

How Bad Politics and Good Intentions Destroyed the Atlantic Canadian Economy: And What That Tells Us About Canada and the Welfare State

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You may not think that regional policy has much to tell us about the welfare state in Canada. But you'd be wrong. In fact I think by examining how we have used the state as an instrument to promote both economic growth and social and economic equity and/or equality across regions in the country, we gain a profound insight into the real drivers of the evolution of the welfare state in this country. Drivers that have almost nothing to do with the alleged philosophical, social or economic justifications for the welfare state as it is commonly understood. Here is why I think this.

Half a century of economic theory suggests, and real-world experience — in places as diverse as Ireland, Japan, the Netherlands, South Korea, and 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, over time, 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 per cent annually. In some cases, it can exceed this rate substantially, but remember that this is the rate of growth that can be achieved over and above the growth in the relevant leading economy. Yet Atlantic Canada's economy has converged with that of the rest of Canada at less than half that rate despite — or, as I will argue, because of — massive federal intervention.

How massive has that intervention been? If you took the net transfers into Atlantic Canada (federal spending in the region minus federal taxes collected in the region) over the past 30 years or so and, instead of having spent them as we did, you had invested that money in US 90-day T-Bills, does anyone know how much would be in that account today? Over \$1-trillion, enough to pay off the entire national debt of Canada and have \$500-billion or so left over. Pretty soon, you're talking serious money. And yet for this vast opportunity cost we have purchased what? A rate of convergence less than half of what we would have expected to achieve if we had done nothing at all other than to let ordinary economic adjustment mechanisms do their work.

Now I said that some conditions were required for convergence to occur. What are they? 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, limited government interference in markets, openness to international trade;
- the rule of law (including relatively low levels of corruption);
- property rights; and
- stable institutions, including political stability.

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

In the right setting, convergence occurs as a result of the spread of productive ideas and methods, the creation of profitable opportunities in economies with chronic underinvestment, the paying of competitive wages that draw capital, and the development of an increasingly skilled labour force as investment creates jobs.

Of particular relevance are 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.

There are many examples of convergence: El Salvador, Slovakia (next year slated to be the largest per capita manufacturer of automobiles in the world), Eastern Europe more generally, the Asian Tigers, China, India, as well as important sub-national regions like many parts of Japan or the American South. The list is long. For a practical example of convergence, however, let's take Ireland, whose economy, until 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 per cent 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 skilful, real wages rose along with tax revenues, and a virtuous circle was created. Growth bred more growth, success bred more success.

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 policy right and then letting investors, employers and workers respond. Just to make this point clear, Atlantic Canada received over the period

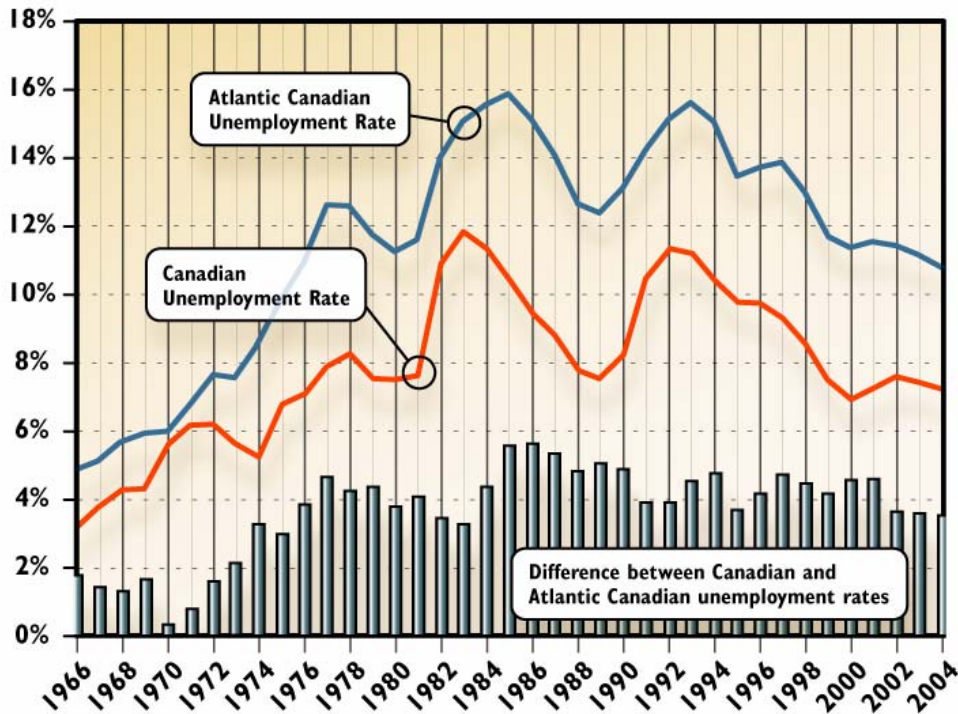
roughly from 1970 to 2000 annual net transfers that varied between 20 per cent -40 per cent of regional GDP, making it the most subsidised region in the Western world until the reunification of the Germanies. By contrast, Ireland got over the same period net transfers from Brussels that varied between 4 per cent and 8 per cent of Irish GDP. Moreover there are many other examples of successfully converging economies such as the Asian Tigers, or El Salvador that got proportionately even less in various kinds of aid.

