Chapter 4
Growth and Recovery in the United States

The National Setting

This chapter moves from a consideration of national economies, such as Ireland and the Netherlands, to subnational economies, individual U.S. states. This limits the scope for policy action, since subnational jurisdictions obviously do not have the full array of policy tools available to nations. Thus, it is important to take a quick overview of the national policy environment in which these states operate. The occasional contrast with Canada will glance forward to the sequel, *Retreat from Growth: Atlantic Canada and the Negative Sum Economy* (McMahon 2000).

The United States has long had the world's most vibrant economy. Among the major western economies, it has the smallest government sector and, by most analysis, the least-fettered markets. Throughout the post-war period, it consistently has had the world's highest per capita GDP, with the possible exception, at times, of the United Arab Emirates.[1] Among the major nations, it also boasts the lowest unemployment rate. And it is one of the few nations that lack significant regional programmes – that is, programmes which transfer wealth to lagging regions and use government-funded "economic development" programmes to spur growth. Yet, even prior to the Second World War, U.S. economists were reporting a convergence of regional incomes. Despite

1. Barro & Sala-i-Martin (1995, 1, 333-34). The reference in the book is specifically to 1990, though it is true of the bulk of the post-war years and certainly of the 1990s. Switzerland is the only advanced nation that would consistently rival U.S. per capita GDP.

the conspicuous lack of regional programmes, convergence appears to have accelerated since the end of the war.

Even economists who promote and design regional economic programs, and who argue the market cannot be left to its own devices to solve regional problems, acknowledge U.S. regional problems dissipate without any special regional effort. For example, Higgins and Savoie (1995, 188), both of whom advocate active government intervention to spur regional development, note that, in the United States, "at no time has there been a *commitment* to reducing regional disparities" (italics in the original) yet market forces themselves quickly eliminate serious regional disparities. "[T]he American faith in 'rugged individualism' and the market as instruments of regional development, in most periods, has been justified" (Higgins & Savoie 1995, 187).[2]

This should not be terribly surprising, since the U.S. economic environment maintains features that are similar to strategies the Netherlands and Ireland adopted to spark economic growth. A key similarity, surprisingly, is in the labour market. At first glance, this will seem an odd statement. After all, the Netherlands and Ireland have fairly high levels of union membership. Union power is even greater than membership numbers would imply. This is because of the structure of the corporatist state, which gives unions, in conjunction with the social partners, government and business, tremendous influence over wage settlements.

In the United States, levels of union membership are low. Unions have less power in the economy than in any other major economy, save perhaps Japan. They have no direct influence on nation-wide wage-setting and only slight indirect influence, in that, for example, a large union victory may encourage other workers to seek higher wages more aggressively, while a significant defeat, such as occurred to the air-traffic controllers in the early 1980s, may discourage worker militancy.

Weak union power is one of the reasons for the flexibility in

2. Savoie is a significant figure in Canada and took credit for designing Atlantic Canada's economic-development agency, the Atlantic Canada Opportunities Agency (ACOA), though more recently he has criticized ACOA.

the U.S. labour market. When economic conditions deteriorate, unions are less able than they are in Europe to maintain uncompetitively high wages through the economy. Thus, wages adjust more readily to economic conditions in the United States – and in individual states – than in Europe. This outcome is strikingly similar to what happened in Ireland and the Netherlands, though the structure leading to the outcome was dramatically different. In Ireland and the Netherlands, unions, business, and government worked together to bring wage inflation under control and set wage rates at a level which reflected the economy's condition. They deliberately aimed at reducing costs and increasing profits in order to spark new investment, and thus economic growth and job generation.

In the United States, as we shall see, this process of wage adjustment naturally occurs through markets. Thus, if a state or regional economy experiences economic difficulties and increasing levels of unemployment, wages tend downward relative to the national average. This opens new profit opportunities and attracts new investment. Thus, it is unsurprising that regional recessions tend to be relatively brief and that lagging regions show strong convergence. Lower wage rates draw in additional economic activity. However, labour-market regulations are not identical in every state. Southern states, for example, tend to be right-to-work states, which further weakens union power and increases the flexibility of the labour-market.[3] This has been one of the reasons Southern economic growth has exceeded average U.S. economic and employment growth. And, counter-intuitively, it is also one of the reasons wage growth in the South exceeded the national rate of growth.

Because flexible labour markets tend to adjust quickly, regional recessions in the United States are usually short-lived affairs. This sets off the U.S. situation from the European environment. In Europe, militant unions or a breakdown in the corporatist state can maintain artificially high wages for a long time, even in the

3. See Chapter 1 for a discussion of the impact of right-to-work laws.

face of rapidly rising unemployment and falling economic activity. Thus, as happened in the Netherlands, a national recession can last many years. We'll have an opportunity in *Retreat from Growth* to view a truly perverse policy package in Canada that had the impact of artificially inflating wages in a lagging region, namely Atlantic Canada.

The other similarity between the U.S. environment and the strategies adopted in Ireland and the Netherlands involves taxes. Policy-makers in the Netherlands, and even more firmly in Ireland, slashed taxes to spur growth. The United States, on the other hand, is a low-tax environment. This, once again, allows faster economic adjustment. Nonetheless, individual states can use their own tax codes to spur increased economic growth when they face hard times. As we shall see, this was an essential element in the remarkable economic recoveries in Massachusetts and Michigan. The South, as a lagging region, has long used low state taxes to attract investment and generate jobs.

Convergence in the United States

Barro and Sala-i-Martin (1995) use a number of sophisticated techniques to test the hypothesis that regional and state economies within the United States converge.

> The main conclusion is that the U.S. states tend to converge at a speed of about two percent per year. Averages for the four consensus regions converge at a rate that is similar to that for states within regions. If we hold constant measures of structural shocks, then we cannot reject the hypotheses that the speed of convergence is stable over time. (392)

A couple of things are worth noting about this statement. First, roughly the same level of convergence is found in the other geographic areas Barro and Sala-i-Martin examine, specifically European regions and Japanese prefectures.

The second point to make, one discussed in Chapter 1, is that

in their discussion of government policy, Barro and Sala-i-Martin note that growth – and therefore convergence – can be heavily affected by policy. They highlight high government consumption and taxation as negative factors in growth while positive factors include "perhaps spending on some form of public infrastructure" (1995, 7-8) and educational expenditures (1995, 433). Given that government consumption and taxation are a negative while some government expenditures are a positive, the key is obviously to focus on limited, well-directed government expenditures. Clearly while the education and infrastructure system in the United States are comparable to Canada's, overall tax rates and government consumption are much lower because of lower expenditures.

So this is the puzzle we will examine in this chapter, as we look at five states: Georgia, Massachusetts, Michigan, Louisiana, and Maine. While we in Canada have entrenched regional problems, why is it that in the United States – no matter how far a region falls, no matter how high unemployment soars, no matter how unique the problems – regional economies keep booming back? Why have regional disparities, even those with deep historic roots, faded even in the absence of government programmes designed to make them fade while in Canada regional problems seem entrenched despite, or because of, massive programs meant to eliminate them?

The opening paragraphs in this chapter sketched part of the answer. Yet the results on convergence, globally and in the United States in particular, might appear to be surprising, given the number of theories that have been developed to explain why regional economies won't converge without persistent and heroic government intervention. These theories have been used to create expensive regional programmes and bureaucracies in Canada and, to a lesser extent, Europe. The results on convergence do not seem well understood in these bureaucracies.

Convergence in the United States may be even more surprising, considering the lack of homogeneity across the nation. Resource endowments vary from extraordinarily rich to virtually nonexistent, while climate varies from tropical to northern. Not only

does the history of the different regions vary considerably, each region's modern economic history has a different starting point. According to many regional-development theories, these differences should have inhibited convergence without government programmes designed to combat them. Barro and Sala-i-Martin, in a number of places, note the need for homogeneity within a region for convergence to take place. But they focus on homogeneity in tastes, technology, and government policy and institutions. These are hardly identical across the United States, but they are "similar" in the broad sense used by Barro and Sala-i-Martin.

U.S. Military Spending as a Regional-development Programme

It became common for Canadian economists – and even some U.S. economists – to attribute convergence in the United States to an unofficial regional-development programme, the military. The idea was that long-serving senators and congressional representatives, particularly from the South, were able to direct a disproportionate amount of military spending to "have-not" regions. A rich proliferation of military bases and facilities helped equalize income and sparked economic growth. If this view were correct, Canada would do well to drop all regional-development programmes and start building a bigger military.

That would be pointless, for this interpretation of U.S. regional economic history is poorly researched. It collapses under any sort of empirical scrutiny. As Wright (1986, 261) shows, the Southern states have received a slightly disproportionately small share of federal spending. Slightly higher direct military spending, in some, not all, Southern states, was offset by lower spending in other areas (Weinstein & Firestine 1978, 29-43). Moreover, the South received an even lower share of federal spending during its fastest period of development. In 1952, per capita federal expenditures in the South (Georgia numbers in brackets) were only 83 per cent (77 per cent) of the national average; in 1959–61, they were 88 per cent (91 per cent); in 1969–71, 96 per cent (105 per cent); and in 1974-76, 97 per cent (94 per cent) (Wright 1986, 261).

The Southern states were also well below the national average in military contracting, which presumably should have created greater spin-offs – through plants, diversification, research, and subcontracting – than direct military spending. In fact, military contracting has been disproportionately centred in California and New England, particularly Massachusetts and Connecticut. An examination of both direct military spending and spending on military contracts clarifies the picture. In 1976, federal outlays on defence salaries averaged $139.17 per capita across the United States. They were high in Georgia, at $213.28, and low in Massachusetts, at $58.04. The mirror image of this picture emerges when one examines federal outlays on defence contractors. The national per capita average was $213.24. Georgia was well below this average, at $129.23. Massachusetts received $346.61 on a per capita basis. (California received $446.25.)

Adding the two together, Georgia received a total of $342.51 per capita in military spending, a whole dime per person above the national average of $342.41. Massachusetts received $404.65, bu California emerged as an even bigger winner, at $646.51 per person. The gross amount of federal spending tells the same story: in 1975, the federal government spent $1,454 per capita in the South Atlantic states and $1,377 per capita in the East South Central states, compared to a national average of $1,412 per capita. (All numbers in this and the preceding paragraph are from Weinstein & Firestine (1978, 31-35)).

In other words, nothing about federal spending patterns, particularly military-spending patterns, in the United States can be interpreted as a regional programme by stealth. This is particularly obvious when considering the case of California and New England, both winners, unlike the Southern states, in overall military spending. Yet these were two of the more prosperous of the states, even before military spending skyrocketed with the Second World War and stayed high through the Cold War. This direction of funds clearly does not suggest spending based on regional-development considerations.

In fact, federal expenditures, particularly in the military, merely

show the feeble long-term effect of government spending on economic growth. When much defence spending was wound down at the end of the Cold War, both California and Massachusetts were hard hit. Many politicians predicted a secular decline in these two economies, and considerable political pressure developed for the introduction of regional programmes to help the two states. This didn't occur, but private-sector activity quickly crowded in after the shrinkage of the military–industrial complex. Both states are booming, with historic lows in unemployment, despite the massive defence-contract cuts of a few years back. Even in Canada, the same might be said. Ottawa and Halifax are the two most government-dependent cities in the nation. Both were hard hit by government cut-backs. Both quickly recovered.

Regional Economic Recovery and Growth

The California–Massachusetts story points up another aspect of the U.S. phenomena. No matter how hard a region is hit by a negative economic shock, it soon bounces back. Massachusetts at the end of the 1980s suffered not just severe military cut-backs, its minicomputer industry – the centrepiece of the Massachusetts technology sector – collapsed in the face of the onslaught of personal computers and desktop workstations. What followed may have been the worst regional recession in the United States since the end of the Second World War, with soaring levels of unemployment. Now every business street in Boston seems decked with help-wanted signs.

In the early and mid-1980s, the U.S. Midwest – the heart of heavy manufacturing in the United States – was devastated by overseas competition, particularly from Japanese automobile manufacturers. It was also damaged by an emerging, world-wide economic trend, the diminution of the relative importance of the manufacturing sector, the economic life-blood of the Midwest, particularly Michigan, and the shift to the service sector. Factories across the Midwest went silent.

Just as with California and Massachusetts, many thought a long-term change had occurred and the Midwest would enter a secular

decline. The term "rust belt" was coined to describe this region. Many thought this phrase vividly captured the bleakness of the region, not just the visual image of a regional landscape of rusting and abandoned plants but also by aptly describing what many thought would be the region's bleak future. But once again, the economy adjusted, and much of the Midwest is, by many measures, doing even better than during the hey-day of the heavy-industry era. And all this without the type of programmes many Canadian policy-makers believe are needed to fight regional problems.

This chapter will look at five U.S. states. Three of them are in the mainstream of what was described above. Georgia, the most successful of the Deep South states, has shrugged off its once-sleepy status to develop one of the world's most dynamic economies. Michigan and Massachusetts now boast vanishingly small unemployment and strong economic growth.

Two of the states examined are atypical. Maine shows inconsistent convergence over the last 40 years. A mid- to late-1980s boom faded quickly. Although Maine per capita economic growth has outpaced Atlantic Canada's (chart 4-1)[4], it has not consistently shown strong convergence with the rest of the United States. A couple of factors may be responsible. The disproportionately rural nature of the state may slow overall economic growth. As well, Maine taxes are unusually high, and this may inhibit growth. On the other hand, recent reports from the state indicate a surge of economic activity. Perhaps convergence has renewed.

Louisiana is the other exception. The Louisiana case should be particularly puzzling to regional economists. According to most versions of regional theory, Louisiana has everything going for it and should be a leading, not a lagging, state. Far from being in the

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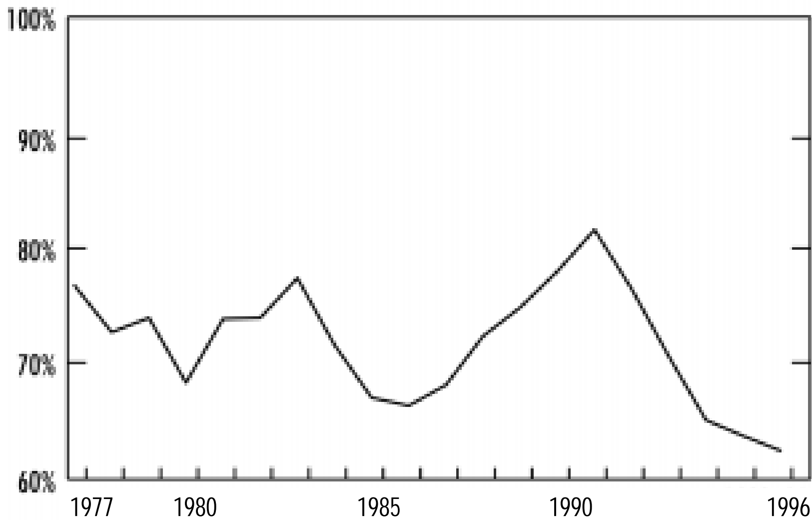
4. Maine and Atlantic Canada's GDP are translated into a common currency for this chart. Large exchange-rate fluctuations are responsible for similarly large fluctuations in relative per capita GDP. Nonetheless, each trough in relative Atlantic Canadian GDP is lower than the preceding trough. In 1977, per capita Atlantic Canadian GDP was just over 77 per cent of Maine's; in 1996, it was just under 63 per cent, about one-fifth lower.

Chart 4-1 Atlantic Canada's Per Capita GDP as a Percentage of Maine Per Capita GDP, as measured in common currency



Source: StatsCan and STATS USA

hinterland, Louisiana is on one of the world's most important transportation routes and New Orleans is at its hub, near the mouth of the Mississippi River. Goods all the way from Canada flow through New Orleans and down into South and Central America. New Orleans itself has long been a major metropolitan area, still more populous than the fast-growing Atlanta, Georgia. If all that were not enough, Louisiana has huge resource wealth from Gulf of Mexico petrochemical deposits. This is hardly a resource-poor peripheral region, yet Louisiana – despite an oil and gas boom in the late 1970s and early 1980s – lags behind not just the United States but the Southeast as well.

