

## Chapter 4

# A Neo-Classical Viewpoint: Economic Distortions in Atlantic Canada

*[B]y assuming perfectly operating product and factor markets in its models, neoclassical economics acknowledges no valid role for politics and the state in the pattern of economic development except to provide a suitable framework for the operation of the market. Political interference in the machinations of the market's 'invisible hand' can cause only distortions in its beneficial effects. Thus, the historical pattern of uneven regional development is blamed on market failure brought on by circumstances and/or the actions of policy makers. ... It is indeed ironic that this should be the reaction to state intervention in the field of regional development considering that it was the inability of the market to solve the problem of persistent regional disparities that precipitated this self intervention. (Bickerton, 1990, pg. 17)*

That was obviously not written by an admirer of neo-classical economic analysis. Yet the description of the negative effects of market intervention, though Bickerton would disagree, is consistent with the facts surrounding government intervention in the Atlantic economy.

The last sentence of the quote, however, strays from the facts, and this provides a launching pad to discuss the idea that the market has been allowed to function in Atlantic Canada and that it has failed. In fact, right from the beginning, Canada has had strong interventionist governments both federally and provincially, and this intervention has worked against the economic prospects of the Maritimes and Atlantic Canada. (See Chapter 7 for an historic overview.) The founding economic cornerstone of Confederation was an interventionist policy, the National Policy, which threw tariff barriers up around Canadian markets. Nor was the National Policy applied in a non-biased manner. For example, coal deposits in the Maritimes, particularly Cape Breton, gave the region a natural advantage over coal-poor central Canada, but tariffs on coal were lowered so central Canadian companies could import from the United States, levelling the one natural advantage the Maritimes would have possessed under the National Policy.

Government interference in the marketplace hardly stopped with the National Policy. Government was constantly fiddling with key transportation issues, one decade subsidizing Maritime transportation costs, the next suddenly increasing Maritime prices much more than elsewhere in the nation, creating a price shock with no time for Maritime businesses to adjust effectively. The federal government has not been alone in interfering with the marketplace. For example, in the 1920s, local interests frustrated U.S. investors who had planned to turn Nova Scotia into a continental fish supplier, "The Fish Pier of America". (See Chapter 9.)

Such policies were put in place not out of bad intent, but for the most part because the

government of the day believed they were best for the nation or the province. Policy-makers, like everyone else, have a tendency to look after their own interests, or, rather, to conclude that policies which favour their own interests happen to be the right policies for the nation. For policy-makers in a democracy, those interests are concentrated where the bulk of the voters are concentrated (except, perhaps, during periods of minority government when the small number of constituencies in the periphery can become disproportionately important). As well, existing constituencies and interests are likely to have more influence than economic potential off in the future.

## **Resource misallocation**

The economy produces an efficient allocation of resources through price. If firm A is able to use an input more efficiently than firm B, it will be able to bid a higher price for the input or be able to afford more of it than firm B. However, in an economy like Atlantic Canada's, government may decide that B should have an increased share of the input and subsidize B's purchases, or tax A's purchases, or preferentially purchase B's product to provide the firm with more money. This results in a less efficient allocation of resources, but it may be justified on other grounds -- equity, provision of essential services, etc.

However, when government expenditures rise to the level they have in Atlantic Canada, equal to two-thirds of GDP, government can introduce extremely large distortions into the economy, particularly if politics plays a role in expenditure decisions. Government influence in the marketplace also operates through a number of other channels: economic development programs, tax policy and rulings, direct and indirect subsidies, etc. When government does step into the marketplace to influence the distribution of resources, the link between price and the most productive use of a resource is broken, and resources can be misallocated to less efficient uses to the detriment of the economy.

Remarkably, government has an incentive not simply to break the relationship between productivity and resource use, but to favour an allocation of resources to less efficient uses. The situation most fraught with economic damage occurs when one company, or a subset of companies, in a competitive sector applies for government support, perhaps due to financial difficulties. This reallocation of resources is unfair to the other, perhaps more competitive firms in the sector; it may even drive them out of business for they face a double problem — they pay taxes and then the government gives some of that money to their competitors. As May and Rowlands (1991, pg. 30) say: "There is also reason to believe that grants to individual firms may permit inefficient operators to force efficient firms out of business."

As well, government has an incentive to favour older sectors of the economy. Existing but declining industries have a ready-made constituency of voters, entrenched areas of influence, connections and the funds to promote their interests. Emerging industries typically have none of the above.

Similarly, government will tend to cushion sectors facing structural adjustment in order to protect the weaker members of the sector. This just makes adjustment more wrenching when it is finally forced on the sector. Moreover, when employment is a key issue,

governments have an incentive to favour industrial structures which employ the most workers. Such moves reduce competitiveness in the long-run, eventually imperilling the continued operation of the firm or sector, or leading to a requirement for continued subsidies.

