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Brooking no Favorites

A New Approach to Regional Development in Atlantic Canada

Jack M. Mintz and
Michael Smart

In this issue...
Critics have long charged that federal regional development subsidies for Atlantic Canada are poorly targeted, ineffective and prone to political influence. This Commentary evaluates the case for regional development reform and argues that business grants should be replaced by measures to reduce existing tax burdens on business investment.

The Study in Brief

This *Commentary* makes the case for a fundamental reform in the delivery of federal development assistance to Atlantic Canada. It argues that the federal government should replace existing grants and tax credits to businesses with a broad-based reduction of corporate taxes in the region.

Existing grant programs are well intentioned, though poorly targeted. Governments are usually not good at picking winners — but losers tend to be very good at picking governments. As well, grants may serve political, rather than economic, objectives. This paper contains a quantitative analysis of the allocation of federal grants in Atlantic Canada in the 1988-to-2000 period, providing evidence that supports this contention.

Since direct grant programs are ineffective, we recommend federal business tax reductions for the region.

A tax cut for Atlantic Canada could be implemented in a variety of ways; we consider two of them. A federal corporate income-tax rate cut of 6.5 percentage points on Atlantic income could be provided to replace about $250 million of existing grants. Alternatively, incentives for capital investments could be provided to encourage new activities in the Atlantic. This Commentary argues that a broad-based tax credit at a 10.5-percent rate should replace cash grants, as well as the existing federal Atlantic Investment Tax Credit, which is seriously flawed in design. Under this proposal, we estimate that the effective tax rate on marginal investment projects in the Atlantic region would be almost eliminated for many investment projects.

The Authors of This Issue

Jack M, Mintz is President and CEO of the C.D. Howe Institute and Deloitte & Touche Professor of Taxation, J.L. Rotman School of Management, University of Toronto.

Michael Smart is an Associate Professor of Economics at the University of Toronto and a Research Fellow of the C. D. Howe Institute.

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Since 1988, the federal government has transferred nearly $4 billion to businesses, governments and non-governmental organizations in the Atlantic provinces through the Atlantic Canada Opportunities Agency (ACOA). Recently, a number of critics have called for a re-examination of the agency's mandate and a fundamental reform in the way that regional development assistance is delivered, including substituting corporate tax cuts for Atlantic businesses for ACOA grants. This *Commentary* evaluates the case for regional development reform. It argues that Ottawa should replace business grants with tax measures directed towards investment, while revamping federal Atlantic investment-tax credit that has been poorly structured in the past.

ACOA is just one of a handful of federal agencies that direct subsidies to businesses in all regions of the country. We focus on ACOA because its expenditures in per capita terms for the Atlantic region exceed those made by other agencies and the federal goverment in other parts of Canada.[1] At the same time, we do not question the important role of the federal government in contributing to public services in have-not regions using, for example, the Equalization program. Rather, our analysis is directed more narrowly at direct subsidies to local businesses for the purposes of regional development. Certainly, some of our analysis could equally apply to other regional development programs.

Regional development grant programs exist in many countries. Their aim is typically to help fledgling businesses obtain financing that private lenders do not provide — the idea being that many lenders are insufficiently knowledgeable about profitable opportunities for investment or are unwilling to take on the risks. A further aim of regional development programs is to help regional economies "get over the hump", to use the vernacular — to establish sufficient investment in productive capital and infrastructure to enable a region to become a magnet for other businesses and for a skilled work force.

While the road to development in Atlantic Canada has long been paved with such good intentions, poor design and implementation of policies has created some significant potholes. Several deficiencies can arise that undermine the usefulness of regional development grants (Mintz 2001). Grants often appear to be directed to infra-marginal investments — projects which would have been undertaken even in the absence of government support. As well, the grants create more demand for land and capital components, resulting in higher rents and capital goods prices, without generating the new activity that was originally intended. Even when grants spur truly new investment, little evidence can be found to support the conclusion that such projects can be made sustainable and profitable in the long run. At worst, inefficient businesses favoured with grants

The authors wish to thank Duanjie Chen for her assistance in computing effective tax rates. They also wish to thank Bob Brown, Monique Collette, Oryssia Lennie, Nicolas Marceau, Frank McKenna and William Strange for comments that helped improve the paper. Any errors that remain are our responsibility.

1 On a public accounts basis, ACOA spent $351.6 million in the 2001/2002 fiscal year, or about $150 per person in the four Atlantic provinces. The corresponding figures for the other regional development agencies are $30-to-$50 per capita. Other business subsidies, including agriculture, technology and job-training are provided by the federal government in various provinces, though we limit ourselves to regional development programs.

drive out competing profitable businesses that are not given the same assistance. Because of the cost of raising taxes to fund grants, the lack of benefits would be a very serious concern to taxpayers who have to ultimately fund the activities.

Because the Atlantic provinces have been catching up to Canada in per capita income in the past two decades, it can be argued that the regional development programs have helped improve the economy. On the other hand, the Atlantic region may be showing vigorous growth through its own entrepreneurship — as well as benefiting from significant investment in energy — with regional development programs reducing, rather than improving, productivity by keeping inefficient businesses in operation.

Losers' Choice

To some extent, these failures reflect the inevitable problems facing any government agency that lacks sufficient information to target its funds at areas where they can be most useful. Governments are unlikely to be very good at picking winners — but losers tend to be very good at picking governments. However, targeting failures may also reflect other, non-economic objectives of governments: cash transfer programs like ACOA may be used to reward political supporters, to buy votes in swing ridings, and for a variety of other political objectives, as well as for their legitimate role as a tool of regional industrial policy. Political scandals have dogged ACOA and the other federal and provincial regional development agencies on a number of occasions in the past. Below, we present some preliminary evidence on how political considerations may have influenced the allocation of ACOA funds.

