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Shaken by Tariffs, Still Weak from Within: Canada Needs a New Economic and Fiscal Model

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Introduction: Canada Faces Layers of Economic and Fiscal Challenges

There is keen awareness that Canada faces a serious economic challenge – if not a crisis – emanating from the US tariff threat. A desperate attempt is being made to lessen the dependence on the United States. But we must be mindful that Canada already faced major issues before the tariff threat, such as woeful productivity growth and high public debt with mounting future spending pressures. Weak productivity and a vulnerable fiscal position will make it difficult to make the Canadian economy more robust and resilient. The tariff threat makes it harder to tackle these problems. The pre-existing challenges and the tariff threat must be tackled together. The journey will not be easy.

The Economic Model Based on US Dependence Looks Shaky

The Canadian economic model has long been based upon a tight relationship with the United States. The US is the destination of 76 percent of Canada's merchandise exports. The US provides almost half of the direct foreign investment in Canada, and the US is the destination of almost half of Canada's global foreign investment. In addition, close to half of Canada's business investment in machinery and equipment is imported from the United States.

The tight relationship with the US economy is logical. The huge, high-income US economy provides an attractive market for Canadian exports, proximity keeps transportation costs low, and there are many common elements such as language and culture. Despite regular irritants, there was a belief that the tight relationship would continue as it was perceived to be mutually beneficial to the United States and Canada. That confidence has been shattered. President Donald Trump's administration does not see value in free trade. It does not accept the logic that a vibrant Canadian economy is also in US interests, as it would provide a strong market for American goods, services, and investments. Even if the tariff threat were to diminish or even cease, Canada would be wise to take the opportunity to diversify its economy beyond its historical reliance on the United States.

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Weak Productivity Will Impede Canada's Transition to a New Economic Model

To displace imports to the Canadian economy and export more around the world, Canadian goods and services must be competitive.[1] That, in turn, requires a high level of productivity. Canada has not delivered on that front in a long time.

The most obvious sign of this long-term deterioration in Canada's global economic standing is its decline in GDP per capita (measured at purchasing power parity). At the beginning of the 2000s, Canada had a roughly 10 percent edge over the average of Organisation for Economic Co-operation and Development (OECD) countries in GDP per capita – a lead it maintained into the early 2010s.

But from 2014 to 2022, Canada recorded the third-lowest growth in GDP per capita among 30 countries, wiping out the Canadian edge and bringing its level down to the OECD average. Looking ahead, the OECD has projected things to get worse: Canada is expected to post the lowest growth in GDP per capita in the OECD through 2060, leaving the level of real GDP per capita in Canada at least 10 percent below the OECD average (Guillemette and Turner 2021). And this already grim outlook existed before the US tariff threat.

The main culprit behind Canada's flagging performance in GDP per capita is lacklustre productivity growth. Labour productivity (output per hour worked) growth in Canada slowed from 1.74 percent annually in the 1973-2000 period to 0.87 percent per year for the past two decades (Haun 2023). Canada has not been alone in experiencing a productivity growth slowdown, but our standing among international peers has steadily deteriorated. Even during the stronger productivity growth era of 1973-2000, Canada's growth in output per hour worked ranked 31 out of 37 OECD countries, demonstrating Canada's slide in international ranking has been going on for many decades. From 2000 to 2022, Canada ranked 28th out of 38. In 1960, Canada had the third-highest level of productivity among the then 24 OECD member countries. Over the past 65 years, the OECD has expanded to include many lower-income members, yet in 2022, Canada ranked 18th out of 38 countries – slightly below the OECD average (Haun 2023).

Comparisons with the United States are particularly alarming. At the end of the 1940s, labour productivity in Canada's business sector was just above 70 percent of that in the United States, but it rose to above 90 percent from the mid-1970s to the mid-1980s. It has fallen dramatically since, reaching a new post-war low of 69 percent by 2021.

Multifactor productivity (MFP) stands out in the decomposition of labour productivity growth for its profound deterioration from 1961 to 1981 and its negative contribution since 2000. Statistically, MFP is the residual in labour productivity growth after removing the influence of capital and labour inputs. Conceptually, MFP captures the overall efficiency with which capital and labour inputs are used together in the production process. MFP is often considered to be driven by technological advancements, but the OECD lists a host of factors, including "changes in management practices, brand names, organizational change, general knowledge, network effects, spillovers from production factors, adjustment costs, economies of scale, the effects of imperfect competition and measurement errors" (Guillemette and Turner 2021).

Canada's research and development (R&D) effort is particularly weak. In 2022, R&D amounted to just 1.81 percent of GDP, well below the G7 average of 2.61 and about half the US level of 3.59 percent. Innovation is held back by a funding

1 A weaker Canadian dollar could boost exports and curtail imports but raise Canadian costs and process and reduce incomes.

gap at the seed stage and by the limited scale of venture capital initiatives under $5 million. High fixed costs relative to investment size, challenges in risk pooling, and limited participation by startup entrepreneurs – who are wary of potential losses – all compound the problem (Lester 2025).

