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To offer Financial Incentives or not….that is the Question!

We have just completed another round of CAW labour negotiations and I have to hand it to Buzz Hargrove. He said he wouldn't settle for anything less than a "substantial" improvement in compensation and sure enough, he successfully negotiated a "substantial" improvement in compensation. By my estimate (the CAW's own estimates are lower) he levered close to 20 percent additional money out of the "Big Three" over a three-year term:

- Base wages increase by three percent, three percent and two percent, which is eight points plus compounding.
- Plus COLA of 90 percent of the CPI. With inflation forecast by the Conference Board at 2.5 percent per year that would be an additional 2.25 percent of wages each year or about seven points over the life of the agreement.
- Plus, Christmas bonuses increase by $300 per year from $1,200 to $1,500.
- Plus, a $1,000 signing bonus.
- Plus, 28 hours of additional paid time off.

Not a bad package for the autoworkers at these companies. With any sort of increase in inflation above 2.5 percent, this contract could cost each company close to 20 percent over the life of the agreement. Even with lower inflation it would still cost at least 15 percent.

Why would the Canadian arms of the "Big Three" agree to these very generous contracts? Remember, the "Big Three" are finding it difficult to hang onto market share in the face of intense competition from import nameplates. More than half of the import nameplate volume is now sourced in North America (we call this product "New Domestic" or "New North American Manufacturer" or "NNAM") and these generous labour agreements make the "Big Three" less competitive relative to this "NNAM" production.

The reasons the "Big Three" gave the CAW what it wanted are somewhat different for each company, but it basically comes down to the importance of Canada in each company's profit picture. The "Big Three" have serious issues to work through in North America but at the same time Canada is a real jewel in each organization's crown. The value of our dollar together with the cost of Medicare relative to the U.S. gives Canada a significant competitive advantage on wage and salary costs. And the plants in Canada are consistently more productive (on an hour-per-vehicle basis) than most other plants in North America. With their

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NORTH AMERICAN PRODUCTION OF VEHICLES - # OF UNITS
INCLUDES HEAVY DUTY TRUCK

YEAR	Total Production All Companies	Total NNAM Production	NNAM as a Percent of North American Production	CAW/ UAW Vehicles	All Other Vehicles	Percent Non CAW/UAW Vehicles	Total Assembly Employment Canada	Vehicles per Worker Canada
1990	12,535,407	2,036,004	16.2%	10,445,254	2,090,153	16.7%	50.3	38.7
1991	11,666,786	2,242,740	19.2%	9,336,250	2,330,536	20.0%	53.5	35.3
1992	12,730,542	2,356,109	18.5%	10,214,702	2,515,840	19.8%	52.7	37.1
1993	14,182,789	2,612,165	18.4%	11,634,874	2,547,915	18.0%	54.8	41.0
1994	15,670,300	2,972,785	19.0%	12,823,690	2,846,610	18.2%	56.4	41.2
1995	15,337,136	2,999,468	19.6%	12,395,696	2,941,440	19.2%	56.2	42.8
1996	15,450,079	3,109,769	20.1%	12,113,370	3,336,709	21.6%	57.7	41.6
1997	16,054,685	3,237,965	20.2%	12,487,423	3,567,262	22.2%	54.7	47.0
1998	16,032,875	3,487,433	21.8%	12,241,343	3,791,532	23.6%	57.9	44.4
1999	17,615,754	3,699,024	21.0%	13,565,369	4,050,385	23.0%	57.1	53.6
2000	17,658,239	4,103,226	23.2%	12,950,876	4,707,363	26.7%	55.9	53.0
2001	15,819,371	3,990,789	25.2%	11,206,709	4,612,662	29.2%	51.6	49.1
2001/2000	**-10.4%**	**-2.7%**	**8.6%**	**-13.5%**	**-2.0%**	**n.a.**	**-7.7%**	**-7.3%**

Source: DesRosiers Automotive Consultants Inc.

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problems in the rest of North America you have to believe that the last thing the “Big Three” would want to do is mess up Canada by taking on the CAW in a nasty labour dispute. Mr. Hargrove knows this and used it to his advantage. It will be interesting to see whether the UAW uses Canada as a pattern for their agreements scheduled to expire next fall.

