Chapter 4
Economic Growth Strategies

It is not by planting trees in a desert or subsidizing tree planting in a desert created by politicians that government can promote…industry, but by refraining from measures that create a desert environment.

Assar Lindbeck, long-time chair of the Nobel Prize in Economics selection committee, speaking about Sweden's economic-development policy

This chapter turns to an examination of the evidence on traditional economic-development programs, the type used in Atlantic Canada by a succession of agencies, from the Department of Regional Economic Expansion to the Department of Regional Industrial Expansion to the current Atlantic Canada Opportunities Agency (ACOA). As well, since a large part of Atlantic policy has revolved around wealth transfers—what might be termed "regional aid"—I consider the evidence on foreign aid in order to provide some insight on the success of transfers in generating economic activity, as well as the conditions under which they are effective.

Economic Development

Active economic-development policies typically involve tools such as direct government intervention in the marketplace, government-owned enterprises, and subsidies and incentives for favoured firms and sectors. The hypothesis justifying this type of intervention is market failure. The private sector, particularly in peripheral regions, is said to be unable—for lack of capital, lack of insight, lack of information, lack of ambition—to take advantage of opportunities for self-sustaining economic activity that would generate prosperity and jobs. Government must step in.

Of course, government action cannot be solely justified by market failure. Government must be sure its activities will alleviate the prob-

lems created by market failure and will not lead to another set of equally bad problems. Even if these conditions are met, government should try to assure itself that its resources couldn't have created more benefits if employed elsewhere—in other words, that policy expenditures produce benefits that outweigh the opportunity cost.

A key justification for active economic-development programs is the idea that disinterested public servants can easily see opportunities that short-sighted, poorly informed, or poorly financed private-sector participants will miss. The same justification is used for other types of direct involvement in the marketplace, such as providing significant government contracts to firms believed important to the economy's future. The goal is not to create firms that will remain dependent on government, but to nurture those firms and concepts whose bright prospects are impeded only by the market's failure to provide appropriate financing.

The financing failure, it is often argued, is particularly acute in peripheral regions. Even if local investors had the foresight to make appropriate investments, they couldn't raise the funds because of their isolation from centralized capital markets. Nations or regions with good policy regimes have no problems attracting capital. For example, when Ireland, long a low-investment country, reformed its policy regime in the late 1980s, investment flooded in. This hardly supports earlier ideas of flawed capital markets. Yet studies of the financial sector—even studies sponsored by government agencies whose existence is largely predicated on the assumption of market failure—have been unable to find that predicted failures (see, for example, McNiven and Plumstead 1996[1]). Government intervention in the economy to spur development can provide benefits if it meets two conditions:

- That government puts an amount of investment into the economy equivalent to the amount of private-sector activity that has been displaced.
- That government investment is roughly as productive as private-sector investment. Obviously, if government investment is more effective than private-sector investment, government can create

1. This study is particularly interesting since it was funded by ACOA, which was established in part to alleviate the perceived market failure in capital financing.

benefits if its level of investment is lower than the private-sector investment it displaces. The opposite also holds.

If government is spending tax money raised elsewhere, how can it crowd out private-sector investment? In actuality, government activity displaces private-sector activity by absorbing resources both when taxing and when spending.

This point is clear on the taxing side; it may be less obvious on the expenditure side of regional transfers. When the federal government spends money in Atlantic Canada, it employs people and resources for things they otherwise would not do. It obtains these resources by bidding for them against other players in the economy. So, for example, government and firms end up bidding against each other for the best workers. This raises costs in the economy—the exact opposite of successful development policies—and weakens profits and businesses, crowding out investment.

Only in a negative-sum market economy can spending by government provide unambiguous benefits, regardless of what it spends its money on. In such an economy, government activity cannot crowd out private-sector activity because the market by itself is incapable of generating any new activity. As noted earlier, this line of argument is implicit every time an interest group calls on government to save or create jobs.

Even in a positive-sum economy, government activity generates economic growth if government invests as much and as effectively as the private sector would have. A key question here is how government divides its expenditures between investment, consumption, and transfers. Most transfer payments to individuals are directly translated into consumption. And consumption tends to be more politically popular than investment because it provides immediate benefits to people, who can be expected to remember the favour at election time.

The divide between government consumption and investment in Atlantic Canada is heavily lopsided. Little of the massive inflow of government money has gone to investment (as we saw in Chapter 3). Moreover, in Atlantic Canada's politicized and patronage-oriented economy, government statistics on investment overstate real investment. Although there's a big difference between building an little-needed road in a politically important constituency and building a

road much needed for the transportation infrastructure to important markets, both count equally as government investment on the books.

Any question about what private-sector investment would have occurred otherwise is a hypothetical question that can never be answered with precision. However, it is safe to say that costs rose dramatically in the Atlantic economy as government activity intensified in the early 1970s. It is also safe to say that as costs rose, investment stagnated. Had private-sector investment in the region kept pace with investment in the rest of the nation, the gain in private-sector investment would have been many times the amount of additional government investment.

