The State and Prosperity

address by

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The Pacific Northwest Regional Economic Association
Spokane, Washington
Friday, April 25th, 1997

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Whenever economists meet, it has been my experience that the discussion inevitably turns to economic policy activism. The role of policy activist is one that I am familiar with but, quite honestly, not one in which I am comfortable. At the very least, "policy activism" implies promoting a particular allocation of resources that would not have occurred in the absence of political intervention.

Policy activists tend to think in terms of particular programs, and not in terms of the overall economic climate. Answers are sought for questions such as: What can be done to increase the skill level of the labor force? What mix of industries will create the most jobs? What tax rates should we impose on labor and capital? Should interest rates be raised or lowered?

Because policy advocates will not be judged by the overall operation of the economic system, but by the successes and failures of individual programs, I fear there is a bias toward overvaluing the gains from state involvement in the marketplace, and grossly underappreciating the costs inflicted on the system. Remember the western farmers who successfully eradicated the wolves only to be left with a vermin problem? When the flow of resources is altered, far-reaching ripples are created in the system that ultimately erode prosperity.

The premise of my remarks today is simple. It is not the specific programs government puts in place that "decide" our prosperity. It is our choice of institutions, the

* This paper draws on the content of two previous speeches: "Jobs Creation and Government Policy" (Nov. 30, 1996) and "Wealth, Economic Infrastructure, and Monetary Policy" (April 13, 1997). Both of these speeches are available on the Cleveland Fed's World Wide Web site: *http://www.clev.frb.org.*

totality of which we call the economic infrastructure, that determines our wealth and development. Indeed, I believe *the* most important element separating economic "haves" from "have-nots" is whether the perspective of an economy's institutions--and particularly its public institutions--is to facilitate, or to confiscate, production.

The Nature and Causes of Economic Prosperity

In 1776, Adam Smith published *An Inquiry into the Nature and Causes of the Wealth of Nations.* His motivation was to explain the large differences in prosperity observed across economies. That inquiry continues today, and for essentially the same reason: The gaps that separate prosperous from foundering economies remain huge. As we near the end of the 20th century, the richest countries in the world are roughly 30 to 50 times wealthier than the poorest ones--a truly astounding difference.[1] Not only do we see large differences in wealth, but we also see tremendous variation in development. Some developing countries tripled their wealth between 1960 and 1985, while others were about three times wealthier in 1960 than they were 25 years later!

If we ask simple questions like, Why are some economies rich and others poor? or Why do economies grow at different rates?, we get a simple answer: Rich economies have greater resources per capita--more capital, both human and nonhuman, and better technology connecting the two. But this simple answer only begs another question: Why do some economies have high levels of capital and technology, while others don't?

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[1] Measured by per capita gross domestic product (GDP). For perspective, consider that this is approximately the same difference separating the U.S. standard of living today from that of approximately 200 years ago!

To answer this question, it is useful to determine whether wealthier or faster-growing economies share characteristics that are not observed in poorer or slower-growing ones. But the lack of a clear link between specific "growth" policies and an economy's ultimate prosperity has led us to think more broadly about the state and prosperity. That is, the policies that nations adopt may not be individually revealing, but in their totality they expose an economic infrastructure that the state helps build.

For example, viewed in isolation, an increase in the state's educational effort should have a decidedly positive influence on an economy's wealth. However, such programs may still fail if the rate of taxation on labor income is high, transfers between generations are large, or other policies are in place that reduce people's incentive to add to their stock of human capital.

Recently we have had a rather unique opportunity to study the role of the economic infrastructure in influencing nations' prosperity. In the last seven years, at least 15 newly created market economies have emerged within the former Soviet Empire, in addition to the liberated Eastern European countries. Not surprisingly, these emerging economies have experienced vastly varying degrees of prosperity. Since 1989, the five worst-performing Soviet spin-offs have seen a decline in measured output about twice that of their five best-performing counterparts. More specifically, the Central European countries appear to have adjusted more easily than many of the Baltic states and Russia, which in turn appear to have adjusted more easily than Kazakstan, Uzbekistan, and the other outlying republics. A reasoned explanation is that the Central European countries have a history as market economies and had maintained a legacy of the business practices that are common in the West. This implies that the economic infrastructure of these nations is more developed than in the remote republics.[2]

The Public Infrastructure of Nations

An economy's infrastructure, very broadly speaking, is the climate created by the institutions that serve as conduits of commerce. Some of these institutions are private; others are public. In either case, the role of the institution can be conversionary--helping to transform resources into outputs--or diversionary--transferring resources to non-producers. Most private institutions are sustained by the value they add--either they produce or they fail. But the same cannot be said of public institutions. These institutions are sustained by the power of the state.

