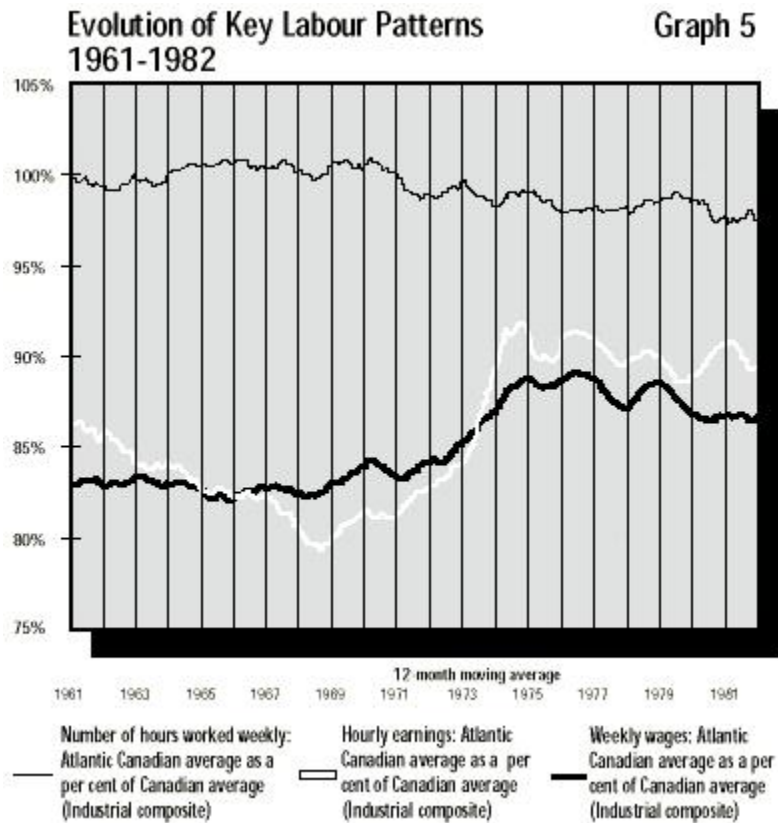


Chapter 2

The Remittance Region: Dutch Disease and the Atlantic Ailment

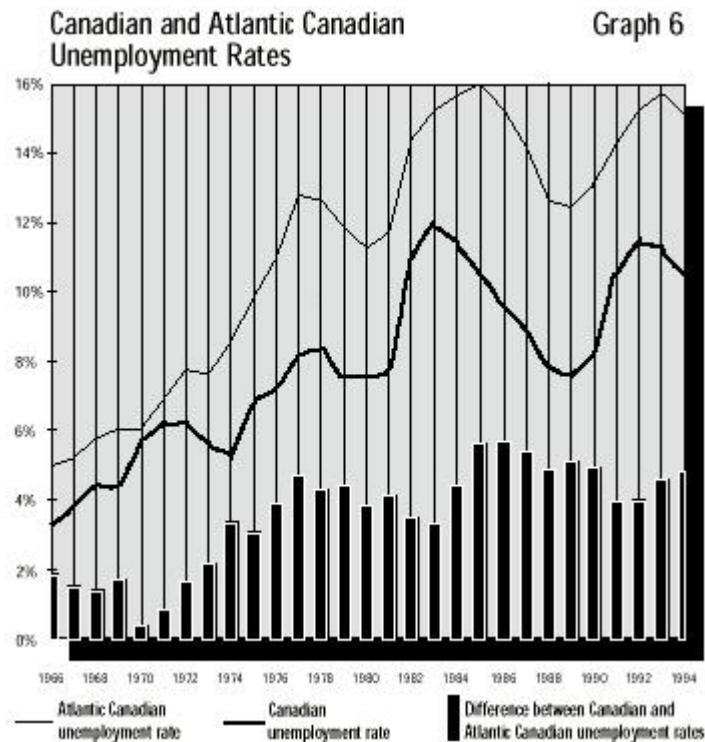
[T]ransfer payments have in one form or another have never lived up to expectations in terms of creating a more self-reliant economy. Why this is so is not clear because of the nature of the data. There is an obvious need for more research in this area. (Savoie and Winter, 1993, pg. 8)

Beginning in the late 1960s, the Dutch economy was damaged by what should have been good news -- the discovery of natural gas in the Slochteren offshore fields. Offshore revenues did not increase the economy's productivity, but the inflow of these revenues led to an appreciation of the guilder; ⁸ the price of domestically produced goods rose relative to the price of foreign goods, a deviation from purchasing power parity. Dutch exports were suppressed and imports replaced domestically produced goods; output and employment fell, particularly in the trade-oriented sectors of the economy.



