Trade and Regulatory Policies in the New Relity: Changing the Mix?

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This paper has three major parts. First, we review the old reality—i.e., the state from which Canadian agriculture has been transiting. Second, we describe the new reality we believe is being faced by our agri-food sector. Third, we address the possibilities that exist for changing the mix of trade and regulatory policies.

Two statements of bias about our approach are required at the outset. First, our emphasis in this paper is on Canadian trade and regulatory policy. We are not going to start out by saying we believe things are roughly similar for you as for us. They are not. Canada comes from a very different policy tradition than does the United States. There is an abiding Canadian belief, with both positive and negative consequences, in a more collective approach to marketing commodities. This is particularly true in Quebec and the Prairie Provinces, where cooperatives are alive and reasonably well.[1] Canada is also the small country in the traditional trade model, while United States is the large country. It is illuminating (and somewhat mind stretching) to think from the perspective of one when you have been raised in the other. The policy prescriptions are different—and they explain the path Canada has taken. We have a set of climatic conditions that are quite different than yours and that give us both advantages and disadvantages. We are a nation of 28 million people spread over a band 4,000 km long and about 100 km wide. This makes for interesting issues regarding transportation and distribution of both raw and finished goods. Finally, unlike us, you are not subjected to the harassment of U.S. trade policy.

So, where we think there is similarity, we will try to indicate it. Where we do not, we will try to indicate it. Where we do not know, we will leave it for you to decide!

Our second bias refers to our framework for analysis. Randy Westgren, in three George Morris Centre papers (Westgren, 1994a and 1994b, and Westgren and Martin, 1995), has attempted to lay out the emerging model of the resource-based model of firm strategy, and some of its implications. In our view, this model builds on both neoclassical economics and earlier models of strategic management in ways that provide useful, descriptive, *strategy-building* concepts for managers and, to a degree, an analytic tool for examining the operations of a firm in the new reality. Without replicating what has already been written, it is enough here to say that this model rests on three interrelated components. The first is that the source of competitive advantage for a firm lies in its uniqueness. The second is that uniqueness is most likely to be built on the basis of a firm's resources, not its products. Third, for a firm to enjoy sustained competitive advantage requires that its unique resources be inimitable by its rivals—i.e., that rivals find it at least very difficult to imitate the resources that are the basis for competitive advantage. Resources are categorized as: human, physical, financial and organizational. This bias will become quite apparent in the paper.

Dinosaurs Awaiting Extinction

Trade and regulatory policies before the Canada/U.S. Trade Agreement are dinosaurs awaiting extinction. The policy reality in Canada before 1989 can, with a number of important exceptions, be characterized as one of public leadership and private followership. Careful examination of almost all of the major policy decisions reveals a strong politician and/or a strong bureaucracy leading a fairly narrow set of private interests to get the decisions made. Seldom (never?) in the old reality did an industry (in its complete vertical structure) or the sector take the lead in developing the policy directions that affected it. Not surprisingly, this resulted in an unconscious, but pervasive, attitude of paternalistic protection in the public sector. A set of pseudo-monopolies was spawned by public policies that protected organizations and individuals from competition, from the marketplace, from the natural environment, and from the need to respond to changes in prices.

This policy environment was manifested through legislation and the resulting series of programs that were aimed at protecting producers and encouraging them to be homogeneous—i.e., to produce commodities. These include the Agricultural Products Cooperative Marketing Act, the National Farm Products Marketing Act, the Canadian Wheat Board Act, the Agricultural Stabilization Act, the Western Grain Stabilization Act, and Feed Freight Assistance. The public also used relatively high tariffs and non-tariff barriers in a number of commodities and technical regulations for a broad range of matters such as variety licensing, pesticide approval, and biotechnological product approval that are based on requirements for both safety and efficacy.

This led to at least three consequences in terms of the way farms and others in the marketing chain did business. First, almost no businesses had strategic visions of what they wanted to be in the future. Rather, most simply walked through a relatively unchanging market environment resting in the arms of a protective nation. There was no reason to have a strategic vision for the future when most firms expected to be just the same in the future as they were in the present. Second, outside the area of food safety, consumers were regarded in this policy environment as being relatively unimportant. It was acceptable to charge them pseudo-monopoly prices in some cases and to restrict their choices. Moreover, suppliers and customers were completely isolated. There was no room in the policy environment to encourage improved supply chain management in the agricultural industries. In general, customers and suppliers regarded each other with mistrust and, *at best*, government policy did nothing to change this attitude.

