Chapter 1
Policies That Work

This book is about what works economically – policies and approaches that have succeeded in bringing jobs and growth to economies which once faced crippling problems. Some less-successful economies will also be examined as a point of contrast for what works and what doesn't. In this sense, the book provides a practical guide to policy-makers of what to do and what not to do.

It could also be considered something of a mystery story. Who, or what, beat the dickens out of once dynamic economies in places like the Netherlands, Massachusetts, and Michigan? What medicine did they take to recover from their prosperity-threatening wounds to become stronger than ever before?

In cases like Ireland and the American Deep South, who or what was poisoning the well water, leaving these economies so weak for so long? What changed, virtually overnight, to transform such doddering wrecks into great wealth generators and job creators?

This book examines the star performers in the turn-around game. Just a few years ago, the Dutch and Irish economies were among the walking dead of Europe. Now, they've become two of the most successful economies in all of the developed world. Policy-makers and business journalists have fallen over themselves to coin handy monikers that capture this success. Thus was born the "Celtic Tiger" for Ireland, and the "Dutch Miracle" or "Polder Model" for the Netherlands.

The turn-arounds did not come accidentally or because of some fortuitous resource discovery, but rather because of consistent, deep, and widespread policy changes which reformed the Dutch and Irish economies from top to bottom. These policy changes will be fully examined in the chapters on Ireland and the Netherlands. Virtually the same set of reforms was launched in both nations, though the timing and depth of reform differed.

The extent of the turn-around in these two nations is hard to comprehend, especially that in Ireland. Ireland has 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. Nearly one in five were without work. Ireland's deficit through the early 1980s averaged more than 12 per cent of 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 in an often-successful attempt to lure expatriates back home. The nation's debt melts away each year, and the vanishingly small deficit is less than a third the rate of economic growth. Government revenues have increased despite huge tax cuts. One comparison provides some idea of the speed of Ireland's growth in recent years. 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.

Back in the 1970s, the Dutch were doing so poorly a new term entered the economic lexicon, "Dutch disease". This described the disastrous policy decisions that were strangling the Dutch economy. By 1984, unemployment had soared to over 17 per cent. The economy had been shedding thousands of jobs: between 1981 and 1983, nearly 300,000 jobs were lost. In 1984, 10,000 people were added a month to the unemployment rolls until the number reached 800,000.

Economic growth hovered close to zero through much of the 1980s. Dutch per capita GDP, which once exceeded the OECD average, continually lost ground and in 1980 fell below the OECD average. Dutch finances deteriorated badly. The deficit through much of the early 1980s was nearly 15 per cent of GDP.

The Dutch cure was remarkable. Unemployment has fallen to about 4 per cent, despite increasing participation in the work-force. The number of jobs in the Dutch economy swelled from five million in the mid-1980s to nearly seven million in the mid-1990s, and the number of jobs continues to increase.[1] The Dutch economy has been growing strongly, and per capita GDP again exceeds the OECD average. The Dutch budget is essentially balanced. The deficit is less than 1 per cent of GDP. As in Ireland, government revenues have increased despite tax cuts. The chapter on the Netherlands will examine the causes of Dutch disease and the policy changes that transformed Dutch disease into the Dutch Miracle.

In the United States, the Deep South held a position analogous to that of Ireland in Europe. The South was the perennial laggard, on the periphery of the U.S. economy, as isolated from the real economic action as Atlantic Canada is from that in the Canadian economy today. Georgia was a sleepy state in the deepest of the Deep South, along with its sister states of Alabama and Mississippi. Georgia's backwardness even turned up in popular songs: in "The Dock of the Bay", Otis Redding sang that he'd "left my home in Georgia [and] headed for the Frisco Bay" hoping for better times. Georgia was a "going down the road" state.

The amazing thing is that it requires some effort to recreate this mental picture of Georgia. Today, we think of Georgia as one of the most advanced economies anywhere. Atlanta boasts a spectacular skyline. Many of the world's most dynamic companies are headquartered there. Tens of millions of people see pictures from Atlanta every day on the Atlanta-based CNN. Georgia's economy creates between 100,000 and 150,000 additional jobs each year. Between 1980 and 1996, Georgia's per capita GDP soared from

1. These numbers are from the U.S. Bureau of Labor Statistics, which uses a standardized definition. I use these data to get a consistent measure across differing economies. The Dutch statistics show fewer jobs both back in the 1970s and today.

86 per cent of the U.S. national average to 106 per cent of the national average. U.S. economic growth may have been strong, but Georgia's was that much stronger.

In the 1980s and early 1990s, Massachusetts suffered crippling blows to its essential high-tech sector. Through the 1980s, the minicomputer industry had been the centrepiece of the Massachusetts high-tech sector. That industry essentially collapsed in the late 1980s and the early 1990s, pushed out of the office by personal computers and workstations. The end of the Cold War decimated Massachusetts's huge defence industry. The malaise spread well beyond the high-tech sector. Businesses were collapsing or fleeing the state for any number of reasons, including sky-rocketing taxes that had earned the state the nickname "Tax-achusetts".

By the late 1980s, employment had stopped growing in Massachusetts. In just 12 months – from mid-1990 to mid-1991 – Massachusetts lost over 200,000 jobs. Unemployment soared to nearly 10 per cent, and would have gone much higher if hundreds of thousands of workers had not left the work-force and the state. Here again, the turn-around has been dramatic. Since 1991, the Massachusetts economy has added nearly half a million jobs. Unemployment has fallen below 4 per cent. Workers have an easier time finding a job than employers have finding workers.

Michigan's fall from economic grace was so great that it got a name. Michigan was the epicentre of the U.S. "rust belt". Michigan's economy was built on the automotive industry, and in the 1970s the U.S. automotive industry was headed for a devastating wreck. By the early 1980s, the rustbelt was no mere concept; it was a vivid image of the Michigan landscape, dotted by closed and rusting factories, which had once spun out the state's prosperity. In less than three years, from mid-1979 to the beginning of 1983, Michigan lost nearly half a million jobs. Unemployment soared to 16 per cent. The turn-around has been remarkable. Since 1983, over 1.4 million jobs have been created in Michigan. The state's unemployment rate has fallen to under 5 per cent. That's even lower than Michigan unemployment before the onset of the rustbelt era.

