Editor's Overview

THIS 13TH ISSUE OF THE *International Productivity Monitor* produced by the Centre for the Study of Living Standards contains five articles. In contrast to the last issue on the Boskin Commission Report after a decade, this issue has a strong Canadian flavour. Topics covered are the benchmarking of Canadian economic performance, policies for improving productivity growth in Canada, Canada-U.S. differences in hours worked, the impact of terms of trade on Canada, and the measurement of government output and productivity.

It is always useful for Canadians to obtain the perspective of non-Canadians on the challenges facing the country. In the first article in this issue, **Jean-Philippe Cotis**, Chief Economist at the OECD, provides such a perspective by benchmarking Canada's economic performance against that of other OECD countries and offering an analysis of obstacles to structural reforms. He finds that Canada often stands out as one of the best in the class, but notes that there are areas where we can do better.

Cotis identifies lagging productivity growth as Canada's greatest economic weakness. While recognizing Canada's strengths in its low barriers to entrepreneurship, high levels of education, and labour market flexibility, he identifies the taxation of investment, limited product market competition, and restrictions on foreign investment as barriers to boosting productivity.

Cotis recognizes that it is increased well-being, not higher GDP per capita, that is the goal of public policy, and that in this context the normative preferences of what constitutes a good society must be integrated into economic analysis. To do this, he develops the concept of "instrumental efficiency," by which he means policies should be set at the efficiency frontier given the normative preferences of society.

Ways to improve the productivity performance of the Canadian economy are at the centre of the economic policy debate in this country. In the second article, **Don Drummond**, Chief Economist at TD Financial Group and a former senior official at Finance Canada, puts forward what he calls the economists' manifesto for curing ailing Canadian productivity. Drummond identifies 17 areas of public policy on which he feels there is an impressive degree of consensus among economists on the actions that should be taken to improve productivity.

Key policy actions recommended include: further reduction in the federal debt/GDP ratio; continued pursuit of freer international trade; removal of interprovincial trade barriers; promotion of competition by removal of foreign ownership restrictions; removal of work disincentive associated with Employment Insurance; reduction in the regulatory burden; a lower tax rate on capital and higher consumption taxes; reform of the administration of the immigration system; reinvestment in key infrastructure; and reinvestment in education.

Canada's lower per capita income levels relative to those in the United States arise not just from lower labour productivity levels, but also from fewer hours worked per employed person. In the third article in the issue, **Alberto Isgut**, **Lance Bialas**, and **James Milway** of the Institute for Competitiveness and Prosperity identify a 157 hour gap in annual hours worked by employed workers between the United States and Canada in the 1997-2004 period and provide a detailed examination of the factors behind this difference.

They find that in a given week 8 per cent of employed Canadians are not at work due to vacation, illness and personal and family reasons, compared to 4 per cent of US workers. This accounts for over 40 per cent of the annual hours worked gap. They also find that the greater proportion of workers in Canada who work part-time, and hence work fewer hours per week than full-time workers, account for over one quarter of the gap. Most of the greater incidence of part-time work in Canada is accounted for by greater involuntary part-time work. From a behavioural perspective, the authors find that the Canada-U.S. annual hours worked gap is explained largely by the less robust nature of the Canadian economy (higher unemployment rate and lower GDP per capita) and by higher labour standards, and to a lesser degree, the higher unionization rate. Higher personal income taxes played only a minor role.

It is well recognized that, in the long run, productivity growth is the only sustainable source of real income gains. But in the short-to-medium term, improved terms of trade or trading gains can contribute significantly to income growth. In the fourth article, **Ulrich Kohli**, Chief Economist at the Swiss National Bank, provides a rigorous analysis of trading gains and presents estimates of their importance for the Canadian economy from 1981 to 2005.

Kohli calculates trading gains by deflating nominal GDP by the domestic price index, which excludes export prices, not the GDP deflator. In the 2002-2005 period when export price increases greatly exceeded that of import prices, he finds that real GDI in Canada advanced 13.4 per cent compared to only 8.2 per cent for real GDP, a difference of 4.8 percentage points. However, over the 1981-2005 period, real GDI exceeded real GDP by only 0.1 percentage point per year.

The measurement of the real output of the government sector represents the Achilles heel of the System of National Accounts (SNA). The conventional approach is to deflate the nominal value of inputs by the price of the inputs to produce a real government output measure where productivity growth is zero by definition. To address this unsatisfactory situation, the 1993 SNA revision recommended that statistical agencies adopt direct measures of government output. In the 1990s, the UK government did adopt such direct measures, but problems emerged. Instead of being zero, productivity growth in certain public services actually became negative. In 2003, the UK government appointed **Sir Anthony Atkinson** to investigate the issue of the measurement of government output. His report, *Measurement of Government Output and Productivity for the National Accounts*, known as the Atkinson Report, was released in 2005.

In the fifth and final article in the issue, **Aled ab Iorwerth** from Finance Canada reviews the Atkinson report, providing a detailed discussion of issues related to the measurement of government output. He notes that in contrast to a number of European countries where over half of government output is measured directly, only 7 per cent of government output in Canada is measured in this matter. He concludes that better measures of government output are needed for Canada.