INSTITUT C.D. HOWE INSTITUTE

COMMENTARY

NO. 467

Enduring Virtues: Saving and Investing as National Priorities for Canada in 2017

Canadians have been consuming like there's no tomorrow. Our national saving rate has plummeted and government deficits are making it worse. We need more saving and investment to boost national wealth and future incomes.

William B.P. Robson

The Institute's Commitment to Quality

About The Author

William B.P. Robson
is President and CEO
of the C.D. Howe Institute.

C.D. Howe Institute publications undergo rigorous external review by academics and independent experts drawn from the public and private sectors. The Institute's peer review ensures the quality, integrity and objectivity of its policy research. The Institute will not publish any study that, in its view, fails to meet these standards.

The Institute requires that its authors publicly disclose any actual or potential conflicts of interest of which they are aware.

In its mission to educate and foster debate on essential public policy issues, the C.D. Howe Institute provides nonpartisan policy advice to interested parties on a non-exclusive basis. The Institute will not endorse any political party, elected official, candidate for elected office, or interest group.

As a registered Canadian charity, the C.D. Howe Institute as a matter of course accepts donations from individuals, private and public organizations, charitable foundations and others, by way of general and project support. The Institute will not accept any donation that stipulates a predetermined result or policy stance or otherwise inhibits its independence, or that of its staff and authors, in pursuing scholarly activities or disseminating research results.

Commentary No. 467
January 2017
Fiscal and Tax Policy

Daniel Schwanen
Vice President, Research

$12.00
ISBN 978-1-987983-16-6
ISSN 0824-8001 (print);
ISSN 1703-0765 (online)

The Study In Brief

Canada's 150th anniversary is an apt time to reflect on past progress and how to build on it. A key lesson from our own history and global experience is that faster-growing economies have higher saving and investment. Forgoing consumption today adds to wealth: resources for the housing, capital, infrastructure and investments abroad that boost living standards tomorrow.

But Canadians' recent national saving – as households, as owners of businesses, and through our governments – has been feeble. Over the year to the third quarter of 2016, we consumed 98 percent of national disposable income. Our national saving rate was 2 percent, way below an average above 7 percent since the mid-1990s.

The problem was not so much our individual behaviour: households saved almost $1,700 per person. But losses by businesses – and, more important, governments running deficits – reduced national saving to barely $900 per Canadian.

Such weak saving meant that, to finance net investment that totaled $3,200 per Canadian, we had to borrow more than $2,300 per Canadian abroad. Not necessarily bad – but about $2,800 of that investment was in housing. Capital spending by businesses and governments – projects likelier to improve our capacity to export and service foreign debt – barely exceeded depreciation.

Sagging national saving has its counterpart in a virtual flat-lining of national net worth. While some of this weakness is cyclical, we would be rash to count on surging world demand and higher commodity prices to pull us ahead.

Our saving as households may look respectable, but with so much of our wealth in housing, and a subdued outlook for returns on financial assets, more would be better. Business profits will rebound, but to get corporate saving back to historical levels, we need greater efficiency. Policy can help private-sector saving: governments should be relying more on consumption taxes and treat household saving more generously, and reduce taxes that raise business' costs and lower returns to investment.

The top priority for governments, however, is fixing their own budgets. Much of what governments call "investment" is transfer payments and consumption. Federal capital spending does not even match depreciation: Ottawa's net investment is negative. And notwithstanding the rhetoric, deficits have nothing to do with investment. Capital spending creates assets, not liabilities. When governments run deficits, consuming more than tax revenue net of transfers and interest payments can cover, their deficits erode national net worth – as they are doing now.

We need less focus on near-term GDP and boosting consumption. Higher saving and investment, as households, through businesses and Canadian governments, is our surest path to a more prosperous future.

C.D. Howe Institute Commentary© is a periodic analysis of, and commentary on, current public policy issues. James Fleming edited the manuscript; Yang Zhao prepared it for publication. As with all Institute publications, the views expressed here are those of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors. Quotation with appropriate credit is permissible.

To order this publication please contact: the C.D. Howe Institute, 67 Yonge St., Suite 300, Toronto, Ontario M5E 1J8. The full text of this publication is also available on the Institute's website at www.cdhowe.org.

Canada's 150th anniversary is a natural time to look ahead to future success. In doing that, it pays to reflect on past progress – not least, how virtually all of us live astonishingly better than our ancestors did.

Food, clothing, shelter, clean water, electricity and fuel, medical care, entertainment, travel and transportation – people living at the time of Confederation would gape at modern abundance. Looking ahead, we who are now adults want to live well, and we want Canadians who are younger – or not yet on the scene – to fulfil their needs and pursue their dreams. Setting the stage for another era of progress should be a top priority in 2017.

Saving and Investment: Drivers of Economic Growth

What drove rising prosperity in the past? In thinking how to build from here for the long term, we need to look through the short-term rises and dips that reflect fluctuations in the world economy and other transitory conditions, and focus on what we did right and how to apply those lessons today. A key lesson from history is that, along with human capital, institutions and norms that foster trust, and openness to the world and innovation, faster-growing economies have higher rates of saving and investment – which is the motivation for this take on national priorities for 2017.

It is no surprise that high investment and fast growth run together, or that high saving correlates with high investment. The influences run in several directions.[1] It is partly because faster-growing economies generate higher incomes from which to save, and offer more opportunities for rewarding investment. More fundamentally, saving builds wealth. Our farming ancestors did not eat everything they grew: they set some aside to plant next season's crop. Forgoing some potential consumption today provides resources for the wealth – housing, buildings, machinery, infrastructure and intellectual property, plus investments abroad – that facilitates technological progress and boosts incomes and living standards tomorrow.

Consumption: Our Current Fad

In a discouraging sign of the times, though, saying that saving, investing and wealth should be priorities for 2017 sounds old-fashioned.

For decades, our main "big picture" measure of the economy – often used as a proxy for wellbeing – has been gross domestic product (GDP). GDP is

I thank C.D. Howe Institute National Council members Steven Ambler, Åke Blomqvist, Wendy Dobson, David Dodge and Gordon Thiessen, as well as Philip Cross, Jeremy Kronick, Daniel Schwanen and other reviewers who wish to remain anonymous, for their very helpful comments and suggestions on an earlier draft of this report. Any remaining errors are mine.

