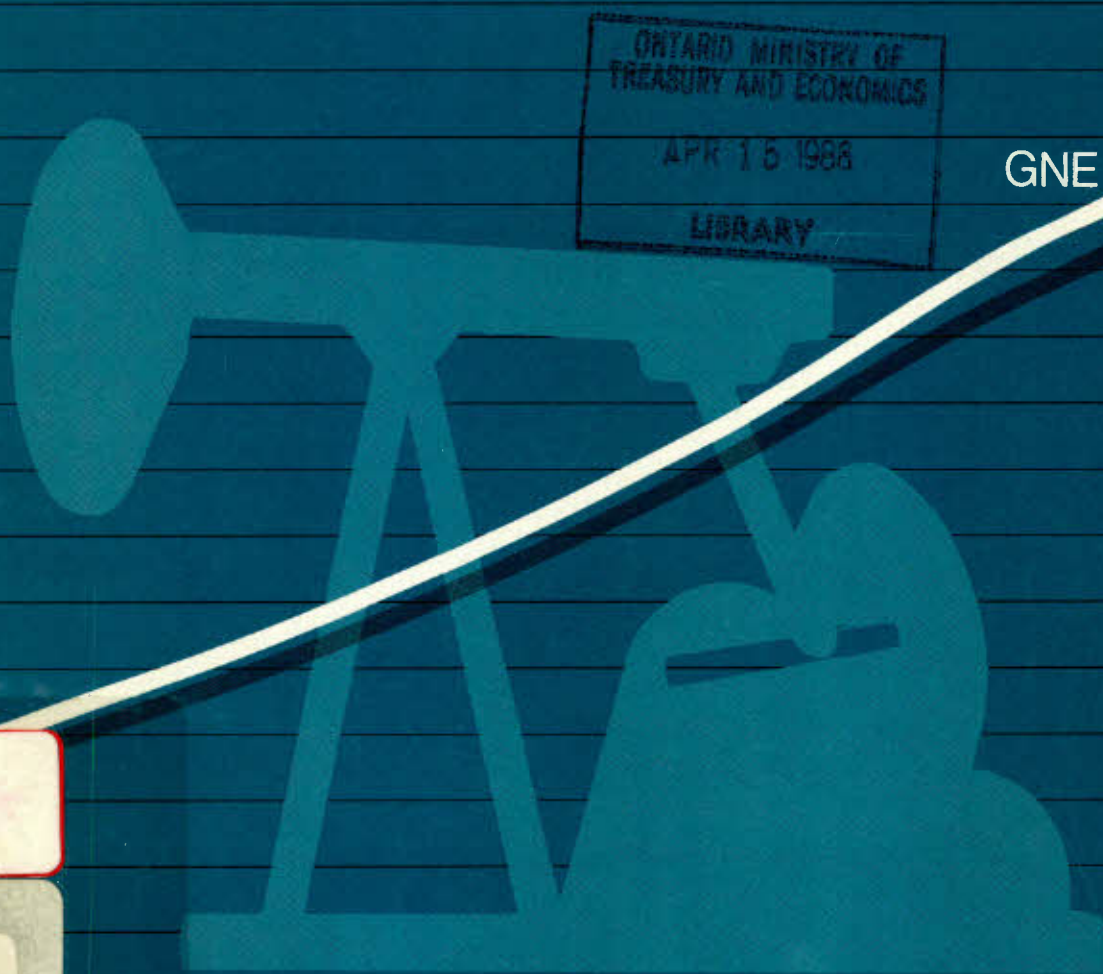


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Economic Council of Canada

Volume 6, No. 4, 1986

The economic impact of falling oil prices



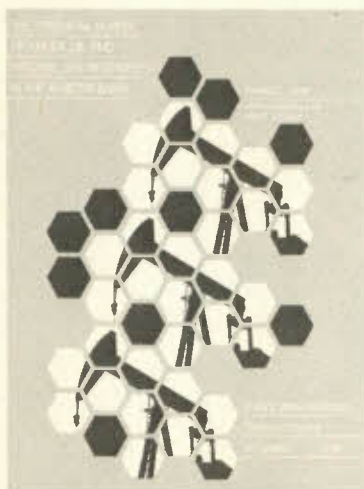
- project on Canada's financial institutions
- Canadians would benefit from a new tax system

PUBLICATIONS



Research Studies

Research studies are published by the Economic Council in both official languages. A list of titles is available on request. Each study clearly attributes the findings and conclusions to the individual author or authors rather than to the Council (ordering information below). One new title has been published since the last issue of *Au Courant*.



The Potential Supply of Crude Oil and Natural Gas Reserves in the Alberta Basin, by *Russell S. Uhler* (EC22-128/1986E; \$7.95 in Canada, \$9.55 elsewhere).

Discussion Papers

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

No. 295 "Crown corporations as instruments of public policy: A legal and institutional perspective," by *Elaine Kirsch*.

No. 296 "Newfoundland revisited," by *Lawrence Copithorne*.

No. 297 "Mergers and merger policy in the Canadian manufacturing sector: 1971-79," by *John R. Baldwin* and *Paul K. Gorecki*.

No. 298 "L'influence de la dette sur le coût des obligations à long terme : Le cas de quatre provinces canadiennes," by *Richard Carter* and *Henri Paul Rousseau*.

No. 299 "SOQUEM : Son mandat, ses contraintes et sa rentabilité," by *Jean-Thomas Bernard* and *Gérard Gaudet*.

Reprint

The following Council report has been reprinted and can be ordered in accordance with the information below:

Looking Outward: A New Trade Strategy for Canada (EC22-27/1975E; \$8.95 in Canada, \$10.75 elsewhere).

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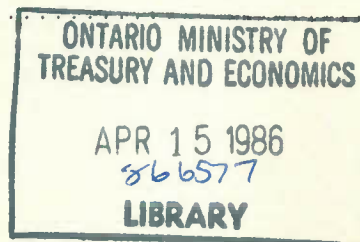
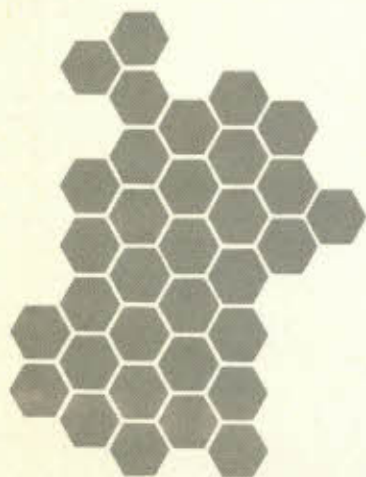
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Au Courant est également disponible en français.

The major reports featured in *Au Courant* reflect the viewpoint of the Economic Council.

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The games-playing aspect of tax reform

Tax reform involves games-playing among self-interested groups, with the result that the most logical or equitable solutions are often overlooked.

Or so says University of Toronto economics professor Douglas Hartle, in a paper written for the Council's study of the taxation of capital income (*Au Courant*, vol. 5, no. 1). In his view, "tax structure changes can be analysed as the outcome of existing sets of continuing games involving politicians, bureaucrats, special interest group leaders, and mass media journalists." All of these "players" are primarily guided by self-interest, be it re-election, or promotion, or image-enhancement, and all contribute to the decision-making process. This means that, in general, certain assumptions can be made about that process, Hartle says. For example: lobbyists will try to affect policy decisions to their own advantage; officials will gain in influence whenever policy issues are highly technical; politicians will block politically damaging reforms; and the electorate will remain uninformed, and therefore uninvolved, unless the media takes up the cause.

