Executive Summary

As the federal government cuts back on regional transfers, many Atlantic Canadians have become concerned about their economic prospects, given the region's dependence on these transfers. Yet, the new research reported in this paper shows that Atlantic Canadians can take their economic fate into their own hands and need not depend on the largesse of the federal government for their economic well-being. In fact, the massive regional subsidies that have become part of Canada's fiscal and political makeup have done more economic harm than good during recent decades in Atlantic Canada.

Although subsidies in the 1960s may have helped Atlantic Canadians by bringing essential services — such as health care and education — up to national averages, increases through the 1970s introduced a number of micro and macro economic distortions which inhibited regional growth through that period. Cutbacks in the 1980s were accompanied by renewed economic vigour in Atlantic Canada.

The idea that regional subsidies suppressed economic activity in Atlantic Canada may be unconventional political wisdom, but it is remarkably consistent with both Keynesian and neo-classical economic theory, the facts of the region's economic development and the international experience with foreign aid.

Although subsidies to Atlantic Canada have absorbed hundreds of millions of dollars and receive a highly spirited defense whenever challenged, little research has been done on the economy-wide impact of the massive net inflow of government money to Atlantic Canada over the last three and a half decades.

Yet, that huge financial inflow, over and above what the region produces domestically, would be expected to produce large changes in the macro economy. This inflow — the difference between what Ottawa spends in Atlantic Canada and what it collects in revenue — is equal to almost one-fifth of regional GDP; it has been close to two-fifths of GDP; and it has fluctuated dramatically and quickly.

Two half-truths have developed around these subsidies and Atlantic Canada's recent economic history: 1) the region is failing to catch up with the rest of Canada despite these huge regional subsidies; and 2) even if these subsidies have not helped spur economic growth, they have at least boosted personal income in the region.

The full truth is rather different. Over the last 35 years, Atlantic Canadian per capita GDP growth has consistently and strongly outperformed Canada's per capita growth. Regional growth faltered only when various federal policy decisions deliberately and dramatically increased regional subsidies in the 1970s.

Personal income in Atlantic Canada has also grown faster than the national average, but its growth has been unrelated to changes in regional subsidies, even though, at one point, these subsidies reached $5,000 (1996 dollars) per capita. When subsidies climbed dramatically in

the early 1970s, relative income growth did not increase; when subsidies fell dramatically in the 1980s, personal income continued to grow faster in Atlantic Canada than in the rest of the nation.

Since relative personal income growth has remained steady while GDP movements have offset changes in regional subsidies, the implication arises that each subsidy dollar suppresses about a dollar's worth of indigenous economic activity.

However, while this line of reasoning has strengths, the precise magnitude of the effect must remain speculative, pending further research. The important question is whether subsidies have significantly suppressed regional economic growth and left Atlantic Canada more dependent while less economically vibrant. Here the evidence is compelling, and supported by statistical analysis, empirical evidence from a number of different data streams, and a review of the region's economic history.

The net inflow of government funds can be viewed as similar to an increase in the regional money supply or — from the viewpoint of Atlantic Canada's trade with the rest of the nation and the world — as a massive inflow of "external" funds which would bid up the regional "currency".

Predictions fall out from this which can be tested in the data. In an independent nation, an inflow of foreign funds leads to a currency appreciation which raises domestic wages and prices relative to foreign wages and prices. The implications for Atlantic Canada are that an increase in regional subsidies would result in an increase in regional wages relative to the Canadian average. This in turn would lead either to an increase in regional prices relative to the rest of Canada or — if Atlantic Canada's integration into the national economy blocked local suppliers from raising prices faster than elsewhere in the nation — to an increasing unemployment gap with the rest of the nation. Regional employers would be squeezed between wages which were rising faster than in the rest of Canada and resistance to price increases greater than the national average.

In fact, regional wages rise at exactly the predicted time. Regional prices continue to rise at about the average Canadian rate, and thus, as expected, the unemployment gap between the region and the rest of Canada increased. These factors lead to another prediction. With an increase in relative wages, not offset by price increases, private sector investment should decline relative to the rest of Canada. It does, again at the expected time. The rise in regional wages would also lead to a demand shift away from regional production to externally produced goods. Data for Atlantic Canada's net exports show this shift at the expected time. Finally, regional economic growth should stagnant, another prediction borne out by the data.

These mechanisms can be viewed from a slightly different perspective: the inflow of external money increases unearned regional wealth. This is conceptually similar to an appreciation resulting from a financial inflow unrelated to an economy's productive activity. The results and predictions remain unchanged. The increase in wealth leads people to consume more leisure, unless they are bid away from leisure by higher pay, leading to increased pay rates and so on.

Many of these negative effects would be mitigated if the inflow of funds went into productive investment, but, as noted, private sector investment weakened with the rise in subsidies. While government investment did increase, it formed only a small part of the overall rise in subsidies and it was significantly less than the fall in private investment.

Regional subsidies also introduce a number of micro-economic distortions into the economy and politicize it. They make it more profitable for many businesses to pursue government contracts and subsidies than to strive to create marketable products. Government also has an incentive to support declining industries with a ready-made constituency and political contacts over emerging sectors and externally produced goods. Data for Atlantic Canada’s net exports show this shift at the expected time. Finally, regional economic growth should stagnant, another prediction borne out by the data.

Atlantic Canada’s experience with regional subsidies is consistent with the international experience with foreign aid. This aid, even when earmarked for investment, goes almost exclusively to consumption with no resulting economic benefit.

The conclusion is that Atlantic Canadians should look to their own economic resourcefulness and not to government or transfers from the rest of Canada for economic succour. A review of the region’s history shows the region has done best when it has open access to external markets. This provides economic potential for the region today as both international and internal trade barriers tumble.

Nonetheless, while regional subsidies have done the regional economy more harm than good, withdrawing from the dependency built up over the last 35 years will not be a painless process. Some sectors and geographic areas will be slower to adjust than others, though it should be noted again that massive reductions in subsidies over the last decade have not slowed regional personal income growth which continued to outpace the Canadian average.