

An Economic Check-up: Complacency May Kill the Cat

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When I served in Washington, the city was full of legendary lawyers who glided effortlessly in and out of government and private practice. One day, an anxious client called one of those legends with a serious problem about a rumoured government measure that would affect his business. “What should I do?”

“Do nothing?” the lawyer said and sent him a bill for \$5,000.

A few days later, the still anxious client called back. “Why should I do nothing,” he demanded.

“Because I said so,” said the lawyer and sent him a bill for \$10,000.

I used to receive advice like that. Now, I get to give it!

When you are not a lawyer, it is one thing to be invited to join a law firm. But now, to be invited to speak to the Canadian Association of Legal Counsels! That is even a bigger leap. You may be relieved to know that I will not focus tonight on legal matters.

My talk is more about doctors, specifically economic doctors.

Let’s take the Canadian economy to the doctor for a stem to stern checkup. What would the doctor find?

Some good news and some not so good news.

The good news is that the patient looks and feels pretty good.

- Economic growth is reasonably strong and spread across the country;
- Inflation is under firm control, job creation is consistently robust and unemployment is at an historic low;
- Corporate profits are buoyant and the stock markets are at record levels;
- Canada is running strong trade and current account surpluses.

The not so good news is that the patient seems complacent about the future and has come to the examination with a definite “if it ain’t broke, don’t fix it,” attitude. So what are the troubling signs of this complacency?

- Sluggish productivity growth is one. Between 2001 and 2005, productivity grew on average only one percent compared to three percent between 1998 and 2000. Canadian productivity growth consistently lags behind our major trading partners and competitors;
- Languishing global competitiveness is another. The World Economic Forum places Canada twelfth, just below Taiwan and Israel, and just ahead of France and Australia. This is up from sixteenth a year ago but a long distance from where we need to, and can be;

- A drop in GDP per capita from fifth to tenth in global rankings, sure evidence that Canada has been slow in adapting to changes in the global economy;
- A large infrastructure gap from transportation networks to buildings to investment in human resources and innovation;
- Concerns about the “hollowing out” of significant Canadian companies.

The former chairman of the US Federal Reserve, Alan Greenspan, said earlier this spring “Serious trouble does not develop from problems that people worry about but from situations that nobody worries about.” And that seems to be our problem.

Canada is blessed with an abundance of natural resources – a crutch of convenience that has, to some extent, enabled us to achieve high growth rates without too much effort or ingenuity on our part. As the saying goes, “We were born on third base but think we hit a triple.”

In fact our economy is performing well below potential.

We need to challenge this complacency and start planning and committing for the economy we want tomorrow.

Do we see our future increasingly as part of a global economy or one shielded from, or indifferent to, a trend towards greater integration and freer movements of capital, goods and services?

Some Canadians on the Left hanker after the impossible: a dynamic, entrepreneurial, risk free economy where the government ignores the global dynamic, tries to pick the winners and look after the losers. Some European countries are finding that the result of striving for this kind of impossible is low growth and high unemployment. “Eurosclerosis” is what it was called a few decades ago.

As we experience an accelerating pace of globalization and technology change, the economy we need is one that embraces risk and entrepreneurship. We should hack away at policies and attitudes that are holding us back and establish a policy and business environment that coherently advances the national interest. We need decisions by governments that are bold and strategic, not merely tactical. We also need business leadership that inspires innovation and growth and helps stimulate a more competitive, more productive policy and regulatory environment.

A good place to start is with investment.

The case for foreign investment scarcely needs to be made. It is a vital part of the international economy.

In recent years, global foreign investment inflows have been growing on average by 30-40 percent annually. Global exports of goods and services have been growing at 2-4 percent.

Some 77,000 firms are multinational in their activities, each accounting for an average of ten separate foreign affiliates. Worldwide sales by foreign affiliates are nearly double worldwide exports of goods and services. That is a dramatic example of how global commerce is shifting.

Foreign investment in both directions contributes to enhanced productivity and competitiveness by encouraging product specialization and strengthening cross-border supply chains. When some two thirds of Canada-US trade is intra-firm trade, you can see how important foreign investment is to us.

For all its undoubted importance to Canadian prosperity, we remain seriously conflicted in our attitudes to foreign investment, both inward and outward. The result is unfocused debate and, on occasion, irrational policies.

The best recent illustration may be the curious budget proposal to rescind interest deductibility on foreign investment: a classic example of good intentions overwhelming common sense. Ottawa can be like that.

Both the process and the proposed solution were questionable, as were initial cost estimates about the impact. While remedies to prevent tax abuse may be needed, policy changes that have a dramatic effect on how Canadian business operates should only be undertaken after consultation and with due recognition of the policies and practices of our major trading partners.

International tax regimes are highly complex, even arcane. All the more reason why unilateral changes by Canada should be contemplated with equal proportions of caution and prudence.

The ensuing debate and the partial fix on “double dipping” have distracted attention from what should be the more fundamental issue: whether we have a business tax regime in Canada that is competitive, especially versus that of the United States. Canada currently has the sixth highest marginal effective tax on capital compared, in a recent study by the Royal Bank, to 36 leading industrial and developing countries. Our overall rate of 34% is well above the OECD average of 28%. It is mostly provincial taxes which make us uncompetitive and which should be the primary focus for reform.

