

## A New Year's Make-Over for Federal Policy in Atlantic Canada

### Making business work in Atlantic Canada

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For decades, the federal government has used explicit measures aimed at narrowing economic discrepancies between Atlantic Canada and the rest of the country. Yet, a significant gap persists – indeed such policies have served to retard economic convergence.

For example, as earlier studies published by the Atlantic Institute for Market Studies (AIMS) have shown unemployment rates in Atlantic Canada were similar to the national rate until the end of the 1960s. However, with the liberalization of unemployment insurance rules in 1971 and the introduction of massive economic development policy spending in the 1970s and 1980s, unemployment and growth rates in Atlantic Canada and the country as a whole began to diverge. The policies of the past were perverse, and the policies of the present are failing.

Half a century of economic theory suggests, and real-world experience – in places as diverse as Ireland, Japan, the Netherlands, South Korea, or US states such as Georgia and Michigan – confirms that lagging economies naturally catch up with advanced ones. Even if advanced nations or regions grow quickly, lagging ones should grow even more quickly. Under certain conditions, a lagging region should close the gap in economic performance with its relevant leading economy by 2 to 3 percent annually. Yet

the convergence of Atlantic Canada's economy with that of the rest of Canada has occurred at less than half that rate, despite – or, more likely, because of – massive federal intervention.

Lagging economies that are closing the gap with advanced economies share a number of characteristics:

- an educated populace or, at minimum, an emphasis on raising the educational standard of the population;
- a market economy and limited government interference in markets;
- the rule of law;
- property rights; and
- stable institutions, including political stability.

Federal policies, however, have actually undermined the development of some of the necessary conditions for convergence, by encouraging development by bureaucrats rather than by sound business planning, by regulating without full regard of long-term benefits, and by failing to develop clear systems of property rights in resources such as the fishery.

In the right setting, convergence results from the spread of productive ideas and methods, profitable opportunities in underinvested economies, competitive wages that draw capital, and increasing skills as investment creates jobs.

If conditions are not right, lagging economies will fail to converge with richer regions or, more typically, fall further behind.

Of particular relevance is the different ways in which labour and capital combine and fructify in different kinds of economies. When labour is abundant relative to capital, labour costs should be relatively low, and potential returns (profits) on the scarcer resource (capital) should be relatively high. The profit motive attracts capital, which creates jobs and economic growth. This mechanism, however, can be derailed by policies that either inflate the cost of labour or reduce returns on capital.

For a practical example of convergence, let us look at Ireland, whose economy, just a few years ago, was among the walking dead of Europe. Now, it is one of the most successful in the developed world. This turnaround did not come about accidentally or because of fortuitous resource discoveries, but because of consistent, deep, and widespread policy changes that reformed Ireland's economy from top to bottom.

The extent of Ireland's transformation is hard to exaggerate. Long one of Europe's most dismal economic performers, dismissed as part of the "Celtic fringe," Ireland's chief export was desperate, job-hungry people, rather than valued goods or services. Even as recently as 20 years ago, nearly one in five Irish people were without work and unemployment was still rising. The country's annual deficit through the early 1980s averaged more than 12 percent of gross domestic product (GDP), about eight times its annual average rate of economic growth. The national debt was soaring.

Today, even though its torrid growth of the past few years has slowed, Ireland faces a labour shortage, and Irish recruiters scour the globe luring expatriates back home. As a share of GDP, the nation's debt ebbs away each year. Government revenues have increased despite huge tax cuts.

