AU COURANT

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Economic Council of Canada

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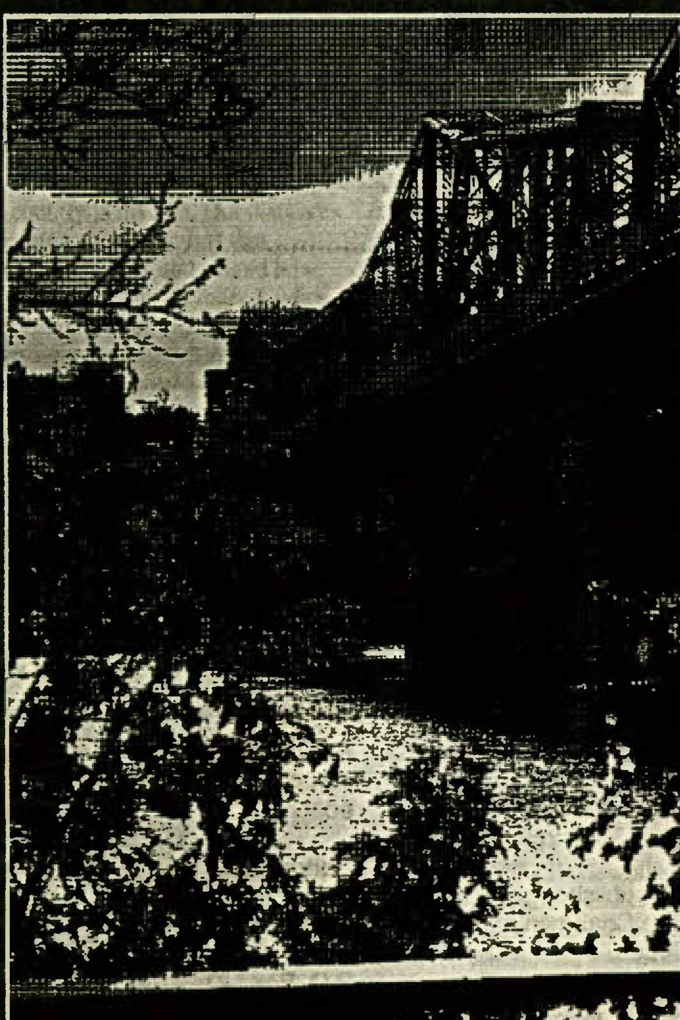
A Joint Venture

The Economics of Constitutional Options



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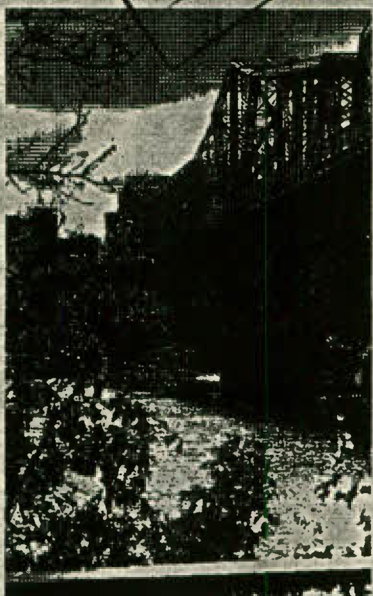

CHAIRMAN'S MESSAGE

FEATURE — 28TH ANNUAL REVIEW

DIALOGUE

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Sharing the same economic destiny

Judith Maxwell

This country is diverse. Our distances separate us. The result is that Canadians do not fully understand how integrated the economy is. Indeed, when times get tough, as they are now, many Canadians fail to recognize that we all share the same economic destiny.

The Council's 28th Annual Review, *A Joint Venture*, points out that despite the process of globalization, and stronger north-south economic ties, interprovincial trade is and will remain important to Canadians. Roughly 2 million jobs are directly associated with interprovincial trade in goods and services. Most provinces sell half or more of their exports of goods and services in other provinces. This domestic market provides the testing ground where Canadian firms can build their strength in preparation for international competition.

The Review also documents the fiscal ties that knit us together. Most Canadians are aware that there is an equalization program which provides for sharing between rich provinces and poor provinces. What they do not realize is how much hidden equalization there is in our social safety net. Most Canadians have access to the same social programs, no matter where they live, at roughly comparable tax rates. Such social programs would be difficult, if not impossible, to support if every province tried to provide its own programs. This important point shows up when the Council does its examination of different stylized constitutional options for Canada.

The Review sets out to test the degree to which the country could decentralize, while retaining the essential economic union which provides benefits to all Canadians. How far can the economic union be stretched in order to accommodate the desire for diversity among provinces?

The Review demonstrates that there are real limits here. In the case of extensive decentralization, where provinces take over responsibility for all social programs and all subsidies to business, we find that there are losses in income per capita for all regions in Canada except Ontario and Quebec. These losses bear witness to the way the fiscal ties in the country support regions facing economic adversity.

For example, the Atlantic provinces lose when programs are decentralized, because their tax base would not provide enough revenue to be able to afford the kind of unemployment insurance system which is now in place. In contrast, Alberta would lose out because it would have to pay for its own subsidies to farmers. Manitoba and Saskatchewan, which benefit both from unemployment insurance and subsidies to farmers, would also experience a severe setback in income. Even British Columbia would be a loser in this particular option because its unemployment rate tends to be higher than the national average.

Of course, I hasten to point out that the fiscal linkages are only one aspect of the overall costs and benefits that have to be assessed when one examines these stylized political options. As the Council points out in the Review, there are important transition costs involved in any radical change in the division of powers between federal and provincial governments. Similarly, we note that strains on the economic union begin to emerge when disparities in tax rates between provinces widen. People and investors will quite naturally migrate from high tax regions to low tax regions if such disparities get too wide.

Canadians all have a lot at stake in the Canadian joint venture. So what to do?

We need to improve our capacity to coordinate decisions among governments. Governments have laboured long and hard to agree on reducing interprovincial trade barriers in the last few years. It would help if all provinces became active supporters of the economic union. The key issue now is the federal constitutional proposals. They provide a blueprint for coordination which now needs to be shaped by all the players, especially the provinces.

We also need to compromise on a vision of sharing that provides Canadians with the reassurance that the political system in this country provides an adequate level of support for people facing economic insecurity.

The basic message that comes from the Council's analysis is that we are all travelling in the same boat. We have long since abandoned the era where the boat was commanded by a federal captain who called all the shots. What we have not yet found is a way to keep all the crew working towards the same objectives, aware of the strengths, needs and constraints faced by the others.

A new relationship

The failure of the Meech Lake Accord set off a new, intense round of constitutional debate. Canadians will soon have to choose – through consultations, referendums, and elections – what kind of political and economic ties will eventually prevail among them.

The problem is highly complex, touching upon a number of areas that resist easy evaluation. In the economic realm, however, Canadians may be able to find their way out of the maze by focusing their attention on two specific issues:

- creating wealth; and
- defining the role of governments in deciding how the proceeds from economic growth and the risks of economic hardship will be shared.

This message is one of the central themes of *A Joint Venture*, the Economic Council's 28th Annual Review, which examines the stakes involved in the constitutional debate from an economic perspective.

A time to choose

The joint venture in which Canadians have participated since Confederation has produced a country that is among the richest in the world, with a quality of life that is the envy of citizens of many other nations. Yet, Canada is now going through one of the most troubled periods of its history.

On the political front, the failure to ratify the Meech Lake Accord was perceived in Quebec as a rejection of its distinct character. It also revealed profound discontent elsewhere with the way the existing political and economic systems operate. Since then, Quebec has established its own timetable for constitutional reform, but it is not alone in calling for change. The native peoples have clearly indicated their exasperation with the current state of affairs, and westerners too have expressed frustration.

These political forces are not the only threat to the Canadian joint venture. Economic and fiscal issues also pose a serious challenge to the current political structure and to federal institutions. After many years of building up the public sector, during which a variety of measures were instituted to strengthen Canadian social safety nets, deficits have grown to the breaking point. Canadians are now paying more in taxes and getting less service in return because debt repayment absorbs one third of tax revenues. This undermines the traditional leadership role of the federal government.

Although the current constitutional debate has, to some extent, exacerbated an already difficult situation, Canadians now have an unprecedented opportunity to rebuild the foundations of their joint venture and thus create greater prosperity for all. The Economic Council does not claim to have all the answers to those challenges. However, in its 28th Annual Review, entitled *A Joint Venture*, it attempts to lay out the economic background to the debate and to explain the issues at stake, at a time when Canadians stand on the brink of momentous decisions about their future.

The 28th Annual Review was completed under the direction of Jean-Pierre Voyer, with the assistance of Ross Preston for the medium-term economic analysis and forecast. The research team comprised David Péloquin, Kei Moray, James Nightingale, and Marcel Bédard. The Performance and Outlook team consisted of Richard Roy, Haider Saiyed, Andrew Burns, Gilles Bérubé, and Marg Willis.

The priority: creating wealth

It is clear, says the Council, that the current constitutional crisis is fuelled by a host of fiscal and economic pressures. In recent years, many Canadians have been unable to preserve their standard of living, let alone improve it.

The creation of wealth must therefore be viewed as the first step in solving the constitutional crisis. If everyone is wrestling for a bigger share of the pie, it only makes sense to ensure that the pie is big enough to accommodate them. Thus any viable option for political restructuring must begin by offering the possibility of better living standards.

The Council finds that governments, businesses, labour, and other economic players seem to lack the political will to address this challenge as a joint venture. Right now, the various parties vie for larger shares of an economy that is no longer expanding as fast as it once did.

Increasing the standard of living of Canadians means, first and foremost, improving productivity and emphasizing innovation in order to foster a diversified output that stresses higher-value-added products. Those are the keys to ensuring the success of Canadian products on world markets and creating good jobs for Canadian workers.

