

## 4.2 Sectoral Development Strategy

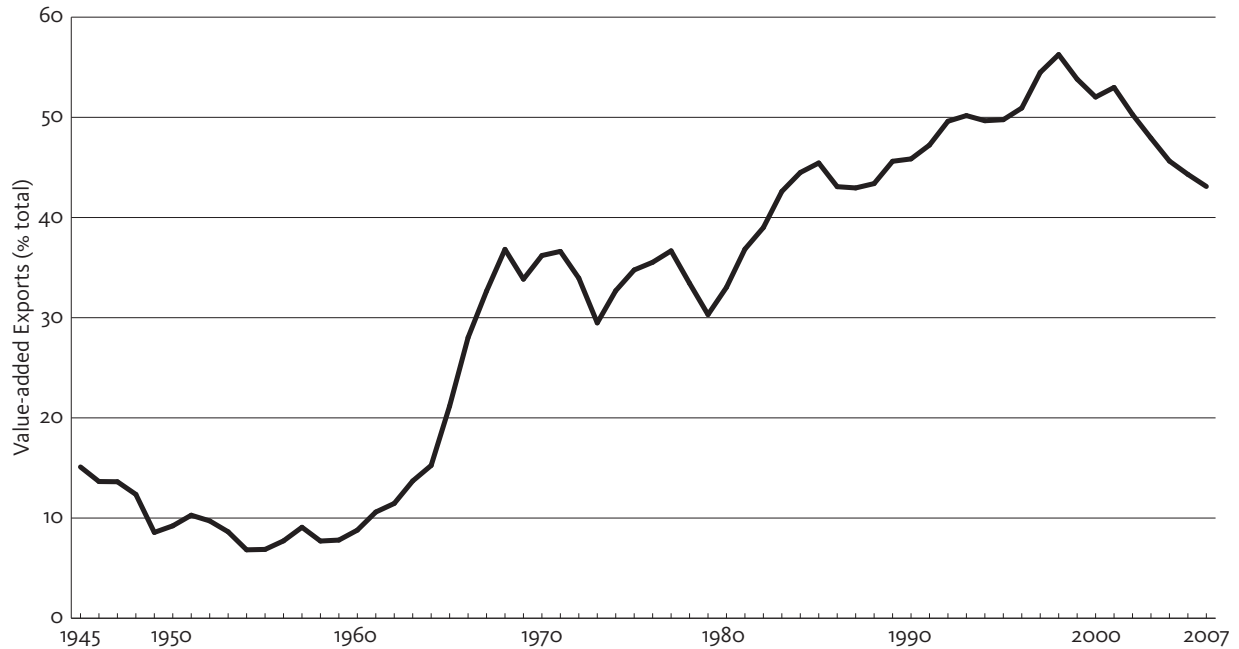
### Introduction

Canada's economy is experiencing a profound structural change that will define and (in many ways) limit our economic prospects for decades to come. We are increasingly specializing in the production and export of unprocessed or barely processed natural resources — especially energy and minerals. The phenomenal growth and prosperity of export-oriented resource industries has both positive and negative effects. On the positive side, it generates incomes and export revenues, some of which “trickle down” from the resource sector into other industries and regions of the country. The resource boom has clearly been an important factor behind the strong nominal income and spending growth that has contributed, until recently, to relatively healthy overall growth and job-creation in the Canadian economy. At the same time, however, the resource boom also carries several negative consequences, including longer-term risks posed to our currency, our value-added industries, our federation, our environment, and our role in the world.

The growth of resource extraction and export, along with the startling erosion of our value-added

manufacturing capabilities (a very negative development which is the flip side of the resource boom) has reversed Canada's previous progress toward becoming a more diversified and developed economy. Indeed, deliberately fostering the development of value-added industries, and reducing our national dependence on resource exports, has been a policy preoccupation of Canadian governments since before Confederation. A long series of important policies — from the National Policy, to the Auto Pact, to Technology Partnerships Canada and other measures — were aimed precisely at trying to ensure that Canadians harvested more value, more jobs, and more stability from the resources we were blessed to own. In the current era, however, where governments have adopted a much more passive role in economic development decisions (for both ideological and fiscal reasons), the market-driven specialization of Canada as global resource supplier has once again predominated. Of course, free trade agreements (especially NAFTA, which explicitly assigns Canada a role as energy storehouse for the U.S. economy, by virtue of its nefarious energy-sharing provisions) have been important in cementing this trend.<sup>1</sup>

FIGURE 1 Share of Canadian Exports from Value-Added Products



Graph shows proportion of Canadian merchandise exports consisting of finished products, machinery and equipment, automotive products, and consumer goods; excludes resource-based products and bulk commodities.

