Chapter 3
Government Structure in Atlantic Canada

Government employment and transfer payments were…
two chief underpinnings of the Atlantic economy.
Atlantic Report, June 1974

Overview

Government is the dominant fact of economic life in Atlantic Canada. Since the mid-1970s, government spending has typically equaled about two-thirds of GDP,[1] though this proportion has declined in recent years. The large transfer of wealth from the federal government to provincial governments, local governments, and individuals throughout the region has fuelled government's central role, producing many of today's problems and challenges. This chapter describes some of them.

The vast literature on public-choice economics demonstrates how the incentives of bureaucrats and politicians often diverge from the larger interests of society (see Box 3-1). Public officials have many incentives to put resources to use in ways that will advance their careers, rather than society. This inclination need not be the result of cynical calculation. People have a natural tendency to associate their own interests with the public good. Thus, a theoretical physicist may quite honestly give greater weight to the benefits of a super collider than a NASA scientist who deeply believes in the profound value of space flight. Public officials are not different from the rest of us.

All jurisdictions face the difficulties raised by public-choice theory. But those problems are deepened in Atlantic Canada for two reasons: the opacity of government, and the outside source of funds.

1. This is well above the optimal size of government. (For further discussion, see Chao and Grubek 1998; and Tanzi and Schuknedat 1999.)

Box 3–1: Public-Choice Theory

A central idea in public-choice theory is that politicians and bureaucrats, like the rest of us, act in accordance with their own preferences and to their own advantage.

Voters have come to recognize this predilection and, in most developed nations, have insisted on new measures to boost accountability and transparency. Such measures enable voters to better understand whose interest the government is acting in.

In Atlantic Canada, accountability is weakened by the fact that so much of the public money spent in the region has an outside source. As well, studies find that government activities are highly opaque in Atlantic Canada, as discussed in the text.

Lack of Transparency

Transparency puts pressure on bureaucrats and politicians to act in the broader public interest. Incentives shift in this direction since voters are likely to penalize those acting against the public interest. If information is withheld, then a set of incentives to act in the public interest disappears. This is one of the reasons voters in many democratic nations are insisting on more transparency.

Transparency is also key for accountability. If government keeps information from the public, citizens have difficulty knowing what has been done and for what reason; accountability becomes impossible.

Atlantic Canadian governments have long had a reputation as being among the most politically driven and patronage ridden in Canada. Thus, it is hardly surprising they have a reputation for being among the most opaque. Political maneuvering and patronage appointments and spending cannot stand the clear light of day. A recent study sponsored by Atlantic Canada Opportunities Agency (ACOA) compared 49 jurisdictions—both developed and developing—on the basis of their world competitiveness rankings. Atlantic Canada scored dismally on transparency: 39 out of 49. As the study concludes: “Regional governments scored low on transparency: citizens and business find it hard to follow how and why decisions are made” (McNiven and Plumstead 1996, 47–48).

In fact, the structure of government spending in Atlantic Canada is partially responsible for lack of transparency. Because a great portion of government money comes from outside the region, taxpayers have less incentive to insist on transparency and accountability than they would if the money was theirs.

Money for Free

Another factor deepening the problems identified in public-choice theory is the fact that Atlantic Canada's government expenditures have become detached from the costs of taxation. This is because of the immense inflow of outside wealth.

Many Atlantic Canadians, including government officials, have come to see public money as a free good. The disconnect between spending and taxation removes pressure to restrain spending. If the money is free and doesn't displace another activity—something assumed in a negative-sum economy—then a nickel's return on a dollar is still a gain.

Obviously, federal spending in Atlantic Canada is, in large measure, free. The region is only a small part of the Canadian economy. Thus, any increase in federal spending has only a small effect on Atlantic Canada's tax rate or on its share of future government obligations. Thus, both federal and provincial politicians from Atlantic Canada lobby vigorously for increased federal outlays.

Also, provincial spending is highly subsidized by money from outside the region. This provides an incentive for provincial governments to keep their spending high. Some quick calculations reveal this point. Particularly during the years when spending was built up, many federal programs were cost-shared.[2] Take a program shared 50:50. That meant a provincial government could spend 50 cents and generate a full dollar of federal spending. And even that provincial half-dollar had a large federal component because direct transfers from Ottawa—through equalization and other programs—equalled 35 to 60 per cent of provincial revenues.[3]

So, by spending roughly 25 to 35 cents of home-raised revenue, a province could generate a full dollar of spending.[4] Few politicians or

2. In recent years, key areas of federal support have been shifted to block grants.

3. The exact proportion depended on the province and the year.

4. Taking into account federal contributions to both the program and the provincial budget.

bureaucracies could turn this chance down.

These calculations also suggest another pervers2e motivation that shared-cost programs have provided provincial governments: to keep taxes high since provincial expenditures often bring in "free" federal dollars.

This view of "free" government money became deeply entrenched in the minds of Atlantic Canadian leaders. Since the late 1960s, the history of the region has been full of impressive boondoggles. Two heavy-water plants in Cape Breton required subsidies far in excess of their wage bills. Although pay rates were high, labour strife was constant, and many days of work were lost. Eventually, the plants were failures—one never produced a drop of the stuff—and had to be shut down.

The workers' actions reflected their correct understanding that no one was controlling government expenditures. They were part of a political project that had little to do with producing heavy water. So low productivity, absenteeism, and frequent wildcat strikes were hardly threats to the continuation of the funding, which continued for years before politicians had the courage to pull the plug.

This government-money-is-free attitude was also reflected in the construction of roads to nowhere, bridges without real transportation connections at both ends, and the massive overbuilding of the fishing industry. Large government subsidies went to building fish-processing plants in communities that already had plants without enough business to remain in operation for much of the year (a situation further discussed in Chapter 7).

The attitude could still be seen even in the late 1990s, long after most public officials, including many in Atlantic Canada, had come to understand that government funds are a scarce resource that needs to be rationed carefully to get value for money. The legacy of the past will continue so long as regional leaders continue to think that the solution to their problems is further spending by Ottawa, rather than an attempt to structure a sensible policy framework for Atlantic Canada.

