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Discussion

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Discussion After the Speeches of Gerhard Rosegger and Stuart Smith

QUESTION, *Professor King*: Stuart, you have a company, Rockcliffe Research, that is engaged in innovation. We are talking about the barriers to successful innovation. Do you have any comments on your actual experience there in terms of moving the company ahead? Were there things that would have been better in terms of climate to make it more successful, or are you satisfied with the success of the company?

ANSWER, *Dr. Smith*: There were two things that we were doing at Rockcliffe. Mostly we were trying to privatize government laboratories. I mentioned that we succeeded with one, and it has been a great success and has been acknowledged as such. But I should also tell you that it took me four years to get one lab out of the government. In consequence, I formulated Smith's law which says that "nothing can happen in the government of Canada without the permission of the person below you." You go in at the top with a wonderful idea (e.g. privatize the labs), but you must always talk to the next person down, and eventually you will find the person whose territory you are invading. That person usually does not think it is such a great idea, and says no. That is not surprising, but then you go back to that person's superior and report the refusal. And the answer is always, "what can I do?" There is apparently no power to force anything to happen because the system is entirely a risk-averse system. There is no benefit for innovation in the federal civil service and there are many punishments for screwing up. The consequence is that people resist change.

As to the other part of our business, during that four years, my firm and I ended up with investments in a number of smaller companies, one of which I described here before. It converts biomass into an inexpensive liquid fuel. That company is doing extremely well now, but it took a very long time because of two things: one was obtaining financing. As I explained earlier, it is very hard to get small amounts of financing.

In my present water business, financial institutions offer term sheets for 500 million dollars each, provided the water deals make sense. But when I tried to get \$250,000.00, I might as well have stayed home and forgotten about it. It is extremely difficult to get small amounts of money because it is a labor-intensive business to loan out or invest small amounts of money. It does not make sense, so they will not do it. Your SBIR [Small Business Innovative Research] program is very interesting, but we do not yet have that. What the government has done is to allow new venture pools to be created, so-called labor sponsored venture pools. The jury is out on these. We do not know if they

will work because even they eventually find that it does not pay to invest small sums like \$250,000.00.

As to our business company which turns wood waste to cheap liquid fuel, the wood products industry said they would love to have this, but each company wanted to be the third one, not the first, to try it. Again, there is that resistance to risk taking and innovation.

QUESTION, *Professor King*: So it is seed money, is that it?

ANSWER, *Dr. Smith*: It is seed money and the initial market for, in this case, a process innovation.

QUESTION, *Professor King*: You have looked at the context for innovation in many countries. How does the United States context compare with the others that you have examined?

ANSWER, *Professor Rosegger*: I do not want to draw an absolute generalization, but I would say that on the whole and on average the U.S. system is the envy of most other countries; although, when you point out that there is a price to pay for that performance, then they are no longer so sure because of their greater risk aversion — a feature Stuart Smith referred to.

And I think another very important factor is that in many western European countries — eastern European countries we can set aside — there is an intellectualized approach to innovation. In the United States you get a guy and he rolls up his sleeves and he goes to work.

In Europe I have served on several commissions that had to develop a concept for innovation, and developing a “concept” always starts with an examination of the current condition. Well, you can be sure that by the time you are done with the context, the context of current conditions will have changed. So, while this looks like a very organized approach, it very often simply gets in the way of any project really ever getting rolling.

QUESTION, *Professor King*: So that is a handicap.

ANSWER, *Professor Rosegger*: And I think there is another cultural factor to be considered: There is no great stigma attached in the United States to having failed at a venture. Bankruptcy is not exactly a strong recommendation; but on the other hand, if it is one that resulted from your having made a genuine effort at innovating with a new product or a new service, it does not earn you the disrespect of your fellow citizens. I often have a feeling that in my former homeland that sort of thing is still probably going to get you closer to suicide than to recognition. That is a cultural factor.

QUESTION, *Professor King*: I guess there is nothing insurance can do on that front. Insurance obviously costs money and of course that loads the cost up for people who have the seed money, is that right?

ANSWER, *Professor Rosegger*: Yes.

QUESTION, *Mr. Langmack*: One of the things you mentioned is

the position of the importance of labor in innovation, and I have heard from different people that one of the advantages the American industry has is that labor is willing to change. American labor seems more willing to change and participate in innovation and make it possible, make it real, make it effective, make it a success, and without the willingness of the labor to participate in this change you have a terrific obstacle in overcoming it.

One of the things that has happened in this country in the past ten or fifteen years is the unions have lost a lot of their clout. I had a small company, five or six hundred employees. We tried to put a profit sharing plan in about twenty years ago. There was a tough union in town, and they fought it vigorously.

