The New International Competitive Environment: A Canadian Perspective

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Gary Hufbauer’s key assumption is that the engine behind innovation is wide-open competitive markets. Clearly competition is a powerful spur to innovation. However, by itself, competition is no guarantee that innovation and rising living standards will occur in all our societies. There is no question that significant gains in total factor productivity, a good proxy for technological progress, have resulted from open markets. This is certainly true when we look over the history of all of the Western advanced economies since 1945. Yet it remains a fact that between 1987 and 1993, the period in which Canada implemented its commitments under the Tokyo Round of the GATT, and entered into the Canada/U.S. Free Trade Agreement, total factor productivity had an annual average growth rate of zero percent throughout that entire period. This was the worst performance of any of the G7 countries and perhaps the worst of all of the OECD countries. So something else was happening there.

My basic argument is that the future well-being of both our countries depends not just on competition, but on our ability to create the institutions, incentives, encouragements, and supports for the creation of new ideas and to put them to commercial use. That is our fundamental challenge. We live in a period of profound change. Some call it a new industrial revolution. The advanced countries in this era of globalization, where developing countries can consume and adapt our existing technologies, depend for their future well-being on the capacity for innovation, new ideas, and the ability to put these new ideas to commercial use. This creates problems in trade policy because as tariffs and other traditional barriers disappear, what we call systemic frictions appear, in which the very nature of societies and how they conduct their affairs becomes an issue for trade policy experts.

Obviously, reducing trade barriers is important. The history of the post-war international economy, the contribution of GATT in raising living standards and spurring innovation, and the market opportunities brought on by the New World Trade Organization, are very important. There are other areas of progress as well. Canada/U.S. “open skies” is

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one example. This has profound potential for Canada and will play an important role in the reconfiguring of the economic architecture of our continent. It will create opportunities not just in air travel but in air cargo for areas that have formerly felt themselves out of the loop. Certainly, the deregulation of telecommunications will bring benefits. In fact, the driving force for telecom deregulation in Canada has been the financial services sector which has long argued that, unless Canada introduced long distance competition and much greater choice in telecom services, it would have to transfer more of its activities outside of Canada.

However, at the same time, there are trade barriers that remain, and efforts are not always driven by economics. Sometimes they are driven by narrow political interests. Canadians are both shocked and angered by two bills in the U.S. Congress that would impose enormous penalties on Canadians and other foreigners who do not share the U.S. foreign policy interests with respect to Cuba. From a Canadian point of view, these proposed bills represent an attempt to impose U.S. foreign policy on other countries. One U.S. congressional sponsor went so far as to argue that Canadians should defer to U.S. foreign policy concerns because of its membership in NAFTA. This was not well-received in Canada.

How do you improve competition policy in an international environment? For Canada that issue is closely linked to the issue of anti-dumping, and what we see as the abuse of anti-dumping provisions by the United States. Canadians, among others, were dismayed when, during the Uruguay Round negotiations, U.S. negotiators were adamant in refusing to consider any kind of meaningful reform to the anti-dumping code. There were some improvements. It took a lot of effort to get them, but they did not go very far.

The Canadian/U.S. views on anti-dumping will reemerge this year. As you may recall, in 1993, when Jean Chrétien became prime minister, he wanted to sign NAFTA, but he had severely criticized the previous government in Canada for its failure to achieve better protection for Canadian exporters with respect to the application of U.S. trade remedy laws. He needed some way out of this dilemma. The same solution was found for him that had been found for former Prime Minister Brian Mulrooney, who had initially said he would not sign the Canada/U.S. Free Trade Agreement unless it exempted Canada from U.S. trade remedy laws. Since it was clear the United States would not agree to this, a facing-saving solution had to be found. So a bilateral working party was established to pursue the issue. The same tactic was adopted so that Mr. Chrétien could sign the NAFTA.

The deadline for the working groups to report back is the end of 1995, and as you heard Gary Hufbauer say, and I agree, it does not seem very likely that much will emerge from this exercise. The basic
Canadian argument is that if we have an integrated market in North America, it does not make sense to have the existing system of anti-dumping laws. They unjustly penalize too many normal business practices when transactions cross borders.

In the United States and in Canada, companies can offer a single price for a product from coast to coast. A book publisher in Boston can sell a book for the same price as in Seattle, and Miami, Los Angeles, and in a small town in New Hampshire. Canadian companies do the same thing. But if a Canadian company tries to create a single price encompassing both Canada and the United States, that is a potential dumping action under U.S. law.

