

Agenda for Canada's prosperity

REPORT ON CANADA 2007



The Institute for Competitiveness & Prosperity is an independent not-for-profit organization established in 2001 to serve as the research arm of Ontario's Task Force on Competitiveness, Productivity, and Economic Progress. The mandate of the Task Force, announced in the April 2001 Speech from the Throne, is to measure and monitor Ontario's competitiveness, productivity, and economic progress compared to other provinces and US states and to report to the public on a regular basis. In the 2004 Budget, the Government asked the Task Force to incorporate innovation and commercialization issues in its mandate.

It is the aspiration of the Institute and the Task Force to have a significant influence in increasing Ontario's competitiveness, productivity, and capacity for innovation. We believe this will help ensure continued success in the creation of good jobs, increased prosperity, and a higher quality of life for all Ontarians and Canadians. We seek breakthrough findings from our research and propose significant innovations in public policy to stimulate businesses, governments, and educational institutions to take action.

We welcome your comments on this report. The Institute for Competitiveness & Prosperity is funded by the Government of Ontario through the Ministry of Economic, Development, and Trade.

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Foreword and acknowledgements



I AM PLEASED TO PRESENT our Report on Canada 2007, *Agenda for Canada's prosperity*. In it, we summarize the findings and implications of our research into Canada's competitiveness and set out an agenda for achieving higher prosperity in the country.

In this Report on Canada, we urge Canadians to take up the challenge of narrowing our prosperity gap with the world's most competitive and prosperous jurisdiction and our most important trading partner – the United States. But we recognize that to persuade Canadians on the merits of this agenda it is important that we build a consensus for the need for such an agenda in the first place. Canadians enjoy one of the most prosperous economies in the world. All around us are the signs of a vibrant successful economy. Unemployment is low, the Canadian dollar is strong, and our stock markets are healthy. Public interest in discussing competitiveness and prosperity is hard to detect if party platforms in recent elections across Canada are any guide.

In Gross Domestic Product, the measure of a country's competitiveness and prosperity, we trail the United States, by \$9,200 per capita. Canadians have all the requisites to improve our standing, and we should not be satisfied with anything less. We propose that we reduce the gap to \$3,300 for each Canadian by 2020 – a realistic goal.

So why does the Institute for Competitiveness & Prosperity think that the prosperity gap is important and that Canadians should care? For us, the answer is that the prosperity gap represents unmet potential in the economic well being of the average Canadian.

Realizing our prosperity potential would enable families more readily to afford important investments in housing, education, and retirement savings. It would make Canada an even better place for immigrants to realize their full potential. It would create more economic opportunities for the less well off. It would generate significant new revenues for federal and provincial governments to support social spending and investments for long-term prosperity. It would also result in our generation passing on a more prosperous economy to our children, as earlier generations did for us.

It is not simply unmet potential that matters. We are also concerned that the stealthily slow drift of under achievement could erode our economic strength, while most Canadians remain unaware of the problem. Doing nothing is not a worthy option.

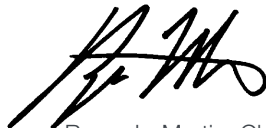
To invigorate the public debate on Canada's competitiveness and prosperity, we present our agenda for prosperity in this year's Report on Canada. We set out specific recommendations, based on our accumulated research to date. Our hope is that this agenda will animate discussions among stakeholders in Canada's prosperity, especially in upcoming federal and provincial elections. Elections are about more than prosperity – but our future prosperity ought to play some role in the development of party platforms and in the scrutiny of voters as they assess their options.

We call for a shifting of our overall attitude from collective complacency to a shared determination to close the gap. We make recommendations that shift Canada's emphasis from consuming today to investing for tomorrow's prosperity. We outline proposals that move us from an unwise taxation system to a smarter one. And we propose a strengthening of our market and governance structures to encourage creativity and growth instead of simply preserving the status quo.

We are concerned that the stealthily slow drift of under achievement could erode our economic strength, while most Canadians remain unaware of the problem. Doing nothing is not a worthy option

Parts of the agenda may not be immediately popular. Nor will the agenda close the prosperity gap soon. We have lagged the United States for more than two decades, and catching up will take time. But we are confident that, if Canadians are committed to pursuing competitiveness and prosperity over the long haul, we will achieve our full economic potential for our own and our children's benefit.

We gratefully acknowledge funding support from the Ontario Ministry of Economic Development and Trade. We look forward to sharing and discussing our work and our findings with all Canadians. We welcome your comments and suggestions.



Roger L. Martin, Chairman
Institute for Competitiveness & Prosperity



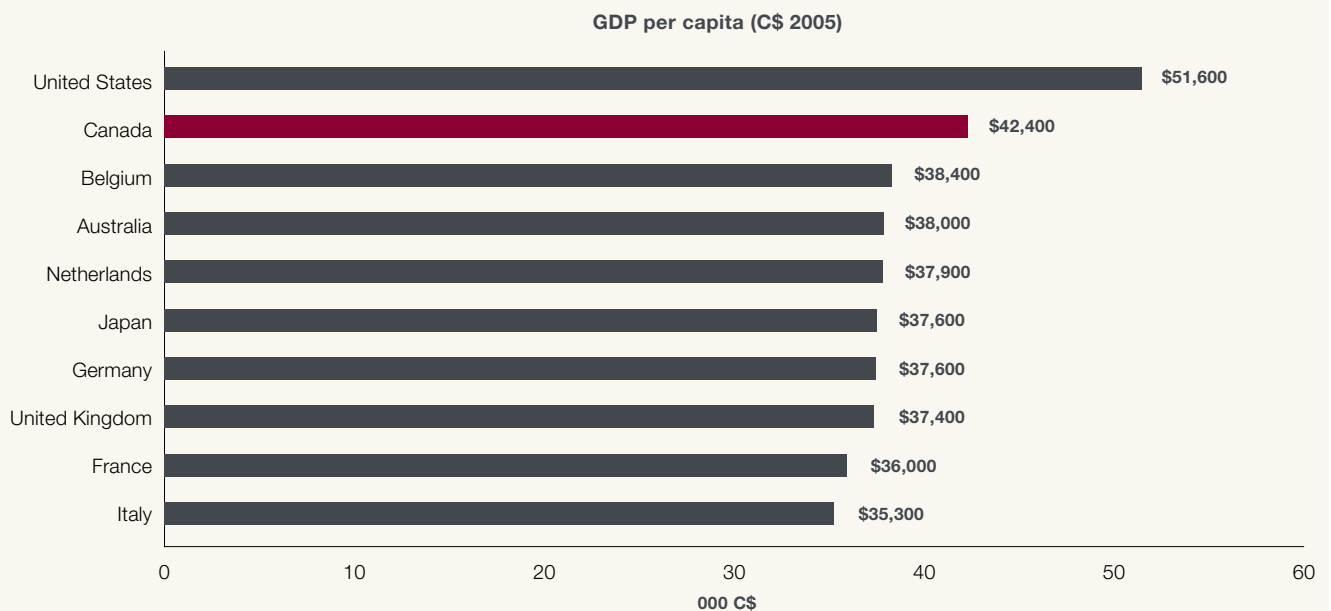
The 2020 prosperity challenge

The challenge for all Canadians is to cut our prosperity gap to \$3,300 per person by 2020

CANADIANS ENJOY ONE OF THE MOST prosperous economies on earth. Few comparable countries have an economy that is as competitive and prosperous as ours (*Exhibit 1*).

This success is built on many advantages. We have a population that is culturally diverse and well educated. Our businesses compete in a rich mix of industries with high potential for productivity and innovation. Our business leaders largely embrace innovation and international competition. We have a growing group of globally competitive firms. And our governments have established a strong fiscal base as

Exhibit 1 Canada's GDP per capita is among the world's highest



Note: Countries with population greater than 10 million.
 Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada; World Economic Forum.

a foundation for generating prosperity. We have an admirable post secondary education system in Canada that provides opportunities for our young and research and innovation support for our businesses. We have also sustained strong social safety nets for all Canadians. And our comparably high average incomes and equitable income distribution are enviable.

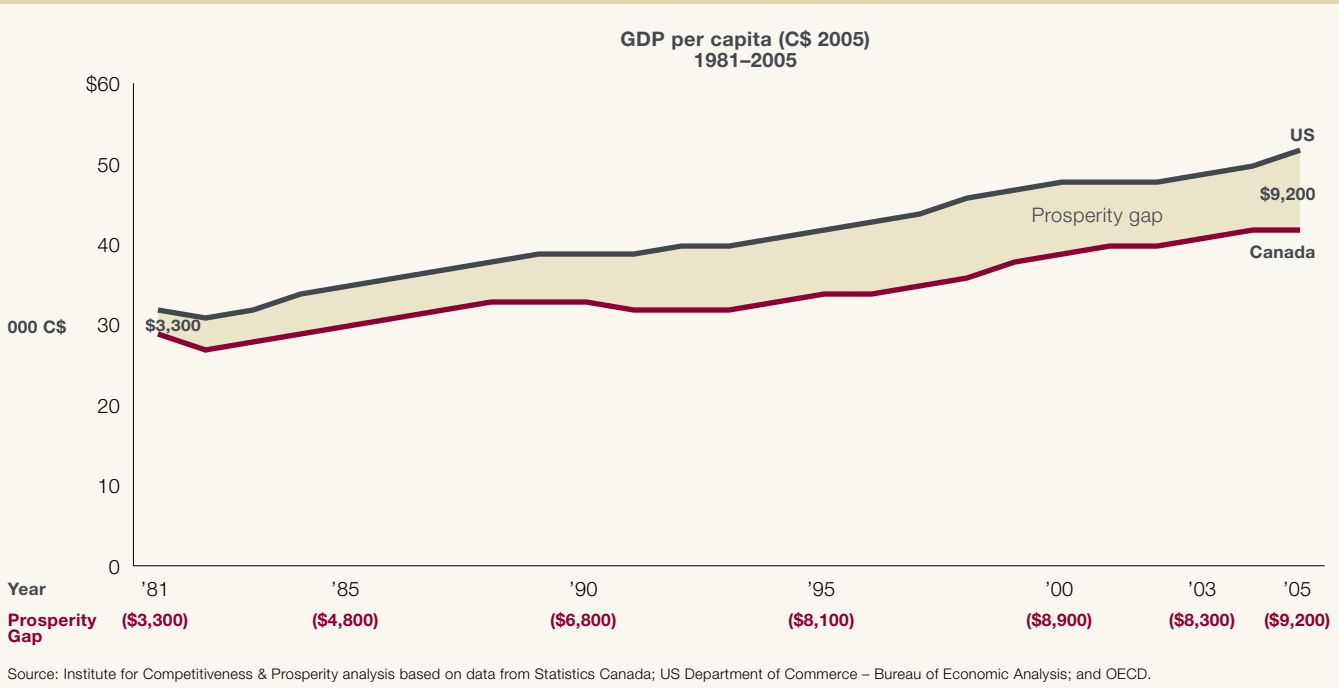
And yet we are not living up to our full economic potential in Canada. While our economic performance matches or surpasses that in leading economies around the world, closer to home we have an ongoing prosperity gap with the United States – our most significant trading partner and North American neighbour.

Compared to the United States, we are less successful in adding value to our human, physical, and natural resources. In 2005, the most recent year for which we have data, Canada’s Gross Domestic Product (GDP) was \$9,200 per capita behind GDP in the United States.

To make these comparisons, we convert all dollar figures into constant 2005 Canadian dollars at Purchasing Power Parity.¹ Unless stated otherwise, we use this approach throughout this report.

This standing ought not to be Canada’s destiny. In 1981, Canada’s prosperity gap with the United States was \$3,300, just over one-third of the current difference. But through the 1990s, we witnessed a decline in our relative prosperity, as the recession

Exhibit 2 Canada’s prosperity gap has widened



¹ We convert US dollars to Canadian dollars at the PPP rate of 1.23. See Task Force On Competitiveness, Productivity and Economic Progress, Fourth Annual Report, *Rebalancing priorities for prosperity*, November, 2005, p. 27 for an explanation of our methodology.

in the early part of the decade ravaged the country. In real terms, Canada's GDP per capita fell between 1989 and 1992. In 1993, that trend reversed, but we still have not closed the gap that opened up during the recession (*Exhibit 2*).

In one sense, Canada's economy has performed well since 1992, growing at a real per capita annual rate of 2.3 percent to 2005, compared to 2.0 percent for fifteen OECD countries over the 1992–2005 period.² In fact, this growth rate exceeds the US growth rate of 2.1 percent over the same period. And most of the day-to-day signals we see in our economy are positive. Unemployment in Canada is at a near record low; inflation has been tamed; government deficits are small or non-existent across Canada; we continue to lead most of the world in prosperity; Canadian stock markets are performing well; and the Canadian dollar has been strong.

As a proportion of the US GDP per capita, Canada's prosperity gap declined gradually from 20 percent in 1992–94 to 17 percent in 2003–05. But before the recession of the early 1990s, over the 1986–88 period, the prosperity gap represented 14 percent of the US GDP per capita. Thus we have ceded the ground lost in the recession of the early 1990s. Today's prosperity gap represents missed potential for stronger economic performance. While we are making slow progress in reducing the percentage gap, the gap in real dollars continues to widen, and it is this difference that matters to workers and families.³

Why does the prosperity gap matter? On a philosophical level, it matters because we are not living up to our full potential. We Canadians have been blessed with an abundance of high quality human, physical, and natural resources, and we are not using these to full advantage. There is no fundamental reason why we should accept a growing gap status against the most competitive economy in the world. Rather, we should strive to create a stronger economy than we have inherited from earlier generations.

On a practical level, not closing the prosperity gap means that we would have to accept a lower standard of living than we would enjoy if the gap were eliminated. Lower GDP per capita would translate into lower wages, fewer full-time quality jobs, and less government revenue to support social spending and prosperity investments.

More specifically, closing the prosperity gap – or increasing our GDP per capita by \$9,200 to match the United States level – would result in an increase of \$11,900 in personal disposable income for the average Canadian household. This additional income for Canadian households would readily pay for many important consumer spending items and investments in their future.

In addition, closing the prosperity gap would generate an additional \$108 billion per year in revenues for the federal, provincial, and local governments. This would provide choices for public policy – for example, increasing spending in high priority areas without raising tax rates, or lowering tax rates for Canadians.

² US Department of Labor, Bureau of Labor Statistics, Office of Productivity Analysis, "Comparative Real Gross Domestic Product per capita and per employed in fifteen countries, 1960-2005," June 2006. The 15 included are: Australia, Austria, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Korea, Netherlands, Norway, Sweden, United Kingdom, and United States.

³ While Canada's percentage growth in GDP per capita is currently exceeding that of the US, in dollar terms the gap is widening. With current momentum, the dollar gap will start to narrow – but by our estimates, this will not occur until 2039.

Our prosperity gap presents an interesting challenge for Canadians. In popular parlance, there is currently no burning platform that requires immediate and obvious attention. Public interest in the questions of competitiveness and prosperity is hard to detect, especially if one reviews the different party platforms in recent elections across Canada.

Yet the stealthily slow drift of under achievement could erode our economic strength before we know it. It is not unrealistic to project a huge prosperity gap of \$17,400 per capita, or almost double the current gap, if we do nothing.

In this year's Report on Canada, we continue to urge stakeholders in our prosperity to pursue an agenda that builds a stronger economy for our own and our children's sakes. This year, we reiterate our earlier themes and make specific recommendations that will contribute significantly to closing the prosperity gap. This is a particularly timely opportunity to set out an agenda for our prosperity, as Canadian voters may face a federal election, and many will participate in choosing new provincial governments through 2007 and 2008.

Canadians need to commit to an ambitious prosperity agenda to build a strong economy for us and our children

Assuming the United States continues its current growth rate of 2.1 percent, Canada's GDP per capita growth rate would need to increase from its current growth rate of 2.3 percent to 3.4 percent to close the dollar gap by 2020. We will recognize that it will not be feasible for Canada to sustain that growth rate and close our prosperity gap between now and 2020.⁴ Nevertheless, we think it remains imperative to pursue an overarching prosperity goal and to set out the solid policies and decisions that will put us on a determined path to narrow the gap.

We propose that Canada embark on a realistic fifteen-year plan to cut the prosperity gap to the 1981 level – or \$3,300 – and develop momentum to do even more. Decision makers will constantly need to evaluate initiatives not only for today's results but also for tomorrow's prosperity with this goal in mind. Canada's prosperity gap with the United States has been widening for two decades; catching up will not happen soon, but that must be the ultimate aim of our prosperity agenda for the next decade. The challenge is for Canadians to be committed for the long haul.

⁴ The highest annual growth rate achieved in Canada's per capita GDP in a fifteen-year period since 1960 was 3.4 percent between 1961 and 1976. Since 1970, Canada's best fifteen-year performance has been 2.4 percent annually (1970–85). Since 1970, no large OECD economy, other than Japan and South Korea, has experienced average annual growth of more than 3 percent over a fifteen-year period.

Our agenda covers the four factors in AIMS, the framework that we have used to inform our past work: attitudes, investments, motivations, and structures.

The 2020 challenge: Agenda for Canada's prosperity		
THE GOAL	Current	Target 2020
Close the prosperity gap	\$9,200 behind the United States in GDP per capita	Cut the prosperity gap to \$3,300
Attitudes	Collective complacency	Shared determination to close the gap
Investment	Consume today	Invest for tomorrow's prosperity
Motivations	Unwise taxation	Smart taxation
Structures	Preserve status quo	Encourage creativity and growth

Attitudes: from collective complacency to a shared determination to close the gap

Today in Canada, we cover most of the basics of our economy well, with sound attitudes toward developing high performing infrastructure, education, and business investment. But, as the United States continues to invest more in post secondary education, productivity enhancing machinery and equipment, and specialized improvements, we stop short. We often fail to pursue the additional initiative – to go the extra mile to match or outdo their performance. We tend to be complacent, lacking the shared determination to be the very best we can be to propel us to higher results.

As a first step in our agenda for Canada's prosperity, we urge opinion leaders to raise the volume on the importance of the prosperity gap to all Canadians. Politicians, business leaders, educators, and individuals need to embrace the importance of prosperity and the need for a highly competitive economy. We need to heighten our level of understanding of concepts like productivity. And the average working person should see that higher productivity means more jobs, better jobs, and higher wages. For all Canadians, this means continuously pursuing opportunities to strengthen their skills and invest in their own and their children's prosperity. We need a strongly shared determination to make our goal a reality.

Investment: from consume today to invest for tomorrow's prosperity

Our agenda places great emphasis on the need for investment in our future prosperity. In the past, we have urged Canadians to shift from the path that consumes today's prosperity to one that values investing more of our current prosperity for future prosperity. The tradeoff between consuming for today versus investing for tomorrow is a delicate balancing act for individuals, families, businesses, and governments. Our concern is that we have been on a "consume today" path that is limiting our opportunities for future consumption and future prosperity.

Our agenda puts investment in human and physical capital at the forefront. We need a dramatic increase in our expenditure in post secondary education. Individuals and governments in the United States are significantly out investing us in post secondary institutions, building a more educated work force that leads to higher prosperity.

Importantly, all governments need to address the issue of sustainability of current expenditure patterns. Our public sector spending continues to tilt away from investing in future prosperity through education and infrastructure toward health care and social services. Our demographic trends will only accentuate this pressure, as the aging population requires more of both. We need to make some principled choices in our spending patterns now – for if we continue on this current path of public spending, we risk having to make even tougher choices in the future. Then, we will have even less prosperity to trade off between consumption and investment.

On the physical investment side, our business leaders need to invest more in machinery, equipment, and software, and particularly in productivity enhancing information and communications technology. We recognize that some of this will come about from changes in motivations through the tax system and some from changes to structures of competitive pressure and specialized support. But business leaders need to raise their awareness of the importance of these investments for their own international competitiveness and vitality as well as their impact on all Canadians' future prosperity.

Motivations: from unwise taxation to smart taxation

People will be more motivated to invest in future prosperity if we shift from a fundamentally unwise to a smarter taxation system than we have today. Smart taxation recognizes that business investment is a driver of prosperity not just for shareholders, but more importantly also for workers, customers, and suppliers of businesses.

Most other developed countries recognize that it is important to encourage business investment to expand the prosperity pie and then tax individually for redistribution. That is smarter taxation.

