



31 May 2006

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The Honourable Maxime Bernier, P.C., M.P.
Minister of Industry
11th Floor, West Tower
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Dear Minister,

We are writing on behalf of the Institute for Competitiveness and Prosperity to urge you to implement the key recommendations of the Telecommunications Policy Review Panel. Our focus is on the Panel's recommendations related to economic regulation and competition – areas that are critical to our mandate to measure and monitor Ontario's and Canada's competitiveness and prosperity. We think the recommendations will enable Canada's telecommunications industries to achieve their full potential in upgrading Canada's innovation and productivity. In summary we support the Panel's recommendations because:

- Strengthening competitive intensity is important for Canada's productivity and prosperity
- Implementing the Panel's recommendations will help achieve greater competitive intensity.

We discuss each in turn.

Strengthening competitive intensity is important for Canada's productivity and prosperity

In its assessment of Canada's competitiveness, the Institute has concluded that improving productivity is our key challenge for closing our prosperity gap with the US. Finding ways to increase competitive pressure on our firms is an important part of improving productivity.

Canada's prosperity gap is driven largely by productivity weakness

Canada's economy is strong, ranking among the most prosperous in the world. Canadians also enjoy a stable and secure environment, with a society that, while

education. And, without action, we will witness a growing gap in economic well-being with our neighbours to the south.

The Institute's research has consistently concluded that improving our productivity performance is Canada's key challenge in closing our prosperity gap with the US. Our work has pointed to the importance of investing more in post secondary education and machinery, equipment, and software, increasing urbanization in Canada, and strengthening the effectiveness of our industries through greater competition. Adopting the Panel's recommendations would help in achieving this last challenge – strengthening the effectiveness of our industries through greater competition.

Effective market structures are critical factors to drive productivity through greater innovation and upgrading

To guide our efforts in analyzing the causes of our prosperity gap we have developed the AIMS framework, which highlights four factors that drive our capacity for innovation and upgrading:

- **Attitudes** towards competitiveness, growth, creativity, and global excellence
- **Investments** in human and physical capital
- **Motivations** for hiring, working and upgrading as a result of tax policies and government policies and programs
- **Structures** of markets and institutions that encourage and assist upgrading and innovation.

In our previous work we identified Canada's chronic under **investment** in physical and human capital as a key contributor to our prosperity gap. We also observed that the high marginal effective tax burden lowers **motivations** for Canadians to innovate and upgrade. On a more positive note, **attitudes** do not seem to be significantly different than those in our peer states on issues such as competitiveness, risk taking, and innovation. In our work on **structures** we have concluded that our industries under perform because our market structures lack support and intense competitive pressure. Stronger structures with greater competitive intensity would raise our capacity for innovation and upgrading.

Our capacity for innovation and upgrading is the result of a structural balancing act. Firms require specialized support to build the capabilities for enhancing their competitiveness. However, they also need to be challenged to innovate and upgrade by demanding and sophisticated customers and capable rivals.

In summary, the research strongly reinforces the reality that an environment featuring a combination of support and pressure is most beneficial in nurturing and growing competitive global companies. While the various researchers point to somewhat different elements of support, specialized human resources and infrastructure figure broadly in their analysis. The presence of such powerful elements of support tends to attract multiple competitors, which helps create an important element of pressure- rivalry among co-located firms. Rivalry among alternative firms helps customers become more demanding and sophisticated which in turn helps drive the firms towards innovative activities. The presence of rival, innovative firms then produces a benefit that loops back into better support. Social networks get created across the competing firms, their customers and their suppliers and this creates a rich environment of knowledge spillovers. Both of these features enhance the supportiveness of the environment for all firms – which serves to attract more firms still, which produces more pressure and more knowledge spillovers, and so on. Overall, the research points strongly in the direction of specialized support and intense competitive pressure and their interaction as being the drivers of competitive performance.

Evidence indicates that Canada's structures are not being driven by pressure

In Working Paper 5, *Strengthening structures: Upgrading specialized support and competitive pressure*, we identified the relatively low level of competitive intensity (versus US peers) as a key factor in Canada's reduced capacity for innovation and upgrading. We found that Ontario and Canada have many of the structures in place for driving innovation and higher productivity, but these structures lack an adequate level of competitive pressure to ensure the complete success in our industries. More specifically we found that:

- The World Economic Forum's Business Competitive Index consistently identifies important disadvantages where Canada's industries lack competitive pressure – buyer sophistication and intensity of local competition. Without the intense pressure to innovate and upgrade and the benefit of specialized support, our firms tend to be rated lower in this

competitiveness index in the effectiveness of our firms' strategies and operations. More specifically, Canadian firms rank lower than many countries in company spending on research and development; competing on the basis of low cost or natural resources rather than unique products and processes, and performing the full range of value chain activities in their operations.

