

The future of productivity

An eight-step game plan for Canada



The productivity gap

Canada's competitive advantages, such as a low dollar and preferred access to U.S. markets, have traditionally insulated our economy and protected our standard of living. In recent years we have seen these competitive advantages erode, leaving Canada's high standard of living increasingly exposed to a problem that has been growing unchecked for almost thirty years – low productivity.

In 2009, Canadian workers produced only 86% of the output of their American peers. Our annualized productivity growth over the past decade has been in the bottom quartile of the OECD. As baby boomers leave the workforce, placing downward pressure on the percentage of Canadians employed and average working hours, only strong growth in productivity will allow Canada to sustain GDP per capita – and maintain our overall standard of living.

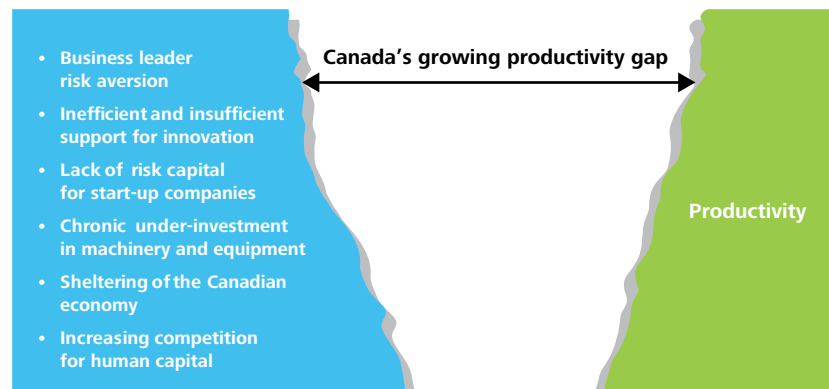
Improving productivity does not translate to working longer hours for lower pay. Instead, economies must increase the number of people employed in high-paying jobs producing premium outputs.

Canadians are far more optimistic about the current and future state of their nation's economy than their peers in the United States. This disjoint represents a finite window of opportunity for Canada to make significant productivity advancements.



What's undermining our productivity?

Deloitte conducted a comprehensive study and identified six key issues driving Canada's productivity performance.



Business leader risk aversion

Canada has long been regarded a risk-averse nation, but there has been little evidence to support this – until now. In 2011, Deloitte engaged a leading national polling firm to conduct interviews on risk tolerance with 450 Canadian and 452 American executives from small, medium and large firms across a broad array of industries.

When asked to self-evaluate their risk tolerance, there was no difference in the distributions of responses of both groups, suggesting that Canadian executives do not *view themselves* as being any more or less willing to take on intelligent risks than their counterparts south of the border.

However, if we dig deeper into the risk tolerance implied by the *actual decisions executives reported making*, a significant difference emerges. Despite being more pessimistic in their economic outlook, American respondents were more likely to make investments. U.S. executives were, on average, 18% more tolerant of risk than Canadians when adjusted for their more negative views on current and future economic conditions.

The survey also revealed that Canadian firms were much more responsive to, and potentially more reliant on, government support for R&D. We also found that while self-reported risk tolerance had minimal impact on the behaviour of U.S. firms, Canadian firms who reported being “risk avoiders” were much less likely to assume risks than their “risk taker” peers.

Inefficient and insufficient support for innovation

Innovation is one of the most important contributors to sustained productivity growth. Canada has strong performance in conducting basic research, but dismal performance in producing new patents. This suggests we are failing to commercialize our research and limiting our ability to drive productivity improvements from innovation.

A critical ingredient to the successful commercialization of basic research is private sector R&D, driving many governments to provide incentives for this activity. At 0.24% of GDP, Canada's R&D incentives are among the highest in the OECD. Yet despite these generous incentives, private sector R&D remains at only 1% of GDP in 2008, the lowest ratio of business R&D per dollar of government support in the OECD.



Lack of risk capital for start-up companies

Small innovative start-up firms tend to grow rapidly and invest heavily in R&D, making them a disproportionate driver of productivity growth. Yet there is a dearth of start-up financing in Canada. Canadian angels constitute only 0.36% of the Canadian population – barely half the U.S. level – and the per capita availability of venture capital (VC) funding has also historically lagged the U.S., sometimes by more than twentyfold. Our interviews with members of the start-up community suggested that this issue is driving some entrepreneurs to leave Canada for jurisdictions where capital is more readily available.