In 1998, Nova Scotia Premier Russell MacLellan issued a remarkable call for further petrochemical-related subsidies. At that time, Nova Scotia's Sable natural gas find had been proved commercial, and plans were being developed for distribution in the province. Yet MacLellan announced he would go to Ottawa to seek "massive subsidies"—the words of the newspaper report—to distribute Nova Scotia's natural gas to Nova Scotians. "We just want fair treatment," the premier said in an interview with columnist Jim Meek. "The province will not subsidize distribution. But we think Ottawa should" (Halifax *Sunday Chronicle-Herald*, November 1, 1998, p. 1). One can think only of Saudi Arabia seeking foreign aid to build gas stations

The story also reveals the perversity of subsidies. All too often a subsidy to one business or sector leads to the replacement of a healthy business with one dependent on continuing government subsidies. Aid to gas distributors would threaten companies involved in oil heating. According to the story, the Nova Scotia branch of the Canadian Oil Heating Association quickly noted that viable firms in the oil side of the heating business could be driven to bankruptcy. And Cape Breton interests had already called on the federal and provincial governments to plan to give further money to coal-related businesses when the natural gas began flowing onshore.

Calls for subsidies ("compensation") in the face of changing business circumstances represent the negative-sum view of the economy: no existing job-generating activity can be lost because no new activity will replace it. Even when the new activities are obvious, they are often interpreted as a threat to existing jobs. Nonetheless, it remains mind boggling that a rich natural-resource find would lead to calls for further subsidies, first to distribute the resource and then to neutralize any changes that its availability might cause in the economy.

Although this particular call for subsidies went unheeded, it shows that demands and lobbying for increased expenditures are not viewed as activities that will cost regional taxpayers money. That attitude suggests how enduring this view of government spending is even after the money has begun to run out.

Absence of Accountability

The disconnect between paying taxes and spending money in Atlantic Canada has damaged government accountability. Governments are usually accountable to taxpayers for the money they spend. But if it's another jurisdiction's taxpayers who are paying the bill, the lines of accountability blur or disappear.

In Canada, external taxpayers, particularly those from central

Canada, may regard transfers to Atlantic Canada as required for national equity—a good use of money—but they have little ability to monitor where the money actually goes. What does it matter when they have been assured the purposes are worthwhile?

Moreover, while transfers are large by Atlantic Canadian standards, they are small from a national viewpoint. And before the free-trade agreements of the 1980s and 1990s, high tariff barriers directed most Atlantic Canadians import spending to goods and services produced by central Canadian businesses. In other words, central Canada sent money to Atlantic Canada, which used it to purchase central Canadian goods.[5]

Then, as now, the end result was a disconnect between those paying the bills and those spending the money—a disturbing absence of accountability. Regional politicians and bureaucrats do not have to account fully to national or regional taxpayers.

Instead, both provincial and federal governments face pressure to spend from industrial and subregional interest groups, who see no relation between their tax bills and additional expenditures. Thus, schools and hospitals are often seen more as makework projects and political rewards than as educational or health care projects.

Regional bureaucrats and politicians reap political credit for the money spent. Given the fiscal clout of government, this politicizes the economy and introduces huge distortions into the labour market and the business sector (as discussed in Chapters 5 and 6). Provincial governments, businesses, and individuals all struggle to tap into the supply of federal dollars. It's a costless proposition for anyone who can muster the political clout. But this only weakens those businesses and interests outside the political circle and suppresses self-sustaining activity that is not government supported.

Handing out "free" money is, of course, an easy way for politicians to score points with voters. Tellingly, Pierre Trudeau's administration in the 1970s announced that it was time for the federal government to get more political credit for all its spending. Leading federal politicians

5. This may in part explain why western Canadians have been considerably more hostile to regional flows than central Canadians, and why resentment of transfers has risen in the era of free trade, when Atlantic Canada is likely to ship the money off to, say, New England companies.

from Atlantic Canada stated this explicitly as a new policy goal. Billboards went up throughout the region, wherever government work was underway, extolling the size of the federal contribution.

The muddying of accountability in government spending has been accompanied by muddied accountability in economic management. Federal politicians are not expected to take overall responsibility for the regional economy, but they are expected to generate opportunities for rent-seeking[6] in their constituencies. So long as Ottawa appeared to be flush with cash, influential politicians in Ottawa had little trouble prying it loose.

Although provincial governments also try to take credit for economically good times, they too sidestep responsibility for overall economic performance. If things aren't going well, they can blame either federal inaction or the region's historic economic weakness. This skews political incentives. With no one really accountable for economic performance, politicians can garner more credit for spending money—money mostly raised outside Atlantic Canada—than for good economic policies.

Perverse Government Incentives

The funding structure of government in Atlantic Canada also creates incentives to sidestep new revenue sources. The equalization formula is the chief culprit here, although not the only one. Federal transfers create a welfare trap for provinces. When new revenue sources come on stream, federal transfers are reduced by a roughly equivalent amount.

The effect is perverse. For example, one of the world's richest nickel deposit has been found in Labrador. The Newfoundland government refuses to let mining proceed unless the operator builds a large smelter for the metal. This idea is politically popular, but the company says that it would be uneconomical and that the smelting would be done most efficiently at its Ontario operations.

For Canada, as a whole, it makes no sense to destroy jobs in Ontario, particularly in a job-poor part of that province, and spend

6. To economists, *rent-seeking* means engaging in unproductive activity in pursuit of profits in excess of competitive earnings.

hundreds of millions of dollars on a new smelter to transfer the jobs to Newfoundland. The redundant investment of building an unnecessary smelter would be a dead loss. Even from Newfoundland's perspective, it would make more sense economically to forgo the smelter in favour of increased royalties, which could be used to reduce taxes and provide all the province's residents and businesses with a tax break—something economists generally agree increases economic growth and job creation. It would certainly make no sense for Newfoundland to increase its dependence on natural resources, particularly when a lower tax load might help with economic diversification.

But the structure of the equalization program, even after some reforms to reduce perversities in the system, would leave few extra dollars in the hands of the Newfoundland government if it attempted to trade off the smelter for greater royalties. Thus, it makes sense for the provincial government to demand not increased royalty payments but rather the construction of an uneconomical smelter. Perverse government incentives lead to perverse policies.

The structure of equalization contains other perversities. Revenue from new sources or economic growth are clawed away by federal reductions in equalization. But extra revenues the provinces gain through increased taxation are not clawed back. In other words, if a provincial government obtains an extra dollar through increased taxes, it keeps that dollar, but if it gains an extra dollar because the economy becomes healthier, it loses the money in equalization payments. Thus, the provinces have an incentive to increase tax rates while ignoring other revenue-building opportunities.

