"The IMF's Structural Adjustment Programme for Canada 1994-1995"

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INTERNATIONAL MONETARY FUND
Article IV Consultation with Canada
Statement of the Fund Mission
Ottawa, December 7, 1995

1. Two years ago, the Government defined its central policy objective as the sustained expansion of output and employment, stressing the importance of low inflation, fiscal adjustment, and labor market reforms in achieving that goal. The Government and the Bank of Canada have made considerable progress in pursuing that strategy: inflation has been kept low and is projected to fall; the federal fiscal deficit has been put on a downward path; program spending has been cut to its lowest levels in many years; and a reform of social programs, including the unemployment insurance system, has begun in earnest. In the period ahead, it will be crucial to maintain the momentum of adjustment in order to lock in the gains made so far and solidify market confidence, particularly given the risks stemming from political developments.

2. Even with the ongoing recovery in economic activity, there is considerable slack in the economy, and CPI inflation is projected to decline into the lower half of the 1-3 percent target band in 1996 (Table 1). Thus it would be appropriate for the Bank of Canada to seek an easing of monetary conditions, particularly if a strong pace of fiscal adjustment by the federal and provincial governments were to result in a substantial withdrawal of domestic demand. However, recent experience shows that aggressive efforts to reduce interest rates could be resisted by financial markets, and it is advisable to undertake monetary easing with caution, as the Bank of Canada has been doing.

3. With the strong measures taken in the past two budgets, the Government is on track to meet its deficit reduction target for 1996/97 (Table 2). After 1996/97, however, the pace of adjustment in the structural deficit would slow sharply, despite strict expenditure control, because of the prospective reduction in the unemployment insurance premium to about $2. The slackening in the pace of adjustment would leave the federal finances in a vulnerable position. The federal debt/GDP ratio, although declining, would continue to be extremely high at around 66 percent at the end of the century, while interest payments would absorb one third of government revenue. An additional source of concern is the large, and growing, unfunded liability of the Canada Pension Plan.

4. The large size and relatively short maturity of the federal debt-- despite efforts to lengthen the maturity--make the budget highly vulnerable to interest rate shocks. The recent period has shown that market confidence in Canada's longer-term prospects is tenuous and can be easily shaken by domestic political events, concerns about the fiscal situation, or financial crises outside Canada. In this context, a faster pace of fiscal

adjustment, with a more rapid reduction in the debt/GDP ratio, would enhance the credibility of the fiscal program and lessen the risk that the adjustment process could be derailed by an economic downturn or other shocks. It would also facilitate the Bank of Canada's efforts to support the economic expansion through an easing of monetary conditions and encourage a decline in real interest rates.

5. In the mission's view, it would be appropriate for the Government to aim to reduce the budget deficit to about 1 2 percent of GDP in 1997/98 and to about 1 percent of GDP in 1998/99. On the basis of present projections and making some allowance for the risk of higher interest rates, these targets would require additional measures yielding between 6 and 9 billion dollars in 1998/99. The type of actions that could be contemplated in the spending and revenue areas are shown in Table 3. In the near term, in particular, it will be critical to maintain the overall tax effort by phasing in slowly the cut in the unemployment insurance premium and offsetting the revenue loss through other means. In certain areas, such as unemployment insurance, the tax system, and pension benefits, further action is required not only to strengthen the fiscal position but also to bring about structural reform.

6. The proposed reform of the unemployment insurance (UI) system, together with the earlier reforms, go a long way towards curtailing the UI system's adverse effects on the labor market. Future reform efforts could aim at eliminating regionally extended benefits and introducing experience rating. The reform proposal also calls for an expansion of programs to assist the unemployed in preparing for and finding a new' job. However, the experience of many industrial countries suggests that the effectiveness of such programs is questionable, particularly if account is taken of the employment cost of the payroll taxes used to finance them. Serious consideration should be given to reducing the scope of these programs and using the savings to cut the budget deficit or the UI premium.