The impacts and consequences of this historic structural change in Canada's economy will be very long-lasting. Yet, despite the vast stakes, this evolution is not the direct result of any deliberate government or collective decision. It reflects the power of global market forces, and private investment decisions, over our economic destiny. Of course, by accepting and even celebrating the power of private businesses to fashion our economic future in this way, Canadian governments (and the federal government, especially) are ratifying their choices.

The Alternative Federal Budget believes that Canadians should take a long, hard look at the long-run consequences of this resource-led restructuring of our entire economy, and what it implies for our national economic and social prospects. We should not automatically assume that, just because overheated global commodity markets have driven prices for certain resources

to extremely high levels (for now, anyway), we should therefore reorganize our entire national economy in response. We should not automatically ratify the decisions by immensely profitable resource companies to commit hundreds of billions of dollars to new resource extraction projects that will shape our national economy for a generation, without carefully reviewing (and regulating) the broader consequences of those massive investment decisions. And we should not accept that Canada's entire economy is being fundamentally remade, before our eyes, without conscious, collective deliberation.

These are huge, epochal economic issues that require more detailed description and analysis. A companion AFB Technical Paper will consider these structural challenges, and possible policy responses, in more detail. This section of the 2008 Alternative Federal Budget will summarize the evidence regarding Canada's backwards

structural evolution, and then describe two sets of policies. The first is aimed at deliberately slowing and controlling the resource boom. The second attempts to foster and support value-added economic activity in Canada, in order to moderate the extent to which our future economic eggs are placed in the energy export basket, and ensure that Canadians receive maximum long-term value for the resources that happen to be buried beneath our feet.

### The Dimensions of Regression

One very simple graph summarizes the extent to which Canada's economy is currently hurtling "back to the future" as a result of the resource boom on one hand, and the corresponding decline of value-added activities on the other.<sup>2</sup> Figure 1 illustrates the proportion of Canada's total merchandise exports which consist of higher-value-added products (such as machinery, automotive, and consumer products), as compared to unprocessed or barely-processed resource products (including energy, minerals, raw forestry products, and agricultural products). This ratio has grown fairly steadily over most of Canada's history, reflecting our qualitative economic development and our growing capacity to produce a broader range of products (for both the home and global marketplaces). Deliberate government programs (including pro-active measures once known as *industrial policy* — now perhaps more appropriately termed *sectoral development policy*) played an important role in this gradual progress. So did broader economic and social factors, such as the fact that Canada's currency was undervalued for much of the 1980s and 1990s, and the fact that Canada's public health care system significantly reduced labour costs for private employers (in contrast to the U.S.); both these factors were important in attracting investment in value-added manufacturing industries.