All this has resulted in high levels of taxes in Atlantic Canada combined with even higher levels of expenditures. Unlike Ireland and the other successful economies examined in *Road to Growth* (McMahon 2000), Atlantic Canada has not, until recently, focused on reducing taxes to bring down costs in the economy and spur growth. Rather, it has done the opposite, with an ever-increasing tax burden placed on businesses and individuals. Yet, as Lane notes from the Irish perspective:

> [T]he performance of the government is an important determinant of international competitiveness. An efficient government enhances the ability to compete in international markets, by reducing the taxation and other costs of attaining pol-

> icy objectives.... In international studies an efficient government is highly correlated with strong growth performance. (1995, 125)

But, in Atlantic Canada, the incentives facing government were all tilted to more spending with little regard for efficiency.

Government Spending Patterns

The evidence on the convergence of growth rates among developed nations and regions within them and on international development,[7] shows that negative forces hindering economic growth include high taxes, big government, and high levels of government consumption. All three characterize the government sector in Atlantic Canada. While nations like Ireland and the Netherlands, when faced by severe economic problems, cut back on government to spur growth, Atlantic Canada's key growth industry has been government. Needless to say, the economic results from Ireland and the Netherlands have been substantially better than the results in Atlantic Canada.

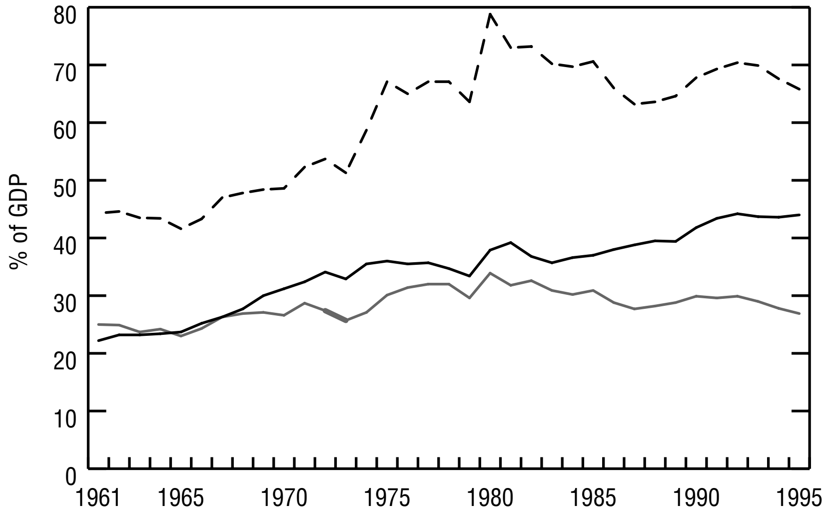
Government, of course, is not simply a negative. Its investment in infrastructure, education, and health care advance well-being and further economic growth. Unfortunately, the data for Atlantic Canada provide little reason to believe government has sufficiently concentrated in these areas, despite its unusually high levels of spending (though later in the chapter we'll discuss a hopeful sign).

As can be seen in Chart 3-1a, both government expenditure and revenue have risen dramatically in Atlantic Canada since the early 1960s. Expenditure rose from just under 45 per cent of gross domestic product (GDP) in the early 1960s to fluctuate above 65 per cent of GDP in most years after the mid-1970s, a rise much greater than the similar evolution toward greater spending by all governments across Canada (see Chart 3-1b.) High government spending, by itself, puts tremendous pressure on the private sector, pushing up costs for scarce resources and otherwise squeezing out private activity.

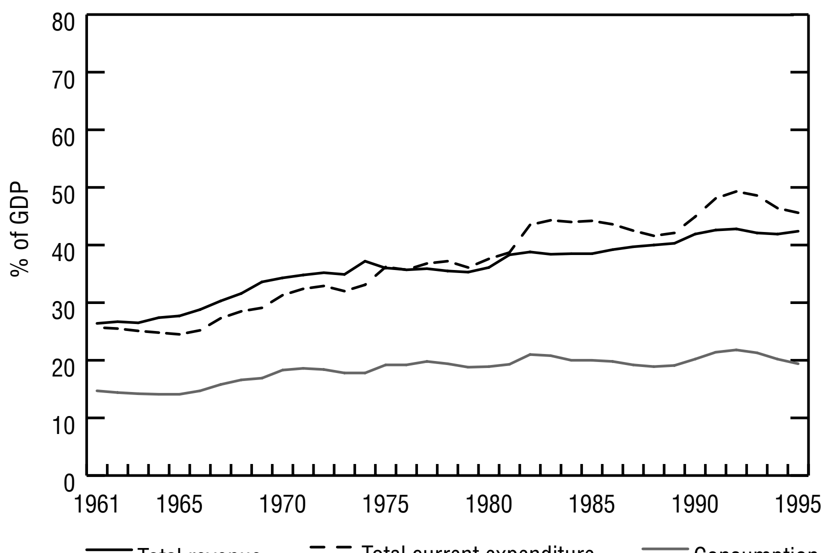
Government consumption—government spending on goods, serv-

7. Reviewed in Chapter 4 of this volume and in *Road to Growth* (McMahon 2000). See also Barro and Sala-i-Martin 1995.

Chart 3–1: Government Revenue and Expenditure
a: Atlantic Canada, All Levels of Government



b: Canada, All Levels of Government



Source: CANSIM.

ices, and wages and salaries—is a strong negative influence on growth, and it is high in Atlantic Canada. It rose from just under a quarter of GDP in the early 1960s to fluctuate near a third by the mid-1970s.

High taxes are also a negative for economic growth. Taxation rose dramatically in Atlantic Canada, particularly during the period when economic development activities were at their peak, going up from an average of about 23 per cent of GDP in the 1960s to about 43 per cent in the 1990s. This high level of taxation is a significant problem for Atlantic Canada's private sector, as business surveys reveal. For example, a recent survey of 20 firms reports that, "The issue of taxes was raised as a significant disincentive to operating from the region by almost half the participants" (DRM Advisory Group 1994, 10).

Another way of looking at the tax burden is to examine the wedge between personal income and disposable income. Chart 3-2a shows how this gap has grown in Canada (a reason often cited for the country's lagging growth in productivity, weak job generation, and low wealth creation).

The burden is even greater in Atlantic Canada (see Chart 3-2b). Across Canada, taxes took about 37 per cent of personal income in 1996; in Atlantic Canada, the figure was 41 per cent. Of course, Atlantic Canadians average an unusually high percentage of personal income from government transfers, but many of these transfers have perverse effects (which are examined later).

