Economic Survey of Canada, 2000

OECD Observer

Summary

After a difficult and lengthy adjustment period, the Canadian economy ended the decade on a strong note, as policy measures implemented during the 1990s have established a sound foundation for better economic performance. The inflation-targeting framework adopted in 1991 has created a low-inflation environment. Improved budgetary positions of governments have put the high public-debt-to-GDP ratio on a clear downward path. Structural reforms in key areas a decade or more ago, which were complemented by important changes to the unemployment insurance system in 1996, have also enhanced conditions for growth. These policy efforts have begun to pay off, as manifest in the current healthy pace of economic expansion and the decline in the unemployment rate to historically low levels. The challenge for policymakers now is to ensure that these favourable developments are sustained. With the economy possibly operating above its estimated potential, a further tightening in monetary conditions from mid-year levels would seem to be warranted to avoid the emergence of excess demand and ensuing inflation pressures if the economy's strong momentum persists. As to fiscal policy, priority should be given to continued debt reduction while creating room for desirable changes to the tax system, by maintaining tight control over spending. In this framework, extreme care is needed to avoid new initiatives with long-term spending implications in response to short-term revenue windfalls. At the same time, there is scope for advancing the structural policy agenda to enhance economic efficiency and thus provide the wherewithal for an improvement in the standard of living in both absolute terms and relative to trading partners. Finally, greater use of economic incentives and instruments would help avoid environmental degradation and resource depletion to the detriment of current and future generations, thus enhancing environmentally sustainable growth over the longer run. ■

This Policy Brief presents the assessment and recommendations of the 2000 OECD Economic Survey of Canada. The Economic and Development Review Committee, which is made up of the 29 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.

Why has economic performance improved?

Canada's recent economic performance has been favourable, underpinned by the sound macroeconomic and structural policies pursued over the 1990s. With improved fundamentals, including a fiscal surplus, activity has rebounded vigorously from the external shocks in 1997-1998. Economic expansion since then has been strong and broadly based, benefiting both from a favourable external environment – buoyant US demand, rising world commodity prices – and improved confidence at home associated with substantial job creation and rising incomes. With real GDP growth averaging over 5 per cent (at an annual rate) since late 1998, slack in product and labour markets has been rapidly taken up. The unemployment rate has fallen to levels last seen in the mid-1970s, and the economy may now be operating at, or slightly above, full capacity, as conventionally measured. Nonetheless, while the sharp rise in energy prices has pushed up "headline" inflation, "core" inflation – excluding energy and other volatile items – has stayed well within the bottom half of the official 1 to 3 per cent target band. At the same time, with the improvement in Canada's terms of trade coming from higher commodity prices, the current account has shifted rapidly towards surplus. ■

What is the outlook?

