YOU *CAN* GET THERE FROM HERE:
How Ottawa Can Put Atlantic Canada on the Road to Prosperity

What the party leaders need to know about the New East on the eve of the federal election

BRIAN LEE CROWLEY
DON McIVER

April 2004

The Atlantic Institute for Market Studies (AIMS) is an independent, non-partisan, social and economic policy think tank based in Halifax. The Institute was founded by a group of Atlantic Canadians to broaden the debate about the realistic options available to build our economy.

AIMS was incorporated as a non-profit corporation under Part II of the *Canada Corporations Act* and was granted charitable registration by Revenue Canada as of October 3, 1994; it recently received U.S. charitable recognition under 501(c)(3) effective the same date.

The Institute's chief objectives include:

a) initiating and conducting research identifying current and emerging economic and public policy issues facing Atlantic Canadians and Canadians more generally, including research into the economic and social characteristics and potentials of Atlantic Canada and its four constituent provinces;

b) investigating and analyzing the full range of options for public and private sector responses to the issues identified and acting as a catalyst for informed debate on those options, with a particular focus on strategies for overcoming Atlantic Canada's economic challenges in terms of regional disparities;

c) communicating the conclusions of its research to a regional and national audience in a clear, non-partisan way; and

d) sponsoring or organizing conferences, meetings, seminars, lectures. training programs, and publications, using all media of communication (including, without restriction, the electronic media (for the purpose of achieving these objectives.

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EXECUTIVE SUMMARY

Spring is in the air and a federal election is in the offing. There can be no better time for all political parties to examine their past policies and declare how they intend to bring Atlantic Canada back into the nation's economic forefront. Atlantic Canada has all the necessary human and physical resources to compete strongly in the North American and global marketplaces, and there is every reason to believe that the existing gap between incomes, productivity, and employment in this region and those in the economically better-off provinces can be eliminated.

This is not wishful thinking — it is a thoroughly realistic vision of what Atlantic Canada's future can be. We have seen the past — and it did not work. Misguided federal policies not only have failed to close the economic discrepancy between the Atlantic provinces and the rest of Canada; they have, in fact, held back the natural process of convergence, which could have closed the gap relatively quickly. Ottawa's policies of regional development spending, equalization transfers, and regionally extended employment insurance benefits are well-intentioned failures. They have left Atlantic Canada with a per capita gross domestic product that is no more than three-quarters of the national average, well below average productivity levels, and unemployment that is high even as the region suffers from increasingly significant labour shortages. Moreover, excessive federal regulation and short-sighted bureaucratic interference have prevented key industries in the region, such as the fishery and offshore energy, from acting as catalysts of economic revitalization.

Atlantic Canada does not need handouts or preferential treatment, and this report does not ask for them. Rather, we ask that the new federal government critically examine the effects on the region of existing policies. We believe that such an examination would lead to conclusions similar to those that many of the Atlantic Institute for Market Studies' authors have arrived at in recent years.

Ottawa's misguided approach to Atlantic Canada is not unique to any particular political party but reflects decades of oversight and misconceptions. Canada's political leaders now must recognize that improving Atlantic Canada's economy will depend on reversing ill-considered measures and introducing effective new policies. As new leadership in Ottawa promises to bring fresh air to national politics, so should policies toward Atlantic Canada get a spring cleaning — not just a light once-over with a feather duster but a thorough clean sweep.

At a minimum, a new federal government that wishes to put Atlantic Canada on a trajectory toward growth and prosperity should take the following steps:

1. Dismantle expensive, politicized, and distortionary regional development programs, by

- using broad, tax-based measures to foster a development-friendly business environment, and scrapping inefficient, politicized, project-specific incentives provided thorough agencies such as the Atlantic Canada Opportunities Agency; and
- replacing programs aimed at individual businesses with federally driven corporate tax reductions that allow consumers to choose which businesses will prosper.

2. Revise the equalization program to reduce its perverse incentives, by

- re-establishing a ceiling on the total amount available for equalization;
- removing natural resources from the equalization formula; and
- swapping equalization payments for a provincial debt-reduction plan.

3. Restore employment insurance (EI) to its original objective of protecting workers from unpredictable short-term interruptions in life-long attachment to the workforce, by

- ratcheting down EI benefits significantly every year for annual repeat claimants;
- requiring first-time claimants to have at least one year of continuous work to qualify for EI benefits;
- making EI experience rated, so that employers pay higher premiums when they repeatedly lay off people who then claim EI;
- funnelling a significant part of the savings generated by the EI reforms into vouchers to allow workers to gain access to a wide range of job and skills training; and
- eliminating regionally extended EI benefits.

4. Develop a business climate and regulatory structure that promotes strong growth in industries, such as the fishery and offshore energy, where the region has a comparative advantage, by

Case Study #1: The Fishery and Aquaculture

- transferring ownership and control of the fishery to those who make their living from the resource, and making fish quotas fully transferable and tradable;
- passing a National Aquaculture Act that creates strong property rights in the ocean resources required for the aquaculture industry to expand and thrive; and
- transferring jurisdiction over aquaculture from the Department of Fisheries and Oceans to an "industry-oriented" department such as Agriculture or Industry;

Case Study #2: Offshore Energy

- creating the conditions in which an internationally competitive oil and gas exploration and development industry can take root and grow by keeping regulatory and tax costs competitive with those in other jurisdictions;

- streamlining the regulatory process for oil and gas to match approval times in competitor regions, such as the North Sea, that are suitable benchmarks;
- eliminating jurisdictional overlap and coordinating policies to move toward a "one-window" solution for the oil and gas industry; and
- introducing "performance-based" regulation.

5. **Build a new, strong, and committed relationship with the US, Canada's most important international partner, that reflects the interests of Atlantic Canada as well as those of the country as a whole, by**

- supporting Washington's study of the transportation infrastructure in the northeastern part of the continent, stretching from Halifax to northern New York state;
- working with the US to create the needed infrastructure that ties Atlantic Canada more effectively into markets in the NAFTA heartland; and
- building on the Smart Commerce initiative to accelerate and further simplify border-crossing procedures, and working with the US on integrated perimeter security, the harmonization of external tariffs, and mutually agreeable standards for entry of persons from third countries.

INTRODUCTION: CONVERGING ON THE FUTURE

For decades, federal government policies have tried without success to narrow economic discrepancies between Atlantic Canada and the rest of the country — indeed, such policies have actually retarded economic convergence. Take unemployment, for example. Studies published by the Atlantic Institute for Market Studies (AIMS) have shown (McMahon 1996, 2000a) that, although unemployment rates in Atlantic Canada were similar to the national rate until the end of the 1960s, with the liberalization of unemployment insurance rules in 1971 and the introduction of massive economic development policy spending in the 1970s and 1980s, unemployment and growth rates in Atlantic Canada and the country as a whole began to diverge.

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 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 percent annually (Barro and Sala-i-Martin 1995). Yet Atlantic Canada's economy has converged with that of the rest of Canada at less than half that rate despite — or, more likely, because of — massive federal intervention.

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 and limited government interference in markets;
- the rule of law;
- property rights; and
- stable institutions, including political stability.

Ottawa's policies, however, have actually undermined some of the necessary conditions for convergence, by encouraging development by bureaucrats rather than by sound business planning, by regulating 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.

For a practical example of convergence, 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 (see McMahon 2000b).

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 percent 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 skillful, real wages rose along with tax revenues, and a virtuous circle was created. Growth bred more growth, success bred more success. (Brian Lee Crowley, in McMahon 2000b, 10–11.)

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 the policy right and then letting employers and workers respond to the signals of the marketplace.

In Atlantic Canada, however, much "economic development policy" has been based on the 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.

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 Frank McKenna, in his 1997 farewell speech, 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 free functioning of the labour market, so that the region's unemployment can be absorbed and labour shortages eliminated.

The Past: Regional Development; The Future: Regional Prosperity

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. 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 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.

Just how badly the policies of the past have served the region is revealed in a recent C.D. Howe Institute study (Mintz and Smart 2003) 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 the marketplace, 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.[1]

1 For commentary on ACOA's "evidence" that its operations have "created" and "maintained" the number of jobs for which the agency takes credit, see website: <www.aims.ca/commentary/acoa.pdf>.

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 period, 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 market determined, but also because 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.

What Is the Alternative?

