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INCOMES POLICY: CANADA'S EXPERIMENT WITH ORGANIZED VOLUNTARISM TO CURB PRICE INFLATION.*

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No matter what happens, 1970 is sure to be a memorable year in the annals of Canadian economic policy. It will be remembered not only as the year when the country undertook major reforms of the mandatory tax system, in the wake of the Carter Report and Finance Minister Benson's White Paper, but also the year when it attempted to curb price inflation through a system of voluntary taxes, under the aegis of the Prices and Incomes Commission.

This resort to a voluntary tax system (alias incomes policy), according to the Government's White Paper establishing the Commission, is based on the conclusion drawn from experience that the conventional monetary and fiscal policy tools are insufficient "to resolve" the conflict between the objectives of maintaining high level employment and restoring the price stability alleged to be necessary for sustained economic growth. The White Paper recognizes that applying conventional monetary and fiscal levers with sufficient force might curtail price inflation. But it argues that the cost in terms of employment and output foregone would be very high. Mindful of the difficulties encountered in other countries with voluntary tax schemes, the warnings of independent experts and the negative conclusions reached by the Economic Council of Canada after an intensive study of the question as well as by the Task Force on Labour Relations, the Government was nevertheless impressed by the comment of the OECD in 1968 suggesting that "there is a need for some sort of incomes policy". Thus, a Prices and Incomes Commission was organized in May, 1969; and since then it has been mainly preoccupied in trying to persuade employees and employers to levy a tax against themselves voluntarily.

Before considering this bold new experiment in economic policy as well as in civic responsibility, it is worth considering the experience from which it was concluded that the conventional tools of stabilization policy were inadequate. Because of the openness of the Canadian economy, one important element in the picture is changes in foreign price levels. As shown in Table 1, there seems to have been some minor divergence since 1965 in year to year movements between price changes in Canada and foreign prices as represented by U.S. prices. The general pattern of price changes in Canada, however, is very similar to the pattern of foreign prices. As far

TABLE 1

PERCENTAGE CHANGES IN CANADIAN AND U.S. PRICES, 1965-69

	Percentage change in consumer price index		Percentage change in implicit GNP price index	
	Can.	U.S.	Can.	U.S.
	(end of year)		(av. of year)	
1966/5	3.6	4.3	4.6	2.8
1967/6	4.1	3.1	3.3	3.2
1968/7	4.1	4.7	4.0	4.1
1969/8	4.6	*5.5	*4.2	*4.7
1969/5	17.3	*20.4	*17.1	*15.6
Annual rates	(end of quarter)		(av. of quarter)	
1968 II/I	3.6	4.4	2.6	3.9
III/II	4.7	4.4	3.9	4.2
IV/III	4.0	4.8	3.9	4.1
1969 I/IV	2.9	6.1	3.8	4.6
II/I	8.8	6.5	6.0	5.1
III/II	3.1	5.2	3.4	5.6
IV/III	4.1	*3.7		

* estimates based on data available to date for 1969.

as one can tell, given differences in the indices and the inadequacies of all such indices, over the full period 1965 to 1969 Canadian prices have risen by about the same amount as U.S. prices.

Another element in the picture is the well-established tendency for price and wage changes to lag far behind the initial conditions giving rise to upward price pressures. As the OECD has recently pointed out, the strong inflationary pressures that were allowed to build up between 1966 and mid-1968 have taken a long time fully to work themselves out in prices and wages. This lag has contributed substantially to the slow response of the North American economies to anti-inflationary measures. Moreover, it seems likely that the inflationary impact of the exchange rate devaluation in 1962 did not fully manifest itself until after 1965 when the excess capacity evident in the economy prior to 1965 had disappeared and unemployment rates for the first time after devaluation fell well below 4½ per cent of the labour force.

The failure to achieve significantly greater price stability in Canada than abroad and the failure to counteract the delayed inflationary effects of devaluation and other influences presumably might represent one of the implied failings of conventional monetary and fiscal policy. Before accepting this conclusion, however, it is necessary to consider how vigorously and how well the conventional monetary and fiscal tools have been applied since 1965 to restrain the strong inflationary pressures emanating from abroad, from the past and from current domestic economic conditions. Summary evidence bearing on this issue is presented in Table 2.

