Open Letter Issued by the Bureau of Municipal Research, 32 Isabella Street, Toronto 5

BUREAU OF MUNICIPAL RESEARCH
TORONTO
ESTABLISHED 1914

CIVIC AFFAIRS

An independent fact-finding organization reporting to the public on civic affairs.

IS THERE A MIDDLE ROAD?

MUST EITHER INFLATION OR CONTROLS DISTORT CANADA'S ECONOMIC EXPANSION?

by

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I AM indeed pleased to have been asked to speak to this annual meeting today; and I may say that I am solely to blame for choosing a topic that has forced me into the middle of the road. In the time available to me I would like to examine the question as to whether there is some middle course between inflation and some direct government controls over the economy.

In considering this question I plan to shift the emphasis a little, but as a prelude we might reflect for a moment on the habit we seem to have—and I sometimes think it is a curious habit—of concentrating on finding a solution to *current* problems without due consideration for the long-run effects for our actions. To some extent this is justifiable and understandable if we are to support the old adage, "live one day at a time". But there also seems to be a tendency for us to assume that our resulting view of current conditions can be projected into the future. The future is usually thought of as a logical development of the past, and this it most definitely is not in any *simple* way. Our recent experiences certainly suggest that complications have a way of arising when they are least expected.

If we look back a bit we can see how fashions in thought have shifted this way and that with the turn of events.

CHANGING FASHIONS IN THOUGHT

The first world war was the war to end war, and when it ended we failed to appreciate the fragile nature of peace. Some held the view that peace was lost even though the war had been won; yet a Brave new World was the emerging attitude. The decade of the nineteen twenties, as we can see now, was characterized by a frenzied faith in the Perpetual Boom—two chickens in every pot. The depression crushed this faith for twenty years or more; and the depression yielded the bogey of economic maturity and a prophecy of perpetual stagnation. The stationary state seemed to lie ahead, and it was not an inviting prospect.

During the second world war, productive capacity in most segments of the economy increased. While most of us were concerned with the war effort, there were thoughtful speculations afoot as to how the huge productive machine would survive after the need for defence production had disappeared. The depression was recalled as a period of excess capacity, of underemployment for capital as well as for labour. The allied governments produced resolute resolutions fervently declaring their intention of pursuing a full employment policy. Privately, many were apprenhensive about the postwar decade. Family allowance and unemployment insurance came into focus as measures designed to raise consumer outlays.

Then the economic lessons of war finance began to come to light. There were huge reserves of forced savings. Taxes were high enough to be cut back sharply. There was a desparate shortage of consumer goods, particularly household equipment and automobiles, and war production had wasted a good deal of industrial machinery and equipment.

An address by Wm. F. Lougheed of William Lougheed Associates, Consulting Economists, Toronto, to a joint luncheon meeting of the Citizens Research Institute of Canada and the Bureau of Municipal Research, Royal York Hotel, Toronto, April 17th, 1957.

As we know from hindsight, these elements produced for us the most unusual decade of economic buoyancy in living memory. The psychology of stagnation and chronic underemployment gradually faded. It died hard, but I think we can agree that it did die.

THE FUTURE WE WANT

The preliminary report of the Royal Commission on Canada's Economic Prospects reflects the glowing view that a good many people have recently come to hold about the course ahead. The very existence of the commission is a measure of another new feature of our society, the responsibility accorded our governments for helping Canadians order the kind of future they want.

The future we want — and perhaps have always wanted, but in an earlier day didn't dare hope for — is a future like our past decade, only more so.

Let us look for a moment at the kind of future we want: Population should increase — it has gone up about one third since the end of the war. National output should increase — it has gone up over 50 per cent in real terms since 1946. Productivity (or efficiency of production, if you like) should increase — output per man-hour of labour has probably risen over twenty per cent since 1946. Industrial diversity should increase — and, partly with the help of the war, Canada cannot be viewed as solely a primary product country. Even increases in mining and petroleum production have been overshadowed by growth in manufacturing, although a fair portion of our increased manufacturing is based on the processing of domestic raw materials. Service industries are growing, made possible by productive efficiency in agriculture, mining and manufacturing.

GOVERNMENTS' ROLE

Finally, all governments have come to have an important stake in economic growth and in securing what is held to be a more equitable distribution of the fruits of progress. An important, and perhaps neglected aspect of the change in the role of governments is the way in which provincial and municipal governments are gradually assuming an interest in promoting economic growth. The services and facilities which make economic achievements possible — roads, water mains, sewers, electricity, gas, schools, and so on — these are not federal responsibilities but provincial and municipal ones. I might suggest in this connection, that capacity in these other levels of government cannot be as large as it should be as long as the federal government operates with the spirit of fiscal monopoly.