The Canadian taxation system is one of the developed world's worst when it comes to taxes on new business investment. Some provincial governments continue to levy a provincial sales tax on many business investments; some tax capital assets once the new investment has been made. Generally, federal and provincial corporate rates on investment returns are high relative to those in other developed economies. We urge the provincial governments to end these practices; federal and provincial governments to work together to harmonize provincial sales taxes with the GST; and all governments to reduce corporate income tax rates and to speed up depreciation allowances on new investments.

A smarter taxation system will encourage people to invest more for future prosperity

The federal government has compounded our shortfall in intelligent taxation by forgoing significant corporate tax reductions in favour of reducing consumption taxation through its Goods and Services Tax (GST) cut. The GST cut from 7 percent to 6 percent was truly unfortunate. We strongly advocate that the five provincial governments who have not yet harmonized their provincial sales taxes with the federal GST take the opportunity to do so when the federal government reduces it again as promised. This will help mitigate the damaging impact of the reduction in the federal GST.

Structures: from preserve status quo to encourage creativity and growth

Currently, Canadian enterprises benefit from a stable environment and vital infrastructure, including education, transportation, and financing, which generally support business initiatives. But we need to ensure that our economic policy does not focus on preserving what we have. Rather, we need to establish market and governance structures that provide a balance of pressure and support to help emerging global leaders in Canada to thrive. Our recommendations aim at building the necessary specialized support and the strong competitive pressure that drive the will to win and innovations to beat out rivals.

Economic policy should not just preserve what we have; it should encourage creativity and innovation to put Canada out in front of competitors

For **market structures**, we need to find ways to ensure greater specialization of support for our firms. That means raising the quality of venture capital and focusing less on the quantity of venture capital. This could occur by scrapping the labour sponsored venture fund tax supports at the federal and provincial levels. We need to find ways to strengthen business research and development. We propose eliminating the federal scientific research and development tax credit in favour of a more broadly based reduction in the taxation of business investment. We also need to ensure that our businesses are being more capably managed through continuing growth in the number of university-trained managers, irrespective of field of study, and through more available spaces for business students. Improved structures also require greater competitive pressure, which can come about by deregulating key sectors and opening our markets up to greater competition from bilateral trade agreements.

Our **governance structures** also need to be strengthened for greater prosperity. Fiscal federalism needs to be restructured more to drive investment and prosperity in the have-not provinces and less to support consumption of current prosperity. A key element of this is a fundamental reform of the Employment Insurance program, which is a major part of the funds that flow to regions of high unemployment with little discernible impact on joblessness. We also need to examine our labour regulations more carefully to ensure that they are not having unintended consequences. Our research indicates that stringent labour regulations in Canada – in areas such as the minimum wage and approval requirements for overtime – are causing a greater incidence of involuntary part-time work. Our concern is that well-meaning labour regulations are stifling economic development, which in turn reduces the demand for worker hours, especially among the least skilled.

Canadians live in one of the most prosperous regions in the world. We have a vibrant economy based on highly capable people, competitive businesses, and effective governments. But we can do better. We have a large prosperity gap with the most prosperous jurisdiction next door. This lost potential reduces opportunities for all of us. The Institute for Competitiveness & Prosperity urges all stakeholders in Canada's prosperity to develop the will and the actions to close the prosperity gap. We are proposing an ambitious prosperity challenge for 2020 and an agenda to achieve our goal. We look forward to discussing it with all Canadians.



Canada's prosperity gap

The prosperity gap limits Canadians' living standards

TO MEASURE AND MONITOR Canada's competitiveness and prosperity, the Institute has focused on Gross Domestic Product (GDP) per capita as the summary measure of success. GDP represents the value added to our endowed base of human, physical, and natural resources. The value we add is driven by our ability to develop and produce products and services that others want to buy – here in Canada, and around the world. It can be raised by expending more effort to increase the goods and services produced in Canada; by finding more efficient ways to produce the same amount of goods and services with the same effort; or by creating new and improved goods and services for which consumers will pay higher prices.

GDP is an imperfect measure. It does not measure quality of life or happiness. It focuses strictly on things that can have a dollar value attached to them. And it does not place a value on leisure time. But it is useful to the extent that a more prosperous economy creates the opportunity for greater quality of life through better health, increased life expectancy, and literacy.

Canada has an enviable prosperity position. Among countries with a population that is similar to or greater than Canada's, no other country outside North America out performs Canada in GDP per capita.

As heartening as these results are, we have a large and widening prosperity gap with the United States – our most significant trading partner and North American neighbour. We continue to measure our competitiveness and prosperity against the economy that most resembles ours.

As we have seen, this prosperity gap was much smaller twenty-five years ago, when Canada's economic results compared more favourably with those in the United States. Starting with 1990–92 recession, Canada began to fall behind, and we have not been able to resume our earlier standing. And, as we have also seen, this prosperity gap matters to Canadians. It represents lost potential for our residents to gain economic security and well being and for our public institutions to provide services and investments for future prosperity.

Why does the prosperity gap matter?

For five years now, the Institute for Competitiveness & Prosperity has argued again and again that the prosperity gap matters to all Canadians.

Why? Because the prosperity gap is a measure of the economic potential we have not realized, especially among the disadvantaged. Simply, Canadians are not achieving everything we possibly can with the resources we have available to us.

We define Canada's prosperity as our Gross Domestic Product (GDP) per capita. GDP measures the value Canadians have added to the national endowment of our resources. Most countries use the same method in calculating GDP, so it tracks how well countries perform over time and in comparison with each other. And, since GDP measures value added, it is a good scorecard for innovation. To the extent an economy is competing on the basis of new and unique products and services, rather than simply extracting and selling raw materials, its GDP will be higher.

But how does our GDP performance matter to the average Canadian? The answer is that, since about 85 percent of our GDP is distributed to individuals in the form of pre-tax personal income, increases in personal income over time are tied very closely to higher GDP.

As we look at GDP per capita among larger countries – those with a population of 10 million or more – Canada ranks second, out performing Germany, France, Japan, and the United Kingdom. But, against our closest neighbour and largest trading partner, Canada has become an increasingly distant second, now trailing the United States by \$9,200 or 18 percent. In 1981, this gap was only \$3,300. We have steadily fallen behind the economy that most closely resembles our own, as we are

less successful in transforming natural, physical, and human resources into prosperity.

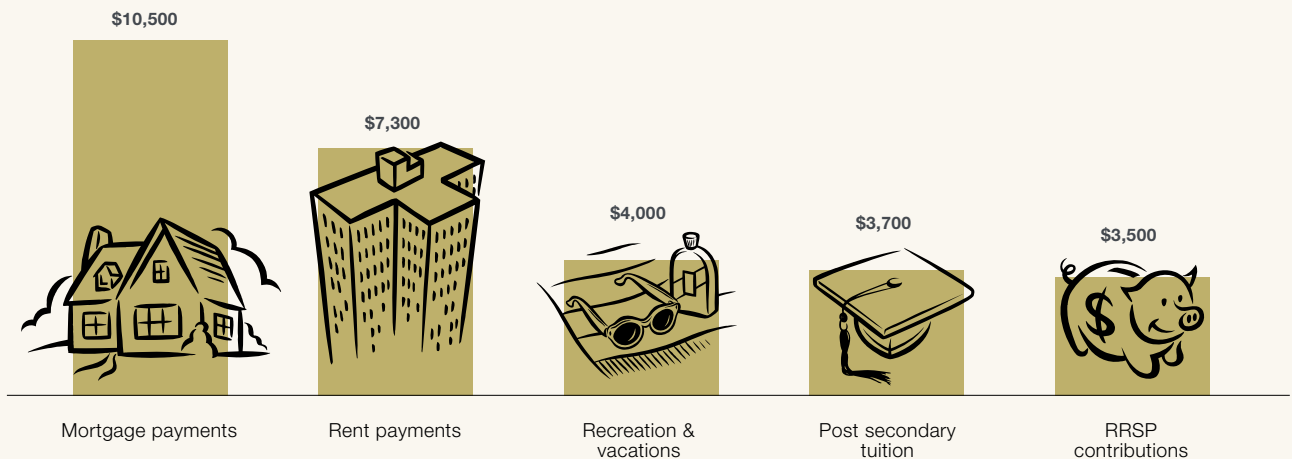
To the average household, realizing that lost potential and eliminating the prosperity gap would mean significant economic advancement. By our estimates, a \$9,200 increase in GDP per capita would translate into an increase in personal disposable income of \$11,900 per household after taxes are paid and government transfers are received. With this increased income, families could more readily pay for many important consumer spending items and investments in their future (*Exhibit 3*).

Equally important, closing the prosperity gap would generate another \$108 billion per year in revenues for all governments across Canada. This amount

Exhibit 3 Closing the prosperity gap affords higher living standards for Canadians

Average annual household spending in Canada, 2005 (C\$ 2005)

Closing the prosperity gap would increase annual personal disposable income for the average Canadian household by \$11,900



Note: Among Canadians with some spending in these categories. Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada, *Spending Patterns in Canada 2005*.

would pay many times over for the kind of spending increases that are being proposed around the country:

- The recent Romanow Royal Commission on Canada’s health care system proposed increasing our public spending on health care by \$4.4 billion annually by 2005–06.⁵ Other groups, such as The Conference Board of Canada estimate required new health care spending at \$4.9 billion annually;⁶
- Fraser Mustard and the Honourable Margaret Norrie McCain recommend that Ontario increase its commitment to early childhood education by \$1.7 billion annually.⁷ When the amount they suggest is grossed up for all of Canada, the annual price tag would be \$4.1 billion – larger than the \$2.9

billion figure developed by the OECD in its recent report on early childhood education in developed economies;⁸

- The Canadian Council of Professional Engineers estimates Canada has an “infrastructure deficit” of \$60 billion that could be eliminated by increased expenditures of \$6.0 billion annually to 2020;⁹
- The Fraser Institute and David Suzuki Foundation estimate the annual cost of Canada’s Kyoto commitments to be, respectively, \$4.0 billion¹⁰ and \$6.5 billion.¹¹

In summary, if we closed the prosperity gap, we could fund these major initiatives recommended over the past several years and still leave room for the

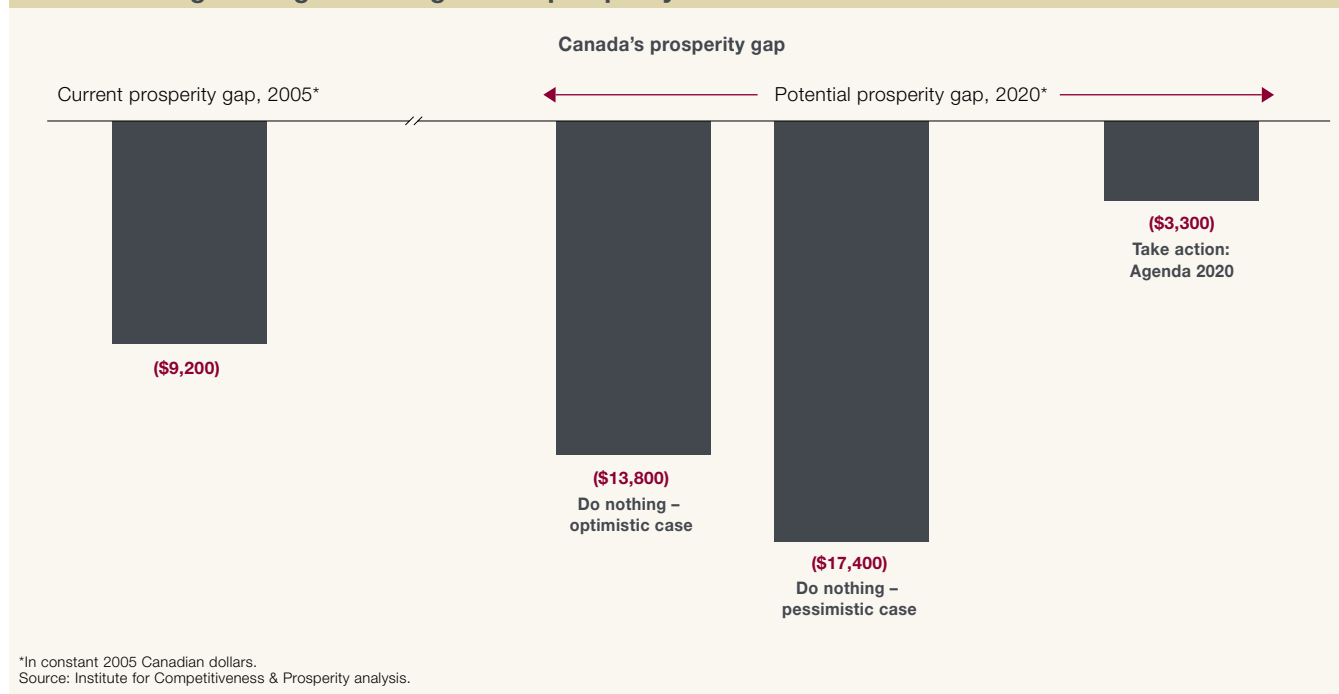
biggest tax cut in Canadian history by a wide margin – an \$87 billion annual tax cut, a massive 18 percent reduction from current levels. This would be a huge benefit for Canadians’ standard of living.

Our *Agenda for Canada’s prosperity* recommends an action plan for closing the prosperity gap. But what if we do nothing?

Doing nothing is not a worthy option

If we take no action, our prosperity will continue to fall further behind that of the United States. A major contributor to the prosperity gap, our lower productivity – or value added per hour of work – continues to drift downward.

Exhibit 4 Doing nothing entails significant prosperity risks for Canadians



⁵ Roy J. Romanow, *Building on Values, The Future of Health Care in Canada*, 2002, pp.71-73. Available online: www.cbc.ca/healthcare
⁶ The Conference Board of Canada, *Performance and Potential 2002–03: Canada 2010: Challenges and Choices at Home and Abroad*, October 2002, p. 6.
⁷ Hon. Margaret Norrie McCain and J. Fraser Mustard, “The Early Years Study, Three Years Later,” August 2002, p. 39.
⁸ OECD, “Early Childhood Education and Care Policy - Country Note - Canada,” 2004, pp. 8 and 75.
⁹ Canadian Council of Professional Engineers, “Brief to the Standing Committee on Finance Regarding The Federal Government’s Pre-Budget Consultation Process,” October 2005, p. 12. Available online: www.cpe.ca/e/files/briefs_prebudget_1105.pdf
¹⁰ Jeremy Brown and Milagros Palacios, “The Kyoto Protocol: Economically Beneficial or Detrimental,” *Fraser Forum*, October 2005, p. 30.
¹¹ Tellus Institute, “The Bottom Line on Kyoto,” prepared for David Suzuki Foundation and World Wildlife Fund, April 2002, p.9.

In addition, the gap in hours worked per worker is widening relative to the United States. If we continue on the path we are on – with these ongoing declines in our relative productivity and work intensity – Canada's prosperity gap will widen to \$13,800 per capita, or 22 percent of US GDP per capita by 2020. Then we could expect much more noticeable gaps in our standard of living and the provision of government services (*Exhibit 4*).

Could it be even worse? If we experienced another recession like Canada suffered through in the early 1990s, we could easily see unemployment rates back over 10 percent. This could drive our prosperity gap to \$17,400 per capita – fully 28 percent behind the United States.

But if we gradually closed the productivity shortfall we have relative to the United States – through more education, smarter taxation, greater capital investment, and more intense competition in our markets – we could reverse the trend in our productivity performance relative to the United States and cut our prosperity gap by almost two-thirds to \$3,300 per capita by the 2020 target. This is not wishful thinking – the gap was \$3,300 as recently as 1981.

That's why our ambitious agenda for prosperity is worth pursuing. We should strive to reverse a 25-year decline in 15 years.

Lagging intensity and productivity are the biggest prosperity hurdles

Our agenda for Canada's prosperity begins with an assessment of what is driving our current prosperity gap. This assessment draws on the same framework we have used in our previous reports. This framework disaggregates GDP per capita into four measurable elements (*Exhibit 5*).

- **Profile.** Out of all the people in a jurisdiction, what percentage are of working age and therefore able to contribute to the creation of products and services that add economic value and prosperity?

Exhibit 5 Institute measures four components of prosperity

Prosperity		Profile		Utilization		Intensity		Productivity
GDP per capita	=	Potential labour force	X	Employed persons	X	Hours worked	X	GDP
		Population		Potential labour force		Employed persons		Hours worked
				<ul style="list-style-type: none"> • Participation • Employment 				<ul style="list-style-type: none"> • Cluster mix • Cluster content • Cluster effectiveness • Urbanization • Education • Capital investment • Productivity residual

Source: Adapted from J. Baldwin, J.P. Maynard and S. Wells (2000). "Productivity Growth in Canada and the United States" *Isuma* Vol. 1 No. 1 (Spring 2000), Ottawa Policy Research Institute.

- **Utilization.** For all those of working age, what percentage are actually working to add economic value and prosperity? To gain further insight into this element, we examine the two contributors to utilization. First, we assess participation – the percentage of those of working age who are searching for work, whether they are successful or not. Second, we assess employment – the rate at which those participating in the job market are employed.

- **Intensity.** For all those who are employed, how many hours do they spend on the job in a year? This element measures both workers' desire to work more or fewer hours and the economy's ability to create demand for work hours.

- **Productivity.** For each hour worked, how much economic output is created by a country's workers? Within productivity we assess six sub-elements; what is left is an unexplained productivity residual:

Cluster mix – how the mix of industries into traded clusters, local industries, and natural resources affects our productivity potential

Cluster content – productivity potential of the sub-industries that make up our clusters of traded industries

Cluster effectiveness – how well our clusters of traded industries compete

Urbanization – the proportion of our population that lives in urban areas, which typically increases a country's productivity

Education – the educational attainment of our population and its impact on productivity

Capital investment – the degree to which physical capital supports our workers' productivity

Productivity residual – a residual value that relates to productivity but remains unexplained.

Note that the first three factors – profile, utilization, and intensity – add up to our labour effort, or the hours worked per capita. That captures the human effort Canadians are expending to create economic value. The fourth factor – productivity, or GDP per hour worked – measures how effectively our labour efforts turn resources into economic value and prosperity.

As we have seen, Canada's divergence from the prosperity performance of our North American neighbour occurred largely during the recession of the early 1990s. During that time, the key factor driving our economic weakness was lagging labour effort, especially utilization and its two sub-elements: participation and employment. Since 1995, we have been successfully recovering to 1990 performance levels. But, at the same time, a growing productivity gap has emerged relative to the United States. If we are to close the prosperity gap, a productivity agenda has to be a priority for all stakeholders.

Canada has mixed labour effort performance

Canada continues to have an advantage over the United States in demographic profile and utilization, but a significant disadvantage in intensity.

Profile remains an advantage for Canada. The first factor in a country's prosperity creation potential is its demographics. The percentage of the population that is of working age – aged 15 to 64 – is a base for prosperity. With more people in that age range, a higher percentage of the population can work and create economic value. In Canada, this ratio has been stable over the short run and has had no appreciable impact on changes in our prosperity gap versus the United States. Positively, it creates an ongoing starting advantage in Canada's prosperity.

In 2005, 69.3 percent of Canadians were aged 15 to 64, while in the United States this proportion is 67.1 percent. Relative to the United States, therefore, Canada has a 3.2 percent potential profile advantage.¹² Holding all other factors constant, we calculate this advantage to be worth \$1,200 in per capita GDP. In other words, because we have a higher proportion of our population able to add to our prosperity, we have a profile advantage over our American counterparts worth about \$1,200 to our prosperity per capita.

But Canada will have fewer workers to create prosperity in the coming years. We estimate that by 2025 the projected smaller percentage of working age Canadians will reduce GDP per capita potential by \$3,100.¹³ As we discussed in our Working Paper on intensity released in 2006, we will need creative retirement solutions to address this decline in our prosperity potential.¹⁴

Canada out performs the United States in utilization. Canada successfully reversed a decline in the utilization of its working aged population during

¹² Calculated as $[1 \text{ minus } (67.1 \text{ (US)} / 69.3 \text{ (Canada)})] = 3.2 \text{ percent.}$

¹³ This comparison is between Canada's GDP per capita in 2005 and its potential in 2025; not the difference between Canada and the United States.

¹⁴ Institute for Competitiveness & Prosperity, Working Paper 9, *Time on the job*, September 2006, p. 21.

the latter part of the 1990s. In 1990, Canada led the United States in participation. Canadians were more eager to work than Americans.

