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The Power of Comprehensive Policy Reform: Lessons for Ontario from Michigan

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Summary

- In recent years, Ontario has experienced weak overall economic performance and rising public debt. Further, the province has seen its manufacturing sector—once a primary driver of growth in the province—decline substantially.

- By comparison, the American state of Michigan—which has historically underperformed Ontario economically, has experienced a surge of economic and employment growth.

- This study compares the economic performance of Ontario and Michigan in recent years, examining a broad range of indicators including aggregate economic growth per person, private sector job creation, and fiscal outcomes (specifically the growth in public debt). On each of these indicators, Michigan has outperformed Ontario in recent years.

- The start of Michigan's recent economic turnaround was contemporaneous with the implementation of a robust and comprehensive pro-growth policy reform agenda which included both tax relief and spending reductions.

- In contrast to Michigan, during this period Ontario's provincial government implemented several significant policy changes that undermined the province's growth prospects.

- Given the state's strong economic performance, Michigan's reform package and economic turnaround deserve careful attention from Ontario's policymakers. Specifically, provincial policymakers should consider the example of how a new government in a neighbouring state implemented a comprehensive policy reform package that preceded a strong period of economic growth and positive fiscal outcomes.

Introduction

In recent years, overall economic performance in Ontario has been weak and the province's public debt has been rising. Further, Ontario has seen its manufacturing sector—once a primary driver of growth in the province—decline substantially.

Various policymakers and analysts have at various points attributed these outcomes to external forces entirely beyond the control of provincial policymakers, such as a global shift in manufacturing to developing countries. However, recent Fraser Institute studies show that US states near Ontario that have historically based their economies largely on their manufacturing sectors have had better fiscal track records than Ontario and have thus avoided a large run-up in debt. The conclusion of the analysis was that Ontario's growing debt cannot reasonably be blamed entirely on broad global economic trends (Murphy et al., 2015).

The present study sharpens the geographic focus of the analysis of that paper to a single US "Rust belt" state—Michigan. At the same, it expands the topical focus of the earlier paper by analyzing economic performance more comprehensively rather than focusing primarily on fiscal outcomes. Home of the Detroit automakers, Michigan has historically been a manufacturing powerhouse in the United States, and its geographical proximity to Canada makes it a natural jurisdiction for comparison to Ontario.[1]

[1] This paper builds on and updates a 2016 paper co-authored by Robert Murphy, Joel Emes, and Ben Eisen. The authors of this update recognize the contributions of all of the authors of that paper in building the foundation for this update and additional research and thank them for it. Any errors in this update, however, are the responsibility of its authors.

This study compares the economic performance of Ontario and Michigan in recent years, examining a broad range of indicators including aggregate economic growth per person, private sector job creation, and fiscal outcomes (specifically the growth in public debt).

In addition to comparing the two jurisdictions' economic performance, this bulletin compares the economic policy trajectories of the two jurisdictions in recent years, analyzing the ambitious policy reform agenda that has been implemented in Michigan and discussing its possible relationship to the state's encouraging economic results in recent years.

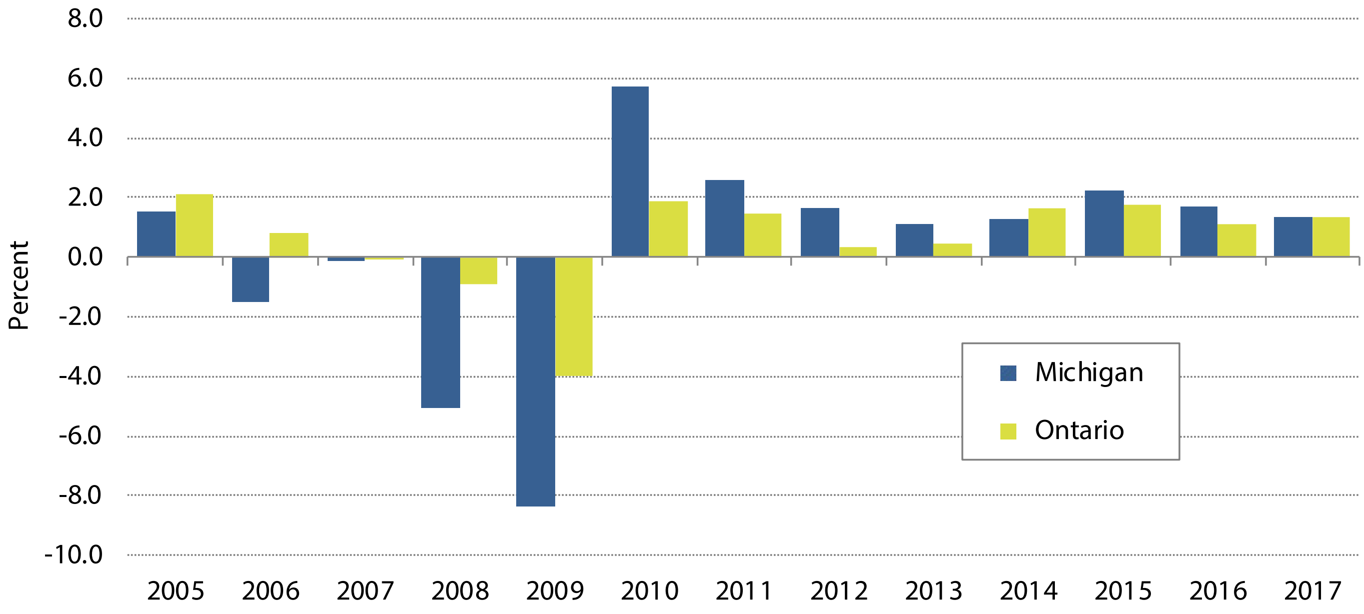
Comparing recent economic outcomes in Ontario and Michigan