Finally, there remains the question of the effectiveness of government investment. To some point, it can generate larger returns to the economy than can private-sector investment. This is obviously true in education, transportation, and, most would agree, health care.

Once, core activities are in place, however, government seems to face a limit on the effectiveness of its investment. Few analysts, even those on the left, now believe that government can effectively manage the means of production (even in industries, like electric utilities, that were once thought to fit naturally into the public sector). Government-owned and government-managed industries in Atlantic Canada have had dismal records. Nor has government done much better in investing through (or by subsidizing) private-sector partners. This has led to a number of improbable schemes in Atlantic Canada, from building winged cars in New Brunswick to manufacturing heavy water in Nova Scotia to growing cucumbers in Newfoundland.

Thus, it is unlikely that government investment, by being supereffective, has made up for the much greater losses of private-sector investment in the region. If government activity has been, at least in part, responsible for the stagnation of private-sector investment in Atlantic Canada, then past policy has contributed to the region's weak performance. Many commentators now argue that government activity has also increased dependence, distorted the labour market, weakened adjustment, protected declining industries, disrupted work patterns, and even had detrimental affects on business management (all topics explored in later chapters).

Theories of Development

Spatial theories of development—those that rely on the concept of peripheral versus core regions—have been used to support government intervention in peripheral regions. Such theories come in two main flavours. The gravity model says the cost and time of transporting products from and to the periphery creates an advantage for firms at the centre. The cumulative causation theory involves the idea that central regions may hold a small initial advantage that mushrooms because slightly higher rates of growth and investment add further advantages and the process continues to concentrate those advantages at the centre. The key motor is economies of scale.

While the theories sound nice, empirical investigations fail to support them (see the collection of studies in Fynes and Ennis 1997, in particular, de Búrca, pp. 39–42). Trade barriers, which once inhibited peripheral regions' ability to enjoy economies of scale, have fallen. Transportation costs are now a small factor in trade in export goods. Many peripheral regions, from Ireland to Georgia, are now at the centre of economic activity. Their geography may not have changed, but their cost structure is attractive, producing jobs and growth. As O'Donnell notes, "Globalisation, by internationalising markets and making firms more footloose, has the effect of making local conditions more, and not less, important to economic development" (1997, 60).

Even before these changes to the global economy, most mainstream economists argue, economic-development programs are conceptually flawed and lead only to a waste of government resources. May and Rowlands, in their assessment of Atlantic Canada, capture the essence of the argument:

> Any number of efficiency arguments exist for eliminating subsidies and capital assistance to business. While these programs might increase regional efficiency if there were huge economies of scale and/or scope present, there seems to be little evidence to validate this assumption. In the absence of documented market failures, the subsidies may simply be trade distorting and may increase production inefficiencies. There is also reason to believe that grants to individual firms may permit inefficient operators to force efficient firms out of business. (1991, 29–30)

Conceptual Concerns

Why do most economists reject active economic-development? Let's examine the conceptual concerns and then review empirical evidence.

One problem with economic-development programs involves the incentives of those who administer them. A common criticism is that government planners and politicians don't have the expertise to pick economic winners over losers and that the dismal record of such programs bears this out. Moreover, as public-choice theory points out, government planners have an incentive to pick declining industries over tomorrow's winners. Such industries come with a ready-made pressure groups of workers, influential lobbyists, and powerful backers, while the unknown workers and profit makers of the industries of the future are unrepresented in government circles. They don't yet exist.

But artificially maintaining outmoded industries creates an obstacle to the emergence of new self-sustaining industries. New industries are taxed to support declining ones, which then use this money to absorb more resources that their output justifies, again to the detriment of emerging sectors.

Clearly, nations that most readily move on from the economy of the past—and allow closures and failures—generate more jobs and wealth over the long term than those that attempt to maintain outmoded industries. A prime example of perverse incentives to maintain declining industries can be found in Cape Breton. The island's old coal and steel industries have consumed over $10 billion in direct and indirect subsidies over the last 35 years.[2] They produce large amounts of atmospheric and local pollution. It's difficult to believe that anyone, from the political left or right, could believe this costly protection of

2. The Cape Breton Development Corporation (Devco), the federal crown corporation that runs the Cape Breton coal mines, has received subsidies of $1.9 billion. When that amount is adjusted for inflation and put into 1997 dollars, the number comes to $3.5 billion. Sysco, the provincial crown corporation that runs the Cape Breton steel firm, has received $2.8 billion in subsidies, or about $6 billion in 1997 dollars. But full costs have been considerably higher than $9.5 billion. That amount doesn't include pension obligations or the cost of shutdown, which must ultimately be faced and will cost billions more. Nor does it provide a measure of the opportunity cost since it does not include the compound interest the subsidies could have earned. On top of these direct subsidies, Nova Scotia Power has been forced to buy Devco coal at well above market prices, and the local pollution in Cape Breton will cost many hundreds of millions of dollars to clean up.