However, from 1990 until 1996, Canada's participation rate plunged dramatically, reaching a low point of 65.3 percent in that last year as many discouraged workers simply stopped looking for work. Then the national participation rate increased every year until 2002, when Canada once again regained leadership in this element of prosperity. In 2005, 67.2 percent of Canadians 15 years of age and older¹⁵ worked or sought work. The US participation rate was 65.5 percent. This 1.7 percent advantage translates into \$900 in GDP per capita.

In the other component of utilization, employment, Canada has traditionally trailed the United States, but this gap accounts for only a small part of our prosperity gap. However, during the recession of 1990–92, the unemployment rate rose significantly, reaching 11.4 percent in 1993. After the 2001–02 downturn, the gap narrowed down again. In 2005, the employment rate was 1.5 percentage points behind the United States. This lower employment rate in Canada relative to the United States cost us \$600 in lower GDP per capita. This is a marked improvement over the results of the mid 1990s.

The combined effect of more discouraged workers and increased unemployment in the first half of the 1990s was a key driver of Canada's growing prosperity gap during those years. Beginning in 1995, Canada

successfully increased the utilization of its human capital; by 2005, Canada employed 62.7 percent of its working age population, above the US rate of 62.0 percent. This superior performance translates to a \$300 utilization advantage (the net effect of a \$900 participation advantage and a \$600 employment disadvantage) in GDP per capita.

Intensity is a significant part of our prosperity gap. Last year, the Institute conducted research into differences in intensity – hours worked per employed person – between Canadian workers and their counterparts in the United States. Our findings showed that the difference in hours worked is the most important contributor to our prosperity gap after productivity.¹⁶

The subject of intensity has attracted recent attention from economists and those involved with public policy. For some, the key challenge is to ensure that, as our society prospers, the goal of public policy is to reduce the number of hours workers are on the job.

But others note that there is a downside to working less. In Canada, the intensity gap with the United States has grown significantly over the past thirty years – from 1.3 weeks in 1976 to 4.4 weeks in 2005. The gap has grown because Canadians are taking more weeks away from work and because we are working fewer hours in the weeks when we are at work. At the same time, workers in the United States have increased the weeks they are at work and the hours per week when they are at work. These two factors are nearly equal sources of

Canada's intensity gap: the percentage of employed persons who work in any given week, and the number of hours they spend on the job during a typical work week (*Exhibit 6*).

Canadians are away from work for more full weeks than workers in the United States. In any given week, about 7.9 percent of workers in Canada are off the job for the full week. In the United States, 4.1 percent of workers report being away from work for a full week. Multiplying the 7.9 percent by 50 work weeks in a year, we find that the average Canadian worker is away from work for 3.9 weeks. In the United States, the comparable figure is 2.0 weeks. This difference of 1.9 weeks per year accounts for 70 hours¹⁷ annually – or about 45 percent of the total 157-hour gap.

In those weeks when they are on the job, workers in the United States work an average of 39.2 hours per week. Workers in Canada achieve 95.4 percent of this, or 37.4 hours weekly. This 1.8 hour difference adds up to 87 hours or 55 percent of the total annual 157-hour gap.

This part of the intensity gap further sub-divides into three factors. The largest of these is the greater incidence of part-time work in Canada. Over the 1997–2004 period, 21.7 percent of Canadian workers were employed part time versus an average of 17.3 percent across the United States.¹⁸ This had the effect of reducing average hours worked in a year by 48 hours versus the United States. The second largest reason for the fewer hours during the

¹⁵Labour statistics base participation, unemployment, and hours estimates on all workers including those who are 65 and over; we follow this convention for utilization and intensity.

¹⁶Alberto Isgut, Lance Bialas, and James Milway, "Explaining Canada-U.S. differences in hours worked," *International Productivity Monitor*, No. 13, Fall 2006, pp. 27–45. For Ontario versus peer states comparison see Working Paper 9, *Time on the job*.

¹⁷At the Canada average hours worked per worker who worked - 37.4 hours. See Alberto Isgut, Lance Bialas, and James Milway, "Explaining Canada-U.S. differences in hours worked."

¹⁸The official definitions of part-time work differ in Canada and the United States. In order to make the incidence of part-time work compatible across countries, we measure it here as the number of persons whose actual hours of work during the survey week were between 1 See Isgut, Bialas, and Milway *op cit.* for details.

work week is that a smaller percentage of Canadians work long work weeks, defined as work weeks with 50 or more hours. Over the same period, 18.8 percent of workers in the United States worked long hours, compared with only 15.5 percent in Canada. Finally, the smallest part of the weekly hours worked gap is the length of the standard work week for the bulk of employed Canadians who work neither part time nor long weeks. The average Canadian worker in the group worked 39.0 hours versus 39.5 hours for their US counterpart. This small difference accounted for just 16 hours per worker in an average year.

The gap cumulates to a difference of 157 hours each worker spent on the job annually on average over the years 1997 to 2004. In 2005, the intensity gap was 164 hours per worker, which

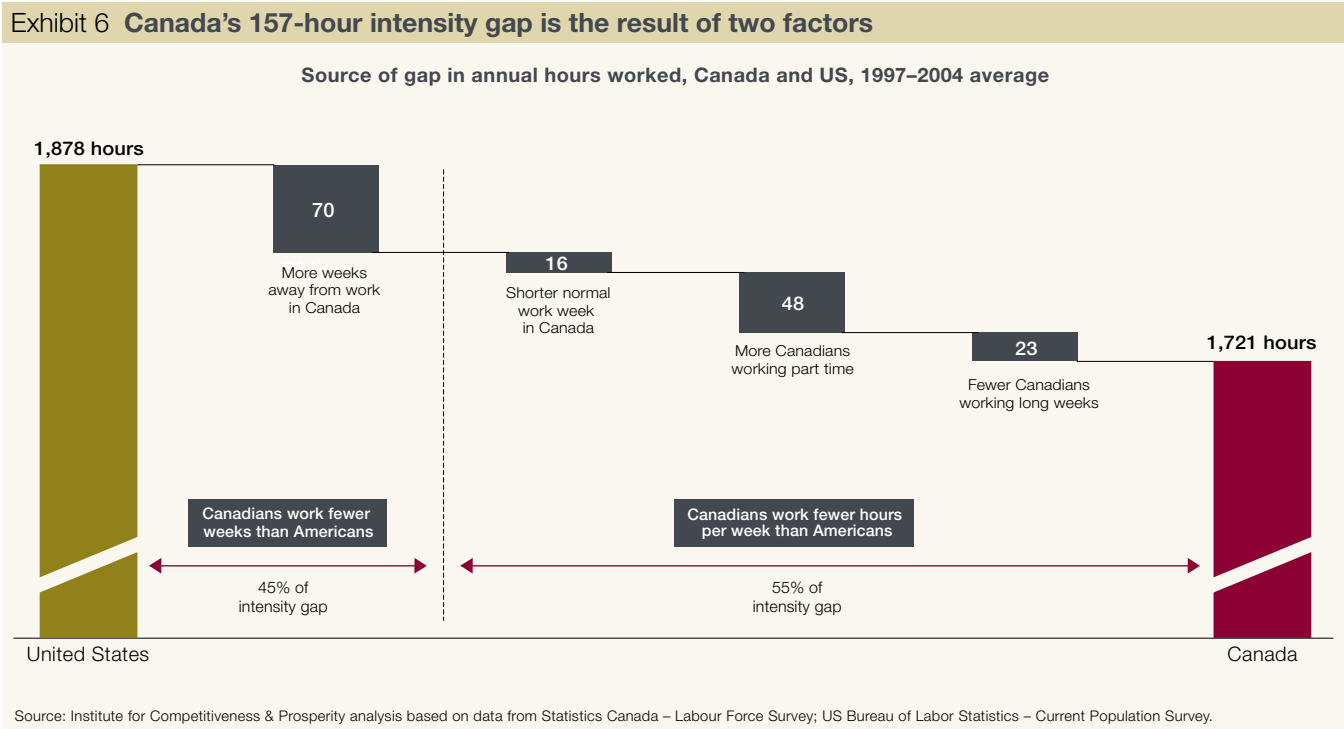
accounted for \$3,900 of the \$9,200 per capita prosperity gap with the United States. Closing some of this intensity gap has the potential to contribute significantly to higher prosperity in Canada.

But we agree with the general proposition that closing the prosperity gap exclusively or even primarily through increased work effort is an unwise course. It goes against the idea of working smarter, not harder, to increase prosperity. It is also impractical if it works against individual preferences. Nor do we conclude that public policy should be geared toward reducing work hours to match the experience of Europeans, since there is no evidence that this can or should be transplanted. Whether we need new approaches to the amount of time workers spend on the job ought to be informed by a

deeper understanding of the situation here in Canada.

While there are many similarities in the Canadian and American work forces and the time they spend on the job, our research pointed to three differences that stand out clearly:

- **Nearly a quarter of the intensity gap is involuntary.** More Canadians than their US peers work part time, and the most important reason for this is that they are unable to find full-time work (*Exhibit 7*). The evidence points to economic conditions as the major determinant. Where and when unemployment is higher, involuntary part-time employment increases. Recent research by Toronto's Daily Bread Food Bank indicates that 60 percent of their employed clients



“say they want more hours of work but are unable to get them from their employer.”¹⁹

This points to the ongoing imperative for strengthening the skills of Canadians, since involuntary part-time work is more prevalent among those with lower skills. We need to continue working to ensure that our children are staying in school as long as possible so that they are less vulnerable to the vicissitudes of economic downturns and the employment market.

- **The intensity gap is wider among our more productive workers.** Compared to their US counterparts, Canadian workers with higher education and higher incomes take more weeks off work (*Exhibit 8*) and are less likely to work long work weeks (defined as more than 50 hours

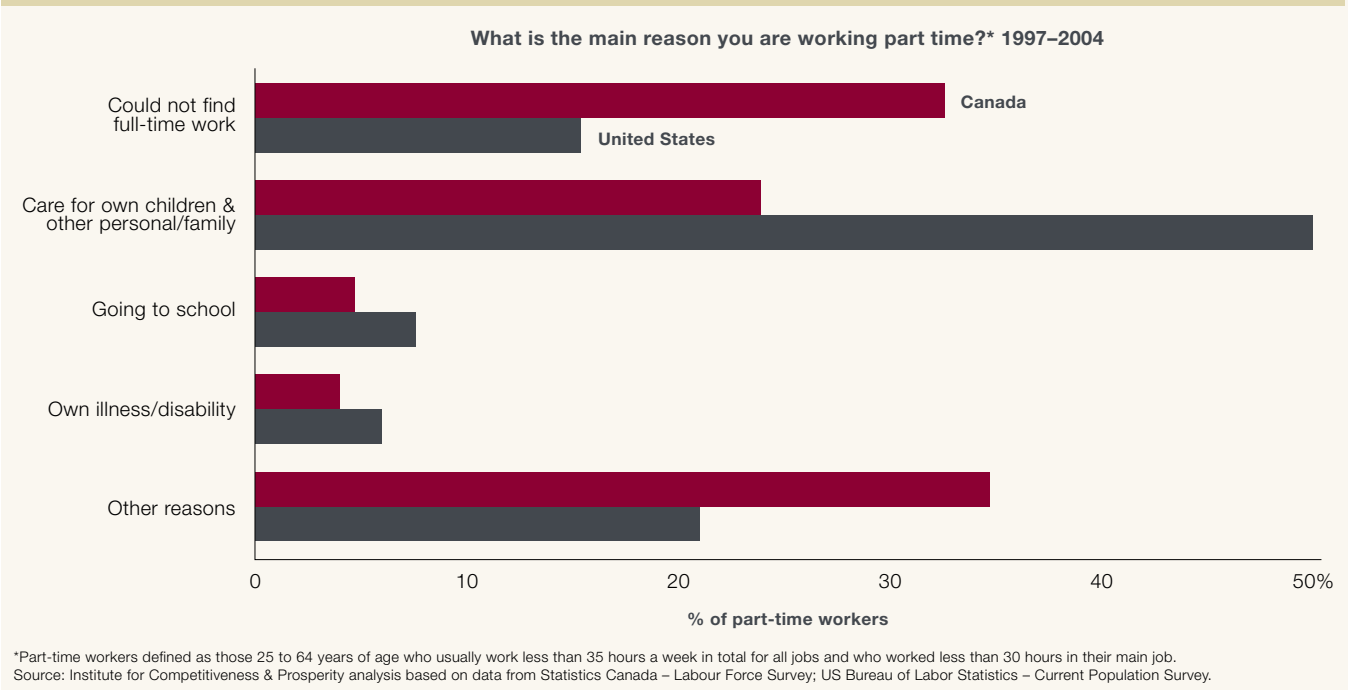
per week). In our previous work in exploring Canadians' attitudes, we did not find significant differences in our overall propensity to work more hours for greater prosperity. However, among the most highly educated and the highest income earners, we found that Canadians are less interested than Americans in working longer hours to augment their prosperity. We also know from our previous work that the premium for higher educational attainment is lower in Canada than among our American peers, since our economy does not reward more education as much as the US economy does.

We may be in a vicious circle. Because higher skilled workers and managers are not valued as much in Canada as in the United States, the incentive for highly educated Canadians to work

longer hours is reduced. Consequently, our overall productivity is reduced, because highly educated workers perform a lower proportion of work. As a result, our economy draws on a lower skill mix overall, which further reduces productivity, and so on.

- **The intensity gap is related to our less robust economy.** Drawing from a multiple regression analysis,²⁰ we found that our lower work intensity is related to our higher unemployment rate and our lower GDP per capita. The inability of our economy to achieve its full competitive potential means that fewer of our workers, particularly those with lower skills, have the choice to work as many hours as they want. For them, the labour-leisure tradeoff is a false dichotomy. We need to recognize that our prosperity gap has real consequences for real people.

Exhibit 7 Many Canadian part-time workers would prefer full-time work



¹⁹Daily Bread Food Bank, *Who's Hungry: 2006 Profile of Hunger in the GTA*, 2006. Available online: www.dailybread.ca
²⁰Working Paper 9, *Time on the job*, p.34.

In summary, the intensity gap is a major contributor to our prosperity gap. To the extent that many Canadians are content to work less and to enjoy the benefits of their current prosperity, that is a positive feature of our economic situation. But, to the extent that those who want to work more to advance their economic situation are being constrained, we need to work at creating the opportunity for them to work and earn more. And to the extent that we are under utilizing the potential contribution from our more productive workers, we need to look for creative solutions that realize all that they can offer to contribute to higher prosperity.

Productivity continues to be the key to closing Canada's prosperity gap

As we have seen, in the three labour effort factors, Canada's advantage in

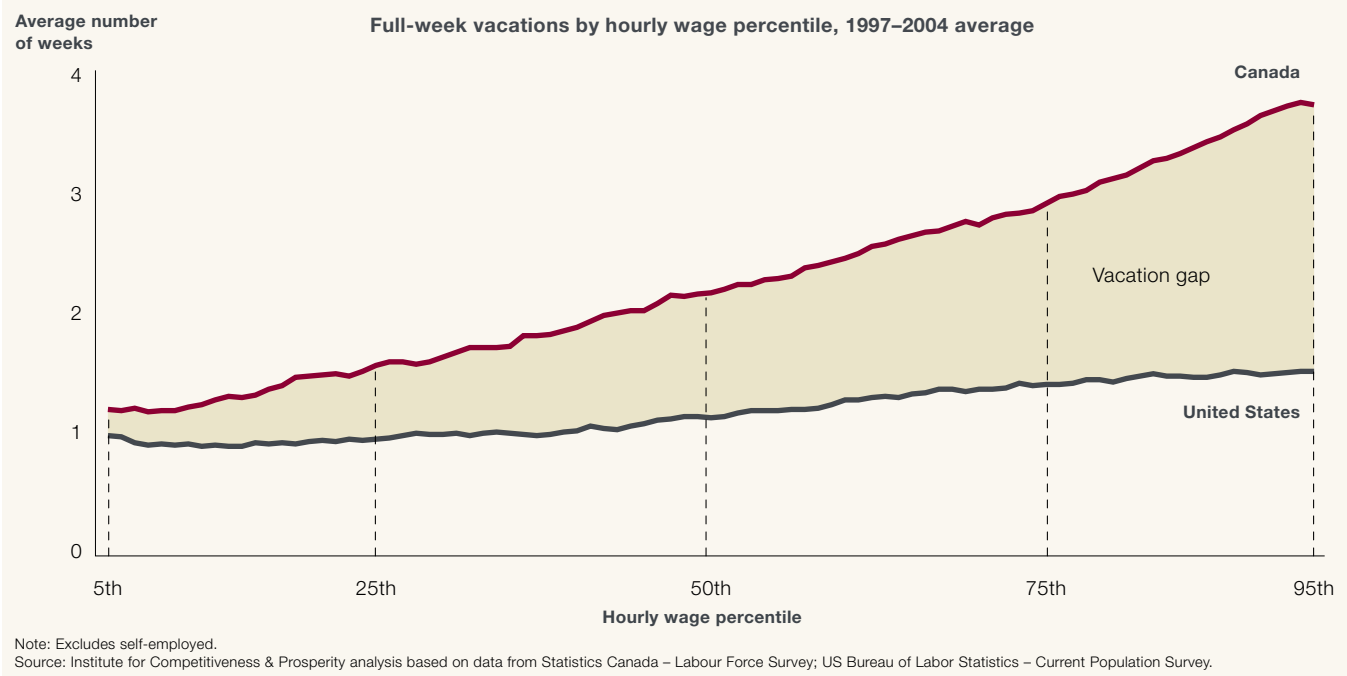
the percentage of our population of working age has strengthened slightly, and we have made remarkable progress in the percentage of Canadians who are working. Still, differences in the number of hours worked continue to be a major contributor to our prosperity gap. And lower GDP per hour worked adds significantly to the gap. We assess the seven sub-elements of productivity to determine the impact of this key driver of our prosperity gap (*Exhibit 9*).

Cluster mix and cluster content contribute positively to our productivity. The Institute continues to conclude that Canada benefits from a good cluster mix of traded industries²¹ that are typically concentrated in specific geographic areas and sell to markets beyond their local region. Research by Michael Porter of the

Harvard-based Institute for Strategy and Competitiveness has shown that clusters of traded industries increase productivity and innovation. In addition, the presence of clusters in a region has a spillover effect, in that they typically generate opportunities for increased success of the local economy.

Drawing on Porter's methodology, the Institute has determined that fully 37.0 percent of employment in Canada is in traded industries versus 30.5 percent in the United States. Canada's employment strength in financial services, automotive, metal manufacturing, publishing and printing, and others has created an attractive mix of traded industries. Our analysis of Canada's cluster mix indicates a \$1,400 per capita advantage over the United States. This benefit is derived

Exhibit 8 The vacation gap widens significantly as income increases



²¹Institute for Competitiveness & Prosperity, Working Paper 1, *A View of Ontario: Ontario's clusters of innovation*, April 2002 and Institute for Competitiveness & Prosperity, Working Paper 5, *Strengthening structures: Upgrading specialized support and competitive pressure*, July 2004.

from a higher output than would be likely if Canada's mix were the same as the US mix.²²

In the sub-clusters that make up each cluster of traded industries,²³ there are also wage and productivity differences. As we compare these with those in the United States, we conclude that our cluster content creates a \$200 disadvantage for Canada.

Cluster under performance is a significant part of Canada's productivity gap.

While Canada has excellent cluster mix and content, cluster effectiveness is much lower than in the United States. In Canada and the United States, traded clusters are more productive than local industries, as represented by wages. In Canada, the productivity

premium is 42 percent.²⁴ But across the United States, the productivity premium is 57 percent. Taking the prevailing wage in local industries as a given, our clusters are under performing their counterparts in the United States by 10 percent (the difference in the US performance index of 1.57 versus Canada's 1.42).

