

CHAPTER 1

Canada: A Success Story

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Introduction

As in most advanced economies, the fiscal pressures in Canada started in the 1970s and became most pronounced in the mid-1980s. Canada stands out among the G-7 countries, however, as it successfully responded to these pressures in the subsequent decades through large and sustained fiscal adjustment. The ex-ante approach adopted in this chapter reveals that the adjustment was underpinned by two substantially different plans in terms of speed and nature of adjustment measures. The chapter compares and contrasts these two plans, based on both ex-ante design and ex-post performance.

The plans are analyzed with regard to:

- The scale of planned adjustment, in particular, whether the scale of the planned adjustment was sufficiently large to stabilize debt
- The comparison of plans vis-à-vis outcomes
- The nature of adjustment measures
- Whether adjustment was sustained in the aftermath of the episode

The main analysis in this chapter focuses on the federal government budget, because fiscal adjustment plans were formulated only at the federal government level, rather than the consolidated general government level including the provinces, territories, and local governments. However, for completeness, a separate section also discusses the consolidation efforts of the subnational governments.

The identification of the federal government adjustment plans is based on an examination of federal budget documents covering 1961–2010. We use three criteria to select an adjustment episode: (i) the adjustment plan is clearly announced to the public (in the budget); (ii) it specifies explicit medium-term fiscal targets involving substantial fiscal adjustment; and (iii) it is formulated in a medium-term framework. Based on these criteria, we identify two adjustment plans in which the federal government announced medium-term fiscal targets against the background of large and increasing debt levels: the 1985 Plan covering 1985–91 and the 1995 Plan covering 1994–97.¹

The actual overall balance, the main fiscal target, outperformed plans in both adjustment episodes. In fact, the extent to which ex-post performance conformed to ex-ante design was exceptional in Canada compared to other G-7 countries. That said, the 1985 Plan was criticized both domestically and internationally for not being sufficiently ambitious: it did not make enough effort to reduce the deficit and eschewed tough measures on major spending programs. The 1995 Plan, on the other hand, scored better, building on the lessons learned from the 1985 Plan. The 1995 Plan was highly ambitious in terms of both speed and nature of planned adjustment measures, as it aimed to introduce major changes to government programs and services. Indeed—to give a preview of outcomes—debt stabilization, the main objective of both adjustment plans, was achieved only during the 1994–97 episode. The overall balance improved by almost 5 percent of Gross Domestic Product (GDP) over 1994–97, moved to a surplus in 1997–98, and remained in surplus until 2007–08 (see Figure 1.1). The federal net debt declined to 34 percent of GDP by 2007–08, compared to 74 percent in 1995–96 (see Figure 1.2).

The following elements were key in ultimately bringing about a lasting improvement in Canada's fiscal position:

- Broad-based public support
- A repositioning of the role of government and profound structural reforms
- Prudent macroeconomic and fiscal assumptions
- Fiscal consolidation at the subnational level

Background

Canada's debt problems started to emerge in the mid-1970s (see Figure 1.2). Debt accumulation was driven by both the global environment and domestic policies. The main global factors were: (i) the 1973–74 energy price surge, which reduced economic growth through a negative supply-side shock; (ii) higher interest rates in advanced economies; and (iii) the 1973 move to floating exchange rates following the collapse of the Bretton Woods

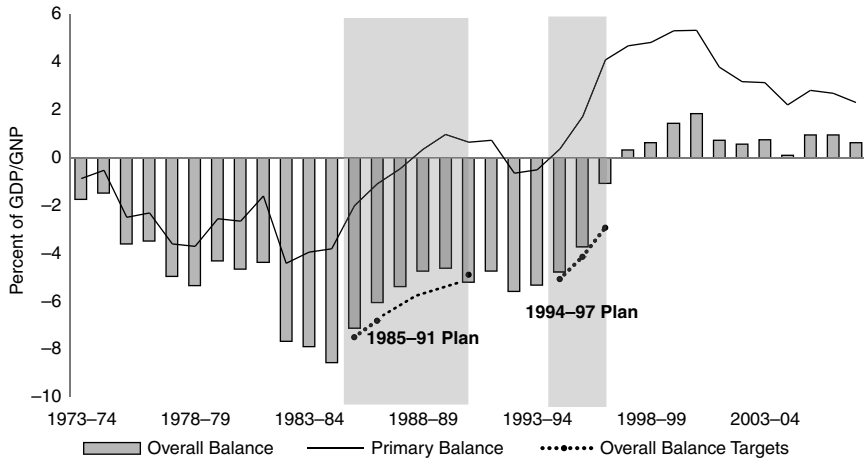


FIGURE 1.1 Federal Government Primary/Overall Balance, 1973–2008

Source: Fiscal Reference Tables 2009, Budget 1985 and 1995, Department of Finance Canada.

Note: Balances between 1984–85 and 1990–91 are in percent of GNP.

system, which removed domestic financing discipline. These factors together contributed to an increase in the differential between interest rates and growth—a key determinant of the debt/GDP ratio dynamics.

The impact of these global factors was compounded by Canadian policies. In 1973–74, Canada indexed to inflation several expenditure programs

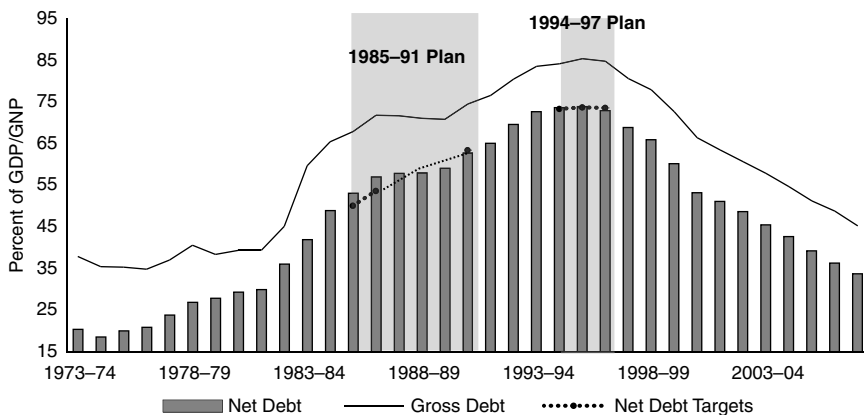


FIGURE 1.2 Federal Government Gross and Net Debt, 1973–2008

Source: Fiscal Reference Tables 2009, Budget 1985 and 1995, Department of Finance Canada.

Note: Debt ratios between 1984–85 and 1990–91 are in percent of GNP.

and the personal income tax system—both the basic exemptions and the brackets were fully indexed. In the high inflation environment of the 1970s, these new indexing systems led to a sharp increase in program expenditures and a weakening of revenue growth.^{2,3} As the economy entered into stagflation in the mid-1970s, the government consistently relied on spending increases and revenue reductions to provide short-term stimulus. There was a strong consensus among politicians and the public in favor of such stimulative policies during this period, partly because the productivity slowdown after the 1973–74 energy price shock was seen as a cyclical phenomenon rather than a structural change. The large primary deficits, combined with increasing cost of debt service, soon led to a rapid increase in public debt. Within less than ten years, the federal net debt more than doubled, reaching 42 percent of Gross National Product (GNP) in 1983–84.

The 1985 Plan (Covering 1985–91)

A new Conservative government, led by Prime Minister Brian Mulroney, recognized that further pursuing expansionary fiscal policy would damage the Canadian economy in the long term. To restore fiscal responsibility and control the growing debt, Mulroney set up the Nielsen Task Force in 1984 to review all federal departmental programs. In November 1984, the government outlined the “Agenda for Economic Renewal,” with the goal of reducing the fiscal deficit in an orderly manner. The essence of this Agenda was incorporated in the 1985 Budget—henceforth “the 1985 Plan.”