For years, the federal government has been unable to move beyond these failed policies because of a lack of a clearly articulated alternative to the "market failure" view. Yet Atlantic Canada's problem is clearly not failure of the market, but failure to *use* the market. Investors have failed to invest in Atlantic Canada because obstacles to investment have been placed in their way. Removing those obstacles will set convergence back on course.

For some time, AIMS' research has pointed to an alternative approach to stimulating activity. Key to this goal is the reduction of taxation levels in the region. Canada's most economically successful provinces, Ontario and Alberta, have pursued aggressive tax-reduction policies in recent years. British Columbia is now reducing its tax rates, and so is Ottawa. The United States is similarly engaged in significant tax reductions. Yet Atlantic Canadians continue to stagger under a tax burden that is significantly higher than the national average. And, as the wealthier provinces cut their tax rates still further, Atlantic Canada's attractiveness as a place to do business continues to be undermined.

The taxes most in need of reduction are those that weigh most heavily on effort, investment, productivity, and growth — namely, taxes on personal income, business profits, and capital. Cuts to other taxes, such as those on consumption, should be of lower priority. Critics of such a tax-based economic growth strategy charge that it is a "race to the bottom". It is, however, quite the reverse.

Competitive taxes help boost sustainable economic activity, which raises the total tax take. Typically, one or two years after a significant tax cut, tax revenues are higher than prior to the cut. They may be lower as a percentage of GDP, but they are higher in real terms because of stronger GDP growth. Critics often forget that, in absolute terms, Americans pay far more in taxes than do people in any other country; tax *rates* are lower there than in Canada, but that simply reflects the fact that governments in the US are taking a relatively smaller share of a huge pie.

Using low tax rates to generate prosperity, rather than attempting to rely on stimulative government spending, removes the element of politics from regional development activity. Under the current system, most economic development efforts simply transfer wealth from self-sustaining activities to government-selected activities, which benefits owners and workers in the selected activities, but at significant cost to other businesses and workers. Allowing profitable businesses to keep a larger share of their profits, however, would *automatically* reward successful businesses and encourage them to become even more successful; government would no longer have to try to choose winners.

Several alternative approaches could be used to offset reductions in direct intervention under programs such as ACOA. As Mintz and Smart (2003) point out, however, any such measure must have a real impact on the growth of regional investment, rather than simply shift profits into a lower-tax jurisdiction. Mintz and Smart favour a broad-based investment tax credit; AIMS' authors, on the other hand, favour either regionally differentiated federal tax rates or the use of federal dollars to help the Atlantic provinces reduce tax burdens on growth and productivity. Politicians as diverse as former New Brunswick Liberal premier Frank McKenna and former Progressive Conservative leadership candidate and now Liberal MP Scott Brison have suggested trading regional economic development spending for some form of tax reduction. The actual design is perhaps best left to the technicians. The important point is to develop a broad, tax-driven means of encouraging business development in the region — not one that targets particular industries or firms, but one that enables businesses and consumers, rather than bureaucrats, to choose the business opportunities that are worth pursuing.

Recommendations:

- **Employ broad, tax-based measures to foster a development-friendly business environment and scrap inefficient, politicized, project-specific incentives provided thorough agencies such as ACOA.**
- **Replace programs aimed at individual businesses with federally driven corporate tax reductions that allow consumers to choose which businesses prosper, thus delivering economic growth in Atlantic Canada.**

The Future of Equalization: Eliminating the Need

Atlantic Canada does not need equalization. Rather, it needs to close the economic and fiscal gap with Canada's better-off regions.

Equalization was originally designed with the best of intentions: to provide reasonably comparable public services at reasonably comparable levels of taxation in all provinces regardless of the strength of the local tax base. Equalization's effects, however, go far beyond the intentions of the program's designers. The Atlantic provinces now receive a quarter of their income from equalization (and about 40 percent from all federal transfers taken together), which reveals how dependant they have become and how badly transfer programs have served the objective of closing the prosperity gap with the rest of the country.

Equalization Encourages Dependence

Equalization discourages provinces that receive it from aggressively promoting economic growth. As an equalization-receiving province (ERP) builds its tax base and earns more revenue, every new dollar of revenue the province generates gives it, on average, only about 10 cents to spend on provincial programs because Ottawa claws back equalization payments on the basis of the new revenue, leaving the province only marginally better off for its efforts. This creates a poverty trap for the province similar in principle to the "welfare trap" that awaits individuals who try to escape dependence on social welfare programs only to find their benefits cut commensurately with their higher earnings. Thus, rather than develop their economies, provinces that receive equalization find it more rewarding to lobby the federal government for extra transfers, since a dollar in new transfers from Ottawa is a dollar available to spend on provincial programs.

ERPs also find it worthwhile to forgo new revenues and take their "share" of new economic activity in the form of low-value, but politically popular, short-term job creation. As a classic example, Newfoundland and Labrador gave up much of its royalty stream from the Hibernia energy project in exchange for an employment-intensive but short-term construction project (the "Gravity-Based Structure", or GBS). Nova Scotia sold off exploration rights in its offshore energy resources, not for cash, but in exchange for "work commitments", a specified but undependable level of economic activity by exploration companies, the economic value of which it was hoped would remain in the province. Had the province auctioned off the rights, Ottawa would have clawed back the cash by reducing Nova Scotia's equalization payments. To put the issue in perspective, the royalty stream from the Sable Island project has amounted to $31 million over the past three years, $21 million of which Ottawa clawed back, leaving Nova Scotia with less than $3.5 million a year — yet it costs the province $7.6 million a year just to operate its Department of Energy. Royalties from the project may well rise significantly as it matures, but Nova Scotia will capture only a fraction of that revenue.

In its March 2004 budget, Ottawa recognized that energy development has not been as rapid in Atlantic Canada as had been anticipated. As a result, it proposed changes to the offshore energy agreements that will provide some retroactive relief of the impact the clawbacks have had on Nova Scotia and Newfoundland and Labrador. Provincial governments undoubtedly will welcome these additional funds, but they cannot compensate for the distortions the program has already created, nor do they deal with the fundamental design problems of equalization, which reach far beyond the treatment of Atlantic Canada's offshore royalty revenues.

Equalization subsidizes poor economic policy and the diversion of economic activity to lower, rather than higher, levels of value added. It also rewards provinces for remaining dependent on federal transfers rather than for reducing that dependence by generating more genuine economic activity. With such economic growth, however, the need for federal transfers would diminish. Thus, Ottawa and the ERPs should aim to grow the local tax base so that taxpayers in the "have-not" provinces pay the cost of public services they wish their governments to provide.

Equalization Leads to Tax Distortion

Equalization also creates incentives for less-developed provinces to keep their tax rates higher than they would otherwise be (Boessenkool 2002). By manipulating their tax rates, poorer provinces affect the size of their equalization payment and receive partial compensation for the debilitating effects of those higher taxes.

The bigger the province, the stronger is the incentive to keep tax rates high. Quebec, the largest ERP, has the strongest incentive, with the Atlantic provinces, Saskatchewan, and Manitoba having correspondingly weaker incentives. Moreover, there is an incentive to levy higher tax rates on weaker tax bases (since those are the tax bases most likely to shrink under the burden of heavy taxation) and to levy lower tax rates on stronger tax bases (since those are more resistant to the effects of heavy taxes). For example, personal income taxes are, on average, one-third higher in the "have-not" provinces than in the "have" provinces of British Columbia, Alberta, and Ontario; capital taxes are more than two times higher; sales taxes are half again as high; and fuel taxes are one-tenth to three-fifths higher. This conclusion holds even if low-tax Alberta is taken out of the calculation and one compares taxes in the "have-not" provinces only with those in Ontario and BC (Boessenkool 2002).

Sorting Out Equalization

Three measures can be taken in the short term to help remove equalization's perverse incentives, reduce its cost, reward provinces for developing their economies, and move provinces that receive equalization along the path of self-reliance and away from dependence, all goals that should be widely shared within Atlantic Canada and the country as a whole.

1. Re-establish a ceiling on funds for equalization

As part of the 2003 First Ministers' Accord on Health Care Renewal, the federal government agreed to eliminate the existing ceiling on the permissible growth of equalization payments. Re-establishing a ceiling, and making it firmer and more rigorous than in the past, would send a clear signal to ERPs that they should seek to improve their fiscal positions through improving their economic performance and own-source revenues, rather than through additional equalization transfers. Over time, this step alone would reduce the weight of equalization in ERPs' total revenue picture, making it easier for them to contemplate an eventual escape from such dependence. Coupled with other measures that are described below, however, it would help to create the conditions under which some provinces could become self-reliant within a relatively short time.

