THE 1996 FEDERAL BUDGET

A Statement Before
The House of Commons
Standing Committee on Finance

By

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Chairman Peterson and Members of the House of Commons Finance Committee. Thank you for inviting the Business Council on National Issues to the Standing Committee on Finance for its second set of annual pre-budget consultations. I look forward to an interesting debate regarding Budget 1996 with my colleagues around the table.

Over the next five minutes I would like to provide you with the perspective of the Business Council on the current economic situation in Canada as well as our preliminary views regarding key issues in the upcoming federal budget, including the 1997/98 deficit reduction target and the relationship between deficit reduction and economic growth and job creation.

The Current Economic Situation

Increasingly, there are signs that Canada will experience modest economic growth in 1996 and in 1997. Indeed, a stagnant economy in the first half of 1995 has given way to stronger economic growth in the fourth quarter. Real growth of between 2.5 and 3.0 percent is expected in 1996. Even more encouraging is that this economic growth will occur in one of the most advantageous inflation environments in the world at the present time. Inflation is expected to remain in the two percent range next year as will growth in employment.

There are several reasons for this relative optimism regarding the economy next year.

1. The United States inflation environment remains stable in the 3 percent range. The outlook for interest rates in the United

States is neutral -- there may even be scope for a further decline in interest rates next year.

2. While experiencing a lull at the moment, Canada's export sector is well-placed to take advantage of stronger growth in the United States in 1996.

3. World economic growth prospects have brightened considerably from earlier this year. The global economic slowdown experienced in 1995 has now been characterized as a mid-cycle pause. The outlook is for sustained non-inflationary growth, particularly given the realignment in foreign currency markets.

4. Canadian short-term interest rates have declined significantly since the Referendum. Three-month interest rates have decreased by more than 100 basis points since October 30. However, long-term interest rates remain at pre-Referendum levels. The declines in short-term interest rates will provide some stimulative impact upon growth in the domestic, interest-sensitive sectors of the Canadian economy in 1996.

5. The more favourable interest-rate climate will have a positive effect upon consumer confidence and hopefully will help fuel a consumer rebound.

6. However, post-referendum uncertainties will keep long-term rates higher than necessary and will prevent a more robust period of growth.

The membership of the Business Council on National Issues shares this guarded or cautious optimism for 1996. Private sector balance sheets remain in good shape, earnings are robust in several sectors and more modest in others, profit levels are continuing to improve from near-disastrous levels two years ago, and the outlook for world commodity prices remains relatively positive across most, not all, products.

The recent stagnant period of economic growth, combined with the referendum result, will probably take its toll upon future private sector investment intentions in machinery and equipment and capital investment -- particularly in Quebec. However, despite the possible moderation, those sectors of the economy that are open to foreign competition will have to continue to restructure, invest and upgrade in order to remain competitive on global markets.

The prospect of recession in the United States, and in Canada, therefore remains low for 1996 in our view, but rises as we move toward the end of the century. The inevitable downturn has implications for the 1996 Federal Budget and argues for determined action to eliminate the deficit in advance of end of the decade.

The 1997-98 Fiscal Target:

We are encouraged with the final deficit results for the 1994-95 fiscal year of $37.5 billion, $400 million below target. Also encouraging is the fact that the 1995-96 federal deficit shows definite signs of coming in below the Government's $32.7 billion target despite weaker than expected economic growth. Finally, absent any significant negative economic events such as a recession in the United States over the next two years, the 1996/97 deficit is likely to be significantly under target as well.

As you know Mr. Chairman, the Business Council has repeatedly called for a balanced budget in advance of the next downturn in the business cycle. Specifically, we have recommended that the federal government should put a credible plan in place to achieve balance by no later than 1998-99. This continues to be our position, particularly in light of the Quebec referendum results.

In this context, and given the above positive outlook for the federal deficit, we believe that a 1997-98 deficit target of 1.50 percent of GDP ($13-14 billion) is reasonable, prudent and credible.

