POLICY PERSPECTIVES

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LONG-TERM PRIORITIES FOR CANADA'S POST-PANDEMIC ECONOMY

HIGHLIGHTS

- The COVID-19 pandemic has radically altered the immediate priorities for Canadian and global policymakers. But before the pre-pandemic economy is forgotten, let's take stock of how Canada's economy was performing and what the long-term policy priorities will need to be once the crisis has passed.
- Prior to the pandemic, federal policymakers had become over-reliant on labour inputs, rather than labour productivity, as a source of economic growth. While it may have been easy to juice GDP growth by raising the immigration intake, a larger population does not lead to higher living standards as measured by GDP per person or real wages. Indeed, average annual growth in Canadian GDP *per person* over the five years to 2019 had shriveled to a meagre 0.3% per annum.
- Prior to the onset of the current crisis, Canada's economy could barely manage 2% real GDP growth without overheating. Fully four-fifths of GDP growth over the five years to 2019 was attributable to labour inputs, while productivity was making its smallest contribution to GDP growth since the 1980s. Capital intensity was *lower* than at the peak of the last business cycle in 2008 across most asset types. Canada was pursuing a curiously *labour-intensive* growth strategy in an era of digitalization and automation.
- GDP growth through a larger population is not a "free lunch." Residents of Canada's gateway cities have been facing serious strains on housing, transport and industrial infrastructure, and education and health services as the urban population has surged. This reflects the geographic concentration of immigration-driven population growth, land scarcity and inescapable lags in planning and building.
- Population policy has become a crutch and a poor substitute for pursuing efficiency-enhancing structural reforms. Going forward, key long term priorities will need to be modernizing the tax system, delivering certainty and timeliness in regulatory processes, reducing interprovincial trade barriers, invigorating competition in product markets, and spurring business innovation and capital investment. These are long overdue national projects that will yield widespread benefits.
- Once the COVID-19 crisis has passed, it will be important for policymakers to start addressing the inefficiencies and disincentives that have been holding back productivity growth and the spirit of innovation. Only through faster productivity growth can Canadians enjoy rising living standards over the long term.

THE CANADIAN ECONOMY'S PRE-PANDEMIC "TOP SPEED" WAS SLOW

Potential GDP growth is the top speed the economy can sustain without generating above-target inflation.[1] In the world prior to the COVID-19 pandemic, the Canadian economy's "top speed" was slow due to an overreliance on policies to promote population and labour input growth and a severe dearth of policies to promote productivity growth. Canada's economy was a lot like the Peel P50 – the world's slowest car with a top speed of 45kph.

The Bank of Canada's estimates for potential GDP growth are in the range of 1.3-2.1% in 2020 and 1.2-2.4% in 2021. They are likely be revised lower when the Bank updates them next month. In other words, abstracting from normal business cycle fluctuations, GDP growth of around 2% or less was about as good as it gets. Looking beyond the pandemic crisis, Canadian policymakers need to focus on raising the economy's speed limit by pursuing policies that promote faster productivity growth and raise living standards over time.

[1] "Potential gross domestic product (GDP) is… the level of output that an economy can produce at a constant inflation rate. Although an economy can temporarily produce more than its potential level of output, that comes at the cost of rising inflation. Potential output depends on the capital stock, the potential labour force (which depends on demographic factors and on participation rates), the non-accelerating inflation rate of unemployment (NAIRU), and the level of labour efficiency" (OECD, 2014).

POOR PRODUCTIVITY GROWTH IS THE CANADIAN ECONOMY'S ACHILLES' HEEL

GDP growth is made up of growth in (1) labour productivity (GDP per hour worked) and (2) labour inputs, measured as total hours worked. The main culprit behind Canada's mediocre economic performance up to 2019 was labour productivity, which was advancing at its weakest pace since the 1980s (**Figure 1**). Productivity growth has made up only around one-fifth of overall GDP growth over the past five years, while growth in labour inputs (i.e. total hours worked) has made up the other four-fifths (**Figure 2**). Canada had not seen a situation like this since Michael J. Fox starred in the *Back to the Future* trilogy.

CAPITAL INTENSITY HAS DECLINED ACROSS MOST ASSET TYPES

A key reason for Canada's productivity performance is that capital intensity across the economy has *declined* relative to the peak of the last business cycle in early 2008. Capital intensity is the amount of capital used in production per unit of labour. The reason capital intensification increases productivity is straight forward: workers can generate more output per hour when they are using more and newer tools, equipment and technologies in the production process.

Raising capital intensity and therefore productivity would seem to be crucial to policy goals in an era of digitalization, automation and population aging. But in Canada they were not priorities. On a per capita basis, real gross capital investment is $740 *lower* than at the peak of the last business cycle in 2008 (**Figure 3a**). That decline is made up of $296 per capita less investment in intellectual property products and $488 less investment on machinery and equipment, offset by just $44 more investment in non-residential structures. On a per worker basis, real investment is $1,345 lower now than in 2008 (**Figure 3b**). This consists of $563 less investment in intellectual property products per worker, $920 less investment in machinery and equipment, and just $138 more investment in non-residential structures.

Prior to the pandemic, the Canadian economy's "top speed" was slow due to an overreliance on policies to promote labour input growth and a severe lack policies to promote productivity growth.