In 2011 immediately following the election of Governor Rick Snyder, Michigan began implementing a substantial economic reform package. Key elements of this reform effort included:

- Right-to-work legislation (signed in 2012, and taking effect in March 2013);
- Tax reform—specifically, the replacement of the complex and onerous Michigan Business Tax (MBT) with a simpler and lighter corporate income tax at a single rate of 6 percent. This reform was effective as of January 1, 2012.
- Sharp budget cuts in fiscal year 2012, with only modest growth in total state spending since.

In the years prior to reform, Michigan endured a severe recession, and had suffered through many years of weak economic performance in the years prior to that recession. The whole package of reforms was ambitious and intended to reverse the state's then-discouraging economic trajectory. As with most comprehensive

Figure 1: Real GDP Growth per Capita in Michigan and Ontario, 2005 to 2017



Sources: Statistics Canada, 2019b, 2019d; US Bureau of Economic Analysis, 2019a, 2019b; International Monetary Fund, 2019.

economic reform packages, Michigan's reforms in the early years of this decade had both enthusiastic boosters and harsh detractors.[2]

The early evidence lends substantially more support to the former group over the latter. While for a number of reasons it is not possible to draw definitive conclusions about the impact of the reforms on economic performance in Michigan, it is clear that those reforms have coincided with a substantial improvement in economic performance. In short, there has been a remarkable economic turnaround in Michigan in the years following the implementation of its broad policy reform agenda.

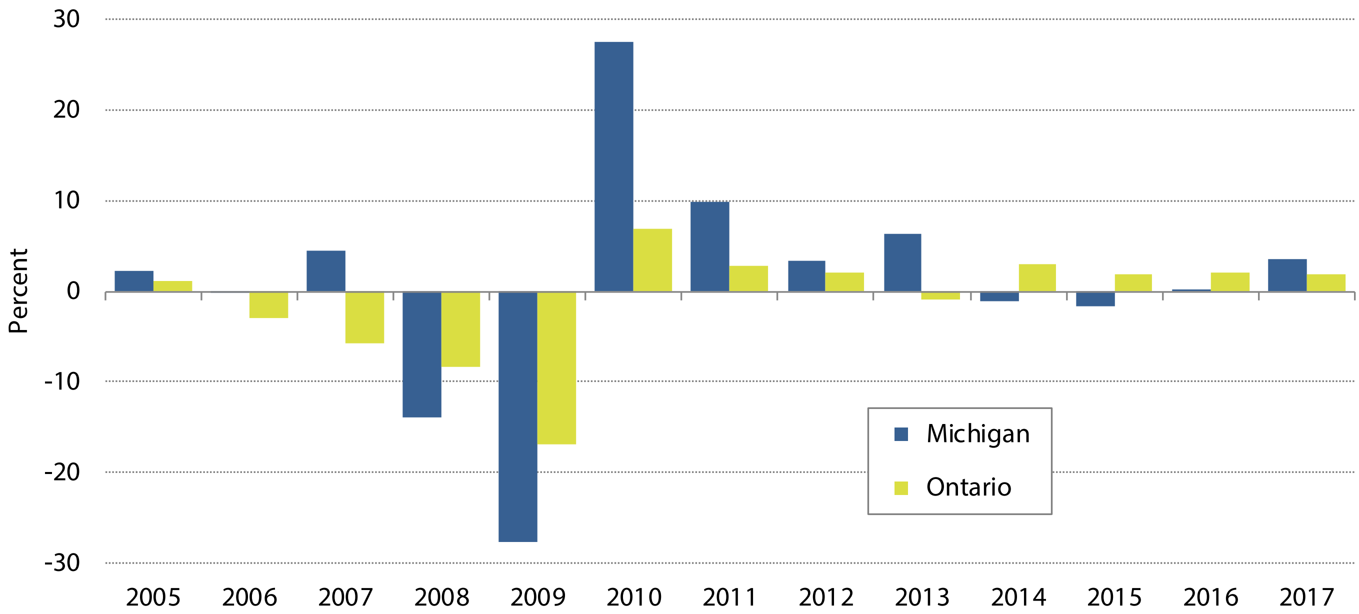
Michigan's economic performance has improved significantly in both absolute and relative terms compared to Ontario's in recent years, as this section of the bulletin indicates.