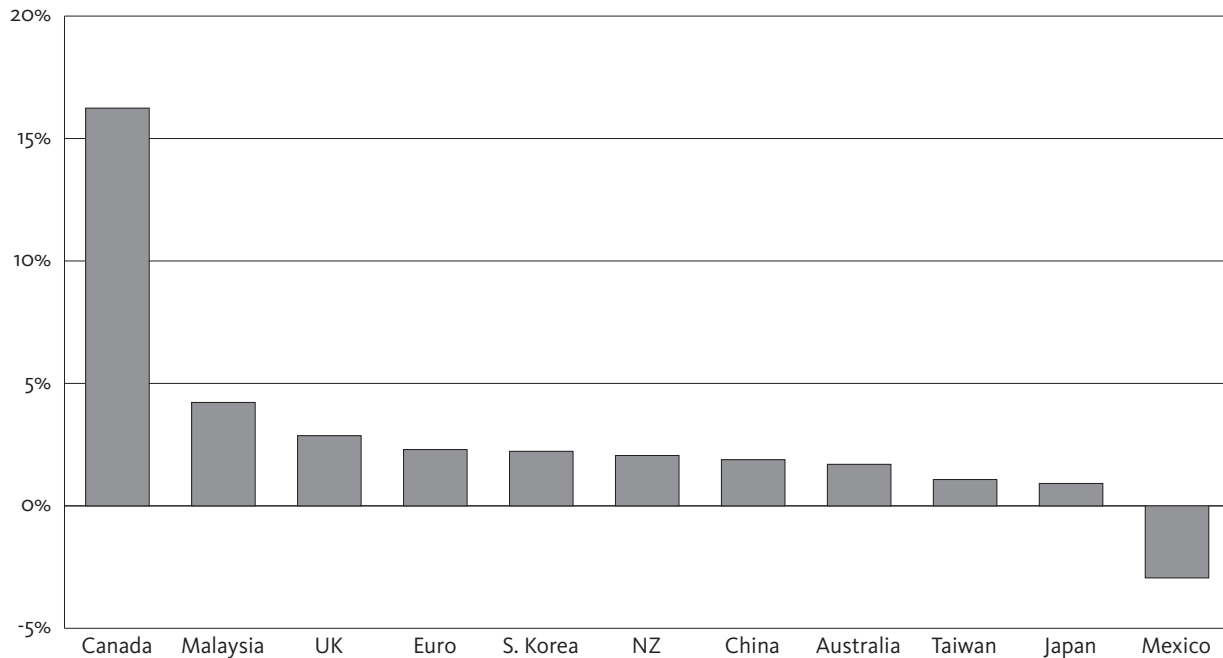
Since 1999, however, Canada's economic trajectory has been fundamentally altered, as the

result of a powerful combination of factors. From a peak of 57% that year, the proportion of our exports consisting of higher-value-added products has plunged by about one-third — to as low as 42% in 2007. This reflects both an increase in unprocessed or barely processed resource exports (these exports have increased mostly because of very high prices for these commodities, but also because of modest increases in the real quantities of resources being exported), and a decline in value-added exports. Manufactured exports have declined as a result of a slowdown in the U.S. market (the destination for most of our exports), competition at home and abroad from new global producers (such as China), and the rise of the Canadian dollar (which has made Canadian-made products very expensive to global customers).

The dramatic run-up in the Canadian dollar is both a consequence and a further cause of Canada's structural economic regression. Rightly or wrongly, currency markets have come to associate Canada's currency with global commodity prices (especially world oil and minerals prices). Our currency has appreciated against the U.S. dollar by over 60% in the last five years. The rise in Canada's currency has been the most dramatic of all the major U.S. trading partners. Indeed, the rise in Canada's dollar against the U.S. dollar has been three times as large as the overall decline in the U.S. dollar (measured against the broad basket of global currencies); this suggests that most of the upward pressure on the loonie reflects unique factors in Canada's economy and policy, not just a general, global weakness in the U.S. currency.

Canada is unique in the world in its decision to tolerate such a large appreciation against the U.S. dollar, despite its very heavy reliance on the U.S. market for its exports; the combination of uniquely rapid appreciation with unique dependence on U.S.-bound exports leaves Canada far and away the most vulnerable country in the world to currency fluctuations (see Figure 2). No

FIGURE 2 Export-Weighted Appreciation Against U.S. Dollar Since 2002



Graph shows proportional rise of national currency against the U.S. dollar from 2002 (year average) to end-January 2008, weighted by the proportion of each country's GDP that is exported to the U.S. market.

producer in global markets could tolerate a 60% erosion of its relative cost competitiveness without experiencing dramatic and painful consequences — and Canada is no exception.

The skyrocketing dollar is resulting in a terrible downturn in investment, production, and employment in Canadian manufacturing, exacerbating other challenges facing our value-added industries (such as competition from China, the restructuring of the North American auto industry, and other factors). At time of writing, the Canadian manufacturing sector had lost some 350,000 jobs since 2002, when the loonie first started rising. For every new job that has been created in resource industries during the current boom, at least five jobs have disappeared from manufacturing. Canada's structural regression is not opening up nearly as many economic doors as it is closing.

