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AMERICAN INDUSTRIAL POLICIES IN THE 1980'S

State/National Trends and Implications for Canada

James D. McNiven

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EXECUTIVE SUMMARY

The recession of 1981-1982 was a watershed in American politics as it applies to the economy. A number of trends that had been building since the early 1970's were thrown into stark relief by the recession. Governmental reaction to these trends was different at the national and state levels. At the national level, some Democrats attempted to put up the idea of activist industrial policy as a counterweight to traditional Democratic thinking and to the more passive policies of the "Reagan revolution." They failed in this attempt, but a yawning trade deficit created the conditions for this approach to economic policy to be resurrected under the guise of a bipartisan 'competitiveness policy' in 1986.

Meanwhile, industrial policy had become ubiquitous at the state level. State governments realized that the threats posed by industrial migration and employment pressures had to be met by them. Voters demanded an active response. The innovations developed by the states are now beginning to infuse the competitiveness debate at the national level with concrete examples of how the U.S. federal government might react to its changing role in the global economy.

The implications of this evolution for Canada will be profound, since the dependence of the country on the American market is extreme.

This report covers this evolving situation in five chapters. The intent is to provide the reader with a simplified version of a number of complex processes that have been underway in the United States since 1981 and to suggest some implications for Canada.

Chapter I, "The Triple Conflict", outlines three trends that have affected recent economic and political thinking and events in the United States. These are, first, a demographic and occupational conflict which has set a fast-growing young labour force against an older, employed labour force within the context of an economy that was growing only fitfully in job opportunities over the 1970's and early 1980's. Second, regions of the country were set against each other as traditional areas of growth failed to meet past achievements and employment migrated to new regions. Third, the export challenge of other countries, especially in East Asia seemed to result in employment moving offshore. Whether this success was grounded in activist business-government partnerships and policies or not, was a key to the American response.

The second chapter follows the generation of the industrial policy idea, points out its political competition in terms of Democratic and Republican party factions. It discusses its fall as an idea and its subsequent rise once again as 'competitiveness policy.'

The third chapter traces the evolution of a pioneer in sub-national industrial policy - Puerto Rico. The island began to promote development in 1940, but its approach began to fail after 1973. Because of its earlier successes, Puerto Rico was unable to shift politic or significantly diversify its activity to continue to provide employment growth. Its example suggests that there are drawbacks to activist policies, especially the tendency to let them fossilize.

The fourth chapter discusses state industrial policies and strategies in the post-1981 period. Coherent development strategies are outlined in form cases: the states of Rhode Island, Nevada, Hawaii, and Michigan. The need to promote economic revival and diversification through better education facilities and a closer attention to technological development ran through all four strategies.

The fifth chapter relates the lessons from the first four chapters to the Canadian scene. The triple conflict has its counterpart in Canada and the reactions of government to shifts in employment within the U.S. and to foreign countries have implications in competition with States for investment and in American attempts to reconfigure the international trading environment to overcome its perceived biases. Canada is directly affected at both levels by changing American policies.

The fall and rise of national industrial policy is having an impact on the present trade negotiations. More seriously, assuming an agreement is reached, will be its effect on the implementation of any such agreement. The agreement will restore the special state of Canada in U.S. policy to some extent, but a more activist Administration after 1988 can only signal continuing difficulties. There is no reason at all to expect a continuation of Reaganomic policies.

The lessons of Puerto Rico are mainly directed at the long-term implications of an active industrial strategy and the role that incentives play in industrial development.

Finally, the experience of States with industrial policies and strategies has some lessons for Canadians. These are muted because Canadian provinces have been engaged in similar exercises at least since the late 1960's. The varied experiences and experiments of 50 states plus Puerto Rico, their reliance on tax incentives instead of grants, and their closer relationships to promote sector activity, however, do provide a basis for learning.

In a way, this is an interim report, in that it is an attempt to assess a number of ongoing processes and policy initiatives. The United States is engaged in working out its relationship to a world that is much bigger, relatively speaking, economically and much smaller in terms of geography and technology than ever before. It will not complete this process in the next decade. Meanwhile, Canada can expect to be buffeted continuously by the policy storms this adjustment will generate.

INTRODUCTION

In the late summer of 1985, the Centre for American Studies at the University of Western Ontario contracted with the federal government to undertake a study of economic development policies in the United States and to relate its findings to Canadian/American trade relations. This report is the result of that research project.

The commencement of active comprehensive trade negotiations between Canada and the United States had an effect on the project. The basic idea put forth in the research proposal was that a number of long-term trends had worked to alter the traditional roles played by federal and state governments in the realm of economic development. There was no question, as the research progressed, that this was in fact the case. The insertion of a comprehensive trade agreement into this rapidly evolving policy area in the United States would carry considerable impact. Neither the debate over American economic policy, nor the makeup of the agreement itself, would likely emerge unchanged.

The focus of the final report has shifted somewhat in response to the trade negotiations. Instead of trying to outline in detail many of the policies and programs pursued by the individual states and to look at Canada/U.S. impacts of some national policy debates, an attempt has been made to outline the causes of the evolution of economic development policies at both levels of government in the U.S. and to relate this evolution to Canadian/American trade in the post-negotiation era. The United States has embarked on a massive decade-long review of its place in the world economy, and the Canada/U.S. negotiations are but one part of this re-assessment.

Its success or failure will mean different things to different political actors.

Chapter 1 describes some of the changes that have occurred in the American economy since 1960 that have fostered this high degree of concern about economic policy.

Chapter 2 attempts to explain the debate on a national level between politicians, academics, and businessmen over the nature of, successes, and failures of American economic policy. It also includes a very preliminary set of judgements about the 'competitiveness' debate which was begun in the 1986 Congress.

Chapter 3 is a case study of industrial policy in Puerto Rico. The Commonwealth of Puerto Rico pioneered an activist approach to industrial policy in the 1940's. The success of 'Operation Bootstrap', based on tax incentives for industry, was world renowned in the 1950's and 1960's, but changing conditions have left the Commonwealth in difficulty.

Chapter 4 discusses the reaction of state governments to the economic changes of the past two decades. The 'Canadianization' of these states has led to a near-universal adoption of activist strategies and programs designed to restore state economies. Even while the big Reagan victory of 1984 silenced the industrial policy debate at the national level, the states continued to propose and implement aggressive and innovative industrial policies. By the time of the 1986 Congressional elections, this state-level consensus resulted in 'industrial policy' being resurrected at the national level as 'competitiveness.'

Chapter 5 attempts to derive some implications for Canadians of this evolution of American policy on economic development. Chief among these is the impact of comprehensive trade negotiations, but other implications exist for provincial governments in competition with state governments for foreign investment, trade promotion, and the commercialization of technology.

This report could not have been done without considerable assistance from many people. Officials representing many state governments contributed their time and experience to a Canadian 'competition'. In all, interviews were conducted with officials of 15 states and the Commonwealth of Puerto Rico. Interviews were also conducted with state legislators and Congressmen, with staff of federal departments and state associations as well as with staff of a number of non-profit agencies and research groups. In addition, academics at a number of American universities were generous with their time and information.

I am grateful to the Centre for American Studies at the University of Western Ontario for providing a research home away from home during the academic year 1985-1986 and to the Canadian Department of External Affairs and Department of Regional Expansion and the Government of Nova Scotia for their financial support for this project.

Mitch Kowlaski acted as my research assistant at U.W.O. and organized and wrote some of the background material. Bob Kymlicka, Bob Young and David Flaherty of the University of Western Ontario reviewed drafts of this report, as did Bill Averyt of the University of Vermont and Emery Fanjoy of the Council of Maritime Premiers. Their suggestions helped to improve the report, but its deficiences are all mine.

CHAPTER I

THE TRIPLE CONFLICT

Introduction

The involvement of American federal and state governments in industrial development is not new, but the intensity of activity has increased dramatically in the past decade and especially since 1981. At the national level, tax reductions that were to have rekindled investment in productive capacity seemed only to have created fiscal deficits and trade deficits based on increased consumer demand for imported products. These two deficits transformed a strong debate over 'industrial policy' in the early 1980s into a similar debate under the guise of 'competitiveness', something which is seen as a growing issue in the 1988 Presidential election.

The recession of 1981-82 was the proverbial straw that broke the camel's back for state governments. State responsibility for employment creation and the threat to state finances from the recession's impact on taxation combined to thrust economic development to the top of election campaign platforms in 1982. The call was uniform - "jobs, jobs, jobs" - and a host of new state administrations came into power determined to make good on their electoral promises.

This heightened governmental interest in economic development grew out of three long-term problems or conflicts. All three cascaded to intensify the effects of each over the decade of the 1970s. As the decade of the 1980s winds down, some aspects of the three conflicts are beginning to subside and the politics are beginning to change, but new problems await.

The first conflict was demographic and occupational, where a growing young labour force, supplemented by increased female participation, collided with an established labour force in a relatively stagnant economy, one filled with recessions and minor booms, but generally averaging out. As well, a general movement from manufacturing jobs to service sector jobs was underway, which added to the competition for employment.

The second conflict centred on the movement of industry from the northeast of the United States to the south and west. This movement added regional conflicts to the demographic and occupational ones mentioned above. Because capital migration within the United States had no real national effect, the responsibility for countering this trend in the northeast, and hastening it along in the south and west, fell to state and local governments.

The third conflict was international in scope. Capital migration was not simply an interstate phenomenon, but increasingly became international as well. The rise of manufacturing exporters in Japan, Brazil, Korea and Taiwan meant that jobs were perceived to be lost to other parts of the world. Along with imported oil, imported manufactures were adding to the trade problem that resulted in a falling dollar and a perception of American economic weakness overseas.

The recession of 1981-82 combined these conflicts with severe contractions in employment, production and the financial capacity of a number of important and visible American industries. Both federal and state governments found themselves under severe pressure to reverse the declines in employment and prosperity and, in particular, to maintain and develop manufacturing industries and employment.

Demographic and Occupational Conflict

1. Age and Sex

Much has been written about the so-called 'baby-boom' generation.[1] This is the group of people born roughly between 1940 and 1960, with the individual age-cohort population peaking in one of the years of the late 1950's, depending on the country or region surveyed. The baby-boom was emphasized by the decline in births during the Depression years and a second decline in the 1960s and after, as birth control technology became commercialized and couples chose to postpone families or limit their size. The baby-boom is thus a unique phenomenon and its relative size has put pressure on different social institutions, as the age cohorts that make it up age, use different facilities, and express different needs.

The commercialization of birth control technology also enabled many women, whose recent historical experience in the industrial workplace had been limited largely to wartime needs, to enter the economy in large and increasing numbers. Partly this trend was due to changing morés about the role of women in society and partly it was due to economic pressures. In order to quickly gain the amenities that their parents had slowly acquired, young married couples found that both individuals had to earn income. Further, the pressure on the job market created by many young people looking for work almost simultaneously meant that available new employment was likely to be low-paying, unstable and with few prospects for promotion.

The early baby-boomers (cohorts born in 1940--1950) were relatively lucky, in that the expanding economy of the 1960's opened up employment opportunities and promotional opportunities at a relatively fast rate. This ease of entry was partly due to the inability of earlier, and smaller, age cohorts to fill up the openings. However, as the 1970's dawned, the slower-growing economy filled with relatively young people occupying most 'good' jobs presented a daunting challenge to the men and women of the later cohorts of the 'baby-boom.'[2]

Employment expansion took place in the 1970s, but the numbers and the quality of the jobs in terms of pay and promotion prospects were inadequate. Unemployment grew, and those under age 25 tended to feel its impact the most. Black youths in urban areas, for instance, often tended to have unemployment rates in excess of 50% toward the end of the 1970's.

2. Sector Shifts

Between 1960 and 1980, a second shift in American society occurred that added emphasis to the problem of the entry of large numbers of new people into the economy. This new development was the decline of the American manufacturing sector as an employer. Between these two years, manufacturing employment grew but, as a proportion of total employment, manufacturing employment declined from 31% to 22.4%.[3] Blue collar employment, most commonly associated with unionization and goods production, declined from 37% to 32% of total employment between 1960 and 1980.[4] The shift out of goods-producing employment is striking: between 1950 and 1980, the proportions moved from a balance between goods-producing employment and service employment to an economy where 2/3 of employed people were in service industries in 1980. In terms of output, however, manufacturing was stable between 1960 and 1980 at about 23.5% of GNP.[5]

Within manufacturing, a second shift was taking place, as traditional manufacturing, considered as labour-intensive (textiles), resource-intensive (steel), and capital intensive (refineries), gave way to production based on technology (computers). Table 1-1 illustrates this shift:

Table 1-1. Shares of value added and employment by industry group, 1960, 1970, and 1980
[Percent of manufacturing total]

Group	Value added			Employment		
	1960	1970	1980	1960	1970	1980
High-technology	27	31	38	27	30	33
Capital-intensive	32	30	27	29	30	28
Labor-intensive	13	13	12	21	20	19
Resource-intensive	28	25	23	23	21	20

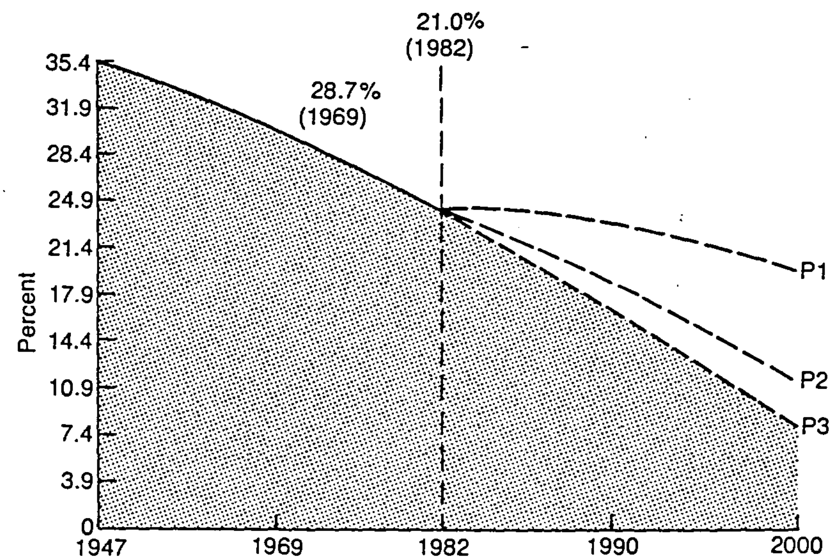
Source: US Government, Economic Report of the President (Washington, DC: US Government Printing Office, February, 1984) p. 89.

In spite of the welter of stories that were current in the 1970's, about PhD's driving cabs, the truth was that advanced education still meant a better chance for employment, and especially for well-paid employment. The alternatives for the baby-boomers were either unemployment or a clerical or other low-level entry position in the service sector.

The shift in employment within the manufacturing sector presented new problems for older, unionized, blue-collar workers. Their skills often were unsuited for shifts into new production techniques or, more ominously, into new firms, plants and locations. The shift among production facilities and products mentioned above presented the existing labour forces in many states with problems of layoffs, plant closures, and unemployment just as the competition for jobs was heating up because of demographic changes. For a black, middle-aged steelworker in Gary, Indiana, the prospect of moving his family to Houston, Texas, to compete with youths for janitorial or other such jobs, must have been daunting in the extreme.[7]

Regardless of what happens in the future, the picture for manufacturing employment, as opposed to production, is not rosy. Automation and robotics will serve to put the manufacturing industries of the future into the same category as resource producers and processors, industries with high income and capital flows but with relatively low employment levels. The same revolution, or a similar one, that sent millions streaming out of the farms and into the factories around the beginning of the 20th century is now doing the same thing to the manufacturing sector as Charts 1-A and 1-B project:

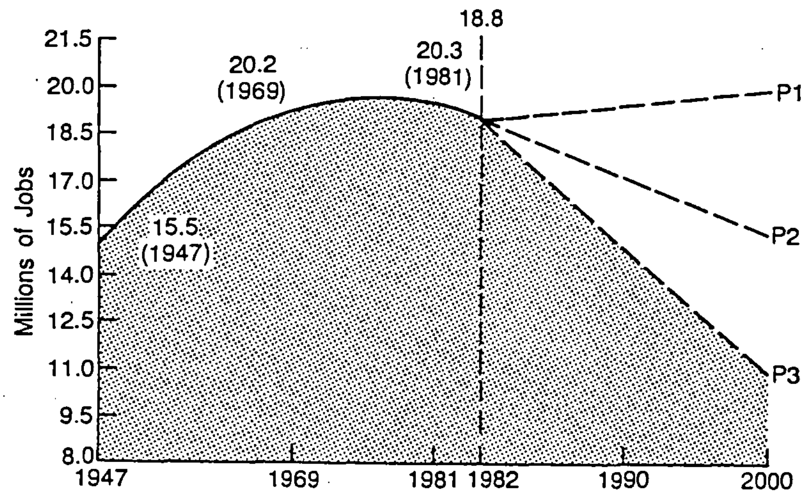
Chart 1-A. Projection of Current Trend - Manufacturing Employment in the United States as Percent of Total Employment



P1 *Competitiveness and high economic growth.* Tracks with some minor, judgmental modifications, the Bureau of Labor Statistics high economic growth rate for manufacturing to the year 2000. Manufacturing as a percentage of employment as forecasted by BLS is possible only with a combination of factors involving greater productivity resulting in part from improved labor-management relations and high general economic growth.
P2 *Competitiveness and low economic growth.* Tracks combination of BLS intermediate and slow growth rate. Manufacturing as a percentage of employment as forecasted by BLS with low-moderate general economic growth is possible only with a combination of factors involving greater productivity resulting in part from improved labor-management relations.
P3 *Noncompetitiveness.* Forecast based on continuation of present trends, although there may be short-term variations; for example, the present upturn in the business cycle. The course of the U.S. economy extrapolated from trend since 1947, which is associated with declining competitiveness in the last two decades.

Source: D. Quinn Mills and Malcolm R. Lovell Jr., "Competitiveness: The Labor Dimension", in Bruce R. Scott and George C. Lodge (eds.). Competitiveness in the World Economy (Boston: Harvard Business School Press, 1985) p. 443.

Chart 1-B. Projections of Current Trend of Manufacturing Employment in the United States (millions of jobs)



Source: Author's calculations
P1 *Competitiveness and high economic growth.* Tracks with some minor, judgmental modifications, the Bureau of Labor Statistics high economic growth rate for manufacturing to the year 2000. (See further explanatory note in Chart 1-A
P2 *Competitiveness and low economic growth.* Tracks combination of BLS intermediate and slow growth rate. (See note in Chart 1-A.
P3 *Noncompetitiveness.* Forecast based on continuation of present trends, although there may be short-term variations; for example, the present upturn in the business cycle. (See note in Chart 1-A..

Source: D. Quinn Mills and Malcolm R. Lovell Jr., "Competitiveness: The Labor Dimension", in Bruce R. Scott and George C. Lodge (eds.). Competitiveness in the World Economy (Boston: Harvard Business School Press, 1985) p. 443.

For the individual states, as well as for the country as a whole, this means that the environment for manufacturing employment will continue to be difficult. Production facilities will not offer considerable new employment, but without manufacturing, the growth of research and development, parts production, sales and corporate service employment will be severely hampered.

3. Entrepreneurship

The growth of employment in the service sector has come at a time when this sector is most open to the entrance of new firms. Manufacturing tends to be concentrated into relatively few hands, with the top 500 corporations employing most, if not nearly all, manufacturing workers.[8] Part of this is due to the capital requirements for manufacturing, which are far greater than for retail establishments, for instance.

The creation of small businesses has been the subject of a considerable amount of debate and analysis. U.S. employment data suggest that of 10.5 million jobs added to the non-farm economy between 1973 and 1983, 5.6 million were added by small businesses (under 50 employees), 3.7 million by medium-sized firms and 1.2 million by large firms.[9] Birch claims that similar small-business proportions in job growth can be attributed to even smaller firms, those with 20 or less employees, over the period 1969-1981.[10]

In comparative perspective, the United States added 23 million net new jobs during 1974-1984 while the EEC added none.[11] Most of the American jobs were added by small businesses and to a great extent by new small businesses. The respective roles of new small businesses and large, older firms has reversed itself since World War II in terms of the generation of employment.[12]

The picture of the small, new enterprise located in the service sector or in the high-technology or 'thoughtware' sector as the driving force on the margin of the U.S. economy is a compelling one.

While the growth of new jobs is tied mainly to the expansion in the number of entrepreneurs, the future does not appear to be the domain of small businesses. Drucker notes that the major industries of the postwar period are based on technology developed before 1900. Many new businesses today are in existence because of new technologies developed since 1945 as well as a 'low-tech' shift into retail services. As the new technologies are absorbed by the economy, a new cadre of growing, mid-size firms will emerge from the creative ferment of the small business sector to give the economy new large firms in the 21st century. The small-business employment 'explosion' is as much a part of the demographic pressures on the job market of the 1970s and 1980s as it is a part of the technological changes affecting the economy.[13]

The pressures exerted on the American political system by 1980 by these demographic and occupational conflicts were not consistent or clear. The early baby-boomers, in a sense, had their advantages and wanted to keep them. They were also of an age that has many financial concerns, such as home and children, and fewer overt needs for public services. The late baby-boomers had employment problems which were often met by new service businesses that did not pay well, but had some psychological advantages in being small. Many late baby-boomers became entrepreneurs, or stayed on unemployment and welfare schemes. Unionized factory workers faced with plant closures and layoffs had clear economic interests to protect. Entrepreneurs had a stake in opening up the economic system to more innovation and in finding new sources for capital. Within a national context, many of these interests would cancel out, but not at the state level. Within an international context, this ferment could pose short-term losses, even while offering long-term gains through the renewal of American productivity and comparative advantage.

