

# POLICIES FOR STRONGER AND MORE INCLUSIVE GROWTH IN CANADA

Better Policies Series

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# Foreword

Canada has experienced solid improvements in living standards in the last two decades and enjoys a higher quality of life than many other OECD countries. GDP per capita is above the OECD average, and Canadians enjoy better environmental quality and better health outcomes than the average in OECD countries. Canada's employment rate is well above the OECD average, and Canada is also one of the strongest OECD countries in terms of students' skills.

However, not all population groups enjoy equally high levels of well-being. Although Canada is one of the few OECD countries where inequality did not rise during the 2000s, inequalities in income and other dimensions of well-being remain higher than in the OECD countries with the lowest inequalities. This suggests that Canada can do even better. Incomes for the top 10% of the income distribution are, on average, nine times higher than for the bottom 10%, compared to five and six times higher in the best-performing OECD countries. Moreover, even though the share of middle-income households has barely changed over the last 15 years, fewer and fewer Canadian households perceive themselves as belonging to the middle class.

The government under Prime Minister Justin Trudeau is determined to tackle these issues, to strengthen equality of opportunity and ensure that every Canadian has the chance to succeed in life. This brochure has been prepared to help the Canadian government identify key policy reforms that would help the country achieve more inclusive growth. Specifically, it suggests that action is required on three main fronts.

First, the Canadian government needs to help Indigenous people, women, older workers, migrants and people with mental health problems to better integrate into the labour market. Currently, all these groups fare worse than the average Canadian in terms of labour market outcomes. To this end, the government needs to strengthen the skills of Indigenous people, put in place better family-friendly supports, strengthen training for older workers, advance the recognition of foreign qualifications and better leverage education institutions and employers to foster good mental health.

Second, since efforts to ensure that all individuals have the opportunity to lead meaningful and productive lives rely on a flourishing business sector, the government also needs to address the slowdown in productivity growth. As in other countries, this slowdown is linked to a growing divide between high-productivity frontier firms that make use of cutting-edge technology (including digital technologies) and other firms. Repairing the technology diffusion machine requires creating a competitive playing field for firms, including through regulatory reform and more targeted support for small business, and helping small firms grasp the opportunities of the digital revolution.

Third, the government needs to continue its efforts to modernise the public sector and strengthen public governance. The multidimensional nature of inclusive growth calls for solutions that are well co-ordinated within and across levels of government. This is particularly challenging in such a highly decentralised country as Canada. A number of important steps have already been taken, including the Canada Free Trade Agreement and the Pan-Canadian Framework on Clean Growth and Climate Change.

Only through complementary reforms in all these areas will Canada be able to succeed in further enhancing the well-being of all its citizens. The OECD looks forward to supporting the Government of Canada in this endeavour as it designs, promotes and implements better policies for better lives.



Angel Gurría  
OECD Secretary-General



# Editorial

Globalisation and technological change are transforming the way the Canadian economy functions, creating tremendous opportunities for growth but also risking higher inequalities. The Canadian economy increasingly operates on a global scale, in a world economy where capital and high-skilled labour are internationally mobile, partly as a result of intensive technological change, and particularly digitalisation, which reduce mobility costs and enhance access to new business opportunities. Canada scores highly in many well-being dimensions but challenges remain as certain inequalities of outcomes and opportunities persist.

The OECD's Inclusive Growth initiative provides an ideal framework for better understanding the challenges that Canada's increasingly globalised economy implies for inclusiveness and for identifying the mechanisms through which policies can ensure that everyone has the opportunity to succeed in life. The framework underscores the vicious circle by which inequalities of outcomes, in particular income, lead to inequalities of opportunities, which in turn reinforce inequalities of outcomes. It builds on the OECD's longstanding expertise on inequalities, growth and productivity dynamics, as well as on well-being, and underpins the OECD's New Approaches to Economic Challenges efforts to develop a new paradigm of economic growth that generates improved well-being for all. The framework also builds on the OECD's analysis of the nexus between productivity and inclusiveness, which suggests that promoting inclusiveness is key to stronger and more sustainable productivity growth and conversely, that a dynamic environment for business and innovation is a pre-condition for reducing inequality and opportunity gaps.

This report applies the Inclusive Growth framework to the analysis of two aspects of Canadian performance, (a) well-being inequalities and (b) productivity growth. It finds that the Canadian economy has grown robustly since the turn of the century and recovered more strongly from the global financial crisis than most other OECD countries. But stagnating productivity and weak business dynamism are a concern. Aggregate firm entry and exit rates and the entrepreneurship rate have been falling since the 1980s. Labour productivity, whilst high, is rising more slowly than in the United States and Australia. The shortfall in labour productivity performance compared to relevant peers is largely due to a deterioration in multi-factor productivity growth, as capital intensity actually rose more quickly in the recent period than in the 1990s. This trend is likely to continue for some time, as GDP growth potential slows and Canada's population ages because of low fertility rates and rising life expectancy.

In terms of inequalities, Canada's performance is similar to the OECD average. Differences in health outcomes as well as education and skills between people with high and low socio-economic backgrounds are even smaller in Canada than the OECD average. Moreover, overall labour market outcomes of immigrants are above those observed in other OECD countries. Canada also does relatively well in terms of gender equality, even though it has not progressed in this area recently. Still, a number of challenges remain as certain inequalities of outcomes and opportunities persist, particularly for Indigenous people, who suffer from various social problems, including living in sub-standard housing, and a higher likelihood to drop out of school, to take up smoking and heavy drinking and to have health problems. They are also 20% less likely to be employed than their non-Indigenous peers.

Canada has already begun responding to these challenges. The federal government is seeking to engage more women and Indigenous people in the labour market, and find ways of boosting productivity growth through increased competition, innovation and skills. To overcome barriers to equitable access to tertiary education, the federal government is increasing targeted needs-based financial assistance, improving the transparency of the aid application process, and expanding information about returns to education. The federal government has also made improving outcomes for Indigenous people a top priority. Moreover, Canada has attempted to boost business dynamism in recent times through measures such as the

Paperwork Burden Reduction Initiative, the Red Tape Reduction Action Plan and the Venture Capital Action Plan.

However, more progress can be made. Fostering growth that is *both* stronger and more inclusive requires countries to create equality of opportunities *ex ante* so that everybody has a chance to thrive and contribute to economic activity, rather than focusing on fixing an unequal distribution of well-being *ex post* through redistribution. This means that the whole range of policy levers available to governments needs to be reassessed to make sure they explicitly take equity considerations into account. To this end, an integrated fiscal policy agenda should be adopted to reduce inequality not just through tax-and-transfer redistribution but by making the pre-tax distribution of income more equal as well, for instance by supporting private investment in human capital. Targeted early childhood care and education support for disadvantaged families and Indigenous people should be expanded. This includes removing barriers to early childhood education and care services for those in need, helping poor parents connect to the resources they need to educate their children and investing in lifelong-learning programmes. Canada also needs to enhance its business dynamism. This can be achieved through regulatory reforms that make it easier for young firms to enter markets and provide them with easier access to finance and stronger contract enforcement, providing direct support and tax incentives for all firms to carry out R&D regardless of size, and reducing compliance costs through the use of digital technologies.

The OECD stands ready to use its inclusive growth framework to help Canada create a more equal society in which all people and firms can thrive.

A handwritten signature in black ink, appearing to read 'Gabriela Ramos', with a horizontal line underneath the name.

Gabriela Ramos  
OECD Chief of Staff and Sherpa

# Key recommendations

Canada needs to reinforce policy efforts to build a prosperous and inclusive society. To this end, policy action is needed to enable all Canadian people to be well integrated into the labour market and contribute to economic prosperity, to give all Canadian firms a chance to create jobs, enhance their productivity and disseminate innovative ideas, and to put in place strong governance structures that support inclusive growth objectives. Specific reforms that could help Canada achieve these goals include the following:

- Support growth-oriented entrepreneurship by women, including by removing unwarranted restrictions on the eligibility of part-time entrepreneurs to public enterprise support programmes and scaling up supplier-diversity initiatives
- Continue building the governance capacities of First Nations, Inuit and Métis communities, and facilitate the exchange of information about successful approaches to employment and job creation.
- Expand the access of older displaced workers to more intensive job-search assistance, case management and training, particularly for those who are affected by small-scale or individual displacements or ineligible for Employment Insurance due to severance payments.
- Establish an institutional mechanism, such as the OECD's Competition Assessment Toolkit, to review existing and proposed public policies, identify those that unduly restrict competition and revise them by adopting more pro-competitive alternatives, where feasible without jeopardising other policy objectives such as inclusiveness.
- Strengthen Canadian small businesses' skills for the digital economy, including through coaching programmes to extend digital literacy.
- Review small business taxation to identify clear market failures and the policy instruments best suited to addressing them.
- Consider strengthening the measurement of public sector productivity, including by measuring outputs beyond the education and health sectors and strengthening intra-governmental co-ordination on productivity measurement.
- Better target policy co-ordination and dialogue between the three levels of government to productivity and competitiveness priorities.
- Ensure effective and timely implementation of the Pan-Canadian Framework on Clean Growth and Climate Change, establish a mechanism for policy evaluation and adjustment, and promote co-ordination of sub-national climate policies.

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# 1 Introduction

After two decades of solid growth of household disposable income and living standards more generally, Canadians enjoy a high level of well-being. GDP per capita is above the OECD average, and the country is one of the strongest OECD countries in terms of students' skills. Canadians enjoy better environmental outcomes than the OECD average and also live healthier lives. However, disparities persist: not all population groups have benefitted equally strongly from past improvements in living standards. Income inequality is close to the OECD average and has remained broadly stable over the last 15 years, but the tax and benefit system is less redistributive than those in most OECD countries. At the same time, productivity growth has slowed down, limiting the potential for further improvements in living standards. The cross-cutting challenge presented by the persistence of multidimensional inequalities and weak productivity growth underlines the need to reappraise Canada's policy-making process with the aim of fostering stronger and more inclusive growth. The government's commitment to strengthening the middle class and providing all those who work hard the opportunity to join it is very welcome in this regard.

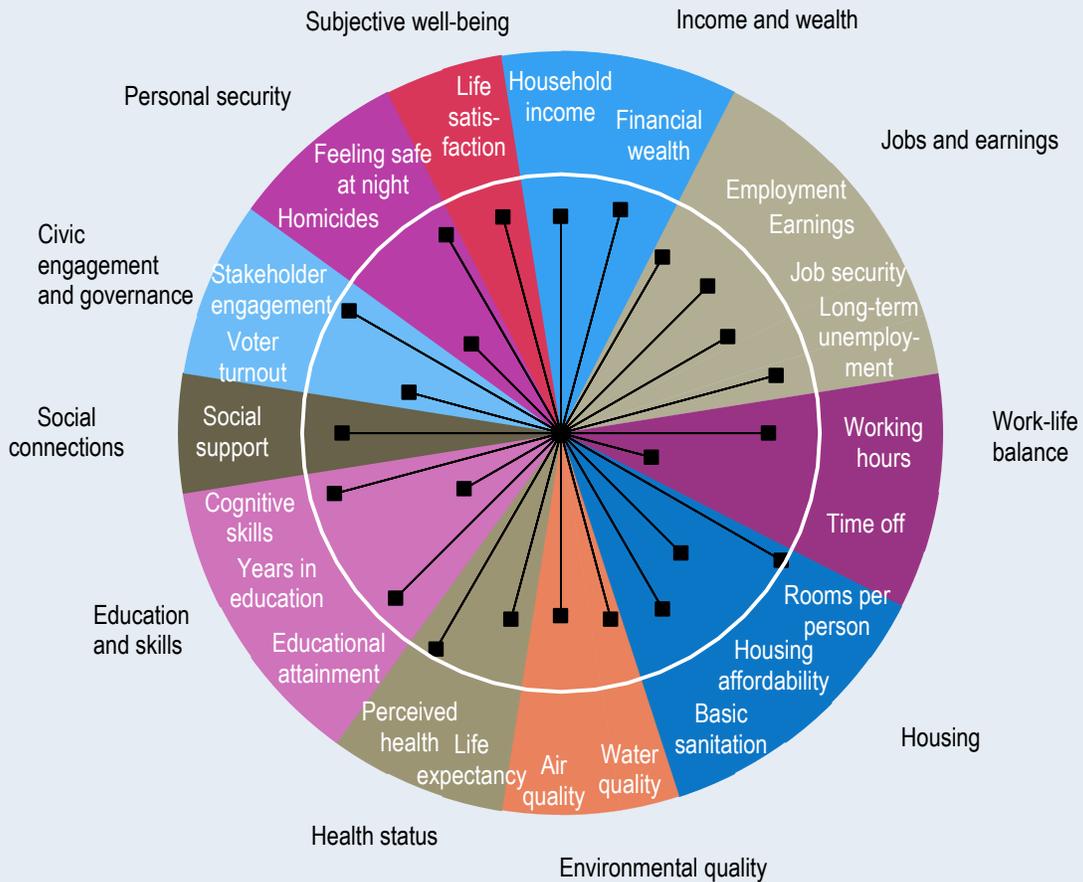
## On average, well-being is high in Canada

Canada performs strongly in terms of the well-being of its citizens (Figure 1.1). In many areas of the OECD's Better Life Index, the country scores among the top-performing OECD countries. Canadians are more satisfied with their lives than the OECD average. When asked to rate their general satisfaction with life on a scale from 0 to 10, Canadians gave it a 7.4 grade in 2015, well above the OECD average of 6.5. GDP per capita is

relatively high (USD 44 963 in 2016, compared with the OECD average of USD 42 096), as is the employment rate (72.6% in 2016, compared to the OECD average of 67%). Canadians enjoy better air quality than the OECD average (the level of tiny air pollutant particles was 12.1 micrograms per cubic meter in 2013, compared to the OECD average of 14.05 micrograms per cubic meter), better water quality (90% of people said in 2015 that they were satisfied with the quality of their water,



FIGURE 1.1. HOW'S LIFE IN CANADA?