If, as we argue, direct grant programs do not work well, then what is the alternative? Some critics have proposed eliminating federal regional development programs entirely, which would be a radical departure from past practice that we do not evaluate or take a position on here. Instead, we focus on the narrower question of how the federal government might best deliver a specified level of support to the Atlantic region. A number of Atlantic politicians have raised the possibility of replacing ACOA spending with a cut in federal business taxes of equal value for the region. Replacing direct grant and loan programs with tax cuts would have a variety of benefits as well as costs. In essence, however, a tax cut would eliminate some of the problems in targeting development assistance, and we believe the alternative deserves serious consideration.

A tax cut for Atlantic Canada could be implemented in a variety of ways and we review the options below. We conclude that the most effective tax cuts would be broad-based ones, not targeted ones. A federal corporate income-tax rate cut of 6.5 percentage points on Atlantic income from 21 percent to 14.5 percent for large companies, and from 12 percent to 5.5 percent for small businesses, could be provided to replace about $250 million in ACOA business grants and expenditures. A corporate income-tax rate cut is a fairly neutral policy that benefits all businesses. However, the effect of the federal policy is to create burdens on other provinces as businesses shift income out of high-tax provinces into the Atlantic region to minimize taxes without having to change provincial production patterns.

Alternatively, incentives for capital investments could be provided to encourage new activities in the Atlantic. The problem with this alternative is to make sure that the government does not target investment incentives to one particular sector or type of investment on the presumption that governments know best what clusters could form. At present, the federal Atlantic investment-tax credit, which reduces federal corporate income taxes by 10 percent of the cost of qualifying investments, serves this function. However, it is inefficiently targeted to certain capital goods and benefits only resource and manufacturing industries. The cost of this program is about $100 million. We suggest that a reformed Atlantic investment-tax credit, provided at a 10.5-percent rate applicable to all depreciable assets and industries, could replace ACOA grants and the existing credit that would be more neutral in application.[2] Under this proposal, we estimate that the effective tax rate on marginal investment projects in the Atlantic region would be virtually eliminated for many investment projects.

What Does ACOA Do, Anyway?

ACOA was established in 1987 with a broad mandate to "increase opportunity for economic development in Atlantic Canada and … enhance the growth of earned incomes and employment opportunities." The agency interprets this mandate liberally, offering loans and "non-repayable contributions" to a wide variety of businesses, non-governmental organizations, and provincial and local governments for a wide variety of purposes. Recipients must apply to the agency for funds and eligibility is determined on a case-by-case basis according to a set of criteria that include incrementality, economic viability and related considerations. About half of ACOA transfers are paid to businesses in the form of capital subsidies for commercial projects, with the remainder allocated to non-commercial projects, such as operating subsidies to local economic development agencies, research centres and industry groups; support for the construction of community centres, roads and other local public "infrastructure", and miscellaneous specific-purpose grants to government agencies (Auditor General 2001).

Recently, ACOA has focused on improving the growth and competitiveness of Atlantic small-and medium-sized businesses and providing economic opportunities for rural Atlantic Canada through community economic development.[3] Little justification is given for the current mandate. For example, it is not entirely clear why only small-and medium-sized businesses should be a focus for ACOA activities, since evidence shows that a large multinational company can contribute strongly to the growth of a smaller town (Institute for Competitiveness and Prosperity 2003).

2 An alternative would be to provide accelerated depreciation for investments in structures and machinery. The investment-tax credit and accelerated depreciation would provide the same benefits for investors on a present-value basis. However, the investment-tax credit provides the funding up front and can apply to all capital goods. Some capital goods are already depreciated at fast rates so accelerated depreciation would be less neutral for that reason.

3 Atlantic Canada Opportunities Agency, 2002-2003 Estimates, Part III Report on Plans and Priorities, Ministry of Industry, p. 5.

In the 2001/2002 fiscal year, ACOA net spending, after revenues and uncharged services, was $261 million. Planned net spending in fiscal year 2002/2003 was $392 million, with some reduction expected in FY 2003/2004 to $381 million and in 2004/2005 to $344 million. Currently, ACOA employs about 560 full-time staff. Program spending in 2002/2003 focused on entrepreneurship ($21 million), trade ($17 million), tourism ($47 million), attracting foreign direct investment ($5 million), innovation ($60 million), community economic development ($85 million), policy, advocacy and co-ordination ($7 million), and access to capital and information ($54 million). Corporate administration of $21 million and other expenditures, net of recoveries, make up the balance of the budget.

In our calculations, we consider scenarios that involve replacing ACOA grants to businesses of $250 million annually with a variety of tax expenditures. The figure used is arbitrary but reflects a conservative estimate of the average value of transfers from the agency in recent years. (Federal budgetary expenditures on ACOA are much higher, including non-transfer expenditures, such as policy advocacy and co-ordination, community development, tourism and administrative expenses.) Our use of this figure does not reflect any assessment of the appropriate level of federal support for regional development; instead we take the pragmatic view that if a major change in federal strategy were implemented, it would most likely occur on an "expenditure-neutral" basis.

What's Right and What's Wrong With ACOA?

The core of ACOA's strategy for the Atlantic region has been to award company-specific investment subsidies, either in the form of outright grants or repayable contributions. Proponents argue that subsidies often play a useful role in encouraging investment, transferring technologies, developing markets and, ultimately, raising wages and increasing standards of living in the region. Critics point to informational and political failures in delivering the subsidies and the inefficiency that may result. Here we offer a brief review of the case for and against ACOA.

Investment Subsidies and Capital Market Failures

The economic argument for government intervention in the regional development arena, as in other areas, is that government policy may succeed where banks, entrepreneurs and other private organizations do not. In this case, the usual story is one of capital-market failures. Fledgling businesses may find it difficult to obtain private financing if banks worry about default risk and local sources of finance are undeveloped.[4] If investment subsidies are to be an effective use of scarce government resources, however, then they must be targeted at investment projects that would not be undertaken in the absence of such assistance. However, there are

4 However, at least some research suggests capital markets may suffer instead from over-lending, rather than credit rationing (Boadway et al., 1998).

many reasons to believe that a significant fraction of projects financed through ACOA is not incremental in this sense.