The 1985 Plan consisted of two distinct, yet interrelated, elements. The first element and the primary focus of the Plan was a set of structural reforms aimed at improving the competitiveness of the Canadian economy, including the Canada-U.S. free trade agreement, which came into effect in 1989, and the reform of the federal sales tax system in 1991. These structural reforms provided long-lasting, important foundations for economic growth and fiscal adjustment. The second element—the focus of our analysis—emphasized the need to curb overall deficit to stabilize public debt. The 1985 Plan viewed these two goals as interrelated: economic growth supported by structural reform would help fiscal adjustment by increasing the tax base; a sound fiscal stance would foster economic growth, with increased confidence in the economy promoting investment.

Given the high levels of inherited public debt and expected real interest rates in the medium-term, the 1985 Plan aimed to stabilize debt at 65 percent of GNP by 1990–91. This was equivalent to an overall deficit reduction of 3.6 percent of GNP over six years (from 8.5 percent of GNP in 1984–85 to 4.9 percent in 1990–91). Four-fifths of the adjustment would be achieved through expenditure measures, with the remainder attributable to revenue measures. The 1985 Plan’s adjustment in expenditures relied primarily on

across-the-board cuts and freezes, and efficiency gains. Details on the revenue and expenditure measures of the 1985 Plan are provided in the “Nature and Composition of Adjustment” section.

The 1995 Plan (Covering 1994–97)

Benefiting from the 1985 Plan, the government initially made good progress in reducing the deficit. By 1988–89, it achieved a small primary surplus for the first time in almost 20 years. However, with increasing interest rates due to growing inflationary pressures, the government consistently underestimated the interest bill. As the recession hit in 1990, the overall deficit once again started to rise, reaching 5.6 percent of GDP and the federal net debt increased to an unprecedented 70 percent of GDP in 1992–93.

Public polls in the early 1990s revealed that reducing the fiscal deficit had become the primary economic issue for Canadians. The 1993 Decima Research polls reported that Canadians’ concern for the deficit reached an all-time high. An April Gallup poll showed that 70 percent of Canadians would cut spending to reduce the deficit, rather than increase it to stimulate the economy (Bourgon, 2009). This is in sharp contrast to the level of public awareness prior to the 1985 Plan. Less than 2 percent of respondents to a 1984 Decima Research poll had cited the federal deficit and national debt as Canada’s most important economic problem.⁴

How did public awareness of the fiscal challenges increase over time? International institutions, international rating agencies, Canadian research institutions, and the media had been stressing the urgency to address Canada’s unsustainable debt for some time. With the federal government net debt at 73 percent of GDP by 1993, Canada had the second worst standing in the G-7 after Italy. In October 1994, the government published its report “A New Framework for Economic Policy” to educate the public about the importance of fiscal adjustment.⁵ It shared the key messages of this report through an intensive communication strategy, including national and regional conferences organized by Finance Minister Paul Martin and substantive public debates across the country.⁶ Furthermore, contrary to the tradition of holding consultation meetings separately with each interest group, the government held meetings mixing interest groups from different backgrounds. The government “wanted the public to understand long before the budget was presented that there were tough choices to be made, that there was no perfect answer and that everyone had to bear their fair share of the burden in the greater good, which meant that everyone had to give” (Martin, 2010). Canadians thus became increasingly aware of the implications of high debt levels for growth and intergenerational equity as well as of the opportunity cost of debt service, which consumed 35 percent of government revenues in the early 1990s.

During the 1993 federal election campaign, the election platforms of most political parties included deficit reduction. A new Liberal government, led by Prime Minister Jean Chretien, was elected in November 1993. The Liberal election commitment was to reduce the overall federal government deficit to no more than 3 percent of GDP by 1996–97 (from 5.9 percent in 1993–94). The 1994 Budget reaffirmed this commitment, but it was not explicit about the supporting measures except for announcing a review of the federal government’s programs and services—called the Program Review.⁷ This budget was criticized by financial markets at the time for not being ambitious enough.

Following the Mexican peso crisis in late 1994, the *Wall Street Journal* ran an editorial in January 1995 arguing: “Mexico isn’t the only U.S. neighbor flirting with the financial abyss. . . . If dramatic action isn’t taken in next month’s federal budget, it’s not inconceivable that Canada could hit the debt wall.”⁸ This editorial sent shockwaves across Canada, increasing pressure on the government to deliver a more ambitious budget. Furthermore, shortly before the 1995 Budget, Moody’s put Canada on a “credit watch.” With these developments, debt stabilization became the number-one priority for the government.

The 1995 Plan introduced a major restructuring of federal department spending, including a reform of the unemployment insurance program, revisions to transfers to provinces, and pension reform.⁹ The government launched a Program Review (i.e., expenditure review) in May 1994 to “review all federal programs in order to bring about the most effective and cost-efficient way of delivering programs and services that are appropriate to the federal government’s role in the Canadian federation (1995 Budget, p. 11).” Program Review decisions were included in the 1995 Budget. The measures in the 1995 Budget aimed to secure the achievement of the government’s interim deficit target of 3 percent of GDP for 1996–97, with the ultimate goal of a balanced budget. The government’s strategy was to adopt two-year rolling targets, that is, each budget laid out the targets only for the next two years and did not make promises for the longer term. The objective of this approach was to help increase political accountability by putting pressure on program managers to deliver promised savings and ensure that targets were not missed due to economic uncertainties. Consistently meeting the targets would in turn help build public confidence in the program.¹⁰ Although the 3 percent target was announced in the 1994 Budget, credible measures to attain it were introduced only in the 1995 Budget (hence, this chapter calls the adjustment plan “the 1995 Plan”). About 90 percent of the adjustment focused on expenditure measures, with the remainder expected from revenue measures.¹¹ The main reason for focusing on expenditure reduction in both plans—and especially in the 1995 Plan—was that the tax burden was already high relative to the United States, although lower than

the Organization for Economic Cooperation and Development (OECD) average. Given the close integration of the economies of Canada and the United States, especially after the North-American Free Trade Agreement (NAFTA) in 1994, the United States was a more relevant comparator for tax burden. Details on the revenue and expenditure measures of the 1995 Plan are discussed in the “Nature and Composition of Adjustment” section.

Plans versus Outcomes: Macroeconomic Factors

In assessing the implementation of a consolidation plan, it is important to understand the role of the underlying macroeconomic developments. For instance, revenue developments are linked to an economy’s cyclical position. We decompose revenues into cyclical and structural components to examine how much of the difference between plans and outcomes can be attributed to cyclical effects. We also decompose expenditures into primary expenditures and interest payments.¹²

Structural and Cyclical Components

Tables 1.1 and 1.2 present the headline and structural fiscal aggregates scaled to nominal income.¹³ The columns of $\Delta a - \Delta p$ present the actual improvement compared to the planned improvement. Several interesting findings emerge from Tables 1.1 and 1.2.

In both adjustment episodes, the outcomes for the overall and primary balances were better than planned. However, the overperformance of the overall balance was much greater over 1994–97, despite the 1995 Plan’s ambitious target over a short period. The actual overall balance outperformed the plan by 1.7 percent of GDP, compared to 0.3 percent over 1985–91.

