



Public Underwriting of Private Debt

The Prospect of Industry Targeting

By the Certified General Accountants
Association of Canada



Certified General
Accountants Association
of Canada

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Table of Contents

Foreword 7

Introduction 9

1. Executive Summary 11

2. “Extraordinary” Economic Stimulus Measures 17

 2.1. Chronology of Introducing Stimulus Measures 17

 2.2. Price Tag of the Stimulus Measures 19

 2.3. Business-as-usual vs. Extraordinary Measures 21

3. Concerns Associated with the Government Bailout of
the Auto Industry 27

 3.1. Structure of the Bailout 28

 3.2. Main Concerns 31

 3.2.1. Is the Bailout to the Auto Industry
 Proportional to its Size?..... 32

 3.2.2. Will Canada Preserve its Share of
 North America’s Auto Industry? 37

 3.2.3. Did the Governments’ Action Preserve Jobs? 42

 3.2.4. Is Picking the Winner the Right Approach? 44

 3.2.5. Is There a Case of Eroding Accountability and
 Transparency? 46

4. Concerns Associated with Federal Public Debt 51

 4.1. Recessions – When Do They End? 51

 4.2. Federal Deficit and Debt – What are the Expectations?..... 54

 4.3. The Main Concern – Are the Expectations Set Correctly?..... 57

 4.4. What Should We Do with the Federal Debt? 64

5. Conclusions 69

6. Steps Forward..... 73

7. Appendix A: Description of Extraordinary Measures 79

8. References 83

List of Figures

Figure 1: Estimated Costs of Fiscal Stimulus Packages – Selected Countries	20
Figure 2: Public Policy Areas of Federal Government Budget Initiatives, 1998-99 to 2008-09 Fiscal Years	21
Figure 3 : Assessing the Quality of Extraordinary Stimulus Measures	24
Figure 4: Industries Contributing More to the Total Industry GDP Than the Auto Industry, 2007	34
Figure 5: Selected Vehicle Statistics	38
Figure 6: Vehicle Production in North America	40
Figure 7: Unit Labour Cost in Manufacturing	41
Figure 8: Past Recessions and Recoveries	52
Figure 9: Federal Budgetary and Operating Balance.....	55
Figure 10: Federal Debt	56
Figure 11: Selected Federal Budget Components	59
Figure 12: Budgetary Projections – Selected Components	63
Figure 13: Debt Service Charges and Interest Rates	67

List of Tables

Table 1: Three Federal Budget Initiatives with the Highest Price Tag in Each Fiscal Year, 1999-2008 (Millions of Dollars)	23
Table 2: Auto Industry Economic Multipliers, 2005	36
Table 3: Top Five Industries That Sustained the Highest Job Losses – Selected Months of 2009	43

Foreword

The world's economy experienced a devastating blow in the fall of 2008. In what appeared to be within the blink of an eye, financial markets buckled, mighty economies previously relied on as global economic engines retreated, and the scale of governments' interventions made some wonder if we were to witness the end of capitalism. The magnitude of this blow served to mark a sharp contrast between the recent past and the present; and when addressing just about any economic or social matter today, most of us are compelled to reference the before and the after of the economic meltdown.

In Canadian context, the 'before' consisted of a 17-year recession-free economy featuring modest yet steady income growth, high demand for labour, expanding business activity, favourably high commodity prices and a strong demand for Canadian exports. The 'after' is still in the making and continues to challenge world economies as experts wrestle with its evolution. This uncertainty leaves hope that the economic recovery will be short and easy, but it also leaves us with a discomfort that financial market sophistication combined with redefined business culture can in fact threaten the well-being of individuals, families, organizations, and governments alike.

An earlier work of the Certified General Accountants Association of Canada – "Where Has the Money Gone" – reveals how the dynamic of the Canadian households' use of financing has changed over the years. Extending the hypothesis, we today see that individuals typically respond to the offerings of the financial institutions that finance them and the governments that affect collective policy; where immediacy and speculation seem to trump persistence and conservatism.

As we make our way through this recession, we have come to appreciate that some corrections were in order. Our goal in this paper has not been to revisit what has happened, or to examine individual and financial institution behaviour, but rather, to deliberate some of the stimulus measures introduced by government. This is deemed important because such measures serve to prop up consumer confidence while bolstering the buffers in other sectors of the economy. Moreover, these measures will have immediate, transitional, and prolonged effects.

Recognizing that Canada's exposure has been moderate relative to the experience of some other countries and that governments' motivation to stem the potential fallout has been absolute, the Certified General Accountants Association commissioned this elementary review to ascertain the nature and foreseeable effectiveness of some of stimulus programs engineered. In so doing, our intention has not been to endorse a formal position, but to arouse curiosity and to identify matters of ongoing diligence. In that spirit, the Association is motivated primarily by continued dialogue and offers this perspective; to the extent that it can contribute to the important work of government and reasonably serve to encourage sustainability.

The Certified General Accountants Association of Canada

Introduction

With a softening of labour markets, declining business activity, a downgrading of asset values, and rising public debt, it simply becomes much more difficult for a number of sectors to absorb the negative developments of the fall of 2008. In that spirit, the Association does applaud the governments' swiftness in initiating a broad-based set of programs to stem the economic fallout. While we are uncertain of what the future holds, it is abundantly clear that our nation's economic challenges commanded additional stimulus; both in the form of customary measures and of extraordinary measures.

Customary measures associated with fiscal or public policy such as the like of tax reduction, health care, safety and security, financial support, research, and the environment may in fact never have been more important. These will endure.

The extraordinary stimulus measures, defined herein as those possessing particular magnitude, encompassing characteristics outside of typical budget initiatives, or temporary in nature include the:

- Insured Mortgage Purchase Program
- Business Credit Availability Program
- Canadian Secured Credit Facility
- New 10-year Canada Mortgage Bond
- Loans to the automobile industry
- Home Renovation Tax Credit
- Infrastructure Stimulus Fund
- Personal Income Tax relief for all taxpayers
- Loans to Municipalities (under actions to stimulate housing constructions)
- Improving Infrastructure at Universities and Colleges.

Extraordinary stimulus measures are generally received in the positive with the caveat however that they are accessible, merit-based, responsive, and are subject to parliamentary approval. Oftentimes forgotten as times improve, the government will be called upon to monitor the performance of these temporary measures; but perhaps more importantly will be called upon to prevent structural deficits to emerge from the existence of such measures. Reasonably then, we should include 'timeliness' and 'foreseeable exodus' to our list of desired characteristics.

It is abundantly clear that our nation's economic challenges commanded additional stimulus

In evaluating the merit of the extraordinary stimulus measures pursued, the loans to the automobile industry conceivably pose the greatest apprehension

A reasonable challenge with some of these measures is that some of the costs of ‘credit easing’ measures will not be manifested in the public budgetary forecasts unless and until they materialize. Along with other difficulties discussed, it is consequentially impractical to assign a true predicted cost to extraordinary stimulus measures.

In evaluating the merit of the extraordinary stimulus measures pursued, the loans to the automobile industry conceivably pose the greatest apprehension. Given the industry’s relative size and its propensity to contract, we are compelled to concede that a number of factors and influences are at work; with ample persuasion in the form of actions taken by our neighbours to the south.

As we navigate the current recession and wrestle with its lingering effects, we would remind Canadians that it will take some time to return to pre-recession conditions. In our trajectory, it is important that we not disproportionately lose sight of other important issues such as productivity, innovation, our pension systems, the environment, and health care. If we are to manage this event with optimal success, we must do so with a view to sustainability and one which embraces the spirit of intergenerational equity. To that end, a balanced approach to planned deficit reduction and debt stabilization is made all the more germane today than it was a short year ago.

Executive Summary

1

In the fall of 2009, the Certified General Accountants Association set out to examine government stimulus measures as introduced to stem the financial crisis emanating from the fall of 2008. The analysis aimed primarily to identify the measures that are extraordinary in nature and scope, and at assessing the inherent abilities of those measures. Recognising the limitations in assessing the effectiveness of such measures and the subjectivity associated with hypothesis of the asserted qualities, focus spontaneously shifts to identifying what might be viewed as the least strategic of the measures and the concerns posed by pursuing the automobile industry stimulus measures.

While the following pages explore a number of themes and approaches, our findings essentially concentrate on the three most salient groupings: (i) extraordinary stimulus measures; (ii) concerns regarding the auto industry rescue; and, (iii) concerns regarding the federal debt.

Extraordinary Stimulus Measures

The estimated cost of Canada's stimulus measures is fairly high when compared to other countries, particularly when we discern that Canada has avoided the housing market meltdown and exposure to toxic assets as experienced elsewhere. However, it is difficult to identify the exact price tag associated with the total of the measures due to inclusion of credit easing measures. Primarily involving guarantees and investment, these measures simply remain outside the total costs of the stimulus package unless or until they mature into liabilities.

For the purposes of this paper, extraordinary measures are defined as measures that extend and call upon public financial resources on a scale surpassing that of the usual range of government spending (i.e. greater than \$1 billion) and/or are implemented in the areas outside of traditional revenue or spending budget initiatives that focus primarily on tax reduction, investment in health, education, social and national security, and aiming to advance science, technology and cleaner environment. Ten such measures were identified including the Insured Mortgage Purchase Program, the Business Credit Availability Program, the Canadian Secured Credit Facility, the New 10-year Canada Mortgage Bond, Loans to the auto industry, the Home Renovation Tax Credit, the Infrastructure Stimulus Fund, Personal Income Tax relief for all taxpayers, Loans to Municipalities (under actions to stimulate housing constructions), and Improving Infrastructure at Universities and Colleges.

Extraordinary stimulus measures were examined across a number of criteria deemed essential for assuring that fairness and effectiveness are safeguarded when stimulating the economy or market activity through the use of public money. Among those criteria are accessibility, merit, disclosure of possible fiscal impacts, and parliamentary approval.

Encouragingly, extraordinary measures related to tax relief and infrastructure improvements score well relying on these criteria. Taken together however, the main shortcoming of some of the ‘credit easing’ measures relates to the appreciation that their potential negative influence is not manifested in the budgetary forecasts, nor is the Parliament given reasonable opportunity to debate and influence the specifics of these measures. As will be seen, loans to the auto industry are assigned the lowest grade due to their inability to meet the identified criteria while bearing a significant price.

Concerns Associated with the Auto Industry Rescue

The financial assistance package provided by the federal government to the Canadian automobile industry consisted of three distinct elements: (i) Interim loans for selected automakers, (ii) a Canadian Warranty Commitment Program, and (iii) Expansion of the Account Receivable Insurance Program. The governments of Canada and Ontario committed some \$14.6 billion in interim loans to General Motors of Canada Limited and Chrysler Canada Inc. with a share of \$9.7 billion and \$4.9 billion respectively. For some, the act of rescuing the automobile industry invokes mild umbrage. For others, the sheer magnitude of the intervention seems to further underscore how public intervention serves to upset the principles of free market enterprise.

Consideration of the rationale used by the government to bail out the auto industry may suggest that (i) the auto industry is just one of a number of other industries supported by the government, but its size is critical to the economy; (ii) the bailout will ensure that Canada’s current share of the North American auto industry is preserved; and (iii) that government action did preserve jobs. An analysis of these three areas reveals:

- (i) A strong imbalance in the scale of the supportive measures provided to the auto industry and to the other key sectors of the economy. The auto industry¹ contributes some 2.1% of the total industry GDP with some 18 other industries individually contributing more to GDP than the auto industry. Contribution of the auto industry to total GDP is also somewhat less than the combined role of the other key sectors supported by the government. In short, auto industry employment accounted for only 1.0% of all employed Canadians in October 2007.

¹ For the purpose of this paper, the auto industry is understood as comprising of three industry groups: motor vehicle manufacturing, motor vehicle body and trailer manufacturing, and motor vehicle parts manufacturing. See Section 3.2 for more details.

The impact that the changes in auto industry production may bring to GDP and to employment (measured through GDP and employment multipliers) are among the lowest among all other industries. For instance, a \$1 change in output production in some 108 Canadian industries would be associated with a greater impact on Canada's GDP than a similar change in the production of motor vehicle manufacturing.

- (ii) The tendency to locate near the final market and the slow (or no) growth in the North America's vehicle demand led to a shrinking share of the world vehicle production that takes place in the North America. At the same time, the rapidly developing middle class in the new fast-growing economies such as China and India will most probably focus expansion efforts of the auto industry in the regions of near proximity to those countries. As such, the nominal volume of vehicle production that takes place in North America is likely to decline in the years to come.

The Canadian auto industry has traditionally benefited from two competitive advantages – the low Canadian dollar in relation to the U.S. dollar and a highly qualified and available labour force at affordable cost. These advantages have been slowly but steadily eroded by Canadian dollar appreciation and relatively increasing unit labour cost in Canadian manufacturing. Saturation of North America's auto market makes the shifts in vehicle production and employment within North America a “zero-sum game” with some places gaining in production capacity at the expense of others.

- (iii) Despite the billions of dollars injected into the automobile industry, the industry's employment sustained one of the highest pan-Canadian contractions between August 2008 and August 2009. It was unsurprisingly one of the leading job losing industries in Ontario as well.

A ‘picking the winner’ industry strategy is associated with uncertainty regarding policy-makers’ ability to identify the “right” industry for intervention, and the suboptimal allocation of productive capacity within that industry. The empirical studies conducted for Asia suggest that the establishment of industrial policy has made only minor contribution to overall economic growth.

Recognizing that time was of the essence, a certain erosion of government transparency and accountability was nevertheless observed. The publicly-available bailout documents did not stipulate clearly the expected outcomes of the financial support, nor did they include specific indicators to be measured in determining progress towards stated objectives. Moreover, the potential

impact of the bailout loans on the budgetary balance was not fully discussed in the initial budgetary documents even though the loans were provided through the Canada Account which is typically used to support higher risk non-commercial transactions.

Concerns Associated with the Level of Federal Debt

As the large number of stimulus measures (particularly those associated with credit easing) are provided in the form of loans, guarantees and investments, their potential impact is not currently reflected in the forecasts of the federal budgetary revenues and expenditures. This raises certain concern regarding possible budgetary developments and a corresponding lack of public awareness.

It is important to acknowledge that a recovery of living standards (measured as GDP per capita) to pre-recession levels may take several times longer than the duration of the recession itself. Canada's recovery from the current (2008-2009) recession may further be exacerbated by a number of factors including low prospects for export expansion, reduced household consumption, and decreased capacity to exploit traditional monetary and fiscal policies aimed at boosting the economy.

Although the current deficit projections do not resemble the magnitudes of federal deficits of the 1980s, the starting point of the current deficit cycle is somewhat weaker than that of the previous cycle; particularly when it comes to the relative level of federal debt.

The current budgetary 5-year projections may not be fully reflective of the possible impact of the economic stabilizers on federal revenue and spending. If that is the case, the overestimation of revenues and/or underestimation of expenses may not only increase the deficit in a particular year but may also lead to increasing fiscal pressures in other years through increased debt service charges.

The International Monetary Fund's (IMF) conservative estimates suggest that the expected fiscal cost of Canada's contingent liabilities (i.e. guarantees provided to the banking sector) may be as high as 3.2% of GDP annually over the next five years. The fiscal impact of measures associated with assets purchasing will critically depend on the realization value of the acquired assets and/or the extent to which these assets will hold their value. IMF estimates Canada's recovery rate at 59.7%.

Inaccuracy of the budget forecasting may be another factor that can increase the actual size of the budget deficit and debt compared to those currently anticipated. Over a more long-term horizon, such ‘traditional’ fiscal pressure as exerted by aging population may also affect the level of debt significantly. According to Organisation for Economic Co-operation and Development (OECD) forecasts, age-related government spending may account for 26.6% of GDP in 2050, a sharp contrast to the 17.9% level registered in 2000.

The economic literature does not offer us conclusive insight into the question regarding the optimal level of government debt – in fact, a number of theories co-exist on the subject. The level of Canada’s federal debt has improved significantly in recent years and the current scenario, as well as the five-year forecasts do not necessarily translate into an alarming condition. In practical terms, though, increasing debt service charges may reduce significantly government’s flexibility to allocate revenues towards carefully chosen priorities.

Based on these findings, it is reasonable to espouse not less than five conclusions. First, one particular stimulus measure – the support for the auto industry – stands out in terms of the level of apprehension associated with its quality. Second, there is reason to doubt that the financial support to the auto industry was commensurate with its relative size or its comparative importance to the Canadian economy. Third, based on the approach employed in providing financial support, there is opportunity to enhance government transparency and accountability. Fourth, the combination of economic uncertainty and the already existing fiscal pressures of an aging population may exacerbate significantly the actual levels of federal deficit and debt. And lastly, a balanced approach to planned federal deficit reduction and federal debt stabilization may once again be desirable.

“Extraordinary” Economic Stimulus Measures

2

The extraordinary events of the second half of 2008 were primarily focused within the financial system; however, the ripple effects of those events were felt across the Canadian and global economies. As such, the economic stimulus package provided by the federal government sought to aggregate a sophisticated blend of measures aimed at multiple areas of the economy including the financial sector itself as well as at certain relationships that unite the financial sector and the real economy.

A variety of ways exist to categorize the measures included in the stimulus package. For instance, the measures can be thought of as monetary versus fiscal, immediate versus gradual, national versus international, etc. Such categorization, though, does not necessarily reflect or restrict itself to the crisis nature of the measures as similar hierarchy can be adopted for any period; even in years in which no defined crisis events occurred. On balance, governments continually provide certain levels of stimulus to the economy through budget spending, tax expenditure, and changes in taxation rates. However, such stimulus may typically be of a smaller scale, more targeted, and generally less publicized. What is truly unique about the economic stimulus measures associated with the 2008 crisis is the “extraordinary” nature and scope of some of those measures.

What is truly unique about the economic stimulus measures associated with the 2008 crisis is the “extraordinary” nature and scope of some of those measures

2.1. Chronology of Introducing Stimulus Measures

In the aftermath of the recent financial crisis and the global economic downturn, three stages may be identified in the evolution of events: a slowly unfolding financial instability during 2007 and the first half of 2008; a rapid escalation of credit apprehension and market failure and the recession transpiring over the second half of 2008 and the beginning of 2009; and, a slowly emerging economic recovery in the second half of the 2009. With the introduction of stimulus measures in Canada, the domestic scenario has similarly experienced multi-phase progress which may be chronologically identified as (i) fall 2007 to mid 2008, (ii) fall 2008, (iii) January 2009, and (iv) post-January 2009.

In the fall of 2007, stimulus measures began with the Bank of Canada providing additional liquidity in the markets, as well as expanding the list of eligible securities for term purchase and resale agreements (PRAs). Budget 2008 tabled in February 2008 expanded the authoritative powers of the Bank of

Canada – to enhance its ability to support the stability of the financial system and to respond more promptly and effectively to an economic crisis, should it arise. In June 2008, the Canadian Mortgage Bond (CMB) program was expanded through a multi-billion CMB issue.

In the fall of 2008, the federal government used the Economic and Fiscal Statement to announce a number of new actions to strengthen Canada's economic and financial fundamentals. These measures included the expansion of the Insured Mortgage Purchase Program (which was first introduced in October 2008), establishment of the Canadian Lenders Assurance Facility, and introduction of a CMB with a 10-year maturity. In addition, the government expanded the borrowing capacity of its Crown corporations – Export Development Canada and Business Development Bank of Canada, and made available (in partnership with the Ontario government) multi-billion interim loans to General Motors of Canada Limited and Chrysler Canada Inc. Another notable initiative introduced in the fall of 2008 was temporary solvency funding relief for federally regulated defined-benefit pension plans.

