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The Canada Project Final Report Volume I

Mission Possible
Stellar Canadian Performance in the Global Economy
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Mission Possible: Stellar Canadian Performance in the Global Economy
by Glen Hodgson and Anne Park Shannon

This volume is one of a set of four volumes comprising the final report of The Canada Project, Mission Possible: Sustainable Prosperity for Canada:
• Volume I—Mission Possible: Stellar Canadian Performance in the Global Economy
• Volume II—Mission Possible: A Canadian Resources Strategy for the Global Economy
• Volume III—Mission Possible: Successful Canadian Cities
• Volume IV—Mission Possible Executive Summary: Sustainable Prosperity for Canada (an executive summary of Volumes I, II and III).

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About The Canada Project

The Canada Project is a three-year program of research and dialogue designed to help leading decision-makers chart a policy course that will improve Canada’s standard of living and position within North America and the world. Spearheaded by The Conference Board of Canada and launched in January 2003, The Canada Project actively engaged private and public sector leaders in setting national policy direction. Forty-five companies and organizations invested in the project, providing invaluable financial, leadership and knowledge support.

As with all the research produced over the three-year term of The Canada Project, the final report, Mission Possible, is aimed at elevating the level of public debate about Canada’s standard of living and position within North America.

For more information about The Canada Project, please visit www.conferenceboard.ca/canadaproject.

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Preface

The Canada Project had its genesis in 2002 at The Conference Board of Canada’s annual Canadian Conference—a meeting of senior public and private sector leaders at which participants are invited to share their most pressing concerns about Canada’s present challenges and future prospects.

Many of the leaders at this meeting raised the same underlying issue: that Canada was floundering in a state of public policy drift at a time that called out for national strategic action in the face of rising global competition.

And thus, The Canada Project was born.

Now, almost four years later—thanks to the $2.4 million invested by business and government organizations, the $1.0 million contributed by the Social Sciences and Humanities Research Council of Canada and the effort and expertise invested by some of Canada’s top researchers and professionals—we present this four-volume compendium of the results of our work. The ambitious task of synthesizing all the research and analyses produced under the banner of The Canada Project required us to focus on what was both essential and new. Much of the original research has been released over the course of the project in 27 separate studies and reports. (See Appendix “The Canada Project Research and Dialogue Activities.”) Mission Possible: Sustainable Prosperity for Canada summarizes our findings in a comprehensive overview. It delivers an integrated set of 76 recommendations in support of seven closely linked strategies for moving forward. Many of these recommendations are consistent with emerging public policy thinking; others are more provocative.

I want to thank my exceptional team of colleagues who, led by Brenda Lafleur, Director of The Canada Project, contributed to this enterprise. All were diligent and thorough in analyzing and weighing policy choices and in selecting priorities for emphasis. Special thanks to my volume co-captains, Glen Hodgson and Gilles Rhéaume.

I also want to thank Janice Gross Stein for agreeing to write the Foreword. Her thoughtful thematic summary of our key messages will help readers absorb this research-laden body of work.

The timeliness of this publication—coinciding with new governments and new leadership in Ottawa and in many provinces and cities across the country—is fortuitous. It arrives at a moment when there appears to be an emerging consensus among Canadians on two themes: that Canada must strive for a global-best level of excellence in embracing the competitiveness challenge, and that it must adopt a sustainability perspective in so doing.

I hope that Mission Possible will be widely read by leaders at all levels and in all sectors. Above all, I hope it succeeds in driving policy debate in constructive directions and contributes to a national resolve to undertake the actions necessary to build a sustainable and prosperous future for Canada.

Anne Golden
President and Chief Executive Officer
January 2007
Canada’s future economic prosperity is at risk. This is a hard argument to make in a country that today enjoys low unemployment, a strong dollar, declining debt and a booming resource economy. Canadians are likely to be skeptical of an argument that points to serious challenges ahead and makes an urgent case for strategic investment today to assure sustainable prosperity tomorrow. Yet this is precisely the argument The Conference Board of Canada makes in this four-volume report. It does so in compelling language as it examines the challenges Canada faces in the global economy, in our resource sectors, and in our cities. In all three areas, our performance is slipping.

Canada lags behind most developed economies in productivity growth. We are becoming less competitive. In just two years, we have slipped from 3rd to 12th place in comparative measurements of macroeconomic and microeconomic performance, according to the results of benchmarking by the Conference Board. Canada lags behind most developed economies in productivity growth. Our resource sectors require significant new strategic investment if they are to meet global competition, and our biggest cities are starved for investment in comparison with global cities elsewhere. In vital sectors of our economy, we are not keeping up with our competitors.
The future demands not only an improvement in productivity, but a productivity that is sustainable. Across the board, Canada must invest in development that meets the needs of the present without compromising the ability of future generations to meet their needs. A central theme running through every volume is the imperative to design sustainability into the economic architecture that we are building for the future. Across the country, Canadians understand that protecting the environment from further damage is not a problem for tomorrow, but a challenge for today. Our record, unfortunately, does not reflect this awareness. Here too, Canada is underperforming and underperforming badly. Without serious attention to economic and environmental sustainability, Canada puts its society and its quality of life at risk. This report speaks with a clear voice. Sustainability matters. It must become one of the yardsticks against which we measure productivity.

**Sustainability matters. It must become one of the yardsticks against which we measure productivity.**

*Mission Possible*, a large-scale and in-depth review of Canada’s economic performance and potential, issues a clarion call. It calls for strategic investment by governments, corporations and people. Canada must be “smart” in its choice of priorities, its policies and its investments if Canadians are to retain their quality of life. It is not the federal government alone that faces the challenge. It is all three levels of government—federal, provincial and municipal—and all sectors of society—public, private and voluntary—that have to work together to develop priorities, translate these priorities into strategies, and make the kinds of strategic investments that are required. We need to develop new habits of collaboration across the three levels of government and with society, and we need to do it quickly. The mission is possible only if the mission is national.

**GLOBALIZATION AND SUSTAINABLE PROSPERITY IN CANADA**

Globalization—the connections and processes that cross borders—is the hallmark of the 21st century. The global economy rewards knowledge, innovation, investment and trade. The signature of this phase of the global economy is the integrated global supply chains that distribute production around the globe in search of higher efficiency and lower costs for each component of the final product or service. Close to one-third of world trade today is intra-firm trade. In this globally integrated economy, Canadian companies must compete vigorously for international investment and trade if they are to prosper.

**North American economic integration is slowing, and, in a much more anxious security environment, the United States is thickening its borders.**

Because of our geography, our rich resource endowment and our heavy dependence on the U.S. market, many believe that Canada has very little direct exposure to globalization. We are insulated, Canadians believe, by the North American market. This report tells us otherwise. Growth in our exports to the United States has slowed in recent years, and the growth that has occurred was largely due to the energy and other resource sectors. The growth in exports that are unrelated to energy—in the automotive sector and in manufacturing—has been weak. North American economic integration is slowing, and, in a much more anxious security environment, the United States is thickening its borders. The North American Free Trade Agreement (NAFTA) has lost its dynamism, its momentum and, in part, its legitimacy, at least for the moment. The Canada–U.S. relationship will continue to deepen, but the glittering promise made by the architects of North American free trade has not been fully achieved. Canadian investors are looking increasingly to other dynamic markets, notably in Europe, Latin America and Asia.

Canadians know that we must pay attention to the United States—that we must manage our relationship carefully and well. The United States is simply too
important to our collective well-being for us to do otherwise. But the Conference Board tells an unexpected story. It tells us clearly that we need to wear bifocals: we need to look out to the world, without taking our eyes off the United States.

In this generation, Canadians are looking beyond North America to the world. Our competitors are global. So are our market opportunities.

Canada is experiencing globalization in all its critical sectors. Volume II of this report demonstrates over and over again that in the resource sectors—forestry, agriculture, mining and energy—our competitors are global. So are our market opportunities. China, India, Russia and Brazil, to mention only the obvious, are shaping our markets and competing with our firms. Our most competitive firms are tightly linked into global supply chains. Our cities benchmark themselves against global competitors. And we measure our productivity against the performance of others. In this generation, Canadians are looking beyond North America to the world.

THE BALKANIZATION OF OUR ECONOMIC SPACE

Every volume of this report emphasizes the adverse consequences to Canadians of chopping up our national economic space. The non-tariff barriers to interprovincial trade, mobility and investment are at times so severe that they inhibit the kinds of east–west connections that characterize our deep connections outside Canada. People cannot move easily to work, some industries cannot recruit easily, students face difficulties in transferring credits from one post-secondary institution to another, and supply chains across provincial borders can face obstacles that global supply chains have eliminated. In an age of global mobility, it simply makes no sense to add degrees of difficulty to the movement of people, goods and services from one province to another.

The costs and consequences of this balkanization of our national economic space are not always obvious. The Conference Board tells a striking story about our cities. Hub cities within provinces play an essential role in sparking economic growth in their own province. This pattern of convergence within provinces—not across provinces—is at least partly due to the chopping up of Canada through interprovincial barriers.

Canadians living in the early part of the 21st century, in an era where markets are global, where the Internet is ubiquitous, and where people move and travel at unprecedented rates, have nevertheless allowed a thicket of provincial barriers to stand largely untouched. In the 21st century, the irony should be obvious: we are dividing and separating ourselves even as we are connecting more deeply with others. Our national economy is being stifled by barriers that we ourselves have allowed to stand. As a result, we have a “chopped-up” economy, poorly suited to compete and prosper in a global economy. This is a problem that governments in Canada can and must fix.

STRATEGIES TO MOVE CANADA FORWARD

In a globally connected world, how can Canadians build sustainable prosperity? This report highlights seven important strategies:

• putting in place a comprehensive national strategy to increase our lagging productivity;
• creating an integrated national market;
• investing in and supporting a workforce that is equipped to meet the challenges of the global economy;
• adopting strategic investment and trade policies;
• sharpening our foreign policy priorities;
• investing in our resource industries so that they are competitive and sustainable; and
• investing strategically in our major cities so they can fulfill their potential as engines of sustainable national growth.

Common to all seven strategies are the imperative to increase productivity in sustainable ways, the necessity to develop knowledgeable and skilled workers and managers, the importance of redesigning our fiscal and regulatory architecture, and the urgency of special treatment for our major cities.
A NATIONAL STRATEGY TO INCREASE PRODUCTIVITY

Canada must develop a comprehensive national strategy to increase our productivity in ways that are sustainable. The data in this report are alarming. Compared to the U.S. economy, only one-fifth of the Canadian economy is more productive, while the other four-fifths are less productive. How can Canadian productivity be improved? There is a great deal that we can do. We need to open industries to competitive pressures, we need to improve the level and quality of capital intensity, we need to encourage organizational and managerial innovation, and we need to reform our tax system to encourage lower-income Canadians to stay engaged in the labour market. We do not, by and large, need to work longer; we are a hard-working country. In a global knowledge economy, we need to work “smarter.”

To work smarter, Canadian governments and companies must invest in research and development and work together to create a climate that is even more supportive of risk-taking and innovation. We are better at innovation than we generally think. Canada ranked fourth globally on a measure of innovation in 2004 and, according to benchmarking by the Conference Board, slipped to fifth in 2005 behind only Finland, Sweden, the United States and Iceland.

We do not, by and large, need to work longer; we are a hard-working country. In a global knowledge economy, we need to work “smarter.”

Canadians are good at diffusing innovation through our openness to foreign ideas, technological cooperation and partnering with foreign inventors on patents. We also have high penetration of broadband technology, an important platform for exchanging ideas. These are all important assets in the global market for ideas. But we lag behind the top global performers in business investment in research and development and in the commercialization of inventions and ideas. We are not leaders in scientific and engineering publications, and we invest significantly less than some of our competitors in our universities. We need research scientists in universities working with their counterparts in the corporate sector to bring innovative products to market and carve out a place for Canadians at the high end of the value chain. If we want to maintain our current standard of living, raising productivity through significant strategic investment in research and development and in post-secondary education is an imperative.

Improving the quality and access to training and education is a refrain that is replayed in the discussion of the Canadian economy, our resource industries and our cities.

Working smarter also means investing in the research and development of sustainable technologies that reduce damage to the environment and society. Volume II, on resources, speaks about the importance of sustainable extraction, management and renewal of our resource endowments. Whether it is forestry, agri-food, mining or energy, all require a full accounting that considers the consequences of resource extraction for the environment. Volume III, on cities, underlines the importance of sustainability in the rebuilding of our badly frayed urban infrastructures.

A SKILLED AND KNOWLEDGEABLE WORKFORCE

The Conference Board pays a great deal of attention in this report to the importance of a skilled and knowledgeable workforce. This kind of workforce is critical to increasing our productivity, to the development of sustainable technologies, and to the re-engineering of our resource industries. Without a high-quality workforce, none of these will happen. It is no surprise that improving the quality and access to training and education is a refrain that is replayed in the discussion of the Canadian economy, our resource industries and our cities. Every volume speaks to the importance of strategic investment in education, in lifelong learning, and in the development of the skills that Canadians will need as global value chains proliferate and deepen.
The Conference Board also worries about an aging demographic that threatens every sector of the Canadian economy and could compromise the quality of life of the next generation. Although immigration can help to address the looming shrinkage of the workforce, it alone cannot solve the shortfall caused by an aging population. But we can do much better at integrating immigrants and helping them to take full advantage of the skills they bring. This report speaks to the importance of immigrants in Canada: their contribution to our productivity, their global connections, and the contributions immigrants can make to the quality of Canadian life if their credentials, education and training are properly recognized.

Although immigration can help to address the looming shrinkage of the workforce, it alone cannot solve the shortfall caused by an aging population.

To compensate for an aging population, governments at all levels and businesses will have to create incentives so that educated and experienced people continue to work. Educational institutions will have to become more flexible so that lifelong learning becomes a shared experience across the generations. Governments will have to invest significant resources to provide the best available education to our young people. Although governments have increased funding for post-secondary education in the last several years, Canada’s universities are still significantly under-funded compared with those of our international competitors. The German government has just chosen three among its many universities to receive special funding so that they can become internationally competitive. In a globally competitive environment where post-secondary institutions educate young people, contribute to lifelong learning, spark research and development, jump-start innovation and build global connections, one size can no longer fit all. Here, as elsewhere, Canada will have to abandon a cherished myth of equal treatment for all its institutions. The importance of strategic investment in education, of differential treatment to build excellence, jumps out of every volume of this report.

REDESIGNING OUR FISCAL AND REGULATORY ARCHITECTURE

Canada is living with 19th-century architecture in the 21st century. Its fiscal arrangement grows out of a rural experience, and is not responsive to the massive shift of population to Canada’s major cities and to the settlement of immigrants in the largest cities. A rigid fiscal structure has produced ongoing arguments about redistribution and health spending while urban infrastructure decays, funding for education declines relative to other countries, and Canada invests less than it should to prepare itself for the coming century. Despite years of effort, governments have been unable to adapt fiscal structures or to innovate. They usually give up in frustration and make do. The fiscal framework has been the handmaiden of the balkanization of the Canadian economy. There is no doubt that institutional rigidities have been a significant drag on our capacity to innovate and to excel.

Governance is the default factor in Canada’s success in the next decade. Without good governance, nothing will go right.

Every volume of this report bemoans the regulatory mess in Canada. Overlapping and misaligned regulations at the federal and provincial levels impose serious costs, do not contribute as well as they might to public safety and environmental stewardship, hamper the mobility of people and capital, and stifle innovation and experimentation. The burden of costly and inefficient regulation will drag productivity down and discourage investment and immigration. In essential areas—capital markets and securities—we have failed, largely because of provincial rivalries, to build the kind of national regulators that global investors have come to expect and depend upon.

Governance is the default factor in Canada’s success in the next decade. Without good governance, nothing will go right. Good governance is about far more, however, than governments. It is the coming together of corporate leaders, voluntary organizations and governments
to work together on sustainable forests and environmentally responsible mining. It is coalitions of citizens, corporate leaders, university presidents, and city officials working together to improve the quality of life in our major cities. It is giving our major cities the requisite money and power to become powerful engines of the national economy. Everything that needs to happen in Canada will happen only when all three sectors of society actively work together to change public policy, innovate and create value.

We are living with architecture built for our earlier rural past—an architecture that fits badly with the new urban Canada.

INVESTING IN CANADA’S MAJOR CITIES

The Conference Board makes clear in this report that strategic investment in our major cities is urgent. Nowhere is the gap between Canada as a global society and our political, fiscal and regulatory architectures more apparent than in our largest cities. Canada, like other societies, has transformed itself from a rural to an overwhelmingly urban society, but we are living with architecture built for our earlier rural past—an architecture that fits badly with the new urban Canada. Urbanization is likely to accelerate. Immigrants who bring valuable skills with them and compensate—at least in part—for our aging population, generally settle in Montréal, Toronto and Vancouver. Yet these cities have little voice in settlement policy or immigration policy. Indeed, Canada’s cities are not officially recognized in federal–provincial discussions and are considered creatures of the provinces. This may have made sense a hundred years ago, but it makes absolutely no sense today. Not only do cities have no official representation, they have no access to taxes that grow as the economy grows. Less than 12 per cent of total government revenues goes to municipalities. Generally reliant on property taxes and user fees, Canadian cities cannot make the kinds of basic investments in urban infrastructure, transportation and waste management required to build sustainable ecologies for the future.

If Canada’s largest cities are to become world-class centres of design, architecture and culture, and attract young, talented, creative people, they will have to do more than invest in physical infrastructure. They will have to sustain vibrant cultures and become centres of excellence in education so that they can take advantage of the global networks that power great cities and drive Canada’s economy forward. Cities today are the principal sites of innovation and production of knowledge-intensive goods and services. They must have the resources—from their province and the federal government—to invest in people so that they are socially as well as environmentally and economically sustainable. The reality of Canada’s cities today is far from this picture of excellence. What can be done to help Canada’s cities?

Canada’s prosperity depends on the success of our major cities. Governments at all levels must flow resources to major cities, which have special potential and face distinctive challenges.

The Conference Board makes the argument clearly and unequivocally: Canada’s prosperity depends on the success of our major cities. Above all, Canadians must recognize that the major cities need and deserve special assistance, and that these investments will benefit everyone. As the German government did recently with its universities and as European countries are doing with their core cities, governments at all levels must flow resources to major cities, which have special potential and face distinctive challenges. If they do not, neither our cities nor our economy will be globally competitive. We are also unlikely to sustain the arts and culture that are so important to Canadian identity.

No longer, the Conference Board insists, can we continue to interpret equality as equal per capita. That is not a popular argument to make in this country, where “fair”
is intuitively understood as “the same for everyone.” If we continue to invoke old language and avoid differentiation, we will continue to starve our cities, and everyone will lose. This is a tough but compelling argument. It deserves very serious attention.

Nor can Canada allow itself to be hobbled by an outdated fiscal and political architecture. Governments at all levels, the private sector and the voluntary sector must pool resources to work together on the shared challenges of urban finance, urban infrastructure, urban ecology and urban governance.

Urban transportation is in especially urgent need of investment. People, goods and services must be connected in ways that are both efficient and sustainable. The gridlock we currently face is a drag on our productivity, a disincentive to come to our big cities, and deeply damaging to the environment. Without major investment in the transportation infrastructure of our biggest cities, Canada will meet none of its basic goals.

People, goods and services must be connected in ways that are both efficient and sustainable.

The Conference Board also underlines the importance of viewing cities as urban ecosystems and developing industrial processes to promote the reuse of industrial by-products and waste. Cities contribute significantly to air and water pollution, greenhouse gas emissions, and overflowing landfill sites. Eco-industrial systems transform open-loop systems—where resources become waste—to cyclical closed-loop systems—where waste products become inputs for new processes. Governments at all levels will have to work together to align incentives and regulation so that industry can experiment with innovative eco-industrial systems.

How can we be truly excellent? That is an important question for Canadians to ask.

STRATEGIC INVESTMENT

This report by the Conference Board speaks with a refreshing voice because, in the final analysis, it is about excellence. It does not ask: what does Canada have to do to maintain the status quo? It asks: what do Canadians have to do to excel? In a world where we are competing with the very best, where yardsticks are now globally made, how can Canadians do much better than we have done in the past? How can we be truly excellent? That is an important question for Canadians to ask.

To be excellent, we need to get the fundamentals right. We are richly endowed, with natural resources, with people, with cities that could be the very best even if they are not now, with a few world-class post-secondary educational institutions. Our challenge—and our responsibility—is to make the most of these endowments, to provide the highest-possible level of stewardship of our resources, our people and our institutions, to differentiate when we need to build excellence, and to measure our performance against the very best in the world.
HIGHLIGHTS

- This volume, the first of four that make up the final report of The Canada Project, looks at what Canada must do to prosper in the 21st century’s global economy.

- This volume describes the dominant structural forces that are driving the global economy today; examines the risks and opportunities presented by these forces; assesses Canada’s performance in adapting to them; and makes recommendations on how we can do better.

- Five major strategies and numerous sub-strategies are identified. These strategies would strengthen the capacity of the Canadian economy to generate sustainable wealth.
Introduction

This volume is one of four comprising Mission Possible: Sustainable Prosperity for Canada, the final report of The Canada Project. Together, these volumes synthesize the results of The Canada Project’s three-year program of research and dialogue, which was undertaken by The Conference Board of Canada to strengthen leaders’ capacity to respond to major challenges facing this country.

The present volume provides both a comprehensive analysis of the global economic environment and recommendations for what Canada must do to prosper in that environment. Its aims are to describe the dominant structural forces driving the global economy today; diagnose the risks and opportunities presented by these forces; assess Canada’s performance to date in adapting to emerging economic realities; and offer guidance on how Canadian governments and business can do better.

Section I of the volume analyzes the drivers of change in the global economy and Canada’s response to date. Chapter 1 begins by looking at Canada “from the outside in,” taking stock of where Canada stands in the global economy and highlighting key opportunities, risks and uncertainties. Chapter 2 assesses Canada’s success to date in adapting to global economic changes, drawing on the benchmarking methodology that the Conference Board has used for a decade in our annual Performance and Potential reports. The chapter examines major forces reshaping the global economy: the rise of China and other key emerging markets; today’s international business system, which uses global supply chains driven by foreign direct investment (FDI); and the uncertain future of the North American Free Trade Agreement (NAFTA) as a driver of North American integration.

Major forces are reshaping the global economy and shifting Canada’s competitive position.

Chapter 3 presents a detailed analysis of the major global economic risks and challenges facing Canada today. It identifies four key issues: sustainability (i.e., the relationship between economic growth and the physical environment); global economic imbalances; the suspension of the Doha Round of World Trade Organization (WTO) negotiations in mid-2006; and the emergence of new markets that present both competition and business opportunities. All four of these issues are shaping Canada’s reaction to global forces, and highlight the need for changed approaches on the part of both government and business.

Section II of this volume shifts from analysis to action, identifying five strategies that must be adopted if Canadians are to enjoy long-term prosperity—including good jobs, adequate public health care and sustained pensions—in the decades ahead. Chapter 4 begins by presenting an overarching strategy to embrace productivity and competitiveness, which sets the framework for the subsequent chapters. Chapter 5 details how a
single Canadian market should be created through comprehensive regulatory reform and alignment, as well as increased competition. Chapter 6 presents the need to rethink the Canadian workforce, while Chapter 7 makes the case for revitalizing international investment and trade policies. Chapter 8 offers guidance for refocusing Canada’s foreign policy priorities to support economic success. The volume concludes with a chapter summarizing major recommendations.

For the recommendations of this volume to succeed in advancing Canada’s sustainable prosperity, their implementation must be conjoined with the recommendations in the other volumes of Mission Possible. Volume II, titled Mission Possible: A Canadian Resources Strategy for the Boom and Beyond, examines the present condition and future prospects of four major Canadian resource sectors: forest products, agri-food, mining and energy. It proposes strategies for government and business to renew these sectors through strategic investments, the development of more skilled workers, better regulatory processes and the introduction of new technologies. Volume III, titled Mission Possible: Successful Canadian Cities, examines how the potential of Canada’s major cities can be realized through initiatives in four main policy areas: the knowledge economy, urban transportation, industrial ecology and social sustainability. It also assesses how cities’ fiscal situations and governance must be improved in order to make major cities stronger drivers of Canada’s national economy and long-term prosperity.
SECTION I

Setting Canada on the Global Stage
At first glance, there is much about Canada’s recent economic performance to celebrate. Economic growth has been solid, stimulated by domestic consumption and investment. Inflation has been well contained within the Bank of Canada’s target range, centred at 2 per cent. Unemployment levels are at a 32-year low. Canada has enjoyed a trade surplus with the United States, its dominant trading partner, for a number of years, and has an overall current account surplus. Government debt has fallen in both relative and absolute terms, as Canada has been the only Group of Seven (G7) country consistently operating in the black.

Based on recent macroeconomic performance, things look very rosy for Canada. However, Canada’s future economic prospects will be determined not just by how we do, but by what we do vis-à-vis others in the fast-changing global economy. And here Canada faces enormous challenges.

Canada is facing a remarkable dichotomy today. Even as we post impressive macroeconomic results, our microeconomic performance is a source of deep concern. As a result, Canada has suffered from weak productivity and income growth for much of the past 20 years. The concerns about our micro-economy and related productivity and income growth are only going to increase, due to the profound structural changes taking place within the global economy. These global changes will place even greater pressure on sectors and firms to improve their international competitiveness in order to survive, let alone thrive. Similar pressure will be placed on international trade and investment policy, which has lacked strategic focus.

The following two chapters of this volume will address these issues by examining Canada’s economic place in the world (in Chapter 2) and by assessing the opportunities, risks and uncertainties posed by four major global economic issues (in Chapter 3). 🍁
HIGHLIGHTS

- The Canadian economy is performing sufficiently well to rank among the best in the world; however, we are stalling or losing ground in areas critical to our ability to compete globally. These areas include per capita income, productivity, exports of value-added goods and services, and innovation.

- This decline will affect our future prosperity. Our long-term success depends on our ability to tap into new growth opportunities in a global economy that is becoming more integrated.

- This new era of “integrative trade” is based on global supply chains and is driven by foreign direct investment (FDI). Canada needs to restructure production, trade and investment strategies to attract more FDI into Canada and to increase outflows of FDI as well.

- North American economic integration has grown under the North American Free Trade Agreement (NAFTA), creating a strong regional platform from which to compete in the global economy. However, signs that NAFTA may be reaching its limits are increasing.

- Exports to the U.S. are growing more slowly, and export growth is increasingly sustained by the energy and resource sectors. Imports of U.S. goods and services have been tailing off. While our relationship with the U.S. is vital, it is changing in response to shifts in the global economy.
OUR GLOBAL ECONOMIC STATUS

SLIPPING IN THE RANKINGS

Since The Conference Board of Canada introduced its international benchmarking a decade ago, Canada has consistently ranked well when compared with the other major industrialized countries. But our relative ranking on income per capita—a commonly used measure of a country’s standard of living—has been slipping relative to other countries. Among countries of the Organisation for Economic Co-operation and Development (OECD), Canada ranked in fifth place in 1990, behind Luxembourg, Switzerland, the United States and Iceland. The most recent year of data, 2005, puts Canada in 10th spot—now also surpassed by Norway, Ireland, the Netherlands, Denmark and Australia.

Canada is stalling or losing ground in areas critical to its ability to compete globally.

How important is such a decline? Fluctuations in year-over-year measures are not necessarily critical. But they can be indicative of a trend which, once underway, could quickly accelerate and become very difficult to turn around. The Canadian economy is performing sufficiently well to rank among the best in the world; we are still in the gifted class among nations. We have the advantages of huge natural resource wealth, skilled human capital and free trade with the U.S., the most dynamic economy on earth. Today, with a strong loonie, we are holding the resources trump card in an era of exploding commodity demand, and we enjoy relative safety in a world rife with risk. But we are slowly being pushed to the back of the class. We need to recognize, admit and come to grips with the factors that are causing us to stall or lose ground in areas critical to our ability to compete globally.

First, we are laggards on productivity, which directly affects our standard of living. Not only is there a persistent and growing productivity gap between Canada and the U.S., but Canada also lags behind most OECD countries in productivity growth. Between 1995 and 2000, Canada’s average annual productivity growth ranked 13th among OECD countries. In the more recent period of 2000 to 2005, Canada’s ranking dropped to 20th. (See Chart 1.)

Second, other industrialized countries are not standing still. Many are outperforming us, even in areas that have been a source of strength for Canada. Our recent strong growth in employment still ranks below that of many other countries, including Spain, Ireland, Australia and the United States.

And third, and of increasing consequence, we are failing to keep pace with the sweeping changes taking place in the global economy, led by the spectacular rise of China and other major emerging market countries like India and Brazil. (See box “Nomenclature: The Emerging and the Emerged.”)
Canada’s slipping overall economic performance occurs at a time when the engine of global economic growth is shifting from aging industrial economies to China and the larger emerging economies, the U.S. being a notable exception. Many factors are contributing to this shift, with demographics and reforms to economic policy being two of the main ones.

In many industrialized countries, long-term growth potential is declining as aging populations reduce the growth rate of the labour force; more workers are retiring, with fewer new workers to replace them. This problem is compounded by significant fiscal deficits, rising public debt and rigid microeconomic policies that inhibit adjustment, lessening the attractiveness of these countries as future export and investment markets. Although real incomes and individual purchasing power will remain high in Western Europe and Japan for decades to come, their economic growth potential—that is, the highest economic growth that is sustainable over the long term—has dipped to 2 per cent or lower, and will fall further in the coming years.

This report therefore generally refers to “China and other emerging economies”—the latter including the large economies of India, Brazil and Russia, as well as other smaller but important market-oriented economies like Central and Eastern Europe, Mexico and South Korea.

Source: The Conference Board of Canada.
The U.S. is an anomaly among industrialized countries: it will maintain potential economic growth at 3 per cent until at least 2020. This is due to higher fertility rates among Latinos and African Americans and strong immigration, which contribute to strong labour force growth and to an economy that is more flexible and more innovative than many others.

There is a fundamental shift in global economic tectonic plates.

Meanwhile, many emerging market countries have significantly boosted their underlying economic growth potential by embracing market-oriented reforms and integrating into the global economy. With lower labour costs, as well as a rising middle class of consumers with disposable income, their rates of economic growth are outstripping those of more mature economies. (See Chart 2.) China’s extraordinary rise leads the way, catalyzed by the country’s entry into the World Trade Organization (WTO) in the late 1990s. It is joined by India, Russia, Brazil and Mexico, as well as other countries in Asia, Central and Eastern Europe, Latin America and even a few in Africa, which are now on a stronger upward growth trajectory.¹

The result is a fundamental shift in global economic tectonic plates. Using conventional measures based on current market exchange rates, Canada’s economy currently stands eighth in the world, behind the rest of the Group of Seven (G7) countries plus China.² (See Chart 3.) Using the more stable measure of purchasing power parity (PPP)—a conversion rate at which purchasing power is equalized—Canada slips to 11th,

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¹ The September 2006 World Economic Outlook published by the International Monetary Fund (IMF) forecasts that 21 countries, all of which are in the developing world, will produce economic growth of 7 per cent or greater in 2007.

² Canada and Spain have essentially the same level of national gross domestic product (GDP), so their respective rankings in eighth and ninth place can change with market-driven movements in exchange rates of the Canadian dollar and the euro.
behind the four BRIC countries. China moves up to second, ahead of Germany and Japan, and India jumps to fourth.3 (See Chart 4.)

It will, of course, be many years before the leading emerging economies catch up fully to those in the industrialized world. Even the most optimistic observers do not expect that China will reach the size of the U.S. economy until sometime around mid-century. Nor are total economic size and growth rates the only factors. China and India account for a third of the world’s population, and Brazil is also a populous country. As a consequence, income per capita in these countries is still very low in relative terms. Nonetheless, each has a growing middle class that has a strong stake in rising living standards and stable future economic growth.

The basic direction is clear. First, powerful forces are at play that will change the distribution of global status, power and influence in the coming decades. And second, Canada—with an aging population and relatively slower rates of sustainable annual economic growth—will find it hard to avoid falling further in the global rankings. In relative global terms, Canada, like many other industrialized countries, is getting smaller in terms of its economic influence.

Shrinking economic weight in the world, however, should not be confused with shrinking economic performance. As many countries have shown, it is possible for a medium-sized or even a small country with a highly successful economy to produce much higher living standards for its citizens. But Canada will remain highly successful only to the extent that we realize the new growth opportunities inherent in the global economy, while mitigating its adverse impacts.

**Powerful forces are at play that will change the distribution of global status, power and influence.**

**KEY CANADIAN SHORTCOMINGS**

The significance of the shift taking place in the global economy due to the rise of China and other emerging economies is compounded by the extraordinary breakthroughs taking place in information and communications technology. Together, they are changing the structure of the global economy, which is becoming more investment oriented, more trade oriented and more

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3 Note that GDP estimates in developing countries like China are subject to greater variability and can be less accurate than in more industrialized countries. There is, however, no compelling evidence that these data systematically overstate (or understate) ongoing economic growth.
services oriented. It is also becoming more knowledge and innovation oriented. Canada is at risk of falling short on all these fronts.

**WEAKNESS IN FOREIGN DIRECT INVESTMENT**

One of the causes of our sliding economic performance relative to others is insufficient inward foreign direct investment (FDI). This shortfall is happening at a time when FDI investment is growing rapidly around the world, outpacing growth in production and in international trade. (See Chart 5.) Since 1990, gross domestic product (GDP) has increased by an average of 4.6 per cent per year, and exports by 7.3 per cent; the flow of FDI worldwide grew by a whopping 12.2 per cent per year.

Consistent with global trends, Canada’s FDI, both inward and outward, has grown rapidly in dollar terms. (See Chart 6.) From 1990 to 2005, the stock of inward FDI rose by more than three times, to $416 billion, while our stock of outward FDI rose even faster, turning us into a net outward investor. Nonetheless, our share of world FDI stock has fallen, due largely to weak inward FDI. Our share of global inward FDI stock fell from 10.2 per cent in 1980 to 6.4 per cent in 1990, and to 3.4 per cent in 2004 (the last year for which global FDI data are available). (See Table 1.) Our global share of outward FDI has also fallen marginally, from 4 per cent in 1980 to 3.9 per cent in 2004. The fall in inward FDI stock in Canada is in sharp contrast to the situation in the U.S., which has largely sustained its share between 16 and 22 per cent, and in Europe, whose share has been maintained at around 45 per cent—due mostly to closer market integration. At the same time, emerging economies are drawing increasing amounts of FDI: China’s share of global FDI stock grew from 0.2 per cent in 1980 to 2.8 per cent in 2004.

Although Canada’s FDI inflows are still impressive in nominal terms, we are lagging behind the top global performers. The FDI Performance Index provides country shares of global FDI inflows and outflows compared with each country’s share of global GDP. (See Chart 7.) The FDI Performance Index thus captures a country’s relative success in taking advantage of global FDI, both inward and outward, for wealth creation. Although

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4 Rhéaume, *Open for Business?* p. i.
Canada’s index ranking in 2004 was high, at sixth place, we nevertheless lagged behind comparable countries like Sweden, the United Kingdom and Australia, mainly because of the declining share of global FDI flowing into our country.

**Canada’s share of world FDI stock has fallen, and confidence in Canada as an investment destination continues to decline.**

Canada has also lost some of its lustre as an FDI destination. The FDI Confidence Index, based on a survey by the Global Business Policy Council of A.T. Kearney, points to probable trends in future FDI flows. Countries like China, Mexico, Poland and Brazil achieved the strongest confidence scores; confidence in Canada as a destination for investment was much weaker. Similarly, the influential World Economic Forum ranked Canada 16th in global competitiveness in 2006—down significantly from eighth place in 2002. Senior executives surveyed by the Conference Board most commonly described Canada as an “average” place to invest, due to factors as varied as our labour force’s skills and ability to adapt, tax competitiveness and persistent barriers to foreign investment. At a time when competition for international investment dollars is skyrocketing, “average” clearly will not cut it.

**UNREALIZED FOREIGN MARKET POTENTIAL**

The global shift taking place among the world’s major economies is mirrored by a shift in the structure of international trade. Total trade between industrialized countries and developing countries (so-called North–South trade) rose from 29 per cent in 1998 to 33 per cent in 2004. Total trade among developing countries (so-called South–South trade) grew from 41 per cent to 47 per cent over the same period. Trade among industrialized countries has fallen.

When it comes to trade in goods, Canada has broadly echoed the global pattern. Exports to the U.S. over the past 15 years have expanded substantially under NAFTA, to 84 per cent of total exports, making our economic integration increasingly regional, as opposed to global. (See charts 8 and 9.) The share of our trade with China and other emerging markets has taken off (albeit from a low base), while that with our traditional non-U.S. partners, Japan and Europe, has declined or stagnated.
The result has been a reshuffling in our trade partner rankings, in which China has replaced Japan in the number two position—partly due to rising exports, but due even more to skyrocketing imports from China. (See charts 10 and 11.)

