Partnering *for* Investment in Canada's Prosperity


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Canada's relatively good economic performance and its stellar record on the trade front in the second half of the 1990s seriously mask its underlying competitiveness problem, say Dean **Roger Martin**, chairman, and **James Milway**, executive director of the Institute for Competitiveness and Prosperity. They argue here that Canadians must invest more than ever before to increase our competitiveness in the global arena.

Illustration: Oleg Koulikov

The news is largely good for Canada these days. Our economy is strong, and we enjoy a stable and secure environment, with a society that is diverse but socially cohesive, sharing fundamental values from coast to coast. But none of this ensures our future prosperity.

Over the past two decades, our standard of living has failed to keep pace with the U.S. – indeed, it has deteriorated significantly. And our performance with respect to innovation, productivity and regulatory efficiency – all key indicators of competitive ranking – has been disappointing, to say the least.

For Canada's standard of living to rise, our economy must grow – and for that to happen, we must be competitive with other jurisdictions, particularly our most significant trading partner, the United States. Currently, this is not the case. We at the Institute have identified a worrisome 15 per cent prosperity gap between the U.S. and Canada – a difference in GDP per capita of $6,800 that translates into a yearly difference in after-tax disposable income of just over *$10,000 per Canadian family.*

Eliminating this gap – which has steadily widened over the past two decades – would allow Canadian families to enjoy significant additional income in countless ways: mortgage holders could cover the average annual mortgage payment ($9,651) entirely; purchasing a car (average cost: $12,163) would be decidedly easier, and people could significantly increase their RRSP contributions. Provincial and federal governments would also benefit, collecting approximately $75 billion annually from Canadian taxpayers without increasing rates – additional revenue that would enable the government to address funding issues in health care, education, and social services.

The prosperity gap is not the result of some mysterious, fundamental weakness in Canada's economy. Our research indicates that it is the result of Canadians' failure to derive as much strength from our available human, physical, and natural resources as we could. And, without targeted action, we will witness ever-growing disparities in our economic well-being with our neighbours to the south.

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Driving GDP per capita

Research shows that four key elements drive GDP per capita: demographic profile, labour force utilization, work intensity, and productivity.

Canada's economy is strengthened relative to that of the U.S. by a slightly higher proportion of our population who are of working age (67.4 per cent of our population is between ages 16 and 64, compared to 65.2 per cent in the U.S.), and hence a better demographic **profile**. If demographic profile were the only factor in economic performance, Canada's GDP per capita would be about $1,200 higher than that in the U.S.

Utilization of the working age population leads to a slight disadvantage for Canada, which has nearly the same percentage of its working-aged population seeking work (67.1 per cent) as the U.S. (66.6 per cent), equating to a $300 per capita advantage for Canada. However, Canada's economy continues to be slightly less capable of creating jobs for people seeking work (a 92.3 per cent employment rate versus 94.2 per cent in the U.S. in 2002), which accounts for $800 of the prosperity gap. The net effect of these two results is under performance of about $500 in GDP per capita.

For most of the last 20 years, official statistics report that Canadians have worked fewer hours than Americans. Based on 2002 results of Canada-U.S. **intensity** difference (34.1 hours worked per week in Canada versus 34.2 hours in the U.S.), we can attribute $100 per capita of the prosperity gap to this factor.

Taken together, profile, utilization, and intensity actually enhance our GDP per capita comparison with the U.S. – and hence provide limited potential for closing the gap. Our research shows that the prosperity gap's key driver is the fourth element: **productivity**.

Deconstructing the productivity gap

In our work at the Institute, we have assessed five sub-elements of Canada's productivity: cluster mix, urbanization, educational achievement, capital investment and overall effectiveness. Following is Canada's report card on each, vis a vis the U.S.

