au courant

Economic Council of Canada
Volume 3, No. 3, 1982

Governments and financial markets

The deficit picture

Why Canadians migrate

Province-building in a resource boom

PUBLICATIONS

New Council Report

Intervention and Efficiency: A Study of Government Credit and Credit Guarantees to the Private Sector (EC22-111/1982E; $9.95 in Canada, $11.95 elsewhere).

Government intervention in Canada's financial markets covers a very broad spectrum. In this recently released report, the Council looks at measures governments have taken to assist the private sector by means of various financial instruments. *Intervention and Efficiency* is available in bookstores across the country and may also be ordered from the Canadian Government Publishing Centre (see 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*.

Internal Migration and Fiscal Structure: An Econometric Study of Interprovincial Migration in Canada, *by Stanley Winer and Denis Gauthier* (EC22-109/1982E; $8.95 in Canada, $10.75 elsewhere).

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No. 219 "The Economic Development of Western Canada: An Historical Overview," *by D. Owram.*

No. 220 "Energy Price Increases, Economic Rents, and Industrial Structure in a Small Regional Economy," *by K. H. Norrie and M. B. Percy.*

Reprints

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

Newfoundland: From Dependency to Self-Reliance (EC22-85/1980E; $10.95 in Canada; $13.15 elsewhere).

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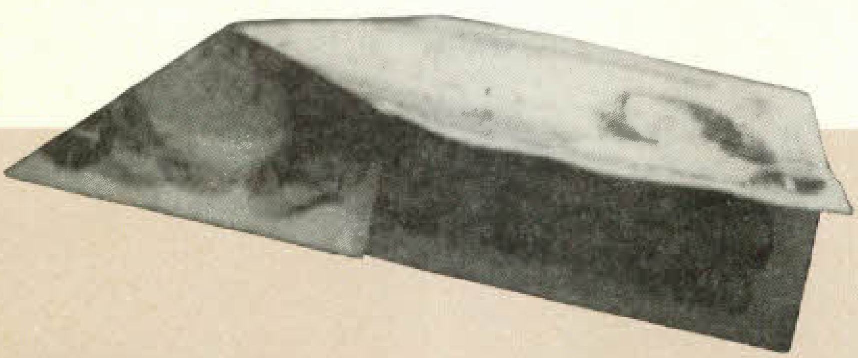
Intervention and Efficiency

Highlights from the Council's report on financial markets



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Western history shaped by resources

Resource boom, resource bust: the same old tune, played on down the years in Canada's four western provinces.

How Westerners responded to this recurring theme over time – moving from contentment with their resource-based economy, through ambivalence towards it, to a determination to escape the resource trap once and for all via industrialization – is the subject of a new paper, written for the Council's western project. (*Au Courant*, Vol. 3, No. 1.)

Western history divides into five distinct phases, says University of Alberta author D. Owram, running from 1870 to 1960 – with a sixth trend apparent in recent years. Aside from the first period, when the main economic activity was the absorption of immigrants, the story of western economic development unfolds in terms of its primary resources: wheat, timber, fishing, minerals and, latterly, oil and natural gas.

In fact from very early on, the West was viewed as Canada's great agricultural region, whose exports would both support, and be supported by, eastern manufacturing. The concept of an east-west transcontinental economy, fostered by the federal government through the building of railroads, encouragement of settlement, and introduction of protective tariffs, formed the basis of the so-called National Policy, which remained a focus of Canadian development for many years.

That policy began when the West was settled, and was firmly entrenched during the second period of development, the Laurier boom years (1898-1912). Western settlement flourished, urban centres prospered, railways were built. At the same time the Prairie West emerged as a major producer of wheat, which rapidly became one of Canada's major exports. It's worth noting, Owram observes, that Westerners of the time focused on improving their agricultural position, rather than on diversifying their economy.

The third phase – 1912-29 – marked the maturing of the wheat economy. It was also a turbulent economic period, as recession, wartime boom, and post-war recession resulted in marked swings in economic activity. Tough times in the West led to explicit expressions of western grievance in the form of political protest and the establishment of very powerful, if short-lived, regional political parties. Westerners still, however, viewed agriculture as their economic mainstay.

But the Great Depression of 1929-39 (the fourth phase in western history) brought home to them the danger of relying on a few major export resources for economic survival. The depression hit the West with particular force as, by cruel coincidence, collapse of the international wheat market was paralleled by a series of years of disastrous weather. Realized net farm income plunged from $363 million in 1929 to *minus* $10.7 million in 1931, with devastating results for the entire regional economy. Westerners blamed the central government for not easing their burden, and feelings of alienation once again sought expression in new political parties (such as Social Credit) and radical solutions.

The war and postwar years (1940-60) heralded the beginning of a new and especially complex period in western development. Strong growth in Canadian manufacturing affected the West as well as the East, as regions dealing in areas complementary to the industrial boom (British Columbia and, after 1947, Alberta) did well, while agriculture declined in importance. Westerners began to visualize a new era in economic development, in which growth of primary industries would create capital investment and skilled employment, encourage population growth, and over time create more secondary industry in response to a growing local market.

The most dramatic force in western economic development in recent years, Owram says, was triggered by the sharp rise in oil prices during the 1970s, an event which brought new prosperity to the three oil-producing provinces, most notably Alberta.

Whether this new boom will change the face of the West or is merely another phase in the boom-bust cycle is still uncertain, Owram says. But it has served to focus attention on some questions central to western economic development in the future, key among them the issue of economic structure. Since the catastrophe of the 1930s, the concept of diversification, particularly in the form of industrialization, has dominated western thought. Recent prosperity has only intensified that concern, as Westerners seek economic security in the face of the inevitable day when the oil runs out. This determination to put an end to the boom-bust syndrome once and for all helps explain the motives behind some provincial policies, Owram says – such as those designed to direct resource revenues into the hands of government, or the "province-building" variety, providing incentives to attract industry and people to western regions.

One question Westerners should be asking themselves now, in the author's view, is whether forced industrialization is necessary or even desirable. "The historical patterns to date," he concludes, "indicate that man's efforts to plan the development of the West have proved less significant than the deeply rooted factors of geography, climate, and demography. Any policies in the future which ignore these factors will inevitably yield disappointing results."

"The Economic Development of Western Canada: An Historical Overview," by D. Owram. Discussion Paper No. 219.

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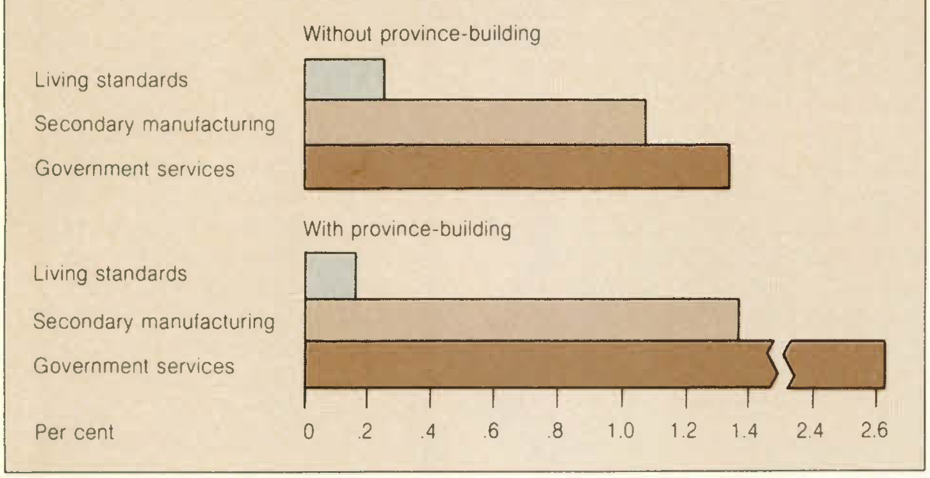
Coping with a resource boom



Impact of province-building strategies in a resource boom

Percentage increase for a 1% resource price increase.