As these figures indicate, over the period in question the federal government can scarcely be said to have followed a very active anti-inflationary policy. Beginning with an overall surplus (on a national accounts basis) of $625 million in 1965, the surplus decreased to $164 million in 1966; and in 1967 and 1968 the federal government was a net dissaver to the tune of $256 and $165 million respectively. In 1969 a surplus again appeared, but this surplus was considerably less than that in 1965, even though the 1965 surplus came at the end of a lengthy period during which excess capacity was widespread in the economy and 1969 came at the end of five years marked by high levels of employment and strong and continuing inflationary pressures. Other Canadian governments have had

TABLE 2

SELECTED DATA ON UNEMPLOYMENT, OUTPUT AND FISCAL AND MONETARY POLICY, 1965-69

	Unemployment Percentage (seasonally adj.)	Percentage Change in Real Domestic Product (a)	Net Government Saving (Dissaving) ($ millions at annual rate) (b)		Percentage Change in Money Supply (c) (% per year)	Nominal Rates of Interest (%) (d)			Real Rates of Interest (%) (e)		
			Federal	Total		3 mos. treas. bill	3-5 yr. govt. bond	indus-trial bonds	3 mos. treas. bill	3-5 yr. govt. bond	indus-trial bonds
Annual											
1965	3.9	6.9	625	325	10.4	4.0	4.9	5.7	1.7	2.6	3.4
1966	3.6	6.0	164	348	7.6	5.0	5.6	6.5	1.9	2.5	3.4
1967	4.1	2.7	(256)	157	11.9	4.6	5.6	7.9	1.2	2.2	4.4
1968	4.9	4.5	(165)	800	12.6	6.3	6.7	7.9	2.4	2.8	4.1
1969	4.8	4.6	487	1957	10.2	7.2	7.6	8.7	3.2	3.6	4.7
1969/5		19.0			49.3						
Quarterly											
1968 I	4.6	6.0	108	1168	8.2	6.7	6.8	7.7	2.8	3.0	3.9
II	5.0	5.6	(936)	220	12.0	6.8	6.9	8.0	3.0	3.1	4.2
III	5.0	2.5	(80)	436	17.3	5.7	6.3	7.9	1.9	2.5	4.0
IV	4.9	7.7	248	1376	12.6	5.8	6.9	8.1	2.0	3.1	4.2
1969 I	4.3	9.6	496	2464	12.6	6.5	7.1	8.3	2.4	3.1	4.3
II	4.8	-2.0	260	1792	6.9	6.9	7.6	8.6	2.9	3.5	4.6
III	4.9	-0.4	568	1616	-1.4	7.7	7.8	8.9	3.7	3.8	4.9
IV	5.1	6.0	624	1956	5.1	7.9	8.2	9.1	3.9	4.1	5.1

a) Seasonally adjusted at annual rates.
b) Seasonally adjusted, National Accounts.
c) Total currency outside banks and chartered bank deposits, annual and quarterly averages, seasonally adjusted.
d) Annual or quarterly averages.
e) Nominal rates <u>minus</u> the rate of average increase in the GNP implicit price index over the preceding three years and the current year.

large and growing surpluses since 1966. These surpluses, however, have mainly reflected their particular revenue and expenditure patterns and particularly the revenues generated by the Canada and Quebec pension plans. They are not indicative of highly active anti-inflationary policies pursued by provincial and municipal governments. This said, it nevertheless remains true that the surpluses that have emerged willy nilly from these governments have helped considerably to dampen recent inflationary pressures.

Turning to the money supply, one finds very rapid rates of increase, exceeding 20 per cent per year in mid-1968. On a year-to-year basis, the increases ranged from 8 to 13 per cent per year from 1965 to 1969. For the period as a whole the money supply increased almost 50 per cent compared with a 19 per cent increase in real output. From the end of 1966 to the end of 1969, real output increased about 10½ per cent and unemployment remained below 5 per cent. An increase in the money supply of 36 per cent during this three year period meant that three dollars of new money were being added to the holdings of the community for every dollars worth of additional output produced by the community. Even in 1969, when price inflation had become a major preoccupation, the growth in the money supply exceeded the growth in real output by a ratio of more than 2 to 1.

Nominal interest rates during this period increased substantially and now stand at record levels. Real rates of interest, on the other hand, increased much less in absolute terms and even now remain well below 5 per cent for many borrowers.

This picture, to say the least, scarcely conforms with prevailing notions of conventional monetary and fiscal policy, whether inspired by the writings of Milton Friedman or Walter Heller or both. During much of this period one might have expected, by most conventional standards, changes in the money supply to at least not exceed significantly changes in real output. And on the fiscal side, according to most conventional ideas, one would have expected to find large and growing federal surpluses deliberately designed to reduce inflationary pressures. Thus, the indictment of conventional monetary and fiscal policy can hardly be that it was tried and didn't work. Indeed, during much of this period these conventional levers appear to have been moved in the wrong direction; and to the extent that they were effective, these policies tended to enhance the upward pressure on prices rather than the other way around.

How in the world did it happen that a government which felt it was confronted "with an inflationary problem --- that threatens our long-run economic well-being" could have followed monetary and fiscal policies that seem so obviously out of line with conventional prescriptions and, in desperation, turned to a new approach implying a system of voluntary taxes? Without going into details, some of the leading clues in this mystery are fairly evident.

