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Canadian Club Speech by Roger L. Martin

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I am pleased to speak to you today on behalf of my fellow members of the Task Force on Competitiveness, Productivity and Economic Progress. At issue is the competitiveness and economic prosperity of our province.

Let's start with the good news. Ontario is a terrifically-prosperous place by global standards. If it were a country, it would rank second in the world in prosperity. And it is actually larger in population than all but the U.S. in the top 10 countries. So it is the richest consequential jurisdiction outside America. This is very good news for Ontarians.

However, there is more sobering news, which we need to take to heart and take action on. We have looked closely at Ontario versus our true peers -- which are not small countries, because we are considerably more prosperous than them. Instead, we compared Ontario to the 14 U.S. states larger than half our size -- from Indiana and Massachusetts on the small end and New York and California at the large end.

Unfortunately, in this more elite group we rank 14th out of 15, ahead of only Florida. And worse still, our competitiveness and prosperity relative to this group are falling. In 1980, we ranked 11th and were $850/capita behind the median; in 2000 we ranked 14th and were $5,900/capita behind.

What does it mean to be $5,900 behind in GDP per capita? It translates almost exactly into $10,000 per Ontario household in after-tax disposable income. Think about it this way: $10,000 per Ontario household in after-tax income is slightly more than all the money spent in Ontario on mortgages, plus rent, plus new car purchases.

Raising our performance by $5,900 would fill the government coffers as well. It would enable Ontario to double annual spending on all levels of education with its portion and the federal government to use its Ontario portion to fund the entire Romanow bill.

So the harsh truth is, we are not keeping pace with the finest economies in the world. The difference between the standard of living in Massachusetts and Ontario is exactly the same as the difference between Ontario and Slovenia.

What explains the gap? At its simplest level, an economy generates prosperity when four factors are positive:

1) When a high proportion of its citizens are capable of working
2) When a high proportion of those capable of work both *want* to work and can find gainful employment
3) When those who do find employment, work hard
4) And when they work productively and effectively

We can relate Ontario's $6,000/capita gap to these four areas as follows:

1) On the first factor, it turns out that Ontario has more working age citizens proportionately than our peer states – providing us with an advantage of $1,000/capita

2) On the second factor, more Ontarians seek to work than those in peer states, but our unemployment rate is higher – creating a net disadvantage of about $750/capita. The state numbers are unavailable for 2002, but when they come out, they will probably show what the U.S./Canada numbers show, which is that Canada is $250/capita ahead.

3) On the third factor, Ontarians work approximately as hard as those in peer states – as of 2000, the disadvantage was $400/capita.

On the basis of the first three factors, Ontario is even with its peer states. Proportionately, it has as many people working as hard as the leading economies in the world. Nothing yet explains the $6,000/capita gap.

4) The fourth factor is the big challenge: productivity. When hard-working Ontarians work an hour, do they work as productively as a worker in the average peer state? The answer is no, to the tune of the entire gap of $6,000/capita. And why is that?

   Is it because they work in bad industries, industries that have lower productivity potential? The answer is no. We have done the most comprehensive analysis ever of the structure of Ontario industry against the structure of the peer states and in fact, Ontario has, on balance, a superior mix – that should result in an advantage of $1,000/capita if everything else were equal.

   Are these industries being hollowed out? That is, do we have the worst parts of the industries we are in? We don't yet have an absolutely definitive answer, but the initial data suggests strongly that the answer is no. In fact an analysis of two thirds of the industries suggests that the composition of our individual industries should provide an advantage of approximately $600/capita, other things being equal.

   This leaves an actual gap of over $7,000 per capita. There are two main pieces to the gap. First is our level of urbanization. It turns out that because of scale economies and the benefits of agglomeration, we can expect a worker in an urban environment to be more productive than one outside of an urban area. And Ontario is considerably more rural than its peer states – 72 per cent vs. 82 per cent, and as a result, we would expect Ontario's productivity to be $3,000 per capita less than the median of our peer states.

   That leaves a gap of over $4,000/capita per person – for a worker in the same part of the same industry in the same type of environment. What accounts for the remainder? We don't fully know yet, but there are pieces of the puzzle that we do know and others that we are in the process of exploring.

In total, we posit four pieces:

a. The clearest piece of the puzzle is **investment**. In two critical ways, we invest significantly less in enabling our workers than our peer states.

The first is investing in machinery and equipment (M&E) that makes workers more productive. Over the past 20 years (and probably more, but that is as far back with the data that we have gone) Ontario enterprises have invested 14 per cent less in M&E annually than the enterprises of our peer states. Suffice it to say, 14 per cent per year, decade after decade, adds up.