As a point of contrast, the book examines several less-successful economies, to see what marks successful policy off from unsuccessful policy. Louisiana has lagged far behind other southern states, making it a natural choice for comparison. Why has this southern state, the one with the most obvious economic potential – situated at the nexus of one of the world's great transportation routes, the Mississippi River, blessed by immense natural-resource wealth, and benefiting from a large population and domestic market – failed to match the growth and job creation found in its less-well-endowed neighbours?

Maine provides a convenient point of comparison with Massachusetts. Maine tends to go up and down with the Massachusetts's economy, yet it has not fully shared Massachusetts's revival, nor has its convergence towards the national level of economic activity matched the record of other lagging states.

This selection of jurisdictions provides several advantages. It includes economies that have overcome long-term, historic weaknesses (Ireland and the Deep South), as well as jurisdictions which recovered from crippling economic downturns (the Netherlands, Michigan, and Massachusetts).

It provides a taste of the different flavours of today's market economy. Among the Western world's major economies, the United States has the least fettered markets and the smallest government. The Irish and Dutch economies are fundamentally market economies, but they are influenced by powerful corporatist entities representing labour, business and government. These groups can collectively manipulate market signals, particularly labour-market signals. They can negotiate broad agreements on nation-wide wage levels. For this reason, these economies are often classified as "corporatist" (see Appendix).

The mix of jurisdictions examined also provides an interesting range of political settings, from the right-wing environment of the Deep South, to hard-to-classify Irish politics, to the soft-left-wing Dutch milieu, where the 1990s reformist government was headed by a former union leader, who had led the largest federation of Dutch unions.

This selection also makes it possible to distinguish between what might loosely be termed "man-made" economic disasters versus "natural" economic disasters. Both the Dutch and Irish economic problems fall into the first category. Economic problems were largely self-inflicted. The Dutch economy had been one of the most successful in post-war Europe, while the Irish economy, for the first time in its history, experienced strong sustained growth in the 1960s. In both cases, a disastrous policy mix knocked the economy off its growth course.

Michigan comes closest to having suffered a "natural" economic disaster, in that state policy-makers obviously had nothing to do with the onslaught of foreign competition that decimated the automotive industry. Massachusetts suffered from a mix of bad policy and bad times in its technology sector. Georgia sat on a pile of historical weaknesses, not the least of which was racism, which not only deprived the state of the full use of the talents of all its citizens, but also set group against group in an effort, on one side, to protect privilege and, on the other, to achieve fair treatment.

The number of different jurisdictions examined does create one difficulty. Identical data series are not available for each jurisdiction, and this limits data comparisons in some cases. As well, some of the problems and structures will not have exact parallels in all economies. This means each jurisdiction may be painted in slightly different hues.

Despite this weakness, the variation in type of economic problem, economic structure, and political background is important. It raises a most interesting question: Do successful economic polices, in such differing environments, have important elements of commonality that can be applied to other economies?

Costs

Indeed they do. While the type of economic structure and problems examined vary a great deal, the strategy utilized in successful jurisdictions boils down to a surprisingly simple, even obvious idea which can easily be duplicated, albeit in different forms, in widely varied economic jurisdictions. Put simply, the strategy is to reduce costs in the economy to allow investors to reap increased profits, thus encouraging further investment, increased productivity, and, ultimately, higher wages.[2] In the Netherlands and Ireland, this was accomplished through tax reductions, and cooperation between unions, business, and government in holding down wage growth. Even the union leadership argued in favour of wage moderation on the grounds that profits needed to be improved.

A similar story emerges in the United States. Georgia's powerful economic growth has been fuelled by low costs, both in taxes and wages. State governments in Michigan and Massachusetts reduced expenditures and taxes to boost economic growth. Flexible, largely self-equilibrating labour markets in the United States put downward pressure on wages during recessions, reducing costs. This was the same result as was achieved in Ireland and the Netherlands. In the United States, it occurred through market mechanisms. In Ireland and the Netherlands, it was accomplished through an explicit policy decision, supported by unions, to rein in wages in favour of profits.

All this – lower taxes, wage moderation – opened more room for profits, which attracts further investment. Higher profits provide investors with the means for further investment and the incentive for increased investment. New investment generates jobs and wealth. Still, this approach has been criticized as one that amounts to a race to the bottom, sacrificing workers' income and government's ability to provide services. In fact, the exact opposite is true. Typically tax cuts within a year or two result in greater government revenues, as increased growth quickly makes up for

2. Other views of development can also be viewed under the rubric of *costs*. For example, the idea of economic clusters, most famously the software cluster in Silicon Valley, is partly based on the idea of cost advantage. Finding and recruiting essential personnel is easier and cheaper within a geographic cluster of similar industries. Not finding the right skills can be hugely costly. The same holds true of access to suppliers and customers. Clusters are also powered by a diffusion of ideas and expertise, but this is another way of saying that essential information can be more inexpensively obtained within a cluster.

the cuts. This is exactly what happened in each of the jurisdictions examined in this book.

Similarly, as we shall see, *real* wages in the Netherlands and Ireland grew more strongly after unions shifted from tough bargaining to a policy of wage moderation explicitly intended to increase business profits. This had two positive effects on longer-term wage growth. As investment, attracted by profits, increased, so too did the capital/labour ratio. This naturally made workers more productive and their labour more valuable. And, as employment grew, learning-by-doing and other forms of training also increased the value of labour. This created the room for real increases in wages that did not cut into profits, holding open the door to further investment and wage increases.