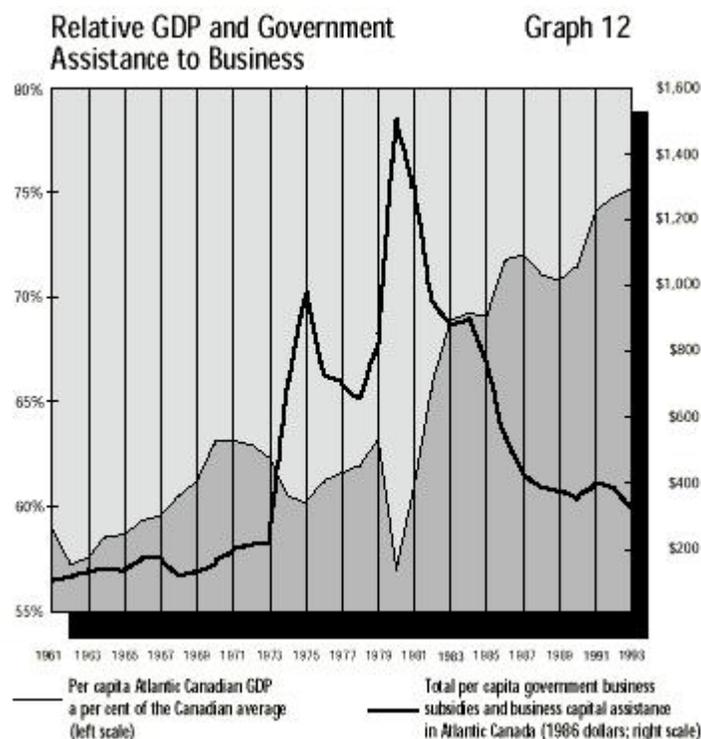
Most unfortunately, these distortions send false messages to workers about what training and skills will be needed for the future and to potential entrepreneurs about investment opportunities.

Such government incentives — reallocating resources away from where they would otherwise have been used — are prevalent throughout the region, from support of declining industries in Cape Breton to the overbuilding of the fishery, which often included regulations preventing the introduction of labour saving devices. Make-work projects, where there is little or no product at all, also gain currency. (It's a popular myth in Newfoundland that the province has the highest ratio of playgrounds to population in the world.)

The respite from the economic forces of change provided by such programs is brief. Constituencies are satiated and jobs saved for a while, but inefficiencies mount, increasing the cost of maintaining the jobs and, in the case of Canada as with most other nations, the fiscal situation worsens until government can no longer afford the support. Instead of gradual market adjustment, changes can be so abrupt and inefficiencies so ingrained that the market has neither the time nor the flexibility to adjust without leaving much wreckage in its wake.

Of course, government will often try to catch the next economic wave and support emerging industries. However, for the most part, bureaucrats do not have the training or the skills to select winners. And, their motivations are different from private sector players. It's not their own money they are investing; success or failure is not the difference between a comfortable winter estate in Florida and delivering pizza. As well, tapping into government grant programs and purchases, virtually a necessity of doing business in the region,<sup>12</sup> favours those with political and bureaucratic connections rather than true business acumen. There is no evidence that entrepreneurs, driven by their vision and often impatient with those who can't understand what they're about, are particularly good at bureaucratic game playing.

The growth of economic development programs corresponded with the 1970s increase in regional subsidies, and the region's relative downturn in economic growth. (See Graph 12.) While this work does not attempt to disentangle the impact of economic development programs from regional subsidies as a whole, it is clear development programs failed to boost the Atlantic economy into a growth phase in the 1970s despite the promising launch pad of strong growth in the 1960s.



This brings us to the question of whether regional subsidies can be directed into productive investment or used to leverage private investment. Government has rarely succeeded in this, and, on an economy-wide basis in Atlantic Canada, government activity has almost certainly suppressed investment. (See chapters 2 and 6.) Moreover, even when government is able to leverage private investment, the money is often inefficiently used, since government officials are not well trained to determine the most productive uses for capital. Government's massive presence can also distort the way businesses allocate resources internally, towards government activities and away from producing competitive products. For business, meeting the criteria for government programs — criteria which often are unrelated or even negatively related to market realities,<sup>13</sup> --- can be more important than efficient market-oriented production. Equally, working the bureaucracy for government contracts can become more important than selling to markets and refining products to meet market demands.<sup>14</sup> Workers in subsidized sectors know government is providing the money to create their jobs through various programs or preferential purchasing and, quite understandably, they want their share of the subsidy and the most labour-intensive means of production used. This leads to sloppy management and increased labour costs, and it cuts away at a company's ability to compete. Business is often willing to go along because profits are provided by government and, to get government money, businesses must play the game.