Another characteristic of the old reality, and one that is breaking down the slowest, is that human resources were generally regarded as a cost to be minimized, not as the basis for sustained competitive advantage. This is evident in a philosophy that generally espouses adopting technology to replace labor, and includes the way they are accounted for. Human resources are among the few that can appreciate over time. Yet they are accounted for in exactly the same way as is fertilizer.

In general, the comfort zone was fairly wide for most businesses that existed before 1989. Therefore, there was little incentive for continuous improvement.

At the George Morris Centre, we espouse five principles for successful organizations: 1) they should have a vision of the future they choose to create; 2) they listen to their customers and respond to what they hear; 3) they see their source of competitive advantage in creating a culture that allows people to achieve personal excellence; 4) they participate in excellent supply chain management that is based on interdependence; 5) they seek to improve all processes continuously. All five of those principles were violated in the old reality.

The New Reality

Paleobiologists theorize that the real dinosaurs became extinct because a meteor shower changed the environment and the dinosaurs could not evolve. Canadian agricultural, trade and regulatory policy has been showered by meteors in the same way. In the new reality, there are at least four major factors that dictate a change in policy. All of them imply less government intervention and more competition. The increased competition should contribute to accelerating the new reality into being.

The Age of the Consumer

Consumers have access to more information today and have more sophisticated and varying tastes than ever before. It appears that about 50 million people currently have access to the Internet. This is expected to reach at least 100 million by the millennium. This and changes in lifestyle, changes in the nature of work, changes in demography, changes in ethnic makeup and a host of other socio-economic factors have changed, are changing and will change the nature of the marketplace. Consumers, even Canadian consumers, are increasingly less likely to accept being exploited by narrow vested interests through public policy. This is quite evident in the fact that Canadian consumers were able to bring tobacco taxes down by 50 percent in 1994 through their black market actions.[2] Similarly, they have put considerable pressure on any number of public and private institutions in the food sector through: 1) cross-border shopping, and the perceptions of food processors about the way consumers feel about paying higher prices for food products in Canada. The front page headline in the the January 9, 1996, *Globe & Mail* said a high proportion of Canadian Generation Xer's believe it is perfectly appropriate to cheat on tax payments to a country that offers fewer opportunities to them than it did to their parents.

In addition to all of the above, it is very clear that consumers in both Canada and the United States are becoming pickier and fussier about the characteristics of the products they buy—and these characteristics increase each year. We have even begun to dust off our old copies of Kelvin Lancaster's work from the 1970s on consumer demand because its time has come.

There are several bottom lines about this aspect of the new reality. First, consumers are creating a plethora of market segments that need to be understood if food companies are to be successful. One of the fundamental aspects of this change is that an individual consumer may be part of different segments at different times: I like to display my culinary prowess on Saturday night when I entertain, but I want something quick, good and nutritious on Thursday night after work. Second, the new reality will continue to change the nature of the way we shop. Many believe, and we are among them, that pushing carts around grocery stores for a few hours each week is a dispensable part of a modern lifestyle. Rather, pressing some buttons to place orders and have money transferred from my account and picking up the completed order on the way home, makes a lot more sense, especially if the order can be placed from my car phone or my personal communication device. In this emerging part of the new reality, if you want me to buy your product, you will need to do something exquisite to get my attention and to make sure that you keep it. Also, if you are not using ECR (Efficient Consumer Response) in your grocery store, then you are not going to be very successful marketing to me on the Internet.

The most important bottom line is that with the emerging quality conscious (or characteristic conscious) consumer, if you do not supply the required quality, then they will get it somewhere else.

Disappearing Borders

And it is increasingly easy to get it somewhere else because of regional, hemispheric and global trade pacts—and because of the emerging dichotomous structure of the food industry. The reduction in trade restrictions that have occurred since the beginning of 1989 is astounding. Most tariffs and a number of non-tariff barriers have disappeared within North America. The breakthrough that has eluded the world through seven rounds of General Agreement on Tariffs and Trade (GATT) negotiations finally occurred. In the most recent round, agriculture is now part of the general set of rules that apply to the remainder of the economy. While the new World Trade Organization (WTO) rules do not bring down tariff barriers as much as many observers would have liked, they do get the process started, remove many non-tariff barriers, and develop a new robust dispute settlement mechanism. If the Asian Pacific Economic Community (APEC) agreement continues to move as quickly as it has over the past two years, then even more remarkable changes will take place in trading opportunities within the next several years.