We put it into effect anyway, and the union fought it again, but the men on the floor who rolled up their sleeves, who were innovative, who did things that they had not thought about doing before, they saw what was coming to them. It was a benefit to them, and they recognized the result. But the union never did accept the idea of a profit sharing plan, and that went on for five or six years.

ANSWER, *Professor Rosegger*: Again, I just want to say that here, as in so many other areas, diversity makes the U.S. innovation system and is its greatest strength. There have been tough unions that have resisted change. There also are some unions that have taken ownership of a whole plant, like the National Steel mill in Weirton, West Virginia and have run it as an employee-owned firm. So it is this tremendous hodgepodge which, as I tried to say in my talk, drives most planners nuts. Where is the concept they say? There is no concept. People just do things.

But I do want to say one thing about the general idea of profit sharing. How well it works depends to some extent on the stability of the business you are in, because if profit sharing also becomes loss sharing, then you can have some serious problems in labor relations.

I know of one firm, interestingly enough a firm in Austria, where they were doing so well for many years, among other reasons, because of profit sharing. Then the labor leaders began to talk, when things went a little bit downhill, about their well-earned, traditional bonuses. The fact that they were earned in connection with a particular performance got lost somewhere. By tradition the profit sharing had become so institutionalized, it was like taking something away from them when suddenly the profit sharing was not possible. That is one of the risks inherent in the system.

QUESTION, *Mr. Robinson*: I have an ill-formed theory that I would like to try out on Stuart, and that is, in Canada we may be well-positioned for public/private partnership salesmanship offshore, with the particular advantage being the significant public operations in Canada as contrasted with the United States. Our electricity, for example,

except in Alberta, is essentially a public monopoly. So we have a lead in the public/private partnership which I think is going to be a tremendous fit in eastern Europe, the former socialist countries in China, and in former quasi-command economies like India, even more than our American colleagues who are used to being privatized. The basis of the theory is that these socialist countries are not willing to go the whole route. They are not prepared for full-scale privatizations. They will take the build-own transfer type of thing as an interim measure, which is a form of public/private partnership. And I think perhaps what you are doing in Poland with the water is an example of the kind of thing where our special expertise in public/private partnership has an application that is unique to Canadian industry.

ANSWER, *Dr. Smith*: There are really two aspects of this. One is the fact that we Canadians are used to what the public sector does. That gives us a sensitivity which allows us to walk into a place like Poland and to take a group of towns, draw them together into an association and offer to form a company with them where we have half the shares and they have half the shares. We are moving ahead on that basis.

On the other hand, there is a second point. We have a number of large public monopolies with expertise they should be able to sell. What they have done up to now is try and sell it themselves. They have been singularly unsuccessful partly because they are not especially good at private sector activities, given that they are basically public sector monopolies, but partly also because they have a political problem to deal with. You know as well as I that Ontario Hydro, for example, is out trying to do various kinds of deals. But they are under such political scrutiny every time they make a move that they have to answer to headlines as to why they are spending money abroad while they are laying off people at home. So it becomes very difficult for them to do business directly and they really should go ahead in a private/public partnership.

Let us say that my company decides to partner with Ontario Hydro. Now, of course, the question is why did Hydro choose me as a partner? Why not somebody else? They are supposed to hold a call for proposals for partners, but that is not an easy thing to do.

I remember when the City of Toronto, which runs a pretty decent subway system, wanted to sell transportation expertise around the world. Again, they just did not have the freedom to do it. The moment they would make any kind of unusual or creative deal, some city counselor would criticize it in light of fare increases at home. We are trying it. There are a number of federal agencies that I have put proposals in front of right now.

In Ontario there is something called the Ontario Clean Water Agency, and they have taken it upon themselves — I say that because I

am not sure the government ever intended this — to go around the world offering services in competition with us, which would be fine except that they do not have to worry if they lose any money because they are a government organization and taxes will pay for it. So my feeling is that they should not be in that business at all. Now, if we did not have any companies in that business, then you could argue maybe they should be. So it is a tough area but, yes, it is a potential area where public/private partnerships can succeed.

QUESTION, *Professor King*: I had one other question. In terms of financing, I would like to have a comment on the role of the banks in financing at the present time, and in a better more ideal world what do you think it should be? Should the banks be doing more in supporting innovation?

ANSWER, *Professor Rosegger*: Well, the difficulty is that that question runs up against a completely different institutional role of banks in various countries. In Germany, for example, that question answers itself, because much to the dismay of many other shareholders, banks are not only the main lenders, but also the main shareholders in many businesses, so they play a dual role which I am sure colors the attitude toward innovation and other prospects in a different way from an American bank which essentially is a lender.

On the whole and on average I am just as happy with the American system because as a depositor of banks I think there are many places where they can put their money other than innovative ventures. In other words, I would think if you ask me point blank should the ordinary American commercial bank be in the venture capital business, my answer would be an unequivocal no.

QUESTION, *Professor King*: Do you have comment on that, Stuart?

