Chapter 8
Conclusion

When you discover you are riding a dead horse, the best strategy is to dismount. [Or you may decide on] buying a stronger whip, changing riders ..., declaring the horse is better, faster, and cheaper dead, and, finally, harnessing several dead horses together for increased speed.

Judge Thomas Penfield Jackson

The preceding chapters have reviewed policy in Atlantic Canada and its consequences. They include

- inflated wages
- stagnant private-sector investment
- escalating unemployment
- shortages of labour, even unskilled labour, despite high unemployment
- incentives that suppress skill enhancement and education
- protection of inefficient industries
- expensive economic-development programs, which involved government selection of winners and, by default, losers that did not receive subsidies but paid for them through taxes
- diversion of business focus from away from the market and toward rent-seeking activities
- urban/rural population imbalances
- use of the fisheries, a key economic sector, as a specialized social-welfare program and the resulting ecological and economic disaster
- thorough politicization of the economy
- high levels of taxation and even higher levels of government spending, supported by borrowing and wealth transfers from the federal government

Many of these policies and consequences have both short-term and long-term implications. For example, rising wages reduce the ability of existing businesses to provide employment in the short term. The negative impact on investment of increasing costs reduces employment growth in the long term.

One would expect this mix to have inhibited economic growth in Atlantic Canada, and the data support that contention. Economic theory predicts convergence between lagging and leading regions. The motor of this convergence is lower costs, particularly wage costs, in lagging regions. Low wages draw in capital, in the longer run increasing the capital/labour ratio as well as the skills of the work force and resulting in wage rises that reflect productivity improvements. But wage increases that are artificial—unrelated to economic fundamentals or improvements in productivity—blunt or destroy a lagging region's wage advantage and thus inhibit convergence.

The convergence hypothesis is supported by a considerable body of empirical research. Lagging regions tend to close the gap in per capita gross domestic product (GDP) with advanced regions by 2 to 3 per cent a year (look back at Chapter 1 or see McMahon 2000). This is true in Europe, in the United States, and in Japan.

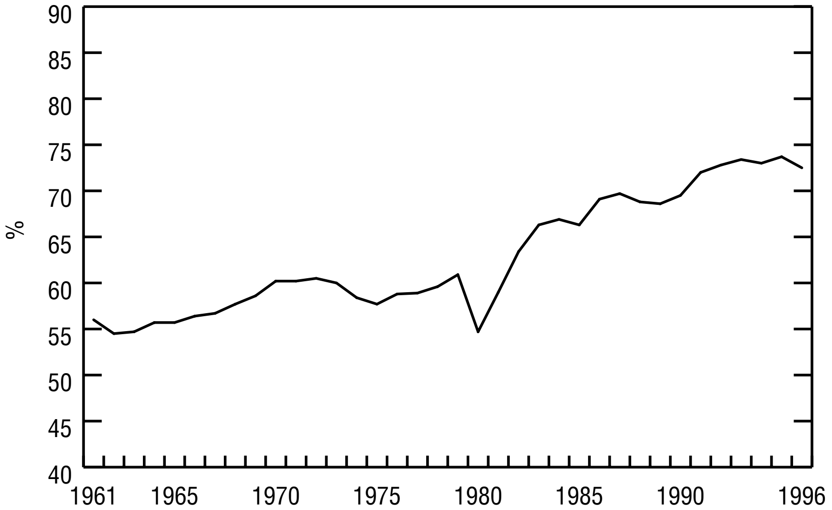
Yet it is not true with Atlantic Canada, despite (or because of) all the heroic efforts at government-directed economic development (see Chart 8-1). Since 1961, Atlantic Canada's per capita economic activity has closed the gap with the rest of Canada by 1.3 per cent a year, about half the expected rate of convergence.

