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LES POLITIQUES COMMERCIALES, INDUSTRIELLES,  
REGIONALES, ET D'ADAPTATION DANS LE  
RAPPORT DE LA COMMISSION MACDONALD :  
UN COMMENTAIRE

par

Pierre-Paul Proulx  
Professeur titulaire  
Département de Sciences Economiques  
Université de Montréal

COMMENTS ON TRADE, INDUSTRIAL, REGIONAL, AND  
ADJUSTMENT POLICIES IN THE REPORT OF THE  
ROYAL COMMISSION ON THE ECONOMIC UNION  
AND DEVELOPMENT PROSPECTS FOR CANADA  
(MACDONALD COMMISSION)

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"A real Canadian is an internationalist by heart, a nationalist in spirit, and a continentalist in the pocketbook. A real Canadian wants an independent Canada within a strong North-America". There are parallels with Quebec's recent trauma about separation!!!"

T. Wills  
What Does Canada really want?  
The Gazette  
Montréal, Saturday, September 7, 1985.

## ABSTRACT

The effect of long discussions between commissioners with divergent views on certain issues is obvious in the Report : it is more oriented towards the short term than expected. Undue attention was paid to trade liberalization with the U.S., a region of the world which the Report describes as one in relative decline. The Report does not deal with a scenario wherein trade liberalization with the U.S.A. is seen as a necessary transitory measure leading towards diversification of Canada's trade relation away from North America. Such an examination would point to a different approach to the U.S.A. in the short term.

The Report does not deal with services, information and telecommunications which are fundamental to the economic development of Canada.

There is also overemphasis on commercial policy and relative neglect on the use of domestic policies, among them industrial policy, in the pursuit of Canada's objectives. The Report notes the interdependence between commercial and domestic policies and rightly recommend that provinces must, as a consequence, be involved in trade liberalization discussions.

It is argued that the Report underestimates the pressures for extra-territorial application of U.S. policies to Canada and the pressure for harmonization of policies which would follow trade liberalization.

The Report pays no attention to the implications of offshore investment going primarily to the U.S.A. and does not pay adequate attention to the role of investment to deal with adjustment problems. Available studies would have allowed the commissioners to clarify the determinants of investment decisions by Canadian head offices who have established subsidiaries in the U.S.A. but they were not examined. Little attention was paid to the role of transnationals and intrafirm trade in examining the implications of trade liberalization.

The importance given to the reduction of regional disparities in earned incomes is welcome. However, the recommendation to leave regional development to provinces and municipalities denies the importance of national policies in the attainment of regionalization job equilization.

The impact of new CAD-CAM-telecommunications technologies on location decisions for the production of goods and services was not examined. Nor were the extent of and changes in interregional (i.e. interprovincial and more particularly province-state) trade flows examined. Knowledge of these patterns is essential in the formulation of industrial and adjustment policies in light of trade liberalization.

The Report recommends passive industrial adjustment policies focussed on the U.S., a reflection of the concern of the commissioners for the short term and the U.S.A.

The implementation of the Report's recommendations would lead to a centralization of economic power at the national level, hence the need to establish a renewed Senate to favour the formulation of regionally sensitive national policies.

## RÉSUMÉ

Le Rapport ayant subi le processus de tamisage et de négociations entre les commissaires est plus axé sur le court terme qu'on aurait pu l'espérer. Ceci fait qu'on a porté une attention particulière et surfaite au libre échange avec les Etats-Unis, qu'on décrit d'ailleurs comme une région du monde en perte de vitesse. La libéralisation du commerce Etats-Unis-Canada, quoique nécessaire, permet difficilement d'envisager la diversification des relations commerciales du Canada à moins qu'on ai fait de la diversification un objectif initial, ce qui changerait la nature de l'entente Canada-U.S.A..

Le Rapport omet presque entièrement la question des services et des activités tertiaires d'information et de télécommunications dont l'importance est grande pour le développement économique du Canada.

On donne une trop grande importance à la politique commerciale et on développe peu le rôle et la contribution essentielle des politiques domestiques dont la politique industrielle...etc dans la poursuite des objectifs. Le Rapport reconnaît cependant l'interdépendance entre la politique commerciale et les politiques domestiques d'où sa recommandation d'impliquer les provinces dans les négociations.

Le Rapport, tout en notant les pressions d'harmonisation des politiques résultant d'une entente bilatérale avec les U.S.A., a sous-estimé l'importance des pressions pour l'application extra-territoriale des politiques américaines.

Le Rapport ne tient pas compte adéquatement des flux d'investissement venant d'outre mer vers les U.S.A. plutôt qu'au Canada et ne met pas suffisamment en lumière l'importance de promouvoir les dépenses d'investissement pour enrayer et commencer à attaquer les problèmes d'adaptation industrielle qui s'amplifient au Canada. Des études existantes permettant de cerner les facteurs déterminants d'implantations de succursales aux Etats-Unis par les Canadiens n'ont pas, semble-t-il été considérées par les commissaires, et on ne clarifie pas le rôle des firmes transnationales et du commerce intrafirme dans le processus d'intégration nord américain.

L'importance donnée à la réduction des disparités régionales dans les revenus gagnés est prometteuse. Par contre, la recommandation à l'effet de laisser le problème du développement régional aux provinces et municipalités exclusivement nie l'importance des politiques nationales dans la poursuite des objectifs de péréquation des emplois.