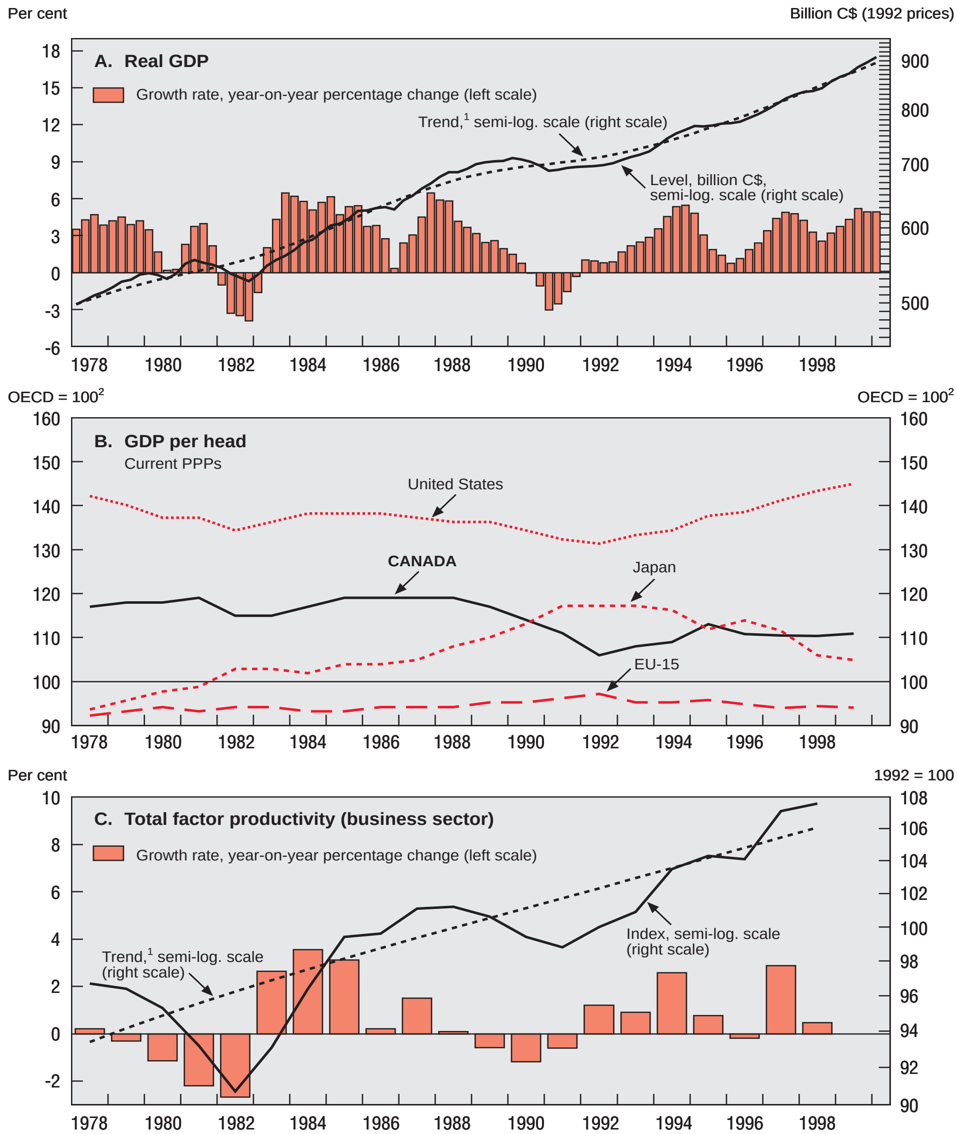
In the period ahead, economic growth is projected to moderate, averaging 3 per cent in 2001 following about 4½ per cent this year, as US demand becomes less supportive and tighter monetary conditions restrain the interest-sensitive components of household and business spending. On the other hand, renewed fiscal stimulus should bolster domestic demand, although households may prefer to take advantage of announced tax cuts to strengthen their balance sheets. Such a "soft landing" scenario would avoid the emergence of major tensions and imbalances in the economy. Core inflation is expected to rise somewhat but to stay near the middle of the official target range,. Despite vanishing terms-of-trade gains, the external balance should be in slight surplus, as imports slow roughly in line with exports.

While unexpected developments in the United States would obviously have consequences for the Canadian economy, given the strong trade and financial linkages between the two countries, there are also important risks to the outlook associated with the domestic economy. The principal risk derives from the fact that, during the projection period, the economy may be operating above OECD estimates of non-inflationary capacity, even though the latter build in a considerable acceleration in potential output growth (to over 3 per cent per annum) owing in part to efficiency gains. Yet considerable uncertainty about aggregate supply remains. Continued low core inflation could mean that the sustainable level of output is even higher than estimated, but it is by no means clear to what extent technological advances and restructuring have enhanced *trend* productivity growth in Canada. These uncertainties about the economy's productive potential will put the inflation-targeting framework to the test, the more so since the surge in energy prices could result in higher inflation expectations and consequently increased wage claims. ■

What should be done to sustain the expansion?

Despite the benign inflation environment, the Bank of Canada has become concerned about economic activity picking up too much momentum. While they had held benchmark interest rates steady when US rates were raised during the summer of 1999, they followed subsequent moves by the US Federal Reserve as from November. Canadian nominal interest rates have remained below their US counterparts, however, which might help explain why the Canadian dollar has appreciated less than might have been expected on the basis of commodity price developments alone. With excess supply in the economy apparently eliminated by late 1999, the modest tightening in the monetary stance was appropriate, even though core inflation has so far remained low. Indeed, looking forward, a further tightening in monetary conditions would seem to be warranted. Given the uncertainties mentioned above, the Bank has de-emphasised the output gap as a guide for monetary policy and is placing increasing weight on various indicators of future inflation, including monetary aggregates which have shown strong expansion of late. This implies, however, a considerable degree of judgement required on its part. It is true that its success in maintaining low inflation has established the credibility of its targeting regime. That, combined with the fact that core inflation remains well below the mid-point of the target range, provides it with some room to explore the economy's productive limits. Given the risks of spillover from any

Growth performance over the long term



1. Hodrick-Prescott filter, λ = 1 600.
2. Excluding Korea, Czech Republic, Hungary and Poland.

Source: Statistics Canada; OECD, *National Accounts.*

pick-up in inflation in the United States and the time it takes for monetary policy to have its impact on activity and prices, it would seem advisable to err on the side of caution and continue to raise interest rates if the strong momentum of the economy persists.

