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Economic Integration and Industrial Policy
In Canada and the European Community

By

N. Patrick Griffith

A thesis submitted to the
Faculty of Graduate Studies and Research
in partial fulfilment of the requirements
for the degree of
MASTER OF ARTS
in International Affairs

the Norman Patterson School of International Affairs
Carleton University
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ABSTRACT

This paper develops the thesis that the decentralized nature of the Canadian federation may make the policy framework which has evolved in the European Community quite relevant in the formulation of a Canadian industrial strategy. The paper takes the main elements of the Community's industrial policy - removal of the original and of residual barriers to trade and to the movement of factors of production, competition policy and selective fiscal supports to industry - and applies them to the Canadian situation. In introducing the Canadian situation the paper reviews the official and semi-official literature on the subject of Canadian industrial structure and competitiveness from the Gordon Commission to the present. This literature contains the origins of the call for a Canadian industrial strategy as well as a number of proposed components of such a strategy.

The final part of the paper seeks to demonstrate that, for Canada, an industrial policy along Community lines may be both necessary and feasible within the realities of Canadian federalism.

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Economic Integration and Industrial Policy
In Canada and the European Community

Chapter 1

Introduction

This paper explores the relationship between economic integration and industrial policy in Canada and in the European Community. The experience of the Commission of the European Community, in dealing with the various national industrial policies of the Community and in developing its own industrial policy, is instructive to an understanding of the origins of and the directions the discussion has taken in the Canadian case.

If we define industrial policy as policy to determine or modify the pattern of industrial activity,¹

¹ Industrial policies can be interpreted as a) being contained in those policies of a general economic nature which affect industry - stabilization policies - and in those policies which relate closely to the level and pattern of activity in the industrial sector - labour and capital market policies - and b) those policies which affect the efficiency of product markets - competition and commercial policies - and finally as c) those policies which support industry directly - procurement policies, public sector equity participation and fiscal support to industry. This definition was used as a starting point in the recent Trilateral Commission's study of industrial policy - J. Pinder, et al. Industrial Policy and the International Economy, (New York, 1979).

how does this relate to the concept of economic integration?

Economic integration, involving the provision of wider markets to industry through the removal of barriers to trade in the broadest sense (commercial barriers, fiscal boundaries, currency fluctuations), is first and foremost an industrial policy; it is an industrial policy based on greater inter-regional competition. This is not to say that the signatories of the Treaty of Rome, or for that matter the British North America Act, did not have visions of wide and enduring political union as a result of their labours. It is only to note that these designs involved, either as a first step or as an integral part of the political union, an assessment of what was necessary either to create a native industry or to provide conditions conducive to the growth and efficiency of existing industry, and the use of a prescription taken from the mainstream of western economic liberalism - wider markets allow specialization and increase efficiency.

In fact, if the trade expanding effects of the new common market are greater than the trade inhibiting effects, economic integration is the preferred industrial policy of the neo-classical economists. However, in the Canadian case industrial policy has frequently been cast as

an alternative to the pursuit of closer economic ties, or economic integration with the United States. It has not always or universally been held to be such an alternative; some writers argue that free trade or a common market between Canada and the United States would be the best Canadian industrial strategy, even as others argue that it would spell the end of Canada as an industrial nation. The experience of the European Community in the development of its industrial policy is the subject of the next chapter.

There are two distinct components evident in the European Community's strategy for industrial development. One of these is a drive for closer integration through the removal of trade barriers, and the other is a desire to support Community industries. It is true that both national and Community officials share this vision of the Community's industrial goals. However, in practice, it has often been the case that the Community official has as his first priority, the attainment of a greater degree of economic integration among the member states. The national official, on the other hand, tends to be primarily concerned with protecting domestic industry, often threatened by the integrating activities of the Community official. From the national point of view, and with some exaggeration, economic integration may be seen

as the industrial policy that a country pursues to gain access to foreign countries' markets, while other industrial policies may then be developed to shield its own industry from the effects of that particular industrial policy.

In Europe, for example, officials at two levels (Community and nation) operate over three somewhat separable economic spheres (national, Community, international). A national official in an industrial support ministry may be developing industrial policies which are in conflict with Community aims, and in particular, which could be opposed by a Community official in the Commission's Competition Directorate. The latter official is charged with removing any artificial obstacles to the complete integration of the member economies of the Community.

At the same time, however, officials of other-than-Community nations are at work attempting to integrate the Community into the world economy, most notable within the General Agreement on Trade and Tariffs through periodic negotiations aimed at liberalizing international trade. In this arena national officials and community officials find themselves in more agreement, to the point where the Commission itself has found it advisable to develop industrial policies

to safeguard Community industries from the economic integration being negotiated in the context of the GATT. While one part of Community industrial policy sees a continuing need for measures aimed at removing barriers to competition within the Community (legal, fiscal, public sector procurement, state monopolies), the other portion of its industrial policy (aid to high technology industries, aid to troubled sectors, a somewhat patchy record on merger policy) bears a striking resemblance to what is considered industrial policy in most other nations.

In is this duality of vision - the need to remove barriers to competition within that market under the Commission's control, and at the same time to avoid excessive disruption and adverse social effects, by the support and development of the Community's industry as multilateral tariff negotiations go forward - that resembles the situation of the Canadian federal government. For example, within the Community, national officials will sometimes attempt to evade or thwart the action taken by the Commission in the area of increased competition when these are seen to threaten national industry. Federal attempts to control or harmonize

the sphere of provincial government procurement, or to interfere in provincial monopolies or in provincial marketing boards would run into similar problems, yet such interference may be vital to the protection of the economic union foundations of Confederation.

Economic integration then is one type of industrial policy, an industrial policy which has as its main active ingredient the provision of wider markets and the reliance on competition to increase efficiency through the achievement of economies of scale in manufacturing. It is an industrial policy that rejects the historical national industrial strategies based on tariff protection and other barriers to trade liberalization. However, it often forces officials of national governments to find other methods of protecting national industry threatened by competitive forces. It is at this point, both in Canada and in Europe, that the perceived need for an industrial strategy emerges; in the Canadian case because, with the multilateral tariff reductions that have taken place since the second World War, tariff protection and associated barriers to trade have to a certain extent been removed as a means for Canadian governments to defend industries threatened with being painfully

integrated into the world market.

Using the example of the Community it is useful to pull together some of these ideas in the Canadian case. In chapter three the origins and context in Canada of the phrase industrial strategy itself are analyzed. The recommendations for an industrial strategy have surfaced in Canada as part of the foreign ownership debate, a situation not unlike the European where a concern over the role of U.S. multinational corporations in Europe was a factor in the formulation of Community industrial policy. It has often been felt that the lack of an overall industrial strategy, in an era of declining tariff barriers, has had a detrimental effect on Canadian industry; that increased integration into international markets will mean that Canada's comparative advantage in resource industry and the branch plant nature of our manufacturing industry could convert the nation once again into one of "hewers of wood and drawers of water". It will be contended that the negotiations surrounding the framework agreement with the European Community and the elaboration of three economic options for Canada in the early 1970's owe much to the Canadian literature on foreign ownership and industrial strategy. These three

economic policy options clearly cast economic integration with the United States as an alternative to an industrial strategy for Canada, the other option, the first, being compatible with closer trading ties with Europe.

In chapter four, the concept of economic integration is given an historical context in the Canadian case. It is clear that the role of the federal government as the guardian of the Canadian common market is central to the federal state and is a role susceptible to erosion by the provincial governments. Working on the assumption that the industrial policy of the European Community may have relevance to the Canadian case, where there are provincial jurisdictions involved in the field of industrial policy, the second half of chapter four attempts to roughly delineate a Canadian industrial policy using the Community framework. This chapter relies, in one particular area, on the more theoretical appendix dealing with competition policy in the area of merger and with other factors leading to large firm size. It is clear that the Canadian federal government has experienced the same difficulties with regard to merger policy as has the European Community's Commission, with much the same results. The appendix explores the

relationship between economies of scale and large firm size.

Chapter four concludes that an industrial policy along Community lines would have relevance to the Canadian situation given the nature of the Canadian federal structure and suggests that perhaps the seeming inability to get agreement on the goals of a Canadian industrial strategy stems from the excessive reliance on a national or centralist model. A Canadian industrial policy will only work if it takes Canadian regionalism and federalism into account.

Chapter 2

Industrial Policy In the European Community

2 This chapter will address the industrial policy of the European Community by considering the industrial strategy implicit in the Treaty of Rome itself, noting the areas where economic integration as an industrial strategy might conflict with national industrial policies and outlining the Commission's approach to the creation of an industrial strategy as such, for the community as a whole.

As one study notes: "the Treaty was concluded to promote the harmonious development of economic activity within the Community, continuous and balanced expansion, greater stability, a steady improvement in living standards and closer relations between the member states".¹ The means by which these objectives would be achieved would be the formation of a customs union, the "approximation of member states' legislation to the extent required for the common market to function", coordination of balance of payments and combines policy, and the creation of the European Social Fund to facilitate the movement of labour

¹ M.A.G. van Meerhaeghe, International Economic Institutions, (London, 1971), 264-265.

from lesser to more productive means of employment.² If we were to substitute Canada for Community and provinces for member states we would probably find agreement on these goals if they were put forward as a Canadian industrial strategy. Certainly the framers of the B.N.A. Act would have concurred that this was indeed what they sought in a confederation of the provinces. But we have a concise statement of the Canadian industrial strategy of the 1970's at hand; it is to increase employment, enhance our competitiveness internationally, increase national income and distribute it more equitably regionally, increase the processing of our natural resources and maximize their return, attain greater domestic control over our economy, improve the quality of life by creating more satisfying jobs (by which is probably meant manufacturing jobs) and reduce the harmful effects of industrial activity on the natural environment.³

Without examining this strategy in detail at this time, it is apparent that there are specifically Canadian concerns in the

² Ibid.

³ Canada, Department of Industry, Trade and Commerce, Objectives, Policies and Strategies for Canadian Industrial Development, (Ottawa, 1974).

latter reference - more employment, more control, more processing of our resources and more manufacturing employment. However, it is also true that the peculiarly European concerns of the Community's industrial policy were not formally enunciated until twelve years after the Rome Treaty was signed, and two years after the last of the tariff barriers had come down. Why could the Rome Treaty be termed an industrial strategy and how was it intended to accomplish the objectives noted above?

The creation of the European common market was an attempt, in its economic intent at least, to affect the growth process through the creation of larger markets for European firms. To quote Goran Ohlin, it was an attempt to "pay as much attention to the growth of an industry's market as is usually lavished on the growth of its capacity", the "first step towards an understanding of the growth process".⁴ Economic theory would indicate that under ceteris paribus assumptions growth in an economy's markets will make possible the attainment of higher

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Quoted in B. Balassa, The Theory of Economic Integration, (Homewood, 1961), 152-153.

levels of manufacturing productivity and therefore economic integration of a number of countries implying the fusion of national markets will improve the growth prospects of the participants.⁵

An increase in growth will result from the movement of factors of production away from sectors where they were only viable with protection, and into sectors where their comparative advantages lie. This movement should allow firms to utilize their existing capital stock fully if economies of scale were hitherto not being achieved due to a limited market, and to plan for and invest in technology which allows for even greater economies of scale.

Economic integration can result in the creation of economies external to the firm such as a growing supply of managers comfortable in the larger market, increased research and development activity, a higher level of skill in the labour force, larger and more efficient service industries -- such as financial firms, engineering firms, and consultants. Finally, economic integration will result in a series of changes to the market structure itself; a lessening of the effects of concentration in that a high profit,

⁵ Balassa, The Theory of Economic Integration, 116.

low volume strategy becomes less viable with improved access for foreign firms to a previously protected market; increased competition will force certain firms to the wall; there will be a lessening of uncertainty on the part of corporate planners and investors as to the intentions of governments in the area of commercial policy; investment decisions will begin to be taken with a view to the wider market; and all of these should begin to drive technological growth.⁶ One final economic advantage that the European common market could be expected to have would be an ability to tap even wider markets through the increased bargaining power that the Community as a whole would have in such forums as GATT and UNCTAD. These then are the mechanisms through which the drafters of the Rome Treaty expected to achieve growth, stability, and an improvement in living standards.

Later in the chapter it will become evident that there are industrial policies which are complementary to trade liberalization; policies aimed at mitigating the side effects of increased competition, or policies which remove

⁶ The analysis above draws heavily on Balassa, Theory; see also John Pinder, "Problems of European Integration" in G.R. Denton, ed., Economic Integration in Europe, (London, 1969) and D. Swann, The Economics of the Common Market, (London, 1975).

intra-national barriers to the movement of factors of production. These are policies which attempt to ease the transition to more liberal trade, policies to cope with or lessen regional disparities in employment levels or incomes and policies to ensure that there are as few barriers as possible (patent law, unresponsive capital markets, etc.) to the adoption of new technology and more efficient methods of production. It is these types of industrial policy which will concern the Community's Commission and which will surface in the early 1970's as one part of the agreed industrial policy of the Community.

The category of industrial policy most in conflict with trade liberalization is that which simply subsidizes inefficient industry. Much of what passes for industrial policy falls within this category: aid to industry simply to maintain employment levels. If the Rome Treaty can be seen as the beginning of a European industrial strategy based on economic integration, it has the effect of making the individual industrial strategies of the member states more difficult to achieve. The

formation of an economic community dedicated to the removal of customs barriers, to the harmonization of tax policies, to a community-wide combines policy, to a common transport policy, etc., will restrict national governments in the use of commercial policy, fiscal concessions, discriminatory transport rates, export subsidies, etc.

These restrictions on industrial subsidies are in addition to, and distinct from, the restrictions placed on balance of payments and stabilization policy in an increasingly integrated industrial world. As Balassa points out:

"In order to effectively carry out planning on the industry level, the risk and uncertainty associated with foreign trade need to be minimized. Conversely, autarchy provides inducements for government intervention in business decisions by increasing the scope of instruments available to governments to ensure the attainment of the chosen target. There is then a trade off between industry level planning and participation in the international division of labour as an intensification of the former necessitates a diminution of the latter and vice versa."⁷

⁷ B. Balassa, "Structural Policies in the European Common Market" in B. Balassa, ed., European Economic Integration, (Amsterdam, 1975), 226.

Here we are dealing only with the limitations on industrial planning and the provision of state aid that result from the interaction of treaty obligations of a common market, that is, with microeconomic industrial policy.

Conversely, if economic integration can have an inhibiting effect on industrial policy, the tools which remain to the industrial planner can have a distorting effect in a free trade area. Tax policy, combines policy, public procurement, pricing by public utilities and public investment decisions can affect a firm's cost structure and its comparative efficiency⁸ either unintentionally if they have not been fully considered with this aspect in mind, or purposely by the national planners. With the signing of the Rome Treaty it was left to the Commission's General Directorate IV, which deals with the Community's competition policy, to address the problems of both residual and more innovative governmental barriers to the free play of competitive forces.

