

POLICY DEBATE/ANALYSES ET DÉBATS

CANADIAN REGIONAL POLICY: LESSONS FROM
THE PAST AND PROSPECTS FOR THE FUTURE*

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Introduction

Consistent with the manner in which Canadians have typically approached the issue of regional disparities, this paper is a blending of ideology, positive economics, and theory. The second section provides a backdrop by reviewing some of the past approaches to regional disparities, particularly the rather comprehensive set of programs and policies that had their origins in the mid-1960s and early 1970s. The commingling of national restructuring and fiscal restraint requires that the 1960s policy mix on the regional front be reassessed. This is the subject matter of the third section. In particular, it will be argued that the nature of the current environment is such that provincial/regional policies will likely be tilted in the direction of adjustment-cum-efficiency, of decentralization, and of greater private sector participation. The arguments are put forth on positive economic grounds, although these measures could also be supported on normative grounds. Surprisingly, little theoretical work of a general equilibrium nature has been addressed to Canada's regional problems. The fourth section offers some initial theoretical insights in this direction. A brief conclusion completes the paper.

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Retrospect

While concern over regional/provincial disparities has been with us since confederation, it was in the 1960s that Canada made its most concerted effort to achieve regional equality. It was in this time frame that most of our current socioeconomic programs were either initiated or consolidated on a national basis; for example, medicare, hospital, insurance, post-secondary education, Canada Assistance Plan, and the comprehensive (RNAS) approach to equalization. All of these programs involved payments to provinces, and they went a substantial distance towards allowing all provinces to offer comparable public services at comparable tax rates. This movement towards equality in provincial finances was carried one step further in 1977, when the established programs were converted from a 50 percent cost-sharing format to a block-funding format which, in effect, made them equal per capita grants. The provinces that gained from this reorganization of financial transfers were, in general, the equalization-receiving provinces. Quebec represented an exception, largely because its overall transfers for post-secondary education were, in effect, rolled back. Quebec was claiming transfers for universities, CEGEP's, and the final year of secondary education - an aggregate per capita transfer considerably larger than that going to other provinces [3:Ch.2].

In 1982, the equalization program was also "regionalized", as it were, with the result that equalization payments were tilted towards the four Atlantic Provinces and away from Quebec and, particularly, Manitoba, the "richest" of the have-not provinces [1:Ch.12]. As a result of all these measures, the regional disparities that once existed in the provision of public goods and services have largely been eliminated. Perhaps it is more correct to rephrase this: the provinces' access to overall revenues is, except for Alberta, no longer determined primarily by market-sector incomes in the various provinces. Indeed, for the last several years Ontario has had the lowest per capita provincial government revenues - several hundred dollars beneath the national average level - even though its tax effort is exactly at the national average level [1].

Hence, the concern about regional or provincial disparities is essentially a concern about unequal access to *private* or *market* incomes, and not unequal access to public goods and services, although the arguments relating to "transfer dependency" suggest that the generosity and incentives embodied in the process of equalizing public sector access may have entrenched and even exacerbated the market income disparities (more on this later). Once again, it is important to note that the period of the 1960s and the early 1970s was also the time when Canada embarked on a variety of programs designed to minimize

these market-income disparities. The Department of Regional Economic Expansion was inaugurated then, and the two largest social insurance programs, the Canada Pension Plan or CPP (1966) and Unemployment Insurance or UI (1971) were established and enriched, respectively. The federal government also began to utilize the corporate and personal income tax system to provide regionally differentiated write-offs favouring the have-not provinces.

But these measures to equalize market incomes across provinces have met with little apparent success. For example, personal income for the Atlantic region has for several years exceeded the regional Gross Provincial Product, a situation that did not exist in the 1960s, and for each of the four provinces, personal consumption expenditures exceed Net Provincial Income at Factor Cost.

Prospect

Not surprisingly, therefore, market income disparities remain a concern in the 1980s. The underlying national environment has, however, undergone a marked transformation. In the decade of the sixties, productivity surged forward by some 50 percent, the world economy was tranquil, and Canada's GNP per capita was nestled at, or near, the top of the international pecking order. Moreover, the fiscal position was not a constraint since, despite the introduction of the new programs listed above, the 1965-74 period saw Canada pare down the federal debt by some \$2.25 billion. Small wonder, then, that Canadians utilized this cushion of growth to mount a comprehensive set of transfers to persons, governments and business in the name of social and regional equity.

