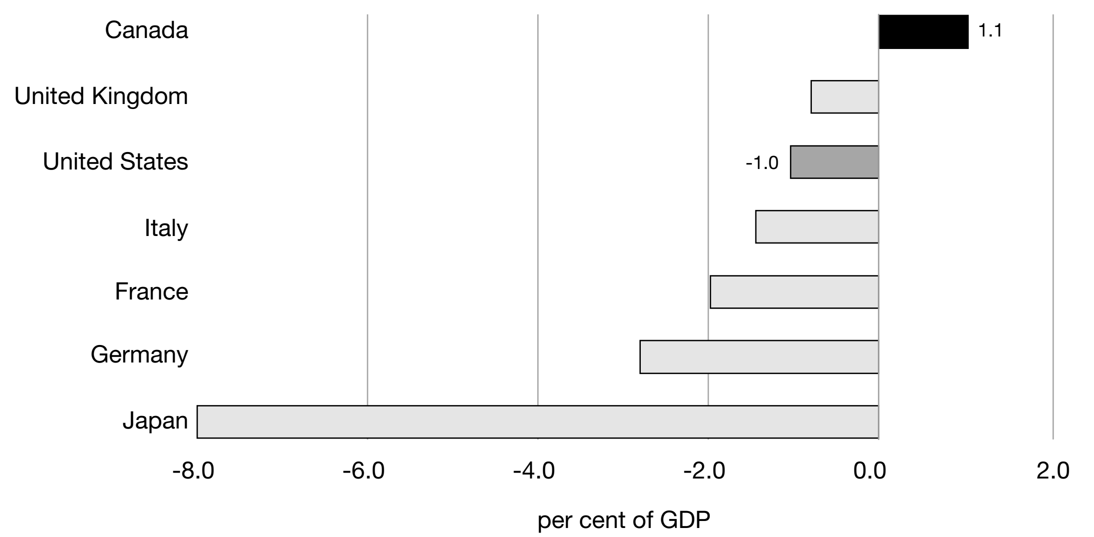


Sources: *Public Accounts of Canada* and Statistics Canada.

- Canada's impressive economic performance during the global slowdown was underpinned by the turnaround in the fiscal situation and the achievement of sustained low inflation. This enabled fiscal and monetary policy to provide timely support to the Canadian economy through lower taxes and interest rates.
- Over the last few years the fiscal position of the federal government has improved significantly – moving from large chronic deficits to consistent budgetary surpluses.
- In fact, fiscal year 2001-02 marks the fifth consecutive year of budget surpluses for the federal government. Over this five-year period the federal government has paid down $46.7 billion in debt.
- This is the result of a systematic fiscal strategy, which the Government has followed for several years. It includes a prudent approach to budget planning, controlling overall spending growth, reallocating spending to priority areas and paying down debt.
- This strategy enabled the federal government to stay in surplus during the global economic downturn last year while fully implementing the $100-billion tax cut plan and taking new measures in the December 2001 budget to enhance security for Canadians.
- This is in stark contrast to the last two recessions in Canada, during which the Government did not have fiscal flexibility.

Canada's fiscal position is projected to be the best among G-7 countries in 2002

Total Government Budget Balances in G-7 Countries, 2002 Projection[1]



[1] Includes all levels of government.

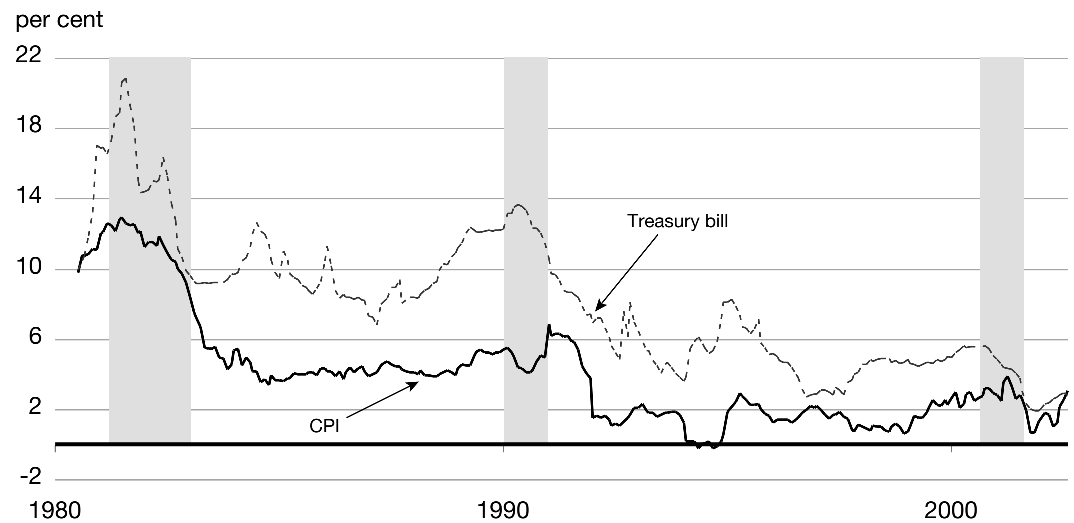
Source: *OECD Economic Outlook No. 71* (June 2002).

- According to the Organisation for Economic Co-operation and Development (OECD), Canada will be the only G-7 country to record a financial surplus at the total government sector level in 2002.

- This is a continuation of Canada's strong performance relative to G-7 countries in the 1990s. Indeed, since 1997 Canada has consistently recorded the highest total government sector surplus of all G-7 countries, relative to the size of the economy.

Inflation has remained low and stable

Total CPI Inflation and Three-Month Treasury Bill Rate



Note: For 1981-82 and 1990-91 recessions, shaded areas denote peak to trough in real GDP.
For the 2001 slowdown, shaded area is 2000 Q4 to 2001 Q4.

Source: Statistics Canada.

- Low and stable inflation has established the credibility of Canadian monetary policy. In fact, Canadian inflation averaged 1.6 per cent over the 1992 to 2001 period – the third lowest average inflation rate among G-7 countries and well within the inflation target range of 1 to 3 per cent.

- This monetary policy credibility, reinforced by the turnaround in Canada's fiscal situation, has increased Canada's monetary policy flexibility.

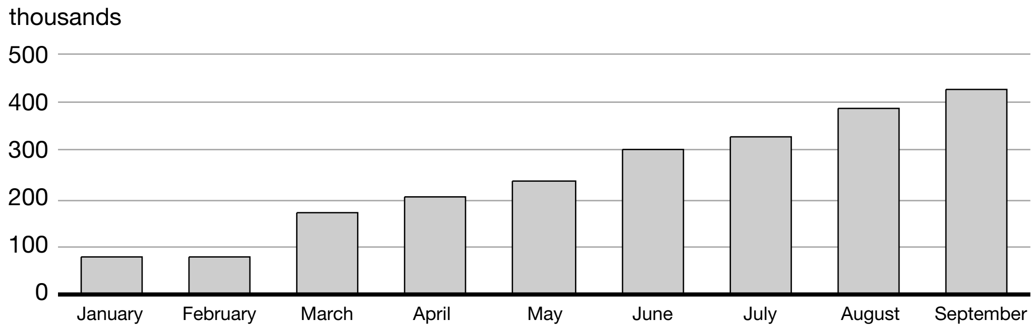
- As a result, the Bank of Canada was able to lower interest rates last year as soon as the economy showed signs of weakness. From January 2001 to January 2002 the Bank lowered its key interest rate by 375 basis points, providing strong support to interest-sensitive sectors such as housing, consumer expenditures and business investment.

- In response to stronger growth, and in order to achieve the 2-per-cent mid-point of the 1 to 3 per cent inflation target range over the medium term, the Bank has raised its key interest rate by 75 basis points this year to remove part of the monetary stimulus in the economy.

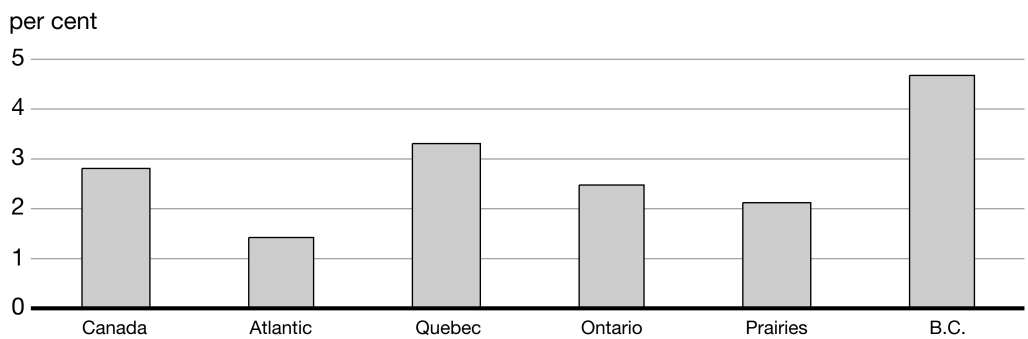
- Nonetheless, short-term interest rates remain at low levels not seen since the early 1960s. These rates will continue to support growth.

Strong fundamentals have set the stage for robust employment gains, which have been distributed across all Canadian regions

Cumulative Employment Growth in Canada
(January to September 2002)



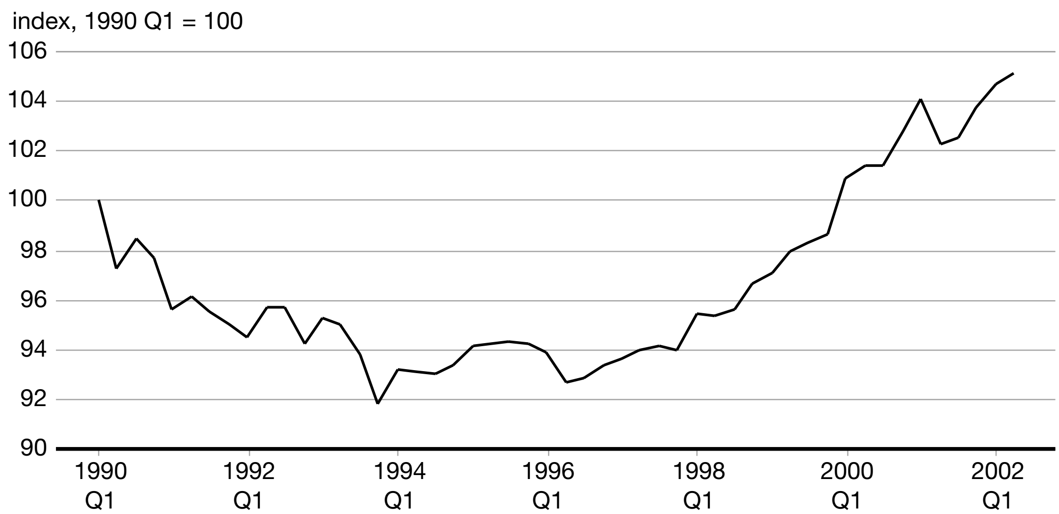
Regional Employment Growth in Canada
(January to September 2002)



- Canada's strong labour market has helped to support domestic demand.
- From January to September 2002 our economy created 427,000 jobs, 60 per cent of which were full-time. This is one of the largest nine-month Canadian employment gains on record.
- Canada's substantial employment gains have been spread across all regions. B.C. and Saskatchewan have led the provinces so far this year, with employment growth of 4.7 and 4.5 per cent respectively. New Brunswick, Quebec and Prince Edward Island have experienced employment growth of over 3 per cent.

Employment gains are reflected in the continued growth in the real personal disposable income of Canadians

Real Personal Disposable Income Per Capita



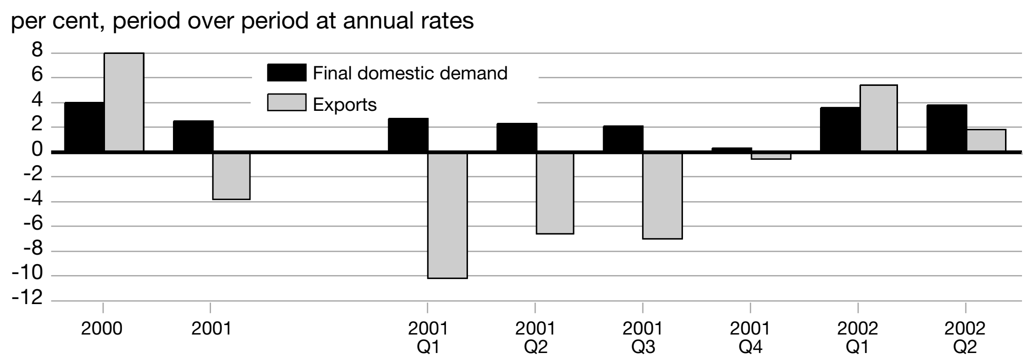
- Real personal disposable income per capita has increased 2.9 per cent over the last 12 months, as solid labour market gains have translated into more disposable income for Canadians.

- This is a continuation of an upward trend since 1997, which is the direct result of a robust labour market, strong productivity growth and substantial tax cuts at both the federal and provincial levels of government.

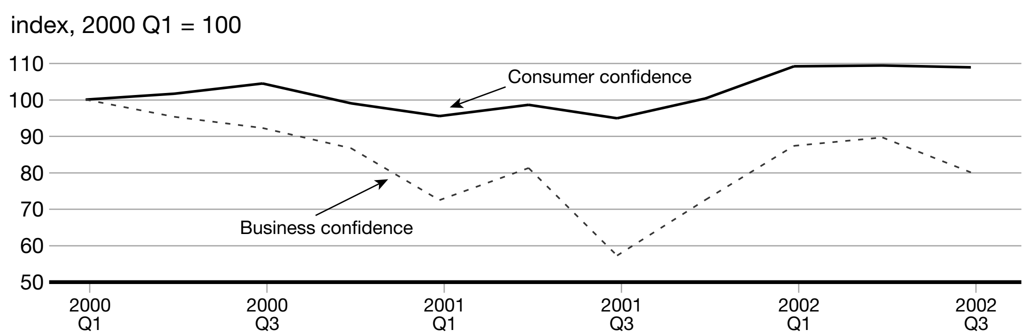
- This is in a stark contrast to the declining trend in real personal disposable income per capita during the first half of the 1990s.

Strong employment growth and rising incomes have supported domestic demand and consumer and business confidence

Real Final Domestic Demand and Export Growth



Confidence Indicators

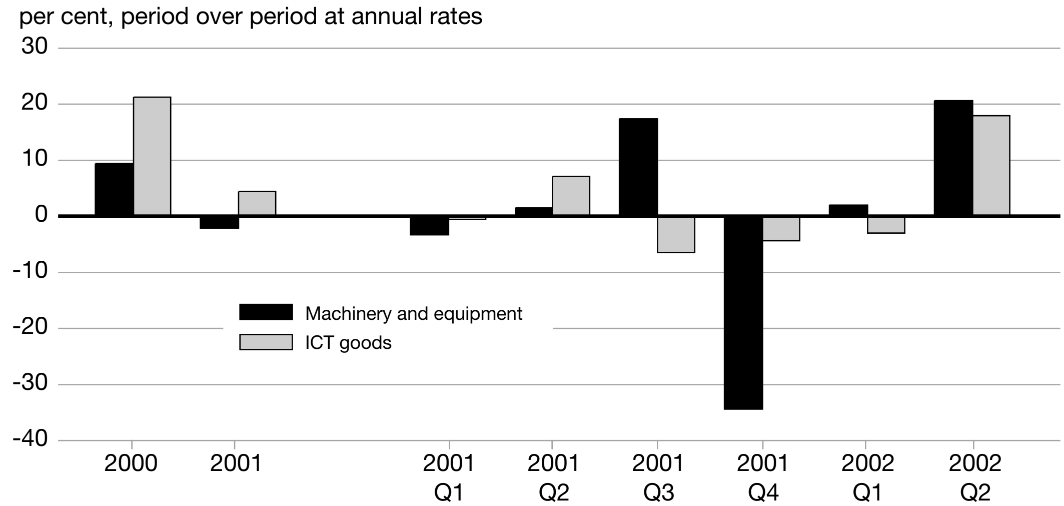


Source: The Conference Board of Canada.

- Healthy growth in Canadian domestic demand provided the support that kept Canada out of recession in 2001, when the slowdown in the US reduced exports.
- Consumer confidence in Canada has remained high. Reflecting this, consumer spending and housing activity have been strong, supported by low interest rates, tax cuts and a robust labour market performance, which have boosted consumers' incomes.
- Business confidence in Canada has recovered following the declines last fall, supported by a 50-per-cent annualized increase in corporate profits in the first half of 2002. At 11 per cent of nominal GDP in the second quarter of 2002, corporate profits in Canada are currently above their historical average.

After declining in 2001, machinery and equipment investment grew in the first half of 2002

Growth in Real Business Investment in Machinery and Equipment

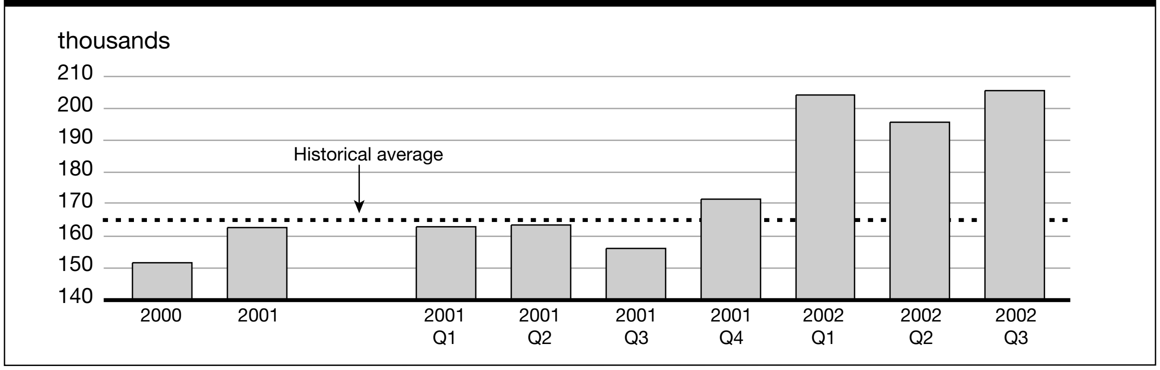


- After declining in 2001, business investment in machinery and equipment (M&E) has recently showed signs of recovery, reflecting improved confidence in economic prospects and the profit recovery. However, even with the rebound in the second quarter of 2002, M&E investment was still below the level recorded a year earlier.