For one thing, administrators inevitably lack sufficient information about companies to know their true investment intentions. Incrementality requires that program administrators observe what investments companies would undertake — and investors support — in the absence of subsidies. Of course, incrementality could be guaranteed by funding projects that were clearly non-viable, but this hardly makes for good policy. The real challenge, therefore, is to determine which projects are best among those that would not be funded by the market — a significant challenge for any program administrators, no matter how well intentioned and well informed.

The actual success of ACOA in this regard is difficult to gauge because there is little real cost-benefit analysis of the grants. ACOA itself estimates that 84 percent of jobs funded under its flagship Business Development Program are incremental (ACOA 2003). But that figure is calculated by comparing employment growth of assisted companies to a sample of other companies in the region. Since ACOA's aim is to finance economically viable enterprises, however, it is not surprising that assisted companies grow faster than average, and the approach tells us little about what would have happened to these companies in the absence of grants. A full study would have to use a methodology to account for the potential displacement of resources to subsidized from unsubsidized sectors of an economy. ACOA also provides estimates of the net impact of its activities on Atlantic GDP, using a macroeconomic simulation model. But evidence from other sources indicates that the number of new jobs created is relatively small, and that the costs per job created are high. One government study examined the Cape Breton Investment-Tax Credit, a federal program established in 1985. While this program was delivered as a tax measure rather than a spending program, companies were required to apply for assistance and eligibility was at the discretion of program administrators. In other words, CBITC operated in a way that was quite comparable to ACOA's company-specific grants. The government study estimated that only about 20 percent of investment projects funded by CBITC were truly incremental. As a result, the cost of the program was quite high relative to ostensible benefits — the foregone tax revenues under the program were equivalent to an estimated one-time payment of $700,000 per job created (Department of Finance 1990).

Even if funding is confined to projects that are truly incremental in this sense, they may still have undesirable economic effects (Usher 1994). These include:

- Bad projects that receive support may drive good ones out of the market through direct competition in product markets by bidding up local wages, rents and capital goods prices — and so crowding out development of viable local markets.
- Because assistance is usually delivered through capital subsidies, it can create inefficiencies in local production techniques, inducing greater reliance on capital and less on labour than is warranted by the true costs of factors of production. (Indeed, the bias towards capital induced by investment subsidies is especially costly in a region of persistently high unemployment.)

- Studies have also shown that prices of land and capital goods might rise with targeted subsidies, thereby reducing the incentive effects of the program since costs escalate (McMahon 2000b).
- Finally, the administrative overhead of the programs and the deadweight costs of raising tax revenues must also be included in the overall cost-benefit analysis of the programs.

Again, direct evidence for these considerations is difficult to come by. In one apposite study, Bergstrom (2000) looked at the effects of company-specific capital subsidies directed at less-developed regions in Sweden. Comparing companies that received subsidies to those that did not, he found that grants did indeed help with expansion, in the sense that the value-added aspect of assisted companies subsequently grew more quickly. More importantly, however, Bergstrom found no evidence that grants affect productivity growth in assisted companies. Indeed, one year after the grant is paid, productivity of components in assisted companies appears to grow more slowly than in the non-subsidized group.

Some countries, particularly the East Asian Tigers like Singapore and Korea, have used industrial policy to expand successfully in the past, and have done so by targeting particular sectors and companies. But these have been very much the exception to the rule, and even in those cases, governments usually delivered assistance through the tax system, rather than through direct spending programs. Since the Asian financial crisis of 1997, some doubts have arisen about the success that the tigers have really had in using targeted tax cuts or subsidies to achieve economic development. Some areas, such as Hong Kong and Chile, have avoided targeted subsidies and still experienced strong growth, although expansion in Hong Kong and some other Southeast Asian countries stalled after 1997.

Still, the evidence that targeted subsidies are successful in generating income is hard to come by (Mintz 2001). Naturally, proponents might point to growth of a particular subsidized business or industry. However, the impact of such measures on the aggregate economy are much harder to judge because subsidies in one sector might displace resources from others, reducing the tax revenues needed to fund the subsidies.

Infrastructure Grants and Agglomeration Economies

A special challenge for development in have-not regions is that they lack what is known as the *agglomerations* of skilled labour and capital, and the access to consumer markets that help make new investment profitable. An old justification for government industrial policies, lately somewhat resurgent, is that they can help underdeveloped regions to exploit a virtuous cycle of growth, in which initial strategic investments create an environment in which investment is more profitable for all. Rosenthal and Strange (forthcoming) provide a good survey of current research on the role and extent of such agglomeration economies in urban growth. The initial evidence is intriguing and contains some lessons for the role of industrial policy.

For one thing, if urban economies of scale are an important part of the growth phenomenon, then even greater agglomeration of economic activity is an inevitable consequence of growth-enhancing policies (Martin 2000). That is, the best growth-enhancing policies will probably also raise inequality within the Atlantic region, and will involve more, not less, movement of labour from rural to urban areas within the region. Viewed in this light, ACOA's propensity to direct much of its assistance to the poorest and least industrialized parts of the region must be seen not as part of a growth strategy for the region, but rather as a very inefficient kind of social policy.[5]

For another, the existence of agglomeration economies indicates that certain investments in public infrastructure, particularly transportation, may play an important role in spurring growth. Infrastructure spending has been part of the mantra of Liberal politicians in Canada since the Red Book promises of 1993, and it is now a big part of the mandate of ACOA, too. Initially, the federal government's emphasis on infrastructure received much intellectual support from research showing that public capital had strong positive effects on growth in local economies.[6] But, as Crowley (2000) has argued, much of what is delivered on the rubric of federal infrastructure programs – in Atlantic Canada and elsewhere – is really about expenditures for current consumption and community development, and not at all about investment in productive public capital.

The Politics of Regional Development

Inevitably, the way in which subsidy programs are allocated among companies and localities in the eligible regions is at the discretion of officials, and decisions on allocation are rarely transparent. This raises the spectre that funding decisions reflect the political calculus of the government of the day as much as legitimate economic development objectives. Allegations of political interference in individual granting decisions have been made about ACOA and the other regional development agencies (Haddow 2001). Of course, such evidence is anecdotal at best. Here we offer a more systematic look at the politics of ACOA grants.