Given the seemingly inherent danger of public institutions, perhaps the natural first question to ask is, "Why aren't all institutions private?" At a most basic level, there can be only two rationalizations for the state's participation in an economy. The first is as a social equalizer, redistributing the fruits of a nation's production under the presumption that a particular social need takes precedence over private desires. The second justification for government intervention is the assertion that markets may fail to produce an efficient outcome.

The rationale underlying government's role in the economic infrastructure is crucial to the prosperity of its citizenry. In the case of equity issues, the role of the state is unambiguous. Society makes a choice to accept a lower level of wealth in exchange for some presumably higher social objective.

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[2] Olivier Blanchard and Michael Kremer, "Disorganization," manuscript, NBER Economic Fluctuations and Growth Meetings, January 31, 1997.

It is as promoter of market efficiency that the role of the state raises the most complex questions. Even if the objective is to overcome a particular market failure, once the state has been introduced into the economic system, its influence can have wide-ranging and unanticipated consequences. And these institutions, which are not bound to obey market forces, exert influence long after their usefulness has passed.

While I am doubtful that market failures occur as commonly as activist policy-makers presume, it is clear that they ***do*** occur. The most frequently cited failure involves so-called "public goods," where providing the good for anyone makes it possible, without additional cost, to provide it for everyone. A legal system and national defense are such goods. Cumulatively, these state activities are part of the economic infrastructure called "the protection of property rights." This means, more or less, that individuals can expect to receive the product of their labor. Although people could privately undertake actions to prevent the diversion of their output (from burglary, for example), it is widely accepted that a social institution (such as a police force) is a less costly mechanism to do so. Let us be clear, however. In order to pay for the police, or courts, or jails, resources must also be diverted to the state from private persons in the form of taxes.

Indeed, once introduced into the economic infrastructure, the state cannot help but tax the productive capacity of the system. Sometimes these taxes are direct and provide the sustenance for the government enterprise. But direct taxes are probably only a small part of the overall cost to the economy. Also important are the costs on private agents who now invest resources to minimize their tax burdens, either through tax avoidance schemes or through attempts to influence the taxing authority.

This is the paradox of any state enterprise. While the state may be the most effective instrument in minimizing the resource diversions of private agents (for example, by protecting property rights and enforcing contracts), it simultaneously introduces the potential for the debilitating diversion of resources for its own account. It is here, I think, where the differences between economies are grossly understated.

A common distinction among governments is whether they are so-called "capitalist" or "socialist," and in very broad terms they define the diversionary appetites of some government entities. Certainly a government committed to allowing the private ownership of capital is, all other things equal, more committed to putting in place an economic infrastructure that favors creation over diversion. But this is only part of the story. Laws, threat of expropriation, government repudiation of contracts--all of the things that cumulatively sum to the protection of property rights--are important.

In a recent study of the productivity of nations, capitalist or mixed capitalist countries were found to have the most effective governments with respect to anti-diversionary commitment, but Hungary and Czechoslovakia, two noncapitalist countries during the study, provided "approximately the same level of anti-diversion policies as Taiwan, Italy, and Hong Kong." On the other hand, Sierra Leone and Malawi, two capitalist nations, offer little protection against diversionary activity. Similarly, many nations which we loosely label capitalist or mixed-capitalist economies have borders that are relatively closed to foreign trade. It is important to consider the totality of government attitude toward diversion to appreciate ***that*** government's role in either fostering or inhibiting national productivity.

The country of Jordan enjoys nearly twice the economic prosperity of Egypt, at least in terms of per capita income levels. According to some recent estimates, government participation in the economic infrastructure has been a prime determinant in that differential.[3] Jordan's anti-diversionary policies are stronger, it is more open to trade, and its economic organization is less statist. These are the "common set" of characteristics that make an economic infrastructure successful. According to some estimates, these characteristics are substantial enough to explain most--and perhaps all--of the differences in prosperity that separate nations today, and I suspect they are the same set of characteristics that separated the wealth of nations in the time of Adam Smith.

The State, Wealth, and Jobs

A statist philosophy can also apply to jobs creation. It is common today to hear aspiring political leaders declare that their number-one economic objective would be to increase employment. For those of us trained in the neo-classical tradition, this is indeed a curious objective of the state!

