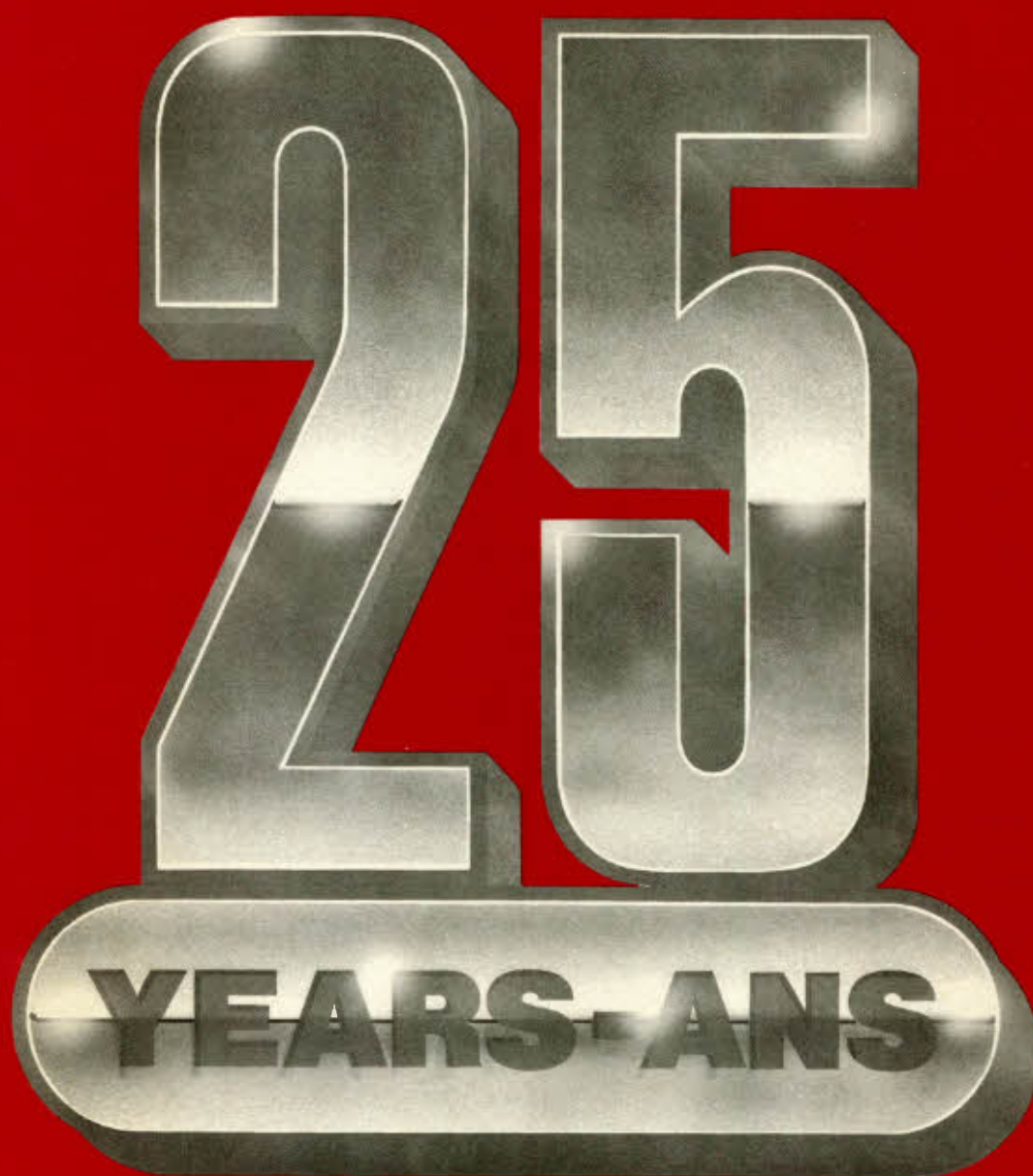


au courant

Economic Council of Canada

Volume 8, No. 3, 1988

The ECC odyssey



- Appraising CANDU
- New project on social policy
- The changing role of Petro-Canada

PUBLICATIONS

New Council report

The Taxation of Savings and Investment (EC22-143/1987E; \$10.95 in Canada, \$13.15 elsewhere).

This research report provides detailed analytical findings to support the Council's Statement on Taxation. It analyses the major taxes on incomes, property, and resources, and examines possible changes that would make the system more efficient in those areas.

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 therein to the individual author or authors rather than to the Council. Three new titles have been published (ordering information below).

Workplace Innovation in Canada: Reflections on the Past... Prospects for the Future, by *Jacquie Mansell* (EC22-146/1987E; \$4.95 in Canada, \$5.95 elsewhere).

Atomic Energy of Canada Limited: The Crown Corporation as Strategist in an Entrepreneurial, Global-Scale Industry, by *George Lerner* (EC22-145/1987E; \$8.95 in Canada, \$10.75 elsewhere).

Petro-Canada: Its Role, Control and Operations, by *Paul Halpern, André Plourde, and Leonard Waverman* (EC22-147/1987E; \$9.95 in Canada, \$11.95 elsewhere).

Technical papers

Technical papers deal with subjects of interest to specialists and contribute new information or original analysis to their particular fields of research. Each paper clearly attributes the findings and conclusions therein to the individual author or authors rather than to the Council. One new title has been published (ordering information below).

Taxation and Savings in Canada, by *Charles M. Beach, Robin W. Boadway, and Neil Bruce* (EC22-144/1987E; \$10.95 in Canada; \$13.15 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 specific or related fields of research. The 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 by the Council does not imply that the conclusions of the paper have been endorsed by the Council.

No. 329 "The origins of government enterprise in Canada," by *John Knubley*.

No. 330 "Something ventured – The Canada Development Corporation, 1972-85," by *Abraham Tarasofsky*.

No. 331 "Impact of Canada-U.S. free trade on the Canadian economy," by *S. Magun, S. Rao, and B. Lodh*.

No. 332 "Taux marginaux d'impôt effectifs du secteur de l'habitation au Canada," by *Pierre Mercier*.

No. 333 "Depository institutions: Risks and insolvencies," by *H. H. Binhammer*.

How to order

Research studies, Council reports, and technical papers are available across Canada from bookstores where government publications are sold. (A list is available from the Council on request.) These publications can also be ordered by mail from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, Canada, K1A 0S9. (Please be sure to include a cheque or money order made payable to the Receiver General for Canada.)

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

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Conference on agriculture

A conference on the "Future of Prairie Agriculture" will be held at the Saskatoon Inn on March 21-22, 1988. Sponsored by the Department of Agricultural Economics at the University of Saskatchewan and supported by the Economic Council of Canada, the conference will focus in large measure on the Council's research project examining the future of Prairie agriculture. The project is being undertaken at the request of the Prime Minister of Canada and the Premier of Saskatchewan.

