RAGS TO RICHES

How "the regions" can and should be leading Canada's productivity push

BRIAN LEE CROWLEY, Ph.D.

A paper for the TD Forum on Canada's Standard of Living

October 2002

Atlantic Institute for Market Studies

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The Institute's chief objectives include:

a) initiating and conducting research identifying current and emerging economic and public policy issues facing Atlantic Canadians and Canadians more generally, including research into the economic and social characteristics and potentials of Atlantic Canada and its four constituent provinces

b) investigating and analyzing the full range of options for public and private sector responses to the issues identified and to act as a catalyst for informed debate on those options, with a particular focus on strategies for overcoming Atlantic Canada's economic challenges in terms of regional disparities

c) communicating the conclusions of its research to a regional and national audience in a clear, non-partisan way

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All errors and omissions remain solely my responsibility.

Brian Lee Crowley
Halifax, October 2002

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About the Author

Brian Lee Crowley, a former member of the Editorial Board of *The Globe and Mail*, is the founding president of the Atlantic Institute for Market Studies (AIMS), Atlantic Canada's public policy think tank. Prior to joining AIMS, Crowley was president of the Atlantic Provinces Economic Council (APEC), and before that he was a professor teaching politics, economics and philosophy at Dalhousie University. He acted as Secretary to the Nova Scotia Working Committee on the Constitution (the Kierans Committee) after which he became Constitutional Advisor to the government of Nova Scotia in the negotiations resulting in the Charlottetown Accord. He advised the Manitoba government during the Meech Lake negotiations. He has been a diplomat for the EEC Commission, an aid administrator for the UN in Africa and an advisor to the Quebec government on parliamentary and electoral reform. He holds degrees from McGill University and the London School of Economics, including a Ph.D. in Political Economy from the latter. He appears regularly in the media to comment on economic and political matters. Crowley is a director of a number of organizations, including the Maine Public Policy Institute, the Society for the Advancement of Excellence in Education, the Center for the Advancement of Energy Markets (Canada), Civitas and the Nigerian Public Policy Institute.

Executive Summary

Lagging economies naturally catch up with advanced ones. Under certain conditions, each year a lagging region should close the gap with its relevant leading economy by between 2% and 3%. Those conditions include a market economy, limited government interference in markets, the rule of law, property rights, and stable institutions, including political stability. Such "convergence" is due to the spread of productive ideas and methods, profitable opportunities in capital-starved economies, competitive wages that draw capital, and increasing skills as investment creates jobs. For the most part, economies lacking these characteristics are either failing to converge with richer nations or, more typically, falling further behind. Ireland is an example of convergence at its most dynamic.

Ireland's turnaround cannot be attributed to government spending, transfers from the EU or an activist "economic development policy," whereas those have been the main tools in Canada's regional development toolkit since the late 1960s. Programmes such as employment insurance, equalization and regional development initiatives aimed at accelerating convergence and minimizing the economic disparity gap have created a reliance on the generosity of the federal government and also obstructed long-term skills training and enhancement.

These policies have been based on the assumption that the primary public policy problem facing the region is unemployment. Yet demographic trends are such that most of the industrialized world faces very significant labour shortages today and in the future. That, coupled with severe mismatches between available skills and jobs, and not unemployment, is the public policy challenge of the future, including in Canada's less-developed provinces (LDPs).[1]

Convergence between the LDPs' and the nation's level of prosperity has been hindered, not assisted by many well-intentioned federal and provincial policy measures. This paper, using Atlantic Canada as the prime example of the lack of convergence in Canada, reviews three specific policy areas — equalization,

[1] For the purposes of this paper, the less-developed provinces will be all those provinces receiving equalization payments, namely Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Prince Edward Island, Quebec, and Saskatchewan. While British Columbia is temporarily an equalization recipient, it is not widely considered to be an LDP, nor is it likely to remain an equalization recipient for long. AIMS' work focuses chiefly on the challenges facing the Atlantic provinces, and so many of the examples advanced to illustrate this paper's arguments are drawn from the Atlantic experience. That does not prevent the vast bulk of the policy prescriptions advanced in this paper from being directly relevant to the other LDCs, as well as to the economic challenges of the country as a whole. For example, while this paper speaks a great deal to the challenges of the fishery, many of the same arguments regarding politicization of decision making and insulation of producers from vital market signals could be made, to choose just one example, with respect to the effects of the Canadian Wheat Board on prairie wheat farmers.

social welfare programmes (including EI) and the fishery (including aquaculture) — and shows how they stunted the potential of Atlantic Canada's economy and retarded convergence.

Genuine convergence will require the removal of many of these policy obstacles. Among the many measures recommended in the paper to achieve this goal are the following:

Tax and equalization reform

- Wind down regional spending programmes in favour of reduced taxes in the LDPs, focusing on taxes that discourage investment, effort and growth.
- Cap equalization and reform the programme to remove incentives to dependence, overtaxation and forgoing of provincial revenue.
- Shift some of the cash transfer to a reduction in federal taxes in the LDPs, supplementing the tax reductions financed through the winding up of regional development spending.

Ending labour shortages

EI reform

- EI benefits should be ratcheted down every year for annual repeat claimants.
- In order to qualify for EI benefits, first-time claimants should have a minimum of a year's continuous work.
- Employers should pay "experience-rated" premiums, so that their premiums rise when they lay off workers.
- Regionally extended EI benefits should be eliminated.

Social welfare reform

- Ensure that working always pays better than relying on social welfare.
- Reduce access to social welfare for people deemed employable.
- Follow Alberta's lead and introduce earning supplements to "make work pay."

Education and training

- Aggressively upgrade work skills, especially for the unemployed and underemployed.
- Make available a welfare-to-work and EI-to-work transition package that includes a training voucher.

Immigration

- Increase the flow of immigrants (including migrants from elsewhere in the country) to the LDPs.
- Achieve this not by compulsion, but by creating a climate of opportunity attractive to immigrants.
- Atlantic provincial governments must put the recruitment of immigrants high on their list of priorities, including negotiating agreements with the federal government in this area.