In 1961, Atlantic Canada's per capita GDP was just under 60 per cent of the average in the rest of Canada; in 1997, it was about 75 per cent. Had the gap closed at, say, the lower range of the convergence effect—2 per cent a year—Atlantic GDP would have reached just over 80 per cent of the national average by 1997 (see Chart 8-2). That's *an annual difference of $1772 per Atlantic Canadian* or over $7000 for a family of four (in 1997 dollars).[1]

That's the per capita GDP level that economic theory and evidence

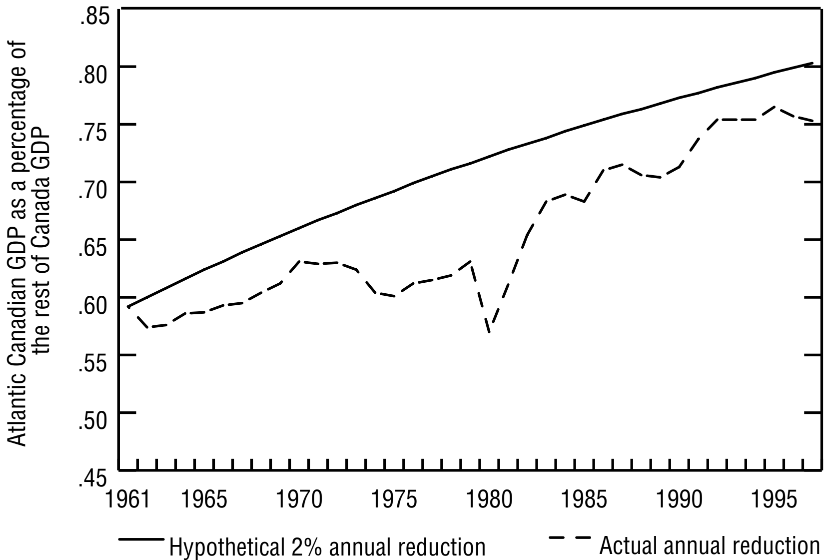
1. Remember this is closing the gap by 2 per cent a year. If a lagging economy half the size of an advanced economy reduced a 50 per cent gap by 2 per cent, it moved from 50 to 51 per cent of the advanced economy.

Chart 8–1: Per Capita GDP, Atlantic Canada as a Percentage of the Rest of Canada



Source: CANSIM.

Chart 8–2: Reducing the Gap Between Atlantic Canada and the Rest of Canada



Source: CANSIM.

would predict so long as Atlantic Canada had simply a normal policy regime, one not much better or worse than the average. In the presence of expensive regional-development programs, Atlantic Canada has done much worse.

Yet through most of the 1960s, Atlantic Canada's rate of convergence was almost 2 per cent a year, close to the international average (see McMahon 2000; Barro and Sala-i-Martin 1995). Even then, though, the regions' government spending and wealth transfers were relatively high, and this may have been behind its relatively low rate of convergence.

Worse was to come. As government spending and regional programs escalated in the late 1960s and early 1970s, Atlantic Canada, far from converging with the rest of Canada, actually lost ground. Some regional economists argue that the oil crises were responsible for this fall off, although the weakening of Atlantic economic growth occurred several years before the first oil crisis. As government spending was cut back through the 1980s and 1990s, convergence increased in Atlantic Canada.

Biswal and Biswal (1997) use sophisticated econometric tools to test the relationship between federal transfers and convergence throughout the 1962–95 period. Their conintegration analysis establishes that federal transfers to provincial governments are negatively related to GDP.[2]

Dhawanu and Biswal also test the convergence hypothesis. Their analysis shows the Canadian provinces converging, most weakly in the 1973–84 period, when federal transfers were high, and most strongly in the 1984–95 period, when transfers were falling. In other words, their results are entirely consistent with the conclusions reached in this volume and in McMahon (1996).