On the other hand, the gold-plated labour agreements negotiated on both sides of the border over the last decade are also one of the reasons CAW/UAW-produced vehicles are losing so much market share within the North America production base.

In 1990, CAW/UAW workers produced 83.3 percent of the vehicles in North America. Last year they produced only 70.8 percent of the vehicles. There is an additional 1.2 million units of known import nameplate capacity coming to North America over the next five years and most, if not all of it, will be non-unionized. In addition, the CAW/UAW have not penetrated existing non-union assembly plants. It is possible that non-CAW/UAW-produced vehicles will exceed 40 percent of North American production by the end of the decade.

Moreover, the market is not growing enough to offset the additional capacity being added to North America. This will inevitably mean further plant closings at unionized facilities, not unlike the half dozen that have been announced for North America over the last year, including the three in Canada — General Motors’ Ste. Therese, Ford’s Ontario Truck Plant in Oakville and the DCX full-size van plant on Pillette Road in Windsor.

This flies in the face of the other primary objective of the CAW/ UAW, and that is job security. I find it ironic that the CAW/UAW have negotiated labour agreements over the last decade that have cost the “Big Three” some of their competitive advantage and thus lost market share that has resulted in plant closings. And at the same time

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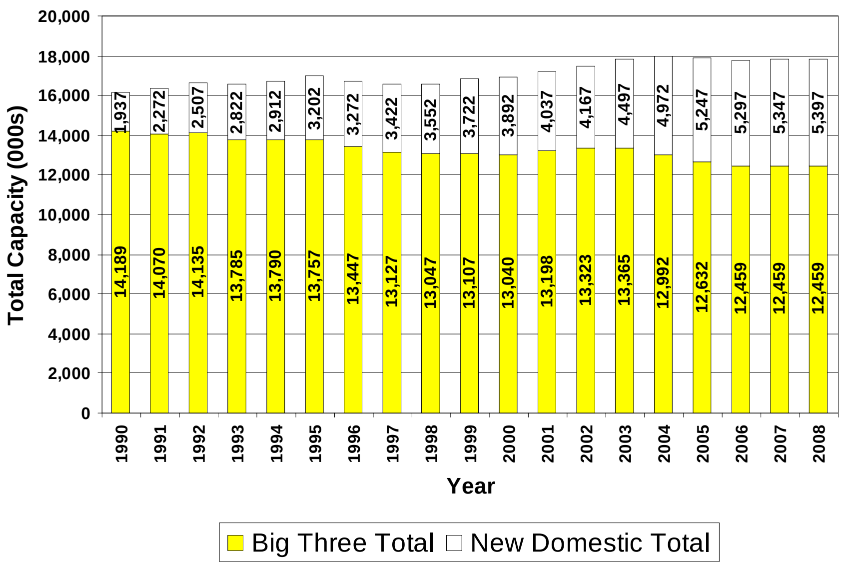
the CAW/UAW have been successful negotiating job security commitments from the OEMs, which ultimately make them even less competitive.

Supply - North American Capacity



Source: Merrill Lynch

The CAW's approach to job security, however, is much smarter than the UAW's approach. In these latest agreements the CAW has gone after the job security objective by getting the OEMs to commit to additional investments in Canada. The theory being that if a company invests, it ultimately will create jobs. The CAW, together with the OEMs, has added an important wrinkle to the equation. Both the Ford and DCX investment announcements have been made contingent on Federal and Provincial financial incentives. They have, in essence, put our governments into the middle of this equation. If governments don't step up with some sort of incentive money it will be the governments who will be blamed for job losses, not the OEMs or the CAW. Of course the governments are not to blame since it isn't the governments who have lost market share, which is forcing a re-alignment of the production base. But the CAW and the OEMs will certainly put the blame squarely at the feet of governments.