There are several implications of the emerging trade reality:

1. As already indicated, there will be increased competition for a given market from new suppliers.

2. There are far more opportunities in marketing than existed even three years ago.

3. Increased access to international markets mean the breadth of quality characteristics required will widen, therefore, there will be increasing opportunities to differentiate.

4. Even the smallest countries now have relatively more power in international trade. A number of past events indicate it is increasingly difficult for individual countries to impose their will on others. Japan's refusal to knuckle under to U.S. demands for specific trade targets, especially in automobiles, is one. A second is the announcement by Canada a few weeks ago that, if the United States does not want to keep its commitment to allow Chile into the North American Free Trade Agreement, then Canada would negotiate an independent free trade agreement with Chile. More generally, the new dispute settlement regulations mean

that the smallest country has essentially the same consideration in the dispute settlement as the largest.

Hopefully this means companies from smaller countries can enter into international trade in good faith without having to worry about the type of retaliation that could wipe them out.

Increasing Competition

One of the most interesting paradoxes of our time is that some big companies are getting bigger while small companies are proliferating. There are many aspects of this, not least of which is that 40 percent of the Fortune 500 companies listed in 1980 are no longer in existence or no longer in existence in the same form. But it also means that, as many companies focusing on a low-cost strategy successfully turn their products into commodities, they leave many niches that can give life to new smaller companies.

One of the major reasons Canada has moved from being a billion dollar per year net importer of agricultural and food products from the United States in 1989 to being a billion dollar net exporter in 1994 is that a number of niche companies have emerged to produce value-added products in markets in which large, low-cost American food processors cannot operate efficiently.

The list (even the part we know, not to mention a larger part that we do not know) is long and impressive. In some categories, these so-called niche players are becoming the dominant firms.

Fiscal Realities Facing Governments

Canada's federal government has a debt of about $600 billion. Ontario and Quebec alone among the provinces have nearly another $200 billion or so. In total, federal and provincial debt exceeds 85 percent of GNP. Public debt servicing, therefore, represents a little more than 5 percent of GNP and more than 20 percent of tax revenues. Its shares are growing through the simple arithmetic of compounding. It has finally become apparent to voters and, therefore, to those they elect, that this cannot continue.

Government is, by necessity, becoming less of a factor in almost everything. Government is getting out of the "safety net" business, it is getting out of much of its former regulatory business, it is almost out of the market analysis business, it is moving rapidly out of the extension business, and the list goes on.

It is not possible for government to continue to provide the "leadership" function it provided during the 1960s through the 1980s. Slowly and surely farmers and their partners in the food marketing chain are turning their rent-seeking behaviors from the ever less lucrative public treasury to the ever more lucrative opportunities available in the marketplace described above.

Changing the Policy Mix

The foregoing says the marketplace has become more complex, offers more opportunities and promises more and more ferocious competition than it did five years ago. The fiscal and consumer reality is that governments have neither the wherewithal nor the clout with consumers or taxpayers to protect commercial interest groups or provide them opportunities for exploitation.

So what is required of public policy in the reality we have described above? First, it requires that public policy be clear about its goals and priorities. As with private interests, governments need to discover their visions of the future. Obviously this needs to be done somehow in conjunction with their citizens. But it is clear, at least for us in Canada, that we need to define a new social contract that is consistent with the new reality in general, some of which is similar to the reality for the agri-food sector, but much of which is different. Fundamentally, we need to rediscover the appropriate role of government.

With clear recognition that the authors have no more insight nor right to define this role than anyone else, a starting point for the agri-food sector might be the following four self-evident objectives for public policy:

- To foster the successful economic evolution of the sector.
- To protect consumers against fraud.
- To ensure a safe food supply.
- To enhance the natural environment.