The sharp improvements in federal and provincial fiscal balances towards surplus have resulted in a marked fall in the very high gross government debt-to-GDP ratio, which by end-2000 will have come down by about 15 percentage points after peaking at over 120 per cent of GDP in the mid-1990s (based on the new definition including funded government pension liabilities), and the prospects are good for further declines over the medium term. This has helped reduce risk premia and interest-rate volatility, both of which have had a negative impact in previous years on government finances and on the economy in general. However, while monetary policy is in a tightening mode, fiscal policies, after six years of retrenchment, are now easing, and this trend may be reinforced by the fact that additional revenue beyond budgeted levels – which has been the rule, given prudent planning assumptions – is largely used for funding one-off spending initiatives. Without any slack remaining, in the near term it would clearly be preferable to use these revenues for debt reduction rather than new spending, so as to take pressure off monetary policy. Indeed, accelerated debt reduction continues to offer substantial advantages for Canada. It would allow an earlier transition to lower tax rates, enhance the flexibility policy makers will have in designing appropriate policies, further reduce the country's vulnerability to economic shocks and strengthen the credibility of the government's macroeconomic strategy.

In a longer-term perspective, the government's current rule of thumb, which allocates half the budget surplus to new spending initiatives, should be reconsidered, with greater weight being given to debt reduction and tax cuts. Tight control over spending and careful evaluation of new initiatives would, over time, make room for even greater debt drawdowns and more comprehensive reform of the tax system, where there is still scope for improvement despite the recent measures, as discussed below. In this regard, the government's presentation of five-year fiscal projections is welcome, as it facilitates public debate on feasible policy options. However, there is still a need for a more comprehensive medium-term framework, providing a coherent prospective plan for programme spending, tax changes and debt reductions, with priority given to reforms in those areas that produce the most significant long-term benefits for the economy. ■

Why has productivity not risen faster?

The broadly based structural reform agenda pursued since the latter part of the 1980s has touched on all aspects of the economy as the authorities have sought to improve its efficiency and thereby productive capacity. The benefits were slow to materialise, possibly reflecting the significant excess supply in the first half of the 1990s as economic imbalances were unwinding, as well as the staged way in which reforms were implemented and the time lags between their introduction and eventual impact. However, as noted, signs are now emerging that these reforms are beginning to pay off in terms of higher potential output and falling structural unemployment.

Amidst these positive signs, there are no clear indications of an improvement in *trend* productivity performance. So far, measured productivity growth has not picked up to the extent it has in the United States. In combination with poorer employment performance over most of the decade, this has implied a decline in relative living standards and has led to a debate over whether Canada is getting left behind in the transition to the "new economy". Indeed, the divergence between the two countries' performance reflects the fact that, in Canada, the two industries which are leaders in the "new economy" – electronic equipment and industrial machinery – make up a much smaller share of output and have made slower productivity advances than in the United States. Thus, at the macroeconomic level, Canada cannot expect to see the same contribution to productivity gains emanating from these industries as its southern neighbour. On the other hand, the recent strength in investment in machinery and equipment, led by spending on computers, could spur a rise in labour productivity growth by increasing the stock of capital available per worker. Recent federal budgets have introduced measures aimed at promoting innovation and taking advantage of opportunities presented by the new economy. But a fuller and more rapid exploitation of the possibilities opened up by new technologies is likely to require continued efforts to complete the structural reform agenda. ■

Is labour market reform on track?

The authorities have made substantial progress in implementing the OECD *Jobs Strategy* recommendations, but there is unfinished work and a need to maintain the momentum of labour-market reform. Recent developments in Employment Insurance (EI) payments, for example, suggest that incentives to take up benefits for certain groups have not been altered significantly. Thus, it is essential that remaining issues be dealt with, including the large variation in regional generosity. At the same time, any renewed easing of eligibility criteria beyond that already announced should be resisted, since this risks creating casual labour-force participation (and dependence on EI), moving away from the insurance principles adopted in 1996. Improved labour-market conditions also imply the need for a greater focus of active labour-market and social policies on shorter-term, and less costly, adjustment measures. In that regard, evaluations of all interventions should be systematically undertaken and those under way completed quickly to ensure that they are bolstering work incentives and reducing dependency. Encouraging inter-regional labour (and other factor) mobility, with the ensuing efficiency gains, would be greatly assisted by the swift completion of the provisions of the Internal Trade Agreement and Social Union Framework, and indeed, by moving beyond the targets already set therein.

