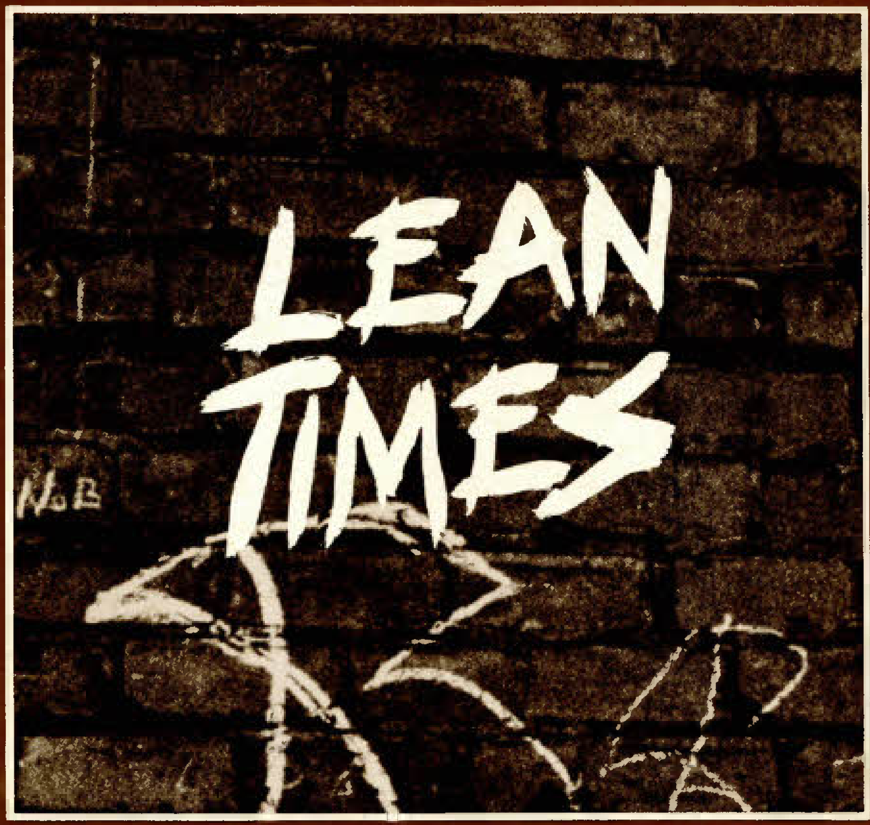
au courant

Economic Council of Canada

Volume 3, No. 2 1982

Outlook for the economy



Government project backfires

New energy study underway

Topical look at job-hunting

PUBLICATIONS

Nineteenth Annual Review

Lean Times: Policies and Constraints (EC21-1/1982E; $5.00 in Canada, $6.00 elsewhere).

In this year's review of the economy, the Council takes a look at Canada's short-term economic prospects in the context of current lean times, examines their implications over the medium-term, and makes policy recommendations. The 1982 review is now available in bookstores across the country, and may be ordered from the Canadian Government Publishing Centre (see below).

Annual Report

This year's annual report includes a message from chairman David Slater, and details on Council research projects currently under way. For a free copy, write to the Communications Division (address below).

Research Studies

Research studies are published by the Economic Council in both official languages. A list of French titles is available on request. Each study clearly attributes the findings and conclusions to the individual author or authors rather than to the Council.

The following research study has been published since the last issue of *Au Courant*.

Equalization in a Federal State: An Economic Analysis *by Robin Boadway and Frank Flatters* (EC22-105/1982E; $6.95 in Canada, $8.35 elsewhere).

Discussion Papers

Discussion papers are typically of a technical nature, and are intended for distribution in limited numbers to individuals who may have a particular interest in these or related fields of research. Of varying length and complexity, these papers are reproduced only in the language in which they are written. Each paper is the personal responsibility of the author or authors, and distribution under the auspices of the Council does not, of course, imply that the conclusions of the paper have been endorsed by the Council.

No. 217 "An Analysis of the Federal Make-or-Buy Policy," *by A. B. Supapol and D. G. McFetridge.*

No. 218 "The Evolution of Industrial Policies in Canada: An Historical Survey," *by M. Bliss.*

Reprints

The following report and studies have been reprinted, and can be ordered according to information below:

Living Together: A Study of Regional Disparities (EC22-54/1977E; $7.50 in Canada, $9.00 elsewhere).

Meeting Skill Requirements: Report of the Human Resources Survey, *by Gordon Betcherman* (EC22-100/1982E; $6.95 in Canada, $8.35 elsewhere).

The Choice of Governing Instrument, *M. J. Trebilcock, D. G. Hartle, R. S. Prichard and D. N. Dewees* (EC22-101/1982E; $8.95 in Canada, $10.75 elsewhere).

How to order

Research studies and Council reports are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request. These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Hull, P.Q., K1A OS9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

Discussion papers, *Au Courant*, and the Annual Report are available without charge from the Communications Division, Economic Council of Canada, P.O. Box 527, Ottawa, Ontario, K1P 5V6.

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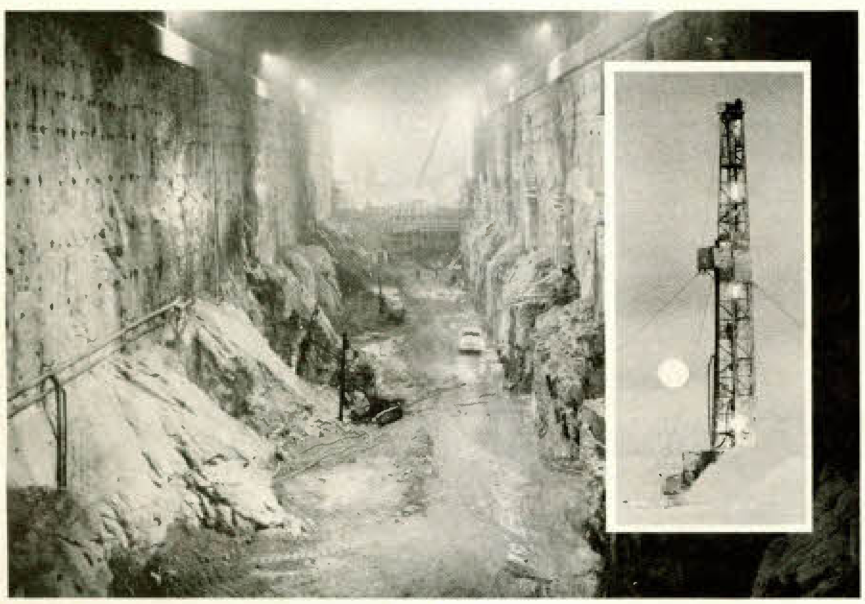
Volume 3, No. 2 1982

Nineteenth Annual Review

Highlights from the Council's review of the Canadian economy for 1982:



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1867-1982

Canada's industrial strategy – still incoherent after all these years

The notion that Canada had, has, or ever will have a single, coherent industrial policy is fantasy pure and simple, according to a University of Toronto historian.

"In the realm of industrial policy, as in so many other areas of our national life, we have to learn to live with diversity, *ad hoc*ery, and a certain amount of disorder," says Michael Bliss, in a paper written for the Economic Council's research into technological change, productivity, and growth.

The author surveys the range of industrial policies pursued by Canadian governments since Confederation, and describes their evolution through to the present. From a historical perspective, he says, the most arresting characteristic of Canadian industrial policies is their sheer variety. Equally striking, in his view, is the unlikelihood "that a single Canadian government has taken stock of the full range of its industrial policies, let alone analysed their origin, evolution over time, degree of coherence, or effectiveness."

In the 19th century, the main industrial policy instruments were the tariff and state control of resources, the former used to develop secondary industries, and the latter to develop resource industries and the railways. Government decision making in these areas, though, was not consciously based on a coherent strategy aimed at linking central Canadian manufacturing with western resource production via an intercontinental railway system, despite historians' arguments to the contrary. In reality, the so-called National Policy of the day referred only to the tariff. "The imputation of a clear, planned and effective relationship between the National Policy of protective tariffs and Canada's other national policies is actually an intellectual construct, imposed after the fact by economists looking backward through glasses tinted by a preference for rationality and clarity," Bliss maintains.

And in retrospect, these policies may not have been successful, he adds. Later analysts have claimed, for example, that the tariff reduced per capita incomes, that the Canadian Pacific Railway was too costly and too early, and that free homesteading grants probably encouraged agricultural settlement before it was socially profitable.

While the years 1867 to 1914 formed the classic period of Canadian development, the decades of the 1920s and 1930s were a time of gathering uncertainty, followed by severe economic crisis. In this climate, traditional industrial policies were thrown into question: some had to be drastically altered; and new policies were developed to meet new problems. For example, growing interest in monetary policy as an instrument to help bring about economic stability ultimately led to the founding of the Bank of Canada; the enormous unemployment of the 1930s fostered a wide variety of policies aimed at job creation; and the Crown corporation and, temporarily, cartelization, were added to the industrial toolkit.

For a brief period following World War II, industrial policies at the federal level actually showed signs of coherence and conscious planning, for two particular reasons: government decision makers, guided by economic super-minister C. D. Howe, agreed that Canada would benefit from international economic co-operation; and a relative eclipse of the provinces as a result of depression and war left Ottawa almost alone on the national policy making stage. Whether this halcyon consensus period made a positive impact on the course of industrial development is yet to be determined, Bliss remarks. Mistakes were undoubtedly made: enthusiastic support for sophisticated aeronautical and other military technology, for example, led to expensive and unproductive commitments, such as the AVRO Arrow project.

A major recession at the end of the 1950s shattered earlier optimism, and brought in its train "a blooming, buzzing confusion" of industrial policy making. High unemployment rates, growing awareness of regional disparities, fears that manufacturing was on the decline, and exploding world oil prices in the early 1970s were some of the concerns that brought about a considerably greater degree of government intervention in the form of a bewildering variety of policy initiatives.

In sum, Bliss says, little rhyme or reason has governed industrial policy development in this country. A moot point, indeed, is whether "Canadian prosperity is a legacy of visionary, effective government economic management, or . . . a testimonial to the triumph of Canadian resources and enterprise over political mismanagement. . . Perhaps the net effect of Canadian industrial policies," he concludes, "is to have made the Canadian people poorer than they would have been had they been far less governed."

He calls for future industrial policy making guidelines with more conscious consideration of the aims, nature, and likely effects of any given action by governments. "We may never be able to walk in a straight line towards our goal, but it will surely help if we stop walking in the dark."

"The Evolution of Industrial Policies in Ca[nada:] An Historical Survey," by Michael Bliss. D[iscus]sion Paper No. 218.

Government research policy backfires

An effort to award government research and development contracts to private industry has backfired, according to a recent Economic Council paper.

Carleton University economists A. B. Supapol and D. G. McFetridge, in research conducted for the Council's study on technological change, productivity, and growth, claim a federal government decision to contract out its research and development (R&D) work to private industry has not had the anticipated result. Ironically, instead, it "has not increased contracting-out in areas where there are potential benefits, and has increased it in areas where there are not," they say.