The first objective needs to be modified to add the phrase, "in the new market reality." How does one define the role of government policy to accomplish this objective? This is where the resource-based model begins to be useful. To slightly paraphrase Westgren and Martin (1995), the resource-based model of firm strategy posits that the source of a firm's competitive advantage is a strategy based on unique or idiosyncratic resources within the firm. These resources are characterized as being valuable, rare and not easily substitutable. For a firm to enjoy *sustained* competitive advantage, they must also be inimitable, or subject to constant innovation.

Those resources that are easiest to imitate are, in general, technology, capital, financial and some aspects of human resources. The most difficult resources to imitate flow from unique organizational capital, either within the firm or between the firm and its partners or allies. These organizational resources are usually difficult to describe because they depend upon the historical path that was taken within the firm to develop them; or they are socially complex, relying on interpersonal relationships such as trust; or their causal effect on competitive advantage is ambiguous—either to those within the firm or, certainly, to those outside.

In short, the source of sustained success in the emerging reality is development of resources within a firm that make it unique and inimitable in its ability to operate in the marketplace. If this is correct, then it follows that the sustainably successful firm or related group of firms is the one that evolves its resource structure to a new internal level that can successfully respond to the new, higher and more complex set of external forces facing it. In this regard, the business organization is seen as an open, organic (as opposed to a closed, inorganic) system similar in nature to the natural systems described by the theoretical chemist Ilya Prigogine in his work based on chaos theory.

What then is the role of public policy in fostering this evolution? As might be expected, our list is short on direct, proactive actions and long on indirect actions that remove barriers. We submit that the following are candidates:

1. Further expand trade agreements.

According to George Morris Centre members, by far the most important role of government in trade policy is to negotiate additional trade agreements and increase access under existing ones so that additional market opportunities can be sought. We were a little surprised at this outcome, but on second thought it seems eminently reasonable. Once the transition has begun, it makes sense to go all the way to the final state. Presumably Prigogine's formula would predict that the greater the amount of external stress on the system, the greater the transformation of the system.

2. Reduce "safety net" subsidies, encourage wider use of private market means of risk management.

Canada has moved substantially to reduce the amount of farm subsidies. This is a logical outcome from the perspective of several aspects of the new reality. WTO regulations and the fiscal situation will drive us to a new form of "whole farm income" insurance program that will be based on all sources of farm income, will have a low slung safety net and will be supplemented by private market instruments for risk management. There is an unprecedented interest in futures, options and other derivatives in Canada—and the role of government in providing and adapting them is limited—at best.

3. Remove many of the restrictive marketing regulations, *but*:

A. Retain the ability to act collectively when there are opportunities to do so.

B. Retain the opportunity for boards to be "agents" for those who want them.

C. Encourage replacement of quotas with contracts during transition.

Many of the regulations that stifle innovation in the market system need to be relaxed. Our supply management marketing boards are most often cited as examples of regulatory bodies that invoke restrictive regulations around which economic rents accrue. But this is the obvious. In many commodities, price pooling is practiced—i.e., all the product is pooled over some period of time, sometimes physically, and always with farmers getting the average price during that time. Great way to encourage farmers *and their customers* to respond to differentiated demand opportunities!

In some cases there is also transportation pooling—i.e., pooling transportation costs so that those farthest from the transaction point receive the same price as those nearest. Even with the removal of the Western Grain Transportation subsidy, hopper cars are allocated administratively, not by the market, making it difficult to pursue or develop especially profitable opportunities.

The list goes on and on. These few examples illustrate that the policy environment is completely at odds with the new reality. A market situation that cries out for farms and firms to differentiate themselves is thwarted by a policy environment that treats them, and expects them to be, the same. This regulatory environment is often maintained on equity grounds—i.e., it is not fair to treat people differently. We have suggested that in the new reality we can only afford a new definition of equity—everyone should have the same opportunity to be different.

Producers of almost every commodity are pushing hard for relaxation of regulations that were meant to protect them and that now restrict them. There is much movement toward something called dual marketing—a marketing board for those who want it, feel that it performs well, or feel that there are places in the market in which one can benefit from collective action, but can still market products in an individual manner when to do so is perceived to be the most beneficial. This will come. The only questions are, how long will it take and how will the systems be structured for the various commodities?

