AU COURANT

Economic Council of Canada
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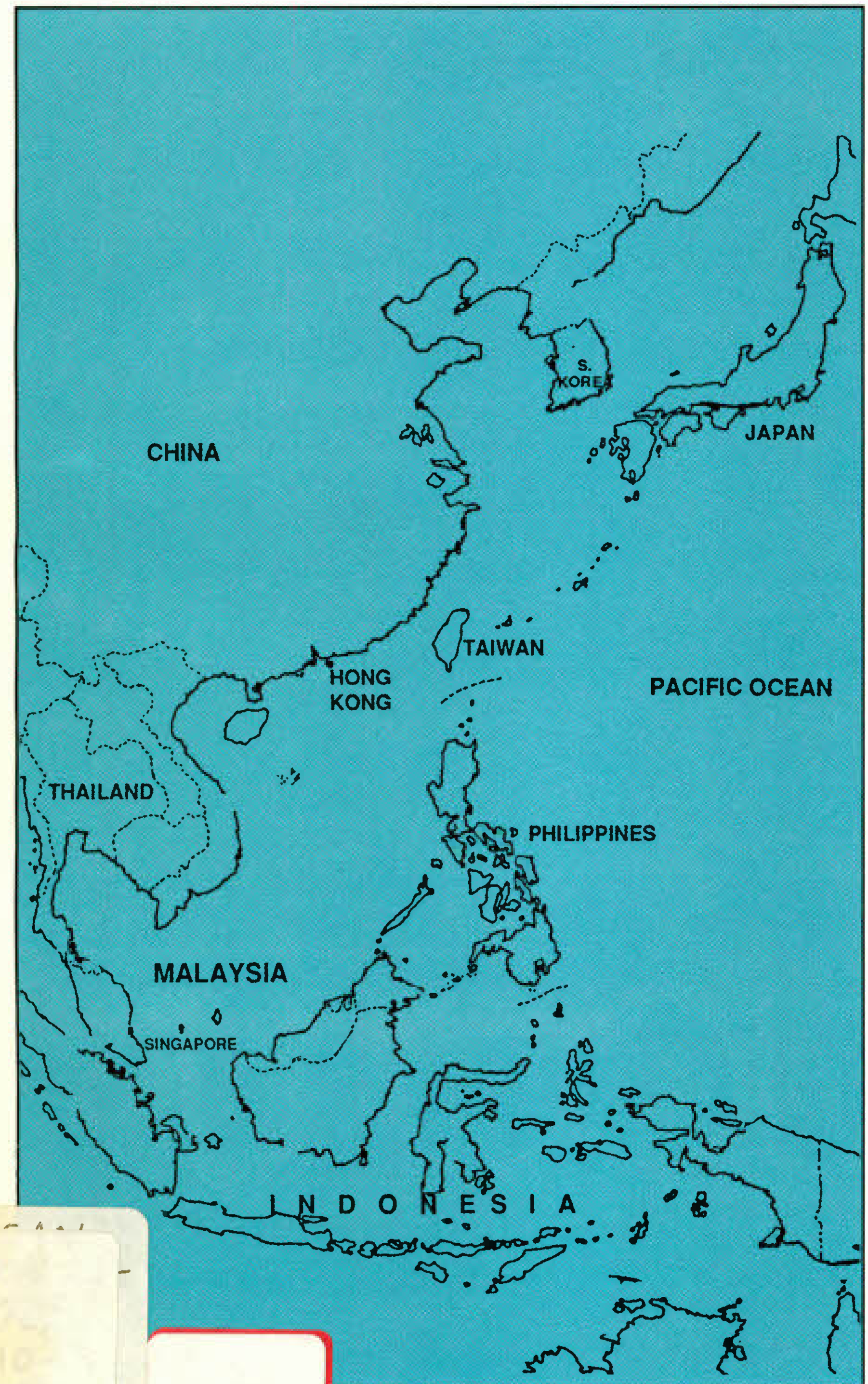
The Pacific Rim: A challenge



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Volume 10, No. 3, 1990

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Judith Maxwell

The New Challenges of the Nineties

Here come the 1990s. The last 10 years of a millennium that spans the decline of Charlemagne's Empire and the end of Stalinism in Europe. The novelist John le Carré has observed that in 1989, the "improbable is happening every day; and the impossible every week." We all pray that the new political structures will help the people of Eastern Europe to pull themselves out of the economic stagnation and the hopelessness of recent decades.

We can be sure that these events will alter the configuration of the world economy in profound ways. It is too early to predict whether they will lend new momentum to the growth in world trade or whether the world will now divide into regional trading blocs that are focused inwards. In either case, it will be important to press ahead with multilateral trade negotiations; above all, we will need to set mutually agreed rules for trade and investment in the 1990s.

Here, at the Economic Council of Canada, we are vitally aware of the degree to which domestic policy decisions are shaped by international forces. Nearly every project we launch has an international dimension, and we are gradually developing new analytical tools to extend our knowledge of international commerce and its impact on Canada. Some of the preliminary results of our project on Competitiveness and Trade Performance are on page 7.

We believe it is essential that Canadians learn more about the success of the Pacific Rim countries, to understand how business is reorganizing production on a global basis and to explore the ways in which newly industrialized countries are using technology to enhance their competitive advantage.

One key aspect of Canada's comparative advantage is the design of the tax system. The proposed Goods and Services Tax is part of a strategy to modernize the tax system in order to gear up for competition in the 1990s. By eliminating the tax on business inputs, the GST will tax exports and imports in a more even-handed way. And, as a result, the Council's assessment of the GST shows a dramatic increase in exports over the next 10 years. However, our assessment of the tax as proposed in August indicated that a 9-per-cent rate also risked destabilizing prices and costs in the short to medium run. Hence, the argument in favour of a lower rate, which is laid out on page 4.

While it is essential to think globally in the 1990s, we must also focus some of our energy on local issues. In particular, how can the disadvantaged regions of the country cope with the centralizing forces of global production and trade patterns? The Council is now in the process of collecting the experience of local development initiatives across the country in order to get a better handle on how communities can promote economic development in an increasingly competitive environment. The Council project is described in Dialogue on page 14. The report of a seminar given by Douglas House, the new chairman of the Newfoundland's Economic Recovery Commission, provides new insights into the way outport communities weave their lifestyle around the land, the sea, and the unemployment insurance system. We think it is important to probe these local stories in the search for clues that will enhance local development even as we adapt to global forces.

These global forces were exhilarating in the last days of the 1980s. The 1990s will certainly bring us all new challenges.

The Council's view on GST

A lower rate and a broader base

One government proposal dominated public debate during the fall of 1989 – the Goods and Services Tax or GST. Put forth by the Minister of Finance in August 1989 and scheduled to take effect on 1 January 1991, this tax would replace the current federal Manufacturers' Sales Tax (MST) and the current Tax on Telecommunications Services (TTS). The debate aroused strong feelings from all sides, as evidenced by the numerous (and sometimes sharply critical) briefs presented to the House of Commons Finance Committee.