On the fiscal side, the federal government found itself faced on every side with tremendous demands for increased government expenditures of all kinds which it was not prepared to resist. Nor was the government prepared to levy mandatory taxes to the extent required to pay for the additional goods and services provided to the public. Indeed, the federal government reduced taxes in the spring of 1965, thereby enhancing the inflationary pressures in the economy during the critical 1965-66 period when unemployment in Canada averaged well below 4 per cent and was significantly less than in the U.S. In short, there was a major failure in the political process in that the public was offered something for nothing rather than a supply of publicly-provided goods and services at the cost of foregoing private expenditure. This failure was exacerbated by a lack of co-ordination and co-operation among the different levels of government in fiscal policy matters. And it was further enhanced by inadequate analysis and understanding within government circles as well as without of the degree to which the policies being followed were inconsistent with the requirements of stabilization policy.

On the monetary side, the authorities found themselves hedged in by a number of factors, some beyond their control and some of their own devising. Among the former were a series of events beginning with the major domestic financial crisis arising out of the debacle of the Atlantic Acceptance Corporation in 1965, the adoption of restrictions on foreign investment by the U.S. beginning in 1963 and tightened up in 1965 and again in 1968, currency revaluations by the U.K. and other countries in 1967 and by Germany and France in 1968 and 1969, and a major international monetary crisis in the fall of 1967 and spring of 1968. Further uncertainty was injected into this picture by the revisions of the Bank Act in 1967 and the readjustments in the money supply following thereupon.

Throughout the period since 1965 Canada's current balance of international payments has not only been relatively strong by historical standards but also has been improving substantially. In 1969, for example, the current account deficit was about two thirds of the $1.2 billion deficit in 1966. The constraint on monetary policy has arisen from the capital side of the accounts where, because of a fixed exchange rate and the sensitivity of international capital flows to interest rate differentials between Canada and the U.S. as well as to U.S. balance of payments policies and international monetary developments, monetary policy has had to be geared largely to Canada's foreign exchange position. As a consequence monetary policy has been largely emasculated as an effective instrument of domestic stabilization policy.

A special word may be added on the ceiling on foreign exchange adopted after 1963 as the price of gaining exemption from the most injurious features of U.S. balance of payments policies. On the face of it, the government seemed to be trying to fix both the price and the quantity of foreign exchange. This dual constraint conceivably could largely explain the lack of a tighter monetary policy during this period and the preoccupation of the authorities with nominal interest rates and their effects on capital flows. There is little evidence, however, that the authorities in fact felt much constrained at the time by the ceiling. For one thing, the ceiling could be and was effectively relaxed when it was approached by such ploys as buying back non-resident holdings of Canadian government bonds. For another, it is doubtful, as mentioned below, whether the authorities would have chosen to follow a tighter policy had there been no ceiling.

Although one may readily concede that coping with the series of special incidents occurring after 1965 would necessarily have interfered to some extent, and at certain times very considerably, with the exercise of monetary policy for domestic stabilization purposes, it is difficult to avoid the conclusion that monetary policy could have played a much more constructive role had Canada been prepared to contemplate either an appreciation of the foreign exchange rate or a freeing of the rate. In principle it might of course have allowed its exchange reserves to pile up. But this was not very practical given the difficulties of financing such accumulations without adding further fuel to the inflationary fires and the formal agreement with the U.S. from 1963 to the end of 1968 setting a ceiling on the level of Canada's foreign exchange holdings. Throughout history, Canada has always been prepared to revalue the rate or to free the rate when it served our interest to do so. During the 1960's, however, the current rate of exchange seemed to become especially sacrosanct as a price to be defended at very heavy cost. Given strong domestic inflationary pressures an appreciation of the rate, whether achieved by decree or under a free rate by more restrictive monetary policies inducing larger capital inflows, would have had a direct deflationary effect on prices. This influence would have been reinforced by the depressing domestic expenditure effects of the tighter monetary policy which would have accompanied an appreciation of the rate. Furthermore, available evidence suggests that given highly mobile capital flows, the inflationary effects of government deficits during this period would have been considerably undermined had Canada been on a free rate. As a consequence of these combined influences - the dampening price effect of exchange appreciation, tighter monetary policy and a weakening of the inflationary effects of the fiscal policy pursued - there would have been a real prospect of achieving greater price stability in Canada than abroad. The failure of the authorities to exploit these possibilities may be considered the second major deficiency of the policies followed since 1965.