1. Cluster mix and cluster content

Canada's strength in business services, financial services, education and knowledge creation, and transportation and logistics has created an attractive mix of clusters of traded industries. We have determined that fully 37.6 per cent of employment in Canada is in clusters of traded industries, versus 31.6 per cent in the U.S. – giving Canada a $1,200 per capita *advantage* over the U.S. Sub-clusters make up each cluster of traded industries, and as with clusters, there are wage and productivity differences across sub-clusters. One of the issues being discussed by business analysts is 'hollowing out': some observers believe that Canada is losing the high value-added component of its industries, as head offices and decision-makers relocate outside the country. Despite this, our analysis of the sub-clusters that make up our clusters of traded industries indicates that the impact of cluster content on GDP per capita is essentially the same in the U.S. and Canada.

2. Relatively low urbanization

Increased social and economic interaction, cost advantages of larger-scale markets, and a diversified pool of skilled labour all improve productivity and promote innovation and economic growth in urban areas – and therefore, Canada's lower degree of urbanization hurts our productivity compared to the U.S. Urbanization is defined as the percentage of the population living in city areas of greater than 50,000 people. For Canada, this includes our 43 largest cities, from Toronto to Lethbridge. Our analysis indicates a $3,200 per capita disadvantage against the U.S. – making low urbanization the largest negative contributor to Canada's productivity gap.

3. Lower educational achievement

Most economists agree that the level of education attained across the workforce is an important determinant of the quality of an economy's human capital – and our analyses reinforce the positive correlation between productivity and wages. Economic studies prove that the best single predictor of personal income is level of educational attainment. Canada's underperformance in educational attainment, mainly at post-secondary levels, translates into a negative impact on GDP per capita of $1,100 per capita.

4. Capital under-investment

Canadian firms under-invest in machinery and equipment compared to their U.S. peers, slowly eroding the relative strength of our capital stock and reducing the productivity of our labour and hence our prosperity. We estimate this under-investment to be worth about $1,000 per capita in lost productivity.

5. Lower effectiveness

The gap that remains ($3,300) is related to productivity on the basis of like-to-like cluster mix, urbanization, education, and capital intensity – reflecting the fact that Canada is less effective overall than the U.S. at converting our natural, physical and human resources into goods and services.

Productivity is the only element of GDP per capita that can improve in the short-run and grow indefinitely, and the first step in tackling it is to address Canada's under-investment problem.

The perils of under-investment

Individual Canadians invest in much the same way as Americans do – initially. We do all the basics, and we do them well. But, as investment requirements become more demanding, we tend to shy away. We stop investing for the long term and instead, increase our current consumption, while American individuals, firms, and governments keep right on investing. The net result is that, in the balance between investment and consumption, Canadian spending is weighted more toward consumption than in the U.S., where a higher percentage of total spending is invested. Relative to our American counterparts, we under-invest in five important areas, and if we fail to address them, it is unlikely that Canada will be able to make substantial progress in raising its productivity.

> Productivity is a driver of prosperity that is earned rather than inherited, and this distinction is particularly important for a natural resource-rich economy such as Canada's.

1. Education

Canada's under-investment in education is more pronounced as we move through the educational system. On a per capita basis, Canadians invest competitively in public primary and secondary schools (85 per cent of U.S. rates) and in colleges (90 per cent). But university spending is at a much lower rate – 50 per cent of U.S. spending per capita. On a per student basis, the spending disparities widen in public primary and secondary schools (81 per cent of U.S. rates) and colleges (86 per cent), since Canada has proportionately more of its population enrolled at these levels. At the university level, because of our lower participation rate, the spending gap narrows on a per student basis, but is still only 63 per cent of the U.S. rate.

While the results achieved by students in Canada's primary and secondary school systems exceed those of their U.S. counterparts, we are concerned about whether post-secondary students' aspirations are competitive with those in the U.S. Our concern is highlighted in findings from a recent study by the **Canada Millennium Scholarship Foundation** reporting that 50 per cent of Canadian students who score in the top 40 per cent on standard achievement tests do not attend post-secondary programs. This reinforces our belief that

Canadians need to do more to encourage high school graduates to pursue post-secondary degrees – especially since the study revealed that it was students' attitudes, and not financial barriers, that dissuaded them from attaining higher education.

The fact is, tuition fees are not a major deterrent for students considering post-secondary education. A recent **Statistics Canada** study shows that over the past decade, the post-secondary participation-rate gap between students from low- and high-income families has actually narrowed, and when high school graduates were asked the main reason for their decision not to go to college or university, 77 per cent listed a non-financial reason.

