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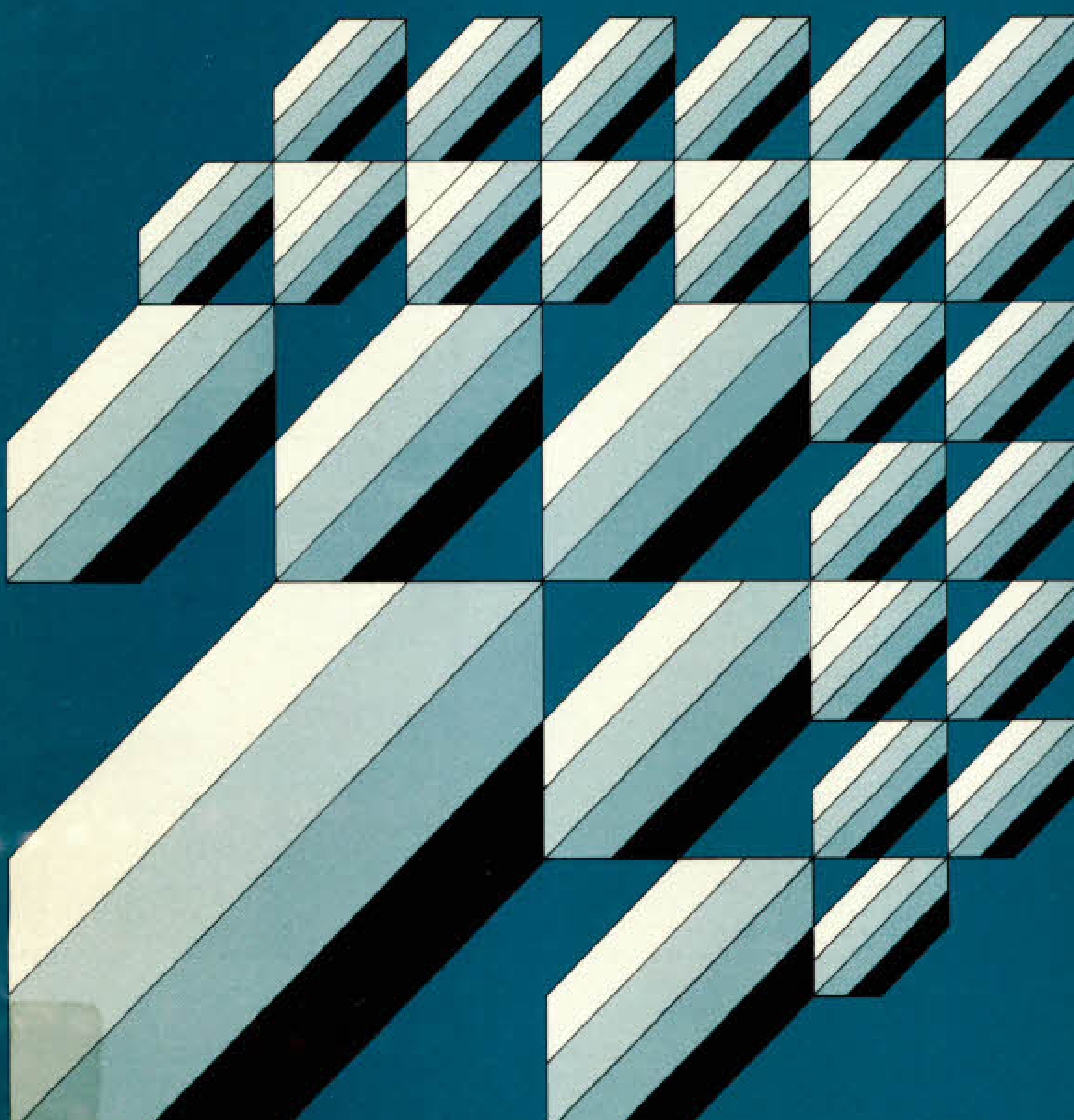
Economic Council of Canada Volume 6, No. 2, 1985

The Council's annual review of the economy

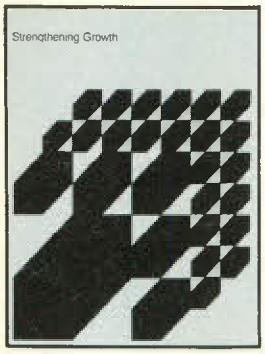


- Inflation and business taxes
- VIA Rail's track record
- Canada's manufacturing performance

PUBLICATIONS

Twenty-Second Annual Review

Strengthening Growth: Options and Constraints (EC21-1/1985E; $5.95 in Canada, $7.15 elsewhere). In its 1985 review of the economy, the Council looks at Canada's productivity performance, the pros and cons of an independent monetary policy, and the worrisome aspects of the current investment situation. In addition, it discusses policy options for the future.



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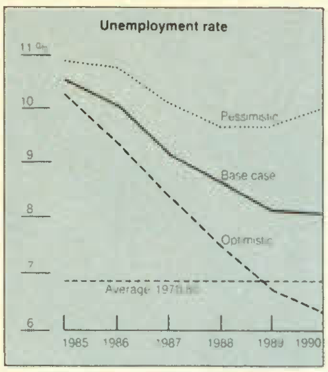

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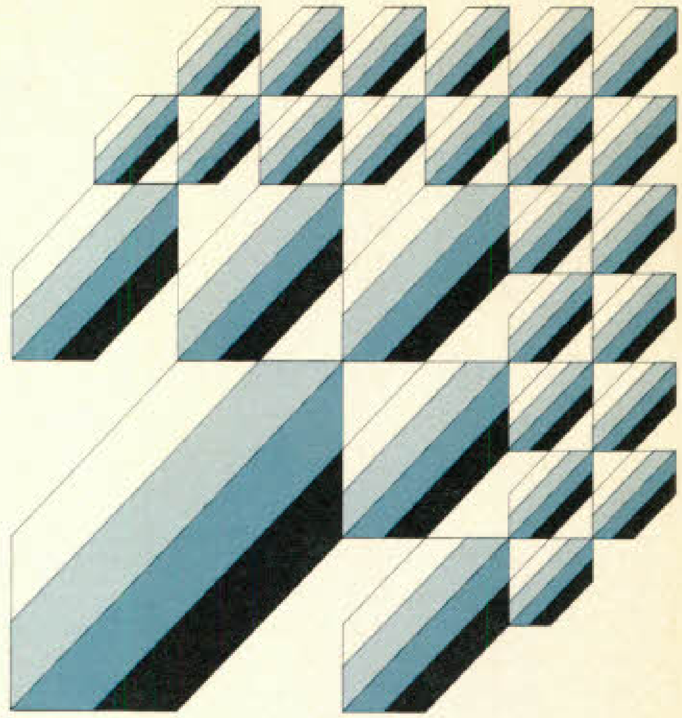
Strengthening Growth



Investment spending, productivity growth, and Canada's monetary policy will require special attention over the next few years, says the Economic Council in its Twenty-Second Annual Review of the economy.

A better understanding of these three key areas, along with continued vigilance on the government deficit issue, should make it easier for Canadians to choose the most effective means of strengthening growth and reducing unemployment in the medium term, says the Council. And some encouraging signs over the past year suggest that problems can be tackled now with greater confidence than in the recent past. In certain respects, 1984 was a good year for the Canadian economy. Growth (as measured by the gross national product) averaged an impressive 5 per cent – not only the strongest showing since 1976 but also based on both consumer spending *and* exports (primarily in the automotive market). At the same time, inflation dropped to 4.3 per cent, its lowest level in 15 years, while both wages and prices continued to rise, but at slower rates.

The greatest weakness in 1984 lay in the low level of investment spending, as evidenced by the poor performance of business and residential "capital formation" (a term used to describe the increase in the number of a country's factories, mines, machinery, and so on). In fact, the ratio of investment to gross national product (GNP) in 1984 was the lowest since the late 1940s, in direct contrast with the situation in the United States, where growth in capital formation of about 20 per cent boosted U.S. real growth to nearly 7 per cent.

While several positive signs now suggest that intentions to spend, as well as spending, are on the increase, the worrisome aspects of the current investment situation persuaded the Council to examine the issue in greater detail (see page 8).

Another cause for concern lies in the fact that, for the seventh consecutive year, wage growth has failed to keep pace with the cost of living, with inevitable consequences for Canadian living standards. Living-standard growth is closely tied to productivity growth, which has remained stagnant for more than a decade. Restoring productivity growth would not only boost Canadian living standards, says the Council, but would help to control inflation and reduce the federal deficit. While growth in labour productivity has recently picked up, there is no guarantee that the problem has been solved. Council research on the complex issue of the productivity slowdown is discussed on pages 5 and 6.

As well, concerns have been expressed about the ramifications of the current monetary policy. High real interest rates and the constraint put on the Bank of Canada by the increased integration of international financial markets have left the Bank with few options but to follow U.S. interest rates while maintaining order in the foreign-exchange market. Yet today's above-average real rates, which translate into double-digit nominal interest rates, are one factor likely to continue to slow the pace of investment expansion in Canada, and leave the federal government less room for policy manoeuvre in the face of the need to service the mounting debt. Would following an independent monetary policy improve the situation, as some believe? The Council looks at the pros and cons of this issue (see page 7).

A view of the economic setting over the next ten years would facilitate discussion of these important questions, so the Council has sketched in the medium-term economic outlook. Since such an exercise, however useful, is inevitably open to debate, the Council also considers areas where a degree of uncertainty could change the outcome – namely, inflation, investment, government deficits, Canadian export performance, and the outlook for the United States.

Outlook for the economy

The Council's basic projection of the key economic indicators – which it calls the "base case" – is founded on certain specific assumptions (on the past performance of the economy, for example, as well as its present position, current information about its future course, the outlook for foreign economies, and so on). Using this basic projection, the Council then tries out various scenarios or alternate cases, to see how the economy would be affected.