I am reminded of a story that a western businessman told me a few years ago. While touring China, he came upon a team of nearly 100 workers building an earthen dam with shovels. The businessman commented to a local official that with an earth-moving machine, a single worker could create the dam in an afternoon. The official's curious response was, "Yes, but think of all the *unemployment* that would create."

"Oh," said the businessman, "I thought you were building a dam. If it's *jobs* you want to create, then take away their shovels and give them spoons!"

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[3] Much of this discussion is based on Robert Hall and Charles Jones, "The Productivity of Nations," manuscript, NBER Economic Fluctuations and Growth Meetings, January 31, 1997.

The dominant view of economic policymakers at least since the 1930s has been that a competitive marketplace will fail to generate adequate employment opportunities, and this belief justifies state "jobs" programs. In the final decade of this century, the Depression-era way of thinking about the role of government is fading. And it is my hope that in the 21st century, creating *work* for people will not be viewed as a primary goal of government policy; fostering an environment for *wealth creation* will be.

Very poor economies are typically characterized by people who work most of their waking hours. To do otherwise would be disastrous. Where one finds impoverished economies with high rates of joblessness, one also finds political/economic systems that have large disincentives to create and accumulate wealth--in short, a weak economic infrastructure.

Suppose, however, that we accept the proposition that labor markets have failed to provide the right number of jobs. What sorts of opportunities should the state encourage? Given the importance politicians generally assign to the task of creating employment for people, it is surprising how little is known about the nature of jobs creation in market economies. Studies of the U.S. record show no identifiable, systematic factors related to industry, region, wages, employer size, capital and energy intensity, or foreign competition that would account for a significant share of the types or number of jobs created or destroyed in the economy.

Since policymakers have no clear foresight of where entrepreneurial energies will be directed in the future, it's impossible for them to predict where jobs creation should occur. For example, two or three years ago, who could have predicted, let alone planned, that a rapidly growing occupation for people would be designing Web sites?

It is not surprising, then, that government policies which seek to direct the flow of entrepreneurial talents in an effort to promote "good" jobs, and presumably to discourage "bad" jobs, will have uncertain and potentially negative effects on economic prosperity. Government-targeted employment policies breed special interest groups that inevitably reduce the efficiency of markets in allocating scarce resources. These policies tend to persist beyond the point of any economic desirability and inhibit a necessary antecedent to jobs creation: jobs destruction. In the United States, sectors and industries that claim the highest rates of net new jobs created are generally those that have the greatest rates of jobs destroyed. Similarly, nations with high rates of jobs creation also tend to have high rates of jobs destruction.[4]

In modern economies, can we conceive of any jobs creation that is not accompanied by the destruction of some less efficient, and therefore less prosperous, jobs? Yet, because of their imperfect vision, government jobs programs are almost everywhere jobs protection policies, which by extension tend to inhibit the creation of new, wealth-enhancing technology. In short, what may have begun as a well-intentioned redirection of labor resources ultimately becomes a debilitating component of the economic infrastructure.

The Competition for Jobs by States

[4] The correlation between jobs creation and destruction rates by industry in the United States over the 1973 to 1988 period is 0.77 percent, as calculated from data found in Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction*, Cambridge, Mass.: MIT Press, table 3.1.

I began my remarks today with a simple premise—that the economic infrastructure plays a major role in the determination of economic prosperity—and that infrastructure depends crucially on the policies and actions of the state. Where the state fosters an environment that functions as--in the words of Vaclav Klaus, Prime Minister of the Czech Republic--a "market economy without adjectives," economic performance has been far superior. It is fairly easy to make this point using cross-country comparisons, but both theory and evidence suggest that the argument is valid across all levels of government--national, state, and local.

Incentives may exist at any level of government that seem to enhance the local environment. These may be individually rational, but not welfare maximizing in the aggregate--that is, collectively irrational. For example, governments often impose barriers to trade in the form of quotas or tariffs, in the name of protection—generally protection of jobs. Although we don't often see exactly the same thing across states in the U.S., the possibility that individual states might not pursue policies that would promote overall welfare led Thomas Jefferson to write in 1785 that the "interests of the States ought to be made joint in every possible instance, in order to cultivate the idea of our being one nation." I don't believe this means that states should fail to exercise their individual rights; but, higher levels of government may need to intercede to address market failures, such as those of public goods. The "takings clause" of the U.S. Constitution, or the provision of a common currency, are such goods and are crucial components of our national economic infrastructure to the benefit of everyone.