The most frequently cited objection to the August proposal was the 9-per-cent rate. Time and time again, those who appeared before the Finance Committee in the fall of 1989 suggested that the 9-per-cent rate should be reduced to 7 per cent or less.

Responding to this, the government acknowledged in December 1989 that prudence called for a lower rate. In a mid-December statement, the Minister of Finance indicated "The GST rate will, therefore, be reduced to 7 per cent."

This issue of *Au Courant* spotlights the GST and the Council's analysis of it. The Council's work was reported in two submissions to the Finance Committee (dated 27 September and 26 October 1989), and in a technical paper prepared by Ross Preston, senior research director, and Haider Saiyed, senior economist.

Early on during the debate, the Economic Council made it clear that its preference was for both a lower rate and a broader base. While agreeing that the GST would help make the tax system more efficient, the Council believed that a rate of 9 per cent was too high. The Council also believed that the GST should be accompanied by a well-designed system of tax credits to help undo the regressive nature of a flat-rate consumption tax.

Some aspects of the debate regarding the proposed GST tended to ignore or overlook the reasons behind the government's decision to replace the MST, a tax that has been on the books since 1924. In fact, the debate often lost sight of the basic purpose of this important initiative – i.e., the retooling of an out-of-date federal indirect tax system.

While the tax experts are likely to be familiar with the pros and cons of the GST, Canadians who have for years paid the MST on everything from automobiles to toothpaste found it difficult to buy the retooling argument. In many instances, individual Canadians preferred to participate in the debate by dwelling on specific or personal aspects of the tax. In the extreme, this new tax was acceptable as long as one was exempt from its effects.

The proposal to revamp the MST is an important component of the government's overall fiscal reform package. Combined with reform of the individual and corporate income tax systems (Phase I of tax reform), which included the replacement of deductions with credits on the tax form for individuals, sales tax reform (Phase II of tax reform) is aimed at producing stronger economic growth and a fairer tax system in Canada.

Disadvantages of the GST

Most specialists, including those in the Department of Finance, agree that the MST has major disadvantages. For one thing, its base is far too narrow. Many industries are exempt from the current tax, which means that a wide range of manufactured goods are treated in a blatantly discriminatory manner. In fact, no less than 22,000 special provisions and administrative procedures exist for a tax system that applies to only 75,000 businesses. Increasingly, many tax specialists had visions of a haemorrhaging tax base, that no longer could be relied upon as a revenue source at a time when deficits loomed large.

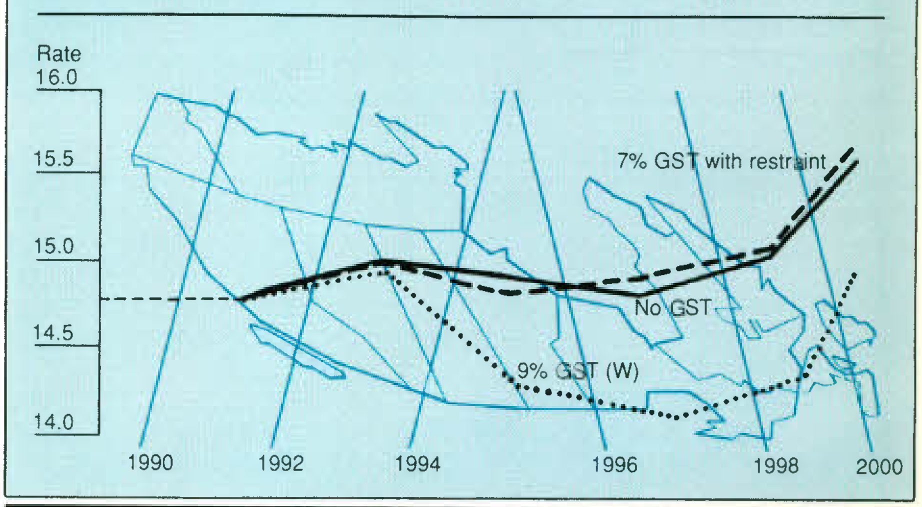
In addition, the MST hurts exports, helps imports, and taxes capital inputs. Taxing the income from capital is appropriate, but taxing the value of capital rather than its return is not appropriate in the eyes of most experts on taxation.

In its 1987 Statement entitled *Road Map for Tax Reform*, the Council drew attention to the economic distortions caused by the variations in the sales tax rates applied to different commodities. It noted that applying different rates to various manufactured goods amounted to a discriminatory practice.

The Statement also noted that the MST acts more like a selective excise tax, with over 60 per cent of its yield drawn from only six commodities. Varying MST rates lead to distortions in investment and savings decisions, which in turn inevitably reduce economic efficiency.

Another major drawback of the MST is that the consumer is generally unaware that he/she is paying the tax. As Judith Maxwell, Chairman of the Council, pointed out to the House of Commons Finance Committee, this complicates the job of winning public acceptance for the GST. Canadians already unknowingly pay about $16 billion in federal sales

Personal Income Tax as a Percentage of Personal Income



taxes every year. One of the objectives of fiscal reform is to make taxation visible. Given the invisible nature of the MST (since 1924), it is not surprising that the idea of a value-added tax such as the GST is not at all popular.

Yet it was not the visibility of the GST itself that raised the strongest objections before the Standing Committee; it was the height of the rate itself and the fact that this new tax would be levied on twice as many goods and services as the old MST. In particular, it would tax many services for the first time.

The GST and its objectives

In tabling its proposed multi-staged value-added tax, the government laid out three objectives:

- revenues from the GST would be much more reliable than the revenue generated under the MST and thus help the government to maintain funding of the programs and services to which Canadians have grown accustomed;
- the GST would be a cornerstone of the government's program to enhance Canadian competitiveness in the new global economy;
- the GST because of the system of income tax credits would make the tax system fairer.

The principle of a value-added tax that effectively exempts business inputs is not new. Multi-stage tax collection is common today having been implemented in 48 countries throughout the world. To date, 19 of the world's 24 industrialized countries have implemented a tax system of this kind in one form or another.

The proposal submitted by the Minister of Finance in August 1989 envisaged broadening the tax base to include a larger number of goods and services, while still exempting some consumer products (for example, food, prescription drugs, and health-care services). The government also promised a major redistribution program involving both spending and revenue transfers to Canadians of some $5.4 billion, plus another $1.5 billion in rebates for housing and small business. Thus the GST at 9 per cent would generate $24 billion (in 1991 dollars), of which $18.5 billion would replace the MST.

To assist those most likely to be adversely affected by the GST – low-income workers and those on fixed incomes – the government proposed compensation in the form of refundable tax credits. In short, the new GST system relied on the credit system introduced in Phase I of tax reform to ensure the fairness of Phase II of tax reform. In this sense, Phases I and II would work together to improve efficiency, lower rates of taxation in selected areas, and ensure fairness in areas where rates of taxation are to increase.

It was the judgment of the Council that the cost of the program of exemptions and redistribution was high. Among the consequences, the exemptions made the GST much more complicated and the combined exemptions and the redistribution program led to a higher rate for the GST than most taxpayers had anticipated.