UNDERACHIEVING IN SERVICES
Services exports are another story of underachievement. The broad structural shift in the global economy toward services, particularly in industrialized countries, is echoed within Canada. Services now account for about two-thirds of Canadian GDP and 7 of 10 jobs, including some of our best-paying jobs in knowledge-intensive industries like financial services, architecture and engineering.

Unfortunately, the high services profile of our economy is not being fully translated into international trade. Our services exports are only 12.8 per cent of total exports—considerably below the 2004 world average of 19.6 per cent and the U.S. share of 29.1 per cent.5 (See Chart 12.) Our share is also well below the service exports share of countries with a similar economy, like Australia, at about 22 per cent.9 (See Chart 13.) In short, our economy has become substantially more services based, but our trade has not.

MISSING OPPORTUNITIES IN KNOWLEDGE MANAGEMENT AND INNOVATION
With strong capabilities in areas like medical research, and information and communications technology, and with high levels of education, Canada should be well poised to succeed in an increasingly knowledge- and innovation-driven world.

What are our areas of strength? One is our openness to foreign ideas; another is the amount of technological cooperation between companies. We have also achieved high penetration of broadband technology. All of these strengths indicate good capacity for trading in the global market for services.

Canada needs to open itself to breakthrough discoveries in targeted priority sectors.

Again, however, there are areas for concern. We lag behind the top global performers in business investment in research and development. We certainly do not measure up in commercialization—extracting the maximum value from our innovation investments by taking

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8 There are structural reasons for this low share, such as the current high energy and commodity prices that are driving energy and other commodities as major Canadian exports. Still, even taking these factors into account, as well as the expectation that official data underestimate the true dimensions of services trade, Canada’s services trade is less well developed than it might be.

9 Note that there is an inconsistency between Chart 12, which shows Canadian services exports falling slightly between 1994 and 2004 as a share of total exports, and Chart 13, which shows them rising slightly. This may be due to methodological issues in how services trade data are recorded for international comparisons. However, the relative share of Canadian services exports to total exports is roughly the same in both cases, at around 13 per cent. Regardless of the methodological differences, Canada has not felt the surge in services exports that other countries have experienced.
new ideas to market and turning them into improved products and services. We are not doing as well as we could when it comes to industry collaboration with governments and universities, as well as in scientific and engineering publications. We are also lagging in the proportion of researchers in our workforce and in registering our own (triadic) patents. Of particular interest for Canada’s ability to improve its standard of living, we rank 13th among OECD countries in the contribution that information and communications technology makes to productivity.

Looking ahead, we will need to think beyond incremental improvements in a variety of sectors and open ourselves to breakthrough discoveries in targeted priority sectors, identified through evidence and analysis, as discussed in the Conference Board report *Picking a Path to Prosperity: A Strategy for Global-Best Commerce*. Some suggest the world may be on the cusp of a transformative leap forward that will usher in a new knowledge era as breathtaking as the advances of previous centuries, and one that may well involve China, India and other emerging economies. If so, it effectively means that while we are still trying to figure out how to succeed in the economy
we know, another new economy is already rapidly coming upon us, one that will change basic assumptions about production, consumption and comparative advantage.

**THE ERA OF INTEGRATIVE TRADE**

These drivers of structural change within Canada and globally are part of a larger phenomenon, fundamentally changing the way the world does business. This phenomenon is captured in the concept of “integrative trade,” a term that reflects the use of global supply chains, driven by FDI, as the ascending international business model. Integrative trade incorporates all the elements used by firms today to achieve the lowest possible cost and maximize return: exports, imports used to create exports, inward and outward FDI that is used by firms to develop global value chains, sales from foreign affiliates and offshore outsourcing. Traditional trade in end goods and services continues to take place, but integrative trade has taken on much greater importance as lower international trade barriers allow firms to reposition elements of their business model around the globe, wherever it makes the most business sense. (See Table 2.)

**GLOBAL SUPPLY CHAINS**

The ascendancy of integrated global supply chains—in which production is distributed around the globe in search of higher efficiency and lower costs for each component of the final good—is revolutionizing global manufacturing. In sectors such as automotive, ground transportation, telecommunications and aerospace,

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**Table 2**

Traditional Versus Integrative Trade Paradigms: A Comparison

<table>
<thead>
<tr>
<th>Traditional Trade</th>
<th>Integrative Trade</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Comparative advantage:</strong> countries specialize in particular goods and services available to them and trade to raise overall wealth.</td>
<td>Dynamic comparative advantage: countries specialize in what they produce best through firms shifting elements of production globally, resulting in greater overall wealth.</td>
</tr>
<tr>
<td>Trade encompasses sale and shipment of physical goods.</td>
<td>Trade encompasses both physical goods and services.</td>
</tr>
<tr>
<td>Trade is largely between firms located in different countries.</td>
<td>There is much more intra-firm trade.</td>
</tr>
<tr>
<td>Foreign markets are primarily end-users of exported products.</td>
<td>Exports and imports are no longer separate but integral parts of same global supply chains, especially in manufacturing.</td>
</tr>
<tr>
<td>FDI is seen as “trade substitution,” to avoid tariff barriers (e.g., branch plant phenomenon).</td>
<td>Outward FDI is associated with “trade creation,” through development of new exporting (and importing) opportunities.</td>
</tr>
<tr>
<td>Inward FDI enhances recipient country’s ability to expand production, resulting in more economic activity, more jobs and income gains.</td>
<td>There is increasing reliance on sales from foreign affiliates, not exports, to meet needs of foreign clients.</td>
</tr>
<tr>
<td>Contracting out, or outsourcing, is to company down the street.</td>
<td>Offshore outsourcing takes advantage of lower cost production and wages in other countries.</td>
</tr>
</tbody>
</table>

Source: The Conference Board of Canada.

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10 First introduced by Hodgson, “Trade in Evolution: The Emergence of Integrative Trade,” p. 3.
semi-finished products typically now travel repeatedly back and forth across borders before completion of the final product; close to one-third of world trade today is intra-firm trade.

Where does Canada fit in global supply chains? We know that integration has grown: the domestic content of total Canadian exports fell from 72 per cent in 1987 to 64 per cent in the mid-1990s, and rose slightly to 65 per cent in 2002, the latest year for which data are available. Our further examination of Canada’s trade over the past two decades indicates a growing integration into global supply chains with emerging markets. (See box “Canada and Supply Chains.”)

Even more revealing is the sectoral distribution of domestic (and foreign) content in exports. Since Canada is a highly open economy, all business sectors rely on foreign inputs in production, but the level of foreign content and of its reciprocal—domestic content—varies significantly among exporting sectors. Using 2002 data, domestic content of Canadian exports exceeds 70 or even 80 per cent for certain resource industries, such as mineral fuels (i.e., oil and gas). (See Chart 14.) Domestic content is also above 80 per cent for many services exports, such as financial services and tourist accommodation.

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### Canada and Supply Chains

As a step toward building better analytical tools, Canadian exports to and imports from 10 countries and regions over the 1990–2005 period were evaluated using a new classification system developed by the Conference Board. Goods are classified based on their point of entry into another country’s supply chain (i.e., from the importer’s perspective rather than the traditional exporter’s perspective).

This work shows that, when measured in real terms (i.e., when the impact of price inflation is removed), the share of raw materials in total Canadian exports decreased from 40 per cent in 1990 to 31 per cent in 2005, and the share for intermediate goods increased from 28 to 32 per cent. (See chart “Composition of Canadian Exports, From the Importer’s Perspective.”) This shift away from raw products towards intermediate goods has occurred to an even greater extent in the BRIC countries. For example, the share of raw material exports to China dropped from 70 to 52 per cent, while the share of intermediate goods increased from 11 to 30 per cent.

When it comes to exports to the U.S., however, these proportions have remained fairly stable. The share of intermediate goods in Canadian exports to the U.S. declined slightly, from 33 to 32 per cent, and the share of raw products to the U.S. fell from 30 to 28 per cent. (See chart “Composition of Canadian Exports to the U.S., From the Importer’s Perspective.”) The minimal movement in the share of raw materials in Canadian exports to the U.S. is largely a reflection of ongoing U.S. reliance on Canadian energy exports.

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### Composition of Total Canadian Exports, From the Importer’s Perspective (per cent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Raw</th>
<th>Intermediate</th>
<th>Finished</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td></td>
<td></td>
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<tr>
<td>2005</td>
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</tbody>
</table>

Note: Only the top 25 export categories for each year have been used.
Sources: The Conference Board of Canada; Statistics Canada.

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### Composition of Canadian Exports to the U.S., From the Importer’s Perspective (per cent)

<table>
<thead>
<tr>
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</tbody>
</table>

Note: Only the top 25 export categories for each year have been used.
Sources: The Conference Board of Canada; Statistics Canada.

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Source: The Conference Board of Canada.
In contrast, sectors that have become deeply integrated into the North America economy, particularly in manufacturing, have seen their domestic content slide to 50 per cent or lower. For example, exports of electrical, electronic and communications products had Canadian content of 51 per cent in 2002. The Canadian content of motor vehicles, transport equipment and related parts was 45 per cent—in other words, Canadian production of automobiles and parts that are then largely exported to the United States relies more on foreign inputs than it does on Canadian inputs. Further disaggregation reveals even lower levels of Canadian content for specific manufacturing subsectors, firms and products. This is clear evidence of the tight integration between Canadian imports and exports—integrative trade in action.

With trade liberalization and the rise of global supply chains, however, FDI has increasingly become a much sought-after means of generating wealth and stimulating trade—in both directions. We should be not only attracting more FDI into Canada, but also doing more to facilitate growing outflows of FDI. (See box “Outward FDI and Trade Creation: The Evidence.”) In other words, international opinion has shifted significantly; the perceived benefits of FDI far outweigh its drawbacks. This is fundamentally changing the way we look at trade and investment, and the relationships between them. Indeed, in future we should perhaps speak less in terms of “international trade and investment”—and more about “international investment and trade.”

The perceived benefits of FDI far outweigh its drawbacks. This is fundamentally changing the way we look at trade and investment.

The broad direction is clear. First, the old “exports good/imports bad” perspective of international trade is giving way to a new realization that for many firms and industries, both exports and imports are critical to an integrated production process. And second, Canadian companies must compete vigorously for this kind of international trade and investment.

FDI AS A DRIVER OF TRADE
Not only is the shape of international trade changing, so are the relationships between trade and FDI. Although Canadians are increasingly recognizing the benefits of free trade, FDI continues to suffer from popular misconceptions. It is still susceptible to being viewed with suspicion—a sign of economic weakness and loss of control, in the case of inward FDI—and as potential job losses due to a shift of investment offshore, in the case of outward FDI. Much of the reason for this suspicion is historical: FDI was often a substitute for exports, a way of getting around trade barriers to enter, and potentially dominate, a foreign market. (See box “The Benefits of FDI—In and Out.”)
SALES FROM FOREIGN AFFILIATES

Associated with the surge in Canadian outward FDI have been growing sales of goods, and more particularly of services, from Canadian-owned foreign affiliates. Canadian businesses—faced with negative factors such as trade or regulatory barriers, or positive factors like serving new foreign customers—are turning to foreign investment as a way of enhancing access to markets and serving them. Such sales in 2004 were in the order of $370 billion, a figure comparable with total Canadian goods exports in that year. (See Chart 15.) The direct benefits of these sales, in the form of dividends and profits that eventually return to Canada, are still relatively minimal. But the indirect benefits, in terms of making Canadian businesses more competitive internationally, are potentially enormous. This phenomenon is just beginning to be captured in Canadian trade statistics. Canada needs to produce more focused intelligence if we want to be a world leader in providing relevant, accurate and timely data on trade in services, including data on sales from foreign affiliates.

FDI, CORPORATE RESTRUCTURING AND “HOLLOWING OUT”

While attracting our fair share of FDI is critical to Canada’s future prosperity, the nature of that investment, the corporate form of multinational enterprises (MNEs)—both Canadian and foreign controlled—operating in Canada, and the specific head office and other business functions that are situated in Canada are no less important.

FEARS THAT FREE TRADE WOULD SPUR AN EXODUS OF FDI AND JOBS FROM CANADA HAVE NOT BEEN REALIZED

During the 1980s debate on the benefits and risks of free trade, one negative prediction was that lowering long-established tariffs would lead to an exodus of FDI and manufacturing jobs from Canada. The argument was that “tariff factories”—previously set up by MNEs to bypass Canadian tariffs—would no longer be necessary or viable. Instead, firms would transfer production to lower-cost plants in the U.S. and abroad, thus servicing the Canadian market through imports rather than through local manufacturing. This fear was reinforced by the belief that smaller Canadian plants were less

Outward FDI and Trade Creation: The Evidence

A 1999 OECD study concluded that, on average, each dollar of outward FDI generated double that amount in additional exports from the originating country to the recipient. The trade multiplier was stronger when the recipient was a developing country rather than a mature economy. FDI to a developing country could boost trade for the investing country by three to six times the amount of the original investment.1 Export Development Canada (EDC) research concluded that flows of FDI from Canada to the U.S. and other mature economies led to follow-on export sales of about 60 per cent of the initial investment, or a multiplier of 0.6. The multiplier used by EDC jumps (conservatively) to 2.0 for Canadian FDI flowing to developing countries.2

A correlation analysis undertaken by the Conference Board assessed the relationship between outward Canadian FDI and exports between 1990 and 2004. This analysis produced a strong positive correlation (0.95).

On a country basis, the correlation between outward Canadian FDI and exports was strongest for the U.S. (0.97), which is not surprising in view of the close integration of the two economies. Also strong was the correlation for Mexico (0.83) and for China (0.73), with positive but progressively weaker correlations for India, Russia and Brazil. The exception was Japan, where a negative correlation (−0.12) suggests that outward Canadian FDI to Japan might act as a substitute for higher Canadian exports to the Japanese market.

1 Fontagné, Foreign Direct Investment and International Trade, p. 21.
2 Hodgson and Evans, The Quiet Creator of Canadian Wealth, p. 6.

Source: Beckman and Hodgson, “Making Connections.”
efficient than the larger American factories. The latter were assumed to be better prepared to benefit from economies of scale and lower labour costs.

Under this scenario, it was feared that Canada would essentially become a “warehouse economy” where the primary purpose of foreign-owned subsidiaries would be to market and sell products manufactured and imported from abroad. Alternatively, MNEs would rationalize production by having their Canadian plants manufacture or assemble final products made primarily from core components produced in the U.S., resulting in a “hollowing out” of the Canadian economy and the loss of competitiveness over the long term.

Despite these concerns, the available aggregate data do not suggest a hollowing out problem for Canada. Statistics Canada data indicate that from 1999 to 2005, the number of head offices in Canada grew by 100 on a net basis, to 4,161—representing net growth of 4.2 per cent.11 Similarly, head office employment grew by 11 per cent over the same period, with positive employment growth occurring in both domestically controlled and foreign-controlled enterprises.

It is similarly noteworthy that while Canadian manufacturing employment has been in decline over the past two years, with net losses of around 200,000 jobs, Canadian manufacturing employment in 2006 is still roughly comparable with 1998 levels. In contrast, the U.S. has lost nearly 20 per cent of its manufacturing jobs over that same period, offering much stronger evidence of a corporate hollowing out in U.S. manufacturing than is the case in Canada. The job loss in the U.S. is strongly related to the transfer of large-scale, standardized manufacturing functions to China and other lower-cost manufacturing centres, guided by outward U.S. FDI to China.

Canada’s cities have a keen interest in the evolution of corporate structures, and are concerned about the risk of hollowing out. Major cities and regions can be affected in multiple ways by changes to corporate functions within head offices. There is the direct impact on highly skilled employment in head offices themselves and in well-paid professional services that support head offices—such as legal, financial, accounting and management advice. Retaining and growing these functions is a key element of keeping cities and regions dynamic and vital. There are other functions and jobs—both within and outside a corporation—that can be affected by decisions on head office location. And there can be an impact through the capacity of cities and regions to attract and retain the creative classes that are so important to the future of cities. The key success factors for Canadian cities will be examined in depth in Volume III of this final report.

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11 Statistics Canada, “Head Office Employment.”

12 Ibid., p. 1.

From 1999 to 2005, head office employment grew by 11 per cent.

Recent Statistics Canada data indicate significant differences in head office employment trends among major Canadian cities, offering aggregate evidence of hollowing out in a few specific cases—even as head office employment in other cities continues to grow. On the positive side of the ledger, head office employment grew by 64 per cent in Calgary, 28 per cent in Ottawa and 19 per cent in Toronto from 1999 to 2005. However, over the same period, it was flat in Montréal, declined by 7 per cent in Winnipeg and shrank by a startling 29 per cent in Vancouver, representing a loss of nearly 5,000 head office jobs in the latter city.12 Much of the decline in Vancouver’s head office employment can be attributed to foreign acquisition of Vancouver-based Canadian corporations.

Surprisingly, the data also indicate that foreign-controlled firms accounted for about two-thirds of the net increase in head office employment, and all of the growth in the number of head offices. Undertaking more extensive analysis on a sectoral basis would provide deeper insights into where Canada has captured growth in head office employment, and where hollowing out may be evident in specific sectors.
BEHAVIOUR AND IMPACT OF MULTINATIONAL ENTERPRISES

In partnership with the Social Sciences and Humanities Research Council of Canada, The Canada Project engaged academic researchers to undertake original work on the behaviour and impact of MNEs. One study examined the changing roles and characteristics of MNEs operating in Canada during the period after the North American Free Trade Agreement (NAFTA) took effect—including both foreign-owned and Canadian-owned subsidiaries—using a detailed survey of senior management representatives from 62 MNEs currently operating in Canada.13 The survey looked at the initial FDI motivations for setting up operations in Canada, the subsidiary’s initial role within the parent company, and the way that free trade has affected the subsidiary’s specific set of competencies and resources.

Fears of hollowing out are often based on the assumption that bypassing tariffs was MNEs’ primary—or even the sole—motivation for setting up operations in Canada. However, this assumption does not take into account that MNEs often had other reasons for setting up in Canada and that subsidiary roles and competencies could change over time.

The study found that, after an initial period of rationalization and consolidation following the signing of the Canada−U.S. Free Trade Agreement (FTA) and NAFTA, the majority of foreign-owned subsidiaries participating in the survey capitalized on firm-specific competencies and the strategic importance of the Canadian environment to carve out roles within their MNEs that went beyond bypassing tariffs to access the Canadian market. Many have since become strategic leaders within or key contributors to their company’s global network.

Most MNEs that were surveyed believe that the FTA-NAFTA have had either a positive or neutral impact on their organization. Only one U.S.-based and one EU-based MNE reported that the impact has been negative on their organization; two EU-based MNEs said that the impact has been both positive and negative. No Canadian-based MNE reported a negative effect.

The value-chain activities that were most often identified as having benefited from the FTA and NAFTA were back-end activities like purchasing and logistics, as well as production activities. Relatively fewer benefits were reported for support activities (such as coordination and control, financial management and human resources management) and customer-end activities (sales and marketing, and after sales service).

Many foreign-owned subsidiaries operating in Canada have become strategic leaders in their company’s global network.

There is, however, a striking gap in the study’s findings between EU-based and U.S.-based MNEs operating in Canada. For many of the U.S.-based firms in the study, the Canadian operations are among the most respected subsidiaries in the company’s global network. But EU-owned subsidiaries in Canada rated themselves as weaker than both their most important local competitor and the most respected subsidiary within their MNE. EU-owned subsidiaries appear to be predominantly implementers, rather than strategic leaders. Also, U.S.-based MNEs have been able to transfer key knowledge and skilled personnel within the home NAFTA region more easily than have EU-based firms. The U.S.-owned subsidiaries have been able to draw upon regional strengths and, in some cases, augment their parent companies’ specific set of competencies through the development of subsidiary-specific competencies within the Canadian market.

Differences between the U.S.- and EU-owned subsidiaries were also evident when survey participants were asked to rank the Canadian subsidiary against the most respected subsidiary within the company. The Canadian subsidiaries of U.S.-based MNEs generally ranked themselves on par with the most highly respected subsidiary; the EU-based firms tended to rank themselves much lower. This is particularly evident in the areas of coordination and control, production, sales and marketing, and logistics.

13 Verbeke et al., The NAFTA Effect.
Another study surveyed 168 of the most senior human resource managers in Canadian- and foreign-owned MNEs operating in Canada. Two contrasting types of Canadian operations of MNEs emerge from the study. The first comprises MNEs primarily focused on the Canadian market that do little or no research and development (R&D) in their Canadian operations. Managers have less autonomy and are unlikely to be innovating in their employment practices or to be exporting their practices elsewhere in their worldwide company. These MNEs are less likely to have substantial links with networks in Canada, particularly with educational institutions or in the area of standards for corporate conduct. These firms are also more likely to be hollowed out, since the absence of main offices in Canada limits their interactions with networks and institutions in Canada.

The second type comprises MNEs whose Canadian operations do engage in R&D. Managers feel they have autonomy to develop human resource and employment policies, and they regularly innovate, notably in partnerships with employees. Such innovations seem to be essential prerequisites for MNEs to compete successfully in global markets, and their innovations are often picked up elsewhere in their worldwide operations. These firms report significant organizational capabilities in their Canadian operations and are making links with educational institutions, leveraging public policy resources and discussing standards for corporate conduct with the community. Such firms also have more significant main offices in Canada that help to influence the institutional environment.

Both of these types of MNEs operating in Canada have viable business models, but the second offers greater potential for Canadian prosperity and well-being in a global economy. The key question therefore is how to foster the development of these MNEs. This study offers some insight into which MNEs are more likely to engage in practices that foster sustainable prosperity in Canada.

- Canadian-owned MNEs operating in Canada are more likely to have an international market orientation than are foreign-owned MNEs.
- U.S.-owned MNEs, which make up almost two-thirds of the foreign-owned MNEs in Canada, tend to grant less autonomy to their Canadian subsidiaries to develop new products, processes, and employment policies and practices than their Canadian counterparts.
- Canadian-owned MNEs, highly transnational firms and the Canadian operations of MNEs competing in international markets are more likely to be at the forefront of management development and to see their innovations in employment practices emulated elsewhere in their worldwide firm.
- The Canadian-owned MNEs, European-owned MNEs and MNEs competing in global markets are the ones that tend to do more R&D.
- Canadian- and foreign-owned MNEs with main offices in Canada, and firms with an international market orientation are all more likely than firms with a domestic focus to build local networks through industry associations, forums for labour market training, educational alliances and standards for corporate conduct.

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Innovation is an essential prerequisite for MNEs to compete successfully in global markets.

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Two key policy conclusions result from the study. First, main offices in Canada and greater investment in Canadian networks and institutions help Canadian operations to play a more significant role within their worldwide companies. Second, public policy cannot be a cheerleader on the sidelines; it is an important resource in this “global game,” helping to develop firm-specific capabilities and differentiating the role of the Canadian operations within their worldwide companies.
OFFSHORING, OUTSOURCING AND NEARSOURCING

“Offshore outsourcing,” also called “global outsourcing” or “offshoring,” is not a new phenomenon. But the growing significance of offshore outsourcing in the global economy is new as India and, to a growing extent, China and other developing countries like Vietnam establish themselves as preferred suppliers to companies seeking to lower costs and improve their competitiveness.

Although offshoring has become a lightning rod for job losses in the U.S. and elsewhere in the manufacturing and information technology (IT) sector, the evidence thus far suggests that the connection exists more in popular imagination than in reality. Job losses are typically small in relation to the overall size of the economy and to domestic outsourcing. They also tend to involve lower-end functions, releasing talent to higher value production that provides a competitive edge, or to employment elsewhere in the labour force.

Offshoring is not for every industry and business, but Canadian industry may be taking too little advantage of this option for improving efficiency. Meanwhile, there has been a resurgence of interest in “nearshoring”—as factors like professional experience, technological skills and quality increasingly drive European and U.S. companies to shift operations from India and similar long-distance locations to destinations closer to home, including Central Europe, Ireland, Mexico, parts of Latin America, and Canada. (See box “Offshoring Versus Nearshoring: The Canadian Experience.”)

Offshoring Versus Nearshoring: The Canadian Experience

To better understand how Canadian businesses perceive offshoring, the Conference Board carried out a survey in 2004 of companies potentially interested in offshoring their business processing—i.e., back office operations or customer interaction services (call centres). The survey results revealed that 58 per cent of the firms sampled are not involved in offshoring. Of those that are, most are in the manufacturing, software and user support areas. Few firms have a strategic management plan for offshoring, and future investment in offshoring was also expected to be low. (See chart “Planned Offshoring Over the Next Three Years.”)

In contrast, there is evidence that a growing number of companies are locating such operations in Canada. KPMG’s 2006 edition of its biannual study Competitive Alternatives found that Canada ranks second, behind Singapore, as the most cost-competitive place to do business among nine industrialized countries. For international cities with a population of more than 2 million, Singapore ranks as the most cost-competitive overall. Montréal is the most cost-competitive large city in the G7, followed by Atlanta, Toronto and Tampa. A 100-person software design company would have annual costs of less than $13.2 million in Montréal, compared with $14.9 million in Boston and $15.7 million in New York—an 11 to 16 per cent cost saving. Annual costs in Singapore would be $9.7 million—a cost advantage over Montréal of 27 per cent.

Sources: Balsom and Nadeau, Business Process Offshore Outsourcing; KPMG, Competitive Alternatives.
REACHING THE LIMITS OF NORTH AMERICAN ECONOMIC INTEGRATION

Over the past two decades, Canadians have largely bought into the unavoidable reality that our future economic prosperity is heavily reliant on close economic relations with the United States. There is little doubt that bilateral economic integration has grown. Firms’ supply chains criss-cross our border, with as much as 40 per cent of bilateral trade now being intra-firm, (i.e., involving different parts of the same company). Many of our companies operate continental; our electricity infrastructure is also largely integrated along continental lines. Not only have such linkages multiplied, but Canada’s most successful companies now view the North American economy as a single platform from which to compete in the global economy. Canadians have a strong interest in eliminating remaining obstructions to the efficient movement of goods, services, investment and people within the continent. And the publics in both countries need to appreciate the enormous economic benefits of mutual interdependence.

At the same time, however, we need to recognize that the structure of Canada–U.S. economic integration is changing in important ways. Our exports to the U.S., the most commonly cited integration measure, have grown much more slowly in recent years. During the 1990s, Canada’s exports to the U.S. rose dramatically as a result of a combination of three key factors: a remarkably strong U.S. economy, a relatively weak Canadian dollar and the trade-liberalizing effect of the FTA and NAFTA. The U.S. share of Canadian exports grew from 74.9 per cent in 1990 to 83.9 per cent in 2005. Between 2000 and 2003, export growth to the U.S. tailed off due to a series of jolts, including the “tech wreck,” 9/11 and the appreciation of the Canadian dollar. Exports to the U.S. bounced back in 2004 and 2005, but were under pressure again in 2006, particularly exports of manufactured goods. (See Chart 16.) The anticipated U.S. slowdown could once again delay the hoped-for recovery in real export growth. (See the discussion on global imbalances in Chapter 3.)

The profile of our exports is also changing. Current export growth is increasingly sustained by the energy and resource sectors, incorporating a strong upward oil and natural gas price component—a feature that is likely to continue in an energy- and resource-hungry U.S. economy and a global economy with a growing resource appetite. In contrast, our recent non-energy trade growth—including in automotive and most non-resource-based manufactured goods—has been discouragingly weak.

We need to recognize that the structure of Canada–U.S. economic integration is changing in important ways.

Other key features of bilateral economic integration show a similar pattern of slowing growth or even decline. Canadian imports of U.S. goods and services, which grew at a less dramatic pace through the 1990s, have been gradually tailing off both in absolute terms and as a share of total Canadian imports. And growth in Canada–U.S. FDI stocks, which was high in the mid- to late 1990s,
has slowed, largely due to slower growth in Canadian FDI stock in the U.S. (See Chart 17.) The share of investment coming into Canada from the U.S. has remained relatively stable at around two-thirds, despite increasing U.S. interest in the oil patch, while the share of Canadian outward investment in the U.S. has declined significantly (from 66 per cent in 1987 to 46 per cent in 2005).

Canadian investors have looked increasingly to other markets, notably Europe and Latin America (but also to tax havens in the Caribbean).

Canada’s economic relationship with the U.S., within a larger North American region, will continue to predominate.

As for Mexico, the expectations that existed at the time NAFTA was signed have not been realized. Mexico accounts for less than 1 per cent of total Canadian exports and about 4 per cent of imports, while it accounts for less than 1 per cent of Canada’s outward and inward FDI stock. The reality is that North American economic integration is more a hub-and-spoke relationship than a triangle; both Canada and Mexico are integrating with the U.S. much more rapidly than they are with each other. (See charts 18 and 19.)

Canada’s economic relationship with the U.S., within a larger North American region, will continue to predominate for the foreseeable future and will remain linked to the growth trajectory of the U.S. economy. But current trends in regional economic integration suggest one of three things:

1. We are not taking sufficient advantage of economic integration with the U.S.,
2. The post-FTA and -NAFTA effect is mature and tapering off, or
3. The market forces that pulled us into the FTA and NAFTA in the first place are now taking both Canada and the U.S. in other directions. For example, the U.S. has aggressively embraced two-way trade with and investment in China, often through pan-Pacific integrated supply chains created by U.S. outward investment; Canada generally has not. (See Chart 20.) Consequently, China is on a path to replace Canada as the United States’ number one trade partner.
The message emerging from this assessment is that Canadians need to wake up to the fact that the Canada–U.S. economic relationship is both vital and changing. The popular vision of a steady, lockstep march toward ever-increasing levels of bilateral economic integration across all fronts will not automatically become reality, and could even become an illusion. Closer North American economic integration may not shield us from global realities that confront us both directly and via the United States. Canadians need an objective understanding of exactly where regional economic integration is taking us, how it is being affected by the rapidly changing global economy, and what steps we should be taking to pursue our interests vis-à-vis the U.S. and with others.
### HIGHLIGHTS

- The changing global economy provides significant opportunities to improve Canada’s economic performance through enhanced trade and investment. But global dynamics create significant risks and uncertainties for Canada’s prospects.

- Economic growth that occurs at the expense of the global environment overstates its net contribution to prosperity. Economic growth and sustainability of the physical environment need to be integrated into a single concept of sustainable national prosperity.

- There is disequilibrium in the global economy. The United States’ external deficit has grown to a massive scale, creating a dangerous imbalance between global savings and investment. The inevitable U.S. adjustment will generate shock waves throughout the Canadian economy. We need to strengthen our capacity to buffer the adjustment.

- With the suspension of the Doha Round of multilateral trade negotiations, future global growth is likely to be stimulated more by technology, energy and resources, and innovative investment, and less by further progress on multilateral trade liberalization.

- Increased U.S. protectionism and greater regionalism in trade (particularly in Asia and Latin America) could leave Canada on the outside looking in.

- Rapid economic growth and transformation in emerging economies (e.g., China, India, Brazil) creates both opportunities and risks. The resource boom is good news for Canada, but we also face stiff competition for markets and investment from both traditional and emerging competitors. There is also the inherent risk of resource sectors crowding out traditional and emerging sectors for goods and services.
The changing global economy provides enormous opportunities for Canada to improve its economic performance through enhanced trade, investment and other economic exchanges. But it also carries some potentially critical downsides. This chapter focuses on four major areas where global dynamics present significant risks for Canada’s economic prospects—but also opportunities and reasons for doing things better.

**SUSTAINABILITY: THE MERGER OF ECONOMIC GROWTH AND ENVIRONMENTAL PROTECTION**

The idea that there is a close, interlinked relationship between economic growth and sustainability of the physical environment is once again in ascendancy. There is growing recognition that gross domestic product (GDP) produced at the expense of the global environment, and at the expense of scarce and finite physical resources, overstates the net contribution of that economic growth to our prosperity. Indeed, measures of national wealth should ideally include some estimation of the net impact on the scarce natural resources used to produce that wealth—the costs imposed on the physical environment—in addition to the current estimation of the economic benefits from growth.

Integrating economic growth and the environment produces the concept of sustainable development—or more simply, sustainability. While there are many definitions and approaches to the notion, the Brundtland Commission’s definition is the most widely used: “Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.”

Measures of national wealth should include some estimation of the net impact on the scarce natural resources used to produce that wealth.

So how do we ensure that economic growth, the environment and related social impacts are woven together into a strong integrated fabric of sustainable national prosperity? Are we using the right measures and instruments to inform and guide public policy debate and business decision-making? And do today’s markets adequately encourage and incent sustainable behaviour, or do they send signals that foster unsustainable outcomes?

1 The concept of sustainability has taken decades to reach today’s level of social awareness. Key points in this journey of realization have included the publication of *The Challenge of Man’s Future* in 1954, and *Silent Spring* in 1962; the first Earth Day in 1971; publication of *The Limits to Growth* in 1972; the first Earth Summit in 1972; publication of the Brundtland Commission report in 1987; and the Rio Earth Summit in 1992. A more complete bibliography would include the American Commission on Intergovernmental Relations, *The Federal Role in the Federal System*, pp. 17–21; Commoner, *Closing the Circle*; and Foster, “A Planetary Defeat.”

THE MACRO LEVEL
Environmental issues with potential national, international or even global impacts can be classified as macro-sustainability issues. More than 20 years ago, the issues of acid rain and water quality in the Great Lakes helped to raise Canadian and American awareness of cross-border environmental issues and the negative relationship between unconstrained economic growth and sustainability. Bilateral agreements were reached with the intent of curbing cross-border and domestic effluents. Depletion of the ozone layer and the need for global action on chlorofluorocarbons (CFCs) helped to raise awareness further, to the global level, and resulted in the 1987 Montréal Protocol. Recent scientific evidence suggests that the erosion of the ozone layer has stabilized,3 and there may even be reasons to hope for a gradual reversal of the damage.4

Sustainability encompasses the use and management of scarce and finite global resources, and has a direct economic impact.

Global environmental concerns are not solely related to managing pollution, but also to the quality and availability of our resources. Both within Canada and internationally, moves have been made to develop effective environmental governance regimes that address globally important resource issues such as forest and fisheries protection and trade in endangered species (e.g., the Convention on International Trade in Endangered Species). Within Canada, the collapse of the East Coast fishery brought home the message that sustainability encompasses the use and management of scarce and finite global resources, and has a direct economic impact on specific communities.

The search for a global approach to sustainability is best demonstrated today by global and national strategies to deal with climate change issues. The hard scientific evidence of change in the global climate continues to grow. Rising levels of greenhouse gases (GHGs) in the atmosphere, particularly carbon dioxide (CO₂), have been linked to the rise of average global temperatures and to the melting of polar ice caps and glaciers around the globe. An apparent increase in the frequency and intensity of extreme weather events has also been blamed on the temperature increase. The direct relationship between human production of GHGs and atmospheric CO₂ is being ever more strongly demonstrated, and there remain only a few unconvinced critics.

But when it comes to policy action, a true global consensus on the strategy and means for addressing climate change has not yet emerged. In 1992, at the second Earth Summit in Rio de Janeiro, the United Nations Framework Convention on Climate Change became the first building block toward a global consensus. The Climate Change Convention was eventually signed or ratified by more than 160 countries, including all the major emitting countries.

The subsequent Kyoto Protocol of 1997 was another critical step toward an action plan to curtail emissions of GHGs, but its implementation is incomplete. The U.S. and Australia chose not to ratify the Protocol. China and India signed and ratified it but did not have targets to reduce emissions under the terms of the Protocol; Canada and Russia ratified it, but their support is wavering.5 Nevertheless, the politically conservative governments in the U.S., Australia and now Canada are acting to develop and implement national plans for dealing with atmospheric emissions, including GHGs. The proposed Canada’s Clean Air Act represents one such effort. Moreover, sub-national governments within these countries—states, provinces and cities—have introduced their own plans for reducing GHGs and adhering to the spirit of Kyoto.

Despite the absence of a meaningful global consensus on the Kyoto Protocol, climate change is now accepted in mainstream political discourse—politicians of all stripes have to position themselves as doing something. Moreover, it should be emphasized that Kyoto is but a first step in a long voyage to stabilize and then reduce global GHG and other gas emissions. Therefore, the

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3 See, for example, Westhead and Andersen, “The Search for Signs of Recovery of the Ozone Layer.”
4 Yang et al., “Attribution of Recovery in Lower-Stratospheric Ozone.”
5 Countries that have ratified the Kyoto Protocol are listed on the United Nations Framework Convention on Climate Change website: unfccc.int/2860.php.
future debate on climate change will not be on whether action is necessary to curtail emissions of GHGs. Instead, the debate will centre on how to develop a full global consensus on the pace of adjustment, the impact on various sectors and fair burden-sharing among nations.