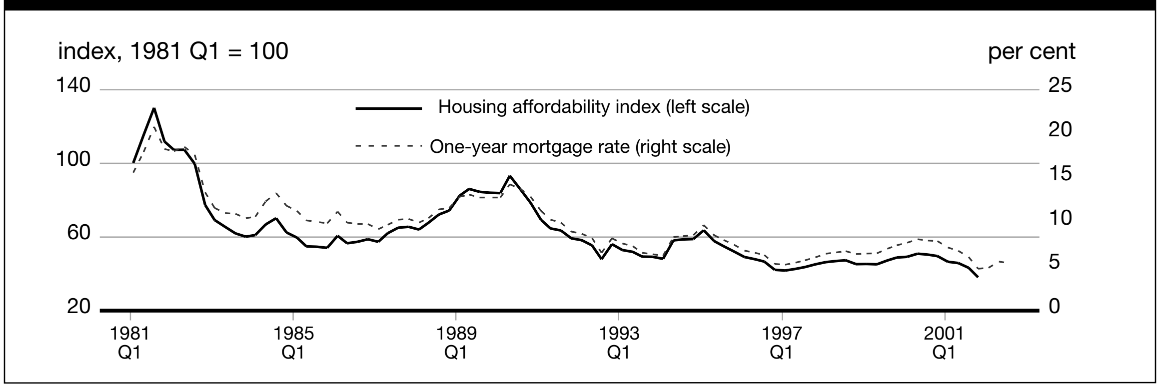
- Higher investment in information and communications technology (ICT) has contributed to the recent growth in M&E investment. The 18-per-cent increase in ICT investment in the second quarter represented the first major increase in almost two years.

The housing sector has been particularly strong

Housing Starts



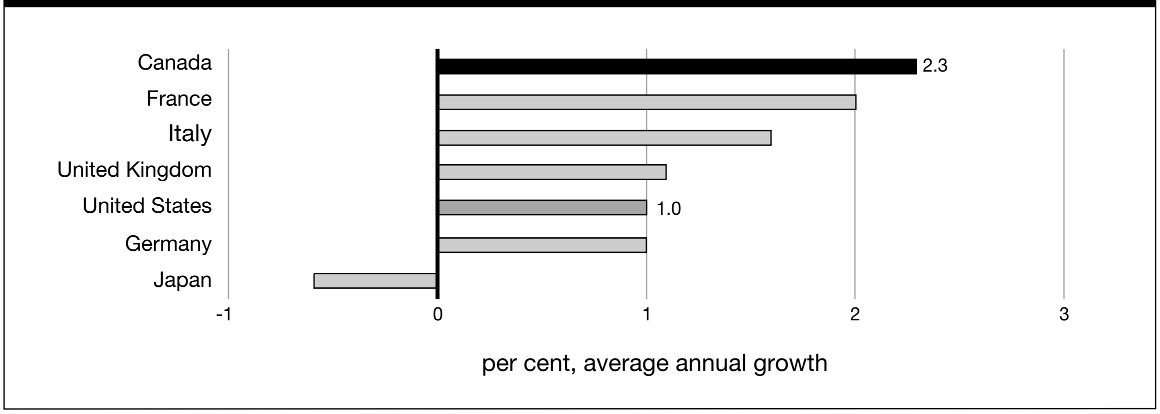
Housing Affordability Index and One-Year Mortgage Rate



- Residential investment is 15 per cent higher than at the beginning of 2001. Both housing starts and renovations have contributed to the strength in residential investment.
- At over 200,000 in the first nine months of 2002, housing starts are at their highest level since 1989 and well above their historical average of 165,000 starts.
- Strong housing demand reflects rising employment and incomes, and low mortgage rates. The housing affordability index, which represents the proportion of average disposable household income needed to make mortgage payments on an average new house, improved throughout 2001 and reached its best level on record.
- Since the beginning of 2001, one- and five-year mortgage rates have declined 240 and 95 basis points respectively, and are currently 5.3 per cent and 7.0 per cent. Households now save close to $1,700 annually on a new or renegotiated one-year mortgage of $100,000 compared to what they would have paid at the beginning of 2001, while they save more than $700 annually on a five-year mortgage.

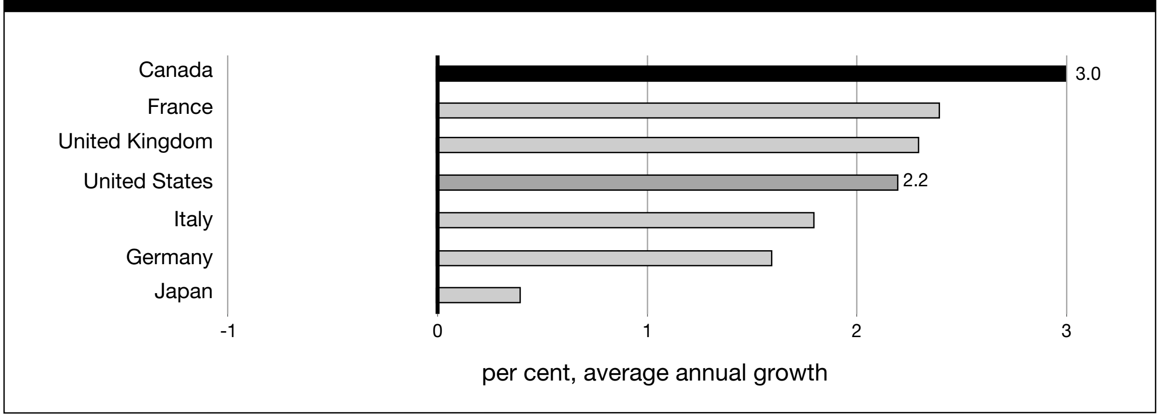
A better labour market performance and improved productivity growth in Canada have resulted in stronger growth in Canada's standard of living

Employment Growth From 1997 to 2001 in G-7 Countries



Sources: Statistics Canada, Bureau of Economic Analysis and *OECD Economic Outlook No. 71* (June 2002).

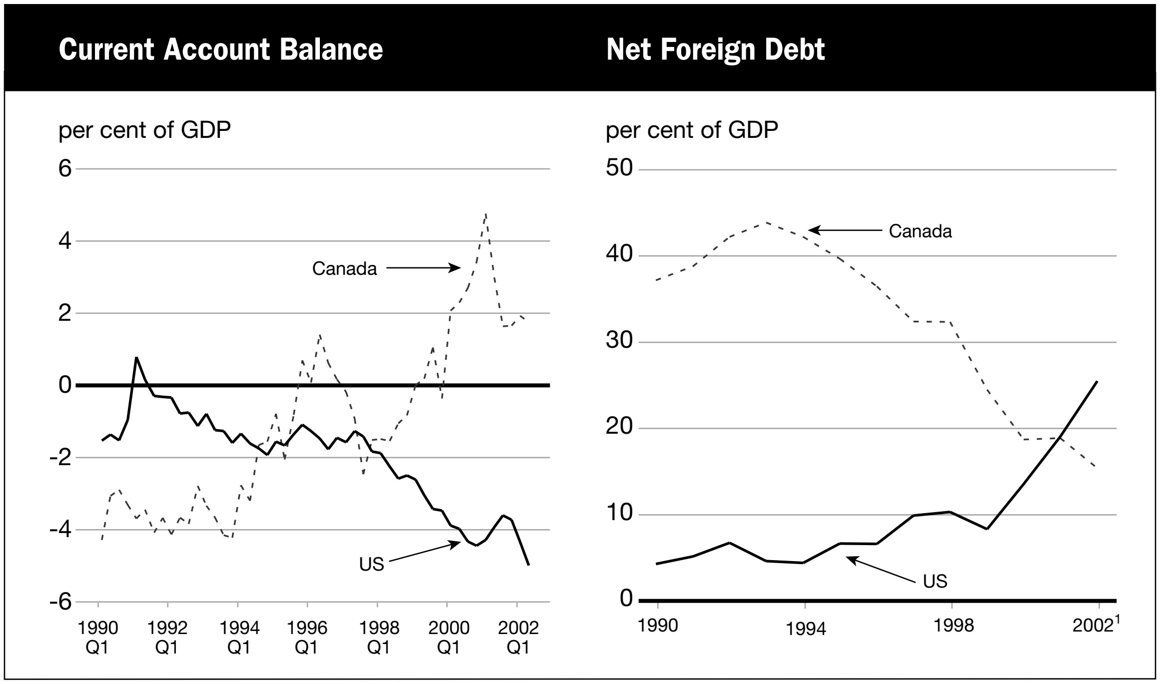
Real GDP Per Capita Growth From 1997 to 2001 in G-7 Countries



Sources: Statistics Canada, Bureau of Economic Analysis and *OECD Economic Outlook No. 71* (June 2002).

- Canada's strong job creation this year is a continuation of the performance of the last five years. In fact, from 1997 to 2001 average Canadian employment growth well exceeded that of the other G-7 economies.
- This solid labour market performance, combined with improved productivity growth, has resulted in a significant improvement in growth in real GDP per capita, which is a widely used measure of improvement in living standards.
- From 1997 to 2001 real GDP per capita growth averaged 3.0 per cent per year in Canada, outperforming all other G-7 countries.
- While the living standards gap with the US has started to narrow in the last five years, it remains sizeable and more progress on a sustained basis will be needed to close the gap.

Canada's current account balance and net foreign indebtedness have improved significantly, while US balances have deteriorated

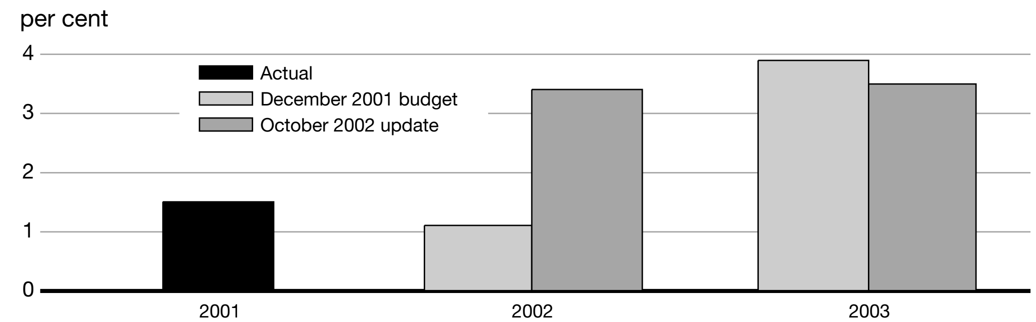


[1] Estimates: Based on current account estimates from the Department of Finance for Canada and DRI-WEFA for the US.

- Canada's stronger economic performance in recent years can also be seen in our current account balance, which has gone from large deficits through the 1980s and most of the 1990s to large surpluses today, despite the US economic slowdown.
- As a result, our net foreign debt as a per cent of GDP fell to below 20 per cent in 2001, less than half the levels of the early 1990s and the lowest level in more than 50 years.
- This means that more of the income that Canadians earn is staying in Canada.
- Canada's net foreign debt as a share of GDP is now lower than that of the US for the first time on record.

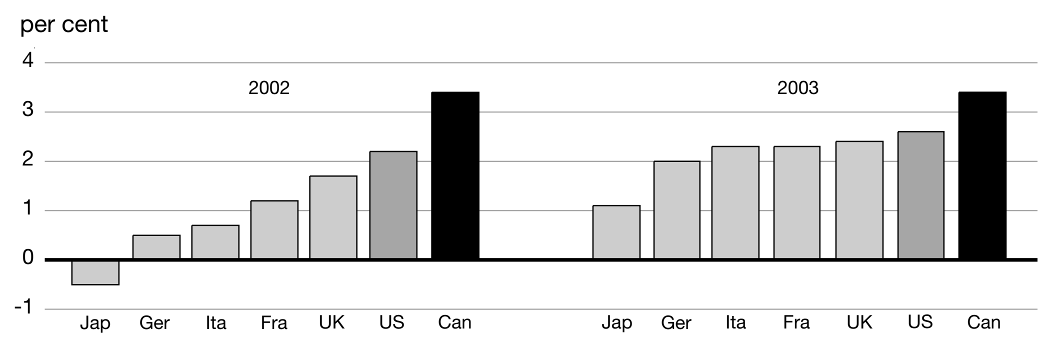
Forecasters expect continued growth in the Canadian economy

Real GDP Growth –Private Sector Forecasters



Sources: December 2001 and September 2002 Department of Finance surveys of private sector forecasters.

Real GDP Growth – International Monetary Fund



Source: IMF.

- The Department of Finance conducted its regular survey of Canadian private sector economists in September, which is the basis for the fiscal projections provided in Annex 3.
- Private sector forecasters expect Canadian economic growth to moderate from the strong pace exhibited in the first half of the year, leading to forecast growth of 3.4 per cent for 2002 as a whole. For 2003 they expect growth to average 3.5 per cent.
- GDP inflation is expected to remain low at 1.1 per cent in 2002, but to increase to 2.3 per cent in 2003. This results in expected nominal GDP growth of 4.6 per cent in 2002 and 5.9 per cent in 2003.

- Private sector forecasters expect short-term interest rates to increase from 2.6 per cent in 2002 to 3.9 per cent in 2003. Current private sector expectations for the 10-year government bond rate is 5.3 per cent in 2002 and 5.5 per cent in 2003.

- The IMF and OECD expect Canadian growth to rank first among G-7 countries in both 2002 and 2003.

- While the economic outlook has improved substantially since the December 2001 budget as a result of the earlier-than-expected economic recoveries in both Canada and the US, there are significant risks to the outlook. The primary risk to the Canadian outlook is continued uncertainty about the near-term momentum of the US recovery. In particular, continued equity market weakness could slow the US recovery in business investment and depress US household spending. Uncertainty regarding potential military action in Iraq also poses an important risk to the outlook.

Evolution of the Average Private Sector Forecasts for Canada

	2002	2003
	(per cent, unless otherwise indicated)	
Real GDP growth		
December 2001 budget	1.1	3.9
October 2002 update	3.4	3.5
Difference (percentage points)	2.3	-0.4
GDP inflation		
December 2001 budget	0.2	1.9
October 2002 update	1.1	2.3
Difference (percentage points)	0.9	0.4
Nominal GDP growth		
December 2001 budget	1.3	5.9
October 2002 update	4.6	5.9
Difference (percentage points)	3.3	0.0
Employment growth		
December 2001 survey[1]	0.2	1.8
October 2002 update	1.9	2.1
Difference (percentage points)	1.7	0.3
Unemployment rate		
December 2001 survey[1]	7.8	7.3
October 2002 update	7.6	7.1
Difference (percentage points)	-0.2	-0.2
3-month Treasury bill rate		
December 2001 budget	2.4	4.0
October 2002 update	2.6	3.9
Difference (percentage points)	0.2	-0.1
10-year government bond rate		
December 2001 budget	5.5	5.9
October 2002 update	5.3	5.5
Difference (percentage points)	-0.2	-0.4

[1] Private sector forecasts for employment growth and the unemployment rate were not available at the time of the December 2001 budget. These data are from the December 2001 Department of Finance survey of private sector forecasters, which was completed after the budget.

Sources: December 2001 budget: December 2001 consultation with private sector forecasters. October 2002 update: September 2002 Department of Finance survey of private sector forecasters.

Annex 2

Canada's Fiscal Progress

Highlights

- *The federal government recorded a budgetary surplus of $8.9 billion 2001-02. This marks the fifth consecutive year the federal budget has been in surplus.*

- *Net debt – the accumulation of deficits and surpluses since Confederation – has been reduced by $46.7 billion to $536.5 billion. This reduction in debt, coupled with Canada's sustained economic growth, has resulted in a significant decline in the federal debt-to-GDP (gross domestic product) ratio, from its peak of 70.9 per cent in 1995-96 to 49.1 per cent in 2001-02.*

- *Federal market debt – the debt issued on credit markets – has declined by $34.6 billion. It now stands at $442.3 billion. Market debt as a percentage of GDP has declined to 40.5 per cent from the peak of 57.9 per cent in 1995-96.*

- *The revenue-to-GDP ratio fell to 15.9 per cent in 2001-02, down sharply from 16.9 per cent in 2000-01. It is at its lowest level since 1993-94. The decline in 2001-02 primarily reflects the impact of the $100-billion tax reduction initiatives announced and legislated in the October 2000* Economic Statement and Budget Update*.*

- *The amount of every revenue dollar collected by the federal government used to pay interest on the public debt declined to 21.8 cents in 2001-02, down from 36 cents in 1995-96, and is now at its lowest level since 1979-80.*

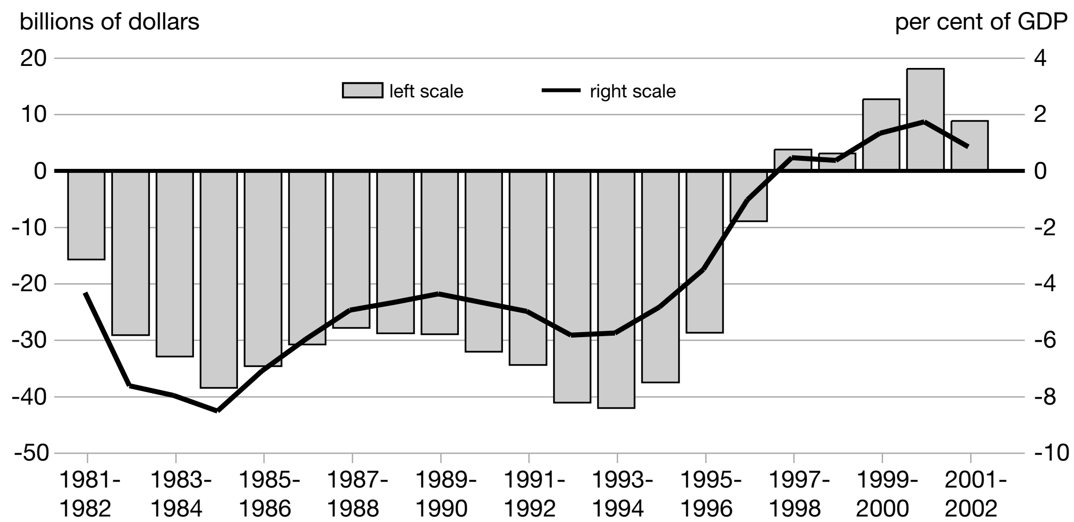
- *Federal program spending increased by 6.1 per cent in 2001-02. Over 80 per cent of this increase was attributable to increased transfers to the provinces and territories under the Agreements on Health Renewal and Early Childhood Development reached by first ministers in September 2000 and to higher employment insurance benefits. Program spending stood at 11.6 per cent of GDP in 2001-02, compared to 16.5 per cent in 1993-94.*

- *The aggregate provincial-territorial budget is expected to record a small deficit in 2001-02. However, six provinces and two territories are expected to report a balanced budget or surplus in 2001-02.*

- *On a total government basis, Canada recorded a surplus of 2.4 per cent of GDP in 2001, the largest among the Group of Seven (G-7) countries. The Organisation for Economic Co-operation and Development (OECD) estimates that Canada will be the only G-7 country in surplus in 2002 at the total government sector level. Since 1995 Canada's total government sector has achieved the largest reduction in net debt among the G-7 countries and its net debt-to-GDP ratio is now below the G-7 average.*

Fifth consecutive budget surplus

Federal Budgetary Balance
(Public Accounts Basis)



Sources: *Public Accounts of Canada* and Statistics Canada.