It is important to contrast this approach with the negotiating militancy that both Irish and Dutch unions abandoned in the 1980s. In any given year, unions would negotiate for as much as they could get. Businesses, rather than close down, would agree to high wages, even if it meant profits were virtually eliminated, as they were in Ireland and the Netherlands. That deprived businesses of the means and the incentive for further investment. Productivity stagnated. In the next round of tough bargaining, businesses would have little extra to give workers in real terms. Nominal wages were forced up, but gains were eaten away by inflation, since the economy itself had no more wealth to spread around. Through this period, Irish and Dutch real wages stagnated or fell.

Now Dutch and Irish unions calibrate wage demands to leave employers strong profits, generating future investment. In other words, they are careful not to kill the golden goose which provides the means for wage increases in future years. Now Irish and Dutch wages are on a steady upward path, maintained paradoxically by a bargaining strategy in which unions refrain from seeking the maximum possible settlement in any given year.

Convergence

Half a century of empirical research confirms powerful theoretical reasons to believe that lagging economies naturally catch up with advanced ones. This is an optimistic prediction. It says that, even if advanced nations are growing quickly, lagging regions should grow more quickly.

Convergence is due to the spread of productive ideas and methods, profit opportunities in under-invested economies, lower wages that draw capital, and increasing skills as investment creates jobs. A key mechanism here is the idea of labour/capital ratio. When labour is abundant relative to capital, labour costs should be relatively low and potential returns, profits, on the scarce 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.

The same story applies to human capital – education and training – though here human capital may increase not merely by added investment in human capital but also by an indirect route – learning-by-doing. As workers become accustomed to working in non-traditional industries, their productivity improves. The process continues as capital is added. This could be regarded as investment by workers and the firm in human capital, or simply as a positive externality of investment-driven economic growth.

Not all economies join the convergence club, though. In fact, the gap between most rich and poor nations has been growing. Membership in the convergence club is straightforward. Economies which have been closing the gap with advanced economies have a number of shared characteristics – an educated populace (or at least an emphasis on education in public policy that is reflected by a large commitment to improving the educational standing of the populace),[3] market economy, limited government

3. Canada spends a larger portion of its national output on education than any other country in the OECD yet has, by some accounts, the lowest rate of productivity growth of all these countries. One of the problems with measuring the quality of education is that the level of expenditure correlates poorly (if at all) with the actual output of the system. Thus, measuring expenditure provides a poor indicator of quality. How education is delivered seems much more important than how much is spent.

interference in markets, the rule of law, property rights, and stable institutions, including political stability. For the most part, economies that lack these characteristics are either failing to converge with richer nations or, more typically, are falling further behind them. However, while it is true to say that in much of the world the gap between rich and poor is increasing, what this really reflects is a growing gap between market and non-market economies. The story is exactly the opposite among market economies, where the gap is narrowing.

In regions characterized by market economies, the “convergence effect” shows up strongly in econometric testing, whether in U.S. states, European regions, or Japanese prefectures. All a lagging region needs is a sensible policy regime – one no worse, or not much worse, than those advanced regions. There is the rub. Lagging regions can be held behind by bad policy. For example, Atlantic Canada, which will be studied in the second volume of this book, has converged with the rest of Canada at only one-third to half the rate of convergence in the United States, Europe, and Japan, although Atlantic Canada has received from the federal government huge wealth transfers and development programmes meant to spur economic growth.

There’s even better news from within developing nations. Econometric testing shows that economic growth, instead of increasing inequalities, raises incomes across the board, reducing absolute poverty and improving social conditions, as measured by the proxy of infant mortality.

> Development economists used to worry that the benefits of growth would be undone by increases in income inequality. Recent evidence has shown conclusively, however, that this is not so.... [One] study examined recent per capita growth and poverty reduction in 67 countries for which household data were available. It found that every country with increasing per capita household income saw poverty decline, and every country with declining per capita income saw poverty increase. In the

> expanding economies, per capita income grew 4 percent, and poverty declined 5 percent. In declining economies an average drop of 7 percent in per capita income lead to an increase in poverty of 19 percent .... (Dollar & Pritchett 1998, 39)[4]

A review of the literature finds strong empirical support for the convergence hypothesis. (See, for example, Baumol et al. 1994, for a wide-ranging selection of articles on the subject, including literature reviews.) Perhaps the most comprehensive examination of the convergence hypothesis, both for modelling and for empirical investigation, is found in Barro and Sala-i-Martin (1995).

Barro and Sala-i-Martin develop data and examine economic performance in three different theatres: among U.S. states since 1880, Japanese prefectures since 1930, and regions within eight European nations since 1950. They find a convergence rate of between 2 and 3 per cent a year in each of these areas. The convergence effect is absolute; i.e., it applies when no explanatory variable other than the initial level of per capita GDP or income is held constant. This means that, each year, a lagging region closes the gap with the leading economy by between 2 and 3 per cent. Convergence is, therefore, a relatively slow process: it would take 25 to 35 years to close the gap by one half. The various authors whose work appears in Baumol (1994) find similar results for the regions they examine. However, several of these authors find a slow-down in the convergence effect after 1973, when productivity growth suffered a world-wide slow-down. But, Barro and Sala-i-Martin note, their results do not reject the possibility that the

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4. In the section quoted, Dollar and Pritchett refer to Burnside and Dollar (1998) (see references). They also site two other studies, not used as references in this work, which reach similar conclusions on the impact of economic growth: Li, Hongyi, Lyn Squire, and Heng-fu Zou. 1998. "Explaining International and Intertemporal Variations in Income Inequality". *Economic Journal* 108; and Bruno, Michael, Martin Ravallion, and Lyn Squire. 1998. "Equity and Growth in Developing Countries: Old and New Perspectives on the Policy Issues", in V. Tanzi and K. Chu (eds.) *Income Distribution and High-quality Growth.* Cambridge, MA:MIT Press.

convergence effect is invariant over time, at least as far as the United States is concerned.

