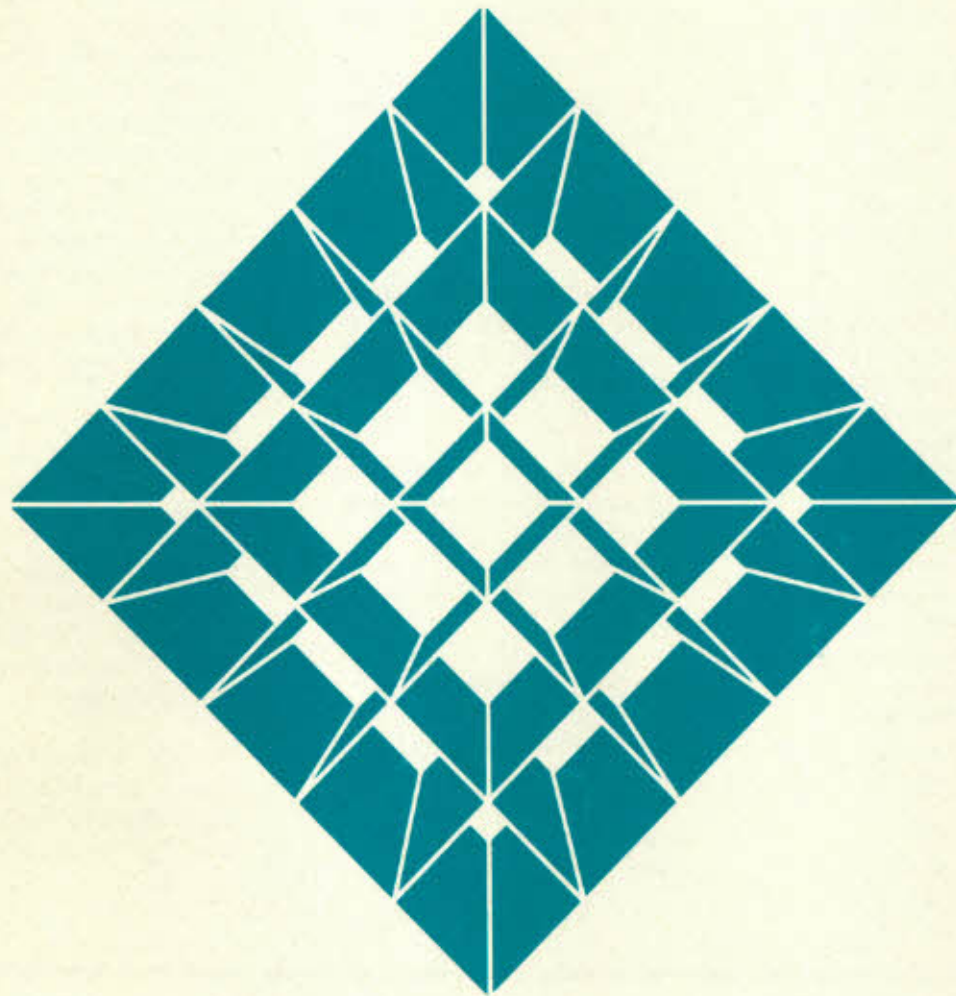


au courant

Economic Council of Canada

Volume 9, No. 3, 1989

Perspective 2000



Handling the risks
Free trade and the productivity gap
Trade: Competitiveness is the key

PUBLICATIONS

Council Report

Handling the Risks: A Report on the Prairie Grain Economy (EC22-154/1988E; \$9.95 in Canada, US\$11.95 elsewhere).

Prairie grain farming is becoming riskier, and Prairie farmers are more dependent than ever on government support. In 1987, over 90 per cent of net farm cash receipts in the Prairies came from government transfers. But massive assistance will not solve the underlying international and domestic problems. Farmers' income has always fluctuated with the weather. Over the past 15 years, changes in the international market have added to the uncertainty. A wider and more secure access to foreign markets is thus a priority for Prairie farmers. Prairie farmers also need help in stabilizing their incomes. Many borrow more to produce more, as the long-term real price of their output declines. Faced with this cost-price squeeze, only the luckiest and most efficient farmers survive. Mandated by the Prime Minister to examine the future of Prairie agriculture, the Council sees that future as bright but risky. Federal and provincial policies must change, if Prairie grain farmers are to survive and recover their entrepreneurial role.

Research Studies

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

Trade Liberalization and the Multinationals, by D. G. McFetridge (EC22-156/1989E; \$5.95 in Canada, US\$7.15 elsewhere).

Grain Market Outlook, by W. H. Furtan, T. H. Bayri, R. Gray, and G. G. Storey (EC22-153/1989E; \$9.95 in Canada, US\$11.95 elsewhere).

The Taxation of Income from Capital in Canada, by M. J. Daly, P. Mercier, and T. Schweitzer (EC22-155/1989E; \$5.95 in Canada, US\$7.15 elsewhere).

Canada and International Grain Markets: Trends, Policies and Prospects, by C. Carter, A. F. McCalla, and A. Schmitz (EC22-158/1989E; \$9.95 in Canada, US\$11.95 elsewhere).

Regulatory Failure and Renewal: The Evolution of the Natural Monopoly Contract, by J. R. Baldwin (EC22-157/1989E; \$11.25 in Canada, US\$13.50 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 sole 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. 358 "Adjusting to trade: A comparative perspective," by M. J. Trebilcock, M. Chandler, and R. House.

No. 359 "The diversification of Prairie agriculture: Opportunities arising from changes in the international trading environment," by William A. Kerr.

No. 360 "A review of the economies of farm enterprise size and implications for farm diversification," by William J. Brown.

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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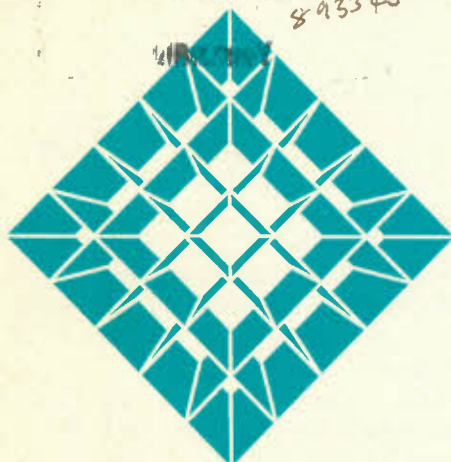
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Au Courant est également disponible en français.

The Economic Council reports featured in *Au Courant* reflect the viewpoint of Council members. Research studies, technical reports, discussion papers, and other background papers are prepared for the use of the Council by members of its

staff and others. The findings of these reports are the personal responsibility of the authors. Neither the original publication of these studies and papers, nor their condensation for the purposes of this magazine, should be taken to imply endorsement of their conclusions and recommendations by the members of the Economic Council.

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Editor: Jean-Guy Bruneau

Perspective 2000

Last year, as part of its 25th anniversary celebrations, the Economic Council undertook to identify a wide range of public policy issues this country could face at the turn of the century and beyond. This major project was named *Perspective 2000*.

From its inception, *Perspective 2000* has had three distinct characteristics. First, it is concerned with the longer run – with 21st century issues. Second, it addresses not only economic questions, but those relating to geopolitics, science and technology, demographics and the environment – and perhaps most important, it examines the linkages amongst each of these areas. Third, *Perspective 2000* asks questions not only from the Canadian viewpoint, but in an explicitly global context.

