Chapter 2
Atlantic Canada and the Negative-Sum Economy

> *It was almost as though Maritime manufacturers had suddenly been pushed another 1000 miles out to sea.*
>
> Maritime historian Ernest Forbes

Atlantic Canadian policy, at both the federal and the provincial levels, exhibits a distrust of market mechanisms and of the profit motive. The focus is on government-directed economic-development programs, and wealth transfers meant to spur economic growth. Policymakers have come to believe that market flaws afflicted peripheral and lagging regions and would forever hold them back unless government intervention breaks the chains.

The Negative-Sum View

Informing much of the policy package here is what might be called a *negative-sum view* of the market economy. It arises, at least in part, from Atlantic Canadian history when the market economy really did seem to produce only negative sums.

This situation is worse than a zero-sum game, in which one sector's loss is at least another's gain, though the overall sum remains the same. Nothing has been subtracted from the total. In a negative-sum economy, however, the weakening of one sector or one firm is a complete loss. No other sector or firm gains. If anything, the other sectors and firms lose from the overall reduction in economic activity. A job lost is a job lost forever.

In the view of the negative-sum market economy often prevalent in Atlantic Canada, only government—operating outside the economy—

can create positive sums or prevent negative ones. Government can, for example, save jobs by providing timely subsidies for troubled firms and create new jobs through subsidized activities.

The negative-sum view of market economies may seem, frankly, nonsensical. After all, economic activities are always fading away and new ones replacing them. This churning process is the generator of increased wealth, expanded opportunity, and new jobs. Nations and regions that are open to change grow more rapidly and generate more jobs than nations and regions that resist change.

Yet the negative-sum view of the economy is surprisingly common in policy debate, though the view is seldom understood for what it is. Government is frequently called on to save some industry or some firm. Otherwise, policy-makers are warned, x number of jobs will *disappear*. The unstated assumption is that new activity will never compensate for the loss of the old activity. Government must step in as savior. Government may have to spend money to save the jobs, but it will actually save in the long run, so the argument goes. If government lets the firm or sector fail, then it will lose all the tax revenue it now collects. Again, the guiding assumption is that no new tax-paying economic activity will fill the void.[1]

In fact, those governments that have reduced their own size have discovered a positive-sum economy: lower unemployment, higher participation rates, and thus much higher employment levels after cutbacks. This is true in Ireland, the Netherlands, Great Britain, the United States, and so on. In Canada, the two cities hardest hit by government cutbacks were Ottawa and Halifax. Both are now more economically vibrant than they were before.

Nonetheless, Atlantic Canadians still make persistent calls for gov-

1. The negative sum crops up in the common concept of the Keynesian multiplier effect. If government hires, say, 10 people who have lost their jobs, their spending will, in turn, generate or save many more than 10 jobs. But this argument too is based on a negative-sum view of the economy. The assumption is that neither the 10 people directly employed by government nor those provided employment through the multiplier would have work without outside intervention.

This is clearly false. Were it not, all those jurisdictions that cut expenditures would face an ever-increasing spiral of unemployment. In fact, unemployment rose, with increasing government intervention in the economy of most developed nations through the late 1960s and 1970s.

ernment to save this or that industry or sector, fund all sorts of make-work projects, use its fiscal muscle to create economic development, and block efficiency or technological advances that would reduce employment. All these measures and many more like them flow from a negative-sum view of the economy.

The Evolution of the Negative-Sum View

Despite Atlantic Canada's label as Canada's "have-not" region, this situation did not always exist. Understanding how the region has fared in the past—in particular the reasons for its decline—is essential to understanding how it can now find the road to growth.

In the years following Confederation, the Maritime provinces, not Ontario and Quebec, were the industrial heartland of Canada. The young nation's economic dynamo was broad based. The region was home to little more than a sixth of Canada's population, but it boasted a quarter of the nation's manufacturing enterprises, including both of its steel mills, six of twelve rolling mills, eight of twenty-three cotton mills, three of five sugar refineries, two of seven rope factories, and one of three glass works (Brodie 1990). By the turn of the century, Halifax was home to more than a dozen banks (including the forerunners of two of modern Canada's big-five financial institutions, the Bank of Nova Scotia and the Royal Bank).

Yet, within a generation or two, the Maritimes would be on their way to economic ruin. Many historians claim Confederation's trade barriers devastated their economy, and there's some truth in that view. Yet the Maritimes' great prosperity and worldwide trading links were in peril regardless. The 19th-century world of relatively free trade, which created the Maritime economic powerhouse, was almost certainly doomed with or without Confederation.

A hairline fracture ran through the Maritime economy. Everything depended on trade. The relative scarcity of agricultural land deprived the region of the hinterland needed for a strong domestic market. Industrial activity vastly exceeded the size of the population and could be maintained only through trade. The flaw was fatal.