The whole issue of financial incentives for the automotive industry is now up for debate. In some respects the timing could not be worse. First, for the CAW to come out and lobby for incentives while at the same time announcing very generous labour agreements is too coincidental. It comes across to the public as the government subsidizing highly paid unionized workers. It isn't, but the public interprets it that way. Second, it creates a serious discrepancy in logic. How can the OEMs afford these generous wage increases but not afford to invest in Canada? The union argues the OEMs can afford these Agreements because Canada is more productive and is also a much lower cost location for vehicle assembly. If that is the case, then why do you need financial incentives to invest? Third, the governments within Canada are currently embroiled in a serious debate on how to spend scarce resources and set priorities. Who gets funded — health care or education or infrastructure or security or the military? How do you politically give a big multi-national hundreds of millions in subsidies and then not fully fund these other priorities? Even if it makes economic sense, politically it is extremely difficult to sell. Fourth, Ottawa is in the midst of an 18-month power struggle over who will replace Jean Chretien as Prime Minister. Will anyone want to pay any attention to this issue especially since the three prime contenders for Prime Minister all have an automotive

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side to their career? Allan Rock is the current Industry Minister, John Manley used to be Industry Minister and Paul Martin has ties to Windsor and his Finance portfolio historically has been very influential in automotive policy matters. I am not sure any of the contenders would want to come out politically at this time and support corporate America.

Twenty-seven influential mayors, led by Mike Hurst from Windsor, have also entered the debate and written a letter to Ministers Allan Rock and Jim Flaherty asking for a meeting to discuss the issue. They document the importance of the automotive industry to Ontario and some of the current issues the industry faces. Their primary concern is the lack of new "Greenfield investments" in Ontario in the face of aggressive financial incentives being offered in the U.S. Southeast. They make the case that Ontario has not gotten a new Greenfield investment since 1989 whereas over one million units of Greenfield capacity has gone into the U.S. South. They make the point that Ontario and Canada will definitively not get any future Greenfield assembly investments unless the governments start to play the financial incentive game that is the current norm in the industry. They make a very interesting point. In the appendix to their letter they document that every single assembly plant in Canada can be tied back to some sort of financial incentive in the past — it is just that the incentive wasn't up-front money like the kind being offered by the U.S. south today. For instance, Chrysler had violated their commitments under the AutoPact in the early 1970s and owed over $70 million in duty. They got out of paying this duty by building their full size van plant in Windsor. The Chrysler Mini Van plant was tied to the loan guarantees in their bailout package in the early 1980s. Both Honda and Toyota avoided time-delaying and profit-killing vehicle inspection programs when they first built in Canada and their expansions have benefited from millions of dollars in duty breaks by the government eliminating the duty on OE parts. It is an interesting list and I've attached it to the end of this *Observation*.

It is hard to argue against the mayors on this point. What is the difference between giving a company tens of millions in the form of reduced duties, FIRA exemptions, AutoPact rule changes, special FTA or NAFTA language and so forth, versus giving the same companies the outright financial incentives that they get from the U.S. South East? Aren't all these multi-million-dollar backroom deals with the OEMs negotiated by Canada over the last 25 years also a type of financial incentive? Canada has always relied on these other types of financial incentives (not just Canada's great competitive advantage) to attract investments. So why is the government so afraid to play the financial incentive game today? I don't have an easy answer to the mayors' logic.

The government is a bit two-faced about all this on the political front. They are more than willing to find a way to forward millions and millions in assistance to companies when they can hide it or package it in other forms but are not willing to take the political heat by coming up with the money directly. For instance, Ontario just announced millions in subsidies for the electricity market. Isn't the whole thing just politics?

This is why GM's suggestion of tackling the issue through the corporate tax window makes a lot of sense. The government could give the OEMs a reduced capital tax or eliminate it entirely. This also isn't easy to do politically but is more sellable than providing up-front grants to these big multinationals. It is also more

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fair in that anybody can take advantage of them; they are out in the open; and they don't smell of special back-room deals. If you want to attract capital to this country in the form of Greenfield investments, you would think that the last thing you would want to do is tax it.