1 A recent effort to sort out the correlations between growth rates and saving is IMF (2014), which finds that regressions focusing on deviations from averages (a more short-run orientation) find that the influence of growth on saving dominates, but that regressions focusing on longer-run trends find that the influence of saving on growth dominates. Although national saving and investment need not be, and typically are not, identical at a point in time, they are strongly correlated, a fact that has generated an enormous literature (Apergis and Tsoumas 2008 survey it in detail). For a recent investigation of economic development that emphasizes the importance of saving to finance domestic investment, see Cavallo and Pedemonte (2015).

a measure of economic activity over an interval of time, and the commonest way to calculate it is to add up spending, in which consumption is by far the largest component.[2] So people who are totting up spending to estimate GDP in the next few quarters or next year tend to focus on consumption. More of it raises GDP: that's good; less of it lowers GDP: that's bad.[3]

Since the financial crisis and economic slump of 2008-2009, moreover, many have urged more consumption to kick-start the world's major economies. We have very low interest rates to encourage spending. And, say the consumption advocates, if stretched households aren't consuming enough, governments should step in, even if they will run big deficits to do it.

National Saving is Near Historic Lows

That's the spirit of the age. Not just in words but in actions. And not just in debt-ridden Europe, Japan and the United States, but here in Canada. The tallies of income and expenditure Statistics Canada produces for the country as a whole show that, at the national level – taking our behaviour as households, as owners of businesses, and through our governments all together[4] – we Canadians have been consuming, well, almost like there's no tomorrow. Over the most recent 12 months for which we have the numbers – the fourth quarter of 2015 through the third quarter of 2016 – we consumed 98 percent of national disposable income.[5]

Our national saving rate – the share of disposable income we do not consume – has plummeted. Over that 12-month period, it registered a paltry 2 percent. Expressed in dollars per Canadian, the resources we set aside to build future wealth amounted to barely $900 each. (All dollar figures in the text are inflation-adjusted per-person amounts. For readers who would like the gross dollar amounts, Table 1 shows national disposable income, consumption, saving and net investment by sector over the most recent 12 months, and the changes in national net worth that occurred over that period, in billions of dollars as well as in dollars per Canadian.)

We can't readily benchmark what we nowadays produce, consume, save and invest against our history since Confederation. Consistent data from Statistics Canada run back to 1980 – when Canada had already transitioned from the very rapid growth and high investment that characterized most of the previous century. Even by the less demanding post-1980 standard, though, our recent performance stands out – and not in a good way (Figure 1).

National saving – which, to repeat, comprises saving, not just by households, but in all sectors of Canada's economy – averaged around 6 percent

2 To be more precise, the spending that enters GDP is spending that uses output, as distinct from income transferred from one person or entity to another.

3 A careful adder up of the numbers will allow for some of any increase in consumption being satisfied by imports, and some of any decrease reducing imports. But the logic of the adding-up exercise, with its short-term focus, still implies that any net increase in GDP spurred by consumption is "good news."

4 Statistics Canada also breaks out saving by the not-for-profit sector, but the sector is small and by its nature typically breaks about even, so it has little effect on the national totals.

5 The data on incomes, saving and investment in this report are from Statistics Canada's Income and Expenditure Accounts, CANSIM Tables 380-0071 and 380-0079. The data on assets, liabilities and net worth are from the National Balance Sheet Accounts, CANSIM Table 378-0121. Population figures are from CANSIM Table 051-0005. All adjustments for price changes are by the author, and use the implicit price index for final domestic demand (the best aggregate indicator of domestic purchasing power), CANSIM Table 380-0066, based to the third quarter of 2016. All data were accessed 30 December 2016.

Table 1: Income, Consumption, Saving and Investment by Sector. Fourth Quarter of 2015 to Third Quarter of 2016

	$ billions	$ per Canadian
Disposable Income		
Households	1,154.8	31,977
Corporations	36.0	996
Governments	410.8	11,375
Other	29.1	806
National	*1,630.7*	*45,154*
Minus Consumption		
Households	1,095.0	30,322
Corporations	47.6	1,317
Governments	426.5	11,811
Other	28.6	793
National	*1,597.8*	*44,243*
Equals Domestic Saving		
Households	59.8	1,655
Corporations	-11.6	-321
Governments	-15.7	-436
Other	0.5	13
National	*32.9*	*911*
Minus Net Investment		
Households	99.8	2,763
Corporations	4.3	120
Governments	10.9	302
Other	1.3	35
National	*116.3*	*3,221*
Net Capital Transfers and Statistical Discrepancies	-1.2	-33
Equals Net Foreign Lending	*-84.6*	*-2,342*
Memo: Opening and Closing National Wealth		
National Net Worth: 2015Q3	9,582.0	265,331
Saving over the Period	32.9	911
Net Impact of Revaluations and Accounting Discrepancies	263.0	7,282
National Net Worth: 2016Q3	9,845.0	272,613

Notes: "Other" is not-for-profits and statistical discrepancies. Net investment is gross investment minus depreciation. Per-Canadian amounts use the average population over the period.

Sources: Statistics Canada, Income and Expenditure Accounts (CANSIM Table 380-0071), averages of seasonally adjusted data at annual rates for the most recent four quarters; Statistics Canada, National Balance Sheet Accounts (CANSIM Table 378-0121); Statistics Canada, Estimates of Population (CAMSIM Table 051-0005); author's calculations.

of disposable income during the 1980s. Expressed in 2016 dollars per Canadian, that comes to about $2,000 per person per year. Saving cratered in the 1991/92 recession, and then rose quite steadily for more than two decades.