- There was a budgetary surplus of $8.9 billion in 2001-02. The federal government has now achieved five consecutive annual surpluses, including revised surpluses of $3.8 billion in 1997-98, $3.1 billion in 1998-99, $12.7 billion in 1999-2000 and $18.1 billion in 2000-01.[1]
- As a result of these surpluses, net debt has been reduced by $46.7 billion since 1997-98.
- As a percentage of GDP, the budgetary surplus was 0.8 per cent in 2001-02.
- This achievement reverses a trend of more than a quarter of a century of uninterrupted government deficits. Five consecutive surpluses have not been recorded since 1951-52.

[1] Budgetary surpluses for 1997-98 to 2000-01 were revised to reflect the misclassification of mutual fund trust capital gain refunds. For more information, see the *Annual Financial Report of the Government of Canada* (fiscal year 2001-02).

Better-than-expected fiscal outcome for 2001-02 due to lower program spending and public debt charges, and higher revenues

Table 2.1
Financial Highlights: Comparison to December 2001 Budget

	(billions of dollars)
December 2001 budget projected surplus	1.5
Changes[1]	
Program spending	
Major transfers to persons	0.3
Major transfers to other levels of government	0.5
Direct program spending	3.2
Total spending	3.9
Public debt charges	1.5
Budgetary revenues	
Personal income tax	3.5
Corporate income tax	0.4
Other income tax	-1.0
Employment insurance premium revenues	0.2
Excise taxes and duties	-0.6
Non-tax revenues	-0.5
Total revenues	2.0
Net change	7.4
Outcome for 2001-02	8.9

Note: Numbers may not add due to rounding.
[1] A positive number implies an improvement in the budgetary balance. A negative number implies a deterioration in the budgetary balance.

- The budgetary surplus of $8.9 billion in 2001-02 was $7.4 billion above the surplus of $1.5 billion estimated in the December 2001 budget.
- Program spending was $3.9 billion lower than estimated in the December 2001 budget, primarily reflecting lower direct program spending. As a result, program spending advanced by 6.1 per cent, considerably lower than the 9.4 per cent estimated in the budget.
  - Major transfers to persons were $0.3 billion lower due to lower-than-expected employment insurance benefits.
  - Major transfers to other levels of government were $0.5 billion below the December 2001 budget estimates, reflecting lower equalization entitlements and higher recoveries under the Alternative Payments for Standing Programs.

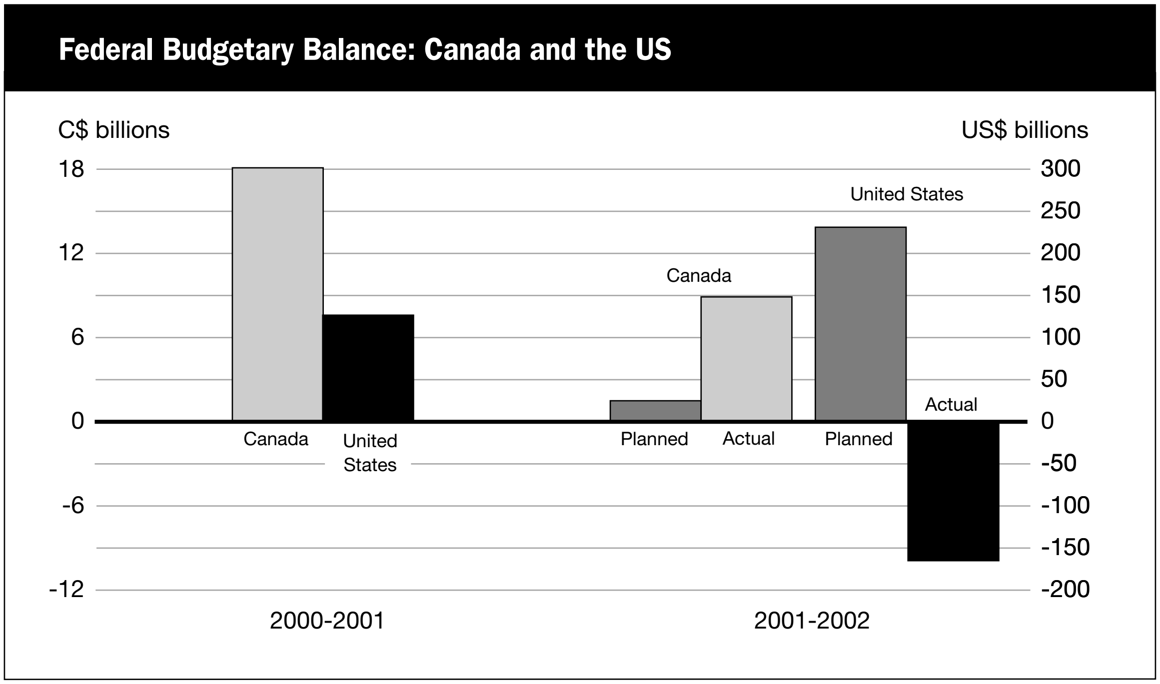
- Direct program spending (subsidies and other transfers, expenditures related to Crown corporations, defence spending, and operating and capital expenditures of non-defence departments and agencies) was $3.2 billion lower than expected due to lower-than-expected liabilities at year-end and a higher-than-assumed lapse in spending authority.

■ Public debt charges were $1.5 billion lower than expected, primarily due to a change in determining interest accrued to the public sector pension accounts.

■ Budgetary revenues were $2.0 billion higher than estimated in the December 2001 budget, primarily due to stronger-than-expected economic growth in the fourth quarter of 2001 and first quarter of 2002. At the time of the December 2001 budget, most forecasters were expecting economic weakness to continue in the fourth quarter, with only modest growth in the first quarter of 2002.

- Personal income tax revenues were $3.5 billion higher than expected, reflecting strong employment gains recorded in the first quarter of 2002 and adjustments related to overpayments to the tax collection accounts.
- The higher-than-estimated corporate income tax revenues were entirely attributable to the lower-than-expected take-up of the December 2001 budget proposal to allow small businesses to defer for six months their corporate income tax instalments for the months of January, February and March 2002. The budget estimated the cost of this initiative at $2.0 billion. Preliminary indications are that the take-up of the initiative amounted to about $600 million.
- Other income taxes were $1.0 billion lower due to a correction of a consolidation adjustment related to refundable taxes withheld from the federal Retirement Compensation Arrangements Account that were previously credited to tax revenues.
- Excise taxes and duties were $0.6 billion lower, primarily due to lower goods and services tax at year-end.
- Non-tax revenues were $0.5 billion lower due entirely to a classification change, whereby "refunds from previous years' expenditures," which in the past were included as part of "other non-tax revenues," are now netted against program spending. This has the effect of lowering both budgetary revenues and program spending by equivalent amounts, with no impact on the overall budgetary balance.

Canada remained in surplus in 2001-02 while the US went into deficit



Sources: Canada: Department of Finance; US: Office of Management and Budget.

- In 2000-01 both Canada and the United States recorded surpluses.
- In the December 2001 budget the federal government estimated a surplus of $1.5 billion for 2001-02. With better-than-expected economic growth in the last six months of the fiscal year and lower-than-expected expenditure growth, the final outcome was a surplus of $8.9 billion.
- In contrast, the US Administration, in its original budget plan for fiscal year 2001-02, forecast a surplus of US$231 billion. However, the final result was a deficit of US$159 billion – a swing of almost US$390 billion.

Fiscal progress between 1993-94 and 2001-02

Table 2.2
Change in the Federal Budgetary Balance Relative to the Size of the Economy

	1993-94	2001-02	Change	Contribution
		(per cent of GDP)		(per cent)
Budgetary revenues	15.9	15.9	0.0	0.0
Program spending	16.5	11.6	-4.9	74.2
Public debt charges	5.2	3.5	-1.7	25.8
Budgetary balance	-5.8	0.8	6.6	100.0

- The contribution of changes in revenues and expenditures to the improvement in the budgetary balance is best illustrated by looking at the evolution of budgetary revenues, program spending and public debt charges, and the resulting budgetary balance, as a share of the economy.

- Between 1993-94 and 2001-02 the budgetary balance went from a deficit of 5.8 per cent of GDP to a surplus of 0.8 per cent – a turnaround of 6.6 percentage points.

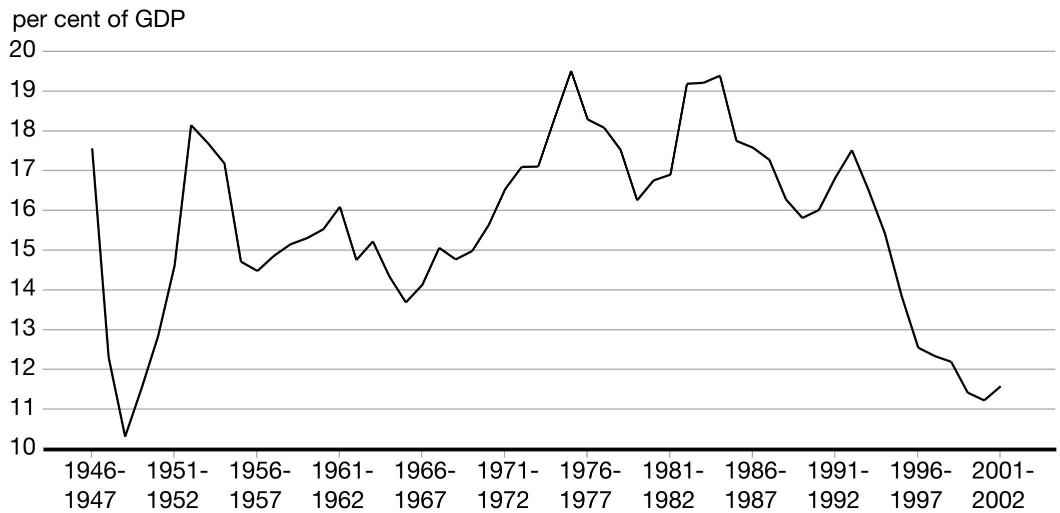
- Nearly 75 per cent of this improvement was attributable to the decline in program spending as a percentage of GDP. This primarily reflected the impact of discretionary actions taken since 1993.

- Reductions in the stock of interest-bearing debt, a decline in the average effective interest rate on that debt, and a change in the accounting for interest costs related to public sector pension plans resulted in a decline in public debt charges as a percentage of GDP. This decline accounted for just over 25 per cent of the improvement in the overall budgetary balance.

- Over this period the revenue-to-GDP ratio was unchanged at 15.9 per cent.

Program spending as a share of GDP up slightly in 2001-02

Federal Program Spending
(Public Accounts Basis)



Sources: *Public Accounts of Canada* and Statistics Canada.

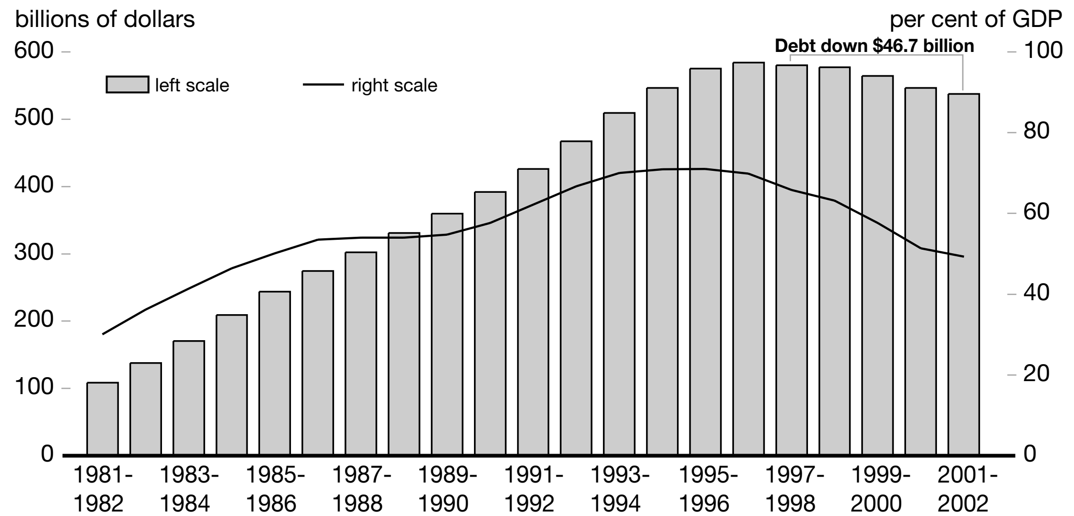
- Program spending increased $7.3 billion, or 6.1 per cent, to $126.7 billion in 2001-02. Of this increase, over 80 per cent went to higher cash transfers to provinces and territories under the Canada Health and Social Transfer and to increased employment insurance benefits. The increase in employment insurance benefits was attributable to a rise in regular benefits resulting from an increase in the number of unemployed, as well as to higher parental benefits, reflecting the doubling of parental leave from six months to one year.

- Between 1997-98 and 2001-02 program spending increased at an average annual rate of 3.8 per cent. This compares to average annual growth of 2.8 per cent in the population and inflation, and 5.5 per cent in nominal GDP, over this period.

- As a percentage of GDP, program spending increased to 11.6 per cent in 2001-02, up from 11.2 per cent in 2000-01. The program spending-to-GDP ratio is nearly 5 percentage points below its level in 1993-94.

Debt-to-GDP ratio declines for the sixth consecutive year

Federal Net Debt
(Public Accounts Basis)



Sources: *Public Accounts of Canada* and Statistics Canada.

- The debt-to-GDP ratio is generally recognized as the most appropriate measure of the debt burden, as it measures the debt relative to the ability of the Government and the nation's taxpayers to finance it.

- The debt-to-GDP ratio fell to 49.1 per cent in 2001-02, the first time it has been under 50 per cent since 1985-86. It has come down nearly 22 percentage points from its peak of 70.9 per cent in 1995-96.

Net debt reduced by $46.7 billion over the last five years

Table 2.3
Federal Government Financial Assets and Liabilities

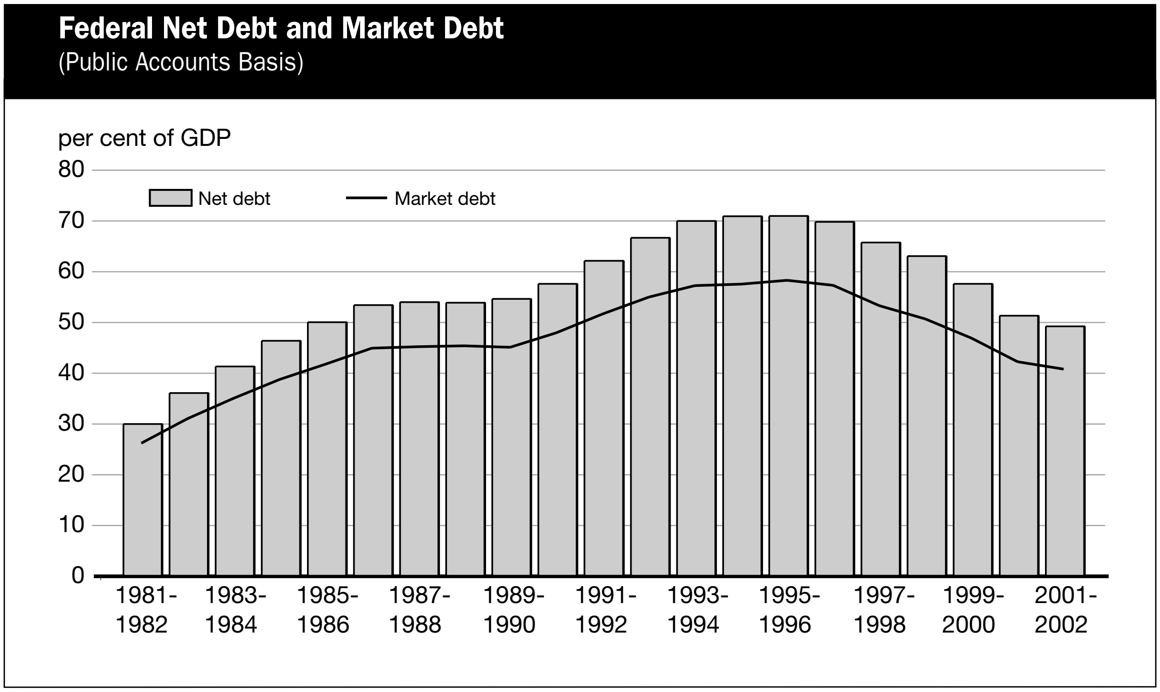
	1996-97	2001-02	Change
		(billions of dollars)	
Financial assets			
Cash and accounts receivable	13.4	16.8	3.4
Foreign exchange accounts	26.8	52.0	25.2
Net loans, investments and advances	17.3	18.7	1.5
Total financial assets	57.5	87.6	30.1
Gross liabilities			
Interest-bearing debt			
Market debt			
Payable in Canadian currency	453.8	415.2	-38.6
Payable in foreign currencies	23.0	27.0	4.0
Total	476.9	442.3	-34.6
Public sector pension and other accounts	123.7	141.2	17.5
Total interest-bearing debt	600.6	583.4	-17.1
Other liabilities	40.1	40.7	0.6
Gross liabilities	640.7	624.1	-16.4
Net debt	**583.2**	**536.5**	**-46.7**

Note: Numbers may not add due to rounding.