Several factors appear to be at work in the United States that reduce regional disparities and allow depressed regional economies to regain their vigour. Strong market forces hold down costs in lagging regions and in regions suffering economic set-backs. This attracts new economic activity. Costs are not inflated in these economies, as they can be in Canada, by large wealth transfers

from the central government. Lagging states, for the most part, kept their tax burden low, while governments of states in regional recessions have tended to reduce taxes to increase the competitiveness of their state. The exceptions examined here, Louisiana and Maine, have held costs high, either through relatively high taxes or government-induced cost inflation and economic distortions.

The specifics of the strategies may not perfectly fit the Canadian context. However, they have produced jobs for the people of lagging states, something that has never been successfully achieved in Atlantic Canada. And they have produced prosperity. Average wages in the once-depressed South are not merely higher than wages in Atlantic Canada; they also exceed the Canadian average.

The South

The southern United States has long had much the same status in the United States as Atlantic Canada in Canada, as the nation's primary "have-not" region. However, unlike Atlantic Canada, where government is a central part of everyday life and economic activity, Southerners have long prided themselves on having small governments, which are expected to stay out of the everyday running of the economy. While Atlantic Canadians, for example, expect government to solve economic problems and "make" jobs, Southerners – perhaps because of their history – are deeply suspicious of government. Much of the political drive for smaller government in the United States has come from, and still comes from, the South.

The South has also promoted itself as the low-cost region of the U.S. This was particularly true of wage rates during the first post-war decades. The South has also typically had relatively low taxes compared to the rest of the United States. Weinstein and Firestine (1978, 139) note the importance of this low-tax regime:

> [T]he economic gains in the South are linked to the region's underutilized tax potential. ... [I]n 1975, state and

> local governments in the South used only 82.5 per cent of their tax potential (defined as the national average tax collection rate). By contrast, the Middle Atlantic states were found to have an over-utilization rate of 10.1 per cent.

They also quote a report of the U.S. Advisory Commission on Intergovernmental Relations making a similar point:

> Both the citizens of the state and multistate corporations are more likely to perceive a heavier burden in those states where tax burdens are rising than in those states where taxes as a percentage of income are either remaining relatively constant or falling. It is that *perceived* pressure which may help to account for some of the resistance on the part of taxpayers to increase the size of the public sector and the reluctance of corporations to locate in certain areas. ... With the exception of Hawaii, California, Nevada and West Virginia, all of the states in the relatively high and rising (tax) category are in New England, the Mideast, and the Great Lakes region, while about half the Sunbelt states are in the relatively low to falling category.[5]

Charts 4-2 and 4-3 compare U.S. and Southern state taxes. This low-tax approach is, in fact, similar to the strategy Ireland and, to a lesser extent, the Netherlands have been following in recent years. On labour costs, Southern officials would also point to several factors that they claim effectively lowered the cost of labour and increased labour flexibility. These factors included low unionization, right-to-work laws, and open labour markets that featured, for example, few obstacles to laying-off or firing workers. Any examination of the economic web sites of the Southern states will show these factors still play a significant role in eco-

5. Weinstein and Firestine (1978, 143), quoting the Advisory Commission on Intergovernmental Relations, *Measuring the Fiscal Blood Pressure of the States, 1964-1974*, (Washington, D.C., 1977) pp. 2-3.

Chart 4-2 State & Local Government Taxes (U.S. Average)

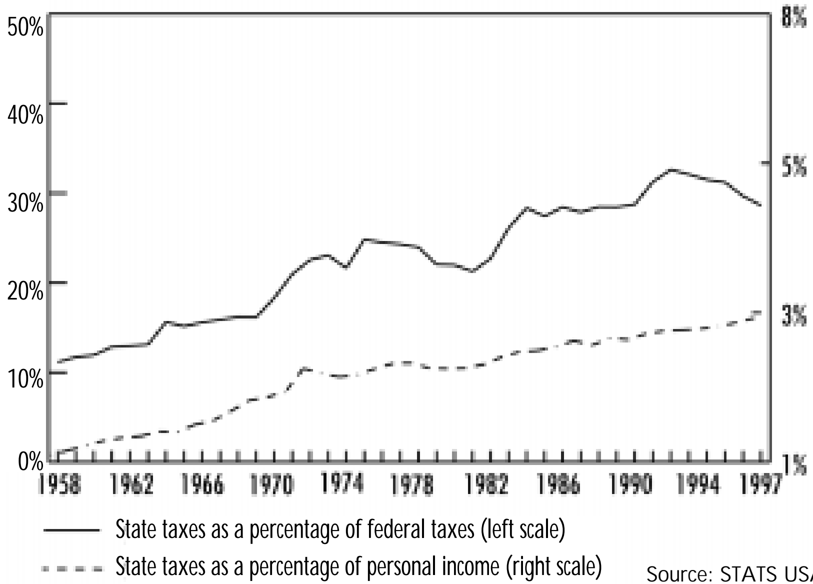
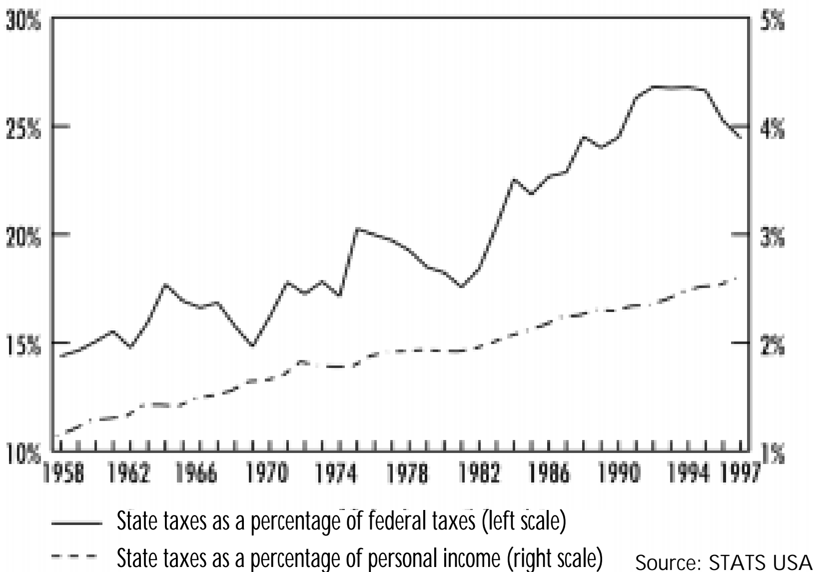


Chart 4-3 Personal & Non-tax Payments in the Southern States



nomic promotion. Government is seldom called on to rescue industries or create jobs. In fact, small government remains a selling point.

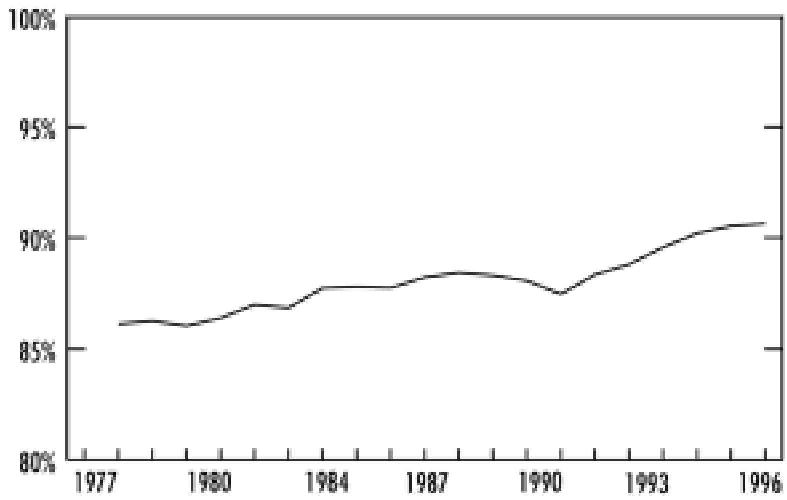
Is the Southern approach deeply flawed, a race to the bottom rather than a successful economic-development strategy? By virtually all measures, including personal income, the Southern economy has been a success, significantly exceeding the very strong performance of the U.S. economy as a whole. In the South, growth in personal income, average earnings per job, and per capita GDP have all consistently outpaced average U.S. growth (charts 4-4 and 4-5.)

Here again, as is the case more recently in Ireland and the Netherlands, holding wage costs down in any given year attracts investment and economic activity which leads to future wage growth as both the capital/labour ratio and human capital increase. Both factors boost the intrinsic value of labour, so that, even as wages rise, they are still relatively low compared to their return. Thus, cost-competitiveness and profits remain strong while living standards continually increase. Pay per Southern job is now almost 90 per cent of the U.S. average, but the region still boasts low wage costs because wage increases have not overtaken productivity improvements.

Although Barro and Sala-i-Martin note they cannot reject the hypothesis that the rate of convergence is constant over time, other observers believe the convergence of the southern United States is largely confined to the post-war period. Wright (1986) shows that, in 1880, the per capita income of the subregions of the South varied between 45 and 60 per cent of the national average. In 1940, they varied between 50 and 65 per cent of the national average. By 1980, the variation was from just under 80 per cent to just over 90 per cent of the national average (Wright 1986, 240).

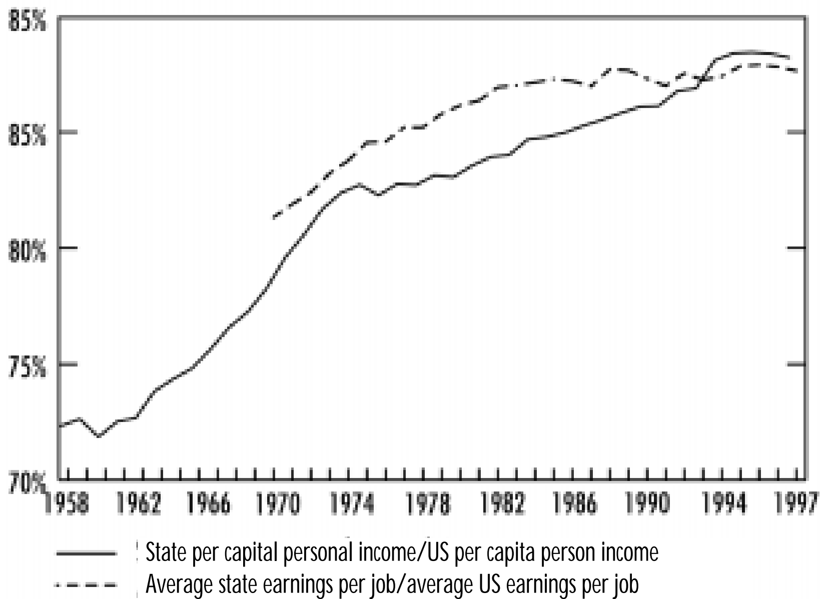
> Since 1940, per capita income in the South has persistently grown at rates well above the national average. ... [T]here was no sustained trend toward regional conver-

Chart 4-4 Southern States GSP as a Percentage of USA GSP Per Capita



Source: STATS USA

Chart 4-5 Relative Personal Income and Earnings



Source: U.S. Bureau of Economic Analysis

> gence before 1930. Since the modest rise during the 1930s primarily reflects the fact that the effects of the Great Depression were even greater in the North than in the South, the southern "take-off" is most appropriately dated from World War II. (Wright 1986, 239)

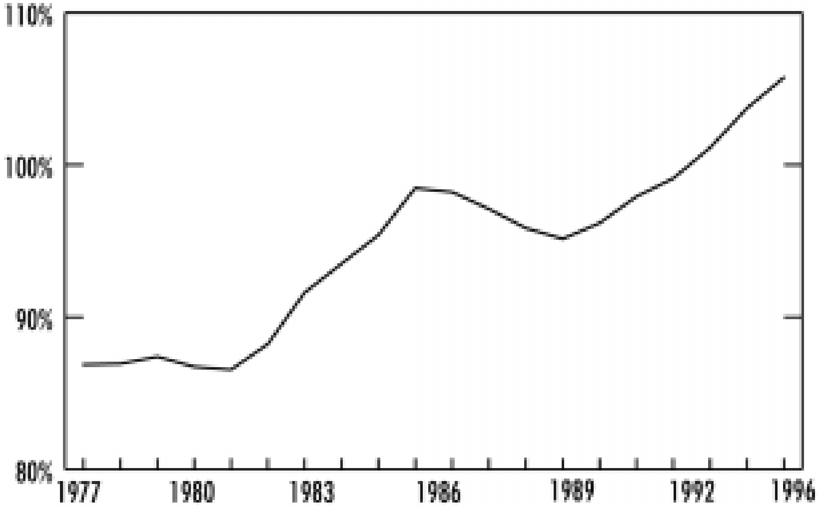
Two non-economic developments have helped open the South up to convergence since the end of the war. One is the invention of air-conditioning, which turned an often unbearable climate, one difficult to work in, into a desirable one. The other is the slow and difficult emergence of the civil-rights movement. While the driving force here was, as it should have been, moral, economic theory would predict large benefits from integration. It means businesses have greater opportunities because they have opened to them the full range of any jurisdiction's most important resource, its people. Integration removes any number of frictions from the labour market.

State officials and business people believe that Georgia – especially Atlanta – exhibited the least resistance of any southern state to integration, and that this provided economic benefits for the state and its capital. Roy Cooper, a retired vice-president of the Atlanta Chamber of Commerce, speaks with a perfect, slow, old-time, Southern drawl. "I'm from Birmingham originally before I came to Atlanta," he told me when I met him at the chamber's offices, "I remember when Atlanta and Birmingham – they were about the same size in the 1960s – both thought they could be the business capital of the South. But Birmingham just threw the opportunity away. They let themselves be taken up by racial problems." The Atlanta business community early on threw its weight behind the integration movement, and civic boosters coined the phrase "The City Too Busy To Hate".

Georgia

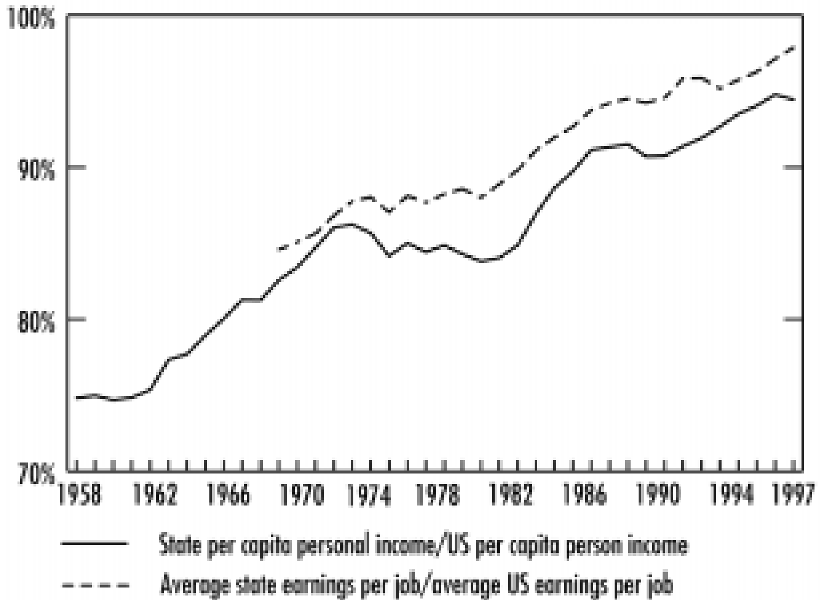
Of all the Southern states, Georgia's success is the strongest. Its per capita GDP now exceeds the national average, and pay per job is close to the national average (charts 4-6 and 4-7). Georgia

Chart 4-6 Georgia GSP as a Percentage of USA GSP Per Capita



Source: STATS USA

Chart 4-7 Georgia: Relative Personal Income and Earnings



Source: U.S. Bureau of Economic Analysis

has become such an economic power-house – one of the world's most successful and dynamic economies – that people forget that not long ago, it was a sleepy state, in the deepest of the Deep South – in a strip of three depressed states, Georgia, Alabama, and Mississippi.

Now Atlanta boasts one of the world's most glittering skylines. Many of the world's most dynamic companies are headquartered here. Tens of millions of people see pictures from Atlanta everyday on the Atlanta-based CNN. Georgia sped ahead of the rest of the United States. Georgia's economy is 150 per cent larger now than 20 years ago. The U.S. economy is only 66 per cent larger; the Canadian economy just 45 per cent larger.