EXPENDITURES

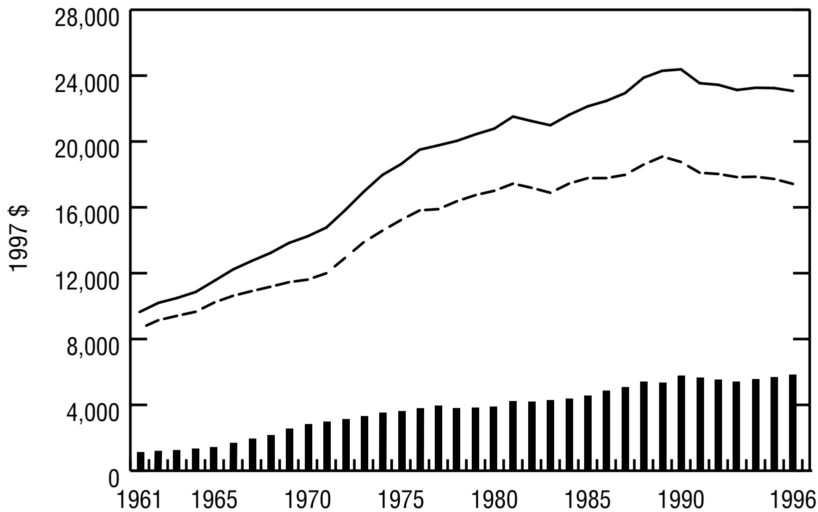
Here we turn to a more detailed examination of government spending in Atlantic Canada (for a description of its composition, see Box 3-2a).

Although the international evidence suggests that the size of government in Atlantic Canada, on both the taxation and expenditure sides, would impede growth, the question also arises about whether government has focused its spending on areas that would benefit the region. Here virtually all the indicators point in the wrong direction.

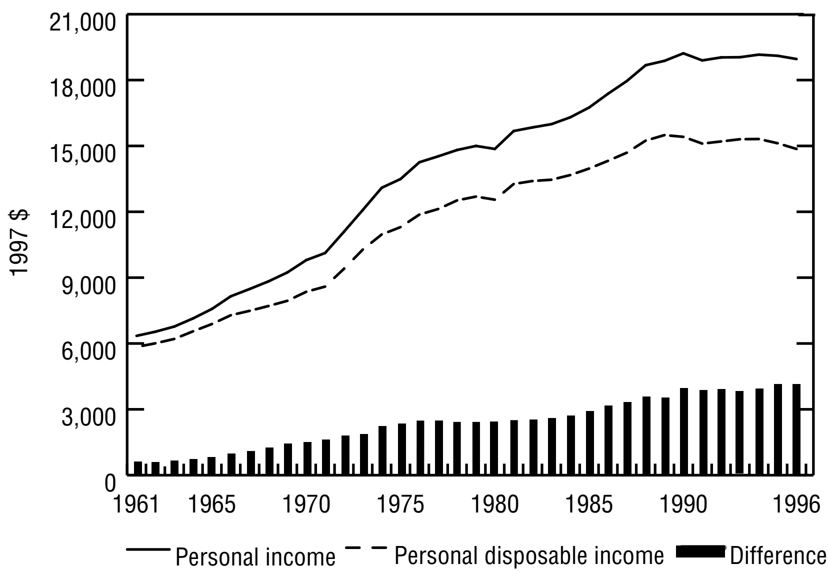
Government Investment

According to the economic evidence, investment, particularly in infrastructure, is the most positive thing government can do to spur economic growth (McMahon 2000). Considering the large flow of

Chart 3–2: The Gap Between Personal and Disposable Income
a: Cross-Canada



b: Atlantic Canada



Source: CANSIM.

Box 3–2: Spending, Consumption and Investment

Almost everyone knows what spending, consumption, and investment mean in his or her personal life. But many people find those words a bit fuzzier when they involve government action.

Economists and accountants differentiate among kinds of expenditure. Government spending includes everything on the expenditure side of the ledger-from funds spent on paper clips to transfer payments. Consumption spending means funds spent on goods, services, and wages and salaries-from helicopters to the pay envelopes of janitors.

In contrast, transfer payments are made without the recipients' providing goods or services in return. Those recipients may be individuals (who receive) "transfers to persons"), businesses, or a lower level of government.

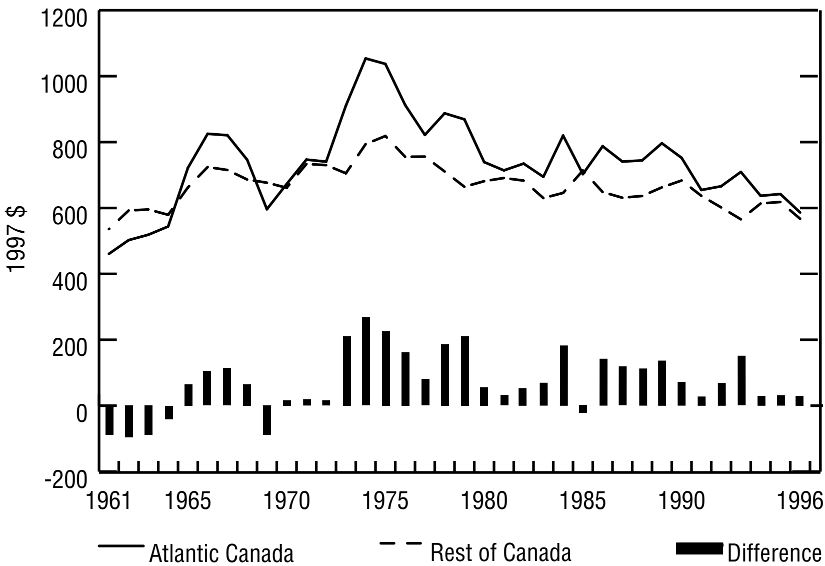
Investment spending, for government as for the private sector, is money spend on capital goods that are expected to produce a payoff over the long run. Government accounting systems restrict the tem mostly to infrastructure improvements, such as building new structures, roads, and the like. The term is also sometimes used more broadly for investment in human capital through education and training.

federal funds into Atlantic Canada and government's emphasis on spurring economic growth, one might expect a boom in government investment in Atlantic Canada as transfers from the federal government increased in the 1960 and 1970s. Unfortunately, that boom never occurred.