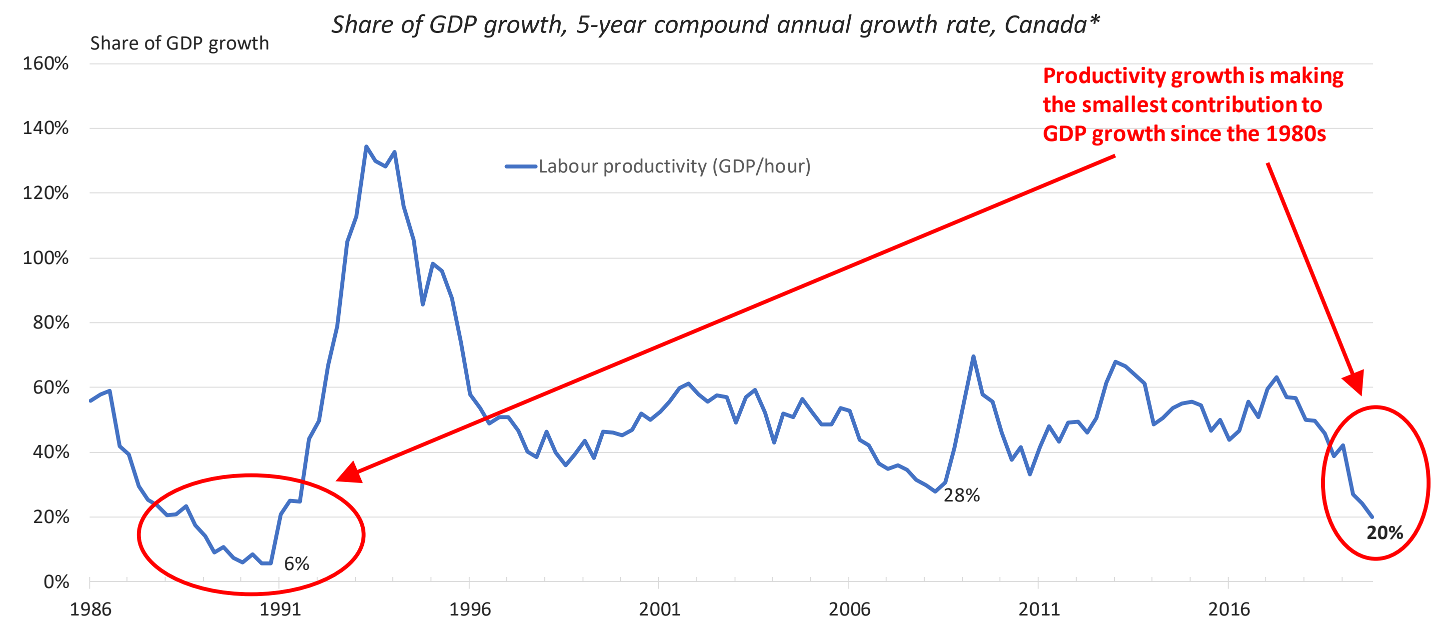
Capital intensity is lower than 11 years ago for all asset types except computers, transport equipment and engineering structures (**Figure 4**). Note, however, that these figures are for gross investment. That is, they *exclude* the cost of wear and tear on assets or their gradual obsolescence, which is especially pertinent in the case of computers and other IT equipment. Net of depreciation, investment per capita would be *even lower*. Overall, it has been a "lost decade" for productivity growth in Canada (**Figure 5**).

CANADA'S CURIOUSLY *LABOUR*-INTENSIVE ECONOMIC STRATEGY IN THE AGE OF DIGITALIZATION AND AUTOMATION

Instead of focusing on raising capital intensity and productivity, the Canadian government has bet on a *labour*-intensive strategy of super-charged immigration and urban-centric population growth to increase the absolute size of the economy. Canada's population jumped by a staggering 560,000 in 2019 – a record. Permanent immigration has reached 335,000 per annum and is expected to further increase across 2020-21, while net temporary immigration (student and work visas etc) was at an unprecedented 177,000 per annum (**Figure 6**).

Fully four-fifths of Canada's GDP growth over 2014-2019 (i.e. over 1% per annum) has been attributable to the growth of labour inputs (higher total hours worked, largely due to immigration and population growth). However, increases in immigration and in the size of the population have no impact on productivity, which is what drives long-term growth in real wages, or GDP per capita, which determines a country's standard of living. Indeed, recent growth in labour productivity and real wages has shrunk to 0.3% and 0.7% per annum, respectively. Growth of GDP *per person* has fallen to a paltry 0.3% per annum (**Figure 7**). It is Canada's worst performance on record, outside of recessionary periods.