Using this general theory, Hartle proceeds to analyse six specific tax reform proposals, which are discussed below.

Estate taxes

The estate (or death) tax – which was imposed on an estate before its proceeds were distributed to the beneficiaries – was abolished in 1972 and replaced by a tax on the capital gains included in the tax return of the individual in the year of his or her death. Hartle cites a number of practical reasons for this change, while noting that media interest in, and public support for, the "social" purpose of the estate tax – to prevent rich families from creating dynasties – was virtually non-existent. On the other hand, the organized opposition – largely from construction and farming industry associations, whose members were adversely affected by the tax – was very strong.

Ontario property taxes

From 1967 to 1978, the Ontario gov-

ernment attempted to reform its system of property taxation by introducing market value assessment. This effort failed utterly, despite the fact that criticism of the prevailing inequitable system had been strident. Hartle ascribes this failure to a list of factors:

... tax structure changes can be analysed as the outcome of existing sets of continuing games ...

the strong opposition of local politicians, who feared the wrath of those who lost by the reform; the general indifference of the electorate; and the precarious position of the minority provincial government of the time. "In retrospect," Hartle observes, "the surprising aspect of the Ontario government's attempt to reform the ... tax was that it was tried at all. Where were the potential political benefits?"

Personal vs. corporate taxes

The issue of whether corporate and personal income taxes should be integrated has long been a controversial one, Hartle says. The pro-segregation camp argues that the corporation is a separate legal entity and should be taxed as such, while supporters of integration contend that shares in undistributed corporate income should be attributed to shareholders, who would then be taxed on their combined personal and capital incomes.

Hartle reviews the developments in this ongoing debate, noting that full integration was rejected in the early 1970s. That decision, he contends, was taken primarily as a result of pressure exerted by special interest groups in corporations and industries, often with the support of provincial governments.

The indexation issue

Hartle sees the partial indexation of the personal income tax (1972-74) as "probably the most significant tax change put into effect in the post-1972 reform period." Opposition to the scheme was slight, since the only losers were governments, which forfeit revenues. But there were large hidden costs

to this move, Hartle observes, primarily in terms of its adverse effect on the deficit. He speculates that this "political blunder" took place because of an attempt by the Department of Finance to regain its control over federal expenditures.

Capital gains and losses

The author discusses the "painful series of compromises" leading up to the implementation of the Indexed Security Investment Plan (ISIP) in 1983 (a plan to ensure that nominal capital gains caused by inflation did not result in tax increases). He observes that the demand for this reform came mainly from financial institutions; that its technical nature meant that the media was absent from the debate and that officials had a greater opportunity to exert influence; and that government manoeuvres leading up to this reform demonstrated "the political wisdom of doing as little as possible as late as possible with maximum consultation."

Manufacturer's sales tax

Hartle notes that there have been "seemingly endless" attempts to replace this indirect federal sales tax with a less arbitrary federal tax at the retail level. These efforts have failed, primarily because of opposition from federal politicians, Hartle says. They wished to avoid a retail tax because at that level it would not be hidden from the public, and because it would anger provincial politicians who, in the confusion, would likely be blamed for the tax. At the same time, the technical nature of this reform aroused no interest in the mass media, nor, therefore, in the electorate who would have benefited. "Reform of the MST is fraught with potentially heavy political costs with no likelihood of perceptible political benefits," Hartle concludes.

"Political economy of tax reform: Six case studies," by Douglas G. Hartle. Discussion Paper No. 290.

The benefits of a new tax system

As income tax time rolls around again, two Economic Council discussion papers should attract some attention.

Both find fault with our current personal tax system and recommend alternatives. In the first paper, Council economist Denis Gauthier finds that replacing the income tax with a consumption tax would boost Canadian living standards. In the second, economists Michael Daly of the Economic Council and Fadle Naqib of the University of Waterloo favour the implementation of a tax system that would incorporate some features of both the current personal tax system and a consumption tax system.

Need for change

Canada's prevailing income tax system is frequently criticized for its unfair treatment of savings. At present, individuals are taxed on their income initially and again on any income they subsequently receive from their savings (interest from savings accounts or dividends from investments in the stock market, for example). When comparing two people with the same lifetime income, this system favours the spend-thrift. By penalizing saving, critics say, the system reduces investment and so restricts the amount of capital with which the labour force has to work. This lowers wage levels, future output levels, and the standard of living.

To eliminate the double taxation of savings, many tax analysts favour replacing the income tax with a consumption tax. Then income from savings deposited in "registered" accounts – such as RRSPs – would not be taxed until it was withdrawn. That way, people would be taxed on the basis of their consumption, or on what they take out of the economy, rather than on their savings and investment, or what they put into the economy.

Benefits of a new system

In the first paper, economist Denis Gauthier finds that, in comparison with their welfare under an income tax system, taxpayers would be marginally better off with a wage tax – and noticeably so with a consumption tax.

The Council researcher arrives at

this conclusion by forecasting the performance of the economy under different personal tax systems. (His main results are illustrated in the accompanying chart.) The taxpayer's well-being under the current income tax system forms the basic assumption or "base case" for the model. This is then compared with three options: a wage tax; a consumption tax; and what the author calls an "optimal tax" – a theoretical system combining all three tax forms, which is included to give an idea of the best possible outcome.

Gauthier finds that if, as Council research now suggests, the tax on capital income is around 35 per cent, then individuals could see their living standards rise fractionally under a wage tax system and by about 7 per cent under a consumption tax system.

Another option

Despite the gains that would be possible with a consumption tax, however, such a system would present certain administrative difficulties in dealing with some forms of saving, such as investment in owner-occupied housing, for example. Under the current system, taxpayers are not allowed tax deductions on savings in this form; nor are they taxed on returns from that type of investment.

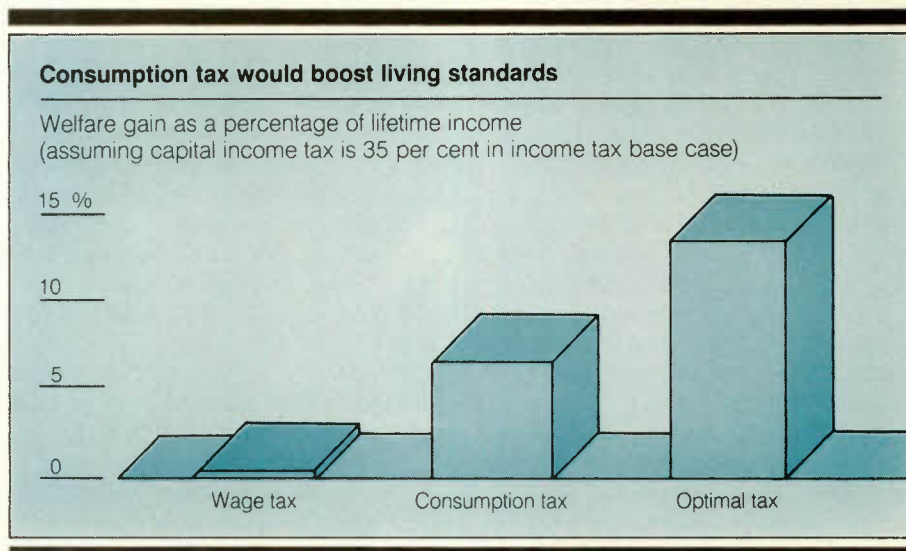
In their paper, Daly and Naqib describe the advantages of moving to a modified consumption tax system by combining tax-deductible savings in

registered accounts (such as RRSPs) and non-tax-deductible savings in unregistered form (such as those affected by the current tax treatment of owner-occupied housing). The principal difference between their proposed system and the present one is that there would be no limit on contributions to registered savings plans such as RRSPs, and income from non-registered savings would not be taxed.