According to this year's base case, the medium-term outlook suggests that during the next ten years economic growth could average 3.5 per cent; inflation will dip below 4 per cent; the unemployment rate will fall to near 7.5 per cent; and the federal deficit will decline as a percentage of GNE. But while the medium term looks reasonably bright, the near-term outlook remains cloudy with respect to the rate of job creation, investment performance, the imbalance between government spending and revenues (despite headway in reducing the deficit in the recent budget), and the real rate of interest.

The charts on the next two pages indicate the outlook for six key economic indicators over the decade. In each case, the base case is compared with an optimistic alternative that assumes low inflationary expectations, low U.S. interest rates, and strong domestic investment; it is also compared with a pessimistic alternative assuming the reverse.

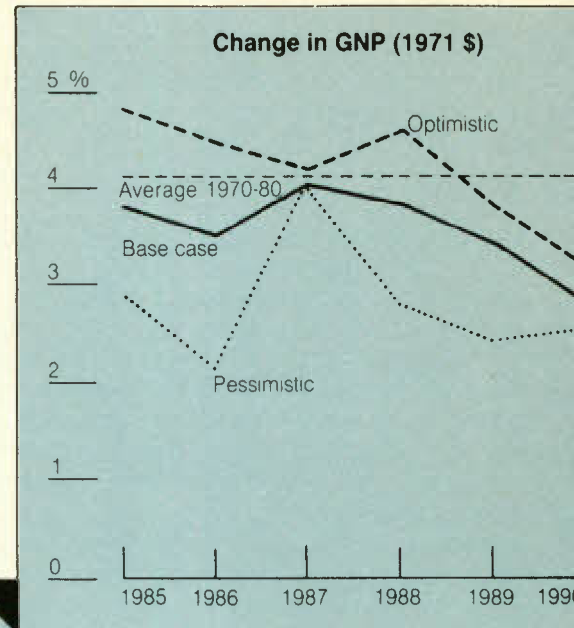
Growth (GNP)

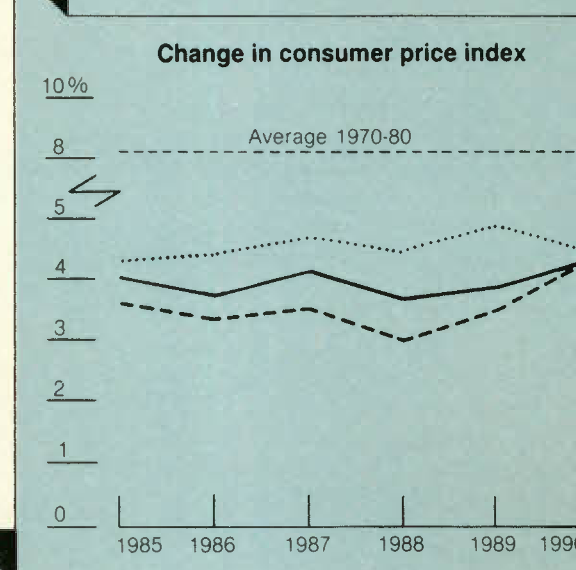
Barring a serious recession, real growth should average more than 3.5 per cent throughout the next decade – the best performance Canada has anticipated in a long while. But because exports have recently become a major contributor to Canada's growth, changes in export markets could affect this outlook. In that respect, U.S. economic prospects are important, as is the development and/or expansion of markets elsewhere.

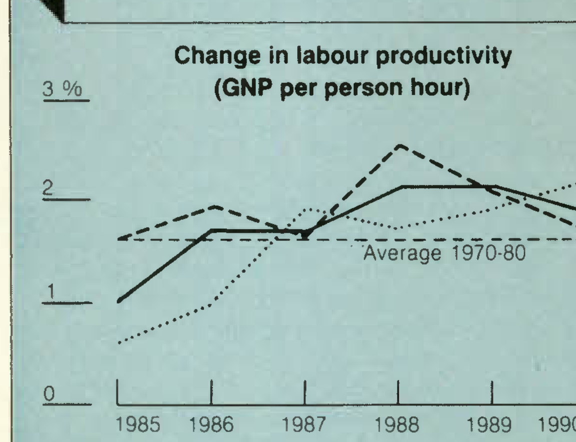
While the outlook for the United States is generally favourable, certain eventualities south of the border could affect Canada's export trade. The most uncertain aspect of the U.S. medium-run outlook pertains to the balance of payments and the dollar. The Council observes that an expected decline in the U.S. dollar (about 21 per cent in the medium run), coupled with any protectionist measures that may be taken by Congress, could erode the recent gains in Canadian competitiveness and affect Canada's position in U.S. markets. In contrast, trade liberalization between the two countries, "although complex to negotiate, could be of great long-term benefit to Canada," the Council says.

Inflation (consumer price index)

All going well, the inflation rate is expected to remain relatively low over the medium term. That outlook, however, assumes the continuation of those elements that have held inflation down in recent years – for example, low inflationary expectations, weak oil and non-oil commodity markets, moderate monetary growth, and stable raw material markets. A critical factor underlying inflation prospects in the medium run is the outlook for nominal







wage growth, the Council observes. It cautions that while lower inflation improves the picture for jobs, productivity, and deficit reduction, even slightly higher inflation has a strong reverse effect.

Labour productivity

Provided that prices remain stable, that real growth continues, and that there are no "shocks" to the economic system, labour productivity and growth in real wages should range between 2.0 and 2.5 per cent over the decade – the most prolonged period of stable gains for those indicators since the 1960s. But unanticipated shocks, a resurgence of inflation, and/or periods of recession could dissipate any advances.

Unemployment

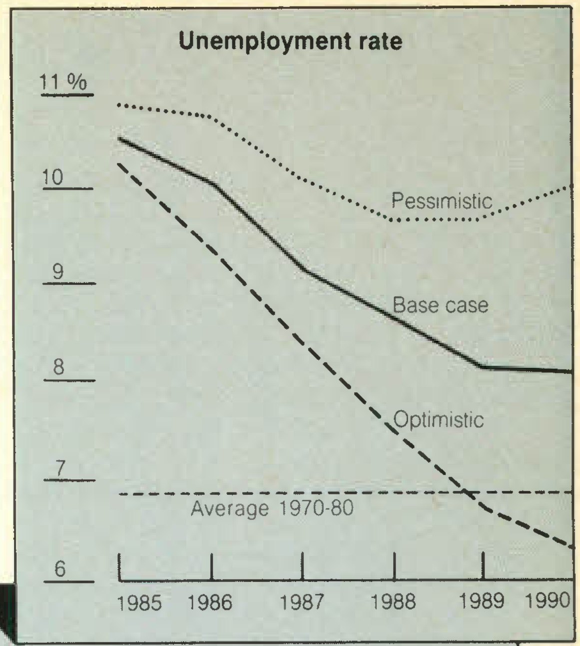
The medium-term outlook for labour markets appears favourable, according to the Council's basic projection. Employment growth is anticipated to be around 2.3 per cent for the period 1985-90 but below 2.0 per cent for 1991-95. Diverse factors, such as some recovery in the rate of productivity growth and a continued upward trend in the female participation rate, will combine with steady growth in output to produce a gradual reduction in the unemployment rate. Under the current policy regime, however, double-digit unemployment will persist until late 1986, after which continued real growth in output of about half a percentage point above potential growth throughout 1985-95 could push the rate of unemployment below 8 per cent between 1991 and 1995.

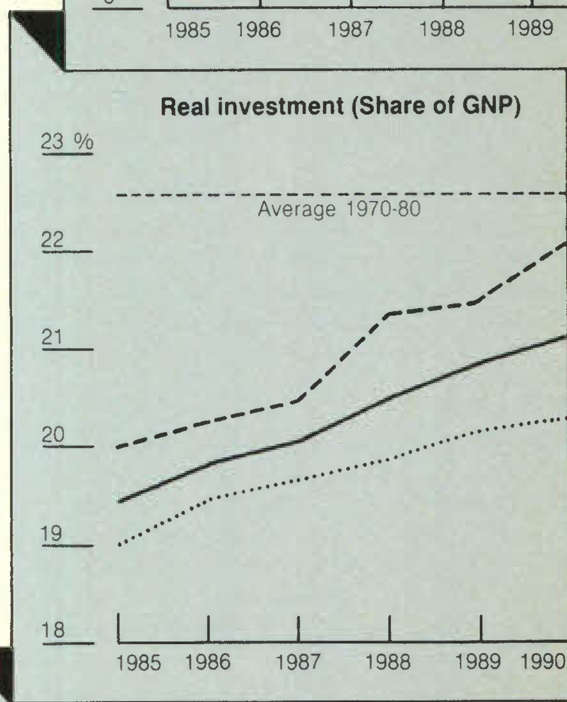
Real investment

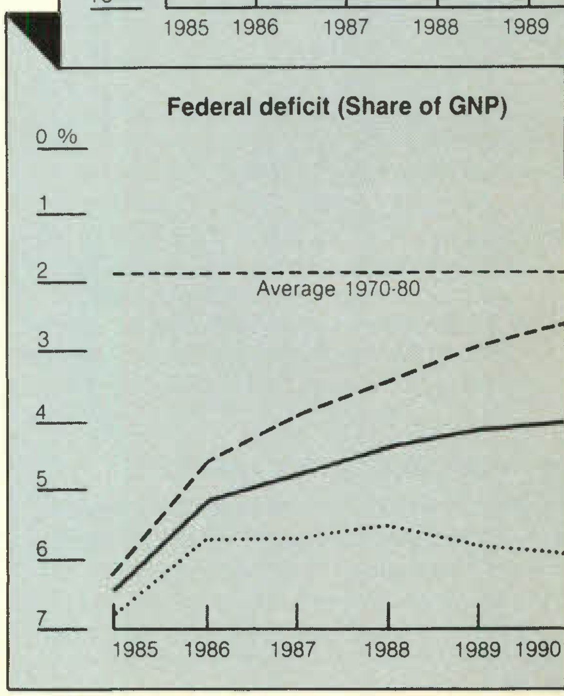
The weakness of investment spending (a concern in 1984) constitutes a worrisome aspect of the medium-run outlook as well. The base case implies a modest recovery in business investment during the medium term, but investment as a percentage of GNE is not expected to recover significantly from its current low levels. Nevertheless, there is some reason for optimism. In the energy area, for example, changes introduced by the Western and Atlantic Accords make the expansion of energy-related investment in Western Canada and Newfoundland more likely. As well, anticipated stable economic conditions should encourage more non-energy, non-housing investment. But according to the Council, the outlook for investment remains, to a large extent, unpredictable and highly dependent on the recovery of business confidence, as well as the policy approach adopted.