You get cyclical problems, and we see that in the steel industry where companies discount prices as the market slows down in order to sustain demand. If a Canadian steel producer offers the same discount to the United States as he offers in Canada, in the United States he can be accused of dumping.

You could have another situation where your customer across the border in the United States suddenly finds its customers being offered a similar product to yours, but at a lower price. You have to beat the competitor's price in order to keep your customer. That again is dumping.

Another Canadian concern is over fairness and a level playing field for competition when a powerful country such as the United States decides that it will use all of its political and military muscle to persuade Saudi Arabia to choose a U.S. telecommunication supplier over a Canadian or Swedish competitor, even if the Canadian or Swedish competitor has a better product or a better price. Another example is if the United States uses its power to persuade a South Korean electric utility to choose a U.S. nuclear power system over a Canadian one, even if the Canadian one were to offer technical or other advantages. The big and emerging war room that we read about in the U.S. Department of Commerce targets major contracts and includes the use of direct political pressure from the White House and members of the U.S. cabinet to win contracts. This does not fall into a Canadian definition of competitive markets.

I want to come back to deal with the more fundamental point: the future economic well-being of the Western advanced economies depends on their capacity to generate ideas and put them to commercial use. In economies where ideas and human capital, as well as traditional capital and labor, are critical factors of production and where comparative advantage depends on knowledge-creation and innovation, including innovation in its design of institutions, comparative advantage becomes something that can be created, and this means the governments will be involved. Governments will be involved because they have a concern over the social well-being of their own economies. Trade policy is
an important discipline in this exercise; but, it is not a substitute for domestic policies to promote economic well-being. Education, research, financial systems, tax policy, competition policy, legal systems, infrastructure, and a variety of other policies are all crucial to innovation and growth. It is here, though, that we really enter the Pandora’s box. While globalization in the role of multinational corporations will lead to some harmonization of national policies and practices, important differences among countries and their national systems of innovation will remain.

This leads to a big question of what is fair and what is unfair. To what extent is the history and culture of a society, the United States, Canada, and North America, Germany, or Japan, to the extent that it is unique in some way or another, an unfair trade barrier? Is there not a benefit from diversity as opposed to a single approach? Can there be only one model or one version of capitalism? That seems to be the view of many in the United States, at least among those who are active in advancing trade policy interests, and of course they consider the U.S. model the correct model.

Take the issues of corporate governance and ownership which are key factors in determining the innovative capacity of a firm. Ultimately it is the firm that is the actor in innovation. Systems of ownership and governance determine the ability of firms to adopt a long-term view versus a short-term view. The United States, and to a lesser extent Canada, operate what some consider to be a form of “casino capitalism” where ownership of companies is traded in much the same way as ownership of commodities. It is a world of mergers and acquisitions, leveraged buy-outs, takeovers, performance measurement by short-term results. In the more extreme form, it leads to proposals such as the recent bid to take over the Chrysler Corporation. This deal would make existing shareholders quite well-off, but would be quite destructive to Chrysler itself as a competitive automobile company in the future because it makes Chrysler, in the end, a smaller and weaker company. It reduces its assets and increases its debt. The Japanese and Germans are quite sensible in their resistance to this kind of capitalism.

The North American form of capitalism has great strengths, such as its capacity for start-ups and initial public offerings, and the ability of innovative new companies to become giants. Think of Apple Computer, Microsoft, Federal Express, and Wal-Mart. You do not see that type of innovative growth anywhere, to the same extent, in other parts of the world. Indeed, when we talk of the new economy, North America remains the world’s most fertile ground for the breeding of tomorrow’s innovators. But what is disturbing is the assumption in North America that different systems of corporate ownership and governance, such as those found in Germany and Japan, are wrong or unfair because they do not conform to the North American model. This
criticism is often directed at Germany, where the banks have been im-
portant shareholders and proxy holders in companies, and much more 
so in Japan where both horizontal and vertical keiretsu are seen as un-
fair. In fact, there is a view that we in North America have a right to 
demand that the Japanese break up their keiretsu system.

From a trade policy perspective, it is really none of our business 
whether German banks can or cannot become corporate shareholders. 
That is their way of doing business, based on their history and culture, 
and who are we to say it is wrong. Likewise, the Japanese keiretsu 
system is none of our business.