In Atlantic Canada, however, much "economic development policy" has been based on an alternative, 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. To cite only one measure of this, look at the way unemployment in Atlantic Canada behaved before and after the broad liberalisation of unemployment insurance in 1971.

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 Ottawa's generosity and have obstructed long-term skills training and enhancement. Former New Brunswick premier (and now Canadian Ambassador to the US) Frank McKenna, in his 1997 farewell speech as premier, 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

with me in a thought experiment. I want you to put yourself in the shoes of a provincial finance minister in an equalization-receiving province. When the minister has to put together a budget, and he or she and his cabinet colleagues would like to find some



Canadian and Atlantic Canadian Unemployment Rates

normal functioning of the labour market, so that the region’s unemployment can be absorbed and labour shortages eliminated. This contrast between the convergence approach and the government-driven approach reminds me of one of my favourite aphorisms, which comes from a well-known historian, who once said that the history of the 20th century was of the abandonment of what works in favour of what sounds good. Of few things may this more truly be said that Ottawa’s approach to Atlantic Canada.

Now I want to walk you through some of the broad range of institutional obstacles we have created to the Atlantic region closing the prosperity gap with the rest of Canada. Let me start by asking you to engage

new money to spend on a program. It doesn’t matter what it is - health care, education, roads - any of those things provinces do. And they’re having a discussion about “where are we going to find that money?”. There are basically four ways they can find it.

The first is they could put in place policies that actually encourage the growth of the provincial economy. Their existing taxes would generate more revenue because there would be more economic activity because the same tax load on a larger pie generates more revenue.

The second thing they can do is they can raise their taxes on the existing economic activity. The third thing they can do is they can get transfers from Ottawa. The fourth thing they can do is they can



borrow the money. Those are basically the four choices. I am, of course, setting aside the fifth option — cutting spending on lower priority programmes — on the grounds that this is not a fairy tale.

Now each one of those choices comes with a certain set of incentives attached to it, and I'd like to talk about those incentives.

Just a word before I delve into this question of the incentives that provinces face. This section of my talk is a discussion about equalization, but I never use that word if I can possibly avoid it, because I don't know about you, but my eyes glaze over when I hear it. So just forget about equalization. This is really a discussion about the conditions in which provincial governments make decisions. Equalization is a very important part of that calculation.