The fishery of the future

- Politics must be removed from industry decision making at all levels.
- Transfer ownership of the resource to those who live from that resource.
- Abolish provincial licensing for processing plants, close excess processing capacity and have fewer plants that have much higher levels of capital investment, that are capable of operating year-round.
- Regulatory barriers to the growth and development of the aquaculture industry need to be removed, including the lack of high-quality property rights.

Other

- Reduce the regulatory burden on the emerging offshore oil and gas industry.
- Create a business-oriented climate in vital publicly owned infrastructure, such as the Port of Halifax.
- Remove interprovincial barriers to trade in electricity.
- Government's intervention, when justified, should support investment, not consumption.

SECTION 1
INTRODUCTION

What are the obstacles to Canada's less-developed provinces (LDPs) achieving significantly higher levels of productivity and therefore making a greater contribution to their own and the nation's standard of living?[2]

A quick glance at productivity levels by province reveals the importance of this question. Exclude the outlier, Saskatchewan, and productivity levels per employed worker in the LDPs range from a low of 82.7% of the national average in PEI to a high of 90.6% in Quebec. Just moving the LDPs' levels of productivity and prosperity to the national average would itself make a marked contribution to closing the standard-of-living gap with the United States. But can it be done? It can, and the world is full of examples that show how.

[2] This paper is part of the response to the challenge to Canadians and their governments, issued by A. Charles Baillie, Chairman and CEO of TD Financial Group. Mr. Baillie observed that Canada's standard of living has been declining relative to that of our neighbour and chief trading partner, the United States; this decline has been underway for several decades and has now reached the point where Americans enjoy a standard of living some 30% higher than that of Canadians. He then went on to challenge Canadians to find ways to close the productivity and standard-of-living gap, while protecting our distinctively Canadian way of life. He made a number of suggestions of places to start (further reduction of our national debt, for example, a more competitive tax system, greater investment in education, and further research and development) and then launched a national dialogue on what else needed to be done. In particular, he approached a small number of national organisations to write short "think pieces" on specific issues related to this theme of closing the standard-of-living gap. AIMS was honoured to be asked to contribute its thoughts on the theme of regional development. I have taken this to be equivalent to asking the question, "What are the obstacles that exist to the less-developed provinces (LDPs)[1] achieving significantly higher levels of productivity and therefore making a greater contribution to their own and the nation's standard of living?" This paper is an attempt to answer that question.

SECTION 2
Not "Regional Development" But Regional Prosperity

Convergence

Half a century of economic theory, borne out by real-world experience, confirms that lagging economies naturally catch up with advanced ones. Even if advanced nations or regions are growing quickly, lagging regions should grow more quickly. Under certain specifiable conditions, each year a lagging region should close the gap with its relevant leading economy by between 2% and 3%.[3]

What are those conditions? Lagging economies closing the gap with advanced economies have a number of shared characteristics: an educated populace, or at minimum an emphasis on raising the educational standing of the population; a market economy; limited government interference in markets; the rule of law; property rights; and stable institutions, including political stability. Convergence is due to the spread of productive ideas and methods, profitable opportunities in under-invested economies, competitive wages that draw capital, and increasing skills as investment creates jobs. For the most part, economies lacking these characteristics are either failing to converge with richer nations or, more typically, are falling further behind.

Of particular relevance is the rather different way that labour and capital combine and fructify in different kinds of economy. When labour is abundant relative to capital, as is the case in most of the LDPs, labour costs should be relatively low. Similarly, potential returns (profits) on the scarcer resource (capital) should be relatively high. The profit motive attracts capital and creates jobs and economic growth. This mechanism can be derailed by policies that either inflate the cost of labour or reduce returns on capital.

Convergence in Practice

For practical examples of convergence, we could look to Holland, Ireland, Japan, Korea, Georgia, Michigan or a host of other places. For the sake of brevity, let's look at one example: Ireland. Just a few years ago, the Irish economy was among the walking dead of Europe. Now, it has become one of the most successful economies in the developed world. This turnaround did not come accidentally or

[3] Barro and Sala-I-Martin (1995).

because of fortuitous resource discoveries, but because of consistent, deep and widespread policy changes reforming the economy from top to bottom.[4]

The extent of the Irish turnaround is hard to exaggerate. Ireland had long been one of Europe's most dismal performers, stuck on the periphery of the continent. Its chief export was its desperate, job-hungry people rather than any valued good or service. Just 15 years ago, things were even more desperate than usual in Ireland. Unemployment was soaring and nearly one in five people were without work. Ireland's deficit through the early 1980s averaged more than 12% of Gross Domestic Product (GDP), about eight times the average rate of economic growth. The national debt soared.

Today, Ireland faces a labour shortage and Irish recruiters scour the globe luring expatriates back home. As a share of GDP, the nation's debt ebbs away each year. Government revenues have increased despite huge tax cuts. In the mid-1980s, Canada's per capita GDP was two and a half times the size of Ireland's. Now Irish per capita GDP exceeds Canada's. Ireland's economic purgatory, just like its subsequent remarkable recovery, was policy-induced. Getting the policy framework right made the difference between productivity and prosperity on the one hand, and unemployment and decline on the other. The right policy has been summed up as follows:

> [The Irish] saw that trying to prop up dying industries was a mug's game. Public debt needed to be brought under control, taxes lowered, and excellent value offered in public services when measured against the taxes paid. Politics needed to be banished from decisions about where and how to invest, whether in public infrastructure or private industry. Work incentives needed to be improved by reforming social welfare. Profitability in the private sector needed to be improved. And costs, including labour costs, needed to be kept keenly competitive. The sum of these measures was a policy environment in which business had every reason to invest and build productive capacity, while workers had every reason to work hard and build their job skills. As the capital investment grew and workers became more skillful, real wages rose along with tax revenues, and a virtuous circle was created. Growth bred more growth, success bred more success.[5]

The Impact of Government Intervention

Ireland's turnaround cannot be attributed to government spending, transfers from the EU or an activist "economic development policy," as has been documented elsewhere.[6] Indeed, the common experience

[4] These policy changes are fully examined in Road to Growth (McMahon, 2000a).