Chart 3-3 shows government investment spending in Canada and Atlantic Canada. Investment in Atlantic Canada—where provincial governments had a lot of catchup to do after the decades of neglect discussed earlier—usually fluctuated around $700 per capita. Net government wealth transfers to Atlantic Canada were many times this amount. Despite the vast inflow into Atlantic Canada and the region's weak public-sector infrastructure, government investment was usually just a few dollars—or a few tens of dollars—above the national per capita average.

As the evidence on foreign aid in Chapter 4 will show, private-sector investment can be crowded out by wealth transfers and increased government spending in jurisdictions with bad economic policy. That certainly appears to be what happened in Atlantic Canada. Later, we shall examine this point in more depth. Suffice to say for now that lost private-sector investment has been about twice the size of total government investment in Atlantic Canada.

Chart 3–3: Total Government Investment Spending, per Capita



Source: CANSIM.

Useful Investment

Unfortunately, government-investment statistics overstate significantly the amount of useful government investment in the region. As described earlier, the structure of government in Atlantic Canada provides political rewards for spending but little taxpayer pressure for restraint. This is because regional taxpayers pay for only a small portion of government expenditures. Taxpayers outside the region pick up the lion's share. The disconnect between expenditure and taxation reduces the pressure to get a dollar's value out of a dollar spent. The money is often seen as free, and accountability is diminished, often to the vanishing point. With the focus off value for money, spending becomes highly politicized.

Thus, government invests in schools and hospitals as often for political reasons as for reasons associated with education or health. The Sydney urban area, with its relatively small population, could be served by one modern hospital. In fact, it has several. Hospitals are seen as political plums.

School construction too falls into this category, as influential columnist Jim Meek notes in a column about a $340-million school project in the Pictou area of Nova Scotia. Even "the [school] board treats the schools as an economic development opportunity without understanding or much caring about the effects on the quality of education" (Halifax *Chronicle-Herald*, December 11, 1999, B1).

Transportation Infrastructure

Nothing better reflects the idea of politicized spending and squandered government investment in Atlantic Canada than its roadwork—or lack of it. But this could be the road to economic growth. One of the most important things government can do here is to improve its primary transportation infrastructure, not the secondary roads that are usually more politically important. This view is supported both by empirical investigation and by experts in industrial location. As an executive consultant with Deloitte & Touche/Fantus notes:

> From a practical standpoint, the most important highway characteristic as it relates to facility location is distance from an interstate highway or limited access highway. According to our data base, over 50 per cent of our ... clients [seeking locational advice] want to be within 25 miles of an interchange to such a roadway. (Ady 1997, 81)

The importance of primary infrastructure is evident in both lagging and advanced economies. In Maine, economic activity has boomed along its twinned highway connection (a multilane highway with a separator between lanes) to the U.S. highway network. In the Toronto region, new growth is concentrated on the twinned network around the city.

In the 1970s, Atlantic Canada had no efficient highway connections to its markets in Canada or the United States. It still doesn't. Given the intense regional-development efforts of that decade, one might have expected work on the primary transportation infrastructure to increase. The opposite occurred.

Atlantic Canadian politicians seem to view roadwork as an opportunity more political than economic. An election call usually unleashes a flurry of activity in all government-held and swing constituencies, regardless of their location, their need for road improvements, or the importance of roads there to the province's overall transportation needs. This frenzy of largely useless "investment" spending on any road is nicely captured in the phrase "The road to Hell is paved just before elections."

In fact, during the 1970s, while billions of federal dollars were flowing into the region each year and economic development agencies were receiving rich funding, work on building an efficient highway structure actually declined. Yet throughout this period, a strong highways infrastructure was becoming ever more important to the economy. An ACOA-sponsored report discusses this:

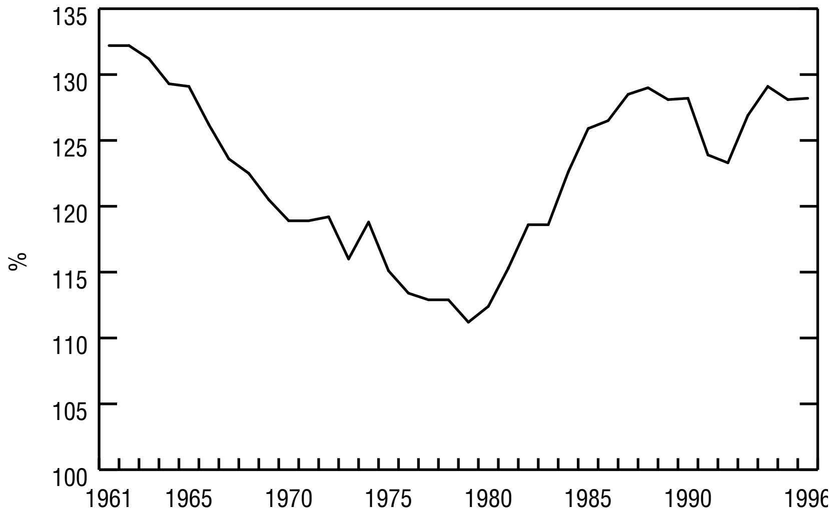
> Spending on highways [in Atlantic Canada] decreased faster in the 1970s, even as freight was increasingly diverted from railways to trucks. The region is now faced with massive spending requirements to refurbish its main roads and bring them up to levels that match the needs of volumes of traffic that use them. Between 1977 and 1997, over $1.3 billion [in current dollars] will have been spent in joint federal-provincial programs on highways, $743 million (55%) of that is federal. The federal share has varied from 50% to 100% depending on the province and cost sharing arrangement.... Despite this spending, the arterial highway network has still deteriorated in quality and is inadequate for the volume of traffic that uses it (DRI Canada, APEC, and Canmec Economics 1994, 4.3–4.4).

Another indicator of the wasteful spending during through the period of rich government is the fact that twinned-highway construction actually increased as federal transfers to the region were being reduced.

The money for building a useful infrastructure was always there; it was just being used for other, largely political purposes. The shift in spending priorities to useful investment is most obvious in New Brunswick. In the mid-1980s, that province had only about 100 kilometres of twinned highway. Now it has several times that amount, despite government spending restraint in the intervening period, and it continues to build more.

Nonetheless, twinned highways in Atlantic Canada are still orphans. There are hundreds of kilometres between the end of a

Chart 3–4: Per Capita Wages and Salaries for Government Administration, Atlantic Canada as a Percentage of the Rest of Canada Average



Source: CANSIM.

