



Economic Survey of Canada, 2008

How is the economy performing given the current turmoil?

What are Canada's key challenges?

How should policies adapt to population ageing?

How can the tax system further enhance economic well-being?

What policies would encourage sustainable energy development?

How to unleash Canada's agricultural sector?

For further information

For further reading

Where to contact us?

Summary

Canada's economic performance has been among the best in the OECD as a sound policy framework has enabled the country to take advantage of strong global growth and soaring terms of trade. The economy has adapted well to recent shocks, as labour and capital have shifted rapidly from manufacturing towards the resource and service sectors, with strong net job increases. Overall supply has benefited from rising participation rates. Inflation has been held in check thanks to appropriate monetary policy settings. Budget surpluses have enabled major debt and tax reductions. More recently, though, activity has slowed sharply in response to the combination of the US downturn and stresses from the high Canadian dollar, as declining net exports have nearly offset still-strong domestic demand. Significant challenges also lie ahead. Demographic ageing will put a premium on longer working lifetimes and faster productivity gains, which have been relatively weak, to sustain per capita income growth and public finances. Sustainable growth also requires successfully addressing the problem of climate change, notably in the important energy sector.

Monetary policy has room to manoeuvre in dealing with the growth slowdown, and tax relief is providing substantial support to the economy this year, but fiscal policy is constrained by declining surpluses in the short term and ageing liabilities in the longer term. The tightening in domestic credit – fallout from the US credit crisis – and prospects for slower growth have led to substantial monetary policy easing. In addition, the strong currency and easing demand for tradables are helping to neutralise commodity price induced inflation, increasing policy room for manoeuvre. The budget surplus is set to shrink on account of weaker growth and tax cuts. As rising health and other ageing costs are also looming, expenditures need to be controlled for debt to be kept on a downward path. Resolute fiscal policy – in particular through investing

This Policy Brief presents the assessment and recommendations of the 2008 OECD Economic Survey of Canada. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

abroad more of the public revenue resulting from high oil prices – could help mitigate real exchange-rate appreciation.

Tax cuts have been a good use of budget surpluses, but there is plenty of scope left for efficiency-enhancing, revenue neutral tax reform.

Business tax competitiveness is being enhanced by deep cuts in taxes on corporate income and capital. Labour supply has been boosted by in-work tax credits. Yet, attractive opportunities for base broadening and shifting remain to be exploited and could enable still lower income tax rates. Remaining provincial retail sales taxes, penalising business inputs, should be converted to more efficient value added taxes, harmonised with the federal GST. Numerous tax breaks to traditional sectors and small firms should be phased out to unleash supply-side dynamism. To further improve capital allocation and build on recent initiatives, personal income should be taxed on a neutral consumption basis, with vertical equity achieved by targeting tax credits on vulnerable groups.

Oil-sands exploitation is booming but jeopardises environmental goals. As conventional oil and gas reserves decline, the industry has been switching its attention to extraction from the western oil sands. However, this requires large amounts of gas, land and water and leads to large rises in carbon emissions. Achieving post Kyoto goals, while sustaining energy development, will require putting a price on all sources of carbon, as well as better technology. Market based solutions – such as the planned permit trading – will be critical: by internalising environmental costs they provide stronger incentives for energy efficiency and innovation. At the same time tax preferences to the oil and gas sector should continue to be reduced.

Canada has lost ground in the longer term global trend toward liberalised farm sectors. While the federal government has been appropriately trying to free up marketing of western grains, it continues to coddle some other sectors with supply management. Dairy farmers in particular have enjoyed a quota system that has created enormous rents at the expense of consumers. Meanwhile, other farmers have been supported by a steady stream of federal and provincial budgetary support that is no doubt inducing dependency behaviour. Farmers also need to be given the right incentives to produce in an environmentally friendly manner. Most importantly, government support for bio-energy production needs to be reconsidered. ■

How is the economy performing given the current turmoil?

The Canadian economy has performed remarkably well for the past decade and a half. Real GDP growth has been robust, employment gains have been impressive, the unemployment rate has fallen to its lowest level in a generation, and positive terms-of-trade effects have combined with real per capita output growth to boost Canadian living standards. Furthermore, higher commodity prices have led to a rapid appreciation in the dollar back to around parity with its US counterpart, helping to discipline wage and price setting and meet the official inflation target. Domestic price inflation has also been held in check by expanding production capacity, thanks to rising female and older worker labour force participation, which has more than compensated for relatively weak productivity growth. However, high commodity prices and the resulting currency appreciation have been forcing rapid economic adjustments through industrial and regional employment shifts. Most signs point to orderly adjustment – even resource poor regions have seen overall employment gains, despite substantial losses in manufacturing.