Policy coordination

Another key ingredient in the drive to raise living standards is the efficiency of the economic union. The Council's research indicates that the provinces cannot ignore the internal Canadian market. For each province, the rest of Canada constitutes a strategic trading partner: 19 per cent of the output of the average province is destinated to other provinces. Moreover, interprovincial migration may account for as much as 8 per cent of yearly job changes in the Canadian labour market.

Whatever political structure is adopted, the federal government and the provinces must share responsibility in managing the Canadian economic union. This will require, in particular, a firm commitment on the part of the provinces to dismantle interprovincial trade barriers and, even more important, to work towards the coordination of federal and provincial economic policies.

The federal government no longer has the economic clout to operate on its own. The situation demands joint accountability by Ottawa and the provinces to ensure the efficient operation of the union and harmonize their economic objectives.

Budget planning is an area where governments can do a much better job of coordinating their efforts. Accordingly, the Council calls for an end to the tradition of budget "secrecy," for coordinated budget planning, and for regular assessments of federal and provincial fiscal plans.

Terms of the joint venture

There is another important issue facing all Canadians: Do they want to maintain similar policies across the country with respect to the redistribution of income and the sharing of the risks of economic adjustment? Should common standards of service and taxation across the country remain a fundamental aspect of Canadian citizenship?

Faced with accelerating technological advance and the pressures of international competition, Canadians as a whole agree that a strong social assistance system and a variety of social insurance plans must be preserved in order to protect citizens against economic misfortune. The Council's research shows that the elimination of equalization would make it impossible for the have-not provinces to deliver social-welfare systems to their residents at tax rates comparable with those in other provinces.

But even if Canadians agree that social insurance and some form of equalization should be maintained, the fundamental dilemma remains. What is the most appropriate philosophy of sharing? A "broad" vision, which states that all Canadians should have access to similar public services with roughly similar tax burdens? Or the "communities" vision, which argues that regional variations in program standards are acceptable, perhaps even desirable?

The question can be put more bluntly. Should elderly people in Cape Breton, the Beauce region, and the Okanagan Valley have access to roughly the same social-security and health-care services? Should we strive for education and training opportunities that are similar across the country? Or should each province instead be responsible for setting its own standards and developing its own programs?

These questions have to do with determining how responsibilities should be divided between the federal government and the provinces, and whether or not national standards in public services are required.

For both political and fiscal reasons, the tide is currently running in the direction of decentralization. However, fiscal considerations may well lose some of their importance in coming years. It would be wrong to think that the federal government will be permanently handicapped by its current financial difficulties. The Council's projections show that there could be a turnaround in the fiscal picture by the mid-1990s, enabling the federal government to repay its debts and consider tax cuts or spending increases.

An efficient economic union must have both guarantees and a degree of flexibility. No matter which option Canadians choose – centralized or decentralized federalism – the rules of the game, whether they are binding or nonbinding, can be determined so as to accommodate all parties. But it will not be easy to define those rules. Binding rules offer greater stability and better guarantees for citizens, but they tend to impinge upon provincial autonomy and are therefore more difficult to negotiate. Nonbinding approaches, on the other hand, are clearly easier to negotiate, but they offer no guarantee against bad faith or a change in government priorities.

The upshot is that provincial autonomy depends not so much on the degree of decentralization as on the decision-making rules and mechanisms governing interprovincial agreements. If Canada decides to pursue the path of extensive decentralization, it might become necessary, says the Council, to institute more-binding mechanisms in order to ensure the efficiency of the economic union.

If it happens that Canadians are unable to agree on a single unifying formula for sharing, they need not abandon their joint venture, stresses the Council. Given the Canadian tradition of tolerance and mutual respect, the Canadian federation may turn out to offer the latitude needed to forge more-asymmetric arrangements permitting the coexistence of different sharing formulas within a common political structure.

Alternative Mechanism for Preserving the Economic Union

	Centralization →	Decentralization
Binding	– Uniform federal laws and regulation – Direct federal spending – Constitutional entrenchment	– Interprovincial contracts or treaties enforceable by the courts – Independent adjudicating bodies with regional representation – Constitutional entrenchment – European Community directives
↓ Nonbinding	– Conditional funding – Direct spending (with opting-out provisions) – Regular federal/provincial conferences	– Codes of conduct – Interprovincial agreements – Regular federal/provincial conferences

Policy coordination

The maximum benefits of the economic union will accrue to Canadians through cooperation and coordination between governments.

According to the Council's 28th Annual Review, one of the key challenges for Canada over the next several years will be to find new ways to ensure policy coordination – not only among the provinces themselves, but also between the provincial governments and the federal government – in order to manage the economy more coherently. Besides natural barriers of distance and language, there are also artificial obstacles to greater integration of the Canadian market. Among them are government initiatives in such areas as taxation, spending, and regulation that interfere with the free flow of trade, capital, and labour. Some of the economic difficulties plaguing the economic union are the result of a lack of coordination in government action in such key areas as taxation and fiscal policy.

Greater cooperation between governments at all levels should be regarded as a priority within the present political structure.

Economic linkages

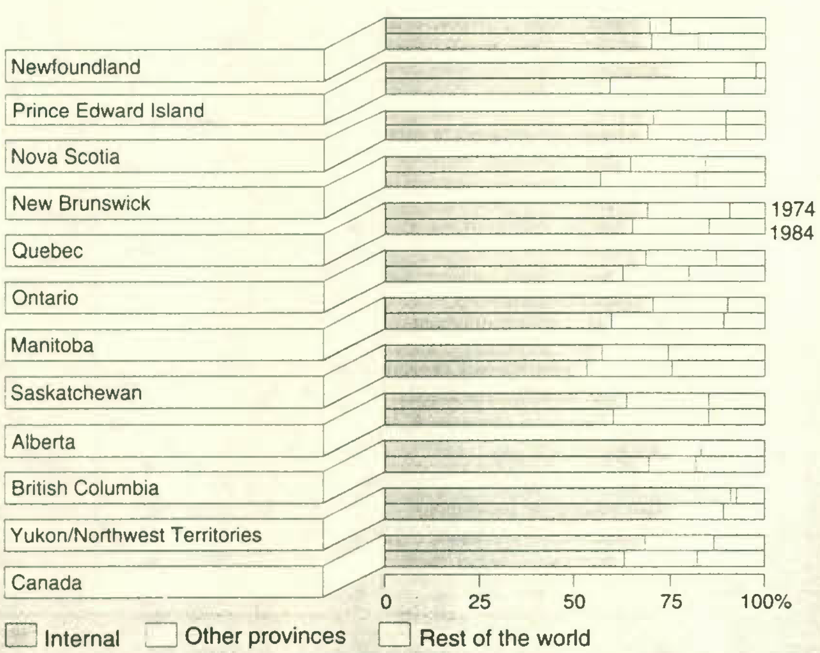
East/west linkages between the provinces do not seem to have weakened in the face of the globalization of markets and the expansion of north/south trade. In all provinces, the local market remains by far the most important. In 1984, for example, nearly two thirds of gross output in each province was sold in local markets. In addition, interprovincial trade as a proportion of gross output was more important than international trade: 19.3 per cent vs. 17.5 per cent. In 1990, interprovincial trade alone may have accounted for about 2 million direct jobs.

The volume of interprovincial trade in goods seems to be higher in Canada (18 per cent of GDP) than within the European Community (13 per cent) or the European Free Trade Area (4 per cent). This is all the more remarkable when one takes into account such factors as the greater distances within Canada, its smaller population, and its greater dependence on resources.

The pattern of trade flows for Canada as a whole conceals important differences between the provinces. Between 1974 and 1984, the ratio of international trade to gross output rose substantially for Ontario, Quebec, and Prince Edward Island; for New Brunswick, Manitoba, and British Columbia, the increase was much more modest. The situation remained the same in Nova Scotia and Alberta, while the ratio declined in Newfoundland and Saskatchewan. For Ontario and Quebec, the share of output destined for markets in the rest of Canada decreased, while for all other provinces it increased, sometimes substantially.

It is interesting to note that the pattern of trade between provinces and their foreign markets is heavily influenced by geography. The western provinces tend to export relatively more to Asia, while European markets are more important for the Atlantic provinces. All provinces sell the larger part of their total exports to the United States, the proportion ranging from a high of 88 per cent for Ontario to a low of 41 per cent for British Columbia. Geography also plays a role in the pattern of trade with U.S. markets.

Destination of Provincial Output, Canada, 1974 and 1984



Interprovincial links

Ontario and Quebec sell more to each other than to any other part of Canada. In 1984, Quebec exported products worth $18 billion to Ontario (11.7 per cent of its gross provincial product), while Ontario shipped $21 billion worth of product to Quebec (7.5 per cent of its gross product). The latest provincial figures indicate that Quebec's exports to the rest of Canada – and to Ontario especially – have increased sharply. Next to Ontario, Quebec's most important markets within Canada are Alberta and British Columbia, where 1.9 and 1.5 per cent of its gross output are sold, respectively.

All provinces have significant trade ties with Ontario and Quebec, but trade links between the Atlantic and western regions are almost negligible: the Atlantic region exports only a tiny portion of its output west of Ontario; conversely, the western provinces depend very little on markets east of Quebec.

Corporate links

The operations of branch offices and links between parent and subsidiary corporations represent another important aspect of interprovincial linkages. Such activities can either substitute for or complement interprovincial trade. When a firm holds a controlling interest in another firm, it can make strategic decisions for it. This has both positive and negative aspects. On the positive side, intercorporate linkages can provide access to technologies and to best-practice management methods. On the negative side, economic decisions made outside the province may have a negative impact on the local economy, since spending on research and development and promotions to management positions tend to favour the province where the controlling corporation has its head office.

