Increasing Economic Competitiveness, Growth, and Investment in a Globalized Market: Lessons for Canada

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Abstract

The following study has been conducted on the basis of analyzing recent literature and empirical data in order to determine a set of policy recommendations to aid Canadian provinces' adjustment to globalization through increased competitiveness and attractiveness to investment. Inspired by the Fraser Institute's 2016 study analyzing Michigan's economic turnaround in contrast to that of Ontario, this study emphasizes alterations in the wage and tax structures as key policy strategies for generating economic growth. Specifically, this paper makes an argument for a decrease or elimination in the minimum wage alongside decreased corporate taxes, either in a targeted or general sense. These policies have been shown in Michigan and numerous other cases to incentivize improved development, growth, and investment in a productive way. By generating an increase in skilled jobs and capital inflows, these strategies address many of the shortcomings of a post-recession economy, particularly one dependent upon a large manufacturing sector, and have proven to benefit an economy in broader, more effective ways than the traditional approach.

Introduction

There's a wide ranging and diverse literature on the demands placed upon an economy by the encroachment of globalization, and the adjustments necessary for successful integration into the global market. As developing countries continue to seek rapid growth and accelerated development through low wages, taxes, and regulations, the challenge in the West, particularly in manufacturing sectors, has been to maintain competitiveness and remain true to the doctrines of a welfare state while ensuring a suitable wage and skilled employment for their citizens. This dilemma in developed economies was only deepened by the recent financial crisis, which saw capital flee to more profitable markets and, resultantly, a drastic fall in many industries that can be performed cheaper in the developing world. The aftermath, therefore, has seen manufacturing sectors, particularly those in the US and Canada, suffer huge losses in financial and human capital and their longstanding industries, around which many major cities were constructed, fall into disrepair and, in some cases, non-existence.

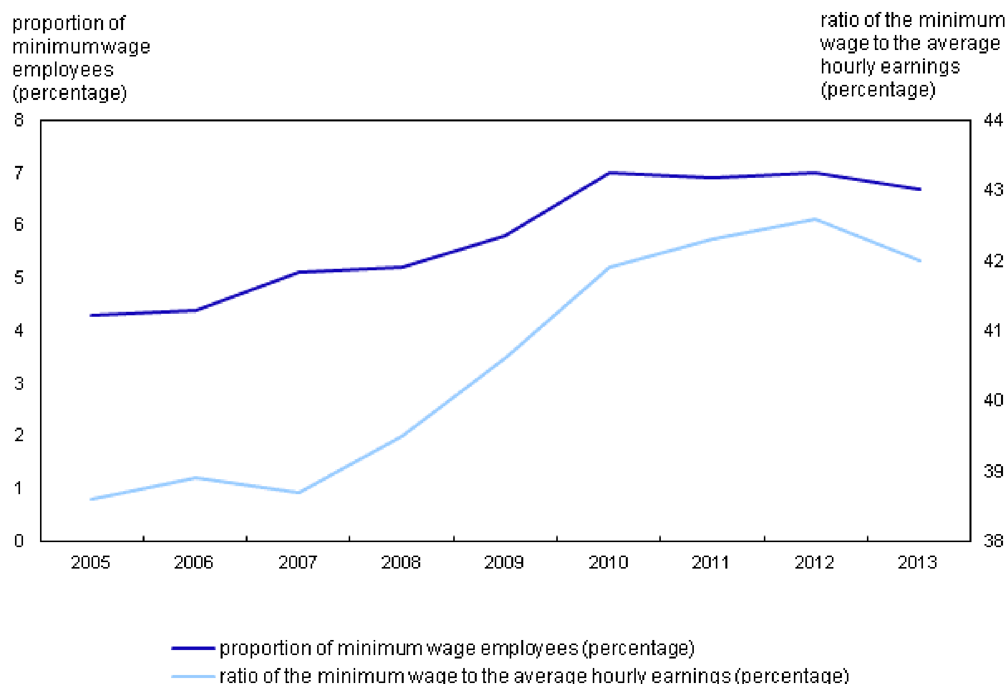
There has been a reaction, however, in both the literature and the actual results in some areas, including some US states, that have managed to rebound and even surpass results immediately prior to the recession. In the literature, there are differing perspectives on what works in such a situation, with policy emphases on making a market more attractive to investment through a restructuring of the tax code or tax incentives, an alteration of the minimum wage (which can manifest in a multitude of ways), and a limitation in the influence of unions. For the purposes of this study, we will look primarily at the considerations for tax and wage reforms in broad terms, as the influence of Canada's unions likely prevents any implementation of a Right-to-Work policy, which would be the first likely step in limiting the functions of unions. As such, what will follow is a brief examination of the vast literature surrounding improved attractiveness to investment and competitiveness in the global market, with particular emphasis on possible measures to be taken in adjusting tax and wage structures to benefit the stated end of attracting capital and stimulating growth.

Adjusting the Wage Structure

Among the first proposals made when attempting to generate economic success through increased investment and competitiveness is an adjustment of the wage structure, which is substantially out of balance between the developed and underdeveloped parts of the world. While countries such as Russia, China, India, and Mexico have maintained minimum wages near $1 USD/hr, Canada's is approaching $10 and there are proposals to increase the federal minimum in the US to as high as $15/hr (Wage Indicator, 2016). This wide wage disparity is partially accounted for in cost of living disparities, but there is no doubting which market is more attractive to businesses seeking to maximize profits and minimize costs.