This phenomenon came to be known as *Dutch disease*. Dutch disease can be a particularly debilitating economic malady because of the crucial role the trade sector plays in economic growth. A version of Dutch disease can be traced back to the 14th century when the influx of new world precious metals had a similar impact on Spain's key cloth and cereal industries, though their decline was hastened by a number of other counterproductive policy moves on the part of the monarchy. Britain's North Sea oil discovery had something of the same consequences for the British economy, although oil and gas exports represented only a small part of Britain's GDP. Nonetheless, some of Britain's economic stagnation in the 1970s may, in part, be traced to the rise of offshore revenues; declines in oil prices may have been partly responsible for the economy's renewed strength in the 1980s. "Analysts were puzzled by the combination [in the 1980s] of an apparently healthy British economy (particularly in the export sector), large capital outflows, and a pound at record lows against the dollar"" (Yarbrough and Yarbrough, pg. 632).⁹

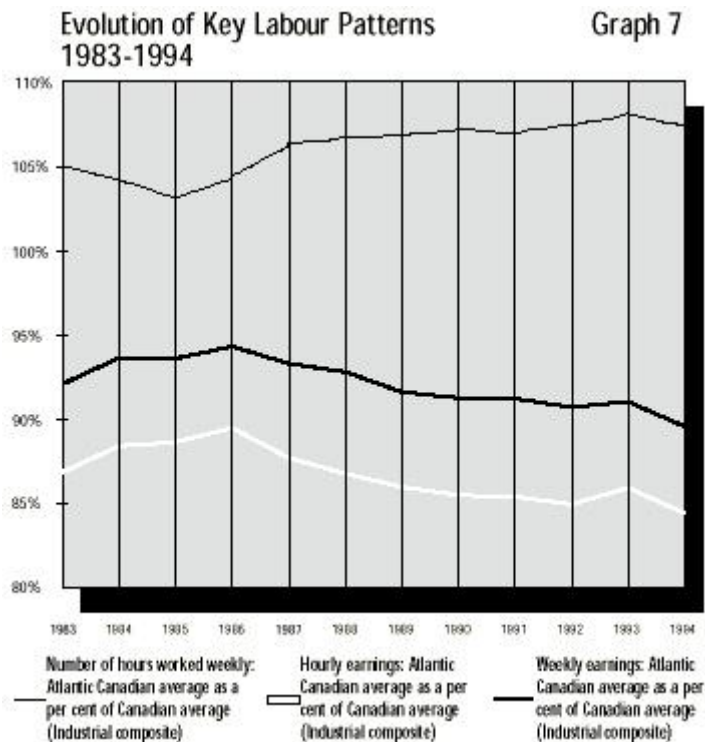
The inflow of funds due to a petrochemical bonanza is comparable to an inflow due to net government regional subsidies, or virtually any other type of inflow where the largest part of the inflow is unrelated to the productive aspects of the economy.¹⁰ (This is particularly true of petrochemical money in times of suppressed supply, when price is unrelated to and far exceeds the cost of production, producing wind-fall revenues for the producing country which flow into the country both through the profits of the producers and through tax revenues.)



