

New Incentives for Business Innovation



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Canada's number one economic challenge is to increase productivity (output per hour worked) in the business sector. Analysis by Statistics Canada shows that Canada's lagging productivity – which has declined from more than 90% of the U.S. level in the early 1980s to about 75% today – is due to persistently weak growth of “multifactor productivity” (MFP), a statistical measure that captures the efficiency with which labour and capital are combined to produce goods and services. The Council of Canadian Academies' expert panel on business innovation concluded that the long-term average growth of MFP is the best comprehensive indicator of innovation, interpreted broadly to include not only advances arising from science and technology, but also from improvements in business models, marketing, and business processes of all kinds. Canada's persistently weak MFP growth therefore points to an equally persistent shortfall in business innovation.

This evidence begs the question as to “why”. If innovation is good for business, why has Canadian business on the whole been consistently less committed to innovation than analysts and policy makers believe it should be? Three entrenched factors appear to lie at the root.

First – Canada is “upstream” in many North American industries owing to a comparative advantage in resources and adjacency to the

American powerhouse. Canada's upstream position in many continentally-integrated value chains has had the effect of limiting contact with ultimate end-customers – who are always a strong source of motivation and direction for innovation.

Second – Canada's domestic market is relatively small and geographically fragmented. Small markets offer lower potential reward for undertaking the risk of innovation. They also tend to attract fewer leading-edge competitors, and thus provide less incentive for a business to innovate in order to survive. Of course, the innovation success of countries like Finland, Sweden and Switzerland shows that the disadvantage of a small domestic market can be offset by a strong orientation toward innovation-intensive exports. Unfortunately, this has not been Canada's habit.

The third factor is that Canadian companies have adapted very profitably despite the foregoing circumstances. Surprisingly, in more than 80% of the years since 1961, pretax corporate profit in Canada (as a percent of GDP) has exceeded that of the U.S. The reasons for this have not been definitively explained, but the Council's expert panel on business innovation speculated that it may be due to more subdued competition in Canada's domestic market. Whatever the reason, the fact is that Canadian business overall has been quite profitable and has therefore not been motivated to change its strategy. Canadian businesses cannot be expected to adopt more innovation-oriented strategies – which would drive stronger productivity growth in the economy at large – unless the circumstances of Canadian business change in ways that make greater focus on innovation strategies superior to the status quo.

In fact, the circumstances are changing dramatically and the implications are likely to become much clearer as the global downturn gives way to recovery. The new business environment has the following principal characteristics:

- Resources

While resource-based activities will always be important for Canada, they are inherently volatile, very unevenly distributed across the country, and subject to increasingly stringent environmental constraints.

- The U.S. Market

Canada's dependence on access to the U.S. market faces a growing threat of protectionism as America itself adjusts to new competitive pressures from emerging markets. And the ever-present terrorist threat creates a constant risk that the U.S. border could close literally overnight in the wake of an attack.

- Emerging Markets

At the same time, by far the biggest growth opportunities today, and in the foreseeable future, lie in the emerging markets, particularly of Asia but also of Latin America. This is a tremendous opportunity, too little exploited by Canadian businesses, but also a new challenge as China, India and others acquire sophisticated skills and cease to rely exclusively on labour cost advantages.

- New Leaders

A new generation of Canadian business leaders is now in the wings. This is a generation at home in the world and often with strong links to the dynamic economies of Asia and elsewhere. They have few of the old habits of mind that, traditionally, may have curbed business ambition in many sectors of Canada's economy.

Whether or not these new circumstances are sufficient to stimulate a new innovation focus in Canadian business strategy remains to be seen. The incentives certainly are shifting in that direction. But there is still too much complacency and short-termism in the face of a new and far more challenging, though potentially rewarding, global business environment. V.O. Marquez, the former Northern Electric CEO writing in 1972, was right when he said we need “small catastrophes” – shock enough to force change, but not so severe as to wreck everything.