Regional Conflict

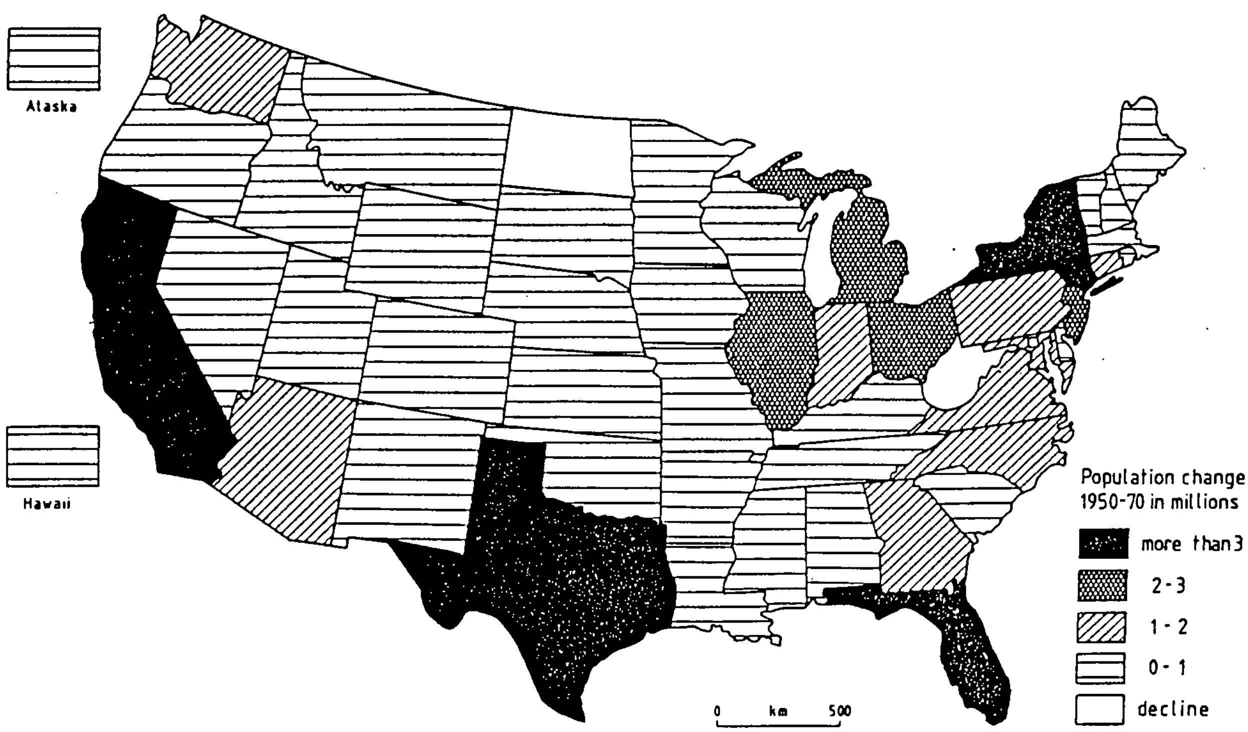
The shift in occupational and demographic patterns was paralleled by regional or spatial changes. Traditionally, the rural and agricultural south had lost population to the growing manufacturing centres in the northeast and west of the U.S. After 1960, this trend slowed and then reversed itself as economic activity began to increase in the south. Table I-2 illustrates the changes since 1960:

Table I-2. Regional Population Data 1960-1978
(Millions)

Census Region	1960	1970	1978	change 1960-78
New England	10.5	11.8	12.3	1.8
Mid-Atlantic	34.2	37.2	36.8	2.6
East North Central	36.2	40.3	41.2	5.0
West North Central	15.4	16.3	17.0	1.6
South Atlantic	26.0	30.7	34.6	8.6
East South Central	12.1	12.8	14.0	1.9
West South Central	17.0	19.3	22.0	5.0
Mountain	6.9	8.3	10.3	3.4
Pacific	21.2	26.5	29.8	8.6
Total	179.3	203.3	218.1	38.8

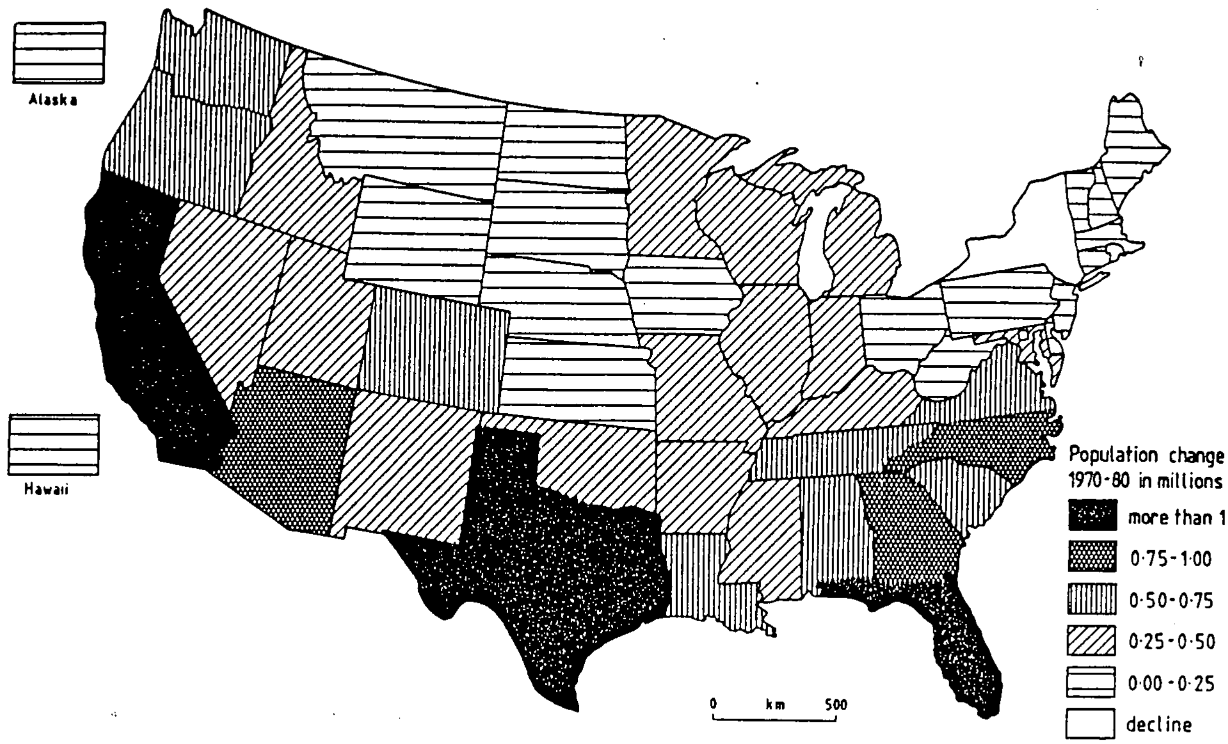
Source: Gregory Jackson et. al., Regional Diversity: Growth in the United States, 1960-1990 (Boston: Auburn House Publ., 1981), Appendix A, Only the East North Central Region managed to have population growth near the national average in the northern and northeastern part of the country. The western part of the country continued to grow strongly, as did the regions centered on Texas and Florida. Even the East North Central region faded after 1970, while the Mid-Atlantic region, centred on New York and Pennsylvania, lost population. Maps 1 and 2 illustrate these trends clearly:

Map 1: Population change, 1950-70



Source: David Clark, Post Industrial America (New York: Methuen, 1985) p. 43.

Map 2: Population change, 1970-80

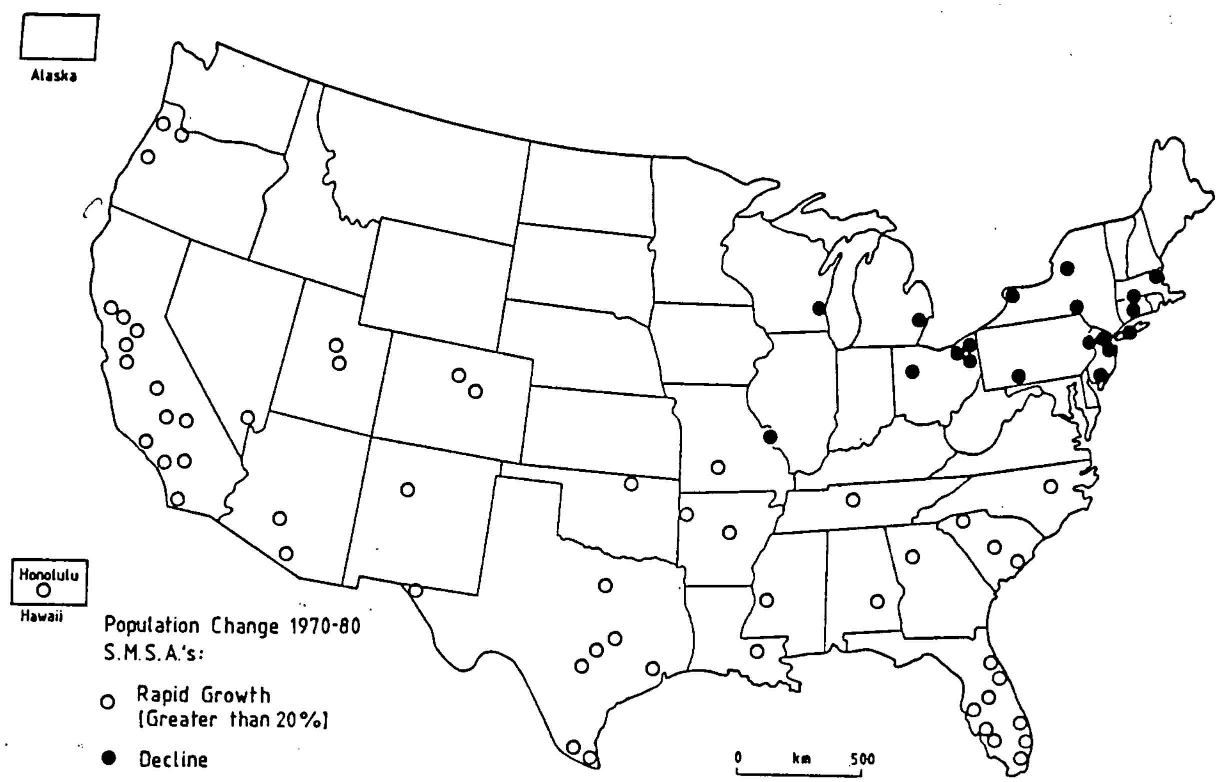


Source: David Clark, Post-Industrial America (New York: Methuen, 1985) p. 45.

Some of the demographic increase in the South can be attributed to relatively higher fertility rates, but migration effects have come to play a critical role in population changes, especially as fertility rates declined overall after 1960. Migration is now the most important variable in population changes.[14]

Changes in urban population growth are also quite regionalized, with all the large-scale growth in the 1970's taking place in the south and west while declines occurred in the north and east. (See Map 3).

Map 3 - Population change by Standard Metropolitan Statistical Area, 1970-80



Source: David Clark, Post Industrial America (New York: Methuen, 1985) p. 47.

These fairly rapid changes in population brought with them changes in employment and occupational structures. It is hard to say whether these employment changes caused or were the result of population movements or even public policy, since migration of the elderly to the Sunbelt, defense expenditures, and manufacturing, labour, and tax regimes may all have played a role.[15] Yet, again, these factors may not have been able to change the regional economies had not deeper changes in social morés, economic infrastructure and public perceptions not prepared the way. In any case, as regional population shares shifted, regional industrial shares also shifted.

Manufacturing employment shifts have been the most noted, if only because manufacturing has been traditionally seen as the barometer of the fortunes of the north and northeastern parts of the country. Table 1-3 shows the shifts in manufacturing employment as part of the regional employment mixes in the United States between 1967 and 1978.

Table 1-3. Regional Manufacturing Employment
(% of total regional employment)

Region	1967	1978	Change
New England	33	27	-6
Mid Atlantic	30	24	-6
East North Central	35	30	-5
West North Central	22	19	-3
South Atlantic	22	20	-2
East South Central	25	25	0
West South Central	17	17	0
Mountain	12	12	0
Pacific	22	18	-4
US Average	26	22	-4

Source: Gregory Jackson et. al., Regional Diversity: Growth in the United States, 1960-1990 (Boston: Auburn House Publ., 1981), Appendix C, pp. 172-188.

While manufacturing employment decreased as a proportion of employment in the nation as a whole, the largest decreases occurred in those areas which were the most industrialized before 1960, including the Pacific region and most of the north and northeast. The north and northeast still had a higher than average proportion of manufacturing employment, but the gap was narrowing. In 1985, the Los Angeles area passed Chicago in the value of manufactures shipped to become the leading manufacturing area in the United States, underscoring the continuing shift in manufacturing activity.[16]

Much of this shift in manufacturing employment is obviously due to a shift in manufacturing activity and not to relative regional rates of automation in industry. Very little is due as well to the physical movement of plant capacity to other regions. Instead a pattern of old plant closures and new plant openings in different regions has taken its toll. Estimates of actual plant movements suggest actual plant migration is a miniscule part of the problem.[17]

A second factor in regional shifts has to do with so-called 'sunrise' and 'sunset' industries. More mature industries such as steel production and automobile production were affected by competiton from highly productive new facilities abroad or, as in the case of steel, from mini-mills in other regions of the country. This competition resulted in plant closures within these industries. At the same time new firms in regions outside the north and northeast were adding to manufacturing employment. The end result was a shift in manufacturing capacity and employment as a result of the shift in manufacturing activities noted above in a previous section.

A study of 410 of the largest manufacturing firms in the U.S. indicated that between 1970 and 1978, they closed, moved or sold 2,500 of the 12,000 establishments they owned at the start of the period. One thousand were closed, 444 were moved, and the rest sold. These same corporations bought or opened 5000 new establishments, for the most part in different regions of the country.[18]

The political distress caused by the shifts is apparent from data on migrants. Low-income and young people are more likely to migrate than higher-income, older people.[19] In part this is due to the investments in home and community already made by older people. The result was a growing unemployment rate in the north and northeast, accompanied by pressure on state and Congressional officials to "do something." Meanwhile, younger people, less politically active, simply migrated to the regions where jobs exist, often getting lower wages than their now-unemployed older brothers in the north once received.

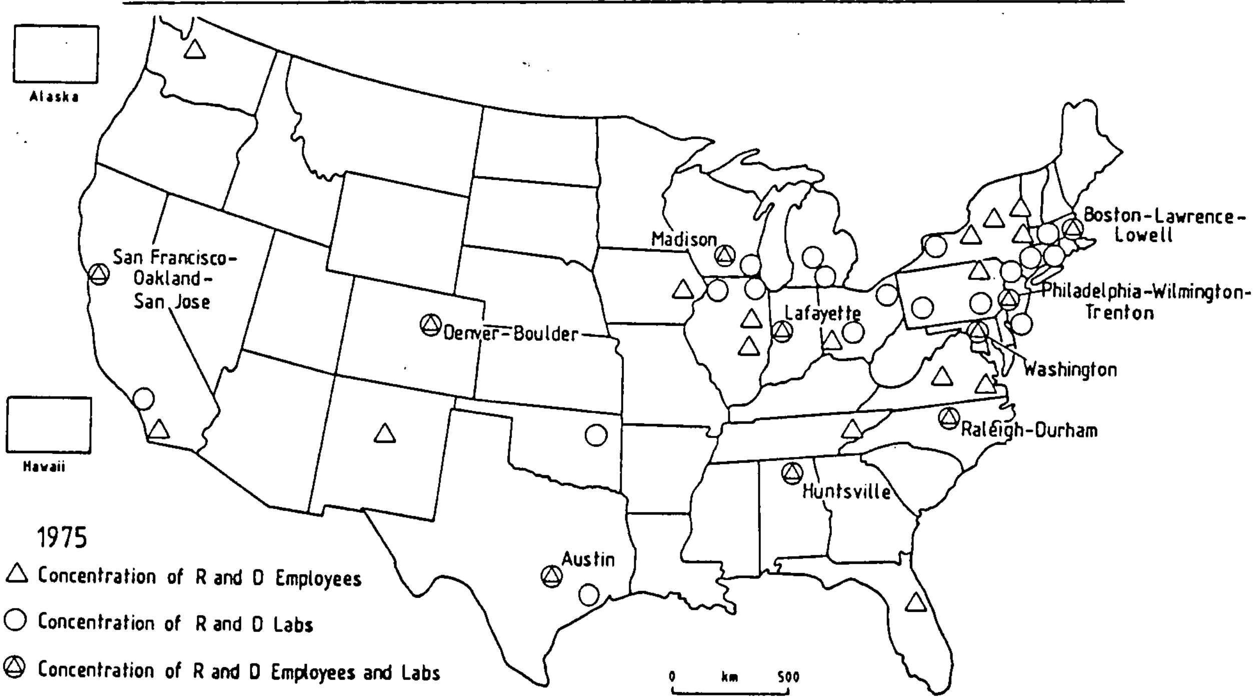
A rough analysis of growth in the service sector (minus government) shows only a rough correlation between regional population growth, 1969-1978, and growth in this sector. The regions with the fastest population growth tended to have the greatest growth in the service sector, but even in the Mid-Atlantic region, where population actually declined slightly, service sector employment growth ranged from 16% to 29%, depending on the industry type.[20] As this sector houses the majority of new firms and entrepreneurs noted above, dispersed employment growth suggests that regional trends in entrepreneurship do not exist. Other data suggest that business taxes have tended to converge among the states and that new ventures have predominated in states in the north and west alongside their existing mature industrial sectors.[21]

Gilder asserts that, since the recession of 1981-2, the states with the fastest growth in employment have been California, Florida and Texas, the fastest growing states of the 1970s.[22] This suggests that the trends of that decade are still having their effect. Ranged against this presumption are an array of counter-trends and suggestions. First, the decline in commodity prices, including oil, since 1984 argues that the important core of the economy in the Mountain and West South Central regions, commodity production, is quite vulnerable.[23] Other analysts argue that congestion in Florida is slowing the migration of the elderly and hampering tourism as well, which may lead to a growth slowdown in the late 1980's.[24] Finally, defense spending restrictions may harm base operations and defense-related manufacturing, both important to southern and California economies. The fall in the U.S. dollar relative to foreign (but not Canadian) currencies and the fall in energy prices should together provide a strong impetus for the revitalization so-called 'Rust Belt.'

Two other arguments are suggestive. In a provocative book, Jane Jacobs has argued that the agglomeration economies of cities have provided the driving force behind economic development throughout history.[25] Whether the new cities of the South can duplicate the performance of old centres such as New York and Chicago is problematical. Indeed, the reconstruction of northern cities since 1970 suggests that they may once again reassert their strong dominance of American life.[26]

The notion of the information economy, and the orientation toward 'thoughtware' and technologically intensive industries, suggests as well, that the Rust Belt may only be in temporary decline. Map 4 shows the location of leading research and development centres in the United States.

Map 4. Distribution of research and development activity, 1975



Source: David Clark, Post Industrial America (New York: Methuen, 1985) p. 96

The vast majority of centres depicted, 29 of 44, lie in the Philadelphia-Boston-Washington, D.C. triangle, the centre of which is the so-called 'Rust Belt.' Eleven lie in the Sunbelt and Mountain parts of the country, while 4 lie in the Pacific region. If there is a connection between concentrations of research and development centres and future economic growth, then the north and northeast parts of the country should reassert themselves over time.

The future, however, takes a back seat to the present, and the north and northeast have been most vocal, until very recently, about the perils of de-industrialization. The concerns of state and Congressional politicians have been focussed on the international threat, though the interregional shift in economic activity has led to some sharp regional disagreements, especially about federal spending policies and industrial development programs.[27] As the commodity-producing areas of the country have slid into recession, calls for protection from agricultural, forest and oil competition have grown stronger from them, while the service and manufacturing centres, enjoying relative prosperity at last, are quiescent. None of this suggests that the interregional tension within the United States is likely to die down, but as the south and west are starting to experience some hard times, the focus and the issues in the debate are beginning to change.

The International Conflict

The third conflict resembles the second in that it consists of a problem in capital and employment migration. Unlike the previous section, however, this conflict involves international boundaries, and any solution must be developed at the federal level. States can become involved only marginally.

This conflict has had two stages. Before the recession of 1981-82, foreign penetration of American markets was seen as arising from an inability of American producers, especially manufacturers, to compete. Since the end of the recession, the continued penetration of American markets has led to a large merchandise trade deficit, which was offset by even larger net capital movements into the country. The high and rising dollar, complete with the assertion that the U.S. was a debtor nation for the first time since the early 1900's, set off a demand for protectionism that has not been seen since the 1920s.

These two phases do overlap, but will be treated separately in this section. Competitiveness and its responses, and the rise of the developmental state and its responses, consist of interpretations and suggestions related to the perception that American industry has failed to keep up with world trends and, furthermore, is being hit by unfair practices perpetrated by its trading partners.

1. <u>America joins the world</u>

One of the most subtle and yet potent trends of our time is the integration of the American market into the world market. For years American producers viewed their world as consisting of two markets - domestic and foreign. Sales abroad tended to represent a large proportion of many American producers' total sales, but exports were based on capacity developed to serve the domestic market. This latter market was insulated from world trade in one direction at least; penetration on a significant scale by foreign exporters.

This began to change in the 1960s as first commodity exporters, in oil especially, began to have an impact on the American market. Then as GATT negotiations led to falling tariff walls, and both American-owned and foreign-owned production facilities came on stream, increasing volumes of manufactured goods began to enter the United States market. As Table I-4 shows, while the American market is still largely an American preserve, it is less so today than yesterday. Penetration has reached a stage as well where

American producers, workers and voters recognize that not all economic decisions affecting their lives are made in America anymore.

This is a point that is easily missed. For over four decades now, America has been a part of the world, economically, culturally and politically. But the world has only been a part of America economically for about a decade. Before the oil shock of 1973 foreign goods were trinkets, curiosities and status symbols. Today, state governors travel to Japan to entice Japanese investment into locating in their states. What has been particularly remarkable about this change is the minor attention it has received as a phenomenon in itself.

It is common to trivialize the word 'revolution' today, but it is still the best word to describe the changed environment that Americans are experiencing. Cataclysmic changes do not proceed from first causes. When revolution occurs, it breaks out as a set of seemingly spontaneous changes, often at the same time irrelevant and momentous. Only afterward do the historians sort things out.

Table 1-4 Importance of Manufactured Imports and Exports 1973-1981

Year	Import penetration[1] Manufacturing	Export proportion[2] Manufacturing
1973	6.4	6.6
1974	7.3	8.0
1975	6.5	8.7
1976	6.9	8.2
1977	7.1	7.7
1978	7.9	8.0
1979	7.9	9.0
1980	8.2	10.0
1981	8.4	9.9

[1] Imports as a percent of the sum of U.S. product shipments and imports.
[2] Exports as a percent of U.S. product shipments.

Source: US Department of Labor, Trends in Manufacturing: A Chartbook. (Washington, DC: Government Printing Office, April 1985) p. 16.

In the revolution that is still underway creating the global economy, a number of events seem to take on importance even now. The oil shock of 1973 marked the end of the postwar economic system. Taking the U.S. off the gold standard in 1972 led to the creation of a number of international currencies, such as the Eurodollar and the SDR. Merging the computer with offshore money markets and satellite communications led to a worldwide capital market. Deregulation of communications and transportation within the United States opened the possibilities for the profitable introduction of new technologies into these industries and is forcing international deregulation as well. New production technologies have enabled some low-wage producing countries to combine transportation and communications advantages with high productivity and reinforce their competitive edge in manufacturing. Technology has also allowed high wage countries to increase productivity. Trade liberalization under the GATT has helped to make the penetration of foreign markets easier for American and foreign businessmen alike. All of these, taken together, have dragged the American market (perhaps only partly as yet) unwillingly into the global market.