Such a target would send a clear signal to financial markets of the federal government's continued commitment to put public finances on a solid footing. A target of 1.50 percent would also dissipate lingering uncertainty about the federal government's resolve to continue with its restructuring program in the post-referendum environment. Finally, a budget with such a target would clearly set the federal government on a path toward beginning to pay down the crushing debt accumulated over the past three decades.

The Federal Debt is the Key Issue: The restructuring program put into place in the 1995 Federal Budget will at best stabilize the debt-to-GDP ratio at about 74 percent in the 1996-97 fiscal year. This is not enough in our view Mr. Chairman.

The upcoming Budget is very important from our perspective because it must firmly establish a declining trend in the debt-to-GDP ratio. A 1997-98 federal deficit in the $14 billion range will result in a debt-to-GDP ratio of about 72 percent -- a clear indication of progress.

Consequently, our second recommendation is for the federal government to begin to concentrate more on the stock of debt and the debt-to-GDP ratio -- issues of utmost priority.

Economic Growth and Job Creation

I would like to take a brief moment to outline how budget measures could be used to create an environment for economic growth and job creation.

First, there does appear to be a general consensus across Canada that governments need to reduce and eventually eliminate their budget deficits. What is less well known, however, is the that there is a linkage between deficits and debt, and economic growth and job creation. The linking factor is interest rates Mr. Chairman.

Right now, the Canada-United States interest rate differential is about 160 basis points -- back to where it was just before the Referendum. Furthermore, the long-term bond yield is about 8 percent while our inflation rate is about 2.5 percent. Consequently, Canada has real interest rates that are about 5.5 percent. This compares with average real, long-term bond yields in the United States of about 3 percent currently.

My point Mr. Chairman is that Canada is paying a heavy price for its political instability and recalcitrance to deal with its debt problems. This heavy price is in the form of higher real interest rates, higher government dissaving, and lower private sector saving. This translates into lost economic opportunities, delayed or foregone future investment decisions, and lower levels of economic output and job creation.

In fact, countries with clearly unsustainable fiscal policies -- such as Canada, Sweden and Italy -- are suffering from what the IMF has termed "confidence effects". In essence, these are risk premiums attached to debt instruments as a result of extraordinarily high levels of indebtedness. As such, credible plans to put the country's finances on a firmer footing are needed. This would translate into lower risk premiums and possibly even a stronger exchange rate.

Mr. Chairman, the export oriented part of Canada's private sector has restructured and reoriented itself to be more competitive on global markets. Our exports have contributed significantly to economic growth, while the domestic, interest-sensitive sectors of our economy have remained stagnant with only nominal growth.

Consequently, our domestic economy needs lower interest rates as quickly as possible to stimulate stronger economic growth and job creation. In our view, the federal government must boldly announce a fiscal strategy to balance the books, within the next two fiscal years. This in effect will increase the level of confidence that our debt levels have stabilized and that the debt-to-GDP ratio will soon be on a downward trajectory. This will result in lower long-term interest rates, and possibly even lower short-term interest rates, Mr. Chairman -- the best possible tonic for our anaemic growth and job creation performance.

Specific Issues Related to the 1996 Federal Budget:

There are several specific issues related to the 1996 Federal Budget which should be addressed by this Committee and they include the following:

- **Unemployment Insurance**
- **The Canada Health and Social Transfer**
- **Canada's Retirement System**
- **Further Restructuring Efforts**
- **The Goods and Services Tax**

Thank you Mr. Chairman and I look forward the roundtable discussion on these and other issues.

BRIEFING NOTES

Unemployment Insurance:

The 1995 Federal Budget allowed for the cumulative surplus in the Unemployment Insurance Account to rise to over $5 billion through to the end of 1996. The rationale for this decision was to avoid having the Account go back into deficit and cause further premium rate hikes during periods of slow economic growth and higher unemployment.