To get at these issues, we obtained data on ACOA spending for the fiscal years from 1987/1988-to-2001/2002.[7] The data set covers transfer commitments under all programs administered by ACOA, including the various federal infrastructure programs instituted since 1994; thus, a significant fraction of spending was paid to local and provincial government agencies, as well as to businesses. Further details on the construction of the data set are given in an Appendix.

Figure 1 shows the agency's total transfer commitments on a calendar year basis from 1988 through 2001. Transfer commitments excludes administrative costs and are prior to actual spending.The level of annual spending has varied widely,

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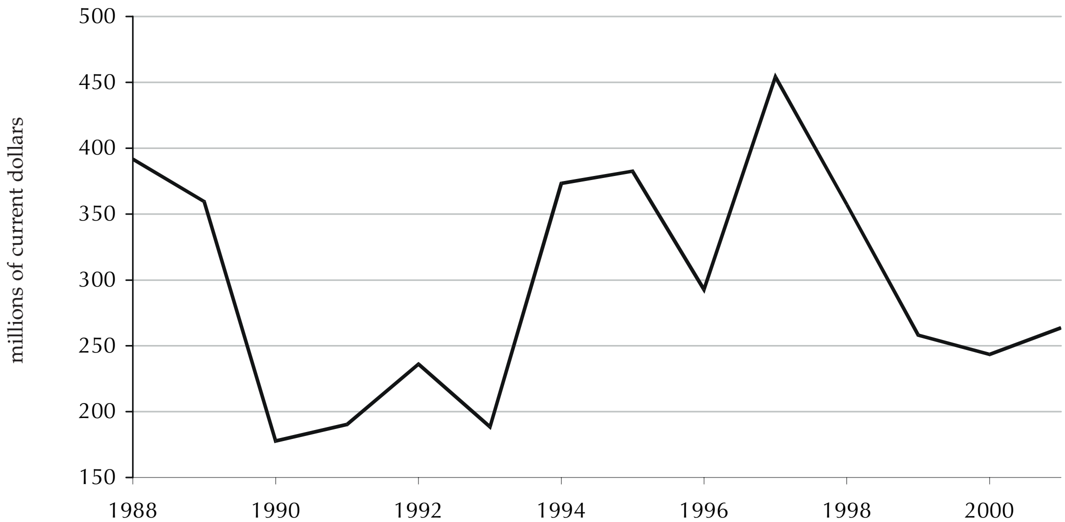
5 Related, recent research has also questioned the effectiveness of regional transfers in achieving the overarching goal of catch-up for poor regions. Puga (2000) argues grants under the Structural and Cohesion Funds in the European Union, comparable to ACOA, have had no discernable impact on the convergence of growth and incomes among Europe's regions. McMahon (2000a) makes similar arguments for Atlantic Canada.

6 More recent reassessments have called into question the statistical basis for the earlier research, however, and the rate of return on public capital may on average be no different than on private investments. See Gramlich (1994) for a survey and discussion.

7 The data were obtained from government sources by the Canadian Taxpayers' Federation. We thank CTF Research Director Bruce Winchester for access to and assistance with the data.

Figure 1: *Total Transfers (grants and contributions), committed by ACOA*



ranging from about $180 million in 1990 to a high of $450 million in 1997. The data show clear peaks in spending in 1988, 1994/1995 and 1997, with a leveling out of spending in 2000 after the preceding decline. Interestingly, these peaks and plateaus correspond closely with the election years 1988, 1997 and 2000. (The exception is the 1993 election. A small run-up in spending occurred in 1992, with a significant increase following, rather than preceding, the election.) Thus, there is some evidence that total funding for ACOA is used to prime the electoral pump.

Does the geographic allocation of spending reflect other political factors? Perhaps. Figure 2 shows the average level of annual spending commitments in ridings with Liberal, Conservative, and New Democratic Members of Parliament. The data show that federal Conservative governments in the 1988-to-1993 period spent slightly more in government than in opposition ridings. (The difference is, however, statistically insignificant.) The pattern is considerably strengthened for Liberal governments of the 1994-to-2001 period. Annual spending in government ridings exceeded that in opposition ridings by about $2.5 million, or 40 percent, on average. This difference is statistically significant, even when controls for economic and demographic differences among ridings are included. The difference may be deceptive, however: In part, it reflects the high level of spending during the 1994-to-1997 period, when the Liberals held all but one seat in Atlantic Canada. As a rule, it is difficult to distinguish between the claim that spending favours government MPs and the possibility that high spending merely happened to coincide with the period of the Liberals' greatest electoral success.

In any case, political influence on spending patterns need not result in greater spending in government ridings. Instead, governments may tilt grant allocations in order to buy votes of undecided voters in future elections. If so, spending should be higher in ridings — whether held by government or opposition parties — where the margin of victory in previous elections was small. In such ridings, spending is more likely to influence the outcome in the next election and is more valuable for election purposes. To examine this possibility, we next look at