In January 2009, the federal government introduced a broad range of stimulus measures under the Economic Action Plan which was imbedded into Budget 2009. The budget documents presented measures as grouped into five broad categories: (i) improving access to financing; (ii) actions to help Canadians and stimulate spending; (iii) infrastructure investments; (iv) actions to stimulate housing constructions; and, (v) actions to support businesses and communities. Among the specific measures, the most notable were the creation of the Canadian Secured Credit Facility, the Business Credit Availability Program, the Canadian Life Insurers Assurance Facility, expansion of Employment Insurance benefit entitlements, implementation of a temporary Home Renovation Tax Credit, and establishment of the Infrastructure Stimulus Fund. The budget also granted new authority to the Minister of Finance to enter into transactions that promote financial stability and maintain efficient and well-functioning markets, and expanded certain functions of the Canada Deposit Insurance Corporation.

The post-January 2009 measures were primarily focused on further expansion of the financial support to the auto industry. In the spring of 2009, the federal and Ontario governments extended interim loans and medium-term restructuring loans to General Motors of Canada Limited and Chrysler Canada Inc.

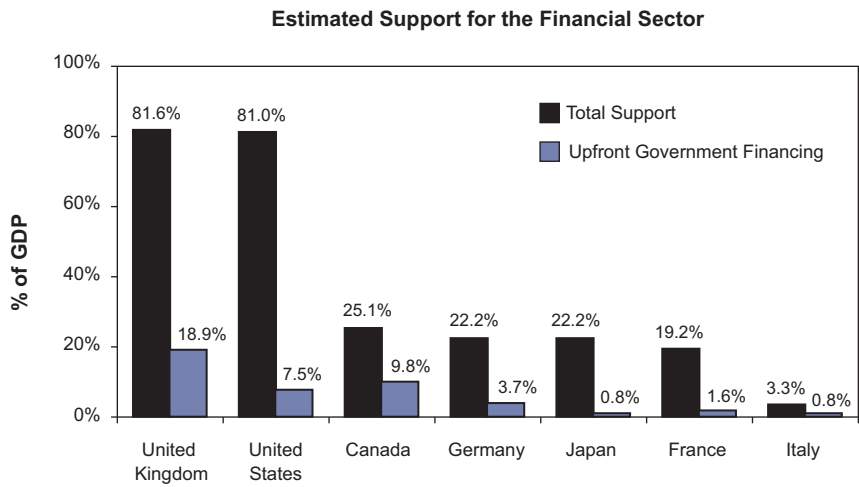
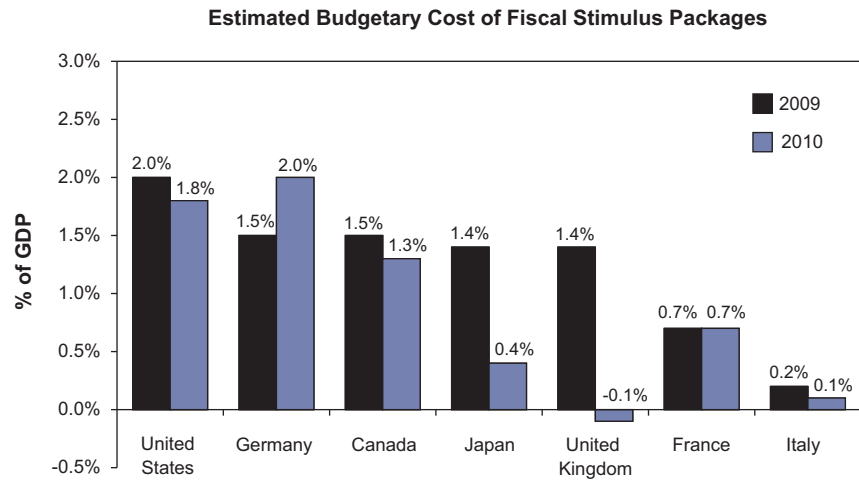
2.2. Price Tag of the Stimulus Measures

Although the list of stimulus measures is extensive, most of the measures may be assigned to one or both of the two categories; fiscal stimulus and credit easing. This duality makes it difficult to determine the price associated with the overall stimulus package or some of the individual measures. While fiscal measures are typically reflected in the budget documents through either changes in revenues or expenses, credit easing measures often represent a temporary lending or guarantees which are not recorded as part of budgetary components in that fiscal year. However, in the years that follow, credit easing measures may under certain circumstances become a government expense, generate income, or remain neutral when it concerns the public finances.

Moreover, a simple dollar amount would not be able to properly capture how the scope of the measures compares to the overall size of the economy. A relative consideration of the costs associated with the measures may then be a more appropriate approach. In order to facilitate the relative approach of measuring the cost, Figure 1 presents estimated costs of the stimulus measures implemented by some advanced countries. Although it has repeatedly been acknowledged that Canada managed to avoid housing market problems and high exposure to toxic assets seen in other countries, Canada's price of the stimulus measures is fairly high compared to that of other countries. For instance, Canada has the third highest estimated costs of both the stimulus package and the total support to the financial sector compared to other countries. Moreover, the upfront government financing provided by Canada is second only to the United Kingdom (Figure 1).

Canada's price of the stimulus measures is fairly high compared to that of other countries

Figure 1 – Estimated Costs of Fiscal Stimulus Packages – Selected Countries



Note: Top graph: Estimated costs exclude financial sector support measures. Bottom graph: The total support to the financial sector is understood as a sum of capital injections, asset purchases and direct lending by the treasury, liquidity provision and other support provided by the Central Bank, and guarantees for financial sector liabilities.

Source: Top graph: International Monetary Fund (2009). *Companion Paper—The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis*, Fiscal Affairs Department, Table 13. Bottom graph: International Monetary Fund (2009). *Fiscal Implications of the Global Economic and Financial Crisis*, IMF Staff Position Note, SPN/09/13, Table 2.1.

2.3. Business-as-Usual vs. Extraordinary Measures

The broad range of stimulus measures may also be categorized into ‘business-as-usual’ or customary and ‘extraordinary measures’. The business-as-usual measures are fiscal and other public policy measures that are similar in nature and monetary scope to budget initiatives implemented in other years. Extraordinary measures, alternatively, are measures that necessitated the use of financial resources in much larger scale than the usual range of government spending and/or are implemented in the areas where the government has not typically been an active economic agent in recent years.

As seen from Figure 2, federal government budget initiatives introduced over the past 10 years have primarily been focused in such areas as tax reductions, improving health care and safety of Canadians, enhancing security, providing financial support for education and families, supporting research in science and technology, aiming to achieve cleaner environment, working closer with Aboriginal communities, and providing funds for international assistance. In some years, the government initiatives also aimed at improving physical infrastructure, supporting small business and traditional industries, and supporting culture and communities. These areas may be identified as business-as-usual areas of the government intervention, or support, provided to the economy.

The broad range of stimulus measures may be categorized into ‘business-as-usual’ and ‘extraordinary’ measures

Figure 2 – Public Policy Areas of Federal Government Budget Initiatives, 1998-99 to 2008-09 Fiscal Years

Area of Budget Initiatives	2008-09	2007-08	2006-07	2005-06	2004-05	2003-04	2002-03	2001-02	2000-01	1999-00
Tax Relief	x	x	x	x	x	x		x	x	x
Investing in Health	x	x		x	x	x	x	x	x	x
Providing Security and Defence	x	x	x	x	x	x	x	x	x	
Investing in Canadians	x	x	x	x	x	x	x	x	x	
Improving Environment	x	x	x	x	x	x	x	x	x	
Investing in Science and Innovation	x	x		x	x	x			x	x
Providing International Assistance	x	x		x	x	x		x	x	
Strengthening Partnerships with Aboriginal Communities	x		x	x	x	x	x			
Investing in Infrastructure	x	x	x				x	x	x	
Strengthening Entrepreneurial Advantage and Effective Markets		x	x	x	x	x				
Supporting Communities	x		x	x	x	x				
Supporting Culture and Sports	x	x		x		x				
Supporting Traditional Industries	x		x		x	x				

Source: Based on information presented in Budget Plans for corresponding years. CGA-Canada analysis.

Extraordinary measures are examined across a number of criteria deemed to be essential for assuring that fairness and effectiveness are safeguarded

The budget cost of the initiatives introduced in the past 10 years varied significantly from year to year and across different areas. Table 1 presents three initiatives that were associated with the highest federal budget costs in the given fiscal year. As most of the initiatives are typically implemented over a number of years, the consideration was limited to the dollar amount that the initiative called for in the fiscal year for which the budget was tabled. For instance, for budget 2008, the ranking of the initiatives was done based on the dollar amounts the initiatives represented in 2008-09 fiscal year. As seen from Table 1, the price tag associated with budget initiatives seldom exceeded \$1 billion. When it did (for instance, the GST cut in Budget 2006), those initiatives were of a broad based nature aiming at improving conditions for a large proportion of the Canadian population.

As such, business-as-usual measures may be broadly defined as revenue or spending budget initiatives primarily focused on tax reduction, investing in health, education, social and national security, and aiming to advance science, technology and cleaner environment. Previously cited, these initiatives seldom exceed a cost of \$1 billion in a given fiscal year.

The analysis of documents related to Budget 2009 and documents that contain descriptions of the stimulus measures introduced during 2007 and 2008² allows us to identify a number of stimulus measures that do not fully fit into the notion of business-as-usual measures due to their area of influence and/or the price associated with them. Figure 3 presents the list of these measures branding them as “extraordinary” for the purpose of this paper whereas Appendix A contains a brief description of the measures.

It should be noted that the identification and subsequent analysis of extraordinary measures are flawed with certain subjectivity, as any qualitative analysis would be. However, in the absence of a more precise tool of analysis, extraordinary measures are examined across a number of criteria deemed to be essential for assuring that fairness and effectiveness are safeguarded when stimulating market economy in a time of economic crisis using public resources. More specifically, the following several features of government action are deemed to be essential for assuring higher levels of transparency and accountability:

- Broad based approach - the access to the measure is available to as many economic agents as possible.
- Merit based approach - funds are allocated through a competitive process on or under condition of meeting certain standards.

² Department of Finance Canada (2008). *Backgrounder – Canadian Lenders Assurance Facility*, Department of Finance Canada (2008). *Economic and Fiscal Statement – Protecting Canada’s Future*, Department of Finance Canada (2008). *The Budget Plan*, Department of Finance Canada (2008). *Backgrounder – Support for Canadian Credit Markets*.

Table 1 – Three Federal Budget Initiatives with the Highest Price Tag in Each Fiscal Year, 1999-2008 (Millions of Dollars)

Budget Initiative	Current Prices	Constant 2008 Prices
2008-09 First Nations water and wastewater action plan Canadian Air Transport Security Authority Strengthening First Nations and Inuit health	165 147 111	165 147 111
2007-08 New \$2,000 child tax credit Income stabilization for farmers - direct costs Working income tax benefit	1,445 600 550	1,479 614 563
2006-07 Reducing GST rate to 6% Reducing the bottom personal income tax rate Universal child care benefits	3,520 1,670 1,610	3,681 1,747 1,684
2005-06 GST/HST relief for municipalities Gas tax fund Strengthening national defence	605 600 500	645 640 533
2004-05 GST/HST relief for municipalities New defence funding Environmental technology	580 245 200	632 267 218
2003-04 Sustainable Development Technology Canada Indirect cost of research National child benefit supplement	250 225 200	277 250 222
2002-03 New approach to air security Equipping and deploying more intelligence Border infrastructure	462 182 150	527 208 171
2001-02 Supporting Canada's military Equipping and deploying more intelligence Indirect research costs	400 235 200	467 274 233
2000-01 Canada Child Tax Benefit Assisting the homeless Sustainable Development Technology Fund	475 235 100	568 281 120
1999-00 Youth Employment Strategy renewal Canada Jobs Fund Increased health funding for research organizations	155 110 50	190 135 61

Note: Equalization payments are excluded from the analysis.

Source: Based on information presented in Budget Plans for corresponding years.
CGA-Canada analysis.

- Share based approach - only a portion of the total funds is provided to each economic agent.
- Disclosure of possible fiscal impacts – information on the possible impact of the government measure on the budgetary balance is available to the public.
- Presence of parliamentary approval – the Parliament is able to influence the allocation of funds.

As seen from Figure 3, extraordinary measures related to tax relief and infrastructure improvements score well based on these criteria. The main shortcoming of the most credit easing measures however relates to the fact that their possible negative impact is not reflected in the budgetary forecasts, nor is the Parliament given an opportunity to debate and influence the specifics of these measures. It should be noted, that the lack of budget visibility for such measures as credit easing is well within the framework of the current legislative requirements. However, it may seem appropriate to assume greater disclosure of the possible fiscal implications of such measures given the extraordinary dollar amount associated with them. As for the loans to the auto industry, they are assigned the lowest score due to their inability to meet any of the identified criteria while bearing a significant price tag.

Loans to the auto industry are assigned the lowest score due to their inability to meet any of the identified criteria while bearing a significant price tag

Figure 3 – Assessing the Quality of Extraordinary Stimulus Measures

	Funds committed (billions of dollars)	Broad based approach	Merit based approach	Share based approach	Disclosure of possible fiscal impacts	Presence of parliamentary approval	Score
Insured Mortgage Purchase Program	125.0	+	+	Low	--	--	Average
Business Credit Availability Program	13.0	+	+	Low	--	+	Average
Canadian Secured Credit Facility	12.0	+	+	Low	--	--	Average
New 10-year Canada Mortgage Bond	10.0	+	n/a	Low	--	--	Average
Loans to Auto Industry	9.7	--	--*	High	--	--	Poor
Home Renovation Tax Credit	3.0	+	n/a	Low	+	+	Good
Infrastructure Stimulus Fund	2.0	+	+	Low	+	+	Good
Personal Income Tax Relief for all Taxpayers	1.9	+	n/a	Low	+	+	Good
Loans to Municipalities (under actions to stimulate housing constructions)	1.0	+	+	Low	--	--	Average
Improving Infrastructure at Universities and Colleges	1.0	+	+	Low	+	+	Good

* For the loans to the auto industry, the submission of restructuring plans as a pre-condition for issuing loans was not considered as a merit based allocation of funds because of the lack of detailed specifications that were supposed to be met by the restructuring plans.

Source: Department of Finance Canada (2009). *The Budget Plan*, Department of Finance Canada (2009). *Canada's Economic Action Plan – A Third Report to Canadians*. CGA-Canada analysis.

The exceptional nature of the extraordinary measures presents us with some caveat – their effectiveness and their possible ‘side effects’ are not known or not clearly understood.

Understanding of benefits achieved versus costs incurred as a result of a government initiative is valuable for any policy measures; particularly those involving public funds. Using a with-and-without approach, which relies on comparing benefits of the measure to the situation that would have been in the absence of the measure, could be an appropriate tool. However, given the global scale of the economic downturn, the sudden nature of its development and the high level of uncertainty in behavioural patterns of economic agents, there is little hope that a with-and-without approach could ever be applied to the extraordinary stimulus measures.

In the absence of precise tools for assessing the quality of the measures, the use of a rather normative notion of “rightness” may be an appropriate approach. However, that is an exceedingly complex task as “rightness” is challenging to define in a way that takes into account the interests of *all* members of society. Recognizing these challenges, further consideration is focused on the extraordinary measure that received the lowest quality score as presented in Figure 3. Given the low quality of the measure, the analysis is directed at identifying concerns associated with the measure which, in turn, may also inform our opinion on the “rightness” of undertaking it.

The main ‘side effect’ of the extraordinary measures lies in their possible impact on the federal budget balance and the eventual federal debt. As most of the largest extraordinary measures are not incorporated into the budget as budgetary components, Section 4 discusses the concerns that may arise regarding the federal public debt.

The main ‘side effect’ of the extraordinary measures lies in their possible impact on the federal budget balance and the eventual federal debt

Concerns Associated with the Government Bailout of the Auto Industry

3

The classical assumption of a market economy is that the role of government is to improve the functioning of the economy by providing public goods (i.e. those that can be jointly consumed by many consumers and that are subject to extensive free-rider problems), mitigating externalities (i.e. consequences of an economic activity that are experienced by unrelated third parties), establishing and protecting property rights, and providing regulations that assure fair functioning of the economy.

The modern economy though, is relatively more complex and governments are now widely received not only as rule-setters but also as important economic agents that shape industrial policies and competitiveness by regulation. If needed, government is apparently expected to participate actively in the market. As the recent global economic downturn showed, governments are increasingly encouraged, and expected, to become a vital part of the solution in times of elevated economic uncertainty.

The unprecedented scope of recent market intervention is often linked to the global nature of the crisis and the overall increased globalisation of the world economy. However, bailouts are not a new phenomenon to the world. Since 1970, the U.S. which is often seen as one of the prevalent market oriented economies has bailed out the private sector on 15 occasions.³ However, these bailouts have primarily (but not exclusively) been focused on the banking and financial industry due to the strong and disruptive feedback mechanism existing between financial sector failure and the ability of the real sector of the economy to continue functioning.

Unlike the financial sector, the feedback mechanism of a non-financial industry is often smaller due to more focused interlinks of the non-financial industry with the rest of the economy. The recent massive intervention of the Canadian government in the operations of the auto industry shifted dramatically the balance between the state and the market; at least in an area other than financial sector. The act itself of bailing out and the sheer magnitude of the intervention, bring certain concerns regarding the rightness of such actions.

The massive intervention of the government in the operations of the auto industry shifted dramatically the balance between the state and the market

³ Based on ProPublica (2009). *History of U.S. Gov't Bailouts*, available at <http://www.propublica.org/special/government-bailouts> accessed October 17, 2009.

3.1. Structure of the Bailout

The financial assistance package provided by the federal government to the Canadian auto industry consisted of three distinct elements: (i) Interim loans for selected automakers, (ii) a Canadian Warranty Commitment Program, and (iii) Expansion of the Account Receivable Insurance Program.

The financial assistance package provided by the federal government to the Canadian auto industry consisted of three distinct elements

The interim loans for the auto industry were provided by the federal government in partnership with the government of Ontario and were announced in three steps:

1. On December 20, 2008, the governments announced the provision of up to \$4 billion (\$2.7 from the federal and \$1.3 billion from the Ontario government) payable to General Motors of Canada Limited (GM of Canada) and Chrysler Canada Inc. (Chrysler Canada). GM of Canada was eligible for loans of up to \$3 billion, whereas Chrysler Canada was eligible for loans of up to \$1 billion. The loans were provided for general business purpose on a 91 day term renewable, up to a maximum of three years, basis. Loan renewal was conditional on submission of acceptable restructuring plans that include specific actions sufficient to ensure long-term viability of the borrower's business operations.⁴ Although available, the loans were not taken up by either GM of Canada or Chrysler Canada. Instead, the two companies (in conjunction with their U.S. parent companies) opted to submit independently business restructuring plans that also included a request for larger financial assistance from both the U.S. and Canadian governments.⁵
2. On April 30, 2009, the governments extended a short-term working capital loan (\$209 million), a medium-term restructuring loan (\$1.116 billion), and renewed the existing interim loan (\$1 billion) to Chrysler Canada. It also joined the U.S. government in providing debtor-in-possession loans to Chrysler LLC (the U.S. parent company) and contributed \$1.45 billion to that purpose. The overall joint package of loans in support of the further restructuring amounted to \$3.775 billion.⁶ In exchange for this support, the governments of Canada and Ontario received a combined 2.46% share in a restructured Chrysler LLC and obtained the right to appoint one independent director (out of nine) to the board of the restructured company. The U.S. government holds 9.85% of the new Chrysler whereas 20% belongs to Fiat and 67.69% to the United Auto Workers' retiree healthcare trust fund.⁷

4 Office of the Prime Minister (2008). *Backgrounder – Government Support to the Auto Industry*, December 20, 2008.

5 House of Commons Canada (2009). *A Study of the Crisis in the Automotive Sector in Canada*, Report of the Standing Committee on Industry, Science and Technology, 40th Parliament, 2nd Session, p. 16.

6 Office of the Prime Minister (2009). *Canada and Ontario: Joint Support for Chrysler Restructuring*, Backgrounder, April 30, 2009.

7 Ramsey, M. and Forden, S.G. (2009). *Fiat Forms Sixth-Largest Carmaker on Chrysler Assets*, Bloomberg.com, June 10, 2009.

