POLICY BRIEF

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Summary

Canada's economy has done comparatively well over the past two years, demonstrating a noticeably improved resilience to unfavourable shocks. Over the medium term the economy is poised to achieve growth rates that compare favourably with past performance, but that will not be enough to eliminate the per capita income gap with the United States. The fundamental challenge is to make Canada an even more attractive place to live, work and invest. While past reforms have begun to pay off, there is still unfinished business. To boost the employment rate further the government should reduce disincentive effects arising from the tax and benefit systems by, for example, making greater use of in-work benefits and reintroducing experience rating of Employment Insurance users. Faster productivity gains are more likely to be achieved in an economic environment conducive to innovation. A key to greater dynamism is strengthening competition by eliminating remaining foreign ownership limits and barriers to internal and external trade and continuing electricity deregulation. Investing in skills should also remain a priority, with a particular emphasis on adult education. The nation has benefited by importing human capital from abroad through immigration but needs to intensify its efforts to remove the obstacles that prevent immigrants from having their skills fully utilised in the labour market. Having introduced a sound fiscal framework and reformed its public pension system Canada is in a better position than most other countries in facing ageing-related fiscal challenges, but the trend rise in health-care costs remains a risk. With the recent budget the government chose to address the short-term needs of the existing system. But, ultimately, ways to control the rise in budgetary costs – whether through incentives to raise efficiency or through cost sharing – will need to be explored, otherwise the resources needed to finance the future burden should be set aside in advance, for example by setting a bolder debt reduction target. Finally, environmental sustainability will be enhanced with least cost to the economy if the ambitious greenhouse gas emissions reduction is achieved through market-oriented instruments rather than command-and-control measures or voluntary agreements. ■

This Policy Brief presents the assessment and recommendations of the 2003 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. The 2003 Economic Survey of Canada was finalised on 30 June 2003.

oecd Observer

Will the good economic performance be sustained?

Canada's recent economic performance has been stronger than in most other OECD countries. In particular, and despite close trade integration, the 2001 slowdown was shorter and the subsequent recovery stronger than in the United States. Canada's job creation performance, exceptionally robust in 2002 after only a pause the previous year, was also significantly more favourable. It has benefited from a less pronounced ICT investment cycle and a smaller impact of stock price declines, as well as from having a proportionately larger automotive sector, which enjoyed booming demand in 2002 thanks to the earlier monetary policy easings in both countries. But recent performance also indicates an increased resilience to external shocks. This is partly the result of past structural reforms that increased flexibility, but it is also due to fiscal consolidation and the establishment of a credible monetary framework in the 1990s, which together lowered sustainable real interest rates and increased the scope for, and the effectiveness of, counter-cyclical monetary policy.

Economic activity has gradually slowed since mid-2002, with the faltering US recovery curbing export growth and international uncertainties holding back business investment. Nevertheless, household expenditure is still strong, supported by earlier employment gains, high confidence and low interest rates. So far the expansion has been relatively well balanced: there is a comfortable current account surplus, while households and most firms are in healthy financial situations. Although the current slowdown could last a little longer in case of a delayed or sluggish US recovery or because of the impacts of SARS and BSE, economic activity is expected to gradually pick up again toward the end of the year and through 2004 as the global economy gathers strength. With some slack in labour and product markets, there is downward pressure on underlying inflation, and headline rates should soon converge on the 2 per cent mid-point of the target range. ■

How can monetary policy help?

The Bank of Canada, which had started to withdraw monetary stimulus in the spring of last year, recently resumed the process, partly in response to disappointing inflation outcomes. Last winter's temporary spike in consumer price inflation was due in part to one-off effects and signs of underlying demand pressure. A sharp fall in actual and expected inflation in the spring, the appreciation of the Canadian dollar, the fall in energy prices and temporary negative demand shocks relieved the need to continue to raise official interest rates in the short term. The Bank will need to closely monitor inflation developments, the impacts of SARS and BSE, signs of recovery in the United States and elsewhere, and the effect of the appreciation of the Canadian dollar on aggregate demand and price levels in Canada. If the negative shocks buffeting the Canadian economy prove larger or more persistent than expected, then a temporary monetary response may be called for. Looking forward, the Bank will need to resume the process of removing the remaining monetary stimulus once the effects of the current negative shocks dissipate. ■

What are the key policy challenges?

