The Conference Board of Canada Le Conference Board du Canada

Economic Advice to a New Federal Government.

Executive Briefing

At a Glance

- This Conference Board of Canada briefing offers non-partisan and evidence-based advice on how Canada's economic growth performance and potential can be strengthened through economic policy reform by the new federal government.
- Structural fiscal measures—the design of the tax system and the evolving allocation of overall public spending—can help offset some of the negative impact of aging demographics and build the growth capacity of the Canadian economy.
- The wider economic policy agenda should foster innovation and productivity, encourage Canadian firms to grow to their full potential, embrace active engagement in international trade and investment, and enhance Canada's competitiveness through domestic policy reforms. It should also increase investment in public infrastructure—an area that requires better coordination with the provinces and cities, and improved financial innovation.

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Executive Summary

The next federal government will have to address some big economic and social issues affecting Canadians and develop the best possible policy options. This briefing provides non-partisan, objective, evidence-based advice from The Conference Board of Canada on the economic policy agenda.

Robust economic growth and related growth in government revenues can no longer be taken for granted. Economic growth has been steady but mediocre over most of the last five years and is not expected to accelerate much in the future. Canada's population and workforce are aging, and baby boomers are retiring in growing numbers. Canada's track record on productivity growth—one way to offset the impact of aging demographics—is dismal. Not all Canadians have adequate savings for retirement, and an aging population will put inexorable pressure on the health care system. Few of these issues were discussed or debated in detail during the election campaign, but a new government can hardly avoid having to address them.

The broad Canadian economy is still operating below its potential growth path as estimated by economists. This reality could provide a *prima facie* case for fiscal deficits. That said, there are large differences in growth performance and potential among regions and provinces. The strongest case for fiscal stimulus today is therefore in those provinces still experiencing recession due to the oil price meltdown—Alberta and Newfoundland and Labrador, in particular.

Rethinking the tax system to shore up Canada's long-term growth capacity would mean examining the optimal mix of fiscal incentives for saving, investment, initiative, and entrepreneurship, while providing government with stable revenues for its spending priorities.

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The highest-profile tax item during the election campaign—proposed tax cuts for small business—is headed in the wrong direction in terms of economic impact.

Domestic policies that complement openness to international trade and investment would position Canadian firms to grow to their full potential, compete internationally, make profits, pay taxes, and create jobs in Canada. Better alignment of goals, standards, and practices within Canada is key to our success. And unlike demographics or globalization, domestic policies are almost entirely under our control.

Introduction

Canadians have elected a majority Liberal government, ending nearly a decade of Conservative governance. The new federal government will have to address some big economic and social issues affecting Canadians, and develop the best possible policy options.

To assist the new government in shaping its path for economic policy, this briefing provides non-partisan, objective, evidence-based advice from The Conference Board of Canada on the economic policy agenda.

Context: The Brave New Economic World

Robust economic growth and related growth in government revenues can no longer be taken for granted. Economic growth has been steady but mediocre over most of the last five years and is not expected to accelerate much in the future. Canada's population and workforce are aging, and baby boomers are retiring in growing numbers. Not all Canadians have adequate savings for retirement, and an aging population will put inexorable pressure on the health care system. Few of these issues were discussed or debated in detail during the election campaign, but a new government can hardly avoid having to address them.

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The federal government has a limited current operating margin for new priorities. For the previous government, tax cuts and resulting lower fiscal revenues were generally a higher priority than reducing the public debt burden or funding new policy priorities. Repeated rounds of tax cutting were perhaps popular at the time; but, as a result, there is limited spare cash available without specific action to re-order spending priorities, increase revenues, or accept fiscal deficits. Weaker economic growth than expected would mean slower revenue growth than projected—which will require real fiscal choices in the months and years ahead.

As well, the tax system has steadily increased in complexity for individuals and businesses. More and more, someone with expertise is being paid to do our taxes in order to squeeze out all the opaque advantages. Without reform, most of us have reached the end of the self-administered personal income tax system, and businesses are required to absorb high compliance costs as a cost of doing business in Canada.

In the following sections, we provide more detailed analysis on these and other priority issues, drawing upon our many years of economic forecasting and analysis, detailed research on many aspects of the economy by The Conference Board of Canada, and recent media briefings.