The weakness in innovation flows through stages. There is a low propensity to patent the inventions flowing from the research that is done, little productivity boost occurs from patents, and innovative Canadian firms often sell their intellectual property to foreign firms rather than commercializing it themselves (Lester 2025).

Weak business investment has been another source of productivity weakness in Canada. The contribution of capital intensity to labour productivity growth has dwindled substantially from 1961-1981 to 1981-2000 and post-2000. Information and communication technology (ICT) capital intensity has made only a minor contribution to labour productivity growth, and that fell dramatically after the 1981-2000 era. The contribution from non-ICT capital declined tremendously after 1961-1981 and has only recovered during the past few years. Naturally, recommendations to bolster labour productivity growth place emphasis on expanding capital.

There is much evidence of the weakness in investment in Canada, particularly in machinery and equipment (M&E). By 2008, Canadian M&E investment per worker was already down to only 60 percent of that in the United States, but things got worse, with the ratio just 41 percent by 2023 (Bafale and Robson 2024; Lester 2025). Intellectual property (IP) investment fares even worse, with investment per worker falling from half the US level to just 30 percent.

Labour quality has played a lesser role in Canada's deteriorating productivity performance, but has contributed negatively, nonetheless. Labour quality drives productivity, as a higher-quality workforce features workers better equipped to use resources effectively in production. The contribution of labour quality to labour productivity growth dwindled steadily from 1961-1981 to 1981-2000 and again from 2000-2019, before showing a brief recovery in 2019-2021. To improve labour quality – and in turn productivity – reforms are often recommended to improve education, training, skills development, and work experience.

Canada's Fiscal Position and Tax Structure Will Impede Transitioning to a New Economic Model

Canada's fiscal position and tax structure are also obstacles to transforming the Canadian economy. The federal government is running a net debt-to-GDP ratio of over 40 percent, and that is expected to remain the case for many years (Robson, Drummond and Laurin 2025a). Provinces are likewise heavily indebted. Weak productivity growth will restrain revenue, and spending will be under pressure from the ageing population and a massive increase in defence spending. The debt burden will constrain the federal government's efforts to drive growth through increased spending or tax cuts. It will force a major reduction in current spending that is not aligned with growth.

The structure of Canadian taxation is also unfriendly to growth. Corporate and personal income taxes are more harmful to growth than broad-based consumption taxes, yet Canada relies heavily on the former and comparatively little on the latter (Dahlby and Ferede 2011).

OECD comparisons suggest there is considerable scope for a shift in the Canadian tax mix. Goods and services taxes account for 21.7 percent of Canada's taxes compared to an OECD average of 31.5 percent. By contrast, taxes on personal and business income represent 51.6 percent of Canada's revenue, compared to an average of 36.5 percent in the OECD. Corporate income taxes alone account for 13.9 percent of Canadian taxes compared to an OECD average of 12.0 percent (OECD 2024).

Canada Is Not Well-Positioned for the Economic Transformation Described by the Prime Minister's Office

In announcing support for the tariff-struck steel industry, Prime Minister Mark Carney's Office described its industrial strategy as:

- investing in domestic production;
- developing Canadian expertise;
- supporting companies to retool and reinvest; and,
- helping industries pivot to a growing Canadian market and those of new, reliable trading partners around the world.[2]

I now consider how well Canada is poised to execute these strands of an economic transformation.

1. Investing in Domestic Production

Canada needs to be globally competitive to increase domestic production, whether the increased domestic production is for Canadian (expanding the domestic market or displacing imports) or foreign consumption, unless there are large government subsidies, which would ultimately choke economic growth through even higher debt. Canada is not competitive and has not been for many years. It may seem that the lack of competitiveness could be masked through protectionist policies or depreciation of the Canadian dollar. But both would raise costs for Canadian businesses and consumers and lower real incomes.

Further complexities are apparent in particular industries. Canadian steel production, for example, is shaped to fit into the US supply chain rather than meet Canadian needs. Structural beams, for example, are not produced in Canada but rather imported. Major investments and operational changes would need to take place. The same holds for the large Canadian automotive industry. In theory, it could replace lost exports by selling more to the domestic market. But of the hundreds of car and truck models Canadians buy, only 10-12 have been fully produced in Canada in recent years.

Fragmentation of the Canadian economic union is another barrier to expanding the domestic market. The federal and provincial governments have expressed interest in removing interprovincial barriers, and some progress has been made, but much more remains to be done. For example, serious barriers remain in place through restrictions to labour mobility, professional credential recognition, trucking, and differing regulations (Schwanen 2025).

