



SHAKERHILL PARTNERS

Shakerhill Partners Ltd.
88 Alexandra Blvd.
Toronto, Canada
M4R 1L9

Alan R. Hibben
Principal

Competition Policy Review Panel
280 Albert Street 10th Floor
Ottawa, ON
K1A 0H5

8 November 2007

Dear Sirs:

CONSULTATION – SHARPENING CANADA’S COMPETITIVE EDGE

I am pleased to provide a response to your request for consultation dated October 30, 2007. I have split the commentary into two sections. In the first, I comment on the state of Canada’s competitiveness using the twelve pillar framework of the World Economic Forum and provide some suggestions under that framework of how Canada might move forward. In the second section I address selectively some of the specific questions that you have raised.

WORLD ECONOMIC FORUM TWELVE PILLAR FRAMEWORK

While the twelve Pillar framework of the World Economic Forum is not the definitive assessment tool for national competitiveness, it is sufficiently widely promulgated and understood and supported by academic leadership that it appears a useful way of looking at the issues. All of the issues raised in the October 30, 2007 Consultation Paper fit under one or more of these pillars. However, the range of issues raised in the consultation paper are, in my view, only a small subset of the issues in Canada (policy and otherwise) that have negatively affected Canadians. The pillars include:

1. Institutions
2. Infrastructure
3. Macroeconomy
4. Health and primary education
5. Higher education and training
6. Goods and services markets efficiency
7. Labour market efficiency
8. Financial market sophistication
9. Technological readiness
10. Market size
11. Business sophistication
12. Innovation

Institutions

For the most part, the institutional frameworks in Canada are near the best in the world. Several adjustments would be helpful:

- The Constitution Act of 1982 and its Charter of Rights and Freedoms do not include explicit guarantees of a right to property. This lack has had a detrimental effect on a number of laws and interpretations of the Charter that have restricted or subordinated rights to property to other rights in the Charter. For example, rights to liberty and security of the person do not include rights to property. This lack of a strong support to property rights makes Canada a less attractive venue for a number of industries and could prevent intellectual and other property developers from making Canada a first base of operations. In addition, this lack of a constitutional property right inserts a degree of uncertainty into the legal framework for corporations that creates friction costs to doing business in Canada.
- Various task forces have historically commented on the multiplicity of regulatory burdens in Canada, in part due to regulatory competition between the Provincial and Federal governments as well as certain obsolete features of the British North America Act continued in the Constitution Act. While various governments have launched “anti-red tape” campaigns, including the most recent part of *Advantage Canada*, very little seems to have been done about the issue. The Canadian Federation of Independent Business had provided one estimate of the costs of such red tape at in excess of C\$33 billion per year (2005). Most of this is a dead weight around Canadian business competitiveness.
- There are a wide range of laws, regulations and policies that are “made in Canada” for no other reason than they can be. While there have been a number of efforts to harmonize our institutions with global standards – much more could be done. As just one example, it is hard to conceive that Canada would require a separate Food and Drug Administration when California does not. Imagine if Canada’s struggling biotechnology sector simply had to comply with FDA approval protocols to make a drug saleable in Canada. Canada’s extraordinary good fortune to be physically and economically attached to a much larger country whose economy can absorb costs over a wider base allows us to appropriate many of the standards available in the U.S. with little real effect on “sovereignty”. I believe that a wide range of our institutional cost structure (both direct and more importantly indirect) can be reduced by further internal harmonization (such as one national securities regulator) and further external adoption. One of the main reasons that this has not happened is that “rent-seekers” – especially in governments – have hidden behind national or provincial “sovereignty”.

Infrastructure

A wide range of task forces have also commented on the “infrastructure deficit” in Canada – especially in cities and some provinces. The main areas are transportation (roads, ports, etc.), water & power, and telecommunications.

