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Canadian Speaker Session 11: Canada and U.S. Approaches - Outsourcing, Offshoring, Nearshoring, Legal Aspects, Possible Conflicts, Economic Impact and Job Effects - Canadian Speaker

Glen Hodgson
Thank you very much, James.

Dr. King, thank you very much to you and your Board for an invitation today. This is kind of an exceptional event for me, and much appreciated. I had a choice of being in Banff, Alberta, this afternoon, or Cleveland, and look what won out.

(Laughter.)

And I looked outside, and I looked at the sunshine and almost didn't come back in, but I figured I better do the presentation. I am going to share with you both a top-down, and bottom-up perspective – from a Canadian perspective – on what I think is really the globalization of Canadian business. And I started this work when I was at Export Development in Canada, and I have continued at the Conference Board. In fact, we have just completed a survey of our members with respect to outsourcing, so you are going to see almost real-time data with respect to the attitudes of Canadian business towards outsourcing, but it is not very heartwarming news. So I will kind of give you that as a foreshadowing.

Big picture level: I spent a lot of time in my previous job trying to convince the Canadian Government to understand that trade had changed, and the way Canada does business with the world has evolved quite a long distance. I am not sure whether I made any progress there, but I thought I would try it out on this audience as well.

So, to start with a little bit of a caricature, when I was a graduate student many, many moons ago, and many of you have seen this in your legal practices, trade was in a very traditional form. We exchanged goods with other

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countries. We didn’t really reflect services much. Foreign investment was used to get inside other markets. That’s sort of the traditional state of foreign investment as a trade development tool: Use it to leap over trade barriers, much as American capital leaped into Canada after the “Borden Tariffs” were put in place after World War I, and allowed the “branch plant economy” to grow up in my country.

Not much weight is given to imports. Imports are almost seen as kind of a negative thing. So export is good; import is bad. This is a little bit of a cartoon, but it also looks at how much rigor we have used to build up import protection regimes in both countries, with antidumping and a whole series of things you can do to assure there is fair competition from imports.

And then lastly, services: Not particularly a big deal; that’s traditionally kind of the state of trade. Then I saw a graphic. I thought it was very, very good in the ECONOMIST magazine, and I took it and did a little bit of manipulation with it, and this is kind of what globalization looks like to an economist:

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You can see three lines on the chart. The bottom line – I believe it is in red; it certainly is on my screen – shows you how GDP (Gross Domestic Product) has grown on a global basis over thirty-five years. This is done sort of in nominal units, and you can see, basically, growth chugging along at about 3% to 3.5% growth over that long period.4 Global exports have grown a little bit faster.5 That’s the middle line, and foreign investment has had a spectacular takeoff since the mid 1980s, and in fact, I would argue, has become really the driving force in the whole globalization process, from where I sit as an economist.6 Why has that happened? Well, it has happened because there have been lower barriers. We have seen significant progress multilaterally with respect to the shift from GATT (General Agreement on Tariffs and Trade)7 to the World Trade Organization (WTO),8 the creation of the Free Trade Agreement (FTA), Canada-U.S.;9 and then NAFTA.10 We have seen expansion of the E.U. discussions within Asia for freer trade, and not

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4 Glen Hodgson, Trade in Evolution: the Emergence of Integrative Trade, EDC ECONOMICS, Feb. 2004, at 3 [hereinafter Trade in Evolution].
5 See id.
6 Id.
8 Id.
9 Id.
10 Id.
just affecting trade, but also investment flows. It is much easier now for businesses to take apart their business activities, their supply chain, chop it up, and reposition elements of production almost anywhere in the world to try and get the lowest cost and the best quality. And it really has led, therefore, to much stronger trade in inputs, not just of goods, but also the creation of global supply chains, and often using Foreign Direct Investment (FDI) as the driving force there.\textsuperscript{11} So we really have shifted to a different world, wherein there is a much more integrated global economy, but also a much greater degree of disaggregation of production. So that’s kind of the conceptual model that I had in mind.

I actually went a step further, and a year ago I wrote a little paper where I gave this a name, and I called it “Integrative Trade.”\textsuperscript{12} The beauty of the English language, of course, is that you can create words, and you are not going to find “integrative,” I think, in a dictionary, but I think you get the concept. It is not integration, which is the end state. It really is a process of taking apart elements of production and moving them around the world to try and make businesses as competitive as possible, understanding that if you don’t do it, your competition is going to do it.