Well-meaning government policies in the energy-producing provinces probably mean residents there aren't as well-off as they could be, says a recent Economic Council paper.

Analysis of the impact of an energy price increase on regional economic development leads University of Alberta economists K. H. Norrie and M. B. Percy to conclude that "much of the economic rent produced by the western energy boom ends up dissipated through resource inefficiencies and excessive in-migration." Were provincial governments to take more of a hands-off approach to province-building, though, consumers would be better off.

The recent energy boom in the West has raised a host of questions about subsequent economic development there, the authors say – on the likelihood of greater industrialization, for example, on the role provincial governments should be playing in promoting that objective, and on the effect of deliberate province-building policies, such as lowering rates of corporate income tax, subsidizing feedstock prices, or cutting the cost of government services.

In search of answers, Norrie and Percy develop a new economic model, combining many characteristics of earlier approaches and adding some new elements – one being the provision of a specific role for government taxation and expenditure policies, in order to study their particular impact.

With the model, the authors develop two different scenarios to test out the effect of an increase in energy prices on six sectors: non-renewable primary industries, particularly oil and natural gas; renewable primary industries, such as agriculture and forestry; resource-processing manufacturing; secondary manufacturing; non-tradable services, such as urban housing; and regional government activities.

Three separate time-spans are included in each test – a short-run period when no in-migration has taken place, a long-run period with in-migration, but where the region does not have to balance its trade with other regions, and a long-run period building in that requirement.

The first scenario shows what happens if resource revenues from an energy price increase remain in the hands of the private sector – as was the case with earlier western resource booms – so that a regional government must continue to meet expenses by levying taxes.

The second sets out an alternative situation, approximating current conditions in Alberta and Saskatchewan, where the government collects some of the resource revenues by means of taxes and royalties, and uses those funds to provide subsidized services to the public.

A comparison of results from the two scenarios has interesting implications for Canada's energy-producing provinces. In the first instance, the chain of events set in motion by the price increase culminates over the short term in expansion of the government and service sectors (particularly the former) and some decline in the remaining four sectors. Long-term growth is much greater, but concentrated in the energy, government and service sectors, as opposed to manufacturing. This result, the authors say, implies that a regional economy does not become more industrialized over time as the result of a resource boom, but rather more specialized in resource production and the non-traded sectors. The authors caution, though, that this finding does not hold if production becomes much more efficient as population density grows.

The second scenario indicates that when government province-building policies are brought into play, short-term growth is slower everywhere but in government. That sector, though, expands even faster than before – at the expense of the other sectors – to keep up with increasing demand for its cheaper services.

Although most people are not better off in the short run under these conditions, two groups stand to do very well indeed, Norrie and Percy say – the civil service, and urban service industries, such as land developers or consulting firms – and both are therefore likely to be keen supporters of this government strategy.

In the long term, without balance of trade requirements, production increases in every sector, thanks to the inflow of labour and capital, attracted by the new policies. Surprisingly, there is new investment even in sectors where income fell in the short run. Landowners do well, and workers benefit, too, as wage gains keep slightly ahead of inflation.

So a province-building strategy does appear to stimulate growth over time. But ironically, the province as a whole is worse off than it would have been otherwise, the authors say. Fast as gross national product (GNP) grows, the population outstrips it, so resource-derived benefits must be shared among increasing numbers of residents. The net result is a slower rise in per capita income than would have been the case in the policies' absence.

"Energy Price Increases, Economic Rents, and Industrial Structure in a Small Regional Economy," by K. H. Norrie and M. B. Percy. Discussion Paper No. 220.

Probing the mysteries of taxation

"In this world nothing is certain but death and taxes," Benjamin Franklin once remarked, an observation most people would find just as relevant today, nearly two centuries later. There's no denying that the tax system remains an indisputable fact of life, affecting virtually everybody's pocketbook in one way or another – either directly, through payment of personal or corporate income tax, property taxes or capital gains tax, for example; or indirectly through such devices as customs duties, excise taxes, or the federal manufacturer's sales tax.

Despite its almost universal impact, though, the tax system is probably something of a mystery to many taxpayers. Most people are aware that taxes help finance the cost of government services, and bring about a reallocation of income and wealth, with inevitable repercussions for the economy. But fewer taxpayers have a clear idea of the intricate workings of Canada's tax system, or of the precise nature of its economic impact. Even the experts have difficulty deciding exactly how taxation affects distribution of the country's resources – yet their findings can have a large bearing on the government policymaking process.

So a recent seminar held at the Economic Council proved both interesting and illuminating. Professor John Whalley, from the economics department of the University of Western Ontario, provided an up-to-date review of the complex issue of tax treatment of capital income – that is, income resulting from the investment of capital, received in the form of dividends, interest, royalties, or rent.

Taxation problems and the connection between taxation and inflation are subjects of ongoing interest to the Council. Over the past couple of years, it has published a study on real rates of return to capital, has sponsored a conference on inflation-induced distortions in financial reporting and taxation, and has published the proceedings of that conference (*Au Courant*, Vol. 3, No. 1.) The Council is contemplating further research in this area in the future.

A pioneer in the international use of large-scale economic models to examine tax systems, and author of several papers explaining recent findings in this field, Professor Whalley discussed the pros and cons of the principal theories – both traditional and radically new – on the workings of the tax system.

Two key concerns arise from any analysis of capital income taxation, he said. First, what does it do to the allocation of resources? And secondly, does it achieve a redistribution of income from the well-off to the needy, as its designers intended?

Dealing first with the question of efficiency, Whalley noted that no tax system scores full marks in this respect. Some wasting of resources, or "tax distortions" are inevitable when income and wealth are channeled in new directions. But until recently most experts believed that these distortions cost the economy very little – probably less than 1 per cent of gross national product (GNP) a year. Now a new school of thought is challenging that assumption, arguing that, in fact, costs to society run significantly higher – as much as 6 to 9 per cent of GNP, in the opinion of some analysts.