For further information and details on registration, contact Glen Hass at (306) 966-5551.

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Editor: Jonathan Massey-Smith

Into the future

Every organization needs a road map – a vision of where it is going and at least a rough idea of how to get from here to there. The Economic Council is celebrating its 25th anniversary in 1988 by setting out a road map showing where it is headed for the 1990s. And that road map calls on the Council to help Canadians make better choices with regard to where the country is heading.

I believe that information matters. By being a creative source of new ideas for use by policy makers, the Economic Council can make a meaningful contribution to the well-being of Canada and Canadians. By helping people to understand policy problems and policy options, we can help them to make better choices as voters, consumers, investors, and taxpayers.

The Council is federal in its funding but national in its focus. We address our advice to federal and provincial governments, and, at times, to the private sector. Our long-term orientation enables us to spot trends, to identify emerging issues, and to study them in a comprehensive way.

Sound analysis

The Council's recommendations are forged from in-depth research by a team of experts in combination with consensus debate among Council members from every region and every economic sector. The research ensures that Council advice is rooted in accurate information and based on sound analysis, while the consensus debate tests such analysis against all the constraints and sensitivities of the real world. No other research organization in Canada offers that unique combination.

In their attempts to reach agreement –



Chairman Judith Maxwell reflects on the future of the Economic Council as it enters its 25th year of existence.

and even when they cannot all agree – members of the Council mirror the debates and discussions of all Canadians. By applying their practical knowledge of Canadian issues to research by our top economists and by experts in other fields, Council members serve as pathfinders for Canadians on some of the most important and contentious issues of our day.

In an era of tough decisions, polarized debate, and high-pressure public relations, the Council owes Canadians a steady flow of research and analysis that will provide objective and accurate information, clearly stated in English and French, on subjects that matter.

Changing needs

The Council was created in 1963, at a time when there were no private economic research organizations and few policy units in government. Lester Pearson, the Prime Minister at that time, and John Deutsch, the Council's first Chairman, saw the need for a research unit, at arm's length from government, that would employ the best and the brightest, and focus on a longer-term horizon. Over the years, the needs changed, as effective private research groups came on the scene and as government departments strengthened their research capacities.

Since I joined the Council as Chairman in November 1985, we have done a considerable amount of soul-searching about the best course to set for the Council in the 1990s. We keep advising Canadians that they must accept change and adapt to new circumstances. This is just as true for the Council as it is for any other organization; hence it has developed a strategy for the years ahead.

New directions

First of all, we recognize the volatile, fragmented, and complex political environment in which economic ideas must be judged. If the Council is to continue to play an active and useful role in informing Canadians on key economic issues, we have decided that we must speed up, diversify, and turn outwards.

Speeding up means organizing our projects so that they will produce useful results within 18 months or less.

Diversifying means attacking many subjects at one time. It also means going beyond economics, using the insights offered by political science, geography, sociology, and even the hard sciences to help solve policy problems.

Turning outwards means that we must pay much more attention to our audiences – both the policy makers and individual Canadians. We must write or speak clearly, in French and English, and find new ways to deliver our messages – through shorter, more-readable reports, for example, and more-frequent seminars, round-table discussions, and conferences.

Canada needs a think tank that can see beyond this year's melee of issues, understand the longer-range consequences of the choices being made this year, and then explain those consequences in a clear, confident voice. It is therefore critical that the Council become much more inventive in the way it defines its agenda.

The future is shaped, to a very considerable degree, by the cumulative efforts of the policy choices that we make. The Council must have the vision, the intellect, and the courage to give Canadians the information they need to make wise decisions. That is the challenge of the Council's next 25 years.

The first quarter-century

It was on August 2, 1963, that Parliament unanimously passed the Act that formally ushered the Economic Council into being.

Almost a quarter of a century and seven chairmen later, the Council has earned a reputation for excellence in fulfilling its mandate to "advise and recommend" how best Canada can achieve such goals as "a high and consistent rate of economic growth" and "rising living standards (for all Canadians)."

The years preceding the founding of the Council were fraught with uncertainty and concern about slow economic growth. The late 1950s and early 1960s saw a virtual cessation of increases in the real living standards of most Canadians, high rates of unemployment, under-utilization of the country's productive capacity, and some slippage in the country's productivity and competitiveness in relation to other countries. It was clear to many that continuing to react to these problems in an ad hoc, short-term fashion would lead to a continuation, or even an intensification, of the country's economic woes. Hence much of the discussion that led to the creation of the Council centred on the need for medium-range study and economic analysis.

The early years

From the beginning, the Council was intended to be an independent, non-partisan research body that would study medium-term economic issues and that would issue recommendations based on a consensus of Council members. As it stands today, the Council consists of a board appointed by the Prime Minister, comprising three full-time and up to 25 part-time members. The full-time members – the Chairman and two Directors – manage the work of a staff of economists and other specialists. The part-time members, who represent various sectors of Canadian society and regions of the country, help in selecting research topics, reviewing research results, and developing policy advice for governments and the public. As well, they serve on advisory committees for

Council research projects, together with outside experts in the particular field under study. This involvement gives pragmatic guidance to the research and facilitates the development of consensus among Council members in fashioning policy advice and recommendations. The Council has five main policy goals: the encouragement of full employment; a high rate of economic growth; reasonable stability of prices; a viable balance of payments; and an equitable distribution of rising incomes among individuals and regions.

Breaking ground

Under the guidance of John Deutsch, the Council's first Chairman (1963-67), much of the early research work at the Council broke new ground. Council researchers were the first in Canada, for example, to experiment with potential output analysis techniques that had only begun to be used by academics in the United States. By comparing actual output with potential output, economists could arrive at some idea of the effectiveness of a country's economic policies. Other ground-breaking work pioneered by the Council at that time included an examination of the relationship between education and productivity. In 1966, the

Council received the first of many government references (contract research requested by the Prime Minister). That first reference dealt with the relationship of prices, costs, productivity, and incomes to sustained economic growth. It, together with another reference that looked at consumer affairs, competition policy, and intellectual property, had a major impact on the structure of government. Among other things, for example, these references highlighted the need to rationalize government programs in such areas as manpower and employment, regional expansion, and consumer and corporate affairs.

At least two important events stand out during the chairmanship of Arthur Smith (1967-71): the Council began developing the original version of its CANDIDE econometric model of the Canadian economy; and the Council confirmed its independent stance. In regard to the latter, many Council documents reflected this independent turn of mind by taking positions critical of the government. In the Council's view, for instance, the government at that time should have been using its stabilization policies less frequently and with an eye to increasing medium-term or long-term potential growth.