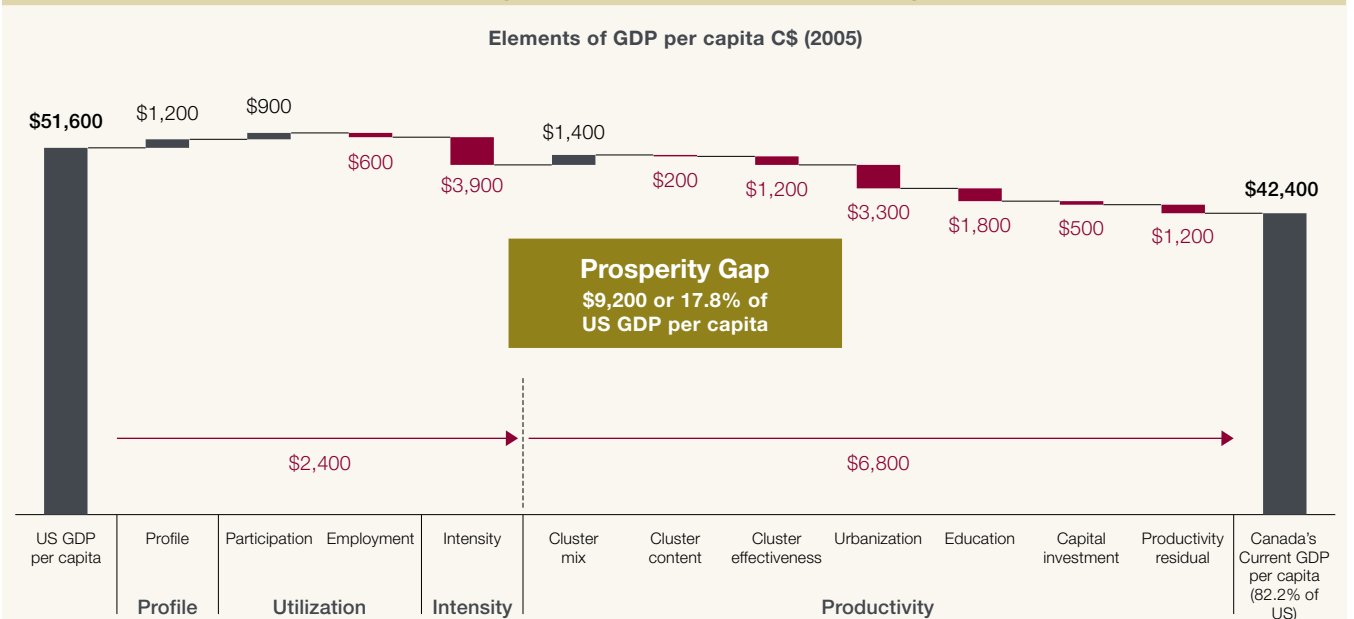
If Canadian clusters were as effective as US clusters, we estimate that wages would be \$4,600 per worker higher. As traded clusters account for 37.0 percent of Canadian employment and given the relationship between wages and productivity, our overall productivity would rise by 4.8 percent.²⁵ From this, we estimate the productivity loss from our weaker clusters to be \$1,200 per capita. Adding together the effects of cluster mix (+\$1,400), content (-\$200),

and effectiveness (-\$1,200) Canada's clusters do not provide a net benefit in GDP per capita versus the United States.

Relatively low urbanization is a significant contributor to our productivity and prosperity gap.

In our work, we have established the higher level of productivity that results from greater rates of urbanization. This is the result of the increased social and economic interaction of people in firms in metropolitan areas, the cost advantages of larger scale markets, and a more diversified pool of skilled labour. The interplay of these factors promotes innovation and growth in an economy. Since fewer people in Canada live in metropolitan areas than in the United States, our relative productivity and prosperity potential

Exhibit 9 Productivity accounts for the greatest share of the prosperity gap with the United States



Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada; US Department of Commerce – Bureau of Economic Analysis.

²² It is important to note that our measure focuses on the mix of industries only. It calculates the productivity performance we could expect in Canada if each cluster were as productive as its US counterpart. It does not measure the effectiveness of each cluster in Canada.
²³ Working Paper 1, *A View of Ontario*, pp. 18-20.
²⁴ Working Paper 5, *Strengthening structures*, p. 26.
²⁵ We have netted out the effects of Ontario's lower urbanization, our under investment in capital, and our lower educational attainment in this calculation.

Does the strengthening Canadian dollar mean a wider prosperity gap?

WITH THE VALUE of the Canadian dollar settling in at the mid to high 80 US cents range, after spending a long time in the 60 cent range, some are concerned that this will hurt our competitiveness and prosperity. The reasoning is that a stronger Canadian dollar makes Canada's manufacturing output more expensive in the important US export market, and that US imports are now a relative bargain.

But a review of the last twenty-five years' relationship between our dollar's strength and Canada's prosperity gap with the United States does not show a systematic relationship between the two. Between 1985 and 1989, the dollar was strengthening with little discernible impact on the prosperity gap (*Exhibit A*).

Between 1991 and 2001, our dollar weakened dramatically. At the same time, our prosperity gap experienced its most significant widening. But in

the current decade, as our dollar has been strengthening, our prosperity gap has grown moderately.

A casual observer may note that the last time the Canadian dollar was showing this kind of strength, our deep 1990-92 Canada recession followed – so maybe an even wider prosperity gap is around the corner.

However, there is a fundamental difference between now and the late 1980s. Then the strengthening of the Canadian dollar was mainly the result of high interest rates in Canada relative to those in the United States, as the Bank of Canada tightened its monetary policy to fight inflation. This tight monetary policy not only caused the dollar to strengthen, but also had a direct adverse impact on economic activity in Canada. The evidence indicates that tight monetary policy was a leading cause of the early 1990s recession.^a

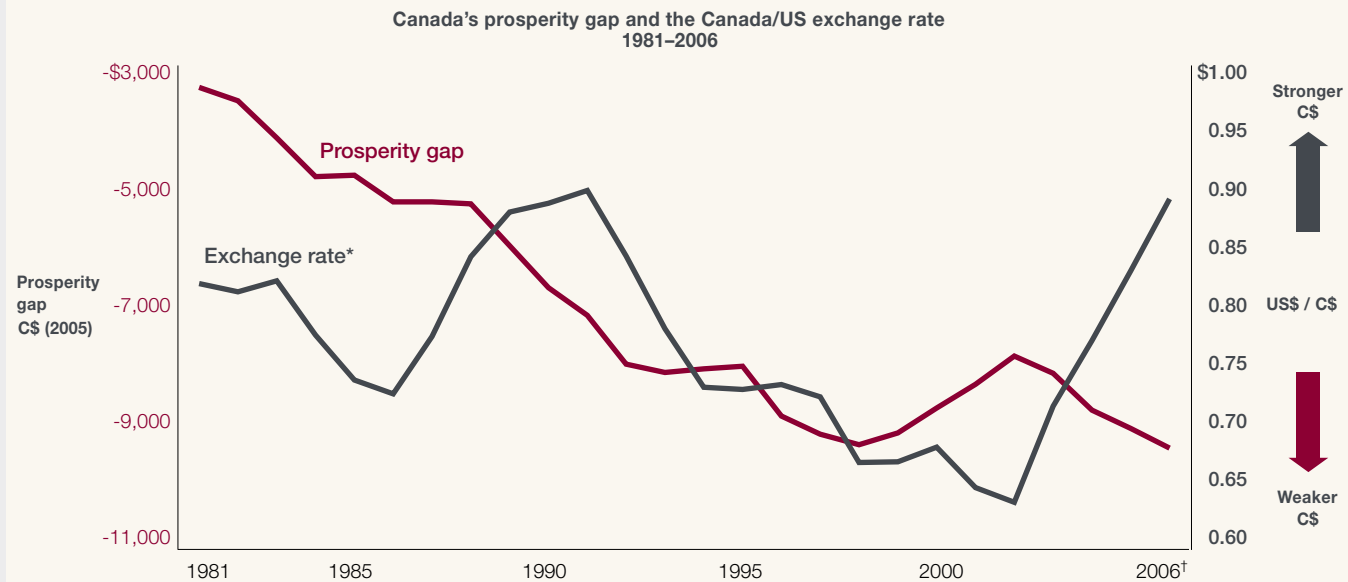
This time around, the cause of the dollar's strength is rising commodity and energy prices, not high interest rates, according to the Bank of Canada's analysis.^b Higher energy prices have led to a comfortable fiscal situation, which makes the macroeconomic picture today much more favourable than in the late 1980s.

In sum, our prosperity gap is the result of several factors – but it is difficult to include the rise and fall of the Canadian dollar in the list. While the dollar fluctuations may have some impact, it is important to consider the underlying reasons for them to assess their impact on our prosperity.

^a See our review of the research conducted by Dungan, Murphy, and Wilson in last year's Report on Canada, *Rebalancing priorities for Canada's prosperity*, p. 21.

^b See Ramzi Issa, Robert LaFrance, and John Murray (2006), "The turning black tide: Energy prices and the Canadian dollar," mimeo, Bank of Canada.

Exhibit A Performance of dollar and prosperity gap has varied



* Bank of Canada published rates adjusted for differences in GDP price deflators.

† Estimate based on first 9 months of 2006.

Source: Institute for Competitiveness & Prosperity analysis based on Statistics Canada; US Department of Commerce – Bureau of Economic Analysis; OECD.

is reduced. Our analysis this year indicates that we have a \$3,300 per capita disadvantage against the United States related to our lower level of urbanization.²⁶

Lower educational attainment weakens our productivity. Economists agree that a better-educated workforce will be more productive. Education increases workers' base level of knowledge necessary for improved job performance. It increases workers' flexibility so that they are able to gain new skills throughout their lifetime. Many studies show the increased wages that accrue to more highly educated individuals.²⁷ And higher wages are the result of higher productivity.²⁸ Canada's population has, on average, a lower level of educational attainment

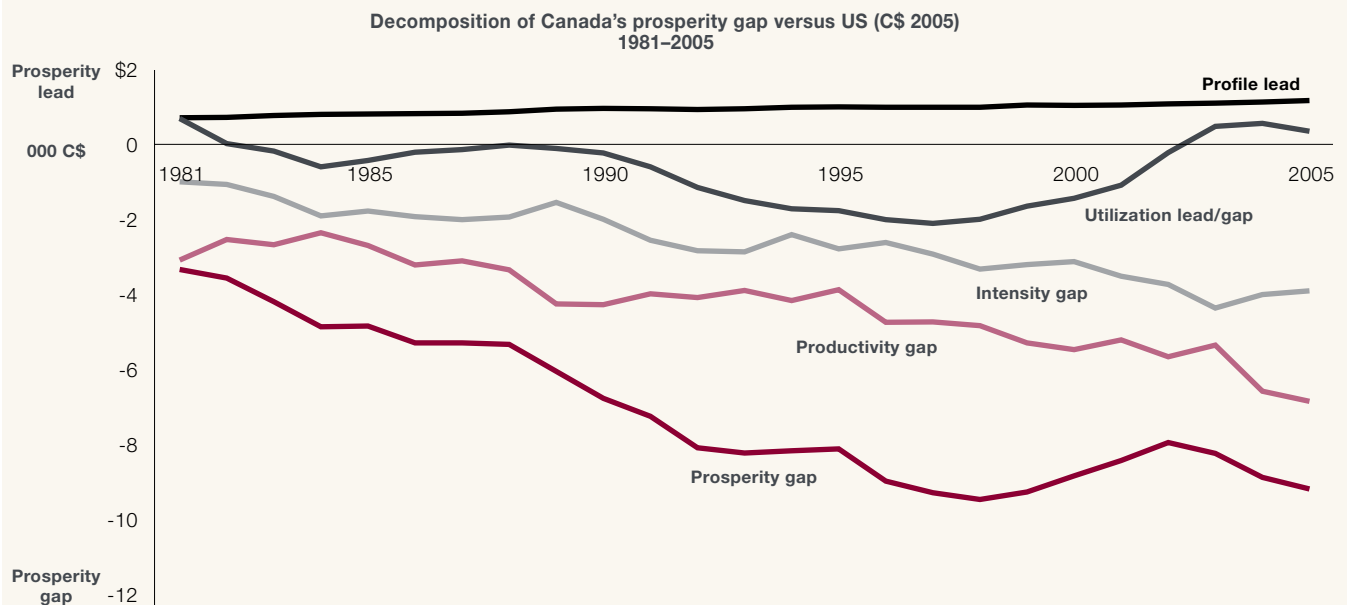
compared to those living in the United States, particularly at the university graduate level. Adjusting the mix of educational attainment in Canada to match the US mix and holding wages constant at each attainment level, Canada's productivity would be higher by \$1,800 per capita.

Under investment in capital lowers productivity. Canadian businesses have under invested in machinery, equipment, and software relative to their counterparts in the United States so that the capital base that supports workers in Canada is not as modern. As a result, Canadian workers are not as productive. We estimate this under investment in capital equipment lowers Canada's productivity by \$500 per capita. This estimate is based on

our simulation of Canada's GDP if we had matched the rate at which the US private sector invested in machinery, equipment, and software. For our estimate, we assumed that higher growth in this investment would translate directly into higher growth in GDP.

Research conducted by the Centre for the Study of Living Standards indicates that the primary source of this capital investment gap is in information and communications technology (ICT).²⁹ As we discuss later in this report, Canada's businesses invest about \$1,400 less per worker in ICT and \$900 less per worker in non-ICT machinery, equipment, and software.

Exhibit 10 Growing productivity gap drives Canada's prosperity gap



Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada; US Department of Commerce – Bureau of Economic Analysis; US Department of Labor – Bureau of Labor Statistics; US Census Bureau; OECD.

²⁶ See Task Force on Competitiveness, Productivity and Economic Progress, First Annual Report, *Closing the prosperity gap*, November 2002, p. 26 for a discussion of our methodology in measuring the productivity disadvantage resulting from our lower rate of urbanization.
²⁷ For example, see Ana W. Ferrer and W. Craig Riddell, "The Role of Credentials in the Canadian Labour Market," *Canadian Journal of Economics*, 2002 Vol. 35, No.4 and Statistics Canada, "Education and earnings," *Perspectives on Labour and Income*, 2006 Vol. 38, No. 03
²⁸ First Annual Report, *Closing the prosperity gap*, p. 27.
²⁹ Andrew Sharpe, "What Explains the Canada-US ICT Investment Intensity Gap?" Centre for the Study of the Living Standards, December 2005.

The residual is related to productivity.

We have been able to account for the impact of profile, utilization, and intensity on prosperity. We have also accounted for the effects of six elements of productivity. The \$1,200 per capita gap that remains is related to productivity on the basis of like-to-like cluster mix and strength, urbanization, education, and capital investment.

Productivity gap has more than doubled over the last decade

As we have seen, through most of the 1980s Canada's prosperity was close to that of the United States. During that period, we had a productivity and intensity disadvantage versus the United States – but our utilization advantage compensated for this. Our prosperity gap increased by 53 percent between 1988 and 1992. This increase was

driven mostly by our poor utilization performance, as both participation and employment worsened significantly with the recession. Our utilization problem began to dissipate around 1997, and by 2001 it was an advantage again. However, our productivity disadvantage began to grow in 1995, and by 2005 it had more than doubled. At the same time, our intensity gap continued to widen and contribute to the prosperity gap (*Exhibit 10*).

In broadening our frame of reference beyond the United States, we continue to see troubling productivity performance. Among the nineteen OECD countries with population of 10 million or more, Canada is a real laggard in productivity growth over the last twenty-five years (*Exhibit 11*). The economic growth we have been

achieving is due more to working harder – through increasing participation and employment rates – than to working smarter.

Despite Canada's enviable prosperity achievements, we can do better.

We lag most other large economies in achieving productivity growth. And against the most comparable economy, the United States, we are drifting ever further behind in competitiveness and prosperity. Doing nothing is not a worthy option. Canada needs to adopt an agenda that drives towards closing the prosperity gap.

Exhibit 11 Productivity growth in Canada has trailed most developed economies



Note: OECD countries with population greater than 10 million. Labour productivity is measured by GDP per hour worked; data for Czech Republic, Germany, Poland are from 1989–2005; growth rates are based on trend lines.

Source: Institute for Competitiveness & Prosperity analysis based on data from The Conference Board and Groningen Growth and Development Centre, Total Economy Database, September 2006. Available online: www.ggdc.net.

Agenda for Canada's prosperity

To invigorate the public debate on Canada's competitiveness and prosperity, we set out specific recommendations to raise our prosperity

OUR AGENDA FOR PROSPERITY builds from the AIMS framework that continues to guide our work. AIMS is built on an integrated set of four factors:

- Attitudes toward competitiveness, growth, and global excellence. Our view is that an economy's capacity for competitiveness is grounded in the attitudes of its stakeholders. To the extent that the public and business leaders believe in the importance of innovation and growth, they are more likely to take the actions to drive competitiveness and prosperity.
- Investments in education, machinery, research and development, and commercialization. As businesses, individuals, and governments invest for future prosperity they will enhance productivity and prosperity.

- Motivations for hiring, working, and upgrading as a result of tax policies and government policies and programs. Taxes that discourage investment or labour will reduce the motivations for investing and upgrading.
- Structures of markets and institutions that encourage and assist upgrading and innovation. Structures, in concert with motivations, form the environment in which attitudes are converted to actions and investments.

These four factors can create an ongoing reinforcing dynamic. That is, when AIMS drives prosperity gains, each one of the four factors would be reinforced. In an economy of increasing prosperity, attitudes among business and government leaders and the public would be more optimistic and welcoming of global competitiveness, innovation, and risk taking. Given these positive attitudes and the greater capacity for investment generated by prosperity, Canadians would invest more in machinery, equipment, and software and in education. Motivations from taxation would be more positive, as governments would not see the need for raising tax rates. And greater economic prosperity would encourage creativity and growth. Then, increased economic activity

would drive more competitive intensity. These developments would lead to even higher prosperity, which would further strengthen each AIMS element, and so on in a virtuous circle (*Exhibit 12*).

But this AIMS-prosperity dynamic could also create a vicious circle. Unrealized prosperity potential could create pessimism and concerns about competitiveness and innovation rather than openness to them. These less positive attitudes would be less conducive to investments, and reduced prosperity would also lead to fewer investment opportunities anyway. Unrealized economic potential means tax revenues would not meet fiscal needs, leading governments to raise tax burdens, thereby de-motivating investments. And reduced economic activity would create fewer nodes of specialized support and less openness to the public policies that would result in more competitive intensity.

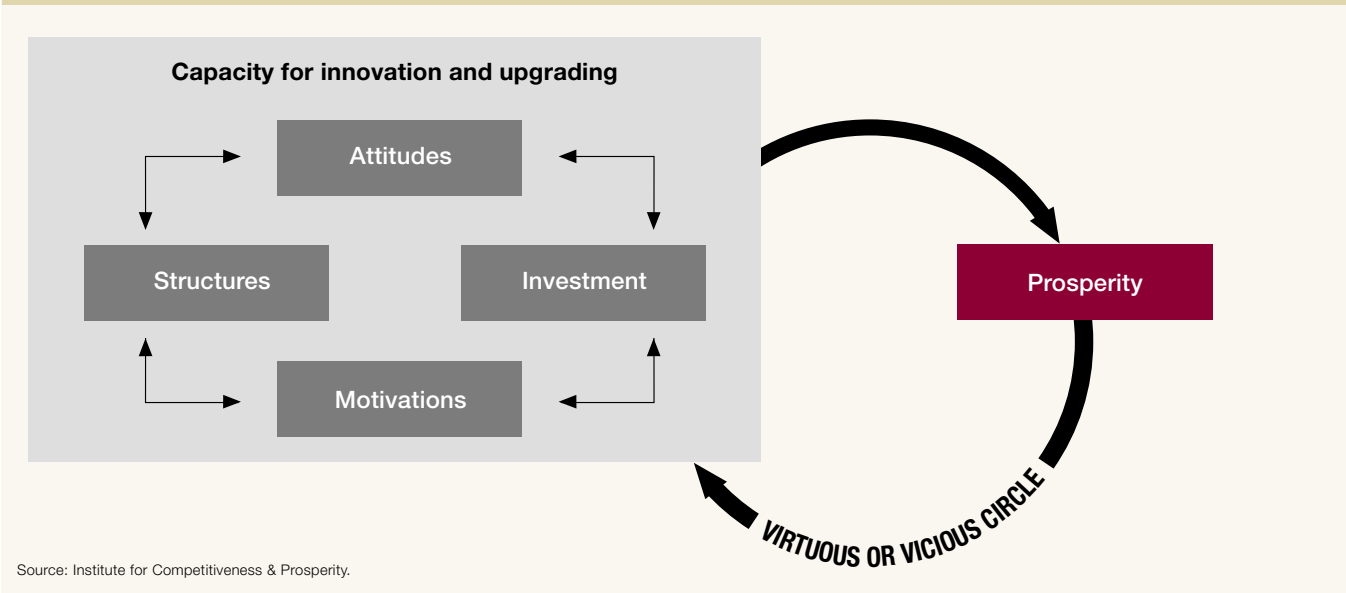
We are concerned that if we do not address our current challenges in under investment, de-motivating tax burdens, and inadequate market structures, we may be on the trail to a vicious circle. We must avoid this trend and ensure we maintain our economy on the virtuous circle track.