The deficit

With the implementation of the tax increase and expenditure reduction initiatives taken in the May 1985 federal Budget, the federal deficit as a percentage of GNE is expected to fall from a high of nearly 7 per cent in 1984-85 to about 4 per cent in 1990 and close to 2.0 per cent between 1991 and 1995. In the Council's view, the recent budget "changed for the better many of the ominous trends related to deficits of the past decade." The Council cautions, however, that deficit projections are very sensitive to assumptions about economic activity and interest rates. So a weaker U.S. economic outlook, coupled with higher real interest rates, could substantially increase both deficit and debt levels above that of the base case; and, conversely, a stronger U.S. outlook and lower interest rates would improve the federal budget position.







The productivity slowdown

When a better cook in a better kitchen can serve up better meals faster, or a lawyer is able to handle more cases with a word processor, or airlines using computerized booking systems can fill more seats, then productivity is on the rise. In more general terms, a reduction in costs per unit of output or an increase in output per unit of input equals productivity growth.

For the economy as a whole, this process is key to improvement in living standards. As the Council puts it: "when the efficiency with which people, machinery, buildings, equipment, raw materials, and knowledge are combined to produce more goods and services improves continually, this inevitably results in higher real incomes and standards of living."

The problem in the recent past, not only in Canada but also in most major industrialized countries, was that productivity growth had been on the wane since the early 1970s and virtually dried up altogether during the early 1980s. While some improvement has been apparent recently, it is still too early to know whether it marks the beginning of a long-term trend. Consequently, "for the first time in the lives of Canadians now in their forties, growth in living standards appears to be seriously threatened."

Returning to the old regime of sustained high growth in real per capita incomes will not be possible without renewed productivity growth. That in turn means determining the causes of the productivity slowdown and developing a strategy for action.

An important first step in this undertaking is to arrive at an accurate understanding of the concept of productivity itself. In the past, it was measured simply in terms of labour productivity – output per person employed, or output per person-hour. The Council, however, prefers the more comprehensive framework provided by the concept of "total factor productivity" or "TFP." Put simply, TFP measures the increases in output that are in excess of the increase in the combined individual elements engaged in the production process. These elements include not only labour but also capital, materials, energy, and many other inputs. Consequently, the Council observes, this measurement bears a closer relationship to many everyday measures of economic performance – such as output growth, labour productivity and cost performance, wage and price prospects, and the outlook for inflation.

A look at TFP performance since 1961 shows that growth prior to 1973 averaged about 2.6 per cent a year; after 1973 it was, on balance, negative. Manufacturing industries, as well as transportation, communications, and trade, made a large contribution to the growth phase. After 1973, TFP growth virtually collapsed everywhere.

Causes of slowdown

Five key areas could have contributed to the reduced growth in living standards during the late 1970s and early 1980s – namely, resource reallocation; labour and skill; capital, "best practice" and its adoption rate; economies of scale; and utilization rates. The Council looked at each of these in turn to determine their relationship to the TFP growth slowdown.

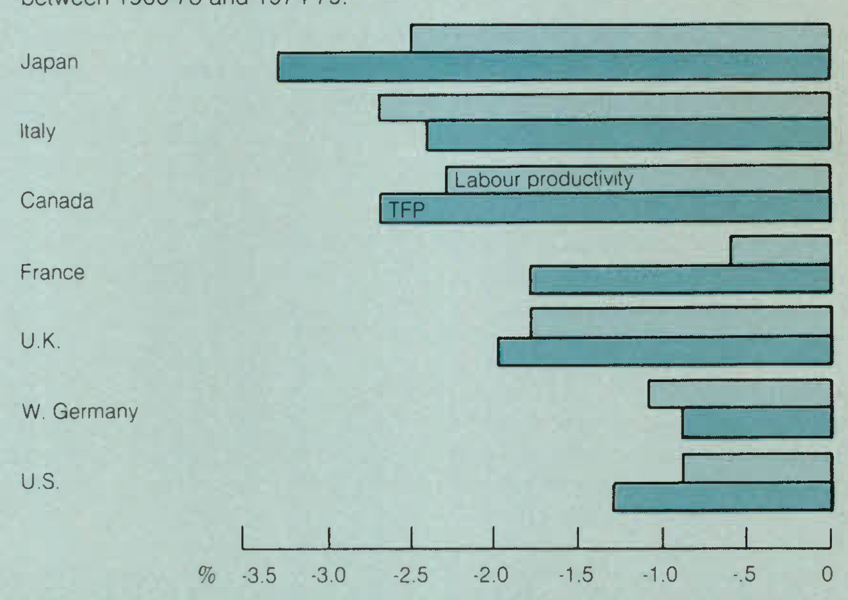
Resource reallocation

When labour and output move from low-productivity industries to higher-productivity ones as part of the industrialization process, then "resource reallocation" (which increases average productivity) is said to take place. When this process slows down or is distorted so that resources move instead to less-productive industries, then productivity suffers. Council research imputes almost 30 per cent of the productivity slowdown to this source. Two possible causes of distortion are inflation and increased government intervention. With regard to the former, the Council says that "it is certain that inflation has distorted tax rates across firms and industries, penalizing those with large stocks of long-lived depreciable assets and rewarding those with proportionately more debt."

Linking increasing government intervention to the productivity slowdown is more difficult – first, because analysis to date has not established a precise relationship between the two; and second, because the slowdown in productivity growth coincided with a slowdown in government discretionary spending. On the other hand, there is evidence that government regulation at the industry level has a negative impact

The productivity slowdown in manufacturing

Change in average annual growth rates of productivity in manufacturing between 1960-73 and 1974-79.



on growth. Furthermore, government intervention in the form of industrial policies has done little to promote economic efficiency and, in fact, has brought about resource misallocations, Council research found. In the Council's view, governments should limit their assistance to those industries and firms with the potential to improve Canada's economic welfare or, in some cases, help to ease an adjustment process.

Labour and skill

Some analysts have argued that the structure of the labour force itself – that is, the age and sex of workers, and their education and skill levels – has an important bearing on productivity growth. They contend that the influx of less-experienced women and young people into the labour force has recently had a negative effect in this respect. Council analysis, however, indicates that their impact has been negligible and quite possibly even offset by the continuing increase in the level of education.

But some other problems in the labour market may be contributing to the productivity slowdown. Shortages of skilled workers, the quality of management education, relatively inflexible training programs, and difficulties in labour-management relations may account for some of Canada's recent poor productivity performance. The Council suggests a number of possible improvements in these areas; for example, training programs might be better geared to teaching a cluster of skills rather than a single skill, in order to provide workers with greater flexibility and occupational mobility. Also, allowing workers a greater share in management concerns – through such schemes as gain-sharing and participatory decision making – might boost company performance.

Capital and "best practice"

In contrast to the experience in some industrialized countries, productivity growth in Canada has not been affected by a slowdown in capital spending (on buildings, machinery, equipment, and so forth). In fact, the Council observes, the ratio of capital to labour for the Canadian economy has continued to increase since 1973.

But capital spending could affect TFP growth in other ways. For example, declining investment in "best practice" (the most efficient) technology might have affected TFP growth. Indeed, some analysts attribute most of the productivity slowdown to a slowing in the adoption rate of best-practice technology since 1973. What caused this decline? According to the Council, the explosion of energy and other raw-material prices, along with the subsequent drop in demand, provides the major explanation. New energy-saving technologies had to be developed and, because of the time lag between invention and diffusion, these have begun to emerge only recently. But there may be other reasons for the technological slowdown as well, including a possible drop in the rate of innovation, the slow speed at which new technologies have replaced old ones, and worker resistance to technological change. Spending on research and development – which, had it declined, could have explained some of the technological slowdown – remained stable in Canada throughout the 1970s and thus was not a factor.

Economies of scale

If it proves cheaper for a business to produce additional units of output – for a factory assembly line to produce more cars, for example, or an airline to sell more seats – then prices will go down or salaries and profits will go up. Either way, real incomes and productivity will rise. But when incremental production costs exceed average costs, the reverse holds true. Evidence suggests that the latter may have been the case in the Canadian manufacturing sector in recent years. According to Council analysis, only 20 per cent of Canadian manufacturing plants were at the minimum efficient size in 1979, suggesting the existence of a scale problem. Council research indicates that larger markets might improve that situation (and thus productivity growth), since plant scale is found to increase under those circumstances.

