TD Bank Financial Group

TD Economics

Special Report

September 18, 2006

THE ECONOMISTS' MANIFESTO FOR CURING AILING CANADIAN PRODUCTIVITY

The following document was presented to the Annual General Meeting of the Canadian Chamber of Commerce September 17, 2006. It represents an attempt to document common elements in the policy suggestions economists have made to improve Canada's poor record on productivity. The document is not meant to suggest unanimity on the policy recommendations nor should it be interpreted as suggesting agreement on the part of any particular economists.

Preamble

Most economists put lackluster productivity growth at or near the top of the challenges facing the Canadian economy. They believe weak productivity is compromising the Canadian standard of living and threatens many aspects of the quality of life that Canadians cherish. There is good reason for concern. Output per hour in the Canadian business sector only grew 1 per cent per annum from 2000 to 2005, down from 2.7 per cent in the previous five year period. The recent Canadian record falls woefully short of international results. With business productivity in the U.S. growing 3.3 per cent on average over the past 5 years, the level of Canadian business productivity has fallen to 74 per cent that in the United States [1]. Canada's productivity standing in the OECD has fallen from third in the 1950s and 1960s to seventeenth.

Canadian governments have taken some positive steps to address flagging productivity. But neither politicians nor the public are as seized with the productivity challenge as economists. Productivity was not featured in the federal Conservative's election platform or the 2006 Budget [2]. Nor did it loom large in the platforms of the other parties and was hardly mentioned in any of the election debates. So far productivity has not been a central feature of the platforms being unveiled by the candidates for the Liberal Party leadership.

So why have the economists' concerns with weak productivity not been embraced? Everyone has a version of the standard joke that economists can never agree on anything. If this were the case, then the overall message would be diluted in a sea of contradictory and confusing messages. But this does not appear to be the case. Indeed, there seems not only to be common belief in the depth of the problem, but an impressive degree of consensus on the actions that should be taken. The perspectives of many economists on productivity have broadened in recent years. There was a time that little attention was paid to anything beyond restoring fiscal balance and cutting taxes. More economists now recognize the importance of other issues such as improving human capital and public infrastructure. The section below attempts to identify the elements of a productivity agenda where there is broad consensus among economists. If dissension in the economists' ranks is not the explanation for failure to seize the attention of politicians and the public, then perhaps ineffective marketing is more to blame. A greater understanding of the degree of consensus on actions to be taken may facilitate economists speaking with a louder voice. This manifesto ends with a few other comments on why economists aren't succeeding in getting their message across.

Elements of a Productivity Agenda Where There is Broad Consensus Among Economists

Macroeconomic Environment

- Low, stable inflation. The current Bank of Canada approach and 2 per cent inflation target are broadly supported.

- Further reduction in the federal debt-to-GDP ratio from the 35.5 per cent estimated for 2005-06. There is general support for the government's target of 25 per cent. Balancing the budget will likely achieve the target by 2013-14 as specified in the 2006 Budget. Most economists recommend modest surpluses to hit the target a bit earlier.
- In aggregate, the provinces should record balanced budgets or modest surpluses.

Business Environment

- Continue to pursue international free trade. Economists would prefer a multilateral approach, but as long as progress remains blocked on this broader front, bilateral agreements should be pursued. Particular attention should be paid to reducing tariffs and non-tariff barriers in sectors such as agriculture which remain highly protected. A possible approach could be to seek inclusion or at least leverage the large number of bilateral deals the U.S. has been making.
- Remove remaining interprovincial trade barriers. Despite the Agreement on Internal Trade and efforts of the Council of the Federation, there are still many impediments to competition including through biases in government procurement, impediments to labour mobility and overlapping jurisdictional control such as with multiple security regulators.
- Promote competition including by removing remaining foreign ownership restrictions in sectors such as air transportation, publication, financial services, broadcasting and telecommunications. This must be done in a careful manner that respects the fact that for decades many of these Canadian industries have been prevented from adopting rational structures that would allow them to compete in open markets.
- Remove barriers to firms growing larger. A variety of measures including a very large jump in federal and provincial corporate income tax rates above the small business threshold provide incentives for companies to remain small although on average larger firms are much more productive.
- Remove work disincentives through reform of Employment Insurance. The EI program impedes labour mobility and dulls the incentives to work. The impact of effective reform might be observed more on labour supply than productivity. Effective reform would also increase the percentage of workers covered by EI.
- Reduce regulatory burden. In many cases the negative impact on productivity is not so much the design of the regulation, but its administration. This encompasses not only slow bureaucratic processes but also inefficient overlapping and unco-ordinated jurisdictional applications both within Canada and in particular between Canada and the United States. Uncertainty in regulation is also a major problem. Confusion over the eventual approach on environmental issues is a prime example.

Taxation

- Cutting the tax rate on capital should be the focus especially as capital inadequacy is a primary reason for lower productivity in Canada than the U.S. The federal government has made strides by eliminating its capital tax and cutting its corporate income tax rates. Some provinces still have relatively high corporate income rate rates. But the most damaging aspect of provincial taxation is the high taxation of capital through continuing capital taxes, distorted industrial and commercial property taxes and the application of retail sales taxes to capital.
- There is political and business support for enhanced Capital Consumption Allowance (CCA) rates but much of the foregone tax revenues would flow from breaks to existing capital (unless a distinction was made between new and existing capital). An Investment Tax Credit would be superior as it would only support new capital.
- Cut high marginal effective personal income tax rates (which typically apply up to around middle-income levels and are often highest for people attempting to exit welfare). The effect might largely be on labour supply rather than productivity.
- The cost of tax cuts on income and capital could be offset through greater use of consumption taxation including economic instruments for the environment.