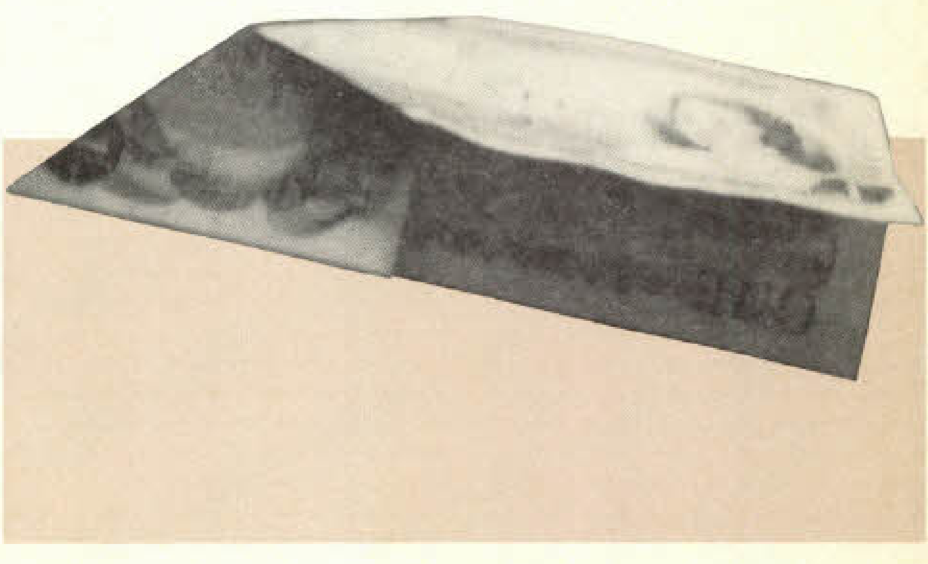
More important, these losses appear even larger when they are expressed as a percentage of the extra revenue raised from taxes. Some experts believe, in fact, that the marginal efficiency loss from an extra dollar of U.S. and Canadian taxation may be as high as 75 to 100 per cent.

A number of the more glaring inefficiencies in the present system, Whalley said, include "double" taxation of savings, whereby individuals are taxed once on their original incomes, and once again on any returns they receive by saving. If they invest any portion of their incomes, moreover, they are required to pay a corporate tax, a capital gains tax, or both, on their returns. Another form of distortion lies in the tax treatment of homeowners, who pay neither taxes on income resulting from that investment, nor capital gains tax on that asset.

Conventional thinking on the second major concern about the tax system – whether it succeeds in redistributing resources from rich to poor – has also been carefully scrutinized in recent days, the economics professor said. Now some analysts are taking issue with the traditional view which holds that the system doesn't have much impact on the distribution of income. Evidence now suggests, they argue, that in fact it may be markedly progressive. One point they make in this respect, Whalley said, is that the old school didn't reckon with the effect of inflation. (The complex interaction between inflation and taxation, particularly the question of inflation indexing, is currently occupying centre stage in taxation discussions.)

Whalley's own opinion in this regard is that other factors, which haven't been taken into account so far, may mean that the tax system favours the rich.

Caution should be the keynote in any appraisal of the distributional effects of the tax system, Whalley concluded, warning that it is dangerous to talk about a "consensus" in this field. Opinions are in a constant state of flux, and the issues are complex and confusing in the extreme. Observers should try to keep a broad picture of the tax system and its interactions in mind at all times, without losing sight of central philosophical principles.



*Government intervention in Canada's financial markets covers a very broad spectrum. In its recently released report, **Intervention and Efficiency: A Study of Government Credit and Credit Guarantees to the Private Sector,** the Council looks at measures designed to assist the private sector through various financial instruments. Material based on the report is featured on the next six pages.*

Canada's private financial institutions influence our daily lives in many ways. Here, at least once a month, we deposit or cash our cheques and withdraw the money we need for our everyday expenses. Here too we borrow the money to buy a house or car.

But it is also here that major transactions occur, such as those affecting the cost and uses of money, the location and scope of industrial development projects, the value of the Canadian dollar – in effect, the rate and direction of the country's economic growth and the welfare of its citizens.

In addition to such private institutions as banks, credit unions, and trust and insurance companies, there is another group of financial institutions that plays an important role in our economy. Every day, farmers, business people, exporters, and prospective homeowners turn to a variety of government institutions for financial assistance.

Whether public or private, financial institutions play a fundamental role in our economy by transferring funds between lenders and borrowers, and by the intermediation of risk.

A variety of financial instruments is used. Deposits and investment certificates gather savings that are placed chiefly through loans and investments in bonds, debentures, and stocks. In the case of loan guarantees and credit insurance, the institution does not transfer funds but instead assumes the risks involved in such a transfer.

Government is active in providing loans or equity finance and in guaranteeing or insuring private credit transactions. In the report, the Council considers only that part of government financial intermediation which at the same time provides assistance to the private sector as a way of implementing general government policies.

The decision to provide assistance through financial instruments is the result of a two-step selection process: first, the choice of financial markets as the scene of action and, second, the choice of a financial instrument as the tool for intervention.

In the report, the Council assesses the use of a specific category of policy instruments – loans, loan guarantees, and limited equity participation – in the pursuit of general government objectives. The Council has attempted to determine to what extent government credit and credit guarantees to the private sector contribute to the achievement of the government objectives of economic growth, social progress, resource reallocation, income redistribution, and economic stabilization.

Most government assistance in recent times has been provided through programs, and is usually intended to solve problems shared by a number of individuals or firms. Loans from the Federal Business Development Bank and credit insurance provided by the Export Development Corporation are examples of this form of financial aid. Ad hoc assistance, on the other hand, meets a specific need at a specific moment, in response to a demand for which better solutions seem hard to find (e.g., guarantees to the Chrysler Corporation and Massey-Ferguson).

The report concentrates on credit and guarantees to four sectors of economic activity that have received more than 96 per cent of total assistance outstanding: business, exports, housing, and farming. Of these, housing has received by far the largest share.

As of March 31, 1980, some 42 agencies and boards offered financial assistance to the four major sectors. Their loans and investments outstanding amounted to $17.5 billion, while guarantees and insurance totaled $27.5 billion.

The number of Crown corporations and government boards with primary responsibility for the four sectors has grown steadily over the last 20 years, from 17 in 1960 to 42 in 1980. Despite this increase, the growth rate for total assistance to the private sector has fallen off in the last few years.

While this decline may to some extent be attributed to the budget restrictions facing government in recent years, the increase in the number of financing agencies demonstrates that the determination to participate in private sector financing has not diminished.

This determination is reflected in the proportion of the public debt attributable to the financing that governments have accorded to the four sectors. For example, about 25 per cent of the federal government's long-term debt outstanding as of March 31, 1980, 57 per cent of that of the government of Alberta, and 42 per cent of that of the British Columbia government were attributable to such financing.

Government loans and loan guarantees incorporate subsidies, which in fiscal 1978/79 amounted to between $188 million and $906 million, depending on whether accounting methods are used or whether social opportunity costs are taken into account as well. The $906 million was distributed as follows: $176 million to business, $118 million to exports, $345 million to housing, and $267 million to agriculture.

It is worth noting that loans, investments, and guarantees are instruments specific to a firm or individual, whereas taxes, regulations, and tariffs are market-specific instruments in the sense that they affect equally all firms or individuals active in one market.

The report found that, when there are some malfunctions in financial markets, the recourse to financial instruments contributes to the achievement of government objectives. In the absence of such malfunctions, the results are of a more mixed nature and the appropriateness of the recourse to financial instruments can be assessed only on a case-by-case basis.

HOW GOVERNMENTS FINANCE HOUSING

Twenty-four million Canadians live in approximately 8 million dwellings, of which almost two-thirds are owner-occupied; 56 per cent of these owners have a mortgage on their home. Housing construction represents between 4 and 6 per cent of gross national product (GNP) and increases Canada's housing stock by 1.9 to 3.7 per cent annually. Gross rents equal about 9 per cent of GNP.

Given the importance of Canada's housing industry, it's not surprising to find that the federal and provincial governments exert considerable influence over the construction, use, and financing of residential dwellings. There are more than 50 government finance programs in Canada, administered by 12 federal or provincial agencies – the largest of which, by far, is the Canada Mortgage and Housing Corporation (CMHC). Mortgage insurance provided under the National Housing Act (NHA) accounts for more than 80 per cent of public guarantees in force extended to the four sectors studied in the report.