Research excellence

Council Chairman André Raynauld (1971-76) brought about a change in emphasis from the policy orientation that had characterized the previous two administrations to an accentuation of researchers' technical skills. In this regard, the Council scored a major success with the completion of its CANDIDE econometric model. It was now possible to show in detailed quantitative terms the consequences of the Council's policy recommendations. This was particularly important, since the Council's five main policy goals were thought by some to be mutually exclusive. (It can be argued, for example, that efforts to fight inflation can cause unemployment. CANDIDE enabled economists to see the effects of policy prescriptions on all of the Council's policy goals.) CANDIDE was an innovation in Canadian economics. The two other models that existed at the time were specialized and were designed to model special problems. CANDIDE, however, was a multipurpose model designed to fulfil many goals at the same time.

Raynauld also placed greater emphasis on consultation. Under his stewardship, the Council organized two national economic conferences that brought together leaders in all sectors of the Canadian economy and society to discuss major issues affecting the economy. Unfortunately – and ironically – it was at that time that labour representatives on the Council walked out over the government's wage and price controls. The walkout was part of a general withdrawal

of trade union representatives from many government bodies.

Internally, Raynauld reorganized the Council by introducing project teams,

country's economic woes. The ferocity of these problems led to more and more demands on the Council to concern itself less with the longer term and more with

Increasingly, the Council's work incorporates research techniques from such disciplines as sociology, political science, even the hard sciences.

each with a specific mandate. The restructuring resulted in improved productivity and project control, and better use of the Chairman's time.

As a footnote to that period, it is worth noting that the Council recommended free trade with the United States. At that time the suggestion received a chilly reception in the business community.

George Post (1976-77) served as the Council's Vice-Chairman and Director prior to being appointed Acting Chairman for a year and a half. Under his guidance, the Council issued several influential reports. Its project on financial markets led to the publication of, among other reports, *Efficiency and Regulation: A Study of Deposit Institutions*. The study called for greater competition in Canadian financial markets, and many of the recommendations in it were reflected in the 1980 revision of the *Bank Act*. In 1977, the Council published *Living Together: A Study of Regional Disparities*, which has been reprinted four times over the past decade.

Higher profile

Sylvia Ostry was appointed Chairman in 1977. In her two years with the Council she was successful in raising its profile by increasing support for the Council's work. During her tenure, for example, the Council received three references from the Prime Minister. Only three had been given prior to that.

In 1980, David Slater, then a Director at the Council, was appointed Chairman. With his appointment, the Council once again took on a more technical orientation. Meanwhile, the Canadian economy was being hit by a number of serious shocks. High unemployment, high interest rates, high inflation, and the collapse of the western Canadian energy-based economy were among the

short-term solutions to these critical problems. The Council undertook a number of projects in such areas as energy; women and the economy; productivity; taxation; and a special report on the western Canadian economy.

Diversification

The appointment of Judith Maxwell as Chairman in 1985 marked the beginning of the present period of the Council's history. Over the past two years the Council has undergone a number of changes. In its research work, there is a more pragmatic policy orientation, faster throughput of work, and a greater diversity of projects under way at one time. The output of the Council has increased dramatically as well. Whereas in earlier years it produced an Annual Review of the economy, along with several other reports, last year the Council published the Annual Review, two Statements, and two research reports, in addition to the regular flow of research studies and discussion papers. It is also putting more weight on communicating its research through speeches, seminars, conferences, media relations, and frequent appearances before parliamentary committees.

In part, these changes reflect the changing environment in which the Council operates. Increasingly, for example, economists are incorporating into their work techniques from such disciplines as sociology and political science. The Council is broadening its focus accordingly, employing experts in fields other than economics. As it responds to continuing changes in the environment, it is certain that the challenges facing the Council over the next 25 years will be as exciting as those which were part of its first quarter-century.



New director discusses Council

Last summer, Harvey Lazar was appointed as one of the Council's two full-time directors. A graduate of McGill University, the University of British Columbia, and the London School of Economics, he has had extensive experience in government at both the federal and provincial levels. Most recently, he was Administrator of the Petroleum Incentives Administration at Energy, Mines and Resources Canada. Before that, he was Executive Director of the Petroleum Monitoring Agency and had worked in a number of capacities for the federal Department of Finance, including that of Director of the Task Force on Retirement Income Policy. He also served as an associate deputy minister for the British Columbia government.

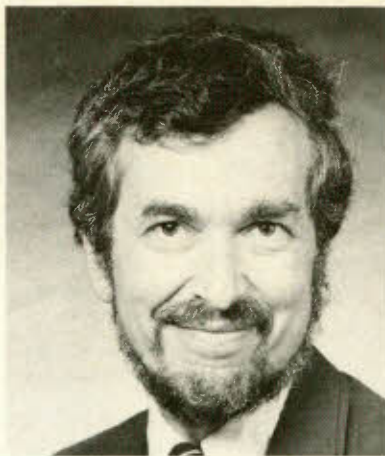
In the following interview with *Au Courant*, Lazar discusses some of his views of the Council.

Au Courant: In what direction do you see the Council moving in the future?

Lazar: It seems to me that we are moving increasingly into a period in which economic issues will overlap environmental, technological, social, and political matters. While this has been true in the past, it is my sense that the overlaps will become even greater in the future. Therefore the Council will probably have to become increasingly interdisciplinary in its approach to economic matters and to public-policy analysis generally. It will become more and more difficult for us to look at issues from a purely economic perspective. I might add, however, that the discipline of economics is sometimes very useful in examining the non-economic aspects of public policy. By that I mean that we can use economics as an analytical tool for examining environmental matters, social concerns, and so forth.

Au Courant: Critics say that the Council is just one of many research organizations in Canada today that offer policy advice. What expertise does the Council have to offer that the other bodies do not have?

Lazar: I'm not sure I see it principally as a question of expertise. Rather, I see the Council as a unique organization in that



Harvey Lazar

its structure encourages a consensus approach to the formulation of economic policy. The Council staff's economic analysis is blended with the practical knowledge of a Council membership that is representative of the major segments of Canadian society, including both the regional dimension and various occupational groupings. So the Council combines – in a unique way, I believe – a strong economics capability with a consultation mechanism that ought to result in its advice being highly relevant to decision makers.

Au Courant: What major economic issues should the Council be addressing over the next few years?