[5] McMahon (2000a). Pp. 10-11.

[6] Ibid.

of jurisdictions able to harness the forces of convergence is that government-driven strategies are far less successful at doing so than ones that rely on getting policy right and then letting employers and workers respond to the signals of the marketplace.

But much “economic development policy” aimed at Canada’s LDPs has been based on the government-driven model. This goes some considerable way to explaining why, despite heroic efforts by the federal government to encourage economic growth, Atlantic Canada has failed to converge with the “have” provinces of Canada. Atlantic Canada’s postwar per capita economic growth was strong before 1971 and had strongly and consistently outpaced the rest of the nation. It was only when Ottawa dramatically increased regional subsidies in the early-to-mid-1970s that regional growth faltered in comparison to the rest of Canada.

Programmes such as employment insurance, equalization and regional development initiatives aimed at accelerating convergence and minimizing the economic disparity gap have created a reliance on the generosity of the federal government and also obstructed long-term skills training and enhancement. Former New Brunswick premier Frank McKenna, in his 1997 farewell speech, observed that dependency has become a narcotic to which Atlantic Canadians have become addicted.

Labour Shortages, not Massive Unemployment

Before examining in detail the policies that might allow the LDPs to close the productivity and prosperity gap with the rest of the country, it is necessary to add one more observation about the assumptions that have buttressed much economic development policy aimed at the LDPs. These well-intentioned policies have all been based on the notion that the primary public policy problem facing the region is unemployment. While it is doubtful that this view was ever true,[7] it is most assuredly not true today. Demographic trends are such that most of the industrialized world[8] faces very significant labour shortages today and in the future. That, and not unemployment, is the public policy challenge of the future.

Atlantic Canada has not been spared these trends. The last census showed that the depopulation of the region is occurring far faster than most knowledgeable observers had predicted, and this is supple-

[7] In our institute’s earlier work — please refer to Retreat from Growth (McMahon, 2000b) and Looking the Gift Horse in the Mouth (McMahon, 1996) for details — we have shown that convergence, including in unemployment rates, was working well for Atlantic Canada in the period up to the end of the 1960s. At that point, regional unemployment rates had in fact converged with the national rates. However, with the liberalization of UI rules in 1971 and the arrival of massive economic development policy spending in the 1970s and ‘80s, regional and national unemployment and growth rates diverged again. It would appear that, like the Irish, many of our economic woes have been policy induced.

[8] Evidence from the Centre for Strategic and International Studies (CSIS) Commission on Global Aging suggests that industrialized countries face an unparalleled transition brought about by rising old-age dependency and a shrinking working-age population. Not only will the care infrastructure for supporting dependent elders need to be improved, but also societal aging could have sweeping implications for global growth. A decreased labour force and a decreased overall national population, which will in turn affect the tax base for national economies, will all threaten global financial stability. For details please visit the CSIS website, http://www.csis.org, accessed in July, 2002.

mented by an aging of the population that is more pronounced than anywhere else in the country.[9]

Using conservative assumptions, in less than a decade there will be 7,800 fewer workers in Newfoundland, 12,500 more in Nova Scotia, approximately 3,000 fewer in New Brunswick and roughly 3,000 more in PEI. But look out 20 years and there will be 32,000 fewer workers in Newfoundland, 11,000 fewer in Nova Scotia, 35,000 fewer in New Brunswick and little change in PEI.[10] Most industries, including the fishery, are forecasting significant challenges finding workers in the near future, and employers regularly report that they have significant difficulties finding people with the proper skills who are willing to work at prevailing wages.[11] The region's labour shortage is real; it is driven by poorly designed social programmes (see below) and a mismatch between the skills that workers possess and those that employers need. For convergence to work, it must be possible for workers to be shifted off dependence on social programmes and out of low-value work and into higher value-added occupations. This flies in the face of a political culture that still clings to the outmoded idea that unemployment is the LDPs' most significant challenge.

If recent US experience is any guide, economic growth can make even the "hard-core unemployed" employable *if and when labour markets are allowed to work, and are not obstructed by welfare traps and other inappropriate policy barriers to people getting into work.* In the 1990s, an abundance of job opportunities prompted record numbers of workers to enter the workforce. The share of people with a job in the population as a whole reached record levels. *Even high school drop-outs saw their unemployment rate fall below 7%.*[12]

For all these reasons, there is far more flexibility in labour force availability in Atlantic Canada than a simple analysis looking at population numbers will reveal. Our labour force (people working and looking for work) is roughly 46.5 % of the region's population. Canada's labour force is approximately 51% of the national population. In 1999 in the US, before this recent downturn, which has not actually changed the figures that much, nearly two-thirds of Americans had jobs. Clearly, even given the differing composition of the population, room exists to put a lot of people to work at higher levels of productivity, just as there is no excuse to allow labour and skill shortages to pose an obstacle to regional growth and prosperity.

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[9] See The Future of Work in our Coastal Communities, http://www.aims.ca/commentary/fcc.htm, accessed in July, 2002, and Population Change in Atlantic Canada, http://www.aims.ca/Archive/1998/praug1198.htm, accessed in July, 2002.

[10] Denton, Feaver and Spencer (1998).

[11] For more information, see Atlantic Canada Opportunities Agency (2001), Atlantic Entrepreneurial Institute (1992), Canadian Manufacturers and Exporters (2002), Information Technology Association of Canada (2002), McMahon (2000b, p. 99), Mallet (2002), and McNiven and Plumstead (1996), Murphy (2000), NovaKnowledge (1998), and Province of Nova Scotia (2002).

[12] Employers were so desperate to find people that they began to devise strategies that allowed them, for example, to put illiterate workers to work. That is why the fast food industry designed cash registers using only pictograms, not words and numbers, so that workers who could not read could nevertheless operate fairly sophisticated machinery. For more information, see the Employment Policy Foundation (1998).