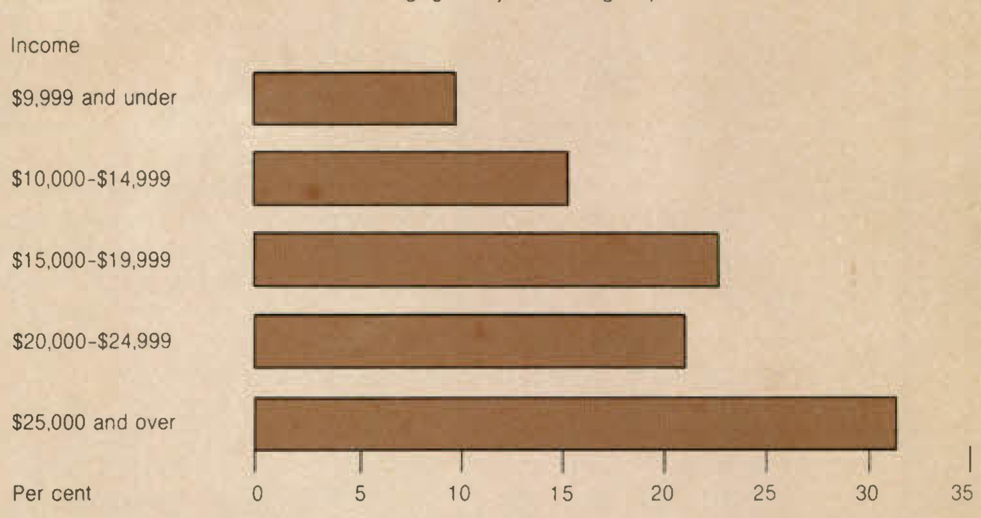
In its consideration of improvements needed in the mortgage loan market, the Council notes that governments have been deeply concerned with the affordability of homeownership. According to CMHC estimates, 42 per cent of housing needs in Canada were not met in 1979 simply because housing was unaffordable at prevailing prices based on the criterion of a maximum debt-service ratio of 30 per cent (the monthly charge, including property taxes, relative to gross income).

The interest rate on a conventional fixed-payments mortgage loan incorporates, among other things, the rate of inflation expected during the life of the loan. Any adjustment made to the interest rate to account for inflation at the time of mortgage renewal will therefore result in an increase (or decrease) in the monthly payment.

If the interest rate is 7 per cent during a period of price stability, it will rise to approximately 17.7 per cent when inflation is expected to average 10 per cent. This represents a 153 per cent increase, while the borrower's income rises on average only 10 per cent annually. This discrepancy makes the purchase of a house an unaffordable proposition, at least during the first years, for potential buyers who in any case would spend a large proportion of their income on housing.

Who owns a mortgaged home?

Distribution of homeowners with mortgages, by income group, 1977



The long-term mortgage is disappearing and, says the Council, this lack of long-term loans poses a serious problem. It creates uncertainty for homeowners and the housing industry and works against an effective government housing policy. The revival of a long-term mortgage market would be a first step in the realization of the government's social goals of homeownership, quality of the housing stock and stabilization of the construction industry.

With the burden of mortgage payments increasing over the past few years, says the Council, new mortgage lending instruments must be found in order to reduce this burden and increase access to homeownership. A promising possibility in this area is the "indexed" mortgage (see accompanying article).

Because of the taxation issues arising from the fact that lenders receive cash payment corresponding only to a real rate of interest, the Council recommends that governments promote introduction of the indexed mortgage for sale to tax-exempt financial institutions such as registered pension funds and retirement savings plans.

WHAT IS AN INDE

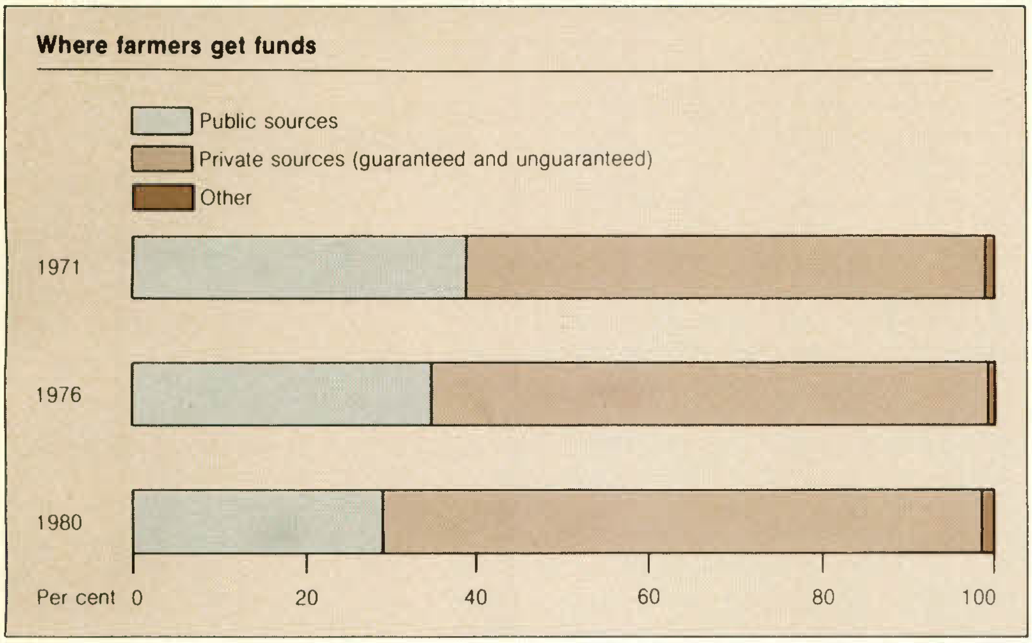
Proposals for financial instruments such as the indexed mortgage have been suggested by the behaviour of house buyers and vendors over the last few years, and by a need to revive long-term financing.

In a standard mortgage agreement, the creditor lends the borrower a given sum at a nominal interest rate (real rate plus inflation) which incorporates a premium for the expected rate of inflation, for the risk of default on the loan, and for the risk that the rate of inflation will turn out to be higher than expected.

The borrower undertakes to make monthly payments covering interest charges, amortization of the principal, and property taxes (if included) over a pre-established amortization period. Monthly payments are usually fixed, except for variations in property taxes, and the outstanding balance decreases with each payment. Adjustment to inflation is made through the interest rate charged, and is thus reflected in the size of the monthly payments.

In the case of an indexed mortgage, the parties agree on a real rate of interest that will be fixed for the duration of the loan. Adaptation to inflation is made by adjusting the balance outstanding in accordance with an index reflecting the rate of inflation, such as the consumer price index (CPI). The adjustment can be made monthly or annually, and monthly payments will increase (or decrease) as the borrower must pay a real rate of interest on the larger (or smaller) amount outstanding.

. . . AND FARMING



XED MORTGAGE?

Indexed mortgages can facilitate access to housing without the need to subsidize first-time buyers and present owners who must refinance their mortgage loans at high interest rates. They would also provide at least a partial solution to cash flow problems experienced by owners of rental properties.