One area that will require further examination by the authorities is electronic commerce (e-commerce). While estimates suggest that expenditures in this area are relatively small, they are nonetheless expected to soar, holding the possibility of substantially improving efficiency in the distributive trade sectors. Careful attention is required to create the conditions for a vibrant e-commerce marketplace by ensuring that unwarranted barriers which might limit this activity's expansion are relaxed, thereby safeguarding the domestic tax base. However, although the United States does not collect sales tax on many e-commerce purchases, Canada should not move in this direction. On the international front, support for free trade under the auspices of the World Trade Organisation (WTO) remains the cornerstone of Canada's trade policy. Commitment to the rules-based trading system has led Canada to agree to implement the recent panel decision on the Auto Pact, which it should do by removing its tariffs on all imports of automobiles and parts. While this may lead to some restructuring of the sector, it would benefit consumers via greater competition and choice in the marketplace. ■

What about fiscal policy initiatives?

Meanwhile, the latest Budget contains very welcome initiatives to lower the tax burden on Canadians, with the announcement of a five-year tax reduction plan. The most important change is the immediate restoration of full indexation of the income tax system; this puts an end to "bracket creep", which will benefit low-income families the most. The authorities have indicated that, should the budget situation allow it, they intend both to bring forward some of the measures currently envisaged for implementation only by 2004 and to go further in the tax reduction process. Moves in this direction would be beneficial, particularly for corporate taxes where corresponding rates for non-manufacturing and non-resource companies are still significantly higher than in the United States and most other OECD countries. Lowering taxes on service-sector firms more substantially would remove the present bias against knowledge-based activities, thereby levelling the playing field among enterprises, while serving to complement other measures that may help to boost innovation, such as R&D incentives. Bringing forward the envisaged measures in the personal tax field (raising the threshold at which the highest tax rate kicks in and eliminating the surcharge on higher incomes) would also be useful, as they should have positive effects on labour supply. A more certain timetable on when new measures would be introduced could be helpful in locking in expectations. In addition, there are ongoing concerns in the area of capital and payroll taxation. Furthermore, shifting the tax system towards increased use of less distorting indirect taxes, as suggested in previous *Surveys*, together with initiatives that could preserve the quality of the environment should be envisaged.

However, as noted above, the ability to move in these directions is constrained by the lack of an effective framework on how to judge and deal with competing, and indeed escalating, claims on budget surpluses. In this regard, it would be desirable to develop a structure for the transparent assessment of the benefits arising from spending initiatives, allowing an appraisal of how these weigh against those generated by tax and debt reductions. A first step would be to ensure that current spending is carefully examined as to whether a re-allocation towards areas that enhance the economy's productive capacity is possible. The latest Budget, for instance, provides for funding for initiatives that, among other things, seek to boost universities' research capacity, improve infrastructure and get the government "on-line" (one objective of which being to promote e-commerce). Since the benefits of such discretionary measures are not always apparent, their implementation and impact should be carefully monitored (including carrying out cost-benefit analysis where relevant) with a view to setting up a list of "what works" in order to target future expenditures efficiently, as well as to better communicate and justify government spending priorities. Claims on surplus funds are most apparent in the area of health care. While some spending increases in this respect might be useful, such claims should be judged in the light of the potential to introduce reforms that could both contain costs and increase service quality. Indeed, changes in the delivery of primary care would help to improve the continuity of services provided to patients, reducing unnecessary interventions, and thereby costs. Physician remuneration remains a controversial area, but Canada could adopt a mixed capitation/fee-for-service model that several other OECD countries have already implemented.

One area that continues to undergo substantial reform is the financial sector. The government's proposals for overhauling the industry's framework currently before Parliament have the potential to enhance competition, which would benefit business and consumers alike through a greater choice of products and more efficient and liquid capital markets. Following the necessary interaction with interested parties the legislation should be passed and implemented quickly to reduce uncertainty, assisting market participants in their planning and decision-making. The recently introduced supervisory framework appears flexible enough to deal with the likely associated challenges, but in some cases more transparent guidelines might be useful (for instance, in the merger process for large banks). At the same time, policy-makers should continue with their efforts to reduce regulatory overlap and duplication, where it exists, in order to minimise the burden on financial institutions as their business environment becomes increasingly competitive. Supervisory bodies should continue to be provided with sufficient resources to deal with the potential for increased risk arising from greater competition. ■

To what extent have sustainable development goals influenced policy?