A major difference in the educational strategy of Canada and the U.S. is the diversity of public and private universities and colleges there, which creates the opportunity for higher levels of private funding and has led to substantially-higher levels of investment on a per student basis, as well as a proportion of GDP. While Canada may be investing at close to competitive levels when only public institutions are considered, our lack of private universities has constrained investment in this critical prosperity driver.

All told, a smaller percentage of Canadians have university degrees than Americans, and the most recent data for the latter half of the 1990s indicates that we are not closing this gap. In 'degrees conferred per 1,000 population', Canada trailed the U.S. – 5.02 versus 6.20 in the 1997-98 academic year. The gap is most prominent at the master's degree level: in Canada, 0.73 master's degrees were granted per 1,000 population, less than half the 1.61 rate achieved in the U.S.

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2. Capital investments

Another critical area of investment is the acquisition by Canadian firms of new physical assets and the refurbishment of existing ones. This investment – in machinery, equipment and structures – enables workers to be more productive, giving them better tools to do their work. Included in this category are new technology and software – key drivers of productivity growth.

Since 1981, Canada's private sector has trailed the U.S. in machinery and equipment investment by an average of 12 per cent in dollars per GDP. If just the past decade is examined, the gap is even larger – an average of 16.1 per cent. This investment gap has a strong cumulative effect. Over the 20-year period, if the U.S. private sector machinery and equipment rate were matched, Canada's capital stock would have been almost $75 billion higher.

If Canada's private sector had kept pace with the U.S. machinery and equipment investment since 1981, our total investment would now be 4.3 per cent higher, and we estimate that this would have raised productivity and prosperity by just under $1,000 per capita.

3. Spending by governments

Governments must achieve an appropriate balance between consuming current prosperity and investing for future prosperity. In Canada and the U.S., governments direct approximately 30 per cent of their total spending to a combination of debt service, basic administration, environment, and protection. In allocating the remaining 70 per cent, a tradeoff between consumption and investment occurs.

While we are not prescribing an exact balance between the two, relative to the U.S., governments in Canada have shifted away from investment expenditures towards consumption. In 1992, our governments spent 55 cents on investment for every dollar of consumption spending, similar to the U.S. at 52 cents. By 2000, this ratio had dropped to 50 cents in Canada, while it rose to 54 cents in the U.S. On a per capita basis, since 1992, governments in both Canada and the U.S. have sustained relatively the same level of consumption expenditure. However, governments in Canada reduced public investment expenditure, while in the U.S. governments chose to increase per capita investment spending. Through the 1990s, government spending as a percentage of GDP declined in Canada and the U.S. In Canada, government spending fell from 55.9 per cent of GDP to 40.1 per cent in 2000, while in the U.S. the decline was from 37.9 per cent to 33.8 per cent.

4. Economic integration of immigrants

Canada has an important competitive advantage over the U.S. – a greater influx of highly-skilled immigrants. Overall, 18.4 per cent of Canada's residents were born outside of Canada, and a third of residents within metro areas are immigrants (in the Toronto Census Metropolitan Area, it's 43.4 per cent.) According to **Human Resources Development Canada**, between 1991 and 1996, fully 71 per cent of labour force growth in Canada was from immigration, with immigrants expected to contribute 100 per cent of labour force growth by 2011.

We are not capitalizing on our strength in immigration to overcome our talent deficit. Statistics Canada data reveals that in 2000, 44 per cent of recent immigrants in the workforce held a university degree, compared to only 19 per cent of native-born Canadians. In contrast, immigration to the U.S. brings down their educational achievement average.

According to data from **Status of Women Canada**, just over half of foreign-trained professionals are working in professions or trades three years after immigrating. In 2000, the ratio of employment earnings of immigrants one year after landing and Canadian born workers stood at 61.8 per cent. For immigrants who had been here ten years the ratio was 83.5 percent. These results indicate that immigrants are taking longer to integrate into the Canadian economy. The **Conference Board of Canada** has estimated that, if this problem were eliminated, overall

Canadian income would be between $4.1 and $5.9 billion higher – the result of lowering unemployment and underemployment as we add between 33,000 and 83,000 post-secondary credential holders to the ranks of Canada's skilled workers.