One can only speculate on the reasons why Canada did not adopt a more flexible approach to the exchange rate during this period. As already noted, a series of external events occurred during this period which inevitably would have had some repercussions on domestic policy. These events, however, do not fully explain Canada's position. Indeed, one might argue that because of the perterbations in the international monetary system the need for a flexible position on the exchange rate was all the greater. More likely considerations explaining Canada's position are the following:

a) There is some doubt whether the authorities felt much constrained in the exercise of monetary policy by balance of payments considerations and whether they would have followed a more restrictive policy had they been freer to do so. This is probably explained in part by concern about the possibility of deflationary over-kill. In addition, throughout the period the authorities continued to be preoccupied with nominal interest rate levels as the index of how restrictive their policies were. And they tended to judge the appropriate level of the index by historical standards and a variety of so-called "practical limitations on increases in interest rates". By this apparently is meant such considerations as those related to the uneven incidence of tight credit conditions on various regions and sectors of the economy, the financing of the public debt and the need to avoid "excessive" foreign investment. Little evidence is to be found in the Annual Reports of the Bank of Canada of the increase in emphasis on the money supply per se and real interest rates to be found in recent years in theoretical, empirical and policy discussions in the U.S. and elsewhere. The views of the Governor of the Bank on this issue are on record:

> "In the day-to-day determination of monetary policy, the central bank is not primarily influenced by considerations relating to the size of the money supply. This does not mean that the Bank of Canada takes no interest in, or is not influenced by, what is happening to the money supply. However, it is a fact that we do not operate on the basis of a precise view about the appropriate trend, over some time, of total chartered bank deposits. We give priority in our thinking to the kind of credit conditions that seem to be appropriate in the prevailing circumstances".

Throughout the period it apparently was the rise in nominal interest rates rather than the increase in the money supply and real interest rates that preoccupied the authorities. And there is some question whether they would have been prepared to see the rates go significantly higher had they not been constrained by balance of payments considerations.

b) Ever since the fixed rate was adopted in Canada there has been an implicit feeling in some quarters that adherence to a fixed rate was one way of enforcing greater discipline on spend-thrift politicians. This hypothesis is far from obvious in the light of experience since 1965. Moreover, experience since 1965 has demonstrated that alternative outcomes are also entirely possible, such as a rapid inflation of prices and the emasculation of monetary policy as an instrument to deal with inflationary pressures.

c) A further factor has probably been the view apparently held by the authorities that the recent price inflation is largely a psychological phenomenon based on expectations rather than a phenomenon reflecting real economic forces. Attention has been directed to the importance of educating opinion on price developments and the policies being followed. This emphasis tends to overlook the point that the public's expectations were highly justified given international price trends and the lack of effective fiscal and monetary policy. Indeed, it has probably been the less informed who have suffered most from "money illusion" and who have added least to the price pressures. Reducing the ranks of those suffering from "money illusion" may well make things more difficult. On the other hand, if what is implied is a large-scale public relations job intended to mislead and to increase the ranks of those suffering from "money illusion", the policy is surely indefensible. Expectations may speed up adjustments and may create their own momentum over limited periods, but they are self-correcting and can scarcely be unrelated to reality over any period of time. It is quite possible that nothing would have done more to change expectations during the late 1960's than the vigorous pursuit of effective monetary and fiscal policies combined with a flexible approach to the exchange rate.

d) Throughout this period the authorities were intimately associated with central bankers in the U.S. and Europe in their efforts to improve the international monetary system. Much of this activity was devoted to establishing an international regime in which the volume of international reserves was expanded and exchange rate variations were kept to a minimum. Working closely in this environment, the authorities could hardly be expected to be very sympathetic to the prospect of revaluing or freeing Canada's exchange rate. Our credentials as a member of the club might have been jeoporadized and our influence at the conference tables in which these arrangements were being developed might have been reduced. Moreover, it has been suggested that the U.S. was strongly opposed to any suggestion that Canada adopt a free rate during this period on the ground that other developed countries might have followed Canada's example. Indeed, it is rumored in some quarters that the possibility of Canada freeing the rate was a major reason why the U.S. agreed to exempt Canada from most of its balance of payments restrictions after 1963.

e) Conceivably the authorities during this period were prepared to sacrifice greater price stability in order to achieve fuller employment on the ground that the costs of more unemployment exceeded the costs of less price inflation. While once can make a case in these terms, it is very doubtful whether the authorities in fact took this view. Judging by their statements at least, one gains the impression that the authorities then, as now, regarded the costs of the rate of price inflation experienced in recent years as relatively high in terms of its effects on the distribution of income and wealth as well as on prospective levels of employment and economic growth. This raises a host of questions that cannot be pursued here. Suffice it to say that there is considerable evidence to suggest that the distributive costs of inflation are frequently greatly exaggerated, that any unemployment generated in order to reduce inflation also has distributive effects which are frequently ignored, and that the view that a continuation of rates of inflation in Canada comparable to those in the U.S. would jeopardize future employment and economic growth in this country is highly questionable. There is little or no evidence to support the sentiment that the "little people" - whether found in the unorganized sector, among the poor or elsewhere - suffer from continuing inflation when the alternative for many of them is to become front-line soldiers in the war against inflation.