Measurement of the impact on national wealth of reducing GHG emissions will matter more and more in the ongoing debate. The Kyoto Protocol focused on commitments to reduce national emissions, but it did not formally link those reductions to impacts on national income or wealth. Countries with a large geographic size (and long distances to travel), cold climates, or heavy reliance on energy and other resource production could reasonably question whether the burden of adjustment was appropriately shared among nations. Canada, of course, reflects all three of those conditions. Similarly, developing nations have argued that it would be unreasonable to expect them to curtail their industrial and economic advancement to deal with a problem caused predominantly by industrialized nations.6 (See box “The Interface Between Trade and the Environment—the Next Frontier?”)

The future debate will centre on how to develop a full global consensus on the pace of adjustment and fair burden-sharing.

At this point, it is useful to recall that the most commonly used measure of national wealth and prosperity—GDP—came into vogue only in the post-war period. Its architects were economists like John Maynard Keynes and Simon Kuznets, who understood the powerful explanatory value of GDP but also cautioned against its misuse as the dominant or sole measure of the welfare of a nation. Kuznets lamented that “the welfare of the nation can scarcely be inferred from a measurement of national income as defined by the GDP … goals for ‘more’ growth should specify of what and for what.”7

As environmental awareness has grown in recent decades, numerous ideas have been offered in the academic and policy literature on how macro-sustainability might be measured and used to improve our understanding of sustainable national wealth. Various analysts have tried to build environmental impacts, as well as social impacts, into these measures. For example, a measure called the Genuine Progress Indicator, or GPI, was proposed in 1994 by Redefining Progress, a U.S. economic research think-tank.8 The GPI adds up a nation’s expenses (GDP), factors in sectors that are usually excluded from the market economy (such as housework and volunteering), and then subtracts social ills: natural resource depletion, crime and loss of leisure time.

The Interface Between Trade and the Environment—the Next Frontier?

The Negatives . . .

Concerns about trade and the environment first arose as a negative. Negotiation of NAFTA and the last round of multilateral trade negotiations gave rise to concerns that expansion of economic activity triggered by trade liberalization could come at the expense of the environment, especially in countries without strong environmental records, like Mexico and emerging economies. At the same time, there were concerns that such things as environmental regulation, standards and labelling could become a new form of disguised protectionism if used to arbitrarily discriminate against imported products. Developing countries in particular have been concerned that a new “green conditionality” could hamper access to industrialized country markets. There are also concerns about potential confusion between trade and environmental agreements.

The Positives . . .

Since the last WTO round, there has been growing recognition that the relationship between trade and the environment can also be a productive one. Where effective environmental policies are in place, the trade system can impact positively on the environment by improving efficient allocation of resources, removing distortions and generating revenues that can be used for environmental protection. Trade can improve environmental protection by opening access for environmental goods and services. And it can encourage investment and trade in innovative environmental technology.

A Future Priority . . .

As global concern about sustainable economic development grows, so too will the need to address the multi-faceted trade and its relationship to the environment. However, although both NAFTA and the World Trade Organization (WTO) have mechanisms for doing so, results to date have been meagre. Trade and the environment needs to move higher up the priority ladder.

8 The GPI was first proposed in Cobb et al., “If the GDP Is Up, Why Is America Down?”
For Canada, an Index of Economic Well-being that takes environmental costs, social inequality and poverty into account when estimating Canadian national wealth was proposed in 1998.9

Another approach was developed by The Conference Board of Canada in its annual Performance and Potential report, which has been produced over the past decade. Canada’s performance is benchmarked against that of leading industrialized countries in six categories, including the Environment. The methodology is based on 22 indicators in a Pressure-State-Response model developed by the OECD.

Perhaps influenced by this work, the 2000 federal budget speech acknowledged the need and urgency to track a full range of Canada’s assets—including the ecosystem services that are crucial to sustaining the economy in the long term. The National Round Table on the Environment and the Economy proposed, in 2003, an approach based on six initial indicators—one human capital and five natural capital indicators—that would augment familiar economic data like GDP. The indicators were educational attainment, forest cover, freshwater quality, air quality, GHG emissions and extent of wetlands. The February 2004 Speech from the Throne repeated the commitment to begin using several of the recommended indicators.

Political circumstances have changed in Canada; consequently, these announcements and sustainability indicators have not yet appeared in a federal budget, but the need for indicators that explicitly recognize the close relationship between GDP and sustainability of the physical environment—or natural capital—has grown, not waned.

To that end, a new Canadian Index of Wellbeing (CIW) is now under construction, measuring the extent to which we are realizing our values and goals as a society. The CIW is the result of a pan-Canadian and innovative partnership that brings together indicator experts, including Statistics Canada.10

9 Osberg and Sharpe, “An Index of Economic Well-being for Canada.”
10 See www.atkinsonfoundation.ca/ciw.

THE MICRO LEVEL

Environmental issues that affect specific industries, sectors, local areas (both urban and rural) and individuals in those areas can be classified as micro-sustainability issues.

These issues are usually understood and assessed in terms of specific local impacts. Going forward, micro-sustainability issues will have to incorporate macro-sustainability concerns.

Measuring the impact of GHG reductions on national wealth will be increasingly important.

Significant progress has already been made on the Canadian and international regulatory framework for assessing and managing micro-sustainability. Legislation governing environmental protection (for example, the Canadian Environmental Protection Act) and environmental assessment (for example, the Canadian Environmental Assessment Act) has existed in various forms for many years at the federal and provincial levels. International guidelines and standards among governments, such as the World Bank’s Pollution Prevention and Abatement Handbook or the recent OECD guidelines for export credits, have also been developed. Generally, these regulatory frameworks are used to guide specific projects and initiatives, and they take social impacts into account in addition to environmental impacts. Volumes II and III of Mission Possible: Sustainable Prosperity for Canada examine the micro-sustainability issues in much greater detail.

Volume II, entitled Mission Possible: A Canadian Resources Strategy for the Boom and Beyond, evaluates the conditions for sustainability in four sectors: forest products, agri-food, mining and energy. Volume II discusses how a well-functioning regulatory system is central to the protection of public interest, safety and the environment. Governments must continuously ensure that regulations are adequate to meet these goals in an efficient and effective way. Further progress on environmental performance and public safety will be
critical, and governments must play a major role in setting the business environment, as well as the rules and regulations to make this happen.

However, current regulatory approval systems are complex, with significant overlap and duplication between the regulatory approval processes of provincial governments and those of the federal government. Departments within each level of government can also create undue complexity in their approval systems. In short, Volume II argues that Canada needs to streamline, harmonize and integrate regulatory approval processes, where appropriate, to ensure not only that approvals take place in a timely fashion but also that the process continues to protect the public and the environment.

This is an important finding in the context of sustainability because it demonstrates that inefficient regulatory processes can constrain wealth creation capacity, to the point that it may even be forgone in specific sectors, without any net improvement in overall sustainability. Indeed, there is a risk that regulatory processes may be stifling innovation in these sectors at a time when innovation through research and development (R&D) and refinements to production processes may be a critical way of reducing the environmental impacts of desirable economic activity.

Volume III, entitled Mission Possible: Successful Canadian Cities, highlights the significant improvements that can be made to the urban environment through greater reliance upon the emerging field of industrial ecology. Within the framework of industrial ecology, a successful urban industrial ecosystem would effectively manage the energy and material flows linked to industrial activities, such that human needs are being met without overwhelming the assimilative capacity of the city, the surrounding area or indeed the planet.

If industrial ecology were put into practice, cities would become more resource efficient—they would make better use of the materials brought into them and produce less waste material. Waste products from one industry or sector would be recycled as inputs used in other sectors, minimizing the need for controversial and costly waste disposal outside the city. Numerous barriers—technical, informational, economic, regulatory, motivational and institutional—will have to be dismantled for industrial ecology to move into the mainstream of urban design and practice, but Volume III offers significant ideas for how our cities could be refounded on principles of sound sustainable economic growth.

Inefficient regulatory processes can constrain sustainable wealth creation capacity.

And individual firms can take their own measures in support of sustainability. As shown by The Conference Board of Canada’s ongoing work with the global Carbon Disclosure Project,11 companies can reduce their own firm-specific environmental footprint and simultaneously contribute to long-term shareholder value.

**Summary on Sustainability**

There has been important movement at the macro level toward social and political acceptance of sustainability—the integration of economic growth, social justice and environmental integrity. However, sustainable management of important global resources like forests and fisheries remains incomplete. As for climate change and atmospheric emissions, there is not yet a meaningful global consensus on what economic actions are needed to slow, and then reduce, GHG emissions; nor is there agreement on how to share the economic impact of adjustment among nations. Improved measurement of the close relationship between GDP and macro-environmental sustainability will be needed if we are to minimize the economic impact on Canada of GHG reduction and other global resources management issues, and to share the economic impact of adjustment fairly.

Canada needs a well-functioning regulatory system to protect the public interest and the environment, and ensure the public safety. In these days of rapid innovation, the current regulatory approval system is stretched to keep up with the demands placed upon it. Reducing overlap and duplication between federal and provincial processes and among departments will help to remove unnecessary

11 See www.cdproject.net.
complexity and cost, and will provide more timely approvals with better sustainability results. Further, governments must ensure that their related agencies are adequately staffed.

For the micro-sustainability of our cities, the adoption of industrial ecology would create systems that use resources more efficiently. This framework thus offers enormous potential to reposition Canadian cities as centres of sound, sustainable economic growth. And individual firms can act in support of sustainability, contributing to long-term shareholder value.

The principle of sustainability provides an important backdrop for the analysis in the balance of this volume.

DISEQUILIBRIUM IN THE GLOBAL ECONOMY

The global economy is out of balance. For 15 years, the U.S. external (or current account) deficit—the difference between the trade and investment flows in and out of the country—has grown progressively to a massive scale. This deficit, together with large U.S. fiscal deficits resulting from the Bush tax cuts, wars in Afghanistan and Iraq and relief funding for natural disasters, can be sustained only to the extent that foreign investors are prepared to buy U.S. dollar assets. The counterbalance has been provided by trade surpluses and huge capital outflows to the U.S. from Japan, China and elsewhere in Asia, and more recently from oil-rich investors in the Middle East and Europe.

Economists see this phenomenon as a fundamental imbalance between savings and investment—although whether the U.S. twin deficits are the cause, or just symptoms, is open to much dispute. What is not in doubt is that the U.S. current account deficit continued to mount in 2006, raising questions about its sustainability, and how and when the inevitable adjustment will occur.

While the financial alliance between the U.S. economy and foreign buyers of its financial assets is holding for now, there are indications that it will not be sustainable over the longer term. Commercial investors in China and India are diversifying away from U.S. dollar assets; central banks in countries like South Korea and Japan, concerned about U.S. dollar assets that have depreciated since 2002, are looking for wider diversification and better yields.

U.S. and global adjustments to current economic imbalances will send shock waves through the Canadian economy.

For the moment, there seems to be no constraint upon the foreign funds available to finance U.S. consumption and investment, even with the U.S. external deficit still stubbornly rising. Investors from oil-exporting countries have taken up the slack, recycling petro-earnings by acquiring U.S. real estate and corporate shares, and by placing money in private equity funds. The trend is away from riskless assets like U.S. Treasuries, and toward assets in the private market with the potential for higher yields (but also with higher risk).

So how will the U.S. and global imbalances eventually be corrected? The last time the U.S. current account deficit ballooned, in the 1980s, the problem was resolved through a combination of orderly depreciation of the dollar and solid growth in the second and third largest economies at the time, Germany and Japan. These countries, however, are not in a position to give the kind of boost to the world economy that they did 20 years ago. This time, the U.S. current account deficit is also larger—US$792 billion in 2005, or 6.4 per cent of GDP, and is still growing through 2006. (See charts 21 and 22.) U.S. exports to the high-growth emerging economies, notably China, are consistently growing more slowly than imports. As a result, the U.S. now has a trade deficit with China that has surpassed US$200 billion annually and that continues to grow.
There are four interrelated possibilities that could bring about the eventual and inevitable adjustment in U.S. imbalances:

- a further decline in the U.S. dollar, which would eventually boost American export growth and slow import growth;
- higher U.S. interest rates, which would dampen domestic demand and thus slow import growth while raising yields for foreign investors;
- restrictive U.S. fiscal policy through some combination of tax increases and cuts to government spending, which would slow domestic demand growth and attack the fiscal deficit directly; and
- a sharp slowing of U.S. domestic demand growth, most likely in response to an equally sharp downward realignment of U.S. housing prices.

Canada’s deep integration with the U.S. exposes us more heavily to a U.S. slowdown and to U.S. dollar depreciation than our competition.

For its part, China took initial steps toward greater exchange rate flexibility and appreciation in mid-2005, though those steps have been cautious at best so far. Moreover, a rising yuan would reduce China’s incentive to keep acquiring U.S. assets.

Should foreign investors in Asia and among the oil-exporting countries get spooked by some unforeseen event, Canada would be on the front line of U.S. and global adjustment. Our deep integration with the U.S. already exposes us more heavily to a U.S. slowdown and to U.S. dollar depreciation than our competition. Canada cannot hope to avoid any such shocks, although our solid overall macroeconomic performance and sustained strong domestic demand will help to mitigate a U.S. slowdown. Nevertheless, additional action is needed to make our economy more vibrant and resilient—the subject of much of this report.

STALLING TRADE LIBERALIZATION

Trade liberalization has been a major factor in shaping the current global economy over the past 15 to 20 years. The lowering of tariff barriers, coupled with the accession of large numbers of countries to the World Trade Organization (WTO), has spurred growth in both industrialized and emerging economies and has resulted in the integration of many countries into the global marketplace. The suspension of the Doha Round of multilateral...
trade negotiations in mid-2006, however, poses important questions about the capacity of trade liberalization to continue to perform this function.

As the negotiation process has made painfully clear, the business of multilateral trade liberalization has become much more complex and challenging. What was once a small club of industrialized countries party to the General Agreement on Tariffs and Trade (GATT) has been transformed into a 149-member negotiation among countries at very different levels of development and with different objectives. Much of the job of tariff reduction and quota elimination in industrialized countries has already been done. What is largely left are challenges that are politically tough, notably reduction of agricultural subsidies and tariffs (including in Canada’s dairy and other supply-managed industries), or technically complex subjects such as services and intellectual property.

The Doha Round suspension could inevitably give dangerous wind to the sails of protectionism.

The suspension of the Doha Round in mid-2006 does not, of course, bring multilateral progress on trade liberalization to an end. There is still quiet momentum in the ongoing implementation of liberalizing measures from the last negotiating round and from the recent scheduled end of textile and clothing tariffs and quotas, as well as domestic reform implementation associated with WTO accession. Unless the Doha Round can be restarted and an agreement submitted to the U.S. Congress under the existing negotiating authority, which expires in July 2007, serious multilateral negotiations would have to wait until 2009, after the next U.S. presidential election. As a critical precondition to completing the Doha Round, the major industrialized nations—notably the EU, U.S. and Japan—must be prepared to bite the domestic political bullet on agricultural protection and support programs (not to mention improved market access, access to intellectual property and domestic reform in many tradable services).

At the end of the day, however, we need to face the possibility that future global growth may be stimulated more by other growth dynamics, such as technology and innovative investment plus the boom in energy and resources, and less by further progress on multilateral trade liberalization.

The main downside of the recent Doha Round suspension is the risk of it being perceived as a setback for the WTO itself—even if those who attack the credibility of the WTO do not offer an alternative paradigm that is consistent or even coherent. Here it should be emphasized that Canada’s trade interests have always been best served by an open international trading system where market access is maximized and power is curbed by an agreed system of international rules and processes for dealing with disputes.

The Doha Round suspension could inevitably give dangerous wind to the sails of protectionism, particularly on the part of a Democrat-controlled U.S. Congress spurred on by the massive U.S. external deficit. The rise of protectionism would pose serious bilateral trade risks for Canada, and for trade discipline.

The suspension could also accelerate the trend toward greater bilateral and regional preferential trade arrangements. While half of global trade still takes place among industrialized countries, there is considerable scope to stimulate more trade among the emerging markets, and between them and industrialized countries. However, the emerging markets would have to be prepared to address the relatively high tariffs they still maintain with the industrialized world, and with one another. Recent trends toward greater regionalism in trade, particularly in Asia and to a lesser extent in Latin America, could leave Canada on the outside looking in. We would miss improved access to the major future sources of global economic growth. It also increases the complexity of what has been called the “spaghetti bowl,” a tangle of bilateral and regional preferential trade agreements all theoretically consistent with the WTO rules, but posing a practical nightmare for exporters and importers (not to mention a windfall for trade lawyers).
EMERGING MARKETS: GOLDEN OPPORTUNITIES BUT CUTTHROAT COMPETITION

There are currently two popular images of emerging economies. One is of vast new markets for goods and services, fuelled by the growing demands of rapidly expanding economies and huge, growing populations of middle-class consumers—and in the case of China in particular, important potential new sources of investment. The other is of voracious, low-cost exports that will wash over economies like Canada’s, leaving businesses and jobs in their wake. Both images are partly right—and partly wrong.

THE RESOURCE BOOM

Exploding demand for energy and resources in emerging economies, coupled with continuing high energy use in industrialized economies, will be a major factor in global growth for at least the next decade. Future global fault lines will also increasingly lie between those that have ready access to resources and those that do not.

The resource boom is good news for Canada’s resource-based industries. Dubbed the “old economy” during the 1990s, in contrast to the “new economy” of knowledge-based services and high technology, the old resources sector is suddenly new again. Our mining and minerals sector, a global leader in the mining equity market, is well placed to capitalize on this opportunity; in 2005, mining companies listed on the Toronto Stock Exchange raised US$4 billion in equity financing, the largest amount raised on any exchange in the world.

The resource boom, however, is a mixed blessing. First, it is not entirely a seller’s market. We face stiff competition—for both markets and investment—from others with more accessible and (or) lower-cost products. Many are emerging markets, like Russia and Brazil, and others are traditional competitors, like Australia.

Second, high prices are not a boon in all respects. While large infrastructure projects like the oil sands and related pipelines have become more economic, the costs of key inputs like steel, related energy, transportation and labour are going up. And while many countries are banking on enhanced energy and resource trade with significant infrastructure expansion, resource prices and markets are inherently volatile. Importers will seek to diversify supply. History contains lessons of overestimation, over-supply and overcapacity—as happened, for example, some years ago in northern British Columbia and Japan. Credible price assumptions are everything.

Third, high resource prices can also spawn what is known as “Dutch disease,” a phenomenon that occurs when a strong currency driven by natural resource earnings crowds out other exporting sectors of the economy, particularly manufacturing. Even though the resources sector remains relatively small compared with the rest of the economy, resource exports—particularly energy—are growing strongly. This phenomenon was first observed in the Netherlands in the 1960s, after the Dutch discovered large natural gas deposits in the North Sea and experienced a large increase in incoming investment and outgoing exports. As the guilder grew in strength, non-gas exports became less globally competitive and firms in the manufacturing sector began to lose markets, lay off workers and eventually stagnate. Canada has the potential to catch Dutch disease, although how strongly the disease would affect us is open to debate.

Canada needs to maximize the advantages of the resource boom—but with its eyes wide open and its thinking cap on. Volume II of this compendium report addresses the challenges facing us in resource sectors.

THE MANUFACTURING JUGGERNAUT

Something similar can be said about the impact of China and other emerging countries on manufacturing. To a large extent, this impact will be positive. Consumers are benefiting hugely from lower prices at the checkout for basic goods like apparel, and for more sophisticated manufactured products like entertainment electronics. Low-cost imports reduce production costs for Canadian
manufacturers and supply chains, while investment in foreign production helps to open new markets. The Conference Board of Canada’s analysis also indicates that Canadian exports to and imports from some emerging economies are steadily moving up the value chain. (See box “Canada’s Trade With Emerging Economies: The Place of Intermediate Goods in Exports and Imports.”)

At the same time, the world is experiencing a profound shift in global comparative advantage, unlike anything in recent history. The adjustment process is telescoped, as countries like China, India and Brazil will move rapidly into higher levels of industrialization in a few years, not gradually over decades in the manner of previous rising stars like Japan or South Korea.

China, the world’s new “back workroom,” produces cheap clothing but also has an automotive industry and a space program, and is bent on going head-to-head with the U.S. and others in high technology. (See box “China’s Booming Auto Industry: Opportunity or Threat?”) Coastal China is already outsourcing some of its lower-cost standardized production to the interior hinterlands and to lower-cost producers in countries like Vietnam. India, the world’s new “back office,” has drawn a significant share of the world’s call centres and computer industry. Brazil competes with Canada in forest products but is also challenging us in aerospace.

While Canada’s bilateral trade deficit with China ($22.4 billion in 2005) is as large as that of the U.S., relative to the size of our economy, imports from China have not been the hot button issue that they have been in the U.S. This is perhaps because our manufacturing sector is in relatively better shape, our unemployment rate is down and we enjoy an overall trade surplus. Nonetheless, concerns over growing Chinese imports of products like bicycles, barbecues and furniture has led Canadian manufacturers to seek “safeguard” protection permitted under the terms of Chinese accession to the WTO. As China and other low-cost producers move up the value chain, Canadian concerns will escalate.

Any notion that we can shield ourselves by hunkering down inside Fortress North America is an illusion.

China maintains that its economic strategy is not export-led—it is consumer demand abroad that is driving exports, much of it a result of foreign offshoring. Still, China has replaced Japan as the world’s third largest exporter, after the EU and the United States. And the rise in global energy and commodity prices has not significantly slowed China down, at least not yet. Its trade surplus zoomed to US$102 billion in 2005 and continues to grow in 2006.

In part, Canada has been sheltered from global realities by its economic integration with the United States. But any notion that we can shield ourselves by hunkering down inside Fortress North America is an illusion. By integrating deeply within the North American economy, we have been placed on the front line of any economic adjustment to the large U.S. external and fiscal imbalances. As for trade more broadly, low-cost imports from China and elsewhere are placing some Canadian exports at risk of being priced out of the U.S. market. We also risk becoming collateral damage in trade actions, directed against China and other low-cost exporters, taken by a protectionist U.S. Congress.
There are several bottom lines. First, China and other emerging economies need to be seen for what they are—sources of both opportunity and competition. Second, a more energy- and resource-intensive economy will shift economic activity toward Western and Northern Canada, in contrast to an increasingly stressed central Canadian manufacturing base—with consequent regional and local strains. Third, the future of Canadian manufacturing, facing both cost competition and a strong loonie, lies in securing positions in U.S. and other global supply chains, in active use of foreign direct investment (FDI) and in offshoring—as well as in becoming niche players in increasingly higher and higher levels of innovation-based production. The biggest risk is that we will slide backwards into a rearguard action with protective barriers and costly bailouts that will serve only to make us less competitive, and delay the inevitable adjustment process.

China's Booming Auto Industry: Opportunity or Threat?

China is the next automotive powerhouse, following on the heels of Japan and South Korea. While estimates of future Chinese auto production vary, a recent CSM Worldwide forecast placed Chinese production at 4.3 million units in 2005, rising to 8.4 million by 2010. This would make China the third-largest producer, after the U.S. and Japan. China will become a main driver—perhaps even the main driver—of the global auto industry in the next 20 years, followed closely by India and smaller emerging economies, notably Thailand.

In theory, China's huge population could absorb considerable auto industry output. However, this will be circumscribed by the extent to which rising Chinese economic wealth is actually translated into rising and widespread personal incomes, as well as by environmental/infrastructure problems associated with rising auto use.

What, then, will China's entry into the global auto stakes mean for Canada's hard-pressed auto sector—at a time when the auto industry is becoming increasingly globalized?

Canadian auto parts manufacturers in China: Rapidly escalating Chinese production, coupled with lower growth prospects at home, are leading auto parts manufacturers (including Canada's) to actively develop strategies aimed at becoming part of Chinese supply chains, either through enhanced exports or joint ventures with Chinese companies aimed at expanding production in China. Meanwhile, China is actively encouraging the emergence of its own increasingly sophisticated auto parts industry; China's Automotive Industry Development Policy, released in 2004, targeted US$70–100 billion in auto parts exports by 2010. The recent WTO action launched by the U.S., EU and Canada will be critical in discouraging China from discriminating against foreign manufacturers as its industry matures.

China's export capacity: Auto parts makers also anticipate increasing competition from China and other low-cost producers in their own markets. The ability of Chinese parts makers to undercut Canada in U.S. markets will, however, be offset to some degree by transportation costs and quality assurance factors that militate against taking advantage of the just-in-time production and delivery systems that North American assemblers now demand from their parts suppliers. As for vehicles, China became a net exporter of automobiles for the first time in 2005. While most Chinese auto exports are destined for the Middle East, Russia and Southeast Asia, Chinese vehicles will inevitably come to North America and Europe; in fact, Chinese-made autos (by Japan's Honda Motor Co. in China) have already hit the European market. The sixty-four thousand dollar question is how long will it take China's own automakers to reap economies of scale and meet the quality, safety, environmental and other performance requirements to compete successfully with Toyota, Nissan and Hyundai, as well as a potentially revitalized Big Three?

Auto sector investment: The future of the North American auto industry lies in growing integration with its Chinese counterpart, which is already breaking into North American sourcing chains. For example, the Wanxiang Group, China's biggest auto parts supplier, includes General Motors, Ford and Volkswagen among its customers. It also has strategic alliances with Bosch and Visteon, and has acquired, established or merged with 30 companies in eight countries, including Canada. In the meantime, China, as well as India, is drawing huge amounts of global auto investment. While Ontario has recently enjoyed some success in securing new investment in the auto sector, Canada will have to fight harder and harder for auto investment in the years ahead. Our challenge will be to ensure that a suitable share of Chinese auto sector investment comes our way so that Canadian manufacturers remain in the game.

Source: The Conference Board of Canada.
SECTION II

Going Forward

Five Strategies for Canadians
To secure its economic future, Canada must get its act together. While there are glimmers of recognition and some signs of progress, we have, on the whole, been slower than others to grasp the need to deal with new global realities.

The problem is not that Canadians are incapable of taking on large challenges. Over the past two decades, Canada has implemented a monetary policy that has given us low and stable inflation, and has recognized the need for fiscal consolidation and debt reduction. It has also participated in three major trade liberalization deals; the U.S.—Canada Free Trade Agreement (FTA); its successor, the North American Free Trade Agreement (NAFTA); and the last round of multilateral trade liberalization negotiations leading to the creation of the World Trade Organization (WTO)—all of which exacted varying degrees of adjustment pain but also contributed to substantial net gain. So what is holding us back?

First, Canadians need a better appreciation of the challenges we face, and the courage and conviction required to take tough decisions. Our leaders need to shape public opinion, not simply be informed by it. “Boosterism” no longer cuts it; instead, we need hard strategies that anticipate where the world is heading. And we need less cross-purpose between federal and provincial/territorial levels of government, and more concerted national purpose to position Canada to best advantage.

Second, we need to dispense with self-images that get in the way of a realistic appreciation of our situation. Although objectively Canada might actually prove to be the “best country in which to live,” others legitimately believe they also have a claim to the title. We have also taken comfort in being sheltered economically, militarily and perhaps even politically by our relationship with the United States—without recognizing that this does not give us immunity from global dynamics.

Third, we need to change the tenor of national debate from the current endless preoccupation with wealth distribution to give at least as much emphasis to wealth creation. Concern about regional equity, fiscal transfers, and the funding of health care and other national social priorities are natural ingredients of the Canadian political discourse. But we need to focus more on what goes into baking the future national pie, beyond who gets how big a piece of it. Otherwise, the end result will simply be a smaller pie than could have been possible.

Ultimately, it will be up to individual Canadian businesses to decide where and how to produce, trade and invest, according to where they think they can earn the best profits for their shareholders. But there is much that governments, and governments working together with businesses and others, can do to shape our economic future.

The remaining chapters of this report examine five areas, studied in depth under The Canada Project, where the policies implemented by Canadian leaders—both in the public and private sectors—will be critical to our future economic prospects: productivity and competitiveness; the domestic operating environment; the future workforce; international investment and trade; and international relations.
HIGHLIGHTS

- Only one-fifth of the Canadian business economy (excluding public administration) is more productive than its U.S. counterpart; the other four-fifths are less productive.

- Canada’s persistent lagging productivity is affecting our international competitiveness. To improve Canadian productivity, we need to:
  - open industries to competitive pressures;
  - improve the level and quality of capital intensity; and
  - encourage organizational and managerial innovation.

- Raising productivity is an imperative; a comprehensive national strategy is required to address Canada’s productivity gap with the U.S. and other leading countries.
Strategy #1: Embrace Productivity and Competitiveness

Improving Canada’s economic place in the world begins at home. In particular, we need to come to grips with our persistent lagging productivity and its effect on our standard of living and international competitiveness. (See Table 3.) There is broad agreement among analysts that Canada’s productivity is well below that of the United States; by some recognized measures, Canadian productivity is only 83 per cent of U.S. levels.\(^1\)

And, despite a broad and growing consensus that Canadian productivity needs to be improved, the gap has been widening, not narrowing. Between 1981 and 2000, for example, business sector labour productivity in the U.S. grew by 1.9 per cent per year, compared with 1.6 per cent in Canada. Since 2000, the U.S. productivity growth rate has been 3.2 per cent per year while Canada’s has been just 1.0 per cent. (See Chart 23.)

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### Table 3
Productivity Versus Standard of Living Versus Quality of Life

<table>
<thead>
<tr>
<th>Term</th>
<th>Measure</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Productivity</td>
<td>Output per worker (labour productivity) or total factor productivity (a more sophisticated measure)</td>
<td>The most important benchmark used to gauge the strength of economies in comparison with other countries. Productivity drives wages and incomes, and measures potential to improve and sustain the standard of living. If productivity is high and growing, countries are more able to pay for programs and services.</td>
</tr>
<tr>
<td>Standard of living</td>
<td>Gross domestic product (GDP) per capita</td>
<td>Like productivity, Canada’s GDP per capita is also in the range of 83 per cent of U.S. levels—which, in 2005, translated into an income difference of US$7,737 per Canadian.</td>
</tr>
<tr>
<td>Quality of life</td>
<td>Hours worked versus hours of leisure time</td>
<td>Canada has lower productivity than the U.S. and a lower standard of living. But this does not automatically imply that Canadians are worse off than Americans in terms of quality of life. Ultimately, most of us would like to have both higher living standards and more leisure time.</td>
</tr>
</tbody>
</table>

Source: The Conference Board of Canada.

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\(^1\) Estimates differ depending on the measurement of hours worked by Canadians and by their counterparts in the United States.
We mislead ourselves, however, if we think of productivity only in terms of how we measure up to the U.S. Although this comparison is natural, it causes us to lose sight of the leading-edge economic performances of other countries one might not expect to be in the lead. Among OECD economies, eight countries surpassed the U.S. in average annual productivity growth between 2000 and 2004, including Ireland and South Korea as well as some emerging market countries.

**Canada does not have just a productivity gap, but a series of productivity gaps.**

Various theories have been advanced, and factors cited, to explain why the productivity gap persists, despite the underlying strength and impressive macroeconomic performance of the Canadian economy. It is widely acknowledged that the large increases in investment in information and communications technologies in the U.S. during the second half of the 1990s fuelled U.S. productivity growth. Analysts point to our long-standing problem of lower capital intensity—the amount of machinery and equipment per worker—relative to the United States. Many companies are currently taking advantage of the rising Canadian dollar to invest in more machinery and equipment, but apart from investment in the oil sands, business construction has not seen the same recent growth. (See box “A Strong Canadian Dollar: Help or Hindrance?”) Others think that a lag may be involved that will self-correct as the impact of U.S. growth finds its way into the Canadian economy, or as the economy responds to Canadian dollar appreciation. Labour productivity can also be volatile, especially at the industry level, as it is strongly affected by the business cycle.

**UNDERSTAND SECTORAL PRODUCTIVITY FACTORS**

Whatever overarching factors are at play, Canada has a productivity problem. The Conference Board of Canada teamed up with the Centre for the Study of Living Standards to undertake a groundbreaking study of the productivity gap at the industry level. This study shows that Canada does not have just a productivity gap, but a series of productivity gaps, sector by sector. A few are on the positive side of the ledger, but most are on the negative. (See box “Productivity: Looking to the Industry Level for Answers.”)

We seem to be winning the productivity battle mainly in sectors whose overall contribution to GDP is relatively small, and losing it in sectors whose contribution to GDP is relatively larger. Those that are most productive—notably resource-based industries, construction, transportation and motor vehicles—contribute only about one-fifth of GDP. Those that are less productive make up the other four-fifths. A large proportion of lagging Canadian productivity occurs in the services sector, notably the financial services sector and wholesale and retail trade.

A further in-depth study of seven industries indicated that there are complex reasons why one industry sector is more productive than another. (See box “Productivity: What Makes the Difference?”) The factors also vary widely from industry to industry, and within Canadian and U.S. industry sectors. But three key directions for improving productivity performance stand out.
Open industries to competitive pressures. It is possible that competition is, on average, less intense in Canada than in the U.S.—particularly in services-producing industries, which are less subject to international competition than goods-producing industries and have a smaller market in Canada. For example, the large productivity gaps in finance, insurance and real estate, and in information and cultural industries may stem in part from a less competitive environment. This contrasts with the high productivity levels of natural resource

A Strong Canadian Dollar: Help or Hindrance?

The current strong value of the Canadian dollar has raised concerns about its potential negative effect on exports and competitiveness. A recent study—sponsored by the Conference Board and the Social Sciences and Humanities Research Council of Canada (SSHRC)—casts doubt on this thinking by documenting the risks of a weak currency on a country’s level of capital investment.

As an example, a fall in the value of the Canadian dollar may affect the level of investment through three channels:

- **Effect on demand:** The lower dollar makes Canadian goods and services relatively less expensive both inside and outside the country. Increased demand for Canadian goods and services in domestic and international markets increases a firm’s profitability, which leads to an increase in production. This results in a rise in the demand for all inputs, including capital.

- **Effect on imported capital:** The lower dollar increases the domestic currency price of imported capital, which tends to decrease investment.

- **Effect on imported intermediate inputs:** The lower dollar increases the domestic price of imported intermediate inputs. The impact of this price change on investment is uncertain, as it depends on the degree of substitutability between these inputs and capital.

Because of these contradictory effects, the net effect on investment of a real currency depreciation is uncertain. It will depend on which effect is dominant. Investment is likely to rise following a depreciation only if the effect on exports and domestic demand is sufficient to outweigh the cost effect.

The study demonstrates that, for the average country in the sample of 17 developed OECD countries, a currency depreciation decreases overall investment in physical capital. The results imply that the negative effect on imported capital outweighs the positive effect on exports and domestic demand. This effect was significant in the short term and often persists for years, particularly in service sectors of an economy.

The net effect will differ by country and sector, depending on such factors as reliance on imported capital and export orientation. For the country with the most open economy, Belgium, a 10 per cent real currency depreciation is predicted to cause a 5.7 per cent fall in investment in the total economy, in the current year. (See chart “Impact on Investment of a 10 Per Cent Currency Depreciation, by Country.”) In contrast, for the country with the least open economy, the U.S., this effect is equal to just 0.64 per cent. In Canada, a 10 per cent real currency depreciation is predicted to cause a 2.4 per cent decline in investment in the total economy in the current year and a 4.1 per cent decline in the long run.

In addition, the study demonstrates that increases in real wages, without corresponding gains in labour productivity, reduce investment in the medium and long term. Thus, inflexible labour markets—created by interprovincial mobility barriers or policies such as mandatory retirement—may hinder investment.

Given the already well-documented evidence of the significance of investment for Canada’s future productivity and output growth, these findings suggest that policies that generate movements in the exchange rate or wage rate have important (perhaps unintended) consequences for industry investment, productivity and economic growth.

Source: Landon and Smith, *The Exchange Rate and Wages.*

Note: Based on the coefficient estimates for total investment.
Source: Landon and Smith.
Productivity: Looking to the Industry Level for Answers

In 2004, the Conference Board and the Centre for the Study of Living Standards undertook a major study of the factors that drive labour productivity industry by industry, using comparable Canadian and U.S. data that had become available. This work was recently updated, using new relative productivity by industry figures produced by Industry Canada.

Of the 32 industries that make up the Canadian business sector, six are above U.S. productivity levels in the same sectors, one is equal to the U.S. productivity level and 25 fall below. (See chart “Relative Labour Productivity Levels in Canadian Industries, 2004.”) What is more important than the number of industries above or below U.S. levels, however, is the percentage of employment these industries represent. Industry sectors whose productivity is above the U.S. level account for only roughly one-fifth of employment (18 per cent), while those below account for roughly four-fifths (82 per cent).