The effect on the economy

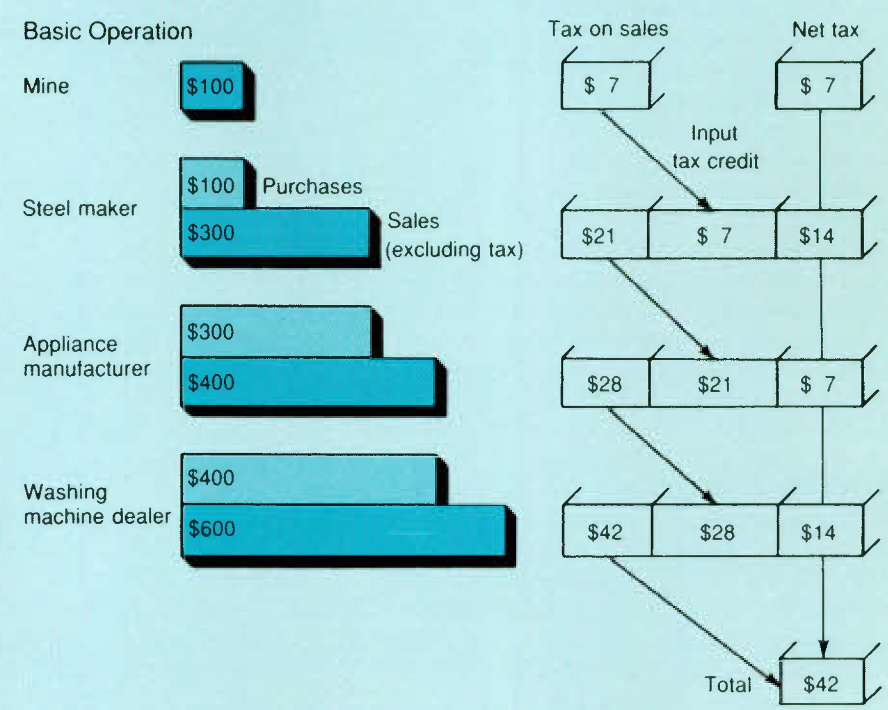
Nevertheless, by virtue of its greater visibility and its applicability to the added value of commodities rather than their total input cost (unlike the current MST), the GST would have a beneficial impact on the economy.

According to the Council, when the 13.5-per-cent tax paid at point of origin on manufactured goods is replaced by the GST, the price of manufactured goods will drop. Services, originally exempt from federal tax, will now be subject to the GST, and their prices will rise.

Under the new price regime, Canadian manufacturers and other large-scale users of Canadian equipment and machinery will become more internationally competitive. Exports will rise, imports of manufactured goods will drop, and both the merchandise trade balance and the current-account balance will improve. Finally, increased export and domestic sales will lead to increased savings and investment. A process of capital upgrading will occur, which will raise productivity and stimulate economic growth.

In sum, the GST will contribute in the long run to greater dynamic efficiency in

Goods and Services Tax



the economy, and thus to higher rates of economic growth.

However, following up on the concrete proposals contained in the August 1989 paper, the Council's research indicated that the proposed rate of 9 per cent would produce a short-term one-time blip in inflation of about 2.7 per cent. According to the Council's analysis, the "flashpoint" at which higher prices imparted by the GST would begin to pump inflation into the economy occurs when the GST rate was set above the 6.5 to 7.5-per-cent range.

With inflation already anticipated in 1991 in a range near 4.2 per cent without the GST, this meant the annual inflation rate in 1991 under a 9-per-cent tax regime would be as much as 6.9 per cent. How labour markets might react to this bubble became a critical factor in the debate as did the possible response of the Bank of Canada. The bubble itself, the reaction of labour markets, and the stance of monetary policy came to be known as the "transitional issues."

The prospect of an inflationary bubble and the uncertain reaction of both labour markets and the Bank of Canada to this bubble led Chairman Judith Maxwell, in her presentation before the House of Commons Finance Committee, to propose a lower rate, namely 7 per cent, in order to even out the impact of this new tax upon the economy during the so-called "transitional" phase.

At the same time, the Council's research demonstrated clearly that one of the major hurdles to be overcome in reducing the rate from 9 to 7 per cent would be a $1.8-billion reduction in the revenue collected. The Chairman pointed out that this revenue shortfall could be dealt with by implementing a phased freeze in government spending.

Different scenarios

Of the many scenarios (18 to be exact) investigated by the Council, one featured a 7-per-cent GST with additional expenditure cuts. The results of this scenario show that the 7-per-cent GST with spending restraint smoothes the entire economic response to the new tax, while strengthening real GDP growth. Inflation in 1991 is contained at 5.2 per cent.

The overall impact of the tax on relative prices and the negative impact on services are less pronounced. The favourable effects on the terms of trade remain. As against the 9-per-cent base case, real wages are much improved.

Even at 7 per cent, the growth of federal tax revenues speeds up in the long run. By the end of the decade, the federal budget deficit is $6.5 billion lower than in the MST base case.

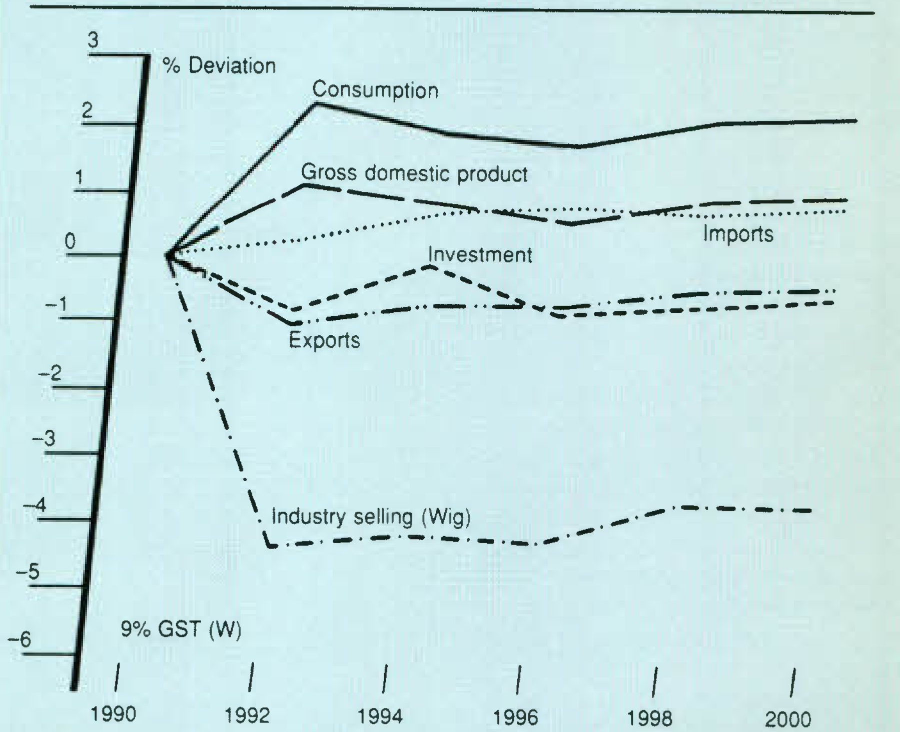
The idea of combining a lower rate with spending cuts follows directly from the Council's analysis of deficits, which is contained in *Legacies*, in its 26th Annual Review. In *Legacies*, the Council presented a scenario for reducing the deficit by means of a two-year spending freeze in five designated areas (capital assistance to business, subsidies to business, transfer payments to the provinces, the indexing factor for family allowances, and the hiring of federal public servants). Under this plan, the federal deficit would fall by some $3 billion by the end of 1992.