In addition to its two major functions of managing the defence program and the national debt, the *federal* government has come to take a keen interest in welfare — in evening-out of real income and economic opportunity. The extent of this interest far overshadows in our experience of twenty years ago or more. Having controlled most of the evil elements of war finance, federal experts are also more optimistic than their depression predecessors about controlling the bumps on the road to the future.

"MINIFLATION" OF 1956

Our ecstatic view of the present and future lasted for a year or so into 1956, when monetary policy began to trancend fiscal measures and the Bank of Canada began to use available monetary weapons to contain what was viewed to be a new of inflation. The consumer price index in January, 1957, was 3 per cent above what it was in January, 1956, and some capital goods prices not ***in*** the index had risen somewhat more.

This record hardly merits the term inflation. With apologies to the Governor of the Bank of Canada, I think a new word should be ***coined***. Perhaps 1956 should be described as a period of "miniflation", a short term for "miniature inflation".

Our miniflation has been attacked vigorously. The policy of monetary restraint pursued by the Bank of Canada has fallen unevenly on various sections of the community. Credit restrictions of a non-specific nature cannot discriminate between potential borrowers in differing circumstances. Such general controls first of all restrict expenditures which would not tend to cause prices to rise as well as those that would add to inflationary pressures. In the second place, general credit controls have no social conscience; the housing situation is an illustration of how what we consider socially desirable projects can be cramped, and of how government policies in two spheres can be brought into conflict with one another. Finally, credit restrictions affect only credit; if a person or organization has sufficient cash reserves to draw on, or foreign sources of supply, expenditure plans need not be stretched out by inability to acquire funds.

MISPLACED EMPHASIS?

The emergence of this federal government policy, and the extensive public discussion occasioned by it, have focused popular attention on the subject of inflation to an extent rather unusual for a peacetime period. There also seems to be a feeling that "something ought to be done". Both the interest and the sentiment for government action in this area seem to me to be relatively new features of Canadian opinion.

Could it be that our current concern with an inflation — or miniflation — may be a little misplaced? Let us examine this query by considering in a little more detail some of the facts and fancies about price levels, bearing in mind all the while that the notion of trying somehow for a stable price level underlies much current discussion.

The price level, so-called, is meaningful only in terms of weighted index numbers. Prices of various goods and services influence the index numbers, such as our consumer price index, in proportion to the importance of each article or service in the budgets of the persons doing the purchasing.

An index number, then, can remain fixed while individual prices go up or down. The index can be falling while some prices are rising and the index can be rising while some prices are falling.

EFFECTS OF PRICE CHANGES

In the meantime, production may be becoming more efficient; that is, productivity may be rising. Suppose that prices in general are falling gently while productivity is rising. In this case people can share in the benefits brought by efficiency without earning higher money incomes. Their relatively fixed incomes can buy more goods and services at the lower prices. Thus, falling prices, rising productivity, and fixed incomes represent one version of progress. It is a situation which favours persons such as creditors and those people who have more or less rigid incomes, such as pensioners, as well as those people who can increase their money earnings. Such a chain of events is characteristic of the last century and, to some extent, of the nineteen twenties.

There are other economic models, however. Suppose that prices are generally stable while productivity is increasing. Then it is argued that people can share in the benefits of greater efficiency by earning higher money incomes and thus be able to buy more goods and services. This situation restricts the fruits of progress to those whose incomes rise. It does not make people with fixed incomes any worse off, but denies them a share in the nation's economic gains. Such a chain of events is a rare occurance, as I will explain shortly, but perhaps the period from 1952 to 1955 is a good recent case in point.

The third variation is the one where prices are generally rising, although not at any runaway rate, and where — as in our other economic models — productivity is increasing. Then people must all achieve higher money incomes just to keep their real incomes constant. Persons with fixed incomes lose ground; those with very elastic incomes gain. This shift in favour of persons with elastic and rising incomes is significant in that the portion of community purchasing power based on fixed incomes may act as a drag on rising prices. This situation is characteristic of the years 1946 to 1952, and to some extent of 1956.