- The transportation infrastructure deficit occurs largely because of the monopoly situation of most transportation infrastructure projects within the government sector. This has resulted in chronic underinvestment versus the requirements of Canadians, excessive cost structures due to bloated and cumbersome government procurement and development processes, coupled with a high cost union labour requirement. While there have been notable exceptions, Canada is well behind a number of other areas of the world in the use of public/private partnerships and outsourcing of development and operation of roads, ports etc. The underinvestment level in Canada restricts the attractiveness of the country – especially with respect to supplying the U.S. market.
- In some parts of the country the water and power infrastructure is shockingly at risk. A main cause of this risk and potential danger to businesses and individuals is the combination of a government forced monopoly over power production and distribution and a similar approach to water treatment plus a ridiculously unrealistic approach to the potential for conservation and alternative power generation. Particularly in Ontario, where power planning and pricing have been political footballs for years, there is a risk that larger manufacturers will not take the risk and will locate on the other side of the Canadian border.
- In the telecommunications space there is a significant lack of competition, which has resulted in a lack of good capacity and speed outside of limited corridors. While not the only reason for this under-investment, the regulatory frameworks that have limited pricing discretion, encouraged uneconomic rural development and prohibited global competitors from entering the space are all combining to make Canada a less attractive telecommunications environment. Another culprit is the regional economic incentive policy that has encouraged governments and others to locate outside of concentrated areas, making the cost of servicing telecommunications requirements higher than it needs to be. Canada should immediately repeal the laws that restrict foreign ownership within the sector.

Macroeconomy

Canada would appear to have a solid policy framework and responsible central bank that both encourage a positive macroeconomic environment. However, the main issue on the macroeconomic front – also impacting on the degree of freedom in the country – is the very high proportion of GDP absorbed by all levels of government. Comparing Canada, the U.S., Ireland and Australia, Canada’s government “take” of GDP is highest at 39.9%, with the others at 36.4%, 33.7% and 35.3%, respectively. The burden of this high government cost structure falls directly on Canadian taxpayers and makes living and working in this country less economic than others. The corollary, of course, to a high government “take” is high rates of taxation both on an average and a marginal basis.

The use of punitive taxation at the individual and corporate marginal level as well as incentive destroying taxes on capital (capital gains taxes, provincial taxes on capital, financial institutions taxes) makes Canada a less competitive country. Recent changes at the Federal level are (for the most part) a step in the right direction. However, the reduction in consumption taxes versus income taxes is widely regarded as an economic mistake. Also, it remains to be seen whether the provincial governments will follow suit or actually use this opportunity to increase their relative “take”.

Health and Primary Education

The World Economic Forum considers Canada’s health and primary education infrastructure to be within the top fifteen in the world. However, I believe that with a number of adjustments, Canada could be the very top performer in this category.

- In the health sector there is a shocking lack of competition due mainly to the Canada Health Act. There are few market mechanisms that provide any sort of stimulus to lower the costs of health care and encourage innovation in the provision of services. Lost time and the uncertainty for individuals trapped in the queue for health services in Canada does not in any way add to national productivity and competitiveness. Further, the monopoly of union-based cost structures in the sector adds to the general burden of health care costs on the taxpayer. Much has been written about the “third rail” problem of discussing health care in Canada. If the Review Panel wanted to make a positive contribution to the competitiveness debate, it should address itself to the inefficiencies inherent in this system that is unique amongst developed countries. A simple legalization of health care purchasing in Canada would be a significant benefit to competitiveness and Canadians generally.

- In the education sector there are issues of both inappropriate cost structure as well as limited basic standards. From a cost structure point of view there is a government monopoly or quasi-monopoly in most provinces, with a combination of a union-mandated cost structure as well as a bewildering and inefficient set of administrations that pretend that local or regional based standards and infrastructure is required. In a globally competitive environment the need for different curricula in Kenora and Kapuskasing – with the attendant need for administrative burden – is unclear in the extreme.
- From a standards point of view, it is unclear whether the standards that are used in Canada’s primary schools are globally competitive. For example, the number of state-owned schools that provide the International Baccalaureate “Primary Years” program in Canada is only 17. While the educational standards in Canada may be attractive in the historic context, they may not be as globally relevant as they need to be for the future.