Twelve eminent scholars were invited to prepare papers with a distinctly international flavour. Twelve discussants analyzed the material from a specifically Canadian viewpoint.

At a major conference held in Ottawa last fall, the 24 scholars presented thoughts to more than 80 business executives, senior public officials, labour leaders, media representatives, and other prominent decision makers.

Five former ECC Chairmen convened subject “blocks” and a plenary discussion of conference themes. Arthur J. R. Smith, André Raynauld, Sylvia Ostry, George Post and David Slater each played major roles at this unique gathering.

Economics, ecology, people, and technology

We must design management skills that will help us . . . in turning the future's unforeseen opportunities to our advantage, and in controlling its unforeseeable dangers within tolerable limits.

William Clark, Harvard University

In what was to become a recurrent theme of the conference, William Clark noted that humanity is entering an era of chronic, large-scale and extremely complex syndromes of global interdependence. In the next century, he said, conventional wisdom may not suffice to handle surprises in global interactions of

demography, technology, and environment.

Clark feels that in order to be of value, long-term visions must eschew mechanistic predictions in favour of imaginative, though disciplined perspectives of what can be done.

Ecologist Pierre Dansereau argued that historically speaking, conventional wisdom has proven advantageous (or at least not harmful) for the survival of the group holding such views. But, he conceded, conventional wisdom is valid only as long as slow-changing trends hold. But echoing some of Clark's views, he said that in order to contribute to the larger theme of human survival through change, economics must reach beyond its traditional boundaries.

Global politics

Bill Maynes, editor of *Foreign Policy*, emphasized that historically, military technology has proven a fruitful path of inquiry when predicting geopolitical change. With the new technology becoming increasingly available worldwide, Maynes suggests that in the 21st century, the First World's Imperial Age will end. In the Second World – that of the communist states – the Revolutionary Age will end. In the Third World – that of the bulk of mankind – the Anti-Colonial Age will end. These developments may lead to more effective institutions of international governance and/or the formation of regional blocs.

The remaining challenge (of the G-7 – the western industrialized countries) during the 1990s is to transform from a northern plutocracy into a genuine global concert.

John Kirton, University of Toronto

Amplifying on Maynes' military technology path, International Relations Professor Kirton emphasized two aspects of technological and geopolitical interactions. First, he foresees an intensified science race between the two superpowers which will create a major arms control challenge. But as a counterbalance, the proliferation of television, particularly satellite broadcasting, will help the global populace to rise to political challenges as

the technologies relay information without the intervention of governments.

A multi-polar economy

Jacques Lesourne of Conservatoire national des arts et métiers in Paris expanded on the international theme by noting that the global economy is becoming increasingly multi-polar. During the 1950s and 1960s, the United States was the dominant pole in the world economy; however the rise of Japan, the revival of European nations and the growing importance of Asia's newly industrialized countries have since given birth to a multi-polar economy, he said.

Lesourne projected that the “Triad” – the United States, Japan, and the European Community – will either move toward a U.S.-Japan duopole, or balanced development will occur in all three poles. From Canada's point of view, it will be significant whether the U.S.-Japan relationship will be asymmetric with America playing a dominant role, or a more symmetrical one.

A naive free-trade strategy relying on unaided markets is unlikely to be a panacea: what is needed is active management of trade.

Gilles Paquet, University of Ottawa

Public policy scholar Paquet sees Canada's main problems very differently, maintaining, in fact that our country suffers from a form of economic arteriosclerosis. He provided a long list of symptoms which, he said, distort the information base needed for clear economic decision making. Classical free trade will not cure our problems. As an alternative, he advocates managed trade, i.e., an offensive strategic trade and targeting policy.

Managed trade, says Paquet, can be feasible, acceptable, stable, and implementable – and the development of such an approach is our main task in the next decade.

Canada's global role

Having sketched out the global setting, the conference turned to Canada's role and “expected problems.” UBC's John Helliwell agreed with preceding speakers

that globalization is of the utmost importance. One of the chief consequences of globalization is the dispersion not only of production, but of an ever-growing number of services, led by those of the financial market.

Picking up on the competitiveness aspect, Marcel Côté of Secor Inc., mapped out the future, using the years 1970 to 1985 – when a series of external shocks hit the Canadian economy – as a benchmark period.

In effect, Canada's economy will have four salient characteristics. First, natural resources (except agriculture) will continue their significant role. Second, manufacturing will continue developing and have greater flexibility. Third, we will remain a "follower" in technology, although we will continue to use new technologies to good advantage. Fourth, we will continue to be plagued with regional disparities, the reduction of which will remain a Canadian economic priority.

On the whole, Côté thinks Canadians will be better off, with a per capita national production at least 25 per cent higher, and a greater personal wealth – more goods, more land, more infrastructure.

But Professor Ken Norrie thought Côté's paper "incredibly optimistic," saying that in the past we have had to deal with a number of problems not mentioned by Côté, and we have not succeeded in solving them. At the same time, there has arisen a "protected society." How, argues Norrie, can the economy be flexible and adaptable when innumerable interest groups expect the government to protect them from the vicissitudes and disciplines of the marketplace?

Professor Lars Osberg of Dalhousie University presented a paper on distributional issues and the future of the welfare state. He looked at cyclical and secular influences on income distribution in Canada in the 1980s, emphasizing the importance of high unemployment in depressing labour's share of national income and in increasing the inequality of earnings and the incidence of poverty.

Evidence that structural change in employment opportunities may eliminate "middle class" jobs is inconclusive, he

says. However the ongoing revolution in computer and telecommunications technology will have a major impact on the structure of employment in information processing occupations, which already comprise the majority of the labour force. An aging and more immobile population will create intergenerational inequities and accentuate regional disparity – and the increasing salience of environmental issues will heighten public awareness of distribution of environmental costs between current and future generations.

Discussant Thomas J. Courchene of Queen's University considers two variants: the Limited Welfare State and the Implicit Social Contract. Courchene prefers the first, because of its stronger reliance on market forces and its more decentralized nature. The Limited Welfare State seeks to abolish the universality of a number of social programs and target them to the "really needy" cases. The

Implicit Social Contract model, as exemplified by the Scandinavian societies, is not, says Courchene, applicable under Canadian conditions of a widely dispersed, heterogeneous population in a federal state.