The Commission of the European Community has found industrial-development-related policies to be running counter

⁸ H.G. Johnson, Aspects of a Theory of Tariffs, (London, 1971), 406-408.

to the spirit if not to the letter of the ~~Rome~~ Treaty in three areas - state aids (both sectoral and regional), merger policy and aids to export. Of the three, it is the problem of state aid which seems to be the most recurrent and difficult to deal with. In the First Report on Competition Policy⁹ the Commission addressed the problem of state aids at some length. Every report since has dealt with some aspect of the problem, and the most recently published Seventh Report on Competition Policy notes: "For the present it is in the area of state aids that competition policy has been subjected to the greatest pressures".¹⁰ Leaving aside the provision of state assistance for regional development, where the Commission sees a valid need for such aid and where it has attempted to lay down guidelines to govern it, the Commission is much less sympathetic to sectoral aids. (It is, of course, often difficult in practice to disentangle regional and sectoral assistance schemes.) The twin problems of sectoral aid are firstly, the effect of the provision of such aid on the comparative competitiveness of Community firms and secondly, the difficulties that the Commission faces in addressing the problem itself.

⁹ European Communities, Commission, First Report on Competition Policy, (Brussels-Luxembourg, 1972).

¹⁰ Commission, Seventh Report, (Brussels-Luxembourg, 1978), 11.

On the former, the Commission notes that there is generally a conflict of interest involved between economic agents in different member states when state aid is provided. The member state providing the aid does not usually act with a Community viewpoint and without this viewpoint the aid often represents a misuse of resources from a Community point of view. Aid schemes can also result in reciprocal neutralization, or they may shift the burden to another member country, or they can have totally unforeseen results.¹¹ Two sectors which have surfaced with regularity in the Commission's reports are textiles and shipbuilding. In each of these cases, and more recently in steel, there is the general problem of outmoded overcapacity affecting the same sector in a number of member states. Each of the member states faced with the problem has tended to implement unilateral aid policies for the sector which often result in increased capacity in the sector, or in competing subsidies to export, or in subsidized production costs, etc.

But as we noted, the Commission is faced with difficulties in even addressing the problem. The aid is often

¹¹ Commission, First Report, 113.

not given on the basis of economic but of political and social rationality, and the community can only rule where the aid is demonstrably harmful to another member state. The aid can take many forms - state guarantees for loans, tax exemptions, etc., and is therefore often not transparent enough to be assessed. Finally the Commission is always in the position of reacting to initiatives of the national government because there is no Community framework for such aid.¹² In the case of shipbuilding, by 1975 the Commission had come up with a set of rules to govern aid to the sector. There would be a moratorium, with exceptions, on aid to build ships after 31 December 1975; aids to sell (export credit, grants) would have to conform to OECD guidelines; there would have to be notification of aid to invest in a shipyard and of aid to save a firm; countries would refrain from any other measures to promote building, conversion or component manufacture on their territory.¹³ This approach went some way to overcoming the disadvantages under which the Commission felt it worked, but it had taken five years

¹² Commission, First Report, 12-13.

¹³ Commission, Fifth Report, 77.

to arrive at rules acceptable to the member nations of the Community.

Textiles present a problem which is often sectoral and regional at the same time. In 1976 the Commission outlines a series of guidelines for aid to that sector which are distinct in focus from those laid down for shipbuilding. Aid must be to assist adaptation: for example, for joint research and development work, to eliminate excess capacity, for the conversion of firms to other lines of work or to promote horizontal or vertical integration. Aid should not go to maintain uncompetitive production. Where aid to investment was being granted because of acute unemployment problems, it should not be confined solely to the sector needing adjustment and should not result in increased capacity in this sector.¹⁴ However, by the spring of 1978, the Commission was still pointing to the shipbuilding and textile industries as examples of areas where there was a need for a policy at the community level to resolve structural problems common to several member states. The Commission noted, yet again, that state aids

¹⁴ Commission, Sixth Report, 114.

which add to excess capacity are harmful from a sectoral point of view and ineffective from a regional point of view.¹⁵ It should not be interpreted from the above that the Commission is against state aid for the purpose of accelerating or cushioning structural change in an industry. It would simply like the aid to have such an objective and to be designed so as to achieve it, to be transparent, to be digressive and to not cover an industry against all its risks.¹⁶ The problem of troubled industries or industrial sectors is a recurrent one in discussions of industrial policy and obviously one not without relevance in the Canadian case. And, as the previous analysis and the experience of the Commission would indicate, the problem of state aid is not one that can be resolved once and for all. The formation of a customs union and the resultant lessening of the protection which commercial policy can provide to a nation's industries at one and the same time accentuates a nation's weak industrial sectors and removes the most politically opaque method of safeguarding them (tariffs). State aid then becomes a natural

¹⁵ Commission, Seventh Report, 12-13.

¹⁶ Commission, First Report, 18 and 130.

second best solution to a short term problem, the prospect of an often localized jump in unemployment if an industry goes under, even though state aid contributes nothing to the long run solution which would entail moving factors of production into more productive uses. Even in the absence of a customs union, the successive lowering of tariffs as a result of GATT negotiations have given Canadian policy makers similar conundrums to ponder, often with similar results. It is also true that provincial governments in Canada have felt driven to the use of state aids to entice **capital and to protect industries** within their jurisdiction from the competitive forces at work in the Canadian common market.

Examples noted thus far have been of one type of state aid, but as noted earlier there are others, and it is necessary to bear in mind that direct grants are only one method of providing "state aid" to industry. Other methods include public procurement policy; the harmonization, or lack thereof, of national standards; discriminatory freight rates; and discretionary tax policy. Then, there are aids to export. The Commission

has found it necessary to outlaw French and Italian export guarantee schemes which would guarantee the price against inflation over the life of the contract, schemes for granting preferential rates on export credit, a French plan to subsidize domestic firms locating abroad and an Italian plan for a state subsidized promotional campaign for Italian goods in France.¹⁷

Ironically though, the Commission has set itself the task of monitoring the activities of member states to prevent the introduction of new barriers to competitive exchange, even while it has had to come to grips with the concept of a Community industrial strategy. One issue area which indicates this clearly is the field of merger policy. In the Commission's experience, its proposals for notifications of mergers over a certain size ran counter to a feeling, at the national level, that one of the problems in the Common Market was that European firms were too small in comparison with their U.S.

¹⁷ Commission, Sixth Report, 124-125.

competition, that the Commission's proposals to address the problem of concentration would run counter to the Community's goals of maintaining high employment rates. The Commission was forced back to the use of the Article 86 restrictions on "mergers which constitute abuses of dominant positions".¹⁸ It has been argued that the drafters of the treaty were dealing with an outmoded concept of competition, that they were in fact pre-Schumpeterian and that not only was monopoly not a problem in the Community - on the contrary the problem was one of too many sub-optimal firms - but that an element of monopoly was necessary for technical progress to take place.¹⁹ It was also felt that certain industrial technologies - a family of computer central processors, integrated circuits and semi-conductors, large modern aero-engineer and airframes, nuclear reactors, wideband telecommunication systems - were beyond the means of a single medium-sized European state and would have to be coordinated on a Community level. So when an industrial policy for the Community

¹⁸ Commission, Third Report, 9.

¹⁹ See for instance D. L. McLachlan and D. Swann, Competition Policy in the European Community: The Rules in Theory and Practice, (London, 1967), 77-86, for a summary of this line of reasoning in relation to the European common market.

began to be formalized in the early 1970's it had to take into account not only the removal of the remaining barriers to competition but also the "need" for competitive high technology European firms, the "need" for European multinationals, the "need" to convert declining industries, etc. What has the Commission proposed and what has the Community agreed to in the way of an industrial strategy for Europe?

In 1970 the Commission outlined its views on a community industrial strategy to serve as a "point de départ pour un large débat avec les autorités des Etats membres ainsi qu'avec les différents milieux professionnels intéressés".²⁰ The Commission felt that an industrial policy was necessary for much the same reasons as the Community itself had been felt to be necessary - to provide an irreversible base for the economic and eventual political unity of Western Europe, and to achieve economic growth. Additionally, in answer perhaps to its Schumpeterian critics, the Commission saw this as a means of attaining a "reasonable" degree of technological independence

²⁰ Commission de communautés Européennes, La Politique Industrielle de la Communauté, (Bruxelles, 1970), 39.

with regard to large external trading partners.²¹ The more proximate goals of this industrial policy are also in keeping with the drive toward closer economic union and with the theory underlying the industrial strategy implied in the Rome Treaty: creation of a single market, unifying the legal, fiscal and financial code, restructuring of enterprises, the organization of change and adaptation, and a common front externally.²² The detailed proposals for the most part represent a working out of Article 3 of the Rome Treaty - eliminate technical barriers to trade, open up public markets, abolish fiscal frontiers, harmonize national social security and state aid programs, eliminate legal barriers to cross-frontier mergers, ease restrictions on money market operations across national frontiers and better utilize the Social Fund to cushion industrial adjustment.

There were also areas of policy which the Commission felt the Community would have to tackle in common. They would have to deal as a unit not only in external tariff negotiations but multilaterally

21 Ibid., 7

22 Ibid., 18.

with the rest of the world on codes for export credit, investment policy, policy towards multinational enterprises and non-tariff barriers to trade. Finally, the Commission recognized the need for larger European companies. An industrial policy for the Community would entail eliminating the barriers to the formation of European multinationals and the provision of public funds to develop industries in technologically advanced sectors.²³ But, obviously, this is an industrial policy which still sees competition and not firm size as the main variable in an industrial strategy.

Thus the Commission remains unconvinced that a dynamic European industry could only be attained at a cost of increased concentration. It is also noteworthy that the Commission felt it necessary to point out that there should be no misunderstanding about the difference between an industrial policy and the concept of planning. Their policy envisaged no increase in either national government or European community intervention in the economy; on the contrary, it would entail less intervention in that it would be keyed to the removal of

²³ Ibid., 24-38.

still existing barriers within the common market. A "sectoral" approach would only be used where industries needed help to adapt or where they showed promise of great success.²⁴

The heads of the member governments along with those from the three prospective members met in Paris in 1972 to approve and to lay down guidelines for a Community industrial policy. In doing so they accepted, in the main, the Commission's proposals put forward two years earlier, and in 1973 the Commission began to turn these guidelines into the practical and detailed modalities of an industrial strategy. Their programme was presented to the Council of Ministers in May of that year and grouped the proposed actions under four main headings: 1) the removal of remaining barriers to trade within the Community to include technical barriers and trade control formalities; 2) the gradual and effective extension of the right to tender for public and semi-public supply contracts; 3) the promotion of competitive undertakings of European scale - mainly through the

²⁴ Ibid., 15-16. See also A. Cairncross et al., Economic Policy for the European Community, 146-154, for the need for coherent industrial and competition policies.

harmonization of national company law and of tax law, through the creation of new legal forms to ease the restrictions of cross-frontier mergers and financing, and by the provision of improved sources of risk capital to small and medium sized businesses;

4) effective coordination of the principal national sectoral policies that deal with advanced technology industries and with industries in crisis; in this area the Commission would continue to submit proposals to coordinate the provision of aid to such sectors as the aircraft industry, data processing, heavy mechanized and electrical engineering, nuclear industry, uranium enrichment, shipbuilding, textiles and paper.²⁵

As a moments reflection will show, much of what the Community has focussed on has relevance to the subject of a Canadian industrial strategy in that Canadian policy makers either face similar problems or are preparing similar solutions. This is the case with aid to small and medium-sized businesses, where Canada has created a separate ministry to deal with their problems; it is the case with provincial and federal public sector procurement policies, with

²⁵ European Communities, Commission, "Memorandum from the Commission on the Technological and Industrial Policy Programme", Bulletin of the European Communities, Supplement 7/73, (Brussels, 1973), 5-16.

federal and provincial regional and sectoral aid policies, to give some examples. Where the Community is attempting to remove remaining technical, fiscal or legal barriers to trade, Canada solved the problem, in industrial goods at least, with the creation of a federal state. Nevertheless, it is instructive to consider that in a disintegration of this federal state, or in a common market between Canada and the United States, the survival chances of Canadian industries would be much improved if the negotiators were aware of the Commission's discovery that free trade is only the first step, although a very large first step, in achieving the growth prospects and industrial development benefits of wider markets. However, in the Canadian case, Confederation,²⁶ and in the European case, the Rome Treaty, were industrial strategies as well as attempts at political union.

This chapter has treated the European

²⁶ See in the Canadian case for example H.G.J. Aitken, "Defensive Expansionism: The State and Economic Growth in Canada", in W.T. Easterbrook and M.H. Watkins, Approaches to Canadian Economic History, (Toronto, 1967), 203-205, and W.A. MacKintosh, The Economic Background of Dominion-Provincial Relations, (Toronto, 1964), 20-27.

Community's formation as being itself an economic policy. It has argued that the formation of a common market was an industrial strategy drawn from the mainstream of western economic thinking. Whatever the political concomitants of the European Community and whatever the dreams of its founders, it is a prescription for economic growth and efficiency in manufacturing using market forces as the agent for the change.

Once launched on the creation of a common market it became apparent to the Commission that national governments were not willing to give market forces a completely free hand. As the tariff barriers came down governments moved to use other devices to protect national industry. Thus a large portion of the Community's industrial policy has to be dedicated to the continuing removal of impediments to trade within the Community itself, regardless of what these impediments might be. As noted, there are many ways, apart from commercial policy, in which a state can protect industries within its fiscal and legal jurisdiction. It is this ongoing aspect of harmonization, years after the tariff barriers have come down, which is a noteworthy feature of the European's common market experience to have in

mind when we consider the Canadian situation below. These are residual, and in the Commission's view serious, economic problems that have surfaced recurrently with only slow progress being made towards acceptable solutions to them.

The Commission also has a role to play in the formulation of a common approach to those areas where broader international agreement is necessary - such things as GATT negotiations, codes for aid to invest, codes for taxation of multinational enterprises, and this constitutes part of their industrial policy. These are obviously not unrelated to the previous problems associated with ensuring competition within the Community; a Community code on aid to investment will be more effective if it is similar or identical to an international code dealing with the same subject. The Community is committed to assist the formation of European multinationals (by removing barriers to cross frontier mergers and by reining in the Commission in the field of merger policy). The Community will also aid high technology industries on a European basis.

In short, the Community's industrial policy seeks to remove barriers to trade and to the movement of factors of production within the Community, while

remaining aware of the Schumpeterian dimension of competitiveness, and of the need to use the larger market of the Community to eventually become competitive in those advanced technology industries, where what may be necessary is an even larger market still.

Chapter 3

The Call for a Canadian Industrial Strategy

There are two major threads which run through the Canadian literature on industrial policy since the 1950's. One of these is the issue of foreign ownership and the other is the efficiency of Canadian manufacturing, particularly in comparison with U.S. manufacturing. Both concerns were evident in the studies done for, and the final report of, the 1957 Royal Commission on Canada's Economic Prospects. This major introspective, happening marks the beginning of the post-war debate on the health and allegiance of Canadian secondary manufacturing. In Europe also, the concerns about U.S. managerial and research and development advantages were closely tied to the call for an industrial policy for the Community, and were concerns which formed the counter-arguments for those opposed to a more rigorous Community combines policy.