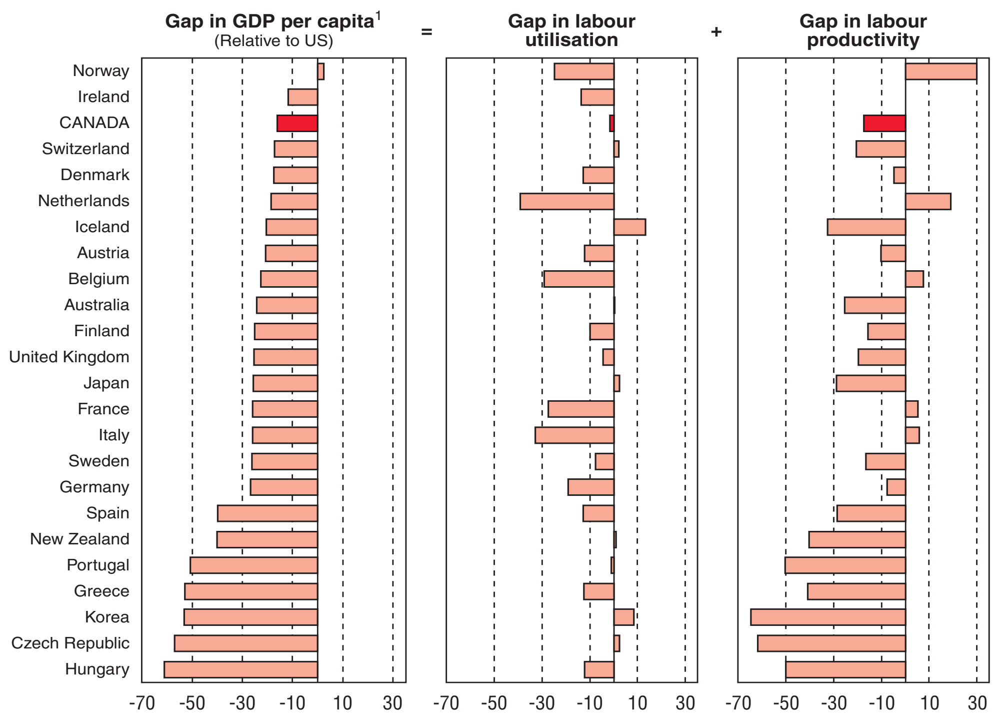
Thanks largely to the long series of structural reforms and the improved frameworks for macroeconomic policy formation, medium-term potential growth has picked up to over 3 per cent per year, and the gap in real income per capita with the United States has narrowed from its 1997 peak. However, the gap remains around 15 per cent. Since it is mainly due to the difference in labour productivity, raising productivity growth is the main challenge facing Canada. To do so, it must focus on boosting innovation, competition and skills. But there is also scope to make better use of labour resources. Structural unemployment remains persistently high, partly as a result of various features of the social assistance and unemployment insurance systems. Improving work incentives could also lift participation rates further; these have recovered to beyond US levels but are still well below the very high rates achieved in, for example, the Nordic countries. ■

How can unemployment be reduced further?

Major reforms since the mid-1990s have made work more attractive relative to social assistance, but "welfare traps" still exist. The introduction of the child tax benefit, which does not depend on work status, has significantly lowered disincentives to move off welfare. But other hurdles remain, including the loss of in-kind transfers such as subsidised health care and housing. More use of in-work or back-to-work benefits could reduce this problem, and provinces could

Figure 1. **Per capita income relative to the United States**

Percentage point differences in GDP per person relative to the United States, PPP-adjusted, 2002



1. The gap in GDP per capita is only approximately equal to the sum of the two components shown as there is a small additional demographic effect (differences in the share of population that is of working age).

Source: OECD.

learn from the innovative federal experiment with such a programme for sole parents. However, the phasing out of in-work payments raises marginal effective tax rates, so any reforms should be part of a package that addresses the uncoordinated stacking of abatement rates more generally. In this regard, the government has recognised the need to work with the provinces and territories to examine claw-back rates and other elements of the tax and benefit systems. The package should also include stronger training and job-search requirements and greater use of initial case management and diversion programmes, as the countries that have been most successful in cutting unemployment are those that have improved both incentives and enforcement.

Features of the employment insurance (EI) programme also contribute to the high unemployment rate. EI has moved well beyond providing income support during unexpected spells of unemployment and has become a major vehicle for delivering family, social and regional assistance. Frequent use of the system in some, mainly seasonal, industries creates a large cross-subsidy between sectors and regions. Workers were experience rated between 1996 and 2000 in order to discourage recurrent use. The criticism of the abolition of worker experience rating contained in the previous *Survey* remains valid. Other aspects of the system also need to be improved. The qualification period is short by international standards, while variations in eligibility rules between high- and low-unemployment regions discourage internal labour mobility, leading to persistent differences in joblessness across the country and thus higher structural unemployment. ■

How can productivity growth be lifted?