Vertical keiretsu in the auto industry, for example, has proven to 
be a highly efficient method of organization which includes, among 
other things, a close long-term relationship between assemblers and 
suppliers. This is in contrast to North American practices which have 
included a more fractious relationship between the two.

We should also remember that until recently, the North American 
auto industry itself had a high degree of vertical integration through 
wholly owned subsidiaries. Who can forget that earlier model of the 
U.S. auto industry, the Rouge plant in Michigan, where Henry Ford 
made the steel, produced the glass, and had the power plant; he did the 
entire thing. In effect, Ford took iron ore, coke, silicon, and other raw 
materials and turned them into cars. Would the Japanese steel industry 
have been justified in arguing that the U.S. vertical integration of a 
previous era was an unfair trade barrier? So who are we to criticize 
Japan for having vertical keiretsu. In fact, I would argue that the Japa-
nese system of vertical integration in the auto industry has been an 
important source of competitive pressure, forcing U.S. and Canadian 
auto companies to innovate, with positive long-term consequences of 
the viability and health of the North American industry.

The horizontal keiretsu has also proven to be a powerful force for 
industrial organization and the advancement of innovation. We are on 
weak ground in demanding that the Japanese abolish their system and 
adopt ours. After all, there is nothing stopping us in our own societies 
from establishing keiretsu if we want to. We are pursuing other indus-
trial forms of innovation, so-called virtual corporations and networks of 
companies; these kinds of institutional innovations are open to us. Are 
they really unfair trade practices? Almost certainly not.

At the same time, we should not overlook the fact that the Japa-
nese face problems of their own. While their horizontal keiretsu system 
has enabled Japanese corporations to adopt long-term strategies, the 
Japanese economic system is much less effective in creating new high-
tech companies. North American economies are much more powerful 
in turning new ideas into commercial applications. This is a serious 
issue that Japan has to face now that it has caught up with the ad-
vanced economies with its existing technologies.
In a world where, despite globalization, national systems of innovation still matter, we must avoid the temptation to argue that there is only one model of capitalism, and it is our own. The great challenge in all our economies is to build our own institutional capacities, incentives, and alliances to create healthy, prosperous societies and communities. This means that our understanding of how economies work is very important; we need a clear framework of understanding to guide us into the next century.

For most of our lives, most of us have worked with what we were taught in university, the neo-classical model of the economy — a world of perfect competition, price taking corporations which lack market power and, therefore, have to accept the market-imposed price, and a production function in which growth is driven basically by increasing inputs of labor, capital, and land.

In the mid-1950s Robert Solow made an important breakthrough by demonstrating that technological progress was the prime source of economic growth. But he was unable to explain what technological progress was, where it came from, and how it happened, so it became more or less a residual in the so-called neoclassical model. We still had a world of perfect competition; technological progress was something that literally fell from the sky.

Today the new growth economists have dug inside the black box of technological progress and in the process forced major changes in our understanding of how economies work. What they have shown is that technological progress, widely defined to include not just new inventions but also workplace reorganization such as investments in marketing, systems of organization, and the design of Wal-Mart stores is something that companies explicitly pursue for profit. This has big implications. It means that we do not live in a world of perfect competition. It means the companies can and do earn monopoly profits so they can be price makers, not price takers, and that, in effect, is the new growth theory. There are new factors of production. One of them is what we call ideas. The other new factor of production consists of human capital which is not labor, but is the human accumulation of education and skills. Since comparative advantage depends on the capacity to develop and put to commercial use ideas and the development of human capital, public policy becomes much more important.

Public policy, in effect, helps shape the capacity of a society for innovation. By increasing this capacity of innovation, public policy can increase the growth rate of the economy, and thereby the living standards. So public policy matters.

The challenge, then, is to pursue economic growth through technological progress which is something we all want for higher living standards. The additional challenge is to do it in a way that minimizes what have been called “systemic frictions;” in other words, frictions
between different societies as they pursue different models of capitalism. We do have to accept that there is more than one model of capitalism.

At the same time, we have to shift our thinking away from business-cycle type economics, where we worry about what the growth rate is going to be this year versus next year, or how we are tracking fluctuations in economy in relationship to potential GDP, and look instead at the major structural changes that are taking place in the world economy especially today when we live in a period of profound change.

