SM/08/17
Correction 3

February 14, 2008

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Canada—Staff Report for the 2008 Article IV Consultation**

The attached correction to SM/08/17 (1/16/08) has been provided by the staff:

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 19, Federal Budget Table, Footnote 1, line 2: "It includes a GST cut of 1 percent point in 2010/11." removed

Questions may be referred to Mr. Bayoumi, WHD (ext. 36333).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

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Department Heads

Federal Budget: Staff Projections 1/
(In percent of GDP)

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Revenue	16.4	16.4	16.2	16.3	15.9	15.3	15.2	15.2
Outlays	15.6	16.3	15.2	15.4	15.2	15.1	15.0	14.8
Budget balance	0.8	0.1	1.0	1.0	0.7	0.1	0.2	0.4
Planned debt reduction	...	...	1.0	1.0	0.7	0.2	0.2	0.2
Planning surplus 2/	0.8	0.1	1.0	0.0	0.0	0.0	0.0	0.3
Net lending	0.3	0.8	0.1	0.6	0.4	-0.1	-0.2	0.0
Net debt 3/	40.9	38.3	35.0	32.3	30.0	28.6	27.2	25.7

Sources: Finance Canada; Haver Analytics; and Fund staff estimates.

1/ The projections are based on the baseline provided by the authorities' 2007 Economic Statement adjusted for staff macro assumptions. ~~It includes a GST cut of 1 percent point in 2010/11.~~
2/ Planning surplus = budget balance minus debt reduction.
3/ Assuming future planned debt reduction is achieved.

50. **This year's budgetary overperformance is to be used for tax relief and debt reduction**. With higher-than-expected nominal GDP growth and corporate income tax revenue, the budget surplus based on current policies is again expected to be substantial (¾ percentage points of GDP) this fiscal year. In the *Economic Statement*, the government proposes to use this overperformance to finance tax relief (¼ percentage point of GDP) and a one-off additional debt reduction (½ percentage points of GDP). Next fiscal year, the overperformance would be used to finance the full annual cost of the tax relief measures, and the projected surplus remains around the debt reduction target.

51. **The mission agreed with officials that the comfortable projected fiscal position provides room for permanent tax relief**. Indeed, given the worsening of the economic outlook, the fiscal stimulus in 2008 appears fortuitously timed. However, staff observed that there was a risk that some recent revenue gains (particularly from commodity industries) may be more temporary than expected. This underscores the importance of expenditure restraint, particularly given relatively rapid recent spending growth. While acknowledging the risk, officials emphasized that the *Statement* incorporated private economic and budget forecasts and that the assumed tax buoyancy appeared appropriately conservative, particularly in the light of past revenue overperformance.

52. **The major short-term uncertainty for the budget is the economic outlook given that the current fiscal framework does not encompass discretionary policy**. Staff calculations suggest that, given the size of automatic stabilizers, nominal GDP would need to slow by 1 percentage points more than in the baseline to push the federal government into deficit in fiscal year 2008–09. This implied either significantly lower real growth or a large fall in commodity prices. Senior officials emphasized that the current fiscal framework incorporated a fixed target surplus but did not exclude the possibility of running a deficit under unexpectedly adverse circumstances.

53. **Staff viewed the reduction in the federal GST tax rate (the Canadian value added tax) by a percentage point to 5 percent in the *Statement* as a missed opportunity**. As has been noted in previous consultations, larger gains in efficiency could have been

obtained by cutting other taxes (see also Chapter 6 of *Northern Star*, IMF Occasional Paper 258).

54. **Staff suggested that the priority for tax relief should be to reduce high marginal effective rates (METRs) on capital, saving, and labor income (in that order)**:

- Accordingly, staff welcomed the 1 percentage point cut in the general corporate income tax rate in 2008 and its further reduction to 15 percent tax rate by 2012. This will have the added benefit of making corporate taxes more neutral with regard to firm size.

- Staff and federal officials agreed that harmonizing remaining provincial sales taxes with the GST base, thereby exempting business inputs, is also central to lowering METRs on capital. Senior officials observed that the government has stated its willingness to work with provinces on harmonization. Staff suggested that a more explicit offer of assistance—as had occurred in earlier efforts to harmonize sales taxes and to eliminate provincial capital taxes—might be a more effective approach.

- The team noted that marginal effective taxes on most forms of saving remain high. Additional measures, such as protecting all types of saving from taxes up to a cap, could help support wealth creation by moving personal income taxes closer to a consumption tax. Senior officials were sympathetic, while pointing out that it was also important to ensure neutrality of taxation across saving vehicles, and that there had recently been a significant rise in the pension income amount eligible for tax relief.

- Staff welcomed the reduction in the lowest personal income tax rate by half a percentage point to 15 percent and the introduction of the Working Income Tax Benefit (a negative income tax).

55. **The team suggested that increasing the relative importance of indirect to direct tax revenues is one way of lowering high marginal tax rates on income**. This proposal, which has also been suggested by some think tanks, would also help maintain the tax base in the face of commodity cycles and population aging. One option for creating room for income tax relief would be to follow the example of British Columbia and explore introducing a carbon tax. Officials responded that the government had chosen to reduce carbon emissions through other means.

56. **While generally supporting the reformed system of equalization transfers to provinces, the mission noted some areas where transparency is still lacking**. Among the key elements of the system are a return to including all provinces in the formula determining transfer payments, the partial inclusion of revenue resources, and a cap on Equalization transfers so that no receiving province has a higher fiscal capacity than a nonreceiving one. Staff observed, however, that agreements allowing some provinces to obtain additional transfers implied by the old system increased complexity. As with the previous Offshore Accords agreed in 2005, this could gradually undermine the rules-based approach.