L.5.2 RFD 321

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

May 5, 1959

Canada's Budget for 1959-60 11 pages

Henry N. Goldstein

NOT FOR PUBLICATION

May 5, 1959

Canada's Budget for 1959-60

Henry N. Goldstein

Introduction and summary

The new budget for the financial year beginning this April 1 marks a significant shift in Canadian fiscal policy. In contrast to last year's expansionary budget when taxes were cut and expenditures sharply increased, the new budget contains a wide range of tax increases and a relatively moderate growth in expenditures. If the forecast growth of 7 per cent in Gross National Product materalizes, the cash deficit will be reduced from $1,300 million last year to $850 million this year.1/

The Government's decision to reduce the deficit stems from the strong recent rise in business activity and from the difficulties it met last year in attempting to finance the deficit outside the banking system, especially after the turnabout in business expectations early last summer.

The debt-management difficulties associated with last year's record deficit were aggravated by the fact that several of the spending commitments in the anti-recession fiscal program were long term in character. Among these commitments were higher old-age benefits, the introduction of a federal hospital insurance plan, increased agricultural price supports and larger provincial grants. As a result, one Canadian fiscal expert estimated that -- without changes in taxation or additional spending commitments -- the Canadian budget would continue in deficit until 1967.2/

The new budget faces up to the need to finance the growth in government expenditures. The deficit in the old-age security fund will be nearly eliminated by a 33 per cent increase in taxes earmarked for social security benefits and a wide range of other new taxes will help cover other spending commitments. At the same time, net government outlays for housing -- the most flexible element in the Government's anti-recession spending -- are scheduled to be somewhat reduced. Finally, with business activity expanding, there will be an automatic increase in tax receipts and a decrease in unemployment compensation payments.

With higher tax rates and an estimated 7 per cent rise in Gross National Product, tax receipts in the new fiscal year are expected to rise by $643 million or about 14 per cent above last year's revenues.

1/ All figures in this paper are in Canadian dollars.
2/ See Harvey Perry, "The Outlook in Taxation," Canadian Tax Journal, July-August 1958, p. 245.

Mainly because of expenditure commitments made last year, budget outlays plus pension payments will rise by $277 million or 4.6 per cent above spending in 1958/59. With a nonbudget deficit only slightly greater than last year, the Government's cash deficit will decline from $1.3 billion (4.3 per cent of Gross National Product in 1958) to $850 million (2.6 per cent of forecast Gross National Product in 1959).

The task of financing the deficit outside the banking system has been materially eased by last summer's conversion loan campaign which succeeded in nearly doubling the average term of the funded national debt and also removed the heavy concentration of issues maturing in 1959, 1960 and 1962. Thus, in spite of the Government's reliance on short-term borrowing since the conversion, there are only $1,350 million of maturing securities to be converted during the new fiscal year as compared with $1,947 million which confronted the authorities on April 1, 1958.1/

These refinancing requirements plus the necessity to finance the cash deficit are bound to add to the Government's debt-management costs. Not only will the total funded debt held outside the government accounts be increased but the Government will be forced to pay interest rates higher than at any time in the postwar period. Since their artificial suppression by the Bank of Canada during the conversion last September interest rates have risen to record levels for all maturities. This rise has reflected a combination of monetary restraint by the Bank of Canada and an increased prospective demand for funds by private borrowers and local governments. Nonetheless the "debt burden" on the Canadian taxpayer, as measured by the ratio of net2/ interest payments to Gross National Product, should be well below the 2.13 per cent mark reached in 1950.3/

Tax receipts to rise by 14 per cent

Tax receipts, including contributions to the old-age security fund, are scheduled to rise from $4,650 million last year to $5,293 million in 1959/60. (See Table 1.) Of this 14 per cent year-to-year rise, almost two-thirds is due to the anticipated increase in economic activity; the increase in revenues due to higher tax levies in the new

1/ There was, however, a striking monetization of the public's debt holdings during the conversion which led to a sharp increase in the money supply at that time.

2/ Interest paid by the Federal Government less interest received by the Federal Government.

3/ Furthermore, the New York capital market often provides a fairly elastic alternative supply of funds to Canadian borrowers, particularly provinces and municipalities. In the past, this ready access to external funds has moderated the rise in interest rates in Canada.

fiscal year is only $245 million, just 4.9 per cent greater than estimated receipts at unchanged tax rates. When all the tax increases are in effect for a full year, however, they are expected to raise revenues by 7.0 per cent.