7. In order to offset the loss of revenue entailed by the prospective reduction in the UI premium, consideration should be given to broadening the bases of the income tax and the Goods and Services Tax (GST) and to raising the GST rate, actions that could improve efficiency and strengthen incentives for saving. The federal government has been negotiating with the provinces to harmonize the GST with provincial sales taxes. Harmonization would improve the efficiency of the indirect tax system by shifting the incidence of provincial taxes away from intermediate inputs to consumption, and it could also permit a reduction in the costs of compliance and tax administration. However, it will be important to ensure that harmonization is reached without a significant erosion of the GST base.

8. Demographic trends will put considerable financial pressures on the federal government and the Canadian Pension Plan (CPP) unless benefits are reduced and the contribution rate and retirement age are raised. With regard to the OAS-GIS system, it would be appropriate to replace the transfers and tax credits with a combined benefit, as explained in Table 3, while raising the age of entitlement and recovering a greater portion of the benefit from higher-income families.

9. The present CPP contribution rate is about half of the actuarially fair rate of 10-11 percent of earnings. consequently, the CPP has accumulated an unfunded liability estimated at 70 percent of GDP, a level similar to the recorded net federal debt, This liability will continue to mount unless the CPP contribution rate is raised fairly quickly to the actuarially fair rate. In the longer term, the unfunded liability will have to be dealt with
through further increases in the CPP contribution rate, reductions in benefits, an increase in the retirement age, and measures to generate savings in the federal budget. It will also be desirable to maximize the
yield of the CPP's assets. In this connection, consideration should be given to assigning the investment of these assets to private portfolio managers under strict supervision.

10. The February 1995 budget took a major step toward rationalizing federal transfers to the provinces in a manner that will assist provincial efforts to reform major social programs in the face of tight fiscal constraints.
With the exception of Ontario and Quebec, the provinces have adopted in recent years sound fiscal adjustment programs and most are expected to achieve budget balance by 1996/97. Recently Ontario announced measures to reduce its deficit through sharp cuts in spending. Quebec, however, has yet
to formulate a much-needed deficit reduction program.

11. Canada has continued to show its strong support for free trade by passing the legislation needed to implement the Uruguay Round Agreement and signing the interim financial services accord reached last July. Tariffs have also been reduced on a wide range of manufacturing inputs, and further consolidation and simplification of the tariff structure are intended. In the agricultural area, the elimination of the Western Grain Transportation Act subsidy is welcome. At the same time, the supply-management system and
the associated prohibitive tariffs for certain agricultural commodities continue to be major impediments to efficient resource allocation, resulting in unduly high prices for Canadian consumers.

Table 3: Canada -- Illustrative
Revenue end Expenditure Adjustment 0ptions

	Comment	Yield 1/ ($ billion)
Elderly benefits	The current system of elderly benefits is generous and provides substantial benefits to middle and higher income pensioners. The February 1995 budget made relatively minor adjustments to elderly benefits and consideration needs to be given to more fundamental reforms that would help ensure the sustainability of the system, including raising the age of entitlement, especially in view of the prospective rise in the dependency ratio. In the nearer term, combining the OAS/GIS transfers and the tax credits, and recovering the combined benefit on the basis of family income, would substantially reduce the system's complexity, improve its horizontal equity, and amplify the means testing of benefits.	1.0

	Substantial fiscal savings (in the 3-4, billion range in l997/98) could result by providing a universal, combined benefit that would be reduced by 50 percent of the amount of other income received between zero and $12,000 (roughly the level of income at which GIS benefits are currently fully recovered for single pensioners) and at a 25 percent rate thereafter. More modest savings (roughly $1 billion) could be achieved by recovering the GIS portion at a 50 percent rate for incomes up to $l2,00O and recovering the balance at a 15 percent rate for incomes above $25,100.	1.5 2/
Transfers to other levels of <u>goverment</u>	Substantial progress was made toward rationalizing the system of federal-provincial transfers as part of the l995 budget. However, additional reforms are needed which could provide further fiscal savings. A formula still needs to be defined to determine the size and allocation of the <u>Canada Health and Social Transfer</u> and consideration could be given to cutting the transfer in the near term to a low and stable level. Given that the cash portion of the transfer is projected to fall to zero in the longer term, this would not imply a permanent improvement in the federal budgetary situation.	
	Equalization payments may reduce incentives for provinces to increase their tax bases and do not redistribute according to provincial spending needs. At the same time transfers to the territorial governments, which were cut in the February 1995 budget, are still high on a per capita basis. Reforms of these programs could include reductions in overall federal outlays.	1.3 - 3/
Schedules and other transfers	While the February 1995 budget made substantial cuts in federal grants and subsidies there would seem scope for further reductions. Areas where additional savings could be sought include: agriculture subsidies, including the Dairy Subsidy and the Net Income Stabilization Account, are projected to be 0.7 billion in 1997/98; Canadian Heritage ($0.4 billion in 1997/98); the regional agencies ($0.3 billion in 1997/98); human resources programs ($2.2 billion in l997/98); Small Business Loans ($0.2 billion); grants to aboriginal peoples ($4.4 billion); and science and technology ($0.9 billion).	