If we are to narrow the prosperity gap with the United States, Canadians need to take action. We need the leadership and the collective will to realize our prosperity potential. Our ultimate goal is to eliminate the prosperity gap. But we recognize this will take time and will not be easy. We think, however, that we can – and should – cut our prosperity gap with the United States to \$3,300 by 2020. To meet this challenge, our prosperity agenda covers the full range of our AIMS framework. In summary we need to shift our:

- current **attitudes** from collective complacency to a shared determination to close the prosperity gap
- balance of consuming today's prosperity toward **investment** for tomorrow's prosperity
- **motivations** by eliminating unwise taxation in favour of smart taxation
- market and governance **structures** from preserving the status quo to encouraging creativity and growth.

We need to embark on this agenda now. We recognize that the payoff in greater prosperity will not be seen next month or even next year. Closing the prosperity gap has to be a slow and steady process that all stakeholders are committed to for the long term.

Exhibit 12 **AIMS drives prosperity; prosperity drives AIMS**



Source: Institute for Competitiveness & Prosperity.

Attitudes: from collective complacency to a shared determination to close the gap

We need to raise the volume on the importance of the prosperity gap

CANADIANS ARE NOT INVESTING as aggressively as their counterparts in the United States. If we are to close the significant prosperity gap, we need to invest more for future prosperity, and that requires a more balanced approach to the consumption/investment tradeoff than Canada has today.

Canadians invest in the basic requirements for keeping our businesses and individuals competitive in the global setting. But after we spend our last investment dollar, our counterparts in the United States continue right on investing. We noted that this attenuation occurs in our investment in education – where our investment and attainment gaps widen at higher levels of education. We also noted that the shortfall occurs in private sector machinery and equipment investment, where our businesses invest heavily to a point but then stop, as their counterparts in the United States keep on investing 12 percent more. Our governments also stop short of the US governments' investments for future prosperity, preferring instead to consume current prosperity.

We seem to have a collective attitude that what we are doing to advance our competitiveness and prosperity is good enough. To be sure, our research into specific attitudes among the general public and business people identified a high level of convergence between

Ontarians and their counterparts in the peer states. In contrast to commonly held perceptions, we differ little from our counterparts in how we view business and business leaders, risk and success, and competition and competitiveness. In the attitudes research we conducted on Ontario and eleven of the province's peer states,³⁰ we found no differences in the attitudes toward risk taking and innovation or toward the importance and the causes of personal success. There is nothing to suggest that we would not find similar results if the sample were expanded across Canada and all the US states.

Our concern is that, if we continue to under achieve our prosperity potential, attitudes may shift so that Canadians no longer welcome competitiveness and innovation. Instead, they may retreat to an overall attitude of defeatism and preservation of our current level of prosperity – rather than welcoming change and the shared goal of fulfilling our prosperity potential.

We need to build on the currently positive attitudes among individuals and urge opinion leaders to raise the volume on the importance of the prosperity gap to all Canadians. Politicians, business leaders, educators, and individuals need to embrace issues such as the importance of prosperity and the need for a competitive economy. We need

to heighten our level of understanding about concepts like productivity. And the average working person should see that higher productivity means more jobs, better jobs, and higher wages.

We recommend that the Prime Minister present an annual message to all Canadians on how far we have progressed in closing the prosperity gap. We also urge business leaders and industry associations to identify opportunities for their firms and industries to make Canada more competitive and prosperous. For average Canadians, this means continuously pursuing opportunities to strengthen their skills and invest in their own and their children's prosperity. We need a shared determination to close the gap.

³⁰Institute for Competitiveness & Prosperity, Working Paper 4, *Striking similarities: Attitudes and Ontario's prosperity gap*, September 2003.

Investment: from consume today to invest for tomorrow

More investment is an imperative for higher prosperity

CANADA IS TRADING OFF spending more today against investing enough for tomorrow's prosperity. This is an issue for all Canadians. Our under investment is an important contributor to our persistent prosperity gap with the United States. Closing the gap will require businesses, individuals, and governments to invest more in our future.

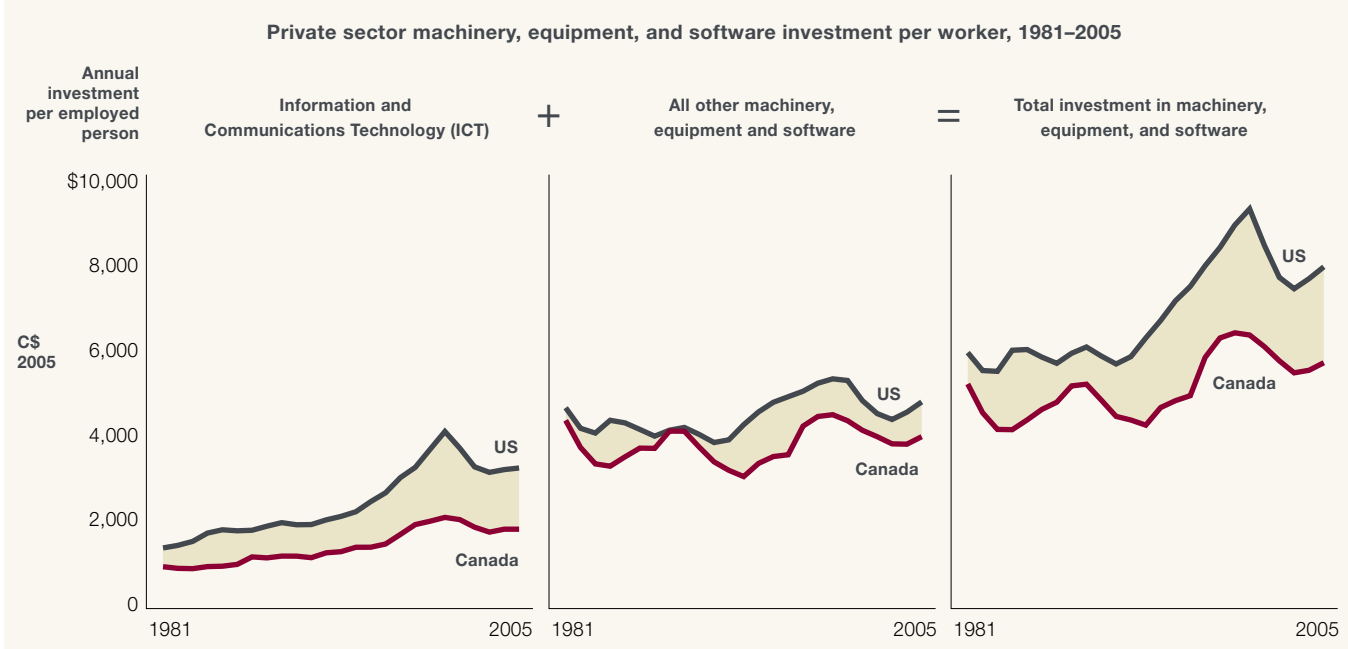
Increase investment in machinery and equipment, particularly information and communications technology

Since our first Report on Canada in 2004, *Partnering for investment in Canada's prosperity*, we have been urging business leaders to increase investment in machinery, equipment, and software. In this year's Report on Canada, we continue to make this recommendation. Every year,

Canadian businesses stop short of their US counterparts in making the critical investments in strengthening the productivity enhancing capital that supports their competitiveness.

Research conducted by Andrew Sharpe at the Centre for the Study of Living Standards has shed more light on this chronic under investment problem.³¹ His research concludes that the real challenge facing Canadian businesses is the under investment in informa-

Exhibit 13 Canadian businesses under invest to support their workers' productivity



³¹Andrew Sharpe, "What Explains the Canada-US ICT Investment Gap?"

tion and communications technology (ICT), rather than the traditional under investment in non-ICT machinery and equipment (*Exhibit 13*). In year 2005, new investment in ICT per worker by the United States was \$3,200 compared to \$1,800 per worker in Canada. Canadian businesses also under invest in non-ICT machinery, equipment and software – \$3,900 per worker in 2005 versus \$4,800 in the United States. In total, new investment by businesses in all machinery, equipment, and software was \$5,700 in 2005 versus \$8,000 for a gap of \$2,300. The annual gap in new investment per worker has ranged from \$2,000 to \$3,000 over the last decade.

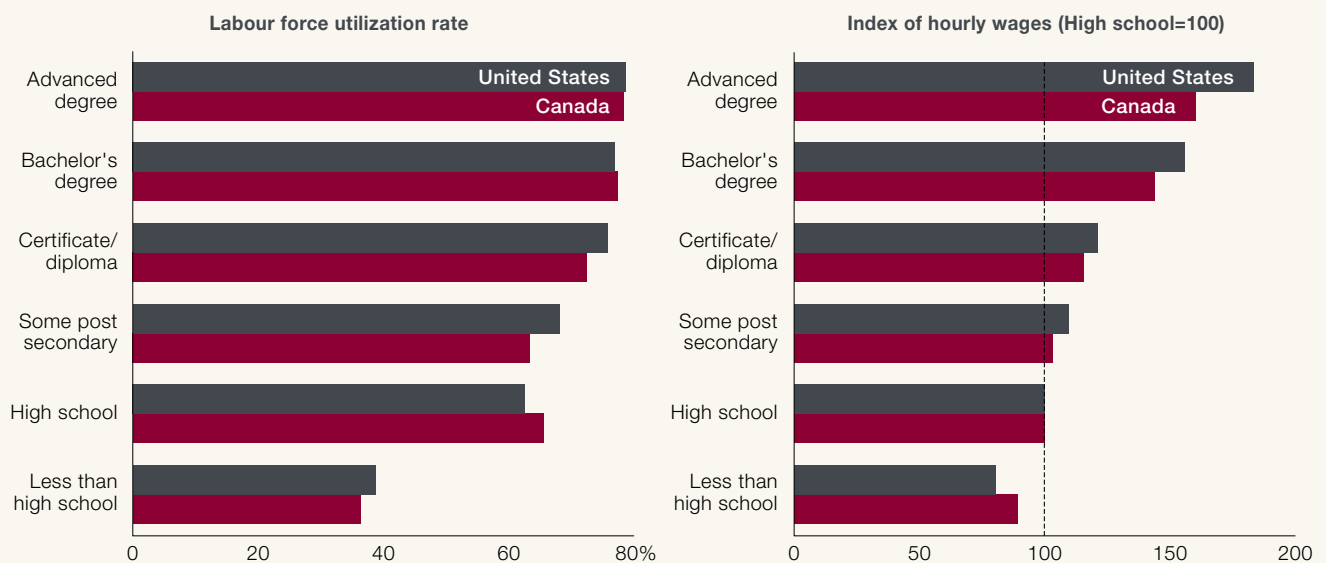
We urge business leaders and industry associations to consider opportunities for closing this investment gap. We recognize that business leaders cannot simply decide to increase their investment. Some of this gap is the result of high taxes on business investment and market structures that provide inappropriate support and pressure, but some is simply the result of short-sighted management decisions. As business leaders and industry associations lobby governments for changes in taxation and regulations, they ought to make commitments to closing the investment gap in exchange as part of the resulting benefit for Canadians.

Encourage Canadian youth to invest in their education

As we have seen, Canada's productivity is reduced by lower educational attainment here than in the United States. We have continued to recommend that young Canadians get as much education as possible, so they can contribute more to their own and the country's prosperity. The importance of education cannot be underestimated (*Exhibit 14*).

In 2006, former New Brunswick Premier Frank McKenna reinforced our recommendation. He was speaking at an event where The Learning Partnership was honouring him. The Partnership is a national not-for-profit organization dedicated to bringing together business, education, government, labour, policy makers, and the community to develop partnerships that strengthen

Exhibit 14 Higher educational attainment increases prosperity



Note: Utilization defined as a percentage of population 15 years and over.

Note: Education premiums obtained from linear regressions using microdata for the period 1997–2004 and controlling for demographic, state or province, and year effects.

Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada – Labour Force Survey; U.S. Bureau of Labor Statistics – Current Population Survey.

public education in Canada. His remarks set out the important reasons for raising educational attainment of all Canadians:

So my point very simply is if we get the education element right, the healthcare, highways, municipalities are all going to be better funded and we're going to be better off as a nation....

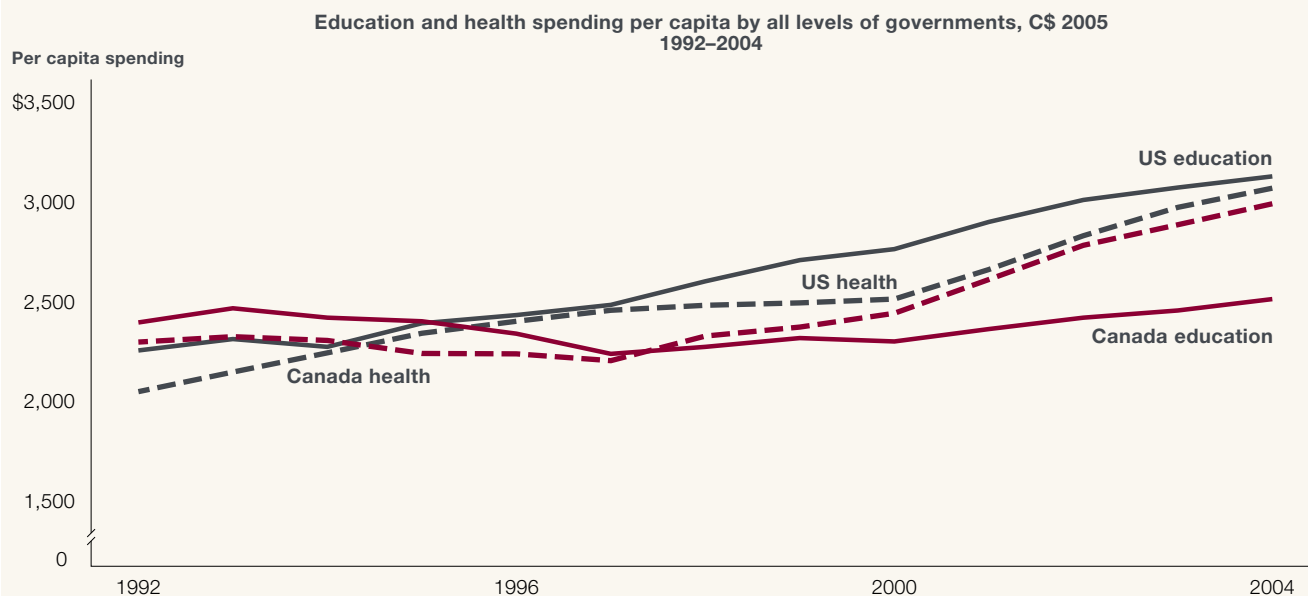
The connection is so intensely visible that there is no excuse in the universe as to why we don't properly fund the badly needed programs in education....

A Chinese proverb ... cuts to the heart of it: "If you're planning for one year, goes the proverb, grow rice, if you're planning for 20 years, grow trees, but if you're planning for centuries you grow men."³²

The evidence from a prosperity perspective is pretty striking – higher educational attainment increases attachment to the labour force and raises earnings. In addition, as we have seen, the Institute's research into differences in hours worked between Ontarians and their peer counterparts also shows the importance of education. A major part of our intensity gap is related to involuntary part-time employment, and this affects those with less education more frequently.

Some provinces have taken the lead in encouraging higher high school completion rates. In 2000, New Brunswick raised the mandatory schooling age from 16 to 18. In 2006, the Ontario government passed a new law that requires Ontario youth to stay in school until age 18 or graduation, up from the previous age of 16. Many other provinces are aware of the challenges of keeping their youth in school and have started initiatives to improve high school completion rates.

Exhibit 15 Public spending on education in Canada lags US spending



Note: US health spending includes workers compensation, medical benefit outlays and excludes administrative and other costs; Canada health spending includes all workers' compensation. Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada; US Census Bureau – State and Local Government Finances; Office of Management and Budget – Historical Tables; National Academy of Social Insurance, *Workers' Compensation: Benefits, Coverage, and Costs*, 2004, July 2006.

³²Remarks given by the Honourable Frank McKenna at The Learning Partnership's 2006 Tribute Dinner, Toronto, April 27, 2006. Available online: www.thelearningpartnership.ca/tributedinner2006-McKenna.html

Rebalance government spending away from consumption to investment

Our governments also need to re-orient their spending so that we invest more for future prosperity and consume less current prosperity. To meet the quest for higher prosperity, we continue to urge them to increase investment in areas such as post secondary education, machinery, equipment and software, housing and transportation.

Our research has shown that the Canadian government continues to shift away from investment in future prosperity towards consumption of current prosperity.³³ The clearest indication of Canada's balance between consumption and investment can be seen by contrasting trends in per capita expenditures on health care and education. Governments in both countries spend remarkably similar amounts on health care – \$2,900 per capita in Canada and \$3,000 in the United States in 2004. Trends in both countries have also been similar. Clearly public policy and programs are responding to similar needs and pressures in the two countries.

However, we have chosen a distinctly different path in our approach to public investment in education. In 2004, governments in Canada invested \$2,400 per capita in education, fully 20 percent below the US public investment of \$3,000 (*Exhibit 15*). The trend line clearly indicates that Canada fought its deficits by attacking education spending; in the United States, per capita education spending by governments has been growing at a 3.3 percent annual rate since 1993, while Canada's growth rate has been 0.2 percent.

Consumption of current prosperity through spending on adequate social safety nets and accessible health care has to be the first priority for government spending; but it is not the only priority. Why? Because, over consuming today at the expense of investment reduces our potential for future consumption of these vital services.

Canadian governments' inability to match the US investment spending limits our progress in raising productivity. Our federal, provincial, and municipal governments must find ways to reorient spending to reverse a decade-long choice of the consumption path instead of the investment path.

³³Institute for Competitiveness & Prosperity, Report on Canada 2006, *Rebalancing priorities for Canada's prosperity*, March 2006, p. 34-35.

Motivations: from unwise taxation to smart taxation

A smarter taxation system will encourage higher productivity and prosperity

WE DEFINE MOTIVATIONS as the impact of tax policy on decisions of individuals and businesses to work and to invest. The Institute continued its research in this area through this past year. Our findings indicate that a prosperity agenda has to include a smarter tax system that will encourage investment for prosperity.

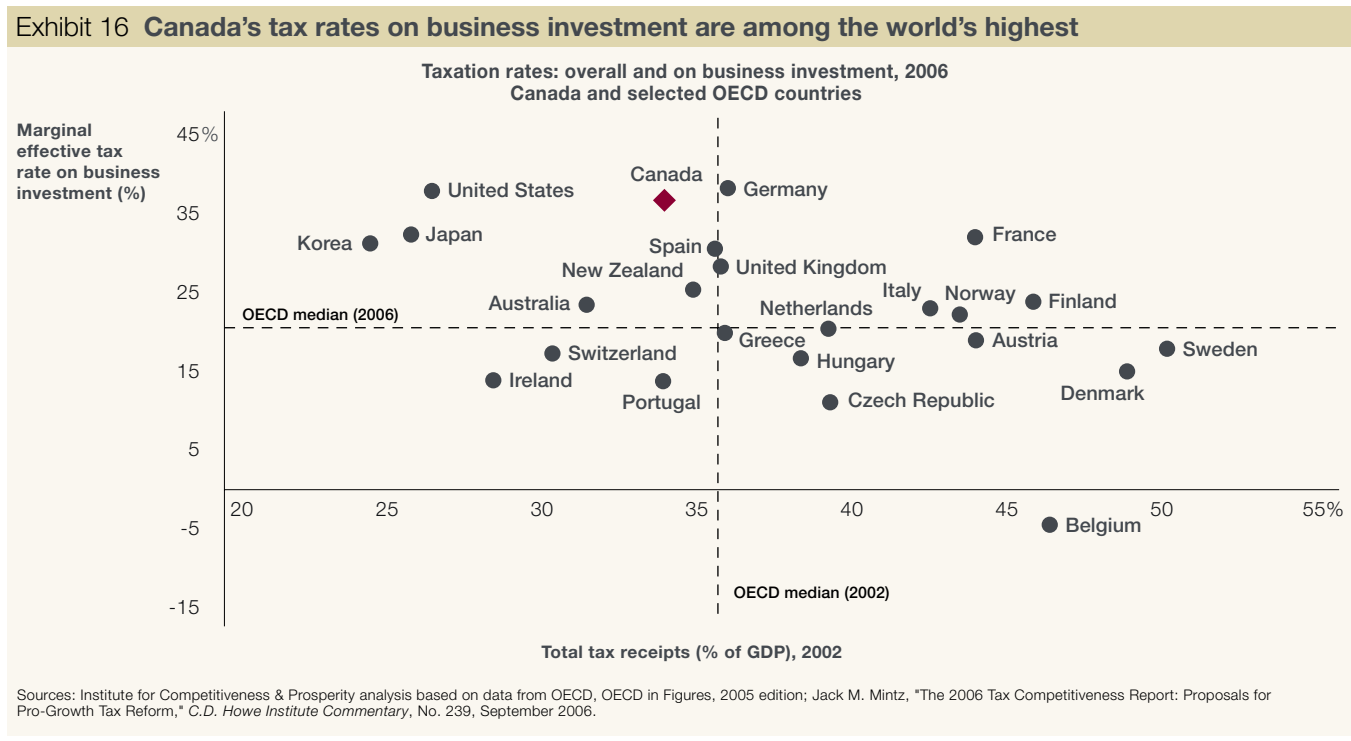
The real improvement opportunity in our tax system is not the levels of taxation, but the types of taxation. Our system in Canada is not as smart as it could be,

if we are to close the prosperity gap. We need to shift away from taxing business investment and towards taxing consumption. We also need to find ways to reduce perversely high marginal tax burdens on low income Canadians as they climb the economic ladder.