Their analysis also shows that federal transfers to persons have been negatively related to growth, but with an interesting though not unexpected twist. Before the 1971 reforms of the unemployment insurance (UI) system increased benefits and made them easier to collect in Atlantic Canada, federal transfers to persons were positively related to economic growth. After the reforms, they were negatively

2. This is also true for the individual Atlantic provinces except Newfoundland.

related.[3] This finding is also consistent the conclusions in this volume and in McMahon (1996).

The relevant subperiods that Dhawanu and Biswal examine, 1962–73 and 1973–84, do not break exactly when the UI reforms were enacted, but the difference in time periods is small. In any event, the reforms were not fully in place effectively until 1972, and one expects some lag before their impact was felt throughout the Atlantic economy. The authors themselves tie the change in transfers to persons from a positive to a negative effect to regionally extended UI reforms.

Nonetheless, Atlantic Canadian economic growth relative to the rest of Canada weakened in the latter part of the 1990s, probably as a short-term result of the most recent round of reductions in government spending in and wealth transfers to Atlantic Canada. Cutbacks usually create short-term dislocations. Government-supported economic activity crowds out self-sustaining activity, and the economy takes time to absorb the resources released and generate new activity. This adjustment process is often surprisingly brief. In Ireland and the Netherlands, for example, it was a matter of two to five years. After this adjustment period, the economy shifts to a higher level of sustained growth than experienced prior to the cutbacks (see McMahon 2000).

This growth generates increased prosperity and leads to powerful job creation, quickly reducing unemployment levels to well below what they had been prior to the cutbacks. This view is consistent with the experience of Ireland and the Netherlands and with the general international experience (see, for example, Alesina and Perotti 1995). It is also consistent with the experience of Atlantic Canada. While cutbacks in the 1980s and early 1990s may have had some short-term negative effects in individual years (as can be seen in Chart 8-2), overall that period of cutbacks was the region's strongest era of convergence.

Atlantic Canada's Policy Regime

Atlantic Canada's economic performance—about half the expected rate of convergence with the rest of Canada—bears the unmistakable imprint of a bad policy regime. As discussed in this volume and its companion (McMahon 2000), empirical investigation reveals that policy

3. Chapter 5 in this volume discusses a number of distortions related to UI reforms.

matters far more than external factors. Lagging economies governed by good policy regimes converge with advanced economies faster than the average rate of convergence. Bad policy regimes converge much more slowly.

This evidence is consistent with what is found in empirical research on foreign aid, a form of international wealth transfers. Nations with good policies benefit from wealth transfers. Their growth speeds up, and aid "crowds in" increased private-sector investment. In bad policy regimes, wealth transfers crowd out private-sector investment. As wealth transfers to Atlantic Canada increased in the late 1960s and early 1970s, the growth of private-sector investment collapsed.

The failure of policy can also be seen when looking at specific policy areas that have a negative impact on growth: high levels of taxation, high levels of government consumption, politicized institutional structure, and an interventionalist government. All these factors characterize the Atlantic economy.

The weakness in Atlantic Canada's economic performance can be considered the net impact of bad policy. The gross impact would have been much larger. Increased government spending, particularly when funded by wealth transfers, does increase demand and spur economic activity. Bad policy offsets this stimulus by weakening sustainable private-sector activity. Atlantic Canada's failure to keep up with the expected rate of convergence, its high unemployment, and its low level of investment indicate that the net negative effect of policy has much outweighed any benefits resulting from increased government spending.

All this would matter little if it could be shown that Atlantic Canada was somehow a special case—that its economic growth should be low. In this instance, since comparisons with other lagging regions would be irrelevant, so one might even argue that government is responsible for what weak growth Atlantic Canada has managed. In fact, this argument is made today, particularly by the federally funded Atlantic Canada Opportunities Agency (ACOA).

The intellectual backbone of this view is provided by regional-development theory, which argues that geographically and economically peripheral regions suffer from severe market distortions that only government policy can overcome. Thus, say proponents, it is hardly surprising that Atlantic Canada's growth has been low.

