Economics
IN FOCUS

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Uh Oh Canada: Is our future that dismal?

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Typically, a Canadian federal budget is replete with content that shows how well we are faring, so an item in this year's edition that had the opposite message caught our eyes. The chart suggested that Canada was destinated for dead last place among a large group of selected countries in terms of the average growth rate in real GDP per capita in the next four decades (Chart 1). That not only has us trailing the US and our rival commodities producer, Australia, but running well behind countries will less-than-stellar growth reputations like Italy, on a variable that is key to living standards.

Is our future really that dismal? A look behind the assumptions that the OECD used to generate the chart suggests that we needn't be quite so gloomy, and an examination of what drives differences in per capita output shows greater complexity than some of the most cited policy prescriptions imply.

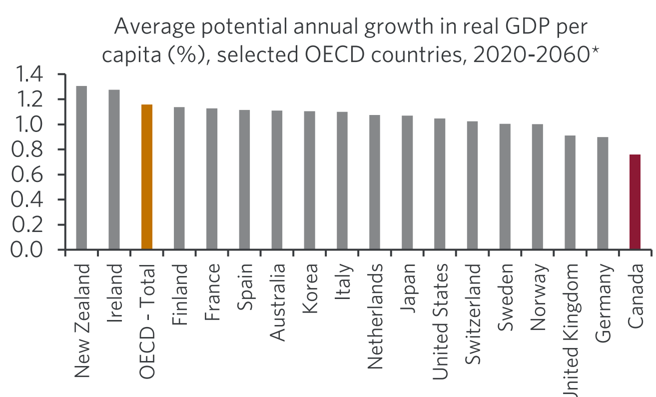
If past is prologue

Let's start with what we can measure, which isn't the next forty years, but how well we've been doing in the past. On that score, Canada looks, as they say these days, "meh", essentially in line with a whole group of countries near the middle of the pack. Most of the countries that significantly outperformed Canada in per capita growth were former east-bloc countries that were merely catching up to productivity levels in more modern, western economies (Chart 2). Note that we dropped Ireland from the sample, since its output has been sensitive to the degree to which technology firms assigned gains to their Irish subsidiaries.

Some of Canada's growth in GDP per capita has come by putting more people to work, particularly women where we've seen a trend rise in labour force participation. Looking ahead, while we may have a bit of elbow room to extend that given support for childcare, we'll also face an aging population with more retirees. So our prospects for GDP per capita might rest more on how we do in generating output per hour worked.

Again, what we can observe is how we've been doing on that metric, and Canada once again looks to be in the middle of the pack of similar countries (Chart 3). We've trailed those catching

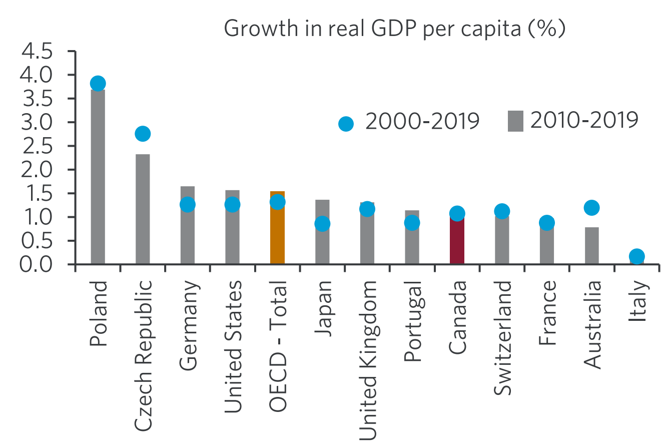
Chart 1: OECD says Canada fated for last place



This chart differs slightly from the one presented in the budget due to the use of rounding by the Department of Finance.

