

CANADA'S SUCCESS IS NO ACCIDENT, AND IT ISN'T A GIVEN

Kevin Lynch

Canada is a highly prosperous and successful country. That's Kevin Lynch's starting point. But "outcomes are not preordained, nor should they be taken for granted," says Lynch. In this piece, written from his previous post as Canada's executive director at the IMF in Washington before he was appointed Clerk of the Privy Council, Lynch identifies three public policy challenges for Canada: first, enhancing productivity; second, "improving our human capital through education and training"; and third, enhancing our global economic reach. "To state the obvious," he writes, "the world matters, and matters greatly, to Canada."



By most measures Canada is an extremely prosperous and successful country. Whether it is the United Nations Human Development Index (Canada placed 5th among 177 countries in 2005), the World Economic Forum's international competitiveness ranking (Canada was 13th in 2005), or the OECD's measure of living standards (Canada's real GDP per capita was 2nd highest in the G7, 9th in the OECD in 2004), Canada ranks very high as a place to live and a place to do business.

But such outcomes are not preordained, nor should they be taken for granted. They depend on the quality of our policies and institutions as well as the quality of our human resources and our national endowments. And, in a profoundly globalized world, they depend not just on the direction of government policies and business strategies, but also on their flexibility and adaptability — speed matters in enhancing a country's comparative advantages in today's competitive and rapidly changing global marketplace. Indeed, Canada's past experience with 27 years of continuous deficits and rising debt is a case in point of how policies can affect economic performance and national opportunity, in this instance for the worse.

The task at hand is to identify the most critical policy challenges and opportunities facing Canada over the medium term. In this context, three public policy challenges worthy of such focused analysis and public discussion are the following. First, increasing Canadian productivity growth on a sustained basis with the objective of closing productivity gaps vis-à-vis our main trading partner, the United States. Second, improving our human capital through education and training with the objective of having one of the best educated societies and economies in the world. Third, enhancing our global economic reach by attracting more global FDI, developing deeper trade links in key markets and creating a stronger "Canada brand."

The key objective of public policy is to increase the well-being of the population in a sustainable manner. The well-being of citizens is a concept that often envelops not only their standard of living but also social goals and security. These goals need not conflict. For example, enhanced growth in income enables increasing expenditure on health care, education and other social programs, thereby also contributing to well-being. Similarly, improved education enables individuals to play a fuller role in society. At the same time, better educated individuals generate the new ideas and new approaches that foster growth in income. In the best of circumstances, economic and social policies are complementary.

There are two basic ways of improving a country's standard of living: employment growth and productivity growth. Over the last decade, Canada's success in significantly improving its standard of living has come about mainly from increasing employment ratios; while productivity growth picked up relative to previous decades, the rebound was less than those of our major trading partners. However, over the next 10 years, the aging population will mean that the pace of employment growth will structurally decline, thereby contributing much less to growth in living standards. The same demographic trends will also lead to greater pressure on pensions and health care expenditures. As this unfolds, the critical challenge facing Canada is to increase productivity growth so that our living standard continues to rise.

Productivity is basically a measure of how well people and physical capital interact within the economy to produce goods and services. To increase productivity performance, focus is needed on what the OECD terms the "drivers of productivity growth": human capital, physical capital and innovation. In this view, productivity can be improved directly through higher investment in both physical and

human capital. Investments in more education and better skills — human capital — allow workers to be more efficient and effective. Workers' productivity also rises if they work with more and better equipment. Investments in human capital can also

OECD studies provide strong empirical support of the importance of these drivers of growth. For example, drawing on diverse international experience, OECD analysis suggests that increasing private, non-residential investment by one percentage point of GDP will

calls out for a better understanding of why we have relatively under-invested over a considerable period of time.

In this regard, it is important to recognize that many of the investments in the drivers of productivity growth are made by individuals and businesses, not government. For their part, governments must enhance their policy frameworks to encourage Canadians to invest more in these productivity drivers. Sound macroeconomic policy also plays a key supportive role: Canada must not miss the opportunity over the next decade to continue to reduce its debt burden, increase national savings,

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raise productivity levels indirectly through increased innovation. Innovation — new ideas — provides better ways of producing existing goods and services and creates new goods and services. These productivity drivers also reinforce each other.

How has Canada done on the productivity front in recent years? The simple answer is: better than in previous decades (see figure 1) but not as well as our main trading competitors (see figure 2). Relative to the US in particular, gaps in productivity levels have widened, both in aggregate and in most sectors as well. These productivity gaps vis-à-vis the United States are the main reason for differences in our standards of living. And Canada-US productivity gaps have increased over the 1997-2004 period.