2. Remove non-renewable natural resources revenues from the equalization formula.

Non-renewable natural resources are becoming an increasingly important part of the economy of Atlantic Canada. The development of those resources, primarily oil and gas but also minerals such as nickel (at the Voisey's Bay deposit), is creating conditions under which economic growth in the region could well outstrip that of the rest of the country in the years ahead. Indeed, Newfoundland and Labrador is projected to be producing around 40 percent of Canada's conventional oil within a few years, while a natural gas pipeline, possibly the first of several, already connects Nova Scotia with New England. Eventually, both offshore and onshore petroleum resources may be discovered in almost every province in the region.

Yet, accommodating volatile non-renewable natural resources revenues has always been a huge challenge for the formula that is used to determine equalization payments (see Boessenkool 2001). During the early days of equalization, Alberta received equalization payments but the formula to determine those payments did not include natural resources. Within a few years, Alberta leveraged its resource riches into a prosperity that allowed it to escape dependence on equalization. If natural resources were taken out of the equalization formula, the Atlantic provinces and others, such as Saskatchewan, could conceivably follow the same path as Alberta. Natural-resources-led growth could feed through to higher corporate and personal income taxes, sales taxes, real estate values, and so on, which would compensate for Ottawa's clawback of equalization.

Ottawa's clawing back of royalty payments on non-renewable natural resource revenues is, in any case, manifestly unfair since, in effect, equalization taxes ERPs that turn a stock of assets into another form but without creating any new economic value. A concrete example may help to illustrate this point. Although Nova Scotia's per capita debt is one of the highest in the country, the province's balance sheet also contains major economic assets in the form of future cash flows from offshore oil and gas royalties. For Nova Scotia, a sensible economic strategy would be to clean up its balance sheet by selling some of those assets and retiring debt. In so doing, however, it would create no new economic value (other than, perhaps, a more efficient use of the assets); rather, existing assets would be transformed from capital stock to cash. Yet, under current equalization rules, as soon as this conversion was completed, already-wealthy Ottawa effectively would seize those assets by clawing back as much as 70 percent of the cash (for other types of resources and in other provinces, the clawback would approach 100 percent). That is a very high marginal tax rate indeed on a transaction that, if undertaken by a company or an individual, *would not be treated as taxable income at all*.

As previously noted, the March 2004 federal budget proposed to compensate Atlantic Canada for some of the past fiscal consequences of the clawback, but it can do nothing about past economic disincentives. And simply resetting the clock by changing the terms under which the clawbacks kick in would have little impact on future revenue streams and would not spur more appropriate provincial growth strategies. If Alberta's historical success is to be repeated in Atlantic Canada, nothing short of removing non-renewable natural resources revenues from the equalization formula is required. Even then, serious benefits would only flow when, and if, the industry achieved critical mass.

3. Consider swapping equalization payments for debt.

The lion's share of equalization payments goes straight back out the door in the form of interest payments on provincial debt. Ottawa could take over part or all of the debt of ERPs in exchange for corresponding but permanent reductions in equalization payments and stringent rules to prevent the accumulation of new debt. Strengthening provincial balance sheets and reducing dependency on federal transfers would give the Atlantic provinces much greater incentives to develop their own economies, as well as a firm, yet reasonable, time frame in which to act. Since Ottawa can service this debt more cheaply than the provinces, a mutually beneficial deal would result.

There are, in short, far more effective means of reducing fiscal disparities among the provinces than are now being undertaken. The overarching objectives should be to eliminate the difference in fiscal capacity by encouraging the tax base to expand and to remove distortions that promote short-sighted regional policies at the expense of longer-term convergence with the rest of the country.

Recommendations:

- **Re-establish a ceiling on the total amount available for equalization.**
- **Take natural resources out of the equalization formula.**
- **Swap equalization payments for a debt-reduction plan.**

The Future Is Jobs, Not Employment Insurance

Employment insurance (EI) creates unemployment. That is not hyperbole; it is reality. As currently designed, EI and other misguided federal policies have fostered a skills imbalance in Atlantic Canada, encouraged inefficient production, and contributed to an unemployment rate that is persistently above the national average.

Initially, EI was meant to support workers who lost permanent jobs. In Atlantic Canada, however, EI has largely become a means of supporting seasonal workers between short-term jobs. In the 1970s, workers could receive unemployment benefits after working for only eight to ten weeks, and many government make-work projects were specifically designed to provide just ten weeks of work, so that those employed by such projects could collect benefits when the projects ended. Closely identified with Atlantic Canada, this annual cycle created a negative stereotype that has clung to the region ever since.

The EI System Mismatches Jobs and Crucial Skills

Policymakers remain wedded to a vision, now outmoded, that Atlantic Canada's chief challenge is unemployment. The real challenge, however, is how to deal with the paradoxical co-existence of both large pools of unemployed and underemployed labour and significant labour shortages.

The construction industry, for example, is clamouring for skilled workers. The Canadian Home Builders Association reports (2003) that 44 percent of its members in Atlantic Canada cite trade and labour shortages as their most critical issue — up from 33 percent in 2002. That concern of Atlantic Canadian builders is double the national average and the highest in the country. Other industries in the region report similar concerns. In a series of articles in the *Halifax Chronicle-Herald* in summer 2003, employers reported looming labour shortages in schools, hospitals, and the hospitality industry. Moreover, the shortages are by no means limited to education-intensive skills. The executive director of the Nova Scotia Fish Packers Association has said that he sees a labour force crisis looming in his industry: "It's a younger persons' industry, and our younger people are leaving the coastal communities and heading for the cities".[2]

The lowest provincial unemployment rate in Atlantic Canada has only recently fallen below 10 percent, which is still well above the national average, yet there is a scarcity of workers on the fish-packing

2 Quoted in the *Halifax Chronicle-Herald*, July 29, 2003, p. C1.

floor! Fish plant workers may soon be as rare as cod. There is excess labour in some regions that have shortages of skilled labour, and there are pockets of virtually full employment in a region characterized by high unemployment. Halifax's unemployment rate has fallen below the national average. Something is clearly out of balance.

What is happening is that Ottawa's policies are delivering a mismatch of outcomes. For decades, policymakers have engaged in misguided "job-creation" exercises while using the EI program and its predecessor, unemployment insurance, to promote workforce behaviour that is completely at odds with the need to encourage labour market adjustment. Federal employment policies are at the root of Atlantic Canada's failure to achieve full employment.

The EI System Distorts Wages

As regional unemployment rose following the "reforms" of the 1970s, wages and salaries in Atlantic Canada also rose dramatically relative to the national average (McMahon 1996). That was because renewed federal wealth transfers increased the size of public employment in the region and bid up wages in competition with the private sector. Private sector employers had to bid not only against employment opportunities in government and a multitude of make-work projects and government-subsidized jobs; they also had to bid against an EI system that gave generous year-round benefits for a few weeks of work. These circumstances distorted the local economy, throwing it into a vicious downward spiral.

The distortions differed in their short- and long-term effects on wages. In the short term, wages were artificially inflated, raising the cost of doing business and suppressing investment. In the long term, the distortions suppressed normal increases in pay rates — the opposite of the short-term effect — by keeping the ratio of capital to labour lower than it otherwise would be and by suppressing the skills that workers would normally acquire by working. In other words, wages rose rapidly, and then became stuck, relatively speaking.

The EI system also bribes people to avoid work once they qualify for benefits, since accepting any job during the benefit period would force them to give up government-funded leisure time and reduce their income. This situation puts a premium on short-term, high-paying work, rather than on long-term employment. Employers find it increasingly difficult to hire people for year-round jobs at wages they can afford. Economic growth is stifled.

The EI System Undervalues Job Skills and Education

EI also distorts the labour market by causing workers to undervalue education and skills enhancement, which further weakens economic growth and contributes to labour shortages. EI removes incentives for training by emphasizing low-skilled, usually seasonal jobs and make-work programs, where employment has nothing to do with a worker's skills and output. This creates a workforce dependent on low-skilled work. It also inhibits diversification and growth by driving up the cost of labour and making it difficult for employers offering year-round jobs to compete with seasonal industries. Many employers, particularly in the fishery, are pressured to hire people just long enough to qualify for EI, and then to lay them off and bring in fresh workers to get them “stamped up” as well — hardly a recipe for developing a high-quality, skilled workforce.

