Comments on "Canadian Competitiveness: Nine Years after the Crossroads" by Michael Porter (Harvard University) and Roger Martin (University of Toronto)

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I enjoyed this paper a good deal and think that, like the 1991 *Crossroads* book it reprises, it should be read by anyone interested in the problem of why the Canadian economy has not been growing as most Canadians would like. Although I agree with much of the analysis and many of the policy prescriptions, I will naturally focus in what follows on areas of disagreement. I want to structure my remarks around three topics: the micro nature of the problem, as Porter and Martin (hereafter PM) see it; the appropriate role of natural resources in the Canadian economy; and whether governments in the 1990s did indeed fail to implement the recommendations made in the *Crossroads* volume. I dare not close without providing my own guess as to why we seem not to be doing as well as most of us would like.

1. The micro nature of the problem

I like the focus – both here and in Michael Porter's work – on a microeconomic understanding of economic growth. In Porter's world, growth takes place, as it clearly does in the real world, in firms and industries. The key to growth, as he sees it, is the pressure to continually (even continuously) upgrade both products and processes. It is the nature of capitalist enterprise that business people have to be perpetually alert to new opportunities – and dangers. Indeed, the fear of being blasted into commercial oblivion by competitors armed with new products and techniques is a principal motivation. This is all very Schumpeterian and therefore in my view very realistic. It's also very much in the spirit of how David Landes sees economic growth, as described in his recent *The Wealth and Poverty of Nations*, which to my mind provides a quite persuasive analysis of why some countries have grown and others have not.

The approach taken here also seems to me to be consistent with Hayek and von Mises, in the sense that it is very hard to say, apart from the necessity to be always open to upgrading, just what strategy will work in any competitive circumstance. The figure on p. 10 of the paper that describes the secrets of Southwest Airlines' success shows six major keys to its "activity system" and a dozen smaller keys. Moreover, there are no fewer than 31 links among these 17 factors. And yet each of these factors and links is apparently crucial. As PM write: "Competitive advantage stems not as much from the individual activities as from the entire system … Sustainability of advantage results from the difficulty of any competitor replicating all aspects of the complex activity system. Imitating some aspects of the activity system, but not all, leads to a large gap in performance…" (pp. 10-11). It almost goes without saying that if even a competitor who knew the industry well could not count on successfully imitating Southwest, a minister of the Crown would have even greater difficulty – a lesson that has not always been appreciated by Canadian ministers of industry, who have often seemed as if they would like to micro-manage Canada's more important firms, whether in transportation or elsewhere.

I also like the Porter principle that commercial rivalry is a spur to alertness. This militates against another weakness of Canadian industry ministers, the idea that the country should support national champions in important industries. (It might also, I suppose, have led Porter to reject the proposed merger of the big banks, on the grounds that this would have reduced rivalry, though in fact I don't know what Porter's view of the bank mergers was.) In Porter's world, domestic rivalry is important because, like the sibling rivalry which it in many respects resembles, it is especially keen. (As a father of four- and six-year-old boys, I must say I had no idea just how keen until I had children.)

My only reservation about the importance of domestic rivalry is the traditional one that the Canadian market is small and may not be able to support enough Canadian firms to provide sufficient rivalry in many industries. I would argue that, if this is indeed the case, rivalry from US firms is a very useful substitute. We may not be the Americans' siblings, but we are at least their cousins, and there is certainly an edge to many Canadians' feelings about them. The satisfaction of beating them likely would provide considerable incentive to many Canadians. Moreover, our legal and economic systems are not so dissimilar that firms cannot fall back on the excuse that the playing-field can never be level.

This raises another point that may be worth mentioning. Although economic growth does take place at the micro level, the PM hypothesis is in fact that systemic forces – macro problems of one kind or another – are preventing us from being as competitive as we should be. In particular, we tend to focus on the wrong industries. (In his lunch-time talk Roger Martin indicated that he and Michael Porter disagree on this: Porter thinks upgrading can be pursued in virtually any industry.) And when we choose the right industries, we compete in them in the wrong way. The main problem is that we are derivative. We tend to copy what other people are doing. We don't try to figure things out for ourselves. And we don't submit ourselves to sufficient competitive pressure.