So this has really become sort of an inherent behavior in the globalization movement. It means that imports and exports now are much, much more integrated, and I will talk a little bit about the Canadian data. I have not drilled into the U.S. data because they are hard to find, and I would have to pay for the data series, and being in a not-for-profit organization, I am not bursting with money to do this. But, we do have access to the Canadian data, and they do tell a very interesting story about how integration has happened, and it also means that Foreign Direct Investment is used much, much more as that integrative agent,\textsuperscript{13} and then, lastly, the rule of service: Services are now 70% of Canadian GDP, and about the same in the United States.\textsuperscript{14} Services have become part of this cutting edge of integrative trade. So that’s the sort of the conceptualized idea.

I have had other economists come up to me and say, “Oh, that’s a new idea,” and my response to them is, “Yeah, but have you read an article about it?” And usually the answer is “No.” So I feel I am sort of like on the cutting edge of conceptual thinking; trying to describe the evolution of international business.

I will go on to a page here to give you the Canadian picture:

\textsuperscript{11} See Trade in Evolution, supra note 4.
\textsuperscript{12} See Glen Hodgson, Integrative Trade and the Canadian Experience, EDC ECONOMICS, Apr. 2004 [hereinafter Integrative Trade].
\textsuperscript{13} Trade in Evolution, supra note 4.
Now, this is not exactly the same as the globalization picture that I showed you in terms of the same three elements, GDP, exports, and Foreign Direct Investment. First off, you can see a takeoff of Canadian export activity post the Free Trade Agreement, and I will give you some of the data on this from a Canadian perspective. There actually was a very clear structural change happening within our economies due to the Free Trade Agreement. This was exactly the intent of opening up the border, doing away with the irritants of the border, and liberalizing the last 10% or 15% in terms of tariff removal, and Foreign Direct Investment took a little bit longer. But again, you get the same sort of spectacular takeoff of Foreign Direct Investment outward from Canada to the rest of the world to allow a structural change in how Canada is trading with the world, and that has had a positive impact, at least until recently, on Canadian growth rates. 15 I will go on to the next step.

Here are the numbers:

15 Integrative Trade, supra note 12, at 2.
If you go back to the time of the Free Trade Agreement, and look at where Canada has ended up today, our economy is actually 50% more open today in real terms than it was at the time of the Free Trade Agreement. You can see that if you take exports and imports and add them together, you end up with a number like 80% of GDP, compared to 52% in 1990. Again, going back to the mid 1980s, Canada traded about a quarter of its GDP. Now we are trading 40%. That’s a fairly significant structural swing. If you compare that to the U.S. experience, the U.S. economy is more open after the Free Trade Agreement, but it has grown from about 10% GDP to something like 13%. So we are inherently much, much more dependent upon international business than the United States economy, for economic growth. You can see that there is both North American integration happening, and the most telling variable – and this is a little bit hard concept so I will work slowly through it – you look at the import share of exports as the measure of integration. To do this, you need to go into a country’s – what is called the “input-output table,” which is actually evaluating all the things that are pro-

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16 Id. at 1.
17 Id.
19 See Jerry Haar and Antonio Garrastazu, Free Trade and Worker Displacement: The Trade Adjustment Assistance Act and the Case of NAFTA, 43 THE NORTH-SOUTH AGENDA 1, 3 (Feb. 2001).
duced in an economy, and these things that are supplied into those industrial sectors to make those things. And over that 15-year period, we have actually seen the import share of Canadian exports rise fairly significantly, or the Canadian content fall, as it shows here, from 71% to about 64%. Now, that doesn’t look like a big swing. That’s actually a 20% increase over that time frame in imports that are used in making that much higher level of exports, and that’s a pretty clear sign that Canada is much more integrated within the North American economy now. We are much more independent of U.S. sources of supply and end buyers for our economic wealth.

Service share is remarkably smaller. It is interesting how services are not on the cutting edge of our trade economy. We are still a very closed economy within Canada when it comes to services. We are actually doing research right now with the Conference Board of Canada, trying to estimate the negative impact on our growth potential for not having services included in the Free Trade Agreement.20 The fact that we have many, many sacred cows in Canada—Canadians will know about the debate about bank mergers, for example, but it goes beyond that into marketing boards and agriculture, interprovincial barriers to trade, and a whole variety of things that have served to slow or undermine our economic growth potential. So it is something we are now looking at and estimating whether that is another means of abusing our economic growth potential.