Achieving faster productivity growth is the main way to raise the standard of living. The government has recognised this in its *Innovation Strategy*, which focuses on developing human capital and fostering a strong research environment. Some encouraging signs of a pickup in productivity growth have begun to appear as the pay-off from the wide-ranging structural reforms of the past 15 years. However, trend productivity growth has risen only far enough to match the US post-1995 acceleration. It has not yet begun to close the gap. There is unfinished business in structural reform before that is likely to happen:

- *Boosting competition.* International experience shows that competition is an important driver of innovation and productivity growth. In general, Canada has one of the OECD's most business-friendly regulatory environments and has been a pioneer in ensuring its regulations are clear, cost-effective and directly linked to its policy goals. There are several glaring exceptions, however. Canada is one of the few OECD countries to have retained widespread foreign ownership restrictions in the *telecoms* sector, a strategy that is holding back investment and competition. This policy is currently under review, along with similar restrictions in the *cable* and *broadcasting* industries that are intended to safeguard Canadian culture. In the *airline* industry, the Competition Commissioner has recommended raising the foreign ownership limit from 25 to 49 per cent and allowing foreign-owned but purely domestic ("Canada only") carriers. In *banking*, the limit on a single shareholder's ownership of a bank has recently been raised from 10 to 20 per cent and now applies only to the largest banks. Additional moves in this direction would further promote potential competition. Restructuring of the *electricity* industry is also lagging behind many other countries. Ontario abandoned its retail deregulation when prices increased sharply, with the taxpayer now picking up the difference between the low fixed retail price and what generators receive in the spot market. Despite attractive wholesale prices, private investors are holding back from building new capacity due to uncertainty about the regime they will face in the future and the possibility of substantial nuclear power capacity being refurbished.
- *Revamping the Agreement on Internal Trade.* One obstacle to competition has traditionally been the array of differences in provincial regulations. Important progress in dismantling barriers to internal trade was made in 2001 with the elimination of most remaining restrictions on labour mobility. But other long-standing issues appear intractable within the current framework, including dealing with the energy sector, agriculture and investment incentives and extending the government procurement provisions. Indeed, the dismantling process now seems to be grinding to a halt, preventing firms from fully exploiting economies of scale. The *Agreement on Internal Trade* therefore needs to be broadened and strengthened. For example, it should be extended to cover the balkanised securities sector (two committees will report on securities regulation this year). More generally, new procedures for reaching agreement among the provinces may also be needed, such as majority rather than consensus decision-making and automatic application of mutual recognition principles in cases where meaningful agreement cannot be reached. In addition, the dispute resolution procedure also needs to be improved: it is slow, costly and lacks teeth because rulings are not binding.
- *Improving adult literacy.* Human capital is a notable strength, with a well educated adult population and excellent achievement by students of school-leaving age. However, this good performance is concentrated in the middle of the distribution. Canada does less well at the two extremes. At the top end, too few school leavers go on to degree programmes at universities. Access to university education could be improved by extending eligibility for the tightly-targeted student loan scheme to more middle-income families. At the bottom end of the distribution, adult literacy is a problem. Although average literacy levels are good, a small number of people seriously underperform by international standards. Provincial governments have taken many steps to improve the adult education system, but it remains underfunded, with long waiting lists in some areas and does not seem to be adequately catching those who need it most. ■

How can Canada make the most from migration?

Immigration policy is seen as part of Canada's strategy to boost its human capital. Receiving substantial numbers of immigrants is in line with Canada's historical tradition, though the focus of selection policy has shifted over time: from settling land to recruiting industrial workers, then to filling specific occupational shortages and, finally, to attracting highly skilled workers who can integrate effectively in a knowledge-based economy. At present, most immigrants are admitted for their skills or are accompanying family members, although substantial numbers are also admitted on family reunification and humanitarian grounds. Immigration is widely seen in a favourable light: its potential economic benefits include positive spillovers from a larger and more culturally diverse pool of human capital, filling skill shortages and smoothing the fiscal burden of ageing, albeit modestly.

An essential condition for such benefits to be realised is that immigrants can integrate effectively into the labour force. Understandably, the deteriorating relative economic performance of the immigrants who arrived over the 1980s and the 1990s has been a cause for concern. The difficult labour-market conditions that prevailed during much of this period account for part of this deterioration, and some signs of an improvement have appeared in the last few years. However, the earlier negative trend also had structural causes. Although their educational levels have risen in step with those of their Canadian-born counterparts, recent immigrants seem to obtain lower returns than their predecessors for their foreign-acquired education and work experience. This is in part because their credentials are not fully recognised, but also in part because their proficiency in Canada's official languages is lower than that of earlier immigrants, a handicap whose importance may have increased in a knowledge-based economy.

