

A New Framework for Economic Policy



Government
of Canada

Gouvernement
du Canada

Canada

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A strong economy is the essence of a strong society. My government will focus on a jobs and growth agenda. We will work with all our partners – provincial governments, business, labour, voluntary groups and individual Canadians.

Prime Minister Jean Chrétien
Quebec City, September 18, 1994

In Quebec City on September 18, the Prime Minister outlined four key components of the government's jobs and growth agenda:

- reforming social security;
- ensuring a healthy fiscal climate;
- reviewing government programs and priorities; and
- strengthening the performance of the Canadian economy in investment, innovation and trade.

A New Framework for Economic Policy sets out the context and broad directions that will shape the government's agenda for jobs and growth. The framework will guide what we *will* do in the future and what we *won't* do. Every decision will be consistent with the principles underlying the framework, including the difficult decisions that will be required in developing the 1995 budget.

The central theme of the paper is that more and better jobs for Canadians can only flow from sustained economic growth. The key to stronger growth is increased *productivity* through more innovative and efficient combinations of people, ideas, capital and resources. Building a

more productive economy requires that Canadians be equipped with the right skills; that businesses and individuals be ready to take advantage of new opportunities; and that Canada offer an attractive environment for investors and entrepreneurs, an essential condition for which is to restore the government to fiscal health.

The government is determined to work in partnership with all Canadians to create an economy worthy of Canada's great potential. *A New Framework for Economic Policy* defines how we intend to proceed.

A handwritten signature in black ink, appearing to read 'P. Martin', with a stylized flourish at the end.

The Honourable Paul Martin, P.C., M.P.
Minister of Finance

Introduction

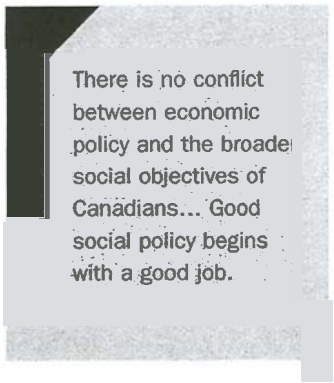
The purpose of this statement is to outline a comprehensive policy framework that will guide the Government of Canada in fostering economic growth and job creation.

We begin from the belief that the basic objective of public policy is to create the opportunity for every Canadian to achieve personal fulfillment through work and leisure in a free and just society.

These aspirations can be attained only through a dynamic economy that generates both ample employment opportunities and the financial resources to undertake those public endeavours – including health care, education, cultural development and assistance for the needy, among others – that have made Canada one of the world’s most civil societies.

There is no conflict between economic policy and the broader social objectives of Canadians – quite the contrary. Good social policy begins with a good job. And good jobs cannot be created by fiat. The central theme of this statement is that good jobs for Canadians can only flow from a productive, growing economy that possesses both the flexibility and the creativity to capitalize on the constantly emerging opportunities the world presents.

Today, those opportunities exist in a challenging new context created by the end of the Cold War and by the emergence of a profoundly interdependent global economy in which knowledge and the ability to shape information define the cutting edge of economic progress.



There is no conflict between economic policy and the broader social objectives of Canadians... Good social policy begins with a good job.

There are times in the life of nations when extraordinary opportunities and challenges demand extraordinary responses. We are now living in such a time. To place it in perspective, it is helpful to recall two other comparable periods during the past 50 years.

In the immediate postwar years, Canadians were challenged to adapt to peacetime and to the aftermath of the Great Depression. Our response during the decade from 1945 through 1955 was to undertake many of the great public projects that were to define the modern industrial architecture of the nation – for example; the Trans-Canada Highway, the St. Lawrence Seaway, and the gas and oil pipelines from the west.

A decade later, key gaps in the nation's physical infrastructure had largely been filled and strong economic growth was yielding unprecedented financial resources. Building on innovative ideas at both the federal and provincial levels dating from the early postwar period, the federal government set about to expand and consolidate Canada's *social* infrastructure. This was to ensure that all citizens and regions had a fair opportunity to share the full economic benefits of nationhood.

There followed through to the early 1970s a period of remarkable creativity and federal leadership in the realm of social policy, marked by the introduction of national medicare; the provision of the Guaranteed Income Supplement for seniors; the Canada Student Loans Act; and the inauguration of the Canada and Quebec Pension Plans. These measures were complemented by a host of new fiscal arrangements with the provinces including the enrichment of the 'equalization' program to ensure comparable levels of public services throughout the country; the sharing of provincial welfare and social services costs under the Canada Assistance Plan; major increases in federal support for post-secondary education; and a number of new initiatives to promote economic development in less advantaged regions.

Today, on the threshold of the 21st century, the opportunities and challenges facing Canada demand a different, but no less creative response. This statement begins to respond by setting out policy directions that will define a new economic mission for the Government of Canada.

The need to re-examine fundamentally the role and responsibilities of government was signalled in the February 1994 budget which was the first of two stages leading to wide-ranging policy reform. The objective of this reform is to help create an economy that will provide more and better jobs for Canadians, now and in the long run.

The key is to foster an economy that is more productive because that is the only way to provide better jobs and a rising standard of living. There is a complementary need to better prepare Canadians to take advantage of the new job opportunities that a more productive economy can create.

This will require active government and smart government, but not 'big government'. It will require co-operative government, committed to partnership with provinces, with business and labour, with communities and with individual Canadians. And it will require government that understands both its potential and its limitations – a government that can focus its energies where they are most needed and that possesses the will to live within its means.

The pages following will outline the ways in which the Government of Canada can best contribute, in partnership with the provinces and with business and labour, to an economic future that is worthy of our nation's potential. The presentation is organized as follows:

- **The Setting:** A description of the most important trends shaping the world economy today and their principal implications for Canada's economic future.
- **The Challenge:** A capsule review of Canada's post-war economic performance, contrasting the period before the mid-1970s with the years since when income growth declined, unemployment increased, government deficits became chronic, and public debt began to mount.
- **Jobs:** A summary analysis of the determinants of job creation and unemployment, the purpose of which is to explain why Canada's unemployment rate has trended up over the past three decades and how this trend can be reversed.
- **Income:** A review of the reasons why the growth rate of per capita income in Canada has declined since the mid-1970s and an identification of what will be needed to re-establish healthy income growth over the medium to longer term.

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■ **Framework for Growth:** Drawing on the analysis of the key factors responsible for job and income growth, five policy themes are identified to guide the government's actions to foster economic growth and job creation – (1) Helping Canadians to acquire skills; (2) Encouraging Canadians to adapt to new opportunities; (3) Getting government right; (4) Providing leadership in the economy; and (5) Creating a healthy fiscal and monetary climate. These five themes constitute an integrated framework of objectives for economic policy.

■ **Policy Themes:** A description of how each of the five themes contributes to job and income growth, together with illustrations of policies and programs that support the themes.

This statement does not introduce new policy proposals. The purpose of the statement is to outline an economic policy framework and the logic that underlies it. The initiatives that will give substance to the framework (beyond those measures already underway) will be developed by the responsible Ministers in the weeks and months ahead and furthered by steps to be announced in the 1995 budget.

1

The Setting

A strategy to foster economic growth and job creation in Canada cannot exist in a vacuum. It must be set in the context of a 'global village' of growing interdependence.

Economies everywhere are being shaped by three fundamental trends: (1) rapid evolution toward a globally integrated economy based on market principles, (2) the emergence of highly dynamic economies in what used to be called the Third World, and (3) a revolution in technology, based on the microchip and related innovations, that has put knowledge and information at the cutting edge of economic progress. The implications of these defining trends are the backdrop for the government's policy to foster economic growth and job creation.

1. Globalization: Economic integration has accelerated in response to spectacular advances in the speed and efficiency of communications and transportation. Liberalization of trade and investment policies world-wide has accommodated to, and fostered, this trend. The development of a round-the-clock global capital market, the rapid diffusion of the latest technologies and management techniques, and the 'free market' philosophies that now hold sway almost everywhere in the aftermath of the Cold War give continuing impetus to this global integration.

2. Developing Regions: Many of the forces propelling global economic integration are also responsible for the emergence of exceptionally dynamic nations and regions in what was once the Third World – notably in the Pacific Rim of Asia and parts of Latin America. These areas are now

reaping the payoff from an emphasis on education as well as from a range of policies to promote export growth and free market institutions. Drawing on huge indigenous populations with rapidly growing material aspirations, these new regions could add one or two billion new producers/consumers to the global market economy over the next 20 to 30 years.

3. The Information Economy: The unit cost of computer performance has been cut in half roughly every 18 months for the last three decades. Still, the power of information technology has only begun to be tapped. But already it is breaking down the barriers of time and space, undermining traditional forms of business and political organization, and transforming the perceptions and learning modes of the entire younger generation. In the advanced countries, *information* is replacing energy and raw materials as the key resource in the creation of economic value. A microchip, a new drug, or a piece of software has almost no material value. These products are the pure embodiment of information, here in the form of highly specialized knowledge.

Competition

All three trends – globalization, the emergence of dynamic new regions, and the information economy – are combining to increase dramatically the scope and intensity of economic competition. Since financial capital, technology and educated people can now be located and combined almost anywhere, the number of potential competitors is mushrooming. For example, a software writer in India can be in touch instantly, via satellite, with a corporate client in North America. Obviously, the knowledge-based industries will not be solely the preserve of the advanced economies. There are fewer and fewer refuges from the unsentimental test of international market competition.

On the other hand, the prospect of continued expansion of the newly developing regions promises to create a vast new reservoir of market demand in the world economy. Many in the industrialized world nevertheless see the growing export competitiveness of the poorer countries as a threat to jobs and wages. That may be true in certain low-productivity sectors. The counter balance is that rapidly developing regions almost always import more than they export as they build a capital base and

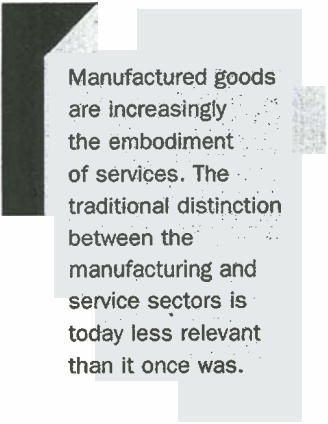
Expanding exports to Asia, Latin America and eastern Europe can be one of Canada's most important sources of new job creation in the future.

broaden their taste for sophisticated products of all kinds. It follows that expanding exports to Asia, Latin America and eastern Europe can be one of Canada's most important sources of new job creation in the future. This underscores the importance of furthering the multilateral liberalization of world trade.

Goods and Services

Employment in the industrialised countries has been shifting for many decades from the production of goods to the delivery of services. In Canada, the broadly defined service sector now accounts for more than 73 per cent of all jobs, up from about 65 per cent fifteen years ago. The falling proportion of jobs in goods production has largely been due to automation in manufacturing and, more recently, to the shift of certain labour-intensive activities to low-wage countries.

Less obviously, the shift also reflects the fact that manufactured goods are increasingly the embodiment of services. Much of the value-added in a modern automobile, for example, can be traced to sophisticated services such as design engineering, R&D, financing, software, marketing and distribution. Many of these activities are now 'out-sourced' to specialists and no longer show up in the job statistics of manufacturing firms. Raw materials and assembly-line production make up a diminishing proportion of the total value of manufactured items. For all of these reasons, the traditional distinction between the manufacturing and service sectors is today less relevant than it once was.



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New Jobs

The service sector itself has meanwhile been feeling the impact of information technology. Many traditional jobs – including middle management and other white collar functions in large organizations – have become redundant while a host of new and more decentralized activities, ranging from telemarketing to software engineering, are expanding to fill the gap. Often the jobs are not at all 'high tech' and have quite modest skill requirements.

It is likely that information technology will sustain long-term growth in service sector productivity, analogous to what has already been accomplished

by machinery and automation in goods producing industries. And since services account for about two-thirds of economic output and for almost three-quarters of employment, increased service sector efficiency is the key to significant productivity growth in the economy as a whole.

No one can say for sure where many of the *new* jobs in the service sector will be created, anymore than one could have forecast a century ago how those leaving the farm would eventually find work in cities and factories or, more recently, how employment in goods production would shift to service industries such as finance, health care, education and entertainment. The image of the service sector as a dead end, low-wage ghetto is far from reality. What is true is that poor skills can generally command only poor pay. But that is a central truism of the new world economy, whatever the sector.

Globalization and the emergence of huge new markets in developing regions imply that continued rapid change can be expected in sectors of the economy exposed to international competition. Many future jobs will be generated in businesses that adapt successfully to this competition. Perhaps even more significant will be entirely new fields of employment as information technology is applied to virtually every human activity. Applications in education, retailing, health care, entertainment and countless specialized areas will require millions of heads and hands to create and sustain. In fact, tomorrow's biggest new employers will almost certainly turn out to be in fields hardly dreamt of today. The future never fails to surprise. Who in the mid-1940s, for example, could have imagined the scale of today's financial industry, or of the industries spawned by jet aircraft, television and the computer? Our ability to predict is very limited; a capacity to adapt is therefore paramount.

The sea-change in the economic environment represented by globalization, emerging new markets, and the information economy has a number of more specific strategic implications for Canada. These point the way to promising new opportunities and also identify areas where Canada will have to overcome short-comings. The following brief assessment highlights a number of emerging issues that will need to be addressed as part of a new economic strategy.

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Attracting Investment

Since capital and talent are increasingly footloose, Canada and other small-market countries will be challenged to offer an attractive environment for risk-takers and for people with highly sought-after management skills in 'new economy' businesses. Key considerations include a welcoming business climate, a secure and healthy living environment (in part the result of forward-looking social policies), first-class infrastructure (including an excellent research environment), clusters of related industries and specialized skills, constructive labour relations, prudent fiscal and monetary policies, competitive tax rates, and political stability.

Canada's location in the North American bloc is clearly a plus, given the dynamism of the U.S. market. On the other hand, most foreign investors eyeing North America think first of locations in the United States. Canada will therefore be expected to more than meet the U.S. competition for new investment in many fields.

Canada suffers from a relative shortage of home-based transnational corporations, particularly outside the resource and financial sectors. (Among small countries, Sweden, the Netherlands, and Switzerland stand in sharp contrast.) Although most new direct job creation is taking place in small and medium-sized enterprises, large international corporations remain essential sources of financial, marketing and R&D strength in the global economy. A key challenge is therefore to strengthen Canada's ability to attract 'headquarters' functions such as marketing and R&D, as well as facilities with mandates to produce for world markets. This will require ongoing effort since all countries are competing fiercely for these same strategic activities.

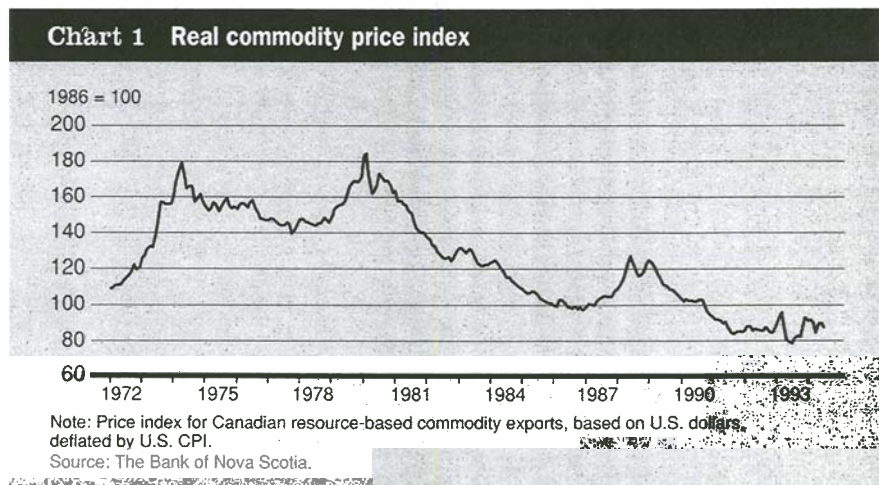
New Export Opportunities

Developing regions in Asia, Latin America and eastern Europe require vast new investments in infrastructure, public systems, and productive capital. The market potential is reckoned in hundreds of billions of dollars over the next two decades. Canada is particularly well-equipped to supply many of these new needs in view of this country's experience in transportation, resource development, energy transmission, communications, real estate development, financial services, engineering services, and health care, among others. But despite several success stories – which

prove the potential – Canadian firms have not been getting their proportionate share of the emerging business. Export financing, government-to-government negotiations, and development strategies for sectors with high export potential – such as the new federal strategy to boost the environmental industry – are key success factors, thus establishing an important role for federal policy.

Resource Industries

Canada's resource industries are in competition with producers in developing countries, now equipped with excellent technology and frequently with cost or regulatory advantages as well. In fact, Canadian resource companies and consultants are often at the forefront of the new overseas developments. Although a cyclical upswing in world commodity prices has recently begun, the longer term trend of most resource prices has been one of decline in the face of increased global supply (Chart 1). Developing country competition could push prices still lower in the medium term and squeeze further Canada's traditional source of export wealth.



Canadian producers will therefore be challenged to upgrade continuously the technological sophistication of the resource sectors and to more aggressively diversify their product and customer bases. This is already happening in a number of firms. Any lingering image of the resource-based industries as low-tech backwaters is far from the truth. The strong cyclical rebound in the profitability of most resource producers now provides the

opportunity to make the further investments in technology, R&D, and new market development that are needed to ensure the long-term prosperity of Canada's vital resource-based industries.

The Information Industry

Canada's service sector, which probably ranks second only to that of the U.S. in sophistication, can aim to become a world leader in applications of information technology in such fields as finance, public services, retailing, entertainment and design. This would sharply boost productivity in several key sectors of the economy while creating Canadian 'comparative advantage' in export markets for the systems and know-how. An encouraging regulatory policy and selective public investment in communications and other information infrastructure would provide strategic leverage.

Canada has several outstanding pools of research and technical talent in the computer and communications fields and a thriving population of small and medium-size businesses that create and use state-of-the-art information products and services. Firms of this type are highly entrepreneurial. Many die young only to be reincarnated in new guises, tougher and wiser. Such companies are the 'green shoots' of the 21st century economy and Canada appears to be an unusually fertile seed bed. The challenge is to ensure that as these and other specialized, knowledge-based businesses mature, they will be motivated to remain and grow in Canada. Since companies of this sort are among the most footloose and opportunity-driven, the environment that Canada presents to entrepreneurs must be made second to none.



Canada's thriving population of small and medium-sized businesses that create state-of-the-art information products and services are the 'green shoots' of the 21st century economy.


2

The Challenge

For more than a century, Canadians have been remarkably successful in creating an economy and a society that has made its way well in the world. By most measures, we enjoy a quality of life that is unequalled, a fact currently reflected by Canada's top rank on the United Nations' Human Development Index (Chart 2). Although the U.S. has higher per capita income, Canada has been able to strike an enviable balance in the social and economic dimensions of daily life. And we have created a multicultural society that many non-Canadians consider to be an exemplary model of tolerance and civility.

In short, Canadians have a great deal to be proud of and much to be thankful for. The issue, therefore, is not to criticize our failings – and we have our share – but to learn from them and to do what is necessary to ensure that Canada's future will be at least as bright as its past.

In drawing out lessons for a new strategy to foster economic growth and job creation, analysis must focus on the medium to longer term *structural* changes in the economy. The daily gyrations of markets, interest rates, and unemployment statistics are only symptoms (often misleading at that) of the more fundamental trends. To discern the factors that are most relevant for strategic policy making requires the perspective of decades. What follows, therefore, is a summary of the key facts of Canada's economic performance over the past 40 to 50 years.



The issue is not to criticize our failings but to learn from them and to do what is necessary to ensure that Canada's future will be at least as bright as its past.

Chart 2 Standard of living measures

United Nations Human Development Index, Ranking of Top Five Countries, 1994

Canada	1
Switzerland	2
Japan	3
Sweden	4
Norway	5

Note: The index is a composite of three components: longevity (measured by life expectancy), knowledge (measured by adult literacy and mean years of schooling) and the standard of living (measured by real per capita GDP).

Per Capita Income Ranking of G-7 Countries, 1993 (U.S. = 100)

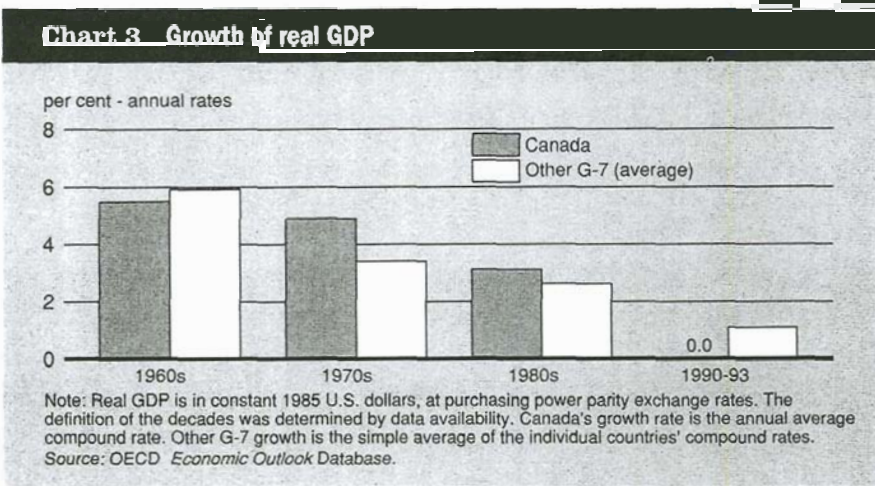
United States	100
Canada	84
Germany	83
Japan	83
France	77
Italy	73
U.K.	70

Note: Domestic incomes are converted to common currency at purchasing power parity exchange rates.