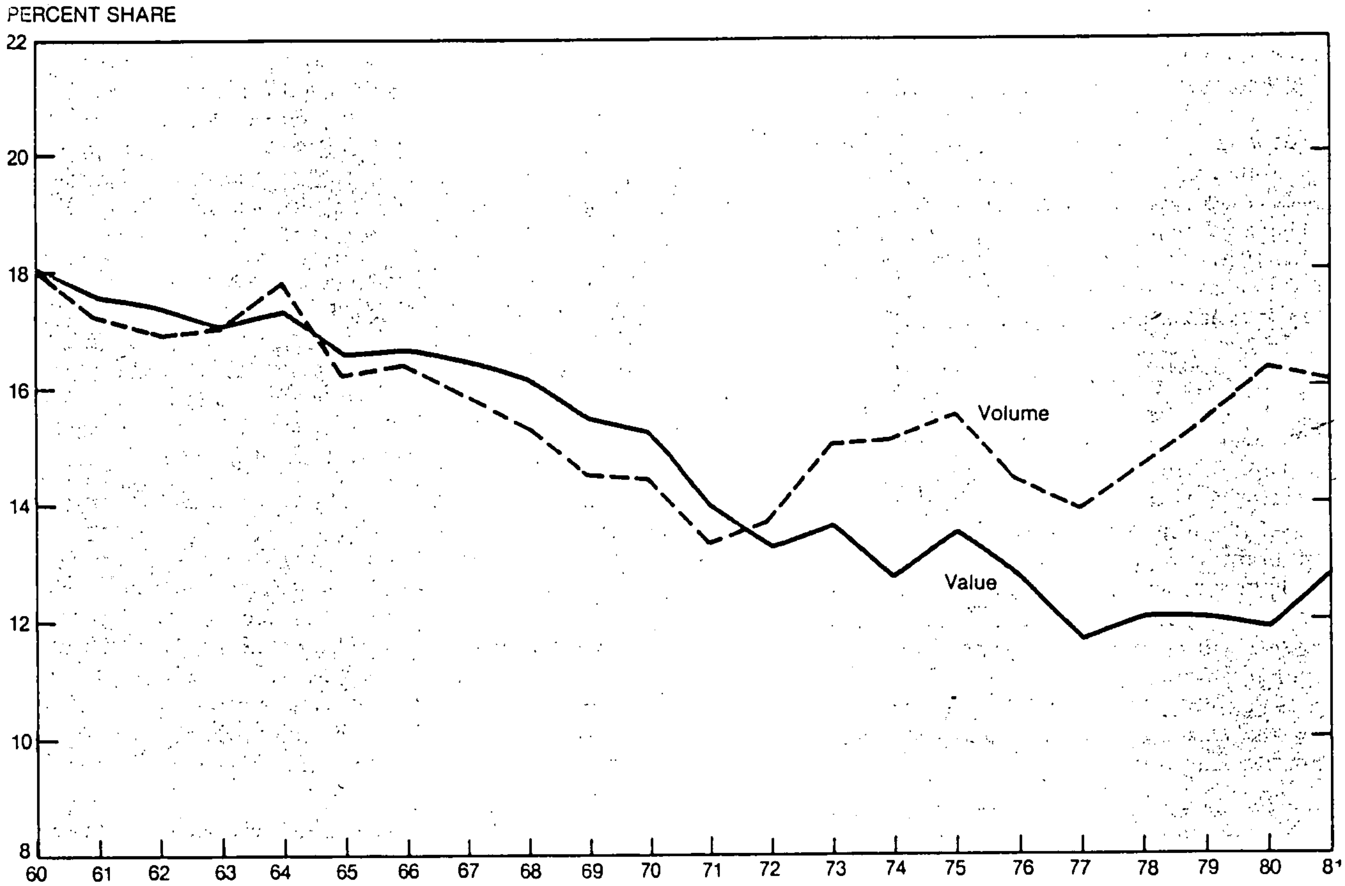
2. Competitiveness and domestic management

> "In too many industries, U.S. companies have not remained competitive with foreign rivals. In certain cases this lack of competitiveness was inevitable; some countries can exploit indigenous raw materials that are inherently superior and more accessible than ours, others can depend on an abundance of low wage labour. In most cases, however, our lack of competitiveness has stemmed from our inability to improve productivity and deliver higher-quality products for a lower price than competitors in other high-wage industrialized economies. This decline of relative productivity is the major reversible cause of our present economic woes.[28]

The principal argument made about competitiveness is that the large trade deficit in the U.S. and much of the loss of manufacturing jobs over the past decade are due to a declining ability to compete in world markets. The decline of the U.S. share in world trade is generally shown to illustrate this phenomenon, as in Chart 1-C. While the volume of exports recovered in the 1970s, value did not, suggesting a movement toward low value exports (agricultural goods) and toward lower profitability for other exports. Scott notes that the turnaround in volume came as a result of U.S. depreciations of the dollar after 1972.[29]

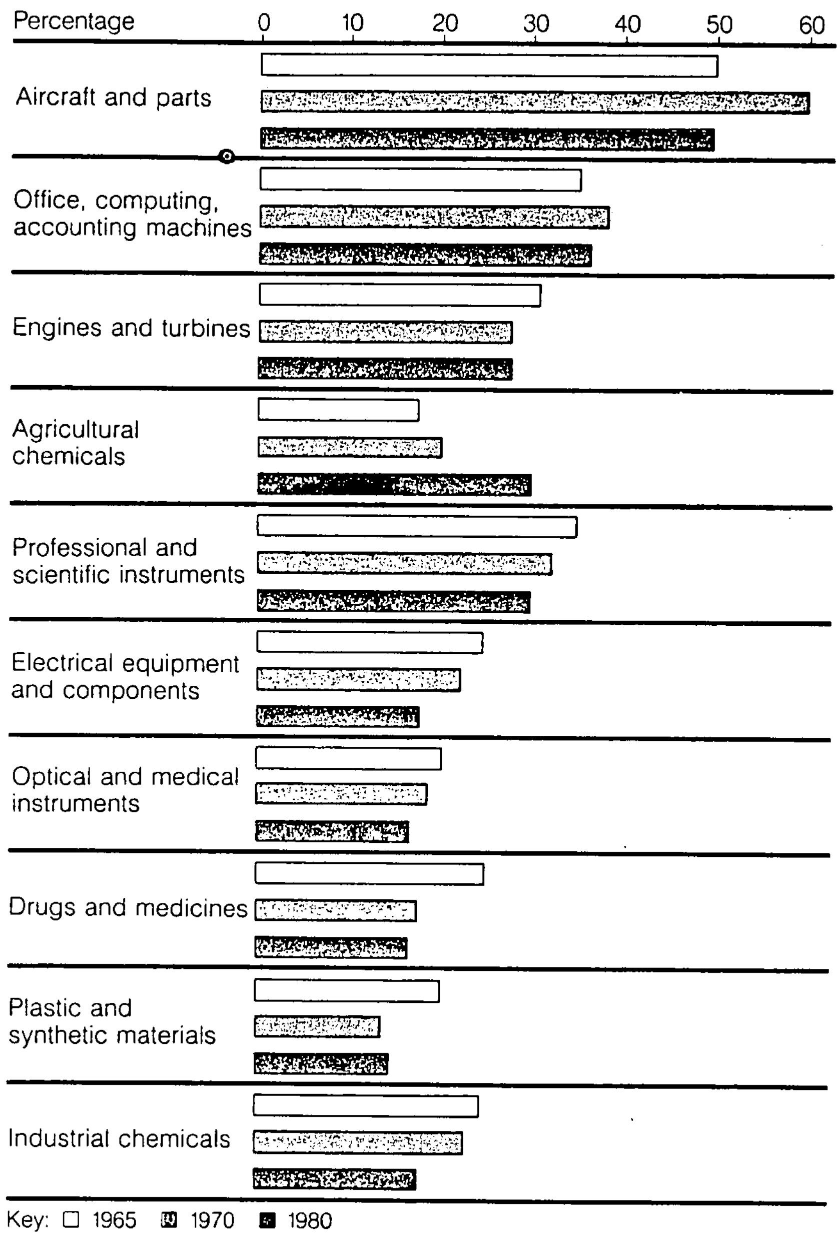
Competitiveness is also measured in terms of the loss or gain in market share amongst exportable products. In this area, the United States performed reasonably well in comparison to its main European trading partners, France and West Germany, but not as well with respect to Japan.[30] American comparative advantage in high-technology exports is respectable but again not as much so as that of Japan.[31] Chart 1-D illustrates the argument that loss of market share in technology-intensive and capital-intensive industries threatens America's manufacturing future.

Chart 1-C. U.S. Share of Exports to the World
(Volume share in 1960 U.S. dollars)



Source: Source: US Department of Commerce, An Assessment of US Competitiveness in High Technology Industries (Washington, DC: US Government Printing Office, February, 1983) p. 8.

Chart 1-D. U.S. Share of World High Technology Exports[a]

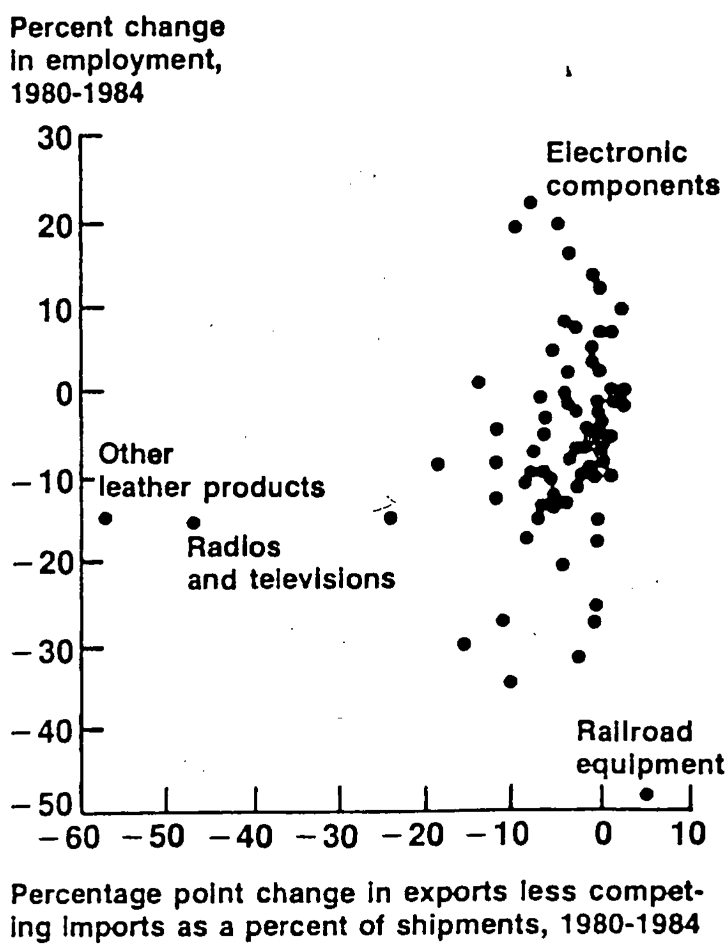


Source: Bruce R. Scott, "U.S. Competitiveness: Concepts, Performance and Implications", in Bruce R. Scott and George C. Lodge (eds.). US Competitiveness in the World Economy (Boston: Harvard Business School Press, 1985) p. 29.

[a]The world is defined as fifteen major industrial countries.

The international competitiveness argument seems to imply that the loss of market share in high-technology exports has led in part to the loss of employment in America's manufacturing sector and it also suggests that future prospects for American industry are in peril. The second assumption is plausible, but research does not really bear out the first. An economist with the Federal Reserve Bank of Boston has analyzed 73 major manufacturing exporting industries' 1980-84 performance against employment changes and found that there was no correlation between net exports/imports performance and job gains or losses over this time. Chart 1-E illustrates this finding:

Chart 1-E. Exports Less Competing Imports and Insured Employment for 73 Manufacturing Industries 1980-1984



Source: Norman S. Fieleke, "The Foreign Trade Deficit and American Industry". Economic Impact (1) 1986, p. 53.

Yet the question of competitiveness not only refuses to go away but has become the new 'buzz word' of those who would promote a more active national policy. A plausible argument may be that foreign import penetration is having a severe impact, not on competing American exporters, but upon industries that could only survive profitably behind American protection granted in part by a declining dollar (in the 1970's) and tariff barriers (now falling as a result of the GATT). This is the case in both autos and steel, generally seen as the big employment and financial losers in the past decade. If one ignores the 'exports' under the Canada/United States Autopact, it is doubtful whether United States-made autos or steel were exported in significant quantity for most of the last twenty years.

3. The developmental state

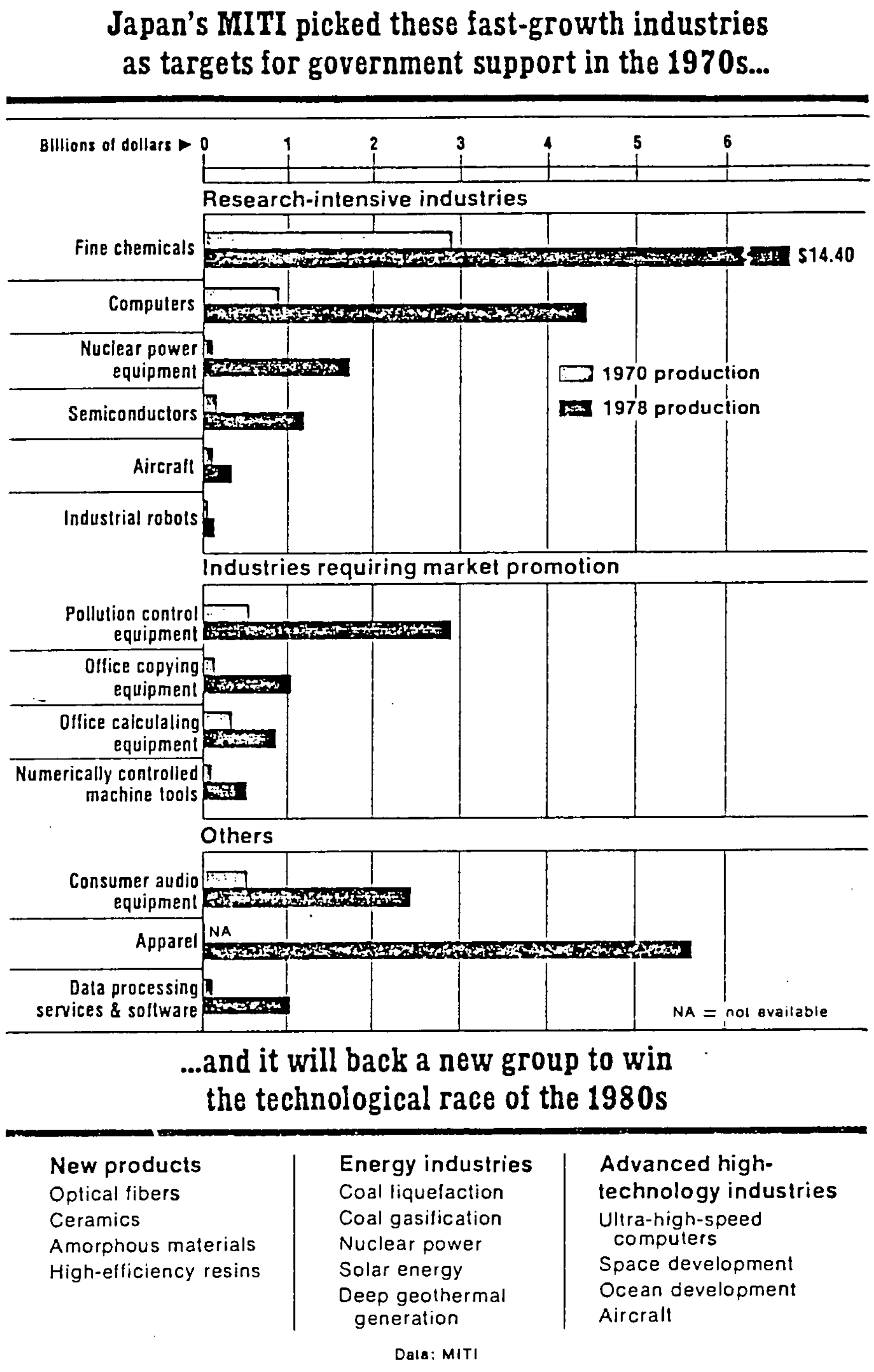
The symbol of the foreign competitive threat is Japan. Its government-labor-business relationship has sparked calls for emulation and adaptation to the American scene.[32] Japan's thrust toward automation and its methods of raising business capital are seen as examples to be followed. Its corporate concern for market share and long-term returns are favorably contrasted with American corporate impatience and concerns for quarterly profits.

Behind all this desire to emulate Japanese practices is another concern: that the Japanese culture and historical experience has helped to create (or recreate) a nation-state with a focussed economic strategy against which the more anarchistic culture in America cannot hope to prevail. Japan is seen as the reincarnation of the mercantilist developmental state in late 20th century garb.[33]

The notion is attractive, though probably overdrawn in most cases. Richard Rosecrance, in his The Rise of the Trading State, defines two ideal-types of states in the modern world; the territorial state and the trading state.[34] The first type gains international influence through the control of populations and resources via the control of territory. The second operates through the control of international trade. Rosecrance tends to tie the evolution of the two systems to technological development and his models as methods of gaining international power are very suggestive. America's reliance on the power of its internal market has been challenged by Japan's organization to deal with international markets. In one state, the U.S., public power is used to maintain domestic competition - in a sense public and private are set against each other. In the other, Japan, the complexities of the international system require that public power be used to supplement private economic activity. As ideal-types, they make good contrasts. In reality, Japan's internal markets are vital to its corporations, while the United States is a very large trading nation.

The main point of interest in the Japanese system has been the relationship between MITI, the Ministry of International Trade and Industry, and the private sector, especially the large exporting companies. The literature on the subject of industrial policy abounds with references to the MITI-corporate connection[35]. Chart 1-F shows a typical reference to MITI's vaunted ability to 'pick winners':

Chart 1-F. An Example of American Impressions of MITI



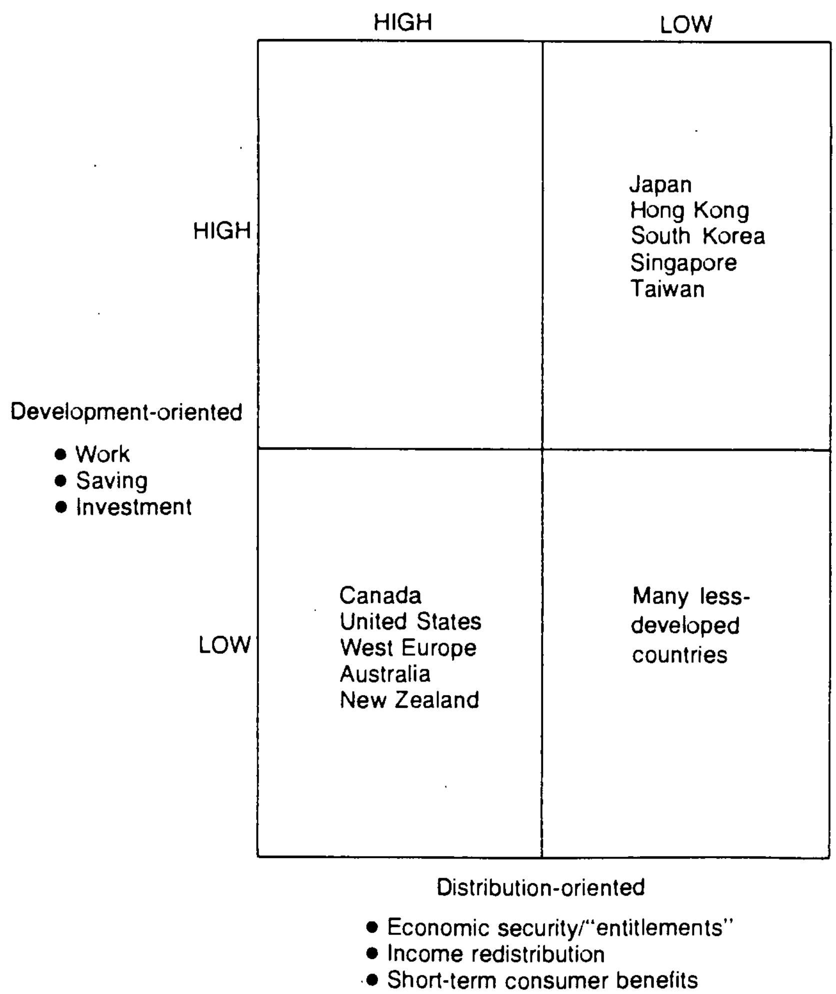
Source: Seymour Zucker, et. al., The Reindustrialization of America. (New York: McGraw-Hill, 1982) p. 144.

Other research is devoted to showing how neither MITI nor its analogues elsewhere have been particularly successful in this approach.[36]

In essence, the argument runs that MITI's ability to get consensus from Japanese corporations on product development, its ability to maintain the Japanese system of raising inexpensive capital from the thrifty Japanese population and its ingenuity at protecting domestic markets while opening up foreign ones has given Japan its competitive edge and made the country into what will shortly become the world's second largest economy.

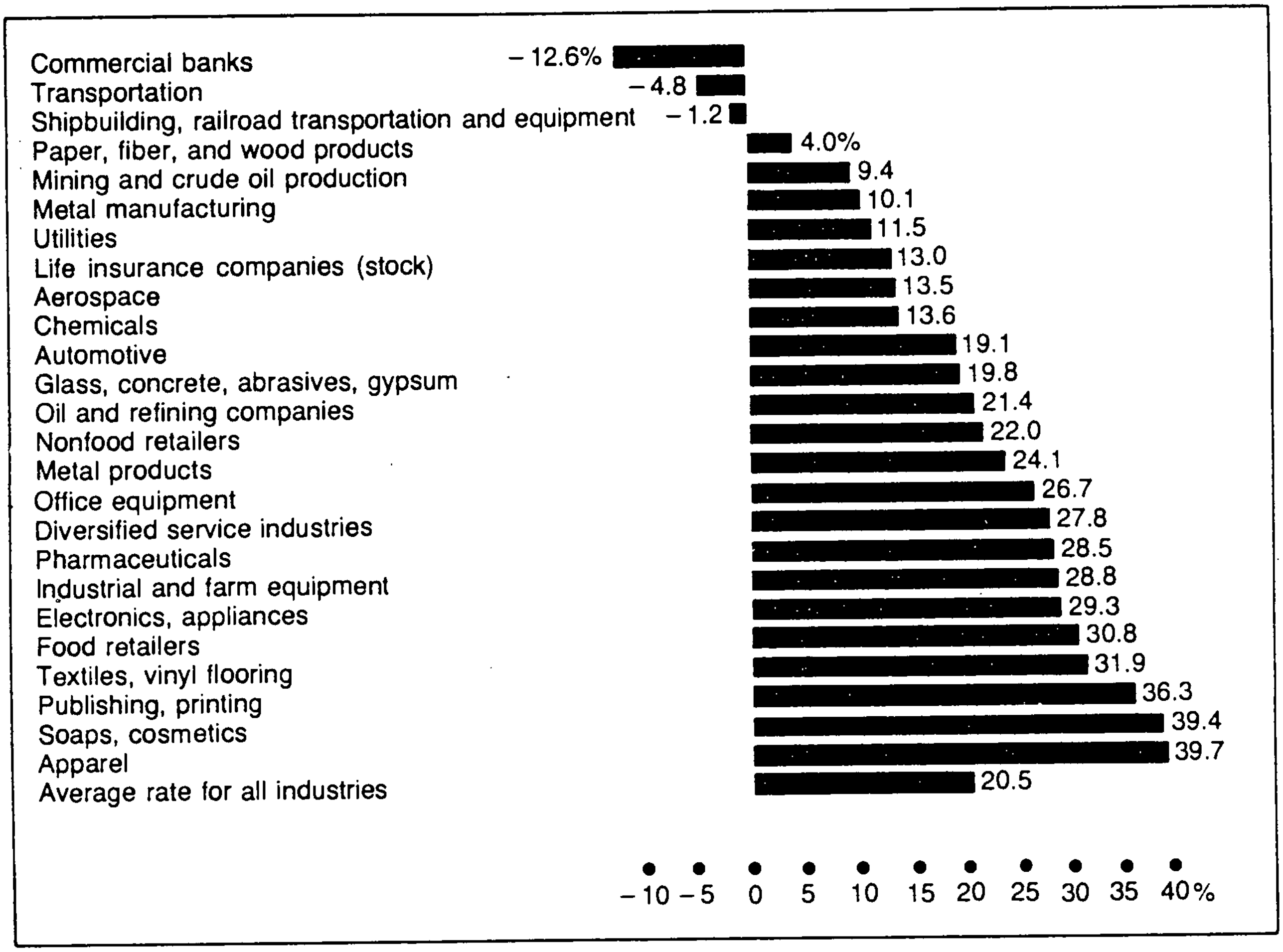
The ability to pick winners is seen as a corollary to the coordinated tilting of the Japanese economy toward development instead of redistribution. Bruce Scott graphically notes the problem in Chart 1-G and 1-H:

Chart 1-G. Country Stategy Matrix



Source: Bruce R. Scott, "National Strategies: Key to International Competition," in B.R.Scott and G.C.Lodge (eds.) <u>US Competitiveness in the World Economy</u> (Boston: Harvard Business School Press, 1985) p. 127.

Chart 1-H. The Huge Tax Gap Among Industries - 1981



Source: Bruce R. Scott, "National Strategies: Key to International Competition," in B. R. Scott and G. C. Lodge (eds.). US Competitiveness in the World Economy (Boston: Harvard Business School Press, 1985) p. 135.

Note: Because of special breaks, the actual corporate taxes paid in 1981 vary significantly from firm to firm.

Chart 1-G underscores the notion that trading states, or developmental states, practice coherent strategies aimed at improving international competitiveness, while others are more concerned with distribution. Chart 1-H suggests that tax burdens in the United States are skewed to favour consumer industries that do little or no exporting at the expense of those that do export. The argument implicit in these charts is that a reorientation toward a more coherent developmental strategy would improve American competitiveness.

Conclusion

In the late 1970's three conflicts emerged within the American economy that were to have important impacts on the politics of the 1980's. These were the entrance of the large age-cohorts of the Baby Boom of the 1940's and 1950's into the labour force, the shift of economic activity from the north into the south and west of the country, and the increasing penetration of imported manufactures into the American economy.

The importance of the Baby-Boom generation lies in its uniqueness. Low birth rates in the Depression, in the 1960's, and after, created a population bulge that began in the 1940's and reached a peak around 1960. This population bulge has affected many institutions in American society as it has grown older and in the late 1970's, it began to put pressure on the job market. The traditional job markets in manufacturing were already under competitive pressure and could not absorb the new baby boom entrants.

The shift of population and economic activity from the north to the south and west of the U.S. was characterized by the closure of many older plants rather than their modernization. Employment moved to new, low-wage factories in the recipient regions of the country. Since the net effect of this movement was seen in a national context as zero, little was attempted at a national level to alleviate the regional problems. Union pressures were significant, as the major job losses took place in unionized industries, while new employment came in less-organized service industries, in high technology firms and in states where right-to-work laws prevailed.

Regional changes in production were not the only forms of conflict. The shift of manufacturing capacity out of the country to East Asia in particular, posed a third problem to American society. Again, the shift was not a physical movement of capacity as a shift in new investment by American and foreign firms into East Asia for purposes of producing for the American market. This just increased penetration of the American market by foreign products. This shift, which was highlighted after 1984 by a growing trade deficit, was felt to be not only a result of lower production costs and competitive pricing policies by East Asian producers, but was seen as actively abetted by the governments of these foreign exporters. Their active industrial policies were seen as eliminating the "level playing field" essential in classical economic theory. Even so, they were seen as possibly worthy of emulation.