Four options, then, for the finance minister and his colleagues sitting around the table. You could, as I said, you could take steps to grow the economy. That's often a difficult thing to do. It might involve say taking on the trade unions, liberalizing labour market rules. That's often an unpopular thing to do. You have to fight with the unions in public. You might have to cut business taxes, and that's often something that's hard to sell politically. You might have to take on the environmental movement if there are any impacts of new economic activity on the environment. You might have to introduce user charges on public services to better distribute costs and benefits. You might have to cut inefficient and unproductive public employment. You might need to reform welfare to encourage people to return to the workforce. Most of the measures that might be necessary in order to generate new economic growth come with a political cost attached to them. And yet, the revenue that will be generated, if you're actually successful in growing the economy, the revenue that will be generated may be several years down the road and, in any case, is not dependable because by definition business is risky. Your efforts might coincide with an economic downturn, or the investment that business makes might not pay off. You might bet on oil and gas development and when you do oil may be \$70 a barrel and two years down the road it may be \$20 and the revenue you were counting on may just not be there. But without revenue, you have

nothing to compensate for the political price you've paid to encourage growth.

So there are all kinds of difficulties with getting new money into the province's hands by stimulating economic growth. But at least if you are an equalization-paying province, you get 100 per cent of the increase in tax revenues that your measures create, so *if* your growth strategy is successful, you'll have money to spend.

But if you are successful in growing the economy and new money comes in the door, what does Ottawa do if you're an equalization-receiving province? Ottawa says, thank you very much, and takes about 90 cents or more on the dollar on that new revenue by deducting that money from your equalization payment. Under the equalization program, that's just the average clawback. In fact in Saskatchewan, the clawback has been as high as \$1.20. In other words, when Saskatchewan was still an equalization recipient, Finance Minister Harry van Mulligen and his colleagues made themselves worse off in their effort to find new money to spend on programmes by developing the Saskatchewan economy, in particular the natural resource sector. How dumb is that?

Now I recognise that the federal government has admitted that the clawback of over 100 per cent on some revenues isn't on, and has made a special \$120-million payment to make up for past losses, but the underlying formula has not been changed, so we don't know what the future holds. But you can rest assured that nothing will change the fact that in the future the provincial finance ministers in equalization-receiving provinces can count on a clawback on the order of 90 per cent on new revenues generated by new economic growth.

Now building the economy is just one of the options that is available to our hypothetical provincial finance minister and his colleagues. Let's talk about the other three options that are available. I said you could increase taxes on the existing economic activity, so let's talk about that for a minute.

If you increase taxes on the existing tax base, in other words you just take the existing business activity; jack up the taxes — corporate income taxes, personal

income taxes, sales taxes, excise taxes, capital taxes — you get to keep all that money. In other words, you bring in an extra dollar by raising your taxes you get an entire dollar to spend. Whereas, if you generate *new* economic activity you get at best 10 cents and maybe nothing at all.

So, ten cent dollars from economic growth versus whole dollars from tax increases. Okay. It's not too hard to figure out what the incentives are there for the province.

And, by the way, it's just an economic fact of life that once you drive your taxes up past a certain point they begin to be counter-productive — in economics this is known as the law of diminishing returns. In other words, they may generate a little extra revenue for you but they often destroy economic activity. So, one of the consequences of raising your taxes will be that quite often you'll lose some economic activity. Well, Ottawa looks at that and says, oh, look, if you engage in policies that actually destroy economic activity in your province; we'll give you more equalization. We will compensate you for bad policy.

And, in fact, Queen's University Professor Tom Courchene, one of Canada's leading experts on public policy, some years ago did a very, very insightful analysis of the impact of equalization on the Province of Quebec. One of the things he pointed out was that Quebec for a number of years had pursued a number of policies that were deeply damaging to its economy. For example, it had for a number of years the highest minimum wage in North America, which caused considerable disruption in the labour market and, therefore, you would assume in the ordinary course of things a loss of revenue to the Government of Quebec. Tom pointed out that, no, on the contrary the equalization system stepped up to the plate and made up most of the lost revenue for the Province of Quebec.

So not only do you get a whole dollar from raising taxes on your existing economic activity, but if you damage the economy as a result, Ottawa will help you out. And remember that economically damaging policies will often be quite politically popular...

The third thing that I said that the finance minister and his colleagues could do in order to raise money would be to get transfers from Ottawa.