The 1995 Plan was more ambitious, especially in terms of the speed of its primary expenditure adjustment: it aimed to reduce primary spending by 3.7 percent of GDP within three years, whereas the 1985 Plan envisioned a reduction of 3.5 percent of GNP over six years. Despite its shorter duration, the 1995 Plan delivered a larger cumulative primary spending adjustment compared to the 1985 Plan. Actual primary spending reduction amounted to 4 percent of GDP over 1994–97, compared to 3.6 percent of GNP over 1985–91. The 1985 Plan was widely criticized at the time for moving too slowly to reduce the deficit, even when the overall deficit target was more than met and before the government started backsliding in its efforts to keep the deficit under control, mainly due to the 1990–91 recession. For example, a 1990 editorial in the *Globe and Mail*, a national newspaper, stated, “On virtually every major spending program, the tough decisions have been deferred,” and criticized the government’s measures for being temporary, piecemeal, and insufficient.¹⁴ International institutions also

TABLE 1.1 Structural versus Cyclical Decomposition—1985 Adjustment Plan

(As percent of GNP)									
Plan (p)					Actual (a)				
	FY 1984-85	FY 1990-91	FY 1984-85	FY 1990-91		FY 1984-85	FY 1990-91	Δa	1990-91 actual minus 1990-91 planned
	p	p	a	a		a	a		
Revenues	15.2	15.9	0.7	14.6	16.3	1.7	0.4		
Cyclical	-0.2	0.0	0.2	-0.2	0.4	0.6	0.4		
Structural	15.4	15.9	0.6	14.8	15.9	1.1	0.0		
Expenditures	23.7	20.8	-2.9	23.4	21.2	-2.3	-0.4		
Primary	18.4	14.9	-3.5	18.3	14.7	-3.6	0.2		
Interest	5.3	5.9	0.6	5.1	6.5	1.4	-0.6		
Overall balance	-8.5	-4.9	3.6	-8.8	-4.9	3.9	0.0		
Primary balance	-3.2	1.0	4.2	-3.7	1.6	5.3	0.6		
<i>Memo items (in percent of potential GNP):</i>									
Structural primary balance	-3.0	1.0	4.0	-3.4	1.3	4.7	0.2		
Structural revenues	15.2	15.9	0.7	14.6	16.3	1.7	0.4		
Primary expenditure	18.1	14.9	-3.3	18.0	15.0	-3.0	-0.1		
<i>Of which:</i>									
								$\Delta a - \Delta p =$ Actual improvement minus planned improvement ^a	1984-85 actual minus 1984-85 preliminary estimate from plan ("base effect")
								1.0	-0.6
								0.4	0.0
								0.5	-0.6
								-0.6	0.3
								0.1	0.1
								-0.8	0.2
								0.3	-0.3
								1.1	-0.5
								0.7	-0.5

^aFor expenditures, the formula is $-(\Delta a - \Delta p)$.

TABLE 1.2. Structural vs. Cyclical Decomposition—1995 Adjustment Plan

(As percent of GDP)										
Plan (p)			Actual (a)			Overperformance (actual relative to plan)				
	FY 1993-94	FY 1996-97	Δp	FY 1993-94	FY 1996-97	Δa	1996-97 actual	1996-97 planned	$\Delta a - \Delta p =$ Actual improvement minus planned improvement ^a	1993-94 actual minus 1993-94 preliminary estimate from plan ('base effect')
	p	p		a	a		actual	planned		
Revenues	16.3	16.7	0.4	15.9	16.8	0.9	0.1	0.1	0.5	-0.3
Cyclical	-0.5	-0.2	0.4	-0.6	-0.5	0.1	-0.3	-0.3	-0.3	0.0
Structural	16.8	16.9	0.1	16.5	17.3	0.8	0.4	0.4	0.7	-0.3
Expenditures	22.2	19.3	-2.9	21.7	17.9	-3.8	1.4	1.4	0.9	0.5
Primary	16.9	13.1	-3.7	16.5	12.5	-4.0	0.7	0.7	0.3	0.4
Interest	5.3	6.2	0.8	5.2	5.4	0.2	0.8	0.8	0.7	0.1
Contingency Reserve	0.0	0.4	0.4	0.0	0.0	0.0	0.4	0.4	0.4	0.0
Overall balance	-5.9	-2.9	3.0	-5.8	-1.1	4.7	1.9	1.9	1.7	0.1
Primary balance	-0.6	3.6	4.2	-0.6	4.3	4.9	0.7	0.7	0.7	0.0
<i>Memo items (in percent of potential GDP):</i>										
Structural primary balance	0.0	3.7	3.8	0.0	4.7	4.6	0.9	0.9	0.9	0.0
Structural revenues	16.3	16.7	0.4	15.9	16.8	0.9	0.1	0.1	0.5	-0.3
Primary expenditure	16.3	13.0	-3.3	15.9	12.2	-3.7	0.8	0.8	0.4	0.4

^aFor expenditures, the formula is $-(\Delta a - \Delta p)$.

viewed a more rapid pace of fiscal consolidation as desirable, especially given the strong economic growth in the late 1980s.¹⁵ In retrospect, it is clear that it would have been preferable to take advantage of the favorable economic circumstances in the second half of the 1980s.

The difference in the overall balance performances of the two episodes is explained by differing performances on the spending side. In the 1985–91 episode, expenditures were higher than planned by 0.6 percent of GNP, due to the underestimation of interest payments by 0.8 percent of GNP—a sizable adverse surprise. As a result, despite the better than planned revenue and primary expenditure performance, the overall deficit reduction exceeded the plan only by 0.3 percent of GNP. By contrast, in the 1994–97 episode, total expenditure reduction was better than planned by 0.9 percent of GDP, with 0.3 percent of GDP coming from the additional reduction in primary expenditure and 0.7 percent of GDP due to prudent assumptions for nominal interest rates.

Learning from the 1985–91 episode, the government adopted prudent assumptions for nominal interest rates and other key macroeconomic and fiscal variables in the 1995 Budget. This helped achieve a strong overall balance performance over 1994–97. From an ex-ante point of view, prudent assumptions in the 1995 Plan also helped set tighter limits on planned primary spending. The 1995 Budget was transparent about its prudent assumptions about key macroeconomic variables, highlighting that they were more cautious than the average private sector forecast. Short- and long-term interest assumptions were higher than the private sector outlook by 60 and 70 basis points, respectively, during 1995 and 1996. Relative to the government's assumptions, long-term interest rates turned out to be 180 basis points lower, and the short-term interest rates almost 240 basis points lower, partly as a result of public confidence in the government's adjustment plan and the Bank of Canada's price stability strategy (see Figure 1.3).¹⁶ The overall fiscal deficit was reduced by 4.7 percent of GDP over three years, outperforming the plan by 1.7 percent of GDP.

An additional factor that contributed to a higher than planned overall balance over 1994–97 was a contingency reserve (of 0.4 percent of GDP) included in the deficit projection to cover the risks of unpredictable events and forecasting errors. The reserve was added to expenditures but was not to be used as a source of funding for new initiatives; and if it was not needed, it had to be used to pay down the debt.