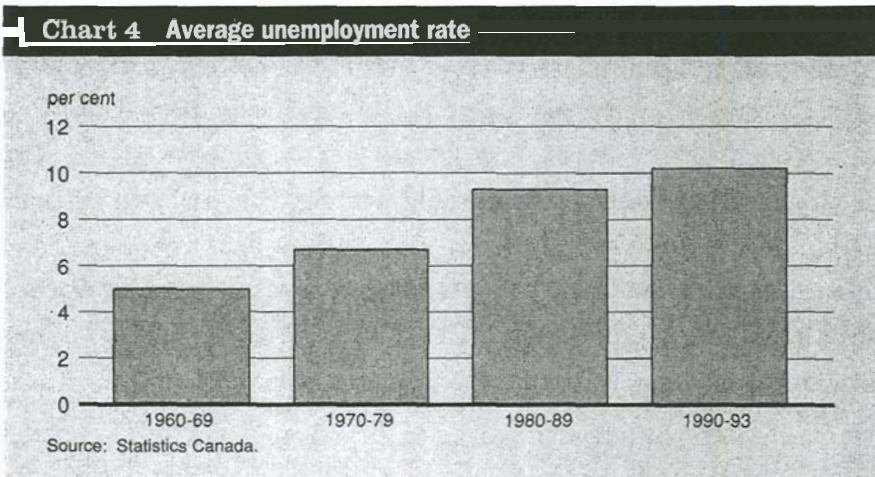
Sources: *United Nations Human Development Report (1994)* and the OECD

- Prior to the mid-1970s, Canada's economy delivered both high job growth and high per capita income growth – the latter deriving primarily from sustained strong productivity increases in the economy as a whole.
- The growth of economic output – i.e. real gross domestic product or GDP – slowed considerably after the mid-1970s both in Canada and in all G-7 countries (Chart 3). In the 22 years from 1953 through 1974, Canada's GDP growth rate was five per cent or more 13 times, but in only three of the 19 years since has annual growth topped five per cent. This long-term slowdown reflects a sharp decline in average productivity growth that began in the early 1970s and has persisted ever since. To varying degrees, all industrialized countries have experienced significantly slower output and produc-

¹ For example, Japan's real GDP per capita increased at an average annual rate of 7.3 per cent between 1962 and 1973, but by only 2.6 per cent during the next 10 years, 1973-1982. Comparing the same periods, U.S. per capita growth slowed from 2.6 per cent to just under 0.6 per cent while Canada dropped from 3.8 per cent to just over 0.8 per cent.



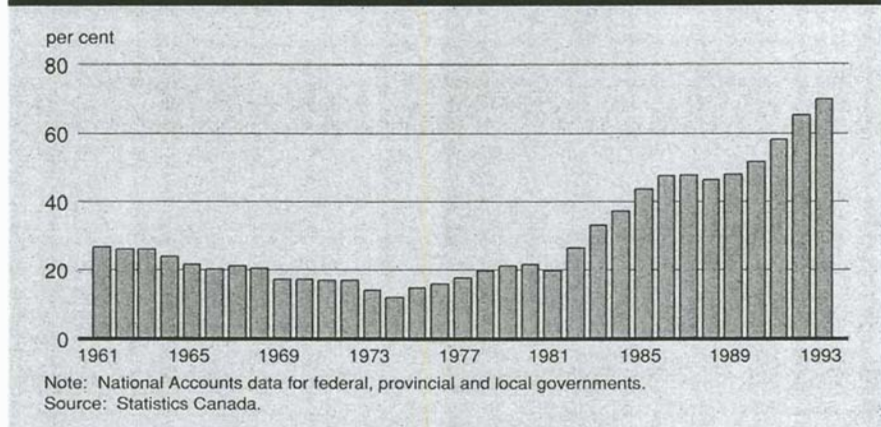
- Among the consequences in Canada of this great slowdown has been the stagnation of household disposable income which, on average, has not increased in real terms since the early 1980s.
- Meanwhile, the average unemployment rate has ratcheted up from about five per cent in the 1960s to more than nine per cent since the start of the 1980s (Chart 4).



- The last overall budget surplus (federal and provincial combined) was recorded in 1974. Revenues from a structurally weaker economy have failed to match expenditures for the past 20 years, despite rising tax rates. Total government debt – the accumulation of each year's deficit on a National Accounts basis – has consequently increased from 18 per cent of GDP in

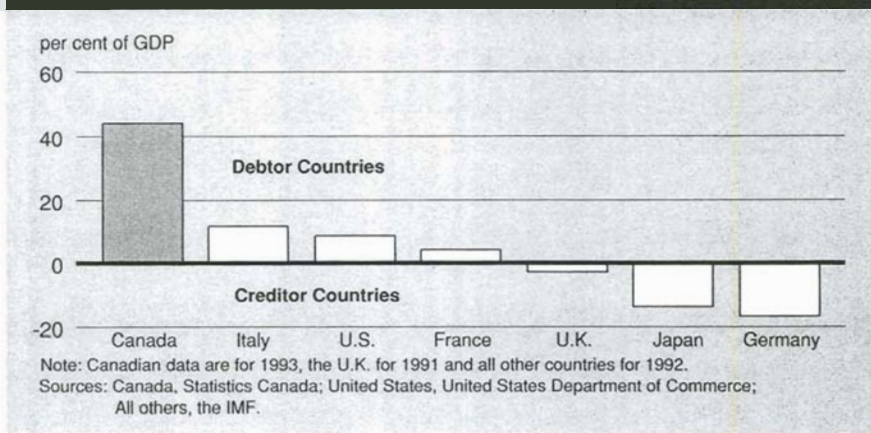
1974 to 70 per cent in 1993 (Chart 5)². Interest payments on the federal portion of public debt now account for roughly 35 per cent of federal revenue, up from 11 per cent in 1974 when the era of chronic deficits began. The compounding effect of debt service cost is now the sole factor driving up the ratio of federal government debt to GDP.

Chart 5 Net public debt as a percentage of GDP

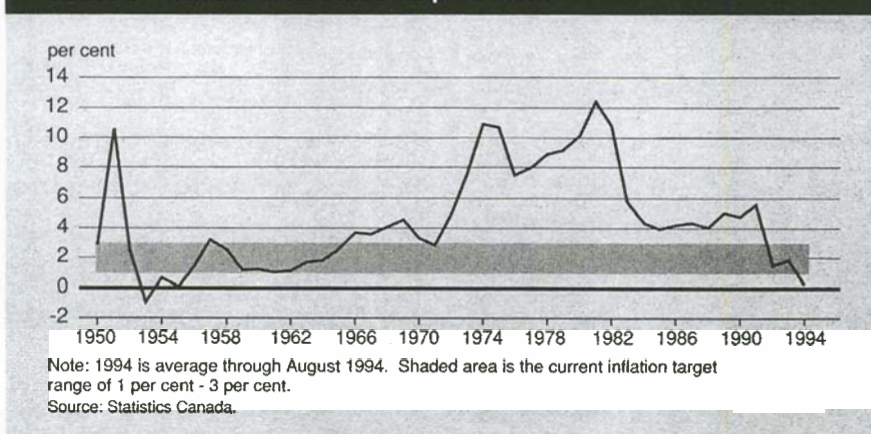


■ The nation as a whole has been spending more than it produces, thus having to borrow the difference abroad. A substantial portion of the borrowing represents the financing of *consumption*, not productive investment for the future. Chronic large deficits in Canada's balance of payments with the rest of the world have produced an escalating net foreign debt, owed jointly by the public and private sectors. (There has been only one year since 1973 in which Canada recorded a surplus on its 'current account' balance of payments.) By 1993, Canada's net external debt had reached \$313 billion, or 44 per cent of GDP. This is by far the highest relative foreign indebtedness among the G-7 countries (Chart 6).

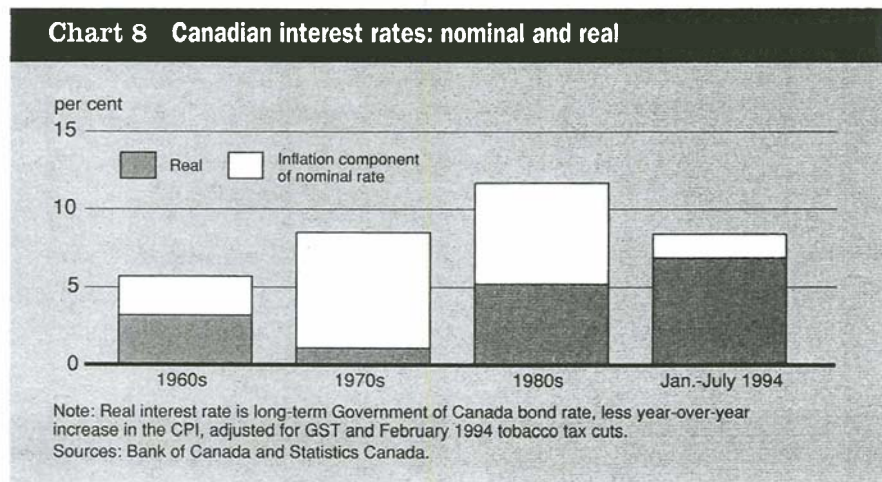
² There are two separate systems of accounting for government debt and deficits – National Accounts and Public Accounts. The Public Accounts is the familiar basis on which deficits are normally reported and differ from National Accounts primarily due to inclusion in the Public Accounts of the future pension liabilities of governments to their employees. The National Accounts basis must be used when making international comparisons and when aggregating federal and provincial debt prior to 1981. The two systems produce significantly different measures of debt and deficit which can cause confusion – e.g., in 1993, the combined federal and provincial debt on a National Accounts basis was approximately 70 per cent of GDP as compared with almost 100 per cent of GDP on a Public Accounts basis.

Chart 6 Net foreign indebtedness of G-7 countries

■ Price inflation trended up only moderately during the 1960s, but exploded to double-digit rates after the first oil price shock in 1973. It accelerated to an even higher peak after the second big hike in world oil prices and before monetary authorities in Canada and other major countries moved decisively to halt the spiral (Chart 7). This triggered the 1981-82 recession, the deepest since the Great Depression. And while inflation was sharply reversed as a result, price increases began to gain momentum again in the late 1980s. This elicited a pre-emptive counter-attack by the Bank of Canada, in part forced by a fiscal stance that had proved to be too lax. The monetary squeeze deepened the 1991 recession. But having made the difficult transition to achieve the lowest rate of inflation (along with Japan) in the G-7, price discipline must now be maintained to secure the benefits of the sacrifice.

Chart 7 Inflation rate: consumer price index

■ Interest rates in Canada have not fallen in line with the sharp drop in inflation. Consequently the ‘real’ burden of debt service cost – i.e. the posted rate of interest less the rate of inflation – has remained high. This is particularly so when compared with average real interest rates in the 1960s and 1970s (Chart 8), and compared with current rates in the U.S. despite that country’s higher inflation. The general level of world interest rates is determined by a complex interplay of factors in financial markets, ranging from increased demand for investment capital in Asia and Latin America to anxiety over the risk of revived inflation in the U.S. Superimposed on these global factors are financial market concerns that are peculiar to Canada, in particular: (i) the increasing burden of public sector debt, and (ii) the growth of Canada’s foreign debt and the perceived risk of further currency depreciation in the face of chronic balance of payments deficits.³ These fundamental concerns have been exacerbated by political uncertainty as to Quebec’s future.



High real interest rates, if sustained, would place a severe drag on future economic performance. A top priority of the government’s jobs and growth strategy is therefore to address the factors that are preventing interest rates in Canada from falling to the level warranted by our commitment to low inflation. Specifically, this demands *sustained* fiscal discipline, beginning with the government’s announced commitment to achieve a ratio of deficit

³ Foreign lenders demand higher interest rates to compensate for perceived risk that they may be paid back in depreciated currency.

to GDP of not more than 3.0 per cent by 1996-97. This is an *interim* target. The ultimate objective is to balance the budget and to significantly reduce the ratio of federal debt to GDP.

Some Conclusions

Taking stock of the past four decades, the most striking feature has been the long-term deterioration of overall economic performance since the mid-1970s.⁴ This was a watershed in the economic history of the postwar era and marks the beginning of two decades of relatively disappointing performance for the western economies as a group – a performance characterized mainly by low productivity growth, stagnating real incomes and rising unemployment rates. In Canada, the productivity slowdown was not sufficiently offset by reduced public and private consumption, resulting in an extraordinary build-up of debt, both foreign and domestic.

Although much of Canada's experience has been echoed to varying degrees in most other advanced countries, the economic trends of the past two decades – particularly the rising jobless rate, stagnant income, ballooning public debt, and high real interest rates – are starkly incompatible with the hopes and well-being of Canadians.

Productivity

At the root of the economic problem has been the failure of *productivity* to increase at the rates that prevailed during the post-war years to the middle 1970s.

Productivity, in the sense used here, is a measure of the efficiency with which people, capital, resources and ideas are combined in the economy. We should therefore think of productivity growth as 'working smarter' – not simply trying to increase the output of goods and services by putting in more hours, or installing more machines, or consuming more energy and materials.

The mid-1970s was a watershed in the economic history of the postwar era and marks the beginning of two decades of relatively disappointing performance for the western economies as a group. ■

⁴ A subsequent section on Income includes a discussion of the possible causes of this marked slowdown.

This comprehensive notion of productivity is called Total Factor Productivity (TFP) to distinguish it from narrower concepts such as the productivity of labour or of capital separately. Numerical estimates of TFP seek to determine the amount of national output growth that is *not* accounted for simply by increased quantities of labour and capital. Total Factor Productivity thus embodies the economic benefits deriving from technological change, from improved organization, from more effective management, and from the millions of improvements wrought by individuals as they go about their daily work.

It is this comprehensive notion of productivity growth – getting more out of less – that primarily determines changes in a nation’s overall standard of living. Increased productivity is what enables the average incomes of Canadians to grow in real terms. And provided there is fair access to opportunities, increased national productivity creates the *potential* for every Canadian to become better off. Without productivity growth, the economy stagnates.

Productivity growth is the foundation of economic progress and must therefore be the primary focus of economic policy. A more productive economy is the only dependable route to more and better jobs for Canadians.

Creating such an economy is primarily the responsibility of business, labour and individual Canadians, with the support of governments and public institutions. It must be a shared undertaking flowing from a sense of common challenge and common opportunity.

The remainder of this paper analyses in greater depth the processes by which jobs are created and incomes are increased, and derives from this analysis the economic policy principles that will support productivity growth and guide the federal government’s role in fostering more and better jobs for Canadians.

Productivity growth – getting more out of less – primarily determines changes in a nation’s overall standard of living. Provided there is fair access to opportunities, increased national productivity creates the potential for every Canadian to become better off.

3

Jobs

Unemployment is a dark cloud hanging over the entire industrialized world. Within the OECD group of countries,¹ there are almost 35 million jobless, a number that has been trending upward since the early 1970s (Chart 9). The failure to generate enough well paid jobs is a central issue facing most advanced societies, and rightly so in view of the tremendous social and economic costs of joblessness.

Chart 9 Total unemployment in the OECD



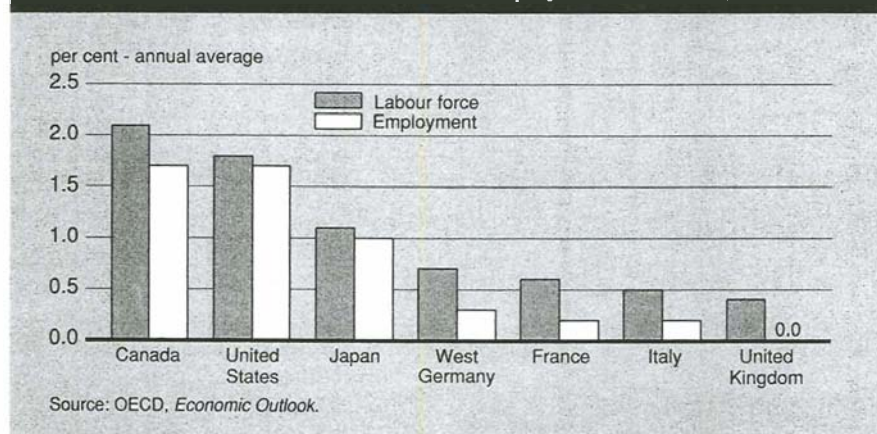
¹ Organization for Economic Co-operation and Development, comprising the world's most developed countries.

With each percentage point reduction of the unemployment rate, an *additional* 140,000 Canadians would become economically productive. They would be contributing to the confidence and hope for the future on which further investment and growth depend. But the greatest cost of unemployment is less easily measured. It is the private despair of individuals and their families; the breakdown of marriages and health; the erosion of job skills and the risk of falling into permanent dependence on income assistance.

That is why getting Canadians who want to work, back to work, must be a top national priority. But to devise a realistic strategy to accomplish this goal requires first an understanding of the job creation process and of the reasons for persistent unemployment.

By international standards, Canada has achieved an excellent rate of job creation – together with the United States, the highest on average among the G-7 countries during the past 20 years (Chart 10). But our labour force has grown even faster, causing average unemployment to rise.² Canada's unusually high rate of labour force growth has been due to: (i) demographic factors – notably this country's unusually large baby boom generation and, more recently, high rates of immigration, and (ii) the strong growth of female participation in the labour force, reflecting both attitudinal changes and economic pressure.

Chart 10 Growth of labour force and employment in the G-7, 1974-1993

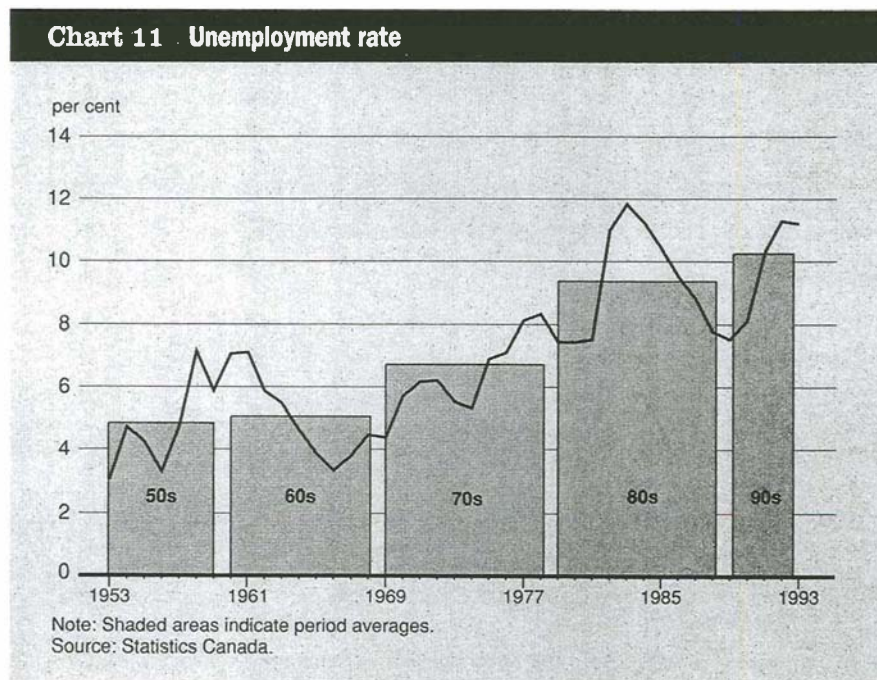


² The labour force is defined generally as those aged 15 and over who are either employed or who state that they are seeking work. The unemployment rate is the number in the labour force who are not employed, divided by the number in the labour force. The 'employment-to-population ratio' is the number employed as a proportion of all persons aged 15 and over.

Although job creation has not kept pace with labour force growth, there have been enough new jobs to increase the *proportion* of the population (over the age of 15) that is employed. With growing numbers of two-earner families and part-time workers, the 'employment-to-population ratio' has trended up (though with a pronounced cyclical pattern) from about 55 per cent in the late 1960s to a peak of 62 per cent just before the last recession. This trend has contributed positively to output growth since a larger proportion of the population has become engaged in the formal economy to which output statistics refer. But that is cold comfort to those who are looking for work, yet cannot find it.

An unemployment rate that rises and falls with the business cycle is an acknowledged fact of economic life. The early postwar experience was that lay-offs associated with recessions were typically short. In the 1950s and 1960s, the unemployment rate averaged a little under five per cent. This was then considered to be approximately 'full employment' since it reflected the inevitable proportion of people who were temporarily between jobs.

But early in the 1970s, this equilibrium changed fundamentally. The cyclical recoveries following recessions tended not to drive unemployment back to its pre-recession level (Chart 11). Now, with the perspective of three decades' hindsight, it is clear that what might be called the 'core' rate



of unemployment has itself been rising.³ This means that an *increasing* proportion of the labour force is not re-absorbed during the recovery phase of the economic cycle.

Although the core rate of unemployment cannot be determined precisely, there is no doubt that it has risen substantially. One early indicator was the rise of inflation during the 1970s, despite unemployment having also risen to 7 per cent and above. In the past, accelerating inflation was not triggered unless the unemployment rate had been pushed much lower. The unprecedented circumstance of simultaneously rising unemployment and inflation was dubbed ‘stagflation’ at the time. More recently, inflation began creeping up in 1985 when the unemployment rate was still as high as 10 per cent.

Most estimates suggest that the core unemployment rate in Canada is now at least 8 per cent.⁴ The cost of this excessively high core rate in terms of extra joblessness is tremendous. The fact that today’s core rate of unemployment is close to 8 per cent means that the benchmark of ‘full employment’ is reached with an unemployment rate roughly 3 percentage points higher than prevailed in the 1960s. Translated in terms of today’s labour force, this implies that there has been an *increase* of more than 400,000 in the number of Canadians that remain jobless even near the peak of the business cycle.

The factors that have caused Canada’s core jobless rate to creep up over the past 30 years thus lie at the root of the structural unemployment problem and must be addressed. Four factors – growing skills mismatches; disincentives in various income support programs and certain labour market regulations; increasing payroll taxes; and the unusual severity of the last two recessions – appear to have been the most significant causes. It is impossible to estimate with any precision the relative contributions of each. Indeed, several of the factors interact.