The National Policy and Its Results

John A. Macdonald's National Policy threw up trade barriers around

Canada. The idea was to liberate the new nation from U.S. economic dominance and to create a domestic industrial base. The Maritimes already had an industrial base. All the national policy did was to cut the region off from rich foreign markets, particularly those of New England. That was probably inevitable anyway. U.S. protectionism would almost certainly have done the same thing in the end.

It may not have mattered. Transportation costs were such that domestic suppliers in New England and other large external markets might eventually have replaced most Maritime goods. But in the New England market at least, Maritime manufacturers might have had a fighting chance over the long term. By sea, they were relatively close to New England. And moving goods by ship was considerably less expensive than moving them by land.

But the long-term trade situation with the central Canadian market was hopeless. The water route—up around Cape Breton, through the Gulf of Saint Lawrence, and then up the St. Lawrence River—was a long, costly voyage. Ice and bad weather closed the St. Lawrence for many months of the year. Water-borne transportation could not service regular trade between the Maritimes and central Canada.

Moving freight by rail overland to central Canada was little better. The route was long and costly to maintain. It made little practical sense to move the heavy, bulky industrial goods of the day over the 1500 kilometres of rail between Halifax and Montreal. The Quebec City area was virtually the only significant market in between. The Maritimes and central Canada were essentially isolated from each other.

Granted, the National Policy initially created a Maritime economic boom. Maritime manufacturers suddenly had the central Canadian market to themselves. Competition from U.S. manufacturers withered behind trade barriers. Central Canada's industrial base was relatively immature. The Maritimes, as Canada's industrial heartland, flourished.

That was short-term gain for long-term pain. Industry may have been located in the Maritimes, but the population was concentrated in central Canada. Given the long, difficult route between the two markets, moving products between them made no sense, especially in an age when goods were heavier than today and transportation costs considerably higher. Central Canadian interests began to buy out Maritime

businesses. They weren't immediately shut down, but investment was stifled. New plants were built in central Canada, where the market was concentrated. U.S. businesses also wanted in on the Canadian market. Because of tariff barriers, they needed to build branch plants; it made no sense to build them in the isolated Maritimes, so they went up in Ontario and Quebec. The region seemed to have developed a negative-sum economy. A job lost was a job that would be lost forever.

The Interwar Years

If all this wasn't bad enough, disaster hit in the 1920s. The federal government, recognizing the difficulties and costs of transporting goods between the Maritime industrial base and central Canada, had been subsidizing the freight rate between the two. By the 1920s, the central Canadian industry had matured. Maritime goods were no longer a necessity. They were competition for manufacturers based in central Canada.

Perhaps the politics of this situation played a role in Ottawa's decision to slash freight subsidies. Beginning in the early 1920s, rail rates between the Maritimes and central Canada more than doubled over four years, and the Maritimes lost its one remaining large market. The distinguished Maritime historian Ernest Forbes captures the impact best: "It was almost as though Maritime manufacturers had suddenly been pushed another 1000 miles out to sea." With this, the Great Depression arrived a decade early in the Maritime provinces.

The federal government was no help at all. Atlantic Canada, suffering from serious economic decline, did not have the financial resources to build the infrastructure, such as roads, required for the emerging economy. The Maritime provinces did not even have the funds to make use of Ottawa's offer to cost-share some types of infrastructure programs during the interwar period (an offer that helped the richer provinces, which could afford their share of the bill).

During this period, Maritime policymakers, with some justification, sensed the negative-sum nature of the regional economy that had developed before World War I and intensified during the interwar years. The region's historical experience could lead to no other conclusion. Existing industries had either closed down or packed up and gone away. Nothing replaced them.

Business closures were subtracting from the economy, but nothing was added to it. As existing industry lost market share, it dwindled away. Few new industries were established. There was no large market to serve. The Maritimes truly had a negative-sum economy.

This situation created a new economic psychology in the region. Every existing job had to be protected.

Maritime policymakers, in a desperate rear-guard action, were energized by this insight. Government policy was directed at saving every job, through either subsidies or restrictions on labour-saving technology. In 1924, subsidies began for the Cape Breton coal mines. Earlier, in 1908, legislation had been passed to limit new technology in the Nova Scotia fisheries, in order to protect jobs that more efficient production might eliminate. Restrictions on technology became progressively more stringent. By 1939, only three mechanized trawlers operated in Nova Scotia, down from ten a dozen years earlier.

Local interests built walls of their own. In the late 1920s, U.S. businesses had the exciting idea of turning Nova Scotia into the "Fish Pier of America," using new freezer technology and steam trawlers. A coalition of inshore fishermen, schooner owners, and fish merchants stymied the plan. Once again, they feared new technology would cost jobs.

