Québec’s economy: private investment lies at the heart of the productivity battle
We must catch up to guarantee our prosperity

Among the many challenges Québec’s economy will be facing in the next few years, staying in the race for global competitiveness is critical. Québec is at a crossroads on several fronts: the obsolescence of public infrastructures, population aging and high State debt levels. Because there appears to be no way to win the workforce aging battle, we must increase our productivity to keep economic growth from undergoing a brutal slowdown in the near future, taking our standard of living with it. To maintain its prosperity, along with the quality of public services offered to its citizens, Québec must immediately pick up the pace on private investment, one of the determining factors in the economy’s growth rate.

This Economic Viewpoint will tackle a number of questions. How does Québec compare to its main trading partners in terms of private investment? Is the province receiving its share, nationwide? Are its companies being hurt by underinvestment in machinery and equipment? Lastly, can the manufacturing sector capitalize on the strong dollar to modernize its facilities? Our conclusions will help us realize the importance of encouraging business to invest more here to foster Québec’s long-term economic development.

IS PRIVATE INVESTMENT AT A LOW EBB IN QUÉBEC?
At first glance, Québec’s relative performance in terms of private investment seems to have been satisfactory over the past five years (graph 1). The totals invested by business have grown at a pace below the Canadian average, as a result of the boom in Alberta. There, investment grew rapidly due to the energy boom. With Alberta excluded, however, Québec’s growth is still below that of the rest of the country. From this perspective, Ontario is the one that is lagging behind in private investment. The weakness is mainly due to the deep restructuring period the motor vehicle sector has been undergoing, which has been sapping investment in construction. If Ontario had not undergone this structural upheaval, Québec would have been well behind.

Graph 1 – Private investment: Québec’s relative importance has been disappointing over the past five years

*2008 outlook according to the survey by Statistics Canada
Source: Statistics Canada and Desjardins, Economic Studies
When we consider the economy’s size, the result for Québec is encouraging (graph 2). The size of private investment in relation to GDP has grown over the past decade, reaching 14.0% in 2007, a peak that dates back to almost fifteen years. Another favourable observation: Québec has caught up to Ontario in the last few years. Ontario’s share of private investment seems to have crested over the last few years, making it possible for Québec to catch up to the province next door. The decline by Ontario’s automotive sector, due to the struggles of North America’s big three carmakers, explains the province’s underperformance, however. Without that, Québec’s results would not have been as good.

The analysis in this Economic Viewpoint refers to the investments made by private sector enterprise. Capital spending by State corporations such as Hydro-Québec is excluded, so as to better pinpoint the investments that have a direct influence on business productivity. Each and every year, Hydro-Québec invests about four billion dollars in capital assets, which is almost 15% of investment by business in the province. Including public investments could therefore skew the analysis of the private sector.

In the early 1990s, almost 20% of private investment in Canada was invested in Québec. This share has gradually eroded, reaching 16.0% last year. Ontario’s situation is more worrisome, as its share has dropped substantially over the last 15 years. While the province was reaping 40% of national private investment in 1991, its share is now in the neighbourhood of 30%. This is well below its economic and demographic footprint in the Canadian landscape, which is about 40%. However, the deterioration has allowed Québec to close the gulf with Ontario. Meanwhile, Alberta has doubled its weight, driven by the energy sector. The province’s gains have primarily been made at Ontario’s expense, while Québec is avoiding a pronounced decline in its relative position.

In short, growth by private investment in Québec has been greater than it has in Ontario since the decade began, but slightly below Canada as a whole, even when Alberta is excluded. When we consider the size of the economy (ratio of investment to GDP), Québec has done well over the last 15 years, catching up with Ontario, which has been afflicted by the automotive sector’s restructuring. There is still a way to go to match the rate of investment for Canada as a whole. Québec is, in fact, grabbing a smaller share of Canada’s private

In this context, the comparison should be broadened to the rest of the country, even though the other provinces’ industrial structure is quite different from Québec’s. From this perspective, the picture is not as pretty. The gap between Québec and Canada has widened in the last few years, even when Alberta is excluded. Last year, the Belle Province’s rate of private investment was 14.0%, lower than Canada’s 17.1% (14.9% if we leave Alberta out). Québec is not out of the woods by any means. Business will have to intensify its investment effort to keep from losing more ground against the rest of the country, which would be hurtful economically.