The Demographic Challenge

Canadian economic growth has been muted over much of the past decade, and the future is not much brighter. Why? One of the most prominent structural factors affecting economic growth is demographics—the aging of Canada's population and workforce. We have been talking about the upcoming demographic forces for many years, and population and workforce aging are now at our doorstep. The impact will be felt across the country as knowledge and skills leave the workplace on an accelerating basis.

Two specific demographic forces are at play. First, fertility rates have fallen steadily for decades—to a point where we are no longer replacing ourselves, which is limiting the number of new labour force entrants born

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in Canada. Second, baby boomers are reaching retirement age in larger numbers. The participation rate has declined by two percentage points since the late 2000s, and labour force growth rates are projected to drop dramatically after 2015.

As a result of these demographic forces, robust economic growth in Canada can no longer be taken for granted. Due to slowing labour force growth, Canada's potential growth has already dropped. By our estimations, potential growth will slow further in the years ahead to less than 2 per cent annually. We also project material differences in future economic growth potential among and between regions. Atlantic Canada and Quebec will grow below the national average; Ontario will grow at the national average; and Western Canada will grow a bit faster due to a slightly younger and faster-growing population.

Why does it matter? These projections of slower growth have important implications for individuals, businesses, and governments. Individual Canadians may view slower labour force growth as positive, since it will put upward pressure on real wages. In contrast, businesses will be constrained by a tepid domestic market and will need to adapt their operations by investing more in capital to offset the impact of fewer available workers. And for governments, slower growth means weak growth in future tax revenues. In turn, slower government revenue growth will make it harder to sustain valued social and economic programs—such as health care, income support, and tax credits.

At the same time, an aging population will place unrelenting pressure on some forms of government spending, such as the health care system. Also, most research indicates that around 30 per cent of Canadian retirees do not have adequate savings (or a pension) beyond CPP and OAS—a growing challenge (or even liability) for governments.

What can be done to offset aging demographics? At the top of the list are boosting productivity for those currently in the workforce and ensuring greater innovation in all parts of our economy and society.

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However, Canadian productivity has lagged the U.S. and other major economies for more than two decades, and our innovation results are often mediocre.

Labour market policies are another key area for reform, and there are a number of policy options available. These include the following:

- Ensuring that Canadian workers have the knowledge and skills needed in tomorrow's workforce. In a world with accelerating technological and competitive pressures, all Canadians will need access to continuous education, training, and development within a philosophy of lifelong learning.
- Improving labour force flexibility and mobility to fully utilize the existing workforce and allow individuals across the country to pursue opportunities that present themselves.
- Providing an opportunity for all citizens, notably under-represented groups, such as Aboriginal peoples and recent immigrants, to fully participate in the workforce.
- Continuing to develop and implement effective approaches to immigration and the full integration of immigrants into Canadian society.
- Creating the best incentives for individuals arriving at retirement age to stay engaged in the workforce and for organizations to make innovative use of their knowledge and skills.

The central message is that aging demographics are already having a negative impact on our economy's performance. The government's challenge is to define its priority policies for strengthening Canada's growth potential.

Fiscal Policy and the Budget

The core challenge for fiscal and overall economic policy, little discussed on the election trail, will be to address Canada's fading economic growth potential. Drawing upon the Conference Board's decades of experience in fiscal policy analysis, we offer the following advice on the conduct

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of fiscal policy and its impact on economic growth, over three time phases—the immediate period, the business cycle (or medium term), and the longer term.

Immediate Fiscal Context

The broad Canadian economy is still operating below its potential growth path as estimated by economists. This reality could provide a *prima facie* case for fiscal deficits. That said, there are large differences in growth performance and potential among regions and provinces. Most provinces have been growing at a steady, modest (if unspectacular) pace since mid-2009, and the Conference Board expects their growth to pick up in 2016. The strongest case for fiscal stimulus today is therefore in those provinces still experiencing recession due to the oil price meltdown—Alberta and Newfoundland and Labrador, in particular.

We also regard fiscal stimulus as a powerful medication with significant side effects (i.e., rising public debt) that should be used when truly needed, notably when the national economy is in deep or prolonged recession. Thus, we have mixed views on the underlying need for federal deficits in the short term to add stimulus to the full national economy; but we agree fully that much higher federal public infrastructure investment is warranted, and on a sustained basis. Middle-class tax cuts may also provide a mild short-term boost to demand by shifting income to a group that will likely spend the money, not save it.