It is worth considering carefully why it is that higher oil and minerals prices have translated so

directly and obviously into an overvalued Canadian currency — because how we understand this relationship will help us decide what to do about the problem. The upward pressure on the dollar does not result from a resource-driven improvement in Canada's trade balance. In fact, our trade balance has deteriorated markedly with the rising loonie: a flood of lower-cost imports is more than offsetting the rising value of our resource exports. Nor does the loonie's rise reflect a real inflow of new foreign investment aimed at developing our tar sands, mines, and other resource facilities. Here, too, the outflow of real foreign investment by Canadian companies (lured by lower cost opportunities in other countries) has generally outweighed the inflow of new real investment to Canada by foreign companies.

Rather, the link between oil prices and the loonie has likely been effected mostly through financial channels, as follows:

- Canadian resource companies (especially oil and gas companies) have collected immense, unprecedented profits as a result of the global commodity price boom.
- Their share prices have soared, attracting interest from foreign financial investors.
- Many resource companies have been taken over completely by foreign companies.
- The value of these takeovers expanded dramatically in 2007, to over \$100 billion.
- The resulting inflow of foreign *financial* capital (not, for the most part, *real* foreign investment) has further driven up the dollar.

This suggests that measures aimed at regulating both the profitability of resource extraction and the foreign takeover of Canadian resource companies would have a powerful impact in limiting the upward pressure on the Canadian currency from the current resource boom (however long that boom lasts).

### Managing the Resource Boom

The 2008 AFB will implement the following measures to ensure that the future pace of mineral and energy development is more consistent with the broader economic and environmental well-being of Canadians:

- *Restore the federal corporate income tax rate to 28% (the initial level that prevailed before deep federal CIT cuts beginning in 2003) for the oil and gas industry.* That will raise approximately \$1.75 billion per year in new federal revenue.<sup>3</sup> The application of differential corporate tax rates for particular sectors has been a feature of federal tax policy at many times in the past, motivated by the desire to stimulate particular sectors (such as secondary manufacturing and processing) or tax particularly lucrative

sectors (such as energy or finance). Recent federal governments have moved away from this deliberate tailoring of sectoral tax policies (reflecting a superficially more “neutral” approach to taxes), but the differential tax rate we propose is by no means unprecedented in Canada’s recent economic history. In 2006, the average after-tax return on equity of the Canadian oil and gas industry reached almost 20% — almost twice as high as the return on equity in other non-financial industries in Canada.

- *Implement a new federal environmental review and approval process regarding new mining and oil sands investments, aimed at controlling aggregate greenhouse gas emissions from those projects in line with federal emissions reduction targets.* Approval for new investments would thus be contingent on the industry’s overall progress in reducing emissions from existing and future projects.
- *Strengthen the regulatory powers of the National Energy Board regarding approval permits for exports of oil and natural gas, and the construction of new export-oriented pipelines.* Approvals for new exports and pipelines must be contingent on satisfactory assurances to the Board regarding security of supply for Canadian consumers, the availability of Canadian natural gas supplies to meet federal targets regarding greenhouse gas emissions, and commitments by producers to the expansion of value-added resource projects (such as upgraders and petrochemical facilities) in Canada.
- *Reform Investment Canada legislation to establish a transparent and binding net benefit test for foreign acquisitions of Canadian-based companies.* To receive approval for a foreign takeover, purchasers

must agree to meet negotiated levels of new real investment spending in Canadian facilities (including investments in value-added facilities, such as refining and processing), preserve Canadian employment levels, and demonstrate that new production and income generated as a result of their acquisition more than outweighs the new liability created to the foreign owners (and the consequent ongoing payment of capital income to those owners).