Now, again, if you can go to Ottawa and get transfers — that could be equalization, it could be CHST, it doesn't really matter very much — that's a whole dollar available for spending. Every dollar that comes in the door is a whole dollar available for spending. Remember, if you're trying to grow the economy, it's only 10-cent dollars at best. So you get a whole dollar available for spending, plus there's an extra bonus with transfer money from Ottawa. Why? Because that money is raised on the national tax base. You're now getting money to spend on programs for people in your province. But the people who are paying the taxes - some of them are in your province, don't get me wrong - but the vast bulk of them are in other parts of the country and do not vote in your provincial elections. So the people who are paying the bills are not the people receiving the benefits from the money that's going to be spent. This is a sweet deal from the point of view of most politicians. They would love to be able to spend money on their voters and raise it on people who don't vote in their jurisdiction.

The final possibility, of course, is borrowing. Now we pretty much maxed out the national and the provincial credit card over the late 1970's and the 1980's, and so borrowing is not as attractive as it once was, but believe me it is certainly true that if you borrow a dollar at the provincial government level, it's an entire dollar to spend. Remember and contrast that with your 10-cent dollar from economic growth, and so you have a big incentive to borrow, as opposed to promoting economic growth. Oh, and by the way, you remember what I said about transfers, that transfers allowed you, as a provincial government, to spend the money and realize the political benefit here while passing the cost on to people in other parts of the country.

Of course, borrowing is a similar sort of mechanism. Borrowing allows you to get money to spend on public services today and to push the bill off, not onto people elsewhere geographically, but people elsewhere temporally, in other words, into the future. Borrowing is deferred taxation, but it's not relevant to

the people who are voting for you in the next election. It's probably only relevant maybe in 10 or 15, or 20 years down the road when the cumulative effect of this bad behaviour becomes unsustainable.

So add all those things up and if you're a rational politician, reacting to the incentives that surround you, what sort of a policy package are you going to end up with? You are going to devote relatively little attention and energy to creating genuine sustainable economic development because it takes a lot of effort, and has a high political cost associated with it. The results are uncertain and, under equalization, you don't get very much money out of it anyway.

So what are you going to end up with? You're going to end up with high taxes. You're going to end up with the vast majority of your energy devoted to endless battling with Ottawa for more transfers. And you're going to end up with high levels of debt. Does that sound familiar to anyone? That is the set of circumstances in which equalization-receiving provinces operate.

Now equalization is not the only federal transfer payment, nor the only programme offering perverse incentives for individuals, companies and governments in the region. However, before I turn to talk about EI and regional development spending further, let me finish my discussion about equalization with a few observations.

First, I sometimes get hot denials from people in both the ERPs and in Ottawa that equalization in fact alters people's behaviour, and that governments always do the right thing in spite of the incentives implicit in equalization. Let me give you just one example that illustrates the opposite perfectly: Voisey's Bay.

For those of you who do not know, Voisey's Bay was one of the richest mineral finds of the post-war period in Canada, and is located in the province of Newfoundland and Labrador, the poorest province in the country. Yet, it took 6 years to get the province to give permission to develop the mine. Why?

As I argued some time ago in *The Globe and Mail*, if Voisey's Bay had been in Alberta or Ontario, the Inco

mining company would swiftly have been given permission to develop it. Hundreds, if not thousands,

of well-paid jobs would have been created, generating lots of economic activity and new government revenue.

Yet in Newfoundland, our poorest province, with its declining population, and high debt, taxes and unemployment, Voisey's Bay languished for 6 years before permission was given. Why? Because of the silent third party to the talks, hovering like Banquo's ghost over the negotiations between various Newfoundland governments and Inco.

Yet hardly anyone correctly identified the spectral presence haunting the discussions between Newfoundland and Inco: the perversities of equalization.

Under Ottawa's equalization system, Newfoundland has little incentive to agree to economically sensible development of Voisey's Bay. On the other hand, it has every incentive to hold out for an uneconomic, but politically popular, job-maximizing strategy of demanding a smelter be built to process the ore in the province when there is already excess smelting capacity in Canada.