Higher Education and Training

Canada also ranks highly on the measure of higher education and training. For a small country we appear to have a very attractive base of universities and training colleges. However, the nature of being a small country, as well as a history of government ownership and control of universities has made the development of truly world-class institutions quite difficult. Canadian universities are much less likely to have strong endowments than U.S. private universities, with the effect that the quality of research and teaching faculty may not be as high and as well the inclusiveness of attendance and graduation may be lower than in the U.S. market. While endowments and other supports are being improved, it may be that Canadian universities need to be encouraged to “borrow” capabilities from other world-class universities in order to provide the very top level educational experience. A good example is the Kellogg Schulich EMBA program at York University.

Goods and Services Markets Efficiency

This is an area where Canada ranks well, but far behind countries such as the U.S., U.K. and Ireland. It is also an area where it would seem that there is already a very good appreciation (at least amongst economists, but sadly not politicians) for what could be done to improve the efficiency of markets. In general, the issues with markets in Canada can be put down to “rent seekers”. Canadians seem to be experts in convincing politicians that there is something special about industries, geographies or sub-populations that will require markets to be constrained and therefore a higher level of inefficiency foisted on businesses and individuals in the country. Most of these, when described to outsiders, sound even more ridiculous than they do to economists. A few classic examples:

- The various systems of supply management (i.e., milk, chicken, turkey, eggs, etc.) raise the cost of products to levels far beyond those that would exist in any rational economy with the effect that a startlingly low number of farmers will be able to generate excess incomes and vote in the right way. Milk prices in 2006 for some forms of milk product were close to 100% in excess of similar U.S. product. With rising exchange rates over the course of the last year, this has of course increased the gap substantially. These transfers of wealth from consumers to a small number of producers are extraordinarily inefficient.
- Strange provincial trade barriers of a bewildering assortment have been the subject of much discussion but little action. While the colour of margarine debate is perhaps viewed by some to be funny, the costs of inter-provincial trade barriers is difficult to estimate because of the huge volume and subversive nature of them. What is the cost to the economy because I can't ship a case of Ontario wine to Winnipeg? What is the excess bill to the taxpayer because governments restrict the firms that are qualified to bid on government contracts? There have been many guesses but all of them involve billions and billions of dollars of lost efficiency.
- Rent-seekers are not restricted to politicians. Consider the well-known absurdity that Canada is the only country in the developed world where you cannot buy a standard insurance product in a bank branch (except if you call the bank a *caisse populaire* and it is in Quebec). Consumers are deprived of choice, cost structures are higher than they need to be and the economy pays for a transfer of wealth from consumers generally to (mostly) insurance agents who happen to be very politically active.
- As already noted, there are wide swaths of the Canadian economy that are owned and controlled by governments for no apparent reason (such as water, power, roads) where there is little attempt to put market disciplines on the operation and thus no real way of knowing whether cost structures, efficiency and effectiveness are at the appropriate level for the service.
- There are a range of Canadian content and control regulations that clearly provide frictions to the economy that are born by Canadians and reduce the overall efficiency and competitiveness of businesses and individuals. Restrictions on ownership of telecommunications and financial services firms clearly provide a degree of protection to Canadian firms and thus have the potential to reduce the need for constant productivity growth and reinvestment. Perhaps more egregious, but of lower dollar impact are the multitude of ways in which Canadian media providers are protected and supported. There are a number of hidden taxes and subsidies that are borne by Canadians generally, but tend to benefit a relatively small number of content providers and especially owners of scarce media outlets (such as cable companies). All of these costs are difficult to add up – but all reduce both the freedom of Canadians and the efficiency of the economy.

Space does not allow a complete description of all of the multitude of laws and regulations that impact negatively on the efficiency and effectiveness of the Canadian economy and thus the competitiveness of its citizens and companies. One can only suggest that a fresh look be taken at the multitude of these barriers to efficiency and require that the costs be quantified and those on whom the burden of payment falls asked to positively support the expenditure.

Labour Market Efficiency

As with efficiency of goods and services labour market inefficiencies in Canada come from a multitude of places within the political environment – too numerous to comment on in total. Several specific points should be made.