Under the current system, the better-off are expected to bear a bigger tax load than others. Consequently, the tax load fluctuates (sometimes dramatically), depending on changes in the incomes of taxpayers over their lifetime. One of the advantages of the system proposed by Daly and Naqib is that tax-deductible savings could be used as a form of do-it-yourself income averaging, enabling taxpayers to maintain their taxable incomes at more or less the same level throughout their lifetime. It would also permit students or unemployed workers to borrow money in the form of registered loans and pay taxes on the proceeds at a low marginal rate, later deducting the loan repayments from their higher employment income.

"Designing a nondistortionary personal tax system for Canada", by Michael Daly and Fadle Naqib. Discussion Paper No. 267.

"Savings and taxes in a life cycle growth model with age-earnings profile," by Denis Gauthier. Discussion Paper No. 288.



Crown corps. should focus on public policy goals

Profit making shouldn't be the overriding goal of Crown corporations. Rather, their ambition should be to achieve well-defined public policy objectives as efficiently as possible.

At present, however, that's rarely the case, according to a paper by lawyer Elaine Kirsch, prepared for the Council's study of government enterprise (*Au Courant*, vol. 4, no. 3).

Kirsch points out that "Canadian Crown corporations are rarely created strictly to generate profits; rather, they are established to fulfil other policy objectives such as boosting employment or developing certain regions of the country." They are, in fact, "instruments of public policy . . . clothed in corporate trappings." As such, these enterprises face a legal and institutional environment endowing them with certain special characteristics not shared by private companies. Since these distinct features often translate into costs to the taxpayer, they are justifiable only if essential for achievement of policy goals, Kirsch contends.

To assess the effectiveness of public enterprise, the author defines the features or "costs" characterizing Crown corporations – both at the federal level and in several provinces – that would not be found in a representative private-sector corporation. She then surveys the objectives of public enterprise to determine whether these costs have been unavoidable. Finally, she suggests certain improvements.

Legal "costs"

The author enumerates the many legal privileges and immunities belonging to a Crown corporation by virtue of its close association with the Crown. For example, corporations that are accorded the status of "agents of the Crown" by and large are not bound by provincial and federal legislation except when they are mentioned specifically. Nor are most provincial corporations required to pay federal and provincial taxes – although most give "grants" to municipalities for services. (Federal commercial corporations, on the other hand, generally pay taxes everywhere.) In theory, public enterprise is not subject to criminal prosecution either, although the courts now tend to dis-

criminate between the Crown and its agents. Yet another advantage comes from their entitlement, through their Crown status, to rank as a preferred creditor in bankruptcy proceedings.

and through the annual report to shareholders. In contrast, a staggering range of methods are employed in public enterprise, including budgets, quarterly reports, committee and Auditor Gen-

Canadian corporations are rarely created strictly to generate profits; rather, they are established to fulfill other policy objectives . . .

These and other advantages impose fairly significant costs on society, Kirsch claims.

Institutional "costs"

The performance of Crown corporations is inadequately monitored, primarily as a result of the institutional environment, Kirsch maintains. Whereas shareholders, directors, and company managers all act as effective monitors of private-sector corporations, they do not perform this role with the same incentives and expertise in public enterprise, where reporting relationships tend to be more "layered" and where fewer incentives prevail. For example, provincial and federal enterprises report to a minimum of eight "shareholders" – ranging from ministers of finance to auditors and civil servants – often with overlapping responsibilities and poor communication links. Also, boards of directors tend to be less effective in the public domain, since few include experts in the particular product market of the corporation. Finally, top management in Crown corporations have less incentive to do a good job, Kirsch contends: they are paid less than their private-sector counterparts, have less power and prestige, and often have to contend with tougher management problems.

In addition, the reporting techniques used to monitor corporate performance are far more complicated in public enterprise than in the private sector. Private companies report on their activities through regular contact between management and the Board

eral inquiries, and others. These impose costs in terms of coordination, duplication of effort, and waste, the author observes.

Public enterprise objectives

While private-sector firms are in business for one paramount reason – to make money – the same cannot be said of Crown corporations. Rather, they are created to meet policy objectives "in addition to, and indeed in opposition to, profits." These goals are rarely set down in a consistent manner. Instead, they are described in a corporation's empowering legislation, in corporate plans, or in government directives; more often, they are conveyed unofficially, usually through the Minister responsible. The most common rationale for public enterprise in Canada, Kirsch says, is national and regional development, and the unification of the country. Other objectives include maintaining employment, constraining a "natural" monopoly (such as telephone and power utilities), guaranteeing security of supply, stimulating competition, and monitoring government productivity.

A review of the costs described above suggests that most are not essential for the attainment of these goals, Kirsch attests. What's more, she concludes, none of the players in the public enterprise sector has any incentive to reduce these costs.

"Crown corporations as instruments of public policy: A legal and institutional perspective", by Elaine Kirsch. Discussion Paper No. 295.

What lies behind the tariff-setting process

As Canada considers a move to freer trade, a new Council paper should prove very informative. It says that industries still protected by the tariff structure are probably less competitive than those that aren't.

Indeed, tariffs (taxes) on imported manufactured goods sold in Canada exist largely to shelter those Canadian industries which do not have a competitive edge. Tariff levels have fallen primarily among industries that needed tariff protection the least.

But because the government actually chooses which industries to protect, the tariff-setting process has been influenced by political factors as well, including the impact of lobbying on government decision making, the benevolent nature of government – as demonstrated, for example, by its desire to protect jobs where adjustment problems are likely to be particularly severe – and its concern with getting re-elected. Economists John Baldwin of Queen's University and Paul Gorecki of the Economic Council break new ground in this paper by modeling and testing the tariff-setting process in much greater detail than hitherto.

Authors' approach

The authors look at the tariff structure and changes in tariff levels in 1966 and 1970 across some 108 manufacturing industries (matched against comparable industries in the United States). To find out which factors influence the tariff-setting process, they develop sets of variables that reflect the costs and benefits to industry of seeking tariff protection, and the government's willingness to grant it. For industry these costs include lobbying, while the benefits relate to reduced competition from foreign goods – now higher-priced – in the domestic marketplace. The government must not only consider these economic factors but also weigh the political trade-offs of supporting one group over another.

Results of process

What the authors find most striking about the results of this process is that industries under the protective tariff umbrella generally had higher production costs than their foreign counter-

parts, mostly because of productivity differences. So cost disadvantages appear to have influenced the tariff-setting process more than anything else. To a lesser extent, the tariff-protected industries showed signs of lacking adaptability to market circumstances and were characterized by low wage rates. The authors infer that concerns over equity may have led to tariff protection in these cases. Also of interest is that industries with high non-tariff barriers generally had high tariffs as well, indicating that those which sought protection usually obtained it in one way or another.