- Our analysis of specific clusters in Ontario identified the lack of specialized support and competitive intensity as a key differentiator between effective clusters (such as automotive and steel) and less effective clusters (e.g., biopharmaceuticals, education and knowledge creation, and tomato processing).
- A review of the firms in Canada who are global leaders (i.e. Canadian publicly traded companies that are one of the five largest in their market) indicates that the degree of competitive intensity in Canada from sophisticated customers and capable rivals has not been a significant factor in producing the country's global leaders we do have. In communications, Canada's industry has been highly regulated. Such regulations range from content and ownership regulations in entertainment media to pricing and technical regulations in telecommunications. Canada's leaders in the media industry are companies for whom these regulations did not apply. In telecommunications services and infrastructure, Canada has no global leader, despite our impressive human and technological capabilities
- In our survey of successful innovative firms in Ontario the most significant disadvantage versus their US competition they reported was the relative lack of sophisticated customers to stimulate their performance. Because of Canada's smaller market size, it will always be a challenge to ensure the presence of this competitive pressure. We can help achieve this by removing barriers to competitive intensity in our domestic markets.
- Our research has consistently shown that Canada has an excellent endowment of industries that by their nature achieve high productivity and spur innovation. These are industries that trade outside their local regions and are concentrated in particular parts of the country. Canada has a higher share of its employment in what Harvard's Michael Porter

diverse, is socially cohesive, sharing fundamental values from coast to coast. We have responded well to the challenges of globalization. Canada leads the world's top performing economies in exports as a share of the economy and on a per capita basis.

But we cannot stand still. In today's world, competitiveness is not an option. To ensure that Canada's standard of living continues to rise, our economy must grow. To grow, our economy must be competitive with other jurisdictions, particularly our most significant trading partners.

As comforting as Canada's position may look globally, the Institute has concluded that a more relevant comparison is with the United States. We believe it provides the most appropriate benchmark for our own economic progress. Against the United States, we have a significant prosperity gap, as measured by Gross Domestic Product (GDP) per capita. Our relatively poor prosperity ranking is worrisome not only because the gap is large, but also because it has slowly and steadily widened over the past two decades. In 1981, for example, Canada was only 10.3 percent or \$3,200 behind the United States. Between 1981 and 1998 the prosperity gap between Canada and the United States widened considerably – more than tripling in real dollars per capita. Since 1998 the gap has moderated somewhat to just under \$7,700 in 2002 before widening again to \$8,700, or 17.7 percent, in 2004.

This prosperity gap does not derive from a fundamental weakness in our economy, such as demographics, industry mix, or work force characteristics. Rather, the gap indicates that Canadians are not deriving as much strength from our available resources as we could. We have found no reason why we should accept being a distant second to the United States.

This prosperity gap indicates that with a similar endowment of natural, physical, and human resources, Canadians are less successful than their US Counterparts at adding value to create goods and services for consumers here and around the world. The prosperity gap means that Canadians are not achieving their potential standard of living. As a society we risk weakening the social safety net in which we all take great pride. By not realizing our full economic potential we are less able to increase our economy's capacity for future upgrades and innovations and to support higher spending in areas such as health care and

has identified as clusters of traded industries. However, our research has shown that in these clusters Canada under performs in relations to its US counterparts. What's more disturbing is that Canada's performance gap is highest in the clusters which are the leaders in an economy's productivity. In the information technology and communications equipment clusters, Canada trails the US in annual wages by 48 percent and 29 percent respectively. In patents granted by the US Patent and Trade Office, one measure of innovation, Canada's clusters trail the US significantly – 81 percent per employee in information technology and 71 percent behind in communications equipment.

In summary, we see a lack of intense competitive pressure to stimulate demand for innovation and commercialization, including the rivalry of firms in the industry, and the sophistication of customers in Canada. A key element of enhancing pressure for innovation is the presence of sophisticated business strategies and operations. Businesses that depend on innovation for survival and success will demand greater innovation in their own firms and from others such as universities and research institutes. The evidence suggests that Canada is not benefiting from this pressure.

If we want to solve the commercialization challenge, we must create a higher demand for innovation. To do this we must look at the competitive pressures that face our leading companies and identify what can be done to encourage businesses to be more competitive in their marketplace.

One of Canada's key challenges is to create an environment in which companies can and must innovate and commercialize. Our business leaders do not face the same competitive intensity as their US peers and are not getting the specialized support they require. Both shortfalls require attention. The toughest public policy challenge is how to intensify competitive pressure – how to encourage the rivalry that will lead firms to take innovation actions to outpace their competitors and how to raise consumer expectations for leading products and services. Clear answers and policies can help close this innovation gap– and in turn the prosperity gap, between Canada and the US.

Implementing the Panel's recommendations will help achieve greater competitive intensity

As we review the Panel's report, we conclude that adopting its recommendations will help increase competitive intensity in a sector that is critical for Canada's competitiveness and productivity. We do, however, disagree with its recommendations related to tax credits.