Canada's tax system results in high tax burdens on business investment relative to nearly all other countries. On a positive note, in 2006, marginal tax burdens on business investment in Canada

dropped to 36.6 percent from 39.1 percent in 2005. This lowered Canada's position in the ranking of tax burdens among OECD countries from the worst to the third worst, below Germany and the United States (*Exhibit 16*). In fact, US rates increased in 2006 with the expiry of accelerated depreciation.³⁴

When we compared levels and smartness of taxation systems across the twenty-four OECD countries, we found that we have one of the least



³⁴Jack Mintz, "The 2006 Tax Competitiveness Report," C.D. Howe Institute Commentary, No. 239, September 2006.

intelligent tax systems for business investment. Some countries, like Ireland, have both low rates of taxation overall and low marginal rates of taxation on business investment. Others, like Sweden and Denmark, have high rates of taxation overall, but low marginal rates on business investment. Canada's rates of taxation overall are below the OECD median, but the marginal effective tax rate on business investment is among the highest. Marginal tax rates on business investment are slightly lower in Canada than in the United States. But the United States has lower taxation rates overall. Other than its high rates of taxation on business investment, it has an environment that is perhaps the most conducive to investment in the world. Our unwise tax system would be even more of a liability to our economic performance if the United States ever did address its own unwise tax system by bringing down tax rates on new business investment.

Some countries, such as the Czech Republic and Ireland, have driven down tax rates on business investment to less than half of Canada's rate. Belgium has now achieved negative tax on business investment. In 2006, its government introduced a deduction for the cost of equity. As a result, the present value of deducting depreciation, inventory costs, and the new equity cost allowance exceeds the ultimate tax paid on income from a new investment.³⁵

It is tempting for governments in Canada to declare victory on this front now that US taxes on business investment have risen above ours. But a prosperity agenda still has to address Canada's global weakness in taxing business investment. Canada's effective

tax rate on business investment is still among the highest in the world.

Canada's high tax rates on tangible business investment may explain why our generous tax credits on intangible investments in research and development (R&D) are relatively ineffective in spurring on business R&D. An important element of business decision making is the ultimate cost of commercializing R&D. In a recent paper, Kenneth Mackenzie describes the two types of tax policy as "push" – tax incentives for R&D – and "pull" – tax rates on the business investment to realize the fruits of the R&D. His empirical work across nine developed countries' manufacturing sectors shows that, while both are important predictors of R&D intensity, "pull" taxes have a greater impact. As Mackenzie concludes:

The obvious implication of this result is that, when considering tax policy in the context of R&D, federal and provincial governments need to consider the effect not only of direct tax subsidies on R&D but also of the overall tax regime. More precisely, failing to take account of both effects might result in governments giving with one hand and taking away with the other: encouraging R&D by offering direct tax subsidies, which lower the cost of undertaking research, but discouraging R&D by imposing high production taxes on the new products and processes that are the fruits of R&D.³⁶

So, despite a modest and potentially temporary advantage in effective tax burdens over the United States on business investment, we urge the provincial and federal governments to establish a smarter tax system to help secure a

global advantage for Canada in business investment. The November fiscal update by the federal Department of Finance indicated a goal of achieving for Canada the lowest marginal effective tax rate on business among the Group of Eight industrialized nations. This is a worthwhile target.

This goal is consistent with work done by the federal Department of Finance indicating that, relative to taxes on consumption, taxes on business and personal investment work against prosperity and economic well being. The Department modeled the impact of several different tax policy changes. To measure the benefit of each change, the Department used a measure referred to as "economic well being." This measure captures the increased potential for consumption or leisure from replacing a specific tax with other taxes. The Department's ranking shows the benefit for each dollar of tax reduction. For example, a \$1 reduction in personal income taxes paid would result in a 30 cent increase in economic well being for the average Canadian (*Exhibit 17*). This is a net benefit, since the analysis accounts for raising the lost revenue in other ways.

The ranking in the Department's analysis shows that the greatest impact on the economic lives of ordinary Canadians would come from reductions in taxes paid by businesses on their investments – through reducing the provincial sales taxes on capital goods or increasing the rate at which businesses can write off their investments in new capital under the capital cost allowance.³⁷ Reducing corporate capital taxes and income taxes would also be beneficial to Canadians' economic well being. Reductions in taxes on consumption,

³⁵*Ibid.*, p. 14.

³⁶Kenneth J. Mackenzie, "Giving with One Hand, Taking Away with the Other," *CD Howe Institute Commentary*, No. 240, October 2006, p. 8.

³⁷Institute for Competitiveness & Prosperity, Working Paper 7, *Taxing smarter for prosperity*, March 2005, pp. 44–48.

especially sales taxes, have the least impact on people's well being. This paradoxical result comes about because shifting taxation from business investment to consumption expenditure will increase the rate of return on business investments, such as machinery, equipment, and software. With greater returns, businesses will make more investments. Higher levels of investment help workers be more productive, and this increases wages. Higher levels of investment also create more jobs.

The Institute modeled the impact of these types of taxation shifts on Ontario's prosperity and found results consistent with those of the Department of Finance.³⁸ The research done by us and others points to a series of recommendations for making our tax system smarter in encouraging business investment.

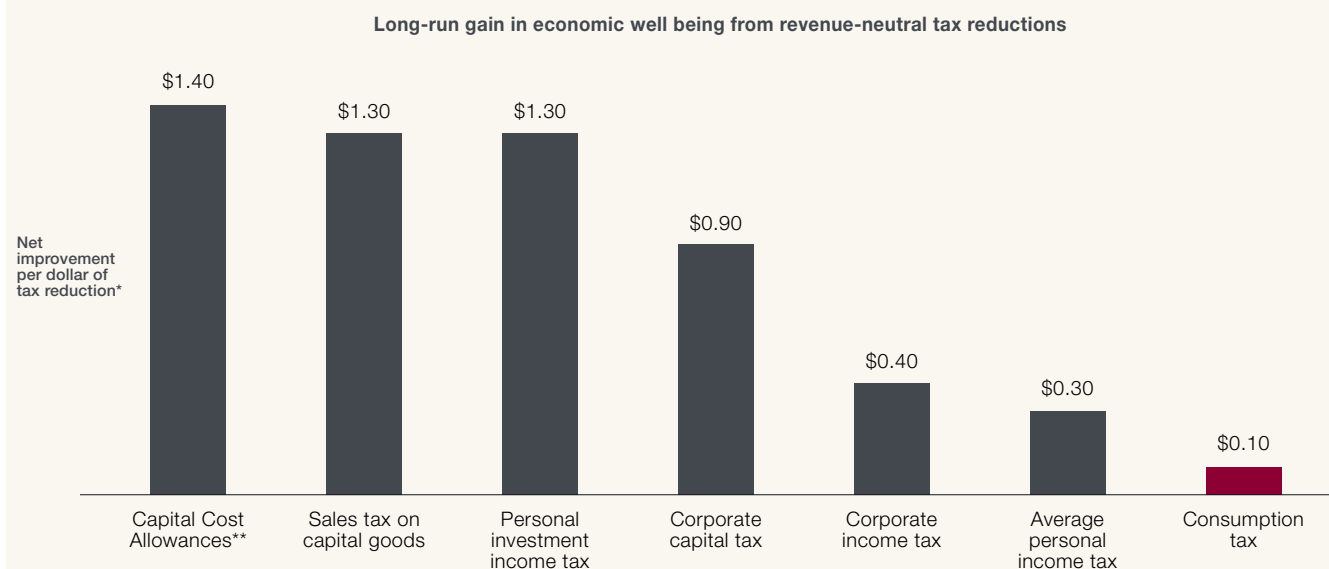
Eliminate or reduce corporate capital taxes immediately

The first improvement opportunity is to eliminate provincial taxes on existing business capital. They are particularly damaging to investment, because they are levied even if the business is not profitable. Few other advanced economies levy business capital taxes. On a positive note, the federal government eliminated its corporate capital tax in 2006. But six of the provinces have capital taxes on non-financial corporations.³⁹ Ontario will begin cutting its capital tax in 2007 and intends to eliminate it by 2012. Quebec intends to cut its capital tax in half by 2009, and Manitoba also plans to reduce its capital tax beginning in 2008.⁴⁰ These taxes should be eliminated now.

Replace provincial sales tax with a value added tax

The second opportunity is to reform provincial sales taxes on capital goods, which are levied in Ontario, British Columbia, Saskatchewan, Manitoba, and Prince Edward Island. While most people regard the provincial sales tax (PST) as a retail tax aimed at personal consumption, it also applies to many items for capital investment – such as steel for construction and office equipment. These taxes raise the overall prices to businesses making capital investments and reduce the returns they earn on those investments. Currently, some exemptions are in place, but these provinces should move toward a broad-based value-added tax covering goods and services, such as those in Quebec and three Atlantic provinces.⁴¹ Modeling done for the

Exhibit 17 Reductions in taxes on investment are more effective than reductions in taxes on consumption



*The revenue losses from reductions in specific taxes are matched through an increase in lump-sum taxation.

**The economic well-being gain for Capital Cost Allowances represents the gain from increasing the Capital Cost Allowance in line with economic depreciation.

Source: Canada, Department of Finance, "Taxation and Economic Efficiency: Results from a General Equilibrium Analysis" in *Tax Expenditures and Evaluations*.

³⁸*Ibid.*, pp.43-48.

³⁹Alberta has no capital tax. British Columbia, PEI, and Newfoundland have capital taxes on financial institutions, but not general corporations.

⁴⁰Duanjie Chen and Jack Mintz, "Business Tax Reform: More Progress Needed."

⁴¹Jack Mintz, "The 2006 Tax Competitiveness Report."

Institute in our taxation research shows this to be the most powerful prosperity generator of the tax changes we considered.⁴²

This shift could be tied in to the ongoing debate around fiscal federalism. It is clear that increases in the federal GST are not likely in the coming years irrespective of which party forms the government – even though most tax and prosperity researchers agree that it should be increased. It may be opportune for the Canadian provinces to propose that the GST be made a provincial tax and in return the federal government could take over another tax – perhaps the corporate income tax.

Increase capital cost allowances to be consistent with economic depreciation

As we discussed, the Department of Finance modeling indicates that aligning capital cost allowance (CCA) rates to be more consistent with the true economic life of assets would improve the average Canadian's well being. Currently, tax rates on business investment⁴³ are higher than they would be if CCA rates were aligned. Our tax research in Ontario indicated that increasing CCA rates on new investments would increase GDP per capita at the lowest cost to the public treasury.

Lower perversely high marginal tax rates for individuals

While most of our taxation recommendations aim to increase business investment, we continue to urge governments to address the high marginal tax rates imposed on individuals and families trying to scale the economic ladder or retire comfortably. The marginal effective tax rate is the effective tax rate paid on the next dollar of income. Because of clawbacks of income-tested government transfers, the effective tax paid by individuals and families at relatively low income levels is very high. For example, a single-earner family of four faces a marginal effective tax rate of 60 percent shortly after taxable income passes \$31,000. This is the result of losing access to transfers, such as the child tax credit. In other words, because of clawbacks, these families are keeping only 40 cents of each new dollar they earn. At \$36,000 the marginal rate climbs to an absurd 90 percent.⁴⁴

We have made recommendations in the past on how to address these perversities in the tax and benefit system. These include federal and provincial collaboration to better integrate benefit and tax design, so that high marginal tax rates can be smoothed out. This would reduce the basic personal allowance, thereby lowering marginal tax rates, and would lower taxation on savings and personal investment income to alleviate high marginal tax rates among seniors.

Assess bold new approaches to taxation

In addition to these recommendations, we urge governments in Canada to explore some fundamental reforms in our tax system. We have presented options for consideration in the past, and we continue to urge governments to explore some breakthrough tax policies.

Convert corporate tax to cash flow basis

Under the current system of corporate income taxation, firms are allowed to depreciate the costs of capital investment over time as well as to deduct the interest cost of financing the investment. With a cash flow tax, a firm's taxes essentially would be based on its cash receipts less its cash expenditures; in years when a large capital expenditure was made relative to sales revenue, taxes paid would be relatively low. We recognize that this approach would require elimination of interest deductibility as well as reforms in the personal income tax system. Nevertheless, it would simplify tax accounting and potentially increase business investment.

Eliminate corporate income taxes

However beneficial our other recommendations on corporate taxes could be, eliminating the corporate income tax could be a much more innovative approach to increasing productivity and prosperity. A corporation's taxes are actually paid by its workers, whose wages are lower than they would otherwise be; by its

⁴²Institute for Competitiveness & Prosperity, Working Paper 7, *Taxing smarter for prosperity*, March 2005.

⁴³See *ibid.*, p. 19 for a discussion of how capital cost allowances affect the timing of taxes paid, not the level.

⁴⁴*ibid.*, pp. 36-37.

customers, who must pay higher prices; and by its shareholders, including pension funds and mutual funds in their registered retirement savings plans (RRSPs). Eliminating corporate income taxes has the potential to enhance prosperity by increasing wages, lowering prices, and increasing investment returns. Governments in Canada should explore this fundamental shift to a potentially smarter tax system.

Base personal taxation on lifetime earnings

Our system currently taxes individuals on the basis of one-year slices of their life. Assessing income taxes on the basis of lifetime earnings, rather than annual earnings, is potentially far better for Canada's poor and enhances prosperity for all Canadians. Income would be calculated cumulatively rather than annually; instead of giving individuals an annual personal allowance of tax free income, the system would give a lifetime exemption. This exemption would be set at five to ten years of average income – say \$250,000. Any income beyond this would be taxed at a base rate until the individual reached the next cumulative income level, when rates would rise again.

With a system based on lifetime earnings, poor Canadians would be dramatically better off and have even better prospects for advancement. For years, even decades for lower wage earners, they would face a zero marginal tax on work, savings, and investment. A critical element of the lifetime earnings approach is to disentangle social benefits from the tax system, so that we can provide assistance to those in need without complicating the income tax system and creating perversely high marginal tax rates for low income people.

A shift to a smarter tax structure will promote job creation, higher business investment, more innovation, and more rapid adoption of new technologies. An agenda for prosperity needs to include new approaches to taxation in Canada.

Structures: from preserving status quo to encouraging creativity and growth

Changing some of our market and governance structures will drive our capacity for innovation to increase Canada's future prosperity

IN OUR MARKET STRUCTURES we have found that, relative to their US counterparts, our businesses benefit from good general support in areas such as infrastructure and a sound primary and secondary education system. In areas of more specialized support – such as people with advanced degrees and formal business education and close collaboration between researchers and business – our businesses trail their US counterparts. Our businesses also benefit less from the positive effects of competitive pressure from customers and rivals. Consequently, our business strategies are not adequately based in innovative products and processes.

Our governance structures, as represented by Canada's fiscal federalism framework, are costly to Canada's prosperity with benefits to Canada's overall competitiveness and prosperity being hard to discern. This is especially true with the Employment Insurance system. We recommend important changes that will increase prosperity.

Increase specialized support

Our agenda for prosperity includes two high leverage improvements to specialized support – improving the quality of venture capital, and enhancing the quality of business management through formal business education.

Continue to improve the quality of venture capital

In their attempt to strengthen our innovation capabilities, governments have too often focused on increasing the quantity of resources available to innovative startups, rather than the quality. Specifically, several funding programs provide support for raising venture capital through generous tax credits, help for startups, technology partnerships, and networks of centres of excellence.

Our real challenge is to improve the quality of our venture funds. As we have shown, venture capital investment returns in Canada have usually been dismal relative to the US results (*Exhibit 18*).

There are many factors behind the poor returns. We have seen the negative influence of Labour Sponsored Investment Funds (LSIFs). These vehicles are designed to attract funds from small investors through generous tax credits and limits to annual contributions. In addition, governments that provide these tax incentives often restrict the type, geography, and timing of investments.

In 2005, LSIFs accounted for 54 percent of all venture capital raised in Canada, and 31 percent of venture funds invested. But returns on investments have been terrible. Recent data show that the median three-year return on a labour-sponsored fund is 3.3 percent, while the median three-year return on Canadian small-cap equity is 15.1 percent.⁴⁵ On various investment horizons – from one to ten years – labour-sponsored fund returns trail.

Some are concerned that eliminating favourable tax treatment for LSIFs, as is currently underway in Ontario, would create a shortage of venture funds for Canada's innovative startups.⁴⁶ Yet, some research finds that LSIFs "have so energetically crowded out other funds as to lead to an overall reduction in the pool of venture capital."⁴⁷

An alternative source of venture capital funding in Canada is US-based venture firms. In fact, venture funding from the United States accounted for about a quarter of total venture funding in Canada since 1999.⁴⁸ In 2005, the Institute engaged Thomson Macdonald, the authoritative source of information on Canada's venture capital industry, to conduct research among some of the key US venture firms investing in Canada.

⁴⁵ Fund Report as at December 31, 2006, Bell Globemedia Publishing. Available online: www.globefund.com

⁴⁶ See for example, "End of the line," by James Bagnell, Canada.com. Available online: www.sandvine.com/news/article_detail.asp?art_id=557

⁴⁷ Douglas J. Cumming, Jeffrey G. MacIntosh, "Crowding Out Private Equity: Canadian Evidence," University of Alberta Working Paper 2003.

⁴⁸ Thomson Macdonald, *The Activity of American Venture Capital Funds in the Ontario Market: Issues, Trends and Prospects*, A report prepared for the Institute for Competitiveness & Prosperity, November 2005, p.8. Available online: www.competeprosper.ca

US venture firms are attracted by Canada's good technology and skilled workforce, the low cost of doing business, and a good network of Canadian venture capital firms with whom they can partner. Canada's proximity is an advantage.

But the Thomson Macdonald study concluded that cross-border tax treatment is an important barrier. The Canada Revenue Agency does not allow Limited Liability Corporations to qualify for the preferential tax treatment in the Canada-US Tax Treaty. This interpretation reduces the potential financial return from capital gains and from interest and dividend payouts to US investors and, for some, this interpretation may be "a very serious challenge to their continued activity in the Canadian market."⁴⁹ We encourage the provincial governments and the venture industry to take the lead

in raising these issues with the appropriate federal tax authorities to revisit the interpretations of the existing tax treaty.

