Executive Summary

By the end of the 1960s, Atlantic Canada seemed ready to leave its poor-relation status behind. Its economic growth had been greater than Canada's throughout the decade. Unemployment in Nova Scotia, Prince Edward Island, and New Brunswick had fallen to, or even below, the national unemployment rate.

Business was finding Atlantic Canada a good place. By the end of the 1960s, it was investing about as much in Atlantic Canada per person as in the rest of Canada. Investment generates dynamism, increased productivity, growing wealth, and new jobs. And all of this was flowing into Atlantic Canada naturally, without the lure of huge subsidies.

In other words, Atlantic Canada was displaying the strong wealth and employment growth that are typical signs of convergence—the natural tendency of lagging economies in the developed world to catch up with more affluent areas.

Yet this promise was never fulfilled. In the early 1970s, Atlantic Canada's economy reversed course and lost ground. The unemployment gap doubled. Investment growth stopped dead (while it rose rapidly in the rest of Canada).

The falloff was simultaneous with regional development theory's growing influence on policy. This theory argues that *peripheral regions* are doomed to forever lag economic cores for various reasons: geography, the concentration of population and economic activity in the centre, flawed capital markets, and lack of resources. And it called for heroic government intervention to overwhelm these inhibiting forces.

Policy Developments and Implications

Partly as a response to this theory, partly because of the hubris of the day, and partly for political reasons, wealth transfers to Atlantic Canada increased dramatically through the late 1960s and early 1970s. The money came in through several policy tools: direct transfers to individuals, payments to provincial government, and large federal projects that pursued a number of economic development strategies. The net inflow of wealth, at times, exceeded a third of the region's gross domestic product (GDP).

The effects spread through almost every aspect of the region's socioeconomic life: the labour market, private-sector investment, the attitude of firms and of government, and the entire economic structure.

The Labour Market

The impact on the labour market was startling. Standard economic analysis predicts that wealth transfers create incentives for individuals not to seek or accept work. That is exactly what happened in Atlantic Canada.

Particularly problematic was the introduction of regionally extended unemployment insurance (UI), which enabled workers to receive up to 42 weeks of benefits for just 10 weeks of employment. This program quickly exceeded all policy bounds and became a central fact of life in Atlantic Canada. In some areas, it became common for 80 per cent or more of two-income households to draw UI each year. Both levels of government, federal and provincial, paid for makework projects primarily intended to enable individuals to draw UI. Cycles of 10-week job sharing developed, while employers offering full-time jobs were unable to fill them.

An unfortunate side effect of this pattern was to discourage educational achievement and skill advancement. Collecting UI required no skills, and payments were not available to those furthering their education. The program thus reduced the incentive to obtain education while creating incentives to leave educational and skill-enhancing institutions. This is a true human tragedy.

Although the past decade has seen a number of reforms to the unemployment-insurance system (including a hopeful renaming to Employment Insurance—EI), many of the old perversities remain. Employers still report problems finding workers even for low-skill jobs and even in areas with very high unemployment. Human Resources Development Canada recently undertook a project offering subsidies to EI recipients who accepted work. The program included the areas of Halifax and Moncton, where jobs were relatively easy to find, yet it had to be cancelled because so few recipients took up the offer.

Private-Sector Investment

Standard economic theory predicts that these developments would push wages upward. This began to happen in the 1970s. Employers were bidding for workers in what was actually a tight labour market, with so many UI/EI recipients unwilling to work. This is borne out in the data. Although wages were growing rapidly in the rest of Canada, they started growing even faster in Atlantic Canada as wealth transfers to the region increased.

Low wages are a driving force of convergence. They attract investment, which, over the long term, boosts productivity and thus wage growth. In Atlantic Canada, however, factors unrelated to productivity drove wage growth. It had become a high-wage region relative to its productivity, making it a much less attractive place to invest, and the difficulty of finding full-time workers made it even less attractive.

The politicization of the economy and government's failure to make appropriate investment in physical and human capital also damaged the attractiveness of Atlantic Canada as a place to do business. Per capita private investment was soon much lower there than in the rest of the nation. Large "economic development" subsidies offered to draw capital into the region had little or no positive effect.

Business Attitudes

Unfortunately, those economic-development programs, along with massive increases in government spending in Atlantic Canada, politicized the business climate. Government had become business's largest customer, one that seemed relatively unconcerned about cost and quality, so long as the political contacts were well maintained.

A 1990 study comparing firms in Nova Scotia and New England found that politicization had undermined the competitiveness of the former. Government grants had provided Nova Scotia firms with newer equipment, and they paid their employees considerably less than New England employees, yet their output was much higher priced and lower quality. In fact, it was unsaleable in international markets.

The study, financed by the federal and Nova Scotian governments, concluded that businesses had become so content on a rich diet of government subsidies and contracts that they put little effort into quality control, productivity improvement, or sound management practices. Instead, they focused on obtaining government contracts, which seldom had stringent cost or quality controls.

Government Structure

Government decisions also became increasingly politicized in the past three decades. Schools, hospitals, and roads came to be seen more as makework projects than as investments in education, health care, or infrastructure. The old climate of patronage may have declined throughout much of the developed world, but it remained healthy in Atlantic Canada.