All the tweaks, gimmicks and loopholes in our current tax regime simply mask the high overall rate. They should be replaced by a straight forward (across the board) lower rate that is genuinely competitive. That, in effect, was a key component in the policy mix that lifted the Irish economy from laggard to leader in Europe.

Rather than piecemeal solutions prompted by allegations about “tax havens” or “tax abuse”, we need a broad-gauged reform based on comparative analyses and direct consultations with relevant stakeholders, extending beyond the narrow policy corridors of Ottawa.

If the objectives are competitiveness and fairness, we need a tax regime that is attractive and equitable and preferably one that creates an advantage and not a handicap for operations in Canada.

If our policy framework is competitive, we will attract investment and stimulate economic growth. If it is not competitive, our economy will suffer. It is that simple.

The underlying message, however, is that business should not be docile or complacent when measures are proposed that would negatively affect their ability to grow and compete. Ottawa is a charming city (with a pretty good hockey team!) but it does not have a monopoly of wisdom.

‘Business’ should not be a pejorative term for government or our society more generally and yet, more often than not, the perceptions in Canada about business, notably big business, are more negative than positive.

Most politicians see value in small and medium-sized entities – the “bulwark of employment”, “the lifeblood of growth”, etc. Few see the direct link between the success of so-called ‘big’ firms and our much smaller enterprises. That is a story that needs better telling if business expects to gain the attention and a fair hearing from those with political power.

Since 1997, Canada has been a net exporter of foreign investment as Canadians are searching out and finding profitable opportunities in the global economy. This investment brings Canadian firms access to markets for exports, access to valuable sources of imports, and access to technology, critically, participating in global value chains. A recent KPMG study showed that Canadian firms are purchasing foreign assets at a faster clip than foreigners are buying Canadian companies.

One reason may be that, according to the OECD, Canada has the highest level of explicit restrictions on foreign equity ownership in the G-7 – primarily in the financial and telecommunications sectors. And yet, these are precisely the areas where technology changes are stimulating more global integration.

But, there are growing concerns that foreign acquisitions of Canadian business are “hollowing out” our Canadian economy. (Here too, there are suggestions about complacency, if not indifference, on the part of government and business.)

It seems to me that the current policy and regulatory regime would benefit from a full review. We should start by taking a very hard look at existing restrictions to see whether or not, or to what extent, they continue to serve any useful purpose.

We should strive for greater reciprocity generally and more transparency on investments. Should state-controlled entities, whether from Brazil or China or wherever, have the ability to acquire companies in our market while they are protected from similar actions in their market. Even some companies that are not state-controlled are shielded by regulations at home from takeovers by others. Is that fair or equitable?

Boards of public companies in the United States have greater scope to fend off hostile takeovers than do their Canadian counterparts. Bond holders in Canada are similarly disadvantaged. What objective or national interest do these differences serve?

At the same time, we should consider new criteria or review provisions or more precise definitions of “net benefit to Canada” that would enable us to safeguard sectors deemed to be vital and to bolster, not hobble, the few Canadian global champions we have. At a minimum, we should institute safeguards that would enable the government to review acquisition efforts by

state-controlled entities and by foreign investors whose home markets block Canadian companies from similar activity in their markets.

Virtually every country in the world, including the bastion of free enterprise on our southern border, has the means to review and block transactions in the name of national security or the national interest.

Remember too, however, that the “nationality” of a corporation may not be as significant as we might think. Thomson, which recently bid for Reuters for instance, is incorporated in Canada. Yet 81% of its sales are in the United States along with its main office and 70% of its assets. Only 2% of its sales and 5% of its assets are in Canada.

What matters even more than who owns significant operational assets in Canada is what is being done to ensure that they grow and provide long-term benefit for Canada. That should be the over-riding objective for any policy review.

Economic theory is one thing but rising nationalist sentiments may require some nimble political footwork on this issue.

It is not really a question of nationalism or fairness per se. There will never be a truly fair global standard for investment and there will always be nationalist undercurrents and not just in Canada. The objective of a full review would be greater fairness, more balance or reciprocity, more certainty and stability for capital markets and a more favourable climate for investment in Canada - with a focus that extends beyond the next quarter's financial performance.

Let me turn to Canadian trade policy. Like investment it needs a serious look. It is currently stuck in neutral and going nowhere fast.

The government tells us that its highest priority is the successful conclusion of the multilateral trade negotiations. The problem is that the Doha Round, as it is called, is in the Doha doldrums and Canada is no longer a member of the inner circle of countries that will determine the fate of these negotiations. It seems that all that the government (and Parliament) has to say about Doha is that Canada will be implacable in its defense of Canadian agricultural protectionism. It is no wonder that we are not a player in the big leagues in Geneva.

The government has ambitions to negotiate a series of bilateral free trade agreements but other countries, notably the United States and Australia, are well ahead of us. While Canada has negotiated only three agreements in the last 13 years, namely with Israel, Costa Rica and Chile, the US has concluded more than a dozen, including the recently announced agreement with South Korea. Australia has concluded 4 and has 7 more under negotiation. Even Chile with 10 agreements under its belt is racing ahead of Canada.