But the 1980s are entirely different. Productivity has been essentially flat. Unemployment has soared. Inflation has fallen from its double-digit levels, but economic agents appear wary of a resurgence - a wariness that is reflected in high real interest rates. In spite of the recent deficit-cutting measures, the nation's fiscal situation has become nothing short of staggering - the \$2.25 billion surplus over 1965-74 has become a cumulative \$150 billion deficit over the last decade. And not only has the world economy been anything but tranquil; as well, economies everywhere are restructuring. In other words, the shoe is now on the other foot; whereas in the 1960s Canada could utilize its cushion of growth to design a comprehensive set of policies geared to interregional and interprovincial equity, the challenge of the 1980s is basically one of reworking our socioeconomic structure in order to rekindle the failing engines of national economic growth and competitiveness.

The challenge can be put differently: Whither regional adjustment in an environment characterized by national restructuring and fiscal restraint? One way to approach this is to focus on three of the general trade-offs implicit in any policy area: *security vs. adjustment*; *centralization vs. decentralization*; and *private sector vs. public sector*. The combination of national restructuring and overall fiscal restraint is likely to move the system towards adjustment, towards decentralization and towards an enhanced role for the private sector, respectively. Moreover, we believe that these are the appropriate directions.

Security vs. Adjustment¹

The "adjustment" rhetoric is widely supported. Michael Wilson's fall economic statement was overflowing with exhortations for adjustment, initiative, fiscal integrity and restructuring. So was his recent budget. Indeed, and perhaps surprisingly, so was DRIE's position paper, *Policies for Industrial Adjustment* [5], issued under the previous government:

In a market economy, the process of healthy industrial adjustment is characterized by a continuous flow of people and capital into more rewarding activities. . . . In a typical year, around one-quarter of the entire Canadian work force change their jobs, many more than once In a health economy these changes are inevitable and, indeed, highly desirable [5:5].

And in terms of the "policy responses", the position paper goes on to note:

provided this recovery can be achieved, the principal instrument of industrial adjustment will be private initiative. Capital resources will move through the private financial markets to where the most competitive returns on investment can be obtained. Workers and managers will move to where the most competitive wages and salaries are offered. The role of government will be generally restricted to providing a supportive economic environment for private initiative to prosper. . . . private initiative will also be the principal method of encouraging workers to move to more productive lines of activity in search of higher rates of return for their labour [5:9-10].

Market-oriented economists would find it difficult to improve on this.

Yet the transition from principle to practice is far from easy. Not only does one soon stumble upon competing principles (that is, "sacred trusts") but one also witnesses the spectacle of gifts to Domtar (when the company ranked, in terms of net income, number 36 overall and atop the forestry sector in the 1965 *Financial Post* 500), of arbitrary

¹Part of this and the following two sections are adapted from Courchene [2].

equalization handouts to Manitoba and Quebec with lesser amounts to the remaining have-not provinces, and of the maintenance of automobile import quotas for Ontario.

The essential underlying point is that, collectively, Canadians are more in a "security" mode than in an "adjustment" mode. We tend to look to government as the first line of defence whenever adversity strikes. In part, this is a throw-back to the 1960s when the cushion of growth and our resource base allowed us to prosper without too much concern for economic efficiency. We were too rich, as it were. In part also it is a reflection that the incentives embedded in our transfers to governments, businesses and persons cater more to security and to maintenance of the status quo than they do to flexibility and adjustment. This is not surprising since, as noted above, these programs were designed in the "good old days". In part, too, this general approach toward government may reflect a signalling problem: many Canadians may prefer a less interventionist approach but, given that government is going to portion out spoils anyway, it is important to get in line and to get in line quickly. Scott Gordon [6] captured the essence of this general issue when he noted (in slight paraphrase) that if success in business owes more to the laws of the state than to the laws of the market, then business is in big trouble. And what is true for business applies also to provinces, regions and individuals.

Trouble is just around the corner. In Canada, we do not seem to be fully aware of just how much the U.S. economy has been restructuring. We focus on the U.S. deficit and tend to forget the fact that ours is, proportionally, considerably larger. We deride the Americans for becoming "leaner and meaner" and appear to ignore the fact that they have got their unemployment rate down to near-acceptable levels, whereas ours has barely fallen from its recession high and, to the extent that it has, this reflects primarily the influx of part-time jobs. We have been lulled into a false sense of recovery, pulled along by the combination of the U.S. recovery, an overvalued U.S. dollar and, for Ontario at least, the boom in the North American auto industry. When the U.S. dollar and the auto industry cycle downward again, the magnitude of our restructuring challenge will become more visible.