The indexed mortgage is proposed for use by buyers of new and existing houses, for first-time and repeat buyers, for both ownership and investment, and for refinancing. In this respect, the proposal differs from previous ones; it also differs in that it doesn't entail tax exemptions or subsidies.

Indexed mortgages present some risk, because the borrower's income or the value of his property may not increase as fast as inflation. This risk, however, is not peculiar to indexed loans. Real incomes and property values can also fall during a period of price stability, and default rates may be higher in situations when prices rise moderately, in comparison with periods of more rapid price increases. A risk of this sort can be reduced by a more careful qualification of borrowers and property appraisal, regardless of the type of financing selected.

Risks can also be reduced by a judicious choice of indexes for loans taken out by different classes of borrowers and for different uses of funds. The particular form the Council recommends for the introduction of indexed loans allows some latitude in the choice of an index.

The 1981 Census counted 318,361 farm operations in Canada – 34 per cent fewer than in 1961. The average size of farms, however, increased by almost 50 per cent over the same period. In addition, there has been an extensive substitution of capital for labour, with considerable repercussions on the financing of farming operations.

Over the past 20 years, the financial needs of Canadian farmers have grown at a rapid pace. During the same period, the role of the private sector in farm financing has grown substantially.

Total farm credit outstanding amounted to $16.6 billion in 1980. About 70 per cent of this amount came from the private sector, with almost 10 per cent of it covered by a government guarantee; the remaining 30 per cent was provided through direct government loans. In 1980, there were four boards and seven agencies at the federal and provincial levels offering financial assistance to farmers.

The terms and conditions of government financial assistance to farmers are more generous than those offered by private lenders. They represent an acknowledgment that there are difficulties the private sector can't resolve.

The most serious of these difficulties is an insufficient cash flow to cover loan payments. Farm production involves the use of land. But the return on land comes mainly in the form of a capital gain that the farmer does not receive in cash – at least not until he sells the farm.

Thus a large part of the farmer's income is not available to make payments on a relatively large debt at a 15 to 17 per cent annual rate of interest – and hence the cash flow problem. With inflation at 12 per cent, the farmer's nominal return on land may be 17 per cent but he would receive 5 per cent or less in cash, while lenders demand interest at 17 per cent or more. In addition, the absence of an adapted long-term financing instrument has seriously aggravated farm finance problems.

Some of these difficulties, says the Council, could be resolved by the introduction of a new financial instrument, the indexed farm mortgage. This would be similar to the residential indexed mortgage proposed for the housing sector (see accompanying article).

Like its housing counterpart, the indexed farm mortgage poses some problems. But this new instrument, says the Council, would reduce the repayment difficulties experienced by farmers by adapting their monthly payments to their cash flow. The Council therefore recommends that governments encourage the introduction of indexed farm mortgages under the same conditions as those proposed for the housing sector.

In addition, the Council recommends that, during a transitional period, government should insure the principal and interest of indexed mortgages against payment default by farmers, in order to overcome the lack of familiarity with farming on the part of new potential lenders.

Given that agriculture is a vital sector of the Canadian economy, says the Council, it is important to maintain its vitality and dynamism. An adequate supply of funds must therefore be made available to farmers – but in appropriate forms. The Council is aware that the introduction of indexed farm mortgages would not resolve all the problems faced by farmers, such as those related to the instability of their income.

ASSISTING BUSINESS

Industrial and commercial businesses are vital to the achievement of Canada's major economic and social objectives, which explains the keen interest shown by all levels of government in their financial health. When necessary, governments participate actively in business finance through the provision of loans, investments, and loan guarantees.

On March 31, 1980, there were 28 agencies, boards, and departmental divisions at the federal and provincial levels whose primary activity was to provide these forms of business finance. Total loans and investments outstanding amounted to $6 billion, and guarantees to $577 million.

The stated objectives of these agencies rarely mention the elimination of deficiencies or of financial market imperfections. Much more often, they mention the goals dealing with the economy as a whole: transformation of the industrial structure, job creation, establishment of new industries in designated provinces or regions, and so on. Contrary to a widely held view, most government programs and agencies were not specifically created to assist small and medium-sized firms or newly established companies.

Deficiencies in the supply of financial capital can affect two major categories of financial instruments: loans (debt finance) and purchases of capital shares (equity finance).

In the past, there were problems in the supply of term loans. These appear to have been resolved to a large extent and, in recent years, businesses seem to have had little difficulty in obtaining loans. The weakness in their financial structure is to be found in a small – and shrinking – equity base, particularly in the case of small and medium-sized firms.

As a rule, the smaller the firm, the greater its use of debt financing and short-term debt; the larger the firm, the more it tends to issue shares and debentures. Some 30 per cent of firms with assets of less than $250,000 have a debt-to-asset ratio exceeding 77 per cent. This proportion drops to 10 per cent for firms with assets exceeding $25 million.

This low equity base of small and medium-sized firms is by no means a new problem, but economic developments in recent years have drawn attention to the urgency of reducing this weakness. When firms lack a solid reserve of equity, they are deprived of a cushion to weather periods of high interest rates and lagging sales.

Many factors may explain the relatively weaker equity base of small and medium-sized businesses. Owners may be reluctant to part with some of the control over their firms, even when their own resources are limited; a lower profitability for some may contribute to reducing their equity; regulation and practices of some categories of financial institutions may restrict the supply of equity capital; certain features of the taxation system may favour debt financing; and some aspects of the structure of the equity market and the relatively high cost of new issues – particularly the smaller ones – may constitute another cause of this problem.

However, says the Council, government agencies that provide assistance to businesses have been geared to term lending and not to the problem of equity financing. Yet government could encourage the rebuilding of the equity base of Canadian firms in several ways, by modifying certain aspects of taxation and regulation, by contributing to the development of Canada's stock markets, or by resorting to limited equity participation.

Regardless of the specific method chosen, the Council recommends that federal and provincial governments modify their assistance policies to facilitate the strengthening of the equity base of Canadian firms, particularly small and medium-sized businesses.

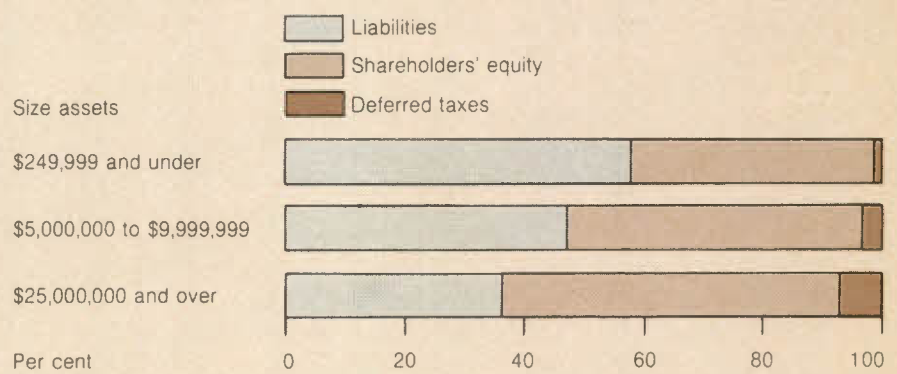
A second recommendation in this area is that public loans be extended only in cases where there is a strong presumption of the existence of a deficiency.

Public financing agencies providing assistance to businesses could, without great difficulty, operate in such a context and could take some limited equity participation in firms – as many of them already do. But the Council notes that a greater focus on the part of public agencies on the supply of equity finance will not be enough to resolve the equity problem, as government institutions hold a relatively low share of business finance.