- *Establish a new joint Aboriginal Benefits Agency to negotiate with the owners of new energy and minerals projects on federal lands to meet targets for the employment of Aboriginal persons and other economic benefits to Aboriginal communities.* Every resource project approved on federal lands must reach an agreement with this Agency regarding the extent and timetable of benefits. The Agency will be governed jointly by the federal government and Aboriginal representatives; its operations will be funded through application fees from resource developers.
- *The collection of royalties on resource extraction in Canada is a provincial responsibility under our Constitution.* Scandalously low provincial energy royalties have contributed to the unsustainable gold-rush-style expansion of tar sands projects. Recent measures announced by the Alberta government will not significantly alter this situation.<sup>4</sup> The unfettered rush to develop energy resources is producing wasteful cost overruns and unnecessary pressure on economic and social infrastructure, and also imposes real economic and environmental costs on all Canadians. At the same time, the huge revenues associated with energy products are

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Restoring the corporate income tax rate will be of benefit to women if revenues generated by the increased rate are re-invested in social spending, including in programs which increase women's access to highly skilled well-paid work, training and employment programs, and family supports, including a national early learning and child care program.

Other broad based social investments in services like public transportation and safe and affordable housing will also serve to strengthen Canada's social architecture, thereby going a long way to ensure women's economic security.

Canada has lost tens of thousands of jobs that pay family-supporting wages because Canada's manufacturing sector is in crisis.<sup>8</sup> Canada has lost more than a quarter million manufacturing jobs, about one in ten positions since 2002. These jobs paid wages of \$20.68/hour on average.

Canadian workers displaced by firm closures and mass layoffs who can find other jobs suffer an average decline of 25% in annual earnings which equates to a loss of about \$10,000 for a typical manufacturing worker. Given the loss of one-quarter of a million manufacturing jobs, the total loss of Canadian earnings is estimated at \$2.5 billion annually.<sup>9</sup>

These changes have a profound impact on the lives of women who not only work in this sector but who also live in communities reliant on the sector for survival. Economic slumps often translate into loss of social services such as hospital and school closures which greatly disadvantage women and their families.

fundamentally altering the fiscal make-up of the Canadian federation.<sup>5</sup> The 2008 AFB will therefore impose a 25% excess profits surtax on petroleum production, to be integrated with the new federal carbon pricing strategy. Any future increases in provincial royalty rates will be deductible against this excess profits tax (such that the federal government receives excess revenue only when provincial royalty rates are too low).<sup>6</sup> The purpose of this tax is

twofold: to slow down the unsustainable pace of resource development (which has imposed costs on the rest of the economy, in part through the overvalued currency), and to encourage oil-producing provinces to raise their own royalty rates to fairer, more sustainable levels — thus ensuring that Canadians receive more value for the resources that they own. (Because they are contingent on the level of provincial royalties, funds from the excess profits tax are surplus to the specified measures and programs outlined in this document and would be deposited into general federal revenues.)

#### Fostering Higher-Value-Added Activities

The 2008 AFB will utilize revenues from the restoration of corporate income taxes on the oil and gas industry to fund the following initiatives aimed at enhancing the longer-term success of industries which add value to Canadian resources, and diversify our economy:

- *The AFB will establish a Value-Added Development Agency, funded from the additional tax revenues accruing through the restoration of corporate income taxes in the oil and gas sector.* One-third of those funds will be directed to supporting efforts aimed at fostering higher-technology processing and secondary manufacturing within Canadian resource-based industries (including energy, minerals, forestry, and agriculture). The remaining two-thirds will be dedicated to supporting new investments and projects in other strategic, higher-value-added tradable industries — including strategic manufacturing sectors such as auto, aerospace, electronics, environmental equipment, telecommunications, engineered building products, and others;
- *The AFB will establish a new Canadian Auto Strategy, building on recommendations from the Canadian Automotive Partnership Council (a group which includes auto assemblers, parts makers, and auto workers).* As part of this strategy, the federal government will commit to match provincial government participation in future strategic auto investments in both assembly and parts projects (funded from the Value-Added Development Agency above), to a maximum of \$750 million in total federal contributions over the next five years.
- *Also to be implemented will be a new Canadian Forestry Strategy, with*

emerging high-technology clusters (such as life sciences and alternative energy industries); and high-value tradable services industries (including high-value tourism, communication, and transportation industries). The Agency will have various delivery mechanisms at its disposal to support incremental sectoral development initiatives, including grants, repayable loans, technology assistance, and even equity participation in new ventures. The Agency's goal will be to use its own funds to leverage maximum investment spending by other partners in supported ventures. Prospective projects will be evaluated and ranked on the basis of broader economic and social criteria, including the use of innovative technology; the export potential of products; contribution to environmental goals; and specific employment targets. The Agency will be governed by an independent board of directors which includes regional, labour, and aboriginal representation. Initiatives financed by the Agency will require input and approval from relevant Sector Development Councils (*see below*).