FUTURE PATTERNS

Which of these three cases are we likely to face over the long future: gently falling prices, stable prices, or gently rising prices? On the first, I suggest that the idea of gently falling prices seems to have disappeared from current thinking, for reasons which I shall come to by inference in a moment. On the second, the probability of stable prices is almost as remote, because absolute general price stability can only be a result of offsetting influences by individual prices, a result which shows up on some overall index or other. Now, not every sector of the economy, nor every industry, nor every occupation gets more efficient to the same degree each year. This variety means a continual tendency towards changes in income, changes in investment, in consumer spending and hence in particular prices. Changes in the relationship between individual prices must certainly result in changes in the index numbers which summarize most or all price movements. Therefore, we are not likely to experience stable prices in the future without a determined and highly sophisticated effort to create such stability through government controls. And this even in the absence of tendencies towards generally rising prices.

In fact, however, there are a number of reasons why prices will tend to rise, at least gently, from time to time in the future. There are also, I suggest, certain factors which will limit the duration and extent of price rises.

PROS AND CONS

One factor favouring long--term upward price movements is that many people *expect* prices to rise. In other words, thoughtful observers have noted the apparent inadequacy of money as a store of value or a medium of saving. This is, after all, only a transient function of money over the long record of economic history. Emphasis on money as a medium of exchange or short-run bearer-of-options on goods and services — the so-called "liquidity function" — will naturally promote spending and investing in real assets rather than cash or bonds with fixed face value. A bias towards spending and a parallel bias against holding money would exert a persistent upward pressure on prices. Against this influence the "money illusion", or the faith which many people have in the value of money, exerts a restraining counter-influence.

Other upward influences might be cited. Some people detect these in union demands for wage increases beyond increases in productivity. Such demands raise costs, and sometimes prices, but nevertheless represent a gain for union members at the expense of the less organized segment of the community. Two points might be noted in this connection. The first is that organized labour is spreading as a social phenomenon, thus making more wages flexible and tending to protect at least the employed portion of the populace against the loss of purchasing power otherwise inherent in rising prices. This tendency, of course, does nothing to check price increases but at least it mitigates the hardship which results from them. It may well be that we shall have to develop a parallel degree of flexibility in what are now considered fixed money claims in general.

One may perhaps be permitted to take some hope from the possibility — I shall not say probability — that as the trade union movement in Canada grows in numbers and in economic and political strength, its leaders and membership will be led into a correspondingly larger sense of community responsibility. Under such circumstances inflationary appetites might be curbed, and it is not without significance that only a relatively conservative element in these matters of union policy will produce a farmer-labour political ticket which alone could elect the union executives to political office.

EXPANDING BUDGETS

Another factor which is sometimes cited as a contributor to a long-run trend to rising prices is the political value of increasing government expenditures occasioned by increased outlays of a redistributive character. Holders of such views assume that there will be heavier tax burdens on middle and upper income groups. Such a turn of events would pose a number of problems with respect to our future wealth, as contrasted to our welfare activity. It might be noted, too, that even a balanced budget, or one with a small surplus, can have an inflationary influence depending on whether a portion of the money the government is spending might otherwise not have been either spent or invested by the taxpayers. By the same token, the recipients of government welfare outlays may also tend to spend a higher portion of these monies that would the taxpayers from whom they originally were taken. This line of reasoning, as you will note, is an argument for smaller budgets as a check on inflation. But will we, in fact, tend to have smaller budgets?

It is hard to say what political philosophy the future will bring forth in Canada. In a determined spirit not altogether expected in some quarters, our Minister of Finance has budgeted again for a surplus, despite the ballot power of tax reductions. One may ponder how long such resolution will prevail.

There are other factors which help balance our outlook, that is, which reduce the prospect of any particularly large inflation in the foreseeable future.

STABILIZING TAXES

One of these stabilizing influences you can see in your income tax forms: when your income grows your tax rates rises; even if the rate does not change, the number of tax dollars rises. The reverse effect occurs when your income falls, since tax bills become more than proportionately smaller. The progressive income tax, no matter what its demerits may be on other counts, does represent a so-called built-in stabilizer of expenditures and hence to some extent of prices as well.