Particularly amidst stagnating growth, Western countries are increasingly under pressure to address this wage gap in order to attract investment, which will naturally generate an influx in capital and jobs. As MaCurdy (2015) has pointed out, there are minimal targeted benefits from the minimum wage and it presents a number of hurdles to conducting business and attracting companies. Indeed, MaCurdy among others has demonstrated that the minimum wage does not successfully target poverty and poor families, rather being distributed among each financial bracket. Equally troubling, as the below figure demonstrates, an increase in the minimum wage as a ratio to average hourly earnings generates a slight but significant increase in those earning minimum wage, creating a surplus of labor in low-wage, mostly unskilled work and an increase in those earning well below the average wage, which has its obvious effects on poverty while further weakening the attractiveness of the market to investment. This clear correlation suggests a hindering of upward mobility by the minimum wage, making low-wage, unskilled jobs more attractive than they should be and skewing the direction of the workforce.

Impact of minimum wage on proportion of those earning minimum wage, Canada 2005-2013



Source: Galarneau and Fecteau (2014)

As the table below suggests, changes in the minimum wage generate inconsistent results related to poverty, with certain ranges proving significant, but overall there is minimal correlation presented that suggests a predictable impact on poverty from an increase, introduction, or decrease of the minimum wage. One of the most common justifications for the implementation or increase in the minimum wage, it would seem therefore, has been largely debunked by previous empirical studies.

Effects of Minimum Wage/Changes Thereof on Poverty

Model	Effect of a Minimum Wage Increase on Poverty
Textbook Model with No Income-Sharing	
Case where $0 < z \leq \hat{w}$	Poverty increases.
Case where $0 < \hat{w} < z$	
$\alpha = 0$	Poverty is unchanged.
$\alpha = 1$	Poverty increases (decreases) if η is greater (less than) one.
$\alpha > 1$	Poverty increases (decreases) if η is sufficiently high (low) and/or α is sufficiently low (high).
Textbook Model with Income-Sharing	
Case where $xb\hat{w} < z < \hat{w}[1-b(1-x)]$	
$\alpha = 0$	Poverty increases.
$\alpha \geq 1$	Poverty increases (decreases) if η is sufficiently high (low).
Case where $xb\hat{w} < \hat{w}[1-b(1-x)] < z$	
$\alpha = 0$	Poverty is unchanged.
$\alpha = 1$	Poverty increases (decreases) if η is greater (less than) one.
$\alpha > 1$	Poverty increases (decreases) if η is sufficiently high (low) and/or α is sufficiently low (high).

Source: Fields and Kanbur (2005)

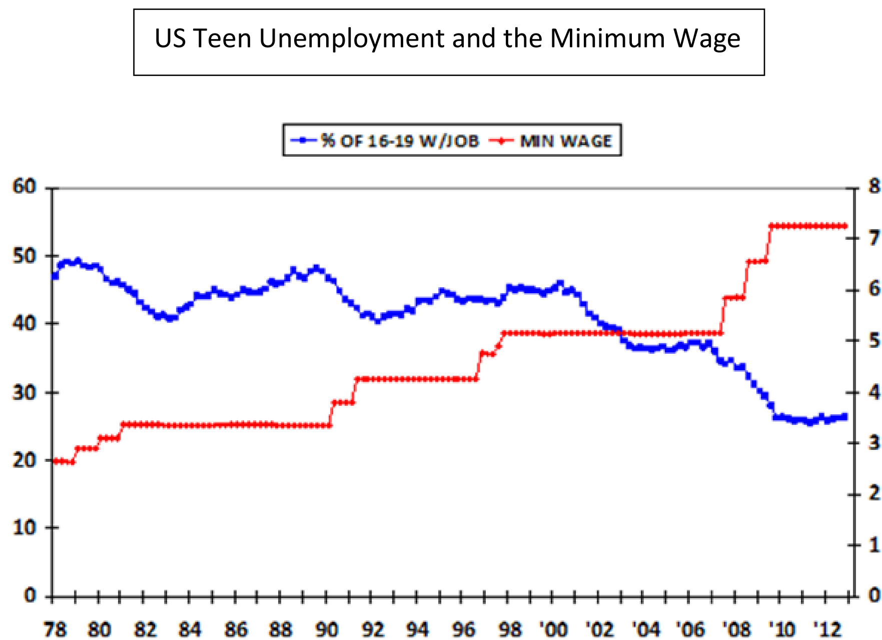
In practice, the costs incurred by an increased minimum wage can be addressed by a company in one of three ways: a loss in profits, a decrease in employment, or an increase in the prices of goods for consumers. As Rebitzer and Taylor (1995) and Card and Krueger (1995) demonstrate, the introduction or increase in the minimum wage does not reduce profits for employers, meaning that these additional costs are paid for either in layoffs or increased prices. There is a range in perspectives at this point, with Brown, Gilroy, and Kohen (1982) demonstrating that the result of a 10% increase in the minimum wage can be a reduction on teen employment by as much as 1-3% while MaCurdy asserts that 'prices for low wage goods will rise' (7).

There is, therefore, some question as to the particular effects felt from the hurdle of minimum wage. As Zavodny (2000), Allegretto et al. (2010), Giuliano (2013), and Meer and West

(2015) have demonstrated, there are 'very small to no effects of the minimum wage on the level of employment'; '[a]lthough it reduces demand for labor by raising the marginal cost of employing a new worker, a higher minimum wage increases the gap between the expected returns to employment relative to unemployment, inducing additional search effort from unemployed works.' Meer and West do, however, find that '[a] permanent ten percent increase in the real minimum wage causes about a 1.7 percent decline in total employment' (17), with 'consistently…negative effect[s] of the minimum wage on job growth' across their three administrative data sets (22).