Whatever the reasons for Canada's rigid position on the exchange rate issue, two points are abundantly clear. First from a strictly technical standpoint Canada could have followed a more flexible exchange rate policy than it did. And secondly, had the rate been allowed to appreciate in combination with a more restrictive monetary and fiscal policy, Canada's price inflation over the past five years probably would have been significantly less than it has been.

The Prices and Incomes Commission, joining battle with rising prices in mid-1969, has three strings to its bow. One of these is to undertake studies of changes in prices and costs in order to inform governments and the public about compliance with the Commission's guide-lines. The White Paper suggested that attention would also be given to the causes, processes and consequences of inflation within various sectors of the economy as well as in the economy as a whole. This work is underway and apparently is now being given greater emphasis than it was initially; but it obviously has not yet become a major feature of the Commission's activities. Secondly, the Commission has brought pressure on the provincial governments to restrain their spending and use their influence to limit price and cost increases within their territories.

Not much has happened to date on this front either. Nor for that matter is this a particularly novel development. In recent years it has been a well-established practice for various levels of government periodically to renew their pledges of fiscal virtue, to review each others expenditure and budgetary plans, to discover that in total they are excessive, to attempt to lay the blame for the excess on competing jurisdictions and for each government to avoid any suggestion that it is prepared to alter its priorities at the behest of another government.

The novel feature of the Commission's work is its attempt to gain voluntary acceptance by employers and employees of a plan to forego the profits and wages which market conditions make feasible and to settle instead for substantially less. In this sense the plan is nothing less than a plan in which the participants are asked to levy a voluntary tax on themselves equal to the difference between the earnings which market conditions permit and the earnings allowed under the plan. The proceeds of this voluntary tax are passed along in full to the community in the form of lower prices than otherwise would prevail. In other words, the tax is used to subsidize prices. One set of beneficiaries of the subsidy includes mainly those whose incomes are fixed in any event, those who for one reason or another do not come under the plan and those who cheat. Another set of beneficiaries are those who, if the scheme works as planned, can escape becoming unemployed during the transition to a more stable price trend. The main immediate losers are those who voluntarily pay the tax.

Who ultimately will pay whatever tax may be collected under this system and how output will be affected is highly uncertain. Much depends on the demand and supply conditions under which factor inputs are sold and, also, on how widely the tax is applied across the economy. If the tax is applied only in limited sectors of the economy, its incidence is likely to fall mainly on less mobile factors used in the production of goods and services for sale in Canada, and highly mobile factors may be largely able to escape the tax.

Perhaps the most incredible feature of the scheme is that in this day and age when we have a very elaborate and reasonably well-functioning mandatory tax system anyone should seriously propose such a weak and inequitable method of coping with inflation as a voluntary tax. One need scarcely emphasize the advantages of mandatory over voluntary taxes: they are collected from everyone rather than only from those who are obvious and can be pilloried in public; the amount can be established with some semblance of rationality; the level can be varied amongst various tax payers in accordance with prevailing ideas of equity; special attention can be given to sectors where reductions in expenditure outlays are considered to be particularly important, and vice versa; and the timing of the tax can be regulated much more closely in response to changing economic conditions.

Beyond these considerations, by collecting the tax itself, the Government has some control over the distribution of the proceeds which also has an important effect on expenditure flows. By using the proceeds in less inflationary ways such as retiring public debt, a further bite at the inflationary process is possible. Probably the least effective way of using the proceeds from an anti-inflationary standpoint is to pay them out directly to subsidize prices to consumers and investors - which is exactly what the voluntary tax scheme does. Thus, even if the Commission has some semblance of success in levying a voluntary tax, its contribution by itself will do little or nothing to choke off the level of effective demand. Admittedly subsidized prices may result in the consumers price index temporarily rising somewhat less rapidly than it otherwise would. On the other hand, production for domestic use is likely to be discouraged, the queue of unfilled orders and shortages is likely to lengthen and the quality of the output is likely to deteriorate. Other strange distortions are also likely to appear. For example, the deferment of the increase in interest rates by some chartered banks and department stores at the request of the Commission has almost certainly meant that these lenders have tightened up their lending criteria and that more of the more risky borrowers have been driven into the arms of lending agencies lending at much higher rates than those proposed by the banks and the department stores. Another example is the gesture in the direction of rent controls, which if it has any effect, is little more than a device for reducing the quality of the housing stock. And what is one to make of an anti-inflationary policy which, in order to conform with the Commission's "call for action", foregoes planned increases in postal rates, other fees for public services and a tax on air tickets, resulting in a loss in government revenues in 1970-71 estimated at $45 million?

