

A Sectoral Analysis of Ontario's Weak Productivity Growth

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Ontario's private sector has had zero productivity growth in the latest six year period. Ontario performed much worse than the rest of Canada or the United States. This is obviously a cause for concern. Productivity is an important measure of progress in the economy, as it is associated with rising standards of living in the long run. The question is whether this observation about productivity is significant in its own right, or if it is more a symptom of the overall state of the economy. The Ontario economy has been hit by major external shocks, resulting in plunging exports and a declining private sector employment rate. Is productivity an independent causal factor, or merely the residual outcome of weak demand?

This paper examines the issue through detailed sectoral data. It examines the diversity of productivity performance in about 50 industrial sectors. The picture that emerges is that the overall productivity growth rate is not really representative. It is the random outcome of a wide range of underlying variation. There are some important sectors (e.g., retail trade and finance) that have maintained decent productivity growth. There are some sectors, especially in manufacturing, where the level of productivity is currently far below its previous *level*. This is not merely weak *growth*, but decline. In some industries (e.g., steel), some of the largest players have shut down, essentially changing the character of that sector even though the name remains the same.

Overall, the implication is that the weakness of productivity is caused by weak aggregate demand. Historically, productivity growth has been pro-cyclical, being positively correlated with demand growth. Strong demand creates economies of scale and distributes overhead costs over a larger base. The weakness of demand in recent years has also been associated with compositional shifts in the economy. Employment and output have plunged in manufacturing (whose level of productivity is above the economy-wide average), while it has grown in some service sectors with below average productivity. Such compositional shifts would reduce the average productivity of the economy even if there was no change in the productivity of any individual sectors. Ontario had positive productivity growth in the service sector, but underperformed the strong growth found in the rest of Canada. Here, too, the explanation is likely found in diseconomies of scale due to weaker demand. For example, the higher productivity growth in retail and wholesale trade in the rest of Canada was associated with growth in sales that was two-thirds higher than in Ontario over the past six years.

The weakness of demand in Ontario is largely due to falling exports, caused by the high Canadian dollar and the weak US economy. This can be considered in a positive light. While a strong rebound in exports does not appear to be around the corner, the worst is probably behind us. There should be a continuing gradual improvement in exports in the coming years, leading to some increase in productivity growth. The Ontario government should focus its policy levers, which are admittedly constrained, on helping to further the upward trend in exports.