On a omis d'examiner le rôle des nouvelles technologies de télécommunication et la CAO-FAO dans les décisions de localisation de la production et de distribution de biens et services. On n'a pas fait avancer l'examen des flux interrégionaux de commerce (entre provinces d'une part et entre provinces et états des U.S.A.) et ce à la lumière du contexte international et des coefficients d'exportation et de la pénétration des importations d'outre mer, renseignements essentiels à la mise au point des politiques industrielles et d'adaptation industrielle advenant la libéralisation du commerce.

Le Rapport prône des politiques transitoires d'adaptation industrielle passives et axée sur les U.S.A., reflet de la préoccupation pour le court terme et le continent nord-américain.

La mise en application des recommandations donnerait lieu à une centralisation de pouvoirs économiques d'où l'importance de mettre en place un Sénat renouvelé pour permettre la mise au point de politiques nationales sensibles aux réalités régionales.



## Introduction

Initially intended as a comment on the trade policy aspects of the MacDonald report, what follows is a selective but broad ranging comment which has called for sifting through the three volumes of the Report, for as the Commissionners correctly point out, trade policy, regional policy, education and training, labour-management relations, the regulatory framework, the taxation system, treatment of foreign investment, export trade policy and marketing issues, reinforce one another and are so closely interrelated that there is now a tendency to regard the international economic and trade rules as extensions, in essence, of particular domestic policies. (I-51, I-234, I-282)<sup>1</sup>.

In summary, those portions of the Report which I have examined can be considered as a useful summary of the main stream position of economists. I have found little new in this report and in fact maintain that some recent relevant research has not been reflected in the Report. The give and take among Commissionners is obvious. That has made for a less polarized presentation of issues, more balance, but the result has been a greater concern with short term issues than was expected.

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<sup>1</sup>These are page references to volumes I, II or III of the english report of the Royal Commission. Errors and ambiguities in the french translation of the Report have obliged me to read it in English. See Jean-Emile Denis, La Commission MacDonald et le libre échange, Le Devoir, jeudi 19 septembre 1985, p. 11, for indications of the poor quality of the french version of the Report.

Generally, my response to the Report can be captured by the two following analogies. Reading the Report reminded me of a situation where an aging, lonely middle-aged person returns to a psychologist who repeats the same prescription : get into shape (read productivity), put on some makeup and sit by the telephone. The problem is that the telephone does not ring! I am of the view that one must get out and hustle in addition to getting into shape! My response to other parts of the report and more particularly the emphasis on trade liberalization with the U.S.A. can be summarized by the following analogy : it's as if one had asked a team of engineers to develop plans for an elevated bridge or an electronic highway to help Canada open up to the world. The team of engineers, very concerned with the short term, has devised plans for the building of a super highway leading directly to the U.S.A., forgetting to plan for on and off ramps to South-East Asia particularly and to Europe for certain provinces i.e. Quebec!

Needless to say I shall be silent on many of the issues in the Report with which I agree. This will therefore convey an impression of a view which is more critical than is warranted, for there is much interesting material in the Report.

### The Commissionners and Free Trade

Freer trade and the related market allocation of resources are two thrust which are obvious throughout the Report. The freer trade with the U.S.A. recommendation is a direct response to the increasing difficulty of penetrating Canada's major market i.e. the U.S.A.. I agree with the thrust of this recommendation and with the proposal to open bilateral negotiations while waiting for a slow moving GATT round to get under way.

The Commissionners quote the usual studies on the possible effects of Canada-U.S.A. free trade (I-328, I-329). They do indicate that the results of the analysis must be accepted cautiously. As I mentioned elsewhere<sup>1</sup>, there are indications that the estimates of the benefits of free trade quoted in the Report are on the high side.

One of the most fundamental lacunae of the Commission's Report is it's non-treatment of the services question. One would have hoped that a Commission with the resources that it marshalled would at least begin exploring this substantive area. The Commissionners note the U.S.A. interest in services and propose, given that interest, that Canadians should bargain harder for access to the U.S.A. markets for Canadians goods. While I agree that one should bargain for the best access possible for resources and goods, I believe that to stop there is a strategic error. The U.S.A. has placed services on the agenda because of their recognition of the growing importance of service activities to the

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<sup>1</sup>P.P. Proulx, Trade Liberalization and Domestic Adjustment, Discussion Paper, October 1985, forthcoming.

creation of wealth and income. More and more, service type activities precede and follow the exports of goods. In addition, services are embodied in goods, i.e. software in computers. To specialize Canada in goods production and to neglect services to the extent that has been done in this Report is to condemn Canadians to a declining standard of living relative to that of those countries which focus on services and goods in their economic development<sup>1</sup>.

The Commissionners would exclude a certain number of sectors from a free trade area with the U.S.A.. It will be interesting to see the extent to which these exclusions make for a result similar to that arising out of an approach which would have announced as an objective the pursuit of freer trade both with the U.S.A. and multilaterally, and indicated an intention to proceed either sectorally or on horizontal policies in the attainment of that objective.

The Commissionners note (I-71) that in the longer term, successful competition in a North-American context will lead to a greater ability to compete abroad and diversify our markets. They also indicate

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<sup>1</sup>I have developed this argument in more detail in P.P. Proulx, Trade liberalization, op. cit.