The second is in higher education. While Ontario invests as much in K-12 and colleges as its U.S. peers, the U.S. peers invest just less than double – per capita and per student – in university education.

And by U.S. peers, we don't mean governments. We mean the entire jurisdiction, from all sources, including government funding, tuition and donations.

In total, we graduate 92 per cent of the university students annually and spend 55 per cent per student compared to our peer states.

This is a major problem for productivity. The data is extremely clear: Higher levels of education are tightly correlated with higher wages, and higher wages are tightly correlated with higher productivity.

So more education produces more productive workers.

On this front, then, we invest considerably less to produce considerably less productive workers on average. So investment is the first explanation and the data is quite clear: We invest less and we get less.

b. The second issue, related to the first, is **motivation** – motivation as individuals to work and invest, and motivation as firms to invest. Motivations are influenced by the marginal tax rates faced by labour and capital.

Ontario's marginal tax rates on labour and capital are considerably above those of our representative peer states, suggesting that our motivations to work and invest are lower – which may partially explain the investment numbers I touched on earlier.

c. The third issue, which is related to investment and motivation, is **aspirations**. We are analysing this question as we speak, but our view from the initial data is that Ontario firms have systematically lower aspirations with respect to competing internationally than their peer states.

This results in lower investments in R&D, branding, international distribution, and innovation in general.

d. The fourth issue is the **structures** of our key markets and institutions. On this front, we know that one feature of the Ontario structure is that government is more highly involved in the economy than in the peer states when measured by the government's revenues as a share of GDP. Ontario's is higher than all peer states other than Florida, which is poorer than Ontario. And this may have an effect.

The net combined effect, we hypothesize, is that because of lower aspirations, we invest less -- in education and M&E -- and we are motivated to aspire lower and invest less by high marginal tax rates on capital and labour. And these high marginal tax rates are a product of a structure by which our governments process a higher share of our output than those of our peers.

So what does Ontario need to do to close the $6,000 per capita gap in prosperity – or more to the point, the $7,000 per capita gap in productivity?

The $3,000/capita attributable to our rural structure will take a long time and may not be in the interests of Ontarians in general. But what about the $4,000/capita gap in effectiveness? Some suggestions:

1) We need to raise our aspirations with respect to upgrading ourselves and the way in which we compete. This is doable. We just need to try harder.

2) We need to figure out how to tax in a more effective manner -- one that enables us to collect the revenue we need without producing the high marginal rates that reduce motivations. This is not a race to the bottom. Massachusetts, now the richest jurisdiction on the planet, has figured out ways to collect substantial revenues in a way that appears less harmful to motivations.

3) We simply need to invest more in our future prosperity. This includes both M&E and higher education. We need to invest more instead of consuming. Our work on this question is incomplete, but from what we can tell, the various levels of our government spend more on consumption of current prosperity versus investment in future prosperity compared to our peers.

   In aggregate, Ontario and our 14 peers spend the same proportion of their total spending – 32 per cent -- on a combination of debt service, basic government operations, environment and protection. Of the remaining 68 per cent, they can choose to spend on consumption of current prosperity – health care, social security, social services, income stabilization, culture and recreation – or investment in future prosperity – education, transportation and communication, infrastructure, research and development.

   Ontario's proportion is 72 per cent consumption and 28 per cent investment. The peer states show a markedly higher 36 per cent proportion of investment.

> This is a big deal. If our proportion were the same as the peer states, it would mean $6.5 billion per year in greater investment in the province of Ontario, or $65 billion per decade.
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> That would mean a vastly different future, a future more like that of Massachusetts, which can spend 3 per cent more than Ontario per person on current needs while continuously spending 50 per cent more on generating future prosperity.

I believe this is doable – but it will take the will of individual Ontario citizens, of Ontario corporations and of our governments – provincial, federal and municipal. It will take a new kind of will, the will to overcome the comfortable-but-unproductive status quo.

I will give an example of one such issue: university tuition, which is currently regulated at a level of $4,100 for everything except professional schools. And that level is in the middle of five years of increases regulated at 2 per cent -- considerably below inflation, so that real tuition will fall steadily over the five-year period.

And before the conclusion is jumped to that this is all about self-interest, I want to make clear that all the programs in my school are deregulated already, so what I am talking about would not help me at all.

