Conclusion

Policy-makers in lagging economies the world over all too often seek some magic elixir for economic growth. Yet, once cost competitiveness is in place, no magic elixir is required to create jobs and economic growth. They come naturally to competitive market economies, whether in lagging or leading regions. Five hundred years of market economic history makes that clear – people in any market economy live in a society immensely wealthier than did their parents. No other economic structure has even come close to creating the same level of prosperity as market economies.

The world's market economies create hundreds of millions of jobs each generation. Only war, pestilence, or profoundly perverse policies can derail them for anything more than a short period. Modern research shows even the length of Great Depression, though not its onset, was more a policy error – too-tight monetary policy and inflexible wages – than a natural outcome.

Moreover, empirical investigations support theoretical reasons to believe that lagging economies catch up with leading economies. However, this research shows that convergence is not automatic. For convergence to take place, the lagging jurisdiction requires the essentials of a market economy: markets, property rights, the rule of law, and stable institutions. An educated populace, or at least one that puts an emphasis on improving education levels, is also essential. Outside this convergence club, the gap between market and non-market economies is growing. Or, put another way, the gap between rich and poor is growing.

Among market economies – whether in Europe, the United States, or Japan – convergence shows up strongly. As we'll see in *Retreat from Growth*, the sequel to this book, convergence is far weaker in Canada, although Canada launched perhaps the world's most heroic regional wealth-transfer and development programme.

Convergence is partly due to the spread of productive ideas and methods. But costs and the profit motive also play a central role. An under-invested economy creates profit opportunities. A key mechanism here is the idea of labour/capital ratio. When labour is abundant relative to capital – as is the case in lagging economies – labour costs should be relatively low. Potential returns, profits, on the scarce resource, capital, should be relatively high. The profit motive attracts capital and creates jobs and economic growth. This can be derailed by distortions in the economy that either artificially inflate wages or attack the return to capital. This not only stymies investment and economic growth, it also stunts the potential for wage growth over the longer term.

Two-fold Purpose

This concluding chapter is not designed solely to provide a conceptual overview of and conclusion to the material found in this book. It is also meant to provide a forward glance to *Retreat from Growth*, which focuses on another type of economic-development strategy – one of heroic government intervention and regional wealth transfers designed to spark growth. The case study is Atlantic Canada, which has received immense wealth transfers from the central government and experimented with an unusual number of differing approaches to government-directed development.

The nations and U.S. states studied in this volume took a very different approach. Not only did they reduce intervention in the economy – for example, moving away from subsidies in Ireland and the Netherlands – they explicitly aimed to reduce costs to spur economic activity.

This approach marks economies which succeed in overcoming backwardness, whether in times past – for example, the United States when it was a lagging economy – or currently, as can be seen in transition of the successful Eastern European economies. In the latter case, the key policy challenge was establishing the institutions needed for democracy and a market economy. Once these attributes were in place in former Soviet-bloc countries, low costs came nearly automatically because of the low standard of

living and low expectations of the people under the Communist regimes that had ruled these nations. Now, new prosperity is being established in nations like Hungary, the Czech Republic, and Poland. Incomes and wages are rising.

In Ireland and the Netherlands, three key costs – taxes, government, and wages – could either be controlled or influenced by policy-makers. Both nations directly tackled the first of these costs. Ireland undertook huge tax cuts in the late 1980s. The Netherlands first tried to control taxes in the early 1980s, but tax cuts were relatively low. The Netherlands has more aggressively tackled tax levels in recent years.