3. On June 1, 2009, the governments provided U.S. \$9.1 billion in new short-term funding, most of which was for GM of Canada, whereas up to U.S. \$3.2 billion was for a joint Canada-U.S. debtor-in-possession loan to General Motors Corporation (the U.S. parent company of GM of Canada). A month prior, the governments of Canada and Ontario approved a U.S. \$413 million working capital loan to GM of Canada as part of an interim loan announced on December 20, 2008. The overall joint package of loans in support of further GM of Canada's restructuring amounted to U.S. \$9.5 billion (C\$10.6 billion⁸). At the conclusion of the court-supervised process, all of this funding is to be transformed into a loan of up to U.S. \$1.3 billion for GM of Canada, U.S. \$403 million of preferred shares in General Motors Corporation, an 11.7% ownership stake in General Motors Corporation and the right to appoint an independent director to the board of the newly restructured company.⁹ The U.S. government received 60.8% of the common equity of the new GM, the United Autoworkers Voluntary Employee Beneficiary Association – 17.5%, whereas bondholders of Motor Liquidation Company (former GM) received a 10% stake with the possibility of increasing their share to 25%.¹⁰

Summing up the three steps presented above, the governments of Canada and Ontario committed some \$14.6 billion¹¹ in interim loans to the two automakers with the respective split of \$9.7 billion and \$4.9 billion between the federal and Ontario governments. Of the total \$14.6 billion amount, 31.8% was provided to the U.S. parent companies of the two automakers, while the remaining 68.2% was provided to GM of Canada and Chrysler Canada. Repayments of loans provided to Chrysler is scheduled to be completed by 2017, whereas loans provided to General Motors will be repaid by 2015.¹²

The Canadian Warranty Commitment Program was launched on April 7, 2009 to ensure that consumer warranties are honoured on new vehicles purchased from GM of Canada and Chrysler Canada. Under the program, a separate entity was to be funded by a loan from the federal government and cash contributed by the automakers to pay for repairs covered by the automaker's warranty on each new vehicle sold during companies' restructuring period. The cash contributions from the government (110%) and automakers (15%) would amount to 125% of the costs projected by the automakers to satisfy anticipated claims under the warranty issued on a particular vehicle. The program was to

The governments of Canada and Ontario committed some \$14.6 billion in interim loans to the two automakers

8 Government of Canada (2009). *Canada's Economic Action Plan – A Second Report to Canadians*, p. 60.

9 Office of the Prime Minister (2009). *Backgrounder - Canada and Ontario: Joint Support for General Motors Restructuring*, June 1, 2009.

10 Isidore, C. (2009). "New" GM Is Born, CNNMoney.com, July 10, 2009.

11 The dollar amounts of the financial support presented in this section may not add to the total of \$14.6 billion. See Section 3.2.5 for details.

12 Government of Canada (2009). *Public Accounts of Canada 2009*, Prepared by the Receiver General for Canada, p. 2.33.

Canada's bailout of the auto industry was, largely, a replication of the measures taken by the U.S. government

cover a 12 month period and assume that in the event of a failure of GM of Canada or Chrysler Canada to honour their consumer warranties, the trust administrator from the separate entity would appoint an auto service provider to supply the warranty services using funds from the Program.¹³ Although government documents did not contain a specific dollar amount assigned to the program, the coverage of the announcement in the media frequently refers to a \$185.3 million price tag. On September 16, 2009, the program was announced to be brought to a close as consumer confidence in the warranty commitments was restored after both companies emerged from bankruptcy protection.

Another announcement made on April 7, 2009, related to the expansion by way of an additional \$700 million, of the Accounts Receivable Insurance Program for auto parts manufacturers. The program is administered by Export Development Corporation (EDC) and covers Canadian companies for up to 90% of losses caused by non-payment from their customers. In the specific case of the Canada's auto industry, the expansion of the program is used to protect the auto parts suppliers selling to the auto manufacturers, such as GM of Canada and Chrysler Canada. This extension brought the EDC's overall exposure for auto parts suppliers to \$1.25 billion.¹⁴

Canada's bailout of the auto industry was, largely, a replication of the measures taken by the U.S. government. The U.S. government initiated three distinct programs to support the automotive industry: the Automotive Industry Financing Program to assist automakers and their financing arms, the Auto Warranty Commitment Program to support consumer confidence in these companies, and the Auto Supplier Support Program to assist the firms that supply them.

As of September 30, 2009, the Automotive Industry Financing Program committed financial assistance of U.S. \$12.5 billion to Chrysler LLC, U.S. \$49.5 billion to General Motors Corporation, U.S. \$1.5 billion to Chrysler Financial, and U.S. \$13.4 billion to GMAC Financial Services. The Auto Warranty Commitment Program allocated U.S. \$641 million to cover all warranties on new vehicles purchased during the Chrysler LLC and General Motors Corporation's restructuring periods. As both automakers were able to honour their warranties during the restructuring periods, these funds were repaid and the Warranty Program terminated as of July 2009. The Auto Supplier Support Program provides select suppliers with access to Government-backed protection that guarantees the receivables are paid for parts supplied to Chrysler LLC and General Motors Corporation and allocates up to U.S. \$3.5 billion to this purpose.¹⁵

13 Industry Canada (2009). *Canadian Warranty Commitment Program*, Backgrounder, April 7, 2009.

14 Industry Canada (2009). *Accounts Receivable Insurance Program*, Backgrounder, April 7, 2009.

15 Office of the Special Inspector General for the Troubled Assets Relieved Program (2009). *Quarterly Report to Congress*, October 2009, p. 89-93.

As financial support to the auto industry unfolded over the 7-month period (December 2008 to June 2009), the rationale for actions of Canada's and Ontario's governments was also changing. When the bailout was first announced in December 2008, the quoted rationale for the government's intervention was to fulfill government's commitment "to supporting the auto industry".¹⁶ The latter was part of the broader commitment announced in the Throne Speech opening the second session of the 40th Parliament of Canada. The speech indicated that the economic stimulus plan will see the federal government acting "to support Canadian industries in difficulty – including forestry, manufacturing, automotive, tourism, agriculture [...]."¹⁷ It was also suggested that the bailout would "protect the Canadian Economy" and ensure that "Canada maintains our current production share of the North American market."¹⁸

In its June announcement regarding the further extension of the interim financing to GM of Canada, the federal government linked the rationale of their actions to the course of actions undertaken by the U.S. government as the auto industries in Canada and the U.S. are tightly linked. Specifically, the Prime Minister's speech suggested that when "the Bush administration announced that it would be putting together a rescue package for troubled North American automakers", that decision required Canadian government to act.¹⁹ Finally, in the second and consecutive progress reports on Canada's Economic Action Plan, the government emphasized that the additional support to the automotive industry was to preserve and to protect jobs.²⁰

As the role of the federal government was noticeably more prominent in terms of the size of funds allocated to the auto industry and influence exercised, the balance of this paper primarily revolves around the issues as they relate to the federal government.

3.2. Main Concerns

The consideration of the rationale used by the government to bailout the auto industry may lead to a number of conclusions. First, that the auto industry is just one of a number of other industries supported by the government, but its size is critical to the economy. Second, that the bailout will ensure that Canada's current share of the North American auto industry is preserved. And third, that government action did preserve jobs. The subsequent sections

As financial support to the auto industry unfolded, the rationale for actions of Canada's and Ontario's governments was also changing

16 Office of the Prime Minister (2008). *Background – Government Support to the Auto Industry*, December 20, 2008.

17 Governor General (2008). *Speech from the Throne to Open the Fortieth Parliament of Canada*, p. 3.

18 Office of the Prime Minister (2008). *PM and Premier McGuinty Announce Financial Support for the Auto Industry*, Media Release, December 20, 2008.

19 Office of the Prime Minister (2009). *PM Announces Support for General Motors*, Speech, June 1, 2009.

20 Government of Canada (2009). *Canada's Economic Action Plan – A Second Report to Canadians*, p. 11 and p. 60; Government of Canada (2009). *Canada's Economic Action Plan – A Third Report to Canadians*, p. 118.

The provision of financing to the auto industry was part of a broader set of measures incorporated in Budget 2009

discuss the validity of these assumptions in greater length. The analysis is also supplemented by the consideration of concerns associated with ‘picking the winner’ approach and a probing of the motivation of the federal government.

For the purpose of this paper, the auto industry is understood as comprising of three industry groups: (i) motor vehicle manufacturing which is primarily engaged in manufacturing chassis and then assembling complete motor vehicles; (ii) motor vehicle body and trailer manufacturing which is primarily engaged in manufacturing motor vehicles bodies and cabs, truck trailers and non-commercial trailers; and (iii) motor vehicle parts manufacturing which manufactures and rebuild motor vehicle parts including engines, electrical and electronic equipment, transmission and power train parts, etc.²¹ The industries that represent the further extension of the auto industry into services (e.g. motor vehicle and parts wholesalers and dealers, automotive equipment rental and leasing, sales financing, automobile insurance and vehicle servicing) are believed to be less sensitive to the changes in the production capacity of the auto industry. As these service industries primarily serve consumers rather than producers, they are deemed to be less affected by the shifts of the market allocations between different brands of vehicles. As such, the service industries have not been included in our analysis.

3.2.1. Is the Bailout to the Auto Industry Proportional to Its Size?

The provisions of financing to the auto industry was part of a broader set of measures incorporated in Budget 2009 and intended to enhance sectoral competitiveness and provide a short-term support for key sectors facing unprecedented challenges due to declining global demand.²² Among the industries identified as key economic sectors (other than the auto industry) were forestry, agriculture, shipbuilding and the space industry.

The measures to be implemented in these key sectors in the 2009-10 fiscal year included \$70 million to improve marketing and innovation in the forestry sector, \$85 million to increase agricultural flexibility through implementing non-business risk-management measures and enhancing slaughterhouse capacity, \$19 million to speed up procurement in the shipbuilding industry, and \$20 million to further develop robotics and technologies in the space industry.²³ Although not incorporated in Budget 2009, the second progress

21 The North American Industry Classification System identifies these industry groups as Motor Vehicle Manufacturing (NAICS 3361), Motor Vehicle Body and Trailer Manufacturing (NAICS 3362), and Motor Vehicle Parts Manufacturing (NAICS 3363).

22 Department of Finance Canada (2009). *Canada's Economic Action Plan – Budget 2009*, p. 169.

23 Department of Finance Canada (2009). *The Budget Plan*, p. 170-174 and Table 3.8.

report on Canada's Economic Action Plan indicated that \$70 million was allocated to extend the mineral exploration tax credit.²⁴

Despite the fairly diverse sectoral support described above, a certain imbalance may be noticed in the scale of the supportive measures provided to the auto industry and to other key sectors of the economy. Specifically, while the federal funding to the auto industry amounted to \$9.7 billion, other key sectors combined received \$0.264 billion. A noticeable difference in the scale and magnitude of the government support to different industries may lead to a conclusion that the auto industry stands out significantly compared to other industries when it comes to the industry's economic importance.

Along with the steel, chemicals and electronics industries, Canada's auto industry is often referred to as a jewel of Canadian manufacturing with strong export capabilities and technological base. Although these merits are well recognized, the relative perspective of the industry size may bring an additional dimension to the discussion of government intervention.

In 2007,²⁵ the auto industry constituted one of the largest manufacturing industries and accounted for 13.5% of the total manufacturing. However, the manufacturing sector itself was (and is) only a fraction of the total Canadian economy which now relies heavily on service-producing industries and natural resource extraction. When the consideration is expanded from manufacturing to all industries, it becomes apparent that the contribution of the auto industry to the total GDP is merely 2.1% with some 18 other industries contributing more to GDP than the auto industry (Figure 4). Contribution of the auto industry to total GDP was also somewhat less than the combined participation of the other key sectors of the economy which received government support in Budget 2009. Forestry, agriculture, shipbuilding and the space industries together made up 2.6% of total industry GDP in 2007.²⁶ It should be mentioned that the auto industry is almost entirely concentrated in the province of Ontario (in 2007, Ontario produced 93.6% of the Canadian auto industry's output). But even though, the auto industry remains a relatively small part (4.7%) of Ontario's well diversified economy.

A certain imbalance may be noticed in the scale of the supportive measures provided to the auto industry and to other key sectors of the economy

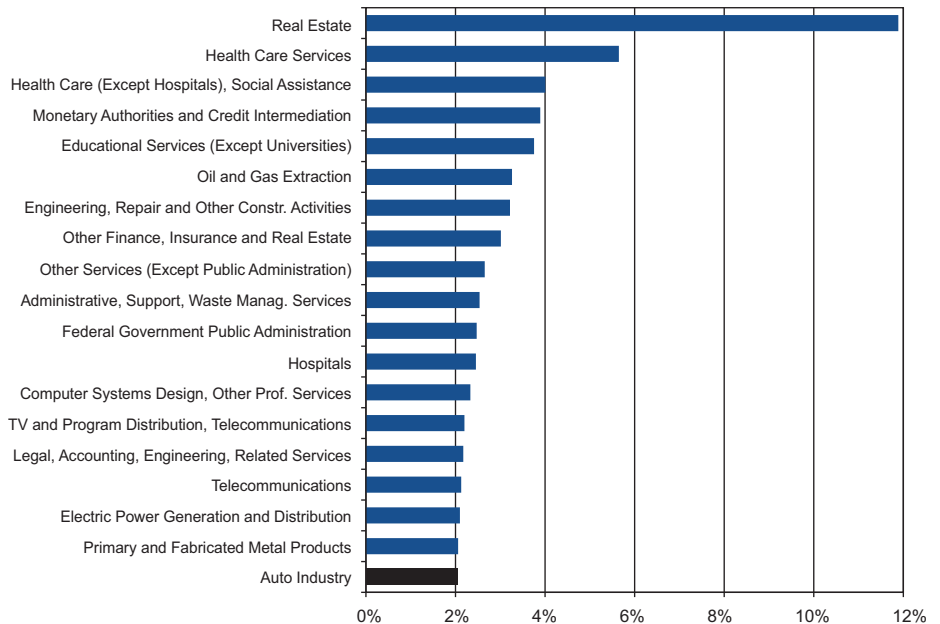
The contribution of the auto industry to the total GDP is merely 2.1%

24 Department of Finance Canada (2009). *Canada's Economic Action Plan – A Second Report to Canadians*, p. 161 and Table 2.12.

25 The year 2007 may be considered as the most recent year prior to the financial crisis and economic downturn which affected the structure of the Canadian economy. As such, 2007 was chosen as the reference year for the analysis of the economic importance of the auto industry.

26 The combined contribution of forestry, agriculture, shipbuilding and the space industries is understood as a sum of GDPs produced by Crop and Animal Production (NAICS 11), Forestry and Logging (NAICS 113), Aerospace Product and Parts Manufacturing (NAICS 3364), and Ship and Boat Building (NAICS 3366).

Figure 4 – Industries Contributing More to the Total Industry GDP Than the Auto Industry, 2007



Note: To allow for a meaningful comparison, the contribution of the auto industry was contrasted with contributions of the Canadian industries coded with 3-digit code of the North American Industry Classification System (NAICS).

Source: CANSIM Table 379-0027, CGA-Canada computation.

The auto industry employment accounted for only 1.0% of all employed in Canada in October 2007

One of the strong features of the auto industry is its high (and increasing) level of labour productivity which exceeds several times the average labour productivity of the Canadian economy. Although a positive element in itself, high labour productivity also implies that the reliance of the auto industry on labour input is lower than in many other industries. Not surprising then, that the auto industry employment accounted for only 1.0% of all employed in Canada in October 2007 – the month that featured the lowest unemployment rate in the past three decades. In turn, the other key sectors supported by Budget 2009 employed some 3.2% of all employed in that month.²⁷

Many industries have contracted as the financial crisis and the impacts of the economic downturn spread into the real economy over 2008 and 2009. Auto industry output has undoubtedly seen one of the deepest drops, while a whole range of other industries have experienced noticeable decline as well. For instance, output of such industries as paper manufacturing, wood product manufacturing, plastic and rubber manufacturing, primary and fabricated metal products manufacturing, forestry and logging and supportive activities

²⁷ Based on CANSIM Table 281-0023.

for mining declined by 20% or more between January 2008 and April 2009. Combined, these industries represented 5.8% of industry GDP in 2007 employing some 4.8% of working Canadians.²⁸

Although the volume of output and the size of employment are two important parameters of any industry, they do not directly reflect the economic impact that may be generated due to expansion, contraction and closure of firms in that industry. To measure these types of effects, economists use the concept of multipliers which reflect the direct and indirect impacts of the industry's activity on the overall economy. Direct effects consist of impacts of expanding or contracting production on the industry itself whereas indirect effects result from backwards linkages in the economy when firms that reduce their production also decrease the commodity purchase of inputs from other firms.

Two main types of multipliers exist – output (or revenue) multipliers and GDP multipliers. Output multipliers measure how industries use each other's output and show the inter-connections between industries at a micro-level. These multipliers reflect the industrial structure and the level of integration among the industries rather than industries productivity and importance. In turn, GDP multipliers measure the real contribution of the industry to total GDP and reflect the change in overall production in Canada from a change in production in a particular industry. GDP multipliers are usually considerably smaller than output multipliers as they net out the purchases made by industries from each other.²⁹

Some industries with highly developed value chains may increase their output multipliers by decomposing the production rather than by adding substantial value to the national output. Manufacturing may be a good example. The analysis conducted by Statistics Canada shows that manufacturing has the 4th highest output multiplier among the 22 major sectors of the Canadian economy, whereas in terms of the GDP multiplier, manufacturing had the lowest multiplier in 2002.³⁰ This is why, it may be important to focus the consideration on the industry's contribution to the national prosperity (i.e. GDP) as opposed to the scope of its interdependency with, and level of outsourcing to, other industries.

The situation with the auto industry is somewhat similar to that of overall manufacturing. As seen from Table 2, output multipliers of the industries that constitute the auto industry are somewhere in the mid range compared to all other industries. However, the impact that the changes in the auto industry production may bring to GDP and employment are among the lowest. For

The impact that the changes in the auto industry production may bring to GDP and employment are among the lowest

28 Based on CANSIM Tables 379-0027 and 281-0023.

29 Cross, P. and Ghanem, Z. (2006). *Multipliers and Outsourcing: How Industries Interact with Each Other and Affect GDP*, Statistics Canada, Canadian Economic Observer, January 2006, p. 3.2.

30 Cross, P. and Ghanem, Z. (2006). *Multipliers and Outsourcing: How Industries Interact with Each Other and Affect GDP*, Statistics Canada, Canadian Economic Observer, January 2006, Table 5.

A \$1 change in output production in some 108 Canadian industries would be associated with a greater impact on Canada's GDP than a similar change in production of motor vehicle manufacturing

instance, a \$1 change in output production in some 108 Canadian industries would be associated with a greater impact on Canada's GDP than a similar change in production of motor vehicle manufacturing.

The relatively low GDP multipliers of the auto industry are partially caused by strong import leakages associated with the industry which satisfies the large part of its supply requirements through international imports. For instance, to produce each additional dollar of output, motor vehicle manufacturers directly or indirectly import 61 cents of inputs reducing significantly their impact on Canada's GDP. At the same time, the high capital intensity of the manufacturing process and relatively low reliance on labour input lessen the auto industry's impact on overall employment should a change in production occur. As a result, the auto industries' job effects per one million dollars of output (the job multiplier) are among the lowest across the Canadian industries.

Table 2 – Auto Industry Economic Multipliers, 2005

	Output Multiplier		GDP Multiplier		Import Multiplier		Jobs Multiplier	
	Multiplier	Ranking	Multiplier	Ranking	Multiplier	Ranking	Multiplier	Ranking
Motor vehicle manufacturing	1.57	56	0.38	109	0.61	2	3.95	105
Motor vehicle body and trailer manufacturing	1.65	41	0.62	98	0.37	13	6.95	85
Motor vehicle parts manufacturing	1.68	36	0.55	107	0.43	4	6.41	89

Note: The multipliers are ranked from the largest to the smallest across 117 industries codified by the North American Industry Classification System (NAICS) at 4-digit level.