(I-263) that there is security in a wider diversity of customers. I agree that greater integration in North-America is a necessary condition for the attainment of Canadian economic, social and political goals. But I do not agree that it is sufficient for their attainment. It would have been preferable to envisage Canada-U.S.A. freer trade as a means towards an end which is diversification of Canada trade relations.

The Report is silent on an approach which would have attempted to view the Canada-U.S.A. free trade measure as a means toward trade diversification. The commissioners should have told us why protectionism which is pronounced in the U.S.A. now will go away and why Canada will not be tied to a producer who in many instances is not and will not be the least cost supplier in the world. I would also have argued more strongly for ties to the E.E.C. given certain social, cultural, historical links which are very pronounced and important to the development of certain regions i.e. Quebec, notwithstanding slow growth and protectionism in Europe.

I have found the commissioners quite convincing in their description of the U.S.A. as a slow growth area and the Pacific Rim countries as dynamic growth areas in the world. Although the U.S.A. recognition of services as a fundamental determinant of growth is a promising one for them, given concerns with the slowness of GATT which to date has not accepted to deal with the services question, I am inclined to agree with the commissioner's picture of the U.S.A. as a slow growth

area. They indicate that European and North-American countries will lose thirteen percent of their relative share of World output between 1980 and 2000, while Asian countries, including Japan and China, would improve their relative shares by twenty percent (I-168); and that Japan has caught up with or surpassed the U.S. as international leader in industrial technology in many sectors (I-239).

I also find quite opportune their following comment :

"A regional power without a region has better cause than most others for diversifying its contacts abroad and for nourishing growth of multilateral decision-making systems". (I-206)

I would suggest that the shift of economic activity to the Pacific Rim is the external influence which should be shaping the nature of Canada's international and domestic economic policies.

The commissioners do develop a worse case scenario for the U.S. and conclude that :

"Canada would have less opportunities to exercise autonomous economic and political initiative in the face of the U.S. demands for better terms as compensation for the military protection it receives".

Such considerations have led me to advocate an examination of trade liberalization with the U.S.A. as a transition measure toward the attainment of the fundamental objective of trade diversification for Canada. I maintain that the nature and characteristics of North-American integration and our negotiation approach to the U.S.A. will differ depending upon the importance given to the diversification objective.

Let me illustrate. The commissioners note that trade liberalization creates trade between the parties and diverts trade from third countries. This is the trade diversion effect long recognized in international economics. The importance given to trade diversion, the difficulties in enforcing and applying rules of origin to ascertain that goods and services are not transhipped via the low tariff and low NTB country, has encouraged others to conclude that a free trade area is a fragile type of arrangement and that the harmonization pressures which would follow could rapidly lead to a customs union<sup>1</sup>.

The short term results of trade deflection or diversion would probably be to encourage Quebec and Ontario firms to expand their production in products now imported from offshore and hence to specialize in low value added textile, clothing, shoes, etc. These products are now and will for a number of years remain the object of a lot of protectionism in the U.S.A. and Canada. Forthcoming GATT negotiations though much slower and resulting in effects perhaps only in the mid 1990's, would indicate the fragility of such further specialization in low value added areas. The short term politically interesting nature of the trade diversion effects which would follow from a Canada-U.S. free trade arrangement are quite obvious, but the Commissionners could have been expected to take a longer term approach to the development of a trade-industrial-regional adjustment policies for Canada.

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<sup>1</sup>See L. Dulude, Yves Rabeau, et P.P. Proulx, "Etude des relations commerciales", Québec-U.S.A., Québec-Canada, Options et impacts, contraintes et potentiel, Gouvernement du Québec, Ministère des Affaires Intergouvernementales, Editeur Officiel du Québec, février 1979.

Increasing pressures for harmonization of policies

The commissioners recognize that the degree of interdependence will continue to increase, causing domestic policies of any one country to be significantly affected and in some instances dominated by global forces and the policies of larger countries (I-209). They also indicate that :

"It is not inconceivable that in many areas a free trade arrangement would generate political forces which over time, would bring Canadian taxation and industrial regulation much closer to the American pattern than they are at present". (I-360)

They indicate that some existing controls on service and natural resource industries may not meet the standard which would allow closing them in the "national interest". (II-238). They also lucidly point out that political authorities might find expressions of discontent concerning regulatory activities designed to serve other public objectives such as labor codes, safety requirements, environmental regulations and products standards all of which increase production costs, more persistent and more difficult to resist under a bilateral free trade regime (I-359). Experience in the European economic community indicates that this is an ongoing and significant problem.

I conclude that the commissioners have underestimated the pressures for harmonization and for extraterritorial application of United States laws which we will be witnessing in future years. These



pressures will be exacerbated to the extent that a bilateral free trade arrangement is negotiated.

To the extent one is concerned about continuing slow growth and protectionism in the U.S.A., this should give rise to significant concern and emphasis upon multilateral and multilateral negotiations and bilateral agreements with countries in the Pacific Rim and Europe for some sectors, given Quebec's interests.

The commissioners recognize that increased international integration has imposed costs on Canada in the form of exposure to external shocks and considerable loss of domestic autonomy in short run macroeconomic policy matters. Further integration with the U.S.A. as proposed by the Commission would give rise to continuing loss in the margin of maneuver of both fiscal and monetary policy, a consideration of great importance since a growth context is conducive to adjustment whereas slow growth is not. They note that flexible exchange rates can help with the adjustment process but closer integration with the U.S.A. would also constrain that policy from being meaningful.

