CANADA'S COMPETITIVE CHALLENGE: THE BUDGET AND BEYOND

BY JAYSON MYERS

Finance Minister Paul Martin stole the headlines in his last budget when he announced the elimination of the federal deficit. But, government budgets and fiscal policy are about more than keeping public sector finances in order. They set the course for economic growth-and they should be judged with respect to how well they respond to the key challenges and opportunities facing the Canadian economy.

Nine years prior to the FTA, back in 1980, Canadian manufacturers exported 25% of what they produced. Almost 73% of the manufactured goods purchased in Canada were made here. Today, nine years after the FTA, 62% of Canada's manufacturing production is being exported, approximately 53% of it into or through the United States. Meanwhile, the domestic market share of Canadian manufacturers has fallen to 38%.

From the point of view of Canadian industry, and especially Canadian exporters, the most important challenge that companies face today is maintaining and enhancing their competitive position in international markets. It's a matter of ensuring that the right product or service is delivered at the right price and at the right time to customers in Canada and around the world. And, it is also a question of attracting and retaining investment and product mandates in this country as other jurisdictions focus their attention on improving fiscal conditions, reducing tax rates, and ensuring a business climate that promotes productive investment, technological development, and job creation as an integral part of their fiscal strategies.

Competitiveness issues have gained prominence as Canadian industry has become increasingly integrated in the North American economy in the aftermath of the Canada-U.S. Free Trade Agreement. Nine years prior to the FTA, back in 1980, Canadian manufacturers exported 25% of what they produced. Almost 73% of the manufactured goods purchased in Canada were made here. Today, nine years after the FTA, 62% of Canada's manufacturing production is being exported, approximately 53% of it into or through the United States. Meanwhile, the domestic market share of Canadian manufacturers has fallen to 38%.

World markets today demand world class business practices. Canadian industry has to invest in cost-efficient, high-quality processes, in product innovation and the development of new markets, in their people and in new technologies in order to ensure customer success. Yet Canadian companies are lagging behind competitors from other countries when it comes to productivity improvement and innovation.

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The Alliance of Manufacturers & Exporters Canada surveyed its 3,500 corporate members late last year in order to determine their priorities with regard to competitiveness issues. Three issues stand out in the survey results:

1. Relatively high corporate tax rates put Canada at a disadvantage when it comes to attracting and retaining direct investment, while high personal tax rates are encouraging an exodus of skilled Canadians to the United States. Over 84% of members indicated in the survey that tax reduction should be a priority for the federal government; 65% say that high taxes are a significant impediment to inward investment and economic growth;

2. The need to keep up with the rapid pace of technological change and continue to innovate in order to service new markets and maintain profit margins in the face of more intense competition. As more open markets have intensified competition in international as well as domestic markets, Canadian companies have had to rely more and more on innovation, not only to increase operating efficiencies and lower unit production costs, but to differentiate themselves from their competitors through new design, the development of new products, innovative customer service, and the development of niche markets; and

3. Their ability to identify, recruit, and retain employees with the skills required by modern manufacturing and exporting businesses. About 31% of members reported difficulties in finding skilled workers last year. The five skills in greatest demand were in the fields of marketing, engineering, design, software development, and manufacturing management.

Even more of a challenge for Canadian companies is their capacity to retain skilled personnel in the face of a low Canadian dollar and relatively high personal tax rates that have made employment prospects in U.S. companies far more attractive than many Canadian firms can afford.

The federal budget was generally well received by Canadian industry, not only because of Ottawa's achievement in eliminating the deficit, but because the budget signals that targeted tax reductions, innovation, and education are also priorities for the Finance minister and the Chretien government. It's still fair to say, however, that there is a great deal of skepticism about the ability of the government to follow through with meaningful measures that will contribute to the capacity of Canadian businesses to compete for investment or sales in international markets. My overall grade for the government in putting together a budget that addresses the issues by competitiveness is a "B". Here's why.

[T]he release in April of the recommendations of the technical working group on corporate tax reform chaired by Jack Mintz are a disappointing combination of average tax rate reductions across all sectors of Canadian business and reductions in tax credits and allowances—including Canada's research and development tax credits—now enjoyed primarily by Canadian manufacturing and resource processing industries. The net effect of the Mintz recommendations would penalize rather than encourage investment and competitiveness of the one sector responsible for most of the innovation, export development, and over the past five years, for a large part of the job creation, in the Canadian economy.

The limited tax changes announced in the budget were aimed almost exclusively at personal taxes; but, they did little to encourage skilled personnel to remain in Canada or to make it easier for Canadian companies to fill the current skills gap affecting almost every sector of industry. Targeted tax changes were introduced, setting a precedent for corporate tax reforms in future budgets. However, the release in April of the recommendations of the technical working group on corporate tax reform chaired by Jack Mintz are a disappointing combination of average tax rate reductions across all sectors of Canadian business and reductions in tax credits and allowances-including Canada's research and development tax credits—now enjoyed primarily by Canadian manufacturing and resource processing industries. The net effect of the Mintz recommendations would penalize rather than encourage investment and competitiveness of the one sector responsible for most of the innovation, export development, and over the past five years, for a large part of the job creation, in the Canadian economy. The Mintz report has been tabled for discussion and does not (I hope) reflect the priorities of the Finance Department itself. It will set the stage for discussion and for tax reforms in future budgets.

Nevertheless, from industry's point of view, the issue of tax reform is an urgent one. In addition to real concerns over the impact of the tax changes recommended by Mintz, there is a general sense of disappointment that the government is still not in a position either to make corporate tax reform a priority issue or to be able to prioritize or even analyze those reforms with respect to their impact on the economy as a whole.

The government increased funding for its popular Industrial Research Assistance Program, but the amount of additional financing is limited by the fiscal constraints Ottawa continues to face. Meanwhile,

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the future of other programs in support of innovation, including the R&D tax credit system, has not been assured. The increasing complexity of interpretation under the R&D tax credit system has, in any event, significantly increased the cost of using the program for small and medium-sized companies.

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From industry's perspective, the budget shows that the federal government may have its priorities rights. But, it is still not clear that the government has a consistent strategy or the appropriate programs in place to encourage Canadian businesses to make the investments in people, technology, and new market development that are required in order to boost productivity growth and ultimately improve the competitive performance of the Canadian economy. Any business will tell you that it is important not only to cut costs but also to reinvest in order to grow. That is a lesson that Ottawa has to take to heart as Canadians respond to the competitive pressures of a global economy.

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