Increasing concern that Canada was not benefiting enough from its R&D effort, primarily because too much R&D was being conducted by government, and too little by industry, has led to the establishment of several new programs over recent years. Each sought to create an environment more conducive to industrial R&D. Private industry, the argument ran, was better geared and motivated to produce "spin-offs" from R&D projects, in the form of new technological advances, new products, or new industries. So, putting the research conducted by federal government departments into the hands of industrial companies should lead to the development of many more successful innovations.

One such program, the "make-or-buy" policy, was set in motion by Cabinet in 1972. Its directive required all new departmentally funded research with definite goals to be contracted out to industrial firms.

The authors' analysis, though, finds flaws in this blanket approach. "One of our principal conclusions," they say, "is that a universal contracting-out policy such as the make-or-buy directive, is not necessarily conducive to more effective use of our research resources." They make the case that farming out R&D projects is worthwhile only under certain conditions: when the objectives are clear, and performance easily measured; when the technology involved is relatively well known; and when the research does not involve a large investment in specialized facilities. Generally speaking, industrial, applied R&D falls into this category.

When they test the policy's success rate to date, by a close look at the R&D operations of seven federal departments – National Health and Welfare, Environment, Agriculture, Communications, Energy, Mines and Resources, Defence, and Transportation – the authors find it has rarely been on target.

To begin with, the departments doing R&D with the greatest commercial potential simply did not comply with the directive, sometimes wisely so. One such example, Communications, is a department where theoretically the new policy should work well: it ranks first in the number of R&D contracts awarded to manufacturing firms, and was heavily involved in industrial contracting-out prior to the new directive. Yet, as the chart shows, it did not step up this activity with the policy's appearance. The implication here, say the authors, is that Communications had been making the most of the contracting-out procedure in any case, and had reached the saturation point by 1972, rendering the make-or-buy directive redundant.

In contrast, another noncomplying department, Energy, Mines and Resources, did little contracting-out to industry either prior to or following the new directive, even though it was engaged in many suitable scientific projects with commercial possibilities. One explanation for departmental reluctance to follow the policy, the authors conjecture, is "the priority attached by the department to assembling and maintaining an internal R&D staff." That being the case, "the goals of EMR would appear to be incompatible with those of government."

A third department, Defence, may have resisted implementing the policy as well, although evidence is ambiguous. The department did a good deal of contracting-out prior to the directive but less thereafter. The possible failure of the policy in this case, Supapol and McFetridge say, may reflect high contracting costs or, perhaps, conflicting departmental and governmental goals.

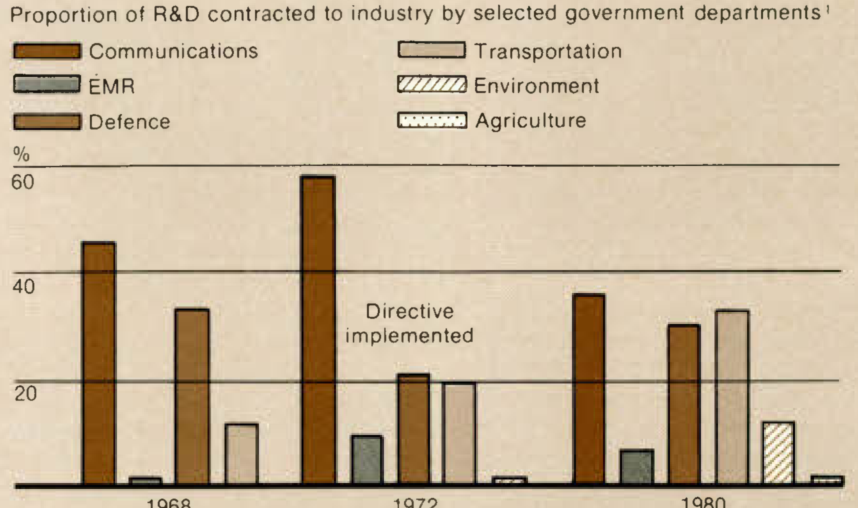
Four departments – Health and Welfare, Environment, Agriculture, and Transport – did implement the directive as requested, but with negative results. The first three did virtually no research with commercial appeal, so most contracts went to the service sector rather than to industrial companies. The fourth, Transport Canada, handed out a high proportion of its contracts to service firms, too. In this case, though, departmental R&D projects in the works did have commercial possibilities – but the department contended that contracting-out scientific research was frequently impracticable.

In sum, the authors conclude, despite the enormous potential of the make-or-buy policy, its net result to date has been that "constant dollar industrial R&D contracting has actually fallen, while service sector contracting has risen."

"An Analysis of the Federal Make-or-Buy Policy," by A. B. Supapol and D. G. McFetridge. Discussion Paper No. 217.

Impact of the "make-or-buy" policy

Proportion of R&D contracted to industry by selected government departments[1]



1. Exclusion of bar means no, or negligible, contracting was done by department in question

IN SHORT SUPPLY
JOBS AND SKILLS
IN THE 1980s

Women in single-parent trap

In its recent report on the Canadian labour market, the Economic Council refers frequently to groups who find themselves at a disadvantage in that market. And it examines a number of problems affecting the largest of these groups: women.

Such issues as access to education and training – and to the labour market itself – discrimination within the labour market, and the high proportion of women among the long-term unemployed are considered in the report. A particularly interesting area of research concerns a high-growth group: women who head single-parent families.

Differing family structures not only impose differing costs and constraints on the ability of individuals to participate in the labour market, but also – because of social transfer programs and the income tax system – cause remuneration to vary widely. Among a number of simulations set up for different family types assumed to be living in Metropolitan Toronto in 1979, the Council studied the case of a single-parent family in which the mother, "Mrs. Smith," was not employed but stayed home to look after her two children, aged 2 and 7.

In such a case, Mrs. Smith would receive social assistance under the Ontario Family Benefits Act. She would also receive financial assistance from Family Allowances, the refundable Dependent Child Tax Credit, and Ontario Tax Credit programs. Despite these contributions, her total income for 1979 would have amounted to only $6,131 – i.e., more than a third lower than Statistics Canada's "low income cut-off" of $9,775 for such a family in 1979.

One might assume that Mrs. Smith would be better off to arrange other care for her children and get a job. But this is by no means certain.

Suppose Mrs. Smith did decide to work full-time. She must average no more than 120 hours of work a month; otherwise, in 1979, she would be disqualified from social assistance under the Ontario Family Benefits Act. If her annual employment income amounted to half the 1979 average Industrial Composite Wage, i.e., $7,494, her social assistance payments would be reduced by more than $4,500, leaving her with just over $30 a month from that source. The other allowances and tax credits would remain the same, but Mrs. Smith would have to contribute to the Unemployment Insurance and Canada Pension plans. If she could place her younger child in a Metropolitan Toronto day care centre, she would be faced with a minimum monthly charge of $189.

When all the calculations are done, Mrs. Smith would end the year with $8,679. In other words, a full year of work would net her an additional $2,548 on a gross income of $7,494, resulting in an effective tax rate of 66 per cent on employment income. Her effective wage rate would be about $1.77 an hour, and she would therefore have joined the ranks of the working poor.

Worse still, if Mrs. Smith had no control over hours worked per month, she might be disqualified from all social assistance and related social and medical services. If space were not available in the public day care system, she would probably have to pay much more for child care. And if she could not command even half the Industrial Composite Wage, her financial position would be bleak indeed.

One way out of this kind of poverty trap, says the Council, is to increase the immediate returns to labour market participation – such as an "employment expenses tax credit" designed to assist with the cost of working.

The Economic Council plans to examine the question of women in the labour force in some detail, and will be releasing a series of studies on the subject in the future (see *Au Courant*, Vol. 2, No. 4).

Based on material from *In Short Supply: Jobs and Skills in the 1980s* (EC22-108/1982; $7.95 in Canada, $9.55 elsewhere).

Job market poor for native peoples

Among the disadvantaged groups in – or standing on the edge of – the Canadian labour market, the native population occupies a particularly unenviable position. Unemployment among native peoples is higher than for any other segment of Canadian society. Those who are employed work mainly in unskilled jobs, with low wages and poor advancement prospects.

Compounding this problem is the likelihood that native peoples will become an increasingly important component of labour supply during the 1980s. Having experienced a delayed baby boom, the working-age population of native peoples is expected to grow at a rate well over double that projected for the rest of the country during this period.

While many factors – cultural, political, and economic – enter into the problem, it is obvious that greater opportunities for education and training will be required before the native peoples can hope for even small improvement in access to the job market.

Better access means skill training. Access to skill training implies a higher level of general education than many native peoples have acquired; dropout rates are extremely high. Yet, in past years, the federal government has discontinued adult education programs on reserves, thus reducing the chances of access to many of the skills now in such short supply in the western and northern regions of the country.

Cultural differences and a history of discrimination, says the Council, would seem to make self-determination an attractive feature of any program designed to alleviate these difficulties. While government money is necessary if Canada's native peoples are to have a better chance in the labour market, past experience indicates that the benefits of funding appear greatest when a maximum amount of decision making is carried out by the native peoples themselves.

Based on material from *In Short Supply: Jobs and Skills in the 1980s*.

Timely look at job-hunting

Looking for work? You're in good company these days, one of a multitude of job-hunting Canadians who have turned this activity into a billion-dollar industry.

Even as long ago as 1977, when unemployment was not nearly as high as it is now, one out of every 10 men, women, and teen-agers in our labour force was trying to find a job, some by choice in order to better their situation, and others from grim necessity. The overall costs of their search probably ran at around $1 billion a year.

For economists and policy makers trying to come to grips with Canada's unemployment problem, understanding the whys and wherefores behind the jobsearch process has taken on considerable importance. Labour market researchers have made the valid point that unemployment resulting from the brief lags between the time people leave old jobs and find new ones – so-called frictional unemployment – can be an earmark of a healthy and dynamic labour market. All that is needed to keep everything running smoothly, they argue, is more and better information about the labour market, and policies designed to keep search costs under control.

Recently, though, others have countered that this kind of joblessness doesn't account for the greater part of the high unemployment rates plaguing many western economies today. They argue for more stringent manpower policies, such as training and job creation programs.

In any event, there's general agreement on the need for thoroughgoing research into this complex issue. So a recent Economic Council study, written in connection with the Council's report on labour markets (*Au Courant*, Vol. 3, No. 1) is most timely. Economists Abrar Hasan and Surendra Gera focus on the overall significance of job-hunting in terms of four key questions. How widespread is it? Do people follow a particular game plan when they're looking for work? What determines how long they'll put up with unemployment in order to find what they want? And finally, how many land higher-paid jobs as a result?

Analysis of the annual average monthly data from the Labour Force Survey for 1977 indicates that remarkable numbers of Canadians – one out of every 10 in the labour force – are out looking for a job at any given time. Not all are unemployed by any means; more than 25 per cent in fact are still working, but want better pay, working conditions, chances of promotion, and so forth. This group doesn't seem to be put off by job shortages either. Even in a province with high unemployment, such as Newfoundland, many employees are on the lookout for better opportunities.