Barro and Sala-i-Martin, like other researchers in the field, find that convergence is not unconditional, but rather is influenced by a number of factors, specifically policy factors:

> Growth depends positively on the initial quantity of human capital in the form of educational attainment and health, negatively on the ratio of government consumption spending to GDP, and negatively on measures of distortions of markets and political instability.... In most cases, the empirical work does not provide robust estimates for the effects of specific government policies on growth, but it does show that the overall package of policies matters a lot. (Barro & Sala-i-Martin 1995, 6-7)

Taxes and Public Services

All successful jurisdictions examined in this book used tax cuts to spur growth. Moreover, the global evidence on convergence shows high government expenditures and high taxes impede growth. This section will examine a broad range of research on the impact of taxes and government expenditures.

At first glance, the evidence on taxes and public services might seem contradictory. The evidence unambiguously shows that low taxes and low government consumption promote growth. It also shows that so do strong public services. But, to get strong public services, taxes and spending have to be sufficiently high. Obviously, the key here is efficiency and productivity – to get the highest possible level of public service for the lowest possible cost. In other words, since high taxes suppress growth but good public services and investment spur growth, government must spend carefully to get a dollar's value for a dollar spent.

Tom Cunningham, vice-president of the Federal Reserve Bank of Atlanta, argues that the key to providing good government – combined with strong growth and employment creation – is to keep government on the efficiency frontier, the idea again being that government provide the highest level of services possible for the lowest cost.[5] “In Georgia, we have a weak education system, but we keep taxes very low. So we’re getting what we pay for. In Minnesota and Wisconsin, they have high taxes but they provide strong services which compensates for the high tax load.”

A couple of caveats need to be provided, on both sides of the spending equation. At some point, even with careful spending, government runs out of worthwhile things to do, and spending itself becomes a drag on the economy. By bidding up the price of scarce resources, it crowds out other activity, including investment, without producing any significant benefits. On the other hand, up to some point, increased government spending, if efficient, boosts the economy. Growth would be stifled in any jurisdiction where the government did not tax enough to fund roads, schools, public protection, etc.

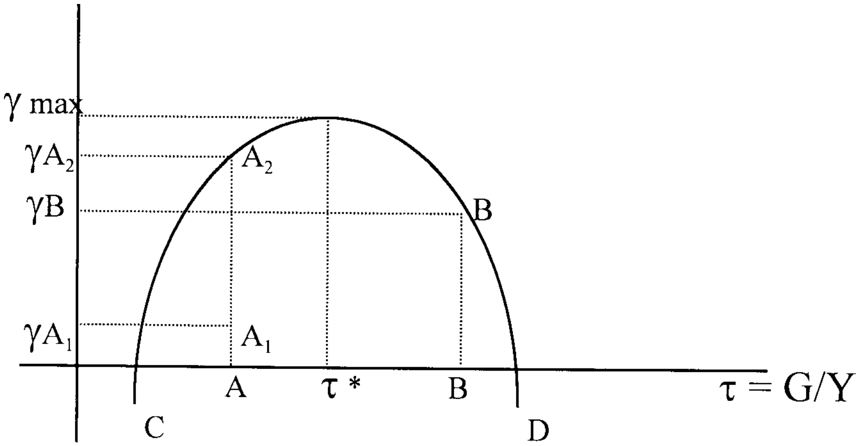
Barro and Sala-i-Martin, based on their empirical research, model this type of relationship. While the model is too complex to develop mathematically in this type of book, the concepts can be intuitively understood through an examination of Figure 1 (Barro and Sala-i-Martin 1995, 152-61). This represents the relationship between the size of government and the economy’s growth rate: G represents government, Y represents per capita economic activity, τ represents the size of government (G/Y), and γ represents the rate of per capita economic growth. At low rates of government spending the marginal product of more spending is high, as is its effect on capital’s marginal product (for example, through further education improving the productivity of the work force). This outweighs the distorting effect of taxes. Thus, the economy’s growth rates rises with τ, though as τ moves up the curve, the distorting effect of taxes becomes stronger relative to the effect of more τ on capital, until it reaches a peak and begins to decline.[6]

The same diagram can be used to capture Cunningham’s

5. From a conversation with the author.

6. Also see King and Rebelo (1990) for a model which shows large effects from taxation in an endogenous growth model, much larger than in a neoclassical model.

Figure 1



insight, though the Barro–Sala-i-Martin mathematical model would have to be modified to do it. The CD curve might be imagined as representing an efficiency frontier. Each point inside the curve represents a less-than-efficient use of government resources. Any point inside the curve, such as A_1, represents a suboptimum mix of government spending. At A_1, the economy obtains only an $A_1\gamma$ rate of growth though for the same level of government spending, an γA_2 rate of growth could be achieved. A number of extensions would be required to capture these effects, but this provides an intuitive sense of the discussion.

Just considering transportation infrastructure for the moment, one might imagine that, at A_1, a certain portion of road spending is distributed as a political reward. The positive economic impact of this is small. Thus, economic growth is slowed by the distorting effect of taxes while not benefiting from the full potential of investment.[7] On the other hand, A_2 might be imagined as a point where all road spending is used to improve the transportation infrastructure, for example, building a more efficient highway to

7. Of course, in a case like this, both taxes and the resulting spending are likely to introduce distortions, weakening growth from both the expenditure and taxation sides of the government balance sheet.

the region's markets. This improves the returns on investment in the region by providing a more efficient transportation infrastructure and regional growth benefits.

This discussion leads to the problem of measuring the impact of taxes and services. The amount of tax revenue collected is relatively easy to measure, but some tax systems are better than others. It becomes very difficult to construct variables that both capture the intake of the tax system and provide a measure of the system's efficiency, but at least a number of conceptual tools are available when one examines a tax system. Similarly, it is easy to judge total expenditures and determine which types of expenditure are good (infrastructure, for example) and which are bad (spending on political rewards, for example).