In conclusion, the Council notes that over the past 40 years, despite some important changes in needs, there has been little change in the objectives pursued or the instruments used by government in its intervention in financial markets to provide assistance to businesses. A reorientation of government activity in financial markets favouring business equity finance would, according to the Council, be a step in the right direction.

How corporations do their financing

1977 distribution of corporate financing by category of instrument and size of firm assets



AND SUPPORTING EXPORTS

Government credit and credit insurance offered to exporters are essentially extensions of government assistance given to businesses. However, trade in goods and services between countries has a number of special characteristics.

The risks undertaken by the partners in international transactions are generally greater than those faced in domestic trade. And the diversity in trade practices, methods of transport and shipment, and regulations – not to mention language and cultural differences – often calls for specialized services to exporters.

Canadian exporters must also face competition in foreign markets from foreign firms that often benefit from the financial support of their own governments. But like their foreign counterparts, Canadian exporters can take advantage of government assistance programs that complement, or replace in their absence, the services offered by financial institutions in the private sector.

Exports are of key importance to the Canadian economy, accounting for one-quarter of GNP in 1980. As of December 31, 1980, loans outstanding granted by the Export Development Corporation (EDC) – the country's main public supplier of export credit – amounted to $3.8 billion; the export credit insurance in force totaled $1.7 billion.

While the Canadian International Development Agency (CIDA) administers Canada's aid to Third World countries, the lines of credit that it extends to some of them benefit Canadian exporters as well. In 1980, loans granted by CIDA amounted to almost $250 million.

As with the housing, farm, and business sectors, government intervenes in export credit markets both to remedy potential deficiencies and to achieve major macroeconomic objectives that extend well beyond these markets. The objectives include the promotion of exports and the diversification of trade patterns and goods exported to improve the balance of trade; the promotion of industrial restructuring; job creation; and enhancement of Canadian firms' capacity to penetrate foreign markets.

To pursue these objectives, government uses two types of financial instrument – credit insurance and direct loans. EDC credit insurance protects Canadian exporters from any default of payment caused by commercial or political factors in the countries where their products are sold. Direct loans take account of the fact that Canadian exporters have greater financial requirements than do producers selling only in domestic markets.

Noting the absence of significant malfunctions in the credit insurance market and that the private sector could well take on at least a part of export credit insurance activities, the Council recommends that the EDC gradually move towards providing export credit reinsurance (i.e., assumption of part of the risk insured by a private company), leaving the field of insurance proper to the private sector. In addition, the EDC should serve as the insurer of last resort to close any gaps left by the private sector in providing export credit insurance.

In the case of export finance (direct loans), the Council recommends that the EDC continue to provide direct financing for Canadian sales abroad when it appears that the private sector is unable to provide the required credits.

But, noting the absence of generalized deficiencies in the export finance market, the Council also recommends that the EDC gradually withdraw from most direct-lending activities, concentrating its efforts increasingly in the field of credit insurance and bank guarantees. In addition, the EDC should be prepared to provide refinancing facilities for private lending institutions engaged in export finance.

One EDC objective is to match the subsidy programs of other exporting countries in order to make Canadian exports more competitive with foreign goods. The support offered by Canada, however, is much less than that offered by most major industrialized countries.

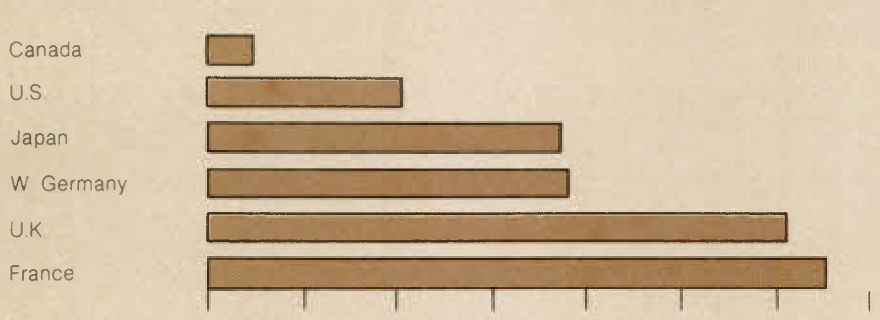
In the Council's view, export subsidies are both costly and a barrier to free trade, and should therefore be eliminated. On the other hand, the signature of an international agreement to that end seems far off, and unilateral abandonment and the necessary restructuring of the domestic economy to compensate for the loss of foreign markets could themselves entail high costs.

This leads the Council to recommend that the federal government continue its efforts, at meetings of the Organisation for Economic Co-operation and Development (OECD) and the General Agreement on Tariffs and Trade (GATT), to obtain an international agreement to further limit subsidized export credit.

Failing such an agreement, the Council recommends that Canada use subsidized credit only when it appears likely that it will facilitate the opening of new markets or will increase the market share for Canadian products.

The support industrialized countries give their exports

Proportion of total exports receiving government support[1] in selected OECD countries, 1980



1 Direct credits disbursed and guaranteed credits approved.

CALL FOR EFFICIENCY AND CONTROL

> *"Increasing the technical efficiency of agencies is the first step to increasing their economic efficiency."*

In the private sector, profitability in a competitive environment is the efficiency criterion generally recognized by business people and economists.

This criterion, however, cannot be applied without modification to government financing agencies and programs, since the objectives they pursue lead them to operate in areas which the private sector has not considered profitable. Their activities are therefore not comparable with those of private financial institutions.

Thus some public agencies often encounter very high costs in gathering information or face risks that are too great to be reduced through portfolio diversification, while others hold specialized portfolios offering little room for diversification. Moreover, the social goals pursued by government often diverge from the private profit motive.

The multiple objectives assigned to public agencies require different operating procedures. For example, agencies may be asked to carry out, simultaneously, policies intended to make up for some private sector shortcoming and to boost economic growth or improve Canadian living standards.

This complicates the management of a program or agency, leading the Council to recommend that, where appropriate, two categories of assistance be established within a public financing agency – one dealing with supplementing the private sector, the other dealing with broader social objectives.

A second recommendation in this area is that managers of public financing agencies be given financial guidelines consistent with the different categories of objectives pursued.

This alone is not enough, however, to ensure that the objectives will be met within the means at an agency's disposal. According to the Council, it is also important that government monitor the agency's activities.

This control can be exercised at three levels: at the budget level (assignment and use of budgets), at the procedural level (e.g., selection of clients, choice of financial instrument, internal operating procedures), and at the objectives level (definition and means of achievement). The control may be exercised by three groups in government – the executive, the legislature, and the Auditor General.

Public financing agencies are generally subject to strict budgetary control. The minister responsible and the Treasury Board, in addition to approving the total budgetary package, often impose constraints on the use of funds.

Given the importance of assessing the scope and the costs of government participation in financing the private sector, the Council recommends that Members of Parliament and of the provincial legislatures be given more opportunities to debate the amounts of the loans and guarantees to be granted in a given fiscal year by the financing agencies under their respective jurisdictions.

> *"It is important... that society, through its governments, maintain a strict control over the agencies that are charged with improving the welfare of all Canadians."*

The control over the actual operations of a public agency is generally not as tight as that exercised over its operating and capital budgets. This control is usually exercised within the agency, although the minister or his representatives occasionally also become involved. And the degree of control exercised varies from one sector to another.