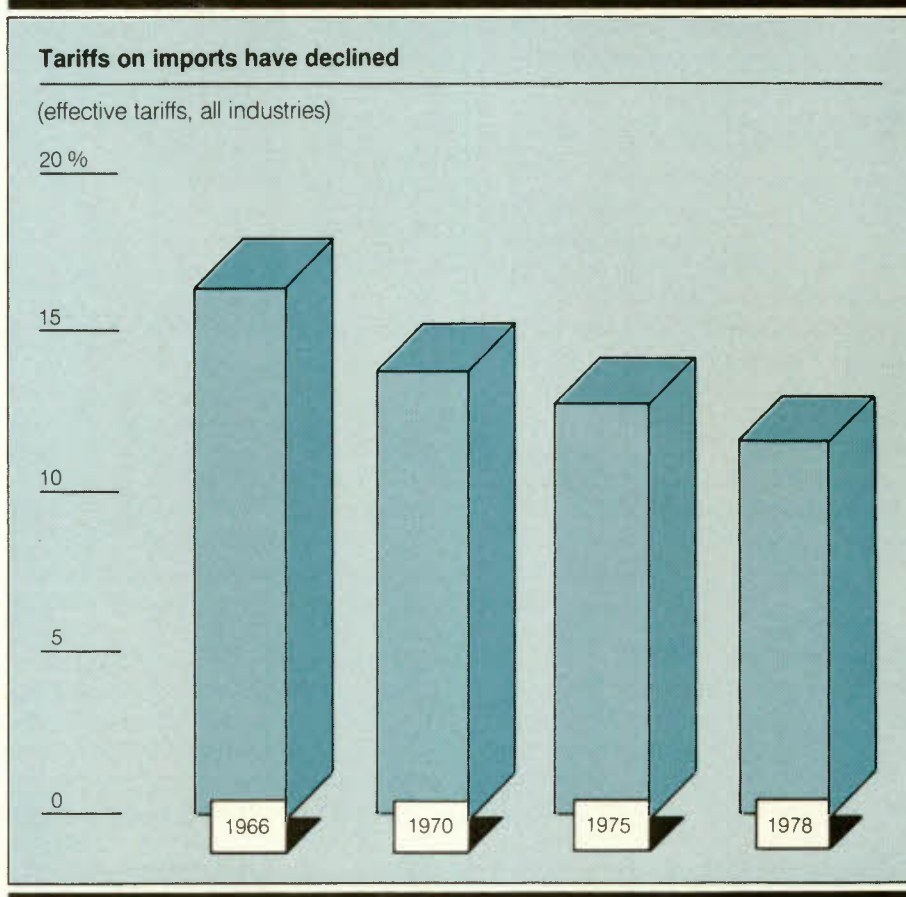
The political process that emerges from this analysis is consistent with the view that government tends to use the tariff-setting process primarily to seek broad-based public support rather than to cater to narrow-based interest groups.

Further evidence

Much of the authors' analysis of the levels of tariff protection in 1966 and

1970 is corroborated by the changes in tariff levels that occurred under the "Kennedy Round" of tariff cuts between 1964 and 1967. Tariff reductions were generally the smallest among the least competitive industries, for example. On the other hand, government may have sacrificed widely based public support in favour of gaining more recognition in the regions – as evidenced by the fact that industries with large numbers of employees experienced more of a decline in tariff protection than so-called "multiplant industries" whose work forces are dispersed geographically. In consequence, the authors conclude that while the "basic economic determinants of the tariff structure have remained relatively stable, the political ones have not."

"The determinants of the Canadian tariff structure before and after the Kennedy Round: 1966, 1970," by John R. Baldwin and Paul K. Gorecki. Discussion Paper No. 280.



Energy update

Early last year the Economic Council published a thoroughgoing report on energy issues, entitled *Connections: An Energy Strategy for the Future*.

In that report, the Council argued that the time was ripe for a fresh energy strategy with much greater emphasis on economic growth and development. In the Council's view, prevailing federal and provincial energy policies were attempting to achieve too wide a range of objectives, including income redistribution, Canadianization of the industry, inflation control, the financing of public expenditures – and a host of others.

According to the Council, more focused, efficiency-oriented policies would streamline the energy industries, improve the energy outlook, and, ultimately, boost Canadian living standards.

Since the report's publication, some major developments in energy policy have taken place, many reflecting Council recommendations and analysis. Consequently, *Au Courant* is taking this opportunity to recall the key findings of the report and to outline the ensuing policy initiatives.

The Council on oil

In *Connections* the Council expressed two key concerns about the oil situation. First, although Canada was a net exporter of crude oil, it remained a net importer of light oil. Second, the country's established oil reserves had been going down steadily since the late 1960s, while the cost of finding and developing new reserves had been rising.

Research carried out for the Council came up with two significant findings: one, that oil supplies respond positively to price increases or tax cuts; and two, that with the right fiscal policies adequate supplies can be obtained from the Western Basin. These and other results led the Council to recommend the deregulation of domestic oil prices and the establishment of more efficient tax and incentive structures to encourage exploration and development (such as the modification of the petroleum and gas revenue tax – PGRT – to allow the deduction of capital costs).

The Council on natural gas

The Council advocated moving from the prevailing highly regulated pricing and taxation system to the gradual deregulation of natural gas prices. The current but temporary oversupply of natural gas, combined with the massive long-term potential in the Western Basin, would, under a more flexible regime, provide Canadian industry with a sterling opportunity to expand both its domestic and export markets without jeopardizing the long-term security of supply, the Council said.