Figure 2: *Average ACOA Spending per Riding by Party of Incumbent*

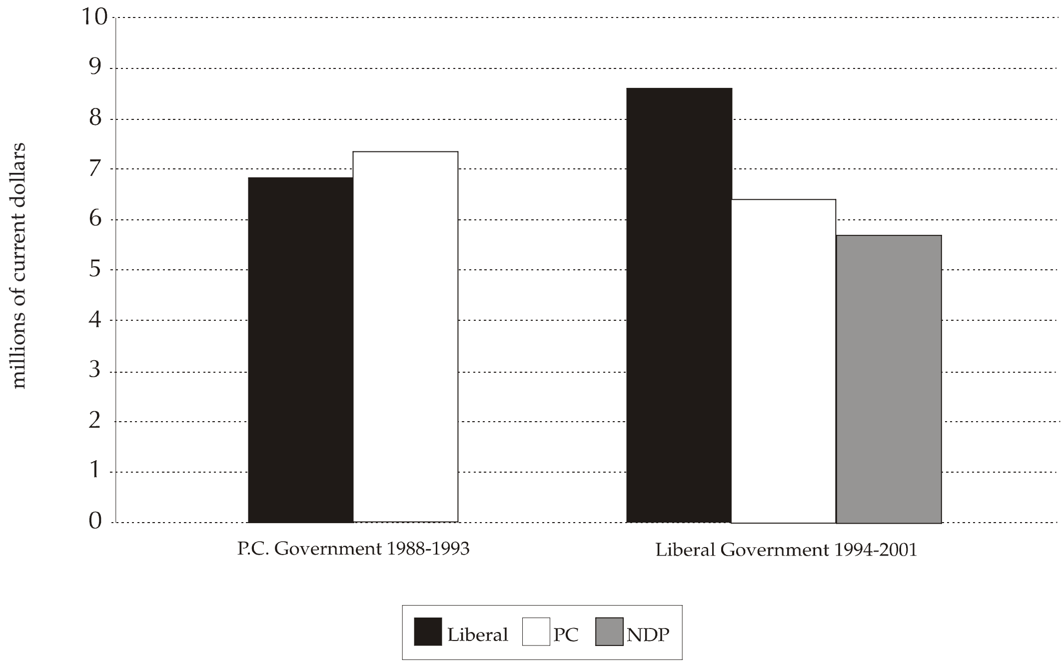
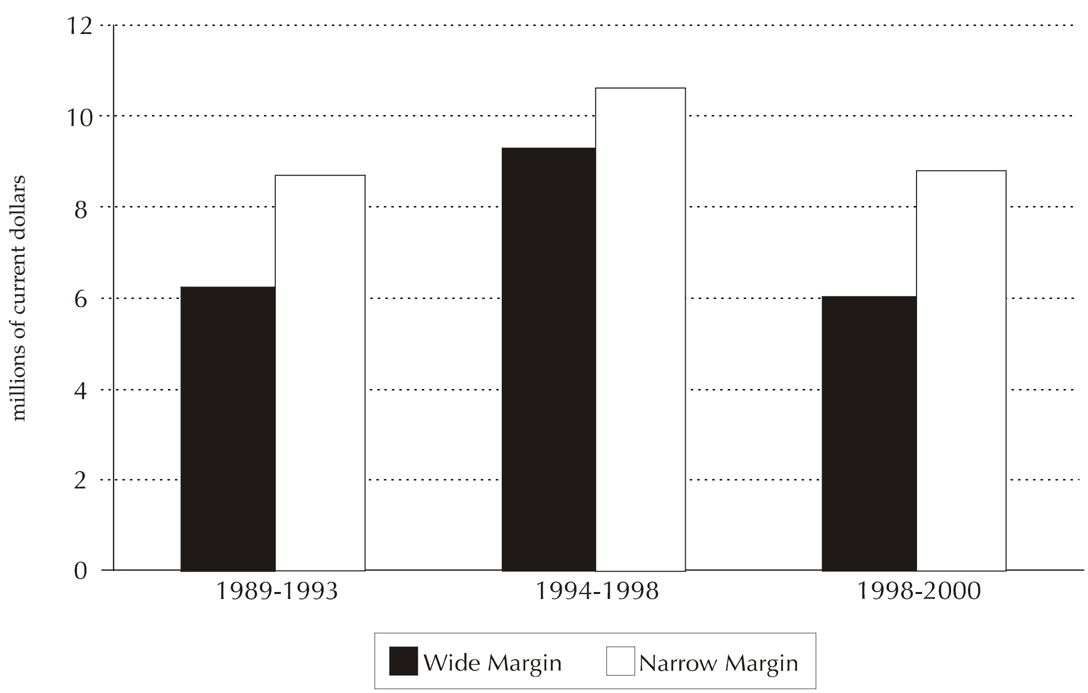


Figure 3: *ACOA Spending per Liberal Riding by Previous Margin of Victory*



Note: Narrow margin ridings are defined as the 25 percent of Liberal ridings with the smallest margins of victory.

spending in Liberal ridings in which the race was close — the 25 percent of such ridings with the smallest margins of victory in the previous election — versus other Liberal ridings. (By examining only Liberal ridings, we control for the patronage effects considered earlier.) As shown in Figure 3, spending during each electoral cycle has been consistently higher in ridings with narrow margins than in those with wide margins.[8]

These preliminary data are suggestive of political motivations in the level and allocation of ACOA spending, with some evidence that regional development funds serve political purposes and are awarded disproportionately to government ridings. Evidence of political motivations is especially troubling because they will tend to undermine the productivity of the grants, in the sense that the money is not being put to the best economic purpose. Our preliminary evidence is not, of course, conclusive. In particular, spending decisions are undoubtedly related to a number of economic and demographic factors, such as poverty, unemployment rates and the degree of industrialization, which are distinct from, but correlated with, the political variables. For more detailed analysis of the data, the interested reader may wish to consult Milligan and Smart (2003), which considers economic as well as political determinants of regional development spending in both Quebec and the Atlantic provinces, and which employs a more elaborate statistical methodology. The analysis there suggests that ACOA spending is abnormally high in ridings that are electorally competitive and that are represented by senior members of the government.

Grants vs. Tax Cuts

If discretionary spending programs are a bad way to deliver regional development assistance, then what is the alternative? Some commentators have suggested that direct spending programs be replaced by tax reductions for companies investing in the region. Admittedly, tax measures have costs as well as benefits when compared to direct spending. The case for tax cuts in place of grant programs depends, in part, on the type of tax cut being considered — targeted or broad-based.

Some tax cuts, such as investment-tax credits, tax holidays, flow-through shares or tax-free zones, can be targeted to specific companies, activities, and types of investment. Consequently, they may share some of the economic costs arising in grant programs. Like grants, targeted tax cuts are chosen by governments trying to pick winners or gain votes. Instead, targeted tax cuts possibly result in the subsidization of uneconomic activity that replaces unsubsidized profitable activity. They may also lead to higher asset prices, without spurring new activity and leave less revenue available to fund basic public expenditures like education and health.