Of those above, only construction, by virtue of its size and strong productivity, seems to have any major effect on narrowing the productivity gap. Other sectors, notably resource-based and some manufacturing industries, also outperform but their contribution to overall output is smaller. The industries that contribute most to the gap are services—wholesale and retail trade; professional services; finance, insurance, real estate and management of companies; accomodation and food services; and administrative services.

Relative Labour Productivity Levels in Canadian Industries, 2004
(per cent; share of U.S. level)

1. Construction
2. Mining and oil and gas extraction
3. Wood products
4. Primary metals
5. Printing
6. Other private services
7. Transportation equipment
8. Paper
9. Non-metallic mineral products
10. Chemicals
11. Transportation, warehousing
12. Petroleum and coal products
13. Food, beverage and tobacco
14. Accommodation and food services
15. Administrative services
16. Furniture
17. Wholesale trade
18. Retail trade
19. Finance, insurance, real estate and management of companies
20. Machinery
21. Agriculture, forestry, fishing and hunting
22. Textiles
23. Plastic and rubber products
24. Utilities
25. Arts, entertainment and recreation
26. Fabricated metal products
27. Information and cultural
28. Professional services
29. Electrical equipment
30. Clothing and leather products
31. Miscellaneous manufacturing
32. Computer and electronic products

Note: This chart shows labour productivity levels for Canadian business sector industries as a share of their U.S. counterparts (vertical axis) and the size of each industry by its share of total employment (horizontal axis). An industry's contribution to the overall labour productivity gap is calculated by multiplying its share of employment by its productivity gap.


industries, such as primary metals, wood products and mining, which are likely related directly to the competitive pressures these industries face in world markets.

**Improve the level and quality of capital intensity.**
Lower levels of capital intensity also account for a significant proportion of the gap in many industries. The Canadian retail trade sector, for example, uses on average only 50 per cent of the level of machinery and equipment per worker that the U.S. sector uses. Although the overall American technological advantage makes it difficult for Canada to overtake U.S. productivity levels in most sectors, we should realistically be able to at least approach them.

Support and foster organizational and managerial innovation. Increased capital investment cannot, in and of itself, increase productivity—it creates only the capacity to increase productivity. Such investments must be accompanied by complementary organizational and managerial innovation, which is in turn frequently driven by domestic and international competition. Similarly, sectors protected from competition (through tariff and non-tariff barriers, or labour rigidities, for example) need not worry about keeping pace with foreign rivals in terms of organizational innovation.

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**Productivity: What Makes the Difference?**

Productivity at the industry level is highly dependent on a mix of factors, as demonstrated below in the summary of the factors influencing the relative productivity of seven Canadian industry sectors.

**More Productive . . .**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percentage of U.S.Level</th>
<th>Key Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wood products</td>
<td></td>
<td>• Natural comparative advantage</td>
</tr>
<tr>
<td></td>
<td>89</td>
<td>• Strong demand from U.S. housing market</td>
</tr>
<tr>
<td></td>
<td>116</td>
<td>• Faster rate of growth in capital intensity</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Highly export oriented</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Competitive pressures from U.S. countervail/anti-dumping increased pressure to reduce costs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Capacity utilization growth</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Investment is a higher share of industry GDP (though now reversing)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Non-factor: research and development (R&amp;D) low in both countries</td>
</tr>
<tr>
<td>Oil and gas (mining)</td>
<td>109</td>
<td>• Different industry mix: some Canadian production (e.g., tar sands) requires more labour and capital than conventional U.S. production</td>
</tr>
<tr>
<td></td>
<td>142</td>
<td>• Different productivity growth drivers: increase in capital stock (Canada), large drop in employment and hours worked (U.S.)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Lower Canadian capacity utilization—higher Canadian investment in sector not yet caught up</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Higher energy prices: exploitation of less accessible reserves will be more cost effective, but higher labour and capital requirements will reduce relative productivity</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Non-factor: capital intensity about the same</td>
</tr>
<tr>
<td>Chemicals</td>
<td>79</td>
<td>• Capital intensity is lower</td>
</tr>
<tr>
<td></td>
<td>81</td>
<td>• Industry shift from basic chemicals to pharmaceuticals</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Enhanced focus on innovation and faster R&amp;D spending</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Well-educated workers, highly knowledge-intensive sector</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Rising share of production geared to export, international pressure to remain competitive and reduce costs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Capacity utilization rate higher</td>
</tr>
</tbody>
</table>

(cont’d on next page)
IMPROVE THE CORE ELEMENTS OF PRODUCTIVITY, COMPREHENSIVELY

Raising productivity is less a choice than an imperative. Given our geographic proximity to the U.S., we stand to lose much in terms of our finest brains, talent and even companies if we fail to keep up with the folks next door. While we may never attain U.S. levels, given the sizable gap that has emerged in recent decades, the failure to achieve a substantial boost in productivity growth will mean lower real wages and incomes, and a standard of living falling further and further behind that of the United States. Introducing cleaner and more efficient technologies and processes can also support more environmentally sustainable economic growth.

If we are serious about addressing Canada’s productivity shortcomings, a comprehensive national strategy is required. Unfortunately, there are no simple explanations or solutions, no quick fixes. As described graphically in Exhibit 1, such a strategy must be inherently complex and interrelated.

The determinants of productivity are multi-faceted. At the core of national productivity performance are the thousands of decisions made daily by individual firms, including the type and amount of physical capital and human resources used in the production process and the rate of adoption and integration of technological change. Well-designed and coordinated government
policies can encourage the development of human and physical capital and can support innovation throughout the economy.

Next, productivity performance depends on the national business and policy environment within which firms operate, specifically the regulatory regime among the provinces and territories and with the federal government, the degree of competition in specific sectors, the tax system and the quality of the economic infrastructure. Since we are deeply integrated into the North American economy, Canadian productivity is affected by our ability to maximize the benefits of this North American economic integration. For example, cross-border alignment on regulatory standards and the adequacy of border infrastructure would be important factors in determining whether Canada is gaining the full productivity benefit from North American integration.

In addition, national productivity performance is influenced by changes in the global landscape. While we cannot control the global environment, it is possible to both influence and adapt to the external environment through well-designed international trade, investment and foreign policies. This underlines the need to make the adequacy and adaptability of Canada’s international trade and investment policies a core element of any Canadian productivity strategy—an element that has, heretofore, often been neglected or ignored in discussions of productivity.

THE CORE MESSAGE: A NATIONAL PRODUCTIVITY STRATEGY IS NEEDED

Developing and implementing a comprehensive Canadian productivity strategy is a top national priority—one that will contribute to sustainable prosperity. Without it, Canada will continue to drive into the future without a road map. It should be emphasized, however, that while a productivity strategy must be national in scope, most assuredly it is not the responsibility of the federal government alone to develop and implement such a strategy. Achieving optimal results will require the full engagement of all three levels of government, plus the full engagement and support of the private sector.

The next four chapters will draw upon The Canada Project research program to articulate specific elements of such a national productivity strategy.

RECOMMENDATIONS TO EMBRACE PRODUCTIVITY AND COMPETITIVENESS

The Conference Board of Canada recommends that:

1. Canadians recognize that economic growth and concern for the physical environment need to be integrated into a single concept of sustainable prosperity:
   - Adopt metrics that integrate the concept of sustainability into our measurement of economic growth and business success.
   - Improve federal and provincial government alignment and efficiency of environmental regulations.

2. Public and private sectors adopt a Canadian national productivity strategy that addresses the key elements affecting our productivity performance.

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2 Treating productivity and competitiveness as top national priorities is broadly consistent with the advice offered in the report of the Standing Senate Committee on Banking, Trade and Commerce—Falling Behind: Answering the Wake-Up Call. Differences do exist, however, in the specific recommendations.
5

**HIGHLIGHTS**

- Canada needs to create a single Canadian market through comprehensive regulatory reform and alignment, and increased competition.

- The current federal and provincial regulatory systems are cumbersome, complex and inefficient. Canada’s regulatory process impedes the flow of capital, goods and talent. Regulatory processes must become more efficient and better aligned across jurisdictions, without sacrificing the protection of well-defined public interests.

- Canada needs to foster innovation. Our most innovative firms generally have better productivity performance, experience faster growth and generate higher-quality, better-paying jobs when compared with other firms. However, we lag behind other industrialized nations in innovation and are falling further behind instead of catching up. Our weaknesses lie in inadequate research and development by private industry and in the conversion of research discoveries into commercial advantage.

- Tax reform is needed to support economic performance, productivity and international competitiveness. Lower-income Canadians should be encouraged to stay engaged in the labour force by sharply reducing the high marginal income tax rates they face. Capital and corporate income taxes at both the provincial and federal levels need to be reduced. Municipalities must be given improved access to the taxation instruments enjoyed by other levels of government, to support their financial needs.

- Canada’s infrastructure is suffering from chronic neglect and under-investment. Transportation infrastructure in particular—used to move goods and people—requires significant upgrading to support a well-functioning national market.
Strategy #2: Create a Single Canadian Market

Research undertaken by The Canada Project has drawn us to the compelling view that Canada needs to create a single Canadian market, supported by a strong national operating environment for business. In concrete terms, this means comprehensive regulatory reform and alignment, increased competition, tax reform, investment in infrastructure and support for innovation.

STOP DEATH BY A THOUSAND PAPER CUTS

Research under The Canada Project has demonstrated that Canada could do itself an enormous favour by tackling the vast web of regulatory and other barriers that currently pervade the Canadian economy, and by reducing barriers to competition in specific sectors. Some of these barriers legitimately serve the public good, but others contribute to lagging productivity by raising the costs of doing business and by sheltering Canadian industry from domestic and international competition. If Canada hopes to compete internationally, this situation cannot continue.

Without sacrificing well-defined public interest objectives that underlie the need for public policy intervention, Canada needs more efficient regulation and improved alignment among all levels of government—with the ideal being regulatory harmonization to create a single national market—which would reduce costs related to both compliance by businesses and enforcement by governments. Our national business and regulatory environment could then become a boost to productivity, rather than a drag on productivity as it is today.

Canada needs more efficient regulation and improved alignment among all levels of government.

The fact that problems persist in the design and implementation of regulation after years of initiatives aimed at reducing such barriers is, frankly, discouraging. Something different needs to be done to give more intelligent regulation the priority its economic importance warrants. As an agenda, it may not be the most enticing priority for governments and political leaders—but the good news is that it is largely within our own power to deliver. And it matters, more now than ever before.

INCREASE COMPETITION WITHIN CANADA

Canada needs a healthy dose of competition. Our economy, like the economies of most industrialized countries, is relatively open. Thanks to multilateral and bilateral trade liberalization over the past two decades, about half of the Canadian tariff schedule is duty-free, and remaining tariffs on industrial goods are quite low. But tariffs in some areas, mainly certain agricultural products and textiles, remain high; the average tariff on agricultural products is 21.7 per cent and the tariff quota in the dairy
sector is a staggering 238 per cent. The higher costs for goods produced by these heavily protected sectors are inevitably passed on as higher retail prices to consumers and as higher costs to Canadian food manufacturers. (See box “Eliminating Barriers to Competition: The Arguments.”)

Moreover, as global tariffs have fallen, the profile of non-tariff barriers (NTBs)—the myriad of technical standards, licensing, local content rules and the like that restrict competition—has risen. NTBs have become the next protectionist frontier, at both the domestic and international levels.

To better understand the connection between barriers to competition and productivity, The Conference Board of Canada recently completed an analysis that breaks new ground in examining the impacts of both tariffs and NTBs, which are much more difficult to measure for the latter.¹

¹ Darby et al., *Death by a Thousand Paper Cuts.*

This work shows that relative Canada–U.S. barriers to competition affect relative Canada–U.S. productivity in the primary and manufacturing sectors, indicating that further elimination of barriers to competition in Canada—particularly in the tradable goods sector—would pay significant dividends in closing the Canada–U.S. productivity gap. (See box “Reducing Barriers to Competition: Increasing Productivity.”)

**REINVIGORATE REMOVAL OF INTERNAL TRADE BARRIERS**

With our federal system of government, the Canadian array of NTBs is daunting. Mainly internal rather than international in nature, they are also often quite opaque. To better understand their impact, the Conference Board conducted a survey of Canadian businesses in 2005, which confirmed that NTBs pose problems for business, primarily in the areas of standards and regulations—though procurement policies and restrictions on labour mobility also rank high. The most serious and difficult choices facing Canada relate to removal of internal barriers that result from provincial and territorial regulations and practices that interfere with the movement of goods and services, the mobility of workers and the free flow of capital. (See box “Barriers to Competition: How Business Sees the Problem.”)

The elimination of barriers to competition in Canada would pay significant dividends in closing the Canada–U.S. productivity gap.

The interprovincial Agreement on International Trade (AIT) process that has been underway since 1995 has made some progress, mainly in the areas of government procurement, non-discriminatory treatment of Canadian investors and businesses, non-imposition of local content requirements, labour mobility/credentials accreditation and the market for alcoholic beverages. Bilateral agreements in 2006 between Alberta and British Columbia, and subsequently between Ontario and Quebec, addressed specific bilateral barriers to labour mobility between the two pairs of provinces and

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**Eliminating Barriers to Competition: The Arguments**

The arguments in favour of open, competitive markets are very persuasive. Competition encourages firms to be nimble, adapting to changing circumstances through innovation. It provides consumers with the widest possible choice at the lowest possible cost. And it encourages both transparency and liquidity in markets, while making it extremely difficult for participants to achieve supernormal returns known as economic “rent.”

A 2004 OECD growth study and other empirical work provide ample evidence that competition-enhancing policies can foster higher productivity and economic growth by improving resource allocation, encouraging managerial efficiency and effectiveness, increasing innovation and technological diffusion, boosting employment and spurring capital investment.

At the same time, there are important and legitimate non-economic goals of public policy, for which regulation is frequently the tool of choice. Examples of such goals are protecting public health and safety, protecting the environment, and fostering a nation’s unique identity and culture. Good regulatory policy requires a judicious balancing of both economic and non-economic goals, and of local and national interests.

Source: Darby et al., *Death by a Thousand Paper Cuts.*

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¹ Darby et al., *Death by a Thousand Paper Cuts.*
Reducing Barriers to Competition: Increasing Productivity

In The Conference Board of Canada's recent analysis, 16 industries where the relationship between barriers to competition and productivity is strongest represent 20.5 per cent of the economy. The chart "Relative Output Prices Versus Relative Multi-Factor Productivity" plots the relationship between Canada-U.S. relative output prices and productivity ratio for the 16 industries. A strong negative relationship exists between relative prices and productivity performance vis-à-vis the U.S., shown by the downward sloping line. This means that the higher relative prices are in Canada, the lower Canadian productivity is relative to that of the United States. Because higher prices reflect barriers to competition, the research suggests that further elimination of barriers to competition in Canada would indeed pay dividends in closing the productivity gap with the U.S.

For the Canadian services sector as a whole, differences between the Canadian and U.S. regulatory frameworks did not appear to be related to relative productivity performance—although further disaggregation of data may well show relationships in such sectors as finance and insurance.

Given the importance of the services sector to the Canadian economy, however, the results suggest that policy-makers must look to other factors, in addition to barriers to competition, for a complete explanation of the Canada-U.S. productivity gap.

Source: Darby et al., *Death by a Thousand Paper Cuts.*

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Barriers to Competition: How Business Sees the Problem

A survey of Canadian companies carried out by The Conference Board of Canada in June 2005 indicated that the majority consider themselves negatively affected by NTBs. The most common barrier identified is standards and regulations (41 per cent), followed by procurement policies (26 per cent); licensing requirements (20 per cent); impediments to labour mobility, especially among provinces (13 per cent); and privacy legislation (12 per cent).

Firms perceived that for all NTBs, roughly 60 per cent originate with provincial governments and about 40 per cent come from the federal government.

The most significant negative impacts of NTBs are loss of business (26 per cent), increased administration costs (24 per cent), reduced competitiveness nationally or internationally (13 per cent), and a higher cost structure (11 per cent). Other negative impacts identified are higher costs associated with fighting or avoiding barriers, higher input prices, reduced innovation and product improvement capacity, and inefficient size of operation.

Approximately one-third of the respondents said their competitiveness is hindered by regulations in their home province, and another third by regulations in other provinces and territories. Close to one-quarter said that provincial regulations hinder their competitiveness internationally.

Companies have adopted various strategies for dealing with NTBs. Some have changed production techniques, product lines or marketing strategies, most of which add to business costs. Some avoid selling in certain provinces because of regulation or procurement programs—or associate themselves with partners or subcontractors in other provinces. Most worrisome, some are seeking business opportunities in more hospitable jurisdictions, or moving their operations out of Canada altogether.

Source: Darby et al., *Death by a Thousand Paper Cuts.*
were another positive step. But there is much more that could be done—in part by taking a leaf out of the international trade negotiation notebook. (See box “Expediting the Removal of Internal Barriers to Trade: Some Ideas.”)

**Expediting the Removal of Internal Barriers to Trade: Some Ideas**

How could faster progress be made regarding interprovincial trade barriers? We could:

- change the operating principles and language of internal trade agreements such that all trade related to particular regulations or rules would be considered to be free and unconstrained, unless a regulation or barrier is explicitly and specifically identified;
- create binding dispute resolution mechanisms;
- promote bilateral and multilateral agreements among provinces to circumvent roadblocks faced by negotiations among all the provinces; and
- conduct more research on the impact of domestic NTBs on Canadian and provincial economic performance.

Source: Darby et al., *Death by a Thousand Paper Cuts.*

**SIMPLIFY AND SHORTEN THE REGULATORY PROCESS**

Closely related to barriers to internal trade and mobility of labour is the more general problem of Canada’s heavy overload of complex and inefficient regulation. Canada has been engaged in the process of regulatory reform in one way or another for decades—from Health Canada’s efforts to improve regulation in biotechnology, to movement in the area of telecommunications, to more recent federal initiatives around “Smart Regulation.” As with internal barriers to trade, however, true progress has been modest.

In part, difficulties stem from a popular perception that improving regulation is synonymous with weakening regulation, particularly in the sensitive environmental and health safety areas. But this need not be the case. Surveys and interviews carried out by the Conference Board have revealed that business concerns over regulation are less about the actual content or level of standards than they are about compliance costs associated with process—the time (and money) it takes to work through regulatory processes, especially when multiple levels of government are involved. Canada needs more efficient regulation that can be enforced at less cost to business, while meeting well-defined public interest objectives. Volume II will make this point in greater detail with respect to environmental regulation.

Regulatory reform needs to be lifted out of small steps and incremental change and into the realm of bold actions that cut through the impasse. We need to take our cue from others that are going down the regulatory reform road, and get the process onto a fast and efficient track. Australia, for example, is reportedly proposing to limit its regulatory approval process for large infrastructure projects to six months, compared with the many years required in Canada. A six-month target is extremely ambitious, but such an objective provides a valuable example of what others are prepared to consider in order to be internationally competitive. Given a choice, the majority of foreign investors would most likely choose to invest in a process-friendly jurisdiction rather than engage in Canada’s complex, time-consuming, multijurisdictional regulatory tangle.

**TACKLE THE “BIG” REGULATORY POLICY ISSUES**

We need to come to grips with the fundamental regulatory policy issues that bear on our future economic competitiveness. It is time to tackle the big issues. For example, on national securities regulation, while the recently agreed-upon “passport” system in national securities regulation among provinces is a step in the right direction, it needs to be accompanied by further simplification and harmonization of securities laws across provinces. The optimal outcome would be to bite the bullet and create a single
national securities system and regulator. The same boldness is required in the financial services industry, where consolidation and openness to international competition should be advanced as core integral elements.

Innovative firms have better productivity performance, faster growth and generate better-paying jobs.

ALIGN CANADIAN AND U.S. REGULATORY FRAMEWORKS MORE CLOSELY

The most important gains in Canadian economic efficiency in the international arena would come from improved alignment of Canadian and foreign regulatory frameworks, particularly with the United States. There is much to be gained by taking the initiative to remove differences between Canadian and U.S. regulatory standards and processes where doing so would meet the needs of both countries. This need not mean ceding national or provincial regulatory authority, since domestic objectives would have to be respected fully. Improved alignment of our country’s regulatory standards—addressed by the Security and Prosperity Partnership of North America—should be given higher priority and is discussed further in Chapter 7.

FOSTER KNOWLEDGE AND INNOVATION

The second key element of the national operating environment is innovation, more specifically the need to foster an innovation culture. (See Exhibit 2.) There is growing recognition of the importance of innovation to Canada’s future, but we have only a partial understanding of its fundamentals. Innovation can also make a critical contribution to environmental sustainability by using resources, particularly energy, more efficiently and creatively. For these reasons, the Conference Board has been examining innovation in depth.4

Our work confirms what we tend to assume: innovative firms, generally speaking, outperform their counterparts. Canada’s most innovative firms have better productivity performance, faster growth and generate higher-quality, better-paying jobs. The work also indicates that innovation is not just about generating economic value; it also generates social value by, for example, creating safer communities and improving health care and environmental protection. More innovative countries reap better economic and social benefits. Sweden, for example, combines first-rate performances on social and environmental indicators with top rankings in both the economic and innovation categories.

3 While ranked seventh-largest in the world based on market capitalization, Canada’s TSX Group accounts for only 5 per cent of total world market capitalization. Notwithstanding vested interests and claims of the benefits of having 13 provincial and territorial regulators (such as the ability to respond to regional interests), the Wise Persons’ Committee—an independent body formed by the federal government—recommended that Canada adopt a single regulator administering a single code. It argued that this approach would best support competitiveness, innovation and growth in Canada’s capital markets.

Canada emerges as a leader in certain aspects of innovation, which suggests that we are producing some of the right overarching conditions needed to support and encourage it. Ongoing efforts to reform regulation, reduce taxes, invest in research and development (R&D), foster clusters\(^5\) and encourage a knowledge-based society and innovation-savvy workforce will help. Our challenge is to develop and sustain a unique innovation system that works for us, recognizing that the ingredients that go into successful innovation vary from country to country.

**BOLSTER COMMERCIALIZATION**

Our biggest weaknesses in innovation lie in inadequate R&D by private industry and in converting research knowledge into commercial advantage. Our investment in knowledge (broadly defined as investment in R&D, software and higher education) has improved, and we have moved up in investment in information and communications technology (ICT). But investment in overall R&D by private industry falls well short of that in other countries. (See Chart 24.) Since 2001, Canada’s expenditure on R&D as a proportion of gross domestic product (GDP) has actually been decreasing slightly, while that of several Western European countries has been increasing.

In the years ahead, we will have a substantial challenge competing with other countries, such as Sweden and the U.K., that are investing heavily in new ideas. The more other countries invest in R&D, the harder it will be for Canada to catch up.

**Canadian companies struggle to generate sales from innovative products.**

However, investing significantly more in R&D will generate little unless we can also extract more value from our investments through more successful commercialization—transforming ideas into goods and services that can be sold in the international marketplace. While no single agreed upon set of benchmarks exists to measure the commercialization performance of any country, there is reason to believe that Canada has not lived up to its potential in this area.

Research comparing Canada with European countries has found that Canadian companies struggle when it comes to generating sales from innovative products.\(^6\) Indeed, it has been suggested that 50 per cent of Canadian innovations may not fully benefit the Canadian economy, because they are either done by individuals who have a hard time commercializing them or owned by foreign assignees.\(^7\) There is also a perception that many of our best ideas simply “go south” or elsewhere, providing other entrepreneurs with profitable opportunities.

To help tackle the commercialization issue, the Conference Board established a Leaders’ Roundtable on Commercialization, which recently produced a strategy for Canadian innovation. (See box “Innovation: Moving Toward Stronger Commercialization.”)

**ENCOURAGE CLUSTERS—WITH CAVEATS**

The Canada Project also conducted research into whether clusters are the strategic way to go. Many of the world’s leading economists think so. Perceived success stories

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5 Clusters are groups of interconnected companies closely located geographically.


7 Trajtenberg, Is Canada Missing the “Technology Boat”?
The Conference Board of Canada

Innovation: Moving Toward Stronger Commercialization

The Leaders’ Roundtable on Commercialization is a two-year blue-ribbon panel composed of 49 senior business executives and deputy ministers, brought together to make bold decisions and plans regarding commercialization challenges in Canada. In addition to some preliminary “quick hits” for action, the Roundtable has identified a priority set of six overarching initiatives, each with measurable targets:

1. Establish priority areas in which Canada will be global best.
2. Increase corporate investment in strategic training and recruitment.
3. Increase corporate investment in research, development and innovation.
4. Increase international and domestic risk capital investment in Canada, and focus on bigger deals.
5. Expand innovation in industrial supply chains.
6. Institute an independent national advisory group in innovation-based commerce.

Source: Guthrie, Picking a Path to Prosperity.

like Silicon Valley have encouraged look-alike initiatives in virtually every corner of the globe. The biotechnology sector, for example, recently announced the intent to establish clusters in over 50 centres around the world.

While much has been said and written about the ability of knowledge-based clusters to accelerate the pace of innovation, attract investment, stimulate job creation and attract wealth, there is also much that is not clear. Fascination with clusters has vastly outstripped our current understanding of the factors that support their growth. Reliable, consistent data on clusters are rare. As a contribution to understanding, the Conference Board undertook a survey of Canadian ICT firms participating in clusters, as well as 11 case studies of clusters in cities around the world ranging from Bangalore and Tskuba to Boston and Vancouver.8 (See box “What Clusters Themselves Have to Say.”)

This work confirmed that clusters contribute to regional economic growth through an influx of skilled labour and firms, as well as investment. But they are not a panacea. Clusters carry risks. Reliance on a single cluster for regional economic growth can be particularly perilous; regions with a number of well-developed clusters are likely to be more stable. Clusters are also subject to boom and bust cycles. They typically are not large employers; the Toronto biopharmaceutical cluster, the largest in Canada, represents only 1 per cent of total employment.

8 The analyses undertaken are described in more detail in Munn-Venn and Voyer, Clusters of Opportunity.
What Clusters Themselves Have to Say

To better understand the role of clusters, the Conference Board surveyed six Canadian information and communications technology (ITC) clusters and six biotechnology clusters.

**Key factors drive the growth of clusters at various stages of their life cycle . . .**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Early stage (per cent)</th>
<th>Growth stage (per cent)</th>
<th>Mature stage (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Skilled technical workers</td>
<td>53.1</td>
<td>64.2</td>
<td>55.8</td>
</tr>
<tr>
<td>Access to risk capital as an obstacle to growth</td>
<td>65.3</td>
<td>38.8</td>
<td>28.8</td>
</tr>
<tr>
<td>Locating near key customers</td>
<td>24.5</td>
<td>32.8</td>
<td>48.1</td>
</tr>
</tbody>
</table>

The survey indicated that the most important factor supporting a cluster throughout its life cycle is a pool of skilled technical workers, which attracts talent, firms and entrepreneurs. Access to risk capital as an obstacle to growth is also very significant, particularly in the early stage. Proximity to markets is less relevant in the early stage compared to the other two factors, but typically becomes more important once the cluster reaches maturity.

**The impact of local support mechanisms is questionable . . .**

<table>
<thead>
<tr>
<th>Support Mechanism</th>
<th>Often helpful (per cent)</th>
<th>Sometimes helpful (per cent)</th>
<th>Not helpful (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>University-based networking organizations</td>
<td>30.2</td>
<td>30.1</td>
<td>39.7</td>
</tr>
<tr>
<td>National or regional trade associations</td>
<td>26.4</td>
<td>31.8</td>
<td>41.8</td>
</tr>
<tr>
<td>Regional industry or cluster councils</td>
<td>21.0</td>
<td>32.0</td>
<td>46.9</td>
</tr>
<tr>
<td>University technology transfer offices</td>
<td>15.9</td>
<td>29.3</td>
<td>54.8</td>
</tr>
<tr>
<td>Economic development organizations</td>
<td>14.9</td>
<td>28.6</td>
<td>56.5</td>
</tr>
</tbody>
</table>

While local support for clusters—through trade associations, cluster councils and the like—is commonly cited as important, the survey suggests that it is less useful than generally believed, or, perhaps, that the approaches themselves are simply inadequate. A substantial proportion of respondents do not find such support helpful at all, which suggests that the support mechanisms either are not providing the services clusters sought or are undervalued. The strongest support (more than 25 per cent) was attributed to university-based networking and national or regional trade associations; less useful were university technology transfer offices and economic development organizations.

**Most—but not all—firms in clusters benefit . . .**

<table>
<thead>
<tr>
<th>Benefit</th>
<th>Strongly agree (per cent)</th>
<th>Sometimes agree (per cent)</th>
<th>Strongly disagree (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased profitability</td>
<td>21.8</td>
<td>38.3</td>
<td>39.8</td>
</tr>
<tr>
<td>Improved ability to keep up with competitors</td>
<td>32.6</td>
<td>31.2</td>
<td>36.2</td>
</tr>
<tr>
<td>Improved quality of new products and services</td>
<td>24.0</td>
<td>40.0</td>
<td>36.0</td>
</tr>
<tr>
<td>Increased ability to introduce new products, services and ways of doing things</td>
<td>36.2</td>
<td>28.3</td>
<td>35.5</td>
</tr>
<tr>
<td>Increased speed at which new products and services are taken to market</td>
<td>28.8</td>
<td>37.1</td>
<td>34.1</td>
</tr>
<tr>
<td>Increased productivity</td>
<td>33.6</td>
<td>37.1</td>
<td>29.3</td>
</tr>
</tbody>
</table>

Approximately one-third of firms belonging to clusters strongly agreed that they are receiving competitive advantage, while about another one-third found that cluster membership was somewhat helpful. These benefits appear to increase as the cluster matures. However, another one-third of firms strongly disagreed that belonging to a cluster provides them with competitive advantage. This challenges the concept that clusters necessarily deliver superior economic performance—or indicates that not all firms are able to capitalize on the benefits of being part of one.

*Source: Munn-Venn and Voyer, Clusters of Opportunity.*
Governments around the world have not had much luck inducing clusters from scratch; successful clusters are typically market driven. Governments can, however, nurture them by building a conducive environment, particularly through core policies aimed at developing of skilled labour and facilitating access to risk capital.

**REFORM THE CANADIAN TAX SYSTEM FOR PRODUCTIVITY**

The overall Canadian taxation system is a crucial element in determining economic performance, productivity and international competitiveness. Taxes do much more than simply collect monies for government spending; they establish relative incentives for work, savings and investment, and they can selectively encourage or inhibit behaviour by individuals and firms that impacts critically on productivity growth. As such, it is important that all three levels of government in Canada take into account the interaction of the structures of their respective tax regimes, and related tax rates, to understand the reforms needed to enhance Canadian economic performance and competitiveness.

While Canada has made significant progress in recent years in improving its tax structure, especially with respect to the lowering of federal and provincial income taxes, the Conference Board believes that three areas for future tax reform deserve priority treatment in support of a national productivity strategy:

1. Encouraging lower-income Canadians to stay engaged in the labour force by removing the tax disincentives to transition from employment insurance (EI) or social assistance to paid employment;
2. Improving Canada’s international competitiveness with respect to taxes on capital investment; and
3. Ensuring the optimal alignment among tax regimes across all three levels of government.

**REMOVE DISINCENTIVES TO WORK**

There is general agreement among economists that high marginal personal income tax rates (i.e., the effective tax rate on the final dollar of earned income) discourage work effort for workers at all levels of the income scale. In Canada, high marginal income tax rates are unreasonably punitive and discouraging for lower-income workers who are attempting to move from social assistance to paid work, or to maintain their foothold in the labour force. Recent work by the C.D. Howe Institute found that for Ontario and Alberta, marginal tax rates approach 80 per cent for incomes around $37,000 in both provinces. They rarely drop below 60 per cent for incomes between $28,000 and $50,000 in Ontario and for incomes between $30,000 and $40,000 in Alberta. Such punitive high marginal tax rates at these income levels reflect a combination of personal income taxes, payroll taxes (EI and Canada Pension Plan [CPP]), and clawbacks of federal and provincial programs that are related to the recipient’s income.

In Canada, high marginal income tax rates are unreasonably punitive.

Personal income tax credits or exemptions that are set at low levels, and average income tax rates that rise steeply—to almost 33 per cent on income as low as $30,000—are also sharp deterrents to work at lower income levels. Individuals may prefer to remain on EI or accept welfare benefits, rather than enter the labour force and have a high level of earned income taxed away while also having social support clawed back. The resulting welfare trap for the individuals concerned makes no positive contribution to national productivity performance, since skills that are needed for improvements in personal productivity are not being developed through regular labour force attachment.

A recent report by the Task Force on Modernizing Income Security for Working-Age Adults (MISWAA) reinforced the C.D. Howe findings by emphasizing the problems faced by low-income earners as they contemplate entering the workforce. In a special report for the MISWAA Task Force, TD Economics quantified the value of benefits that social welfare recipients receive in Ontario and compared these benefits with the recipients’ situation as they transitioned to paid employment. The TD Economics calculations showed that the

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10 Ibid., p. 7.
marginal effective tax rate under these circumstances is generally well over 50 per cent and can even jump to more than 100 per cent. This calculation reinforces the message that under the current system of taxes and clawbacks, individuals can be financially better off remaining on social assistance than accepting paid work, to the benefit of no one.12

Finally, work performed under the auspices of the Institute for Competitiveness and Prosperity reached similar conclusions.13 According to this study, a single-earner couple with two children in Ontario faces a marginal effective tax rate of 60 per cent shortly after they pass $31,000 in taxable income, and as taxable income reaches $36,000 the marginal rate climbs to an absurd 90 per cent. As the Institute’s report indicated, any progressive tax system will have the feature of higher marginal tax burdens at certain income levels.14 However, difficulties arise in both Ontario and Alberta because of the large range of incomes characterized by high marginal effective tax rates. Brief marginal rate spikes over a very narrow income range are less likely to be a major economic problem than are high, persistent plateaus. A small raise in pay may move an individual past a spike, but a high plateau of unreasonable marginal effective tax rates will influence a wide range of incremental work decisions.15

At a time when Canada is already facing severe labour shortages in certain provinces, and given the forecast for shrinking labour availability when the baby boomers begin to retire in significant numbers (beginning as early as 2010), it is clear that the disincentives to move from social assistance or EI to paid work need to be addressed and eliminated without delay. A smoothing in federal and provincial clawback rates on income-tested benefits is in order, combined with an increase in the basic exemption level.

12 Ibid., p. 24.
13 The Institute for Competitiveness and Prosperity, Taxing Smarter for Prosperity, pp. 36–37.
14 Ibid., p. 37.
15 Poschmann, “Marginal and Average Effective Tax Rates in Ontario.”

IMPROVE INTERNATIONAL COMPETITIVENESS

Federal and provincial governments have begun making important progress in lowering personal income tax rates. However, taxes on capital investment remain discouragingly high. According to the C.D. Howe Institute’s 2006 Tax Competitiveness Report, Canada’s effective tax rates on capital investment are the eighth highest of 81 industrialized and developing countries.16 Indeed, Canada’s effective tax rate on capital investment, 36.6 per cent, is more than 6 percentage points higher than the average for all 81 countries.17

The evidence is clear: Canada’s effective tax rates on capital investment need to come down.

Economic research has reached a general consensus on the issue: the higher the rate of business taxation, the lower the rate of capital investment. Recent work by staff at the federal Department of Finance found that a 10 per cent reduction in the cost of capital can increase investment in machinery and equipment by 10 per cent in Canada.18 Similar results have been obtained by studies on foreign direct investment (FDI); a 2003 study of this issue showed that a 1 per cent reduction in the effective tax rates on capital investment can increase the foreign direct capital stock by about 3.3 per cent.19 The recent poor performance of Canada as a destination for FDI is at least partly attributable to Canada’s high rates of taxation of capital investment.

The evidence is clear: Canada’s effective tax rates on capital investment need to come down. The federal government has recognized this fact and has begun to phase out the capital tax (a specific tax levied on capital spending) and reduce corporate income tax rates. Various

16 Only China, Brazil, Germany, Russia, the United States, the Republic of Congo and Argentina have higher effective tax rates on capital than Canada.
17 The effective tax rate on capital investment measures the amount of tax paid through such measures as corporate income taxes, capital taxes (a tax levied directly on the purchases of capital goods), sales taxes on capital goods and other capital investment-related charges such as stamp duties as a share of the pre-tax returns on investment.
18 ab Iowerth and Danforth, Is Investment Not Sensitive to Its User Cost?
provinces have slowly begun to follow suit. However, the reductions to taxes on capital investment currently planned by the federal and provincial governments will still result in a high effective tax rate on capital investment. The C.D. Howe Institute estimates that this rate would equal 32.6 per cent in 2010, improving Canada’s international ranking by only one position—we would have the ninth-highest effective tax rate on capital investment among 81 nations, rather than the eighth-highest. And of course, this assumes no other changes to tax rates on capital investment in other countries.