In Ontario or Alberta, if a development such as Voisey's Bay went ahead, even without a smelter, the province would realize major revenues. Mineral royalties, as well as business and personal income-tax revenues, would all rise handsomely.

Not so in Newfoundland. More than 90 per cent of those increased revenues would simply be deducted by Ottawa from equalization payments. So identical developments that in Ontario would yield, say, \$100-million in tax revenue to Queen's Park would generate less than \$10-million for Newfoundland.

Inco was prepared to invest \$750-million immediately in a mine and mill, and a further \$95-million in underground exploration, plus a \$180-million experiment to see whether local chemical processing of the ore was feasible. It was not enough for Newfoundland. All the ore had to be processed in Newfoundland, period. Why? Because doing the

processing in Newfoundland would create jobs, and lots of them. That confers huge political advantage on the government that obtains it. But if they do what governments in wealthier provinces would do, and let the development proceed incrementally in a constructive partnership with the mine developer, they get fewer jobs, and only token revenue gains to spend on Newfoundlanders.

Equalization's spectre whispers constantly in the Newfoundland premier's ear, "Go for the jobs at all costs." Thus do equalization's good intentions make fools of us all?

Let me close off this part of the discussion about the perverse impacts of equalization on the recipient provinces by observing that equalization is not an essential feature of a federation. Indeed, it was not a feature of Canadian federalism until 1957, and it does not exist within the American federation, for example.

Now you will often hear it said that there are proxies for equalization spending in the United States, and often defence spending is mentioned in this regard — lots of defence money is allegedly spent in poorer states as a form of compensation for their lower levels of development.

The only problem with this theory is that it is untrue. We have done the calculations, and if you include money spent on defence research, in fact defence spending is regressive – in other words it is concentrated in high income states, such as Massachusetts and California, and not in low income states. And interestingly, while Canada has highly developed regional development and equalization programmes, neither of which have a close equivalent in the US, our regional economic disparities are larger and more durable in Canada than in the US.

Moreover, it is argued by e.g. Ken Boessenkool that one of the reasons that the argument for equalization never really got going in the US is because there are self-correcting economic mechanisms at work that do the job of equalization with less inefficiency. For example, high income and high employment regions also, as a general rule, have high costs and labour shortages. Low income and high unemployment

regions generally have lower costs and labour availability. Thus capital flows from the wealthier to the less well-off regions as returns will tend to be higher there. This is in fact the convergence argument in a slightly different form.

On the other hand, our research has convinced us that many aspects of regional transfers become capitalised in local costs, thus raising costs within Atlantic Canada to close to national levels, without attracting the corresponding levels of economic activity. And this disadvantage is compounded by the poisonous policy mix which the provinces create in response to equalization, as I've already shown.

Now, the impact of all these transfers is not felt only in the ERPs, because, of course, the money comes from somewhere. Look at the people of Ontario, for instance — they're hopping mad. They are hopping mad because, as the Premier of Ontario notes, Ottawa takes a lot more money out of Ontario than they put back, in terms of public services. That money goes, amongst other things, to finance the equalization transfers that go to other provinces. And the transfers out are growing faster than the Ontario economy, meaning that they are not being paid for by economic growth, but rather by a declining relative standard of living in Ontario. And in return, Ontarians are not at all convinced that they're getting good value from the services delivered elsewhere. Yet this is a shift from the traditional Ontario attitude of benign approval of the edifice of intergovernmental and inter-regional transfers. What has happened?

I think what's happening is that we are seeing the beginning of a fundamental challenge to the equalization and other transfer systems that we have known in Canada basically pretty much since the 50s. The reason I think this is contained in a little story I'm going to tell you. I was quite good friends with the late Eric Kierans, who was a minister, of course, in Ottawa in the first Trudeau government, but in the 1960s was a minister in the Lesage Government in Quebec, the Quiet Revolution government. And, Eric, in that role as a minister in the Quebec government, went to a Federal-Provincial meeting in Toronto one day. They were seated around the table talking about the creation of a new Federal transfer program. These were the days of Lester Pearson when the

fully-developed transfer system that we have known really emerged. Eric said that the premiers from all the provinces were seated around the table, and they were talking about the creation of a brand new transfer program. It was going to take millions of dollars out of the Ontario economy and send it off to other provinces in the country.