This must be a great puzzle to traditional economic developers. Georgia is not a resource-rich state. Lack of resources, under many of the traditional regional-development theories, should block the acquisition of capital needed to boost economic growth. Moreover, traditional theory says, isolation from centres of economic activity should lock in backwardness, particularly in the absence of resource wealth to spark and fund investment. That argument is often used to justify regional subsidies.

Georgia was in the midst of an economic hinterland, separated by difficult geography from the industrial heartland of the United States. The state's main city was not connected by any natural transportation feature to more prosperous areas, as New Orleans was by the great Mississippi. It grew because it was at a railroad crossing. Government and business have worked hard to improve transportation links.

Traditional development theory also focuses on money. Poor regions need subsidies to bring services up to the level needed to spark economic growth. And poor regions must give subsidies to business to attract investment, which would naturally prefer to stay at the centre unless bribed away. This is even more important, the argument goes, since the capital market is thought to be imperfect and would undersupply poor regions. The Georgia story puts paid to this argument.

Georgia did not benefit from federally sponsored regional-

development programmes. It could not even use traditional state-run programmes. Georgia's cranky constitution prohibits state "gratuities", which the Georgia Supreme Court has interpreted as a prohibition on subsidies to business. Georgia has a smattering of small tax-reduction programmes and programmes to provide infrastructure and training, but it simply cannot compete with neighbouring states in the subsidy game. Georgia has thus lost out on the big catches made by other Southern states, most notably large automotive investments, such as Mercedes to Alabama and Saturn to Tennessee. These packages can be hugely expensive:

> As an example of the price escalation in this [economic development] war ... Tennessee paid $11,000 for every job created at a major Nissan plant in 1980. Five years later, the state paid $26,000 per job to win the Saturn plant. More recently, South Carolina paid $71,000 per job to land the BMW plant, and Alabama paid $169,000 per job to win the Mercedes plant. (Toft 1995)

So why is Georgia doing better than these states? There is no evidence that active economic-development programmes produce economy-wide benefits. And, even when they succeed, the attracted business may simply crowd out other private-sector activity, leaving even the local community little better off, but at a significant cost to taxpayers. Finally, and most dangerously, subsidies may go to a politically connected business in competition with other business, possibly allowing a less competitive business to drive out a better-run business, leaving the economy worse off in the long run. The economy has lost a good, taxpaying business and gained a state client. Finally, such programmes can weaken the overall competitiveness of business by leading business to concentrate on rent-seeking opportunities rather than market opportunities. This dependence and misplaced effort creates another net loss to the economy.

Certainly, Georgia has not been harmed by not having direct subsidy programmes, as can be seen from charts 4-6 and 4-7.

Georgia officials like to tell visitors they can assure indigenous businesses and ones which may be considering a Georgia location that their tax dollars will never be used to subsidize a competitor and that Georgia taxes will be low for every business. That creates a level playing-field inside the state, but a competitive advantage nationally.

Typically, economic-development subsidy programmes are disproportionately directed at out-of-state enterprises. When these programmes are large, they use tax dollars raised from indigenous business to subsidize external firms. Even when these firms don't compete with local business, they have a negative impact by forcing up costs as they compete for land, labour, and other resources. Thus, Georgia's lack of subsidy programmes may have indirectly benefited indigenous businesses.

Yet indigenous firms – not outside economic stars like carmakers – are the key to economic growth. The importance of indigenous firms holds true in the southern United States. Weinstein and Firestine (1978) review the literature and find that employment growth and loss has very little to do with the in-migration and out-migration of firms "both [in] the North, where employment is growing slowly, and the South, where employment is growing rapidly. Births and expansions [of indigenous firms], by contrast, vary significantly among regions and can be cited as the major causes of differential employment growth. ... [T]he primary cause of rising employment in the Sunbelt has been the expansion of existing firms and the birth of new firms" (1978, 131, 134).

Georgia's development programmes, instead of emphasizing subsidies, focus on "soft" services, like training, and investments in infrastructure, which remain in the state even if the assisted business fails. Because money is not passed on to the company, no firm invests in Georgia to reap a subsidy. But Georgia – in a renowned and much-copied programme – will provide training for a new company's work-force, though they will not fund a company training programme. This avoids companies settling in Georgia to seek a subsidy under the guise of training. Instead, company officials tell the state what skills they need and they work

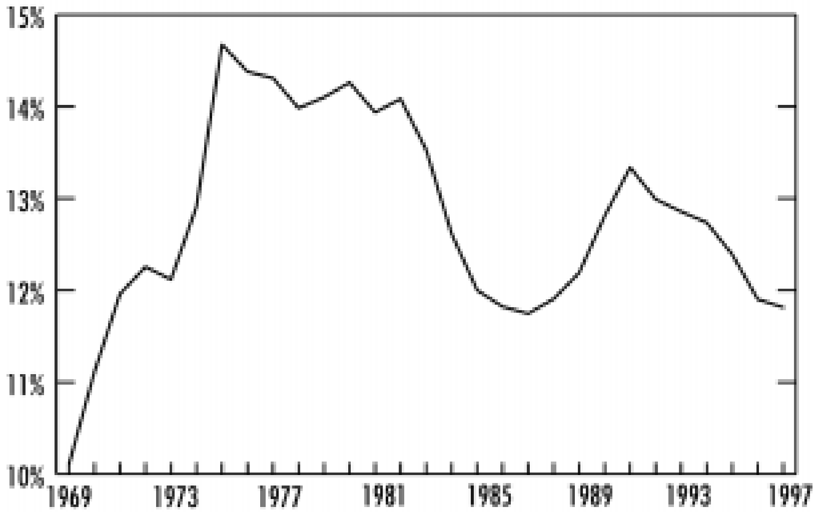
with state officials in setting up the programme, which is run by the state. Whatever happens to the client company, the skill level of the work-force is improved.

Georgia will also help with infrastructure costs. But such infrastructure obviously remains in the state even if the client company leaves. And Georgia has developed a bank to provide that most necessary of all ingredients for success: information. Georgia's data bank will tell a company which locations meet its requirements – whether these are for specific transportation links, several nearby machine-tool shops, or a work-force with experience in the furniture industry. Thus, firms can find the most cost-efficient location for them in Georgia.

Labour costs in Georgia are now close to the national average. But Georgia has maintained a consistent gap between its per capita GDP and average state wages. For example, in 1996, Georgia's per capita GDP was over 105 per cent of the national level, but average Georgia wages were only about 92 per cent of the national average. This suggests that Georgia workers were somewhat underpaid or, looked at another way, that labour costs were inexpensive compared to level of output. Yet Georgia's average wages and personal income have consistently risen against the national average. This supports the idea that competitive labour costs, while, in any given year, providing workers less than their maximum possible pay, create long-term benefits for workers. It attracts more capital, increasing the capital/labour ratio and thus the pay-out to labour. New and ongoing investment and continuous employment increases the value of human capital, intrinsically increasing the value of labour and the pay-out to it.

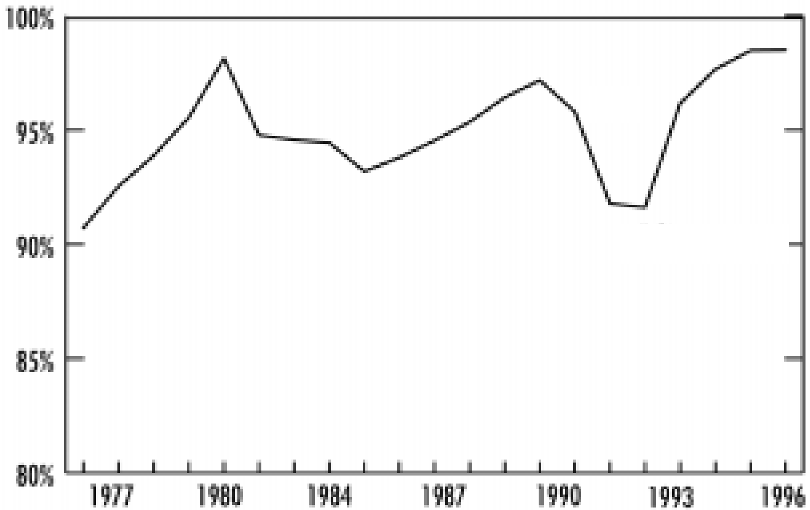
Georgia has maintained a relatively small, inexpensive state government. Georgia state and local government employment, at about 13 per cent of total employment, is similar to the national average (chart 4-8). But state and local government as a percentage of GDP are below the national average (chart 4-9), as are Georgia state and local taxes. Only about 15 states have taxes lower than Georgia's. In 1993, state and local revenues in Georgia equalled \$219 for every \$1,000 of personal income; the national

Chart 4-8 Georgia: State and Local Employment as a Percentage of Total Employment



Source: U.S. Bureau of Labor Statistics

Chart 4-9 Georgia: State and Local Government as a Percentage of the National Average



Source: STATS USA

average was $232 per $1,000 of personal income (Tan Foundation 1997; chart 4-10). Moreover, Georgia spends its money wisely. For example, Georgia has "the nation's best highway quality", according to research conducted by the independent Corporation for Enterprise Development (1996, 56).

This helps, but Georgia's most important competitive advantage is clearly in the cost of labour. The relationship between Georgia's unemployment and pay rates is not clear-cut, in part because Georgia's relative pay has been on a long-term secular rise. Nonetheless, increases in relative pay soften as Georgia's unemployment rate rises against the national average (chart 4-11).[6] Georgia has experienced strong employment and labour-force growth and shrinking levels of unemployment for the last decade and half (charts 4-12 and 4-13).

Georgia provides a road-map for success. It shows that when labour and tax costs are kept competitive, not only does the state economy grow, but wage rates also rise. It also shows that heroic government economic-development efforts are hardly necessary for success. In fact, given Georgia's record against other Southern states, which boast massive subsidy programmes, lack of such efforts appears to be quite beneficial.

Louisiana

If Louisiana is not the most blessed state in the United States, it is certainly the most blessed Southern state. New Orleans sits at the nexus of one of the world's great transportation routes. A key to

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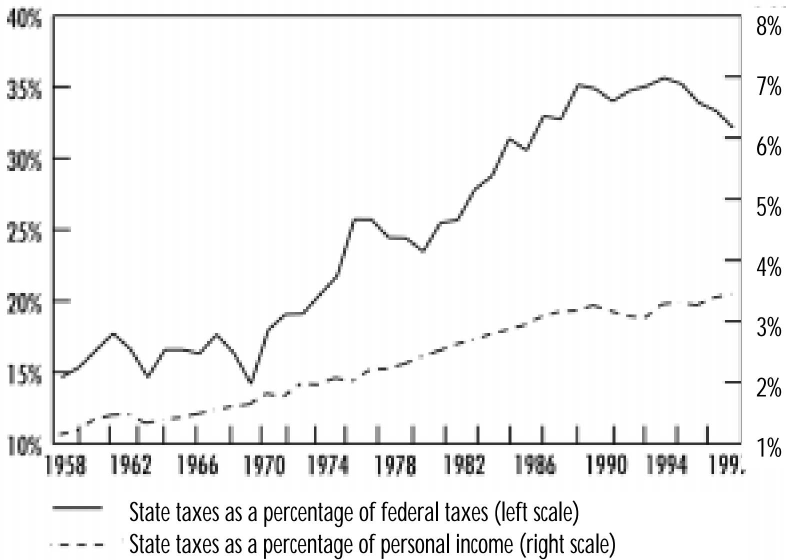
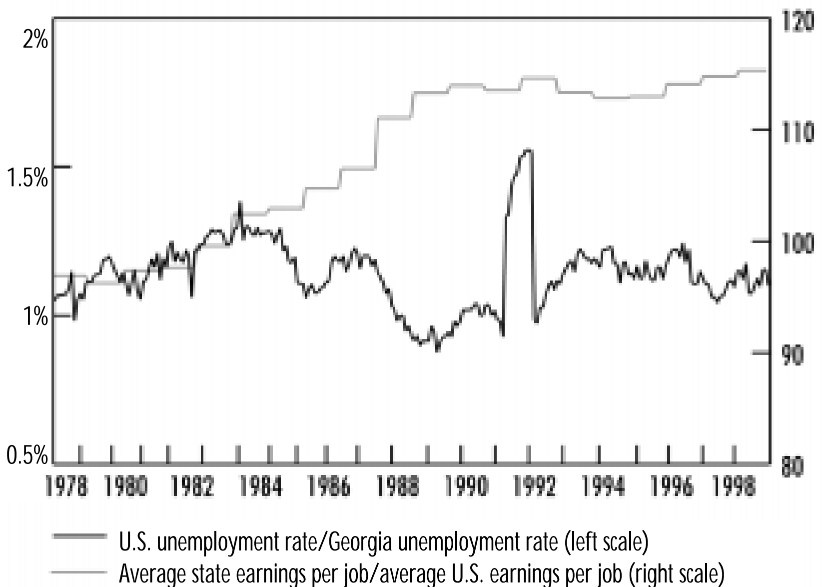
6. A state's unemployment rate relative to the national average should move in the opposite direction from average state earnings relative to the national average. To help visually interpret the data, I've used the U.S. employment numbers as the numerator of the first series, and U.S. average earnings as the denominator of the other series in this chart and similar charts for the other states examined. This inverts one series relative to the other, so on the chart they should move in the same direction. The blip in Georgia employment in 1991 is probably due to the Gulf War. As noted earlier, Southern states have somewhat higher concentrations of military personnel than the national average, though lower levels of defence contracting.

Chart 4-10 Georgia: State Taxes



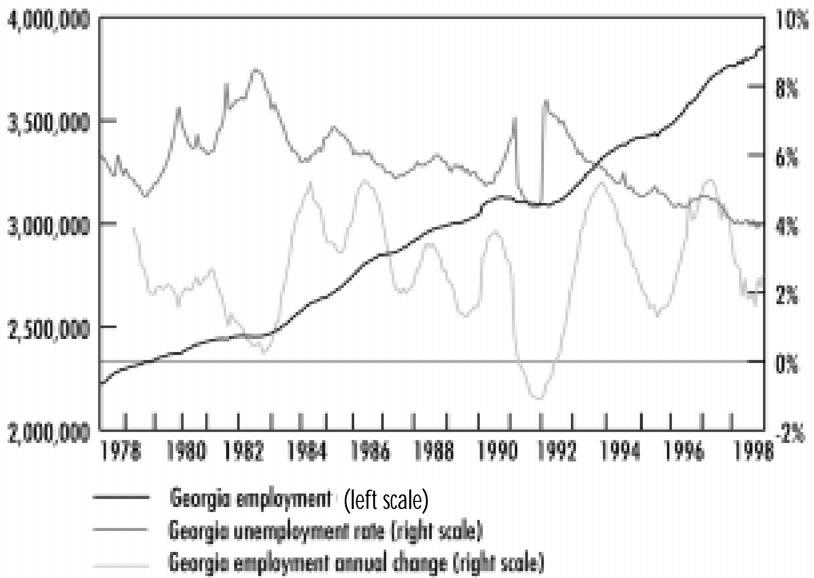
Source: STATS USA

Chart 4-11 Georgia: Unemployment and Real Wages



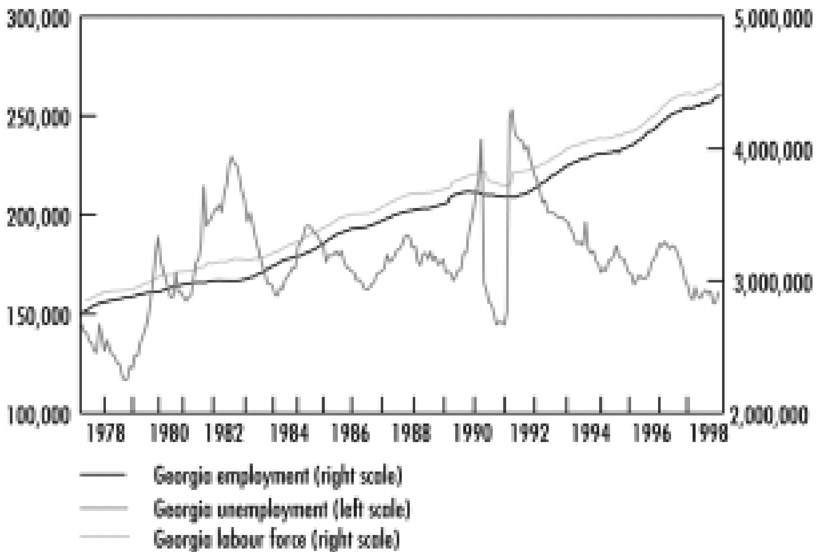
Source: U.S. Bureau of Labor Statistics

Chart 4-12 Georgia: Employment Growth



Source: U.S. Bureau of Labor Statistics

Chart 4-13 Georgia: Employment and Labour Force



Source: U.S. Bureau of Labor Statistics

economic development and growth throughout economic history has been proximity to trade routes.