The successful resolution of the triple conflict had to see an increase in job opportunities in America to satisfy the Baby Boom generation. The jobs had to be relatively evenly dispersed in order to relieve pressures in the Rust Belt. In order to accomplish these two objectives, either imports from abroad would have to be restrained or American exports increased, or both. The public policy debate since the late 1970's has continually accepted these goals as given: how to achieve them has been the issue.

The next chapter focusses on this industrial policy debate at the national level. Even though most net new jobs have come from the service sector in the past two decades, the debate has resolved around the fortunes of the manufacturing sector and to a lesser extent, resource production. This is because those involved have seen manufacturing as the key generator of economic wealth and the major underpinning of the service economy. It is commonly assumed, with little factual evidence, that service activity is somehow dependent upon a healthy manufacturing sector. It is no wonder that much of the concern over manufacturing has focussed on the production of high-technology products. Not only do they come out of the most glamorous part of the manufacturing sector, but high-technology is at the interface of the goods-producing and service-oriented sectors. The addition of more information and design into goods is the essence of high-technology production and as such is seen as having a strategic economic importance that exceeds its contribution to the American economy.

It is important to keep the triple conflict in a dynamic context. None of the forces has remained the same over time. The peak of the Baby Boom generation is seven years older in 1987 than it was in 1980. Because of the age-segregation in our society, seven years can represent a great deal of change in employment expectations, family responsibilities and consumer tastes. The crisis in American durables manufacturing, especially in autos and steel, still has some ongoing features, but the shake-out has largely been accomplished. In the mid-1980's, there has even been a great deal of new investment in the auto industry especially. Regional fortunes have reversed themselves to a degree, with the rise of New England and the decline of the oil, mining and agricultural states.

Only the problem of trade imbalances with East Asia and elsewhere has intensified. This has led to trade relations becoming the symbol of success or failure for all the industrial policy debate. Yet, one must not be seduced into thinking that even this focus will remain constant for the next few years, though its continuing relative importance cannot be denied. The critical problem is the establishment of American's place in the global economy and the manner in which it will be integrated into this new economy, and this problem will remain unsolved until after the turn of the century.

Footnotes to Chapter I

1. One of the most interesting and comprehensive pieces is Landon Y. Jones, Great Expectations: America and the Baby Boom Generation (New York: Ballantyne Books, 1981). See also, Patrick Caddell, "Baby Boomers Come of Political Age" Wall Street Journal, 30 December 1985; Ira S. Steinberg The New Lost Generation. (Oxford: Martin Robertson, 1982) and George Sternlieb, et al., Demographic Trends and Economic Reality (New Brunswick, N.J.: Center for Urban Policy Research, 1982).

2. Ibid., Chapters 12, 13, 22. See also, "Do We Need an Industrial Policy?", Harper's, 270, February 1985, pp.38-39, "The New Collar Class" US News and World Report, 16 Sept 85, pp. 59-65, and Ira C. Magaziner and Robert B. Reich, Minding America's Business (New York: Vintage, 1982) pp. 38-29, and Peter Drucker, "A Growing Mismatch of Jobs and Job-Seekers", Wall Street Journal, 26 March, 1985.

3. US Government, Economic Report of the President (Washington, DC: United States Government Printing Office, February 1984) p. 89, Table 3-1.

4. David Clark, Post Industrial America (New York: Methuen, 1985) p. 24, Table 1.3. The sectoral shift in employment has seriously affected the size and influence of the union movement, as it has not serously penetrated those industries where job growth is highest. The pressure exerted by the union movement has intensified the political struggle over jobs.

5. Economic Report of the President, op. cit., p. 89, Table 3-1.

6. Clark, op. cit., p. 24, Table 1.3.

7. John Oliver Wilson, The Power Economy (Boston: Little, Brown, 1985), pp. x-xi. See also, Barry Bluestone, "Is Deindustrialization a Myth?", Economic Impact (2) 1985, pp.71-73 (reprinted from The Annals of the American Academy of Political and Social Science, 1984).

8. Eli Ginzberg, "The Changing US Work Force", Economic Impact (4) 1976, p. 52.

9. "The US Economy: Incubator of Jobs" (Interview with Thomas J. Plewes, Associate Commissioner for Employment and Unemployment Statistics, US Department of Labor) Economic Impact (2) 1985, p. 35.

10. David Birch, "The Changing Rules of the Game: Finding a Niche in the Thoughtware Economy", Economic Development Commentary 8(4) 1984, p. 14.

11. George Gilder, The Spirit of Enterprise (New York: Simon & Schuster, 1984) p. 46.

12. Peter Drucker, "Our Entrepreneurial Economy", Harvard Business Review, January-February 1984, p. 59.

13. Peter Drucker, Innovation and Entrepreneurship: Practice and Principles (New York: Harper and Row, 1985) pp. 3-22, 144.

14. Clark, op. cit., pp. 33, 51, 59.

15. Clarke, _ibid._, pp. 60-65, 78-80, 104-107. See also Steven C. Ballard and Thomas E. James (ed.) _The Future of the Sunbelt: Managing Growth and Change_ (New York: Praeger, 1983) pp. 1-15, 283, and Mancur Olson, "The South Will Fall Again", _Southern Economic Journal_ 49(4) 1983 pp. 916-932.

16. "California Area No 1 in Output", _New York Times_, 1 May 1986.

17. Barry Bluestone and Bennett Harrison, _The Deindustrialization of America_ (New York: Basic Books), pp. 6-9. Bluestone and Harrison acknowledge this point and focus their analysis on capital flight instead.

18. Noted in Bluestone, "Myth" _op_. _cit_., p. 68.

19. Bluestone and Harrison, _op_. _cit_., p. 100.

20. Based on figures taken from Gregory Jackson, et. al., _Regional Diversity: Growth in the United States, 1960-1990_ (Boston: Auburn House Publ., 1981), Appendix C. Tables C.9-C.26.

21. Bluestone and Harrison, _op_. _cit_., pp. 184-186. Drucker _Innovation_, _op_. _cit_., p. 4.

22. Gilder, _op_. _cit_., p. 102.

23. Bernard L. Weinstein and Harold T. Gross, "The Frost Belt's Revenge", _Wall Street Journal_, 19 November 1985. Bernard L. Weinstein and Harold T. Gross, "An Economic Role Reversal" _State Legislature_ 12(4) April, 1986, pp. 22-24. See also, "Oil States Slashing Services as Price Plunges, _New York Times_, 5 April 1986, "6 Governors Seek an Oil Import Tax" _New York Times_, 16 April 1986, and "For Texas Workers, Economy Has Gone Dry" _New York Times_, 7 May 1986.

24. Jackson, et. al., _op_. _cit_., pp. 36-46.

25. Jane Jacobs, _Cities and the Wealth of Nations_ (New York: Random House, 1984) ch. 11.

26. See for instance, "Outsiders Spur Rebirth of Baltimore," _New York Times_ 2 June 1986. Similar stories about New York City, Boston and Philadelphia have appeared over the past two years in numerous publications.

27. Kevin Phillips, "The Balkanization of America", _Harper's_, 256, May 1978, pp.37-47. See also, Peter R. Gottschalk, "The Regional Allocation of Federal Funds" _Policy Analysis_ 7(2) 1981 pp. 183-4 and Robert M. Kaus, "Can Creeping Socialism Cure Creaking Capitalism?" _Harper's_, 266, February 1983, pp.17.

28. Magaziner and Reich, _op_. _cit_., p. 2.

29. Bruce R. Scott, "U.S. Competitiveness: Concepts, Performance, and Implications", in Bruce R. Scott and George C. Lodge (eds). _US Competitiveness in the World Economy_ (Boston: Harvard Business School Press, 1985) pp. 44-45.

30. Ibid., pp. 34, 49-70.

31. U.S. Department of Commerce, An Assesment of U.S. Competitiveness in High Technology Industries (Washington, D.C.: U.S. Government Printing Office, February 1983) pp. 11-12.

32. One of the more sensible is Ezra Vogel, Comeback. (New York: Simon and Schuster, 1985), a sequel of sorts to his Japan as Number One: Lessons for America (Cambridge Mass.: Harvard U. Press, 1979).

33. Chalmers Johnson, MITI and the Japanese Miracle (Palo Alto, Calif.: Stanford U Press, 1982), ch. 1. Scott's empirical analysis tends to underline this notion. See his "US Competitiveness..." in Scott and Lodge (eds), op. cit., pp.55-63.

34. Richard Rosecrance, The Rise of the Trading State (New York: Basic Books, 1985).

35. Johnson, op. cit., is the most important work on this subject.

36. Roy George, Targeting High - Growth Industry (Ottawa: Institute for Research on Public Policy, 1983).

CHAPTER II

THE FALL AND RISE OF A NATIONAL INDUSTRIAL POLICY

The effect on American society of the three conflicts discussed in the previous chapter was additive. That is, they caused wrenching changes in some parts of the country, while leading those other parts that had partially benefitted to fear that their good fortune was perhaps only temporary. Changes and fears of still further changes set off demands for political solutions for what appeared to be economic and technologically-based problems.

The recession of 1981-82 was not so much a climax to the process of change that had been working on American society as a hastening and a dramatization of these changes. Northeastern states had been concerned for some time about their relative deindustrialization, but it took the recession to make the outlines of the process harsh and clear. The Sunbelt had benefitted from individual and corporate migration, but the recession brought home the potential future effects of losing industrial capacity to overseas producers. No part of the country was left unaffected by what the recession highlighted.

Since the effects of the above mentioned conflicts were more apparent at the state level, it is not surprising that state governments moved towards active industrial policies almost unanimously. As Chapter IV brings out, almost without exception state governments of all political and ideological stripes have developed such policies, including formal strategies, programs for export development, small business financing, and better university/business/government technological development. Each state seems to realize that it is in competition for industry with all other states and foreign countries, in order to generate employment and tax revenue. While they all engage in competition to recruit new investment from outside their borders, industrial policy of the 1980's has overwhelmingly focussed on the development of indigenous enterprises.

The Politics of Industrial Policy

The response at the national level has not been the same as in the individual states. Two reasons can be advanced to help account for the difference. First, the impact of the regional and demographic conflicts within the United States has tended to translate into varied local pressures at the national level. The different interests of Michigan and Texas, for example, may cancel out at the national level, while at the same time, both states may be engaged in developing active industrial policies. As long as the regional benefits and losses tended to cancel each other out nationally, policy responses at the latter level would likely be limited and partial. Only as international implications become serious as shown in widening trade deficits, would there likely be a serious debate over an American response.

The second reason is ideological. Both the Republicans and the Democrats have strong factions committed to particular responses to the problem of declining American economic competitiveness. The clash of their ideas served, at least until 1987, to decrease policy coherence at the national level. The economic policy communities in the two parties represent a variety of interests. For a long time after the Depression, economic policy was largely the domain of the traditional Republicans and the New Deal Democrats. Since the shocks of oil prices, inflation and recession hit in the 1970's, the dominance of these groups has been challenged. The Republicans were the first to feel a change, as the so-called supply-side economists came to the fore with Reagan's victory in 1980. Before the 1984 election a similar challenge was launched in the Democratic Party by the so-called Atari Democrats and the industrial policy economists. This challenge was turned back by the nomination of Walter Mondale, who was seen as the champion of the traditional Democratic coalition and thinking. His defeat in 1984 then left open the question of whether the Democrats would move to a new stance on economic policy.

At present, there are three factions within each party, based on different approaches to economic policy. Traditional Republican economic policy has focussed on the need to inject fiscal prudence and austerity into government[1]. Balanced budgets and the careful management of the money supply are its hallmarks. Not surprisingly, this approach is seen by its opponents as being of use to the rich and of threatening the welfare state. With the exception of the Eisenhower years, it is hard to see where this approach has led to any electoral success.

The challenge of supply-side economics arose as a result of conservative rethinking after the Nixon Presidency. Its basic tenet was that economic growth could only be achieved if the tax system were reformed so as to penalize less those who were entrepreneurs or producers, thereby allowing them to channel more disposable income into investment.[2] The famous Laffer curve was added to show that overall tax revenues could rise as rates went down.[3] The key political move towards supplyside economics was the Kemp-Roth tax cut proposal of 1977.[4] This could not win acceptance from the Democrats, but it became a rallying cry for the new conservative economists. The promise of supply-side economics lay in the notion that government revenues to support both the welfare state and defense expenditures could be maintained in the face of a massive tax cut, partly because of the effects of the Laffer curve and partly due to the increased economic growth that the cut would stimulate. The combination was politically attractive, especially to those who had high incomes or expected to be earning them in the future and whose need for the welfare state was not overt. Essentially this included suburbia, some unionized workers within suburbia, and the rural areas. Together these formed a voting majority that swept Reagan to power.[6]

A third strand of Republican thinking held little appeal but should be mentioned. This is libertarianism, which can be seen as a radical variant on supply-side economics, though it predates it. Libertarians believe that the state has intruded into peoples lives unnecessarily and that a radical trimming of public expenditures, including most programs of the welfare state, would result in the revitalization of the American economy.[7] This extreme position, while it touches on strands of conservative feeling, has virtually no electoral appeal.

The Democrats by 1984 also included three factions in the field of economic policy. Unlike Republican experience, the mainstream of the Democratic party developed around an approach that was successful at the polls for decades. It was centered around a commitment to provide public support for those in need, justified economically as a means of stimulating and maintaining demand.[8] The traditional Democratic support for this approach came from geographical regions and industrial areas whose people had incomes that did not allow them to amass significant savings and investments and who therefore needed public support for pensions, unemployment, education and health. The Democratic coalition fell prey in the 1970's to the very success that had made it electorally popular. Many of the groups in the coalition found themselves better off, and their sons and daughters felt more secure because of education and the changing occupational structure. They began to desert the party in droves, for the most part becoming political independents.

The challenging approach was not so concerned with the maintenance of the old Democratic coalition as competing for the allegiance of those who had been attracted to supply-side Republicanism. To these Democrats, the central concern was not the protection of the welfare state in all its aspects, but the problems caused by economic instability. They agreed with the supply-siders that more had to be done to stimulate investment and productivity, and for that they were characterized as right-wing Democrats. As well, they returned to a traditional Democratic mechanism in advocating various methods of planning, or government coordination of a national industrial strategy, that would allow the country to meet foreign competition.[9] This basic approach was embraced by Gary Hart in the nomination campaign before the 1984 election, but was put aside by the party when it nominated Mondale, who was closer to the traditional Democratic approach.[10]

The Democrats too had their radical wing. This group dates from the 1960's and may be called the 'community developers.' In the 1960's, one of the approaches tried in Johnson's War on Poverty was to encourage inner-city organizations to set up local economic development groups to provide productive employment. By the 1980's, with the shock of recessions in 1974-75 and 1981-82 having provided both a large degree of unemployment and job uncertainty, the call for more effort to provide employment in areas of high and chronic unemployment through publicly-owned or cooperative organizations. This approach had a certain appeal.[11] In part, Jesse Jackson was able to enlist the supporters of these ideas in his Rainbow Coalition.

The Elements of Industrial Policy

President Reagan's reelection in 1984 only temporarily settled the question about which approach the country might take in meeting foreign competition. Increasing trade deficits in 1985 and 1986 seemed to indicate that the Republican strategy was not working. The election of Democratic majorities in both Houses of Congress in 1986 brought a new version of industrial policy to the fore, under the guise of developing America's international competitiveness.[12] The differences between the 1982 version of industrial policy and the 1987 version of international competitiveness policy are hard to perceive, and the following discusson will be couched as if there were no change.

The core industrial policy debate has been over the role of the state in promoting economic development. Conservatives have consistently held that a less-interventionist state and one that had proper tax and regulatory policies would give the American business community enough incentive to meet the challenge. Industrial policy on this vein can be said to be 'passive.' More liberal opponents feel that this approach is inadequate, in that the Japanese have found that a coordinated mix of passive measures and more active intervention to support and promote business development has, and will continue, to give a competitive edge to their businesses. In this view, meeting the Japanese challenge requires an American version of a more coordinated and active public policy toward industrial development.[13]

The difference between these two views is probably more apparent in rhetoric than in action. The United States is an 'invented' nation, in that it is composed of descendants of immigrants who came in pursuit of individual fulfillment. Japan, on the other hand, has had an indigenous population for thousands of years and a history of social solidarity lacking in an immigrant country. Though it is probably an overstatement, it can be said that the Japanese state finds it easier to work toward collective economic goals within a capitalist framework, while Americans have tended to concentrate more on achieving national ends through the 'invisible hand' behind individual and corporate pursuits of fulfillment. Americans are more process-oriented when it comes to economic development, whether they are conservative or liberal.[14]

The distinction between liberal and conservative American industrial policy advocates is blurred in another way as well. The Japanese state has functioned inside a capitalist framework for the past century and its public policy is not as directive as that of the USSR, for example. Individual interests are still paramount. The United States, in contrast, has many examples of goal-oriented industrial policies, especially in wartime. Other examples are the NASA space program and power complexes such as Tennessee Valley Authority (TVA) and the Bonneville Power Authority. Some observers have also noted that the large financial impact of national security expenditures through the Department of Defense in itself constitutes a variation of industrial policy.[15]

The term "industrial policy" is nowhere well-defined. In general, it is concerned with the nature of government policy that helps or hinders commercial enterprises, whether privately or publicly owned. This definition is too wide, however, and could include almost everything government does. Instead, a narrower definition is preferred that tends to focus on the international competitiveness of firms, especially manufacturers. Industrial policy therefore focuses on the problems and opportunities faced by those firms in a country that are engaged in international trade or subject to international competition. For the most part, these are manufacturers. Industrial policy is also seen in a positive mode, that is, it is a collection of sub-policies that taken together, try to improve national competitiveness. (At the state level, a further dimension of competitiveness is added: that between one state's firms and those of other states.)

Those who discuss industrial policy sometimes present it in terms of its being the 'third leg' of overall economic policy, complementing fiscal and monetary policy in this regard. Rightly or wrongly, industrial policy is not seen as having the specificity or concreteness ascribed to the other two 'legs.' There are too many potential elements involved in industrial policy to allow it to be as clearly defined a term as the other two.[16]

The effects of industrial policy are also not as tangible as those of fiscal and monetary policy. According to Hiroya Ueno:

> Unlike traditional fiscal and monetary policies, industrial policy demonstrates no clear relationship between its objectives and the means of attaining them. Its conception, content and forms differ, reflecting the stage of development of an economy, its natural and historical circumstances, international conditions and its general political and economic situation, resulting in considerable differences from nation to nation and from era and era.[17]

In keeping with this sentiment, an argument can be made that through much of the past century concern over industrial policy meant the development of industry to satisfy domestic needs. In the 1920's Turkey and Argentina tried to develop autarkic regimes which protected domestic production at almost any cost. The aim was to produce a 'full-service' economy in these countries. U.S. domestic competition policy and tariffs through the first half of this century may be seen in a similar light. Later French and Russian economic planning were also primarily oriented toward domestic market demand.

Today, the focus has shifted to the role of various countries in the world market. There is no pretense that a country can absent itself from the world economy and stil keep up with the rest of the world at the same time. Technological change has overcome many national barriers, since often products cannot be easily duplicated, especially given the investments needed to produce the technology. Specialization in technology is more and more forced upon nations and they are increasingly forced to trade for goods that they are unable to produce. Secondly, technological change has affected the modes of production and distribution, making it increasingly necessary and desirable to construct factories to produce on a scale that outstrips any local demand. The economics of scale argue for 'world' products, not national ones.

Industrial policy today is an attempt to respond to this new environment. To export is to demonstrate competitiveness. Conversely, any productive facility that is or wishes to be competitive has to strive to open export markets. It is impossible to say whether the liberal trading regime under the GATT led to the technological development of world-scale plants or whether the technical practicability of producing on a global scale led to the liberal trading regime. At any rate all discussions of industrial policy today have at their core a concern over competitiveness as it is defined, not on a domestic scale, but on the international scene.

Challenge and Response

In the United States, this overall concern for international competitiveness is broken down into two perceived challenges and two potential responses. The first challenge is that of ensuring that domestic industries are organized, led and financed in such a way as to assure their being competitive with their equivalents in the rest of the world. This is the 'domestic' challenge. The 'foreign' challenge is to make sure that these competitive American industries have few or no roadblocks to their penetration of foreign markets. The two challenges are to some extent interlinked, but they are also amenable to separation. American firms can be competitive, yet can be blocked from foreign markets. American firms can be uncompetitiveand unable to penetrate foreign markets. Or they may be both uncompetitive and subject to barriers in any case. This ambiguity lends itself nicely to political debate and formulae.

The response to these challenges falls into two broad categories. The first type of response is to claim that the free market system will sort out the problem and that, in a situation where the international scene is cleared of barriers to trade and investment, American industry, or at least a good part of it, will hold its own. The second type of response arises from the feeling that the international scene is so fraught with subtle and sometimes impenetrable barriers that only the coordinated use of political power can overcome them. In this view, the free market solution is both idealistic and naive. Political management is required, through trade retaliation measures and trade management agreements.

The arguments over the ability of domestic producers to function competitively in a benign international environment are similar. The conservative view is to let the market forces exercise their discipline, and the industries that survive the 'revolution,' provided they are not hampered by excessive regulation or taxation, will emerge as world leaders.[18]

The alternative argument focuses on the shortcomings of American public policy and corporate behaviour. The decline in competitiveness is attributed in part to improper taxation policies that encourage investment in non-tradeable and non-productive facilities such as housing and commercial real estate at the expense of plant and machinery.[19] This concern begs the question of whether the correctness of investment decisions is more important than the volume invested. Research and development expenditures are often suggested as a factor, but U.S. performance in this area seems to be about the best in the world.[20] Low savings rates, encouraged by a consumption-oriented public policy, is another suggested cause, since these low rates lead to higher costs for capital.[21] Federal deficits, which raise the cost of capital and perhaps 'crowd out' private borrowings for investment purposes, are also suggested as a problem. In the end, most criticisms of public policy related to domestic corporate behaviour tend to revolve around the problem of ensuring a continuous flow of investment capital.

Corporate behaviour by itself is more intensively analyzed.[22] Case studies of the problems of industries such as steel, textile and autos abound and lessons are drawn from them. A variety of problems are identified, such as inadequate quality control, a lack of automation, poor or destructive investment decisions, especially when plant closings are discussed, inadequate attention given to production management and cost control, an obsolete labor-management system, and the forces on 'paper entrepreneurialism' or growth, through takeovers and mergers rather than through sales and profits.[23]

The situation is complicated where modernized industries and manufacturers increased their reliance on technology and design in their products and in their production facilities. Automation has increased the number of potential site locations for production facilities while considerably lowering production costs. The result has been heightened instability in employment in American manufacturing centres as companies move their production to areas where costs are less. In cases where technology has made production facilities obsolete, corporate failure and plant shutdowns have occurred. Product design has also had an impact through an increased separation between sources of physical supplies and production facilities. There is an increasing tendency to locate both final and intermediate assembly plants in areas distant from traditional raw material supply routes and closer to research centres and central distribution points. The key raw material today is increasingly mental rather than physical, and this has had its impact on plant location and corporate survival.

Plant mobility and employment instability have combined to create a range of pressures acting on the political system. Not only is Japanese competition threatening jobs and corporate survival in the United States, but the very process of American corporate response is adding to the problem. The questions surrounding the creation of 'sunrise' industries, protecting 'sunset' industries, picking winners and abandoning losers, maintaining 'strategic' industrial sectors and even products constitute a considerable amount of the industrial policy debate.[24]

The list of industrial policy concerns and solutions is nearly endless, and large amounts of data have been marshalled to support these concerns. The malaise of American business can, in many authors' opinions, only be corrected by public policy that operates at the micro-level of firms and industries. Developing a focused national strategy that addresses these problems within a corporatist framework (organized cooperation between government, labour and business) is a generalization that fits the majority of their recommendations.[25]

The Resurrection of Industrial Policy

In late 1984, the reelection of Ronald Reagan appeared to have put an end to the hopes of those who had advocated an active industrial policy for the United States. Yet only two years later, the subject, in a somewhat modified form, was restored to the political agenda of the nation.