dirty, dangerous, unhealthy jobs is a good use of government resources. But it has made good politics in Cape Breton. Without coal and steel, the argument goes, virtually nothing would be left of the Cape Breton economy—the market would fail to take advantage of any new opportunities.[3]

Government planners also have an incentive to cover up past failures by injecting more money into losing propositions. The argument is that a government-supported firm or sector is just on the verge of making it; all that is needed is one more infusion of money. Of course, this motivate is common in the private sector as well. Business people, from entrepreneurs to owners of old family firms, struggle to keep their enterprises afloat long after the writing is on the wall. The difference is that a business person in the private sector must convince other people to risk their money, and that means showing the firm really does have potential. Otherwise bankruptcy occurs. Bureaucrats have a comparatively limitless supply of government money. All they have to do is convince other bureaucrats, often ones also implicated in the original decision, that only a little more investment is needed.

Other incentive differences are equally troubling. Business people invest their own money. Making the right or wrong long-term decision means the difference between eventually enjoying a retirement home in Florida and delivering pizzas for a living. For civil servants and politicians, the risks are much less dramatic. And incentives for civil servants often amount to pleasing their superiors in the short term.

In the long term, as often noted in economic literature, civil servants involved in a decision have often moved on to another job by the time a project succeeds or fails, so the immediate incentive to create the appearance of success trumps incentives to produce long-run winners and prune the losers. And for politicians, the most pressing question is often not a project's long-term viability but whether it can be announced in time for the next election.

A subsidy-rich environment also leads to the weakening of business plans. Private-sector decisionmakers must make their plans conform

3. Of course, if the Cape Breton labour market has been very distorted by past activities and perverse incentives introduced into the economy, there may be some truth in this statement. But that's a leftover of bad policy, not a market failure. Other regions have successfully shed their heavy industries for a brighter future.

with government requirements, which can range from the number of people hired to where the firm locates.

As well, politically connected firms can use government support to drive more efficient competitors out of business. This has happened frequently in Atlantic Canada. Private-sector developers have watched as near-empty government towers went up, drawing away their tenants; one fish plant beggared another's business; a successful motel owner could walk down the street to see the groundbreaking for a much fancier government-subsidized motel.

A Politicized Economy

All this highlights how active economic-development programs can distort incentives throughout the economy.

The amount of government money in Atlantic Canada has tended to politicize the economy, something even government studies discuss (see, for example, O'Farrell 1990). When a government subsidizes or provides preferential purchasing to firms for their political connections, political value, and other factors not related to their ability to compete, the economy ends up with firms that can't face the marketplace on their own. Management's incentives swing from attempting to build competitive firms to rent-seeking.

Incentives facing workers can also change. Protected in dying industries or subsidized activities, workers may forgo training, education, and skill-enhancement opportunities. When government creates or maintains employment for employment's sake, skills become less and less important. People are hired to give them work, not because of their skills.

Moreover, the extra expense of economic-development programs (and related activities such as government procurement programs) cost all businesses through higher taxes, while only the favoured firms get benefits through subsidies or lucrative government contracts. This misallocation of resources is a key objection to active economic-development programs.

Overall

The conceptual and empirical problems with economic-development strategies, combined with their obvious past failures, have led many

commentators to question the value of regional-development theory, even many who have spent years studying it. For example, Mark Rosenberg, in his presidential address to the Canadian Regional Science Association, said:

> [E]conomic development policies have mainly brought propped up manufacturing activities that are now disappearing, retarded reorganization and technological innovation in primary sector industries in "have-not" regions, and worst of all, leave too many people in Canada ill-equipped to work or become entrepreneurs in those sectors where Canada's future is likely to lie. (1993, 112)

Another key worry about economic-development programs is the crowding out of other economic activity—the known winners of subsidy activity displace the unknown losers. William Fox, who in the early 1980s worked as an economic developer to help bring Nissan to Tennessee, describes this problem in a concrete way. The effort to bring Nissan to Tennesse is often reported as a great success and justification for the state's economic-development program. It is even cited by economic-development departments in other jurisdictions when they seek increased funding. But Fox, who is now the Director of the Center for Business and Economic Research at the University of Tennessee at Knoxville, has come to a different view. He believes the Nissan plant only crowded out other economic activities—that the unknown losers would have generated as much economic activity as the Nissan plant without the cost to government:

> I worked on the in-lieu-of-tax-agreement for the Nissan plant in Tennessee about 15 years ago. After this work, we got a plant with 2,200 employees that quickly expanded to 6,000 employees. What a great impact that must have had on Rutherford County, a small county outside of Nashville, I thought. Then I went back almost a decade later and could not find any evidence that the area grew any faster or that its income was higher relative to other places in Tennessee. In fact, nothing seemed different about the county except that more of its employment was in manufacturing than before. As it turned out, when Nissan came in, it paid high wages and skimmed off

> the best employees. It also raised land rents. As a result, other activity—such as new businesses starting up—that might have occurred in Rutherford County did not happen. So you have to be aware of the difference between the short-term and the long-term impacts of having major business facilities come into a particular area. (Fox 1997, 142)

Other researchers make the same point; the impact of the locating firm is easy to measure—and take political credit for—but no one can measure the unknown business formation that would have occurred without the subsidized firm (see, for example, Arndt 1987).