Source: Statistics Canada (2008). *2005 National and Provincial Multipliers*, Catalogue no. 15F0046XDB. Ranking determined by CGA-Canada.

When considering the size of the financial support to the auto industry, it may also be worth mentioning that the lion's share of government support to the auto industry was allocated to two automakers – GM of Canada and Chrysler Canada – which constitute only part (although a large one) of all auto assemblers present in Canada. Overall, six companies currently build vehicles in Canada – General Motors, Chrysler, Ford, Toyota, Suzuki, and Honda.

3.2.2. Will Canada Preserve Its Share of North America's Auto Industry?

Some experts suggest that output and employment in the Canadian auto industry will fall by at least a third compared to the production peak registered in 1999.³¹ A number of factors may suggest that such a trend (if not the actual slope of the decline) is quite likely to materialize.

In past decades, the auto industry has developed a strong tendency to produce in the near proximity to the markets it serves. For the assemblers, the main reason continues to be the transportation costs – motor vehicles and many of their main parts, such as engines and body panels are large, heavy and somewhat delicate, raising transportation costs. For parts suppliers, the main reason lies in the “lean” production techniques and just-in-time parts delivery that requires parts production to be located close to the final assembly.

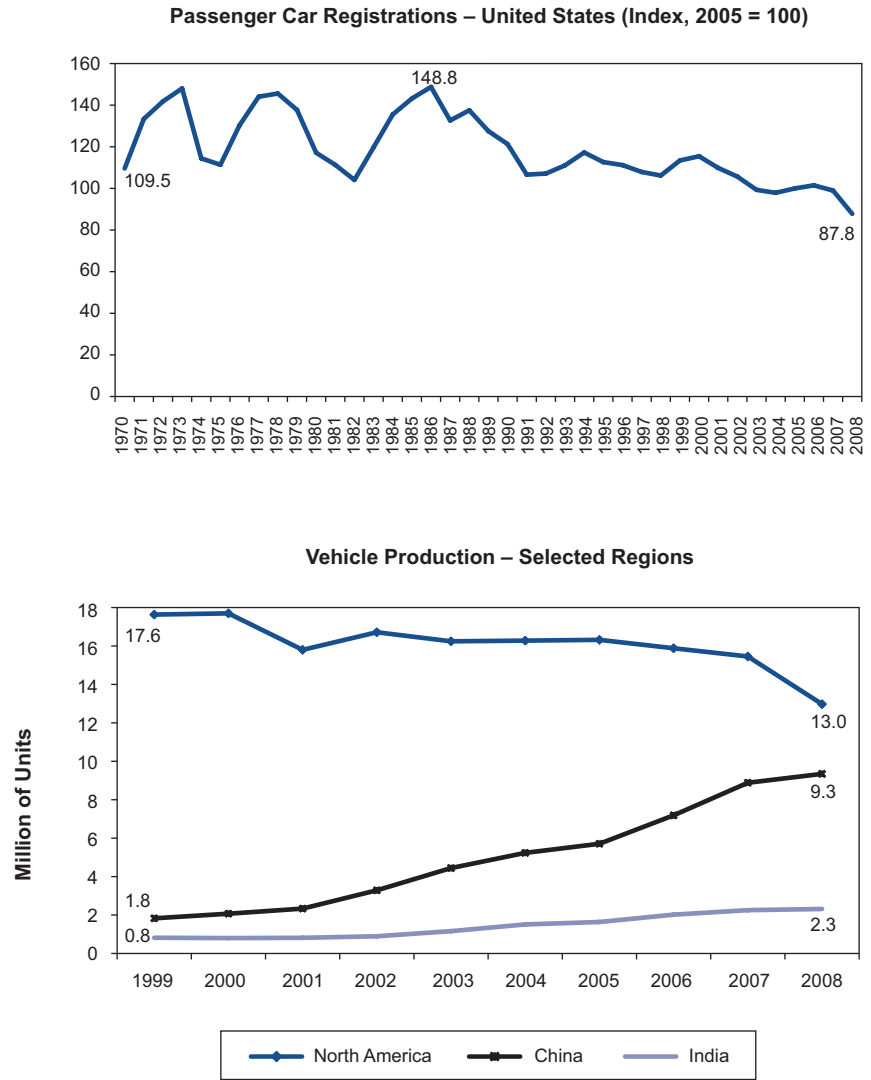
At the same time, the North American market (particularly the U.S. and Canada) are seen to be nearly saturated in terms of vehicle ownership and are believed to be close to reaching the maximum level of vehicle ownership per each 1,000 of population. The fairly slow population growth and high level of income observed in the past three decades resulted in a situation where the nature of vehicle sales is primarily motivated by replacement of existing vehicles, rather than selling to first time vehicle owners. For instance, the annual numbers of passenger car registrations has been declining in the U.S. since the late 1980s (top graph of Figure 5).

The tendency to locate near the final market and the slow (or no) growth in the North America's vehicle demand led to a shrinking share of the world vehicle production that takes place in the North America. For instance, North America's vehicle production declined at an average annual rate of 3.4% dropping from 17.6 million of units produced in 1999 to just 13 million in 2008. Contrary to the North American trend, other regions have been gaining production share. For instance, in China, vehicle production increased fivefold within the same time frame (bottom graph of Figure 5).

The share of the world vehicle production that takes place in the North America is shrinking

31 Dennis DesRosiers as referred to in The Economist (2009). *The Humbling of Detroit North*, July 30, 2009.

Figure 5 – Selected Vehicle Statistics



Note: Top graph: Passenger car registrations are recognized as the number of new passenger cars or vehicles registered to the authorities. Bottom graph: Vehicle production is recognized as a sum of car production and commercial vehicle production.

Source: Top graph: OECD, Stat portal. Bottom graph: The International Organization of Motor Vehicle Manufacturers – Production Statistics (available at <http://oica.net/category/production-statistics/>, accessed on August 26, 2009). CGA-Canada computation.

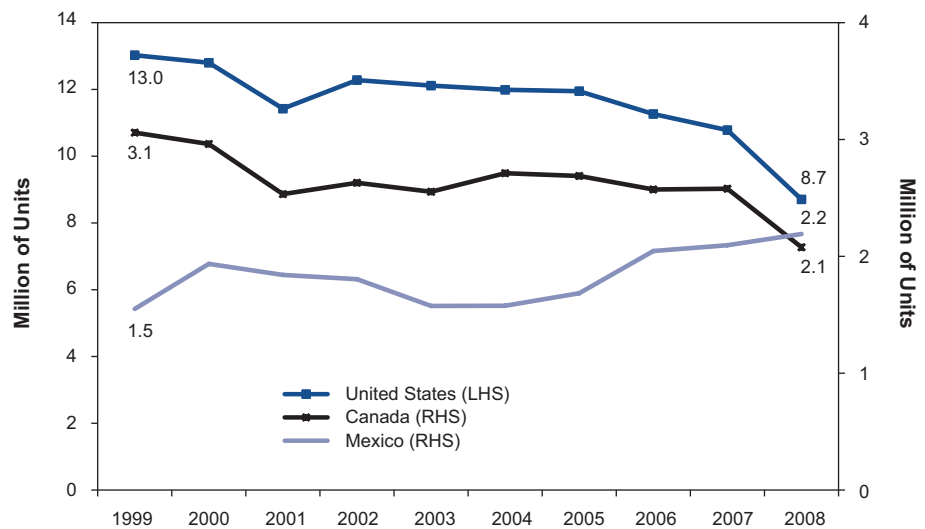
Low consumer confidence, tight credit conditions and relatively high unemployment rates that have become familiar features of the U.S. economy over the past two years may further suppress household demand for new vehicles in North America. At the same time, the rapidly developing middle class in the new fast-growing economies such as China and India will most probably focus the expansion efforts of the auto industry in the regions of near proximity to those countries. For instance, vehicle ownership is forecasted to grow by a mere 1.1% annually in the U.S. between 2002 and 2030 while expanding by as much 11.1% and 8.1% per year in China and India respectively.³² Taken together, these trends strongly suggest that the nominal volume of vehicle production taking place in North America is likely to decline in the years to come. Whether or not Canada will be able to preserve its current share of a shrinking market is another important question.

While vehicle production in Canada and the U.S. has been declining, vehicle production in Mexico saw an accelerated growth

The lion's share of North America's vehicle production still takes place in the U.S.; however, the past decade witnessed a noticeable change in the production breakdown between the three North American countries – the U.S., Canada, and Mexico. That is, while vehicle production in Canada and the U.S. has been declining at an annual average rate of 4.2% and 4.4% respectively between 1999 and 2008, vehicle production in Mexico saw an accelerated growth averaging 3.9% annually (Figure 6). This allowed Mexico to double its share of North American vehicle production in the past decade from 8.8% in 1999 to 16.9% in 2008.

³² Dargay, J. et al (2007). *Vehicle Ownership and Income Growth, Worldwide: 1960-2030*, University of Leeds, Table 3.

Figure 6 – Vehicle Production in North America



Source: The International Organization of Motor Vehicle Manufacturers – Production Statistics (available at <http://oica.net/category/production-statistics/>, accessed on August 26, 2009).

The Canadian auto industry's competitive advantages have been slowly but steadily eroding over past and recent years

The Canadian auto industry has traditionally benefited from two competitive advantages – the low Canadian dollar vis-à-vis the U.S. dollar, and a highly qualified labour force that can be accessed at lower costs than in some other regions. However, these advantages have been slowly but steadily eroding over past and recent years. After a noticeable appreciation of the Canadian dollar during the 1990s, the exchange rate advantage faded away with the exchange rate declining from its peak of 1.6 per US\$1 in January 2002 to a thirty-year low of 0.97 per US\$1 in November 2007.³³ This noticeable change increased significantly the relative cost of Canadian-purchased goods and services such as energy, raw materials and parts. Although since its 2007 pummelling the U.S. dollar did briefly gain some ground, the consequences of the current economic downturn appear to be much more severe and profound in the U.S. – making it less likely for the U.S. dollar to re-gain its stature in the immediate future. The expected recovery of oil prices may put an additional upward pressure on the Canadian dollar (for instance, Bank of Canada projects crude oil price to be at approximately \$80 per barrel level over 2010 and 2011³⁴).

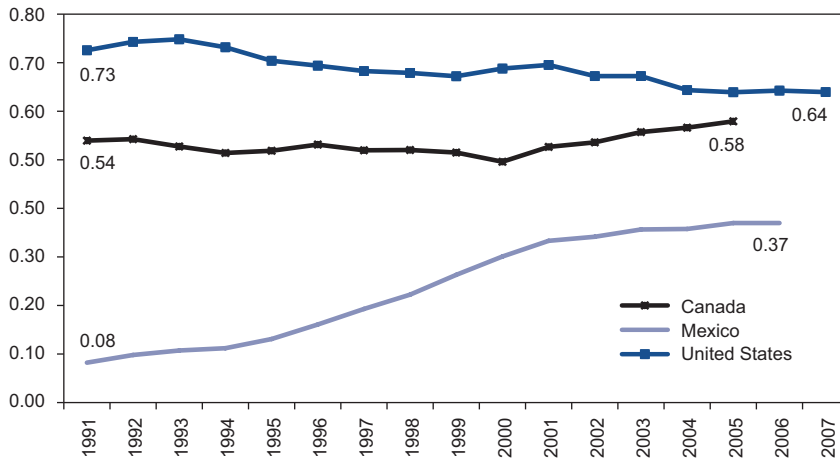
In addition, the appreciation of the Canadian dollar affected the Canadian labour cost advantage increasing (in relative terms) labour and related benefits and pension costs. However, the labour cost advantage has also declined in

³³ Based on CANSIM Table 176-0064.

³⁴ Bank of Canada (2009). *Monetary Policy Report*, October 2009, Chart 9.

currency-neutral terms. For instance, unit labour cost in manufacturing – an indicator that reflects the cost competitiveness and represents the share of labour costs in producing one unit of output – has historically been much higher in Canada than in Mexico. However, recent years reveal a fast narrowing of the gap between U.S. and Canada unit labour cost which may further diminish the attractiveness of Canada for location of the U.S. operations (Figure 7).

Figure 7 – Unit Labour Cost in Manufacturing



Source: OECD.Stat portal.

The saturation and distribution of North America’s auto market described above leads to a situation where the shifts in vehicle production and employment within North America essentially represent a “zero-sum game” – with some places gaining in production capacity at the expense of others losing.³⁵ At the same time, the diminishing competitive advantages of the Canadian auto industry and the strong political will of the U.S. government to maintain the presence of the auto industry in the U.S. may create strong preconditions for the Canadian auto industry to continue losing its share of vehicle production in North America.

The signs that the auto industry (and particularly U.S. automakers) slowly but steadily withdraws from Canada have been fairly obvious in the past several years. For instance, since the beginning of 2006, General Motors Corporation has made four announcements indicating closures of Canadian plants or job cuts that cumulatively affect some 6,170 automotive jobs. Chrysler LLC and Ford have each made two announcements of a similar nature planning to cut some 7,200 jobs.³⁶ These changes did not remain unnoticed in the overall

The signs that the auto industry (and particularly U.S. automakers) withdraws from Canada have been fairly obvious in the past several years

35 Industry Canada (2007). *Prospects for Canada in the NAFTA Automotive Industry: A Global Value Chain Analysis*. Available at http://www.ic.gc.ca/eic/site/gvc-cvm.nsf/eng/h_00024.html, accessed August 25, 2009.

36 Calculated based on information provided in CBC News (2009). *A Timeline of Auto Sector Layoffs*, February 9, 2009. Available at <http://www.cbc.ca/canada/story/2008/10/21/f-autolayoffs.html>, accessed July 31, 2009.

employment numbers of the Canadian auto industry. For instance, the number of workers employed by the auto industry declined at an average annual rate of 4.6% over 2006 and 2007 while in the overall economy employment was growing by 2.3% annually during the same period. The total decline of employment in the auto industry from its peak in May 2001 to January 2008 amounted to 17.6% or some 31,000 employees.

It should be noted that reallocation of resources across sectors and countries, particularly labour force, is a constant phenomenon in the current age of increased labour mobility and the global nature of the value chain and competition. For instance, between 2003 and 2008, the rapid raise in commodity prices and the sharp appreciation of the Canadian dollar led to a noticeable shift in employment from manufacturing industries to extracting and so-called non-tradable sectors (the latter includes construction, finance, insurance and real estate, and the wholesale and retail trade sectors).³⁷

However, the shift of employment in the auto industry is different as it is primarily driven by the overcapacity of the industry itself rather than by more attractive employment opportunities existing elsewhere. For instance, the U.S. vehicle production forecasted to be around 6-7 million units per year over 2009-2013 leaving ample capacity room compared to the production peak of 13 million in 1999.³⁸ Similarly, North America's current annual demand of about 10-11 million units is considerably smaller than the current North American production capacity of some 16 million units.³⁹

The shift of employment in the auto industry is primarily driven by the overcapacity of the industry

One more fact seems to be of importance. The adjusted for inflation profitability of the Canadian motor vehicle and trailer manufacturing (measured as profit before income tax) declined at an average annual rate of 24.6% between 1999 and 2007 while in other non-financial industries, profit grew by an annual average of 6.9% within the same period of time. Is it really possible to expect that the industry demonstrating such financial results will not respond through restructuring, consolidation, and/or withdrawal?

3.2.3. Did the Governments' Action Preserve Jobs?

One of the main challenges in assessing the validity of the assumption that financing of the auto industry preserved jobs is the lack of information of what would have otherwise happened in the absence of the governments' financial support. For instance, an insolvent company has a number of options at its disposal: it may pursue a merger with another company, refinance business

37 Dupuis, D. and Marcil, P. (2008). *The Effects of Recent Relative Price Movements on the Canadian Economy*. Bank of Canada, Bank of Canada Review, Autumn 2008, p. 46.

38 Rubin, J. (2009). *Wrong Turn*, CIBC World Markets, StrategEcon, March 2, 2009, p. 6.

39 House of Commons Canada (2009). *A Study of the Crisis in the Automotive Sector in Canada*, Report of the Standing Committee on Industry, Science and Technology, 40th Parliament, 2nd Session, p. 13.

loans, negotiate out-of-court arrangement with its creditors, file for bankruptcy, and, finally, wind down the company. Estimating how many jobs have been preserved by the government bailout would require a number of assumptions; particularly regarding the option the particular automaker would have chosen in the absence of public funds, the willingness of other market participants to take an active role in that option (e.g. be motivated for a merger or acquisition of liquidating assets), and the geographical concentration of these actions.

To mitigate this challenge, attention is focused not so much on whether the jobs have been saved, but rather on the magnitude of the job losses sustained by the auto industry and how the outcome compares to the job losses in industries that have not been financed by the government. The analysis was based on industries that employ a comparable or greater number of workers than does the auto industry.⁴⁰ As seen from Table 3, and despite the billions of dollars injected, the auto industry's employment sustained the highest contractions on the pan-Canadian scale and in the province of Ontario. This was true in April 2009, shortly prior to the government approving the restructuring plan of Chrysler and General Motors, and in August 2009 when both Chrysler LLC and General Motors Corporation had already emerged from bankruptcy protection.

Despite the billions of dollars injected, the auto industry's employment sustained the highest contractions on the pan-Canadian scale and in the province of Ontario

Table 3 – Top Five Industries That Sustained the Highest Job Losses – Selected Months of 2009

CANADA		ONTARIO	
Industry	% change in employed	Industry	% change in employed
April 2009 to April 2008			
Auto industry	-17.6%	Auto industry	-17.4%
Fabricated metal product manufacturing	-13.8%	Administrative and support services	-10.4%
Machinery manufacturing	-13.5%	Specialty trade contractors	-8.0%
Accommodation services	-8.3%	Credit intermediation and related	-6.6%
Truck transportation	-7.9%	Professional, scientific and techn. services	-1.4%
August 2009 to August 2008			
Auto industry	-22.1%	Auto industry	-22.1%
Machinery manufacturing	-16.2%	Credit intermediation and related	-10.0%
Fabricated metal product manufacturing	-15.5%	Administrative and support services	-9.7%
Truck transportation	-10.0%	Specialty trade contractors	-7.8%
Administrative and support services	-8.8%	Professional, scientific and techn. services	-4.1%

Source: CANSIM Table 281-0023, Statistics Canada (2009). *Employment, Earnings and Hours*, Catalogue no. 72-002-X. CGA-Canada computation.

⁴⁰ To allow for a meaningful comparison, the employment was analysed in industries coded with 3-digit code of the North American Industry Classification System (NAICS).

Although labour statistics indicate that non-farm payroll employment was on the rise in July 2009 (the first increase since its peak in October 2008), this positive trend may not necessarily be the case in the auto industry. The recent analysis conducted by the Conference Board of Canada suggests that the labour force of the Canadian auto parts manufacturing industry may further fall by one third over 2009 following closely the production trend in this industry which is projected to fall by 39% in 2009.⁴¹ Car manufacturers also plan to reduce further the number of employees. For instance, GM of Canada expects that its hourly wage workforce will decline from 10,300 in 2008 to 4,400 in 2014. Cuts to the salaried staff are also expected and the number of GM dealerships in Canada will drop from 705 dealers in 2009 to between 395 to 425 dealers at the end of 2010.⁴²

3.2.4. Is Picking the Winner the Right Approach?

The support of the auto industry fits well within what the political fabric would identify as an ‘industrial policy’. Using industrial policy to promote economic growth or to achieve other social benevolent outcome has been used extensively by many countries over past decades.