Broad-based tax cuts are not aimed at particular activities and therefore benefit the economy more generally. However, as an instrument to achieve certain aims, such as building infrastructure or supporting education, the broad-based tax cut is unable to achieve certain aims without costing significant revenue.

8 Indeed, examining annual data shows that spending in close ridings has been higher in all years since 1988, but the effect is strongest in 1994, 1997, and 2000.

Grants vs. Targeted Tax Cuts

Grant programs provide certain advantages over targeted tax cuts for three reasons: accountability, broader application and cost control.

- Grant programs are scrutinized by Parliament or provincial legislatures as part of their review of public accounts. The programs are also subject to review by the Auditor General at the federal or provincial levels. Targeted tax cuts, like investment-tax credits or allowances, are not similarly reviewed and are therefore less subject to accountability procedures. The Department of Finance does review certain tax expenditures, although the reviews are not selected by a legislative committee and are not given the same scrutiny as a program reviewed by the Auditor General.
- Grants support projects regardless of the taxpaying status of the company. Tax cuts may benefit those that pay taxes at a particular time – those businesses with losses for tax purposes are unable to use the incentive until they begin paying taxes. Some entities, such as non-profit organizations, charities and crown corporations, may not benefit from targeted tax cuts at all.
- The program costs associated with grants is fixed according to the government's budget. Program costs can run in excess of original budgets (as with the burgeoning expenditures on the federal gun registry), but parliamentary approval is necessary and the management practices of bureaucrats operating the program are therefore exposed to public view. Tax incentives, however, are open-ended, with costs depending on the number of qualifying businesses. The costs of operating the program are therefore less certain and less subject to review.

The case for targeted tax cuts is argued on other grounds, as well. For one thing, tax relief benefits the successful enterprises because only profitable companies pay taxes. Unless the tax relief, such as the investment-tax credit, is made refundable, with the government paying money to non-taxpaying businesses if they cannot claim the benefit, the tax relief is targeted to the companies most likely to succeed. For another, because tax cuts are open-ended, they are less subject to political considerations and more certain in application since the rules for qualification are better known.

However, the open-endedness of tax-cut programs leads to a different concern. When governments provide tax assistance to fledgling companies to offset capital-market failures, the resulting new entry into the market can undermine the profitability of existing, high-quality businesses (Mintz 1997). The result is not to improve market performance, but to worsen it, as high-quality companies find it more difficult to raise capital. Studies indicate that many policies supporting the financing of businesses through the tax system seem to attract poor quality companies, rather than improve profitability. These policies include stock-savings plans to assist financing small businesses (Suret and Cormier 1997), labour-sponsored venture capital (Cumming and MacIntosh 2002) and flow-through share financing (Jog, Lenjosek and McKenzie 1995). Targeted tax cuts can therefore weaken rather improve market performance.

Grants vs. Broad-Based Tax Cuts

Cogent arguments can be made both for and against grants or targeted tax cuts. But a better alternative than either, we argue, is to replace ACOA with a broad-based corporate tax cut in the Atlantic region.

Universal tax cuts are appealing for several reasons. The cut applies more generally and neutrally so that many taxpayers are given incentives to work, make investments and heighten productivity. Supporting arguments are based on the principle that the tax system is most efficient and fair if businesses bear similar tax burdens (Technical Committee on Business Taxation 1998). With neutrality, the economy can best reach its potential as businesses and entrepreneurs allocate resources to their most economically productive uses rather than to those favoured by the tax system. Since most taxes, especially the corporate tax, impose significant economic costs on the economy (Dahlby 2002), a broad-based tax cut can be the tonic for an economic boom.

Recent experience in Ireland where the government cut corporate taxes for manufacturing and financial-services income in the 1980s, and more generally for all businesses in the 1990s, indicates that broad-based tax cuts could be critical to improving per capita incomes. Ireland has been the fastest growing OECD economy in the past two decades, with its per capita GDP increasing sevenfold (Canada's per capita GDP doubled in the same period). Although other relevant policies were also critical, including gaining access to the European Union for trade and investment of resources, receiving European regional subsidies and increasing investments in education to improve population skills, the corporate tax cuts certainly helped attract multinational investment and profits to Ireland (Honahan and Walsh 2002).

The Irish experience with large scale corporate tax cuts is frequently cited by proponents of major federal corporate tax reductions for Atlantic Canada in place of ACOA grants. With the savings in ACOA payouts used to pay for a major corporate tax cut, taxes on capital investments could be significantly reduced, increasing the incentive to invest in up-to-date capital goods that would enhance labour productivity and spur wage growth.

Looking for a Better Way

In our search for a better approach to regional economic development, we have come to the conclusion that a more neutral, broad-based tax cut would achieve more balanced growth in the Atlantic, compared with targeted funding of certain virtuous businesses selected by the government of the day. Such a reform could be implemented in two ways — as a general cut in the federal statutory tax rates applied to Atlantic income, or as a broad-based incentive for capital investments in the region.[9]

9 Although we believe that a revamped Atlantic investment-tax credit is superior to ACOA business grants and a proposal to cut federal corporate income-tax rates for the Atlantic region, we suggest that broader tax reform, in which lower corporate tax rates, coupled with better tax bases reflecting economic income, are provided for all Canadian investments, would be superior overall to programs put in place for only one region. However, since a wider reform is not consistent with a regional-based program, we do not consider this as an option.

In either case, we consider situations that involve replacing ACOA grants to businesses of $250 million annually with tax expenditures of equal value. The figure used is arbitrary and reflects a conservative estimate of the average value of transfers from the agency in recent years. Our use of this figure does not reflect any assessment of the appropriate level of federal support for regional development, rather it is pragmatic assumption that if a major change in federal strategy were implemented, it would most likely occur on an expenditure-neutral basis.