- Immigration should be a substantial addition to labour market efficiency in Canada. Educational and training systems in many parts of the world are producing a wide range of skills that may not be as plentiful in Canada. However, two barriers restrict the ability of immigration to add to competitiveness. First, immigration trends by class are not encouraging. Of the 251,511 new immigrants to Canada in 2006 (down slightly from 2005) the growth categories were Family class (up 11.2%) and Provincial Nominee Program (up 65.6%) while both Business Class and Skilled Workers were down by more than 10%. Only 47% of immigration in 2006 was in these two latter classes. Canada would benefit by substantially increasing the business and skilled classes and reducing the family class of immigration in the mix. Secondly, there still remain many barriers to skilled immigrants being able to practice under Canadian laws and regulations. Much more needs to be done to ensure that qualifications from foreign institutions are assessed and immigrants quickly brought into Canadian high quality professional status.
- There is substantial evidence that countries without “right to work” legislation have greater labour market rigidity, slower productivity growth, lower profits, less investment in physical capital and research and development, and slower rates of employment growth than countries with such legislation. It is time for Canada to re-look at this in the context of a globalizing economy where many countries do not have as restrictive labour laws as Canada.

- Canadian employment insurance laws have three distorting effects on competitiveness. First, the EI charges to companies and workers substantially lag the actuarial performance of the funds – with the effect that all businesses and workers bear an additional “tax”. Second, there are also distortions that arise because a number of industries have a very high intensity of use – effectively a permanent and continuing subsidy from other sectors. The greatest of these are fishing and forestry, but other net subsidy receivers include mining, processing, machining, transport, materials handling and (remarkably) teachers. The third distortion relates to labour mobility. The regional and industry subsidies inherent in the EI system also artificially restrict labour mobility in the country – reducing the efficiency of the labour markets.

Financial Market Sophistication

Generally speaking Canada has sound and modern financial markets. While these markets could be improved, I do not believe that there are major issues from a policy perspective apart from the state of the venture capital industry – which is substantially less developed than the industry in the U.S.

- A vibrant venture capital industry has been developed in the U.S. over the course of the last 50 years. Almost none of the essential elements of a vibrant venture capital market can be developed from government policy and it is in fact likely, given the Canadian experience in this regard, that policy intervention can be counter-productive. In the U.S. the essential ingredients include: large markets; a tradition of entrepreneurial effort; lots of rich people; universities with a distinct interest in commercialization; academics that want to make money; a very active IPO marketplace with a significant participation by individual stockholders; solid management training and education; large and progressive long term pension money managers; a relatively benign business policy environment; freedom; and, a tax structure which is somewhat supportive. For the most part these elements are either intractable (the large market problem) or need much more time to develop (increasing the number of rich people and the size of pension pools).
- With recent changes to the tax policy of (at least) the Federal government, it would appear that tax policy is not generally getting in the way of financial markets – with one exception that taxes on capital still remain.
- Lastly, while the increase in sophistication may be minor, I believe that financial market efficiency would be enhanced with further market integration with the U.S. such that regulatory overburden could be reduced and ownership and control restrictions around market players could be eliminated.

Technological Readiness

I believe that Canada is at a good state of technological readiness. Improvements could be achieved if (as already noted) there was further integration with U.S. telecommunications and other networks, specific technical requirements could be further harmonized with the U.S. market and the border opened up to foreign ownership and capital.

Market Size

It is extremely difficult for a small country to be competitive in a global environment unless it extends its markets. Even though NAFTA was a great step forward, there are still dramatic barriers with the U.S. and especially other parts of the world. With the WTO process stalled, Canada needs to do a much better job of bi-lateral or multi-lateral free trade arrangements – including putting pressure on the U.S. to join in and extend the NAFTA arrangements to other parts of the world.

In addition, it is important to allow for a much more complete harmonization (where possible) of standards and structures such that Canadian service providers and manufacturers do not have to tool for only the Canadian marketplace. This suggests a much closer relationship with the U.S. around environmental, securities, product standards, and other legislation.