Policymakers need to make sure that the higher growth that is expected to result from structural reform and skilful macroeconomic management is sustainable not only economically but also in terms of its effects on the environment. In an effort both to strengthen the government's performance in protecting the environment and bring consistency to its policies, legislation has been enacted that requires federal departments regularly to table sustainable development strategies. In addition, it has established the position of the Commissioner of the Environment and Sustainable Development who plays a key role in monitoring policy progress. As noted by the Commissioner, there is still an "implementation gap" in many areas. It is true that, in Canada, sustainable development policies face a number of specific conditions: the proximity of and economic integration with the United States; the large inter-provincial differences in environmental conditions and resource availability; and last, but not least, the shared jurisdiction between the federal and provincial governments in these areas. Nonetheless, there is scope for enhancing policy performance. Improving the mechanisms for decision-making at all government levels, as well as those intended to ensure co-operation among them and to reinforce accountability, would be helpful. Voluntary agreements have not proved up to the task of dealing with the resource and environmental challenges on their own. Thus, more extensive use of economic instruments will be necessary.

The sense of "immensity" and Canada's rich endowment of natural resources have led to policies favouring their development and use. Although, apart from the Atlantic groundfish sector, the limits of availability of resources have generally not been reached, the sustainability of such policies is an issue in the long run. Resource-based production is energy-intensive and may in the end cause serious pollution problems, notwithstanding the Canadian environment's substantial assimilative capacity compared with other OECD countries. Support has been especially important for activities based on non-renewable resources (such as oil, gas, metals and minerals), coming mostly in the form of preferential tax treatment. Although the recently announced tax measures will, over time, contribute to levelling the playing field, this has put other sectors of the economy, such as knowledge-based industries, at a disadvantage, while elevating the overall tax burden. The resulting intensive exploitation of non-renewable resources also has environmental consequences in the form of polluting substances release and greenhouse gas emissions.

In the same way, overuse of water, because it is under-priced, has become a problem in some regions, despite the abundant supply overall. While the government has been endorsing the principle of "economic pricing" of water for some time, provincial and local governments, which are responsible for water management, are moving only slowly in this direction. In regions with extensive irrigation in particular, the current implicit subsidisation has reduced water availability and increased pollution by boosting chemical-intensive agricultural production. To bring about more efficient water use, provincial and territorial governments should therefore implement the principle of "economic pricing" without delay, while making water rights transferable in problem areas (provided that does no harm to the ecosystem). This requires substantially increased use of water metering, which is still far from universal, and the elimination of quantity discounts. Such a policy would be consistent with the recent decision to ban bulk water removal, thereby preventing exports, which reveals a very high implicit social valuation of water. Nonetheless, a carefully designed export licensing system might allow Canada to reap some benefits from its abundant aggregate water resources, while at the same time preventing harmful environmental effects.

The Atlantic groundfisheries provide an illustration of how well-intentioned public support, in the face of unexpected environmental developments, may contribute to the overexploitation of a common resource. Although significant progress has been made in reducing the number of license holders in the groundfish sector, the sector is still overcapitalised and has too many fishers. This reflects the difficulty in trading-off the short-term adjustment costs for fishing communities, with their distributional and regional implications, against the longer-term sustainability of the sector. Other beneficial measures taken in Atlantic fisheries management (both groundfish and others) – notably the increase in the share of fisheries based on property rights in the form of individual transferable quotas and measures to foster industry commitment to responsible fishing – are also working towards reducing overcapacity and improving efficiency, which will serve to make activity in this sector both ecologically sustainable and economically viable. However, some labour-market policies, which tend to impede mobility, have been less helpful in achieving these objectives. While the Atlantic groundfish experience has not been typical of the industry as a whole, initiatives that could further improve efficiency and sustainability throughout the fisheries include: increasing the share of individual transferable quotas, reducing discretion in setting allowable catch levels, applying user charges that more closely reflect the costs of managing specific fisheries, further de-linking regional investment support from the fishing industry, and redesigning support to workers in the fishing and fish-processing industries so as to encourage them to search for other employment possibilities. The key challenge for policy makers is to make social and resource management policies compatible with considerations of economic efficiency in order to achieve both conservation and societal goals. ■

Specifically, what about pollution problems and climate change issues?