Some of the new tax increases are classified as "budgetary levies" and some as "old age security fund contributions." The increases in budgetary levies, are as follows:

(a) Personal Incomes -- All rates on taxable incomes over $3,000 are increased by 2 per cent effective July 1. This measure will affect only the upper 17 per cent of Canadian taxpayers.

(b) Corporate Tax -- Rates on corporate incomes over $25,000 are raised by 2 per cent retroactive to January 1, 1959, a change affecting 8,000 out of Canada's 50,000 corporate taxpayers.

(c) Excise Taxes -- Effective immediately, taxes on spirits distilled in Canada are raised from $12 to $13 per proof gallon and taxes on a regular pack of cigarettes are increased by 2 cents a pack. These increases, plus other minor changes, will bring in 7 per cent more revenue from excise taxes.

The new budget increases old age security contributions by 33 per cent. This rather drastic change will raise revenues by $196 million in a full year. "Contributions" from personal incomes will now be 3 per cent instead of 2 per cent and the upper contributory limit will be $90 instead of $60; corporate incomes will be taxed 3 per cent instead of 2 per cent; and the general sales tax will be raised from 2 per cent to 3 per cent.

The new tax increases compared to the 1957 tax reductions

In appraising the impact of these changes on total spending and on Canada's over-all federal tax incidence, the tax decreases put into effect in December 1957 should be kept in mind. At that time total taxes were cut by 3.8 per cent and the cuts made were heavily weighted in favor of lower-income taxpayers. If only the personal income tax (including social security contributions) is considered, taxpayers in the lower and middle income brackets will still pay less in direct taxes than before the 1957 tax cut. "At the same time," as the Finance Minister put it, "they are receiving the protection of a social security system which has been greatly improved and extended." Nevertheless, the new increases in indirect taxes mean that the average lower income earner will probably still pay, in real terms, for at least the same proportionate share of government expenditures as before the 1957 tax reductions.

Budget expenditures to rise by 5 per cent

The Government's regular expenditures excluding payment of the deficit in the old age security fund will increase by 4.8 per cent over expenditures in 1958/59.1/ Almost the whole increase is in non-defense spending. Roughly half is due to larger federal contributions under the Hospital Insurance and Diagnostic Services Act passed in 1957 which this year will amount to $160 million.

A slight increase in the nonbudget deficit

For an adequate appreciation of the Canadian Government's effect upon the nation's income and spending stream, government receipts and outlays in the nonbudget category must also be analyzed. These transactions consist mainly of loans and advances to various crown corporations and repayments to the Government by these corporations. Sometimes, however, receipt and expenditure items from the regular budgetary accounts are shifted "below the line" and vice-versa; thus, last year, budget outlays were reduced and extra-budgetary outlays were increased by $211 million through the liquidation of the "national defense equipment account."2/

In the new fiscal year the nonbudget deficit is expected to amount to $450 million, slightly greater than last year's excess of outlays over receipts. Most of the important increases in loans to the national railway and to the Government's housing agency will be maintained, but payments to the unemployment insurance fund will probably be reduced.

Financing the budget's cash deficit

Although its cash deficit is 40 per cent less than last year, the new budget still poses a serious financing problem. Even if the Government can achieve the high level of net sales of Savings bonds reached last year, it will still need to borrow in the market $500 million to meet its cash deficit and $1,350 million to roll over maturing bond issues.

The Government's efforts to finance its current deficit outside the banking system would be even more difficult if last summer's conversion operation had not drastically reduced the quantity of debt maturing in the next few years. The conversion removed $905 million

---

1/ The increase will probably be somewhat greater since it is customary to make supplementary appropriations later in the year.

2/ When a budget surplus to combat inflation is desirable such political bookkeeping is used to avoid political pressure for a tax cut; last year however the accounts were juggled to make the deficit appear smaller than it really was, thus reducing pressure for a more nearly balanced budget.

in debt maturing in 1959, $1,119 million maturing in 1960 and $1,262 million maturing in 1962. Of the issues falling due in 1959 and 1960, $1,020 million were converted forward only until December 1, 1961 but all of the issues maturing in 1962 were shifted into new issues maturing in 1965 or later.1/

This debt reconstruction was achieved, however, at the "cost" of a large scale monetization of nonbank debt. As Table 4 shows, the general public reduced its debt holdings by $520 million in the third quarter of 1958. The resulting simultaneous expansion in the money supply was much greater than the authorities considered desirable and has led the Bank of Canada to adopt a very restrictive policy in the seven months since the conversion ended. In this period, the Bank of Canada and the government accounts have reduced their combined government security holdings by $401 million.