Furthermore, it has been demonstrated by numerous studies that the most drastic of impacts felt by an increase in the minimum wage is among teen employment, which is significantly impacted by the drop in demand for low wage labor. Furthering this, as has been touched on earlier, an increase in the minimum wage, and thereby wage equilibrium as a whole, has been shown to negatively impact the quality of jobs available and the quantity of skilled, upwardly mobile workers. Therefore, a decrease in the minimum wage and adjustment of the wage structure can increase market competitiveness in a number of ways, not the least of which being a rise in the demand for skilled labor and an increased desire by workers to leave low paying jobs sooner.

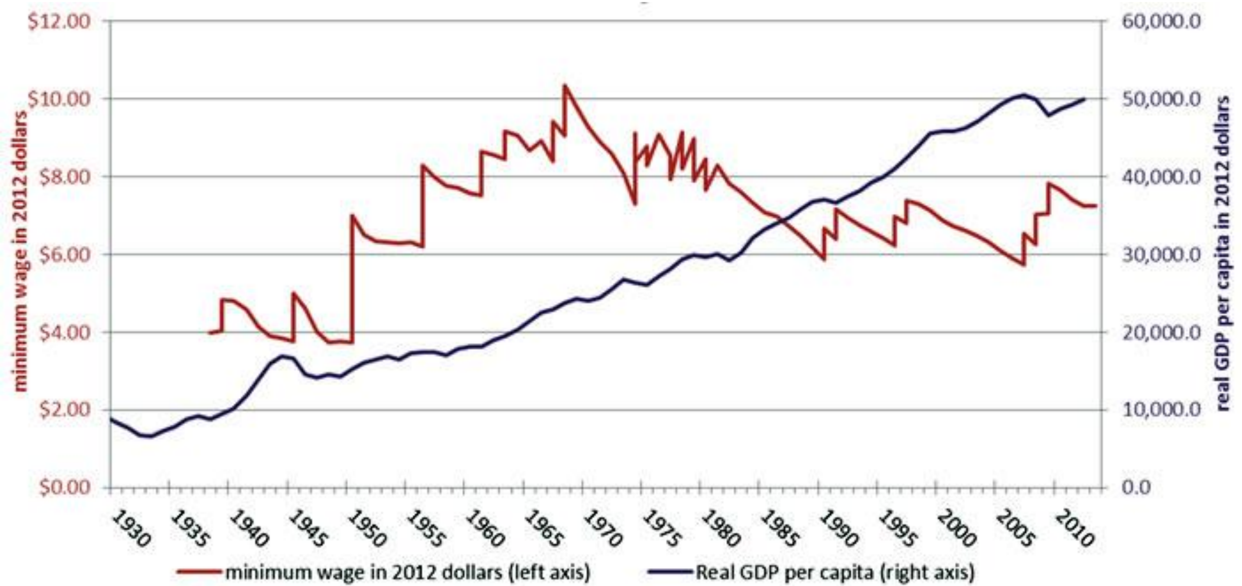
US Teen Unemployment and the Minimum Wage



Source: Worstoll (2015)

The empirical results, therefore, are a mixed bag to say the least. While an increase may not generate the loss in employment that might have been expected, there is still a statistically significant impact, particularly on teen employment, as well as the presumed impacts felt by an increased population making minimum wage or even slight increases in prices, which likely would disproportionally affect poor families relying on low-wage goods in a way that changes in the minimum wage, positive or negative, do not. Furthermore, the Fraser Institute's annual *Economic Freedom of North America* report for 2015 asserts that '[h]igh minimum wages restrict the ability of employees and employers to negotiate contracts to their liking', thereby diminishing economic

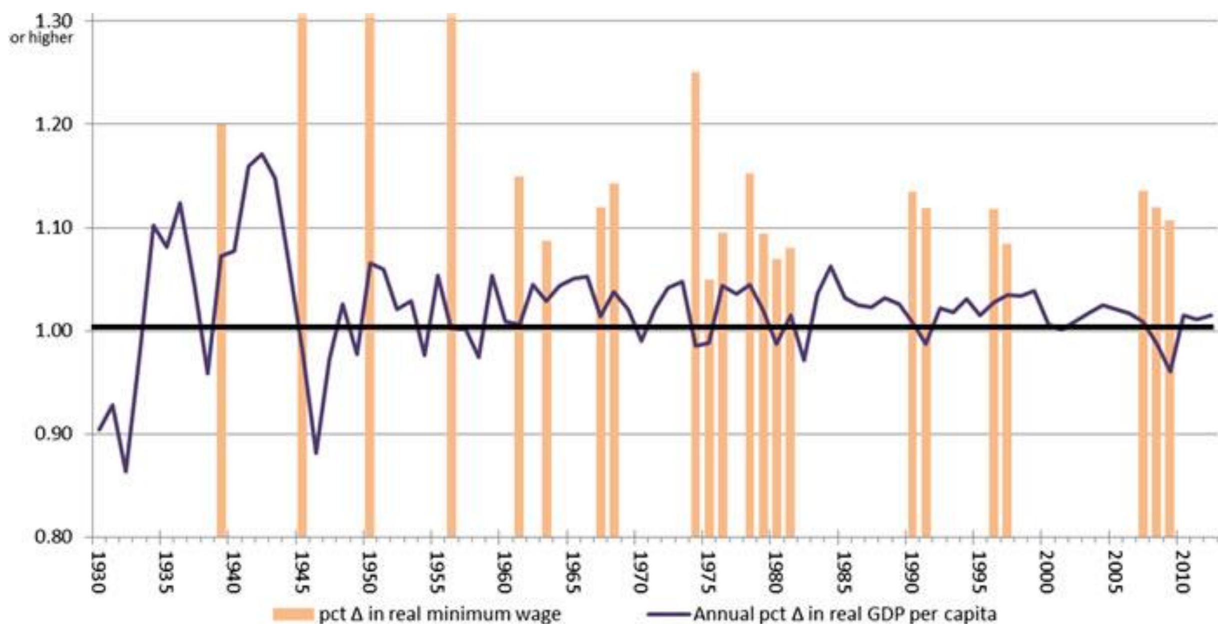
freedom and providing a hindrance to free operation that businesses crave when moving into a new market or expanding their presence within already established markets (12).



