

Free trade and industrial policy

by Mario Iacobacci

Critics and proponents of bilateral free trade with the US have given little attention to the role of industrial policy in dealing with the adjustment problems that Canadian firms are expected to encounter in the post-agreement phase. This is largely a by-product of the artificial dichotomy between laissez faire and government intervention that characterizes the free trade debate. Free trade advocates, on the one hand, argue that once the trade pact is negotiated with the US the operation of market forces is all that will be required for Canadian industry to rationalize its activities, thereby generating the desired GNP gains. There is no role for government policy to facilitate industrial adjustment; market forces will do the job. The critics of free trade, on the other hand, have been too preoccupied with criticizing the principle of bilateral free trade to devote attention to the importance of industrial policy in easing adjustment during the post-agreement phase. In this context, industrial policy is viewed as an alternative to free trade.

How to live with free trade

A number of recent publications have attempted to remedy this inadequate consideration of industrial policy in a situation of free trade. This was the primary objective of a Macdonald Commission research study on *Trade, Industrial Policy and International Competition*. Prepared by Professor Richard Harris, it develops a cogent argument to the effect that both free trade and interventionist/industrial policy are required if the economy is to emerge strengthened from the structural changes caused by increased competition and technological change.

Harris recognizes that the conventional theory of comparative advantage is only of limited relevance to current policy discussions, because it fails to account for the economies of scale and other factors that cause imperfect competition in product markets. He corrects for these limitations by explaining that the nature of international competition is determined by the barriers that prevent firms from freely entering or exiting from production. For example, production in sectors such as manufacturing is characterized by economies of scale and large capital requirements, both of which can be used as leverage by existing firms in order to discourage potential competitors from entering production in their sector.

Barriers to entry

The "barriers-to-entry" approach has two important policy implications for small open economies such as Canada's: (1) in order to compete effectively, they must gain access to large markets, which enable their firms to exploit scale economies in production, and (2) such economies must

develop an active industrial policy to enable firms to overcome entry barriers in their competition for expanding markets, as well as in their efforts to withdraw from losing industries. This analysis leads Harris to conclude that bilateral free trade with the US is necessary but not sufficient. To compete successfully, Canada must complement free trade with an industrial policy based on "business-government-labor relations at the micro level." In this respect, Britain's entry into the European Community is instructive. Its failure to develop an industrial policy has led to a long-term decline in the competitiveness of its manufacturing sector in the face of common market competition.

Trade, Industrial Policy and International Competition by Richard C. Harris for the Royal Commission on the Economic Union and Development Prospects for Canada, Research Studies, Vol. 13. Toronto: University of Toronto Press, 1985, 167 pages, \$14.95.

The Free Trade Papers edited by Duncan Cameron. Toronto: James Lorimer & Company, 1986, 227 pages, \$24.95 cloth, \$14.95 paper.

Canada-U.S. Sectoral Trade Study: The Impact of Free Trade by Gilbert G. Winham et al. Halifax: Centre for Foreign Policy Studies, Dalhousie University, 1986, 323 pages, \$11.00.

Policy Harmonization: The Effects of a Canadian-American Free Trade Area edited by Richard C. Lipsey and Murray G. Smith for the C.D. Howe Institute. Scarborough, Ont.: Prentice-Hall Canada Inc., 1986, 164 pages, \$12.00.

Industrial policy can work

The upshot of the Harris analysis is that comparative advantage can be engineered by governments able and willing to design effective industrial policy. These policies include selective subsidies to accelerate investments into more efficient technology, and other programs to encourage forward-looking investment and marketing strategies among firm managements. But industrial policy also includes labor adjustment measures (e.g., compensation, mobility grants and job retraining) to enable firms to withdraw as quickly as

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