Corporate Tax-Rate Cut

Currently, federal corporate income tax applies at different rates to small and large businesses. A federal rate in 2004 of 21 percent (22.12 percent with the surtax) applies to corporate income earned by public corporations and large Canadian-controlled private corporations (CCPCs above $15 million in assets)[10]. Smaller CCPCs are subject to a tax rate of 12 percent (13.12 percent with the surtax) on profits up to $300,000 (by 2006). Provincial corporate income taxes are also levied on corporate income earned in each of the provinces – on average the corporate income-tax rate is about 15 percent at the provincial level in the Atlantic region.

We estimate that the federal corporate income tax base in the Atlantic provinces is approximately $3.8 billion in a typical year. Therefore, on a revenue-neutral basis, and ignoring the fiscal effects of behavioral responses to the tax change, the federal government could eliminate ACOA net spending equal to $250 million with a corporate income tax-rate cut of 6.5 percentage points for both large and small business income in the Atlantic region. There are several advantages to Atlantic Canada of a corporate rate reduction. It benefits all industries and businesses that pay taxes. Lower taxes reduce the cost of investment projects and increase the competitiveness of businesses operating in the Atlantic region. As well, a lower federal-provincial corporate income-tax rate — about 30 percent — would be substantially below the statutory rates of other provinces and somewhat below the OECD average corporate income-tax rate (Mintz and Chen 2000). A low corporate income-tax rate will attract companies with high profitability, as well as signal investors that a region is conducive to investment (Technical Committee on Business Taxation 1998). And a low corporate income-tax rate will provide incentives for businesses to shift taxable profits through financial and other transactions from high-taxed jurisdictions to the Atlantic, without moving business components, such as labour or capital.

In Table 1, we provide a comparison of effective tax rates on capital held by large businesses for the four Atlantic provinces. Assuming no change in provincial tax policies,[11] the cut in the federal statutory tax rate by 6.5 percentage points would substantially reduce the effective tax rate on capital, especially for the

10 The value of assets is determined in accordance with taxable capital of a corporation under the large corporations tax.

11 Such an assumption is not innocuous. Provincial governments might respond to a federal rate cut by increasing their own tax rates, effectively converting the tax measure into an intergovernmental transfer. Presumably, an explicit federal-provincial agreement would be needed to achieve the objective.

Table 1: *Effective Corporate Tax Rates on Capital for Large Corporations*

	Effective Tax Rate as Expected in 2008	Cut in Corporate income-tax rate by 6.5 Percentage Points	Broad-based Atlantic Investment-tax credit at 10.5%
Newfoundland	16.8	12.9	-8.1
Prince Edward Island	23.4	19.6	6.4
Nova Scotia	21.1	15.0	1.9
New Brunswick	21.0	15.8	2.8
Canada	27.4	27.2	26.6

Note: Corporations are assumed to be fully taxpaying. Therefore, any tax losses or tax credits provided for marginal investment can be fully claimed against taxes paid on infra-marginal investments.

Source: International Tax Program, Institute of International Business, University of Toronto.

higher-taxed investments. The Atlantic region would have an effective tax rate on capital that would be half the level found on average in Canada.

While a lower corporate income-tax rate is appealing on these grounds, some troubling issues make it less appealing as a policy prescription at the federal level.

For one thing, a lower corporate income-tax rate benefits owners of new investment projects, as well as owners of existing assets. A cut in corporate income-tax rates therefore confers windfall gains on owners of old investments, which increases the cost of providing incentives to capital. While we note the importance of this issue, the figures in Table 1 show that a rate cut would still result in a substantial decrease in the after-tax cost of new investments, especially over the long run.

Another concern is that federal policy, discriminating in favour of the Atlantic region, could impose an unfair tax burden on other provinces, without necessarily causing any change in economic behaviour. In particular, the lower federal corporate income-tax rate would encourage businesses to use financial and other transactions to shift income from provinces with high corporate statutory tax rates to the Atlantic region.[12] Without moving machines or people, a company could reduce its total tax burden through a strategy of borrowing by subsidiaries in high-tax provinces and a reduction in debt carried by Atlantic subsidiaries. Mintz and Smart (2003) estimate that a cut of one percentage point in the corporate income-tax rate by a single province causes an 8 percent increase in the corporate tax base due primarily to income shifting.[13] As a result, other provinces would bear some of the cost of providing lower federal corporate income-tax rates to the Atlantic region. It is one thing for the provinces to lower rates but it is another for the

12 There would also be income shifting into the Atlantic region from other countries by multinational corporations, which would be a positive gain from the perspective of Canada. Honohan and Walsh (2002) report that transfer pricing and financial transactions that have shifted income into Ireland have significantly affected Ireland's per capita growth in GDP.

13 The estimate of income shifting includes both the impact of shifting production to the low-taxed area, as well as moving the income base through financial and other transactions. We believe that the latter tends to dominate in our estimates because tax effects on investment would be expected to be smaller than what is implied by our estimates of income shifting.

federal government to provide opportunities for income shifting under the federal corporate income tax.

Not only that, under the federal equalization formula, an increase in the share of corporate taxable income declared in the Atlantic region would raise the measured fiscal capacity there, inducing a decline in equalization payments equal to 100 percent of the new provincial revenues. Given the potential for income shifting, a low federal tax rate for Atlantic Canada might cause a marked increase in corporate tax bases in the region, without an increase in provincial revenue net of equalization. While corporate rate reductions would encourage greater investment and job-creation in the Atlantic region, some of the impact would be lost because of income-shifting activities in which businesses move profits from high-tax jurisdictions to the Atlantic without increasing investment.

What About a Broad-Based Investment-Tax Credit?

An alternative to statutory rate cuts is to provide tax incentives for investments on a broad basis. One approach is accelerating tax depreciation deductions for fixed assets, which would increase their value and lower the cost of capital for investments in structures and machinery. Although the incentive would provide benefits to taxpaying businesses, others that are written off already at fairly fast rates for economic reasons would not benefit from the policy.