The Council's analysis shows that the provincial revenue shares accounted for by locally controlled firms ranged from less than 50 per cent in Alberta and Manitoba to as much as 69 per cent in Quebec. While Quebec had the highest degree of local control of its corporate activity (as measured by corporate revenues), about 30 per cent of corporate activity involved firms controlled by interests in other provinces and in other countries. The share of corporate revenue controlled in other provinces ranged between 10 per cent in Ontario and 29 per cent in Manitoba.

Labour mobility

Canadians are quite mobile compared with people in other countries. During the 1980s, for example, no fewer than 320,000 people a year, on average, moved from one province to another. This degree of mobility is comparable with that of the United States and is higher than that of the European Community.

Even though migration from Quebec is limited by the language barrier, the net outflow from Quebec over the past 30 years has totalled half a million people – more than 7 per cent of the province's current population. Although net outflows have occurred every year since 1962 in Quebec, they were particularly large at the time of the FLQ crisis in 1969-70 and after the election of the Parti Québécois in 1976. Outflows have slowed considerably after 1984, with the strong recovery in Quebec's economy. In Ontario, net flows have generally been positive, except during the 1970s when the western economies were booming. After 1982, however, Ontario recorded a total inflow of 200,000 people.

Net migration flows have generally been negative for Manitoba and Saskatchewan. Although attracting large net inflows for most years since 1961, British Columbia lost population in the early 1980s. The Atlantic provinces, meanwhile, have generally experienced net outmigration, although the flow reversed in three of the four provinces during the 1970s following the reform of the UI plan in 1971.

Outmigration rates are much lower in Ontario and Quebec. Ontario's low rate is linked to the diversity, strength, and size of its economy. In Quebec, while the same factors play a role, language is the dominant explanation for the low rate of mobility.

Distance is again a critical factor in explaining linkages between provinces. Ontario is the clearing house of the national labour market. With the exception of Saskatchewan and the Northwest Territories, all provinces have strong links with that province. In the West, provincial labour markets are highly integrated with one another. This is particularly evident in Saskatchewan, where about 80 per cent of migrants go to other western provinces. The Atlantic provinces have relatively weak links with one another, but closer ties with Ontario.

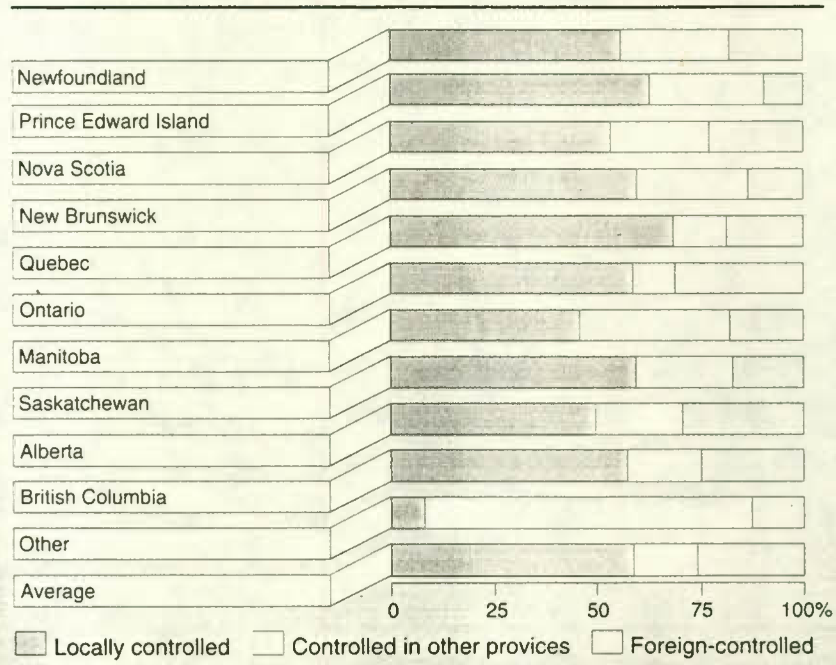
Quebec has weak links with all provinces except Ontario and, to a lesser extent, New Brunswick.

Obstacles

Among the obstacles to the integration of the Canadian domestic market are government actions that discriminate against flows of trade, capital, or labour through tax, spending, or regulatory policies. Some of these policies implicitly discriminate on the basis of origin; others do not, but distort flows nonetheless. Other obstacles exist because of a failure to coordinate government actions in such key policy areas as tax structure and fiscal policy.

Some policies of the federal government also interfere with the common

Corporate Revenues Earned by Firms Controlled Locally and Non Locally, Canada, by Province, 1987



market, such as regional and industrial development policies, regionally differentiated UI benefits, and transportation subsidies.

Despite the various obstacles that shackle it, the Canadian domestic market remains extremely important for all provinces.

Thus, states the Council, "any changes in the political structure must be carefully judged to avoid disrupting this trade. To do so would be to disrupt the livelihood of many Canadians."

Under the current circumstances the Council does not support the idea of imposing legislative or constitutional measures to protect the integrity of the common market. It does recommend, however, recourse to federal-provincial negotiations to attempt to secure a commitment to eventually eliminating trade barriers.

In particular, new institutional arrangements will be needed to create a forum where political trade-offs can be achieved. In addition, the current mandate of the Committee of Ministers on Internal Trade to dismantle impediments to interprovincial trade should be reinforced.

New procedures for coordinating federal and provincial policies are needed in order to assist all regions of the country in dealing with the challenge of stronger competition resulting from the globalization of national markets and economies.

Fiscal harmonization

Differences in various governments' tax regimes also have an adverse effect on the health of the Canadian economic union. The purpose of tax harmonization is to ensure that the tax systems of the three levels of government operate in such a way as to limit the costs of collection and compliance. Taxpayers should be subject to the same rules, no matter where they live, so that capital and labour may continue to flow freely within the economic union.

Although, internationally, the Canadian federation is viewed as a model of tax harmonization, there have been worrying signs in recent years of fragmentation with respect to both income and sales taxes. Changes have allowed the provinces to introduce tax credits to individuals and corporations; such measures, says the Council, run the risk of compromising the high degree of harmonization that has been achieved through federal/provincial negotiations.

The Council believes that it should be possible to accommodate provincial requests for more flexibility within the national income tax system, as long as the following conditions are met: 1) a relatively comprehensive equalization system is preserved; 2) similar tax-base definitions are maintained in all provinces; and 3) there are uniform attribution rules for allocating personal income earned outside the province of residence.

Wide interprovincial differences also exist in the area of indirect taxes. To cite but three examples, sales taxes, tax bases, and tax rates vary considerably across provinces.

A new budget process

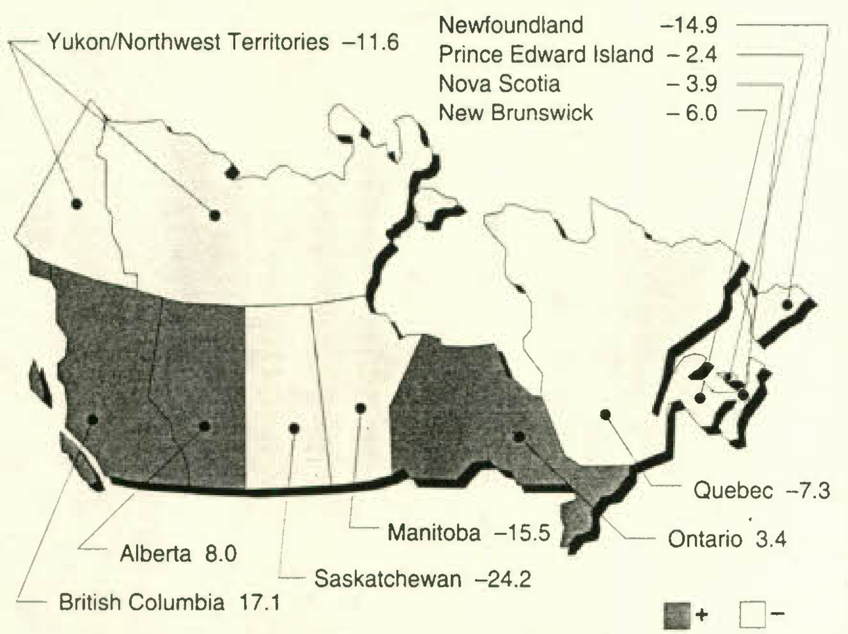
If there is one area where greater coordination is essential, it is the process by which tax and fiscal policy is developed. In the past, provincial tax or fiscal policies that contradicted national priorities could usually be counteracted by federal measures. Canadians seemed ready to accept these contradictions as one of the costs of diversity. Today, the thrust of economic and political forces is to create a new role for the provinces in the management and stabilization of the economy.

The Council suggests that the tradition of budget secrecy be abandoned, so that all governments may participate in setting economic targets and policies.

With the veil of budget secrecy lifted, the federal government would be able to make public its fiscal plan and economic forecast several months before actually tabling the budget. These initiatives would facilitate consultation with the provinces, which would be invited to present their own budget plans in the intervening months.

It would also be desirable to create an organization with an analytical capacity that would be mandated to identify inconsistencies between federal and provincial policies and to bring them to public attention.

Net Interprovincial Migration, Canada, 1961-91



Reconciling two different visions

The current political debate over the respective roles and responsibilities of the federal and provincial governments involves two very different perceptions held by Canadians on how the nation's wealth should be shared.

Tax equalization, national standards, and the simple question of how spending and taxation powers should be allocated among the various levels of government are all issues that involve political choices for Canadians. Two different visions of federalism exist – the "broad" vision and the "communities" vision.

