

The Economists' Manifesto for Curing Ailing Canadian Productivity

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ABSTRACT

Most economists blame Canada's lackluster productivity performance in recent decades for sluggish growth in per capita incomes and a declining position in international rankings of economic well-being. Political leaders are reluctant to embrace a productivity agenda because of the public's confusion, indeed fear, of the subject. Many believe productivity is about working harder for less pay, or precisely the opposite of the economist's definition.

Despite poor productivity growth, Canada remains a wealthy country. But there is ample reason for concern. Canada's level of productivity has slipped to 17th among OECD nations from third in the 1950s and 1960s. Unless our record is turned around quickly, Canadians' quality of life will stand still while other nations move ahead.

This article summarizes the elements that are in common in most economists' recommendations on how to raise productivity in Canada. Some of the recommendations require governments to tackle issues such as removing interprovincial trade barriers and reforming employment insurance where firmly established interests would be rocked. The private sector would have to shed some complacency. But the pay-offs would be enormous. Economists have come together impressively on an action plan to raise productivity, now they need to hone their communications skills to convince the country to swallow the prescribed medicine.

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 2.4 per

cent in the previous five years. The recent Canadian record falls woefully short of international results. With business sector productivity in the United States growing 3.3 per cent on average over the past five years, the level of Canadian business productivity has fallen to 74 per cent of that in the United States.² Canada's productivity standing in the OECD has fallen from third in the 1950s and 1960s to seventeenth in 2004.

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2 If adjusted for the finding of John Baldwin at Statistics Canada that Canada and the United States do not measure hours worked comparably, business sector productivity in Canada would be closer to 84 per cent of the US level.

A fairly common assumption in economic projections is that labour productivity will grow around 1¾ per cent per annum over the medium term. Given the record of only 1 per cent labour productivity growth per annum so far this decade, a concerted effort may be required to record even this rather modest pace. We should really aspire to much more. Just raising productivity growth from 1¾ to 2 per cent per annum would generate an additional \$1,100 of real GDP per person after 10 years.

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 are economists. Productivity was not featured in the federal Conservative election platform or the 2006 budget.³ 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 when 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. And it is more widely recognized that some taxes are more harmful to productivity than others, so the composition as well as the level of the tax burden matters.

This article 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 comments on why economists are not succeeding in communicating their message.

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

Public policy

Macroeconomic environment

- Low, stable inflation allows resources to be concentrated on productive uses. 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 35.1 per cent for 2005-06. A lower debt burden reduces the risk of crowding-out private borrowing, keeps interest rates modest, avoids devoting a large share of tax payer money to paying for past consumption and minimizes the risk of swings in the stance of fiscal policy. 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 spec-

³ 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. The importance of productivity was also featured in the document "A Plan for Growth and Prosperity" by the Liberal Government in November 2005.

ified in the 2006 Budget. Most economists recommend modest surpluses to hit the target a bit earlier.

- Provinces should record balanced budgets or modest surpluses.

Business environment

- Continue to pursue freer international 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 United States has been making.
- Remove remaining interprovincial barriers. Despite the Agreement on Internal Trade and efforts of the Council of the Federation, there are still many impediments to competition including biases in government procurement, impediments to labour mobility and overlapping jurisdictional control such as with multiple security regulators.
- Promote competition by removing remaining foreign ownership restrictions in sectors such as air transportation, publication, broadcasting and telecommunications (there are no foreign ownership restrictions per se in financial services although the rule that firms must be widely held constitutes an indirect impediment). 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 distorts labour participation decisions and hurts labour mobility, human capital accumulation, and the allocation of scarce resources among sectors and regions. Reforms would raise both labour supply and productivity. Effective reform would also increase the percentage of the unemployed covered by EI. The link between benefits and local labour market conditions could be relaxed somewhat and complementary programs could be examined to cover the self employed and recent immigrants.
- Reduce the 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 uncoordinated 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 a much lower capital-labour ratio is a primary reason for lower labour productivity in Canada than the United States. 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 tax 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 (in five provinces) to capital goods.

- Enhanced Capital Consumption Allowances (CCAs) would reduce the cost of capital. Any change should only apply to new or refurbished assets rather than existing capital. An Investment Tax Credit would be an alternative that would advance the receipt of benefits to firms.
- 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 leave 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. Gross immigration currently accounts for 86 per cent of Canada's population growth. By the early 2020s, natural population increases will fall short of emigration so that gross immigration will begin to account for all of Canada's population increases. Yet as immigrants' earnings now remain below those of Canadian-born workers 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 practice of considering applications in the order they are received could be replaced by choosing applicants most likely to be

employed in Canada, regardless of when they applied. The impact of reforms would be felt both on labour supply and productivity.

Infrastructure

- Re-invest in key infrastructure such as transportation and electricity generation. Reducing congestion to and across the key Canada-U.S. border crossings should be one priority. In many areas the cost to public treasuries could be mitigated through greater use of Public-Private-Partnerships (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 1980s and early 1990s. This has since 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 worker skills through literacy programs, apprenticeships, workplace training and training for those temporarily out of the workforce.

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 expenditures 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.

What Explains the Lack of Influence of Economists on the Productivity Agenda?

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. Many Canadians also believe productivity causes job losses. Of course, this can be true at the industry level. However, stronger productivity growth creates income, which in turn increases employment in other industries.

Productivity is inherently a difficult subject to communicate because it is not directly observed or measured, being a residual between outputs and inputs. It receives little media attention rel-

ative to 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 of productivity levels need to be put on a common-currency basis and there are legitimate disagreements as to how this should be measured.

The quality of 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 of Statistics Canada identified important discrepancies in how Canada and the United States measure hours worked, but the results are not available for recent years and are rarely reflected in comparisons of U.S. and Canadian productivity levels. 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 tale of productivity inferiority relative to the United States. Many interpret this as inferring that all aspects of American life are superior. Indeed, despite the data on relative 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 areas such as the environment and health care or to work fewer hours (in this latter regard, pro-

ductivity should be measured as output per hour rather than output per worker).

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 workers. 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 strength-

ening 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 labour productivity has not substantially picked up (in absolute terms or relative to other countries) in recent years 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. Some governments and business groups have attempted to skirt the communications problems surrounding productivity by speaking of prosperity and innovation instead. But ultimately they must still explain why actions that are perceived to be difficult will be necessary for the greater good of the well-being of Canadians.