Finally, it is this general approach to government and to adjustment (and, correspondingly, a lack of faith in our own ability) that tends to make us approach freer trade with the U.S. with a mentality that emphasizes concerns about permanent safeguards and guarantees rather than concerns about market access, opportunities, and transitional adjustment measures. But enough about analysis of the problem. The remainder of this section presents a series of observations relating to how and why Canada ought to break out of its current

overemphasis on security rather than adjustment in terms of regional policy.

First, successful regional adjustment within a faltering national economy is a non-starter. The first priority is to set the national economy on a more appropriate course. What is required here is a change in the mix on the macro policy front. Specifically, we need to move in the direction of tighter fiscal policy and looser monetary policy. An elaboration of this, however, is beyond the scope of the present paper.² Further, policy makers must recognize that in the present volatile international economy, regional fortunes will not likely move in unison. Low raw-material and energy prices are wreaking havoc with the economies of the westernmost provinces, whereas Ontario is humming along nicely, thanks in part to the strength of the auto industry. Next year the story may be entirely different. Overall policy must run with the regional strengths, not against them. It is to be hoped that one aspect of the National Energy Policy (NEP) mentality - levelling in the name of regional or national equality the only growth pole in the country at the time - is gone forever.

Second, Canada should adopt framework policies for industrial and regional development and should not become enamoured with the notion that what is required is some national or regional interventionist industrial strategy. Typically, such a strategy incorporates two components - picking winners and protecting losers. With respect to the problems which beset the former, Charles Schultze [15] offers two observations:

The first . . . [is the assumption] that the government has the analytical ability to determine with greater success than market forces what industrial structure is appropriate, who the potential winners are, which of the losers should be saved, and how they should be restructured. The second is that the American political system would (or could) make such critical choices among firms, individuals and regions on the basis of economic criteria rather than political pressures [15:4].³

. . . one does not have to be a cynic to forecast that the surest way to multiply unwarranted subsidies and protectionist measures is to legitimize their existence under the rubric of industrial policy [15:11].

²This is the thrust of Peter Howitt's forthcoming C. D. Howe monograph, which evaluates Canadian monetary policy since 1980.

³Schultze goes on to challenge the notion that Japanese post-war growth had much to do with MITI and industrial policy generally. Rather, the combination that worked so well for Japan consisted of "a huge savings rate, aggressive business leaders, and a backlog of modern technology waiting to be exploited. . . . To the extent that there would have been differences, there is no reason to believe that MITI's influence, on balance, improved choices in any major way" [15:7].

If Schultze can make this statement within the context of the U.S. industrial and regional environment, then surely it applies even more to Canada.

Where Canada does excel, however, is in protecting losers. The achilles heel of an interventionist industrial policy is government's *inability to exit*. Restructuring necessarily implies a process of creative destruction. Schultze again identifies the heart of the problem:

For every twenty new entrants into the high tech race, nineteen will probably perish and only one succeed. But the federal government's portfolio would likely carry all twenty forever" [15:10]

While we recognize that the process of exit is a very painful experience in human and perhaps regional/provincial terms, we all too frequently tend to underestimate the resource cost of propping up declining industries. In his paper for the National Economic Conference, Glen Jenkins [10] produces the following data related to the protecting-losers syndrome:

- For workers displaced over the 1974-76 period in the textile, clothing and electrical products sector, in no case was the present value of the average income lost in a region greater than \$6,800 (in 1978 dollars). For males, the average financial loss never exceeded \$3,500.
- In the case of the automobile sector the average income loss on displacement was approximately \$11,000 for females and \$13,000 for males.
- For workers displaced from the aircraft industry the average loss for workers under 45 years of age averaged 7 percent of annual wages. For those 45-55 the loss increased to approximately 22 percent of their previous wage.