And then the most recent evidence is interesting. There has actually been a plateauing in the last five years. Since the tech wreck on the record in 2000, and the slowdown, we have experienced the series of shocks that the North American and world economy have felt since 2000;21 there has actually been a play together. Canadian exports have not really grown in the past five years, and they have certainly not grown towards the United States.22 We have had a couple of years where exports actually fell. There was a sharp uptake the first half of last year, and then a sharp slowing in the second half of last year.23 Part of that is due to external shocks, everything from 9/11, to

the SARS (Severe Acute Respiratory Syndrome) epidemic, to the turbulence we have had in the Middle East.24

The rising dollar has also been another factor, but I also think this is evidence, perhaps, we reached kind of a maturation point with respect to NAFTA. NAFTA has had this tremendous upswing for the Canadian national economy,25 and we may now have found the maturation point. And we are going to have to think much harder about what we do next. The Free Trade Agreement with the United States was almost an easy answer for the way to boost Canadian productivity and output growth. I think the next stage is going to be much harder. Can we actually go much deeper with respect to free trade with the United States? Do we have to go broader like – I think it has entirely failed, but the stalled Free Trade of the Americas Agreement, where we were trying to expand trade within the Western hemisphere,26 or do we have to do something else? So it is evident that we are kind of on a plateau today within our national economy.

The other piece of evidence – this is very new – Canadian companies had become much more aggressive. I showed you earlier that rapid rise in outward Foreign Direct Investment by Canadian business. And there has been a structural shift in our behavior. We have now become a net outward investor.27 For the Canadians in the audience, that’s a real shock. We were raised knowing about the “branch plant.” It was interesting having heard Herb Gray up here as a participant earlier because he actually was the responsible author for a report kind of at the peak of the “branch plant” in Canada, in 1972, talking about how subject Canada was to American capital coming in and controlling our economy.28

We have now shifted a long way. We are now a provider of capital to the rest of the world. We have had an outflow of investment, and the investment is bearing fruit. StatCan, Statistics Canada, has only in the last three or four years began gathering data on the sales from foreign affiliates of Canadian companies. So again, rather than exporting to the U.K., Canadian companies are investing in Britain, leaping over the trade barriers of fortress Europe to

25 A Tale of Two Economies, supra note 20.
27 A Report Card on Canada’s Trade and Investment Record, 5 Micro. 1, 11 (Spring 1999).
get inside, and basically becoming British companies selling in Europe. And it has happened in many other jurisdictions.\textsuperscript{29} And the number that StatCan has reported to us recently is the sales from Canadian foreign affiliates are as big as our goods exports. They were $360 billion in 2002,\textsuperscript{30} and for me, that’s a sign that, in fact, Canadian business is finding a way to diversify, a way from relying solely upon integrated North America, and using foreign investment as basically the market-entry tool, or delivery tool, to expand their global footprint.

Another interesting element of that is the fact that the U.S. share of these foreign sales is only 60\%, as opposed to an 82\% concentration.\textsuperscript{31} We obviously have massive trade concentration in our exports to the United States, and there has been a long-term debate about dependence and whether we can diversify, but if you look at the lower U.S. share of our sales from foreign affiliates, you can actually see what I call “diversification through the back door.” Our businesses are finding ways to generate corporate business revenue through outward foreign investment.

\textsuperscript{29} Canadian Outward Foreign Direct Investment to the World, available at http://www.asiapacificbusiness.ca/data/trade/general_dataset5_toworld.cfm (last visited Nov. 3, 2005).


\textsuperscript{31} See Measuring Canada’s International Trade and Investment Performance, 4 MICRO. 1, 7 (Spring 1998).
There is the ratio. It shows you how the ratio between outward and inward investment has slowly crept up over a long period of time, and we crossed the one point where they were equivalent in 1997, and our businesses continued to use outward investment as a vehicle to enter new markets, to access resources, to build up partnerships in other places, and to really do innovation.\textsuperscript{32} It is not resources either.

Somebody asked me yesterday, I was talking about this in the corridor, and they said, "Oh, that’s the resource economy, isn’t it?" Resources are only 12\% of the outward investment in sales. Half is manufacturing, and 42\% is services.\textsuperscript{33} So when you see a firm like Manulife buy a John Hancock, as they did a couple years ago,\textsuperscript{34} and begin to become a global company through acquisition, that’s evidence of somebody in the financial services industry in Canada acquiring assets of the United States, and using that as a platform to go global. And Manulife is now active in places like Indonesia, the Philippines, and China, selling life insurance to people who have never had it before.\textsuperscript{35} So it is an interesting innovative company in Canada.