2. Developing Canadian Expertise

Much of the expertise Canada will need to succeed in the global economy must come from Canada's post-secondary education sector. But this sector is under severe financial stress. As with the broader economy – where attention has focused on the recent tariff threat rather than long-standing challenges – concerns in post-secondary education concentrate on the recent slashing of foreign student intake and the large associated revenue flow. However, even before that decline, from 2018 to 2024 university costs rose about 7 percent per annum in real terms, while revenues grew only

2 Prime Minister of Canada. 2025. "Prime Minister Carney Announces New Measures to Protect and Strengthen Canada's Steel Industry." July 16. https://www.pm.gc.ca/en/news/news-releases/2025/07/16/prime-minister-carney-announces-new-measures-protect-and-strength.

3.7 percent.[3] Layer onto this trend a 40 percent drop in foreign students, and universities could collectively be in deficit of around $20 billion in a few years.[4] While such an outcome is unlikely, the real question is whether financial sustainability will be achieved through cost – and likely quality and quantity – cutbacks, or a different financial model that takes on the challenge of developing Canadian expertise.

We also must be mindful that the Canadian post-secondary education sector accounts for double the portion of overall R&D than in the overall OECD. That speaks to the historical strength of university-based research in Canada. But it also captures the weakness of private business research efforts. It will be hard to rely even more on the post-secondary sector to continue to pull more than its weight in research when, in real terms, total federal research funding in 2024-25 was at its lowest level in 25 years.[5]

Canadian expertise can also be bolstered through immigration. Over the past few years, the selection processes have skewed toward short-term labour market needs, including low-paying occupations in transport, agriculture and agri-food. There has also been a surge in temporary residents who may not possess high skills (Mahboubi 2024). Under a revamped immigration system, the opportunity should be taken to target those with skills above the Canadian average (Worswick 2024).

3. Supporting Companies to Retool and Reinvest

What in the government's new industrial strategy is going to change the persistent weakness in Canadian business investment described above? Companies have long wished for faster depreciation write-offs. They have received more favourable treatment in some investment areas, but more classes could be swept in. A lower corporate income tax rate? More government subsidies? And, if so, how will they be financed, given Canada's high debt burden?

Just prior to appointment as Clerk of the Privy Council Office, Michael Sabia referred to Canada having an "ambition deficit." He placed a fair bit of the blame on excessive and inappropriate regulations. Perhaps these can be amended, and that will make a difference. But still, one must wonder what it will take for Canadian businesses to become more ambitious – to invest more, to research more, to export more and to more countries. In 2011, I noted that many of the growth-inhibiting public policies had been improved to a considerable extent, yet businesses were still not investing more (Drummond 2011). The questions posed 14 years ago are still in need of answers if this part of the government's industrial strategy is to work.

The answers may well lie in shifting the tax burden away from corporate and personal income taxes (especially the marginal personal income tax rates exceeding 50 percent, which dull the incentives to work, save, train, and invest) in favour of a higher GST rate.[6] It may be necessary to go further still and offer a broad-based investment tax credit (Robson, Drummond, and Laurin 2025b).

3 Usher, Alex. 2025. "Post-COVID University Surpluses (Deficits)." *Higher Education Strategy Associates Blog*. May 6. https://higheredstrategy.com/post-covid-university-surpluses-deficits/

4 Ibid.

5 Usher, Alex, and Janet Balfour. 2025. *The State of Postsecondary Education in Canada, 2024.* Toronto: Higher Education Strategy Associates. September 4. https://higheredstrategy.com/the-state-of-postsecondary-education-in-canada-2024/.

6 Lester (2025) provides a more comprehensive set of recommendations to bolster innovation and growth more generally in "An Economic Strategy for Canada's Next Government."

To address the ongoing weakness in the corporate sector and support the shift toward domestic activity, Jack Mintz and Munir Sheikh propose exempting small and large business profits from taxation if they are reinvested in Canada.[7]

To a considerable degree, the tax, subsidy, and regulation policies in Canada encourage entry of firms that wish to remain small and present barriers to growth for those wishing to expand. When they stay small, they get a lower (almost zero) corporate tax rate, larger credits for activities like research, and often lighter regulation. Such impediments to growth must be replaced by incentives to grow.

4. Helping Industries Pivot to a Growing Canadian Market and Those of New, Reliable Trading Partners Around the World

While diversifying Canadian trade is critical, we should not be under any illusions that it will be easy to pull off. First, we are handicapped by a weak competitiveness position, rooted in lacklustre productivity. Second, many of the obvious markets, due to their size, are not necessarily reliable due to their political climate. China and India, for example, have a history of actions unfavourable to Canadian economic and political interests. Finally, global trade is shifting from a basis in competitiveness in price and quality to jurisdictional protectionism. The United States is a prime example of the shift, but they are not alone. Defensive and proactive actions and bilateral and multilateral agreements will take time and energy, with likely constant attention to violations.