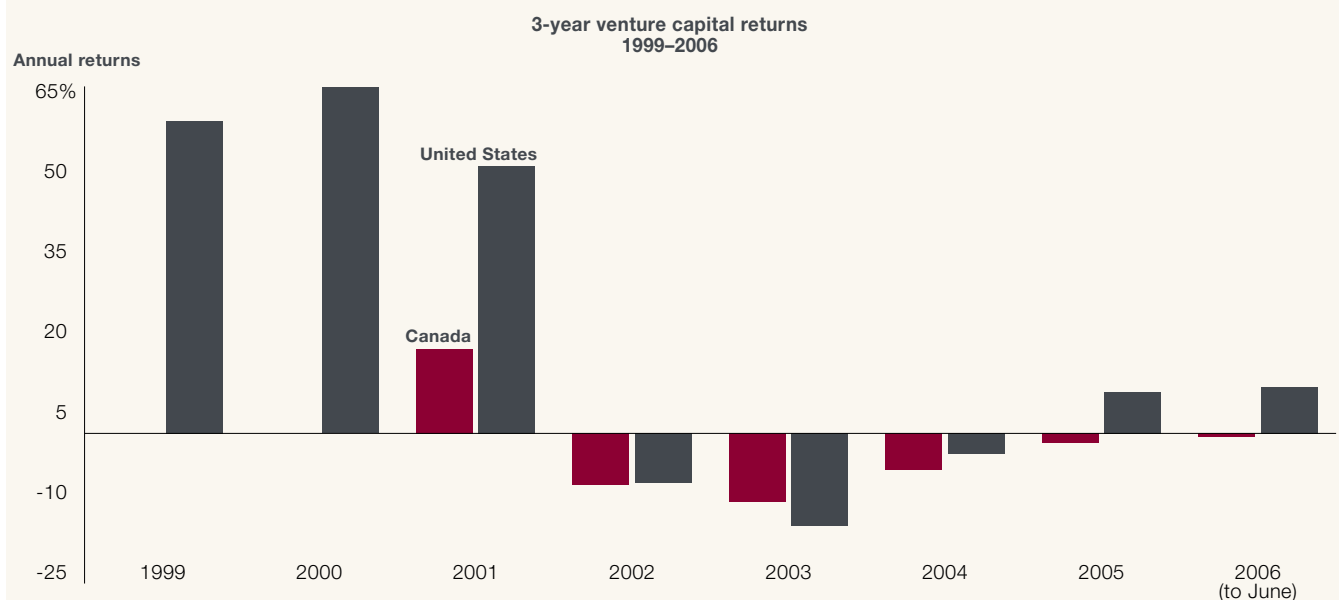
This is an important opportunity, because US venture firms can help raise the quality of financing of innovation in Canada. These firms can bring experience and expertise gained in their home market to add significant value to our fledgling innovative firms.

In other research conducted by the Institute, we found that successful Canadian startup firms were critical of the breadth and depth of support they received from their venture capital investors. Survey responses indicated that venture capitalists were not important sources of advice or experience in providing information on the relevant industry or global markets, assistance in building the company or supplying

management expertise, or in adding value to product development.⁵⁰ We cannot be certain that successful US startups would be as critical of their venture capital providers. Certainly, the standard expectation of the value added by a venture capitalist is more than monetary.

The net effect of Canada's support for innovation financing is that we finance many small deals in Canada – and that these may be too small. The average investment per Canadian company by Canadian venture capitalists was about \$5 million over the 2001–05 period. At the same time, foreign (primarily US) venture capitalists invested an average of \$13 million per company when they invested in Canada. In the United States, venture capital investment averages about \$11 million per company (*Exhibit 19*).

Exhibit 18 Venture capital returns in Canada have been dismal



Note: All US returns are "Net"; Canada returns are "Gross" for 2001–2004; Canada returns are not available for 1999 and 2000. Gross returns are before subtraction of management costs and expenses.
Source: Institute for Competitiveness & Prosperity analysis based on data from Canadian Venture Capital Association, *Performance Study 2001–2006*; Venture Economics – Venture Xpert.

⁴⁹*Ibid.*, p. 31.

⁵⁰The Strategic Counsel, *Assessing the Experience of Successful Innovative Firms in Ontario*, September 2004, Research conducted for the Institute for Competitiveness & Prosperity. Available online: www.competeprosper.ca

Sub-scale deals in Canada may mean that our venture capitalists cannot build sufficient expertise in industries or in companies they are investing in. It may also mean that by making fewer big bets and more small bets they are not forcing themselves to analyze the investments more thoroughly. And it can also mean that our innovative firms with real success potential are being starved for venture funding.

Canada's still young venture capital industry lacks the pressure of a long track record of good returns, consistently applied valuation standards, private equity products, and industry information. Breakthroughs in financing for innovation and commercialization need to come from broadening and strengthening the quality of support provided by venture capitalists to innovative startup firms. And creating the

environment for Canadian pension funds and US venture funds to invest in innovative startups thereby ratcheting up the pressure to upgrade their quality will generate better results. An agenda to enhance the quality of venture capital in Canada has to include elimination of labour sponsored funds as soon as possible and removal of public programs or incentives that result in sub-scale investments in Canada.

Increase business education

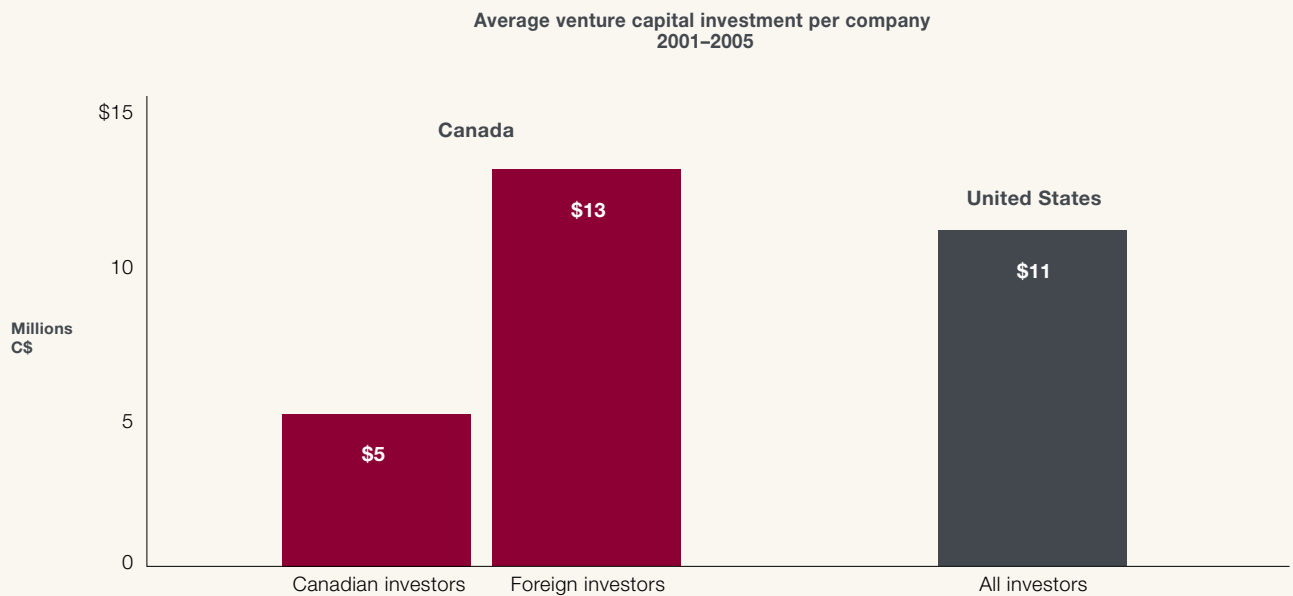
A recurring theme in our work has been the lack of management sophistication in our businesses in Canada. Our previous research indicates that:

- Our managers have lower educational attainment overall and in business education specifically;⁵¹

- CEOs of our largest corporations tend less to have formal business education at the graduate level;⁵²
- A key challenge for growing innovative firms is having access to management talent.⁵³

If the link between education and innovation can be drawn, it is quite apparent why we are less innovative in Canada. The more educated managers are, the more likely they are to think innovatively and strategically and to operate more effectively. The lower education level of our human capital resources means that we are less able to compete in a technology-based knowledge economy, and less capable of serving sophisticated and demanding customers in the global marketplace.

Exhibit 19 Canada's venture capitalists make smaller investments than US counterparts



Note: Location of portfolio company receiving investment.
Source: Institute for Competitiveness & Prosperity analysis based on data from Thomson Macdonald – VC Reporter (Canadian data); Venture Economics – Venture Xpert (US data).

⁵¹ Report on Canada 2006, *Rebalancing priorities for Canada's prosperity*, March 2006, p. 30.
⁵² Report on Canada 2005, *Realizing Canada's prosperity potential*, p. 19.
⁵³ Report on Canada 2006, *Rebalancing priorities for Canada's prosperity*, p. 46.

A key factor in the shortage of managerial talent for leading innovation and commercialization in Canada's firms is the lack of investment in business education. Our universities produce only 59 business graduates per capita for every 100 in the United States (*Exhibit 20*). Analysis coordinated by the Institute and performed by Ontario's Ministry of Economic Development and Trade shows that it is more difficult to gain entry into an Ontario business program than into an engineering or arts and sciences. The challenge is to increase the supply of spaces. We encourage provincial governments and universities to work together to increase opportunities for more Canadians to pursue university education in business; an education they want, but whose access is limited.

Strengthen competitive pressure

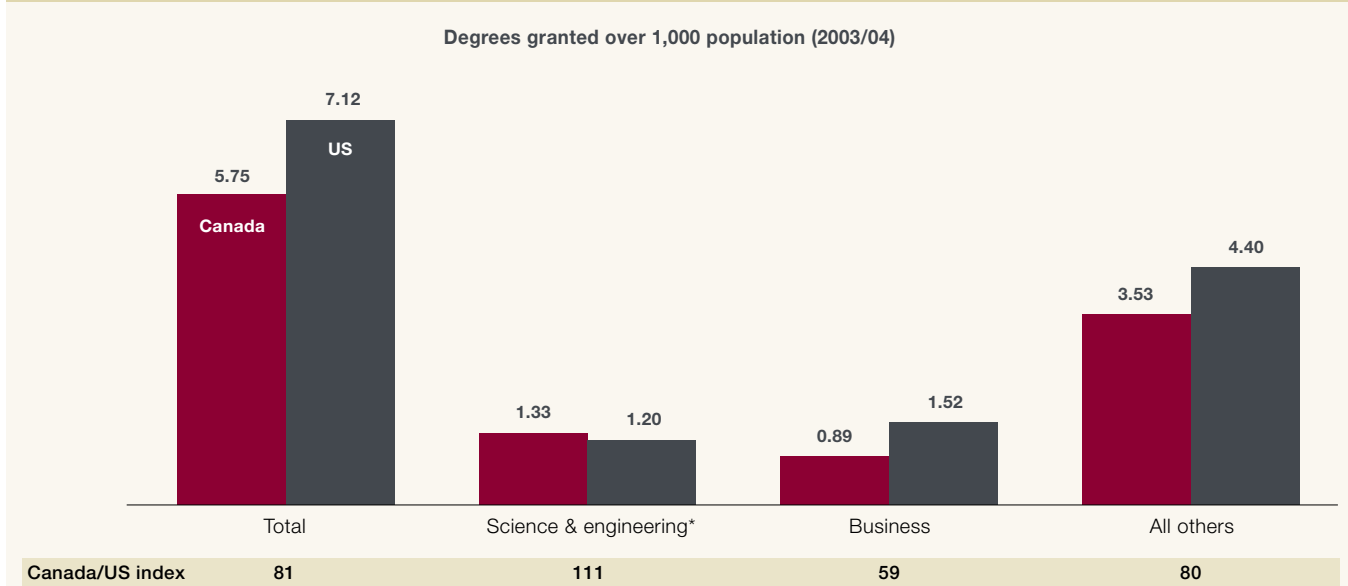
In our research, we have identified the relatively low level of competitive pressure versus the United States as a key factor in Canada's reduced capacity for innovation and upgrading.⁵⁴ We found that Canada has many of the structures in place for driving innovation and higher productivity, but these structures lack an adequate level of competition to ensure the complete success in our industries. We have looked at several hurdles.

First, the World Economic Forum's Business Competitive Index consistently identifies important disadvantages where Canada's industries lack competitive pressure – low buyer sophistication and less local competition. Without the intense pressure to innovate and

upgrade and the benefit of specialized support, our firms tend to be rated lower in this competitiveness index in the effectiveness of their strategies and operations. In particular, Canadian firms rank lower than many countries in company spending on research and development. Instead, they tend more to compete on the basis of low cost or natural resources rather than unique products and processes.

Second, our analysis of specific clusters identified less specialized support and competitive pressure as a key differentiator between effective clusters, such as automotive and steel, and less effective clusters, for example, biopharmaceuticals, education and knowledge creation, and tomato processing.

Exhibit 20 Canada produces fewer business degrees than the United States



*Excludes health and social sciences, and psychology.
 Note: Includes bachelor's, first professional, master's, PhD.
 Source: Institute for Competitiveness & Prosperity analysis based on data from Statistics Canada (special tabulations); US Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2005*.

⁵⁴See Working Paper 5, *Strengthening structures: Upgrading specialized support and competitive pressure*.

Third, a review of the firms in Canada that are global leaders – large Canadian companies that are among the five leaders in their world market – indicates that the degree of competitive pressure in Canada from sophisticated customers and capable rivals has not been a significant factor in producing the country's global leaders.⁵⁵

Fourth, in our survey of successful innovative firms,⁵⁶ respondents reported that the most significant disadvantage versus their US competition was the relative lack of sophisticated customers to stimulate their performance. Because of Canada's smaller market size, it will always be a challenge to ensure the presence of this competitive pressure. We can help achieve this by removing barriers to competitive intensity in our domestic markets.

We conclude that one of Canada's key challenges is to create an environment in which companies can and must innovate and commercialize. Our business leaders do not face the same competitive intensity as their US peers and are not getting the specialized support they require. Both shortfalls require attention. The toughest public policy challenge is how to intensify competitive pressure – how to encourage the rivalry that will lead firms to take innovation actions to outpace their competitors and how to raise consumer expectations for leading products and services. Clear answers and policies can help close this innovation gap – and, in turn, the prosperity gap between Canada and the United States.

Reduce regulation to increase competitive pressure

As we have seen, Canada trails the United States in investing in machinery, equipment, and software. We also see that this under investment is especially apparent in the information and communications technology (ICT) industry. A recent paper published by the OECD suggests that greater regulation in a developed economy results in slower productivity growth. The authors showed that regulations in Canada affect our ICT-producing and our ICT-using industries most significantly. This in turn affects productivity performance across the economy.⁵⁷

The authors then estimated the annual productivity growth forgone by each of the OECD countries because of its regulatory regime. Of the eighteen countries studied, Canada's regulations had the fourth most negative impact⁵⁸ on its business sector productivity growth over the 1995–2003 period. This forgone productivity was more pronounced in sectors identified as ICT intensive, such as electrical optical equipment and telecommunications, than in non-ICT intensive sectors, such as food products, beverages, tobacco, textiles, hotels and restaurants. This lower productivity is related to lower investment in ICT. The authors found that restrictions to competition have a strong negative effect on ICT investment.⁵⁹

To be sure, Canada's regulatory environment is less onerous than that of many of the other OECD countries. However, relative to the United States, our more stringent regulatory environment contributes to the lower

investment in ICT. This in turn, as we have seen, accounts for part of our prosperity gap.

In communications, Canada's industry has been highly regulated. Such regulations range from content and ownership regulations in entertainment media to pricing and technical regulations in telecommunications. Canada's leaders in the media industry, Harlequin and Pattison billboards, succeeded without this regulatory protection. In telecommunications services and infrastructure, Canada has no global leader, despite our impressive human and technological capabilities. Nevertheless, Canada has a good track record in developing global leaders despite the concern by some of the economy's "hollowing out." (See *Hollowing out is a myth.*)

One positive development in the regulatory environment is the report of the federal Telecommunications Policy Review Panel. It was appointed to "review Canada's telecommunications policy framework and recommend how to modernize it to ensure that Canada has a strong, internationally competitive telecommunications industry."⁶⁰

In summary, the Panel concluded that "it is time for significant changes in Canada's current policy and regulatory approaches.... [Its] proposals seek to accelerate the pace of deregulation of competitive telecommunications markets and will rely more on market forces to achieve Canada's economic goals."

⁵⁵*Ibid.*, pp. 34–41.

⁵⁶The Strategic Counsel, *Assessing the Experience of Successful Innovative Firms in Ontario*.

⁵⁷Paul Conway, Donato de Rosa, Giuseppe Nicoletti and Faye Steiner, "Regulation, Competition and Productivity Convergence," OECD working paper No. 509, p. 11.

⁵⁸*Ibid.*, ahead of Greece, Portugal, and Norway. See Figure 10, p. 40.

⁵⁹*Ibid.*, p. 14.

⁶⁰Telecommunications Policy Review Panel, *Final Report 2006*, March 22, 2006, p. 4-11. Available online: www.telecomreview.ca

The hollowing out of corporate Canada is a myth

The term “hollowing out” has gained currency in the past few years. The proponents of the hollowing out “crisis” have created a nearly universal belief that corporate Canada is being eviscerated by the foreign takeover of our corporations and the export of their head office functions with a loss of our autonomy. As a result, they claim, we are heading toward an economy of branch offices, which is one of the depressing future results of foreign control. For them, the only question now on the table is what our government should do to slow this ownership exodus.

To be sure, some significant Canadian firms have recently been taken over by foreign firms – Inco, Falconbridge, Zenon Environmental – to name a few. But do these visible changes really signal a hollowing out of our corporate infrastructure? Or are they just getting noticed more now, just like the attention

paid to large scale layoffs, even though these are being more than offset by the unannounced, unpublicized creation of new jobs?

In the Institute’s Working Paper 5, *Strengthening structures*, we identified companies that were Canada’s global leaders in 2003. We focused on the globally competitive companies, because the most critical firms to Canada’s long-term prosperity are those that compete successfully in the global arena. We defined a Canadian global leader as a Canadian-owned corporation ranked in the top five of its particular product or service category globally by sales revenue or assets. We started with the *National Post FP500* and the *Report on Business Top 1,000 Companies* and identified those public and private companies with sales greater than \$100 million that claimed top-five status in a market niche. To do this,

we reviewed companies’ public filings and checked with company officials, where necessary.

In 2006 the Institute updated this list of global leaders. And to shed light on the hollowing out issue, we went back to 1985 to determine how many companies were global leaders back then, using the same criteria – except to lower the sales revenue hurdle to \$50 million to account for inflation.

By our count, we had 33 global leaders in 1985 (*Exhibit B*). The list includes such firms as Hiram Walker, McCain’s, Northern Telecom, Canada Malting, Alcan, Inco, Abitibi-Price, Bombardier, and Laidlaw. The hollowing out thesis holds that we currently have markedly and worrisomely fewer such firms today because of foreign takeovers, such as those of 1985 leaders Falconbridge, Moore Corp, Seagram’s, and Hiram Walker.

Exhibit B Of Canada’s 33 global leaders in 1985, only 16 remain

33 Global Leaders in 1985

Abitibi-Price	Harlequin	Northern Telecom
Alcan	<i>Hiram Walker</i>	<i>Scott’s Hospitality</i>
AMCA	HBC fur auction (now North American Fur Auctions)	<i>Seagram Co.</i>
<i>Asbestos Corporation Ltd.</i>	<i>Inco</i>	SNC*
Atco Ltd.	<i>Laidlaw</i>	Teck-Cominco
Bombardier	Lavalin*	Tembec
<i>Canada Malting</i>	<i>Lumonics</i>	<i>Thomson Travel</i>
CCL Industries	McCain	Timminco
<i>Falconbridge</i>	Mitel	Trimac
Finning International	<i>Moore Corporation Ltd.</i>	<i>Trizec</i>
<i>Geac Computers</i>	<i>National Business Systems</i>	<i>Unican Security Systems</i>

16 departures and 1 merger (*): loss of 17 global leaders since 1985

Source: Institute for Competitiveness & Prosperity analysis.

The results of our research were surprising. We now have 72 – or more than twice as many global leaders as in 1985 (*Exhibit C*). In fact, we are growing globally competitive Canadian firms at a rate that wildly exceeds the rate of foreign acquisition. Net, we simply are not being hollowed out. We are thickening up.

Where are the new global leaders coming from? They come from many sectors: high tech (e.g., Automation Tooling Systems, CAE, Celestica, Open Text, Research In Motion), retail (e.g., Couche-Tard), manufacturing (Gildan, Husky Injection Molding), financial services (Manulife Financial), information (Thomson), and health care (TLC Vision), to name but a few. And the average size of Canada's global leaders today is nearly twice as large as the 1985 leaders (86 percent bigger) as defined by sales revenue in constant dollars.