Business Sophistication

Business sophistication is good in Canada. It could be improved by a much more global attitude on the part of companies and educators, coupled with a greater willingness for Canadians to explore the outside world from a business perspective.

Innovation

Almost all of the suggestions that have been made above will encourage further innovation. Governments should avoid being involved in the innovation process as much as possible and should try to stay out of the way of markets in this respect. Modest tax rates, elimination of taxes on capital, an open and sophisticated immigration stance, solid laws around intellectual property and open markets will eventually encourage a degree of innovation in the economy.

Most importantly, a very competitive marketplace encouraged but full and open markets for investment and ownership will force companies and individuals to be more innovative in order to compete.

CANADIAN OWNERSHIP AND CONTROL

A number of the specific questions raised by the Panel relate to the importance of Canadian ownership and control and to some degree the attendant questions around “head offices”.

My belief is that the creation of a vibrant and open competitive environment is the best way to ensure that top management talent is happy to locate in Canada. However, it must be understood that Canada is a very small market and thus outside of those companies where it is critical for top management to be very close to the end customer Canada is not a natural place to locate a head office. Even for those companies that have started with Canadian bases and have developed globally relevant businesses one would expect that sooner or later management might migrate to other countries. To the extent that the physical, cultural and economic environment can be made more conducive to a high quality of life for managements globally, there could be a reason to locate here – especially if there is a more complete degree of integration with larger markets that are easy to travel to. But aside from an aggressive and attractive tax policy (such as the U.K.’s *resident non-dom* regime) it is hard to see how management can be induced to locate in Canada when the customer base does not require it directly.

When one looks at the balance of advantages of head offices and attendant infrastructure requirements versus the potential competitive losses from some sort of mandate of Canadian control I think it is clear that efficiency should prevail.

In one respect I think that the policy framework could provide some benefit to the development of companies that might find it attractive to remain headquartered in Canada (no matter what their ownership). To the extent that a company has already grown large enough to be globally relevant, it will find it difficult to move itself somewhere else – except over a very long period of time. While this might not be the case for companies such as mines and oil companies – where the head office staffs are relatively small in relation to the revenues and footprint of the company, it may be the case for banks and insurance companies. While our large insurance companies are about at the point of being globally relevant, our banks are still too small to be so and will remain so until the ability to merge domestically is available to them. Only at double or more of the existing market capitalizations would one be confident that the Canadian banks would be of a size to have the *potential* for global relevance – and thus a large potential for head offices to remain in Canada. I would thus suggest that the Competition Act be applied rigorously to domestic mergers – but that no further restrictions be placed on the ability of any domestic firms to merge to a position of strength.

INVESTMENT CANADA ACT

Most of the companies and counsel that I have come across generally believe that the ICA is no significant impediment to attracting foreign direct investment in Canada. Given my views expressed above that an open market is the best market I would be reluctant to change this legislation in any significant way. The test itself is so vague as to be meaningless – but perhaps it serves some form of political purpose.

SECTORAL INVESTMENT REGIMES

Again, for all of the reasons set out above, there would appear to be little use for the sectoral investment restrictions on the six sectors identified. However, the movement from a fully controlled regime to one that is uncontrolled would have to be done in a phased basis.

For example, for financial services, broadcasting, transportation services and telecommunications I would suggest that an open ownership regime have a five to ten year phase-in period to allow for domestic consolidation to occur only subject to the provisions of the Competition Act. At the end of the phase-in period Canadian companies would either have developed to the point of global relevance or would be better owned by others.

The cultural sector is much more difficult and as much as I would like to have the efficiencies of an open marketplace it is very unlikely that foreign ownership would be interested in most of our “cultural” industries. For this sector I would suggest as well a five to ten year period where the degree of subsidization was reduced over time, so that by the end of the period the business would be fully competitive on a market basis. After decades of protectionism, it would not appear to me as if the industry can still stand alone and the course of adjustment to global realities should at least start now.

I have no comment on the uranium sector.