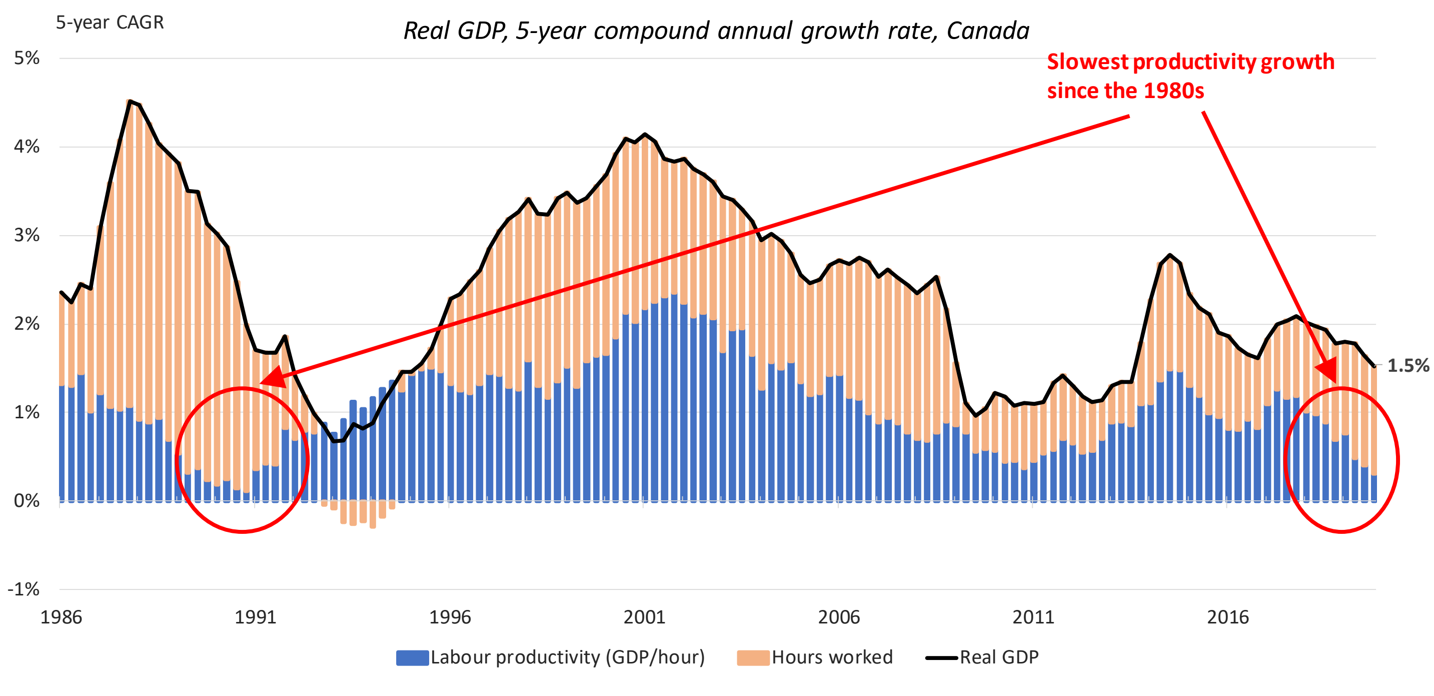
FIGURE 1: **PRODUCTIVITY GROWTH MAKES UP ONLY A QUARTER OF RECENT GDP GROWTH — ONLY THE 1980S WERE WORSE**



Source: Statistics Canada.

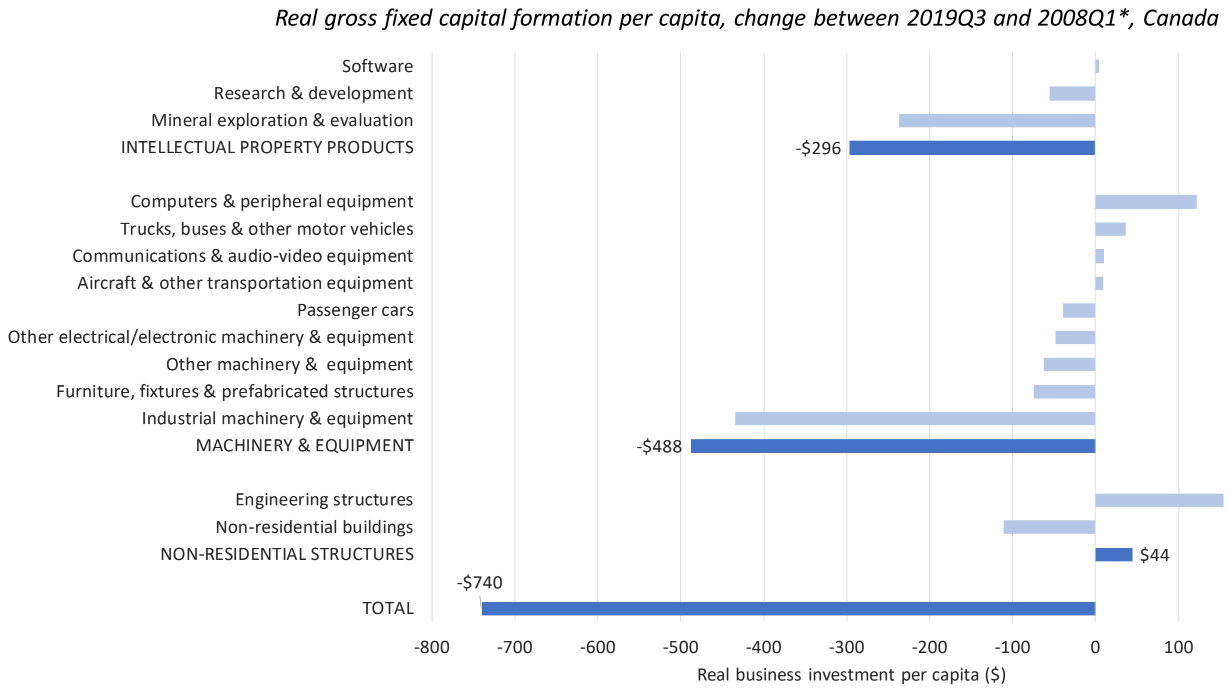
* GDP growth is the sum of growth in labour productivity and total hours worked.