There is also the interesting question of how such a voluntary tax scheme affects exports and imports. A voluntary tax which goes to subsidize export prices clearly makes no sense at all and presumably no attempt will be made to hold down export prices by this device. For companies that sell both at home and abroad, there will obviously be a strong incentive to increase exports at the expense of sales at home - given the tax-subsidy on domestic prices, thereby adding further to domestic inflationary pressures. On the import side, import prices presumably cannot be taxed by this voluntary scheme. To the extent that the prices of domestically-produced import-competing goods are subsidized, imports will be reduced contributing still further to domestic inflationary pressures. Given the incentives to increase exports and reduce imports the balance of payments is likely to improve implying either an accumulation of reserves - which will need to be financed - or an appreciation of the exchange rate - which on past performance has been strongly resisted - or a reduction of capital inflows through an easing of monetary policy - which will have pro-inflationary effects. The external implications of the scheme, to say the least, are anything but straight forward.

Finally, a voluntary tax - price subsidy scheme such as proposed is almost sure to be temporary at best, since in time the voluntary nature of the scheme is very likely to break down. To the extent that it is effective in the short-run, the scheme is likely to store up latent pressures for very large price increases when the scheme is abandoned. Thus two or three years from now the latent price increases now being obscured by subsidies may manifest themselves in addition to whatever price increases are being generated by the current economic conditions which may prevail in future. In short, some current relief may be obtained at the cost of storing up even more difficult problems for the future.

This picture admittedly differs considerably from that which the Commission portrays. Evidently, it sees itself as a pilgrim posted at a turning point in the upward trend of prices. Its reading of the economic signposts and its confidence in the outcome of the government's war on inflation, leave it in little doubt that the economy is in fact at a turning point. It is implied, furthermore, that this fact is more clearly appreciated in government than in private circles and that private expectations about future price changes are temporarily misguided. The Commission's mission, therefore, is to proclaim loudly its view of future price trends in the hope winning adherents to this view and to help guide both private and public decision makers smoothly on to a less inflationary trend. Without such guidance, it is suggested, many of these decision makers are likely to overshoot the turn and find themselves temporarily stranded on a high cost-high price embankment from which they can only be freed at the cost of considerable dislocation and unnecessarily high unemployment in the economy.

In order to avoid this from happening, Governments and business men have been asked to adopt the principle of reducing "the number and size of price increases they would normally make in 1970 by ensuring that such price increases are clearly less than the amount needed to cover increases in costs". A "comparable measure of restraint" is being asked for by wage and salary earners. Linked in happy harmony and guided by the Commission's sure sense of direction, business, labour and government, it is hoped, can round the turn to a more stable trend in prices with less disruption and cost if they voluntarily agree to real prices and wages (-- i.e. act as if the rate of inflation will be zero over contract periods) rather than conventionally bargain in terms of nominal prices and wages reflecting prevailing market forces. By voluntary agreement on real prices and wages is apparently meant a bargaining process whereby employers and employees attempt to anticipate directly, without going through the market, what their future real incomes would be were they to rely on the normal process of nominal price-wage interaction through the market, conditioned by the adjustments in aggregate demand deemed appropriate by the government.

Viewed in a different light, this picture of the Commission as a benevolent guide to smoother and less costly adjustment at times comes close to portraying a policeman prepared to use strong arm methods on employers and employees who resist the good advice given to them. The White Paper establishing the Commission gave assurances that the Commission would not play the role of a policeman and that it would not intervene in particular price and income decisions. In recent months, however, a more coercive approach has become apparent in the form of a detailed price review procedure that extends to the level of the firm, the threat of sanctions imposed by federal and provincial governments against errant firms and the threat of still tougher measures to come if existing methods fail to win compliance.

Regardless of whether one may more accurately view the Commission as a Pilgrim or a policeman, it seems naive to expect that a substantial range of the prices and wages in the community can be voluntarily established in real terms along the lines suggested. Moreover, given the openness of the Canadian economy, it is far from clear that even if this unlikely prospect were realized, nominal prices and wages would be much different than if they had been worked out in nominal terms in the first place. Faced with the need to forecast real prices and wages in Canada, one is likely to assume that the nominal prices of Canadian exports and imports will rise by about the same as U.S. prices. Further, one would expect most other Canadians to make the same assumption. On these assumptions and allowing for the secondary spill-over effects of changes in foreign prices on other sectors of the economy, one is very likely to end up assuming that nominal prices in Canada will rise by about the same amount as in the U.S. And if most Canadians build this assumption into their voluntary agreements on future real prices and incomes, nominal prices and incomes in Canada will rise by about the same amount as in the U.S. This is, of course, exactly what has happened over many years in the past. Thus, little will have been gained by working in terms of real rather than nominal terms, even if such a possibility were realistic.