Note: The centre of the circle depicts the worst-performing OECD country and the white circle depicts the best-performing OECD country. The black dots at the end of the black lines depict the performance of Canada. Longer lines show areas of relative strength, while shorter lines show areas of relative weakness.

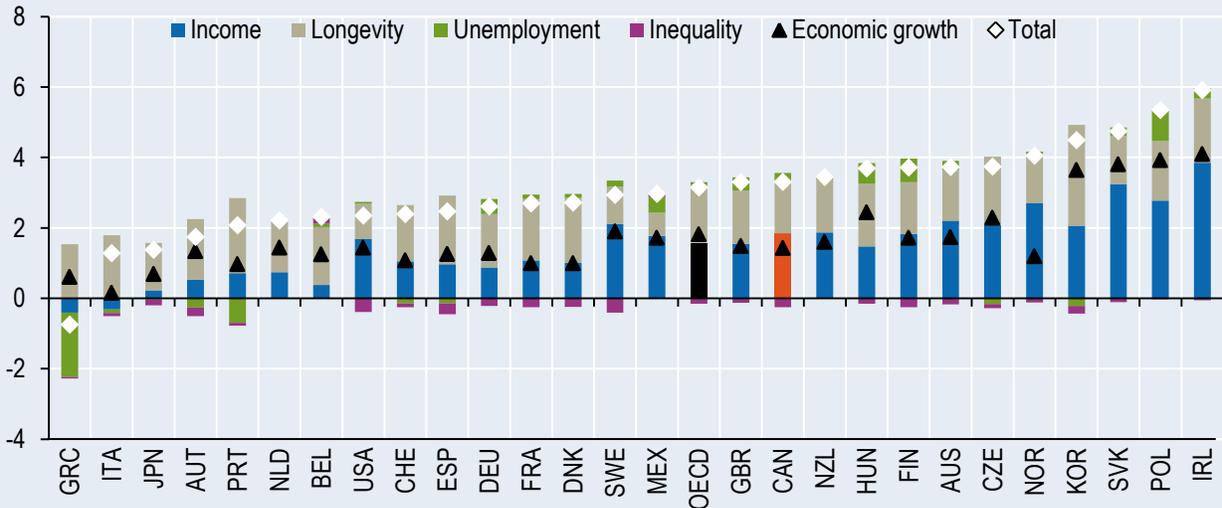
Source: OECD Better Life Index, 2016.

compared to the OECD average of 81%) and better health outcomes (89% of Canadians rated their health as good in 2013, one of the highest shares among OECD countries). And there is a strong sense of community among Canadian citizens. In 2015, 94% of Canadians said that they know someone they could rely on in time of need (higher than the OECD average of 88%). Canada is also one of the strongest OECD countries in terms of students' skills. In the OECD's Programme for International Student Assessment (PISA), the average Canadian student scored 523 on average in reading literacy, maths and science in 2015 (well above the OECD average of 486).

But there are also a number of areas in which Canada performs less well. For example, while overall living conditions are very good (Canada has the highest number of rooms per person in the OECD), housing expenditure is high, with 43% of low-income renters spending more than 40% of their disposable income on rent in Canada (5 percentage points more than the OECD average). Moreover, full-time employees on average report having less time off (i.e. time spent on leisure and personal care) than full-time employees in most other OECD countries. While the unemployment rate has fallen over the last year, at 6.7% it was still above the OECD average

FIGURE 1.2. LIVING STANDARDS HAVE BEEN RISING RAPIDLY IN CANADA

Growth of multidimensional living standards, median households, in % 1995-2015



Note: Calculations on income inequality are based on an inequality aversion parameter equal to 1.5 and are based on the difference between the income growth of the average income and that of the median income.

Source: OECD calculations based on OECD Annual National Accounts; OECD Income Distribution Database, <http://www.oecd.org/social/income-distribution-database.htm>; and OECD Health Database, <https://data.oecd.org/health.htm>.

of 6.3% in the first quarter of 2017. Canada also scores less well in terms of personal security. While Canadians generally feel safe when walking alone at night, the homicide rate is higher than in most other OECD countries.

Canada's good performance on the OECD's Better Life Index is also reflected in two decades of rapid improvement on the OECD's index of Multidimensional Living Standards (MDLS), which combines household average disposable income, life expectancy at birth, the unemployment rate and income inequality. Focusing on households with median disposable income, Canada had the fastest growth rate of MDLS among G7 countries over the last two decades (Figure 1.2). The substantial margin by which MDLS growth (3.3%) exceeded income growth (1.9%) reflects a large increase in longevity and a decline in the unemployment rate over the period.

### **Inequality is not particularly high in Canada, but the gap with the most equal OECD countries is sizable**

Income inequality in Canada is close to the OECD average. As measured by the Gini coefficient, income inequality in Canada is close to the OECD average, lower than in the United States, but

higher than in some European countries (Figure 1.3). In Canada, taxes and benefits reduce income inequality among the working-age population by 21% (i.e. the Gini coefficient for household disposable incomes is 21% lower than for market incomes, which are before taxes and transfers). This is below the OECD average of 25% and well below the redistributive effects of the tax and benefit systems of some European countries (e.g. 28% in Germany, 34% in France and 41% in Ireland), but above that of the United States (18%).

Although inequality increased considerably in Canada in the 1990s, reflecting both widening disparities in market wages and weaker redistribution through taxes and transfers, Canada is one of the few OECD countries where inequality did not rise during the 2000s and throughout the economic crisis. This is partly explained by stagnating incomes at the top end of the income distribution and a slight increase in the middle, although low incomes also stagnated between 2008 and 2011. Income inequality has also remained stable during the recovery. Households at the top and the middle experienced higher income growth between 2011 and 2013, while

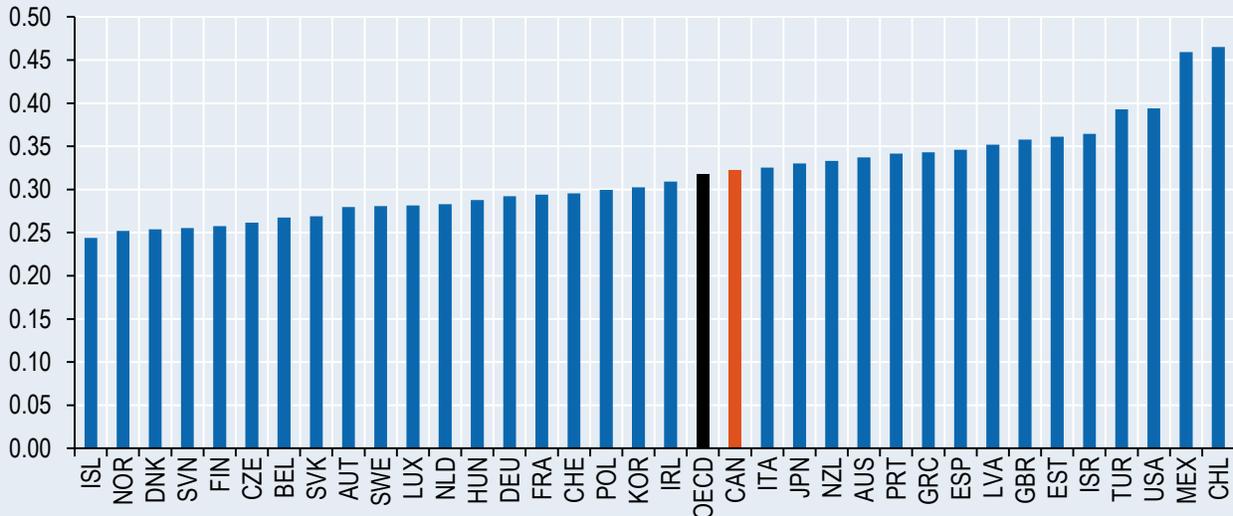
lower-income households caught up in 2014. Canada’s poverty rate declined slightly in recent years, to 12.6% in 2014 (about 1 percentage point above the OECD average of 11.5%).

High inequality hinders social mobility because low-income parents are not able to invest as much in their children’s education and development as high-income parents, and they do not have access to such strong social connections to help their children get ahead. In terms of social mobility, Canada performs quite well over a number of different dimensions, including health, earnings, social class and education, compared with other countries. For instance, on average across the OECD, children with lower-educated parents have just a 13% chance of attaining tertiary education, while about 42% remain with lower education attainment. By contrast, in Canada, similar individuals will actually be more likely to attain tertiary education (a 33% chance) than to stay at the same level as their parents (20%). Similarly, the degree of persistence between parents’ and children’s social class and earnings is below the OECD average. Indeed, the elasticity between father’s and son’s earnings is 0.32 in Canada, but close to 0.4 on average in OECD countries.



FIGURE 1.3. INCOME INEQUALITY IN CANADA IS CLOSE TO THE OECD AVERAGE

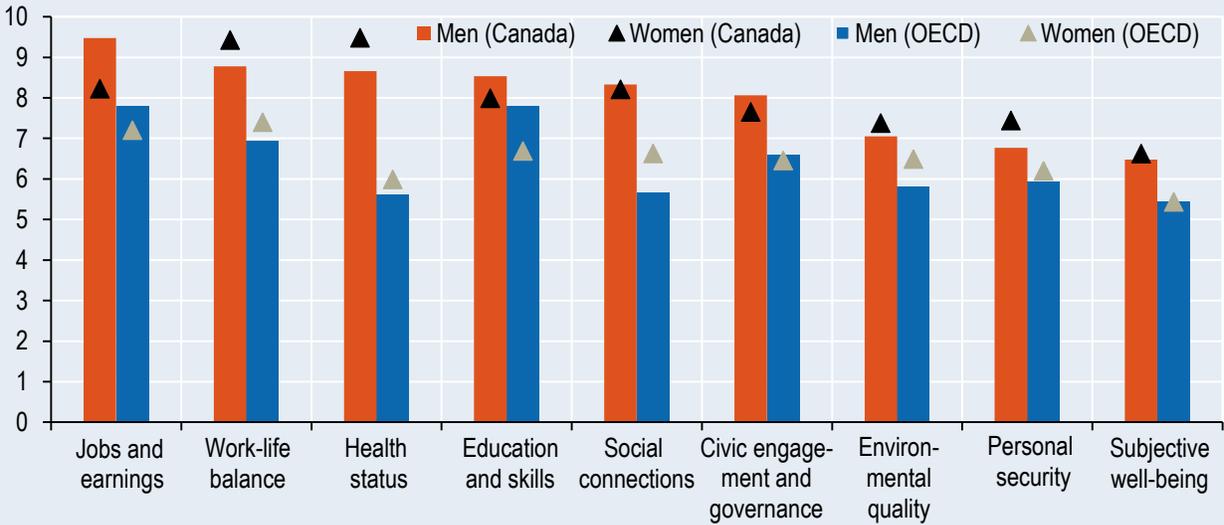
Gini coefficient of disposable income inequality, from 0 (most equal) to 1 (most unequal), 2014 or latest available year, total population



Source: OECD Income Distribution Database, <http://www.oecd.org/social/income-distribution-database.htm>.

FIGURE 1.4. **DISPARITIES IN WELL-BEING BY GENDER ARE SOMEWHAT LARGER THAN THE OECD AVERAGE**

Normalised scores on a scale from 0 (worst condition) to 10 (best condition)



Source: OECD Better Life Index, 2016.

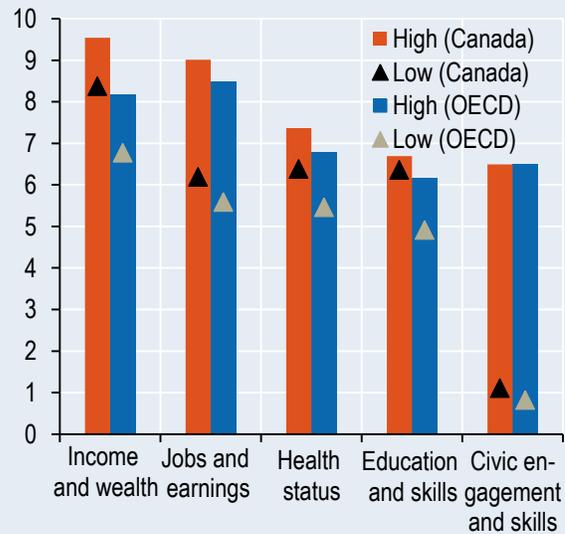
As in most other OECD countries, women score less well than men in the OECD’s Better Life Index on the dimensions of jobs and earnings, environmental quality and personal security (Figure 1.4). With the exception of personal security, the gender differences are smaller in Canada than the OECD average. Women outperform men in terms of education and skills, health status, work-life balance and subjective well-being, with a larger gap than the OECD average in all areas with the exception of work-life balance. Canadian women are less likely to be employed than men and have lower average earnings than men. However, the proportion working 50 hours or more per week is five times lower for women than for men, and women are more likely to have attained at least an upper secondary qualification. With respect to women in public life, Canada is below the OECD average when it comes to representation in the lower house parliament (26.3% in 2017 compared to the OECD average of 28.8%), though in the executive, it has established gender parity in its Cabinet at the federal level. In terms of social connections and civic engagement, gender differences in Canada are very small.