Ninety per cent of Canada's unemployed are also hunting down jobs – a disproportionate number of them women, teen-agers, or young adults. And about one-third of the total have actually quit work deliberately in order to find something better.

Job hunters appear to follow a general strategy that weighs the pros and cons of further search, Hasan and Gera discovered. As a rule, they start out with a certain salary in mind, confident they'll land a more attractive position. The longer they're unemployed, though, the more prepared they become to accept somewhat lower wages – particularly during a recession. Highly paid workers and union members are relatively more flexible in this respect, partly, perhaps, because unemployment insurance benefits don't replace a good portion of their wages.

Whether it pays to go job hunting, and how long you should keep at it, depends largely on who you are, the authors found. People who quit in order to find new work usually do come up with something better – in contrast to those who have been laid off – probably because they are more informed about the job market and more self-confident, and perhaps because they seem a better bet to prospective employers. As well, people who combine on-the-job search with further hunting while unemployed do better than those who begin to look only when they're out of work.

Women benefit (as do all groups) as long as they find work within 15 weeks – but looking longer means they'll forgo 4 per cent in wages for each additional jobless month. For men, on the other hand, it pays to be even more choosy: each extra week of unemployment could add as much as $2 (in real terms) to their wages.

The explanation for this difference probably lies in the kind of jobs men and women tend to hold, the authors say. Men as a rule operate in what economists call the "primary labour market" where salaries are higher, skills greater, jobs more permanent, and promotion more likely. Job hunters in this market stand a better chance of improving their positions through an exhaustive search. Many women, on the other hand, are trapped in the "secondary labour market" in low-paying, unspecialized jobs: opportunities there are limited, with little to be gained from prolonged searching.

Active job hunters probably account for slightly less than half of Canada's unemployment rate, Hasan and Gera conclude, indicating that the labour market is functioning reasonably well, and would benefit from supply measures to streamline the matching of people and jobs. On the other hand, signs pointing to the co-existence of two labour markets suggest that manpower policies will also be necessary.

So the authors suggest taking a two-pronged policy approach to handle problems on both the supply and the demand side; and they advocate careful analysis of institutions and laws contributing to the creation of labour market barriers, with an eye to eliminating these obstructions altogether.

Job Search Behaviour, Unemployment and Wage Gain in Canadian Labour Markets, by Abrar Hasan and Surendra Gera. Available later this year.

Voter appeal key in policy making

Voter appeal, not logic, determines the choice of policies to regulate economic activity, says a recent Economic Council study.

University of Toronto professors M. J. Trebilcock, R. S. Prichard, D. G. Hartle, and D. N. Dewees, in a report prepared for the Council's study on government regulation of the economy, say that Canada's regulatory system is a creature of the political process, rather than the logical creation of economic planners. Reformers of regulation will have to come to terms with that reality, they caution, in attempting to achieve their objectives.

While subtlety is the keynote to imposing taxes, when it comes to government spending in that area "doing good works by stealth is rarely a political virtue." Transfer payments to the provinces have the poorest political pay-off in this regard, while Old Age Security, Guaranteed Income Supplement, and Family Allowance cheques, frequently accompanied by "propaganda-type messages," score the most points. The high visibility of these payments is of great advantage to a ministry when it can announce increases or extensions, the authors note.

"Asking how we can achieve superior regulation is equivalent to asking how we can achieve a better system of politics."

As a policy instrument, public ownership has its political uses, too. Crown corporations have the great appeal of "a lack of explanatory power," say the authors. They enable politicians to keep a low profile while reversing policy decisions or imposing taxes. They're attractive, too, as a way of making a symbolic gesture – on issues of foreign ownership, for example – or soothing public anxiety with promises of new beginnings, as in the recent reorganization of the post office. This policy approach is gaining in popularity, the authors say, and now touches on many fields of activity: natural monopoly regulation, such as provincial hydros and some provincial telephone systems; nation building and community development, as with the CNR, Air Canada, and the CBC; and the promotion of national security and security of supply, as with Petro-Canada, Telesat, and Eldorado Nuclear, are only a few examples.

"The striking common feature of all traditional summaries of the rationales for the choice of public ownership as the instrument of intervention is their lack of explanatory power."

Given these political realities, the authors conclude, attempts to reform regulations by improving their economic efficiency are unlikely to have much effect. In fact, they say, "Asking how we can achieve superior regulation is equivalent to asking how we can achieve a better system of politics." With that in mind, they suggest various reforms to improve political organizations and processes. Proportional representation, Senate reform, new rules on party financing, subsidization of small interest groups, and freedom of information legislation are some changes that in their opinion could make the process of policy choice more economically efficient.

Economists can make a contribution, too, by providing politicians with more and better information on the implications of policies under consideration. Even more important, they can affect the ultimate decision making process by influencing voter knowledge and understanding, and hence voter decisions. "While politicians can and do ignore economists," the authors conclude, "they cannot, however, easily ignore voters armed with relevant information."

"Most tax experts would probably agree that the manufacturers' sales tax is probably the worst major tax in existence in this country from a technical point of view."

In any democracy, their argument runs, politicians will operate with one clear goal in mind: winning elections. So, they will invariably choose policies that appeal to key potential voters, while imposing costs on other, less critical groups. "In short, a strategy that seeks to magnify the gain and depreciate the pain will be influential in instrument choice," the authors conclude.

Voter ignorance, coupled with "the mass media imperative to satisfy the demand for simple answers to complex questions" makes this tactic possible. Further, in the event that they do encounter unexpected public disapproval for a particular policy approach, politicians can easily substitute another course of action, thanks to the wide variety of potential policy instruments at their disposal.

The four professors draw attention to a number of public policies and mechanisms in order to prove their case, including Royal Commissions and Task Forces, methods of taxation and tax expenditures, use of Crown corporations, and the choice of regulatory instruments in the fields of environmental protection and agriculture.

"'Doing good works by stealth' is rarely a political virtue, where expenditures on marginal voters are concerned."

Use of illusion in taxation, in the authors' view, clearly illustrates how politicians follow the old adage that "What the eye doesn't see, the heart doesn't grieve about." They point to the manufacturer's sales tax as a classic example of a tax that raises major federal revenues and yet is unknown to most voters. Even though tax experts agree on its critical technical weaknesses, the tax remains popular with politicians for the simple reason that it lies buried in the prices paid by retailers, where increases pass largely unnoticed by the consumer.

The personal income tax is another example of political sleight of hand, in this case affecting all working taxpayers. Generally oblivious to the amount of taxes deducted at source from their pay cheques, employees tend to regard their take-home pay as their actual income – and so rejoice at any refund coming in at the end of the fiscal year, "instead of being outraged at the fact that they have been forced to make a non-interest-bearing loan to the government."

The Choice of Governing Instrument, by M. J. Trebilcock, R. S. Prichard, D. G. Hartle, and D. N. Dewees. (EC22-101/1982E, $8.95 in Canada, $10.75 elsewhere).

In this year's review of the economy, the Economic Council of Canada takes a hard look at the country's short-term economic prospects in the context of current lean times, before examining in depth the implications of these prospects for the medium term and making appropriate policy recommendations. The material on the next eight pages is based on the 1982 Annual Review, ***Lean Times: Policies and Constraints.***

Canada's economic performance has deteriorated significantly over the past year. The current recession has been both longer and deeper than most people expected, bringing with it much hardship and badly undermining the hope with which Canadians entered the 1980s.

Although the recession can't be blamed for all our ills – structural weaknesses in the economy provide their fair share of input – many domestic and external forces have combined to produce Canada's current lean times. A look at some of these forces should help put the problems facing us into perspective.

The last few years have been turbulent ones for the world economy. The international oil price shocks of the 1970s touched off waves of inflation worldwide, which tighter demand management policies ultimately translated into slowed growth – most notably, lost output and high unemployment. Still, inflation remained high.

Monetary policy was especially tight in the United States, with subsequent high interest rates largely responsible for kindling the back-to-back recessions of 1980 and 1981-82. Changes in the international trading environment added to the various forces already buffeting the Canadian economy.

The 1981-82 recession in Canada has turned out to be the most severe in the postwar period. The two recessions (1980 and 1981-82) are expected to keep average real growth to virtually zero over this period – a considerable slowdown from the average 3.1 per cent growth of the 1975-79 recovery and a striking drop from the average 5.5 per cent in the 1960s and early 1970s.

Among other things, the current recession has spawned an unemployment rate of almost 12 per cent. Despite this slack in the economy, inflation not only persisted but worsened. The 12.5 per cent rise in the consumer price index (CPI) in 1981 has been edging down only slowly and will produce a lower, but still double-digit, inflation rate for 1982.

The current weakness of demand in the Canadian economy reflects monetary and fiscal restraint, weak business finances and the reluctance of consumers to spend. The drop in demand has particularly affected the automotive industry, residential construction and business investment. In fact all the major components of demand – with the exception of government – have registered declines over the past year.

Not surprisingly, corporate finances have been squeezed by a combination of reduced profits and growing debt commitments. Slackening activity and high interest rates were largely to blame for a 22 per cent rise in business bankruptcies in 1981, with another 37 per cent increase in the first half of 1982 over the same period last year.

Higher energy prices, though unfortunately necessary on other grounds, have been a major contributor to high inflation rates. While Canadians were initially shielded from increases in world energy prices, they are now feeling their effects, with the CPI for energy rising by 16 per cent in 1980 and by 30 per cent in 1981.

Wage settlements have come to reflect the high rates of inflation, with average weekly wages and salaries increasing at an annual rate of about 12 per cent in 1981.

Employment growth, which rose rapidly in the 1970s, has weakened considerably. As mentioned, the unemployment rate is now running close to 12 per cent, a postwar record, with the long-term unemployed bearing a disproportionate share of the burden, and with certain groups and regions harder hit than others.

Through all this there has been a disturbing slowdown in long-term labour productivity, reflecting both cyclical and structural forces at work. And externally, Canada's current account balance – a source of strength in 1980 – became a factor in the economy's poor performance in 1981.

The tightening of U.S. monetary policy and resulting sharp climb in interest rates had a pronounced impact on events here. As Canadian monetary policy remained tight in the fight against inflation, interest rates followed U.S. rate increases in both 1980 and 1981, while the Bank of Canada kept a close eye on the exchange rate between the Canadian and U.S. dollars. The exchange crisis of summer 1981 – when the Canadian dollar fell 3 per cent against the U.S. dollar in as many weeks – left the Bank no choice but to hike short-term interest rates to the stratospheric level of 23 per cent. The run on the dollar was halted, but the impact of the high rates on the economy is still being felt.

Fiscal policy, for its part, was launched on a more restrictive course in the October 1980 budget. At that time, the government adopted an explicit policy of deficit reduction, with fiscal policy to be aligned more closely with monetary policy in the battle against inflation. But with an acute worsening of the fiscal position as a result of the recession, the federal government now faces a budgetary deficit of $19.6 billion for fiscal 1982/83.