As promised in the election campaign, the new government is expected to pursue small fiscal deficits in the near term to pay for new high-priority items such as public infrastructure. If this remains its immediate fiscal objective, we would advise the government to adopt three conditions as it develops its first and subsequent budgets:

1. Use modest economic growth projections to guide expectations for future revenue growth. This will leave possible room for stronger revenue growth and upside fiscal performance if more robust economic growth than expected is realized.

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2. Be prepared to consider ways to generate more fiscal revenue without impairing the economy, such as by reducing the revenue leakage from existing tax expenditures that are not a high economic priority.
3. Aim for continued decline in the federal debt-to-GDP ratio, now around 32 per cent of GDP, when the economy is growing. This would be accomplished by holding the target fiscal deficit to a modest level of $10 billion or less annually.

Counter-Cyclical Fiscal Policy

Let's now move on to the second phase of fiscal policy, which is counter-cyclical demand management. Fiscal policy, if managed properly through the business cycle, provides a powerful tool for boosting aggregate demand and warding off the worst effects of recession. In our view, the strongest reason to reduce the federal debt-to-GDP ratio and seek to maintain rough fiscal balance when the economy is growing is to create and build the capacity to provide significant and exceptional fiscal stimulus in periods of recession.

Canada was well positioned to add fiscal stimulus during the 2008–09 financial crisis and recession precisely because it had spent over a decade getting its public debt under control. In contrast, many other developed countries added fiscal stimulus in 2009 while already holding high levels of public debt. Seven years after the global recession, they continue to face severe challenges getting their public debt under control. Indeed, the IMF has warned that without more stringent action to reduce their debt burden, many countries will not have the capacity to add fiscal stimulus during the next recession. Japan and Greece are extreme cases, but they are hardly alone.

Over the medium term, the government will be able to make adjustments to its budgetary management strategy and to major elements of federal spending. Such elements would include health care transfers to the provinces, federal programs like skills development and employment insurance, or national defence and international assistance.

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But our core economic message on counter-cyclical fiscal policy is simple: prudent fiscal management in good times provides the federal government with the ammunition to inject significant fiscal stimulus during bad times, while still maintaining control over federal public debt.

Structural Fiscal Reform

The third phase of fiscal policy is structural, implemented incrementally over the longer term through a series of budgets. This phase is arguably the most important, but is often overlooked. Well-designed structural measures in both the design of the tax system and the evolving allocation of overall public spending can help build the growth capacity of the Canadian economy, offsetting some of the negative impact of aging demographics. The reverse is equally true: a poorly designed tax system and misallocation of public spending can erode the long-term growth capacity of the Canadian economy and the income and wealth of Canadians.

Structural fiscal and tax reform could also address concerns with income inequality, although we should be careful to base the policy discussion on Canadian data and experience, not the experience in the U.S. or elsewhere. The data indicate that income inequality did rise in Canada during the 1980s and 1990s, but has been stable since. Furthermore, Canadian social and income mobility is high relative to most major industrial countries.

So what is the current structural condition of federal taxation and spending? After decades of incremental interventions, the Canadian tax system has become cluttered, complicated, and administratively inefficient. The federal and provincial governments have introduced some specific reforms to business taxation in recent years in an effort to improve business competitiveness; however, promoting robust economic growth has not been a key design principle for the full tax system.

Rethinking the tax system to shore up Canada's long-term growth capacity would mean examining the optimal mix of fiscal incentives for saving, investment, initiative, and entrepreneurship—which are

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fundamental to robust long-term growth—while providing government with stable revenues for its spending priorities. This issue received scant attention during the election campaign, and the attention it did gain—like proposed tax cuts for small business—headed in the wrong direction in terms of economic impact. (We will address this later.)

Similarly, the full array of government spending priorities could be examined through an economic growth lens. Much of the election debate focused on transfers between income groups and social policy issues, not on how and where federal spending could support economic growth. (Investment in public infrastructure was a notable and welcome exception.) Redefined federal spending priorities for growth would focus on building the economy's productive capacity through long-term funding commitments for public infrastructure, advanced education and skills, research and development (R&D), and the commercialization and implementation of innovation. The functioning of government itself could contribute to the economy's productive capacity through more efficient and effective delivery of the government's overall policy agenda.