³ Technically, what we here call the ‘core’ rate is that rate of unemployment which cannot be forced lower without causing inflation to accelerate. If an attempt is made to push unemployment below the core rate – e.g., by highly stimulative macroeconomic policy – the economy produces little extra real output or jobs, except very temporarily. Instead, the economy spins its wheels by generating an upward spiral of higher prices and wages which is unsustainable. Economists call this core rate of unemployment, the NAIRU, or the non-accelerating inflation rate of unemployment.

⁴ See, for example: Rose, D.E.; *The NAIRU in Canada: Concepts, Determinants and Estimates*; Bank of Canada Technical Report, No. 50.

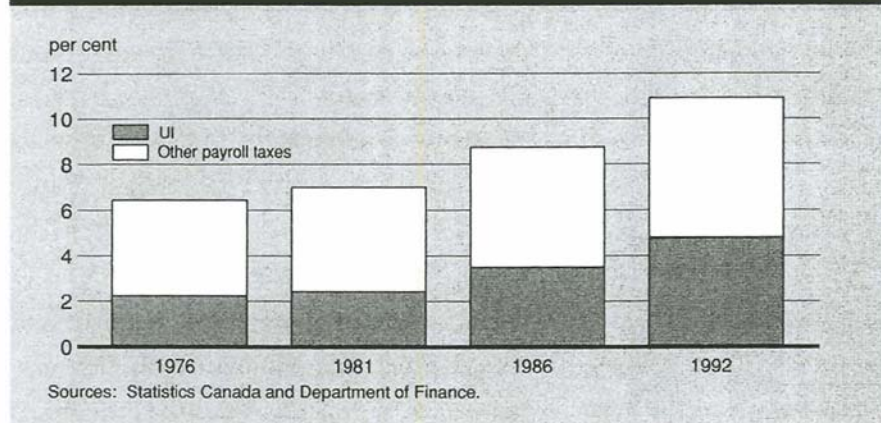
Skills Mismatches: Every industrialized country is in the throes of a fundamental transition to a more knowledge-based economy in which those lacking the education, the new specialized skills, and the flexibility to adapt are increasingly frozen out of the job market. The problem is particularly difficult for older workers in downsizing sectors and for young people who fail to take any further training beyond high school. Since these groups appear to be unable to adjust their skills to the rapid pace of change in the job market, the core rate of unemployment has risen.

Disincentives: Programs of income security – including Unemployment Insurance (UI), Workers' Compensation and various forms of social assistance – are essential to Canadian norms of fairness. Particularly in the case of UI, they also help to maintain purchasing power during economic downturns. These programs, which were first designed in an era when unemployment was largely cyclical, are now understood to harbour features that can discourage the active search for work. The disincentive effects for individuals are especially perverse when the rules require income support to be reduced at rates close to dollar-for-dollar against any outside earnings.

Added to these disincentives has been a growing body of labour market regulation (largely provincial) designed to increase employment security and augmented by a body of legal precedent which has strengthened safeguards against arbitrary dismissal. While the principles underlying these developments are valid and important, the cumulative effect has been to reduce the willingness of many employers to take the risk of hiring a new employee. Instead, there has been increased resort to overtime and other methods to economize on labour.

Increasing Payroll Taxes:⁵ Total payroll taxes in Canada have been rising steadily relative to average wages (Chart 12). The effect of imposing a payroll tax – which is typically paid in part by both employer and employee – is to increase the effective wage cost to the employer and to decrease the take-home pay of the potential employee. The payroll tax

⁵ The most significant examples of such taxes are the premiums paid for UI, Workers' Compensation, and the Canada and Quebec Pension Plans.

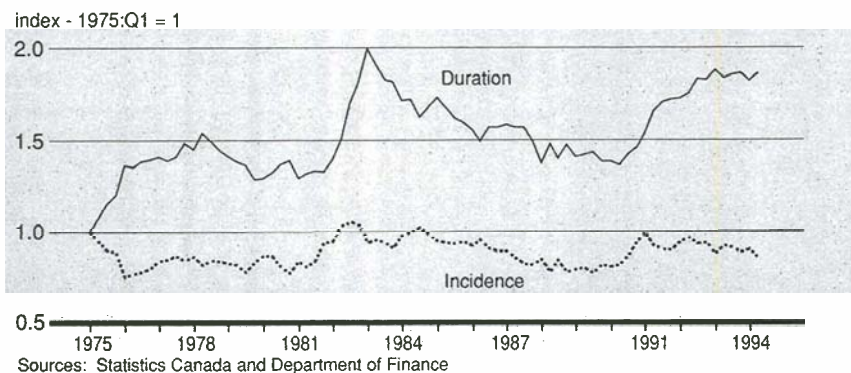
Chart 12 Payroll taxes in Canada as a share of labour compensation

drives a wedge between the two. This makes a wage bargain harder to reach and thus raises unemployment relative to the situation in which there is no tax, or a lower tax.⁶

Severe Recessions: The last two recessions, beginning in 1981 and 1990, were unusually severe in Canada, both in their depth and in the time taken for employment to recover subsequently. This meant that the spells of unemployment associated with these downturns tended to be longer than in the past. During long spells of joblessness, skills and confidence often erode significantly and this works to diminish the likelihood of re-employment even as the recovery matures. Thus deep and long recessions may themselves be responsible for some of the increase in the core rate of unemployment.

These four factors taken together have caused the prevalence of long-term unemployment in Canada to increase very significantly. More than 13 per cent of those without jobs in 1993, or approximately 200,000 Canadians, had been unemployed for over a year. This proportion of long-term unemployed has been growing. In fact, the rise in the unemployment rate since the mid-1970s is completely accounted for by a rising trend in the average length of jobless spells – the so-called ‘duration’ of unemployment (Chart 13). There has been growing polarization with increasing proportions of both very short and very long spells of unemployment.

⁶ The initial impact of a higher payroll tax is to raise the employer’s total labour cost, usually with no offsetting benefit. This diminishes willingness to hire and raises the unemployment rate, other things being equal. Studies indicate that in the longer term, provided the tax is unchanged, wages will eventually readjust with most of the ultimate impact of the tax falling on the employee. Thus a constant payroll tax has a diminishing impact over time on the employer’s reluctance to hire. But if the tax is frequently increased, the adverse impact on hiring will be continuously reinforced.

Chart 13 The duration and incidence of unemployment

The chance of any given individual becoming unemployed at some time during the year – or what is called the ‘incidence’ of unemployment – has meanwhile remained approximately constant on average, rising and falling with the rhythm of the business cycle.

The essence of the problem, therefore, is that an increasing proportion of those who do become unemployed, remain so for a long time. A similar trend has been observed in virtually all industrialized societies. The long-term jobless have trouble becoming re-employed and can become alienated and lose faith in the fairness and basic values of society. It is therefore vitally important to help the unemployed get back to work as quickly as possible.

Some have objected that there may be little point encouraging unemployed people to search hard for work because there have simply not been enough jobs to go around. While it is true that there has been insufficient aggregate demand in the Canadian economy since the onset of recession in 1990, it is important to recognize that even in a cyclically weak job market, there is tremendous employment turnover always underway. On average, more than 20 per cent of Canadian workers (roughly 2.5 million individuals) leave their jobs each year through quits or permanent lay-offs, while a somewhat greater annual number usually become employed. This means that there is tremendous turn-over constantly going on in the national workforce, though not always in particular communities. So while there will inevitably be individuals who cannot find work despite their best efforts, those fortunate to have enough flexibility run a reasonable chance of landing something amid the constant job turnover, even when economic activity is weak.

The essence of the problem is that an increasing proportion of those who do become unemployed, remain so for a long time. It is therefore vitally important to help the unemployed get back to work as quickly as possible.

While the high normal rate of job turnover, combined with active job search, can help reduce the duration of individual spells of unemployment – a good thing in itself – the churning effect is certainly not a solution to the unemployment problem. To put enough people back to work on a regular basis, requires an expanding source of new jobs. Healthy job growth has in fact been taking place in some parts of the economy (Box 1). New jobs have been relatively abundant: (a) for those with higher skills, especially in the

Box 1 Major shifts in employment shares since the mid-1970s

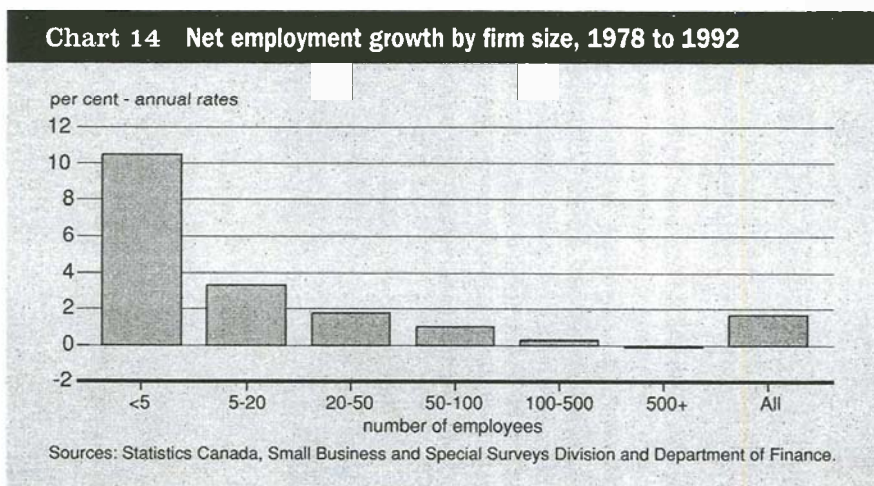
Characteristic	Increasing share	Diminishing share
Industry	Service industries in general: especially services to business management, health, communications and finance.	Agriculture and manufacturing: in part because the share of output in these industries is declining but largely because they have experienced rapid productivity growth.
Wages	Industries that pay, on average lower wages. In particular, the average wages received by newly-hired workers in the faster-growing industries are below the wages of those displaced from slower-growing industries.	Industries that pay, on average, higher wages, typically in the capital-intensive goods producing sectors.
Age and sex	Prime-aged women (25-54) who accounted for 80 per cent of all employment growth from 1975 to 1989.	Youths and men, especially men over age 45.
Firm size	Very small firms. Of the cumulative net job gain from 1978 to 1992, almost all was in firms employing fewer than 50.	Very large firms. The number of jobs in firms employing over 500 declined slightly between 1978 and 1992.
Level of technology	Industries that use high technology. Between 1975 and 1993, employment in these industries grew almost three times as fast as in those that use low technology.	Industries that use low technology predominantly.
Occupation	Managerial and professional occupations. These accounted for almost three-quarters of total employment growth between 1975 and 1993.	Blue-collar occupations. (The share of less-skilled white-collar jobs has remained roughly constant.)
Education	University graduates.	Workers with only primary education.
Form of employment	Self employment and part-time employment, both of which are much more prevalent in the fast-growing service industries.	Full-time employment, particularly with larger firms. About 30 per cent of jobs in Canada now fall outside the traditional full-time mould.
Job tenure and union participation	Industries with higher rates of worker turnover and lower union representation.	Industries where workers have above-average workplace seniority and union representation.

professional and managerial ranks of the service sector; (b) in firms using more sophisticated technology; and (c) in the smallest firms – those employing fewer than 50 people.

For most people fortunate to have sufficient skills and educational preparation, the challenge of finding a job should be manageable, although today’s young graduates often have trouble landing a first job in their chosen field. It is also true that a lot of the newly-created jobs offer lower incomes than was typical in the past. (Income trends are addressed in the next section.)

Increasingly, the hard core unemployed are those without the right skills and lacking the flexibility, or the opportunity, to acquire new skills. The recovery from the last recession in Canada, for example, has not been ‘jobless’ for most of those with good educational qualifications. Although between 1990 and 1993, there was a net loss of 190,000 jobs in Canada, for people with preparation beyond high school there was a net job *gain* of 450,000. For those with high school education or less, on the other hand, the net loss was 640,000.

Viewed from another angle, most of the net job creation in Canada is taking place in the smallest firms, growing numbers of which are being started by women. Firms with fewer than 50 employees – which accounted for a third of all employment in 1992 – were responsible for virtually all of Canada’s net job growth between 1978 and 1992 (Chart 14).



It should not be concluded from these statistics that small businesses are all that matter for job creation. These firms depend on demand that originates elsewhere in the economy, including purchases and franchising by larger firms. There is, in effect, a commercial 'ecology' in which each type of firm has its role and where interdependence and niche-filling are the essential characteristics.

A number of policy implications flow from this broad analysis of unemployment and job creation. They include the need for:

- Better ways to upgrade the skills, and thus the job prospects, of people who are most at risk of long-term unemployment;
- Redesign of income support programs so as to reduce disincentives for individuals to seek work, and to ensure that employers are not implicitly encouraged to maintain unstable employment patterns;
- Income support that is focused on the most vulnerable and needy; and
- A reversal of the steady rise of payroll taxes.

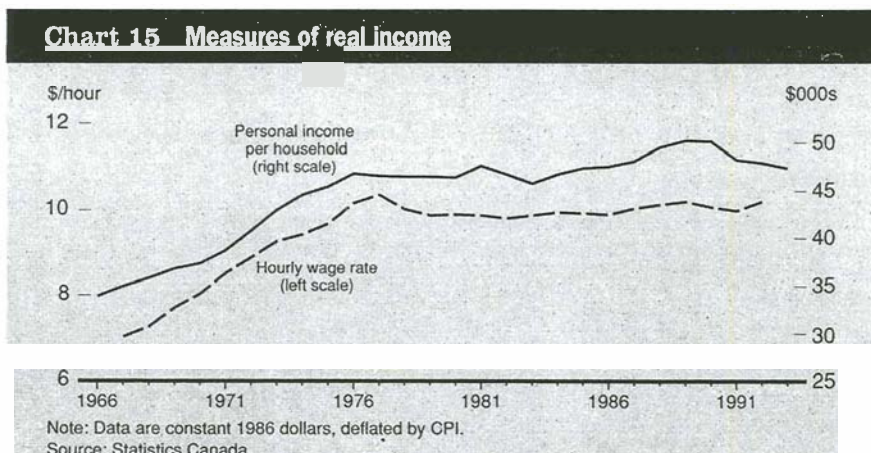
It is also important that the government be in a position to reduce the depth of inevitable recessions so that recovery can pull the jobless more quickly back to work. The unusual severity in Canada of the last two recessions was due in part to the strong measures required to curb inflation. To avoid repeating this pattern, inflation must be kept under control and the government's fiscal capability to cushion the severity of cyclical downturns must be restored.

4

Income

Reducing unacceptably high unemployment is only part of the economic challenge. Canadians, working together, must not only create *more* jobs; we must also create *better* jobs that catch the rising tide of opportunities outlined in the earlier description of the new economic environment. Only then will Canadians have the means both to achieve a rising standard of living and to sustain our financial commitment to principles of social justice.

Since the middle of the 1970s, the average hourly wage and the incomes of Canadian households have stagnated in real terms (Chart 15). Despite increasing numbers of two-earner families and growing resort to part-time work to make ends meet, the purchasing power of the average household

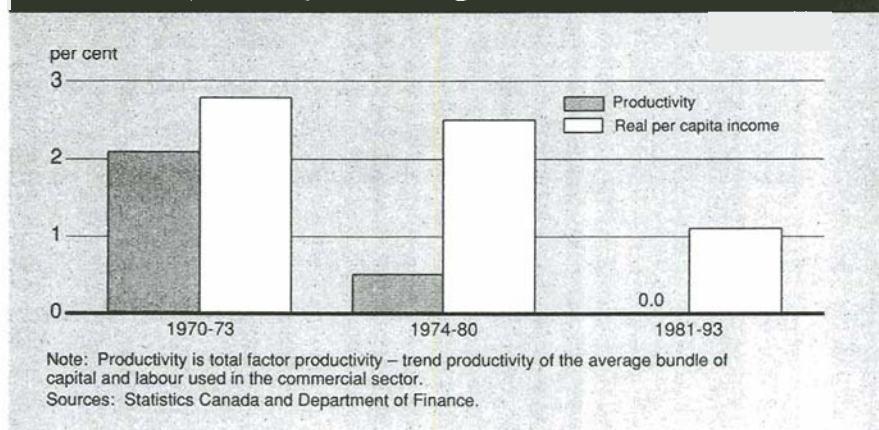


has improved only slightly, if at all. Many young people consequently sense that theirs is the first generation since the Great Depression to be less well-off than their parents.

What has gone wrong?

As described earlier, the problem of weak income growth has been due to the failure of *productivity* to increase at the rates that prevailed during the postwar years to the mid-1970s. In fact, there was on average no overall productivity growth in Canada between the late 1970s and 1993. And as productivity growth declined, so did the growth of income per capita (Chart 16). Indeed, shrinking productivity growth has been responsible for virtually the entire decline in the growth rate of Canada's GDP since the early 1960s (Chart 17).¹ It is obviously important, therefore, to understand why productivity has stagnated and how it might be revived.

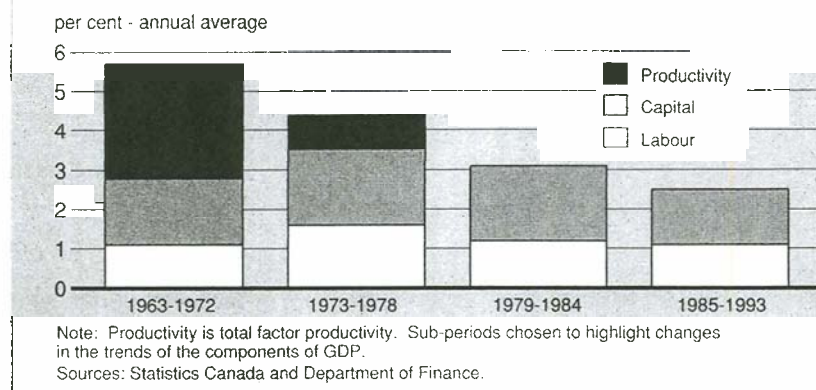
Chart 16 Productivity and income growth



The sharp decline in productivity growth since the early 1970s, as noted earlier, is a worldwide phenomenon affecting all industrialized countries. But the decline in Canada and the United States has been particularly marked.²

¹ The economy grows as a result of: (a) increasing the supply of labour (e.g., total hours worked), (b) increasing the supply of capital (e.g., net addition of machinery), and (c) increasing the economic effectiveness of capital and labour and the efficiency with which they are combined. The latter measure is called Total Factor Productivity or simply 'productivity' in this paper. Chart 17 displays the sources of the trend change in commercial sector GDP since 1963. It shows that the growth of capital and labour inputs combined has remained in a narrow range of 2.5 per cent to 3.5 per cent per year on average. The overall decline in the *growth* rate of the economy is explained almost entirely by the disappearance of productivity growth.

² The U.S. and Canada have had the highest *levels* of productivity. The higher (but still slowing) rates of productivity *growth* in Europe and Japan appear to reflect a 'catch-up' phenomenon in which the international diffusion of technology and investment has caused productivity levels in the advanced countries to converge over time.

Chart 17 Sources of growth: commercial sector real potential GDP

Economists have put forward many theories, including the impact of the oil price shocks in 1973 and 1979; the growing dominance of the service sector where measured productivity growth has been much less than in manufacturing; or the effect of the baby boom generation whose entry on the job market in the 1970s brought a disproportionate number of new and therefore inexperienced people into the workforce.

While all of these factors have had an impact – more in some countries than others – careful studies seem to indicate that these explanations cannot account for either the extent or the persistence of the widespread decline in productivity growth. A comprehensive review under the auspices of the OECD concluded in 1992 as follows:

“...[there is a] contradiction between the apparently rapid acceleration in technical progress since the end of the 1970s and the absence of any significant measurable impact on the growth of total factor productivity. The analysis here suggests that the causes of the observed contradiction lie in a mismatch between earlier forms of corporate organization, as well as those of the public sector, and the characteristics of the new technologies, notably information technology. The slow rate of productivity growth could also be due to deficiencies of countries and firms in the training and management of human resources.”³

³ Technology and the Economy: The Key Relationships; OECD, 1992, p.18.

It is taking a long time for individuals, firms and governments to adapt to the revolutionary potential of new technologies based on the microchip.

In plain language, it is taking a long time for individuals, firms and governments everywhere to adapt to the revolutionary potential of new technologies based on the microchip. Some scholars, including Professor Richard Lipsey of Simon Fraser University, point out that the technologies and methods of organizing work that sustained the postwar boom involved large, hierarchical companies and industrial mass production. By the mid-1970s this form of industrial organization may have begun to approach the limits of further major efficiency gains. So the *growth* of productivity slowed before the skills and organization required to make best use of new computer and communications technology were effectively in place. Many big organizations – governments and educational institutions prominent among them – have been slow to change their ways. And only now has the ‘Nintendo generation’ – the first to be completely comfortable with the new microchip technology – really begun to make its presence felt in the workforce.

In prospect, therefore, may be a revival of sustained productivity growth, particularly in the service sector where the unexploited potential of information technology is greatest. But the size and timing of a productivity revival are still very uncertain and nothing can be taken for granted. Since productivity growth depends on working smarter – for example, mastering the economics of ‘ideas’ (Box 2) – Canada must position itself to be at the forefront of *innovation* in the products and services we create; in the ways we organize economic and social activity; and in the ways we govern ourselves. It should be stressed that the organizational and managerial dimensions of productivity improvement are at least as important as the technological dimensions.

Broad-based innovation requires fundamental change and is therefore a challenging and sometimes threatening process. Some believe, moreover, that the efficiencies inherent in improved productivity are more likely to destroy jobs and incomes than to create them. If that were so, policies to foster productivity growth would contradict the principal objectives of the government’s economic strategy.

Box 2 The role of ideas in economic growth⁴

For the analysis of economic growth, the most important fact about the physical world is that there are an incomprehensibly large number of ways to combine a relatively small set of basic raw materials. Of all the possible random combinations of a few pounds of iron ore, aluminum, copper, silicon, and petrochemicals, there are a few highly valued ones such as a personal computer, a stereo receiver, or a video cassette recorder. An economy grows when someone discovers a valuable new combination of the existing raw materials. We say that the economy 'grows' because the value of the raw materials in their new configuration is higher than the value of the old one.