The Conference Board of Canada agrees that taxes on capital investment should be cut to bring Canada’s rates much closer to the world average. This would require further reductions in corporate income taxes at the federal level and, even more importantly, business taxation reform at the provincial level. Provinces need to eliminate capital taxes and to convert sales taxes levied on business inputs into value-added taxes, such as those reforms already adopted in Quebec and in three Atlantic provinces.

Finally, the federal government had little choice but to act on the broad preferential tax status accorded to income trusts. Not only do income trusts reduce corporate tax revenues flowing into federal coffers, but future national productivity growth would have been impaired if firms transformed into income trusts did not retain sufficient earnings for future reinvestment in innovation and renewal.

ENSURE OPTIMAL ALIGNMENT OF TAX REGIMES

Tax rates are important, but so too is the design and alignment of our multiple systems of taxation. The three levels of government and myriad individual jurisdictions in Canada impose a host of taxes, levies and user fees with little regard for whether such taxes are aligned to achieve a common purpose. At a time when the federal government is moving to eliminate capital taxes, such taxes remain stubbornly high in many provincial jurisdictions, with considerable variation among the provinces. In terms of sales taxes, only three Atlantic provinces in Canada have harmonized their sales tax systems with the federal goods and services tax (GST). Tax regimes that operate at cross-purposes across the country undermine desirable incentive structures and impose added costs on businesses in terms of compliance.

Our overall tax system acts as a brake on productivity growth.

The sheer number of taxes, levies and fees across the various political jurisdictions serve as a substantial barrier to trade. For example, trucking companies wishing to operate nationally face different licensing fees and requirements in virtually every province, which adds to the cost of doing business. As stressed by The Canada Project report Death by a Thousand Paper Cuts, differing regulations across provinces serve as non-tariff barriers that add significantly to business costs and help to lower Canadian productivity. When coupled with insufficient alignment with the federal tax system, our overall tax system can act as a brake on productivity growth. More research is required in this area to examine the current pattern of taxation across political jurisdictions in order to identify the top priorities for action on alignment and, ideally, areas where harmonization is desirable.

And what of taxation in Canada’s cities? Perhaps the most glaring shortcoming of the current national taxation structure is the lack of flexibility with respect to taxation instruments at the municipal level. At present, income taxes and general sales taxes are not open to Canadian municipalities as sources of revenue, even though municipalities in other countries can draw upon these revenue instruments. Canadian cities are instead restricted to using a combination of property taxes, development charges, licences and user fees to finance expenditures. Numerous Conference Board studies for individual cities have stressed the inadequacies of the current taxation choices available to municipalities; the 2004–05 edition of Performance and Potential devoted

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21 See for example Les défis fiscaux; Measuring Toronto’s Fiscal Capacity; La situation financière des municipalités de la communauté métropolitaine de Montréal; and La situation financière de la ville de Gatineau; and a joint study by the Conference Board and L’Union des municipalités du Québec, La situation fiscale des municipalités québécoises.
an entire chapter to this topic. Each of these studies concluded that under current conditions, cities are unable to provide the services for which they are responsible while securing a level of infrastructure sufficient to meet current demands and accommodate future growth. (See box “Vertical Fiscal Imbalance: What Next?”)

Given the long-term demographic outlook, with an aging labour force translating into slower economic growth on the near-horizon, it will be hard to attain future growth in aggregate revenues from property taxes without punitive increases in mill rates. This politically difficult option leaves municipalities chronically under-funded over the long term as they attempt to take on the challenges of providing appropriate infrastructure and levels of service. Municipalities must be given improved access to the taxation instruments enjoyed by other levels of government if they are to remain fiscally viable and assume their place as the locomotives of innovation and economic growth. Volume III of this report considers this issue in detail.

Vertical Fiscal Imbalance: What Next?

There has been much debate in Canada in recent years on the topic of “fiscal imbalance.” Various federal and provincial politicians have either called for it to be redressed, or denied its very existence. As part of the debate, a study done by The Conference Board of Canada in 2002 concluded that there was a growing fiscal imbalance between the federal government and the provinces in aggregate, based on the actual and expected fiscal revenue capacities and expenditure obligations at that time. As we shall see, the picture has changed since then.

Where does the issue of fiscal imbalance stand today? Before we can answer this question, we must be clear on our terms. Fiscal imbalance has been understood by the general public as surpluses at the federal level of government and deficits for the provinces. This interpretation is not complete or accurate. Fiscal imbalance is not just about the current fiscal framework for the federal and 10 provincial governments. Rather, it reflects the structural relationship among and between the three levels of government in Canada, with different tax regimes and related revenue-generating capacities, and different obligations to deliver services to the public. At its core, fiscal imbalance is about specific governments not having the ability to generate the revenues needed to meet their spending obligations.

Fiscal imbalance can appear in two forms. It can be vertical—between higher and lower levels of government, which is the subject of this discussion. Or it can be horizontal—among governments at the same level, specifically the provinces. The equalization program exists as one means of addressing horizontal fiscal imbalance.

The Current Fiscal Context

The May 2006 federal budget contained numerous tax-cutting and expenditure actions that sharply reduced the level of expected federal fiscal surpluses for the coming decade. That budget came on the heels of multi-year commitments by the previous Martin government to transfer huge sums to the provinces for health care, equalization and other programs. The Conference Board expects the federal government to generate modest annual surpluses of $5–$7 billion over the coming five years, including the $3 billion annual contingency reserve. Concurrently, thanks to policy adjustment and stronger-than-expected revenues, the provinces as a whole have now moved into a surplus position, based on their current budgets. In aggregate, the provinces had a fiscal surplus of about $8 billion in 2005–06, and we expect them to remain in fiscal surplus for the next five years, with that surplus slowly declining.

However, the aggregate provincial surplus obscures important differences in the current and projected fiscal performance of individual provinces. Alberta has a large current fiscal surplus, which reached nearly $9 billion in 2005–06 and is projected at $5 billion in 2006–07. Most other provinces have small surpluses or are in rough budgetary balance. Three provinces—Ontario, Newfoundland and Prince Edward Island—are projected by the Conference Board to have fiscal deficits for fiscal year 06–07.

Structural Imbalance

But what about the longer term structural fiscal relationship among governments? There is strong evidence that Canada is facing a structural, vertical fiscal imbalance between the federal and provincial levels of government over the medium term. Recent work done by the Conference Board for The Council of the Federation shows that the provinces as a whole will begin moving into significant and deepening structural fiscal deficits beginning in 2013–14, even as the federal government continues to enjoy fiscal surpluses. Although the May 2006 federal budget sharply reduced the expected level of future federal surpluses, the federal government is still expected to continue generating fiscal surpluses well into the future.

(cont’d on next page)

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2 The Council of the Federation, Reconciling the Irreconcilable: Addressing Canada’s Fiscal Imbalance, April 2006, p. 64. Note that the federal fiscal forecast provided in this report was done before the May 2006 federal budget, which reduced significantly the size of projected federal surpluses.

22 Lefebvre and Swettenham. “Canada’s Cities: In Need of a New Fiscal Framework.”
**Vertical Fiscal Imbalance: What Next? (cont’d)**

For the provinces, the key driver of the projected structural provincial deficits, and the resulting vertical fiscal imbalance over the medium term, is the public health care system. The combination of rapid growth in health care costs and the aging of Canada’s population will escalate the strain on provincial budgets. In the Conference Board’s forecast for the Council of the Federation, total health care spending is expected to grow by 5.7 per cent annually on average for 2005–06 to 2024–25. This projected compound growth rate is quite conservative, as it is far below the average annual increase of 7.5 per cent recorded from 2000–01 to 2004–05. Nevertheless, even with this conservative assumption for annual growth in health care spending, the provinces move into aggregate fiscal deficit in 2013–14, which grows to a deficit of $63.5 billion in 2024–25. If annual growth in health care spending cannot be constrained to 5.7 per cent, the gap becomes far more ominous.

**Cities and Fiscal Imbalance**

The fiscal imbalance of our cities is a further core element of the national debate that has yet to be addressed. As emphasized in Volume III of The Canada Project final report, our cities are already facing a significant structural fiscal imbalance. On the cost side of the ledger, cities face heightened expectations to provide services and quality of life that promote their competitiveness, as well as rising costs of urban transportation and other infrastructure. Infrastructure in our cities has been under-funded for decades now, resulting in a municipal infrastructure gap estimated three years ago at between $55 billion and $120 billion. At current levels of maintenance and capital expenditures, the infrastructure gap will continue to grow as existing capital stock ages and growth adds new demands.

Yet our cities do not have the fiscal capacity to close this infrastructure gap themselves. Canadian cities can only generate revenues from property taxes on businesses and residences, development charges, and licensing and other user fees. Certainly they could do more to help themselves, through increased user fees to reflect the true cost of service provision and by accepting increased debt loads for capital projects.

But more importantly, shrinking intergovernmental transfers, combined with the off-loading of federal and provincial responsibilities, have starved our cities of financial resources. From 1989 to 2004, growth in municipalities’ total revenues did not keep pace with the rate of revenue growth enjoyed by other levels of government (4.4 per cent average annual revenue growth for the federal government; 4.0 per cent for provincial governments; 3.1 per cent for local governments). These annual disparities add up. From 1996 to 2001, provincial/territorial and federal governments saw revenues increase by an average of 25 per cent, while municipalities saw only a 14 per cent increase over the same period. The responsibility lies largely with declining transfers to municipalities. Transfers were just under 16 per cent of local governments’ total revenues in 2004, down from 25 per cent in 1993. And if the fiscal imbalance of our cities is not addressed, their financial health will only worsen.

Some have argued that the Constitution limits the extent of federal engagement in our cities, since cities are the responsibility of the provinces. However, Ottawa is already involved in myriad city-focused programs on several policy fronts: immigration, transit and housing infrastructure, employment insurance, social welfare support, etc. A federal-level policy focus on cities is needed to allocate transfers and investments strategically; to collaborate effectively with other governments’ efforts; and to generate better data to inform public policy. If the federal government is to achieve its overall economic and social objectives, it needs to help Canada’s cities to flourish.

**Options for Action**

So how might vertical fiscal imbalance be addressed among all three levels of government? Given the consensus view that Canadians are highly taxed relative to our international competitors for foreign investment and talent, the option of simply raising taxes is not considered here. So there are essentially four policy options:

- Option 1 is to increase fiscal transfers to junior levels of government, subject to certain conditions attached on how the funds are to be used.
- Option 2 is to assume responsibility for services that are now being managed, and funded, by junior levels of government. This option has been called “up-loading,” and is particularly germane to cities.
- Option 3 is to create tax room through one level of government cutting its own rates of taxation, providing room for other governments to increase taxes for the services they deliver.
- Option 4 is to give city governments access to growth taxes like income or sales taxes that generate increased revenues as the economy grows.

All four options are now in play in the public policy debate. These options are not mutually exclusive; they can be combined across the three levels of government in Canada to produce more sustainable fiscal performance and deliver better services to the public.

What is now required is frank recognition of the facts of vertical fiscal imbalance within Canada, a full debate on the options and their impacts, and a shift into action.

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3 The federal government has passed on to cities part of maintenance of municipal airports, local ports and local harbours, and immigration settlement. Provinces have downloaded responsibilities in transit, child care, education, social housing, social assistance, ferries, selected airports and property tax assessment. The Ontario government has passed on responsibility for some provincial highway maintenance. The Quebec government has recently established new norms for fire and police protection that municipalities must meet, but without new funding.

Source: The Conference Board of Canada.
INVEST IN INFRASTRUCTURE

A further critical element for the national operating environment is infrastructure. Canada’s existing transportation infrastructure is, for the most part, aged and fragile. Be it the state of infrastructure in our cities, the bridges and roads needed for trade with the U.S., or ports and access linkages on both the west and east coasts, much of our infrastructure is suffering from chronic neglect and under-investment—and it shows. Investing in infrastructure at appropriate levels will be an increasingly important ingredient in our economic performance.

Our major airports are the notable exception. Their infrastructure has improved in many cases after undergoing a fundamental shift from federal to local ownership and control, and with many adopting a user-based capital funding model. Nevertheless, we need to keep up with the intense international competition in air freight, and the ground infrastructure linking our airports into the broader transportation grid for people and goods remains strikingly inadequate in a number of cases.

INFRASTRUCTURE IN CANADA’S CITIES—MIND THE GAP

As is discussed in detail in Volume III, Canada’s cities require significant public infrastructure investment for maintenance and renewal, and to accommodate growth. Estimates range between $50 billion and $125 billion for the Canada-wide infrastructure backlog of deferred maintenance, rehabilitation and replacement, with at least half of the backlog recorded at the municipal level. The 2005 report of the intergovernmental Urban Transportation Task Force estimated that a total investment of $89 billion was needed over the following 10-year period. This included $22.4 billion for maintenance, renewal and expansion for conventional transit infrastructure and $66.3 billion for urban roads and bridges. It did not include costs that would be incurred by municipalities to establish new transit systems where none currently exist or for specialized transit, nor did it include

23 Airports in smaller communities are another story; there are reasons to question the divestiture of these airports by the federal government.

transit needs in Saskatchewan, Prince Edward Island, the Northwest Territories or Nunavut, as those jurisdictions did not provide an estimate to the Task Force.

INVEST IN BETTER TRANSPORTATION AND BORDER INFRASTRUCTURE

Achieving necessary levels and composition of public and private investment in transportation infrastructure will be a key success factor in determining whether Canadian businesses will be able to succeed in both North America and emerging markets. There is strong international competition from countries that are already moving significantly in this direction; Australia, for example, has embarked on a major round of infrastructure building to serve the Asian energy and resource market. But trade is not the only consideration; the state of our infrastructure is also viewed as a significant deterrent by potential foreign investors.

And improving infrastructure is about more than tarmac and vehicles; it is also about streamlined transportation systems that are coordinated among themselves and with border security systems, allowing the trucks, trains, planes and ships to get Canadian goods (and services) to market as quickly and efficiently as possible. The rise of terrorism has changed the way we look at all forms of infrastructure, from transportation and border to energy and utilities, and information and communications technology. The fact that about 85 per cent of this infrastructure is in the hands of the private sector makes a strong argument for engaging the private sector on these issues and including leading private sector representatives on the federal government’s Advisory Council on National Security. Protecting our infrastructure is a growing priority—and the bill will not be cheap.

Extensive micro-economic reform is needed to improve Canada’s productivity.

Improvements to Canada–U.S. border infrastructure, enhanced programs for land-based pre-clearance and pre-screening for shippers and travellers, and the new Pacific Gateway Strategy are important moves in the right direction. But governments—federal, provincial and
municipal—need to become more proactive in streamlining and modernizing transportation and border infrastructure. Anyone who has recently travelled through the Windsor–Detroit corridor knows about the fragility of the current transportation infrastructure portal. Private industry and all levels of government need to be relentless in pursuing the modernization and coordination of trade transportation and border infrastructure, including security, as a national priority.

**THE CORE MESSAGE: THE DOMESTIC OPERATING ENVIRONMENT MATTERS, A LOT**

In sum, creating a much more supportive national operating environment—comprehensive microeconomic reform that creates a single Canadian market—will be a critical success factor in improving Canada’s productivity performance. The microeconomic reform agenda entails everything from ending the death by a thousand paper cuts (caused by insufficient competition and excessive and misaligned regulation), to fostering innovation through implementation of the strategy already developed by the Leaders’ Roundtable for Commercialization, to tax reform at all three levels of government, to investment in infrastructure and in making the border work more effectively. Such extensive microeconomic reform designed to create a single Canadian market is a tall order, but one that is critical to improving Canada’s productivity performance.

**RECOMMENDATIONS TO CREATE A SINGLE CANADIAN MARKET**

The Conference Board of Canada recommends that:

3. Governments tackle the vast web of regulatory and other non-tariff barriers that currently pervade the Canadian economy, and reduce barriers to competition in specific sectors:
   - Reinvigorate the removal of barriers to internal trade by adopting some of the techniques used in international trade negotiations, like binding dispute settlement mechanisms and enhanced bilateral/regional agreements.
   - Align, and ideally harmonize, regulatory standards and processes among all levels of government.
   - Pursue the big regulatory policy issues, like national securities regulation or openness in the financial services industry.
   - Simplify and shorten the regulatory process and improve regulatory coordination, for example, by identifying a regulatory “champion” for specific projects.
   - Align Canadian and U.S. regulatory frameworks more closely by removing differences in regulatory standards and processes where doing so would meet the needs of both countries.

4. Business and governments foster knowledge and innovation by implementing the strategy developed by the Conference Board’s Leaders’ Roundtable for Commercialization, which identified six priority areas for businesses and government:
   - Establish priority areas in which Canada will be global best.
   - Increase corporate investment in strategic training and recruitment.
   - Increase corporate investment in research, development and innovation.
   - Increase international and domestic risk capital investment in Canada, and focus on bigger deals.
   - Expand innovation in industrial supply chains.
   - Institute an independent national advisory group in innovation-based commerce.

5. Governments reform tax policy in support of productivity:
   - Reduce marginal tax rates on low incomes.
   - Eliminate capital taxes and reform business taxation.
   - Strengthen the alignment of the Canadian tax system across three levels of government.
   - Provide cities with the tax instruments they need to meet their fiscal responsibilities.

6. Governments, working with the private sector, invest in the modernization and coordination of trade transportation and border infrastructure, including security, as a national priority.
HIGHLIGHTS

- Canada needs to invest more energy and resources in the “people side” of our economy if we are to support innovation, productivity and growth.

- Canada’s population, along with the populations of many industrialized countries, is aging at an accelerating rate. The resulting slower labour force growth will create a drag on Canada’s economic growth potential, and increase related social and economic friction.

- The immigration system is a critical tool for recruiting talent, but it is currently mired in red tape and politics. We need to improve immigrant selection, processing, credential recognition, coordination among all levels of government, and coordination among the public, private and voluntary sectors.

- In addition to enhancing economic- and skills-based immigration, Canada needs to build an integrated policy framework that weaves together the demand and supply sides of our aging workforce.

- Employers must change policies, processes and attitudes to attract and retain older workers, and these workers need to be encouraged to stay in the workforce.

- Our education system must be able to produce highly educated and skilled talent, and both educators and governments need to support skills development, innovation and lifelong learning among all segments of the population. A much higher priority should be given to public investment in our system of post-secondary education, for both universities and colleges.

- Ultimately, it will be necessary for Canada to embrace the concept of lifelong learning for all Canadians, including our Aboriginal and immigrant populations.
Strategy #3: Rethink the Workforce

Without a major shift in policy, in the years ahead our economy is unlikely to have enough workers—or enough of the right kinds of workers. We need to invest a good deal more of our collective energy and resources in the “people side” of our economy than we have done in the past.

ADDRESS THE LOOMING DEMOGRAPHIC CRUNCH

Longer lifespans and falling fertility rates are “aging” the population of many countries at an accelerating rate. (See charts 25 and 26.) This will fundamentally alter the functioning of labour markets, as the labour surpluses of the last quarter of the last century are replaced by potential labour shortages. Although relative prices will adjust—that is, real wages will rise—and production processes will be altered as firms substitute capital for labour, slower labour force growth will also drag down Canada’s economic growth potential and increase the social and economic friction related to these major structural demographic changes. (See box “The Demographic Outlook: Fewer Babies and More Elderly.”)

In principle, there are three ways of dealing constructively with this looming problem. One route is to try to raise the rate of natural population increase by making it easier for women to have children while remaining in the workforce, as some European countries are trying to do—although Quebec’s experience with tax and other measures of this kind suggests this approach is unlikely to

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**Chart 25**
Total Fertility Rates for Selected Countries
(average number of children per woman of reproductive age)

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<td>1.0</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.1</td>
<td>1.7</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>U.K.</td>
<td>1.8</td>
<td>1.4</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>U.S.</td>
<td>2.0</td>
<td>1.6</td>
<td>1.4</td>
<td>1.4</td>
</tr>
</tbody>
</table>

Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat.
have much impact. Higher rates of fertility among the
Aboriginal population could be part of the solution to
labour force shortages in specific regions—such as
Saskatchewan and Manitoba—but fundamental changes
in social and education policies will be required to ele-
vate the education and skills levels of this community.1

A second route is to arrest labour force decline through
substantially increased immigration—although trying
to make up for empty cradles with full immigration
queues would require very high immigration levels to
even make a significant dent in the problem. It will
also become increasingly difficult for all industrialized
countries to find sources of skilled immigration, as
population growth in countries like Brazil, Iran, Turkey
and China is also slowing and will eventually fall below
replacement levels, meaning they will not have signifi-
cant skilled labour to spare.

The third route is to increase the number of older work-
ers by inducing them to remain in the workforce longer.
We will focus on these latter two options.

1 The share of the population reporting Aboriginal identity in the
2001 Census was highest in Nunavut (85.2 per cent), Northwest
Territories (50.5 per cent), Yukon (22.9 per cent), Saskatchewan
(13.6 per cent) and Manitoba (13.5 per cent).
IMPLEMENT A NEW DEAL FOR IMMIGRANTS

Canadians need to realize that the nature of global immigration is fundamentally changing. It is now intensely competitive—and will become even more so. Mindsets must change: we can no longer assume that Canadian needs will be met by immigrants who simply walk in the front door. We have to shop much more seriously for immigrants, and particular kinds of immigrants.2

Canadian immigration policy and programs should be geared to the needs of the economy.

To begin with, we need to recognize just how significant immigration already is for the Canadian economy. Recent immigrants now account for 20 per cent of the Canadian labour force, 30 per cent of all new labour market entrants and about 70 per cent of Canadian labour market growth. Increasingly, the bulk of immigrants to Canada come from Asia, and a large proportion qualify based on economic criteria. (See box “Immigrants: Where Do They Come From?”) With the aging of the Canadian population now underway, immigration is becoming even more important. Statistics Canada estimates that immigrants, who tend to be younger than the Canadian average, will account for the lion’s share of Canada’s population increase in the years ahead, from about two-thirds in 2005−06 to 75 per cent in 2020, and for the entire increase by 2031.3

We also need to assess immigration through the lens of Canada’s future labour force needs. Thus far, Canada has been reasonably successful in attracting entrepreneurial immigrants. We have also attracted a strong cadre of immigrants with professional skills. In the past, we did more than others to gear our immigration programs to the needs of our economy. However, in recent years, other countries have been catching up and may even be surpassing us. The U.S. is expediting immigration processes on behalf of employers, as is the United Kingdom. Australia has undertaken an intense immigration drive with expedited processes for skilled workers. Canada’s immigration system, in contrast, seems all too often to be mired in red tape and politics.

A strong case can be made in Canada for giving even greater priority to the economic class of immigrants.

STRENGTHENING IMMIGRATION POLICY

Improve immigrant selection and processing. The present Canadian immigrant selection system is not as beneficial to Canada as it should be due to a technical inability, or a political unwillingness, to prioritize the three classes of immigrants: economic, family reunification and refugee. Given the crucial importance of skilled and entrepreneurial immigrants to our economy, a strong case can be made for giving even greater priority to the economic class. Similarly, a strong case can be made for more aggressive matching of skill demand gaps in the labour force with the skills of prospective immigrants. This should include taking on the issue of undocumented workers in Canada, whose skills could address specific labour force shortages.

Ultimately, we need to stop losing talented immigrants to other, more aggressive immigrant-soliciting countries due to cumbersome and clogged immigration processes,

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Immigrants also bring challenges. Above all, action must be taken to deal with the substantial backlog of applicants.\(^4\)

### What Immigration Means for the Canadian Economy

**Immigrants bring benefits . . .**

- **Skills:** Immigrants are disproportionately represented in several highly skilled populations. For example, in 2001, 12 per cent of recent immigrants worked in information technology occupations, compared with 3 per cent of the Canadian-born population.
- **Education:** The average level of education of immigrants is higher than that of people born in Canada; in 2005, 80 per cent of business class immigrants (principal applicants) had a university degree, as did 29 per cent of family class immigrants and 16 per cent of refugees, compared with about 15 per cent of the Canadian population in the 2001 Census.
- **Capital:** Between 1980 and 2004, each immigrant brought $30,000 into Canada (which totals more than $100 billion in current dollars). During those years, the federal entrepreneur program attracted $184 million and led to the creation of nearly 3,000 full- and part-time jobs.
- **Economic efficiency:** By increasing the size of the population, immigration helps Canada to achieve significant economies of scale.
- **New trade links:** Some immigrants use their knowledge of international markets and personal connections in their native countries.
- **Innovation:** Immigrants are an important source of new ideas and risk capital.
- **Urban transformation:** Canada’s major cities, especially Toronto, Montréal and Vancouver, are heterogeneous—ethnically and culturally diverse centres in the increasingly globalized community.
- **Net economic contribution:** The net balance of taxes paid and public goods, services and transfers received by foreign-born individuals is positive: for example, government transfers to an average Canadian-born household totalled $7,300 in 1995 as against $6,100 to the household of recent immigrants.

**Immigrants also bring challenges . . .**

- Customs and religious and other beliefs that can be controversial (e.g., concerning the rights of women).
- Stress on health-care systems, housing and settlement services, particularly in cities.
- Workplace adjustment and potential discrimination.

Source: Bloom, “Immigration: A New Deal for Newcomers.”

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4 Potential solutions suggested by experts and governments include: streamlining the application review process; spending the funds necessary to increase the pace of application processing; setting a yearly quota for the intake of applications; placing a time limit on open applications so they expire after a given period; using technology to manage applications more efficiently; and creating an expedited entry process for certain kinds of applicants. As of September 2006, the last of these options is currently being pursued through a pilot program in Vancouver and Calgary that is issuing temporary foreign worker visas to some categories of skilled trades.

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5 Bloom and Grant, *Brain Gain*, and 2006 custom updates to that report.

6 For instance, lack of communication and relationship continuity among various bodies have resulted in municipalities and other partners designing and delivering programs, only to have funding retracted by other orders of government. See Bloom et al., *Towards an Immigration Agreement.*
strategy for immigration—one that involves employers, educational institutions and community groups—to better focus immigrant selection, improve settlement and integration, and ease labour market entry.

RETAIN OLDER WORKERS

While enhanced economic and skills-based immigration will help, it will not be enough. The participation of older Canadians in the workforce is already low relative to other countries’ participation rates. Although our overall labour participation rate is reasonably high (78 per cent compared with the leader, Switzerland, at 81 per cent), it falls considerably when the indicator focused on those over age 55. At the same time, rising life expectancy and low fertility together are creating a demographic pincer movement, the impact of which is sharpened by increasingly early retirement. These trends are eliminating labour surpluses, lowering labour force growth and undermining economic potential—while at the same time putting pension plans under pressure.

This means that the generous policies of the 1980s and 1990s that favoured early retirement will need to be modified. Given the time lags involved, Canada has about a decade before the accelerating age of the population will begin to significantly undermine economic performance. The time to act is now, by building an integrated policy framework that weaves together both the demand and supply sides of our aging workforce.7

FUTURE DIRECTIONS FOR EMPLOYERS

An aging workforce presents challenges for employers. In some cases, employers will need to modify products and services to meet the needs of an older customer base. In other cases, it will involve making fundamental changes to human resources policies, workplace design and even work production processes in order to retain and engage older workers.

Canadian industry and public sector employers need to move more deliberately in this direction. A 2005 Conference Board survey of employers showed that while 88 per cent are aware of the problem of an aging workforce, only 8 per cent have plans to hire retired employees. Nor were many making strategic changes to address aging workforce issues—unlike their European and American counterparts. (See box “Retaining Older Workers: What European and American Industries Are Doing.”)

**Adopt strategies to attract older workers.** Like their counterparts in other countries, Canadian private and public sector employers need to develop strategies that encourage the increasing number of underutilized older people to participate in the workforce. Specifically, they need to eliminate ageism, modify rigid work schedules, encourage skills upgrading and, where appropriate, create age-friendly workplaces and production processes.

**The accelerating age of Canada’s population will significantly undermine economic performance.**

**Encourage a more gradual transition to retirement.** Employers also need to eliminate the customary abrupt work–retirement separation in favour of policies that encourage a more gradual transition to retirement, such as institutionalizing “bridge jobs” and increased compensation flexibility.

FUTURE DIRECTIONS FOR GOVERNMENTS

Market-driven action alone, however, will not be enough. On the demand side, organizations need to be motivated to hire and retain older workers. And on the supply side, older workers need to be encouraged to remain in the workforce. Japan and European countries, which are ahead of us on the demographic curve, have already taken significant steps in this direction and there is much that Canada can learn from them. (See Table 4.)

**End mandatory retirement.** Forcing people to retire is an anachronism. Canada needs to take decisive and early action to end age discrimination by eliminating
Retaining Older Workers: What European and American Industries Are Doing

As the population ages, some in the international business community are taking steps to retain older workers—and finding it profitable.

Age Diversity Strategies
- B&Q, the largest home improvement and garden retailer in Europe, made age diversity a key element of its strategic plan in 1989 by introducing “Over 50” stores. These stores recorded higher profits, lower staff turnover, lower absenteeism and better customer satisfaction.
- Deutsche Bank formed intergenerational investment teams for wealthy clients, recruited experienced relationship managers in the consumer business, hired retired managers to support junior employees as “door openers” in the banking business, and promoted phased retirement and other flexible work arrangements.

Attraction, Recruitment and Retention
- Netto, a large Danish supermarket chain with operations in Scandinavia, Germany and the U.K., found hiring older people and opening “senior supermarkets” profitable, and plans to introduce more age diversity into its workforce.
- Borders, the American bookstore chain, found that 50 per cent of all books were purchased by people over the age of 45; it now has 16 per cent of its workforce over the age of 50. It also found that the turnover rate in the older worker population is 10 times less than for younger workers and has adjusted its pension plan in an effort to retain them.
- Westpac, a large Australian financial services company that hired older people to work in its call centre operations, has reported that older employees relate better to customers and have lower rates of absenteeism, higher productivity and higher employee satisfaction levels.

Work Design and Organization
- Volvo’s Torslandaverken plant in Sweden coped with a severe labour shortage in the early 1990s by having older employees, as well as those with acute medical problems, perform specialized service or preparatory tasks on vehicles. This retained the experience of older workers while saving money by reducing retirements and sick leave.
- Ruoka Saarioinen Oy, a large Finnish food production company, has extended its older employees’ working life by one or two years by improving the physical working environment. They have introduced ergonomically designed equipment, and fitness and weight loss programs, recouping costs through reduced recruitment and training costs.
- International Truck and Engine Corporation in the U.S. reduced injuries and increased productivity by modifying one of its assembly lines, rotating it upside down so that it could be worked on from above rather than below, which was less physically demanding and safer for older workers.

Work Flexibility
- Fidisco NV, a Belgian finance company, instituted flexible working patterns that allow older workers to work fewer hours without a loss of salary.
- St. Mary’s Medical Centre, a large American medical facility, has allowed older workers to reduce their work hours without jeopardizing retirement or other benefits.
- IBM-Sernet, a partnership in which a group of retired managers from IBM Italy work with their former employers to offer consulting services, has kept highly experienced professionals in the IBM sphere.

Training and Professional Development
- Air France, much of whose workforce is over 50, adopted a complex system that lets 500 employees each year evaluate their careers and better position themselves within the organization and (or) ease transition to retirement.
- The Environment Service Department of the Groningen town council in the Netherlands lets employees vary their work responsibilities based on life stage and capability.
- The Ohio State University Medical Center’s “60 Plus” program lets older employees audit any college class free.

Source: Benimadhu and Darby, “Rethinking the Workforce.”
### Table 4
Keeping Older Workers Working: What Other Countries Are Doing

#### Motivate employers to employ older workers

<table>
<thead>
<tr>
<th>Japan</th>
<th>Europe</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>End legal age discrimination in the workforce</strong></td>
<td>Equal opportunities in hiring regardless of age; guidelines to employers; extension of fixed-term contracts for workers over age 60</td>
<td>Mandatory in European Union by 2006</td>
</tr>
<tr>
<td><strong>Create financial incentives</strong></td>
<td>Extensive system of subsidies to encourage businesses to hire and retain older workers</td>
<td>Special Employment Subsidies program covers half of wage costs for people over age 57, for up to two years</td>
</tr>
</tbody>
</table>

#### Motivate older people to work

<table>
<thead>
<tr>
<th>Japan</th>
<th>Europe</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Create financial incentives</strong></td>
<td></td>
<td>Earned Income Tax Credit</td>
</tr>
<tr>
<td><strong>Institute pension reforms to create an incentive to remain in the workforce</strong></td>
<td>Major pension reform: increased minimum age of entitlements; pensions indexed to inflation rather than wages; proposals to reduce benefits further and increase payroll taxes</td>
<td>New pension system to generate higher returns from each additional year of work after age 61 (Sweden)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Minimum age for drawing non-state pension increased; workers can receive partial pension while still working; older workers can increase pensions by delaying retirement (U.K.)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Workers who retire at age 62 receive only 70 per cent of pension</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Workers can increase pensions by working beyond age 65, until 69</td>
</tr>
<tr>
<td><strong>Reduce generosity of unemployment and disability benefits to prevent use as route to early retirement</strong></td>
<td>Disability pensions based solely on medical grounds; recipients of unemployment benefits cannot claim old-age pension benefits; duration of unemployment benefits significantly reduced for those aged 60 to 64</td>
<td>Disability benefits slightly decreased; eligibility criteria and investigation strengthened (Sweden)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Disability claimants sent to state-employed doctors (U.K.)</td>
</tr>
<tr>
<td><strong>Provide training to enhance employability</strong></td>
<td>Public study grants and individual skills assessment (Sweden)</td>
<td>Enhanced student loan regime for older students; special training programs for job seekers over age 45 (U.K.)</td>
</tr>
<tr>
<td><strong>Improve working conditions for older workers</strong></td>
<td>Subsidies for employers who improve facilities for older workers</td>
<td>Guidelines for developing strategies for managing an aging workforce (European Foundation for Improvement of Living and Working Conditions)</td>
</tr>
<tr>
<td><strong>Help older workers find employment</strong></td>
<td>Array of placement services to help older workers locate employment</td>
<td>Prince’s Initiative for Mature Enterprise start-up loans</td>
</tr>
<tr>
<td></td>
<td>Subsidies to create new businesses involving older workers</td>
<td>Senior Community Service Employment Program provides subsidized employment to older low-income workers; U.S. Department of Labor guide to serving mature workers</td>
</tr>
</tbody>
</table>

Source: Benimadhu and Darby, “Rethinking the Workforce.”
legislative and structural barriers for those who choose to work beyond age 65. Such action is now being taken in Ontario and some other jurisdictions.8

Reform public funded pensions to promote later retirement. The lagging limits on registered retirement savings plan and registered pension plan contributions indicate that tax-sheltered retirement savings have, over time, offered less support for early retirement. Given the importance of financial incentives, reform is now needed to the Canada Pension Plan/Quebec Pension Plan (CPP/QPP) early retirement provisions, as well as to the structure of many public sector defined-benefit pension plans that provide strong incentives for early retirement.

In recognition of the better health and longevity of the Canadian population today, the age of CPP/QPP eligibility should be increased gradually from 60 to 65. At the same time, positive incentives for older workers could be introduced, such as continuing to contribute to pension plans beyond the existing maximum, new age-related tax credits or lower rates of taxation on earned income.

Canadian private and public sector employers need to develop strategies that encourage older workers to remain in the workforce.

Encourage industry to retain older workers. As in other countries, governments also need to work with private and public sector employers to ensure ample employment opportunities for older workers—through such initiatives as job subsidies or lower taxes on income earned after age 65, government-subsidized training and wage subsidies for employers, as well as ad campaigns and other mechanisms to encourage older workers to remain in the workforce.

8 This will require new thinking around expected performance from employees and the need for clear and unbiased objectives and measures, to ensure that older workers (and indeed, all employees) continue to meet their job performance objectives, but are also evaluated fairly.

EMPHASIZE EDUCATION AND SKILLS

Canada scores well in most international education comparisons—but we are skating on thin ice.9 Below the surface lie problems that, if not addressed, will soon undermine the ability of Canada, and Canadians, to prosper in an increasingly interconnected, knowledge-based world.

Conference Board surveys indicate a perception among some foreign investors that the quality of our labour force is a significant deterrent in attracting foreign direct investment (FDI).10 Foreign investors are concerned about a number of things when it comes to our labour force—availability of workers with specialized skill-sets, the level of basic skills among workers and education levels. Foreign investors are similarly interested in the capacity of our education and training systems to support the productivity and competitiveness of operations in which they invest, and they often turn to the local college system to supply the training needs. This evidence supports the call for strong cooperative action between investors and educators, and among provincial and territorial governments and the federal government.

