SPEECH
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to the Association of Certified Chartered Accountants (ACCA)
May 20, 1999

THE ISSUE THAT DARE NOT SPEAK ITS NAME
COMING OUT ON THE PRODUCTIVITY GAP IN CANADA

Good afternoon.

I was delighted to accept your invitation to join you today and talk about one of my favourite topics – productivity. I have to admit, I don't get asked to do this very often. In fact, in my conversations with government and business leaders over the past several months, I've been told repeatedly and unequivocally, "No one wants to talk about productivity." Canadians hate the word. It either agitates them into labour militancy or sends them into a deep sleep.

I must say you surprised me. We like to think of chartered accountants as the starched mainstream of business and community life. But clearly that perception needs an overhaul. You're out on the fringes with this one and I'm happy to join you there.

For all that nobody in Canada wants to talk about productivity it's sure generating a lot of attention. Industry Minister John Manley came out of the gate the day after the last Federal budget raising the alarm on Canada's productivity challenge before the Empire Club. He cited findings from the OECD that warned that our per capita GDP would drop from 10 per cent above OECD average to 15 per cent below if current trends persist. "I hope that I can convince Canadians that a productivity agenda need not mean lower wages, more hours worked and greater hardship," he said.

"With time and a concerted effort, with the government and the private sector acting in partnership, we can make sure that all Canadians see an increase in their standard of living."

So productivity, which my old economics textbook defines as "output produced per unit of input," took on a new meaning under the mantle of "standard of living."

The private sector, notably two leaders of the IT industry, was quick to assert support for some of the ideas Minister Manley was promoting. They seized on the standard of living issue from their perspective as employers who must compete with the lure of the American good life to attract and keep talent.

John Roth, the CEO of Nortel, for example observed, "Taxation is testing the allegiances of some of Canada's best and brightest high-tech talent."

And Newbridge Network's Terry Matthews weighed in by insisting "it is critical for us to stop the loss of our high-tech brain power to the United States…when this happens we all lose. Business loses and we as taxpayers lose, not just our public investment in education but the wealth and job creating potential of some of our most skilled and creative citizens."

While business was lining up behind Manley, some of his key Cabinet colleagues were going in the opposite direction. We did have Sergio Marchi, our Minister for International Trade, return from a mission to Silicon Valley and express concerns about Canada's need to innovate and compete. But others, notably Finance Minister Martin and the Prime Minister himself cite 1997 data to insist that there is no problem. This divisiveness suggests that those of us who hoped for a strong productivity agenda from the Liberals may be overly optimistic.

Anyway, the by-product of this debate has been to paint two more coats of meaning on "productivity". Taxes and the brain drain are now part of the discussion.

Anything that prompts controversy in caucus is bound to capture media attention. Canadians may not want to talk about productivity but columnists and journalists across the country seem pretty confident they want to read about it.

Peter Foster of the Financial Post recently editorialized "The answer to Canada's productivity problem is less punitive and incentive-destroying taxes across the board…" David Crane, the Toronto Star's economics editor says that Canada must innovate or lose…ultimately the living standards of Canadians and the quality of our health and educational systems depend on whether we welcome the productivity challenge or fear it.

Rarely a day goes by when there isn't a story on someone's pronouncement about productivity. But as Eric Reguly pointed out recently in the Globe, "When Preston Manning rambles on about tax cuts to enhance productivity, TVs across the country are flicked off by the thousands. There is hardly anyone, economists included who can explain what productivity is, why it is important and how to improve it." It seems that all this discussion about the subject that dare not speak its name is doing little to clarify our situation.

There is dense fog swirling around this topic. I'm not an economist and I can't claim to have the power to lift it. So I've set myself a more modest purpose today. I want to try to show you how productivity, innovation, taxation and the brain drain are all linked. I want to explain for you why these linkages are creating huge problems for Canada's IT industry. And then I want to try and incite you into action.

I want you to take your understanding of the productivity challenge this country faces and apply your influence to help address it.