Lazar: First, the events in the stock market (in October 1987) suggest that we are going to have to revisit the world of macroeconomic policy. In recent years, macroeconomics has fallen into disrepute in the eyes of many people. But the failure of the world's major economies to get their fiscal and trade figures into balance is quite clearly a tremendous source of disequilibrium in the world economy. So I believe that governments are going to have to return to the principal lessons that macroeconomics can teach and to take them far more seriously than they have over the last decade. Second, and a related point, there is the growing integration of the world economy and what this implies in terms of international trade and capital flows, and movements of technology and know-how. The Council will have to continue to place heavy emphasis on these issues.

In this regard, we are indeed continuing our work in the area of international trade, and we also have under way a major project on international finance. Third, there will be an increasing need to be concerned with people – or “human capital” if you prefer jargon. This will require us to sustain our efforts in the areas of employment, labour markets, and diffusion of technology, and it will probably result in a growing interest in education and training. In addition, there are numerous specific industries and regions of the country that are cause for continuing concern. Some of these are now being studied by the Council. Prairie agriculture and regional development are examples of two projects now under way. In fact, I think the Council has done a good job in recent years in identifying where the challenges lie. Finally, we're just beginning a project entitled “Visions of the Nineties.” This will entail looking ahead and anticipating in a systematic way the kinds of concerns that are likely to be on the public agenda in the mid-1990s and beyond.

Au Courant: From a personal point of view, what do you hope to contribute to the Council?

Lazar: I bring to the Council considerable experience in how governments operate and how economic and social policy is made. For some years I have been involved in a broad range of areas – from international economics to social policy, from international negotiation to federal-provincial relations. I hope that this institutional knowledge and practical experience in government, when blended with the professional capabilities of the Council staff, can help it in the formulation of constructive policy proposals for governments. More generally, I would hope that I could help to build bridges between the Council and the major decision-making organizations at the federal and provincial levels. My past work has given me an opportunity to get to know very well many of the key people at both levels. I believe that this will assist the Council in understanding better the needs of government and, at the same time, assist governments in understanding how the Council can contribute to their decision-making process.

An assessment of CANDU

Atomic Energy of Canada Limited has failed to make its CANDU nuclear reactor a commercial success because it is at a disadvantage in being a Crown corporation, according to new Council research.

The federal government established Atomic Energy of Canada Limited (AECL) in the early 1950s to develop the Canada Deuterium and Uranium (CANDU) nuclear reactor system. When the CANDU was first considered for commercialization, it was thought that it could be profitably exploited for the Canadian market alone. But its commercial success depended upon breaking into highly competitive world markets, where government enterprises are "at a disadvantage," says George Lerner of the University of Lethbridge, in a study done for the Council's project on government enterprise (see *Au Courant*, vol. 7, no. 3).

Lerner explains that the government restricts the options available to the managers of public firms because it retains control over financing; hence these managers are unable to implement long-term market strategies. But in highly competitive world markets, firms that do not have a viable long-term strategy are "unlikely to be in the industry when the 'shake-out' is complete," Lerner says.

In the nuclear reactor business, companies such as Westinghouse and General Electric have been movers and shakers from the outset. Westinghouse, for example, provided nuclear power stations on a fixed-price, "turnkey" basis (ready to operate); it guaranteed the price of uranium under long-term sales contracts; and it licensed its technology and entered joint ventures in France, Japan, and elsewhere.

Entrepreneurship lacking

Canada, on the other hand, displayed no such capacity for marketing entrepreneurship, Lerner says. AECL focused its marketing efforts on Ontario, where its major buyer was Ontario Hydro. That was a natural step for a mission-oriented firm whose task was to develop the CANDU system for Canada. But a private

company, with the knowledge that long-run survival is unlikely if based solely on the domestic market, would have acted differently, Lerner argues. When AECL later realized that it would lose credibility at home and abroad if it failed to market its reactors outside Canada, it concentrated on selling to Third World countries at concessionary prices. All such sales, in fact, have been made at subsidized export financing rates.

Because AECL was convinced that industrial countries would protect their home markets, it stayed out of the U.S. and German markets. However reasonable that assumption may have seemed, "AECL can be faulted for not having tested those limits," Lerner says. There were opportunities to sell to privately owned utilities, he insists. AECL, possibly along with Canadian General Electric, could have made an effort to sell reactors in the U.S. market during the 1965-74 boom in reactor sales, for example. The fact that U.S. reactor manufacturers had stopped offering turnkey projects in 1967 provided a door through which AECL could have entered the U.S. market. A turnkey sale to a U.S. utility "would have made a real impression abroad during that critical time when operating experience was unavailable for any of the competing types of reactors," Lerner explains.

Instead, AECL became dependent upon a single market that unexpectedly evaporated in the 1970s. (At the moment, there is thought to be some potential in Quebec and the off chance that AECL may place a reactor or two in British Columbia and another one in the Maritimes.) Today, with German, French, and U.S. producers of light-water reactors so firmly entrenched in international markets, the odds are now against any revival of CANDU, Lerner maintains.

Marketing failures

The most damaging marketing failure of AECL was its cavalier attitude to heavy-water development and pricing. Though fears about the availability and cost of heavy water to supply CANDU reactors was the Achilles heel of the

CANDU program, "no dramatic steps seem ever to have been taken to dispel customer concerns," Lerner discloses. The U.K. rejection of the CANDU in the early 1970s is alleged to have been due to the cost of heavy water and the risk of producing it in highly populated areas. In the mid-1960s, when customers were worried that the CANDU might leak heavy water, AECL should have guaranteed supplies at its own expense, Lerner suggests. Later, when AECL was able to establish that CANDU is leakproof, it should have guaranteed firm concessionary prices for heavy water.

The second major factor that hindered CANDU's success was the three-year delay during the boom period in reactor sales in bringing into operation the Douglas Point reactor, which was Canada's demonstration stage reactor. Here, the weaknesses in allowing a research or mission-oriented organization to dominate



AECL's CANDU reactor at Pickering, Ont.

commercial enterprise seems to have come into play, Lerner says. For instance, one of the sources of delay was AECL's decision to change the design of a fueling machine during the construction stage of the project. "Had the Douglas Point reactor operated successfully in 1964 and had heavy water become available at reasonable cost, it is likely that CANDU could have become a major player in world markets," Lerner believes.

Another marketing weakness that remains today is that AECL is one of the few vendors of nuclear reactors that is not also integrated into manufacturing the basic components of its system. This situation developed primarily because Ontario Hydro was the only utility willing to co-finance reactor development. It agreed to take on the risks of developing CANDU, in partnership with AECL and the provincial government. It took on responsibility for the manufacture and construction of nuclear power stations, leaving AECL as the designer only.

Costs and benefits

Because the demand for electricity, and thus for nuclear reactors, has fallen

far below pre-1975 estimates, the CANDU has been expensive for Canada. In

money to improve the CANDU, he adds. Without such expenditures, however, the

If Canada's nuclear industry does not receive a major financial infusion, it is unlikely to survive.

