THE MARITIME ECONOMY: INSTITUTIONS THAT INHIBIT ECONOMIC DEVELOPMENT

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The economic problems in the Maritime provinces are well known. Incomes on a per person basis are roughly three-quarters of the national average, unemployment rates in the region are significantly higher than the national average and, importantly, levels of productivity and productivity growth are lower than the national average. All this is in spite of significant federal government spending and transfer payments which make up 25% of Gross Domestic Product (GDP) of the region in net terms. What can be done to change this picture? What is the role of institutions in slowing economic growth in the region? Are there institutional changes that can lead to innovation and increase productivity growth and help the Maritime provinces achieve standards of living in line with those in the rest of the nation?

As North describes,[1] institutions are "any form of constraint that human beings devise to shape human interaction." The institutional framework, in turn, leads to the formation of organisations which interact with the established environment. Yet, often, economists downplay the role of institutions. Economists focus on the market as the predominant institution, but in fact, institutions lead to the establishment of a wide range of organisations and these influence decision-making behaviour throughout the economy. Indeed, the major economic actors in society (households, goods and service-producing firms and governments) all respond to the institutional framework they face.

Why are institutions and the organisations they create important? Generally, economists want to ensure that decisions are made in an efficient way. Institutions that act to interfere with this efficiency can lead to lower productivity growth or, in the current vernacular, a loss of competitiveness.

Before turning to the institutional structure of the public sector, which is the focus of this brief paper, I will give several examples of private sector institutions which are important in gaining efficiency. The legal system is clearly critical in allowing markets to function efficiently. One need only look at jurisdictions where there are no property rights or private contracts (for example, the former Soviet Union) to see the importance of this institution. Yet, there is also evidence that developments in the legal system may also have contributed to some inefficiency.

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[1]D.C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990).

For example, there has been strong growth in recent years in the number of lawyers and a marked increase, at least in the U.S., of malpractice and other civil suits. It is arguable whether the increase in these legal actions has been an efficient allocation of resources. In terms of the type of wealth creation that matters in the economy, there can be little doubt that the rapid growth in this class of litigation has not been beneficial.

Another important organisation arising from institutions is the financial sector. A smoothly functioning financial system can remove much of the uncertainty associated with investments by firms. Yet even the financial sector has, at times, inhibited economic innovation. A case in point is the use of junk bonds to undertake leveraged buyouts; once again, the development of these financial instruments has not led to the most efficient use of resources in the economy.

The public sector perhaps provides the best examples of institutions that have influenced productivity growth and hence competitiveness. Consider the provision of public infrastructure. The establishment of a good transportation system can lead to efficiency gains since it allows the private sector to make use of the system to ensure the timely arrival of inputs into the production process. While the debate about the magnitude of the productivity gains continues,[2] there is little argument that there is a positive effect.

In the public sector, inefficiency can arise due to federal government policies that interfere with business decisions or decisions by individuals to become more productive members of the labour force. Provincial government policies can also inhibit the free movement of goods, services and factors of production. In addition, businesses and labour organisations can set up different standards for their goods, services or professions that restrict the movement of the associated factors.

In assessing the impact of institutions, there are a number of concerns. First, there is the broad issue of government industrial policy manifested in tax concessions, in-kind or cash transfers to firms, regulations and procurement policy. Second, there are policies that affect the factors of production. For example, the regionally differentiated unemployment insurance program and regional development programs may lead to inefficiency in the economy. Similarly, the existence of widespread interprovincial non-tariff trade barriers can result in a slower reduction of regional economic disparities. With the movement toward Maritime economic integration,[3] one might expect that income levels in the Maritime provinces may approach those in the rest of Canada more rapidly. It

[2]See the discussion in A.H. Munnell, "Infrastructure Investment and Economic Growth" (1992) 6 Journal of Economic Perspectives 189.

[3]See, for example, *Challenge and Opportunity* (Halifax: Council of Maritime Premiers, 1991).

may well be important to encourage institutions like the Council of Maritime Premiers that help eliminate barriers to trade.

One of the important issues facing us today is how to increase productivity in the Maritime provinces. Moomaw and Williams, in the U.S. context, find that the growth in total factor productivity in manufacturing depends on a number of components, some of which can be directly affected by government institutions.[4] Perhaps the most obvious of these factors is the education system and, in particular, the educational attainment and experience of the work force. This means that the education system must be reevaluated in terms of both technical and university education. Beeson argues that large cities make the adoption of innovation easier through agglomeration economies.[5] This concept is similar to that of Porter's "clusters of economic activity."[6] Institutions that can assist in the development of these clusters through the provision of venture capital (risk sharing, for example) must be explored.[7] Finally, characteristics of the region, including infrastructure such as transportation, communication and research and development expenditures, may be important.