SECTION 3
Convergence is not Inevitable

Convergence means, by definition, that lagging economies can not merely grow as fast as leading economies, but faster. It is mathematically impossible for the poorer regions of Canada to catch up with places like Alberta and Ontario, let alone the United States, without growing faster than these jurisdictions do. This is not pie-in-the-sky. A lagging economy, as explained earlier, will naturally grow faster than a leading economy, consistently closing the gap each year. However, since 1961 Atlantic Canada has managed to close the gap with the rest of Canada by only 1.3% a year, approximately half the rate found elsewhere.

It is worth noting that the provinces that lead the prosperity pack in Canada, namely Alberta and Ontario, have been pursuing the policies that promote growth for several years. Like Ireland, they have cut taxes and reformed social programmes. In the LDPs, however, and especially in Atlantic Canada, well-meaning federal programmes have actually frustrated and obstructed the pursuit of the policies that alone can allow convergence to operate. Provincial government policies, often shaped by the perverse incentives implicit in federal policies, have also contributed to the difficulties the region experiences in shifting its economic activity toward higher-value activities.

To make this concrete, in this section I will review how several specific policy areas — equalization, social welfare programmes (including EI) and the fishery (including aquaculture) — have operated so as to stunt the potential of Atlantic Canada's economy and retard the process of convergence. Many other policy areas could have been chosen, but these will illustrate the nature of the problem and the nature of the policy response that is needed.

Equalization

Equalization was originally designed with the best of intentions: to provide reasonably comparable public services at reasonably comparable levels of taxation in all provinces regardless of the strength of the local tax base. Equalization's effects, however, go far beyond the intentions of the programme's designers.

These are two of the many practical effects of equalization with which we should be concerned:

Incentives to remain dependent

The first is the impact equalization has had on LDPs, particularly with respect to promoting economic growth and therefore reducing dependence on federal transfers. After all, the alternative to dependence on equalization is to grow the tax base so provincial taxpayers pay the cost of public services they choose to have their government provide.

Equalization actually works against this goal. As the province builds its own tax base and earns more revenue, Ottawa withdraws equalization payments, in most cases virtually dollar for dollar, leaving the province no better off for its efforts. This creates a poverty trap similar in principle to the one that awaits individuals trying to escape dependence on social welfare programmes, a social policy problem usually known as "the welfare trap."

Equalization-receiving provinces (ERPs) find it more rewarding to engage in lobbying Ottawa for extra transfers rather than developing their own economy. After all, a new dollar in provincial revenue only generates approximately 10 cents to spend on provincial programmes, after the federal government claws back equalization payments because of the new revenue. On the other hand, a dollar in new transfers from Ottawa is a dollar available to spend on provincial programmes.

Similarly, provinces find it worthwhile to forgo revenues and to take their "share" of new economic activity in the form of low-value but politically popular short-term job creation. A classic example would be the way that Newfoundland gave up the royalty stream from the Hibernia project in exchange for an employment-intensive but short-term construction project: the gravity-based structure. A similar story can be told of the Nova Scotia government selling off exploration rights in the offshore in exchange for "work commitments," a specified but undependable level of economic activity by exploration companies, instead of auctioning them off for cash. Ottawa would scoop up the cash (via equalization), but with work commitments the economic value has a greater chance of staying in the province. Thus, equalization subsidizes poor economic policy and especially the diversion of economic activity to lower rather than higher levels of value added, and it rewards provinces for remaining dependent on federal transfers rather than rewarding them for reducing that dependence by generating more genuine economic activity.

Taxing incentives

Equalization has also been shown to create incentives for less-developed provinces to keep their tax rates higher than they would otherwise be.[13] By manipulating their own tax rates, poorer provinces affect the size of their equalization payment and receive partial compensation for the debilitating effects of those higher taxes.

[13] Boessenkool (2002).

The bigger the province, the stronger the incentive: these incentives are strongest for Quebec, the largest ERP, and correspondingly weaker for the Atlantic provinces, Saskatchewan and Manitoba. Additionally, the incentives are to levy higher tax rates on weaker tax bases (those tax bases most likely to shrink under the burden of heavy taxation) and lower tax rates on stronger tax bases (those more resistant to the effects of heavy taxes). For example, personal income taxes in poorer provinces are, on average, one-third higher than in richer provinces (British Columbia, Alberta and Ontario). Capital taxes in poorer provinces are more than two times higher than in the rich provinces; sales taxes are half again as high; and fuel taxes are one-tenth to three-fifths higher. Even if you take low-tax Alberta out of the calculation, and compare taxes in the equalization-receiving provinces only with those in Ontario and B.C., the conclusion still holds.[14]

Social Programmes

Employment Insurance

Another well-intended federal program with devastating outcomes for the prospects of convergence has been employment insurance (EI). Initially, employment insurance was established to support employees when they lost permanent jobs; however, increasingly it has become a system for supporting seasonal workers between seasonal jobs. At one point, in the 1970s, workers could receive unemployment benefits after working eight to 10 weeks. Many government make-work projects were set up and specifically designed to provide 10 weeks of work and no more. Closely identified with Atlantic Canada, this annual cycle created a negative stereotype that has clung to the region ever since.

Amazingly, as regional unemployment rose dramatically, wages and salaries in Atlantic Canada rose dramatically as well against the national average.[15] Renewed federal wealth transfers increased the size of public employment in the region and bid up wages in competition with the private sector. Private-sector employers not only had to bid against government-employment opportunities and the multitude of make-work projects and government-subsidized jobs, they also had to bid against an EI system that gave generous year-round benefits for a few weeks of work. These circumstances distorted the local economy and threw it into a vicious downward spiral.

These distortions differed in their short-term and long-term effects on wages. In the short term, wages were artificially inflated, raising the cost of doing business and thus suppressing investment. Thus, in the long term, such distortions suppressed normal increases in pay rates — the opposite of the short-term effect — by keeping the capital/labour ratio lower than it otherwise would have been and by suppressing the skills that workers would normally have acquired by working.