A further consideration in assessing the Commission's recommendations is that many of the rules, regulations and policies which would be targetted for pressure by competing U.S. interests are provincial and are within provincial jurisdiction. This would add to the pressures for centralization in Canada and could potentially give rise to a very institutionalized legalistic approach which would be undesirable.

The commissioners also indicate :

"that since Canada's industrial policy and trade stances are so closely intertwined, a commitment to freer trade must be accompanied by a commitment to "level the playing field"...

It would be even more important than it is now for certain of our policies to be sufficiently similar to those of the U.S. to enable us to be reasonably competitive. Taxation, where a parallel approach is required for competitive reasons; regulation, which must not unduly impede the restructuring of industry, efforts to promote exports; are identified as policy areas where significant pressures for harmonization would be felt (II-202). I believe that "levelling the playing field" in making for fair trade will more often than not mean alligning Canadian Federal and Provincial policies on U.S. policies<sup>1</sup>. Canadian governments should in all instances, ascertain the effects of such alignment of Canada's policies on those of the U.S. on Canada's trade relations with third parties in order to estimate the possibility and desirability of such harmonization.

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<sup>1</sup>I have documented elsewhere how foreign subsidiaries benefit from higher canadian effective tariff protection and government grants than canadian owned firms. See Proulx, Rabeau, Dulude, op. cit.. Such pressures would increase.

### The commissioners and industrial policy

The commissioners' policy recommendations in this area were formulated in light of an examination of a number of indicators of competitiveness. Commissioners examined trade balances in manufacturing (II-190), trade balances in selected high tech industries (II-192), share of O.E.C.D. exports (II-193), in addition to growth matrix analysis prepared by J.R. D'Cruz and James D. Fleck reported on pages II-196-197 as relative market shares of canadian industries. Their analysis indicates no general deterioration except in leather, textiles, knitting mills, and clothing. Concerning high technology, industry trade balances indicate that most of the balances are negative, but that the 1982 balance was more favorable than the 1966-82 median in many cases. The Report notes that Canada's share of overall O.E.C.D. exports have declined between 1972 and 1983, a decline concentrated in crude materials and fuel exports. They also note that canadian exports fell relative to those of the three largest export countries in most industries between the periods 1971 to 1976 and 1976-1981. These declines were largest in the raw materials sectors. They do quote one of the D'Cruz-Fleck conclusions to the effect that there has been a reduction in the proportion of high growth high share industries in a growth matrix, is a sign of serious structural weakness. Perusal of Table 9-14 (II-196) indicates that except for chemicals and photographic equipment, Canada's relative market share has declined in the high tech sectors.

The commissioners also note that Japan's export basket had ceased to be filled predominantly with light manufactures and come to include more capital intensive industrial products such as automobiles, planes and ships in the 70's and more knowledge intensive products in the 1970's and 1980's. According to commissioners, the use of forward looking industrial plans and government business cooperation has been unique in the economic restructuring of Japan. They also had noted the growing vertical integration and internationalization of the Japanese industry. (II-253).

According to the commissioners, the most severe problems of Canadian industry are lack of product specialization and short production runs. Other problems include the lack of product innovation which is especially related to the branch plant characteristics of our economy. The commissioners are of the view that it is urgent for Canada to expand economies of scale and to realize greater productivity. Note that there is no mention of the role of information and knowledge based services in the attainment of these objectives.

The Report also indicates that from 1973 on, governments ceased to be a net source of savings and became increasingly heavy net users in Canada. They indicate that this shift in savings :

"can be interpreted as evidence of the private investment which has been at low levels in Europe and Canada in the 1980's, is insufficient" (I-146).

I have emphasized the problems of weak investment and accumulating adjustment problems in many other writings. I would emphasize this observation by the commissioners as being fundamental to the formulation of appropriate industrial, regional and adjustment and trade policies for Canada.

The commissioners note that Canadian competitiveness is influenced by many factors other than productivity. They note in passing the importance of exchange rates and add that countries produce goods and services in which they have some form of comparative advantage. They indicate :

"such an advantage may be natural in origin (the result of climate, for example), or it may be engineered (that is, derived from superior organization, more advanced technology, innovation or some other such factor or factors". (I-152)

The commissioners emphasize the importance of rationalizing production to achieve economies of scale and though they note that in some circumstances CAD-CAM technologies will lead to a scaling down of a large number of manufacturing processes. They conclude that it is impossible to predict whether economies of scale will increase or decrease, on average. They note services are traded but to a much smaller extent than are primary commodities or manufactured goods, and suggest that the slow growth experience in the growth of world trade since 1973 may reflect in part the rapid growth of the service sector.

I find these sections of the commissioners' Report very unsatisfactory in light of analysis existing during the preparation of the Report. Available studies have indicated that American subsidiaries

seem to be diversifying whereas the Canadian counterparts are specializing recently. The relative importance of economies of scale and economies of scope which could be related to the different adjustment patterns and use of new technologies by subsidiaries and Canadian firms, has been posed as a question but the commissioners do not arrive at any meaningful or significant conclusion on these very fundamental issues<sup>1</sup>. The commissioners do note that the principal limits to growth are not physical, but political, social and institutional. They indicate that the major challenge thus lies in the fruits of technological and institutional ingenuity. (I-209). The commissioners did document rapid increases in knowledge and state that the rapid advance in science and technology is bringing about far reaching changes which will require adjustments in the short and long terms (I-125). They also document the lateness and lags in the diffusion of the technology in Canada and state, and this is a fundamental observation, that :

"Unfortunately, however, the doctrine of comparative advantage fails to account adequately for a good deal of the international trade that is presently going on around the globe. The basis of trade and manufactured products, for example, appears to be provided by factors much more subtle than a country's relative endowment in human, capital or natural resources". (I-157)

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<sup>1</sup>See P.P. Proulx, "Trade Liberalization", op. cit. for further discussion of these issues and references to available studies.