- The five consecutive annual surpluses have reduced the stock of federal net debt by $46.7 billion since 1996-97. The net debt was $536.5 billion in 2001-02.
- Net debt consists of financial assets and gross liabilities.
- Financial assets consist of cash, accounts receivable, assets in the foreign exchange account, investment in Crown corporations and loans to other governments. These have increased by $30.1 billion since 1996-97. This increase is largely attributable to higher international reserves held in the Exchange Fund Account. The purpose of this account is to aid in the control and protection of the external value of the Canadian dollar by acquiring or selling assets, as required. The increase over the last five years reflects the Government's announcement in the 1995 and 1998 budgets to bring the level of Canada's international reserves more in line with those of other countries. Net gains on these assets are credited to budgetary revenues (return on investments), although borrowing costs associated with acquiring these assets are part of public debt charges.

- Gross liabilities include the Government's obligations with respect to interest-bearing debt and other liabilities, such as accounts payable. Interest-bearing debt consists of market debt and the Government's liabilities to federal employee pension plans and other accounts. Gross liabilities have declined by $16.4 billion since 1996-97, with interest-bearing debt down $17.1 billion and other liabilities up $0.6 billion. Within interest-bearing debt:
  – Market debt, consisting of debt issued on credit markets in the form of Government of Canada bonds, Canada Savings Bonds and Treasury bills, for example, declined by $34.6 billion between 1996-97 and 2001-02: debt payable in Canadian currency declined by $38.6 billion while debt payable in foreign currencies increased by $4.0 billion. The latter is solely used for exchange fund operations.
  – Liabilities to the federal government employees' pensions and other accounts increased by $17.5 billion over the last five years.

Decline in market debt mirrors decline in net debt



Sources: *Public Accounts of Canada* and Statistics Canada.

- The decline in market debt of $34.6 billion since 1996-97 has resulted in a market debt-to-GDP ratio of 40.5 per cent in 2001-02. The decline in market debt, which is the single largest component of net debt, mirrors the rapid fall in the net debt-to-GDP ratio over the last five years.

Financial source of $4.7 billion in 2001-02

Table 2.4
Federal Budgetary Surplus and Financial Source

	2001-02
	(billions of dollars)
Budgetary surplus	8.9
Non-budgetary transactions	
Loans, investments and advances	-0.1
Pensions and other accounts	-1.7
Other transactions	-2.4
Total	-4.2
Financial source (excluding foreign exchange transactions)	4.7

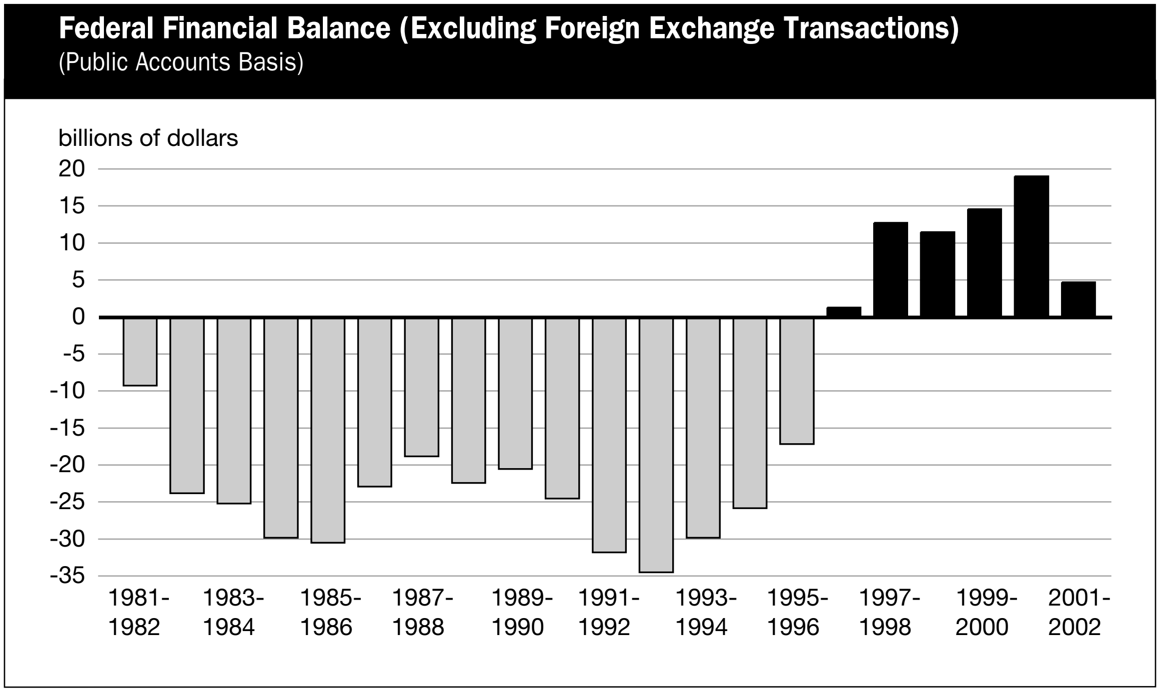
- The Government's fiscal anchor is the budgetary balance. This measure is presented on a modified accrual basis of accounting, recording government liabilities when they are incurred, regardless of when the cash payment is made, and recording tax revenues only when cash is received. The budgetary balance covers only those activities over which the Government has legislative control.

- The federal government's cash position is referred to as the financial requirements/source, which measures the difference between cash received and cash disbursed. It differs from the budgetary balance in that it includes transactions in loans, investments and advances, federal government employee pension accounts, other accounts, changes in financial assets and liabilities, as well as the conversion from accrual to cash accounting. The net change in these activities is included as part of non-budgetary transactions.

- Non-budgetary transactions produced a net requirement of $4.2 billion. Loans, investments and advances recorded a net requirement of $0.1 billion, as borrowings for the Canada Student Loans Program were virtually offset by repayments in other areas. Pensions and other accounts recorded a net requirement of $1.7 billion, primarily attributable to the transfer of applicable pension assets to those Crown corporations establishing their own pension plans. Other transactions provided a net requirement of $2.4 billion due to the cash payments of liabilities incurred in previous fiscal years.

- As a result, with a budgetary surplus of $8.9 billion and a net requirement of $4.2 billion from non-budgetary transactions, there was a financial source, excluding foreign exchange transactions, of $4.7 billion in 2001-02.

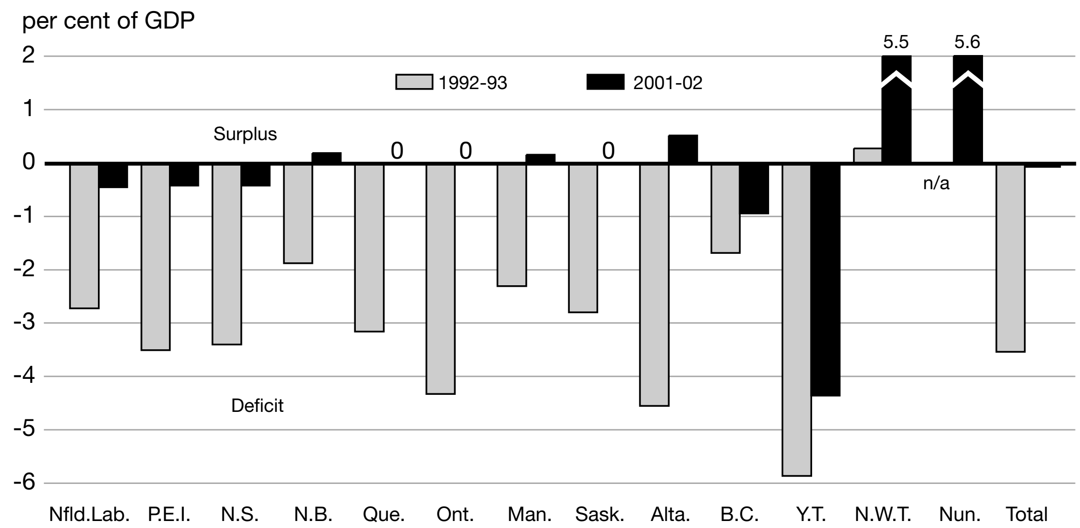
Financial source recorded for the sixth consecutive year



- Financial sources have now been recorded in each of the past six years. This is in contrast to the large financial requirements observed from the mid-1970s through the mid-1990s.

A majority of the provinces and territories reported budgetary surpluses in 2001-02

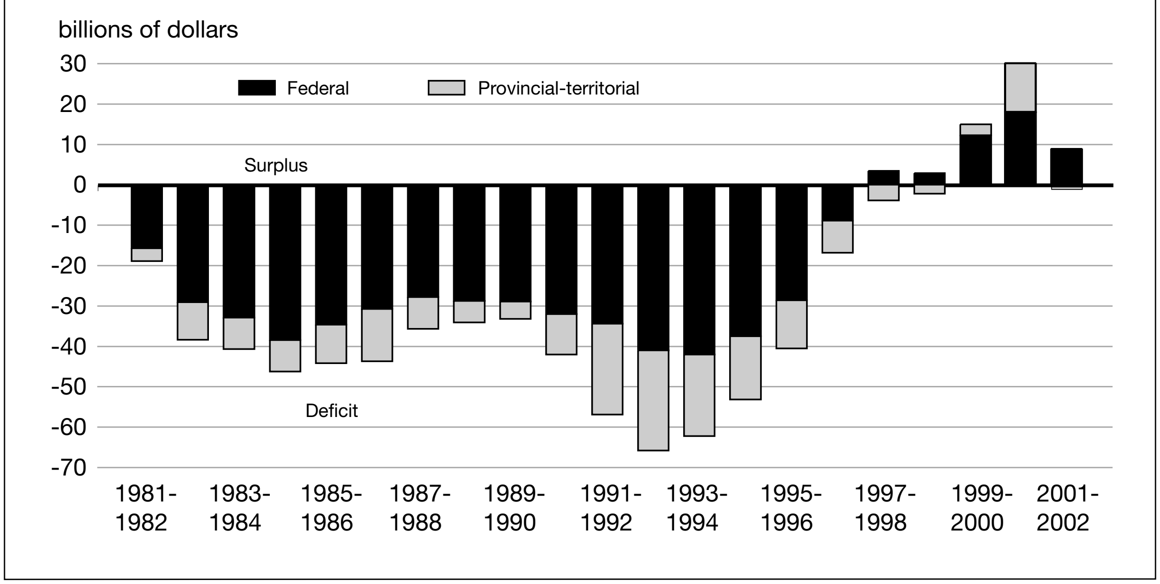
Provincial-Territorial Budgetary Balances
(Public Accounts Basis)



- Like the federal government, the provinces and territories have made substantial progress in restoring their fiscal health.
- Six provinces and two territories are estimated to have recorded a balanced budget or surplus in 2001-02. Preliminary estimates suggest that the provincial-territorial government sector, as a whole, will report a deficit of about $300 million in 2001-02. However, final provincial-territorial financial results could turn this into a small surplus.
- This represents a substantial improvement from the situation in 1992-93, when all but one of the then 12 provincial-territorial government budgets (Northwest Territories) were in deficit.

The combined federal-provincial-territorial government sector recorded a surplus in 2001-02 for the fourth consecutive year

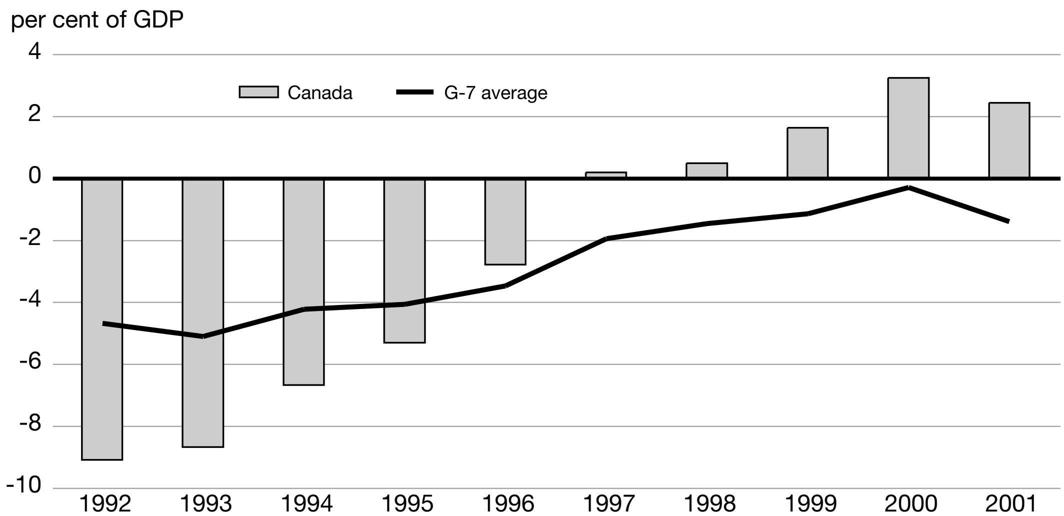
Federal and Provincial-Territorial Budgetary Balances
(Public Accounts Basis)



- The federal-provincial-territorial government sector is expected to record an aggregate surplus of $8.6 billion in 2001-02. This is the fourth consecutive year that this sector has been in surplus.

Canada's financial balance has improved significantly compared to the G-7 average

Total Government Financial Balances: Canada and the G-7
(National Accounts Basis)



Sources: *OECD Economic Outlook No. 71* (June 2002), Department of Finance calculations.

- Canada's total government sector financial position,[1] measured on a National Accounts basis (the measure commonly used to make comparisons across countries), has shown a similar substantial improvement since the early 1990s.

- Measured on this internationally comparable basis, the total government deficit peaked at 9.1 per cent of GDP in 1992, compared to the G-7 average deficit-to-GDP ratio of 4.7 per cent that same year.

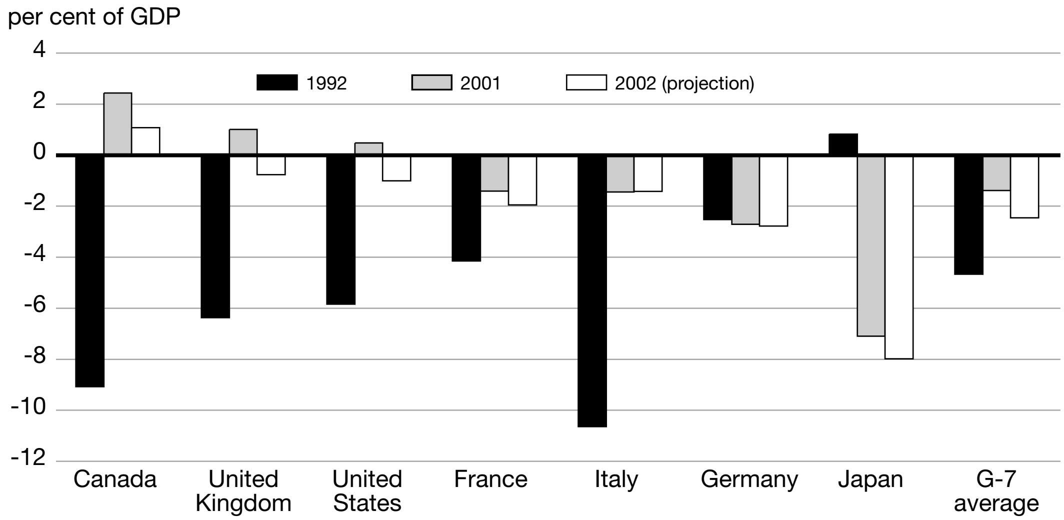
- By 1997, however, fiscal improvements at all levels of government enabled Canada's total government sector to post a surplus. Since that time Canada has consistently recorded the highest financial surplus of all G-7 countries, relative to the size of the economy.

- In 2001 Canada's total government sector surplus stood at 2.4 per cent of GDP, compared to an average deficit of 1.4 per cent of GDP in the G-7 countries.

[1] Includes federal, provincial-territorial and local governments as well as the Canada Pension Plan and Quebec Pension Plan.

Canada has achieved the largest improvement in its financial balance of any G-7 country

Total Government Financial Balances in G-7 Countries
(National Accounts Basis)

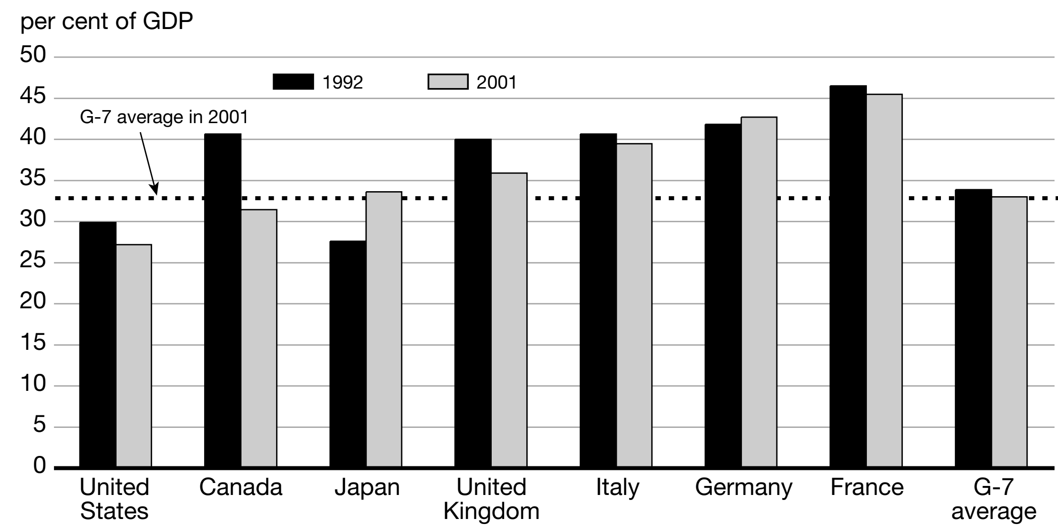


Sources: *OECD Economic Outlook No. 71* (June 2002), Department of Finance calculations.