That outcome was probably a function of Canada's fiscal evolution. Other jurisdictions had a clear relationship between spending and taxes, creating pressure for the judicious use of public funds. But in Atlantic Canada, such a large portion of the money came from outside the region that accountability was weakened. Government spending seemed like a free good. Politicians competed with each other over how much money they could spring from public coffers and dole out as political rewards.

Yet both federal and provincial taxes rose rapidly. One motive for increased provincial taxes was the cost-sharing nature of many federal programs. For every 50 cents a provincial government raised, it could often leverage a full dollar of government spending—more if the money was used for a makework program that would draw in UI/EI payments. Atlantic Canada was becoming a high-tax region of high-tax Canada, further weakening investment.

Infrastructure spending provides the most startling evidence of politics' trumping sensible government investment. Tens of billions of federal dollars were flowing into the region for, among other things, building fish plants and secondary roads, often in politically important constituencies. Yet spending on Atlantic Canada's primary road link to its major market in central Canada declined in this period.

Economic Structure

A growing economy needs flexibility to move into new, higher productivity activities. This is the path to increased wealth and job creation. Over time, fewer people are employed in primary activities and more in advanced sectors.

Here again, an astonishing level of government interference in the Atlantic economy comes into sharp focus. Old activities were frozen into place by rich subsidies. A noteable example was in Cape Breton, where a coal-mining industry—uneconomical since 1924, when subsidies to it began—and an antiquated steel-making industry were supported with billions of dollars of government money.

The fisheries suffered the worst damage, both ecologically and economically. Atlantic Canadians are often told of the need to preserve their fishing heritage, but the political artifice that evolved had little to do with the region's once self-sustaining fishery. By the late 1980s, fish plants employed nearly two-and-a-half times as many people as in 1961.

This expansion was fuelled by an immense number of subsidies to build fish plants and buy fishing equipment and was sustained by the UI/EI system, which allowed people to obtain a full year's income for seasonal work.

This, of course, was another factor behind wage inflation and three other devastating consequences. Many people were diverted to seasonal work in the fishery, rather than the pursuit of education or skill enhancement. The ecological results, especially the collapse of northern cod stocks, are well known. And the quality of fish produced in the region was severely damaged. People were fishing more for government money than for saleable product, reducing incentives to handle the product with care. As Iceland and New England were developing a worldwide reputation for high-quality whole fish, the broken, often deteriorating fish bodies produced by Atlantic Canada's fishery were jammed together in blocks, which sold only at heavily discounted prices.

Now that much government money has been withdrawn from the fisheries, quality has improved dramatically, and the value of the catch, despite the lingering ecological problems, is often higher than ever before.

Overall

Thus, regional development policies in Atlantic Canada inflated wages, dampening investment; politicized the economy, weakening business activity; discouraged educational achievement; and froze in place declining economic activities. It also likely had an effect on the regional psyche. People came to expect government to support them.

Yet regional-development programs remain popular in many quarters of Atlantic Canada. This has led to a curious view of the region's economic history. The weakness in its 1970s economy is often attributed to the oil crisis of that decade. But Atlantic Canada's downturn began in the first years of the decade, at the time of growing regional programs and two years before the first oil crisis. Nor does this thesis explain why Atlantic Canada has so underperformed lagging regions in the United States, Europe, and Japan in the period since. If regional policy, as it is understood in Canada, were a good thing, then over time Atlantic Canada should have outperformed regions not similarly blessed.

Road to Growth

This book's companion volume, *Road to Growth: How Lagging Economies Become Prosperous*, examines how the convergence effect works, what policies reinforce the effect, and how economies facing severe setbacks have managed to recover. Jurisdictions as different as Ireland, the Netherlands, and several U.S. states achieved turnarounds by promoting a flexible labour market, reducing taxes to help attract investment, curtailing efforts to protect outmoded production activities, depoliticizing their economies, and focusing on needed physical and human infrastructure rather than makework projects.

These once-lagging regions are now at the forefront of prosperity. The forces leading to convergence are powerful, and Atlantic Canada needs to shift to a regime that encourages them.

That means depoliticizing the economy by eliminating development programs and makework efforts, which too often reward political contacts. Instead of subsidies and government aid, it's far more effective to create a low-tax environment, so that all businesses are left more money to invest.

Policies that have distorted the region's labour market must be drawn down. An important human consideration must be taken into account here. For more than a generation, many Atlantic Canadians and their families have come to rely on government transfers for their existence. Many supports must be left in place for these families. But it is essential that the next generation not be trapped in this cycle.

If the government of Canada truly wants to help Atlantic Canada move ahead, it must stop putting money into largely political projects and programs and switch to two types of transfers that would aid economic growth. It should provide transfers designed to help provinces reduce taxes and thus spur growth. And it should take the third of a billion dollars a year that Atlantic Canada still receives in economic-development money and divert it into building economic infrastructure. (An impartial group should be set up to monitor the expenditures, to ensure the money is not diverted to political projects.)

These straightforward policy changes would recapture the economic dynamism of Atlantic Canada in the 1960s, before the ascendance of regional-development theory. There's no secret set of policies. All the region needs are normal policies.