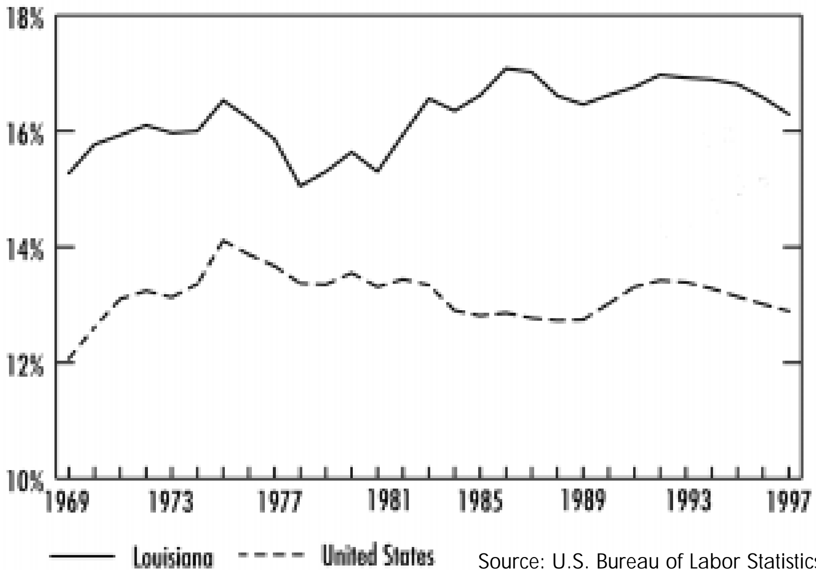
Louisiana has also experienced a resource bonanza because of Gulf of Mexico petrochemical deposits. The two together – transportation routes that tie Louisiana to many major markets and resource wealth – should, by most versions of economic-development literature, push Louisiana's development into fast forward. Yet Louisiana's experience shows that resource wealth is not a recipe for real economic activity that produces sustained wealth for people, good-paying jobs, and high employment.

It also shows what a difference policy makes. While neighbouring resource-rich Texas prospers, resource-rich Louisiana's per capita GDP has fallen well behind the national average. Texans have traditionally been suspicious of big government. In Louisiana, government, at least since the days of Huey P. Long, has played a large role in the state economy and society. Louisiana, unusually for a Southern state, is a high-tax state. In 1993, state and local revenues in Louisiana equalled $262 for every $1,000 of personal income, 13 per cent above the national average of $232 per $1,000 of personal income. Only about half a dozen states collect more revenues than Louisiana. (All figures in this paragraph are from Tax Foundation (1997)).

Louisiana has a history as the South's high-tax state. In 1975, Louisiana was the only state in the South with a tax burden above the national average, though West Virginia and Mississippi, two other low-growth Southern states, were within three percentage points of the national average. All other Southern states had considerably lower burdens. Georgia's tax burden was 84 per cent of the national average, for example.

Most Southern states had higher levels of taxation, relative to the national average, in the early 1950s, but Louisiana's was a whopping 138 per cent of the national average, obviously much higher than the national average but also higher by at least 10 percentage points than any other state in the nation save North and South Dakota (Weinstein and Firestine 1978, 140-141). State

Chart 4-14 State and Local Government Employment as a Percentage of Total Employment



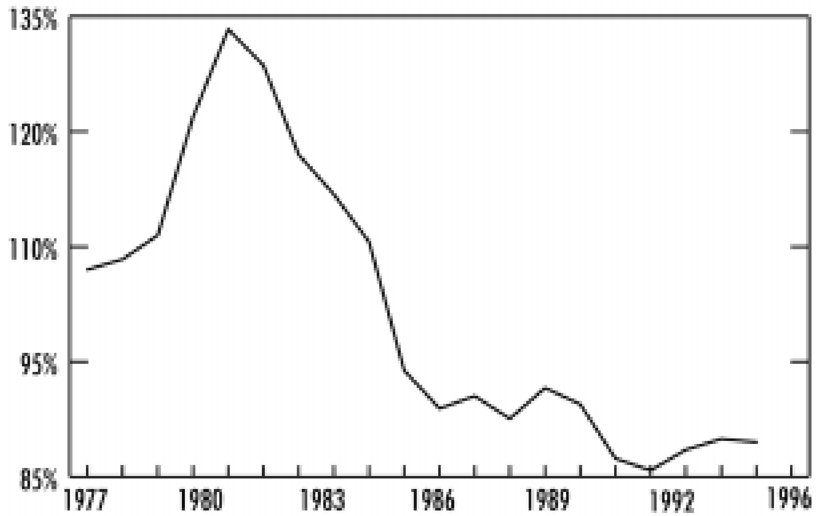
Source: U.S. Bureau of Labor Statistics

and local unemployment is an unusually high percentage of total employment (chart 4-14).

Economic activity was driven to new heights in Louisiana in the late 1970s and early 1980s by the petrochemical boom. But, far from bringing any lasting benefits, this bonanza seemed to do lasting damage to Louisiana's economy. Per capita GDP, personal income, and wages all rose rapidly then fell precipitously. By the mid- to late-1980s, all had fallen to levels below where they had been, relative to national averages, prior to the boom, though personal income has recovered somewhat since 1989 (charts 4-15 and 4-16).

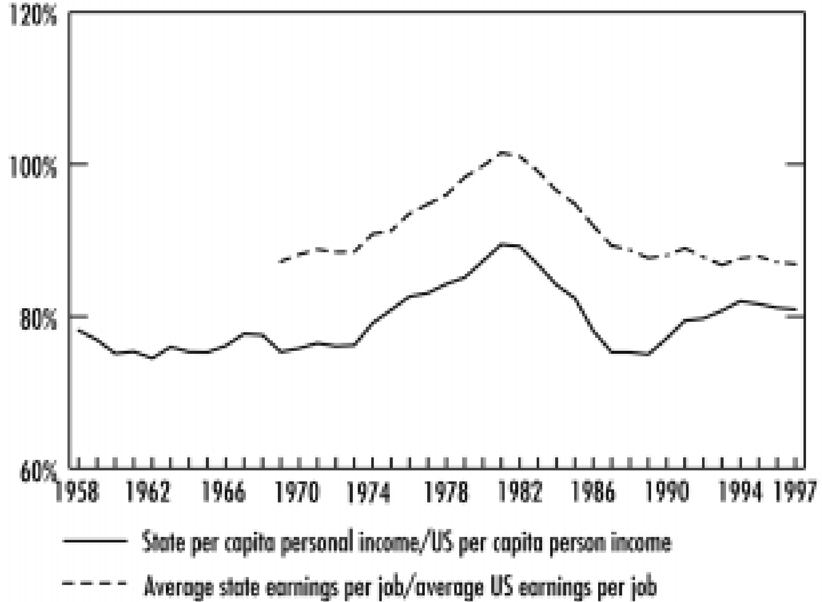
Average earnings were driven well above national averages, as would be expected, by the boom. The attractiveness of high-paying jobs in the petrochemical industry doubtless made it more difficult and expensive for other businesses to attract and hold labour, particularly skilled labour. Increasing state employment

Chart 4-15 Louisiana: GSP as a Percentage of USA GDP Per Capita



Source: STATS USA

Chart 4-16 Louisiana: Relative Personal Income and Earnings



Source: U.S. Bureau of Economic Analysis

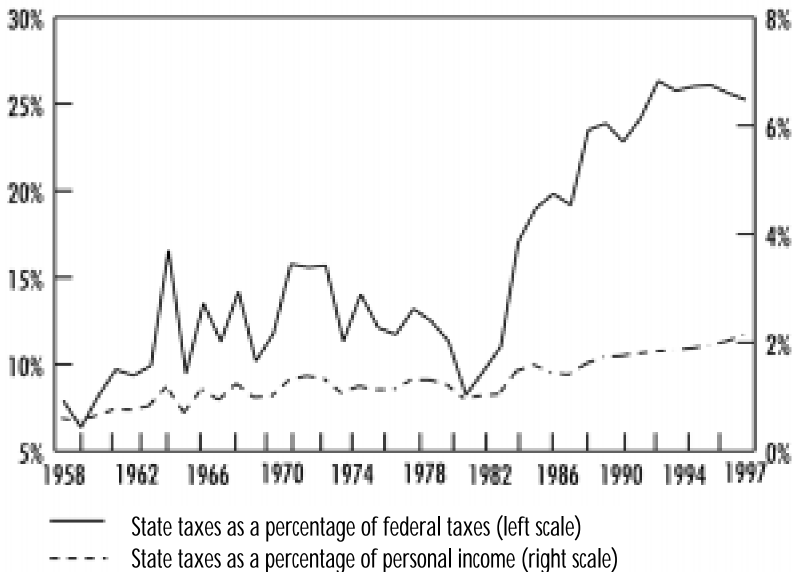
also put upward pressure on wages, again making life more expensive for other state businesses. The impact on wages is obvious in chart 4-16. This suppressed other economic activity, and, when the petrochemical boom was over, the state economy was in worse shape than before. This is classic "Dutch disease" and shows that resource wealth, far from being the cutting edge of economic-growth strategy, is a dangerous two-edged sword.

The bloating of state government is strongly evident in chart 4-14. State and local employment start rising as a percentage of total employment with the oil crisis of the late 1970s. Nationally, the ratio is falling through this period. Because Louisiana is a resource-rich state, the oil crisis created tremendous investment and private-sector job growth in the state. By itself, this should have pushed down ratio of government workers to private-sector workers. As well, with incomes rising and unemployment falling, the need for state services should have declined.

Successful resource jurisdictions, like Texas and Alberta, use petrochemical wealth either to provide increased services at no extra cost to taxpayers or to decrease the tax load. Either strategy reduces costs and offsets the inflationary impact of petrochemical activity. Unfortunately, Louisiana chose to increase taxes. This meant non-petrochemical businesses faced both rising wage costs and higher tax bills. State personal income taxes grew dramatically as the oil boom reached and then passed its peak. At the top of the oil boom, 1981, Louisiana's state corporate-tax collections had risen to the eighth highest in the nation per $1,000 of personal income. The state government pumped itself up as well, though higher rates of economic growth and employment creations should actually have reduced state expenditures.

Although Louisiana maintained high corporate taxes and royalities, its personal taxes remained low by national standards (chart 4-17). In fact, they did decline somewhat towards the end of the oil boom, before moving upwards once again. The size of the state government as a percentage of GDP did rise against the national average during the oil boom – when the government actually should have been getting relatively smaller because of the

Chart 4-17 Louisiana: State and Local Government Taxes

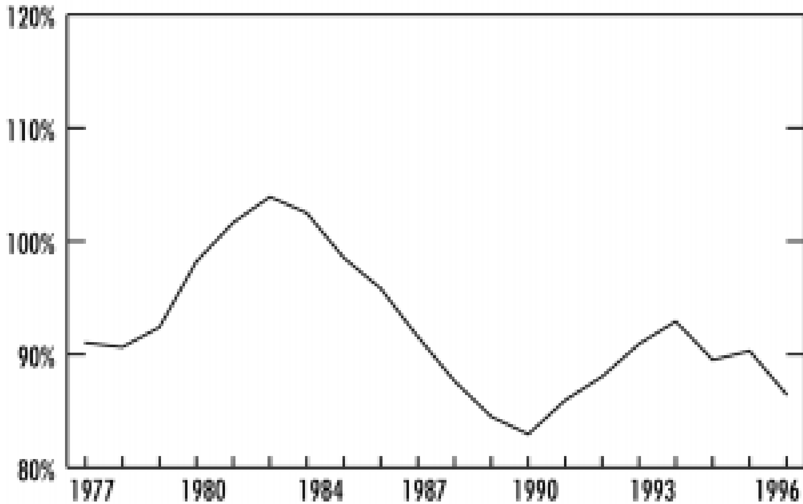


Source: STATS USA

growth of resource activities – but after the oil boom it slipped back below the national average (chart 4-18).

The problem appears to be return for these expenditures. Regardless of the level of state spending, Louisiana has always ranked low on measures of provision of services, like education and infrastructure. As the Corporation for Enterprise Development reported (1996, 72), “Louisiana’s development resources are the worst in the nation. With the nation’s lowest high school graduation rate, the state’s Human Resources receive a failing grade.” Louisiana policy-makers exhibited a lack of attention to providing key state services, particularly as government was growing through the oil boom. In 1978, prior to the boom, Lousiana’s state and local government were at 91 per cent of the national average; the same GDP-based measure of spending on education was at 77 per cent of the national average. Lousiana state and local government climbed to 104 per cent of the national average in 1982;

Chart 4-18 Louisiana: State and Local Government as a Percentage of National Average



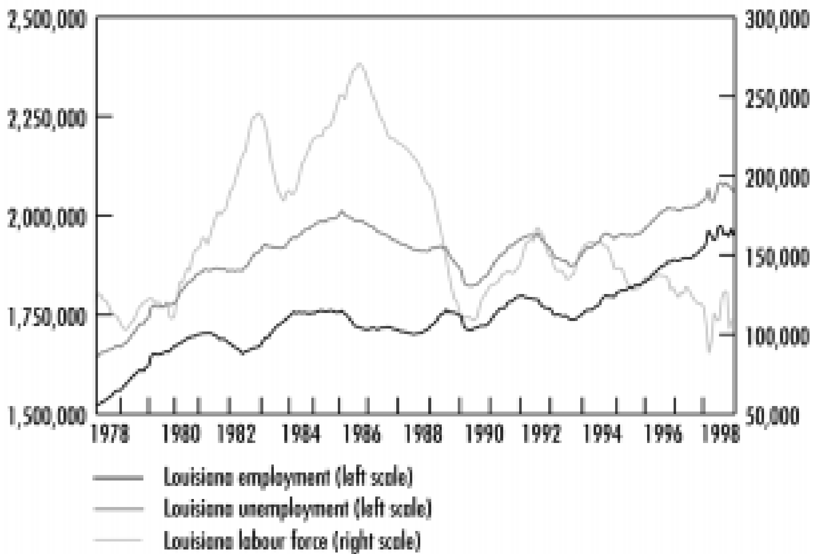
Source: STATS USA

education had fallen to 73 per cent of the national average. In 1996, state and local government had fallen to 86 per cent of the national average, education to 68 per cent. The list could go on. For example, Louisiana also rates in the bottom five states for transportation infrastructure.

It also has a widespread reputation for political spending and corruption, neither of which provide value for taxpayers' money. Although it is far beyond the scope of this book to examine closely the nature of spending during the petrochemical boom, the universal view across the state is that the money was simply frittered away in ways that may have bought votes but did not improve infrastructure, that may have rewarded powerful political friends but contributed little to education and other essential state services. I heard this view from city officials in New Orleans, from high state officials, including at the cabinet level, in Baton Rouge, and from economists – for that matter, everyone I spoke with in the state.