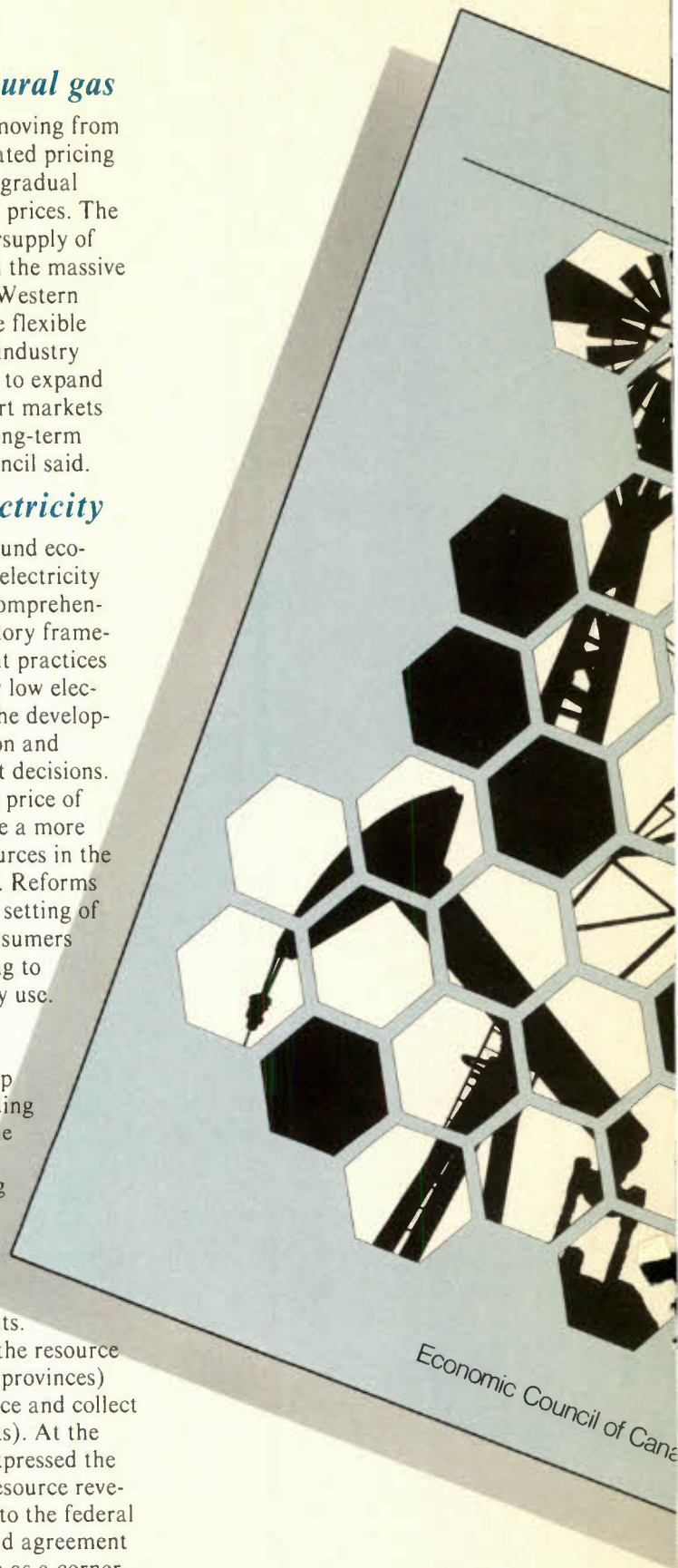
The Council on electricity

In the Council's view, sound economic management of the electricity industry requires a more comprehensive and systematic regulatory framework. Current management practices have resulted in artificially low electricity prices, which slow the development of energy conservation and adversely affect investment decisions. An increase in the average price of electricity would encourage a more efficient allocation of resources in the economy, the Council said. Reforms were also advocated in the setting of rate structures, so that consumers would be charged according to the time of their electricity use.

A new strategy

The Council summed up its analysis by recommending a new energy strategy. The first step towards this goal, it said, lay in settling the contentious issues of resource management and of revenue sharing between the federal and provincial governments.

The Council argued that the resource owner (in most cases, the provinces) should manage the resource and collect resource royalties (or rents). At the same time, the Council expressed the view that a share in the resource revenues should be passed on to the federal government, under a broad agreement to establish fair allocation as a cornerstone of the federation. In the interim, the Council said, federal taxes on provincial lands should be made more flex-



Economic Council of Canada

ible. It also called for improvements in the federal taxation of federally owned Canada Lands, where it also recommended a change from grants to refundable tax credits.

Recent developments

A number of key developments have taken place since the Council made those recommendations, and some of them are discussed below:

The Atlantic Accord (February 1985)

The Atlantic Accord between Canada and Newfoundland provides for joint management of all hydrocarbon developments off the coast of Newfoundland. It transfers to the

province the responsibility of establishing and collecting all royalties and taxes on oil and gas production as though the resource were on land. As well, it slows the reduction in federal transfer payments that would otherwise take place automatically as resource revenues flowed into the provincial treasury.

The Atlantic Accord is a step forward in promoting early development of the Hibernia field and in helping Newfoundland surmount its economic problems.

The Accord may have some impact on the equalization system, in that it appends clauses on an ad hoc basis rather than developing a broader approach to the problem of revenue sharing and equalization.

The Western Accord (March 1985)

The Western Accord between Ottawa and the western provinces removes price controls on oil and establishes a calendar for the gradual elimination of the petroleum and gas revenue tax. It also eliminates other taxes and lifts all controls on the import and export of crude oil and oil products.

The Western Accord reflects Council recommendations for oil price decontrol and for the provision of full management responsibility to the provinces, as resource owners. In contrast to the Council's recommended approach, however, it allows the PGRT to continue for a period of three years as a flat tax on production, and it does not deal with the revenue-sharing issue.

The Quebec Budget (April, 1985)

Fewer developments have occurred in the electricity sector over the past

year. One initiative that was taken by the Province of Quebec in its 1985/86 Budget was the plan to issue a 10 per cent share on the open market in the equity of Hydro-Quebec. Shares are intended to be preferred and non-voting. This undertaking reflects Council recommendations for improved management of the electricity sector.

The New Frontier Energy Policy (October 1985)

The federal government's new management policy for Canada Lands is generally in accord with the Council's recommendations. It establishes a system of competitive bonus bidding, eliminates the PGRT, and replaces petroleum incentive payments with a more modest system of tax credits, which apply uniformly to all applicants, irrespective of the level of Canadian ownership.

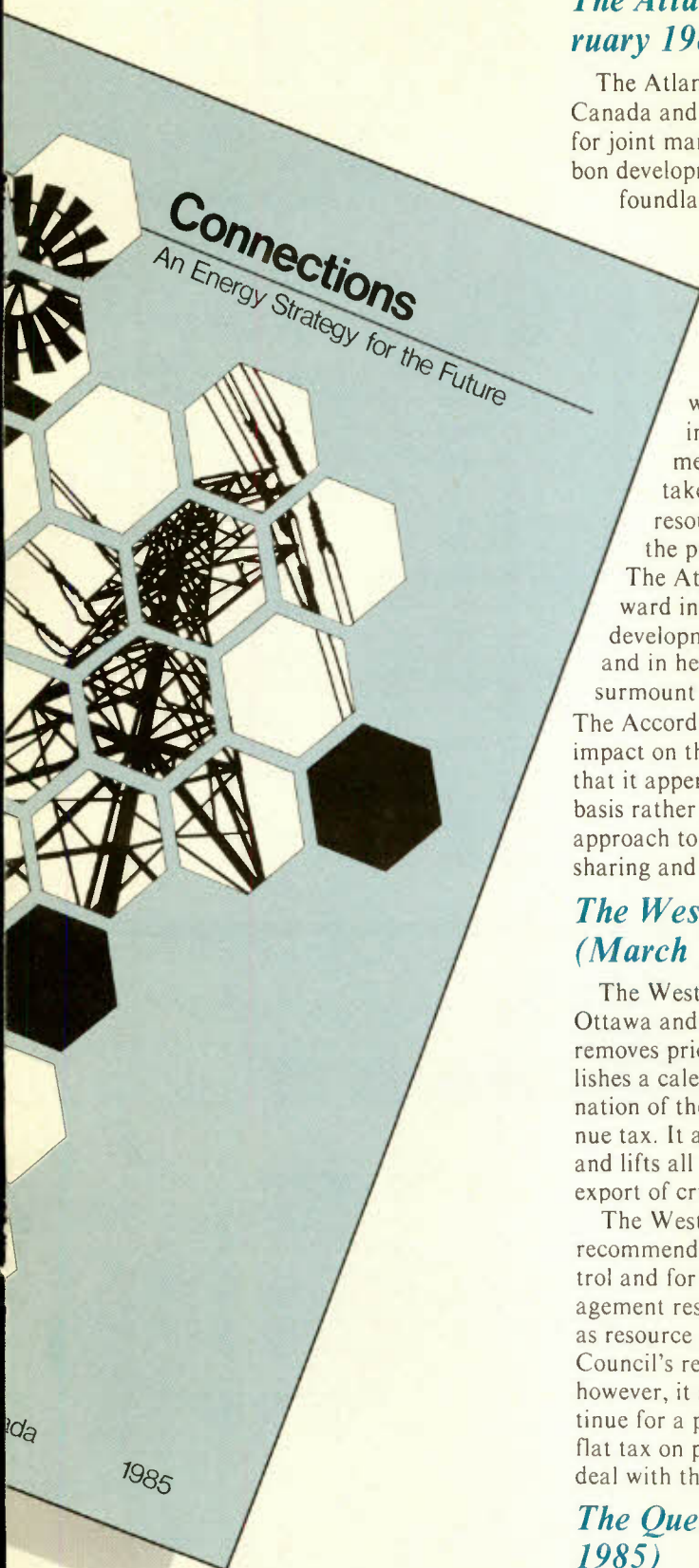
It differs from *Connections* only in that it makes the tax credit partially refundable. The Council had recommended full refundability to avoid discrimination against non-taxpaying companies.

