National Fiscal and Monetary Policies: A Regional Interpretation

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Hartley Lewis has provided background information on the links between the B.C. region and the federal government and further information on how major cyclical variables have recently moved in B.C. in comparison to their movements in Canada as a whole. From the information he has provided it is quite clear that B.C. is substantially different from the rest of Canada. There are two obvious implications of this.

1. Aggregate national monetary and fiscal policies, unless carefully tailored with regional balance in mind, will have effects that differ by region, so that even if the economic problems are the same in each region, a standard dose of policy medicine that is right for the country as a whole will be wrong for most of the individual regions.

2. At any given time, each region will have a different balance between aggregate supply and demand, so that even if a standard dose of monetary or fiscal policy had equivalent effects in each region, the use of policies that achieve national targets would not achieve equivalent targets in each of the regions.

There is, of course, the happy but unlikely possibility that the differing effects of the various policy instruments will exactly balance the differing requirements of the regions, so that a set of policies chosen to suit the national averages will also suit the regional situation. Such happy accidents have not occurred in Canada and there is not much chance they will occur in the future. Thus it will continue to be in the interest of people living in the various regions to have an eye to the effects that national policies are having on them, and to consider ways in which national policies could be realigned so as to take better account of special circumstances in particular regions. In the remainder of the paper, I shall try to indicate in principle how various short term government policies might influence the B.C. region. Although I shall illustrate the discussion by reference to recent policy changes, the discussion will be fairly general, partly to provide a better basis for future use of the relevant tools, and partly because it is very difficult to be specific about the regional effects of current policies. Although it is increasingly easy to make quantitative

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judgments about the national effects of national policies, we are at present without the necessary data to permit us to measure and explain the inter-regional flows of people and goods in Canada.

After the discussion of how various national fiscal and monetary policies act on the country as a whole and on B.C. in particular, I shall conclude by considering some of the pros and cons of more regional autonomy in policy making.

This is one of the most complicated measures to analyse in regional terms because it can take so many forms. The first possible split is between government purchase of goods and services provided from outside and wages paid to persons directly employed by government. We do not have information available allowing us to show which region or regions are most influenced by changes in government purchases of goods and services. However, it can be seen from Hartley Lewis' tables that a change in government employment, if applying equally in proportionate terms to all the regions, has its most predominant effects in Ontario and in the Maritimes. If there is a cut-back in direct government employment, or in government purchase of goods produced in a particular area, the immediate effects of that policy are felt in only the area directly concerned.

If there is a desire to focus government expenditure in particular regions, as implied by the establishment of the Department of Regional Economic Expansion (D.R.E.E.) and its predecessor agencies, then policies can be made very specific indeed.

General changes in personal or company tax rates have impacts across regions that depend on the distribution of the tax base. The personal tax yields slightly higher proportions of taxable income in the richer regions, and changes in marginal rates have similar effects. The company tax situation is slightly more complicated, with a difference between the average situation and what happens when there are changes in tax rates. The marginal tax rates applicable to corporations do not differ much from region to region, and taxable corporation profits are arbitrarily split among the provinces according to each corporation's regional distribution of wages and salaries. Thus a simple change in the corporation tax rate has the same effects on the various regions. However, there are sharp differences between regions in the average rate of corporation tax paid, primarily because the depletion allowance, and the tax-free period for new-mines, are applicable chiefly in the resource-rich regions. From the point of view of those regions, the incentives permit the use of tax revenues from other provinces to finance new projects in the resource-rich areas. Whether these inter-regional transfers make idealistic sense is another matter, as they cannot be supported on the usual argument that the richer regions ought to help pay for services in the poorer regions. If the tax incentives for extractive industries had always come directly out of the tax share of the region in which the development takes place, there would probably have been little objection to the reforms originally suggested in Mr. Benson's White Paper. This is because the provincial governments would have seen little reason to continue a scheme in which their tax dollars were used to subsidize developments whose profits were then subject to special provincial taxes and royalty payments. As it is however, there is every reason to use federal dollars to bring developments into the region, so that provincial taxes can be levied on the resulting profits.

Before leaving the subject of direct taxes, there is a useful contrast, from the regional point of view, between the personal and company taxes. A federal change in basic personal income tax rates or exemptions alters provincial and federal income taxes in roughly the same proportion, because the provincial take is a percentage of the basic tax. A federal change in the corporation tax rate, on the other hand, alters only federal revenues, as the provincial share is defined as a certain percentage of taxable income. The federal government has tried to by-pass this difference, from time to time, by imposing or altering Old Age Security taxes, Social Development taxes, or surtaxes, which are not defined to be part of the basic personal income tax. All such schemes have been forsworn in the tax reform bill, however, so we shall have to wait and see whether this leads to more use of corporation tax in preference to the personal income tax as a tool for stabilization policy.

Turning to indirect tax changes, there is nothing special to say, beyond pointing to the limitations posed by crowding when the provincial "direct" sales tax at the retail level is superimposed on the federal "indirect" tax at the manufacturer's level.

