# DO CITIES CREATE WEALTH?

## A Critique of New Urban Thinking and the Role of Public Policy for Cities

**PATRICK LUCIANI**

The AIMS Urban Futures Series, Paper #2

June 2004

The Atlantic Institute for Market Studies (AIMS) is an independent, non-partisan, social and economic policy think tank based in Halifax. The Institute was founded by a group of Atlantic Canadians to broaden the debate about the realistic options available to build our economy.

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PATRICK LUCIANI

*Based on a speech delivered to the*
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# About the Author

**Patrick Luciani** is AIMS Senior Fellow in Urban Policy. Mr. Luciani has an extensive background in public policy. He currently acts as Senior Advisor to the Canadian Statistical Assessment Services (CANSTATS), a media watch organization that comments on how the media covers public policy issues. He sits also on the boards of The Dominion Institute and the Global Cities Project, Munk Centre, University of Toronto.

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He is also the author of the best-selling book, *What Canadians Believe, But Shouldn't, about Their Economy*, published by Addison Wesley (1994) and has written many articles in the area of business and economics for the *Globe and Mail*, *National Post*, *Financial Post Magazine*, *Report on Business Magazine,* and *Canadian Business*.

Mr. Luciani studied economics at the University of Guelph and Queen's University and holds a Masters in Public Administration from the John F. Kennedy School of Government, Harvard University.

# EXECUTIVE SUMMARY

Over the past few years, there has been a flurry of academic papers and "informal" reports and studies documenting and arguing that cities are crucial to the overall health of the national economy. Politicians have taken hold of this "flavour of the month" and placed it centre stage with health and taxation as a core issue for the 2004 federal election campaign. They are calling for a "new deal" with cities that would restructure their financial relationship with Ottawa and provincial capitals. Major cities, it is argued, are the engines not only of economic wealth and growth in their regions, but drivers of the overall economy. Strong and prosperous cities mean a strong economy.

But is this view right? Are Canada's big cities really the engine of economic growth? If they prosper, will the country, too? Or are big cities simply where wealth is created and consumed? The distinction may be more than a question of semantics. The answer has important implications for whether senior governments should take an active or a passive role in public policy for cities.

In this, the second paper in the AIMS Urban Futures series, the author briefly reviews the three key arguments that justify a greater role for government policy (and government spending) in the affairs of Canada's cities. These arguments centre on the themes of clustering, the rise of the global city-state, and the importance of attracting educated workers or what has come to be known as the "creative class".

The conclusions run counter to the big spending ideas being promoted by politicians of all stripes:

- Cities have to be good at getting the basics right. That means good schools, good roads, safe streets, and reasonable municipal taxes — skilled workers will follow.
- Get the smart people and let them figure what sectors or industries to work in. Cities are complex creatures with their own cycles of growth, decay, and sometimes re-growth — overplanning is an overburden.
- Macro policy isn't dead: Getting fiscal and monetary policy right swamps anything we can do to micromanage wealth creation at the municipal level.
- Price public services correctly — an example, gridlock isn't simply a question of more or even better public transit, but of pricing externalities properly. On the same theme of fewer subsidies and more user fees, property taxes reflect an outdated model of the services municipalities provide.
- Eliminate unnecessary regulations — unnecessary and irrational zoning laws do more harm than most suppose.

In essence, the best urban policy is to deliver municipal services efficiently without the distraction of attracting specific clusters, creating global city-states, or attempting to attract knowledge workers without establishing an environment where businesses want to invest and expand.

# INTRODUCTION

Over the past few years, there has been a flurry of academic papers and "informal" reports and studies documenting and arguing that cities are crucial to the overall health of the national economy. Increasingly, politicians, scholars, and policymakers are calling for a "new deal" for cities that would restructure their financial relationship with Ottawa and the provincial capitals. They argue not only that major cities are the engines of economic wealth and growth in their regions, but that they also drive the overall economy. Strong and prosperous cities mean a strong economy

Here is what one report, prepared by TD Economics (2002), says about Canada's largest city: "Canada's economic future depends on the fate of our cites and none more so than the [Greater Toronto Area]…Building a more prosperous GTA will benefit not just local residents, but the country as a whole…[I]ts health and vitality are critical to Canada's ability to bolster its standard of living and compete on the world stage".

The Toronto City Summit Alliance (2003) continues on the same theme: "With its five million residents, one-fifth of Canada's entire GDP and 40 percent of Canada's business head offices, the GTA is Canada's largest driver of economic activity and the source of significant spin-offs throughout the country".