Empirical Investigation

Unfortunately, while mainstream theoretical work on traditional economic development is unequivocal—it is a bad idea—the empirical literature is a mess. Economists, often very good economists, try to capture the impact of economic-development programs. But these attempts are bedeviled by lack of clarity about what economic development is, by measurement problems (how do you measure economic-development effort?), and by outright contradictory results mixed in with occasional absurdities.

The Evidence

The rubric of economic-development may cover a number of programs: training programs, tax rebates, tax holidays, subsidies, loan guarantees, concessionary loans, spending by economic-development agencies, and so on. Reviewing the evidence on such programs, Fisher and Peters (1997) find that they matter within narrow geographic zones: for example, in a competition between two neighbouring municipalities. That's because neighbouring municipalities draw on the same work force, face the same economic and environmental conditions, and are likely to have similar tax structures. Thus, a small factor, like an economic-development grant, can tip the balance.

This, of course, is hardly helpful for efforts to spur regional economic growth. In such instances, where work forces, economic and environmental conditions, and tax structures differ, researchers quickly find that fundamental conditions are far more important than eco-

nomic-development programs. Fisher and Peters, for instance, note that incentive programs are dwarfed by a jurisdiction's tax structure (itself is a small factor compared to many others):

> [T]o claim any benefits from economic development policy we must be reasonably sure it that it works—that incentives can reasonable expected to influence the investment behavior of expanding and relocating firms.... However, the costs of locally supplied labour are about 14 times state and local business tax costs. Regional variation in construction, transportation and energy costs are often larger than variations in state and local taxes and, presumably, development incentives. The result is that small differences in labour and other costs can outweigh quite large differences in tax costs and incentive awards.... Thus some have claimed that where local taxes and development incentives do influence location decisions, it is largely as tie-breakers between essentially similar locations. (*Ibid.*, 111)

In other words, fundamental economic conditions massively outweigh economic-development programs. Thus, some development experts believe that firms basically decide where they are going to locate and then try to leverage the largest subsidy possible by holding up the threat of going elsewhere. As Paul Cronin, Vice-President of the Irish Development Agency, told me in conversation at the IDA's New York office in 1997:

> When it comes time to negotiate, [the company has] already run the numbers, usually without the subsidy, on all the sites and they probably know where they are going to locate. They typically send in some 35-year-old hot shot vice president, basically to see how well he can negotiate. His future's on the line, even if the plant's location is already decided.[4]

Nonetheless, Fisher and Peters argue that, on balance, the literature on economic development provides some weak support for small bene-

4. The IDA has called on all jurisdictions to agree to hold back on the interjurisdictional subsidy competition.

ficial effects arising from the programs, at least within narrow geographic ranges. Yet, they acknowledge that this tentative conclusion is muddied by confusion across jurisdictions between what is just part of the tax code and what is an incentive. Moreover, much of the research work they review actually shows a negative effect from economic-development programs or contains cautions that apparently favourable results from studies of small areas may hide harmful effects on larger scales.

Netzer (1997) questions the reliability of the economic-development papers Fisher and Peters examine. For example, regarding one of the key studies they use to support their conclusion—a 1994 paper by E. Goss and J. Phillips that reports an elasticity of 0.2 for economic-development spending, implying that a 10 per cent increase in that spending will increase employment in the state by 2 per cent—he says,

> The authors...report entirely preposterous coefficients without comment.... [C]onsider what [an elasticity of 0.2] means for a largish state with a generous economic development budget of $50 million and employment of 3 million people. The coefficient says that a $5 million increase in the state agency's budget will increase employment in the state by 60,000, at a cost per job of $83. And a doubling of that budget would increase employment by 600,000. Who needs oil wells, when a state can be another Kuwait just by increasing the budget of a tiny agency? (Netzer 1997, 134)

The studies just discussed refer to research on U.S. programs. But the same results occur when economic development is examined on the international scale. Michael Porter, in his broad-ranging study of why some nations succeed, finds that such programs actually hinder economic growth. The following passage, from Porter's study of many nations could be an economic history of Atlantic Canada over the last 35 years:

> Providing direct subsidies to firms has been a prominent tool used by governments to attempt to influence factor cost and otherwise shape competitive advantage. Subsidized capital, subsidized research, subsidized raw materials, subsidized exports, and direct grants are employed by virtually every nation in one industry or another. The aim is to tilt advantage

> in a nation's favor.… We found many instances, in contrast, where it was associated with chronic failure..... Subsidy delays adjustment and innovation rather than promoting it. Most forms of subsidy come with explicit or implicit strings attached, such as limits on where plants can be located or the number of jobs.... These limit flexibility and dampen innovation. Ongoing subsidies dull incentives and create an attitude of dependence. Government support makes it difficult to get an industry to invest and take risk without it. Attention is focused on renewing subsidies rather than creating true competitive advantage.... Once started, subsidy is difficult to stop. What is worse, subsidies to one ailing industry encourage others to seek them. (1990, 639–640)

Measurement Problems

On top of all this, studies of economic development confront measurement problems. How does a researcher measure economic-development effort to see whether it correlates with growth?

One possible variable is expenditure. This may seem straightforward if the researcher is taking into account only the budget of the government's economic-development agency. But subsidies come from many levels of government and many departments. Training may be provided by the education department; road construction by the transportation department; a loan guarantee may not even show up on the government books. And the researcher faces the problem of how to measure the cost of various tax abatements, which may be provided by different levels of government.

The difficulty of capturing a good spending variable has led a number of researchers to the idea of simply counting the number of programs a state offers. This approach has a scale problem. It takes no account of whether a program costs tens of millions of dollars or tens of thousands.

As well, program counts reveal serious discrepancies: programs still on the books that have been effectively closed down; programs that were never funded; programs listed separately but now consolidated; a single program now split into several programs without any changes in budget; several different programs doing essentially the same thing;

apparently similar programs of greatly different magnitude; multiple programs in one state with a smaller budget than a single program in another state; programs that are additive; and programs that are mutually exclusive. That such a flawed measure would be used merely highlights the difficulty of other attempts to obtain an acceptable variable.

An alternative attempt to obtain some sense of the impact of economic-development programs is to survey firms. However, surveys depend on firms' voluntarily completing them and thus are notoriously unreliable, with an unknowable bias. The researcher often cannot determine whether the questionnaire even reached someone with the appropriate level of knowledge or authority in the firm. Perhaps only firms particularly interested in subsidies bother to reply, or perhaps responses come from firms that find subsidies relatively unimportant but want to encourage governments to keep on giving money away.

Even setting aside these problems, few survey results say much interesting, "with some research indicating that incentives are indeed important to location decisions..., and other studies saying the opposite" (Fisher and Peters 1997, 117).

The Survival of Economic-Development Programs

In the end, little can be said about active economic-development programs. Theory suggests they do considerably more damage than good and raise everyone's taxes. Even researchers examining economic development openly admit that all the research, their own included, is seriously flawed. And even setting aside the flaws, the evidence from these studies ambiguous.

The studies emphasize that economic fundamentals hugely outweigh active economic-development programs. Indeed, as noted in *Road to Growth* (McMahon 2000), Georgia, the most successful of the southern U.S. states, is the most limited in its economic-development programs (because the state's supreme court has ruled that subsidies violate the state's constitution).

Why then do economic-development programs continue? Normally, one would expect that economic developers would bear the burden of proof in showing that their expenditures do some good. Yet, as public-choice theory suggests, public benefit may less important

than the incentive structure facing public officials in maintaining their own departments. Economic developers can convince themselves and others of their importance by pointing to the known winners, while the losers remain unknown. Little attention is paid to broader research.

> Those of us who work with state and local policy-makers realize, moreover, that understanding the problem [with economic development programs] does very little to dampen the enthusiasm of political leaders for these policies. They have much to gain politically by pursuing such policies, regardless of the magnitude of their economic effects, and political leaders remain largely impervious to whatever the empirical evidence may be. (Enrich 1997, 144)

Oddly enough, though, the key flaw with economic-development programs may justify maintaining some sort of program structure. The flaw is that various jurisdictions compete against each other in the incentive game. In the end, their subsidies offset each other, leaving none better off and taxpayers stuck with the bill for programs that have no effect.

Realizing this situation, some of the better economic-development agencies (the IDA, for example) now regard their work as largely defensive. Agency officials have come to believe grants are ineffective in attracting investment but may be necessary at the margin to stop firms from shifting to another jurisdiction that offers a similar cost structure.

In this case, neither competing jurisdiction has been short-listed because of the incentive package, yet both have a motivation to offer the package. If the jurisdiction with the slightly better cost structure manages to just match the highest subsidy offered by the other jurisdiction, the location decision is unchanged but at great cost to the taxpayer. This event is not uncommon. The firm has an incentive to provide the superior jurisdiction with enough information to match competing incentives, so that the firm can locate where it wanted to anyway but with an added inducement thrown in.