They do indicate that comparative advantage depends increasingly on major investment decisions, on research and on development of human capital through training. They write that it is now easier to acquire a comparative advantage in a particular sector through manipulation, and that this development offers countries greater opportunities to influence their own trade patterns. As a result, the composition of trade flows is becoming more subject to the actions of governments. Modern foreign investment policies give governments greater scope to create trade, and except in the matter of subsidies, GATT rules generally do not regulate this aspect of international activity. Recent research would seem to confirm that technological change and more particularly the diffusion of technological changes through the investment process is a fundamental one for the establishment and maintenance of Canadian competitiveness<sup>1</sup>, a consideration not developed in the Report.

Commissioners do recognize that many governments are intervening to a greater extent in their domestic economies and formulating all kinds of strategies for industrial and agricultural development. As a result, they note that some governments, especially those of the larger countries, now tend to regard the international economic and trade rules as extensions in essence of particular domestic policies. (I-282)

The commissioners emphasize the importance of good taste, good design and creative innovation and high quality business education and

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<sup>1</sup>Voir P.P. Proulx, "Les effets du dernier budget du gouvernement fédéral et du gouvernement provincial sur la R & D au Québec. Rapport au Conseil de la politique scientifique, septembre 1985, non publié.

entrepreneurship to the attainment of Canada's competitive advantages. They do not conclude that there is a greater need for venture capital operations in the pursuit of these objectives. They note the importance of changing the tax system to make equity ownership more attractive and basically can be associated with the main stream of current thinking on these issues<sup>1</sup>. In their analysis of the diversity of adaptation to freer trade, the commissioners were prompted to distinguish strong exporting sectors from resource base sectors from weaker exporting sectors. The analysis of industrial adjustment seems to be going in the direction of identifying different sectors for different policy approaches, a path the commissioners are loathe to follow.

The commissioners' thrust towards a greater role for the market in the allocation of resources prompts them to caution against utilization of industrial policies. They note :

"that overzealous attempts by governments to engineer comparative advantage can prove highly disruptive to traditional concepts of fair trade". (I-194).

The commissioners have given too little importance to low investment and slow diffusion of technology through the investment process as a factor in attaining competitiveness for Canada.

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<sup>1</sup>Voir P.P. Proulx, Rapport au Conseil de politique scientifique, op. cit. for further discussion.



These factors plus the relative concentration of offshore investments in the U.S.A. to feed an integrated North-American market, a phenomenon which did not attract the commissioners' attention, are all indicators which should have been given greater play in the diagnosis of the Canadian problems and potentials.

The commissioners state that :

"Whatever one thinks of the proper role of states in the domestic economy, the international economy must be managed". (I-193)

I would conclude that since the international and domestic economy are significantly interrelated as conclusion shared by the commissioners, there is also a very significant role for government in the management of the domestic economy. Part of the theoretical basis for that involvement is made in an additional comment to the Report by one of the commissioners (R. Breton) who argues that governments, when they are well structured and competitive, do as good a job as markets, and like them over the longer term, allocate resources in ways that maximize the well-being of people. In his view, allocation of resources can be attained through competition between Government and market institutions, competition shaped and conditioned by the demands of the public and by the supply of entrepreneurial talents to each sector.

Another commissioner (L. Picard) in his dissenting comments, indicates that one cannot resolve the problem of developing industrial policy or strategy by staying inside an interventionist or not interventionist, Keynesian or Smithian theory. He is of the view, which I share,

that ideology and theory are bad advisors in a strategic situation. I would add that what is necessary for Canada is the development of a national game plan or strategy keeping in mind economic, social, technological and political dimensions. Picard argues that Canadians should tilt towards high technology and export activities and reminds readers that the targetting debate is far from being closed and that strategy formulation and implementation are a search process which is in perpetual evolution. I find the Report lacking in strategic direction. I would agree with the commissioners that what is needed is a balanced approach recognizing that criteria of success vary from sector to sector and that countries make mistakes in the exercise of industrial policy. To leave the issue with the general statement to the effect that resource misallocation is an inevitable consequence of Government support programs, just as resource misallocation is an inevitable consequence of the private sector decision and to propose that the challenge for Canada is to do at least as well as its major competitors in the exercise of industrial policy is, to say the least, disappointing.

I would argue that it is essential for Federal and Provincial Governments to provide much more information in the strategic growth matrix context as utilized by D'Cruz and Fleck and others on the ongoing related changes in international trade and competitiveness of domestic industries<sup>1</sup>.

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<sup>1</sup>Voir P.P. Proulx, Comments on the Kelleher and Clark Reports, Behind the Headlines, CIIA, September 1985, for further comments.

