

Economic Survey of Canada, 2004

Summary

Economic performance has been solid, and macroeconomic policies are appropriate. The economy is expected to expand by close to 3½ per cent in 2005, and the output gap will soon be closed. Monetary stimulus should gradually be removed and the fiscal policy stance needs to remain neutral. The Canadian dollar appreciated sharply in 2003 and is now probably not far from its fundamental value. Canadian firms will need to continue to adjust by making efforts to improve productivity to maintain competitiveness. Policy makers should remain focussed on policies that enhance productivity growth across all sectors. With a sound macroeconomic framework and structural policies that are mostly conducive to a well functioning economy, the country is well placed to meet the challenges of an ageing population, namely, maintaining rises in living standards through strong rates of productivity growth and policies to attenuate the expected fall in hours worked on average across the whole population, and ensuring that public finances are sustainable, especially given pressures on health care outlays.

Product market competition could be strengthened. Competition in general is quite strong, but the Competition Act could still be improved. Remaining restrictions on inter-provincial trade should be lifted, especially for professional services. Restrictions on foreign direct investment should be eliminated, and policy objectives in this area should be achieved through other means. Provincial governments need to inject more competition into all segments of electricity markets.

This Policy Brief presents the assessment and recommendations of the 2004 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.

What are the main challenges?

How could product market competition be strengthened?

How can obstacles to investment in physical and human capital be tackled?

What more could be done to encourage people to work?

How can pressures on public finances be contained?

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Obstacles to capital deepening and investment in human capital should be tackled. Provincial governments should ease taxes on capital by eliminating sales taxes on capital goods and abolishing capital taxes. Capital cost allowances should continue to be examined to ensure that they are aligned with useful economic lives. More effective programmes for adult education are needed to improve literacy skills and provide opportunities for Canadians without qualifications to improve their labour-market prospects.

Policies should be adjusted where they discourage people from working. The rules governing Employment Insurance should be changed to address persistent unemployment through more effective case management and activation requirements, reconsidering more generous benefits in high-unemployment regions, and addressing the favourable treatment of seasonal full-time work. Enterprise experience rating should be applied to discourage repeated use of temporary layoffs by some firms. The disincentive effects of persistent high effective marginal tax rates (EMTRs) faced by modest-income families need to be addressed by a concerted effort across all levels of governments. Return-to-work income supplements could be used to encourage people to move off social assistance. The present disincentives to continued work in the Canada Pension Plan should be removed and the scheme made actuarially fair for early and later retirement, as the Quebec Pension Plan is set to do.

Pressures on public finances will need to be contained. The long-term sustainability of public finance needs to be closely monitored across all levels of government. Structural improvements are needed in the health sector to improve the quality of data, deliver efficiency gains and provide stronger incentives to improve health outcomes. Case-related payment systems for hospitals and more extensive use of mixed payment systems for primary care providers could provide better incentives. With a long-term federal contribution to provincial health budgets now agreed, provinces should focus on greater efficiency, instead of seeking additional federal funding, in order to meet health care objectives. ■

What are the main challenges?

The Canadian economy has delivered solid performance for nearly a decade with increased resilience to economic shocks, demonstrating the benefits of a well-designed macroeconomic framework and the

pay-off from a range of structural reforms implemented since the late 1980s. A relatively weak outturn in 2003 was mainly attributable to the impact of the sharp appreciation of the Canadian dollar, lacklustre foreign demand and a series of other unfavourable, but transitory, shocks affecting specific industries. These effects have now dissipated, and activity is once again buoyant. Given recent developments, the economy is expected to expand by around 3 per cent in 2004 and 3½ per cent in 2005, somewhat above the rates projected in the last *Economic Outlook*. At this pace, the OECD's measure of the output gap would close during the course of 2005, and the Bank of Canada will need to continue removing monetary stimulus so as to avoid inflation picking up. The March 2004 budget reflected the federal government's continuing commitment to achieving balanced budgets or better and reducing public debt, a strategy that has widespread public support. The current macroeconomic policy mix is appropriate for this point in the economic cycle. But it will be important to maintain a neutral fiscal stance: any easing of fiscal policy would provide an unhelpful pro-cyclical stimulus that would need to be offset by higher interest rates, pushing up the Canadian dollar still further and squeezing the interest- and exchange-rate-sensitive sectors of the economy.