Lerner's estimate, the federal government has spent the equivalent of \$18 billion (in 1981 dollars) on the CANDU program. Ontario Hydro is estimated to have saved \$1 billion in choosing nuclear power over coal-fired generating stations. In Lerner's view, the high hopes held for the CANDU program "have failed to materialize." The best that can be said for the economics of the program is that it did stimulate research and development in Canada, and it enabled Canadians to participate in nuclear-engineering research without leaving home, he says.

Future demand

Since 1978, AECL has taken stock of the need to restructure itself in light of reduced government support for research and development, and of few, if any, new orders for CANDU reactors. But no clear-cut strategy has been settled upon. Rather, the company has appeared to plod on in the expectation that the odd reactor order will be forthcoming over the next decade and that the market will rebound in the late 1990s. As for the industry's future prospects, the U.S. market remains the most promising for Canada; an enormous aging, and expensive, stock of generating capacity will be replaced there over the next few decades. But the CANDU faces an uphill climb in the United States because of the abundance of coal and the surplus manufacturing capacity in the industry. (It is by no means clear that nuclear power has any cost advantage over coal, even in Ontario, Lerner points out.) Canadian orders for the CANDU will only follow if domestic utilities sell surplus power to U.S. utilities, which, according to Lerner, is more a hope than a prospect.

Moreover, unless AECL sustains research and development at some reasonable minimum level, it is conceivable that even Ontario Hydro will turn to foreign producers and designs for the next generation of Canadian reactors, the author warns. Unless AECL aims at selling in world markets as well, it would be "foolhardy" to expend large sums of

CANDU is unlikely to even hold on to the domestic market.

Lerner sees AECL's choices as limited. Either it develops a marketing strategy that offers some hope of expanding the market for the CANDU or it forms some sort of alliance with a foreign reactor developer. The first alternative would require an investment of about \$6 billion over the next 10 years, and AECL would have to develop credibility in world markets, preferably by selling in the U.S. market. But Lerner has "serious reservations" as to whether a Crown corporation is the proper instrument for so large and risky a public investment. The second strategy would entail seeking partners, whether for CANDU or someone else's technology. It would likely be less costly than the first option, but it could be difficult to find a partner.

Possible merger

If Canada's nuclear industry does not receive a major financial infusion to carry it into the next century, it is unlikely to survive, Lerner concludes. At the same time, there is no certainty that the market for nuclear power will revive. Lerner suggests that if the CANDU program is to be allowed to wither, consideration should be given to a merger of all or part of AECL with Ontario Hydro. Alternatively, if the government chooses to invest heavily in a new effort to prepare for the next round of reactor orders, then some form of privatization of all or part of AECL should be seriously considered. Lerner cautions, however, that his study does not provide a sufficient basis for deciding on either AECL's or CANDU's future. Rather, his analysis reveals that greater consideration should be given to channeling government support for commercializing new technologies to private enterprises.

Atomic Energy of Canada Limited: The Crown Corporation as Strategist in an Entrepreneurial, Global-Scale Industry, by George Lerner (EC22-145/1987E; \$8.95 in Canada, \$10.75 elsewhere).



A.E.C.L.

The evolution of Petro-Canada

Petro-Canada's 1984 mandate to operate basically as a commercial enterprise suggests that there are few reasons to maintain it as a Crown corporation, a new Council study says.

The study contends that, in general, Crown corporations without a valid social purpose should not be maintained, because of the costs and difficulties in effectively monitoring and controlling them. But the study cautions against making a hasty decision to privatize Petro-Canada. The federal government should first examine the long-term potential of the oil and gas sector, the nature and extent of public-policy objectives in that sector, and the range of policy instruments available to achieve those goals. Should such an analysis find little scope for a social role to be attributed to a national petroleum corporation – or that a Crown corporation is not the most effective tool – “then we would recommend the privatization of all of Petro-Canada's equity,” conclude professors Paul Halpern, André Plourde, and Leonard Waverman of the University of Toronto.

Their study traces the emergence and development of Petro-Canada, and it suggests ways to assess the company's performance and to control its activities more effectively. Their suggestions apply generally to the monitoring, control, and evaluation of all Crown corporations. The research was carried out as part of the Council's project on government enterprise (see *Au Courant*, vol. 7, no. 3).

The early years

At its inception in 1976, Petro-Canada's mandate included a number of social objectives. Principally, it was established to increase Canadian supplies of oil and gas, mainly by exploring and developing the country's geological and technological frontiers; it was to be a vehicle that would enable the federal government to increase its knowledge of the oil and gas sector (the “window-on-the-industry” function) and subsequently assist it in designing policies for that sector; and it was established to increase Canadian participation in the domestic oil

and gas industry. The authors explain that several developments spurred the creation of Petro-Canada, including concern over foreign ownership of the oil and gas sector, and problems in the international petroleum market in the early 1970s. Overall, the government perceived Petro-Canada's role to be that of increasing the industry's capacity to discover and produce the country's oil and gas resources.

The authors note that during its first few years of operation Petro-Canada did not depart appreciably from the scope of activities defined as appropriate either by the federal government or under the firm's original mandate. Many of Petro-Canada's activities related to the exploration and development of oil and gas reserves on Canada's geographical and technological frontiers, including joint-venture projects with private companies. But in 1978 it became embroiled in a battle for control of Husky Oil Ltd., whose assets included oil refineries and retail product outlets in the United States as well as Canada. At the time, the government agreed with Petro-Canada that the acquisition was the only way to bring about the development in the near future of Husky's heavy oil deposits in Lloydminster, Saskatchewan. But neither the government nor Petro-Canada made any statement about what would happen to Husky's U.S.-based assets or its downstream activities should the take-over occur.

The bid for Husky failed, but soon thereafter Petro-Canada acquired a controlling interest in Pacific Petroleum Ltd. The federal government defended the acquisition as a commercial transaction that would provide Petro-Canada with the cash flow from production needed to finance some of its frontier exploration and development projects. This would reduce Petro-Canada's reliance on the public purse, the government argued. But the acquisition also meant that Petro-Canada would now actively compete with existing companies in the refining and retailing business. In the ensuing political debate over Petro-Canada's entry into these downstream activities, proponents of the move noted that the company's retail outlets had become very popular with the Canadian public. They also argued that the outlets provided a concrete example of increased Canadian ownership of the industry. Whether or not the Crown firm initiated the transaction in order to acquire downstream assets cannot readily be determined from the available evidence, the authors concede. But Petro-Canada did manage to hold on to its refining and marketing assets even during the period when its sole shareholder (the minority Conservative government in 1979) seemed intent on returning to the private sector at least some of those assets which served no public-policy purpose.