Here the Council recommends that the federal and provincial governments consider the possibility of regularly selling off part of the loan portfolios of their financial agencies. This might enable legislators and the public in general to evaluate the operations of public loan and guarantee agencies and to determine whether the agencies had invested wisely in viable projects or had distributed the amount of subsidy judged necessary to fulfil their social role.

Finally, control over objectives is almost nonexistent. Not only are the objectives vague and sometimes beyond the reach of the agency, says the Council, but their merits are rarely questioned. When they are, the re-evaluation is generally done internally. According to a Council survey carried out for the report, the goals of nine lending agencies have never been reviewed, and those of 10 others have been only superficially examined.

In view of the importance of subjecting agencies to periodic review, the Council recommends that the objectives and operations of public financing agencies be reviewed every five years.

The Council notes that annual reports of public agencies can also provide a potentially useful source of information about their budgets, stated goals, and means adopted to achieve these objectives. But major shortcomings were found by the Council in most of the 34 annual reports it studied. They fall into two categories: those dealing with general information and those dealing with financial information.

General information primarily covers the statement of an agency's objectives, a description of its programs, and an analysis of its clientele. Here the Council recommends, among other things, that the annual reports of all public loan and guarantee agencies include a statement on each subprogram that they administer, giving the rationale and cost of each program and, to the degree appropriate, the characteristics of the beneficiaries.

Shortcomings in financial information are addressed in a recommendation that the financial statements of public loan and guarantee agencies follow the generally accepted accounting rules that are in effect in the private sector, where applicable, and that standards for the disclosure and presentation of financial statements specifically designed for public agencies be put into place, where necessary, as soon as possible.

Why do people move?

A better tax deal in another province, more generous unemployment insurance benefits, more federal money – these all have an impact on decisions Canadians make about moving to other cities or staying home.

It's not only the prospect of getting jobs or better-paying jobs that encourages people to move, says a study prepared for the Economic Council of Canada.

Many people in the 1970s pulled up stakes and moved to Alberta because they believed growing resource revenues meant they would get public services at lower cost than they would at home. These revenues helped hold down taxes.

Ten to 13 per cent fewer migrants would have moved to Alberta in 1977 if natural resource revenues had remained at real 1971 levels (after allowing for job-hunting migration).

There are other influences, too. Changes in the unemployment insurance system alone have reduced migration from the Atlantic provinces in the 1970s and have encouraged people to go to British Columbia.

The federal system of equalization payments, designed to partially close the gap between rich and poor provinces, is another factor in affecting people's decisions on whether to stay in an economically depressed area.

The study authors, economists Stanley Winer of Carleton University and Denis Gauthier of Queen's University, say the fiscal structure – government spending programs and the tax system – helps explain migration within Canada from 1968 to 1977. It was almost as important as the prospect of new jobs in encouraging poor Ontario migrants to move to Alberta, and explains why the Atlantic provinces switched from losing people to gaining them in overall terms during that period.

The study found that government fiscal programs had a greater influence on poor migrants than on richer people. This may be because poor families receive a larger portion of their income from government programs, say Winer and Gauthier.

The migration report, say the authors, is another contribution to the debate on the effect of these fiscal measures on the economy. Some economists argue that equalization payments block efficient development of the economy while others say that they yield real benefits.

Economist Thomas Courchene, now chairman of the Ontario Economic Council, has suggested that regional differences in earned income would be reduced if people moved to richer areas from poorer regions. Such measures as the equalization program frustrate this migration, he says.

On the other hand, the Economic Council of Canada concluded in its report *Financing Confederation* this year that an equalization program is essential to the efficient functioning of the economy. People and plants should stay where they are most productive.

The migration report does not settle the question of fairness and efficient economic development, but it does offer evidence that government programs do influence migration.

Analysing migration series developed from personal income tax and family allowance data, Winer and Gauthier say the unemployment insurance system is one of the strongest elements in reducing the flow of migrants from the Atlantic region.

Amendments to the Unemployment Insurance Act in the 1970s made it easier to qualify for benefits and for longer periods in regions where the unemployment rate exceeds the national average.

If these changes had not been introduced, the authors estimate, the rate of migration to Ontario from the Atlantic provinces would have been up to 42 per cent higher in 1977 than it was.

Interestingly, the unemployment insurance changes have also stimulated migration to British Columbia, normally considered a wealthy province, say Winer and Gauthier. B.C. is a relatively high unemployment region and migrants who fail to get jobs or lose jobs can be assured of good unemployment benefits.

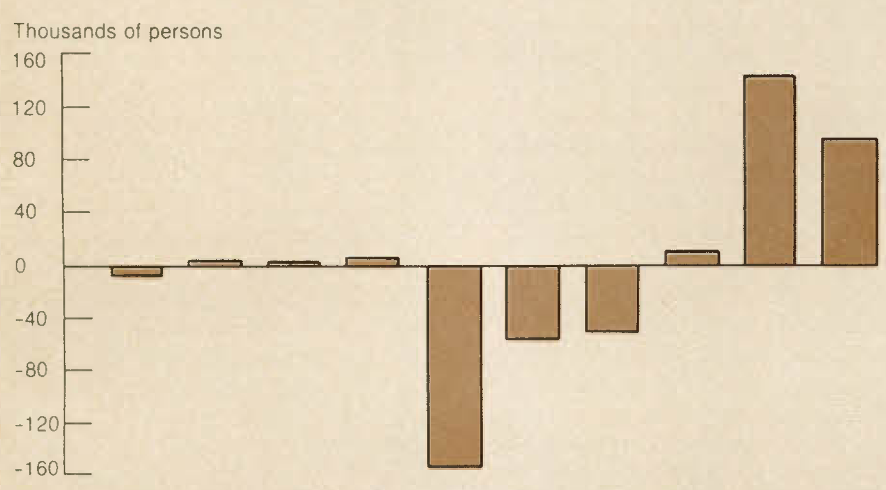
Increased equalization payments in the early 1970s also helped to deter some people – particularly low-income earners – from moving to wealthy western provinces such as Alberta and B.C. The number of poorer migrants to these provinces from the Atlantic region was up to 16 per cent lower in 1977 than it would have been without these increased payments.

This increase in equalization payments was largely the result of a rise in western natural resource revenues.

These growing western resource revenues helped draw both rich and poor people to Alberta, says the study. People were counting on getting public services at less cost to themselves.

Comings and goings in Canada

Net interprovincial migration, 1976-80



Internal Migration and Fiscal Structure: An Econometric Study of Interprovincial Migration in Canada, by Stanley Winer and Denis Gauthier (EC22-109/1982E; $8.95 in Canada, $10.75 elsewhere).

Council chairman talks about government deficits

The ballooning federal deficit has alarmed many commentators and has prompted some to demand a policy of deficit reduction.

While concerned about the deficit, the Economic Council of Canada has said its recent spectacular jump in size is both "understandable and manageable."

In fact, the Council recommended in its latest Annual Review that the government stimulate the economy with a $2 billion package even though that might increase the deficit a bit. The Council also urged the government not to try slashing the deficit during the current economic slowdown.

Au Courant asked Dr. David Slater, Council chairman, to discuss the deficit question.

Au Courant: Perhaps I could start by mentioning that a number of commentators have criticized us for recommending a $2 billion stimulus when the federal deficit is already at $20 billion. Are they not right to be concerned about such a large deficit?

