

IS THE BOTTOM LINE “IMPACT” OR PROFITS? A REJOINDER

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There are two very different views about the value of subsidizing otherwise unviable businesses in declining regions of the economy. One view emphasizes that an economy cannot succeed by investing in money-losing businesses. Kristian Palda, professor emeritus in the faculty of business at Queen’s University, recently wrote of the Export Development Corporation of Canada: “The logic is that by bleeding healthy parts of the economy to coddle non-performers, Canada will breed efficient businesses, or businesses that serve some vaguely defined national interest” (Palda, 2000).

The second view was exemplified by the Premier of Quebec, Lucien Bouchard, when he spoke in 1998 of the “boost” that the economy of Quebec had received from spending to repair the ravages of the great ice storm. The repairs made the provincial gross domestic product figure look good for a year or two. The “impact” was a higher “growth” rate. GDP numbers are key, even if the activity is debt-supported and profits and wealth have taken a beating.

The article “Evaluating Policy Outcomes: Federal Economic Development Programs in Atlantic Canada” is an extreme version of the second view. Not only does it claim that it is costless for the federal government to tax the prosperous areas of Canada to provide subsidies to business in depressed areas, it is actually profitable. The authors state that, in 1997, the federal government reaped approximately five times as much in tax revenues “resulting from ACOA expenditures” as it made in grants.

Over the period of the study, manufacturing employment in the Atlantic provinces dropped 18.1%, and business employment overall fell by 6.1% (figures 5 and 6). What is the explanation for the disparity between the rosy view of a great success of subsidies in Atlantic businesses and the disastrous economic bottom line? The authors argue that the non-subsidized part of the economy performed

much worse than the subsidized part, and the success of the subsidized businesses offset the losses elsewhere. They state that in 1997 approximately \$8.2 billion (1997 dollars) of Atlantic Canada's Gross Domestic Product of \$45.3 billion "resulted from ACOA programming" (Figure 2) — about 20% of the whole economy.

This seems implausible. It is unlikely that subsidizing projects that are not otherwise viable will have such great economic benefits.

FREE MONEY

A key assumption by the authors is that the money ACOA disburses is costless. This does not seem a reasonable assumption for a federal government agency to make. The source of funds is either federal tax money or foreign borrowing and neither is costless.

In addition to the obvious cost, there is a "deadweight loss." It costs the federal government about \$0.50 to collect, administer, and spend every tax dollar. Therefore the "opportunity cost" of a tax dollar is approximately \$1.50. So the legitimate comparison is between the benefits that would have been generated if the \$1.50 had been left in a profitable business and the benefits generated by \$1 granted to subsidize a business in a depressed area.

MULTIPLIERS

The analysis not only ignores the cost side but also applies an "economic multiplier" of 1.4 to the benefits side. This increases the benefit to take into account "induced and indirect employment effects." However, no attention is paid to the fact that the "multiplier" on the cost side is certainly larger since, on average, the taxes come from the more economically dynamic parts of the Canadian economy.

THE "IMPACT" DOUBLE ENTENDRE

Although the authors state that "over the ten years of its operations, every \$1 of ACOA spending generated \$5 of GDP impact," a 500% return in 10 years seems unlikely from subsidized investments. The explanation is probably in the use of terminology. The \$1 in subsidy is called the "cost." The \$1 of subsidy plus \$4 in business costs covered from other sources of financing is called the "impact." Then this impact of \$5 is talked about as if it were a "benefit."

However, the whole \$5 is economic cost. Speaking of impacts implies benefits, but nowhere in the analysis do the authors demonstrate that there are any actual profits at all from these subsidized businesses.

CROWDING OUT, POISONING THE WELL, AND THE INCOMPETENCE TRAP

In the long run, tax-and-spend will crowd out private investment. Some of the investment crowded out will be in Atlantic Canada, but most would be in other regions depending on the distribution of taxes.

The federal government also runs two other risks — first, “poisoning the well” whereby subsidized businesses make it impossible for competitors to operate without a subsidy themselves, and, second, the “incompetence” trap whereby the best business talents are diverted away from competitive enterprises and towards harvesting subsidies.