The Natural Gas Pricing Agreement (October 1985)

The Natural Gas Pricing Agreement between Ottawa and the western provinces sets in motion the process of phased gas-price deregulation recommended by the Economic Council. It includes provision for direct price negotiation between buyers and sellers of gas after a transitional period of one year.

Declining oil prices

The Council has analysed the impact of lower world oil prices on the medium-term outlook for the Canadian economy. Its main results are discussed on the following page.



The economic impact of falling oil prices

Falling oil prices are, by and large, good news for the Canadian economy.

In a submission to the House of Commons Standing Committee on Finance, Trade and Economic Affairs, Council chairman Judith Maxwell outlined the probable economic effects of a sustained period of low world oil prices.

Mrs. Maxwell explained that the staff at the Council has been estimating the potential impact of a wide variety of "shocks" or changes in the economic environment, as part of the preparation for its *Twenty-Third Annual Review*, scheduled for release next fall.

When the Council projects the economic outlook, it uses a performance band, which embraces a set of optimistic and pessimistic assumptions. The idea is to portray both the best and the worst that could happen under realistic conditions. The base case assumes no further changes in policy during the period. The performance band in its *Twenty-Second Annual Review* released last October is illustrated in the accompanying chart. It includes a range of cases, from the optimistic to the pessimistic.

The optimistic case is based on the assumptions of low inflation expectations, low interest rates in the United States, and strong investment in Canada. The pessimistic case is based on the view that inflation pressures will be stronger; U.S. interest rates, higher; and domestic investment, weaker. The base case is near the middle of the range. It allows for growth in the volume of activity (real gross national product) of 3.5 per cent in 1986 and an average of 3.5 per cent per year over the period 1985 to 1995. In the base case, unemployment falls to 8.1 per cent in 1990, and the rise in consumer prices averages 3.9 per cent over the five years 1985 to 1990. In brief, the Review projected solid economic expansion in Canada, as long as there were no dramatic changes in the international economic environment.

Generally speaking, the economy has been following this projected course in recent months, Mrs. Maxwell observed – although net exports have

been somewhat weaker, and business investment stronger, than anticipated.

However, that base case assumed an average international price for oil (delivered to Montreal) of about \$28.50 per barrel in U.S. funds. The Council has recently rerun the base case using an average price of \$19/barrel in U.S. funds for 1986 and 1987, followed by a gradual rise of 1 per cent per year in real terms over the next three years. (In real terms, the 1986 price is still more than double the average price in 1973.)

The results of the \$19 oil price can be summarized as follows:

- By 1990, total output (real GNE) will be 2.3 per cent higher than in the base case outlined above (see chart). This means that the average growth rate for the period 1986 to 1990 accelerates from 3.5 per cent in the base case to 3.9 per cent in the oil-price shock case.
- Employment in 1990 will also be higher, and the unemployment rate will be 7.8 per cent versus 8.1 per cent in the base case.
- The consumer price index will rise by an average annual rate of 2.3 per

cent (from 1986 to 1990), compared with 3.9 per cent in the base case.

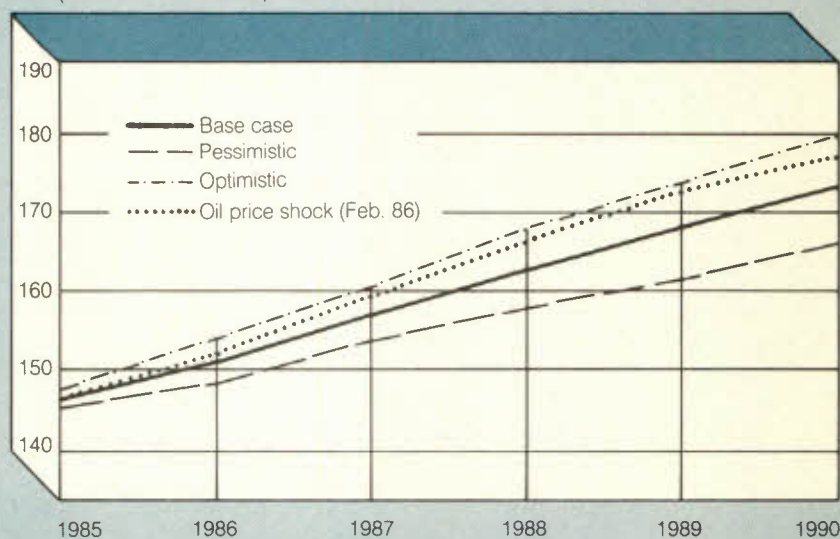
- The federal budget deficit (on a national accounts basis) as a percentage of GNP will drop to about 3.9 per cent in 1990 versus 4 per cent in the base case. (The loss of revenue from the energy sector raises the deficit during the first two years following the price change, but in the next three years the higher taxes generated by a stronger economy more than offset the loss of energy tax revenue.)

- The current account of the balance of payments will be in deficit in 1990, compared with the surplus in the base case. This is mainly due to the lower prices received for our exports of oil and gas.

Mrs. Maxwell also pointed out that this outlook masks some disturbing structural effects. As one example, she noted that the higher growth and employment will be concentrated in central Canada – Ontario and Quebec – where the majority of energy consumers live and work. In contrast, the producing provinces in the West and the potential producers in the East could experience a setback in growth and employment.

Alternative growth scenarios for Canada

GNE (billions of 1971 dollars)



How would Air Canada and CN fare on the stock market?

What would happen if shares in Air Canada and Canadian National Railways were sold to the public?

The two federal Crown corporations would probably be considered an above-average risk, says a recent Council paper by economists D. H. Drury and C. W. Sealey of McGill University. Because riskier ventures demand a better return, the cost to these firms of raising equity would also likely be higher than average, the authors claim. The cost of debt financing might increase as well because of the higher risk of not having it guaranteed by the government.

As both corporations offer more and more commercial services in increasingly less regulated markets, the prospect of privatization increases. With that in mind, the authors attempt to estimate what the total cost of capital would be if the two firms were publicly traded. Part of the answer – the cost of debt – is available from financial statements (though it has to be revalued and other considerations must be taken into account). But the remaining part – the cost of equity – is more difficult to determine, because neither firm's equity is actually traded on the market.

As a result, the authors match the Crown firms with publicly traded companies having similar income trends. These trends indicate a firm's risk/return ratio and its cost of equity. The Crown companies are also compared with firms in their own industries. American firms are used in this case because of the few air and rail companies in Canada.

What they find in the case of CN Rail is that the average growth in its net operating income over the period of analysis (1972-83) paralleled that of the rail industry in general. But the swings in these growth rates were slightly wider than the industry average, suggesting a higher degree of operating risk for CN Rail. Net income (operating income minus interest charges and other expenses) also varied more widely than the industry average, suggesting that the company's financing, as well as its financial structure, gave it a higher-than-average financial risk.