Now, I am going to try to bridge to the more recent research we have done at the Board, and draw the link between outsourcing and foreign investment. Here Marcelo and I, I think, are going to have a little dispute, and that’s a good thing, I think to have a debate about terms and defining the phenomena that we are seeing right now. The business literature is now looking at a choice, to a great degree, between things like outsourcing and offshoring,\textsuperscript{36} which can happen in many forms. Are you going to use foreign investment as the vehicle, or are you going to use outsourcing?

In the business economics literature right now, a distinction is being drawn between standardized functions, and things that are more specialized, and increasingly the academic research indicates that if something is standardized, it can be a fairly sophisticated function, but if it is repetitive, something that is done on an ongoing basis, that becomes the best for Canada for outsourcing or offshoring, as opposed to things which are more specialized, where you want to retain control over technology or processes or relationships, and those are the functions that become candidates for Foreign Direct Investment.

\textsuperscript{32} Id. at 6-7.
\textsuperscript{33} Id. at 3.
Investment, and using FDI outflow as the vehicle.\textsuperscript{37} So that is kind of the conceptual framework. That may be too simplistic, and I think we will have a discussion about that, but think about them as a spectrum where you have standardization at one end, and the probability is you will use outsourcing as the delivery vehicle for things that are standardized, and then Foreign Direct Investment, where you are maximizing control and influence.

Canadians, too, have had an interest in outsourcing.

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\textbf{Offshore Outsourcing: Canadian views}
\begin{itemize}
\item Senior Canadian executives have embraced outsourcing as a business strategy.
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\item 80% of Canadian businesses either award or perform outsourcing contracts as part of their business strategy.
\end{itemize}
\item 75,000 Canadian IT jobs may move offshore or be repatriated to the U.S. by 2010.
\item But lack of reliable empirical evidence or critical debate on BP offshoring.
\end{itemize}
\end{center}

I won’t read all these, but this gives you the kind of excitement we have seen in Canada the last few years. Gee, outsourcing holds great promise and great risk for our economy, and there have been a number of periodicals and commentaries there. So we at the Conference Board decided we would find out what’s actually happening, and I have a colleague in another part of the organization who has put together a survey, and I will share with you the results of that survey. I have five minutes left, so I am going to move a little bit faster here. In fact, I am just going to – we put a press release out that I think David Crane certainly mentioned to me yesterday in the hallway. And here is what the title was, just to give you a sense as to what the results say: “Canadian Companies Adopt Outsourcing Sparingly – and Not Very Successfully,”\textsuperscript{38} and in fact, there is a line further down, there is a quote from my

\begin{footnotesize}
\textsuperscript{37} Id.
\textsuperscript{38} Canadian Companies Adopt Offshoring Sparingly-and Not Very Successfully, The Conference Board of Canada, Apr. 15, 2005, \emph{available at}
\end{footnotesize}
colleague that says, "The businesses we surveyed are taking a tentative, conservative approach...there is much more talk about offshoring by commentators than action by Canadian firms."\(^{39}\)

And so I am going to scoot through the data very quickly. The slides are available outside if you want to take them away. First of all, we asked our membership, we selected a number of companies and circulated a survey.

First question: "Are you doing it?" Well, more than half said "No."

\(^{39}\) Id.
"What sort of things are you outsourcing?" The biggest result was manufacturing, and then IT functions were the other areas that people responded to. As you can see, the more knowledge-based functions within a corporation are still largely retained in Canada, or perhaps they are being delivered through that foreign investment model.

Going forward, the same sort of results:
"Expectation over the next three years: Are you going to use outsourcing to really do things in your manufacturing chain, things that presumably can be standardized in terms of manufacturing?" And again, some responses around information technology, management, and support.
"What's your investment?" Interesting that the vast majority of results here are less than a million dollars. It is actually a fairly small potatoes thing within a company's supply chain. There are some scores, some results over $100 million, and a few between $100 million and, let's say, a million dollars. But it is interesting, out of 140 responses, clearly the majority are for things that are less than a million dollars. It is not a big deal within the business activities of companies that are actually doing this, and going forward, in fact, it becomes less of a big deal.