Government doesn't create costs solely through taxes. High government debts and deficits increase costs through the uncertainty related to inflation, concerns about future tax increases needed to pay down the debt, and increased borrowing costs which suppress private-sector investment. Ireland and the Netherlands got these costs under control by slashing the deficit and, more slowly, whittling away the debt relative to GDP. Heavy-handed government regulation also creates costs. Ireland had never developed an over-regulated economy. The Dutch are moving aggressively to eliminate unnecessary regulation in their economy.[1]

Government can also increase costs in an economy through programme spending. The impact is indirect. Costs are introduced by distortions in the economy. The most prevalent are labour-market distortions caused by government supports that discourage people from working. The Netherlands is reforming its perverse disability system, while the Irish are attempting to tackle long-term unemployment through changes to the unemployment system and tax relief for low-wage workers. As well, when government expands, high public-sector employment and wages compete against private-sector employers.

Wage levels are essential to both the Irish and Dutch stories. In both nations, the corporatist actors in the economy – unions, busi-

1. On the subject of the most fruitful approach to government regulation, see a forthcoming AIMS study of regulation, by Brian Flemming.

ness, and government – worked together to restore wage competitiveness. Yet real wages have actually risen more rapidly under a union strategy of wage moderation than they did under a regime of aggressive union bargaining.

All the U.S. states examined in this volume that succeeded in sparking strong economic growth either moved to cut taxes and government size, or consistently kept taxes low and government small. Policy-makers in both Michigan and Massachusetts believed high state taxes had slowed state growth and contributed to their regional recession. Both states cut taxes, spending, and government employment, despite high levels of unemployment by U.S. standards. The private sector responded: it created hundreds of thousands of jobs more than government had cut. Both states boast unemployment rates below five per cent. Georgia has long maintained small government and low taxes, and this helped transform Georgia from a lagging state to a leading state.

U.S. policy-makers do not have corporatist tools for influencing wage levels, but the flexible U.S. labour market accomplished the same end achieved in Ireland and the Netherlands – competitive wage levels appropriate to current economic conditions.

Interventionist Policies

In some jurisdictions, policy-makers seem largely to ignore the fact that costs are key to economic growth and the implications of this fact – for example, the impact of taxes on creating jobs and wealth. Instead, they attempt a more direct approach to economic development, either through government enterprise or through government's selection of certain companies or sectors for favoured treatment through government contracts, subsidies, or special tax concessions. The impact of such interventionist policy will be more extensively examined *Retreat from Growth*, but for now it is important to make the contrast between this interventionist approach and the market-oriented cost approach.

In some jurisdictions, like Atlantic Canada, interventionist policies still dominate, despite a long record of failure. In part, this is political. Policy-makers gain more power from interventionist

policies and can take credit for direct job creation or job preservation. But, as will be seen in the next volume, such policies create hidden losers. The high taxes needed to support such policies raise taxes for all businesses, except those receiving the subsidies. Unsubsidized businesses face other increased costs. They have to compete with subsidized businesses for resources, most notably labour. These extra costs will discourage business formation, slow growth among unsubsidized businesses, and increase the rate of failure. But these are unseen costs – businesses that either haven't formed or grown as much as they would have, or business failures attributed not to policy but to general economic conditions. Thus, policy-makers can take credit for the results of direct intervention while side-stepping blame for the negative consequences created elsewhere in the economy.

The argument for government intervention is based on the idea of market failure. According to this view, the cost structure of an economy is of small relevance. Instead, market failures, particularly in providing capital to lagging and peripheral regions, mean that investors will ignore, or be ignorant of, profit-making opportunities. Thus, since a low-cost structure will do little to spur development and attract investment, and since lagging regions themselves don't have the capital for investment, richer governments must sponsor regional-development programmes that transfer wealth to the lagging region. This gives government the means for direct intervention in the economy, enabling it to solve this market failure either by investing itself or by bribing private investors into the lagging region through subsidies.

This view is obviously wrong. It is directly contradicted by the evidence of convergence between lagging economies with leading economies, whether or not regional programmes are in place. In this book, the contradiction can be seen in the experience of Ireland and the American Deep South. Both were long-time lagging regions. Both were on the periphery of economic activity. Both have experienced strong convergence despite either the lack of regional programmes, for the Deep South, or the presence of fairly weak regional programmes, in the case of Ireland. Both are

now outperforming some leading economies at the centre of economic activity. More surprisingly, as discussed in *Retreat from Growth: Atlantic Canada and the Negative Sum Economy* (McMahon 2000), the lagging region with perhaps the world's most heroic regional-development programme – Atlantic Canada – has underperformed the convergence effect and underperformed lagging regions which receive little or no outside government help.