Slater: Well, our position is that if you take a medium- to longer-term view of things there may well be something to worry about in the size of the deficit, in the sense that there may be some structural features in our government programs giving us deficits larger than we would like even if the economy were operating at a good level.

The thing we've been pointing out is that there are also some extraordinary short-term factors in play. And it's those short-term factors that are primarily responsible for the enormous increase in the government deficit recently. We're arguing that the current deficit, looked at as a short-term problem, is both understandable and manageable. Fundamentally, what we have shown is that when you have a recession, and the more severe it is, the more automatically government expenditures increase and government revenues shrink. And since we've had, by everybody's admission, the worst recession since the end of the war, it's not at all surprising that the government's expenditures, such as unemployment insurance and welfare payments, have gone up very rapidly, or that its revenues have shrunk by a greater degree than in any postwar recession. The upshot of that, of course, is that, when the economy recovers, there will be a reversal of this particular short-term factor.

We pointed to two other temporary factors, as well. As you know, for the first time since 1973, we've actually had a significant fall in the absolute price of oil in international markets. Well, the way that our government revenues and expenditures associated with oil are set up, the net oil revenue position of the federal government is very sensitive indeed to variations in the international price of oil. And that, too, has given an extraordinary shortfall compared with budget plans in the federal government's oil revenue. Those oil prices just have to flatten out, stop falling – they don't even have to increase – to bring about some improvement in the federal government position.

The third factor relates to the cost to government of servicing its debt. The net cost depends on the level of interest rates. And what we've pointed out is that we have had an exceptional period of high interest rates for a longer period than predicted, which has tended to increase the debt service cost of the Canadian government and the deficit on that account. But as everybody can see, interest rates have already come down a fair bit, and that factor alone will significantly reduce the relative burden of debt service of the government over the next year or two.

Then there's the question of the manageability. Does the public in general, do the people who hold securities, who manage pension funds, who are investment dealers, have the same understanding as we do of the causes and the enduring and temporary features of the deficit? It's not a question of whether we're right or wrong, but is there in fact a meeting of minds about this? I would say, yes there is, and because there is, the people who are managing capital funds are not particularly panicky about the deficit.

The second thing is that the deficit is more or less manageable depending on whether you've got a high savings rate or a low savings rate in your country. If you have high government deficits which need to be financed by extraordinary borrowing abroad, as in Brazil or Mexico, that's one thing. If they are being financed out of a high level of domestic saving, and indeed domestic savings levels are much larger than the government deficits themselves, then that is another thing. In Canada, we have a high personal savings rate which is available to finance the deficit. If in fact Canadian households were spending more, saving less, the economy would be stronger, and it would turn out that the government deficit would be smaller.

Au Courant: How does Canada compare with other OECD countries, as far as the deficit is concerned?

Slater: Well, I guess you'd say in comparison with the other OECD countries that Canada is neither a country with the largest deficits as a percentage of the national output, nor with the lowest in recent years. For example, Japan and Germany, two countries which are admired in many respects for their growth and for their inflation performance and so on, have persistently had deficits as a percentage of GNP which are quite a lot larger than those in Canada. On the other hand, the United States and France, in recent years, have had smaller deficits as a percentage of GNP than Canada. But the interesting thing is to make a comparison between deficits and saving performance in these various countries. What you have had in both Japan and Germany is a long history of high saving, so that they've been able to manage these government deficits fairly easily. And in Canada, it's also fair to note that, though we've had somewhat higher deficits than some of those countries, nevertheless our deficits have not been outrageous in comparison with our savings rate.

Now, if you take the most recent experience, I think what you are faced with is for Canada an exceptionally high government deficit position. When you get federal government deficits running at 5 per cent of GNP and deficits for all governments together running maybe at 3 1/2 or 4 per cent of GNP, that's exceptional by Canadian historical standards. But it remains true that some of the other countries had exceptionally high deficits too. The U.S. experience recently has been to have a much bigger deficit than their historical experience and the same is true in France and Italy. But even with all of that, in Canada you've got two exceptional things at the same time, remarkably high government deficits, but extremely high personal savings, too.

Au Courant: If we were at full employment, would the government be in a deficit position? Can we expect, for example, that a recovery in the next few years would bring the deficit into balance?

Slater: I think one has to make some allowance for debt service adjustments and oil and gas revenue adjustments, as I mentioned earlier. I don't know that one can be certain that full employment or a reasonable average level of employment will tip the balance for the federal government or, for that matter, for any government in Canada, into a surplus position. There are some calculations, but they depend on judgment calls.

There's no doubt that there would be an enormous difference, an enormous reduction both absolutely and as a percentage of GNP, in the federal government's deficit position if we could get to an average business cycle condition that's not based on exceptional stimulative action by government, but rather on average performance of the private sector in terms of spending, housebuilding, investment, inventory accumulation, and buying of autos, stoves, fridges, and so on.

Au Courant: What is the danger of trying to reduce the deficit at this point?

Slater: The main danger of trying to reduce the deficit at this point is that, as households and as businesses, we'll be driven to such a holding back on our spending that we'll drive the unemployment rate much higher, we'll drive the capacity utilization much lower, we'll drive profits much lower, and indeed we may even drive ourselves into a kind of trap, perhaps temporarily, but still a trap, in so far as we won't be able to get people to spend and businesses to invest because activity is low – and activity is low because we're not spending.

Au Courant: So, on balance, how would you suggest the government approach the whole question of dealing with the deficit?

Slater: I think that what the Council suggested is that the first order of business is to get the message about the reasons for and the manageability of current deficit positions presented to the Canadian people in ways that they can see and can examine and so on.

I think, too, that the message of fiscal responsibility has to be put across to foreign governments, international institutions, foreign capital markets, and so on. I have no reason to doubt that message is getting across, but it's something that has to be worked at on a continuing basis. The Council took the view that prospects of the winding down of inflation are so strong in Canada that indeed we could and should shift our attention a little towards getting employment up and unemployment down, and if some small stimulative action would result in a marginal increase in the deficit, that's a risk worth taking.

New appointments to the Economic Council of Canada

Paul-Émilien Dalpé is founder and past president of the Centrale des syndicats démocratiques. A former executive of the Confédération des syndicats nationaux, and past president of two hospital unions, Mr. Dalpé has also served as a member of numerous committees, including the Conseil d'administration of the Société générale de financement, and the Consultative Council of Labour and Manpower of Quebec.

Gerald V. Schuler is chief executive officer of the Co-operative College of Canada in Saskatoon. A past director of the Rural Education and Development Association in Edmonton, and holder of various offices with the Farmers' Union and Co-operative Development Association of Edmonton, Mr. Schuler has been involved in farming, co-operative management and enterprises, and education for many years.

Douglas P. Thomas is a partner in Toronto Investment Management Inc., an investment counseling firm managing assets such as pension funds, insurance companies, and personal accounts. Previously associated with Collier, Norris and Quinlan, and Pitfield MacKay Ross Ltd., Mr. Thomas is regent for the Canadian Investment Seminar, and past director of the National Society of Financial Analysts.

J. Irving Zucker is owner and president of three lighting companies in Burlington and Hamilton, Ontario, and is also involved in real estate redevelopment in Hamilton. He is a member of the Faculty of Business at McMaster University, and patron and sponsor of "The Zucker Lectures" there. Mr. Zucker was formerly a partner in the ownership and operation of five Ontario radio stations.

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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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