Compare these numbers to the costs to consumers of protecting these industries. Jenkins' estimate of the costs of import quotas on garments coming into Canada is in excess of \$35,000 per job per year. The Brookings Institution study by Crandall [4] of the cost of the voluntary export restraints imposed on Japanese automobiles entering the U.S. was nearly \$160,000 per job per year. The results for Canada are likely to be of similar magnitude. Jenkins' conclusion from all this is worthy of note:

While the income losses imposed on individual workers are in some cases not insignificant, they appear almost trivial when compared with the government subsidies or the higher costs imposed on Canadians by policies designed to protect jobs from foreign competition. Since de Havilland and Canadair were made Crown corporations, the Canadian taxpayers have been saddled with billions of dollars of losses. The hemorrhaging continues [10:4].

Thus, the cost of short-circuiting market forces through subsidies, protection, or regulation is in many cases very substantial. Moreover, the likely opportunity cost is that we are trading jobs and output in the sunrise industries for jobs and output in the declining sectors.

Third, our socioeconomic assistance and insurance programs must be redesigned to facilitate adjustment and initiative. In light of the above analysis, lump-sum compensation payments and mobility subsidies to displaced workers in declining sectors would be more efficient and in many cases more equitable than enticing workers to a lifetime of work in subsidized, low-productivity sectors. In this regard, it is instructive to highlight again the old chestnut of unemployment insurance. For six consecutive years (1969-74 inclusive) the province of Saskatchewan lost population as its agricultural sector underwent restructuring and capitalization. In all likelihood, this would not have occurred if the Saskatchewan farmers were treated like the Newfoundland fishermen; that is, entitled to UI in the off-season. With UI benefits to fishing running, year in and year out, in the neighbourhood of \$12 for every dollar of UI contributions, it is not surprising that the fishing industry is still in serious trouble and that the notion of fishermen as rugged individualists has undergone some rethinking. The problem is not with the fishermen. The farmers of Saskatchewan would have reacted the same way if they were allowed UI in the off-season. The problem lies with the nature of the incentives embodied in the UI program.

Fourth (and consistent with the later analysis of decentralization), one must question Ottawa's view that there ought to be equal wages for federal employees across the country, or at least question the set of policies that have come to be associated with this equal-pay syndrome. To elaborate on this, consider the difference that exists between international and interregional adjustment. In the former, labour is generally immobile, so the bulk of the adjustment occurs via relative price movements (probably via exchange rates) and flows of goods and capital. Interregional adjustment is quite different. Exchange rate changes are not possible. Moreover, the existence of nationwide pay scales and the accompanying wage patterning tends to limit factor price flexibility. Hence, when adversity strikes, the initial disequilibrium is reflected in increased unemployment, with resulting pressures for migration as the adjustment valve. Not surprisingly, provincial premiers are not too excited about the prospect of outmigration. One of the ways to rationalize the regionally extended benefits associated with UI is that they represent an attempt to prevent this outmigration. But this attacks the symptom, not the problem. The problem is that wages are too inflexible. If as a nation we desire to have nationwide pay scales, then we have to accept the fact that the accom-

panying adjustment policy must include mobility subsidies and not the antimobility provisions of UI. The provinces cannot have it both ways. Nor can Ottawa.

This leads rather naturally to the fifth point relating to economic adjustment. The provinces must bear a larger burden of their own actions on the economic front. Too often in the past individual provinces have been able to "export" the costs of their policies, via Ottawa, to the rest of the country. Quebec comes most readily to mind. Its high minimum wage a few years back led to increased unemployment and, hence, increased UI, welfare, and equalization from Ottawa's coffers. Then Quebec was able to argue, successfully, for tariffs and/or quotas for its beleaguered labour-intensive industries. Other instances would include the games provinces play (for example, temporary job creation programs) to move citizens from welfare to UI. These federal-provincial tradeoffs will always exist under a federal system [12] but steps can and should be taken to minimize them.

These federal-provincial or interprovincial spillovers can go both ways. For example, over the past year Nova Scotia recorded one of its best job-creation performances in the post-war period. However, it also experienced one of its largest labour force increases, due in large measure to return migration from Alberta and to inflows from the rest of Atlantic Canada. As a result, its unemployment rate remained steady until the spring of 1985, when it jumped several percentage points because job creation fell off sharply. Predictably, its welfare case load is now rising. One can be fully assured that Nova Scotia will join the chorus of other have-not provinces in once again calling upon the federal government to "equalize" welfare expenditures - either by incorporating a "needs" component in the equalization program [9] or by arguing for an equalized shared-cost scheme (for example, 60 percent of welfare costs for high-need provinces and 40 percent for low-need provinces). But one of the last things Canada needs to do is to build equalization into yet another program or, more generally, to begin to equalize on the "expenditure side" of the provincial budgets. Since these externalities arise from the adjustment process, it seems appropriate to at least consider the option that the federal government might absorb the bulk of the costs of welfare; for example, some *minimum* federal support level across the country with provincial top-ups allowed. Not only would this reduce the UI-welfare interplay, but the fact that the federal government would now control the funding for both would make it possible to integrate the two programs in a more intelligent way.