Since last September, when the refunding ended, the rise in the total government debt has been more than completely absorbed by the nonbank public who, as Table 4 shows, have increased their debt holdings by over $1,700 million. In this period, the Government has not tried to float any long-term marketable issues.2/ Instead, it has marketed $600 million in short-term issues ranging in maturity from 12 to 48 months and also increased the outstanding issue of 91-day Treasury bills by $100 million. These recent issues have been priced to pay extremely high yields and in some cases have embodied substantial tax advantages for wealthy investors.

The new budget's impact on aggregate spending

In the fiscal year just ended, the Government's cash outlays exceeded its receipts by $1,263 million. Since the Government increased its cash liabilities during the year by $122 million its "real" cash deficit amounted to $1,385 million. This would be equivalent to a $20.0 billion deficit in the United States or almost three times the cash deficit which this country actually incurred.

The new budget's cash deficit is expected to fall to $885 million, because of the rapidly expanding tax base and the various tax increases. If the economy advances as the Finance Minister has projected, the ratio of the cash deficit to Gross National Product will be whittled down from 4.3 per cent last year to 2.6 per cent in the current year. This would still be equivalent to a $12 to $13 billion deficit in the United States.

1/ The conversion also shifted $2,520 million in bonds maturing in 1963 and 1966 forward to 1972 and 1983.

2/ A government guaranteed Canadian National Railway issue to be dated May 15, 1959 and having maturities of 9 and 18 years was announced on May 4. The issue totals $150 million.

The question naturally arises: Is this an appropriate deficit for Canada to run under present economic conditions?

Nearly all Canadian business indicators have moved upward since October 1958 but substantial margins of unused human and physical resources remain. Hence, the Government has had to strike a compromise between promoting rapid recovery and restraining the build up of inflationary pressures.

At present, a widespread economic recovery is taking place. Output and employment are rapidly increasing in spite of a relatively depressed demand for Canadian exports, a static level of private investment in the resources industries, and the completion of several large resource investment projects -- e.g., the Saint Lawrence Waterway, the trans-Canada pipeline and various large private power projects. These factors have been more than offset by the rapid recent growth in consumer spending, especially on durables, continued high expenditures for housing, and expansion in a variety of social capital areas such as hospitals, schools, roads and railways. The reaccumulation of business inventories, sharply reduced in the recession, will further strengthen recovery.1/

Nevertheless, at the end of April a great deal of surplus capacity remained in the Canadian economy. Real Gross National Product for the first quarter of 1959 was only about 4 per cent higher than in the same quarter two years earlier; unemployment in March, seasonally adjusted, was almost 6 per cent of the labor force, and a wide margin of unemployed capital equipment was reported, especially in the capital goods and export industries. Other factors which will tend to restrain rises in prices and costs are the rapid recent growth in industrial and agricultural productivity in Canada and the United States and the growing competition from overseas manufacturers, especially in Europe and Japan.

The recent behavior of the Canadian retail price index, excluding the food component, reflects this slack in Canada's economy. Although the index rose through most of 1958, in spite of the economy's depressed condition, it leveled out in November and, in the first four months of 1959, has actually declined slightly. Wholesale prices remained level throughout 1957 and most of 1958 but they have risen slightly since last October.

1/ The recent rapid growth of chartered bank loans since early March suggests that this restocking may already be in full swing.

The new budget and inflationary expectations

Prebudget statements by economists, busiessmen, and financial writers, suggested that the recent weakness in Canadian bond prices stemmed from a belief that the Conservative Government would not be prepared to raise taxes sufficiently to pay for its expansion of government services and benefits. The tax increases in the new budget plus the Finance Minister's remarks on the probable nature of future budgets if recovery progresses should help dispel such a belief. Speaking of the future the Minister said:

> "I believe all honorable members recognize that we must look forward to a time when conditions of prosperity and employment will allow a balanced budget and when we can also make proper provision for an orderly retirement of debt."

This statement contrasts sharply with criticisms of the Liberal Government's use of fiscal policy to fight inflation during 1956 and 1957, made by the Finance Minister when he was a member of the opposition. Then he taunted the Liberals for retiring debt instead of cutting taxes. The tone of this latest budget message makes it clear, however, that neither major Canadian policital party feels it can follow anything but a "sound" fiscal policy when in power, no matter how irresponsible its criticisms when out of office.