1/ Yield estimates are for 1997/98.
2/ Roughly 15 % of the projected 1997/99 level of the cash portion or the CHST.
3/ Roughly 10 % of projected 1997/98 amount

<u>Revenue end Expenditure Adjustment 0ptions</u> (cont-d)

	<u>Comment</u>	<u>Yield 1/</u> ($ billion)
Crown Corporations	Subsidies to Crown corporations remain large and may be difficult to justify on efficiency or other grounds. Cuts could involve, inter alia, eliminating transfers to the CSC, VIA Rail, the National Film Board, and the Canadian Film Development Corporation and reducing transfers to the Atomic Energy Corporation and the National Capital Commission.	1.6 1/
Defense and other departmental spending	The 1995 budget made substantial cuts in the area of defense but additional savings may be needed to archive fiscal objectives. In addition, the February 1996 budget called for reductions in general government consumption of goods and services roughly equivalent to a reduction in general employment of about 45,000 (14 percent) Further	1.5 2/

cuts in civil service staffing would be warranted especially if additional reductions in federal transfer programs can be achieved.

Unemployment Insurance

The December 1996 UI reform proposals, as well as measures adopted in recent years, are likely to improve significantly labor market flexibility. However, the economic efficiency of the program could be enhanced further by measures including the introduction of experience rated premiums and larger in reductions in regional differences in UI benefits.
Also, the benefits of active labor market policies are questionable, especially given the distortionary effects of the payroll taxes financing these programs. Under present policies, annual UI cashflow surpluses totaling over 1/2 percent of GDP are projected to be eliminated in 1997/98; it will be important to maintain these surpluses until replacement fisca1 savings are found. 4.5 3/

Tax measures

The federal revenue to GDP ratio is projected to decline by about 1/2 percentage point between 1996/97 and 1997/98, mainly owing to the projected reduction in the UI premium rate. Further downward pressure on the revenue ratio is expected owing to a prospective rise in the (deductible) CPP contribution rate. In light of the need for deficit reduction, it will be important to maintain federal revenues at roughly current levels as a share of GDP. Measures that could be used to achieve this objective include:

Goods and Services Tax (GST): An increase in the GST rate of 1 percent would yield roughly $3 billion in 1997/99 while at the same time strengthening incentives for private sector saving. Also, the efficiency of the GST could be strengthened by broadening its base to include basic groceries (raising the rate from zero to 7 percent would yield roughly $3 billion in 1997/99).

Personal Income Tax Expenditures: Personal income tax expenditures could also be reduced, including those for lottery and gambling winnings, employer paid health premiums, small business shares, capital gains (including the basic 25 percent exclusion and the $500,000 lifetime exemption for small businesses and farm property), education expenses, workers' compensation benefits, and Northern 3enefits. These specific tax expenditures are estimated to have cost $5 billion in 1992; cuts in this area could have a significant yield without adversely affecting the efficiency of the tax system.

Corporate Income Tax Expenditures : Reductions in corporate income tax expenditures also could assist in deficit reduction. For example, preferences for small business and research and development are considered to be relatively generous and are estimated to have cost $2.6 billion in 1991.