In the Canadian case the concern over foreign ownership, which was to become more of a concern during the 1960's, was somewhat ironic in that the original "national policy" was probably intended, inter alia, to attract

foreign manufacturing firms to the Canadian market. As one early student of the subject commented about Canadian policy in regard to this issue: "There can be no question that in planning its tariff policy Canada has, throughout at least the past 35 years, been perfectly aware of the relation between branch plant movement and tariffs".¹ Access to foreign capital has been an objective of Canadian industrial policy.

The Royal Commission was also concerned about the lack of scale and specialization in Canadian secondary manufacturing. The study done for the Commission on this sector felt that it was a serious problem stemming from the effects of the smaller Canadian market on business behaviour.

"...Canadian secondary industry is handicapped by its smaller market and inability to obtain the same economies of scale as its American competition. These economies stem not only from the direct advantages of the large size

¹ H. Marshall, et al., Canadian-American Industry, (Toronto, 1936), 274.

of the market but from the greater specialization and concentration of production. For reasons which we have suggested, Canadian secondary industry is a good deal less specialized and concentrated than considerations of productive efficiency alone would appear to warrant."²

The Commission, as we will see, dealt with many other issues, but these two, foreign ownership and efficiency, would surface with regularity over the next decade and a half as subjects of federal government concern.

It may be useful to note that the original Canadian industrial strategy was that of a less developed country and was therefore designed to address the subject of industrialization and economic development per se, to provide the climate and the social capital necessary to develop an industrial base. When we address the question of industrial policy over the last twenty years, the industrial sector is already established, and the concern of the policy maker is with its health, its capacity to transform and its growth. These latter were the concerns of the Gordon Commission.

² D.A. Fullerton and H.A. Hampson, Canadian Secondary Manufacturing Industry, (Ottawa, 1957), 78.

The Report said a great many things about the Canadian economy but nowhere did the Commissioners outline an overall industrial strategy as such. The Report consists of a series of sectoral reviews, prefaced by an assessment of the economic environment and an historical review of Canadian economic growth to date, and concluded by a number of chapters best described as those things about which the Commission was uneasy. One has therefore to range over much of the study to piece together a strategy. And although the Commission found certain aspects of foreign ownership to be undesirable, nevertheless "the continued confidence of foreign investors in Canada" and the inflow of foreign capital, would be as integral to Canadian industrial development in the future as they had been in the past.³

The Commission addressed itself to the question of the structure and performance of the Canadian economy. Canadian secondary manufacturing was less productive than its counterpart

³ Canada, Royal Commission on Canada's Economic Prospects, Final Report, (Ottawa, 1957), 385-400.

in the United States because of the small size of the Canadian market and because of overcrowding in that market.⁴ It was felt that increased concentration of production would make Canadian secondary manufacturers more efficient by allowing them to achieve economies of scale and that if the combines legislation was standing in the way of such concentration it should be amended.⁵ (It was apparently the Canadian legislation to which the Commissioners were referring, as businessmen had told them this was the reason the market was overcrowded.) The Commissioners felt that the tariffs in Canada were sufficiently low and import competition so fierce that there was "some safeguard against exploitation by domestic monopolies or cartels".⁶ Achieving this increased rationalization of production was to be the job of an increased staff of federal officials.⁷ The tariff was considered a cumbersome policy tool, but a

⁴ Ibid., 48, 248-9, see also Fullerton, Secondary Manufacturing Industry, 63-93 and the appendix for a discussion of the scale argument.

⁵ Ibid., 249.

⁶ Ibid., 249.

⁷ Ibid., 250.

tool nonetheless, for achieving this kind of rationalization:⁸ presumably because it was very difficult to design a scientific tariff,⁹ but also because of the potentially harmful effects that tariff reductions could have on employment, population growth and economic development.¹⁰ The Commission recommended faster write-offs for capital equipment and that large government expenditures be phased to ease the problem of a small market, although the authors did not deal further with the issue of domestic procurement.¹¹

On the matter of additional resource processing in Canada, the Commission felt that it would be desirable and that governments at both levels should support such further processing. The provinces could discuss the matter with mining corporations during the course of some ongoing review process of the mining licences themselves and the federal government could get involved

⁸ Ibid., 442-443.

⁹ Ibid., 441.

¹⁰ Ibid., 49.

¹¹ Ibid., 249-250.

in more research on the technology of the issue.¹² The Report noted however, that where Canada was in competition with other producers, it would not do to press too hard.¹³ There was also the question of foreign, particularly U.S., tariffs and trade restrictions which favoured less processing in Canada.¹⁴ In the area of further resource processing the Commission recommended exhortation and research expenditures but it did not recommend tax measures or export restrictions to achieve further resource processing in Canada.

On the subjects of trade, balance of payments and the sensitivity of the Canadian economy to external forces, the Commission attempted to see all facets of the problem. Canada's current account deficit was both a result and a cause of the capital inflow from abroad.¹⁵ There was indeed a "possibility of a distortion of the economy as a whole" by too rapid a rate

¹² Ibid., 228.

¹³ Ibid.

¹⁴ Ibid., 227.

¹⁵ Ibid., 371.

of expansion in the resource sector.¹⁶ The sentence is worth quoting in its entirety.

"We may simply note here that while we have been extremely prosperous in recent years, to some extent our good fortune is being paid for not in terms of exports; nor through a reduction in exchange reserves; nor by a shortage of capital for investment; but in increased ownership and control of Canadian resources by residents of other countries." ¹⁷

On the other hand the Canadian balance of payments was not felt to labour under a "major" unfavourable long-run structural problem of adjustment and the trend in the economy as a whole was towards less reliance on trade, more import substitution and, the continued confidence of foreign investors in Canada as net inflows of foreign capital underwent a secular decline.¹⁸ There was, in the view of the Commission, no hope of insulating the Canadian economy from the world economy, or for that matter from the U.S. economy which at that time was really the same thing, and inflationary or deflationary pressures as well as balance of payments problems were viewed a bit like acts of God. There was however,

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Ibid., 372.

the presumption that these pressure would slowly decline as the economy matured, that is, became more self sufficient.

On the trade side the Commission was concerned about Canada's trade deficit with the U.S. and its surplus with Europe. This was at a time - the 1950's - when exchange controls were still in use in Europe, making our traditional triangular trade relationship difficult. According to the Commission three possibilities were open to the economy: more exports to the U.S., more imports from Europe, or fewer imports altogether.¹⁹ The measures recommended for secondary industry it was felt would improve its ability to compete and thereby reduce imports. However, our propensity to import made the pursuit of an aggressive expansionary policy, during a period of recession abroad, very difficult to pursue without running up a balance of payments deficit.²⁰ Except for a little tinkering here and there to make the tariff more rational, the Commission recommended no change

¹⁹ Ibid., 373.

²⁰ Ibid., 374.

upwards, and as we noted before, no change downwards, in the overall tariff structure.²¹ The Commission made a point of dismissing the idea of reciprocity with the United States as a move which would cause excessive "upheaval" forcing many people to seek new employment in the United States.²² Indeed, it has been suggested that the Commission disavowed Young's study, Canadian Commercial Policy, the only one of the thirty-three studies to achieve this distinction, because of its reading of the cost of the tariff to Canadians and its effect on the Canadian economy.²³

The Commission had something to say about the tax laws and the role of government in the economy. The Report noted that certain provisions of the tax laws relating to dividends made wholly owned subsidiaries hesitate to provide equity shares to Canadians. It was also noted that the provisions of the U.S. tax laws, as they affected the oil and gas industries, gave U.S. firms an advantage over Canadian firms.²⁴ The

²¹ Ibid., 441.

²² Ibid., 444.

²³ I. Brecher, "The Myth and the Reality of Canada - U.S. Relations", International Perspectives, Nov/Dec., 1975, 30.

²⁴ Op.Cit., 256.

Commission felt that a much larger study of the effects of the tax system on economic development was warranted but that it was beyond its resources.²⁵ The attitude was that the tax system should at best be neutral on the subject of foreign ownership but should perhaps be slightly discriminatory against such ownership. On the other hand, the system should be studied in more depth as a tool for economic development. The Commission foresaw short-term preferential tax treatment for the mining industries as a means of developing new sources of ore and as a way of taking the sting out of unstable commodity markets.²⁶ The government's role was clearly to provide a framework, in which growth would achieve the desired ends. The government would ensure high employment and stable prices as best it could given its divided jurisdiction, regional economic differences and the openness of the economy.²⁷ It would manage the tariff within the limitations expressed elsewhere in the report,²⁸ provide high levels of trained manpower,²⁹ and support research.³⁰

²⁵ Ibid., 456.

²⁶ Ibid., 229.

²⁷ Ibid., 421-427.

²⁸ Ibid., 437-445.

²⁹ Ibid., 445-455.

³⁰ Ibid.

Embodied here is a view of the economy and a view of government that merits comment. The Commission's recommendations in the area of industrial development are merely distributive since there are no recommendations for increased state ownership of the means of production and few fiscal implications for the government in the report. In this regard the Report maintains a hands-off stance in terms of policy preferences. If a change in the structure of the economy is warranted then tax, tariff or combines legislation should be altered to provide for stable prices and full employment and the change will occur. This is not to maintain that nowhere did the Commission recommend fiscal or discretionary policies; clearly its recommendation that the federal government get into research for the mining industry and that the provincial governments set up some review mechanism for further resource processing involves allocation and discretionary legislation respectively. Nevertheless, there is a clear sense in which the Commission favours a governmental role in providing the "climate" for development - such things as high employment, stable prices, investment incentives and removal of barriers to merger.

The Commission then identified the Canadian - U.S.

productivity gap, the need for more mineral processing in Canada and the need to exert some control over foreign-owned firms in Canada³¹ as areas of concern for policy makers dealing with Canada's economic prospects. The Commission dealt with all aspects of what could be labelled industrial development - competitiveness, competition, trade, balance of payments, investment, resource processing, the sensitivity of the Canadian economy to external forces - in recognizing that tariffs, limited competition, resource exports, capital imports, were still the main ingredients of Canadian industrial policy, even though Canada was an industrialized nation. However, questions of industrial health, flexibility and growth were coming to the fore as the tariffs began to come down in the post-war years. It was no longer enough to have an industrial sector, you had to have one that was competitive.

Through the 1960's, with Walter Gordon sometimes in and sometimes out of the governing Cabinet, a Canadian industrial strategy began to be seen as an alternative or more precisely a necessity, if the country was to deal with the question of foreign ownership. To some extent this was an argument borne of the

³¹ Ibid., 389-393.

necessity to convince the opposition that it was possible to reject the accepted economic wisdom of generations of finance ministers; that Canada could do without foreign investment and not suffer a precipitous decline in living standards. In his book Walter Gordon outlined the need for an industry by industry review/rationalization to increase exports and decrease imports, the need to use tariffs to buttress a pro-merger anti-combines policy, and the formation of the Canadian Development Corporation (CDC) to provide venture capital.³²

In the latter part of the decade Gordon chaired a Cabinet committee on the subject of foreign ownership and the Task Force that this committee established produced a report entitled Foreign Ownership and the Structure of Canadian Industry. In dealing with the issue of foreign ownership the task force felt that this would have to be handled within the context of an industrial strategy. "Undoubtedly, a country which restricted foreign investment, and did nothing else, would risk creating economic stagnation and turning the country into a technological backwater."³³ In the area of industrial strategy, the task force went over much the same ground as the earlier Gordon Commission had,

³² W. Gordon, A Choice for Canada, (Toronto, 1966), 104-123.

³³ Task Force on the Structure of Canadian Industry, Foreign Ownership and the Structure of Canadian Industry, (Ottawa, 1968), 37.

advocating that the problems of competitiveness and competition be tackled at the same time, the first by a merger/rationalization strategy to be carried out by the Department of Industry with the financial backing of the CDC, and the second by taking the whole problem of combinations in restraint of trade out of the criminal courts and giving them to a civil tribunal where economic considerations could be taken into account. The tariff, through its reduction, would be a significant tool in this overall strategy although it was not clear whether it would come down before, during, or after the rationalization.³⁴ There was a greater concern with market structure, with competition and with trade liberalization in the report of the task force than there was in the Gordon proposals. In the scenario envisaged by the task force it would still be appropriate to refer to anti-combines legislation as anti-combines legislation. The Gordon proposals left the reader with the feeling that the government, through the CDC, would provide Canadian capitalists with the financial means to buy out their competitors, with advice from the combines authorities.

Two years after the task force report, the matter of foreign ownership and industrial structure was referred to the Common's Standing Committee on External Affairs and National Defence.

³⁴ Ibid., 395-414.

and in July 1970 that Committee tabled its Report to the House.³⁵

The Committee was heavily indebted to the previous literature, and particularly to the Task Force report, in its recommendations regarding economic efficiency. The Report made four recommendations in this area,³⁶ and the reader will note the similarity to what we have already discussed in regard to the European community:

1) The Canadian government, through the Department of Industry, Trade and Commerce, should "continue to provide leadership and planning in rationalizing Canadian industries through the encouragement of mergers of existing sub-optimal firms and the rationalization of the tariff." Anti-combines legislation would allow for this and would "ensure public benefit". The Canadian Development Corporation should aid in the financing of this strategy and

³⁵ Canada, House of Commons, Standing Committee on External Affairs and National Defence, Second Session, Twenty-eighth Parliament, Eleventh Report to the House, Committee Issue Number 33, July, 1970.

³⁶ The Committee actually made seven recommendations under the heading "Positive Measures for Economic Efficiency" but I would suggest that only the first four would qualify. The first three dealt with problems associated with U.S. balance of payments restrictions on foreign ownership, with spreading foreign ownership in the Canadian economy around to lessen concentration in certain sectors, and with increasing Canadian equity participation in foreign owned companies. The relationship of these recommendations to economic efficiency is not clear from the literature on foreign ownership.

where it does this it should participate in the equity; 2) The government should pursue multilateral tariff reductions to facilitate the access of Canadian industry to export markets but should take "special steps" to ensure that, under either freer trade or industrial rationalization, the "locus of private decision-making" does not leave Canada or that overall Canadian employment does not suffer; 3) The government should attempt to improve management education and training in Canada, should encourage research and development in Canada, should ensure Canadian benefits from government-subsidized research and development, should take steps to encourage the growth in Canada of merchant banking facilities - financial institutions with entrepreneurial ability; 4) There should be "a special effort" to encourage the growth of Canadian-owned companies in the "high technology" industries but this policy should avoid encouraging those industries "which are being given special incentives by other countries for the same reason and at the same time".³⁷

³⁷ Ibid., 133-134.