THE IMPORT CUSHION

Foreign trade also has a bearing on the price level, and it cannot be said too often that we Canadians are dependent to a high degree on economic conditions in other countries. If we can continue to import freely without unduly depressing the foreign exchange value of our dollar, our imports help ease inflationary pressures. Our open economy and free exchange rate thus represent an import cushion against inflation. By spending money abroad we help take immediate pressure off Canadian prices. If our dollar remains strong, export industries and those competing with imports will be less likely to expand and this, too, cuts down pressure on Canadian prices. Much more could be said on this point, but I shall have to leave it with the observation that the import cushion against inflation depends on stable foreign prices; if these are rising too, then imports do nothing to reduce inflation in Canada, and would produce it if it did not already exist. During and after the war, higher American prices were partly responsible for many cost and price increases in this country — second only, perhaps, to overt or hidden increases in our wage rates during a period of labour shortage. But our open economy is not likely to suffer severe inflations engendered at home as long as there is exchange stability and freedom to import.

GROWTH AND PRICES

Then there is the growth factor. Although economic growth implies an active interest in work, and an active interest in work suggests higher prices for various reasons, an increasingly efficient production set-up in Canada would have some tendency to check overall upward price trends. More goods per dollar becomes a possibility at least, though not everyone is likely to share equally in the gains. In our future, service industries are likely to become more important than they are now. Service industries are already much more significant in the community than they were a few years ago. But Productivity increases are harder to come by in these industries, and certainly they must share the cost patterns of the other economic sectors if they are to get labour, capital and managerial Skill. Therefore, their future growth does suggest some upward price pressure of its own, as Canadians become willing and able to buy more services instead of performing them for themselves.

Expansion holds a good deal of the key to productivity. In my opinion, it was a scramble for expansion in various lines, primarily investment, that disturbed price stability last year. Personally, I do not believe that the events of 1956 were harbingers of disaster, but one must sympathize with the sense of responsibility being assumed by government officials.

NOT CHIEF PROBLEM

You can see that the degree of future inflation will depend on a whole complex of forces and counter-forces. Looking ahead, it may be fairly suggested that over the next few years the most serious problems we shall face will not be concerned with preventing inflation. The special circumstances of the Canadian economy I have reviewed, particularly our foreign trade pattern and apparently strong growth potential, do not seem to me to add up to the kind of inflation which would move ahead very fast or very far at any one time. And if foreign prices rise, especially those of our vital imports from the United States, we shall not be able to avoid a degree of sympathetic response on the part of Canadian prices.

Higher taxes and tighter credit restrictions can certainly be used, without detailed controls, to check what might be termed home-grown Canadian inflation. This we may be sure of, although there would undoubtedly be hardships created by using these controls on a major scale.

What is not so clear is the effect on economic growth of continual tinkering by government authorities chasing a chimera of short-run price stability. Let us be clear on this. Once detailed price controls of any kind get started, they have to be extended farther and farther to plug loopholes. That we know from our wartime experience. Rationing and detailed control of saving and investment by government lie at the end of such a course. Few intelligent men would argue that a full control system would be worth its cost, either administratively or through adverse effects on initiative, ambition, and economic development.

When only small-scale forces are loose in the price system, I am frankly dubious about the merits of general policy shifts to control them. When an economy is growing and having its face lifted at the same time, when future horizons are wide and bright, an occasional round of price increases seems to me to be a rather small cost to pay for freedom of activity. Perhaps we should be better advised to focus attention on remedies for adverse price effects than to try to damp down all change.

CHALLENGE OF GROWTH

The main reason for my skepticism about the arguments for short-run price stability stems from my inclination to regard the problems of real economic growth as both more important and more unmanageable than the problems of maintaining price stability. The main economic challenge facing us Canadians today is not, I believe, inflation, but how we are to underwrite the springs of growth. The Gordon Commission's prognostications for 1980 were based primarily on a remarkable postwar decade. We most assuredly have not seen the last of recessions, and our long-run problem concerns national output, it may be suggested, rather than the prices at which this output will be sold.

When economic projections of recent experience point to future wealth it is necessary to understand that these are not forecasts or predictions. The actual course of events will depend on what millions of people in Canada and millions of people elsewhere in the world decide about working or not working, spending or not spending, saving or not saving. The national accounts published by the Dominion Bureau of Statistics and projected by the Royal Commission are not things in themselves. They are the passive resultant, the lifeless reflection, of individual activities which make progress such a human, personal thing.

HAZARDS: DIRECT CONTROLS

The road of direct controls in price policy certainly is, therefore, not a useful one, if only because of its cramping effect on economic development — to say nothing of the value of freedom as a thing in itself. When one talks of a middle road on price policy, one must suppose another, libertine way strewn with severe inflationary hazards. As I have suggested, this third way does not seem very real. The middle way is, therefore, basically a way of freedom on which all may travel. One must have some faith in the resilience of the free economy. This faith has not been misplaced in the past and should not be considered misplaced for the future. Economic freedom reflects an emphasis on opportunity, competition, rising productivity and growth, rather than a primary emphasis on how the fruits of progress are to be shared by various sections of the community.