The key question comes down to fundamental economic conditions. Although many people credit the IDA's subsidy effort with Ireland's recent economic success, the basic Irish economic-develop-

ment strategy has been in place since the 1950s, during periods of weak and negative growth and periods of exceptionally strong growth. Irish commentators and the granting agencies themselves credit fundamental reforms in the country's cost structure—in both taxes and labour costs—with its strong economic showing, giving incentives at most a defensive role. In fact, Ireland's industrial incentives were lower through the recent high-growth period than in previous periods (see McMahon 2000).

Any jurisdiction that continues with economic-development programs should keep a few simple principles in mind. First, such programs are probably effective only as defensive measures. They are not solutions to economic problems. Calls for increased development efforts can be little more than attempts to sidestep needed fundamental reform.

Another requirement is openness. Taxpayers have the right to know how their money is being spent. And openness can prevent economic-development departments from being used politically. (Not surprisingly, economic-development departments are often among the most opaque in government.)

The need for confidentiality in giving money to firms is often cited as the justification for withholding information. Yet it is difficult to see how a firm's competitive position will be weakened by divulging information about how it benefits from state largesse. In many jurisdictions, regulations require transparency for a large infusion of cash from a private-sector investor. It is much easier to understand why public officials may wish the information hidden. Furthermore, there is the question of fairness. If a firm is receiving government largesse, competitors not so benefited have the right to know so they can make their own case to officials and the public. Firms going to the market to raise money routinely have to release this sort of information. Surely the same could be required of a firm receiving public money.

Finally, policy should focus on inducements that benefit the overall economy, not just the favoured firm. For example, publicly subsidized training programs create a better-trained work force even if the firm fails. The same is true of much infrastructure investment. This approach reduces the danger that a firm will make a decision largely to reap a subsidy and disappear when the subsidy runs out because

the locational decision never made basic economic sense. Government help for infrastructure or training reduces or eliminates this perverse incentive, since there is no ready money on the table for the firm to pocket.

External Aid as a Source of Growth

Studies of foreign aid are useful in considering interregional transfers. Both are wealth transfers that seem, at first thought, to be a generous answer to the problems of the recipients.

Indeed, foreign aid was once thought to be a key, perhaps the crucial motor, to converging growth among nations. Essentially, the idea is consistent with regional-development theory and was based on the same sort of hypothesized market failure. Not only did underdeveloped nations face private-sector financing shortages, went the theory, they also suffered from underfunded governments and structural problems. Money, combined with government planning, could overcome these weaknesses.

Several economists, notably Milton Friedman, expressed reservations about this view from the beginning. As it turns out, the impact of aid is dwarfed by the impact of domestic policy. At best, aid has no effect in a bad policy regime. It may even damage the economy by strengthening the power of a government that promotes bad policy. The economic clout given to such governments also may further politicize economic decisions, induce and strengthen distortions in the economy, and crowd out private-sector investment. But, surprisingly to many economists, aid to nations with good policy regimes has a measurably positive growth effect, though one considerably smaller than the domestic policies themselves.

The Effects of Foreign Aid

In the mid-1990s, Peter Boone published two groundbreaking studies on foreign aid. He examined a large basket of countries that were in roughly similar circumstance but received aid of differing levels, usually for political reasons. This type of comparison is well suited to pick up any impact aid may have on growth or investment. On the surface, one would certainly expect some effect on investment since the researcher included only aid that had "the objective of promoting eco-

nomic development or welfare" (Boone 1994b, 1).

Boone's results can be quickly summarized: the level of aid has no impact on either investment or growth. The effect on the marginal propensity to consume differed insignificantly from one and the marginal propensity to invest differed insignificantly from zero.[5] In standard English, that means that every extra dollar of aid meant an extra dollar of consumption; not a cent went into investment, regardless of whether the aid was allocated for investment or not.

Government is a key mechanism that funnels aid into consumption, Boone finds: "Government consumption rises by approximately three quarters of total aid receipts" (1994a, 4). Worse, Boone says, aid had no significant impact on human-welfare indicators such as "infant mortality, primary schooling ratios nor life expectancy.... [T]his is strong evidence that aid flows primarily benefit a wealthy political elite" (*Ibid.*). Boone finds that aid is completely fungible. In other words, no matter what the funds were targeted for, they went to whatever purpose the recipient wanted. Thus, a dollar's aid for, say, education simply replaced a dollar already targeted for education, and, in the end, the extra dollar was shifted to whatever purpose the government chose.

A more detailed and comprehensive report from the World Bank (Dollar and Pritchett 1998) supports Boone's conclusions and investigates some of the implications of his work. Like Boone, Dollar and Pritchett find no relationship between the level of aid and economic growth. They also show that aid is fungible. For example, in a nation that devotes, say, 10 per cent of its expenditures to education and 40 per cent to military spending, a dollar's foreign aid directed specifically toward education boosts education spending by only about 10 cents. Yet, the funds go directly into increased government spending. In other words, a dollar's aid to education boosts government spending by a dollar: 40 cents to military spending, 10 cents to education spending, and the remaining 50 cents to whatever the government wishes.