Last year's appreciation of the dollar reflects a shift in portfolio preferences after a long period when Canada was unjustifiably seen as a perennial underperformer, and the currency is now at a level that is probably not far from fundamental values. This shift in relative prices for domestic *versus* foreign produced output will bring about structural changes as firms adjust. In any case, Canadian enterprises will face even stronger competition from rivals in emerging economies in coming years and higher security costs at the US border. Despite some calls from business for a lower dollar or for government inducements to keep production in Canada, the most appropriate response is for domestic policy-makers to redouble their focus on enhancing productivity growth and innovation in high- and low-technology sectors alike.

Canadians have benefited from an expansion in GDP per capita at a rate of around 2½ per cent per year since the mid-1990s, significantly faster than was experienced in the first half of the 1990s. This partly reflects a turn-around in labour utilisation, with strong employment growth offsetting some shrinkage in average hours worked per employee. A larger contribution has come from an increase in hourly productivity growth, which has averaged close to 2 per cent

per year since 1995. Although productivity growth is subject to cyclical fluctuations, especially in the business sector, the stronger underlying productivity performance since the mid-1990s in part reflects the better functioning of the economy following a series of structural reforms. These have allowed the economy to adjust more rapidly to the forces of change.

This positive backdrop provides the new federal government and its provincial counterparts with an ideal opportunity to identify previously overlooked pockets where changes in approach would deliver better outcomes and tackle those areas that for various reasons have so far proved too difficult to address. Looking ahead, as Canada's baby-boomers pass into retirement, the dependency ratio will rise and the working-age population shrink in the absence of net inflows of migrants. Responding to these developments presents the country with two key challenges:

- Maintaining steady improvements in living standards, despite increases in the old-age dependency ratio. This will mainly require continued strong rates of productivity growth, although adjustments to policies affecting labour supply could contribute by attenuating the expected fall in total hours worked.
- Ensuring that public finances across all levels of government remain sustainable in the long term, especially given the upward pressures on publicly financed health care outlays. ■

How could product market competition be strengthened?

One of the key drivers of productivity growth in OECD countries is product market competition. Competitive forces are, in general, strong in Canada, in large part because most barriers to international trade have been dismantled, and administrative and economic regulations inhibiting competition are amongst the lowest in the OECD. Nonetheless, there are a few areas where improvements could be made. The institutional framework governing competition policy could be enhanced in several ways:

- The Competition Act could be strengthened by permitting ready prosecution of hard-core cartels while providing appropriate civil law enforcement for economic conduct that warrants more refined examination, and by converting the prohibitions on predatory and discriminatory pricing from criminal to civil violations.

- Compliance with the Act's civil provisions may be enhanced by authorising monetary penalties for abuse of dominance and other civil violations of the Competition Act; expanding private access to the Tribunal to cover all of the Act's civil provisions (except mergers); and permitting private plaintiffs to sue and recover for damages for violations of the Act's civil provisions.
- Although progress has already been made, lingering misperceptions regarding the independence of the Competition Bureau could be further dispelled by continuing to present its budget as a separate line item within Industry Canada's Estimates. This would reinforce the move towards greater transparency for the Bureau.
- More generally, the Bureau (or an independent third party) could be mandated to undertake comprehensive studies of competition in relevant sectors on its own initiative, to identify the causes of market failures and to make competition-enhancing recommendations.

Although competition in most sectors appears to be vigorous, it is rather lacklustre in several specific cases. Canada's regulated conduct doctrine exempts anti-competitive behaviour when required by regulation, and thus some significant parts of the economy remain shielded from competition law. This is a particular problem with provincial government regulation. Hence, identifying sectors where reform is most needed through a comprehensive review of the impact of these restraints on competition would be welcome. Although progress has been made, restrictions on inter-provincial trade continue to exist, and implementation of the Agreement on Internal Trade is less effective than it could be. More attention needs to be focussed on removing those regulations that restrain competition in professional services, both within and between provinces.

Canada also has more significant restrictions on foreign ownership than almost any other OECD country — even though they are confined to a few key sectors — and they should be eliminated. For example, removing them in airlines (as well as lifting cabotage restrictions on domestic air routes) would spur competition and provide gains to consumers in the form of price reductions and greater choice. Foreign ownership restrictions in telecommunications and broadcasting may slow the diffusion of new technology, often provided by foreign firms. They are also burdensome, both here and elsewhere, because they could limit the pressure on incumbents to bear down

on costs. In any case, the cultural and other policy objectives that Canada has traditionally sought by such means could be achieved more effectively through the direct and transparent mechanisms — such as Canadian content rules — that are already in place.