Whether this apparently economy-wide problem is in our economy-wide policies or our upbringing is obviously both hard to say and crucial, both to the analysis and to our future. I might add that the emphasis on always being original goes against much conventional economic wisdom: In this case, apparently, the free rider loses, while the innovator succeeds in appropriating many of the benefits of innovation, be it policy or industrial innovation.

2. The role of natural resources

(This section of my remarks could be titled, following Monty Python, "I'm a lumberjack and I'm OK." Or at least, "I'm a recovering lumberjack and while I'm not OK yet I'm making steady if slow progress.")

When Jacques Cartier described what is now Labrador as "the land God gave to Cain" he meant that it contained nothing at all of value. We know now that was not true: Labrador contains many valuable natural resources. On the other hand, these days abundant natural resources are widely regarded as a curse. In the 1980s people worried about the "Dutch disease": Having oil in a rising oil market made you fat and happy, caused your currency to appreciate, and squeezed your manufacturing sector. More recently, resources have been seen as a wasting disease: As commodity prices sag, so does your currency, which means you manufacturers thrive, but only because they enjoy the unbeatable cost advantage conferred by relatively poverty. Manufacturing may employ more and more of your labour force but your manufacturing industry feels no need to upgrade or be productive and therefore in the long run both it and your living standards languish.

The difficulty I have with this argument – whether made by the Science Council of Canada in the 1970s or by PM today – is: What are you supposed to do if you are unfortunate enough to possess natural resources? A chart on page 22 of the PM paper, titled "Movements of stock prices versus commodity prices," seems to suggest that you should take the investment share of your GDP and invest it in the US stock market: Since August 1971 the S&P 500 has increased 355 per cent in real terms, while the price of commodities declined 55 per cent, also in real terms. Of course, as Pierre Duguay pointed out in the question period following Roger Martin's lunch-time talk, this is not a relevant comparison: The prices of the electrical and electronic products that have powered the stock markets in recent years have fallen even farther and faster than commodity prices, and yet companies have obviously made money – and dramtically increased their productivity – making and selling these goods.

Like Michael Porter, apparently, I'm not convinced that having resources is necessarily a problem. I'm certainly not convinced , as Roger Martin is, that the secret to making success of your resource predicament is to find ways of adding value to them: Just because you have a comparative advantage in raw materials does not mean you have a comparative advantage in processing them – nor in producing the machinery and equipment to process them, another traditional complaint about our industrial structure. It may be that the best thing to do is sell the resources to the highest bidder and (to cite Monty Python again) do something completely different with the labour left over.

But if resources really are a problem, I wonder if they aren't a problem that will solve itself in the long run. If commodity prices are falling and productivity improvements aren't sufficient to keep a decent profit margin open, then capital presumably will leave the resource sector over the long run. Figure 1, taken from the *Canadian Economic Observer's* annual historical series, shows the change in various sectors' share of Canadian exports between 1971 and 1997. Natural resources are becoming less important in relative terms. We are exporting more industrial materials – many of which presumably are the upgraded raw materials that Roger prefers – as well as automotive products, machinery and equipment and, of all things, consumer products.

Figure 2, taken from the UN "Intracen" data bank, compares the factor intensity of Canadian and American exports. We obviously do more in the way of raw materials-intensive exports than they do. Neither country does much exporting of unskilled-labour-intensive goods, we do more human-capital-intensive goods and they obviously have a large lead in high-technology-intensive goods, though our performance, at 23 per cent of total exports, is not entirely disappointing. (The charts behind these data can be found at http://www.intracen.org/itc/services/rau/usa-t.pdf and http://www.intracen.org/itc/services/rau/canad-t.pdf . The definitions of factor intensity are at http://www.intracen.org/itc/services/rau/notes_uk.htm.)

If it is true that we are consistently choosing industries that are "bad" for us, an obvious question is why? Figure 3, again taken from the latest *Canadian Economic Observer* historical annual, shows what has happened in recent years to the prices of various goods, expressed in Canadian dollars. Oil prices have been flat since 1981, but a number of other commodities have not done badly. In fact, wood products top the list, and several other commodities also beat out electrical products, this generation's growth engine. So perhaps we continue in these industries because there is money to be made in them.