The Panel's recommendations on regulation are sound

The Panel was appointed to "review Canada's telecommunications policy framework and recommend on how to modernize it to ensure that Canada has a strong, internationally competitive telecommunications industry." One of its specific mandates was to make necessary recommendations on changes to its regulatory framework. The Panel's work represents a historic opportunity for addressing the competitiveness of one of Canada's critical sectors. We encourage the Minister and the Government – and all Canadians – to seize this opportunity.

In summary the Panel has concluded that "it is time for significant changes in Canada's current policy and regulatory approaches... [Its] proposals seek to accelerate the pace of deregulation of competitive telecommunications markets and will rely more on market forces to achieve Canada's economic goals."

We concur with the Panel that the rapid adoption of Internet Protocol (IP)-based networks, broadband and wireless technology, and by the convergence of previously distinct information and communications technologies (ICT) is revolutionizing the telecommunications market. This transformation is making it clear that the current regulatory approach is outdated. This current approach starts with the presumption that telecommunications services should be regulated unless the CRTC forebears regulation. Instead, as the Panel recommends, policy ought to be informed by the principle that services should not be regulated unless there is compelling evidence that market forces will unlikely achieve telecommunications policy objectives within a reasonable time period and that the costs of regulation do not exceed its benefits.

The Panel recommends that the CRTC should have the onus to establish the existence of significant market power by a service provider rather than starting

with the assumption that such power exists and ought to be curtailed through regulation. It may be that in the past telephone companies were natural monopolies whose actions needed to be restricted. This is certainly no longer the case. In general, regulatory bodies restrict competition, not enhance it, and we think the Panel has made a persuasive case that Canada's current approach to regulating telecommunications is no exception. As Don McFetridge of Carleton University has argued, in a January 30, 2004 brief to the CRTC, "It is seldom the case, perhaps never the case, that inhibiting competition increases competition."

The Panel's recommendations also remove barriers to future innovation in the telecommunications sector by recommending that downstream transmission, discretionary, and retail services be free from the presumption of regulation. Instead, these should be unregulated and open to customer or competitor challenges to uncompetitive behaviour for adjudication on their merits.

This approach is consistent with our recommendations that governments need to find ways to strengthen competitive intensity in our markets. We think the evidence that Canada needs more intense competition is clear.

The Panel's recommendation on tax credits should not be implemented

We disagree with one set of recommendations by the Panel: that the federal government should introduce an ICT adoption tax credit targeted at small and medium-sized industries. More specifically these tax credits would be designed to encourage investments in ICT assets, including computers, communications equipment, software and computerized manufacturing equipment, and expenses related to ICT adoption, including training, organization change and process re-engineering.

No doubt these are worthy objectives. Our research has consistently shown that Canada's productivity is impaired by businesses' under investment in machinery, equipment, and software. The Panel received impressive submissions by experts pointing to under investments by Canadian businesses, specifically in ICT. Like the Panel, we are persuaded that we need to find ways to address this under investment. And tax measures are part of the solution. But the key tax challenge facing Canada is reducing the marginal effective tax rate on business investment overall. Canada's governments tax new business

investment at a rate higher than in any other developed economy. The elimination of the federal capital tax in the recent budget was a welcome initiative. But more needs to be done, particularly in reducing corporate tax rates and, to a lesser extent, implementing more appropriate economic depreciation rates of assets for tax purposes. We are concerned that new tax credits will reduce the affordability of these broader measures.

Tax credits aimed at stimulating business investment in research and development do not appear to have improved Canada's poor record in this area. The Report of the Technical Committee on Business Taxation chaired by Jack Mintz, for example, recommended that tax policy to stimulate innovation should focus on lowering overall rates thereby improving the environment for business investment.

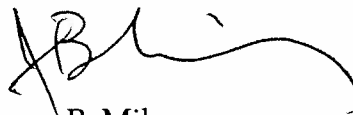
We urge you, Minister, to work with your Cabinet colleagues to advance a broader agenda of reducing taxes on business investment. Along with the measures recommended by the Panel to intensify competition in telecommunications we conclude this will have greater impact on increasing ICT investment by businesses in Canada.

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The report of the Telecommunications Policy Review Panel has the potential to be a defining moment in the development of Canada's telecommunications industry. It sets forth a direction that can help Canada realize its full potential in productivity and innovation. The Panel's work has shown that the sector's regulatory framework is outdated; reforming this framework will lead to greater competitive intensity which will strengthen productivity and innovation performance of our telecommunications businesses. This is important for the success of telecommunications. But it is also important for the competitiveness and prosperity of all Canadians. We urge you to implement the Panel's recommendations related to the regulation of telecommunications.



Roger L. Martin
Chairman



James B. Milway
Executive Director