Of all the tools used in stabilization policy, monetary policy is perhaps the most difficult to tailor to regional needs. Aside from federal direct or guaranteed lending schemes, which can be, and have been, very specific, the general level of interest rates and the degree of credit availability are bound to be very similar across the country. The Bank of Canada has at times asked the chartered banks to look after the credit demands of their customers in the depressed regions when credit has been generally tight elsewhere, but the ease with which capital moves frustrates almost any such attempt to segment credit markets. Indeed, if there is a fixed exchange rate and there are no impediments to international capital flows, there is little scope for a national monetary policy to establish interest rates different from those abroad. A floating exchange rate, or prospects of a change in a fixed rate, or of taxes or guidelines influencing capital flows, provide more scope for independent national policies. By the same token, a B.C. currency area, with an exchange rate free to float against the Eastern Canadian dollar, would provide increased scope for regional monetary policies, and for inflation rates to differ between East and West. Whether there is anything to be gained from regional currency areas in Canada is less likely, but I shall return to the general issue below.

Devaluation is a time-tested way of attempting to export unemployment, by increasing global demand for home products relative to foreign products. On the other hand, devaluation is also the inevitable result for countries with inflation rates higher than average, with slow productivity growth, or with international trading positions declining for other reasons. Whether the countries on the other side of the exchange rate change regard it as due reward for their hard work (their yen are now worth more abroad), or as a nasty blow to the unemployment rate depends on the circumstances. And, as we have already seen, these circumstances differ across regions in Canada. To the extent that an increase in the value of the Canadian dollar were due, for example, to U.S. demand for Canadian autos and parts, the results in B.C. would have more in them of unemployment than of reward for high productivity in the woods industries. Under the classical adjustment mechanism, of course, the relatively high unemployment rates in B.C. would lead to emigration to Ontario — just in time to encounter the effects of the U.S. New Economic Policy, to which subject we shall turn in a moment. But first note the underlying point — that changes in exchange rates are relatively painless parts of the adjustment process only if the previous rate was equally out of line for all the regions, or if the inter-regional movements of people and activity otherwise required are desirable when viewed as part of the longer haul.

The U.S. measures of August 15, 1971 are national policies to be viewed from a regional point of view. In this case, unlike the ones considered previously, B.C. is not in the nation making the policies, but one foreign example should be useful as well as topical. Alternatively, we can view the U.S. import surcharge as a pair of Canadian policies — a tax on exports to the U.S. coupled with an untied foreign aid grant to the United States of the entire proceeds of the tax. The only quantitative measure we can provide about the likely impact of the surcharge on B.C. is to be found in Hartley Lewis' Table 3, showing the possible coverage of the surtax to B.C. exports.

As for other features of the New Economic Policy, (N.E.P.), the ones most likely to impinge upon Canada are the investment tax credit restricted to U.S.-made machinery, the extension of tax advantages to Domestic International Sales Corporations (D.I.S.C.'s), various measures to expand demand in the United States, and the wage-price freeze. The net effect of the package is uncertain. Some simulations have been run with the basic N.E.P. measures built into a quarterly model of the U.S. economy, and that model jointly solved with a Canadian model and models of several other industrial countries, each of which was assumed to revalue against the U.S. dollar by 4%. All exporters to the U.S. were assumed to absorb the surcharge, so that only the revaluations influenced trade flows. Income and employment were seen to increase in the U.S., and to decrease in most other countries. An exception was Canada, whose output was expected to rise slightly because of increased exports to the U.S. induced by the expansion of activity in that country. Those simulations probably get the direction wrong for Canada, because they do not take account of all the incentives provided to buy from U.S. rather than Canadian sources. However, the experiments do help to show how much Canadian aggregate demand depends upon what is happening in the United States, especially under a regime of fixed exchange rates.

As for a regional assessment of the U.S. measures, an economist can only decry the application of trade restrictions as a supposed means of obtaining freer trade in the future.

Other features, such as the wage-price freeze, ought not to damage Canada's position under a flexible exchange rate — a successful freeze will just make the Canadian revaluation less than it otherwise would have been, and life goes on as before.

From a global point of view, it is natural to criticize the N.E.P. as a misguided search for a trade surplus when the more rational strategy would have been to close the gold window and to ignore the balance of payments altogether; but all that lies beyond this paper.

The material presented above, and in the paper by Hartley Lewis demonstrates how and why national policies cannot, in general, accord with regional interests at all times. This provides reason for debating whether or not the various regions could in general do better for their residents if policies were made closer to home. The issue bristles with complexities, and is laden with emotional content.

I shall venture only to start the hare, and mention a pair of important considerations. On the one side, one can argue that there is a greater community of interests and uniformity of economic structure within a single region, so that it is easier to choose specific policies that meet agreed local objectives. On the other hand, this uniformity within regions and diversity between regions means that trade and mobility between regions are likely to be of great mutual advantage. Unless there are elaborate ground rules accepted by all the regions (the inter-regional equivalents to the international G.A.T.T.), the unco-ordinated and self-interested policies chosen by the independent regions might soon make everyone worse off by blocking the flows of people and trade between the regions. The international parallels are all too easy to find. And who could guess what would happen to inter-regional aid if it came to be determined like foreign aid?

We live in a constantly changing balance of political pressures making for more or less centralization; and we would do well to consider some of the economic consequences of the alternatives — while we still have at least the illusion of choices open to us.