Problems which the European Community felt the need to address - sub-optimal firms, aid to high technology industries, problems of financial/capital markets, support to research and development, the need to produce more and better managers - begin to surface in the foreign ownership debate in Canada. There is a clear sense in which it can be maintained that the foreign ownership debate, and the research that was done on both sides of the argument, drew attention to the fact that foreign ownership per se was not the problem, that the problem was one of industrial efficiency and that perhaps Canada should have an industrial strategy. However, rather than act precipitously, the government decided to further study the matter of foreign ownership. In the spring of 1970 a working group was set up under a Minister without Portfolio to advise the Cabinet on the issue.³⁸ Predictably, this working group felt that foreign ownership could not be treated in a vacuum separately from the issue of Canadian industrial structure and economic efficiency. The working group felt that

³⁸ Canada, Privy Council Office, Foreign Direct Investment in Canada, (Ottawa, 1972), Preface.

foreign ownership could be complicating the task of industrial rationalization.³⁹ (Clearly, if as noted above, it has been an objective since the turn of the century to attract foreign branch plants through the use of tariffs and incentives to invest, and if Canada now finds herself with too many sub-optimal firms, then foreign ownership insofar as it relates to the branch plants of consumer goods producing firms is largely a self-inflicted problem.) Encouraging rationalization of these firms can be complicated if their parent companies have no desire to rationalize nor to vacate the market completely by selling their assets to a competitor. But it is also true that throughout the late 1960's and early 1970's industrial strategy was often a euphemism for foreign ownership policy.

Thus the study could not decide if foreign direct investment was ~~the cause~~ or the result of the "stultification" of Canadian capabilities.⁴⁰ However, a foreign ownership policy

³⁹ Ibid., 428.

⁴⁰ Ibid., 426.

for Canada would have to satisfy a number of criteria: a "satisfactory" rate of economic growth, adequate employment opportunities, continuing improvements in living standards, regional development and political and constitutional realism.⁴¹ Although advocating a Foreign Investment Review Agency, the study was quick to point out that such an agency would be "ineffective" unless its decisions could be guided by a well-defined industrial strategy.⁴² The implication was that in the absence of such a strategy it would be unable to satisfy the criteria noted above. The authors of the study recognized that badly designed tariffs and an ineffective combines policy had contributed to the state of Canadian manufacturing.⁴³

However, when it came to defining an industrial strategy there were few guidelines on what it should be and how it should be put together. The basic thrust of an industrial strategy would be to specialize the Canadian economy (the study is mindful of

⁴¹ Ibid., 431.

⁴² Ibid., 433.

⁴³ Ibid., 401.

some of the managerial effects that continental rationalization can have) into pre-selected lines of industrial activity. Canada would then trade in these goods and import many of the goods currently produced domestically under tariff protection.⁴⁴ The industrial lines would be selected on the basis of comparative advantage and economic efficiency.⁴⁵ The tools required would be a rationalized tariff structure, a well-thought-out tax structure, incentives programs, a de-criminalized competition policy and less restrictive patent laws.⁴⁶ And finally, industrial policy comes to the fore in that all of these policies should key on the industrial strategy, the foreign ownership policy included.⁴⁷ The working group did not feel compelled to go beyond basically framework-type policies for this industrial strategy.

The concepts of industrial strategy, trade diversification and economic integration came together in their most comprehensive policy focus in a paper authored by the Canadian Minister of External

⁴⁴ Ibid., 440-442.

⁴⁵ Ibid., 442-443.

⁴⁶ Ibid., 433-435.

⁴⁷ Ibid., 442-443.

Affairs in 1972.⁴⁸ As Mitchell Sharp pointed out Canada had three options:

"(a) we can seek to maintain more or less our present relationship with the United States with a minimum of policy adjustments;

(b) we can move deliberately towards closer integration with the United States;

(c) we can pursue a comprehensive long term strategy to develop and strengthen the Canadian economy and other aspects of our national life and in the process to reduce the present Canadian vulnerability."⁴⁹

In expanding on the first option the author noted that "an effort to diversify our export markets, would not be incompatible" with it, nor would more processing of Canada's mineral and energy resources, nor would "moderate Canadian action to achieve greater control over the domestic, economic and cultural environment."⁵⁰ Thus, for example, the framework agreement with the EEC, and the policy drive behind it to diversify our trade, are consistent

⁴⁸ M. Sharp, "Canada - U.S. Relations: Options for the Future", in International Perspectives: Special Issue, (Ottawa, Autumn, 1972).

⁴⁹ Sharp, Relations, 13.

⁵⁰ Ibid., 14.

with this first or "pragmatic option".⁵¹

In rejecting the second option the author noted that it made economic sense in terms of Canadian living standards and the stability of our economy but that it had been rejected in the past because "it was judged to be inconsistent with Canada's desire to preserve a maximum degree of independence".⁵² Free trade with the U.S. would speed up the pace of economic integration and Canada would "be more affected than ever by decisions taken in Washington with only limited and indirect means of influencing them". Free trade would reduce our room for bargaining with third countries, it would lead towards "a full customs and economic union as a matter of internal logic", and it could be irreversible for

⁵¹ Nevertheless, there has been a tendency to equate the framework agreement and the third option, see for instance P. Pilisi, "Both Europe and Canada can Benefit from the Link", International Perspectives, (November/December, 1976) and D. Humphreys, "Canada Link with Europe Still Not Widely Understood", International Perspectives, (March/April, 1976). In this latter reference see particularly page 36 where the author notes that the link is the most substantial exercise of the third option, being an exercise in separate identity which leads us away from North American integration. He sees it as in fact an option based on European integration.

⁵² Sharp, Relations, 15.

Canada.⁵³ The author touches on the possibility of political union with the United States, not only as a natural tendency that closer economic ties might foster, but as a possible Canadian policy goal to mitigate the uncertainties felt to be entailed by free trade alone. In summary, this second option is rejected because "it is a moot question whether this option or any part of it, is politically tenable in the present or any foreseeable climate of Canadian public opinion".⁵⁴ Although the government felt that there might be widespread opposition to this option across the country, there would definitely be opposition in Quebec, where they would see themselves submerged in a polity of 200 million English-speaking North Americans.⁵⁵ The economic integration option is here recognized as the most effective economic solution to what is essentially the economic problem under discussion. It goes without saying that the arguments, on which the rejection of this option is based, are not universally accepted by students of the subject.

Finally, the government outlined the third option. "Its purpose is to recast (the Canadian) economy in such a way

⁵³ Ibid., 15-16.

⁵⁴ Ibid., 16.

⁵⁵ Ibid., 16-17.

as to make it more rational and more efficient as a basis for Canada's trade abroad", to encourage the specialization and rationalization of production and the emergence of strong Canadian-controlled firms"; it is in fact "an industrial strategy" and will have to involve the coordination of "fiscal policy, monetary policy, the tariff, the rules of competition, government procurement, foreign investment regulation (and) science policy . . . on the objectives associated with this option".⁵⁶ This industrial strategy concept clearly owes much to the official research and literature addressed to the foreign ownership question in Canada. The particular formulation is heavily indebted to the Gray Report on foreign ownership in Canada.⁵⁷ It was also most likely a product of the state of the Canadian economy at that time. Our current account balance had been in the black for two years in a row; the Canadian dollar was strong; the world economy was buoyant and the U.S. President had recently

⁵⁶ Ibid., 17-18, my italics.

⁵⁷ Canada, Foreign Direct Investment in Canada, (Information Canada, 1972), see particularly pp. 442-443.

(August 1971) given Canada a lesson in the vulnerability it faced in having so much trade tied to the U.S. market. It was a time when these options could all seem feasible. Certainly, on the policy side, it would be difficult to argue that anything approaching the comprehensiveness envisaged here as the third option has been implemented.

To summarize, this policy statement contains three approaches to the question of making our economy more competitive and less vulnerable to outside influence: 1) increased multilateralism in Canada's trade and increased but moderate Canadian control over new foreign investment in Canada, 2) closer economic integration with the United States and 3) a comprehensive and long term strategy to give us a balanced and efficient economy.⁵⁸

It was clearly the aim of the government to choose the third option at the time of writing, and the formulation of the Gray Report gives some idea how comprehensive this option was

⁵⁸ It should be noted that many economists would maintain that depending on what is meant by "balanced", these two adjectives can be considered mutually exclusive.

intended to be. The intervening years have not been kind to the third option. Certainly, Canada has been constrained from using commercial policy as a tool for a grand industrial rationalization by the provincial interests and by the ongoing GATT negotiations. Combines legislation dealing with mergers, and the attempt to bring this aspect of competition policy out of the criminal courts for use as a rationalization tool, has yet to withstand the withering broadsides of business interests and make it into law.⁵⁹

The government adjusts the tax law and the incentives programs, and the Department of Industry, Trade and Commerce carries out sectoral studies to develop sectoral strategies, but these seem to be concerned with helping threatened industries and areas cope with greater trade liberalization and increased competition. The Foreign Investment Review Agency on occasion

59 For a detailed analysis of the criticisms the government faced over this issue and others relating to competition policy see W.T. Stanbury, Business Interests and the Reform of Canadian Competition Policy, (Toronto, 1977).

has an opportunity to promote a merger/rationalization deal. Since the early 1970's nothing has surfaced in the way of policies with the dirigiste flavour of the recommendations noted.

It may have been that due to international economic constraints and Canadian constitutional limitations the government could not act on the advice that it was given, or it may have been that the advice was not very good, but there is little doubt that a grand Canadian industrial strategy has not been a policy issue of the late 1970's. An extract from a Canadian Finance Minister's recent speech is indicative of this:

"The government has recognized the strategic importance of the manufacturing industry and provided assistance to it in many ways I am frankly skeptical about the search for a single grand industrial strategy in a competitive market system. But we must have a set of sensible industrial policies, designed to provide a healthy framework for all industries, and specific incentives tailored to particular needs. The government has gone a long way to putting these in place. . . . 60

60 House of Commons Debates, November 16, 1978, 1199.

The "sensible industrial policies" to which the Minister refers are in the realm of assistance to industry through the tax system (incentives to do research and development), the Export Development Corporation, the Federal Business Development Bank, the Enterprise Development Program, etc. Given the realities noted above, this type of state aid to industry is the major tool the federal government has in the realm of industrial policy.

This brings the Canadian problem of industrial policy into a position comparable to that of the European Community's Commission in its recognition that the Industrial Policy of the Community was not to involve economic planning in the sense that either national or Community intervention in the economy would grow.

As for productivity differential could there be a long term solution to the problem of the U. S. - Canadian productivity gap? One of the traditional tools Canadian governments have used to compensate for the productivity differential between the U.S. and the Canadian economies has

been the exchange rate. If, in fact, the productivity differential is one of the major Canadian industrial policy problems, and this fact, together with the proximity (in all senses) of an economy the size of the U.S. economy, accounts for a large portion of the angst which continental economic and political relations bring to Canadians, then what should Canadian industrial strategy be? Canada must either "distance" the U.S. economy, or raise Canadian industrial productivity (and thereby real wages) to U.S. levels. The job of "distancing" the U.S. economy, given the degree of integration of capital markets, the trade flows, transnational and transgovernmental relationships and labour mobility on the continent, may be quite beyond the realm of the possible, and even if possible in a theoretical sense, not realistically attainable given the social and political dynamics of Canada. On the other hand raising the productivity of the Canadian economy would seem to be a much simpler task, requiring only an expansion of markets for Canadian industry, and a more rigorous combines policy to ensure that any gains from increased productivity are passed on to the consumer. An expansion of Canadian markets could be attained simply by taking the United

States up on their offer of a free trade agreement.

R. F. Wonnacott has come at the same question from a slightly different angle.⁶¹ He notes that productivity has always been a major problem of Canadian industrial policy. He analyzes the political economics of, on the one hand a merger/rationalization strategy carried out in the Canadian economy unilaterally and, on the other, a regional free trade arrangement including the United States, as policies to increase Canadian productivity. His conclusion is that the "go it alone" strategy will result in 1) political problems as intractable as those entailed by free trade or, 2) increased tariffs and lower productivity to overcome these political problems. Wonnacott also noted that the free trade policy would have the added advantage of removing what is perhaps the most serious distortion of Canada's industrial structure - the U.S. tariff schedule.

What a study of the subject of an industrial strategy

⁶¹ R.F. Wonnacott, "Industrial Strategy: A Canadian Substitute for Trade Liberalization", CJE, Vol. VII, No.4, (Nov., 1975).

ultimately comes to is the realization that it is **often**
a call for a new "national policy". And it is perhaps part
of the irony that, in the light of demands for an industrial
strategy, much of the reason Canada is felt to need one
is due to the effects over time of the old national policy.
At this point I would like to quote at length from a long time
student of the subject of foreign ownership in Canada.

"It has been established by aggregative and industry
studies that the large foreign-owned manufacturing
sector and its domestic counterpart both suffer from
too many firms, too many products, and too short runs.
It is fairly convincingly established that the most
important ultimate determinants of this inefficient
industrial structure have been Canadian and foreign
protection against trade, a lack of effective
competition (partly because of tariffs and a weak
anti-combines policy), and badly devised government
industrial policies on research and other matters.
Industrial policy may well have dissipated part of
the potential gain from both foreign and domestic
investment in an inefficient and fragmented structure
of industry. Indeed, until recent years, much of what
passed for industrial strategy in Canada consisted
simply of inducing firms to invest in Canada (rather
than importing goods) via a high effective rate of
protection. In recent years this has been combined
with substantial tax concessions as well, by both
federal and provincial governments, partly to induce
them to locate in certain regions or to undertake more
research activity. To the extent such policies do not
succeed, not only is the specific policy goal unrealized

but much of the potential benefit from direct investment is lost both by way of a tax loss and inefficient industry. It would be easy to ascribe this state of affairs to the "branch-plant economy" with which it is associated, without asking where the fundamental causes lie. I suggest that the main responsibility should be borne by the complex of policies historically used to speed industrial development in this country."⁶²

This formulation agrees completely with the European Community's Commission in seeing that industrial policy should be mainly a matter of competitiveness, and with the exception of the need to develop special policies for the troubled and the advanced technology industries, should concentrate on removing barriers to trade in the broadest sense of the phrase.

Though similar concerns, and similar arguments, have characterized the discussion of industrial policy both in Canada and in the European Community, there are areas of distinction caused by the differences in the two cases. Europeans are concerned with the removal of residual and novel trade barriers within a relatively recently created common market. The overall size of this market is some ten times larger than the Canadian. Therefore, although the commercial

⁶² A.E.Safarian, Foreign Ownership of Canadian Industry, (Toronto, 1973), xxii-xxiii.

policy of the Community as a whole is important to the Commission, it has not been as important as ensuring that the common market itself is really free of trade barriers.

With a much smaller market, external commercial policy is much closer to the heart of Canadian industrial policy. As we have seen, for example, the Sharp "options" wrestle with industrial policy almost exclusively in terms of Canada's trade orientation. All of the reports we have looked at reserve a large space for a discussion of commercial policy. Two alternative Canadian commercial-policy-based industrial strategies would be: 1) lower trade barriers with some government involvement in micro-investment decisions or, 2) more protection for Canadian manufacturers with a more vigorous combines policy to replace the discipline of the market over prices. Canada seems to be pursuing the former policy.

Also in the Canadian case, and the subject of the next chapter, is the issue of barriers to trade within the existing Canadian common market. The federal government, and more often the Canadian judicial system, have a role to play ensuring that no barriers to the free flow of goods and

services are erected within Canada. It may be argued that this function is not being particularly well executed at the present time and that perhaps the central government's role here should be more clearly defined.