Compared with firms traded on the Canadian market (Toronto Stock Exchange), CN Rail appeared to have a low operating risk but a relatively high financial one. Overall, the firms it most resembled had a higher degree of market risk than the average portfolio of firms in the market. Hence the cost of equity was generally more expensive for these firms and could be expected to be higher for CN Rail as well. "Share equity is not a cheap form of financing to this firm," the authors maintain. Together with the cost of debt, the total cost of capital over the period of analysis – had the company been traded publicly – would have averaged 10.5 per cent.

For Air Canada, much of the analysis is similar, though growth in its net operating income remained below that of the airline industry. Because it resembled those Canadian firms having an above-average degree of market risk, it too would have had to pay a higher-than-average return on its equity. "Share capital is relatively expensive given the operating and financial risk of the company," the authors conclude. Had Air Canada been traded publicly, its overall cost of capital would have averaged 10.9 per cent over the period of analysis.

In both cases the authors warn that

the figures from their analysis "should be considered as groundwork and not the final results," given the assumptions about each firm's performance, the prevailing economic conditions, and the constraints on the data analysis and the methodology. Even so, their findings suggest that "if privatization is regarded as a costless or cheap form of raising capital, then there are serious doubts" about taking this step without considering substantial restructuring of the companies.

At the same time, they are in favour of a more "hands-off" approach to the funding of Crown corporations, as this would allow decision making aimed at maximizing the value of the corporation "as if, indeed, the shares did trade," the authors conclude.

The government, if it has social objectives such as maintaining unprofitable air routes into remote communities, should subsidize those activities separately from the commercial operations of a Crown corporation rather than provide overall assistance such as preferential interest rates. This type of "cross-subsidization" can lead to inefficiencies in both instances, the authors point out.

"A study of issues in government enterprise finance with applications to Air Canada and Canadian National Railways," by D. H. Drury and C. W. Sealey. Discussion Paper No. 292.



B.C. forest regulations need an overhaul

Forest regulation in British Columbia could be leading to "costly distortions" in the industry, a new Council study indicates.

As it stands, the regulatory framework may impede economic efficiency and inhibit investment in the industry, as well as underestimate the true value of the resource base, says University of Alberta economics professor Michael Percy, in research carried out for the Council's project on the Western Canadian economy (*Au Courant*, vol. 5, no. 2).

As regulator and owner of the forest base, the B.C. government allocates harvesting rights, determines how many trees can be cut (the "allowable annual cut") and the appropriate harvesting age, and collects revenues, mainly through "stumpage fees" (the price of standing timber). Its objectives include maximizing the value of the resource base and making sure it yields an uninterrupted flow of timber over time, so as to protect jobs and incomes in the province. But current policies may prevent those goals from being achieved, by placing too much emphasis on physical rather than economic criteria. The result, Percy suggests, is too slow a harvest of mature timber and too long a rotation period of second-growth stands.

To make sure existing timber stocks are not depleted before new ones are ready, for example, the allowable annual cut of mature timber is restricted in most regions to a small percentage of the total. Evidence shows that huge quantities of this timber occupy some of the most productive sites in the province. By failing to harvest and replenish these sites, the province forgoes millions of dollars in annual revenue. In some cases the forest loses value through aging and other natural factors. Percy argues that future generations might be better off if more of the forest were harvested and the increased government revenue invested, keeping in mind the need for reforestation and conservation of the environment. "We may have maintained too large an inventory of timber," he suggests.

At the same time, rotation periods are structured to ensure that the max-

imum amount of wood is harvested. This approach fails to reflect the influence of timber prices, discount rates, and harvesting costs. It also results in the loss of potential income, both from current harvests and from delayed future harvests. The main policy goal, Percy explains, should be to maximize the value of the forest base instead of the volume of timber it produces through time.

Possibly the most effective way to increase future timber supplies is by launching an intensive forest management program right away, Percy says. Such a program would involve treatments to improve forest productivity, such as forest protection, backlog reforestation, and research aimed at producing genetically superior trees. Current policies may not be as successful as they could be in this regard, partly because those who bear the costs of forest management in some cases do not reap the benefits. Also, private investment decisions are not likely to take account of such "non-timber" benefits as the protection of wildlife habitat, the prevention of soil erosion, and better water flows. Thus the province should ensure that all private forest-management initiatives are fully compensated, possibly by establishing a heritage savings fund to maintain a steady stream of investment subject to normal investment criteria, Percy maintains.

The way in which the province values the resource base, through what is called the "stumpage formula," may lead to serious inefficiencies in the allocation of capital and labour, the author claims. The longer-term consequences could lead firms to "invest less in capital and in so doing reduce the productivity of labour employed in the industry," he adds.

At the same time, evidence suggests that the province has been reasonably efficient in collecting revenue under

this formula. But even greater efficiency might be possible in the absence of regulatory distortions, Percy notes. Recent claims that low stumpage rates in B.C. constitute an export subsidy for firms in the province is "economic nonsense," he asserts. Failure to collect the maximum revenue simply leaves more money in the hands of producers but does not subsequently encourage them to increase production and hence exports. The author also says the industry would experience a net gain in its overall growth with the removal of government restrictions on the export of unprocessed logs.

In addition to regulatory bottlenecks, the industry must contend with market forces that are beyond the control of policy makers. Percy develops a model to simulate the impact of such major shocks on the industry as a decline in world softwood lumber prices, the imposition of duties on exports to the United States, and a "falldown" in the allowable annual cut (a decline in the timber harvest that may accompany the shift from mature to second-growth sites). These scenarios – which "highlight the critical importance of the forest industry" to the B.C. economy – would bring about a significant decline in real incomes in the province and a contraction in overall economic activity, he reports. In fact, the likelihood of a falldown and of reductions in the productive forest base depend in large part on whether the province institutes more-efficient forest management policies to prevent such occurrences, the author concludes.

Forest Management and Economic Growth in British Columbia, by Michael B. Percy (EC22-130/1986E; \$7.95 in Canada, \$9.55 elsewhere).



A look at Quebec's Caisse de Dépôt

Quebec's pension fund investment agency may not be getting the best return on its investments, possibly because of a conflict in its mandate.

About half the value of the portfolio held by the Caisse de Dépôt et Placement du Québec is concentrated in a handful of companies. That means the risk of earning a return is higher than it would be if the total value were spread across more firms. Because the portfolio's overall earnings do not reflect stock market trends in general, it suggests that the Caisse's stock holdings may not be "efficiently diversified" – with the result that it bears too much risk in light of expected returns, says a recent Council paper by economist James E. Pesando of the University of Toronto. (He cautions, however, that the portfolio's actual performance cannot be judged inferior on this basis.)

The paper looks at the investment activities of the Caisse and the Alberta Heritage Fund, and discusses the impact of legislative changes on the efficiency of those activities.

The Caisse is funded mainly by contributions from public-sector pension plans, Pesando explains. Though it seeks a profitable return on private stocks, government bonds, and other investments, its secondary concern is to support economic development in Quebec. These aims are in potential conflict with one another, Pesando argues.

For example, the Caisse might not earn the best return were it to make an investment in order to support a certain industry rather than to make a profit. Similarly, if the Caisse purchases sufficient shares in a firm to give it management control or influence, it could effectively promote economic development without necessarily having acted in a profit-maximizing manner.

The debate over the recent unsuccessful federal attempt, through Bill S-31, to limit provincial ownership in certain transportation companies has been "somewhat misdirected," Pesando continues. Claims that it would have prevented public-sector agencies from holding efficiently diversified portfolios are unsubstantiated, while the impact on the companies whose shares are the

Many investors believe the Caisse may seek to alter real investment and other management decisions of the firms whose shares it holds.

