

Industrial policy now!

possible from "those industries which are genuine losers in the changing international division of labor." Harris argues convincingly that a policy of non-intervention in such sectors is politically irrelevant, because the absence of adequate adjustment policies compels politicians to give in to pressure for protection — the worst of all possible options.

The validity of the Harris thesis, however, depends on a rather tenuous distinction between policies intended for industrial adjustment and those intended for protection. In theory, it is possible that a free trade arrangement with the US would allow for the legitimate use of industrial policy instruments. In practice, such an agreement could prove to be elusive, partly because industrial policies necessarily imply a certain degree of protection and partly because the large disparity in bargaining power between Canada and the US enables the latter country to pressure Canada to harmonize domestic economic policies with US standards.

The first reason for the conflict between free trade and industrial policy is that the latter requires a degree of import controls that may conflict with free trade. Without such import controls a small open economy would be unable to ensure the full effectiveness of its industrial policies, because of its inability to implement a reflationist policy for fear of causing a serious deterioration in its trade balance and exchange rate. The need for reflation is dictated by current conditions of low aggregate demand, which reduces the response rate of firms to incentive-based policies.

Difficulties of adjustment

If Harris is correct in arguing that the adjustment period to free trade requires active industrial policies, it follows that the inability to fully exercise these policies (as suggested above) reduces the GNP gains that one would otherwise expect from free trade. In other words, the ineffectiveness of industrial policy would mean that some firms would not fully adjust to the increased competition and greater market access. Thus, some inefficient producers would fail to leave the market, while some relatively efficient firms would fail to make the leap into large-scale production, thereby leaving US market opportunities unexploited. This was effectively argued by Duncan Cameron in his excellent introduction to *The Free Trade Papers*, a collection of twenty-seven documents from leading participants in the free trade debate, including economists, government officials, journalists, trade unionists and other affected groups. Cameron explains that while US firms require only a limited increase in production to capture Canadian markets, a Canadian firm would need a major expansion in operations to do the same in US markets. Although the benefits from such an expansion could be great, the risks and costs would also be enormous. As a result, "few firms could be expected to take the leap," especially without the support of an effective industrial policy. The crux of this analysis is that the empirical estimates of GNP gains from free trade tend to exaggerate the actual benefits that accrue to the Canadian economy, because they are based on research which *assumes* that Canadian firms fully adjust to the new market conditions. According to Cameron, who refers to a point made by one of the contributors to the volume (economist Bruce Wilkinson), the real danger in overestimating the gains from free trade is that Canadian negotiators will be prepared to give up more than they otherwise would have. Given the view of the US Congress that that country's trade

deficit is due to "unfair trade" practices by foreign governments, and given the tendency of the Conservative government to shun industrial policy instruments, industrial policy is probably the area where Canadian negotiators are most likely to compromise (i.e., give up some authority). This is all the more likely in light of the enormous disparity in bargaining power between the two trading partners and the resulting pressure to harmonize Canada's trade-related policies with US standards — the second reason for the incompatibility of free trade and industrial policy.

Reform commercial policy

There do, of course, remain some possibilities for GNP gains through bilateral or even unilateral rationalization of commercial policy, without exacerbating existing pressures for harmonization. This is one of the conclusions that can be drawn from the *Canada-U.S. Sectoral Trade Study*, a background study by Gilbert Winham for the Macdonald Commission. It offers a detailed examination of trade statistics and commercial policies for each sector, thereby providing numerous instances where a rationalization of policy could generate significant GNP gains.

The trade negotiations, however, will do more than just rationalize the commercial policies of both countries. The trade agreement is expected to be comprehensive in its coverage of goods and services. Therefore, if such an agreement is implemented, it can be expected to lead to greater integration of North American markets, with a commensurate increase in harmonization pressures. As suggested above, this would constitute as second source of incompatibility between free trade and industrial policy.

Harmonization small problem.

A recent publication by the C.D. Howe Institute, entitled *Policy Harmonization: The Effects of a Canadian-American Free Trade Area*, arrived at the opposite conclusion. Commissioned by the federal government, the study includes five papers analyzing the potential for increased harmonization pressures in the areas of fiscal policy, commercial policy, cultural support policies and agricultural issues. In their overview to the volume, editors Lipsey and Smith conclude that a bilateral free trade area would not lead to any significant increase in existing pressures for Canada to harmonize its domestic economic policies with those of the US. The exceptions are agricultural and cultural support policies, which the authors argue could be exempted from the bilateral agreement.

The authors are to be commended for providing a coherent analytical framework for dealing with an aspect of the free trade debate that is rarely discussed in terms other than emotional or rhetorical. Nevertheless, the reader can detect a systematic reluctance of the authors to recognize forces making for policy harmonization under a Canada-US trade agreement. For example, Lipsey and Smith argue that a free trade area allows the trading partners to capture the gains from free trade without requiring that they harmonize their policies. But this kind of *a priori* reasoning only obscures the discussion. The real source of harmonization pressures is not the "type" of agreement, but rather the enormous disparity in bargaining power that characterizes the Canada-US trading relationship. One manifestation of this asymmetry is the fact that "non-discrimination against foreign investment" is an