Future budgets and overall fiscal policy should also aim to take on a "greener" hue. Climate change is already driving the transition toward a lower carbon future. Federal budgets could become an enabling force by fostering greener economic growth through a mixture of fiscal incentives and expenditures that reflect a full awareness of environmental consequences.

To move forward, the new government might consider creating an independent, arm's-length commission to examine the options for structural fiscal reform that promotes stronger, greener economic growth. A thorough examination of tax policy and the priorities for public spending could be part of its mandate. The commission could then share its research findings and policy advice with the public, the government, and Parliament.

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Raising Our Game on Innovation and Productivity

One critical way to offset the impact of aging demographics is through faster productivity growth supported by enhanced innovation. But Canada's track record on productivity is dismal.

Productivity (at its simplest, output measured in dollars per hour worked) is about working smarter, not working harder. Canadian productivity growth has lagged behind the United States and many other major industrial countries for nearly three decades. As a result, there is a significant gap in income between Canadians and Americans—estimated at $7,000 per capita, and rising. Slow productivity growth limits our ability to fund health and social programs, particularly as an aging population increases demand for services such as health care.

Productivity is complex and its importance can be difficult to communicate to the electorate. So, let's focus on concrete ways to increase productivity by:

- directing our work efforts toward products or services that can be sold at a premium and have widespread markets;
- ensuring that workplaces are well organized and managed and that the equipment, technology, and processes we use are going to make us more effective;
- developing the appropriate skills and knowledge for the jobs we undertake, and focusing those skills on delivering results for customers and clients.

Greater innovation must be at the centre of the conversation. Innovation is linked to productivity because constantly increasing the value of products and services and improving processes are key to boosting productivity growth. Without a greater commitment to innovation, we should not expect serious improvement in Canadian productivity.

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How is Canada doing on innovation? Not as well as we could, or should. The Conference Board of Canada's recent *How Canada Performs* report card on innovation gives Canada a "C" overall on innovation—we ranked 9th out of 16 countries. This ranking is better than in previous years, but still below what is necessary to be a highly innovative economy.

Innovation, too, is complex and, as the report card shows, Canada's results are mixed. Thanks to the efforts of successive federal governments, we get good results on public spending on research and development and scientific articles generated (particularly by researchers in our post-secondary institutions). Due in part to injections of funding from federal and provincial governments, we also get much-improved results in venture capital investment. In addition, it is clear that Canadians have the entrepreneurial ambition to be innovative, as we get an "A" in this category.

Despite these bright spots, Canada remains weak in key areas that boost innovation. There is not enough business investment in R&D. Moreover, not enough of the research being done at our post-secondary institutions is being commercialized in existing businesses or growth-oriented entrepreneurial enterprises or supported by business R&D investment. And Canada needs more investment in connectivity and information and communications technology.

Productivity and innovation, while complex, are critical to Canada's future economic prosperity. The key policy levers for improving productivity and strengthening Canada's innovation include the following:

- Education: Invest in education, skills, and life-long learning and renewal.
- Well-functioning markets: Foster the free flow of capital, goods, labour, skills, and knowledge within the country and across borders (e.g., free trade agreements, foreign direct investment, elimination of interprovincial barriers).
- Infrastructure: Ramp up public investment in necessary infrastructure, particularly in cities.

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- Strategy: Pursue a comprehensive pan-Canadian innovation strategy that promotes business investment and the business and entrepreneurial commercialization of our ideas.
- Flexibility: Eliminate unnecessary barriers and streamline regulatory and labour practices that impose needless costs and reduce needed operating flexibility.
- Tax reform: Simplify and clarify the tax system to improve incentives and cut compliance costs and investment delays due to uncertainty.
- Intellectual property (IP): Review and rethink the IP system to reflect global best practice in fostering the development of intellectual property.

In short, the federal government now has an opportunity to take action in a number of areas to strengthen Canadian productivity, based on greater innovation.

Policies for Business Growth

One of the trickiest economic challenges for Canada is to create more large businesses—firms that grow to their full potential, compete internationally on the same scale as global business, make profits, pay taxes, create jobs, and maintain and grow their presence in Canada.