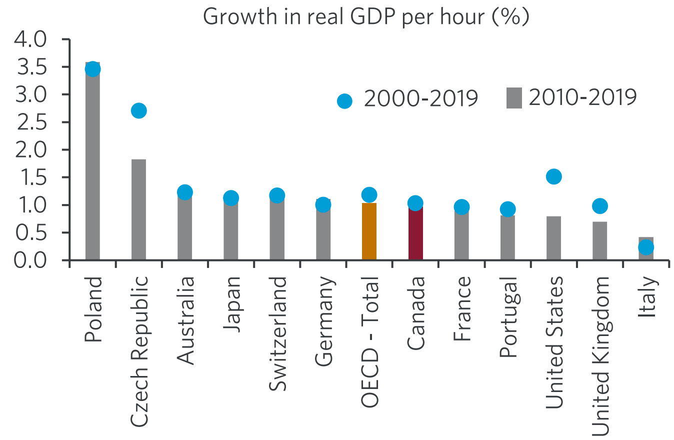
Source: OECD, CIBC

Chart 2: Canada has been in middle of the pack



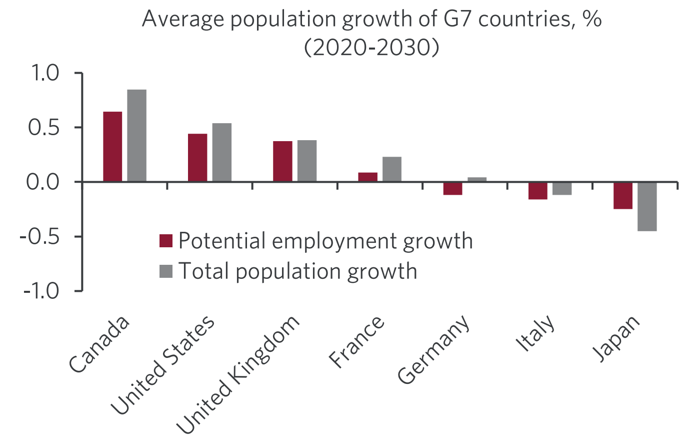
Source: OECD, CIBC

Chart 3: Our productivity has been near OECD average



Source: OECD, CIBC

Chart 4: Retirements mean our employment will trail population



Source: OECD, CIBC

up from east bloc inefficiencies, but aren't out of line with most others. And we're miles ahead of Italy, by the way.

Demographics aren't quite destiny

So how did the OECD's analysis shove Canada to the back of the pack in the next four decades? In part because whoever said "demographics are destiny" had a point. Immigration will keep Canada's population growth above those of other developed economies, including the US. But remember that population is the denominator for GDP per capita, and only helps the numerator enough if it results in a parallel gain in employment.

Particularly from here to 2030, Canada fares poorly on that score, not only due to the high starting point for employment, but also due to the bulge of baby-boomers hitting retirement age. Just this past month, the results from the latest Canadian census made headlines about the impending surge of retirements. The result is that Canada's population growth will exceed its employment growth by more than the US, which had a somewhat earlier baby-boom bulge that has already retired and maintained a higher fertility rate, although some European countries also face a weak employment outlook (Chart 4).

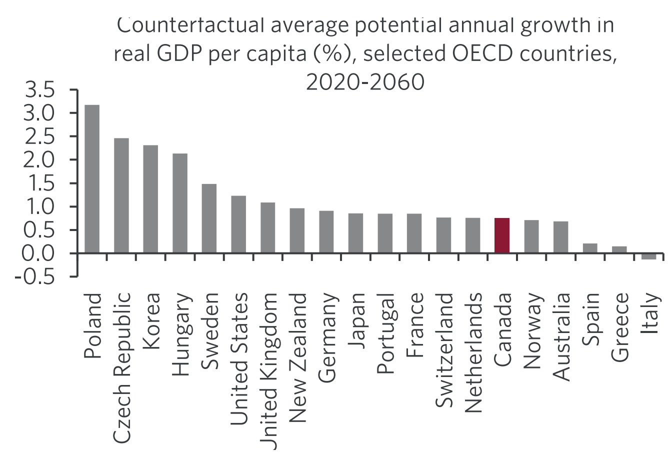
But that doesn't, of course, tell the whole story, which is why demographics aren't quite destiny. All it suggests is that per capita growth in hours worked will be weaker in Canada than in the US. Output per capita will then also depend on what the trend looks like for output per hour worked, and on that front, the OECD's productivity assumptions biased Canada's results downward.

A more realistic base case

The OECD chose to assume that countries that have lagged in GDP per hour will narrow that gap in the period ahead. That made sense when understanding how former east-bloc countries would gain ground as they opened up to trade and technology from the west, and freed themselves from the inefficiency of their state-planned economies. They likely still have room to go on that metric. But it makes little sense to make that same assumption about differences between countries that are already fully developed, particularly for countries like Italy that have been perennial laggards.

A more realistic base case would be to allow current trends in GDP per hour worked to be sustained over the forecast horizon, and ask how Canada will fare if we maintain our ranking in productivity. Instead of being in last place, that base case shows Canada still trailing the emerging Eastern European countries, as well as some others that have better demographics, with less of a gap between total population growth and the growth of those of working age. But we run ahead of Australia, and underperformers like Italy, Greece and Spain. Not great, but not dead last either (Chart 5).