To distinguish this particular notion of growth, economists sometime refer to it as productivity growth or growth in income per capita. It must be distinguished from the civic boosterism notion of growth, which aspires merely to a multiplication of the same activities many times over: more houses, more shopping centres, more factories producing the same products, etc.

The accumulation of ideas has been the driving force behind economic growth throughout human history. If one focuses solely on objects and accepts the local boosterism model of growth, it is obvious that resource scarcity imposes absolute physical limits to growth. Moreover, many existing transformation processes are accompanied by unwanted side effects like pollution, so higher levels of output from the same set of production activities can have serious negative consequences.

But once growth is understood in terms of the potential for discovering more valuable ways to rearrange the same raw materials, there is no basis for pessimism on technological grounds. Nor do new discoveries necessarily lead to more serious negative side effects. On the contrary, discoveries have tended over time to conserve raw materials and to reduce unwanted side effects.

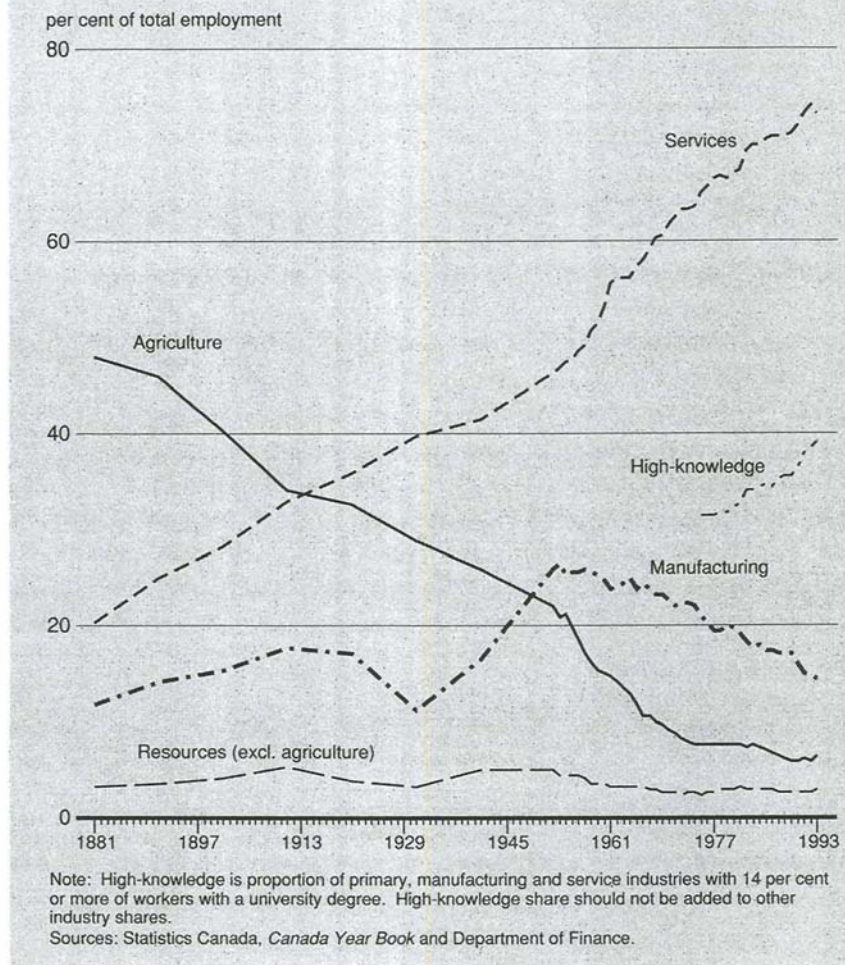
To evaluate the effects that public policy has on our long run prospects, we need a theory of how policy affects growth. For this theory, we must understand the economics

of ideas. The economics of ideas is, however, considerably more subtle than the economics of objects.

An *idea* – such as a recipe or formula for combining raw materials – has properties that are quite different from those of an object. It is easy for the owner of an object to keep another from making use of it. It is hard for the owner of an idea to prevent others from using it. More important, if someone else uses an idea, this does not prevent the owner from using it as well. This last property, the 'shareability' of ideas, makes them uniquely powerful in generating growth. For example, if all the research leading up to the discovery of the transistor had instead been devoted to the discovery of a pool of oil, the economic value would be limited, for only one user could take advantage of each unit of oil and the pool would eventually be depleted. Instead, the research was devoted to finding a recipe for combining raw materials into a transistor, an idea that is now used trillions of times each year and that will continue to be used for the indefinite future.

It is undeniably true that technical progress can displace people from jobs. The systematic application of science and technology to agriculture, for example, was associated with a massive reduction of Canada's farm population beginning in the last century (Chart 18). Today, robots and computers have made many manufacturing jobs obsolete.

⁴ *Directions for Future Research on Economic Growth* by Paul Romer, Fellow of the Canadian Institute for Advanced Research; CIAR Working Paper, March 1991.

Chart 18 Composition of Canadian employment, 1881-1993

But it would be wrong to conclude from these experiences that increasing productivity destroys more jobs than it creates (Box 3). The truth is that the vast majority of those who left the farm found new employment as factory workers, as school teachers, as sales persons, as doctors and so forth. They became part of the rapidly expanding urban economy. Most of those who remained in farming – equipped with scientific methods, improved machinery, and better credit arrangements – were able to do much better than would have been possible if agriculture had remained in a low-productivity rut.

The benefits represented by the evolution of agricultural productivity, and the corresponding changing structure of employment, are in fact typical. Throughout the world, and within every country, regions of lagging

Box 3: The job creating power of technology

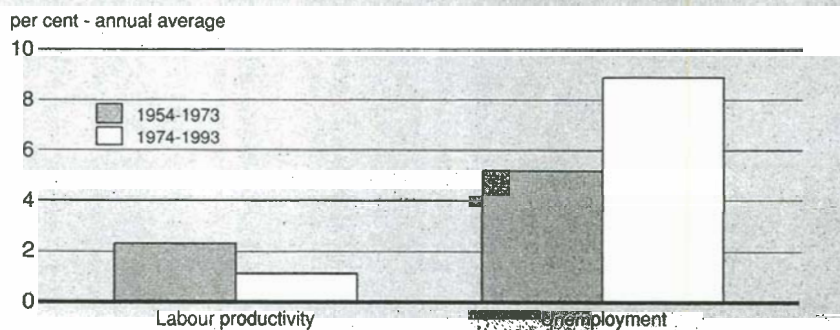
"Technology both eliminates jobs and creates jobs. Generally it destroys lower wage, lower productivity jobs, while it creates jobs that are more productive, high-skill and better paid. Historically, the income generating effects of new technologies have proved more powerful than the labour displacing effects. Technological progress has been accompanied not only by higher output and productivity, but also by higher overall employment."

*The OECD Jobs Study:
Facts, Analysis, Strategies
June 1994*

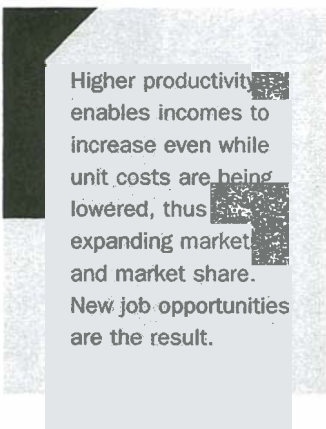
productivity usually suffer the highest rates of unemployment and the lowest earned incomes. Areas of high productivity growth – for example, the dynamic new economies of Asia – enjoy the opposite conditions.

Canada's economic history bears out this general truth. The postwar years to the mid-1970s were a period of extraordinary productivity growth – e.g., from 1953 to 1973 labour productivity in the economy as a whole increased at an average rate of 2.3 per cent while the unemployment rate averaged a moderate 5.2 per cent. Since then, productivity growth has declined sharply while the average unemployment rate has risen significantly (Chart 19).

Chart 19 · Labour productivity growth and the unemployment rate



Note: Labour productivity refers to real GDP per employed person.
Source: Statistics Canada.



Higher productivity enables incomes to increase even while unit costs are being lowered, thus expanding markets and market share. New job opportunities are the result.

It follows that there is no conflict between rising productivity and expanding job opportunities in the economy as a whole – in fact, quite the contrary. This is because the conditions that underlie productivity – innovation, entrepreneurial vigor, strong investment growth – are precisely the conditions that expand the general pace of economic activity. Higher productivity meanwhile enables incomes to increase even while unit costs are being lowered, thus expanding markets and market share. This creates net new demand and new job opportunities are the result. Policies that impede productivity, on the other hand, guarantee weaker job and income growth in the economy as a whole and over time.

Provided, therefore, that Canadians have the opportunity and the encouragement to acquire new skills; provided labour markets foster the required adaptability; and provided we create an environment that encourages innovation and new investment here in Canada, most of those who might be displaced as a result of productivity increases are likely to find new employment within a reasonable time.

5

A Framework for Growth

The ultimate goal of the government's economic strategy is to foster the creation of more and better jobs for Canadians. This goal can only be achieved through sustained economic growth flowing from increased productivity and complemented by measures to reverse the decades-long rise in Canada's core unemployment rate (Chart 20).

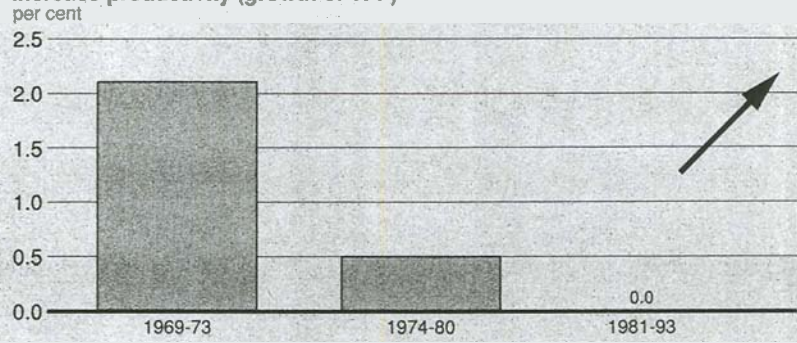
The required policies will be mutually reinforcing since what is needed to foster productivity and income growth – a more innovative and adaptable economy – will also contribute to healthier job creation. As well, the measures directed to lowering core unemployment – e.g., helping Canadians upgrade their skills, encouraging dynamic small business, removing disincentives in the labour market, reducing the severity of recessions – will also spur higher productivity.

Flowing from the analysis in preceding sections, the government's strategy to promote economic growth and job creation is based on five broad themes:

- **Helping Canadians acquire skills**, to build a more productive economy, to foster better job opportunities and incomes for individuals, and to establish the basis for life-long personal development.
- **Encouraging Canadians to adapt to new opportunities**, to minimize long-term and repeated joblessness and to ensure that businesses and individuals face the right incentives to take advantage of more productive opportunities.

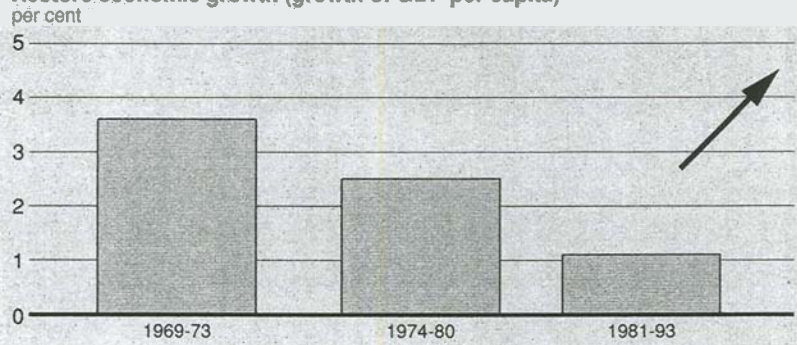
Chart 20 Goals of economic policy

Increase productivity (growth of TFP)

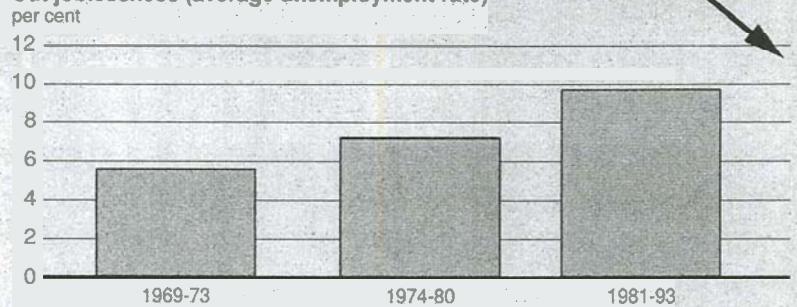


Note: Total Factor Productivity trend for commercial sector.

Restore economic growth (growth of GDP per capita)

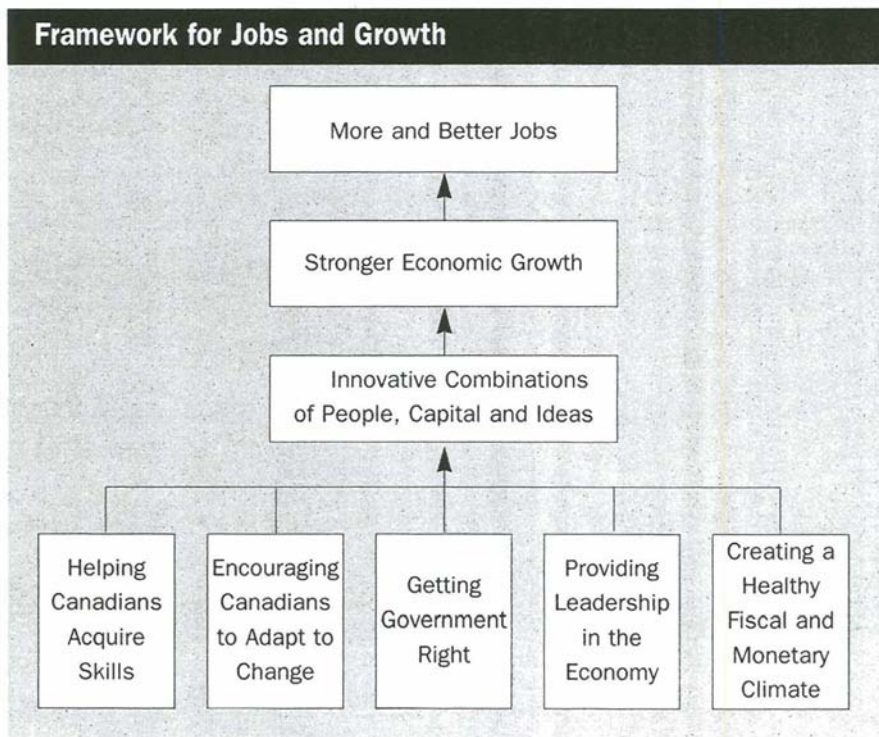


Cut joblessness (average unemployment rate)



Note: Productivity and per capita GDP growth are average annual compound rates. Average annual unemployment rate is a simple average of the monthly rates. Sources: Statistics Canada and Department of Finance.

- **Getting government right**, to ensure that government itself, through efficient management and appropriate policies, contributes all it can to a more productive economy.
- **Providing leadership in the economy**, to build a more innovative and outward-looking economy through actions that government is in the best position to take, in partnership with the private sector.
- **Creating a healthy fiscal and monetary climate**, to establish the broad economic conditions for sustained growth and job creation and to ensure that the government will have both the resources and the degree of public trust needed to succeed in the other four theme areas.



These policy themes have been designed to address Canada's particular circumstances. They are also entirely consistent with both the analysis and conclusions of international bodies that have studied similar issues. The outcome of the jobs conference in Detroit in March 1994 and the conclusions of the G-7 Summit in Naples point to a near universal consensus among industrial country governments regarding both the nature of the jobs problem and the policy directions needed to address it (Box 4).

Box 4 G-7 consensus on a growth and jobs strategy¹

“Following the jobs conference in Detroit and the analysis of the OECD we have identified the actions we need to take.”

- We will work for growth and stability, so that business and individuals can plan confidently for their future.
- We will build on the present recovery by accelerating reforms so as to improve the capacity of our economies to create jobs.

Both of these elements are essential in order to achieve a lasting reduction in the level of unemployment.

We will concentrate on the following structural measures. We will:

- increase investment in our people: through better basic education; through improving skills; through improving the transition from school to work; through involving employers fully in training and – as agreed at Detroit – through developing a culture of lifetime learning;
- reduce labour rigidities which add to employment’s costs or deter job creation, eliminate excessive regulations and ensure that indirect costs of employing people are reduced whenever possible;
- pursue active labour market policies that will help the unemployed to search more effectively for jobs and ensure that our social support systems create incentives to work;
- encourage and promote innovation and the spread of new technologies including, in particular, the development of an open, competitive and integrated worldwide information infrastructure;
- pursue opportunities to promote job creation in areas where new needs now exist, such as quality of life, and protection of the environment;
- promote competition, through eliminating unnecessary regulations and through removing impediments to small and medium-sized firms.”

The following sections elaborate the five themes of the government’s economic policy, describing how each is related to productivity, growth and job creation and outlining principles that define the future direction of federal economic policy.

¹ G-7 Summit Communiqué; Naples, July 9, 1994.

6

Helping Canadians Acquire Skills

As the pace of global competition quickens and technological complexity intensifies, the fortunes of individuals and of nations turn increasingly on the skills they already possess or are prepared to acquire.

The right skills are the key to building the smarter, more productive economy on which job and income growth depend. Skilled and adaptable workers are needed to master, and re-master, the increasingly sophisticated technology and work methods that are making virtually every occupation, in some sense, high-tech (Box 5). Concentrations of people with highly specialized know-how are now essential to attract and retain globally foot-loose investment.

These realities are clearly reflected in Canada's employment statistics. Over the past two decades, job growth has been polarized toward those with higher skills. For persons with less than high school, jobs are shrinking rapidly (Chart 21). It is estimated that almost half of the *new* jobs that are likely to be created during this decade will require more than 16 years of formal education and training combined (Chart 22).

Obviously, not all new jobs will require highly specialized training or advanced degrees. In fact, about a third of the jobs being created can still be filled by those with high school or even less. Even the most technically sophisticated new businesses require the support of a full range of skills and therefore contribute to employment of maintenance workers and bankers, as well as of engineers. In fact, wherever there is vigorous economic

activity, job creation is never far behind. The new jobs often show up in unexpected places – restaurants and car dealerships, for example – that have only indirect links to the original activity.

In the past, one could expect to spend an entire career in the same industry, often with the same employer. Today, several career changes are becoming the norm and the traditional idea of job security has become almost obsolete. Instead, individuals must take an active role in creating their own career security, based on a solid foundation of literacy and on a willingness to improve their employment skills continuously. Lifelong learning is needed to update old skills and acquire new ones. Although governments will continue to play a role, lifelong investment in human resources will increasingly be the responsibility of individuals and employers.

Chart 21 Employment growth by education level, 1975–1993

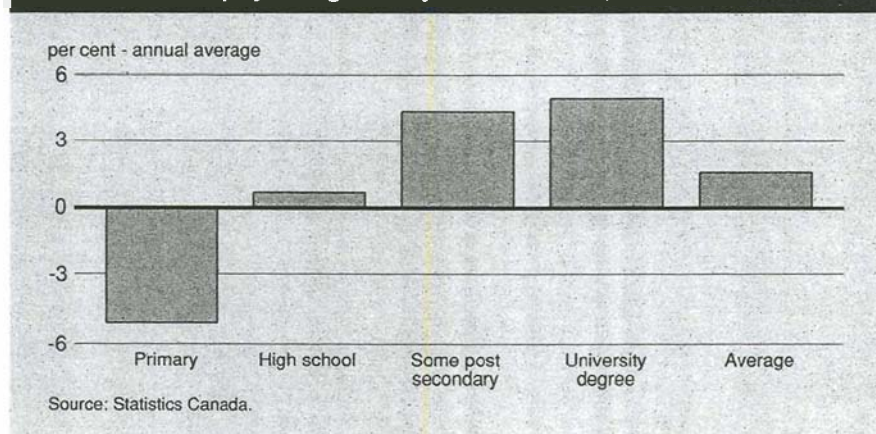
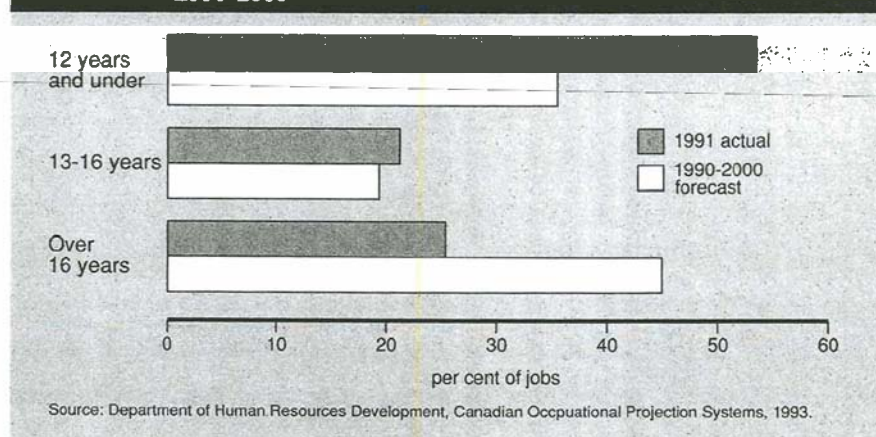


Chart 22 Years of education and training required for new jobs, 1990–2000



Box 5 Skills and productivity in the new economy

“Major clusters of new technologies will significantly change the way economies operate; they have considerable potential for productivity increases and thus lead to rising growth and employment. If these new technologies have so far had relatively little impact upon productivity increases, it is because

society has not succeeded in matching these advances with the necessary innovation in the workplace. The crucial bottleneck is insufficient human resources development at both the micro-economic and macro-economic levels. When human knowledge replaces machines and plants as the

moving factor behind productivity change, and when the required knowledge is missing, output suffers however much finance and hardware are supplied.”