It is both socially and politically popular to offer tax and other advantages that favour small business. According to Startup Canada, the vast majority of the more than 1.2 million businesses in Canada are small and medium-sized enterprises (SMEs), generally defined by number of employees—a small enterprise has fewer than 100 employees and a medium-sized business has fewer than 500 employees. In total, SMEs employ more than 5.1 million people and produce about 30 per cent of gross domestic product.

Yet, while small businesses sustain up to a third of overall employment and economic growth in Canada, most small businesses stay small. Furthermore, small businesses launch and fail at a high rate of turnover. The real engine for creating high-wage jobs is sustained high-growth businesses, firms that happen to have been small at one point. The

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challenge for the next Canadian government is not just how to sustain small enterprise, but how to create more high-growth businesses that become large enterprises.

Canada is good at creating start-ups. Compared to other advanced developed countries, Canada has relatively few regulatory barriers for opening new businesses. When combined with the high level of entrepreneurial ambition that Canadians exhibit (as identified in The Conference Board of Canada's *How Canada Performs* report card on innovation), it means an annual "birth rate" for SMEs of about 100,000 new businesses.

However, the churn rate for these new businesses is very high. Up to half of SMEs go out of business within the first five years of operation. SMEs are often limited in their ability to grow by insufficient access to private investment capital and limited management skills and experience to expand their operations, implement technology, and commercialize innovations. Even for the many firms that stay in business, too few ever grow to become large regional, national, or global leaders.

Business taxation policy has encouraged the formation of more small enterprises. Small businesses benefit from significantly lower corporate income tax rates and often enjoy reduced regulatory compliance. There is little evidence, however, that further reducing the tax and regulatory burden on SMEs will help them grow taller and stronger, especially if the full scale of taxation and regulation rises rapidly on those who grow. Preferential tax rates and reduced regulatory barriers can distort market forces, create financial and psychological barriers to growth, and inadvertently encourage businesses to stay small.

The economic evidence shows that SMEs are both a necessity and a challenge for the Canadian economy. As discussed in the previous section, productivity growth is the surest way to create enduring wealth in an economy. On that score, Canadian SMEs are being outperformed by firms that are larger and more committed to growth and innovation. The Bank of Canada and other analysts have demonstrated that firm-size differences between Canada and the United States play a significant

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role in explaining the productivity gap between the two countries (the $7,000 per capita we noted earlier). Similarly, firms that are committed to growth invest much more of their revenue in research and development than SMEs. This enables them to grow larger, which creates additional employment, as well as higher employee compensation and benefits.

Rather than basing business policy on current size, let's broaden our focus to support firms based on additional business criteria. These include:

- sustained high growth rates;
- growing and accelerating employment;
- commitment to investment in new technology (notably, information systems and telecommunications) and research and development;
- organizational innovation, with delivery of new products, services, and business processes;
- the willingness and demonstrated expertise to pursue business sales and growth internationally.

In short, Canada is a good place to start a small business. The focus of Canadian policy needs to shift toward helping more small businesses become growth businesses. The new government should reflect on how best to encourage the formation and continued growth of larger new enterprises, on how best to encourage more successful SMEs to grow to their full potential and to compete globally.

Canadian Trade Policies in a Globalized World

Globalization is clearly the dominant international business model today. It has been with us in one form or another for centuries—the spice trade between Europe and Asia and the development of North America as a source of inputs and goods for European consumers are examples. Globalization has always been about the unrelenting pursuit of competitiveness, which is producing the highest value at the lowest sustainable cost. And globalization is here to stay, although its form is constantly changing and has cycles in both trade and investment.

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What is driving the process of globalization? First, multilateral and regional action has reduced barriers to international trade and investment. Second, firms today have a greater ability to separate the production of goods and services into global value chains, and to conduct trade in inputs as well as in final goods and services. And third, there are much more efficient global communications and transportation networks that expedite business around the world.

The core economic policy choice for a trading nation such as Canada is whether to try to resist these forces of globalization or to embrace globalization and take full advantage of opportunities by constantly adapting, while addressing competitive and social impacts. In our experience, countries that have tried to resist these forces by creating barriers to trade and investment, or that significantly slow the impacts of globalization, have only suffered. Globalization is like gravity: it is ever-present and ultimately wins.