Chart 5: Trend productivity moves Canada up from last place



Source: OECD, CIBC

What is to be done

If, as in the Olympics, our country isn't satisfied with being an also-ran, what is to be done to push us towards the medal podium in per capita growth? Most prescriptions focus on a single idea: more capital spending. While adding more capital to the stock of labour is the textbook's answer to improving productivity, the real world of economic data is more complex than that.

The attention that capital spending gets in Canadian policy circles owes in part to the fact that it's one dimension on which we're clearly lagging our favourite base of comparison, the US. Real gross fixed capital formation has been on a slower growth trend on this side of the border for decades. The gap narrowed a bit during the heydays of Canada's oil and gas boom, but widened again when energy sector capital spending fell off after the plunge in crude prices in late 2014 (Chart 6).

Policies that promote more capital spending, particularly if they are aimed at mechanization or technology upgrades, would surely be of benefit. But remember that capital spending is a cost for the businesses or governments undertaking it, and for the economy as a whole. To finance it, a country has to either defer current consumption and increase savings, or import funding from abroad, on which a stream of interest or dividends then has to be paid to the foreign lenders or owners.

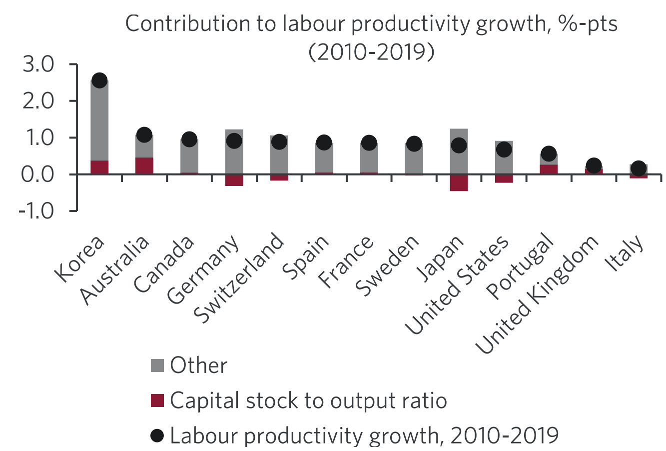
Capital projects don't always pay off in sufficient economic gains to cover those costs. Mirabel airport was a capital project, as were the stores that Target turned into Canadian outlets that vanished as fast as they came. Perhaps Canadian companies are simply being judicious about their spending and are staying clear of projects with inadequate returns. If governments step in to promote certain types of projects, we need to take care that private and public capital is put to work where the payoffs in per capita output will be greatest. Its not the more the merrier.

Indeed, the data across countries, or across time, also show that increases in the country's capital-to-output ratio explains a lot less of the variation in labour productivity than you might think. "Other" forces, which would include immeasurable factors like innovation, growth in the skill set of the workforce, or a shift in output towards higher productivity sectors, explain most or even all of the differences in labour productivity growth over the past decade (Chart 7). The same has been true in looking at the growth in Canadian labour productivity over past periods (Chart 8).

Canada's spending on R&D and innovation has also been compared unfavourably with other countries, but here again, more dollars aren't always the key. As a smaller economy sleeping next to a giant, Canadian business can often put technology and innovations developed into other countries into good use to increase output per hour. It's then the skill set of our workforce that becomes key to adopting such innovations.

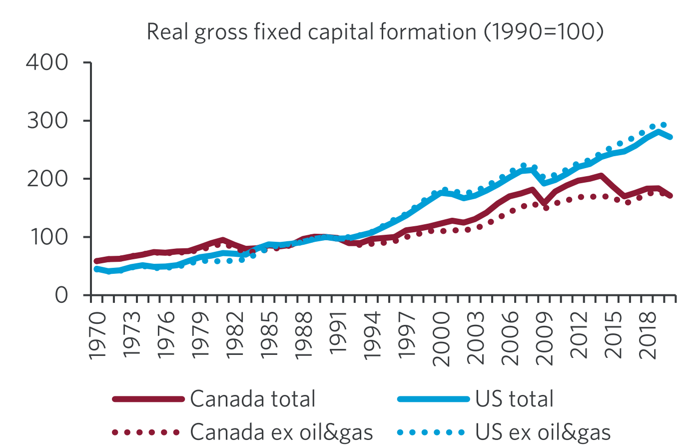
As a result, government support for skills training and education could be as important as efforts to enhance capital spending. On that score, there is hope that Canada will do better than what the path ahead for hours worked would suggest. Recent Bank of Canada research showed that despite a