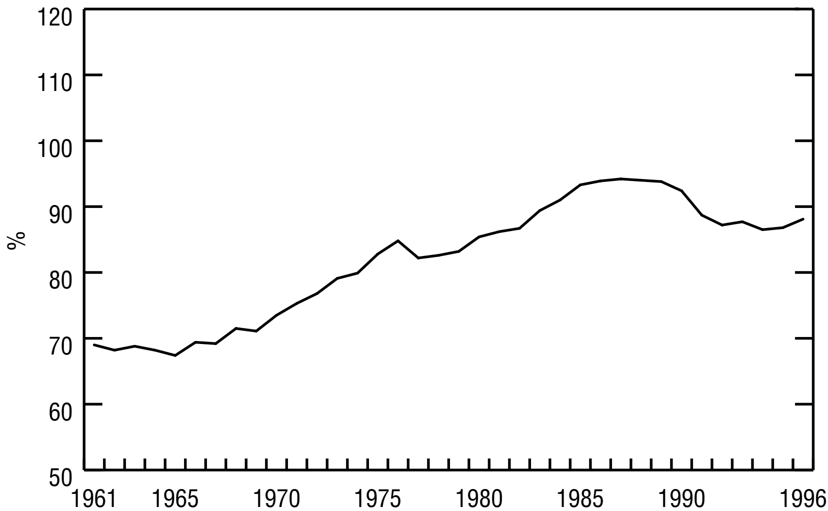
twinned highway in New Brunswick and the beginning of another in Quebec. There is also a difficult journey through northern Maine between the end of the New Brunswick twinned highway and the beginning of the interstate network in Bangor, Maine.

Government Administration, Health Care, and Education

Another sign of misplaced government priorities is the size of government administrative spending in Atlantic Canada. It has been consistently larger there than in the rest of Canada (see Chart 3-4). The pattern, however, is surprising. Although government administrative spending in Atlantic Canada is always higher than in the rest of the nation, the ratio declined throughout the 1960s and 1970s (except in the first years of the 1970s) and then rose again in the 1980s until it stabilized in the early 1990s at a level well above what is found elsewhere in the nation.

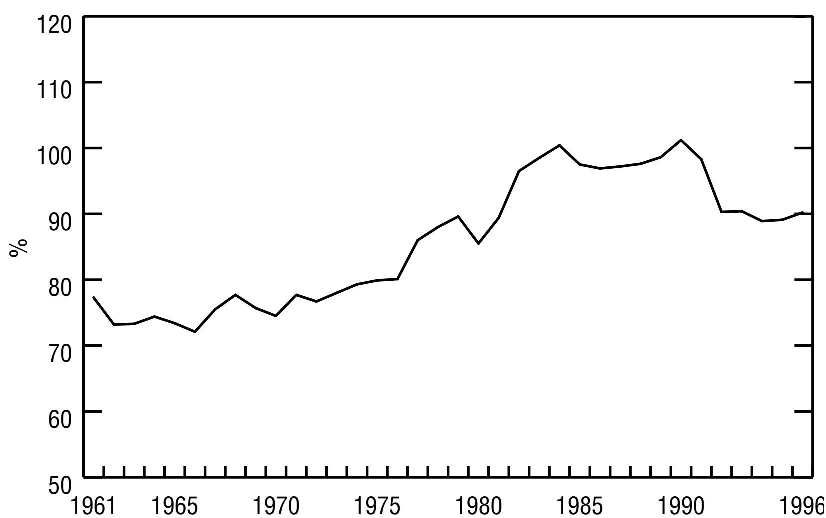
An even more serious problem is that spending on key areas, like health care and education, were consistently below the national average for most of the period we have been discussing, though health and

Chart 3–5: Per Capita Education Wages and Salaries, Atlantic Canada as a Percentage of the Rest of Canada Average



Source: CANSIM.

Chart 3–6: Per Capita Wages and Salaries in Health and Social Services, Atlantic Canada as a Percentage of the Rest of Canada Average



Source: CANSIM

social-service spending in Atlantic Canada are now close to the national level (see Charts 3-5 and 3-6).

Here is the only encouraging sign about the focus of government spending in Atlantic Canada. Administration costs compared to those in the rest of Canada have declined while expenditures on health care and education have risen toward national averages. Nonetheless, no Atlantic Canadian policymaker should be pleased that such useful areas of spending remain below the national average while administration costs still take an oversized bite of government expenditure.

Regional Economic-Development Spending

A significant set of transfers to Atlantic Canada has been for economic development. Although far from the largest transfer area, it lay at the heart of the 1960s view that government efforts, by themselves, could boost the region's economic growth.

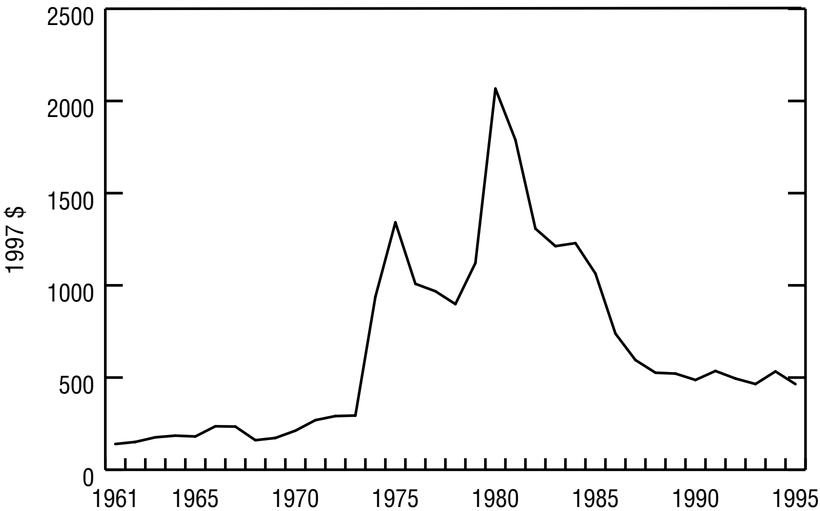
Chart 3-7a shows the per capita total of all business subsidies received in Atlantic Canada; Chart 3-7b excludes petroleum-related subsidies and thus provides a better picture of the evolution of economic-development spending. Notice that subsidies sharply beginning in 1969 and continued to rise until the late 1970s.