In another paper, by the Canadian Policy Research Networks, the author writes, "In a globalized world, the quality of local places [has] become crucial to citizen well-being and national prosperity. Yet our cities, on the front lines in the search for innovative sustainable solutions to the challenges of the global age, lack the means to contribute fully to the updating and redesigning of our physical and social infrastructure" (Bradford 2002).

The same theme runs through a number of other studies, published by such places as the Institute for Competitiveness and Prosperity at the Joseph L. Rotman School of Management at the University of Toronto, the Federation of Canadian Municipalities, and the Canadian Urban Institute.

To push for a new agenda, the mayors of Canada's five largest cities have joined forces to call for a new relationship with senior levels of government.[1] Some have even called for a new constitutional relationship where city-states would be put on an equal footing with the provinces. And the prime minister, in one of his many promises, even wants mayors at the cabinet table. Cities are now exempt from GST payments, and we'll probably get some sort of gas tax revenue sharing scheme down the road.

1 "Urban cowboys",. *Globe and Mail*, November 15, 2003, p. C5.

Is this view right? Are Canada's big cities the engine of economic growth? And if they prosper, will the country? Or are big cities simply where wealth is created and consumed? The distinction may be more than a question of semantics. The answer has important implications for whether governments take an active or passive role in public policy for cities and municipalities.

Here, I briefly review what I think are the three key arguments that justify a greater role for government policy in the affairs of Canada's big cities. These arguments centre on the themes of clustering, the rise of the global city-state, and the importance of attracting educated workers — or what has come to be known as the "creative class". If you hold that big cities are the way of the future, then you're likely to support any or all of these arguments. These are examples of what I call the "new urban thinking" and why cities have grabbed the attention of policymakers at all levels of government. I believe that this "new urban thinking" is just another name for "new industrial policy", with an urban twist: a justification for greater state involvement in urban affairs. Industrial policy once focused on specific sectors and companies; now, that attention has turned to places.

## *Why Cities? Why Now?*

What's behind this new interest in cities and how they develop? One reason is the growing political clout of urban areas: more of us now live in cities than at any time in Canadian history.

Futurists such as Alvin Toffler, who predicted the end of cities with the advent of information technology, got it wrong. North Americans have rushed in greater numbers to urban and suburban places. Today, about 80 percent of Canadians live in cities (compared with 75 percent of Americans). We have to go back to 1930 to find a time when fewer than 50 percent of Canadians lived in cities. Not only are we an urban country, we seem to be concentrating in fewer cities. Today, about half of Canada's population lives in just 10 cities. Because of this shift, urban problems are now national problems.

Anyone who has to commute in and out of Toronto has seen a dramatic increase in road and transit congestion along with an inability to keep up with crumbling roads and highways. And the whole country knows of Toronto's landfill problems. Pollution, public transportation, housing issues, and homelessness have also made more people aware of the problems facing our cities. Similar scenarios are being replayed in major centres throughout Canada. And when people face the problems of big city life, along with the political clout of growing populations, politicians aren't far behind.

# CITIES AND WEALTH CREATION

Despite these problems, the interplay between cities and wealth creation has been understood since the work of economist Alfred Marshall, who first recognized that cities exist because of economies of scale, or the indivisibilities of firms. More recently, researchers have explained further how the availability of workers in a metropolitan area — particularly specialized workers in accounting, law, advertising, and other technical fields — can reduce costs for businesses. In short, agglomerations exist because firms enjoy internal economies of scale. Marshall made the point that cities reduce the cost of moving ideas.

This era was ushered in by reconsideration in the 1990s of the new economic geography, or how firms are located through space (that is, where and why they locate). Almost all of the interesting ideas in location theory rely, implicitly or explicitly, on the assumption that there are important economies of scale enforcing the geographic concentration of many activities. We are rediscovering that place matters and that, as cities grow, so do productivity and output. Without scale economies, there is no role for the city at all.

According to some estimates, doubling city size increases productivity up to 27 percent and overall output by 7 percent (see Quigley 1998). The conclusion is that increased city size and diversity are strongly associated with higher output, productivity, and growth. Large cities mean more specialization along with higher profits, wages, and salaries for workers. We get the benefits of external economies of scale on both the production and consumption side of the equation. "Smart Growth" advocates point to the advantages of higher population densities, by reducing the costs of delivering public services.