– *Technology and the Economy: The Key Relationship*, OECD

Canada’s potential to increase productivity and income growth, and to push down the core rate of unemployment, will require an increasing national commitment to building human capital. This does not automatically equate to the need for higher public spending on formal education. Canada already spends relatively more on public education than almost all other advanced countries, but does not always have the results to show for it. The objective, therefore, is not to spend more money overall, but to invest more efficiently in building our human resources.

In this endeavour, the provinces’ responsibility for public education is unequivocal. And since our national future is at stake, this must be a co-operative effort where the principal test that should guide the sharing of effort is to determine who is best placed to get the job done.

Individuals

The primary responsibility to develop the nation’s base of skills rests with Canadians themselves. Institutions can ‘teach’ but it is up to the individual to ‘learn’. And while society gains collectively from the skills of its citizens, the greatest beneficiaries of investments in human capital are individuals themselves, in terms both of lifetime financial return and potential for personal development.

Employers

The principal responsibility of employers in helping Canadians to acquire skills is to invest in the training of their own employees. The familiar slogan that “our people are our greatest resource” must be taken to heart. Undeniably, there is some risk that an investment in training will be lost if the employee takes a better offer somewhere else. But for good employers this will be the exception, not the rule. Companies that invest in people tend to attract the best in the first place. Moreover, it is a two-way street. For every trained employee lost to one competitor, another may be gained from a different competitor. It follows that businesses should normally need no direct training subsidies from government to do what is already vitally in their own interest.¹

One important exception is the case where government may wish to support skills upgrading of hard-to-employ individuals and it is decided that on-the-job training is the best option. A specific subsidy would then be required to induce an employer to provide training to someone who would otherwise not have been hired.

Government seed funding can also help to stimulate firms in a particular sector to define collectively their training needs and occupational standards and to develop industry-led training programs. There has been considerable progress in this regard by Sector Councils which have recently been formed in, for example, the steel, electronics, auto repair, tourism and horticulture industries.

The advice and assistance of business and labour can also add relevance and motivation to the school experience. This may be the best way to reduce a school drop-out rate that is still unacceptably high and to foster a more successful school-to-work transition – for example, through innovative co-op programs and other partnership arrangements between businesses and schools.

¹ Government already provides a very substantial indirect benefit to businesses through basic and post-secondary education, the costs of which are borne largely by all taxpayers.

The Government of Canada

The interest the federal government takes in helping Canadians to acquire skills derives from a general responsibility to foster better national economic performance, and from a more specific concern to minimize the extent and consequences of unemployment.

To these ends, the Government of Canada has been spending more than \$3 billion annually – from a combination of general revenue and the developmental uses of Unemployment Insurance – to increase the employability of the jobless. Many federally-sponsored training courses are delivered through provincially-controlled institutions, although programs increasingly include an on-the-job training component.

The federal government also provides substantial support for post-secondary education through transfers to the provinces of cash and tax points, through student loans, the education and tuition tax credits, and grants to support graduate research in the social and natural sciences, engineering and medicine. These latter grants, now totalling \$790 million annually, are a key investment in training the highly qualified people that will be needed to keep Canada at the leading edge of the knowledge economy.

Additionally, the government announced in the last budget a number of new initiatives, many still in the pilot phase, to broaden the skills of young people, in particular during the crucial school-to-work transition period (Box 6).

How might this substantial, though largely indirect, federal role be made more effective? Detailed proposals are beyond the scope of this paper and many of the issues will be addressed in the course of social security reform under the leadership of the Minister of Human Resources Development. Certain broad principles can nevertheless be stated:

- The federal interest in this domain is primarily linked to the objective of fostering the integration of people into the labour market i.e. ensuring that Canadians have the skills required to succeed in the labour market.

Box 6 New federal initiatives to help Canadians acquire skills

Youth Internship Program: Addresses the school-to-work transition, targeted on the 60 per cent of young Canadians who currently take no formal education past high school. Through better involvement of the private sector in defining needs, the Program will establish apprentice-like training in areas of good growth potential where traditional apprenticeship is lacking – e.g., software, logistics, electronics, horticulture, environmental services. The first demonstration projects are now being launched. Working with provinces and territories, industry Sector Councils and communities, it is hoped to develop up to 20,000 internship places each year.

Youth Service Canada: Begins to address some elements of youth unemployment and contributes to a better school to work transition. Aimed at those under 25, the objective is to teach job and life skills through participation in community-based projects in the social and environmental areas. The target is eventually to involve about 10,000 young people a year.

National Literacy Program: Helps the estimated 38 per cent of adult Canadians who are functionally illiterate to become contributors to the economy. In partnership with provincial governments, the private sector, educators, literacy groups and

other volunteer organizations, the Program supports the development of learning materials, research, information sharing and public awareness of the need for higher levels of literacy and numeracy.

Aboriginal Headstart: Helps young native people overcome serious early disadvantages which, if not addressed, can stunt opportunities permanently. The program, which is to begin with pilot projects designed and controlled by native people, is aimed at pre-school age aboriginal children in urban areas and large northern communities.

- While jurisdiction rests with the provinces, who co-ordinate their efforts through the Council of Ministers of Education, the federal government can encourage: (a) development of *national* learning goals, including ways to measure results, and (b) agreements to ensure the nationwide *portability* of appropriately certified qualifications. These measures would foster employment and productivity by allowing people to be more efficiently matched with job opportunities throughout Canada and by giving employers greater confidence as to the basic qualifications of job applicants.
- Government officials are usually not in the best position to determine the right training options for individuals. The requirements of the workplace are changing too rapidly and bureaucratic, rules-based programs inherently lack the flexibility to best respond to individual needs and circumstances. A more ‘client-centered’ approach is therefore needed in government-sponsored training to enhance employability. Choices should be made in close consultation with the individual and in light of detailed knowledge of

local circumstances and the real needs of potential employers. A client-centered approach would have the further key benefit of fostering a more responsive and efficient education and training establishment, both regionally and nationally, as a result of competition to attract trainees. (Similar considerations would apply in the case of college and university education.)

■ Provincial and local governments must be partners in the actual planning and delivery of training, including training sponsored or funded by the federal government.

7

Encouraging Canadians to Adapt to New Opportunities

Economic progress depends on the ability and willingness of individuals and businesses to embrace new opportunities. The growth of jobs and incomes relies on this fundamental process of adaptation in which there are always new and more productive activities superceding the old. In the words of the OECD Jobs Study: “The single most important cause of rising unemployment, as well as a growing incidence of low-wage jobs, is a growing gap between the need for OECD economies to adapt and to innovate and their capacity, and even their will, to do so.”¹

Yet change is often very disruptive since it may mean losing a large investment in one’s existing skills, seniority, and capital, to say nothing of possibly severing ties to community and friends. And there can be no guarantee that a particular individual, or firm, or community will be able to survive the changes with their economic welfare intact.

Society as a whole nevertheless reaps great economic benefit from this process of adaptation to more productive opportunities. A portion of the overall gain should therefore be invested in the appropriate social ‘safety nets’ to cushion the impact on those most adversely affected through no fault of their own. Not only is this basic justice, but it also promotes the growth process by giving people greater confidence to embrace change.



“The single most important cause of rising unemployment is a growing gap between the need for OECD economies to adapt and to innovate and their capacity to do so.”

¹ *The OECD Jobs Study: Facts, Analysis, Strategies*; June 1994, p. 41.

A delicate balance must nevertheless be struck between providing shock absorption on the one hand, and retaining the incentive to seek new opportunities on the other. There is also a balance to be struck between the personal and community stability that Canadians rightly cherish, and the need to adapt to a world where the challenges and opportunities are always changing.

Different societies make different choices in striking these balances and those choices can have significant consequences for income and employment (Chart 23; Box 7). It appears, for example, that most of the European countries have allowed their economies, and particularly their job markets, to become too resistant to change. And while European wage growth has so far remained relatively high, and income inequalities relatively low, the price has been rising unemployment and a growing fiscal cost that in some countries has become unsustainable.

The United States, by contrast, has given much freer rein to market forces, leaving people few options but to adapt rapidly to competitive pressures. This has been accompanied by considerable and growing income inequality, with a great many of those who are near the bottom rung of the skills ladder working at a poverty wage. On the other hand, the U.S. has achieved a remarkably low unemployment rate (about six per cent currently) compared with the advanced European countries and Canada.

Box 7 The central importance of adapting to change

"The appearance of wide-spread unemployment in Europe, Canada and Australia on the one hand, and of many poor quality jobs as well as unemployment in the U.S. on the other, have thus both stemmed from the same root cause: the failure to adapt satisfactorily to change. In Europe, Canada and Oceania (Australia and New Zealand), low-wage jobs were, by and large, disallowed by society, whether through state-imposed or union-negotiated wage floors and employment protection. So the problem which appeared as a

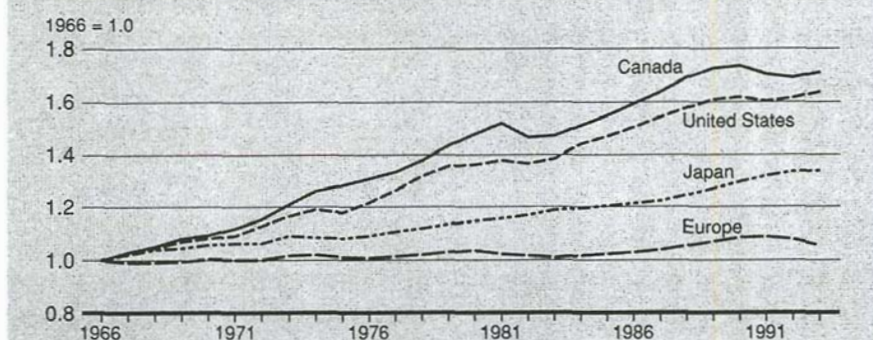
combination of low-wage jobs and unskilled unemployment in the U.S., took the form in Europe mainly of unemployment of the low-skilled...

The basic policy message of this report is unambiguous: high unemployment should be addressed not by seeking to slow the pace of change, but rather by restoring economies' and societies' capacity to adapt to it. ...

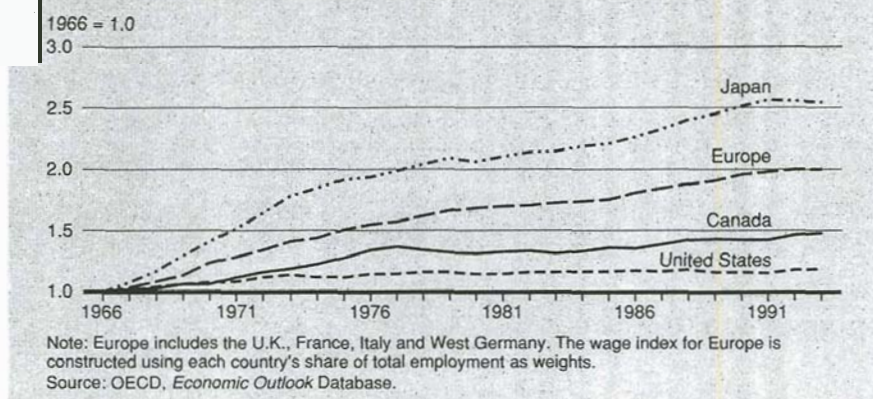
But this must be undertaken in ways which do not abandon the social objectives of OECD societies. Rather, social objectives must be met in new, more carefully-designed

ways that do not have the past unintended and undesirable side effects. The limitations that policies inadvertently, but progressively, put on the capacity and the will to adapt and innovate were not envisaged when many of them were conceived and implemented. Now that the problem is recognised in all its importance, it should prove possible both to meet social objectives and to permit much more ready adaptation to change."

*The OECD Jobs Study:
Facts, Analysis, Strategy
June 1994*

Chart 23a Employment in the G-7 countries, 1966–1993

Note: Europe includes the United Kingdom, France, Italy and West Germany.
 Source: OECD, *Economic Outlook Database*.

Chart 23b Real wages in the G-7 countries, 1966–1993

Note: Europe includes the U.K., France, Italy and West Germany. The wage index for Europe is constructed using each country's share of total employment as weights.
 Source: OECD, *Economic Outlook Database*.

Japan has uniquely achieved both very low unemployment and high incomes with relatively little earnings inequality. This has been due to that country's excellent productivity performance and particular social consensus. These unique characteristics have enabled Japan largely to enjoy the best of both worlds, though strains have recently begun to appear.

Canada's position has been intermediate between that of the U.S. and Europe – higher unemployment than the US, but less income inequality. Recently, however, Canada's unemployment rate has reached European levels and the fiscal sustainability of our income protection system has been called into question.

A strategy to foster jobs and growth must confront these realities. This means re-examining a number of government policies afresh to ensure that they still strike the right balance between change and stability, and that the incentives implicit in the policies are still having the originally intended effect.

The most significant federal programs in this regard are Unemployment Insurance and the Canada Assistance Plan in the case of individuals, and a range of implicit and explicit subsidies and other protections in the case of businesses.

Business

The issue of government assistance to business is not black or white. Assistance can sometimes be justified – for example, to counter subsidies by governments of competitor nations; or where public ‘spillover’ benefits may be very high (e.g., early stage R&D); or where the short-term cost, in terms of local job and income losses, of deferring to market forces is judged to be unacceptably high.

The right action will therefore always depend on striking a balance in the particular circumstances. But too often in the past, the presumed economic benefits flowing from various forms of business subsidy have been overestimated and the broader job and income costs significantly underestimated. Among prominent examples have been a number of ill-conceived industrial megaprojects.

Inappropriately designed assistance to business can be far more damaging to the economy, over time, than a simple static accounting of costs and benefits might suggest. This applies particularly to those forms of assistance which help to sustain, or to subsidize investment in, activities that are not competitive. As the OECD Jobs Study concluded: “Subsidies tend to operate in exactly the opposite way from what is needed: they slow rather than stimulate adjustment; they discourage rather than encourage innovation; and they tend to become permanent.”

There are two major ongoing costs in these circumstances: (i) people and capital become locked in dead-end situations, and (ii) the public resources required to sustain these dead-ends are not available to support constructive initiatives elsewhere or to reduce the deficit and, eventually, to lower taxes. For these reasons, reducing the kind of business support that inhibits economic adjustment can lead to *increasing* net job creation and income in the economy over time. And with the help of well-designed worker adjustment programs, the human cost of adaptation to necessary economic change can be minimized (Box 8).

Too often the presumed economic benefits flowing from various forms of business subsidy have been overestimated and the broader job and income costs significantly underestimated.

Box 8 A model of industrial adjustment: The steel industry

Canada's steel industry has had to grapple with all the challenges faced by many mature sectors in the industrialized world – i.e. over-capacity, low product prices and the emergence of new technology. These pressures forced Canadian steel makers to restructure, including significant lay-offs. Employment in the industry has

declined by about 25 per cent since 1988, with layoffs totaling approximately 11,000. Assistance to laid-off workers has been provided through the Canadian Steel Trade and Employment Congress (CSTEC), a co-venture between the United Steel Workers of America and Canadian steel producers. Both federal and provincial governments

have also provided resources to CSTEC to assist steel workers through training and worker adjustment programs. By early 1994, CSTEC had helped about 90 per cent of the laid-off workers. Approximately 70 per cent have now found new jobs with, on average, no loss of pay.

In light of these considerations, the 1994 budget announced reductions in business assistance. Further steps should be taken to determine whether the redesign of certain subsidies and other supports in, for example, transport and agriculture could lead to a more efficient transportation system and to a more internationally competitive agri-food industry, better adapted to Canada's inherent advantages.

In a similar vein, regionally-targeted assistance should be focused on genuine economic opportunities – tourism, for example – that have high potential to become self-sustaining. This implies a continued shift away from support of industrial megaprojects and toward creation of a supportive environment for smaller local enterprises, as well as increased use of repayable contributions or loans rather than grants.²

Individuals

Unemployment Insurance is by far the most significant federal government program of income support for working-age people – e.g., total UI expenditure was \$19.4 billion in fiscal year 1993-94. Unemployment Insurance was originally intended to cushion the income loss of short jobless spells and thus give people reasonable time to search for a new job that would be a good fit – i.e. they would not be forced to take the first thing that came

² The support of public infrastructure is a separate matter which, if wisely targeted, can yield significant regional economic benefits. See, for example, the subsequent discussion of the 'information highway'.

along. In this regard, well-designed UI improves economic efficiency. Unemployment Insurance is also an important economic stabilizer that helps maintain purchasing power during recessions.

Extensive studies over the years have concluded that UI nevertheless contains significant adverse incentives deriving from the rules of the program – e.g., the qualifying period and the level and duration of benefits.³ The method by which the program is financed – i.e. a payroll tax, regularly adjusted to keep the UI account roughly in balance – has also discouraged hiring.

The rules of the program have encouraged chronic, repeat use. For example, almost 40 per cent of people receiving UI in 1993 had claimed benefits at least three times during the past five years and the number of frequent repeaters has been rising. The average duration of spells on UI has also increased steadily. Moreover, the attractiveness of the program has induced people to enter the labour force in order to qualify. Studies estimate that these factors have combined to raise the unemployment rate in Canada by 1 to 2 percentage points, thus explaining some of the increase in the core rate of joblessness.

The program has unquestionably fostered a dependency in certain regions and industries. This has inhibited the adjustment of both people and businesses to more productive opportunities and has thus perpetuated job and income stagnation, greatly to the detriment of the people and regions affected.

The payroll tax that finances UI has its own perverse effect on job creation which, as noted earlier, has contributed to Canada's rising core rate of unemployment. The rate of increase of total payroll taxes in Canada has been unusually rapid. For example, UI premiums increased from 2.1 per cent of total labour compensation in 1976 to 4.5 per cent in 1992. Although UI is often seen as an income support for the less skilled, the irony is that the rise of payroll taxes induced by higher UI payouts particularly damages job prospects for the less skilled. This is because the tax constitutes

Almost 40 per cent of people receiving UI in 1993 had claimed benefits at least three times during the past five years and the number of frequent repeaters has been rising.

³ See for example: Card, D. and Riddell, C.; *A Comparative Analysis of Unemployment in Canada and the United States*, in Card and Freeman (eds), *Small Differences that Matter*; University of Chicago Press (1993); and Coe, D.T.; *Structural Determinants of the Natural Rate of Unemployment in Canada*; IMF Staff Papers, Vol. 37, March 1990, pp. 94-115.

a progressively higher *proportion* of wages at the lower end of the scale and thus drives an increasingly thick 'wedge' between what the potential employer is prepared to pay and the employee wants to receive.

The rules requiring premiums to be increased when the UI account goes into deficit have also interacted perversely with the business cycle. During extended downturns, UI payouts increase causing a deficit in the account and triggering premium hikes. This is effectively a tax increase at precisely the wrong time since it discourages hiring and thus works against recovery. A substantial surplus should therefore be permitted to accumulate in the UI account during the expansionary phase of the economic cycle so that premiums do not have to be raised during a contraction.

The 1994 budget introduced significant reform of the UI program rules and announced a modest reduction of the payroll tax to take effect in January 1995. But more will be needed to return UI closer to insurance principles and to create programs that improve job readiness. When jobs are scarce due to insufficient aggregate demand in the economy – certainly the case during the slow recovery from the 1991 recession – unemployed people will often not be able to land a job, even after training, until the recovery is more advanced. But if they have in the meantime used the period of forced idleness to invest in new skills, they are subsequently able to bring a more valuable 'asset' to the job market. This will improve future employability and permit a higher wage to be earned.

Provided, therefore, that changes in UI are designed with sensitivity to their human impact, they will be good for people and good for the economy. These issues will be addressed as part of the government's reform of social security which will consider how UI might be improved so as to:

- (a) Remove the incentives that lead to chronic repeat use of UI by individuals and that lead businesses to design artificial hiring and layoff patterns to maximize UI payments; and
- (b) Ensure that those who still have repeated difficulty finding employment are *actively* followed-up with counselling and training, preferably on-the-job.

Savings from a better designed UI program will permit premiums to be reduced and more effective employment development services to be provided for those with poorer skills.

Provided that changes in UI are designed with sensitivity to their human impact, they will be good for people and good for the economy.

8

Getting Government Right

Government is the most pervasive institution in every modern state. In Canada, for example, federal program spending was about 17 per cent relative to GDP in 1993-94, while the ratio to GDP of program spending by the public sector as a whole was approximately 42 per cent.¹

Government *policy*, even more than sheer spending, plays a major role in determining the economic decisions of individuals and businesses. Especially important is the way policies affect the behaviour of investors and entrepreneurs since it is their actions that define the cutting edge of job creation and income growth. A strategy to improve Canada's economic performance will thus depend critically on getting government right, to ensure that the public sector is part of the solution, not part of the problem.

Government itself must therefore learn to work smarter. The fiscal constraint alone requires this. But as many businesses and voluntary organizations have already discovered, the act of fundamentally rethinking one's mission, and how best to achieve that mission, can produce major dividends, not only in terms of cost efficiencies but especially in terms of service quality and customer satisfaction. It should be no different with government.

¹ Almost three-quarters of federal program spending is for transfer payments. Federal spending on its own operations, including defence, was 4.7 per cent of GDP in 1993, a proportion that has fallen over the years from the neighbourhood of 6 per cent in the 1960s (National Accounts basis).

For several years, under the banner of deficit reduction, the federal government attempted to cut back on spending growth but with little strategic direction. The objective appeared to be the cuts themselves, with much less attention paid to getting better value from the spending that remained.

We have reached the limit of that approach. To engage only in uniform, across-the-board spending reductions will lead to a situation where the government is left with most of the overhead cost, but with a critically diminished capacity to deliver program value for taxpayers' money.

The time has come to make choices as to what the necessary and appropriate role of the government really is, and then to allocate the resources needed to do a first-class job. The federal government should withdraw from those things that are no longer essential to the public interest, or that can be better accomplished by provincial or local governments, or by the private/voluntary sector. At the same time, there are certain activities currently under provincial regulation that could be accomplished more effectively on a nationwide basis. Securities regulation is one example that has often been suggested.