There are large differences in well-being between people with high and low socio-economic background (Figure 1.5), albeit smaller than the OECD average. Incomes for the top 20% of the

income distribution are, on average, five times higher than for the bottom 20%, compared with the OECD average of six times. Canadians with a tertiary

FIGURE 1.5. **WELL-BEING DISPARITIES BY SOCIO-ECONOMIC BACKGROUND IN CANADA ARE AROUND THE OECD AVERAGE**

Normalised scores on a scale from 0 (worst condition) to 10 (best condition)

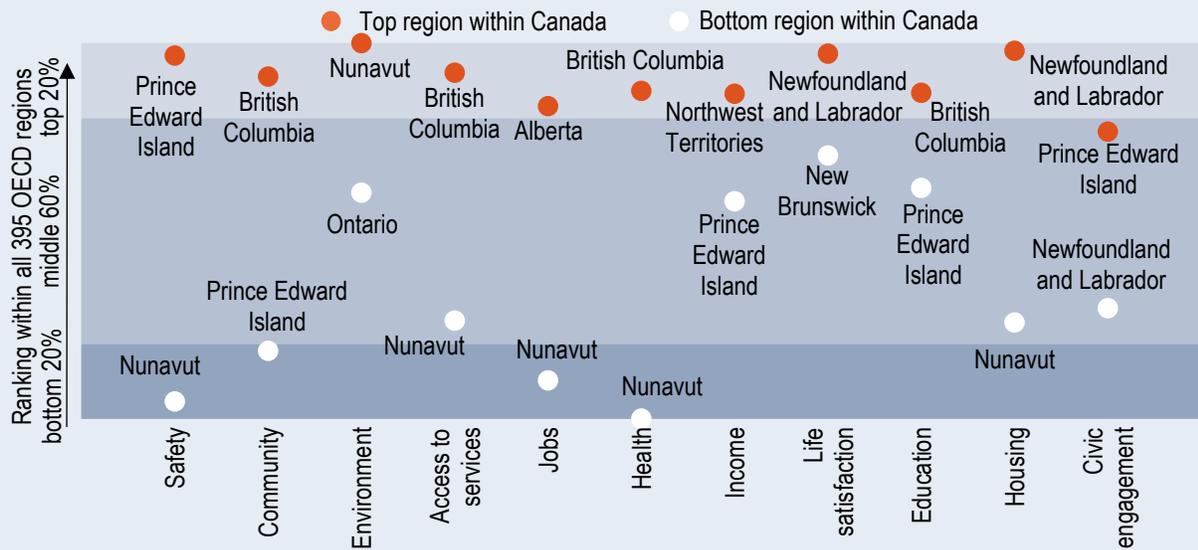


Note: High/low socio-economic background (denoted “High”/“Low”) is defined as having a disposable income among the top/bottom 20% or having attained tertiary/only primary education.

Source: OECD Better Life Index, 2016.

FIGURE 1.6. REGIONAL DISPARITIES ARE RELATIVELY HIGH IN CANADA

Relative performance of Canadian regions by well-being dimensions



Source: OECD Regional Well-Being Database, <https://www.oecdregionalwellbeing.org>.

education are more likely to be employed, less likely to be in long-term unemployment and earn almost two-and-a-half times more than Canadians with less than upper secondary education. Conversely, there are relatively smaller differences in health status, education and skills and civic engagement and governance. However, people with a disposable income among the top 20% tend to report better health and are more likely to vote, and students with higher socio-economic background perform better in school.

There are also large regional disparities in Canada (Figure 1.6), particularly in the areas of safety, health and jobs. However, these disparities are largely due to the particular challenges faced by the sparsely populated territory of Nunavut. Moreover, regional disparities are smaller than in some other OECD countries, such as the United States or Australia. It should also be noted that the high-performing Canadian regions fare better than the OECD average in all dimensions of the OECD's Better Life Index, and even the low-performing regions perform better than the OECD average in relation to education and access to services.

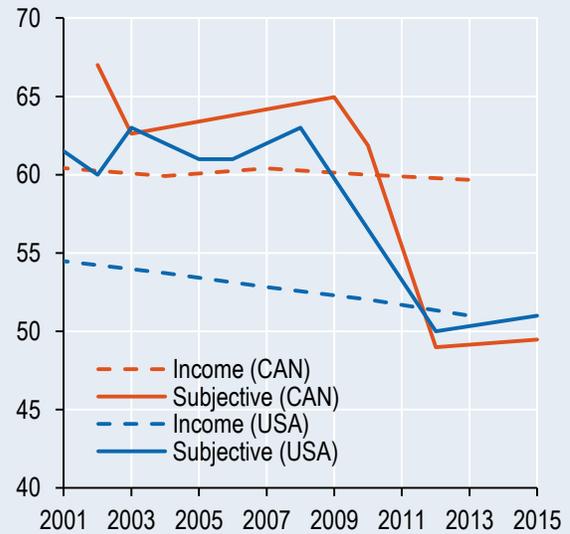


**Middle class self-identification has fallen significantly in recent years**

The share of the population that considers itself as belonging to the middle class in Canada fell from two-thirds to one-half in the last ten years. This decline is almost entirely due to a rise in the share of population perceiving itself as belonging to the lower class, which is now almost as large as the middle class. Trends in household income do not reflect such pessimism: the share of middle-income households has barely changed in the last 15 years (Figure 1.7). Currently, 60% of Canadians live in middle-income households, close to the OECD average of 62%. Possible explanations for the change in perceptions include rapid increases in house prices and associated rising household debt, together with the elimination of many well-paying jobs for moderately educated people during the crisis. Labour market changes driven by technological change and rising non-standard forms of work stir growing financial and employment insecurity.

**FIGURE 1.7. FEWER AND FEWER CANADIAN HOUSEHOLDS PERCEIVE THEMSELVES AS MIDDLE CLASS**

Share of middle-class households, subjective and income definition



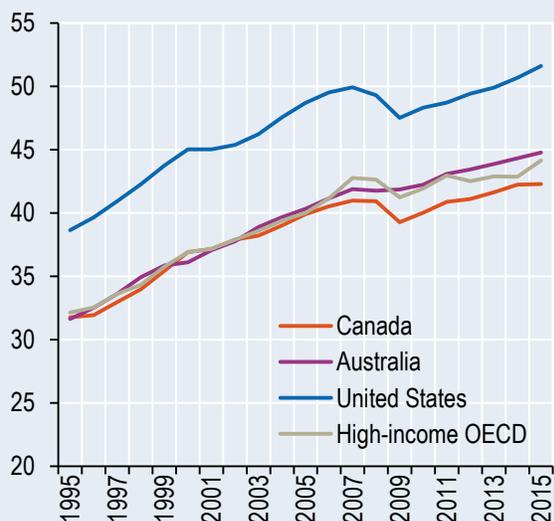
Note: Subjective definition based on self-identification (upper middle and middle class in the United States, and middle class in Canada). Income definition based on household disposable income (75-200% median).

Source: OECD Secretariat calculations based on data from LIS Cross-National Data Center, Gallup (USA) and EKOS (Canada).

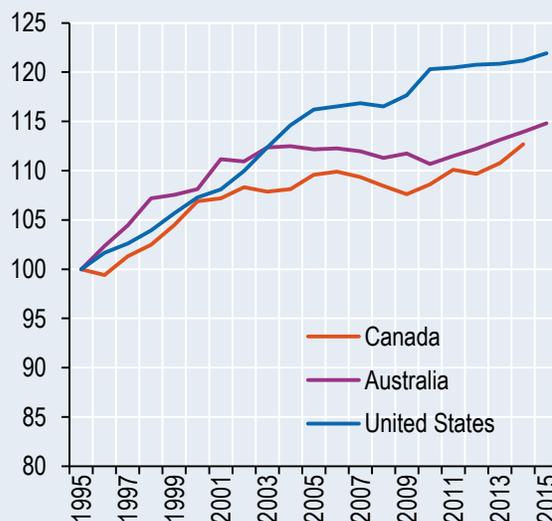


FIGURE 1.8. IMPROVEMENTS IN GDP PER CAPITA ARE HELD BACK BY LOW PRODUCTIVITY GROWTH

A. GDP per capita in thousand USD, 2010 PPP



B. Multifactor productivity, index 1995 = 100



Note: High-income OECD is the median of the 17 OECD countries with the highest GDP per capita. Multifactor productivity in the business sector is based on quality-adjusted hours worked.

Sources: OECD (2017a), *Economic Policy Reforms: Going for Growth 2017*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/growth-2017-en>; OECD Productivity Database.

### Productivity growth is low, and the gap between high-productivity firms and others has grown

GDP per capita was similar to the median of the most affluent OECD countries until 2005, but fell slightly behind over the last decade (Figure 1.8, Panel A). Labour productivity growth in the business sector has been weak, due to poor multifactor productivity growth (productivity growth after accounting for increases in employment and capital) (Figure 1.8, Panel B). Canada has only stayed so close to leading OECD countries in terms of GDP per capita due to a rising employment rate, which increased from 67.5% in 1995 to 72.5% in 2015, well above the OECD average of 66.3%. Improvements in the employment rate cannot be sustained indefinitely and will be more difficult with an ageing population. This underscores the importance of improving productivity growth.

Labour productivity growth in the 10% of firms with the highest productivity levels (i.e., firms at the national productivity frontier) has been robust since the turn of the century, averaging 5.1% in manufacturing and 6.1% in non-financial services over 2000-12 (Figure 1.9). Most other firms have



recorded much lower productivity growth, resulting in a growing gap in productivity levels between the productivity leaders and others. As in other countries, the productivity diffusion machine appears to be broken. This may reflect a diminished capacity of non-productivity-frontier firms to learn from frontier firms. This is consistent with longer-run evidence on the penetration rates of new technologies (e.g. Comin and Mestieri, 2013), possible winner-takes-all dynamics (Gabaix and Landier, 2008; Autor et al., 2017) and the growing importance of tacit knowledge.

Small business dynamism appears to have weakened, weighing on productivity growth. Firm entry and exit rates have declined (Figure 1.10, Panel A), as has happened in most other countries (Crisuolo, Gal and Menon, 2014). The start-up rate in Canada appears to be relatively low by international comparison (Figure 1.10, Panel B), and there seems to be a relatively large share of small old firms that contribute less to productivity growth than other firms (Figure 1.11). However, these international comparisons are subject to uncertainty, as Canadian data exclude spurious start-ups and exits resulting from reorganisations or mergers and acquisitions, thereby reducing

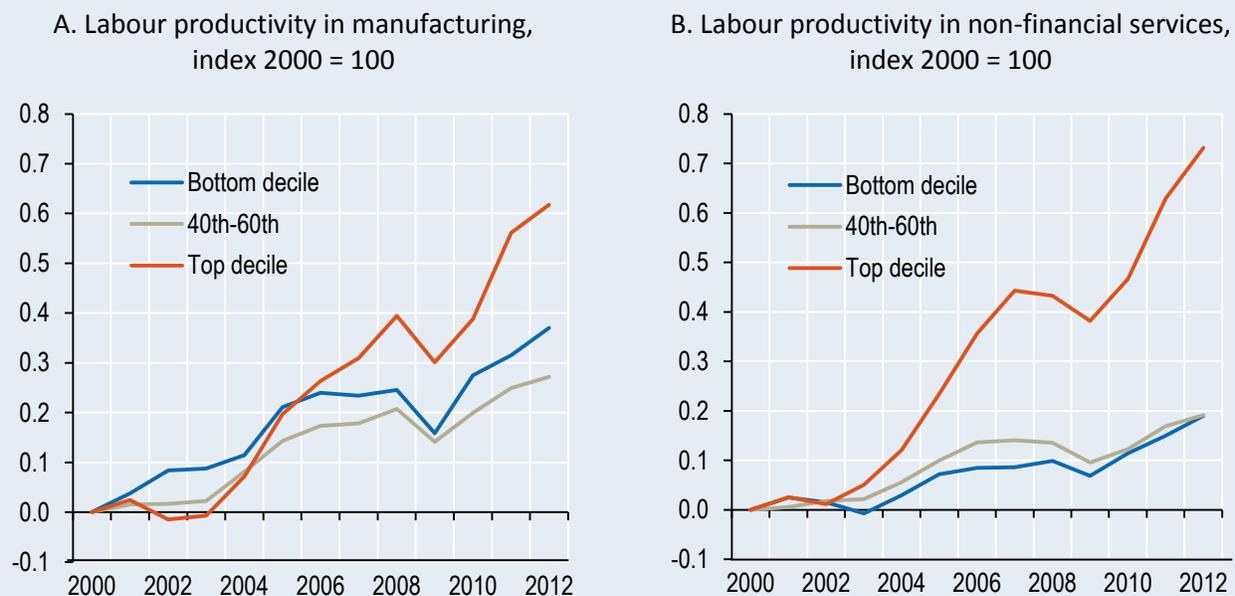
start-up and exit rates and increasing the share of small old firms. The slowdown in business start-ups is problematic for productivity growth, as start-ups are a key source of innovations and put pressure on incumbents to innovate. The survival of many small old firms with low productivity can be a drag on productivity growth, by hogging resources that could otherwise flow to innovative firms with high growth potential (especially start-ups).

### Canada needs to foster more inclusive growth

The twin challenges presented by the persistence of multidimensional inequalities and slow productivity growth underscore the need to reappraise Canada's policy-making process. Such an exercise should span an array of domains essential for promoting growth and helping all individuals and firms to fulfil their potential.