Canada has entered the 1980s in difficult economic straits, and it appears Canadians will have to look to the medium term – some 3-5 years hence – for genuine signs that the current lean times are ending and that the economy is again on the way to realizing its full – and considerable – potential.

New projections for the economy

Changes in Canada's economic prospects during the last year emphasize the uncertainty of economic projections. In order to develop an up-to-date view of the future, we focus on current information about the future course of events, on the present position of the economy, and on its past performance.

As part of its yearly review of the Canadian economy, the Council makes a basic projection of the key economic indicators – which it calls the "base case" – founded on certain specific assumptions. It then uses this basic projection to try out various scenarios, or alternate cases, to see how the economy would be affected.

In 1982, a base case plus a more favourable and a less favourable projection are presented. The base case is built on a set of working assumptions related to the external environment (including international oil prices), fiscal policy, monetary policy and domestic energy policy.

Here are the highlights of the 1982 base case:

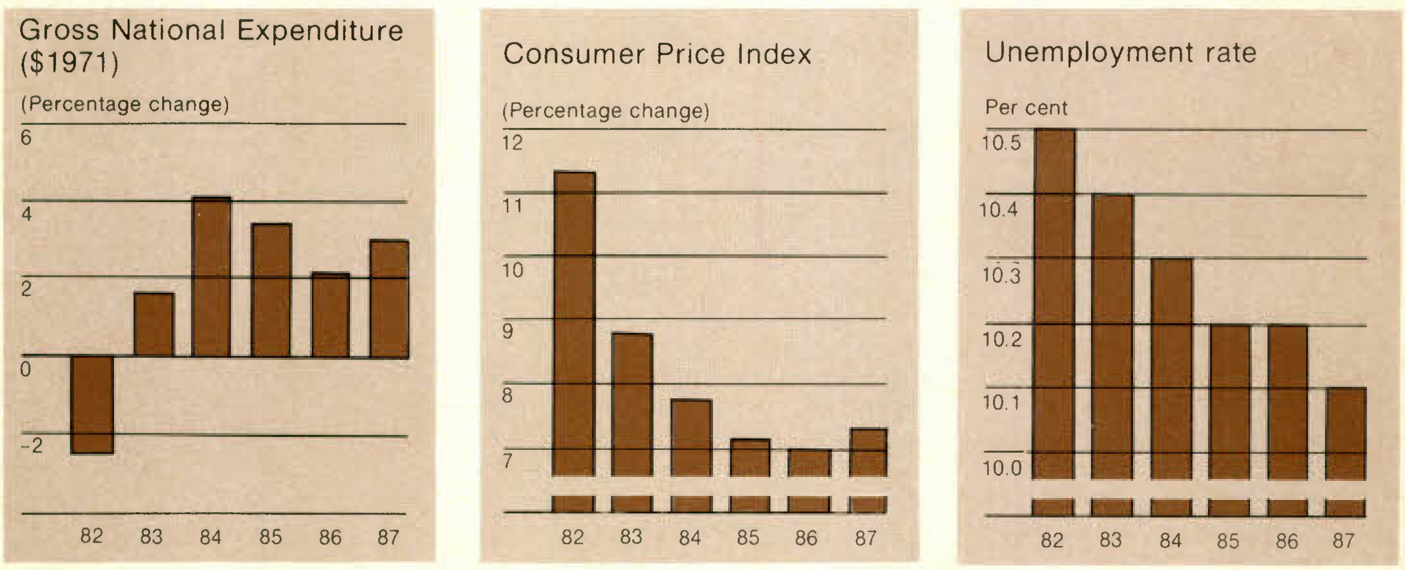
- Because of very poor performance during the first six months of 1982, real gross national expenditure (GNE) is expected to decline by 2.4 per cent for the year as a whole. Canadian economic growth will average 2.8 per cent in 1983-84 – just barely in line with potential growth – and the same in 1985-87.
- One indication of current poor performance is the anticipated average unemployment rate of 10.5 per cent for 1982. As the gap between actual performance and potential is expected to show little improvement in the medium run, the unemployment rate could average just above 10 per cent over the next five years.
- The rate of inflation, as measured by the consumer price index (CPI), will average 11.4 per cent in 1982. This average will drop to 7.9 per cent over 1983-85, with inflation nearing 7.2 per cent by mid-decade.
- Employment is expected to decline sharply in 1982. During the recovery period, employment prospects will just keep pace with relatively moderate labour force growth. By mid-decade, job opportunities will expand, but not enough to imply a substantial fall in the unemployment rate.
- In the medium run the growth of productivity and real wages will increase at a rate slightly lower than 1 per cent per year – a considerable decline from the late 1960s and early 1970s. Growth of these two key indicators will remain substantially below past performance.
- During the current recession, the personal savings rate increased to just above 13 per cent from its previous norm of about 10 per cent. With the anticipated recovery, this rate should drop by 1-2 percentage points but may not decline further in the medium term.
- Real investment as a percentage of GNE is expected to decline over 1982-84. There should be an increase in this ratio from a low of 22.1 per cent in 1983 to a high of 24.3 per cent in 1987.
- The federal deficit as a percentage of GNE will remain large and will persist to mid-decade. The sharp downturn in 1981-82 has led to a short-term erosion of the tax base, and the continued poor performance of the Canadian economy will contribute to reduced growth in all forms of tax revenue.
- The current account deficit of the balance of international payments will fall slightly as a percentage of GNE. The energy balance will strengthen in the medium run, but by mid-decade the nonenergy current account balance of payments will again show weakness.

The assumptions underlying this year's base case include, among other things: average real U.S. growth of 3.8 per cent in 1983-84 and 3 per cent over 1985-87; an increase in international oil prices of 1.9 per cent (nominal) in 1983 and an average of 2 per cent (real) over 1984-87; fiscal measures as set out in the November 1981 and June 1982 federal budgets; and money supply growth held to the midpoint of the Bank of Canada's 4-8 per cent target band.

Once the base case projections are set, Council economists then use the CANDIDE econometric model to simulate how these prospects would change if alternate cases were considered.

What lies ahead for the economy

Projected changes in key economic indicators, 1982-1987



How growth is affected

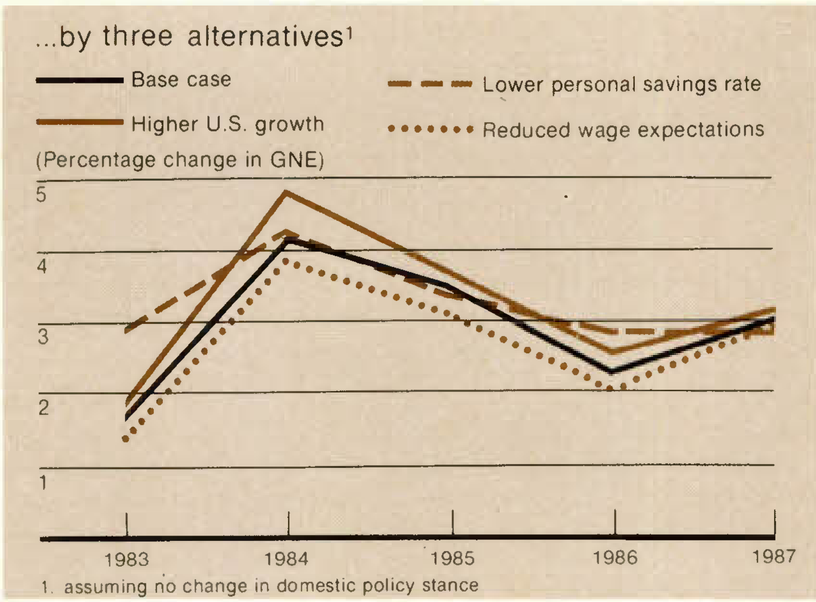
In 1982, seven alternate cases were chosen to see how they would affect the basic projections for selected economic indicators over 1983-87. The alternate cases chosen were: higher and lower U.S. growth; higher and lower international oil prices; a lower personal savings rate; reduced wage expectations; and reduced megaproject activity.

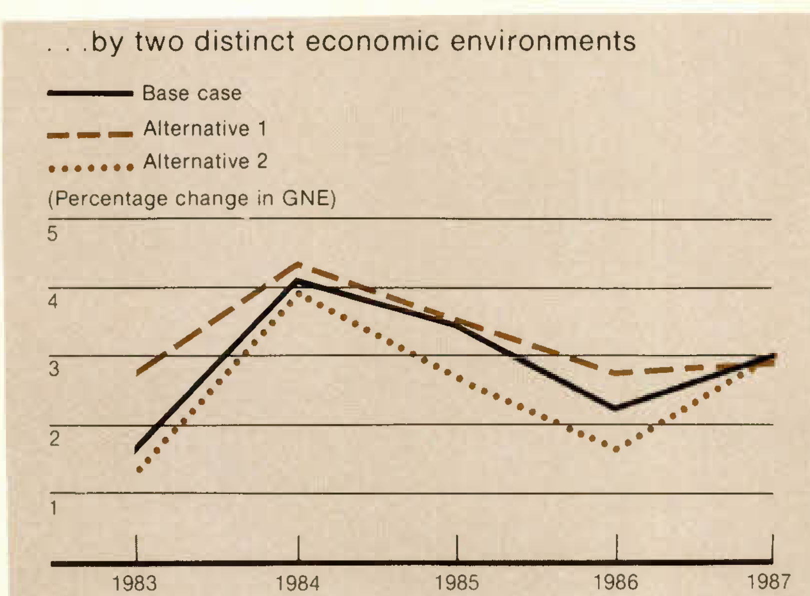
If we look at the key economic indicator of real gross national expenditure, for example, we can see just how the seven alternatives would change the basic projections for GNE over the medium term.

Considering first the impact of the U.S. recovery on the Canadian medium-run outlook, we can see that in the case of higher U.S. growth, real growth of Canadian GNE cumulatively could be 1.2 percentage points higher by 1985 (see chart). On the other hand, lower U.S. growth could reduce GNE growth cumulatively by nearly 1 percentage point over 1985-87. So even a strong U.S. recovery cannot be counted on by itself to improve the outlook substantially.

In the case of international oil prices, an assumption of higher prices over 1983-87 than those projected in the base case implies lower real GNE growth as well as higher rates of inflation and lower federal deficits. Lower international oil prices would produce the reverse.

The influence of the personal savings rate on Canadian medium-term prospects is significant. The base case projection for 1983-85 shows a decline in the rate to an average 11.3 per cent, leveling off to an average of about 11 per cent in 1985-87. In order to see what a personal savings rate lower than that projected might produce, Council economists developed a case where the savings rate would average about 9 per cent during 1985-87, with a prior decline to 10 per cent in 1984. If this were to occur, real GNE growth in Canada could reach an annual average of 3.2 per cent in 1983-87, substantially above the 2.8 per cent average of the base case projection.