There is the question of government ability to identify the sectors that are most worthy of intervention

Although widely used, industrial policy remains a complex phenomenon. In broad terms, two types of industrial policy may be identified. First is to use government strategies to create conditions for overall private sector competitiveness and enhance the ability of domestic firms to increase their productivity to outcompete foreign rivals. Second is to undertake selective government interventions that attempt to alter the sectoral structure of production which would have been different in the absence of such interventions. This is often referred to as ‘industrial targeting’, or more colloquially – picking the winner. While the first type of industrial policy is largely driven by the desire to achieve competitiveness on global markets, the second is primarily justified by the presence of market failures (such as imperfect competition and information asymmetries) which do not allow a competitive market system to yield the socially efficient outcome.

As with other areas of public policy, a consensus regarding the efficacy and benefits of government interventions to increase the overall competitiveness has not yet been reached.⁴³ The often listed shortcomings include distraction from the more important determinants of prosperity; namely domestic productivity growth, possible intervention of geopolitical strategies into industrial policy, and harsh penalties that may be associated with excessive

41 Conference Board of Canada (2009). *Auto Parts Manufacturers Forecast to Cut 36,000 Jobs in 2009*, News Release 10-03.

42 CBC News (2009). *GM to Drop Pontiac in 2010, Cut Thousands More Jobs*, April 27, 2009. Available at <http://www.cbc.ca/money/story/2009/04/27/gm-pontiac-gone.html>, accessed August 11, 2009.

43 See, for instance, DeMartino, G. (2000). *Global Economy, Global Justice: Theoretical Objections and Policy Alternatives to Neoliberalism*, Chapter 5 - Contesting Competitiveness, New York: Routledge.

global exposure. However, a picking the winner strategy is associated with an even greater number of shortcomings. Among those are the uncertainty regarding policy-makers' ability to identify the "right" industry for intervention, and potentially of suboptimal allocation of productive capacity within the industry.

Identifying "Right" Industry

Participants in a given industry seldom know all events that have taken place in their industry and respective markets, and as such do not have the complete, timely, and perfect information that can eliminate all uncertainty. Information constraints facing policy-makers pursuing industrial targeting may be even greater due to the natural distance from the industry. This leads to the question of government ability to identify the sectors that are most worthy of intervention. The range of knowledge that policy-makers need to possess to structure a successful industrial policy is remarkable. One of the studies identifies 15 dimensions that a policy-maker needs to master in order to be able to make well informed decisions when venturing into industrial targeting. Among those are understanding of which firms and industries generate knowledge spill-overs, which sectors have a long-term comparative advantage, knowledge about potential competitiveness of particular firms, the ability of the industry to benefit from dynamic scale economies (i.e. learning by doing), and generation of new knowledge.⁴⁴

Some researchers refer to industry targeting as an 'experimentation' process through which policy-makers selectively influence firms' entry and exit decisions in the targeted industries. In such experimentation, policy-makers have modest assurance against mistakes of "picking losers" instead of winners. In fact, the research findings suggest that even "an optimally designed industrial targeting policy may lead in the long-run to the country's specialization in industries in which it has little comparative advantage", or even abandon industries in which it has true comparative advantage.⁴⁵

Influencing Allocation of Production Capacity

In addition to the risk of picking the wrong industry for targeted support, direct support to a single firm (or group of firms) within the industry may affect the effectiveness of the composition of the industry itself. In the case of the industry with excessive capacity (such as the North American auto industry), government incentives may affect the pattern of capacity reduction by altering the optimal product planning and plant location decisions. Encouraging the firm to maintain its operations in less favourable locations may, in turn, jeopardize its long-term competitive prospects.

Government incentives may affect the pattern of capacity reduction by altering the optimal product planning and plant location decisions

44 Pack, H. and Saggi, K. (2006). *The Case for Industrial Policy: A Critical Survey*, The World Bank, Policy Research Working Paper 3839, p. 28-29.

45 Klimenko, M (2004). *Industrial Targeting, Experimentation and Long-run Specialization*, Journal of Development Economics, Vol. 73, Issue 1, p. 78.

Targeted government intervention may simply shift the job losses or gains from one firm to another

In addition, targeted government intervention may simply shift the job losses or gains from one firm to another as the government incentives for the firm to stay do not affect the final demand which ultimately determines the level of production. Preventing exits of firms that could have prevented their failure by applying more effective planning regimes and adjusting to changing consumer preferences also signals implied reward for bad business practice.

The empirical analysis of industrial policy undertaken to date is not decisively conclusive on whether or not industrial policy works. The main challenges of the analysis relate to lack of counter-factual information on what would have happened in the absence of the government intervention and the complexity of assumptions that need be employed to construct such a scenario. The diversity of stages of economic development and types of government interventions across different countries further increase the difficulty of arriving at a one-fit-all conclusion. However, a fairly thorough analysis of outcomes of industrial policy in Japan, Korea and Taiwan did conclude that industries having benefited from intervention did not experience significantly faster growth in productivity and capital accumulation. As such, industrial policy methodology was found to make only minor contributions to the economic growth of Asia.⁴⁶

3.2.5. Is There a Case of Eroding Accountability and Transparency?

Budget transparency, which is understood as the full disclosure of all relevant fiscal information in a timely and systematic manner,⁴⁷ is naturally a crucial element of public finance. Canada is seen as using many of the OECD's best practices for budget transparency and Canada's budgetary documents and procedures are typically viewed as containing a relatively high level of detailed publicly available information.⁴⁸ At the same time, the transparency of the federal budgeting process has been criticized on a number of occasions. For instance, the repetition of much larger than expected federal budget surpluses in previous years has led to a perception that the federal government had not been fully transparent regarding the amount of prudence incorporated in budget planning.⁴⁹ In the case of the auto industry rescue, some concerns regarding the sufficient budgetary transparency may be identified as well.

46 Noland, M. and Pack, H. (2005). *Industrial Policy in an Era of Globalization: Lessons from Asia*, Peterson Institute for International Economics, e-book, available at <http://bookstore.piie.com/book-store/358.html>, accessed October 3, 2009.

47 Organisation for Economic Co-operation and Development (2001). *OECD Best Practices for Budget Transparency*, OECD Journal on Budgeting, Volume 1, no. 3.

48 Mühleisen, M. et al (2005). *How do Canadian Budget Forecasts Compare With Those of Other Industrial Countries*, International Monetary Fund, IMF Working Paper, WP/05/66, p. 4 and 17.

49 Department of Finance Canada (2006). *Restoring Fiscal Balance in Canada – Focusing on Priorities*, Budget 2006, p. 15.

Possible Fiscal Outcomes are Not Fully and Timely Discussed

One of the concerns regarding budget transparency relates to the fact that the possible impact of the measure on the budgetary balance was not fully discussed in the initial budgetary documents.

The lion's share of the financial support to the auto industry was provided in the form of loans. According to the Government's accounting policies, government loans are recorded as assets on the balance sheet of the government whereas an expense is recorded only when loans become impaired or written down as a result of default. For that reason, the loans committed to the auto industry in December 2008 were not reflected in projections of expenses and budgetary balance presented in the five-year fiscal outlook incorporated into the budget. At the same time, there is conjecture that the high likelihood of the rescue funding becoming an expense rather than an asset was known to the government at the time of the first announcement in December 2008 (i.e. prior to tabling Budget 2009).

The interim loans to the auto industry were provided through the *Canada Account* managed by Export Development Canada (EDC).⁵⁰ *Canada Account* is typically used to support export transactions which EDC is unable to support, i.e. when the risk of the transaction and default exceeds EDC's normal operational thresholds applied to commercial lending. The risks for transactions undertaken through *Canada Account* are assumed by the federal government.⁵¹ Logic may suggest that providing the rescue financing through an account that assumes less-than commercial basis of the transaction is highly likely to be an expense, in fiscal terms, rather than an asset on the balance sheet of the federal government. The Prime Minister himself was of a similar opinion when announcing the support in December 2008. As quoted by the New York Times, the Prime Minister suggested that "there is obviously money at risk here and there may well be more money at risk going forward".⁵² However, it was not before June 2009 (5 months after tabling the budget), that the auto loans were taken into accounts in the projections of the federal budget deficit.

Moreover, the mere fact that the loans equating to 2.4%⁵³ of direct program spending for 2009-10 were provided to two private companies in the state of high financial distress may further emphasize that the risks to the projected federal fiscal outcomes were not fully discussed and disclosed in the budget documents.

The possible impact of the measure on the budgetary balance was not fully discussed in the initial budgetary documents

50 Office of the Prime Minister (2008). *Backgrounder - Government Support to the Auto Industry*, December 20, 2008.

51 Based on information available on EDC website (available at http://www.edc.ca/english/disclosure_9239.htm, accessed October 6, 2009).

52 As quoted by Austen, I. (2008). *Canada Agrees to Its Own Auto Bailout*, The New York Times, December 20, 2008, available at <http://www.nytimes.com/2008/12/21/business/worldbusiness/21canada.html>, accessed October 6, 2009.

53 Based on Table 3.8 and Table 4.6 of Department of Finance Canada (2009). *The Budget Plan*. It should be noted that by the end of September 2009, the loans to the auto industry were equivalent to 8.1% of direct program spending for 2009-10 (compared to 2.4% mentioned above). This change was primarily caused by the increased amount of loans versus that incorporated in the budget.

Support to the auto industry did not stipulate clearly the expected outcomes of the financial support

Objectives and Expected Outcomes are Not Clearly Stated

Another concern regarding potential erosion of budget transparency relates to the outcome measurements. Support to the auto industry did not stipulate clearly the expected outcomes of the financial support, nor did it include specific indicators to measure the impact and the progress towards achieving objectives. Moreover, the objectives themselves were scarcely identified. To date, the Backgrounder⁵⁴ that accompanied the announcement of the bailout made on December 20, 2008 is probably the most detailed publicly-available documents in regards to terms and conditions of the assistance package. Yet, the rationale for the support does not clearly reflect the public interest and the benefits of the government actions, nor does it identify a specific problem the support is intended to resolve. Instead, the rationale focuses on the fact that “the Government of Canada is committed to supporting the auto industry”. As was discussed at the beginning of this section, a similar lack of clarity was also observed in other documents accompanying the funding announcement where the rationale for the government’s actions was motivated by the necessity to follow U.S. actions, to protect the economy, and to save jobs.

The sufficiency of diligence in formulating terms and conditions attached to the financial support may also be questioned. For instance, the requirements associated with the restructuring plans were of a very general character indicating that renewals of the loans require the submission of “acceptable restructuring plans” that would ensure long-term viability and restore competitiveness.⁵⁵ In turn, such important financial and economic conditions as repaying loans, achieving net present value after repayment of the loans, and ability to improve fuel efficiency were not specified. The conditions that accompanied the loans committed to automakers once restructuring plans had been approved were likewise not comprehensive. They primarily focused on limitations on executive compensations and privileges, limitations on dividend payments, and oversight conditions missing on the conditions related to, for instance, jobs and profitability.

Inconsistencies in the Format of Reporting Documents

Increased transparency, particularly in the time of financial crisis and economic instability, is predominantly important as it diminishes information asymmetry (perceived or actual) between the government and the public, increases government’s credibility, and assures more positive acceptance of the public measures. In this regard, the publication of documents that present quarterly progress in the implementation of the Economic Action Plan is commended. However, the suggested downside of those documents is the inconsistency of their structure with the budget documents which reduces readers’ ability to

54 Office of the Prime Minister (2008). *Backgrounder – Government Support to the Auto Industry*, December 20, 2008.

55 Office of the Prime Minister (2008). *Backgrounder – Government Support to the Auto Industry*, December 20, 2008.

easily navigate and track the implementation progress of the specific measures as well the consistency of the dollar amounts associate with those measures.

At the time of writing (December 2009), the federal government had released 5 documents containing information on allocation of government funds in 2009-10. These documents include the Budget itself that lays out Canada's Economic Action Plan (tabled in January 2009), and four progress reports presenting advances in Plan implementation (tabled respectively in March, June, September and December of 2009). The most significant inconsistencies observed in those documents may be summarized as following:⁵⁶

- The measure "Loans to Auto Industry" initially included under the category "Improved Access to Financing", was renamed to "Support for the Auto Industry" and moved to the category of "Support for Industries and Communities".
- The category "Action to Help Canadians and Stimulate Spending" was renamed to "Helping the Unemployed" whereas the subcategory "The Canada Skills and Transition Strategy" was substituted with "Strengthening Benefits for Canadian Workers".
- Such measures as "Improving Infrastructure at Colleges and Universities" and "Canada Foundation for Innovation" were moved from the category of "Immediate Action to Build Infrastructure – Investments in Knowledge Infrastructure" to "Creating the Economy of Tomorrow – Action to Invest in Colleges, Universities and Research".
- Such measures as "Transformation to a Green Energy Economy" and "Canadian Environmental Sustainability Indicators" were moved from the category "Action to Support Businesses and Communities – A More Sustainable Environment" to "Creating the Economy of Tomorrow – Investing in Science and Technology".
- The initiative "Public-Private Partnerships" was introduced in Budget 2009, but was not included in summary tables of the implementation reports.

Inconsistencies may also be noticed in the announcements of the financial support to the auto industry. For instance, loans provided to Chrysler Canada were denominated in Canadian dollars whereas loans committed to GM of Canada were denominated in U.S. dollars with no information provided on the exchange. Similarly, the only initial announcement dated December 20, 2008 contained a somewhat detailed backgrounder on terms and conditions of the loans. The April and June announcements of the extended support were not accompanied by specifications on terms and conditions of loans such as closing date, interest rate, security, etc.⁵⁷

⁵⁶ Based on CGA-Canada analysis and information presented in Office of the Parliamentary Budgetary Officer (2009). *Third Quarterly Update of a Monitoring Framework for Measures Contained in the Economic Action Plan*.

⁵⁷ See, for instance, Office of the Prime Minister (2009). *Backgrounder - Canada and Ontario: Joint Support for Chrysler Restructuring*, April 30, 2009; Office of the Prime Minister (2009). *PM Announces Support for General Motors*, Median Release, June 1, 2009; Office of the Prime Minister (2008). *Backgrounder – Government Support to the Auto Industry*, December 20, 2008.

Summing up the discussion, the following points are deemed important. First, the governments of Canada and Ontario provided some \$14.6 billion in rescue loans to two automotive companies with nearly one third of the funds allocated outside of Canada. Second, support to the auto industry does not seem to be proportional to the size of the industry measured in terms of industry's output and employment; nor is the support comparable to the size of financial support provided to the other key sectors of the Canadian economy. Third, a number of trends suggest that the North American auto industry will contract (in nominal terms) in the years to come. Canada's ability to maintain its share of the shrinking market is highly uncertain. Forth, despite government financial support, the auto industry reported one of the highest (in relative terms) levels of job losses. As such, the government's objective to maintain jobs may not be fully achieved. Fifth, governments and policy makers have a number of hurdles to conquer in making optimal choices in terms of industrial support. The empirical research does not find strong supportive evidence for industrial policy either. And finally, there is contention that the sufficiency of budgetary transparency can be improved.

Concerns Associated with Federal Public Debt

4

The accounting policies guiding preparation and implementation of the federal budget stipulate that the value of loans, investments and advances should be adjusted in the financial statements to approximate their estimated net realizable value. Prior, loans and investments remained government's assets unless they became impaired. As the large number of stimulus measures (particularly those associated with credit easing) are provided in the form of loans, guarantees and investments, their potential impact is not currently reflected in the forecasts of the federal budgetary revenues and expenses. This raises certain concerns regarding the possible budgetary developments and the degree of awareness.

4.1. Recessions – When Do They End?

The financial crisis that unfolded over 2007 and 2008 and the global economic recession provoked by it have often been referred to as the worst, deepest and most unprecedented recession since the Great Depression. One of the most dangerous features of this recession has been its synchronous nature among industrialized and developing countries. And yet, after three consecutive quarters of a declining real GDP, the recession was "technically" over when Statistics Canada reported a 0.1% increase in real GDP in the third quarter of 2009. This contrasted sharply with the projections released in April when a 1% decline in real GDP was anticipated for the third quarter of 2009.⁵⁸

It seems to be beneficial to our current discussion to highlight that the mere switch from the negative to the positive rate of growth (although a notable achievement) does not fully reflect the different shades of what can be referred to as the “end of the recession”. A recession is commonly defined as two consecutive quarters of negative growth of real GDP and a simple change to, for instance, zero growth would already be considered as non-recessionary. However, such a proclamation of the end of the recession will say nothing about the time required to reach the pre-recession GDP level or about the level which the economy could have achieved without the recession (i.e. if the pre-recession growth had continued without interruption).

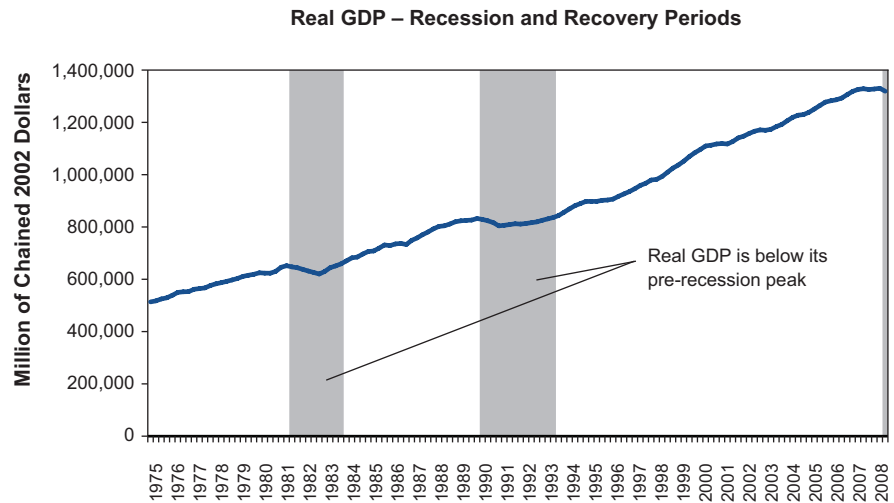
Consideration of the recessions that took place in Canada in the 1980s and the 1990s may provide an interesting illustration of this point. Prior to 2008, the

The mere switch from the negative to the positive rate of growth does not fully reflect the different shades of what can be referred to as the “end of the recession”

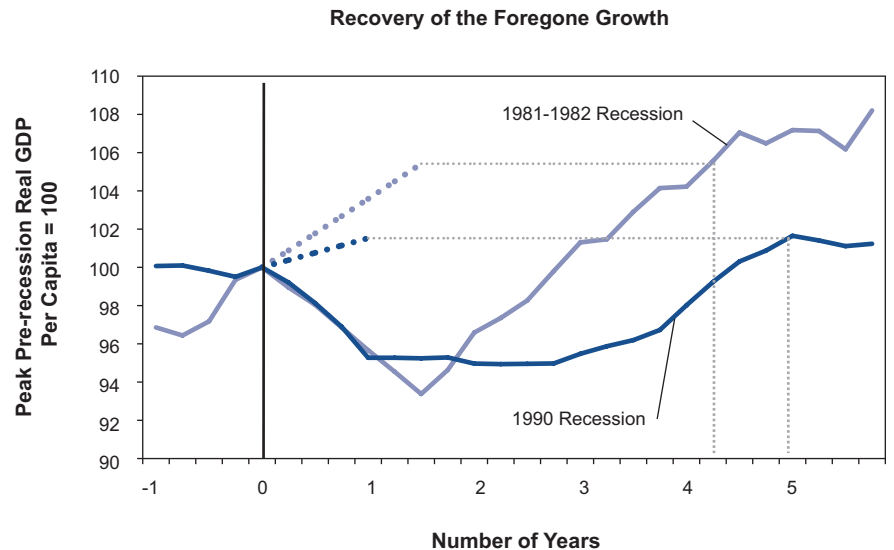
⁵⁸ Statistics Canada (2009). *Canadian Economic Accounts*, The Daily, November 30, 2009 and Bank of Canada (2009). *Monetary Policy Report*, April 2009, Table 4.

most recent recession took place over four quarters between April 1990 and March 1991, while the one prior to that started in July 1981 and lasted six quarters until December 1982. Although these recessions were not judged as very prolonged or deep, it took additional four quarters in the 1980s and ten quarters in the 1990s for the economy to recover to the pre-recession levels of real GDP. Altogether, 2.5 years were 'lost' in the 1980s and 3.5 years in the 1990s just to restore the level of economy experienced prior to the recessions (top graph of Figure 8).