But no budget breaks transportation spending into categories such as "Road construction: Infrastructure improvement" and "Road construction: Cabinet minister's constituency". For example, an examination of infrastructure spending in Atlantic Canada would not reveal that the region never funded a modern highway to Atlantic Canada's major inland market in central Canada, despite government expenditures typically equallng about two-thirds of GDP (see McMahon 2000). Nor has public policy in Atlantic Canada focused on building a major highway to the region's emerging market in New England, thus connecting into the efficient U.S. highway infrastructure. The problem of determining the quality of government spending becomes intractable if only government books are available. Is a new hospital being built to improve health care or improve the governing party's chances of being elected in a swing constituency?[8]

Despite these complications, a number of researchers have attempted to quantify the impact of taxes and government services on economic growth and job creation. Wasylenko (1997) examines 38 econometric studies of the impact of taxation on per capita

8. The probability of the latter being the case approaches 1 if an adequate new hospital is built and the old hospital down the road is also kept open in a small community, as has happened in Nova Scotia.

GDP in U.S. states. Of these, 23 report statistically significant elasticities, with median values ranging from –0.58 to –0.02,[9] though he notes "several carefully done studies by respected researchers find tax elasticities larger than ... –0.6" (45). This is balanced by the fact that "at least an equal number of researchers" find small or statistically insignificant elasticities. Overall, he argues, the studies taken together suggest an elasticity of about –0.20 for interregional studies.[10] Yet Wasylenko also notes that World Bank research consistently shows that low-tax developing countries outperform high-tax developing countries. Wasylenko suspects one reason for the weak results in studies of the United States is the similarity of tax regimes across the country:

> [S]tates and regions have acted to neutralize the effect of taxes by adopting tax systems that are more alike. Without significant differences in state tax systems, taxes will not play a significant role in firm location and expansion. Given any particular tax elasticity estimate, however, the degree to which a specific state's tax rate will affect economic activity in the state depends on the degree to which a state's tax burden deviates from that in relevant comparison states. As long as the tax elasticity is negative and significantly different from zero, high tax states will lose more economic activity than average or low-tax states. Indeed, the highest tax states, such as Minnesota, Wisconsin and New York have recently acknowledged that high taxes may be responsible for low rates of job creation in those states. (Wasylenko 1997, 47-48)

9. The negative sign indicates a negative relationship between tax levels and GDP growth. For example, with an elasticity of –0.60 means a 0.10 (10 per cent) increase in taxes reduces per capita GDP by 6 per cent (0.10 x –0.60 = –0.06).

10. Wasylenko's review of intraregional studies suggests an intra-regional elasticity of about –0.80, while Bartik (1997, 67) puts it slightly higher at –1.0 to –3.0. Bartik's range for interregional elasticity, –0.10 to –0.60, is consistent with Wasylenko.

The homogeneity of tax regimes in the United States may make it difficult to pick up tax effects – though they are still evident in the majority of the research, and policy-makers in states such as Michigan and Massachusetts believe tax reductions helped power their recoveries – but international comparisons are more revealing, Wasylenko notes. These results are consistent with the studies on convergence and foreign aid, which point to government consumption as a strong negative factor affecting growth.

Fisher (1997) reviews the other side of the balance sheet: the impact of government services on economic growth. He looks at three service variables: highway and transportation facilities, public safety, and education. He notes that, of 15 econometric studies on transportation infrastructure, ten find a positive effect from such spending, with eight of these reporting a statistically significant impact. Of nine studies reviewed on public-safety spending, four report statistically significant positive results. Of 19 studies reviewed on education spending, 12 show a positive relationship but only six report a statistically significant positive relationship. One problem with this measure is that other tests have found little or no relationship between the quality of education and the amount spent on it, so the spending variable used in these tests is a poor proxy for what needs to be measured: educational outcomes rather than money inputs.

This may appear surprising, since the quality of labour is almost always on the top of the list in factors firms cite as important in making investment decisions. This highlights the disconnection researchers have found between the level of education spending and education outcomes. The fact that the level of spending appears to have little or no effect on educational attainment has been known since the late 1960s and is supported by the most recent comprehensive studies.[11] It appears that the approach to education matters much more than the actual amount spent, but

11. See, for example, the series of studies produced in recent years by the International Association for the Evaluation of Educational Achievement, *Third International Mathematics and Science Studies*. This effort involves between about 20 and 40 nations and usually significantly above 1,000 schools and 10,000 students and includes both international and intranational comparisons.

the econometric studies measure only spending. Fisher points to additional reasons for the surprising results: the lag between changes in the educational system and the effect on adult participants in the labour force, wide variations within states on educational spending, and the many different variables that effect educational achievement.

Both Fisher, on the expenditure side, and Wasylenko, on the taxation side, also note the problem discussed above – the weakness of any study that examines taxes and services in isolation from each other. This reflects the idea of cost. It's not simply the price tag – tax level – which is important, but the worth of the goods and services obtained for that price which determines whether the tax load provides good value.

Ady, who, as an executive consultant with Deloitte & Touche/ Fantus, has practical experience in such matters, points this out when he discusses the final selection process for a site:

> At this level of the analysis, the "services" side of taxes is also carefully measured – what the company will receive for its tax dollars in the way of services, such as police protection, education capabilities, and the like. For our clients, education has been found to be the single most important service, greatly exceeding the value of all other services combined. A distant second is highway adequacy, followed by public safety and then infrastructure. (Ady 1997, 79)

He then discusses how firms judge the quality of the services. One striking fact is that the measures are largely unrelated to spending amounts, but instead focus on factors which provide an indication of outcome, such as SAT/ACT scores. For example, in the relationship between education and the quality of the available work-force, he says,

> [B]ased on our practical experience, the single most important determinant of the potential of labor quality in an

> area is the presence of post-high school educational facilities, along with the degree to which these institutions are working with local businesses to meet their recruitment needs. (Ady 1997, 81)

Nonetheless, Ady says firms pay careful attention to the overall tax burden, and high tax rates may eliminate a jurisdiction even before the actual burden for the firm is calculated: "Taxes will be brought into the analysis but only on a comparative basis.... If any state is not reasonably competitive with the others based on these general tax inputs, it will probably be eliminated at this [preliminary] stage. For example, if most states in the defined area of search have corporate tax levies of 5 or 6 per cent but one has a 10 per cent levy, the latter state may be eliminated, even though the actual corporate taxes for the project have not been calculated" (Ady 1997, 78). But these comments should be put beside Ady's view that, among U.S. states, taxes are a small part of overall costs. For that reason, they are rarely the key determining factor in location decisions, and the importance of taxes – unless the taxes in one jurisdiction are significantly out of line with neighbouring jurisdictions – can only be judged in relation to the service being provided.