Chapter 4

Industrial Policy In Canada

Chapter two outlined the industrial policies of the European Community noting that one of them related to the search for wider markets and the removal of barriers to trade in the Community as a whole, and the other was concerned with coordinating national state-aid policies to industry - either direct aid for a persistently uncompetitive industry or state-aid to technologically advanced sectors. There are, then, two distinct approaches to the concept of an industrial strategy in the European Community, one which could be characterized as competition policy in the broad sense - the economic integration or structural approach, and one relating to state-aid, perhaps eventually to community aid, which would be labelled the private sector welfare or fiscal approach. This latter approach can take many forms - aid to invest, depreciation allowance, export credit, government development banks, etc. It also includes those aids to industry which run counter to the economic integration approach to

industrial policy - the provision of tariff and non-tariff protection to industry, the use of public sector procurement policies to support Community or national or, in the Canadian case, provincial industry. However, the European Community has not seen fit to consider Community ownership of industrial assets as a tool for industrial development. As noted earlier the Commission made a point of the fact that industrial policy in the European Community would not entail increased national or Community intervention in the market place.

What is obvious in the Canadian case is that in the areas of natural resource development, advanced technology industries, troubled industries, industries felt to have social or cultural impact, etc., governments both federal and provincial have felt the need to intervene with equity participation. Government participation, or nationalization, in the fields of petroleum, potash, asbestos, aircraft production, transportation, communications, to name only a few, are examples of a third general type of policy for economic or industrial development which has historically been used

fairly commonly as a Canadian industrial policy. It is worth reiterating in connection with this third, or state capitalist approach to industrial policy that the merger or rationalization strategies that have been proposed over the last twenty years have most often envisaged increased government equity participation to finance them, and have less often advocated a simple multilateral lowering of the tariffs to allow for/force rationalization to take place under market pressure.

Another point quite obvious in a discussion of Canadian industrial policy and the role of governments in this area, is that such discussions and such policies have a long history in Canada. Indeed, it has been argued that it is not so much a case of Canadian governments having traditionally created the nation's industrial policies, but more accurately Canadian industrial policies that have created political institutions. As one historian described the process:

"The federal government which was established by the British North America Act was the creature of the national policy and its most prominent instrument....The federal government was created an agent within the framework of the first national policy and continued to act as an agent until,

with the attainment of the objectives of the national policy, it had exhausted its usefulness to its original principles, the commercial, financial, and manufacturing interests of the central provinces."¹

According to V.C. Fowke, the country that is Canada came about because two more desirable alternatives - imperial economic integration or continental economic integration - were not possible due to the British decision to adopt free trade in 1846 and the U.S. withdrawal from the reciprocity arrangements in 1864.²

Seen from the point of view of economic development and of economic and political sovereignty:

"...to protect itself against political and economic incursions from the United States and to mobilize credit for expansion, private enterprise through colonial governments, created the federal government of Canada to be a common instrument for mobilizing capital. That is to say the weaknesses of private enterprise as an institutional support for rapid accumulation under conditions of uncertainty, and the general weakness of the price system in organizing a retreat from positions of long term

1 V.C. Fowke, "The National Policy - Old and New", in Easterbrook and Watkins, ed., Approaches to Canadian Economic History, (Toronto, 1967), 245.

2 Ibid., 240.

capital commitment, were overcome by the instruments of government enterprise."³

A recent analysis of the Canadian federal system as an economic integration arrangement concluded that:

"The record of the speeches and debates of the Fathers of Confederation indicates their intention that Confederation should bring about a customs union, a common market, a high degree of monetary integration and a growing national economy to support the political union. Indeed there is evidence that this was the main purpose of Confederation."⁴

It would be quite wrong to view Confederation as an isolated incident of economic integrationist nation building. Private entrepreneurial use of the state for developmental purposes was common before and after the British North America Act. The whole of the 19th century, with its canals and railroads, has been categorized in the Canadian case as being a time of public enterprise.

"The secular decisions at this stage of Canadian development were made by governmental bodies; the basic developmental policies to be pursued were stated by governmental officials; and the implementation of these policies involved the exercise of initiative by governments."⁵

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- 3 R.F. Neill, A New Theory of Value: The Canadian Economics of H.A. Innis, (Toronto, 1972), 63; the idea is attributed to Innis.
 - 4 A.E. Safarian, Canadian Federalism and Economic Integration, (Ottawa, 1974), 15.
 - 5 H.G.J. Aitken, "Defensive Expansionism: ~~The~~ State and Economic Growth in Canada", in Easterbrook and Watkins, Approaches, 210.

The matter of specifying which class is being used by which other class at this time, that is whether entrepreneurs are utilizing the state to develop the national economy, or whether instead it is the governmental officials who are laying down the priorities for private enterprise, is beside the point, since the line between entrepreneur/financier and government official was frequently imaginary in Canada at this time.⁶ It is evident from the various state involvements in the formulation and execution of Canadian industrial policy, or conversely, in the creation of and uses to which political instrumentalities were put by the bankers, merchants and industrialists of British North America, that economic integration, state aid and state ownership were the historical industrial strategies of this country.⁷ If it is possible to describe the history of Canada as an example of an industrial policy with integration as the keystone what is the present reality.

⁶ See G. Myers, History of Canadian Wealth, Vol. I, (Chicago, 1914) for a lively exposition of this situation.

⁷ In a sense Canada went to a common market/free trade arrangement (1867) and only later to a customs union (1879). Of course the British North America Act created the means whereby the federal government could use the tariffs for industrial protection, but it was not until the depression of the late 1870's that the government chose to move from revenue to protective tariffs; and it was in 1879 that the Conservative Minister of Finance gave Canadians their oft quoted choice "of whether (to) simply be hewers of wood and drawers of water".

What is interesting in the context of present day discussions of industrial policy is that there were similar differences of opinion on the matter in the 1870's; there were free trade proponents, soft money advocates and those who favoured high tariffs and large government development projects (build the western railroad and settle the west).⁸ It is perhaps the problem at the present time that the latter two courses are difficult to render into a 1980's equivalent given the existence of GATT, the openness of the economy to international capital flows, the lack of any projects grand enough and, more important, obviously in need of being carried out, that brings the free trade option to the fore. And, as Fowke pointed out, it also brings into question the role of the federal government. If the federal government was created to develop and industrialize Canada, and if it has gone as far as it is possible to go in this direction, then its legitimacy begins to be called into question,⁹ which

⁸ Neill, Value, 117.

⁹ See for instance K. Levitt, Silent Surrender, (Toronto, 1970), 145-146.

is indeed what is happening, although it is often ascribed to the natural regionalism of Canadian society. It is not too outrageous to argue that Canada is approaching the status of common market from the federalist direction. As one student of the process of federal provincial relations has noted:

"Federal-provincial negotiations-diplomacy is perhaps a better word - is a central process in Canadian policy-making. The pattern, indeed, is one of the most distinctive characteristics of Canadian federalism."¹⁰

One difference between Canada and the European Community lies in the fact that Canada is a disintegrating federalist state and the European Community represents a group of integrating nation states.¹¹

I feel that this argument can easily be carried too far. There are indeed federal-provincial problems of jurisdiction, which seem to hamper the formulation of economic policy and which call for federal provincial conferences to reach an agreement, but the federal provision of services (transport, postal, defence, foreign affairs), its redistributive role in the economy (old age pensions, unemployment insurance, equalization payments), its role

¹⁰ Richard Simeon, Federal Provincial Diplomacy: The Making of Recent Policy in Canada, (Toronto, 1972), 312.

¹¹ Ibid., 300.

as a guardian of the common market foundations of federalism, its monetary role, are all unquestioned and unquestionably legitimate. In terms of industrial policy the power to provide state aid, the ease with which the state can acquire industrial assets, and control over the integrative mechanisms of the Canadian common market - removal of barriers to trade within the country and control of Canadian commercial policy - represent all the policy tools that any nation has in this area. The appendix will address the issues of firm size and merger policy. It should be noted here, however, that the reason Canada does not have a more rigorous combines policy has little to do with federal-provincial relations, but simply reflects the fact that federal policy makers have never been able to decide whether they wanted a rigorous combines policy, and judges have acted according to the laws as they have been written. So it is hard to agree that the Canadian federal state is disintegrating, and even harder to agree that the federal government lacks the levers to create an industrial policy.

But whether our common market is in any danger should

be the first question that one would ask about a potential industrial policy for Canada. As Machlup points out:

"...where internal economic integration has been hindered (or obstructed) by obstacles to the movement of factors and products, by institutional rigidities and by administrative bungling, removal of these disintegrating roadblocks may deserve the highest priority of the nation's (or region's) agenda."¹²

One of the duties of the federal government has been to maintain the Canadian common market and, as noted earlier, this may even be seen as the raison d'être of the Canadian federal state. In this context the periphery or frontier of Canada can be seen as the protected and internally unfenced territory of eastern (or central, depending on the writer's location) Canadian interests.

"A study of disallowance reveals the persistent pattern of national interests which successive federal governments have been prepared to defend. While the emphasis has differed the central pattern has remained the same. Despite the change and decay which flow from economic development, the interest has been that of the dominant commercial, financial and manufacturing activity, mainly centered at the pressure points on the St. Lawrence system, which function on a national scale. Whatever changes have taken place in the Canadian constitution and in the

¹² F. Machlup, "Conceptual and Causal Relationships in the Theory of Economic Integration in the Twentieth Century", in Ohlin, ed., Allocation, 204.

relevant balance between the Dominion and the provinces, they have not yet materially limited the manoeuvrability of dominant economic interests similar to those which were at once the strongest advocates and the greatest beneficiaries of Confederation."¹³

It is obvious that, even in a drive for increased political sovereignty, a French Canadian nationalist might see some advantage in maintaining certain federal government institutions to guard against the erection of new barriers to trade and to administer the common monetary policy of the new "Marché Commun Canadien". So, if it has been a traditional role of the federal government to safeguard the Canadian common market then national unity is obviously the main Canadian industrial policy for the last quarter of the twentieth century, as it has been since at least 1840.

Leaving aside the possibility of the actual demise of the common market through the withdrawal of one of the largest members, whether intentionally or through political shortsightedness on the part of the rest of Canada, a study¹⁴ commissioned by the federal government on the role of the common market today found some erosion and some danger of

¹³ J.R. Mallory, Social Credit and the Federal Power in Canada, (Toronto, 1954), 179.

¹⁴ Safarian, Federalism and Integration.

further erosion in the common market structures of Canadian federalism. The constitutional provisions considered in the study were "those which form the basis of the common market in goods, services, labour and capital and a number of associated economic institutions".

Safarian defined the logical and economic necessities of the Canadian common market as being the free movement of goods internally, a common commercial policy, mobility of labour and mobility of capital.¹⁵ He felt that enactments by provincial governments within their proper areas of responsibility could have trade inhibiting effects and that the federal government was excluded from certain economically necessary arenas; that this was true in regard to matters relating to labour mobility, natural resource policies, capital markets (regulation of insurance companies), service industries, etc.¹⁶

"The main conclusion in this paper is that constitutional revision is necessary to guarantee more fully the common market and economic union basis of the Canadian federal state. This basis is susceptible to considerable erosion and is incapable of adequate realization in the absence of a strengthened guarantee. The ultimate result is a loss to all Canadians."¹⁷

It is likely then that part of the Canadian industrial strategy

¹⁵ Ibid., 77.

¹⁶ Ibid., 94-111.

¹⁷ Ibid., 96.

would be in the realm of closer economic integration within Canada in the areas of policy harmonization, constitutional divisions of responsibility, provincial regulatory activity and the whole matter of public sector procurement. If Canada is indeed moving away from federalism towards a simple common market structure, then the matter of the constitutional (treaty) provisions of such an arrangement and the way in which it will differ from federalism should be traced out along the lines that Safarian has examined. In a new political relationship we should seek to minimize the cost of being a Quebecois or an Albertan. Let us examine more closely the industrial policy environment in Canada.

What is noticeable about industrial policy in the Canadian context is that in spite of the great deal of thought and ink which has been lavished on the subject, both historically and more recently, there is little in the way of a consensus as to an appropriate set of industrial policies for Canada. This somewhat ironical situation is apparent even to the casual international observer.

"There is also a great interest (in Canada) in finding the best possible industrial strategy. Some Canadians say they practically invented

the subject since the government has always had a prominent part in shaping the national economy. The original question was what economic measures besides the development of transportation could best create national unity among the far-flung and diverse parts of the country. A comparable question is in the minds of Canadians today. An even older source of industrial policy is claimed in Quebec where a type of étatisme may be traced to Colbert. In modern times there is no doubt that industrial strategy has been what an experienced federal civil servant called 'an institution of our national debates'¹⁸

The authors continue:

"In matters of investment, raw materials, taxation, government procurement and other activities important to industrial policy, the Canadian provinces have significant powers which limit the ability of the federal government to shape or conduct a nationwide industrial strategy. These powers are asserted more strongly and frequently than in the past. Federal aid to economic development in the poorer regions continues to be important but is not guided by a national industrial policy. To create local manufacturing capacity, provide employment and raise revenue, provincial governments pursue their own industrial strategies implemented by procurement and tax policies and sometimes the use of government-owned corporations. Groups of provinces come together in regional blocs that have considerable power to influence the country's industrial structure. Oil-based growth in the west has accentuated differences in wealth and at the same time strengthened resistance to central government policies for evening out living standards. The heavy concentration of textiles,

¹⁸ J. Pinder, T. Hosomi, W. Diebold, Industrial Policy and the International Economy: Report of the Trilateral Task Force on Industrial Policy, (New York, 1979), 19.

clothing and furniture industries in Quebec where there are limited alternative opportunities provides political as well as social and economic arguments for protection."¹⁹

And they conclude:

"Uncertainty, the numerous divisions within the country, the persistence of economic difficulties and political strains have combined to make it more difficult than ever for Canadians to agree among themselves on the goals or the means of a national industrial policy or indeed, on how far the government should be involved in shaping one."²⁰

It is arguable that the Canadian development of an industrial strategy could not be fraught with any problems of conflicting jurisdictions or of cultural differences that the European Community would not have faced in developing a Community industrial policy. It is instructive to apply the Community's industrial policy thinking to the Canadian case. In fact, it may be the similarities of the two cases which would imply that the success of the Community in this endeavour indicates that the Canadian situation cannot be as intractable as the Trilateral Commission study seems to feel.

A Canadian industrial policy might, similarly to that of the European Community, be made up firstly of policies aimed at the removal of barriers to trade within Canada, with barriers to trade being interpreted in the broadest sense. Within this category of activities Canadian policy makers

¹⁹ Ibid., 21.

²⁰ Ibid., 22.

would have to address conventional barriers to the free flow of goods and services in Canada - labour licensing schemes, provincial marketing boards, intervention to prevent takeovers of provincially based industries - as well as a number of provincial fiscal devices which are in fact barriers to trade - devices such as provincial procurement, investment incentives and long term subsidies which cover part of the operating cost of provincial industry. This latter policy could appear as a straight **subsidy** to a particular industry's research or raw material costs, or as lower utility rates, energy costs, taxation rates, etc.²¹ In Canada there is both an economic and a political cost incurred by these types of policies.

Economists who have written on the subject felt that provincial assistance per se to industry was not a large problem in the late 1960's and early 1970's, but they cautioned that in an era of more liberal trade these devices could be used to replace tariffs.