The Council also urged a reduction in the rate in order towards a framework that the provinces could join. In addition, broadening the base would eliminate much of the complexity associated with the GST and would create a more solid base of support for tax reform.

In the end, the government chose a 7-per-cent rate and covered the revenue shortfall through a combination of spending cuts and increases in corporate, personal, and excise taxes.

Not all issues surrounding the implementation of the GST have been resolved. For example, there remains the question of provincial participation. Nevertheless, the macroeconomic issues relating to the inflationary bubble have been resolved by changing the mix of spending and taxation in a way which is perhaps least injurious to the macroeconomy. Reducing the inflationary impact of this tax is perhaps the biggest contribution of the debate to date. In effect, a needless clash between monetary and fiscal policy will be avoided.

Relative Price Changes Induced by 9% GST
Selected Final Demand Prices and Manufacturing



The Pacific Rim countries

A great opportunity for Canada

The Pacific Rim countries are increasingly attracting the interest of the world's industrialized nations. During the last 25 years, this corner of the globe has engineered an economic recovery which is without precedent anywhere in the world.

Beginning with Japan, then Hong Kong, Singapore, Taiwan, South Korea, and, more recently, Malaysia, Indochina, Thailand, the Philippines, and even China, the world export shares of these countries have increased dramatically. The vigour of Asian industrial structures and their ability to assimilate the latest techniques of high value-added production have made these countries leaders on global markets.

As a result, Canada is well aware of the need to maintain and improve its international trade performance and it is particularly interested in the enormous potential of the Pacific Rim. The Economic Council of Canada started a research project on export markets and Canadian competitiveness, undertaking to analyse the vast possibilities of this region and the many challenges that Canada faces as it tries to take advantage of them.

One of the economists working on this project, P. Someshwar Rao, prepared the following text for *Au Courant*.

Canada and the Pacific Rim countries

The fastest-growing economies in the world are those of the Pacific Rim. As we approach the 21st century, these countries offer immense potential as a target for Canadian exports.

Canada's success in expanding its trade with this exploding market will depend critically on its ability to broaden its export base and to carve out a larger market share in the high-technology sector.

Canada will not find it easy to achieve these objectives. If it is to have any hope of competing successfully against the United States, Japan, and the Pacific Rim countries, it must first substantially improve its productivity and cost performance.

Canada must also arrest the erosion that is occurring in markets where it traditionally has been strong: resources and agricultural products. Competition is being felt in these areas mainly from the United States, China, Australia, New Zealand, and the member countries of the Asean, or Association of South-East Asian Nations.

The Pacific Rim

There are good reasons why the economies of this region are expanding so vigorously. These countries possess a number of key advantages, including:

- high savings and investment ratios;
- an educated, skilled and highly motivated work force;
- well-developed transportation and communication infrastructures;
- an outward orientation with respect to foreign trade and investment; and
- economic policies specifically tailored to market expansion.

Combined with a favourable global economic climate and a worldwide trend towards trade liberalization, the above factors have set in motion a virtuous circle where export expansion cycles, rising productivity, higher real incomes, greater industrialization, and increased investments in human and physical capital all serve to reinforce mutual growth.

The result is a remarkable record of output and productivity growth that has led to real per-capita incomes rising at a substantially faster pace in these Asian countries than in the United States, Canada, and other industrialized nations. The gap separating these countries from the major industrialized nations has also narrowed significantly in the past 25 years.

Someshwar Rao

In 1960, for example, per-capita incomes in Hong Kong and Singapore stood at about 25 per cent of U.S. levels. Today, the same workers are earning approximately 70 per cent of U.S. workers. While the growth in per-capita incomes in the other countries of the Pacific Rim is not quite so impressive, they too have shown remarkable improvement.

Over the last 25 years, first Japan and then Hong Kong, Singapore, Taiwan, and South Korea have become major players in world exports of manufactured

Regional Distribution of Canadian Exports and Imports, 1971 and 1987

	Exports		Imports	
	1971	1987	1971	1987
	(Per cent)			
Region/country:				
United States	68.4	76.0	70.5	65.0
EEC	14.5	7.6	12.4	13.0
Japan	4.6	5.4	5.4	7.1
Asian NICs	0.5	2.1	1.4	5.3
Asean countries	0.4	0.6	0.2	0.6
China	1.2	1.2	0.1	0.7
Rest of the world	10.4	7.1	10.0	8.1
Total	100.0	100.0	100.0	100.0

products. Their exports jumped from U.S. $31 billion in 1971 to more than $508 billion in 1987, an increase of more than 1,500 per cent. From 11.5 per cent of the world export market in 1972, the Pacific Rim countries now account for almost 20 per cent.

This represents a record of expansion unequalled by any industrialized country.

The challenges for Canada

The emergence of the Pacific Rim as a major centre of manufacturing production offers tremendous trading possibilities for Canada. But to take advantage of these opportunities, several daunting challenges must first be met.

The Pacific Rim countries are inevitably at the centre of policy discussions about trade, technology, foreign investment, and structural adjustment in Canada and elsewhere. This is because the burgeoning economies in this part of the world provide Canada with considerable potential for expanding and diversifying its commercial relations.

In terms of future trade, Canadians will continue to benefit from the high-quality, low-priced goods offered by these countries. On the other hand, many of Canada's labour- and medium technology-intensive industries will face increasingly fierce competition on both domestic and foreign markets from the Asian newly industrialized countries, the countries of South-East Asia, and China.

The composition of Pacific Rim trade

The commodity composition of exports from the Pacific Rim countries has changed markedly during the past 25 years, largely reflecting the rapid pace of industrialization and economic development in these countries.

Technology-intensive and "value-added" products now account for 50 per cent of Pacific Rim countries' exports, compared with only about 35 per cent in 1971.

And while Canada and the United States absorb almost 40 per cent of total exports from the Pacific Rim, these countries in turn purchase only 20 per cent of their imports from North America.

In contrast, the trade and investment linkages among the Pacific Rim countries themselves have grown markedly during the last 20 years. For instance, the intra-Pacific region share in total imports of that part of the world is close to 50 per cent today, compared to 33 per cent in 1971.