And so the Maritime economy stumbled through the interwar period. World War II might have been expected to produce some economic benefits for Atlantic Canada, but they turned out to be limited. Investment and war production was directed to central Canada, even when it made no sense at all. According to Ernest Forbes, British technical advisors suggested that it made little sense to build war and cargo ships in inland cities cut off from the Atlantic for several months every year when the St. Lawrence River froze over. Building ship-repair facilities there made even less sense. But that's where investment was concentrated. By the end of the war, the Maritimes had received only about 5 per cent of federal industrial investment, despite the region's location and its skills in marine manufacture.

After the war, things pretty much reverted to form. The only big change was that Newfoundland joined Canada in 1949, and the term *Atlantic Canada* was coined to describe the Maritimes plus Newfoundland.

The Evolution of Federal Transfers

During the 1950s, Ottawa's attitude to Atlantic Canada began to evolve in a different direction. Three key factors were at play. A deep recession in 1956, which hit the Maritimes particularly hard, focused national attention on Atlantic Canada. The Progressive Conservatives, under John Diefenbaker, were elected as a minority government. This minority situation put a premium on all electoral seats; with standings so close, the next election might not be determined in central Canada. Atlantic Canada might be the swing region. That gave the region rare political clout.

The third new factor was changing attitudes, reinforced by a study by R. Howland, *Some Regional Aspects of Canada's Economic Development* (1957), published as one of the papers of the Royal Commission on Canada's Economic Prospects (The Gordon Commission). Howland's study crystallized several things. It revealed the size of the economic gap between Atlantic Canada and the rest of the nation; that got policymakers' attention. It revived complaints from the 1920s and 1930s about the shabby treatment the Maritimes had experienced in Confederation. Finally, it gave intellectual heft and legitimacy to calls for more regional fairness.

Fairer Policies

From the mid-1950s onward, the federal government began to create programs to benefit Atlantic Canada or at least to provide services fairly. The equalization program was established in 1956 to transfer money directly to the "have-not" provinces on the basis of their taxing capacity. The poorer the province, the greater the per capita transfer. A number of economic-development programs were launched. Cost-shared programs were designed so Atlantic Canadian provinces could take advantage of them. These include the *Hospital Insurance and Diagnostic Services Act* (1958), the *Established Programs (Interim Agreement) Act* (1964), postsecondary education cost-sharing (1967), the *Canada Assistance Plan* (1966), and the *Medical Care Act* (1966).

One thing notable about these measures is that for the most part they focused on the provision of services that both served a valuable social function and boosted economic growth. (See McMahon 2000, for a review of this evidence.)

The 1960s were the period of the Atlantic Revolution. Although Canada's economy was expanding at great speed through the decade, Atlantic Canada was growing, per capita, even more rapidly. But this too held a peril.

By the late 1960s, the Canadian government, like other western governments, had developed a case of hubris. This was entirely reasonable. Nothing like the recovery after World War II had been experienced before. Out of ashes of history's most destructive war emerged the most dynamic economic period in human history. The generation of tens of millions of new jobs across the developed world, unprecedented wealth, and large, never-ending productivity improvements ushered in a new era. Governments, which had expanded their role in the economy, not surprisingly believed their activities lay at the heart of an optimistic new world.

With Atlantic Canada's economy growing strongly in the late 1960s, policymakers believed the time had come to use government's powerful tools to tackle and solve once and for all the problem of the region's economic weakness. Economic good times, not any regional weakness, sparked a renewed growth of federal transfers to Atlantic Canada in the late 1960s. This is a point Atlantic historians have long understood. As Bickerton says,

> Far from attenuating the demands of Atlantic Canada for a greater national commitment to reducing regional disparities in the country, the general prosperity of the 1960s made the idea of regional development seem a more attainable goal, if only the Canadian state would commit itself to the task. (1990, 175)

And, indeed, Ottawa did commit itself to the task, as Bickerton and many others convincingly demonstrate. But the nature and purpose of transfers to Atlantic Canada changed, reflecting this new commitment, regional optimism, and the emerging view of the potency of government's economic tools.

Regional Theory

An economic theory was standing by to justify increased economic intervention in peripheral regions such as Atlantic Canada. Regional-development theory (and its many variants) are based on the idea of

pervasive market failure in peripheral regions.

Regional-development theory was particularly strong in Canada, doubtless because of the dismal economic history of Atlantic Canada. It also fit into the view of the time: that government had all the tools needed to solve economic problems.

For the most part, however, regional theory—instead of examining the history of Atlantic Canada and how government actions and politics might have caused market failure—argued that market failure was inherent to peripheral regions. Government needed to act ever more forcefully to overcome these failures.