FIGURE 2: **CANADA'S "BACK TO THE FUTURE" ECONOMY**



Source: Statistics Canada.

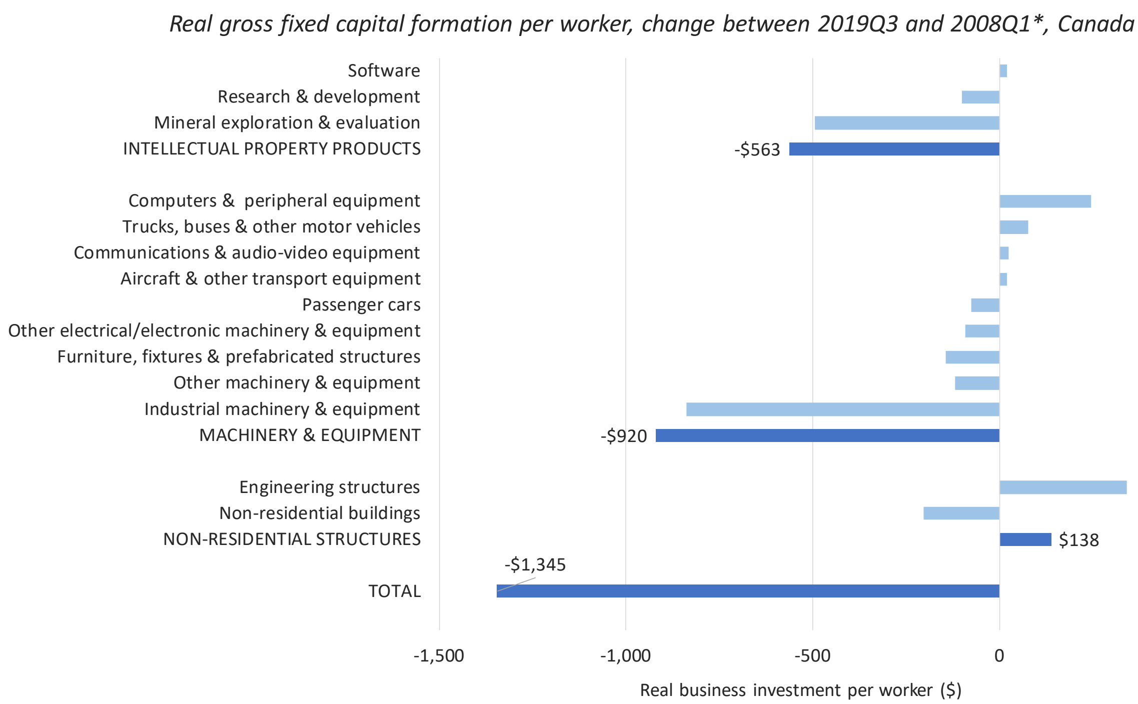
FIGURE 3A: **BUSINESS INVESTMENT *PER CAPITA* IS LOWER THAN AT THE PEAK OF LAST BUSINESS CYCLE**



Source: Statistics Canada.

* Change in 4-quarter average level. Note: investment is before depreciation costs.

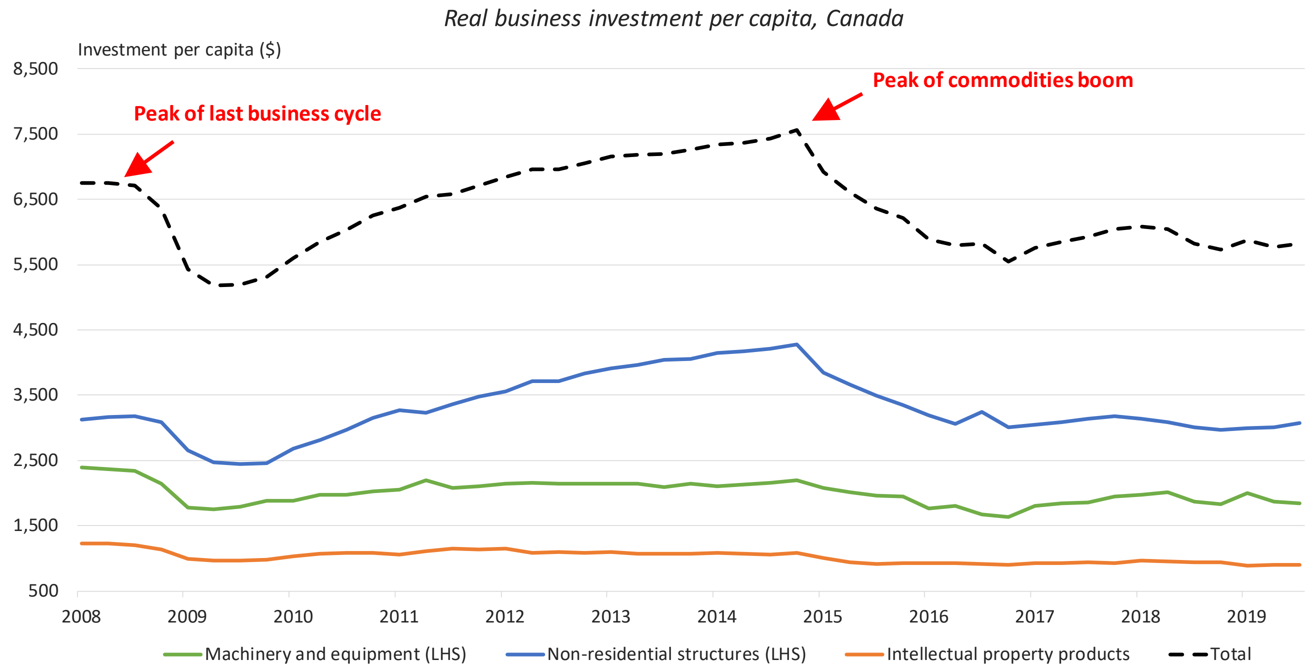
FIGURE 3B: **BUSINESS INVESTMENT *PER WORKER* IS LOWER THAN AT THE PEAK OF LAST BUSINESS CYCLE**