Turning to the effect of reduced wage expectations on real GNE growth in the medium term, Council economists speculated on the outcome if the federal government's wage restraint guidelines reduced wage expectations throughout the economy to 6 per cent in 1983 and 5 per cent in subsequent years. Inflation would be lowered, but not by as much as wages. The growth rate of GNE would be depressed by the real wage loss.

The seventh alternate case, reduced megaproject activity, would cut back GNE growth in 1985-86, with a lower ratio of investment to GNE and higher unemployment rates.

Finally, Council economists considered combinations of some of the above alternate cases which, if incorporated in the base case, could have a significant impact on the base case projection.

For example, we could combine higher U.S. growth, higher international oil prices, a lower personal savings rate and reduced wage expectations to yield alternative 1. In this case, real GNE growth would average a little less than 3.5 per cent over 1983-85, a substantial improvement over the 3 per cent average of the base case projection for this period (see chart). This alternative would also produce a decline in both the unemployment rate and the federal deficit, though not enough to balance the federal budget or return unemployment rates to the level of 6 per cent.

On the other hand, we could assume a combination of lower U.S. growth, lower international oil prices and reduced megaproject activity to give us the less favourable alternative 2. This would produce a mid-decade reduction in real growth, combined with continuing high unemployment rates and federal deficits.

It would seem then that even in the best of circumstances, Canadians cannot expect a dramatic improvement in economic prospects over the medium term.

Key medium-term issues

In assessing the Canadian economy's current lean times, the Council took an in-depth look at four important medium-term issues – inflation, investment, housing, and the current account of the balance of payments.

While these issues are all related to present economic difficulties, each also embodies fundamental problems with potentially important implications for the economy's performance in coming years. The problems and challenges posed by inflation, for example, constitute a recurrent theme that will be with us for some time yet, affecting the other three issues in a wide variety of ways.

Inflation

Concern over inflation is not new, but it has become more pressing in recent years with high rates of price increase that are becoming deeply entrenched in the Canadian economic system. As a result, there has been a sharpening of the conflict between those who are concerned about the failure of government policy to significantly reduce inflationary pressures and those who worry about the costs such policy measures would entail.

Certainly a sustained weakness in demand will eventually produce a substantial reduction in inflation. Price and wage expectations will change over time in response to vigorous anti-inflationary policies. The federal government's 6 and 5 per cent guidelines set out in the June 28, 1982 budget may help speed up the process.

As this occurs, the reduction in demand imposed by the government will likely have more of an effect on prices and show up less in the form of reduced output. Because of the large chronic component of inflation, however, these results will probably materialize slowly and at considerable cost.

If the development of an appropriate policy response requires an understanding of the costs of reducing inflation, it also implies an appreciation of the costs of living with it. The latter comprise economic efficiency costs, which arise because the inflationary process leads to some forms of waste and the use of additional resources, and distributive costs, which result from the fact that inflation produces both winners and losers.

Economic costs arise from the effect of inflation on economic growth, because rising prices lead to the use of additional economic resources and produce distortions and other inefficiencies. Examples include the difficulties and costs of long-term planning when there is much uncertainty about future price performance, and distortions in the tax system.

The distribution of income and wealth is also affected by inflation. According to the Council, winners here include those who have held appreciating assets, such as real estate, while losers include those who have held long-term fixed-income financial assets and unindexed pensions.

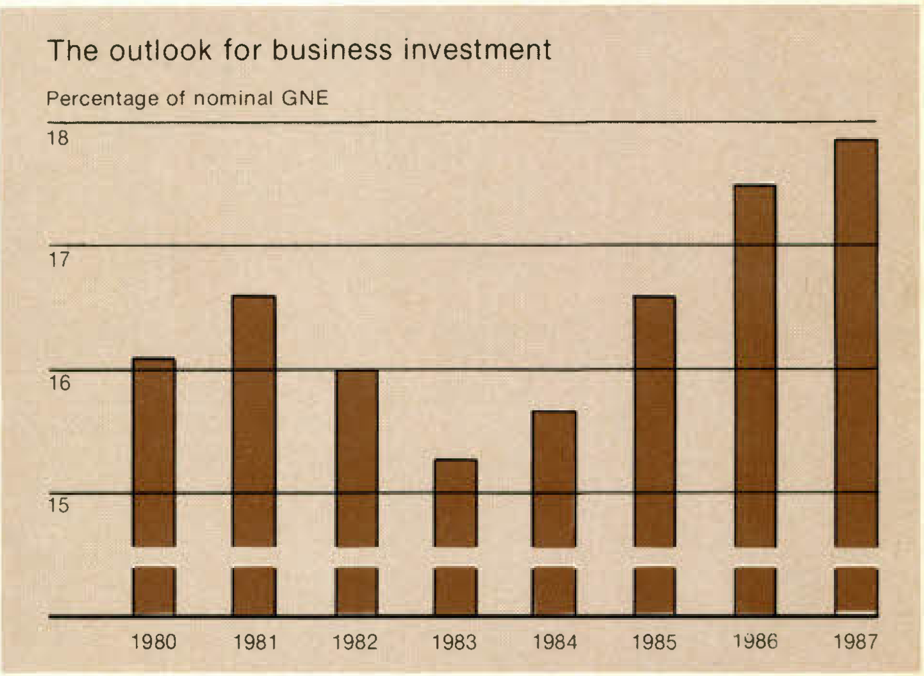
Ultimately, the basic policy question is: Do the longer-term benefits of controlling inflation – improved efficiency and higher real output, along with a less haphazard and more equitable distribution of income and wealth – outweigh the costs of temporarily forgone output and employment? In the Council's view, control of inflation remains very important, although there may be some scope for judgment with respect to how quickly reasonable price stability can be achieved. A desirable policy would balance the need for firmness and resolve with a sensitivity to the extreme hardship that would result from efforts to reduce inflation too quickly.

Investment

The importance of investment – the dynamic element on the supply side of the economy – hardly needs to be emphasized. Among other things – and if conditions are right – it can be a leading force in generating growth of demand. But because business investment tends to lag behind the business cycle and does not pick up until recovery is well under way, the question at the moment is whether and to what extent investment is likely to be a factor in the Canadian economy's recovery from the current recession.

At present, the investment climate is not good. Low operating rates are expected to persist. Relief from high real interest rates (i.e., nominal or actual interest rates minus the rate of inflation) is likely to be limited as long as a restrictive monetary policy is maintained. The financial position of the business sector is weak. Profits are down and are not expected to bounce back quickly. Balance sheets are strained. In a word, conditions are decidedly not right for strong growth of business investment in general.

Before passing judgment on the likelihood of a strong investment-led recovery, we should consider the prospects for investment in megaprojects which, despite their concentration in the energy sector and in the western part of the country, could generate benefits to other sectors of the economy and to all regions of Canada. These projects should contribute more generally to economic growth by creating a broad-based demand for the output of primary industries, construction, manufacturing, utilities, trade, finance and services, with the resulting employment



increases spread across the entire country.

However, with the softening of international oil prices and consequent limits to scheduled increases in the domestic oil price, and with the emergence of excess generating capacity for electricity, incentives for expanded energy megaproject activity will be reduced. If we also consider the risks inherent in such projects, it would perhaps be prudent not to count so heavily on them to fuel growth over the decade.

In summary, total business investment is projected to decline in 1983 to 15.3 per cent of gross national product (GNP) from its high of 16.6 per cent in 1981 (see chart). The weakness in investment is expected to be concentrated in the manufacturing sector – especially hard hit by the recession and high real interest rates. Investment is projected to lag rather than lead the recovery, and will probably not pick up strongly until 1985.

Housing

The outlook for housing in the medium term is clouded by the prospects of high interest rates and slow growth in real personal disposable income. Against such a backdrop, a gap of an average 43,000 units per year between housing starts and requirements has been projected over 1982-86, yielding a cumulative shortfall of almost 215,000 units by 1987.

Homeownership has long been favoured as an investment as well as for the accommodation it provides. The prospects of capital gains have attracted many into the housing market, with the exemption of principal residences from the capital gains tax providing an extra boost. However, with high interest rates and a relatively tight monetary policy, the chances of realizing real capital gains are not as favourable, and housing may no longer look like such a good investment. And while federal and provincial assistance programs may provide some help, prospects are far from rosy.

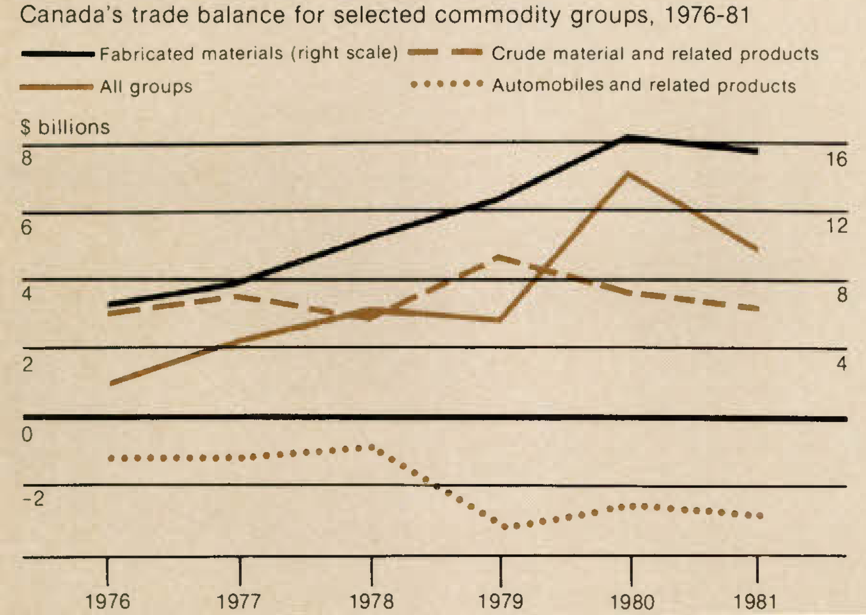
For rental accommodation, the story is similar but the actors are different. The landlord rather than the tenant faces the immediate impact of high interest rates. With such rates, investment in rental construction without government support doesn't look like a paying proposition. There is thus a shortage of equity capital for rental developments.

A wide gap has opened up between rents and the operating and financing costs of new units. Rents of existing units tend to increase only sluggishly due to rent controls and other characteristics of the housing market. Mortgages taken out at earlier, lower rates also hold down rent increases. At current mortgage rates, rents might equal only half the costs of a new project. Not many new rental units will be built on these terms.

As with owned accommodation, government assistance is helpful. But, says the Council, there is no way to avoid the basic reality that substantial rent increases will be needed to bring rental supply and demand into balance.

The trade picture

Canada's trade balance for selected commodity groups, 1976-81



Current account of balance of payments

Canada's current account deficit in 1981, while the largest on record in absolute terms, was not unusually large relative to the size of the economy; it amounted to 1.6 per cent of GNP. This was lower than most years since the mid-1970s when, with two exceptions, it was around 2 per cent.

The deficit on the service component of the current account has increased steadily since 1967. The continuing growth in Canada's foreign indebtedness will likely increase the deficit further in coming years. The question then is whether growth in the merchandise surplus will offset the rise in the service deficit or at least be sufficient to prevent the current account deficit from increasing in importance.

