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**WEAK PRODUCTIVITY A THREAT TO CANADIANS' STANDARD OF LIVING**

- Canada has a serious productivity problem, which if not solved threatens the well being of Canadians.
- Productivity growth has dropped to a standstill and Canada's performance has lagged that in other countries over the past several decades.
- There is a role for governments and businesses to play in addressing the issue.
- Public policy should be aimed at reducing the barriers to competition and at increasing the incentives to work, save and invest. Tax relief is just part of the remedy. For example, additional investment in infrastructure and post-secondary education can be productivity enhancing. However, all existing and new government initiatives must be judged on the basis of whether their benefits outweigh their required tax burden.
- The private sector can do more in terms of capital investment, research and development, identifying economies of scale, implementing new technologies and innovative business practices, as well as maximizing the efficiency of an increasingly diverse labour force.

**TORONTO –** In many ways the Canadian economy has been the envy of the industrial world in recent years, however, in one critical area Canada has failed dismally. "Canada has recorded a remarkably bad productivity performance. Productivity has been tepid in terms of absolute growth rates and relative to the growth and levels recorded in other major economies. If this continues it will threaten the standard of living of Canadians," said Don Drummond, Senior Vice President and Chief Economist of TD Bank Financial Group in a new report entitled *Canada's Productivity Challenge*. The report is available online at www.td.com/economics.

Canadian productivity – as measured by output per hour worked – rose rapidly in the 1960s, with average annual gains of 3.6 per cent. However, productivity growth fell in the 1970s and the 1980s, dropping to 2.1 per cent and 1.4 per cent, respectively. In the 1990s, productivity growth edged back up to 1.8 per cent, but slowed anew and dropped to a virtual standstill in 2003 and 2004.

Much of this slowdown in productivity growth was also experienced in the other major industrialized countries that are members of the Organization of Economic Cooperation and Development (OECD), but Canada's underperformance has been particularly notable.  Canadian productivity grew more slowly than 18 out of 22 OECD nations since 1960 and 21 of 23 OECD nations over the past two years.  Given Canada's record of lacklustre productivity growth relative to its international peers, it is not surprising that the nation's domestic productivity level has also fallen behind.  Whereas Canada ranked at a lofty 3rd out of 23 OECD nations in its level of productivity in 1960, it now sits at a lowly 17th out of 24.

In reaction to this regrettable trend, TD Bank Financial Group launched a standard of living forum in 2001 to raise awareness.  "TD proposed that Canada should aim to exceed the U.S. standard of living within 15 years.  It is now four years later and the gap between real Canada-U.S. per capita income is virtually unchanged," remarked Drummond.

The good news is that there is increased recognition about the issue. Since the start of this year, various politicians, associations, journalists and economists have renewed the debate about how to alleviate the problem.  "But, the subject has not gripped the hearts and minds of most Canadians," noted Drummond.

Many think higher productivity is just a catch phrase for working longer, harder or for less pay.  There is also a perception that stronger productivity growth can lead to weaker job creation.  "These views are unfortunate, since the reality is almost the exact opposite," stressed Drummond.

Productivity is a key driver behind a rising standard of living over time.  Stronger productivity growth allows for faster economic growth without leading to higher inflation.  For households, the implication is additional income without loss of purchasing power.  For businesses, higher productivity allows for stronger profit growth, while governments benefit from additional tax revenues, which in turn supports health care, education and other social priorities.  Over the long haul, the faster economic growth will fuel employment growth.  "Other factors – like poverty rates, the environment, and life expectancy – also have a bearing on the standard of living of Canadians, but productivity growth does act as a catalyst for improvement in these other areas.  Indeed, higher productivity allows for greater choices regarding the kind of society a population wants," observed Drummond. And, demographic trends suggest that productivity will be an increasingly important determinant of economic growth in the future.

There is considerable speculation that the federal government might make a renewed commitment in the Fall to improving Canada's productivity performance. The TD report discusses the shape that the agenda might take based on a speech last June in Halifax by Finance Minister Goodale. However, recent comments from Ottawa suggest that the action plan may be delayed until early next year and could be delivered as part of a platform for a federal election in the Spring of 2006. "The key issue is whether the federal government is on the right track," remarked Drummond.

The TD report examines the various factors affecting Canada's productivity performance, both in absolute and relative terms and outlines the lessons that can be drawn. "What Canada needs is a shift in focus away from consumption and towards savings and investment. This is not just about tax cuts. It's about a cultural shift involving a major review of public policy and an increased commitment by the private sector to investment and innovation," states Drummond.