The reasons for this quick fall and rise of the industrial policy idea are complex, but some may be sketched out quickly. First, was the failure of the Reagan revolution to significantly change the direction of American politics. Stockman wrote of the revolution's subversion by 'politics' in 1981-1982. The combination of high trade deficits and high fiscal deficits graphically illustrated his point by 1985. Reaganomics not only seemed to be a temporary fad, but it was also looking, in its execution, as little more than President Carter's retrenchments dressed up in neo-conservative rhetoric. By default, the notion of an industrial policy was given more credence as it was seen as the incorporation of competitiveness concerns into the old framework of Democratic policies that had led to so many electroal victories in the past.

The ephemeral nature of the Reagan revolution was also suggested (quietly, if not invisibly) by the adoption of industrial policy measures by most states in 1983-1985. Reagan's victory, in the context of state reactions to it, had to be seen as personal and not as a reaffirmation of an ideology.

Also, the forces noted in Chapter I had evolved by 1986 into a configuration rather different than in the 1980's. The shakeout of American productive capacity in the first half of the decade left the union movement weakened. Job pressures had declined , with the 'miracle' of New England and the revival of the Rust Belt absorbing new workers and leading to much new job creation. Conversely, the west and south were affected by declines in commodity prices that muted neo-conservative voices and introduced many states to the excruciating problems that had fused their northern counterparts in the early years of the decade.

Finally, the balance between these forces had shifted in the intervening years to place greater emphasis on the international conflict. As long as trade was roughly in balance and the dollar strong, a passive approach to international competition was credible. Only as trade imbalances became large after 1984, in spite of the boost to competitiveness that Reaganomics was supposed to have provided, did the search for new solutions take on some urgency. President Reagan's sporadic attempts to punish 'unfair' exporters with tariffs and enforced 'voluntary' restraints were rightly seen as attempts to relieve the pressure for a large-scale national solution to the problem as an alternative to the passive Republican policy.

The Congressional elections of 1986 produced Democratic majorities in both houses, a victory that holds out promise that a Democrat might win the Presidency in 1988. This victory has also restored the idea of an industrial policy to the national political agenda.

This time there is limited bipartisan support for the idea. Under the new guise of a 'national competitiveness strategy,' a bipartisan Caucus on Competitiveness has begun to look at policy and program ideas.[26] The new Speaker of the House has said that "Competitiveness will be our number one priority" in 1987.[27] The Administration has been moving toward limited protectionism under the goad of the trade deficit, and the President has called for a more productive America in recent speeches.[28]

While many Republicans are still wary of competitiveness strategy, other feel that circumstances have changed since the early 1980's. Then, it did not appear that there were any structural problems in the national economy that could not be cured by less government and a more tolerant regulatory climate. The growth and persistence of the trade deficit has apparently indicated to them that something is definitely wrong and that some initiatives must be taken to convert the uncompetitive stance of American industry.[29]

For their part, the Democrats favouring industrial policy or, as it is now called, a national competitiveness strategy, have moved away from their initial tendencies in favour of a policy with government as the central actor. The adoption of active industrial policies by the states has suggested to some that a federal/state partnership be formed, with the federal government helping to set a national climate for competitiveness, while the state governments continue to operate as they have on the micro, or firm, level.[30] Others recognize that the interests of business and labour must be given equal stature with those of governments, if the goal of a more competitive society is to be reached.

The movement of both of these factions makes it feasible today to discuss an emerging consensus for a national competitiveness strategy, even though the range of possible policy options is extremely wide.

Robert Reich has recently outlined four versions of a possible new strategy, all of which are mostly incompatible, and each of which is acceptable to only part of this new consensus.[31]

1) We're Living Too High on the Hog

This is the big business version that advocates a more investment and savings oriented society. Consumption oriented taxes and smaller governments are part of the formula.

2) We're Victimized by Big Business and Big Government

This is the populist version that sees America's entrepreneurial and innovative talents being stifled by oligopolies and red tape. A greater reliance on state and local governments and the dismantling of large corporations would lead to an American renaissance.

3) We're Being Exploited by Foreigners Who Don't Play Fair

This is the xenophobic version advanced by those hurt by industrial change, which they identify with foreign competition. It is largely a defensive stance based on using access to American markets as a weapon to lessen competitive pressures.

4) We're Not Strategic Enough

This is the mercantilist version that says America must organize to meet foreign competition. More attention has to be paid to technological development and to restoring the cutting edge of American competitiveness.

It is unlikely that any one of these versions of strategy will be accepted as a whole. Some aspects of each, especially the populist and mercantilist versions, have been adopted by state governments. The xenophobic version has some advocates in Congress and the big business version (as well as the populist version) has advocates in the Administration. The end result, as we approach the 1990's, is likely to be a mixture of all of them to greater or lesser degrees.

With this variety of proposed economic strategies, it is insufficient and incorrect to ascribe Congressional interest in industrial policy to a simple desire for protectionism. The need to protect American industry from foreign competition has always been a part of the industrial policy idea, but it has not been a central part. Neither is protectionism an exclusively Democratic concern. Protectionist tendencies among Democrats are strongest among those closest to the union movement, since it is in the older manufacturing industries and, by coincidence, the ones most unionized, that job losses have occurred. However, these Democrats do not constitute the whole of the protectionist spectrum. Republicans tend to represent the rural resource industries, such as agriculture and forest products firms, whose management and employees are vocal in their cries for protection. Furthermore, both parties have a stake in the health of high technology firms hurt by Japanese competition.

In general, the call for protection is seen as a means to an end and not as an end in itself. The aim is not to keep out foreign goods but to assure American goals of access to foreign markets. The danger is that, like the half-completed Reagan revolution, the industrial policy/competitiveness program will come to a halt once a single symbolic act is made. Then, the voters of the 1990's will be faced with the results of two abortive 'revolutions', one that created a fiscal mess in Washington and another that crippled international trade.

Conclusion

For over a decade, the United States has been engaged in a debate over its economic place in the world. The trading and industrial system initially established at the end of World War II broke down in the early 1970's, and the renewed growth of Europe and Japan, in spite of the quadrupling of energy prices, led to a situation where American dominance was eroded.

The dynamics of the triple conflict noted in Chapter I led to two prescriptions for meeting the new challenges. One was passive and relied on the classical notions of supply and demand and freer trade to resolve the conflicts. The other was an activist solution that saw the changed fortunes of the United States as due to basic failures in corporate management and to the involvement of foreign governments in industrial development and trade promotion. Ronald Reagan's victory and leadership led to the adoption of the passive approach. The trade deficits that grew after 1984 have led, in spite of Reagan's opposition, to the revival of the active approach. It would seem reasonable to expect that the active approach would continue to dominate after the 1988 elections as well.

The major question is not whether an active industrial policy will be pursued, but the nature and dimensions of this policy. So far, only the trade aspects have been seriously discussed in Congress. Domestic industrial adjustment, corporate management reform, technological change issues and other aspects of competitiveness have not entered the debate as yet. If protectionism constitutes the sole plank of a realizable industrial policy, then the U.S. is likely to be left with a new set of economic problems to parallel those created in the monetary and fiscal areas by the abortive Reagan 'revolution.'

It is doubtful whether the debate over America's place in the world economy will be over a decade hence. The underlying question concerns the reaction of Americans to the penetration of their domestic economy by outside forces, not just as sellers of goods but as managers of a significant section of America's productive and financial institutions. The fall and rise of a national industrial policy is but an indicator of the long-term nature of this debate.

Footnotes for Chapter II

1. A good discussion of the relationship of Reaganomics (or some variation of supply-side economics) and traditional Republican fiscal austerity may be found in Herbert Stein, Presidential Economics (New York: Simon and Shuster, 1984) pp 226-257.

2. Chapters 6 and 7 of George Gilder, The Spirit of Enterprise (New York: Simon and Shuster, 1984) provide a clear version of this argument.

3. A concise discussion of the Laffer Curve and its relation to Reaganomics may be found in John Oliver Wilson, The Power Economy (Boston: Little, Brown & Co., 1985) pp 23-33.

4. See David A. Stockman, The Triumph of Politics: Why the Reagan Revolution Failed (New York: Harper and Row, 1986), and Paul Craig Roberts, The Supply-Side Revolution: An Insider's Account of Policy-Making in Washington (Cambridge, MA: Harvard University Press, 1984), especially chapters 1-2.

5. Ibid.

6. The logic of this conclusion is discussed at length in my "Ron, Reaganism and Revolution", presented at the University of Western Ontario Center for American Studies Conference on "The Reagan Revolution", London, Ontario, 7-9 May 1986. Published in: The Reagan Revolution? edited by B.B. Kymlicka and J. Matthews (Chicago, Illinois: The Dorsey Press, 1987)

7. See, for instance, Thomas Moore, "The New Libertarians Make Waves", Fortune, 5 August 1985, pp. 74-78. Moore exaggerates a bit in calling the particular people he interviewed libertarians, but he does realistically estimate the political impotence of this strain of thought.

8. Aaron Wildavsky provides a connection between Keynesians, the Democrats and the use of industrial policy notions in Chalmers Johnson (ed.), The Industrial Policy Debate (San Francisco: IPC Press, 1984) pp. 27-47. See also, "Democrats' Ideas on the Economy Shift", New York Times, August 12, 1986.

9. See Gary Hart, A New Democracy (New York: Wm. Morrow & Co., 1983), and Sidney Blumenthal, "Drafting a Democratic Industrial Plan", New York Times Magazine, 28 August 1983.

10. Ibid.

11. See, for instance, Gar Alperovitz and Jeff Faux, Rebuilding America, (New York: Pantheon, 1984) and Martin Carnoy, et.al., A New Social Contract: The Economy and Government after Reagan, (New York: Harper and Row, 1983).

12. One of the more interesting developments not yet outlined in detail is the 'graduating' of the industrial policy issue from the state level to the federal political arena. This report is primarily concerned about the earlier process of state governments taking the issue from the national scene and adopting it

as their own. That the process, as gauged by the aftermath of the 1986 elections, is reversible is fascinating.

13. The variations on this theme are wide, ranging from calls for lower capital costs for industry (to meet Japanese capital costs) to outright economic direction by Washington through an American version of Japan's Ministry of International Trade and Industry (MITI) to imitating Japanese cultural forms of consensual decision-making. Probably the best discussion is in Chalmers Johnson, MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975 (Stanford: Stanford University Press, 1982).

14. Ibid, pp. 19-29.

15. See, for instance, Ezra Vogel, Comeback: Case by Case: Building the Resurgence of American Business (New York: Simon and Shuster, 1985) Chapters 7 and 12. David Clark, however, makes it clear that defense spending, especially on research and development, has not driven regional economic development in the United States, but has reacted to deeper structural shifts. See his Post-Industrial America, pp. 102-107.

16. Chalmers (ed.) op.cit, p. 7.

17. Ibid, p.6.

18. See, for instance, Office of the President of the United States, Economic Report of the President (Washington DC: U.S. Government Printing Office, 1984) Chapter 3.

19. Ira Magaziner and Robert Reich, Minding America's Business (New York: Vintage Books, 1983). Another influential book with a different, yet related slant, is Barry Bluestone and Bennett Harrison, The Deindustrialization of America (New York: Basic Books, 1982).

20. The President's Commisison on Industrial Competitiveness, Global Competition: The New Reality (Washington DC: U.S. Government Printing Office, 1985) vol. II, pp. 95-100. The real question seems to be whether military research and development expenditures translate well into commercial innovation. If not, then the American civilian R&D effort falls far short of Japan's or West Germany's as a proportion of GNP.

21. The supposed relationship between fiscal deficits and high interest rates is a litany among fiscal conservatives, though it ignores the Japanese public debt, which is high even by North American standards. A better, more comprehensive argument is that the mix of public programs and taxes that promote income redistribution over economic growth is at the root of American problems. See, especially, Bruce R. Scott and George C. Lodge (eds.) U.S. Competitiveness in the World Economy (Cambridge: Harvard Business School Press, 1985), chapter 2.

22. See Ibid, chapters 3-8, Magaziner and Reich, op. cit., and Paul Lawrence and Davis Dyer, Renewing American Industry (New York: The Free Press, 1983), chapters 2-8.

23. Robert Reich, The Next American Frontier (New York: Times Books, 1983).

24. "Do We Need an Industrial Policy" Harper's, February 1985 vol. 210(2), pp. 35-48, Kevin Phillips, Staying on Top: The Business Case for a National Industrial Strategy (New York: Random House, 1984) and Lester C. Thurow, "American Industrial Competition: A World Class Economy", Current, December 1985, pp. 23-29 (reprinted from Technology Review, August-September 1985).

25. See Chalmers Johnson's comments in Chalmers Johnson (ed.) The Industrial Policy Debate, op.cit., pp. 3-24.

26. "The Clamor for Competitiveness", New York Times, 14 January 1987.

27. Robert Reich, "The New Competitiveness Fad" New York Times, 14 January 1987.

28. "Reagan's Call: Productivity" New York Times, 29 January 1987, "Clamor", op.cit. and "Economic Advisers Downplay Problem of Falling Industrial Competitiveness" Wall Street Journal, January 30, 1987.

29. Ibid.

30. "Comptetitiveness, Not Industrial Policy", New York Times, 26 January 1987.

31. Reich, "Fad", op.cit.

CHAPTER III

AN INDUSTRIAL POLICY PIONEER: THE CASE OF PUERTO RICO*

Introduction

There is no clean dividing line between the recent attempts of states to practice some kind of industrial policy and earlier approaches. The only way to suggest some sort of starting point for the modern period is to look for an early jurisdiction that espoused a relatively coherent policy when most states were only fitfully trying to promote development. Some see the State of Mississippi as the originator of the modern period with its Depression-induced move towards an agency to attract Northern manufacturers into the State and the laws its Legislature passed to assist this process.[1]

Possibly a better starting point could be established with Puerto Rico during World War II, when it embarked on a set of laws and institutions that led to the famous 'Operation Bootstrap' of the 1950s and 1960s, which created a modern economy on a poor Caribbean island. Puerto Rico is not technically a State, though its voters and parties are evenly divided between pro-Statehood and pro-Commonwealth (the existing arrangement) political stands. In fact, the question of political status seems to play as great a role in Puerto Rican politics as it does in Quebec. Regardless of its status, the fact that Puerto Ricans are U.S. citizens and the economy is tied to the U.S. through common currency, tariffs, monetary policy, and most federal legislation, means that it must act as, and compete economically with, the states themselves.

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*A draft of part of this case study was written by Mitch Kowalski, a graduate student at The University of Western Ontario.

The Puerto Rican Experience

Puerto Rico is one of the largest islands in the Caribbean, being approximately 100 miles long and 30 miles wide, and located 1,000 miles southeast of Miami. In terms of natural resource endowment, the island hardly lives up to its name, Puerto Rico, which in Spanish means Rich Port. Except for uneconomical deposits of copper and nickel, all other mineral deposits are negligible. Arable land is confined to the coastal lowlands, which account for only 25% of the island's rugged land mass, where most of Puerto Rico's industry is located, and 3.2 million people live.[2]

Despite a low level of American interest in its economic problems, Puerto Rico did gain some economic advantages after it was ceded by Spain to the United States in 1898. It gained free access to the American market in 1902, and the addition of Section 262 to the Internal Revenue Code in 1921 granted American businesses in "overseas possessions," including Puerto Rico, exemption "from federal taxation on remitted profits."[3] This exemption was formulated originally to give an extra advantage to American businesses operating in the Philippines.

The island's economy, until World War II, was tied to agricultural production, especially sugar, tobacco and coffee. It was devastated by the collapse of commodity prices in the Depression, which led to considerable political unrest. In 1940, the Popular Democratic Party (PPD), which advocated an independent Puerto Rico, gained minority control of the Puerto

Rican Congress in 1940, while its leader, Luis Muñoz Marin, became President of the Puerto Rican Senate. Due to the poor state of the island economy, Muñoz Marin shifted the PPD emphasis from that of Puerto Rican status to that of economic development.

In an effort to give the island an interested and sympathetic American connection, President Roosevelt appointed Rex Tugwell, one of the intellectual founders of the New Deal, as the Governor of Puerto Rico in 1941.[4] The PPD and Tugwell agreed that government "investment was... (to be) the prime mover in development."[5] In order to institute this program, the Puerto Rican Industrial Development Company (PRIDCO), the Government Development Bank (GDB), and the Puerto Rico Planning and Zoning Board were all set up in 1942. PRIDCO, as the major actor of the program, was created

> "to own, establish, and operate new enterprises for the purpose of exploiting and distributing products manufactured from raw materials available on the island."[6] PRIDCO began by investing in industries producing for the local market, which had been disrupted by the war, two cement plants and four other plants making shoes, paperboard, glass containers for rum, clay products, and sanitary wares. PRIDCO also "operated labor training and technical research projects, handicraft projects in textiles, ceramics and furniture."[7]

Upon his election as the first elected Governor of Puerto Rico in 1948, Muñoz Marin reassessed his party's development program. Deciding that government investment could not provide the development needed, the government adopted a new development strategy. This new plan emphasized privately-owned and operated export industries as the lead development sector.[8] The PRIDCO plants were to be sold off. The Industrial Incentive Act of 1948 provided for a ten year exemption from Puerto Rican income taxes, property taxes and excise taxes "for any corporation that built a plant in a new industry, expanded in an approved existing industry or constructed a new hotel."[9]

Further, Section 931 was added to the U.S. Internal Revenue Code, which allowed a '931 subsidiary' to avoid paying U.S. corporate taxes during its tax holiday in Puerto Rico as long as earnings were not regularly repatriated to the parent company. Dividends paid by these corporations to their U.S. parents were taxable. However, if the subsidiary was liquidated at the end of its Puerto Rico tax holiday, all accumulated earnings could be transferred to the parent company, totally exempt from U.S. income tax. The liquidation would also be free of any Puerto Rican taxes.[10] Eventually this resulted in a build-up of billions of dollars of assets in the 931 subsidiaries.

When Puerto Rico was granted Commonwealth or Free Associated State (Estado Libre Asociado) status in 1952, the combination of these tax incentives and a rigorous promotion campaign became officially known as 'Operation Bootstrap.' A government agency entitled the Economic Development Administration (EDA), which had been created in 1950 in order to coordinate and promote Puerto Rico's industrialization program, was merged with PRIDCO, and the two were collectively known as FOMENTO (which means 'development' in Spanish).[11] FOMENTO began a massive promotion campaign on the U.S. mainland touting many of the tax, wage and direct subsidy advantages of locating in Puerto Rico.

Local manufacturers also received incentives from FOMENTO. If the item to be produced had not been manufactured on a commercial scale prior to 1947, these manufacturers became eligible for the same tax exemptions as foreign companies.[12] Local manufacturers could also rent buildings in industrial parks at reduced rates from PRIDCO and receive start-up grants from the GDB.

Unfortunately, the local manufacturers could not easily liquidate operations upon the expiry of the tax holiday, like foreign owned subsidiaries. The taxes on their profits could then reach as high as 45%.[13] Further, high shipping costs forced most local manufacturers to stay near major urban centres where exemption periods were shorter and discounts on rental fees in industrial parks were smaller. Finally, high and steeply progressive personal income taxes encouraged successful businessmen to leave. Since there were not as many benefits for local entrepreneurs as there were for foreign businessmen, the locally-owned part of the economy largely stagnated.

The agricultural sector of the economy declined drastically, as most government effort went into industrial development. As a percentage of Puerto Rican GDP, agriculture declined from 20.6% in 1947 to 3.5% in 1977, while manufacturing rose from 22.4% to 34.4% in the same time period.[14]

During the 1960s, government policy-makers began to focus on attracting industries which were less vulnerable to business cycles and increasing wages, while also providing economic linkages and a more integrated sector structure. This latter point was vital to building a solid industrial base, since most of the branch plants locating in Puerto

Rico did little business with each other.

In 1961, the Industrial Incentives Act was amended to increase exemption from Puerto Rican taxes for 10, 12, and 17 year periods for manufacturers locating in different parts of the island. Areas with the highest unemployment received longer exemption periods.[15]

A series of U.S. recessions had serious effects on the Puerto Rican economy. Over a hundred plants closed down, and the number of new or expanded plants fell 23% in 1970 and 21% in 1971.[16] "Inflation, declining exports, the inability to diversify trading relationships, and the downward trend in previously bouyant growth sectors" acted to hurt the Puerto Rican economy during the 1970-71 recession.[17]

The recession of 1974 brought 'Operation Bootstrap' to an effective halt. The drastic rise in world oil prices and Puerto Rico's total reliance on imported oil had severe consequences for the island economy. Many of the island's petroleum industries closed down and GNP in 1974 rose only 1.3%, as compared with 7.3% the previous year, while GNP in 1975 declined 2%.[18]

The Puerto Rican government responded to the turbulence of the early 1970s by increasing the number of public employees and creating new public corporations. The Puerto Rico Telephone Company was bought from ITT and expanded, while three major shipping lines (TTT, Sea-Land and Seatrain) were merged into the Puerto Rico Maritime Shipping Authority (PRMSA).[19] Traditional tax incentives were also overhauled. In 1975, tax holidays were revised to create exemption zones of 10, 15, 25, and 30 year duration, based on relative disparity inside Puerto Rico.[20]

A year later, in 1976, the American Congress, added to the pressure on Puerto Rico. Under Section 936 of the United States Tax Reform Law, the tax exempt status of '931 subsidiaries' was replaced with a 100% tax credit on earnings from Puerto Rican manufacturing operations.[21] Tax-free status was given for one year to all dividend repatriations to the parent company. The '931 subsidiary' assets at this point amounted to some $5 billion, much of which was invested overseas.[22] The parent companies could leave them alone or repatriate the assets to the U.S., in either case paying taxes on their subsequent earnings, or they could re-invest these subsidiary assets tax-free in Puerto Rico's economy. Puerto Rico was given, and took, the opportunity to place a 10% 'tollgate tax' on repatriated earnings, in effect inducing the parents of '931 subsidiaries' to opt to reinvest their money in Puerto Rico.

In attempting to become less dependent upon tax incentives, the pro-statehood New Progressive Party Administration introduced a new Industrial Incentives Law in 1978. The Law provided for the partial exemption for various periods of time from property and income taxes for firms meeting specified criteria. The law also gave the former '931 subsidiaries' the option of investing part of their earnings in designated local investments and thereby receiving lower 'tollgate tax' rates on their repatriated earnings.[23] Finally, special incentives were given to "certain firms in apparel, textile and leather industries and firms that provide services largely to customers outside of Puerto Rico that meet specified criteria."[24]

FOMENTO's efforts and the new tax reductions began to entice capital-intensive and skilled-labour using industries to Puerto Rico.

Pharmaceuticals emerged as the leading industry in the manufactuing sector with 27% of the net manufacturing income in 1978.[25] Between 1978 and 1983, the share of the labour force employed by manufacturers producing "electrical machinery and equipment, chemicals and allied products and professional and scientific instruments rose from 29.1% to 33%."[26] Thus it appeared that the Puerto Rican manufacturing sector was achieving some employment diversification, though still based on tax-incentive policies.

Despite the government rhetoric about self-reliance for Puerto Rico, the main incentive for new industry remained tax exemptions. In a 1980 FOMENTO survey of over 100 corporate heads, 49% claimed that the main reason for their locating in Puerto Rico was tax incentives; only 29% mentioned that it was because of the availability of productive labour.[30] A 1979 U.S. Government study on the Puerto Rican economy stated that tax incentives would continue to be the basis of Puerto Rican industrial policy:

> It appears that future Puerto Rican development will continue to depend on long-term external capital inflows to maintain a strong growth trend. This inflow rests heavily on continued facilitation by Federal tax actions and policies.[31]

Only with Puerto Rico's involvement in the 1983 Caribbean Basin Initiative (CBI) has a recent innovation been made using tax incentives and even that depends on the 936 funds invested in the island rather than the tax expenditures themselves. The CBI is a modified free-trade initiative taken to help stabilize the economies of the Caribbean Islands. In doing so the CBI implicitly sets Puerto Rico against the Caribbean nations, and so protection for some Puerto Rican industries was retained.