Although I agree with the mayors that Canada hasn't gotten any Greenfield investments recently, Canada has done very well on the investment front in the vehicle assembly sector. Canada has received over 20 percent of Canada-U.S. assembly investment over the last decade and a half (we do not have data for Mexico, but if factored in, Canada would still have averaged over 15 percent of North American assembly investment). Due to these investments, Canada has increased its share of North American production. Only four regions in North America have

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Vehicle Production by Region in North America

Region	1990	1995	1999	2000	2001	Average Growth
(9)Pacific	332,269	393,788	437,408	397,462	384,786	1.3%
(8)Mountain	2,996	-	-	-	-	n.a.
(7)West South Central	443,462	546,325	599,454	575,936	423,970	-0.4%
(6)West North Central	1,326,570	1,249,987	1,707,313	1,565,194	1,518,305	1.2%
(5)East South Central	844,717	1,770,866	1,891,980	1,897,463	1,732,374	6.7%
(4)East North Central	5,429,972	6,508,963	6,576,383	6,604,542	5,933,110	0.8%
(3)South Atlantic	1,048,143	1,079,373	1,428,164	1,356,802	1,141,442	0.8%
(3)Canada West	1,734	5,246	7,307	5,173	2,020	1.4%
(2)Middle Atlantic	338,665	444,885	383,101	375,148	289,866	-1.4%
(2)Mexico South	651,632	608,148	1,033,075	1,384,285	1,379,320	7.1%
(1)New England	-	-	-	-	-	n.a.
(1)Mexico North	167,423	326,569	501,085	538,604	477,794	10.0%
(1)Canada East	1,945,637	2,402,753	3,049,309	2,956,463	2,530,343	2.4%
Other	646	1,061	1,175	1,166	836	2.4%
Total	**12,533,865**	**15,337,964**	**17,615,754**	**17,658,239**	**15,814,166**	**2.1%**

Region	1990	1995	1999	2000	2001	Difference 1990 & 2001
(9)Pacific	2.7%	2.6%	2.5%	2.3%	2.4%	-0.2%
(8)Mountain	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
(7)West South Central	3.5%	3.6%	3.4%	3.3%	2.7%	-0.9%
(6)West North Central	10.6%	8.1%	9.7%	8.9%	9.6%	-1.0%
(5)East South Central	6.7%	11.5%	10.7%	10.7%	11.0%	4.2%
(4)East North Central	43.3%	42.4%	37.3%	37.4%	37.5%	-5.8%
(3)South Atlantic	8.4%	7.0%	8.1%	7.7%	7.2%	-1.1%
(3)Canada West	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
(2)Middle Atlantic	2.7%	2.9%	2.2%	2.1%	1.8%	-0.9%
(2)Mexico South	5.2%	4.0%	5.9%	7.8%	8.7%	3.5%
(1)New England	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
(1)Mexico North	1.3%	2.1%	2.8%	3.1%	3.0%	1.7%
(1)Canada East	15.5%	15.7%	17.3%	16.7%	16.0%	0.5%
Other	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	0.0%

Source: DesRosiers Automotive Consultants Inc.

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increased their share of vehicle production — Ontario, Mexico South, Mexico North and the East South Central U.S. Indeed, between 1985 and 2001, Ontario increased its production of vehicles by over 730,000 units, which made it number one in North America among over 50 U.S. States and Mexican provinces. Canada was able to do this without the aid of direct financial incentives. When you look at the list of jurisdictions on the table shown on page 8, you realize just how brilliant Ottawa and Ontario have been levering automotive investments into this country. Michigan is last on the list followed by Wisconsin, Oklahoma, Massachusetts and Ohio who have all lost over 200,000 units and Michigan has lost close to 600,000 units. The industrial North East in the U.S. has been getting hammered by Canada, the U.S. South and Mexico.

To be certain, Ontario did so well partly because of the levers that the mayors discuss in their letter. But a lot of the reason also has to be because Ontario is a very competitive location. The same list of competitive advantages that the CAW uses to argue for higher wages can also be used to argue for more investments. The OEMs are pulled in a lot of directions with their investment decisions but they are not stupid. They know Canada is very profitable and they can reap even more profits by investing here. And this is exactly what they have done year in and year out for a long time.