Most recently, the currency appreciation, together with the worldwide turmoil in credit markets and associated weakening in foreign demand, has caused a sharp drop in Canada's net exports, slowing growth to a crawl. Looking ahead, the US downturn is expected to continue to exert downward pressure on Canada's GDP growth through the trade and credit channels, but the economy should rebound somewhat in 2009. Risks are skewed to the downside and mostly derive from large uncertainties regarding the future path of the US economy and its currency and the extent of the financial market correction that will ultimately occur there. In any case, it is likely that economic slack will open up, alleviating residual price pressures and holding inflation well below rates seen abroad. This will allow the Bank of Canada room to lower interest rates further, helping to return output to its potential level as quickly as possible. ■

What are Canada's key challenges?

Policy-makers are struggling with an unprecedented series of global shocks and risks. Oil, food and other commodity prices have increased almost uninterrupted for the past five years – mainly reflecting rising global demand rather than temporary supply disruptions as in the past. As a commodity exporter Canada can easily learn to live with a quasi permanent high oil price – but it must also adjust to the corresponding downside of a strong Canadian dollar and a weaker US economy. Meanwhile, demographic ageing is underway, implying that employment – up to now a mainstay of growth – will be shifting into a lower gear while pressures on age related public spending will build. At the same time climate change risks have intensified; Canada's oil sands sector, a fast growing emitter of GHGs, faces the uncertain costs of planned abatement policies, as do other investors. Three key structural challenges, roughly corresponding to the short, medium- and long-term policy horizons, emerge.

- The structural shift provoked in part by the terms-of-trade shock may be one of unparalleled magnitude in Canada's modern history. It must continue to be managed in a sustainable way, notably to prevent excessive crowding out of exposed sectors like manufacturing and forestry by other natural resource production and the public sector as they benefit from oil and other commodity price windfalls.
- While greater labour-force participation, especially of marginal groups, longer working lives and immigration can still be of use in boosting labour supply, the looming rise in the old age dependency ratio means that the onus will increasingly be on higher productivity growth to maintain rising living standards and sustainable public finances.
- Climate change and Canada's commitment to joint global action in fighting it requires a switch to a model of sustainable development, i.e. much less energy intensive consumption and production patterns, notably in the energy sector itself.

Up to and through most of 2007, monetary policymakers were primarily concerned with domestic inflationary pressures arising from rising commodity prices, strong domestic demand and tight labour markets. By the end of 2007, however, emphasis had shifted to managing Canada's response to the global financial market turmoil, the associated tighter domestic credit conditions and to concerns about a slowing US economy, which led to substantial monetary policy easing. *The main immediate challenge for monetary policy is to design the appropriate policy stance to keep inflation on target as the Canadian economy reacts to the US slowdown and global financial market turbulence. This may well involve some further easing. But when credit conditions return to more normal levels and the economy starts to recover, interest rates will need to increase. Regulators should also be reviewing whether steps need to be taken to ensure that institutional incentives in the financial sector are appropriate. Longer-term, research is ongoing at the Bank of Canada and elsewhere to assess whether it should switch to a lower inflation target, and/or to price level path targeting. As the Bank has stated, the research would need to uncover compelling evidence in favour of a change to alter a regime that has proven successful.*

Further efforts by the Bank and other regulators are desirable to improve transparency, flexibility and competition in Canadian financial markets. The current diversity of regulations – for example, each province has its own securities regulator – makes it difficult to maximise efficiency, and increases the risk that firms will choose to issue securities in other countries. *A single regulator would eliminate the inefficiencies created by the limited enforcement authority of individual provincial agencies. Also, the impact on economic growth from reducing competition restraining regulation in the banking sector could be significant. It is now time, ten years after the first merger proposals were blocked by government, to welcome competition in financial*

markets by allowing Canada's leading financial institutions to become global players by lifting the ban.

Canada's fiscal situation has improved significantly since the mid-1990s, as deficits were turned into surpluses and Canada's public debt burden declined from the second highest to the lowest among G7 countries. This, combined with lower interest rates, has reduced debt service costs substantially over the past decade. Government's size relative to the economy has shrunk, as shown by lower revenue, spending and net debt relative to GDP. However, current primary expenditures as a share of GDP have risen slightly since 2000. Over the next few years the combination of recent sizeable tax cuts and lower economic growth will eat into budget surpluses, raising the prospect of renewed small general government deficits, especially if lower commodity prices were to pare tax payments by the resources sector.