Puerto Rico was protected from the CBI agreement through free-trade benefits for products processed on the island, rebates on excise taxes on mainland rum imports, and the exclusion of processed tuna from duty-free treatment.[29] In return, Puerto Rico took the twin-plant notion that has been used along the U.S.-Mexican border and constructed a form of Caribbean economic assistance policy around it. Funds from the government's 936 allocations are directed through the GDB as low cost loans to companies who establish twin plants in Puerto Rico and the Caribbean. The Caribbean plants are to provide semi-finished goods from low-wage labour-intensive plants. These products will then go to the Puerto Rican facility for finishing, packaging and distribution.[30] By mid-1985, 24 companies had pledged $114 million in investments, creating an estimated 15,000 jobs in the region.[31] In effect, Puerto Rico is substituting itself as the high-wage finished-products producer for the Mainland in this scheme.

Old Rhetoric and New Strategy

By the time of the first oil shock in 1973, conditions had begun to change, blunting the effect of Puerto Rico's traditional development strategy. Wages, relative to those offered in the rest of the Caribbean or in East Asia, became high. The U.S. welfare programs of the 1960s, as they impacted on Puerto Rico, began to reduce employment. Energy costs began to rise. American tariffs and corporate tax rates began to fall. Suddenly, the tax incentives for new industry could not offset these relative disadvantages. Employment growth in labour-intensive industries began to falter and reverse itself. Outmigration slowed and the combination of labour force growth and lagging employment growth led to a strong and persistent rise in unemployment.

The response to these altered conditions was an implicit change in strategy. The rhetoric of industrial development remained, as did the general features of the tax incentive system, but, in truth, emphasis was placed elsewhere. Puerto Rico began to look to growth in government employment and consumption activities as the primary generators of prosperity. The latter was encouraged by lobbying to maintain and increase federal transfers, which put more money into the island without necessarily adding to employment.

The 1976 U.S. changes to the tax system and Puerto Rico's response in 1978, added substantial momentum to this thrust. The effect of Congress closing off 936 subsidiaries' ability to invest abroad was, when Puerto Rico's own incentives were added, to flood the island with millions of dollars of new liquidity. This action managed to pull Puerto Rico out of recession in the same way that massive deficit spending might, by providing consumers with the ability to buy more goods and services.[32] By 1984, $5.6 billion, or 40% of all deposits in Puerto Rican banks, were so-called 936 funds.[33]

The maintenance of tax inventives as Puerto Rico's prime development mechanism led to a shift in the type of business attracted. <u>Ex post facto</u>, this was described by FOMENTO as a strategy change, but the truth appears more to be that the type of industry interested in tax incentives shifted, as relative wage levels became uncompetitive. As a result FOMENTO was pressed to change its strategic orientation. Employment as the real objective was downgraded. What appears to have risen in importance is the need to maintain and expand the amount of 936 funds available to provide low-cost financing for public expenditures and the liquidity available for consumer housing and automobile loans.

FOMENTO's new emphasis on so-called high-technology industries was only a partly accurate description. What was attracted was the assembly, or bulk production ends, of the pharmaceutical and electronic industries. Some Canadian research on the automobile industry suggests that assembly is the lowest value-added part of the productive process, while Puerto Rican figures suggest that profitability in these operations was in the order of multiples above U.S. mainland operations.[34] The only reconciliation between these two assertions has to be the difference in allocating profits based on the difference in tax systems between Puerto Rico and Ontario. In Puerto Rico, this high level of profitability meant that a high and continuing level of 936 funds was injected into its banking system. The capital-intensiveness of the new production operations did not produce significant employment gains.[36]

The structure of employment did not change significantly between 1970 and 1984 except for shifts from agriculture and construction (from 10% to 5% and 11% to 6% respectively) into public administration (up from 15% to 24%).[36] Between 1980 and 1984 total employment declined slightly while the labour force grew. In 1985, the labour force grew 4%, employment 3% and the service sector share of employment increased one percentage point at the expense of manufacturing.[37]

It is hard to see where a tax expenditure of $1.3 billion in 1980, equalling 18% of Puerto Rico's GNP, could be viewed as a development mechanism, when manufacturing employment was stagnant over the decade of which this formed the middle year.[38] Arguments have been made that this apparent stagnation masks the movement away from labor-intensive, high-wage pharmaceutical and electronic jobs. This could be seen as a parallel to the shift from agriculture to manufacturing in the 1950s and 1960s.[39] But, if so, it is a high price for U.S. taxpayers to pay for this shift, possibly as much as $13 billion over the decade to 1986.

The true cost of using the tax system as an engine of development in Puerto Rico is hotly debated, not least because of the ramifications that the system has for the economy of the island. The U.S. Treasury has consistently asserted that the cost in taxes outweighs the benefits received. In 1982, the Treasury estimates tax expenditures equalled 147% of direct compensation received by employees of 936 subsidiaries.[40] The Puerto Rican government tends to see the system in wider perspective, claiming that reforms in the 936 system in 1983, comparable welfare costs on the mainland for those who would be thrown out of work by a termination of 936, and the liquidity crisis that an end to 936 would cause in Puerto Rico, far outweigh the cost to the U.S. Treasury.[41] The arguments are interesting only in passing, as it can be assumed that the U.S. Treasury, like the Canadian Department of Finance, is externally sensitive to, and critical of, any tax expenditures that are areally or regionally specific, regardless of their merit.

Today, the 936 system has become the main generator of consumer prosperity in Puerto Rico. The importance of 936 funds to the Puerto Rican economy can hardly be overstated. They constituted 40.4% of the total bank deposits in 1984, 70% of which were deposited in terms of 90 days or less and 90% for one year or less.[42] A total of $10 billion had been invested in Puerto Rico by 1983 using 936 funds.[43] A termination of the tax provision by the U.S. Government would lead to a massive outflow of funds that could only be replaced by more expensive borrowings. The instability would send the Puerto Rican economy into a serious recession. Much of the money is lent at far longer terms than the 936 depositors make, and this situation of "borrow short, lend long" would put most of the Island's local banks, savings and loan, and credit unions out of business quickly were the system terminated. Much of the money lent for government and commercial purposes by the financial institutions also has a rate of interest below that required on the mainland, in part because of the supply of funds and in part because of the favourable tax treatment 936 money receives. In 1975, commercial, industrial and agricultural borrowers were paying nearly 3.5% above prime for their loans, while in 1985 these borrowers were paying ½% below prime, largely because of the 936 fund availability.[44]

These 936 funds have been instrumental in providing relatively low-cost mortgage money, which has maintained the housing industry, and has assured governmental agencies and municipalities of a steady supply of low cost funds for the economic infrastructure. The Puerto Rican government requires that 10% of these 936 funds be redeposited in the GDB and that 20% of all funds be invested in government securities.[45] Much of the money is tied up in bonds for facilities of which foreign plants are the prime users and whose service charges constitute the major source of repayment of the loans. During the period 1983-85, the U.S. Treasury and the Reagan Administration unsuccessfully attempted to cut back or eliminate the 936 provisions, with predictably strong Puerto Rican resistance. What began as an industrial development tool has turned into the financial lifeblood of the whole island economy. It is almost irrelevant at this point whether another plant is ever built under the tax provisions: the unrepatriated profits of existing plants maintain the economy as a whole.

Conclusion

There are a number of reasons why the Puerto Rican experiment with an active industrial policy is not representative of the states as a whole. Because of its unique status, it had more fiscal latitude than did states themselves. It had more extreme poverty than did any of the states and with the exception of Hawaii, and possibly Alaska, it was more isolated geographically. Its Spanish cultural heritage left it more open to public intervention in the economy than was the case on the Mainland. The combination of all these factors produced a unique set of conditions that made an active industrial policy possible during and after World War II.

Yet, in other ways, Puerto Rico behaved similarly to the Mainland states. The experiments with public corporations in poor areas that led to institutions like the Tennessee Valley Authority had parallels in PRIDCO. The Government Development Bank had a Depression-era precursor of sorts in the U.S. Reconstruction Finance Corporation. Once World War II was over, the momentum swung away from public corporations in Puerto Rico as in the Mainland states.

The use of tax exemptions as a means of attracting industrial investment, and coupling this financial device to low-wage labour was popular and successful in Puerto Rico and a number of southern states at about the same time. The development of the interstate highway system permitted cheap transportation to boost southern state development while the economies of sea transportation assisted Puerto Rico.

The intensity with which the Puerto Rican government pursued new industry in the 1950's and 1960's differed from that of the state governments. The heyday of 'Operation Bootstrap' in the 1950's and 1960's has a certain parallel to the dynamism with which states today are pursuing economic development.

The major lesson to be learned from the Puerto Rican experience seems to be that an activist approach to industrial policy can work, especially if it meets the needs of industry at the time. However, to single-mindedly pursue policies after conditions have changed is to produce a stagnant situation. Puerto Rico failed, after 1973, to develop a new policy approach that would allow it to continue to develop economically. Instead, it continued to rely on tax expenditures as an engine of development and, even worse, tied the tax expenditure system into the consumer economy in such a way as to require it as a permanent feature of the Puerto Rico fiscal situation.

As the next chapter points out, industrial strategies in the states, after 1980, came to focus largely on the development of locally-based tradeable firms. Puerto Rico has opted to remain tied to the attraction of outside plants for its development even after more than a decade of flat employment levels from these plants. It could be argued, on the basis of the data provided in Chapter I, that to have maintained flat employment levels in the manufacturing sector through the 1970's and 1980's was an indictator of success. There is no denying that overall American employment in this sector is declining. Yet, the experience of many states has shown that diversification has to be pursued as well and, as of 1986, there was little indication that Puerto Rico was prepared to follow the lead of the newly-active state governments on the Mainland.

Finally, regardless of how its industrial policy might be evaluated, there is little evidence to suggest that Puerto Rico might elect to abandon active public attempts to generate economic development. The Puerto Rican experience strongly suggests that, if the present attempts of Mainland states to generate economic development through public means are at all successful, it is unlikely that they will abandon industrial policy-making in the foreseeable future. The state governments may have been dormant in the area of industrial policy making since the Civil War, but now awakened, may not be easily put back to sleep.

Footnotes for Chapter III

1. Robert Vaughan, Robert Pollard, Barbara Dyer, The Wealth of States: Policies for a Dynamic Economy (Washington D.C.: Council of State Planning Agencies, 1985) p. 1. See also some comments on Mississippi in the next chapter.

2. United States Department of Commerce, Economic Study of Puerto Rico, Volume I (Report to the President prepared by the Interagency Task Force coordinated by the United States Department of Commerce, December 1979), p. 54; and Maria Helena Price, Puerto Rico: Critical Choices for the 1980s (New York: Business International Corporation, 1980) p. 2.

3. Raymond Carr, Puerto Rico: A Colonial Experiment (New York: New York University Press, 1984) p. 204.

4. Diana Christopoulos, "The Politics of Colonialism: Puerto Rico from 1898 to 1972", pp. 129-70 in The Puerto Ricans: Their History, Culture and Society, ed. Adalberto Lopez (Cambridge: Schenkman Publishing Company Inc., 1980) p. 150.

5. U.S. Department of Commerce, Economic Study Vol. II, op. cit., p. 18.

6. Thomas Hibben and Rafael Pico, The Industrial Development of Puerto Rico and the Virgin Islands of the U.S., Report of the U.S. Section Caribbean Commission, 1948, p. 30, quoted in U.S. Department of Commerce, Economic Study of Puerto Rico Vol. II, p. 127.

7. U.S. Department of Commerce, Economic Study Vol. II, op. cit., p. 18.

8. Ibid.

9. Price, Puerto Rico: Critical Choices, op. cit. p. 155.

10. U.S. Department of Commerce, Economic Study Vol. II, op. cit., p. 15.

11. Ibid., p. 1.

12. Gary D. Martin, "Taxes and Small Business Development in Puerto Rico", (unpublished discussion draft) 1982? p. 4.

13. Ibid.

14. Jorge Heine, ed., Time for Decision: The United States and Puerto Rico (Lanham Md.: North-South publishing Co., 1983), p. xix.

15. U.S. Department of Commerce, Economic Study Vol. II, op. cit., p. 5.

16. Morris Morley, "Dependence and Development in Puerto Rico" in The Puerto Ricans: Their History, Culture and Society, ed., Adalberto

Lopez (Cambridge: Schenkman Publishing Company Inc., 1980) p. 194.

17. Price, Puerto Rico: Critical Choices, op. cit., p. 19.

18. Ibid.

19. Ibid., p. 31.

20. U.S. Department of Commerce, Economic Study Vol. I, op. cit., p. 116.

21. Ibid. p. 21.

22. Government Development Bank for Puerto Rico, Impact of 936 Funds in the Financial Markets in Puerto Rico (San Juan: Government Development Bank, July 1985), p. 7.

23. Ibid., pp. 7-8.

24. "Puerto Rico", Puerto Rico Business Review Special Supplement, May 1984, p. 11.

25. Price, Puerto Rico: Critical Choices, op. cit., p. 35.

26. "Puerto Rico", Puerto Rico Business Review, op. cit., p. 6.

27. Martin, "Taxes and Small Business", op. cit., p. 2.

28. U.S. Department of Commerce, Economic Study Vol. II, op. cit., p. 6.

29. Ibid., p. 9.

30. Impact of 936 Funds, op. cit., p. 41.

31. Rafael Hernandez-Colon, "Puerto Rico: U.S. Link with the Caribbean," Business America, 8(24), 25 November 1985, p. 1. Other articles in this issue also deal with twin-plants in Puerto Rico and the Caribbean. See also articles in Puerto Rico Business Review II (1) January 1986, on the CBI initiative.

32. Impact of 936 Funds., op. cit., pp. 10, 43.

33. Ibid., Appendix I, Table 1.

34. See, for instance, data on pharmaceuticals, electronics and non-electronic machinery in Economic Study Vl. II, op. cit., pp. 144, 153, 170. Leonard Wanerman, of the University of Toronto presented some draft materials on the Auto Pact that illustrated the automobile assembly case in Canada at the Fourth Annual Workshop on U.S.-Canadian Relations, 5 April 1986, University of Western Ontario.

35. Between 1979 and 1984, pharmaceutical shipments increased in value by

69% while employment increased by 22%. Overall manufacturing employment did not grow at all during these years. See figures in "Profile of Performance: The Drug and Pharmaceutical Industry in Puerto Rico", January 1985. Puerto Rico Economic Development Administration, p. 2, John Stewart Jr., and Theodore Lane, "An Analysis of the President's Tax Proposal to Repeal the Possessions Tax Credit in Section 936 of the U.S. Internal Revenue Code" (San Juan: Puerto Rico Economic Development Administration, Sept. 30, 1985) p. 43 and Economic Indicators, December 1985, Government Development Bank for Puerto Rico, p. 10.

36. Economic Indicators, ibid, p. 9.

37. Ibid., pp. 3, 9.

38. Peter R. Merrill, "The Possessions Tax Credit and Puerto Rican Economic Development" in Puerto Rico: The Search for a National Policy, Richard Bloomfield (ed.) (Boulder Col.: Westview Press, 1985), p. 59.

39. See, for instance, Stewart and Lane, "An Analysis", op. cit., pp. 27-38.

40. Ibid., p. 48. Both Stewart and Lane (p. 86) and Merrill (p. 69) note that some tax expenditures have reached $100,000 per job. Pharmaceutical jobs on average have a tax expenditure of about $60,000.

41. Ibid., pp. 48-70.

42. Impact of 936 Funds, op. cit., Appendix I, Table 3.

43. Stewart and Lane, "An Analysis.", op. cit., p. 10, note 2.

44. Impact of 936 Funds., op. cit., p. 23.

45. Ibid., pp. 33-36.

CHAPTER IV

STATE INDUSTRIAL POLICIES AND STRATEGIES

Introduction

In a federation where national considerations have taken precedence over those of the states for at least a century, there is no lack of controversy over the propriety or relevance of activist state industrial policies, even though they were a feature of the early Republic. The evidence is clear that in both the American and Canadian federations, the federal governments have been unable to generate consensus over the manner and method of pursuing industrial policies, while, at the state and provincial levels, there has been no real disagreement, even where party lines and administrations differ significantly. Each state has, since 1980, begun to pursue its own version of an industrial policy, based on some common denominators, as well as a candid look at the environment that the state has to face.[1] Those few that elected to rely on a passive 'business climate' approach, stressing low taxes and deregulation alone, have done so by realizing a geographical advantage from being close to a highly industrialized high-tax state. Ideology seems not to be a factor in the policy equation.

The idea of state involvement in economic development is not new. For example, a manufacturing company promoted by Alexander Hamilton was given a tax break by New Jersey in 1791.[2] States were instrumental in the development of railways and canals before the Civil War. That war itself taught the southern states that prosperity as well as power lay in manufacturing, and states like Georgia began campaigns to attract northern industry. An early alliance between university research and business needs, in this case in agriculture, resulted from the Morrill Act, which led to the creation of a system of state land-grant colleges.[3] With the New Deal in the 1930's, nearly every state created a planning office to take advantage of federal employment and infrastructure programs. Some even created industrial recruitment agencies, one of the more notable being the Balance Agriculture With Industry (BAWI) program created by Mississippi in 1936. BAWI included the invention of the tax-free industrial revenue bond, which became the mainstay of state development finance programs 40 years later, a program to build facilities for new industries and the establishment of tax abatements as an industrial attraction tool.[4]

During World War II, planning offices and economic development programs were seen as unnecessary and were largely abandoned. Only in Puerto Rico, as the previous chapter has outlined, where shortages occurred because of shipping dangers and other supply problems, was an active development policy pursued. The 1950's and 1960's saw some revitalization of state-level development efforts, but, as in the 1930's, they were pursued only with federal encouragement. These state development efforts were focussed primarily on regions like Appalachia where poverty was extreme by American standards. Southern states also began to develop industrial recruitment programs once again. North Carolina gained a reputation for aggressive recruitment, offering low wages and taxes along with anti-union right-to-work legislation.

The oil shock of 1973 symbolized the changes that were taking place in the world and the American economies. Economic revitalization became important as high-wage and energy-consumption industries came under pressure. Manufacturing activity began to shift location dramatically, leading states like New York and Connecticut to begin experimenting with new programs to encourage local firms to resist the tax and wage blandishments of the Sunbelt states and Puerto Rico.

The observations that were critical to the generation of state industrial policies in the 1980's are found in David Birch's The Job Generation Process, published in 1979.[5] Birch claimed that the large corporations that were the objects of the 'smokestack-chasing' development agencies of the previous decades had not created any net new jobs in the 1970's. Instead, new employment was coming from small businesses.

The White House Conference on Small Business in 1980 publicized these findings. Suddenly, a new avenue of opportunity opened up to those states where job losses were assuming serious proportions. As well, the Reagan Administration was making it clear that economic adjustments which had no net national implications were the problem of the affected states and that job losses related to international competition would be restored as the private sector retooled in the wake of federal tax cuts. The states were largely on their own. The overall result was a shift in emphasis in state development efforts from programs in industrial recruitment to a wider policy perspective.[6] In turn, this led to the publication of explicit state development strategies in 27 States by 1987,[7] and a wave of public innovation aimed at the generation of jobs through new firm creation and expansion, technology and product development, export promotion, procurement and a range of other methods. Surprisingly, many states appeared to welcome the challenge, as Massachusetts Gov. Dukakis indicated:

> We're showing that you can do what you want--and do it better--at the State level. Instead of a mayor or a businessman in a dying city going to Washington to lobby for a $500,000 loan, let him come to the state.[8]

The Policy Arguments

Arguments for state industrial policies are neither very deep nor well-thought out. One idealistic view, with some historical support, is that the states are the "laboratories of democracy," experimenting with governmental approaches to social problems and providing the federal government with research results to be applied in federal policy-making.[9] Given the differences in the economic tools available to national governments, this is an underwhelming contention. A second argument is partisan: that the majority of governors elected in 1982, just as the country was coming out of a recession, were Democratic and amenable to the industrial policy ideas floating around Democratic circles at the time. This hardly explains why almost all of the states are engaged actively in policy innovation in this area. One could accept a scenario in which one or two governors elected, began to try out some new ideas, but the notion that nearly all states might focus on Magaziner's or Reich's or Thurow's ideas and try to translate them into policy boggles the imagination. Perhaps the most telling argument is political: the recession of 1981-1982 hit home and hit hard. Those who were elected in 1982 and those facing reelection in 1984 knew that economic development was not just one of many issues, but the issue facing them. They had to act on it. Governor Bruce Babbitt of Arizona has expressed some relevant ideas on the subject:

> State and local governments across the United States have discovered scientific research and technological innovation as the prime forces for economic growth and job creation. And local officials have also uncovered a broad base of public interest that can be translated into support for aggressive action programs....
>
> Recent changes in the American economy have enhanced the role of state and local governments in formulating industrial policy. In past decades, technology had a centralizing impact..The microelectronics revolution is now exerting an opposite, decentralizing force....[10]

Public support and perceived economic opportunity significantly explain why the states would en masse adopt active industrial policies.

The arguments against state industrial policies are worth noting, whether or not they are politically relevant today. The ideologue would argue that the free market ought to decide where and to what extent investments ought to be made and new businesses formed. The states should restrict themselves to providing good climates for business and to the provision of public services as education and infrastructure. People are voters, however, and they are unlikely to accept the loss of their jobs to technological change or large corporate decision-making simply because it is good for the nation as a whole. A second argument is that the powers accorded to the states are not strong enough to withstand national, let alone international, economic trends. Again, the voters appear to reject this argument, preferring that even a small attempt to protect them be made. A third argument, that industrial policy is best left to the federal government, is similarly impractical, given the inconclusive debate on the subject at that level so far. The allied notion that state industrial polices are 'balkanizing' the country has made little impression either.[11]

One of the more interesting arguments has been that local economic conditions have tended historically to play a minor role, if any at all, in the election of State officials. The analysis of this subject, up to 1980, seems to bear this out. Kenney looked at 14 gubernatorial races between 1946 and 1980 and found no correlation between results and economic conditions.[12] Hibbing and Alford found some correspondence between congressional shifts in off-year elections and short-term economic conditions, but the evidence appears weak to other analysts.[13] The fact that nearly all governors after 1982 have consistently stressed the importance of economic development in their 'State of the State' messages, implies that the governors perceive a change in public attitude, either in support of state industrial policies or against politicians who do not promote such ideas, regardless of the findings of the analysts.

Industrial Strategies

One of the most consistent features of the new state approach to development is the composition and publication of a comprehensive state development strategy. More than half of the states have produced such documents in the past four years. Some, like California and Pennsylvania, produced them under Republican governors. Some were done in-house, while others were the result of private-sector Task Forces created by the Governor. Some included detailed 'laundry-lists' of programs and laid out their expected financial implications. Some are lengthy statements of good intentions. One went to the people in a referendum. No matter how they were created, all parts of the country produced strategies, though the Great Lakes, Mountain, and Pacific States predominated.

For purposes of illustration, four strategy documents are described below. They include one from New England (Rhode Island), one from the Great Lakes (Michigan), one from the Mountain States (Nevada) and one from the Pacific Region (Hawaii). Three of the four are smaller states, having about a million people, but they all face different and interesting problems. There seemed little value in a study as limited as this to look at a number of 'Rust Belt' states with similar problems. One indicator of the economic volatility of these chosen states is shown by a ranking by five year intervals of each state's 'employment health,' a ranking derived from a combination of the state's rank in employment growth and unemployment reduction.

TABLE 4-1 STATE EMPLOYMENT HEALTH RANKINGS

	1971-75	1976-80	1981-84
NEVADA	19	7	17
HAWAII	36	15	24
RHODE ISLAND	45	35	14
MICHIGAN	46	50	41

Source: Adapted from Detroit Free Press, July 20, 1986, p. 48

While this is only a single indicator of state differences, it does serve to indicate the respective state challenges along lines of real interest to voters and politicians alike. Rhode Island entered the 1980's on an upswing, though it was not noticed locally until the middle 1980's. Nevada and Hawaii perceived threats to their positions, something that the index confirmed. Michigan's position was so bad that there was nowhere to go but up.

1. Rhode Island

The Rhode Island experiment was an active development strategy centred around the formulation and ultimate defeat at the polls of the Greenhouse Compact. This ambitious 1000-page development strategy was unveiled by the Rhode Island Strategic Development Commission in October, 1983.[14] It had been created by Governor J. Joseph Garrihy a year before. The Commission and its report appear to have been the brainchild of Ira Magaziner, a strategic planning consultant based in Providence and co-author with Robert Reich of Minding America's Business, one of the key books advocating a national industrial strategy.[15]

The Commission was made up of 19 people representing business, labour, government and educational organizations. It was supplemented by an advisory body of 50 others. The Commission was supported by a research staff led by Magaziner, which produced, in his words, "the most thorough study of a state's economy that has ever been done."[16] The researchers analyzed 23,000 corporate tax returns in terms of jobs and studied every company with more than 50 employees that had gone out of business or left the state in the previous decade. They interviewed officers of 90% of all the companies in the state that exported goods and traced the development of 3500 small businesses that had formed in the years 1975-76. They interviewed all the managers of all the research activities in the state. Over 100 people then reviewed these findings before they were incorporated in the report.