HIGHER PRIORITY FOR EDUCATION FUNDING

At a time when many countries are investing more in education, Canadian spending on public education is increasingly being crowded out by other priorities, particularly ever-higher health-care demands. As a result, Canada’s relative public expenditure on education has been falling. In 1995, Canada was second in the world, investing 6.2 per cent of gross domestic product (GDP); by 2002, we had fallen to 4.6 per cent, earning us 18th place. (See Chart 27.) Figures supplied to the OECD by selected member countries also reveal that Canada spends less on early childhood education than many countries do. (See Chart 28.)

The challenge begins with our schools. We are relying on our public education system to provide something that the system itself is finding increasingly difficult to deliver. Canadians need to come to grips with the future of public education in this country, its funding priority

9 Lafleur and Little, “Crunching the Numbers,” pp. 49–51.
10 See, for example, Iqbal et al., “Foreign Direct Investment,” p. 110.
and the reforms required to provide students with the knowledge and skills they need to succeed in tomorrow’s economy. We need to understand the distinction between education for broader knowledge, which contributes to longer term creativity and innovation (but does not fill immediate gaps in the skilled labour supply) and education as a more immediate investment supporting national productivity, where funding of technical schools and colleges in particular can develop specific priority skills. Both forms of education are necessary and deserve priority support.

Advanced degrees and advanced research are increasingly important. Eight out of the 10 occupations with the fastest employment growth in Canada from 1990–2003 required post-secondary qualification. By comparison, roughly 6 per cent of job postings seek workers with less than high-school education.11 Canadian universities will find it ever more difficult to keep up with premier academic institutions around the world, particularly in the U.S., where many are funded by generous private sector and alumni support. Our universities are moving in the right direction. They are increasingly turning to private sector dollars for directed research, with the support of government initiatives like the Canadian Foundation for

11 Canadian Council on Learning, Canadian Post-Secondary Education, p. 5.
Innovation and provincial counterparts. The role of post-secondary institutions in R&D is much greater in Canada than in most other countries; according to the Association of Universities and Colleges of Canada (AUCC), about one-third of research in Canada is now done in universities.

Increasingly, the cash crunch is also encouraging universities to examine specialization and rationalization among themselves, regionally and nationally. Many are also vigorously attracting foreign students. Even with such steps, however, it is difficult to see how Canadian universities will be able to sustain first- or even second-tier standing in the world without significant new investment by governments, leveraging of more public and private sector support, and (or) a bold new strategy of focusing on one or two major centres per university.

A similar argument for higher sustained levels of financial support can be made for Canada’s colleges, but for different reasons. Colleges are a key link between (mostly) young Canadians seeking practical skills for the labour force and the current labour market that will employ those skills. Governments often refer to the need for highly qualified persons (HQPs) in our economy. HQPs include people with university degrees as well as graduates of colleges from across the country. Colleges therefore need to be regarded, and treated, as the practical counterparts of our universities and funded at levels that allow them to produce graduates with the concrete skills needed in today’s labour market.

**Canadian universities will not be able to sustain first- or even second-tier standing in the world without significant new investment by governments.**

**IMPROVE EDUCATION LEVELS AND SKILLS**

Our education system is not only under-funded, it is also not producing enough of the right mix of skills and knowledge. A 2003 OECD study that assessed the skill levels of 15-year-olds in 40 countries ranked Canadian students seventh in mathematics and third in reading. But 28 per cent of students in the study were not capable of completing tasks above a basic level of complexity in both these areas of learning. Our low science scores ranked us 11th—lagging behind not only industrialized countries like Finland, Japan and South Korea, but also emerging countries like China and the Czech Republic. These results suggest that our flow of new entrants to the labour market do not have the requisite skills to allow us to compete.

Canada has a highly educated workforce, with the highest level of working-age adults with post-secondary degrees among OECD countries. But we have a lower proportion of engineering and science graduates than do European countries, and there is a much lower percentage of working-age adults with university degrees in Canada than in the U.S.

**Recognize the importance of innovation.** A more innovative economy calls for graduates with the right mix of skills and knowledge, one with creative thinkers, implementers, risk takers and people who can work with others to innovate. Public education needs to recognize the importance of innovation by focusing on innovation skills in curricula and programs, and in its credentials. Problem-solving abilities, communication skills, teamwork skills and personal accountability are often described as desired outcomes of the K–12 and post-secondary systems. Provincial and territorial education jurisdictions, school boards, colleges and universities alike have mapped their academic outcomes onto these desired skills, but generally they themselves have not been sufficiently innovative in changing teaching and testing practices to ensure better skills-based outcomes in graduates. More needs to be done to adjust curricula and programs to focus more deliberately on the development of skills (including innovation skills) and to credential students for the skills they have developed. To help accomplish this, links will need to be strengthened among educational institutions, business and communities through such things as mentoring and work-study programs. Educators also need training to teach innovation skills effectively.

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Expand international experience and language skills. University-level education should be more than a matter of advanced degrees. We need more study programs abroad to give our students international experience and opportunities, an area in which we have long trailed countries like the U.S. and Australia. We need to welcome foreign students, but also to facilitate more Canadian students going abroad. Moreover, success in the future global economy will require language skills. English may be a lingua franca and a passport in North America, but multilingual skills provide an edge in global markets. Our increasingly multicultural society helps, but our students are far behind their counterparts in Europe, Asia and Latin America.

Address the skilled trades gaps. University-level education is not the only answer. Canada will have difficulty maintaining its high-productivity sectors like resources and construction, and raising the productivity of others, if it does not also invest in highly skilled professional trades. There are growing skills gaps in the labour market that are recognized by all stakeholders, consumers included. Our K–12 system needs to be more innovative in terms of providing “career pathways” into the trades, and the college system will have a pivotal role to play in addressing the specific skilled trades gaps.

English may be a lingua franca in North America, but multilingual skills provide an edge in global markets.

Enhance Aboriginal- and immigrant-sensitive education. Demographic trends indicate that the future Canadian student body will have an increasingly large proportion of Aboriginal people and immigrants. The largest decline in Canadian fertility rates is among women in the highest educated and highest paid category, while the highest birth rates are among young, single Aboriginal women and recent immigrants with lower education levels. (See box “Aboriginal Education—Improve the High School Completion Rate.”) According to ethnocultural

Aboriginal Education—Improve the High School Completion Rate

Canada needs to do a better job of tapping into the talents of Aboriginal people—they will be an ever-larger component of our future labour force. One key is to improve the job Canada does in helping Aboriginal people develop their knowledge and skills through formal education and training.

Aboriginal high school graduates are just as likely as other graduates to earn post-secondary degrees and diplomas, so the key to helping Aboriginal people achieve their potential and increase their contribution to the economy lies in improving their high school graduation rates. According to the latest available census data (2001), the overall rate for Aboriginal people not completing high school is 48 per cent—much higher than the rate for the Canadian population as a whole. Non-completion rates for Aboriginal people living on reserves range from 59 to 70 per cent. The high school non-completion rate for Aboriginal people living in cities is better, at 40 per cent, but even this rate of non-completion is well above the 31 per cent non-completion rate for the total population.

Besides being a threat to social cohesion and inclusion, dropping out of high school has a staggering economic cost to Aboriginal people and to the economy at large. A study conducted by Eric Howe found that an Aboriginal female in Saskatchewan who completes high school and carries on to university will earn an estimated $1 million over her career, compared with only $90,000 if she drops out of high school. An Aboriginal male who drops out of high school will forgo half a million dollars in income over his lifetime.

In recently published research, Michael Mendelson urges Canada to redouble its efforts to improve graduation rates among Aboriginal people and makes four main recommendations:

1. Set quantitative, geographically specific targets and dates to increase high school graduation rates.
2. Measure progress toward targets while protecting individual privacy.
3. Set up a new agency to do this work.
4. Using a “franchise” model, identify best practices in keeping Aboriginal people in high school and in attracting and graduating Aboriginal people from colleges. Then translate these best practices broadly to high schools and universities.

These and other ideas for change merit serious consideration, since the status quo is clearly not meeting the needs of the Aboriginal population.

1 Mendelson, Aboriginal People and Postsecondary Education, pp. 10, 15, 24.
2 Mendelson derived these calculations from Howe, Education and Lifetime Income, p. 1. Note that the lifetime income was adjusted by Howe to account for labour force participation, which means that the extremely low lifetime earnings for Aboriginal women reflects, to a large extent, the low employment rate of Aboriginal women without a high school diploma. When the wage was not adjusted by labour force participation, the average annual wage of an employed Aboriginal female without a high school diploma was 96 per cent of that of an employed Aboriginal female who had graduated from high school.
3 Mendelson, Aboriginal People and Postsecondary Education, pp. 35–37.

Source: The Conference Board of Canada.

14 This and other ideas relating to post-secondary education, some of which appear elsewhere in this report, are reflected in Association of Universities and Colleges of Canada, People and Ideas!
projections released by Statistics Canada last year, Canada’s visible minority population is projected to increase by between 56 and 111 per cent between 2001 and 2017—while the rest of the population is expected to increase by between 1 and 7 per cent over the same period.15 Our education system will increasingly have to reorient itself to the implications of this shift in our national demographics.

9 million Canadians do not have the requisite literacy skills considered necessary for success in today’s economy and society.

IMPROVE THE QUALITY OF THE WORKFORCE THROUGH LIFELONG LEARNING

The future will demand not only higher levels of education and skills, but also readjustment to a constantly changing job market. While the concept of “lifelong learning” has worked its way into the national lexicon, it is taking longer to find its way into practice in the workforce. Canadian performance in lifelong learning is mixed; studies show that those who participate in continuing education and training spend relatively longer at it, but the overall levels of participation in both in-job and non-job learning is low. Improving the quality of the workforce must therefore remain an overarching national objective if Canada is to remain prosperous.

Address basic literacy and numeracy skills. Basic reading, writing and number skills are required by the entire labour force. Many adults appear to have difficulty coping with the literacy and numeracy demands of modern life and work, which undermines both the productivity and the adaptability of the workforce. In fact, 40 per cent of adults—9 million Canadians—do not have the requisite literacy skills considered necessary for success in today’s economy and society. A recent update of the literacy study found that the proportion of the Canadian population at the lowest levels of document and prose literacy skills has not changed significantly since the previous major survey, in 1994.

A recent Statistics Canada report of a study conducted across 14 OECD countries showed that, on average, every 1 per cent increase in literacy scores is linked to an eventual 2.5 per cent relative rise in labour productivity and a 1.5 per cent rise in GDP per capita.16 The study also identified strong growth effects associated with the distribution of literacy and numeracy skills. Therefore, even as we invest in schools, colleges and universities—in innovation and the trades—governments and employers must not forget the basic skills that are required to function in the modern marketplace. The aim should be to create a culture of lifelong learning for all Canadians.

THE CORE MESSAGE: TAKE ACTION TO ADDRESS OUR AGING LABOUR FORCE

Businesses and governments would reap individual and collective benefits by addressing seriously the issue of the skills and composition of our labour force—and we need to do it soon. To date, most organizations have been extremely slow to recognize the issues and seize the initiative. No single approach will solve the problem; instead, we will need a strategy that develops multiple approaches.

RECOMMENDATIONS TO RETHINK THE WORKFORCE

The Conference Board of Canada recommends that:

7. The federal government implement a new deal for immigrants by improving immigrant selection and processing, reforming credentials recognition and strengthening intergovernmental and public–private sector coordination.


16 Coulombe et al., Literacy Scores, Human Capital and Growth, p. 31.
8. Business and governments actively seek to retain older workers by adopting more flexible working arrangements, changing the mix of financial incentives and modernizing attitudes toward older workers.

9. Governments establish education funding as a much higher national priority and ensure that both universities and colleges have the financial resources they need to meet their respective mandates.

10. Governments and employers improve the quality of the workforce:
    - Recognize the importance of innovation within the education system.
    - Expand international educational experiences and language skills.
    - Address the skills gap.
    - Revitalize our commitment to Aboriginal education.
    - Enhance immigrant-sensitive education.
    - Commit to lifelong learning.
Canada's international investment and trade policy must adjust to the profound changes taking place in the global economy. These changes include the spectacular rise of China and other emerging economies, and their potentially massive impact on the global marketplace; the emergence of “integrative trade”; and the growing role of knowledge-based services.

Canada must grow its relative global share of foreign direct investment (FDI) by reducing the high cost of complying with complex regulations; examining the elimination of withholding taxes; and specializing in niches within global supply chains.

Similarly, we must take action to actively encourage Canadian FDI abroad, which is a creator of wealth in Canada.

We must increase our trade in services by ensuring that domestic regulations create a positive business environment that fosters a healthy and globally competitive services industry.

Canada must become more strategic in developing and implementing international trade and investment policy, aligning it with domestic policy. We need to embrace integrative trade and address pockets of protectionism.

We must aggressively advance our bilateral and regional trade interests, starting with a deepening of the North American Free Trade Agreement (NAFTA), while re-establishing a leading multilateral role within the world.
Looking ahead, Canada’s international investment and trade policy will have to shift gears to take account of the profound changes taking place in the global economy: the spectacular rise of China and other emerging economies, and their potentially massive impact on the global marketplace; the emergence of “integrative trade”; and the growing role of knowledge-based services. The Canada Project has highlighted three major approaches to revitalizing our international investment and trade policies and practices: becoming a major player in foreign direct investment (FDI); energizing trade in services; and adopting a more strategic approach to international trade.

BECOME A MAJOR PLAYER IN FDI

It is becoming increasingly evident that the future winners in the world economy will be those who successfully play the foreign investment game—both attracting FDI and sending it outward. Canada therefore needs a clear strategy for both inward and outward FDI.1 (See box “What Is FDI?”)

1 See Iqbal et al., “Foreign Direct Investment” and Rhéaume, Open for Business?

What Is FDI?

The International Monetary Fund defines FDI as an activity in which an investor resident in one country obtains a lasting interest in, and a significant influence on the management of, an entity resident in another country. This may involve either creating an entirely new enterprise (a so-called greenfield investment) or, more typically, changing the ownership of existing enterprises (via mergers and acquisitions). Other types of financial transactions between related enterprises, like reinvesting the earnings of the FDI enterprise or other capital transfers, are also defined as FDI.

FDI occurs when an investor owns 10 per cent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise). This contrasts with a foreign portfolio investment, where an investor owns less than 10 per cent of the capital stock.

Source: International Monetary Fund.
FDI in Canadian primary resource sectors has fallen as a share of total inward investment over the past 20 years. The resource share of inward FDI has risen in more recent years, ironically masking the continuing overall decline in Canada’s FDI share.

Our ability to compete on efficiency grounds—in essence to make use of inward FDI to fit the Canadian economy more deeply into global value chains—is now the principal attraction for FDI. However, as shown earlier, our international competitiveness is being undermined by lagging productivity and the national business environment, as well as the recent erosion of our small cost advantage over the United States, caused by a stronger Canadian dollar. And we are up against stiff competition for investment capital, from not only the U.S. and Europe but also low-cost and increasingly highly skilled and English-language-proficient countries like China, India and Mexico. Attracting inward FDI has become a much bigger challenge.

Even in resource sectors, where Canada continues to attract significant foreign investment, we are facing fierce competition. Because many emerging economies offer cost-effective access to rich resources, it is important to deal with those things that make Canada a less attractive place to invest: particularly complex and lengthy regulatory processes, and social and environmental concerns, including specific protracted land claim negotiations or the time required to conduct environmental review consultations.

Our FDI competitiveness is being undermined by lagging productivity and the national business environment.

The North American Free Trade Agreement (NAFTA) has not prompted—as many of its proponents predicted it would—non-U.S. companies to set up operations in Canada to service the North American market. Canada is attracting not only a smaller proportion of inward FDI from non-American countries but also less investment from the U.S. and Mexico. (See Chart 29.) Canada’s share of North American inward FDI stock has fallen over the past 25 years, while the U.S. share has grown significantly. The reasons for this shift are complex, but the bottom line is that Canada is not offering an attractive competitive advantage to non-American direct investors.

How can Canada transform itself into a more FDI-friendly destination in these circumstances? For guidance, The Conference Board of Canada turned to those who...
know best: the executives of foreign multinationals.²
(See Table 5.) Our survey confirmed that investors are increasingly motivated by efficiency considerations. The good news is that this is an area we can do something about: while some efficiency factors, notably costs, are beyond our control, there is much that Canada can do to attract a larger share of FDI if we are prepared to take the necessary steps to make this happen.

Address factors that deter potential investors. We need to address those factors that we know are causing potential investors to look elsewhere. There is a strong overlap between what we need to do to make our economy more productive—improve our lagging productivity, our business environment and the overall quality of our workforce—and what we need to do to attract more FDI.

### Table 5
Canada’s Image as an FDI Destination: What International Chief Executives Tell Us

<table>
<thead>
<tr>
<th>Main Pluses</th>
<th>Main Minuses</th>
<th>Neutral</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General</strong></td>
<td>Scale of production vis-à-vis the U.S.; Canadian plants tend to be smaller and located farther away from large markets than those in the U.S.</td>
<td></td>
</tr>
<tr>
<td><strong>Productivity</strong></td>
<td>Poor productivity performance compared with the U.S.—evident not only in subsidiaries but also in local suppliers</td>
<td></td>
</tr>
<tr>
<td><strong>Business environment</strong></td>
<td>Investment in research and development (R&amp;D)</td>
<td></td>
</tr>
<tr>
<td>Conducting R&amp;D in Canada is cheaper than doing so in the U.S., and Canada has one of the most attractive R&amp;D tax credit systems</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unfriendly business environment: Canadian public is “anti-business”</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interprovincial barriers in certain sectors (such as forest products, and food and beverages) often prevent large-scale plants from gaining economies of scale</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pace of adopting new technologies is slower than in the U.S. and Europe</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory environment, especially the time it takes to work through the regulatory process when different levels of governments are involved</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poor state of physical infrastructure in cities and at the border</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Workforce</strong></td>
<td>Overall composition of the skilled workforce</td>
<td></td>
</tr>
<tr>
<td>Managers and professionals are at least as good as those in other industrialized countries, including the U.S. (but the overall workforce is not)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quality of local suppliers and employees</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Rhéaume, Open for Business?

² The Conference Board survey was conducted from November 2003 to February 2004 and involved executives at the vice-president level or higher who had a direct involvement in making foreign investment decisions. There were two categories of survey respondents: head offices of foreign multinationals and Canadian subsidiaries of foreign multinationals. About 65 per cent of the respondents are U.S. multinationals and the rest are from Europe, largely the United Kingdom and France. About 55 per cent of participating companies have more than 10,000 workers, and about 70 per cent have an asset size of over $1 billion. The companies represent a range of business, but are dominated by finance, insurance, information technology and manufacturing. In addition to the survey, interviews were conducted with 18 senior executives from a variety of sectors.
The regulatory environment is a key concern. In their 2006 study on Canada, the OECD stated that firms in Canada faced one of the highest average marginal effective tax rates on capital in the OECD countries in 2005.³ “This means a worthwhile investment project before tax is less likely to be profitable after tax in Canada than elsewhere, slowing the rate of capital-deepening that is one source of productivity growth.”⁴

The OECD ranked Canada as one of the countries with the highest level of restrictions on FDI.⁵ The most recent study by the OECD ranked Canada as one of the countries with the highest level of restrictions on FDI.⁵ Although restrictions in manufacturing and business services were few, we scored poorly in transportation, telecommunications and electricity generation. The biggest improvement to Canada’s investment climate, the study suggested, would come from reducing—or where appropriate eliminating—regulation. An earlier OECD study suggested that if Canada adopted a regulatory regime similar to that of the U.K. (the least restrictive OECD country), it could expect to increase its stock of inward FDI by 70 per cent.⁶

The Conference Board survey of chief executives also identified aspects of Canada’s regulatory environment as a major concern: more than half the respondents felt that our environmental, health and safety regulations have a negative impact on investment decisions.⁷ In the interviews, several executives said the real problem with regulation is not so much the content but the time it takes to work through the regulatory process, especially when different levels of government are involved. The whole process is seen as excessively bureaucratic and time-consuming.

Use tax reform to maximize investment attractiveness. While the Conference Board survey suggested that Canada’s current tax regime is not the primary deterrent to investment—only 16 per cent of respondents found it unfavourable—taxation is still an important factor in taking decisions on where to locate FDI. Other studies have found more negative results on Canadian business taxation. World Economic Forum surveys show that tax rates, followed by tax regulations, are the chief deterrents to doing business in Canada.⁸ These findings are consistent with the earlier discussion on the importance of tax reform, which is a key instrument for enhancing our attractiveness as an FDI destination.

With Canada now a net capital exporting country, consideration should also be given to eliminating the federal withholding tax. Most Group of Seven (G7) countries have eliminated withholding taxes on interest, and some, such as the U.K. and the U.S., have dispensed with withholding taxes on dividends. The provinces too should consider the impact on FDI of their tax decisions: continued provincial action on reducing business taxes would reinforce positive perceptions of Canada as an investment destination.

Carve out a competitive FDI advantage. Canada does not have the advantage of large scale that the U.S. does, or the low labour costs of Mexico, China or other developing countries. But we can carve out a new competitive advantage in FDI by specializing in niches within global supply chains, such as high-value specialized products that require smaller production volumes and highly skilled labour. We could also focus our energies on the following:

- advanced technologies, from aerospace to pharmaceuticals and biotechnology;
- high value-added business services such as engineering, consulting and communications; and
- expansion of our capacity in emerging areas like life sciences, fuel cells and environmental technologies.

³ The marginal effective tax rate on capital is a summary measure of the tax that would be paid on a new investment. It measures the extra return that an investment would need to earn to pay taxes, over and above the rate of return needed to make the investment worthwhile if there were no taxes to be paid.


⁵ Koyama and Golub, OECD’s FDI Regulatory Restrictions Index, p. 6.


As we have already stated, a positive business climate in which to commercialize the future applications of these technologies within Canada, for North American and world markets, is a critical success factor.

**Blow our own horn.** The executives surveyed pointed out that Canada does not do a good enough job of making its investment strengths known to the world. We could take all of the actions above and still fall short in improving our share of global gross domestic product (GDP)—unless we tell the world about our successes and attractiveness.

**Make the border work efficiently.** A final factor not directly addressed by the survey of chief executives, but already discussed in this report, is the issue of border efficiency. Canada has a major stake in making the border as seamless as possible in terms of infrastructure and security coordination, so that investors from outside North America that want to serve the entire North American market do not perceive the border as a deterrent to investing in Canada.

**PROTECT AND FACILITATE OUTWARD CANADIAN FDI**

Canadian direct investment abroad is the result of both “push” and “pull” factors. The push factors are those that discourage additional investment in Canada: domestic market size, workforce quality, infrastructure bottlenecks, regulatory restrictions and a tax environment that is less than fully competitive. The pull factors are those that attract our investment to foreign countries. Some pull factors are negative, like barriers to entry for Canadian exports that encourage Canadian businesses to leap the barriers via investment. Some pull factors are more positive, such as the ability to secure new natural resources, to improve efficiencies by integrating into other countries’ supply chains, and to serve customers abroad.

Thus, Canadian direct investment abroad is another way to take advantage of integrative trade by improving Canadian access to global value chains and reaching more foreign customers, which in turn strengthens the international competitiveness of our firms.

**Canadian direct investment abroad is another way to improve access to global value chains and to reach more foreign customers.**

The U.S. is still the largest recipient of Canada’s outward FDI, although the U.S. share fell from 50 per cent in 2000 to 46 per cent in 2005, while the share of some other markets has grown. (See Chart 30.) About 10 per cent of our outward FDI is destined initially for the three tax-friendly “B” countries—Bermuda, the Bahamas and Barbados—although those funds may then be onward-invested in other destinations. The finance and insurance
industry, particularly deposit-accepting intermediaries, has the largest share of Canada’s outward FDI stock. (See Chart 31.) Other sectors with a substantial share of Canadian direct investment abroad are manufacturing and mining.

**Reduce the risk of outward foreign investment.**

Canadian FDI can be protected through a variety of means, from political risk insurance for specific investments—which is available through Export Development Canada (EDC) as well as from the private insurance market—to bilateral agreements or even a global foreign investment understanding.

Bilateral foreign investment protection and promotion agreements, or FIPAs, are designed to protect Canadian foreign investment assets in other bilateral markets. Canada has a bilateral FIPA with about 20 countries at present. We are currently in an advanced stage of negotiations with Peru, but more importantly, bilateral FIPA negotiations have begun with both China and India. These negotiations should be treated as a high priority, as successful outcomes would help to strengthen Canada’s investment and trade linkages with these two critical emerging markets.

A multilateral investment understanding is still highly desirable for all the reasons that multilateralism makes sense in any international negotiation: it creates the largest level playing-field possible and the greatest potential benefits. The failure of the ill-fated OECD Multilateral Agreement on Investment (MAI) some years ago, followed by the refusal of some key developing countries to proceed with investment negotiations through the World Trade Organization (WTO), were setbacks. But a multilateral investment understanding should not be abandoned as a long-term objective.

**Strengthen outward FDI facilitation.**

Economic analysis earlier in this study pointed to available benefits from the growing links among outward FDI, expanded business sales today and additional future trade. Since outward FDI makes Canadian businesses more competitive and profitable and creates additional trade, there are good reasons to actively encourage Canadian investment abroad, in addition to protecting that investment. Although political attitudes toward Canadian investment abroad are slowly shifting from negative to positive, it is time for governments at all levels to join with business stakeholders in extolling the considerable net economic benefits of outward FDI.

**Bilateral FIPA negotiations should be treated as a high priority.**

Sales by Canadian foreign affiliates are a further dimension of Canadian direct investment abroad. These sales are nearly invisible, but are enormous—rivaling Canadian goods exports—and are thus an important source of revenue and diversification for Canadian global companies. In some markets, such as the European Union (EU) and particularly the U.K., establishing foreign affiliates is the preferred and necessary approach for Canadians to do business, in order to overcome trade barriers and tap into local supply chains. (See Chart 32.) Sales of goods and services by these affiliates need to be better captured in Canadian statistics, so that this phenomenon can be better understood.
Ultimately, if Canadian businesses, particularly small and medium-sized enterprises (SMEs), are to take advantage of outward investment opportunities, they need a more encouraging and supportive policy framework in Canada. SMEs often lack the balance-sheet size and in-house expertise needed to invest abroad successfully, and they would benefit from policies that acknowledge the business and economic value of outward investment. This could be accomplished by strengthening the government institutions that can help facilitate FDI in both directions—particularly Investment Canada and EDC. Investment Canada, now housed within the Department of Foreign Affairs and International Trade, should be given the mandate and tools to encourage Canadian direct investment abroad.

EDC should be encouraged by its shareholder, the federal government, to become an active facilitator of outward FDI and sales by foreign affiliates, where there are material benefits to Canada. In addition to providing political risk insurance coverage and structured debt financing as it does now, EDC should be a strategic equity partner with Canadian firms investing outside Canada. It should use its insurance and financing expertise to facilitate global sales by Canadian foreign affiliates, particularly for SMEs seeking to “go global.”

**ENERGIZE TRADE IN SERVICES**

As comparative advantage in industrialized countries shifts increasingly toward sophisticated commercial services, Canada must deal with its underachieving services trade performance.9 (See box “What Is Services Trade?”)

Most industrialized countries have experienced a surge in their services industries and services exports, which account for about 22 per cent of total exports among the countries of the OECD. In the U.S., services exports account for roughly 28 per cent of total exports.

Canada’s services exports, at 12.8 per cent of total exports and declining slowly, lag far behind those of other advanced countries. Admittedly there are structural reasons for this. Energy and other natural resources have a significant weight in Canadian trade and are experiencing a price boom. Motor vehicles and parts

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**What Is Services Trade?**

The General Agreement on Trade in Services, or GATS, identifies four modes of trade in services. “Supplier” refers to the country offering the service, and “consumer” refers to the country that purchases the service.

**Mode 1—Cross-border supply:** A service supplied from a supplier’s country of residence to a consumer’s country of residence (e.g., a call centre in New Brunswick serving American consumers).

**Mode 2—Consumption abroad:** A service supplied by the movement of a consumer to a supplier’s country of residence (e.g., a British tourist visiting Canada).

**Mode 3—Commercial presence:** A service supplied by the movement of a commercial organization to a consumer’s country of residence (e.g., a Canadian bank operating in the Caribbean).

**Mode 4—Presence of a natural person:** A service supplied through the movement of a natural person—that is, an individual who does not reside in the country and who is a national of another country—to a consumer’s country of residence (e.g., a Canadian consultant who goes to the U.S. to provide management services to a U.S. company).

Source: Hodgson and Tomlin, *Opportunity Begins at Home*.

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Canada’s Services Trade: How Much and Who Is It With?

According to Statistics Canada data, Canada now exports about $67 billion annually in services, about one-seventh of our goods exports and slightly less than we import (which is about $79 billion). In 2005, about one of every eight dollars earned from Canadian exports came from services.

Canada’s services trade is much more diversified than its trade in goods. The U.S. accounts for about 60 per cent of services exports and imports; the remaining 40 per cent is mainly with Europe and Japan. Some of the fastest-growing services markets, however, are in developing countries.

Commercial services—a category composed of a broad range of business-related services (insurance, finance, construction, architecture, management, and computer and information, to name a few)—is the largest component of Canadian services trade. (See chart “Canada’s Commercial Services Trade, 2004.”) Most of the remainder is roughly divided between travel (about 27 per cent) and transportation (about 20 per cent).

It should be noted that services trade data are far from perfect. The data are reported with a lag, and classification is a challenge because the nature of services is under constant evolution. In addition, many services like maintenance, refit and refurbishing are contractually integrated into the sale of specific goods.

Source: Hodgson and Tomlin, Opportunity Begins at Home.

<table>
<thead>
<tr>
<th>Canada’s Commercial Services Trade, 2004 (CDN$ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Miscellaneous services to business</td>
</tr>
<tr>
<td>Insurance services</td>
</tr>
<tr>
<td>Management services</td>
</tr>
<tr>
<td>Royalty and licence fees</td>
</tr>
<tr>
<td>Computer and information services</td>
</tr>
<tr>
<td>Architectural, engineering and other technical services</td>
</tr>
<tr>
<td>Communications services</td>
</tr>
<tr>
<td>Audiovisual services</td>
</tr>
<tr>
<td>Research and development</td>
</tr>
<tr>
<td>Other financial services</td>
</tr>
<tr>
<td>Non-financial commissions</td>
</tr>
<tr>
<td>Advertising and related services</td>
</tr>
<tr>
<td>Equipment rentals</td>
</tr>
<tr>
<td>Construction services</td>
</tr>
</tbody>
</table>

Source: Statistics Canada.

are also important to Canadian trade because of the integrated nature of North American motor vehicle production. Nevertheless, Canada’s services trade is much less developed than it could be and deserves to be treated as a higher national (not just federal) policy priority. (See box “Canada’s Services Trade: How Much and Who Is It With?”)

The challenge is to capitalize on Canada’s potential as an exporter of high-value services by deepening our present market penetration in industrialized country markets, while taking advantage of the growing services orientation of emerging markets. We also need to expand the range of services where we can and should be competitive. This calls for a coherent strategy based on three complementary elements, which are presented in the following paragraphs.10

Improve the domestic structural and regulatory environment. As already discussed at length, governments at all levels need to ensure that domestic regulations create a positive business environment—one that fosters a healthy services industry that is able to compete at the international level. A national champion for services trade could provide valuable leadership in advancing the agenda for domestic regulatory reform on services.

Promote more effectively exports and investment for services-producing industries. Canadians need to be encouraged and assisted to venture into the global services market. This requires a conscious move beyond the traditional focus on goods-producing industries in Canadian trade development and promotion; more needs to be done to equip Canadian exporters and investors of all sizes with the skills, knowledge and infrastructure required to pursue opportunities abroad.

10 These elements are discussed in more detail in Hodgson and Tomlin, Opportunity Begins at Home.
There is, for example, no intrinsic reason why Canada should not take more advantage of the potential of education services trade, where we are far behind competitors like Australia and the U.K. (See box “Education Services: Why Australia Is Ahead of Canada.”) To improve education exports, we must create a national body that acts as the champion for education exports, along with a distinct Canadian education brand. There are a host of other areas where we should be internationally competitive: environmental services, information technology services, business and professional services, and management of health care systems (as opposed to health care delivery), to name a few. Specific trade promotion action could be targeted at these sectors.

Companies also need to diversify business strategies, with an eye to future developments in demand for services and in anticipation of increased competition in Canada and around the world for services markets.

**Improve market access.** If successful, the ongoing multilateral services negotiations ("the GATS") under the WTO would help to improve the access of Canadian suppliers to international markets, in exchange for the progressive liberalization of Canadian services sectors. (See box “Liberalizing Financial Services.”) This process would be instrumental in opening up new opportunities and ensuring this takes place on as consistent a basis as possible, and needs to be reinvigorated.

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**Education Services: Why Australia Is Ahead of Canada**

Some countries have turned education services into a winner. Between 1989 and 2000, the U.K. grew its education services exports by 70 per cent, the U.S. by 125 per cent, and Australia by an astonishing 270 per cent. Canada’s exports, in contrast, grew by a mere 50 per cent. (See table “Exports of Education Services.”) The reason for our weaker performance lies in our multijurisdictional approach to education and an inward-looking, rather than outward-looking, attitude toward internationalization of education services.

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**Exports of Education Services**

<table>
<thead>
<tr>
<th>Country</th>
<th>1989 (US$ millions)</th>
<th>1989 (percentage of total exports in services)</th>
<th>2000 (US$ millions)</th>
<th>2000 (percentage of total exports in services)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>584</td>
<td>6.6</td>
<td>2,155</td>
<td>11.8</td>
</tr>
<tr>
<td>U.S.</td>
<td>4,575</td>
<td>4.4</td>
<td>10,280</td>
<td>3.5</td>
</tr>
<tr>
<td>U.K.</td>
<td>2,214</td>
<td>4.5</td>
<td>3,758</td>
<td>3.2</td>
</tr>
<tr>
<td>Canada</td>
<td>530</td>
<td>3.0</td>
<td>796</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Source: OECD.

**Australia (270 per cent increase from 1989 to 2000)**

- Large, relatively untapped Southeast Asian market targeted
- Australian education services promoted through government-run Australia Education International
- Concentration on courses enabled by information and communications technology (ICT) and cross-border e-learning
- No discrimination against long-distance learning in standards recognition
- Strong advocate of international liberalization of education services

**Canada (50 per cent increase from 1989 to 2000)**

- Anticipated expansion of education services within NAFTA not materialized
- Lack of collaboration among 13 different provincial and territorial jurisdictions
- No identifiable Canadian education brand or national leadership
- Inconsistency in processing of student visas
- No meaningful effort to put education on the international liberalization table

Source: Hodgson and Tomlin, *Opportunity Begins at Home.*
Liberalizing Financial Services

North American and European markets are already relatively open, and financial services flow rather smoothly across borders. Most developing country markets remain closed in whole or in part to financial services, and the majority of remaining significant barriers to trade in financial services are found in Latin America and Asia.

To make progress in further opening of financial services markets under the GATS negotiation process, Canada will need to review its own domestic financial structure in three areas:

1. Limits on authority of governments to interfere in the functioning of financial markets—an area in which many developing countries are hesitant about reform;
2. Removal of remaining restrictions on intrasectoral financial activities—such as prohibiting banks from offering insurance services, as is the case in Canada; and
3. Standards in the prudential regulation and supervision of financial institutions—which relates to the lack of a national securities regulator as well as removal of regulatory barriers to competition.

Canada’s key export markets for financial services are as follows:

- **Asia**: China, Japan, India, Taiwan, Singapore, Malaysia, Hong Kong, Indonesia, Philippines, Vietnam
- **Europe**: U.K., Ireland
- **North America**: U.S., Mexico
- **South America**: Chile, Brazil, Argentina, Costa Rica
- **Caribbean**: Caribbean Community (CARICOM)

Source: Hodgson and Tomlin, *Opportunity Begins at Home.*

ADOPT A MORE STRATEGIC APPROACH TO INTERNATIONAL TRADE

Over the past decade and a half, Canada’s already heavily trade-dependent economy has become even more so. Trade as a share of Canadian GDP is now 72 per cent, up from 52 per cent in 1990; for comparison, in the U.S. its share is about 26 per cent. There is a close correlation between international trade and productivity. Sectors that are trade oriented tend to attain stronger productivity performance as a result of their greater exposure to international competition as well as to technological and managerial innovation. There is also a link between trade openness and quality of life. (See box “The Link Between Economic Growth, Openness to Trade and Quality of Life.”)

Canada needs to become much more strategic about international trade and related investment at a time when trade is becoming vastly more competitive and complex, and will have an even greater impact on the future potential of the Canadian economy. Trade promotion strategies like putting more trade commissioners on the ground and helping SMEs to swim in the global economy are useful. But the challenge is more fundamental than that.