What theory and traditional models can't tell us is the optimal size for a city. How big can cities get before external costs and such unpriced factors as congestion, pollution, and crime start swamping the benefits? Agglomeration is good, but only to a point. Toronto may still benefit from more growth. The same thing can't be said for Mexico City.

However, advocates of a stronger urban economic policy don't base their arguments on the natural phenomenon of external economies of scale. They argue that, unless government policy actively encourages either industry clusters or a program that supports global city centres, while actively attracting educated workers, our cities will become less productive, with negative consequences for Canadians' overall standard of living. Adopting policies based on these propositions may not have the benefits many assume. Let's briefly review each in turn.

## *Clustering*

Clustering, usually associated with the work of Michael Porter, happens because companies capture the benefits of external economies. Porter's analysis of a "diamond" of competitive advantage, consists of the elements of factor conditions, demand conditions, related and supporting industries, and firm strategy, structure, and rivalry. He also argues that government policy and chance play an important role in cluster location. All of these factors are mutually interdependent. From this, we get industry agglomeration, or a concentration of firms and industries all competing and benefiting from being closely linked geographically.

We normally think of high-tech industries that cluster, such as Silicon Valley and Route 128 around Boston, but research (Rosenthal and Strange 2003) confirms that higher levels of clustering takes place among older manufacturing industries. Policymakers are attracted to clusters because they are linked to high wages, higher productivity, and more exports. Based on this evidence, some researchers recommend supporting industry-specific clusters as a way not only to increase productivity and growth, but to close the prosperity gap between the United States and Canada.[2]

Start with the notion that industrial clusters should be nurtured and supported in someway by government policy. We know that certain cities in Canada have a concentration of specific industries: financial institutions and entertainment clusters in Toronto, aerospace and fashion in Montreal, and food processing in Halifax. Halifax even has a thriving cluster in oil technology. In some cases, we know why clusters exist, in others we don't. To say the clustering is the result of localized external economies is too vague. It's a bit like saying agglomeration takes place because of agglomeration effects. Clustering is still a bit of a black box. Why, for example, did Calgary develop a wireless cluster? And if policymakers try to direct these agglomeration effects and encourage more clustering, they may be in for a rude surprise. We know a lot about clusters only after the fact.

In the mid-1990s, Frankfurt was poised to overtake London as Europe's main financial centre by 2001, according to a poll of finance directors. It had all the ingredients of becoming a financial centre after the European Central Bank located there. Frankfurt even referred to itself as "Europe's Manhattan". That all changed as Germany began to lose international banks while London's banks expanded even though Britain hadn't adopted the euro.[3] Now, hampered by rising taxes, even German banks have started moving out of Germany. In North America, Toronto and Vancouver are centres of film and cinema now, but those fortunes could shift with a strengthening Canadian dollar. Starting or even promoting an existing cluster through government policy may be a costly mistake.

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2 Other studies make the case that, if Ontario is to close the income gap with the United States, a new federal fiscal framework is needed. See Martin and Milway (2003).

3 See "Why Frankfurt is no London", *Wall Street Journal*, July 11, 2003.

## Globalization

As economic activity is becoming increasingly globalized and as industries need more specialized services, some believe a new world or “system of cities” has emerged (see Sassen 2003). In the process, sophisticated networks of high-level financiers, lawyers, accountants, and advertising professionals are clustered in so-called global cities. In other words, not only are clusters occurring in cities, some sectors are clustering only in certain cities or regions. Decisions made in these cities, such London, New York and Tokyo, affect countries and cities around the world. The influence of these cities is growing, while that of secondary cities is declining. Paris is growing in economic wealth and power; Marseilles is declining.

To survive and prosper in this new world environment, some argue that it is crucial to see our major city regions as competitors on a global scale, in line with German city-states such as Bremen, Berlin, and Hamburg. This may not be as important for US cities such as Los Angeles, Chicago, or New York, but it is crucial for Toronto, with roughly 20 percent of Canada’s GDP.

The obvious conclusion is that, because Canada’s biggest cities are relatively more important to the country’s economy than are the biggest cities in the United States, the future of Canada’s economic prosperity depends on whether these cities can compete with other region-states around the world. We once thought nations and companies competed. Now we’re told city regions do.[4]

Regarding matters of globalization and competition, it is useful to remember that it is companies that compete, not regions, cities, or nations. Over the years, we’ve been seduced into thinking that competition among countries will determine our overall economic well-being. But, as economist Paul Krugman (1994) reminds us, our obsession with national competitiveness can lead us down the wrong path when it comes to public policy such as the temptation to start subsidizing export-oriented industries. Even though the GTA has become a ‘global city-region’ with strong north-south ties in North America, where Ontario exports 50 percent of its GDP, it is important to remember that all this came about without any direct or conscious effort to make Canada’s largest city-state more competitive.