In line with this approach, the federal government has adopted a plan to deliver CAD 181 billion of infrastructure spending over 12 years, three times the amount in the baseline when it took office. The plan covers physical, social and green infrastructure (including investments in clean

FIGURE 1.9. THERE IS AN INCREASING DIVERGENCE IN LABOUR PRODUCTIVITY PERFORMANCE ACROSS FIRMS

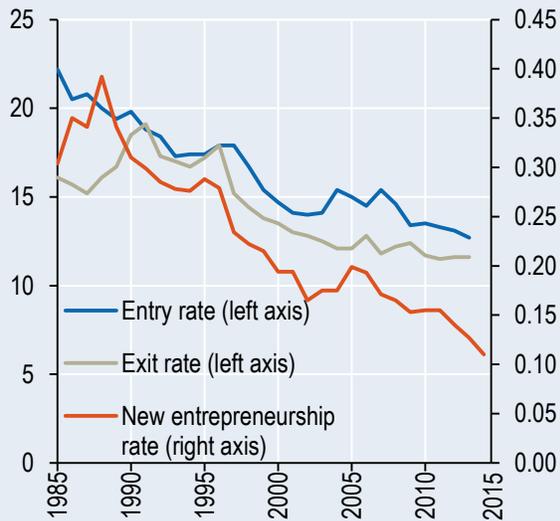


Note: The graph reports the unweighted average of real labour productivity (defined as real value added per employee) expressed in 2005 USD. Estimates are based on micro-aggregated data and might differ from official national statistics.

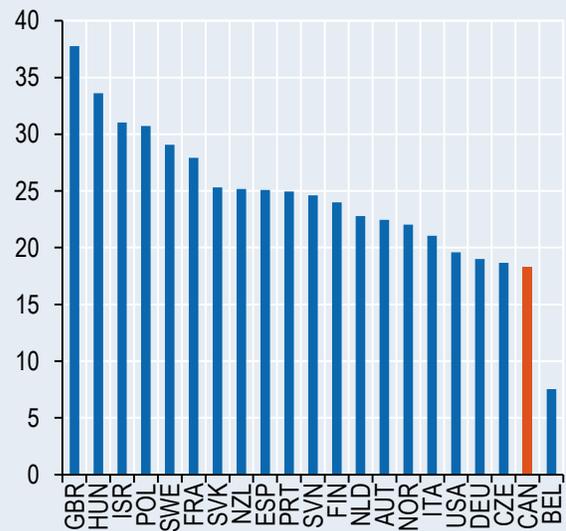
Sources: Data from the OECD Multiprod project, preliminary results, April 2016, <http://www.oecd.org/sti/ind/multiprod.htm> and see Berlingieri, G., P. Blanchenay and C. Criscuolo (2017), "The great divergence(s)", *OECD Science, Technology and Industry Policy Papers*, No. 39, OECD Publishing, Paris, <http://dx.doi.org/10.1787/953f3853-en>, for more details.

FIGURE 1.10. SMALL BUSINESS DYNAMISM HAS DECLINED

A. Aggregate firm entry and exit rates and new entrepreneurship rate, in %



B. Percentage of 0 to 2 year old employer enterprises in % of all employer enterprises, 2014



Note: Panel A: The start-up rate is the number of start-up employer enterprises (0-2 year old) as a percentage of the number of active employer enterprises. Panel B: 2013 data for FIN, FRA and PRT, 2012 data for USA and BEL.

Sources: Cao, S. et al. (2015), "Trends in Firm Entry and New Entrepreneurship in Canada", Bank of Canada Discussion Paper, No. 2015-11, October, Charts 1 and 3, Bank of Canada, Ottawa, <http://www.bankofcanada.ca/2015/10/discussion-paper-2015-11/>; OECD Structural and Demographic Business Statistics Database, <http://www.oecd.org/std/business-stats/structuralanddemographicbusinessstatisticsdsboecd.htm>.

energy, climate change adaptation and local water and wastewater facilities). It should promote longer-term growth and enhance environmental performance and inclusiveness.

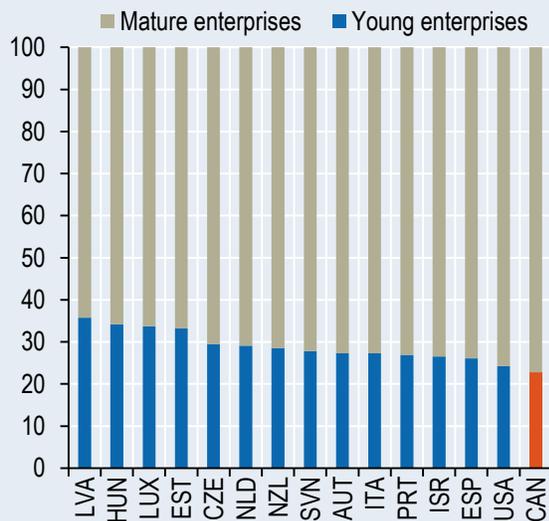
The infrastructure plan includes a substantial increase in funding to improve the substandard socio-economic conditions facing Indigenous people. This amounts to a 22% increase in end-of-period levels and represents a big effort to make growth more inclusive and opportunities more equal. Most of this expenditure (about half of the total) will be on education and training, including upgrading of school buildings, and social and green infrastructure (housing, water and wastewater treatment, and health care). Funding is also being provided for improving governance by their representative organisations and for strengthening the capital base of the First Nations Finance Authority, which raises private long-term capital for economic development in their communities.

Building a fair and open government is a key priority of the federal government. It has set in motion plans to make government information



FIGURE 1.11. **MANY SMALL CANADIAN FIRMS ARE OLD**

Young enterprises in % of all enterprises with less than 10 employees, 2008-14 average



Note: Young enterprises are a sum of nascent enterprises as well as those surviving 1 and 2 years. EST, USA: 2006-12, ISR: 2007-14, NLD: 2006-14 excluding 2008, NZL: 2006-15.

Source: *OECD Structural and Demographic Business Statistics Database*, <http://www.oecd.org/std/business-stats/structural-and-demographic-business-statistics-sdbsoecd.htm>.

more accessible and to expand and accelerate open data initiatives. It also plans to close political financing loopholes and strengthen public sector integrity. Enabling Parliament to better represent communities and hold the government to account also feature prominently in the government's agenda.

Fighting climate change and protecting the environment are also high priorities. The federal, provincial and territorial governments (with the exception of Manitoba and Saskatchewan) agreed on the Pan-Canadian Framework on Clean Growth and Climate Change in December 2016. It sets a national benchmark for carbon prices that will rise progressively to facilitate the achievement of Canada's greenhouse gas emissions abatement goals at least cost.

This brochure looks at the key policy reforms that would help Canada advance its inclusive growth agenda. Chapter 2 focuses on how the Canadian government can help all people to create prosperity and thrive. Indigenous people, women, older workers, migrants and people with mental health issues currently fare worse than average Canadians in terms of labour market outcomes. Promoting greater inclusion in the labour market requires strengthening the skills of Indigenous people, putting in place better family-friendly supports to make it easier for mothers and fathers to combine work and family life, strengthening training for older workers, advancing recognition of foreign qualifications and better leveraging education institutions and employers to foster good mental health.

Efforts to ensure that all individuals have the opportunity to live meaningful and productive lives rely on a flourishing business sector. Against this background, Chapter 3 investigates how the Canadian government can ensure a level and competitive playing field for firms, enable them to access the finance they need at fair cost, provide regulatory clarity and consistency, and put in place framework conditions that are conducive to innovation. Small business dynamism and productivity would also benefit from focusing small business support more clearly on reducing market failures.

Strong public governance is crucial to implement an inclusive growth agenda. Chapter 4 therefore looks into how Canada can build on recent progress in fostering public sector innovation, ensuring stakeholder engagement and developing good regulatory practices to further enhance the quality of public goods and services. Addressing multilevel governance challenges is also crucial, as policies for inclusive growth need to be designed, implemented and reviewed in a highly co-ordinated manner. With Canada being a very decentralised country, where provincial or local governments are responsible for many of the policies that are essential for inclusive growth, governance co-ordination is particularly crucial at the vertical level.

## 2 Enabling all Canadians to create prosperity and thrive

**Labour force participation in Canada is strong and well above the OECD average. However, there are considerable variations across the country and between socio-economic groups. Indigenous people, women, older workers, migrants, and people with mental health issues are less likely than average Canadians to be employed and more likely to have jobs of lower quality. By furthering policy action to promote inclusion in the labour market, Canada can enable its citizens to create stronger and more inclusive growth.**

### **Strengthening the skills of Indigenous people is key to better integrating them into the labour market**

Indigenous people are an important part of Canadian society, with 1.4 million people who reported an Indigenous identity in 2011, representing 4.3% of the population (Statistics Canada, 2011). It is estimated that the Indigenous population will continue to grow at a faster rate than the non-Indigenous population, possibly increasing to between 2.0 million to 2.6 million by 2036 (Statistics Canada, 2015). But many of them continue to face barriers to successful labour market integration. The unemployment rate for Indigenous Peoples aged 25-54 was 11% in 2015 – nearly double the rate for the non-Indigenous group of the same age at 5.7% (Statistics Canada, 2017). To a large extent, poor labour market integration reflects lower educational outcomes: in 2015, only 51% of Indigenous Peoples had completed post-secondary education, compared with 70% of the non-Indigenous population. At the national level, Indigenous people aged 16-64 scored lower in numeracy (244) and literacy (260) than the non-Indigenous population (266 in numeracy and 274 in literacy) in the 2012 OECD Survey of Adult Skills, although these differences varied considerably across provinces and territories. Educational attainment gaps, however, do not fully account for poor labour market integration, as employment rates are lower even for Indigenous people with a post-secondary education (78% versus 86% for non-Indigenous individuals).

The government has undertaken several initiatives to strengthen higher education and labour market outcomes for Canada's Indigenous people. For example, the Aboriginal Skills and Employment Training Strategy is a broad-based labour market

programme, and the Aboriginal Bursaries Search Tool helps Indigenous students to search for bursaries, scholarships and other incentives offered by governments, universities and other organisations. Apprenticeship programmes can be a key tool for helping Indigenous people to develop skills that are well linked to a job. In the Yukon, the Tr'ondëk Hwëch'in First Nation acts as an intermediary between employers and the vocational education system, minimising the administrative burden for employers and recognising that Indigenous apprentices will move between employers to obtain their necessary training.

Entrepreneurship could also be a route to better integrate Indigenous people into the labour market. Only 2% of small and medium-sized enterprises (SMEs) are operated by Indigenous entrepreneurs, about half of their share in the total population (Gulati, 2012). There are organisations dedicated to strengthening networks of entrepreneurs, mentoring and entrepreneurial skills, and helping to develop successful role models, but these efforts need to be reinforced. To promote Indigenous entrepreneurship, the top priority is to invest in education and capacity building (Gulati and Burleton, 2015), both in Indigenous Economic Development Corporations that account for most Indigenous SME income (how to set up and run one and create effective corporate governance arrangements) and in the Indigenous community at large (job and skills training). Indigenous firms also need better access to IT infrastructure – 20% of those in Ontario did not have an Internet connection in 2013, rising to 37% for those on reserves (Canadian Council for Aboriginal Business, 2015). The government's commitment to invest up

to CAD 500 million over five years, starting in 2016-17, to extend and enhance broadband service in rural and remote communities is therefore welcome.

### Strengthening the labour force participation of women requires better family-friendly supports

Labour force participation among women in Canada (74%) is 7.6 percentage points lower than among men, but above the OECD average for women (67%). Young Canadian women are more likely to obtain tertiary education than men, but Canada has room to improve their participation in manufacturing and construction and other science, technology, engineering and mathematics (STEM) fields in tertiary education. The gender pay gap remains stubbornly high (Figure 2.1). The monthly median wage of women is 18.6% lower than that of men, compared to the OECD average of 14.7%.

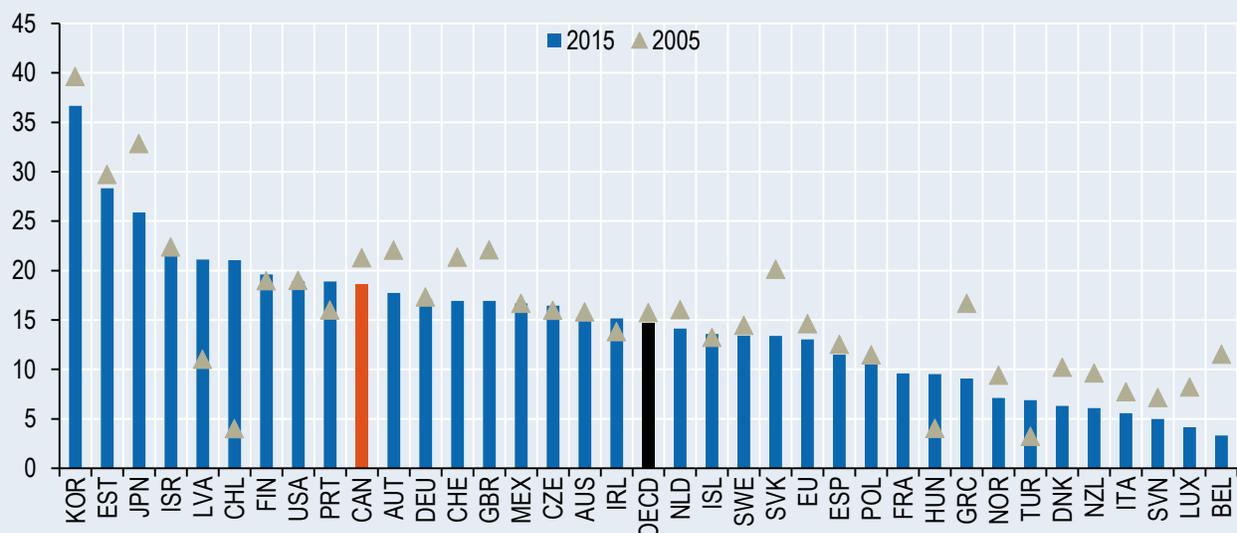
Family-friendly supports (including parental leave, childcare and flexible work options) are needed to maintain and strengthen labour force participation among women. The Canada Child Benefit, which was introduced in 2017, provides a maximum annual benefit of CAD 6 400 per child under the age of 6 and up to CAD 5 400 per child aged 6 to 17. This benefit will help reduce child poverty, but

should be combined with incentives to work. Issues around the availability of affordable quality childcare are widely acknowledged in Canada, with only the province of Quebec having a comprehensive childcare support system. The available evidence suggests that participation in preschools is low in international comparison. Only 56.7% of 3-to-5 year-olds participate, compared with the OECD average of 83.8%. To address this challenge, the government plans to invest CAD 47 billion over 10 years, starting in 2018-19, to support and create more high-quality, affordable child care places across the country.