Figure 8 – Past Recessions and Recoveries



2.5 years were 'lost' in the 1980s and 3.5 years in the 1990s just to restore the level of economy experienced prior to the recessions



Source: CANSIM Table 380-0002, CGA-Canada computation.

Although in the long-term, the rate of growth of real GDP is seen as paramount to the creation of national wealth, in the more immediate future, the absolute levels of real GDP may prove to be critically important as well. In the short-term, the absolute dollar amount of GDP reflects the level of production (and, consequentially, employment) in the economy, and influences greatly revenue flows into government budgets. The proper understanding of this connection may prove to be crucial for the consideration of the mid-term impact of the recession on the federal budgetary components.

It should be noted, though, that achieving the pre-recession levels of real GDP does not, by itself, restore the pre-recession levels of living standards which are typically measured as GDP per capita. As Canada's population continued to grow during the recession and the 'lost' years as well, it took some 3 years in the 1980s and 4.25 years in the 1990s to reach the level of living standards enjoyed prior to the recessions.

Another approach to understanding the magnitude of the foregone output due to the recession is to assume that the economy would have continued growing if the recession had not taken place. For instance, what would be the level of real GDP if the economy, instead of sinking into recession, would have grown at the rate observed in the previous 12 months? The bottom graph of Figure 8 intends to provide a simplified depiction of that scenario. These estimates should not by any means be considered as a methodologically robust exercise; however, they nevertheless illustrate well the fact that it takes many years to achieve the level of living standard (measured as GDP per capita) foregone by virtue of recession.

Canada's recovery from the current (2008-2009) recession may further be aggravated by a number of factors. Canada is a small open economy and its economic growth depends greatly on export. In light of the global nature of the economic slowdown, the reliance on export to boost Canada's economy is diminished and the weak outlook for the U.S. short- to medium-term economic prospects does not bode particularly well. Household consumption, which has been a driving force of Canada's economic growth for decades, may somewhat be suppressed in the next several years as households may have tendency to increase their savings due to precautionary and retirement motives. The two important policy tools that are typically used to promote economic growth – fiscal policy and lending interest rates – have excessively been used to stop the spread of the financial crisis – and little room exists for further reliance on these instruments. Moreover, unprecedented simultaneous stimulus packages have been injected into economies around the world. The withdrawal (or phasing out) of the stimulus measures, although a necessary step, may have a somewhat procyclical impact on the global economy and may slow down the currently forecasted pace of recovery.

Achieving the pre-recession levels of real GDP does not, by itself, restore the pre-recession levels of living standards

4.2. Federal Deficit and Debt – What are the Expectations?

Although 11 years of consecutive federal surpluses have made achieving “balanced budget or better” nearly a habitual situation, budget deficits are far from being a new phenomenon for Canada. Both federal and provincial governments have experienced prolonged periods of budget deficits at different points in time over the past three decades. In the case of the federal government, the latest deficit cycle persisted for 27 years (from 1970-71 to 1996-97 fiscal years) and was characterized by chronic, large-size budget shortfalls. The length of the current deficit cycle is naturally not known yet; however, if the government budget forecast is of any indication, the latest projections suggest that deficit will persist for at least seven years between 2008-09 and 2014-15 fiscal years (top graph of Figure 9).

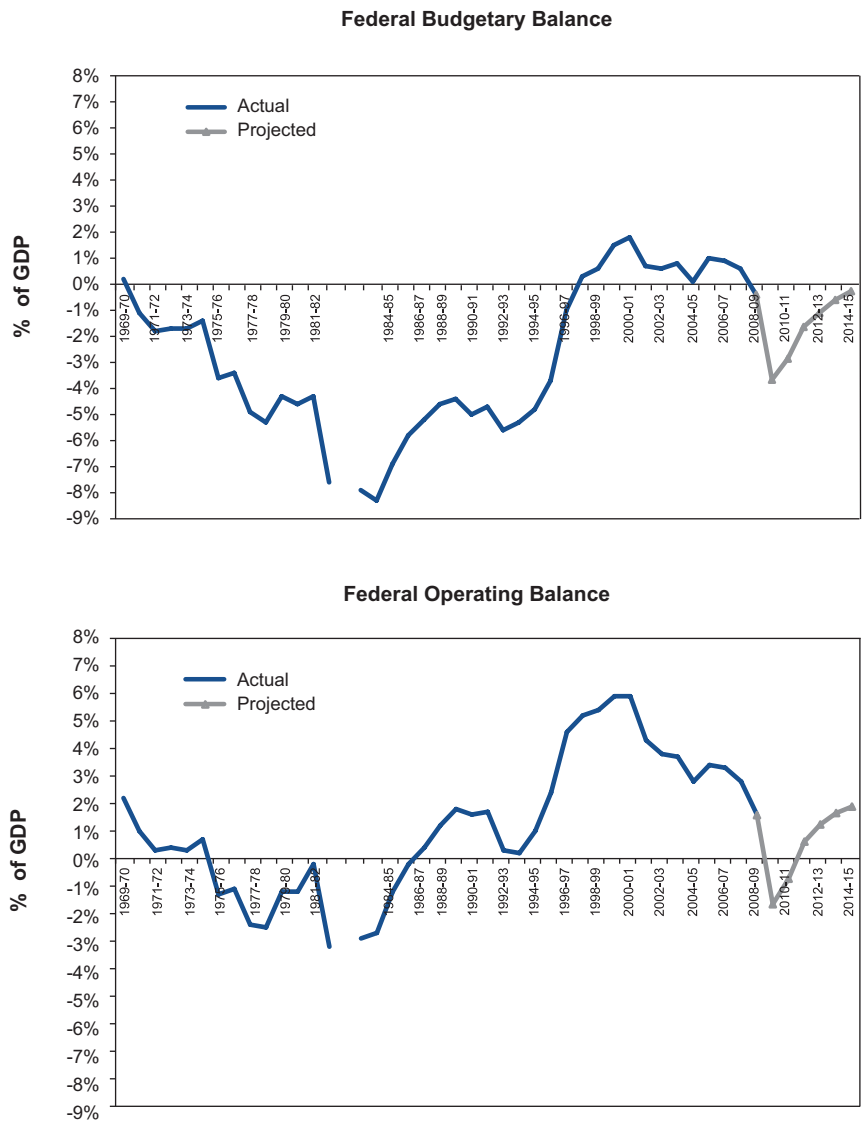
The latest projections suggest that deficit will persist for at least seven years between 2008-09 and 2014-15 fiscal years

The size of the budgetary balance is influenced by a number of components. Public debt charges is one of them; and its main peculiarity lies with the fact that the government has limited influence on the level of the debt charges which are largely shaped by current interest rates. Revenue and program spending are two other primary variables determining the magnitude of the budgetary balance. Unlike debt charges, budgetary revenue and spending are directly controlled by the government.

However, achieving a positive operating balance – the excess of revenues over program spending – is not always enough to avoid a deficit. For instance, in the early 1970s, the operating balance remained positive for the first five years of the deficit cycle but was not large enough to offset debt service charges (bottom graph of Figure 9). A similar situation occurred in the late 1980s when the positive margin of the operating balance persisted for 10 years but still was not able to withstand the mounting debt service charges and the negative consequences of global recession of the early 1990s. When the relatively modest surplus (0.3% of GDP) was first achieved in 1997-98, budgetary revenue had to exceed program spending by 40.1% in order to create the surplus. A somewhat similar trend may already be observed in the projections of the current deficit cycle. Although a surplus is not forecasted prior to 2015-16, the operating balance is expected to become positive as early as 2011-12 and account for nearly 2% of GDP in the 2014-15 fiscal years. Whether or not these expectations may be over-optimistic is discussed later.

Federal budget deficits are seen in negative light primarily because they increase federal public debt which is a mere accumulation of deficits over time. The prolonged era of federal budget deficits in the 1970s and 1980s resulted in the federal debt more than tripling (in relative terms) between 1974 and 1995 when it peaked at 68.4% of GDP. Comparatively, the projected

Figure 9 – Federal Budgetary and Operating Balance



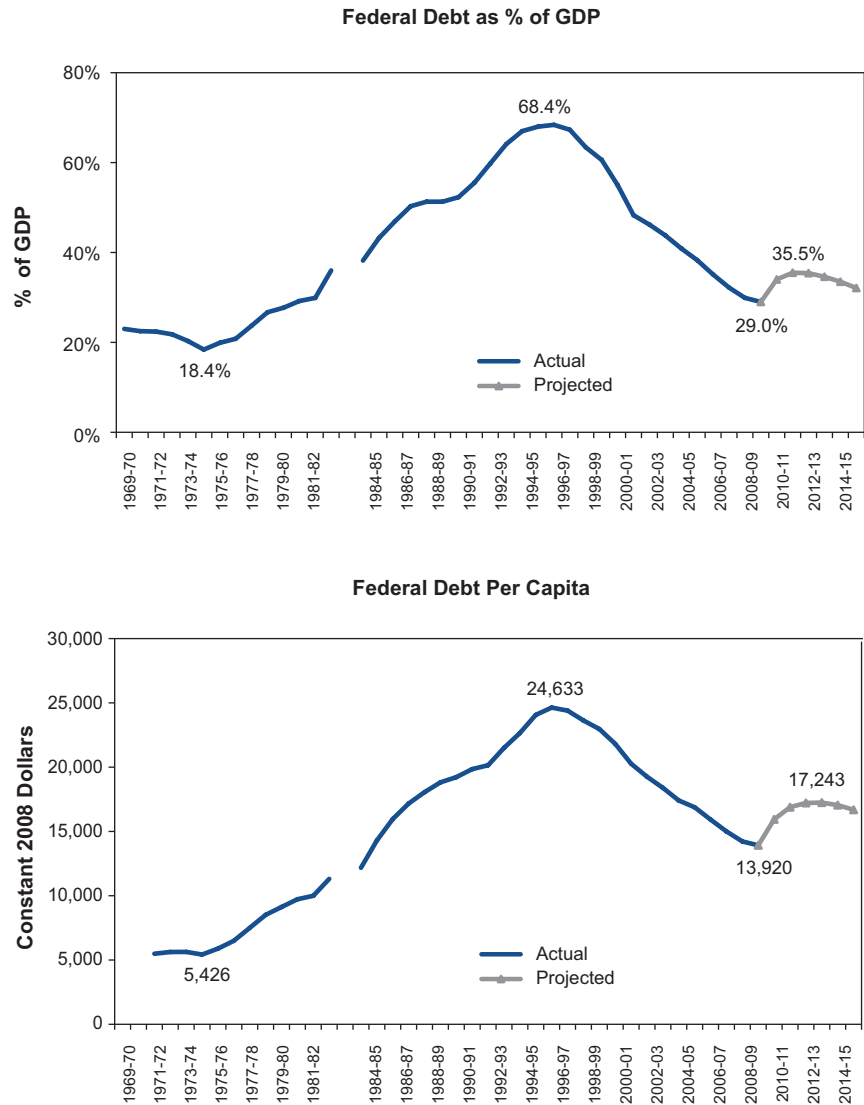
Note: The break in series between 1982-83 and 1983-84 fiscal years marks the shift from modified accrual to full accrual accounting framework.

Source: Department of Finance Canada (2009). *Fiscal Reference Tables*, Table 2; Department of Finance Canada (2009). *Update of Economic and Fiscal Projections*, Table 3. CGA-Canada computation.

increase in federal debt triggered by the current economic downturn is fairly mild with the highest level expected to peak at 35.5% in 2010-11 (top graph of Figure 10).

Some caveats to measuring the level of public debt are important to note. The most common measure of the level of federal public debt – debt-to-GDP ratio – is influenced by the relative growth rates of both deficit and GDP. If deficit

Figure 10 – Federal Debt



Note: The break in series between 1982-83 and 1983-84 fiscal years marks the shift from modified accrual to full accrual accounting framework.

Source: Department of Finance Canada (2009). *Fiscal Reference Tables*, Table 2; Department of Finance Canada (2009). *Update of Economic and Fiscal Projections*, Table 3. CGA-Canada computation.

grows slower than GDP, then the relative level of debt (i.e. debt-to-GDP ratio) declines even though the government still reports a deficit. This was the case in the early 1970s when for the first 5 years of the deficit cycle, the relative level of federal debt was declining reaching its lowest of 18.4% in 1974-75 fiscal year although deficit averaged at 1.5% of GDP over those years. Similarly, persistent deficits that increase public debt but at a rate equal to that of the economic growth will maintain the level of debt-to-GDP indicator unchanged.

Measuring public debt relative to GDP allows taking into account the growing income (i.e. GDP) which forms the basis of servicing the debt. At the same time, one of the main shortcomings of this approach is that it compares income over a given period of time against the stock of debt which is to be repaid over several periods of time. As such, it does not account for a possible sudden reduction in income. Measuring federal debt per capita and adjusting it for inflation somewhat mitigates this shortcoming as it shows the debt burden of each Canadian at any given point of time. As seen from the bottom graph of Figure 10, the per capita measurement presents a less progressive debt reduction and a much sharper increase in the debt level over the budget forecast horizon.

It is also worth mentioning that even though Canada had experienced strong fiscal positions for over a decade prior to the 2008 crisis, the starting point of the current deficit cycle is somewhat weaker than that of the previous cycle when it comes to the relative level of federal debt.

4.3. The Main Concern – Are the Expectations Set Correctly?

A number of factors may further negatively affect the already weakened federal fiscal position. Among those are the work of automatic stabilizers, contingency risk of liabilities, inaccurate fiscal projections and some traditional but seemingly forgotten fiscal pressures. These possible ‘add-ons’ are further discussed.

Automatic Stabilizers

Automatic stabilizers are usually defined as those elements of fiscal policy that mitigate output fluctuations by adjusting government revenues and/or expenditures without discretionary government actions.⁵⁹ Automatic stabilizers are often seen as contributing to demand stabilization through mitigating income shocks on household consumption and business activity. Examples of automatic stabilizers include corporate and personal income tax, employment insurance, and income-tested social benefits such as child care tax credit and guaranteed income supplement for seniors.

The automatic stabilizers of personal income tax are activated by the progressive nature of Canada’s tax system which imputes that lower income is taxed at a lower statutory rate. As an individual’s income declines, the individual pays less as a proportion of their income in direct taxation. In addition, some sources of income such as capital gains allow for recognition of losses of the current and some of the preceding years. In the case of corporate taxation,

The starting point of the current deficit cycle is somewhat weaker than that of the previous cycle when it comes to the relative level of federal debt

⁵⁹ Dolls, M. et al (2009). *Automatic Stabilizers and Economic Crisis: US vs. Europe*, The Institute for the Study of Labor, IZA Discussion Paper Series No. 4310.

IMF estimates that the contribution of automatic stabilizers to Canada's fiscal balance amounts to 0.8% of GDP in 2008 and 1.4% of GDP in 2009

automatic stabilizers work through the actuality that taxation is primarily based on profits rather than revenues. In a recession, profits tend to fall much faster than turnover which results in a corporation paying less taxes even though the economic activity may have decreased only slightly. Recognition of losses and their carry forward is also built into the corporate taxation. The works of employment insurance and income-tested benefits are fairly straightforward – the frequency and intensity of benefits paid tend to increase as individuals' income is interrupted or declines.

The impact of automatic stabilizers may be significant, particularly given the harsh nature of the financial crisis and economic downturn. The International Monetary Fund (IMF) estimates that the contribution of automatic stabilizers to Canada's fiscal balance amounted to 0.8% of GDP in 2008 and will contribute some 1.4% of GDP in 2009.⁶⁰ These calculations may still be underestimating the total of the automatic stabilizers as the computation was based on changes in the output gap⁶¹ whereas some of the variables that affect fiscal balances are not perfectly correlated with output fluctuations. In Canada, such variables may include equity prices, financial sector profits, and interest and exchange rates. The fall in equity prices may affect revenues through declines in capital gains and consumption taxation (latter is transmitted through the reduced wealth effect). The unaccounted effect from financial sector profits may come from profits derived from trading activities whereas the increase in interest rates and exchange rate depreciation may impose additional burden on the debt service. Although country specific estimates of these additional factors' contribution to the automatic stabilizers are not available, IMF estimates that on average, G-20 countries will experience an additional 1.3% of GDP deterioration in fiscal position due to these factors in 2009.⁶²

Previously described, the work of the automatic stabilizers is linked to declines in individual income and corporate profits, and increases in number of persons receiving Employment Insurance benefits. A look at the dynamic of these components during the past two recessions may then provide some guidance on the extent to which the use of automatic stabilizers may be solicited over time during the current economic crisis.

The longer of the two previous recessions discussed lasted 18 months; however, the decline in individual income and corporate profits compared to their pre-recession levels was much more persistent. As the top graph of Figure 11 reveals, it took 3 years in the 1980s and 5 years in the 1990s for the total

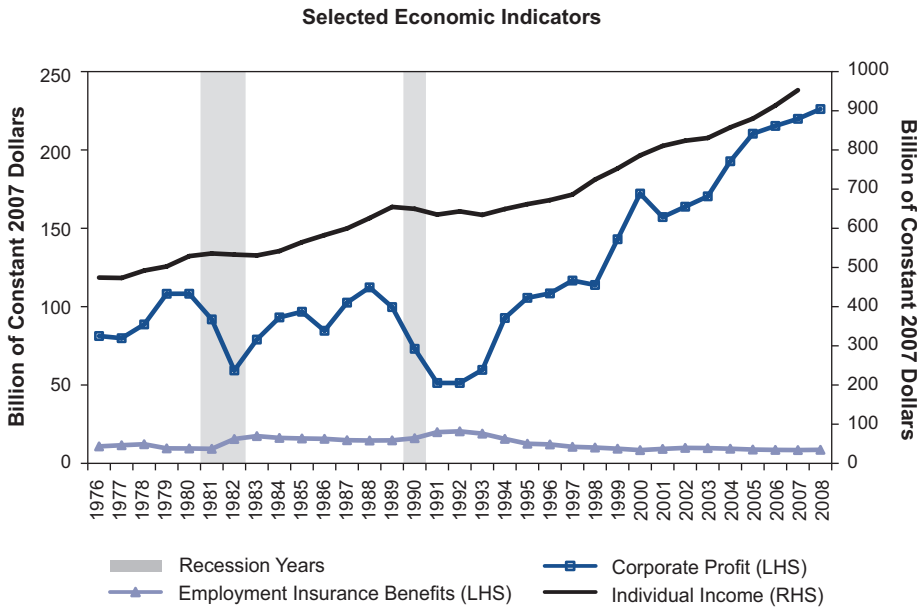
60 International Monetary Fund (2009). *Companion Paper—The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis*, Fiscal Affairs Department, p. 52.

61 Output gap is understood as the difference between country's actual and potential GDP, whereas potential GDP is understood as the highest level of real GDP that could persist for a substantial period without raising the rate of inflation.