We begin with the broadest measure of economic health—real Gross Domestic Product per capita. This metric measures a jurisdiction's total per-person economic output. Figure 1 shows a stark reversal in the relative performance of Ontario and Michigan in recent years.

As figure 1 shows, in the pre-reform years, Michigan's real per-person GDP growth significantly underperformed Ontario's. Although Michigan's economy suffered a steeper recession than Ontario's during the global economic downturn of 2008/09, Michigan's underperformance compared to Ontario predates the recession. Michigan had experienced negative per-person growth in both 2006 and 2007, a

[2] Scholars for the Mackinac Center for Public Policy compiled, for example, a list of warnings about the impact of various legislation that had recently been implemented in Michigan (Hohman and Skorup, 2013).

Figure 2: Real Manufacturing Output Growth in Michigan and Ontario, Annual Averages, 2005 to 2017



Sources: Statistics Canada, 2019e; US Bureau of Economic Analysis, 2019a, 2019c; International Monetary Fund, 2019.

trend that persisted right through the recession years, up until 2009 inclusive.

Since the state undertook its economic reforms, however, the situation has reversed; Michigan's real per-person GDP growth has outperformed Ontario's. Between 2011 and 2017, annual real per-person GDP growth in Michigan averaged 1.7 percent compared to 1.2 percent in Ontario.

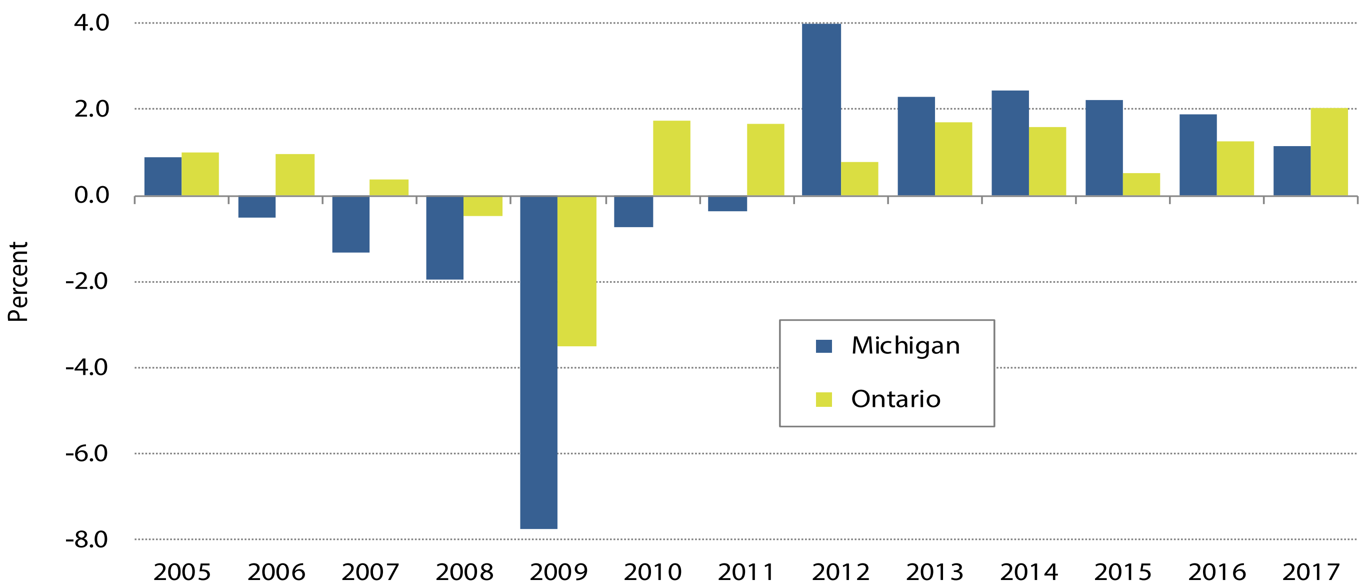
The pattern is similar if we focus more narrowly on manufacturing output. Figure 2 graphs real manufacturing growth rates in Michigan and Ontario.