What then are the policy implications? Clearly, we would love both to keep our current globally competitive corporations and to build new ones. No committed Canadian wants to see our globally competitive companies taken over. But we should not stand in the way of foreign investors who are prepared to buy Canadian companies that have not aggressively capitalized on opportunities in their own business. Nor should we be afraid to admit that sometimes our Canadian management teams are not up to the challenge of global competition and that new, foreign-based management is needed to face it. And we must recognize, if reluctantly, that anything we do that would have the effect of slowing the creation of new globally competitive corporations in order to staunch the takeover of existing corporations would do real harm to Canada's prosperity.

There is no single silver bullet to prevent the takeover of Canadian companies. Peter Munk, who put Barrick onto the current list of Canada's global leaders, is probably correct when he asserts that Canadian company executives have to show more fortitude in going global.^a But they need the help of the Canadian capital markets, which systematically underestimate the risk of Canadian firms staying domestic and overestimate the risk of Canadian firms going global. And they need the help of provincial and federal governments, whose tax policies make capital investment by businesses among the most heavily taxed in the industrialized world.

For Canadians, it is distressing to see companies like ATI, Masonite, and Zenon bought by foreigners. But that simply raises the stakes for creating the appropriate balance of pressure and support for innovative, growing companies – our global leaders of the future.

Exhibit C Canada has created 56 new global leaders since 1985

72 Global Leaders Currently (since 1985)

Abitibi Consolidated	<i>Cinram</i>	<i>Megellan Aerospace</i>	<i>Ritchie Bros. Auctioneers</i>
<i>Agrium</i>	<i>CN Rail</i>	<i>Magna</i>	<i>Scotia Mocatta</i>
Alcan	<i>Connors Bros.</i>	<i>Major Drilling</i>	<i>Shawcor Ltd.</i>
<i>Ashton-Potter</i>	<i>Coolbrands</i>	<i>Manulife Financial</i>	<i>Sierra Wireless</i>
Atco Ltd.	<i>Cott</i>	<i>Marsulex</i>	SNC-Lavalin
<i>ATS</i>	<i>Couche-Tard</i>	McCain's	<i>Spectra Premium Industries</i>
<i>Axcan Pharma</i>	<i>Dalsa</i>	<i>MDS</i>	<i>SunGro Horticulture</i>
<i>Barrick Gold</i>	Finning International	<i>Methanex</i>	<i>TD Waterhouse/Ameritrade</i>
Bombardier	<i>Fording</i>	Mitel	Teck-Cominco
<i>CAE</i>	<i>Four Seasons*</i>	N. American Fur Auction	Tembec
<i>Cemeco</i>	<i>Gildan</i>	Northern Telecom	<i>Thomson Corp.</i>
<i>Canam Steel</i>	Harlequin	<i>NOVA Chemicals</i>	Timminco
<i>Canfor</i>	<i>Husky Injection Molding</i>	<i>Open Text</i>	<i>TLC Vision</i>
CCL Industries	<i>Imax</i>	<i>Pantheon</i>	<i>Tree Island Industries</i>
<i>Celestica</i>	<i>Jim Pattison Group</i>	<i>Peerless Clothing</i>	Trimac
<i>CHC Helicopter</i>	<i>Linamar</i>	<i>Potash Corp.</i>	<i>Westcast Industries</i>
<i>Chemtrade Logistics</i>	<i>Maax</i>	<i>Quebecor World</i>	<i>Weston Foods</i>
<i>CGI</i>	<i>MacDonald Dettwiler</i>	<i>Research in Motion</i>	<i>Zarlink</i>

*Four Seasons will become foreign owned in 2007.
Source: Institute for Competitiveness & Prosperity analysis.

^a Ian Austen, "Canada Wonders Why It's the Bought and Not the Buyer," *The New York Times*, October 24, 2006.

We concur with the Panel that the rapid adoption of Internet Protocol (IP)-based networks, broadband, and wireless technology and the convergence of previously distinct information and communications technologies (ICT) are revolutionizing the telecommunications market. The Panel recommended that policy ought to be informed by the principle that services should not be regulated unless there is compelling evidence that market forces will unlikely achieve telecommunications policy objectives within a reasonable time period and that the costs of regulation do not exceed its benefits.

The Panel recommended that the CRTC have the onus to establish the existence of significant market power by a service provider rather than starting with the assumption that such power exists and ought to be curtailed through regulation. As Don McFetridge of Carleton University argued in a brief to the CRTC: "It is seldom the case, perhaps never the case, that inhibiting competition increases competition."⁶¹

The Panel's recommendations also remove barriers to future innovation in the telecommunications sector by recommending that downstream transmission and discretionary and retail services be free from the presumption of regulation. Instead, these should be unregulated and open to customer or competitor challenges to uncompetitive behaviour for adjudication on their merits.

We think the evidence that Canada needs more intense competition is clear. As we have recommended in our previous work, provincial and federal governments need to identify

ways within their jurisdiction to eliminate regulations that are precluding intense competition. The Panel's work represents a historic opportunity for addressing the competitiveness of one of our critical sectors. We are encouraged that the federal government is indeed seizing this opportunity.

Reduce counter-productive labour regulations

In our work to understand the differences in hours worked between Canada and the United States, we assessed the impact of labour standards regulations. Our research indicates that increasing regulation may have the effect of reducing hours worked, including among those who would prefer more hours. We hypothesize that this occurs because regulations create rigidity in the labour market and reduce job opportunities.

In our research for Working Paper 9, we estimate that 39 percent of the Canada-US annual hours worked gap over the 1978–2002 period can be attributed to tighter labour standards in Canada.⁶²

This analysis also indicates that more stringent labour standards account for 15 percent of the difference in involuntary part-time employment. In other words, stringent labour regulations may not be helping the most vulnerable workers – those who work part time but would prefer to be working full time. In fact, through increased rigidity in the economy, these standards may be having the opposite effect.

Our research results are suggestive, not conclusive. But we think a prosperity agenda has to include a

fact-based review of the impact of labour standards regulations on those they are meant to help.

Continue to pursue bilateral free trade agreements

Free trade provides both specialized support and competitive pressure to enhance Canada's innovative capacity. Free trade increases the size of markets available to support Canada's firms. Our work shows that small market size in Canada is an ongoing challenge to our productivity and innovation. This is a key reason why exporting to the United States has been so important to the success of Canadian firms – the impact of increasing scale by adding US customers to our potential sales is huge.

Free trade also strengthens the competitive pressure for our firms, workers, and managers to become more competitive. By opening our markets to more competitors, we increase rivalry from competing firms. That also exposes our firms to more sophisticated customers who provide pressure for greater upgrading and innovation.

Ideally, multilateral free trade could be the most effective way to broaden our markets. But the complexity of negotiating such arrangements and the time required to complete the deals mean that it is difficult to make them happen. Implementation of effective bilateral arrangements is a stronger possibility.

The Canada-US Free Trade Agreement (FTA) is the best example of how free trade has affected our competitiveness and prosperity. In his study of the long-term effects of the agreement,

⁶¹ Donald McFetridge, "Comments on Public Notice," CRTC 2003-10, Brief to the CRTC, January 30, 2004, p. 9.

⁶² Working Paper 9, *Time on the job*, p. 34-36.

Dan Trefler, professor of economics at the Rotman School of Management at the University of Toronto, noted that before the agreement more than one in four manufacturing industries was protected by tariffs of more than 10 percent.⁶³ Trefler measured the impact of the agreement in critical areas of economic performance:

- **Employment effect was neutral.** The agreement affected protected industries significantly. In the ones he identified as being most protected by tariffs before the agreement, Trefler found that 12 percent of jobs disappeared between the pre-FTA period of 1980–86 and the post-FTA period of 1988–96.⁶⁴ Across all manufacturing, he found a 5 percent reduction in jobs – fully 100,000 jobs. As Trefler observed, there was “a very large transition in costs of moving out of low end heavily protected industries. It reflects the most obvious of the costs associated with trade liberalization.” However, subsequent growth in manufacturing employment relative to that in other parts of the world suggested to Trefler that the lost employment was offset by employment gains in other parts of manufacturing.⁶⁵
- **Labour effects were positive.** Trefler found that the FTA resulted in a shift from less-skilled production jobs to higher-skilled non-production jobs. Overall, wages increased with no impact on hours worked as a result of free trade. Finally, he detected no increase in wage inequality, as measured by differences in production and non-production workers' wages.

- **Productivity increased.** According to Trefler, the FTA increased labour productivity in manufacturing by a remarkable 0.93 percent annually. Much of the productivity gain came from market share shifts favouring high productivity plants – high productivity plants grew, while low productivity plants were in decline.
- **Consumers benefited.** One of the concerns with bilateral trade agreements like the Canada-US FTA is that they simply divert trade with many countries to the other partner – with a net effect of no growth in trade. Trefler found that the trade increase between Canada and the United States significantly outpaced their trade reduction with the rest of the world. The FTA resulted in trade creation, not diversion. Drawing on the work of others, Trefler concluded that this net increase in trade had a positive impact on consumer welfare. Importantly, at the same time, import prices did not rise.

In summary, Trefler points to the positive effects of free trade as well as the short-term costs. The challenge is to continue to expand free trade while finding ways to mitigate the short-term adjustment costs.

In a recent paper, Wendy Dobson of the Rotman School of Management highlighted the potential benefits from a bilateral agreement between Canada and India and set out the general argument for increasing trade between countries.⁶⁶ Trade liberalization increases the competitive pressure on previously sheltered firms in both countries, driving productivity gains. Much of this comes about from removing trade barriers

that enable firms in both countries to specialize and expand intra-industry trade. This supports the development of integrated supply chains. Why should Canada be interested? Dobson argued that Canada would benefit from deeper integration with one of the world's increasingly dynamic economies. Why should India be interested? More bilateral agreements would be a natural contribution to their goal of liberalizing trade and capital flows. Dobson suggested the two countries start small, perhaps with a services-only free trade agreement.

We agree that more bilateral trade agreements would benefit Canada – for the usual market expansion opportunities espoused. We also see bilateral trade agreements as an important way to increase competitive pressure on our industries. But, while Canada is exploring or negotiating trade and investment enhancement agreements with several countries, we have made no progress in concluding bilateral trade agreements since the agreement with Costa Rica came into effect in 2002.

Canada's Minister of International Trade recently indicated his interest in moving on this front: “I have no reservations about saying that we have not been aggressive enough and focused enough on ensuring that Canada keeps up with the rapid, almost competitive, expansion of bilateral free trade agreements. Canada is the only major trading nation that has not negotiated a single free trade agreement in the past five years... we are falling behind Australia, Mexico, and particularly the United States in terms of bilateral agreements.”⁶⁷ Clearly, Canada needs a strategy that puts greater energy and focus on increasing

⁶³ Daniel Trefler, “The Long and Short of the Canada-U.S. Free Trade Agreement,” *American Economic Review*, Vol. 94, No. 4, 2004.

⁶⁴ Trefler controlled for a variety of effects including industry- and period-specific trends, business conditions, and US industry shocks.

⁶⁵ *Ibid.*, p. 879.

⁶⁶ Wendy Dobson, “The Elephant Sheds its Past,” C.D. Howe Institute Commentary, No. 235, 2006.

⁶⁷ The Honourable David L. Emerson, Minister of International Trade, in a speech on International Trade Day, Ottawa, June 8, 2006.

bilateral trade agreements, especially with countries whose industries fit well in our firms' supply chains.

Rebalance fiscal federalism

Much of the current debate around the fiscal federalism gap – the difference in the amount that have provinces contribute to federal revenue versus the amount returned to these provinces through federal spending – is whether it is fair. In our research, we focused instead on the question whether fiscal federalism is effective. To what extent is the new transfer of resources out of have provinces effective in narrowing regional economic disparities and building the long-term competitiveness and prosperity of the recipient provinces? We concluded that fiscal federalism is not realizing its full potential to reduce regional disparities in prosperity.

We need to ensure that these transfers are helping strengthen the potential to create prosperity in the have-not provinces. This requires that transferred funds are balanced appropriately between current consumption and investment for the future. As fiscal federalism becomes effective in encouraging investment in the have-not provinces, their prosperity will rise, and the burden of fiscal federalism will be reduced.

Today, we see that while some regional disparities are narrowing under the current fiscal federalism system, on critical economic indicators, such

as investment and unemployment, convergence is much slower. In addition, surprise budget surpluses and the Employment Insurance (EI) program have contributed to the problems of fiscal federalism. Canada should take several steps to increase the effectiveness of the system.

Make fiscal federalism more effective in reducing interprovincial prosperity gaps

It is important to assess the impact of fiscal federalism on the consumption and investment balance. We measure the consumption side of the equation by personal disposable income – the after tax income that flows to individuals – or the ability of individuals to consume current income. The investment side is captured by GDP per capita – the value created by converting human, physical, and capital resources into goods and services and building future prosperity.

Over the last two decades, the positive story is that disparities in personal disposable income across the provinces have narrowed. Canada has also achieved more equality in personal disposable income across the provinces than the United States has experienced across its states over the twenty-year period.⁶⁸ It is hard to imagine that federal transfers have not contributed to that success. But we are concerned that a significant portion of the shifted resources has been aimed at consuming current prosperity – through equalization payments, health and social transfers to provinces, transfers to individuals, and Employment Insurance benefits. Much less has been aimed at investing in future prosperity.

Over the same period, regional disparities in GDP per capita have stayed higher in Canada than in the United States. In seventeen of the past twenty years, the United States has had lower levels of inequality in regional GDP per capita than Canada, and the trend indicates that, without a change in course, Canada will never match US convergence performance. We also see that the rankings of have and have-not provinces have changed little, with the same provinces remaining stuck at the bottom of the list. In the United States, there has been more fluidity among the states, with both up and down shifts in the rankings.

We conclude that fiscal federalism is missing opportunities for increasing Canada's prosperity potential. A truly effective fiscal federalism system would lead to greater and faster convergence, a more effective balance between consumption and investment, and greater competitiveness and prosperity. More specifically, we have recommended shifting from transfer spending to tax relief that stimulates business investment in the have-not provinces and also shifting the focus from greater funds transfer to increased tax authority transfer.

Make Employment Insurance a true insurance program

We also need to address the role of Employment Insurance (EI) in creating the fiscal federal gap and its destructive effect on prosperity. Canada's EI program has created excessive surpluses and the wrong kinds of transfers. Every year since 1993, the federal

⁶⁸Institute for Competitiveness & Prosperity, Working Paper 8, *Fixing fiscal federalism*, October 2005, pp. 25-26.

government has collected more EI revenue than it has paid out, accumulating a surplus of \$71.7 billion by 2003. Effectively, EI is a tax on labour, rather than a true insurance program.

On top of that, its design perpetuates regional inequalities. First, it interferes with the labour supply by providing higher benefits after lower qualifying periods for unemployed workers in regions with higher unemployment. In effect, it creates disincentives to work in the regions with the highest and most persistent unemployment rates. Second, it creates perverse incentives for employers, allowing firms to avoid the natural consequences of high rates of layoffs and closures. The system encourages firms with seasonal fluctuations to lay off workers rather than bear the costs of retaining them during the off season.

A recent study by economists Peter Kuhn and Chris Riddell compared the impact of Canada's EI system in New Brunswick with a more modest program in neighbouring Maine.⁶⁹ The study compared these two areas that are similar in their climate, geography, population and in their growth, incomes, and urban-rural split. However, in Maine's northernmost counties, about 6.1 percent of employed men worked fewer than 26 weeks in 1990 compared to 20.8 percent in New Brunswick – more than triple the Maine result. The authors estimate that the more generous Canadian program accounts for two-thirds of this difference. In Maine, according to the authors, EI payments account for 6 percent of the province's GDP – six times the proportion in Maine.

They conclude that workers and firms adjust to the features of Canada's EI system. Workers' "educational decisions, occupational choices, fertility decisions, migration ...and the development of informal institutions" depend upon access to EI. For their part, employers are likely re-labeling workers who quit jobs as layoffs to help EI eligibility or permitting sequential job-sharing in a single job so that two employees can take advantage of the system.

Unemployment is an economic and social tragedy. But our EI system is making it worse, not better, diminishing Canada's competitiveness with the United States and other trading partners.

A prosperity agenda needs to strengthen our structures. Market structures need to provide greater specialized support and competitive pressure, thereby encouraging creativity and growth. Governance structures need to be rebalanced so that fiscal federalism is more effective in reducing interprovincial prosperity gaps.

⁶⁹Peter Kuhn and Chris Riddell, "The Long-Term Effects of a Generous Income Support Program: Unemployment in New Brunswick and Maine, 1940-1991," NBER Working Paper No. 11932.



Prosperity challenge 2020: Agenda for Canada's prosperity

Canadians need to pursue an aggressive agenda to close the prosperity gap

WE PROPOSE THAT CANADA embark on a realistic fifteen-year plan to narrow the prosperity gap with the United States significantly by 2020 – from \$9,200 in GDP per capita in 2006 to \$3,300. Catching up will not be easy, but Canadians need to be committed for the long haul. Doing nothing is not a worthy option, for the gap could widen further and raise the risk of falling living standards for us all.

Our agenda covers the four factors in AIMS, the framework we use to guide our analyses and recommendations.

Attitudes: From collective complacency to a shared determination to close the gap

- Recognize the imperative for closing the prosperity gap and commit to taking the extra steps to increase our productivity and our capacity for innovation and upgrading

Investment: From consume today to invest for tomorrow

- Increase investment in machinery and equipment, particularly information and communications technology
- Encourage Canadian youth to invest in their educational attainment
- Increase investment in post secondary education
- Rebalance government spending away from consumption to investment

Motivations: From unwise taxation to smart taxation

- Increase Capital Cost Allowances to match economic depreciation
- Eliminate the capital tax in Canada
- Convert provincial sales tax to a value added tax, where applicable
- Lower perversely high marginal tax rates for individual Canadians
- Assess radical new approaches to taxation
- Reduce or eliminate Scientific Research and Experimental Development (SR&ED) and focus on reducing taxes on business investment overall

Structures: From preserve status quo to encourage creativity and growth

- Continue to improve the quality of venture capital
- Increase business education
- Reduce regulation to increase competitive pressure
- Reduce counter-productive labour regulations
- Continue to pursue bilateral free trade agreements
- Rebalance fiscal federalism to encourage investment in have-not regions
- Introduce employer experience rating to Employment Insurance

Meeting the 2020 prosperity challenge: A template for Canadian policy makers

WE ARE CONFIDENT that our proposed agenda for Canada's prosperity addresses many significant points of leverage to close the prosperity gap. But we think it is also important to set out a template that helps policy makers think through the impact of other proposals on long-term prosperity.

We draw on our AIMS model to outline the series of questions that should be addressed by those proposing and opposing various policy options. Although we recognize that prosperity is not the only agenda item facing Canadians, it is an important consideration. We think all proposals should be reviewed through this lens.

Attitudes: Achieving a shared determination to close the prosperity gap

- How will the policy encourage and reinforce the prosperity agenda?
- How much will the policy encourage Canadian individuals and businesses to “go the extra mile” in strengthening our competitiveness and prosperity?

Investment: Investing for future prosperity

- How does the policy reduce consumption of current prosperity?
- How can it promote investment for future prosperity?
- How can it help Canadians invest more in upgrading their education and skills?
- To what extent, does it stimulate businesses to invest more in productivity enhancing machinery, equipment, and software, especially in information and communications technology?

Motivation: Making the taxation system smarter

- How could the proposed tax policy motivate greater investment?
- How does the proposed policy affect all taxpayers?
- Where does it place the burden – from a few taxpayers to all taxpayers?
- What does the proposed policy do to make Canada more internationally attractive as a place to invest in a business?

Structures: Developing more specialized support and competitive pressure

Increase specialized support

- How will the proposed policy improve the quality of investors and investment decisions?
- What will the proposed policy do to drive greater business investment in research and development?
- What will it do to enhance the quality of business management?

Strengthen competitive pressure

- How will the policy increase rivals' pressure on Canadian firms to be more innovative and productive?
- What will the policy do to increase the sophistication of Canadian customers and drive firms to be more innovative and productive?
- What cost adjustments are associated with increased pressure and how will they be addressed?

Rebalance governance structures

- How will a proposed change to fiscal federalism encourage investment for future prosperity and competitiveness in Canada's have-not regions?
- How will a proposed change in policy reduce unemployment? Increase hours of work for those who want them?

Each of these questions points to the need for measures and milestones toward closing our prosperity gap. These benchmarks are critical for achieving the agenda for prosperity and making real progress by 2020 in closing our prosperity gap.

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