QUÉBEC’S SHARE IS DWINDLING, BUT ONTARIO IS THE MAJOR LOSER

The situation deserves to be looked at from one last perspective, to round out the diagnosis. The evolution of Québec’s relative share of private investment within Canada confirms that the province’s position is gradually eroding (graph 3). Because of Alberta’s remarkable boom, due to the thriving energy sector, Québec has naturally lost some altitude in the last few years. However, unlike Ontario, which has lost ground, Québec has stood up fairly well.

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investment because of the oil windfall out west. Québec is not out of the woods by any means. Companies will have to intensify their investment efforts to keep from losing ground against the rest of the country. The province cannot be satisfied with having caught up to Ontario for private investment. It must take charge and aim higher to boost its potential for economic growth. This is critical for fostering our economy’s long-term development, especially as the demographic situation will increasingly play against us.

INVESTMENT IN MACHINERY AND EQUIPMENT: THE LYNCHPIN

To gauge an economy’s ability to increase its productivity, we must focus on private investment in machinery and equipment. This makes it possible to increase business’ productive capacity which, in the long run, makes business more competitive. That’s where it pinches. Even though Québec is doing well in terms of total private investment (including investment in building construction), the situation is very different when it comes to investment in machinery and equipment, which has a direct impact on productivity. Over the past five years, Québec has posted less growth than Canada as a whole, even with Alberta excluded, but this growth is equal to Ontario’s (graph 4). In fact, the amounts invested in modernizing have gone up by an average of 4.5% a year over the past five years in Québec, a pace that is equivalent to that of Ontario.

The same is true when we take the economy’s size into consideration. Private investment in machinery and equipment has been showing a persistent lag in Québec for about 15 years. The rate of investment in equipment is even substantially below the rates recorded by its main North American trading partners (graph 5). The United States’ performance, however, relies on heavy investments in ITCs (information and communication technologies). According to the Fortin Report, Québec also makes a poor showing globally, ranking 19th out of the 21 major industrialized economies. In this context, it is no surprise that the province is recording a chronic lag where productivity is concerned. Québec must not only pick up the pace to catch up to its neighbours, but outperform them to close the productivity gap that has deepened over the years.

INVESTMENT IN MACHINERY AND EQUIPMENT: WE MUST PICK UP THE PACE

Québec is being hurt by private sector underinvestment in the area of business modernization. Given that the province is behind its major trading partners in the area of productivity, we must turn things around quickly. Québec must redouble its effort to accelerate companies’ productive investments. The province must not just make up for the lost ground, but move into the lead, in order to increase its competitiveness in North America, as well as worldwide. In a context of market globalization, Québec must make a shift to become more competitive both nationally and internationally.
THE MANUFACTURING SECTOR MUST TURN AROUND

In the manufacturing sector, investments have plummeted in the last few years (graph 6). The Canadian dollar’s ascent and intensified international competition have undermined manufacturers’ financial situations. This translated into a wave of layoffs and a drop in investments. The tough context would have called for a change in order to modernize plants and do more to take on the merciless competition from emerging nations.

The loonie’s appreciation has substantially reduced the cost of acquiring machinery—over two thirds of machinery is imported from abroad. The price of equipment has even declined by 20% over five years, due to the Canadian dollar’s surge (graph 7). The substitution effect in China’s favour, where equipment production costs are much lower, also helped to bring prices down.

The ongoing period of structural adjustment has substantially sapped manufacturers’ profitability, with the result that the liquid assets available for investment projects have been scarcer. The tax on capital, which is especially hard to handle during tough times, has certainly discouraged manufacturers from investing. One disadvantage of this type of tax is that it also applies to a company’s debts, whether it is making a profit or not, adding to manufacturers’ tax burden during this trough period. The Québec government’s decision to abolish this type of tax on productive investment with the tabling of its 2008-2009 Budget must be hailed. Manufacturers will have more money to invest, and companies that are struggling financially will no longer be penalized.