Since 2011, annual real manufacturing output in Michigan has averaged 3.0 percent—significantly higher than in Ontario at 1.8 percent. In addition to coinciding with the start of Michigan's reform agenda, 2011 is a useful baseline year for comparison because it excludes both the steeper recession that occurred in Michigan as well as the commensurately larger rebound year in 2010 during which Michigan's manufacturing output grew dramatically.

Clearly, during the reform period, manufacturing output in Michigan has grown at a faster rate than in Ontario. Unsurprisingly, manufacturing employment has also grown at a much faster rate than in Ontario over this period, too. In fact, while Michigan has had annual average employment growth of 4.8 percent in its manufacturing sector, Ontario has had annual growth of only 0.1 percent (on average).

Overall private sector job creation is another important indicator of economic health. Here too, Michigan's performance has been stronger

Figure 3: Total Private Employment Growth Rates in Michigan and Ontario, Annual Averages, 2005 to 2017



Sources: Statistics Canada, 2019a; US Department of Labor, 2003–2017b.

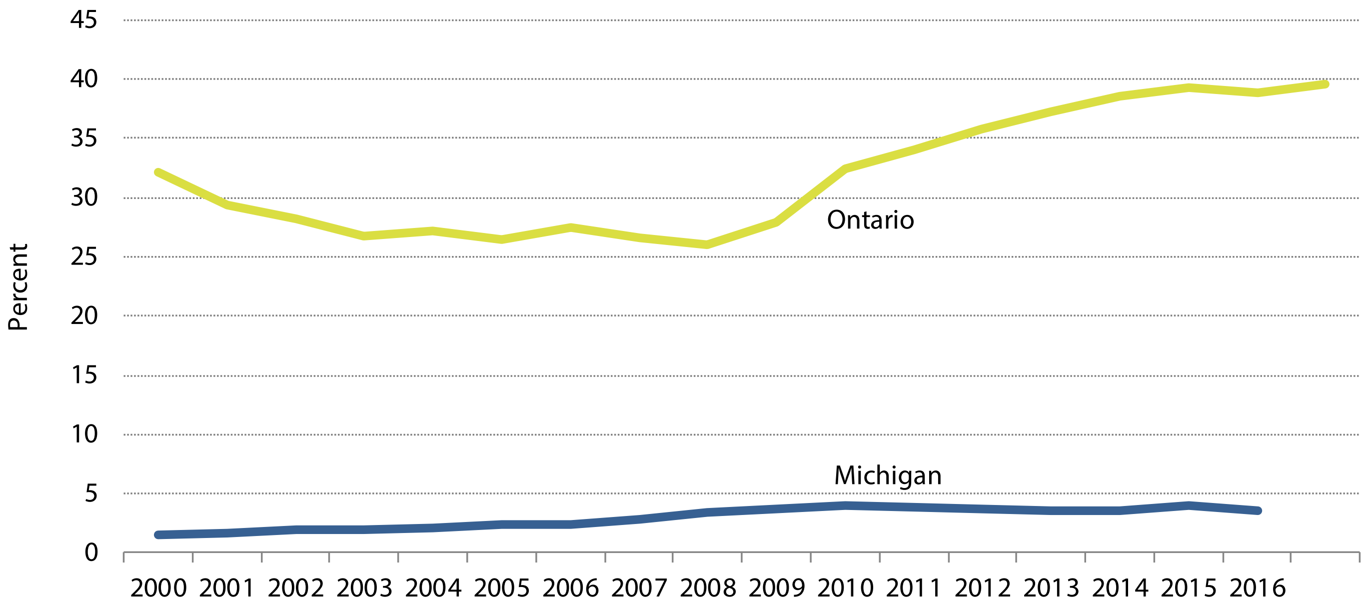
than Ontario's during the former's reform era. As figure 3 shows, Michigan's private sector job creation rate in the pre-reform era was very weak. Between 2006 and 2011, the state experienced 6 consecutive years of negative private sector job creation.