The comparison is even cleaner after 1995, since volatile inflation distorts saving, and inflation has been consistently very close to 2 percent since the mid-1990s. From then until now, including the most recent four quarters, we have saved, on average, more than 7 percent of income. In real dollars per person, average saving topped $3,000 annually – not too shabby, especially considering that the income we were saving from in the late 1990s was lower than income today (Figure 2).[6]

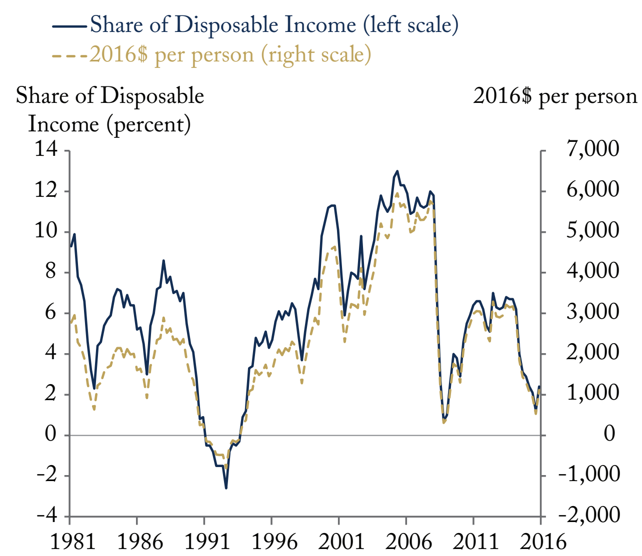
Looking at the most recent decade, national saving plunged after the crisis. Its trough in mid-2009 was below 1 percent of national disposable income – less than $400 per Canadian. Then it recovered: the saving rate hit 6.6 percent – better than $3,000 per Canadian – by the end of 2011. But we did not see a 1990s-style further climb from there: saving leveled off and then turned down in 2014.

Households are Saving…

Why are we saving so little? Commentary on the economy usually highlights the household saving rate and household indebtedness regularly makes headlines, so it is natural to start by asking if maxed-out consumers are the villains. Not entirely, it turns out.

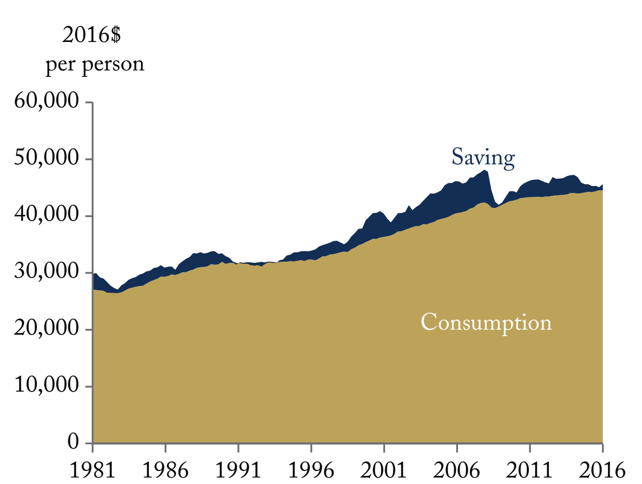
Saving by Canadian households averaged 5.2 percent of their disposable income over the year to the third quarter of 2016 – above the 3.9 percent

Figure 1: Canada's National Saving



Source: For all data see footnote 5.

Figure 2: National Income Saved and Consumed



6 The position of the national saving line with respect to zero does not directly determine our foreign borrowing. Canada has often borrowed from abroad to finance domestic investment beyond what domestic saving can cover. Over the period shown in Figure 2, the early 1990s was the only period when national saving itself – that is the difference between income and consumption – was negative.

saving rate typical since the mid-1990s (Figure 3). On average, as individuals – working, managing our homes, or retired – and as owners of unincorporated businesses, we have kept our consumption within what our incomes can cover. We put aside almost $1,700 each over the past year – better than the $1,100 average (again, measured in real 2016 dollars) over the previous two decades.

…But Businesses and Government are Not

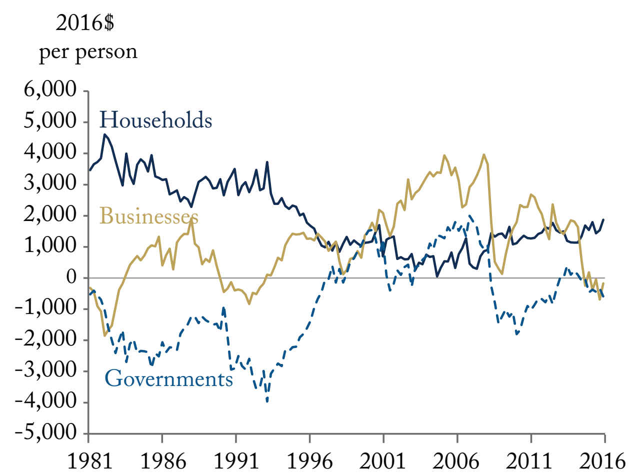
Our recent collapse in saving occurred through the businesses we own,[7] and the governments we elect.[8]

Businesses have been in rough shape since oil prices tumbled in late 2014. Corporate profits always rise and fall with the business cycle, but businesses have usually been able to pay dividends and taxes and still add to national saving. On average since the mid-1990s, business saving has amounted to about $1,800 per Canadian annually. The trend in corporate saving has been down over the past decade, however, and over the most recent 12 months businesses subtracted from national saving.

Also important is the change in the public sector. Negative saving is nothing new for Canadian governments: the large and chronic deficits of the 1980s and early 1990s mark years when governments made a major negative contribution to national saving.[9] But after the mid-1990s, governments on the whole made a positive – if nominal (an average of only $150 annually per person) – contribution to national saving. Even after the crisis sent them into the red, subsequent fiscal consolidation made them net contributors once more.

Then deficits became fashionable again. Over the year from 2015's fourth quarter to 2016's third quarter, our governments subtracted more than $400 per Canadian from our national saving.

Figure 3: Saving by Sector



Saving Too Little to Finance Domestic Investment

So the combined effect of our recent saving performance – as households, and through our

7 Although the data are imprecise, returns to Canadian owners of domestic corporations are in principle part of national disposable income, and returns to foreign owners are not.

8 Because income, expenditure and other aggregates in the national accounts come from different sources, what should add up exactly in theory does not add up exactly in practice. The statistical discrepancies Statistics Canada publishes in the national accounts typically fluctuate in a narrow range around zero, however, so I leave them out.