Real GDP per capita compared to real minimum wage, 1930 to 2012

Source: US Department of Labor (2012)

Annual change in real GDP per capita, compared to change in real minimum wage



Source: US Department of Labor (2012)

In addition to the effects, ambiguous as they may be, on real employment and wages, the above figures demonstrate the lack of correlation between minimum wage and growth, with data from the US clearly indicating that an increase or decrease in the minimum wage has no bearing on the overall projections of growth, as measured by GDP per capita. Each of these figures illustrates a

fluctuating minimum wage, increasing and decreasing with the sociopolitical and economic climate, parallel to a fairly stable, steady growth in real GDP. Subsequently, this ineffective tool for addressing poverty and wage disparities is further ineffective in targeting economic growth, with inconsistent results to adjustments in the minimum wage and therefore a lack of evidence supporting an increase, or even continuation, of a minimum wage given the priorities of competitiveness and economic growth.

Income Mobility in Canada

In Canada, there is a specific argument to be made regarding the effect of minimum wage levels on poverty and social elevation; having clearly demonstrated that an increase in minimum wage bears little to no advantage for the economy as a whole nor for employment or poverty levels, the final nail in the coffin, so to speak, of a high Canadian minimum wage is the potential ramifications of such a policy on upward mobility, a particular strength of the Canadian system. As has been demonstrated, teen employment is significantly impacted by policies targeting the bottom range of wages, with increases generating a decrease in teen employment. Furthermore, an increase in the minimum wage fosters an increase in the number of people earning the minimum wage, potentially establishing a worrying trend.

As has been demonstrated by multiple Fraser Institute studies (Grubel, 2016; Lammam, 2016; Lammam and MacIntyre, 2016a), the propensity for a Canadian worker to remain among the rank of 'the poor' is low, with the vast majority moving into the higher quintiles. This is an economic asset for Canada and, based on the results of this study, would be diminished by an increase in the minimum wage. While increases in income levels for the poorest Canadians have been marked and consistent, increasing 180% between 1990 and 2009 (Grubel, 2016), a notable 87% of those in the bottom 20 per cent as of 1990, according to the Fraser Institute's study based on data from Statistics Canada, had elevated their position into one of the higher income levels by 2009 (11).

While an increase in income levels and subsequent success in elevation of one's economic status might suggest that artificially raising wages could amplify this same trend, the data simply does not support that in Canada's case. Indeed, though mobility and rapid improvement in circumstances has coincided with naturally increasing wages, the factor that is key to the success of such a trend is the temporary manner in which poverty is experienced in Canada. Indeed, this does not only apply to the poorest of Canadians, but to each of the income brackets. As the following table demonstrates, a majority of Canadians experienced an increase in income, with the most consistent movement among the bottom four quintiles (Lammam, et al., 2016).

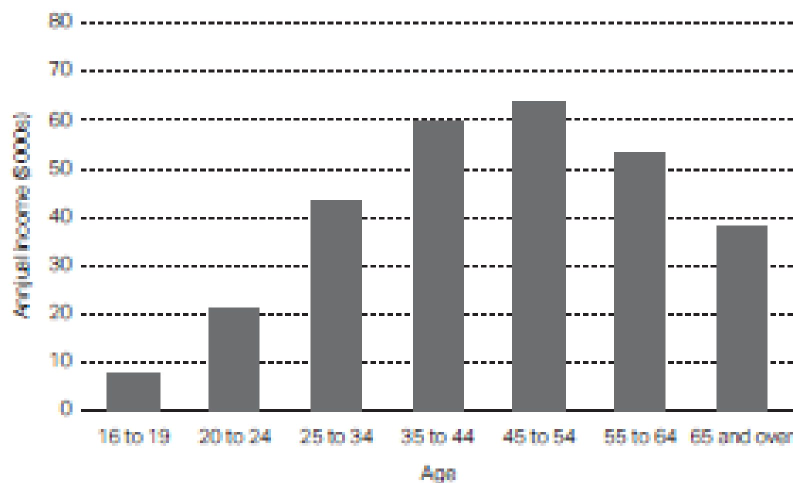
Canadian Income Mobility by Income Bracket, 1993-2003

Income group in 1993	Income group 10 years later: Percentage that moved into a higher income group	Percentage that moved into a lower income group	Total mobility (%)
Bottom 20%	87.5	0.0	87.5
Second	69.6	7.6	77.2
Third	50.7	14.6	65.3
Fourth	36.4	18.2	54.6
Top 20%	0.0	18.5	18.5

Source: Lammam, et al. 2016, p. 20

As such, what is clear, and what must be emphasized and understood when examining minimum wage policy with respect to Canada, is the function of income mobility and a fluid process of movement between each of the income brackets. As the below chart supports, poverty is, for the vast majority, a temporary stepping stone in the natural evolution as one integrates, embraces, and achieves within the modern economy. As one ages into peak earning years, typical incomes follow suit and increase to a certain point, illustrating an average economic lifecycle as individuals move up and down the income ladder over the course of their lives. Resultantly, increasing wages at this bottom income bracket would not only artificially inflate wages and have the predictable impact in that regard, but it may also remove incentive to elevate oneself out of the lowest income brackets, crippling upward mobility and severely hindering the recycling and education of the Canadian workforce (Veldhuis and Clemens, 2016).

