

## Appendix A

# A Matter of Timing

The question of the direction of causality needs to be addressed. Graph 1 ([Introduction](#)) shows an apparently inverse relationship between changes in regional subsidies and changes in Atlantic Canada's relative GDP growth. Coincident movements in relative regional GDP growth and the growth of regional subsidies raise several possibilities:

1. No casual relationship: It's all a matter of coincidence.
2. Causality runs from regional GDP to regional subsidies: A downturn in growth attracts additional government spending, an uptick leads to reduced regional subsidies.
3. Causality runs from regional subsidies to GDP: Large amounts of free money suppress (or boost) economic growth.
4. All of the above: Causality runs in both directions, but neither time series completely explains the other.

The right answer is, of course, (4). Nonetheless, in weighing all of the above, it becomes clear that causality most importantly runs from regional subsidies to GDP - that changes in GDP cannot explain movements in regional subsidies and that coincident movements are not purely coincidental, as (1) would imply. While it is certainly correct to say that neither series, GDP or subsidies, fully explains the other, it is not realistic to argue that regional subsidies which have equalled between 20 and 40 per cent of GDP had no impact on GDP growth.

However, (2), the idea that GDP movements explain changes in regional subsidies, is appealing. Given the mechanisms on which transfers to both individuals and governments are calculated, it makes sense that a slowdown in the region would draw in increased regional subsidies, thus creating a spurious relationship from regional subsidies to reduced growth. This is certainly the case in individual years and, in each year, a portion of the regional subsidies will be related to changes in economic performance. The question is whether the large movements in regional subsidies apparent in Graph 1 - particularly in the early 1970s and then in the early-to-mid 1980s - can be explained by changes in economic performance.

Appealing as this interpretation is on the surface, it is inconsistent with political history, economic history, and the time series relationship between regional subsidies and regional economic activity. (See Appendix B2 for an illustrative regression on the relationship between regional subsidies and a proxy for differing relative growth in the "have" and the "have-not" provinces.)

The political history of regional subsidies is revealing. Regional subsidies grew rapidly at the beginning of the 1970s due to a series of deliberate political moves by the Trudeau government. Regional subsidies began to shrink in the 1980s as the fiscal crunch led Ottawa

into expenditure retrenchment in a number of areas.

A considerable literature has grown up around these policy moves. In the early 1970s, policy makers were explicit about increasing support of "have-not" provinces but they did not cite a new economic crisis on the east coast as the reason for increases. Indeed, at that time there was some sense that the economic situation in Atlantic Canada was improving and great optimism that increased government activity could significantly narrow or even erase the gap between Atlantic Canada and the rest of the nation; public motivation centred on sharing the wealth and improving the region's chronic economic weakness.

Far from attenuating the demands of Atlantic Canada for a greater national commitment to reducing regional disparities in the country, the general prosperity of the 1960s made the idea of regional development seem a more attainable goal, if only the Canadian state would commit itself to the task. (Bickerton, page 175.)

This increase in expenditure on regional subsidies occurred when many other nations were also increasing government expenditure. Governments throughout the world had great confidence they could solve most, if not all, economic problems. More cynically, many observers attributed the increase in government spending in general and in regional subsidies in particular to the Trudeau government's near election loss in 1972, which led to a focus on the region's electoral importance in close elections. At the same time, a number of Atlantic Canadian ministers rose to great influence in the Trudeau cabinet where they could affect spending decisions. Regardless, the massive build-up in regional subsidies in the early 1970s was clearly a deliberate policy move, and was recognized as such at the time. It was not triggered by automatic adjustment mechanisms, related to a downturn in growth. In fact, Atlantic Canada's relatively good economic performance was used as a reason for increasing subsidies.

Through the 1980s, the flow of regional subsidies was restricted. A number of programs, including UI, were reformed, in some cases several times, to bring down expenditures. A complete history could take several volumes. Here are some examples. In 1982, the equalization formula was amended in a way which effectively reduced payments, and a ceiling was placed on equalization payments. As well, beginning in 1982, Ottawa took a number of measures which effectively reduced Established Programs Financing (EPF). EPF included hospital, medical and post-secondary education funding. The 1982 hit was the single largest reduction according to Courchene (as of 1994, pg. 112), who estimates it effectively reduced EPF funding by seven per cent. Nonetheless, the Petroleum Incentive Program helped maintain the net flow of regional subsidies, forming a large part of federal expenditures in Atlantic Canada, in the early and mid-1980s, until spending in this program was curtailed.

The motivation for the draw-down in regional spending was the evolving fiscal crisis. Politicians were not arguing that Atlantic Canada's economy had strengthened to the point where the region no longer needed much help. In fact, at the time, there was great concern about the health of the regional economy. A number of critics, even in recent years, seem unaware of the region's relatively strong growth in the 1980s and write of the reduction in

regional subsidies at the beginning of the decade as a damaging and unfair blow directed at Atlantic Canada.

Writing of the reduction in regional subsidies, Forbes (pp.27-28) says: "The region arrived unprepared at the sudden march of events in the 1980s which represented a major revolution in the traditional policies of the Country. ... Maritime leaders were left to react in a belated and ad hoc fashion to the sudden changes of the decade. Indeed the changes came so thick and fast as to give little time for study or resistance... (emphasis in the original) Thus, large changes in regional subsidies can be traced to political/fiscal decisions and not to mechanisms which automatically altered regional subsidies to fit economic circumstances."

Other lines of reasoning lead to the same conclusion. Consider economic history. Graph 1 shows two significant changes in relative economic growth in Atlantic Canada: an abrupt slowing down in the early 1970s and a surge of growth in the early 1980s.

Outside of regional subsidies, there is no reason why Atlantic Canada's strong relative economic growth through the 1960s should have suddenly fallen off in the 1970s. And, equally, there is no reason why relative growth should have suddenly spurted in the early 1980s. Yet, anyone who wishes to argue that causality ran from GDP growth to regional subsidies - or that no causality runs between the two - has to find an explanation for these abrupt and large changes in relative economic direction.

Recall that the GDP data is relative - Atlantic Canada to Canada. An explanation for the changes in relative growth should focus on economic factors which affected Atlantic Canada differently than the rest of the nation. No economic factor of appropriate magnitude and duration seems available, other than regional subsidies which were a net outflow out of the rest of Canada and net inflow to Atlantic Canada and which suddenly exploded from under 20 per cent of regional GDP to nearly 40 per cent in the early 1970s and then just as suddenly imploded in the early 1980s. It is difficult to imagine a factor of this magnitude not having a profound impact on GDP.

But, some may argue that perhaps no causal relationship exists between regional subsidies and relative economic growth. Yet, it's difficult to fathom how the huge swings in regional subsidies, given the magnitude of these subsidies, could not have an impact on GDP. Someone who maintains this also has the task of explaining the coincident and opposite changes in relative regional growth. Observers who maintain that regional subsidies are *beneficial* have an even harder task: they would have to argue that, without the beneficial increase in regional subsidies in 1970s, Atlantic Canada's economy was headed for something like an economic collapse, and, that without the *damaging* decrease in the 1980s regional growth would have exploded.

Thus, due to political history, the time series properties of key series (explored in the next appendix) and economic history, it is reasonable to conclude that changes in Atlantic Canada's economic performance can explain only a small part of multiyear movements in regional subsidies.