"This is not to say that purchasing, selling and area development policies have become as

²¹ Some work has been done in this field in Canada, see for instance A. Breton, Discriminatory Government Policies in Federal Countries, (Canada, 1967), and K. Stegemann, Canadian Non-Tariff Barriers to Trade, (Canada, 1973).

important as tariffs and other restrictive measures, but only to suggest that they are substitutes, albeit imperfect substitutes, for tariffs."²²

The author goes on to note that these policies can be developed and implemented by central and junior governments in such a way as to negate all, or a large part of, the effect of liberalizing world trade.²³

Another student of provincial barriers to trade noted:

The protective effects of provincial assistance for manufacturing would tend to be limited at the present time because the funds involved are quite small. However, the provincial aspects might become more important if the federal government were restrained by some internationally agreed limitations on government assistance to import-competing or exporting industries."²⁴

It is difficult to put a figure on the cost of provincial government purchasing policies, but with their increasing share of fiscal activity since the second world war, this cost can only be rising. The literature on this subject would indicate that provincial purchasing policies, and other discriminatory aids to industry are in widespread use in Canada.

²² Breton, Discriminatory Policies, 75.

²³ Ibid., 76.

²⁴ K. Stegemann, Canadian Non-Tariff Barriers to Trade, 109.

The political costs of these policies in Canada probably outweigh the economic costs. The spectacle of provincial governments bidding against each other for investment activity, or choosing a higher priced bid from a provincially-based corporation, or blocking a takeover of a corporation based in the province because its head office would then be moved to some other province, are all seen as distressing symptoms of political disunity and parochialism. These political costs are incalculable, but they are painfully obvious to thinking Canadians.

On the regulatory side of the barriers to trade issue, at least one author feels that these need to be solved by constitutional amendments guaranteeing the common market/economic union foundations of federalism.²⁵ Safarian, as we noted above, feels that the Canadian labour market, capital market and the service industries are currently being imperfectly regulated from a common market standpoint because of provincial jurisdiction in the fields.²⁶ Perhaps it is not out of place to note in passing that if Canada's constitution were rewritten along common market/economic union lines, the provinces might have less power

²⁵ Safarian, Economic Integration, 95.

²⁶ Ibid., 96.

to implement industrial policies than they do now. It is probably true to say that the devices we have enumerated in this first category of industrial policies- removal of barriers to trade among provinces- draw more study and criticism from Commission officials when they appear in Europe than they do from the federal government when they appear in Canada. So that the provincial governments could be ~~less~~ "maître chez eux" economically under sovereignty-association than they are now under federalism. At any rate, removal of internal barriers to trade is a major part of the industrial policy of the European Community, and there is good evidence that Canadians have not paid enough attention to it given the prevalence of these barriers to trade in Canada.

The second part of Community industrial policy is concerned with structural change (not policies to give an economy less resource processing and more manufacturing, but structural change designed to increase competitiveness and dynamic efficiency). On the face of it Canada should be in a more favourable position here since two important policy tools to achieve this structural change, commercial policy and combines policy, have always been within federal jurisdiction. In the European Community a Community commercial policy and negotiating stances have

had to be worked out since these powers were handed over to the Commission with the signing of the Rome Treaty. Working out a Community combines policy has been a more time consuming process and, as we will see, the Commission has been stalled in the creation of a merger policy for the Community as a whole.

Many, if not most, economists would agree that the Canadian federal government has never focussed commercial and combines policy on the goal of a structurally dynamic economy. There has been a lot written on the subject of commercial policy in the hundred plus years that Canada has existed, and the debate has heated up over the last fifteen years as Canadians have considered the question of freer trade, either multilaterally, unilaterally or with the United States. The literature has focussed on the costs of the tariff, including regional costs, the long term effect that the tariff has had on the structure of Canadian industry and the likely effects of the various variants of freer trade.²⁷

²⁷ For a recent discussion of the cost of the tariff and a review of the literature on this aspect of the subject see Roma Dauphin, The Impact of Free Trade on Canada, (Ottawa, 1978), 3-13, 72-83; for a summary of the literature on the long term effects of the tariffs on the structure of

From our point of view, the salient aspect of the commercial policy debate is that part of the debate that deals with the use of commercial policy as a tool for industrial change. There are basically two options for such a use of commercial policy at the present stage of Canadian industrial development, the GATT option (a gradual lowering of tariff barriers perhaps with refinements), and the free trade option. Both options aim to give Canada a more competitive industrial structure by lowering tariffs. They differ on the pace and comprehensiveness.

Growing out of the literature on scale, specialization and rationalization there has been a feeling recently²⁸ that the pace and uneven pattern of multilateral tariff negotiations may be working against the needs of Canadian industry. To reap the economies of scale, felt to be lacking in Canadian industry because of product diversity and short production runs, Canadian industry

Canadian industry - the scale and specialization arguments- see D.J. Daly and S. Globerman, Tariff and Science Policies: Applications of a Model of Nationalism, (Toronto, 1976), 21-30; finally, both the Dauphin study and Hugh McA. Pinchin, The Regional Impact of the Canadian Tariff, (Ottawa, 1979) assess the overall and regional impact of a variety of freer trade arrangements.

²⁸ Possibly originating with the Economic Council of Canada's study of the possibilities of freer trade, Looking Outward, (Ottawa, 1975), 81-83.

needs access to a large market. The rate at which foreign trade barriers are coming down may not be fast enough for Canadian industry to make this transition, although it could be fast enough to put severe pressure on Canada's weakest industries. It is this line of reasoning which has led to some of the recent research done to ascertain the costs and benefits which would be derived from a free trade area encompassing Canada and the United States or from some other major step towards freer trade on Canada's part.

The conclusions of some of these recent studies are worth quoting. Pinchin notes that:

"Although all regions would enjoy cost savings from the removal of the tariff, in Ontario and Quebec these would be largely offset by the loss of tariff transfer receipts from the other regions. Losses in manufacturing output and employment from the tariff removal would likely emerge principally in Quebec and the Prairies. However, because of the different importance of manufacturing industries in these two regions, the losses in Quebec would be more disruptive."²⁹

The author feels that the benefits-from-a-larger-market argument is valid for Ontario where existing trade patterns and industrial structure would allow for the maximum attainment of the scale and specialization benefits from freer trade.³⁰ Dauphin on the other hand finds more to

²⁹ Pinchin, Regional Impact, 29.

³⁰ Ibid., 84-85. Other studies would also indicate that Ontario might benefit significantly from freer trade. See for instance J.R. Williams, Resources, Tariffs and Trade, (Toronto, 1976) and Daly, Tariff and Science Policies, op. cit.

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be cautious about in the free trade options.

"First, a free trade area area between Canada and the United States might involve a net loss to Canada, because Canada clearly does not have an intra-union comparative advantage in manufacturing. Second, free trade achieved through a unilateral action might not increase income per capita by more than 2 per cent. Third, both unilateral free trade and a protectionist free trade area between Canada and the United States would have undesirable effects on the distribution of income in Canada. Fourth, both unilateral free trade and multilateral free trade are likely to lead to diversification of Canadian trade. And, finally, unilateral free trade is likely to be associated with a depreciation of the Canadian dollar of approximately 10 per cent and with a once-for-all jump in Canadian prices of approximately 5 per cent."³¹

Although this negative a stance is not widely held, or supported, among economists, for our purposes it is clear that there is at least some uncertainty as to the likely effects of the free trade option, in whichever form, and this combined with the possibility of differential regional impact in a country where every region keeps its own balance sheet of confederation, is enough to make for some hesitancy about the political wisdom or feasibility of negotiating a free trade arrangement of whatever sort all at once.³² This

³¹ Dauphin, Impact of Free Trade, 83.

³² However, if the federal-provincial arrangements on industrial support discussed below could be attained, then Canada would be a long way towards meeting the transitional needs of industry in a freer trade environment. Negotiating a free trade arrangement might then seem less of a jump into the unknown.

does not mean that commercial policy has no immediate role to play in a Canadian industrial strategy.

Most economists have felt that commercial policy and combines policy must be used together in a market the size of Canada's. Quotations could be multiplied but one will suffice:

"...changes in commercial policy are a necessary but not a sufficient condition for a more competitive and efficient Canadian economy, and ...a more effective competition policy is a necessary accompaniment to revisions in commercial policy. It is very doubtful that competition policy could be effective in reducing costs in isolation, even if tariff changes were eventually to be made."³³

Canada's combines legislation already allows for the use of lowered tariffs in anti-trust judgements. Additionally economists have been documenting the need for a much more flexible merger law for over fifteen years, one that would take economic factors more into account and one which would be separate from the criminal code. Since competition policy is a major part of European Community industrial policy let us briefly compare the Canadian situation with theirs.

If we look at the types of merger policy as being similar to either a) prohibiting all mergers above a certain

³³ Daly, Tariff and Science Policies, 67.

size, however defined or, b) assessing the particular mergers on a case by case basis to weigh the social benefits against the dangers of lessened competition or c) allowing all mergers and criminally prosecuting abuses of dominant positions, it is clear that both the European Community's Commission and the Canadian Department of Consumer and Corporate Affairs have been attempting to move from this last position to the middle position. The U.S. law, in contrast, resembles the simple prohibition policy. However, neither the Canadian authorities nor the European Commission has been successful in this endeavour.

The details of the Community attempt to develop a comprehensive merger policy are covered in the appendix; one of the arguments was that such a merger policy would run counter to necessary industrial policies. In fact the proposal for civil economic tribunals in the Canadian case was to counter just that criticism and to ensure that a decision taken on merger policy was not capricious in terms of industrial policy, as it might have been if taken on considerations of pure size alone. However, business then objected to the amount of power being granted to non-elected officials and the Government went back to the drawing board.³⁴

³⁴ For an account of the business reaction to recent federal government legislative initiatives in the field of combines policy see W.T. Stanbury, Business Interests and the Reform of Canadian Competition Policy, 1971-1975, (Toronto, 1977).

As the appendix seeks to demonstrate, the arguments for large firm size are not compelling enough to force governments to encourage horizontal merger, and they would be even less compelling for vertical and conglomerate merger. In terms of economic efficiency and technological innovativeness there are few advantages to large firm size. On the other hand, large firm size may be seen, both by the large firms themselves and by their potential rivals, as providing barriers to entry and thus protection from competition. Thus, it is one of the functions of large advertising expenditures on the part of oligopolistic industries to provide just such a barrier to entry. It is also true that, although technological innovativeness may be widely available in smaller establishments and among entrepreneurs, developmental capital and the managerial expertise to bring a new product to market may be harder to acquire for a smaller firm. Another barrier to entry is widespread vertical integration. This is one of the complaints of independent automotive parts manufacturers in Canada.

However, to say that large firms are not clearly necessary for economic efficiency and technological change, and that they may throw up barriers to entry thereby stifling competition, does not provide a compelling rationale for a rigorous anti-merger policy. As noted in the appendix, the

evidence for the economic costs of concentration or even for concentration and collusive business practices combined, is difficult to arrive at. The Commission of the European Community has been doing research into the extent and growth of concentration in the Community, but this research is still simply descriptive. The research has come up with no telling indictment of large firm size.

In the Community there was then, a reluctance on the part of national governments to allowing the Commission to review mergers above a certain size, rule on their effect on competition and order a dissolution of the merger if it was felt that it would render competition ineffective. It is probably only a slight exaggeration to say that national governments in Europe tend to feel competition is threatened when one of their national industries is taken over by a foreign competitor. However, when one of their own companies absorbs a foreign company, the merger is seen to promise greater economies of scale. The Commission, as one part of the Community industrial policy, has committed itself to removing the barriers to merger between national companies of the Community. The argument that, on the whole, European firms are still too small to compete with U.S. multinationals, and that for high technology industries, where long lead times and high capital requirements prevail, there is a need for larger European companies, seems to have carried the day. The Community would seem to be focussing on

market imperfections in capital movement as opposed to market share (large firm size) as the thrust of their combines policy in the area of merger.

It is also the case that in an era of declining tariff barriers to international trade it is felt to be more difficult to monopolize any given market. This was already felt to be the case in Canada at the time of the Gordon Commission. That Commission set a tone for discussion of merger policy in Canada similar to what the European Community found to be politically realistic in the seventies, when it advocated the liberalization of Canadian merger policy to allow for the rationalization of inefficient and small scale Canadian industries. Two other features, similar to the European situation, have bedevilled Canadian federal officials involved in the formulation of combines policy in the area of merger.

The Canadian provinces have not been enthusiastic about federal restrictions on mergers if these involve restricting the activities of firms headquartered in their provinces. On the other hand there is provincial concern when such firms are taken over by firms headquartered in another province - Quebec financial institutions and Pacific Western Airlines are cases in point. So there are internal political problems in Canada similar

to those in the European Community.

It is likewise felt to be the case in Canada that larger Canadian firms are necessary if Canada is to compete with large foreign firms. Thus the Canadian government's concern with merger has been in the area of foreign takeovers of Canadian firms and has resulted in the Foreign Investment Review Act, as opposed to merger controls as part of combines policy. The Foreign Investment Review Agency reports, not to the Department of Consumer and Corporate Affairs which deals with competition policy, but to the Department of Industry, Trade and Commerce which formulates industrial policy. One of the benefits to Canada, which the Agency is committed to achieving in its review process for foreign takeovers, is rationalization of Canadian production.

Thus one part of a Canadian industrial policy could be an economically more sophisticated combines policy on mergers - perhaps a review of all mergers above a certain size - with the power to lower tariffs and to allow for a waiving of customs duties for the imports of such rationalized industries (to avoid negative protection situations). This would allow the Foreign Investment Review Agency to be subsumed into a takeover review board which would treat the national origin of a takeover bid and the value to Canada of new investment as being much less important than the

takeover's effect on market behaviour and industrial competitiveness.

If it is provincial opposition that the removal of regulatory and fiscal barriers to trade would face, it is business which will oppose an attempt to fuse commercial and combines policy on mergers into a tool for rationalizing Canadian industry if past experience is any guide.³⁵

Canadian business seems to prefer the status quo in this area, which means virtually no government involvement to analyze or derive some consumption benefits from increased concentration. However, in this case the federal government has control over the relevant policy tools and there would be no adverse reaction on the part of the international community to a Canadian decision to unilaterally lower tariffs to either promote takeovers or to lessen their effects. The Canadian provinces would probably prefer to see the federal government shift its attention from a review of investment, particularly new investment, to a review of positions of market power. Certainly FIRA has not been universally acclaimed by the provinces.

³⁵ Stanbury, Business Interests.

This brings us to the final element in the European Community's industrial policy- industrial aid. There, the need to provide fiscal support to industry has been recognized in the case of troubled industries or industrial sectors, in the case of support for small business, to foster research and development where the governments feel there is a social need for such research - areas such as energy and transport for example - or in advanced technology applications requiring long lead times and large capital expenditures. The Commission's role here is largely one of coordination, since the national governments are still the spending authorities. The Commission would like to ensure transparency and equivalence between national programs.