![Occurrence of Offshoring](www.conferenceboard.ca)

There is nobody who said that they had plans to offshore more than $100 million of functions, and again, the biggest scores are less than $100,000, or less than a million dollars. So this is very instructive. This is not a dominant phenomenon for the Canadian business community, at least not from the sample we had.
"What sort of role is it?" "Is it strategic?" No. "Is it very core to the business?" It is not core. It is something that is just another part of the business activity. You are not taking major head-office strategic functions and putting them out to India, to China, even to the United States.
"What are the drivers?" Well, cost is number one, and service improvement and sort of staying competitive within your particular market share, are the key drivers. You are not looking for something exceptional; you are largely looking at things that help deliver your core product. "What are the drivers of the decision?" Well, again, cost reduction, that's just a highlight on the screen.

![Benefits of Offshoring Table](image)

"What are the benefits?" "Cost savings." Seventy percent say they are saving costs. The rest are well below half.
“What about the results so far?” “Have you achieved your objectives?” Well, 58% say, “Yes.” I guess I would have been happier if it was 75% or 80%. That's the majority of the score, but it is not kind of an overwhelming vote of confidence for outsourcing as a business strategy.
“What about the barriers?” “What are the internal barriers?” Take a look at this one, and then the following slide with respect to the external barriers. Most of the barriers that exist to outsourcing within Canadian companies are internal. It is organizational resistance, whether you can actually achieve the cost savings you are looking for, and the ability to control things.

![Image of Barriers to Offshoring chart]

Compare that now to what happens when you are talking about the external barriers. In fact, the scores are much lower, and people gave us fewer examples. So it is like what Pogo said. Some of you might be old enough to remember the comic strip Pogo, who said, “I’ve seen the enemy, and it is us.”

Increasingly, the evidence that we are seeing is the constraints to outsourcing in Canada are Canadian businesses’ own capacity to manage this effectively, and the last few slides show the same thing.

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“What characteristics are you looking for?” Service levels, quality, is kind of the job one. So, if you can find an offshore delivery provider, or service provider, who does work of sufficient quality, that’s what is going to drive your decision making.
"What about management?" "Do you think you are very good at it?" "Well, we are kind of ordinary. We are okay." It is kind of like the way the Canadian Olympic team performs at the Olympics. You know, we put all our eggs in the hockey basket, and for everything else, if we get a bronze medal, we are feeling pretty good. And that's kind of the analogy I would draw to our behavior, so far, on outsourcing.

Management capacity, have you developed a core competency?" "Well, kind of, kind of as the result." And yet, you are saving money at it, so you would think the businesses would try and get a little bit better practice on how they are doing this.
“Where do you do it?” You do it through procurement. You notice that the legal department is well down the list, as are HR [Human Resource] functions, so again, a lot of the core corporate functions are staying within Canada.
“Have you gone outside?” “Have you tried to look for somebody who is best-in-class?” “Well, No.” That’s actually the answer. Instead of 82% or 83%, even though they don’t think they are developing the sort of best-in-class practice at home, it just isn’t worth their while, perhaps because you are looking at functions that are only costing you a million dollars or even $100,000 to perform.

And again, looking forward to success rates, cost savings really are the major driver. It sort of dwarfs the numbers that you see in other categories.
“Knowing what you know, would you do it again?” This is really interesting, so I think there is a real disjoint here. People actually would offshore again, even though 58% said they met their objectives, and very few have said that they are actually doing it very, very well. So it is sort of an odd series of results here, which sort of leads to the headline we had.

I am getting the wrap-up signal, so here it is: I have done that top-down look at the way Canadian trade is happening today. I think there is a fascinating evolution in how we are increasingly using investment as the market-entry and partnership-building vehicles. We go around the world and it is leading to more diversified Canadian trade, kind of through the back door, and that may well reflect the failure to advance beyond the first round of the Free Trade Agreement of NAFTA, and it probably does cost policy makers in Canada to think hard about what to do next.

The flip side is we have an interest in outsourcing. It is not that prominent, even though we thought we were going to do a lot of thinking, but haven’t really seized the bit within our teeth. The driver for doing it is cost savings, and ultimately, we need to do a lot more in terms of our own capacities at home to manage this effectively if Canadian businesses are going to take greater advantage of that as a globalization tool.

Thanks very much.

(Applause.)