Deloitte also found that Canadian VCs are further limited by geographic restrictions and job creation targets placed on capital provided by alternative sources of capital, including governments. These constraints limit the ability of VCs to pursue the most profitable opportunities, further depressing the returns of the asset class and making it more difficult for them to raise private funds.

Chronic under-investment in machinery and equipment (M&E)

One of the most direct ways to improve productivity is to help employees increase hourly output through the use of new machinery and equipment (M&E). The high Canadian dollar, depressed prices in the U.S. and a recently lowered effective tax rate on capital have created ideal conditions for investment in M&E. Yet the stock of M&E per Canadian worker in 2009 was at only 49% of U.S. levels.

Sheltering of the Canadian economy

Since the implementation of NAFTA, Canada has made limited progress in expanding formalized trading relations. Protectionist policies at both the federal and provincial levels are limiting Canada's ability to finalize new agreements. At the same time, interprovincial trade barriers subdivide the already small Canadian market, and can limit the ability of our firms to develop the scale necessary to compete in the global marketplace.

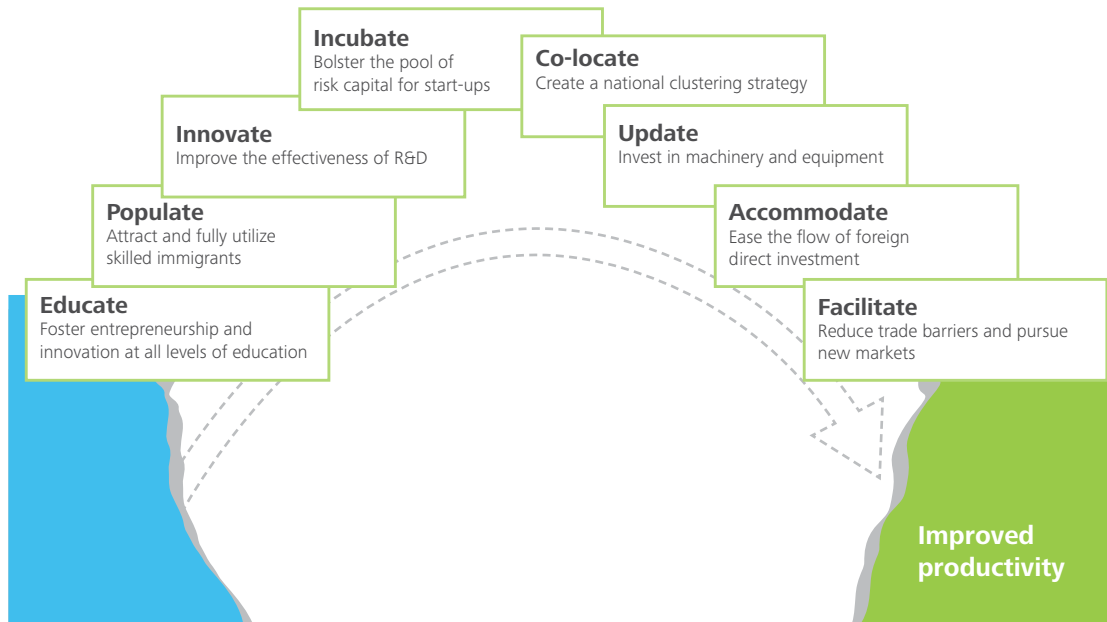
Canada also faces problems in the realm of foreign direct investment. Our numerous protected sectors and the limited transparency of the "net benefit test" have contributed to one of the highest FDI Regulatory Restrictiveness scores in the OECD, slow growth in the stock of FDI, and a declining global share of FDI inflows.

Increasing competition for human capital

Canada has historically relied on its immigration system to fill skill gaps in the labour market. However, under today's system, a number of barriers exist. Many regulatory bodies do not recognize the standards of other countries, and, in some cases, other provinces. As a result, individuals who may have practiced as a doctor, or a mason – and whose immigration was approved on the basis of a strong demand for these skills – may find themselves unable to practice in their field.

Eight actions for a stronger Canada

Deloitte has developed a set of eight long-term strategies that should be pursued in the near-term. If implemented as an integrated whole, these actions will create a self-reinforcing system that will drive a transformational shift in Canadian productivity over the coming decades.



Educate: ensure our education system fosters entrepreneurship and innovation at all levels

The shaping of Canadian attitudes towards innovation, risk and the value of learning itself begins in our primary and secondary (K-12) education system. Deloitte recommends the development of new content to equip the next generation with an awareness of entrepreneurial opportunities and seed the skills to intelligently manage risk.

Post-secondary institutions should encourage students to combine their specializations with business and managerial studies, leveraging alumni and members of the private sector to enrich the student experience.