There are both positive and negative elements colouring the outlook for Canadian trade. The data available suggest that, due to the weakness of the economy and the resulting sluggishness of imports, the country may be heading for a record trade surplus this year. Other factors, including the projected U.S. recovery in 1983 and 1984, augur well for medium-term prospects.

On the negative side are the relatively fast growth rate of Canadian costs – especially the rapid rise in domestic labour costs – and their impact on the competitiveness of Canadian manufacturing; the growing threat posed by the newly industrialized countries; and the emergence within the industrial nations of some strong protectionist sentiment that could endanger the considerable progress made toward increased trade liberalization.

According to the Council, the positive elements will be strong enough to yield significant improvement in Canada's trade performance in coming years. In spite of this, it is likely that the current account deficit will edge upward in the medium term. But although the deficit will probably be higher in absolute terms by the mid-1980s, it may not increase as a proportion of GNP.

So while it will be necessary to monitor carefully Canada's trade in goods and services, says the Council, there is a reasonable basis for optimism that the deficit in such trade can be kept within manageable proportions.

Fiscal and...

The government's fiscal strategy has been designed to support its monetary policy in fighting inflation and, as a result, has become more restrictive. Since the first budget brought down by the present government in October 1980, fiscal policy has been cast in terms of spending restraint and deficit reduction.

Three events, however, have overtaken this strategy – the recession, the increase in interest rates and the softening of international oil prices. The last bears directly on the domestic oil price, and all three have produced either increased spending or a substantial reduction in government revenues.

The result was the announcement by the Minister of Finance in the June 28, 1982 budget that the deficit for the 1982/83 fiscal year is now projected at $19.6 billion, more than $9 billion higher than forecast in the November 1981 budget.

In the Council's view, this larger deficit, while giving cause for concern,

"To accept larger deficits in the present circumstances is not to throw in the towel in the fight against inflation."

is understandable and manageable under current circumstances. In recent months the balance of risk has shifted from worsening inflation to growing unemployment. A moderate additional injection of fiscal stimulus, says the Council, might be considered in order to restore the balance – "moderate" meaning in the $2 billion range, which represents 0.5 per cent of GNP.

It is true that a moderate dose of fiscal stimulus will not by itself have an overwhelming impact on the economy. It will not make the difference between recession and slow growth or between slow and rapid growth. It would raise GNE by only about 1 per cent, and would lower the unemployment rate by roughly half that amount.

What it can do, however, is give a signal to economic agents that the government still stands ready to stabilize the economy if necessary. If businessmen and consumers are confident of this, they will be willing to proceed with investment and spending on consumer goods, and the economy will be more likely to stabilize itself.

The impact of administering different types of moderate doses of tax cut stimulus to the faltering economy can be illustrated using CANDIDE, although the exact magnitude of the economy's response to a tax cut cannot be predicted with any precision. The tax cuts considered are: a personal tax cut, a reduction in the corporate income tax, and a cut in the general manufacturers' sales tax. Each of these cuts would cost about $1 billion and could be combined in various ways to yield up to a $2 billion tax cut package.

A $1 billion cut in the personal income tax rate would raise disposable income and thus stimulate consumer spending, particularly on high-priced durables such as cars and appliances. Production would expand to meet this new demand, with a corresponding increase in output and employment.

A cut of this sort, taking effect in 1983, would raise real output growth

"A modest net tax cut might serve as a spark plug for the private sector engine of recovery. A massive net tax cut would not only start the engine, but could set the economy off down the road to greater inflation."

by 0.2 per cent that year and lower the unemployment rate by 0.1 per cent. By 1985 real output would be up by 0.3 per cent and the unemployment rate down by 0.2 per cent. These are not large effects, but they could provide additional support to the recovery.

However, the principal factors in a recovery of consumer expenditure appear to be lower interest rates and a restoration of consumer confidence, rather than a lack of disposable income. In addition, the design of an equitable reduction in personal income taxes may be especially difficult in the period ahead, in view of the incomplete state of legislation on the changes in personal taxation from the last two budgets and the complications that arise from the incomes and prices policy.

All or part of the stimulus could take the form of a corporate income tax cut. This would focus more directly on lagging business confidence and on providing some measure of relief from financial stringency. It would thus restore the business community's will to invest. On the other hand, under the present circumstances the responsiveness of investment to corporate tax cuts may not be large.

The Council considered a $1 billion reduction in the corporate income tax effected by lowering the federal tax rate by 15 per cent. Starting in 1983, this would increase real GNE by 0.1 per cent that year. By 1985 output would be 0.5 per cent higher and the unemployment rate 0.2 per cent lower. Capital stock would be 0.4 per cent greater in 1985 and productivity would be up by 0.3 per cent, reflecting the increased supply of capital inputs and the higher level of demand.

An indirect tax cut is another attractive way to administer a moderate dose of stimulus. A reduction in the general manufacturers' sales tax of $1 billion, if passed on to consumers, would stimulate consumption, particularly of durables and semidurables, which are

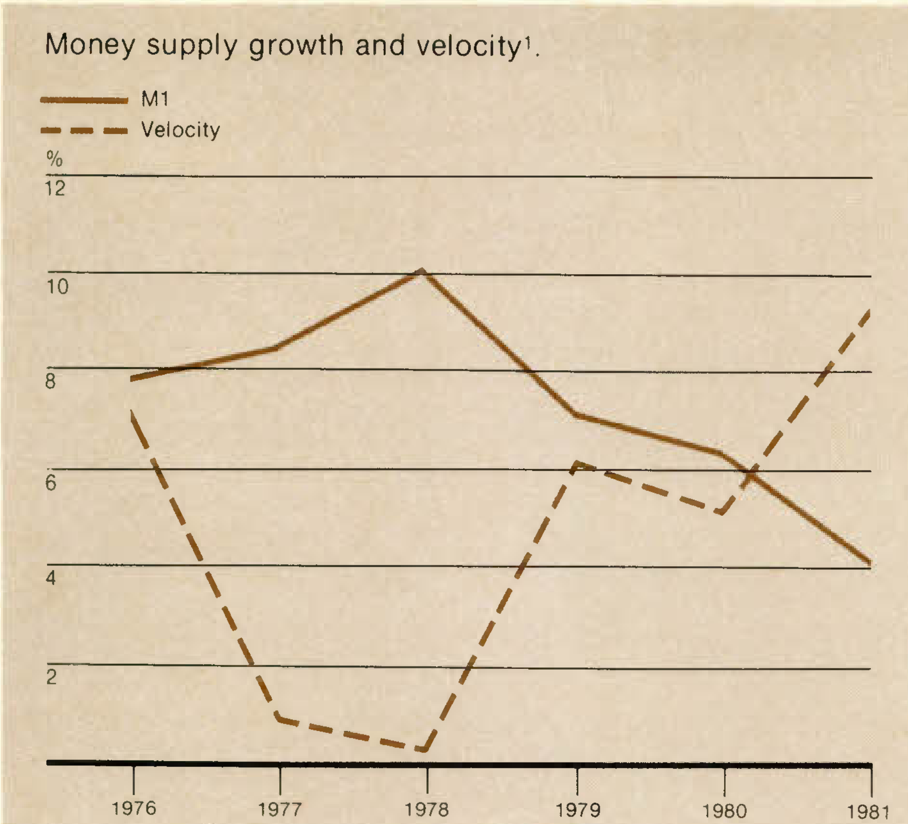
". . .it is important that the government carefully explain to the public the reasons for the larger deficit and reaffirm its continued commitment to fiscal restraint."

more heavily taxed.

A cut of this type, starting in 1983, would increase GNE by 0.2 per cent that year and by almost 0.5 per cent by 1985. The unemployment rate would decrease by 0.2 per cent by 1985. The drawback is that there is a limit to how far it would be desirable to reduce this tax, because of its relatively narrow base (which excludes most food and clothing). And unless the proposed shift in the point of impact to the wholesale level had been made, it would be difficult to identify and measure the extent to which cuts in the manufacturers' sales tax were passed on to final purchasers.

All the tax cut simulations demonstrate that a modest injection of tax cut stimulus can be expected to have a relatively small positive impact on economic activity and employment. No promises of supply-side miracles can be made. But a tax cut would indicate to Canadians that the government is committed to getting a recovery under way. A modest net tax cut at this time, says the Council, could help to restore the confidence of investors and consumers and spark a resurgence of spending.

...monetary concerns



1. Speed of money circulation. Here defined as GNP divided by M1.

For almost six years, the Bank of Canada has been pursuing a policy of gradually reducing the growth rate of the money supply. Monetary policy is set on a firm anti-inflationary course, with a current target range for money supply growth of 4 to 8 per cent. The narrowly defined money supply, M1 (comprising the total amount of demand deposits and currency in circulation), has actually been running below the bottom of the range recently.

The consistency with which the Bank has met its targets has helped establish the credibility of monetary policy as an anti-inflationary tool. This credibility is important because it serves to dampen inflationary expectations. It also guards against a take-off in inflation should the economy suffer an inflationary shock (e.g., a dramatic rise in world oil prices).

There are a number of important issues relating to the conduct of monetary policy. A restrictive policy, for instance, has its costs, most notably in the form of high interest rates, lost output and unemployment.

External forces produce their own constraints, converging to focus mainly on the value of the Canadian dollar in terms of other currencies. Exchange rate fluctuations and the depreciation of the Canadian dollar relative to its U.S. counterpart over the last year clearly demonstrate the vulnerability of Canadian policy to such outside forces as high interest rates in the United States.

Shifts in the demand for money pose considerable problems for monetary authorities. For monetary targetry to work smoothly, the relationship between the demand for money on the one hand, and nominal interest rates and income on the other, must be stable and predictable.

However, if money demand is not stable, a simple money growth rule will not be stabilizing. For instance, reductions in the demand for money can cause problems for monetary policy focused on controlling the narrow M1 money supply definition. In 1976 and 1977, a downward shift occurred as corporations took advantage of newly available cash management facilities to minimize their holdings of demand deposits. One estimate put the decline in money demand from this source at 7.9 per cent after two years.

In late 1979, with the availability of daily interest savings accounts, individuals began to cut back on their holdings of personal chequing accounts to benefit from the interest paid on the new accounts. The Bank of Canada has estimated that the growth of daily interest savings accounts has lowered money demand by about 2 per cent.

The spread of cash management services to small and medium-sized businesses has also decreased the demand for money. Yet another recent development that could lower money demand significantly was the introduction of daily interest chequing accounts by the major banks in July 1980. Since these accounts pay interest, they are not included in M1. By December 1981 they amounted to $675 million, or 2.5 per cent of M1, and are still growing rapidly.

The advent of daily interest savings and chequing accounts is of major significance for the conduct of monetary policy. In an inflationary environment with high nominal interest rates, a demand deposit bearing no interest may come to look increasingly unattractive. The new daily interest savings accounts, providing a competitive return on cash deposited even for very short periods of time, should constitute an additional incentive to minimize holdings of non-interest-paying demand deposits. With these innovations, M1 could quite easily become an increasingly less comprehensive and perhaps less reliable indicator of the transactions demand for money.