In the Canadian case, aid to industry may involve direct aid in whatever form, and it can involve equity participation. Either level of government can and does become involved in both types of activity in Canada. The Community's recognition that this area requires clear and realistic guidelines and intra-Community coordination is valid for the Canadian case as well. The best way to demonstrate that effective cooperation in this area is possible in Canada is to point to a policy area very close to industrial aid - and that is regional aid.

Regional policy is coordinated very closely between the federal and provincial governments. Both levels of government share in the funding under General Development Agreements (GDA's) and agreements subsidiary to these. The main concern is usually with local areas of high unemployment and with provincial unemployment rates relative to the Canadian average. To take Quebec as an example, the GDA for that province aims, in part, to improve employment opportunities and to strengthen traditional but threatened industries, eg. pulp and paper, to reinforce industrial and urban infrastructure, to promote the balanced development of Quebec relative to the rest of Canada.³⁶ In May 1979 the active subsidiary agreements with Quebec were worth 1.5 billion dollars. Over half of the sum (834.7 million) is earmarked for transportation and municipal and/or industrial public sector infrastructure, usually aimed at particular regions - regions with high unemployment or transportation bottlenecks or a lack of serviced industrial land, etc. Another third of the total sum is devoted to improving the competitive position and capacity of the pulp and paper industry (322.3 million for forest development, 150 million for modernization of the industry itself and 50 million

³⁶ Canada, DREE, Summaries of Federal-Provincial General Development Agreements and Currently Active Subsidiary Agreements, (Ottawa, 1979), 115.

for a bleached kraft paper mill).³⁷ One of the points to be made here is that regional policy and industrial policy are going to be closely related insofar as the latter attempts to deal with the troubled industry, since given the resource base and in some cases the historical development of many of Canada's uncompetitive industries, they are often a problem precisely because they are localized or regionally concentrated.

A more important lesson to be drawn from regional policy is that in Canada it would not be politically possible, nor particularly effective economically, to locate responsibility for regional aid exclusively within one political jurisdiction or the other. The involvement of both levels of government ensures that provincial perception of need and familiarity with local problems are taken into account while ensuring that a national focus and a larger redistributive capacity are brought to bear on regional problems. The argument that Canada cannot develop a coherent industrial policy because of the federal-provincial division of powers is based on the assumption that these two levels of government cannot coordinate

³⁷ Ibid., 115-157.

policy between them. This does not seem to be true in the case of regional policy.

This chapter has taken the experience of the European Community in the development of an industrial policy and applied it to the Canadian case. It has addressed the anomaly of a Canadian debate on industrial policy that has a long history but no resolution. That impression is misleading. It arises because industrial policy in Canada might better be developed along the lines of European industrial policy, since Canada resembles the European Community in some of the relevant jurisdictional areas more than it resembles a nation state such as France or Japan. When the main areas of Community industrial policy - removal of barriers to trade internally, structural change in the direction of increased competitiveness and fiscal support to industry on a selective basis - are applied to the Canadian case there is widespread consensus among Canadian economists as to the methods.³⁸ The

³⁸ For a series of seemingly overlooked proposals from a respected Canadian economic advisory body which would, if implemented along with an attack on the problems addressed by Safarian, Breton and Stegemann noted above, effectively put into place the structural and fiscal components of such an industrial strategy, see Canada, Economic Council of Canada, Looking Outward, recommendations 17, 18, 19 and 21, pages 190-191.

experience of the European Community may simply provide a more appropriate framework for a Canadian industrial policy.

APPENDIX

Merger Policy and Firm Size

There has been debate both in Canada and in Europe as to what constitutes an appropriate merger or concentration policy under conditions of freer trade. Some students of the combines and industrial policies of the European Community have argued that Europe has too many sub-optimal firms.¹ The argument notes that with the expanded market, and with the need to capture economies of plant and firm scale to compete against U.S. firms, that merger activity should be, if not encouraged, then at least not impeded. As noted in the body of the thesis, this removal of the barriers to merger is in fact one of the industrial policies of the Community. It is also argued that large firm size is necessary for technical progress,² a theory which will be taken up later in this appendix. There has been friction

¹ D. McLachlan and D. Swann, Competition Policy in the European Community, (London, 1967), 12, and D. Swann, The Economics of the Common Market, (Great Britain, 1975), 212-214, and B. Belassa, "Structural Policies in the European Common Market", in Belassa, ed., European Economic Integration, (Amsterdam, 1975), 273.

² McLachlan, Competition, 81-86.

between the Community's competition directorate and the French government over the matter of firm size and what the French regard as the need for increased industrial concentration.³

Moreover, economists are not doctrinaire advocates of Adam Smith's brand of competition in Europe. They note that there is a "need to deal with questions of concentration and competition in the framework of a coordinated industrial policy".⁴ A student of Canadian combines policy noted that the debates in the Canadian Commons more than fifty years ago were concerned with economies of scale and the need for large firms to do research.⁵

This appendix deals with the theories underlying the arguments for large firm size and reviews some of the studies which have contributed to the debate. Before beginning however, a word on the experience of the European Commission in the field of merger policy is required. In the European Coal and Steel Community, Article 66 of the Treaty requires notification of merger plans whereas

³ Swann, Economics, 160.

⁴ Belassa, "Policies", in Integration, 254.

⁵ L.A. Skeoch, Restrictive Trade Practices in Canada, (Toronto, 1961), 22.

Article 86 of the Rome Treaty only allows the Commission to rule on mergers which constitute abuses of dominant positions. In 1972, the final ²communique of the Summit Conference of Heads of State of the Enlarged Community called for "the formulation of measures to ensure that mergers involving firms established in the Community are in harmony with the economic and social aims of the Community, and the maintenance of fair competition" and called for the use of Article 235 of the EEC Treaty to accomplish this.⁶ Ten days later the Commission announced that it would put forward "proposals designed to introduce a more systematic control of merger operations of a given scale."⁷ In July 1973, the Commission proposed a system which would have required the notification of mergers over a certain size, and which saw concentrations which gave the power to hinder competition as being incompatible

⁶ Allows Council to take on new powers to achieve a Community objective.

⁷ European Communities, Commission, Second Report on Competition Policy, (Brussels-Luxembourg, 1973), II.

with the Common Market.⁸ The Commission argued that if the Treaty required the removal of limitations to the competitive process, then it had to entail that competition not be eliminated by merger.⁹ However, the Commission merger proposals were felt to be running counter to the Community goal of creating industries which would be competitive with the U.S., maintaining high employment and with the social protection of workers. The Commission went back to Article 86.¹⁰ It is the relationship between competitiveness and firm size, innovativeness and firm size, efficiency and firm size, that I would like to examine more closely.

There are at least two reasonable ways in which it is possible to disagree over the nature of the competitive process in an economy. The first, aptly described by Brecher, we can call the "eye of the beholder" disagreement.

"To the lawyer prosecuting or defending business conduct under anti-combines law, the paramount

⁸ European Communities, Commission, Third Report on Competition Policy, (Brussels-Luxembourg, 1974), 32.

⁹ Ibid., 30.

¹⁰ Ibid., 9.

consideration has typically been the presence or absence of collusive arrangements among competing firms. To the businessman, competition has traditionally meant rivalry and struggle more or less unfettered by government restraint. To the economist, competition has signified that state of affairs in which a particular industry or the economy as a whole most closely accommodates consumer demand. To the staunch advocate of democracy, competition has been a vital instrument for checking the concentration of power in the hands of a relatively small number of large business units. For the most part, and over a substantial period of time; there has been little or no meeting of minds as between the various strands of the social fabric. The result could only be to weaken the force of public policy in the anti-combines field.¹¹

This appendix will concentrate on the view of competition which is attributed above to the economist. It would be desirable though, to have a combines policy which satisfied all of these demands. It is not clear why this should be theoretically impossible.

The second way in which it is possible to disagree about the meaning of competition is much more fundamental; that is, the extent to which "real" competition has a significant Schumpeterian dimension, whether price competition

¹¹ I. Brecher, "Combines and Competition: a Reappraisal of Canadian Public Policy", in The Canadian Bar Review, Vol. XXXVIII, 1960, 554.

is really very important in maximizing consumer welfare in the long run. Adherents to this view argue that an element of oligopoly is necessary for economic and technical progress to take place. In fact, as one economist points out, there were two different theories in Schumpeter's own work detailing the process of "creative destruction".¹² In the earlier Schumpeter, innovation was seen to be brought about by the entrepreneur who developed a marketable product from the exogenous stream of science and technology, created a monopoly position by this act, and then saw his monopoly position whittled away by other entrepreneurs : attracted to the high profits. Later, Schumpeter described a situation where competition, still through innovation, took place in large oligopolistic industries. These industries were rewarded for their successful innovational record, and were both forced and induced by this form of competition to integrate and expand research and development activities in the firm itself. It is the second variant of the theory

¹² A. Phillips, Technology and Market Structure, (Massachusetts, 1971), 4-7.

which has permeated much of the discussion about "real" competition versus price competition. To have this innovation take place there is a need to reward the innovator or the innovating firm, and the mechanism by which this is accomplished is the presence of an element of short term or longer term monopoly, depending on which Schumpeter is being read.

A number of very widespread "notions" are based on this idea that there is a need for large, stable business units if innovation is going to take place. For example, once such a thesis is accepted, there may be a prima facie case for countervailing power; power which may have to be created by the state or which may grow up on its own through some unexplained social dynamic. The innovative imperative also underlies much of the product cycle theory developed by Vernon¹³ and the fact that American firms predominate among the largest firms, has given rise, in an era of declining barriers to trade and capital flows,

¹³ R. Vernon, Sovereignty at Bay, (New York, 1971), esp. 92.

to demands to protect "national" innovative capabilities.¹⁴

Even among less nationalistic writers, the product cycle theory coupled with large amount of foreign investment in Canada, is felt to make investment location under continental free trade problematic for Canada.¹⁵ So it is a matter of some interest to know how large firms have to be to be innovative, how much and what kind of competition there has to be to ensure that this innovation benefits the consumer, and whether all innovation really creates more real wealth.¹⁶

The above is not to imply that the adherents to the view that the Schumpeterian description most accurately describes reality have carried the field. One of the criticisms has been that, innovations or not, the concentration of economic power conflicts with the requirements of political democracy.¹⁷ With respect to the performance of large firms, it is

¹⁴ See K. Levitt, Silent Surrender, (Toronto, 1970), and some of the work of the Science Council of Canada, particularly A. Cordell, The Multinational Firm, Foreign Direct Investment and Canadian Science Policy, (Ottawa, 1971).

¹⁵ B.W. Wilkinson, Canada's International Trade, (Montreal, 1967), 161.

¹⁶ S. Stykolt, Efficiency in the Open Economy, (Toronto, 1969), 29.

¹⁷ Brecher, "Competition", 560, and G. Rosenbluth, "Concentration and Monopoly in the Canadian Economy", in M. Oliver, ed., Social Purpose for Canada, (Toronto, 1961), 223.

not possible to argue from even the most prolific stream of inventions, that they could not have been attained without the prevailing market structure, or that a more competitive market would not have been even more prolific. Some economists have questioned, as well, the integration of research into the business firm, arguing that the rights so acquired to this information constitute barriers to entry to the industry.¹⁸ There is also evidence that the largest firms have not been responsible for a proportionate share of significant innovation,¹⁹ that where there were no barriers in the form of patent rights or closely held technology, there was no shortage of entrepreneurial talent to develop an invention. The evidence led Rosenbluth to conclude that: "...there are no sound theoretical grounds, and no convincing empirical evidence, that would make it reasonable to regard the giant corporation

¹⁸ Rosenbluth, "Monopoly", 229, and S. Hymer, "The Efficiency Contradictions of Multinational Corporations", in G. Paquet, ed., The Multinational Firm and the Nation State, (Toronto, 1972), 56-57.

¹⁹ Stigler, quoted in Rosenbluth, "Monopoly", 229.

as a 'necessary', or even a particularly convenient, vehicle of technical progress." ²⁰

It is possible then, to be unconvinced of the truth of the proposition that only large firm size and industrial concentration are compatible with economic progress. The innovational aspect of economic power is relevant to the Canadian economy where it is often entangled with an argument to the effect that economies of scale are not being realized in the small Canadian market, a subject discussed below. On the negative side, the efficiency losses of market power and collusive activities are well known. Thus, an estimate of these losses in the private, unregulated sector (excluding defence and space contractors) of the United States economy, produced a figure of 5% of GNP for 1966. (Adding in the regulated sectors and the defence and space contractors gave a figure of 6.2%.)²¹ One final comment

²⁰ Rosenbluth, "Monopoly", 230.

²¹ F. M. Scherer, Industrial Market Structure and Economic Performance, (Chicago, 1970), 408.

on the matter of economic progress via the mechanism of "creative destruction". If Schumpeter's first model - short term monopoly under fire - is a correct description of reality, then an effective combines policy would strive to remove barriers to entry down to the point at which the fluidity of factor movements created a disincentive to developing a new product. Such a policy would seek out rigidities in capital markets, unwarranted marketing barriers such as certain forms of advertising, barriers to the free flow of knowledge, etc. If, on the other hand, the second model is correct - stable oligopolies to finance and plan innovation - then combines policy becomes an esoteric economic science tasked with assessing how much oligopoly is required here or there, possibly in the Canadian case tempered by the "need" to have national oligopolies large enough to compete with other national oligopolies. Schumpeter was not distinguishing between national economies, and it is, as one commentator points out, not possible to simplistically apply these arguments for innovation through oligopoly to an economy like the Canadian.

one in which so much innovation originates abroad.²² After all, Canada has never had an effective merger policy and the nation's industry is not demonstrably more innovative, or competitive, over the long term, than that of other countries.

It is useful, in discussing economies of scale, to distinguish firm economies and plant economies (process economies are really the economies of Adam Smith's pin factory, economies of specialization.) Economies of scale of either sort are attained when a firm is operating at the lowest point, or at some multiple of the lowest point, on its long run average cost curve. In the case of plant economies of scale:

"The scale, at which all the discrete specialized processes dovetail perfectly, is the minimum optimum scale. The scale at which the largest or most specialized machine can be utilized fully."²³

A plant is capturing all such economies when it is at some multiple of the minimum optimum scale. This concept of scale is directly related to the production and distribution

²² Brecher, "Competition", 571.

²³ Scherer, Market Structure, 74-75.

technology of any given industry. Analogously, firm economies of scale result when the most specialized non-production unit is being utilized fully. Scale economies in this usage rest on the assumption either that there is some critical minimum size for such a unit - research and development laboratories might fall into this category - and that it is not possible simply to adjust staffing to the size of the firm below a certain size or, that a minimum firm size will allow for both stability of tasking and the most efficient use of specialized manpower. In this latter assumption such economies of firm scale most closely resemble economies of process scale, which are attained when the most efficient use is made of specialized manpower on the plant floor. If there is excessive diversity of production in a single plant it results in a great deal of time being spent on machine changeover and in some cases an inability to specialize fully the tasks involved in each separate production run. Diversity has its plant scale aspect as well if it prevents

the use of the most specialized or automatic machinery available. Although related to the size of the market, such economies of process scale, as Scherer points out, are also related to the need for a full product line and cannot be separated from the marketing variable or from advertising costs.²⁴ In Canada these two factors were felt to explain much of the lack of specialization in secondary manufacturing in a study done for the Royal Commission on Canada's Economic Prospects,²⁵

It can be argued that the economies of firm size which really matter so far as survival and growth are concerned are pecuniary, that is they do not involve a more efficient use of resources so much as their redistribution; the ability to acquire large scale financing or to acquire it at a

²⁴ Ibid., 91.