Source: Statistics Canada.

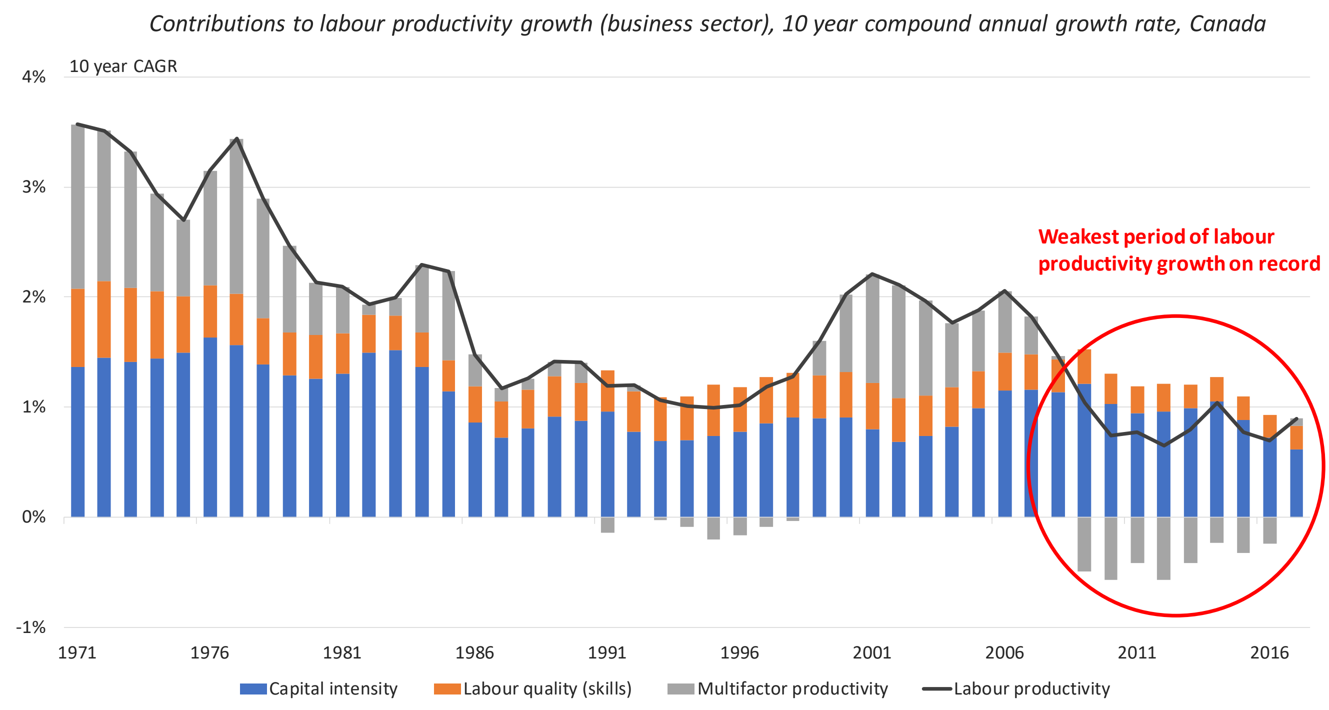
* Change in 4-quarter average level. Note: investment is before depreciation costs.

FIGURE 4: **CAPITAL INTENSITY IS LOWER THAN IN 2008 (PEAK OF LAST BUSINESS CYCLE)**



Source: Statistics Canada.