The lesson from the petrochemical boom seems to have been

Chart 4-19 Louisiana: Employment and Labour Force

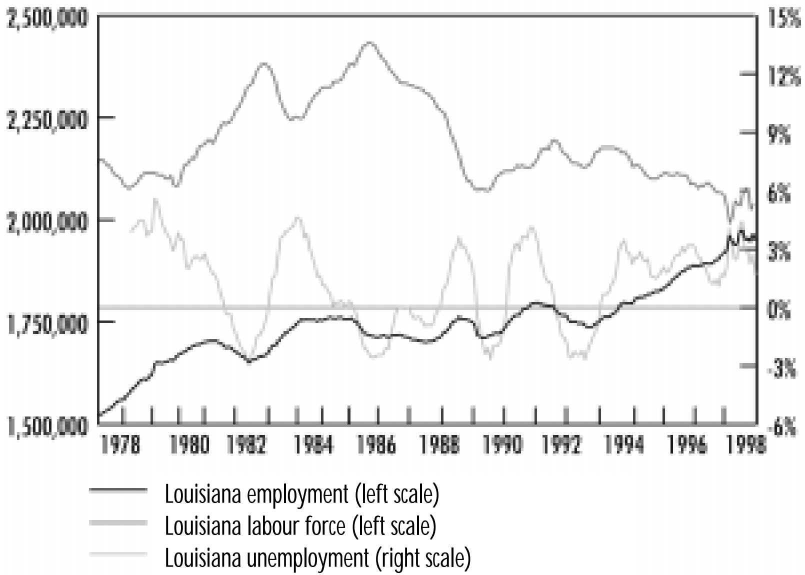


Source: U.S. Bureau of Labor Statistics

well absorbed in the state. The state government is working to reduce taxes and provide better services for the money. Budgetary problems are being brought under control. State employment as a percentage of the work-force has been on a slow decline since the early 1990s. This is largely due to non–government-employment growth. State per capita GDP has at least stabilized against the national average and, since the early 1990s, has shown some signs of increased growth. Similarly, over the same period, employment and the labour force have grown while unemployment has decreased (charts 4-19, 4-20, and 4-21).

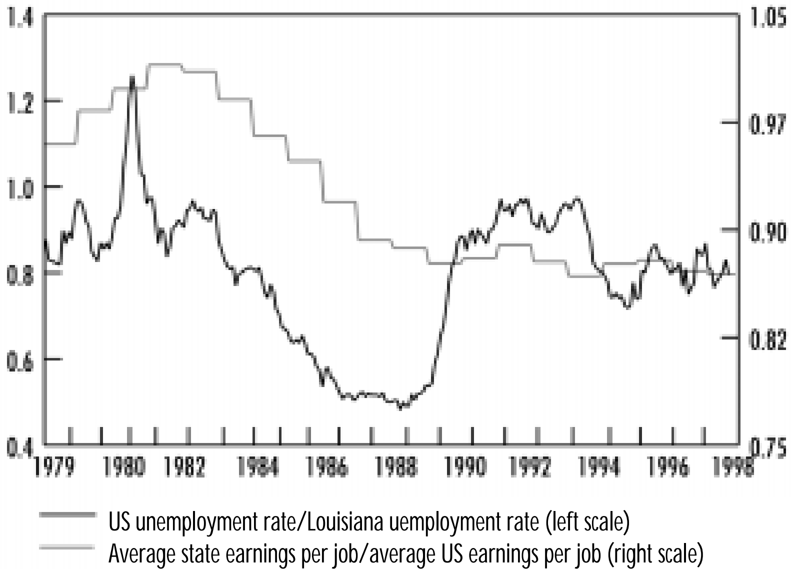
Louisiana once again shows that policy matters and that states have to be careful about their cost structure and about getting value for money. Both locational advantage and a sudden surge of resource wealth – like a lottery winning – can be frittered away if policy is bad. Resource wealth can damage a state economy instead of bringing benefits to the citizens of the state.

Chart 4-20 Louisiana: Employment Growth



Source: U.S. Bureau of Labor Statistics

Chart 4-21 Louisiana: Unemployment and Earnings



Source: U.S. Bureau of Labor Statistics

Massachusetts

It was the worst of times. By the late 1980s, the Massachusetts economy had been slammed by a triple whammy – a state budget out of control, and the virtual collapse of both the state's computer and defence industries. It was, by some counts, the worst regional recession in the United States since the end of the Great Depression, and it hit about two years before the rest of the U.S. economy was affected. Unemployment soared nearly to the double-digit level, even though hundreds of thousands of people left the work-force, or simply left the state. Taxes were high; spending was higher still. The state was nearly bankrupt. Massachusetts was the hardest-hit state, but the whole of New England was in deep recession:

> New England is now [i.e. in 1994] emerging from its longest and deepest recession since the Great Depression of the 1930s. From its peak in early 1989 to its lows in the summer of 1993, the region's non-farm employment fell 10.9 %, representing the loss of 725,000 jobs. New England's recession was far more severe than the nation's – U.S. employment fell just 1.5% from mid-1990 to mid-1991 and had fully recovered by the end of 1993. Unlike the mild contraction of the 1980/82 period, this recession was experienced in every sector of the New England economy except health care. White-collar jobs became as expendable as blue-collar jobs. (DRI Canada et al.1994, 3-128)

Today, Massachusetts is booming. Taxes are down, yet the state runs a surplus. Unemployment has fallen to under four per cent, the lowest of any major state. (Canadian and U.S. unemployment rates are calculated differently. By Canadian measures, the Massachusetts unemployment rate would be about four per cent. Given that some people are always moving between jobs, this still translates into full employment in most of the state. It's hard to walk a

block in any Boston business district without seeing a bevy of help-wanted signs.)

What happened? Let's look firstly at reasons for the boom. Massachusetts's large defence industry benefited mightily from the Reagan military build-up. Massachusetts receives even today about three times as many defence contracts per capita as the rest of the country, and four times as many research awards. This became a river of gold during the Reagan build-up.

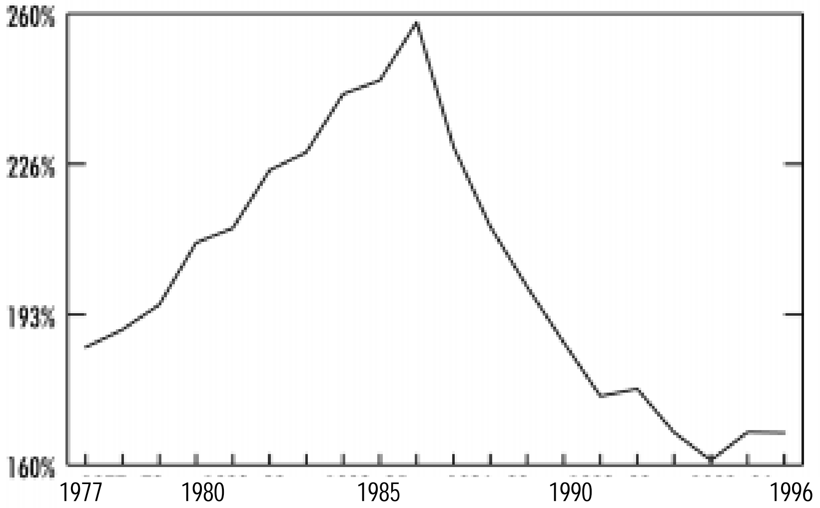
The 1980s were also a time of great excitement around Massachusetts's high-tech industry. There were three reasons for this excitement: military spending contributed to it; a number of new commercial technologies were emerging from Massachusetts' institutes of higher education, particularly the Massachusetts Institute for Technology (MIT); and the minicomputer industry, largely centred in Massachusetts and led by Digital Equipment Corp. (DEC), was booming.

Chart 4-22, which shows the rise and fall of Massachusetts's electronic industry, can serve as an approximate proxy for both increased military spending and the minicomputer industry. Explosive growth is evident until 1986, when the industry began to shrink rapidly. The early growth helped power Massachusetts's economy. Per capita GDP rose strongly against the national average (chart 4-23). Employment growth was also rapid during this period, and the unemployment rate fell to around 4 per cent (charts 4-24 and 4-25).

Massachusetts's Economic Problems

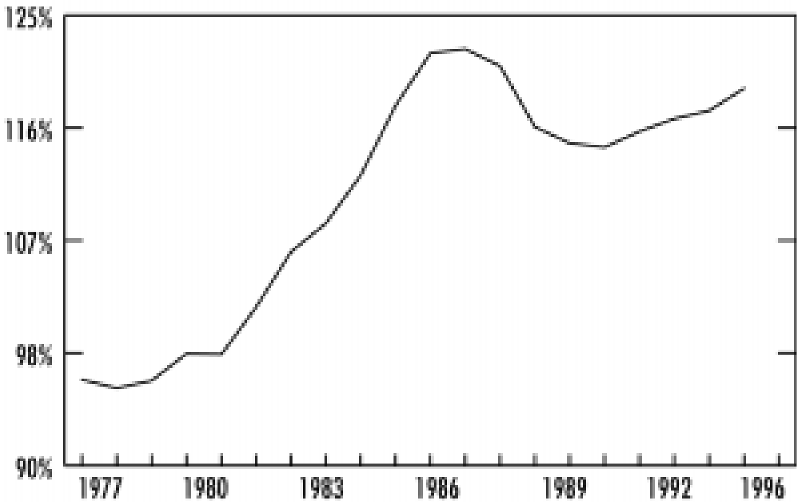
Now let's look at the state's three key economic problems. The biggest was self-inflicted. The state government took credit for the "Massachusetts miracle". It started building ever-bigger state government and feeding itself through ever-higher taxes. People started calling the state "Tax-achusetts". Taxes were spectacularly raised and government enlarged just as the bloom was coming off the boom (charts 4-26 and 4-27). By 1987, state corporate taxes were the third highest in the nation (Massachusetts Taxpayers

Chart 4-22 Massachusetts: Electronic Industry on a Per Capita Basis as a Percentage of the National Average



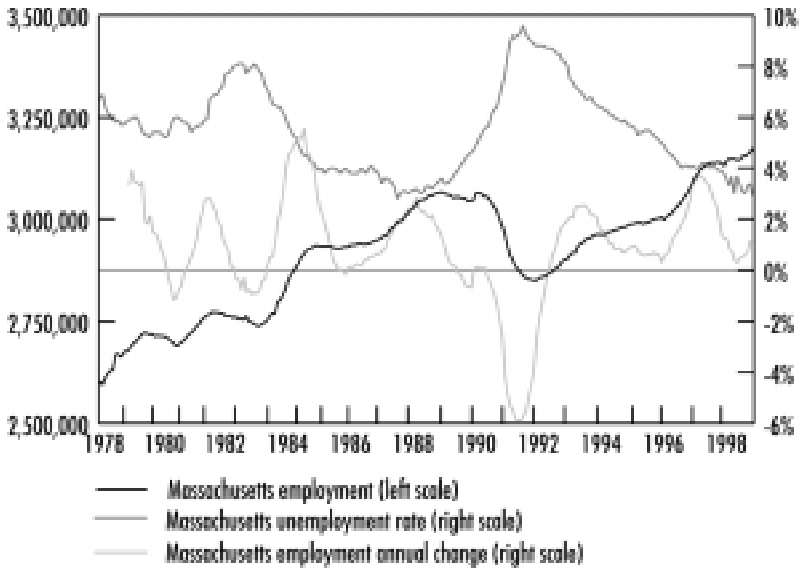
Source: STATS USA

Chart 4-23 Massachusetts: GSP as a Percentage of USA GSP per capita



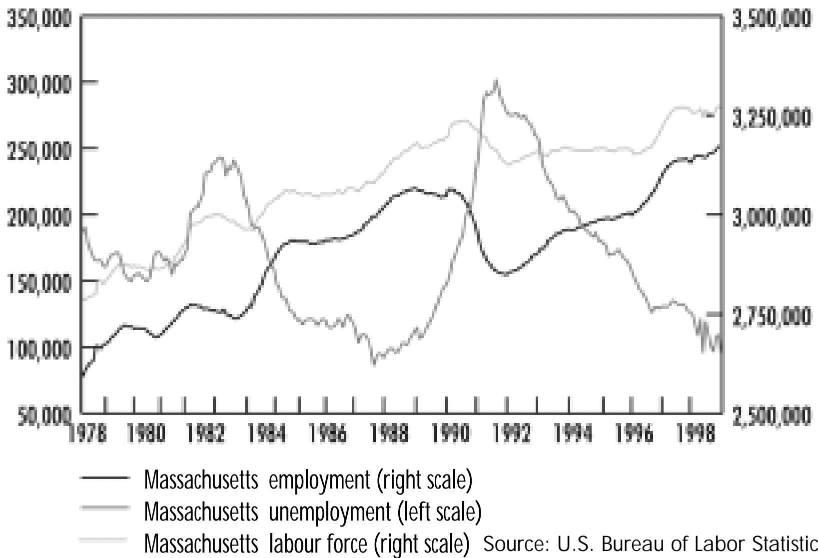
Source: STATS USA

Chart 4-24 Massachusetts: Employment Growth



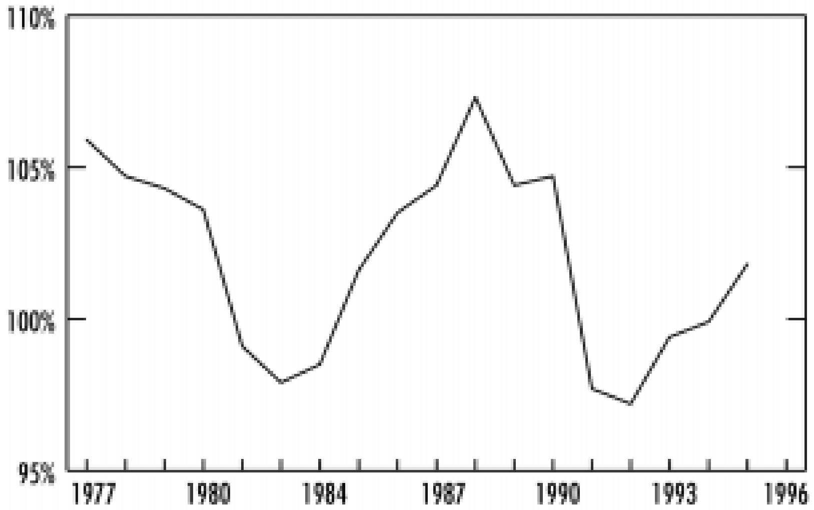
Source: U.S. Bureau of Labor Statistics

Chart 4-25 Massachusetts: Employment and Labour Force



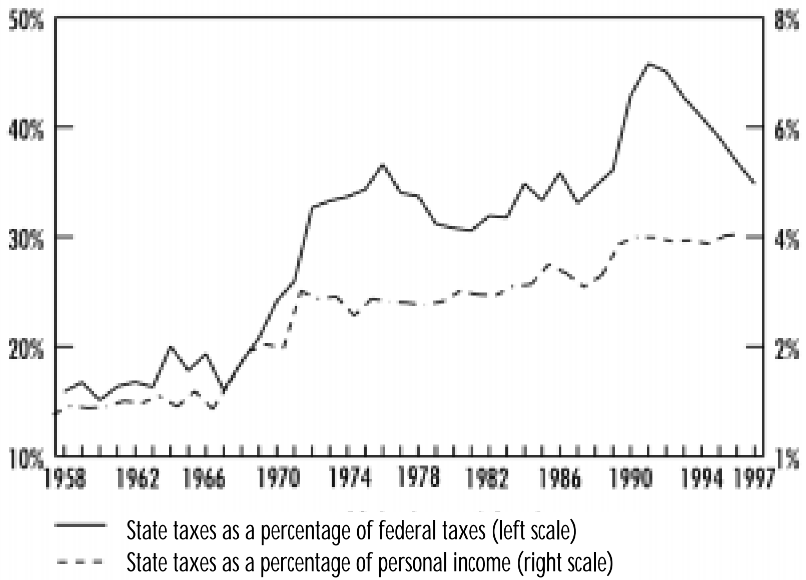
Source: U.S. Bureau of Labor Statistics

Chart 4-26 Massachusetts: State and Local Government as a Percentage of National Average