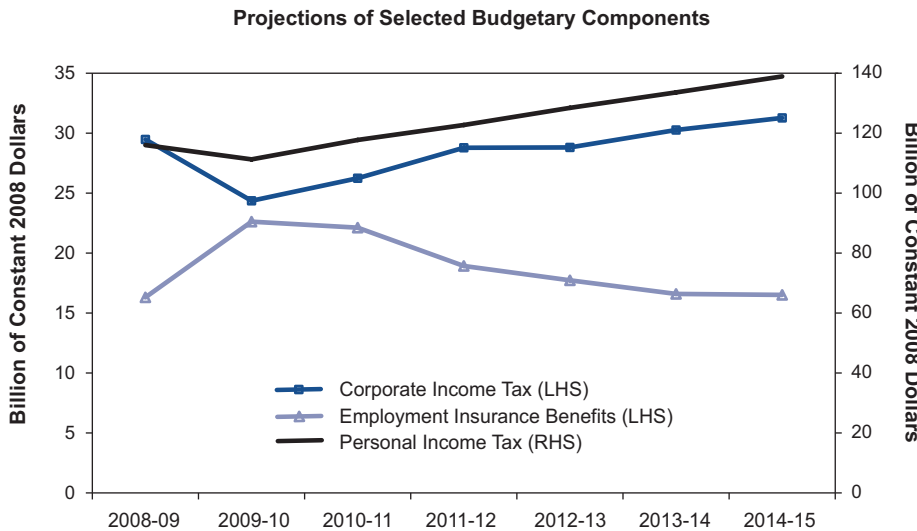
62 International Monetary Fund (2009). *Fiscal Implications of the Global Economic and Financial Crisis*, IMF Staff Position Note, SPN/09/13, p. 12-14.

income of individuals (adjusted for inflation) to return to pre-recession levels. A similarly long recovery was observed for corporate profits. Concurrently, the total regular Employment Insurance payments (adjusted for inflation) that were triggered by the 1990s recession were higher than the pre-recession levels for 4 years after the initial hike in 1991.

Figure 11 – Selected Federal Budget Components



It took 3 years in the 1980s and 5 years in the 1990s for the total income of individuals to return to pre-recession levels



Note: Top graph: Corporate profit is recognized as profits before taxes of corporations and government business enterprises.

Source: Top graph: CANSIM Tables 202-0407, 380-0020, 276-0005 and 326-0021. CGA-Canada computation. Bottom graph: Department of Finance Canada (2009). Fiscal Reference Tables, Department of Finance Canada (2009). Update of Economic and Fiscal Projections, Table 2, 5 and 6, CGA-Canada computation.

The current budgetary 5-year projections may not be fully reflective of the possible impact of the economic stabilizers on the federal revenue and spending

The 5-year projections of such budgetary components as personal and corporate income taxes and Employment Insurance benefits presented by the federal government in September 2009 assume a somewhat different trajectory than past experience would suggest. As seen from the bottom graph of Figure 11, the government projections anticipate a steady, strong growth in personal and corporate income taxes as early as the 2010-11 fiscal year whereas the Employment Insurance benefits payments will see a fairly steep decline over 2010-11 and 2011-12. In fact, the growth in personal income taxes (adjusted for inflation) is projected to average 4.5% per year between the 2009-10 and 2014-15 fiscal years. This contrasts noticeably with the 3.5% growth rate of individual income which was observed during 2003-2007 – the most recent years of the strongest economic growth.

Given the considerations presented above, two points are worthy of repeated emphasis. First, the current budgetary 5-year projections may not be fully reflective of the possible impact of the economic stabilizers on the federal revenue and spending. If that is the case, the overestimation of revenues and/or underestimation of expenses may not only increase the deficit in a particular year but also lead to increasing fiscal pressures in other years through increased debt service charges. Second, should Canada experience a slower than expected economic recovery, additional expenditure, not incorporated in the current forecasts, and add-ons to the levels of federal deficit and debt may be expected.

Contingent Liabilities and Assets Recovery Rates

Presence of contingent liabilities is one of the key difficulties in determining the scope of the fiscal consequences of the stimulus measures due to the uncertainty with the timing and magnitude of the payments associated with them. In technical terms, contingent liabilities are understood as potential debts which may become actual financial obligations if certain events occur or fail to occur.⁶³ Contingent liabilities are often grouped into liabilities related to: guarantees by the government; insurance programs; claims and pending and threatened litigation; contaminated sites; and international organizations. Although contingent liabilities have no immediate impact on government debt, they may weaken the fiscal balance and impair fiscal sustainability if and when the guarantee is called upon. Contingent liabilities are known to lead to so-called “hidden deficits” as such liabilities may increase the level of public debt which will not be mirrored in the headline level of fiscal deficit.⁶⁴

Contingent liabilities may be particularly costly in the event of a crisis. For instance, recent research concluded that the overall fiscal costs, net of recoveries,

63 Government of Canada (2009). *Public Accounts of Canada 2009*, Prepared by the Receiver General for Canada, p. 1.21.

64 Cebotari, A. (2008). *Contingent Liabilities: Issues and Practice*, International Monetary Fund, IMF Working Paper WP/08/245.

associated with crisis management of some 40 banking crises episodes over 1970-2007 averaged 13.3% of GDP, with some reaching as high as 55.1% of GDP.⁶⁵ In the case of Canada, IMF's conservative estimates suggest that the expected fiscal cost of financial guarantees provided to the banking sector may be as high as 3.2% of GDP annually over five years. However, this is still lower than the average cost of 9.7% of GDP per year over five years for G-7 economies.⁶⁶

Another part of the stimulus package which entails no immediate fiscal cost for the government is the acquisition of assets. The Insured Mortgage Purchase Program which acquired some \$64 billion of insured residential mortgage pools is a good example. At the time of purchase, such assets have no impact on the fiscal balance unless funded by drawing down cash balances. Over time, though, the fiscal impact will critically depend on the realizable value of the acquired assets and/or the extent to which these assets will hold their value. As accumulated deficit (i.e. public debt) is the difference between the government's total liabilities and its financial and non-financial assets, the decrease in value of assets is reflected directly in the level of debt. As such, the eventual cost of the stimulus package is subject to significant uncertainties and depends on the evolution of the financial sector and the economy.

The experience of past crises shows that the recovery rate may vary greatly even among the countries with similar levels of economic development. For instance, within five years following the 1991 crisis, Sweden recovered 94% of the cost of assets acquired by the government through financial support during the crisis. The experience of Japan, in turn, was bitter. After five years following the 1997 crisis, Japan recovered only 1% of assets whereas by 2008 – some 10 years after the crisis – the recovery rate stood at 54%.⁶⁷

The analysis conducted by the IMF⁶⁸ shows that recovery rates are positively associated with a country's per capita income and the "fiscal space" existing at the beginning of the crisis (i.e. fiscal balance-to-GDP ratio). In turn, the negative influence on the recovery rate is brought by such factors as the occurrence of an exchange rate crisis, the gross fiscal cost of the crisis, and the economy-in-transition status of the country. If this list of factors is of any indication, Canada may score fairly well in terms of recovery rate.

However, "fairly well" is a relative notion. For instance, the latest of the IMF's estimates suggest that Canada may be among the top 5 countries (out

Expected fiscal cost of financial guarantees provided to the banking sector may be as high as 3.2% of GDP annually over five years

65 Laeven, L. and Valencia, F. (2008). *Systemic Banking Crises: A New Database*, International Monetary Fund, IMF Working Paper WP/08/224, p. 24.

66 International Monetary Fund (2009). *Companion Paper – The State of Public Finances: Outlook and Medium-Term Policies after the 2008 Crisis*, Fiscal Affairs Department, Table 10.

67 International Monetary Fund (2009). *Fiscal Implications of the Global Economic and Financial Crisis*. IMF Staff Position Note, SPN/09/13, p. 10.

68 International Monetary Fund (2009). *Companion Paper – The State of Public Finances: Outlook and Medium-Term Policies after the 2008 Crisis*, Fiscal Affairs Department, p. 39-40.

19 advanced economies) in terms of the asset recovery rate. Yet in terms of numbers, this means only a 59.7% recovery rate for the upfront government financing allocated for financial sector support (which is estimated to be 8.8% of GDP).⁶⁹ The recovery rate may further be curbed by the fact that a number of countries may be attempting to liquidate assets at approximately the same time. Should the disposition of assets require additional institutional arrangements, the administrative costs in that arrangement may repress the recovery rate even further.

Accuracy of Budgetary Forecasts

The accuracy of the federal budgetary forecasts had been questioned on a number of occasions in the recent past. In 1994, in response to concerns about the credibility of the forecasting process in which the federal government had often underestimated the size of its deficits, the Department of Finance Canada commissioned an independent, external review of the Department's forecasting performance. A similar review was conducted in 2005; however, at that time the primary motivation for the review was to understand the nature and causes of the systematic underestimation of the recurring budgetary surpluses.

The accuracy of budgetary forecasting did not seem to improve considerably since the earlier review. The federal government continued to register much larger than expected surpluses in both 2006-07 and 2007-08 fiscal years. It is highly likely, then, that the high level of uncertainty currently present in the economy may further erode the accuracy of the budgetary forecasting. The recent evolution of the budgetary projections supports fairly well that assumption.

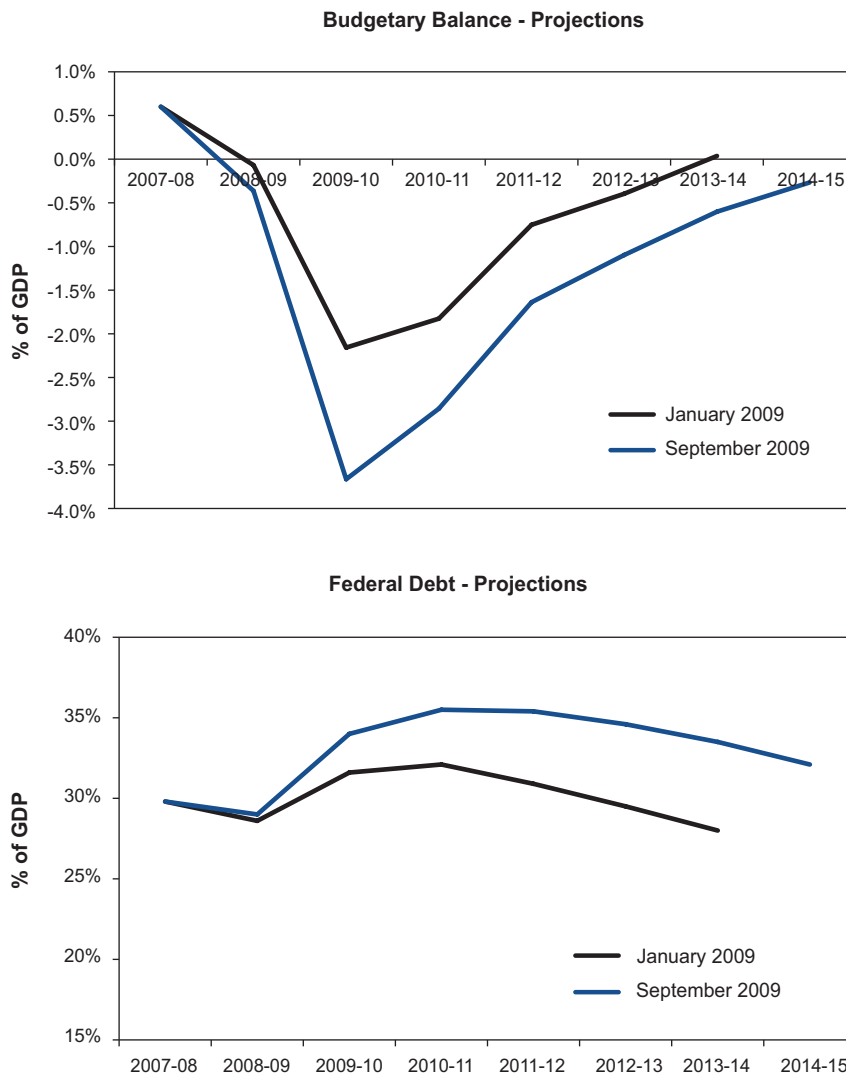
Further revisions to the current projections of the federal fiscal balance are quite possible in the near future

The budget forecasts presented in Figure 12 were prepared on two occasions: the January 2009 forecast was incorporated in Budget 2009 whereas the September 2009 forecast was presented in the Update of Economic and Fiscal Projections released by the government in the fall of 2009. The forecasts were prepared some 7 months apart over which the economic situation started to stabilize, and the forecasts of economic growth and global economic recovery improved significantly. Contrarily, the budgetary forecasts deteriorated. Discrepancies in deficit forecasts, for instance, reached as much as 1% of GDP in certain years. The discrepancies in the forecasts of the level of federal debt were even higher and amounted to 5% of GDP in 2012-13 and 2013-14 fiscal years. Taking into account that as recently as November 2008 the government was forecasting 5 years of recurring surpluses,⁷⁰ further revisions to the current projections of the federal fiscal balance are quite possible in the near future.

69 International Monetary Fund (2009). *Companion Paper – The State of Public Finances: Outlook and Medium-Term Policies after the 2008 Crisis*, Fiscal Affairs Department, Table 3.

70 Department of Finance Canada (2008). *Economic and Fiscal Statement – Protecting Canada's Future*, Table 3.3.

Figure 12 – Budgetary Projections – Selected Components



Slowing population growth and a shifting age structure are two well recognized dynamics of Canada's future

Source: Department of Finance Canada (2009). *The Budget Plan*, Table 4.4; Department of Finance Canada (2009). *Update of Economic and Fiscal Projections*, Table 3. CGA-Canada computation.

Aging Population

Slowing population growth and a shifting age structure are two well recognized dynamics of Canada's future over the next three to four decades. The so-called "double-aging" arising from the sharp decline in fertility rates and falling rates of mortality will continue to change significantly the ratio of elderly to young age population.

As the age structure of the population changes, so too does government expenditures and the expectation is that the public funding may experience some financial relief from the smaller size of the young population requiring

While age-related government spending accounted for 17.9% of GDP in 2000, it will amount to 26.6% of GDP in 2050

education and health services, but also an amplified pressure on the health care system and increased honouring of the social insurance commitments due to the aging of baby-boomers. The impact of the expectedly increased budget spending requirements will further be amplified by the fact that the primary revenue earning population (i.e. those in their mid-thirties to mid-sixties) will decline and may affect negatively the level and stream of budget revenues.

Over the past years, a substantial body of literature has been developed analysing the fiscal implications of an aging population.⁷¹ One of the often cited projections conducted by the Organisation for Co-operation and Economic Development (OECD) suggests that by 2050, total age-related spending will increase by 8.7 percentage points compared to the level registered in 2000.⁷² In other words, while age-related government spending accounted for 17.9% of GDP in 2000, it will amount to 26.6% of GDP in 2050.

Some researchers⁷³ suggest that deferred tax payments on the funds accumulated by Canadians in their RRSPs and RPPs may be sufficient to offset the fiscal pressures associated with increased the population aging. However, the sharp decline in values of most of financial assets during the 2008 financial crisis weakens the relevance of this argument at least in the short and medium-terms.

4.4. What Should We Do with the Federal Debt?

Public debt as a phenomenon bears certain benefits as well as negative implications. The benefits of government debt include the role that it plays in enhancing the liquidity of households. Government debt may provide a relatively safe saving instrument which smoothes household consumption over time. It may, as well, reduce household exposure to idiosyncratic shocks by raising the overall private net asset position and easing households' borrowing constraints.⁷⁴ The presence of these benefits is one of the reasons why countries seldom consider reduction of public debt to zero.

The most often cited negative implication of public debt is decreased national savings which leads to increased net foreign indebtedness and a lower capital stock due to high risk premium on interest rates and lower private consumption.

71 See, for instance, Robson, W. (2007). *Time and Money – The Challenge of Demographic Change and Government Finance in Canada*, C.D. Howe Institute, Backgrounder No. 109; Jackson, H. and Matier, C. (2002). *Public Finance Implications of Population Aging: An Update*, Department of Finance Canada, Working Paper 2003-03; Brimacombe, G.G. et al (2001). *The Future Cost of Health Care in Canada – 2000 to 2020*, The Conference Board of Canada.

72 Organisation for Economic Co-operation and Development (2001). *Fiscal Implications of Aging: Projections of Age-Related Spending*, OECD Economic Outlook no. 69, Table VI.3.

73 See, for instance, Mérette, M. (2002). *The Bright Side: A Positive View on the Economics of Aging*, Institute for Research on Public Policy, Choices, Vol. 8, no. 1.

74 James, S. and Karam, P. (2001). *The Role of Government Debt in a World of Incomplete Financial Markets*, Department of Finance Canada, Working Paper 2001-01.

Debt also has an adverse effect on wealth distribution and may encourage an increasingly distortive structure of the tax system as well as crowding out of capital through higher interest rates and lower private consumption.

Economic literature does not offer a conclusive answer to the question regarding the optimal level of government debt and a number of theories co-exist on this matter. One of the extreme theories suggests that the size of the debt does not impose any consequences on the allocation of resources as long the debt is either stable or grows at a sustainable pace. However, this approach is associated with strict theoretical assumptions that seldom hold in real life. The presence of liquidity constraints and/or distortive taxation leads to a trade off between financing government spending through debt or taxes. As such, a more moderate approach recommends achieving and maintaining a certain optimal fiscal balance. This can be done either by keeping tax rates relatively constant and thus minimizing inter-temporal tax distortions, or through maximizing intergenerational equity by choosing levels of debt that would place even burden on the capital stock of the current and the future generations. Another set of theories focus more on the trade-off between the benefits and costs of government debt and suggest that the optimum level of debt is positively linked to the effectiveness of debt in smoothing out private consumption and negatively to the crowding out effect of private investments that is associated with debt.⁷⁵

Economic literature does not offer a conclusive answer to the question regarding the optimal level of government debt

Moreover, maximization of social welfare – an important element of debt reduction – relies on optimizing such competing objectives as equity and efficiency between different social groups and across generations. As such, determining the optimal level of debt as it pertains to a particular country may also depend on the set of social and economic values commonly accepted by that country.

As was seen in Section 4.2 (see, for instance, top chart of Figure 10), the level of Canada's federal debt has improved significantly in recent years and the current situation as well as the five-year forecasts by no means pose question regarding government solvency. History provides ample examples of situations when countries with much higher levels of public debt have successfully advanced their economies. For instance, such wealthy countries as the United States, the United Kingdom and Japan had all, at one point in time or another, a public debt-to-GDP ratio exceeding 100% (in the case of the UK, the ratio exceeded 250% in the aftermath of the WWII).⁷⁶

Similarly, the fear that public debt puts an upward pressure on interest rates may be overstressed somewhat. The results of the empirical analysis undertaken for OECD countries show that one percentage point increase in deficit-to-GDP

⁷⁵ International Monetary Fund (2000). *Canada: Selected Issues*, Country Report No. 00/34, p. 52-53.

⁷⁶ International Monetary Fund (2009). *The State of Public Finances: Outlook and Medium-Term Policies after the 2008 Crisis*, Fiscal Affairs Department, Figure 10.

Rising public debt causes the debt service charges to consume an increasingly larger proportion of revenues which otherwise could be directed to other priorities

ratio is associated with 10 basis points increase in nominal long-term interest rates. However, the influence of the debt-to-GDP ratio on long-term interest rates is positive only for countries with the initial debt-to-GDP ratio exceeding 100%.⁷⁷ When effects of fiscal policy are isolated from other factors affecting interest rates (e.g. business cycle and varying quality of budget expenditures), the research results still show a fairly mild influence of public debt on the interest rates. In the U.S., for instance, a one percentage point increase in the projected debt-to-GDP ratio is estimated to raise the 10-year bond rate expected to prevail in the future by about 4 to 5 basis points.⁷⁸

Consideration of the economic theory and the results of the empirical studies discussed above do not transmute an alarming notion regarding the increasing public debt; however, reflection on the practical implications may be different. Unless the interest rates are falling, rising public debt causes the debt service charges to consume an increasingly larger proportion of revenues which otherwise could be directed to other social and economic priorities.

Moreover, the rise in public debt represents an increase in intergenerational transfers of costs to the future generations affecting intergenerational equity; particularly so because associated benefits do not transfer in corollary fashion to the costs and future generations effectively cannot participate in the decision making. As seen from the top graph of Figure 13, the bell shape of the curve formed by the interest ratio is more skewed towards the future compared to the curve depicting deficits.