Annual Income of Canadian Men, 2008



Source: Grubel, 2016, p. 37

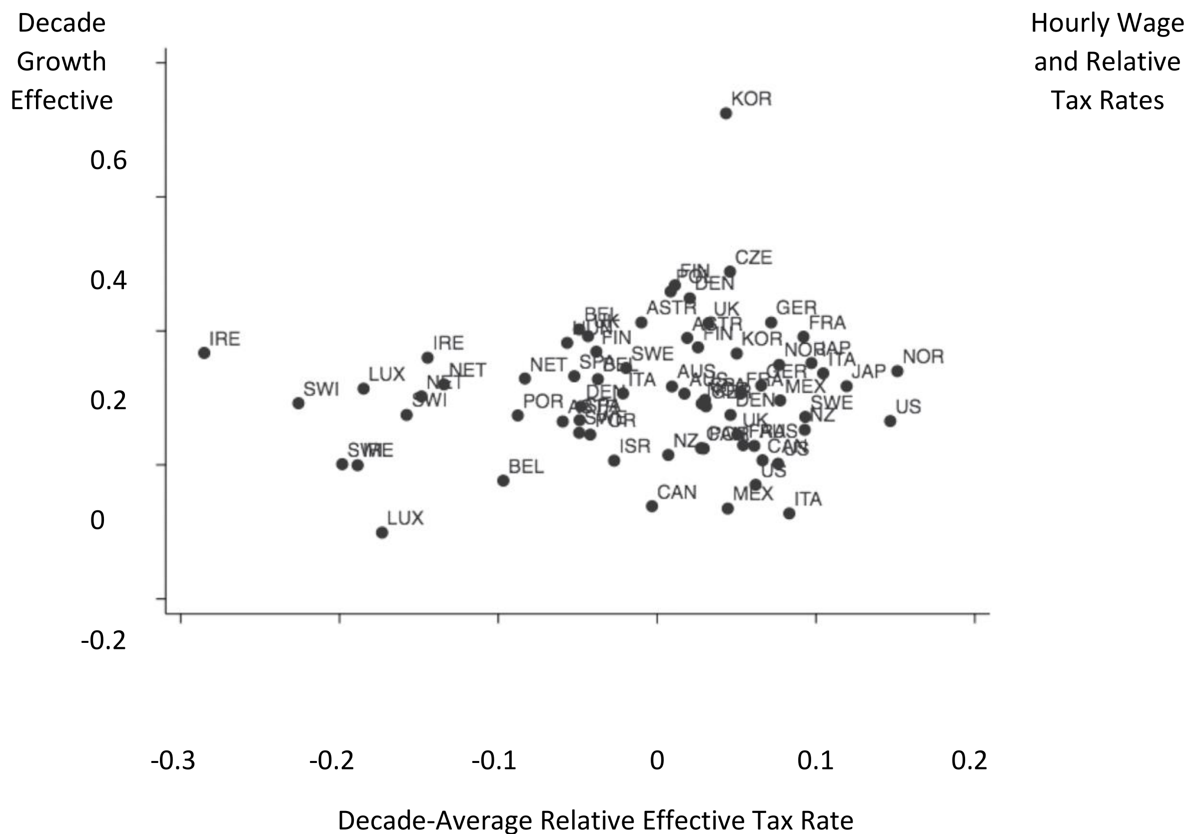
In all, much of the evidence in the literature and data clearly suggest that the minimum wage does not fulfill the role that its proponents often claim. As a poverty tool, it is widely ineffective; failing to target specific sectors of the populace and distributing the benefits widely rather than working to elevate specifically those in need (e.g. the 13% who fail to get out of poverty). Furthermore, it has been demonstrated that increases in the minimum wage do not negatively impact profits, which suggests that the effects of higher wages are translated either in decreased employment or in increased prices for consumers. Multiple studies have presented a slight impact on the level of employment as a result of increases in the minimum wage, particularly among teens, as well as increases in the prices of low-wage products, which are usually consumed by poorer families. Additionally, the minimum wage fails the test as an effective growth mechanism, having minimal impact on changes in GDP per capita and only serving to exacerbate trends in investment and economic growth.

There is, therefore, significant reason to call for a decrease or lifting of the minimum wage in order to maximize the potential of a market, increasing attractiveness and growth potential and ensuring a free, steady flow of capital and labor. Minimizing or eliminating the minimum wage has the potential to impact growth, employment, and poverty in a more effective way than an untenable figure might, elevating the populace and economy as a whole and ensuring the freedom of employers and employees to negotiate wages and develop a more rational system for facing a highly competitive, increasingly globalized world (Stansel, et al., 2016).

Addressing the Tax Structure

Another category of reform that has been thoroughly studied and revealed to have a fairly significant impact on economic success and attractiveness is the design and function of the tax system, with particular emphasis on corporate tax rates and tax incentives. Such policies have been predominant in literature and empirical analyses for decades, with inconsistent results. According to Clausing (2013), '[t]he theory of corporate tax incidence suggests that corporate taxes are more likely to harm labor in a globally integrated economy. However, a review of the prior empirical work in this area fails to reveal persuasive evidence of adverse effects in labor…finding no robust link between corporate taxation and wages' (151).

This lack of a correlation between taxation and wages, however, should not be interpreted as an argument in favor of increased corporate taxation. Indeed, the evidence demonstrating that an increase in tax rates does not impact wages or employment significantly suggests that, given these results in labor, policies in this realm should be chosen on the basis of attracting businesses and generating sustained investment and growth, rather than increasing government revenue and spending. Indeed, as Clausing notes, there has been a recent trend among OECD countries to decrease corporate tax rates in the interest of attracting increased trade and investment; '…despite declining rates, corporate tax revenues have not declined in typical OECD countries…many corporate tax rate cuts have been accompanied by measures to broaden the corporate tax base' (173). As such, in typical implementation of decreased corporate tax rates, at least a portion of the drawbacks are accounted for by adjusting the corporate tax code as a whole in order to absorb the capital necessary to cushion the potential loss of revenue.