Revenue increases also played a role in both episodes even though both plans emphasized expenditure reduction as the major adjustment tool. This is particularly true for the 1985–91 episode, when actual revenues outperformed plans by 1 percent of GDP. This episode benefited from a positive growth surprise—leading to a cyclical revenue overperformance of 0.4 percent of GNP—and additional income tax policy measures not foreseen in the 1985

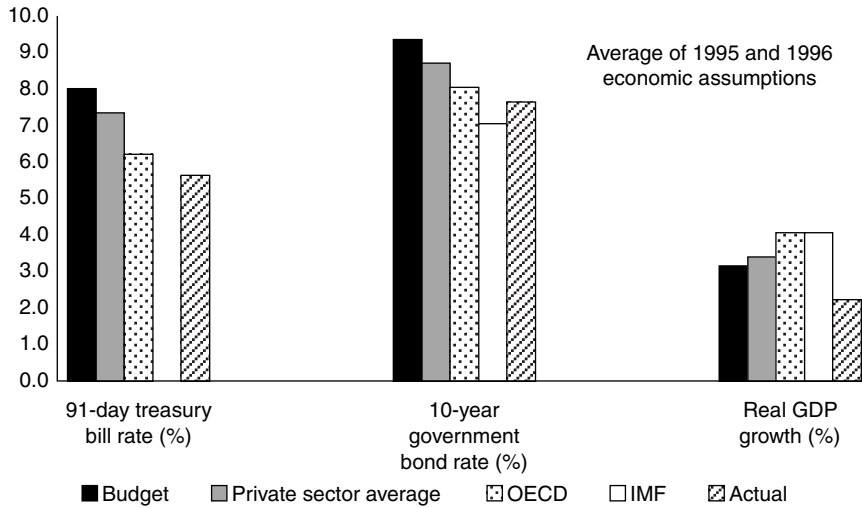


FIGURE 1.3 Comparison of the Economic Assumptions with Other Forecasts (As of February 1995)

Budget—leading to a structural revenue overperformance of 0.5 percent of GNP. In 1994–97, actual revenues outperformed plans by only 0.5 percent of GDP, because the negative output gap eroded 0.3 percent of GDP of revenue improvement. Structural revenue overperformance, at 0.7 percent of GDP, was actually higher than in the earlier adjustment episode.

Growth (Denominator) and Inflation Effects

In the comparison between planned and actual expenditure cuts, a deviation from the planned reduction in the expenditure-to-GDP/GNP ratio results from either a higher- or lower-than-expected expenditure cut in nominal terms (i.e., the numerator effect), or a higher- or lower-than-expected nominal GDP growth (i.e., the denominator effect). To examine the extent to which the government adhered to its original expenditure reduction plans, we decompose the planned adjustment in the expenditure-to-GDP ratio into (i) inflationary effect; (ii) the nominal GDP growth (or denominator) effect; and (iii) expenditure changes in real terms.¹⁷ Applying the same decomposition to the actual reduction in the expenditure-to-GDP ratio, we examine the extent to which each factor contributes to the deviation between planned and actual adjustment.

During the 1985–91 episode, actual expenditure reduction in real terms turned out to be 0.8 percent of GNP greater than planned, even though the overall cut in primary spending was only 0.1 percent of GNP greater than planned (see Table 1.3). This unexpected real cut was largely due to the

TABLE 1.3 Sources of Greater-Than-Expected Expenditure Cuts

	1985 Adjustment Plan (as percent of GNP)				1994-95 Adjustment Plan (as percent of GDP)			
	Over-performance	Denominator effect	Inflation effect	Real changes	Over-performance	Denominator effect	Inflation effect	Real changes
Primary expenditures	0.1	-0.4	-1.0	0.8	0.3	0.1	0.0	0.4
Transfers to persons	-0.4	-0.2	-0.3	-0.3	0.1	0.1	0.0	0.2
Transfers to other levels of gov't	0.0	-0.1	-0.3	0.2	0.1	0.0	0.0	0.1
Defense	0.1	0.1	-0.1	0.3	0.2	0.0	0.0	0.2
Other ^a	0.4	-0.1	-0.4	0.7	-0.1	0.0	0.0	-0.1

^aOther spending includes spending by departments (other than defense), agencies, and Crown corporations, and transfers other than major transfers to persons and other levels of government.

underestimation of inflation (1.0 percent of base-year GNP). In addition, the denominator effect contributed to another 0.4 percent of base-year GNP difference. In the 1994–97 episode, by contrast, actual reduction for most expenditures was greater than planned. The contributions of GDP growth and inflation effects were both marginal.

Nature and Composition of Adjustment

The previous analysis showed that the compositions of expenditure adjustments in the 1985 and 1995 Plans were different. This section further decomposes revenues and expenditures in order to investigate the differences in the nature of adjustment measures introduced in the two consolidation plans. (For the 1985 Plan, disaggregated revenue projections are available only for the first two years.)

Revenues

In both plans, revenue increases were expected to make only a small contribution to deficit reduction. Ex-post, revenue increases outperformed projections in both episodes. As discussed earlier, revenue overperformance was entirely structural over 1994–97, and more structural than cyclical over 1985–91.

In the 1985 Plan, revenues were expected to increase by 0.7 percent of GNP from 1984–85 to 1990–91, accounting for about 20 percent of the total adjustment effort. Key revenue increasing measures were to:

- Change the indexation factor of personal income tax exemptions, deductions, and tax brackets from full indexation to the consumer price index (CPI) to a partial indexation of CPI minus 3 percentage points.
- Impose temporary surtaxes on higher-income individuals and large corporations.
- Eliminate the federal personal income tax “reduction” (a sizable tax deduction).
- Broaden the sales tax base by reducing exemptions.
- Increase the sales tax rate by 1 percent.
- Increase automotive fuels tax.

In the 1995 Plan, revenues were expected to increase by 0.4 percent of GDP from 1993–94 to 1996–97. The contribution of revenue to the adjustment effort, at 13 percent of total adjustment, was lower than in the 1985 Plan. The key revenue measures were to:

- Eliminate tax deferral on business income.
- Limit tax assistance for contributions to registered retirement savings plan by high-income earners.

- Introduce an additional tax on investment income of private corporations.
- Increase the large corporation tax rate and the corporate surtax.
- Increase excise taxes on tobacco and gasoline.

The excise tax on gasoline would be the largest contributor.

Tables 1.4 and 1.5 present the basic features of the revenue plan and outcome, and the contribution of each disaggregated revenue item to the overall revenue overperformance in the two episodes. The numbers in Table 1.4 are calculated as the two-year difference of the budget projections and outturns, because a six-year projection for disaggregated revenues is not available for the 1985 Plan. For example, the second column of the third panel in Table 1.4 represents the difference between the planned and actual changes over 1984–85 and 1986–87.

Actual revenues outperformed plans by 1 percent of GNP in the 1985–91 episode (see Table 1.1) and 0.5 percent of GDP in the 1994–97 episode (see Table 1.5), with a different set of overperforming revenues in each episode. More specifically, personal income tax revenues consistently outperformed the budgets in the 1985–91 episode, owing to tax policy measures not foreseen in the 1985 Plan and introduced to compensate for higher than planned public debt charges. (Specifically, the surtax on personal income tax was increased from 3 to 5 percent and an additional 3 percent surtax was levied on high-income earners in 1989.) An additional contributing factor to the overperformance was the restriction of indexation of brackets to increases in CPI in excess of 3 percentage points. The so-called “bracket creep” was estimated at 0.2 percent of GNP annually. Sales and excise taxes and duties underperformed budget projections dramatically over 1988–89 to 1990–91, likely due to the introduction of the Value Added Tax (VAT)—called the Goods and Services Tax in Canada, which while intended to be revenue neutral in actuality caused a temporary revenue decline. The corporate income tax revenue outcome also tended to be lower than planned. In the 1994–97 episode, personal income tax revenues slightly underperformed while other revenues marginally overperformed, due to the prudent revenue elasticities in the 1995 Plan (see Table 1.5).