²⁵ D.H. Fullerton and H. A. Hampson, Canadian Secondary Manufacturing Industry, (Ottawa, 1957), 72-77.

lessened cost because of superior bargaining power.²⁶ Some would go further and argue that all economies of firm scale, economies in marketing and advertising included, do not accrue to society at large and therefore offer no argument for size.²⁷ From a combines point of view if unwarranted or excessive advertising in an industry constitutes a barrier to entry then it should be curtailed. It is nevertheless difficult to see how economies of firm scale as we have described them could be substantial enough to account for the large size and amount of concentration in certain industries. Why for example, would these specialized managerial and non-production services not be available from the marketplace at a price which would reflect all scale economies? Indeed many of them are available this way. Such an approach would seem in fact to minimize the diseconomies of large firm size, which might result from integrating the functions

²⁶ Scherer, Market Structure, 100-101.

²⁷ Rosenbluth, "Monopoly", 227.

into the firm itself.²⁸

One factor which should be mentioned as a pecuniary economy of firm scale is survivability. It is possible that security against a takeover increases with firm size, as does the ability to indulge in corporate predation. Related to this, and to the Canadian case, is the matter of attaining economies of plant scale through merger. The evidence for this being possible is lacking and Scherer argues convincingly that there can, by definition, be no such attainment of scale.²⁹ The main saving in a merger comes when it allows the firm taking-over to close down redundant capacity. Such an approach might be the only profitable method of attaining both efficient production and the larger market share to sell the output. What can an application of this material

28 Scherer discusses this matter in the context of plant economies of scale and the possibility of purchasing the bottleneck process in the market. In that case the market had disadvantages if the process was specialized and "shopping" was not possible, or if a very few sellers of the bottleneck product could create a monopoly. Whether these arguments apply to the sort of managerial services discussed here is less clear and would vary with the service.

29 Scherer, Market Structure, 116-118.

to the Canadian economy tell us about the need for a unique Canadian combines policy in the area of merger and monopoly?

What would an effective combines policy have been for a market the size of Canada's? Do we not have a need to achieve economies of scale at the expense of competition?

Many writers have argued that this is indeed the case in Canada, or in countries like Canada.³⁰ However, the Canadian situation would indicate that other factors are at work. Canada has a virtual lack of any case law in the field of mergers;³¹ Canadian industry remains significantly diversified when "substantial" economies of scale could be obtained from concentration and specialization;³² horizontal merger is a method of market share agglomeration practiced by oligopolistic industries. Why then is Canadian secondary manufacturing so diversified?³³ This is not to ask

³⁰ Scherer, Market Structure, 93, and Royal Commission on Canada's Economic Prospects, Final Report, (Ottawa, 1957), 249, and R. Wonnacott and P. Wonnacott, Free Trade Between the United States and Canada, (Cambridge, 1967), 273.

³¹ Brecher, "Competition", 547.

³² Fullerton, Manufacturing, 73.

³³ Scherer, Op. Cit.

why there is not more price competition, to which the answer is that such competition is not to be expected among oligopolistic industries protected by tariff barriers, but rather why a natural rationalization does not take place via merger? Researchers in the field have been told repeatedly that one of the barriers to specialization ³⁴ is a fear of bringing on combines action.³⁵ Is it possible that all our productivity problems stem from this simple misunderstanding between government and business over whether mergers are permissible?

³⁴ It is clear that more than one form of specialization is being discussed here. One way in which product-differentiated wide-line oligopolies could specialize, and still market their whole line in Canada, would be to import part of it. However, given the tariff structure, the cost savings from specialization do not cover the increase in tariffs paid in most industries. Another specialization variant would be an agreement to discontinue certain product lines and to specialize in others. In addition to being fraught with uncertainty - will the market for tea kettles outperform the market for toasters - this sort of arrangement could run afoul of Canadian combines legislation which, in the matter of agreements in restraint of trade, keys on an "undue" restriction of supply or lessening of competition; and such an arrangement could result in both. The final specialization technique would be the acquisition of all one's rivals' markets and the consequent lengthening of all production runs by specializing the acquired plants (these are process not plant economies).

³⁵ Royal Commission, Final Report, 249, and D. J. Daly, B.A. Keys and E. J. Spence, Scale and Specialization in Canadian Manufacturing, (Ottawa, 1968), 24.

It is plausible that one of the difficulties in the area of merger may be U.S. combines law where large U.S. companies are concerned. This may be the combines authority they refer to. This hypothesis is supported by a study undertaken by Richard Caves for the Economic Council in which he found that the plants of U.S. multinational enterprises in Canada are more diversified than their Canadian counterparts, and that this diversity does not seem to correlate with "ill-chosen policies (such as tariffs)" but rather seems to be dependent on "undetected company-specific forces and historical accidents".³⁶ Neither does this diversity correlate with the scale of non-productive activities - such as marketing. In fact this lack of correlation could be because not all product-differentiated wide-line oligopolies are subsidiaries of U.S. firms.

A more convincing explanation of the lack of natural rationalization would view merger activity in a manner somewhat analogous to price competition among large foreign owned firms - such competition may have unforeseen consequences.³⁷ Acquiring

³⁶ R. Caves, Diversification, Foreign Investment and Scale in North American Manufacturing, (Ottawa, 1975), 4-5.

³⁷ Daly, Scale, 45, and H.E. English, Industrial Structure in Canada's International Competitive Position, (Montreal 1964), 36.

a wholly-owned or closely-controlled subsidiary in Canada might be difficult without acquiring the parent as well.

In fact this consideration, added to the above, means that much uncertainty and effort could be involved in an attempt to specialize certain Canadian industries via the merger tactics of one firm. It is possible that conglomerate

"empires" serve the same or a similar function - that

is they make it difficult to get control of just a portion of the conglomerate. None of this answers the original question which is, given this diversity of production at the plant level, what should Canadian combines policy be on mergers?

Inter-firm specialization might be hastened by the pursuit of a rigorous combines policy in the area of trade practices.

Insofar as such diversity is the result of peculiarities of marketing or of advertising practices it is within the competence of the combines authorities to limit such activities.

The slant of Canadian combines policy towards this end - the prohibition of exclusive dealing, of tied lines, of resale price maintenance, of misleading advertising - indicates a recognition that the marketing structure may be very important

in a small market, and perhaps an attempt to minimize the amount of product differentiation and full-line forcing which takes place. Given Scherer's insight noted above, that process economies of scale cannot be separated from the marketing variable, this seems to me to be the correct tack for combines authorities to take. Suggestions range from proposals to separate the production from the retailing of petroleum, to calls for the application of exclusive dealing suits against automotive dealership networks. Neither of these examples is simply vindictive. On the contrary each aims directly at marketing barriers to the entry of goods or of efficient capacity. Where capacity is available but is being underutilized, fluid anonymous marketing structures make collusion difficult.

What about plant economies of scale? In the definition of plant economies of scale given above it was noted that these are based on the production and distribution technology at the plant level. It is clear that without large export markets certain technologies are beyond the reach of "Canadian" industry on any competitive basis.

These industries are not really the concern of a combines policy since their very existence in Canada reflects either the presence of such export markets (certain electrical equipment) or a decision on the part of the government that it is in the "national interest" to have this industry (aircraft for instance), at whatever cost.

However, studies have shown that in the case of certain more prosaic industries, Canadian plants may be using technology and equipment which is below efficient scale compared to the United States and further, that only between one quarter and a little less than one half of the plant below efficient capacity was explained by the variable of market size.³⁸ As noted above, below scale capacity is of little use unless there is an element of oligopoly involved. If, in fact, a merger will result in below scale machinery being replaced with higher capacity equipment then it will likely lead to labour dislocation and cannot be considered a painless method of rationalization compared to freer trade.

38 Stykolt, Efficiency, 83-101, and H. C. Eastman and S. Stykolt, The Tariff and Competition in Canada, (Toronto, 1967), 102.

In fact, much of the recent work of the foreign investment review authorities is probably devoted to reconciling the requirements for more exports and more employment from prospective merger clients. From a combines point of view what is required for these scale economies to be attained is the erection of a plant of efficient scale which ruins all the competition (no government intervenes). This would create a monopoly which could then be brought before the bench, convicted of monopolizing and exposed to free trade. A more realistic approach would be the realization that, if it is not possible to expand markets through freer trade, then it is not in the Canadian interest to produce certain manufactured goods in which scale economies are very important. Still it is not clear that this affects the vast majority of Canadian industries, and it is in fact the market power of the large firms which indirectly inhibits the installation of efficient capacity. So a vigorous combines policy aimed at barriers to entry of all kinds would help, not hinder, the attainment of efficient plant scale.

On the matter of firm scale, the Stykolt study referred to

above, noted that the amount of capacity at efficient scale correlated weakly and consistently negatively with capital barriers to entry and product differentiation.³⁹ The Royal Commission on Canada's Economic Prospects felt that inefficient, as opposed to excess capacity (plant as opposed to process economies of scale) was the more serious Canadian productivity problem, and advocated faster depreciation allowances to alleviate it.⁴⁰ Parenthetically, if in fact this was a correct diagnosis, and if barriers to the addition of efficient capacity were present, including rigidities in the capital markets, then the Commission's blessing to the "protection" of Canadian financial institutions was certainly counterproductive.⁴¹

In his studies Bain found little evidence that there were substantial economies of firm scale accruing to multi-plant firms.⁴² However, such economies of scale have only an oblique relationship to the concept of firm scale as defined

³⁹ Eastman, Tariff, 104.

⁴⁰ Royal Commission, Final Report, 249-250.

⁴¹ Ibid., 397.

⁴² Quoted in Scherer, Market Structure, 72.

above, that is firm size sufficient to utilize fully the specialized support units such as research and development laboratories, marketing teams, etc. Thus multi-plant operations may lower average costs by allowing a firm to reach this minimum size when a single plant would be too small to allow this.⁴³ Whether it is possible to generalize from this fact to the conclusion that in Canada sub-optimal plants result in a higher incidence of multi-plant firms⁴⁴ is problematic. Conceivably, a sub-optimal plant could still be large enough to attain all possible firm economies of scale; it may not be possible, that is, to equate "size" with sub-optimality. In our definition of firm scale the matter of plant size really translates into the proper interaction between production and non-production units and will vary from industry to industry.

The matter of firm size is closely tied to the

43 Eastman, Tariff, 104.

44 Ibid.

size of the market in specialized services. This may be felt to be a problem in countries like Canada where such markets are not as well developed, causing firms to either internalize the function or import it from another market. In fact, however, there is virtually one continental market in specialized managerial, financial or scientific service industries. There may be information costs in using the market for specialized services, and it is possible that a step function in scanning capability is associated with some minimum firm size.

For small firms there may be problems in using the market at all in competition with much larger firms. Pecuniary economies apart, there is little evidence that the inability to achieve firm economies of scale is a serious problem in the Canadian economy.

It is difficult not to conclude that economies of scale of whatever sort should not bear heavily on a merger policy designed to prevent undue concentration, defined according to Brecher as, a policy which would make it illegal to merge when this will render competition ineffective,⁴⁵

⁴⁵ Brecher, "Competition", 584.

and with competition defined as market-protected consumer benefit.⁴⁶ Thus there may be better ways to achieve the specialization of Canadian industry than by promoting mergers indiscriminately. When such mergers are felt to be the only "acceptable" method to attain significant process economies of scale, then there should be an expectation that tariffs will be lowered to "restore" at least the previous level of competition.

What about the possibility that if once offended by a vigorous combines policy all MNE's, Canadian and foreign alike, would promptly depart. The thesis is not self-evident. It is quite likely that indeed the opposite would be true, and that a vigorous combines policy would lead to a higher level of economic activity than would be the case in its absence. This is consistent with Rosenbluth's findings that in fact foreign capital was not attracted to the most heavily concentrated industries in Canada.⁴⁷ It is also what would be expected

⁴⁶ Ibid., 575.

⁴⁷ G. Rosenbluth, "The Relation Between Foreign Control and Concentration in Canadian Industry", in Canadian Journal of Economics, (February, 1970), 32.

from the removal of barriers to entry in long monopolized industries. If a combines policy enhances the ability of an economy to move factors from less to more productive uses and remove barriers to entrepreneurship it is not clear that this will result in a lessening of economic activity. Indeed, if this global scanning characteristic is a true attribute of the multinational corporation, then increasing the fluidity of factor markets and perhaps the quality of the factors themselves, can only attract investment. The increased competition will ensure that the consumer benefits from this investment.

In conclusion, it is hard not to agree with Brecher that, although it may be necessary to recognize that an "open" economy combines policy will differ from a "closed" economy one in the area of competition for domestic markets, in the needs of advanced technology industries and in the need to be competitive in world markets,⁴⁸ such a recognition is

⁴⁸ Brecher, "Competition", 567.

compatible with a selective policy to reduce concentration in non-competitive markets in Canada.⁴⁹

In a study for the Royal Commission on Corporate Concentration⁵⁰ the authors reviewed the evidence for real, i.e. social, as opposed to pecuniary economies of scale accruing to large firms in Canada, and came to the conclusion that there were few significant real economies of large firm size in those areas where such economies have been traditionally felt to exist - marketing, finance, management, research and development and multi-plant operations. For example, "there is no evidence that large firms export proportionately more than small firms",⁵¹ evidence on the relative efficiency and costs of using the internal versus the external capital market was inconclusive,⁵² there was no evidence that a large firm

⁴⁹ Ibid., 571.

⁵⁰ D.C. McFetridge and L. J. Weatherley, Notes on the Economies of Large Firm Size, (Ottawa, 1977).

⁵¹ Ibid., 254.

⁵² Ibid., 255.

reduced the risk to its owners more than could have been affected by an individual managing his own portfolio,⁵³ "there would seem to be little scope for a merger defence based on the notion of R and D synergism".⁵⁴ The authors were unimpressed with the arguments for economies of multi-plant operations and of management services.⁵⁵

In summary, a Canadian combines policy in the field of merger - such as a mechanism to review an industry's structure (market share and number of firms) and its tariff protection when concentration is felt to be increasing through merger activity - could operate without being unduly constrained by the arguments for large firm size, if a complementary policy to reduce barriers to entry in all markets was developed and if programs were put in place to minimize the disadvantages that small businesses work under in areas such as research and development, access to investment funds, and lack of marketing expertise. It is also true that in the short term the economies that will accrue to large firms will be economies of process scale and these could result in lay-offs as surplus capacity is

⁵³ Ibid., 255.

⁵⁴ Ibid., 256.

⁵⁵ Ibid., 246-253.

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taken out of production. This being the case it would be
unwise to assume that increased efficiency achieved via
merger and selective tariff reductions will require less
attention to the need for adjustment assistance than will
efficiency attained via free trade.

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