Immigration

- Reform the design and administration of immigration to make a more effective economic contribution. Within a few years all of Canada's population growth will come from immigration. Yet as immigrants' earnings now remain below those of Canadian-born for long periods, immigration is likely reducing Canadian productivity. The system could be more attuned in design and administration to select, indeed recruit, immigrants more closely matching job shortages in Canada and those selected could be integrated more effectively into the Canadian economy. The impact of reforms would be felt both on labour supply and productivity.

Infrastructure

- Re-invest in key infrastructure such as for transportation and electricity generation. Reducing congestion to and across the key Canada-U.S. border crossings should be one priority. In many areas the direct hit on public treasuries could be mitigated through greater use of P3s and user fees.

Education and Training

- Re-invest in education. Knowledge is a key in the modern economic environment yet Canadian governments starved funding for much of the 1990s. This has recently turned around, but Canada still has deficiencies relative to other countries in key areas such as graduate studies. Greater attention also needs to be paid at improving labour skills in the non-PSE stream through literacy programs, apprenticeships and training.

Other Government Spending

- Governments will have to be parsimonious in "non-investment" spending areas. The budget identity dictates that under modest budget surpluses, lower tax burdens and increased investments in certain investment areas, the rest of government spending must be constrained to a modest pace of growth. Unfortunately, this has not generally been the case in recent years and unless this is turned around, the other objectives will be compromised.

Private Sector Economic Behaviour

- Economists generally acknowledge that the Canadian private sector needs to invest more in capital, training, R&D and absorption of technologies developed elsewhere, should be more trade-oriented and in general be more "entrepreneurial". Yet there is little consensus on how to promote these objectives. Undoubtedly moving on the policy fronts identified above would elicit positive business behavioural responses. Some have suggested incentives to shape private sector business behaviour – such as tax breaks for internal training efforts. But others appropriately note there would likely be a deadweight loss to entice businesses to do what they have not perceived on their own to be in their best interests – unless of course substantial externalities are present.

If the assertion that there is broad consensus among economists on the above productivity agenda is valid, then dissension in the ranks cannot be the explanation for lack of traction on the economists' cause. Poor communication or marketing may be to blame.

Public opinion surveys tend to support the notion that the public has not embraced the economists' message on productivity. In fact, many Canadians associate productivity with working harder for less pay. In other words, they believe the opposite of the economists' story that higher productivity will bring higher wages and a higher standard of living. Productivity is inherently a difficult subject to communicate because it is not directly observed or measured, being a residual between outputs and inputs. It is not officially reported on as regularly or with nearly the same profile as other indicators such as employment or GDP. As the historical pace of productivity fluctuates and given the apparent break in productivity growth in the 1970s, it is difficult to convincingly provide an anchor for what is a "reasonable" performance. International comparisons are fraught with difficulties on data and concept. All international comparisons need to be put on a common-currency basis and there are legitimate disagreements as to how this should be measured. The quality of the international comparisons is highly suspect in aggregate and in particular at the sectoral level. For example, it is probably not the case, as shown in official data, that the Canadian public sector is much more productive than its American counterpart. On the other hand, the Canadian finance, insurance and real estate sector is not likely as inefficient relative to the American sector as the official Canada-U.S. data show. John Baldwin identified important discrepancies in how Canada and the United States measure hours worked, but the results have not been incorporated into the official productivity statistics. Given the importance of productivity, a concerted effort needs to be made in Canada and other countries to clean up the data difficulties. This would undoubtedly enable the economists to tell a clearer story.

Canadians clearly balk at the standard economist productivity tale of inferiority relative to the United States. Many interpret this as inferring all aspects of American life are superior. Indeed, despite the relative data on productivity and GDP per capita, many Canadians believe Canada has a higher "quality" of life. Economists need to be clearer that a high quality of life cannot be preserved without adequate productivity. It is the productivity that allows a society to make choices to allocate resources to things like the environment and health care or working fewer hours (in this latter regard, productivity should be measured as output per hour rather than output per capita). And speaking of health care, economists run into a communications problem on that front as well. The public consistently identifies health care as their number one interest and concern. Yet economists sometimes lump health care into the consumption side of the consumption-investment dichotomy and infer that allocating resources to this is undesirable. The argument could be put that higher productivity will allow Canadians to receive the health care they desire without compromising other aspects of the Canadian quality of life.

The economists' story that higher productivity will increase wages is weakened by the observation that recent productivity gains have largely accrued to corporations rather than individuals. Corporate profits are at an historic high as a share of GDP while real wages have not advanced substantially. Further, while business investment has strengthened, it has not kept pace with the growth in profits nor has it fully reflected the price declines on imports of machinery and equipment due to the strengthening of the Canadian dollar. If and when businesses drive up investment even more aggressively, or as real wages rise, the story will become easier to tell. Even more generally the economists' case is weakened by the observation that productivity has not substantially picked up (in absolute terms or relative to other countries) despite Canadian governments acting on some of the economists' prescriptions, most notably restoring fiscal balance.

In conclusion, there appears to be a strong consensus among economists on what needs to be done to bolster Canadian productivity. Some positive action has been taken but neither politicians nor the public are seized with the productivity agenda at this time. Realization of the consensus among economists might facilitate them speaking with a louder, more united voice. But some more savvy marketing of the productivity agenda is also in order. Some attempts have been made at it. For example, governments and business groups tend to speak of prosperity rather than using the word productivity.

Don Drummond, SVP & Chief Economist
416-982-2556

Endnotes

1. If adjusted for the finding of John Baldwin at Statistics Canada that Canada and the United States do not measure hours worked comparably, the Canadian business sector productivity would be more like 84 per cent than of the American.

2. The federal 2006 Budget does commit to working on a competitiveness-productivity agenda over the following year but few details are provided as to the measures that might be contemplated.