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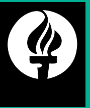

Executive *Action*

May 2011

An Economic Policy Agenda for a New Majority Government

At a Glance

- The Conservative majority creates an opportunity for the government to consider strategic approaches to the longer-term challenges facing Canada, rather than the short-term imperatives that shaped the March budget.
- The economic policy agenda should focus on five priority themes: embracing productivity and competitiveness; creating a single Canadian market; rethinking the workforce; revitalizing international investment and trade; and investing in infrastructure.

On May 2nd, 2011, Canadians decided to give the Conservatives the parliamentary majority they were seeking. By many media accounts, voter confidence in the Conservatives' ability to manage the economy was an important factor in that decision. While The Conference Board of Canada assumes that the federal budget presented in March will be reintroduced, the achievement of a majority government—after seven years of minorities—creates an opportunity to move beyond the short-term imperatives that shaped that budget, and to consider strategic approaches to the longer-term challenges facing Canada. That is the purpose of this executive action briefing.

SHAPING MACROECONOMIC POLICY

We start with macroeconomic policy, which defines the overarching fundamentals for the entire economy. The policy tool that the government can control most directly is fiscal policy: the spending priorities for government and the design and implementation of the tax system, which provides revenues to government and offers incentives to individuals and firms. Macroeconomic policy also includes monetary policy and management of the exchange rate, which we will address briefly. Aging demographics are at play in Canada and most other industrial countries, shaping the economic policy context.

The fiscal balance—deficit, balance, or surplus—is the nexus of government spending and generating revenues. In our view, it was appropriate during the global financial

crisis and recession of 2008–09 for the federal government to shift into deficit and to provide exceptional fiscal stimulus to kick-start the Canadian economy. Now that growth is restored, it is equally appropriate to chart a medium-term course back to fiscal balance, as the government has done. We went on the public record last August saying that we expect the federal books to be back in balance by 2015, a full year ahead of plan. Based upon the budget that Finance Minister Flaherty tabled in March, and our assessment of the economic outlook, this continues to be our view. We have a high level of confidence that the federal budget can be re-balanced by 2015 if the government sticks to its announced medium-term plan.

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To make those overall fiscal objectives a reality, the government will have to keep careful control on annual spending growth while redefining its own priorities. The one area of federal spending on which we will comment at this time is health transfers. In the heat of the election campaign, commitments were made to extend the existing federal–provincial health accord (often called the Martin Accord) beyond 2014 and to continue to increase federal health transfers to the provinces at an annual growth rate of 6 per cent. This growth rate exceeds the projected nominal growth rate for the Canadian economy, which we forecast to be 4.7 per cent in 2015. In other words, at a 6 per cent annual growth rate, health-care transfers to the provinces could be eating up an ever-greater share of available federal resources.

We suggest the coming period of stable majority government could be used to re-examine the fiscal sustainability of the Canadian health-care system, and also to review Ottawa's role in funding and in creating conditions for ongoing reform of the system. To help that re-examination, The Conference Board of Canada is creating the Canadian Alliance for Sustainable Health Care (CASHC). CASHC will provide Canadian business leaders and policy-makers with quantitative research and analysis of the sustainability of the Canadian health-care system. CASHC will also offer a forum for open dialogue on this research and its implications, with a view to improving the Canadian health-system as a whole, as well as the health-care practices within firms and organizations.

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Regarding tax policy, the government has made electoral commitments to introduce additional tax preferences into the Canadian federal tax system. Tax preferences are often good politics, but the policy impact is generally to add further complexity and opaqueness into the tax system at the price of lost tax revenues.

Our policy preference, based upon our research, would be to:

- simplify the Canadian tax system—limit increases in rates of taxation, while ensuring adequate resources to invest strategically in critical infrastructure for future prosperity;
- improve incentives to invest and to work, especially for labour force entrants; and
- use the tax system to begin putting a price on what economists call "negative externalities"—specifically, the production of greenhouse gases.

The implementation of monetary policy in Canada is relatively straightforward. The Bank of Canada has been accorded a high degree of operating autonomy, and it has a strong policy anchor in place—the inflation target of 2 per cent within an operational band. The Bank demonstrated considerable pragmatism and flexibility during the financial crisis and its aftermath, without losing sight of its core mandate to protect the value of money in Canada. And we expect the Bank of Canada to continue to operate with significant autonomy.

Exchange rate policy is a shared responsibility of the Bank of Canada and the government. Canada adopted a flexible exchange rate policy four decades ago, allowing the external value of the loonie to be guided by market

forces. In fact, under a flexible approach to the exchange rate and with open capital markets, there is little a government can do to influence the path of a currency on a sustained basis—notwithstanding occasional market intervention by governments and central banks. The loonie has been propelled to par and beyond by strong global commodity prices and by currency weakness in some of our major trading partners, notably the U.S. and the EU. As we have argued on previous occasions, it falls to Canadian businesses to adapt to the new reality of a structurally strong Canadian dollar—specifically, by accelerating business innovation and undertaking measures to boost productivity, such as through greater investment in machinery and equipment.

