On productivity, the 'invisible hand' lacks visible success

By Jim Stanford
September 6, 2012 – *The Globe and Mail*

When it comes to Canada's lousy record in productivity and innovation, the standard prescription of economists is both clear and predictable. They believe unregulated markets are the best way to allocate resources and determine the composition of output. Therefore, to improve efficiency and innovation, simply improve markets: Eliminate "distorting" taxes. Eliminate regulations. Sign more free-trade agreements. Cut "red tape." That will unleash the full potential of the private sector to innovate and optimize, and Canada will become a northern tiger.

Canadian economic and social policy has been generally following this advice for a quarter-century. Taxes are lower, globalization is embraced, labour markets are unforgiving, business is freer (and more profitable) than any time in our history. Ironically, however, the more vigorously we pursue the holy grail of self-adjusting markets, the worse our productivity and innovation has been.

Over the last decade, Canada ranked 30th out of the 34 countries in the Organization for Economic Co-operation and Development in annual labour productivity growth. Relative to our neighbour and biggest trading partner, our record has been even worse. Since 1984 (when the Macdonald Commission recommended comprehensive free trade with the U.S., precisely to boost our productivity to their levels), productivity in Canada has faded from 90 per cent of U.S. levels to 70 per cent. The promise of free trade, tax cuts, and deregulation to spur productivity (and deliver trickle-down benefits to the rest of us) has been utterly broken.

This seeming contradiction between Canada's business-friendly policy environment and the failure of the resulting empowered private sector to deliver innovation and productivity growth puzzles economists who advocate market-driven approaches. They search for some remaining imperfections or residual market impediments to explain the failure of Canadian productivity and innovation to take off.

But what if the starting assumption of their model – namely, that unconstrained private market forces always produce the most efficient, innovative economy – is not justified? What if, in fact, markets work more productively and creatively when they are guided, supported, and constrained, rather than simply being unleashed? What if the best approach is to challenge and direct markets to more productive and innovative outcomes?

International experience reinforces my skepticism of market-driven policy. The successful state-led industrialization experience of several Asian and Latin American economies in recent decades, where policy was proactive and interventionist, suggests that innovative, productivity-enhancing growth does not occur spontaneously as a result of market forces. Instead, the "visible hand" of government intervention, manifested in a wide range of forms, is more strongly associated with qualitative and quantitative economic progress. Targeted subsidies, strategic trade interventions, active industrial strategies in high-tech industries, domestic procurement strategies, and even public ownership of key firms have all been more effective in promoting innovation and export success than Canada's hands-off approach.

Canada's poor performance, from this viewpoint, is a consequence of our liberalization – not a paradox. Of course, large government by itself is no more a guarantee of productivity success than small government: Interventions must be smart, efficient and disciplined. But experience shows clearly that market forces on their own cannot be relied on to guide the economy to its innovative, efficient potential.

To meaningfully address and reverse the continuing failure of Canadian innovation and productivity, therefore, we need to adopt a more open-minded approach to economic policy. We must set aside our knee-jerk assumption that private-market forces produce optimal, innovative outcomes. Instead, we should view effective public interventions and leadership as a key asset in nurturing investment and growth in the most desirable industries of the future.

This approach has been derided as "picking winners" by a generation of market-worshipping economists, who believe that only the private sector can pick winners. (In fact, the private sector cannot pick winners … as any mutual fund investor can attest!) But we cannot continue to wait for the forces of unregulated private competition to develop Canada's economy in a sustainable, diversified manner. If we want to maximize Canadians' potential for innovation and productivity, we will have to collectively step into the fray and make it happen.