Utilization rates

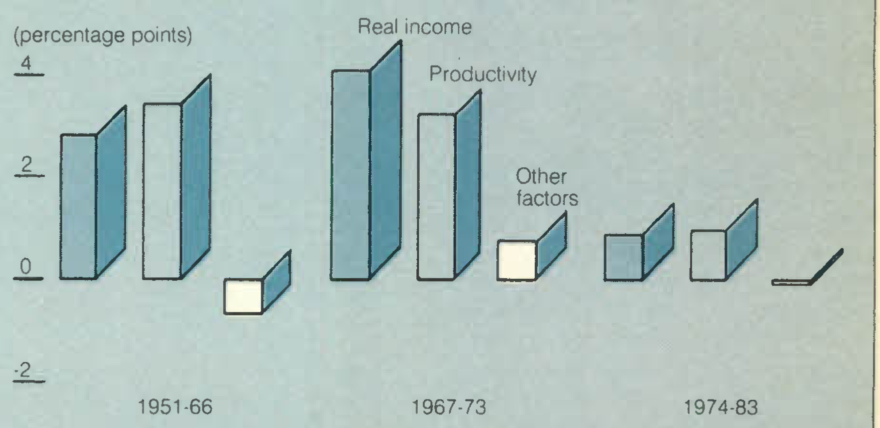
The degree to which industries use their productive capacity – which varies with the swings in activity characterizing the business cycle – can also affect productivity performance. In that respect, the energy price crises in the 1970s, the subsequent worldwide recession in the early 1980s, and the consequent slowing of demand reduced the level of capacity utilization. In addition, some analysts have argued that the practice of "labour hoarding" – whereby employers keep underemployed workers on the payroll during a downswing in the business cycle, in expectation of an early recovery – also contributed to the productivity slowdown. The Council found evidence to be very mixed in this regard, however.

Outline for action

Given this analysis of the productivity slowdown, what should be done to revitalize the Canadian economy and restore TFP growth? At the global level, sustained non-inflationary growth, low unemployment, and a high level of capacity utilization, achieved through fiscal and monetary policy, should do the trick, the Council says. At the national level, measures should be taken to promote markets that function efficiently, with priority given to strengthening competition, reforming regulation, and promoting an aggressive approach to trade expansion. In addition, action should be taken to modify government policies that undermine efficiency by causing a misallocation of resources.

What makes living standards grow?

Factors contributing to growth in real income per capita in Canada, 1951-83



Should Canada change its monetary policy?

Canada's current monetary policy has been under discussion recently. Its critics allege that allowing Canadian interest rates to shadow U.S. ones has imposed a heavy burden on this country's economy and that Canada would be far better off with its own independent monetary policy.

High interest rates since the late 1970s have indeed taken their toll in Canada, the Council says, by depressing investment and output growth and clouding the prospect of sustained expansion. But how feasible is the notion that this country can adopt a monetary policy that insulates domestic interest rates from adverse movements in world rates? The Council analyses this question, first, by assessing how domestic rates are determined and, second, by reviewing the success of other industrialized countries in detaching their interest rates from developments on world financial markets.

Determining interest rates

In an open economy like Canada's, with a high inflow and outflow of trade and investment, there is understandably a large degree of economic and financial integration with the rest of the world. In Canada's case, by far its closest economic links are with the United States, its largest trading partner. As well, Canada's financial sector is wide open both to the United States and to other countries – as evidenced, for example, by the high level of total foreign direct investment outstanding in Canada, the worldwide operations of Canada's chartered banks, and the impressive sales of Canadian corporate and provincial government bonds on foreign markets.

This kind of economic integration lessens government control over domestic interest rates. So, too, does the fact that investors currently regard securities denominated in Canadian and U.S. dollars as being very close, if not perfect, substitutes (termed "asset substitutability").

Another determinant of domestic interest rates is the flow of capital between Canada and other countries ("capital mobility"). The main factors affecting this flow are differences in interest rates and expected changes in exchange rates. Investors tend to seek out the highest interest rates, except when they anticipate an offsetting currency appreciation.

The experience abroad

Four major conclusions emerge from Council analysis of the pursuit of independent monetary policies by other countries. First, exchange controls (government restrictions on the sale or purchase of foreign currencies or assets by its citizens) do not work in the long run. Most countries that took that course of action have now abandoned it (West Germany and the United Kingdom) or are easing off (Japan and France). By and large, notes the Council, the trend nowadays is towards liberalization of financial markets, along the lines of that in Canada and the United States.

Second, for many countries there appears to be a trade-off between adjustment of domestic interest rates to foreign rates and a depreciation of their currencies. In comparison, the Canadian dollar has remained relatively stable.

Third, a country's success rate in decoupling its interest rates is heavily dependent on the expectations for, and confidence in, its economy.

Finally, countries appear to be grouping into "currency areas," where a number of subordinate economies stabilize their exchange rates with respect to the currency of a dominant economy. For example, France, the Netherlands, Belgium, and Austria have oriented their currencies towards the West German Deutschemark.

Lower interest rates should not be viewed as an end in themselves.

Options for Canada

The Council also considered the likely results of a made-in-Canada monetary policy. Detaching domestic interest rates from those in the United States could be effected in two key ways, it observed. First, by the imposition of credit and exchange controls. Reducing capital mobility has its costs, however, which could turn out to be very high for Canada. For example, controls to prevent capital from leaving the country could discourage potential investors and also penalize Canadian investors by denying them access to foreign markets.

Second, by directing policies towards reducing domestic interest rates while allowing the dollar to seek its own market-determined level. Council simulations developed on its new CANDIDE economic model show that this approach significantly increases inflation and gives only slight impetus to real investment and exports over a ten-year period (1985-95). A small improvement in the unemployment rate is offset by a decline in real disposable income and real wages.

The most effective way to bring down Canadian interest rates, the Council concludes, is through the fundamental improvement of economic performance, which will inspire investor confidence. In the event that the Canadian economy becomes stronger than its neighbour's, interest rates could decline without any adverse effect on the exchange rate. The Council, however, cautions against viewing lower interest rates as an end in themselves, noting that desirable economic goals may be attainable via policies other than an interest-rate-oriented monetary policy.

The investment picture

Capital spending – on new machinery and equipment, factories, roads, buildings, and other assets – is what keeps an economy healthy and growing. So Canada's poor investment performance recently has been the cause of some concern. As a percentage of GNP, investment is down both in the public domain – where spending on roads, hospitals, schools, and so on has been declining since the mid-1960s – and in housing, where the precipitous decline of the early 1980s has stabilized somewhat. But particularly worrisome is the performance of business investment, which has not rebounded in this recovery to surpass its pre-recession peak, as it did in the wake of earlier recessions. Instead, capital formation (the increase in capital assets) remains well below the high reached in 1981.

An analysis of business investment by sector indicates that the decline is more pronounced in some areas than in others. Most alarming in this regard has been investment behaviour in the manufacturing sector. While capital spending has increased steadily over the past 30 years, it has been losing ground as a proportion of GNP since the early 1970s, and the most recent drop (1981-83) was the largest recorded in 30 years. In 1984, the Council observes, "net investment...was not even sufficient to maintain the productive capacity of the manufacturing sector." That was not the case in the United States, as the chart shows.

A run-through of manufacturing industries shows that while some (most notably motor vehicles) have continued to attract investment, others – machinery, furniture and wood, metals and nonferrous metals, iron and steel, metal fabricating, and textiles (excluding leather) – have recorded a diminishing share of total investment, in some cases dating back to the mid-1970s.

Cause of the decline

A company's decision to invest is influenced by a variety of considerations. The bottom line, notes the Council, "is that the firm expects to make money.... Thus, there must be a market for the product that will result from the new investment." But demand alone is not enough to trigger investment spending. In addition, the productive resources required by the firm must be available at a cost in line with the expected sale price of the product.

The poor investment performance since 1981 has been due to a downswing in the business cycle combined with some long-term forces affecting both demand and supply – including a slowdown in population growth, a decline in Canada's competitive position abroad, an increase in the savings rate, the combined impact of the recession and lower inflation, weak prices for resource-based products, and the weak financial position of nonfinancial business.

The right climate

What, then, persuades a business to engage in new investment? First and foremost, says the Council, is the expectation of a strong demand for its products. At the same time, though, it must be unable to meet additional demand with its existing productive capacity. That was not the case between 1979 and 1982, when a declining rate of capacity utilization contributed to the weak investment performance.

Other factors often cited as influencing investment decisions include interest rates (which affect the price tag of the investment project), the financial position of the firm, its confidence in the future, and taxation (in terms of both investment incentives and tax rates). The Council assessed the relative importance of these and other different "variables" by means of a sector-by-sector analysis, as well as through simulations on its CANDIDE econometric model. The results indicate that final demand is the major determinant of investment decisions, whereas high interest rates, and even tax measures, are generally less important.

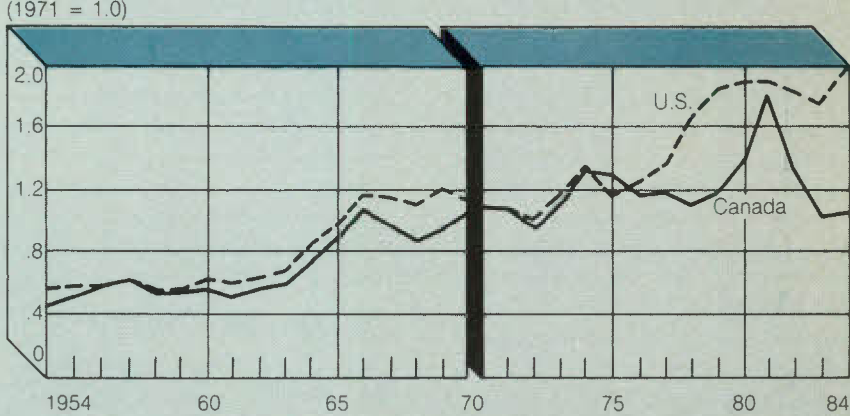
Future outlook

Forecasters and the business community agree that investment will be a rather cautious and slow process in coming years, as the long-term influences mentioned above continue to have a negative impact. In the shorter run, though, an upward turn in the business cycle will bring an increase in investment in 1985-86 relative to 1984.

Governments can seek to improve the investment outlook in several ways. First, they can give a boost to sectors in which the prospects for investment are good – such as oil and gas, auto and auto parts, and the high-tech industry. Second, they can encourage investment in new technologies in order to brighten the profit picture for business and offset high interest rates. Finally, they can create a favourable climate for investment by taking measures to increase confidence in Canada's economic potential.