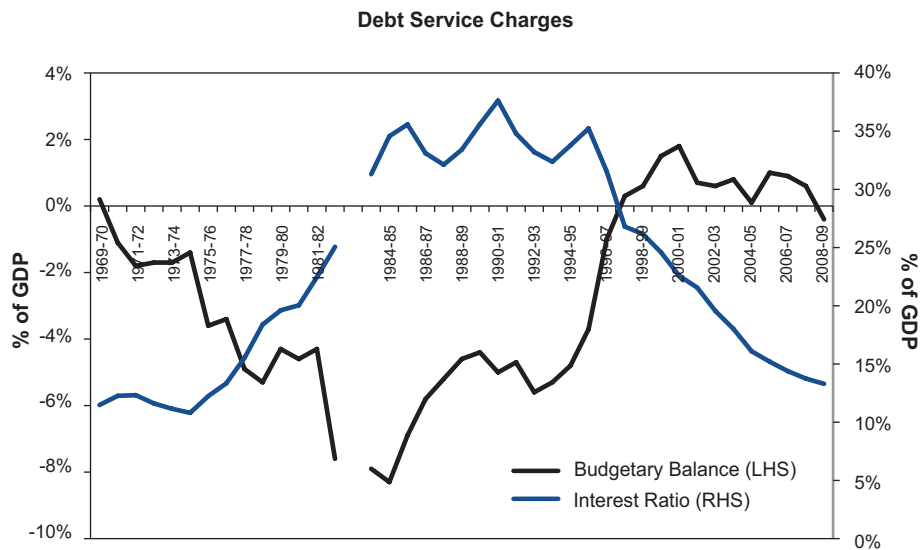
It is also worth mentioning that the interest rates paid by the government on its debt declined noticeably over the late 1980s and 1990s contributing to the reduction of debt servicing payments. The starting point of the current deficit cycle is very different with interest rates being at a 30-year low with little help being expected from them in terms of easing the debt burden of the federal government (bottom graph of Figure 13).

Summing up the discussion, several points are worth noting. First, the recovery of the pre-recession levels of living standards (measured as GDP per capita) may take several times longer than the duration of the recession itself. Canada's recovery from the current (2008-2009) recession may further be aggravated by a number of factors. Second, the starting point of the current deficit cycle is somewhat weaker than that of the previous cycle and a number of factors may further aggravate this situation. Third, certain 'add-ons' to the currently projected levels of federal deficit and debt may be expected. Such

77 Ardagna, S. et al (2004). *Fiscal Discipline and the Cost of Public Debt Service: Some Estimates for OECD Countries*, Centre for Economic Policy Research, Discussion Paper No. 4661.

78 Laubach, T. (2004). *New Evidence on the Interest Rate Effects of Budget Deficits and Debt*, Board of Governors of the Federal Reserve System, p. 2.

Figure 13 – Debt Service Charges and Interest Rates



10-Year Government Bonds – Yield



Note: Top graph: Interest ratio is public debt charges expressed as a percentage of budgetary revenues

Source: Top graph: Department of Finance Canada (2009). *Fiscal Reference Tables*.
Bottom graph: CANSIM Table 176-0043.

add-ons may channel through the work of economic stabilizers, contingent liabilities and low recovery rates of the acquired assets. Forth, economic theory does not offer a clear benchmark regarding the optimal level of debt. In practical terms, though, increasing debt service charges reduce government’s flexibility to allocate revenues to carefully chosen priorities.

The analysis of the preceding sections has intended to provide valuable insight into the three distinct elements which form one logical continuum. Starting with the identification of components of the overall economic stimulus package implemented by the federal government during the 2008 economic crisis, consideration has shifted to the least invulnerable stimulus measure, i.e. support to the auto industry. This followed with a discussion of the possible implications of stimulus measures and other selected factors on the level of federal debt. During this examination, a number of contentions have been exposed.

One particular stimulus measure – support to the auto industry – stands out in terms of the level of concern associated with its quality

As may be expected, a number of factors were fairly ‘extraordinary’ regarding the overall stimulus package introduced by the federal government during the economic crisis. Some of the measures represent an aggressive intervention in the areas where the government is present only moderately or not at all (i.e. credit easing). Other measures were in more traditional areas such as taxation or infrastructure development but their price tag exceeded the range typically seen in previous years. However, when validated against such criteria as accessibility, merit base, disclosure of possible fiscal impacts and parliamentary approval, these measures scored at least “average”.

The rescue of the auto industry, in turn, fairs less favourably. The possible negative fiscal implication of the loans were not reflected in the initial budgetary forecasts; nor was the Parliament given opportunity to debate and influence the structure of the bailout beyond the very general information presented in the budget documents. Moreover, the full amount of the financial support was provided on a non-merit basis to a very narrow range of recipients.

There is reason to doubt that the financial support to the auto industry was appropriate to its size and importance to the Canadian economy

A number of indicators may be used to assess the importance of the industry. Among those are the industry’s contributions to total GDP, the number of workers

employed in the industry, the impact that change in industry production may induce in other industries, and to the economy as a whole. Although the Canadian auto industry is a technologically advanced, well paying employer to thousands of workers, when compared to the whole Canadian economy, the auto industry represents only a small part.

The heavy concentration of the auto industry in only few geographical locations should be given proper recognition. However, a heavy dependence of a multi-thousand inhabitant community on one big employer may rather be seen as a faulty industrial policy than a justification for rescue. Similarly, overt favouring of a highly capital-concentrated industry over fairly dispersed industries that experience economic difficulties of similar magnitude does arouse curiosity.

There is reason to question the sufficiency of government transparency and accountability in carrying out its financial commitment to the auto industry

The absence of clearly stated objectives when allocating large sums of public funds, changing rationale for actions, and admitted adoption of U.S. policy do little to bolster the confidence of the electorate. Although stressful and challenging times, Canada will be well served to maintain its doctrine of best practice and to foster government accountability and transparency. To that ends also, consistency should be maintained in disclosures that relate to the Economic Action Plan.

The combination of economic uncertainty and the already existing fiscal pressures of aging population may exacerbate significantly the actual levels of federal deficit and debt

The large number of stimulus measures (particularly those associated with credit easing) was provided in the form of loans, guarantees and investments. As such, their potential impact is not fully reflected in the forecasts of the federal budgetary components. Contingency risk of liabilities, recovery rate of assets acquired by the government, additional revenue losses, and increased spending due to automatic stabilizers may affect the level of federal deficit and debt in a way currently not reflected in the fiscal projections. Additional fiscal requirements associated with the aging of the Canadian population will impose elevated fiscal pressures on the federal budget and these pressures will persist regardless of whether a positive or a negative scenario of economic developments materializes.

A balanced approach to federal deficit reduction and federal debt stabilization may be desirable

Economic theory does not provide clear guidance on the optimal level of public debt in the economy. Although the possible economic implications of increasing levels of debt are well articulated, there is little agreement as to whether those implications are of positive or negative or neutral nature to the economy. Given this and Canada's enviously strong fiscal position compared to that of other advanced economies, the temptation may be to loosen fiscal policy allowing moderate deficits to persist. Such attitudes are best avoided as increasing over time public debt service charges may diminish the government's degree of freedom in identifying and attending to key economic and social priorities, including the fiscal pressures associated with a shifting demography and the like.

The development of effective public policy on some of the issues exposed throughout this paper can admittedly be a daunting task. This is particularly so because the economic crises, stimulus packages, and government budgets embody extremely broad concepts having an infinite number of interconnections and likewise having an endless number of implications. In search of the right balance, decisions must reconcile and reflect the importance of national values, a variety of stakeholder interests, and recognition that Canada is an open economy constituting only a small part of a large, dynamic, and interrelated global system.

Putting the Fiscal House in Order

It is definitely incorrect to characterize the state of the federal budget as disorderly. Canada entered the current economic downturn with a strong record of federal budget surpluses and one of the lowest debt-to-GDP ratios among the G-7 countries. The current projections also suggest that Canada will remain a ‘success story’ among the advanced countries when it comes to public debt. In fact, Canada is projected to maintain the lowest debt-to-GDP ratio in 2014 as well.⁷⁹ However, the relatively recent experience of Sweden shows how easily the fiscal gains of previous years may yield to unsustainable shortfalls of the current years. A systemic financial crisis that broke out in Sweden in 1991, wiped out the country’s pre-crisis surplus of nearly 3.8% of GDP replacing it with a whopping deficit amounting to 11.6% of GDP just two years after the crisis.⁸⁰

In order for the government to maintain its fiscal house while concurrently promoting economic growth and improvement of living standards of Canadians, the following four elements are deemed to be essential: (i) setting of clear fiscal targets; (ii) avoidance of increasing economically distortive taxes; (iii) increase in government accountability and transparency; and, (iv) support for development of social finance and enterprise.

79 Based on International Monetary Fund (2009). *Fiscal Implications of the Global Economic and Financial Crisis*, IMF Staff Position Note, SPN/09/13, Table 5.2.

80 Reinhart, C.M. (2009). *The Economic and Fiscal Consequences of Financial Crises*, VOX, January 26, 2009. Available at <http://www.voxeu.org/index.php?q=node/2877>, accessed October 9, 2009.

Set Clear Fiscal Targets

Fiscal rules are typically designed to maintain fiscal discipline as they are set to keep certain budgetary indicators within set limits or levels. Generally, those fiscal rules that combine budget balance rules and expenditure rules are found to be more effective than those referring only to the general budget balance.

Prior to Budget 2009 budget, federal government fiscal policy incorporated a combination of short, medium, and long term fiscal rules. Specifically, the budgetary framework included such fiscal targets as achieving a balanced budget or better in any given fiscal year, to reach a 25% debt-to-GDP ratio by 2011-12, to maintain the growth in program spending at the rate of growth in nominal GDP, and to eliminate net total government debt by 2021.⁸¹

Budget 2009 silently abandoned fiscal rules suggesting instead that the federal government debt-to-GDP ratio of 2013-14 is projected to rival 2008-09 levels.⁸² While defining fiscal rules in a time of financial and economic fragility may hardly be expected, the current environment of economic stabilizing and desired recovery strongly encourage the federal government to commit to fiscal prudence and to clearly define fiscal targets and timeframes. Articulating principles and strategies that will facilitate the path and manage the schedule are also essential – particularly in areas where temporary spending (extraordinary stimulus) is concerned.

Avoid Increasing Economically Distortive Taxes

Returning to a surplus, or at least a balanced budget position, over the medium-term may require the federal government to take contracting measures – the choice from which is very basic – tax increases and/or spending restraints.

Gaining control over the previous deficit cycle that ended in 1997 was primarily achieved through structural reforms to the Employment Insurance Program and reduction in other forms of federal spending that disproportionately disadvantaged interprovincial transfers.⁸³ These measures resulted in lower benefit rates and increased entrance requirements for the Employment Benefit Program and complex adjustment processes on the parts of provinces. As similar strategies may be of limited desirability during the current deficit cycle, the circumstances may call for certain adjustments in the tax system. A word of caution is deemed appropriate.

81 Department of Finance Canada (2008). *The Budget Plan*, p. 65

82 Department of Finance Canada (2009). *The Budget Plan*, p. 28.

83 Dyck, D. (2003). *Fiscal Redistribution in Canada, 1994-2000*, Department of Finance Canada, Working Paper 2003-22.

Over the years of strong economic growth experienced by Canada during the early and mid 2000s, the public policy debate had clearly identified and rationalized the need to reform the Canadian tax system. The achievement of that goal was primarily envisioned through taxation which causes significant distortion onto the economy and which diminishes incentives for individuals and businesses to engage in productive activity. The current economic downturn did not reverse the need for such an evolution of the tax system; however, the means for achieving this goal have been reduced significantly.

Rapid growth has been a key factor in attaining sustained improvements in the public debt-to-GDP ratio. Strong growth has also been a key source of reducing the nominal amount of public debt. Finding the optimal solution of how to balance the possible need to tighten the budget and still ensure that the fiscal and budget measures do not impede the economic growth may, to say the least, be a challenge. Even in those circumstances, though, the government should strive to avoid increasing economically distortive taxes such as individual and corporate income taxes – and in fact continue to pursue more reductions.

Increase Government Accountability and Transparency

Insufficient transparency within the government can have a detrimental impact on the management of resources within the government. It may also erode the strong level of public trust the federal government currently enjoys and jeopardize government's ability to gain public support in implementing difficult decisions regarding increasing tax burden and reduced levels of services which may be necessitated by the fiscal pressures. The Certified General Accountants Association continues to advocate for continued improvement in public transparency and accountability. The government financing to the auto industry and the expected spike in liabilities and contingencies assumed by the federal government will only heighten the call for increased disclosure.

Moreover, the Association contends that the opportunity for broad-based adoption of International Public Sector Accounting Standards (IPSASs) is before us. Supported by the International Federation of Accountants (IFAC), governments worldwide would be well served to follow the same high standards of financial reporting as their private counterparts. Importantly, a concerted move to IPSASs is deemed critical to improving government transparency, accountability, and credibility; especially in light of the unprecedented takeovers, lending, guarantees, and bailouts of major market institutions, banks, and companies that have taken place in different parts of the world. Currently, a number of prominent international organizations including the United Nations, NATO and the OECD already conform to such standards.

Support Development of Social Finance and Enterprise

Canada's modern welfare state continues to rely heavily on the not-for-profit sector to deliver state-funded public services; however, the size of funding provided by the federal government to the not-for-profit sector is much lower than it once was (for instance, in the 1960s and the 1980s). In the 1990s, the government adjusted its levels of spending and began reducing or eliminating some of the programs and services, while also reducing the amount of income support provided to individuals. This increased dramatically the demand for social services while concurrently impeding the capacity of the not-for-profit sector to provide these services.⁸⁴

As federal government program spending may come under increasing pressure for additional spending cuts, the not-for-profit sector's capacity to satisfy the still increasing demand for social services may further be tested. In these regards, the government is encouraged to consider adopting a holistic approach to supporting the development of so-called social enterprise (or social finance).

Social enterprises are organizations that are driven by social mission and engage in business activities of trading goods or services for a social purpose. They often use blended value business models that combine a revenue-generating business with a social-value-generating structure. An increasing presence of such entities in the economy may mitigate the seemingly opposing veracities of increased demand for public services and corresponding inability to satisfy that demand.

Diversifying Canadian Economy

Canada is a small open economy with export accounting for some 40% of Canada's GDP. However, the overwhelming majority of this trade (86.9%⁸⁵) takes place with the U.S. Although historical and geographical links make Canada and the U.S. mutually valuable economic partners, such basic lack of diversification makes Canada uncomfortably dependent on the U.S. as its market.

The strong Canada-U.S. economic integration has also been observed in areas other than trade. For instance, more than 60% of foreign direct investments come to Canada from the U.S. Tight economic relations are critically important in the increasingly globalized world; however, the excessive one-country orientation may also be harmful for the host country's economic autonomy, particularly in industries of high concentration. The rescue of the auto industry proves to be an excellent example. The federal government had to allocate an

84 Hall, M. et al (2005). *The Canadian Nonprofit and Voluntary Sector in Comparative Perspective*. Imagine Canada, p. 23

85 Web portal of Canadian Manufacturers and Exporters. Available at http://www.cme-mec.ca/national/template_na.asp?p=3, accessed October 23, 2009.

equivalent of 8.1% of its overall direct program spending to two private companies due to an implied threat to withdraw Canadian operations in the absence of the funding.

Technology transfer and spill-over, job creation, and human capital enhancement are well recognized, important and valuable benefits of the foreign direct investments. However, the government's strategy should also be intensified in ensuring open and fair trade in international markets other than U.S. This may include negotiating of multilateral, regional, and bilateral trade agreements that eliminate both tariff and non-tariff barriers to trade in international markets. In this regard, the recently intensified work towards a new Canada-European Union Trade and Investment Enhancement Agreement is commendable.

As for the domestic market, the opportunity for government should come not only from restoring the competitiveness of firms but rather in providing displaced workers with the assistance and skills they need to secure new employment prospects.

Appendix A: Description of Extraordinary Measures

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Insured Mortgage Purchase Program (IMPP)

The federal government will purchase up to \$125 billion of insured residential mortgage pools through reverse auctions administered by Canada Mortgage and Housing Corporation and normally held once or twice a month. A schedule of planned auctions is published before each quarter. At each auction, funds are allocated beginning with the highest bid until the amount of available funding is depleted. Only mortgages that are pooled under the National Housing Act Mortgage Backed Securities program are eligible. All qualified issuers of mortgage-backed securities under the National Housing Act Mortgage Backed Securities program may participate. Other entities may participate indirectly through a qualified issuer. To date (October 2009), 16 different financial institutions have participated directly in the IMPP, including banks, non-bank deposit-taking institutions, and life insurance companies.

Business Credit Availability Program (BCAP)

BCAP will provide at least \$5 billion in additional loans and other forms of credit support and enhancement at market rates to businesses with viable business models whose access to financing would otherwise be restricted. By working in close cooperation with private sector financial institutions, this program will fill gaps in market access and lever additional lending by private sector institutions where joint participation facilitates private action.

Canadian Secured Credit Facility (CSCF)

CSCF will purchase up to \$12 billion of term asset-backed securities (ABS) backed by loans and leases on vehicles and equipment. CSCF funds will be offered on a “first-come, first-served” basis until March 31, 2010 to provide continued support for participants in the auto and equipment financing sectors. The funds will be available to large and small companies alike. All ABS which are backed by assets originated by Large Enterprise Originators and Small Enterprise Originators must be rated AAA by any two of DBRS Limited, Fitch, Moody’s Investors Service, Inc., or Standard & Poor’s Rating Services.

New 10-year Canada Mortgage Bonds (CMB)

The program intends to launch a new quarterly CMB with 10-year maturity to attract a broader pool of investors to culminate to \$10 billion in supplementary, cost-effective funding for financial institutions and mortgage lenders. Homebuyers and housing industry will benefit through improved access to lower cost mortgages.

Loans to auto industry

See Section 3.1 for description of the interim loans to the auto industry

Home Renovation Tax Credit (HRTC)

HRTC is a non-refundable tax credit based on eligible expenses for improvements to house, condo or cottage. It can be claimed on 2009 income tax return. It applies to eligible purchases made after January 27, 2009, and before February 1, 2010. HRTC applies to eligible expenses of more than \$1,000, but not more than \$10,000, resulting in a maximum non-refundable tax credit of \$1,350.

Infrastructure Stimulus Fund (ISF)

The federal government has established a new \$4 billion ISF that provides funding to provincial, territorial and municipal construction-ready infrastructure rehabilitation projects. Funding is available for two years for projects that begin during the 2009 and 2010 construction seasons and can be completed before March 31, 2011. The full \$4 billion will be distributed in fiscal years 2009-10 and 2010-11. Projects will focus largely on the rehabilitation of existing assets such as water, wastewater, public transit, highways, roads, culture, parks, trails and municipal buildings.

Personal Income Tax Relief

The basic personal amount has been increased to \$10,320 in 2009 from \$9,600 in 2008, allowing individuals to earn more income before paying federal income tax. The top of the first personal income tax bracket has been increased to \$40,726 in 2009 from \$37,885 in 2008, allowing more income to be taxed at the lowest 15-percent rate, rather than the 22-percent rate. The top of the second personal income tax bracket has been increased to \$81,452 in 2009 from \$75,769 in 2008, allowing more income to be taxed at the 22-percent rate, rather than the 26-percent rate. These measures will provide tax relief of \$470 million in 2008-09, \$1,885 million in 2009-10 and \$1,950 million in 2010-11.

Loans to Municipalities

Budget 2009 will make available up to \$2 billion over two years in direct, low-cost loans to municipalities through the Canada Mortgage and Housing Corporation. These low-cost loans will significantly decrease the cost of borrowing for municipalities, and can be used by them to fund their contribution for cost-shared federal infrastructure programming.

Improving Infrastructure at Universities and Colleges

Budget 2009 provides up to \$2 billion to support deferred maintenance and repair projects at post-secondary institutions. Preference will be given to projects

at universities that can improve the quality of research and development at the institution. The funds under this initiative will be managed by Industry Canada, with 70 per cent of the funding dedicated to university infrastructure and the remaining 30 per cent for infrastructure at colleges. Allocation will be based on project merit and readiness. The funds will pay for up to half of project costs, leveraging an equivalent amount from other partners.

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