## Impact on competitiveness

A number of competitiveness studies of Atlantic Canada have been prepared, but one in

particular stands out, and it will be the basis of this sub-chapter, providing empirical support for contentions made in the previous sub-chapter. Most competitiveness studies focus on the raw price of homogenous inputs, though this is only part of the price equation. Quality plays an important role: a computer engineer up on the latest software is, other things being equal, worth more than a computer engineer who's still managing a 1970-era mainframe. The pure price comparison found in many competitiveness studies would be misleading. And, by focusing on the homogenous price of inputs, the studies fail to note misallocation of resources, distortions in the economic process, and the quality of final output.

Many of these weaknesses are avoided in a study by P. N. O'Farrell of the Heriot-Watt Business School, Edinburgh, comparing the competitiveness of matched pairs of Nova Scotia and New England firms. O'Farrell focuses on the quality and price of the output of these firms, and examines the micro-functioning of the firms to explain differences in quality and price.

O'Farrell isolates large distortions and inefficiencies in Nova Scotia which he importantly attributes to government activities and, more generally, to an overly large government presence in the economy — in short, exactly the type of distortion the reasoning in the opening part of this chapter would lead one to expect to find. The study cannot be accused of bias against the government. It was financed by the Nova Scotia Department of Industry, Trade and Technology, and by the Atlantic Opportunities Agency (ACOA). O'Farrell's study was focused on Nova Scotia, but similar economic conditions apply in all four Atlantic provinces.

O'Farrell finds that Nova Scotia firms typically offered poorer quality products at higher prices than New England firms and British firms which he examined in addendum to the paper. Weak productivity was endemic, even though Nova Scotian firms often had newer equipment, subsidized by government money. O'Farrell notes that more productive New England producers can end up buying second-hand equipment from Nova Scotia — equipment first purchased with government assistance and being replaced in Nova Scotia by the government-assisted purchases of even newer equipment.

Noting that many Nova Scotian firms depend on government assistance and government contracts to maintain profits, rather than on efficient market-oriented production, O'Farrell explores “major factors explaining the apparent paradox of the Nova Scotia companies sampled being profitable and yet manufacturing much more expensive and, on average, lower quality products than the matched companies in New England and the U.K.” Government induced distortions in the marketplace are key to understanding this paradox, O'Farrell says.

*[T]he large implicit subsidy to profits provided by the public aids and incentives, although some of it may leak into wages, exacerbates market failure.... [A] significant proportion of the Nova Scotia firms visited were partially dependent either directly upon provincial or other forms of public purchasing or indirectly through sub-contracting to larger firms which are in turn reliant upon government spending for their survival and profitability....*

*Public policy appears inadvertently to have reinforced market failure to some extent by cushioning profits via grants, subsidies and preferential purchasing thereby reducing the incentive to change....*

The heavy reliance upon Federal transfers has indirectly promoted a dependency culture in the province. While one would not question the need for equalization transfers on equity grounds to ensure that public services are provided on an equal basis across Canada despite differences in wealth, the low proportion of resources devoted to economic development in the disadvantaged areas will serve to perpetuate dependency and disparities. The severe imbalance creates a culture, as one owner manager said, of 'a whole region being on the dole'... (pp. 24-25, emphasis in the original) <sup>15</sup> Dependence on government, rather than the market, have adversely affected the firms' marketing and selling effort. Most firms do not engage in market research, the identification [of] target customer groups, or the design and adaptation of products for different market niches. Selling is characterized by a casual and rudimentary approach. Price is often the major marketing platform used by too many firms, especially as this research has conclusively demonstrated that, on average, products manufactured in the province are not price competitive (pp. 28-29).

The lack of priority attached to marketing, in general, and selling, in particular, is underlined by the experience of a large multinational enterprise (MNE) which recently located a branch plant in Nova Scotia. They attempted to set up sub-contract relationships with precision engineers. The purchasing officer approached six Nova Scotia firms for quotations; several replied they were too busy; another said they would not be 'comfortable' quoting 'because of the tolerances and finish required'; and one firm delivered the parts 6 weeks late and 10 per cent of their components were rejected. The MNE now subcontracts the work to Ontario. None of the Nova Scotia machine shops has approached this large multinational seeking a share of their sub-contract business; and when the MNE contacted the suppliers many were still reluctant to tender for contracts (pg. 8).