- At the total government sector level, Canada made the greatest fiscal improvement of the G-7 countries from 1992 to 2001.
- In 1992 Canada had the second highest deficit of the G-7 countries in relation to GDP, whereas it posted the highest financial surplus relative to GDP in 2001. Over this period Canada's financial balance registered a turnaround of 11.5 percentage points.
- For 2002 the OECD projects that Canada will be the only G-7 country to record a surplus.

Canada's program spending as a share of GDP has been reduced to below the G-7 average

Total Government Program Spending in G-7 Countries
(National Accounts Basis)

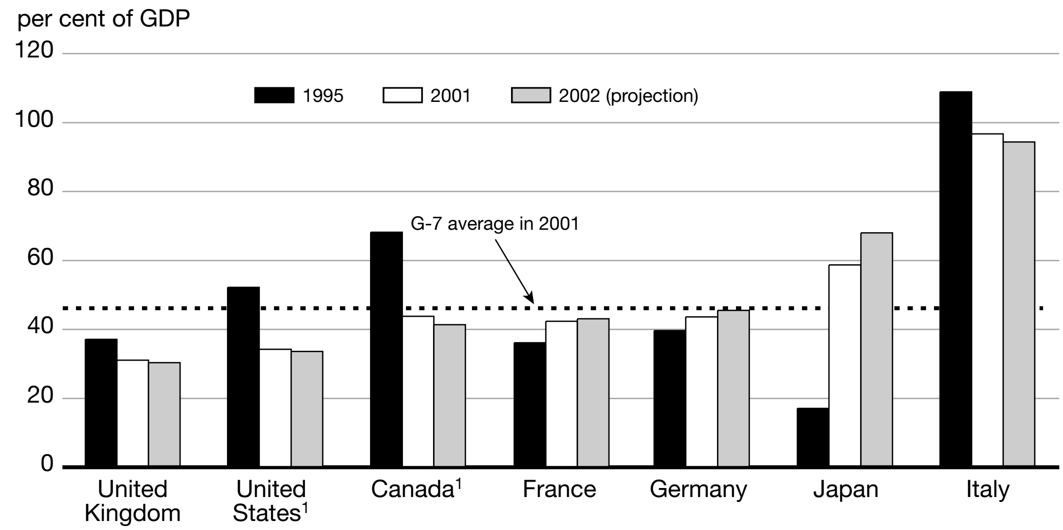


Sources: *OECD Economic Outlook No. 71* (June 2002), Department of Finance calculations.

- The rapid turnaround in Canada's financial position, as a percentage of GDP, is attributable in large part to a sharp reduction in program spending, i.e. all expenditures less gross debt charges.
- Between 1992 and 2001 Canada's total government program spending as a share of GDP was reduced by 9.2 percentage points, again a greater reduction than in any other G-7 country.
- Indeed, Canada's total government sector program spending, as a percentage of GDP, is now lower than in all other G-7 countries, with the exception of the US.

Canada has recorded the largest decline in the net debt-to-GDP ratio among the G-7 countries

Total Government Net Debt in G-7 Countries
(National Accounts Basis)



[1] Excludes government employee pension liabilities in order to be more comparable with other countries' debt measures.
Sources: *OECD Economic Outlook No. 71* (June 2002), Department of Finance calculations.

- Over the last six years Canada's total government sector has achieved the largest decline in the net debt-to-GDP ratio among the G-7 countries. Between 1995 and 2001 the ratio was reduced by 24.4 percentage points.
- As a result, Canada's total government net debt-to-GDP ratio is now below the G-7 average.
- According to the OECD, with Canada's economic growth expected to lead the G-7 countries this year and with a total government financial surplus expected, only the United Kingdom and the United States will have a lower net debt-to-GDP ratio than Canada in 2002.

Annex 3

Private Sector Five-Year Economic and Fiscal Projections

Highlights

- *The Department of Finance meets each fall with the chief economists of the major chartered banks and three private sector economic forecasting firms. The objective of this exercise, which was initiated in 1999, is to agree on a set of economic assumptions for planning purposes, which the three forecasting firms then use to develop status quo fiscal projections of the budgetary balance for the current fiscal year and each of the next five years.*
- *However, because of the greater degree of uncertainty associated with longer-term projections, budget decisions are made on a rolling two-year horizon.*
- *Prudence is an essential element of budget planning. Therefore, in order to arrive at an estimate of the fiscal surplus for planning purposes, the average fiscal surplus projections are adjusted to include:*
  - *$3 billion each year as a Contingency Reserve to guard against unforeseen circumstances. As usual, any year-end surplus goes to pay down debt; and*
  - *economic prudence to provide further assurance against going back into deficit.*
- *After subtracting the Contingency Reserve, the economic prudence and the impact of new policy decisions since the December 2001 budget from the average private sector forecast of the surplus, the surplus for planning purposes is estimated at $1.0 billion in 2002-03, $3.1 billion in 2003-04, $3.5 billion in 2004-05, $6.8 billion in 2005-06, $10.5 billion in 2006-07 and $14.6 billion in 2007-08.*

- *The smaller projections of the fiscal surplus in the short term reflect the lagged impacts of the slowdown in economic activity in 2001 on tax revenues, as well as the effects of the Agreements on Health Renewal and Early Childhood Development signed by first ministers in September 2000 and the $100-billion Five-Year Tax Reduction Plan, which fully matures in 2004. Thereafter larger fiscal-planning surpluses are projected.*

Framework for budget planning

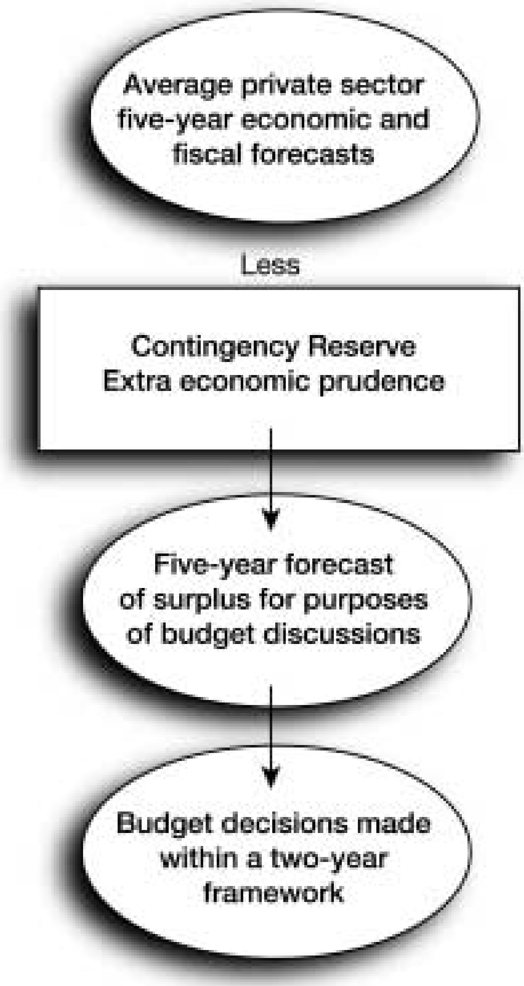
- Since 1993, the Government's approach to budget planning has involved a number of important steps.

- The first step involves using private sector economic forecasts for budget-planning purposes.
  - The Department of Finance conducts surveys of private sector economic forecasters. In total, about 20 forecasters are surveyed on a regular basis.
  - Each fall the Department of Finance conducts extensive consultations with an economic advisory group, which includes the chief economists of Canada's major chartered banks and leading economic forecasting firms. A key purpose of these consultations is to assess the risks associated with using the average of private sector economic forecasts for budget-planning purposes.

- The second step involves using these economic assumptions to develop status quo fiscal projections.
  - Since 1999, each fall the major private sector economic forecasting firms develop detailed status quo fiscal projections, on a National Accounts basis, for each of the next five years, based on tax and spending policies in place at that time, using the average of the private sector economic forecasts.
  - These forecasts are then translated into Public Accounts projections by the Department of Finance, in consultation with the private sector economic forecasting firms.

- The third step involves including in these fiscal projections for budget-planning purposes:
  - $3 billion each year in the Contingency Reserve to guard against unforeseen circumstances. As usual, any year-end surplus goes to pay down the public debt; and
  - an extra degree of economic prudence to provide further assurance against falling back into deficit.

Summary: framework for fall update and budget



- It is the view of the private sector economic advisory group that, for the purposes of public debate on policy options, a five-year time horizon is appropriate.
- However, it is also the view of the advisory group that great caution is warranted in the use of long-term projections as a basis for budget decisions. Therefore, budget decisions continue to be made on a rolling two-year horizon.

Assumptions underlying average private sector fiscal projections

Table 3.1
Average of Private Sector Economic Forecasts: September 2002 Survey

	2002	2003	2004-2008
		(per cent)	
Real GDP growth	3.4	3.5	3.0
GDP inflation	1.1	2.3	1.9
Nominal GDP growth	4.6	5.9	5.0
3-month Treasury bill rate	2.6	3.9	4.8
10-year government bond rate	5.3	5.5	5.8

Note: Based on a survey conducted by the Department of Finance in early September.
The number of respondents declines from 19 in 2003 to 6 in 2007 and 5 in 2008.

- As noted in Annex 1, average real gross domestic product (GDP) growth in the private sector survey of forecasters for the October 2002 update is 3.4 per cent in 2002 and 3.5 per cent in 2003. The average growth forecast over the 2004 to 2008 period is 3.0 per cent. GDP inflation is expected to average just under 2 per cent over the 2004 to 2008 period. As a result, nominal GDP growth is forecast to average 5.0 per cent over the same period. Short-term interest rates are expected to rise through to 2004. The average of private sector forecasts anticipates relatively flat interest rates between 2004 and 2008, along with consumer price inflation at the mid-point of the official target band of 1 to 3 per cent.

- Based on the private sector survey of forecasters for the October 2002 update, the three forecasting firms derived projections of the major components of the budgetary balance on a National Accounts basis, which were then converted into Public Accounts projections by the Department of Finance. The projections are based on the following assumptions:
  - The projections include the impact of the $100-billion Five-Year Tax Reduction Plan as set out in the October 2000 *Economic Statement and Budget Update*, the $23.4-billion Agreements on Health Renewal and Early Childhood Development signed by first ministers in September 2000, and the policy decisions announced in the December 2001 budget. In addition, fiscal projections have been adjusted, where appropriate, to take into account the impact of the final fiscal results for 2001-02 and those for the first five months of 2002-03.
  - The employment insurance premium rate assumptions are those used in the December 2001 budget – $2.20 (employee rate per $100 of insurable earnings) for 2002, declining to $2.00 by 2004.
  - The projections of public debt charges assume that the Contingency Reserve is not required and is applied each year to reducing the net public debt.

October 2002 status quo fiscal outlook – Average of private sector fiscal projections

Table 3.2
Surpluses for Purposes of Fiscal Planning

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
			(billions of dollars)			
Average of private sector fiscal projections	**5.0**	**8.9**	**9.7**	**14.1**	**18.3**	**22.8**
Initiatives announced since the December 2001 budget						
Canada Strategic Infrastructure Fund	0.1	0.1	0.3	0.5	0.5	0.4
Africa Fund	0.1	0.2	0.1	0.1		
Support for agriculture	0.7	1.3	0.8	0.8	0.8	0.8
Softwood lumber assistance	0.1	0.2				
Total	1.0	1.8	1.2	1.3	1.3	1.2
Average of private sector projections adjusted for policy initiatives	4.0	7.1	8.5	12.8	17.0	21.6
Prudence						
Economic prudence		1.0	2.0	3.0	3.5	4.0
Contingency Reserve	3.0	3.0	3.0	3.0	3.0	3.0
Total	3.0	4.0	5.0	6.0	6.5	7.0
Surplus for planning purposes	**1.0**	**3.1**	**3.5**	**6.8**	**10.5**	**14.6**

Note: Numbers may not add due to rounding.

- The fiscal surplus for planning purposes for the upcoming budget is derived from the average of the private sector fiscal projections.

- The average of the three forecasting firms' fiscal projections, converted to a Public Accounts basis but prior to adjusting for the Contingency Reserve, economic prudence and new policy initiatives, results in a fiscal surplus of $5.0 billion in 2002-03, $8.9 billion in 2003-04, $9.7 billion in 2004-05, $14.1 billion in 2005-06, $18.3 billion in 2006-07 and $22.8 billion in 2007-08.

- These projections are then adjusted to include the impact of policy decisions since the December 2001 budget and prudence.

- The net fiscal impact of the policy initiatives since the December 2001 budget amounts to $1.0 billion in 2002-03, $1.8 billion in 2003-04 and about $1.2 billion per year thereafter.
  - In the December 2001 budget the Canada Strategic Infrastructure Fund (with a minimum federal contribution of $2 billion) and the Africa Fund ($500 million) were announced. The original intention was that these initiatives would be set up as arm's-length organizations, funded from the 2001-02 surplus funds at year-end. However, on February 4, 2002, the Government announced that these initiatives would be part of regular program spending, with the costs recorded in the year the expenditures are made.
  - In September 2002 the federal, provincial and territorial governments agreed in principle on a long-term action plan for an agricultural policy framework, with the objective of making Canada the world leader in food safety, innovation and environmentally responsible production. In addition, further income assistance is provided over the next two years to assist farmers affected by current drought conditions. The federal cost amounts to $5.3 billion over the next six years.
  - Assistance has also been provided to workers and communities affected by the softwood lumber dispute with the United States.
- The projections are adjusted to reflect the economic prudence and Contingency Reserve.
  - In the December 2001 budget the unforeseen circumstances of both the global economic slowdown and the terrorist attacks of September 11th created fiscal pressures, which needed to be addressed. Given the surplus available at that time, the Government decided to use the economic prudence and part of the Contingency Reserve for each year of the December 2001 budget plan. However, the Government indicated that it would rebuild the economic prudence and Contingency Reserve as soon as possible.
  - The full Contingency Reserve of $3 billion per year has been re-established.
  - In addition, for planning purposes, the economic prudence has been set at $1 billion in 2003-04, $2 billion in 2004-05, $3 billion in 2005-06, $3.5 billion in 2006-07 and $4 billion in 2007-08.
- Therefore, after these adjustments the fiscal surplus for planning purposes is $1.0 billion in 2002-03, $3.1 billion in 2003-04, $3.5 billion in 2004-05, $6.8 billion in 2005-06, $10.5 billion in 2006-07 and $14.6 billion in 2007-08.

October 2002 status quo fiscal outlook – Average of private sector fiscal projections

Table 3.3
Summary Statement of Transactions

	2001-02[1]	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
	(billions of dollars)						
Budgetary transactions							
Budgetary revenues	173.3	173.9	184.1	191.9	201.5	211.2	221.0
Program spending	126.7	134.3	140.7	146.6	152.4	158.0	163.6
Operating balance	46.6	39.6	43.4	45.2	49.1	53.2	57.4
Public debt charges	37.7	35.6	36.3	36.7	36.3	36.1	35.9
Budgetary surplus	8.9	4.0	7.1	8.5	12.8	17.0	21.6
Prudence							
Contingency Reserve		3.0	3.0	3.0	3.0	3.0	3.0
Economic prudence			1.0	2.0	3.0	3.5	4.0
Total		3.0	4.0	5.0	6.0	6.5	7.0
Planning surplus		**1.0**	**3.1**	**3.5**	**6.8**	**10.5**	**14.6**
Per cent of GDP							
Budgetary revenues	15.9	15.2	15.2	15.1	15.1	15.0	15.0
Program spending	11.6	11.8	11.6	11.5	11.4	11.3	11.1
Public debt charges	3.5	3.1	3.0	2.9	2.7	2.6	2.4
Budgetary surplus	0.8	0.4	0.6	0.7	1.0	1.2	1.5
Net debt							
Assuming balanced budget	49.1	47.0	44.4	42.1	40.1	38.2	36.4
Assuming Contingency Reserve applied to debt reduction	49.1	46.7	43.9	41.4	39.2	37.1	35.2

Note: Numbers may not add due to rounding.
[1] Actual results.

- Table 3.3 sets out the fiscal projections based on the September 2002 survey of private sector economic projections to 2007-08.

- Adjusted for the policy decisions since the December 2001 budget and for the Contingency Reserve, the surplus for planning purposes is $1.0 billion for 2002-03. The outlook for 2002-03 is consistent with the fiscal results for the first five months of 2002-03. For the period April to August 2002 there was a budgetary surplus of $4.6 billion, down $6.8 billion from the surplus of $11.4 billion reported in the same period of 2001-02. Given the seasonal pattern of revenues and spending over the balance of the fiscal year, this surplus should be reduced to an estimated $4.0 billion by year-end. Excluding the $3-billion Contingency Reserve results in a planning surplus of $1.0 billion for 2002-03. The fiscal outlook for the current fiscal year is affected by the lagged impact of the economic slowdown in 2001, as significantly higher personal and corporate income tax refunds related to lower earnings and losses in 2001 are depressing the growth in budgetary revenues in 2002-03.

- Thereafter somewhat larger fiscal-planning surpluses are projected. However, they remain constrained through 2004-05, reflecting the impact of the $100-billion tax reduction measures announced and legislated in the October 2000 *Economic Statement and Budget Update* and increased transfers to provinces and territories under the September 2000 Agreements on Health Renewal and Early Childhood Development reached by first ministers. Other budget measures, specifically the enhancements to employment insurance benefits and the security measures announced in the December 2001 budget, also impact on the fiscal outlook over the short term. After 2004-05 larger fiscal-planning surpluses are projected.