Expenditures

The entire approach to expenditure adjustment differed markedly between the two plans. The main measures in the 1985 Plan included: (i) rationalization and improved efficiency of government programs; (ii) privatization and rationalization of the activities of Crown Corporations; and (iii) reduction in transfers and subsidies to various sectors. The 1985 Plan’s adjustment in nonstatutory expenditures relied primarily on across-the-board cuts and

TABLE 1.4 Disaggregate Revenues (Two-year Rolling Changes)—1985 Adjustment Plan

	1984-85 (Base-year level)	1984-85 to 86-87	1985-86 to 87-88	1986-87 to 88-89 ^a	1987-88 to 89-90	1988-89 to 90-91	1990-91 (End-year level)
(As percent of GNP/GDP)							
<i>2-year projected changes</i>							
Budgetary revenues	15.2	0.8	0.8	n/a	-0.4	0.5	17.9
Tax revenues	13.4	0.9	0.9	n/a	-0.2	0.8	16.7
Personal income tax	6.9	0.7	0.9	n/a	-0.4	0.5	8.2
Corporate income tax	2.3	0.2	0.0	n/a	0.1	0.2	2.2
UI contributions ^b	n/a	n/a	0.0	n/a	-0.3	0.0	1.8
Sales and excise taxes and duties	4.3	-0.1	0.0	n/a	0.3	0.2	4.5
Other revenues	1.8	0.0	-0.1	n/a	-0.1	-0.3	1.2
<i>2-year actual changes</i>							
Budgetary revenues	14.6	0.8	1.7	n/a	-0.2	0.6	17.6
Tax revenues	13.0	0.9	1.5	n/a	-0.2	0.4	15.9
Personal income tax	6.7	0.9	1.3	n/a	-0.2	1.0	8.5
Corporate income tax	2.2	-0.2	0.1	n/a	0.0	-0.2	1.7
UI contributions ^b	n/a	n/a	0.1	n/a	-0.2	0.0	1.9
Sales and excise taxes and duties	4.2	0.1	0.1	n/a	0.2	-0.4	3.8
Other revenues	1.5	0.0	0.1	n/a	0.0	0.1	1.6
Overperformance (actual relative to plan)							
Budgetary revenues	-0.6	0.0	0.9	n/a	0.2	0.0	-0.4
Tax revenues	-0.4	0.0	0.6	n/a	0.0	-0.4	-0.8
Personal income tax	-0.2	0.2	0.4	n/a	0.2	0.4	0.3
Corporate income tax	-0.1	-0.4	0.0	n/a	-0.1	-0.4	-0.4
UI contributions ^b	n/a	n/a	0.1	n/a	0.0	0.1	0.0
Sales and excise taxes and duties	-0.1	0.2	0.1	n/a	-0.1	-0.5	-0.7
Other revenues	-0.2	0.0	0.3	n/a	0.2	0.4	0.4

^aThe 1987-88 Budget was not published.

^bThe 1985 Budget recorded and projected the net unemployment insurance expenditure (benefits minus contributions).

TABLE 1.5 Disaggregate Revenues—1995 Adjustment Plan

	(As percent of GDP)					
	Plan (p)			Actual (a)		Greater-Than-Expected Increase $\Delta a - \Delta p$
	1993-94 (p)	1996-97 (p)	Δp	1993-94 (a)	1996-97 (a)	
Budgetary revenues	16.3	16.7	0.4	15.9	16.8	0.9
Tax revenues	14.9	15.6	0.7	14.5	15.4	0.9
Personal income tax	7.2	7.9	0.7	7.1	7.6	0.5
Corporate income tax	1.4	2.0	0.6	1.3	2.0	0.7
UI contributions	2.6	2.3	-0.3	2.5	2.4	-0.1
Sales and excise taxes and duties	3.8	3.5	-0.3	3.7	3.5	-0.2
Other revenues	1.4	1.1	-0.3	1.4	1.4	0.0
						0.5
						0.2
						-0.2
						0.1
						0.2
						0.1
						0.3

freezes, and efficiency gains, rather than a fundamental review or change in mandate.¹⁸ The 1986 Budget Papers stated that a general cut averaging 2 percent of nonstatutory expenditures (excluding defense and foreign aid) would be implemented by 1986–87, and funding for operations and maintenance would be allowed to grow by only 2 percent per year from this reduced base over the remainder of the decade. Departments were expected to use efficiency gains. Although the 1985 Budget recognized that reduction of the deficit over the medium-term would require a reduction in transfers to persons and other levels of government (which accounted for half of primary expenditures), measures in these areas were limited.¹⁹

Having learned from the 1985–91 episode and backed by unprecedented public support, the government introduced in the 1995 Plan major initiatives centered around four pillars:

- i. A Program Review encompassing a comprehensive review of federal department spending, excluding only major statutory programs
- ii. A reform of the unemployment insurance program
- iii. Major revisions to the system of transfers to the provinces
- iv. Pension reform

This section will focus on the Program Review, leaving the discussion of the latter three initiatives to the section on structural reforms.

The Program Review, announced in the 1994 Budget and incorporated in the 1995 Budget, aimed to “ensure that the government’s diminished resources are directed to the highest priority requirements and to those areas where the federal government is best placed to deliver services” (1995 Budget, p. 11). It stressed that fiscal adjustment could not be the only element to a strategy to promote growth and employment. The Program Review, consequently, helped refocus the role of government by examining the mandates for the federal government as a whole and for each department.²⁰ It encompassed all program spending, except major statutory spending, such as unemployment insurance, old age security, and major transfers to the provinces.²¹ Ministers were asked to assess their own programs and activities by applying six criteria:

- i. Serving the public interest
- ii. Necessity of government involvement, as opposed to the private sector
- iii. Appropriateness of federal role, as opposed to other levels of government
- iv. Scope for public and private sector partnerships
- v. Scope for increased efficiency
- vi. Affordability

The Program Review suggested a “long-lasting structural change in what the government does” and a “fundamental change in how the government delivers programs and services” (1995 Budget, pp. 11–12). The main changes included:

- Elimination and substantial reduction of subsidies
- Redesign of programs to make them more efficient
- Merger and consolidation of programs
- Transfer of programs to other levels of government
- Privatization of activities

The program review exercise was politically challenging, including within the government. Many ministers initially found it difficult to accept the extent of the cuts expected of them. Nevertheless, Finance Minister Paul Martin fostered their support, with the firm backing of Prime Minister Jean Chretien.²² “The [program review] process was disciplined by a firm requirement that the individual spending cuts had to add up to a predetermined level of savings needed to meet the budget targets” (Martin, 1996). “If a minister did not identify the cuts necessary to reach the target, the [program review] committee would do it for him. . . . [The committee] was told they could alter the specific targets for cuts to each department, but it was a zero sum game: if they wanted to lower the target on one department from 20 percent to 10 percent, they could; but then they had to cut deeper elsewhere” (Martin, 2008). After the committee ratified the departmental amounts, individual ministers established priorities within their own areas of responsibility.

As a result of the reduction or elimination of government programs, expenditures of some departments would be cut in half. There would be a reduction in the number of federal civil servants by 14 percent compared to the 1994–95 level over three years. In addition, there was an extension of the civil service wage freeze.²³ Other major cuts in spending included a reduction in defense spending by 0.4 percent of GDP.