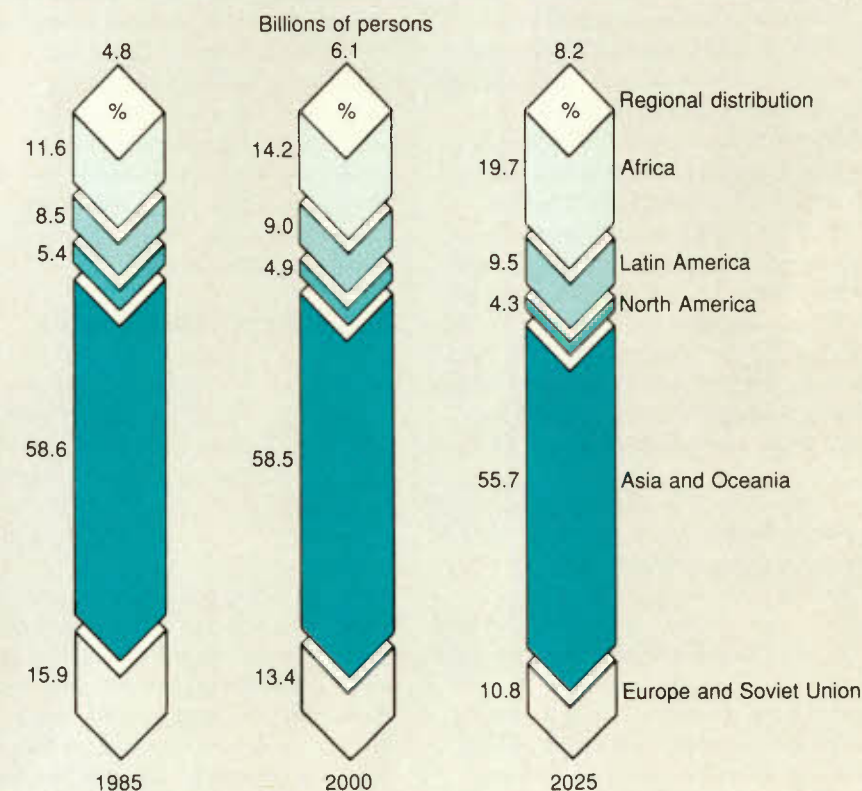
The human factor

The "union-free environment" goal and "anything goes to defeat unions" attitude of U.S. business are likely to spill over, at least in part, to Canadian management.

Professor Richard Freeman,
Harvard University

Freeman nevertheless contends that Canada need not follow the U.S. de-unionization path and need not suffer major economic losses from increased foreign competition and the shift of manufacturing to the Third World. He warns, however, that to take advantage of

Actual and projected size and growth rate of the world population, by regions, 1985, 2000, and 2025



the changing scene, and to minimize the costs of adjustment will require greater flexibility and foresight on the part of all decision makers, substantial changes in trade union policies and possibly, initiatives to improve the wages of the least skilled workers.

Commenting on Freeman's paper, UBC labour economist Craig Riddell referred to growing anti-union sentiments in Canada, but noted we are more likely to see organizational and institutional adaptation in the industrial relations setting than the outright attack that characterizes the American scene. Riddell did, however, make the observation that when one considers the relationship between various countries' industrial relations systems and their economic performance, one sees that the best performers have either a high or a low degree of centralization of national wage setting: not, as in Canada, something in between. So the question is (supposing we will not follow a Swedish-style centralized bargaining system): will economic forces push us toward more decentralized, U.S.-style, wage setting systems?

Industrial relations expert Thomas Kochan of MIT supports the view that Canada need not follow the U.S. path but warns that to avoid the adversarial characteristics of adaptation to labour market changes, Canadians will have to shed traditional beliefs and practices.

"Labour will have to become more of a champion of innovation and adjustment at the workplace, and play a broader role in the management and governance of the enterprise." And governments will have to recognize that such industrial relations innovations are critical to the performance of the national economy, he said.

... it may be overly idealistic to expect a global economic revolution not to generate dislocation, readjustment, and reassessment.

Judge Rosalie Abella,
Canadian Labour Relations Board

While not disagreeing with Kochan's conclusions, Judge Abella is much less sanguine about the prospects for such institutional adaptation in the industrial

relations field. For one thing, "Canadian labour has always resisted concession bargaining, profit-sharing, quality circles, and generally most of the collaborative approaches to the reduction of tension and the enhancement of productivity. . ." The need to respond to urgent short-run adjustment problems in the face of rapid change may well curb the development of longer-run, more collaborative strategies, she suggests.

... a lifetime career in a given occupation will be a thing of the past.

George Psacharopoulos, World Bank

The challenges facing global labour markets in an era of intensifying international competition, technological change, and institutional adaptation will include, in the final analysis, the fundamental sources of human resource development: education and training. Thus, in the view of World Bank economist George Psacharopoulos, the perennial dilemma of vocational versus general education will continue to dominate the public policy debate as we approach the 21st century.

The strategic role of education in long-run economic development is emphasized by Professor Jeannine David-McNeil of Montreal's École des Hautes Études Commerciales, who argues that education policy is not just a question of social cost, but an instrument of economic growth. Thus, educational expenditures are a source, in the medium and long term, of income and prosperity.

Setting the framework

... meeting the challenge of the growth of government and restoring its effectiveness, manageability and accountability must be essential to any consensual prescription.

Ian Stewart

Former Deputy Minister of Finance Ian Stewart showed that with the decline of Keynesianism, it is the ideological and political foundations for the compromise of capitalist democracy that are under attack. (*Keynesianism extended the era of "political economy," and was concerned as much with the collective provision of*

social welfare as with the tools of macro-economic management.)

Stewart stresses that the absence of strong consensual agreement severely limits our capacity to improvise and sustain coherent public action to shape a strategic response to international competitive forces.

The capacity of governments and the institutions and conventions of government in Canada to respond to global forces is also the main topic of Professor Al Johnson's paper. He discussed how politicians and policy makers will perceive these forces, and what political forces and institutional limits they will confront in coping with them. Johnson argues that because Canada has been preoccupied with regional and cultural tensions, we tend to be an insular nation. As a consequence, the political agenda has been dominated by efforts to rectify these differences and by efforts to define our "nationhood."

Canada, in short, is an uncertain country, and like all uncertain countries, it has tended to be preoccupied with itself.

Al Johnson, University of Toronto

Johnson proposed a series of directions for change in order to address the nation's preoccupations with regional discontents. He also proposes clarifications to the spending power beyond what is now included in the Meech Lake Accord, and to the amending formula.

Ian McDonald disagrees somewhat with Johnson's prescription. He believes the problem is how to convince voters that global issues are also personal and local. The key, he thinks, is to ensure a much better understanding of the importance of the issues in personal lives.

Economists: Are we up to the task?

A blunt question indeed. Alan Blinder of Princeton examined the usefulness of economic science for policy making, using macroeconomics as a case in point. The once-symbiotic relationship between macroeconomic scholars and policy makers has, he says, reached the point where there is a "blend of tension and detachment seasoned with mutual disdain."

Block I: The Global Setting

- Author:** William Clark
Kennedy School of
Government
Harvard University
- Paper:** The World Physical Setting
in the Year 2000
- Discussant:** Pierre Dansereau
Université du Québec
à Montréal
- Author:** Bill Maynes
Editor, *Foreign Policy*
Washington, D.C.
- Paper:** The Global Political
Setting in the Year 2000
- Discussant:** John Kirton
Department of
International Relations
University of Toronto
- Author:** Jacques Lesourne
Conservatoire national
des arts et métiers
- Paper:** The World Economy in the
Year 2000
- Discussant:** Gilles Paquet
University of Ottawa
Institute for Research on
Public Policy

Block II: Canada's Place in the World Economy in the Year 2000

- Author:** John Helliwell
Department of Economics
University of B.C.
- Paper:** Globalization of the
Canadian Economy
- Discussant:** Yoshihiro Tsurumi
City College of New York
- Author:** Marcel Côté
Secor Inc.
Montréal
- Paper:** Competition and
Industrial Structure
- Discussant:** Ken Norrie
Department of Economics
University of Alberta
- Author:** Lars Osberg
Department of Economics
Dalhousie University
- Paper:** Distributional Issues in the
Year 2000
- Discussant:** Tom Courchene
Department of Economics
Queen's University

Block III: Employment/Human Resource Development

- Author:** Richard Freeman
Department of Economics
Harvard University
- Paper:** Global Employment
- Discussant:** Craig Riddell
Department of Economics
University of B.C.
- Author:** Tom Kochan
Sloan School of
Management
Massachusetts Institute of
Technology
- Paper:** The Future of Industrial
Relations
- Discussant:** Rosalie Abella
Ontario Labour Relations
Board
Toronto
- Author:** Emmanuel Skoufias for
George Psacharopoulos
World Bank, Washington
- Paper:** Future Trends and Issues in
Education
- Discussant:** Jeannine David-McNeil
École des hautes études
commerciales
Montréal

Block IV: Environmental and Insti- tutional Framework for Economic Policy

- Author:** Ian Stewart
Former Deputy Minister
Finance Canada
- Paper:** Consensus and Economic
Policy
- Discussant:** Richard Simeon
Queen's University
- Author:** Al Johnson
Department of Political
Science
University of Toronto
- Paper:** Economic Decision-
Making in the Year 2000
- Discussant:** Ian Macdonald
York International
York University
- Author:** Alan Blinder
Department of Economics
Princeton University
- Paper:** Is the Discipline of Eco-
nomics Up to the Task?
- Discussant:** Rod Dobell
Institute for Research on
Public Policy
Victoria, B.C.