Can Ontario's performance be maintained without playing the financial incentive game? That's the multi-million dollar question. Those in favour argue that without financial incentives we will not get any new investments. They argue that the payback in terms of jobs and economic benefits is relatively short (five years). They also argue that once a jurisdiction gets a Greenfield investment the OEM will expand over the long term and add even more jobs and investment. This certainly is why Ontario did so well over the last 15 years. Ontario got Greenfield investments in Alliston, Cambridge, Ingersoll and Bramalea. These plants have grown more than the others. They argue that the investment game has changed from the 1980s and 1990s and Canada has to play by the new rules. They also argue that we do not have a pure economic system, but rather a political-economic system. Other jurisdictions are playing a very sophisticated political game with their financial incentives for investments. Canada needs to understand and play this game as well.

Those who argue against financial incentives refer to the enormous cost of these subsidies. There is the problem of stopping them or capping them. There is also the problem of giving them to one industry, such as automotive, and not to all the other industries such as aerospace, information technology or farming. The line-up is very long. They point to the economic inefficiencies of incentives. There already are 20 to 25 million units of excess capacity in the global automotive industry, so why would you want to subsidize even more capacity. They point to the many mistakes that can be made when governments try to pick winners and avoid losers. Canada subsidized Hyundai to locate in Quebec and the plant failed. What guarantee is there that the newly subsidized Hyundai plant or the other plants in the U.S. South East will be successful? They point to the fact that subsidies favour growing companies who need added capacity over companies losing market share. The "Big Three" have enough trouble competing with the "NNAMs" without giving the imports big subsidies to build more plants.

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Needless to say this whole financial incentive debate is very complex and fraught with political minefields. Perhaps this is why the WTO forbids the practice at the national level under trade law. Financial incentives are in essence one local jurisdiction benefiting at the expense of all other local jurisdictions to the determent of the whole economic system. The WTO believes that in the end everyone loses because of the actions of a few.

The problem is that in the automotive sector the reward is so great, local jurisdictions will do almost anything to skirt the rules. Maybe the ultimate solution is to get the WTO to ban all types and forms of financial incentives at all levels of government. Then the best locations, like Canada, could really shine.

Appendix to the Mayors' Letter: The following is a list of automotive plants and some of the external factors that influenced the decision to locate in Canada. These external factors can be viewed as a form of financial incentive.

DCX's Pillette Rd. van plant came into Canada in the early 1970s as a result of their missing their production to sales ratios under the AutoPact. They faced a heavy-duty penalty and chose instead to invest in a new plant in Windsor.

DCX's Windsor Mini Van plant came to Canada directly as a result of Canada's participation with loan guarantees in the U.S. bailout of the then Chrysler Corporation in the early 1980s.

DCX's passenger car plant in Bramalea originally came to Canada as a result of FIRA rules when Renualt purchased the old AMC Corporation. When Chrysler purchased Renault in Canada, the Canadian government forced them to commit to re-investment in Bramalea or face penalties under FIRA.

Ford's plant in St. Thomas originally came to Canada to help Ford meet their AutoPact requirements but penalties under the U.S. CAFÉ rules have resulted in new investments in this plant in the last decade.

Ford's Oakville Mini Van plant came to Canada as a result of AutoPact rules but was reinforced with favourable language in the FTA in 1989 which allowed Ford and others a competitive advantage over the Japanese.

Ford's Ontario Truck Plant in Oakville, which is about to close, came to Canada as a result of a special rule change under the AutoPact that saved them millions in duty payments.

The Oshawa assembly plants were modernized into fully integrated assembly plants as a result of the AutoPact and reinvestments in these plants in the early 1990s were directly linked to favourable language in the FTA.

Both Toyota and Honda built their plants in Canada as a result of the Canadian government closing the border to Japanese imported vehicles during the early 1980s. This was costing Honda and Toyota millions in lost sales. The expansion of the Honda and Toyota facilities in the 1990s has been linked to the elimination of the duty on OE parts, which saved them millions in duty payments.

CAMI made its home in Ontario as a result of Suzuki being allowed into the AutoPact even though the FTA was about to be signed prohibiting their inclusion. As a result, Suzuki became a full AutoPact member and saved millions in duties. DAR

Observations - “To offer Financial Incentives or not….that is the Question!”