In conclusion, most studies show that taxes have an impact on economic growth, but that this impact is small unless the tax regimes are significantly different. This is a problem in Atlantic Canada, where taxes are much higher than elsewhere in Canada and where the quality of services provided in return is suspect, as we shall see in *Retreat from Growth: Atlantic Canada's Dismal Experience with Regional Development*, the sequel to this book.

In Massachusetts policy-makers believe that, through the 1980s, taxes in Massachusetts had risen to such a level – the state became known as Tax-achusetts – they did discourage economic growth and job creation. Yet the impact of taxes can only be examined in relation to the services provided. This does emphasize the need for good governance which focuses on providing essential services at the lowest possible cost.

Labour

The quality of labour, the cost of labour, and the state of the labour market, together, are essential to economic growth. The key question is whether the cost of labour in one jurisidiction is competitive with that in other jurisdictions.

Any number of competitiveness studies compare wages and salaries across different jurisdictions. But these studies have a central failing. Two engineers of apparently similar qualifications may have very different levels of skills. Variable factors include work culture, degree-granting institution, years worked, sub-field, etc. Consider two computer engineers with, for simplicity's sake, degrees from the same institution. One works in Silicon Valley and has specialized in advanced applications; the other returned to Wyoming, took several years off to try ranching, and now runs the aging mainframe system of a regional business. A competitiveness study would indicate the Wyoming engineer, who is doubtless paid less than the Silicon Valley engineer, has the more competitive pay rate. Such a competitiveness study would likely show that Wyoming is a more competitive location for a software maker than Silicon Valley.

Cross-national or even cross-regional comparisons just can't pick up even broadly spread differences in work culture, regional educational quality, workplace opportunities which advance human capital, etc. Yet wage levels are obviously important, as we shall see, though companies try to evaluate regional work-forces by the compensation rates taken in conjunction with skills and work habits, something competitiveness studies typically do not handle comprehensively. Thus, these studies are not terribly useful in examining the impact of wages on economic growth.

The safest relative comparisons are wages of the same labour force compared over short time horizons. If real wage rates escalate over the short term, for example, because of union pressure, government stimulus, or external wealth transfers, then it is fairly safe to say wage rates are less competitive than they were. Even if real wage gains prove to be transitory, due to accompanying inflation, the lack of wage stability and the worry of future wage shocks becomes a disincentive to invest. On the other hand, if real wages decline in relation to productivity (say, because unions agree to wage restraint), then one can with relative safety say wages have become more competitive, particularly if this development holds the promise of future wage stability.

In a market-oriented economy, wages will change in response to market conditions. But these changes can be overridden by other factors. This is particularly true in a corporatist economy, where unions, business, and government may strike deals that have a large influence on wage settlements. The other possibility is a flexible labour market, where wages adjust rapidly in response to changing economic conditions. For any number of reasons, no labour market is perfectly flexible, but many economists believe that the rates of unemployment in the United Kingdom and the United States are much lower than those in continental Europe in large measure because the former have much more flexible labour markets.

For example, it is typically easier to fire or lay off someone in the United States than in Europe. European-style policies thus maintain existing jobs, but they dampen job creation. Firms have difficulty adjusting to changing conditions. During a downturn, they may not be able to make appropriate staffing adjustments, cutting into profits or creating losses. As well, firms become reluctant to hire in good times because, if a downturn occurs, a firm may not be able to adjust its labour force. Thus, such inflexibility in the labour market weakens firms' growth prospects and profits. It leaves firms with less money to invest and less incentive to invest. And this has a negative impact on job creation.

Another aspect of labour-force flexibility concerns the degree of union penetration and power, and the attitude of the union leadership. In Ireland and the Netherlands, unions have significant power over wage settlements, but the attitude of the union leadership in recent years directed this power towards the goal of wage moderation. In the United States, relatively low levels of union membership weaken union influence over wages and allows the labour market to adjust to changing economic conditions, including by moderating wage demands during economic downturns. These are essential points in later chapters, so it is important to examine the impact of unions on wages and labour market flexibility.

Many economists argue that union power distorts the labour market and weakens productivity gains, thus slowing growth and job creation. Mancur Olsen has a slightly different take on union power. He argues that either high or low levels of union power produce benefits but that moderate levels of union membership and power are likely to damage an economy.

While Olsen accepts the idea that unions may harm economic growth, he argues that, when an economy is largely unionized, the labour movement may accept responsibility for the general welfare of the economy. This benefits all workers, not just unionized workers. This is what Ireland and the Netherlands have experienced in recent years as their central union bodies officially adopted the wage-moderation policy. In both nations, union and non-union employment has grown rapidly.

But Olsen believes that when unions have substantial clout, but not an overarching interest in the economy, they may introduce substantial distortions in the economy through rent-seeking activities for their members – benefits beyond the level that their productivity would justify – which reduces general welfare. In this case, union power may force wages to a level incompatible with full employment, whereas in the former case, unions may adopt a policy of wage moderation which generates employment across the economy.