He predicts, however, that the closer relationship may reemerge now that the new classical tide of economics is receding in favour of a resurgence of Keynesian economics which is now staging a come-back in Academia. But, "academic economists must reorient themselves in more empirical directions. They must focus more on the world as it is rather than on the world as they wish it to be."

Rod Dobell, President of IRPP, was the final discussant. His comments, for the most part, confirmed and underlined Blinder's argument. According to Dobell, the question of economics being up to the task can be taken well beyond economic policy in the sense of traditional macro-economics – to apply to economic aspects of regional, social, or environmental problems.

It was noticeable to a number of participants that economic decision makers from the public sector, in particular the federal government, found this discussion both stimulating and thought-provoking.

Future plans

Council staff are now engaged in reviewing and editing the commissioned papers, formal commentaries, and general discussion from the conference. The team will write short syntheses of each paper on the agenda. These, along with the full text of all papers and formal commentaries, will form the core of a volume of Papers and Proceedings, which will also contain a scene-setting introductory preface and an epilogue in which the team will draw out some of the major themes, conclusions, and future policy issues.

A much shorter version will also be prepared. This summary document and associated slide material will provide input for a series of workshops and consultations with various interested groups across the country.

Perspective 2000 was orchestrated by ECC Senior Research Director, Keith Newton. His team included economists Kathryn McMullen, Tom Schweitzer, Jean-Pierre Voyer, and Jac-André Boulet. Media relations were handled by Bob Douglas.

Handling the risks

While grain farming in the Prairie provinces remains viable, its increasing vulnerability means that major change must take place both in attitudes and in existing farm policies.

Canadian grain production continues to be internationally competitive and remains an important part of the nation's economy. Nevertheless, over the past 10 years grain farming has become fraught with greater risks than before.

In a report entitled *Handling the Risks*, the Economic Council of Canada concludes that the soundness of the Prairie grain economy is being undermined by income instability, overcapitalization, extremely low grain prices, and adverse weather conditions. But the Council is convinced that the vast Prairie farmland can still provide stable and reasonable incomes for many families if existing assistance programs are appropriately modified. To this end, the Council proposes a series of measures designed to rebuild the spirit of entrepreneurship among farmers, to restore profitability to their operations, and to give the agricultural sector the flexibility it will need to survive the challenges ahead.

Even though public outlays in agriculture totalled more than \$4 billion in 1987 (including transportation subsidies), a great many farmers still face severe financial hardship. In 1985-86, about 23 per cent of farmers were in financial difficulty; by 1987 this figure had climbed to 28 per cent. In the same year, government transfers accounted for more than 90 per cent of net farm incomes.

The Council believes that the federal treasury simply cannot sustain this level of expenditure, not only because of the need for deficit reduction but also because this approach is contrary to the long-term interests of farmers. The current crisis can be seen, in some ways, as proof that existing assistance programs – focused primarily on production volumes rather than incomes – are inefficient.

The new Canada-U.S. trade agreement and the current round of multilateral GATT negotiations (if successful) will benefit Prairie farmers and Canadian consumers as a whole. Now is the time, says the Council, to restructure the assistance programs offered to Prairie farmers.

The Council began to study the difficulties facing Prairie farmers in 1986, at the request of Grant Devine, Premier of Saskatchewan. The Council's Deputy Chairman, Caroline Pestieau, assumed overall management responsibility for the project; the research was supervised by Andrew Schmitz, of the University of Saskatchewan and the University of California (Davis), and by Ludwig Auer, senior economist at the Economic Council of Canada.

Goals of a new agricultural policy

According to the Council's report, government support must be aimed at making farms more profitable and at helping farmers to be more competent and more dynamic in managing their operations. Agricultural policy should be improved so as to avoid a recurrence of the current crisis and to enhance the efficiency and independence of farmers. This will put them in a better position to handle the risks inherent in the grain economy.

Special programs, such as those set up in the last few years, sometimes have the appearance of rescue operations. They tend to distort market signals and to diminish the responsibility of farm operators. While recognizing that modern agriculture demands a great deal from farmers, the Council points out that management skills are sorely needed in the agricultural sector.

The Council took all of those factors into account when formulating its recommendations. These recommendations set six objectives:

- reduce income instability
- improve long-term competitiveness
- increase the autonomy of farmers
- promote the conservation of Prairie soils
- reduce interregional tensions among farmers, and
- lower government expenditures by incorporating a larger self-financing component into assistance programs and ensuring that the latter correspond to farmers' real needs.

Recommendations

On the basis of these objectives, the Council offers a series of recommenda-

tions designed to help farmers successfully weather the boom-and-bust cycles inherent in the grain economy. The following steps are recommended by the Council:

- The federal government should continue to support the work of the Farm Debt Review Boards. The federal and provincial governments are urged to consider developing mechanisms for encouraging private-sector equity financing.
- The *Western Grain Stabilization Act* should be amended to make all crops eligible for payments, and the levies paid by farmers for the stabilization fund should be tied to price fluctuations.
- Crop insurance should be made compulsory, and its coverage should be extended to pasture and forage. The government should consider offering a similar program to livestock producers.
- The Farm Credit Corporation and provincial credit agencies should base their subsidy decisions on the repayment capacity of farm borrowers rather than on the value of their farm assets. The purpose of loans should be to enhance productivity rather than to finance land purchases.
- The capital-gains tax exemption should be modified to allow farmers to claim a tax deduction on certain capital gains in order to diversify their financial risk.
- Assistance to farmers wishing to change occupations should be improved.
- Farm-management training programs should be developed that are targeted at present needs and at opportunities for diversifying farm output. These programs should be developed in cooperation with the private sector and farm organizations.
- A Conservation Reserve Program should be set up, under which farmers who convert lower-yielding grain acreage into forage or pasture would be financially compensated.

The Council also puts forward some specific recommendations for an improved international trade environment. If the current round of GATT negotiations succeeds in liberalizing grain trade, the Council recommends that farm-income support be "decoupled" from the cultivation of particular crops and that transportation subsidies be gradually reduced.

A decoupled support system

Prairie farmers are plagued by two main problems: low farm incomes, and income instability.

The Council's research indicates, however, that not all farmers are affected to the same degree and in the same way. Low farm incomes are found primarily on small marginal farms, while the problems faced by the larger commercial farms stem primarily from unstable incomes.