The Programs

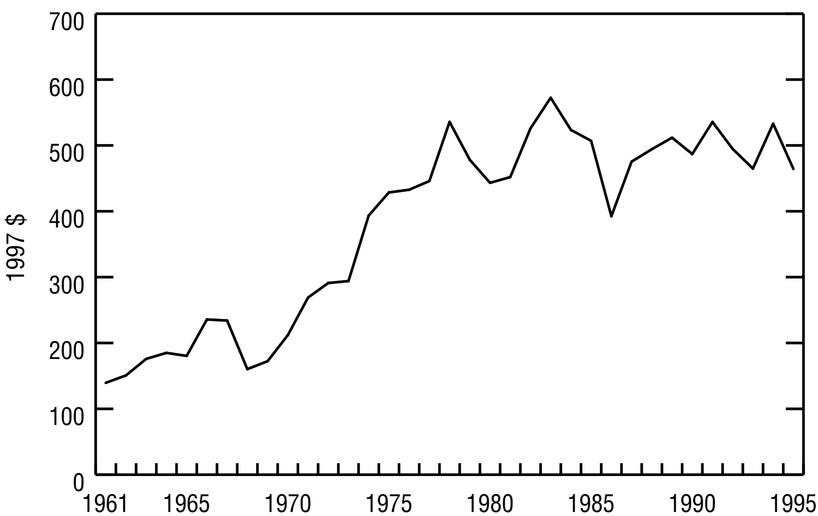
Economic-development programs seem largely ineffective. Chapter 4 describes some of the reasons why. In brief, these programs turn business's focus from creating successful goods and services to obtaining government money. They tempt firms to distort their business plans so as to qualify for grants or concessionary loans. They politicize the economy. They lead to misallocation of resources by bureaucrats and politicians, who simply are not equipped to choose winners and who are hobbled by incentives to protect existing interests and political friends. And they result in successful businesses' being undercut by subsidized competitors, who themselves may well fail when the subsidy runs out but not before damaging or destroying successful businesses in the sector.

The failure of economic-development programs, acts, and agreements in Atlantic Canada can be glimpsed simply by examining a list of names: Atlantic Canada Opportunities Agency (ACOA); Area

Chart 3–7: Per Capita Business Subsidies, Atlantic Canada
a: Including Petroleum-Related Subsidies



b: Excluding Petroleum-Related Subsidies



Source: CANSIM.

Development Agency (ADA); Atlantic Development Board (ADB); the Cape Breton Development Corporation (Devco), which started as an agency designed to invigorate the whole Cape Breton economy but was left simply running loss-making coal mines; Department of Regional Economic Expansion (DREE); Department of Regional Industrial Expansion (DRIE); Enterprise Cape Breton Corporation (ECBC); Economic and Regional Development Agreement (ERDA); Fund for Rural Economic Development (FRED); Industrial Estates Limited (IEL);[8] *Maritime Coal Production Assistance Act* (MCPA); *Maritime Freight Rates Act* (MFRA); and *Regional Development Incentives Act* (RDIA).

This list is mainly of federal programs, and it is hardly complete. Adding provincial bodies would fill pages. In the past decade alone, for example, Nova Scotia has gone through the Nova Scotia Department of Industry, Trade and Technology, renamed and restrategized as the Economic Renewal Agency, which then became Economic Development and Tourism. (As this book is being finished, the department has two identities: the Department of Economic Development is now separate from the Department of Tourism.) Many other government agencies and departments are involved in the same sort of economic-development work.[9]

Why are these lists of programs revealing? Because each new program was built on the failure of an old one. It would quickly become obvious that the approach of the day wasn't working. Policymakers, rather than question the fundamental assumptions behind handing out government money, would simply shift things around a bit, come up with a new name, and then explain why the old approach failed and why the new one would work marvels. Jim McNiven, a former deputy

8. IEL, a Nova Scotian initiative, had some early successes. Observers from the time attribute them largely to two factors. The budget was relatively small, and the organization did not have the fiscal clout to bribe an industry to come to the region unless doing so made strong economic sense. Thus, it was as much a marketing body as a subsidizing agency. It was a cooperative government-business enterprise, a fact that may also have reduced politicization.

9. An example is the Nova Scotia Film Development Corporation, which, in partnership with the Departments of Transportation and Public Works and of Economic Development, is as busy subsidizing film and sound studios as government bodies once were subsidizing fish plants. Halifax has three studios. Sydney has one. Soon Shelburne will have one, with various government agencies picking up more than $2.5 million of the $3.4 million cost [in current dollars]. (R. Boomer, Halifax Daily News, February 21, 1999)

minister of economic development for Nova Scotia, argues that development policy has changed every 40 months since 1961 (1988, 9). Lithwick identifies six major policy shifts between 1947 and the mid-1980s (1986, 113).

The Theories

Over time, the regional-development theories behind these economic-development programs have shifted as much as the programs themselves. The theories all assume market failure and a need for the steady hand of government to direct economic development in peripheral regions.

The variations and even the names of the theories have been many. They have included resource scarcity, growth poles, balanced growth (then, in an aboutface, unbalanced growth), planned structural change, and the basic-needs approach. These shifts appear to reflect a failure of theory that parallels the failure of economic-development programs. When efforts arising out of one growth theory collapse, regional theorists maintain their view of market failure and develop another idea that wraps the need for government intervention in a new theoretical structure.

Policymakers hardly had to wait until the 1990s to discover this pattern of a failed program's being replaced by another program, which would again fail, and so on. As Abraham Rotstein wrote almost three decades ago, soon after the beginning of Canada's huge regional efforts:

> Heroic efforts in the past have been launched with great fanfare, only to be followed by an uneasy silence. The plans and strategies are dissipated against the cruel realities; one after another of these regional programs awry amidst reports of inept management, endless delay, misuse of public funds.... New government agencies are launched and one acronym follows another into a state of suspended animation; ADA, ARDA [*Agriculture Rehabilitation and Development Act*] and FRED. (1971, vii)

Given his early insight, Rotstein might be surprised—or perhaps not—at how long the list of acronyms has grown, along with the list of failed policies and disastrous endeavors. Yet, *plus ça change…* A brand-new start was supposed to begin with the founding of the ACOA in the mid-1980s. Prime Minister Brian Mulroney asked Donald Savoie, a renowned regional expert from Université de Moncton, to design the new agency so as to avoid the pitfalls of the past. Savoie was hailed as the "father of ACOA". In 1997, Savoie published a book highly critical of ACOA, *Rethinking Canada's Development Policy: An Atlantic Perspective.* But flaws in economic-development strategies should have been long understood. Rotstein had discussed many of them in his brief 1971 essay.