However, following the reforms, Michigan's turnaround for this indicator has been dramatic: it had 6 consecutive years of positive private sector job creation between 2012 and 2017. In fact, during the entire reform period (2011–2017), Michigan had stronger private sector job creation than Ontario in five out of the seven years. All told, during this period, Michigan averaged 1.9 percent annual private sector employment growth compared to 1.4 percent in Ontario.

Having discussed broader measures of economic success, we will now briefly compare fiscal outcomes in the two jurisdictions in recent years. For the period under analysis (and in fact dating back to 2008/09), Ontario has run continuous budget deficits which have resulted in substantial accumulation of debt. In fact, as figure 4 shows, provincial government debt as a share of Ontario's economy has increased significantly over the past decade—from 26.0 percent in 2008 to 39.6 percent in 2017.

Like Ontario, Michigan suffered a steep recession in the late 2000s. However, as figure 4 shows, unlike Ontario, Michigan has not substantially run up its public debt. In short, Michigan's fiscal outcomes have significantly outperformed Ontario's in recent years.

Figure 4: Net Public Debt as Share of the Economy in Michigan and Ontario, Fiscal Year 2000 to 2017



Sources: Finance Canada, 2018; Statistics Canada 2019c; Urban Institute and Brookings Institution, Tax Policy Center, 2019; US Bureau of Economic Analysis, 2019c.

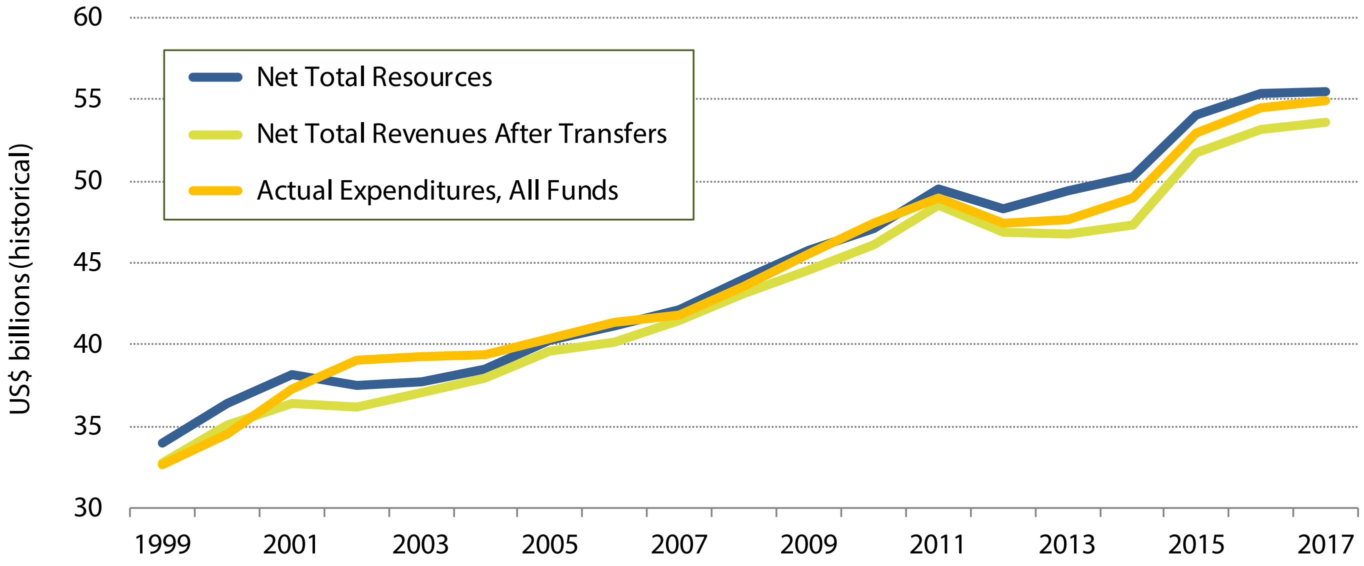
Michigan's policy reform package and possible lessons for Ontario

As we have seen, since it introduced its package of reforms in the early years of this decade, Michigan's economic turnaround has been remarkable. For years, the state was an economic laggard, but in recent years, Michigan has seen strong economic growth and private sector job creation. Further, after years of underperforming relative to its neighbour Ontario, in the post-reform years, Michigan's performance has been stronger than Ontario's on several indicators of economic well-being.