The broad vision calls for a relatively robust federal government that can actively promote equity by, for example, ensuring equal treatment of individuals across the country and redistributing income from those who are better off to those worse off. This implies very similar (perhaps even identical) sharing mechanisms across the country. The broad vision thus focuses on similarities between the nation's citizens and sometimes asserts uniformity of government taxation and services as a basic right.

The second model, based on what might be termed the "communities" or "decentralized" vision, puts greater emphasis on the importance of responding to regional needs. It finds expression in the desire of many – particularly in Quebec but also in other parts of the country – for greater provincial autonomy.

While the clash between the two models has been evident since Confederation, the recent debate on the country's future has revealed some cracks in the consensus over how powers should be shared among the various levels of government. One measure of the importance of this debate is the fact that more than half of government expenditures are oriented towards sharing, either directly or indirectly.

In its 28th Annual Review, the Council explores the nature of intergovernmental fiscal arrangements and discusses how these arrangements could be adapted to more decentralized forms of federalism, while ensuring the preservation of a strong economic union.

While there is much scope for innovation in redefining the current division of powers, Canadians must consider fully the long-term effects of any changes.

The budget crisis and federal power

There is little doubt that the budget crisis has shaken public confidence in the federal government's ability to play its redistributive role in recent years. Federal involvement in areas of provincial jurisdiction was traditionally justified on the grounds that the central government was paying some of the bills. By altering its commitments under existing fiscal arrangements with the provinces (among other actions), the federal government has unleashed pressures for decentralization.

Notwithstanding the federal government's fiscal difficulties, the Council advises caution in drawing conclusions from the current state of affairs. The future is not necessarily cast in stone. Indeed, according to some projections, the government's budget crisis will subside by the mid-1990s. While this is by no means a certainty, it would be a mistake to assume that extensive decentralization must inevitably occur simply because the federal government's room for manoeuvre is currently restricted by the state of its books. The crisis will not necessarily be a permanent handicap.

The cumulative effect of budget cutbacks and federal tax increases in the past few years may eventually produce a "virtuous" circle, which, by encouraging more-rapid economic growth, will make it possible for the government to reabsorb the public debt, reduce taxation levels, and so forth.

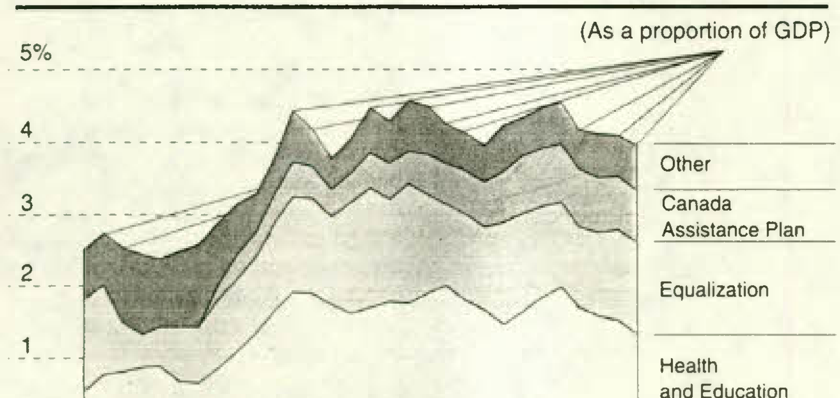
The allocation of powers

While it is sometimes tempting to view the struggle for power between the federal and provincial governments as nothing more than political squabbling, it is important to realize that the allocation of powers has real consequences for the state of the economic union and for long-term social cohesion.

To the extent that preserving or reinforcing the economic union is the goal of all Canadian governments, it must be recognized that decentralization may not increase the scope for independent action by provinces: increased powers inevitably entail increased responsibilities, but the need to coordinate provincial actions may limit their freedom of action.

Competition between the various levels of government may, depending on the circumstances, have harmful effects on the economic union because of policy incoherence, overlap or duplication. It can also have favourable effects, encouraging the development of better-quality public services.

Federal Cash Transfers to Other Levels of Government, Canada, 1960-89



How can such overlaps and duplication be overcome? The Council has a number of suggestions.

Obviously, the problem would disappear if Canadians were to opt for either extreme centralization or extreme decentralization. Between these two extremes, however, lies the option of entrenching a truly watertight division of powers in the constitution, which would also eliminate overlapping. This approach has the merit of clarity but it does sacrifice the flexibility needed for policies to be adapted to a constantly changing economic environment.

There is another possibility: continuing the practice whereby the two levels of government exercise more or less concurrent powers in the same policy areas but specifying which one has "paramountcy." For example, when the federal government would exercise its spending power in an area of provincial paramountcy, each province would be entitled to opt out and receive unconditional compensation.

Under this option, the two levels of government would be empowered to intervene in a new policy area where there are unmet needs, while the jurisdiction with paramountcy would be able to avoid costly, inconsistent, or contradictory regulations or spending programs.

National standards

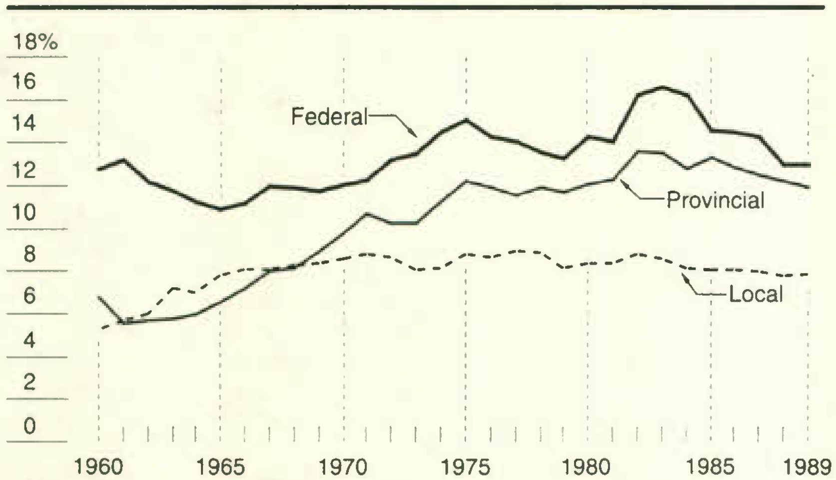
Constraints on the growth of federal transfers in support of health care, postsecondary education, and social assistance have raised tough political questions: How can the federal government justify its imposition of national standards governing provincial programs in these areas when it is in the process of cutting back its financial contributions? Here again, the answer depends on one's point of view regarding the Canadian federation.

Total federal transfers in these areas, which will amount to nearly $14 billion in 1991-92, represent a key component of "implicit" equalization in Canada. They help to bring the fiscal capacities of the have-not provinces more into line with those of the richer provinces. It is the role these transfers play in setting national standards that is the most controversial, however.

Equity and efficiency concerns also enter into this question. It can be argued on equity grounds that national standards maintain a common set of rules and benefits that are the basic entitlements of citizenship.

There are some situations, however, where national standards may themselves create inequities, particularly if they force the provinces to spend more in certain sectors while significant gaps remain between them with respect to revenue-raising capacity.

Program Expenditures, by Level of Government, Canada, 1960-89



The concept of efficiency is based primarily on the principle that national standards are essential to preserve and promote the economic union.

The one-sided nature of negotiations between Ottawa and the provinces has frequently been criticized. One alternative would be to make such arrangements more like "contracts" that would be binding on all parties for a fixed or indeterminate period and which could be enforced through the courts.

Another solution, modeled after the European approach, would give the federal government the power to set national priorities, subject to provincial approval, while allowing the provinces enough leeway to decide themselves what action to take to meet those goals.

Fiscal equalization

Like national standards, questions of efficiency and equity will likely remain important underlying issues in the debate on reforming Canada's equalization system.

The equity argument is straightforward. The equalization of provincial fiscal capacities ensures that, on the average, people in comparable circumstances – but living in different provinces – are able to enjoy similar public services. On efficiency grounds, equalization helps to maintain the integrity of the economic union, since disparities in fiscal capacity can lead to labour shifts that are inefficient for both the province of destination and the province of origin.

The greater the spending responsibilities of the provinces (particularly when differences in the corresponding fiscal capacities are wide), the greater the need for equalization – whether in implicit or explicit form. Conditional transfers are an implicit form of equalization that may, however, lead to greater entanglement of federal and provincial jurisdictions and to excessive uniformity. With explicit, unconditional equalization payments, the provinces have more latitude to respond to local preferences.

A strongly decentralized federation is not necessarily incompatible with a highly developed equalization system, since the provinces could assume responsibility for designing and financing equalization payments themselves.

Constitutional options and transition costs

Regardless of the constitutional option eventually chosen in Canada, there will be far-reaching effects – some positive, some negative – on the way the economic union operates and on the well-being of Canadians. In economic terms, however, some options are more costly than others.

Indeed, the more radical the political changes, the higher the inherent transition costs and the higher the potential risks of uncoordinated action. One certainty is that the degree of unease felt by the public about constitutional change and the sensitivity of financial markets will be strongly influenced by the political climate prevailing before, during, and after the new structure is put into place. The costs of political change can be minimized – but not eliminated – if there is no escalation of tensions and if the process is orderly and takes place in an atmosphere marked by calm and mutual respect.

The Council acknowledges that its analysis of the various options inevitably leaves out many important aspects of constitutional issues – including some that are probably at the core of public debate, such as the preservation of a Canadian identity, the protection of culture and language, minority rights, political autonomy, and native land claims. However, these aspects fall outside the Council's mandate.