The various farm-support programs established to alleviate these two problems have had, to say the least, inconsistent results, since they are generally tied to the production of specific commodities – the more a farmer produces, the more the government pays. This mode of support raises farm prices, obscures real production costs, encourages excess production, and changes the competing position of exporting countries.

Subsidies also open the door to the adoption of *ad hoc* programs in response to lobbying by farm pressure groups. The end result is a patchwork quilt of programs without consistency.

The Council's solution to this problem is to base support not on output or acreage, but on farm incomes.

An advantage

While the concept of "decoupled" support will not, in itself, solve the problem of low farm incomes, it has the advantage of being commodity-neutral. It will not encourage excess production and so will help to stabilize farm incomes. This may represent one solution to the international and domestic problems mentioned earlier.

Decoupled support involves tailoring government assistance to the particular situation of individual farms. This will necessarily require that a "program file" be set up for each operator. The administrative requirements of adopting such a personalized approach could be simplified by the use of income tax files.

An approach to decoupled income support

The Council has developed four examples of income-support programs to illustrate the potential advantages of

decoupling government support to farmers. They are as follows:

- farm-income insurance
- income-stabilization fund
- farm adjustment option, and
- family-income disaster assistance.

Farm-income insurance: This program is designed to protect farmers against major farm-income losses caused by unfavourable market prices or adverse weather conditions. Farmers would receive cash payments whenever their farm incomes dropped below "normal" levels (calculated as the average of the previous five years). There would be a ceiling of, say, \$60,000 a year. Government and farmers would share the cost of the program on an equal basis.

Income-stabilization fund: This program would encourage farmers to invest a portion of their farm incomes in a self-administered fund during good years to guard against future income losses. In this way, the cost of farm-income insurance would be reduced. This investment would also be tax-deductible. Government would match farmers' contribution on a one-to-one basis.

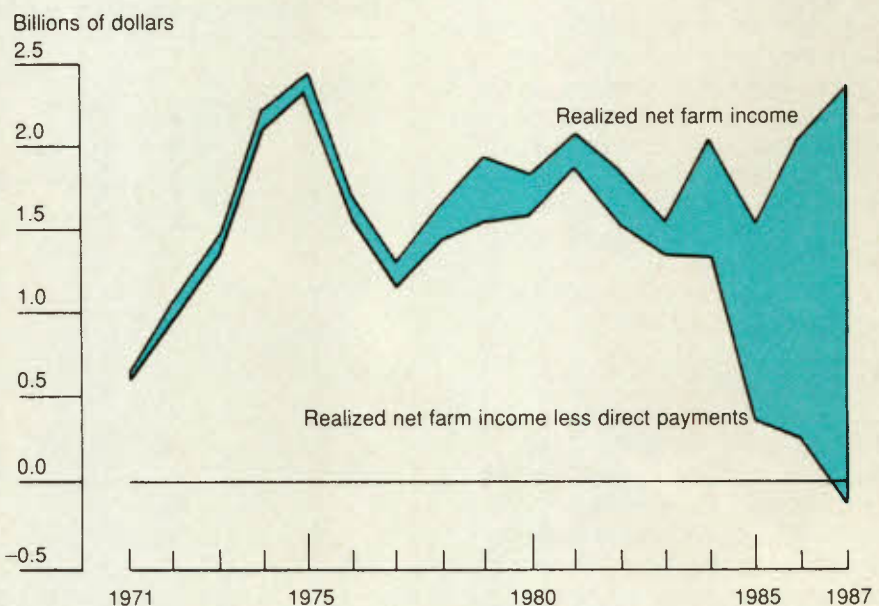
Farm adjustment option: A farmer would be entitled to withdraw the accumulated balance in his stabilization fund, including the government's matching contribution, when he decided to quit farming. This amount would be tax-free and treated in the same way as a tax-free capital gain from the sale of farmland. A maximum of \$500,000 would be set for such tax-free capital gains.

Family-income disaster assistance: This program would be triggered when provincial or regional farm incomes dropped to disastrous levels. Farmers with incomes below \$14,000 would be provided with cash payments up to a maximum of \$7,000.

These four examples of decoupled support programs were designed to provide maximum benefits at lowest cost. Their objective is to ensure that farmers enjoy the same protection as they do under existing programs, but at a better cost and without ignoring market signals.

The potential gains to be made in efficiency, self-reliance, and income stability make decoupling a worthy objective in the medium to long term.

Direct government payments and realized net income, prairie region, 1971-87



Free trade and the productivity gap

The sizeable manufacturing productivity gap that has grown in recent years between Canada and the United States could be narrowed as a result of the Free-Trade Agreement between the two countries says an Economic Council of Canada researcher.

P. Someshwar Rao, a senior economist at the Economic Council, also contends in his recent discussion paper, that productivity and living standards are likely to be influenced in a number of important ways by free trade, such as speeding up the reallocation of resources from declining to growing industries, accelerating the implementation of new technology and improving the operating efficiency of markets. With the size of the market available to Canadian producers expanded, it will also be possible to lengthen production runs and therefore benefit from economies of scale and the specialization of production.

While the real gains in efficiency are often hard to measure, says Rao, the net long-term output and real income improvement from freer trade could be quite significant. Closing the size of the productivity (GDP per person employed) gap between the two countries will be a measure of the extent that progress is achieved.

The researcher addresses the following questions in his study.

- Is there an overall productivity gap between the United States and Canada?
- If so, how much of that gap can be attributed to the poor performance of Canadian manufacturing productivity?
- Why, after 1970, were Canadian manufacturing firms unable to close the productivity gap significantly vis-à-vis their U.S. competitors?
- What caused the further deterioration between 1980 and 1987?

The evidence

Canada's measured income per capita and overall labour productivity have traditionally trailed the levels achieved in the United States. But over the past 25 years Canadians have made substantial improvements in their relative economic performance. Rao points out, for example, that Canada's per capita income increased from 71 per cent of the U.S.

level in 1961 to about 91 per cent in 1980. He notes, however, that Japan, Germany, France, and Italy managed even more impressive performances over the same period.

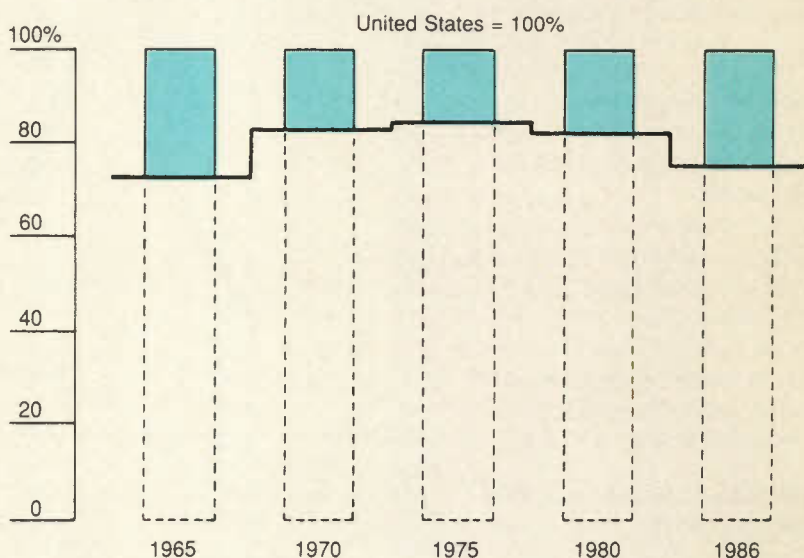
Most of the relative improvement in income per capita occurred in the period 1965-75, following the Kennedy Round of GATT trade liberalization, the signing of the Canada-U.S. Auto Pact and the commodity price boom and favourable terms of trade in the early 1970s. In most of those years Canada was achieving annual overall labour productivity increases of 3 per cent or more. By 1975 Canada's overall productivity level had risen to 86 per cent of the U.S. level. Subsequently, with the baby boom generation entering the labour market, and with the OPEC energy price shock and mounting inflationary pressures, the growth rates of annual productivity slowed both in Canada and in the United States. But overall, by 1986 Canada's aggregate productivity had moved up to 91 per cent of the U.S. level.