The difficulties of interpreting money demand components in the face of the ongoing process of adjustment to financial innovations, and the problem of consistency between money supply growth targets and projected nominal income growth in the medium term, underline the need to continue to monitor a wide range of indicators to assist in the conduct of monetary policy. These indicators would include the exchange rate, nominal and real interest rates, and the broader components of money demand, as well as M1.

But real interest rates would appear to be a particularly helpful supplementary indicator of the stance of monetary policy, on which much greater and more explicit reliance could be usefully placed. At present, real interest rates would seem to be higher than necessary to restrain inflation. Lower real interest rates would help in getting the recovery well under way.

Policy action needed

The general thrust of Canadian economic policies has become increasingly restrictive over the last few years. Yet inflation continues high; unemployment is at a postwar record; and government deficits, as usually measured, are high.

At some time, says the Council, this restrictiveness should be reduced. The question is when, in what form, and to what degree? Given the long lags and complex expectational forces at work, one thing is certain: if we want results a year or more from now, action will have to be taken soon.

Under the heading "Policies to combat inflation and unemployment," the Council this year has put forward 14 policy recommendations. These cover a wide range of areas of concern.

Tackling first the problem of inflation, the Council recommends that for monetary and fiscal policy, the federal government continue its anti-inflationary stance, with the Bank of Canada maintaining its control over the money supply growth rate. This includes government expenditure restraint, and deficit reduction in the medium term as the economy recovers to more normal levels of activity.

However, says the Council, with unemployment close to 12 per cent, the time has come for at least some reduction in the degree of restraint. In recommending that the federal government introduce a moderate dose of fiscal stimulus in its next budget, the Council proposes a $2 billion cut in the personal, corporate or general manufacturers' sales tax – or some combination thereof. The exact form of the cut would be a matter for public prebudget consultation.

Turning to the question of unemployment insurance, the Council notes that large increases in both employer and employee contributions could take place as early as January 1, 1983. But in view of the current difficult economic circumstances, the Council recommends that the government limit any such increases in the coming year.

Returning to the question of federal government spending and deficit reduction, the Council offers three recommendations. The first urges the government to subject new energy initiatives to the same critical scrutiny given to other new spending programs. The second arises from the view that the government should not be expected to meet its objective of deficit reduction during a recession. The Council thus recommends that the federal government not take further action to reduce the deficit until the economic situation improves and that in the meantime it accept, at the very least, the deficit increases resulting from automatic stabilizers. However, says the Council, the deficit must remain a source of concern.

The third recommendation under this heading concerns lower international oil prices and their effect on the domestic oil price and hence on government revenues. Since the domestic wellhead price has been set to rise gradually to a maximum of 75 per cent of world prices – and is thus now facing lower and slower increases – the Council urges the federal government and the governments of the oil producing provinces "to address specifically, at an early date, the implications of lower international oil prices for domestic wellhead oil prices resulting from the 75 per cent cap."

"We have to face short-term realities, but at the same time we must maintain a sound medium- and long-term perspective. . . Since there are long lags in the impact of policy on the economy, it is necessary to act now. . ."

Monetary policy and high interest rates are the subject of two more Council recommendations. In the first, given the narrow definition of the money supply and its increasing unreliability as the sole indicator of money demand, the Council recommends that the Bank of Canada put more explicit reliance on real short-term interest rates as a supplementary indicator of the stance of monetary policy. In addition, the Council recommends that, in so far as is consistent with combatting inflation and as international circumstances permit, the Bank of Canada try to bring current real interest rates down to more normal levels and that interest rates be allowed to decline with inflation in the medium term.

Another recommendation concerns increased Canadian ownership of the oil and gas industry, and the disruptive effect the wave of government-encouraged takeovers of foreign-owned oil companies has had on the Canadian dollar. Here the Council recommends care in proceeding with Canadianization so that it does not become a source of instability for the economy.

In the June 1982 budget, the government announced a program of mandatory 6 and 5 per cent wage guidelines for the federal public sector, together with a call for comparable voluntary restraint in the private sector. If the private sector respects these guidelines, says the Council, it should be possible to bring inflation down more quickly and at a lower cost in lost output and employment.

While the Council has some reservations about the specifics of the restraint program, it believes it is important that everyone understand the basic message underlying the government's strategy. It is that inflation will slow down only if everyone exercises restraint in pressing their income claims. This leads the Council to recommend that provincial governments, business and labour cooperate fully with the government in the effort to bring down inflation.

If inflation doesn't yield to the current strategy, the government will come under pressure to take tougher action. Wage and price controls, says the Council, are the obvious alternative. However, they entail very high economic and social costs and could well engender bitter conflicts among the federal government, labour and business. As a result, the Council recommends that controls be used only as a last resort if wage inflation spirals dangerously upward.

The Council's three remaining recommendations are:

- that the government initiate a more formal process of public prebudget consultations on the broad fiscal strategy and specific tax changes under consideration;
- that business tax legislation be re-examined by governments with a view to ensuring that taxes are based on real rather than nominal profits, and that existing business tax incentives be reviewed in the light of such a change; and
- that the indexation to the consumer price index of the personal income tax and transfer programs be resumed on schedule and that no further modifications to indexing be made.

Regional disparities: ongoing dilemma

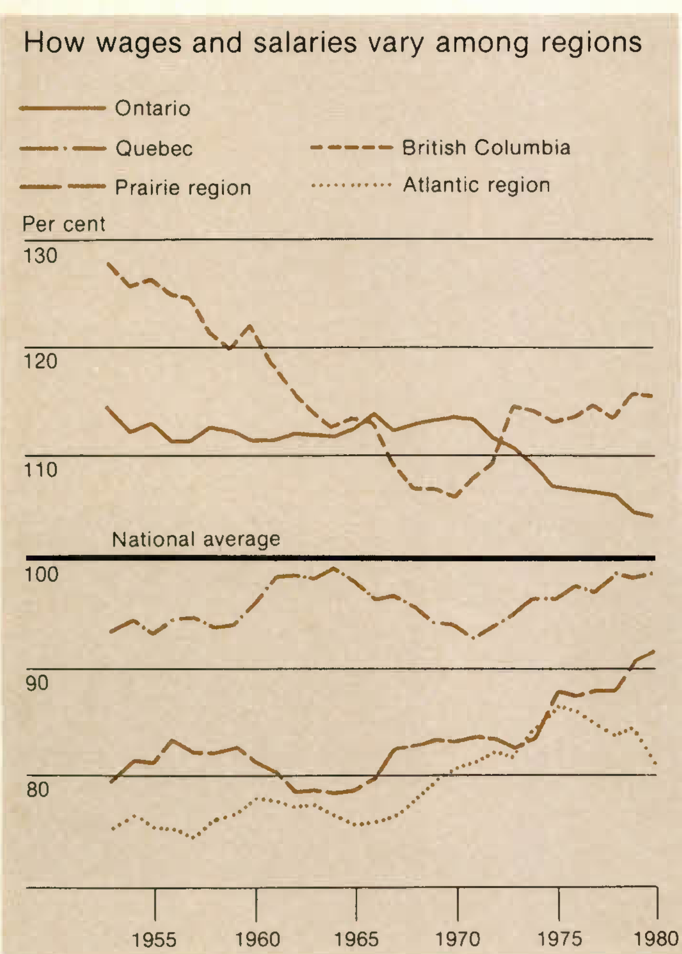
Regional disparities remain very serious. Finding a job is far harder in some regions than in others, in good times or bad. Chart 1 shows that unemployment is persistently higher than the national average in the Atlantic region, Quebec and B.C. Indeed, even a "boom" in the Atlantic region is only about as good as a recession in Ontario. Chart 2 shows that what you earn when you do have a job also varies a lot by region. It is much less than average in the Atlantic region, and much more in Ontario. While some lessening of earning disparities shows in Chart 2, none appears in the rather more serious unemployment disparities of Chart 1.

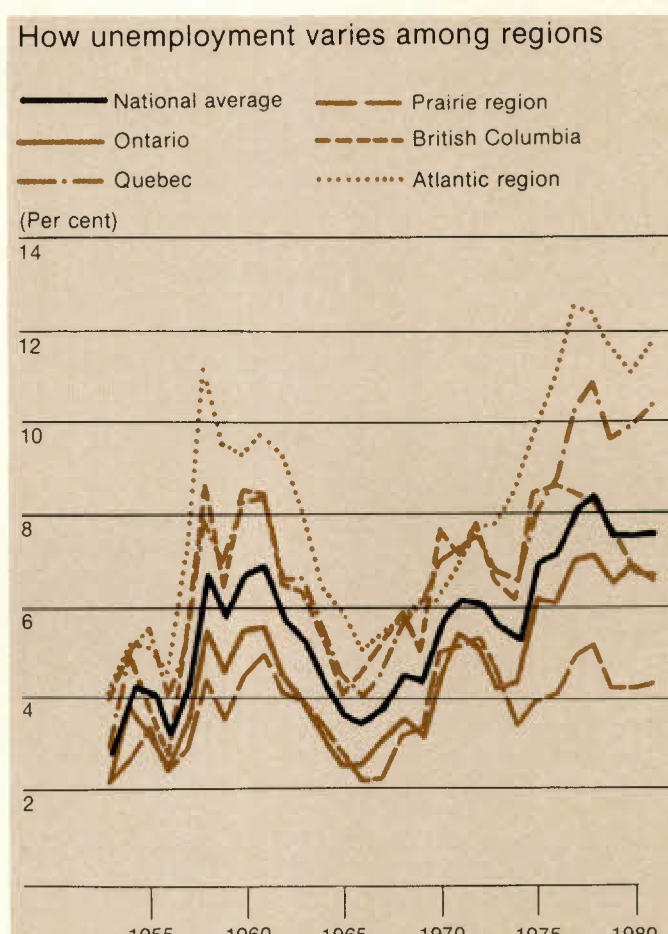
Many would argue that, despite evidence such as that in Charts 1 and 2, disparities are not a cause for concern. Either they are a statistical illusion or they show only that some people prefer the lifestyle in a region even when employment or income opportunities are poor there. The Economic Council carefully assessed such arguments in 1977, when the first printing was made of a Council report on regional disparities, called *Living Together*. This summer *Living Together* went into a fourth printing, having sold several thousand copies to date. Charts 1 and 2 are updates of charts appearing in the report. The conclusion reached in 1977, on whether disparities were a cause for concern, was that "... we are impressed that no amount of juggling with statistics can lead any reasonable person to deny that economic well-being is sharply affected by the region in which one happens to be born or brought up. In short, disparities are real."