The Current Thinking

At least, as Chart 3-7b shows, policymakers now appear to have realized the ineffectiveness of business subsidies, allowing their per capita level in Atlantic Canada to fall through the 1990s. Nonetheless, the search for a way to justify economic-development measures continues.

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The newest idea is that the problem has always been with government bureaucracy, and the money needs to be shuffled down to a lower level of government. As Higgins and Savoie put it:

> The failures of past regional development efforts...have more to do with this fact (bureaucracy) than with the substance of the initiatives themselves.… The solution is to push out of government and down to community groups...responsibility for planning and implementing regional development measures. (1995, 403–404)

Notice that the proponents do not suggest the classic approach to development has any fundamental flaw. The approach was right all along, they imply. The economic miracle failed to occur simply and only because the money was given to the wrong level of government.

Meanwhile, the federal Liberal government also appears anxious to boost business subsidies and government-directed economic-development efforts despite the vast history of clearly documented failures. Four members of the Atlantic federal Liberal caucus recently presented a report, *Atlantic Canada: Catching the Wave* (Bryden et al. 1999), calling for more money for a increased economic development effort in

Atlantic Canada, including an expanded role for the ACOA. The writers rely on typical arguments for this expanded role for government. For example, they claim the Canadian capital market will not properly finance Atlantic Canadian activities, although they present no evidence of this. Even research conducted for ACOA has failed to find the hypothesized failures to finance business opportunities in Atlantic Canada, though, as discussed elsewhere in this volume, various studies show that government money often displaces private capital, and distortions in the Atlantic economy limit business opportunities.

Politicization

Of course, active economic-development programs enable politicians to take direct credit for job creation (though they are seldom around when subsidies run out and a company either needs another round of money or fails). They also create a tool to reward friends and direct projects to where votes are needed. Even Liberals in Atlantic Canada acknowledge that increased government handouts could help them politically (see Halifax *Sunday Daily News*, December 5, 1999, 52).

One problem with all agencies is the political imperative. For example, when Norman Spector became president of ACOA, he tried to take politics out of the system. This created dissension within the agency and political anger outside. Several regional members of parliament publicly complained that the political side should be making the decisions. Spector resigned after a short time on the job. The view that development agencies have become largely political in nature is now widely accepted.

For instance, after the announcement of the shutdown of the largest Cape Breton coal mine, the federal Liberal government promised Nova Scotia's Liberal government it would give an extra $68 million to Enterprise Cape Breton, the economic-development agency responsible for the island. This aroused the ire of David Muise, mayor of the Sydney Regional Municipality and a prominent Liberal, who argued the money would be squandered on patronage and political projects. As Parker Barss Donham, a prominent regional columnist, put it, Muise's "belief that ACOA and ECBC have squandered their development budgets on a handful of prominent, well connected friends of the [Liberal] government is widely shared on the island

[Cape Breton]" (Halifax *Daily News*, February 24, 1999).

The past political bias of development agencies should not be used as a stepping stone to lobby for yet another flavour of government economic-development spending, one devoid of political interference and thus able to objectively focus on increasing economic activity. All the development agencies have been advertised as being free of partisan politics from the start.

Small Business

An interesting aspect of the development approach in Atlantic Canada is that ACOA and other agencies now say their prime focus is on helping small business. Yet perhaps the most vocal critic of the development efforts is the organization that represents small business in the region, the Canadian Federation of Independent Business. Peter O'Brien, the outspoken vice-president for the Atlantic region, told me in conversation:

> There is no record of success and there is no indication that these things are done fairly. Particularly in the early days of ACOA, if there was a business succeeding down the street they wanted to subsidize the same business up the street. I got a lot of complaints. One member [of the Federation] complained he had just invested $250,000 and another group suddenly had a big subsidy to go into business against him.

If economic-development agencies can't get the support of those they claim they're helping most, one is left wondering who is receiving the benefits of the hundreds of millions of dollars spent on these agencies each year in Atlantic Canada. O'Brien, who is based in Nova Scotia, calls for the elimination of the province's economic-development department as a first step in putting the province's fiscal house in order.

O'Brien adds two caveats. He thinks that ACOA has become a better organization with time and is now focusing its resources on training and cooperative ventures. And he believes business subsidies now being undertaken by rich regions may undermine Atlantic Canada's ability to grow. The fiscal situation in most of Atlantic Canada, he argues, is too tight for a continuation of the subsidy game:

> Small firms which bear the brunt of taxation bear no benefit from these [subsidies]. Instead of giving subsidies we have got to start reducing debt. The compound impact of grants and high spending since the 1950s is that we are now in a position where we have high taxes. From my membership's point of view, that hurts every one of them.

CONCLUSION

Growth is positively associated with a small, efficient government, low levels of government consumption, and low levels of taxation. Atlantic Canada has large government, a big government administration sector, high levels of government consumption, and high levels of taxation.

Government investment is a positive factor for economic growth. Yet few of the billions of government dollars that have flowed into Atlantic Canada have gone to investment. And because of the politicized nature of spending in the region, the official numbers almost certainly overstate the amount of money that has gone to useful investment.

The most important investment for economic growth is an efficient transportation system. Yet policymakers have, until fairly recently, almost entirely ignored the expenditure area most likely to bring real economic benefits to Atlantic Canadians.

Transparency and accountability are signs of good governance. Atlantic Canadian governments are relatively opaque, and the lines of accountability have been severely muddled because of the disconnect between spending and revenue collection. The framework of governance in Atlantic Canada is largely responsible for this situation, which provides a set of perverse incentives in government.

Until Canada's fiscal squeeze began to hurt in the mid-1980s, political leaders in Atlantic Canada had large incentives to spend and few incentives to restrain spending. The Canadian equalization program creates incentives for provincial governments to ignore potential revenue sources and to make perverse economic decisions.

Many billions have been spent on subsidies and economic development, even thought there is no evidence that this produces favourable economic results. Government attempts to manage economic growth are negative to the extent that they amplify the politicization of the economy and increase intervention and control of the economy. As we shall see later, much evidence suggests this has happened in Atlantic Canada.

One hopeful sign is that the region's spending on education and health care has risen toward the national average. But this positive sign is balanced by rises in administration spending, which is higher than the national average; that raises a question about why relatively high administrative costs are accrued to manage relatively low program spending. Nonetheless, at least some categories of spending have been moving in the right direction.

All in all, if some jurisdiction wanted to design policies to suppress economic growth, it couldn't do much better than to look to Atlantic Canada. On virtually every measure, Atlantic Canadian policies have been the mirror image of those that would speed growth.