The electricity sector has traditionally been characterised by vertically integrated, provincially owned public enterprises, and competition has been largely absent. The sector stands out: while prices are low in international comparison — essentially reflecting the ample supply of low-cost hydroelectric power — performance has been sub-standard over the past decade, as illustrated by comparatively poor productivity gains. While it is widely recognised that reforms are necessary, those undertaken in the past have mainly been aimed at bringing in private-sector investment and protecting access to US wholesale electricity markets, while avoiding full competition in generating and retail markets. Only Alberta and Ontario have introduced widespread competition. Full wholesale competition in Alberta began at the same time as the California electricity crisis. The introduction of both retail and wholesale competition in Ontario was accompanied by an unusually hot summer and shortages in capacity. In both cases these unforeseen circumstances led to increases in prices and volatility and the imposition of retail price ceilings. In contrast with Ontario, Alberta's reforms have been successful in large part because those caps were set at a relatively high level, thus preserving incentives for investment. Provinces would benefit from introducing more competition and implementing the structural reforms, such as vertical separation, required to achieve competitive electricity markets. In this effort, the success of reforms in Alberta and lessons learned from the mistakes in Ontario could be used to guide provincial policy makers. ■

How can obstacles to investment in physical and human capital be tackled?

Vibrant competition provides the pressure for faster productivity growth, which comes about, in part, through capital deepening, *i.e.* the process of augmenting the amount of capital available for each hour worked. Although significant progress has already been made on reducing the impact of taxation on the user cost of capital through various measures announced over the past few years, some business

tax distortions that inhibit investment could be removed, namely by:

- Eliminating provincial sales taxes on capital goods and abolishing capital taxes.
- Continuing to examine capital cost allowances to ensure that they are aligned with useful economic lives.

However, such moves would need to be taken within the present prudent fiscal framework.

Productivity growth also depends on improvements in human capital. Canada already has a well educated adult population and an education system that delivers excellent achievement overall. Boosting the skills of those who are already well qualified would possibly make the largest contribution to human capital growth. But it is less clear how public policies effectively contribute to that process: the analytical and empirical underpinnings are currently being re-examined by the authorities. In the meantime, greater efforts are clearly needed to provide help for those Canadians who have fallen through the cracks of the education system and who have not obtained even a high-school qualification and thus have both a lower earnings capacity and higher unemployment risk. Their difficulties are closely related to improving their basic literacy skills, but the quality of the programmes available for helping them is mixed. Programmes to meet the needs of this low-skilled group need to be redesigned to make them more effective. Improving the efficiency of such investments could pay significant returns over time through better labour-market outcomes, especially for younger people. ■

What more could be done to encourage people to work?

Rising living standards depend not only on productivity growth but also on the average hours worked by each member of society. Although employment rates are generally high by OECD standards, Canada's structural unemployment rate remains persistently elevated at around 7 per cent of the labour force, and seasonal unemployment claims are significant. The parameters of federal Employment Insurance (EI) could be adjusted in several ways to address pockets where unemployment is persistent, namely by:

- Adopting more effective case management techniques and activation requirements (especially for workers who are frequent users). They should be

oriented towards addressing the skill gaps that currently limit such users' options in the labour market.

- Reconsidering the present rules that offer more generous unemployment benefits in regions where unemployment is high so as to achieve a better balance between providing stronger incentives for job search and a fair access to benefits among regions.
- Addressing the present favourable treatment of seasonal, full-time work for those working close to the minimum qualifying hours, especially in high unemployment areas.
- Incorporating experience rating of employers into their premium rates. This would effectively eliminate the significant subsidy that arises because EI is used disproportionately and repeatedly by some firms for seasonal and short-term layoffs at the expense of other employers. This would internalise these costs without reducing income protection to those who become unemployed.

Another weak spot in Canadian policies that affect the labour supply concerns "welfare traps". The incentives to move from social assistance to work have improved since the mid-1990s, in large part because of the introduction of the National Child Benefit (NCB), which does not depend on work status. But a range of other in-kind benefits are still linked to social assistance, including subsidised health care and housing. Greater use could be made of back-to-work benefits, accompanied by more effective job-oriented case management, to both encourage and facilitate the shift from welfare into work. Although the NCB has reduced the extremely high effective marginal tax rates (EMTRs) faced by families in moving from welfare to work, it has increased EMTRs for some low- to middle-income working families, which are disproportionately headed by lone parents. As a result, many of these households remain persistently below income levels where EMTRs fall back to more moderate values. The problem is exacerbated by means-tested provincial programmes, and all levels of government need to engage together in a concerted effort to address the disincentives associated with these stacked claw-back rates. This exercise may need to be embedded within a broader assessment of tax and benefit arrangements as instruments for dealing with equity concerns.