Despite the successes of the 1960s, regional theory suggested that market failure limited what Atlantic Canada could do without influential government intervention.

The phrase *market failure* implies merely that the market, on its own, creates a less-than-optimal outcome. The negative-sum view goes to the extreme of implying that the market is so flawed in peripheral regions that government intervention is necessary to generate growth. Thus, without government intervention, a peripheral region will fall further and further behind, an idea always implicit and often explicit in regional theory.

The cost structure of a peripheral or lagging region is deemed of small relevance in this view. Market failures mean investors ignore or are ignorant of profit-making opportunities. Private-sector participants in the core region have little interest in exploiting opportunities in the periphery. Local investors do not have the means to invest, and market imperfections in the financial sector prevent them from obtaining investment capital. Since a low cost structure does little to spur development in peripheral regions, government must directly intervene, either by investing itself or by tempting private investors with subsidies.

Whatever truth this view once held, over the years it has become increasingly difficult to argue that it accurately reflects Atlantic Canada's current structure. The experience and success of peripheral regions in the United States and Europe contradict it. Although Atlantic Canada has received immense government attention to resolve supposed market failures, it has performed much more poorly than lagging regions that have done little or nothing to address such perceived failures.

Regional Action

The burst of transfers, particularly from the late 1960s onward, was increasingly directed to intervention in the economy to spur government-directed and government-subsidized growth and to solve vexing social problems like unemployment. The federal government also stepped up transfers to individuals as well as to provincial governments and businesses. These measures too were largely intended to fuel economic activity.

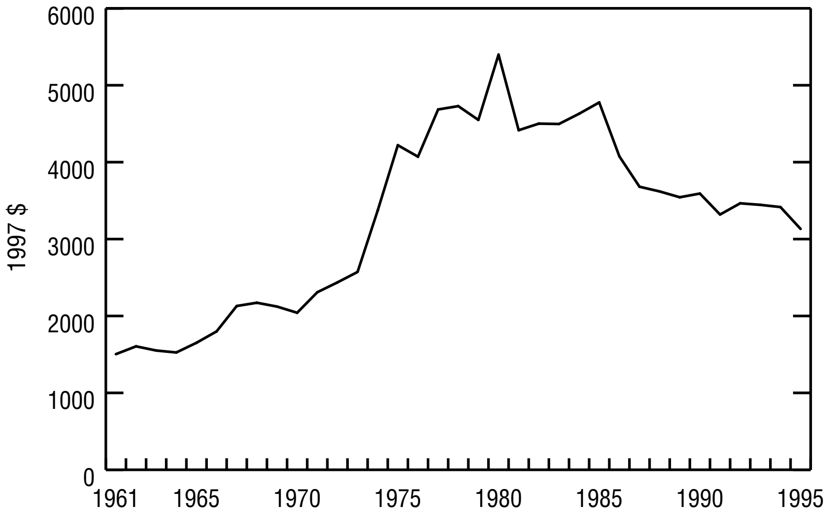
The role of government was changing in Atlantic Canada from providing traditional services to managing economic growth. This process was accelerated in the early 1970s, when Pierre Trudeau's Liberal party limped back into office with a fragile minority government. Once again, the next election might be determined in Atlantic, not central, Canada. This lent political force to demands for more regional spending.

These developments were unfortunate. Later research would show that providing quality basic services and infrastructure is associated with economic growth, but that increasing government consumption and intervention has a negative effect on economic growth and job creation (see Chapter 4).

But that's not the way things seemed in the 1960s. Any number of programs were introduced or modified in a way that would increase transfers to Atlantic Canada and government intervention in the economy. The list is long. Key changes included a broadening of equalization payments to "have-not" provinces in both 1967 and 1972; the establishment of the Department of Regional Economic Expansion, (DREE) in 1969 to fund regional-development programs in Atlantic Canada; and the introduction of regionally extended unemployment insurance (UI) benefits in 1971. Also important through the period were changes to funding formulas in established programs to make them more generous and to tilt them to favour of the "have-not" provinces, mainly in Atlantic Canada.

As we shall see, the changes to UI, changes that made the program far more generous and easily accessible in Atlantic Canada than in other regions, had dramatic consequences. This policy change, by itself, effectively increased transfers to the region in good times and in bad.

Chart 2–1: Net Federal Transfers to Atlantic Canada, per Capita



Source: CANSIM.