Similar techniques help large companies to proceed with their investment and portfolio allocations and it would seem desirable for governments to provide such information so that medium sized firms particularly, but also some large firms, might confront their information with that provided by Governments in order to enhance and improve their trade promotion and exporting strategies. I would also venture that such information would prompt a more significant examination of developing trade with Pacific Rim countries simultaneously with the penetration of U.S.A. markets. The commissioners indicate :

"That Governments do not generally observe the operation of international market forces without concern for their impact on their society, economy and people, and indirectly, therefore, on the status and power of individual states in the international system". (I-31)

They do indicate some of the elements of more positive and strategic government involvement in this process and in doing so, indicate their preferences for tax incentives over selective growth programs and for both of these over direct regulation. Recent writings on these issues<sup>1</sup> would indicate some limits to the general tax route in the attainment of some Canadian objectives, given the importance of exports in Canadian GNP. We shall, however, not attempt to engage that debate, but close by indicating that the Report is rather bland on these questions.

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<sup>1</sup>See Kotowitz, on industrial policies, Ontario Economic Council.

### On Regional Development Policies

The commissioners' attempt to present a balanced discussion of this issue was particularly difficult, given the free trade and market thrusts which characterized much of the Report.

The discussion of factors underlying regional disparities in earned incomes is nicely formulated and the policy suggestions flowing from it which emphasize focussing on regional productivity differentials and the operation of the labour market hence training, R & D, infrastructural support, assistance for intra and interregional mobility, capital stock per worker, the rate of adoption of technology, quality of management, urban hierarchy, distance to markets, are all interesting contributions to our understanding of this complex issues.

The emphasis on 'differentials in earned incomes as against total incomes is relevant, for it indicates the limitations of fiscal equalization approaches and emphasizes the job equalization approach as an important element in regional development.

It is interesting to note, however, that the Report's proposal that place prosperity be the concern of local and provincial authorities will inevitably make for more government intervention in the allocation of resources and interregional competitiveness.

The emphasis on providing incentives to firms, workers and governments to help them break out of the transfer dependency cycle are welcome, although they are formulated in very general terms.

The proposal that federal government activities should not be inconsistent (I would add should be harmonized and consistent) with provincial plans is a welcome one. One is, however, left wondering about the proposal that no plant modernization be undertaken at the national level. This brings one back to the previous discussion on the role of government intervention in industrial policy, an issue which is left in a rather uncertain state in the Report, for on this issue, as on many others, a wide range of views are found, an indication of commissioner's give and take.

The Report's proposal to the effect that policies ensure that industries that do locate naturally in poorer regions can produce as efficiently as their counterparts elsewhere is a fine general statement which should be compatible with the utilization of domestic policies and the pursuit of regional development objectives. However, as the Michelin case indicates, the concern of U.S.A. entrepreneurs and governments and those of other countries by no means ascertain that this can be achieved.

Of the three theoretical approaches to the problem of regional disparities i.e. national interregional adjustment, the compensatory approach and the developmental approach which focusses on the causes of underdevelopment, the last seems most relevant. That the bulk of such efforts should consist of people mobility adjust and place adjustment at municipal and provincial levels is inadequate. One conclusion which many

Quebec economists have long ago formulated is that there is no such thing as a neutral national policy. They have also argued, and the argument is the same we have reviewed earlier on an international scale, that it is common for governments to utilize policies to "engineer" economic advantages, as likely a phenomenon within Canada as internationally. These arguments leads one to propose the establishment of new institutions in Canada to allow for the formulation of more regionally sensitive national policies.

The discussion of regional development issues is lacking in at least two respects. No mention is made of the potential impact of new telecommunication and CAD/CAM technologies on localization of industry. These may have fundamental impacts on interregional adjustment mechanisms.

In addition, as argued elsewhere<sup>1</sup>, the formulation of appropriate industrial policies by the provinces calls for an examination of export performance, import penetration, and interregional trade flows between provinces, and between provinces and states in light of international trade developments.

The commissioners do address this issue in a very partial way. In their examination of goods and services flows in chapter 22, they indicate that in 1979, 1/5 of total output moved across provincial

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<sup>1</sup>Voir P.P. Proulx, Redéploiement industriel et flux de commerce dans le nord-est de l'Amérique du Nord, Cahier 8526, Département de Sciences Economiques, Université de Montréal.

boundaries while 15% was marketed abroad. When trade in services is excluded, only 44% of total output of goods was initially marketed in the province of origin, more than 1/4 was shipped interprovincially, a figure only slightly less than that for exports in 1979. They indicate that New Brunswick, Newfoundland and Saskatchewan find their largest markets outside Canada. In Ontario and Quebec, 1/2 of the output is sold within the province, the remainder being equally divided between shipments to other provinces and exports.

Examination of trade balances for goods and goods and services by province, indicates provincial and regional impacts of trade liberalization would be significant and different.

In addition, as indicated elsewhere<sup>1</sup>, there are indications that province-state trade flows have increased at a more rapid rate than interprovincial trade flows, a phenomenon of some consequence and importance for the formulation of local provincial, regional and national trade industrial and regional policies.

There is nothing new on these questions in the Report. The commissioners do state that :

"free trade will reduce regional divisions" (I-61),

but I have been unable to find adequate analysis on this question in the Report.

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<sup>1</sup>P.P. Proulx, Redéploiement, op. cit.

The statement that although there might be short term tradeoffs there are no medium term tradeoffs between regional development and maximization of national income are welcome, as are the statements to the effect that the national economy will be stronger to the extent that each regional economy develops its full potential. Commissioners finally advocating to a "bottoms up" approach as against a bland national "top-down" approach, both being necessary.