ANSWER, *Dr. Smith*: Yes. Our Minister of Finance set up a committee to look at small business. I was a member of that committee and this was an issue we discussed at great length. How do you get Canadian banks to be less conservative in their lending and so on?

There are two things we looked at: One is to cause more competition by letting new banks get into banking or bringing in foreign banks. The second is to let them hold equity, as well as debt instruments, and consequently they would then perhaps be willing to invest in some of these companies that may be a bit risky, but the rewards might be proportionately great. Both of those ideas fell through. Emotionally I wish they would work, but rationally I do not think they do.

In Canada we have a long record where we just do not have bank failures. That is all there is to it. I think there was one in our history or something like that, but we just do not have it. It is not like what happened in the United States. We expect our banks to be rock solid, and people just do not like the idea that the guy lending the money might

be lending the money to a bad risk because he is trying to make good the loss he created by buying some shares in that company. We have a different expectation of our banks, and I am not sure we could or should overturn that.

The other side of it is to force them to compete more, hoping to drive them into the low end of the business. Unfortunately, the evidence so far is that it does not do that. We have allowed other institutions to get into these businesses, and they all end up doing exactly the same thing. The foreign banks have come in, but just to find a niche for themselves, usually in commercial loans. I do not know the answer.

As I say, one thing I am toying with is the idea of something to value intellectual property so at least a bank could loan against those assets with the same degree of confidence as when they loan against physical assets. You would need somebody to stand behind that evaluation to guarantee to the bank that it is somehow going to get its value, and I am not sure that that would not just create another bureaucracy. I am sorry. I do not have an answer as to how the banks can be obliged to get into this area of lending.

COMMENT, *Mr. Robinson*: We did the usual Canadian compromise after those other two methods did not work. We had the Small Business Loans Act where the government guarantees a good proportion of the bank's "risk" for loans to small business, and that has been successful. But again it is out of the taxpayer's pocketbook. The only reason the banks would do it is they have guarantees for eighty percent of their small loans.

ANSWER, *Dr. Smith*: They were not necessarily innovative businesses either. This could be your mom-and-pop stores or your dry cleaning establishments. It could be anything.

QUESTION, *Professor Shanker*: I have been very much intrigued by the idea of how to reward the worker to do a better job. But, you have discussed it more in terms of businesses that have a profit they can earn if the worker does a better job.

There is a lot of activity, needed activity in society where at least I find it very difficult to know how you value workers. Take a librarian, a social worker, a government worker, or a teacher, have you come up with any ideas on how to: (1) measure the quality of that person's performance; and (2) to reward it in the kinds of businesses that do not necessarily produce profits in the same sense as a business as you are talking about? If you have trouble evaluating intellectual property, how do you value a worker that does nothing but pure service to an individual and then reward him for it? Any ideas?

ANSWER, *Professor Rosegger*: First of all, I will quote Professor Maury Adelman of M.I.T. who once said that the hardest sentence for an economist to pronounce in any language is, "I do not know." I do not want to sidestep your question. We have an entrepreneur here, but

I think the question you have raised, of course, lies at the root of the problem we have today with assessing how well our whole economy is doing.

We have no way of satisfactorily measuring the output of huge chunks of the service sector, and so if the manufacturing sector stays relatively stagnant and the service sector increases in terms of labor and output, it is really no miracle that our productivity numbers have been stagnating or declining. You also have a growing government sector. Our statistics assume that any increase in monetary input is going to produce an equivalent increase in output. Of course it is not true. It is just statistically convenient.

COMMENT, *Dr. Smith*: I ran the Science Council of Canada. I had the rank of deputy minister. I have been in the public sector for a long time so I know the public sector. I do not have an answer to your problem and not just because of my background in social science. I forgot who said this but what social science does is prove that what happens is possible. No offense. But the fact is in the public sector you want to give rewards for productivity. It is very hard to measure productivity. Even if you could, it is extremely difficult to sort it out because, generally speaking, the work is done as a team and it is very, very hard to single people out. Monetary rewards are never used that way. Until recently I was chairman of the board of a large hospital, and again we would like to give rewards, but we ended up giving non-monetary recognition to people who made major contributions. Of course, we give money to people whose suggestions work, the old stuff that everybody has tried, but we gave prizes, had banquets, and honored people who did outstanding work.

The touchiest area is in education where people have wanted to do merit recognition for teachers, and the teachers' unions are constantly opposed to that, at least in Canada. They are afraid that the principal will reward some pet teacher rather than the one who is truly doing a really bang-up job with the children. Now, some people suggest if you had community-run schools with community boards and the principal was answerable to the community board, that the community board could then break the existing rigid system and start doing evaluations of individual teachers based in part on what the families thought about these teachers. Conceivably that could work; it looks promising, but at the moment it is too early to tell.