Encouraging a broadly equal use of parental leave and flexible workplace measures by men and women can also help promote gender equality in the workplace. With the introduction of the Quebec Parental Insurance Plan, which includes five weeks of paternity leave in addition to sharable parental leave, the number of fathers claiming some leave increased from 22% in 2004 to 79% in 2013, and fathers often took leave for more than eight weeks. Changing attitudes may take time, but it can help reduce the burden of unpaid work on women and facilitate greater economic participation of women on an equal footing (OECD, 2017b).

FIGURE 2.1. THE MEDIAN MONTHLY GENDER PAY GAP FOR FULL-TIME EMPLOYEES IS ABOVE THE OECD AVERAGE

Gender gap in median monthly earnings, full-time employees



Note: The gender pay gap is defined as the difference between male and female median monthly earnings divided by male median monthly earnings for full-time employees. Full-time employees are defined as those individuals working more than 30 paid hours per week. 2015 refers to 2015 or the latest year available.

Source: OECD (2017c), *OECD Employment Outlook 2017*, OECD Publishing, Paris, [http://dx.doi.org/10.1787/empl\\_outlook-2017-en](http://dx.doi.org/10.1787/empl_outlook-2017-en).



Canadian women are actively engaged in entrepreneurship, more than in most other OECD countries. However, they are less likely than their male counterparts to run growth-oriented enterprises. SMEs owned by women tend to be smaller and report lower revenue growth than those owned by men (ISED, 2015). They are less likely to seek external finance and more likely to have loans rejected because of insufficient collateral, and they are also less likely to export. Women entrepreneurs are also under-represented in high-technology manufacturing and knowledge-intensive sectors (Institute for Competitiveness and Prosperity, 2012), and far fewer self-employed women (31.3%) than men (50%) incorporate their businesses (Canada Works, 2014; OECD, forthcoming). The federal government has given priority to reducing gender inequalities in growth-oriented entrepreneurship through new programmes in areas such as networking, mentorship, access to international markets (e.g. the Business Women in International Trade programme) and finance (e.g. Business

Development Bank of Canada's investment of CAD 50 million to support women entrepreneurs in the technology sector, as announced in November 2016). Moving forward, stronger support by the Business Development Bank of Canada, including through a new dedicated programme for women entrepreneurs, removal of restrictions on the eligibility of part-time entrepreneurs to public enterprise finance programmes and further expansion of supplier diversity initiatives would have disproportionate benefits for women business owners.

#### **Older workers would benefit from stronger participation in training**

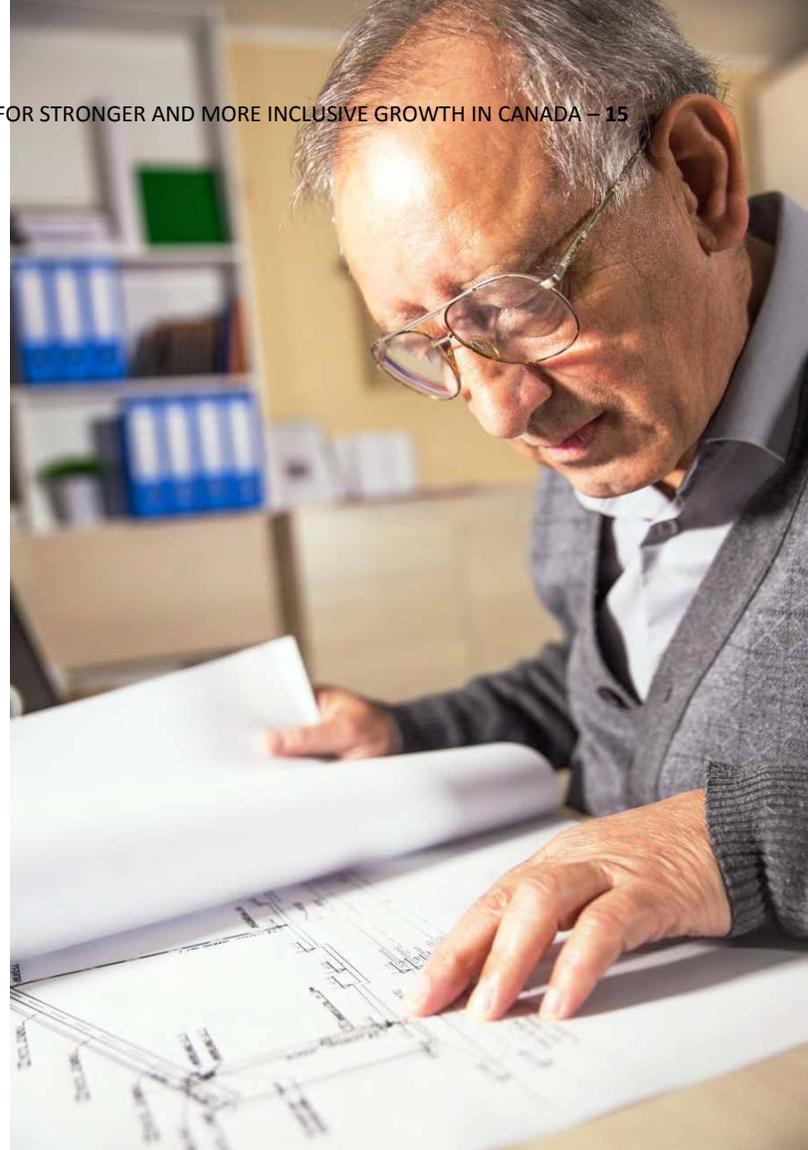
While population ageing has been somewhat slower in Canada than in many other OECD countries until now, it is set to accelerate sharply in the next decades. In 2015, there were 26 persons aged 65 and over for every 100 people of working-age (20-64 years) in Canada, compared to the OECD average of 28 persons. By 2050, the number for Canada is projected to rise to 45

persons according to Statistics Canada. This makes it very important for Canada to put in place the right policies to ensure that growth is also inclusive for the elderly.

Currently, Canada performs well in terms of labour market inclusion for the elderly. According to OECD data, the poverty rate for Canadians aged over 65 (6%) is in the bottom third of OECD countries, while the employment rate for Canadians aged 55-64 (60.9%) exceeds the OECD average by around 3 percentage points. However, there is a clear education-related employment gap in Canada, and older workers tend to participate less in training than younger workers. The ratio of participation in training for older workers relative to workers aged 25-54 is 0.78. Moreover, adult education tends to reinforce inequalities inherited from the school system, in particular for workers in their mid to late careers. While only 26% of older employees with no upper secondary education participate in training, the rate is 59% for older workers with higher education qualifications (OECD, 2014a).

**A multipronged approach is necessary to foster inclusion of people with mental health issues**

In Canada, one in five people are estimated to experience mental illness every year, and mental illness is one of the top three drivers of both short-term and long-term disability, accounting for some 30% of claims. Adults with severe mental health problems and illnesses in Canada die up to 25 years earlier than adults in the general population, often from co-morbid physical illness such as cardiovascular disease. The economic costs of mental illness are significant. The OECD estimates that the total indirect and direct costs of mental illness exceed 4% of GDP worldwide (OECD, 2014b; OECD, 2015b). Canada's high-level political recognition of the importance of good mental health is most commendable. Both Prime Minister Trudeau and Minister of Health Jane Philpott have clearly stated their belief in the importance of high-quality, accessible mental health services for all. Addressing the high burden of mental health issues and responding to significant unmet needs still pose a significant challenge, but Canada has a good range of treatments, interventions, and policy solutions in place.



To make further progress in this area, Canada, like other OECD countries, should focus on three priorities. First, developing indicators of performance and progress in mental health care would allow a deeper understanding of the burden of mental illness, the state of the mental health system and outcomes for people using mental health services. Second, access to evidence-based treatment for mental illnesses needs to be improved, as unmet need for mental health care is a major concern. Only one in three people in Canada who report that they experienced a mental health problem also report that they sought and received treatment. Third, improving the engagement of education institutions and workplaces can help foster good mental health by providing a supportive environment and thoughtfully facilitating return to work after sick leave for depression.

### Canada could further improve the integration of its immigrant population by advancing the recognition of foreign qualifications

Relative to its population, Canada has one of the largest foreign-born populations among OECD countries: more than one person in five is an immigrant. Canada has a large managed labour migration programme, and the bulk of annual inflows are labour migrants and their families. Canada's immigrant population is among the most highly educated in the OECD. Contrary to what happens in most OECD countries, foreign-born students and the children of foreign-born parents in Canada perform on a par with their native peers. This has contributed to overall labour market outcomes of immigrants that are above those observed in other OECD countries.

However, Canada could make even better use of immigrants' skills, particularly those who have

foreign qualifications, as immigrants are at high risk of working in jobs below their formal qualification level. The process of foreign credential recognition is a key element in enhancing transparency for employers and facilitating access to certain higher-skilled occupations. Canada has taken several actions in this respect, and it is important to continue this initiative.

Special efforts are needed for refugees who face particular challenges in integrating into the labour market. In response to the Syrian refugee crisis, Canada resettled more than 40 000 Syrian refugees between November 2015 and January 2017. Early access to employment is crucial for refugees to integrate into the labour market and society more generally.

## Key recommendations

- Consider introducing a country-wide non-transferable individual paid leave period for fathers of one or two months.
- Swiftly implement the plan to increase the supply of affordability childcare places.
- Continue efforts to raise the education and employment outcomes of Indigenous youth by providing access and incentives to higher education and training programmes.
- Ensure that national and regional policies related to labour market, skills and economic development promote flexibility and co-ordination at the local level.
- Continue building the governance capacities of First Nations, Inuit and Métis communities, and facilitate the exchange of information about successful approaches to employment and job creation.
- Support growth-oriented entrepreneurship by women, including by removing unwarranted restrictions on the eligibility of part-time entrepreneurs to public enterprise support programmes and scaling up supplier-diversity initiatives.
- Provide better access to training adjusted to the experience and learning needs of older workers.
- Collect robust and internationally comparable indicators of performance and progress in mental health care.
- Ensure access to high-quality evidence-based mental health services, such as psychological therapies, early intervention approaches or pharmacological therapies, to address unmet need.
- Better engage education and workplaces in fostering good mental health, using the Recommendation of the OECD Council on Integrated Mental Health, Skills and Work Policy as a guiding framework.
- Continue efforts to improve the recognition of foreign credentials.

# 3 Giving all Canadian firms a chance to flourish

In the long run, a thriving business sector is the most important source of greater living standards and well-being. Businesses provide employment opportunities, foster individual well-being in the work place, contribute to the development of skills, and promote the creation and dissemination of knowledge and technology. Reversing the decline in productivity growth and business dynamism is therefore crucial for Canada. The country's framework policies, such as product and labour market regulation, are generally supportive of a thriving business sector. Labour market regulation poses few barriers to the reallocation of labour, and the country performs very well with respect to the cost and time to set up a new company, the administrative burden of running a corporation and the ease of the insolvency regime. However, barriers to foreign direct investment and the regulatory protection of incumbents are higher than in many other countries, the latter primarily due to an above-average use of antitrust exemptions. Small business dynamism and productivity would also benefit from focusing small business support more clearly on reducing market failures and better harmonising provincial legislation.

## Greater product market competition can help boost productivity growth

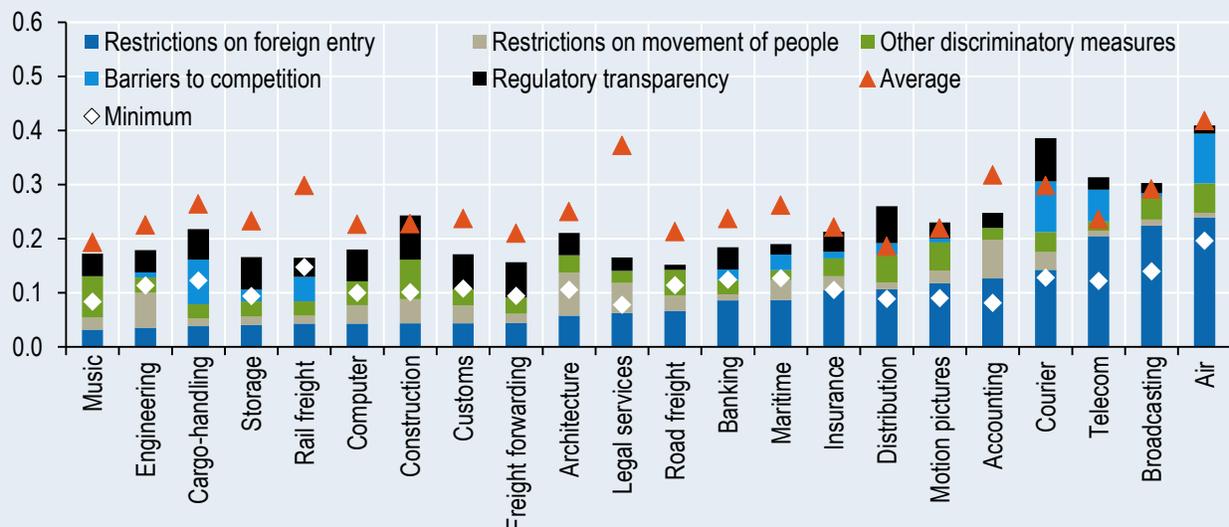
As noted above, productivity growth has been weak in recent decades relative to rates in comparable high-income countries. It is not clear what the major causes of this weakness are, but encouraging product market competition and

strengthening the internal market (Chapter 4) could help to improve performance.