Winter (1990), while not referring to Dutch disease, showed how a similar mechanism was at work with regional subsidies. His insight was straightforward and intuitive. One can

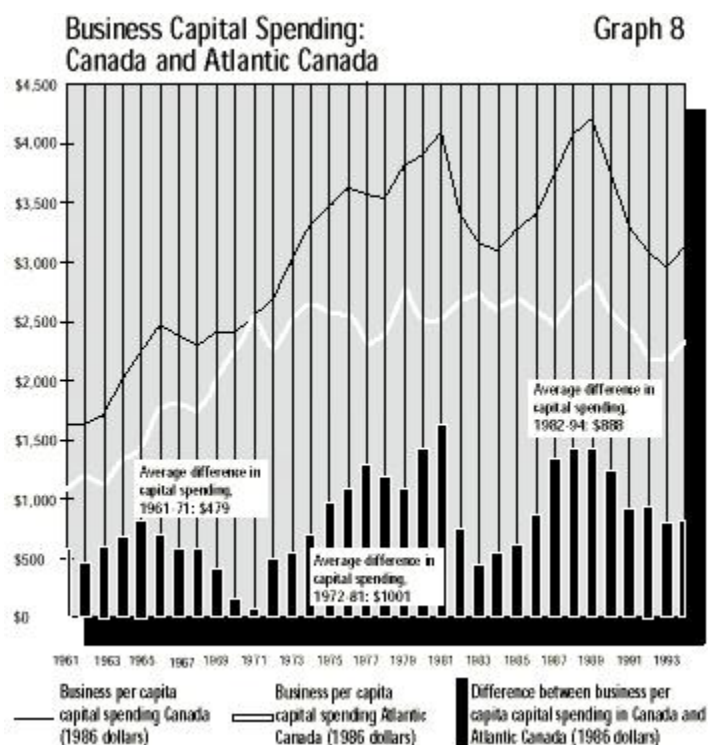
visualize, he says, the flow of regional subsidies into the region as a flow of goods and services. This goes a long way to explaining the negative impact of regional subsidies. As Winter says, "You can imagine the impact on a dairy farmer in this region if Ontario decided to supply us with free milk."

In other words, as noted in the previous chapter, the flow of money into the region in a pure accounting sense must go to buy goods and services produced outside the region and this suppresses demand for locally produced goods — the Atlantic Ailment. In a nation with its own currency, the balance between financial and product flows works through a currency appreciation, which makes imports more competitive than many domestically produced products. The fact that the same balance is required in the face of massive regional subsidies leads to a strong prediction that increases in regional subsidies of the magnitude under consideration must be accompanied by an increase in relative pay rates. The prediction is precisely borne out by the data. Graph 5 shows that Atlantic Canadian relative pay rates moved sharply upwards in the early 1970s coinciding with the rise in regional subsidies. (Consistent data for Graph 5 is available only to 1982; see also Graph 7.)



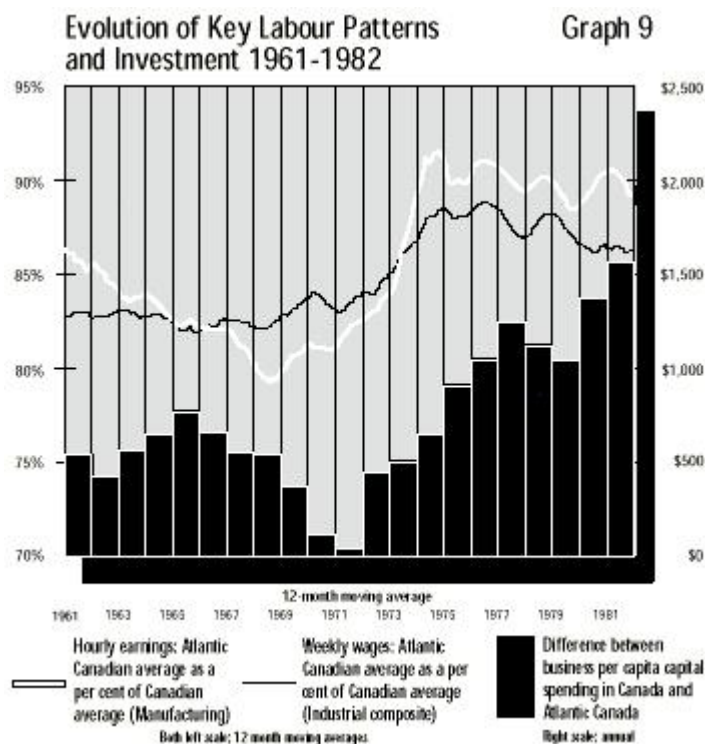
The mechanisms leading to higher relative wages are not difficult to understand. Courchene (1995, pg. 125) estimates that total federal transfers equal at least 50 per cent of all wages and salaries for each of the Atlantic provinces, save Nova Scotia, where the total is in the mid-40 per cent range. The profusion of government work, government subsidized work and make-work programs effectively subsidized by unemployment insurance would force local employers to raise pay rates to compete with these alternatives. As well, by increasing the regional endowment of wealth, the relative value of leisure increased.