This trend has ameliorated somewhat since the EI reforms of 1995, and young Atlantic Canadians are now staying in school longer. But the problem persists, as is evident, for example, from the still-significant numbers of first-time EI claimants in the Newfoundland and Labrador fishery.

What to Do about EI

Competitive labour costs and a dynamic labour supply are vital to regions, like Atlantic Canada, that are trying to escape underdevelopment. Part of the solution, therefore, is to undertake further reform of EI in general, and with regard to seasonal workers in particular. Recognizing that entrenched patterns of behaviour are difficult to change and that workers who are trapped in the old system need to be given time to adjust, EI benefits should be ratcheted down fairly significantly every year for annual repeaters. The effect, with each passing year, would be to send an ever-clearer signal that work, not employment insurance, is the route to improving one’s economic circumstances. Moreover, to prevent a new generation of young people getting hooked on EI, the system should require potential claimants to show better evidence of workforce attachment. For example, a first-time claimant should need a minimum of a year’s continuous work in order to qualify for EI benefits.

Additionally, the system should be *experience rated* — that is, employers that repeatedly lay off workers who subsequently collect EI should pay higher premiums. Such a system is already in place in the US state of Maine, whose economy is similar to Atlantic Canada’s, and helps to explain Maine’s lower unemployment rate. Under experience rating, employers are slower to hire because they want to be sure they can sustain a job, but they are also slower to fire, ensuring that workers actually stay long enough in a job to acquire valuable skills and good work habits. Such a reform in Atlantic Canada would give employers a much stronger incentive to resist social pressure to create many short-term jobs rather than fewer permanent ones in order to “stamp up” as many members of the community as possible. Moreover, such a new dynamic would enhance work-place attachment, encourage longer-term skills upgrading, and deepen employers’ commitment to their sites and their workforce.

In order to deal with the problem of the mismatch between the skills workers possess and those that employers need, as well as to help in the transition away from dependency on the EI cycle, a significant part of the savings generated by the EI reforms should be funnelled into training programs for workers. However, an important caveat needs to be attached to this recommendation. Government officials are no better at picking the jobs of the future than they are at picking the industries of the future. No one knows better than displaced workers themselves what their interests, talents, and opportunities are, if they are prepared to move, and the other factors that determine their training choices. Thus, the money should be put into vouchers available to workers to support their own training decisions. These vouchers should be generous, but not enough to cover the full cost of both tuition and living expenses during retraining. Just as higher tuition fees at the university level have focused students' minds on getting the best value out of their university education, having workers contribute to their training would avoid their treating it as merely another form of more or less passive income support. And prospective employers might be prepared to share this cost with potential employees in exchange for a longer-term work commitment.

Finally, regionally extended EI benefits should be eliminated. Full-time jobs are going unfilled in Atlantic Canada because, among other reasons, the wages offered for them cannot compete with seasonal work and EI benefits. The balance needs to be changed decisively in favour of work, so that people see they would be better off, not worse off, to accept the work that is available and to acquire the training and education needed to qualify for that work.[3]

Recommendations:

- **Ratchet down EI benefits significantly every year for annual repeat claimants.**
- **Require first-time claimants to have a minimum of a year's continuous work in order to qualify for EI benefits.**
- **Make EI experience rated — employers should pay higher premiums when they repeatedly lay off people who then claim EI.**
- **Funnel a significant part of the savings generated by the EI reforms into vouchers to allow workers to gain access to a wide range of job and skills training.**
- **Eliminate regionally extended EI benefits.**

3 Shorter qualification periods and longer periods of benefits in regions of higher unemployment tend to draw Atlantic Canadians home from Ontario and Alberta when they are temporarily laid off. These comfortably unemployed reduce their living costs and live in a supportive social network in which there is no compulsion to seek work until benefits run out. These imported unemployed then raise the unemployment rate in the Atlantic provinces, which then secures the regionally higher rate that other migratory workers can enjoy. Eliminating regional benefits would eliminate this disincentive to re-enter the workforce.

REDESIGNING THE FISHERY

Perhaps the greatest distortion of Atlantic Canada's economy has taken place in the fishery. Political commentators and regional policymakers often argue about the necessity and fairness of supporting the region's "traditional" way of life in the fishery. In fact, the fishing industry in Atlantic Canada today is a political artifice, constructed with billions of dollars of public money, that has little to do with the region's traditional fishery. By the early 1990s, about two and a half people were working in the fishery for every one in 1961.

The Fishery as a Gateway to Social Welfare

In many communities throughout Atlantic Canada, the fishery is regarded as the employer of last resort — a means to "stamp up" as many members of the community for EI benefits as possible and provide them income for the year in a crude kind of workfare program. Indeed, before the northern cod stocks collapsed, EI benefits provided a larger share of income in fishing communities dependent on the cod fishery than did fishing itself (see May and Hollett 1995; Audas and Murrell 2000). Large numbers of people became trapped in a cycle of seasonal work and EI benefits that kept them locked in low-value economic activities and impeded reforms to the structure of both the fishing industry and social welfare programs. The recent controversy about Fishery Products International's plans to modernize its fishing and processing operations in Newfoundland and Labrador shows that many communities find it difficult to see the value of putting the industry on a year-round, sustainable, profitable footing when that strategy requires some job losses.

Resource Ownership and the "Tragedy of the Commons"

In addition to problems caused by federal and provincial interventions in the management of the fishery, there is the underlying problem of the ownership structure of the resource itself.

Under the current regime, fish stocks are a common property resource, owned by the Crown and managed by the federal government. It is a well-established economic principle of a common property regime, however, that self-interest causes people to act in ways that are destructive of the resource. Furthermore, no amount of moral exhortation or heavy-handed bureaucratic management is ever more than modestly successful in changing this "Tragedy of the Commons" (see Crowley 1996). Incentives matter, however. If people's behaviour in the fishery is to change, a way must be found to encourage their self-interest to coincide with the need for sustainable management of fish stocks. The alternative is future ecological and economic disasters along the lines of the collapse of the northern cod stocks.

On land, ranchers own their cattle and farmers own the productive capacity of their land. Ranchers and farmers who run down the long-term value of their assets through poor management pay a direct, personal cost. In other words, ownership of these assets introduces a direct and tangible accountability into the quality of stewardship of the resource. Fishermen, on the other hand, by and large do not own the fish until they have landed their catch in the boat. Instead of owning the resource, fishermen have a licence from the federal Department of Fisheries and Oceans to put their nets, lines, or traps in the water at the times and places the department's bureaucrats authorize. Fish that any one fisherman does not catch during the short season do not simply remain in the water to reproduce, but are sought by other fishermen. Thus, all fishermen have an incentive to catch as many fish as possible as quickly as possible, and to cheat on artificial rules designed to hold down harvesting capacity so that access to fish stocks can be distributed on the basis of political pressure.

The federal government reaps few of the benefits that sound resource management would produce. Instead, it runs the fishery to maximize short-term employment — which then acts as a gateway to social benefits — and to maintain coastal populations in a state of political dependency. In this, Ottawa is aided and abetted by provincial governments that regulate fish processing with the same short-term employment objectives in mind. Productivity and profitability pay the price.

The politicization of fish management has resulted in a huge influx of people into the fishery over the past 30 years. Yet, the resource will become sustainable only if the people who make their living from it also own and manage it. And only then will people now in the industry be able to decide whether to fish, rent out their quotas, or sell them outright and do something else with their capital.[4]

Fully half the fish caught on the East Coast, by value, do not fall under some form of property right. Moreover, those property rights that do exist are usually of poor quality and subject to high risk of political interference. This means that, on the whole, the chief asset of many coastal communities cannot be leveraged to create new economic opportunity or recombined effectively with other assets to create higher value added. This "dead capital" stunts economic life and opportunities in coastal communities.