Sixth, and finally, the single most important policy initiative that would enable Atlantic Canada (and, with some transition period, Quebec as well) to break out of the regional disparity mold is a move

towards free trade. These provinces would immediately gain on the consumption side, and it is hard to foresee that gains would not also accrue in terms of increased production and employment. The four Western provinces have now come out in favour of freer trade with the U.S. Surely Atlantic Canada should lend its support to this initiative. Quebec is also on record as favouring freer trade. Ontario remains the odd man out. While there are no doubt more risks for Ontario in this venture, there are also greater potential gains. Not incidentally, freer trade would also provide a dramatic boost in terms of the overall adjustment thrust in this country; the opportunities to compete and penetrate new markets would eventually overwhelm our natural instinct to shelter and protect.

In general, then, recommendations on the regional adjustment front are that Canada: (a) move to a more appropriate monetary-fiscal mix; (b) adopt framework policies rather than regional industrial strategies; (c) gear its policies to equalizing provincial fiscal capacities and avoid distorting the regional allocative mechanisms; (d) build more appropriate incentives in the transfer network; and (e) recognize that in the present volatile world climate it is inevitable that regional fortunes will not rise and fall in unison. Finally, the poorer provinces should mount an intensive campaign directed towards ensuring freer trade with the U.S.

Decentralization

Canadians divide ideologically on the degree of decentralization that is optimal for the country. Already Canada is among the most decentralized federations (by some acceptable measures, it is the most decentralized). The need for flexibility that is called for on restructuring grounds may argue for even greater decentralization. Over the short run, however, the real thrust for decentralization will come from the paring down of federal-provincial fiscal transfers. From Michael Wilson's budget speech: "to spread the burden of expenditure reduction fairly, the government will also be seeking to limit the rate of growth of transfers to the provinces to yield annual savings of \$2 billion by the end of the decade" [16:18]. To be sure, this decrease is not in absolute terms but rather in terms of what a continuation of present arrangements would deliver. Nonetheless, the provinces have the unpleasant task of planning now to accommodate this revenue paring. Some of this may come in the form of cutbacks, but the provinces may be forced to become much more inventive in the way they attempt to rationalize their operations and delivery mechanisms in order to maintain quality of service. Some of this has already occurred (for example, experimentation with private sector management of publicly-funded hospitals), but it will surely escalate across a wide range of programs.

This experimentation is important in its own right. Indeed, in order to maintain our hard-won post-war gains on the socioeconomic front we must find better and more efficient ways of doing things. Saskatchewan's innovations in the early 1960s gave Canada its medical and hospital programs. The pressure of fiscal restraint and economic restructuring means that we are probably in for a further round of innovation and experimentation. This may mean that the system will become somewhat more uneven over the near term, but it should generate structures and concepts that, by their demonstrated superiority, will then spread across the system.

There is, however, on-going decentralization in another and equally exciting way. More so than in the recent past, the provinces are embarking on novel policy initiatives on the economic front. Part of this may well reflect their exasperation over what is occurring (or, rather what is not occurring) at the national level, but it is also a reflection of the fact that the provinces are beginning to tackle their own problems in earnest. The provincial initiatives in the area of freer trade have already been alluded to. Quebec's Stock Savings Plan and Ontario's Small Business Development Corporation have attracted considerable attention, and there are moves afoot to have Ottawa "nationalize" these initiatives. Saskatchewan has recently pushed out the frontiers of tax reform by implementing a tax surcharge in the form of a "flat" tax on income. This represents the first attempts by any provinces under the tax collection agreements to move away from levying provincial taxes against federal taxes and towards levying them against the base (income) itself. This may pave the way for the provinces to design their own rate and bracket structures and, in the process, some of them may well go the flat tax route. In any event, Saskatchewan is pressing hard for tax reform (simplification, base broadening and lower marginal rates). Finally, Quebec's *White Paper on the Personal Tax and Transfer System* [7] may well be the most important position paper in the social security area since the 1960s. It proposes to redress the disincentive effects of excessively high tax rates in the transition from welfare to work by integrating the myriad of tax and expenditure programs into a comprehensive negative-income-tax framework. One of the factors motivating the white paper is that Quebec is becoming alarmed with the rate of growth of its welfare rolls. To the extent that Quebec implements most, or even some, of these provisions it will intensify the pressure on the rest of the system to rationalize the entire income-insurance, income-support, tax system nexus. Obviously, this initiative is welcome.