5. City regions

One of our most surprising findings is that in Ontario, the prosperity gap versus its peer jurisdictions is in the city regions, not the rural areas. GDP per capita in Ontario's metro areas in 2000 was 12.8 per cent lower than metro areas in a peer group of 14 U.S. states. Outside of metro areas, Ontario's GDP per capita was actually three per cent higher than the non-metro areas in peer states – which is likely consistent with results for Canada versus the U.S.

Government's role

Government investment in areas such as infrastructure and education can help establish the foundation for individuals and businesses to increase productivity. In addition, the appropriate level of consumption expenditures is an important determinant of our quality of life. At the same time, taxes that are necessary to fund these expenditures can act as de-motivators to work, investment, and entrepreneurship. Governments need to balance expenditures and taxes on an ongoing basis to ensure competitiveness, and that our citizens are receiving an adequate level of services. Given the 12 per cent shortfall in investment relative to our peers, the challenge is also to trade off spending on current consumption against long-term capital investment.

Urban prosperity is negatively affected by public structures in two ways. First, Canada's fiscal framework transfers resources from 'have-provinces' to other parts of the country at about double the rate experienced in the U.S. However, these transfers do not seem to be having a significant impact in reducing regional disparities in the Canadian federation. We should seek opportunities for innovation in Canada's fiscal framework that preserve the concept of sharing inside the federation and strengthen both national and regional prosperity.

Second, our political governance structures inadequately represent urban voters. If rural and urban voters had equal representation in the federal legislature, urban voters would have 16 more of the 301 seats in the House of Commons. By inadequately representing our urban areas – the main source of productivity – representation in our current political structure is not contributing as fully as possible to Canada's prosperity.

Partnering for investment

All stakeholders in Canada's economic future need to examine our strategies and actions to ensure that we are making appropriate investments for future prosperity. We recommend that individual Canadians raise their aspirations for personal upgrading of their skills and capabilities through increased formal education and life-long training. Canadian firms must raise their aspirations from competing locally, provincially, or nationally to competing globally against the best in the world. Governments at all levels must also raise their aspirations to achieve an invigorating environment that encourages citizens and firms to upgrade and innovate and that compares favourably with the environment in the U.S. We need to determine and reverse the negative impact of Canadian market structures on productivity and prosperity.

We recommend that a long-term strategy be developed to raise Canadian investment in post-secondary education, and we encourage provincial governments to recognize that, by historically maintaining a government monopoly on university education and strictly regulating most tuition levels, they have been primarily responsible for producing an investment level in higher education that is half that in the U.S. A long-term strategy for higher education should explore a sustainable approach to provincial funding, consider the role of tuition deregulation, and continue to foster the development of a diversity of post-secondary institutions.

We encourage individuals to continue supporting the not-for-profit sector in developing programs for settling recent arrivals into our communities. We encourage employers to continue exploring innovative approaches to reaching out to the talent inherent in our recent immigrants, and we encourage governments to continue their cooperation in developing settlement policies.

Canada must continue to reduce taxes, especially taxes on capital. In 2002, we identified the disadvantage in marginal effective tax burdens in Ontario versus a group of U.S. states and showed how this affected Ontarians' motivations to invest. Our latest research indicates that the disadvantage widened in 2003. The Institute urges our governments to recognize that taxes represent a disadvantage for Canada that can be overcome by developing innovative solutions in our tax regimes.

To continue to prosper, Canadians everywhere must participate in a partnership to invest more than ever before to raise our competitiveness in the global arena. This is the only way to close the prosperity gap and continue to enjoy the economic well being that comes from our place as one of the leading economies in the world. Our efforts today represent our investment for future generations.

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The Institute for Competitiveness and Prosperity is an independent organization funded by the Government of Ontario, whose mandate is to deepen public understanding of the macro and microeconomic factors behind Ontario's economic progress. The Institute is also the Canadian partner for the World Economic Forum's Global Competitiveness Program. For more information, visit www.competeprosper.ca.