However, we are concerned that Unemployment Insurance premiums will become just another form of tax on business. Our long-standing position -- supported by recent evidence -- is that U.I. premiums are an inefficient form of taxation which results in distortions in the labour market.

- The Bank of Canada, in a recent study, in fact concluded that increases in supplementary labour income -- payroll taxes such as employer's contributions to U.I., health insurance, workers' compensation and Canada/Quebec pension contributions -- reduced employment by about one percent in 1993.[1]

- The Department of Finance concludes that a one-percent

[1] The negative effect of higher premiums upon wages and employment growth is reflected in two recent articles published in the Summer Bank of Canada Review, Aspects of Economic Restructuring in Canada, 1989-1994 and in Canadian Business Economics, Summer 1995, Payroll Taxation in Canada: An Overview.

reduction in the overall effective rate of payroll taxation results in a long-term employment increase of more than 30,000 (the same result obtained in an analysis conducted by the Department of Human Resources.

- A recent article in Canadian Business Economics on payroll taxation concluded that a one-percent increase in the average tax rate will result in a 0.6 percent increase in wage costs and a 0.3 percent decline in employment.

This is exacerbated by actuarial estimates that Canada Pension Plan premiums are going to have to increase dramatically as a result of projected C.P.P. outlays. This means that U.I. premiums will remain high in the face of almost certain increases in C.P.P. premiums. The consequences for private sector competitiveness and for future investment are ominous indeed.

Finally, we are concerned that representatives from the labour community and social action groups will call for the surplus funds to be used to enrich the U.I. program or to invest in new employment development services. Pressure could intensify to spend the U.I. surplus rather than reduce the deficit.

Consequently, premium rates should be reduced modestly in 1996. Beyond 1996, U.I. premiums should be further reduced. In addition, assurances should be given that appropriate legal limits will be set on the level of the surplus and that constraints be established on how monies dedicated to developmental uses will be spent.

The Canada Health and Social Transfer:

The federal government made the commitment in the 1995 Budget to consult with provincial governments on the level of funding for the 1997-98 fiscal year under the Canada Health and Social Transfer. As well, the federal government stated it would consult with the provinces regarding principles that should govern the allocation of funds dedicated to the CHST.

Some of the general principles are as follows:

Certainty -- provinces should have better assurances regarding the future level of transfers for budgetary planning purposes.

Flexibility regarding design of social programs at the provincial level.

Conpatibility across jurisdictions regarding design of social programs.

Federal/Provincial Joint Coordination, i.e., joint responsibility at both levels of government.

Creativity -- Can envision CHST negotiations regarding tax points tied to GST harmonization efforts.

Portability of benefits and/or personal mobility and access to benefits.

Design should encourage efficiency and effectiveness, as well as individual responsibility.

Equal or equitable distribution of federal funding to the provinces.

The new allocation of cash transfers under the CHST will depend upon the success of the program restructuring already undertaken to reduce the federal deficit as well as further restructuring efforts undertaken in this Budget.

Canada's Retirement System:

Changes necessary because of demographics and because Canada has an unfunded pension liability equal to the size of the economy.

Reforms to the Canada Pension Plan, if made within the next three years, will help preserve the system. The reform package must include:

- tighter eligibility requirements for a pension based on disability claims,
- possible higher premium rates, and finally
- a gradually higher retirement age.

Old Age Security and Guaranteed Income Supplement are also in need of reforms, to insure sustainability. Will comment on discussion paper to be released on the changes required in the public pension system to ensure its affordibility.

Program Review:

Restructuring efforts on the part of the federal government must continue because of the ultimate goal is better government. There are areas of expenditure where there is some degree of overlap.

In this regard, the October 30 referendum may offer certain opportunities to eliminate some of the overlap, as long as it results in substantive restructuring efforts.

Could include: mining, forestry, social housing, tourism and recreation, etc.

Taxation:

Comments regarding the GST.