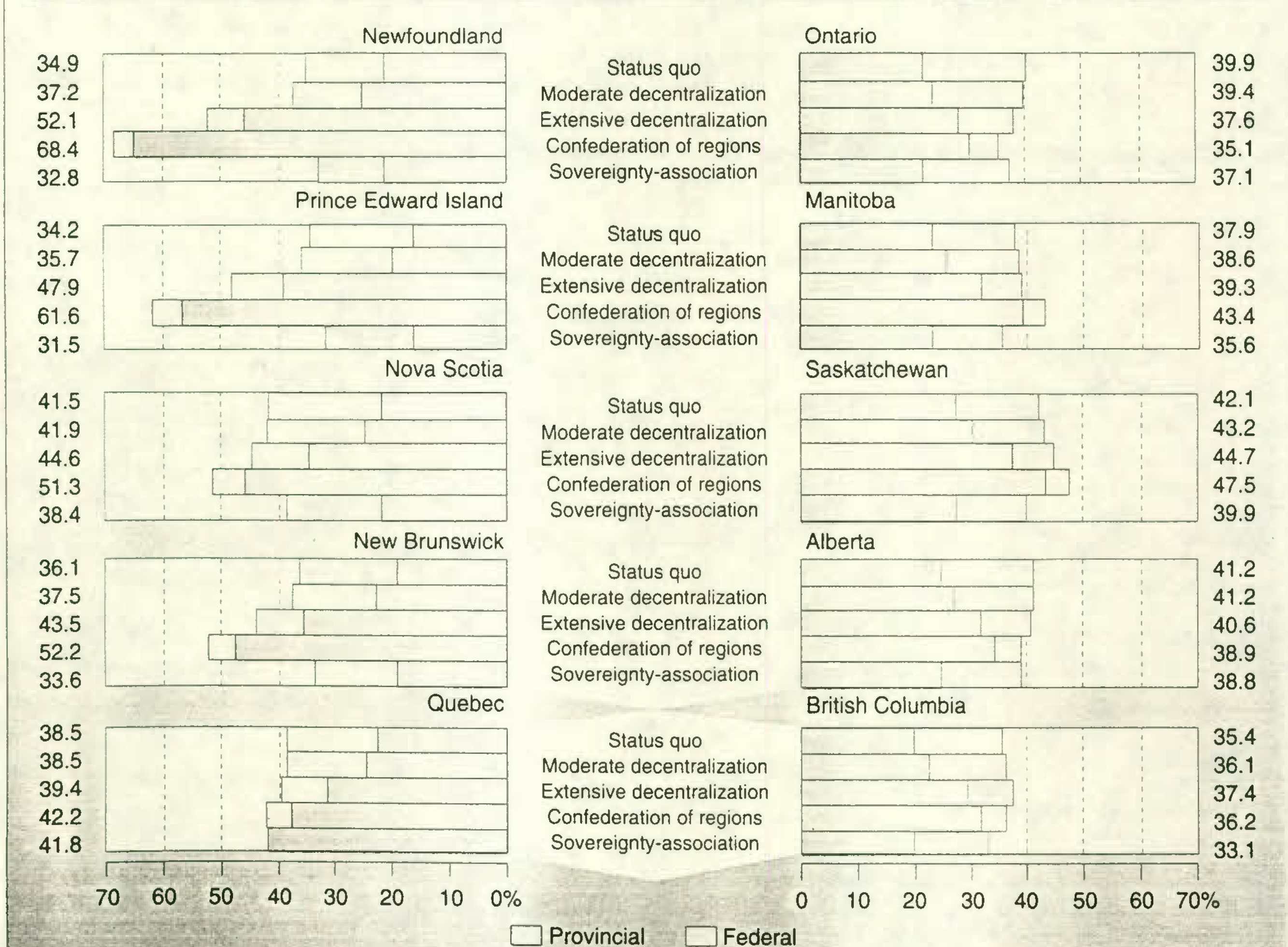
Constitutional options and economic impacts

Rather than try to assess all of the options proposed over the past few years by numerous task forces and parliamentary commissions, the Council selected a number of options that capture the range of possibilities. They are as follows:

1 the status quo;

2 moderate decentralization of federal responsibilities and functions;

Projected Government Revenues Required to Maintain the Same Levels of Government Expenditures under Various Constitutional Options, Canada, by Province, 1994-95



3 extensive decentralization;
4 a confederation of regions; and
5 sovereignty-association (where Quebec is assumed to sever all fiscal connections with Ottawa while the other nine provinces stay with the status quo).

These options must be assessed in the light of five types of costs and benefits: the impact on the economic union; dynamic gains; efficiency gains; transition costs; and the long-term impact on per capita income of a reorganization of taxes, transfers, and spending responsibilities in line with the new division of powers. It is this last impact where the Council has done unique in-depth analysis

Any change in the political structure will have an impact on the operation of the economic union. The more decentralization there is, the more difficult it is to keep the economic union operating efficiently. This problem can be offset if the federal and provincial governments agree on coordinating mechanisms.

Also, in the case of extensive decentralization, where substantial powers are devolved to the provinces, there is the potential for dynamic gains. These are the gains that come from greater social consensus and willingness to work together to solve economic issues.

Fiscal impacts

As well, the Council has also analysed the long-term impact caused by reorganizing taxes, transfers, and spending in line with the new divisions of powers. It has also studied the chain reaction that occurs when taxes and transfers are altered. The immediate effect shows up in disposable income, but this in turn changes the mix of goods and services consumed, produced, and traded across provinces.

One of the most important effects of the "moderate" decentralization scenario would be a decline in income in regions that are currently net recipients of federal transfers. The Atlantic region, British Columbia and the territories, for instance, would give up more in federal transfers for health care, education, and social welfare than they would gain from reduced federal taxes. Residents of these regions would see their standards of living decline by close to 2 per cent, while those of Ontario would see an increase of about 1 per cent.

The "extensive" decentralization model assumes that the provinces would take over responsibility for transfers to individuals (family allowances, unemployment insurance, grants to businesses, and so on). The magnitude of the impacts would increase dramatically. Declines in welfare in the Atlantic region, Saskatchewan, and Manitoba would range between 4 and 8 per cent. The Prairie provinces would find their fortunes deteriorating substantially because of a significant drop in agricultural subsidies, which have been particularly high in recent years. Under the extensive decentralization option, Quebec and Ontario would post significant gains. The federal government's powers in the area of taxes and transfers would be reduced to such an extent under this scenario that it would no longer be able to pursue its goal of equity among citizens. Its ability to act to stabilize the economy would also be impaired.

Under the confederation-of-regions option, all regions that formerly received equalization payments would see their situation deteriorate, while Ontario, Alberta, and British Columbia would see some improvement because of their lower federal tax burdens. The impact on the Atlantic provinces and the Prairie region would be devastating. The cost would be somewhere between 23 to 27 per cent in the Atlantic region. Manitoba and Saskatchewan would experience a 15-per-cent decline. The confederation-of-regions option would reduce the size of the federal government to about one fifth of total provincial expenditures in 1994-95.

Under the sovereignty-association scenario, Quebec would receive no federal transfers or equalization payments, and the federal government would stop buying goods and services from that province. But the trade and commercial ties with the rest of Canada would be

Economic Impact of Constitutional Options

	Decentralized federation			
	Moderate	Extensive	Confederation of regions	Sovereignty-association
Economic union	○	?	−	−
Dynamic gains	○	?	+	+ (Quebec)
Long-term impact of a new division of powers[1]				
Atlantic provinces	−	−−	−−−	○
Quebec	○	+	−	−
Ontario	+	+	++	○
Manitoba and Saskatchewan	−	−−	−−−	○
Alberta	○	−	+	○
British Columbia and territories	−	−	+	○
Increased government efficiency	○	+	+	+ (Quebec)
Transition costs				
Political risk	○	○	−	−
Default risk	○	○	−	−
Currency risk	○	−	−	−
Debt-sharing and others	○	○	−	−
Treaties and others	○	○	−	−

Note ? Uncertain + Benefit − Cost ○ Insignificant

1 Reflects the impact of a reorganization of responsibilities in the areas of taxation, transfers, and government spending.

maintained. Under this scenario. Quebec would see the welfare of its residents fall by 1.5 to 3.5 per cent of provincial GNP.

Transition costs

The cost of re-confederation could be extremely high during the period of structural transition. And as noted earlier, the magnitude of these costs will primarily be a function of the social and political harmony prevailing during the period of constitutional change. Even in the best social and political climate, however, some transitional costs are inevitable.

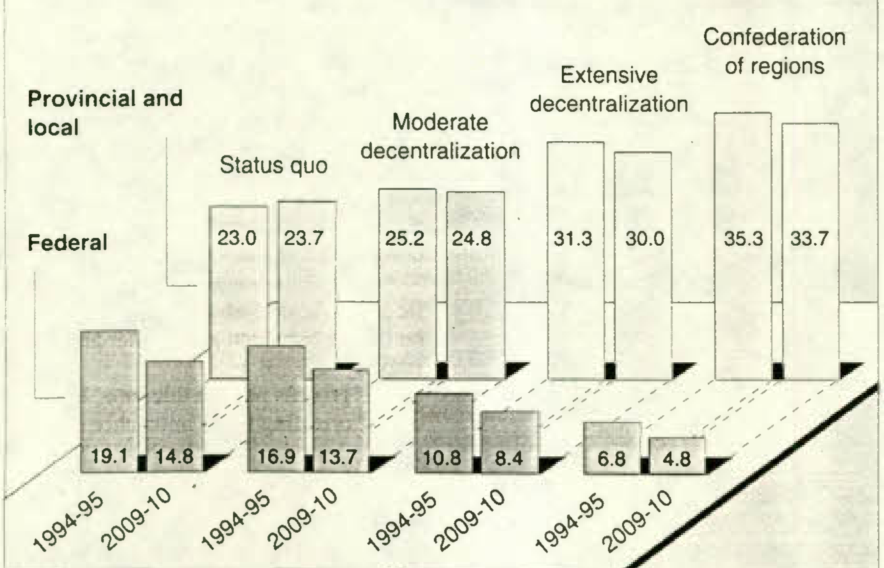
Risk premiums would probably rise under the sovereignty-association and confederation-of-regions options because the changes would affect important political institutions.