Petro-Canada

Petro-Canada was created mainly for exploration and development.

Canadian ownership

The introduction of the federal government's National Energy Program (NEP) in 1980 expanded the role of Petro-Canada. It signaled an increase in the interventionist nature of Petro-Canada's mandate by suggesting that Petro-Canada would be a key vehicle in the pursuit of increased Canadian ownership and control of the oil and gas sector. The Crown firm subsequently purchased Petrofina Canada Ltd., the downstream assets of BP Canada Ltd., and later the western Canadian downstream assets of Gulf Canada, making it one of the country's larger retailers of oil products. At the same time, Petro-Canada's continued role as a source of information and advice to the government on matters relating to energy policy (including the NEP) placed the Crown firm's officials in a potential conflict-of-interest situation, the authors maintain. "We do not suggest that any impropriety has taken place," they counter. Nonetheless, Petro-Canada did benefit from many of the provisions under the NEP.

Prior to 1982, Petro-Canada's record shows strong support for projects at the frontier of oil and gas technology, consistent with the Crown firm's original mandate. But in subsequent years Petro-Canada refocused its activities "to emphasize a better balance between short-term cash-generating activities and higher-risk, longer-term projects," according to the company's 1983 annual report. In fact, the firm announced no high-risk, long-lead-time projects in 1983 (nor were any proposed in 1985 and 1986). "This heightened concern about 'bottom-line' performance meant that Petro-Canada was moving closer to operating like any private-sector oil and gas firm," the authors maintain.

New mandate

In 1984, when it was given a new mandate to operate in a fundamentally commercial manner, Petro-Canada nonetheless retained its "window-on-the-industry" function. Since it was now supposed to operate even more like a representative industry player, the potential for conflicts of interest in providing information to the government would appear to have increased, the authors warn. Moreover, the new mandate requires that a written directive be issued should the government decide for Petro-Canada to undertake an activity deemed to be in the national interest. But the government failed to issue such a directive when it intervened in Petro-

Canada's purchase of Gulf Canada assets in 1985.

In order to prevent the misuse of Petro-Canada's social objectives in the future, the authors recommend minimizing Petro-Canada's role in policy formation and terminating its "window-on-the-industry" function. "Petro-Canada should not be involved directly or indirectly in any policy setting," they argue. In that vein, civil servants should not be allowed to sit on the board of directors of any Crown corporation that competes, or engages in joint ventures, with private-sector companies. Furthermore, the firm's objectives should be redefined to make them less vague, to suggest priorities if there are trade-offs between them, and to incorporate efficiency of operation as one of them.

Monitoring performance

To help monitor the company's performance more effectively, the authors suggest expanding the capital budgeting process. In particular, capital budgets should contain more detail; a larger staff at Energy, Mines and Resources should be devoted to examining those budgets; amendments to an already approved budget should be minimized; and Petro-Canada officials should be liable for more public information than their private-sector counterparts.

After comparing Petro-Canada's financial performance with that of private-sector companies in the same industry, the authors caution against using this evaluation test, especially for comparisons of profit and revenue. Since Crown firms operate under mandates that differ from those of privately owned companies, it is difficult to make such comparisons, they say, even after allowing for differences in accounting and financing practices.

Instead, the authors suggest an expanded audit that would, where possible, compare certain performance indicators (rather than output or profit indicators), such as productivity growth, exploration costs in conventional and non-conventional areas, and oil-sands technology and development. While such evaluation is possible in industries where private-sector firms operate, the authors suggest external auditing of performance or expenses in industries where the Crown firm is the major or sole operator. They also call for expanded use of written directives to augment or specify legislative objectives, or to signal a change in direction that the government might wish to see take place. This would

allow for easier identification of the ultimate source of responsibility (political or other) for the company's activities.

In addition, the authors would substantially expand the role of the Standing Committee on Energy, Mines and Resources. The committee would be charged with reviewing Petro-Canada's annual reports, corporate summaries, and annual budgets and audits. It would have the right to call any official of Petro-Canada to testify before its members. It would also undertake its own annual evaluation of Petro-Canada, and it would have the budget and professional staff needed to handle these enhanced responsibilities.

As part of their study, the authors analysed the impact of Petro-Canada's formation and growth on the share prices of private-sector firms in the oil and gas sector. They conclude that the announcement of the creation of Petro-Canada was viewed with some trepidation by financial markets, in that the share prices (as measured by indexes) of companies fell in both the oil- and gas-production sectors and in integrated production. But none of the Crown firm's acquisitions since then would appear to have had any significant discernible impact on the financial performance of other firms in the oil and gas sector.

Petro-Canada: Its Role, Control and Operations, by Paul Halpern, André Plourde, and Leonard Waverman (EC22-147/1987E; \$9.95 in Canada, \$11.95 elsewhere).



Today Petro-Canada is a large retailer.

Lessons in innovative management

A key lesson for managers who are planning innovative changes in the workplace is that it is unwise to copy others.

While the principles and approaches to workplace innovation are transferable, each organization must design its own structures and processes to fit its own needs. The various parties in the organization must also go through the important learning process that comes from having to work together to identify problems and goals, says Toronto researcher Jacquie Mansell, in a study done for the Council's project on the labour market impacts of technological change. That project led earlier to a Council policy statement entitled *Making Technology Work* (see *Au Courant*, vol. 8, no. 1), along with other reports.

Mansell traces the development of new, more flexible ways of organizing work, many of which give employees a major role in determining how they are to carry out their work. These approaches include rotating employees among jobs; allowing them to carry out a variety of functions; setting up joint union/management committees; and creating "semi-autonomous work groups" (where each group is responsible for most aspects of its work, including planning, production, and some support activities, and where each member of the group is able to perform most of the tasks).

Successful innovation

The author looks at a number of case studies of successful workplace innovation, concluding that it is as important to Canada's economic future as new technologies. In fact, new technologies may force organizations to explore new methods of organizing work, she says. In many cases new technologies are more effective when there is innovation in the way the firm is organized and in relations between managers and employees. Workplace innovation has also led to significant benefits, Mansell notes, including lower costs and less absenteeism, and more challenging roles for workers.

Mansell draws some key lessons about the conditions necessary for successful

innovation from the vast amount of evidence that has been accumulated over the past 15 years. In addition to noting that it is unwise to copy others, Mansell points out that innovation usually does not survive long if it has been limited to only part of the organization. In fact, the kinds of change that are most likely to produce the most significant results – such as the introduction of semi-autonomous work groups – eventually need to be implemented throughout the establishment if they are to last.