Olsen's insight has been repeated in many different forms, which have somewhat different implications but maintain the central insight. One idea is that "[e]xtreme centralisation or decentralisation of bargaining encourages wage moderation in collective bargaining, whereas intermediate union structures are associated with wage demands inconsistent with high employment."[12] As well, the insider–outsider hypothesis has been used as an "explanation of upwardly ratcheting unemployment rates in Europe…. [U]nions and other institutions tend to represent the interests of 'insiders'(job-holders) at the expense of outsiders (the unemployed)" (Burda 1997, 96).

Clearly, powerful unions may contribute to economic growth by promoting wage moderation, which generates jobs, profits, investment, and economic growth. We'll see this in Ireland and the Netherlands. But what about the other side of Olsen's idea – that a medium level of union power suppresses growth more than weak union power? One way to explore this idea is to examine the impact of right-to-work laws in the 21 U.S. states that have such laws. These laws prohibit unions from imposing membership on workers in unionized workplaces. In the 29 non–right-to-work states, workers are required to join a union and pay dues as a condition of employment in unionized shops. This provides a point of comparison between jurisdictions with moderate union power (at least in the U.S. context) and those with weak union power, the right-to-work states.

Tannewald (1997) notes that a number of econometric studies – eight of the 11 reviewed – have found "that the existence of a right-to-work law exerts a positive, statistically significant impact on economic activity." On the other hand, Tannewald argues, studies have not produced convincing evidence that right-to-work laws either diminish unionization or lead to lower wages. One possible explanation is that unions are less militant in right-to-work states, creating flexibility in the workplace, which could increase economic growth, and that employers pay union-level wages regardless, to ensure labour peace and a sense of fairness.

Holmes (1996) attempted to overcome econometric problems by presenting a very simple test. Cutting across the United States runs something very much like a continuous border which sepa-

12. Burda (1997, 96) refers this concept to Calmfors, L., and J. Driffill. 1988. "Bargaining Structure, Corporatism and Macroeconomic Performance." *Economic Policy* 6: 13-62.

rates southern and western right-to-work states from northeastern and midwest non–right-to-work states. Another western border separates the Pacific states, which don't have right-to-work laws, from the western states, which do. Holmes finds large differences between the two sides of the border: "The differences at the border are surprisingly big. On average, the manufacturing share of total employment in a county increases by about a third when one crosses the border to the [right-to-work] side" (Holmes 1996, 28-29).

Even some union economists accept this view. For example, Jim Stanford, of the Canadian Auto Workers, writes: "Anti-union 'right-to-work' laws in the Deep South states of the U.S. have clearly been important in motivating a significant migration of manufacturing investment to those states from the free-association states of the northern part of that country" (Stanford 1999, 172).

Yet there are many anecdotal instances of unions and management working together to improve productivity and competitiveness, on one side, and working conditions on the other. This depends on a dynamic developing where employers and workers come to believe they both prosper or suffer together – where unions believe only a productive, competitive, profitable business can maintain their jobs and increase pay, while company officials understand the company's future depends on the quality and co-operation of labour.

In both Ireland and the Netherlands, large union groups played a key role in reforms that were explicitly designed to stabilize labour costs and increase profits. In both nations, the unions had come to believe that weak profits were stifling investment and job creation and that they needed to expand their focus to the whole state of the economy.

Case Studies

The economies selected for examination in this book were chosen because of their strong growth following either a significant setback or a long period as a lagging region. The goal is to isolate successful turn-around strategies. In all these successful cases of economic growth, policy-makers focused on reducing the costs facing business and, particularly in the corporatist setting, on strategies explicitly meant to boost business profits. This is also true of turn-around economies not examined in this book, whether in Europe (for example, Denmark) or in the United States (for example, California).

In corporatist states, government policy-makers can not only tackle the cost of taxes, they can also deal with wage levels through the social partners – business and the labour movement. This is important, since market signals can easily be overridden in the corporatist state, halting wage adjustment when economic conditions changed. This happened in during the bad times in the Netherlands and Ireland.

U.S. states typically have flexible labour markets. This itself is an inducement to growth or a path to recovery, since wage levels adjust to economic circumstances. However, policy-makers in the United States can attempt to further the flexibility of the labour market. In both Michigan and Massachusetts, as part of these states' response to their economic downturn, the government reduced labour-market regulation and cut payroll taxes.[13]

All successful jurisdictions, in both Europe and the United States, focused on the cost of government. Through their economic advance to increased prosperity, southern states have long positioned themselves as low-tax jurisdictions. In both Michigan and Massachusetts, policy-makers came to believe that levels of taxation that were relatively high, at least in the U.S. setting, were holding back economic growth and job creation. This view was widely shared among the people of these states, who elected governors and legislators committed to tax reduction.

The corporatist states took even broader measures to reduce labour and tax costs. In both nations examined, comprehensive deals were struck to hold down wage growth. Both nations also moved to reduce taxes, the Netherlands more recently and less

13. The role of regulation is only touched on lightly in this book. It is the central focus on an upcoming AIMS book by Brian Flemming, a former senior aide to Prime Minister Pierre Trudeau.

aggressively than Ireland. Both nations are now addressing the problem of the long-term unemployed or, in the Netherlands, the long-term disabled. The Dutch disability system was, in effect, open to anyone who claimed to be disabled, and it offered generous payments. At one point, one million of six million Dutch workers were collecting disability. Both Ireland and the Netherlands are addressing the long-term unemployed/disabled problem by tightening restrictions on social payments, reducing the payments, and increasing the take-home pay of low-paid workers, either directly through subsidies or through reforms in the tax system designed to reduce the effective tax rates imposed on low-income earners.

The hope is to create a more flexible labour market by reducing incentives to stay out of the labour market, eliminating disincentives to join the labour market (such as the loss of secondary benefits) and increasing the take-home pay of workers, without increasing the cost, to employers. There are both economic and social justifications for these reforms. Generous social systems can weaken economic growth and job creation by creating artificial shortages of low-skill labour and forcing up its cost, since employers have to bid against social-assistance payments.