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4 Although these arguments are now widely understood in the fishing industry and in natural resources economics generally, a further argument is only now making its impact felt, largely as a result of a book by Hernando de Soto called *The Mystery of Capital* (2000). De Soto, a renowned analyst of the challenges of Third World development, attributes the lack of such development to the absence of formal title to the means of production and real estate used by the vast majority of people in those countries. De Soto argues that a formal and developed property system endows the owners of assets with the ability to adapt them to any economic circumstances in order to produce continually higher value-added mixtures. Such a formal, developed property system does not exist, however, for most people in the Third World, for people in the former communist countries of Europe, for people living on aboriginal reserves in Canada, or for those in Canada's coastal communities who depend on the oceans as their chief productive asset.

One approach to overcoming the problems of ownership and control in the fishery would be to make fish quotas fully transferable and tradable (see Pearse 1997). Where such a strategy has been implemented, the fishery has been rendered sustainable and the quality and use of the resource have increased. Under such a system of property rights, fishermen, rather than frantically racing to wrench indiscriminately as much stock from the ocean in the shortest time, tend to adopt better management strategies that handle catches more respectfully and reduce the number of unwanted species of fish caught, thus ensuring maximum value from each fish (see Jones 2003).

Aquaculture: The Farming of the Future

Aquaculture provides another example of the difficulty of shifting economic activity to higher value added in traditional natural resources industries burdened by overregulation and behaviour patterns reinforced by social welfare programs.

World aquaculture production has increased seventeenfold in the past 50 years, and the industry now supplies a fifth of all the protein consumed from the sea. In the not-too-distant future, farmed fish, shellfish, and algae will overtake the wild fishery in value — the industry is already worth more than $150 million a year to the New Brunswick economy, for example. Aquaculture's advantages are many: it is based in coastal communities where jobs are scarce, it is not seasonal, it uses — and therefore encourages — high technology, and it meets a growing worldwide market demand.

Ironically, Canadian aquaculture technology and expertise is in demand around the world, but legal and bureaucratic hurdles make the industry's local growth slow compared to that of the global industry, representing huge lost opportunities for workers, investors, and taxpayers in Atlantic Canada. On the legal side, the absence of high-quality property rights in the water column, foreshore, and seabed hampers the industry's development. On the bureaucratic side, numerous federal and provincial departments must each give their separate approval for an aquaculture operation to go ahead; the process for allowing fish farmers to use the water is capricious and arbitrary; and leases are often too short or too small for efficient operations.

The Absence of Property Rights in Aquaculture

Aquaculture could easily become a vigorous and lucrative industry for Atlantic Canada, as the wild fishery continues to decline and markets open up for high-grade farmed fish. Yet "fencing" this last frontier is hampered by a property rights system essentially developed for the hunter/gatherer nature of the wild fishery, rather than agriculture, which aquaculture more closely resembles (see Neill 2003).

The development of agricultural-style property rights for aquaculture faces two major hurdles. First, the agricultural frontier advanced under the assumption that the land was empty and to be had for the taking — although we now realize that this assumption was wrong, since aboriginal peoples lived on the land and had rights of which Europeans took little account. Today, however, aquaculture faces prior ownership and usage rights — on the part of aboriginals, recreational users, and capture fishermen, for example — in coastal waters.

Second, unlike in agriculture, where ownership was transferred from the Crown to the individual farmer, in aquaculture the Crown continues to own the seabed, the water column, and the water surface. In effect, the fish belong to the fish farmer but the fish farm does not. The fish farmer's relationship to government is one of lessee to lessor, not owner to regulator. As lessee, the farmer has obligations, while government imposes its will through decisions made by the relevant minister and bureaucrats, with all the pressures to bend to special interests and political expediency such a relationship implies.

Individual property rights are important in aquaculture for the same reasons they are important in all other settings — such as radio frequency auctions and tradable pollution permits — where new legal instruments have been developed to extend the logic of property rights to new circumstances. Yet, there are no federal or provincial statutes dedicated solely to aquaculture. Even as recently as February 2003, "aquaculture" had not been defined in case law. Accordingly, the fish farmer faces a situation in which there is no legal restraint on government or on administrative discretion, no right to sue government in the courts, and no rights that government itself is duty bound to protect. Canadian fish farmers have been arrested for "illegal fishing" even though they were harvesting animals that existed chiefly because of the culturing efforts of their owners. The police refuse to lay theft charges against people who rustle aquaculturists' fish stocks because property rights are so muddy that it is unclear that the aquaculturists own what is stolen. Given the precariousness of their ownership of animals and farm, aquaculturists face huge problems in getting adequate financing and insurance, so that substantial productive capacity in the oceans is being squandered. Canadian aquaculture is, in effect, controlled by a sluggish and inept bureaucracy that is blinkered by a concern for short-term economic development and endowed with discretionary power biased by the political strength of established interests.

As Neill (2003) demonstrates, international experience with property rights in aquaculture has important lessons for Canada. Chile, for example, has conducted several interesting legal experiments to kick-start its salmon-farming industry, which is now one of the largest in the world. That country has created a legal foundation that grants licences and leases bestowing virtual private property rights in fish-farming sites. It has also developed a national aquaculture policy that encourages entrepreneurship, supports export efforts, and helps fish farmers navigate the bureaucracy. Despite its problems — controversy exists over environmental impacts on the country's southern fiords, for example — Chile's national policy is one that promotes aquaculture, not one that defends the wild fishery or an outmoded common property approach to managing coastal resources.

If Canadian aquaculture is to grow, become profitable, employ more people, and feed more of the world's population, the industry needs secure property rights to the foreshore, the water column, and the seabed — rights embodied ideally in a National Aquaculture Act and backed by the courts. It does not need more government economic incompetence and inefficiency, or arbitrary decision-making by bureaucrats.

An Abundance of Regulation in Aquaculture

Canadian aquaculture is overseen by a veritable "who's who" of federal government agencies and departments dealing with customs, veterinary drugs, navigation, fisheries, research, industry, and so on, each with a specific mandate and usually a narrow focus. What is needed, as AIMS' authors have argued (see Neill and Rogers 2002), is a single-source regulator — or at least a single agency that has paramount authority. Moreover, that authority most emphatically should not be the Department of Fisheries and Oceans, whose institutional structure is too wedded to an anti-industrial wild fishery culture, but a more industry-oriented agency, such as Agriculture or Industry.

Recommendations:

- **Transfer ownership and control in the fishery immediately to those who live from the resource. Make fish quotas fully transferable and tradable.**
- **Pass a National Aquaculture Act that creates strong property rights in the ocean resources required for the aquaculture industry to expand and thrive.**
- **Transfer jurisdiction over aquaculture from the Department of Fisheries and Oceans to an industry-oriented department such as Agriculture or Industry.**

Oil and Gas: Uncapping the Well

No recent development has promised so much potential for turning around Atlantic Canada's economic fortunes as the discovery and exploitation of oil and gas. But so far, the outcome has proved to be more tantalizing than real. Tremendous hurdles must be overcome before the full economic benefits materialize. In the meantime, the rewards must not be siphoned away, and every effort must be made to encourage much more exploration. Disappointing production results, especially in offshore Nova Scotia, and the failure to resolve longstanding regulatory issues threaten the future of this crucially important development.

The oil and gas industry in Atlantic Canada faces some inherent natural challenges — extreme weather and water conditions, the presence of icebergs, the need to explore in deep water — that make it one of the costliest in the world to develop. Nothing can be done about that, although the industry continues to seek technological solutions to mitigate those harsh realities. In addition to the hand nature has dealt them, however, developers must also face the regulatory constraints and onerous commitments imposed on them by government. This excessive burden seriously impedes the very real prospect that the oil and gas industry will realize its potentially important roles as a major contributor to government revenues, a locus for technological development, and a motor of growth and job creation. Something *can*, however, be done about this man-made burden.

In deciding what actions are needed to help realize the industry's potential in Atlantic Canada, we would do well to recall that four crucial factors will determine the success of any oil and gas basin in attracting a successful industry. Each of these factors is an independent "test" that a resource basin must pass to be considered attractive by the oil and gas industry. It is not sufficient that the resource basin pass one or two of these tests — it must pass all four.

First, and most important, is what the industry calls *"prospectivity"* — the likelihood that expensive exploration efforts will be repaid with major resource discoveries. Put bluntly, if the industry does not believe that there is a resource to be found, or if the odds against finding it are long, it will not invest money in exploration, the foundation stone of any successful resource basin. This is not a public policy issue, however, and since the best public policy in the world cannot compensate for inadequate resource finds, we leave it to one side. Yet, we should note that the industry is beginning to have doubts about the region's prospectivity, especially in the Nova Scotia offshore.