Over the last decade, the federal government and almost all its provincial and territorial counterparts have underestimated revenue on average, and have reacted by a combination of debt reduction, tax cuts and spending beyond levels announced at budget time. However, it is unlikely that recent growth rates in public expenditures are sustainable. *Given the likelihood that the current slowdown in economic activity will curtail future favourable revenue surprises, all levels of government should avoid spending beyond originally budgeted levels. Furthermore, with the imminence of ageing pressures on spending, budgets should be subjected to serious continuing expenditure reviews. The major areas for the federal government to focus on are the level of subsidies, especially in agriculture (see below) but also transfers to lower levels of government. For their part, the provinces should redouble their efforts to ensure their spending is efficient, notably in health care.* ■

How should policies adapt to population ageing?

Despite its relatively enviable fiscal position, Canada faces the same long-term fiscal challenges related to population ageing seen in other OECD countries. The old-age dependency ratio is expected to more than double over the next 50 years, putting significant pressure on public spending mainly through rising health-care expenditures, since the earnings-based public pension system has now largely been put on a sustainable footing. *Among the policies that could help alleviate the problem are: more rigorous spending controls; programme and financing reforms aimed at improving the efficiency of public expenditures, especially in health care; faster debt reduction; shifting provinces' taxation to more efficient bases; and, above all, growth-friendly policies to help future generations afford the rising costs of government programmes.*

Making good use of sizeable budget surpluses has been a key policy issue in Canada, and governments have appropriately used them as a justification for tax cuts. Whereas debt reduction contributes to fiscal sustainability by pre-funding implicit demographic liabilities, tax cuts may

serve the same purpose indirectly: lowering taxes can improve incentives to work, save and invest, thereby boosting labour supply, productivity and growth, and expanding the tax base to recoup part of the revenue lost while significantly improving long-run welfare. Given the economic outlook, there is no fiscal room for further net tax cuts over the next few years, but plenty of broadly revenue-neutral, growth-enhancing reforms could still be made in both the business and personal income tax systems. ■

How can the tax system further enhance economic well-being?

Marginal effective tax rates on business investment have been cut sharply in recent budgets: the federal corporate rate is being reduced by a third and the federal capital tax (an inefficient tax on wealth) eliminated. Most provinces are also phasing out their capital taxes, in part in response to federal incentives. But more could still be done. Businesses in some provinces pay retail sales taxes on inputs, penalising investment. A variety of permanent preferences in the tax code divert resource flows away from their most productive uses toward tax favoured ends, notably in “traditional” sectors like manufacturing, natural resources and agriculture to the detriment of market services sectors that have been some of the key sources of recent US productivity growth. Small Canadian-owned firms are also unduly advantaged, which may discourage them from growing and becoming more productive. *Given the need to raise productivity growth, revenue neutral tax reforms to reduce distortions inherent in the current tax system should now be pursued. The top priority is to convert retail sales taxes in the five provinces that still have them to a harmonised VAT, whose broader base (including non financial services) would offset lost provincial revenues from retail sales taxes on business inputs. As well, accelerated capital cost allowances in manufacturing should not be renewed when they expire in 2011, existing generous deductions for mining and other resource activities should be removed, and the general corporate income tax rate should be lowered to the level of the small business rate, with base broadening measures largely paying for the statutory corporate income tax cut.*

Recent years’ tax/benefit reforms have helped lower income families, but they have also inadvertently produced higher marginal effective tax rates as refundable tax credits or cash benefits are withdrawn with higher earned income. This reduces work incentives for groups whose labour will be needed so as to counteract ageing and present labour shortages in the booming areas. Low-income retirees face similarly high marginal effective tax rates (METRs) due to the claw-back of their old-age cash benefit as taxable pension savings are withdrawn, reducing their incentive to save for retirement, although the newly announced Tax Free Savings Account should help to alleviate this problem. High METRs due to benefit withdrawals continue up to middle incomes. The top marginal tax rate has been reduced but is still the second highest in the G7. These factors inhibit longer working hours, and efforts to achieve upward mobility and pursue

higher education, all of which are necessary to raise labour utilisation further and reverse declining multifactor productivity growth. Hence, high METRs should be reduced by earlier but more gradual benefit phase-outs, eliminating “middle-class welfare benefits”, and by better co-ordination of federal and provincial tax/benefit systems, or through broad-based tax reductions.