Province/State	Region	1985	1990	1995	2001	Difference 1985 & 2001
Ontario	(1)Canada East	1,750,300	1,810,171	2,231,773	2,480,881	730,581
Kentucky	(5)East South Central	476,999	599,080	991,280	1,141,586	664,587
Indiana	(4)East North Central	0	273,049	411,106	598,032	598,032
Tennessee	(5)East South Central	154,629	245,637	779,586	508,559	353,931
Coahuila	(1)Mexico North	21,852	73,775	172,280	318,574	296,722
Puebla	(2)Mexico South	98,263	193,196	191,438	380,690	282,427
Guanajuato	(2)Mexico South	-	-	48,431	222,307	222,307
Aguascalientes	(2)Mexico South	-	-	53,656	218,457	218,457
Mexico	(2)Mexico South	127,198	193,539	156,386	327,436	200,238
Illinois	(4)East North Central	459,862	579,636	732,086	605,278	145,416
Sonora	(1)Mexico North	-	88,604	140,369	143,378	143,378
South Carolina	(3)South Atlantic	-	10,670	31,943	135,771	135,771
Virgina	(3)South Atlantic	97,447	142,365	165,564	208,321	110,874
California	(9)Pacific	261,843	316,644	352,675	351,703	89,860
Alabama	(5)East South Central	-	-	-	82,229	82,229
Morelos	(2)Mexico South	73,845	136,462	53,138	111,223	37,378
North Carolina	(3)South Atlantic	7,969	13,123	39,076	37,168	29,199
Minnesota	(6)West North Central	148,376	236,814	177,664	173,163	24,787
Jalisco	(2)Mexico South	-	-	135	23,825	23,825
Oregon	(9)Pacific	9,740	9,120	26,492	25,198	15,458
Nuevo Leon	(1)Mexico North	330	2,629	13,317	10,393	10,063
New Jersey	(2)Middle Atlantic	275,325	186,445	327,790	283,087	7,762
Washington	(9)Pacific	3,888	6,505	14,621	7,885	3,996
California Norte	(1)Mexico North	1,477	2,388	461	5,355	3,878
Other US		512	646	1,061	836	324
San Luis Potosi	(1)Mexico North	-	-	142	94	94
Sinaloa	(1)Mexico North	65	27	-	-	-65
British Columbia	(3)Canada West	2,305	1,734	5,246	2,020	-285
Districto Federal	(2)Mexico South	97,920	121,393	103,190	95,327	-2,593
Utah	(8)Mountain	4,208	2,996	-	-	-4,208
Other Mexico	Mexico	7,291	-	-	-	-7,291
Hidalgo	(2)Mexico South	8,132	7,042	1,774	55	-8,077
Nova Scotia	(1)Canada East	10,078	8,062	7,588	-	-10,078
Chihuahua	(1)Mexico North	20,656	-	-	-	-20,656
Louisiana	(7)West South Central	195,531	161,741	185,155	154,048	-41,483
Missouri	(6)West North Central	1,237,909	976,820	885,816	1,175,533	-62,376
Maryland	(3)South Atlantic	164,272	167,161	180,072	82,264	-82,008
Texas	(7)West South Central	305,643	101,073	138,144	209,745	-95,899
Delaware	(3)South Atlantic	336,448	368,673	343,909	235,961	-100,487
Pennsylvania	(2)Middle Atlantic	121,598	4,573	8,316	6,779	-114,820
Quebec	(1)Canada East	169,948	127,404	163,392	49,462	-120,486
Kansas	(6)West North Central	293,887	112,936	186,507	169,609	-124,278
New York	(2)Middle Atlantic	142,701	147,647	108,779	-	-142,701
Georgia	(3)South Atlantic	621,631	346,150	318,808	441,957	-179,674
Ohio	(4)East North Central	1,993,655	1,573,543	1,998,229	1,793,919	-199,736
Massachusetts	(1)New England	239,791	-	-	-	-239,791
Oklahoma	(7)West South Central	301,519	180,648	223,026	60,177	-241,342
Wisconsin	(4)East North Central	496,994	301,537	264,367	248,334	-248,660
Michigan	(4)East North Central	3,285,759	2,702,207	3,103,175	2,687,547	-598,212
Total		**14,027,797**	**12,533,865**	**15,337,964**	**15,814,166**	**1,786,369**

Source: DesRosiers Automotive Consultants Inc.

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