The second most important factor is *access to markets*. If the resource is found in commercial quantities, can it be delivered to markets cost effectively? Obstacles here can include poor or inadequate infrastructure, as well as legal tariff and other barriers to crossing borders.

The third factor is the *fiscal regime*, including royalties and other taxes. If companies determine that they cannot earn a decent return on their investment after governments have taken their cut, investment will not be forthcoming.

Finally, there is the *regulatory regime*. Even if the resource is found to exist in viable quantities, access to markets is assured, and a fiscal regime is in place that contains the appropriate incentives, the industry will prefer other basins if the "time and effort tax" that industry regulation represents is disproportionate to that existing elsewhere. Because time is money in this as in any other industry, a regulatory burden that causes long and costly delays is a major obstacle to investment and development. In addition, an uncertain regulatory outcome can add a further, man-made element of risk to investment in environmentally difficult basins that can easily tip the balance in favour of investment in more development-friendly locations.

Atlantic Canada Is a High-Cost Region

Exploring for oil and gas resources under the ocean floor is an inherently expensive and risky business. It is especially so in Atlantic Canada, where circumstances are uniquely difficult. The region is relatively unexplored, it is characterized by severe climatic conditions, and exploration of new deposits is being driven further offshore and into ever-deeper water — with ever-higher costs. The reality is that, after initial seismic testing, the probability that an exploratory well will find any resource at all is estimated to be one in ten; the chance that it will find *commercial quantities* of hydrocarbons in such a relatively unexplored area is about one in twenty.

The real potential of oil and gas to promote prosperity in the region lies in more exploration and development and in bringing a much larger supply on stream — enough to justify the massive investment in infrastructure, such as the pipelines, floating production, storage and offloading units, processing plants, and so on, that provide access to markets. Unless exploration is actively encouraged and energy actually produced, the economic opportunities that the industry represents for Atlantic Canadians will remain unrealized. Unless this region's discovered petroleum reserves continue to grow, its days as a significant producer are numbered.

Since Atlantic Canada competes for investment with other global opportunities, the fiscal regime — which includes the effects of the federal and provincial tax systems, royalty regimes, and other taxes and fees — is a key component in establishing a solid foundation for investment in the oil and gas industry. Although there are some bright spots in the fiscal regime,[5] it also has egregious defects.

To choose just one example, Canada is the only industrial country that continues to charge a significant import tariff on offshore drilling platforms from countries that are not parties to the North American Free Trade Agreement (NAFTA), even though the domestic industry that the tariff is

5 See, for example, Watkins (2001), who establishes that the offshore royalty regime in both Nova Scotia and Newfoundland and Labrador is internationally competitive with comparable resource basins.

meant to protect no longer exists in any significant way. Even if it did, this kind of protectionist barrier flies in the face of Canada's commitment to free trade, a commitment that makes sense for a medium-sized economic power highly dependent on international trade. Unnecessary government-imposed costs of this kind are extremely damaging to a resource basin that already must contend with the high exploration costs imposed by nature. While there seems to be widespread agreement within government circles that this anomaly must be eliminated, it remains in place for the moment.

Moreover, there is a case to be made that the recent reduction in the federal corporate income tax rate and the transition from resource allowance to royalty deductibility has damaged the attractiveness of investment in the east coast offshore, in part because the royalty regime here is "backloaded". That means that royalty deductibility only helps the tax burden on relatively mature projects, whereas companies have to invest huge resources up front in exploration and development because of the unusually high costs associated with the offshore, and it is in these early stages that tax incentives may matter the most.

Since Atlantic Canada's interests lie principally in stimulating new resource exploration and discoveries, the mismatch between when costs are incurred and when tax relief becomes available is an important issue. We have already argued for reducing the tax burden on business, investment, and effort in the region, but the particular circumstances of the high-cost offshore may well justify specific tax measures, such as the recent proposal to increase the Atlantic Investment Tax Credit to 15 percent from its current 10 percent and to make so-called intangible costs, such as drilling, eligible for the credit.

The Need for Efficient and Effective Regulation

The exploration, development, production, and distribution of crude oil and natural gas are highly regulated by governments and Crown agencies in the region. Each step of the process, from seismic testing through exploratory drilling to building and maintaining production systems and pipelines, requires prior approval and the satisfaction of a huge number of conditions.

No industry participant or serious observer contests the need for regulatory supervision. There is, however, a growing recognition, including within the ranks of the regulating governments, that the edifice of overlapping regulatory and supervisory programs and agencies largely exceeds what is necessary or productive. The Canadian Association of Petroleum Producers (2003) reports, for example, that the development of offshore resources in Nova Scotia involves as many as 20 federal and provincial government agencies; the situation is similar in Newfoundland and Labrador. Consequently, there is duplication and even triplication in the approval process. For example, the National Energy Board, the Nova Scotia Offshore Petroleum Board, and the Nova Scotia Utility and Review Board all claim jurisdiction over the construction, operation, and maintenance of subsea pipelines in Nova Scotia, while the joint federal-provincial offshore boards and Transport Canada share responsibility for the inspection of offshore installations. In many instances, different provinces set different compliance standards, compounding the confusion.

A recent *National Post* article[6] details just how counterproductive jurisdictional overlap can prove. Corridor Resources, a Halifax-based junior oil and gas company, has been struggling for eight years to gain approval to explore a formation that it believes may have reserves twice those of Hibernia or Sable Island. Unfortunately, the prospect is located in deep water, straddling a boundary area between Quebec and Newfoundland in which the federal government also claims jurisdiction. Partly because of these conflicting jurisdictions, the company complains that it has had to deal with nine different federal and provincial energy ministers over the past eight years, and it still has not obtained approval to drill.

Such overlap and consequent delays cost substantial amounts of money and discourage commitment to developing Atlantic Canada's oil and gas resources. Regulatory approval times in the region range between 13 months (for Hibernia) and 21 months (for White Rose), with the Terra Nova and Sable Island fields requiring 17 and 18 months, respectively. Moreover, approval times appear to be lengthening. By contrast, according to one recent study (Gaffney, Cline & Associates 2003), approval times for areas such as the UK's North Sea fields range from 5 to 12 months (with the median being about 9); in the US portion of the Gulf of Mexico, they range from 6 to 12 months (with a median of 10). In other jurisdictions, such as Australia and Norway, median approval times are slightly longer, but even in the worst, Australia, they are still only 14 months. And the length of the regulatory approval cycle has been falling in all of these comparable major offshore areas.

Over the past several years, Canadian policymakers have listened attentively at high-level government/industry "roundtables" convened to examine regulatory problems, including such issues as the length of the regulatory cycle, overlapping regulatory authority, and the imposition of import duties on imported drilling rigs. Yet, despite commitments made in apparent good faith to move on these issue, they have failed to follow through with the decisive actions needed to improve conditions on the ground.

Unfortunately, time is now of the essence. The Atlantic offshore is competing with resource basins in other parts of the world for scarce exploration and development funds, and the persistence of an onerous, costly regulatory regime combined with poor results from exploration in the region so far make further exploration that much more difficult. Yet more exploration is vital to produce a viable, long-term industry — even the important Newfoundland and Labrador discoveries are now 20 years old.

Assuming governments are serious about regulatory reform, what sort of regime should be put in place? There are two separate, but intimately linked issues here. One is the "cycle time" for regulatory approval of exploration and development projects. The other is the approach to regulation that should inform a reformed regulatory regime.

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6 "Norm Miller's Trouble with 'Old Harry'", *National Post*, January 12, 2004.

The lengthy and uncompetitive regulatory cycle time in this region is due not solely or even mainly to an unsuitable regulatory philosophy. Rather, it is driven chiefly by the fact that too many cooks are spoiling the regulatory broth. On the federal side alone are literally dozens of departments and agencies with a hand in regulatory approval. Provincial involvement adds another series of insatiable regulatory maws into which industry must pour time and resources, often merely to duplicate a regulatory result already achieved at another level of approval.

The only cure for the long regulatory cycle time, is much better federal coordination of the regulatory effort so that, for example, there is a single regulatory hearing and approval process. All regulatory parties need to be present at the table, and all necessary regulatory approvals need to issue from this single process. The federal government should take the lead, through agreements with the relevant provincial governments, to ensure that this structure is put in place and that regulators are held accountable for the efficiency of their regulatory oversight. Ottawa must exercise strong leadership to override parochial departmental and jurisdictional opposition and to rewrite the current regulatory system to arrive at clear, certain, and predictable regulatory policies and to eliminate jurisdictional overlap.