- The revenue-to-GDP ratio was estimated at 15.9 per cent in 2001-02, down significantly from 16.9 per cent in 2000-01. This primarily reflects the impact of tax reduction measures. It is expected to decline to 15.2 per cent in 2002-03 and to 15.1 per cent in 2004-05, as the Five-Year Tax Reduction Plan is fully put in place. The revenue ratio remains relatively stable thereafter.

- The program spending-to-GDP ratio increased to 11.6 per cent in 2001-02 from 11.2 per cent in 2000-01, primarily reflecting the impact of a slowing economy and the fiscal costs of the Agreements on Health Renewal and Early Childhood Development and changes to the employment insurance program. The ratio is projected to increase slightly in 2002-03, before again resuming its downward path.

- The net debt-to-GDP ratio stood at 49.1 per cent in 2001-02. If the Contingency Reserve is not needed and the $3 billion per year is used to reduce net debt, the net debt-to-GDP ratio would decline to under 40 per cent in 2005-06 and to about 35 per cent in 2007-08 – a decline of over half from its peak of 70.9 per cent in 1995-96.

Average private sector projections of budgetary revenues

Table 3.4
Budgetary Revenues – October 2002 Update: Private Sector Average

	2001-02[1]	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
			(millions of dollars)				
Income tax							
Personal income tax	83,790	82,300	88,156	92,365	97,987	103,260	108,788
Corporate income tax	24,013	22,500	24,765	25,706	26,478	27,301	28,038
Other income tax	3,035	3,750	3,942	4,060	4,136	4,236	4,316
Total income tax	110,838	108,550	116,862	122,131	128,601	134,796	141,142
Employment insurance revenues	17,980	18,246	18,081	18,307	19,129	19,996	20,948
Excise taxes/duties							
Goods and services tax	24,909	26,700	28,413	29,991	31,763	33,678	35,664
Customs import duties	3,018	3,170	3,202	3,382	3,532	3,668	3,775
Energy taxes	4,758	4750	4,873	4,975	5,101	5,213	5,335
Other excise taxes/duties	3,953	4,694	4,772	4,885	5,022	5,157	5,283
Total	36,638	39,314	41,260	43,234	45,418	47,717	50,057
Total tax revenues	165,456	166,110	176,203	183,672	193,148	202,509	212,147
Non-tax revenues							
Return on investments	5,892	5,739	5,774	6,011	6,145	6,374	6,523
Other non-tax revenues	1,967	2,092	2,142	2,192	2,242	2,292	2,342
Total	7,859	7,831	7,916	8,203	8,387	8,666	8,865
Total budgetary revenues	173,315	173,941	184,119	191,875	201,535	211,175	221,012
Per cent of GDP							
Personal income tax	7.7	7.2	7.3	7.2	7.3	7.4	7.4
Corporate income tax	2.2	2.0	2.0	2.0	2.0	1.9	1.9
Employment insurance revenues	1.6	1.6	1.5	1.4	1.4	1.4	1.4
Goods and services tax	2.3	2.3	2.4	2.4	2.4	2.4	2.4
Other excise	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Tax revenues	15.1	14.5	14.6	14.4	14.4	14.4	14.4
Non-tax revenues	0.7	0.7	0.7	0.6	0.6	0.6	0.6
Total	15.9	15.2	15.2	15.1	15.1	15.0	15.0

Note: Numbers may not add due to rounding.

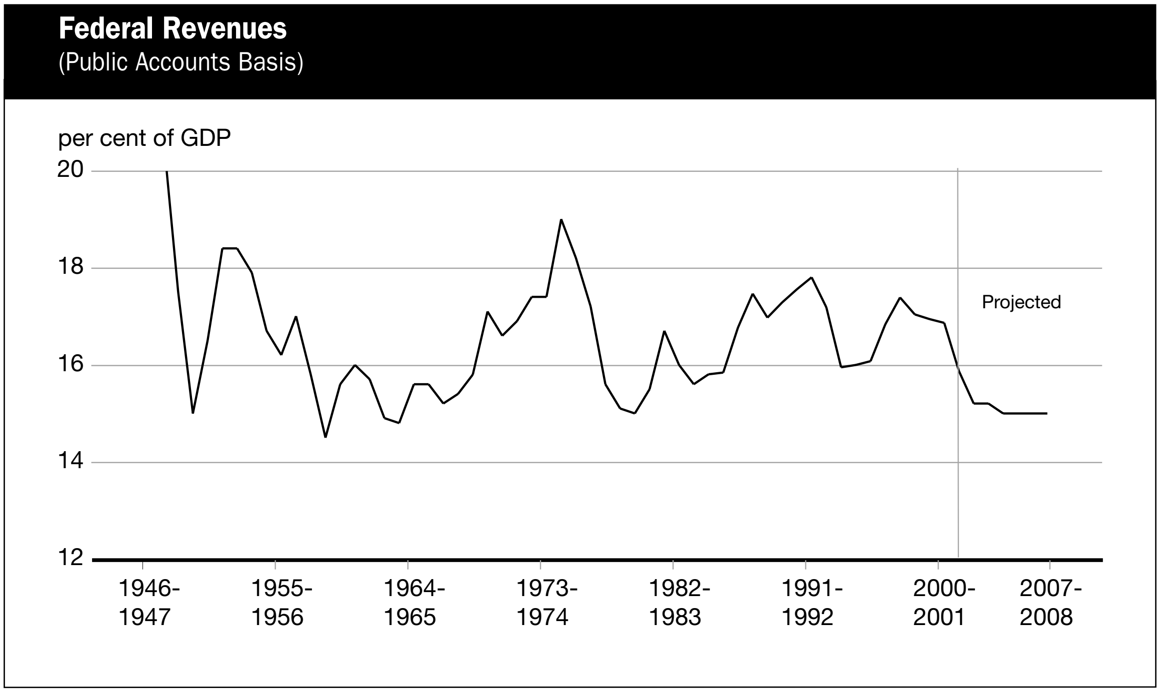
1 Actual results.

- Based on the economic-planning assumptions described in Annex 1, budgetary revenues are expected to remain virtually unchanged in 2002-03 from 2001-02. This reflects the lagged impact of the economic weakness in 2001 on tax collections, especially personal and corporate income tax revenues.

- As reported in the August 2002 *Fiscal Monitor*, both personal and corporate income tax revenues are down significantly in the first five months of 2002-03 from the same period of 2001-02. This deterioration primarily reflects the decline in the stock market in 2001, which resulted in higher personal income tax refunds and lower settlement payments in April and May 2002. In addition, corporate income tax refunds are higher, as corporations are applying losses experienced in 2001 to taxes paid in previous years. These largely one-time adjustments depressed revenues in the first half of 2002-03. Increases in budgetary revenues are expected over the balance of the year, thereby offsetting the declines recorded in the first half.

- Thereafter the profile of revenues reflects the impact of sustained economic growth and the ongoing impact of the $100-billion Five-Year Tax Reduction Plan. Beyond 2004-05 revenue growth is somewhat stronger, as the tax reduction plan is fully implemented.

Revenue ratio permanently lowered due to tax cuts



- A more revealing picture of movements in tax revenue can be obtained by examining the "revenue ratio" – total federal revenues in relation to the total income in the economy (or GDP).
- This ratio primarily reflects the impact of policy decisions and economic developments. The large decline in the ratio following World War II was largely attributable to the lowering of taxes and the ending of special arrangements with the provinces to finance the war effort. The reform of the income tax system and the transfer of tax points to the provinces were largely responsible for the reduction in the ratio from 1972-73 to 1977-78. Economic developments accounted for most of the remaining fluctuations in this ratio. It declines during economic downturns and tends to increase during recoveries, reflecting the progressive nature of the tax system and the cyclical nature of corporate profits.
- Looking forward, the revenue ratio is projected to be significantly lower than in the past. This is attributable to the ongoing impact of the Five-Year Tax Reduction Plan, which has lowered the ratio on a permanent basis.
- The revenue ratio is projected to decline from 16.9 per cent in 2000-01 to 15.1 per cent by 2004-05 – a level not seen since the early 1960s – and to remain relatively stable thereafter.

Average private sector projections of total program spending

Table 3.5
Program Spending – October 2002 Update: Private Sector Average

	2001-02[1]	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
	(millions of dollars)						
Major transfers to persons							
Elderly benefits	25,365	26,559	27,639	28,618	29,629	30,736	32,012
Employment insurance benefits	13,748	15,356	15,284	15,883	16,685	17,387	17,905
Total	39,113	41,915	42,923	44,501	46,315	48,123	49,916
Major transfers to other levels of government							
Canada Health and Social Transfer	17,300	18,600	19,300	20,400	21,000	21,600	22,200
Fiscal arrangements	12,010	12,704	13,420	14,133	14,817	15,537	16,279
Alternative Payments for Standing Programs	-2,662	-2,544	-2,697	-2,752	-2,779	-2,876	-2,977
Total	26,648	28,760	30,023	31,781	33,038	34,261	35,502
Direct program spending	60,944	63,662	67,724	70,365	73,074	75,623	78,158
Total program spending	126,705	134,337	140,670	146,647	152,427	158,007	163,576
Per cent of GDP							
Major transfers to persons							
Elderly benefits	2.3	2.3	2.3	2.2	2.2	2.2	2.2
Employment insurance benefits	1.3	1.3	1.3	1.2	1.2	1.2	1.2
Total	3.6	3.7	3.6	3.5	3.5	3.4	3.4
Major transfers to other levels of government							
Canada Health and Social Transfer	1.6	1.6	1.6	1.6	1.6	1.5	1.5
Fiscal arrangements	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Alternative Payments for Standing Programs	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Total	2.4	2.5	2.5	2.5	2.5	2.4	2.4
Direct program spending	5.6	5.6	5.6	5.5	5.5	5.4	5.3
Total program spending	11.6	11.8	11.6	11.5	11.4	11.3	11.1

Note: Numbers may not add due to rounding.
[1] Actual results.

- The projections of program spending in Table 3.5 include the impact of the Agreements on Health Renewal and Early Childhood Development reached in September 2000, the February 2000 budget and September 2000 enhancements to employment insurance benefits, and initiatives announced in the December 2001 budget. They also include initiatives announced since the 2001 budget, which are shown in Table 3.2.

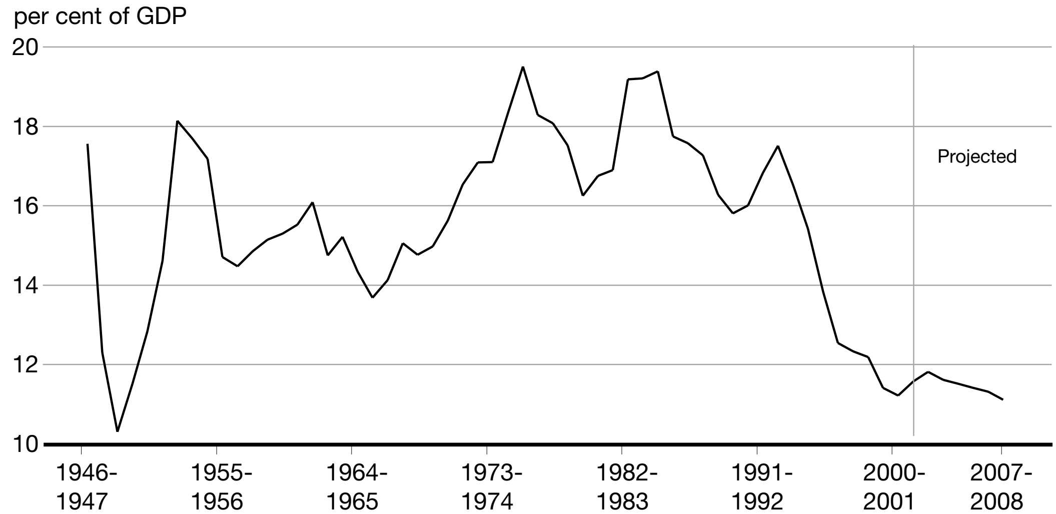
- Program spending is divided into three major components: major transfers to persons, major transfers to other levels of government and direct program spending.

- Based on the average of the projections provided by three forecasting firms, total program spending is estimated to increase from $126.7 billion in 2001-02 to $134.3 billion in 2002-03, representing an increase of 6.0 per cent. This increase of $7.6 billion is spread among all three major components of program spending.
  - Major transfers to persons, consisting of elderly and employment insurance benefits, are expected to increase by $2.8 billion, or 7.2 per cent. The growth in elderly benefits is largely determined by the growth in the elderly population and average benefits, which are fully indexed to quarterly changes in consumer prices. The growth in employment insurance benefits reflects the lagged impact of the economic slowdown in 2001 as well as the effect of program enhancements. The latter includes the extension of and related changes to parental benefits and modifications to the intensity and clawback provisions.
  - Major transfers to other levels of government are expected to increase by $2.1 billion, or 7.9 per cent. Under the Agreements on Health Renewal and Early Childhood Development reached by first ministers in September 2000, cash under the Canada Health and Social Transfer (CHST) increases by $1.3 billion in 2002-03. An increase of $0.7 billion is expected in fiscal arrangements, primarily for equalization entitlements, which for planning purposes are assumed to grow in line with nominal GDP.
  - Direct program spending is expected to increase by $2.7 billion, or 4.5 per cent, reflecting the impact of the security measures announced in the December 2001 budget as well as new spending decisions announced since the budget.

- Thereafter, on a status quo policy basis, the rate of growth in program spending is projected to slow as the measures announced in previous budgets are fully reflected in the spending projections and the impact of an improving labour market restrains the growth in employment insurance benefits. For planning purposes, a continuation of the increase in CHST cash transfers in 2005-06 is assumed for both 2006-07 and 2007-08.

Program spending as a share of GDP continues to decline

Federal Program Spending
(Public Accounts Basis)



- Program spending as a per cent of GDP, on a status quo basis, is expected to increase slightly in 2002-03, reflecting the impact of higher cash transfers to the provinces and increased employment insurance benefits.
- Beyond 2002-03, on a status quo basis, the ratio declines as the growth in the economy exceeds that in program spending.

Sensitivity of the fiscal outlook to economic shocks

Table 3.6
Estimated Change in Fiscal Position

	Year 1	Year 2
	(billions of dollars)	
1-per-cent decrease in real GDP growth		
Revenue impact	-1.8	-1.9
Expenditure impact	0.5	0.7
Deterioration in fiscal balance	-2.4	-2.6
1-per-cent decline in GDP inflation		
Revenue impact	-1.9	-1.8
Expenditure impact	-0.5	-0.5
Deterioration in fiscal balance	-1.4	-1.3
100-basis-point decrease in interest rates		
Revenue impact	-0.4	-0.5
Expenditure impact	-1.1	-1.9
Improvement in fiscal balance	0.8	1.4

Note: Numbers may not add due to rounding.

- The fiscal projections are extremely sensitive to changes in economic assumptions – particularly to changes in real economic (GDP) growth, inflation and interest rates.

- A decrease in the growth of real GDP (through equal reductions in employment and productivity) would lead to lower federal government revenues through a contraction in various tax bases and an increase in spending, primarily due to higher employment insurance benefits. Using standard sensitivity analysis, a 1-per-cent decrease in real GDP for one year would lower the budgetary balance by $2.4 billion in the first year and by $2.6 billion in the second year.

- A 1-per-cent reduction in the growth of nominal GDP resulting solely from a 1-per-cent decline in the rate of GDP inflation would lower the budgetary balance by $1.4 billion in the first year and $1.3 billion in year two. Most of the impact would be on budgetary revenues, as wages and profits would be lower, as well as the price of goods and services subject to sales and excise taxes. The impact on expenditures would be largely reflected in programs that are indexed to inflation, such as elderly benefit payments.

- A sustained 100-basis-point decline in all interest rates would improve the budgetary balance by $0.8 billion in the first year, rising to $1.4 billion in year two. This improvement comes solely from the reduction in public debt charges, which reduces overall budgetary expenditures. Expenditures would fall by $1.1 billion in the first year and $1.9 billion in year two, as longer-term debt matures and is refinanced at the lower rates. Moderating this impact are somewhat lower interest earnings on the Government's interest-bearing assets, which are recorded as part of non-tax revenues.

Annex 4

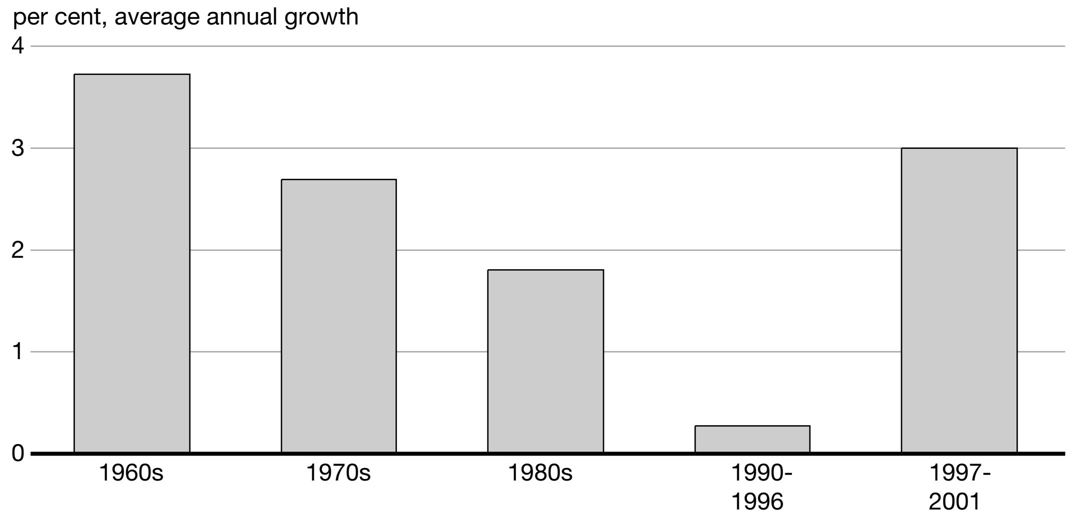
Improving Canadian Living Standards

Highlights

- *The central objective of economic and social policy is to enhance the well-being of people through higher living standards and a higher quality of life.*
- *Growth in Canada's living standards has increased substantially over the past five years, more than in any other Group of Seven (G-7) country.*
- *Our superior performance since 1997 has narrowed the gap in living standards between Canada and the United States, but a sizeable gap remains.*
- *Both stronger productivity growth and labour market progress have been responsible for narrowing the Canada-US living standards gap since 1997. Looking ahead, population aging will limit the scope for further large contributions from employment and we will need to look predominantly to stronger productivity growth to raise living standards and help close the gap with the United States.*
- *Economic factors such as fiscal and monetary stability, competitive taxes, investment in learning, new technologies and research and innovation are all key to helping Canada improve its productivity performance. Equally important is building a stronger society to give Canadians a higher quality of life and the skills and confidence to participate in the new economy.*
- *Only through integrated and complementary economic and social progress will Canada achieve its goal of strong and sustainable living standards growth along with a better quality of life for all Canadians in the future.*

Canadian living standards growth slowed in the 1980s and early 1990s, but has rebounded since 1997

Growth in Canadian Real GDP Per Capita



Source: Statistics Canada.