There have been many attempts to generate economic development in Atlantic Canada through federal government regional development programs. In the period since 1960 there has been a profusion of programs which have arisen from the political structure and the institutions it creates. The Atlantic Development Bank, which was designed to fund capital projects in the region, was formed in 1962. At about the same time (1966-67), the *Agricultural and Rural Development Act*[8] was passed to assist rural and agricultural communities. In the mid-1960s the Fund for Rural Economic Development (FRED) was set up to fund large scale regional planning and continued to exist, in Prince Edward Island at least, until the mid-1980s. In 1969, the Department of Regional Economic Expansion (DREE), which focused spending on infrastructure in urban areas where growth was most likely to occur, began operation. After a major overhaul in the early 1970s, this led to two different programmes, the *Regional Development Incentive Act*,[9] and the General Development Agreements. Both of these programmes encouraged capital intensive projects. In 1982, DREE was abolished in favour of the Department of Regional Industrial Expansion (DRIE). DRIE was national in scope and

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[4]R.L. Moomaw and Williams, "Total Factor Productivity Growth in Manufacturing: Further Evidence From the States" (1991) 31 Journal of Regional Science 17.

[5]P. Beeson, "Total Factor Productivity Growth and Agglomeration Economies in Manufacturing, 1959-73" (1987) 27 Journal of Regional Science 183.

[6]M. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990).

[7]C.J. McMillan, *Standing Up to the Future* (Halifax: Council of Maritime Premiers, 1989).

[8]R.S.C. 1970, c. A-4.

[9]R.S.C. 1970, c. R-3.

consequently, there was a shift of funds towards Ontario and Quebec. By 1984, the Ontario and Quebec economies were booming while the West and East remained relatively depressed. This led, in 1987, to the establishment of the Atlantic Canada Opportunities Agency (ACOA) and the Western Diversification Office. The political process which encouraged these programmes arose from a desire for employment creation in the region.

It is clear that federal government policy aimed at regional development in the Maritime provinces, has had a capital intensive bent. Has it worked? There is certainly no evidence that it has generated extensive economic activity. If we look at capital stock per person employed, it would appear that there is too much capital investment in the Maritime provinces compared to Ontario. There is no reason to believe that the observed capital available to an employed person in New Brunswick should be almost one and one-half times more than that available to an employed person in Ontario. If this had the desired effect we would observe that labour productivity was growing faster in the Maritimes than in the rest of Canada. This has not been the case.

Many commentators have noted the failure of these regional development programmes. Porter notes, "direct subsidies also often result in costly mistakes, as the failed history of many Canadian regional development policies attests."[10] Furthermore, there has been little or no analysis of the effect on communities and their residents of the failed programmes.

Overall, there are strong reasons to believe that an appropriate policy need not be a regional development policy, but should be rather a policy that encourages businesses and individuals across the country to operate in an environment conducive to physical and human capital investment respectively. As Romer notes, subsidies to capital accumulation (such as the federal development programs) have had no impact on the steady-state growth path.[11] The level of research in an economy and hence the rate of growth will depend on interest rates and on the presence of an adequate pool of funds for investment purposes.[12] There is an urgent need to guarantee policy co-ordination between the federal and provincial governments. A new institution may well be required to undertake this.

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[10] M.E. Porter, *Canada At the Crossroads: The Reality for a New Competitive Environment* (Ottawa: Supply and Services, 1991) at 377.

[11] P.M. Romer, "Capital, Labor and Productivity" (1990) Brookings Papers on Economic Activity: Microeconomics 337.

[12] *Ibid.*

I would sum up the important issues that arise from this discussion as:

1. How do we encourage the formation of pools of venture capital in the region? What institutional changes in the financial sector (perhaps through the *Bank Act*[13]) or in government programs are required ?

2. How do we ensure that there is no disincentive to work? Are there changes in labour market policies that can help to foster employment and productivity growth through assistance to individuals?

3. How do we generate added value through processing of basic commodities? Are there institutional constraints caused by the size and linkages of firms in the Maritime provinces that limit innovation in this area?

4. What is the relationship between individual development and regional development? Should we change the priorities of our institutions (including the federal and provincial governments, unions and business organizations) to refocus aid away from regions and towards individuals?

Atlantic Canada has a mix of large international companies and individual entrepreneurs (for example, fishers and woodlot owners). Together with the extent of federal government presence, this makes the region a particularly interesting jurisdiction in which to study these issues.

[13]R.S.C. 1985, c. B-1.