The big exception was manufacturing. In 1961, labour productivity in Canadian manufacturing was roughly 73 per cent of the levels being achieved in U.S. manufacturing. Subsequently, through modern-

ization, Canadian firms were able to close part of the gap; by 1970 their productivity levels were about 82 per cent of their U.S. counterparts. That gap of 18 per cent persisted throughout the 1970s. Then after 1980, North American inflation rates sky-rocketed, followed by the worst recession since the 1930s. The Canadian economy was much more severely hit than the American and Canadian manufacturers suffered. Despite widespread lay-offs, plant closures and restructuring in both countries the manufacturing productivity gap widened to 25 per cent.

How has Canada successfully narrowed the overall productivity and per capita income difference with the United States in the face of a widening manufacturing productivity gap? Evidently because in sectors other than manufacturing (construction and transportation for example) Canadian enterprises achieved productivity growth rates greater than those in the United States. The upshot has been that the contribution of manufacturing to the remaining overall productivity gap has gone up from 20 per cent in 1960 to 55 per cent in 1987. This implies that improvements in Canada's manufacturing performance are crucial if overall productivity and real income differences

Manufacturing productivity gap between Canada and the United States



between the two countries are to be further reduced.

Some explanations

Rao develops a model that allows him to measure what factors have contributed most to manufacturing productivity performance in both Canada and the United States, and thus to account for the narrowing and widening of the manufacturing productivity gap. The results are quite robust, and effectively explain roughly 90 per cent of the causes of variations in the gap. They include the following observations.

- Other things remaining constant, Canadian manufacturing productivity growth will normally exceed U.S. manufacturing growth and thus narrow the productivity gap. This could reflect one of several phenomena – a process of technological “convergence” in which Canadian firms borrow and apply the technology of the U.S. “leader”; the faster growth of the Canadian economy and population relative to the United States; or the greater responsiveness of Canadian manufacturing firms to international competition.

- However, escalating energy prices have hurt Canadian manufacturers more than American. They have contributed to slower technical progress and higher rates of inflation in Canada than in the United States.

- In the United States profits count. When U.S. manufacturers achieve a growth of sales that outstrips the growth of wages and other costs, this tends to create a virtuous cycle of improved productivity and competitiveness, and widens the U.S./Canada manufacturing productivity gap. Surprisingly the relationship between profitability and output growth in Canada is relatively weak.

- Exchange rates matter. An appreciated exchange rate puts competitive pressures on manufacturers to revitalize and improve productivity in their businesses. A depreciated exchange rate tends to protect manufacturers from foreign competition, and retards the pace of productivity improvement. The drop in the value of the Canadian dollar vis-à-vis U.S. dollar and other currencies in the late 1970s seems to have contributed to

the relatively poor productivity performance of Canadian manufacturers.

- The post-1980 widening of the manufacturing gap seems to reflect the stimulative effect that a large worldwide appreciation of the U.S. dollar and increased profitability had on U.S. manufacturing productivity. Canada’s depreciated dollar vis-à-vis the American during most of this period led to a slower rate of revitalization in Canada than might otherwise have occurred.

- This suggests that with the wider market offered under U.S./Canada free trade, relatively low energy prices and a stronger Canadian dollar, Canadian manufacturing productivity growth rates should outpace American rates and narrow the productivity gap.

Manufacturing productivity and gains from free trade

Historically, Canada has had a small domestic market protected by tariff and non-tariff barriers and, as a result, a great many Canadian manufacturing firms are relatively small. And smallness in turn, is accompanied by inefficient scale in the operation of the plants, short production runs, limited research and development

budgets, and slow diffusion of technology. The author estimates that more than 70 per cent of plants in the Canadian manufacturing sector in 1987 were operating at a scale less than sufficient to compete successfully within a tariff-free North American market. Many firms will have to adjust, and restructure their operations so as to specialize production and take advantage of economies of scale.

If even half of them do this, Rao asserts that Canada-U.S. free trade could produce manufacturing productivity gains of about 4 per cent. These gains alone, he says, could increase real gross output and per capita income in Canada by about 2 per cent. But in the process, Canadian manufacturing firms will have to learn to use new workplace technology more rapidly and effectively, expand research and development to generate new products and services, and help in the encouragement of a flexible, motivated, and highly-skilled labour force.

“U.S.-Canada productivity gap, scale economies, and the gains from freer trade,” by P.S. Rao. Discussion Paper No. 357.



Free trade could narrow the productivity gap between Canada and the United States

Regulating natural monopolies

Why has Canada adopted government enterprise more often than the United States to help regulate its industries?

In some cases, Crown corporations were viewed as the best instrument to meet specific objectives. But in a number of key instances they were established partly because of the inadequate protection given to property rights in Canada, according to a new research study done for the Council's project on government enterprise (see *Au Courant*, vol. 7, no. 3). In his study, Queen's University economics professor John R. Baldwin traces the evolution of the regulatory process and also compares it with the U.S. experience.

Baldwin looks, in particular, at the evolution of regulation in the utilities sector (water, gas, electricity, and transportation). He explains that regulation of utilities evolved partly out of the need to ensure that such public services would be adequately available at reasonable cost. Initially, a system of regulation developed whereby local governments issued franchise contracts to deliver those services. When tenders were first called for these contracts, municipalities generally had several bidders from which to choose. But when the contracts came up for renewal, the number of bidders declined. The franchise contract no longer worked in those circumstances.

Regulatory agents

In this environment, franchise owners could use their monopoly power to raise prices exorbitantly. Governments, on the other hand, could threaten to expropriate the business if that happened. What was needed was a regulatory agent that could function impartially to ensure that each party to the contract did not abuse its power, Baldwin explains.

In the United States, state regulatory commissions became the normal form of regulation.

In Canada, on the other hand, many utilities were nationalized. (Regulatory commissions were later established as well.) Baldwin attributes the more frequent choice of public enterprise in Canada to at least two factors. First, it could have been the result of a greater

predilection for government enterprise. Second, it could have been the result of the lower cost of expropriation. In Canada, private property is not given the same protection from nationalization without confiscation as it is in the United States. Without the protection afforded by a written constitution that guaranteed the right to private property (as in the United States), there developed fewer judicial restrictions in Canada against confiscation of property.

Forced bankruptcy

In the railway industry, the government used contracts to stimulate construction of trans-Canada railway lines, with a regulatory body to control freight rates. That regulatory body, under the government's direction, contributed to the bankruptcy of some of the new transcontinental railways by failing to allow price increases that were commensurate with mounting costs. Additionally, when the

government subsequently nationalized the Grand Trunk, it did not compensate the owners for the value of their stock (as it did in the case of the Canadian Northern). In Baldwin's view, this instance clearly demonstrates the "failure of the regulatory system to safeguard the interests of capital."