So too, certain types of competition among states or local governments, perhaps more aptly labeled "The Economic War among the States," eventually gave rise to the Commerce Clause, giving Congress the power to regulate interstate commerce. Nearly 200 years later, we are once again witnessing such interstate and even intrastate competition, which may not be in the best interest of society at large.

The competition for sports franchises is the most cited example, although it is dwarfed by the dollars spent on other forms of business. Ironically, arguments made by the teams and the cities courting them often fall under the guise of economics. Cities justify construction of a stadium using tax dollars and tax breaks or subsidies for the team by arguing that there will be external benefits to the citizenry if the team relocates. This same argument is also heard when localities attempt to woo businesses away from other locations or to keep existing ones from moving elsewhere. In 1978, Pennsylvania gave a large incentive program to attract a Volkswagen factory--which closed 10 years later. And since then, the ante in the firm-relocation pot has been successively raised.

Such competition has been likened to an arms race, in which stockpiling weapons is a strategy for each country, no matter what the other country does. Therefore, the outcome is an arms race even though the welfare of people on both sides of the border would be higher if the race did not exist. Orchestrating and achieving a nonproliferation treaty is extremely difficult, indeed impossible if there is reason to believe the other side will not cooperate. For various reasons--mostly political, I think--cities and states have entered into a "business race," spending increasing sums to attract specific firms. As Jefferson recognized, if countries or states could successfully collude and agree not to pursue "beggar thy neighbor" policies, resources could be devoted to better use and both sides would gain.

Before anyone gets the wrong idea, I do believe that competition among countries, or states, or cities is healthy. Certainly having states compete over *general* levels of taxes, types of business regulation, and varying amounts of public goods will lead to the optimal mix of tax rates, regulation, and public amenities. Individuals can vote with their feet--and with their investment capital--to achieve their preferred mix. However, there is a type of competition that lowers social welfare. Tax-preferred or subsidy policies to specific private enterprises create resource distortions which, without an increase in some other tax, will cause a decline in spending on some public good. Yet, it was provision of public goods that led to the government intervention in the first place.

Consider again the professional sports industry. Competition among teams for free agents has led to skyrocketing salaries, perhaps affecting the profitability of the entire sport. The owners' solution has been to mandate policies that increased the cost of bidding up salaries. In basketball there is a salary cap; baseball has a salary cap and a luxury tax that taxes the payroll of a team above a certain amount and redistributes it to the poorer teams. So, too, some states have colluded not to enter a bidding war against their partners. Indeed, some scholars have proposed that the federal government could deny tax-exempt status to public debt used to compete for businesses, or impose other taxes that would make inefficient moves more expensive. Several state legislatures have passed resolutions calling for the end of federal programs that encourage "incentive wars."

Disillusionment with economic incentive packages is occurring because many of the past efforts to influence plant locations have resulted in dismal failures, similar to Pennsylvania's experience with VW. Such stories are repeated in a broad cross-section of industries and communities. The targeted incentive programs have either failed outright, or have proven to be exorbitantly expensive for the gains ultimately generated.

In these failures we can readily identify the missing ingredients of economic development: the infrastructure. Unless the rest of the pieces of the puzzle are in place, the intended outcome is not likely to be realized. If a tax preference is granted to one firm, only to increase taxes on other people, then entrepreneurs will not be attracted to the community, and the hoped-for wealth gains will not be realized. Likewise, if an incentive package is dangled before a firm to prevent it from leaving its current locale, but the adverse environment is still confronting the other remaining firms as well as any prospective new firms, that community will end up no better off for the effort.

In the final analysis, sustainable long-term prosperity--whether at the national, provincial, or local level--occurs when human action is focused on converting productive resources into marketable goods. When the role of political institutions becomes one of diverting resource utilization away from natural comparative advantage, the general welfare is necessarily reduced.

In my opinion, the government's relationship to its citizenry is not that of an architect, engineer, carpenter, or any other metaphor implying activism. I think of the state as a nurturer of an economic garden. It cultivates a soil that allows growth to take root, wards off pests who seek to feed off the budding crop, and keeps weeds from suffocating the plant before it achieves its potential. Simply planting one seedling in the middle of infertile ground is like moving a factory or business to an area without the proper economic infrastructure: we wouldn't expect either one to survive for very long.