Table 1

Federal Government Budgetary Revenue and Expenditure for the Fiscal Years Ending March 31, 1958, 1959 and 1960

(In millions of Canadian dollars)

Revenue	1957-58	1958-59	Forecast 1959-60
Personal income tax	1,500	1,371	1,578
Corporation income tax	1,234	1,029	1,097
Other taxes	1,889	1,874	2,082
Total tax revenue	4,623	4,274	4,757
Nontax revenue	426	497	510
Total budgetary revenue	5,049	4,771	5,267
Expenditure			
National defense	1,693	1,635	1,672
Health and welfare			
Hospital insurance	--	58	160
Family allowances	438	475	571
Other	121	160	92
Total health and welfare	559	693	823
Interest on public debt	567	644	651
Selected payments to provinces	383	467	462
Other	1,787	1,962	2,052
Total budgetary expenditure 1/	4,989	5,401	5,660

Old Age Security Fund

	1957-58	1958-59	1959-60
Tax receipts	372	376	536
Total pensions	474	560	578
Deficit	102	184	42

1/ Adjusted to include outlays from special defense accounts and to exclude the deficit in the old age security fund.

NOT FOR PUBLICATION

Table 2

Federal Government Nonbudgetary transactions and Cash Needs for the Fiscal Years Ending March 31, 1958, 1959 and 1960

(In millions of Canadian dollars)

Nonbudgetary receipts	1957-58	1958-59	1959-60
Repayments of loans and advances	62	103	250
Increase in net current liabilities	-157	125	?
Other receipts	457	560	?
Total receipts and credits	362	788	?
Loans and advances			
Central mortgage and housing	108	336	300
Canadian national railways	- 11	207	200
Agricultural price support	6	42	?
Net payments from unemployment fund	131	242	?
Other	215	389	?
Total loans and advances	489	1,216	?
Balance in nonbudget accounts	-127	-428	-450
Balance in budget accounts from Table 1	- 44	-814	-435
Total Federal Government cash need	171	1,242	885

NOT FOR PUBLICATION

Table 3

Yields on Government Securities
Canada and the United States

	Government Securities-Selected Issues 1/			Government Securities-Selected Issues 2/			Three month Treasury bills 3/		
	Can.	U.S.	Spread	Can.	U.S.	Spread	Can.	U.S.	Spread
1956 - March	3.37	2.94	.43	3.30	2.88	.42	2.62	2.37	.25
June	3.38	2.94	.44	3.40	2.90	.50	2.67	2.58	.09
Sept.	3.76	3.28	.48	3.81	3.33	.48	3.05	2.77	.28
Dec.	3.88	3.34	.54	4.00	3.39	.61	3.59	3.27	.32
1957 - March	3.92	3.27	.65	4.06	3.35	.71	3.73	3.24	.49
June	4.16	3.52	.64	4.49	3.70	.79	3.79	3.26	.53
Sept.	4.33	3.67	.66	4.71	3.82	.89	3.93	3.63	.30
Dec.	3.79	3.27	.52	3.66	3.04	.62	3.64	3.14	.50
1958 - March	3.83	3.28	.55	3.56	2.87	.69	2.42	1.53	.89
June	3.81	3.22	.59	3.39	2.81	.58	1.78	0.95	.83
Sept.	4.09	3.79	.30	3.67	3.62	.05	2.17	2.61	-.44
Dec.	4.42	3.81	.61	4.48	3.83	.65	3.56	2.90	.66
1959 - March	4.84	3.96	.88	4.87	3.94	.93	4.22	2.76	1.46
April	4.64	3.99	.65	4.79	4.09	.70	4.61	3.08	1.53

1/ Canada 3-1/4 per cent, October 1, 1979. U.S. 3-1/4 per cent, June 15, 1978-83. Wednesday nearest 15th of month.
2/ Canada 2-3/4 per cent, June 15, 1967-68. U.S. 2-1/2 per cent, December 15, 1963-68. Wednesday nearest 15th of month.
3/Average tender nearest 15th of month.

NOT FOR PUBLICATION

Table 4

Recent Changes in the Distribution of Canada's Net[1/] Funded Debt

(In millions of Canadian dollars, par value)

	Total Net Debt		Held by: General Public		Held by: Banking System	
	Quarterly change	Cumulative change	Quarterly change	Cumulative change	Quarterly change	Cumulative change
1958 - I	+184	+ 184	- 4	- 4	+189	+ 189
II	+393	+ 577	- 219	- 223	+611	+ 800
III	+216	+ 792	- 520	- 743	+736	+1,536
IV	+569	+1,361	+1,018	+ 275	-450	+1,086
1959 - I	+461	+1,822	+ 540	+ 815	- 78	+1,008
April	- 17	1,805	+ 216	+1,031	-233	+ 775

1/ Total Federal debt outstanding less holdings of government accounts.

NOT FOR PUBLICATION