The federal government has launched a comprehensive Program Review which aims to provide the best and most efficient services that can be afforded. This will be accomplished by eliminating or reducing activities of lower priority and targeting scarce resources on programs of the highest priority and in areas where the Government of Canada is in the best position to provide the service (Box 9).

A number of more specific reviews announced in the 1994 budget are underway to complement the Program Review, including, among others:

■ **Social Security Reform** which, in co-operation with the provinces, aims to create an affordable system that enhances job skills and fosters independence by offering incentives to work while protecting the most vulnerable. To this end, the Minister of Human Resources Development has sought the views of Canadians with the release on October 5, 1994 of a discussion paper entitled: *Improving Social Security in Canada*.

■ **The Science and Technology Review**, which is examining ways to maximize the benefits to the economy of the federal in-house research capability and the government's extensive programs to encourage S&T activities in universities and businesses.

The time has come to make choices as to what the necessary and appropriate role of the government really is, and then to allocate the resources needed to do a first-class job.

Box 9 Comprehensive review of government programs

The February 1994 budget pledged the government to undertake a comprehensive review of “all aspects of departmental spending to ensure that lower priority programs are reduced or eliminated and that the government’s diminished resources are directed to the highest priority requirements and to those areas where the federal government is best placed to deliver services”.

The Program Review is an ambitious initiative to fundamentally rethink government’s role and priorities in the context of the overall jobs and growth strategy. Virtually all the activities of the federal government fall under the scope of the review, the exceptions being the major statutory transfers to provinces and to people. Most of these are

being examined separately — e.g., in the review of social security.

All other government activities are being assessed to determine if they still serve a public interest and, if so, if there continues to be a necessary and appropriate role for the federal government. If not, the activities might be devolved to the provinces or transferred, all or in part, to the private/voluntary sector. For those activities that most appropriately remain under the federal wing, the review will be expected to come up with ways to maximize efficiency and ensure affordability.

To complement the Program Review (the focus of which is primarily on the activities of individual departments), the

government has also launched a number of special policy assessments, several of which cut across the mandates of many departments — e.g., reviews of science and technology, sustainable development, and small business, among others.

The consultations and analytical work associated with the Program Review and the complementary sectoral reviews will provide a rational basis for a significant transformation of the federal government. The goal is a federal public sector that works smarter, spends smarter and gives Canadians more of what they genuinely need from their national government.

■ **Reviews of Defence and Foreign Policy**, that will ensure that Canada’s objectives going forward are more clearly defined and accomplished in a cost-effective manner; and

■ **The Small Business Review**, which will determine how the federal government can best foster the growth of small and medium-size enterprises (SMEs). The main concerns of these businesses are already clear and include calls for lower taxes, reduced paper-burden, more flexibly implemented regulations, improved financing, and more ready access to government information and programs.

The government’s determination to proceed with fundamental reform of its own activities is already evidenced, for example, in the plans announced by the Minister of Transport to commercialize significant parts of the Department’s activities (Box 10). As a result, spending by Transport Canada will be reduced significantly while overall service quality will be improved. Further opportunities will be sought in other departments and

Box 10 Transport 'commercialization'

The Minister of Transport has announced a number of far reaching initiatives to 'commercialize' certain traditional functions of the Department.

Commercialization means adopting a business-like approach to the delivery of certain public services. The objective of commercialization is to improve service and reduce costs, while continuing to protect the public interest. Commercialization embraces a number of possibilities for owning and operating assets –

e.g., Crown corporations, 'mixed' public-private enterprise, transfer to other levels of government, or outright privatization.

Commercialization can also involve greater cost-recovery from users. In return, service delivery can be expected to be more responsive to clients. In all cases, consultations will be a key element in determining the option to be chosen in any particular case.

Under the new National Airports Policy announced in July 1994, Canada's 26 busiest airports will be

leased to local, not-for-profit organizations that will manage them to self-sufficiency within five years. Operational subsidies for smaller airports will be largely phased out over two to five years and they will be offered for sale, first to other levels of government, then to interested parties. Those that still cannot be sold, will be closed. A small number of airports in the Arctic and other remote locations will continue to be operated by Transport Canada under existing programs.

agencies for commercialization of activities. These might involve outright privatization or, where appropriate, having the private sector build, own and operate facilities to provide certain public services.

The government is also determined not to become involved in new industrial 'megaprojects' since experience has demonstrated that the costs too often considerably exceed the public benefits. Certain existing projects will continue, but the future policy direction has been signalled by the government's exit in June 1994 from the Newgrade Upgrader and in August from the Bi-Provincial heavy oil upgrader.

In a related vein, the government has substantially reduced its involvement in the enormously expensive International Space Station Program. Instead, the space program will focus on areas of Canada's comparative advantage – e.g., earth observation and remote sensing. Investments of this kind help to lay the scientific foundations for sustainable development, a vital national priority, and at the same time support upgrading Canadian expertise in areas of technology with high export potential.

Giving greater value for money is not the only goal in delivering government that works better for Canadians. Indeed, the most significant impact of the federal government on the economy flows from its conduct

of fiscal and monetary policy and from its regulatory and other policy actions – e.g., competition policy, protection of intellectual property, foreign investment and trade policy, industrial relations in the federal domain, among others. Taken together, these go far to determine our overall quality of life and whether Canada provides a welcoming, or a hostile environment for the investors and entrepreneurial people who are the ultimate job creators.

Reforming Regulation

Regulatory reform, for example, is an area of particularly high potential payoff in terms of increased business productivity, the stimulation of new investment, and more efficient government. The cost to the private sector of regulatory compliance amounts to tens of billions of dollars annually. And in the federal government alone, approximately 20,000 people are engaged in overseeing some 3,000 regulations. Clearly, getting government right means getting regulation right.

Good regulation is essential to a well-functioning society and economy. Rules to safeguard the health and safety of Canadians and to support environmentally sustainable development are vitally in the public interest. Similarly, no market economy can function efficiently without adequate rules of the game. Regulatory reform is therefore *not* simply synonymous with deregulation, though there will always be regulations that have outlived their usefulness and should be eliminated.

The inherent difficulty of reform in this area is reflected in the fact that regulations have always proven far easier to create than to remove. Once behaviour has become adapted to a regulation – even a bad regulation – change is resisted. Regulatory enforcement also tends inherently to be bureaucratic and inflexible for a reason. It is to reduce the risk of abuse and inequity that too much discretionary latitude would create.

Despite these fundamental difficulties, the reform of regulation to create greater flexibility, more efficient and responsive administration, better harmonization with other jurisdictions, and greater sensitivity to potential adverse economic impacts of regulation will be a top priority of the government's strategy to improve Canada's productivity and job creation potential.

Good regulation is essential to a well-functioning society and economy. Regulatory reform is therefore *not* simply synonymous with deregulation.

Progress is already being made. For example, federal departments are being required to re-justify every regulation. Of the roughly 1,700 reviewed to date, about a quarter have been eliminated, another quarter confirmed and the remainder are being revised or further examined. In addition, the 1994 budget committed the government to accelerate the development of a more flexible regulatory regime. And the Task Force on Economic Instruments and Disincentives to Sound Environmental Practices is examining: (a) how market-based instruments (e.g., effluent charges) might lead to better environmental management, and (b) situations where government incentives and disincentives may inadvertently be causing environmental disruption.

9

Providing Leadership in the Economy

The dynamic core of every successful economy is a thriving private sector. From the lone consultant working out of her basement to the largest transnational corporation, it is businesses that are on the front line – innovating, investing, competing for markets – and thereby creating more and better jobs for Canadians. Government must play a complementary role through the provision of essential goods and services that the private sector is not best equipped to supply – e.g., public infrastructure, organization of health care, and general education.

There is also a more pro-active leadership role for government. In a knowledge-based economy, success depends less on a nation's natural endowment and more on its skills and innovative capabilities – in other words, on 'comparative advantages' that can be shaped by government policy (Box 11). This basic insight defines the appropriate new leadership role for government in the economy.

That leadership role will place greater emphasis on fostering trade and innovation, and less emphasis on the traditional, and now largely sterile, issue of industrial policy based on targeting firms for financial assistance. The role of government will increasingly be to exploit its comparative advantage in gathering, assembling and disseminating information, and in fostering networks and linkages among firms. The need for better business information services and networking has multiplied as activity shifts toward smaller, highly-specialized firms that must somehow keep abreast of market opportunities and the latest technologies on a world-wide basis.

Box 11 The new shape of industrial policy

"In this new, knowledge-based world of multinational enterprises, many countries' comparative advantages depend more on acquired knowledge and skills than on nature-given endowments. If comparative advantage depends mainly on skills that are acquired by management and labour – and possibly also on human institutions – then it no longer seems to be beyond policy control. Instead, comparative advantage can be 'shaped' by government policy. Furthermore it can be lost by bad policy, at least as easily as it can be acquired by good policy."

– Richard G. Lipsey,
The Sir Charles Carter Lecture
1993

"One recent assessment suggests that targeting 'winners' is more likely to succeed as a strategy that involves catching up than for one that involves pushing back the frontier. With no clear model to follow, it is difficult and indeed hazardous for governments to identify the leading industries and technologies of the future.

Today, successful policies for competitiveness will be those primarily aimed at supporting the aspects of intangible investment infrastructures and collective governance which are outside the purview of individual firms, and at facilitating the formation of linkages, networks and interactive mechanisms."

– *Technology and the Economy:
The Key Relationships*
OECD, 1992

There remains a vital public sector responsibility – shared among the federal, provincial and local levels of government – to provide first-class public infrastructure to enhance productivity and Canada's attractiveness for investment. This will range from the more traditional Canada Infrastructure Works Program launched in January 1994, to a key federal role in the creation of Canada's section of the global 'information highway' (Box 12).

The initiatives that will give substance to an active federal role in the economy cover an extremely broad range which, even in outline, go beyond the scope of this paper. The development of specific initiatives on the government's 'microeconomic' agenda is the responsibility of the Minister of Industry. The balance of the discussion here will therefore be limited to general observations on two critically important themes of that agenda – supporting innovation and fostering export growth.

Box 12 The information highway

The 'information highway' is the central metaphor of the emerging information society. The 'highway' is partly vision, but already partly reality. It is a communications network of networks over which phenomenal amounts of information will eventually travel. The reality of the highway consists of the building blocks that are already everywhere – telephones, cable television networks, communications satellites. A preview of the 'vision' is represented by the Internet, a global network of inter-connected personal computers that already unites tens of millions of homes and businesses.

The information highway promises to reduce the disadvantages of

distance and remote location in Canada. This has profound implications for the economic prospects of less-advantaged regions and smaller communities throughout the nation. The development of an effective information highway promises to revolutionize the electronic delivery of government information and other services, as well as to deliver 'distance education' to every corner of the country. The development of Canada's branch of the information highway will play an important role in maintaining the competitiveness of our world-class telecommunications industry.

The actual construction of the information highway will depend primarily on the private sector. The

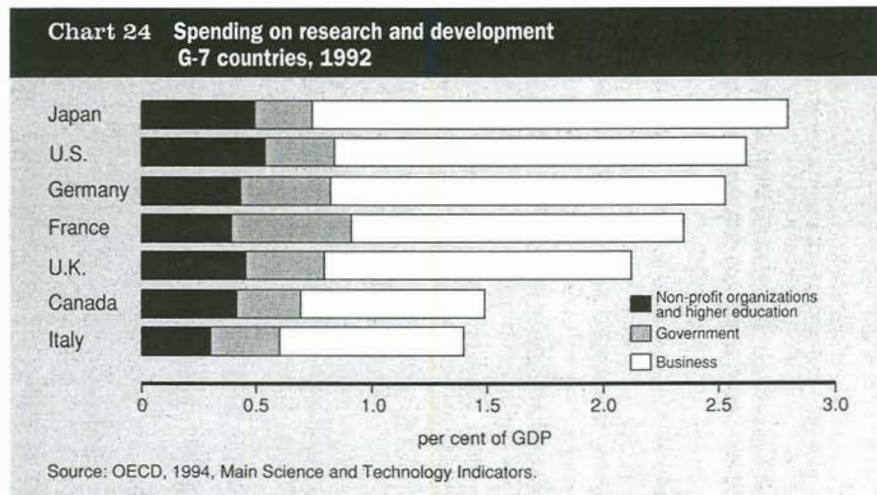
federal government will also play a key role by providing a supportive policy and regulatory framework for the communications industry; by participating in R&D activities; and by being a major customer of the network. The Minister of Industry has appointed a broad-based Advisory Council on the Information Highway. The government is contributing to the support of the seven-year, \$1.2 billion CANARIE project to build an experimental communications network and test facility. And, under the leadership of the Treasury Board, the government has begun the process of adapting and transforming its own services to harness the enormous capability of information technology.

Innovation

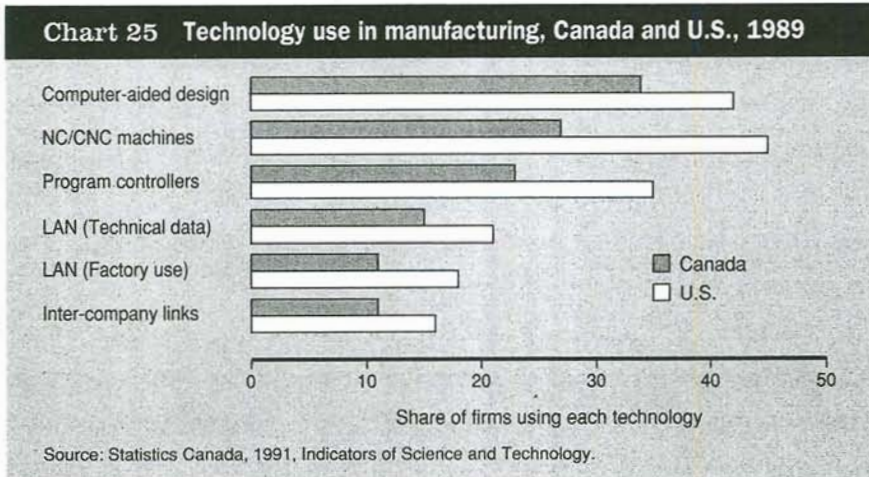
Innovation is the driving force behind improved productivity and is thus central to economic growth and long-run job creation. This basic truth was echoed in the OECD Jobs Study which concluded that "the main way to job creation in OECD countries must be through improved productivity in firms that have a solid capacity to innovate and use technology effectively". It follows that no nation can afford to leave innovation to happenstance.

While businesses obviously are motivated to innovate, commercial incentives alone cannot be relied upon to forge all the links of the innovation chain. For example, private firms are quite prepared to make large investments in late stage R&D when the results are likely to be proprietary. But at earlier stages of the process, when openness and collaboration are essential to progress, a private firm has much less incentive to spend its own money since it cannot corral the results. Society nevertheless has a huge collective stake in the success of the innovation process. Government must therefore complement the private sector by filling the most important gaps.

This is particularly true in Canada where many indicators of innovative effort by the private sector, especially those related to applications of science and technology (S&T), are low by industrial country standards. For example, Canada's relative expenditure on R&D – 1.5 per cent of GDP in 1992 – is well below that of all G-7 countries except Italy (Chart 24). Canada's low R&D spending is due partly to the structure of our economy (e.g., resource industries rarely do as much R&D as high-tech manufacturers) and partly to the unusually high degree of foreign ownership in Canada (e.g., the auto assemblers perform relatively little R&D here). It must nevertheless be recognized that Canadian workers in auto assembly plants, and in many other industries, are major beneficiaries of world-class technology embodied in imported machinery and in the production know-how of transnational companies.



It is often pointed out that R&D is only an *input* to the innovation process. It is a means, not an end. But it is also the case that companies should perform some R&D, or at least have in-house engineering skills, to enable them to successfully adapt the latest technology to their particular needs. Statistics show that, on average, Canadian manufacturing firms are less likely than their U.S. counterparts to use the most advanced technology (Chart 25). Thus, Canada's apparent under-performance of R&D is also mirrored – and probably with more serious economic consequences – in a relatively less intensive use of technology on the shop floor. This is especially true for smaller companies, though there are many individual exceptions.



Since we must rely heavily on technologically sophisticated businesses (in *all* sectors of the economy) to be the primary job generators of the future, the S&T capabilities of Canadian industry must be upgraded. The federal government can help principally in three ways:

Direct Spending on Science and Technology: Currently the government spends just under \$6 billion annually on S&T activities, roughly 60 per cent of which is performed in 150 federal laboratories whose activities range from health protection to industrial research in cooperation with the private sector. The federal government currently funds close to 30 per cent of *all* R&D performed in Canada including transfers to businesses and universities of just under \$1.0 billion each to finance basic and applied research. The cost-effectiveness and relative priorities of these substantial expenditures are being examined as part of the S&T Review.

Tax Incentives: The Scientific Research and Experimental Development (SR&ED) investment tax credit provides a substantial benefit to Canadian R&D performers. These businesses currently claim over \$1 billion of tax credits annually. The tax credit rate is higher for small businesses and the credits themselves are refundable for small businesses. In addition, eligible capital expenditures on SR&ED are fully tax deductible. A recent study by the Conference Board concluded that Canada's system of SR&ED tax incentives for manufacturing companies already appears to be the world's most attractive.

Diffusion of Technology: Smaller Canadian firms – which often lack the resources and expertise to keep abreast of the latest technological developments – can benefit greatly from government programs that provide information to assist the acquisition and implementation of technology and best practice techniques. Agricultural extension services, which date from Confederation, have been an exceptionally successful demonstration of the importance of technology ‘diffusion’.

Methods to promote the diffusion to Canadian firms of the world’s current best techniques can have very high payoff because they exploit the results of innovation that has already been developed. Since the cost of reproducing is far less than the cost of first developing a new technique, there is considerable strategic leverage inherent in diffusion programs. A particularly successful Canadian example has been the Industrial Research Assistance Program (IRAP) managed by the National Research Council.

There nevertheless remain important gaps in Canada’s innovation system – for example:

- Too many small manufacturers lack the technically sophisticated staff needed to absorb leading edge technologies.
- Securing adequate finance (including equity capital) for smaller firms whose principal assets are ideas – the capital of the knowledge economy – is a continuing challenge.
- Although Canadian academic scientists and engineers are among the world’s best in many fields, there has been far too little success translating good research ideas into commercial success. Canadian medical researchers, for example, are at the leading edge in several fields but the commercial ‘receptor capacity’ to develop their ideas scarcely exists in this country. This is unfortunately all too typical. Developing linkages that really work between Canada’s knowledge base and its commercial base will therefore remain an ongoing challenge and priority.

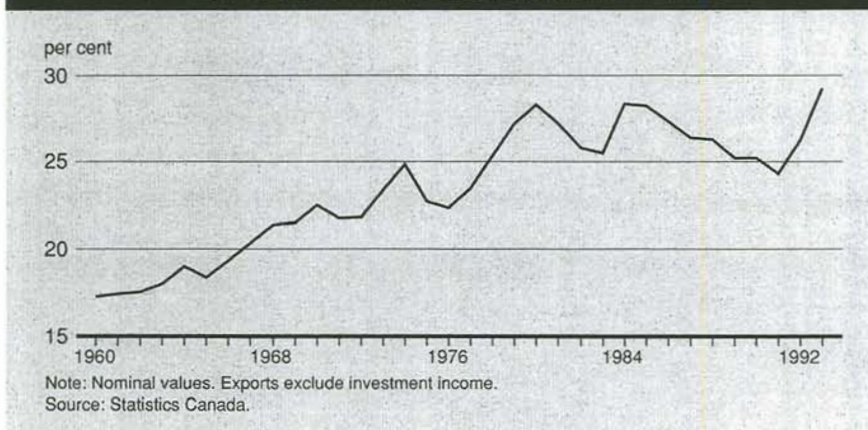
The Science and Technology Review will give further direction as to how government can cost-effectively address these gaps and, more generally, assist in upgrading Canada’s entire innovation system.

Methods to promote the diffusion to Canadian firms of the world’s current best techniques can have very high payoff because they exploit the results of innovation that has already been developed.

Trade

The growth of trade has consistently outstripped growth of world output since the end of the Second World War. This reflects progressively tighter global economic integration of which there is no end in sight. This is a fundamentally positive trend since Canada is one of the world's most trade-dependent nations – e.g., exports of goods and services now account for just under 30 per cent of GDP. That proportion had trended up strongly until 1980 and has lately accelerated again (Chart 26). International trade today accounts, directly and indirectly, for approximately one Canadian job in four.

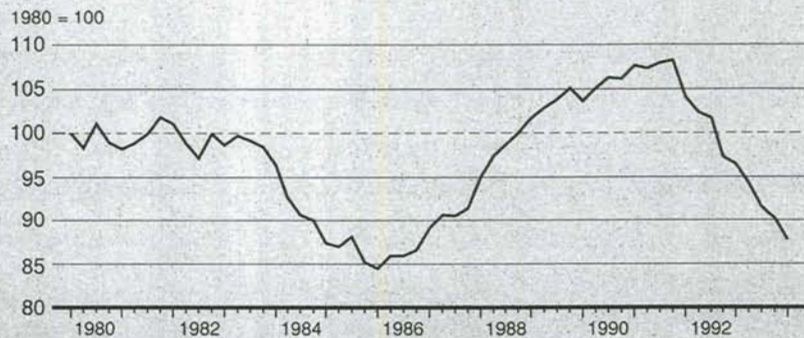
Chart 26 Exports of goods and services as a share of GDP



The growing success of Canadian exporters is perhaps the most encouraging feature of our current economic performance. Thanks to recent strong improvement in labour productivity, tight cost control, and a sharply lower exchange value of the Canadian dollar, our export cost competitiveness (as measured by changes in Canada's unit labour costs relative to those in the U.S.) has recovered all of the ground that had been lost during the second half of the 1980s (Chart 27).