Ontario Hydro

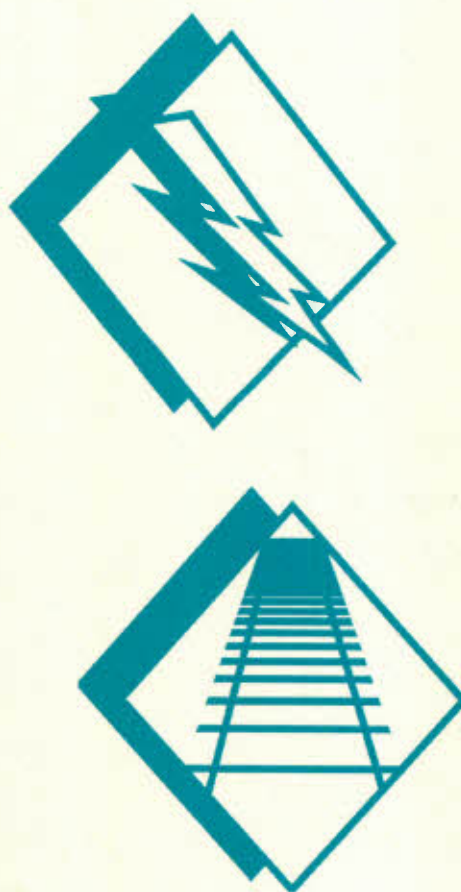
As in the railway sector, the electric utility industry in Ontario was transformed by the creation of a large public enterprise. The provincial Crown corporation, Ontario Hydro, was established as a quasi-regulatory agency, which purchased power and then redistributed it for purchase by municipally owned systems. But it eventually became the dominant producer of hydro-power by purchasing various facilities. In so doing, the provincial government voided its original contractual obligation that prevented Ontario Hydro from competing in power generation with private interests.

Bell Canada

Bell Canada managed the evolution of the regulatory process to its own advantage, Baldwin explains. It quickly developed a monopoly grip on the telephone market by buying up its competitors and negotiating exclusive contracts with local governments. At the same time, it was able to avoid local regulation and possible expropriation (in central Canada) because it had been given a federal charter that superseded municipal and provincial government regulation. In Manitoba, however, the provincial government was intent on local control. It forced Bell to sell out by threatening to impose a discriminatory tax and then established a Crown corporation.

Baldwin examined the reasons behind the differences in the evolution of the regulatory process in various jurisdictions, including the impact of the political, economic, and social environments.

Regulatory Failure and Renewal: The Evolution of the Natural Monopoly Contract,
by John R. Baldwin.



The local-development alternative

Council Deputy Chairman Caroline Pestieau spoke on the subject of local development at the Europe-North America International Conference held recently in Montreal which explored different aspects of local development. Following is an abbreviated version of that speech.

Canada is a laboratory where the local-development experiment has taken on particular importance. The second largest country in the world, it has a population of only 26 million. Approximately 9 million people live in the nation's three main urban centres, with the rest of the population spread out along a thin band some 5,500 kilometres long.

Economic and social indicators reveal large and persistent differences between the various regions of the country. In 1986, for example, unemployment rates ranged from 7 per cent in Ontario to 20 per cent in Newfoundland.

Most of the issues in local development arise from two fundamental questions. First, is it enough simply to distribute the benefits of national economic growth by means of compensatory transfers, or should we try to get growth going in individual communities across the country?

Second, assuming that it is important to diffuse economic growth throughout Canada, should people be moved to where the jobs are, or should jobs instead be brought to the people living in disadvantaged communities?

The federal government redistributes resources to economically disadvantaged regions in three ways. First, it makes unconditional transfers to provincial governments under the tax-equalization system, which enables the poorer provinces to offer national levels of public services without having to impose a higher tax burden than that in the better-off provinces. Second, it makes targeted transfers to cover expenses in health care, post-secondary education and income security. Third, it provides more generous unemployment insurance to unemployed individuals in regions with high unemployment rates.



Caroline Pestieau

Compensatory transfers have two weaknesses, however. First, because of the federal structure of the country, redistribution is largely carried out on a provincial basis. But the province may not be the most appropriate unit for tackling local underdevelopment.

Second – and more important – compensation through transfers does not encourage local development. It can even work against it by encouraging residents of disadvantaged communities to accustom themselves to dependency on the public purse.

Regional development

Since the early 1960s, Canadian governments have adopted a series of regional development policies to stimulate economic activity in the disadvantaged regions. These have had limited success and are currently under review. But it will not be easy to improve our national regional development policies. The slackening demand for Canada's natural resources means that the economy must become more competitive. It can no longer afford the luxury of subsidizing inefficient businesses or industries in various regions.

To sum up, there are several compelling reasons to investigate an alternative approach to regional development:

- The drawbacks of relying exclusively on compensatory policies,
- The difficulties involved in spread-

ing economic growth by means of centralized policies,

- Fiscal and contractual constraints on industrial subsidization.

That alternative is local development.

Local development

Local development offers a third option for victims of regional economic decline, who are otherwise forced to choose between remaining in their communities as social assistance recipients or moving to the city to find work. That is the reason why the Economic Council decided to study the local-development experience in Canada. In the course of two years, we undertook 14 different case studies across the country.

Our research reveals a role for local-development organizations (or LDOs).

- They mobilize underemployed and "discouraged" workers.
- They identify the obstacles to economic development.
- They set their own objectives.
- They serve as catalysts for local enterprises particularly by helping them to access capital.
- By taking control of the development process, they maximize the spin-off effects and set the pace of growth to the needs of the local community.

In all of these respects, LDOs may do a better job than public or private sector managers from outside the community. But our work also shows that there are problems in giving public support to LDOs.

The main problem is how to rate the contribution they make to regional development. How can cost-benefit analysis be performed on subsidies awarded to LDOs? A second problem is the legitimacy of an LDO as opposed to that of a statutory organization such as a city council.

Overall, LDOs play, in many ways, the traditional role of the entrepreneur. They identify niches and business opportunities, and they coordinate the existing, though underutilized, resources of the local community. However, unlike the private entrepreneur, they ask society to share their risks. The challenge is to create efficient risk-sharing mechanisms.

Trade: Competitiveness is the key

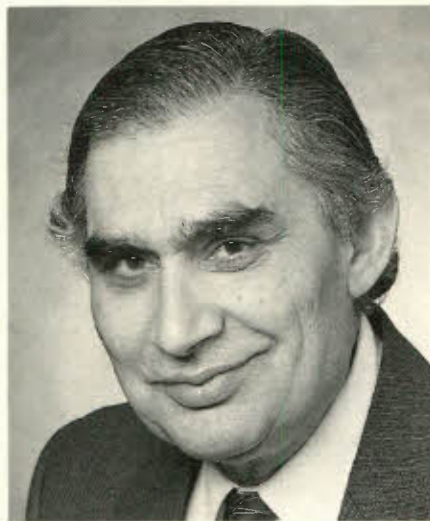
Competitiveness! That's an increasingly important issue as Canada seeks to improve its trading performance with its partners around the world.

As one of the major trading nations, Canada has high stakes in the trade liberalization process going on as a result of the recent Canada-U.S. Free-Trade Agreement or through the current Uruguay Round of multilateral trade negotiations. Opportunities to expand and diversify Canadian commercial relations with many countries are great but competition is also becoming a lot fiercer whether it originates from Japan, the United States, the European Community countries, and more recently from the Newly Industrialized Countries (NICs).