Secondly, there is little reason for believing that the Commission has any better sense of the future direction of prices than the prevailing views on which the public is daily betting its money. As far as is known, little or no research has so far been done within the Commission on the short-term outlook for prices, production and employment; at any rate, none has been released to the public. If there is a convincing case to be made that current expectations about future price changes are wrong, presenting this case to the public would be one important way of inducing a change in expectations. As for market performance and the role of market power, here too we are no better informed than we were a year ago prior to the advent of the Commission. How, for example, can one explain those 50 per cent increases in wages awarded in the construction industry in Toronto last summer? Is the same thing likely to recur? Why are prices rising so much faster in the service sector than in the goods sector?

Thirdly by seeking agreement to a voluntary tax programme through a vigorous public relations job, the Commission may simply be hoping to impress on public opinion the Government's concern about inflation and thus to deflate the inflationary psychology which in some quarters seems to be regarded as the major source of trouble. This issue has already been referred to. Accepting the view that "money illusion" tends to restrain inflationary forces, this view might almost be interpreted as suggesting that one of the Commission's jobs is, in effect, to create more "money illusion" for anti-inflationary purposes. To the extent that the public's expectations about inflation are justified - and there is no evidence to the contrary - this amounts to suggesting that a public agency be established to "con" the public - a position that can scarcely be justified by any reasonable standard of public policy. Public morality aside, it is questionable whether an attempt to create "money illusion" has much chance of success, given the persistent price trends of past years in Canada and abroad and the plethora of ill-founded assurances from public officials over many years that, because of the steps being taken by the government, price stability is just around the corner.

Aside from effects on transitional adjustments, much of the emphasis recently given to inflationary psychology seems to be based on the premise that, because of expectations about future price changes, the trade-off relationship between the rate of price change and the level of unemployment has become less favourable. In other words, it is suggested that maintaining any given level of full employment has implied higher and higher rates of price inflation over time as the public has continuously adjusted upward its expectations about price changes. Although a theoretically feasible proposition, very little sound empirical evidence can be found to support the view that this is what has actually happened since 1965. Moreover, the lesson drawn by those who have emphasized this view of the trade-off relationship is certainly not that the appropriate antidote is a policy which attempts to work directly on expectations through education, propaganda or voluntary taxes. Instead, the emphasis is placed on more skilful use of monetary and fiscal policy, thereby providing some reasonable basis for expectations for greater price stability.

In considering the effect of a voluntary tax - price subsidy plan on the price-unemployment trade-off relationship, it is important not to fall into the trap of comparing measured market prices in the pre-Commission period with subsidized market prices in the post-Commission period. Drawing such a comparison would be misleading and an apparent improvement in the trade-off relationship on this basis would be illusory. Any price subsidy scheme can produce a once-for-all improvement in the price-change-unemployment relationship on this basis and such a comparison would be meaningless as a measure of the effectiveness of the policy. Leaving the question of adjustment discussed earlier aside, the key question is whether the relationship, measuring price changes on a comparable basis, is likely to be more favourable if a voluntary tax policy is followed than if mandatory monetary and fiscal policies are followed.

In principle there is no reason for believing that a voluntary tax system will result in a more favourable trade-off than use of more conventional mandatory tools. Indeed, exactly the opposite seems more likely. For one thing, whatever their weaknesses, the conventional tools are likely to be, and to be thought by the public to be, much more effective and acceptable in influencing economic activity than the will-o'-the-wisp of voluntary taxes. Further, having been launched with maximum publicity, the scheme may well evoke an adverse reaction on expectations after a time when, as seems quite likely, prices continue to rise. To the extent that expectations enter the picture, conventional weapons probably have more to offer than a voluntary tax.

Although one may question along the foregoing lines whether the Commission's activities are likely to make any significant difference to the future level of prices, wages and unemployment in this country, it must also be conceded that we are very poor in ideas about what else might be done to restrain prices whilst simultaneously maintaining full employment. The chances of the Commission having some favourable influence are not zero. Given that this is the first time such measures have been used, the uncertainty generated may itself serve to deter price changes. Even if this and other favourable influences seem weak and uncertain, what harm is there in at least trying this approach since no obvious alternatives are at hand except conventional monetary and fiscal measures and slow-moving measures to improve market competition?