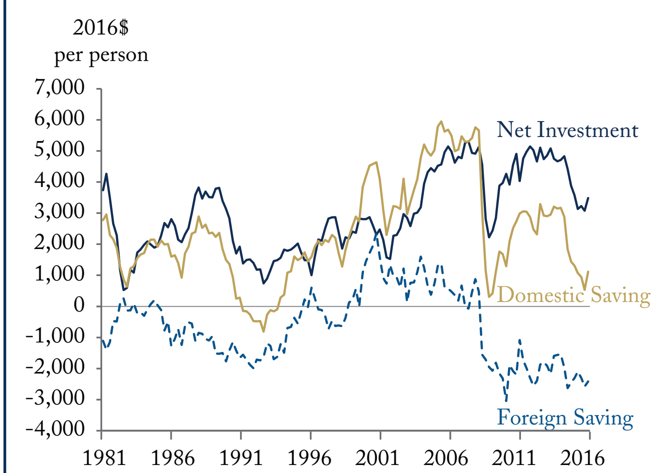
9 The bottom-line surpluses and deficits in governments' public accounts do not map exactly onto government saving in the national accounts. The two accounting systems use different depreciation schedules for capital assets, for example, and treat capital transfers differently (public accounts reports typically show them as current spending, but the national accounts put them in a sector's capital account – that is, after the calculation of net saving). These differences affect levels more than trends over time, however: the fluctuations in the government saving line in Figure 3 will not surprise any observer of government budgets in Canada over that period.

businesses and governments – has been unimpressive, especially during the most recent four quarters for which we have numbers. Before getting to the bottom line, and sorting out what might take care of itself and what we should do to improve the outlook for future national wealth, however, there is an international aspect to cover off.

Saving flows readily across Canada's borders. If we save more than we need for our own investment, we can lend abroad; if we save less than we need, we can supplement it from abroad. So anemic Canadian saving does not translate directly into anemic Canadian investment.

Net investment in Canada – net new capital added every year after subtracting what wears out and gets used up or scrapped (the blue line in Figure 4) – registered more than $3,200 per person over the most recent 12 months. While that is down from the peaks around $5,000 annually (2016 dollars) recorded in the mid-2000s and during the energy boom – and somewhat below the $3,600 average since the mid-1990s – it is a decent-looking number.

Figure 4: Financing of Investment



Borrowing from Abroad …

Because we had only about $900 per Canadian of domestic saving (the gold line in Figure 4) to finance that investment, though, we had to find the balance abroad. The difference between domestic investment (the blue line) and domestic saving (the gold line) is foreign saving.[10] (For easier reference, Figure 4 also shows foreign net saving separately as a dashed line: above zero when we were net lenders to foreigners, as in the early 2000s; below it when we were net borrowers from them, as we have been lately).[11]

Over the year to the third quarter of 2016, foreigners filled the gap between what we invested on the one hand, and what we were willing to forgo in consumption on the other, to the tune of more than $2,300 per Canadian. Even when our governments were running big deficits in the 1980s and early 1990s (as shown in Figure 3), our private-sector saving covered most of the public sector's dis-saving, and annual foreign financing never surpassed $2,000 (2016 dollars) per person. As individuals, we are not aware that we are drawing on saving from abroad, but we have been doing it in a big way.

10 In the national income and expenditure accounts, the net saving of each sector – households, non-profits, corporations, governments and foreigners – is typically not the same as its net lending. Most important, in the domestic sectors, capital consumption reduces saving but does not absorb funds, while gross investment absorbs funds but does not affect saving. The foreign sector is the exception: it neither consumes capital nor invests in capital assets. So, aside from relatively small capital transfers, foreign net saving and foreign net lending are the same.

11 Because the statistical discrepancies in these accounts are small and unsystematic, I exclude them from the calculation.

…Without Increasing our Ability to Repay

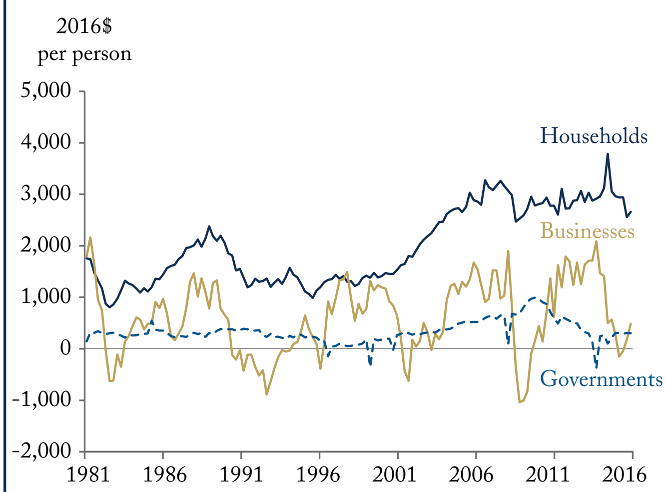
Having access to foreign saving is better than not having access to it, but relying heavily on it directs extra attention to how we use it. Is it supporting new plant, equipment, infrastructure and intellectual property? Are we creating assets that will enhance our prosperity and ability to service the resulting obligations? Or will we later wish we had used the money more wisely?

If we look at capital spending in Canada (Figure 5), a striking fact about the past decade is how much of it has been in housing (the blue line in Figure 5). Other countries saw a similar run-up in residential construction before 2008, but nearly all of them saw a subsequent bust. Our household investment has stayed close to the level – some $3000 per Canadian in real dollars – that it achieved in the mid-2000s. In our home lives, we are saving – but a striking amount of our new wealth is in our residences.

Business investment (the gold line in Figure 5), sadly, is much weaker. Net corporate investment in plant, equipment and intellectual property – that is, capital spending less depreciation – has typically been less than household investment since 1980. But the gap has widened since the mid-1990s. And the most recent figures are disheartening: net business investment registered scarcely more than $100 per Canadian over the year to 2016's third quarter.

What about governments? We hear a lot about government "investment." Yet the most recent 12 months' figures show net investment – that is, capital spending in excess of depreciation – by Canadian governments (the dashed line in Figure 5) at only about $300 per person. That is way down from its peak close to $1,000 per Canadian in 2010, and unimpressive compared to the $500-plus average since the mid-1990s. So net additions to business and public plant, equipment and infrastructure are lately far less prominent than net additions to housing. Better housing is certainly nice to have, but it is less oriented to the output that sustains desirable private-sector jobs or helps us service obligations to foreigners.