Both federal and provincial governments are attempting to address these problems. Programmes to help immigrants to integrate into the host society and into the labour market, mostly run in collaboration with local communities, are reasonably effective. Entitlements to government benefits and services provide effective social protection without creating a culture of dependency. Moreover, the school system does a good job in integrating immigrants' children, so that the second generation seems to experience no disadvantage. But improving the process by which immigrants get their credentials recognised has proven difficult. The steps that have been taken so far – setting up specialised agencies for the assessment of academic qualifications, putting pressure on professional bodies to make their standards and procedures more transparent, disseminating information about the latter among applicants and encouraging them to start the recognition process early on – all go in the right direction. These efforts should continue to be intensified, since the payoff is potentially large.

Immigrant selection policies now emphasise adaptability and general skills, including knowledge of Canada's official languages. This is sensible, as previous attempts at skill-based micro-management proved too difficult in a rapidly changing economy. The latest changes were introduced only last year and it will take some time to see their effects, but both the analysis of past immigrant outcomes and the experience of other countries suggest that Canada could go further in the same direction. For example, it would be consistent with the new emphasis on adaptability to target a younger age range and to make a minimum level of language skills a requirement for economic immigrants (rather than just one element in the points tally), while reducing the weight assigned to past work experience. The recent decision to make it easier for temporary foreign workers who have been in Canada for some time and already have a job to apply as permanent immigrants filled an obvious gap in the system; introducing a similar possibility for foreign students with a job offer could be explored.

Canada is part of an increasingly integrated North American labour market, where the higher returns to skills offered by the US economy continue to exercise a strong enticement. Indeed, emigration increased in the mid-1990s, partly as a result of diverging labour-market conditions in the two countries, as well as specific push or pull factors in certain professions (*e.g.* health-care workers, computer specialists). But with the net flow of university graduates still clearly positive, concern about a "brain drain" seems to be overstated. In the context of the global trend to greater international mobility of the highly skilled, attracting such workers from abroad and retaining its own will be facilitated if Canada is successful in its efforts to raise living standards and remain an attractive place to live and work. This includes finding the right balance between lowering taxes and achieving better value for money in public spending. ■

Is fiscal policy too focussed on the short term?

Managing longer-term fiscal pressures is a further challenge. Federal policy for the past few years has been to set a balanced budget, after putting aside contingency and prudence margins of around 0.3 per cent of GDP in each of the two following years, increasing spending or cutting taxes to aim to absorb whatever is left. In recent years, however, stronger-than-expected output growth has allowed debt reduction averaging nearly 1 per cent of GDP per annum. Strictly maintaining a policy of balancing the budget or better in the event of a sufficiently significant downturn would force the government to take pro-cyclical fiscal measures. Moreover, a future upturn could lead to unsustainable increases in baseline fiscal commitments because increasing spending or cutting taxes in an upswing is easier than reversing those actions in a downturn. Adding more medium-term elements to the framework by adopting a broader set of financial objectives over a longer planning horizon, including, for example, a medium-term debt target, would avoid this problem and better ensure that the stance of fiscal policy is appropriate to the business cycle. To the government's credit, however, it should be noted that it has taken several efficiency-enhancing steps to improve public expenditure management. These include re-introducing a programme review process, moving to accrual accounting and fixing the longstanding problem of an excessive premium rate on the EI scheme (partly by cutting the rate, partly by enriching benefits). It also intends to improve the governance of any future arms-length foundations, which are increasingly being used to implement public policy, and will attempt to upgrade arrangements for existing ones.

This year's budget left virtually no fiscal room over the next few years for further spending increases, tax cuts or debt reduction beyond what is already planned. Increased spending – especially on health care – and further small personal and corporate tax cuts leave the projected federal balance around zero (after setting aside the safety margin) until at least 2008. With provinces also near balance, the healthy-looking general government position is largely due to the public pension surplus.