High government spending and interventionist policies would not present a problem if government activity could itself create self-sustaining jobs, jobs that did not require continuing subsidies that are, in effect, paid for by other sectors of the economy, weakening those self-sustaining sectors.

But government's record in this area has been dismal. One often-noted problem has been government's inability to pick winners with future economic potential. Government's track record gives overwhelming evidence of this failure. But less noted is government's bias towards picking losers, the declining industries of yesterday. These come with a ready-made lobby of voters and businesses who can provide political benefits in exchange for state aid.

Government intervention also politicizes the economy, a recipe for the misallocation of resources. Powerful bureaucrats and politicians are able to direct resources to benefit politically important groups and interests, rather than to their most productive uses. This is a key reason why heroic economic-development efforts have failed to generate sustainable prosperity, and one of the reasons such efforts persist in the face of powerful evidence of their ineffectiveness and wastefulness. They continue to provide political benefits.

These programmes also change incentives in the economy. When companies' profits are maintained by government contracts and subsidies – say, the point at which government spending equals more than 50 per cent of GDP – business incentives move away from producing goods and services people want to buy. Instead, they move towards rent-seeking – that is, currying favour with politicians and bureaucrats in order to obtain government sup-

ports and contracts. This can have a devastating impact on the business sector, something we'll examine in *Retreat from Growth*.

Taxes also have to be high enough to pay for intervention. Aside from directly increasing the costs of government, this leads to further misallocation of resources. Profitable businesses, which pay taxes and generate jobs without cost to government, find their tax dollars going to less-successful competitors and other activities which are all too often selected to receive government largesse in the form of subsidies or preferential contracts because of their political power.

However, one of the most serious and most over-looked problems with intervention is its indirect impact on costs. Government spending and subsidies for government-selected private-sector investment bid up the price of scarce resources, discouraging investment not supported by government. Since government investment, and its ability to pick winners, has a poor track record, the cost-inflated suppression of other investment is likely to more than offset whatever benefits government-aided investment provides.

The strategy of government-directed regional economic development is often supported by wealth transfers to lagging regions. The key question, of course, is how such transfers are typically used. If these transfers primarily go to consumption, rather than investment, then any sort of economic analysis indicates this will result in increased costs in the economy. Wealth transfers, if used for consumption, bid up the costs of scarce resources in the economy. This makes investment more expensive, and suppresses investment that would have taken place in the absence of wealth transfers. That can only damage self-sustaining development. The evidence supports such analyses. Although some jurisdictions (e.g., Ireland) carefully direct outside help to productive investment, wealth transfers, whether in the form of foreign aid or regional aid – say, in the case of Atlantic Canada – predominantly inflate consumption at the cost of investment. This evidence will be reviewed in *Retreat from Growth* (McMahon 2000).

Wages

Although government-directed economic development has consistently failed, there remains resistance to the idea of holding down costs, particularly labour costs. This is viewed as a demeaning approach that is unfair to working people. It only creates a "race to the bottom", critics say, which locks the economy in competition with other low-wage, low-cost jurisdictions. Yet, as numbers we have examined conclusively show, the exact opposite is the case. The low-cost, market-oriented approach leads ultimately to higher wages, because of increased investment and skill acquisition, leading to higher productivity.

Competitive wages result in solid profits. The opportunity to make profits draws in investment. Consequent increases in physical capital and skills – human capital – through increased training and through learning-by-doing drive up the value of labour by increasing productivity. Employers can afford to pay more and still maintain relatively low wage costs in relation to the productivity of labour. Thus, the company can continue to be profitable while increasing pay. Provided wage increases do not squeeze out profits, this begins a virtuous circle. Profits continue to attract investment. Investment continues to increase the value of labour. This permits another round of wage increases while profits remain healthy, and so the virtuous circle continues to turn.