Figure 5: Investment by Sector



The Causes and Consequences of Stagnating Net Worth

The payoff from any investment – including its impact on our ability to service foreign debt – is, of course, uncertain. Business investment that exceeded $5,000 per Canadian annually from 2011 to 2014 looks less impressive in early 2017, with lower energy prices having rendered much of the capital installed back then uneconomic. Changes in global demand and technology affect other elements of national wealth also, loosening the links between domestic saving and investment on the one hand, and changes in our net worth on the other.[12] But the links, though loose, still exist.

12 So too does the value of human capital, but we do not yet have any accepted way of including the stock of human capital in our measures of national wealth.

Growth in Canadian Wealth since 1990

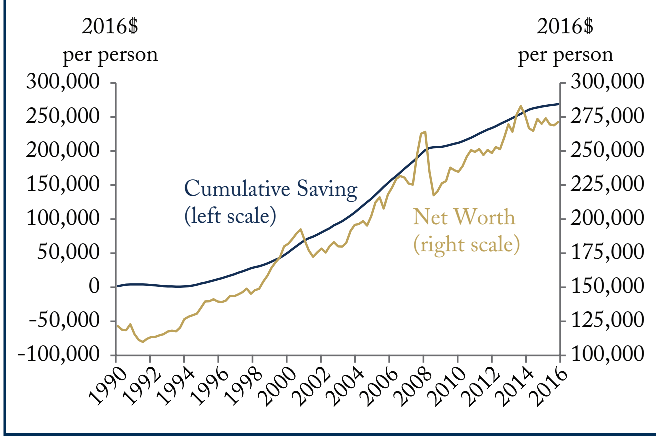
For a look at Canada's net worth, our best source is Statistics Canada's national balance sheet statistics. In addition to the housing, plant and equipment, infrastructure, and intellectual property measured in the national income and expenditure accounts, they also include estimates of the current value of assets such as housing, land and natural resources, as well as consumer durables. Because this ambitious attempt to measure national wealth is relatively new, we have consistent figures back only to 1990 (the gold line in Figure 6 shows national net worth in 2016 dollars per person).

For a quick look at the correlations between saving and wealth since then, we can compare cumulative net national saving since 1990 (the blue line in Figure 6) with national net worth. Notwithstanding the differences in coverage of the income and expenditure accounts that measure saving, and the balance sheet accounts that measure wealth, it is clear that periods of higher saving tend to coincide with periods of faster-growing wealth.

Like the correlations between saving, investment and growth noted earlier, this association reflects influence both ways. Cycles in resource prices and demand for our products abroad affect the value of natural resources – a key reason why national net worth sags during periods like the recent one – as well as household incomes, business profits and government balances. So it's partly about cycles. And, straightforwardly, saving builds wealth. That's about trends.

The coincidence of very low saving in the early 1990s with no progress in per-person wealth during that period is clear, as is the coincidence of higher saving and progress in per-person wealth later in the 1990s. The economic weakness of the early 2000s hurt net worth, but robust saving helped it grow through mid-decade. The 2008 crisis and slump dealt a more severe blow to saving and wealth, but we moved ahead again afterwards – until 2014. Since then, our cumulative net saving has been weak, and our national net worth has flat-lined.

Figure 6: National Saving and Net Worth



Stagnating Wealth and Stagnating Income

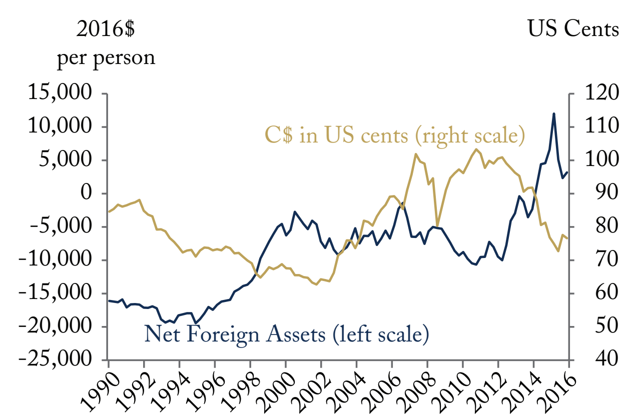
So, to repeat, we see short-term swings. Changes in the value of built assets, land, natural resources, and exchange-rate-related movements in our foreign balance affect Canada's net worth. Changes in global demand, technology and our terms of trade are not things we can control – at some times, we will benefit from them and our wealth will rise faster than our saving would support; at others, we will suffer and our wealth will rise more slowly than our saving would support.

Indeed, if we were confident that our wealth will rise over time, we would not need to worry much, if at all, about short-term dips in saving: a rational consumer will look through temporary ups and downs. With national saving as low as it has been over the past decade, however, and the trend of national net worth being as flat as it has been, we should not take for granted that Canada's wealth will spring back and take off at a rate that validates our current consumption. We should actively promote that happy outcome.

Box 1: A Caveat about Canada's External Balance

Returning for a moment to the international side of the story, Canada's national balance sheet – like all balance sheets – requires some interpretation. One wrinkle relates to the assets and liabilities abroad created by flows of saving across our borders.

Figure A: Foreign Balance and the C$



Because the value of most of what we hold abroad is in foreign currencies, and the value of most of what foreigners hold here is in Canadian dollars, changes in the value of the Canadian dollar affect our net foreign position. When our dollar rises, assets in Canada gain value relative to assets elsewhere. When it falls, assets in Canada lose value relative to assets elsewhere.

The result – perverse at first glance – is that a strengthening Canadian dollar makes the balance of our external assets versus liabilities look worse, and a weakening dollar makes it look better (Figure A). The dollar's fall since 2014 actually flatters our measured net worth. Looking at the overall national balance sheet, the gain in our net external position offset some of the decline in the value of natural resources since then. When commodity prices, the value of natural resources and the exchange rate rise again, the offset will work in the other direction.*

* While the balance of our assets and liabilities abroad has turned positive, dividends and interest paid out of Canada still exceed dividends and interest paid into Canada, reducing our national disposable income. So the flows of income tell a less positive story than the exchange-rate influenced balance-sheet measures.

Through good times and bad, what we can control is the domestic saving that supports the underlying trend of net worth. And the experience of the past 25 years is consistent with what any historian of Canada's longer-term development would tell us: on the time-scales appropriate to understanding why each generation lived better than the one that came before it, increases in national wealth and increases in income went together (Figure 7).

What to Do?