Apart from ensuring that markets remain open to Canadian exporters and that existing trade rules are applied fairly, Canadian trade strategy faces two principal challenges: (i) to achieve a greater share of expanding markets in Asia, Latin America and eastern Europe; and (ii) to build greater export capability in small and medium-sized enterprises (SMEs).

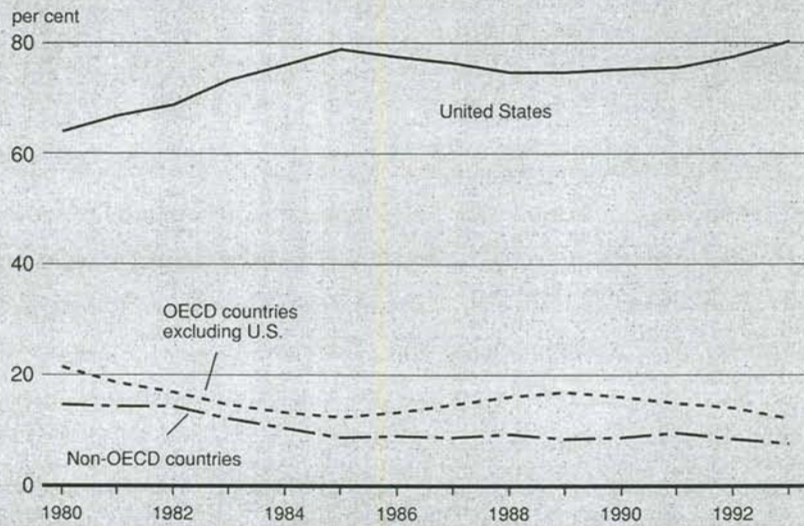
Chart 27 Ratio of Canadian to U.S. unit labour cost (common currency)



Note: A falling line indicates increased competitiveness of Canadian producers.
Sources: Statistics Canada, and U.S. Bureau of Labour Statistics.

Canada's traditionally strong export orientation toward the U.S. has actually been increasing while exports to rapidly growing developing country markets have declined as a proportion of the total since the late 1970s (Chart 28). The United States, meanwhile, has been focusing on the emerging markets which now account for about 40 per cent of U.S. exports and for the majority of their current growth.

Chart 28 Canadian exports to each region as a share of total exports



Note: Data is for merchandise exports.
Source: Statistics Canada.

A more aggressive penetration of these dynamic markets is now a primary objective of Canada's trade development strategy, principally because of their extraordinary growth potential, but also to begin to reduce

our unusually heavy relative reliance on the U.S. market. The United States will of course always be Canada's most important trade partner by a wide margin. Policies to build on our export competitiveness in that market will therefore also continue to have high priority.

A strategic emphasis on dynamic developing markets implies: (a) some reallocation of the government's trade development resources toward Asian, Latin American and eastern European markets and away from markets with lower *commercial* potential, (b) a more explicitly commercial orientation of Canada's foreign policy in these and other rapidly developing areas, and (c) the consideration of new or expanded regional trade agreements – e.g., encouraging the accession of Chile (now a major destination of Canadian direct investment) to NAFTA.

This strategy must be complemented by continuing trade and investment negotiations to improve market access for Canadian exports and investment in partnership with Canadian firms who must act to take up the opportunities. This will be important, for example, in the financial services area where negotiations under auspices of the new World Trade Organization are to be reopened in 1995.

The second principal element of a new trade strategy is to foster more exporting by SMEs. At present, this sector accounts for approximately 10 per cent of the dollar value of Canada's manufactured exports. Only about 15 per cent of our manufacturing companies export directly at all.¹ On the other hand, almost one-quarter of all Canada's merchandise exports originate in five giant companies.

Canada's future export expansion, through product and market diversification, depends on developing the capabilities of our increasingly sophisticated and diverse smaller firms. These firms include not only goods producers, but increasingly service sector firms as well, including businesses in the tourism sector. The dollars spent by visitors to Canada are equivalent to exports since they reduce Canada's overall balance of payments deficit with the rest of the world.

Canada's future export expansion depends on developing the capabilities of our increasingly sophisticated and diverse smaller firms.

¹ These statistics understate somewhat the contribution of SMEs in that they fail to reveal the 'hidden exports' of smaller companies that supply the larger ultimate exporters. As large companies 'outsource' more production, an increasing proportion of SME output is finding its way indirectly into export markets.

Improving the export capabilities of small firms can be achieved in part by general policies to strengthen the SME sector – e.g., by facilitating technology diffusion. But it will also require more directed efforts: (a) to improve access to export finance – e.g., new services tailored to the needs of SMEs are being worked out co-operatively by the Export Development Corporation and commercial banks, and (b) to build up the export-readiness of smaller businesses through training and market intelligence and other services designed collaboratively with SME needs uppermost in mind.

These and other issues of trade development – including an examination of the direction and cost-effectiveness of the government's \$625 million annual direct expenditure on trade development – are being addressed in the International Business Development Review. This review is part of the government's comprehensive evaluation of role and method, reflecting the high priority of getting government right.

10

Creating a Healthy Fiscal and Monetary Climate

Returning Canada to fiscal health is a prerequisite to achieving all of the other elements of the economic strategy outlined in this statement. Increasing productivity and sustained job growth are the results of investment, of entrepreneurial vigour, and of consumer confidence. All are being undermined by a growing public debt that has led to higher taxes, higher real interest rates, and a diminished capacity of the Government of Canada to address the other vital issues of an economic strategy for the future.

Canada's fiscal deterioration must be halted and reversed. Although the deterioration has been cumulative, rather than sudden and dramatic, the unusually high real interest rates and the instability of the exchange rate are clear signs of unsustainability. This is all the more regrettable because many other components of Canada's economic performance are exceptionally upbeat.

The financial problem facing the public sector in Canada is due fundamentally to the accumulating stock of *debt*. Chronic annual deficits cause the debt to grow, but the deficits themselves are now almost solely the result of interest payments on the existing stock of debt. If it were not for interest, the federal budget would be moving into surplus since projected revenue in the fiscal year 1994-95 exceeds projected program spending by over \$5 billion. But debt charges are forecast to exceed \$44 billion, implying that the deficit for the year will be in the neighbourhood of \$39 billion.

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Most of this amount must be borrowed, adding to the debt and increasing the base on which next year's interest must be paid. Interest on this *additional* debt is likely to be more than \$3 billion in 1995-96.

By fiscal year end 1994-95, the net federal debt is expected to be \$548 billion. If program spending remained roughly in balance with revenue, compound interest alone at today's average rate of about 8 per cent would cause this debt to grow by almost 50 per cent to more than \$800 billion within just *five* years.¹ By then, the annual interest payment would be about \$64 billion, or \$20 billion more than this year's forecast debt charges.

To put this in perspective: a \$20 billion increase in annual interest payment is an amount equal to the government's total spending on behalf of the elderly. It is almost twice the annual expenditure on defence. It is more than twice the annual equalization payment to the poorer provinces. To repeat – this would represent the effect of only five years' compounding. This must not be allowed to happen.

The government is therefore committed to reverse Canada's fiscal decline, first by achieving the announced target of reducing the deficit to no more than 3.0 per cent of GDP by fiscal year 1996-97. This is an interim step. But it is a significant step. The annual federal deficit has not been held to 3 per cent of GDP since 1974-75. The ultimate objective is to achieve a balanced budget and to significantly reduce federal debt as a percentage of GDP.

The deficit will be reduced to no more than 3.0 per cent of GDP by 1996-97. The ultimate objective is to achieve a balanced budget and to significantly reduce federal debt as a percentage of GDP.

Monetary Policy

These objectives will be achieved without compromising the integrity of monetary policy. The government and the Bank of Canada have agreed that monetary policy will be conducted so as to keep annual consumer price inflation within a band of 1 to 3 per cent. The long run goal of monetary policy is to preserve confidence in the value of money in Canada. The maintenance of Canada's enviable inflation performance will contribute to a more stable and attractive business climate and, as public debt is brought under

¹ The example is to illustrate the interest compounding effect in isolation which would be the case if the 'operating budget' (revenue minus program spending) were in balance. In 1993-94, the operating budget was in deficit by \$4.0 billion whereas in 1994-95 an operating surplus of between \$5 and \$6 billion is expected. The actual operating balance over the next five years will depend on conditions in the economy and on fiscal actions taken by the government.

control, to lower interest rates. Moreover, the control of inflationary pressures, before they gain momentum, ensures a steadier economic expansion and thus minimizes both the severity of recessions and the resulting impact on employment.

Fiscal Policy

The debt and deficit are often portrayed as issues primarily of concern to financial markets and ideologues. The truth is that those who suffer most immediately from Canada's fiscal deterioration are the unemployed, the poorer regions of the country, and the average young to middle-aged family with a mortgage and other debt incurred to raise and educate their children. The unease of financial markets in the face of Canada's debt spiral translates directly to higher loan and mortgage payments for the average Canadian. And the relentless compounding pressure of interest costs on the public debt is severely eroding the ability of the government to provide for Canada's less advantaged citizens and regions. The social consequences of debt are every bit as grim as the economic consequences.

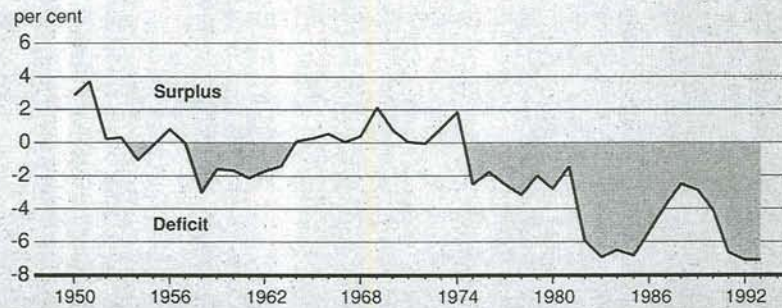
How have we come to this?

The earlier discussion of Canada's postwar economy described how the era of chronic deficits and rising debt began in 1974 when productivity and economic growth declined from the buoyant trend of prior decades. Successive governments – both federal and provincial – failed to recognize or to act on the fundamental shift that had taken place in the economy, one effect of which was to reduce the underlying rate of growth of tax revenues. Consequently, the divergence between expenditure and revenue trends produced an uninterrupted string of deficits from 1974 to this day (Chart 29). These deficits were incurred primarily to finance the maintenance of consumption – capital investment spending by governments has actually *declined* as a share of total government spending since the 1960s.

The steady accumulation of deficits for 20 years has caused government debt to rise inexorably relative to GDP. By fiscal year-end, 1993-94, total federal and provincial government debt had reached \$700 billion or more than \$24,000 per capita. The associated *annual* interest cost of more than \$56 billion was equivalent to approximately \$2,000 for every Canadian. In the 13 short years since 1981, public sector debt has multiplied six-fold in nominal dollars (Chart 30). And in real, per capita terms, the debt has

The unease of financial markets in the face of Canada's debt spiral translates directly to higher loan and mortgage payments for the average Canadian.

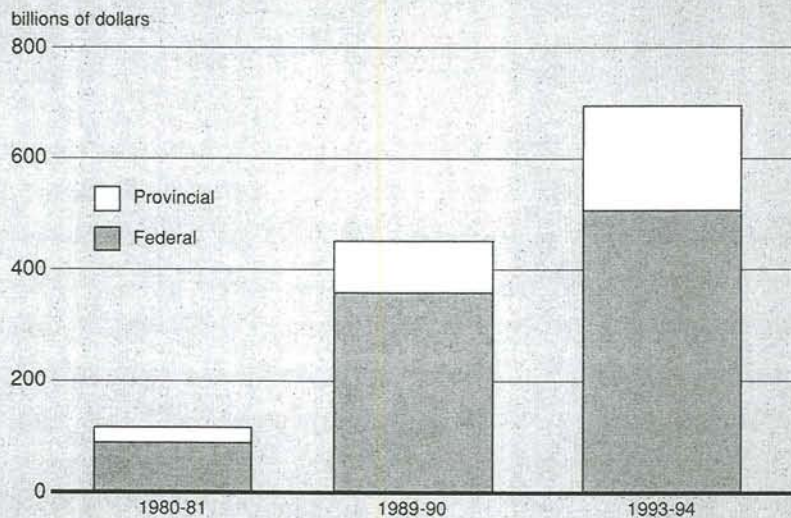
Chart 29 Total government fiscal balance as a share of GDP



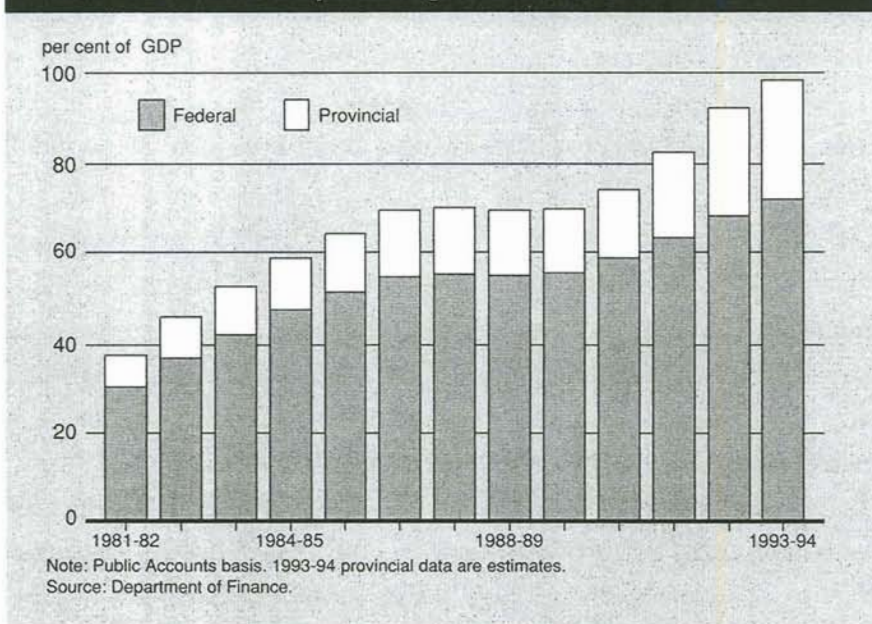
Note: Federal, provincial and local government budget balance, plus the net savings or lending in the Canada and Quebec pension plan on a National Accounts basis.
Source: Statistics Canada.

increased 2.4 times since 1980-81. At this rate, real per capita debt doubles every *ten* years. Remarkably, this debt explosion has taken place despite relatively strong growth during the second half of the 1980s and despite substantial tax increases and efforts to control spending. Today, total government debt in Canada has reached 100 per cent of GDP, of which close to three-quarters is the federal portion (Chart 31).

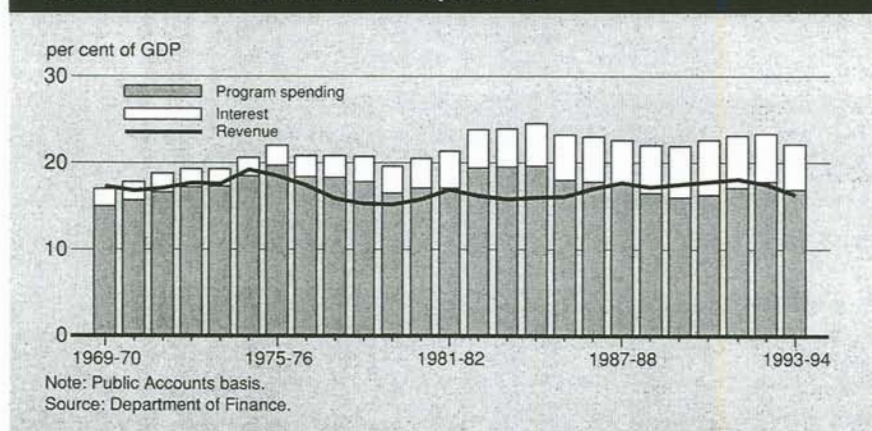
Chart 30 Federal and provincial government net debt



Note: Public Accounts basis. 1993-94 provincial data are estimates.
Source: Department of Finance.

Chart 31 Federal and provincial government net debt

The compounding effect of interest on the existing stock of federal debt has long since replaced program spending as the factor responsible for persistent deficits and a rising debt to GDP ratio. Indeed, spending on federal programs, including all transfer payments, is lower today as a proportion of GDP than was the case in the mid-1970s (Chart 32).

Chart 32 Federal revenue and expenditure

The debt statistics are beyond real comprehension and thus have probably lost their power to shock. A figure more at human scale is that interest on the federal debt is now accumulating at \$85,000 per minute, twenty-four hours a day. But in the context of policy to promote economic growth and job creation, does it really matter?

Absolutely.

Deficits, and the debt from which they now derive, matter a great deal for several reasons.

Taxes: Chronic deficits cause taxes, and the expectation of future taxes, to increase in order to cover the increasing cost of debt service. Other things being equal, the prospect of rising taxes discourages investors and entrepreneurs, thus diminishing future growth and job prospects. And higher taxes themselves distort economic behaviour in ways that are detrimental to efficiency and growth. The negative employment effects of payroll taxes have already been described. Income taxes have some of the same distorting characteristics. Taxes are necessary, but as they rise, their impact on growth and job creation is progressively adverse.

Interest Rates: Debt and deficits cause real interest rates to increase once the level of debt becomes viewed as excessive by financial markets (Box 13). High interest rates deter investment since they increase its cost. Reduced investment today translates to lower productivity and lower job growth tomorrow. Higher than necessary interest rates have also slowed the recovery of the economy from recessions, increasing the average duration of unemployment and keeping the jobless rate elevated.

Crowding-Out the Public Sector: Debt, and its resulting interest cost, squeezes out government spending on programs that Canadians value. Tax dollars would be far better spent to address many of the opportunities described earlier in this statement. Most of these are structural measures that

Interest on the federal debt is now accumulating at \$85,000 per minute, twenty-four hours a day.

Box 13 The rewards of fiscal prudence

"Apart from its budgetary problems, Canada's macroeconomic environment is very hospitable: negligible inflation and a rising trade surplus... It is important to recognize that, should the federal government take positive steps to cut spending, the vicious circle of budgetary problems leading to higher interest rates, increased debt service costs and a more intractable budget

problem could easily be replaced by a virtuous one. A credible program of spending reduction would not only result in a lower projected budget deficit directly, but the debt service cost savings generated by lower interest rates would also multiply the budgetary windfall. Last year's U.S. experience with deficit reduction or the experiences of Ireland and Denmark during the

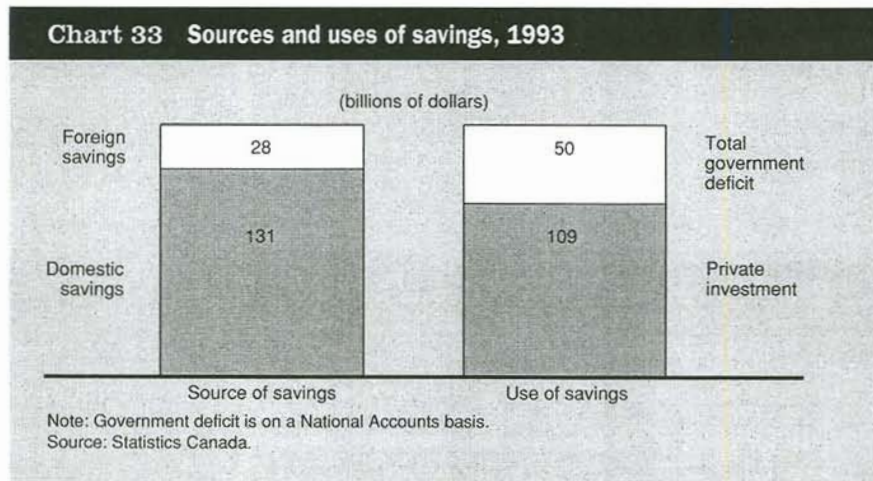
1980s illustrate that a credible program of fiscal stridency can often achieve even greater deficit reduction and a more favourable economic environment than anticipated."

– Goldman Sachs,
*International Bonds
and Forex Bulletin*
July 1994

would have a big payoff in terms of more and better jobs in the longer term, but the debt constraint is now so severe that many important initiatives cannot be undertaken. (Government deficits also ‘crowd-out’ the private sector by inducing higher real interest rates.)

Foreign Debt: The huge annual deficits that result from interest on the accumulated stock of public debt are to a large degree responsible for the relentless increase of Canada’s net foreign debt. This is because Canadian savings chronically fall short of the amount needed to finance both necessary domestic investment and annual government deficits at both the federal and provincial levels. The shortfall must be borrowed abroad.

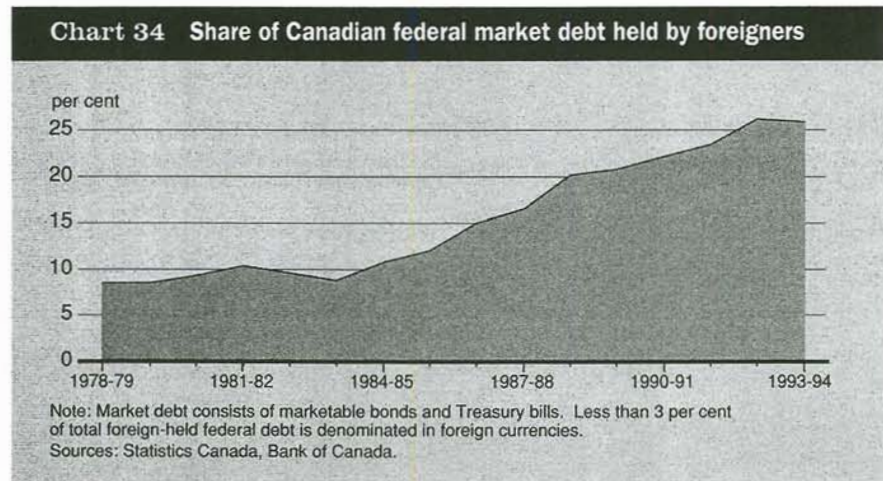
In 1993, for example, Canada’s private savings (by households and businesses) totalled \$131 billion, enough to fund total private investment of \$109 billion, with about \$22 billion to spare. But the borrowing requirements arising from federal and provincial deficits were \$50 billion. This was more than the remaining domestic savings could cover. So the difference of \$28 billion had to be borrowed abroad (Chart 33). Each year, a comparable shortfall has been adding to the mountain of Canada’s external debt.¹



¹ It has sometimes been suggested that foreign borrowing could be reduced or even eliminated if governments were somehow to restrict their borrowing to Canada. But unless the savings of Canadians increased, or private investment were curtailed, or deficits were cut, Canada’s net foreign borrowing requirement would be unchanged. If governments borrowed more domestically, it would force the private sector to borrow more abroad.