The implication is, of course, that, instead of targeting aid to specific areas, like education or health care, donors should target aid to

5. Boone's results do not apply to a handful of very poor nations, which receive aid equal to more than 15 per cent of their gross domestic product (GDP). In such cases, he argues, aid is typically tied to one or two large projects and thus forced into investment.

governments with worthwhile spending priorities (see *Ibid.*, 62–74).

Policy Environment

Thus, the important questions are, Does a nation's economic policy affect the effectiveness of aid? If so, what policies make aid effective?

To examine these questions, Dollar and Pritchett select "three factors that have been shown to affect developing countries' growth: inflation, the budget surplus, and trade openness" (*Ibid.*, 12), and they clarify nations with good results on these axes as having good economic policy.

Then they examine "institutional quality [through] an assessment of the strength of the rule of law, the quality of the public bureaucracy, and the pervasiveness of public corruption" (*Ibid.*). In nations with both weak institutional quality and weak economic policy, growth was minuscule or negative; with just good economic polices, growth averaged just under 1 per cent a year; with just good institutional quality, growth was under 2 per cent a year; with good institutional qualities *and* economic policies, growth equals about 2.5 per cent a year (Burnside and Dollar 1998).

For the nations they designate as well managed, Dollar and Pritchett's econometric testing finds a strong correlation between aid and economic growth: "1 per cent of GDP [gross domestic product] in assistance translates to sustained increase in growth of 0.5 percentage points of GDP" (1998, 14).

This discussion is important. If Atlantic Canada was characterized by good policy, its growth should have much exceeded that of other lagging regions, given the wealth transfers it received. On the other hand, if it was characterized by bad policy, then, regardless of wealth transfers, its growth should have converged more slowly than that of other lagging regions—which is what happened.

Effects on Equity

Dollar and Pritchett also show that economic growth, rather than increasing inequalities, raises incomes across the board, reducing absolute poverty and improving social conditions (as measured by the proxy of infant mortality). This point is important for those who would urge aid but are reluctant to send it to market-oriented economies for

fear it will fail to reach the poor and benefit only the rich.

> Development economists used to worry that the benefits of growth would be undone by increases in income inequality. Recent evidence has shown conclusively, however, that this is not so.... [One] study examined recent per capita growth and poverty reduction in 67 countries for which household data were available. It found that in every country with increasing per capita household income saw poverty decline, and every country with declining per capita income saw poverty increase. In the expanding economies, per capita income grew 4 percent, and poverty declined 5 percent. In declining economies an average drop of 7 percent in per capita income lead to an increase in poverty of 19 percent. (1998, 39)

The analysts show that foreign aid can have either a powerful negative or a powerful positive impact on private-sector investment. Aid to bad policy regimes crowds out private-sector investment by increasing distortions in the economy, by enabling government to undertake projects that the private sector would otherwise have taken, by setting up and funding government enterprises or politically connected private enterprises that compete with and weaken true private-sector enterprises, and by bidding up the price of scarce resources in the economy, thus increasing costs.

In well-managed nations, however, aid crowds in private-sector investment. Dollar and Pritchett speculate this is because nations that spend money on such things as education, infrastructure, and other high-return public investments increase private-sector returns by strengthening the quality of the work force and creating vital transportation links to markets. This, in turn, decreases training costs and transportation costs. Such reduced costs and the resulting opportunity for profit can be expected to draw in increased investment:

> One percent of GDP in assistance increases private sector investment an extra 1.9 percent of GDP in good management countries.... Thus the combination of good management and foreign aid is welcomed by the private sector, and this helps explain the strong effect aid has on growth in such an environment. In a poor management country, however, 1 percent

of GDP in aid is estimated to reduce private sector investment by 0.5 percent of GDP. (*Ibid.*, 40)

The Implications for Atlantic Canada

These empirical studies throw an interesting light on Atlantic Canada as a recipient of a massive transfer of wealth. As net wealth transfers to the region increased, particularly after the late 1960s (a situation detailed in Chapter 2), the investment gap between it and the rest of the nation, which had been closing, widened considerably. In other words, as what can be thought of as domestic aid flows increased to Atlantic Canada, private-sector investment fell. This is a symptom of a badly managed economy. It suggests that government money was poorly spent and dedicated to consumption, rather than investment, an implication borne out by the numbers, as we have seen.

A quick example may bring home the idea. As already noted, many studies show that spending on transportation infrastructure, particularly on efficient connections to major markets, is the most effective way government can spur economic growth. Many of the billions of dollars sent to Atlantic Canada were meant specifically to spur growth. One might have expected a resulting increase in investment in transportation infrastructure, rather than the more politically rewarding activity of subsidy granting.