It remains to be seen whether manufacturers will step up in 2008 and beyond, because it will take a long time to climb back up the hill. Statistics Canada’s latest survey on business investment intentions was encouraging here. The more than 20% rebound by investment in machinery and equipment in 2008 is a step in the right direction, though it is not enough to make up for the lag that has been accumulating for several years. According to the survey, an increase of more than 10% is expected in most manufacturing sectors this year. That said, let’s hope that the intentions of investing more to modernize facilities will materialize, unlike what happened last year. Abolishing the tax on capital should provide an extra boost this year.

DO COMPANIES HAVE ENOUGH METTLE TO INVEST?

Given the current economic problems plaguing North America’s economy, we can well wonder about companies’ financial capability for increasing their investment effort. Of course, the manufacturing sector is in a critical period, which undermines its profitability. The amounts invested by manufacturers in equipment and machinery account for almost 20% of the total for business. The other sectors of activity, like transportation and warehousing and the mining sector, have the wind in their sails and profits are being made. In Québec, the ratio between profits and GDP even reached a historic peak at the end of 2007, attesting to business’ financial soundness (graph 8). Ontario is seeing a similar situation, although it has crested somewhat since the decade began. For Canada, profits represent almost 20% of GDP, a much higher level, owing to the oil boom. Although corporate profits are expected to go up more slowly this year, their financial situation will remain sound.
THE TAX SYSTEM: POWERFUL LEVERAGE

We must conclude that high profits before taxes have not been enough to stimulate investments in modernization in the last few years. Québec’s tax system, which was a deterrent to capital spending by businesses in Québec, was certainly a major brake. The high tax on capital and a relatively high income tax rate can be blamed here. While the tax system is not the only factor to consider, decisions on investing are closely associated with it. A climate that is favourable to investment depends on taxation, among other things, and, by implication, on the political will to remedy the situation.

The Québec government’s 2008-2009 Budget has made a change in this regard, to allow businesses to intensify their investment efforts. By the end of 2010, the tax on capital will gradually be eliminated for all companies at the provincial level. For manufacturing, it was abolished altogether after the budget was passed. What’s more, a 5% investment tax credit now applies to the purchase of manufacturing and processing equipment. For some regions, the credit can go as high as 20% to 40%. We should also note that the federal government abolished the tax on capital for all companies on January 1, 2008. These measures aim to encourage business investment, and attest to the government desire to create conditions that are conducive to providing the required push in this area.

PRIVATE INVESTMENT MUST ACCELERATE

In conclusion, Québec has performed relatively well in the area of overall private investment over the past five years. Ontario’s underperformance, which is due to the decline in the automotive sector, has a lot to do with it. Investment growth since the decade began is below that of the rest of the country, however, even when Alberta is excluded. Efforts must be made to intensify the pace of growth and allow the province to take the lead with respect to its main trading partners. Moreover, although business investment in machinery and equipment is advancing in Québec, the faster growth being recorded by our main trading partners means that the province must pick up the pace. The amounts invested to modernize businesses are the driving force in productivity, and we must close the gap that has developed in the last few years. In this context, a turnaround is needed to cope with underinvestment in machinery and equipment.

Given the many economic challenges that are already knocking at the door, such as brutal international competition and the aging workforce, the way to prosperity is by closing the gap on productivity. Among the levers that Québec must use to stimulate economic growth, whose potential could weaken over the next few years, we must focus on increasing private investment. The purpose of the recently tabled Fortin Report was, among others, to find solutions for strengthening private investment in Québec. The tax measures implemented by the Québec government in its last budget are in line with this, which is a step in the right direction. Investment is highly sensitive to tax policy, which should encourage businesses here and elsewhere to invest locally, bolstering the long-term development of Québec’s economy.

The fact that productivity is now one of the Charest government’s driving issues is very encouraging. A tax system that is more favourable to investment should be effective, but the productivity battle is far from won, for all that. This avenue, which the Québec government privileged in its latest budget, should be strengthened to allow the province to stay in the race in the context of increasingly fierce global competition. Investments in human capital, by providing education and ongoing training to workers, as well as by integrating immigrants better, must be closely linked to economic policy to meet the productivity challenge. To preserve its prosperity, Québec will also have to be more open to the world by conquering new markets.

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References