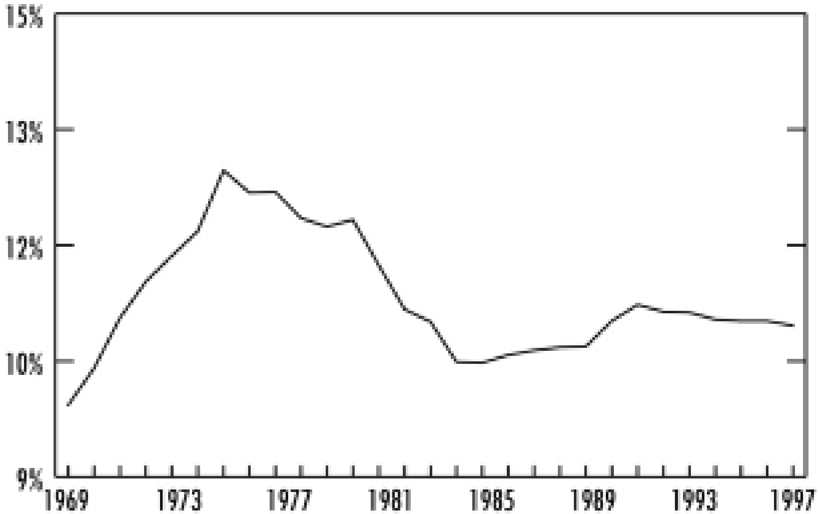
Source: STATS USA

Chart 4-27 Massachusetts: State Taxes



Source: STATS USA

Chart 4-28 Massachusetts: State and Local Employment



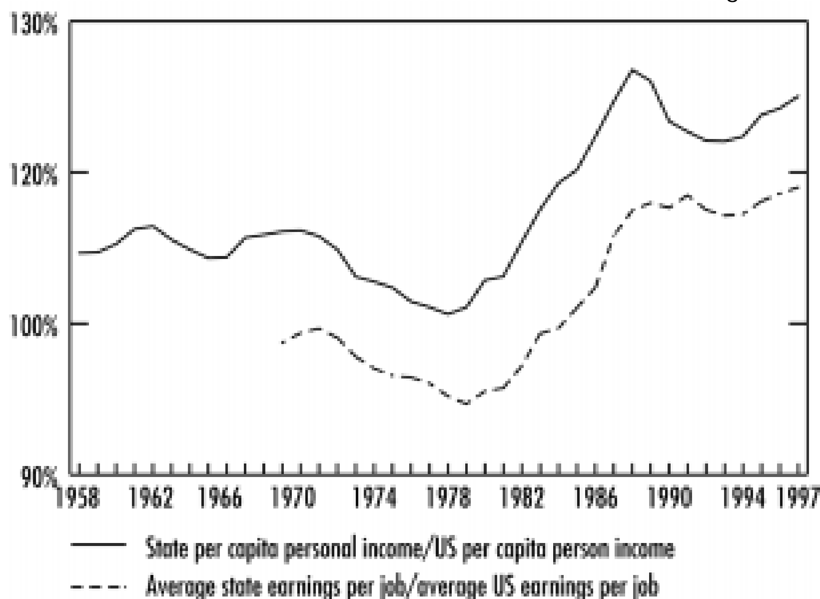
Source: U.S. Bureau of Labor Statistics

Foundation 1997). Although state and local employment as a percentage of total employment has never been particularly high in Massachusetts, it also grew through the Tax-achusetts period (chart 4-28).

Business costs soared, lifted higher by the upcurrent of a speculative bubble. This exacerbated the other two economic difficulties facing Massachusetts – the disasters that befell the huge computer and military industries.

Minicomputers had been busily pushing mainframe computers out of the office. But, towards the end of the 1980s, personal computers and workstations began to come of age, and the minicomputer industry went into a tail-spin. Much of what survived of Massachusetts's computer industry picked up and moved to the friendlier business climes of North Carolina, Texas, and, of course, California – the PC hot spot. At the same time, the Cold War was winding down. Spending cuts devastated the Massachusetts defence industry. And high taxes in Massachusetts didn't make it an attractive place for whatever defence work remained on the table.

Chart 4-29 Massachusetts: Relative Personal Income and Earnings



Source: US Bureau of Economic Analysis

As can be seen from chart 4-22, Massachusetts's electronic industry has never recovered its national pre-eminence.

Employment growth turned negative. In just two years, from 1989 to 1991, Massachusetts lost over 200,000 jobs (charts 4-24 and 4-25). Personal income, which had been driven up by the boom, now dove (chart 4-29). And relative per capita GDP also fell dramatically, as noted earlier.

If these woes hit a regional economy in Canada, we'd call on the federal government for help. We'd demand subsidies for failing industries. We'd call for make-work projects, economic-development measures, and a more activist government. If Massachusetts were a Canadian province, we'd probably still be subsidizing the mini-computer business against all odds, just as the federal government and Nova Scotia have subsidized the province's much more antique steel and coal industries.

This kind of response only papers over failure. It entrenches

and artificially props up the very structures that caused the problems. But Massachusetts did the opposite. The state's heavy fall from economic grace led to a revolution in thinking. Maybe it had to. Federal regional aid is low to non-existent in the United States. U.S. regions must solve their own problems with their own resources. So Massachusetts, Michigan, California, and other depressed states adopted virtually identical policies. And had virtually identical success in halting their problems before they became entrenched.

The timing and the politics differed from state to state. In Massachusetts, for example, the legislature remained overwhelming liberal, Democratic, and sympathetic to organized labour. The socially liberal, economically conservative Republican Bill Weld became governor.

Just as in other economically troubled states, a clear consensus developed on what needed to be done: get government under control and reduce its interference in the economy. Cut expenditures and slice away at the cost of doing businesses in Massachusetts – specifically taxes. Massachusetts took a counter-intuitive approach to job creation. No one doubted Massachusetts needed jobs, but government reduced the number of state jobs. Massachusetts policy-makers understood an economy is made strong, not by spending tax dollars on make-work activity, but by allowing the private sector to create sustainable, productive jobs. Even the state economic-development department was downgraded, its budget slashed, as was the state's executive department, from 70,000 in 1994 to 54,000 in 1996.

High taxes had been slowing down real job creation. State income taxes as a percentage of federal taxes were slashed (chart 4-27). Corporate taxes were also slashed. In 1987, the state collected $11.25 in state corporate tax per $1,000 of personal income ($206 per capita) compared to a U.S. average of $5.72 ($85 per capita). In 1994, the state collected $6.83 in state corporate tax per $1,000 of personal income ($176 per capita) compared to a U.S. average of $3.95 ($109 per capita). These cut-backs enabled the state to reduce its tax burden by about eight per cent. Unemployment

fell. State taxes remain relatively high in Massachusetts, but, at their present level, they are compensated for by world-class education, health care, and research facilities. While many are private institutions, almost all are supported by government money. The state also has a strong infrastructure. In other words, value is provided for tax dollars.

The government also moved to reduce regulatory costs. "Since February 1996, the administration has reviewed 1,600 regulations. As of January 1997, 22 per cent of regulations were rescinded, 49 per cent of all regulations were modified, and only 29 per cent of all regulations were retained in their existing form" (Cellucci 1997, 11).

A flexible labour market was also key to Massachusetts's recovery. When Massachusetts's unemployment rate skyrocketed, average earnings per job, as a ratio to the U.S. average, levelled off and then fell, before growing again with the state's recovery in the late 1990s (chart 4-30). Nonetheless, many economists in Massachusetts are surprised at how little average wages moved in response to the large increase in unemployment.

Labour economist Andy Sum, a professor at Northeastern University and head of the university's Center for Labor Market Studies, thinks he can solve at least part of the puzzle. He notes the state's actual job losses are far greater than the numbers that show up in the Stats USA data base on unemployment. "From the start of the Massachusetts recession to its bottom, we ... lost 568,000 jobs. Unemployment should have gone up to 14 per cent."[7] But, unemployment hit only 8 or 9 per cent, and the state employment numbers, based on a labour-force survey, show a much smaller job loss.

Several things happened to reduce the impact of job losses. Some people left Massachusetts to go where the work was; others, particularly the older and the less skilled, left the labour force. Consequently, the labour force declined as unemployment grew (chart 4-25). Here a distinction arises between people and place

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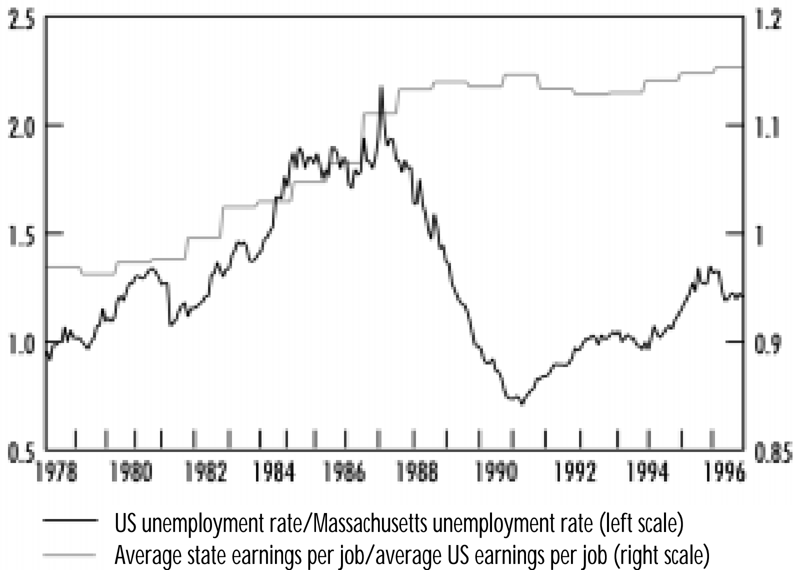
7. In conversation with the author.

Chart 4-30 Massachusetts: Unemployment and Earnings



Source: U.S. Bureau of Labor Statistics

prosperity. When prosperity in one area declines, people in the United States have historically been open to moving to where jobs and wealth are being created in order to maintain their personal prosperity. This produces good outcomes for the people and for the economy as a whole, because resources are shifted to more productive activities and regions.

But this is only part of the story. In the United States, regions themselves tend to recover their prosperity, though population change will interact with economic conditions. Key elements in restoring "place prosperity" in Massachusetts were wage flexibility and the rise of self-employment and "contingent" workers. Contingent workers work for a company through some contractual arrangement; they are not on its payroll and typically do not receive benefits. "The advantage of these things is that they keep people in jobs," Sum says. "They preserve work-skills." This resolves the paradox, Sum believes, of the difference between the

number of jobs lost and the numbers which show up in the Stats USA data-base. Many workers who had lost jobs created their own employment and reported themselves as employed when surveyed. And average pay fell much more than is apparent in payroll data, because of lower remuneration received by self-employed and contingent workers.

All this creates labour-market flexibility. People are willing to work for less, so employers, even in a recession, can afford more workers than they otherwise could. This breaks the fall in employment. With more people working, even if they don't show up in the payroll data, economic activity remains relatively higher. This helps push the economy towards recovery. As the Massachusetts recovery took hold, self-employment and contingent employment fell. Workers moved back to higher-paying, full-time jobs.

Sum believes that, without this labour-market flexibility, the Massachusetts recession would not only have been deeper and unemployment higher, but the recovery would also have been less robust. Without flexible labour costs, firms would have had to further reduce both their work-force and their production. They would have been weaker coming out of the recession. Many people would have fallen out of the work-force for good. Massachusetts would have started down the road towards a Canada-like regional problem – persistently weak economic activity and high unemployment.

Instead, people preserved their job skills, and unemployment has virtually disappeared in Massachusetts. Employment growth has been exceptionally strong since the early 1990s. State per capita GDP, personal income, and average earnings have all begun to rise against the U.S. average. Many folks now think it is the best of times in Massachusetts.

The recovery has been broad based and has not been powered simply by the high-tech sector, as some observers believe. The incomplete recovery of the electronics sector shows this. Because of reduced costs in taxes and wages, a number of sectors have been able to thrive in Massachusetts. But, at the same time, the

value of a high-tech, entrepreneurial, independent institution like MIT, both for the regional and national economy, should not be understated:

> If the companies founded by MIT graduates and faculty formed an independent nation, the revenues produced by the companies would make that nation the 24th largest economy in the world. The 4,000 MIT-related companies employ 1.1 million people and have annual world sales of $232 billion. That is roughly equal to a gross domestic product of $116 billion, which is a little less than the GDP of South Africa and more than the GDP of Thailand. (BankBoston 1997, 2)

The recipe for success in Massachusetts was a flexible state cost structure that responded to the downturn, restoring Massachusetts's costs to a level where companies could make profits. That kept companies alive through the downturn and eventually spurred new investment and growth. The key ingredients were a flexible labour market and a government that reacted by reducing taxes and government employment, rather than trying to create make-work projects and a government-managed economic recovery.

Michigan

The stories for Michigan and Massachusetts are broadly similar, so the discussion which follows will be briefer. Michigan became the centre of the "rust belt", a region which had been the midwestern heartland of the United States's industrial might. The rust belt was not just a conceptual idea, but also a raw physical image. Anyone travelling through the industrialized areas of the Midwest, particularly Michigan, would have been struck by the number of deserted, rusting, falling-apart factories that dotted the landscape in the late 1970s and early 1980s. This gave the region a palpable sense of desolation and the apparent promise of a bleak future, as once-vibrant towns and cities became ghost towns and

cities, like deserted towns of the Old West. Anyone who has seen the movie *Roger and Me,* a powerful attack on the car industry and government's *laissez-faire* attitude, will have a sense of the stark outlook of the time.

Just as the personal computer decimated the minicomputer sector, the United States's industrial prowess had been crippled – along with confidence in U.S. manufacturing ability – by cheaper, often higher-quality imports from emerging economies. The sudden surge of competition was nowhere more ruinous than in the automobile industry, though other sectors, like machine tools, suffered similar devastation. The external threat was accompanied by another trend. As manufacturing processes became more efficient and automated, fewer workers were needed to manufacture the same amount. Thus, while manufactured goods tended to maintain a fairly constant share of the economy, the number of workers declined – and more and more of those workers lived in Germany or Japan or Korea instead of Michigan or Ohio or Indiana.

From 1977 to 1982, Michigan per capita GDP declined from over 106 per cent of the national average to under 90 per cent (chart 4-31). Similar losses occurred in personal income and average earnings per job (chart 4-32). Job growth was negative for most of the period from mid-1979 to the beginning of 1983 (charts 4-33 and 4-34). The unemployment rate peaked at 16 per cent and was in the double digits for most of the first half of the 1980s, unheard of levels in the United States since the great depression.

But, for the most part, these were the Reagan years, and government was sizing down, not sizing up to help lagging regions. Save for a famous government bail-out of Chrysler, Washington mostly let industries fail and launched no persistent regional-aid programme.[8]

Yet the economies of the rust belt appeared to have had the natural resilience to heal themselves, despite the lack of emer-

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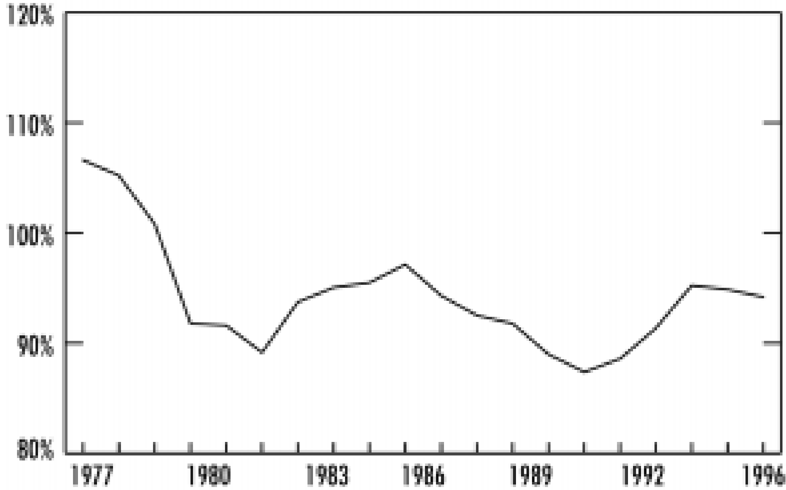
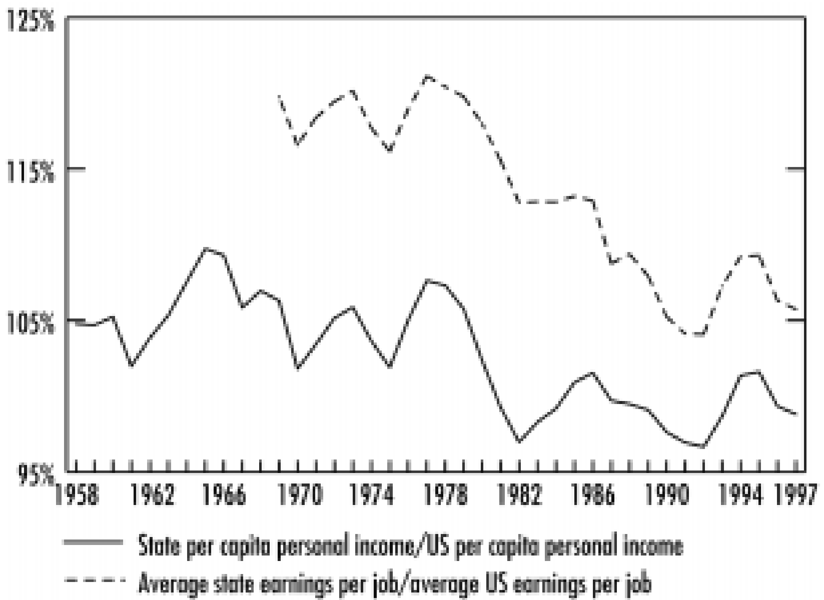
8. This is not to claim governments did not try to aid U.S. industries in any number of ways. But this was small beer. No rescue efforts of anything like the magnitude common in Canada or Europe were made. Tens of thousands of businesses failed, and thousands of factories were closed.