Once these lines of authority and accountability have been drawn, it will then be appropriate to look at the philosophy that should inform the regulations that are being put in place. Here, international experience has something to teach us. In the United States, the UK, and Australia, the trend is toward a "performance-based" approach to regulation, which emphasizes the regulatory objective that industry must meet, while allowing greater flexibility in the means used to reach the objective.

In performance-based regulation, it is the "end" that counts, and operators who have demonstrated responsibility are better able to adapt to changing circumstances and technological innovation. Experience has shown that it also encourages operators to exceed minimum standards (Gaffney, Cline & Associates 2003). The objective is to escape micromanagement by regulators who are not well informed about conditions on the ground or about technological innovation. By agreeing on the outcome that must be achieved, but leaving industry to find the best and most cost-effective method of reaching that objective, performance-based regulation lowers costs and achieves regulatory outcomes that are often better than those under regulatory micromanagement.

The Need to Encourage Exploration

Unless exploration is encouraged and energy actually produced, the economic possibilities the oil and gas industry promises for Atlantic Canada will be mere paper assets. Existing reserves cannot be exploited forever. If exploration is not constantly being undertaken and new discoveries made, the industry will become a footnote in Atlantic Canada's economic history. Many more resources must be discovered and developed before they can justify the huge investment in infrastructure necessary to move them cost effectively to consumers.

Despite the region's high development and production costs, it must compete for investment with other global opportunities. Governments cannot change the geology, but they can control the balance among the regulatory burden, taxes, and the royalty regime the industry faces. Watkins (2001) concludes that, at least with respect to the royalty regime, “producers are not enjoying a free ride, and governments are not trying to grab too much”; that balance must be maintained, but it is only a piece of the puzzle.

Results so far are insufficient to assure the development of a sustainable, long-term industry in the region. Industry analysts believe that the critical mass necessary to achieve a viable offshore petroleum sector requires the sinking of at least ten new exploratory wells each year for the next ten years. In both 2002 and 2003, however, only seven such projects were undertaken, and only a single exploratory well has been confirmed so far in 2004 — with the possibility of a second. A lot more drilling must be undertaken — and all the conditions must be in place to ensure that exploration and development in Atlantic Canada earn a competitive reward compared with other jurisdictions.

Recommendations

- **Create the conditions in which an internationally competitive oil and gas exploration and development industry can take root and grow by keeping regulatory and tax costs competitive with those in other jurisdictions.**
- **Streamline the regulatory process so that approval takes no longer than in competitor regions that are suitable benchmarks, such as the North Sea.**
- **Eliminate jurisdictional overlap and move regulatory policies toward a “one-window” solution.**
- **Introduce “performance-based” regulation.**

ATLANTICA: THE INTERNATIONAL NORTHEAST

Atlantic Canada is part of a region that AIMS' authors call "Atlantica", which broadly encompasses the Atlantic provinces, eastern Quebec, the northern tier of New England states, and northern New York state. Geography has placed Atlantica near the centre of the two largest trading relationships in the world. On the one side is the Canada-US trading relationship, the largest in the world at $2 billion per day; on the other is the trading relationship between North America and the European Union, which accounts for 40 percent of total world trade. Clearly, Atlantica's title of the "International Northeast" is well deserved. The port of Halifax is a day's sailing time closer to Europe and the dynamic Southeast Asian region than any other major east coast ports. But Atlantica has not been able to leverage that strategic advantage into the kind of strong growth and sustained prosperity that characterize other regions on Atlantica's borders, such as the Quebec City to Windsor corridor or the Boston to New York conurbation.

In the 21st century, transportation infrastructure is becoming more important to the economy than ever before. Relatively remote and inaccessible regions with higher transportation costs will see economic opportunities leak away to better situated, more economically coherent regions. In this sense, geography and the shape of the Canada-US border are the Achilles' heel of Atlantica. The state of Maine thrusts north, a peninsula surrounded on three sides by Canadian territory and virtually cutting off the Maritime provinces from central Canada, while Atlantic Canada is hemmed in on nearly all sides by water. Atlantic Canada is not simply a relatively poor region within Canada but part of a relatively poor region that straddles, and whose economic problems are exacerbated by, the Canada-US border, which, from a Canadian perspective, forces people and goods to make a long and inefficient trek around Maine and down the St. Lawrence River (see Map 1). NAFTA has accelerated continental economic integration, so that business production and marketing decisions now take less account of the existence of the border. But the explosion of international trade that the agreement has fuelled has brought many border issues into sharper focus. The border still matters — perhaps much more than we realize.

Atlantica's relative degree of underdevelopment can be explained in large part by the failure of policymakers to think of the region as a whole, where local success depends on working effectively across boundaries to achieve the economics of scale, transportation efficiencies, and other regional coherences that more successful regions — such as the US Midwest and Ontario or Texas and Mexico — take for granted. In short, Atlantica's political and natural disadvantages have been exacerbated by the Canadian and US governments' relative disregard for the region's economic requirements. On the Canadian side, the cumulative effects of more than a century of policies favouring the popula-

Map 1: ***The Long and Inefficient Trek***

tion centres of Quebec and Ontario are crumbling infrastructure and provincial governments and electorates corrupted by large transfer payments. On the US side, the northern New England states have been the losers in political battles with richer, more powerful states such as California, Texas, New York, and Massachusetts.

Free trade and globalization now give Atlantica an opportunity to establish its rightful place in the continental economy. If the border cannot be made to disappear, its impact must at least be blurred. The introduction of vehicle-handling efficiencies and the building of new crossings at the border will help, but the concept is much bigger than that. Ideally, commercial relationships should be equally attractive across provincial-state lines between the two countries as they are across political boundaries within the two countries. Canada's Atlantic provinces and the US northeast must become as economically integrated and coherent as is, for example, southwestern Ontario and the US Midwest. Only then will Atlantica realize its economic potential.

To achieve that goal, however, it will be necessary to rethink the policy, planning, and regulatory settings of all the provinces and states in the region, as well as those of the two national governments. Such an undertaking will require an unprecedented degree of common purpose — including, but not limited to, an understanding of how taxation regimes interact, the establishment of complementary regulatory and licensing regimes, new policies respecting corporate linkages, and freer movement of labour. Much can be accomplished at state and provincial levels, but participation at the federal level is essential.

Regional Transportation Coherence

Thinking about binational regional transportation coherence in this corner of North America is much further advanced in the US than in Canada. US authorities already recognize that the economic fates of the Canadian provinces and US states in the Atlantica region are deeply intertwined — for example, they regard the port of Halifax as a crucial piece of strategic NAFTA infrastructure that must be fully integrated into the transportation network. Moreover, US authorities are willing to spend US taxpayers' money on assessing the adequacy of the transportation infrastructure throughout the entire region to ensure that their citizens benefit from the region's potential. Largely due to the efforts of Maine's Senator Susan Collins, with support from many other senators, congressmen, and state legislatures in the region, the US Department of Transportation has agreed to fund a study that will examine major modes of transportation in the region reaching from Halifax through northern New England and over to the border between New York state and the provinces of Quebec and Ontario (Griffin 2002).

For its part, Ottawa has shown relatively little interest in such studies, at least when it comes to Atlantica. It contributed funding for the Canada-US-Ontario-Michigan Partnership Transportation Planning/Need Feasibility Study,[7] which has released recommendations on ensuring the safe and efficient movement of people, goods, and services within the region of southeast Michigan and southwest Ontario; Atlantica is deserving of the same commitment.

In 2002, AIMS wrote to Prime Minister Jean Chrétien and responsible ministers, pointing out the gathering interest in studying a binational Atlantica transportation corridor and asking that the federal government give policy and financial support to such an initiative.[8] No commitment on the part of Transport Canada has been forthcoming. Yet, across the continent, public and private authorities are taking measures to ensure that their economic regions — which almost never correspond to state

7 The partnership consists of the US Federal Highway Administration (an arm of the US Department of Transportation), Transport Canada, the Ontario Ministry of Transportation, and the Michigan Department of Transportation. See website <http://www.partnershipborderstudy.com/pdf/PNFStudyReport_FINAL_Jan1204.pdf>.