SHARPEN INTERNATIONAL TRADE POLICY AND MACHINERY

We have to face it: Canada is up against exceptionally well-armed trade competitors. Our traditional partners and competitors—the U.S., the EU, Japan and other open economies like Australia—all have strong national trade policy and machinery, as increasingly do China and leading emerging economies like Brazil. Our international trade policy and management regime has its strengths. But international trade is a remarkably tough business, and we need the vision, structures, policies and mechanisms that will enable us to compete with the best.

In the meantime, it must be recognized that multilateral services liberalization is a complex business that is proceeding slowly. And there are areas where we can secure improved access on a bilateral or regional basis. Transportation services, which have historically been handled more bilaterally than multilaterally, are particularly ripe for this approach. The recently opened discussions on a new Canada–U.S. “Open Skies” deal moves this agenda forward in the air sector. We need initiatives to spur similar movement in trucking, rail and, to the extent U.S. legal restrictions permit, maritime transportation.11

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11 The Conference Board of Canada and the Social Sciences and Humanities Research Council of Canada sponsored a project that examined the effect of deregulation and liberalization, as well as tax, labour, security and bankruptcy policies, on the aviation industry and the broader national economy. In this project, researchers at McGill University Institute of Air & Space Law and Concordia University International Aviation MBA Program collaborated to formulate policy recommendations addressing the current challenges in international aviation and Canada’s role in creating a new transnational legal framework for aviation relations. See Dempsey et al., *Report on International Aviation Policy.*
The Martin government’s effort to separate the international trade function from the Department of Foreign Affairs and International Trade addressed the wrong issue. The real question is not about whether, or how, to arrange the deck-chairs, but about what kind of trade ship will carry Canada’s fortunes through the turbulent global trade waters ahead. At the moment, the trade ship is a creaky and leaky one, beset by institutions that have become dated and by a fragmentation of national effort.

Canada’s international trade and investment policy must allow us to compete with the best.

Strengthen Ottawa’s international trade role. Future success in the global economy depends on strong national trade and investment policy leadership; these are not areas to be “contracted out.” Stronger federal vision and leadership must be backed by stronger federal–provincial cooperation that goes beyond the jingoistic “Team Canada” trade promotion ethos. Australia—another federal state—has had recent success in Asia, in part due to clear, long-range, strategic national trade leadership. The specific elements of trade policy leadership are discussed in detail below.

To attain a stronger position, we will need to examine the institutional structures of others to stimulate thinking about what might improve our performance. Both the U.S. and the EU have strong international trade negotiation machinery. Australia, like Canada, houses its international trade and foreign policy functions together, but has introduced private sector oversight into its trade commissioner service. There is no single best model, but there must be scope for innovation, based on rigorous analysis and open engagement with stakeholders: doing what has always been done may no longer suffice.

Recognize the growing intersection of the foreign and domestic spheres. At the same time, the distinction between what is international and what is domestic is gradually disappearing. Trade issues today are not so much about traditional border barriers to market access as they are about things like subsidies and the impact

The Link Between Economic Growth, Openness to Trade and Quality of Life

In recent years, considerable attention has been paid to questions associated with the pattern of economic growth in different countries. One of the “big questions” that has tantalized economists who specialize in growth and economic development is the following: “As economies grow over time, do they tend to converge toward one another, or toward some ‘leader,’ in terms of per capita output?” There is a body of economic theory that predicts that this will happen and that the extent to which economies are open to international trade plays a role in this convergence.

However, just because a country’s economy is growing, it does not necessarily follow that its citizens are becoming any better off. For example, economic growth may be unequally distributed across different population groups or the growth may come at the expense of the environment. In short, economic growth need not go hand-in-hand with an improvement in citizens’ quality of life.

A recent path-breaking study—sponsored by the Conference Board and the Social Sciences and Humanities Research Council of Canada (SSHRC)—appears to be the first to explore the connections between economic growth, the extent to which economies are open to international trade1 and improvements in various quality of life measures.2 The study presents evidence that greater openness to trade can foster growth in economic output and improvements in various measures of quality of life, in Canada and other similar countries. Increased trade openness also tends to help with the catch-up process if we wish to narrow the gap with the leading countries in terms of real per capita output. However, it may not be sufficient when it comes to converging with the leaders in terms of quality of life. In any case, output catch-up seems to precede the catch-up that occurs in quality of life, although there is evidence in the case of Canada of a more direct causal link between trade openness and quality of life.

Canada has not made any significant progress in catching up with the economies of the U.S. and Norway in terms of real output per head in recent years. This research suggests that increased trade liberalization offers one opportunity to rectify this situation. The various quality of life indicators considered put Canada in the middle of the pack, when compared with similar developed economies. The research also indicates that further opening Canada’s economy to international trade should eventually improve these quality of life measures, though there is no guarantee of a complete catch-up with the world leaders. Overall, the study concludes that Canada’s standing in the international comparisons can be improved in several dimensions, directly or indirectly, by increasing the economy’s openness to international trade.

1 Giles, The Link Between Economic Growth, Openness to Trade and Quality of Life.

2 The individual quality of life measures used in this study are life expectancy, share of population with a university education, wealth per capita, human capital per capita, carbon dioxide emissions per capita, income inequality and the infant mortality rate.

Source: The Conference Board of Canada.
of non-tariff barriers on domestic performance. As shown earlier in the productivity conceptual framework (Exhibit 1 on page 49), international trade and investment is a fully integrated part of national economic performance.

The future will require much closer linkages between what we think of as domestic policy—non-tariff barriers, limits on competition, regulation, our investment climate, skills and education, and innovation—and international trade policy. Ireland, for example, a recent global winner in international investment and trade, has fundamentally restructured itself to strengthen the linkages among innovation, investment and trade. (See box “Creating a More FDI-Friendly Environment: The Irish Case.”)

INCORPORATE INTEGRATIVE TRADE INTO OUR THINKING AND PRACTICES

Canada’s approach to international trade is largely still rooted in the classic view of trade as an exchange of goods between countries. The rise of global supply chains, in which imports and exports are exchanged across borders as part of the production and marketing processes of a single company or a network of companies, challenges these traditional perceptions. So does trade that is increasingly led by FDI in both directions, and trade where services are deeply integrated into the entire process. We need to better understand and articulate what this phenomenon means for Canadian trade and investment policy in all its dimensions.

Creating a More FDI-Friendly Environment: The Irish Case

Ireland is a stellar example of a country that became a major FDI recipient by actively transforming itself into an attractive destination for FDI. With less than 1 per cent of the EU population, Ireland now attracts a major share of inward EU investment: 41 per cent of software projects; 34 per cent of pan-European shared services centres; 31 per cent of pharmaceutical/medical technologies; 25 per cent of pan-European customer contact centres; 12 per cent of ITC; and 8 per cent of R&D centres. That is not to argue that Canada, in whole or in part, can repeat the Irish miracle, but it does show that countries can change their fortunes through the adoption of an improved policy environment.

Sources: The Conference Board of Canada; IDA Ireland, Ireland, Knowledge Is in Our Nature, p. 5.

For industries that are already highly integrated around the Canada–U.S. border, such as the motor vehicle industry, one priority is obvious: streamline the border process and reduce unnecessary obstacles in the form of tariff, regulatory, security or other barriers, no matter how subtle. Efficient border management will become increasingly important as countries like China, India and Brazil try to cut into our supply chains with their own lower-cost inputs of sufficient quality. Likewise, the demands of modern manufacturing, like just-in-time production and quality control, give an important natural advantage to geographic proximity, provided it is not neutralized by regulatory and security barriers.

International trade is no longer about exchange; it is about integration.

Facilitate key imports. The external challenges for Canadian exporters and trade policy are clear: how to secure and maintain market access and strengthen positions in the global supply chains of U.S. and other companies. A different question arises on the import side, where growing imports from China and India can reduce production input prices without necessarily sacrificing quality, thereby making Canadian businesses more internationally competitive.

In this changing world, higher import costs due to inefficiencies will impact on export competitiveness. While import facilitation is tricky, there is a case for positive action, such as improving access to credit for key imports, to ensure that Canadian firms can compete on a level playing field with businesses abroad. Specifically, EDC should have the legislative capacity to ensure that exporters can finance or insulate key production imports on competitive terms. This could be an important success factor for some firms in an integrated manufacturing world where the foreign (or imported) content of exports exceeds 40 per cent, or even 50 per cent, in many manufacturing sectors.
Examine trade remedy. Notwithstanding the beneficial dimension of imports in many sectors, we cannot ignore the reality that some imports can put Canadian manufacturers at risk of going out of business. This suggests a need to review the Canadian system of so-called trade remedy—that is, the systems relating to dumping, countervail, safeguards and export restraints—to ensure that it does not impede critical imports, while protecting domestic manufacturers from unfair competition and giving them breathing space to adjust.

REASSERT INTERNATIONAL TRADE POLICY LEADERSHIP

Canada’s international trade policy is oriented in two directions: our bilateral focus on the U.S. and our multilateral focus on the WTO negotiating forum. It is not a question of one or the other. Both are essential—and to a large extent, reinforcing. Bilateral trade policy serves our major trading interests in the U.S., while the international rules-based trading system implicit in the WTO provides a critical offset to what would otherwise be overwhelming domination by the U.S.

Somewhere along the road, however, Canada seems to have fumbled the multilateral trade ball. With the recent demise of “the Quad”—the influential group of trade ministers from the U.S., Europe, Japan and Canada that informally steered key trade negotiation decisions—Canada has lost significant ground in the WTO. We find ourselves today on the outside looking in on a new informal leadership group in which we have effectively been replaced by Australia. This is a product of our inability to show leadership by sacrificing some of our protected and political sacred cows in key areas like agricultural supply management and shipbuilding, as well as long-term strategic positioning by Australia as an agricultural free-trader with strategic and growing ties to Asia and elsewhere.

At the same time, it has become abundantly evident that the process of multilateral trade negotiation itself has become unwieldy. In part, the problem stems from the domestic political challenge in many jurisdictions, including Canada, of reducing agricultural subsidies. But the WTO has also become the victim of its own success. The kind of informal processes that have historically shaped the outcome of past negotiations, including the existence of leadership groups like the Quad and its successor, do not suit an organization that now has 149 members including China and other emerging trade giants. So, the solution is not simply for Canada to rejoin a reconstituted Quad. Something more is required.

The suspension of the Doha Round of negotiations was due largely to the inability of the major industrialized trading nations to address their own domestic agricultural protection and support programs, and to recommit themselves to serious discussions on more liberal global trade. As noted earlier in this volume, the existing trade-negotiating authority from the U.S. Congress expires in July 2007, providing a very brief window for the Doha Round to be completed under this presidency. A U.S. president in the final two years of his term will have less influence with Congress. A new president would need to seek a new negotiating mandate from a new Congress in 2009.

For Canada, the Doha Round suspension poses serious risks for bilateral trade with the U.S.—but it creates an opportunity for the federal government to examine in depth its policy toward international trade and investment, to consider the costs of being left outside the inner circle of multilateral trade, and to articulate its trade vision and priorities. Volume II addresses the importance of strengthening Canada’s multilateral negotiating position with respect to agricultural trade, and makes the case that domestic reform in heavily protected supply-managed agri-food sectors would help to reposition Canada as a leader on trade liberalization in agriculture more generally.
Whenever the Doha Round resumes, pressures will rise for a new informal collective management structure that can lead to the successful completion of the negotiations and implementation of the resulting agreements. Canada has a strong interest in helping to drive this train toward mechanisms where we can exercise our influence. Standing by and hoping for the best, as we have done in recent years, is simply a recipe for getting left out in the cold.

Ultimately, we need to decide whether we are again going to be the leader we have historically been in multilateral trade, or lapse into default mode. And if we are going to have influence, we need to earn our keep by taking a constructive lead on key issues with the U.S. and other key trading partners. Specific aspects of trade in services, for example, would be an innovative place for Canada to take a leading role, if we are prepared to reduce our own domestic barriers to competition and to improve national regulatory alignment.

The U.S. will continue to be Canada’s top bilateral trade priority but NAFTA has reached the limit of its influence on structural change.

Moreover, to be taken seriously as a free and open trader, we need to get serious about our own remaining pockets of protectionism in agricultural supply management and other protected sectors of the economy. Protection in these sacred cow sectors not only is indefensible in trade terms but also works against the interests of Canadian consumers, while protecting a small and shrinking number of producers and workers. A smarter policy with greater net benefits for the Canadian economy can be found, if we have the imagination to look for it.

**GET SERIOUS ABOUT OUR BILATERAL INTERESTS**

Although Canadians have a strong interest in multilateral pursuit of free trade, and specifically in a successful outcome to the Doha Round, we have never put all of our eggs in the multilateral basket. Multilateral progress has been uneven at the best of times, and our trading partners are already actively pursuing new bilateral and regional free trade agreements. We risk being left far behind if we do not become more aggressively and actively engaged in advancing our bilateral and regional trade and investment interests.

**Deepen and improve NAFTA.** The U.S. will continue to be Canada’s top bilateral trade priority, NAFTA, and the Canada–U.S. Free Trade Agreement (FTA) before it, has played a critical role in promoting Canada–U.S. trade, but NAFTA is now a mature agreement that has reached the limit of its influence on structural change. Meanwhile, the U.S. is pursuing its own bilateral trade interests, and we thus risk becoming marginalized in U.S. trade policy—without a credible bilateral or regional alternative.

The answer to preserving some special status with the U.S. is to reduce the remaining barriers to access to the American market, which means deep engagement in the Security and Prosperity Partnership with the U.S. and Mexico. This issue is explored at greater length in the next chapter.

**Refocus bilateral and regional trade agreements.**

Canada got into the business of negotiating bilateral free trade agreements in the wake of NAFTA, largely to offset the gravitational pull of our preferential arrangement with the United States. The results, however, have been meagre at best. To date, we have negotiated three agreements, with less than sterling results: the agreement with Israel was followed by above-average growth in exports; the agreement with Costa Rica was followed by below-average growth in exports; and the agreement with Chile was followed by a 10 per cent export decline. There is little evidence of deeper economic integration with these three bilateral partners. Another eight proposed agreements remain stalled along the pipeline.12

We also suffer from a paradox; countries that are interested in negotiating bilateral agreements with us tend to be marginal to Canadian economic interests, while larger countries with greater economic potential tend to

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be less interested, viewing us more as a regional adjunct of the United States. The latter certainly appears to be the case in our relationship with the EU. Where proposed bilateral trade agreements might be helpful, such as with South Korea and the European Free Trade Association (EFTA) countries, they have foundered on such things as our unwillingness to deal with high shipbuilding tariffs.

The conclusion on bilateral and regional agreements is that Canada needs to stop pursuing marginal trade agreements that have some political appeal but yield little in the way of economic gains—and certainly yield little relative to the negotiation and implementation effort required. Instead, Canada must pursue bilateral and regional trade and investment agreements with countries that are important to our economic interests, based on rigorous analysis of the expected benefits.

**Canada may increasingly finding itself a spoke in a larger U.S. preferential trade wheel.**

We should further recognize that regional trade liberalization appears to be a growing wave of the future. In addition to the existing North American and European trade blocs, Asian countries are now making noises about developing their own regional approach to trade liberalization (although there is a need to separate rhetoric from reality). Canada should therefore be prepared to engage our NAFTA partners in serious discussions about the advantages of region-to-region trade liberalization. Any bilateral or regional agreements pursued should be as comprehensive as possible, addressing barriers to traditional goods but also barriers to services and investment.

In the larger scheme of things, an international trading system riddled with overlapping and confusing trade rules—what has been called the “spaghetti bowl”—is not optimal for Canadian business. Multilateral trade liberalization is superior in terms of economic benefits. Nonetheless, bilateral and regional trade agreements are not something Canada can afford to ignore, especially following the 2003 U.S. decision to actively pursue them.

**Canada needs to stop pursuing marginal trade agreements that have some political appeal but yield little in the way of economic gains.**

To date, U.S. moves appear to have been guided as much by politics and security concerns as by commercial interest, with little practical economic impact on Canada. But this trend, if continued and extended to more significant players, raises the prospect of Canada increasingly finding itself a spoke in a larger U.S. preferential trade wheel—our preferential access diluted and without the same degree of favourable access in third markets. (See Table 6.) At the same time, developments like Australia’s recent free trade deal with China or the rumbles of pan-Asian free trade speak to the aspirations of our competitors. Both these factors confirm that we need to get into the bilateral and regional game as a serious player.

**THE CORE MESSAGE: PURSUE A MORE COHERENT INVESTMENT AND TRADE POLICY**

Ultimately, we cannot afford to forget that we live in the real world, one where other countries often attempt to use trade and investment rules to “advantage” their firms and to “disadvantage” firms from other nations. In that real world, we need a tougher approach to international trade and investment that uses international agreements and their complete follow-through to enable Canadian businesses to meet the hard-nosed international competition. We need to position our country for the medium and long term, as our competitors are doing. And we need to ensure that there is improved coordination and even synchronization among our international trade and investment policies, trade and investment promotion efforts, and domestic policy reform.
The implications of the preceding discussion are clear. We need a coherent, deliberate international trade and investment strategy that:

- focuses on positioning Canada as a leader once again in multilateral trade and investment liberalization through the WTO;
- deepens and improves NAFTA;
- pursues other regional and bilateral trade and investment agreements with key countries that are vital to our economic interests, based on rigorous analysis; and
- ensures we are not undercut in markets through agreements struck by our competitors and partners, or through other special arrangements.

As a trade and investment policy agenda, that is a very tall order. Nevertheless, it is an unavoidable one if we want to maximize our advantage in a highly competitive world.

**RECOMMENDATIONS TO REVITALIZE INTERNATIONAL TRADE AND INVESTMENT**

The Conference Board of Canada recommends that:

11. The federal government pursue a coherent, deliberate international trade and investment strategy:
   - Position Canada as a leader once again in multilateral trade and investment liberalization through the World Trade Organization.
   - Deepen and improve the North American Free Trade Agreement.
   - Pursue other bilateral and regional trade and investment agreements with countries that are important to our economic interests.
   - Ensure that we are not undercut in markets through agreements struck by our competitors and partners, or through other special arrangements.
12. Governments recommit to making Canada an attractive destination for new productive foreign investment by addressing factors that deter foreign investors—the regulatory environment, tax competitiveness, the quality of the labour force, and constraints at the border—and by bringing greater clarity and transparency to the legislation and rules governing FDI.

13. The federal government facilitate outward Canadian FDI where there are material benefits to Canada through actions that reduce the risk of investing outside Canada, like Foreign Investment Protection Agreements, and by strengthening facilitation of outward FDI through agencies like Export Development Canada.

14. Governments and business promotion organizations energize trade in services through an improved domestic structural and regulatory environment for services, more effective promotion of exports and investment for services-producing industries, and improved market access for services trade.
HIGHLIGHTS

- Canada’s dominant foreign policy priority is our relationship with the U.S.

- Stronger regulatory alignment with the U.S. is required. It is important to focus on streamlining border processes; reducing remaining obstacles to preferential access to the U.S. market; tapping into the potential of services; and developing strategies for dealing with increased U.S. protectionism.

- Yet, we must balance the relationship with our neighbour to the south by giving greater weight to our ties with China and other key emerging markets. Canada should pursue all elements of integrative trade with China—supply chains, trade-creating foreign direct investment flows to China and other Asian countries, sales by foreign affiliates and offshoring.

- Our traditional partners, Japan and Europe, should not be forgotten.

- Canada can demonstrate multilateral leadership by focusing on areas where we offer specialized expertise, like risk management in public health.
Strategy #5: Refocus Foreign Policy Priorities

There has been much debate about the future direction for Canada’s foreign policy, especially with changing minority federal governments. Global political and economic change has challenged our comfortable assumptions about who we are and how we can best pursue our interests and our values. At the same time, we have allowed our international status to run down—we are no longer the global defence, trade or development assistance player we used to be. And we have ended up with fragmentation—too many priorities and not enough strategic focus—as well as too little coherence between our domestic and international priorities.

A full evaluation of Canada’s future foreign policy direction is beyond the framework of this report. Instead, this section suggests directions for making better use of international relationships to improve our economic performance. Specifically, the section will articulate why we must learn to advance foreign policy along two primary tracks:

- Focus constantly on the critical foreign policy relationship with the United States.
- Give priority treatment to China and other key emerging powers.

Nurturing our relationship with our traditional partners, Europe and Japan, is an important secondary track.

Rethink our critical relationship with the U.S.

Canada’s dominant priority—and most difficult challenge—is its relationship with the United States. Two realities—our future economic prosperity is overwhelmingly tied to the U.S., but our political relationship with the U.S. had eroded until recently—demand that we rethink our approach to the U.S.

Canada is no longer the global defence, trade or development assistance player it used to be.

Catching up with reality

Canadians have always been deeply divided in their perceptions of relations with the United States. Geography and market forces inevitably drive us toward the U.S., but we are suspicious of the consequences of its power and influence. To take charge in our relationship with the U.S., Canada’s approach needs to be framed by recognition of the changing underlying dynamics.

First, since the Free Trade Agreement, Canada is more highly integrated with the United States. Industry and infrastructure are increasingly rationalized and integrated across our common border. This has occurred at a time when the locus of U.S. power is shifting toward the south and southwest. The North American Free Trade

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1 For a more detailed analysis, see The Conference Board of Canada, “Revitalizing Canadian Foreign Policy,” pp. 97–115. See also MacDuff, Course Correction.

Agreement (NAFTA) does not resonate well in the U.S. Congress, where it is popularly associated with job losses to Mexico and immigration problems. And with our large trade surplus with the U.S. (CDN$151 billion in 2005), we are part of the overall U.S. external deficit picture. (See box “The U.S. Economy: What Kind of Horse Is the Canadian Wagon Hitched To?”)

Second, U.S. perspectives have changed. Twenty years ago, Canada and the U.S. shared an interest in facilitating North American economic integration. With the Canada–U.S. Free Trade Agreement (FTA) and NAFTA in place, U.S. economic attention is increasingly turning to other markets and issues, particularly China. Canada is comparatively less important to the global production and distribution systems of U.S.-based transnational companies.

Third, U.S. global interests have moved from trade to greater preoccupation with energy security and the war on terrorism. As the popular U.S. dictum goes, security now trumps trade. Canada’s economic links with the U.S. are now irrevocably tied to security and how well we deal with it. The temporary closure of the border after 9/11 jolted Canadians awake about our vulnerability in trade access to the United States. Both governments have taken measures to address the “thickened border,” but the risk of further disruption is real.

And fourth, although the NAFTA dispute panel system has been working well in general, the softwood lumber issue raises deep questions about U.S. respect for international commitments in trade. Ultimately, it speaks to the ability of Canadians to pursue policies that are different from those of the U.S., and to the U.S. congressional disposition to bow to powerful domestic lobbies.

U.S. global interests have moved from trade to greater preoccupation with energy and the war on terrorism.

PUTTING NAFTA INTO PERSPECTIVE

The FTA, which was subsumed by NAFTA, played a key role in promoting Canada–U.S. trade and economic integration. But NAFTA is now a mature agreement that has largely stalled.

The political vision of “broadening” NAFTA by extending its provisions to the rest of the hemisphere is happening in a haphazard way through bilateral agreements. The Free Trade Agreement of the Americas (FTAA) has been slow to materialize, largely because the Mercosur countries (including Brazil, Argentina, Uruguay and Paraguay) prefer their own arrangement and perhaps because of growing anti-U.S. sentiment in the region. Ultimately, fundamental differences between the U.S. and Brazil mean that the prospect of a truly hemispheric arrangement is remote. The most we can hope for is “FTAA-lite.”

Deepening NAFTA through the extension of its provisions among the three signatories has not worked out as hoped. Chapter 11 of the agreement—which establishes a mechanism for the settlement of investor versus state disputes—has led to much broader challenges for national legislation. Progress in the harmonization of regulations and standards, as well as in rules of origin for imports from third countries, has been slow. The track record of NAFTA’s 30 working groups is mixed at best. As argued earlier, we are now at risk of becoming just another spoke in a larger U.S. preferential trade wheel. There is only one answer to preserving some special status: reduce the remaining barriers to access to the U.S. market.

The U.S. Economy: What Kind of Horse Is the Canadian Wagon Hitched To?

The U.S. economy is a strong factor in Canadian growth and prosperity. At the same time, our close economic integration makes us vulnerable to its weaknesses.

The U.S. growth outlook beyond 2006 is uneven, coloured by the twin deficits and by heavy consumer indebtedness that is linked directly to the U.S. housing market. If housing prices make a soft landing, consumer confidence should not be stirred. That soft landing is our baseline forecast. If, however, housing prices were to make a sharp downward adjustment of 20 per cent or more—a hard landing—consumers may be shaken and the U.S. recovery may stall.

It is uncertain whether the rest of the world will remain as enthusiastic about investing in the U.S. as it has been for the past decade. The most likely scenario on the horizon depicts slower growth in North America and a further fall in the value of the U.S. dollar against other major currencies. The implication of this scenario is that global prosperity, not just American, will increasingly be a key driver of future North American—and hence Canadian—growth.

Source: The Conference Board of Canada.
We also need a more realistic appreciation of the future of our economic relationship with Mexico. As reflected in the first section of this volume, Canadian trade and investment with Mexico have grown significantly, but from a very small base. The relationship holds promise and needs to be stimulated. But we also need to recognize that Mexico is a growing competitor in U.S. markets in areas of interest to Canada, such as automotive and higher technology. The preoccupations of the parties are also different, Canada’s being more with economic issues and Mexico’s with migration. Increasingly, we may need to differentiate between where pursuing our U.S. interests is best done with Mexico and where we are best to meet the Americans without Mexico.

**“BIG IDEAS”**

Growing Canada–U.S. economic integration, coupled with the events of 9/11, gives rise to options about the future shape of the Canada–U.S. relationship. One option would have Canada distance itself from the U.S. and go down a new path defined by multilateralism. This thinking is associated with the fashionable thesis that Canadians and Americans are diverging due to different “world views” and different values. It is coloured by concerns about unilateral U.S. power, the Iraq war and the current U.S. president. While this approach has considerable public resonance, “going it alone” weighs very heavily against the reality of continental economics.

Another option seeks further deepening of Canada–U.S. economic integration through the creation of new supranational institutions, ranging from a fully fledged Economic Union to a Customs Union to proposals for various kinds of commissions and other joint bodies.

The most prominent proposals involve negotiation of a new strategic “grand bargain” with the U.S., linking Canadian cooperation on U.S. physical and energy security with assured access to the U.S. market. The fundamental difficulty with such proposals lies in the asymmetry of power between Canada and the United States. What is the likelihood of a genuinely bi-national approach to trade policy or its administration? Nor is it clear that Canada’s problems with the U.S. stem from a lack of formal institutions, or that there is much support in either country for moving in this direction. (See box “The Popular Limits to Formal Integration in North America.”)

**BE PRAGMATIC: COMMON ECONOMIC SPACE, INDEPENDENT POLICY SPACE**

In the view of The Conference Board of Canada, a coherent, practical, step-by-step approach to managing relations with the U.S. offers the best promise of addressing Canada’s economic concerns, while protecting other Canadian interests and values.

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3 The first track is associated with the “soft power” approach advocated by Thomas Axworthy. The second track has appeared in various forms in the media. Proposals for new institutions, including a North American Commission, an Office of North American Statistics, a North American Planning Office, and a Permanent North American Court on Trade and Investment, were advanced by Robert Pastor in Toward a North American Community, pp. 100–101. An alternative position was presented by Robert Wolfe in “See You in Washington?” pp. 4–5 and by the Canadian Council of Chief Executives, New Frontiers. This latter organization suggests that smaller joint bodies, with limited mandates to identify and resolve problems, are the most promising means of enhancing the institutional capacity to manage the continuing process of economic integration between Canada and the U.S.

4 Variations of the so-called grand bargain were advanced by the C.D. Howe Institute and the Institute for Research in Public Policy. See, for example, Dobson, Shaping the Future of the North American Economic Space.

5 The Conference Board’s views are discussed in more depth in the report In Search of a New Equilibrium, pp. 26–28 and 35–37, and in “Revitalizing Foreign Policy: Carving Out a New Role,” p. 107.
Canada needs renewed political determination to press forward in those areas where we can maximize our advantage and better secure our place in the U.S. market. NAFTA has taken us a long way, but we need to finish the job. This kind of nitty-gritty may not have the grandeur of new architecture or sweeping negotiations—but it carries the prospect of near-term concrete results. The importance of doing everything possible to facilitate trade with the U.S. is all the more important with a strong Canadian dollar that threatens to price us out of some U.S. markets. The following areas—some of which we can undertake ourselves and some of which require bilateral action—will generate the biggest gains.

**Canada’s existing preferential access to the U.S. market under NAFTA is unfinished business.**

**Focus on the border and near-border.** The Canada–U.S. Smart Border and related initiatives have improved the flow of goods and people across the border. But the problem of border security and border thickening is far from solved. Protecting business supply chains and integrated infrastructure is interrelated with our willingness to cooperate with the U.S. in the areas of security control, intelligence gathering and information sharing, and immigration and refugee policies, while recognizing legitimate privacy and rights concerns. Streamlining the border process by making major investments in border-related infrastructure, such as intelligent technology to move the process of customs pre-clearance away from the border area, could make a significant contribution to reducing transportation costs, customs-processing times and wait times. Customs and revenue agencies also need to simplify their reporting processes.

**Reduce remaining obstacles to access.** Canada’s existing preferential access to the U.S. market under NAFTA is unfinished business. We need greater cooperation on, or even harmonization of, regulations where this makes sense, without sacrificing Canadian regulatory objectives. Remaining tariff differences between Canada and the U.S. need to be reduced or phased out—which will also help to address the rules-of-origin problem for imports from third countries. Priority progress on these fronts would give Canadian exporters an important edge in the U.S. market and help to secure our position in U.S. supply chains.6

**Realize the untapped potential of services.** NAFTA contains only limited provisions for services, which offer considerable scope for rationalization and integration. Transportation should be targeted for bilateral liberalization—not only the commercial air sector but also the trucking and maritime subsectors, with the objective of a seamless transportation corridor. With high integration in trade in goods, anything less than liberal trade in underlying transportation services limits gains.

**LIVING WITH TRADE VULNERABILITY**

There is also much that we can do to improve the tenor of our relations with the United States. A more civil dialogue and closer ties in the security and defence areas will contribute to a better overall relationship, although we should not be under any illusion that closer dialogue and engagement will overrule powerful U.S. domestic lobbies and their influence on Congress and the Administration.

Recent U.S. protectionist pressures, directed mostly at China, have been largely contained for the moment. But rising and increasingly sophisticated imports from emerging economies, coupled with the enormous U.S. trade deficit, could drive a growing protectionist U.S. mood in which Canada is at risk of becoming ensnared—either directly or as collateral damage. We should anticipate this by moving in two directions.

**Reduce the scope for trade disputes, where feasible.** While trade disputes are an inevitable feature of the Canada–U.S. economic relationship, given its exceptional breadth, we need to ensure that we are fighting the right battles. The scope for disputes can be reduced through greater regulatory, and where it makes sense policy, cooperation. However, embracing “the U.S. way”—adopting American standards and practices—will not necessarily or automatically do the trick.

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6 Dobson, *Taking a Giant’s Measure*, p. 21.
Focus on rules-based dispute resolution. As the less powerful partner in its major economic relationship, Canada has a strong interest in seeing international rules-based dispute resolution work in both NAFTA and the World Trade Organization (WTO). However, as the softwood lumber issue demonstrates, any system of dispute resolution is only as good as the will of the parties to enforce it. The development of rules-based dispute resolution has been an important Canadian achievement, and we have a strong interest in making it a priority both bilaterally and multilaterally. Otherwise, we should simply prepare ourselves to live in a less than rules-based trade world, one where disputes get resolved the old-fashioned way, through negotiation (which inevitably favours the more powerful partner) or taking our chances in the U.S. courts.

The U.S. will remain our dominant trading partner, but we also need to explore other markets.

A WIDER-ANGLE LENS: INVESTMENT AND ENERGY
Canada’s relations with the U.S. over the past two decades have been trade focused and must remain so, but we also need to give greater attention to other dimensions of our economic relationship.

Attach a higher priority to investment. We need to address, as a priority, how to secure a larger share of U.S. foreign direct investment (FDI) at a time of heightened international competition for FDI. Simultaneously, we will want to capture more trade-expansion benefits from our surging FDI into the U.S.

Engage on energy and global warming. The tight Canada–U.S. energy grid, rising concerns about energy security, and the enormous investment required to bring new Canadian sources of oil and gas on-stream all point to a growing profile for energy in Canada–U.S. relations in the years ahead. Energy exports are already a significant part of Canada’s trade surplus with the U.S., driven in recent years by high prices for oil and gas. However, Canada’s booming energy trade surplus also reflects a growing American appetite to secure its imported energy from a politically stable and secure source like its neighbour to the north. (See Chart 33.) This will have important implications for the Canadian economy—and for progress on global warming. We should devote more consideration to the fact that our two largest trading partners, the U.S. and China, have strong interests in energy, as well as a need to reduce emissions. Volume II of this report, on resources, addresses these issues in greater depth.

FOCUS MORE STRATEGICALLY ON CHINA AND OTHER EMERGING ECONOMIES
Canadian perspectives on relations with the world beyond the U.S. tend to fall into two camps. One assumes the U.S. is so central to Canadian interests that it makes our economic relations with the rest of the world peripheral at best. The other sees diversification of Canada’s economic relations with other countries as a way of reducing dependence on the U.S. (See box “The Old ‘Third Option’: Political Versus Market Drivers.”)

As already discussed, for reasons of geographic proximity, the U.S. will remain by far the most important economy for Canada as long as it retains a dominant position in the global economy. But this does not detract from the need to explore other markets, first because these offer attractive commercial opportunities, and second because it makes economic and political sense to diversify toward attractive opportunities.

**Chart 33**
Canada’s Merchandise Trade Surplus With the U.S., With and Without Energy (CDN$ billions)

*Source: Industry Canada.*
Canadian businesses have been quietly diversifying through outward FDI, related sales by foreign affiliates and, to a lesser extent, exports. But much more could be done under a deliberate strategy to capitalize on expanding international trade and investment opportunities beyond the U.S., by taking advantage of where markets are leading us.

**NEEDED: A COMPREHENSIVE STRATEGY FOR CHINA AND THE CHINA HUB**

Canadians have bought into the idea of north–south North American economic integration. We now need to readjust to the reality of the rise of Asia, which will increasingly pull our economy east–west as well. In effect, Canada now stands between the two major global growth poles: the U.S. and Asia.

There are practical limits to this phenomenon. China will not sustain its recent torrid annual growth rates of 8 per cent or more forever. We expect China’s real annual gross domestic product (GDP) growth to slow to about 6 per cent by 2013 and 4.5 per cent by 2025 as its population and labour force age, due largely to the country’s “one-child” policy. There also remains the risk that China will be blown off-course by the difficult transition to a more pluralistic society, although the Chinese authorities have been extremely pragmatic and skilled at maintaining positive momentum in their ongoing reform program. (See box “Just How Risky Is China?”)

**Canada needs to readjust to the reality of the rise of Asia.**

There still remains considerable scope for rapid growth in Canadian exports to China, which grew by an average of 14 per cent per year between 2000 and 2005. That said, a Conference Board scenario suggests that China’s share of Canadian exports would still be only about 10 per cent by 2025—underlining just how dominant the U.S. market will remain.7 (See box “Canada and China Trade in 2025.”)

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Nonetheless, as China’s rate of growth in output and trade slowly declines, India and other Asian economies are poised to sustain Asia’s rise. For example, China is already outsourcing some types of production to Vietnam.

**Canada needs a comprehensive and creative high-level China strategy that goes beyond classic concepts of trade and investment promotion.**

Although recent growth in exports to China has been impressive, in 2005 these exports as a share of total Canadian exports were only slightly higher than they were in the early 1990s. (See Chart 34.) Canada is not among China’s top 10 import sources, but we do rank among the top 10 countries China exports to. (See charts 35 and 36.) The biggest factor in our China relationship is skyrocketing exports from China to Canada, resulting in a significant bilateral trade deficit for Canada of over $22 billion in 2005. Sheltered by our economic relationship with the U.S., Canada has been slow off the mark with China. We are now playing catch-up.

The proposed Pacific Gateway strategy to streamline transportation infrastructure and other recent initiatives will help. But Canada needs a comprehensive and creative high-level China strategy that recognizes the magnitude of the China phenomenon, and goes beyond classic concepts of trade and investment promotion. Responding to demand driven by China’s huge and increasingly middle-class population is one opportunity, but we need to find a way to take advantage of China’s cost structure and integrate more fully into its supply capacity.