Yet, John Robarts the Premier of Ontario, just sat there looking very avuncular and sucking on his pipe and was very benevolent. Eric cornered him at the elevator outside in the lobby of the hotel where they were meeting. He said, Look, you know, this is not a question from the Government of Quebec, this is just me, Eric Kierans, personally, saying to you I don't understand, why is it that you sit there in these meetings, while we talk about using the Federal Government as a mechanism to suck millions of dollars out of your economy and send it elsewhere in the country, and you just look like you never heard such good news in your life. Why is that?

And Robarts said something very interesting. He said you have to understand (I'm paraphrasing slightly) the political economy of Confederation. He said, We are the industrial heartland of Canada. Every one of those dollars that's sent out into the hinterland comes straight back in the form of the purchase of goods and services. We have got the tariff wall at the border. We have got these branch plants here that are the foundation stone of the Canadian economy. Every one of those dollars comes straight back here. This is just a scheme to maintain purchasing power in less-well-off parts of the country, so they can buy things from us.

Now whether you agree with the economics that underlie that view is actually irrelevant, because the point is that the Premier of Ontario believed it to be true, and that's all that matters.

Now we no longer inhabit that world. We now inhabit a world of continental integration, of free trade between Canada, the United States and Mexico, of market opening through the World Trade Organization and so on, the tariff barrier at the border is gone, the branch-plant economy is gone. We now inhabit a world in which those transfers which are siphoned out of the Ontario economy and sent hither

and yon to many other parts of the country can no longer be relied on to go straight back to Ontario in the form of the purchase of goods and services. They may end up in Minneapolis, they may end up in Seattle, and they may end up in Boston, New York, Chicago, Shanghai, Tokyo, or many other places, because that is where we now have the freedom to send that money.

In the 1960s, transfers were a way to prop up purchasing power to the benefit of Ontario industries. In the 21st Century, transfers are a burden on the Ontario economy, a cost which many of its competitors do not bear in Michigan, and Ohio, and Pennsylvania, and places like that, because America has, for example, no equalization system.

So the important thing to bear in mind is that Ontario is increasingly restive because the political economy of this country no longer supports the transfer system that grew up 30 and 40 and 50 years ago. They are going to be increasingly resistant to that transfer system and I think we need to start thinking today about what is going to take the place of a transfer system that we had become very comfortable with on which many provinces rely, but which I do not think has much of a future.

Now equalization is not the only arrow in Ottawa's quiver of programmes for dealing with regional economic disparities. There have been regional economic development agencies and spending programmes too, aiming to develop the local economy through injections of capital. Yet their efforts have been remarkably unsuccessful as well. 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, the exact opposite of the convergence approach. 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 a lagging region does 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 economic theory, and 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. That is why I sometime refer to the convergence theory as "Evolution", and the government-driven theory as "Intelligent Design".

Just how badly the policies of the past have served the region is revealed in a recent C.D. Howe Institute study (by Jack Mintz and Michael Smart) 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 investors risking their own money, 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. ACOA spending appears to have been ramped up during the run-up to elections; moreover, during the 1994–2001 periods, 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 actually about the economy. Much of it is spent not for economic but for political 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 to targeted regional development spending programmes.

But of course, all of this discussion to this point takes as its underlying assumption that the policies pursued by the federal government are in fact a rational attempt to pursue the development of the Atlantic economy. But in fact, the behaviour of the federal government totally belies this assumption. For example, if this was such a good-faith rational effort, Ottawa would be carefully measuring the impact of these programmes and adjusting them as evidence emerged about their impacts for good or ill. But this is not what is happening. On the contrary, take two examples: employment insurance and regional development spending.