Chart 4-31 Michigan GSP as a Percentage of USA GSP Per Capita



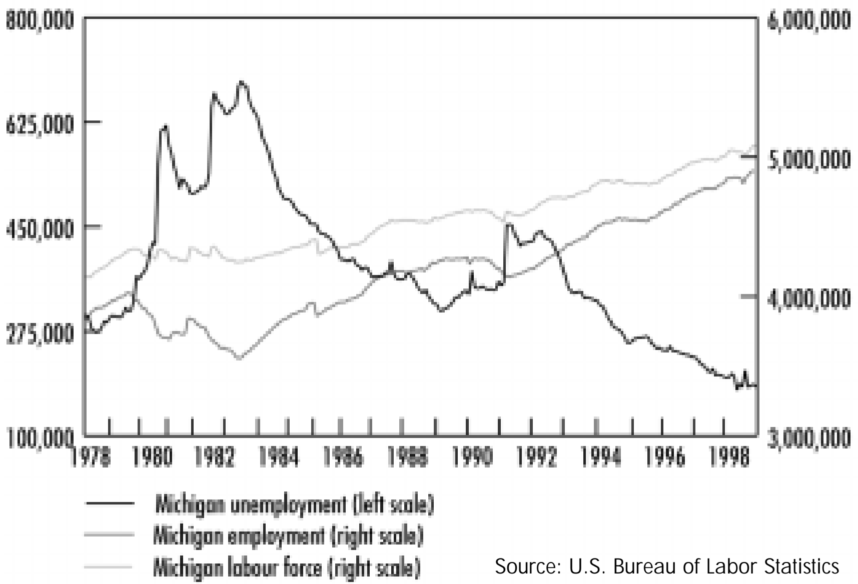
Source: STATS USA

Chart 4-32 Michigan: Relative Personal Income & Earnings



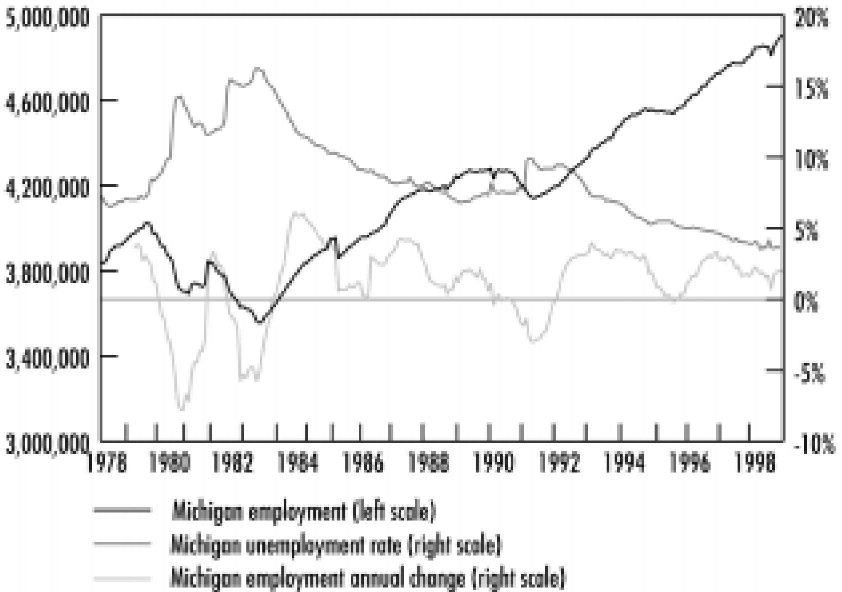
Source: U.S. Bureau of Economic Analysis

Chart 4-33 Michigan Employment and Labour Force



Source: U.S. Bureau of Labor Statistics

Chart 4-34 Michigan Employment Growth



Source: U.S. Bureau of Labor Statistics

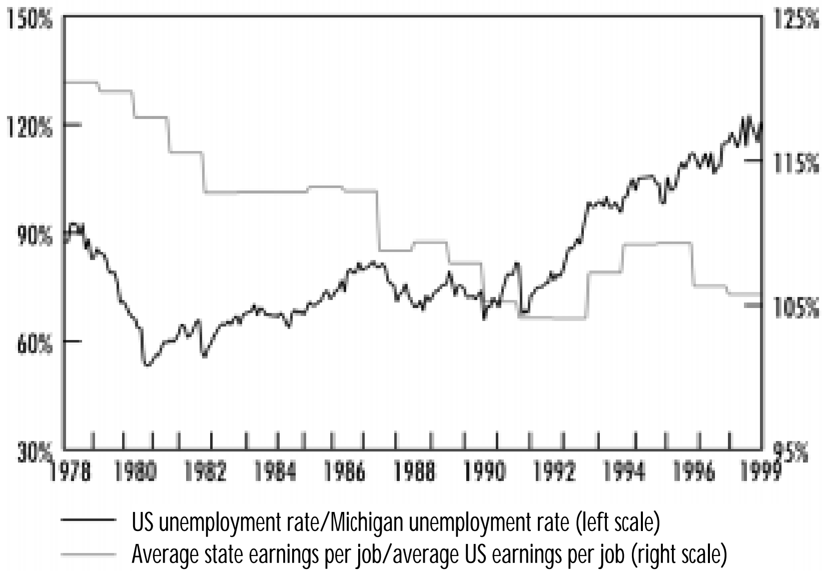
gency government action or even significantly increased protectionism to help the imperiled industries. After 1983, employment growth turned consistently positive, except for a couple of very brief blips and the short economic downturn of the early 1990s. By the beginning of 1987, Michigan's employment exceeded the level of employment that preceded the rust-belt era.

Wages proved flexible throughout the period, something that would have been inhibited by rich regional income-support programmes. Average pay adjusted downwards to levels which generated new employment (chart 4-35). This flexibility reflects two factors. A number of companies negotiated wage concessions with their workers and, often, agreements which allowed them to hire new workers at lower levels of pay. This kept these companies competitive and began to generate new jobs. Loss of high-paying manufacturing jobs also reduced the average pay-level as most displaced workers either accepted lower-paying jobs, left the workforce, remained unemployed, or moved.[9]

State government also reacted with some downsizing, though not particularly dramatically. Personal income taxes initially rose in Michigan as it tried to cope with the downturn, but they have been falling since, albeit with a number of large bumps on the way (chart 4-36). State and local government as a percentage of GDP has continuously declined relative to the national average since the early 1980s. Instead of attempting to generate government employment, state and local government in Michigan significantly reduced employment in the early 1980s. While gov-

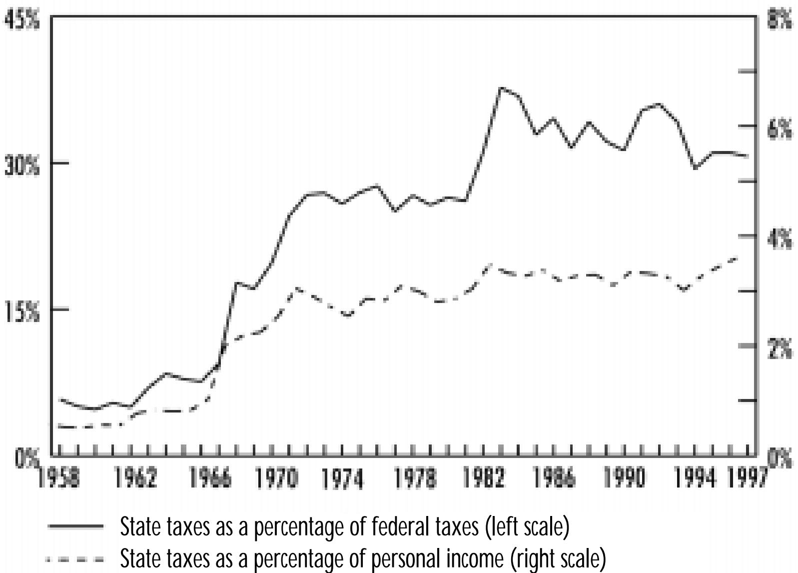
9. This is an economically efficient process, though many in Canada would argue that, in such cases, efficiency should be moderated by a greater level of public assistance. Personally, I agree with this point of view – that government should help ease transitions. But this becomes a route to long-term economic disaster if government intervention is so large it virtually halts all possible economic adjustment and traps a new generation in declining industries, as has been the case in Cape Breton, for instance, where old, inefficient industries were kept alive with government money and where a rich diet of regionally enhanced UI/EI programmes discouraged people from seeking full-time work, and thereby diminished the ability of businesses to generate such work, because of the wage-cost of competing with UI/EI.

Chart 4-35 Michigan: Unemployment and Earnings



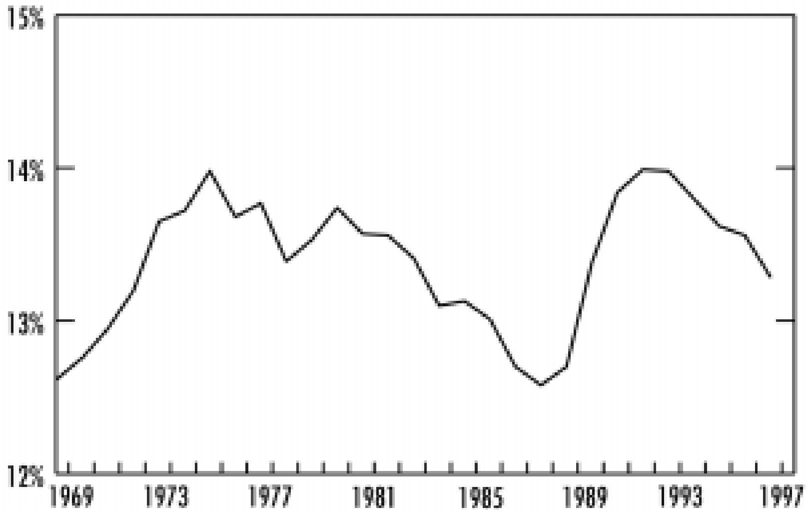
Source: U.S. Bureau of Labor Statistics

Chart 4-36 Michigan State Taxes



Source: STATS USA

Chart 4-37 Michigan: State and Local Government Employment as a Percentage of Total Employment



Source: U.S. Bureau of Labor Statistics

ernment employment has been on the rise since the mid-1980s, it has consistently fallen as a percentage of the Michigan work-force for most of the last two decades, with the notable exception of a brief upswing from 1989 to 1991 (chart 4-37).

Although relative per capita GDP, personal income, and average pay have had significant ups and downs since the mid-1980s, each appears to be stabilizing around a new level. It is worth emphasizing that these numbers are all relative to the U.S. average, so a stabilized level means Michigan's per capita GDP, personal income, and average pay are growing at the same healthy rates as those for the U.S. economy as a whole.

In 1991, a new governor, John Engler, was elected. Engler campaigned on getting the government out of the economy and reducing its size. In fact, when he came to power, the state government had been on a hiring binge, finances were weakening, and taxes were again on the rise, as is evident from the charts in this section. Per capita GDP, personal income, and wages were declining against the national average.

By standard Keynesian economics, this was hardly the time to cut government. But that is exactly what Engler did, as a review of the charts which detail government activity will show. Engler argued tax cuts were key to generating jobs. By his own count, he cut taxes 24 times, saving Michigan taxpayers, the administration claims, $11 billion. Whether it was this medicine, the natural resilience of a market-based economy, or a combination of the two, Michigan has exceeded national economic growth through most of the Engler administration.

Through this period, the state has made gains in per capita GDP, personal income, and average wages, though the indicators have widely fluctuated, and it is difficult to say at this point whether the gains are secular. Recent economic news suggests a positive long-term outcome. Michigan's employment growth remains impressive, and its unemployment rate has fallen to the lowest level since the 1960s. It is below the U.S. national average for the first time in generations, and the national unemployment rate has been famously low by international standards for a number of years

Not surprisingly, Gov. Engler's administration credits the increased vigour of the Michigan economy in the 1990s to the administration's efforts to reduce government and cut taxes. Still, Michigan over the last 15 years has exhibited a powerful recovery from what appeared to be a clinically dead state. Few economists in the early 1980s would have predicted the rust-belt economy could ever again be healthy, let alone recover anything like its lost glory. Yet that process is now in place. Although many indicators are lower now than in the 1970s against the national average, because of strong U.S. growth, they have still increased in real terms. Most importantly, unemployment is not just down; it is lower than it was before the regional recession began.

As with Massachusetts, the recovery was not powered by concerted government action but rather the reverse – concerted government restraint though most of the recovery period. Even more important than this was labour-market flexibility. All this opened the potential for profits and, thus, job creation. Many in Michigan now believe this is the best of times.

Maine

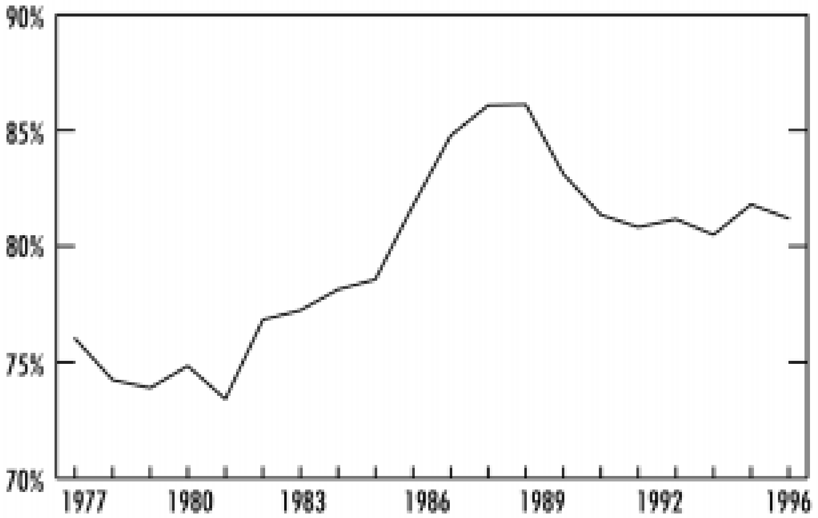
Maine's economy is significantly affected by developments in Massachusetts. The Massachusetts boom of the 1980s spilled over into Maine, inflating the economy and leading to a boom–bust cycle (chart 4-38), particularly in real estate. "A prime piece of shorefront property in the Mount Desert Island area, for example, went for about $10 a front foot in 1960, $100-$200 in the mid-1970s, $500 in 1986, and $1,000 in 1987" (Condon & Barry 1995).

These prices made it more expensive for indigenous businesses, as did inflation in wage rates. Government also absorbed increasing resources, and boosted costs directly through taxes and indirectly by putting increased inflationary pressure on the boom. Democrat Joseph Brennan was Maine governor from 1978 to 1986. His eight budgets increased state expenditures between 7.3 and 12.9 per cent each year, pushing up state expenditures from $482 million to $961 million. Brennan's successor, Republican John McKernan, increased expenditures at an even faster rate, peaking in a 19.7 per cent increase in 1989, when state expenditures had jumped to $1.52 billion. In McKernan's first term, state employment increased from 12,492 to 13,710 and pay increased 19 per cent (Condon & Barry 1995, 588-89). Wages also rose dramatically against the national average, though they did with a lag adjust to changes in employment (chart 4-39).

The groundwork for the bust was being laid. Like Michigan and Massachusetts, Maine built larger state and local government during the boom period, but it was much slower in cutting back following the economic downturn than either of those two states, and its reductions were smaller (charts 4-40 and 4-41).