Yet despite large fiscal transfers through the 1970s, the Atlantic provinces failed to make even a significant start on building an efficient road network to their major market in central North America. In fact, as federal transfers to the region increased in the 1970s, expenditures on transportation infrastructure declined, even though some of the transfers were explicitly targeted for infrastructure. The implication is that, like poor-management countries, the Atlantic provinces shifted the wealth transfers to other, politically motivated projects.

Dollar and Pritchett also show that actual expenditure categories are less important than the quality of policies behind them. Money spent on education may go to improving education or to building a bigger education bureaucracy; money spent on transportation infrastructure may build roads to markets or become a political reward through makework projects unrelated to transportation needs.

Of course, the composition of government spending can also be

perverse: for example, subsidizing outmoded industries, building environmentally unsound industries, and providing subsidies and concessionary financing to affluent sectors of society. The following quote from Dollar and Prichett could apply to policy in Atlantic Canada as well as to poor-policy nations in the third world:

> Too many developing country budgets have been devoted to activities with no growth potential and no effect on poverty: wasteful and inefficient public enterprises, middle-class subsidies for fuel, electricity, and more, and spending that benefits mainly the rich such as credit subsidies and free universities. Moreover, the efficiency of government spending is at least as important as its composition. Governments should be judged not on how much they spend but on how much they accomplish. (1998, 20)

Overall

In the end, the research on foreign aid presents a heartening picture, both for developing nations and for lagging regions in the developed world. Regardless of external generosity or indifference, it is domestic policy that makes the crucial difference, not the attitude of the outside world. Good economic management matters more than outside financial aid. Policy and institutional gaps, not financing gaps, hold back lagging economies. Aid money has a positive impact only after countries have made substantial progress in reforming their policies and institutions (*Ibid.*, 103).

In other words, people are in charge of their own fate. Outside aid can help a good policy regime; it has no effect or a negative effect in a bad policy regime. "Foreign aid in itself is neutral with respect to development, for its positive or negative effects depend on government policies" (*Ibid.*, 37).

CONCLUSION

A straightforward and apparently unsurprising conclusion arises about economic growth. *Policy matters a lot.* That message is clear in the research on foreign aid and convergence, and in the economies examined in *Road to Growth* (McMahon 2000). Still, this conclusion may not be as expected as it appears. Much analysis in regional economics

emphasizes initial conditions, geography, and relations between core and peripheral regions. The desired policy response is mainly government measures meant to offset these disadvantages. Under most variants of regional theory, that offset requires significant public expenditures, government intervention in the economy, and in some cases trade barriers to build and protect infant industries.

Interestingly, the policy mix recommended by regional theory is almost the mirror opposite of the policy mix found to speed economic growth. The lagging regions that converge with the greatest speed are those with open economies, fiscal balance, low public-sector consumption, and a government focused on providing essential services, such as education and transportation infrastructure. Large government, high taxes, and aggressive government intervention in the economy are all found to weaken economic growth.

The fact that lagging and peripheral regions in the United States, Europe, and Japan are growing faster than core regions—a process underway for some time but one that may have accelerated in recent years—puts paid to much of the reasoning on the disadvantages of peripheral regions and the need for concerted government action to overcome these disadvantages.

The research on foreign aid points to the same policy mix as does the research on convergence. Nations that adopt this policy mix benefit from wealth transfers; those that do not receive no such benefits from them. Nations in the first group build useful infrastructure and focus on education and other essential services but otherwise keep government consumption and intervention in the economy low. This approach draws in investment.

Those nations that focus government expenditures on consumption and intervention in the economy crowd out private-sector investment by bidding resources away from private investors, politicizing the economy, and limiting market opportunities.

Atlantic Canada's record on investment, like its record on convergence, suggests an inferior policy regime. For most of the past 30 years, per capita investment in Atlantic Canada (for details, see Chapter 6) has been roughly a third lower than the national levels, despite large interregional transfers. This is exactly what would be expected in a bad policy regime, where wealth transfers tend to crowd out private-sector

investment. In contrast, wealth transfers to good policy regimes increase private-sector investment.

Much of the development effort in Atlantic Canada has focused on government intervention in the economy. This emphasis has allowed policymakers to sidestep debate on fundamental reform. For example, when the federal and provincial governments announced they would stop subsidizing coal and steel production in Cape Breton, there was little or no talk of the need for reform of the island's economy, on either the tax or labour side, but instead a call for more government money for more government-directed economic development.

Yet the research on economic-development strategies fails to show any resulting economic benefits, while the research on fundamental reform shows profound benefits. Atlantic Canadian policymakers need to stop using government intervention as a substitute for economic reform. This is the clear message of the international evidence. Ideology is irrelevant here. The evidence is eloquent.