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[14] Ibid.

[15] McMahon (1996).

The benefit system also bribed people to avoid work once they had qualified for EI benefits. Accepting any job during the collection period meant they would have to give up government-funded leisure time and reduce their income. This situation put a premium on short-term high-paying work, rather than long-term employment. Year-round employers found it increasingly difficult to hire people at wages the firms could afford. Economic growth was stifled.

Undervalued job skills and education

In addition to driving up wages and creating labour shortages, EI also introduced another distortion in the labour market that weakened economic growth and job creation. The programme caused workers to under-value education and skill enhancement, further contributing to the labour shortage. The system removed incentives for further training by emphasizing low-skill, usually seasonal jobs and make-work programmes, where employment had nothing to do with a worker's skills and output. This created a population dependent on low-skill work. It also inhibited diversification and growth by driving up the cost of labour and making it difficult for year-round employers to compete with seasonal industries. Many employers, particularly in the fishery, were expected to rotate people through 10-week (later 12-week) jobs, hardly a recipe for developing a high-quality, skilled workforce.

The 1995-era reforms began changing this trend somewhat and helped keep young Atlantic Canadians in school, although the still significant numbers of first-time fisheries EI claimants in Newfoundland, for example, shows that the problem is still not completely resolved.

Social welfare

The welfare trap, or the interaction between the benefit structure and the tax system that actually penalizes people for moving from social welfare and into work, is deeper in the four Atlantic provinces than in most of the rest of the country. For example, take a Nova Scotian trying to escape welfare by working. If he or she can earn $14,000 as the sole wage earner for a family of four, that person actually loses just over 15 cents of take-home pay for every extra dollar of wages earned. At $16,000, the loss is just under 15 cents. It's only when income passes the threshold of approximately $21,000 that the marginal tax rate falls to a more "normal" 39.8% or so.[16]

This is about the most perverse social policy one can imagine. Statistics Canada data are very clear: the most effective way for people to escape low income and make themselves better off is not for the government to raise welfare rates. It is for people on low incomes to get into the labour force and work more hours. Even if wages are initially low, people quickly improve their situation because low wages are merely the first rung on a ladder that leads to higher wages as people establish the skills and disci-

[16] Boessenkool (2000a).

pline that make them valuable employees. With Atlantic Canada's high welfare dependency rates, in addition to the high rates of seasonal EI usage, social policy is clearly an obstacle to higher labour force participation.

Fisheries

The greatest distortion of Atlantic Canada's economy is in the fishery. Political commentators and regional policymakers often argue about the necessity and fairness of supporting Atlantic Canada's "traditional" way of life in the fishery. In fact, the fishing industry has become a political artifice, constructed with billions of dollars of public money, that has little to do with the region's traditional fishery. By the early 1990s, about two and a half people were working in the fishery for every one in 1961.

The fishery as gateway to social welfare

In many communities throughout Atlantic Canada, the fishery was regarded as the employer of last resort, and a means to "stamp up" as many members of the community for UI/EI benefits as possible, providing them with income for the year in a crude kind of workfare programme. Prior to the collapse of the northern cod stocks, in fishing communities dependent on the cod fishery UI provided a larger share of income than did fishing.[17] The result was that large numbers of people became trapped on a seasonal work/EI cycle that kept them locked in low-value economic activities and impeded reforms to both the structure of the fishing industry and of social welfare programmes. The recent controversy in Newfoundland about FPI's plans to modernize its fishing and processing operations in that province shows that it is still difficult in many communities to see the value of putting the industry on a year-round, sustainable and profitable footing when that requires the creation of some unemployment.

Resource ownership and the tragedy of the commons

In addition to the various federal and provincial interventions in the management of the industry, there is the underlying problem of the structure of ownership of the resource itself. Under the current regime, the fish stocks themselves are a common property resource, owned and managed by the Government of Canada.

It is well established that under a common property regime, people's self-interest causes them to act in ways that are destructive of the resource, and no amount of moral exhortation or heavy-handed bureaucratic management has ever proven more than very modestly successful in changing this.[18] Incentives matter, so that if we want to change the way that people behave in the fishery, we have to make their

[17] Please see The Rock in a Hard Place (May and Hollett, 1995) for details on social welfare and the fishing industry. For details on the impacts of EI reform in the mid-1990s, please refer to Beyond a Hard Place (Audas and Murrell, 2000).

[18] Crowley (1996).

self-interest coincide with the need for the stocks to be managed sustainably, to avoid future ecological and economic disasters such as the collapse of the northern cod stocks.

Ranchers own their cattle and farmers own the productive capacity of their land. If either run down the long-term value of these assets through poor management, they pay a direct personal cost. In other words, ownership of these assets introduces a direct and tangible accountability for the quality of stewardship of the resource.

Fishermen, on the other hand, by and large do not own the fish until they've landed them in the boat. All they have, besides the boat, is a license from the Department of Fisheries and Oceans (DFO) to put their nets or lines or traps in the water at the times and places authorized. If they don't catch all the fish they can in the artificially short seasons, the fish will not remain in the water to reproduce; they will be caught by the guy in the next boat, so everybody has a big incentive to race to catch as much as possible, and to cheat against the artificial rules designed to hold down harvesting capacity so that access to the stocks can be distributed on the basis of political pressure.

The Government of Canada reaps little benefit from sound resource management. It runs the fishery so as to maximize short-term employment as a gateway to social benefits and to maintain coastal populations in a state of political dependency. In this they have been aided and abetted by provincial governments that have regulated fish processing with the same short-term employment objectives in mind. Productivity and profitability have paid the price.