1/ Assumes elimination of transfers to the CBC, VIA Rail, the Canadian Film Development Corporation, the National Film Board and a 50 % cut in other transfers. all relative to projected 1997/1998 levels.
2/ Assumes a 5 percent reduction from projected 199.7/98 levels,
3/ Equal to 1/2 percent of projected 1997 GDP.

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

May 18, 1995

The Honorable Paul Martin
Minister of Finance
Ottawa, Canada

Dear Minister:

I understand that you and your colleagues will soon begin the process of shaping the 1996-97 budget, and are considering a number of important structural reforms. I would like to take this opportunity to summarize some of the key points that were raised during the Executive Board discussion of Canada's 1995 Article IV consultation on May 3.

The Board generally commended the Canadian authorities for their conduct of monetary and fiscal policy in the recent period, which was viewed as having contributed to Canada=s strong growth and low inflation. In particular, the February 1995 budget, which showed considerable political courage, was considered a significant step toward reducing the federal budget imbalance.

However, there was a consensus among Executive Directors that important challenges remained. In particular, while the 1995 budget would permit a reduction of the federal deficit to 3 percent of GDP by fiscal year 1996-97, it would still leave federal debt and interest payments at extremely high levels by international standards. Hence, the fiscal position would continue to be vulnerable to adverse interest rate shocks from abroad or to an economic downturn. Moreover, concern was expressed that the persistence of a sizable fiscal imbalance would increase the risk of a loss of confidence in the Government's economic policies, and could lead to higher interest rates and a. weaker currency.

There was broad agreement among the Directors with the staff's view that a more fundamental correction of the fiscal situation was warranted. Specifically, there was a call for a front-loaded package of additional
measures that would lead to a mare rapid balancing of the budget and put the debt/GDP ratio and the interest burden on a clearly declining path. Such action would strengthen market confidence and help alleviate pressures on interest rates. It also would strengthen national saving, contribute to an improved external current account performance. and improve Canada's growth prospects.

During the course of the Article IV Consultation discussions in Ottawa, the Fund mission prepared a detailed list of measures that could be considered to reduce the deficit to below 2 percent of GDP by 1996-97 and to
well below 1 percent of GDP by 1998-99. The February 1995 budget took measures in many of the areas identified in that list but there seems to be scope for additional action in a number of important areas. In particular:

Elderly benefits: The current system of federal benefits to the aged is very generous, providing substantial benefits to middle- and upper- income pensioners. Early action to increase the means testing of the system would yield considerable fiscal savings. At the same time, the unfunded liability of the Canada Pension Plan is one of the largest among the industrial countries in terms of GDP. In order to resolve this situation, an increase in premiums or a reduction in benefits will be required. In this connection., consideration also could be given. to raising the age of entitlement for public pension benefits.

Unemployment insurance: Reforms are needed in the unemployment insurance system so that it provides short-terra basic income support without discouraging job search. This would help reduce the structural rate of unemployment in Canada, which is high by international standards. While such changes would not provide a permanent improvement in the fiscal situation, they could be used to build up a higher surplus in the short term, while other fiscal adjustment measures are phased in

Subsidies and other transfers: Considerable progress was made in reducing industrial and agricultural subsidies. However, transfer payments are expected to remain large for the Crown corporations, cultural subsidies, and employment programs. Since these programs often lead to an inefficient allocation of resources, there would seem to be scope for further saving in this area.

Transfers to other levels of Government: The current system of federal-provincial transfers may have led to inefficient provincial spending programs, an overdependence on federal transfers, and reduced incentives to develop provincial revenue bases. The first step toward reforming the system was taken with the establishment of the Canada Social Transfer. However, the modalities for determining the site and allocation of these transfers still need to be addressed. This could provide the opportunity to achieve further saving.

Tax Policy: The scope for increasing tax revenues may be limited given that effective tax rates are already high compared to the United States and many other industrial countries. However, the potential exists for adopting measures that would broaden the base for the Income tax and Goods and Services Tax, thereby improving their horizontal and vertical equity.

In closing, I would like to thank you and your staff for the cooperation that was shown to the Fund mission during the Article IV consultation discussions, and I wish you every success in your endeavors.

Yours Sincerely,

Michel Camdessus
Managing Director