Canada has been built on international trade and investment. There is abundant evidence that freer trade and investment is a net creator of wealth, and Canada, as a comparatively small export-driven nation dependent upon world markets, benefits from globalization. But our policy environment over the decades has been uneven and at times ambivalent, as have some pockets of the business community. Moreover, some Canadian sectors and interests continue to resist freer trade, wishing to protect their own narrow interests (often ultimately hurting themselves) at the expense of the wider economy. Political decisions would be required to overcome these vested interests.

For Canada to extract the full benefits of globalization, reforms would be needed to both international and domestic policies are needed. On the international front, Canada is a small market compared with the massive business opportunities in North America, Europe, Asia, and globally, so trade is critical to our present and future wealth.

Over two decades ago, Canada secured and benefited from free trade in North America, and it has begun to engage in free trade beyond North America. The next test case is the Trans-Pacific Partnership,

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or TPP. The new government will need to quickly embrace the benefits of the TPP and ensure Canada has a level playing field for trade in the U.S. market in particular—or risk missing the opportunity and give an advantage to other TPP players.

China is a very special case. It will soon pass the U.S. as the world's largest economy, and it is still growing at a faster pace than most other countries, despite recent slowing. However, Canada may have already missed its window of opportunity for enhanced trade with China. Our share of Asia's trade in general, and China's specifically, has fallen by half over the past decade, which is a worry for policy-makers and should be a specific concern for many Canadian businesses. Similar policy choices and decisions will be faced on foreign direct investment (or FDI), both into Canada and by Canadian firms abroad. We will address FDI in more detail in the next section.

If Canadians and Canadian firms are to succeed in the global marketplace, there are several aspects the new government will want to address as it defines its trade policy agenda:

- the best mix of policies to build and mobilize interest in global opportunities;
- its implementation of the various trade partnership opportunities that have been negotiated, notably the TPP;
- how best to address specific vested interests (e.g., supply management) that generally have a negative impact on most other Canadians;
- how to capture our fair share of commerce with large emerging markets such as China and India.

Domestic Economic Development Policies for Competitiveness

Domestic policies are by far the most important factors determining a country's global economic performance, according to the Organisation for Economic Co-operation and Development. Domestic policies that complement openness to international trade and investment

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would position Canadian firms to grow to their full potential, compete internationally, make profits, pay taxes, and create jobs in Canada. Better alignment of goals, standards, and practices within Canada is key to our success—and almost entirely under our control.

The hardest part may be where to start.

Many subtle internal barriers to trade are a legacy from previous eras. Some barriers limit the movement of goods—beer and wine are prominent examples. There are interprovincial barriers to accessing largely public services, such as delivery of health care and education. And there are market controls via quotas, price fixing, and tariff barriers, notably the outdated controls over the production of dairy, eggs, and poultry.

There are also scores of subtle non-tariff barriers on capital and people among the provinces. With no common pan-Canadian securities regulation, Canada suffers from second-best solutions in capital markets. A number of vested interests—professional associations, unions, and government regulators—have worked hard to maintain the barriers to movement of people. These restrictions prevent skilled workers, including immigrants, from contributing fully to the economy. Misaligned regulations in areas such as food safety, pharmaceuticals, transportation, and environmental protection—between the federal and provincial governments, and with our biggest trading partner, the U.S.—create further barriers to commerce and add costs to doing business.

The federal government could demonstrate a renewed commitment to making Canada more internationally competitive by pressing for reduced barriers and better aligning our regulatory practices. The New West Partnership Trade Agreement among British Columbia, Alberta, and Saskatchewan is an important step forward. But further progress will require active federal leadership—such as establishing a negotiating process with firm timelines and milestones for success and encouraging the multiple stakeholders to stay engaged in the initiative.

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Domestic policies also influence foreign direct investment—both in terms of the investment coming into Canada and by Canadian firms abroad. FDI is critical to embracing globalization because it builds global value chains and creates operating scale and efficiencies within Canada—which improves productivity. It also expands access to foreign markets for Canadian firms, not only for resources and manufacturing but, increasingly, for services as well.

Canadians, however, are often ambivalent toward FDI. Trying to be open and selective at the same time, we mix up our economic and political interests. There are still material barriers to inward FDI, and we are reluctant to support Canadian firms as global investors, which impedes their ability to be globally competitive.