To begin with, you need to understand a bit of what life is like for an IT enterprise in Canada. Three key characteristics distinguish this sector – it's fast, it's global and the stakes are huge.

No other industry depends so heavily on the power of new knowledge to fuel growth and competitiveness. No other industry invests as heavily on its creation. IT in Canada spends over $3 billion on R & D annually. The pharmaceutical industry spends less than a third of that. The aerospace industry spends $1.4 billion annually.

Why does IT spend so much on the creation of new knowledge? One word. Survival.

It's a jungle out there. The IT space is indisputably the most dynamic market on earth. The product cycle for a breakfast cereal can be measured in generations. My father had Kellogg's Corn Flakes on his breakfast table as a kid. So do my kids and it's likely my grandchildren will too. Automobile life cycles can last for decades. Ford just retired the Thunderbird last year after a 35-year run.

But if you're building a microprocessor, or a graphics accelerator, if you're developing a new portal for the Internet or cracking the puzzle of data encryption, you have to calculate that your innovation will be superseded in four quarters – if you're lucky. And there's no relief in sight. If anything, product life cycles in our business are getting even shorter.

The pace is frantic but that's not all we have to worry about.
While globalization has created huge opportunities in wonderful new markets, it has also opened up a multiplicity of new sources for competition. If you do introduce a new innovation into the IT market, it's just a matter of time before somebody in India or Singapore or Korea is going to find a way to replicate it for less.

So space and time conspire to keep the IT innovator hopping. And we wouldn't have it any other way. Michael Dell, the founder of Dell Computers, was recently asked why, with all his money and all his precocious success, he still stays in the business. "The pace of change," he said. "You never know what to expect." He could have been speaking for us all. And if you want to keep your sanity, you have to learn to accept the pleasant surprises with the unpleasant ones.

The quest for innovation can take you to the heights of scientific and commercial eminence, or it can plunge you into a gut-wrenching descent into a pit of despair and bankruptcy. It's a crapshoot, a running crapshoot where the dice are thrown on the fly and players are continually looking over their shoulders. Except a crapshoot generally offers better odds. Noel Coward used to declare that remarriage is the triumph of optimism over experience. Well I say you haven't met a true optimist until you've visited Nortel's labs or dropped in on the skunk-works of a software start-up.

Taking a great idea, working the bugs out of it and finding just the right way to make the idea commercially viable is a complex, lengthy process. Get the formula right…find the right combination of inspiration, enterprise and capital…and your quest for innovation has power to change society and build immense wealth.

And in the process you'll enhance productivity. Your IT solutions will build productivity advances not only for your company, but the clients you serve.

A key component of this formula is "inspiration"…ideas…knowledge. And where does knowledge come from? It comes from people. It has become fashionable to refer to these highly trained, entrepreneurially focused employees as knowledge workers. But Terry Matthews has taken to calling them "high brain-power wealth creators." Terry personifies them and I think I'm going to steal the term.

These high brainpower wealth creators are distinctively different than the nine-to-five workers who powered the industrial age. They are independent. They seek opportunities that are challenging as well as remunerative. And they are highly mobile.

Like steamboat captains in Mark Twains' era, innovators in advanced technology can write their own ticket just about anywhere. They are expensive to train but if we can keep them in Canada they are capable of amazing things. Look at someone like Terry Matthews. He left Microsystems International in 1972 to launch his own venture. Since then he's created or helped to create over 30 of them.

So it makes sense to keep these wealth creators here. And we have a fair bit to offer. We are the best country to live in on earth. We have a strong social safety net and a superb health care system. But in order to pay for all of this, we're also among the most heavily taxed citizens in the world. And to make matters worse, the tax burden is disproportionately loaded on those with the greatest potential to create wealth.

In Canada we consider anyone who earns $63,000 a year a high-income earner. They're charged a marginal tax rate of 55 per cent and in addition they're still hit with a 5 per cent surcharge to reduce the deficit. We retired the deficit two years ago but the surcharge lives on. In the U.S. the highest marginal tax rate is 43% and, in some states such as Washington, it kicks in at $271K.