On the other hand, our tax policy more or less guarantees that profits can be had in these industries. Figure 4, taken from the Mintz committee's report, shows the effective marginal tax rate by industry group in Canada in 1997. There is obviously considerable variance. It's also obvious that the big winners in the tax sweepstakes are mining and the oil & gas industries. The rate of tax on forestry is actually surprisingly high, though it is not as high as in several service industries. Of course, these numbers do not include direct and indirect subsidies to various industries, whether through regional, industrial development, or social transfer programs. I don't know of any all-in estimates of the overall effect of tax and spending policies, but the *National Post's* Lawrence Solomon has argued recently that in several resource industries subsidies now exceed profits. (The flavour of his conclusions is suggested by the headline that appeared over his story on mining: "They get the gold, we get the shaft.")

I disagree with Roger Martin's view that we should be leery of resources, but I certainly don't think we should subsidize them. For a nation that worries about being "hewers of wood and drawers of water" to tilt its tax system in favour of natural resources is suggestive of deep neurosis.

3. Are governments the problem?

I make part of my living criticising governments, something I enjoy very much. But in this instance, I would actually be less critical of Canadian governments than PM are. I don't disagree that taxes should be reduced – though there are many other reasons to favour such a policy besides their likely effect on productivity growth – but it seems to me that through the 1980s and 1990s Canadian governments have done many things that should, at the very least, have set the stage for more rapid economic growth. In fact, the puzzle is that, after a stirring policy prelude, the curtain has not yet gone up on growth. Deficit and expenditure control, the FTA, NAFTA, the WTO, the GST, UI reform (however modest), the *Agreement on Internal Trade*, deregulation and privatisation in a number of areas, the end of inflation – these are all significant and, to anyone who grew up in the Canada of the 1960s and 1970s, surprising, even shocking, policy achievements.

So I would be a little less hard on our governments than PM are. If the key to economic success is that firms need to be put under competitive pressure, then I suspect the policies of the last 15 years have put Canadian firms under considerably more pressure than most firms had previously experienced. So in those areas where government can be most successful – namely, in opening up markets and exposing firms to competition – it seems to me our governments, while hardly perfect, have done a pretty good job in recent years.

In the area where problems remain – and the most important is, according to PM, in the relative lack of sophistication of our management – I don't really see how government can contribute usefully. PM argue that "there is room for governments to show greater entrepreneurial acumen and zeal in providing support to clusters…" The governments I am familiar with are very unlikely to show "entrepreneurial acumen and zeal" (even if the present federal government has tried its hardest to nurture a tourist cluster in Shawinigan). In Charles Lindblom's famous phrase, governments have "strong thumbs, no fingers": They are not designed for precision work. Moreover, a good argument can be made that, because we don't really want governments to exercise discretionary power in favour of some businesses and not others, that is exactly as it should be.

More fundamentally, I'm not persuaded by PM's argument that our managers are so incompetent. Even setting aside the well-known weaknesses of competitiveness indexes – or indeed of indexes of any kind – if you look at PM's chart, "The Microeconomic Foundations of GDP Per Capita," which puts real per capita GDP on the vertical axis and a "Microeconomic Competitiveness Index" developed by Porter on the horizontal, we find Canada at the extreme right, to the left of only the US, Germany, Finland, and (it looks like) the Netherlands. It's true that we are right on the regression line and not above it, which means that our GDP does not exceed what our competitiveness index suggests it should be, but, if anything, given the poor reputation of our managers and entrepreneurs, I'm surprised by how favourable our position is. It may be true that since 1996, the year for which the exercise was conducted, we have fallen one or two places in the rankings, but it is difficult to become exercised by that. In most instances, rankings *are* like hand grenades: close counts.