Finally, decentralization may be desirable on welfare grounds. As Melvin [12] has shown, if preferences differ across regions, one neces-

sary condition for the maximization of welfare is that the provision of public goods and services approximates these regional preferences.

Privatization

Arguments for greater reliance on the private sector also follow from the underlying premise that economic restructuring-cum-restraint will be the order of the day. In the broadest sense, privatization means enhancing the role of markets at the expense of the state. As David Heald [8] has noted, one can conceive of several types of privatization:

- privatizing the financing of a service which continues to be produced by the public sector (e.g., tuition fees, medicare premiums)
- privatization of the production of a service which continues to be financed by the public sector (e.g., contracting out, education vouchers)
- enhancing the workings of the market (e.g., competition policy, removal of statutory monopolies)
- denationalization of commercial crowns.

There will probably be initiatives in all of these areas. The whole debate about universality can also fall under this general rubric of privatization. Greater targeting of benefits is essentially a resort to the ability-to-pay principle. One recognizes the line of debate that suggests that if the programs are directed only to the poor they will end up as poor programs. This may have been the case when the welfare system was first initiated. It is not the case now. Moreover, it seems that a greater targeting of benefits is consistent with the underlying notions of equity.

This completes the analysis of the view that restructuring-cum-restraint will tilt regional adjustment towards efficiency and adjustment, towards decentralization, and towards an increased reliance on private sector participation. In the last substantive section the analysis becomes more theoretical in nature. In particular, some recent general equilibrium analyses relating to regional aspects of the Canadian economy are reported on.

Equilibrium vs. Disequilibrium⁴

Generations of politicians and policy analysts alike have tended, instinctively, to look upon regional disparities in Canada as *prima facie* evidence of the existence of a disequilibrium. Often, the presumption is that the disequilibrium persists only because of the lack of ability to find the policy instrument most suited to the problem. This, in our

⁴Portions of this section are based on recent contributions by Melvin [11;13].

opinion, is incorrect. It is more appropriate to view the existing socio-economic structures across the provinces or regions as reflecting an *equilibrium*. Specifically, it is not surprising that decades of interrupting the natural adjustment processes in the country have entrenched and even exacerbated regional disparities. In short, much of the current pattern of regional disparities represents a policy-induced equilibrium.

It may well be that many Canadians nonetheless prefer the status quo to what the result might have been if market forces had been allowed to operate unfettered. This is a perfectly acceptable position, since implicitly they are evaluating the costs and benefits of the alternatives. But what is not acceptable is to approach regional policy from the perspective that just a few more programs are needed to restore "equilibrium". Rather, the truth probably runs in the other direction. The legacy to the regions of past largesse and inappropriate incentives is the existing set of regional disparities. In other words, government intervention is part of the problem, not part of the solution, especially if any future interventions take the traditional form. This can be viewed as an approach based on ideology. The purpose of the rest of this section is to bring some theory to bear on regional disparities.

Clearly, the key regional questions are whether the observed differences among regions represent a genuine problem in need of solution and, if so, what is the nature of the solution. Without a full understanding of the root cause of these disparities, it is highly unlikely that policy makers can legislate appropriate policies to redress the situation. Rather surprisingly, almost no attention has been paid to the theoretical underpinnings of such issues in Canadian regional policy discussions. Regional disparities and regional policy proposals are almost never analyzed in terms of a full general equilibrium model which would allow consideration of the impact of a particular set of policies, let alone the interaction among different policies. Yet the general equilibrium nature of the issues is apparent. Towards this end, an analysis making use of the basic two-sector, two-factor general equilibrium model can provide some important insights into many of these issues.