Box 2–1: Calculating Federal Spending

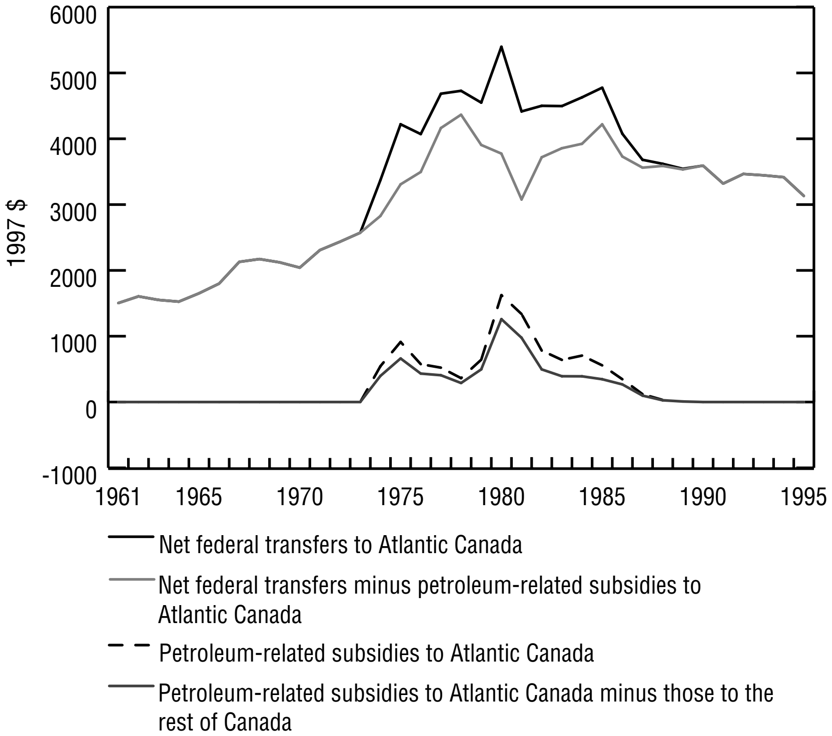
When trying to determine how specific federal programs have affected net wealth transfers to Atlantic Canada or any other region, the researcher faces a problem. Taxes go into general government revenues. Government doesn't have a specific revenue source for specific programs.

So when trying to determine the impact of a particular transfer program or even a group of them, the researcher cannot simply look up the program's revenue and subtract its spending to obtain a net figure. Yet without some such calculation, the numbers could soon falsely show that Atlantic Canada was subsidizing the rest of the nation.

One approach to this problem is to determine the difference between the average per capita program spending in the rest of Canada and subtract this amount from the average per capita spending in Atlantic Canada. This calculation at least provides some flavour of the "net" impact. Though this figure is not a real net, I use that word in the text and charts for convenience.

Chart 2-1 shows the growth of net wealth transfers to Atlantic Canada, calculated as the difference between federal revenues raised

Chart 2–2: Petroleum-Related Transfers to Atlantic Canada, per Capita



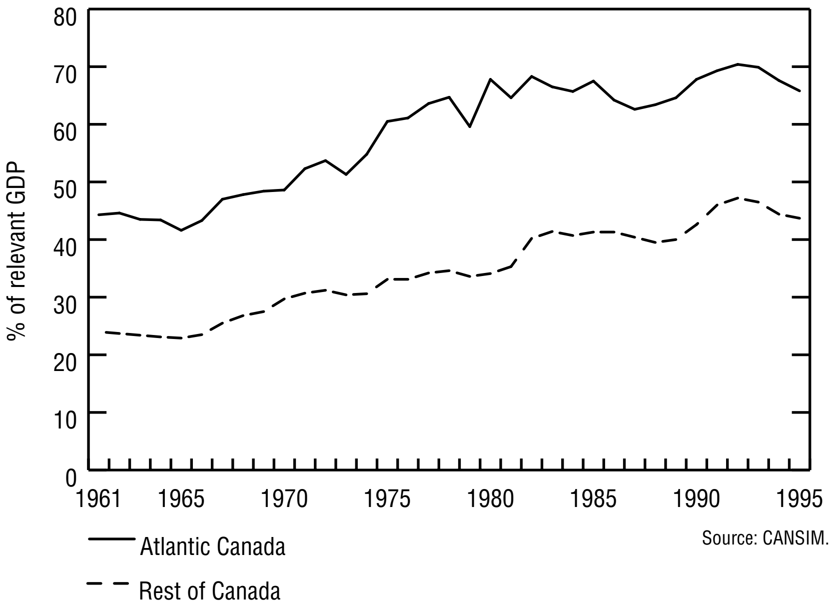
Source: CANSIM.

in the four provinces and federal expenditures in those provinces (see Box 2-1).[2]

Such net transfers have obviously been huge, but some commentators believe the sharp rises of the 1970s (followed in many cases by much smaller falloffs) were the result of special circumstances. They involve the oil crises of the 1970s and 1980s, which led to petroleum-related subsidy programs in those decades, and the extensive pres-