Source: Clausing (2013), 157

In this light, there is an extensive literature, including Schwellnus and Arnold (2008) and Vartia (2008), who offer an insight on the potentially negative impact corporate taxes can have on firms and industries' productivity levels among OECD countries. Lee and Gordon (2005), similarly, 'find a significant negative correlation between statutory corporate tax rates and growth for 70 countries during 1970-1997' (7-8). As such, Arnold (2008) concluded based on growth regressions of data from 1971-2004 that '…corporate income taxes have the most negative effects on GDP per capita' (18). Therefore, the literature, and data, would suggest favorable results from a reduction in the corporate tax rate for economic growth, as well as the subsequent benefits from increased capital and demand for labor. It has been shown that revenue will not be negatively impacted by such a move, and the benefits of attracting new partners and increased investment are undeniable given the influx of capital as well as demand for skilled and unskilled labor.

As Bellak, Leibrecht, and Stehrer (2008) argue in their report for the OECD, existing studies on the matter 'reveal that countries with a high corporate income tax rate receive less FDI' (4), supporting the argument that cuts to the corporate tax rate are vital in attracting investment when added to further reforms to make the market more competitive. These reforms can come in multiple forms, but 'should focus on lowering taxes and improving their unit labour cost position. Changes in unit labour costs might be achieved via productivity effects, e.g. resulting from lowering the share of unskilled workers, as larger wage reduction might not be a viable option. Thus, policies in these countries should focus on research and development and the education and training of workers' (19).

Tax Incentives

Therefore, the literature clearly supports the premise of reducing the minimum wage and burdens on investment in the form of taxes, while providing incentives in the form of an improved labor force and a favorable environment for R&D and an increase in skilled workers. These are points further advocated for by Economy Watch (2010); '[t]he business environment often requires work to remove onerous regulations, reduce corruption, and encourage transparency. Governments often also seek to improve their domestic infrastructure to meet the operational needs of investors.'

As such, it is vital, in seeking to understand effective policy choices for improved competitiveness and investment, to examine the effectiveness of fiscal and tax incentives that can be implemented in order to foster increased growth and investment through appealing to targeted industries and developing the infrastructure necessary for these industries to thrive. Though, as the Economy Watch report states, '[p]roviding fiscal incentives for attracting FDI is a subject of great controversy…[a] general consensus is developing in favor of certain incentives which have been proven historically to grow profits and therefore foreign investments.' Often times, these incentives are designed with the specific goal of increasing investment, targeting particular sectors of the economy, and working to structure specific deals with major investors, such as multi-national corporations.

The concept of improved incentives for investment is a common consideration within the discussion of a restructuring of the corporate tax code. The attractiveness such policies can add to the market, allowing a developed market with high capital flows to compete directly with cheaper markets by specifically targeting an industry, such as specific areas of a struggling manufacturing sector, has been examined at length, with conflicting results. In theory, tax incentives or reductions will decrease the cost of capital to the firm in question and, therefore, generate further investment as benefits continue to exceed the costs. As Klemm and Van Parys (2010) identify, however, the correlation between implementation of tax incentives and private investment can be tentative at best.

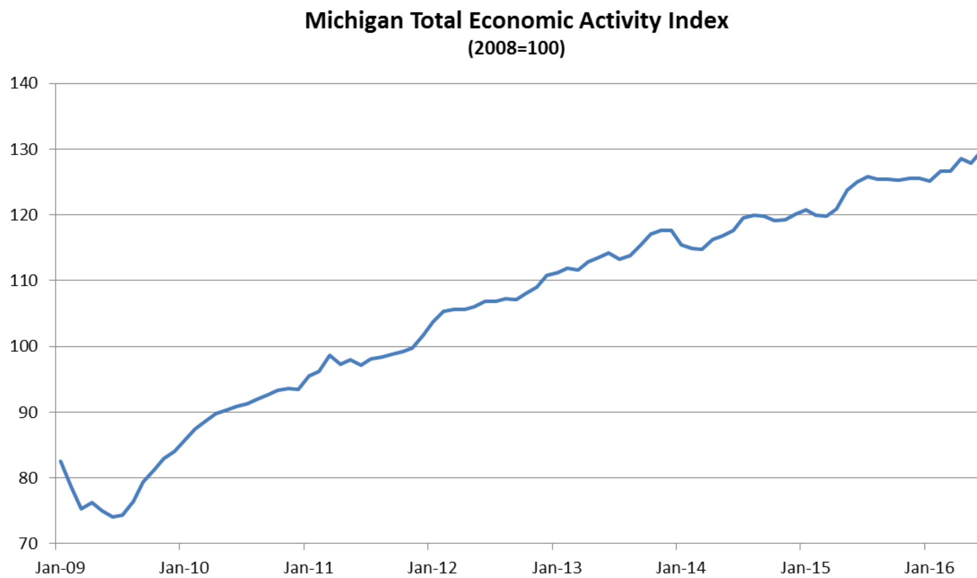
These policies, nonetheless, have come to be implemented by as many as 27 OECD member states as of 2013, versus 12 in 1995, as a way to compete with states such as Brazil, Russia, India, and China, who offer extensive credits for investment and R&D, as well as those whose overall tax environments are particularly business-friendly, such as in Germany and Sweden (Gokhberg, Kitova, and Roud, 2014, 19). The concern with these types of policies, certainly, becomes an excess of government expenditure for minimal gain or 'limitations on the range of beneficiaries, which are mostly major transnational companies (1,500 of such companies account for 90% of global R&D expenditure)' (20). In fact, according to the results of Gokhberg et al., the short and long term results of tax incentive programs as an actualized policy are 'heterogeneous, ambiguous and often disparate' (22).