Without doubt, the aspect of regional disparities seen as the most important, and the one which has received most policy attention, is the difference in interregional per capita incomes or factor payments. But do such differences represent a problem requiring government action? Consider an economy in which all consumers have exactly the same preferences; further, suppose that the variables which provide utility to these consumers include certain public goods as well as the usual private goods provided by the market. As one example, we can suppose that individuals obtain utility from proximity to sandy ocean beaches. Now, sandy ocean beaches are not found in all regions of the

country. And if this simple model is to have an equilibrium such that all regions remain populated, consumers in regions without sandy beaches must be compensated by receiving a higher wage rate. Thus the interregional differences in the return to labour in equilibrium will reflect the utility received from the amenity present in one region but absent in the other. In such a model the interregional disparities in per capita incomes are not a problem since, in equilibrium, consumers are just as well off in one region as they are in the other. Any action by government to try to redress the wage disparities through transfers will produce a distortion and will make individuals in one region better off than individuals in the other. This will represent a disequilibrium situation, since interregional transfers will encourage factor mobility - mobility which is entirely a consequence of government policy and not associated with any underlying economic reality.

The differences in public goods among regions need not be amenities provided by nature but could include services provided by local governments. If provinces provide different levels of services, one should certainly not expect the equilibrium wage rate to be the same across provinces. The concentration on per capita incomes or factor returns in the analysis of interregional disparities can therefore be misleading, for in a regional context money income may be a very poor proxy for utility. Of course, the concentration on money income is not surprising, for it is relatively easily measured, certainly in comparison to utility. The direction of, and motivation for, economic policy measures, however, should not depend on the degree to which economic variables can be measured.

Government policies to "correct" income disparities which are simply a reflection of different characteristics of regions are certainly inappropriate. Equally inappropriate would be policies which, in the face of differences among regions, nevertheless require that workers in different regions receive the same wage. This brings us back to an issue discussed earlier; namely, government policy of equal wages for federal employees regardless of location. Quite aside from the difficulties that such policies generate for interregional adjustment, they produce interregional distortions in their own right.

Thus far, it has been assumed that all consumers have identical preferences, regardless of location. Does relaxing this assumption make the analysis more complex? Not if the equilibrium location of individuals and the equilibrium wage rate are determined by market forces, for each individual will simply maximize over both income and location. For government policy that attempts to equalize interregional factor price disparities, however, the existence of individuals with geographically different preferences will result in further distortions, since the handouts to those perceived to be disadvantaged and the taxes

collected from those perceived not to be will generally be unrelated to the utilities enjoyed by these individuals.

Interregional factor price differences could occur for other reasons. Assume an economy in which significant transportation costs exist between regions and where international transportation costs are relatively small. If regional endowments of the factors of production are sufficiently different, then the trade patterns of the regions will differ. In particular, the international exports of one region may be the international imports of the other, and we have cross-hauling of identical commodities for the economy. In such a model, it can be shown that the imposition of tariffs has distinctly regional consequences [13]. Only importing regions will be affected by tariffs; thus tariffs would be expected to generate interregional differences in relative commodity prices. Such commodity price differences, in turn, will generate interregional differences in both relative and real factor prices; thus tariffs can be another explanation of interregional differences in factor prices. Furthermore, these differences will be qualitatively the same, regardless of which commodity bears the tariff. In particular, the relatively more abundant factor in a region will be made worse off by any tariff structure. Thus in the Canadian economy any tariff will reduce the wage rate in any region which is relatively well endowed with labour.

Regional factor price differences due to tariffs have some other interesting characteristics. While such interregional factor price differences will result in interregional factor movements, such movements will not, at least in the short run, result in any tendency towards equalization of wage rates among regions. Factor prices are a function of commodity prices, and as long as relative commodity prices differ among regions so will factor prices. Thus policies by governments to encourage the free mobility of labour within the economy, while appropriate in their own right, should not be expected to reduce interregional factor price differentials.

The effects of a tariff on the return to capital in the two regions will be the opposite of those for wages, and thus the real and relative return to capital will rise in the labour-abundant region and fall in the capital-abundant region. If one feels that there should be income transfers to compensate for the effects of tariffs, then transfers within the region would be the most appropriate policy. Capital could be taxed and labour subsidized in the labour-abundant region and labour taxed and capital subsidized in the capital-abundant region. The appropriate taxes and subsidies re-establish equality between the wage-rental ratios of the regions. Certainly no case can be made for interregional transfers of income.