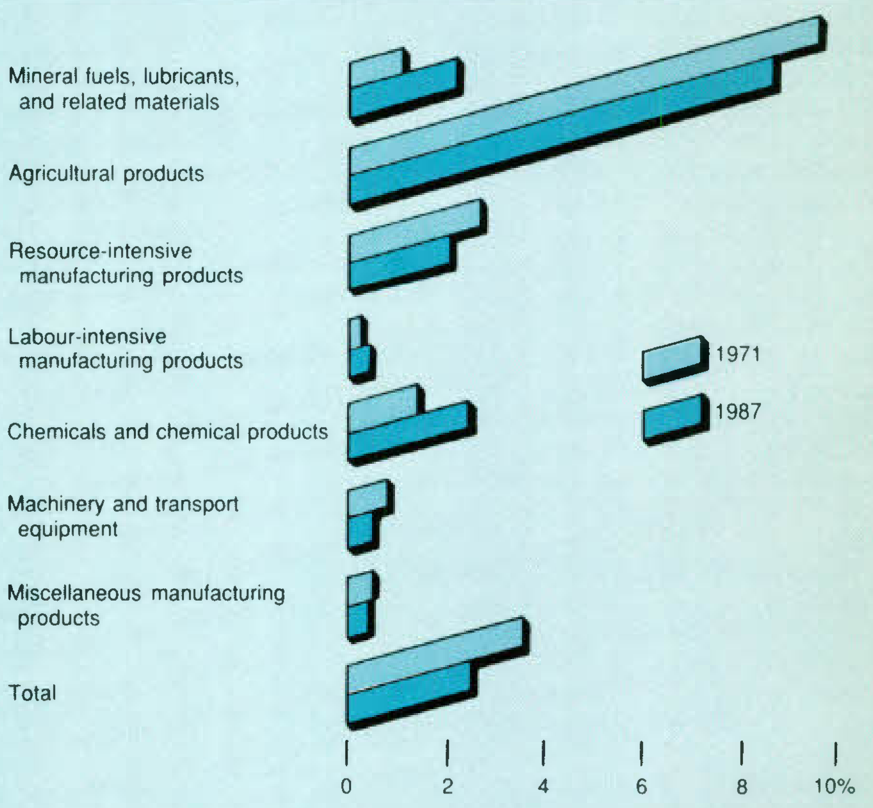
Trade between Canada and the Pacific Rim countries

Between 1971 and 1986, the increased trade between Canada and the Pacific Rim countries benefited primarily our Asian partners. While Canadian exports to these countries rose from 6.7 to 7.9 per cent during this period, their exports to Canada doubled, from 7.1 per cent in 1971 to 14 per cent in 1987.

The types of products imported and exported cover a wide range. Almost 50 per cent of Canadian exports are resources and resource-based manufactured products. More than 80 per cent of Asian exports to Canada, on the other hand, are in the high-technology sectors. This is yet another indication of how successful these countries have been in concentrating their production on high value-added products.

Trade with Japan, to take a more specific example, has risen from U.S. $1.7 billion in 1971 to more than $11 billion in 1987. Japan accounts for over 60 per cent of Canadian exports to the Pacific region. Despite these increases, however, Canada's performance in the Japanese market has been disappointing – its market share declined from 5.4 to 3.8 per cent between 1971 and 1987. An even more telling statistic is that Canada's share of Japan's imports of machinery and other equipment, a sector marked by rapid growth, was barely

Canadian Share of the Asia Pacific Rim Countries Imports, by Major Commodity Group, 1971-87



0.8 per cent in 1987. It was at the same level in 1971.

On the other hand, Canada's imports to the newly industrialized countries (Hong Kong, Singapore, Taiwan, and South Korea) grew strongly over the same period, jumping from U.S. $0.1 billion in 1971 to $2 billion in 1987. Yet, again, Canadian imports from these countries increased even more dramatically. In 1971, barely 1.4 per cent of Canadian imports were from these countries, but by 1987, this figure was 5 per cent.

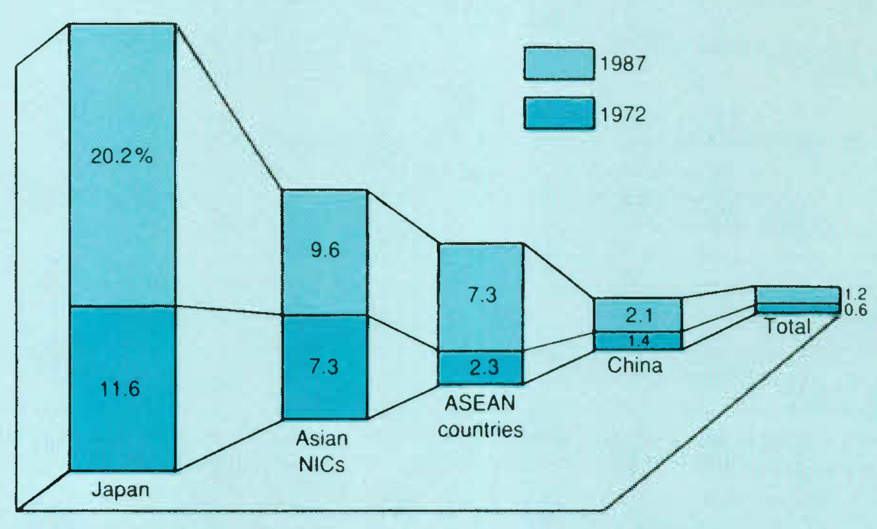
Resources and resource-based products again dominate Canadian exports to this region. These products accounted for 80 per cent of Canadian exports to Taiwan and South Korea in 1987.

In contrast to its loss of market share in Japan, Canada has managed, slowly but surely, to increase its market share of the other Asian countries, from 0.7 per cent in 1971 to 1 per cent in 1981 and 1.5 per cent in 1987.

Canada's trade with countries such as Malaysia, Indochina, Thailand, and the Philippines pales by comparison with its Pacific Rim trade. No more than 0.6 per cent of Canadian exports are destined for these countries. However, Canadian imports from these countries have been growing steadily and, as of 1987, they represented 0.6 per cent of total Canadian imports.

While Canadian exports to China have grown substantially in recent years, Canada's share of the Chinese market has been shrinking. From 13 per cent in 1971, it fell to 5.7 per cent in 1981 and to 3.3 per cent by 1987. The main reason behind this slide is the United States, which has come to dominate the Chinese market for machinery and other equipment. Canada, unfortunately, has had little success in broadening its trade base with the most populous nation on earth.

Market Shares of Asia Pacific Rim Countries in World Exports of Goods



Small coastal villages in Newfoundland

The role of unemployment insurance

An arsenal of national statistics and polling methods is not enough to understand the role of unemployment insurance in small Canadian communities. Case studies showing how unemployment insurance operates in local economies are also needed.

That is the task undertaken by Douglas House, former Director of Research for the Institute of Social and Economic Research at Memorial University in Newfoundland. House, who is now Chairman of the Economic Recovery Commission of Newfoundland, found that residents of small coastal villages in Newfoundland viewed the UI system as a sort of guaranteed annual income that they must "earn."

Despite gloomy economic statistics, these villages are vibrant communities. Community spirit and self-sufficiency linked to the UI system ensures residents a standard of living that compares with those of many city dwellers in Canada.

The system is not without faults and House says that it sometimes hampers the development of these communities. *Au Courant* summarizes below a recent presentation that House made at an ECC seminar.