Lower national resource prices have recently dealt our net worth and our incomes a blow. Our priority for 2017 and beyond should be saving and investment that build them up again.

More Private Sector Saving Would Help

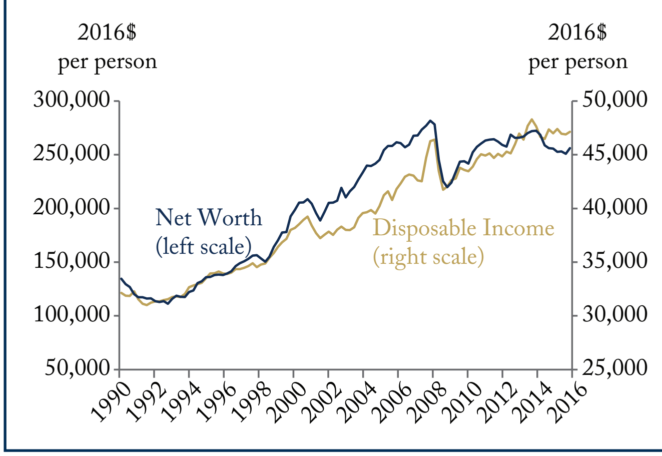
Starting at home – and notwithstanding respectable-looking household saving rates – we probably should save more in our private lives. Rising house prices and land values have boosted household wealth in the recent past out of proportion to what we should count on in the future. To judge by the four-percent real-return assumptions in major pension plans and much of the promotional literature for individual saving vehicles, many Canadians may be counting on their financial assets for more income than a slow-growing economy will reliably provide.

As for businesses, greater efficiency is always a virtue. Many companies let costs get out of hand during the resource boom; others that enjoy a protected home market are less efficient than they could be. Healthier profits would give a welcome boost to national saving.

Policy Actions Could Boost Private Saving

We can and should also insist on changes from our governments. Governments can help, or at least not discourage, private-sector saving. Relying less on income taxes and more on consumption taxes would encourage household saving. So would less grudging treatment of household saving: Canadians who do not work for government have far less opportunity to save for retirement while they are working, and to preserve capital once retired, than government employees do. As population aging moves more Canadians to the point in life where these biases matter, redressing this problem will become a more central aspect of any program to bolster national saving.

Figure 7: Net Worth and Disposable Income



Turning to policies toward businesses, too many taxes that affect them, notably corporate income taxes (Bazel and Mintz 2016) and business property taxes (Found and Tomlinson 2016) raise costs and encourage distribution of earnings rather than reinvestment. A number of these taxes likely tilt private investment away from business plant, equipment and intellectual property and toward residential investment. Government can help on that front also.

Government "Investment" is More Talk than Action

Most straightforwardly, governments need to fix their own budgets. Governments do talk a lot about investment. But that talk is often misleading in two ways.

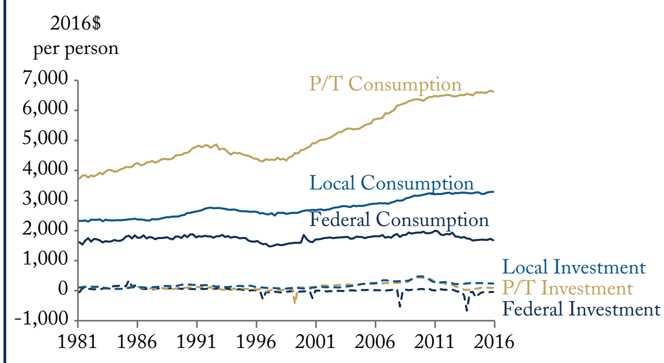
Crafters of political messages know the words "investment" and "infrastructure" poll well. So they promote many things as "investment" and "infrastructure" that, in reality, are transfer payments that will support private-sector consumption, or are government consumption – paying their own employees, plus rent, light and heat, travel and myriad other activities that consume resources rather than creating assets that will benefit Canadians in the future.[13]

Looking at consumption versus net investment – gross capital spending minus depreciation – since 1981 (Figure 8) reveals the "investment" spin to be just that. Consumption dwarfs net investment at every level of government. Lately, only local governments have made any significant net investment. And while transfers from the federal government may have boosted local and provincial/territorial (P/T) capital spending,[14] Ottawa's own capital spending does not even keep up with the rate at which its assets are wearing out and going obsolete.

Another misleading element in much talk about government investment and infrastructure is the implication that they justify deficits. Spending on a capital project does not create a deficit.[15] It creates an asset. If a government finances a project with funds provided by past surpluses, it replaces financial assets with a real asset: the impact on net worth and the annual bottom line is zero. If a government finances a project with debt, it adds an asset to one side of its balance sheet (the project) and an equal liability on the other (the debt): the impact on net worth and the annual bottom line is again zero.

It is far more accurate to relate deficits to consumption: more precisely, consumption that exceeds what taxes, net of transfers and interest payments, can cover.[16] When governments are

Figure 8: Government Consumption and Investment



13 Some spending classified as consumption in the national accounts has an element of investment in it: education that increases people's mental capacity, say, or healthcare that increases their physical capacity. But that qualification does not overturn the argument. Any proper measure of human capital investment would also include depreciation, which would be large (consider how much public healthcare spending is on people in their last years of life), so net investment in human capital would be much lower than gross investment. Moreover, those human capital investments produce value principally for the individuals who receive them. They are not the kinds of public-use infrastructure most of us think of when we hear about government "investment." Many of the most important government actions that have helped make Canadians healthier up until now, moreover, were investments in hard assets – not just hospitals, but water, sewage and transportation infrastructure.

14 I say "may have" because every dollar in a government budget is fungible, and there is no guarantee that a transfer labelled for spending on infrastructure will not substitute for money that then flows to some other kind of spending, or finances a tax cut. Research on what is often termed the "flypaper effect" suggests that the label on transfers does matter, inducing more of an increase on the designated purpose than if the recipient government allocated each extra dollar according to its previous preferences.

15 Governments do not expense capital in their financial statements: they record new buildings, machinery, structures and so on as assets, and write them down as they wear out. Although Statistics Canada's calculations of capital spending and depreciation are not identical to those in public accounts documents, the concepts are the same.