In addition, change cannot be implemented successfully without significant resources – funds; time; and, above all, people. "The right people have to be involved in, and in charge of, the change process," she says. People in key areas of influence within the organization must participate actively in the change process, and those who are respected throughout the organization must be in charge of it.

Finally, managers and unions should realize that the change process is not only intellectually demanding; it is also a

design that will always be most effective. As the environment within and outside the firm changes, so too must the design of workplace innovations.

Second, innovative organizations are limited by, and threaten, their environment. For example, the idea of semi-autonomous work groups is based on a fundamentally different set of values than are most organizations in Canada. In that sense, change cannot ultimately survive within organizations unless it is supported by changes at the societal level.

Workplace tensions

The author singles out two major sources of tension between innovative forms of work and the underlying fabric of the workplace in Canada. Both relate to the fundamental assumption that management will maintain control over the workplace, and the union will act as a "counter-organization" to limit management's control in specific areas such as job security and fair compensation. In

Innovation usually does not survive long if it has been limited to only part of the organization.

highly political and emotional process. In this regard, workers cannot always be told what they ought to do: they insist on making their own mistakes. They will only be able to learn if they are prepared for, and able to cope with, some pain. That is why workplace innovation needs to be supported by strong, committed leaders and directly guided by mature and competent people, Mansell explains.

Other lessons

Two important lessons have also been learned about why successful innovation has sometimes not been sustained. First, within many organizations, innovation has been regarded as a product rather than an on-going process. People have not realized that there is no one best

the first instance, many corporations are not prepared to make fundamental changes to their management systems, which now support the role of the manager as decision maker and decision enforcer. Second, unions sometimes oppose innovation because many of the changes that management wants – for example, flexible job descriptions and work rules – threaten the current system of collective bargaining. Unless such threats are addressed in a creative manner, workplace innovation may ultimately weaken the trade union movement.

Workplace Innovation in Canada: Reflections on the Past . . . Prospects for the Future, by Jacquie Mansell (EC22-146/1987E; \$4.95 in Canada. \$5.95 elsewhere).

Air Canada's costly ownership

Government ownership may have cost Air Canada \$370 million a year in additional expenditures between 1964 and 1981, according to a recent Council discussion paper.

Most of the additional costs were in the form of excess aircraft, which the airline probably had to purchase in order to meet government-imposed service requirements, the paper says. The airline may also have been more likely than other domestic air carriers to purchase new aircraft because, as a Crown corporation, its capital costs are perceived to be relatively lower. (The government backs the airline's debt, for example, making it less of a risk to creditors.) Cost inefficiencies at Air Canada also arose in the use of labour, fuel, and other purchased materials.

Since its inception, Air Canada has been pressured directly or indirectly to maintain what is perceived to be uneconomic service to some points in Canada. The federal government has also intervened in the airline's management on such matters as aircraft purchase, service standards, fuel consumption, and labour contract negotiations. In total, Crown ownership is believed to have added 18 per cent to Air Canada's total costs over the 1964-81 period, the paper concludes. Furthermore, because Air Canada is such a large player in the domestic airline industry, privatizing it would lead to an industrywide reduction in labour costs that would have amounted to \$50 million in 1981. (These savings would probably be smaller today, because Air Canada has made substantial gains in cost efficiency as a result of both the liberalized regulatory framework and the introduction of the new *Air Canada Act* in 1977, which made the airline more market-oriented.)

The Council paper, which looks at the impact of government ownership and regulation on airline performance, was carried out as part of the Council's project on government enterprise (see *Au Courant*, vol. 7, no. 3). Authors David Gillen, Tae Oum, and Michael Tretheway compare Air Canada with other domestic carriers on the basis of productivity and cost efficiency.

On both counts Canada's regional carriers had a slightly better average performance over the 18-year period, primarily because they grew more rapidly during that time. While these carriers also operated to some degree with excess capital stock, Air Canada and, to a lesser extent, Canadian Pacific Airlines (now part of Canadian Airlines International) had the worst records in that regard. Air Canada's productivity performance was almost 25 per cent lower than CP Air's for that reason. While the authors were unable to pinpoint where Air Canada overexpanded its capacity, they suspect that it occurred with "both the number of aircraft and the purchase of larger aircraft than the market required."

As for the impact of government regulation on airline performance, the authors find that it, too, raised carriers' costs — by 7 per cent for Air Canada and CP Air, and by 17 per cent for the regional carriers. Again, the principal reason was the excess capital stock that carriers were induced to use. But most carriers have improved their cost efficiency since 1977, as a result of both regulatory relaxation and the introduction of competitive market forces. On the basis of what has occurred in other countries, the authors speculate that over the longer term the price of labour in the industry would decrease significantly in response to deregulation or the introduction of a more liberalized regulatory structure.

The authors point to a number of interesting results from their cost analysis. For example, they find that adding new destinations to a carrier's network will

not, by itself, reduce average unit costs. In that sense, Air Canada, despite its size, may not have a cost advantage over other airlines. Carriers can reduce unit costs, however, by increasing traffic within existing markets. "A properly designed hub and spoke system which effectively increases the (traffic) density of any given network link could be desirable from a cost perspective," the authors explain.

In the past, regional carriers have suffered cost inefficiencies in their scheduled services by undertaking a large portion of charter business. One reason is that they needed larger, long-haul-oriented aircraft for charter services, while having only smaller, short-haul-oriented aircraft for scheduled services. As a result, they had to lease or acquire aircraft for charter services that could not be used for scheduled business (and vice versa). National carriers like Air Canada, on the other hand, could use their long-haul aircraft for both purposes. The regional airlines had been encouraged to seek growth in charter markets because of the Regional Carrier Policy, which restricted their routes geographically and thus limited their ability to expand scheduled services or to increase stage length. That policy, which was abolished in 1984, "had been very costly for Canada," the authors say.

"Identifying and measuring the impact of government ownership and regulation on airline performance," by David W. Gillen, Tae H. Oum, and Michael W. Tretheway. Discussion Paper No. 326.



S·P·E·A·K·I·N·G·O·U·T

Canada's social policies are likely to become increasingly the target of reform, as governments respond to growing concerns about the efficiency and fairness of the social system.

In particular, a number of recent studies suggest that it is difficult to make progress in the fight against poverty in Canada. In 1981, almost 3.5 million Canadians fell below the low-income cutoff line, as defined by Statistics Canada. Despite the economic recovery since then, some 3.7 million Canadians remained below the cutoff line in 1986. (By now, the percentage of people living in poverty may have returned to 1981 levels.) In one year alone, Canada spent almost \$16 billion to help people out of poverty. Studies also indicate that a serious problem of social-program dependency has developed in Canada. Some researchers claim that certain transfer programs actually contribute to poverty by reducing the incentive to work (thus creating a "poverty trap") and by distorting demographic choices (such as marriage, divorce, and birth rate). In many provinces, for example, welfare recipients are discouraged from taking part-time jobs because their benefits are reduced by an amount equal to the income they earn.