<u>Discussion: The Example of Michigan</u>

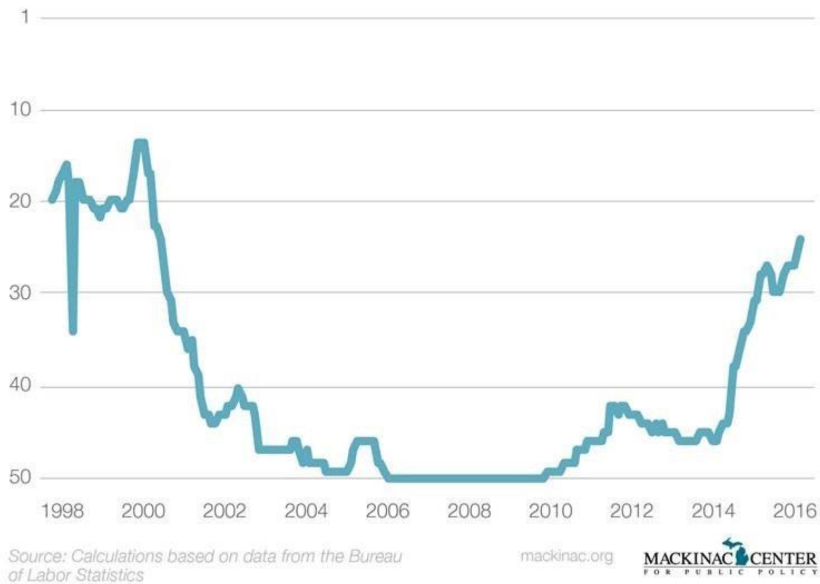
It is, therefore, evident from the literature that there are certainly measures which can be employed to generate economic growth and help an economy adjust to the wave of globalization. As has been shown, policies such as a minimum wage, corporate taxes, and tax incentives can have a significant impact on the success of a market; serving to attract, or stifle, investment and the subsequent influx of capital and jobs. It is important, however, when analyzing any policy set, to study the relevant cases such as those which have recently implemented similar policies.

With this in mind, the Fraser Institute recently released a study (Murphy, Emes, and Eisen, 2016) examining the remarkable economic turnaround experienced by the US state of Michigan

since the recession, with a key comparison to its similar neighbor in Ontario. Similar to the proposals the author of this study has made, the Fraser Institute reveals a key set of reforms that aided in the surprising success the state has experienced of late. Specifically, Michigan has instituted substantial tax reform, government expenditure and employment cuts, and Right to Work policies, which we haven't covered here. In the realm of tax cuts, Michigan made significant cuts to their business tax (MBT), both in general and for specific industries, 'including auto dealers, construction contractors, self-employed individuals, and members of partnerships and limited liability companies' (29).

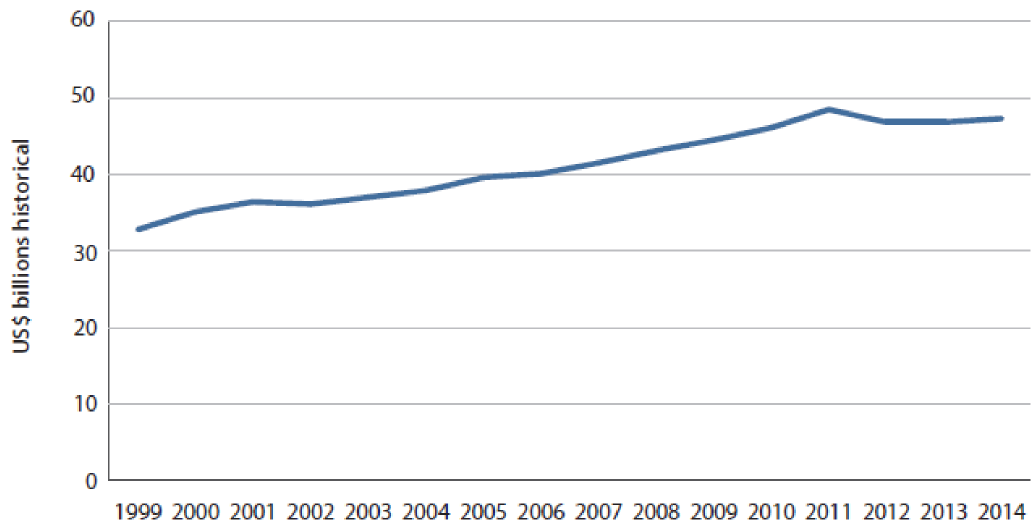


Source: Sanabria (2016)



Source: Gantert (2016)

Further alterations were to be made, however, with the MBT becoming a Corporate Income Tax (CIT), which significantly simplified the previously onerous system and instituted a flat 6% rate. Effective 2012, this drastic reform of the tax structures would prove significant in Michigan's overall turnaround, yielding improved tax freedom rankings from 49th to 7th for corporate taxes (30). Despite these significant reforms and the resultant cuts to corporate tax rates across the board, the following table clearly demonstrates that government revenues have remained stable, which certainly contrasts with the expectations of proponents for an increased corporate tax rate.