On EI, the government's own studies have consistently shown that EI has a devastating effect on the region's economy. This was the reasoning behind the attempt at serious EI reform in the 1990s. But the government approached its reform in a rather ham-fisted way and paid a political price because they disturbed the existing patron-client relationship that exists between MPs and their constituents in much of rural Atlantic Canada whereby the MPs ensure that a large number of people's incomes are topped up by generous EI payments in exchange for which the locals vote for the government. Since the government suffered serious losses in the region in 1997, they not only rolled back a major portion of their reforms (but not all), but at each subsequent election they have

come forward with explicit “offers” to the population of how they will enrich even further the EI programme – this at a time of falling and relatively low unemployment and at a time of worsening labour shortages in many industries, so that immigration is increasingly a major issue in a region that previously had no demand for immigrants whatsoever.

On regional development, the Auditor General has consistently criticised ACOA and the other regional development agencies for a failure to measure the true impact of their massive spending. I would argue that this failure to measure the impact of their programmes, together with the measurable politicisation of these programmes indicates that the government has not inexplicably forgotten to measure their impact, but rather that it wishes to avoid having these programmes measured by rational criteria, for that would reveal them for the political boondoggles that they are.

Like so much else about politics and government in Canada, this analysis leads inexorably back to the self-interest of the governing party. That is usually the Grits, but is equally true of the Tories during their brief interludes of power. But if all roads in Canadian politics lead to the Liberal Party, so too do they lead to Quebec.

So we must go even further than this in our analysis of the failings of regional policy as it applies to Atlantic Canada, for in the title of my talk I said that I would talk about what I thought the treatment of Atlantic Canada means for the future of the country, and I mentioned the perils of being a poor region in, not just a rich country, but a rich and *frightened* country. What’s that about?

Well let’s return to what I said at the outset about Atlantic Canada giving lots of evidence of the convergence theory throughout the 50s and 60s. In fact there was a positive correlation between regional transfers during that period and regional growth – when the transfers were at a relatively low level compared to today. But around the end of the 60s/early 70s, the relationship flipped over. As the transfers were massively ramped up, the correlation between transfers and regional growth became negative.

And what was happening right in that period? I am sure that I scarcely need tell this audience that it was the growth of the explicitly separatist nationalist movement in Quebec. In fact, my argument would be that everything that has happened over the period since the late 60s, in terms of regional policy has not been aimed at Atlantic Canada at all but rather at Quebec – my region has merely been collateral damage, as has Ontario’s increasing burden under the intergovernmental transfer system.

What has occurred is that the Government of Canada has got into a bidding war with the Government of Quebec for the loyalty of Quebecers. Both sides of the equation have taken it as axiomatic that while emotion and sentiment will play their role, the most powerful force binding Quebecers to one government or the other, and hence to one or the other of our competing national projects, is self-interest, and that in turn they have defined in terms of dependence. A citizen dependent on a flow of benefits from one government will likely not vote to quit that government’s jurisdiction. Thus, the feds ramped up EI, regional development, equalization, marketing boards and a host of other programmes, including in areas of provincial jurisdiction.

In response, the Government of Quebec wanted to make it appear that they could step into any void created by Ottawa’s absence. Thus, for example, the Province of Quebec now spends more on business subsidies than all the other provinces put together. And if we look at the tax burden that the provinces put on their respective provincial economies (looking at provincial own-source and local revenues as a percentage of GDP), a very interesting picture emerges:

Based on this measure there is a clear divide between the more developed and less developed provinces. The two richest provinces, Ontario and Alberta, both have a provincial government fiscal burden of under 20 per cent of GDP. Most of the other provinces group together in the 21-23 per cent of GDP range, with Saskatchewan the outlier among English-speaking provinces at 25.1 per cent

The real outlier, however, is Quebec. In most years, the size of Quebec’s provincial and local government

as a percentage of GDP is much larger than in the other provinces, and it has remained largely stable over the period while the size of provincial government in most other provinces has declined – in the case of Alberta by as much as 4.3 percentage points of GDP.