The generous but still partial alleviation of taxes on personal capital income is designed to improve savings incentives but also misallocates capital, as post tax rates of return on marginal, non-tax sheltered savings are low. Moving toward consumption based taxation (by eliminating taxation of the normal return to all savings) may be politically difficult because expected efficiency increases come at a cost: large gains to rich savers against losses to the non saving poor insofar as consumption taxes are raised to cover the resulting revenue shortfall. Nonetheless Canada has already taken significant steps in this direction and is well positioned to go further since two thirds of Canadian individuals already hold all their financial assets in tax-efficient savings vehicles. With the recent introduction of the Tax-Free Savings Account, this proportion is expected to increase over time to 90%. Hence, revenue losses and the resulting increase in consumption taxes should be modest. Another reason is that Canada does not allow mortgage interest deductibility on primary residences, which would be incompatible with consumption-based taxation and very difficult to remove once in place. Thus, present tax preferences to certain savings vehicles should be extended to all forms by taxing personal income on a consumption basis. Any revenue shortfalls, including those needed to pay for desirable cuts in the top marginal tax rate on personal income, should come from increases in efficient tax bases. These would include environmental taxes at all levels of government, property tax and user fees for various public services, and provincial VATs (once all have converted their retail sales taxes). VATs should have as large a base as possible so as to keep rates as low as possible. Exemptions are costly, benefit the rich as well as the poor, and are an inferior way to enhance equity relative to increasing low-income credits. As such, the current GST exemptions for basic groceries should be eliminated and the adverse distributional consequences neutralized by boosting the GST tax credit. Municipal property taxes should be increased for households and reduced for firms, with net tax increases allowing reductions in provincial transfers and hence further provincial income-tax reductions. ■

What policies would encourage sustainable energy development?

The energy sector has been growing at a fast pace, as higher prices, topped up by generous tax incentives, have caused profits and investments to soar. With shrinking conventional oil and gas production, the focus of activity has shifted toward non-conventional sources, mainly the vast oil-sands reserves located in the province of Alberta. Its rapid pace of development has bumped up against infrastructure bottlenecks and created labour shortages. The provincial government, flush with oil

revenues, is greatly stepping up its infrastructure spending, the cost of which has recently increased at a rapid pace. Wage increases have picked up sharply to draw workers from the rest of Canada and abroad, in turn putting pressure on housing, consumer prices and public services. Despite comparatively high inter provincial labour mobility, it is insufficient to cope with Alberta's pressing needs, and shortages of various skills are acute. *Employment insurance should be harmonised across low and high unemployment regions to foster migration towards the former. Barriers to inter-provincial trade should be torn down, especially those that hinder mutual recognition of professional credentials (notably in the building trades). Participation of all marginal population groups should be encouraged by tax/benefit, education and training policies. The move by the federal and several provincial governments to the public-private partnership model for some infrastructure projects can help to ensure their efficient building and operation so long as they are carefully designed and risks transparently allocated.*

The Alberta oil boom has created many jobs in the rest of Canada, especially in professional services and in the materials and capital equipment supply industries. However, the induced real exchange rate appreciation has cost jobs in manufacturing-based provinces, which are also competing with emerging Asia. For a time the positive job and income spill-overs offset the negative ones. However, with the gathering US recession and depreciating US dollar, the balance has been shifting. This is straining the fiscal federal equilibrium and increasing demands for subsidies and transfers. *Alberta should implement allocation and withdrawal rules for its Heritage Fund: preferably, it should save all its oil revenues in a foreign asset fund, as Norway does, spending only smoothed yearly fund income. The federal government should consider doing likewise for revenues resulting from transitory terms-of-trade gains. This would not only avoid Dutch disease effects, but also pre-fund ageing costs and share resource wealth with future generations. Tax policies for the oil and gas sector must be updated for the era of high oil prices by: removing the preferential elements of federal deductions for exploration and development; discontinuing "flow through share" agreements; continuing to review Alberta's royalty regime to ensure that pure economic rents are being captured by the province, while reassessing the federal deduction for provincial royalty payments if that is not the case; and removing the exploration/production requirement for tenure rights.*