Analysis here has been in terms of tariffs, but it is clear that anything which results in interregional differences in commodity prices will also result in disparities in regional factor prices. This would include different rates of commodity taxation, different corporate tax rates, or simply differences in distances to major trading partners. Other more fundamental differences among regions could also produce factor price differences. If production functions differ, or if there are increasing returns to scale in some industries, then there would be no reason to expect equality of factor prices among regions. If certain factors such as resources are specific to particular industries, then even the equalization of commodity prices will not, in general, equalize factor prices.

Therefore, to the extent that interregional differences in factor incomes are seen to be a problem requiring policy action, the first step is to determine why they exist. The next step is to devise policy actions which will address the cause of the difference. For factor price differences due to tariffs the solution is obvious - remove the tariff. If differences in regional factor prices are due to differences in provincial tax regimes, then one first must decide which has priority, the factor price differences associated with the taxes or the benefits associated with the expenditure generated by the tax revenue. In any case, this would seem to be an internal provincial issue and not one with which the federal government should become involved. If differences in production functions are the problem, then the policy should be to ensure that all regions have access to the most up-to-date technology. The point to be made is that the appropriate policy differs substantially depending on the source of the differences. Without an understanding of why the differences exist, appropriate policy action can hardly be expected to be forthcoming.

Another policy issue which can be addressed using simple general equilibrium models is the cause of differences in interregional unemployment rates [11]. It can be shown, for example, that effective minimum wages will generate unemployment and that the level of unemployment will be an increasing function of the level of the minimum wage. The existence of strong unions can have exactly the same effect, and in both cases it is possible that high wages will be associated with high levels of unemployment. Again, since the problem has been created by provincial policy, provinces should accept the responsibility for any solutions. As was suggested earlier, it makes little sense for the federal government to pursue policies in an attempt to save provincial governments from the economic impacts of their own policy actions.

Finally, there is evidence that Canadians are falling into yet another policy trap on the regional front; namely, that we should

reduce provincial barriers to the mobility of goods and services in order to increase the interprovincial flows of goods and factors. The problem with this concept is that, in the presence of such major distortions as the tariff and transportation subsidies, it is certain to be the case that *zero* barriers across the provinces are inappropriate. Indeed, under second-best arguments, it may be efficient for provinces to attempt to offset distortions arising from, say, the tariff [13]. Interestingly enough, this was the position of the Province of Saskatchewan in the summer of 1980 Constitution debates:

Surely the national tariff and transportation policies have an immeasurably greater impact (than, say provincial purchasing policies) on relative prices, rates of return and ultimately the location choice for labour and capital. . . . The only defence available to a small province may be to take action which creates barriers to protect its competitive position within the economic union [14].

Thus, message number one in this area is that there is no reason to expect that generating free internal mobility while still persisting with policies that close off (distort) the economy internationally will enhance efficiency.

There is also a second message. If one were to assume that both external and internal barriers were removed, the most likely result would be a *decrease* in the interprovincial flow of goods and services [13]. But we knew this all along. John A. Macdonald was a great nation builder because he put in place the two policies to generate east-west-trade—the National Policy and the Canadian Pacific Railway. Remove the distortions and/or subsidies from these two programs and the trade flows will tend to move north-south. The point is that freeing up internal trade (that is, removing domestic and international distortions) need not, and probably will not, result in greater interprovincial trade. Thus, to push for greater interprovincial trade is tantamount to lending support to the existing distortions and, perhaps, adding new ones. This is yet another area where a bit of interregional general equilibrium theory lends substantial insight.

Conclusion

The 1960s generated a comprehensive set of socioeconomic programs to individuals, businesses and regions. No doubt they were appropriate for their economic environment. But the environment has changed. The challenge now facing Canada is one of economic restructuring within the context of fiscal restraint. It has been argued that in terms of the three tradeoffs - adjustment vs. security, decentralization vs. centralization, and private sector vs. public sector - restructuring-cum-

restraint will tilt the system towards adjustment (efficiency), towards decentralization, and towards greater reliance on private sector participation. The arguments were based principally on positive economic grounds, although these directions could also be supported on normative grounds. Finally, the prevailing wisdom that it is appropriate to view the existing regional disparities as representing a disequilibrium situation has been challenged. More generally, the prevailing approach to regional issues in Canada reflects too much in the way of ideology (present authors included) and too little in the way of analysis. The insights gained even from some fairly simple theoretical general equilibrium models challenge some of the motivating factors for government intervention on the regional front. Much more needs to be done.

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