Corporate slackers, let's roll

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Canadian firms are caught in a vicious circle of underinvesting. Productivity gurus ROGER MARTIN and JAMES MILWAY want to turn things around

Recently economist and Globe and Mail columnist Jim Stanford observed that, despite recent reductions in corporate tax rates and an upturn in profits, Canadian businesses had failed to invest in machinery and equipment. He likened these corporations to welfare cases, and argued that "it's time to cut them off, until they start doing their job."

That Canadian businesses are underinvesting in machinery, equipment and software is neither new nor surprising. We've been underinvesting relative to the United States for most of the past 20 years. As economists would say, we're in equilibrium — an equilibrium of low expectations.

Taxation is still a disadvantage: While Canada has reduced corporate rates, U.S. rates have come down faster, widening the gap in effective tax burdens. Many academic studies have shown that Canada's relatively high tax burden on capital results in lower investment in machinery and equipment — which has the knock-on effect of lowering labour productivity, reducing potential wealth-creation for workers and investors.

But business underinvestment is part of a larger story. World Economic Forum studies indicate that our businesses don't compete through innovation and value-added strategies, instead relying too often on old or imported technology in our production processes rather than developing our own. Our businesses lean on low labour costs or Canada's natural resources rather than unique products and processes.

At the Institute for Competitiveness and Prosperity, we've studied the problem and are hard-pressed to find factors in this country's business environment that hone skills for international success. We see few examples of specialized support or intense local pressure that encourage Canadian companies to develop effective global strategies. Indeed, it appears that where public policy aims to help businesses (e.g. in banking, transportation, communications, and cultural industries), we fail to produce global leaders. Why?

While Canada generates a base level of general infrastructure — roads, administrative and legal structures, general education — we don't generate the focused, specialized support that comes from human resources and infrastructure, such as local availability of specialized research and training, highly capable suppliers, and scientific institutions. To foster globally-competitive companies, we must create a virtuous circle.

The presence of powerful, specialized support tends to attract many competitors. This builds creative pressure: the rivalry of co-located firms. Rivalry among alternative firms makes customers more demanding and sophisticated, which in turn helps drive firms toward innovation.

The presence of investing and innovating rivals produces a benefit that loops back into better support. Social networks get created across the competing firms, their customers and suppliers — all creating a rich environment of knowledge spillovers. This, in turn, attracts more firms, building more pressure and more knowledge spillovers.

Overall, the research strongly indicates that specialized support and intense competitive pressure, and their interaction, help drive competitive performance.

Sad to say, these are weaknesses for Canada. In an environment lacking competitive pressure and specialized support, companies will have uninspired strategies and mediocre operations.

Canada has yet to get the virtuous circle working at full capacity. We don't yet benefit from pressure and support, and our underinvestment in machinery and equipment is just one result. Businesses aren't required to invest, nor do they have the opportunities for investments that will strengthen specialized capabilities.

Call it an equilibrium of low expectations. On the pressure side, it starts with investors, who don't push Canadian firms to produce better results. It's hard to blame them for not pressing Canadian firms to invest more when the returns to shareholders in Canada have traditionally been lower than in the United States.

Sophisticated, demanding investors would move their money to more promising markets, exerting greater pressure on firms to build innovative capability and invest in productivity. But our investors (big pension funds, and individual RRSP investors) are constrained in moving their investments abroad — because Canada mistakenly assumes that it ought to "help" Canadian firms gain access to investment funds.

We think that's wrong: If investors weren't trapped in Canada and had more options, Canadian managers would feel pressure to strengthen their business performance. Nor are our businesses being challenged by sophisticated, demanding customers and fierce competitors, as in the United States.

On the support side, Canadian managers tend to be less well educated than their U.S. counterparts; fewer managers and leaders here have formal business education. Most serious observers of a country's competitiveness agree that the knowledge and skills base of our workers is critical to success. Deficiencies in management skills are equally important to businesses' operations and strategies.

If we want to raise the bar on expectations, we must work on both pressure and support.

On the pressure side, we can all become more sophisticated customers. Business customers should demand more from their suppliers and look for ways to collaborate for innovation. At the other end of the value chain, every industry has a small group of customers whose tastes and requirements are at the vanguard of demand, and our businesses need to find them, here in Canada or around the world, in order to challenge themselves to meet their needs. Meanwhile, governments should pursue deregulation and strengthen competition in key industries, and consider relaxing the foreign-content allowances for investment funds.

On the support side, schools and governments need to make available more spaces to students who want to enroll in business programs. Canada trails the U.S. overall in our educational attainment, particularly at the postgraduate level where specialized skills are developed.

Underinvestment by our businesses is a recurring challenge for Canada's economic performance — but it's logical, given the environment we all work in. We're stalled in equilibrium. If we want to strengthen businesses' capacity for innovation and upgrading, let's increase pressure and support. Let's not "cut them off"; let's raise the bar of expectations.

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