However, the case for Atlantic "exceptionalism" collapses if other peripheral regions every bit as geographically and economically isolated as Atlantic Canada have grown more quickly than it has. Indeed, the whole foundation of regional theory is destroyed by any finding that peripheral regions grow faster than core regions. The structure of regional theory rises out of the assumption that peripheral regions grow slowly, particularly without government intervention. Empirical results are devastating to regional theory if lagging regions without regional-development programs performed better than Atlantic Canada with its battery of regional programs.

Yet empirical investigations of convergence show all of these things to be the case, and regional theory is almost entirely devoid of empirical investigation that would back up its claims. In fact, peripheral regions, especially those which do not receive regional aid, have been growing faster than core regions for some time. A decade ago, Jacques Delors, European Commission president from 1985 to 1995, noted that peripheral regions in Europe were growing faster than core economic regions, a situation he also found in the United States despite an absence of regional programs:

> In general in the United States regional income disparities have greatly reduced over the last 50 years, with the South-East moving up from 53 [per cent] to 86 in relation to the national average, the South-West moving up from 69 to 94 and the Plains from 76 to 96. Federal subsidies can hardly be regarded as the key to this convergence. (1989, 87)

Although regional programs in the United States had always been small beer, Delors notes that earlier in the 1980s "the Reagan Administration in the United States...abolish[ed] the federal revenue sharing system" for lagging regions and "reduced the importance of...'Keynesian' or 'demand-side' regional policies" (*Ibid.*, 86). Yet regional convergence continued apace in the United States.

In short, if policymakers wish to improve economic conditions in Atlantic Canada, they must be willing to re-examine the policy package that has prevailed in the region for at least the last 30 years. Given the experience of other lagging and peripheral regions, Atlantic policymakers cannot blame external factors for weak growth. International

research shows that domestic policy structure is key to economic growth. That is good news for Atlantic Canada. Its people can take control of their own fate.

But the region needs to benefit from an intelligent debate among policymakers and regional experts who are well informed about the Atlantic provinces' economy, their history, and the international evidence. Progress cannot be made if even simple facts are ignored or denied in order to defend past policies and justify their continuation.

POLICY RECOMMENDATIONS

None of my policy recommendations is radical. I simply call for what might be considered a normal policy regime in Atlantic Canada. For example, government taxation and, particularly, spending levels must be brought into a normal range. Hardly any developed region in the world bears the level of government spending found in Atlantic Canada, with its crowding out of private-sector activity.

Policy reform is required on both the federal and provincial levels. Federal policy, with its bundle of perverse incentives, has been particularly devastating. But Atlantic Canadian leaders cannot wash their hands of the impact. Both provincial politicians and Atlantic politicians at the federal level have been crucial in designing federal regional policies.

The region would benefit from an effort by Atlantic leaders, at both the federal and provincial levels, to push for reform of Ottawa's regional programs. But the worst of those programs are the ones that regional politicians often support most strongly: federal transfers to the region, regionally extended employment insurance (EI), and economic-development efforts.

These programs have proved negative for growth. Tax cuts have a strong international record of producing growth. Thus, Atlantic Canadian leaders should look to a reform of regional programs that would end perverse spending, including at the federal level, especially the perversions in EI, and funnel the freed resources into worthwhile programs, such as education, health care, and infrastructure building, while using the remainder to reduce taxes.

Resistance to change is likely to come from outside the region. Federal transfers to Atlantic Canada reduced its growth, leaving it in a

weakened competitive position, one that, at least until the institution of free trade, was a lucrative captive market for central Canadian products. Diverting federal transfers from wasteful spending to tax cuts would create a magnet for investment in Atlantic Canada.