Tables 1.6 and 1.7 show that the primary (program) expenditure outcome was better than planned in both episodes. In terms of the composition of expenditure adjustment, the 1995 Plan put somewhat more emphasis on cuts in transfers compared with the 1985 Plan: 55 percent of planned primary expenditure adjustment in the 1995 Plan was in transfers to persons and other levels of government, compared to 45 percent in the 1985 Plan. Ex-post, transfers were lower than planned over 1994–97 and higher than planned over 1985–91. This reflected the lack of structural reforms in the 1985 Plan, which relied primarily on a change in the indexation scheme, in contrast with a major structural reform of the unemployment insurance program in the 1995 Plan. Similarly, other spending, the primary focus of the

TABLE 1.6 Disaggregate Expenditures—1985 Adjustment Plan

	(As percent of GNP)						Greater-Than-Expected Cuts $-(\Delta a - \Delta p)$
	Plan (<i>p</i>)			Actual (<i>a</i>)			
	1984-85 <i>p</i>	1990-91 <i>p</i>	Δp	1984-85 <i>a</i>	1990-91 <i>a</i>	Δa	
Budgetary expenditures	23.7	20.8	-2.9	23.4	21.2	-2.3	-0.6
Program spending	18.4	14.9	-3.5	18.3	14.7	-3.6	0.1
Transfers to persons	4.0	3.1	-0.9	3.8	3.3	-0.4	-0.4
Transfers to other levels gov't	4.2	3.5	-0.7	4.3	3.5	-0.8	0.0
Defense	2.1	2.0	-0.1	2.0	1.8	-0.2	0.1
Other spending ^a	8.1	6.3	-1.8	8.3	6.1	-2.2	0.4
Public debt charges	5.3	5.9	0.6	5.1	6.5	1.4	-0.8

^aOther spending includes spending by departments (other than defense), agencies, and Crown corporations, and transfers other than major transfers to persons and other levels of government.

TABLE 1.7 Disaggregate Expenditures—1995 Adjustment Plan

	(As percent of GDP)							Greater-Than-Expected Cuts $-(\Delta a - \Delta p)$
	Plan (p)			Actual (a)				
	1993-94 p	1996-97 p	Δp	1993-94 a	1996-97 a	Δa		
Budgetary expenditures	22.2	19.3	-2.9	21.7	17.9	-3.8	0.9	
Program spending	16.9	13.1	-3.7	16.5	12.5	-4.0	0.3	
Transfers to persons	5.5	4.5	-1.0	5.2	4.1	-1.1	0.1	
of which: UI benefit	2.5	1.7	-0.8	2.4	1.5	-0.9	0.1	
Transfers to other levels gov't	3.8	2.8	-1.0	3.7	2.6	-1.1	0.1	
Defense	1.5	1.2	-0.4	1.6	1.0	-0.5	0.2	
Other spending ^a	6.0	4.6	-1.4	6.1	4.8	-1.3	-0.1	
Public debt charges	5.3	6.2	0.8	5.2	5.4	0.2	0.7	

^aOther spending includes spending by departments (other than defense), agencies, and Crown corporations, and transfers other than major transfers to persons and other levels of government.

1985 Plan, overperformed over 1985–91. Furthermore, the reduction in most expenditure categories was greater than the target set by the 1995 Plan. The next section will further examine the structural reforms introduced in the 1985 and 1995 Plans.

Structural Reforms

The spending reduction in the 1994–97 episode was buttressed by a structural reform of major statutory spending programs associated with transfers to persons and transfers to other levels of government, whereas there was no major attempt to reform these programs during the 1985–91 episode.²⁴

Most of the reduction in statutory spending over 1985–91 was carried out through a change in the indexation factor used for family allowances and old-age security payments, from full CPI adjustment to an increase in the CPI minus 3 percentage points—introduced in the 1985 Budget. The change in indexation for old-age security was later withdrawn in response to intense public criticism. Toward the end of the 1985–91 episode, there were also efforts to contain transfers to the provinces (through freezes and caps) and an unemployment insurance reform, but these were of relatively limited scope and implication. By contrast, the 1995 Plan aimed to reduce spending in the statutory programs through major reforms explained below.

Transfers to Persons: Unemployment Insurance

The Canadian unemployment insurance system was characterized as not only distortionary but also fiscally costly relative to other OECD countries in the early 1990s.²⁵ Two distortions stood out: (i) the system encouraged a high incidence of frequent users; and (ii) the regional differences in the benefits exacerbated the regional differences in unemployment.

An initial set of reforms was introduced through the 1994 Budget, including: (i) an increase in the minimum period of work required to qualify for unemployment insurance benefits; and (ii) a reduction in the maximum duration of benefits and the benefits rate, especially for the high-unemployment regions. A major labor market reform was introduced by the 1996 Employment Insurance Act, which overhauled the system of benefits as well as labor market policies and funding of the system.²⁶ Together, these reforms helped reduce the distortions and excessive cost of the unemployment insurance system.

Transfers to Provinces

In the 1995 Budget, the system of transfers to the provinces was changed, to increase cost-effectiveness and flexibility. Canada Assistance Plan, a shared-cost

program for provincial social welfare programs, and Established Programs Financing, a block grant from the federal government to finance provincial post-secondary education and health, would be replaced by Canada Health and Social Transfer, a full block grant. In addition to reducing federal transfers to the provinces, the move from partial cost-sharing to full block grants was designed to increase the incentive for provinces to limit additional social expenditure. The shared-cost program, under which the federal government covered up to one-half of the provincial governments' spending on a broad range of social services and social assistance, had grown at an unsustainable rate even during periods of strong economic growth. The full block grant system would also provide the provinces more flexibility in allocating social expenditures.

With these reforms, the provinces played an important role in the elimination of the federal government deficit. Actual transfers to the provinces had already been reduced by 0.5 percent of GNP from 1984–85 to 1993–94. They were further reduced by 1.1 percent of GDP by 1996–97—from 3.7 percent of GNP in 1993–94 to 2.6 percent of GDP in 1996–97. Despite these cuts in transfers, the provinces improved their own finances, as discussed below.

Both adjustment plans were at the federal government level, rather than at the consolidated general government level. However, in view of the reduction in transfers to subnational governments, we augment the analysis through an assessment of the consolidated general government overall balance.²⁷ This assessment is done on an ex-post basis due to the constraint in budget data availability at the subnational government level. Figure 1.4 depicts the overall balance paths at the federal, subnational, and consolidated

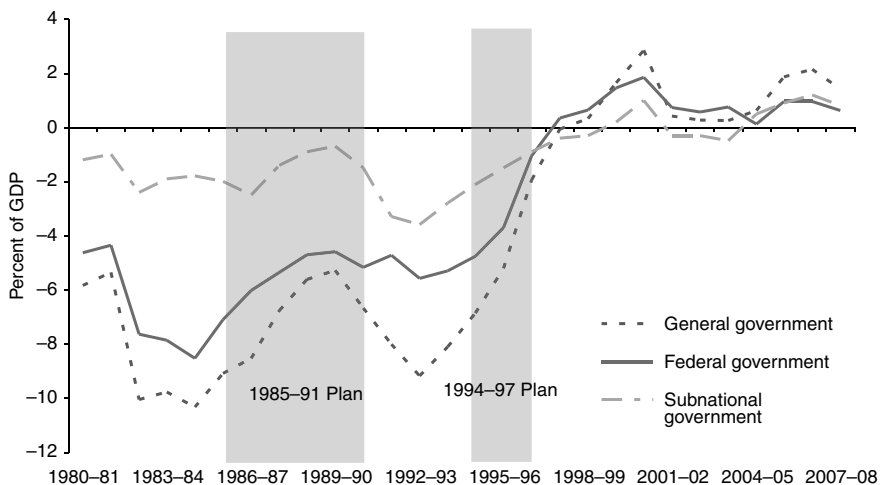


FIGURE 1.4 General, Federal, and Subnational Government Overall Balances

general government levels. The subnational government overall balance improved together with the federal government overall balance over 1986–87 to 1989–90. However, the former deteriorated to a much larger extent than the federal government overall balance after 1989–90, resulting in a fast deterioration of the consolidated general government balance. The deterioration in the subnational government overall balance is explained by the large increase in subnational government expenditure related to the 1990–91 recession. The financial markets reacted to these developments by downgrading provincial credit ratings, which in turn induced most provincial governments to take drastic adjustment measures in their 1993 Budgets. In response, most provincial governments introduced plans to balance their budgets within three years, with some passing balanced-budget legislation.²⁸ During 1994–97, the overall balance of subnational governments, the federal government balance, and the consolidated general government balance all improved.