The sovereignty-association scenario assumes a division of the federal public debt and assets between Quebec and the rest of Canada. The confederation-of-regions option, too, might also require such an exercise, unless the regions decided to delegate responsibility for managing the public debt to the central authority.

This is a zero-sum game. Any gain by one party through a reduced debt share would represent a loss to the others through increased shares. Negotiations over how the debt is to be shared would be more difficult if carried out in a climate of conflict.

There are several ways that the transition costs and the costs associated with the division of assets and liabilities could be minimized. First, maintaining a common currency through a monetary union would avoid introducing any element of exchange risk into the financing of the debt. Second, it would be desirable to avoid redeeming existing debt and replacing it with new debt, by negotiating a phasing-in of the transfer. Third, the transfer of debt could be phased in over a period long enough to allow the development of new markets, so that the new securities could be issued without paying a premium over market interest rates. Finally, it might be advantageous to assign the responsibility for managing the debt to the federal government or to a special agency created for that purpose.

Projected Federal and Provincial/Local Government Spending under Four Constitutional Options, Canada, 1994-95 and 2009-10



Conclusion

The Council's analysis of the various factors involved in the constitutional options shows that any alteration to the fiscal and trade linkages has a bearing on the economic well-being of *all* provinces. In the short to medium term, the transition costs are significant. Even in the long run, the more radical options may entail a serious penalty in terms of higher real interest rates.

While some major adjustments would be required in order to make the status quo economically viable, the Council doubts that these changes would be enough to make that option politically acceptable to many Canadians at this point in the debate.

On the other hand, the confederation-of-regions option would place some provinces in such dire circumstances that the Council believes it must be excluded as a viable economic alternative.

The main concern with extensive decentralization is the negative impact it would have on provinces with lower fiscal capacity. They would likely have strong objections to this solution unless arrangements were made to strengthen the equalization system.

In the case of sovereignty-association or some other form of asymmetric arrangements. Quebec would bear most of the direct cost of changes to the tax and transfer systems but all provinces would be affected by the strains on the economic union.

Quebecers who expect large dynamic gains from that autonomy would also expect that citizens would benefit from long-run advantages. But again, the asymmetric federalism option can only be viable for Quebec and the other provinces as long as the question of political representation in central institutions is resolved. That, says the Council, is the major unknown in the asymmetric formula: how to build institutions that are accountable and where the allocation of voting rights is compatible with the aspirations and requirements of all the players.

All the provinces are members of the same economic system. This means that they would all share in the transition costs and in the cost of any failure to coordinate federal and provincial policies.

A fitful recovery

The economic recovery is under way – but it is fitful and shows signs of weakness.

There are indications that the economy is barely sputtering along, saddled with an unemployment rate of 10.2 per cent in September, consumer price inflation of 5.4 per cent, and about a 2-per-cent decline over last year in the volume of total output.

In its 28th Annual Review, the Economic Council notes that the most troubling aspect of the current situation is the persistence of the level of unemployment generated by the last recession. That recession – and perhaps the recession of the early 1980s as well – has left a deep mark on the economy.

On the surface, the rise in joblessness in 1990-91 seemed almost indistinguishable from that of 1981-82; in both cases, rates rose by 3.3 percentage points during the first 12 months of recession. But this similarity conceals some important differences. For example, the burden of unemployment in the 1981-82 recession was distributed fairly evenly between Quebec, Ontario, and British Columbia, whereas today, Ontario is bearing the brunt of the problem.

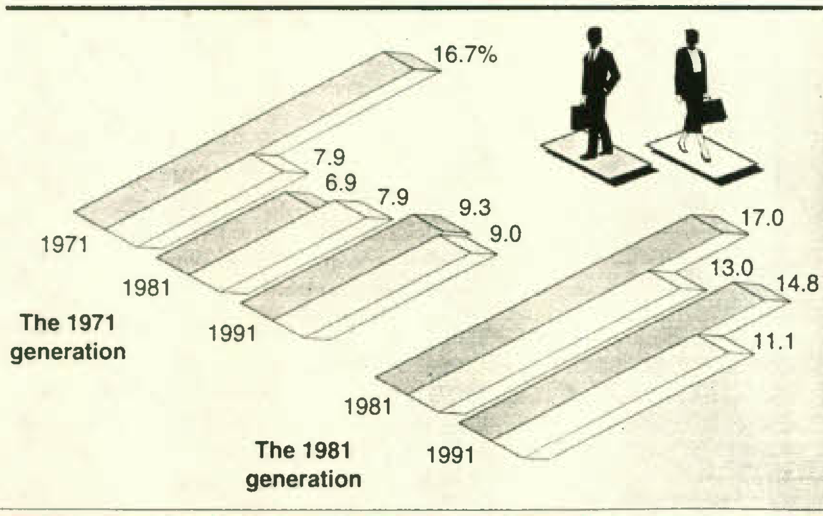
At the same time, the current plight of the jobless is cumulative in the sense that many younger workers, caught up in a cycle of short-term, seasonal, insecure jobs, may become trapped in the unemployment quagmire and find themselves unable to break away from it as they grow older. The Council views this as a profound social problem.

In the recession of the early 1980s, half the unemployed were under 24 years of age. In 1991, half of them are in the 25-44 age group. According to an analysis of unemployment data for the period 1971-89, 50 per cent of men claiming UI benefits in 1989 were doing so for the fifth time or more. Among women, dependency on unemployment insurance was much weaker. Only 30 per cent of women receiving UI benefits in 1989 were making a claim for the fifth time. On average, UI recipients who return to work experience another spell of joblessness once every three to four years and their second spell turns out to be longer than their first.

In light of these trends, the Council would like to see a more ambitious target for reducing unemployment.

In the past, government strategy has been, at least implicitly, to alternate between fighting inflation and fighting unemployment: first attack inflation for a certain length of time, then turn the attack to the resulting unemployment. The harmful effects of this strategy make it clear that the two goals should be given equal priority. New inflation-fighting methods must be found. To achieve this, monetary policy must be complemented by two other policy instruments – coordination of fiscal policies, and cooperation with business and labour leaders.

Unemployment Rate of Two Generations of Young Labour-Force Participants, Canada, 1971, 1981, and 1991



Some fundamental shifts

In part, Canada's current political and social difficulties stem from economic problems, including the federal debt and the country's inefficient industrial base.

There are two fundamental shifts that Canada must make in order to see improvements in living standards:

1 Canadian industry must restructure itself so as to produce higher-value-added products and to meet international competition head on; and

2 Canadians must adapt to a new economic policy regime focused jointly on curbing inflation, creating more jobs, and reducing the federal deficit.

The manufacturing sector accounts for the bulk of world trade, but Canada's productivity performance in this area is particularly disappointing. Not only has Canada been lagging further behind the United States since 1980, but it has been passed by West Germany, France, and Italy. Canadian hourly compensation is still high, and productivity performance remains low relative to the United States. Consequently, Canadian industries find it harder to compete.

The arrival of new players in the international arena – including Mexico, which seeks the creation of a North American free-trade area – the emergence of the newly industrialized countries of the Pacific Rim, and the inconclusive results of the Uruguay Round of GATT negotiations all point to the importance of enhancing Canada's competitiveness.

A shift is also occurring at the domestic policy level. Initiatives are focusing on deficit reduction and greater price stability.

This process poses a dilemma, however. Correcting fiscal imbalance is essential for the future health of the economy, but at the same time the remedial measures create political and social friction; for instance, substantial cuts in cash transfers to the provinces have had a direct impact on federal/provincial relations. And friction of this kind impedes the ability of governments to tackle pressing short-term problems such as recessions.

The federal budget of February 1991 took steps to break the deadlock caused by inflation expectations, tight credit, and budget deficits. For the first time in many years, there is clear evidence of close coordination between federal fiscal and monetary policies.

Most of the provinces have adopted similar budget strategies, with the exception of Ontario, which in its last budget injected about $800 million of discretionary stimulus. At the end of fiscal year 1993-94 – two years after the anticipated end of the recession – the Ontario deficit will still stand at $8.4 billion. The net effect of the Ontario budget was to undo about one fourth of the contribution towards restraint made by the other provinces.

Overreliance on monetary policy to control inflation in recent years has had costly consequences. High interest rates have frustrated the government's efforts to reduce the deficit and have caused the Canadian dollar to rise in value. This, in turn, has diminished the competitiveness of Canadian exports.

The Council is pleased to see some encouraging initiatives in the area of cooperation, such as the new Labour Force Development Board. Several jurisdictions, including New Brunswick, Saskatchewan, Nova Scotia, and the Yukon, have agreed to establish parallel organizations.

Medium-term outlook and targets

According to the Council, as the economy recovers from recession it can grow at a rate of between 4 and 5 per cent during the 1992-95 period without jeopardizing prospects for a further decline in inflation rates. Once recovery is complete, a growth rate of 3 to 3.5 per cent is compatible with low inflation.

Over the medium term, the federal government's inflation targets of 3 per cent by 1992 and 2 per cent by 1995 appear to be attainable. However, the Council questions the appropriateness of an inflation target of less than 2 per cent after 1995. More research on the subject is necessary before setting long-range objectives of this kind, writes the Council.