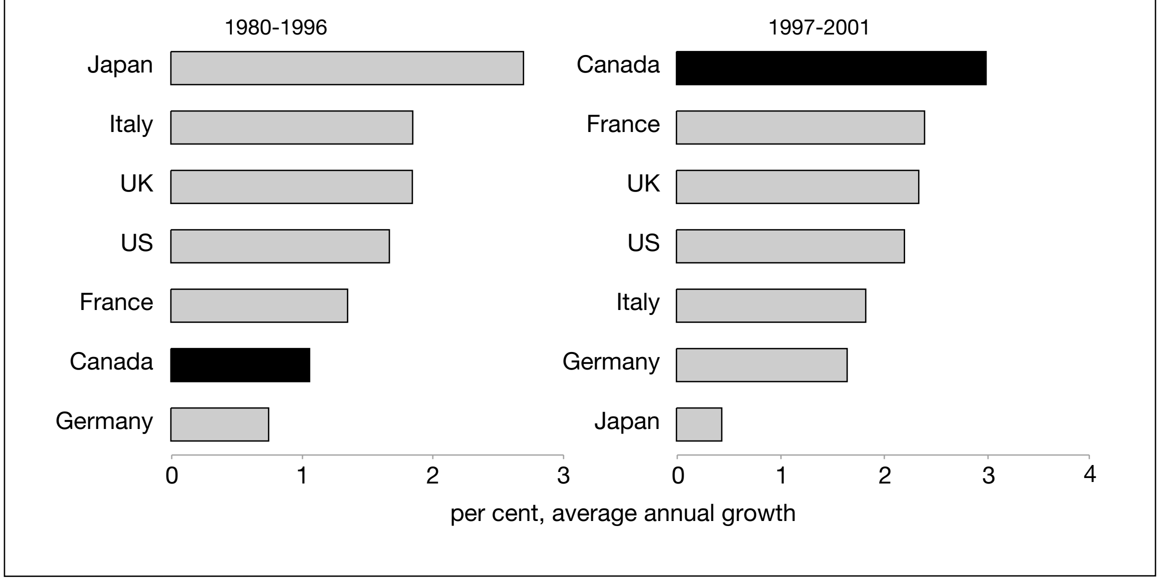
- The most commonly used measure of living standards is real (inflation-adjusted) GDP per capita. GDP is a measure of all goods and services produced in the country in a year. Equivalently, GDP measures the amount of income generated in Canada during a year, including wages and salaries, business profits and earnings from self-employment.

- In the 1960s and 1970s real GDP per capita grew rapidly in Canada, averaging over 3 per cent per year. However, this was followed by slow growth in the 1980s and almost no growth in the first half of the 1990s.

- Since 1997, with governments balancing their budgets, Canada's living standards performance has turned around substantially. Real GDP per capita has grown by an average rate of 3 per cent per year, similar to that achieved over the 1960s and 1970s.

Canada's performance relative to other G-7 countries has improved significantly

Growth in Real GDP Per Capita in G-7 Countries



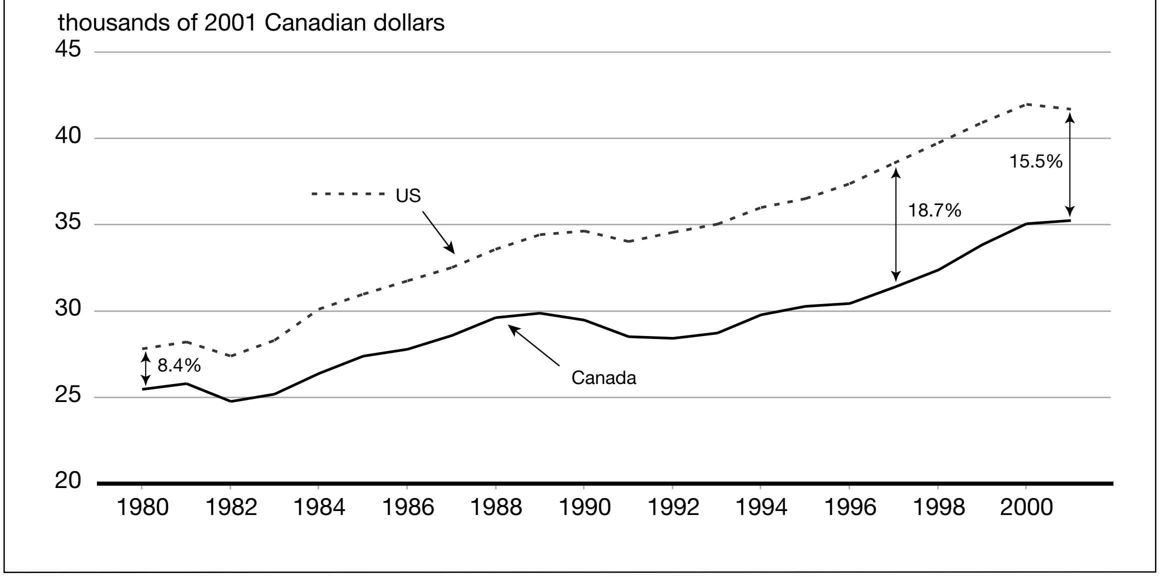
Source: *OECD Economic Outlook No. 71* (June 2002).

- Over the 1980-1996 period, a period when Canada was experiencing sustained and large fiscal deficits, it ranked second last among the G-7 countries and 22nd among all Organisation for Economic Co-operation and Development (OECD) countries in terms of real GDP per capita growth.

- The 1997-2001 period marked a major turnaround, with real GDP per capita growing faster in Canada than in any other G-7 country. Our ranking among OECD countries improved from 22nd to 9th place over this period.

The living standards gap with the United States has narrowed over the last five years but remains sizeable

Real GDP Per Capita: Canada and the US



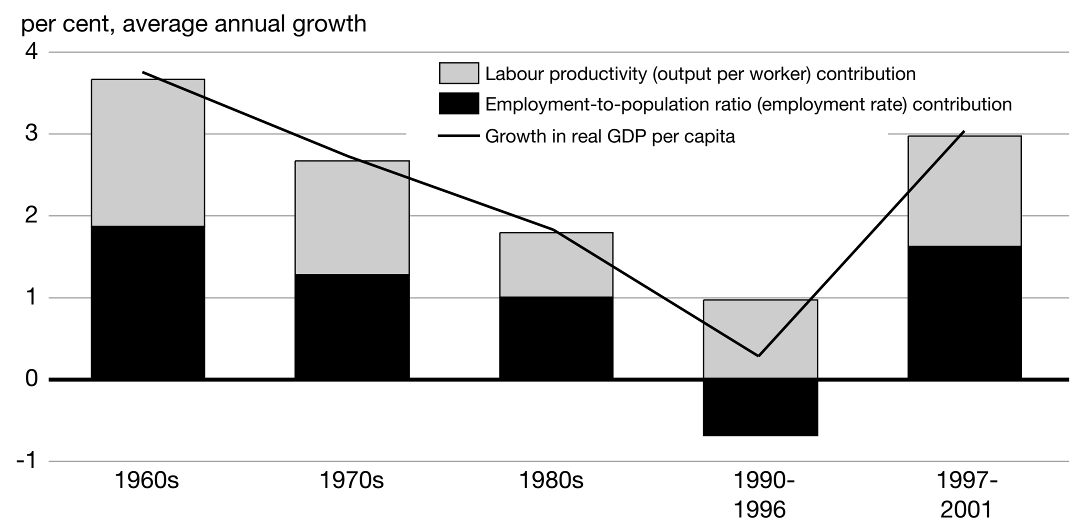
Note: Based on Statistics Canada's bilateral purchasing power parity of 0.85 US$/C$ for 2001.

Source: Department of Finance calculations based on data from Statistics Canada and the US Bureau of Economic Analysis.

- The living standards gap between Canada and the United States, which stood at 8.4 per cent in 1980, widened through the 1980s and the first half of the 1990s, peaking at almost 19 per cent in 1997.
- With Canada's strong economic performance over the past five years, the gap has started to narrow to roughly 15 per cent; however, it remains sizeable.
- Clearly, one of Canada's key challenges in the future is to further narrow and eventually close our standard of living gap with the United States.

Strong employment growth and faster labour productivity growth have both contributed to the recent living standards growth rebound

Contribution to Real GDP Per Capita Growth



Source: Department of Finance calculations based on Statistics Canada data.

- Living standards can be raised by increasing the share of the population that is working (the employment rate) or by growth in productivity (the average value of goods and services produced by each person working).

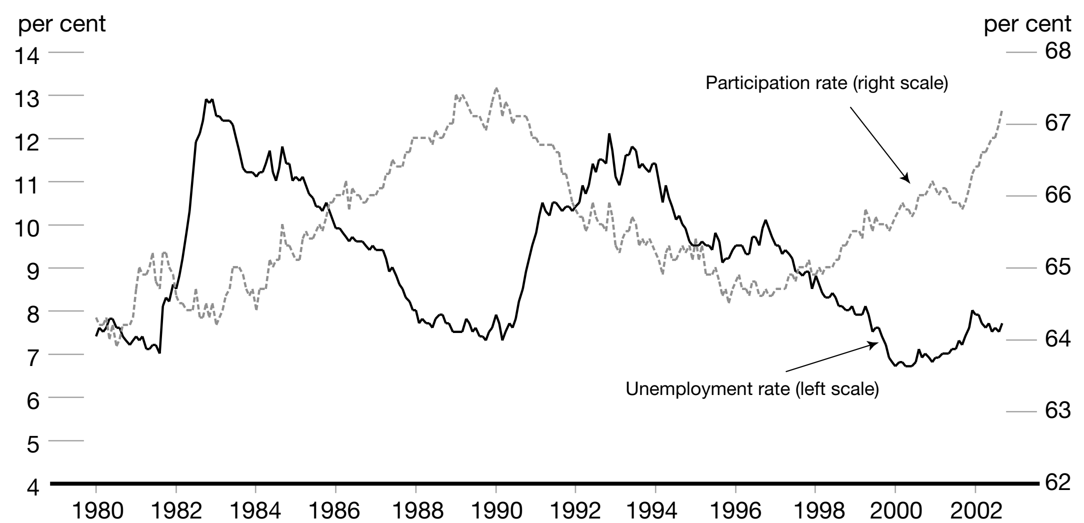
- In the 1960s and 1970s living standards growth was generated by both strong labour productivity growth and a rising employment rate, as the baby boom generation entered the labour market and the participation rate of women increased.

- By the 1980s the growth in both productivity and the employment rate had slowed significantly, and in the early 1990s the employment rate fell. As a result, the growth in our standard of living virtually stalled between 1990 and 1996, with increases averaging only 0.3 per cent annually.

- Real GDP per capita growth has rebounded significantly since 1997, generated by both a sizeable increase in the employment rate and a strong improvement in labour productivity growth.

Labour market progress has been responsible for narrowing the Canada-US living standards gap over the past five years ...

Unemployment and Participation Rates

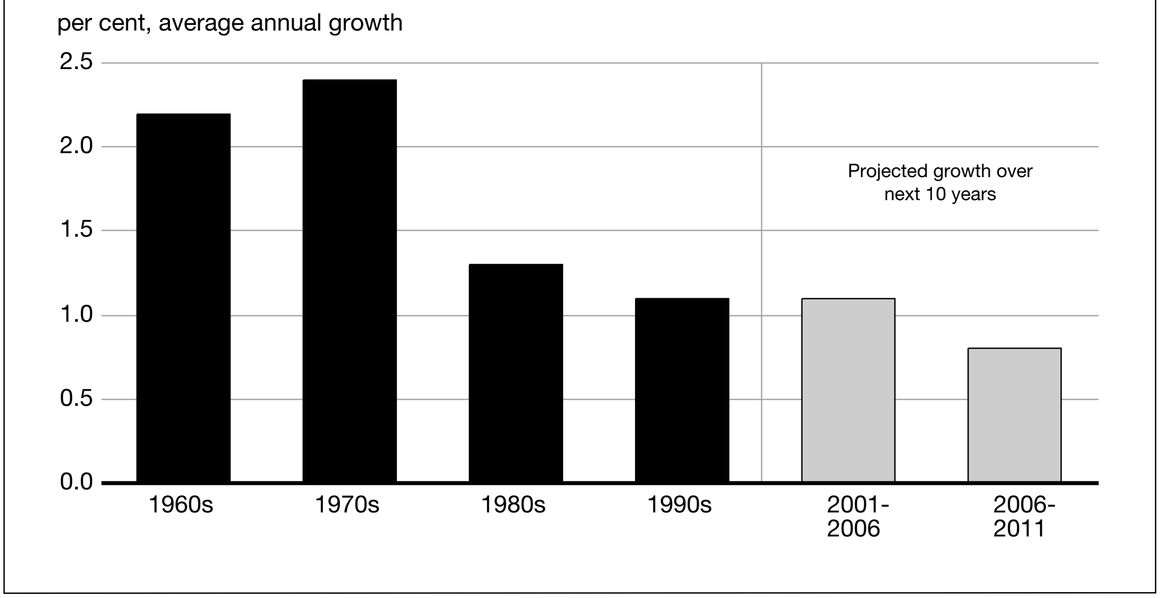


Source: Statistics Canada.

- The rebound in the employment rate since 1997 reflects a rise in the proportion of the population in the labour force (the participation rate) and a decline in Canada's unemployment rate.
  - The participation rate increased by 1.3 percentage points from 1996 to 2001, after declining through the early 1990s. It has continued to rise in 2002 and is now above the US rate for the first time since 1991.
  - Canada's average annual unemployment rate declined by 2.4 percentage points from 1996 to 2001, from 9.6 per cent to 7.2 per cent. In contrast, the US unemployment rate declined by only 0.6 percentage points over the same period.
  - In 2001, 1.6 million more Canadians were working than five years earlier. Canada's job creation record over this period was the best among the G-7 countries, including the United States.

... but population aging will limit the scope for further large increases in the employment rate

Growth in Working-Age Population (Aged 15-64)

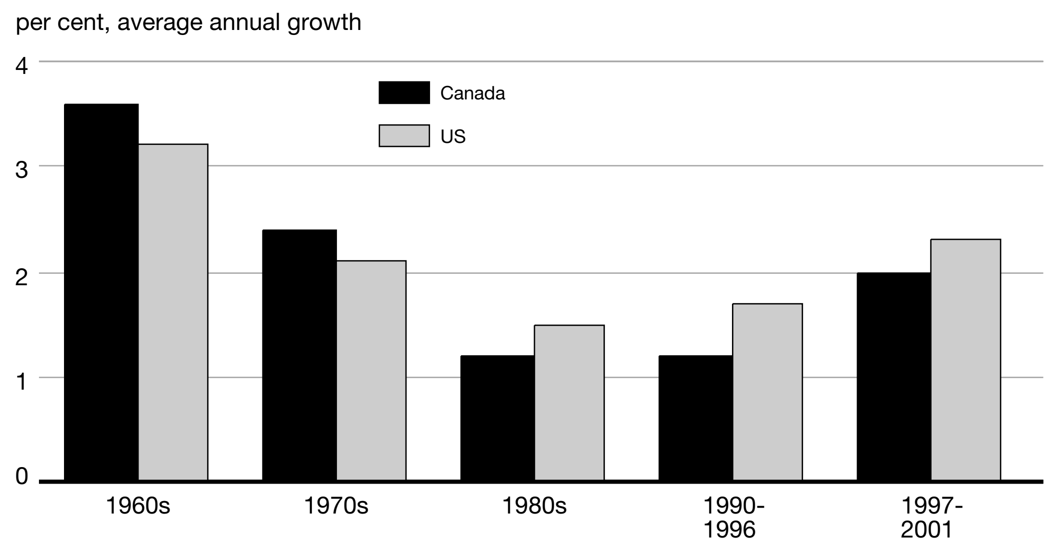


Source: Department of Finance calculations based on Statistics Canada data.

- Looking ahead, there will be less potential for Canada to make further gains in living standards growth through increases in the employment rate.
  - The participation rate is near its historical peak.
  - The unemployment rate has declined and while it could certainly fall further, declines of the magnitude seen over the past decade are unlikely. Canada has narrowed its unemployment rate gap with the US from almost 5 percentage points in late 1996 to 2.1 percentage points in September 2002.
  - Growth in the working-age population (aged 15-64), which was a key factor behind the growth in overall employment during the 1960s and 1970s, has since slowed considerably. Demographic projections show that working-age population growth will slow even further as the baby boom generation reaches retirement age.
- As a result, we cannot count on a rising employment rate as a key source of living standards growth in the future; improvements in living standards will have to come predominantly from productivity improvements.

Closing the Canada-US living standards gap will require faster productivity growth

Business Sector Labour Productivity[1] Growth in Canada and the US



[1] Measured as output per hour worked.

Source: Department of Finance calculations based on data from Statistics Canada and the US Bureau of Economic Analysis.

- In the 1960s and 1970s Canadian business sector labour productivity growth outpaced that of the United States. However, in the 1980s it lagged US growth, with the gap widening further in the first half of the 1990s.