**Think differently about China.** China presents a potentially enormous market for Canadian resource products, notably wood pulp, chemicals, cereals and nickel, and it is also currently a small market for manufactured goods (mainly auto parts and mechanical/electrical machinery and equipment). But the export of natural resources is not enough. Resources will also be a highly competitive market; Australia, for example, is about to become the first country to ship liquefied natural gas to China, is negotiating to supply enriched uranium for China’s growing nuclear market and is building an “energy

**Canada and China Trade in 2025**

A Conference Board analysis suggests that Canadian exports to China could reach an order of magnitude of $46.7 billion by 2025—an increase of about $35 billion or 600 per cent—under a generous export growth scenario (i.e., Chinese growth slowing gradually to 7 per cent; Canadian business sustaining its growth of FDI to China; and the yuan permitted to appreciate, making Canadian goods more price competitive). This increase would amount to less than 4 per cent of Canadian exports, raising China’s share to about 10 per cent—about where Japan was two decades ago. But it would still be dwarfed by Canada’s exports to the U.S., which would increase by more than $350 billion, assuming they grow by an average of 4 per cent annually over the next 20 years.

An analysis of Chinese imports shows a similar pattern. China’s current torrid export growth is expected to gradually slow as China moves up the value chain and other countries with even lower costs, such as Vietnam, steal market share from China. Some analysts expect China’s export growth to slow to about 8 per cent annually by 2008 and to about 4 per cent by 2025. Appreciation of the yuan against the dollar will also make Chinese imports more expensive in Canada. Chinese import growth will remain strong compared with growth from traditional industrialized markets. But double-digit rates will not be maintained over the next two decades.

Source: Beckman and Hodgson, “Making Connections.”

**Chart 34**

**Canada’s Level of Merchandise Exports to China and Merchandise Exports to China as a Share of Total Canadian Merchandise Exports (CDN$ billions)**

- Exports to China (CDN$ billions; left axis)
- Share (per cent; right axis)

Source: Industry Canada.
highway” to supply coal. Russia recently undertook to provide oil from Siberia. Our resource market share in China is not assured.

Instead, Canada needs to take better advantage of the features of integrative trade: the implications of global supply chains, trade-creating Canadian FDI flows to China, sales in China by affiliates of Canadian companies, and offshoring. We also need to see China as a huge and burgeoning services market, and we need to take strategic advantage of low-cost Chinese imports to reduce Canadian costs.

China’s vast accumulation of capital also presents opportunities to attract Chinese FDI into Canadian resource and other sectors. This means Canadians will need to get their minds around the prospect of acquisition of Canadian assets by Chinese state-owned companies. To do so confidently, a review of the Investment Canada Act is badly needed to ensure that we are attracting FDI from China that is sustained and economically driven, not politically motivated.8 In a similar vein, we need to approach the issue of human rights in China from the right perspective if meaningful progress is to be made on that thorny issue. (See box “And What About Human Rights?”)

Put China into a regional Asian perspective. The China growth phenomenon is not simply about China; it is also about China’s impact on the surrounding region. China’s economic emergence has revolutionized trade and financial flows within the Asia region. For certain trade categories, Japan and South Korea now have closer economic ties with China than with the U.S., and Southeast Asia is more and more tied into Chinese production. The huge and increasingly integrated East and Southeast Asian regions (including Japan) have a current combined GDP of around US$8.6 trillion and a potential aggregate growth rate of around 5 per cent. This makes the combined region only slightly smaller than the European Union (EU), and growing considerably faster. Therefore, selling into the region is another way to capitalize on the China phenomenon.

Strengthen the immigration connection. The prevailing wisdom that the Canadian business community will inevitably default to the U.S. market is being challenged by China; it is simply too big a phenomenon, as a market and as a competitor, for smart companies to ignore. And Canada also has a significant advantage in the Chinese market: the large number of Chinese

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8 An interesting case in point is that of China Minmetals, a company owned by the Chinese government. In October 2004, it publicly announced its intention to buy mining giant Noranda for approximately $7 billion. The announcement raised an exceptional number of concerns (and opposition) from both ends of the political spectrum. Controversial issues ranged from resource security to the question of whether a foreign government should be allowed to own a piece of Canada. See Keller, Should Canada Update Its Foreign Investment Rules?
immigrants, many of them entrepreneurs. This advantage must be used more effectively and augmented by more economic-based Asian immigration. Every serious Canadian company of material size should be attracting in-house China expertise.

In sum, Canadian businesses and the federal government should get serious and build a China strategy around the elements of integrative trade, in addition to our traditional resource exports. If we do not, someone else will.

**INDIA: INCOMPLETE JOURNEY TO REFORM**

Until recently, India ranked more as a Canadian development assistance recipient than an economic partner. But India has changed significantly. Although it lags China’s reform efforts and performance by a decade or so, India has seen its growth potential increase to about 8 per cent, fuelled by partial market reform combined with an expanding position in information services. (See Chart 37.) At the same time, the old India persists, an impoverished, overpopulated, traditional agrarian economy.

India’s economic reform has registered some successes, but progress is still lacking on privatization, financial sector reform, labour market reform, opening to international investment and reductions in subsidies to interest groups, not to mention the country’s poor physical infrastructure. If India ever fully opens and reforms its economy, however, it could achieve a sustainable annual growth rate rivalling or even surpassing that of China—particularly as China’s population growth rate is expected to slow considerably after 2020. Canada needs to do here what it failed to do with China—move quickly and get in on the ground floor.

**LATIN AMERICA: ETERNAL LAND OF TOMORROW?**

Latin America has figured prominently over the past two decades in Canada’s assessment of our economic future beyond the United States. In effect, having successfully completed NAFTA, we kept looking further south with a view to expanding our trade while diversifying our relationships within the historical U.S. economic backyard.

The problem with this strategy is that Latin America has not, generally speaking, lived up to its billing. Canada’s economic ties with Latin America are solid on investment but much lighter on trade. After much effort at trade
promotion, our exports to Latin America (excluding Mexico) still total only around $5 billion (1.2 per cent of Canada’s total exports) and our imports are $12 billion (about 3.2 per cent of Canada’s total imports). These figures are in sharp contrast to our growing trade activity with Asia. (See charts 38 and 39.)

Parts of Latin America are changing. Brazil has crossed the Rubicon into sustainable economic policies and performance after decades of economic imbalances that generated hyperinflation, external debt crises and sharp currency devaluations. It is quickly opening its economy to trade and investment, and has rebuilt confidence with creditors; it launched an international bond issue in its own currency late in 2005, for the first time in decades, while fully repaying its credits to the International Monetary Fund (IMF). With continued progress, Brazil could sustain annual growth of 4 per cent through 2025.

A growing Latin America led by fiscally sound Brazil presents opportunities for further Canadian investment and exports.

Solid macroeconomic policies and strong global demand for fuels, metals and agricultural products are contributing to renewed economic performance in other countries. Chile has a strong track record of economic reform, and Colombia is trying hard to sustain economic reform in difficult security circumstances. But Venezuela and Argentina are continuing the regional tradition of weak commitment to sustainable economic policies. Although strong commodity prices are producing acceptable growth in the near term in these two countries, we fear that trouble lies ahead.

A growing Latin America led by fiscally sound Brazil presents opportunities for further Canadian investment and exports, with or without a Free Trade Agreement of the Americas. (See charts 40 and 41.) But it will also be a growing source of competition for Canada in third markets. And, as the ongoing aerospace saga between Bombardier and Embraer attests, the potential for competition lies in not only resource sectors but also manufacturing and higher technology.

RUSSIA: OIL AND GAS BOOM, BUT DUTCH DISEASE

On an economic roller coaster since the collapse of Communism in 1991, Russia’s economy has performed remarkably well in recent years. This success is driven by heavy dependence on the oil and gas sector, which has allowed the Russian economy to achieve annual growth of around 6 per cent or more. But it leaves the country vulnerable to loss of competitiveness in most other sectors, resulting from what is called “Dutch disease”—strong currency appreciation driven by oil and gas earnings that crowds out other exporting sectors of the economy, particularly manufacturing.
Russia’s future is also being clouded by its demographics. Due to very low fertility rates, the World Bank estimates that Russia’s overall population could decline from 143 million to 100 million within the next half-century. Moreover, World Bank analysis has highlighted another significant concern for Russia’s future, that of declining male life expectancy due to alcohol-related illnesses, accidents and suicides. If Russia cannot successfully tackle the combination of Dutch disease and falling life expectancy, its future will hardly be rosy, notwithstanding its hydrocarbon wealth.

**FORGE NEW TIES WITH OLD PARTNERS**

The importance of China and other emerging economies does not mean that Canada should take its eyes off its traditional economic partners, Japan and Europe. While economic and demographic dynamics mean they will not in the future be the economic powerhouses they once were, they are still hugely important to Canada’s interests.

**Canada’s economic relationship with Japan is changing.**

**Canadian businesses are increasingly using investment to serve the Japanese market.**

### JAPAN: REVIVING, FINALLY

After a decade of stagnation, Japan appears to have turned a corner with a consensus growth forecast in the range of 2 to 3 per cent over the next two years and the end of deflation that depressed domestic consumption. Although it may never return to the explosive growth of the 1980s, Japan is at least back in the game—driven by a renewed push to get its domestic financial, economic and political house in order.

Canada’s economic relationship with Japan is changing. While our exports to Japan are still heavily weighted toward our traditional resource trade and have sagged in recent years (see Chart 42), Canadian businesses are increasingly using investment to serve the Japanese market. They are also providing high-end services and technology-based products, such as environmental services, information technology, telecommunications,
biotechnology and new media. At the same time, we should recognize that Japan’s economic fortune is increasingly tied to China and the rest of Asia as Japanese companies move elements of their supply chains offshore. Canada will need to see its economic relations with Japan in the broader context of supply chains and investment links into and out of China, South Korea and the rest of Asia.

**CANADA AND EUROPE: UNREALIZED POTENTIAL**

We cannot dismiss the potential of more business with Europe. Superficially, the signs point toward decline: largely stagnant trade patterns and European investment shifting away from Canada toward other markets to take advantage of factors like skilled labour and lower costs, specifically among the new EU members of Central and Eastern Europe. But Europe remains a global economic force to be reckoned with. The modest growth outlook for the traditional parts of the EU (the EU15), in the range of 2 per cent, needs to be balanced against strong growth rates among the new EU members (the new EU10), whose growth potential rivals that of many other emerging economies. Although the level of Canada’s exports to the new EU10 is much smaller than to the EU15, exports to the new EU10 grew by 11.5 per cent per year between 2000 and 2005, while exports to the EU15 grew by only 4.6 per cent. (See charts 43 and 44.)

**Canada now sells much more in Europe than it does to Europe.**

Canada’s trade with traditional EU partners—the U.K., France and Germany—is caught in a historical time warp: an exchange of largely unprocessed resource goods for intermediate and finished goods with high value-added, such as machinery and equipment. But this pattern is not being replicated in our small but growing trade with the rapidly expanding EU members of Central and Eastern Europe; in 2004, approximately 36 per cent of these exports were intermediate goods and 40 per cent were finished goods.

The nature of the Canada–EU economic relationship is also changing. Canadian investment to Europe is growing as increasing numbers of Canadian businesses establish a presence there, in many cases based upon sales by their affiliates. (See Chart 45.) Canada now sells much more in Europe than it does to Europe: in 2004, sales by Canadian foreign affiliates in the EU were twice the level of Canadian exports to the EU. Services exports to the EU have been climbing steadily, and Eastern Europe is attracting Canadian FDI.

The Conference Board’s recent work with the Canada–Europe Round Table for Business (CERT) confirmed a long-standing perception that our relationship with
Europe is drifting and underdeveloped, with little sense of urgency on the part of either business or government about developing deeper economic integration. Opportunity is being lost through neglect.10 (See box “Canada and Europe: The Business View.”)

This assessment is not new. The history of Canada–EU relations is largely a saga of polite European disinterest, coupled with our own primary focus on the United States. The EU has not been receptive to a free trade agreement with Canada, in the absence of one with the United States. The recent decision to enter into negotiations on a 16-point Canada–EU Trade and Investment Enhancement Agreement (TIEA) creates potential for progress, but risks the fate of previous well-intentioned yet ultimately ineffectual Canada–EU exercises.

If the slow downward spiral is to be broken, strong leadership is needed in the reforms that will generate the biggest gains: aggressive reductions to the panoply of non-tariff barriers on both sides of the Atlantic, as well as tariffs; a commitment to improved regulatory synchronization, if not harmonization; serious steps to re-attract EU FDI; and expansion of our already substantial services trade.

PURSUE MORE PRAGMATIC MULTILATERALISM

The Conference Board’s dialogue on the future of Canadian foreign policy revealed two distinct, and seemingly contradictory, perceptions.11 One is that Canadians tend to have an inflated sense of their power and influence in the world, based largely on a nostalgic view of our historical role as international honest brokers and peacekeepers in a world that has fundamentally changed. The other is that Canada’s global presence is fading; although our image in the world is positive, our international profile has slipped to near invisibility, with a high quotient of feel-good diplomacy, pretense and photo-ops. “Exporting the Canadian societal model” may have its merits, but it does nothing to advance our interests with global decision-makers. An honest evaluation says that we have gone from punching above our weight to punching below it.

Canada and Europe: The Business View

The Conference Board–CERT study included a survey and workshops with 20 companies, of Canadian and European origin, in Canada.

Old Barriers to Trade and Investment

The main concern of respondents is non-tariff barriers, particularly regulatory cooperation and harmonization of regulations and standards, especially in the environmental area. Other priorities are mutual recognition of professional qualifications to enable companies to obtain work permits in a timely fashion for skilled labour, and policies to facilitate open competition, allowing all countries the opportunity to compete on a level playing field.

New Opportunities in Central and Eastern Europe

Most businesses see EU enlargement as a positive development, although not one that will significantly enhance business prospects or result in major growth in trade and investment between Canada and the EU. This is largely because new members are small compared with major EU states, such as the U.K. and Germany, with poorer infrastructure, corruption, erosion of low-cost advantage and macroeconomic instability. Nonetheless, many companies have strategies for pursuing opportunities in the new EU10, particularly Poland, the Czech Republic and Hungary.


Chart 45

Canada–EU Bilateral Investment Stock

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<th>EU FDI stock in Canada</th>
<th>Canadian FDI stock in the EU</th>
<th>Balance</th>
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<td>1995</td>
<td>20</td>
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<td>2005</td>
<td>220</td>
<td>240</td>
<td>-20</td>
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</table>

Note: Data for 1993–2003 pertain to the EU15 countries; data for 2004 and 2005 pertain to the EU25 countries.

Source: Statistics Canada.

10 Lemaire and Cai, Lost Over the Atlantic?

11 For more information, see The Conference Board of Canada, “Revitalizing Canadian Foreign Policy,” pp. 97–115. See also MacDuff, Course Correction.
Canada’s role in the world has changed as a result of the emergence of the U.S. as the world’s sole superpower, and it will change further as China and other major emerging economies demand centre stage. We need to adjust to these realities. But this does not mean that we should think, or act, smaller. On the contrary, it points to a need to think bigger—but in a more focused and strategic way—about where our future place in the world should be, and how to get there. Unless we take more initiative to further our own interests, the world will simply pass us by and we will truly become policy-takers, not policy-makers.

This means narrowing the focus to a key set of objectives and pursuing them in a coherent fashion across the three kinds of multilateralism we practise: the high-level multilateralism of the Group of Seven/Group of Eight (G7/G8) countries, as well as high-profile regional groupings like Asia-Pacific Economic Cooperation (APEC); the economic multilateralism associated with our membership in the IMF, the World Bank and the WTO; and the multilateralism associated with the United Nations and its specialized agencies.

**ANTICIPATE THE FUTURE: THE G7/G8 AND THE LEADERS-20**

Canada’s sliding global ranking will make it increasingly difficult for us to hold on to our seat at the G7/G8 table. Spain is already angling to replace us. In the longer run, the G7/G8 itself also risks declining relevance unless it finds ways to expand its engagement with emerging economies. Even as Canada strives for influence within this group, it is critical that we anticipate the future by becoming a central player in a wider circle of influence, as envisaged in the proposal for a Leaders-20 (L20)—a higher level version of the existing and generally successful Group of 20 (G20) finance ministers and central bank governors of 19 of the world’s largest economies, together with the EU.12

**ENHANCE ENGAGEMENT WITH ASIA**

Similarly, Canada risks being sidelined in high-level dialogue with Asia. We have the Organization of American States for dialogue with Latin America, but the traditional vehicle for trans-Pacific dialogue (the unwieldy 21-member APEC) is of decreasing relevance. Our long-standing dialogue with the Association of Southeast Asian Nations (ASEAN), like ASEAN itself, is at best slow moving. Tellingly, Canada was not even invited to what could be the new vehicle that matters, the first Asian Summit in December 2005, although our competitors—Australia, New Zealand, and informally Russia—were. Nor are we part of the U.S.–China dialogue.

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Canada’s sliding global ranking will make it increasingly difficult for us to hold on to our seat at the G7/G8 table.

The existing G20 will remain the key multilateral forum for addressing major international trade and economic policy issues, such as China’s exchange rate policy. There is also a more creative role available for the OECD, which already includes South Korea and Mexico, and is in the process of reaching out to India. Increasingly, however, our economic, and potentially also our security, interests will take on a trilateral dimension: Canada–U.S.–Asia. We therefore need to find a mechanism that allows us to have a seat at the table in this critical triangular relationship.

**RE-ENGAGE WITH THE U.S. MULTILATERALLY**

Multilateralism is vital to Canada, both as a way of contributing to the shaping of the global commons and of curbing the exercise of unilateral power. But Canada’s approach to multilateralism has lost its way. Instead of being a means to an end, Canada’s support for multilateralism has become almost an end in itself, a way to distinguish ourselves from the U.S. in the eyes of the world. This kind of multilateralism has brought us to some odd places, like criticizing the U.S. for not signing onto the multilateral Kyoto Protocol, even though their performance in reducing greenhouse gases is actually better than our own—a confusion of the importance of international process and rule-making versus what really matters, which is results.

Even though the U.S. has veered recently into a more unilateral “exceptionalism” mode, we should not forget that, historically, the U.S. was a key architect and champion of much of the present global multilateral

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12 The G20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, U.K., U.S. and the EU.
superstructure, including the IMF, the World Bank, the General Agreement on Tariffs and Trade (GATT) and its successor, the WTO, and the United Nations. The American window of interest in multilateral institutions is far from closed, despite the Iraq experience. Canada has much to gain through continued constructive engagement with the U.S. in strengthening the role of key multilateral institutions.

**TAKE LEADERSHIP IN SELECTED AREAS OF FUTURE GLOBAL RISK AND INSECURITY**

Finally, we need an approach to multilateralism that addresses issues of global risk and security, since, if not managed, these can blow our economic prosperity substantially off-course. Over the next 15 years, the world will grow increasingly interconnected, complex and turbulent. Globalization will create rapid and expansive shifts in the geopolitical, economic, social, environmental and biological landscape. Although these changes will increase opportunities for wealth and well-being, they will also increase opportunities for risk and insecurity.

There are three principal kinds of risks arising from globalization: conflict risk, including weapons of mass destruction, terrorism, and failed and failing states; social and health risks, including increased vulnerability to disease and crime; and economic and technological risks, such as disruptions to economic and resource infrastructures. Canada can and should play a key role as a catalyst to intensify international action and coordination in these areas of risk. We need to set priorities by picking a small number of areas or sub-areas where we have strong interests and capabilities, and become very good in, and well known for, these priority areas. Governance, where we are already significantly engaged, is one obvious choice. Health could be another.

**THE CORE MESSAGE: REPOSITION FOREIGN POLICY TO SUPPORT PRODUCTIVITY**

In sum, this chapter offers guidance on how our key international relationships can help to improve our economic performance. Foreign policy has generally not been considered in the context of our national productivity performance. This is an oversight. Strong international relationships set the stage for dynamic and effective trade and investment policies, which must be a core element of any Canadian productivity strategy.

To do this, we need to ensure the right weighting of Canada’s bilateral foreign policy priorities. The relationship with the U.S. needs to be managed as a critical priority; we need to take a coherent, practical, step-by-step approach in dealing with America. But as a counterpart, we must give more weight to, and focus strategically on, China and key emerging economies while not neglecting the ties with our old partners, Europe and Japan.

We should also not forget that multilateralism is a means to an end, not an end in itself. Canada’s aim should be to link together our key relationships with the U.S. and the G7/G8 countries, with deeper engagement of the leaders of the emerging world. We should also not be afraid to show leadership in selected areas of future global risk and insecurity.

**RECOMMENDATIONS TO REFOCUS FOREIGN POLICY PRIORITIES**

The Conference Board of Canada recommends that:

15. The federal government advance foreign policy along two primary tracks:
   - Focus on the critical foreign policy relationship with the United States.
   - Give priority treatment to China and other key emerging powers.

Nurturing our relationship with our traditional partners, Europe and Japan, is an important secondary track.

16. The federal government pursue more pragmatic multilateralism as a means, not an end in itself:
   - Work to engage the U.S. in credible multilateral initiatives and programs.
   - Anticipate the future by working within the G7/8 to engage the leaders of the emerging world.
   - Take leadership in selected areas of future global risk and insecurity.

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HIGHLIGHTS

- Canada has significant human capital, resource and economic advantages, yet its economic performance is slipping when compared with that of other leading industrialized and emerging market nations.

- To ensure sustainable prosperity, we need to take a strategic approach to improving our productivity and competitiveness while embracing the concept of sustainability.

- At the heart of the matter is the need for a national productivity strategy that pulls together the many factors examined under The Canada Project into a complete and integrated approach, including action on all five of the strategies outlined in this volume.

- In setting priorities, The Conference Board of Canada endorses identifying and addressing the areas where Canada’s under-performance is greatest relative to potential. The top three policy priorities are:
  - creating a single, competitive Canadian market by tackling the vast web of regulatory and other barriers to competition that currently pervade the Canadian economy;
  - developing a well-defined strategic Canadian trade and investment policy that includes addressing the infrastructure and security barriers at the Canada–U.S. border; and
  - implementing measures to revitalize the workforce, to address the impact of our aging population.

- If we can find the ambition and political will to develop—and more importantly, implement—policies in these areas, while embracing the concept of sustainable prosperity, there is every reason to believe that Canada will achieve stellar performance in the global economy.
Canada is fortunate in so many respects. We have huge natural resource wealth, skilled human capital and free trade with the dynamic United States economy. We have the remarkable combination of social cohesion and cultural and linguistic diversity, enjoy relative safety in a risky world and are benefiting from our resource endowment at a time of exploding commodity demand. We are in the gifted class among nations.

Canada cannot afford to be complacent in a global economy that is evolving rapidly.

Yet despite all of these advantages, The Conference Board of Canada’s benchmarking and the path-breaking research conducted under The Canada Project demonstrate clearly that we are slowly being pushed to the back of that gifted class. Why is Canada slowly sliding when compared with other leading industrialized countries, not to mention when compared with the spectacular rise of China and other leading emerging market nations? Why are we not reaching our full potential? We need to recognize and come to grips with the factors that are causing us to lose ground if we are to compete successfully in global markets.

This volume, one of three summing up the work of The Canada Project, focuses on Canada’s place in the global economy. We have argued that Canada cannot afford to be complacent in a global economy that is evolving rapidly, driven in particular by global demographics and the rise of the emerging nations, led by China. We have further argued that we need to consider Canada’s place within the global economy through the lens of integrative trade, under which foreign investment and trade, exports and imports, and goods and services are increasingly inseparable. And we need to be mindful of the risks on the horizon, posed by factors such as large and still-growing global imbalances, the suspension of the Doha Round of multilateral trade negotiations in mid-2006, and the rise of emerging markets as new competitors on the global stage (while recognizing their potential as new markets to pursue). And all of this must be measured against the issue of sustainability, since economic growth and global structural changes will bear little fruit if achieved at the expense of the physical environment.

NEEDED: A NATIONAL PRODUCTIVITY STRATEGY

A summary of 16 major recommendations follows below, addressing the specific challenges stemming from the broad array of issues covered in this volume. At the heart of the matter is the need for a national productivity strategy that pulls together the many factors examined under The Canada Project into a complete and integrated whole.
As demonstrated in this report and through much of the research conducted under The Canada Project, the determinants of productivity and of our national prosperity are multi-faceted. At the core are the three traditional factors that are commonly used to explain productivity—physical capital, human resources and innovation (both technological and systems-based). Well-designed and coordinated policies for governments and businesses alike can encourage the development of human and physical capital, and can support innovation throughout the economy. And technological innovation is a key factor in improving sustainability.

There is scope for Canada to adapt to the external environment through well-designed policies.

But as emphasized in The Canada Project research, the productivity equation does not stop there. National productivity performance depends heavily on the policy environment within which firms operate. Factors such as the national regulatory framework governed by the federal government and the provinces/territories, the degree of competition in specific sectors, and the quality of the physical and information and communications technology (ICT) infrastructure are also important drivers of Canadian productivity and determinants of the level of our national wealth.

Moreover, we depend heavily upon international trade and investment, so the design and effectiveness of our international economic regime is a further driver of national prosperity. We are deeply integrated into the North American economy, where Canadian productivity is affected by our ability to maximize the benefits of this North American economic integration, which is in turn determined by several factors, notably the degree of regulatory alignment and the efficient management of the border.

And changes in the global landscape also matter. We cannot control the global environment, but there is scope for Canada to influence and adapt to the external environment through well-designed policies.

International trade and investment policy and foreign policy have generally not been included in the recent productivity debate. This is surprising, as in the decades prior to the signing of the Canada–U.S. Free Trade Agreement (FTA), international trade policy was a central feature of the research agenda and policy discussion on productivity. Moreover, international trade policy was seen at that time as integrally interlinked with the domestic microeconomic agenda. We want to correct the recent oversight by reinserting international trade and investment policy and foreign policy as core elements of a Canadian productivity strategy.

It must also be emphasized that this strategy is national in scope, but most assuredly is not the responsibility of the federal government alone. Achieving optimal results will require the full engagement of all three levels of governments, plus the full engagement and support of the private sector.

SETTING PRIORITIES

All five strategies outlined in this volume deserve action, since all of them would contribute to stronger national prosperity. This, admittedly, is a huge agenda. So what deserves priority treatment? Adopting the concept of sustainability, which combines economic growth with concern for the environment, is a top priority. So too is developing and implementing a national productivity strategy; without such a plan, Canada will continue to drive into the future without a road map, missing opportunities to generate the sustainable prosperity to fund our aspirations.

There are two options for establishing the top priorities for early action: focusing on the “quick hits,” or taking action in the areas of greatest under-performance. It must be re-emphasized that the two priority-setting options presented here need not be mutually exclusive; all five strategies outlined in this volume deserve action.

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1 See, for example, the extensive work in this period by the Economic Council of Canada; academics like the Wonnacott brothers; and the MacDonald Commission.
OPTION 1: FOCUS ON THE “QUICK HITS”

One option would be a “quick hits” strategy that would aim to make immediate progress by picking the lowest-hanging fruit—an approach that could appeal to politicians who want to show quick progress to electors. Priority treatment would be given to areas with relatively strong starting points and less resistance from vested interests. Priorities for action would include making education spending a higher national priority, since there is already a shift in this direction in policy advocacy and public attitude; implementing the strategy for Canadian innovation that has already been developed by the Conference Board’s Leaders’ Roundtable for Commercialization; and making the U.S. our top bilateral foreign policy relationship, which the federal government has embraced.

OPTION 2: TAKE ACTION WHERE UNDER-PERFORMANCE IS GREATEST

The alternative, more ambitious approach, would be to identify and address areas where Canada’s under-performance is greatest relative to its potential. The economic payback from structural reform in these areas would be the most significant over time—even if reform might be more challenging and thus less politically appealing, in the short term. The priorities would be quite different under this approach.

We need to end the slow death by a thousand paper cuts that is imposed on Canadian productivity.

The top policy priority identified by our research would be a serious national commitment to tackle the vast web of regulatory and other barriers that currently pervade the Canadian economy and to reduce barriers to competition—in other words, the creation of a single, competitive Canadian market. We need to end the slow death by a thousand paper cuts that is being imposed every day on Canadian productivity. Taking environmental regulation as but one example, wealth creation capacity and innovation in key resource sectors are being constrained by inefficient process, without improving environmental sustainability. Volume II of this report addresses this issue in detail.

The second priority would be a well-defined strategic Canadian trade and investment policy. This policy area has not been a national priority for over a decade, and the net economic return from improved foreign market access and from domestic adjustment when faced with heightened international competition should be considerable over time. Addressing the infrastructure and security barriers at the Canada–U.S. border would be an essential corollary.

And the third priority would be to address seriously the issue of an aging labour force, which would result in individual and collective benefits for both businesses and governments. To date, most organizations have been extremely slow to recognize the issue and seize the initiative. Measures to attract and keep older workers engaged in the labour force, combined with a redesigned and strengthened immigration system, would help organizations to keep functioning effectively and would support the growth potential of the entire economy.

OUR ADVICE: PURSUE THE SECOND OPTION, VIGOROUSLY

The Conference Board of Canada endorses the second approach—to identify and address the areas where under-performance is greatest. Although more difficult to accomplish politically (since traditional behaviour will be more deeply entrenched and there are more vested interests to overcome), the payback in terms of sustained economic prosperity would be greater over time.

If we can find the ambition and political will to implement the elements of the national productivity strategy, while embracing the concept of sustainable prosperity, there is every reason to believe that Canada could be the most prosperous and successful nation on the planet for decades to come. We can, indeed, accomplish Mission Possible and achieve stellar performance in the global economy.
EMBRACE PRODUCTIVITY AND COMPETITIVENESS

1. Canadians recognize that economic growth and concern for the physical environment need to be integrated into a single concept of sustainable prosperity:
   - Adopt metrics that integrate the concept of sustainability into our measurement of economic growth and business success.
   - Improve federal and provincial government alignment and efficiency of environmental regulations.

2. Public and private sectors adopt a Canadian national productivity strategy that addresses the key elements affecting our productivity performance.

CREATE A SINGLE CANADIAN MARKET

3. Governments tackle the vast web of regulatory and other non-tariff barriers that currently pervade the Canadian economy, and reduce barriers to competition in specific sectors:
   - Reinvigorate the removal of barriers to internal trade by adopting some of the techniques used in international trade negotiations, like binding dispute settlement mechanisms and enhanced bilateral/regional agreements.
   - Align, and ideally harmonize, regulatory standards and processes among all levels of government.
   - Pursue the big regulatory policy issues, like national securities regulation or openness in the financial services industry.
   - Simplify and shorten the regulatory process and improve regulatory coordination, for example, by identifying a regulatory “champion” for specific projects.
   - Align Canadian and U.S. regulatory frameworks more closely by removing differences in regulatory standards and processes where doing so would meet the needs of both countries.

4. Business and governments foster knowledge and innovation by implementing the strategy developed by the Conference Board’s Leaders’ Roundtable for Commercialization, which identified six priority areas for businesses and government:
   - Establish priority areas in which Canada will be global best.
   - Increase corporate investment in strategic training and recruitment.
   - Increase corporate investment in research, development and innovation.
   - Increase international and domestic risk capital investment in Canada, and focus on bigger deals.
   - Expand innovation in industrial supply chains.
   - Institute an independent national advisory group in innovation-based commerce.

5. Governments reform tax policy in support of productivity:
   - Reduce marginal tax rates on low incomes.
   - Eliminate capital taxes and reform business taxation.
   - Strengthen the alignment of the Canadian tax system across three levels of government.
   - Provide cities with the tax instruments they need to meet their fiscal responsibilities.

6. Governments, working with the private sector, invest in the modernization and coordination of trade transportation and border infrastructure, including security, as a national priority.

RETHINK THE WORKFORCE

7. The federal government implement a new deal for immigrants by improving immigrant selection and processing, reforming credentials recognition and strengthening intergovernmental and public–private sector coordination.

8. Business and governments actively seek to retain older workers by adopting more flexible working arrangements, changing the mix of financial incentives and modernizing attitudes toward older workers.
9. Governments establish education funding as a much higher national priority and ensure that both universities and colleges have the financial resources they need to meet their respective mandates.

10. Governments and employers improve the quality of the workforce:
- Recognize the importance of innovation within the education system.
- Expand international educational experiences and language skills.
- Address the skills gap.
- Revitalize our commitment to Aboriginal education.
- Enhance immigrant-sensitive education.
- Commit to lifelong learning.

**REVITALIZE INTERNATIONAL INVESTMENT AND TRADE**
11. The federal government pursue a coherent, deliberate international trade and investment strategy:
- Position Canada as a leader once again in multilateral trade and investment liberalization through the World Trade Organization.
- Deepen and improve the North American Free Trade Agreement.
- Pursue other bilateral and regional trade and investment agreements with countries that are important to our economic interests.
- Ensure that we are not undercut in markets through agreements struck by our competitors and partners, or through other special arrangements.

12. Governments recommit to making Canada an attractive destination for new productive foreign investment by addressing factors that deter foreign investors—the regulatory environment, tax competitiveness, the quality of the labour force, and constraints at the border—and by bringing greater clarity and transparency to the legislation and rules governing FDI.

13. The federal government facilitate outward Canadian FDI where there are material benefits to Canada through actions that reduce the risk of investing outside Canada, like Foreign Investment Protection Agreements, and by strengthening facilitation of outward FDI through agencies like Export Development Canada.

14. Governments and business promotion organizations energize trade in services through an improved domestic structural and regulatory environment for services, more effective promotion of exports and investment for services-producing industries, and improved market access for services trade.

**REFOCUS FOREIGN POLICY PRIORITIES**
15. The federal government advance foreign policy along two primary tracks:
- Focus on the critical foreign policy relationship with the United States.
- Give priority treatment to China and other key emerging powers.

Nurturing our relationship with our traditional partners, Europe and Japan, is an important secondary track.

16. The federal government pursue more pragmatic multilateralism as a means, not an end in itself:
- Work to engage the U.S. in credible multilateral initiatives and programs.
- Anticipate the future by working within the G7/8 to engage the leaders of the emerging world.
- Take leadership in selected areas of future global risk and insecurity.
Bibliography


APPENDIX B

The Canada Project Research and Dialogue Activities

RESEARCH ACTIVITIES

- Building Successful Cities: Lessons from the United Kingdom
- Canada’s Hub Cities: A Driving Force of the National Economy
- Clusters of Opportunity, Clusters of Risk
- Course Correction: Advice on Canada’s Future Foreign Policy
- Death by a Thousand Paper Cuts: The Effect of Barriers to Competition on Canadian Productivity
- In Search of a New Equilibrium in the Canada–U.S. Relationship
- Lost Over the Atlantic? The Canada–EU Trade and Investment Relationship
- Open for Business? Canada’s Foreign Direct Investment Challenge
- Opportunity Begins at Home: Enhancing Canadian Commercial Services Exports
- Performance and Potential 2003–04: Defining the Canadian Advantage
  - Chapter 3—Understanding the Impact of Population Ageing: How It Will Affect the Supply of Labour and Health Care Costs
  - Chapter 4—Revitalizing Canadian Foreign Policy: Carving Out a New Role
  - Chapter 5—Assessing Canada’s Fiscal Capacity to 2015: Tough Choices Remain

- Performance and Potential 2004–05: How Can Canada Prosper in Tomorrow’s World?
  - Chapter 2—The Canada–U.S. Productivity Gap: Deepening Our Understanding
  - Chapter 3—Canadian Trade: Scenarios and Policy Options in an Insecure World
  - Chapter 4—Foreign Direct Investment: Ins, Outs and Implications for Canada
  - Chapter 5—Immigration: A New Deal for Newcomers
  - Chapter 6—Canada’s Cities: In Need of a New Fiscal Framework

  - Chapter 2—Making Connections: The New World of Integrative Trade and Canada
  - Chapter 3—Pursuing Sustainability: Global Commodity Trends and Canada
  - Chapter 4—Rethinking the Workforce: Aging Populations and Canada
  - Chapter 5—Facing the Risks: Global Security Trends and Canada

- Sustainability: A Winning Merger of Growth and the Environment
DIALOGUE ACTIVITIES

• Bi-National Leaders Roundtable: The Future of Canada–U.S. Relations
• Canadian Commercial Service Exports Forum
• Capturing the Vision Advisory Panel
• Commodities Research Advisory Panel
• Consultative Forum on Canada’s Role in the World
• Countries Research Advisory Panel
• Human Resources Management in Multinational Companies: An International Conference on Global Value Chains, Employment Practices and Public Policy
• Panel on Barriers to Competition
• Urban Research Advisory Panel
• Workshop on Enlargement of the European Union

RESEARCH AND DIALOGUE ACTIVITIES
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• Employment Practices in Canadian Multinational Enterprises
• The Exchange Rate and Wages: How They Affect Capital Investment
• The Link Between Economic Growth, Openness to Trade and Quality of Life
• The NAFTA Effect: Multinational Enterprises in Canada
• Workshop on International Aviation Policy for Canada

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