The proposal that regional economic development grants be provided to provinces that qualify for equalization payments is a recommendation which is interesting for it follows upon one of the elements introduced into the IRDP-DRIE program. However, as indicated at the time of development of this approach by DRIE, the fiscal equalizations are a lagging indicator of potential for regional economic development, hence, according to some, the need for the application of different criteria to determine access to regional development grants

It is also interesting to read in a national report a recognition of "the reluctance of workers to move" (II-246).

The commissioners' proposal that provinces be involved in place prosperity suggest that they formulate industrial and trade development plans so as to allow for a harmonized national approach to these questions.

The Report notes that differentiated tax rates, or the depreciation provisions of the corporate income tax provide an alternative



means of achieving the objectives of current expenditures by DRIE.. Notwithstanding the reservations indicated above concerning the utilization of differentials in fiscal capacity to determine and skew tax and program measures for regional purposes, no convincing argument is given why different measures should not be used in the pursuit of regional objectives.

In the discussion of regional fiscal policy, it is noted that differentiated stabilization measures could deal with more than average stimulus to poor regions when general economic weakness leads to stimulative fiscal policy nationwide, and exemption of poor regions from restrictive national policies when the national activity is strong. It is argued that implementation of both options would go beyond stabilization policy into permanent differentiation in favour of a given region, in other words, to an enlarged version of what is already done through DRIE, equalization, and the national tax transfer system. One has here an indication that the commissioners do not wish all policy and program instruments to be dealing with structural differences in regional development. However, the suggestion that more funds be allocated to combat regional disparities should overcome the concerns of those who find it difficult to square regionally sensitive national policies which market allocation and free trade.

### On Adjustment Policies

I shall not repeat here the analysis and observations I have made elsewhere on this topic<sup>1</sup>.

It should be emphasized that there are many interrelated causes to domestic adjustment, i.e. trade, technological change, natural resources, government policies of foreign and domestic governments, etc.

In their diagnosis of the nature of adjustment problems, the Report correctly points out :

"that Canada's rich resource base, its access to capital, its well educated and well trained labour force, and other advantages as well, are no guarantee of a prosperous future".

However, as indicated above, the shift to a knowledge-information-service based economy has not been developed in the Report, hence an inadequate analysis of the nature of the adjustment policies for Canada.

Commissioners indicate that Quebec and Ontario will be most affected and they also indicate that given the importance of intrafirm trade, the adjustment process will be considerably affected. Few new insights are reported concerning intrafirm as against market adjustment processes. One is still left with a fundamental question concerning the implications of North-American integration in an intrafirm context with

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<sup>1</sup>See P.P. Proulx, Trade Liberalization and Adjustment, op. cit.

significant unknowns concerning the localization of production vs wholesaling and retailing, for these can easily be divorced in an integrated market, particularly for services.

The commissioners' focus in the short term U.S. question and their neglect of medium term trade diversification is reflected in their approach to adjustment policy. They indicate :

"transitional assistance could take many forms : government backed loans, special R & D grants, or accelerated depreciation for Canadian firms which are rationalizing in order to expand into the U.S. market".

Why not also propose transitional assistance for rationalization aimed at exports to the Pacific Rim or the EEC?

Although commissioners prefer the worker adjust to firm adjustment route, the fact that much adjustment results through the firm entry and exit route calls for various tax, financing, and other measures targetted at firms.

Without advocating picking of winners as an approach to adjustment, I do agree with the Report's suggestion that assistance be skewed towards the more successful firms in declining sectors, in addition to the suggestion to provide more information on markets and competitiveness. Firms have characteristics i.e. innovative management and emphasis on marketing and exports which are indicators of success. These could be helpful as criteria to engage in multiyear adjustment and rationalization

contracts with firms. In addition, the development of an early warning system and monitoring of the adjustment experience of firms and plants are relevant activities for governments.

#### On Investment

The Report documents the fall off in the flow of inward direct investment towards Canada through the 60's and 70's. One would have been grateful for some documentation of trends in offshore investment as between Canada and the U.S.A., for summary analysis of this phenomenon indicates a disproportionate share going to the U.S.A.. This sets the stage for production in the U.S.A. for distribution in an integrated North American market.

The commissioners' do not report on very relevant research concerning factors which have influenced Canadian firm decisions to establish subsidiaries in the U.S.. Although unpublished, these studies, which were available, indicate that market pull factors are strong determinants of localization of production decisions. The market pull factors are reported to be stronger than the cost push factors. In addition, those results indicate that under equal costs of production and tax-subsidy considerations, Canadians would rather go South for proximity to markets and customers. One would have expected more on this basic question from the Commission.

Many of the Commission's recommendations are relevant to the establishment of a more positive climate towards investment and production in Canada, but they have not been related to the question of adjustment following upon the establishment of a Canada-U.S.A. free trade area.

There is discussion of the utilization of performance undertakings by foreign controlled firms but that is an inadequate approach to a process which is making for more investment South of the border, even by Canadians.

There is debate concerning the extent to which the push of outward investment is atypical given the exchange rate interest rate and trade deficit situations in the U.S., but the issue is not discussed at any length in the Report. More secure access to the U.S. market could, as indicated in the Report, diminish incentives to establish facilities South of the border, but the implication is that greater attention should be placed upon the domestic policies to accompany the trade policies in order to attain these objectives. It is not through performance requirements, or shares of the North American market à la autopact that one will attain efficient North American rationalization to meet offshore competition.