A MICROECONOMIC GROWTH AGENDA

The richer and more interesting agenda for reinvigorated policy action is in relation to microeconomic reform, including trade and investment policy. In this area, The Conference Board of Canada has the advantage of having produced a series of studies on the priorities for Canadian economic policy reform, known as The Canada Project. Several broad themes for action were identified in that work and in our subsequent research. Five priority themes define a sound framework for action:

1. **Embrace productivity and competitiveness.** For nearly three decades, Canada has been an underperformer on productivity growth compared with the U.S. and other major OECD countries. Firms were able to rely on a cheap dollar for their competitiveness—but, with the structural shift upward in the loonie, Canadian firms are being challenged. Firms should respond by seeking ways to re-invent themselves, restructure their operations globally, and create a culture of innovation that feeds stronger productivity growth. A strong Canadian dollar should act as a catalyst for stronger productivity growth, as a strong dollar makes imported goods—including imported technology that can help firms become more efficient—cheaper. But things are seldom that simple or linear in the real world, so a more strategic approach by the federal government would help to encourage concrete business action to improve productivity.

   The federal government has already taken important steps to support business innovation and productivity by reducing business taxation. There is still more that governments can do, from improving incentive programs to strategic procurement. Much of the onus for innovation now falls to business. To help Canadian businesses develop an innovation culture, The Conference Board of Canada is now creating the Centre for Business Innovation, with the mandate to explore obstacles, measure and benchmark performance, and develop business and government strategies for improvement in business innovation.

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2. **Create a single Canadian market.** To create the conditions needed to boost productivity, Canadian governments, led by the federal government, should reduce barriers across the economy and improve the alignment of regulations. Some progress has been made on this front in recent years—such as the Trade, Investment, and Labour Mobility Agreement (TILMA) between Alberta and British Columbia, and improved regulatory alignment between different levels of government on environmental assessments of projects. However, this remains an unfinished agenda. Assuming that the Supreme Court affirms the necessary degree of federal authority, the government should move quickly to establish a single regulator for Canadian securities markets. In addition to strengthening efforts to reduce regulatory overlap and improve alignment between jurisdictions, the federal government should intensify its own efforts to streamline the regulatory burden. Action to reduce regulatory barriers and costs is especially important at a time when governments are trying to reduce deficits. That's because this type of action has the potential to add significantly to economic competitiveness at little or no fiscal cost.

3. **Rethink the workforce.** Canada is in transition from a labour-surplus economy to one with chronic labour and skills shortages. This transition is being driven by

the twin demographic trends of the aging of society, and of the rapidly growing dependence on immigration for net population growth. A well-articulated federal labour market strategy—designed for a time of labour and skill shortages—is therefore a priority. This strategy should include under-represented groups, such as people with disabilities; visible minorities; Aboriginals; and in some sectors, women. We have to be prepared to think creatively to ensure that Canada is able to attract the talent it needs, at a time when competition for talent has become global. In particular, the government needs to build on its recent efforts to make it easier for Canadian businesses to recruit skilled people from abroad, to enable employers to understand and recognize the experience that immigrants bring to our communities, and to enable new Canadians to fill gaps between their existing credentials and the requirements of the Canadian workplace.

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Action by governments and by employers is needed to deepen Canada's human capital through increased investment in people. While public education is primarily a provincial responsibility, and the post-secondary system is generally performing well, there are specific areas requiring attention. The goal of increasing the number of highly qualified people must remain a federal priority. Federal transfers to provinces could be targeted toward increasing the number of science and engineering graduates, thus advancing a process that began a decade ago. The federal government must act to improve the educational outcomes for Aboriginal young people, as well as to improve incentives for Canadians of all ages to save for, and to invest in, life-long learning. While the government could consider added inducements for training and development, employers in every sector face increasing market competition for available talent. Employers will have no choice but to ramp up their own investments in employee development.

4. **Revitalize international investment and trade.** Canadian trade with the United States has not grown in real terms for a decade. As well, the combination of a strong loonie and the structural challenges facing the U.S. point to the need to re-energize free trade and investment within North America and globally. Conference Board research points to the benefits of pursuing greater regulatory alignment in North America, and undertaking new bilateral free trade deals, such as with the EU, India, and even China. Acting on the Red Wilson panel report on reform to the *Investment Canada Act*—with appropriate safeguards to protect public interest—could help revitalize foreign direct investment flows to Canada. At the firm level, the government should work with businesses of all sizes to examine how they fit into global supply chains, and to develop ways to manage risks and opportunities in the international marketplace.

5. **Invest in infrastructure.** Canada's infrastructure deficit is mind-boggling—$125 billion for municipalities alone. This deficit can be seen in our cities, along the border, and in the vast areas of Canada lacking broadband. It is evident on our roads and bridges, in power transmission capacity, and in our ports and passenger railways. It is holding back the productive capacity of the Canadian economy. Any hope of making real progress on clean energy and the environment will require serious infrastructure investments.

   The infrastructure deficit is holding back the productive capacity of the Canadian economy.

   To address both the deficit and future needs, a major national infrastructure program—led by the federal government in cooperation with the provinces and major cities—is essential.

Ottawa has a leadership role to play on all these fronts—and a majority government strengthens the opportunity to do so.

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by *Anne Golden* and *Glen Hodgson*

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255 Smyth Road, Ottawa ON K1H 8M7 Canada
Tel. 613-526-3280 • *Fax* 613-526-4857 • *Inquiries* 1-866-711-2262
The Conference Board, Inc. 845 Third Avenue, New York NY 10022-6679 USA *Tel.* 212-759-0900 • *Fax* 212-980-7014 • www.conference-board.org
The Conference Board Europe Chaussée de La Hulpe 130, Box 11, B-1000 Brussels, Belgium *Tel.* +32 2 675 54 05 • *Fax* +32 2 675 03 95
The Conference Board Asia-Pacific 2802 Admiralty Centre, Tower 1, 18 Harcourt Road, Admiralty Hong Kong SAR *Tel.* +852 2511 1630 • *Fax* +852 2869 1403

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