Due to the comparatively brief time window involved, the fact that several reforms were introduced nearly simultaneously, and the existence of a number of exogeneous factors that have influenced the economic performance of both Michigan and Ontario, it is hard to make strong causal statements about the impact of any specific policy change on the state's economic performance. However, given Michigan's remarkable economic turnaround in the years since the reform package's implementation and the fact that the state has outperformed Ontario in the years since, it would be prudent for Ontario's policymakers to study Michigan's initiatives to assess whether some or all of the reforms could help spur similar growth in the province. Specifically we will focus on the state's corporate tax reform as well as its approach to government expenditures and public sector employment.[3]

[3] For a detailed discussion of a further major dimension of Michigan's reform package—the introduction of a right-to-work law, see Murphy, Emes, and Eisen (2016).

Figure 5: Michigan State Government Expenditures, Total Revenues, and Total Resources (in US$ billions (historical))



Note: To maintain consistency from1999, FYs 2015 onward are based on the 2017/18 executive budget (beginning in 2018/19 budget data are updated but presented slightly differently). FY 2016, 2017, and 2018 are estimates (total resources and total revenues). FY 2017 and 2018 are executive recommendations (expenditures).

Sources: Michigan, State Budget Office, Budgets, various years.

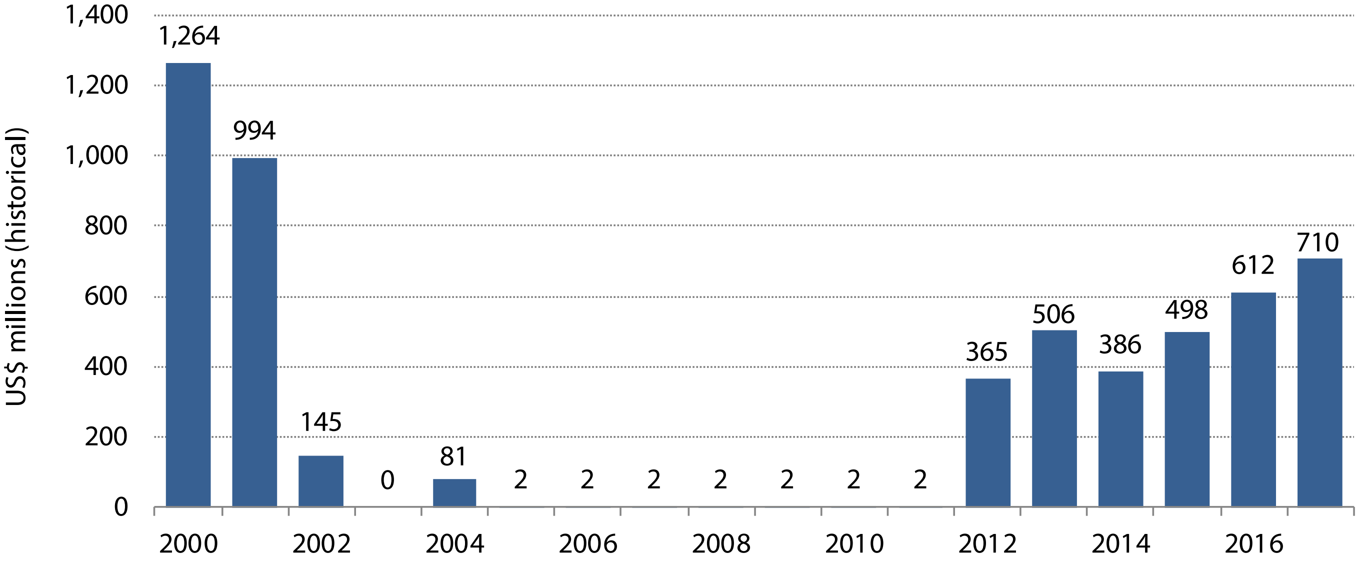
Tax reform

One of Michigan's most important policy reform initiatives was to tax policy. More specifically, the state implemented a substantial overhaul of its approach to corporate taxation during this time.

Prior to the 2011 reform period, the state maintained the complex and onerous Michigan Business Tax (MBT). The MBT gave significant yet arbitrary power to state officials. Gary Wolfram, an economics professor and former advisor to former Michigan Governor Engler, noted that the law gave the state's economic development bureaucracy the power to "grant credits to reduce or eliminate a firm's tax." Wolfram characterized this approach to tax policy as unfair, and as "the rule of man" as opposed to "the rule of law," where the rules of the game weren't even laid out in plain form by statute. Indeed, Wolfram was harshly critical of the MBT overall, stating, "There is no theoretical basis behind [the MBT]," which he went on to characterize as a "freakish combination" of a gross receipts tax and profits tax (Wolfram, 2010).