These economic projections depend, however, on a number of domestic and international factors, including relative political stability in the Soviet Union and the Middle East, strong economic growth and low inflation in the United States, acceptance by both the public and private sectors of the proposed inflation targets, a gradual reduction in the borrowing requirements of the federal and provincial governments, and movement towards the resolution of constitutional issues.

ECC seminar program

The Economic Council periodically releases a list of its upcoming seminars, which are open to academicians, researchers from the public and private sectors, and interested members of the general public.

Below you will find the schedule of Council seminars (and guest speakers) planned for the next six months.

For more information about the seminar program please call (613) 952-1711.

Date	*Speaker*	*Topic*
December 11, 1991	Dr. Michael Wolfson Director General, Social and Economic Studies Statistics Canada	A Template for Health Information
January 15, 1992	Prof. David Laidler Department of Economics Univerity of Western Ontario	Price Stability and the Monetary Order
February 12, 1992	Prof. Lars Osberg Department of Economics Dalhousie University	Social and Economic Rights in a Constitutional Revision
March 11, 1992	Prof. Steven Globerman Department of Economics Simon Fraser University	Intra-Industry Trade
April 9, 1992	Prof. Pierre Fortin Centre de recherche sur les politiques économiques Université du Québec à Montréal	Persistence of Unemployment in Canada
May 20, 1992	Prof. Christopher Freeman Science Policy Research Unit (SPRU) University of Sussex (England)	The Future of Economics
June 15, 1992	Prof. Richard Lipsey Canadian Institute for Advanced Research (CIAR) Simon Fraser University	The Long-Term Determinants of Economic Growth in Advanced Countries

Mergers and acquisitions

Corporate takeovers and mergers have a tendency to grab the headlines in the economic sections of leading newspapers.

That is not surprising. In the eyes of many business people and observers, the size of a company is important: large is beautiful, because it suggests excellence and the ability to compete. The bigger the company, in this view, the more profitable it must be.

In a recently published study on acquisitions and mergers – the two main avenues for increasing company size – two researchers from the Economic Council, Abraham Tarasofsky and Ronald Corvari, challenge some of those clichés. Their main conclusion is that as a means of expanding operations, takeovers have little impact, on average, on the financial health of corporations.

The two economists analysed over 100 corporate takeovers and mergers in Canada during the period 1963-83. All of the companies involved were publicly traded on stock markets both before and after their acquisition.

The authors found that the average profitability of acquired firms as a group tended to remain unchanged after the transaction: about 40 per cent of them became more profitable, and an equal proportion saw their profitability deteriorate; the remaining companies showed no change. This was true regardless of whether the acquired company was Canadian- or foreign-owned.

Corporate takeovers, which first appeared at the beginning of this century, occur in cycles. As the authors point out, because of the sheer complexity of the subject and of the scarcity of data, great caution must be exercised in analysing mergers and acquisitions.

Profitability is only one criterion that can be used to gauge the economic effects of corporate takeovers. The two economists propose an ambitious research program that would identify other criteria, assess the economic impact of takeovers, and determine appropriate policy responses.

The many-sided corporate takeover

The corporate takeover is a multifaceted activity and may be set in motion for a wide variety of often overlapping reasons. Once a company has decided to expand its operations through acquisition, it may proceed directly (by buying the assets of the targeted firm) or indirectly (by purchasing a controlling portion of its shares).

There are three types of acquisitions: horizontal, vertical, and conglomerate. In a horizontal acquisition, both the buyer and the acquired firm are in the same industry; in a vertical acquisition, one of the two parties to the transaction produces a good or service that is an input to the operations of the other; and in a conglomerate acquisition, the products of the firms are not directly related.

In all three cases, the firm that is planning to expand must ask itself whether it is more advantageous to acquire the assets and facilities of another than to expand its own operations. Similarly, the target company must determine what arguments will convince shareholders that they will benefit more from selling their shares than from maintaining the status quo.

Specialists have suggested a number of factors that may enhance the attractiveness of takeovers to either the acquiring and the target firms, or to both.

According to Tarasofsky and Corvari, the pre-takeover profitability of a firm is a key factor in the likelihood of its becoming involved in a merger or an acquisition. There is a 40-per-cent chance that "losers" and average performers will be takeover targets, whereas only 20 per cent of the more profitable "winner" corporations risk being targets.

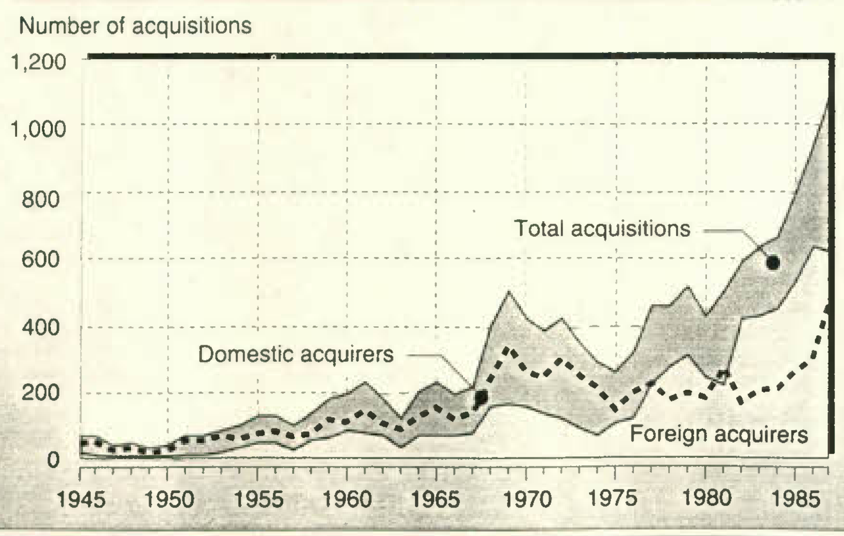
The outcome of takeovers also appears to be related to whether the acquired firm is a winner or a loser. Over half of loser corporations improved their profitability after being acquired – more than double the rate posted by winners. Conversely, well over half the winners saw their post-acquisition performance deteriorate, while only about one third of losers had the same experience. The results were more evenly distributed in the large category of average performers, with negative results outweighing positive outcomes.

The reasons a firm decides to expand by acquiring another boil down to one overriding goal: the new owners want to increase profits.

Rather than compare corporate takeovers and mergers to a marriage, the authors suggest that they should more appropriately be viewed as transactions between two parties, one of which immediately ceases to be a separate entity while the other undertakes to create a third party whose success will determine that of the whole venture.

According to Tarasofsky and Corvari, the main impression emerging from a comparison of the pre- and post-

Domestic and Foreign Acquisitions in Canada, 1945-87



acquisition profitability of firms as a group is one of motion without movement – certainly without progress – no matter what measurement techniques are used: when a Canadian company is acquired by another firm, it has only about two chances in five of seeing its profitability improve and is just as likely to see it decline.

Managers and shareholders

Overall, these results are of great interest from several points of view. They show, for example, that managers are often the first to pack their bags and leave after their firm is acquired by another. As for the shareholders, although they are indispensable to the process, they tend to remain passive and acquiesce in the proposed transaction. Since it is their assets that are at stake, they should understand that a takeover bid, although invariably presented to them as being in their interests, is just as likely to leave them worse off as better off.

The managers of target firms are often no more than bystanders to the entire takeover process, unless they are themselves shareholders. Not surprisingly, some of them are left wondering how they will fit into the new "ménage."

The authors also note that the organizational dynamics associated with acquisitions have been largely neglected by both economists and scholars in other disciplines and that much of the available evidence on this subject is anecdotal.

Problems

Acquisitions typically involve firms that are far apart geographically, and this may give rise to problems. For example, an acquisition may have the curiously perverse effect of increasing both the job security and the frustration levels of incumbent managers. Enjoying perhaps less autonomy than before, they must now follow the dictates of a new management team whose "feel" for the local situation may be, at least for a time, superficial or even deficient.

If the incumbent managers are replaced by a new team, the latter may find itself faced with a good deal of suspicion or even hostility from subordinates who had grown accustomed to working with the previous team.

Sometimes, the new owners insist on forcing the acquired firm into a straitjacket to make it conform to some preconceived notion. However, this may result in discarding the benefits of many years of hard work by the firm's previous management. If the new managers arrogantly reject any possibility of alternative approaches, they may end up losing more than they gain. And yet, the higher the price of the takeover, the greater the likelihood that control will be tight and uncompromising. At the same time, the former managers are unlikely to be inclined to roll out the red carpet for the new "bosses" sent by the acquiring firm.

The two authors also note that the managers of acquiring companies are sometimes more concerned with increasing corporate size – and their own "empire" – than with improving profits, as the shareholders would probably prefer. This may give rise to differences of views with the existing managers.

A limited phenomenon in Canada

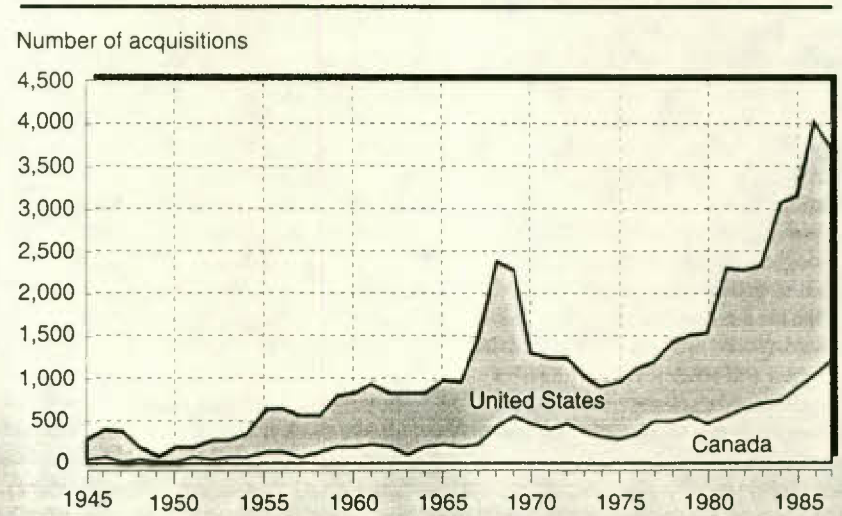
The proportion of takeover candidates is smaller in Canada than in some countries with a comparable degree of development – the United States, for example. The shares of traded corporations are probably less widely held in this country than in the United States.