Another chart, "Company Strategy versus Business Environment," shows that we fall below the regression line relating our "index of microeconomic business environment" and our "index of company operations and strategy." This means that our companies have less sophisticated operations and strategies (however that might be measured) than would be expected given our overall microeconomic business environment. But what struck me about the graph was that our companies ranked relatively high in terms of sophistication. In his lunch-time talk, Roger Martin talked about what great companies Italy has. Yet we do better on this index of company operations and strategy than Italy.

Another traditional area of Canadian weakness highlighted by PM is in R&D. Just how bad is our R&D, and what could we do about it? In fact, as is well known, we provide very generous incentives for R&D. The Mintz Committee reported that the effective marginal tax rate on R&D performed by large companies is -28 per cent, while for small companies it is –39.8 per cent. We could reduce it even further, I suppose, though before doing so it would be useful to have even a rough estimate of the social payoff to yet another dollar of Canadian R&D spending.

Figures 5 and 6 present recent OECD data on, respectively, business spending on R&D as a percentage of GDP, and researchers per 10,000 workers. Though we are in the middle of the pack, I suspect our performance in R&D spending is actually considerably better than in previous decades. And again, before investing in the training of more researchers, I would like to see even rough estimates of the likely costs and benefits of doing so. The same goes for higher education in general. PM complain that although we are number one in the OECD in education spending, our ranking is slipping. It may be heresy for an academic to ask this question, but *would* an extra dollar spent on higher education be money wisely spent? The most recent estimates I have seen of the return to education, which admittedly were done with mid-1980s data, suggest it is not high. Remember that, unlike the US experience, the skill premium has not increased in Canada in the last decade and a half. I have not seen any estimates at all of the return to management education, which PM identify as being a potential contributor to Canadian economic success, but it strikes me they would be largely, though possibly not exclusively, private.

Let me end this section of my comments by quibbling with PM on their obsession with uniqueness, especially in the policy area. They write that "Canada has followed a set of policy prescriptions (spending cuts, restrained monetary policy and tax cuts) similar to other leading countries and has not innovated in any respect." To my mind, it is more important in these matters to be right than unique. There are many, many countries and only so many policy packages to go around. Put it another way: Our high business taxes may soon make us unique, but that is not a very strong argument for them. True, if we reduce them, we will be simply imitating Ireland. Though it might have been better to lead in this area, if it is too late for that, I don't see the harm in following.

4. So why no joy in the 1990s?

One of the most telling indictments of the economics profession is our collective failure to explain the post-1973 productivity slowdown. The concern that founded modern economics was an inquiry into the wealth of nations. We have not ignored this problem in recent years. Far from it, we have many possible explanations for the declining rate of growth of the wealth of nations after 1973. What we lack is ways of deciding among them with much confidence.

With that caveat in mind, my own guess at why Canada's productivity performance did not improve substantially in the 1990s, as I would have thought it should have, given the many important policy initiatives of the late 1980s and early 1990s, is mainly that the macro environment was not very favourable. I don't doubt that the initiatives of, first, John Crow on monetary policy and then Paul Martin on fiscal policy have paid off, and will continue to pay off, in terms of increased economic potential, but in the medium term they seem likely to have slowed the economy's actual rate of growth, which may well have slowed its productivity growth. Now that the transition to a low-inflation, zerodeficit environment is complete and employment is (presumably) nearing a cyclical high, the stage has finally been set for productivity growth.

Of course, there has been one very important exception to the many market-friendly policies introduced in the last 15 years. Recently-published OECD data on the revenues of member countries show that in 1997, the latest year for which data are available, Canadian taxes were at an all-time high as a share of GDP. Moreover, as a number of recent studies have shown, at the margin individual Canadians often face very high effective rates of tax after the effects of clawbacks of one kind or another have been taken into account. I do realize that in cross-country regressions of, taxes do not always show up as significant explanatory variables. On the other hand, as far as taxes are concerned, we have, as the OECD data suggest, entered uncharted waters for Canada. It is hard to believe that such an important economic phenomenon wouldn't have an effect on the growth rate, so I am quite sympathetic to PM's policy prescription that taxes, including business taxes, be reduced – though I would argue that there are even more compelling reasons for tax relief, having to do with fairness and social cohesion. The presumption that government has the right to all the money unless this can be shown to damage the economy is to my mind dangerous.

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