So to sum up this part of my argument, and to bring this talk to a conclusion, one of the consequences of living in a rich and frightened country is that money will often appear to be the solution to every problem, because money is easy to come by, whereas other resources, such as loyalty to Canada in Quebec, or

As a Percentage of GDP

1994-95	24.5	22.6	21.8	24.1	26.7%	21.9	25.7	26.6	22.4	25.6	
1995-96	25.1	22.8	22.6	24.4	27.8%	22.2	26.6	24.9	21.7	25.5	
1996-97	25.7	23.1	23.4	24.8	27.3%	22.0	25.3	25.6	21.9	25.5	
1997-98	23.9%	22.9%	22.6%	24.7%	27.6%	21.7%	25.4%	26.5%	21.3%	25.5%	
1998-99	23.1%	22.8%	23.3%	25.2%	28.7%	21.9%	25.4%	26.4%	20.7%	24.5%	
1999-00	22.6%	24.4%	23.6%	23.7%	28.9%	22.1%	25.5%	25.9%	21.5%	24.5%	
2000-01	20.2%	22.2%	22.4%	22.1%	28.8%	21.3%	25.6%	27.7%	23.4%	24.6%	
2001-02	20.5%	22.1%	22.3%	21.5%	26.6%	20.4%	24.4%	24.5%	18.5%	24.2%	
2002-03	18.9%	20.7%	22.6%	21.8%	26.4%	19.6%	23.1%	27.2%	19.5%	22.6%	
2003-04	18.3%	20.8%	22.9%	22.2%	26.6%	19.6%	23.1%	25.1%	18.1%	22.8%	

Source: Statistics Canada Public Sector Database, with calculations

federal government authority and prestige, are much scarcer resources.

And since Ottawa finds it difficult to own up to the fact that much of its policy is driven by a fear of Quebec separation and an unwillingness to confront the nationalist movement directly, a great deal of policy is packaged as pursuing other goals than national unity. But their true intentions are always revealed by their unwillingness to subject

Note, by the way, that Quebec’s equalization payment, in the \$4-billion dollar range, accounts for almost the entire net fiscal benefit for the province in belonging to Confederation, an interesting point to ponder if you want to understand the federal government’s unwillingness to countenance real equalization reform. Ironically, though, this net fiscal benefit to Quebec (i.e. benefits the province receives from Ottawa minus taxes paid to Ottawa) is achieved at the price of subsidising the activities of a provincial government generally dedicated to undermining the legitimacy of Ottawa with its own electorate. EI, regional development, marketing boards — Ottawa will not cease supporting these programmes no matter what damage they do to Quebec or the rest of the country, because these programmes are not about what Ottawa says they are about. They are bids in an auction where Ottawa believes that the future of the country is going under the hammer.

their policies to rational tests of effectiveness and efficiency. Just one example will have to suffice: when Ontario recently started to make a fuss about the amount of money being extracted from their economy each year by Ottawa for redistribution to other jurisdictions, a federal minister was sent to make a speech that did not address Ottawa’s case for such redistributive efforts, but berated Ontario for asking the question, thereby threatening, in some unspecified way, the integrity of the country. It was apparently “unCanadian” to ask if transfer payments were a good thing. They are, from Ottawa’s point of view, self-evidently good and asking for proof of this proposition is to prove that you do not have the faith. It is heresy and an act of apostasy.

I could repeat such example over and over again. We cannot discuss openly and critically equalization, regional development, employment insurance or any one of a host of other programmes to see if they actually do good, or if they in fact corrupt our politics, mire us in dependence, ruin our



competitiveness and obstruct efforts to raise our productivity and hence our standard of living.

When we cannot ask whether programmes are actually achieving their stated goals because such questions are not asked by true Canadians, who accept them as an article of faith, you begin to understand what Samuel Johnson meant when he said “Patriotism is the last refuge of a scoundrel” and what Socrates meant when he said that “The unexamined life is not worth living.”



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