To meet these new challenges, with some measure of success, Canada must have a fairly good idea as to what are its strengths and weaknesses as well as its competitiveness with some of its trading partners.

The Economic Council of Canada will be trying to find answers to these questions by undertaking a new research project entitled "Canada's Trade Prospects and International Competitiveness."

This research project is unique. It will use a new World Trade Data Base, recently developed by Statistics Canada. It will analyze in detail, for the first



Sunder Magun

time, the changing comparative advantage of Canada's exports and imports, by product or industry and by country during the period 1971 to 1986. The research will show who the competitors of Canada really are in various sectors of the world market and how they have evolved over time.

The study will also aim to develop various indicators of competitiveness according to the industry or to the trading partners with whom Canada is dealing.

To find out more about this new undertaking, *Au Courant* interviewed project director Sunder Magun.

Au Courant: Why did the Council undertake this project?

Magun: There are basically two reasons why the Council has undertaken this project. One, Canada is a trading nation. Future improvements in our standard of living critically depend on our ability, as a nation, to compete and sell in world markets. Therefore, it is essential, to start with, to examine our competitive position relative to our major trading partners. That means looking at the reasons for our current position and the trends in our trade with other countries. Secondly, our access to the global market is determined by the state-of-the-world trading system. Although the Canada-U.S. Free-Trade Agreement has improved our access to the market in the United States, we want to diversify and expand our trading relation with the developing and

Pacific-Rim countries and with the European Community. Our share in trade in the Pacific-Rim countries is still small even though it has become a very high growth area. We also want to develop our trade and investment links with Japan and the Far-East Newly Industrialized Countries. Canada is actively involved in the liberalization process of the world trading system through the Uruguay Round of multilateral trade negotiations (GATT). The study we are undertaking will help us to understand the issues and options that are being discussed at the Uruguay Round and to improve our knowledge about the emerging trade and investment opportunities and challenges in the Pacific Region.

Au Courant: What are the broad objectives of your research?

Magun: We will analyze the evolution of Canadian trade patterns of the last 25 years. By doing so, we hope to develop various indicators of competitiveness whether by industry or by major trading partners. We will be looking at different economic aspects such as labour productivity, total factor productivity, unit total costs, unit labour costs, and finally technological growth. By trying to understand more about our trading relations with the Pacific-Rim countries and the developing countries, we will identify the obstacles to expansion and the barriers which certain countries are imposing on Canadian exports and ultimately find out how they influence our trading performance in various world markets.

Au Courant: Which commodity sectors will the study concentrate on?

Magun: We will be working from a new and very large, database produced by Statistics Canada containing trade information for about 160 countries and almost 600 commodity groups. Our analysis will, in fact, condense these commodity groups into 63 categories and 15 country blocks. We will also conduct a detailed analysis of our trade in high-tech products.

Au Courant: Why this renewed interest in the Pacific-Rim countries?

Magun: One of the main reasons is that this is the area where the future growth will take place. Investment is growing in this region and, on the other side of the coin, the flow of investment from this area to other countries is also increasing. Our trade with these countries is mainly concentrated in a few commodity groups like agriculture and mineral resources. The Pacific-Rim countries offer great possibilities for Canada in its effort to increase its share of global world trade.

Au Courant: What about our strengths and weaknesses?

Magun: There are a number of areas where Canadians fare rather well such as in the agricultural products, mineral resources, natural resource-based manufacturing commodities like paper

and paper products, motor vehicles, non-ferrous metals, etc. But I think we have to do more. We have to diversify our trade and expand in other manufac-

of intellectual property, government procurement, and subsidies have been postponed. They will be discussed in the multilateral trade negotiations. As

"The Pacific Rim countries offer great possibilities for Canada in its effort to increase its share of global world trade."

turing industries, particularly in the high-tech market which is growing rapidly in the industrialized and newly-industrialized countries.

Au Courant: *Are there any particular countries with which Canadians will be competing to secure a bigger share of world markets?*

Magun: The competition is very fierce all over the world. There are many countries that are competing with us in several markets. In the highly labour-intensive products, such as textiles and leather, Canada's competition comes from the newly industrialized countries such as South Korea, Hong Kong, Brazil, Taiwan, and Singapore. Canada faces strong competition from the United States, Japan, and the European Community countries in manufacturing products with high-skilled labour and capital content.

Au Courant: *How can we consider your project in the context of the Free-Trade Agreement with the United States?*

Magun: The Canada-U.S. Free-Trade Agreement provides us with a fairly safe market in the United States. By increasing our benefits from economies of scale and industry rationalization, the free-trade agreement will improve our competitiveness and consequently our ability to compete more effectively in other global markets. We must remember that certain issues have not been settled in the Canada-U.S. bilateral agreement. For example, the questions

part of our research program, we will look at these trade policy issues.

Au Courant: *Currently what is Canada's share of the world global market?*

Magun: Our share of world trade, and I am talking about export volume, has fluctuated with time. In the 1965-72 period, it increased from 3.7 to 4.2 per cent. From 1973 to 1980, our total export share averaged around 3.7 per cent. During the last four years, 1984-88, it rose to 4.4 per cent.

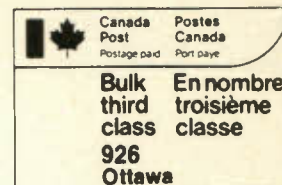
Au Courant: *What would be a realistic objective for Canada for the next 25 years?*

Magun: This question is very difficult to answer. It evidently depends upon future economic growth in Canada as well as in other countries. Although we should aim to improve our share in world exports, it would not be easy because of the intensity of the competition in the global market. Several less-developed countries are growing quickly and converging to the level of industrialization already attained by the major industrialized countries. Because of stronger competition emerging from the NICs, Canada may find it hard to even sustain its relative position in world trade. However, Canada's absolute level of exports would increase because of the growing size of the world economy during the nineties. There is, of course, another way of improving our international competitiveness and standard of living. Rather than increasing its share in world trade, Canada could improve its competitiveness by moving up the value-added scale in its export specialization. This approach is being used by Japan and other industrialized countries.



Canada's share of world markets critically depends on its ability to compete with its trading partners around the world

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NEW STAFFING PROGRAMS FOR RESEARCHERS

To commemorate its Twenty-Fifth Anniversary, the Economic Council of Canada has launched two programs designed to provide researchers and highly qualified Ph.D. students with an opportunity to work, for a fixed term, with Council research staff on a variety of projects.

The first program provides a Ph.D. student whose thesis topic is relevant to the Council's research program with an opportunity to write his/her dissertation at the Council. The student will receive an assignment lasting up to two years with the possibility of a one-year extension in certain cases. The Council offers two positions of this kind.

The second program comprises two options. The first option, involving a term not to exceed one year, is aimed at professors planning sabbatical leave in order to pursue their research

or to undertake new projects. The second option, involving a term of at most two years, is open to professors taking leave without pay, to public service professionals, to researchers from other institutions, and to other individuals with appropriate qualifications. The incumbent's responsibilities will combine research work with the provision of advice and counsel to senior management at the Council. One position is available for each of these two options.

Brochures describing each of these programs have been sent to universities and to most research centres across Canada. Candidates interested in obtaining additional information are invited to contact Mr. Jac-André Boulet, Coordinator for Institutional Relations, Economic Council of Canada, Post Office Box 527, Ottawa, Ontario K1P 5V6; telephone (613) 952-1715.



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