Productivity growth in utilities has been weak over the last decade, constraining firm growth in other sectors through higher input costs. In the electricity sector, the poor productivity performance is likely to be linked to the

FIGURE 3.1. CANADA HAS ROOM TO FURTHER EASE TRADE RESTRICTIONS IN A NUMBER OF SERVICES SECTORS

Services Trade Restrictiveness Index (STRI), from 0 (least restrictive) to 1 (most restrictive), 2016

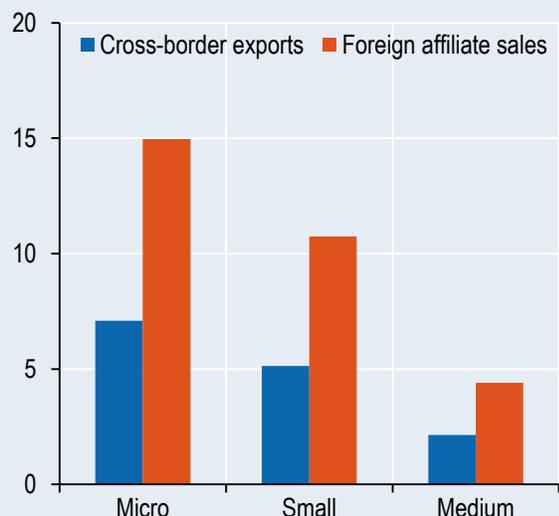


Note: The STRI records measures on a most-favoured-nation basis; preferential trade agreements are not taken into account. Air transport and road freight cover only commercial establishment (with accompanying movement of people). The data have been verified and peer-reviewed by OECD member countries.

Source: OECD, STRI database, <http://www.oecd.org/tad/services-trade/services-trade-restrictiveness-index.htm>

FIGURE 3.2. **SMEs SUFFER PARTICULARLY STRONGLY FROM SERVICES TRADE RESTRICTIONS**

Estimated additional *ad valorem* tariff in %, equivalent of an STRI of 0.2 on top of what is paid by firms of CAD 400 million and more in turnover



Note: Average turnover used for calculations is CAD 1 million for micro enterprises, CAD 5 million for small enterprises and CAD 25 million for medium-sized enterprises. Import demand elasticity is -2.5.

Source: OECD calculations based on estimates from OECD (2017d), *Services Trade Policies and the Global Economy*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264275232-en>.

predominance of vertically integrated public providers. OECD estimates suggest that the level of economy-wide multifactor productivity would rise by 0.5% within a decade if generation of electricity were fully separated from its transmission and distribution, with non-discriminatory access to network infrastructure (OECD, 2016a). In addition, improving transmission interconnection between provinces could facilitate market deregulation and further investment in renewables, by increasing resilience to electricity shortages, as well as raise efficiency. The lack of east-west interconnection between provinces is largely a result of geography and the uneven distribution of the population, but it also reflects regulatory fragmentation. Expanding efforts such as the Atlantic Energy Gateway, a collaborative effort of federal-provincial utilities, and working towards greater harmonisation through the energy chapter in the Canada Free Trade Agreement (Chapter 4) would enhance efficiency.

Canada could also do more to encourage competition in a number of services sectors, including by further opening up the country's markets to foreign services providers. The OECD's Services Trade Restrictiveness Index (STRI) shows the scope for reform in Canada to be greatest in air transport, courier services, telecommunications and broadcasting and distribution services (Figure 3.1). Recent OECD analysis (OECD, 2017d) found that the costs of dealing and complying with diverging regulations in every new market fall particularly heavily on small and medium-sized enterprises, imposing the equivalent of an additional 5% to 15% import tariff compared to larger firms (Figure 3.2).

In air transportation, the high STRI score is attributable to restrictive foreign ownership limits. These limits result in financing restrictions that may deter entry, raise finding costs for incumbents and lead to slower adoption of new technology and know-how. Competition could be increased and downstream cost competitiveness enhanced by lessening these restrictions, for instance by increasing the foreign voting equity limit from the current 25% to 49% for carriers operating international air services (allowing more could invalidate international Air Service Agreements) and eliminating them completely in the domestic market on a reciprocal basis, including granting rights of establishment, as in Australia and New Zealand.

Of the sectors with high STRI scores, telecommunications and distribution services take on particular importance given their potential role in helping businesses access a wider set of opportunities at home and abroad, including through digital means (e.g. e-commerce and other Internet-enabled business). The relatively high score for telecommunications is largely related to Canada maintaining a 20% cap on foreign equity in large telecoms operators. Rouzet and Spinelli (2016) estimate that eliminating the ownership restrictions in telecoms could reduce price-cost margins by 2 percentage points from Canada's average for exchange-listed companies, yielding tangible gains for consumers and downstream firms. In distribution services, the high STRI score reflects discriminatory access to certain settlement methods, which can act as an impediment to e-commerce and multichannel retailers in Canada (OECD, 2017d).

To remove as many barriers to competition as possible, Canada should also consider implementing the 2009 OECD Council Recommendation that calls for governments to identify existing or proposed public policies that unduly restrict competition and to revise them by adopting more pro-competitive alternatives. The Recommendation also invites governments to establish institutional mechanisms for undertaking such reviews. One option could be to apply the OECD's Competition Assessment Toolkit, which provides a structured guide for policy makers to identify regulations that have anti-competitive effects and to design pro-competitive alternatives.

### There are ways to help firms catch up with the productivity leaders

The rising productivity gap between high productivity firms and the rest raises questions about the obstacles that prevent all firms from successfully adopting well-known and replicable innovations. OECD analysis has identified five key factors that shape the productivity diffusion process: 1) global connections and knowledge exchange via trade, FDI, participation in Global Value Chains (GVCs) and the international mobility

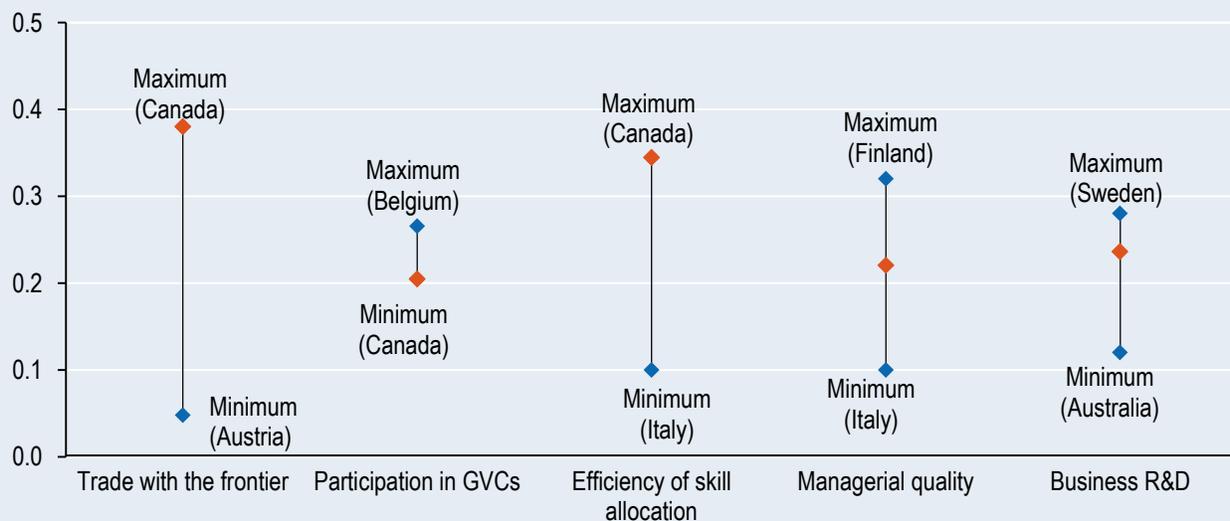
of skilled labour; 2) connections and knowledge exchange within the national economy; 3) scope for experimentation by firms (especially new entrants) with new technologies and business models; 4) synergistic investments in R&D, skills and managerial capabilities and other forms of knowledge-based capital; and 5) efficient reallocation of scarce resources.

Structural factors that shape the diffusion process from the global productivity frontier are generally favourable in Canada (Figure 3.3). In particular, Canada trades intensively with the frontier economy (the United States) and allocates skills efficiently (it has low skills mismatch). The factor where there is the largest potential to increase productivity spillovers from the productivity frontier is managerial quality, followed by increasing participation in GVCs and increasing business R&D intensity.

Enhancing managerial quality is also critical to support adoption of digital technology by small firms, identified as a key focus area in the Innovation and Skills Plan recently launched by the federal government. Canada does well in terms of

FIGURE 3.3. POLICIES MATTER FOR THE EFFICIENCY OF TECHNOLOGY DIFFUSION FROM THE GLOBAL FRONTIER

Percentage point difference in annual productivity growth linked to differences in policy settings



Note: The chart shows how the sensitivity of multifactor productivity (MFP) growth to changes in the frontier leader growth varies with different levels of each structural variable. The diamond refers to the estimated frontier spillover effect associated with a 2% MFP growth at the frontier around the average level of the structural variable.

Source: Saia, A. D. Andrews and S. Albrizio (2015) "Productivity spillovers from the Global Frontier and Public Policy: Industry-Level Evidence", OECD Economics Department Working Paper No. 1238, OECD Publishing, Paris. <http://dx.doi.org/10.1787/5js03hkvxhmr-en>.

broadband penetration (it tops the OECD league in terms of cable connections per 100 inhabitants, followed closely by Belgium and the United States), but Canadian small businesses experience poor ICT adoption rates. In 2015 only 13.4% of small Canadian firms used enterprise resource planning software, well behind their large Canadian counterparts (63.5%) and much lower than small firms in Germany (50.1%) and Belgium (44.5%) (OECD, 2017e). Coaching programmes to extend digital literacy are an effective way to tackle this problem, that Canada could consider expanding in the future. Another is to reduce impediments to competition to allow firms to grow, as larger firms tend to be better managed (Adalet, McGowan and Andrews, 2015).

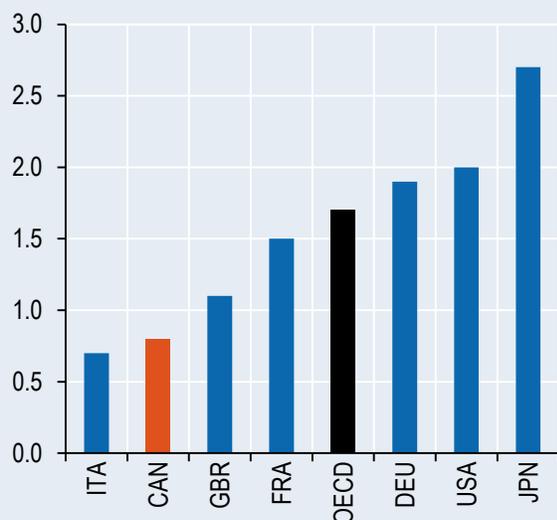
Public R&D expenditure (R&D expenditure by higher education institutions and the government) is above the OECD average (0.8% of GDP in Canada, compared to the OECD average of 0.7%), but business expenditure on R&D, at 0.8% of GDP, is below it (Figure 3.4), despite R&D tax credits that are among the highest in the OECD (OECD, 2017f). This reflects numerous factors, not all of which are amenable to policy. Besides industry structure,

possible factors include subpar investments in tangible capital, small market size, high corporate taxes, business complacency, the low educational attainment of Canadian managers, the dearth of management experience and business acumen, and the aversion to risk in Canadian businesses.

Following a recent review of support for business R&D, there has been a slight shift away from Canada's strong reliance on tax incentives, which represented approximately 80% of federal government innovation spending in 2014 (OECD, 2017g), towards direct funding instruments (e.g., competitive grants, equity funding). However, more could be done to shift the balance from general tax credits to targeted programmes that also reward innovation outcomes, such as research commercialisation, and not just innovation inputs, such as R&D spending (OECD, forthcoming). It is also important to acknowledge the importance of non-R&D-based forms of innovation, and better identify projects with the highest potential spillovers to the broader economy. The government plans to create a new CAD 1.26 billion five-year Strategic Innovation Fund to consolidate and simplify existing business innovation programmes.

**FIGURE 3.4. CANADA HAS LOW R&D BUSINESS INVESTMENT BY INTERNATIONAL COMPARISON**

Business R&D expenditure, % of GDP, 2015 or latest available year



Note: Canada data refer to 2014.

Source: OECD, *Main Science and Technology Indicators Database*, [www.oecd.org/sti/msti.htm](http://www.oecd.org/sti/msti.htm).

It appears that over-reliance on aggregate input and output performance indicators by analysts and policy makers means that little attention has been paid to factors inside firms, including innovation management capabilities, internal structural/organisational competencies such as work organisation and talent management, or the culture of innovation in Canadian firms more generally. More focus on schemes that offer assistance with expertise and managerial competence could help to address these shortcomings. Canada's Innovation Agenda, which is attempting to better co-ordinate and align support for Canadian innovators, is a step in the right direction.