It is worth considering the incentives set up by a system of business subsidies. If the investment is viable by itself then it is not eligible for subsidy. If it is not viable, then it can get a 20% subsidy. Consider two investments:

- A normal business project that generates \$10.50 each year for costs of \$10 (a profit of \$0.50 on an investment of \$10)
- A money-losing project that generates only \$9 for the same costs of \$10, but gets a \$2 subsidy (a “profit” of \$1 on net costs to the business person of \$8).

The business person gains by pursuing the subsidized project, but the economy loses.

OTHER METHODOLOGICAL PROBLEMS

Jobs and GDP

The federal government has rules-of-thumb for translating an increment of government spending into an estimate of “jobs created.” Statistics Canada’s input-output tables are used as the basis of these estimates. However, it is a misuse. The input-output tables are a static model, not a dynamic model. That is, they provide a snapshot

of the economy, but they do not say what will happen if there is an exogenous increase in expenditure in a particular sector or region.

However, the authors cite an approach that reverses the normal procedure, making it even less defensible. Apparently estimates of jobs created were made by surveying the grant recipients. Then the rules-of-thumb were reversed to convert claims of jobs created into dollars of GDP. This is a very dubious procedure.

Misunderstanding Incrementality

When subsidies are given to businesses for particular projects, it is quite possible that the subsidizer never knows the actual use of the money. The World Bank recently made this point strongly (World Bank, 1999). Money is fungible. Consider a business person who without subsidy will make three investments this year: A, B, and C. Given a grant, he/she will do a fourth project, D. However, to get the subsidy he/she will put forward the project that best fits the application criteria — say project B. When he/she receives the grant, he/she goes ahead with the four projects A, B, C, and D. It is the marginal project “D” that is really being supported, although the subsidizer never saw any information on “D.”

Misplacing Incrementality

An estimate of incrementality is somewhat beside the point when the cost side is not considered. Incrementality should be applied to both the cost and the benefit sides equally, not just the benefits. Applied correctly, estimates of incrementality change the absolute scale of net benefit, but do not normally change the ratio of costs to benefits.

Validation of the Research Results?

The article states that the subsidizer had “ensured reliability and credibility of its estimates” (or incrementality and benefits) by commissioning an “independent audit.” However, the work in question was not an audit and did not produce an audit opinion. It was a review by the management consulting side of the firm and was not independent since the terms of reference were drafted and the work paid for by the subsidizer. This is not what independent means.

To their credit, the authors attempt some comparisons between the subsidized businesses and other businesses. However the comparisons are not well-based. The authors refer to a “quasi-control group” of businesses that were refused assistance after May 15, 1989, when a ceiling of \$200,000 was temporarily imposed on project size. This is not a control group because it was not selected randomly and is not representative of all applications because the size of project is constrained. The authors also speak of a “comparison group” (all small- and medium-sized enterprises in Atlantic Canada). This is not a good comparison group either, again because it is obviously non-equivalent.

The authors state that ACOA “remains the only major department or agency of the Canadian government that has a legislated requirement to evaluate the economic impact of its programming.” This is no longer so. All departments and agencies are required to report their performance to Parliament. The Canadian Food Inspection Agency, for example, is not only required by legislation to present a performance report to Parliament each year as part of its annual report, but the agency is instructed in its founding legislation to obtain an opinion from the Auditor General each year on the validity and accuracy of the report.

CONCLUSION

It is important context to this debate that something has gone badly wrong with the Canadian economy — from rough per-capita income parity and a dollar at par, we have slipped about 30% behind our American neighbours. There are undoubtedly many factors involved. However, slippage on such a scale indicates that we’ve got something big wrong. Our national equalization strategy needs to be reassessed in this light. The Canadian government might want to give subsidies to businesses in depressed areas, but it cannot be done without cost.

REFERENCES

- Palda, K. (2000, March). Quoted in *Ottawa Citizen*, editorial.
- World Bank. (1999). *Assessing aid*. Author.