Sending money from Ottawa to Atlantic Canada—transfers that comprise only a small portion of federal expenditures—is not a problem so long as it is ineffectively spent. But if federal transfers were instead used to fund tax cuts, then Atlantic Canada would grow as an attractive site for investment. And firms moving into the region would create the impression that it was stealing investment from the rest of Canada, using transfers from wealthier regions to cut taxes.[4] A storm of protest could arise in the rest of the nation. In other words, national support for regional development is, to some extent, based on the unspoken understanding that the efforts don't work. Thus, a push by Atlantic politicians for real reform would be difficult. But this is no reason not to make the effort, particularly when the potential benefits are so large.

Another impediment to good policy is lack of transparency in government in Atlantic Canada. Public-choice theory reveals the conflicts policymakers face between the public interest and their own interest. The more opaque the government, the less their incentive to act on the public's behalf. Policy mistakes and outright negative results can be hidden or explained away if the public is denied information.

Governments in Atlantic Canada would do much to further the cause of economic growth if they forcefully moved to increase transparency. Transparency nurtures good policy, which, in turn, is the basis for economic growth.

The idea of the negative-sum economy must be banished to a fantasy world, which is the only place where it is found. The fact that some firms may be forced to lay people off or even close does not mean those jobs are forever lost to the economy. Therefore, the idea cannot justify government subsidies to "save" jobs. The economy must be allowed to adjust into more productive activity, as it has elsewhere.

4. This view is based on the idea of a zero-sum economy, an idea more benign than the negative-sum view found in Atlantic Canada but one that is wrong nonetheless. Prosperity reinforces itself.

Thus, Atlantic Canada needs to shut down those activities that remain dependent on government subsidies. They are a drain on the public purse, and they crowd out the development of new, self-sustaining economic activity and jobs. Still, government has a responsibility to the workers it bribed to remain in unsustainable industries. They should be treated generously, but programs must be carefully designed to avoid trapping another generation by continuing subsidies to these industries.

Similarly, a process already underway in the fisheries needs to be maintained. This process is the move away from treating the fisheries as a social-welfare program. The bloated fisheries of the 1980s had almost no relationship to the traditional self-sustaining fishery that flourished in Atlantic Canada before large-scale subsidies were directed at it. The fisheries can be—and are becoming—a vitally important source of economic growth in the region. A fishery free of government intervention would be much more like the region's traditional industry than the political artiface of the last 30 years has been. Here again, victims of past policy should be treated generously, but government must avoid designing support programs that will trap another generation.

Policymakers need to understand something that has become common currency elsewhere: that generous income-support programs increase unemployment and weaken economic activity. There is intense regional pressure to roll back recent EI reforms, which reduced some of the greatest perversities in the system. If Atlantic Canada is to have a prosperous future, this pressure must be resisted and reform continued. Once again, government has a responsibility to help those already trapped in the unemployment system, but policymakers must avoid catching another generation in the EI merry-go-round of short spells of work and long stretches collecting benefits. The remaining incentives that discourage people from seeking or accepting work must be eliminated. Most important, incentives that weaken labour-force attachment and inhibit training and education must be removed.

Active economic-development programs must be de-emphasized. They have no record of success in Atlantic Canada or elsewhere. Lower taxes do have a record of economic success.

As noted in relation to federal spending, overall government

spending at all levels should be reduced and focused on activities that bring benefits, education, health care, and investment, particularly in transportation infrastructure. A reduction in government spending would go a long way toward removing distortions in the incentive structure faced by both business and labour.

A clearer policy debate is required on the impact of costs in the economy, particularly wage costs. Although it is unlikely that Atlantic Canadian unions would ever accept wage restraint as a policy goal—something unions in Ireland and the Netherlands endorsed—a more informed debate, along with reduced government spending, might help moderate wage pressure in Atlantic Canada, or at least make policymakers aware of the negative impact of wage inflation.

None of these policy recommendations is radical or ideological. All of them urge Atlantic Canadian policymakers to move toward a normal policy regime. Considering the region's economic record over the last 30 years, a normal policy regime and a normal rate of convergence would be a dramatic change for the better.