Manufacturing investment in Canada and the U.S., 1954-84

(1971 = 1.0)



Options and constraints

Canada's number one priority over the next few years should be to "strengthen the bases for growth and job creation both regionally and nationally," concludes the Economic Council. A favourable medium-term outlook for the economy makes those goals attainable through the reinforcement of favourable trends and the correction of less favourable ones.

As a framework for future performance, the Council set out a number of targets in its past two Annual Reviews (see box). These goals may well be closer at hand now than they were a year ago, the Council observes, but much will depend on the right conditions at home and abroad.

A quick rundown of the targets shows that, in the past year, progress has been made both in containing inflation and in controlling the federal deficit. Future action on the inflation front should be directed towards maintaining, or possibly slightly lowering, the current rate, the Council says, rather than attempting to reach a zero rate. It also notes that larger and faster deficit reduction in the absence of strong domestic and international economic growth could have costly side effects.

As for Target 5, the Council believes that it should be possible to improve social policy at little extra expense through a much-needed restructuring of the welfare system and related tax changes.

Business investment

Targets 1, 2, and 4 will present the greatest challenge in future years. Restoring productivity growth, creating jobs, and reducing unemployment will depend to a large extent on an improved economic climate overall. That, in turn, requires the participation of a revitalized private sector. While business investment, a key indication of that sector's well-being, has been down in recent years (see page 8), signs of renewed financial health in the business community have appeared lately. Certain measures would give this recovery an extra boost, the Council says. The restoration of business confidence, fostered by the May 1985 federal Budget, would be further encouraged by a reform of the tax system, particularly in the area of tax subsidies and penalties.

New technology could also change the medium-term investment climate for the better. But that will depend on Canada's ability to keep abreast of new developments. Government policy should actively encourage the adoption and subsequent diffusion of new ideas, products, and processes originating abroad, says the Council. It notes as well that cooperative R&D (research and development) ventures on the part of Canadian companies could, under careful management, pay off substantially.

An important consideration in this technological era is the "nurture and care of human resources," the Council asserts. Company managers must be prepared "to adopt innovations in the organization of work that will successfully accommodate human needs." The Council observes further that while new technologies will provide many workers with fresh job opportunities, others may need substantial retraining or other forms of assistance. In that regard, the Council advocates more broadly based training programs to equip workers with a wider variety of skills.

Productivity growth

Productivity growth remains a major concern, in the Council's view. The recent slowdown stems from a variety of causes (see pages 5 and 6), including the complex issue of resource reallocation. The flow of resources from less- to more-productive areas has been unintentionally impeded on occasion by certain government measures, including regulation, some tax incentives, and

TARGETS

1 – Productivity growth of 1.5 to 2.0 per cent a year.

2 – Employment growth of 2 to 3 per cent a year in order to lower unemployment to a range of 6 to 8 per cent.

3 – Annual inflation of 5 per cent or less.

4 – Net capital inflows of less than 2 per cent of GNE.

5 – The maintenance and improvement of existing social policies.

6 – A gradual reduction of the federal deficit as a percentage of GNE.

various industrial subsidies and programs, the Council says. It underlines the "need for a more thorough assessment of the rationale for government intervention in the marketplace and of the effects of any resulting impediments to the free operation of markets."

That issue ties in with the question of regional differences in income, productivity, and economic growth. Governments have developed a large and complex set of programs to deal with these disparities that, together, have given a boost to net incomes in the Atlantic provinces and Quebec. These programs have tended to dissuade people from moving to areas of greater employment, the Council notes, proposing that the focus of government adjustment assistance could be shifted periodically, as circumstances warrant, from income support to retraining and relocation.

Trade liberalization

Target 4 calls for a domestic savings rate high enough to keep Canada's dependence on net capital inflows to about 2 per cent of gross national expenditure (GNE). That depends, in turn, on Canada's trade performance, which could be threatened by growing signs of protectionism in the United States – Canada's largest trading partner. To guard against that possibility and, further, to raise Canadian living standards, the Council believes that Canada should move towards trade liberalization. This initiative is likely to increase Canadian real incomes in two ways, it contends. First, consumers would benefit directly from cheaper goods; and, second, the consequent reorganization of Canada's industrial structure would boost productivity growth.

Critics of trade liberalization argue that adjustment to the new system would be very costly for many Canadian firms and workers. But that is not borne out by the adaptation process that followed the substantial lowering of tariff barriers in the Tokyo Round of GATT (General Agreement on Tariffs and Trade), says the Council. Rather than causing the demise of whole industries, adjustment took the form of expansion in some areas and greater specialization or fewer "births" of new firms in other less favourably affected areas.

The Council therefore proposes a "two-track" approach to trade liberalization. First, it suggests that Canada "vigorously pursue preparations for a new round of multilateral trade negotiations [MTN], with special emphasis on strengthening the GATT machinery and on new initiatives to overcome the objections of the developing nations to the MTN process."

Second, it suggests that "Canada should also intensify its efforts to open negotiations with the United States at the earliest possible opportunity with a view to achieving a comprehensive bilateral liberalization of trade," in line with the GATT.

Suggested policy package

While many issues will require attention if the Council targets are to be met, one particular policy mixture could speed up progress in that direction. Council analysis suggests that combining trade expansion within the GATT framework with a looser monetary and tighter fiscal policy, and more deficit-reducing activity than was included in the May 1985 federal Budget, could have positive results. "In isolation, each component might have unwanted side effects," it notes, "but as a package the components compensate one another for their less desirable effects."

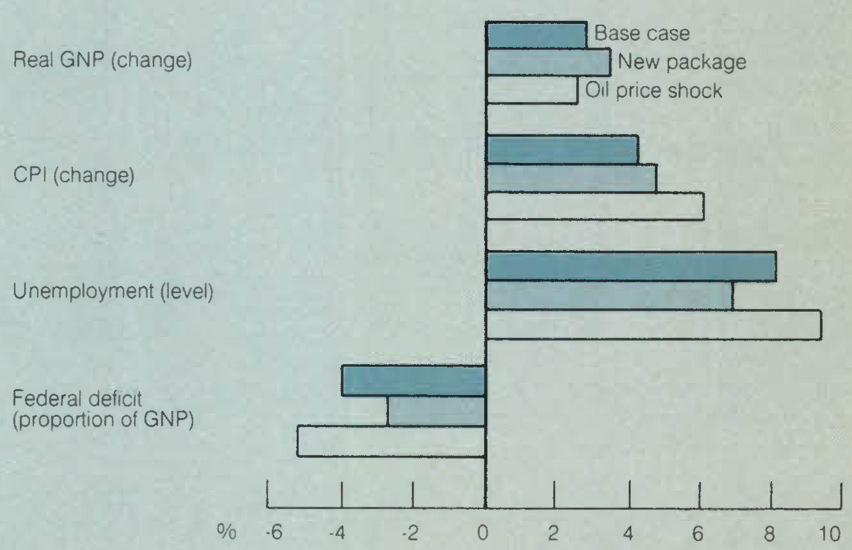
Simulations carried out on the CANDIDE economic model support this approach (see chart). The net effect of gradually expanding exports to 2.5 billion (1971) dollars above the basic projection by 1990, of reducing the Canadian short-term interest rate by 1 percentage point from base-case values, and – because these measures would enlarge the economic pie – of extending the surcharge on personal income contained in the May Budget through to 1990 would be progress in almost all areas. Real growth would average above 4 per cent; inflation would average about 4 per cent by 1990; the unemployment rate would fall below 7 per cent; and the deficit would fall below 3 per cent of GNP, about 1 percentage point lower than that of the base case.

These results imply that improvements can take place in many areas simultaneously under one policy regime. Further tests indicate, however, that this policy package cannot avert a major downturn in the event of a serious economic "shock," such as a doubling of the world oil price. With that in mind, the Council notes that "this is perhaps a good time to make as much progress as possible in strengthening the competitive structure of the economy and consequently its ability to withstand adverse external shocks of any origin."

The Council concludes on an optimistic note. "We believe," it says, "that many small forces of improvement are beginning to appear in the Canadian economy, that they are reinforcing one another, that the momentum of economic growth is building, and that the right policy improvements can add to this momentum.... All things considered, Canada appears to be in a position to achieve more sustained and more broadly based improvement in the growth in real income in the years ahead than it has experienced during the last decade."

How a new policy package could affect the economy

Changes in selected economic indicators under three scenarios, 1990



Putting VIA Rail on track

VIA Rail won't be able to improve its passenger service unless it gains more control over the cost of its operations.

The federal Crown corporation purchases many of its services from two carriers – Canadian Pacific and Canadian National. But the costs of these services aren't negotiated in advance, so the carriers lack incentive to deliver them at minimum expense. Federal transport regulations also prohibit VIA from auditing railway charges. Yet VIA's lack of control over railway service charges accounts for much of its growing cost burden – reflected in a doubling of government subsidies between 1979 and 1983.

These are among the "serious institutional constraints" VIA faces in trying to improve passenger rail service, says a recent Council paper by economist Jerome T. Bentley.

Bentley's work is part of the Council's ongoing research into government enterprise (*Au Courant*, vol. 4, no. 3). Drawing upon his knowledge of Amtrak, the U.S. government-owned passenger rail carrier, his paper looks at the methods of measuring and promoting service quality in three key areas: reliability, scheduling, and passenger comfort.

To make progress in these areas, however, VIA must initially overhaul some of its operating procedures. Legislation establishing VIA in 1977 failed to define specific objectives and rail service standards, Bentley says. What the corporation needs most, as a result, is a set of clearly defined goals and objectives against which to measure its performance, he concludes.

Controlling costs

To improve cost control, Bentley suggests that VIA negotiate fixed-price agreements with the two carriers. This would enable more efficient budget planning on VIA's part and encourage the railways to keep costs below a specified maximum. VIA must also be given access to railway cost records in order "to make rational decisions regarding alternative service quality projects," the author explains.