In this context, one of the most important elements of Michigan's policy reform package was the replacement of the MBT with a Corporate Income Tax (CIT), featuring a single flat rate of 6 percent. The impact on the state's overall tax competitiveness was transformative. An analysis from the Tax Foundation showed that in the area of corporate taxation policy, Michigan went from having the second worst policy

Figure 6: Michigan State Government Budget Stabilization Fund (in US$ millions (historical))



Source: Michigan, State Budget Office, Budgets, various years.

in the United States to having the seventh best. This dramatic change led directly to a substantial improvement in the state's ranking in the same analysis on overall tax policy (Tax Foundation, 2012).

Government spending and public sector employment

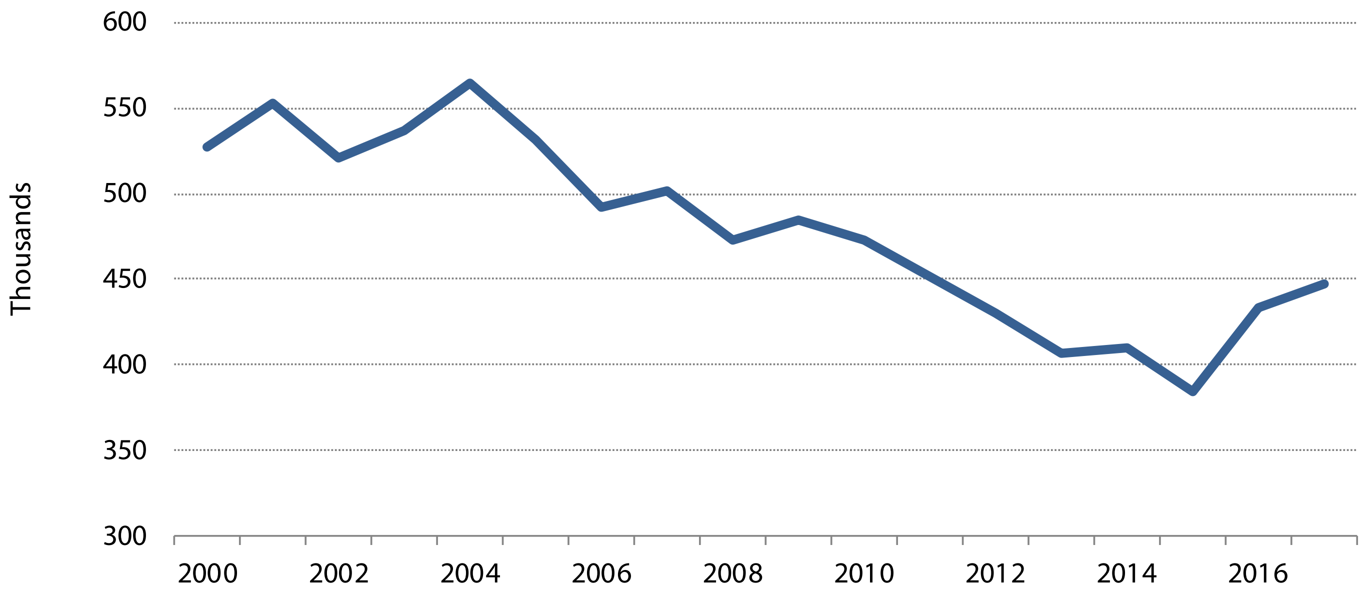
A key component of Michigan's 2011 reform agenda included a reduction in government expenditures. Figure 5 illustrates recent trends in government spending in Michigan.

Specifically, in Fiscal Year 2012, Michigan saw a meaningful nominal reduction in overall government expenditures. Total spending fell by 3.1 percent that year and spending growth was restrained in the next two years. This meant that by 2014, nominal spending levels were restrained such that nominal spending was still lower than it had been in 2011. Some critics warned that spending reductions would harm the state's economic recovery. On the contrary, Michigan enjoyed robust economic growth during the period in question.

Subsequent years have seen an uptick in spending growth. However, the 2012 spending reductions and the spending restraint in subsequent years has had a lasting effect on the state's spending levels. The executive recommendation (ie., the budget approved by the governor) for spending in 2018 was just 11.1 percent higher in nominal terms than it had been in 2011, 7 years prior.[4]

[4] Critics of government restraint have attempted to link this period of reduced government spending to the deplorable situation in the city of Flint, where

Figure 7: Michigan Government Employment, State and Local, 2000 to 2017



Sources: US Department of Labor, Bureau of Labor Statistics, 2000-2002, 2003-2017b, 2019.