From a longer-term perspective, it is not clear whether a balanced budget is good enough. The fiscal position will come under heavy stress when the baby boomers begin to retire. The government has taken several steps to put its finances on a sound footing, including pre-funding the earnings-based component of the public pension. However, the pension burden is projected to rise a little over the next 3 decades, and several other fiscal risks remain. The pension system could be much more expensive than expected if the real rate of return on investments is less than the assumed 4.5 to 4.7 per cent per annum or if price indexation of the first-pillar pension cannot be sustained. These risks are dwarfed, however, by the risks to health spending. Long-term "baseline" fiscal projections are fairly favourable, with net debt being eliminated over the next 40 years, provided that spending on health care by each age group rises no faster than incomes (and also assuming that the government allows primary surpluses to grow over the next couple of decades). However, even slightly quicker growth in health-care costs could make the fiscal position unsustainable. Unless effective measures to control these costs are put in place, it would be prudent to save more now by targeting surpluses of perhaps ½ to 1 per cent of GDP. ■

How healthy is the health system?

Canadians need to confront the longer-term issue of how much they are collectively willing to spend on health and through which mechanisms costs should be controlled and spending allocated. Core health services provided under the Canada Health Act (CHA) – roughly speaking, doctors' visits and most hospital-based care – are free of charge, so there is little apart from queuing that can currently be used to control spending. In response to public dissatisfaction with supply shortages, the federal government substantially lifted funding to provinces as part of this year's inter-governmental *Accord on Health Care Renewal*. However, the system is not demonstrably under-funded; in fact the expenditure share of GDP is among the highest in the OECD. Current supply problems are therefore more likely to reflect structural factors. Given these bottlenecks, the immediate challenge is to make sure the extra money buys an increase in output rather than simply pushing up wages and prices in the sector. The longer-term challenge, however, is to deal with the underlying structural problems. While there are no easy answers, there are several options for reform. *First*, considerable efficiency gains could be obtained by improving the institutional framework. Steps could include reform of primary care, using alternatives to fee-for-service payments for physicians once provider supply shortages have been resolved, adopting output-based funding mechanisms for hospitals, making more use of contracting out and enhancing the information base in order to improve management decisions. *Second*, demand could be controlled more effectively by making more use of cost sharing mechanisms such as user charges and co-payments, so long as this does not compromise equality of access nor health outcomes. This will become increasingly important if the government broadens the CHA to encompass home care and catastrophic drug coverage, as it plans to do. ■

How can growth be made more environmentally friendly?

Longer-term sustainability issues extend beyond public finances to encompass social and environmental developments. While large parts of Canada are free of many of the environmental difficulties faced by other OECD countries, there are nevertheless a number of sometimes severe localised problems, some of which call for careful co-ordination of policies across jurisdictional boundaries. In particular, the eastern provinces could usefully design a trading system for sulphur emissions in order to reach their targets, and this could be generalised to cover other local air pollutants. There are also localised water problems related to the use of manure as a fertiliser and more specific issues that have arisen with inadequately controlled water supply systems. It is difficult to determine whether relying on codes of good practice is sufficient to ensure high-quality drinking water in the absence of systematic monitoring; gathering such information should be a priority. Further investment is needed to reduce the chances of accidental pollution, and the cost of this would best be met by charging users on a full-cost basis.

In ratifying the Kyoto agreement last year, Canada has signed up to an ambitious target for greenhouse gas emission reductions, especially as its major trading partner has set itself a much easier goal. Canadian emissions are currently high and by 2008–12 are projected to be 42 per cent above its Kyoto target. The challenge is to reduce them without imposing an unmanageable burden on the economy, or on particular industries or regions, as emissions are very unevenly distributed. The government's proposals include a permit trading scheme for large industrial emitters, but it covers just 40 per cent of projected emissions and will deliver only a small part of the required reduction. If this scheme is to be efficient, emitters will need to be able to buy permits abroad in order to back their emissions. Outside this sector, the government has ruled out the use of a uniform carbon tax linked to permit prices on world markets, which would have been an efficient way to guarantee the lowest-cost abatement. Instead, it has made a large number of additional proposals, including voluntary agreements, covenants with major industries, command-and-control measures and subsidies. Taken together, these will probably be unnecessarily costly as marginal abatement costs will differ widely and will, in some cases, far exceed the international permit price. These measures will almost certainly not ensure compliance with the target, so the government has indicated that it is developing additional measures and is willing to cover any excess emissions by purchasing permits on the world market, despite the fiscal risks involved. ■

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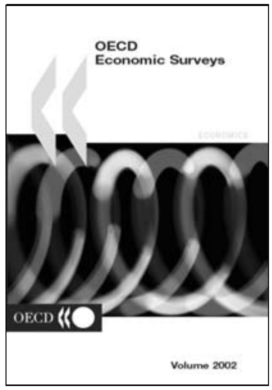

- **Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at *www.oecd.org/eco*.

- **Economic Outlook No. 73,** June 2003. 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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