Thankfully, this government deregulated professional school tuitions in the mid-1990s. Had they not done this, I most certainly would not be Dean of the Rotman School, nor chairman of the Task Force on Competitiveness, Productivity and Economic Progress. When Rob Prichard first asked me to consider taking this job, my first reaction was to decline. A key reason was that I had been out of Canada for long enough to have been unaware of the deregulation of professional school tuitions. And my assumption was that they were still regulated. I felt that there was no reason to consider leading a school that had absolutely no chance to compete internationally. But fortunately, the current government made the change, and as a consequence we have taken on the challenge of building a globally-competitive business school in Ontario – as have several of our fellow schools.

Let's explore the facts regarding regulated tuition:

Level of education is tightly correlated with wages, productivity and prosperity: a better educated population makes for a more prosperous province.

That notwithstanding, we invest only half the level of our peers states in higher education. We do this by having a system that, until very recently, has been a regulated monopoly – only public universities were allowed. And our provincial government, in addition to reducing real funding, maintained strictly-regulated tuition at a low level, and one that has been falling in real terms.

So students and their parents are prevented from investing in the very universities that the government under-funds. This suppression of tuition is bad for the prosperity of our province.

That notwithstanding, there is a universal consensus that tuition should be suppressed – an absolutely rock-solid, universal consensus.

Each political party believes it strongly. The Progressive Conservatives have been and continue to be committed to falling real tuition. The Liberals have promised to go further and freeze tuition. And the NDP -- who knows?

But none of the parties are crazy. Their polling numbers show that the electorate is overwhelmingly behind suppressing tuition. And students are vigorously and vocally against any increases in tuition. Even university professors are generally against increases in tuition.

So what supports and sustains this powerful consensus? First, it is comfortable. 'No increase' feels better -- for all the above groups -- than does an increase and the hassles that would come with it.

Second is the issue of access. The fear is that with higher tuition, access will be impacted negatively. This is a very important issue, which we should explore.

Tuition is indeed higher in the U.S. -- including our peer states – though not nearly so much higher as the comparison to US$35,000 Ivy League tuitions make it sound. Fifty-four percent of full time U.S. students pay tuition (including fees) of US$5,000 or less. Many pay a lot less, and the average across all full-time students is US$9,000. So tuition is indeed higher in the U.S. -- and that logically creates a question of access.

However, it must be understood that increased education has a strong private return to the individual for each increasing level of education. This is well-documented. Thus, it is in the student's interest to invest in his or her education because it pays off.

So, if the higher tuition in the U.S. discourages access among less well-to-do students, we should expect to observe higher participation rates in university education among the poor in Canada versus the U.S. – otherwise there would be no accessibility problem linked to higher tuition levels.

And among well-to-do kids, we would expect equally high participation in Canada as in the U.S., because they should be insensitive to the cost of education and should understand the economic benefit to which I just referred. If anything participation among wealthy kids in Canada should be higher if they show any price sensitivity at all.

In Canada, wealthy kids should participate at a rate at least as high as in the U.S., and poor kids at a greater rate. We should observe higher participation in Canada than the US, if accessibility is real problem.

So let's go to the data. Per 1,000 of population, the U.S. graduates more university students per year than Ontario by 8 per cent -- and more than Canada by 23 per cent: This is the opposite of what the above accessibility theory holds.

So the U.S. has managed to deal with its accessibility problem better than Canada despite higher tuition. That is, unless our accessibility to the poor is higher, and our overall numbers are lower because our wealthy kids skip university because they are lazier and less intelligent than their U.S. counterparts. I don't believe this.

The political left, in particular, has this issue all wrong. It should actually read more Karl Marx, who in 1890 launched a blistering attack on subsidized university tuition, arguing that it is simply a subsidy for the rich out of general tax revenues. He is right, and the left is wrong. High tuitions in the U.S. help to fund generous scholarships for needy students. Is U.S. accessibility perfect? Hardly, but higher U.S. tuition has not led to lower accessibility than in Ontario.

And the conservatives have it wrong as well. True economic prosperity depends heavily on higher education, and starving higher education isn't helping a bit.

Students also have it wrong. This is the most important investment they will likely make in their lives, and suppressing its quality does nobody a bit of good. And parents have it wrong. This is the best investment they can make on behalf of their children.

Basically, this is an issue in which every relevant constituency is dead wrong -- and they have no logic or data to buttress their views. The status quo is comfortable, and remains well entrenched in an unwitting conspiracy of corrosive complacency. As such, it is a challenge of will: will to do the best thing for Ontario's future.

Ontario faces a choice. We need to show will on this issue if we are to reverse the slide and close the prosperity gap. Without will, we will continue to slide, and in relatively short order, will lose complete touch with the lead pack of prosperous economies.