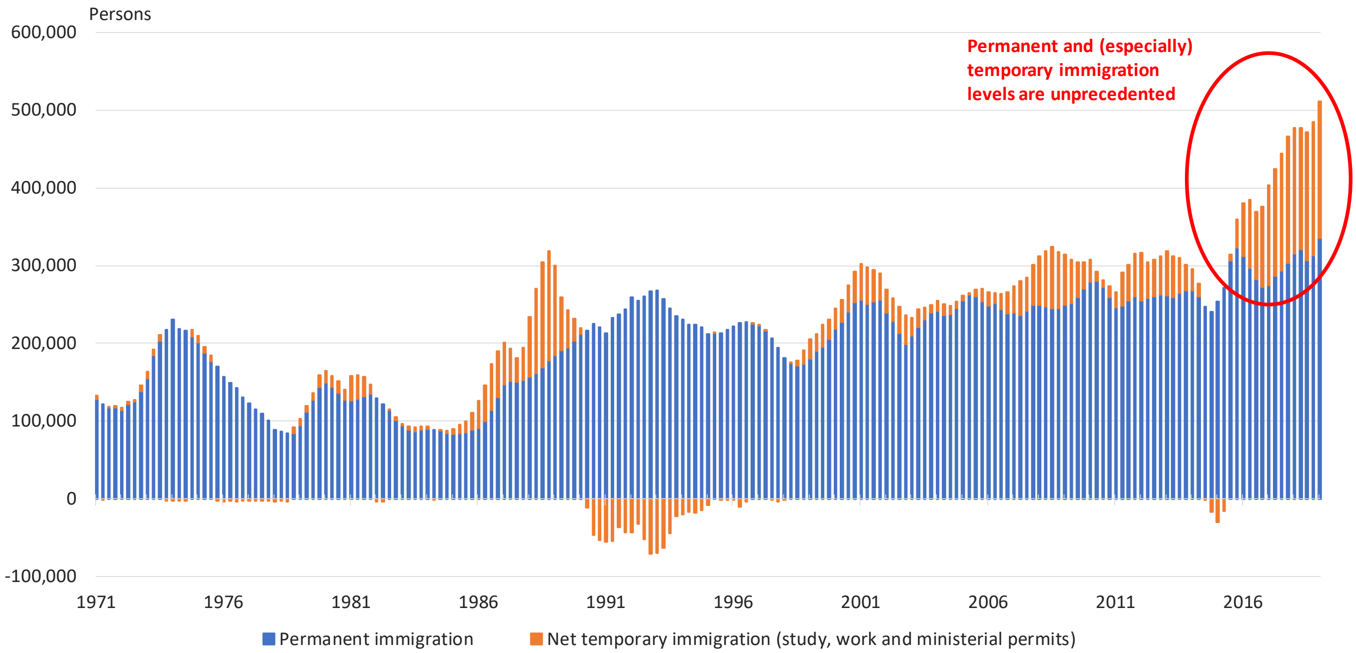
FIGURE 5: **CANADA'S "LOST DECADE" FOR PRODUCTIVITY GROWTH**



Source: Statistics Canada.

FIGURE 6: **SUPER-CHARGED IMMIGRATION IS CENTRAL TO THE GOVERNMENT'S ECONOMIC GROWTH STRATEGY**

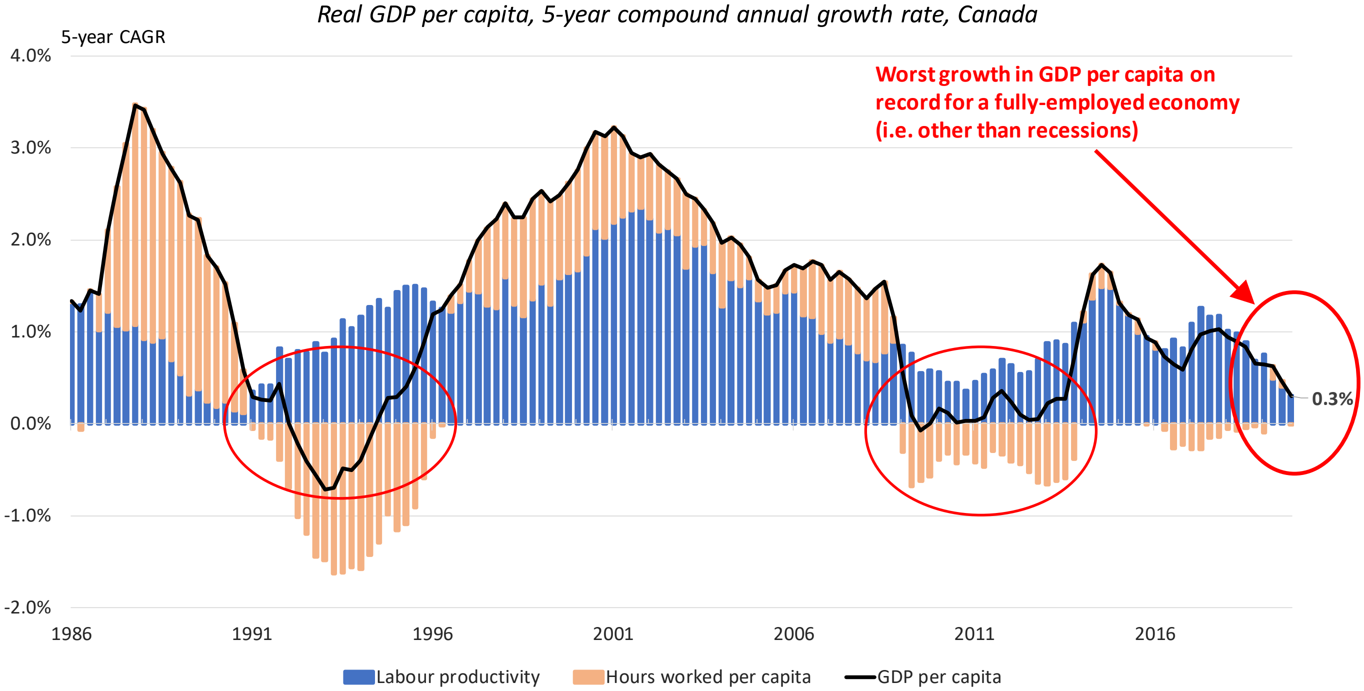
Permanent and net temporary immigration, rolling annual totals, quarterly data, Canada