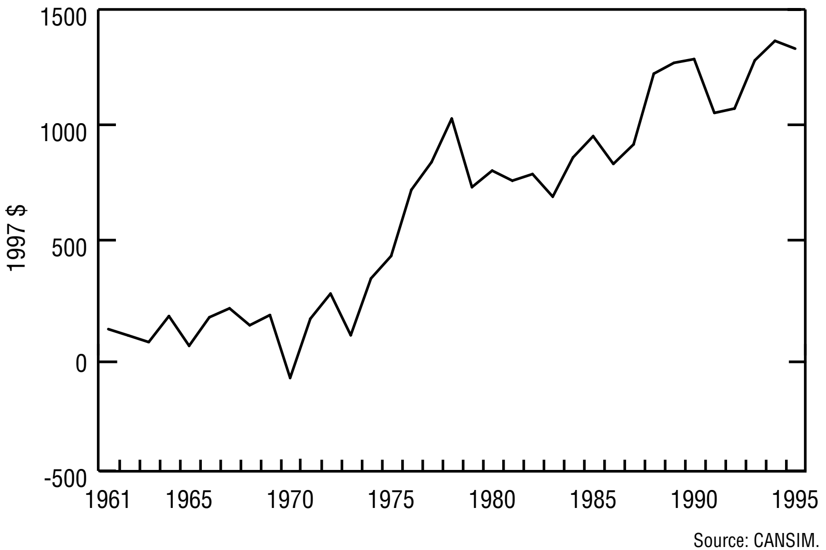
2. The province per capita shares of federal debt servicing are not included in these calculations. Doing so would increase the size of the net transfers. However, the purpose of the charts in this book is to reveal the net inflow of wealth to the region. Only a minute part of debt-servicing costs would have flowed to creditors in Atlantic Canada. Thus, these expenditures, which are now calculated on a per capita basis in the CANSIM data bank, need not be considered part of the net inflow.

Chart 2–3: Total Government Expenditure minus Petroleum-Related Subsidies in Atlantic Canada and the Rest of Canada



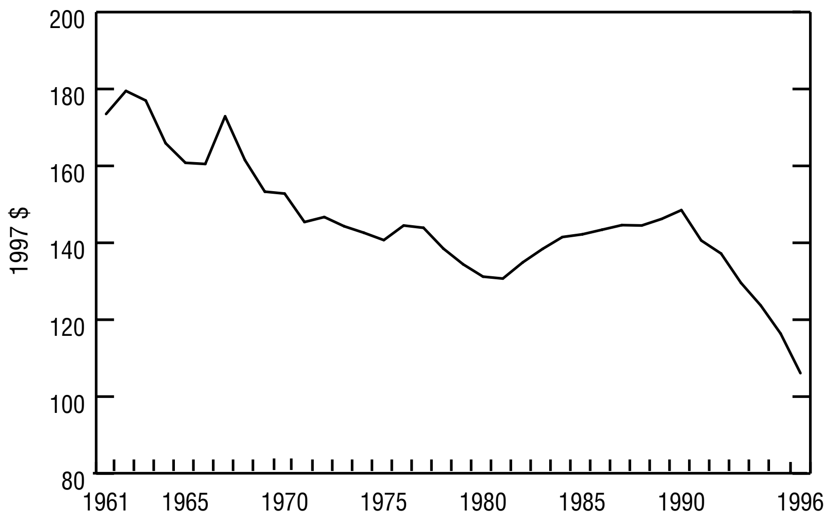
Source: CANSIM.

Chart 2–4: Total Government Spending minus Petroleum-Related Spending in Atlantic Canada and the Rest of Canada, per Capita



Source: CANSIM.

Chart 2–5: Military Spending in Canada, per Capita



Source: CANSIM.

ence of the Canadian Armed Forces in Halifax, which attracts military spending.[3]