Chart 7: Cap-ex explains little of variation in countries' labour productivity



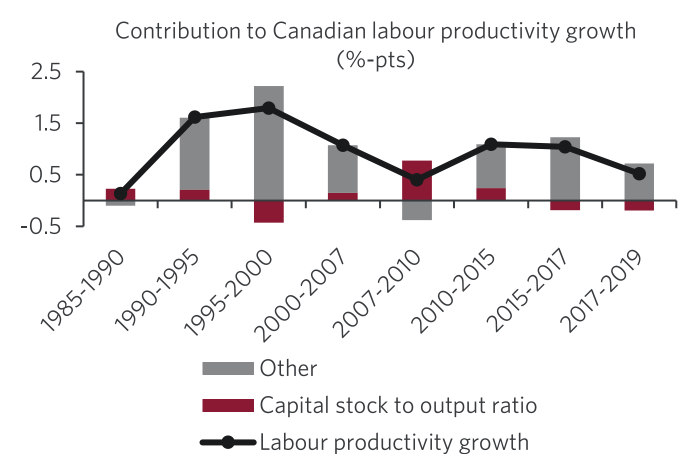
Source: OECD, CIBC

Chart 6: Canada trails US in capital spending



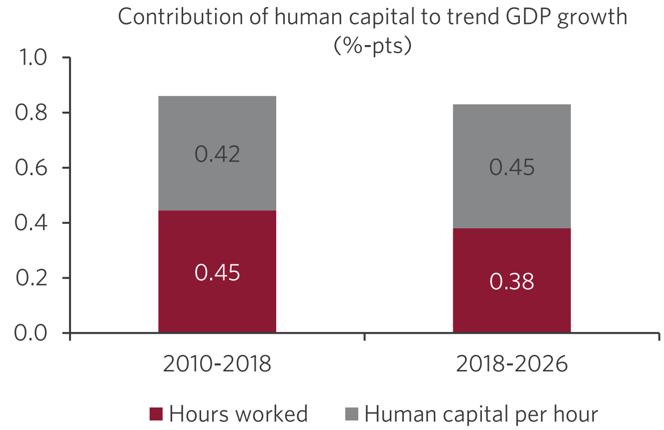
Source: Statistics Canada, OECD, CIBC

Chart 8: Also explains little of variation over time



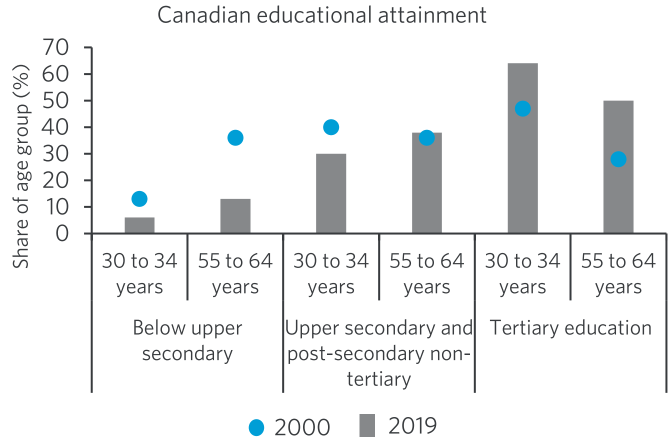
Source: OECD, CIBC

Chart 9: Slower gain in hours offset by improving labour quality



Source: Bowlus, Park and Robinson, Bank of Canada Staff Discussion paper 2022-7

Chart 10: New young workers more educated than upcoming retirees



Source: Statistics Canada

slowing in gains in hours worked in 2018-2026 versus 2010-18, the total contribution to growth from the increase in "human capital" is unlikely to decelerate. Essentially, accelerating growth in the skill set of the average worker should roughly offset the deceleration in working hours (Chart 9).

That trend is likely to continue to be the story for 2020-30, the period in which Canada's output per capita will be most impacted by baby-boom retirements. Educational attainment is the key variable along with hours worked in measuring the availability of human capital. The generation that will be entering the workforce in the next decade is likely to mirror the education attainment of todays 30-year-old, which includes a much greater share of people with advanced degrees, and fewer with less than high school than the generation that is now verging on retirement (Chart 10).

So rest assured that a last place finish isn't likely to be Canada's fate in the competition for the best growth in GDP per capita. There's room to improve our outlook, not just by incentivizing more capital spending in the right places, but also by enhancing innovation and worker skills and education. We need to take the discussions on growth beyond a more-the-merrier view on capital spending, towards a more sophisticated understanding of all of the forces at play.

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