8 What might such a corridor look like? The Texas Department of Transportation, for example, is planning a 4,000-mile Trans Texas Corridor Plan. A typical swath would contain three dedicated passenger vehicle lanes and two dedicated truck lanes in each direction; rail tracks for passenger and freight; and a dedicated utility zone, with water, electric, natural gas, petroleum, fibre optic and telecommunications links. Moreover, the plan is explicitly designed to link strategically across the international border with Mexico's highway and railway systems. Currently, almost 80 percent of Mexico's trade with the rest of the continent passes through Texas, and Texas authorities know the volume will continue to grow. Such a scheme may be typically Texan in dimension, but such corridors will be the superhighways of the 21st century, and regional interests throughout the continent are doing what they can to ensure that trade passes through their regions and that businesses locate in their vicinity.

A less audacious program is under way to develop "North America's International Trade Corridor". A coalition of businesses, states, provinces, and cities is actively promoting a route linking Winnipeg and Laredo, Texas. Not only does the coalition endorse infrastructure improvement, it is also seeking ways to expedite traffic — for example, vehicle transponders and electronic records-keeping that will allow customs preclearance, safety and weight checks that need not be repeated in numerous jurisdictions, and registrations, fuel tax credentials, and special permits that are obtainable electronically.

and provincial boundaries — are efficient and coherent, allowing goods, services, and people to work together seamlessly across borders wherever the highest value can be added.

It is not simply a question of trucks and highways — every mode of transportation matters. For example, air transport between Atlantica's major centres is minimal to nonexistent, especially across the international boundary. The issue of a cross-Atlantica corridor is about developing a fast, efficient means of moving goods and resources within the binational region and beyond. It is about providing industries with the incentive to locate and expand throughout the region, unconstrained by the border. It is about putting Atlantica on the transportation and trade map.

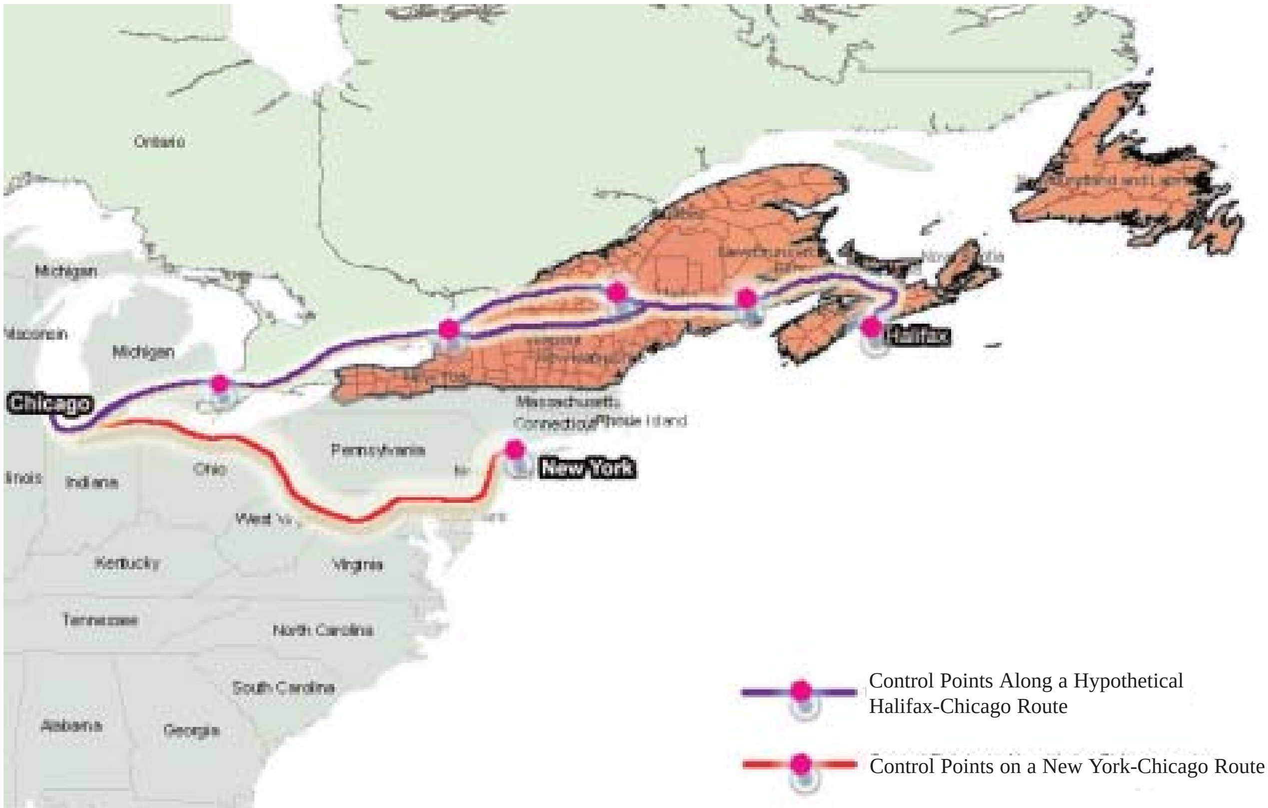
Transport Canada should offer to cooperate with the US Department of Transportation in reviewing the international implications of the transportation corridor, and the prime minister should declare his support for the first evaluation of the shared region, as a single entity, in its modern history. Such a report would also be the first to weigh the implications of modern trade treaties, economic transformation, and changed global trading patterns for the binational region.

Keeping Commerce Flowing at the Border

To keep commerce flowing at the border, the federal government should take immediate steps to accelerate and simplify border-crossing policies. It also needs to explore with its US partner integrated perimeter security, the harmonization of external tariffs, and mutually agreeable standards for entry of persons from third countries. Moreover, Atlantic Canada deserves a place at the forefront in defining this new openness in the Canada-US relationship.

Indeed, the border is probably more costly and more disruptive to Atlantic Canada than to any other region of Canada. Consider, by way of illustration, a container bound for Chicago via Halifax. In order to travel the geographically shortest distance (assuming that the infrastructure to allow that to happen exists, which it does not), that container would have to go through border formalities four times: once at Halifax, once at the Maine-New Brunswick border, once at the Canada-US border in either Quebec or Ontario, and once more at the border between Ontario and Michigan. By contrast, the same Chicago-bound container, if entering via the port of New York, would go through border formalities just once (see Map 2). Although progress has been made in reducing obvious border obstacles — for example, New Brunswick and Maine have agreed on the location of a new border crossing between St. Stephen, NB, and Calais, ME — a great deal more needs to be done to enhance the efficient movement of goods and people throughout the region (for further discussion, see Crowley 2001).

Map 2: ***Border Formalities En Route to Chicago***



Recommendations:

- **Support the US federal government's study of the adequacy of transportation infrastructure in the "International Northeast", stretching from Halifax to northern New York state.**
- **Work with the US to create the needed infrastructure that ties Atlantic Canada more effectively into markets in the NAFTA heartland.**
- **Build on the Smart Commerce initiative with the US to accelerate and further simplify border-crossing policies; work with the US to integrate perimeter security, harmonize external tariffs, and establish mutually agreeable standards for entry of persons from third countries.**

CONCLUSION

If the objective of the federal government is to improve Canadians' standards of living by improving their productivity and removing barriers to opportunity, then Atlantic Canada offers a rich variety of areas in which this could be achieved. In fact, both the theory and practice of convergence suggest that Atlantic Canada has been a land of lost opportunity in recent decades. With better policies by all levels of government and new attitudes on the part of Atlantic Canadians, this region, the poorest in the country, could make a disproportionate contribution to Canada's success in meeting the challenge of prosperity.

Ottawa's economic focus for Atlantic Canada should shift from supporting consumption — that is, the direct provision of incomes and jobs — to supporting investment and the creation of economic opportunities. Building genuine infrastructure, such as top-quality transportation links between Atlantic Canada and its fast-growing markets in the US, is a good example of where Ottawa could profitably and intelligently put its efforts in closing the economic gap between the Atlantic provinces and other regions of Canada.

Getting the policies right would, however, do more than just eliminate the gap between Atlantic Canada and the rest of the country. It would eradicate the wasteful and politicized haemorrhage of funds from "have" provinces for "regional development" and provide a template for a new national policy that reduces, rather than entrenches, regional inequalities. The outcome would be greater national cohesion and higher standards of living for all Canadians.

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