Mansell and Copithorne (1986) and Vanderkamp (1986) provide an overview of the literature on the impact of federal programs, particularly UI, on wages in Atlantic Canada; the DRM Advisory Group study on export oriented firms (1994, pg. 207) cites “wage rate and other forms of government competition” as a factor weakening the region’s ability to export. (See Chapter 3 for a brief discussion of wage pressures and the existence of “voluntary” unemployment implied here.)



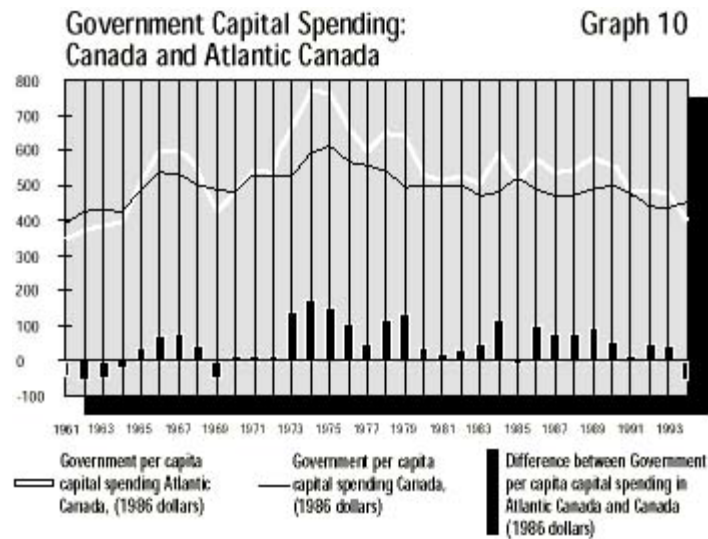
Chapter 1 discussed the fact that Atlantic Canadian producers were unable to pass rising wages on to prices. Squeezed between rising wages and price resistance, standard economic theory would predict that regional employers would be forced to reduce employment. This contention is well supported by the data. The gap between Canadian and Atlantic Canadian unemployment rates doubled in the early 1970s and the number of hours employed Atlantic Canadians worked weekly declined relative to the rest of the country. (See Graphs 5 and 6; consistent data for Graph 6 is available back only to 1966.) Not all transfer programs are equal in their impact. This research examines the whole package of regional subsidies, but it is highly likely that the unemployment insurance program — which is an important component of regional subsidies and offers extended benefits in Atlantic Canada — is disproportionately responsible for the labour market impact, though other regional subsidies certainly played a role. UI subsidized long periods of unemployment, enabling workers easily to trade off work for leisure; it supported part-year employment industries; and it allowed workers to lengthen their search time. There has been excellent research done on the UI program, in particular its negative impact on regional employment; see in particular May and Hollet (1995) and May and Gunderson (1996). As Vanderkamp (1986, p. 100-101) notes:

Suppose that an industry has been hit by an unexpected decline which will produce a 50 per cent reduction in output and employment unless there is a dramatic lowering of the wage rate. For the typical worker, a six-month layoff will still generate 80 per cent of the normal annual income before tax (with 60 per cent unemployment insurance replacement), and the after-tax situation is likely to be better. Moreover, the six-month layoff may be worth something in terms of leisure and related activities. As a result wage reduction is likely to be unacceptable