This politicization of fish management has resulted in huge influxes of people *into* the fishery over the past 30 years. Only giving ownership and management of the resource to the people who live from it will move the industry to a sustainable basis, allowing people to make decisions about whether they want to fish themselves, or rent out their quotas, or sell them outright and do something else with their capital.[19]

Even though half of the fish caught by value on the East Coast is caught under some form of property right, that means that half is not, and those property rights that do exist are usually of very poor quality and subject to high risk of political interference. This means that coastal communities' chief asset,

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[19] While these arguments are now widely understood in the industry and in natural resource economics, there is a further argument that is only now making its impact felt, largely as a result of Hernando de Soto's book The Mystery of Capital. De Soto, one of the world's great analysts of the challenges of Third World development, situates the greatest obstacle to that development in the absence of formal title, or ownership, of the means of production and the real estate used by the vast bulk of the world's population. De Soto argues that once assets are in a formal and developed property system, they endow their owners with an enormous advantage in that they can be split up and recombined in more ways than an Erector set. Most people can adapt their assets to any economic circumstances, to produce continually higher value-added mixtures. But not people in the Third World, not people in the former Communist countries of Eastern and Central Europe, not people living on aboriginal reserves in Canada, and not people in Canada's coastal communities who rely on the oceans as their chief productive asset.

on the whole, cannot be leveraged to create new economic opportunity and it cannot be recombined effectively with other assets to create higher value added. As a result of all this "dead capital," economic life and opportunities are stunted in coastal communities.

Aquaculture: the fishery's new face

Aquaculture provides another example of how difficult it is to shift economic activity to higher value added within traditional natural resource industries whose flexibility has been reduced by over-regulation and by the behaviour patterns reinforced by social welfare programmes.

Unlike the declining wild or capture fishery, world aquaculture production has increased seventeenfold in the past 50 years. The industry supplies a fifth of all the protein consumed from the sea. In the not-too-distant future, farmed fish, shellfish and algae will overtake the wild fishery, producing a vast array of domesticated fish species. Some are comparing this Blue Revolution to the Green Revolution that boosted world food production in the past 30 years.

In many ways, this is an ideal industry for Atlantic Canada. It's based in coastal communities where jobs are scarce, it's not seasonal, it's high tech, it meets a growing market demand worldwide. And indeed the industry has established itself, to the tune of more than $150 million annually in New Brunswick, for example. Ironically, our technology and expertise is in demand around the world, but the industry's local growth is slow compared to that of the global industry, representing huge lost opportunities for workers, investors and taxpayers in the region.

Dozens of federal and provincial departments must give separate approvals for an aquaculture operation to go ahead. Some of this is proper and necessary, to protect all legitimate uses of the ocean - recreation, sport fishing, navigation, and tourism as well as aquaculture. Much of it is unnecessary and damaging to the industry and coastal communities.[20]

Just as seriously, the process for granting aquaculturists use of the water is capricious and arbitrary. Leases are often too short or too small for efficient operations, and this *absence* of high-quality property rights in the water hampers the development of aquaculture, just as the *presence* of private property on the prairie hastened the development of a rich agricultural society.

In summary, I have already noted that convergence can be derailed by policies that either inflate the cost of labour or reduce returns on capital. A review of the effects of federal and provincial regional development policy over the past 30 years shows that it has inflated the cost of labour, especially relative to its productivity, and reduced returns on capital, partly through policies designed to prevent improvements in productivity by substituting of capital for labour.

[20] Neill and Rogers (2002).

SECTION 4
LOOKING FORWARD: REVIVING CONVERGENCE

The dependency and weakness of Atlantic Canada's economic performance, then, is chiefly the result of bad policy. Atlantic Canada's failure to sustain convergence at the normal rate, its high unemployment and its low level of investment indicate that the net negative effect of policy has greatly outweighed any benefits resulting from increased government spending.

The argument for government intervention in 'regional development' is based on the idea of market failure. According to this view, the cost structure of an economy is of small relevance. Instead, market failures, particularly in providing capital to lagging and peripheral regions, mean investors will ignore, or be ignorant of, profit-making opportunities. Thus, since a low-cost structure will do little to spur development and attract investment, and since lagging regions do not have the capital for investment, richer governments must sponsor regional development programmes and transfer wealth to the lagging region. This view gives government the justification for direct intervention in the economy, enabling it to solve market failure either by investing itself or by bribing private investors into the lagging region through subsidies. The entire edifice of regional development policy, including the activities of regional development agencies such as the Atlantic Canada Opportunities Agency, has been based on exactly this understanding of the operation of lagging economies.

Unfortunately for residents of the LDPs in Canada and for the taxpayers of Canada who have financed a massive array of well-intentioned transfers to the LDPs over the past 30 years, this vision of how to achieve growth and convergence is wrong. It is contradicted by the evidence of convergence between lagging economies with leading economies, evidence already reviewed in this paper. It is also contradicted by Atlantic Canada's own experience with convergence in the period leading up to the early 1970s. That evidence indicates that success comes from a policy package focusing relentlessly on productivity, investment, competitiveness, welfare, and EI reform, removing disincentives within equalization and eliminating barriers to the free functioning of the labour market, so that the region's unemployment can be absorbed and labour shortages eliminated. Politicization of decision making in what are essentially business endeavours must be eliminated, with the fishery being a classic case of an industry that has been devastated by government regulation designed to maximize seasonal employment rather than build sustainable long-term economic activity. Here is a very brief overview of the policy programme that would be needed in order to put Atlantic Canada in particular, and the country's LDPs in general, on the road to higher productivity and prosperity.

Tax reductions

The LDPs' problem is not market failure, but failure to use the market. Investors have not failed to invest in the LDPs for inexplicable reasons, but for very precise reasons, and the removal of those obstacles to investment will set convergence back on course.

Key to this package of measures will be the reduction of taxation levels in the region. The most successful provinces in Canada — Ontario and Alberta — both are pursuing an aggressive policy of tax reduction. Ottawa now is reducing its tax rates, as is B.C. The United States is similarly engaged in significant tax reductions. Yet under the status quo, the LDPs have tax rates that are significantly higher than the national average.[21] And as the wealthier provinces cut their tax rates, in relative terms the LDPs' attractiveness as a location for business is being undermined every day. Based on Ireland's experience, the taxes that should be cut are the ones that weigh most heavily on effort, investment, productivity, and growth, namely taxes on personal income, business profits and capital. Consumption taxes, for example, would be a low-priority target for tax cuts.