Living on the periphery of North America, the residents of small Newfoundland outport villages have managed, despite difficult economic conditions, to belie the somewhat depressing picture painted by official statistics and to carve out a standard of living that rivals that of many urban Canadians.

Their method of doing so, however, is different from the mainstream: a sense of community sharing and family self-sufficiency, particularly when it comes to housing, cash income from seasonal employment in primary industries, mainly fish harvesting and processing, and supplemented by unemployment insurance.

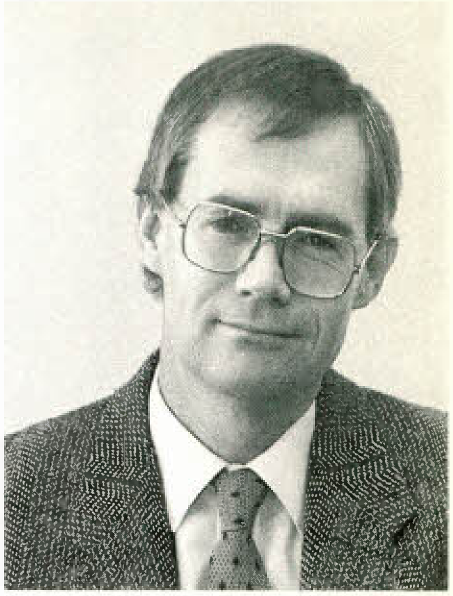
Douglas House, a well-known Canadian economist, reports that his research among villages located in the northern peninsula of the province has led to his discovering a number of vibrant local communities whose efforts, he feels, deserve our respect and encouragement.

At a recent seminar on regional development organized by the Economic Council of Canada, House used case studies to illustrate how the residents of these villages (like, no doubt, residents of small communities all across Canada) have managed to turn unemployment insurance into a "reasonably" satisfactory income security system. In these circumstances, unemployment insurance has become a kind of guaranteed annual income that people have to "earn."

House feels that the UI plan is not without its shortcomings, however, in that it sometimes impedes development in these outport communities.

According to House, the people in these areas consider unemployment insurance as a resource, similar to other available resources such as fishing and tourism. While the majority of Canadians organize their lives around a career, the citizens of these villages, faced with a lack of local opportunity, find what work they can, when and where they can. By working sporadically for various periods, even if only in short spells, they succeed in qualifying for unemployment insurance or for increases in their benefits. In this way, House discovered, total household incomes are sometimes twice as high as incomes from paid employment.

According to House, it is important to understand the dynamics of the local community, which aims to ensure that as many citizens as possible qualify for unemployment insurance. Workers in the various communities stick closely together, even to the point of passing up employment opportunities in order to allow a village neighbour or friend to attain UI eligibility. Often, in fact, there is a collective effort to provide a large number of citizens with basic incomes that, while not that high, are still enough to purchase a good range of consumer goods.



Douglas House

"Thanks to a well-developed sense of community, the residents enjoy a wide range of free or very inexpensive services."

Household production

House points out that the residents of outport communities demonstrate a remarkable ability to keep housing costs down and to attain a wide range of services at low cost.

They construct, renovate, and maintain their homes by themselves. Despite the gloomy economic statistics for these regions, the percentage of family-home ownership is higher in Newfoundland than anywhere else in Canada. By building their homes themselves, people manage to keep mortgages low. Local taxes are also lower here than elsewhere in the country.

Many residents cut their own firewood and heat their homes very cheaply. They also supplement their store-bought diet through hunting, fishing, and making preservatives gathered while berry-picking. They also do many of their own mechanical repairs.

Thanks to a well-developed sense of community, the residents enjoy a wide range of free or very inexpensive services. A woman who finds a job in a fish plant, for example, will likely arrange to have her children looked after by a family member or friend without charge. In the same way, the construction of a house often becomes a collective project, everyone pitching in to help his neighbour.

This capacity for self-reliance in the form of what House terms "household production" enables residents to enjoy a standard of living higher than their official incomes would suggest.

"Cash" income is used not only to buy consumption goods, but a portion is also directed to purchases of equipment such as freezers, snowmobiles, tools, and construction materials that are used to generate wealth in household production.

Aside from the unique aspects of their local economy, the citizens of Newfoundland outport villages enjoy a lifestyle that is similar to the majority of Canadians. More than half, notes House, have a truck and a car. More than half also have a boat, and sometimes two. Two thirds of them have VCRs, and one or more televisions. One hundred per cent have a refrigerator and over 84 per cent a freezer.

Failings of present system

According to House, there are nevertheless a number of shortcomings in the present UI system. For example, it encourages workers to decline part-time or casual work out of fear of compromising their eligibility for UI benefits. Workers may sometimes forego opportunities to further their education in order to accept jobs that will ensure their UI eligibility in the off-season.

"Workers may sometimes forego opportunities to further their education in order to accept jobs that will ensure their UI eligibility in the off-season."

House claims the system discriminates against self-employment and small business entrepreneurship, since workers risk compromising their UI eligibility by such initiatives, and self-employed people are not eligible for unemployment insurance. He finds that workers are unwilling to strike out on their own unless they are certain to receive good incomes right from the start – a remote prospect for a fledgling business.

Thus, continues House, the UI system represents both a blessing and a curse for the residents of these areas.

While it acts in some ways as a guaranteed income plan, the system's failings nevertheless mean that it contributes to economic stagnation in the region. It remains a system that shackles people to established ways of organizing their lives and their economy.

House concludes, however, that the answer to these problems certainly does not lie in lower benefits. What is needed instead is an income security system designed to support, rather than to discourage, the initiatives of local people to improve their economic circumstances.

Getting our act together

Council Chairman Judith Maxwell spoke recently about the transition taking place in our financial institutions at the Financial Post Conference in Toronto. She talked more specifically about the overlapping and conflicting regulation of our financial system, a luxury we can no longer afford. Following is an abbreviated version of that speech.

From the beginning, financial legislation in Canada has been a patchwork quilt. Because of the way powers are imbedded in the Constitution, federal and provincial governments share the responsibility for regulating financial institutions.

Fragmenting jurisdiction in this way has had some advantages. Nevertheless, we have paid a price for this diversity.

The problem

The cost of overlapping and conflicting regulations were a luxury that Canadians could afford in an era when the distinction between the pillars was clear-cut, when financial intermediation was less important, when domestic markets were more or less isolated from international markets, and when financial transactions were transparent. Those days are gone.

On the domestic front, the erosion of the pillar system, which has intensified since the beginning of the 1980s, has meant that the various categories of financial institutions fulfil similar roles. Yet their activities remain subject to different legislation and monitoring systems, even within the same jurisdictions.

There have also been major shifts in the nature of financial activities. In Canada, these changes are reflected in wider international circulation of capital, increasing volumes of international issues, the establishment of foreign institutions, and greater diversity in currency use.

Our research on internationalization shows that it has brought benefits; to borrowers – seeking cheaper sources of funds; to savers and portfolio managers – looking for better investment opportunities; and to financial firms – wishing to expand and diversify beyond their national borders.