Improving our international reputation on the environment is a third way that domestic policy can improve international competitiveness. The right mix of federal policies can help Canada compete in a low-carbon world, thereby improving our social licence and our competitiveness.

For instance, putting a price on carbon, combined with stronger regulations, would nudge the Canadian economy toward cleaner technologies. A growing number of provinces are now putting a price on carbon (and some have made it revenue neutral), which avoids the challenge of revenue-recycling between regions. Better coordination of provincial initiatives could eventually lead to a pan-Canadian carbon pricing system.

The new federal government should take the lead on: negotiating international greenhouse gas targets; implementing effective measures at the border to ensure a level playing field for Canadian firms; and promoting continuous education of Canadians on the inter-connections among environmental, energy, and economic issues—since there should be no trade-off between the economy and the environment.

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Given the reality of globalization, the new government will need to consider carefully the challenge of enhancing Canada's competitiveness in the global marketplace.

Federal Leadership on Public Infrastructure Investment

No economy can achieve its full potential unless people can get to work and goods can reach their markets with ease. Investment in infrastructure was appropriately given a higher profile in the federal election campaign. So what's the best federal role?

Canada under-invested in its public infrastructure for decades and is now in catch-up mode. Moreover, with population growth and shifting patterns of urbanization, regional expansion, and international trade, the demand for high-quality infrastructure increases every year.

Investment in infrastructure offers a good payback from public spending, particularly if the projects are addressing priority needs. In general, each dollar invested in infrastructure will lift GDP by more than a dollar. Thus, infrastructure investment can be an effective form of short-term fiscal stimulus when and if required—but more importantly, it is a long-term structural necessity.

How great is the infrastructure need now and in the future?

The Federation of Canadian Municipalities (FCM) estimated that the replacement cost to bring municipal drinking water, waste water, storm water, and road infrastructure to a "good" standard is $172 billion. This does not include public transit investment or national and regional infrastructure priorities such as border crossings, ports, and power distribution. Regions such as the Canadian North are in need of special attention.

How can the federal government best show leadership? First, by promoting alignment and coordination among the three levels of government. Our three levels of government must work together to

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address the right infrastructure needs in the right way—recognizing that often some of the investments with the highest returns can be the most controversial or the least visible.

Strong cities, in particular, help build a strong national economy, so there is a federal role in building city and regional infrastructure, notably for public transportation, roads, and bridges. But most cities have lacked sufficient provincial and federal support for public infrastructure, and few have revenues that grow in line with the economy. A greater allocation of federal and provincial government resources to cities is one part of the answer.

Second, by developing and implementing a multi-year plan. Public infrastructure is not just a quick fix with "shovel-ready" projects—as when the economy is in recession. Projects should be prioritized within a transparent, "evergreen," multi-year plan and proceed as funding is made available. Priority projects should be identified based on their economic merit, with a clear return as well as an immediate need.

And third, by demonstrating innovation in mobilizing the financing. In the years ahead, the federal government should expect to have more fiscal capacity for new initiatives than will the provinces, which have the lead responsibility for funding and delivering health care in particular. At a minimum, multi-year investment funding should be protected within the federal budget in the face of inevitable strains on operating budgets.

But there is considerable room for innovation in how infrastructure investment is financed. A variety of innovative approaches, including public-private partnerships or even a pan-Canadian infrastructure bank, can create infrastructure financing alternatives that shift the burden away from current on-budget spending. The private sector is able to share the risks, responsibilities, and opportunities.

Canada's need for modern public infrastructure is not going away. Neither will the pressures on governments to find solutions. All three levels of government should be taking advantage of low long-term interest rates while they last to begin funding an ambitious, innovative public sector capital investment program. And additional revenue

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sources to support infrastructure should be open to consideration—including improved and appropriate pricing of services such as water and sewage, road congestion charges, and putting a price on greenhouse gas emissions.

It's time for some pan-Canadian innovation on public infrastructure.

Conclusion

Canada's economic performance is already being challenged by forces largely beyond its control, including demographics and globalization. With a strong political mandate, the federal government has the opportunity to define the priority economic policies that would best respond to those forces, and to implement its policy agenda. The ultimate goal would be to strengthen Canada's growth potential and enhance the long-term prosperity of Canadians.

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