- Since then Canadian productivity growth rates have increased significantly, almost catching up with those in the United States even as US productivity growth surged ahead. Average hourly business sector labour productivity growth in Canada rose from 1.2 per cent between 1990 and 1996 to 2.0 per cent over the 1997-2001 period, whereas in the US it rose from 1.7 per cent to 2.3 per cent. However, a sizeable gap in the levels of productivity performance between the two countries remains.

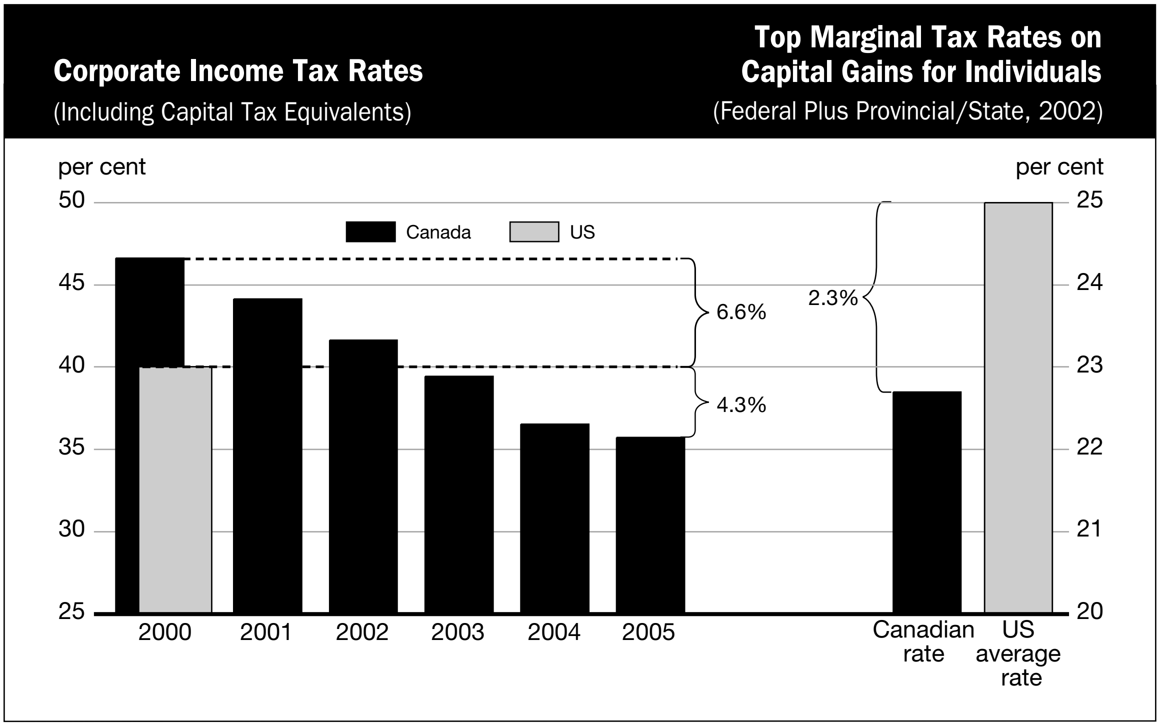
- Looking forward, given the more limited scope for the employment rate to increase, labour productivity growth in Canada will need to exceed that of the United States if we are to close the living standards gap with the US.

Economic factors that influence productivity

Key Economic Factors
✓ Fiscal and monetary stability
✓ Research and innovation
✓ Investment in machinery and equipment
✓ Adequate access to financing for firms
✓ Openness to trade and foreign investment
✓ Favourable business climate

- Canadian businesses must be the catalysts for raising productivity growth. However, there are a number of areas in which government policy can play a role – to help create the right economic conditions to support private sector productivity growth.
- A stable macroeconomic environment with balanced budgets and low inflation brings lower interest rates and boosts confidence, thereby encouraging investment, which is an important source of productivity growth.
- Government support for research and innovation helps provide the funding needed for firms and researchers to create new products, processes and services that enhance their productivity. Access to capital is also critical to fostering innovative companies – for new businesses as well as those at various stages of development.
- Openness to trade and foreign investment allows goods and services to move freely across countries and allows Canadians to benefit from technological developments abroad.
- A favourable business climate includes factors such as supportive, more efficient regulation and competitive taxes. Lower personal taxes improve incentives to work, save and invest; lower corporate and capital gains taxes encourage entrepreneurship and innovation and stimulate investment.
- Governments have been making a significant number of contributions in Canada on these fronts over the past few years.

Canada's recent $100-billion tax cut created tax advantages for firms and entrepreneurs to grow



Source: Department of Finance.

- For example, in the 2000 budget and October 2000 *Economic Statement and Budget Update*, the Government introduced a five-year, $100-billion plan of tax reductions – the largest tax cuts in Canadian history. The tax reduction plan announced significant personal income tax reductions and created tax advantages for firms and entrepreneurs to grow:
  - By 2004–05, federal personal income taxes will be 21 per cent less on average and 27 per cent less for families with children.
  - Combined with tax reductions by the provinces, the average general corporate tax rate in Canada will fall below that of the US in 2003, from almost 7 percentage points above the US rate in 2000. By 2005 firms in Canada will have a 4.3-per-cent corporate income tax rate advantage over their US counterparts (including capital taxes).
  - Canada's top marginal capital gains tax rate is now lower than the typical top US rate.
  - As well, the employment insurance premium rate has been reduced by 28 per cent, falling from $3.07 in 1994 to $2.20 in 2002.
- These tax reductions will enhance incentives to work, save and invest, help create jobs and improve our productivity performance.

Social factors can support a productive economy

Key Social Factors

✓ Helping children and families

✓ Medicare/health

✓ Social policies geared to learning
  – Early childhood development, kindergarten to grade 12, post-secondary education, on-the-job training

✓ Healthy communities

- Progress on the economic front is key to raising productivity and living standards, but equally important is improving our social capital by investing in people and the infrastructure that supports them. Canada's education and health care systems, for example, provide Canadians with the skills and the sense of security that allow them to participate in the economy with confidence. Equally, they provide Canadian businesses with a competitive advantage in the global marketplace.

- As an example of combining good social policy with good economic policy, the National Child Benefit supplement, the federal contribution to the National Child Benefit initiative (a joint federal-provincial-territorial initiative) and a component of the Canada Child Tax Benefit (CCTB), has allowed provinces to reinvest social assistance savings to improve incentives to work for low-income families with children. Total federal government support to help low- and middle-income Canadian families through the CCTB will have increased from $5.4 billion in 1997-98 to $8.7 billion by 2004-05, an increase of $3.3 billion or 61 per cent.

- Policies geared toward learning help bring more people into the workforce and better equip them to work in higher-wage, higher-skill jobs. Implementing those policies requires investments at all stages of life: from early childhood development through to post-secondary education, to graduate schools that can attract the very best from around the world, and on-the-job training and mentoring programs to help Canadians become lifelong learners.

- As well, healthy communities are key to attracting and retaining talent and investment. As stated in the 2002 Speech from the Throne, competitive cities "require not only strong industries, but also safe neighbourhoods; not only a dynamic labour force, but access to a rich and diverse cultural life."

- The goals of attaining a stronger, more productive economy and building a stronger society are mutually reinforcing. Only through progress on both fronts will Canada be able to achieve its ultimate goal of rising living standards and a better quality of life for all Canadians in the years to come.

Annex 5

Implementation of Full Accrual Accounting in the Federal Government's Financial Statements

Highlights

- *Since the mid-1980s the Government has made a number of accounting policy changes to better reflect its overall financial position. These have included the recognition of most liabilities (such as public sector employee pension liabilities), the accrual of non-tax revenues and the consolidation of a number of specified purpose accounts. As a result of these changes, the Government's financial statements are currently on a modified accrual basis of accounting.*

- *In the February 1995 budget the Government announced its intention to adopt full accrual accounting as one of the initiatives undertaken as part of its Program Review exercise to increase efficiency through better management. The adoption of full accrual accounting has been endorsed by the Auditor General of Canada as being superior to the Government's current accounting practices.*

- *It is the Government's intention to implement full accrual accounting in the upcoming budget provided it is able to finalize and verify the accrual accounting amounts by late fall. The Office of the Auditor General of Canada has been assisting in the verification of these amounts. The Government's objective is to have sufficient assurance as to the reliability of the accrual accounting amounts before proceeding with formal implementation in the upcoming budget.*

- *The Government's fiscal anchor remains the budgetary balance. With this shift in accounting treatment in the upcoming budget, it would be calculated on a full accrual basis of accounting rather than on the current modified accrual basis.*

- *This annex explains what accrual accounting is, sets out the rationale for moving to full accrual accounting and indicates the potential impacts on the Government's financial statements. Once the full accrual numbers are finalized, a more comprehensive analysis of the difference between the current modified accrual and full accrual results will be published.*

What Is Accrual Accounting?

- An accrual accounting framework provides a more complete picture of the overall size of government, enhances accountability to Parliament and improves internal decision making and cost-effectiveness.
  - Accrual accounting recognizes transactions and other events when they occur and not when cash is received or paid. Expenses are recorded in the period when the goods and services are consumed (used). This implies that multi-year benefits associated with capital assets are matched to the time that they are expected to be used. Revenues are recorded in the period to which they pertain rather than when they are received.
- Under the Government's present accounting practices (modified accrual):
  - Expenditures, with the exception of capital, some retirement and post-employment benefits, and environmental liabilities, are on an accrual basis of accounting. This means that payables and liabilities are recognized when they are incurred and not when the cash payment is made.
  - Capital assets and consumable inventories are fully expensed, or accounted for, in the year in which they are acquired. For example, when the Canadian Coast Guard buys a new vessel, the costs of that vessel are recognized when the Coast Guard takes ownership of it. The full cost, therefore, is reflected in the Government's financial statements at that time.
  - Tax revenues are on a cash basis. This means they are included when they are received. Given collection lags, administrative changes, etc., this results in revenues being received after the economic event giving rise to these revenues has taken place. As a result, the fiscal outcome in the current fiscal year reflects not only what happens in the current fiscal year but also what happened in the previous year.
  - While the financial activities of enterprise Crown corporations have been reflected in the Government's annual balance since 1992-93, their net assets and liabilities, outstanding at that time, have not been included.
- Under full accrual accounting:
  - Capital assets will be recognized in the Government's financial statements. Capital expenditures will be amortized over their economic life rather than being fully expensed in the year(s) in which they are acquired. For example, the cost of a vessel purchased by the Canadian Coast Guard will now be spread out over the estimated useful life of that vessel rather than fully expensed in the year it is purchased. This will more accurately reflect the cost of using these assets and relate them to the services provided and results achieved in these periods.
  - The recognition of retirement and post-employment benefits will be expanded. Benefits, such as health care and dental plan liabilities, workers' compensation and veterans' disability pensions, will be included in the Government's financial statements.

- Tax revenues will be recognized in the period to which they pertain and not when they are received. There are significant collection lags between the economic event giving rise to tax revenues and when those revenues are received. For example, taxpayers are required to file their personal income tax returns for the preceding taxation year no later than the end of April of the current taxation year. This results in a large influx of personal income tax revenues in late April and early May pertaining to tax liabilities incurred in the previous taxation year. The Government sends out refunds during the April to June period for overpayments of taxes made in previous years. The annual flow of revenues can also be affected by remittance procedure changes, delays due to labour disputes, system processing problems, etc. Under accrual accounting, revenues will be recorded in the year to which they relate, thereby eliminating the distortions between cash collections/disbursements and economic developments. These changes would present a better picture of the Government's overall financial position.
- Since 1992-93 the Government has been reporting its investments in enterprise Crown corporations on a cost basis, with an allowance for annual profits and losses. The Public Sector Accounting Board of the Canadian Institute of Chartered Accountants recommends that governments account for enterprise Crown corporations using the modified equity approach, whereby annual profits and losses and the Government's investments in these corporations are reflected fully in the Government's financial statements. Although this change will have no impact on the annual results, it will increase the Government's recorded financial assets as a result of not having recognized these profits and losses prior to 1992-93.
- Currently the Government does not recognize its environmental liabilities in the financial statements and Aboriginal liabilities are not fully recognized. In moving to full accrual, the Government will change its accounting policies with respect to these liabilities and fully incorporate them in the financial statements.

What Is the Rationale for Implementing Full Accrual Accounting?

- Accrual accounting helps users, including legislators, managers and budget planners, appreciate and better understand the full scope of government activities.
  - The financial results are more indicative of economic developments and government actions undertaken during the course of the fiscal year.
  - A more complete picture enables Canadians and legislators to hold the Government more fully accountable for the stewardship of its assets, the costs of its programs, the results achieved, and its ability to meet its short- and long-term financial commitments.
  - The accrual and resulting amortization of capital assets requires the Government to consider the long-term benefits and consequences of purchasing capital assets. Complete records of assets will now be required. This additional information will require that departments consider maintenance needs, appropriate replacement policies, and the identification and disposal of excess assets, as well as risks such as loss due to theft or damage.
  - Recognition of liabilities (environmental, Aboriginal, retirement and post-employment benefits) will require the development of plans for managing these liabilities. This will place more responsibility on departments to ensure that these liabilities are effectively managed. It will also ensure that costs are recorded when incurred.
  - The inclusion of all costs of operations will result in a more complete picture of the cost-effectiveness of programs.
- The Public Sector Accounting Board of the Canadian Institute of Chartered Accountants recommends that senior levels of government adopt full accrual accounting in their financial statements.
- Many provinces have adopted full accrual accounting as have a number of foreign governments, including the United States, Australia and New Zealand. The United Kingdom has indicated its intention to adopt full accrual accounting.

- The Auditor General of Canada fully supports the use of full accrual accounting and urges the Government to implement it as soon as possible. In her "Observations" on the Government's 2001-02 financial statements, the Auditor General states: "I remain convinced that accrual accounting is superior to the Government's current accounting policies. It provides a more complete measure of the overall size of the Government, which should enhance accountability to Parliament; it eliminates the distortion of reported financial results caused by altering the timing of cash receipts and disbursements; and it is an essential component of management reform initiatives underway in the Government. I encourage the Government to resolve concerns which are causing delays in the full introduction of accrual accounting and implement it for the 2002-03 financial statements."[1]

- The Government is still reviewing and consulting with stakeholders as to whether the Main Estimates and appropriations to Parliament should be put on full accrual as well. A working group has been established to examine these issues.

[1] *Public Accounts of Canada* (2002), Volume 1.

What Does It Imply?

- The Government's financial statements summarize both the annual flow of revenues and expenditures (the annual budgetary balance) and the stock of assets and liabilities. Adopting full accrual accounting will affect both statements.

Impact on Annual Budgetary Balance

- The Government's fiscal anchor – the budgetary balance – remains the same except that it will now be presented on a full accrual basis of accounting rather than on the current modified accrual basis. As such, it will be more reflective of current economic events and liabilities.

- The most significant changes will be:
  - Annual expenditures will no longer include the amounts spent during the year on capital (i.e. buildings and equipment). Instead, they will be expensed as they are used. That is, their cost will be amortized over their economic life. This will tend to slightly improve the annual budgetary balance, other things being equal, as the amortization adjustment for capital is somewhat less than current expenditures on capital.
  - The annual budgetary balance will now include a larger group of liabilities than before. Annual changes in these liabilities will have a direct effect on the budgetary balance.
  - Although the annual budgetary balance will include the same revenue sources, tax revenues recorded in each year will now be more reflective of economic developments during that year. Under the cash basis of accounting, there are significant collection lags, whereby the revenues reported in the current period can be more reflective of what happened in the previous fiscal year than in the current one. For example, given the different pattern of economic developments in 2000 and 2001, it is expected that the accrual of tax revenue will increase the budgetary surplus in 2000-01 but reduce it in 2001-02.

Impact on Net Debt and Accumulated Deficit (Statement of Assets and Liabilities)

- Under the modified accrual basis of accounting, the Government's net debt and accumulated deficit (the accumulation of all past deficits and surpluses) were measured the same way. Under full accrual accounting, net debt and the accumulated deficit will no longer be defined in the same way, as the accumulated deficit will now include non-financial assets.

- Net debt under full accrual will still represent the difference between gross liabilities and financial assets.
  - It will be more comprehensive as gross liabilities will include an expanded list of liabilities, which will increase total liabilities.
  - Financial assets will now include tax receivables.
  - It is expected that the impact of these changes will be largely offsetting. Net debt under full accrual could be slightly higher or lower than under the current modified accrual basis.
  - Net debt is an important financial indicator as it provides information regarding the extent to which the expenditures of the Government in the fiscal year have been met by revenues recognized in that fiscal year. Net debt will continue to be shown on the Government's financial statements.
- The accumulated deficit will now include non-financial assets.
  - It will be defined as the Government's net debt plus its non-financial assets. Accordingly, it will be smaller than net debt.
- It is still too early to provide quantitative estimates of the impact of these changes, as the Government is in the process of finalizing the required accrual estimates.

Impact of Accrual Accounting on Net Debt and Accumulated Deficit

		(billions of dollars)
Net debt at March 31, 2002		536.5
Impact of accrual accounting on net debt		
Impact on liabilities		
Aboriginal claims		plus
Environmental liabilities		plus
Post-employment benefits		plus
Retirement benefits		plus
Impact on financial assets		
Net tax receivables		plus
Unrecorded equity of enterprise Crown corporations		plus
Net impact on net debt	plus/minus	536.5
Non-financial assets		
Tangible capital assets		plus
Prepaid expenses		plus
Inventories		plus
Accumulated deficit	less than	536.5

Next Steps

- It is the Government's intention to implement full accrual accounting in the upcoming budget provided it is able to finalize and verify the accrual accounting amounts by late fall. The Office of the Auditor General of Canada has been assisting in the verification of these amounts. The Government's objective is to have sufficient assurance as to the reliability of the accrual accounting amounts before proceeding with formal implementation in the upcoming budget.

- The timing of the implementation of full accrual accounting in the Government's financial statement and budget projections will depend on whether the accrual accounting adjustments meet the Government's required levels of audit assurance. Once that assurance has been received, the Government will present a paper comparing the 2001-02 financial results on both bases of accounting.

- Major accounting policy changes normally result in the restatement of previously published numbers. As a result, the current estimates for previous years will be restated to reflect the impact of these changes.