

Canada: The best of times and the most challenging of times

THE GOOD NEWS

We Canadians are living in both the best of times and, perhaps, the most challenging of times. As of mid-2000, we seem to combine short-run optimism, if not euphoria, on the state of our economy, with medium-term concerns over the future of our country, our employers, and ourselves in a world of globalization and increasing continental integration.

On the first point, there is no doubt that the Canadian economy is on a roll. We have enjoyed super-strong job creation over the past couple of years. This has fed into rising disposable income, consumer confidence, and consumer spending. Tax cuts by the federal government and many or most provincial governments are further raising disposable income. Investment spending on machinery and equipment has been picking up nicely. On top of all that, the United States continues to forge ahead, with positive effects on our exports.

In recent weeks we have been subjected to solid evidence of a slowing U.S. economy. This is a good thing when compared with the alternative. That alternative is a boom-and-bust U.S. economy with U.S. interest rates rising very substantially. Sharply rising U.S. interest rates would have presented the Bank of Canada with a dilemma—follow the U.S. rate hikes and risk stalling the economy, or not follow the U.S. rate hikes and risk an attack on our currency. Moreover, whatever the Bank of Canada did, the bust phase of a U.S. boom-and-bust cycle would have been bad news for Canada. We are still the mouse, and they are still the elephant. The good news is that the recent statistics from south of the border increase the chances of a soft U.S. landing, with minimal further U.S. in-

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terest rate hikes. This, to repeat, is further good news for us.

A BIG DROP IN LIVING STANDARDS

So much for the short-term outlook, which is about as good as it gets. On the other side of the ledger, many Canadians are worried about our medium-term future in a world of apparently shrinking borders and globalization. Notwithstanding our recent progress, for much of the 1990s Canada experienced declining absolute living standards and sharply declining incomes relative to the United States. Although the brain drain numbers are not particularly large (only a fool would argue against UBC

economist John Helliwell on the question of numbers), there is a risk that the invasion of our university campuses by the Microsofts of this world, not to mention a continuing relative decline in living standards, will exacerbate the brain drain issue in coming years. Canadians are worried about the powerful drawing power of a U.S. economy that has clearly been on a roll. People are also worried about the border-eroding effect of the Internet.

People are right to worry about these things. If we measure living standards by after-inflation, after-tax income per person, then two decades ago Canadian living standards were more than 80 percent of U.S. living standards. One decade ago, that number had dropped to 75 percent. Today, it stands at a little more than 60 percent. At the rate we're going, a decade from now Canadian living standards will be a mere 50 percent of living standards south of the border. Alternatively, we could measure living standards by real gross domestic product per capita, which includes not only take-home pay but also government-provided services in such areas as health and education. Even on that measure, Canada's living standards have declined relative to the United States over the past two decades, but at a less precipitous pace.

THE PRODUCTIVITY GAP

The other reason for medium-term concern is Canada's less than stellar performance on the productivity front. Over the last three years, Canada's productivity growth has shown only a modest increase, notwithstanding booming job growth. The United States, on the other hand, has experienced a very large increase in productivity growth over this same period. Much of our underper-

formance has been in the so-called new economy, in which the United States has experienced double-digit productivity growth and has also benefited from a much larger new economy relative to the total economy in the first place. Clearly Canada faces major challenges to keep pace with our southern neighbour in the new economy.

Now the reader may challenge this contention with the point that just about every economy in the world is behind the U.S. new economy. And the reader would be right. So, if we Canadians want to feel better about ourselves, we could compare our performance with that of non-U.S. economies. If we really want to feel good, we could compare ourselves with Russia. The problem, though, is that the United States is our dominant trading partner and neighbour. Like it or not, Canada-U.S. comparisons are most relevant for Canada.

My point, then, is that business-as-usual, status quo policies are inadequate for Canada in the new century. Let me offer two alternatives to the status quo.

AMERICANIZATION

One option would be to copy the Americans in the hopes of replicating their superior performance. If you can't beat them, join them. We could copy the Americans on everything from external tariffs to taxation and social policy. We could even go for a common North American currency, which is a euphemism for Canada using the U.S. dollar.

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There are two dimensions to this issue—politics and economics. On the politics, it's a question whether we attach any value to a distinct Canadian identity. Personally, I do, but that's just the political judgment of one citizen. On the economics, the question is whether we'd do better economically through the Americanization route. Here, my answer is "yes and no"—yes, we'd do better if we could reduce remaining border impediments, since that would enhance investment, both Canadian and foreign, on the northern side of the border; and no, we're much better off with a flexible exchange rate than we would be if we simply used the U.S. dollar.

CANADIAN ADVANTAGE

The better option, in my opinion, is for Canada to seek to do better than the Americans in selective areas, rather than simply to copy them. On the tax front, we should strive to reduce the Canada-U.S. gap on personal income tax. I also agree with Jack Mintz that we could do an Ireland by getting our business tax rates lower than those in the United States, and this could be done at the relatively

low cost of around \$3 billion.

In terms of non-tax policy, there is a role for government in fostering basic research and innovation and also in providing funds to the most pressing social needs, such as the homeless and the aboriginal population. At the same time, in both health and education, there is scope for Canada to outperform the Americans, with very positive longer-term implications for our economy and citizens.

It is important to emphasize that this is a problem involving the private sector as well as governments. Indeed, a recent report by Michael Porter and Roger Martin suggests that the problem resides at least as much in Canadian companies as in Canadian governments. So we have to hope that better policies will have a positive impact on the performance of Canadian businesses.

Finally, recent Canadian budgets have moved in the direction I am recommending, so it is possible to end on a note of guarded optimism for the medium-term outlook of the Canadian economy, as well as a note of guarded euphoria on the short-term outlook. ♣

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Finally, a huge economic literature documents the positive impacts on growth and productivity of public investment in infrastructure, education, training, health care, basic research, and development, and so on. The notion that public investment is unproductive is manifestly wrong. The thrust of current research is to show that the growth-enhancing impacts of well-selected public investments outweigh any inefficiency costs arising

from the taxes needed to finance the investment.

These points suggest a conclusion that is intuitively fairly obvious: good public programs can have economic benefits that justify the cost in terms of taxes. This leaves open a huge set of questions with regard to the mix of programs and tax measures that represent the best balancing of equity and efficiency goals. The implicit Canadian social bargain of higher taxes

in return for greater equality, greater security, and higher levels of "social cohesion" does not appear to have greatly eroded. "Tax rage" is easier to discover in editorials and columns than in public opinion surveys. That said, there is no reason for progressives to deny the case for some tax relief as growth picks up, as the cost of servicing accumulated public debt shrinks, and as needed reinvestments in public programs are made. ♣