Populate: re-tool the immigration system to attract and fully utilize skilled immigrants

Deloitte recommends that the Canadian government work with professional associations and licensing bodies to identify more effective mechanisms for determining foreign credential acceptance, and ensure that they act in the best interests of the Canadian economy and allow labour market needs to be addressed.

Provincial governments should support the standardization of trade and professional certifications across provinces and the development of nation-wide qualification recognition programs. Once in place, the government should also consider an "employer driven" approach similar to Australia's, where candidates must have their credentials recognized by the relevant regulatory body *before* they are able to qualify as an economic class immigrant.

Innovate: improve the effectiveness of R&D

To increase private sector R&D, Deloitte believes that Canadian governments should align their R&D incentive programs with the needs of different innovation life-cycle stages and firm sizes. In doing this they should consider the role that SR&ED refundability and increased direct funding for early stage companies can have in improving the accessibility of R&D incentives. Furthermore, governments should streamline the bureaucracy associated with accessing government funds and services for small businesses, while universities and firms must increase the level and quality of their communication and collaboration.



Incubate: bolster the pool of risk capital

Deloitte recommends the creation of angel tax credits at both the provincial and the federal level similar to those instituted by the province of British Columbia. Studies of the B.C. credit show that it has increased angel investment by 50-70%, and that for every dollar spent on the credit an average of \$1.98 in new tax revenue is created.

We also believe that the government should collaborate with leading experts and members of the start-up community to identify a mechanism to support a

sustainable expansion of early-stage financing to companies attempting to grow beyond the seed stage. We believe that this mechanism should focus solely on increasing the availability of early stage financing, avoid creating a separate government-sponsored class of early-stage financing, and should encourage the ongoing development of talent in the start-up financing space.



Co-locate: create a national clustering strategy

Significant quantitative evidence shows that when similar firms co-locate, productivity gains result from improved efficiency, higher rates of innovation, and improved incubation of start-ups. Deloitte believes that a national clustering strategy is necessary to capture these gains, but that this strategy should be a regional effort rather than a top-down initiative. Local businesses, municipal governments and nearby universities have the strongest grasp of local strengths, and should be encouraged to develop local cluster associations and strategies. The federal and provincial governments should then collaborate with these associations to reinforce the regions' advantages and help create conditions that will support the implementation of the strategy.

Update: invest in machinery and equipment

Conditions for Canadian businesses to invest in machinery and equipment are extremely favourable. U.S. price levels remain depressed, tax rates on capital investment are highly competitive, and the Canadian dollar is above parity. However, these favourable conditions could dissipate at any time. Canadian business must seize this opportunity to increase their productivity and become more competitive while protecting themselves from the rising labour costs expected as the population ages.

Accommodate: ease the flow of foreign direct investment

Deloitte believes that the net benefit test should be made more transparent, with more information provided on the metrics used to measure each component and on their relative weightings. We also suggest that the term "strategic industries" be better explained, as there is no definition or mention of strategic industries (outside of cultural industries) in the Investment Canada Act (ICA). If certain transactions are subject to more rigorous review processes, clarity should exist regarding which industries, companies, and intellectual properties are protected as well as the nature of the rigours. Ministries responsible for protected sectors should conduct periodic reviews of ownership restrictions to identify opportunities to update or remove restrictions that limit competitive pressures.

Facilitate: reduce trade barriers and pursue new markets

Canadian businesses need to reframe their point of reference beyond North America to the global economy, while our government must foster conditions for them to compete with greater agility around the world. New trade agreements with emerging economies should be created, and the backlog of pending trade agreements finalized. Federal and provincial governments should routinely review trade barriers, and weigh their benefits against disadvantages in the form of lost revenues and higher prices for imports.

The courage to lead

must come from within the highest levels
of business, government and academia

A finite window of opportunity is presented by today's promising economic conditions. To capitalize on this window of opportunity, business leaders must fundamentally re-examine their attitudes towards taking intelligent risks to ensure their future competitiveness. Leaders from across government, business and academia must recognize their important role in preserving our standard of living. To allow Canada to reset its productivity trajectory, we have laid out a comprehensive game plan – one with recommendations for people, ideas, supporting infrastructure and access to markets that will allow Canadian businesses and individuals to flourish.

As a long-term participant in, advisor to, and observer of Canadian business, the public sector and academia, Deloitte Canada is passionately concerned with the future of our country. We have a unique perspective on the trends and international practices that can combine to solve Canada's productivity problem at the national, enterprise and individual levels.

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