On several occasions in the past, the Council has turned its attention to the issues of income distribution, poverty, and social policy. (It played a pioneering role in the development of more accurate measurements of poverty in the late 1960s, for example.) To continue its work in that area, the Council recently launched a new project on social policy that will report its findings in early 1989. To find out more about it, *Au Courant* spoke with project director Sylvester Damus.

Au Courant: Why is the Council undertaking this project?

Damus: The whole area of social policy is likely to be high on government agendas over the next few years. The Council wants to be in a position to take part in that debate. At the same time, there is apparent reluctance to undertake reform of income-security programs because of the absence of research into the expected results. We are focusing our efforts on two fronts – the development



Sylvester Damus

of analytical instruments, so that decision makers can assess the merits of various reform proposals; and an assessment of how well the current system combats poverty.

Au Courant: What will the project be looking at specifically?

Damus: We are tackling three issues: the measurement of poverty; the dynamics of poverty; and the costs and benefits of tax and transfer programs. In the first two areas we are attempting to get a statistical picture of poverty and of the characteristics associated with people living in poverty. We will also be analysing the poverty experience of people over time, in order to identify the factors that influence the movement of various types of households in and out of poverty. We noticed in our tax research, for instance, that people's incomes fluctuate considerably, even though average incomes remain stable; therefore the need for income supplementation may be more widespread than is generally recognized. The third area is the modeling exercise, where we are developing a general equilibrium model of the economy to answer "what if" questions about possible changes to the tax and transfer systems. There are two objectives in the modeling exercise: to assess proposals for income-security reform in terms of how they affect income distribution, and with respect to the nature and extent of

their economic costs; and to measure the impact on income-security programs of changes in the economy, such as technological progress, free trade, and industrial reorganization. We have already developed a model of the Ontario economy similar to the one that was developed in Quebec for its White Paper on the Personal Income Tax System. The central feature of the simulation model is its ability to analyse the effects of alternative tax and transfer schemes on labour supply and economic activity. An accessory to the model is an accounting model that translates the impact of existing or proposed tax rates, transfer benefits, and eligibility rules on representative socioeconomic groups. You can think of this accounting package as a cousin of some smart tax-planning software. The simulation model then determines the impact of these tax and transfer changes on labour supply, wages, prices, and incomes. This helps to determine what happens to the economy as people respond to changes in the tax and transfer systems. For example, how are you going to react if your social assistance benefits are increased or if your taxes are reduced? Will you spend more, and thus create jobs, or vice versa? There is a belief that high transfer payments discourage work effort by making it unattractive for recipients to return to work. Our model will help to focus the debate by putting such beliefs to the test.

Au Courant: Have you had any preliminary findings in this area?

Damus: We have had some interesting results with respect to the "trickle down" theory of economic growth. This theory holds that economic growth is like a tide that lifts all boats, in the sense that even the poor will experience some benefit as the economy grows. But what our results have made clear is that poverty depends not only on whether incomes are rising (as a result of economic growth), but also on the distribution of rising incomes and on whether transfer payments are increasing as well. So, in a macroeconomic sense, there are three factors that can reduce poverty over time: rising incomes, increased social assistance, and a more equal distribution of income. But these developments do not all necessarily

happen at the same time; nor do they always move in the same direction. Our research has shown that in some periods disparities among various income groups increased as overall incomes grew. We were able to identify broad, social economic groups that suffered a greater incidence of poverty during those periods. At other times, the rise in incomes resulting from economic growth was accompanied by a more equal distribution of income; and in those cases, poverty clearly diminished.

Au Courant: What has your research shown about the causes of poverty?

Damus: Actually, we are looking at the factors associated with poverty, not the causes. Let me explain. Suppose we discovered that 90 per cent of the poor had less than a grade 12 education. We could then conclude that not having finished high school is associated with poverty. But we couldn't identify that as a cause because there are reasons why those people didn't finish high school. In the course of our research, we would expect poverty to be associated with such factors as education, health, marriage, and labour market attachment (work experience).

Au Courant: You said you will be looking at the measurement and dynamics of poverty. Why?

Damus: There are a number of significant limitations in the way that poverty is currently measured. First, the poverty figures provide no information on the movement of various types of households in and out of poverty. While we know that some social-assistance beneficiaries

are short-term recipients and others are long-term, we do not know the make-up of either group. A better understanding

poverty as long as you don't have a perfectly equal distribution of income, with everyone receiving the same

There are a number of significant limitations in the way poverty is currently measured.

in this regard would enable us to judge more accurately whether the assistance programs are meeting actual needs. Second, poverty indicators do not take account of how far below the poverty line personal income lies. The result is that a helpful transfer program that increases household incomes without actually raising them above the poverty line may well have no effect on measured levels of poverty. Finally, there are numerous omissions in the income figures used to determine poverty levels and the poverty line in Canada. For example, subsidized housing, health services, and other special assistance are not taken into account in statistical measures of the resources of the poor; neither are assets. In the United States, a recent study concluded that there were almost 50 per cent fewer poor people when those transfers were taken into account.

Au Courant: Where do you draw the line between who's poor and who isn't?

Damus: Some economists argue that you cannot draw a poverty line because it is misleading in the sense that some of the population will always be poorer than others. You will always have some

amount, be it the prime minister or a high school drop-out. But if you look at poverty in the absolute sense, you recognize that the poor of today may be better off than the middle class of many years ago or that in Canada the poor are better off than they are in many other countries. But you can make some misleading statements from that perspective as well. For example, conditions that you might regard as progress in some countries could be perceived as shocking if you found them in Canada. So it's very difficult to draw a poverty line. What one can do instead, however, is to recognize the diversity of opinion as to where the line should fall or whether it should even be drawn. Then we can make a statement about whether poverty has increased or decreased with respect to that diversity of opinion. That is why, in developing new ways to measure poverty, we intend to put more emphasis on the distribution of income within a certain range.

Au Courant: At this stage, do you have a feel for the types of recommendations you will be putting forward?

Damus: Primarily we will be providing information that will be useful to policy makers. The project will not necessarily produce recommendations; rather, it will provide them with the information with which to make recommendations. It will produce the tools of analysis that will enable people to update information on poverty as time goes on and to analyse that data, including simulation of the probable consequences of various approaches to the relief of poverty.

Au Courant: Why is the Council shying away from making recommendations?

Damus: If areas emerge where we can make recommendations, we will; but the main objective is to lay the groundwork of research on which recommendations can later be formulated.



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