The UI system creates additional problems, O'Farrell writes. In high unemployment regions, where UI is a mainstay of incomes, it also has undesirable side effects by creating incentives in favour of short-term employment, maximization of unemployment benefits, and disincentives to long-term re-employment. It affects the supply side of the labour market by influencing work attitudes where workers may wish to work the minimum number of weeks necessary to obtain stamps; it rewards conformity to the system rather than initiative. For employers, it discourages training investment and the creation of [a] suitable workforce; and it contributes to a high labour turnover and increased training costs (pg. 25).

"[L]oans and soft grants for equipment provide no answer to the region's problems... The more modern machinery found everywhere in Nova Scotian firms seems to be related to the more generous levels of assistance available rather than to commercial success. The 'grantpreneur' mentality, as I have observed in other areas such as Northern Ireland, appears to be widespread. Yet the American firms did not complain that they were undercapitalized ... . As one precision engineer in Bristol stated succinctly when I showed him the U.S. and Canadian samples, 'if you can't compete without grants, you won't

compete with them.’ Any shortfall in Canadian competitiveness [productivity and quality] cannot be traced to the vintage of machinery.” (pg. 16) The fishing industry in Atlantic Canada has received the most government attention, and it is here government-induced distortions, which may be more subtle but still damaging in other sectors, are most evident. O’Farrell’s analysis of the fishing industry was prepared before the extent of environmental crisis became clear, and O’Farrell’s comments focus only on the economic distortions created by government. <sup>16</sup>

The emphasis on landing government support, rather than fish of competitive quality and cost, distorted the competitive orientation of the fishing industry. <sup>17</sup> Canadian groundfish sell at a lower price in New England than groundfish landed in Maine. Fish are generally not gutted on the Canadian boats and are apparently less well handled. These two differences contribute to a U.S. price advantage over Canadian groundfish of 15-20 per cent on the New England market. As one Maine fish proprietor stated succinctly: ‘I can buy in Canada at half the price and half the quality’; while another said: ‘Unless I’m there, I wouldn’t buy from Canada.’ Even allowing for a degree of American chauvinism in such comment[s], there are obviously problems with the quality of Canadian fish sold on the New England market. ...

The U.S. matched plants visited, in contrast to their Canadian counterparts, process fish all year by buying in supplies from the west coast, California and the Gulf of Mexico in winter. This enables them to spread their fixed costs over a larger output than the Canadian companies. This situation is partly a consequence of a lack of entrepreneurship by Canadian proprietors and partly due to the Unemployment Insurance syndrome [which makes it difficult to find workers in the off-season since they have to be bid away from UI compensation]. The Canadian boats are subsidized (many Maine fishermen purchase the Canadian vessels second hand), the processing plants are eligible for financial assistance, and the resulting products compete on price at the lower quality end of the U.S. market. Conversely the New England boatmen, with no grants and similarly unassisted fish processors, compete on price at the high value added quality end of the market. ... Clearly the large scale subsidies provided to [the Nova Scotia] sector have not been used to enhance productivity, quality and product development. (pp. 13-14, emphasis in the original) Government activity was designed to maximize employment, though this is almost always at the cost of productivity and even quality, since labour intensive handling methods often produce lower quality fish. Government’s insistence on a seasonal fishery increased capital costs (since capital was utilized for only part of the year), increased training and recruitment costs, and lowered quality due to high turnover and relative lack of continuous experience. In this area, O’Farrell blames the UI system for considerable economic damage in the fisheries.

## **Chapter conclusion**

The first part of this chapter examined why government’s intervention would misallocate resources between sectors and away from their most productive uses. The second part of this chapter examined micro distortions which would exacerbate the misallocation: Once resources are allocated to sectors, they are often inefficiently used because of non-market

incentives created by government, affecting the motivation of both workers and businesses. O'Farrell's empirical work provides strong support for the existence of the distortions predicted by neo-classical theory. Interestingly, surveys of economic freedom show a strong correlation between economic growth and economic freedom, a concept closely related to lack of government induced economic distortions. (See Gwartney et al, 1996.)

Chapter 2 discussed how regional subsidies in effect led to an appreciation of costs in Atlantic Canada. However, an appreciation normally has beneficial side effects. Much like the painful medicine of a recession, it forces out weaker players and leads to productivity-enhancing strategies as firms struggle to remain competitive. On the other hand, continual depreciation and easy selling times can clog economic arteries with inefficiencies.

Curiously, government policies in Atlantic Canada combined the worst effects of a depreciation with the worst effects of an appreciation, and the benefits of neither. The impact of regional subsidies shifted demand outside Atlantic Canada through an appreciation-like effect while, at the same time, the very same regional subsidies were used to support continued inefficiencies within the Atlantic economy.