Despite the rhetoric of the day on diversifying beyond the US economy, it is too big, too wealthy, and too close to ignore. Comfort is being expressed by some that, despite the US tariffs on products such as steel, aluminum, and cars, about 91 percent of Canadian exports to the US continue to be tariff-free under the Canada-United States-Mexico Agreement (CUSMA). Yet that agreement comes up for review next year. Given all the US hostile trade talk and actions over the past six months, it would be naïve to assume there will be a smooth review process ending up in an agreement little changed from what we have now. A process is urgently needed to set out a framework for CUSMA renewal (C.D. Howe Institute Trade Crisis Working Group 2025).

And Let Us Not Forget Environmental Challenges

There is something of a movement globally to downplay actions addressed at the environment, in particular, to slow climate change. Perversely, the movement is gaining ground precisely as the evidence of the costs of climate change becomes more tangible, with rising temperatures, wild storms, and wildfires. The movement is strong in the United States. Canada seems to have landed in an uncertain position vis-à-vis the environment. The Canadian Climate Institute estimated Canada would be at least 10 percent short of its emissions reduction target by 2030 when the consumer carbon tax was in place and scheduled for steady rate increases (Beugin et al. 2024). That tax, now scrapped, was to contribute 8-9 percent to the target. With no replacement announced, Canada is presumably now headed toward emissions in 2030 around one-fifth above the target.

The emissions miss may be larger still. Much of the rhetoric around a new Canadian economic model revolves around greater exploitation of natural resources. The Prime Minister's expression "Build Baby Build" captures a heightened interest and urgency in infrastructure. Much less, if

7 Schotter, Andreas, Adam Waterous, Jack Mintz, Munir Sheikh, Ian Robertson, and Tom MacDonald. 2025. "How to Win a Trade War." *The Globe and Mail*. May 30. https://www.theglobeandmail.com/business/commentary/article-how-to-win-a-trade-war-canada-trump-tariffs-experts-united-states/.

anything, is said about how the expansion of natural resources and infrastructure can be done in an environmentally supportive manner.

Will the federal government introduce new actions to get on track for the 2030 emissions target, or will it admit that it is not attainable? And if so, what then is the likely course of emissions?

Little is also said about the opportunity for Canada in "clean growth." The United States, which was becoming a formidable global leader, is moving away from the field. Canada should seize the moment to take a leading position for itself.

Process Matters

The new economic and fiscal models Canada needs are among the most difficult challenges the country has ever faced. Success will require great and creative thought. It will also require buy-in from Canadians. And that will not happen if Canadians are not brought into the discussion. The new Liberal government under Mr. Carney repeats the mantra that there will be a budget in the fall of 2025. It is widely expected in October. A fiscal accounting is absolutely in order and should have been delivered before now. But it would be a mistake to pull new economic and fiscal models out of a hat and deliver them by decree to Canadians.

A better path would be an early economic and fiscal statement which reveals the economic and fiscal positions of Canada, sets out the challenges ahead, and provides ideas for a consultation period with Canadians. Even this might come across as a rush.

The Free Trade Agreement of 1989 and the North American Free Trade Agreement (NAFTA) of 1994, which heavily shaped the economic model that has guided Canada for the last three decades, came from advice from the Royal Commission on the Economic Union and Development Prospects for Canada (also known as the Macdonald Commission) from November 1982 to August 1985. Those trade agreements and Canadian attitudes were also influenced by a Finance Canada discussion paper (An Agenda for Economic Renewal, November 8, 1984), a lively and divisive public debate and a federal election considered to be largely over trade policy (November 21, 1988).

The US tariff threat alone does not allow the luxury of anything like the timeline followed in the 1980s. The processes of tapping into ideas and engaging the public would need to be greatly accelerated.

Boldness in action is needed in the circumstances, but failures in process can impede success. The Justin Trudeau Liberal government promised a productivity commission and then never mentioned it again. The Liberal election platform, under Mark Carney, promised a review of corporate taxation with external expertise. Nothing has been heard since.

The government does not have all the answers. And even if it did, it would be unwise to dump them upon unsuspecting Canadians. Catch-up must be played to set out the challenges for Canadians, listen to ideas, and consult across the land. Rather quickly, mind you.

Conclusion

The US tariff threat is a wake-up call for Canada. We must diversify and build greater economic resilience to reduce our dependence on an increasingly unreliable partner, while also addressing the baggage we have carried for a long time, including weak competitiveness and productivity, as well as fiscal policy that is anti-growth. The new government must not just deal with the crise-du-jour; it must also fix many wrongs of history.

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