With respect to key productivity drivers, Canada's private sector R&D investment performance is well below best practices elsewhere (figure 3). Public sector research spending has increased, but commercialization of research lags compared with that in the United States in many areas. A similar picture emerges in private sector investment, particularly in machinery and equipment, where Canada's investment as a percentage of GDP is the lowest in the G-7 (figure 4).

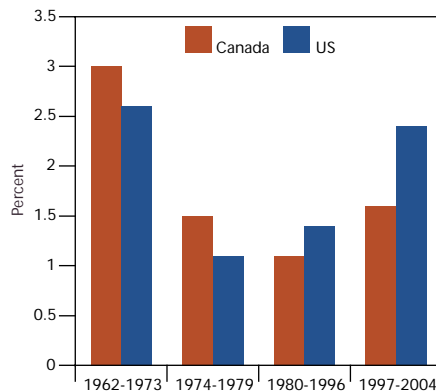
increase GDP per capita by 1¼ percent. Increasing business R&D investment, one proxy for innovation, by 0.1 percentage point of GDP, is estimated to have a similar impact.

Given the degree of business sector competition and integration within North America, it is surprising that there has not been greater convergence of sectoral (and hence aggregate) productivity performance, and this is something we need to understand more fully. Increased investments in the key factors that propel productivity growth are clearly needed, but this also

keep inflation low and stable, and have a competitive tax regime.

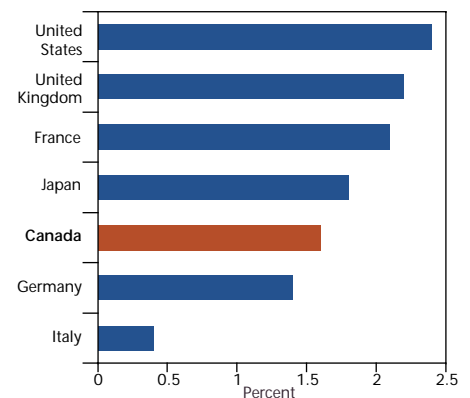
No discussion of policy challenges would be complete without considering the key role of education and training. A good educational system is a source of sustained advantage in three ways. First, in the labour force of the 21st century, well-educated knowledge workers are the new "natural resource" of the new global economy. Second, it is indisputable that a strong educational system is needed to foster innovation. Third, by increasing

FIGURE 1. CANADA'S AVERAGE ANNUAL PRODUCTIVITY GROWTH, 1962-2004



Sources: Statistics Canada; Bureau of Economic Analysis; Bureau of Labor Statistics and Department of Finance (2005).
Note: Productivity is GDP per hour worked.

FIGURE 2. G7 AVERAGE ANNUAL PRODUCTIVITY GROWTH, 1997-2004



Sources: *OECD Economic Outlook* No. 77 (July 2005); Statistics Canada; Bureau of Economic Analysis; Bureau of Labor and Department of Finance (2005).
Note: Productivity is GDP per hour worked.

education, citizens are better equipped to contribute to the development of public policy and participate fully in public discourse.

In framing the importance of human capital formation, several global trends bear on the role of education and training in shaping individual, business and national success. These include:

- *The greater complexity of modern life.* We are living in an extraordinarily inter-connected global economy, with capital, goods and services moving around the world in unprecedented volume and with unprecedented speed. Fifty years ago, most of a business person's competitors were local and well known; 25 years ago they were regional and known; today, they are global and often anonymous. Fifty years ago product life cycles were over 10 years; today, they are less than a year. As Tom Friedman has so eloquently argued, the only constant is change: "if globalization were a sport, it would be the 100 metre dash, over and over and over."
- *The world has moved dramatically toward market-based economies.* With the fall of the Berlin Wall and the breaching of the Great

Wall by Deng's reforms in China, large swaths of the global economy have now entered market-oriented systems to varying degrees. Continued trade liberalization through the WTO, and the rise of truly global capital markets, are accelerating this process of change and binding the various

In this environment, education is increasingly recognized as a key "growth driver" for economies at all stages of development, and a key determinant of an individual's relative economic success within any particular economy. OECD estimates suggest that adding one year to the average educational attainment in a

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players together in networks of capital, foreign direct investment and global supply chains.