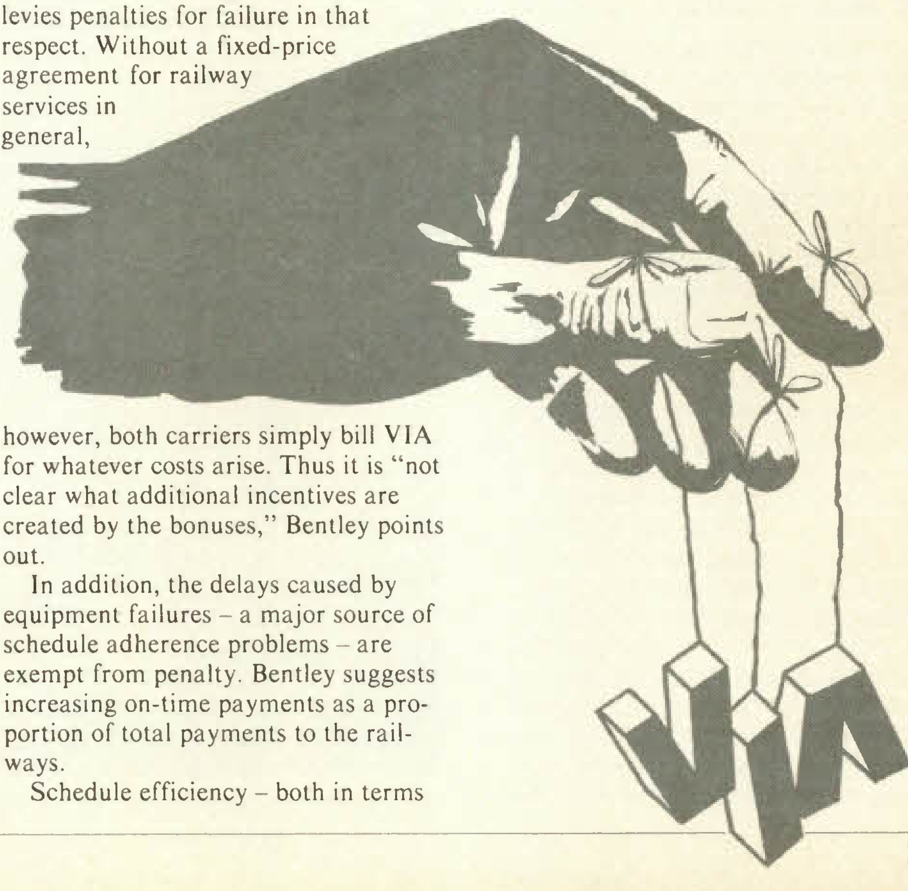
As a long-run goal, VIA should reduce, to the extent possible, its reliance on sole-source suppliers – namely, the railways; however, arrangements such as in-house maintenance must be accompanied by incentives to encourage internal cost efficiency. "Lump-sum subsidies (currently granted to VIA) do not provide incentives for service quality improvements," Bentley concludes, suggesting that performance be made a condition of government subsidization.

Potentially the largest obstacle to improved service is the condition of VIA's equipment. A recent study shows that more than 80 per cent of VIA's cars and locomotives are 30 years old. Even the new LRC (light, rapid, comfortable) equipment is "unreliable and expensive to maintain," the study finds.

Hence, Bentley concludes that Canada's passenger rail service "cannot be significantly improved without upgrading – in some fashion – the condition of its rolling stock."

Incentive schemes

These institutional constraints have affected VIA's ability to handle service quality problems. To promote reliability, for example, VIA either awards bonuses for on-time performance or levies penalties for failure in that respect. Without a fixed-price agreement for railway services in general, however, both carriers simply bill VIA for whatever costs arise. Thus it is "not clear what additional incentives are created by the bonuses," Bentley points out.



In addition, the delays caused by equipment failures – a major source of schedule adherence problems – are exempt from penalty. Bentley suggests increasing on-time payments as a proportion of total payments to the railways.

Schedule efficiency – both in terms of trip frequency and running time – is currently determined through contract talks with the railways. Improvements in that respect, consequently, depend on VIA's negotiating leverage and thus its control over railway service costs, Bentley concludes.

Overall, Bentley views competitive tendering as the most effective means of promoting service quality. It offers such advantages as affording the purchasing agent significant control through the threat of contract termination. At the same time, he acknowledges, the railways' monopoly over many aspects of passenger service, together with the presence of large sunk-capital costs (rail beds, rolling stock), makes this option unfeasible in some instances. Bentley favours using it where possible, along with performance incentives, as long as objective measures of performance are available and enforceable.

"Issues in subsidization with attention to the subsidization of passenger rail service," by Jerome T. Bentley. Discussion Paper No. 282.

Coal policies should be overhauled

Better resource management policies would instil new vigour into the coal industry of western Canada.

Specifically, changes in export management and domestic pricing policies – and a more efficient tax structure – would enhance its contribution to western income growth, a recent Council paper concludes.

Economist Brenda J. Dyack of the University of Alberta investigates the status of the coal industry and major impediments to its growth as part of the Council's recent study of the western Canadian economy (*Au Courant*, vol. 5, no. 2).

Coal has been mined in western Canada since the nineteenth century. Although production slowed in the 1940s, when oil, natural gas, and propane became attractive alternative fuels, the 1960s brought an upturn in demand with the emergence of coal-fired electricity-generating plants in Alberta and Saskatchewan. The oil crisis of the early 1970s encouraged export trade with major markets – for example, Japan, where sales of Canadian coal put Canada among the world's top coal exporters by 1981.

A modest outlook

In western Canada, however, coal mining remains a small part of the economic landscape. By province, the industry accounts for about 1 per cent of Gross Domestic Product, and it contributes slightly more than 1 per cent of provincial taxes.

The outlook, moreover, is relatively modest in light of the recent oil glut and the effects of the past recession on energy demand in general. Coal producers have already slowed production and reduced prices – as much as 15 per cent under one contract.

These income losses are difficult to minimize because of the underlying market structure of the coal industry. World trade in coal involves a host of suppliers but only a few buyers. Hence, consuming nations have the market power to influence the price and thus, theoretically, to pay less than the resource is worth, the author explains.

Trade in coal is further affected by the high cost of transportation, which restricts the West's access to all-important world markets such as Japan, where some two-thirds of Canadian coal exports are sold.

A unified front

Little can be done to alter these market circumstances; but, despite the trend to freer, more competitive international trade, Dyack suggests that western producers "may find it to their mutual advantage to share information and co-ordinate their actions to prevent further losses." This approach would require the full support of the industry, as well as the two levels of government.

"It may be that the only effective solution to combatting price losses imposed by powerful buyers is a reciprocal unified supply front," the author concludes.

The West is in a difficult position, however, because of its standing as a relatively high-cost producer. Thus it may not benefit as much as other suppliers from the formation of an international producer group – even though it could be forced to join one.

The author also questions the effectiveness of other resource management policies, including the recent attempts to encourage foreign investment in the coal industry and the nature of government subsidies to coal producers. She also criticizes the current domestic taxation and pricing policies. The structure of resource taxation is highly distorting, she says. In particular, the revenue-based tax applied to coal operations in Alberta and British Columbia "can lead to altered rates of extraction, exploration effort, cut-off grades and mine lives." The author suggests a profit-based tax instead.

Distortions also exist in the pricing of coal for domestic consumption. For example, coal is generally sold at cost to power plants in the West, in effect subsidizing western consumers. But this means that coal is not being used with maximum efficiency; nor is it being directed to its most profitable market.

The author recommends that coal be priced at its true value or that, at the very least, an attempt be made to estimate how much potential income is lost through consumer subsidies. This practice would ensure that when investment decisions were made, coal would be used in the most valuable way possible, and consumer incentives would not be distorted, she concludes.

"Western Canada's coal industry: Status and potential," by Brenda J. Dyack. Discussion Paper No. 278.

New policies would benefit the coal industry

Inflation's impact on business taxes: two views

If there were no inflation, Canadian industries would pay virtually no income tax. Or so argues a new Economic Council paper.

In 1981, for example, inflation increased the taxable income of the country's non-financial industries by $15.1 billion. That meant a net tax overpayment of $7.7 billion, almost exactly what those industries actually paid in taxes in 1981, according to calculations by Harvard University economist Glenn P. Jenkins.

"The corporation income tax system has been made so generous that were it not for the spurious effects of inflation the effective corporate income tax rate would, on average, be close to zero," Jenkins concludes in a new Council paper. His analysis, part of the Council's ongoing research into taxation issues (*Au Courant*, vol. 5, no. 1), constitutes one of two recent papers on the impact of inflation on the taxation of corporate income.

Jenkins explains that inflation increases taxable income because of the methods used to determine cost depreciation, inventory values, interest income, and the cost of holding cash balances. Partially offsetting these effects is the provision for the full deduction of interest expenses during periods of inflation.

Discriminatory impact

Overall, these factors "tended to increase the taxable income of corporations substantially" over the period 1965-81, Jenkins finds. The increases were also highly discriminatory, affecting some industries considerably more than others. Furthermore, they caused significant reductions in short-term cash flows. This, in turn, affected short-term investment and in some cases created financing problems, the author notes.

Partly to compensate for the large amounts of spurious income being added to the tax base by high inflation, the government introduced tax concessions that effectively reduced tax payments. These measures are still in place even though inflation has fallen off consistently since 1981. Consequently, the government now faces a potentially serious shortfall in its corporate tax revenues, Jenkins contends. He suggests that many of these concessions be removed.

At the same time, his findings show that even relatively low rates of inflation "are likely to increase the overall level of taxation borne by business." Thus the author supports the notion that the "business sector would be substantially better off if the Canadian tax system were reformed so that the impact of inflation was reduced."

> ***Were it not for the spurious effects of inflation the effective corporate income tax rate would be close to zero.***

Opposing view

Another Council paper that analyses the proposal to index the tax system in order to take inflation into account argues, however, that the costs of so doing appear to outweigh the benefits.