Some of the implications are non-controversial in trade terms. No one can quarrel with a country that puts more emphasis on the early development of children, the quality of child care, and the quality and accessibility to education. These are long-term investments that are profoundly important. The lifetime learning and coping skills of people are developed in the earliest years of life, as is their susceptibility to disease. A country which neglects its children, or some of them, is handicapping not only the life chances of those children as they become adults in the knowledge society, but is also imposing serious constraints on its own capacity for the future in terms of both the lost productivity of those neglected children once they become adults in a world where brain power is very important; and secondly, in the social costs of future social dysfunction and poor health. That is why, in a way, economic policy and social policy can be very closely linked. That is why programs like Head Start in the United States and similar programs in Canada have very important long-term economic implications.

No one can quarrel with efforts by countries to bolster their systems of university research, their research universities. There is an international spill-over to this in the sense that research at universities becomes widely known through the publication of papers, conferences, and these kinds of things, as well as through the entry of foreign students to obtain their postgraduate degrees. The sponsoring society which invests in research universities gains advantage in the supply of trained people that these institutions produce, and in the early start that the society should get in putting new ideas to commercial use.

The design of a country’s financial system is also important in providing and pursuing innovation and ideas. Again, this is a matter for individual nations as to what kind of banking system and what kind of financing systems they want to have. For example, Canada has adopted, effectively, a universal system of banking; the U.S. system is much more compartmentalized. Financing systems can become an issue in international trade when problems of national treatment arise, for example. However, each country has to determine the kind of financing system it wants in the context of its own society, experience, and culture.

Where we really get into trouble is when we go beyond these kinds
of areas into the kinds of areas that Gary Hufbauer talked about. For example, the European Airbus enterprise: is that a good thing or a bad thing? From the perspective of the Europeans, it is probably a very good thing, and as a Canadian who would like to see more choices to buy aircraft, it probably is good as well. Yet, there is no doubt that it created tremendous trade frictions in the process.

The entire area of pre-competitive research and development and research consortia is loaded with potential for trade disputes; but nonetheless, countries are going to pursue them. Most countries have R&D tax incentives which vary widely from country to country. That is an implicit subsidy. They are generally available so they are not a matter of real dispute. The World Trade Organization recognizes that certain types of R&D supports pass a green light, and there are quite remarkable provisions in the new subsidies code. They go far beyond what people had originally expected would be permitted, but it was at the instigation of the United States that the subsidies code became much more generous than had been expected.

One way or another, governments will continue to invest in ideas, knowledge, and innovation because there are clear payoffs. The United States is a prime example of how government support for R&D has yielded enormous commercial benefits. Look at agriculture, aviation, semiconductors, computers, medical products, software, and telecommunications, for example. A lot of this has been done in the past through the military, yet the United States industry and economy has benefitted enormously from public investment in innovation.

The Bush Administration pushed a lot of these ideas further with its special projects such as high performance computing and communications, biotechnology, flexible manufacturing, new partnerships such as Sematech, and support for the auto industry. The Clinton Administration has gone further with its plans for the 21st century car and for its defense conversion programs.

All countries are going to continue to do this. What is important is to have a set of rules which determine who can and who cannot participate. Are foreigners excluded from research consortia, for example? The Europeans have come up with some ground rules. If you have a research and development facility in Europe, you can participate in their programs, regardless of country of ownership. That is not a bad test. In addition, you have to agree to make the first commercial application in Europe. These are fairly good starting points for some kind of rules on participation.

In areas such as telecommunications, information systems, and multimedia cultural issues will continue to be important. Canadians have been and remain very concerned about the scale of foreign ownership and penetration of cultural industries such as films, film distribution, books and magazines, publishing, television, and the music indus-
try. We do not want United States, or other foreign values to totally overwhelm our own through the media, which is why a majority of Canadians continue to support Canadian policies to strengthen Canadian cultural industries. This concern also applies to the so-called information highway and this 500 channel universe of information and entertainment we hear so much about. A national poll showed that fifty-three percent of Canadians and sixty-one percent of Ontario residents were concerned that transborder information flows would undermine Canadian values and identity, and sixty-two percent of Canadians said government had a role to play in preventing this from happening. As a result, those kinds of cultural issues which will continue to be important for Canada.

In summing up, the great challenges we all face is how to raise our potential growth rates and to improve our capacity for healthy communities and healthy societies. We are living in a period of profound change, one of the great waves of creative destruction, but it is one in which I believe we should be optimistic, because there is still enormous potential through ideas and innovation for a better life for all. My only other point would be that we should welcome diversity, not try to choke it out.