In the mid-1980s, Canada's per capita GDP was two and a half times the size of Ireland's; Ireland's per capita GDP now exceeds Canada's. Ireland's economic purgatory, like its subsequent remarkable recovery, was policy induced. Getting

the policy framework right made the difference between productivity and prosperity on the one hand, and unemployment and decline on the other. The foreword to an AIMS study summed up the right policy in the following way:

*[The Irish] saw that trying to prop up dying industries was a mug's game. Public debt needed to be brought under control, taxes lowered, and excellent value offered in public services when measured against the taxes paid. Politics needed to be banished from decisions about where and how to invest, whether in public infrastructure or private industry. Work incentives needed to be improved by reforming social welfare. Profitability in the private sector needed to be improved. And costs, including labour costs, needed to be kept keenly competitive. The sum of these measures was a policy environment in which business had every reason to invest and build productive capacity, while workers had every reason to work hard and build their job skills. As the capital investment grew and workers became more skillful, real wages rose along with tax revenues, and a virtuous circle was created. Growth bred more growth, success bred more success. (Brian Lee Crowley, in McMahon 2000b, 10–11.)*

Ireland's turnaround did not happen because of government spending, transfers from the European Union, or an activist "economic development policy." Rather, Ireland, like other jurisdictions that have harnessed the forces of convergence, focused on getting the policy right and then letting employers and workers respond to the signals of the marketplace.

In Atlantic Canada, however, much "economic development policy" has been based on the government-driven model, which largely explains why, despite heroic efforts by the federal government to encourage economic growth, the region has failed to converge strongly with Canada's "have" provinces.

In the postwar era up to 1971, Atlantic Canada's per capita economic growth was strong, consistently outpacing the rest of the nation.

Only when Ottawa dramatically increased regional subsidies in the early to mid-1970s did the region's growth falter relative to the rest of Canada.

Programs such as employment insurance, equalization, and regional development initiatives aimed at accelerating convergence and minimizing the economic disparity gap have instead encouraged Atlantic Canada to rely on the generosity of the federal government and have obstructed long-term skills training and enhancement. Former New Brunswick premier Frank McKenna, in his 1997 farewell speech, observed that dependency has become a narcotic to which Atlantic Canadians have become addicted.

The evidence demonstrates that success for Atlantic Canada can come only from policies that focus sharply on productivity, investment, competitiveness, appropriate social support, removing disincentives within equalization, and eliminating barriers to the free functioning of the labour market, so that the region's unemployment can be absorbed and labour shortages eliminated.

Why have successive federal governments continued to endorse policies that fly in the face of strategies that have proven successful in other countries and even in other Canadian jurisdictions?

The argument for government intervention in "regional development" is based on the idea of market failure. According to this view, the cost structure of an economy is of small relevance. Instead, market failure, particularly in providing capital to lagging and peripheral regions, means investors will ignore, or be ignorant of, profit-making opportunities. Thus, since a low-cost structure will do little to spur development and attract investment, and since lagging regions do not have the capital for investment, richer governments must sponsor regional development programs and transfer wealth to the lagging region.

This view gives government the apparent justification for direct intervention in the economy, believing that it can solve market failure either by direct investment or by bribing

private investors into the lagging region through subsidies. The entire edifice of regional development policy, including the activities of regional development agencies such as the Atlantic Canada Opportunities Agency (ACOA) – a major conduit of federal funds for regional development – is based on exactly this view of why some economies lag behind others.

Unfortunately for Atlantic Canadians and for taxpayers across the country who have financed a massive array of well-intentioned transfers to the region over the past 30 years, this vision of how to achieve growth and convergence is dead wrong. It is contradicted by international experience, such as Ireland's. And it is contradicted by Atlantic Canada's own experience with convergence in the period up to the early 1970s.

Just how badly the policies of the past have served the region is revealed in a C.D. Howe Institute study (Mintz and Smart 2003) that examines the activities of ACOA and how its purposes can be subverted toward political ends. The study underlines the well-known difficulties government agencies face in trying to identify suitable projects for financial support. Indeed, there is no reason to believe that a bureaucrat is better able to choose winners than the marketplace, and the track record of grants and loans targeted at specific projects is spotty. Moreover, the risk is not insignificant that publicly subsidized operations will drive competing firms created with private capital out of business.