Ottawa-based economic consultant Patrick Grady, in looking at the practical aspects of indexing both business and investment income, presents evidence that contrasts with that of Jenkins. He concludes, for example, that tax concessions introduced in the last two decades have generally caused more distortion than inflation. Inflation, in fact, probably has not caused an increase in the effective tax rate, he argues, in large measure because of the offsetting impact of the interest expense deduction on debt-financed investments.

"In spite of the differences of opinion concerning the impact of inflation on the aggregate effective tax rate, there is general consensus that inflation has distorted tax rates across firms and industries, penalizing those with large stocks of long-lived depreciable assets and rewarding those with lots of debt," Grady writes. He points out that the elimination of the interest expense deduction (as a result of full indexation) could exacerbate the effects of high interest rates on firms as well as remove the incentive for debt-financed investment. This would be done "at risk of seriously depressing investment spending," the author contends.

> ***Inflation has distorted tax rates across firms and industries . . . rewarding those with lots of debt.***

Other costs

The administrative costs of full indexation would also be significant. Comprehensive indexation has international implications as well. If it leads to the raising of taxes above those in the United States, for instance, it could discourage U.S. investment in Canada.

"If inflation continues to decline, however, there is no reason to adopt comprehensive indexation regardless of what is done in the United States," he says. "It would just add another unnecessary element of additional complexity to the tax system."

Instead, more attention should be given to rationalizing the structure of tax incentives, with a view to eliminating the distortions caused by the tax measures originally introduced to compensate for high inflation, he concludes.

"Indexation and the taxation of business and investment income," by Patrick Grady. Discussion Paper No. 283.

"The impact of inflation on corporate taxes and the cash flows of business," by Glenn P. Jenkins. Discussion Paper No. 286.

Towards more stable employment in the West

Employment in western Canada would be considerably more stable if governments pushed growth in certain manufacturing industries, a new Council paper suggests.

This would help reduce the West's long-term dependence on natural resources and thus the impact on employment of the "boom and bust" cycles of a resource-based economy, the paper finds.

Council economists Harry Postner and Lesle Wesa examine employment instability in the four western provinces over the 1970-83 period, measuring it on the basis of month-to-month variations from a long-term growth trend.

The findings show that while such instability is generally not much more of a problem in the West than elsewhere, minimizing it would be equivalent to "maximizing economic diversification." A more diversified economy is better able to "avoid recurring periods of high unemployment," the authors point out.

The brunt of their analysis – carried out as background research for the Council's recent study of the western Canadian economy (*Au Courant*, vol. 5, no. 2) – focuses on how to minimize provincial employment instability.

Authors' approach

To do this, the authors employ an approach known as "portfolio analysis" to determine what changes in the distribution of sectoral employment – increases or decreases – would lessen overall provincial employment instability. These changes are kept to levels considered historically realistic, the authors note.

They explain that a particular industry will promote stability not only when its employment fluctuations are relatively small but primarily when these fluctuations tend to offset those experienced by other industries in that province.

Hence, when two industries exhibit countervailing patterns of employment behaviour – for example, one expands while the other contracts – then there is successful diversification of the employment resources in that province, the authors say.

Three scenarios are developed to gauge the impact of promoting growth in certain areas. The first scenario is neutral in that it allows the same degree of employment change for all sectors; the second and third scenarios are biased respectively in favour of manufacturing in general and secondary manufacturing in particular.

The findings

The results show that the manufacturing sector as a whole is always a more stable source of employment than agriculture, mining, or construction; it even compares favourably with commercial services. But the trade and the finance, insurance and real estate sectors usually display greater overall employment stability.

At the same time, certain industries within the manufacturing sector provide viable sources of stable employment. Though not usually the same in each province, the ones that perform well regionally include printing, publishing, and the electrical and chemical products industries. Most of these results apply to the other scenarios as well.

What's more, the authors find that overall gains in stability occur "without sacrificing other economic goals" - namely, the maintenance of high average employment earnings and long-term employment growth rates. Indeed, many of the industries found to promote stability do, in fact, meet or exceed the provincial averages in these respects.

The authors concede, however, that overall gains in stability "only become significant in the very long term." The provinces of Manitoba and Saskatchewan benefit the most from the economic diversification process.

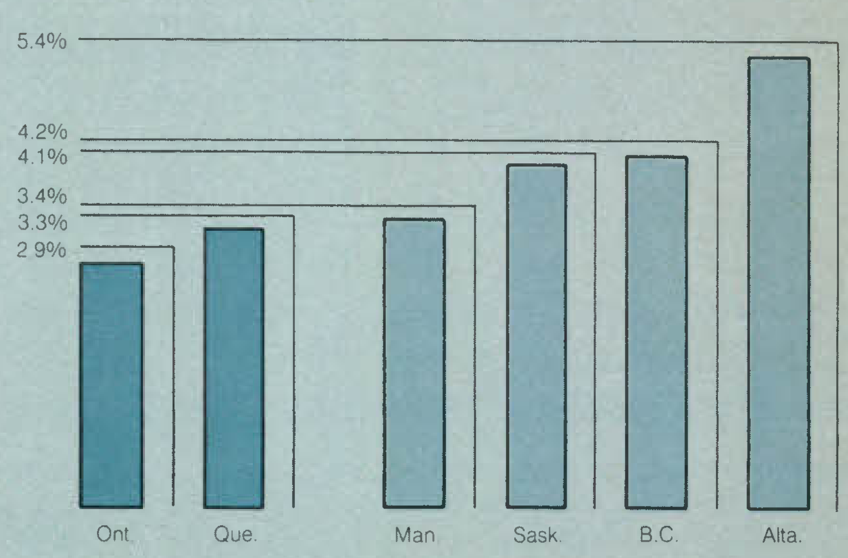
Greater potential

Also, the authors suggest fine-tuning the portfolio-analysis technique, essentially by providing a more complete breakdown of employment at the industry level. This "raises the potential for more effective industrial diversification," they conclude.

"Employment instability in western Canada: A diversification analysis of the manufacturing and other sectors," by Harry H. Postner and Lesle M. Wesa. Discussion Paper No. 275.

How unstable is provincial employment?

Employment fluctuations as a percentage of total provincial employment, based on two-month averages



Prairie farmers would benefit from wheat agreement

Canada needs an international wheat price agreement to help stabilize Prairie farm incomes, a recent Council paper claims.

Three-quarters of farm income instability on the Prairies is linked to crop farming and thus to wheat production. Since half the country's wheat is sold abroad where prices are highly volatile, efforts to reduce income instability must consider the international wheat price.

Council economist Jacques Jobin examines the issue by focusing on crop and livestock production, the two principal Prairie agricultural activities. His work forms part of the research undertaken for the Council's recent study of the western Canadian economy (*Au Courant*, vol. 5, no. 2).

Causes of income instability include poor weather and disease, changing consumer preferences, market conditions, the existence of production cycles, and even better technology (which, for example, can lead suppliers and consumers to switch from one farm commodity to another). These forces can have a drastic effect, not only on farmers but also on business activity in related industries such as transportation, farm machinery and supplies, packaging and retailing.

Author's approach

Jobin measures instability in terms of deviations from a growth trend. He also uses a procedure known as "component analysis" to pinpoint the sources of instability from among the variables that are components of farm income, such as prices, revenues, expenses, and production (cultivated area and yield).

Generally, his findings show that farm incomes are most unstable in Saskatchewan, though the instability of farm variables in all three provinces has been on the decline since 1926. The notable exception is the price of wheat, which has grown increasingly unstable since the mid-1940s.

Jobin examines crop and livestock farming separately, finding that incomes from crop farming are intrinsically more unstable than those derived from livestock operations.

In the case of the latter, instability arises mainly from the relationship between price and production, Jobin finds. The time lags involved in producing livestock – one year for pork, three years for beef – create a production cycle in which prices are low as long as the product is abundant but rise steadily as it becomes increasingly scarce. Because of that linkage between production and price, Jobin concludes that we "cannot establish precisely which is responsible for instability and to what extent."

Crop farming presents less difficulty in this respect. For grains other than wheat (barley, flax, and canola), production accounts for more than two-thirds of income instability.

Fluctuations in the area cultivated account for most of this production instability, largely because of farmers' attempts to maximize incomes from sales to the Canada Wheat Board. The Board quotes prices for various grains at the beginning of each season, in effect signaling to farmers which crops have the highest income-earning potential.

In the case of wheat, price and production contribute equally to instability. As with other grains, variations in the area cultivated have been the main source of production instability; yields have remained stable.

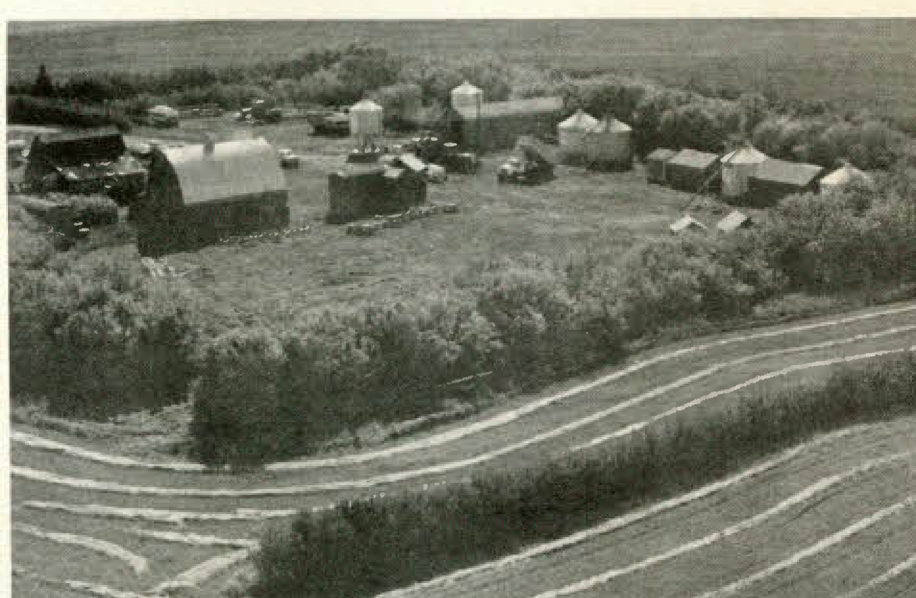
Jobin finds this trend alarming, because stable yields depend on such unreliable factors as good weather and other favourable conditions. He recommends continued research to develop hardier strains of wheat, particularly drought-resistant varieties.