16 As noted earlier, capital transfers typically show as spending in governments' statements of operations but as part of their capital accounts in the national income accounts. They are substantial in dollar terms, but do not loom large relative to total government activity or national income. Moreover, a high proportion of them are intergovernmental, and are netted out of consolidated measures of government activity. While it is not strictly accurate to identify the aggregate budget surpluses and deficits of Canadian governments with government sector saving and dis-saving, it is not badly misleading either.

subtracting from national saving, they are not leaving output unconsumed for future use, as the word "investment" implies. They are using resources up.

Excesses of consumption over what the rest of their budgets could support are reflected in large deficits – dis-saving – recorded by Ottawa, the provinces and territories during most of the 1980s and early 1990s (Figure 9).[17] As noted already, the period from mid-1990s until the 2008 crisis was different: the federal, provincial and territorial governments – and local governments, which were already net savers – all contributed a few hundred 2016 dollars per Canadian to national saving. But post-crisis, we again had sizeable deficits. And after a fitful move back to balance, they are at it again. Ottawa has plunged back into the red. Progress toward budget balance in some provinces is being offset by fiscal deteriorations in others. And lately, and unusually, even local governments are consuming beyond their means.

Governments talk mainly about investment. But they would more properly talk mainly about consumption. They are not building our net worth. They are eroding it (Figure 10).

Figure 9: Saving by Level of Government

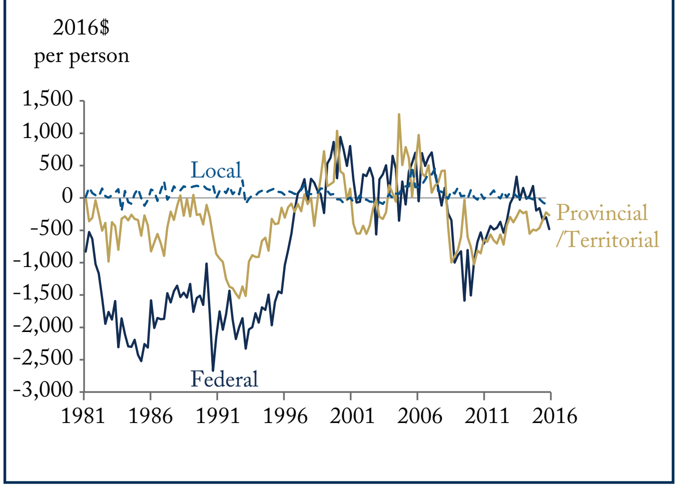
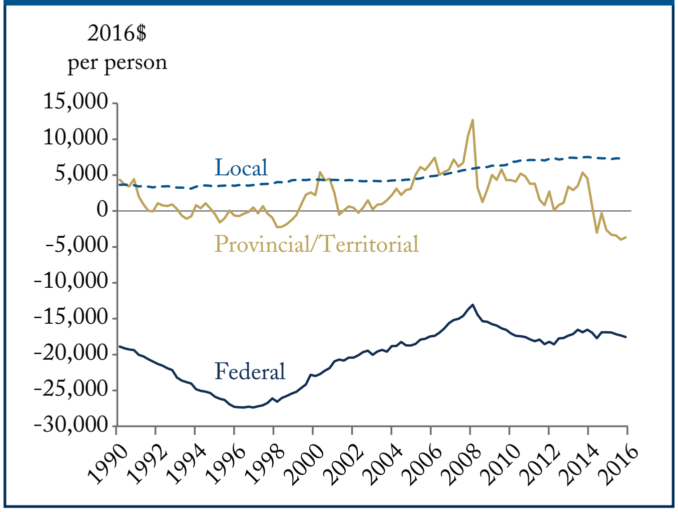


Figure 10: Net Worth by Level of Government



Governments Should Stop Dis-saving

The direct negative effect of government dis-saving on Canadian wealth gets too little profile in debates over fiscal policy's role in promoting economic

17 Statistics Canada also includes Aboriginal governments and the assets of the Canada and Quebec Pension Plans in its tally of the government sector. Aboriginal governments are relatively small, and data for them are too incomplete to justify showing them separately. As for the Canada and Quebec Pension Plans, I follow the convention of including them in the aggregate government-sector statistics discussed to this point, but do not break them out here: it is misleading to show only their assets, because their liabilities calculated on a solvency basis (which would be the logical comparison to the current value of their assets) are much larger, and their net worth on that basis would be negative. One final pension-related note is that governments discount the obligations of their employees' pension plans using rates that are higher than returns on securities with comparable seniority and security. This practice understates the pension wealth accruing to government employees and the corresponding liability to taxpayers. Underfunding social security programs and government employee pensions may depress national saving if the beneficiaries consume as though their pension wealth were secure, while those on the paying end – younger Canadians and people not in government penison plans – consume as through the higher taxes those pensions will require them to pay will not occur.

growth. Much of the commentary focuses on GDP over the next few quarters – in that context, more government consumption looks positive, especially if the additional demand prompts more private-sector consumption and investment.

While a positive multiplier of that sort is possible, the Canadian experience documented in the charts above supports a different interpretation: one that stresses our disappointing economic performance during the 1980s and early 1990s, when governments were running big deficits, and the improvements in national saving, investment and the pace of wealth formation after they returned to surplus in the mid-1990s. We need more convincing evidence that they promote private-sector income growth and investment before accepting that government deficits today are making Canadians better off.[18]

Building National Wealth: A Priority for 2017 and Beyond

Our collective behaviour over the year to 2016's third quarter suggests that we in Canada have decided to live for the moment, and hope that some change in the external environment – a surge in foreign investment in our real estate, perhaps, or a rebound in oil prices – will set us back on the road to growing wealth. Yet despite the tendency of many economists and pundits to extol consumption for the sake of GDP in the next quarter or the next year, that is probably not the course most of us intend. Indeed, looking at household saving as a share of income or in dollars per person, our performance as wage-earners, consumers and householders seems pretty decent.

Part of the problem may be that most of us, as individuals and householders, are not directly aware of the problems afflicting Canadian businesses. While we benefitted from their saving and investment in the past – as workers enjoying productivity gains and as owners through our savings and pension plans – we do not factor corporate saving and net worth into our household budgets. Yet saving and investment by businesses will matter for the future, and even though profits are recovering from their trough in the most recent year, it will take heavy lifting and some policy support to get business saving back to historical levels. To the extent that we as householders are spending in anticipation of productivity gains and investment returns higher than will reliably occur, a bit more individual saving would be wise.