A different approach to accelerated depreciation is to provide an investment-tax credit. Compared to accelerated depreciation, the advantage of the investment-tax credit is that it provides an upfront incentive for a business that is able to claim a percentage of the cost of investment against taxes owing. Further, some assets are already highly depreciated because the economic life of the asset is short. Accelerated depreciation would not provide benefit to the user of those assets that are already written off quickly. In principle, the investment-tax credit can be made wholly or partly refundable so that a business not currently paying taxes can still receive the credit as a refund from the government.

An investment-tax credit can also be provided at a single or differential rate for the purchase of structures, machinery and the acquisition of depletable assets. The advantage of the differential rate is that it recognizes that assets with shorter lives benefit more from the investment-tax credit because greater turnover results in larger claims for the investment-tax credit over time. As a result, structures should be given a greater investment tax-credit rate than machinery because machines have the shorter useful life.

Currently, the federal government provides a 10-percent tax credit for investments in the Atlantic region and some qualifying eastern Quebec regions. However, the investment-tax credit is primarily targeted to resource and manufacturing industries and some capital goods are excluded from eligibility. For example, manufacturing investments eligible for the 10-percent Atlantic Investment-Tax Credit earn credits at an effective rate somewhat higher than 8 percent. About half of the Atlantic Investment-Tax Credit program has been paid to the oil and gas sector. However, service industries do not qualify for the credit and that results in a biased incentive towards resource and manufacturing sectors, even though services are a fast-growing sector in most modern economies.

The federal Atlantic Investment-tax credit needlessly tilts economic development in the region away from the service sector and creates disincentives to invest in the several asset classes that are excluded from eligibility. Because of the importance of the service sector to economic growth and the fact that such services have become more internationally competitive (Technical Committee on Business Taxation 1998), a new approach to the Atlantic Investment-tax credit is needed.

The elimination of ACOA business grants would provide an opportunity to reform the Atlantic Investment-Tax Credit to make it broader in application and more neutral. The elimination of $250 million in the ACOA budget could be added to the existing cost of $100 million for the tax credit to broaden its credit base and enhance the rate. We estimate that a 10.5 percent non-refundable Atlantic Investment-Tax Credit could be provided to all industries and capital goods on a broad basis while maintaining budget balance.[14] If the tax credit were made refundable for businesses, the rate would have to be lowered to 6 percent to maintain the same revenue cost for the federal government.

This Atlantic credit would substantially reduce effective tax rates on new investment projects (see Table 1). Compared to corporate rate cuts, the broad-based Atlantic investment-tax credit is directed more specifically at new capital projects, with a greater impact in reducing the effective tax rate on capital for the same revenue cost as corporate rate cuts.[15] As well, the possibility of income shifting under the investment-tax credit is much reduced because only businesses purchasing capital goods can obtain the credit–shifting profits from high-tax jurisdictions.

However, the investment-tax credit is less neutral than corporate rate cuts. A flat-rate Atlantic investment-tax credit favors machinery assets substantially over other investment expenditures like structures, land and inventory. To improve the neutrality of the tax credit, a lower credit rate could be provided for machinery relative to structures and some allowance could be considered for inventory and land investment expenditures.

Conclusion

While the mandate of ACOA is to improve economic growth and employment in the Atlantic region, the impact of its activities has questionable effects on the economy at a relatively significant cost. In part, the effectiveness of ACOA is hampered by politics because governing parties seem to use spending to influence

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14 In our estimates, we account for the reduction in annual tax depreciation claims that are based on the cost of assets net of investment-tax credit claims and government capital assistance. We also take into account that 40 percent of businesses are non-taxpaying. Estimates of Atlantic private capital investment are taken from Statistics Canada capital expenditures in the private sector net of housing expenditures (approximately $6.6 billion in 2002).

15 The third column of Table 1 includes the effect of reallocating the $100 million tax expenditure of the existing AITC, as well as the $250 million new tax expenditure considered in the second column of the table. This difference has only a minor impact on effective tax rates in aggregate, although much larger differences would be observed for particular industries and asset classes.

marginal ridings in their favour. Even if politics did not influence ACOA spending patterns, grant programs will not have much impact on economic growth if they are targeted at inefficient businesses that drive out more efficient ones, result in higher prices of components used in production or provide funding for businesses that would have undertaken the activity anyway.

A regional development policy more likely to be successful, in our view, is a broad-based corporate tax cut in the Atlantic region. A proposal heard from some quarters in Atlantic Canada is to cut the federal corporate income-tax rate for large and small businesses that would bring effective Atlantic tax rates on capital to about half the level found elsewhere in Canada. However, we believe that this policy would lead to substantial shifting of income from other provinces into the Atlantic region, without necessarily increasing capital investments there. A better alternative is one that is more directed at investment. We propose that the current federal Atlantic investment-tax credit should be revamped into a broad-based measure that applies to all industries and capital goods, and expanded in size to offset the loss of ACOA payments. The effect of the policy would be to virtually eliminate taxes on marginal investment projects in the region. That is a reform that could redraw the economic contours of Atlantic Canada.

Appendix: Data Construction

The spending data we use cover all commitments from 1978 to 1988 to transfer payments under programs administered by ACOA, and were obtained from the agency at the request of the Canadian Taxpayers' Federation. The data provide the name and municipality of the transfer recipient, the date, and the amount committed by ACOA. To calculate spending in each federal riding, we first linked names of Canadian municipalities and census subdivisions to federal ridings using information from Statistics Canada (for CSD names) and Elections Canada (for their municipal place names). When parts of a municipality were located in more than one riding (including St. John's, Halifax, Sydney, and a few others), and when the municipality was missing from a record, we searched for the postal code of the recipient's head office using provincial business registries and a variety of other sources. We then linked postal codes to federal ridings using Statistics Canada's Postal Code Conversion File.

In calculating the spending totals for each riding, we exclude payments to provincial government offices, and to province-wide business associations and NGOs. These payments are likely to have a wide impact within the region, rather than being confined to the federal riding in which the organization's offices are located. However, the data on total transfers commitments, depicted in Graph A, include payments to all recipients.

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