The spending restraint exercised in the reform era helped ensure that Michigan did not acquire substantial new debt in the years following the 2008/09 recession, as occurred in Ontario. As noted previously, Michigan's net public debt as a share of the economy held steady at approximately three percent, while Ontario's debt burden climbed significantly during the same period. In fact, as figure 6 shows, by some measures, Michigan's fiscal health improved during this period. Specifically, the state's budget stabilization fund, which was essentially empty in 2011, grew to $710 million over this period.

residents were exposed to unsafe drinking water for 16 months. The evidence, however, does not support suggestions that the water crisis was an inevitable outcome of spending restraint, particularly given that there were available strategies to prevent the crisis that were "well within the means even of a cash-strapped city," according to regional experts (Dalmia, 2016).

How did Michigan achieve its spending reductions and subsequent restraint? Part of the answer is that the state was able to reduce public sector employment during the early reform period. Figure 7 shows that state and local government employment in Michigan fell sharply from 2010 through 2015. State and local government employment had already been falling for some time, but the drop accelerated during the reform years. State and local employment fell from 473,000 in 2010 to 384,000 in 2015. Employment levels have rebounded significantly in recent years, but as of 2017, public sector employment in Michigan at the state and local levels remained below 2011 levels.

Clearly, the reduction in state and local government employment in the years immediately following the 2008/09 recession were a contributor to the state's overall success in reducing and then restraining the growth of overall expenditures and preventing the emergence of substantial new debt such as occurred in Ontario during these years.

Conclusion: Lessons for Ontario

As of late 2010, Michigan held a dubious and longstanding reputation as an economic laggard in the United States. In 2011, however, Michigan embarked upon an ambitious reform program that included significant tax reform and spending reductions followed by a longer period of restraint. In the subsequent years, Michigan shed its reputation for weak economic performance, and has enjoyed robust economic growth.

While Michigan was embarking on its policy reforms, Ontario's government was simultaneously pursuing several policy choices that hindered the province's performance and made it more difficult for Ontarians to prosper (Cross, 2015).

Michigan has reversed the long-standing historical trend in which its economy underperformed Ontario's. Specifically, as this bulletin has shown, since 2011 Michigan has outperformed Ontario in terms of real GDP growth per person, private sector employment growth, and fiscal outcomes.

Given the state's strong economic performance in subsequent years, Michigan's reform package and economic turnaround deserve careful attention from policymakers in Ontario. Specifically, the still relatively new Ford government should consider how a new government in a neighbouring state implemented a comprehensive policy reform package which preceded a strong period of economic growth and positive fiscal outcomes.

Much like Michigan in 2010, and notwithstanding an uptick in performance in recent years, Ontario has recently developed a reputation as an economic laggard in Canada. In fact, one recent Fraser Institute analysis went so far as to characterize the period from 2007 to 2017 as a "lost decade" for Ontario's provincial economy (Eisen and Palacios, 2018).

Specific dimensions of Michigan's policy reform package are particularly worthy of Ontario's attention. Of perhaps greatest importance for Ontario is the state's pursuit of ambitious tax reform. Ontario currently has the second highest top marginal personal income tax rate in North America at 53.5 percent. Further, business tax reform at the federal level in the US as well as in several states (including Michigan) have essentially eliminated a tax advantage that Ontario once had in this area, thus reducing the province's overall competitiveness. Recently, domestic challenges to Ontario's business tax competiveness have also emerged; Alberta has committed to a significant reduction in its Corporate Income Tax (CIT) rate. In light of these factors as well as Michigan's experience in recent years, the Ford government should recognize the advantages of pro-growth tax reform in Ontario such as was implemented in Michigan in the early years of this decade.[5]

Ontario policymakers should also recognize how Michigan's example demonstrates that state/provincial spending trajectories play an important role in determining fiscal outcomes. Rapid debt accumulation can be avoided even in periods immediately following steep recessions if governments are willing to implement

[5] Eisen, Lafleur and Emes (2018) provided one blueprint for business and personal income tax reform in Ontario. That study's analysis showed the degree of spending restraint that would be needed to provide tax reform while also making progress towards a balanced budget.

spending reductions and/or periods of spending restraint in order to align revenues with expenditures. More specifically, Ontario would do well to learn from Michigan's policy experience and consider strategies for reforming and reducing provincial spending to quickly halt the province's string of deficits and begin reducing the province's debt burden.

Michigan's economic revival shows that even seemingly moribund economies can reverse course and become economic powerhouses. Further, the fact that the turnaround occurred in the years immediately during and following the implementation of a major policy reform package by a newly elected government should serve as an example for other struggling jurisdictions. More specifically, the relatively new Ford government in Ontario should carefully study Michigan's strong economic performance in recent years and embark upon a similarly ambitious pro-growth policy reform agenda.

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