### **Greater small business dynamism can help enhance productivity**

A dynamic small business sector can heighten competition and underpin productivity growth. Dynamism can be reflected in high rates of firm creation, exit and scaling up, and in relatively few stagnant, old firms – in other words, a high start-up rate and strong “up-or-out” dynamics. A recent OECD study (OECD, 2015c) found that an increase

in the share of firms younger than 6 years old relative to firms aged 12 years and over is associated with higher multifactor productivity growth and that this effect is mainly attributable to start-ups (i.e., firms younger than 3 years old). It also finds that an increase in the share of employment in small old firms, which indicates an absence of “up-or-out” dynamics, is associated with lower productivity growth. As noted above, small business dynamism has declined in Canada, as in other countries, and on most dimensions Canada lags well behind the leaders.

Canada’s framework policies, such as product and labour market regulation, are generally supportive of small business dynamism, although less so than in the United States. Labour market regulation, in particular, poses few barriers to the reallocation of labour, which is critical for a vibrant small business sector. There is, however, scope to lower barriers to trade and investment to increase product market competition. As noted above, Canada has relatively high barriers to foreign direct investment, which inhibit allocative efficiency and discriminate against foreign suppliers in public procurement. Regulatory protection of incumbents is high by international standards and arises primarily from an above-average use of anti-trust exemptions.

Small business dynamism and productivity would also benefit from focusing small business programmes more clearly on reducing market failures. The programme with the largest budget cost, the preferential tax rate for companies under a threshold size based on taxable capital (known as the Small Business Deduction), is not so focused. The aim of this arrangement is to leave these firms with more money to invest, effectively making it a financing programme. However, the economic literature on capital market failures does not establish a case for subsidising SMEs based on their size alone. In the Mirrlees Review of taxation in the United Kingdom (Mirrlees et al., 2010), it was concluded that there was no evidence of any general capital market failure affecting small firms. Accordingly, there was no economic case for a reduced small business corporate tax rate. The principal financing gap in the United Kingdom was for new and start-up businesses (Graham, 2004), and this gap could be more effectively addressed through targeted measures. The Canadian federal government should review the Small Business Deduction and, if it reaches the same

conclusions as the Mirrlees Review, eliminate this tax preference, as the United Kingdom did in 2015.

The federal government is also a major player in the venture capital market. A case can be made for subsidising venture capital based on the external benefits from innovation in firms suitable for venture capital. Indeed, such benefits may be much higher than for business R&D (Lerner, 2010). The key to success is finding instruments that increase the quantity of venture capital without diminishing its quality. One promising approach is to establish funds that operate like independent, limited partnership venture capital funds, with private partners selecting investments and mentoring, while the government leverages returns for private investors by not sharing fully in any profits but fully sharing in losses. This approach was adopted by the federal government in the Venture Capital Action Plan (VCAP). The government plans to make available through the Business Development Bank of Canada CAD 400 million on a cash basis over three years, starting in 2017-18, for a new Venture Capital Catalyst Initiative that will increase late-stage venture capital available to Canadian entrepreneurs.

A new OECD report on SME and entrepreneurship policy in Canada documents the country’s extensive package of federal government interventions that are effective in overcoming market failures and institutional problems affecting the emergence and growth of new and small firms. Good initiatives include the National Research Council’s Industrial Research Assistance Program (IRAP), supporting innovative SMEs through financing and tailored business/technical advice, and the Community Futures Program, fostering entrepreneurship and SME development in the rural regions of Canada. Today’s challenge is to fill gaps in this policy offer where there is insufficient scale of interventions or gaps in responses to market and institutional failures (OECD, forthcoming).

To this end, some of Canada’s support programmes could be adjusted. The government’s plan to review all federal innovation and clean technology programmes across all departments with the aim to simplify them and improve their effectiveness is therefore welcome. One adjustment that seems warranted relates to the Build in Canada Innovation Program, which encourages the procurement of innovative products and services from Canadian

businesses and other organizations. The programme could move from a responsive approach in which the government waits for proposals to emerge from the market, to a proactive approach in which it identifies the innovative public procurement needs within the government and invites proposals from companies to meet such needs (OECD, forthcoming). The government proposes in its 2017 budget to provide up to CAD 50 million to launch a new procurement program, Innovative Solutions Canada, which will follow the model of the Small Business Innovation Research programme of the United States, which applies a more proactive approach.

Other programmes with potentially high external benefits to the economy should be maintained and possibly expanded, subject to evaluation. This is the case of VCAP. The latest figures show that CAD 340 million of government investment has generated CAD 886 million of total investments, and that VCAP has been able to attract some categories of private investors back to the venture capital asset class, including some large Canadian banks, insurers and corporations. With the first VCAP programme to be fully committed by late 2017, further government action will help keep momentum and make its impact more sustainable. In addition, fostering the role of the TSX Venture small cap stock exchange in providing initial public offering exit routes for later stage ventures should also benefit the innovation finance ecosystem as a whole.

Entrepreneurship education could also be strengthened to enhance the quality of entrepreneurs. Such education is well established at Canadian tertiary education institutions and supported by both provincial and federal governments. In its 2017 budget, the government proposes to set up a new Digital Literacy Exchange Programme to teach basic digital skills and to provide Futurpreneur Canada with CAD 14 million to offer young entrepreneurs mentorship, learning resources and start-up financing.

To get the most out of the support programmes, greater dialogue and collaboration between the federal government and bodies such as the Council of Ministers of Education could be encouraged, while existing good practices at provincial and local level could be better shared to foster mutual learning in this new field of education. Educational institutions could also be encouraged to employ experienced entrepreneurs to teach as adjunct

professors and include more practice-based learning formats in entrepreneurship training (e.g. by meeting real entrepreneurs, starting virtual companies or the use of informal educational processes such as gaming technologies) (OECD, forthcoming; OECD, 2016b).

## Key recommendations

- Develop more east-west interconnections in electricity networks through provincial co-operation where there is an economic case to do so and liberalise the generation and distribution segments to encourage wholesale and retail competition in jurisdictions that have not yet done so.
- Reduce foreign ownership restrictions in air transportation.
- Establish an institutional mechanism, such as the OECD's Competition Assessment Toolkit, to review existing and proposed public policies, identify those that unduly restrict competition and revise them by adopting more pro-competitive alternatives, where feasible without jeopardising other policy objectives such as inclusiveness.
- Strengthen Canadian small businesses' skills for the digital economy, including through coaching programmes to extend digital literacy.
- Shift the balance of support for business innovation further from Canada's high reliance on tax incentives towards direct funding instruments, including those that reward innovation outputs or offer assistance with expertise and managerial competence.
- Review small business taxation to identify clear market failures and the policy instruments best suited to addressing them.
- Maintain and possibly expand good-practice programmes, including IRAP.
- Strengthen the design and delivery of entrepreneurship education through better co-ordination between the federal government and education stakeholders at all levels, the sharing of provincial and local good practices, and the adoption by educational institutions of practice-based learning methodologies.

# 4 Supporting inclusive growth through strong governance

**Public governance plays an important role in delivering on inclusive growth objectives. The multidimensional nature of inclusive growth calls for the need to deal with complex problems and ensure strong levels of policy coherence both within and across levels of government. Recognising the need to foster inclusive growth, Canada has taken important steps to support the innovation capabilities of the Canadian Public Service, ensuring stakeholder engagement in the development of good regulatory practices, and investing in Open Government Data. Multilevel governance challenges must also be addressed to enable inclusive growth. With Canada being the most decentralised country in the OECD in terms of public spending, co-ordination among and across levels of government and across different spheres of stakeholders is critical to align priorities and funding.**

## **Canada needs to better mobilise the public sector for inclusive growth through innovation and good regulatory practices**

Public sector governance is an essential lever for inclusive growth, in particular given its important share in Canada's economy. In Canada, the gross value added of government represented 16.1% of GDP in 2015, above the OECD average of 12.3%.

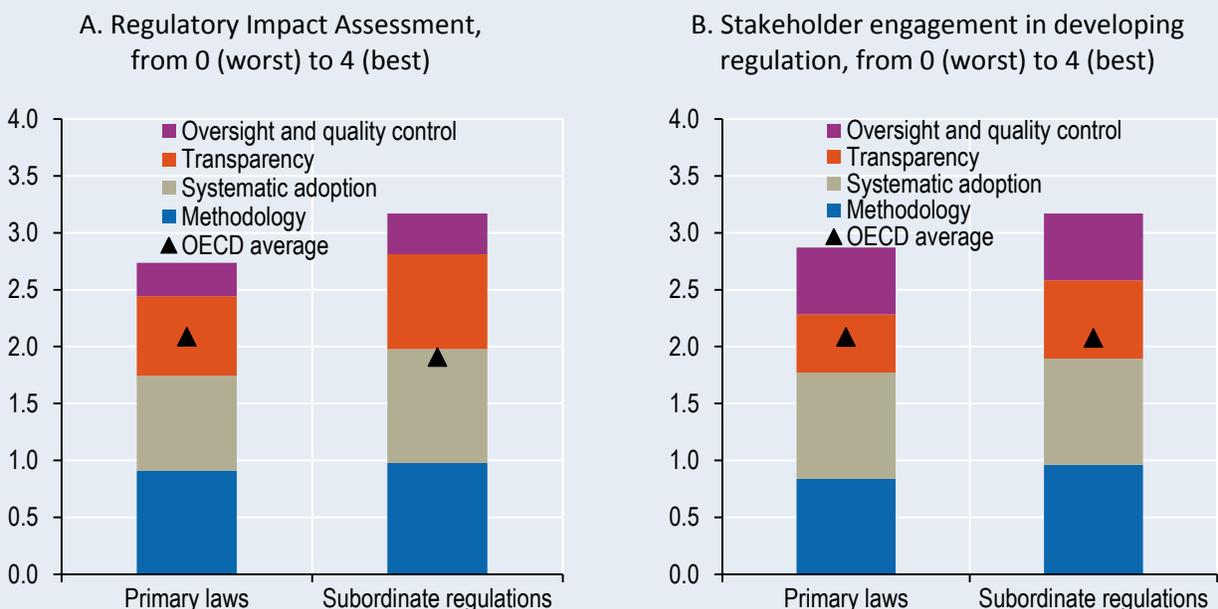
Boosting the ability of the public sector to deliver on inclusive growth outcomes requires investment in innovation. As in many countries, there is a long history of innovation by the public sector in Canada. However, also as in many other countries, the need for more consistent and sophisticated innovation by the public sector is growing, as citizen expectations evolve and complex challenges require more effective responses. Over the past few years, a number of initiatives have been undertaken to further strengthen the innovation capabilities of the Canadian public sector. One of the most recent has been a government commitment to devote a fixed percentage of programme funds to experimenting with new approaches and measuring impact to instil a culture of measurement, evaluation and innovation in programme and policy design and delivery. This emphasis on experimentation is welcome, but balancing the exploration of new ideas with the need to deliver on existing core business is a major challenge. Despite the growing number of examples within the Canadian public administration of new approaches being applied, there remain questions as to whether this

balancing challenge has really been met. Further time and evidence will be needed to assess whether these promising practices are truly part of a consistent and sustained shift to integrating innovation into core business.

Good regulatory policies are also an important lever to enable inclusive growth. Canada has made strong regulatory governance a critical pillar of its development. In particular, the processes for developing subordinate regulations are generally detailed and transparent. Open consultation is conducted for all subordinate regulations, and regulators must indicate how comments from the public have been addressed. All subordinate regulations are subject to regulatory impact assessment and evaluation requirements. Canada could improve the transparency of developing primary laws by systematically consulting on draft legislation and supporting impact analysis before legislation is put before Parliament (Figure 4.1).

The strategic use of digital technologies can help the public sector to better deliver services to citizens, for example by drawing on the smart use of data as an input to predict the needs of citizens. The Canadian government has invested technical, human and financial resources to foster the publication of Open Government Data and, as a result, it is among the top five OECD countries in regard to the definition and implementation of open government data policies. Still, like many other OECD countries, Canada faces the challenge of fully reaping the value of open data (produced either by the public sector or external actors)

FIGURE 4.1. CANADA WOULD BENEFIT FROM APPLYING THE GOOD PRACTICES IT HAS FOR SUBORDINATE REGULATION ALSO TO PRIMARY LAWS



Note: The results for stakeholder engagement and Regulatory Impact Assessment (RIA) apply exclusively to processes for developing primary laws initiated by the executive. As in Canada approximately 77% of primary laws are initiated by the executive, the indicators on RIA and stakeholder engagement cover 77% of primary laws. The composite indicators are based on regulatory policy practices as described in the 2012 OECD Recommendation on Regulatory Policy and Governance. The more of these practices a country has adopted, the higher its indicator score.

Source: OECD Indicators of Regulatory Policy and Governance 2015, <http://www.oecd.org/gov/regulatory-policy/indicators-regulatory-policy-and-governance.htm>.

as a key building block of the overall transformation of the public sector. Results from the 2017 edition of the OECD's OURdata Index show that Canada could further strengthen the capacities of public sector institutions to reuse open data. The index shows that developing skills among public officials to leverage open government data in policy development processes would be crucial to utilise these data as a valuable input for more data-driven and evidenced-based policies, and more efficient public services and organisational processes. Further developing these capacities would also build a knowledge base among public officials to better capitalise on data produced by external actors.

### Multilevel governance can be further improved

Canada is the most decentralised country in the OECD in terms of public spending (Figure 4.2). Subnational governments (10 provinces, 3 territories and 3 945 local governments) manage almost 80% of total public spending, notably in

policy areas that are key for inclusive growth, such as education, health, social protection, economic affairs and environmental protection. They also collect almost 60% of tax revenues and finance more than 90% of public investment.