Pension Reform

Consistent with the focus on long-term fiscal sustainability and following extensive debate, the federal government and the provinces also reformed the Canada Pension Plan (CPP) in 1998. CPP pensions are paid entirely by contributions made by employers and employees; hence, public pension accounts are not part of the federal government's budgetary accounts.²⁹ Nevertheless, as in several other advanced economies, pensions are a key long-run fiscal challenge for the government.

In the mid-1990s, it was clear that, owing to population aging, slower productivity growth, and generous benefits, action needed to be taken to ensure the sustainability of the pension system. The net present value of the unfunded liabilities of the CPP stood at 75 percent of GDP in 1995, a level comparable to the net federal debt at the time. Based on status quo trends, the contribution rate would have to increase from 5.6 percent in 1995 to 14.2 percent for pay-as-you-go sustainability. In 1998, the federal and provincial governments agreed to pre-fund the CPP by raising premiums over 1998–2003 from 5.6 percent to 9.9 percent, and to create an independent CPP Investment Board charged to invest the excess contribution income using a market-driven investment strategy (Courchene, 1997). Thanks to these measures, the CPP has since been assessed to be actuarially sound.

Extent to which Adjustments Were Sustained

The last element in our analysis examines the extent to which the adjustment gains accomplished by the plans were sustained in subsequent years. In

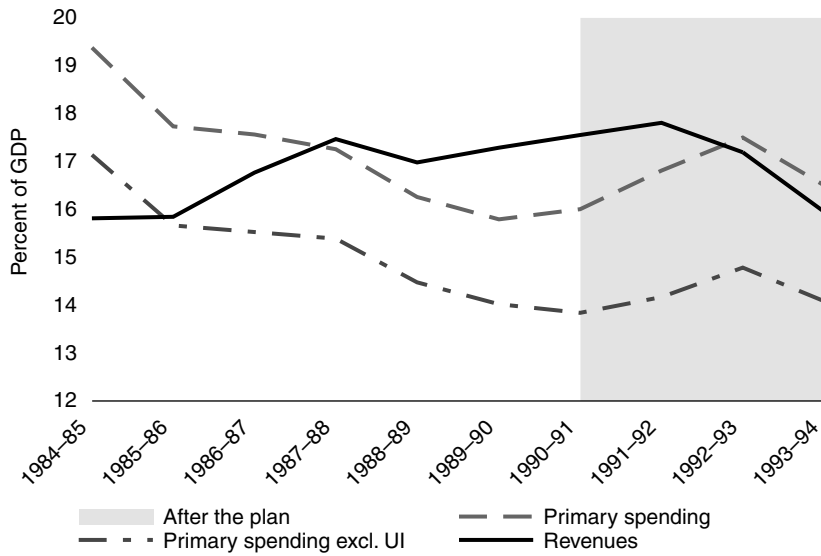


FIGURE 1.5 Period after the 1985-91 Plan

short, while both adjustment plans resulted in improved fiscal balances, the 1994-97 gains were better sustained, because they were accomplished through durable, structural reforms. Figures 1.5 and 1.6 present the development of the headline fiscal aggregates after each adjustment episode.

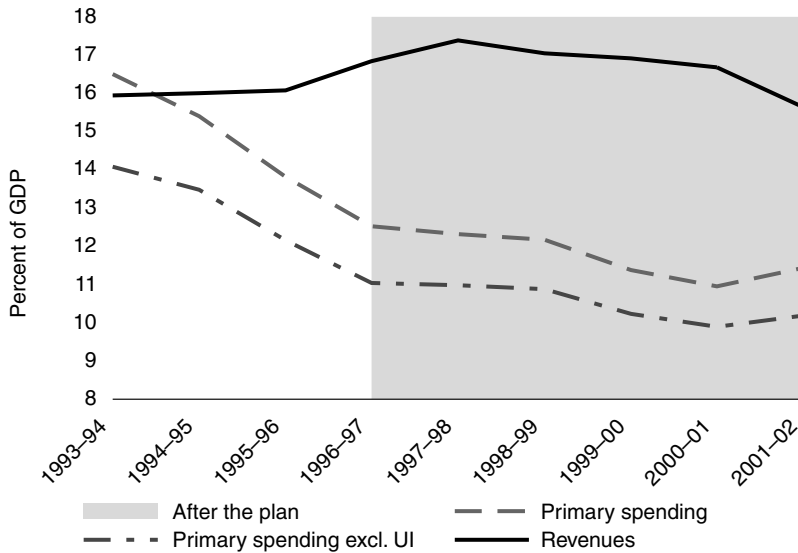


FIGURE 1.6 Period after the 1994-97 Plan

The 1985 Plan resulted in an improvement in the primary surplus to 1.6 percent of GDP in 1990–91. However, the primary balance deteriorated in the following three years, owing to a recession and subsequent moderate growth. Both declining revenues and increased spending contributed to this deterioration (see Figure 1.5). Spending increase was a result of both the automatic increase in the unemployment insurance benefits and other discretionary policies.

The 1995 plan firmly raised the primary surplus to above 4 percent of GDP in 1996–97, setting the debt-to-GDP ratio on a downward path. In subsequent years, this permitted some tax cuts in combination with a stabilization of the spending-to-GDP ratio.³⁰ Primary surpluses were maintained for 11 consecutive years until the economic crisis of 2008–09.

Conclusion

Canada, which currently has the lowest net general government debt-to-GDP ratio among the G-7 countries, stands out based on its successful response to fiscal pressures through large and sustained adjustment. This chapter's analysis of two fiscal adjustment plans in Canada finds that four elements brought about a lasting improvement in Canada's fiscal position:

- i. Broad-based public support
- ii. A repositioning of the role of government and deep structural reforms
- iii. Prudent macroeconomic and fiscal assumptions
- iv. Fiscal consolidation at the subnational level

In both adjustment episodes, the actual overall balance outperformed plans. The 1985 Plan, however, was not able to stabilize the public debt-to-GDP ratio. The 1985 Plan relied primarily on across-the-board cuts and freezes and was criticized both domestically and internationally for not being sufficiently ambitious. Indeed, throughout the 1985–91 episode, the general government overall deficit remained higher than all G-7 countries' except Italy's.

By contrast, over 1994–97, Canada's general government overall balance improved from the second worst to the top ranking in the G-7 countries and remained there until 2009 (see Figure 1.7).

Despite its shorter duration, the 1995 Plan was able to stabilize debt, benefiting from a repositioning of the role of government and profound structural reforms. A comprehensive review of federal departmental spending proposed and implemented major changes to what the federal government did and how it delivered its programs and services. In addition, structural reforms addressed inefficiency and sustainability issues with

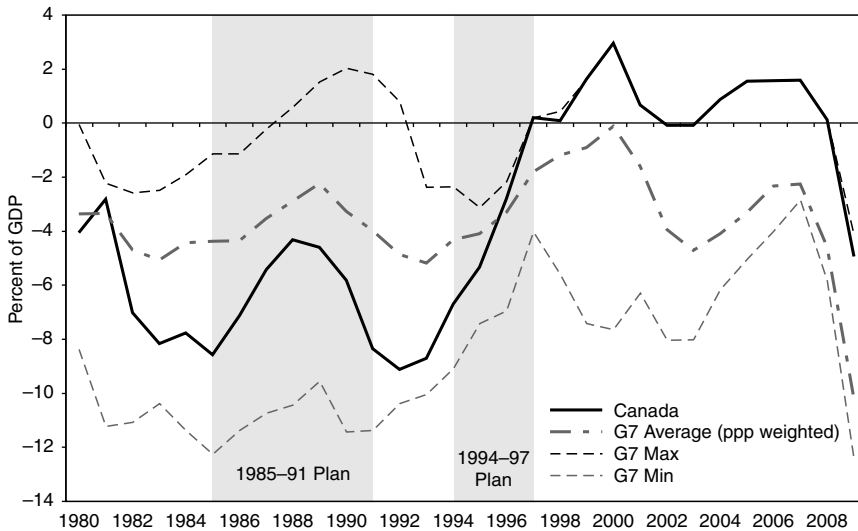


FIGURE 1.7 General Government Overall Balance Canada versus G-7

transfers to provinces, unemployment insurance, and the pension system. Prudent macroeconomic and fiscal assumptions helped the overall balance outcome to be consistently better than plans, raising public confidence in the plan. The subnational governments also helped to improve the general government balance, by increasing their fiscal balances despite cuts in transfers from the federal government.