Labour supply could also be boosted by greater participation by those in older age groups. Although sig-

nificant numbers of Canadians already work into their late 60s and even their early 70s, surveys suggest that higher proportions would follow suit, at least part-time, if they did not suffer a financial penalty for doing so, as is currently the case under the Canada and Quebec Pension Plans (CPP/QPP) and many employer-sponsored pension plans. The CPP and QPP (and possibly other retirement income programmes, such as Old Age Security) should be changed to make actuarially neutral adjustments for early or late commencement of benefits. Furthermore, the requirement to stop working in order to start drawing an early pension should be lifted. A proposal along these lines, already made to eliminate obstacles to work from the QPP, deserves support and should be extended to the CPP as well. Changes to public pension plans along these lines could accommodate the trend towards more varied patterns of work and retirement and could also have a significant signalling effect by encouraging employer-sponsored pension plans to similarly revisit their early retirement incentives in anticipation of projected future labour shortages. A further constraint on some of those wishing to continue working is contractual mandatory retirement provisions in collective agreements. For those people, searching for a new job may involve costs and frustration, and their new wages may be lower, because firm-specific skills have little value to other potential employers. On balance, it would be helpful to extend the ban on compulsory retirement that already applies in the federal civil service and some provinces across the rest of the country. ■

How can pressures on public finances be contained?

Demographic pressures will also weigh on public finances, although deferred taxes on private pension payments will provide some offset and the CPP/QPP are on sustainable paths, unlike in most other OECD countries. Nevertheless, public debt needs to be reduced to make room for future pressures, and the main forces driving up public expenditures, most notably health care, need to be contained. In the 2004 budget, the federal government not only reaffirmed its commitment to budget balance or better but also introduced an objective to reduce federal debt to 25 per cent of GDP within 10 years. Both actions are welcome; indeed this blend of fiscal responsibility year by year and attention to longer-term outcomes could be developed further. Federal and provincial governments should join together in

adopting a long-term fiscal sustainability framework covering all levels of government that could identify where pressures are likely to emerge and assess the long-term implications of different policy options. An independent agency could be assigned the task of periodically assessing the situation to set it outside the political decision-making process and enhance its credibility.

A comprehensive long-term framework would also help Canadians to assess the costs involved in future increases in publicly funded health service standards and the trade-offs in the form of higher tax liabilities and/or reduced non-health public services. The public is very concerned about the current cost, quality and responsiveness of the health care system, but the validity of this disquiet is difficult to assess because of gaps in information. More intensive efforts are needed to upgrade financial management and information systems: detailed, activity-based costing of services is essential to obtaining a comprehensive understanding of present strengths and weaknesses of the system as a whole, as well as the effectiveness of alternative treatments and the efficiency of different providers and institutions. It is also a pre-requisite to ensuring that additional resources currently being pumped into health will be applied in the most effective areas and deliver commensurate increases in outputs.

Several adjustments to the institutional framework for managing health care could also deliver efficiency gains and provide stronger incentives to improve health outcomes:

- Extending the public health care system to provide coverage for home care and to put a cap on out-of-pocket expenditures on pharmaceuticals. This would lead to more appropriate use of hospital services by reducing present biases in clinical decisions due to differences in coverage.
- Increasing incentives for hospitals to enhance efficiency by modifying funding mechanisms, for example, by reimbursing hospital care on the basis of reimbursement rates established for each

Diagnosis Related Group. This would facilitate more transparent, informed choices about health priorities and help in identifying where delivery could be improved.

- Using mixed payment methods more extensively for primary health care providers. Combining a salary or capitation component along with fees for services rendered could provide better incentives for doctors, encouraging them to provide care focused on long-term health outcomes.

A laudable initiative is the Canada-wide approach to establishing electronic patient records, which would help to provide a more integrated approach to health care, reaching across all points in the system.

Funding of health care has been a contentious issue, with provinces eager to persuade the federal government to contribute an increasing share. However, the scope to lobby continuously for extra federal funds reduces the pressure on provincial governments to get better value for money out of their own health spending. The September 2004 agreement between the federal government and the provinces sets out a 10-year plan for strengthening health care, accompanied by an additional C\$41 billion in new federal funding. To achieve associated efficiency gains, these arrangements should be made impervious to any further renegotiation efforts over the 10-year period. They provide the provinces with a clear basis for long-term planning and allow them to concentrate their efforts on delivering better results than achieved under the previous arrangements. ■

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- **Economic Outlook No. 75**, June 2004. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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