ENLARGING THE PIE

You have doubtless heard a national economy compared to a pie. Economic growth, with rising productivity, may be thought of as increasing the size of this pie in such a way that everyone in the country could get a larger portion than he used to. This is one kind of progress which we may associate with the word "wealth". Social justice, or welfare, is primarily concerned with how the pie should be cut for various groups in the community. In policy decisions on income tax, family allowances, veterans and old age pensions, and public health care, this question is answered implicitly insofar as it is not answered by the wage and salary structure.

Of all the choices we have to make, and have to continue making, perhaps the most obscure and important is how much priority we are going to give to productive effort — making the pie bigger — and how much to distributive effort — directed, say, towards a more equal share for various people. This must be recognized as a hard choice between good things, not between bad things and good things.

At an annual meeting of these organizations some years ago, the President of Queen's University, W. A. MacIntosh, emphasized this problem of choosing between good things as one of the challenges of economic expansion.

I am skeptical about the ability of governments to *create* development themselves, but I am one of these persons who support wholeheartedly the notion that governments can and should pave the way for development by creating a hospitable economic climate.

GROWTH HANDICAPPED?

The budgetary policy of the present federal government may, indeed, be working against this development. This can be seen in the invidious financial position in which local governments have been placed, mainly by federal attitudes towards the revenue requirements of the provinces. Provincial sources of revenue, apart from tax rentals, are intimately related to drinking, driving and departing, and it is difficult to imagine the public reaction to conscious efforts on the part of public officials to urge acceleration in any of these activities.

As the Americans are continually re-discovering, however, it is hard to know where to apply scissors to federal budgetary estimates. Defence and debt servicing make up about one-half of our own federal expenditures. These are apparently hard for us to cut down. Aside from defence outlays and interest payments on the national debt, a good part of the balance of the federal budget, while devoted to undoubtedly worthy ends, seems to me to have little or no encouraging effect on economic development. Yet we do need this money for other good things, for better social capital on which to build a bigger and better economy. Cuts in welfare expenditures are always surrounded with very real political difficulties, but this illustrates the problem of making a choice.

WEALTH BEFORE WELFARE

In looking at the responsibilities of the various levels of government it seems a little incongruous that since 1937 federal revenues have risen tenfold while net municipal revenues have barely tripled. This is part of what I mean by getting on a middle road between an excessive concern with production and an excessive concern with the justice of distribution. Welfare problems should, it seems to me, be solved after the event of the accumulation of wealth. An attempt to reverse this process, I suggest, can only result in a stunted growth curve for Canada. This amounts to a question as to how economic security is to be attained. Is personal security primarily the responsibility of the state? Anyone who says it should be must be prepared to explain how such a philosophy can be reconciled with the prerequisities of rising man-hour productivity and expanding wealth creating capacity. It seems to me that placing universal security before expanding enterprise is not a priority which would contribute to a successful living on a national scale.

The prosperity of recent years has underlined the importance of freedom and sense of individual responsibility. As for political philosophy, I am compelled to suggest that there is not enough *thinking* — and I would underline thinking — about the broad consequences of a mixed or British-type economy as it applies to the kind of economic structure we have in Canada. One wonders just how many Canadians are willing to pass their responsibilities to the apparently willing hands of public administrators. The number may be too large for comfort. It may reflect a decline in materialism, an oft-maligned philosophy of life. If this has any possible implications for the future then we must re-examine the kind of projections made by the Royal Commission on Canada's Economic Prospects. My interpretation of the commission's version of Canadian Progress is that it strongly implied a widening and deepening interest in materialism. After all, a prediction of rising production implies a commensurate interest in increasing consumption.

The rather uncomfortable note on which I conclude is that we may unwittingly be restricting our range of choices in policy matters of the kind we have been considering. Do we really have to choose between controls and inflation? Much more significant is the kind of policy we must follow to insure the optimum degree of future economic growth in this country. One of the dangers of looking into the future is that it can create an illusion of a pre-determined and, in our case, an upward course of economic activity. And this in turn often invites a negative or restrictive attitude towards the prerequisites of growth and an excessive concern with short-run containment. Our urgent need, therefore, is to mark out our road to growth; when this is done we can preoccupy ourselves with whatever is left of the problem of price stability.