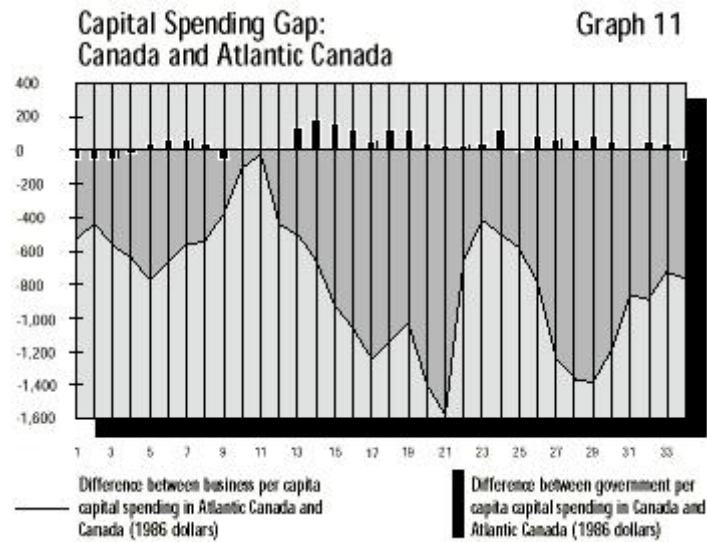
As regional subsidies were reduced in the 1980s, relative regional pay rates moved downwards, but only with a lag. (See Graph 7; Statistics Canada data calculations were changed in 1983 and, rather than artificially trying to join the differing series, I thought it more accurate to show the series separately.) Many economists believe pay rates are far stickier downwards than upwards, and this may help explain the lag.

More troubling, the gap between Atlantic Canada's and Canada's unemployment rates has not narrowed with the decline in regional subsidies. This may be because a) the most serious labour market distortions, those created by UI, have not been subjected to serious reform, at least until the recent Employment Insurance reform package, though many argue these reforms are far from adequate, and b) many economists believe that once unemployment rates are increased — even if by apparently temporary factors — there is a tendency for unemployment to stick at a higher level for at least a time, though it is well beyond the scope of this work to review this voluminous and controversial literature.



The discussion of wage rates in Atlantic Canada leads to another prediction with even more negative consequences for the region. Put very loosely, the theory of factor price equalization, as it relates to labour and capital, states that a poor region with low pay, excess labour, and low capital intensity will attract additional capital due to the potential savings on labour costs. Price of labour, wages, is equalized among regions. The problem for this region is that artificially inflated wages would lead to the prediction that movement of capital to the region would be discouraged as wage rates rose. Again, this prediction is supported by the facts. (Graph 8 shows the development of business capital spending over the full period under consideration; Graph 9 shows capital spending in relation to the wage and earnings series—consistent data for these labour series is available only between 1961 and 1982.)

The gap in per capita business investment between Atlantic Canada and Canada was narrowing in the 1960s, though the graph seems to suggest some cyclical component. This cyclical component may be partly responsible for the narrowing in the late 1960s. Nonetheless, after the dramatic rise in regional subsidies and the region's relative increase in wages, the gap between regional and national per capita business investment doubled on average. It's troubling that the gap did not decline in the 1980s but some of the wage stickiness discussed earlier may be at work, and it is also possible that the graph does show evidence of a secular decline in the gap in the late 1980s.



Government investment in Atlantic Canada has been above the national average for most of the period. (See Graph 10.) However, on a per capita basis the gap favouring Atlantic Canada in government investment is minute compared to the gap in business investment. (See Graph 11.) And, while much government investment doubtless went to worthwhile infrastructure projects, there is little evidence that government infrastructure grew more dynamically in Atlantic Canada than in the rest of Canada during this period. The lack of a twinned commercial highway through the region by itself suggests this. Much of what was entered as government investment went to overbuilding fishing industry infrastructure, to the support of declining industries, and to what would be better described as make-work projects. It is beyond the scope of this work to investigate in depth what government entered as investment on its books, but this certainly would make an interesting topic for future research.

This chapter has outlined how the massive increase in subsidies in the 1970s might be expected to suppress economic growth through what might loosely be termed an “appreciation” effect. A number of predictions fall out of this analysis and they are consistently borne out by the data: relative economic growth rates, net exports, pay rates, unemployment rates, hours worked and investment levels all move abruptly and significantly in the direction and at the time predicted.