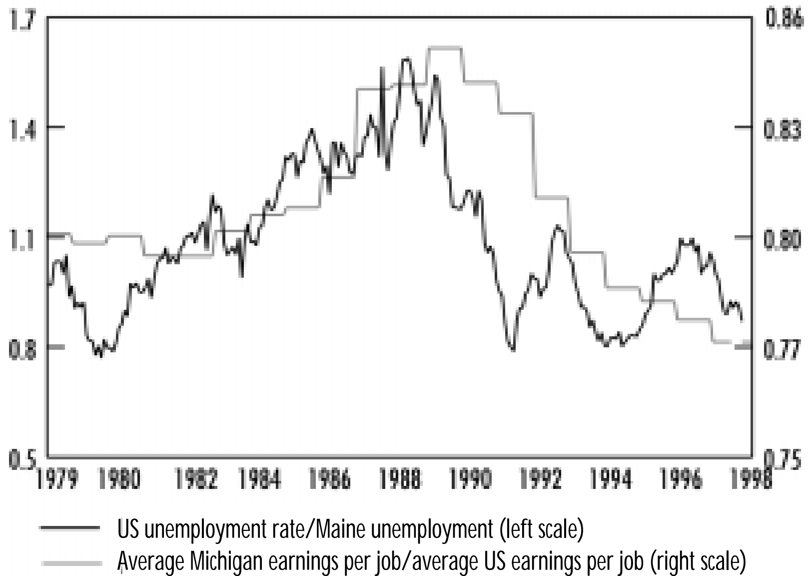
Maine's recovery from the bust of the late 1980s was weaker than Massachusetts's recovery at the same time and Michigan's earlier recovery. Although relative state per capita personal income is now higher than it was in the early 1990s, perhaps in part because of the increasing choice of Maine by wealthy retirees, relative average state earnings are now lower than in the late 1950s (chart 4-42). It is worth noting, however, that this measure is against

Chart 4-38 Maine GSP as a Percentage of USA GSP



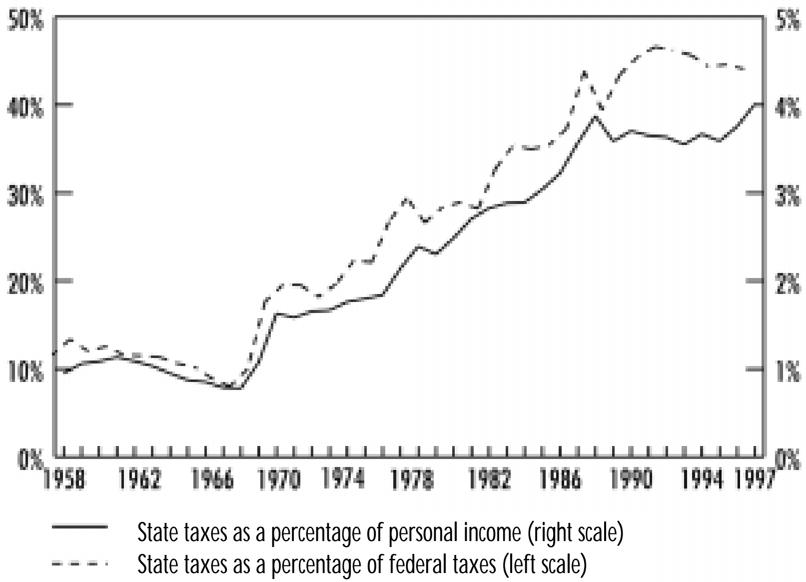
Source: STATS USA

Chart 4-39 Maine: Unemployment and Earnings



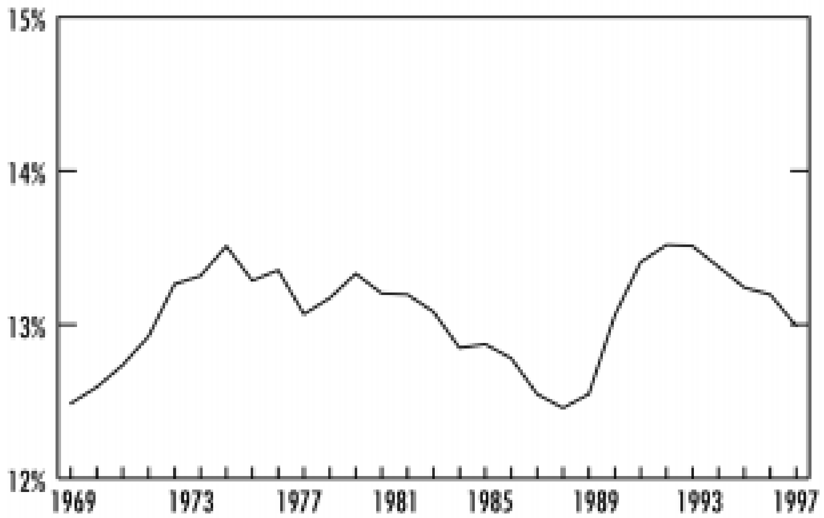
Source: U.S. Bureau of Labor Statistics

Chart 4-40 Maine: State Taxes



Source: STATS USA

Chart 4-41 Maine: State and Local Employment as a Percentage of Total Employment



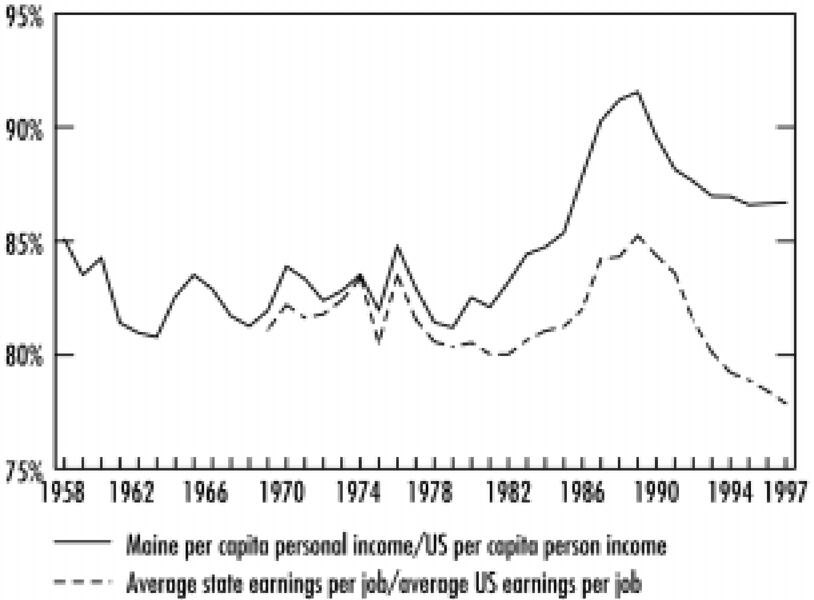
Source: USA BLS

the U.S. average and that, in real terms, Maine's earnings have increased, but not as much as in the national economy. Maine's employment growth was strong during the early part of the 1990s but has weakened since. Nonetheless, unemployment has fallen dramatically because of employment growth, on one hand, and weak labour-force growth, on the other hand (charts 4-43 and 4-44).

The size of Maine's government stands out. Although Maine per capita GDP is just over 80 per cent of the national level, state and local government spend at nearly 90 per cent of the national average (chart 4-45). As noted, the state also has relatively high taxes. In 1994, Maine had the eighth-highest level of state and local taxes in the United States, a level it has fluctuated around for at least the last decade. Maine's state and local employment as a percentage of total employment is also above the national level, but not significantly so. In other words, Maine did not take the same cure as Massachusetts and Michigan – significant reductions in state government and taxes – and has not benefited from as strong an economic turn-around.

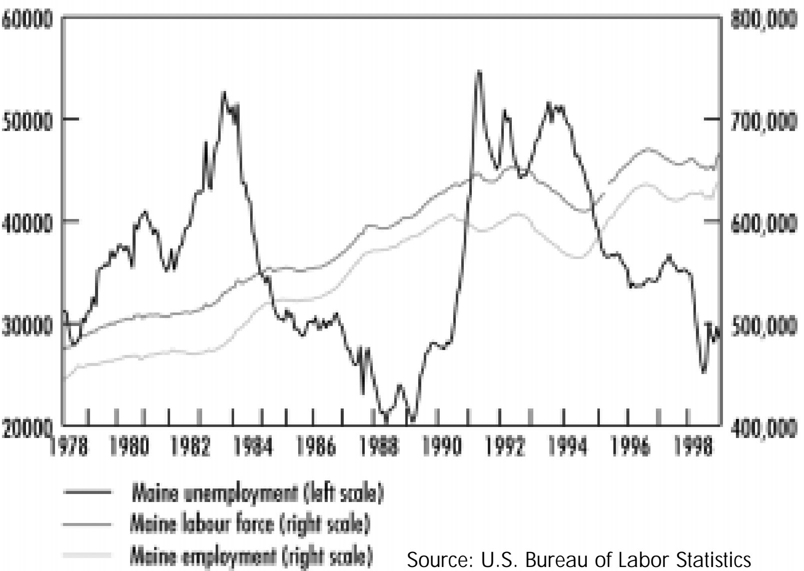
A couple of questions about Maine stand out. Maine is showing signs of reducing the size of its government and its tax rates. If it does follow this course, will that be associated with stronger economic growth in the future, as it was in Massachusetts and Michigan? The Maine economy is more resource based than those of other states, and it has doubtlessly been negatively affected by the long-term downward trend in resource prices. But most U.S. states at one time depended on resource-based economies. Will Maine, like these other states, build a modern economy which is not held back by the secular decline in resource prices? Maine's employment growth has experienced both ups and downs since the recovery of the early 1990s, but the unemployment figures conceal very different rates of unemployment within the state, about 2 per cent in the more urban south and about 6 per cent in the predominantly rural north.

Chart 4-42 Maine: Relative Personal Income and Earnings



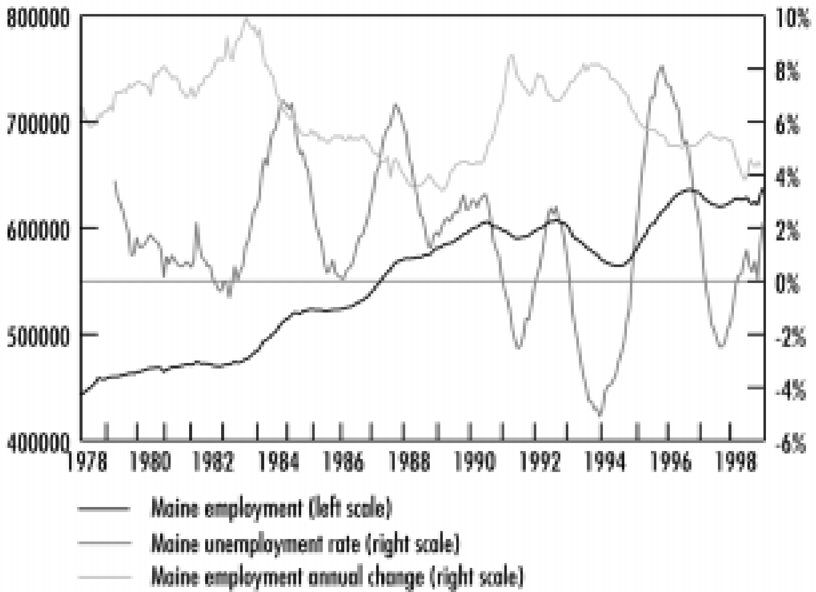
Source: U.S. Bureau of Economic Analysis

Chart 4-43 Maine: Employment and Labour Force



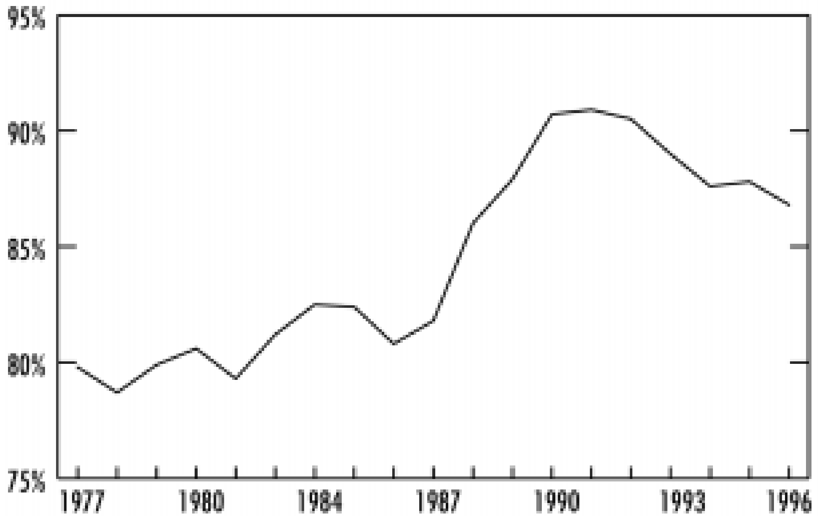
Source: U.S. Bureau of Labor Statistics

Chart 4-44 Maine: Employment Growth



Source: U.S. Bureau of Labor Statistics

Chart 4-45 Maine: State and Local Government as a Percentage of National Average



Source: STATS USA

Conclusion

All the successful jurisdictions examined have effectively lowered the cost of doing business – and thus increased profit opportunities – in order to spur economic growth and job creation. The two key ingredients examined were cost of labour and cost of government.

Of the five states examined, one, Georgia, has consistently kept government small. It is a right-to-work state, and wages are consistently a notch below the level implied by state per capita GDP. Both the state's economy and wage rates have consistently grown, and Georgia is now much more of a have than a have-not state.

Both Michigan and Massachusetts reacted to a severe economic downturn with reductions in government, though over different time frames. Labour markets proved relatively flexible in both states, as they are through the United States. This allowed wage costs to react to economic developments. Wages decline in a downturn, increasing the cost-attractiveness of the state. This helped local business cope with the downturn and served to draw in new investment.

Two states examined had weak adjustments. Both Louisiana and Maine have relatively large state governments, and both have been bedeviled by resource problems. Louisiana's economy was inflated by resource wealth. The resulting increase in government revenues went to building larger government instead of to reducing costs through lower taxes or providing superior services and government investment. Moreover, by all accounts, much of the money was spent for political, not productive, purposes. As with the Netherlands, resource wealth seems to have done Louisiana more harm than good. Maine also has a relatively large resource dependence which may hold back economic growth, though, as noted, Maine can boast of stronger economic growth than Atlantic Canada or, indeed, Canada as a whole.

Maine and Louisiana – along with a handful of other states, usually high-tax states like West Virginia – are exceptions to the strong force of convergence in the open U.S. economy.

Finally, the U.S. experience should be compared with that of Ireland and the Netherlands. Neither of these nations have labour markets as flexible as those in the United States, though Ireland comes closer than the Netherlands. Still, in both nations, the union movement has a large role in setting wages. Yet the successful Irish and Dutch strategies were remarkably similar to what occurs in the United States, though motivated as much by policy decisions as by the market. While U.S. wages naturally tend down during economic weakness, in the Netherlands and Ireland, government, unions, and business worked together to get the same effect through planning. This led to the Irish and Dutch miracles, though, as noted, whether this corporatist structure can be as flexible in the long term as open markets remains a question. The Dutch and Irish governments also reacted in a similar way to U.S. states seeking stronger growth. Both governments down-sized and worked to reduce taxes. The effort was far more dramatic in Ireland than in the Netherlands, and Irish growth has been stronger.

The dramatic whittling away of regional disparities across the United States has attracted the attention of even strong proponents of regional programmes, who note the phenomena but seem to draw no lessons from it. However, this phenomenon is not universal in the United States. Some high-tax states with an interventionist government and a politicized economy – notably Louisiana and West Virginia – have failed to converge at the average U.S. rate.

Policy-makers should turn their attention to factors that led to the dramatic recoveries in Michigan and Massachusetts and the reasons for the South's long climb from economic obscurity to prosperity. Not only have the Southern states, as a group, been catching up with the rest of the United States, exceeding even the strong overall U.S. rate of economic growth, but the most successful of the Deep South states, Georgia, has exceeded the national level of economic activity. These are stories worth paying attention to.