Living Together deals with much more than discussing whether disparities are real and whether they matter. It also examines the goals that regional policy ought to have, and conflicts between these and other worthy social goals. Particularly important is a discussion of the relative weight to give to government action and individual initiative (through migration) in solving regional disparity problems. A chapter on economic theories of regional disparities is included, to set the stage for the Council's own analysis. This analysis covers: measures of disparities; sources of regional differences in productivity; the merits of regionally differentiated stabilization policy; the part played by urban structure in regional economic development; assessment of the role of the Department of Regional Economic Expansion; and discussion of other policies relevant to disparities. The report closes with sixteen recommendations.

The book remains relevant today for four reasons: it insists the problems are real, and shows why; it makes recommendations that still might help, if vigorously implemented; it analyses and refutes some faulty ideas about causes of disparities, reducing the risk of misdirected policies; and it makes some progress in understanding the causes of the problems. Continuing sales of the report seem to be heartening evidence that these are worthwhile contributions.

Living Together: A Study of Regional Disparities (EC22-54/1977E; $7.50 in Canada, $9.00 elsewhere).





Council takes a look at energy

The Economic Council of Canada is tackling the controversial issues of energy pricing, supplies, and investment in a sweeping new study.

Economist Lawrence Copithorne, who heads the Council's energy group, says he expects the study will play an important part in the debate leading to the next set of federal-provincial energy agreements in 1986. Target date for publication is mid-1984.

The energy review, he says, will attempt a more comprehensive look at energy resources than the National Energy Program of 1980, which concentrated mostly on oil and gas. For example, the vital role of hydro-electricity in Canadian energy supplies and pricing will get a thorough examination.

"We are interested in policies that will reduce the cost of energy to Canadians and increase the security of supply," says Copithorne.

It is with that in mind that the energy group will evaluate such policies as provincial pricing of electricity, development of frontier oil and gas, and some of the consequences of Canadianization of foreign-owned oil and gas holdings.

Copithorne says that the group will concentrate on the economic consequences of current energy policies. It will also dissect the recent stormy history of energy policy making in Canada to see how policies and federal-provincial agreements are formed. The Council hopes to show what impact this has on the energy picture.

The Council expects its wide-ranging examination of the energy industry will cast fresh light and produce useful proposals for the energy debate in the mid-1980s. In a recent interview with *Au Courant*, Copithorne elaborated on the Council's plans.

Au Courant: *Why do we need another study on energy? Don't we have enough already?*

Copithorne: I think there is an important role for an Economic Council study at the current time. An economic study is worthwhile for two reasons: first, in terms of the historical background; and secondly, there is a set of explicit reasons that the Council has for wanting to do the study at the current time, certain aspirations it hopes to fulfil.

If we look at the historical issue, we find that energy policy has gradually, in the past couple of decades, become more and more important in Canadian economic policy generally, not merely because of the OPEC price hikes of 1973 and 1979, or because the federal government has introduced the 1980 National Energy Program, but also because of a number of underlying factors in the economy that inevitably make energy policy issues more important.

In North America, we find that, even prior to the OPEC crisis of 1973, there was a fundamental change in the economy whereby North America became much more dependent on the rest of the world for its oil supplies. The fact that it became a stronger net oil importer has set in train a number of forces that impact not only on the oil and gas industry but on electricity as well, since it is a substitute in competition with oil and gas.

Now in addition, energy resources are not evenly distributed across the country. So any impending change in the long-run price of energy for Canadians would have long-lasting ramifications for the provinces.

If we turn to the current reasons for the study, there is a much greater need for public understanding of energy policy now than ever before, because there is much more government involvement now in the Canadian energy market – and governments have a strong influence on prices and on energy investment. People need to be much more informed about the economic consequences of setting prices and investment than in the past, if they're going to avoid the kind of surpluses and shortages which inevitably result in prices and export policies being incorrectly set.

Now, apart from that market question, relatively little is known about energy supplies and economic incentives. We know more about the responsiveness of energy demand to changes in prices, but we don't know as much about how changes in energy prices and netbacks affect the exploration for new oil and gas reserves, or even how they can affect production from existing oil and gas reserves. There is explicit emphasis on responsiveness of supply in our study.

In addition, energy policy has become intertwined with economic development policy, fiscal policy, regional economic disparity policy, and so on. It may be that some unraveling of energy policy from these other interests would be desirable. The Council will want to question the extent to which energy policy is being used to solve so many problems.

Now there are also some shortcomings in the way energy policy is formulated, not just the policy itself but the mechanism by which this policy is devised. The process used recently may not have been the ideal one in this respect. So the Council is interested in not only what constitutes good policy but also how it is made.

And finally, there are some major negotiations that have to take place some months after the Economic Council's energy document comes out. The Council hopes to have an input into those negotiations, and to have a voice in the way in which these policies are negotiated and even the policies themselves.

Au Courant: *You have mentioned some of the problems you will be looking at.*

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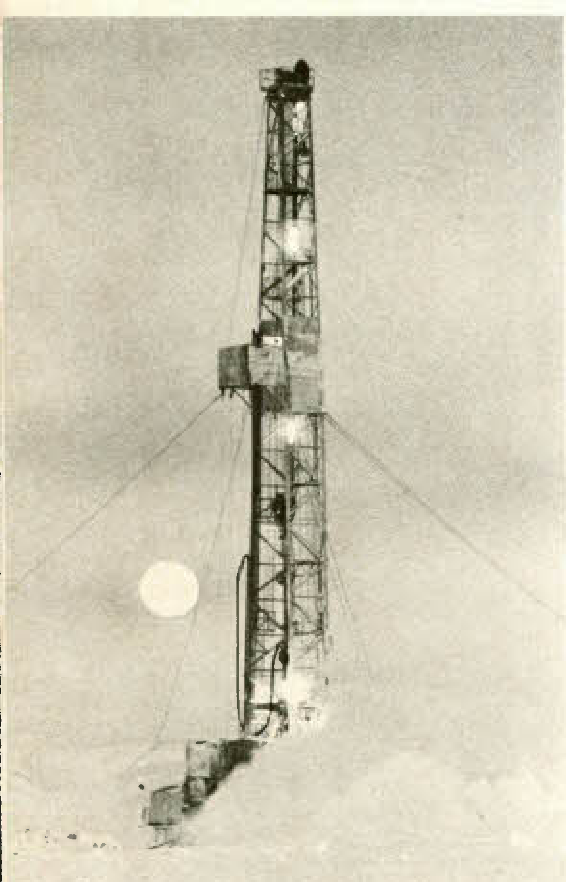
Hydro-electric project

Can you elaborate on some of the issues you will be studying? Can you also mention some of the projects you plan to launch as part of the study?
Copithorne: I think we should first mention that there is a set of orientations that we would like to see in the research program. One is that we are interested in finding ways of taking advantage of the economic opportunity afforded by our energy resources. And we are interested in reducing the cost of energy produced and the risk of producing that energy.

As far as the individual topics are concerned, you could categorize them in many different ways. I think people will find that we have directly or indirectly addressed most of the questions that are of interest in the energy area, but we have grouped our research projects under about half a dozen different broad topics.

The first is what I call a search for common ground among the energy policies of the federal and provincial governments. The second is the study of hydrocarbon supply, which is broken down into the economic development of conventional oil and gas exploration, conventional oil and gas production, enhanced oil recovery, and frontier oil and gas production.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Oil-drilling site

Thirdly, we have the study of electricity supply. Fourthly, there is a study of regional energy demands. Fifthly, there is some study of energy conservation questions.

Sixth, there will be a study of macroeconomic implications of energy policy alternatives. Regional economic considerations will be dealt with.
Au Courant: *Will you be looking at the National Energy Program in any detail? Will you be dealing with some of the issues raised by that policy?*
Copithorne: Yes, we will be dealing with the issues of the National Energy Program, but we don't intend to single out that federal program as a special study in itself. Issues of public energy policy crop up in all the various topics that I have mentioned to you. So we will definitely deal with virtually all the issues that you find in the NEP.

But our study will be broader in so far as we will have a more balanced emphasis on all energy sources, including electricity, than the National Energy Program, which is predominantly an oil and gas policy document. It will be narrower in the sense that it will focus more closely on economic issues and the implications of the various objectives of energy policy.
Au Courant: *One of the issues that you mentioned was the question of electricity and provincial pricing of electricity. Are you doing something about the way pricing affects the allocation of energy generally?*
Copithorne: It is important to point out that the Economic Council will not be trying to second-guess the energy producers as to what constitutes the best set of investments in energy. Our work will concentrate on economic *strategies* that influence the economic allocation of these resources. The strategy that you use in setting prices is terribly important in influencing the amount of energy that will be produced and demanded, and whether or not you will be producing shortages or surpluses.

So, we will be studying energy supply and demand to see how different pricing policies and different export policies impact on production and demand. Our objective, of course, is to find the policy that will help markets function efficiently even though pricing and some of the allocation is being done by government decree or government action.
Au Courant: *Consumers are mostly interested in how much they are going to have to pay for energy. Will you be looking at the price implications over coming years of how energy is used in Canada and what that might mean for the consumer?*
Copithorne: Price policy is going to be a major consideration of the study, from the production level right through to the consumer level. We will definitely be looking at the implications of different economic strategies for the cost of energy to the consumer.
Au Courant: *Can you indicate what kind of a contribution you think the Council study will make to the public debate leading up to renewal of the energy agreements with the provinces in 1986?*
Copithorne: There are a number of subtle ways in which Council reports have their effect. In the recent study of the Newfoundland economy, which we completed in 1980, and in the current study, much of the impact of Council research comes from consultations with people at the research and policy making levels. By the time the report is published many of these people have already learned something in the course of helping us with our research program, and provincial governments, for example, may be using some of our ideas.

For the public at large, the document and its supporting studies will be available for discussion in public forums and in universities. I think we can provide some original economic information on, for example, the responsiveness of oil and gas supplies to different taxation schemes, or on the effectiveness of some of the government energy conservation programs. The Council's work is put out not only in the main report but also in supporting studies, which provide a lot more technical detail.
Au Courant: *Is the Council planning to have people operating outside Ottawa for periods of time on this energy study?*
Copithorne: In the case of the Newfoundland report and the recent Western study, there has been a formal Economic Council office established outside Ottawa to carry out part of the research. In the case of the energy study, there is considerable consultation going on with the electrical utilities, with various provincial governments, and with certain universities. That results in some researchers working in Calgary, and possibly other Canadian cities, for some weeks at a time. In addition, there will be a fair amount of short-term consultation. But we won't have a formal office outside Ottawa.

Looking Ahead

That's the task assigned by Parliament to the Economic Council of Canada when it was created in 1963.

Since that time the Council, drawing on the expertise of its staff of economists and other specialists, has provided Canadians with an ongoing analysis of the economy, looking at economic policies and the effect of possible alternatives on the country's economic prospects. The projections, policy analysis and recommendations formulated by the Council in the past decade have played a significant role in public policy.

The issues the Council deals with affect each of our lives. They include inflation and the erosion of our buying power, human resources planning for future jobs, the distribution of wealth among Canada's regions, and even the cost of taking a taxi in Montreal, land use planning in Vancouver or the effect of the spruce budworm on Newfoundland's economy.

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