Bigger challenges – and bigger opportunities for lasting improvement – are in the public sector. Some in government see saving as a problem – less stimulative to GDP than consumption, and too oriented toward things such as retirement that don't yield tax revenue right away. The pre-eminent problem, though, is that Canadians voted for, and are hearing they will get, something different from what is actually happening. The words "investment" and "infrastructure" imply additions to national wealth. The recent reality, however, is the opposite.

In the short run, households might usefully react to the erosion of wealth in the public sector by hiking their saving another notch – in practical terms, to prepare for the taxes they will pay to cover interest on unproductive public debt. Far better would be for governments to get leaner. In the medium and long run, we need them to

18 A further major problem with government deficits is the tax distortion created by the need to finance interest payments on the resulting debt. Dahlby (2009) warned shortly after the crisis that the benefit-cost balance for fiscal stimulus was less favourable toward deficits than generally understood. Even though yields on government debt are now low, governments have tended to rely recently on relatively damaging taxes such as taxes on high income earners, corporate profits and real property to finance additional spending, including incremental interest payments – which will discourage work, investment and the recognition of income in Canada long after any temporary boost to demand has faded.

consume less. They should run budget surpluses, add to national saving, and ramp up investments in genuine assets that will boost our living standards in years and decades to come.

Enduring Virtues

Our current prosperity rests on past increases in wealth. Over 150 years, through the ups and downs of economic cycles, past Canadians did something vitally important. They did not consume everything they made; they saved and invested for the future.

We want and need further increases in living standards – for ourselves and for those who will come after us. Saving and investing are enduring virtues. Recommitting to them may sound old-fashioned, but it is the surest path to a richer and happier future – a worthy national priority for 2017.

References

Apergis, Nicholas, and Chris Tsoumas. 2009. "A survey of the Feldstein-Horioka puzzle: What has been done and where we stand." *Research in Economics* 63 (2009).

Bazel, Philip, and Jack Mintz. 2016. 2015 "Tax-Competitiveness Report: Canada Is Losing Its Attractiveness." *SPP Research Papers* Vol. 9, Issue 37. University of Calgary School of Public Policy. November.

Cavallo, Eduardo, and Mathieu Pedemonte. 2015. *What is the Relationship between National Saving and Investment in Latin America and the Caribbean*? IDB Working Paper Series Nº IDB-WP-617. Interamerican Development Bank. August.

Dahlby, Bev. 2009. *Once on the Lips, Forever on the Hips: A Benefit-Cost Analysis of Fiscal Stimulus in OECD Countries*. Backgrounder 121. Toronto: C.D. Howe Institute. December.

Found, Adam, and Peter Tomlinson. 2016. "Business Tax Burdens in Canada's Major Cities: The 2016 Report Card." E-Brief. Toronto: C.D. Howe Institute. December.

International Monetary Fund. 2014. "Perspectives on Global Real Interest Rates." *World Economic Outlook*, Chapter 3.

Recent C.D. Howe Institute Publications

January 2017	Ciuriak, Dan, and Jingliang Xiao. *Protectionism and Retaliation.* C.D. Howe Institute Working Paper.
January 2017	Rémillard, Richard. *Government Intervention in Venture Capital in Canada: Toward Greater Transparency and Accountability.* C.D. Howe Institute Commentary 466.
January 2017	Hicks, Peter. *Toward a New Balance in Social Policy: The Future Role of Guaranteed Annual Income within the Safety Net.* C.D. Howe Institute Commentary 465.
January 2017	Johnson, Jon R. *The Art of Breaking the Deal: What President Trump Can and Can't Do About NAFTA.* C.D. Howe Institute Commentary 464.
January 2017	Sutherland, Jason M., and Erik Hellsten. *Integrated Funding: Connecting the Silos for the Healthcare We Need.* C.D. Howe Institute Commentary 463.
January 2017	Guo, Huijie, and David R. Johnson. "Unfair Advantage? School Fundraising Capabilities and Student Results." C.D. Howe Institute E-Brief.
December 2016	Found, Adam, and Peter Tomlinson. "Business Tax Burdens in Canada's Major Cities: The 2016 Report Card." C.D. Howe Institute E-Brief.
December 2016	Cross, Philip. *What do the Different Measures of GDP Tell Us?* C.D. Howe Institute Working Paper.
December 2016	Dodge, David A. "The Role of Macro-Economic Policies in an Era of Global Economic Stagnation." C.D. Howe Institute Verbatim.
December 2016	Busby, Colin, and Ramya Muthukumaran. *Precarious Positions: Policy Options to Mitigate Risks in Non-standard Employment.* C.D. Howe Institute Commentary 462.
November 2016	Schwanen, Daniel, Jeremy Kronick, and Ramya Muthukumaran. *Playing from Strength: Canada's Trade Deal Priorities for Financial Services.* C.D. Howe Institute Commentary 461.
November 2016	Dachis, Benjamin, William B.P. Robson, and Jennifer Y. Tsao. *Two Sets of Books at City Hall? Grading the Financial Reports of Canada's Cities.* C.D. Howe Institute Commentary 460.
November 2016	Geraghty, Sharon C. "Takeover Rules: In Support of the Longer Minimum Bid Period." C.D. Howe Institute E-Brief.

Support the Institute

For more information on supporting the C.D. Howe Institute's vital policy work, through charitable giving or membership, please go to www.cdhowe.org or call 416-865-1904. Learn more about the Institute's activities and how to make a donation at the same time. You will receive a tax receipt for your gift.

A Reputation for Independent, Nonpartisan Research

The C.D. Howe Institute's reputation for independent, reasoned and relevant public policy research of the highest quality is its chief asset, and underpins the credibility and effectiveness of its work. Independence and nonpartisanship are core Institute values that inform its approach to research, guide the actions of its professional staff and limit the types of financial contributions that the Institute will accept.

For our full Independence and Nonpartisanship Policy go to www.cdhowe.org.

C.D. HOWE
INSTITUTE

67 Yonge Street, Suite 300,
Toronto, Ontario
M5E 1J8

Canadian Publication Mail Sales
Product Agreement #40008848