Source: Statistics Canada.

FIGURE 7: **CANADA'S PROSPERITY-FREE ECONOMIC GROWTH STRATEGY PRIOR TO THE PANDEMIC**

Real GDP per capita, 5-year compound annual growth rate, Canada



Source: Statistics Canada.

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THERE IS NO RELATIONSHIP BETWEEN POPULATION SIZE AND GDP PER PERSON

Implicit in the federal government's economic development strategy is the idea that Canadians would enjoy a higher standard of living if only the country could overtake Afghanistan, Poland or Iraq in population size. However, GDP per person is determined by productivity and hours worked per capita, *not* absolute population size. **Table 1** shows the top five countries in the world ranked by population size, as well as their GDP per person. It also shows Canada's place and the next five largest countries by population. **Figure 8** plots population and its relationship with real GDP and GDP per person for roughly 180 countries. **While a larger population is associated with a larger economy (GDP), there is no relationship at all between population size and a country's standard of living (GDP per person).**

A WELL-DESIGNED IMMIGRATION SYSTEM

To be sure, a well-designed immigration system focused on attracting appropriately qualified workers is a healthy part of a smart economic strategy. Recruiting high skilled workers and managerial talent can enable domestic companies to scale up, commericialize technologies or access international markets. Increasing the relative supply of high skilled workers versus low skilled workers can mitigate income inequality by reducing the wage premium for skills. Canada's refugee intake is also highly commendable. A thoughtful critique of Canada's immigration system is by Green and Worswick (2017).

The state of Canadian academic research on the economics of immigration is well summarized by Riddell et al. (2016) as follows:

- "First, there is no evidence that substantially increased immigration will lead to increased growth of a type that shows up in positive impacts on wages and employment of those already here.
- Second, there is also no evidence of dire consequences from immigration.
- Third, fiscal impacts of substantial increases in immigration are likely to be negative, at least in the short run.
- Fourth, immigration is not a solution to demographic problems such as population ageing.
- Fifth, there are some areas in which we need more information, especially about the Canadian context. These include the distributional impacts of our immigration, the impacts on innovation, and the long-term consequences of trying to target immigration outside the biggest cities."

As noted by Riddell et al. (2016), an oft-claimed rationale for Canada's immigration surge is that it will supposedly mitigate population ageing. However, that claim is not supported by the evidence. Immigration has negligible impact on a country's age structure, because in any given year, the intake is small relative to the total population and, once resident, immigrants age along with the rest of the population.

A C.D. Howe Institute study, Robson and Mahboubi (2018), simulated various scenarios for the immigration intake. They found: "A key message from these simulations is that changes in immigration levels have impacts *at the margin only: no increase within the realm of practicality can prevent population ageing*. Other policies to ease demographic transition…are as least as powerful." [italics added]

Residents of Canada's gateway cities have been facing serious strains on housing, transport and industrial infrastructure, and education and health services as the urban populations surges.

Finally, while population growth raises GDP (but not GDP per person), it is not an economic "free lunch." Residents of Canada's gateway cities have been facing serious strains on housing, transport and industrial infrastructure, and education and health services as the urban populations surges. These realities reflect the geographical concentration of immigration-driven population growth, land scarcity and inescapable lags in time to plan and build.

