Panel on Policy Levers to Improve Manufacturing Productivity Performance

S. Boutziouvis Thank you. When the Research Advisory Committee of this particular conference first came together very early last year to discuss the conference, I remember as if it were yesterday the words of John McCallum and his immutable logic at the time. Many of us around the table suggested that a policy session should be included in what would be a conference obviously be bound up with a number of highly technical papers.

Both Rick Harris and Andrew Sharpe at the time agreed that it might be interesting to have a session on policy and productivity. But John McCallum warned that we really don't know what policy levers to pull. In other words, we really do not know which levers to pull that clearly and unambiguously might increase productivity.

Well, without commenting on whether or not to agree or disagree with that sentiment, the policy side appears now to be decidedly even more complex. And for a good reason. The Canadian economy is definitely on an upswing -- we're on a roll. The economy is firing on all cylinders -- unemployment is below 7%, after taxable incomes appear to be set to increase perhaps in dramatic fashion, our standard of living is set to increase, our output gap has closed so to speak, and our productivity levels are probably going to increase about 2% this year.

And yet, I for one believe that unless our productivity growth increases in dramatic fashion over the next few years, Canadians will be consigned to greater stagnation and a relative decline in their standard of living. So how can one inject a sense of urgency in an obvious era of increasing optimism where it's sort of a don't worry be happy type of attitude?

Well, there's been a lot of progress, in particular in 1999. It's been an interesting year and a revealing year on the determinants of productivity. While there were many contributions to the debate in '99, 3 key contributors in my view seem to have zeroed in on the main drivers. There is a very long list of potential factors that appear to have indirect effect upon productivity and we've all heard them today: innovation, technology, adoption of spatial agglomerations or clusters, economies of scale, size of government, management practices, infrastructure.

But recent contributions by Rick Harris, Pierre Fortin and the Department of Industry indicate a core set of determinants -- what Rick

Harris has referred to as the big 3. There does appear to be a strong correlation between machinery and equipment investment as a percentage of GDP, human capital investment and openness of an economy, with productivity growth.

I think that a very compelling case can be made on the contribution of M&E investment to productivity performance, especially when one looks at: U.S. performance; at the contributions of investment to innovation; and, when one takes a more Shumpetarian viewpoint on how an economy functions. A look at the evidence suggests that Canada clearly underperforms the United States by about 1/3 on M&E investment as a percent of GDP. A comparison with the OECD suggests the same sort of conclusion. Further, our M&E investment in computer and office equipment, a more narrow subsector of M&E, is even worse as a percent of the overall economy -- in terms of performance with the U.S. This is disturbing because information innovation -- and therefore the required investment that underpins it -- is at the root of the productivity and economic growth in the United States, at least in the 90's.

Getting back to Shumpeter, it's clear to me that in the United States the information revolution and the rapid pace of redeployment of resources and investment has accelerated the pace of creative destruction… that is, the shifting of capital from failing or maturing technologies into those technologies at the cutting edge.

But for this to take place and even to accelerate means that the rate of return on capital embodied in that technology, innovation or piece of machinery, must exceed the cost of capital. What appears to have happened in the U.S. is that not only has productivity of capital invested increased in the 90's, but higher equity valuations and stock prices has also helped to reduce the overall cost of capital.

Indeed, Robert Fairholm at Standard and Poors recently concluded that a higher cost of capital in Canada is one of the key reasons for Canada's underperformance in M&E investment. And to quote Alan Greenspan in a recent speech, "[h]ad high prospective returns on U.S. capital projects not materialized, the current capital equipment investment boom -- there's no better word for it -- would have petered out a long time ago. In the event, overall equipment and capitalized software outlays as a percent of GDP in nominal terms have reached their highest level ever in post-World War II history" -- a point that was raised earlier this morning.

Before I get to policy choices, I would point out that while management strategy is definitely a factor in productivity performance, I would respectfully submit that Canada still has a whole host of micro issues that it needs to deal with to improve the environment for business investment. In other words, management decision making to a significant degree reflects the environment in which managers operate. So I think we'll have to do some more work on the micro-front despite the very good news from Michael Porter, Roger Martin, and the World Economic Forum.

Debt reduction, as Robert Fairholm points out, is one of the obvious reasons for a higher cost of capital in Canada, at least through the 80's and 90's. Our public sector debt is in decline, both in absolute and relative terms. But the key policy question is -- is it declining fast enough? Should a higher proportion of resources be put towards debt reduction than the just the contingency reserve? I think there is a compelling case to be made for accelerated debt reduction beyond the contingency reserve, despite the minimal impact we all know that it will have in relative terms on the debt.