Operating under the eyes of fewer but more observant shareholders, Canadian managers may be more protective of shareholder interests and may be less likely to embark on ill-advised acquisition projects or succumb to the temptations of empire-building. Canadian managers are generally more cautious.

Tarasofsky and Corvari discuss the course that government should follow, given the finding that takeovers are not a particularly promising way for firms to expand and the fact that government can no more force corporate managers to act prudently and wisely than it can legislate morality.

The authors suggest that governments can still take action to ensure that shareholders are well informed about what is going on in the industry. For example, they could pass legislation forcing management to provide more complete information on acquired subsidiaries.

Acquisition Activity in Canada and the United States, 1945-87



The business of Prairie farming

Ken Stickland has been a member of the Economic Council since 1987. As a farmer and agricultural adviser, Mr. Stickland is familiar with the important challenges facing today's Prairie farmers. In particular, he is knowledgeable about the government's various agricultural assistance programs. *Au Courant* recently had the opportunity to interview Mr. Stickland.

Au Courant: Being in the consulting business, are you still managing your family farm?

Stickland: I spend about 95 per cent of my time in the Edmonton consulting firm, including 30 per cent on many farm-level marketing decisions with different family farm operations all across Alberta. Our Red Deer grain farm is one of my larger customers and gets help about every two weeks plus one to five days of physical work during most harvests.

Au Courant: As a consultant, how do you interact with your farmer clientele?

Stickland: I speak at agricultural conferences and run three strategic planning seminars each year in five locations. I communicate with them weekly by recorded telephone message and respond to their individual phone enquiries. When on their farms, we talk not only about economics but also about human relations and other factors involved in farm decisions. Farming is a pretty complex and intriguing family business. One of our objectives is to encourage the full participation of the family members, particularly farm women.

We discuss the economic, political, biological and weather signals as to what to grow and when to put the crops on the market in the most advantageous way. We try to remain focused and strategic, regardless of whether our assistance is in individual consulting, seminars, a newsletter or through software. For example, we sell and train farm families to use FMS – farm financial management software – to plan, record and evaluate all enterprises on and off the farm.

Au Courant: Does that mean that most farmers use a personal computer?

Stickland: Oh no. Whereas 40 to 50 per cent of small businesses in urban areas would have computers, agriculture lags behind, with only about 15 per cent of farmers having one. Effective computer use for management purposes is limited mostly to specialized or larger farms or to advisors; but the GST and the need for bookkeeping for programs such as the Gross Revenue Insurance Plan (GRIP) and the Net Income Stabilization Account (NISA) should accelerate the adoption of computers.

Au Courant: How do the latest government programs differ from the traditional farm commodity programs?

Stickland: There was a major shift in 1991, the biggest since the formation of the Wheat Board in 1935. Essentially, it's a movement away from the "collective" Western Grain Stabilization Act (WGSA) system to an "individual" insurance mechanism that protects against fluctuations in grain incomes. In that sense, we've moved towards the American style of farm programs. Under GRIP, for example, assured target revenues vary between farmers because of crop mix, crop insurance, yield experience, and program options. This calls for individual decision making.

We have developed spreadsheets and we provide regular predictions of the impact of the government program to make sure that the control of the farm remains with the farmer and that he is not blindly influenced by perceptions and "coffee-shop" decision making. Farmers are very independent people. Sometimes government programs become the big determinant, but as an independent consulting firm, we help the family to retain control.

In the past, a lot of farmers weren't buying crop insurance. They probably didn't think it was appropriate, didn't understand it, or didn't feel the need for protection. So this spring government came along, not with hail or weather protection, but with price/income protection. Would the farmers, who had rejected crop insurance, opt for the new price/income insurance? It was a real struggle, and I think the Economic Council can take some credit for its recommendations in 1988 that farmers should show some risk management initiative if they expect public help during extreme times.

Ken Stickland

What's curious is that I'm sure that if farmers and the Council had been in charge of these programs, GRIP and NISA would have been introduced in reverse order, NISA first and GRIP second. GRIP came out first when it appeared that GATT was going to fail. With the prospect of a greater farm income problem, the government next responded with the NISA proposal. NISA is broader than GRIP, it's more flexible and it's almost to the letter what the Council had proposed in 1988 as an income stabilization fund, a saving mechanism.

Au Courant: What was the community's reaction at that time?

Stickland: What was fascinating for me as a Council member was to hear the arguments of professional, university and other researchers, on the 1988 Agricultural Advisory Committee (which the Council formed to assist its research team) discuss the document then see it go through a full Council and now witness some of its policies be implemented three years later. I saw the willingness of business and taxpayers to help agriculture, subject to specific guidelines. I then saw the agricultural community go through an intensive policy review in 1990, followed by a Farm Income Protection Act, implementation of the GRIP and NISA programs, and then the outcome. The government had to sell its program, so it made a pay-out during the first year. It's as if you had bought fire insurance knowing that you were going to get a payout the first year.

The controversy about the GRIP program in the West was about two or three times as intensive as the debate in the East. It is a relatively good program. Some economists criticized it, claiming that GRIP would encourage wheat production and aggravate the adjustment out of glutted grain markets. Those February 1991 criticisms got the debate going when farmers should have focused on understanding GRIP and made a yes/no decision. A lot of farmers got lost in that debate, delaying their entry until May, when they joined like lemmings.

Au Courant: Did you have any problems with the GRIP program?

Stickland: The major drawback is that GRIP uses a 15-year moving average in order to raise the level of support high enough for Saskatchewan. You will recall that the Council was recommending about a five-year moving average of income, but GRIP is based on a 15-year moving average of grain prices. I think that 15 years is too long. Structural shifts have moved the price of wheat lower than the 15-year average. Setting it so high will favour wheat over livestock production to a certain extent. The preoccupation with the GRIP decision may have inhibited farmers from planting forages and barley.

Yet the government was aware of some of the program's problems. By April, it announced some fine tuning. More money was made available to farmers for planting grass as permanent cover on erosion-sensitive land. Furthermore, when you work at the farm level, as I do, you just don't let a farm program stop clients from diversifying. You look at any program as support along the way to a more world-competitive farm. So we counselled adding grass or pea acres, even if there was a lower GRIP target revenue. Good farmers are looking for the sum of all the factors – for the optimum situation – and surely the market is saying, "get diversified." Governments try their best and send us signals, then good managers and their advisers apply some common sense about what's good for the long run.

A serious drawback with GRIP is the delay in payout, which is affecting cash flow. Three payments are anticipated after harvest in November, in June 1992, and then in January 1993. Angry rallies this fall are mostly about the timing of GRIP help, not the magnitude.

Au Courant: NISA is the farm program that is closer to the Council proposal?

Stickland: Exactly. Part of the Council's objective was to encourage asset diversification. Instead of putting profits into more land during good times, under NISA farmers can put it into bonds and then during bad times they'll have access to cash to cover the downside risk. Farmers loved NISA. In Alberta, farmers kept saying, "I wish the NISA program was here because I would join that right away but I'm not so sure about this GRIP program." That increased the farmers' frustration. It would have been more appropriate for NISA to come first and for GRIP to come later. But the federal government couldn't get the provinces to agree, so GRIP came first and NISA last.

Au Courant: Is there any way of switching from GRIP to NISA?

Stickland: Yes, but slowly. Once the grain farmer signs up for GRIP, he must stay in it for four years. Now that NISA is available, more farmers will probably plan this spring to give notice of intention to leave GRIP while continuing their inputs to NISA.

There has been some loss of freedom by the farmers who joined GRIP. But from a taxpayer's perspective, from a local businessman's perspective, GRIP makes a major contribution to lowering risk; and, remember, the title of the Council's report was *Handling the Risk*. GRIP only covers prices up to 70 per cent of the 15-year indexed moving average, so you still have a 30-per-cent unprotected swing. That is more risk than most urban businesses are subjected to, but clear-thinking farmers are saying, "GRIP makes the farm business a bit more reasonable."

Au Courant: Do these farm programs favour the smaller or larger farms more than the earlier farm programs?

Stickland: There is no limit on the size of payout under GRIP, and there are going to be some large cheques. Effectively, then, the medium-sized and larger farms get more from GRIP. The concerns of the Council, therefore, were not met by GRIP but they were met by NISA. The government sets a limit on the maximum pay into NISA (and hence payout). NISA also has a low-income trigger, similar to what the Council proposed.

Au Courant: If farmers should switch from GRIP to NISA over the longer run, how do you think it will affect the exit of farmers from agriculture and the size of farming communities?

Stickland: A good question! In the short run, GRIP will provide considerable stability to farmers and the rural communities, but that comes at the cost of continued unrealistic upward pressure on land prices and rents. Within three to four years, GRIP's bias towards wheat will be less. Providing NISA is broadened to include livestock, it will probably have a positive effect on diversification and hence on rural employment. NISA may affect the small towns more than other government programs did in the past; it should encourage liquidity, enabling farmers to be more entrepreneurial and to invest in municipal bonds or other financial instruments, or perhaps in hometown business. So NISA should make a positive contribution to rural development over the longer term.

(See *Handling the Risk*, ECC 1988)

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