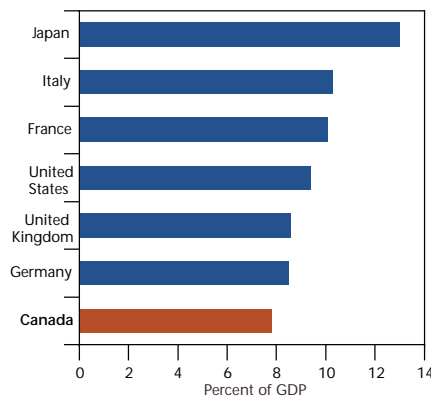
- *The internet (and related communications technology) has fundamentally changed the paradigm for processing, distributing and acquiring information.* It has opened up incomprehensible stores of data to citizens. But data is not the same as information, and information is not necessarily knowledge — in other words, adding value to all this data depends on an individual's ability to process this increasingly ubiquitous global data warehouse.

country can increase its GDP per capita by 5 percent. Not many investments produce such large economic payoffs as education.

Where does Canada stand? A couple of illustrative statistics are useful to demonstrate the richness of the issues involved. One Canadian strength is that 44 percent of the population has some post-secondary education — the highest in the OECD (see table 1). But, in a knowledge-based world, with growing competition from countries like China, will less than 50 percent or even 60 percent be adequate to ensure our competitiveness in the future? Notwithstanding the overall statistics, our rate of university education is less than that of a number of competitors, particularly the US. Is this something that we should be concerned about? And, Canada still has significant high school drop out rates, which impose increasing economic costs as the economy shifts to ever more complex production processes in all sectors.

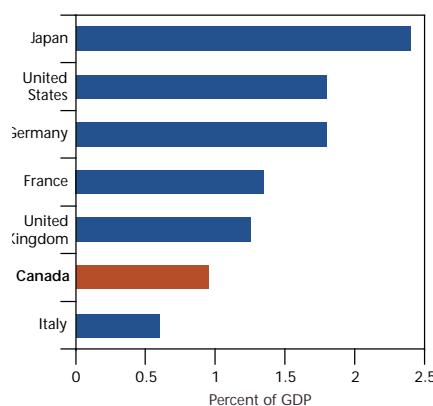
Furthermore, quantitative measures aside, there are also quality issues. Should we be more focused on the quality of education Canadians receive? Here, Canada does well on average compared to other OECD countries on standardized international tests (on math, science and

FIGURE 3. PRIVATE SECTOR R&D AS A PERCENTAGE OF INDUSTRY VALUE-ADDED, G7, 2004



Sources: OECD, *Annual National Accounts*; Statistics Canada; Bureau of Economic Analysis; Department of Finance (2005).

FIGURE 4. AVERAGE INVESTMENT IN MACHINERY AND EQUIPMENT, G7, 1993-2003



Sources: OECD, *Main Science and Technology Indicators* (May 2005); Department of Finance (2005).



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reading scores for 15-year olds, Canada's rankings were in the 3rd-to-8th place range. However, there is a wide range of educational attainment scores across provinces within Canada. What about disciplines: should we be concerned about our relatively weak orientation toward certain disciplines, such as management, commerce, and the natural sciences, and the possible impact on our capacity for innovation? And what about graduate degrees, particularly in areas that are aligned with our comparative advantages as a country? Do we need better incentives in these areas through excellence-based scholarships to encourage the world's best students to pursue doctorates in Canada?

TABLE 1. POPULATION AGED 25-64 WITH POST-SECONDARY EDUCATION, 2003

	%
Canada	44
United States	38
Japan	37
Sweden	33
Finland	33
Denmark	32
Australia	31
Norway	31
New Zealand	31
Korea	29
Belgium	29
United Kingdom	28
Switzerland	27
Ireland	26
Iceland	26
Spain	25
Netherlands	24
Germany	24
OECD mean	24
France	23
Greece	18
Hungary	15
Mexico	15
Luxembourg	15
Austria	15
Poland	14
Czech Republic	12
Slovak Republic	12
Portugal	11
Italy	10
Turkey	10

Source: OECD (2005).

Globalization is increasingly knitting together the world's economies through trade, financial flows, technology and migration. In recent decades, trade has grown faster than GDP, and investment has outpaced trade. And, measured by either trade or investment, Canada has one of the most open economies — it is the world's fifth largest trader, with the sixth largest stock of inward FDI. But the world is not static, and competitive forces are constantly shifting.

Thus, to state the obvious, the world matters, and matters greatly, for Canada. Whether it is the international trade and investment rules-of-the-game, the international financial architecture, international surveillance and policy coordination, or international development, Canada's interests are always at stake and we need to seek outcomes that support our comparative advantages and our values.