Higher prices have made the exploitation of the oil sands feasible under existing technologies, but they are still extremely intensive in terms of natural gas and water inputs and greenhouse gas (GHG) emissions. Even though Canada signed up to the Kyoto Protocol, its GHG emissions are currently some 33% above the target. It accounts for 2% of world GHG emissions, second only to the United States in per capita terms, and its emissions are growing faster than nearly any other OECD country, mainly on account of rising oil-sands production. The government now has a

plan to rein in such emissions. However, it is based on intensity targets, rather than absolute levels. At foreseeable oil-sands exploitation rates, the government's objective of getting to within what amounts to 8% of the missed Kyoto target by the year 2020 is probably attainable only if technological breakthroughs are achieved. In that context, the federal government has set aside funds for financing pilot projects in carbon capture and storage. *Market-based incentives to devise and adopt helpful innovations will be of primary importance, using standards only when there is an identifiable market failure that cannot be addressed by a price on carbon. The federal plan to implement permit trading is a welcome development and should now be implemented expeditiously. It would benefit from having a price corridor to reduce uncertainty both for firms contemplating a choice of production technologies with varying emissions intensities and for researchers seeking emissions-saving innovations. Finally, not only in the domain of climate change but throughout the environmental area, the cost of regulations needs to be calculated in a transparent manner and monitored on a regular basis.* ■

How to unleash Canada's agricultural sector?

It is perhaps surprising that a country like Canada with its vast agricultural potential has not seen fit to be a recent leader in pushing for liberalisation, especially when so many of its farmers would benefit so handsomely from a freer global trading regime in this sector. Admittedly, in the 1980s and 1990s government support to agriculture was cut back sharply, and Canada looked set to join Australia and New Zealand in having open agricultural markets. Over the past six years it has been almost alone among OECD countries in backtracking in the protection provided to its farmers. Canadian farmers now receive more generous support than those in the United States and Mexico, but less than their counterparts in most OECD countries. This has had heavy recurrent budgetary costs (CAD 3.8 billion or 16 600 per farm per year in 2006, for example), thankfully in a period of surpluses. But surely *the burden of proof of net benefits has to be set higher for such spending. It needs to be more strictly controlled, particularly in view of the risk of moral hazard behaviour by farmers growing used to living off government handouts. Given high agricultural prices, the time is ripe for setting all farmers free to test out their capabilities in the world marketplace, not just grain producers as the government is trying to do.*

Nowhere in Canadian agriculture are the distortions greater than in the supply-managed sectors and above all in dairy farming. Not only are dairy farmers' outputs protected by prohibitive tariffs that result in retail prices for butter and cheese that are around two and a half times those in the none-too-free US market, but their median annual gross income levels have surged to over CAD 250 000, and milk quota values on their balance sheets have soared to over CAD 26 billion in 2006 (around 2% of GDP). This represents several million dollars per farm and CAD 26 000 per cow. Such

rents are a blight on the economic landscape and totally unjustifiable in a world of skyrocketing global dairy prices. While support cannot be cut off overnight, it is crucial that a long-term plan be established whereby they would be phased out. The first step would be to eliminate restrictions on inter-provincial trade in supply management quota. The federal government could then offer some sort of transitional payments that would avoid too great a hit to the finances of current farmers.

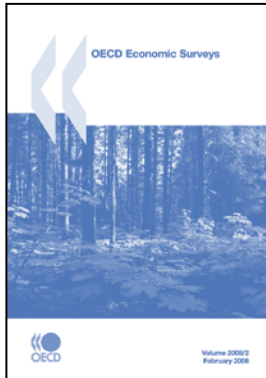
Farming has also been a part of the nation-wide effort to improve environmental performance, including addressing the challenge of climate change through bio-energy production. The goal has been to improve the efficiency of its production so as to lower GHG emissions, boost farmer incomes and enhance air quality. As in other parts of the OECD, the federal and some provincial governments have introduced consumption mandates and subsidies to expand its use. At present it is obvious that conditions in Canada do not allow its canola farmers to compete with Brazilian sugar farmers on a cost alone basis, but the hope has been that producing ethanol from cellulose would promise better returns, and substantial budgetary support for research and development has been granted. However, even this source has now been questioned as to its benefits in terms of emissions saving, much less for its cost efficiency and its regressive impact on global food prices. It would seem prudent to re-examine the premises upon which support has been granted and the mandates imposed and allow the government's reliance on emissions-trading to run its course, possibly supplemented by prizes offered for technological breakthroughs. ■

**For further
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Economic Outlook No. 83, June 2008.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2008 edition.

More information about this publication can be found on the OECD's website at www.oecd.org/growth/goingforgrowth2008.

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