I don't know what salaries are like in your industry. In ours, a programmer with as little as one year's experience can earn $56K. A software design <u>trainee</u> can earn $59K. And a help-desk support technician with three years experience can earn $60K. We're talking about close to entry-level positions here. The reality of life in Canada for most IT workers is that they will give nearly half of their annual earnings to the government virtually every year of their working life.

I know it's hard to try and work up sympathy for people who are making $60,000 right out of university. I'm not asking you to weep for them. They'll make out quite nicely. If they get to the point where they can't stand the tax burden, they'll go somewhere else. They'll go somewhere with a culture very much like ours. They'll go to North Carolina or Dallas or San Jose where the climate's warmer. They'll go where the mortgage on their house is tax deductible and the purchasing power of their dollar is 25 to 30 per cent stronger. They'll go where the government rewards enterprise by letting them keep more of the dollars they earn. And you know what? It's a really short drive – across an increasingly transparent border. An alarming number of Canadians are making that trip.

We live and breathe the brain drain every day. While it's true we don't have the statistical data to quantify the problem, there's enough operational evidence to give it credence.

Here's a letter from the chief scientist in a prominent Canadian IT company to Paul Martin. "Our company employs about 130 people in R & D in Toronto, plus a group of six Ph.D. level people engaged in advanced research. In the last <u>24 hours</u> I have lost one world class researcher to a U.S. competitor and have had a third person in a row decline an offer for a position that needs to be filled for us to pursue a significant growth opportunity. And if you think this is just an isolated anecdotal situation, have your staff pick any 10 competitive companies that depend on innovation and call their HR departments. You will hear the same story or worse."

Canada's best and brightest are voting with their feet. While it may seem like a small problem to some, it has the potential to evolve very quickly into a national tragedy.

The brain drain is more than a numbers game. One IT analyst has calculated that a high performance knowledge worker can be up to 100 times more productive than the industry average. Even if we're only losing a few of these, the impact can be enormous. What if, instead of founding Mitel in 1974, Terry Matthews and Mike Cowpland took jobs in Silicon Valley? There goes 8,300 jobs. You're the accountants. You figure out the impact of that on the GDP. And that's just two high brainpower wealth creators.

The reality is that if we cavalierly export our best and brightest to the U.S., we're also exporting our ability to innovate. We're exporting our ability to compete effectively in a global knowledge economy.

In the early industrial economy Canadians were cast in the unenviable roles of hewers of wood and drawers of water. As the industrial age evolved, the roles improved a bit. We became a branch plant economy. But as we move from the industrial model into a knowledge economy, Canada doesn't have to settle for a secondary role.

In the global knowledge economy, success doesn't depend on your resource base, your access to trade routes, or even on the size of your domestic market. Today success depends on how smart you are, how quickly you can innovate, and how skillfully you can bring your innovations to market. In circumstances like these, Canada has the potential to lead. But we can only seize that potential if we rid ourselves of some of the trappings of the industrial economy. We have to start by doing a better job of rewarding innovation and entrepreneurship.

That's one of the reasons why ITAC has called for an overhaul of the tax treatment of employee stock option plans. Stock options have emerged as the fuel additive of the technology sector. It's a key competitive differential in our ability to attract those high brainpower wealth creators. A few thousand dollars of salary won't hook an IT innovator nearly as effectively as the opportunity to own a piece of the action and potentially become very wealthy indeed.

We can offer appealing stock option plans to employees, but once again the tax structure shoots us in the knees. Think of the huge fortunes being made in IT and compare that to the $500K lifetime capital gains exemption Canada offers its taxpayers. I can go through the ITAC board of governors' list and show you entrepreneurs who used that up before they were thirty. What incentive do they have to keep building new businesses?