The Report indicates a preference for the utilization of tax and subsidy policies towards domestic and foreign firms and the regulatory stance of Investment Canada over domestic trade barriers as means to influence foreign investment patterns.

The nature of the approach to domestic and foreign firms is not developed in the Report. The commissioners do indicate however that the same tax and regulatory policies could be applied to both, except in sectors where cultural or national security issues predominate.

Previous examination of North American rationalization and investment patterns pointed to the possibility of joint Canada-U.S.A. activities for rationalization and exports offshore. This is not mentioned in the Report.

The Report also points to efficient labour-management cooperation and social control of technology as determinants of the pace of new investments and adjustment and the pace of diffusion of new technologies. Discussion of the potential of shifting the emphasis from high level labour-management cooperation to shop floor cooperation is not found in the Report.

The commissioners have emphasized the importance of innovation, R & D, style and design in their examination of approaches to increased competitiveness. I support their proposal that the definition of R & D be broadened to encompass all of the components of the innovative process and more particularly those involved as one nears to ultimate consumer, to the extent that they meet benefit/cost constraint as reported upon in Kotowitz<sup>1</sup> and Tarazovsky<sup>2</sup>.

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<sup>1</sup>Y. Kotowitz, O.E.C., op. cit.

<sup>2</sup>A. Tarazovsky, The Subsidization of Innovation Projects by the Government of Canada, ECC, 1984.

The Report's emphasis upon obtain and disseminating information on foreign technological developments, among other methods by experts within and outside Canada are welcome. I would add that the utilization of the tax route aimed at consortiums, with the tax rebates being determined by individual firm participation in the consortium are to be further explored.

In addition, recent research would seem to indicate that tax programs related to investment in machinery and plant are very fundamental to the process of technology diffusion in Canada, hence, the importance of focussing on such policies<sup>1</sup>.

The commissioners do note the role of transnationals in the diffusion of new technologies, but they do not reference or document the extent of the importation of such which should have an impact in the formulation of policies for domestic R & D and innovation.

In addition, their well documented presentation of the relative decline in the U.S. as a source of new technologies suggests policies aimed at a diffusion mechanism and a concentration on European and South East Asian countries.

#### On Services

Previous discussion has indicated the extent to which the Report is focussed on goods as distinct from services.

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<sup>1</sup>See P.P. Proulx, Les effets, op. cit. for details.

The Report documents the shift to service employment in the OECD economies. It places some emphasis on innovation and knowledge based tertiary type activities but does not emphasize these. A growing body of literature is documenting the impact of new telecommunications and communications technologies which are rendering the direct export of services more prevalent. These studies also refer to the embodiment of services in goods, an indication that the available statistics are not measuring properly the nature of economic activity, in that they report as manufacturing activities which are to a growing extent service type activities. More and more, service type activities are leading and following goods. The Report does not reflect this phenomenon which U.S. research had identified and which explains their insistence in putting services on the GATT agenda in order to establish rules on rights of establishment, rights to national treatment, unimpeded transborder data and other service flows etc. all of which would protect the further development of U.S. export of services.

A medium term view by the Commission would probably have brought out the importance of this component of the international economy.

#### On Federal-Provincial Government Balance

In their examination of changes in the international environment and implications for Canadian federalism, the commissioners indicate that they have seem deeply concerned about Canadian responses to external forces that shape our private and public lives . They write that such forces :



"may even alter the delicate balance between the federal and provincial governments". (III-18)

I would argue that the changing international environment and Canada's response to it, particularly the Report's proposal for a free trade area with the U.S.A. will alter the balance.

The commissioners indicate that such an agreement would require the provinces to give up some of their latitude in the use of public policies.

They add :

"that it is conceivable, that in the long run the free trade arrangement would reduce the power of the provinces relatively to the Federal government and the market". (I-364).

As a result of their assessment, the commissioners sought a procedure whereby treaties could be binding and enforceable upon the federal and provincial governments. The recommendation that provincial representatives might appropriately be members of the Canadian bargaining team flow naturally from the linkage between trade and domestic policies. This reality points to the importance of establishing a renewed senate in order to promote the formulation of regionally sensitive national policies on a whole ensemble of interrelated economic and social policies.

## Conclusion

The comprehensive nature of the Report is such that we have been quite selective in our review of the few issues raised for discussion above.

Let us be equally selective in these concluding comments and indicate that free trade as the major instrument in the attainment of Canada's economic objectives is not enough. Though necessary, it must be accompanied by significant attention to domestic policies, more information on the dynamics of world trade and competitiveness, a focus on services, examination of the nature of an approach to the U.S. compatible with diversification of Canada's trade relations, analysis of offshore investment patterns in North America, definition of the proper role of governments in the adjustment process, and the development of a strategic approach to market diversification with emphasis on knowledge intensive high technology diffusion of innovation through incentives to investment towards high elasticity of demand products etc.

In addition, much of the analysis in the Report indicates the continuation of slow growth and protectionism, hence the necessity for enlightened canadian governments to continue arguing for bilateral and multilateral trade liberalization while simultaneously indicating that they will attempt to play on a level playing field and match foreign utilization of subsidies and other NTB's until enlightened rules are arrived at and enforced.