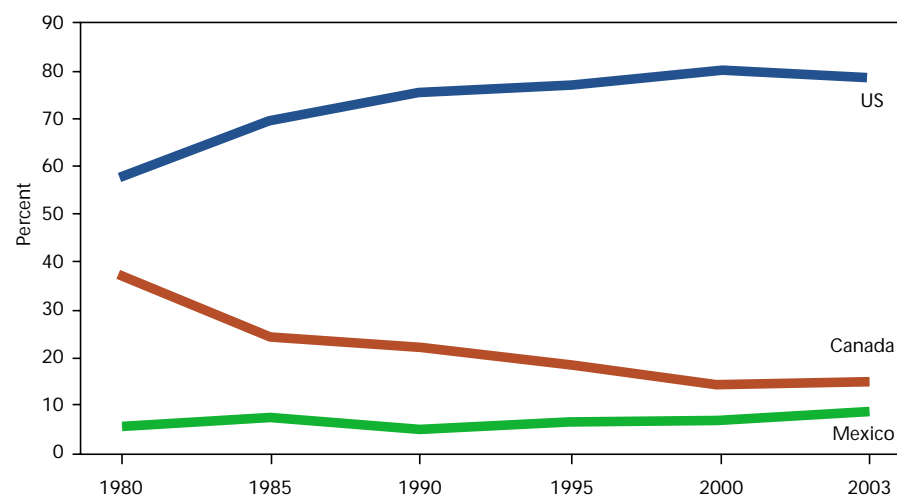
In considering the importance of enhancing our global economic reach, several factors are worth bearing in mind:

- First, trade and investment increasingly go hand in hand. For example, about 40 percent of Canada-US trade is intra-firm. Similarly, highly linked trade and investment networks are evident in parts of Asia and the EU. In this context, while inward FDI stocks as a percentage of GDP are still

quite high in Canada compared to many other G7 countries, our relative position has deteriorated significantly over the last 20 years as Canada's share of global FDI (and North American FDI) has declined (see figure 5). Given the growing importance of intra-firm trade links, this trend may impact on long-run trade growth prospects unless it is reversed.

- Second, having the US — the world's largest, richest, and most productive economy — as our main export market is a significant advantage that we need to deepen. At the same time, emerging Asia, particularly China, is growing at such a sustained pace and scope that it is showing signs of reversing secular declines in global commodity prices. It has the potential for stimulating enormous domestic demand, provided the pace of policy reform continues. In this context, with our substantial natural resource endowment and export potential in the services area, China is an economy and market that warrants ever increasing Canadian attention.
- Third, in the competitive international market for trade and investment, branding matters. Is our international economic profile

FIGURE 5. CANADA'S SHARE OF NORTH AMERICAN INWARD FDI STOCKS, 1980-2003



Source: United Nations Conference on Trade and Development; Department of Finance (2005).

consistent with our economic weight? As a relatively large, resource rich, high income, multi-cultural country, Canada has the potential to enhance its global economic reach. Part of this entails increasing our competitiveness, part involves our policies, and part should be a focus on projecting to the world why Canada matters. Particularly in attracting FDI, it is important to establish in the minds of global investors the comparative advantages of Canada, the whole of which is the Canadian brand.

To be at the top rank of global living standards, Canada needs to be at the forefront of globally competitive economies. With 40 percent of our GDP coming from trade today, we need a clear global focus on what it will take to be competitive over the next decade. In short, is 13th on the


World Economic Forum "Business Competitiveness Rankings" where we want to be, given the dynamic competitive forces such as the US and China at play in the world?

What is it going to take to enhance our global economic reach? Relative to China and India, Canada's competitiveness neither should nor can be based on wage costs; it has to be based on rising productivity, higher-end products and services, and human capital. Relative to the US, our competitiveness needs to be based on productivity, specifically closing Canada-US gaps, and the quality of our products, services and labour force. Finally, competitiveness means we need to be more attractive to global FDI, which increasingly shapes global trade and drives growth.


While the focus for these policy challenges is Canada, and the goal is

a prioritized list to concentrate public policy discussion, the lens must be decidedly global. We need also to be careful to avoid increasingly sterile distinctions between economic and social policy, between domestic and international policy. For example, is an effective immigration policy with efficient labour market integration a foreign policy, a social policy, an economic policy, just good 21st century public policy? Finally, in all our policy formulation and delivery, we need to focus on flexibility, adaptability and speed, in both the public and private sectors.


Kevin Lynch wrote this article while serving as Canada's executive director to the IMF in Washington. He was recently appointed Clerk of the Privy Council and served previously as deputy minister of finance and deputy minister of industry.



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