And then there's the problem of the holding period. I told you at the beginning that IT is fast and highly competitive. Take the field of routers for example. This is a hotly contested area where the next big idea comes with a huge premium. In the U.S. recently a start-up router company barely two years old was bought for $400 million U.S. It was in its infancy, 20 employees, no public share offering, no product, and no shipments. From start up to $400 million in barely two years. In Canada, many employee-shareholders of that company would not have been eligible for any capital gains exemption. The government would have taken over half of what they realized on the sale. Talk about being punished for innovation and risk taking!

We need to encourage ownership and a level playing field with U.S. regulations.

There, the recognition of income is calculated when the stock is sold. Here, it is calculated when the option is exercised. Another measure with a punitive impact on innovation.

ITAC has been working with CATA and the Alliance of Manufacturers and Exporters to try and make our finance departments understand the need for change here. We've been more successful in some places than in others. Ontario Finance Minister Ernie Eves has promised to consult with the industry to deliver the kinds of reforms I've just outlined. This is part of a concerted industrial policy to keep high performance wealth creators in Ontario…to encourage them to stay and reinvest their knowledge and their wealth right here. This is a very progressive step. It will tilt the playing field in Ontario's favour in attracting technology entrepreneurs.

But we still seem to have a way to go to capture the imagination of officials at the federal Department of Finance, Minister Martin says he will listen to us. But there are also strong indications that he's reluctant to deliver swift tax relief.

We need tax relief to stem the brain drain. We also need to outgrow the practice of creating high priced instruments for the government to endow on sectors and business wherever it sees fit. Minister Martin likes to talk about the benefits that do accrue to the high tech sector. But this interventionist approach to R & D funding only gives government the power to prop up sagging enterprises that a free market might consign to the dustbin. While in the short term this may save jobs, it does nothing for our long-term evolution as an innovative economy.

Reforming our taxation regime will help produce an improved standard of living. It will keep more wealth creators in the country and it will make us that much more attractive to foreign investment.

Maybe Canadians don't understand productivity but they do get "standard of living." We live just north of the most robust economy on earth. In the 1990s U.S. real income per capita has been increasing at double the rate of that in Canada. Put in simpler terms, the best selling car in the U.S. is a Toyota Camry. It costs $21K. In Canada, our best selling car is a Honda Accord – sticker price $15K. Maybe we can live with this differential. I don't think so. It's already proving to be a magnet for some of our best and brightest. And it's going to get worse. Do we have to wait until the U.S. standard is a Cadillac and ours is a bicycle before we agree we have a problem?

So why should chartered accountants care about this? I believe Accountants are professionally dedicated to the management and protection of the wealth of their clients and their country. If this assumption is correct, I can offer three reasons:

1. The productivity gap will drive wealth-creating companies away. We'll lose our ability to innovate and any potential we have to lead. What do Microsoft-Mail, synthetic insulin, Playtex bottles, IMAX film and the Space arm all have in common? They are Canadian innovations that went south (in both senses of the term) and took their wealth creating potential with them.

2. The productivity gap will drive high performance, wealth-creating individuals away. and,

3. Those individuals are our children.

Last winter ITAC appeared before the finance committee to present our request for tax reform. We were there on a panel with a number of other association reps including Judy Erola of the Canadian Pharmaceutical Association. Judy told the committee how at a recent dinner party the topic of émigré children came up. Everyone at her table had a child, nephew or niece either studying or working in the United States. <u>This</u> resonated in the committee room.

I was studying in Halifax in the sixties when the “Goin’ Down the Road” phenomenon was devastating Maritime cities and towns. I don’t want to see that replicated on a national scale. We have the capacity to innovate, to create exciting jobs and entrepreneurial opportunities right here in Canada. We must do whatever we can to seize that potential now.

This isn’t just an issue for IT. It’s an issue for everyone who believes that Canada can be a nation of smart, skilled, prosperous and innovative men and women. If you share this vision, I ask you to join your voice to the movement for personal and corporate tax reform as a key step to bridge the productivity gap today. Canadians have to start talking about productivity. That conversation can begin right here.

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