Whether or not this is the case, many investors believe that the Caisse "may seek to alter real investment" and other management decisions of the firms whose shares it holds, Pesando finds. That perception could reduce share values and raise investor risk in the marketplace, subsequently increasing the cost of equity (investment) capital and dampening the prospects for economic development. It is "virtually impossible to determine if this has occurred," Pesando concedes. But on two occasions the price of shares in Domtar Ltd. temporarily fell sharply when the Caisse announced purchases in that company.

As a result of his analysis, he theorizes that pension contributors and taxpayers in general may in fact pay for subsidizing private debt without receiving any direct benefit. In some cases taxpayers may also bear the cost if public-sector pension funds accept a below-market return on their investments.

The case of the Alberta Heritage Fund is somewhat different, Pesando writes. The fund does not invest with risk/return considerations in mind, except for a small equity portfolio managed exclusively for that purpose. In this instance, it does not seek management influence or control; it has the diversification of its holdings as an explicit objective.

target of such legislation "is likely to be minimal, so long as these shares are actively traded," he maintains. Concern over its effect on the use of non-voting shares is unwarranted as well, he adds.

Pesando also finds that raising or eliminating the 10 per cent limit on investing in foreign securities would enable pension funds to earn a higher return for a given risk, without any adverse effects. More generally, he finds no economic grounds for exempting the Caisse and other public agencies from federal and provincial company law and securities legislation. In fact, their exclusion has, in some instances, given them a cost advantage.

Finally, using the Canada Pension Plan as an example, Pesando illustrates how public-sector pension funds might be invested more efficiently by allowing private-sector employers who collect the contributions to invest the surplus funds. Though decentralizing the system would be complex, it would be the most effective way to separate political considerations from investment decisions, he concludes.

"An economic analysis of government investment corporations, with attention to the Caisse de Dépôt et Placement du Québec and the Alberta Heritage Fund," by James E. Pesando. Discussion Paper No. 277.



S·P·E·A·K·I·N·G·O·U·T

Shock waves rippled through Canada's financial sector in 1985 as two regional banks failed, several others suffered a flight of deposits, and a few trust companies collapsed. At the same time, financial institutions continued to diversify outside their traditional areas, and financial conglomerates grew in importance on the financial scene.

A number of government and private-sector studies of the Canadian financial sector have been undertaken recently, including the launching of a major report by the Economic Council of Canada. The Council report is expected to be released in the fall. To find out more about it, *Au Courant* interviewed project director André Ryba.

Au Courant: *Why is the Council studying financial institutions?*

Ryba: There have been some dramatic changes over the past five years in the way financial institutions operate and in the organization of the financial sector. The traditional distinction between what we call the "four pillars" of financial activity – banking, life insurance, trust, and securities activity – is eroding. These various groups of financial institutions are attempting to diversify across institutional lines. Financial holding companies – as yet unregulated – have emerged, and new financial instruments and practices have been developed. The regulation of the financial sector has not kept pace with these changes. In the process, some institutions have encountered serious financial difficulties. Obviously there is a need to look at the stability of the system and the protection afforded consumers and investors.



André Ryba

Ryba: Most of these studies have failed to look at some basic questions in a broad framework. Many of them have come to different, and sometimes contradictory, conclusions and recommendations. We developed a simple tabular overview to demonstrate this point (which is available on request). What our report will do is take stock of the issues and recommendations that have been brought to light in the current debate. It will provide an analytical framework within which all the issues

tives of the financial system, it will spell out the conditions under which that system can operate efficiently. The report will focus on the need to strike a balance between two of these conditions – competition and solvency. This should be a major policy goal.

Au Courant: *Isn't there a trade-off between these two conditions?*

Ryba: Yes, there's definitely a trade-off between competition and solvency, but not between efficiency and solvency. In fact, a financial system in which there is no confidence cannot be an efficient one. In the quest for efficiency we need to have solvency. You are not going to entrust your savings to a bank unless you are confident that you will be able to withdraw the funds with interest at a later date.

Of course, there are other trade-offs as well. For instance, we do not want financial institutions making questionable or potentially harmful transac-

It would be wrong to stifle growth and development by attempting to ensure that no institutions fail.

Au Courant: *How will the Council's report differ from the other studies that have been carried out recently?*

and recommendations can be assessed, and it will add some suggestions of its own. Starting with the role and objec-

tions. But we also do not want to prevent them from reallocating their funds efficiently. There is a trade-off between making sure that conflict-of-interest abuses do not occur and creating a regulatory environment that prohibits the free flow of information vital to investors in their day-to-day decision making.

Au Courant: *How do you know where to draw the line?*

Ryba: This is difficult. From one perspective, we should not have a system that is so fail-safe that innovation and growth are discouraged and financial institutions are prevented from entering uncharted territory because of the risk of failure. There are bound to be failures in the course of doing business. I do not think that this undermines the system, so long as depositors are well protected. It would be wrong to stifle growth and development by attempting to ensure that no institutions fail. We need a system that is flexible and adaptable, one that can respond to market changes.

The report will focus on the need to strike a balance between competition and solvency.

Au Courant: *What are some of the causes of change in the financial sector?*

Ryba: There has been pressure from competition, technological developments, and the move to a less regulated society in other sectors of the economy. Many of the changes have come in response to the performance of the economy. The recession of the early 1980s – the most severe that Canada has experienced since the Great Depression – brought hardships for many businesses, which in turn affected the financial sector. Some institutions lost their traditional niche when the long-term securities and deposit markets dried up as a result of escalating inflation and increased interest volatility.

At the same time, the consumer has become much more sophisticated, partly in response to the high inflation

of the late 1970s. Long gone are the days when consumers would blindly invest their savings in a 3 per cent deposit account. The emergence of two-

family incomes has had a profound impact as well. Families have more money but less time; some may want the convenience of one-stop shopping, where they can get a mortgage, home insurance, and life insurance under one roof. Institutions have to offer these types of diversified services, but the regulatory environment in many ways prohibits them from doing so. Investment dealers cannot really offer banking services; trust companies do not have full access to the commercial

lending field; commercial banks are not allowed in the life insurance underwriting business, and so on. To by-pass these restrictions, we have seen the development of new financial practices and instruments, and the emergence of financial holding companies that operate in a totally unregulated environment.

Au Courant: *What are some of the problems involved in bringing about regulatory changes?*

Ryba: Part of the problem is that there has never been a complete overhaul of financial legislation, only piecemeal reviews. We review the Bank Act every

10 years or so. In the 1967 review the banks were allowed to enter the mortgage field, which until then was the traditional niche of the trust companies. But the trust companies have not seen their legislation change. We have to be careful not to give an advantage to one group without considering the interests of the others, and indeed there have been a lot of complaints in this area.

This problem is exacerbated because in any attempt to review financial legislation we can have up to 11 jurisdictions involved – Ottawa and the 10 provinces. In some cases, the process is relatively simple. Banks, for example, are primarily a federal responsibility. But many other financial institutions – trust companies and life insurance companies, for example – come under both jurisdictions. It has been suggested that we regulate by function instead of by institution. But any solution will require some agreement between the two levels of government, so that we can develop a consistent regulatory framework.

Au Courant: *What role can the Council play in bringing this about?*

Ryba: I think there is an opportunity for the Council to act as a disinterested

third party in the process of legislative review.

There is a need to look at the stability of the system and the protection afforded consumers and investors.

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