Increased benefits are rarely free, however. For financial institutions, moving into foreign markets has entailed a new and different set of risks.

The combination of internationalization and financial innovation has reduced the transparency of the financial system.

Finally, differing requirements may discourage foreign firms from establishing in Canada. Canadian investors and borrowers then lose the benefits of increased competition that flow from the entry of new actors into the market.

In light of these considerations, the Council believes it is crucial for Canada's regulatory authorities to get their act together to minimize the problems generated by our fragmented jurisdiction.

"If Canada is going to profit from the advantages offered by the globalization of financial markets, it has to hold risks to a manageable level."

Alternative solutions

There are at least two possible cures for fragmentation. The first, which involves surgery, is to eliminate overlapping responsibilites by assigning specific categories of institutions and types of activities to specific governments. The second, which does not require surgery but does assume long-term therapy, is a serious commitment to coordination and harmonization.

Realistically, we should try to harmonize legislation rather than homogenize it. The European experience demonstrates that uniformity of legislation is an elusive goal for an economic federation or union comprising more than a few members. As long as the European Community espoused the philosophy of uniformity and centralization, nothing much happened. The situation began to change in 1985, with the adoption of the Single European Act, which set out the dual goals of "minimal harmonization" and "mutual recognition." This new approach recognized the individuality of each member country. It led to the establishment of minimum standards.

These principles could be applied to the Canadian situation. Agreement on basic standards for investment powers, capital requirements, related-party transactions, and distribution of financial products would ensure that no player could accept excessive risk or could engage in fraudulent activities by profiting from loopholes in the system. The principles would also allow financial institutions to operate from coast to coast, according to mutually recognized standards of security, while granting the provinces the right to maintain legislative arrangements aimed at meeting local needs. But to make it happen, we will have to establish an official forum where the 11 jurisdictions and all their regulators can get their act together.

We have a long way to go to get there. It seems that the only way to build confidence among all the players on the field in this complicated country of ours is to create an agreed set of rules of the game and then delegate the task of inspection and supervision to individual players. If the 12 European nations can do it, so can we.

In summary, if Canada is going to profit from the advantages offered by the globalization of financial markets, it has to hold risks to manageable levels. I think Canadian regulators can manage these risks, if they make a commitment to harmonization and coordination.

Agriculture in the Prairies

A need for policy review

Council Deputy Chairman, Caroline Pestieau, spoke recently on the subject of farm policies review at the Canadian Agricultural Finance Conference held in Winnipeg. Following is an abbreviated version of that speech.

Agriculture is one of the main issues in the current Uruguay Round of Multilateral Trade Negotiations. This gives it a much higher profile on the G-7 agenda and on national agendas that it has had in the past.

While in the medium term we foresee the productive capacity of the food sector growing faster than effective demand, it is by no means certain that this will continue.

Moreover, it is important not to lose sight of the interdependence between the goods and services sectors. Goods producers are increasing the proportion of their expenditures devoted to services, and there is a close link between the two sectors. For every dollar spent in agriculture, about 20 cents are spent on services.

Since agriculture is here to stay and we live in an interdependent world economy, we are being forced to review our agricultural policies in the context of the GATT negotiations. The need to reduce income instability, to increase competitiveness, to get rid of federal/provincial frictions, to limit government expenditure, and to conserve the environment, all demonstrate the need to rethink our farm policies.

In its report on the Prairie grain economy, *Handling the Risks*, the Economic Council concluded that Canadians should share the uninsurable risks of agricultural production with the farmer.

There is a paradox that is familiar to all of us. The owner-operator – the very symbol of autonomy and independence in our society – has become so dependent on government that he is often accused of farming support programs rather than the land. The low point was in 1987 when support programs accounted for all realized net farm incomes in the Prairies. Meanwhile, in the supply-managed sectors, quota rights have become marketable commodities and are sometimes more valuable than land or equipment.

In the sectors not regulated by marketing boards, farmers have become dependent on commodity-specific support, such as the Western Grain Stabilization Program, and on emergency measures, such as the Special Canadian Grains Program. In some cases, the distortions caused by these measures provoked compensatory action by federal or provincial governments. One result of this "ad hocery" is the unintended pro-wheat, anti-livestock bias in several federal Prairie farm programs. Such a policy maze also obscures market signals and discourages farmers from exploring new markets.

The numerous federal and provincial programs facilitating farmers' access to credit are another example. It is now clear that easy money is not an unmitigated benefit to farmers.

The Council's work shows that farming, at least in the Prairies, has become riskier than it was in the early postwar period. Our work shows a wide range in cost effectiveness between different Prairie producers. Higher production costs and poor management often prevent producers from reaping the expected benefits of diversification.

All this tells us that farmers require a much higher level of financial and general management training and support than used to be the case. The need for better quality education and training is a common cry across the Canadian economy. Farmers and prospective farmers must be included in any action on this front. It is important to all of us that this training take place since we are sharing in or "socializing" farmers' risks.

I believe that well-trained farm managers should be the senior partners in the sharing of risks with governments in Canada. I suggest that the role of public policy is to return the initiative to the farmer and then socialize part of his/her risks, rather than providing commodity-specific support or sponsoring new market endeavours. Risk sharing leads us to examine the design of safety nets.

A good safety net should reduce farm income instability, strengthen market signals, and encourage cost-effective managers. It must provide for emergency relief in times of disaster but still facilitate movement out of farming when economic circumstances require it. One of the Council's senior economists, Dr. L. Auer, has developed a farm income insurance system with these features. (See *Au Courant*, Volume 10, No. 2, 1989, "A more even-handed program.") It has some similarities with other recent proposals for decoupled income support. There are, however, differences. The program we have developed and simulated would cover all Prairie farmers. Farmers and taxpayers would share the costs equally. We have calculated that such an income insurance program initiated in 1966 would have allowed Prairie farmers to build up substantial cash holdings in their stabilization funds. Such a program would have enabled farmers to manage their own responses to the crisis of 1986-88 – absorbing price declines while continuing the same activities, specializing, diversifying, or quitting farming.

Caroline Pestieau

There are many open questions regarding Canada's agricultural programs. There are also constraints limiting our policy choices. Nonetheless, I am greatly encouraged by the atmosphere and circumstances surrounding the current policy review. International and domestic pressures seem to be converging to help us design a framework for a set of efficient, affordable, and coherent farm support policies.

"Local development," a new approach

Regional inequalities – how to eliminate them or at least reduce them – have long been one of Canada's principal economic concerns. Over the past 20 years or so, many different regional development initiatives have been tried, with (as even the experts admit) rather limited success. The reason for this lack of success, however, is a subject of debate.

In recent years, a new formula has emerged: "local development." What exactly does that imply? What makes the "local development" approach different from the others? What is the relationship between social or cultural development and economic development efforts? Is it possible to develop policies that will give "local autonomy" a fair chance to succeed while maintaining reasonable standards of accountability for the user of public funds.

These are just some of the questions that the Economic Council of Canada hopes to answer in its research project on local development.

To find out more about this important undertaking, *Au Courant* interviewed economist and project director Tim O'Neill, the President of the Atlantic Provinces Economic Council.