Specific public policy recommendations include:

- Governments must lower disincentives to save and invest and encourage increased competition. For example, Canada should reduce many of the remaining barriers to foreign direct investment, which restricts the inflow of capital and new business practices. Impediments to interprovincial trade should be eliminated.
- Governments should not pursue industrial policies aimed at fostering growth in higher-productivity industries. Subsidies, tax breaks and other incentives targeted at the sectoral level are often counterproductive. They reduce the drive for productivity by limiting the competition and can lead to international trade disputes. "Industrial policy too often amounts to taxing the winners to subsidize the losers," claims Drummond.
- Policies should be aimed at encouraging greater private sector investment, both in terms of the amount of capital per worker and the quality of capital per worker. The C.D. Howe Institute has concluded that Canada currently has the second highest

marginal effective tax rate on capital across the 37 major economies. This is a major constraint on business investment and makes Canada less attractive to foreign capital. Consequently, a reduction in corporate income tax rates and the introduction of capital tax credits would be beneficial. At the provincial level, several governments continue to have capital taxes that should be eliminated. An end to the double taxation on dividends would also be worthwhile.

- A reduction in personal marginal tax rates could also lead to productivity gains. The prevailing level of personal tax rates act as a deterrent to work, save and invest. "For example, various clawbacks mean that low and modest-income Canadians often face effective personal income tax marginal rates of 60 percent and sometimes much higher," notes Drummond. A shift towards a greater reliance on user fees and consumption taxes would also be superior to the dependence on income taxes, as the former two revenue sources act as a disincentive to spend and an incentive to save.
- Canada would benefit from a greater emphasis on promoting post-secondary education. While history and theory suggest that the emphasis should be on university education, particularly at the graduate level, the importance of colleges should not be minimized. In order to avoid labour shortages that would hamper economic growth and productivity from an aging population, Canada will require more college graduates with technical training.
- Public sector investment in infrastructure (such as border crossings, highways, ports, and airports) could lead to productivity gains, as would policies aimed at urban development (including roads, water systems, electricity generation and transmission, public transit, etc). Much of Canada's infrastructure was put in place in the 1960s and is badly in need of replacement.
- Renewed investment in cities can be a catalyst for productivity growth, as healthy cities act to pool capital and labour and attract foreign investment. Governments need not carry the infrastructure burden alone, as efficiencies can be created from increased use of public-private partnerships.

The TD Economists stress that a review of existing and any new policy initiatives must pass the fundamental test that the boost to productivity derived from them must be greater than the advantage that would have been received from lowering taxes by the cost of the new initiative. "It is not enough to throw money at health care, education, and infrastructure. The money must be used effectively and the payoff has to be greater than the resulting tax burden," observed Drummond.

"While the onus is on governments to create the right incentives for stronger productivity growth, the ultimate responsibility rests on the shoulders of the private sector," states Drummond.

- Governments have targeted R&D for many years and it is time for the private sector to step up to the plate and put a larger emphasis on research. Canada also needs to improve its track record in developing commercial applications from new innovations. This requires managerial leadership in adopting new technologies and an openness to new ways of doing things.
- Despite the past reduction in barriers to trade and investment, it is not clear that Canadian businesses have taken full advantage of the opportunities to build scale. Consider that of the 2.2 million firms in Canada only 50 firms account for roughly 46 per cent of all Canadian merchandise exports, and only 18 per cent of all small and medium size enterprises do any exporting at all.
- The private sector must put greater weight on productivity enhancing capital investment. The rapid growth in corporate profits over the past few years has not been accompanied by a matching increase in capital spending, which is evident in the resulting decline in machinery and equipment investment as a share of GDP. Surprisingly, these issues have occurred during a period of rapid strengthening in the Canadian dollar that has reduced the cost of imported capital.

In the final analysis, Canada would benefit from more competition in domestic markets and greater investment in human and physical capital. There is a wide array of public policies that would accomplish these goals. The private sector has a crucial role to play in boosting productivity. "Only by pulling together in unison, with governments, businesses and individuals playing their part, can Canada achieve a sustained acceleration in productivity growth that would raise the standard of living for Canadians over time," concluded Drummond.

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The report *Canada's Productivity Challenge* is available in PDF format on TD Economics' Home Page at: www.td.com/economics.