Critics of a tax-based economic growth strategy criticize this as a "race to the bottom." It is quite the reverse. Competitive taxes help boost sustainable economic activity, which raises the tax take. Typically, one or two years after a significant tax cut, tax revenues are higher than prior to the cut. They may be lower as a percentage of GDP, but they are higher in real terms because GDP growth has been strong. In the United States, where tax *rates* are typically significantly lower than in Canada, taxpayers nevertheless pay more taxes, i*n absolute terms*, than anywhere else in the industrialized world.

Another advantage is that by using low tax rates to generate prosperity, instead of government spending, much of the politics is automatically taken out of regional development activity. Allowing profitable businesses to keep a larger share of their profits means that the system automatically rewards successful businesses and encourages them to become even more successful, without the government being required to choose winners and losers. Under the current dispensation, most economic development efforts simply transfer wealth from self-sustaining activities to government-selected activities, benefiting the set of owners and workers in the selected activities, at significant cost to other businesses and workers.

An alternative strategy that is gaining considerable attention in Atlantic Canada would see the federal government wind down its regional spending programmes in favour of reduced federal taxes in the LDPs. There is already precedent for such regionally differentiated tax rates in the federal tax abatement

[21] For details of the interaction between LDP tax rates and equalization, see Dahlby (2002) and Boessenkool (2002).

for residents of the province of Quebec. The objective should be for the federal government to help the LDPs reduce the appropriate taxes to roughly the national average. The extra effort required to take tax rates down to more competitive levels should come from the provinces themselves.

Equalization reform

Equalization reform would be a key element of this policy package. As outlined earlier, equalization focuses LDP governments' attention more on seeking additional transfers from Ottawa rather than generating genuine long-term sustainable economic activity to reduce dependence. Moreover, the evidence seems strong that equalization rewards provinces for keeping their tax rates too high.

Capping equalization, removing the incentives to dependence, overtaxation and forgoing of revenue, and the transfer of some part of the cash transfer to a reduction in federal taxes in the LDPs would all push the policy package in the direction of genuine economic activity, while ultimately building the capacity of the LDPs to pay their own way out of own-source revenues. The details of equalization reform are too complex to enter into here, but a great deal of material is available in the *AIMS Equalization Papers.*[22]

It is worth underlining, however, that while equalization has its virtues, it is by no means an essential element of federalism. Nor is it necessary to equalize to the relatively high level that we do in Canada. The United States does not have an equalization programme, yet Serge Coulombe finds that, compared to Canadian provinces, U.S. states show a greater degree of economic convergence in incomes and employment.[23] The U.S. approach is based on the idea that differences in fiscal capacity are capitalized in other prices (housing and wages, for example).[24] To the extent that differences in fiscal capacity are capitalized, there is a reduced need for federal transfers to account for these differences. Worse, to the extent that capitalization occurs, equalization payments will merely serve to dampen the natural economic adjustment that would otherwise take place.[25] We should therefore be aiming to replace the current programme that merely maintains the LDPs in a state of dependence with one that actively encourages and rewards them for escaping the underdevelopment that makes equalization necessary in the first place. The greatest accomplishment of a successful transfer system would be the elimination of the need for transfers.

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[22] Buchanan (2002), Dahlby (2002), Boessenkool (2002), Boessenkool (2000b), Grubel (2002), and Martin (2001).

[23] Coulombe (1999).

[24] Without going into details, the argument is that less-prosperous regions find that relative underdevelopment represented in wages, house prices and so forth. These lower costs represent a competitive advantage compared to other higher-cost jurisdictions: it is generally more expensive to buy a house, rent an office or hire a plumber or a manager in New York or Toronto than in Moncton or Halifax. That should also lower the cost of public services and increase the incentives for investment, reducing the need for transfers in the LDCs. But if instead expectations of high levels of personal and intergovernmental transfers are capitalized into wages and real estate prices, then the need for transfers becomes a self-fulfilling prophecy.

[25] For the full argument, see McMahon (1996, 2000a and 2000b).

Ending labour shortages: 1 – EI reform

A major theme of this paper is that policy makers remain too wedded to an outmoded vision that the LDPs' chief challenge is unemployment, whereas that challenge is really the co-existence of large pools of unemployed and underemployed labour on the one hand and significant labour shortages on the other.

Yet competitive labour costs and a dynamic labour supply are vital to regions trying to escape underdevelopment. One part of the solution is, therefore, further EI reform in general, and especially with regard to seasonal workers. Recognising that entrenched patterns of behaviour are difficult to change, and that workers trapped in the old system need to be given time to adjust, EI benefits should at least be ratcheted down fairly significantly every year for annual repeaters. The effect, with each passing year, will be to send an ever-clearer signal that work, not EI, is the route to take to better one's circumstances. Moreover, to prevent a new generation of young people from being trapped by the system, greater evidence of workforce attachment should be required. For example, a first-time claimant would need a minimum of a year's continuous work in order to qualify for employment insurance benefits.

Additionally, employers should pay higher premiums when they lay off people who then claim EI. Such an experience-rated system applies in Maine — a state whose economy is similar to Atlantic Canada's —and helps to explain Maine's lower unemployment rate. Employers are slower to hire, because they want to be sure they can sustain a job. On the other hand, they're slower to fire, ensuring that workers actually stay long enough in a job to acquire valuable skills and good work habits. Such a reform in Atlantic Canada would give employers a much stronger incentive to resist social pressure to create many short-term jobs rather than fewer permanent ones in order to "stamp up" as many members of the community as possible.