*recommended measures proposed by business, labour, and environmental stakeholders, to address the unprecedented crisis in forestry that has devastated dozens of northern communities.* This strategy will also disburse supports for new investments in forestry technology, to a maximum of \$750 million in federal contributions over the next five years.<sup>7</sup>

- *A special focus in all projects supported by the Value-Added Development Agency will be placed on implementing and advancing green technologies, including advanced energy-conservation and pollution abatement equipment.*
- *The AFB will establish multi-stakeholder Sector Development Councils in identified sectors (including major resource industries, key manufacturing sectors, and strategic tradeable service industries such as tourism, film and broadcasting, and business services).* On a parallel track, environmentally-focused cross-sector Green Jobs Councils will be established to promote the adoption of advanced environmental technologies and the development of Canadian-based industries to supply those technologies (such as wind power equipment, energy-efficient automotive components, and others). The Sector Development Councils are responsible for identifying major economic challenges and opportunities facing the identified sectors, and developing policy responses. Each Council must include representation from business, labour, government, and non-governmental stakeholders. The operation of the Councils is funded with an annual \$50 million budget, paid from the Value-Added Development Agency. Identified projects and policies recommended by the Councils

can apply for additional funding from the Agency.

- The *Bank of Canada Act* explicitly instructs our central bank to act in the interests of broad economic stability. Unfortunately, in recent years the Bank (backed by the federal government) has interpreted this mandate far too narrowly, focusing solely and strictly on inflation control. The federal government's formal agreement with the Bank of Canada regarding inflation targeting should be amended to clarify that the Bank's pursuit of inflation targets must be conducted in the context of protecting broader financial and macroeconomic stability, including the exchange rate and Canada's external competitiveness — consistent with the current *Act*. The run-up in Canada's currency reflects the broader structural changes discussed in this chapter, more than monetary policy. But the Bank of Canada's recent actions (first increasing interest rates to control domestic inflation despite the damage being done by the currency, and then failing to match U.S. interest rate cuts as the continental economy dramatically weakens) have made matters worse. The Bank must be directed to pursue its mandate more broadly and flexibly. Other export-dependent economies (including Japan, Mexico, China, and Taiwan) actively and successfully manage their currencies to retain cost competitiveness in global markets. The claim by the Bank of Canada and the federal government that currencies cannot be actively managed is clearly false; Canada's inaction on the currency has imposed a disproportionate burden of adjustment on our economy to the decline of the U.S. dollar and other global developments. Ultimately, of

TABLE 9 Sectoral Development Strategy Summary of Proposed Measures

<b>Revenues:</b>	\$1.75 billion
Restore corporate income tax rate to 28% for oil and gas sector.	Unknown*
Excess profits tax on petroleum production	
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<b>Expenses:</b>	\$1.75 billion
Annual contributions to Value-Added Development Agency, including:	
• Auto Strategy (\$750 m over 5 yrs)	
• Forestry Strategy (\$750 m over 5 yrs)	
• Sector Development Councils (\$50 m/yr)	
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<b>Regulatory Measures (no fiscal impact):</b>	
• Environmental approval for new oil sands projects	
• Restore NEB power to regulate energy exports	
• Amend Investment Canada Act re foreign takeovers	
• Create Aboriginal Benefits Agency	
• Revise Bank of Canada target instructions	
• Changes in foreign trade policy	

\* Tax revenue is contingent on level of provincial energy royalties collected; this revenue is therefore not budgeted within the AFB and is surplus to identified needs.

course, a balanced international solution to the problem of currency instability is required — one that imposes a fair share of the adjustment burden on all regions (especially those enjoying large trade surpluses).