Policies and regulatory mechanisms aimed at curbing air, soil and water pollution have been successful in some areas, notably the Great Lakes. However, there is scope for improvement. The polluter-pays principle is not systematically applied, and reliance on voluntary agreements has not been sufficient to achieve environmental objectives (for instance, in the case of the management of toxic substances). No-cost opportunities for curbing pollution are rare, and, a strategy based on voluntary agreements alone cannot be expected to correct completely for the external costs of pollution. Hence there is a need to increase the use of economic instruments (for instance, charges on toxic emissions and waste, and disposal fees for products containing toxic substances) to reinforce the polluter-pays principle.

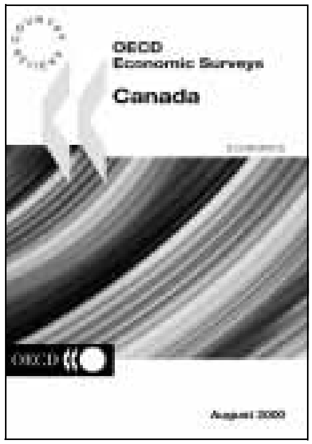
The government has been a leading proponent of international action on climate change. However, while an extensive consultation process has been launched, much more concrete action is needed. Meanwhile, greenhouse gas (GHG) emissions are rising steadily and are currently about 13 per cent higher than in 1990. With a government plan forthcoming only later in the year, it will be very difficult to meet the Kyoto Protocol targets agreed in 1997, which commit Canada to reducing emissions to 6 per cent below the 1990 level in the period 2008-12. Even if Canada is able to buy GHG emission quotas on an international market, it will probably have to take steps to accelerate the reduction in domestic fossil-fuel consumption per unit of GDP. In this case, rather than resort to command-and-control-type regulations, it would be advisable to rely primarily on a cost-effective instrument, such as a tradeable permit scheme, and not to exclude specific sectors (such as transport and energy) from its application. Increased taxes on fuel might be helpful to reduce emissions related to transport. In any case, measures will need to be implemented well before the target period in order to allow for a gradual adjustment in the energy-using capital stock. ■

For further information

Further information on this *Study* can be otained from Hannes Suppanz (email: hannes.suppanz @oecd.org, tel: (33-1) 45.24.87.62) or Robert Fay (e-mail: robert.fay @oecd.org, tel: (33-1) 45.24.92.98). ■

For further reading

- **OECD Economic Surveys:** Economic Surveys review the economies of Member countries and, from time to time, selected non-Members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at www.oecd.org/bookshop.



- **Additional Information**: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco/eco/.

- **Economic Outlook No. 67**, June 2000. A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: www.oecd.org/eco/out/Eo.htm.

OECD publications can be securely purchased from the OECD Online Bookshop
www.oecd.org/bookshop

The OECD Policy Briefs are prepared by the Public Affairs Division, Public Affairs and Communications Directorate.
They are published under the responsibility of the Secretary-General.

Where to contact us?

FRANCE
OECD Headquarters
2, rue André-Pascal
75775 PARIS Cedex 16
Tel: 33 (0) 1 45 24 81 81
Fax: 33 (0) 1 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY
OECD BERLIN Centre
Albrechtstrasse 9/10, 3. OG
10117 Berlin-Mitte
Tel: 49 30 288 8353
Fax: 49 30 288 83545
E-mail: berlin.contact@oecd.org
Internet: www.oecd.org/deutschland

JAPAN
OECD TOKYO Centre
Landic Akasaka Bldg
2-3-4 Akasaka, Minato-Ku
TOKYO 107
Tel: (81-3) 3586 2016
Fax: (81-3) 3584 7929
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO
OECD MEXICO Centre
Av. Presidente Mazaryk 526, Colonia: Polanco,
C.P., 11560, Mexico D.F.
Tel: (00.52.5) 280 1209
Fax: (00.52.5) 280 0480
E-mail: mexico.contact@oecd.org
Internet: www.rtn.net.mx/ocde

UNITED STATES
OECD WASHINGTON Center
2001 L Street N.W.,
Suite 650
WASHINGTON D.C. 20036-4922
Tel: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail: washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

80917

The OECD Policy Briefs are available on the OECD's Web site
www.oecd.org/publications/Pol_brief/