One other sector that is not mentioned in your consultation paper is the Health Sector. As noted above, the Canada Health Act is an egregious violation of citizen’s freedoms as well as supporting a bloated and inefficient health infrastructure. At a minimum the policy framework should introduce a degree of competition into this sector, including the kind of competition that could come from foreign health professionals (immigrants or not) and foreign healthcare providers. Both foreign and Canadian participants should be introduced into the system on a basis that would provide both choice and competition to the domestic environment.

CANADA'S COMPETITION ACT

For the most part, I believe that the Competition Act is an appropriate statute and has been used in an effective and efficient way – especially in the merger environment.

However, the Competition Act leaves large amounts of the domestic economy outside of its purview. For example, the markets for grain and other agricultural products are subject to various rules that would all be viewed under the Act to be anti-competitive. Governments sponsor a whole range of monopolies that are not supported by any form of Competition Act review. The panoply of provincial trade barriers (direct and hidden) could all be viewed to be anti-competitive under the Act. These are the policy challenges that the Panel should focus on, rather than the merger components that appear to work well.

CANADIAN DIRECT INVESTMENT ABROAD

I believe that Canada's role in this respect would be to ensure the most efficient and productive domestic sector that should produce companies of scale and resilience. In addition, Canada should strive to make sure that it has reciprocal understandings with as many countries as feasible (to the extent that the WTO does not guarantee reciprocity under the new round) that would provide a reciprocal freedom of investment.

I do not believe that taxpayer funds should in any way be involved in supporting direct foreign investment by Canadian companies.

Most of the barriers that Canadian companies face in foreign investment relate to the relatively small scale of most Canadian companies in a global context as well as limited experience and capability to understand global issues. To the extent that the policy framework has allowed Canadian companies to grow (through merger or otherwise) to effective scale, they should be in a position to make effective investments. The current elevated level of the Canadian dollar will have a strong natural tendency for Canadian companies to invest outside of Canada in order to reduce costs of production that are now less economic in Canada.

CONCLUSION

The consultation paper has asked for responses over a very wide range of issues that have many complex facets. I have been able to touch only the tops of a minority of the issues that have or should have been raised.

I am concerned that the tone of the consultation paper would seem to invite a substantial degree of additional government “policy” rather than an approach that would have the government try to get out of the way and reduce the barriers that have accumulated over the decades to a competitive and efficient set of markets in Canada. It is likely that the Panel will receive more submissions by volume by “rent seekers” and thus will have to take care to ensure that such “rent seeking” efforts are not at the expense of Canadians generally.

I think in discussions such as this it is quite easy to wrap oneself in a nationalist flag and therefore take the discussion from a level of what is good for Canadians to what is good for Canada. This is a slippery slope, especially when one thinks that queuing up for medical services is now a source of national pride – at least to some. The world is moving inexorably and clumsily from a series of city states to nations to a world of individuals. Connectivity and the death of distance will shortly have Canadians selecting the communities in which they wish to relate not because of their physical location, but because of their affinities. It should be the goal of national and provincial governments to ensure not that the world becomes more fragmented but that it continues to become more “flat”.

The relationship between freedom and economic progress has been fully documented over decades. Good economic results, efficiency and effectiveness of economies must rest on a base of free action by individuals and companies. Necessary and community agreed restrictions on freedom can and do have a place in ensuring that legal frameworks support the potential of individuals to strive and succeed without coercion. However, restraints on freedom to act – whether it is the silliness of making the purchase of healthcare illegal in Canada, or forcing consumers to subsidize dairy farmers or requiring ownership of fiber cable by groups that have some “Canadian” quality to them – all these restrictions on freedom have costs and these costs are borne only by people. These restrictive practices are sometimes thought of as curbs on corporate activity – but in the end, it is all of us who pay for them. It is sometimes quite sad to see the degree to which Canadian corporations wrap themselves in the flag in order to extort amounts from Canadian consumers and taxpayers.

I want to take this opportunity to thank the panel members for taking this on. You are all busy people with day jobs. I would hope that the policy setters will pay close attention to your conclusions.

A handwritten signature in black ink, consisting of a stylized, cursive 'R' followed by a horizontal line.