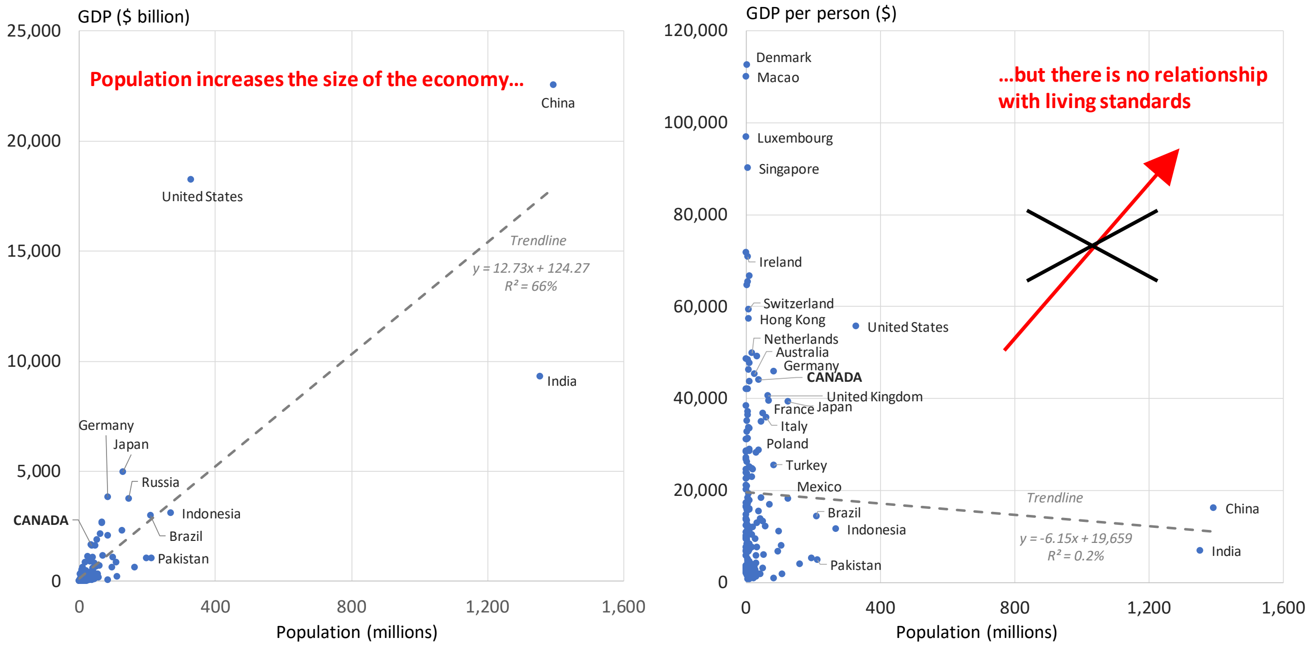
ONCE THE PANDEMIC HAS PASSED, CANADA NEEDS PRODUCTIVITY-ENHANCING STRUCTURAL REFORMS

Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise output per worker. (Krugman, 1997)

High living standards are not a product of a large population. Higher living standards are *earned* by becoming more productive over time, as the quote from Nobel laureate

FIGURE 8: **POPULATION SIZE DOES NOT DETERMINE A COUNTRY'S STANDARD OF LIVING**

Population, GDP (PPP, constant 2011 international $) and GDP per person, 2018



Source: World Bank.

TABLE 1: **POPULATION AND GDP PER PERSON, 2018**

Rank by population	Country	Population (millions)	GDP per capita (PPP, constant 2011 international $)
1st	China	1,393	16,182
2nd	India	1,353	6,888
3rd	United States	327	55,719
4th	Indonesia	268	11,606
5th	Pakistan	212	4,490
...			
30th	Algeria	42	13,737
31st	Iraq	38	15,471
32nd	Poland	38	28,786
33rd	Afghanistan	37	1,735
34th	**CANADA**	**37**	**44,078**

Source: World Bank.

Paul Krugman highlights.[2] Canadians rightly desire economic growth that raises their living standards over time. This has not been happening.

Since the peak of the last business cycle in 2007, Canadians have seen the largest deterioration in relative GDP per person – compared to the United States as the global benchmark – among peer countries (see Williams, 2019 and Williams and Finlayson, 2019). This is primarily because peer countries have increased their productivity by more than Canada. Meanwhile, Canada has the least inequality in market incomes and the third least inequality in disposable incomes among the G7 countries, Australia and New Zealand. The evidence is that Canada is good at sharing economic gains – but less good at generating them in the first place.

Prior to the COVID-19 pandemic, Canada's economy could at best manage 2% or less GDP growth per annum without overheating. Fully four-fifths of recent GDP growth was attributable growth in labour inputs (hours worked). Labour productivity was making its weakest contribution to GDP growth since the 1980s. Meanwhile, growth in GDP *per person* had shriveled to around 0.3% per annum, and trend growth in productivity and real wages had similarly been slow.

All of this suggests that federal policymakers have become over-reliant on population growth, rather than productivity growth, to drive the economy. While it may be tempting to juice GDP growth by raising the immigration intake, the simple fact is that a larger population does not translate to higher living standards as measured by GDP per person or real wages. In fact, the overall *neutral* economic impact of immigration is well supported in the academic literature.

In pre-pandemic Canada, population policy appears to have been a crutch and a substitute for pursuing efficiency-enhancing structural reforms. Going forward, key long-term priorities will need to be modernizing the tax system, delivering certainty and timeliness in regulatory processes, reducing interprovincial trade barriers, invigorating competition in product markets, and spurring business innovation and capital investment. These are long overdue national projects and they will deliver widespread benefits by raising Canadian living standards. However, such reforms are technically complex and they will require exemplary political leadership to balance competing interests and compensate those who stand to lose from policy change.

Once the COVID-19 crisis has passed, it will be important for policymakers to start addressing the inefficiencies and disincentives in Canada's economy that have been holding back productivity growth and the spirit of innovation. Only through faster productivity growth can Canadians enjoy economic growth that raises their living standards over the long term.

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[2] While small open economies like Canada can also benefit from favorable movements in the terms of trade (which has been the case since the 2000s), this is exogenous and cannot be relied upon as a source of long-term prosperity.