The report was made public in October 1983 and, between that date and March 1984, it was endorsed by a wide variety of citizens' groups, business and labour organizations and other bodies. In April, 1984, the Greenhouse Compact was endorsed by the State Legislature, 81-7, and by the State Senate, 36-13.[17] Though there was no need to submit the package to a referendum or to ask for new taxes to support the measures recommended, a decision was taken to place the Compact on a special ballot held June 12, 1984. Approval of new taxes was seen as a commitment by Rhode Islanders to invest in their future. In spite of the wide endorsement of the Compact and the convening of 800 meetings around the State to explain the proposal, it was rejected by the electorate by a 4-1 margin.[18]

This rejection was attributed to a number of factors.[19] First was the feeling that the proposal had not been properly explained to the public, giving rise to a variety of fears about it. Second, it was felt that the wide endorsement of the Compact suggested that organized business and labour were both to receive benefits at the expense of the public as a whole. In effect, wide endorsement was seen as a detriment to the Compact's credibility rather than as an enhancement. This was a blow to the industrial policy theoreticians who claimed that a tripartite consensus on the Japanese model was necessary for the achievement of a national industrial policy. Consensus in America seems likely to be viewed as a conspiracy to fleece the citizenry. Thirdly, rejection was attributed to the political climate of the day, where a rash of indictments of public officials led many to fear that a new development body would only serve as a new vehicle for corruption. Finally, those who opposed an activist strategy saw the rejection as an indication of the good sense of the voters.

The basic strategy outlined in the Greenhouse Compact focussed on the need to encourage domestic industrial growth. With the exception of some initiatives to enhance the business climate of the state and in, particular, the perception of this climate, little is said about the attraction of new industries from outside.[20] This is a distinctly different tack from that of Puerto Rico, for instance, which is almost wholly committed to industrial attraction rather than to local firm development. There is good reason for this approach since the report noted early on that Rhode Island had enjoyed a strong economy many times over the centuries and that it has the basic skills to do so once again. In 1940, for instance, the state enjoyed a per capita income 25% above the national average, while in 1982 it was 7% below the average.[21] The justification for an activist strategy lay in the desire of the Commission to reverse this declining trend and to do it in a relatively short time-frame (by 1990).[22]

The report assumed that the key to increased prosperity is the tradeable firm, that is, a firm whose goods or services can be sold outside the local market as well as inside it. Non-tradeable firms are dependent on the growth and prosperity of the tradeable ones, so that even though the majority of jobs are created in the non-tradeable firm category, these are derivative of the income generated by those in the tradeable category. The report then analyzes the problems facing the tradeable firms and economic sectors today.

Three sets of solutions are offered. Of the $248.6 million estimated for the programs in the Greenhouse Compact, $138 million was allocated to programs to enhance the state's existing industrial base. These included partly forgiveable loans for expansion, a stablilization fund to help companies in trouble, and specific programs to improve the performance of a half-dozen industries requiring special, targetted assistance.

The most innovative aspects of the Greenhouse Compact lay in the area of programs to enhance the development of new industries. Almost one-half of the $102.5 million allocated to these programs was targetted at focused research 'greenhouses.' These would consist of research institutions concerned with applying research conducted in Rhode Island to commercial needs. The greenhouses would form a link between researchers and local firms, and their new products and enterprises would be supported by local venture capital firms. Four areas of endeavour were identified initially; clinical trials of drugs and procedures in medicine, geriatric enterprises, robotics and flexible automation, and thin film materials. A program of tax credits and incentives would be set up to promote new tradeable enterprises in addition to the activity around the 'greenhouses,' and a small amount of funds would be used to create a Rhode Island Academy of Science and Engineering and to provide for special technical training needs.

Finally, attention would be paid to improving the state's perceived business climate through reforms in government regulation, workers' compensation provisions, unemployment benefits, taxation levels and electricity costs.

These public reforms and expenditures were expected to lead to an additional private investment of $500 million before 1990 and to restore Rhode Island to its position of preeminence in the American economy. The whole effort would be overseen by the Strategic Development Commission, once it had been given a mandate by the government.

The combination of tactical errors that led to the rejection of the Greenhouse Compact did not result in its total abandonment. A new administration, elected in 1984, began to adopt parts of the Compact package as part of its political agenda.[23] Voters rejected the Compact as an individual policy item, but the challenges facing the state after the recession of 1981-2 meant that some of its ideas had to be carried forward, but in a different fashion. Rhode Island was faced with a serious situation in which its industrial base was largely eroding due to international pressures, wage rates and productivity were declining, and there was a need to find and support new industries. A change in administrations did not mean a change in these conditions but rather a change in the style adopted to meet them.

2. Nevada

On March 18, 1985, the State of Nevada Commission on Economic Development released its "Nevada State Plan for Economic Diversification and Development."[24] The process that led from the decision by the State Legislature in 1983 to ask for a plan to its publication has some similarities to the Rhode Island experience, though Nevada did dispense with one vital ingredient: there was no desire on anyone's part to hold a referendum on the plan. The Commission was composed of six private sector individuals and supported by staff from the state government and the University of Nevada. The University created a System Task Force to review data related to the socioeconomic status of the state and to prepare an initial study of practical diversification options. More than 1000 options were reviewed and reduced by 90%.[25] After the Commission reviewed the recommendations of the task force, a draft plan was prepared, which was then reviewed by an outside consultant. Comments were also invited from state departments and agencies, and in October, 1984, ten public forums were held to communicate the plan's conclusions and solicit public reaction. By mid-1986, approximately half of the 111 recommendations were underway or had been executed. Four others had been rejected by the Legislature and the rest awaited action.[26]

As in Rhode Island, the proximate cause of Nevada's experiment with a development strategy was the recession of 1981-2, which for the first time since the Depression saw the state in economic difficulties. Always before, recessions had not significantly cut into the economic activity surrounding Nevada's gaming and recreation industry. This time, however, the recession was more severe, and the response of other states in liberalizing lotteries, racetack betting and, in the case of Atlantic city, permitting casinos did have an adverse effect. Where Rhode Island faced a problem of replacing declining industries, Nevada saw itself in the position of needing to supplement its large and mature industry with new activities, if its rapid growth were to continue.

The state itself is made up of two distinct and not really related parts. The urban areas lie along the California border and may be seen as outliers of that state's economy. Las Vegas is tied to activity based in the greater Los Angeles area, while Reno and the Carson City/Lake Tahoe area is likewise tied to the San Franciso area. As in California, 90% of the state's population lives in these two areas. The other part of Nevada consists of nearly all of its 109,000 square miles, most of which is unpopulated or made up of large ranches, a few mining towns, and regional shopping and administrative centers. Where the urban areas feel the need for diversification because of the maturing of their gaming and tourism industries, rural Nevada shares the concerns of its resources-based neighbors to the east, north and south about the future of mining in an era of low commodity prices. Rural diversification is complicated by the problems of distance between centers and the lack of water supplies that might be used to support alternative economic activity.

Urban diversification is complicated first of all by an attitude that large-scale industrial spillover from the California economy would bring environmental and social problems with it, a feeling shared by other outliers of California, such as Oregon and Arizona. Only the shock of the recession and the continuing depression in commodity prices have worked to change this attitude, but it is not gone and a few years of renewed prosperity will see it arise again. A second urban problem is the real constraint of watersupply and the treatment of waste in an area where there is no eventual outlet to the sea. One of the most striking sights in Nevada is to view the dry plains and mountains of the western part of the State from the heights surrounding Lake Tahoe, knowing that immense volumes of water are falling on the mountains behind the viewer. Only a little of that water flows eastward to evaporate in the lakebeds of the Great Basin. Water usage is commplicated by the same fact that the effluent just sits there in Nevada. It must be treated well or the citizens of the state will find themselves mired in their own sewage.

According to the Commission, the plan consists of three parts; the University study, the initiatives to be taken, and the budgetary implications of these initiatives.[27] The first of these, "A Study of Economic Diversification in Nevada," is a 170-page survey of the problems Nevada faces in eleven sectors, including such areas as education, labor force, small business financing, tax policy and international trade.[28] The study pointed out that Nevada's labour force has increasingly found employment in general services (primarily hotels, gaming and recreation), FIRE (finance, insurance and real estate), and to a small extent in manufacturing. The manufacturing statistics are interesting in that they show Nevada to be growing in this area as a proportion of total employment from 1970 to 1983, while the national proportion was declining. The Nevada percentages moved from 3.7% to 4.4%, both of which are minuscule when compared to the national averages of 25.1% and 20.8% for these dates. Nevada's regional neighbours other than Californa ranged from 13% to 19% of employment engaged in manufacturing.

Tax receipts underline Nevada's dependence on gaming and related activities. The state has one of the lowest tax incidences in the country, largely because gaming and casino taxes provide over 47% of the state's tax revenue. The study noted that if the state were to succeed in moving away from this dependence through diversification, a more broad-based tax system would have to be developed. As well, more expenditures would have to be made on labour force training, including a university system that could act to attract high-tech industries.

The study also pointed out that Nevada lacked a good financial base for fostering local new industries. Venture capital was noticeably absent and the local banks were unaggressive commercial and industrial lenders. Little use was made of federal Small Business Administration lending facilities and industrial development bonds. Enterprise zones and foreign trade zones were nonexistent or underutilized.

The study made some 164 recommendations, many of which were repetitive. The focus was primarily on the problems of labour force quality and, by implication, the deficiencies in the State's education system, which was seen as being geared to the needs of the gaming industries and reflective of a kind of rural cowboy mentality. Diversification meant technology and high-skill, high wage jobs, which in turn required a good education system. A secondary focus of the study was the needs of local small business, since it was seen that attraction of outside industry could not be the sole basis for diversification.

The second part of the plan consisted of the initiatives recommended in the 56-page plan document itself.[29] In broad outline, and in many details, these are an outgrowth of the university study. The initiatives constitute the middle six chapters of the plan document. The first three of these chapters contain the bulk of the recommended initiatives. They are grouped into statewide, education, and cooperative state/rural initiatives.

Statewide diversification initiatives focussed on the need to attract and develop high-wage industries. The Commission appears to have recognized, more than the university researchers, that the development of new firms that pay high wages, whether manufacturing or not, should be of prime concern. This may have come as a result of two successes that occurred between the time of the study and the release of the plan. These were the attraction of Porsche's North American headquarters to Reno in part through the use of industrial development bonds and the attraction of Citicorp's credit card processing facility to Las Vegas through a change in Nevada's banking legislation.[30] The possibility of attracting tradeable services suddenly came to the fore.

The education initiatives that were proposed followed the recommendations made by the study to a great degree. Salary raises for

K-12 teachers were advocated, and reductions in teacher/student ratios in university disciplines related to the diversification effort were recommended among other initiatives.

Chapter Five outlined a number of initiatives to be taken in the area of rural development. Not surprisingly, these focussed on opportunities in agriculture and mining, with attention being paid as well to the job training needs of rural occupations.

The last three chapters focussed on the need to change the image that outside business interests have of Nevada, which largely derive from the gaming industry, the creation of a number of functional task forces to continue to monitor and update the plan, and a recommendation that a symposium on diversification be held to increase the awareness of both the public and the legislators of the need to pursue economic diversification.

The third part of the plan consisted of financial estimates of the initiatives recommended. The Commission approached this task gingerly and with a bit of legerdemain. At the beginning of the plan document, the Commission tried to suggest that the plan was largely cost free. Reference was made to the conservative, free-enterprize climate in Nevada. Then, it was estimated that 35 of the 111 proposals would cost a one-time $645,900,while 47 more would have an annual cost of $1,286,600. All of these were in non-education areas and, while the education initiative costs are spelled out in Chapter Nine, their costs are not highlighted. There is good reason as the five-year fiscal implications of the educational changes can be roughly estimated at $455 million. As well, $1,267,000 of annual tax expenditures were not explicitly pointed out. In effect, the diversification plan is almost entirely a massive upgrading of the whole Nevada education system. Given that other states, such as South Carolina, Georgia and Arkansas, are also working on education reform of related magnitudes, this should not be seen as a bad thing, though it is curious that so much time should be spent on the analysis of other economic topics when 97% of the recommended plan expenditures over five years were in education.

Interestingly, as of mid-1986, the only initiatives definitely turned down by the Legislature had to do with small programs that would have encouraged the gaming industry to get involved in venture capital programs or would have used gaming tax revenues for venture capital or industrial park purposes. The education reforms were at least partially underway.[31]

3. Hawaii

Hawaii has certain similarities to Rhode Island and Nevada. Like them, it has a population of about a million, most of which is concentrated in one large city. Like Nevada, it gains much of its economic activity from tourism and, like Rhode Island, it is a small state with few natural resources. Unlike both, it is made up in its entirety of islands and is located well away from the Mainland. In this respect, Hawaii has some similarities to Puerto Rico.

Once Hawaii had been discovered by Captain Cook in 1778, it became a provisioning and trading center for Pacific ships. During the American Civil War, disruptions in the Southern sugar trade led to high prices and the Hawaiian sugar industry was born.[32] Agriculture was the mainstay of the economy until well after World War II, when defense expenditures and tourism overtook it. A slowdown in the growth of these sectors in the 1980's led the State government to explore possibilities for the rise of new sectors.

TABLE 4-2: SECTORAL CONTRIBUTIONS TO HAWAII'S ECONOMY

	% OF GSP		
	1963	1973	1983
SUGAR	9	4	5
PINEAPPLES	6	4	1
DEFENSE	21	18	14
TOURISM	9	18	24

Source: Compiled from: Governor's Committee on Hawaii's Economic Future, Hawaii's Economic Future (Honolulu: Department of Planning and Economic Development, State of Hawaii, January, 1985) p. 80.

As table 4-2 shows, Hawaii is caught between an increasing dependency on tourism and the threat that it too may slow down as a generator of economic well-being. In the 1980's, this possibility seems real and, like Nevada, Hawaii seems to be looking toward diversification.

The shift from agricultural dominance in the postwar period brought with it a political shift. The corporate power of the so-called

'Big Five' agricultural companies in State politics was broken in the late 1950's and early 1960's, and Hawaii since then has been governed by a Democratic coalition whose chief economic concerns were the regulation of business use of land and the protection of the labour force.[33] Hawaii gained the reputation of being a difficult place in which to do business and where government and its regulations were more obtrusive than anywhere else in the United States. There was a certain logic in this approach, as the state went through a massive tourist-driven economic boom, and there was little pressure to do anything for the economy except protect Hawaiians from the excesses of this boom. However, since 1980, growth has slowed, with job creation sliding to about 2000 per year from the average in the 1970's of 10,000 per year.[34]

The first term of Gov. Ariyoshi (1974-8) was characterized by the work of a State Policy Council, which led to the adoption of the State Plan in 1978.[35] It set out a framework for development with emphasis on land-use and public hearings. Twelve functional plans were devised as parts of the overall Plan. The third term of Gov. Ariyoshi was characterized by an about-face with respect to economic development. The Governor created a number of private-sector committees to examine the troubled areas of sugar production, taxation, workers' compensation and the problems of doing business in Hawaii.[36] The reports of these committees acted as a base for the deliberations of still another committee, the Governor's Committee on Hawaii's Economic Future, which was created in

January 1984 and presented its report in January 1985.[37] Thirty-four people served on the committee and they were assisted by ex-officio members and government staff. The 100-page report consisted of two parts; a summary of the committee's recommendations and a set of four subcommittee reports that cover thirteen sectors of the economy.

The main theme of the report reflected Hawaiians' determination to maintain their living environment while providing for new economic growth:

> Like heirs of a vast private estate, we have come to enjoy the fruits of our prosperity. But, as heirs, we have become fearful of losing our wealth and have consequently focused our greatest efforts on the regulation of that wealth, our economy. We have become fearful of the change that originally stirred the creators of our legacy.[38]

The report returned often to the concerns that Hawaiians have about maintaining their environment and tried to suggest that the recommendations for change will go far towards improving overall lifestyles while meeting changing realities. The report included 99 specific recommendations that are consolidated into 11 general recommendations. No price tags are associated with them, unlike both Nevada's and Rhode Island's reports. Instead, the document reads more as an advocacy for change and as a list of ways that change can be beneficial.

The general recommendations are not really surprising. They included: an exhortation to develop a global viewpoint; an emphasis that Hawaii's future depends on knowledge, communications and understanding; a realization that education is the key to future development; a recognition that government must set the climate for private sector growth; an emphasis on trade, marketing and promotion and small business as cornerstones of the new economy; a recognition that the 'visitor industry' must continue to be encouraged, given its central place in today's economy; a concern that land-use and water-use conflicts must be resolved; an appeal to the federal government to assist in the growth of new industries, and a fear that if a consensus in the society is not reached on balancing economic and environmental goals, that future prosperity will be jeoparidzed. This list is probably more important for what it says about existing Hawaiian values than for its economic recommendations. In this sense, the report is more of a navel-gazing exercise than a strategy or plan along the lines followed by Rhode Island or Nevada.

The Agriculture subcommittee reported that price and environmental problems were threatening an already diminished sector. Sugar makes up half of Hawaii's agricultural production and its price supports were up for renewal in 1986. The subcommittee noted that the winding up of these supports by Washington would lead to a collapse in the rural economies of most of the counties of the state, driving more people into Honolulu. The pineapple crop was threatened by the outlawing of certain pesticides, making it virtually impossible to maintain non-irrigated plantations any longer. Mixed agriculture, largely dependent on the tourist trade, appeared to be the only one sector with any promise.

These were hard words for a society that traced much of its politics, history and attitudes to plantation-style agriculture.

The Energy subcommittee enthusiastically reported progress on alternative energy supplies, but noted that the most promising sources, geothermal and oceanic, had their greatest potential on the island of Hawaii, while the greatest demand was on Oahu.

The Manufacturing subcommittee reported that Hawaii had experienced declines in the importance of this sector of the economy even while it had grown on the Mainland. The subsequent declines there in the 1970's were paralleled in the State as well to the point where manufacturing represented only 3.5% of the economy in 1983, half of which was represented by food processing. The subcommittee felt that emphasis had to be placed on the development of technologically-based industries, if any turnaround was to be made. The fact that most high-tech manufacturing was tied to the military presence on Hawaii underlined the importance of federal assistance in economic development. Recommendations were also made to promote assistance to small businesses, increase the almost-non-existent supply of venture capital, and improve university-business relations.

Two themes emerged from the Services subcommittee report. First, the subcommittee noted that the health of the tourist industry was and would continue to be vital to the economy of the state. Facilities and management had to be maintained and upgraded. Second, the subcomittee suggested that other services be developed with the location of Hawaii halfway between North America and East Asia kept in mind. Marketing should shift from a 'make and sell' orientation to a 'buy and sell' one. Hawaii should strive to become the middleman between the continents, providing services, communication and understanding between these societies.

The report on Hawaii's economic future added impetus to policy change in the state government. In 1983, the Legislature had created the High Technology Development Corporation (HTDC) and the Pacific International Center for High Technology Research.[39] Three high-tech or research parks are being developed, one by the HTDC, one privately and a third by a county government. A special deputy attorney-general has been appointed to deal with small business problems, some land-use policies have been relaxed, especially for small projects, and extra funds have been allocated to the Hawaii capital Loan Program and the Hawaii Industry and Product Promotion Program.[40]

4. Michigan

For Michigan, the recession did not start in 1981, but in 1979. Most of the country experienced a recession in 1979, but the economy bounced back only to falter again in 1981. In Michigan, dependent as it is on durables manufacturing, the turnaround in 1980 did not really materialize and the 1981-2 period simply made a bad situation worse. Unemployment reached 17.6% at one point, and the state government was nearly bankrupt.[41]

For decades, the automotive manufacturing firms that lay at the heart of Michigan's economy, enjoyed prosperity, profits and wages that exceeded the national averages and whose continuity was only interrupted by downturns in the nation's business cycles. The industry was slow to respond to the changes forced by the rise in the price of oil in 1973 and to intensified competition from foreign auto firms. The end result was a crisis in the American industry after 1978 that saw the near bankruptcy of Chrysler and the radical restructuring of the automotive production process in the early 1980's. Michigan's travails as a result of the latest downturn of the business cycle were compounded by this restructuring. Its reactions were representative of a large number of industrial states in the north-central and north-eastern parts of the country that came to be know about this time as the 'Rust Belt,' to distinguish it from the relatively more stable southern and western 'Sunbelt.'

In 1980, then Governor Milliken convened a High Technology Task Force to advise the state on future industrial strategy.[42] While the severe problems encountered by Chrysler the year before seemed to suggest that Michigan's traditional reliance on auto production was nearing its end, the Task Force took a different tack, recommending that efforts be made to incorporate technological change into existing industries in order to upgrade them and improve their competitiveness. The state moved to create the Michigan Economic Development Authority, giving it revenues from the State's oil and gas production and allowing it to issue bonds. The Authority then acted, in concert with private sector partners, to create three technology centers, the Industrial Technology Institute to explore possibilities in automated production, the Michigan Biotechnology Institute, to do applied research for and assist start-ups in wood and farming industries, and the Michigan Center for High Technology, to assist new technology ventures in the Detroit area.[43] The State also moved to permit government employee pension plans, with assets estimated at $9 billion, to invest up to 5% of their capital in Michigan-based venture capital projects.[44]

A new Democratic state administration, elected in 1982, thus had an activist industrial policy precedent to build upon. While a congressman, Gov. Blanchard had actively supported the federal guarantee that helped to stave off bankruptcy for Chrysler in 1979, so he came to state office uninhibited about the use of government power to assist in economic development. He created a Cabinet Committee on Jobs and Economic Development and a like-named advisory Commission, made up of private sector members. The Governor then created the Task Force for a Long-Term Economic Strategy for Michigan in the fall of 1983. It was made up of eight government officials and academic economists and submitted its report, The Path to Prosperity in November 1984, containing 18 policy recommendations in four subject areas.[45]

As befits the heavy academic influence in the document, the first four of its five chapters were dominated by ten 'research findings,' and both the notes and bibliography were appended to the report. The research findings were in part parallel to, or derived from, work published by Reich, Magaziner and Bluestone, works which are discussed in preceding chapters and chapter footnotes. The Michigan report as a whole is an intellectual cousin to the Rhode Island report.

The first chapter was a short rationale for the creation of the Task Force. The second chapter, "Assessing Our Economic Engine," developed the standard economic base argument that a state's prosperity is based on tradeable firms, i.e., those that primarily gain their income from outside sources and sales. The central focus of the State's economic strategy is then said to be on the development of the economic base. Needless to say, the major portion of this base lay in manufacturing and especially in durables manufacturing. With about one-quarter of the State's employment being in the manufacturing sector, as opposed to about one-fifth nationally, it is not hard to see why this rather prosaic approach was adopted. It was academically safe and justified targetting the strategy on the depressed southeastern part of the State, rather than on the relatively more prosperous west and north (excluding the Upper Peninsula). Continuing the focus on manufacturing meant in effect continuing the focus on the automobile industry, since it directly or indirectly employed about one-half of those involved in manufacturing.

The report noted that manufacturing employment was fairly stable during the 1970's, which in effect meant a decline in its proportion of the employed labour force in the economy. Wages and per capita incomes were above average, and problems were primarily related to the business cycle. However, loss of Michigan's market share in auto production and non-electrical manufacturing presaged the unemployment problems of the 1980's. Manufacturing lost 330,000 net jobs (out of about 1.2 million in 1979), and three-fourths of these were in the auto industry. These losses overshadowed some gains in other manufacturing activities.

The third chapter explored "Michigan in the Global Marketplace," focussed on the challenges from the Sunbelt and foreign competition, and looked at the role that inappropriate federal fiscal and monetary policies had played in Michigan's decline. The Task Force concluded that wage differentials seemed to play a central role in industrial migration from Michigan, and that improvements in transportation and communications had meant that production could move away from the markets of the north and east. While Michigan, Ohio, Indiana and Illinois lost jobs because of high wages, Wisconsin and Minnesota gained manufacturing because they developed new products, an observation that the Task Force did not adequately follow up. Little more than brief mention is made of the effects of foreign competition and federal policies. The chapter concluded with some evidence to show that controlling business costs and providing financing and trade protection are all 'quick government fixes' that are unlikely to work.