But if wages rise to the point where profits are squeezed out, investment inevitably declines, unemployment rises, and the value of labour stagnates. The value of labour stagnates because of low investment and reduced opportunities to improve skills. This creates a vicious circle. Wages squeeze out profits. Investment declines. Skills erode. The value of labour stagnants or declines. Real wages decline. Worker militancy is likely to increase in the face of weak or negative wage growth. Aggressive bargaining continues to wreck profits, investment continues to decline, as do real wages, regardless of the nominal settlement, and so the vicious circle continues to turn.

This means that workers who practise wage moderation to boost

profits will actually see greater wage increases over the long term than workers who aggressively bargain for the highest possible wage in any given year. In other words, the race to the bottom is actually a climb to the top. This rather counter-intuitive proposition is strongly borne out by the experience of the Netherlands and Ireland, where a period of aggressive wage bargaining was followed by a strategy of wage moderation. Real wages grew more strongly and consistently under wage moderation than under aggressive bargaining, which often led to declines in real wages, even while nominal wages were increasing. In the United States, too, where unions are relatively weak, real wages have grown much more strongly than in Canada, where unions are relatively strong and typically seek the highest possible settlement for any given contract.

Georgia may be considered a low-wage state, but wages in Georgia are higher than in Canada. This is because the capital attracted to Georgia and the skills of the work-force permit higher levels of pay while still allowing investors to reap substantial profits.

Taxes

Just as there is resistance to wage moderation as a tool of development, many commentators object to reducing taxes. This, too, they claim, is a race to the bottom, in this case in government services. But it is important to understand that taxes may be considered the cost of government services, so whether the cost is high or low depends on the value of the goods and services provided in return. Fifteen thousand dollars may be a high cost for a 10-year-old wreck, but it's a low cost for a new Mercedes. Thus, one jurisdiction with a moderate tax regime may provide excellent value for money while another, which inefficiently spends government resources, should properly be considered a high-cost area.

The real question about taxes concerns what might be called their "net" cost – the amount of taxes paid, along with some calculation of the both the positives and negatives provided in return for taxes. A low-tax jurisdiction might be a high *net-cost* tax

jurisdiction if the government fritters away tax dollars. A moderate-tax jurisdiction, on the other hand, might be a low *net-cost* tax jurisdiction if large benefits are provided efficiently. Thus, the idea of low costs, including low taxes, does not imply a vanishingly small government. For example, a jurisdiction does not have to have taxes as low as those in Georgia to succeed, but it does need to spend its tax revenues wisely to succeed.

When governments collect money in taxes and spend them on services that genuinely benefit the population, they very often also reduce costs for businesses. This is not to argue that all government policies should be directed at reducing costs. Many factors motivate government policy, but good policy tends not only to make a jurisdiction a better place to live, but also to make it a better place to do business. For example, both education and health care are essential to citizens and to business. An educated populace reduces training and education costs for business. An efficient government-provided medical-care system provides a better life for a nation's citizens and better workers for companies. It saves on the cost of providing private health care. So, properly run, Medicare in Canada, for example, is a competitive advantage.

Moreover, in the same way that competitive wages do not imply a race to the bottom in wages, competitive taxes do not imply a race to the lowest-possible tax revenue. In fact, once again, the real case is quite the reverse. Just as competitive wages open the door to sustainable real wage increases, competitive taxes help boost sustainable economic activity which raises the tax take. Typically, one or two years after a significant tax cut, tax revenues are higher than prior to the cut. They may be lower as a percentage of GDP, but they are higher in real terms because GDP growth has been strong.