The consequences of increasing reliance on foreign savings – in effect to finance a portion of annual domestic *consumption* – are twofold.

■ First, interest payments flow abroad rather than being recycled in Canada, and are thus a net drain on the incomes of Canadians today and in the future. The old (and always questionable) notion that the public debt does not matter because “we owe it to ourselves”, has long since ceased to describe reality (Chart 34).



■ Second, the sheer magnitude of Canada’s foreign debt in relation to the size of the economy means that Canada has become excessively vulnerable to the volatile sentiments of global financial markets. We have suffered a tangible loss of economic sovereignty.

Burden on the Future: The accumulation of debt has a significant moral dimension. To the extent debt has been incurred to finance annual consumption rather than public investment – and that has been the case – the debt represents a dead-weight burden on the future. Since the borrowed funds were not, for the most part, invested in ways that would give an extra boost to Canada’s future growth, there will not be sufficient future ‘surplus’ to cover the ongoing stream of debt service cost. That cost will have to be paid by our children and grandchildren out of their future incomes.

Those future incomes will also have to provide for an ageing population. The proportion of Canadians older than 64 is forecast to increase from 12 per cent now to approximately 22 per cent by 2030. Today, there are five Canadians working for every person who is retired. By 2030, that ratio will have dropped to about three to one. To add today's consumption-induced debt to our children's *growing* obligation to provide for retirees is a shameful legacy that must not be allowed to become even worse.

What then is to be done?

Some have suggested that the problem will correct itself with a little good fortune. After all, at the end of the Second World War, the ratio of net federal debt to GDP slightly exceeded 100 per cent, even higher than today. The debt ratio then declined rapidly to about 35 per cent by 1957. It continued to fall gradually to 18 per cent of GDP in 1974, before recommencing a 20-year ascent (Chart 35, panel I).

Might history not repeat itself? It is most unlikely that it will, for the reasons revealed in the bottom two panels of Chart 35 and in Chart 36 which traces the major components of federal spending since 1939.

When the War ended, demobilization resulted in a drop of total federal spending from 45 per cent relative to GDP to about 13 per cent in 1948, a cut equivalent to 32 percentage points of GDP. For comparison, total federal spending today, including debt service, is about 22 per cent of GDP. An even remotely comparable reduction of current spending is thus arithmetically impossible.

Moreover, in the early postwar years the operating budget balance of the government – i.e. the difference between revenue and spending, *excluding* interest on the debt – was in the range of 7 to 9 per cent of GDP (Chart 35, panel II).

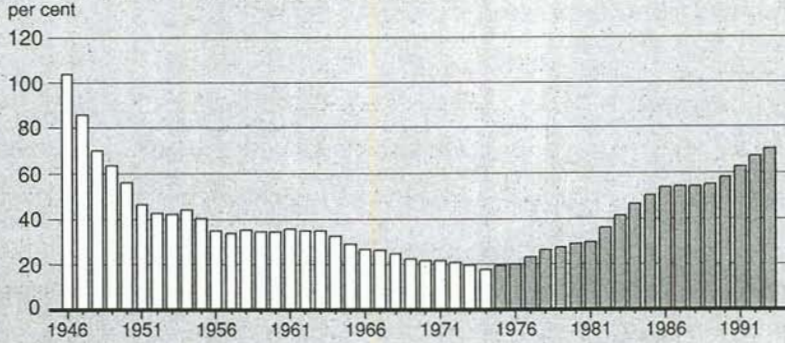
Translated into today's terms, this would imply a surplus of revenue over program spending of \$50 to \$65 billion. The actual federal operating surplus (i.e. the budget balance before interest payment) forecast for the fiscal year 1994-95 is between \$5 and \$6 billion, or less than 1 per cent of GDP.

Finally, the economic conditions that prevailed in the postwar years were very different from those of today, a point stressed repeatedly throughout this paper. They were years of high economic growth and low interest rates. The growth of GDP (in nominal dollars) typically exceeded the average rate of interest on the public debt by 4 to 8 percentage points (Chart 35, panel III).

To add today's consumption-induced debt to our children's *growing* obligation to provide for retirees is a shameful legacy that must not be allowed to become even worse.

Chart 35 Dynamics of the federal debt-GDP ratio in the postwar period

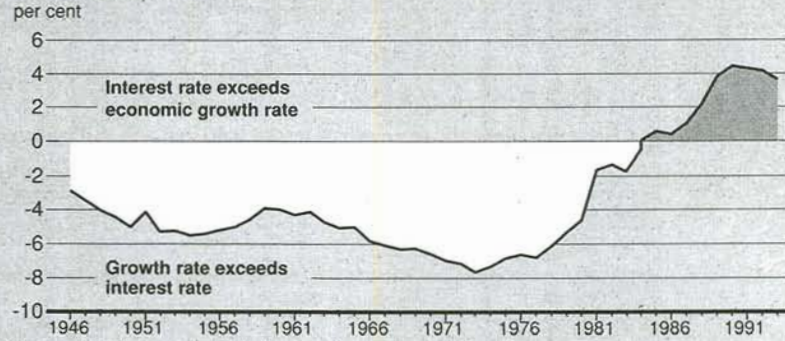
Net federal debt as a percentage of GDP



Operating balance as a percentage of GDP



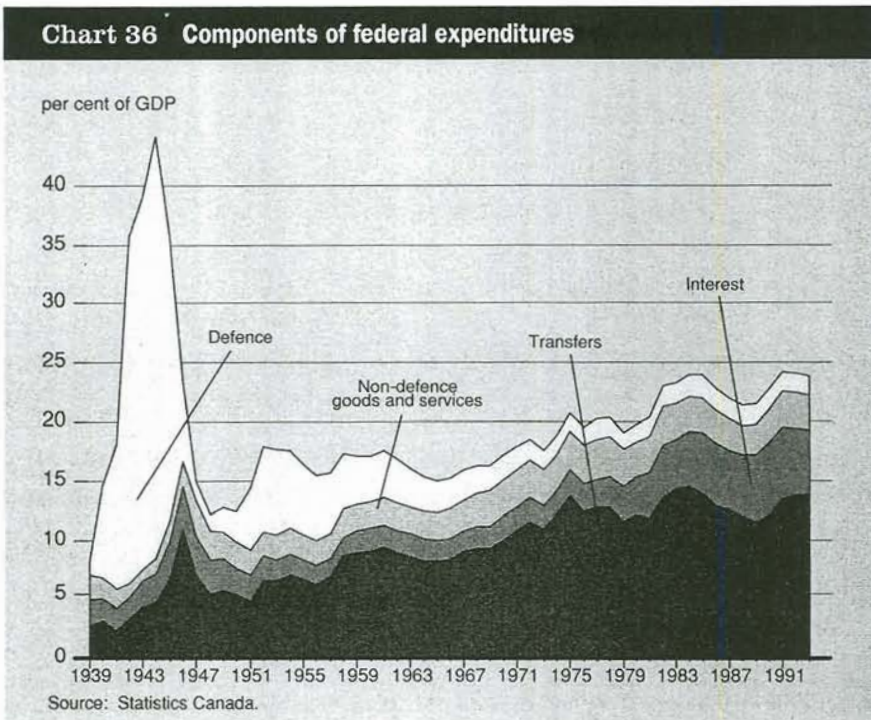
Effective rate of interest minus smoothed rate of growth of nominal GDP



Sources: Public Accounts, Statistics Canada, and Bank of Canada.

Under these conditions, the growth of the economy strongly exceeded the rate at which interest was compounding on the public debt. Consequently, the ratio of debt to GDP tended naturally to decline.

Since the mid-1970s, that benign trend has completely reversed. Interest rates have risen while economic growth has slowed. In the early 1980s, the average interest rate on federal debt began to exceed GDP



growth for the first time since the War and the gap has since widened (Chart 35; see shaded area in panel III). Now interest is compounding at a more rapid rate than the economy is growing. It is, moreover, unlikely that the sustained economic growth rate will recover sufficiently to exceed the interest rate anytime soon. This is because the *global* level of real interest rates is expected to remain high in the face of strong demand for capital in the dynamic developing regions and continued high deficit financing requirements in many of the advanced countries.

As long as the average rate of interest on federal debt exceeds the rate of (nominal) economic growth in Canada, larger operating surpluses will be needed just to keep the debt ratio from rising exponentially (Box 14). It is for this reason that Canada's fiscal trend has become unsustainable and that comparison with the immediate postwar experience is inappropriate.

Sustained stronger growth is clearly needed to reverse the inexorable increase of debt. Unfortunately, the momentum of debt itself is undermining Canada's growth potential through the drag of high real interest rates and high taxes, as well as the squeezing out of public investments that would lead to a more productive economy in the longer run. Consequently, Canada's public debt problem cannot be solved by growth alone.

Box 14 The arithmetic of debt

The ratio of government debt to GDP will increase from one year to the next if the percentage increase in debt (the numerator) exceeds the percentage increase in GDP (the denominator). This is simple arithmetic.

The increase (decrease) in debt from one year to the next is equal to the annual budget deficit (surplus). The deficit is in turn equal to the interest cost on the net public debt, plus spending on government programs, less revenue collected. The difference between revenue and program spending is often called the operating balance (OB). The deficit is therefore equal to the interest cost less any operating surplus. (If the operating balance is itself in deficit, this operating deficit is *added* to interest cost to arrive at the overall deficit.)

As the debt grows, or if interest rates rise, the interest cost component of the deficit obviously increases. The effect on the debt ratio of this increase can nevertheless be offset in two ways:

- (1) If GDP growth is sufficiently strong – specifically, if the annual rate of nominal economic growth (g) exceeds the interest rate on public debt (i) – the growth effect can more than offset the interest cost effect;
- (2) Alternatively, if the operating surplus is sufficiently large, the annual deficit will be small enough (it might even become an overall surplus) that the percentage increase in debt will be less than the percentage increase in the size of the economy, thus causing the debt ratio to decline.

Combining these effects shows that the debt ratio will *increase* year over year unless the operating balance (expressed as a ratio to GDP) exceeds the interest rate minus the economic growth rate, all multiplied by the current debt ratio, 'D/GDP'.² In symbols:

Debt ratio grows unless:
 $OB/GDP > (i-g) \times (D/GDP)$

The whole story is summed up in this fundamental relationship. We may think of the term, $(i-g) \times (D/GDP)$, as a *structural* factor since it involves variables that characterize the economy as a whole and are not directly subject to policy influence, particularly in the short run. The other term, OB/GDP , is the difference between current government revenue and program spending (relative to GDP.) It is a *policy* factor since it can be directly and quickly influenced by taxing and spending choices. Put in these terms, the key relationship states that the debt ratio will continue to grow unless the policy factor at least counter-balances the structural factor.

Today, with an average interest rate on federal debt of roughly 8 per cent, economic growth (in current dollars) trending at between 4 per cent and 5 per cent, and a federal debt ratio approaching 0.75, the structural factor is approximately

² The debt ratio will rise unless the annual percentage change in debt, ' $\Delta D/D$ ', is less than the percentage rate of growth, ' g ', of nominal GDP. The change in debt, ΔD , is the interest cost, iD , minus the operating balance, OB . Thus to keep the debt ratio, D/GDP , from rising: $(iD - OB) / D < g$. Rearranging terms, and dividing both sides of the inequality by GDP , yields the condition for the debt ratio to decline: $OB/GDP > (i-g) \times (D/GDP)$.

2.6 per cent.³ Thus the debt to GDP ratio will continue to increase unless the operating surplus – i.e. the policy factor – is at least 2.6 per cent of GDP, or roughly \$20 billion. For comparison, the forecast operating surplus in fiscal year 1994-95 is between \$5 billion and \$6 billion.

This simple analysis of debt dynamics has a number of fundamental and far-reaching implications:

- What matters is not the interest rate or the economic growth rate separately, but rather their difference, $(i-g)$. When the interest rate exceeds the growth rate – as it has on average since the early 1980s – the undertow of debt overpowers the buoyancy of growth and the debt ratio tends to rise exponentially, unless offset by sufficiently large and *sustained* operating budget surpluses.
- If a debt problem is not addressed, it grows steadily worse. This is

because the structural factor, $(i-g) \times (D/GDP)$, tends to become larger as the debt ratio, D/GDP , increases. Furthermore, as the ratio increases, it puts upward pressure on the interest rate, which in turn places a drag on growth. These factors taken together tend to accelerate the growth of the structural factor which means that progressively larger operating surpluses are needed to bring things under control. The failure to address the debt problem decisively during the second half of the 1980s, when the economy was strong, has made the debt problem much tougher to deal with now.

- On the positive side, once the debt ratio is turned around, all of the factors begin to work in one's favour. The declining ratio tends to be self-reinforcing provided fiscal discipline is sustained and a downward momentum of the debt ratio is

established. Too often in the past – e.g., in the second half of the 1980s – a few years of relatively strong growth during the upswing of the business cycle produced modest operating surpluses and complacency. The debt ratio stabilized temporarily, only to accelerate upward again with the onset of recession (Chart 35).

- The principal policy implication of the debt arithmetic is the following. When the trend of interest rates exceeds the trend economic growth rate – as is now firmly the case – very large operating surpluses must be achieved during the upswing of the economic cycle. This is needed to offset the inevitable decline of the operating balance – which may even slip into deficit – during the downswing of the cycle. Budgetary measures must therefore be at their most stringent when the economy is clearly gaining strength.

³ At a nominal GDP growth rate of 4.5 per cent, the structural factor, $(i-g) \times D/GDP$, is $(8.0 \text{ per cent} - 4.5 \text{ per cent}) \times .75 = 2.6 \text{ per cent}$. Although growth in the second quarter of 1994 was much stronger, the relevant measure for analysis of debt trends is a longer term average growth rate.

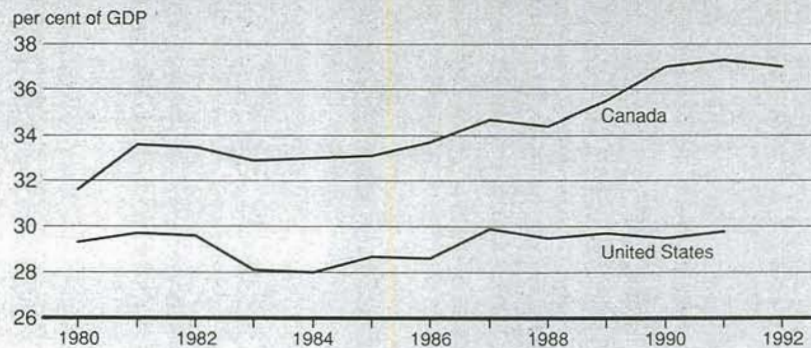
Once a debt problem has become embedded, the first priority must be to boost the operating budget surplus as quickly as possible to counteract compound interest and stabilize the situation. The government's interim deficit target of 3 per cent of GDP by 1996-97 will require a large operating surplus and is forecast to halt the growth of the debt to GDP ratio in that year. But continued fiscal discipline will be needed so that the inevitable next recession will not simply cause the debt ratio to surge again, as it has in the past, making the problem even more difficult in future.

To reach the path of higher growth and a falling debt ratio therefore requires a significant fiscal adjustment. There remain no alternatives except to cut spending, or raise taxes, or some combination of both.

The scope for higher tax rates is extremely limited. In fact, the ultimate goal must be to *lower* the overall burden of taxation in Canada over time. Total taxes levied by all levels of government – expressed as a percentage of GDP – are already very high relative to our immediately competing jurisdiction (the United States) and the gap has been widening (Chart 37).

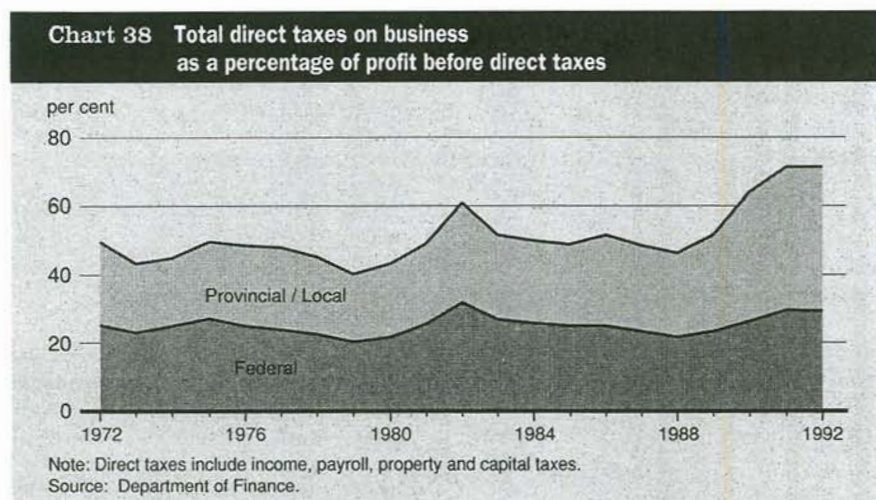
To reach the path of higher growth and a falling debt ratio requires a significant fiscal adjustment. There remain no alternatives except to cut spending, or raise taxes, or some combination of both.

Chart 37 Canada's rising tax burden



Note: Calculation based on taxes levied by all levels of government.
Source: OECD, Revenue Statistics of OECD Member Countries.

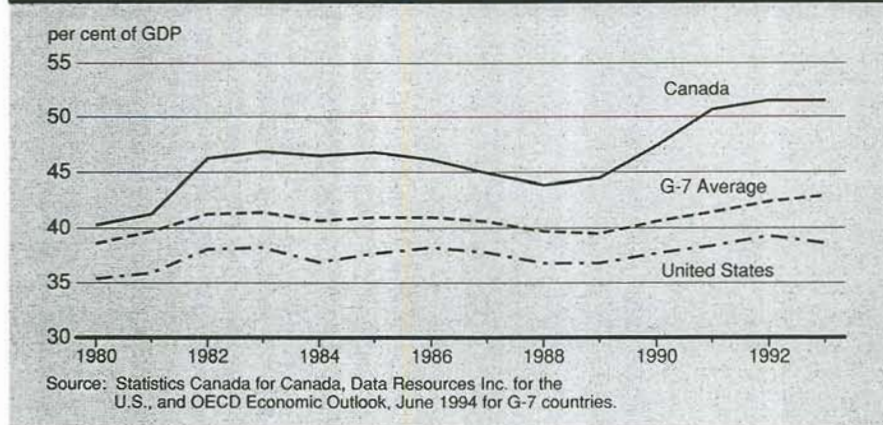
While virtually everyone is aware of higher personal income taxes, many believe, erroneously, that the tax burden on businesses has diminished. The opposite is the case. Direct taxes on business – federal, provincial and local combined – totalled \$51 billion in 1993, up almost 42 per cent



in constant dollar terms since 1980. More significantly, total business taxation has risen sharply as a percentage of pre-tax income (Chart 38). Approximately 70 per cent of direct business taxes, including many levied at the provincial/local level, are *not* proportional to income. They include employer-paid payroll taxes, property taxes and capital taxes. Because they must be paid regardless of profit level, they have produced extremely high and increasing effective tax rates during economic downturns.

Higher overall relative taxes in Canada have always in large part reflected a higher level of public services, many of which have contributed greatly to the fairness and quality of Canadian life. Some tax-financed services in Canada have also improved the cost competitiveness of Canadian businesses. Relative to the U.S., for example, Canada's national health care system has lowered employer costs and has increased flexibility since workers are able to move anywhere in the country without fear of diminished health coverage.

Now, however, taxes are rising not to finance more and better public services, but rather to cover interest on exploding public sector debt. We have to get back on track. The ultimate objective is to halt, and eventually reverse, the increase of taxes. This must encompass the totality of federal, provincial and local taxes since there is ultimately only one taxpayer.

Chart 39 Total public sector spending, 1980 to 1993

Total public sector spending in Canada is also high in relative terms – well above the G-7 average as a percentage of GDP – and has risen with each downturn of the business cycle (Chart 39).

The conclusion is inescapable that spending restraint, and not tax increases, must bear the brunt of fiscal adjustment. Canada has run out of easy options. But if we act decisively to put federal finances on a track toward balance – as the government is firmly committed to do – the last fundamental obstacle standing in the way of sustained growth and job creation will have been removed.

Epilogue

There are few people who look good in the harsh light of Canada's fiscal history. Certainly not those who have called incessantly for spending cuts, but always said "not in my backyard". And not governments who, year after year, took the path of least resistance, pushing ahead the day of hard decision.

The government is committed to break that pattern. The Prime Minister said in Quebec City on September 18, 1994 – "The time to reduce deficits is when the economy is growing. So, now is the time." The commitment of the government to meet its fiscal targets – and to meet them on time – is ironclad.

Those targets are not ends in themselves. Rather, they are among the necessary *means* toward the overarching objective of providing more and better jobs for Canadians. The attainment of that objective is the purpose of the new framework for economic policy outlined in this paper.

That framework is constructed of five central policy themes:

- Helping Canadians acquire skills;
- Encouraging Canadians to adapt to new opportunities;
- Getting government right;
- Providing leadership in the economy; and
- Creating a healthy fiscal and monetary climate.

All of the federal government's actions in the broad realm of economic policy will be in furtherance of these interrelated and mutually reinforcing policy directions.

To achieve the common objective of more and better jobs, Canadians, in partnership with their governments, must now act with a sense of shared challenge and opportunity to create an economic future worthy of Canada's magnificent potential.