The March 2007 budget targets South Korea, Singapore, the Andean Community, the European Free Trade Association, and Caribbean and Central America countries for attention. “Success in these negotiations,” the Budget tells us, “will position Canada for further progress in opening markets for Canadian business.”

If bilateral agreements with this group make sense, why not negotiate such agreements with China or India, two of the largest and fastest growing economies in the world? Or Japan?

Why not break with Canadian tradition and think big as we did in negotiating the free trade agreement with the United States?

Frankly, I do not understand why we are pursuing any of these negotiations unilaterally and outside the framework of NAFTA despite the increasingly integrated nature of our North American economies. I have difficulty, too, understanding how the government will overcome the inevitable domestic opposition of Canadian protectionists to new agreements when it seemingly cannot overcome opposition to agreements that we have been negotiating now for several years with EFTA and 4 Central American countries.

We like to think of the United States' system of government as divided, gridlocked and incapable of clear decision-making. And yet, despite a weakened President in the White House and a Congress controlled by trade averse Democrats, Washington fashioned a consensus earlier this month to approve four more free trade agreements (Peru, Panama, Colombia and South Korea.) Contrast that with the paralysis of will on trade in Ottawa and you have to wonder.

On trade policy, the voice of the business community seems somewhat mute, dominated more by sectoral 'blockers' than by more broadly based promoters of trade liberalization. That needs to change.

The previous government abandoned a long-standing and reasonably effective consultative mechanism with the business community on trade negotiations in favour of a politically correct but ineffective process with civil society groups. The consequence is a trade policy that is nebulous, short term and more responsive to narrow protectionist interests than to longer term needs. In my view, the previous, sectoral consultation process should be re-activated.

Closer to home, other provincial governments should follow the excellent example of Alberta and British Columbia and dismantle internal barriers to trade and impediments to the mobility of labour, as well as obsolete or over-lapping regulations. Prime Minister Charest's proposal to negotiate free trade with Ontario merits strong support. Just imagine what Free Trade in Canada would do for our economy.

A sensible trade policy strategy begins right here at home where artificial barriers and out of date regulatory provisions thwart productivity. But those who favour more open trade have to speak up and against those who are opposed.

Trade and investment policy are not the only issues suffering from complacency.

We have a serious deficit in infrastructure, human capital and innovation. For too long, we have let the national infrastructure deteriorate. The signs are everywhere - clogged transportation in our big cities, crumbling bridges, roads and buildings, not to mention hospitals and schools. We have also underinvested in education and in research and development.

That, I suggest, is the real "fiscal imbalance" in today's Canada. There will be serious long term environmental and economic costs unless we give a higher priority, more funding and clearer accountability between levels of government to these essential building blocks.

Roger Martin of the Rotman School of Management points out that 64 cents of investment in education and infrastructure brings a dollar in return. If we instill a spirit of excellence over egalitarianism in our educational system and we upgrade our infrastructure to meet the challenge of globalization, we will strengthen both the scope and the capacity for innovation in Canada. It will not come from osmosis. We need facilities and educators that inspire imagination and innovation.

When Bill Gates visited Canada in February he posed a critical question. “What is our edge? What is our unique thing in North America?” His answer in essence was investing in education, changing the way we teach, changing the way we evaluate the performance of students and teachers, adapting to the latest technologies and experimenting. He urged direct engagement by the business community to drive interest and innovation in education. Gates concluded that the economies that make serious breakthroughs in education will succeed in an era when the world is indeed flat and the pace of global change is unprecedented.

The price of minority government may unfortunately be the triumph of short-term political tactics over the national interest.

But, complacency about the future is not confined to the government or public policy.

Think about the great Canadian firms like Eatons who thought that their past was their future and who are now history.

Think about the Eastman Kodak company who dismissed digital cameras as a passing fad and is now fighting to survive.

We need to nurture a healthier culture of entrepreneurship in Canada, stimulating and nurturing home-grown champions and substituting some competitive zeal for the timidity and caution so prevalent in Canadian Boardrooms.

With that diagnosis, the time is ripe to disabuse our patient of any belief in complacency.

If we truly believe our political rhetoric about the value of freedom let us adopt practices and goals that enable young Canadians to flourish with ideas and achievement. If we aim at less than the best, remember that the result will be second rate.

From governments, we need a policy framework – in terms of spending, tax, regulations and interprovincial barriers – that will facilitate productivity and innovation.

From the private sector, we need an appetite for risk as well as reward and a determination to adapt aggressively to the challenges of global competition.

Instead of a culture of entitlement, we need a climate of entrepreneurship

Most of all, we need a healthy partnership between the public and private sectors replacing complacency and inertia with commitment and action.

In closing, I would urge you to enlist the direct involvement of your CEOs and help stimulate a vision for Canada's future that moves us beyond a false sense of achievement to a more promising, more confident, more productive future.

As for each of you personally, well, eat your vegetables, go easy on the salt and get lots of exercise. That is what my doctor tells me!

Enjoy your dinner.