But problems arise when taxes are used for policies that focus large benefits on small numbers of people. For example, an efficient transportation structure to important markets is essential for growth. If it suffers from underinvestment while little-used roads

in politically important constituencies are well tended, and if contracts are awarded based on patronage not efficiency, then the whole economy suffers. Everyone pays higher taxes for services that benefit primarily the politically connected. This same criticism may be levelled at most economic-development efforts, which, in the end, only transfer wealth from self-sustaining activities to government-selected activities, benefiting the set of owners and workers in the selected activities, while harming other businesses and workers.

Bad policy can increase costs both directly through taxes and indirectly through distortions in the market-place. For example, economic growth and job creation would be stifled by a disability system so generous and easy to tap into that people become unwilling to work. This happened in the Netherlands. It creates huge costs. Business has to compete with government – with their own tax dollars – to attract workers. That drives up labour costs, thwarts expansion plans, and suppresses investment. Why invest and create jobs if the company cannot get anyone to fill them at wages the company can afford to pay?

Thus, costs are raised both directly, through paying taxes, and indirectly, through the effect of the programmes funded by these higher taxes. The same problem which afflicted the Dutch economy because of its disability system would be created by an unemployment-insurance system so generous people shun work to collect unemployment-insurance payments. This happened in Atlantic Canada, as is examined in *Retreat from Growth*. At times, nearly twice as many collected unemployment as were unemployed. This created labour shortages throughout the region and thwarted growth because businesses either couldn't find workers or had to bid against the unemployment system to obtain workers, thus increasing costs and stunting investment. Recent research shows that many of recipients of unemployment benefits in Atlantic Canada will refuse work even if government offers to subsidize wages. This immobilizes large parts of the work-force and profoundly damages economic opportunity.

A Challenge for Policy-makers

The idea of cost in an economy is relatively straightforward. In corporatist economies, policy-makers have tools to directly affect wage rates, taxes, and other government-related costs. In the North American setting, policy-makers can directly affect taxes and other government costs. Wage rates can only be influenced indirectly by policy – for example, labour-market regulation, unionization laws, and social-support programmes that may compete with employers for workers.

The question of whether wages are competitive does not depend solely on the wage level. The key point is the value being returned for labour. Thus, in Ireland and the Netherlands a strategy of wage moderation – by leading to increased investment and economic activity – sparked a long-term rise in real wages. Similarly, the question of whether a jurisdiction has a high-cost or a low-cost government is not simply a matter of the level of taxation. Rather, it is the tax level, and other costs related to government, in relation to the value of the services government is providing that determines the real cost to the economy.

These complications motivate this book's effort to examine a wide range of policies in an equally wide range of economies that had to address a number of differing economic problems. Policy-makers in the successful economies examined adopted the same fundamental strategy, that of making their economy more competitive by reducing costs.

Consideration of cost in an economy to spark growth is not a matter of ideology, though some view it that way. This book has examined success stories from the soft-left milieu of the Netherlands to the ideologically hard-to-classify Ireland. We've also looked at success stories in the more market-oriented United States.

Yet, despite their differences, all these areas have something in common. They all experienced hard times, either historically, like Ireland and the southern United States, or from set-backs like those in the Netherlands, Michigan, and Massachusetts. They all tackled costs in their economy. And now they're all growing strongly

– generating new wealth, and more and better-paying jobs.

These results contrast sharply with those in other lagging economies – most notably, Atlantic Canada – that initiated heroic efforts to encourage economic growth, but through very different policies. These polices focused on government-directed economic growth but paid little attention to the costs in the economy. Atlantic Canada is characterized by immense wealth transfers from more prosperous regions of the nation; very large government, even by European standards; and large economic-development programmes. As we shall see, such policies often inflated costs and thus weakened overall economic growth. One clear fact stands out: Atlantic Canada's economy has underperformed other lagging regions, whether in Europe, Japan, or the United States. This is a remarkable result, given the effort to boost regional development in Atlantic Canada. We'll look at this more closely in *Retreat from Growth*.