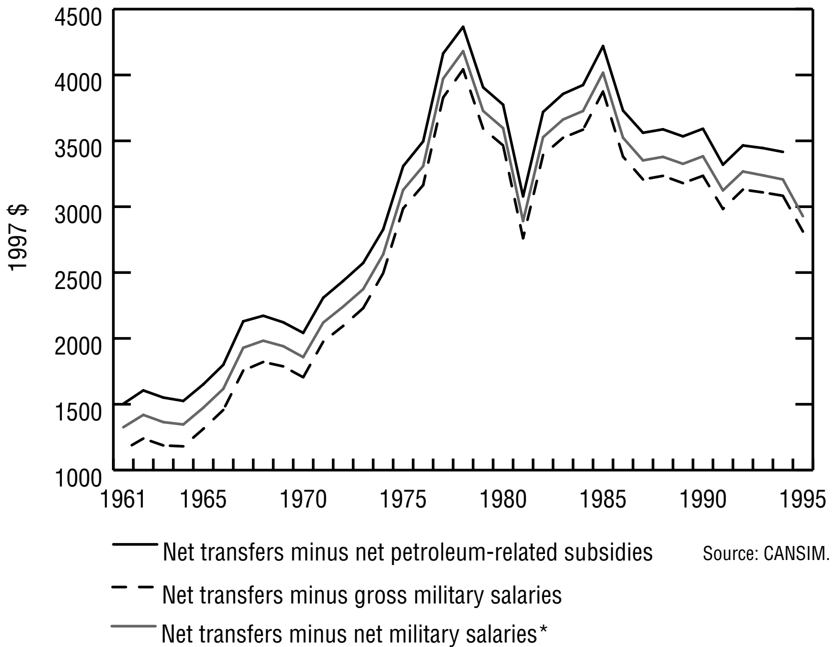
The evidence runs counter to these explanations and to the claim that the federal government was acting, in the 1970s, simply to stabilize the economy. Spending in Atlantic Canada on petroleum-related subsidies and on military pay more or less tracked the same expenditures in the rest of the country and was a small portion of them (see Charts 2-2 through 2-6).[4]

Rather, government spending in Atlantic Canada was soaring disproportionately in almost all categories, very much including personal transforms, as reflected in Charts 2-7 through 2-9. Indubitably, as a 1993 review of regional policy for the Atlantic Canada Opportunities Agency notes: “The 1970s marked a period of increasingly generous transfer payments from the federal government to provincial govern-

3. Mostly for military pay. Atlantic Canadian industries receive relatively small benefits from military procurement, which is concentrated in central Canada, a pattern seen even during wartime, as discussed earlier.

4. For more on my arguments against these hypotheses, see Appendix A.

Chart 2–6: Adjusted Federal Transfers to Atlantic Canada, per Capita

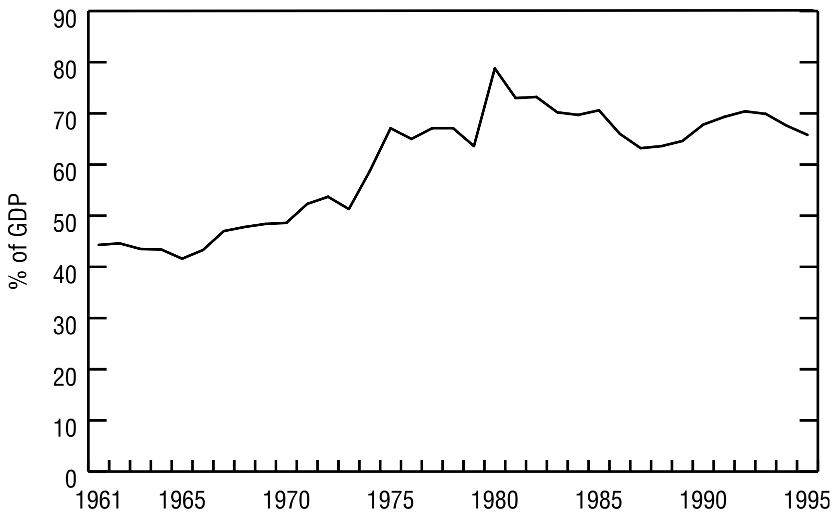


* Net military salaries approximated by the difference between average per capita spending on military pay in all Canada and in Atlantic Canada.

ments and individuals.... Regional policy hit its stride during the 1970s" (APEC 1993, 8).

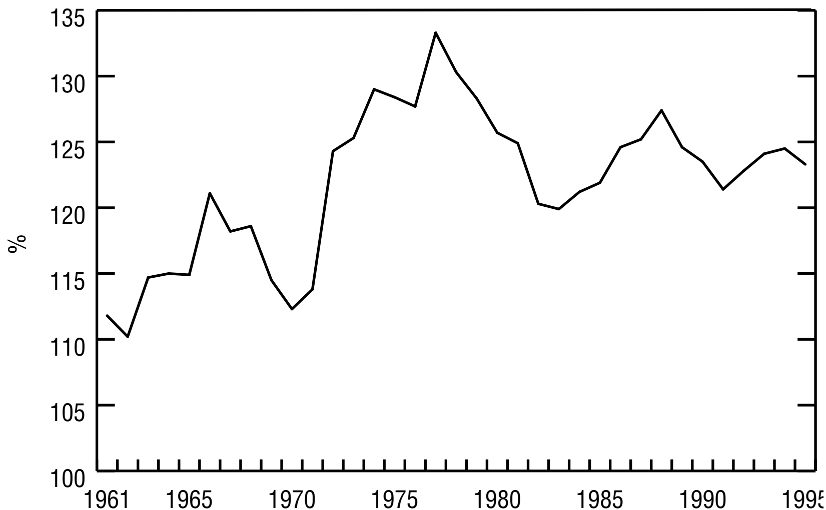
Contemporary observers understood this point. It was discussed in virtually every edition of the Atlantic Provinces Economic Council's (APEC's) *Atlantic Report,* the most comprehensive ongoing report on the region's economy through the period. Economists had even started to view the increasing government transfers and the resulting increases in government spending as one of the pillars of Atlantic Canada's economy. For example, the July 1974 report noted that "government employment and transfer payments" were one of "two chief underpinnings" of the Atlantic business economy, the other being resource exports (p. 2).