Au Courant: *What are the main objectives of your research project?*

O'Neill: There are actually two phases to this project. In phase one, the focus was on case studies of actual local development efforts in Canada. In the second phase, we are adding a conceptual understanding of what local development means and what it could mean. We are also attempting to synthesize the information provided by the case studies and gathered from other studies on the subject. This will allow us to achieve the overall objective of both phases which is to assess the actual and the potential contribution of local development efforts to economic development in Canada. This phase then is designed to evaluate the available information and to provide some policy directions for public sector support of local community development.

Au Courant: *Did the policies instituted in the last 25 years to correct regional disparities have their intended results?*

O'Neill: I think there is a general agreement that the attempts to deal with regional disparities have not had the intended results of reducing differences in key areas, such as unemployment rates and earned income levels. On the other hand, there is considerable disagreement as to why that is the case. Some have argued that policy intervention is wrong headed and that the best approach is to let the market take care of things by moving people out of underdeveloped areas into more-developed ones. Others have contended that policy intervention is appropriate but that it has not been extensive enough, or that it was not carried out for a long enough time period, or that we did not have the right mix of programs, and so on.

Au Courant: *What exactly is meant by local development?*

O'Neill: Local development can mean a variety of things. We have tried in this project to give it a very specific focus. We are looking at economic development as meaning economic growth combined with structural change which improves the well-being of people in local communities and regions in the country. It is local in the sense that we are talking about small geographical areas – often municipalities or small groupings of municipalities in which people have a common set of political, social, and economic institutions, and share common services and infrastructure. Although there are somewhat different views on this, local development has also come to imply that the community itself is involved in the direction of its own economic development.

Au Courant: *Is enough information already available on the various regions involved or will you have to carry out some research on your own?*

O'Neill: At the beginning, we were concerned that there was not sufficient information in the case studies alone, so we have had to supplement it with

Tim O'Neill

information from other works and from interviews that we have conducted with local development practitioners and government officials. We feel that we have enough information at this stage to give us some reasonable indication of both the type and the scale of contribution, and also the potential for further contribution of local development efforts.

Au Courant: *Is there a danger of uneven results with a local development approach, given that regions are not equal in terms of resources, dynamism, and so on?*

O'Neill: There is already unevenness in development if you are comparing different local areas or different regions. In fact, the economic disparities within regions among local areas are more pronounced, more significant than differences between regions. There are many who view the local development approach as a way to reduce the unevenness by focusing on smaller geographical areas and by boosting those areas to bring them closer in terms of economic performance to more prosperous locals.

Au Courant: *What are the advantages of local development compared with other approaches?*

O'Neill: The knowledge in the local community of existing strengths and weaknesses and the capacity to tailor economic activities to the features of the local area is one type of advantage. As well, community development and groups, by involving themselves in the process of development, can spread the risk of investing economic development. This can be an encouragement to potential entrepreneurs in the community.

Au Courant: *Does local development touch upon other aspects of development?*

O'Neill: Actual local development efforts have tended in fact to involve other aspects such as social and cultural development. One of the questions that we are trying to wrestle with is the extent to which we should be looking at the contribution of those areas which are much more difficult to evaluate. Certain types of social development and perhaps even certain types of cultural development can have an influence on economic development. Since our focus is on economic development, we will consider how those other types of development support or complement the economic development of the community.

Au Courant: *Should local development funds be channelled into infrastructure development or rather directly into specific projects?*

O'Neill: We are leaning very strongly in favour of suggesting that public sector support for local development be primarily for building up local structures that will enable the community to foster development more effectively. We should be careful here because we are not really talking about traditional infrastructures such as water and sewer systems, roads, and industrial parks. We are thinking more about the institutional structures that need to be built up within the community. This type of institution can, for example, analyse prospects for development and engage in the information gathering and analysis required to be looked at for new market opportunities and new technologies. We are also inclined to suggest that programs of business assistance currently available at the provincial and the federal levels be modified so that local development initiatives have access to funding available for specific projects.

"There is a general agreement that the attempts to deal with regional disparities have not had the intended results of reducing differences in key areas such as unemployment rate and earned income levels."

Au Courant: *Should development strategies and policies be uniform across the country or should they be individually tailored to the particular characteristics of the regions?*

O'Neill: Since many of the strategies will be formulated within the community itself, they will automatically tend to be tailored to the specific features of that locality. The real challenge is rather on the policy side – designing policies that are sufficiently flexible and broad to allow tailoring to occur.

Au Courant: *How much consideration is given to local autonomy in economic development?*

O'Neill: Literature produced by local development practitioners and discussions with the people involved in that "milieu" will show that quite a bit of emphasis is placed on local autonomy. The problem that we have had to deal with in the research report is to determine precisely what is meant by local autonomy. Does it mean local ownership or local control, or does it mean something less sweeping than that, such as local involvement in the development process?

The second issue is, what purpose local autonomy serves? If local autonomy means better prospects for development, if it is inherently superior to control from the outside, then of course it has an obvious benefit. But it is not clear that local autonomy, especially in its more sweeping versions, contributes significantly to the process of economic development. There are many cases of communities of various sizes that have survived and thrived with considerable ownership and control from "outside" the community.

Au Courant: *Is the approach adopted by your research intended to complement or to take the place of existing programs?*

O'Neill: We are anticipating something of both. If programs for supporting local development activity are going to be expanding, the expansions will come, to some extent, at the expense of funding for existing programs. However, to the extent that local development efforts make existing approaches more effective or add an important missing ingredient to those programs, the impact will be complementary to existing efforts.

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26th Annual Review

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Discussion Papers

Papers on Local Development

No. 1 "Loan funds for small business: Lessons for Canadian policy makers – A case study of Colville Investment Corporation," by *Lloyd I. Baron* and *Noel Watson* (also available in French).

No. 3 "Regional development in Atlantic Canada: An overview and a case study of the Human Resources Development Association," by *Elizabeth J. Beale*.

No. 4 "Where credit is due: A case study of the Eagle River Credit Union," by *John Wickham*, *Richard Fuchs*, and *Janet Miller-Pitt*.

No. 5 "A case study of the Kitsaki Development Corporation," La Ronge Indian Band, La Ronge, Saskatchewan, by *Michael Decter* and *Jeffrey Kowall* (also available in French).

No. 6 "The Great Northern Peninsula Development Corporation: An organizational framework for revitalization?," by *Peter R. Sinclair*.

No. 7 "The West Prince Industrial Commission: A case study," by *Wayne MacKinnon*.

No. 8 "Equity capital and economic development in Newfoundland and Labrador."

No. 10 "What we can do for ourselves: Diversification and single industry communities – The implications of a community economic development approach," by *Michael B. Decter*, and "The vulnerability checklist: A tool for community self-assessment," by the *Canadian Association of Single Industry Towns*.

No. 11 "The community as a base for regional development," by *Stewart E. Perry*.

No. 12 "Canadian regional development – The urban dimension," by *A.F.J. Artibise* and *Matthew J. Kiernan*.

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