At a different level, it is evident to many producers in the supply management system that the ability to manage supplies and prices will eventually be lost. Hence there is a need to address the transitional questions: what kinds of price discovery mechanisms, delivery systems, and supply chain management systems will replace them? How should primary producers manage their valuable quota assets to extract the greatest amount of wealth and profit? What role is there for the public to compensate producers for their loss of wealth?

In this regard, there will undoubtedly be a role for enforceable contracts for both the transition, but also in developing differentiated products with appropriate values. It is in this area that the markets for supply-managed and non-supply-managed commodities have a commonality.

Public markets and traditional price discovery mechanisms are breaking down all around us—in both Canada and the United States. What will replace them and how it will be enforced and policed are issues that urgently require debate and investigation.

4. Reinvent the system of technical regulations affecting product approval to remove efficacy as a standard.

Nothing in our system is more stifling to the evolution of uniqueness, and nothing is more patronizing, than a regulatory environment that allows civil servants and/or politicians to hold up the registration of a new product on the grounds that she/he needs more proof that a product is efficacious. NatureMark's NewLeaf® potato, a transgenic potato that is resistant to the Colorado potato beetle lost a year in Canada because it was not approved for production early enough for 1995 planting, even though it was approved for consumption much earlier. This threatened the Alberta seed potato industry whose major customers in Idaho wanted a product Alberta could not legally produce.

This list is also long. Efficacy testing as part of a product registration policy simply says customers are so stupid that they would buy a product that does not work, and suppliers are so stupid that they would risk their image and brand name by selling products that do not work. Civil servants are therefore much better qualified to make these decisions for people than they are themselves. And, of course, it implies that criminal and civil courts are less able to settle disputes after the fact than are civil servants before the fact.

The sarcasm that drips from the previous paragraph should be enough to indicate that we reject this notion and feel strongly that the marketplace is where efficacy should be determined. If it was able to do so, then we might see considerably more uniqueness among both suppliers and customers of the seed, pesticides, food and feed ingredients and bio-tech products than now occurs in Canada.

5. Provide good basic education, clearly defined standards for food safety, fraud and environmental protection.

Beyond the specific issues addressed above, there are few concrete actions by government that cannot be categorized as simply "good government." This includes an improving educational system, and increased emphasis on legal structures that deal with fraud and the criminal aspects of predatory market behaviour.

One specific area of technical regulation continues to stand out as being in need of reform. It is the area of food and environmental safety. Few members of the industry seem to doubt that these regulations are needed, and many understand that providing safe and environmentally "sustainable" products is simply part of responding to customers. We do hear two issues about this area of regulation. First, it is widely perceived that regulations are often not sufficiently transparent to indicate what *can* be done. Rather, they are used by regulators to indicate what cannot be done—often after the fact. Second, regulations are not harmonized across the country. The implications on cost of both are readily apparent. So is the general solution.

Conclusion

We were asked to write about how the mix of policies will change in the future as they relate to trade and regulations. As is probably apparent from the foregoing, we have no idea where to draw the line between "trade," "regulatory," and farm income (or other types of) policy. The new WTO agreement declares rather clearly that farm income and technical regulations are trade policies. Logic says that both trade and regulatory policies are part of incomes policy. We are simply not smart enough to know when to draw the line.

We do, however, suggest that the foregoing discussion leads to the following conclusions about some aspects of mix:

1. There will be more private leadership and more public leadership in policy formulation. Governments will increasingly get out of the way and provide opportunities for industries, especially vertical industries, to lead in developing appropriate policies. Even in the areas of food and environmental safety, industry will enhance both the standards and their policing through good manufacturing practices (GMP's), hazard analysis critical control position (HCCP) or International Standardization rganization (ISO) procedures.

2. Regulatory policy will move away from reliance on administrative and, perhaps. statutory law, and will rely increasingly on contract law—therefore, more civil and fewer criminal or administrative actions.

3. There will be less public input in general, but more of it will be in developing, expanding and enforcing trade agreements, and in providing the best possible environment at home to encourage farms and firms to take advantage of the trade opportunities.

NOTES

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1. Even here the landscape is changing as evidenced by the decisions of United Grain Growers (UGG) and, most recently, the Saskatchewan Wheat Pool to partially restructure with a corporate shape in order to have access to the equity markets.

2. The rumored retrenchment of that tax in the next federal budget will face the same actions with the same result.

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