Chart 2–7: Total Government Expenditure in Atlantic Canada as a Percentage of Regional GDP



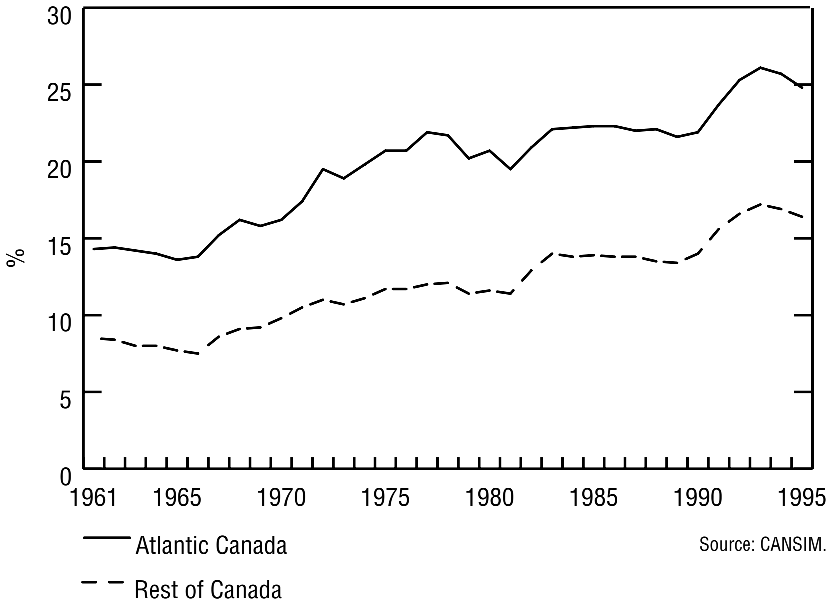
Source: CANSIM.

Chart 2–8: Government Transfers to Persons in Atlantic Canada as a Percentage of Those to Persons in the Rest of Canada



Source: CANSIM

Chart 2–9: Total Government Transfers to Persons as a Percentage of Personal Income



Cutbacks

Just as the 1970s' increases in transfers can be clearly associated with policy changes, so too can the reductions of the 1980s. In 1982, the equalization formula was amended in a way that reduced payments. And a ceiling was placed on them. As well, in 1982, the government took a number of steps that effectively reduced established programs financing, the arrangement that provided provinces money for health care and education. Petroleum-related subsidies were wound down through the middle of the decade, and the Petroleum Incentive Program was eliminated at the end of it.

Cutbacks increased after 1984, when a new federal Conservative government pledged to fiscal responsibility was elected. With one exception, regional transfers were reduced each year after 1985, regardless of how well or poorly the regional economy was doing. Nonetheless, the Conservative federal government never succeeded in balancing the budget. Increasing debt-servicing costs offset the cutbacks, leaving a little less to spend the following year as the new deficit

again increased servicing costs. Thus, further cutbacks were always necessary. The Liberal government elected in the early 1990s undertook a more concerted attack on the deficit, in the end eliminating it and then generating surpluses. Regional wealth transfers fell even further through this period.

Nevertheless, expectations of government largess continued. (See Chapter 3 for a story of recent demands for subsidies to distribute natural gas.)

Conclusion

Atlantic Canada has been buffeted by strong winds out of central Canada. The National Policy, launched shortly after Confederation, first created an economic boom in the Maritimes and then decimated the Maritime economy.

Decades of neglect and policy decisions that weakened Atlantic Canada were followed by a period in the 1950s and 1960s when the federal government began to adopt a more fair-handed policy structure. This didn't last long. Soon all the stops were pulled out in an attempt by Ottawa to make up for all past sins by providing the fiscal muscle and the wise policy guidance needed to finally break the region free of its "have-not" status.

The question arises were these policies wise? Was the money well spent? What was the impact on economic growth and job creation in Atlantic Canada? We turn to these subjects in the next chapter.