The voluntary tax plan now being promoted by the Commission may be harmful in several respects. First, as already noted, it may easily result in an adverse reaction on prices if hopes for greater price stability are raised only to be subsequently disappointed. Secondly by setting out guide-lines below which no tax is levied and above which a 100 per cent tax is levied an incentive is provided to raise prices by the full extent of the guide-line. Given some slack in the economy which will permit some redistribution of resources, the guide-lines tend to become a floor rather than a ceiling. This conclusion is pointed up in a recent empirical study of U.K. experience with a voluntary tax scheme. And as the same study suggests, this feature of the voluntary tax scheme further implies that it is misplaced to suggest that the scheme should be used in conjunction with conventional tools to restrain inflation since it is precisely in these conditions, when some slack is induced in the economy, that the voluntary tax scheme tends to set a floor rather than a ceiling on price changes.

Thirdly, the Commission's voluntary tax plan, paraded with a maximum of public fan-fare, may serve as a major diversion. As a consequence other policies that are likely to be more effective in curbing inflation may be neglected. There seems little question that the main weaponry for dealing with price inflation remains conventional monetary, fiscal and exchange rate policies reinforced by special policies dealing with tariff reductions and steps to establish and enforce effective business competition. These options have been open to Canada during the past five years. Instead of assisting in the firmer application of these measures, the Commission has invited the public to place its faith in organized voluntarism.

These considerations bear particular emphasis in view of the suggestion being put about that a leading feature of the Commission's work is to reduce the lag in the response of prices to current economic conditions. From the standpoint of more accurately gauging the effects of policy changes both conventional monetary and fiscal policy seem highly preferable to a voluntary tax scheme. Further, these conventional tools, appropriately applied, are likely to have a more significant and useful effect on expectations. In addition, any apparent reduction in the lag of prices is likely to be illusory, because of the price subsidy implied by the Commission's scheme; in fact, as already pointed out, the scheme is more likely to increase the lag in price adjustments to developments over the past few years. Finally, given the recent appearance of slack in the economy and the possibibility of this situation continuing for some time, the voluntary tax system is as likely to serve as a floor on downward price adjustment as a ceiling on upward adjustments, judging from U.K. experience.

Fourthly, the Commission's activities may have the long-term effect, whether intended or not, of encouraging more direct government intervention in product and factor markets and of discouraging reliance on market-oriented policies implemented through monetary, fiscal and exchange rate measures. Whether one considers this good or bad is, of course, a very large question that cannot be pursued here. Nevertheless, it seems quite possible that the Commission's activities will lead in this direction. In the words of one commentator, "if the public, witch hunters and cost-push theorists that they are, judge the Commission's efforts to have been successful, they will conclude that formal wage and price controls would have been more successful still. If they judge the Commission to have failed they will conclude that it failed because the operation did not have enough teeth in it". In either case, the environment in which public policy is conducted may have become less market oriented and more interventionist in outlook than in the past.

Finally, the Commission's activities run a serious risk of undermining public confidence in the credibility of governments. As my old teacher Sir Dennis Robertson remarked fifteen years ago, "Persuasiveness and persuadability are valuable things; but, like most valuable things, limited in supply. It is the duty of society to create a framework of monetary law and administration, and to operate a regime of incentives and disincentives, which will prevent these precious qualities of persuasiveness and persuadability from being wastefully squandered through being set tasks which it is outside their compass to perform".

From the standpoint of current policy there remains, of course, the immediate and central question of what our policies should be now. This is a separate topic for discussion. To the extent that expectations about future price changes have been shaped by inappropriate policies in the past, the answer to this question may be more difficult to provide than would otherwise be the case. Be that as it may, how difficult it is to find an answer will depend in large measure on the particular objectives that we set for ourselves. It seems evident that Canada's price-level objective can be sensibly defined only in relation to the external factors conditioning Canadian wages and prices and the ability and willingness of governments to contain or offset these external influences. If we set as our objective a substantially greater degree of price stability in Canada than in the U.S. - greater say than we have been able to achieve on average during the 1960's - and the maintenance of a fixed exchange rate, the task becomes overwhelmingly difficult. Attempts to achieve this objective are likely not only to meet with indifferent success but also to prove very costly in terms of high levels of unemployment and real income foregone. The task becomes somewhat less formidable if some flexibility is allowed in the exchange rate but even so remains very difficult. In this connection it is noteworthy that since 1920, with the exception of the immediate post-war period, consumer price changes between Canada and the U.S. have been less on average - irrespective of whether Canada was on a fixed or a free exchange rate - than interregional variations in consumer prices within the U.S. If, more realistically, we set as our objective maintaining stability in the domestic component of prices and perhaps leaning somewhat against the inflationary winds blowing from south of the border, the task becomes much more reasonable. Pursuit of this more limited objective is likely to save us, on the one hand, from serious over-indulgence of our appetites and, on the other, from risky cures that may well be more harmful than the disease itself.