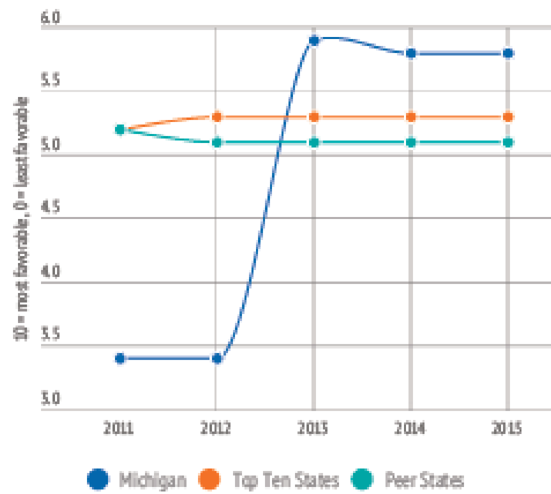


Source: Murphy, Emes, and Eisen (2016), p. 31

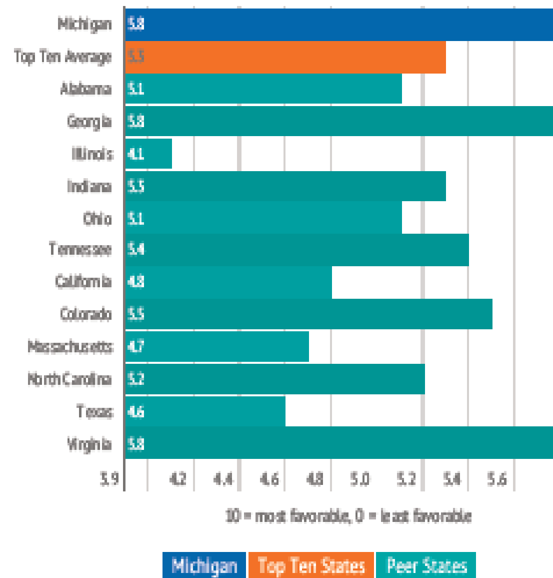
Furthermore, the specific incentives for particular industries, namely the automotive industry, that preceded the implementation of a flat corporate tax were a key first step in salvaging a floundering automotive industry with some of America's key manufacturers on the verge of collapse. Though there were indeed many federal incentives as well, particularly the bailout packages, Michigan's initial tax reform packages followed suit, suggesting that a combination of specific and wide-ranging cuts to corporate tax rates may be a reasonable option for consideration.

Indeed, the steps taken by Michigan has allowed the state to outperform many of its peer states in recent years, thanks largely to a business tax climate that has ranked around the top nationally (Walczak, et al., 2016). With Michigan's per capita GDP growth from 2013-2014 ranking 3rd nationally, there is a clearly accelerated rate of growth and recovery, particularly considering its continued presence among the lowest GDPs per capita in the US since the pre-recession years. Though there are a number of factors at work allowing the state to succeed, it is the purpose of this study to argue that its restructured, more favorable tax climate has been the most influential. Indeed, the other major aspect of Michigan's reforms was the implementation of Right to Work (RTW) in 2013; there are only three RTW states ranked in the top ten for economic performance, and only ten in the top twenty (Kiersz, 2015). Furthermore, as the below figure demonstrates, the top ten states in terms of economic performance have an above average, and more favorable than Michigan's peers, corporate tax climate. Michigan, however, exceeds even the top ten performing states, ranking among the top ten for corporate tax climate (Business Leaders for Michigan, 2015).

Corporate Tax Climate Trends



Index: Corporate Tax Climate Standings



Source: Business Leaders for Michigan (2015)

Source: Business Leaders for Michigan (2015)

Indeed, the steps taken by Michigan are a key example for Ontario and similar areas, demonstrating results consistent with the expectations of much of the literature and parallel to much of the data that has been accumulated. Though Michigan has, indeed, been gradually increasing their minimum wage, it is not yet clear what the long term impacts will be in this case, with the implementation gradually from 2014 to 2018, at which point analysis of its impacts will be more effective. This difference between the Fraser Institute's chosen case and our study aside, the lesson from Michigan's economic turnaround is simple: an economic environment that is attractive to investment and fosters more-free business operations can be vital in the modern global economy where growth and development among the richest nations is decided by such narrow margins.

Conclusions

There are, therefore, a number of conclusions to be drawn from the literature and data presented in this study. Firstly, there is a clear theoretical perspective on the policies which best amplify a market's economic competitiveness and attractiveness, focusing on restructuring the minimum wage for greater freedom and skilled employment, minimizing corporate taxes to simplify the burdensome tax system and address one of the primary factors in attracting new investment and capital, and, in some cases, providing specific incentives to target at-risk industries whose success is vital. Each of these policies has proven to generate the types of investment and economic growth necessary for competing in a global economy.

With the minimum wage clearly not addressing many of the issues its proponents claim, and with minimal correlation between it and growth or employment, there is little reason to continue to emphasize it as a plausible option for targeting poverty or wage disparities. Indeed, an increase in the minimum wage has been shown to lessen the quality of labor and prevent the kind of upward mobility necessary to maintain a functioning market. It has therefore been suggested that a decrease or elimination of the minimum wage might serve to have the type of impact, through the overall economic activity generated, that is desired from such policies. Furthermore, a restructuring of the tax system is vital in attracting improved investment, incentivizing particular industries or creating a low general tax that allows for unhindered growth across sectors.

Each of these strategies has its benefits that have been demonstrated, though as is the case with many such policies the empirical results are ambiguous. It can generally be concluded, however, that the policy recommendations made in this study, as well as the examples found throughout an extensive literature and in the case of Michigan in particular, represent necessary adjustments to an economic system in need of making a recovery and transition into the globalized economy. By opening a market up to investment and lifting many of the burdensome policies which might obstruct or prevent a company's behaviors in that market, core industries and general economic performance as a whole will be significantly impacted as capital and a demand for labor flood the market.

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