However, not all subnational governments enjoy equal levels of fiscal autonomy, which can affect territorial disparities and inclusive growth. For example, urbanisation is putting pressure on the capacity of many municipalities to fund increasing needs for infrastructure, thus creating a financing gap. The establishment of the Canada Infrastructure Bank in late 2017 will contribute towards diversifying financing sources for public investment, notably by attracting private sector capital.

Metropolitan areas in Canada are spatially segregated by income groups, with a higher concentration of rich households in specific neighbourhoods (whereas metropolitan areas in Denmark and the Netherlands, for example, tend

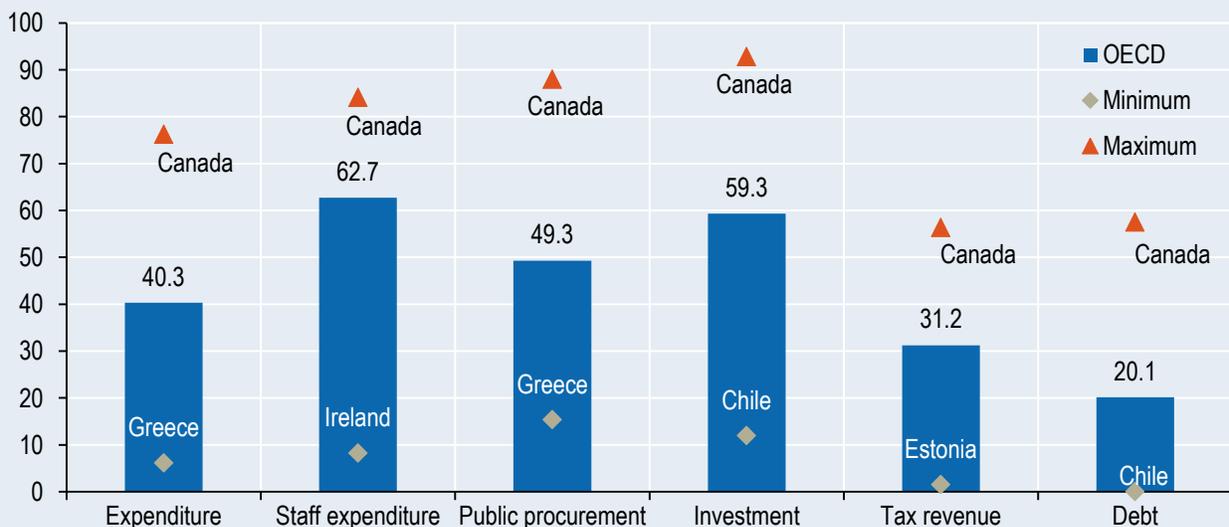
to have pockets of poor households) (OECD 2016c). There are growing concerns that rising house prices in Canada’s largest cities may be pushing people further away from the city centre, thus aggravating social spatial inequalities, increasing commuting time and generating negative environmental effects.

Co-ordination among and across levels of government and across different spheres of stakeholders is critical to align priorities and funding. This requires a clear allocation of responsibilities and a policy-making process that cuts across sectors and integrates inputs from a wide range of stakeholders. For instance, while Canada has no elected layer of metropolitan government to address core-periphery disparities in metropolitan areas, there have been several waves of municipal amalgamations to harmonise public service delivery (e.g. Halifax in 1996, Toronto in 1998, Ottawa in 2001), sometimes combined with the creation of a metropolitan co-ordination body (e.g. Montreal Metropolitan Community in 2001). Regional authorities have also been set up to co-ordinate a specific policy across member municipalities (e.g. transport in



FIGURE 4.2. CANADA IS THE MOST DECENTRALISED COUNTRY IN THE OECD

Share of subnational governments in general government indicators, 2014



Note: Debt includes insurance reserves and other accounts payable, in addition to financial debt.

Source: OECD elaboration based on OECD (2016d) *Subnational Governments in OECD Countries: Key Data, 2016 edition*, OECD Publishing, Paris, <https://www.oecd.org/cfe/regional-policy/Subnational-governments-in-OECD-Countries-Key-Data-2016.pdf>.

Vancouver and Toronto). Moreover, civil society engagement can help drive policy change. For example, in Toronto, a non-profit organisation convenes all three levels of government with business, labour, academic and non-profit sectors every four years to foster collective action on pressing issues such as transport, energy and socio-economic inclusion.

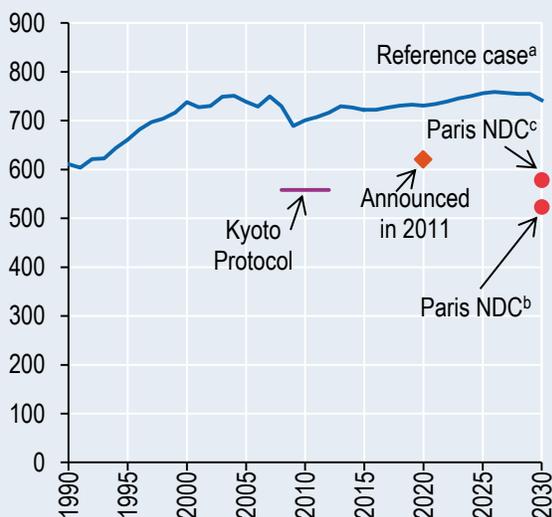
### The Canadian Free Trade Agreement will enhance opportunities and living standards

Interprovincial barriers to trade are a major hurdle for better economic performance and living standards in Canada. The Bank of Canada estimates that removing interprovincial barriers to trade could increase Canada's potential growth rate by 0.2 percentage point. Federal, provincial and territorial governments engaged in negotiations from late 2014 until early 2017 to strengthen and modernise the Agreement on Internal Trade (AIT). They agreed on the new Canadian Free Trade Agreement (CFTA) that will take effect on 1 July, 2017. This represents a major step forward in intergovernmental co-ordination.

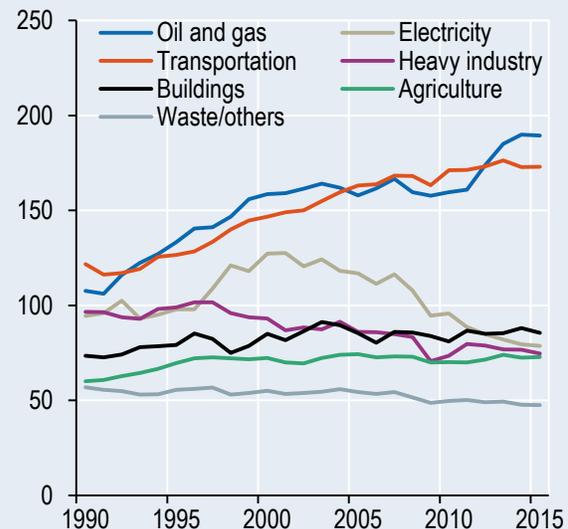
The CFTA will reduce barriers to trade, investment and worker mobility. In contrast to the AIT, it adopts a negative-list approach to exclusions, meaning that almost all areas of economic activity in Canada are covered unless explicitly excluded. This change is particularly important for innovation, as new goods and services that come to market will automatically be covered by rules designed to promote economic development. The CFTA will cover most of the service economy, accounting for 70% of GDP and, for the first time, the energy sector, accounting for a further 9% of GDP. While the inclusion of the energy sector is promising, increases in interprovincial trade will depend on making provincial regulatory regimes compatible, in particular by having competitive electricity generation and distribution markets (Chapter 3). Agriculture is not covered by the agreement, which is unfortunate, as supply management contributes to a misallocation of resources, notably in dairy production. The resulting higher prices are particularly burdensome for low-income households.

FIGURE 4.3. CANADA'S GHG EMISSIONS SHOW NO SIGN OF FALLING YET

Panel A: GHG emission and targets in million tonnes of CO<sub>2</sub> equivalents



Panel B: GHG emissions by sector in million tonnes of CO<sub>2</sub> equivalents



Notes: Panel A: a) Government of Canada emissions projections with policies and measures in place as of 1 November 2016; b) Canada's Nationally Determined Contribution (NDC) under the Paris Agreement, including purchases of international credits; c) Canada's Nationally Determined Contribution (NDC) under the Paris Agreement, domestic reduction only. Panel B: Waste/other includes coal production, light manufacturing, construction and forest resources.

Sources: ECCC (2017), *National Inventory Report 1990-2015*, ECCC, Ottawa,; country submission.



To reduce regulatory differences across jurisdictions that act as a barrier to trade, governments have agreed to establish a regulatory reconciliation process. A new Regulatory Reconciliation and Co-operation Table is to be established. It will be mandated to eliminate existing trade barriers and prevent new regulatory differences from emerging. This will be particularly helpful for small businesses, many of which have identified regulatory differences between jurisdictions as a significant barrier to internal trade. The performance of this Table will be vital for the success of the agreement. The CFTA also contains improved dispute resolution provisions (e.g. higher maximum monetary penalties for governments that act in a manner inconsistent with the Agreement, higher administrative efficiency of person-to-government disputes, and a new summary dismissal process). Government procurement is to be more open, which will help to create a level playing field and improve value for money. For the first time, the energy sector and many utilities will be covered by open procurement rules, opening up more than CAD 4.7 billion per year in procurement to broader competition. The CFTA also creates processes to help strengthen Canada's economic union in the future, committing the parties to assess options for further liberalising

trade in alcohol, triggering future negotiations on financial services and committing them to enhance economic development in the food sector in the territories.

The CFTA is better aligned with Canada's commitments under international trade agreements than the AIT was. For Canadian firms, this will reduce compliance costs for those doing business both at home and abroad and secure the same access to Canada's market as that enjoyed by foreign firms covered by an international trade agreement, such as Canada-European Union Comprehensive Economic and Trade Agreement.

**Better co-ordination is particularly crucial for climate policy**

Canadian greenhouse gas (GHG) emissions are among the highest in the OECD on a per capita basis. Emissions are almost 20% above the 1990 level and have fallen back only slightly since 2000. While emissions in electricity generation have been cut quite significantly, they have grown substantially in domestic transport and in the oil and gas extraction industry – the two largest emitting sectors in absolute terms (Figure 4.3, Panel A). Canada's Nationally Determined Contribution for the Paris Agreement specifies an emissions reduction of 30% from the 2005 level by 2030.

While this target leaves Canada's emissions not much below previous commitments (Figure 4.3, Panel B), it remains ambitious given the country's current and foreseeable emissions profile. Without a change in its current policy set, Canada will not meet its targets.

Until recently, federal policy action on climate change has operated primarily through a sector-based regulatory approach, including stringent regulations for coal-fired electricity generation, as well as progressively tightening vehicle standards (aligned with tighter standards introduced in the United States). In the meantime, several provinces moved ahead with ambitious cross-sectoral climate policies, including various schemes of carbon pricing. British Columbia has a carbon tax. Quebec has a joint cap-and-trade system with California that Ontario is planning to join in 2018. Alberta has a hybrid system that involves emission-intensity targets for major emitters, with offset trading between under-performers and over-performers, or payment of a set price per tonne for under-performers, combined with a carbon levy elsewhere in the economy.

In December 2016, Canadian First Ministers announced the Pan-Canadian Framework on Clean Growth and Climate Change (PCF), the country's first-ever overarching plan to meet the mitigation target in a co-ordinated approach among federal, provincial and territorial levels. A key component is to expand the application of national carbon pricing across Canada in 2018. The PCF sets a national benchmark of CAD 10 per tonne of CO<sub>2</sub> equivalent in 2018 (with an expectation that it will rise to CAD 50 per tonne by 2022). For jurisdictions with cap-and-trade regimes, it requires (i) a reduction in emissions by 30% or more by 2030 and (ii) a decline of annual caps until at least 2022 that corresponds with projected emission reductions from the carbon price in price-based systems (e.g. a carbon tax). For any jurisdiction not having a carbon pricing system that aligns with the benchmark, a federal government carbon pricing backstop system will apply, with revenues returned to the jurisdiction. All jurisdictions have signed on to the PCF except Manitoba and Saskatchewan.

The PCF is a well-thought-out strategy, building on progress that different provinces and territories have already made. Practical implementation will,

however, be a huge challenge. Much work will be needed to understand how to ensure some sort of level playing field from a competitiveness perspective. Indeed, differences in the coverage and price levels across jurisdictions may create pressures for eventual conversion of the different pricing systems to reduce costs, improve efficiency and address business competitiveness concerns. The linkage of the Quebec-Ontario-California cap-and-trade system presents another challenge. To ensure successful implementation of the PCF, Canada should establish a strong accountability mechanism that would allow for tracking and comparing progress across provinces.

## Key recommendations

- Consider strengthening the measurement of public sector productivity, including by measuring outputs beyond the education and health sectors and strengthening intragovernmental co-ordination on productivity measurement.
- Improve the transparency of developing primary laws in the executive by making evidence publicly available already before legislation is put before Parliament.
- Connect the open government data policy to overarching public sector modernisation strategies to ensure it contributes to the overall digital transformation of the public sector.
- Better target policy co-ordination and dialogue between the three levels of government to productivity and competitiveness priorities.
- Ensure diversified financing methods for public investment (including co-financing between different levels of government and public-private partnerships).
- Adopt adequate equalisation or other fiscal mechanisms for municipalities that struggle to meet their responsibilities.
- Ensure effective and timely implementation of the Pan-Canadian Framework on Clean Growth and Climate Change, establish a mechanism for policy evaluation and adjustment, and promote co-ordination of sub-national climate policies.

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