Finally, regionally extended EI benefits should be eliminated. There are jobs in Atlantic Canada going unfilled because the wages cannot compete with the EI/seasonal work nexus and the welfare trap more generally. EI needs to change the balance decisively in favour of work, so people see that they become better off, not worse off, by accepting the work that is available, and by acquiring the training or education needed to qualify for that work.[26]

[26] Shorter qualification periods and longer periods of benefits in higher unemployment regions tend to draw Atlantic Canadians home from Ontario and Alberta when they are temporarily laid off. These comfortably unemployed reduce their living costs and are in a supportive social network where there is no compulsion to seek work until benefits run out. These imported unemployed then raise the unemployment rate in the Atlantic Provinces, securing the regionally higher rate for other migratory workers to enjoy. Eliminating regional benefits would eliminate this disincentive to re-enter the workforce.

Ending labour shortages: 2 – Social welfare reform

In addition to EI reforms, social welfare reforms can also successfully move individuals from social assistance and employment insurance into the labour force. Evidence of successful reform, strengthening the labour force and reducing poverty, already exists in Canada.

Social welfare reform requires reducing access to assistance for people deemed employable. By tightening the criteria to qualify for social assistance, we would almost certainly see employment rates rise among the poor and poverty rates decrease.

Alberta has already taken significant steps to reduce the percentage of people on welfare and employment insurance and move them into the labour force. It has introduced earning supplements to "make work pay." The program encourages low-income parents to prefer work to welfare by directing earnings supplements to families (single and dual parent) with children, with the supplement often tied to the number and age of the children.

Not only has the Alberta experience given us evidence that welfare reform can work in the Canadian context, but welfare reforms in the United States have helped to drive a significant decline in dependence and a large upswing in the labour force participation rate across the country.[27]

Ending labour shortages: 3 – Education and training

Both EI and social welfare reform need to be supplemented by an aggressive programme to upgrade work skills. Given the poor performance of most government-driven training programmes, however, it would be far wiser to make available a transition package to people leaving these social welfare programmes that includes a voucher-like training element. This would give these individuals the power to make their own choices about the mix of talents they have and the opportunities that are available, rather than government picking "winners" (in training terms) on their behalf.

Ending labour shortages: 4 – Not out-migration but in-migration

Because of the major changes that are foreseeable in the structure of the population throughout the LDPs, and especially in Atlantic Canada, finding ways to renew the population is essential. Since natalist policies have been of doubtful success, it would appear that the only reliable strategy would be to increase significantly the inflow of immigrants (including migrants from elsewhere in the country) to the

[27] For details please see *Welfare Reform Helps Keep Economy Working*, http://www.aims.ca/Media/1999/prsep0499.html, accessed in July, 2002. Also refer to Crowley (2001), Boessenkool (1997), and the Employment Policy Foundation (1998).

LDPs. I am sceptical that this can be done by compulsion; rather the key is to create a climate of opportunity that is attractive to immigrants. Many of the other policy prescriptions offered here, including a reduced tax burden in the LDPs, a culture of education, a lightening of the regulatory burden, including on newcomers' access to many regulated professions, would all be powerful recruitment tools. Attracting highly skilled professionals and entrepreneurs from elsewhere will also both help to fill skills gaps while generating economic activity that can help employ less-skilled workers currently unemployed or underemployed in the LDPs. Governments in Atlantic Canada have not yet put the recruitment of immigrants high enough on their list of priorities. At a minimum this requires negotiation of immigration agreements with Ottawa to give provinces a greater role in immigrant recruitment and selection.

The fishery of the future

The future of the fishery as a sustainable and profitable business can only be realised by removing politics from decision making at all levels. Ownership of the resource must, as a matter of urgency, be transferred to those who live from that resource. One strategy for doing so has already been sketched out by prominent natural resource management authority Prof. Peter Pearse.[28] Then it will be possible to create the institutions for a self-managed fishery, eliminating the current adversarial relationship between the DFO and the coastal communities that live from the fishery. Introduction of good quality property rights (as in individual transferable quotas, or ITQs) creates the conditions under which seasonality can be greatly reduced, while improving conservation efforts. Prof. Anthony Scott has already laid out the basis for a self-managed fishery under property rights.[29]

On the processing side, the reform of social programmes and the consequent shifting of many seasonal workers into other opportunities will allow management to be done on the basis of sustainable opportunities. This will mean the closure of excess processing capacity, centralization in a limited number of facilities with much higher levels of capital investment, requiring higher skill levels from workers and capable of operating year-round. The current licensing system by which provincial governments regulate virtually all aspects of the processing industry would need to be abolished, allowing the industry to operate as a normal business.

Finally, the regulatory barriers to the growth and development of the aquaculture industry need to be removed, including, again, the lack of high-quality property rights without which needed investment will not be made.

Again the point needs to be made that the fishing industry is merely an egregious example of heavy-handed government intervention undermining genuine economic opportunity in the name of employment maximization. The lessons learned here are also relevant to other major economic opportunities

[28] Fenwick (2001).

[29] Scott (1996).

facing the region, such as the oil and gas industry. It faces major regulatory burdens that attempt to extract maximum short-term employment rather than creating the conditions in which the industry will find it profitable to invest and grow in the long term. The same could be said for the transport sector, such as the Port of Halifax, a major piece of infrastructure that suffers from politicized management and an absence of a commercial culture seeking to maximize opportunity, or the electricity industry that suffers from the indefensible barriers to interprovincial trade that still prevent the region from generating new wealth from exploitation of its energy resources in this field.

In sum, the focus of government must be shifted from supporting consumption (that is, the direct provision of incomes and jobs) to supporting investment and the creation of opportunity. Building genuine infrastructure, such as top-quality highway links to the region's fast-growing markets in the United States, would be a good example of where an activist government could profitably put its efforts in hastening convergence.

SECTION 5
CONCLUSION

If the objective is to improve Canadians' standard of living by improving their productivity and removing barriers to opportunity, then the LDPs, and Atlantic Canada in particular, offer a rich variety of areas in which this can be achieved. In fact, the theory and practice of convergence suggests that the LDPs have been lands of lost opportunity in recent decades. Better policies by all levels of government, combined with new attitudes on the part of the population, could result in the poorest regions of the country making a disproportionate contribution to Canada's success in meeting the challenge of prosperity.

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