The fourth chapter, "The Path to Prosperity," developed some ideas about ways to restore Michigan's manufacturing economy. The state can 'get poor,' by cutting wages in the hope of keeping its plants; it can 'get out', moving out of durables manufacturing in favor of other products, or it can 'get smart' and move from routine to complex manufacturing processes and develop Michigan into the high-skill, high-wage 'factory of the future.' The Task Force opted enthusiastically for this last since it stated that industrial innovation was the key to the future. New technologies, new skills (the Task Force noted that Michigan has problems with its large educational system that must be addressed), new labour/management relations, and new managerial styles must be integrated into the manufacturing base if a 'culture of innovation' is to be created. The Task Force noted that in spite of bouncing back from the recession, the State was going into 1985 with an unemployment rate of 11% and with a million people on welfare. There was no invisible hand available to lift the State out of its troubles; it had to take action itself.

The last chapter outlined "The State Government's Role," which was to hurry the future by focussing on four strategic targets: ensuring the survival of existing industries; assisting the creation of new firms; establishing a competitive business environment; and developing social policies to help individuals and communities through transition periods. The first recommendation reiterated the primacy of the private sector in providing for economic growth, while the public sector was to be of assistance. Specific recommendations related to the target of ensuring the survival of existing industries included the need to invest heavily in centers of applied research (and, in particular, the University of Michigan College of Engineering), and the value of a state-led effort to develop new materials to be used in durables manufacturing. Changes in labor and management behaviour should be promoted by new training centres, while innovation and technology transfer should be promoted through a Michigan Manufacturing Extension Service, based on the agricultural extension model. Lastly, industrial retention should be encouraged through the maintenance of existing state financial incentives.

Three recommenations were made concerning the birth of new firms: the universities should reinforce and support the transfer of ideas and applications from professors to the private sector; state investment funds should be targetted at gaps in the capital market that pose obstacles to the growth of new firms; and state policies for attracting new firms should focus more on servicing the needs of potential clients than throwing money at them.

Furthermore, six recommendations were made to encourage the provision of a competitive environment: the establishment of minimum achievement standards in the schools; more aggressive recruitment of the best university students, especially in science and technology; decisions on infrastructure should reflect economic development concerns as well as social concerns; the aggregate of state-controlled costs, such as workers' compensation, should be brought into line with the regional average; state-provided business assistance services should continue to be provided; and the state's quality of life should continue to be safeguarded.

In addition, three recommendations were made for policies to assist in transition problems: a partnership between the public and private sector is needed to provide those with no, or obsolete, skills with the means to improve themselves; the state must help those in the inner-city areas to gain access to jobs outside the urban cores; and new revenue-sharing methods must be devised to help urban areas to meet their overwhelming problems, so they can begin to renew themselves.

<u>The Path to Prosperity</u> is squarely based on the industrial policy literature of the early 1980's. It is also an endorsement of the sorts of measures taken near the end of the previous state administration. Regardless of party affiliation, the problems of Michigan's durable manufacturing sector have dominated the economic scene of the 1980's. The apparent correspondence of the policy vectors of the Milliken and the Blanchard administrations illustrates the relative narrowness of the options available to the State government in attacking the problems. It also shows the willingness of State leaders of whatever political stripe to pursue industrial policies actively in order to meet economic crises and changes.

Conclusion

The development of state industrial strategies is an indicator of a resurgence in state policy activism. The combination of difficult economic circumstances and a passive national and tax-based approach to these difficulties by Washington either forced or gave the opportunity to the states to set their own economic agendas. The response to this situation has been pragmatic and not confined along partisan lines. The timing of the strategies discussed above, and many others as well, has underlined the uncoupling of state activity in industrial policy from the national debate on the subject. One could assume from the national media in the summer and fall of 1984 that the defeat of Gary Hart by Walter Mondale and his subsequent defeat at the polls by Ronald Reagan meant that the industrial policy debate had been thoroughly settled. Yet it was at precisely this time, or even after, that three of the four strategies outlined above were released. These activities implicitly, and correctly, could be argued that the real national debate on the subject of industrial policy has yet to take place.

The strategies outlined above clearly exhibit a concern for the overall development of the states' economies. This is a significant evolution from the more passive approaches that preceded those of the 1980's. Earlier, the primary concerns were almost solely with the 'business climate,' labour regulations, conditions of work, local taxation and the like. What activity existed was centered around industrial recruitment for the most part. Exceptions, such as the Connecticut Product Development Corporation and North Carolina's development of its Research Triangle Park, were rare.

In most strategies, an overriding motif came to the fore. The traditional industry upon which a state's economy was based was either in decline, under pressure or maturing. It had to be modernized or replaced and, in any case, new industries had to be fostered to absorb the state's labour force growth. This may be expressed as a need to provide adaptation and diversification. In the end both can be reduced to the same common denominator: new industries had to be fostered in the state. Even the old industries had to be renewed.

Four overlapping elements recur in these strategies, once one ventures past the concerns about improving business climate and maintaining the existing economic base. These are: an emphasis on assisting the economy to produce or make use of technology, attempts to improve the financing for local industry, a determination to foster the birth and growth of new small businesses, and a determination to encourage more local firms to export goods and services. Nearly all the programs and initiatives in all the strategies, and even those taken in states that did not elect to write strategies, issue from these four topics.

Footnotes to Chapter IV

1. Massachusetts Governor Dukakis: "While the national debate rages on whether we ought to have an industrial policy, there isn't a State that doesn't have one or isn't putting one together, whether it has a Republican or Democratic, Liberal or Conservative governor." Quoted in Kevin Phillips, Staying on Top: The Business Case for a National Industrial Policy (New York Random House, 184), p. 83.

2. "States are Going Down Industrial Policy Lane". Fortune, 5 March 1984, p. 112.

3. Bruce Babbitt, "The States and Re-industrialization", Economic Impact 1985/3, p. 54.

4. Robert Vaughan, et al., The Wealth of States, (Washington D.C.:Council of State Planning Agencies, 1984) pp. X-XI.

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CHAPTER V

THE IMPLICATIONS FOR CANADA

Introduction

The primary aim of this report is to lay out the evolution of industrial policy in the United States. Because of historical forces and circumstances, activities at the state level have been emphasized. As in Canada, there has been less controversy over the notions of explicit industrial strategies and development programming at the subnational level than at the federal level of government. It has been argued that American federal government actions related to defense purchases and research and development expenditures may construe an industrial policy, but this seems to carry the idea that there may be an implicit consensus within the sprawling federal bureaucracy to an extreme.

It is harder to see the vectors of trends when viewed up close, but to wait for the historians' verdict runs the risk of not taking advantage of immediate opportunities and avoiding threats. The subject of this report has been an aspect of very recent American political activity. The latest materials referenced are but two months old. Hopefully, this 'close up' report will allow Canadian policy-makers to better evaluate the dynamic context of Canadian-American economic relations. The future of these relations must be seen in the context of the evolution of the debate over industrial policy in America.

Perhaps the most useful observation that one might gain from this report is that the popularity of what has been called 'Reaganomics' has passed and that its influence, unlike that of Keynesianism, is apparently ephemeral. The main contribution of Reaganomics to American politics has been the marking of the move from the political agenda set out in the Depression. What it has failed to provide is a new agenda. That is being hammered out in the context of the industrial policy debate.

This new agenda does not focus on the welfare state. Instead, it is concerned with the definition of the American place in a world economy that it does not control and will dominate less and less as the century nears its close. The debate is not over yet, and the ideas of competitiveness and protectionism are just its most recent manifestation. The U.S. has not yet reached the predictable national concerns over foreign investment and domestic business practices that are also a part of the necessary accommodation to the new global economy.

Canada has been going through a similar evolution. The practical limits of the welfare state as a political device were reached in the middle 1970's. A policy shift to an economic nationalist agenda was attempted in the decade 1974-1984 but was discredited. A more globalist phase has taken its place, but it is not certain that it will have a lasting impact. Part of the uncertainty lies with the debate going on in the U.S., since moves there that related to its economic debates will have an important effect on the Canadian future. For instance, the 'free-trade' issue depends in part on the lasting effects of Reaganomics, since it is this economic posture that provides the underpinnings for American support for such a trade policy. The task of implementing any agreement will have to fall to a post-Reagan Administration.

The aim of this chapter is to provide a set of conclusions for the report by examining each of the previous chapters for their implications with respect to Canadian concerns and interests.

The Triple Conflict

Canada has been affected by the same demographic and occupational changes that characterized the American scene in the 1970's and 1980's. However, these impacted on an economy that was structured differently than the American and upon a political agenda that had different priorities. These differences may be briefly noted. One is the lack of a geographical shift of manufacturing activity within Canada, though similar overall job losses were taking place and similar shifts in the geography of economic prospierty were occurring. The prosperity shift was produced by the relative increase in commodity prices that came with the oil crisis of 1973. This shift in turn left to some movement of jobs out of central Canada to the West, but it had none of the characteristics of the shift to the Sunbelt that took place in the U.S. Instead, it was more as if the Rust Belt and the Mountain region were the only American regions replicated in Canada.

The Canadian economy was also more heavily regulated than the American, which meant that parallel moves to deregulate in order to free the economy to expand and diversify were bound to be weaker. Instead, regulation, including barriers to international trade and investment, seem to have been used to protect the Canadian employment structure to a greater degree than in the U.S. while the process of job growth through entrepreneurship took hold in the urban service sector. This approach did not meet the needs of the Canadian baby-boom cohorts as well as the American met its challenge, but a more generous public support system managed to relieve the pressure.

The political agenda in Canada began to shift away from a preoccupation with the welfare state at about the same time as did the American agenda. In Canada, however, the shift took place not toward accommodation to the international challenge, but toward attempts to protect the national economy from one facet of the challenge -- foreign ownership of Canadian production facilities, especially in the commodity sectors. Since 1984, a new shift has taken place that stresses the accommodation to the globalization of the world's economies. These shifts have occurred in almost opposite phase to those in the U.S., where accommodation has been followed by a nationalist reaction to the trade deficit. Concern with foreign ownership lurks below the surface of American politics, but it has never been an issue of itself, as it has in Canada. At this point, it appears that Canada is moving to accommodate itself to world trends while the U.S. is moving to resist them. Because of the close linkages between the two economies, these shifts in the political agendas may have considerable impact.

Industrial investment policy is an example of where these policy differences may have an impact. Chapter I outlined the geographic shifts in manufacturing and other business activity that have taken place in the

United States over the past 25 years. Chapter IV showed some of the ideas that states have put forward to counter these trends. Though it is not covered in these chapters, the effect of these shifts and state reactions to them cannot be seen by Canadians as in a vacuum. Because of the integration of the Canadian economy with the American, Canadian provinces and the Canadian government itself are in competition with the states for new investment, including scientific and technical establishments as well as manufacturing plants.

This competition has not diminished in recent years. Rather it has heated up to a remarkable degree. Canadian efforts seem to have largely been on a plateau, with the federal government hampering intensive provincial efforts in the early 1980's with its anti-foreign investment message while in the latter 1980's the inability of the provinces to continue financing their earlier high levels of activity has been contrasted with a new federal aggressiveness to seek and encourage investment. Meanwhile the American federal government moved to encourage more capital inflows and investment with the tax changes of 1981 and the states have virtually all begun to pursue active industrial policies. To a large degree they are now into head-to-head competition with Canadian provinces, where this was not true a half-dozen years ago.

It is impossible to say at this time whether the new policies adopted by the states will prove effective. They are too new. Yet, many of the program ideas they have generated are quite similar to programs that have been in place in Canada for many years. Only in the science and technology application areas have innovations that have no Canadian predecessors been found. This report does not elaborate on them, but they are significant. In large part, it would seem that the rise of business/government/university partnerships in developing and commercializing new services, products and processes is due to the lack of provincial reseach organizations that exist across Canada to carry out a similar function. However, the vigor with which these partnerships are pursued in the United States may well lead to significant new developments of technology-based industrial complexes just at the time when Canadian government investment in our facilities is stagnant or declining.

U.S. Industrial Policy and Canadian Trade

Chapter II presented an outline, with some details, of a decade-long move in the United States toward an active industrial policy at the national level. This process shows no signs of abating. As well, the Reaganomic adherence to a classical free-trade doctrine seems more and more to have been a policy of resistance to this movement rather than the dominant or even alternative policy thrust of the 1980's. The implications for Canada of this movement are profound.

Whether the present negotiations between Canada and the United States over a comprehensive trade agreement succeed or fail, or if they did not exist at all, the basics of the bilateral relationship remain. Canada is extremely dependent on the United States market for its production of goods. To a lesser extent, the United States needs the Canadian market to absorb services and investment surpluses. However, Canada is more dependent, and excessively so, on this exchange than is the United States. This excessive dependence, to the tune of three-quarters of our exports and imports, is the true measure of how far Canadian soveriegnty has diminished. An active American industrial policy, geared to reducing the trade imbalance in goods primarily, constitutes a major problem for Canada and will only add to the pressures of economic transition and adaptation facing the country.

It is clear, given the experience of the past three years, that if comprehensive trade negotiations were not underway, that Canada would be in a continuous process of sectoral negotiations to protect or gain a 'special status' for its exports in any case. The comprehensive negotiations have served, among other things, to give focus to what would otherwise be a whole series of negotiations to accomplish the same end. The rise of a consensus of sorts about a more active industrial policy in the United States means that that process would only have intensified over the coming months and years. The end result would probably be a patchwork of deals, some good and some bad, spread out over the decade of 1985-1995.

If the present negotiations fail, then Canada and the United States would probably revert to the process outlined in the preceding paragraph. The atmosphere for at least the next two years, and possibly beyond, would be somewhat poisoned by the failure and the proportion of bad (to Canada) agreements to good would probably be higher. However, unlike

1911 or 1947, it is virtually impossible that the re-examination of Canada's economic relationship with the United States would stop. If anything, failure would bring about an intense soul-searching inside Canada as our dependence on American markets is driven home even more clearly than it is today. Jingoistic flag-waving aside, in this scenario Canadian governments in the future would be faced with the excruciating problem of how to move the Canadian economy away somewhat from the high degree of dependence on the American economy into which it has drifted in the last half-century. This would call for no less than the refashioning of Canada, no mean feat.

The success of the present negotiations, given the trend in America towards an active industrial policy, probably would signal, in Churchill's terms, not the beginning of the end, but the end of the beginning. If one were to consider that Reaganomics was the dominant economic force in American politics, then the notion that a level playing-field, free of subsidies and government manipulations, would allow the most competitive industries to flourish and the least to disappear, then one could see an agreement as the beginning of the end. What is left is to provide for decent adjustment measures for those employed in losing firms and for economic adjustment where strucutral factors work to one country's or another's detriment.

But what if Reaganomics is not dominant in the rests of this decade and the next? A trade agreement based on free-trade principles would likely result in the dependent partner being constrained to adhere to these principles while the dominant partner begins to implement the very measures its partner gave up in order to get the agreement. It is by no means assured that the next administration would see itself bound by the principles signed in an accord with Canada in the case of an economic struggle with Brazil, the EEC or Japan. More likely Canada, regardless of an agreement and its compliance with it, will be sideswiped as the United States goes after more irritating countries.

Also disturbing is the present case of existing business assistance programs in both countries. The internal Canadian argument that seems to be put forth by our negotiators is that Canadian programs should be restricted more than American programs. Part of the reason advanced is that the Americans are dismantling some of theirs, such as the curbing of tax-free industrial development bonds (IDB's) in the 1986 tax reform bill. The thrust of this report is to suggest that this trend is ephemeral at best and that one can expect the new Congress and the next Administration, regardless of party, to be activist in terms of industrial policy and to promote new or restored business incentives, regardless of a deal with Canada. To disarm ourselves would likely prove to be a mistake. A second part of the argument is that our economy is more export-oriented than is the American, so that incentives given to American firms to help compete in domestic markets cannot be equated with Canadian incentives that would have a great impact on exports. Any careful reading of the industrial policy literature and the state strategies makes it clear that incentives are designed to counter competition from imports. In effect, we are asking

Canadian businessmen to desist asking for assistance at exactly the same time that U.S. governments are developing a myriad of tools to assist their businesses to undercut foreign competition, including Canadian exports. This is hardly a level playing field and it would be wildly optimistic to assuime that the movement towards and active industrial policy in the United States will be checked by a trade agreement with Canada.

Irrespective of who might win the next federal election, the next Canadian government is going to be faced with the challenge of seriously addressing the economic structure of the country. An agreement with the United States on trade will not result in the panacea to adjust Canada to international realities, which is what the Macdonald Commission seemed to think. The United States, like other countries, has both a dynamic economy and a fluid political scene. It is moving towards a more active industrial policy and a more interventionist one. Reaganomics appears to be but an interlude in a trend towards a more managed economy. In truth, a trade agreement that is most compatible with the probable direction of American economic policy would most likely be an agreement to manage trade, not to free it. Jargon aside, such an agreement would effectively turn the Macdonald Commission's recommendations on their collective head. Yet, attractive as real free trade might be to the Commission, as it is to the ideologues of Reaganomics, it is far more likely that we are entering into an era of great attempts to manage trade and economic activity. Whether this is in the best interests of Canada seems almost be to superfluous: the more pertinent question is whether we understand where things are leading and whether we will leave ourselves enough policy space to take advantage of what opportunities might exist in the strange new world of the 1990's.

So, regardless of whether an agreement is reached, or its terms and conditions, the process of coping with our dependency on the American market has just begun. This issue is likely to remain high on the Canadian political agenda for the next decade, as the world, the American and the Canadian economies proceed with a massive process of adjustment.

The Lessons of Puerto Rico

Puerto Rico was involved in actively trying to promote economic development before the rest of the United States. Its experience has something to tell Canadians about the process, especially with respect to strategy and incentives. The island attempted to overcome its problems of poverty, unemployment and dependence on a declining agriculture by the wholesale attraction of branch plants through massive tax incentives. As long as other conditions were favorable, this strategy was successful. By 1973, conditions started to change, but the strategy did not. The result was a decade and more of stagnation, as new plants were attracted that required less labour while older industries faded as lower-wage countries entered these fields.

Puerto Rico's problems today do not argue that an active industrial policy is not useful or appropriate. It argues instead that careful attention must be paid to adapting a strategy to changing conditions. It is doubtful whether the island's present level of relative prosperity in the Caribbean could have been achieved without 'Operation Bootstrap.' Instead, the island's experience points up the critical necessity of diversification in economic development.

Two kinds of diversification must be at the core of any development strategy. The strategy cannot be based on one process or industry if it is to succeed over the long run. To stress resource development or attraction of branch plants or anything else as virtually the sole generator of prosperity will only lead to crisis as conditions change and an economy is too narrowly based to cope. A number of approaches have to be taken simultaneously if success is to be preserved. Secondly, there must be the willingness to act pragmatically and to recognize that changed conditions require a change in strategy. Diversification of development tools is vital to success.

The experience of Puerto Rico also raised the question of incentives for investment. Incentives are generally seen as a means of overcoming locational impediments to investment. As such, they enjoy a dubious reputation among economists and politicians. They are either accorded immense importance or near total ineffectiveness and are a good investment or a waste of money. Most specialists in industrial location take a more limited view in that incentives are seen as being important only after more substantive variables are eliminated. Incentives come into play once locational considerations have been narrowed down to a few relatively equal sites. Puerto Rico enjoyed what is probably the richest incentive package in North America and even this package was not enough to attract the plants necessary to absorb labour force entrants in the 1970's. Other conditions left the island too rich relative to is lower wage neighbours and too poor relative to locational competition in the U.S. proper.

One of the difficulties faced in discussing incentives or subsidies to industry in the Canadian/American context is that both sides see them in different ways. Often both are talking about different things.

Until the states began to be active in industrial policy after 1981, most incentives for business location and development in the United States were tax-based. The incentives consisted of various measures to reward businesses or investors through the tax system. The best example, and probably the most-used incentive, consisted of tax-free industrial development bonds (IDB). IDB's were first developed by the State of Mississippi in 1934 and became very common until their use was curbed by the tax reform of 1986. There appears to be pressure to reinstate them already. IDB's were issued generally by municipalities and their proceeds were free of taxation from all levels. Because of their status, an IDB could be issued at an interest rate considerably lower than that of regular bonds. Instead of applying the money raised by IDB's to municipal purposes, it was re-lent at cost to designated private industrial facilities, thus lowering the cost of capital for them. Generally, Republican ideology has held that a tax not collected is not a subsidy, since their theory of government finance was that governments take what they need and whatever is left, no matter how unevenly distributed, is the property of the individual or corporation. Democrats, and to a greater extent, Canadians, tend to hold a different view. Taxes are to be applied uniformly and any deviation for whatever reason must be considered as a tax-expenditure, differing only from direct expenditures in that it is not made by first collecting tax due and then giving it back, but by not collecting the tax due in the first place. To those who accept the logic of tax-expenditures, the difference between them and grants as business incentives is simply instrumental. To those who do not agree, the difference is between government interference and the private use of private money. This ideological gulf has great political significance since it is claimed that Canada has a large interwoven web of subsidies while the U.S. is fundamentally an unrestricted market economy. Conversely, a trade agreement that restricts subsidies may or may not include tax-expenditures and, since the Canadian approach is largely one of providing incentives through direct expenditures, may hamper one country's policies while not affecting the other's.

The utility of these methods of providing business incentives is open to debate. Some Americans and Canadians share the view that grants help losers and tax-expenditures reward winners. The reality is far more complex and ambiguous. If anything, it might be said that grants tend to support risky and new (and innovative) ventures while tax-expenditures are of most use to well-established, large corporations. Partly, this argment about utility is at the base of the argument over active and passive industrial policies and it is not surprising to see Democratic support for direct expenditure or grant-based industrial assistance. Again, the prospect of a post-trade agreement Canada abandoning its approach in incentives just as a resurgent Democraic party embraces a similar approach, possibly in violation of the spirit of the trade accord, is disturbing.

State Industrial Strategies

The Canadian provincial governments have been engaged in active industrial policies for much longer than their American counterparts. Most provinces have written industrial strategies. The Prince Edward Island Development Plan was approved in 1969 and is one of the most comprehensive documents of its kind. Since then, most other provinces have published documents as well. The movement toward supporting local business development as opposed to a concentration on industrial attraction appeared in Canada first as well. In part this was due to federal discouragement of foreign investment, which left provinces to focus on making the best use of local resources.

The surge in state development activity after the 1981-1982 recession was surprising to those Canadian counterparts who had become used to a relatively low level of activity on the part of most states. Instead of having to compete for investments with a few states, there were now dozens putting together packages and development tools. States were sending trade and investment missions to Canada when they had not done so before. Much of this activity was repetitive of what others had done, but some was innovative. The potential for Canadian provinces to learn from such innovative activity in a number of areas is now greater than it has ever been.

For instance, both countries face problems in economic diversification in various regions. Michigan and Ontario share a dependence on durables manufacturing. Alberta, Oklahoma, Texas and Louisiana face problems related to a great dependence on oil production. Saskatchewan and the Great Plains states share agricultural concerns. The number of state 'laboratories' where partial solutions might be worked out exceeds their equivalents in Canada. These must be monitored carefully if we are to work towrds solving our problems.

The United States has also had considerably more experience with urban development schemes than has Canada. To a great extent, we have tended to ignore urban problems because Canadian cities have managed to keep their cores vitalized and have seen run-down neighborhoods rebuilt with upscale residences. However, the problem or urban development may be a function of the age of larger cities and the relative youth of Canadian cities may have only retarded a process, not bypassed it. The efforts being expended to revitalize Montreal and the urban development needs of smaller centres, such as Sydney, N.S., and the looming needs of depressed cities such as those in Alberta, show that urban redevelopment is no longer just a problem for the United States. So far, Canadian responses, taken largely in an intellectual vacuum, seem weak.

There are many other areas where the federal government and the provinces might learn from state experiments in economic development. To do so will require a shift in attitude, since whenever Canadians think of development initiatives it is highly unlikely that they look to the state governments in the U.S. Such thinking, in the post-recession era, is a mistake as the tools developed in the 51 'laboratories' (including Puerto Rico) are likely to contain many useful features for Canadians. Likewise, the federal government has a stake in monitoring state activity in this area as it is through borrowing from state successes that the innovations in American national industrial development are likely to be created.