The social justification is to halt the growth of dependent subpopulations and reduce the social problems related to dependence; to encourage youth to remain in educational and skill-enhancing streams rather than become another dependent generation; and, indirectly, to reduce long-term poverty. Pay rates are typically low for new labour-force entrants and for re-entrants into the labour market. Thus, social assistance can offer a higher level of living at this stage – and that's the reason for reducing perverse incentives, on one hand, and increasing take-home pay though tax cuts, on the other. But, in the longer term, pay progressively increases with work experience, as both skills and work discipline are gained. Thus, in the longer term, those who enter the labour market, even at initially low rates of pay, are likely to escape poverty, unlike those who remain on social assistance.

However, corporatist states may face a time-limit problem.

Corporatist states must depend on consensus between key players rather than automatic market mechanisms. As union leaders readily acknowledge in both Ireland and the Netherlands, only the dire economic conditions of the 1970s and 1980s brought home the need for wage restraint and an improved profit performance. Now that the economies of both nations are doing well and the labour market is tightening, there are signs the agreements are coming unraveled, with increasing numbers of union members voting against agreements negotiated by union leadership. In Ireland, fiscal restraint is weakening, and government expenditures are growing rapidly, though the strength of the economy continues to generate strong tax revenues, and the government's overall fiscal position is good.

The Netherlands, even more than Ireland, provides a study of the time-limited nature of corporatist recovery. That's because the Netherlands has been through the corporatist cycle several times and has experienced both the breakdown of social consensus and its rebuilding. The recent Irish society-wide wage and tax agreements are Ireland's first large-scale experiments with the corporatist strategy.

In the Netherlands, a strong social consensus between unions, business, and government, including a harmonious agreement on the need for wage restraint, following World War II led to a prolonged period of growth. Wage restraint came unravelled in the 1960s and 1970s. Good times, supplemented by natural-gas revenues, led to increasing government expenditures. But government's appetite was even greater. Both taxes and the deficit rose dramatically. Spending was out of control. This was classic "Dutch disease".

Through the 1970s, Dutch unemployment, which had been virtually non-existent, soared. Dutch GDP fell relative to other advanced economies, and the deficit rapidly rose. Dutch unions aggressively bargained for every cent they could get. But inflation wiped away gains, and the economy continued to deteriorate both for unionized and non-union workers. These circumstances led to a breakthrough social pact on wage restraint in 1982 and a return to growth. This began to come unravelled again in the early 1990s, after the economy had returned to a higher growth path. Renewed wage pressure dramatically weakened Dutch economic performance in the early 1990s. This was enough to alarm the members of the social pact – labour, business, and government – back into an even stronger pact than before. This time the social partners added on a menu of significant government cuts and tax relief. This was under a new prime minister, Wim Kok, head of the Labour Party and former leader of the Netherlands' largest union federation. Kok, as finance minister in the early 1990s, was responsible for the first significant cuts in runaway welfare spending. By the mid-1990s, growth has resumed. This is the period policy-makers and journalists have dubbed the "Dutch miracle".

The corporatist model faces another serious problem in the pricing of labour. Labour rates are determined not by market forces but by agreement between powerful corporate bodies. This is remarkably similar to the much greater problem the planned Soviet-style economies faced, and the solution is remarkably similar. Economic policy-makers look to what is happening in other economies to set prices. The corporatist players in Ireland and the Netherlands look at labour costs in nearby nations and use this as a base, tacking on productivity improvements, currency fluctuations, and other adjustments.

Troubled Economies

As a point of comparison, Chapter 4 also looks at jurisdictions that have performed less well, Louisiana and Maine, though Maine boasts a somewhat more successful record.

Louisiana has long been a Southern laggard, yet it would seem better suited for economic growth than any other Southern state. It has a large population, creating a significant domestic market. It has the Deep South's largest city, New Orleans, which is situated on one of the world's greatest trade routes, the Mississippi River.

Moreover, unlike the other Deep South states, Louisiana is blessed with immense resource wealth, huge petrochemical reserves.[14] Yet, more than other Southern states, Louisiana has a deeply politicized economy. This creates economic distortions, diverts resources from their most efficient uses, weakens government provision of real services, and creates a difficult climate for business. “Louisiana is the only southern state with a reputation for being hostile to business” (Holmes 1996, 29).

Perhaps the most telling episode in recent Louisiana economic history was the oil boom at the end of the 1970s. Because of the state’s petrochemical wealth, state GDP skyrocketed as did state revenues. It was Louisiana’s bout of “Dutch disease”. Government grew larger, costs increased, and, unlike Texas and Alberta, the state did not use resource wealth to reduce taxes to offset the increased costs non-petrochemical businesses faced during the oil boom, as rich petrochemical companies bid up the price of labour, land, and materials. Survival became increasingly difficult for businesses that did not benefit from the petrochemical boom.

As a result, when the boom was over, Louisiana’s economy nosedived. New non-petrochemical businesses had not been built, and existing businesses had been bloated and weakened by the boom. High levels of state spending through the boom did little to improve infrastructure or services. All informed observers I spoke with in Louisiana – from economists to senior government officials – believed the money had been squandered by the state government. They pointed to lack of infrastructure improvements to support this view. In the end, both the petrochemical industry and government activity increased costs through the Louisiana economy without offsetting these costs through tax reductions or useful government expenditures. This crowded out other activities and left the Louisiana economy devastated when the oil boom busted.

Maine, too, has underperformed the convergence effect. The state has long suffered from unusually high taxes by U.S. stand-

14. The phrase “blessed with” should be read ironically because resource wealth is too often a curse. Natural gas was the root cause of “Dutch disease” and resource-rich nations in general tend to grow more slowly than less endowed nations.

ards. Nonetheless, Maine has grown much more strongly than the neighouring Atlantic Canadian provinces, whose per capita GDP continues to fall further and further behind per capita GDP in Maine. Moreover, there are more recent signs Maine's economic vigour is increasing. As well, a new administration elected in the mid-1990s is directly tackling costs and attempting to make the state more responsive to business. It will be interesting to watch the results from this effort.