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SUPPORT TO BUSINESS IN UNDERDEVELOPED REGIONS MAKES ECONOMIC SENSE: A REPLY

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The reviewer claims, based on wholly subjective evidence, that there is an economic cost to subsidies to businesses in depressed areas. It was not the mandate or purpose of our article to provide a socio-economic benefit-cost analysis of ACOA support to business. Rather, the article measures the effectiveness of the Agency in achieving its legislated mandate of increasing earned incomes and employment in the Atlantic Region. Nevertheless, in responding to the reviewer's criticisms, we hope to provide a convincing argument that government investments in support of Atlantic business can provide a net economic gain to Canada.

The reviewer contends that we have assumed a dollar of ACOA funds to be costless and that the appropriate cost comparison would be the benefits generated by leaving \$1.50 of taxes with profitable businesses. In fact, we do not assume that ACOA funds are costless. We clearly indicate that the impact on GDP is net of the impact of spending the funds on transfer payments to persons — roughly equivalent to a personal income tax cut. Assuming that ACOA funds come from income tax payments and given that personal income taxes make up close to 80% of the total, we would argue that we have used a more appropriate cost comparison than that suggested by the reviewer. Let us consider the reviewer's contention that it costs the federal government \$1.50 to collect, administer, and spend \$1.00 of taxes. Firstly, from the current estimates of the Canada Customs and Revenue Agency, one can derive an average cost of collection of 2–3¢ per \$1.00 of federal income tax revenue. The marginal cost of collecting an extra \$1.00 would be minimal. Secondly, our analysis includes the direct operational costs incurred by ACOA in administering its programs in the expenditures required to produce the measured impact.

We would argue therefore that our analysis adequately accounts for the “deadweight loss” issue raised by the reviewer.

The “bottom line” on benefits to society from capital investment equals the value of goods and services (GDP) which otherwise would not have been produced. It goes well beyond profits or private returns to the investor. Firstly, in addition to profits before taxes, economic returns include interest payments to suppliers of capital and depreciation. Then there is the labour benefit.

The labour benefit is equal to the wages paid by the assisted businesses less the social opportunity cost of labour (i.e., the economic value to society of the workers’ output in the most likely alternative activity, including unemployment).

The size of the labour benefit depends principally on the extent to which workers are drawn from the ranks of the unemployed or represent new entrants to the labour force. At very high levels of unemployment, all workers are likely to come from the unemployed, though not necessarily directly.

During the 1992–97 period, the unemployment rate for the Atlantic Region as a whole averaged over 14% compared to 10% for Canada. However, 75% of ACOA’s expenditures go to areas outside of major metropolitan centres. In a number of these rural areas, unemployment rates were in the 20–25% range. If one also takes into account the lower labour force participation rates in the Atlantic, the level of unemployed resources relative to the rest of Canada is higher still. It would seem clear then that the labour benefit from expanded business employment levels will be higher in the Atlantic than in the rest of the country.

Some workers will be drawn from other jobs and these jobs may be left unfilled. In this case, the labour benefit can be taken to be the difference in wage levels. It is worth noting that the most recent data indicates that wages paid by ACOA-assisted firms are about 8% above the Atlantic average.

The Agency employs Statistics Canada to track the profits of ACOA-supported firms. The most current estimates indicate a profit to equity ratio of 10%. However, it is worth noting that even in the absence of a private rate of return to investors, a project can produce net benefits to the economy.

As we indicated earlier in our analysis, the multiplier has been applied to the cost side, the increase in consumer incomes through transfer payments. Contrary to the reviewer's contention, benefits from the multiplier effect would be larger in the Atlantic Region than in what the reviewer calls "the more dynamic parts of the Canadian economy." This is so because of the relatively larger supply of unutilized labour in the Atlantic. In the rest of the country, there is more competition for scarce, already employed, labour. As a result, the multiplier effect is likely to be dissipated by wage gains and inflation.

The reviewer bases his case against business subsidies on a number of theoretical arguments (e.g., the incompetence trap and crowding out). These arguments ignore the reality of how ACOA does business and the business investment climate in Atlantic Canada.

As for the "incompetence trap," a fundamental requirement for ACOA support is that the investment must be viable in the sense of providing net economic returns to the Atlantic Region and Canada.

ACOA provides not grants but interest-free unsecured loans. As such, the Agency addresses primarily the problem of inadequate access to capital by Atlantic business. The reviewer's crowding-out argument just does not stand up given the wealth of evidence that the region suffers from insufficient access to capital. Studies by the Canadian Federation of Independent Business (1994, 1997) revealed that the availability of debt financing is lower in Atlantic Canada, and rejection rates are higher than national averages. A study by Thompson and Lightstone (1997) for the Canadian Bankers Association indicated that the loan approval rate was below the national average. Finally, a study by the Conference Board of Canada (1999) concluded:

> The SME debt market appears to be less developed in Atlantic Canada than in Canada as a whole. Indeed, there may be fewer suppliers, less breadth, fewer providers and fewer local choices. This is an important finding, which may suggest an additional role for government agencies whose mandate it is to fill this possible regional financing gap. (p. 10)

One factor behind the access to capital problem is that Atlantic Canada is considerably more rural than the rest of Canada, with nearly 50% of people living in rural areas as compared to less than

25% for Canada. Rural areas are not attractive for banks because they are historically high risk.

ACOA focuses on the most critical areas of this financing gap, such as investments in new technology and trade development, which do not meet the risk (i.e., security) requirements of banks. Far from crowding out investment, the ACOA support brings commercial lending into the investment package by making the project "bankable." Also, ACOA support, at an average of about $100,000 per project, is targeted to investments that do not meet the size requirements of venture capitalists who are looking for projects in the $1 million range and up. In recent years, only 2–3% of Canadian venture capital has been invested in Atlantic companies.

To a lesser extent, ACOA support addresses the problem of cost of capital. For projects which provide net economic benefits but less than normal private returns, the support can provide the incentive for the investor to proceed.

The Conference Board of Canada Model is a general equilibrium model of the economies of each of the provinces with each provincial economy modelled explicitly. It provides dynamic estimates of the impacts of exogenous increases in economic variables affected by ACOA support. This model produces more realistic estimates of indirect and induced activity than input/output models. Because the input/output approach models an economy that is assumed unconstrained in factors of production, the multipliers are unrealistically high. The fact that industry averages for value added per job were used in the model may in fact understate the impact of ACOA support. The ACOA programming enables firms to employ more capital per worker. On balance, this is likely to mean that the marginal product of labour in ACOA-assisted firms would be above the average. In fact, this is borne out by preliminary data from Statistics Canada, which indicates that labour productivity is higher for ACOA-assisted firms than for the industry average.

The incrementality factor is an estimate of the proportion of investments which would not have been able to go ahead as planned without ACOA support. An adjustment for incrementality is necessary whether or not the cost side is accounted for. However, firms in the rest of Canada face fewer barriers in accessing capital from commercial sources than Atlantic firms. Therefore, the incrementality factor to be applied to the cost comparison suggested by the reviewer (i.e., investments from taxes left with profitable businesses) would certainly be lower than the incrementality factor for Atlantic Canada.

Summing up, investments in support of Atlantic businesses can be expected to produce a net economic gain for Canada compared to income tax cuts due to higher incrementality, larger net labour benefits, and larger benefits from the multiplier effect.

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