On the dollar, as Robert Fairholm points out as well, most of Canada's machinery and equipment is imported from the U.S. The depreciation of the Canadian currency against its American counterpart therefore has had the effect of increasing the overall cost of the imported machinery and equipment. Canada's level of investment spending therefore would be higher if the exchange rate had not depreciated and increased the price of that machinery and equipment.

Now, let me make it perfectly clear, I don't think that this conclusion lends itself easily to some policy response or recommendation. Recommending a stronger dollar or some sort of pegging would of course remove the benefits of a floating currency to deal with external economic shocks. As well, such a policy response would imply higher interest rates over time. This does imply though that private sector actors respond to market signals, to the rewards, risks and costs that they face. For behaviour to change implies a need to change those benefits, costs and risks -- risks associated with an investment decision. This of course leads me to corporate taxes.

There seems to me a growing body of evidence that high corporate taxes have a negative effect on growth. Their effect on productivity is also obvious to me, although less direct, given the high degree of sensitivity of the level of corporate taxation upon the level of foreign direct investment.

The link between productivity and FDI is related to the benefits that multinational enterprises bring to the Canadian economy. When FDI comes into the country the MNE also brings knowledge, R&D, organizational and management expertise -- all indirect factors which influence productivity.

A couple of recent studies which are quoted in a paper by Rick Harris, suggest that taxes have a much larger effect upon FDI than previously thought. For example, one study suggests a 10% increase in corporate taxes reduces FDI by about 6%. The implication is that a corporate tax cut could have a significant effect upon the rate of FDI inflows, which as every one of you knows has been falling as a share of total FDI globally and as a share of total North American FDI.

This is why I find compelling the proposal by Jack Mintz that Canada does not just need a corporate tax cut. Canada, to distinguish itself among other industrialized nations and other newly industrializing nations (all in competition for FDI), should seriously consider a significant corporate tax cut.

By this I mean a corporate tax cut that puts Canada on the map globally. We need a corporate tax cut that doesn't just go below the U.S. corporate general rate but goes substantially below it. We need something dramatic in my view. Otherwise I feel strongly that the recent nascent trend of outward migration of companies may in fact accelerate. There is also a case to be made, although with several caveats, for lower corporate taxes and tax rule changes to spur M&E investment and therefore productivity. Again, quoting from Harris, U.S. corporate and personal taxes tend to favour investment in M&E, in particular through generous depreciation provisions, a point which he brought up this morning. This issue has been top of mind for one of the BCNI's most prominent member CEOs. He has commented on productivity in the past and has stated that the elimination some time ago of a key rule on depreciation of capital equipment in the manufacturing sector created a discontinuity which made the Canadian private sector somewhat less competitive than in the United States.

Indeed, the OECD suggests that the effect of depreciation rules on M&E in the U.S. is equal to a reduction in the required rate of return on that capital of 4.4%. Meanwhile in Canada and many other economies, taxes on M&E investment raises the required rate of return by 1.4%. This is a severe distortion in favour of the United States private sector and it puts them at a competitive advantage.

While I'm not arguing for such distortive practices to be put in place in Canada, because it in effect amounts to a subsidy, I think there's a case to be made for taking a serious look at the effects of depreciation rates between our two countries. And this is especially the case given that Canada sits atop the United States, is heavily integrated with that economy, an economy which has generated phenomenal M&E investment and has benefited from it immensely in my view.

There is also evidence to suggest a complimentarity between skilled labour and physical capital investment. An increase in the stock of human capital raises the returns of physical capital. A cut in PIT rates will raise the returns to human capital development and acquisition. It will increase growth by encouraging more human capital development and attract an inflow of FDI.

This is a sentiment which time and again has been expressed by private sector leaders in speeches extolling the virtues of Canadian competitiveness and the benefits of a skilled labour force. But the corollary is also true and this is the point I want to make.

Attracting investment in more physical capital will increase the demand for human capital development and acquisition in my view. In other words, the better the environment for capital investment, the greater number of opportunities for Canada's best and brightest and for the best and brightest from other countries to come and work and stay in Canada. So therefore there's a virtuous circle implied by lower corporate tax rates to spur on investment, both FDI and M&E, and in human capital retention, acquisition, and development.

I'll skip the section on labour market flexibility and just conclude by saying, littered throughout my remarks was a choice. We can try to make Canada into the best place in the world in which to live, work, invest, save. In my view we can do this and be better at what we do than in other societies and nations that we trade with and compete with.

Does this imply more rapid growth and a higher standard of living on productivity? It does, but it also implies greater insecurity than in a more stable, perhaps more stagnant economy. And so the question then becomes how to equip Canadians and our society for the inevitable dislocations and deal with the insecurity in a compassionate and fair way while at the same time embracing competition more fully than we have done in the past. Thanks.

APPLAUSE