- *Federal trade negotiators will be directed to make adjustments to our trade policy consistent with our broader effort to maximize the domestic spin-offs from resource development, and foster a more diversified and sustainable industrial base.*

In particular, free trade negotiations with Korea (a country which imports Canadian resources and exports back a much larger quantity of higher-value manufactured products) will be stopped, as will FTA negotiations with Colombia (a country whose notorious record of human rights abuses would implicitly be approved by a Canadian trade deal). Negotiations will be opened with China aimed at ensuring an ongoing reduction in the quantitative and qualitative imbalance in bilateral trade with that nation, setting targets for

future Chinese purchases of higher-value-added Canadian manufactured goods. Failing success in those negotiations, Chinese access to Canadian markets will be curtailed through targeted tariffs and other safeguard measures. Discussions will also be initiated with the U.S. and Mexico to eliminate Chapter 11 provisions from NAFTA; failing success in those negotiations, Canada will unilaterally repeal Chapter 11.

### Fiscal Implications

The measures described in this chapter are fiscally neutral, in that all of the new revenues raised as a result of higher corporate income taxes in the oil and gas sector are allocated to measures aimed at better managing resource development and fostering the development of higher-value-added industries in Canada. Table 9 summarizes the fiscal impacts of this section of the Alternative Federal Budget.

## Notes

**1** The shameful actions of Exxon-Mobil, in using NAFTA's Chapter 11 mechanisms to challenge Newfoundland's recent attempts to require petroleum producers in that province to fund provincial energy-related R&D activity is just the latest example of how NAFTA hamstringing Canada's ability to maximize the domestic benefits of resource developments. Exxon-Mobil recently reported the largest annual corporate profit in world history (over \$US 40 billion).

**2** The term "value-added" activities can refer to industries which aim to enhance and diversify value-added production through secondary processing and manufacturing of resources; the growth of other tradable industries (including both manufacturing and tradable services) which reduce our reliance on resources; and the more intensive qualitative and quantitative development of the supply industries which feed into resource extraction. All of these industries would help Canada to both reduce its reliance on raw resource extraction, and to maximize the domestic economic spin-offs from resource activity.

**3** Pre-tax profits in the oil and gas and related services sector have averaged \$25 billion per year in the past three years (and with oil prices testing all-time record levels, those profits are certainly not going to decline in coming years). Restoring the basic federal rate to 28% (from 21% at present) for this sector will raise an additional \$1.75 billion per year (7% of \$25 billion).

**4** In fact, ironically, the impact of the Alberta royalty proposals on the bottom-line of new oil sands developments has been more than outweighed by the new proposed federal corporate income tax cuts — so that on balance the overall tax environment has become *more* amenable to new oil sands developments.

**5** Measured in terms of per capita GDP, the three oil-producing provinces — Alberta, Saskatchewan, and Newfoundland — are now the only "have" provinces in Canada (with per capita GDP exceeding the national average). Every other province (including Ontario) is now a "have-not" province.

**6** The excess profits tax would be structured as follows. Oil and gas companies are charged a surtax equal to 25% of any net after-tax income reported the preceding year, in excess of that sufficient to generate a 15% return on average shareholders' equity. Any post-2007 increase in effective provincial royalty rates (measured as a share of gross revenue) would be deductible against the surtax, up to the point of reducing the surtax to zero. This tax establishes a "use it or lose it" incentive for provincial governments: they must increase their royalty regimes sufficient to reduce after-tax return on equity in the oil and gas industry to no higher than 15% (a level which is still far higher than average returns experienced in Canadian businesses as a whole), or else the federal government will occupy the corresponding fiscal space. Because the revenues from this excess profit tax will be contingent on provincial royalty rates, they are not predictable and hence are not counted within this budget.

**7** Federal participation in the auto and forestry strategies would thus together constitute just over 15% of the total investments made by the Value-Added Development Agency (\$1.75 billion per year).

**8** [http://canadianlabour.ca/index.php/Made\\_in\\_Canada\\_Jobs](http://canadianlabour.ca/index.php/Made_in_Canada_Jobs)

**9** [http://canadianlabour.ca/index.php/Made\\_in\\_Canada\\_Jobs](http://canadianlabour.ca/index.php/Made_in_Canada_Jobs)