Need for stable wheat price

But the "cornerstone of farm income instability on the Prairies" continues to be the international wheat price, Jobin concludes. Its stability ensures not only steadier incomes for grain growers but also more stable costs for livestock producers who rely heavily on feed grains. Regrettably, however, an international wheat price agreement "may well be wishful thinking" – at least for the immediate future.

Since the thirties, governments have offered income support through numerous programs and policies. The most effective (and expensive) scheme, Jobin finds, has been the Western Grain Stabilization Program, launched in 1976. It insulates producers from sudden dips in cash flow but yet enables them to benefit from any increases. Another effective measure, the two-price wheat policy (launched in 1973), protects both consumers and producers from severe fluctuations in the international wheat price.

"Farm income instability on the prairies," by Jacques Jobin. Discussion Paper No. 273.



National Film Board of Canada

Stable wheat prices would help Prairie farmers

Does Canada need an industrial policy?

Despite repeated calls for a government-led industrial strategy, Canada's manufacturing sector is probably better off without one – at least for now.

Indeed, the sector is adapting surprisingly well as Canada moves to freer trade and, hence, less government intervention in the marketplace, according to a new study for the Council.

But the controversy over the need for an industrial policy remains a perennial topic. It has become especially lively in recent months, in the context of a new examination of the merits of comprehensive free trade with the United States. The key question is whether trade liberalization should be extended without first instituting special measures to prepare Canadian industry for the potentially damaging onslaught of intense foreign competition.

The Council study – part of its research into technology, trade, and income growth (*Au Courant*, vol. 4, no. 1) – was conducted by Council economist Roy A. Matthews, in collaboration with Donald J. McCulla of the federal Department of Regional Industrial Expansion. The conclusions are attributable to the authors, not the Council.

Matthews approaches the issue by focusing primarily on changes in the manufacturing sector from 1960 to 1980. The study does not look beyond this point, partly because results from the worldwide economic slowdown of 1981-82 would obscure long-range trends. The author also documents the impact of past policies in shaping Canada's industrial base.

Looking back

Historically, Canada has long had an industrial strategy of sorts. The National Policy of 1879, for example, included import tariffs (taxes) on foreign products sold in Canada.

This permitted "infant" Canadian firms to establish themselves, despite the inadequate scale of a small economy, which prohibited the specialization necessary for optimum production efficiencies.

But tariff protection also permitted more firms to operate on an economically inefficient scale. Hence, trade barriers weakened the sector's overall competitiveness, Matthews concludes.

Today, the problems of inadequate scale and thus insufficient specialization "may not be quite as formidable," the author finds. New evidence suggests that the Canadian market "is sufficiently large, in principle, to provide for fully efficient production techniques in the great majority of industries," Matthews concludes.

Meanwhile, trade liberalization has begun a process of "industrial rationalization." The sector adjusts by expanding production in areas of comparative advantage at the same time as it withdraws from the spheres more efficiently served elsewhere. But this raises concern over whether Canada, in the process, is "de-industrializing" – losing more than it gains.

The evidence

Matthews' research indicates otherwise. Manufacturing industries, he concludes, have "held their own in overall terms," with the increase in imports to Canada balanced almost exactly by Canadian export successes.

In fact, in 1980 Canada accounted for a larger share of the developed world's manufactured exports – slightly more than 4 per cent, compared with just over 3 per cent in 1960. The trade deficit on manufactured goods in 1980 was also proportionately smaller relative to the country's overall trade and output.

In addition, Canadian exports generally rose less in price than comparable goods produced and sold in ten of the country's most important foreign markets. At home, the price pendulum swung back and forth to keep Canadian goods on par with comparable imports.

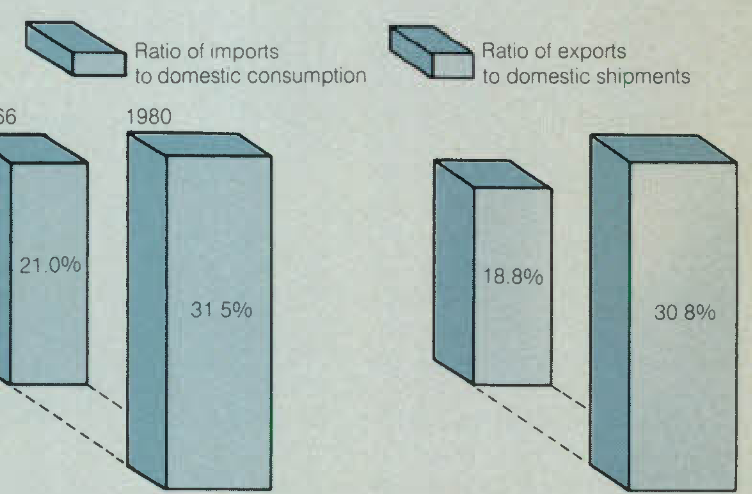
A disquieting trend does exist, however, in the area of manufacturing costs. Though Canada has maintained its position in this regard, its performance rests on the mutually offsetting effect of sluggish productivity gains and slowly growing labour compensation.

A maturing process

As a whole, the sector did lose ground in more areas than it gained, but its aggregate standing did not alter. The move to a more concentrated spectrum of manufacturing activity, the author concludes, "bears all the marks

Competition spurs trade

Import penetration and export orientation of manufactured goods, 1966-80



of a maturing industrialization process."

These adjustments, in fact, generally coincide with recent work on revealed comparative advantage in Canada and with data on the country's "factor endowments" – the types of resources needed to be competitive in specific fields.

Canada's generous endowment of land, for example, accords with the emphasis on primary product resources. Among the most competitive industries in Matthews' analysis were wood products, paper and allied products, iron and steel, nonmetallic mineral products, and petroleum and coal products, along with some individual categories of fish products, a small selection of textile and clothing goods, and some types of furniture.

Industries other than the primary product group are also making inroads – most notably transportation equipment, machinery, chemical processing, and fabricated metal goods, among others.

Despite these generally positive developments, vested interests in the status quo – business with sunk capital, workers with established jobs – tend to oppose strenuously the adjustment to a new situation. And of concern to governments is the maintenance of balanced economic growth and income across the country.

Such concerns have led to the call for a "defensive" industrial strategy – one that protects existing industries from wholesale dismemberment by foreign competition. Others advocate an "innovative" policy to encourage the rise of new industries considered vital to future economic success.

In both cases, the idea has developed that an industrial strategy must be selective. Indeed, giving blanket encouragement to every inventive notion would be a waste of taxpayers' money. But there is nothing in the way of analytical tools to provide a pointer, so the grounds on which to make a selection "are far from clear," Matthews concludes.

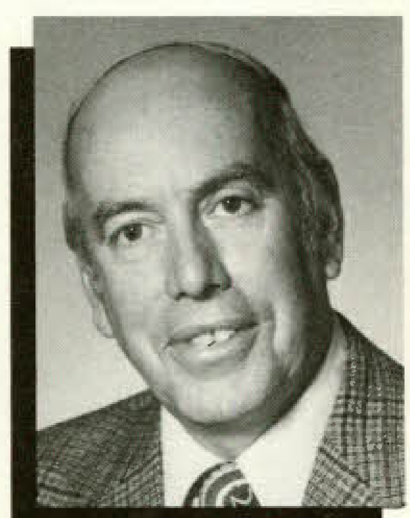
Moreover, the rigid policy framework associated with an overall strategy could actually inhibit industrial responsiveness to rapidly changing market conditions. Similarly, the comparative advantage of a country is not static but dynamic; it can change with the changing circumstances of industrial development. Unfortunately, the fragmented structure of Canadian industry as it evolved under trade protection also makes it difficult to see where such comparative advantage lies.

Thus, while the debate should continue, Matthews' verdict on the case for an industrial strategy "can be found in trials under Scottish law – not proven."

Structural Change and Industrial Policy: The Redeployment of Canadian Manufacturing, 1960-80, by Roy A. Matthews (EC22-127/1985E; $6.95 in Canada, $8.35 elsewhere).

New members appointed to the Economic Council of Canada

Dian Cohen is president of the economic communications consulting firm Cohen Couture Associates of Montreal. She is also an economic columnist, whose writing appears regularly in various newspapers and magazines.



George A. Key is chairman and director of a number of Atlantic Canadian corporations. He is also a director of the Canadian Chamber of Commerce and the Council for Canadian Unity, and is vice-Chairman of the Atlantic Transportation Commission.

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WORKING TO IMPROVE CANADA'S POLICY PERFORMANCE

. . . that has been the chief concern of the Economic Council of Canada since its creation as an independent advisory body in 1963.

Over the past two decades, the Council has focused on public policy issues of key importance to Canadians — including economic growth, the role of new technology, the impact of government regulation and the changing job market, to name only a few.

The Council pursues its goal of improving Canada's economic performance in three ways:

Consultation

Members of the Council, representing a wide cross-section of Canadian society, meet regularly with governments and groups to study, analyse, and make recommendations on significant economic issues.

Research

An expert staff originates research and provides background information on a variety of topics, with particular stress on the medium- and longer-term problems of the Canadian economy.

Information

The need for better information on economic issues has led the Council to place strong emphasis on its contact with the public, through the use of topical publications, speeches, conferences, workshops and media relations.

Economic Council of Canada

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