The ambition of the 1995 Plan reflected a stronger public mandate for fiscal consolidation. While a small percentage of the public viewed the federal deficit and national debt as a major economic problem prior to the 1985–91 episode, 70 percent of Canadians were in favor of cutting spending to reduce the deficit, rather than increasing it to stimulate the economy, prior to the 1994–97 episode. The government's intensive communication strategy on the implications of high debt levels for growth and intergenerational equity helped to raise public awareness of the need for fiscal adjustment and supporting structural reforms.

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Notes

1. More specifically, the 1985 Plan was announced in the February 1985 Budget and covered fiscal years 1985–86 to 1990–91. The 1995 Plan was announced in the February 1994 and February 1995 Budgets and covered fiscal years 1994–95 to 1996–97. The fiscal year in Canada runs from April 1 to March 31.
2. Strong productivity growth before 1973 and tax bracket creep from inflation had resulted in strong personal income tax revenue growth in the 1960s and early 1970s.
3. Bank of Canada's policy switch toward greater emphasis on price stability in the early to mid-1980s further contributed to high short- and medium-term interest rates. (See Courchene, 2005, for a more detailed discussion.)
4. *Globe and Mail*, "Confronting the Debt," August 14, 1984.
5. Government of Canada, *A New Framework for Economic Policy*, Ottawa, 1994.
6. Another important document ("Creating a Healthy Fiscal Climate") presented the required fiscal actions to achieve the desired deficit reduction targets for 1995–96 and 1996–97; Government of Canada, *Creating a Healthy Fiscal Climate*, Ottawa, 1994.
7. This budget contained some expenditure reduction measures, primarily for defense spending and unemployment benefits.
8. *Wall Street Journal*, "Bankrupt Canada?" January 12, 1995.
9. The 1995 Plan launched the discussions with the provinces on the reform of the Canada Pension Plan (CPP). The pension reform was implemented in 1998.
10. The 1995 Budget proposed revenue and expenditure *measures* for three years (i.e., 1995–96 to 1997–98). However, medium-term revenue and expenditure *projections* were limited to the first two years.
11. A budget allocation of 0.4 percent of GDP was to be kept in a contingency reserve, and hence, was not recorded as part of planned deficit reduction (see Table 1.2).
12. Previous studies have shown that the elasticity of expenditures, and thus, the cyclical expenditure component is small in Canada.
13. To match the authorities' original presentation, we use GNP as a scaling variable for the 1985 Plan and GDP for the 1995 Plan. For simplicity, we scale the headline and structural variables to nominal GNP (or GDP) rather than potential GNP (or GDP). The equation we used for decomposition is

$$\frac{R}{Y} = \frac{R}{Y} \frac{Y^P}{Y} + \frac{R}{Y} \frac{Y - Y^P}{Y}$$

where R is nominal revenues; Y is actual GNP (or GDP), and Y^P is potential GNP (or GDP). For comparison, we also present major structural variables as percentages of potential GNP (or GDP) in memo items.

14. *Globe and Mail*, "[Finance Minister] Mr. Wilson Didn't Go Far Enough," February 21, 1990. For a similar comment a year earlier, see *Globe and Mail*, "Ottawa Urged to Halve \$29 billion Deficit," February 22, 1989.

15. International Monetary Fund, "Staff Report for the 1988 Article IV Consultation," Washington, D.C., 1989; Organization for Economic Co-operation and Development, "OECD Economic Surveys: Canada," Paris, 1994.
16. The government's real GDP growth assumptions were also prudent compared to the private sector and OECD assumptions, however, the government's assumptions turned out to be more optimistic than the outcome.
17. Denote G as the planned nominal government expenditure, and Y as the nominal GDP. Subscript t refers to the year when the fiscal adjustment plan is announced, and $t+N$ is the target year. The adjustment (both planned and actual) in the expenditure-to-GDP ratio can be decomposed as follows:

$$\left(\frac{G_{t+N}}{Y_{t+N}} - \frac{G_{t-1}}{Y_{t-1}} \right) = \frac{P_{t-1}(g_{t+N} - g_{t-1})}{Y_{t-1}} + \frac{(P_{t+N} - P_{t-1})g_{t+N}}{Y_{t-1}} - \left(\frac{Y_{t+N} - Y_{t-1}}{Y_{t-1}} \right) \left(\frac{G_{t+N}}{Y_{t+N}} \right)$$

Assuming that government expenditures are fully indexed to the consumer price index, P , the first term on the right-hand side of the above equation describes the contribution from expenditure changes in real terms, the second term the inflationary effect, and the last term the denominator effect coming from the nominal GDP growth. This analysis is especially important in periods of high inflation and output volatility, as in the 1980s.

18. Nonstatutory expenditures are those that Parliament approves annually through an Appropriation Act. Federal departmental expenditures fall under this category. Statutory expenditures are those that Parliament has approved through legislation (other than Appropriations Acts) setting out the purpose of the expenditures and the terms and conditions under which they may be made. Transfers to persons and to other levels of government fall under the latter category.
19. Major components of expenditures were (i) transfers to persons (28 percent of total primary expenditures); (ii) transfers to provincial governments (22 percent); (iii) defense (9 percent); and (iv) other expenditures (40 percent) in 1984–85.
20. See Bourgon (2009) for a detailed discussion on the distinct approach taken by the Program Review.
21. 1995 Budget in Brief, p. 8.
22. The political challenges of the program review process were discussed with the then–Finance Minister Paul Martin and Assistant Deputy Minister for Economic and Fiscal Policy Paul-Henri Lapointe. They are explained in detail in Paul Martin's memoirs (Martin, 2008).
23. Civil service wage freeze was first introduced in March 1991.
24. Transfers to persons consisted of old-age security benefits, family allowance and children's benefits, and unemployment insurance benefits. Transfer programs to other levels of government included the Established Programs Financing, the Canada Assistance Plan, and Equalization Payments.
25. See OECD Economic Surveys, Canada, 1994.

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26. The main changes to the system of benefits included: (i) the basing of the eligibility requirement on hours worked rather than weeks; (ii) the basing of the benefit calculation on earnings over a fixed reference period; (iii) the introduction of a new intensity rule that reduced the replacement rate for frequent users; (iv) a reduction in the duration of benefits in higher unemployment regions; (v) a reduction in maximum insurable earnings; and (vi) a clawback of benefits for frequent high-income users.
 27. The reduction in transfers to provinces was found to be too drastic in some cases. These transfers were later increased, although they never went back to the levels in terms of GDP prior to the 1994–97 adjustment.
 28. The two largest provinces, Ontario and Quebec, were slower to adjust.
 29. CPP is included in the general government accounts, which is relevant for international comparisons.
 30. The 2000–01 recession was very mild in Canada compared to the United States or compared to the 1990–91 recession.