The C.D. Howe Institute study also paints an unsettling picture of how efforts to out-guess market forces can be bent to political advantage. It found that ACOA spending appears to have been ramped up during the run-up to elections. Further evidence of politicization is revealed in the pattern of ACOA spending by federal riding. During the 1994–2001 period, ridings represented by the governing Liberals benefited more than other ridings from ACOA commitments, and ACOA also gave a marked preference to ridings where the Liberal MP's margin of victory in the preceding election was relatively narrow.

In short, the money ACOA spends does not achieve good economic results, in part because its decisions are not market determined, but also because much of it is not spent for economic reasons. We are skeptical that there is any way to remove politics from discretionary spending decisions – which is why analysts increasingly prefer broad tax-based measures.

### What Is the Alternative?

For years, the federal government has been unable to move beyond these failed policies because of a lack of a clearly articulated alternative to the “market failure” view. Yet Atlantic Canada’s problem is clearly not failure of the market, but failure to *use* the market. Investors have failed to invest in Atlantic Canada, not for inexplicable reasons, but because of obstacles to investment that have been placed in their way. Removing those obstacles will set convergence back on course.

For some time, AIMS’ research has pointed to an alternative approach to stimulating activity. Key to this goal is the reduction of taxation levels in the region. Canada’s most economically successful provinces, Ontario and Alberta, have pursued aggressive tax-reduction policies in recent years. British Columbia is now reducing its tax rates, and so is the federal government itself. The United States is similarly engaged in significant tax reductions. Yet Atlantic Canadians continue to stagger under a tax burden that is significantly higher than the national average. And, as the wealthier provinces cut their tax rates still further, Atlantic Canada’s attractiveness as a place to do business continues to be undermined.

The taxes that are most in need of reduction are those that weigh most heavily on effort, investment, productivity and growth – namely, taxes on personal income, business profits, and capital. Cuts to other taxes, such as those on consumption, should be of lower priority. Critics of such a tax-based economic growth strategy charge that it is a “race to the bottom.” It is, however, quite the reverse.

Competitive taxes help boost sustainable economic activity, which raises the total tax take. Typically, one or two years after a significant tax

cut, tax revenues are higher than prior to the cut. They may be lower as a percentage of GDP, but they are higher in real terms because of stronger GDP growth. Critics often forget that, in absolute terms, Americans pay far more in taxes than do people in any other country; *tax rates* are lower there than in Canada, but that simply reflects the fact that governments in the US are taking a relatively smaller share of a huge pie.

Using low tax rates to generate prosperity, rather than attempting to rely on stimulative government spending, removes the element of politics from regional development activity. Under the current system, most economic development efforts simply transfer wealth from self-sustaining activities to government-selected activities, which benefits owners and workers in the selected activities, but at significant cost to other businesses and workers.

Allowing profitable businesses to keep a larger share of their profits, however, would *automatically* reward successful businesses and encourage them to become even more successful; government would no longer have to try to choose winners.

Several alternative approaches could be used to offset reductions in direct intervention under programs such as ACOA. As Mintz and Smart (2003) point out, however, any such measure must have a real impact on the growth of regional investment, rather than simply shift profits into a lower-tax jurisdiction. Mintz and Smart favour a broad-based investment tax credit; AIMS’ authors, on the other hand, favour either regionally differentiated federal tax rates or the use of federal dollars to help the Atlantic Provinces reduce tax burdens on growth and productivity.

Politicians as diverse as former New Brunswick Liberal Premier Frank McKenna and former Progressive Conservative leadership candidate and now Liberal MP Scott Brison have suggested trading regional economic development spending for some form of tax reduction. The actual design is perhaps best left to the technicians.

The important point is to develop a broad, tax-driven means of encouraging business development in the region – not one that targets

particular industries or firms, but one that enables businesses and consumers, rather than bureaucrats, to choose the business opportunities that are worth pursuing.

**Recommendation:**

- **Employ broad, tax-based measures to foster a development-friendly business environment and scrap the inefficient, politicized, project-specific incentives provided through agencies such as ACOA. Replace programs aimed at individual businesses with federally driven corporate tax reductions that allow consumers to choose which businesses prosper, thus delivering economic growth in Atlantic Canada.**
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