One can also argue that, in the past decade, when Canada’s major cities have been undergoing their most challenging fiscal problems, Canada’s economic growth has been improving markedly compared with that of other OECD countries, reversing the country’s 15-year economic swoon that began at the end of the 1970s. Labour productivity rates have increased over the past six years, although they still trail rates in the United States. From 1996 to 2001, Canada’s average growth rate

4 Another reason for the rise of the importance of Canadian cities is more political than economic. As cities have grown over the past couple of decades, their economic power has been constrained by the limitations of their provincial governments. This has especially been the case in Toronto, where the election of a Conservative provincial government in 1995 coincided with the presence of a predominately left-wing municipal government. Amalgamation was supposed to quell this leftward trend in municipal governance, but the strategy backfired with the election of David Miller as Toronto’s mayor in November 2003. In order to gain more autonomy from their provincial masters, cities have had to devise arguments to justify why they should have more independence, both politically and economically.

was 1.9 percent per annum, compared with only 1.1 percent per annum from 1972 to 1996. This is an impressive number indeed, indicating that, despite the problems facing our cities, the economy sometimes can rally without an urban agenda (see Nicholson 2003).

## *Innovation and Human Capital*

A factor closely linked to agglomeration, clustering, and globalization is the role played by innovation and human capital. Here, a substantial amount of work has been carried out over the past two decades.[5] Essentially, skilled workers in human-capital-rich cities earn more than those in human-capital-poor countries. The heart of the new urban economy is the interactions among an educated and diverse workforce working in an open environment that encourages innovation. Therefore, cities and regions that are more open and tolerant of different people and talent from around the world will prosper more than "closed" economies.

This is one reason that the work of Richard Florida at Carnegie Mellon University has attracted much attention in Canada. He argues that creative workers, or "talent", will go where the welcome mat is out — places with lots of culture and diversity. Successful cities exhibit a high propensity for artists and writers, a high level of foreign-born workers, and a high proportion of university-educated workers. Not surprisingly, Toronto, Montreal, Vancouver, Halifax, and Calgary all score highly in these areas (see Gertler et al, 2002). They're even better than their US counterparts. According to Florida and his colleagues, if you want to attract the creative classes, cities need to support the arts if they want to become a magnate for talented and productive workers. They claim that places such as Silicon Valley, Austin (Texas), Boston, and Seattle are thriving clusters of high-technology not because of any natural resources or their proximity to raw materials, but because they have the 3Ts: tolerance, talent, and technology.

Florida's observations, however, beg the question: what came first, the bohemians or high-tech jobs? If someone wanted to be provocative, one could construct a series of positive correlations between fast-growing cities and an index showing high crime, traffic congestion, pollution, homelessness, and cost of living.

It's costly to live in cities such as Toronto, but people go there for many reasons. And they'll continue to arrive, especially immigrants from outside North America, because it's still a better place than where they came from. Moreover, it's questionable whether diversity is a factor in growth or prosperity. Would anyone argue that Tokyo, with one of the world's highest innovation rates, measured by registered patents, has a diverse and inclusive workforce? According to the US Bureau of Labor Statistics, many cities with high job growth rates perform poorly on the "creativity" index. One of the big winners, by contrast, is Las Vegas, described as a loser "stuck in paradigms of old economic development" (Malanga 2004).

5 Even Jane Jacobs, in her book, *Cities and the Wealth of Nations* (1985), recognized that innovation was a major factor in creating prosperity.

There is no doubt that skilled, creative people are good for urban economies, but if you wanted to predict growth in the 1990s, you would have looked to places with warm climates, high skills, and friendly to urban sprawl and cars (Glaeser 2002).

Aside from the obvious conclusion that cities are special places in need of specific public policy attention, there are other implications. One is that growth and productivity are no longer the exclusive domain of macro levers such as trade and fiscal and monetary policy. New urban thinking relies more on policies that attract industries and talent to designated regions. Another implication is that cities, not corporations, are at the centre of competition. If we are to succeed in a more global world, it's not how efficient or competitive our firms are, but whether Toronto can compete with Barcelona, Milan, or Tokyo (Federation of Canadian Municipalities 2002).

# NOT EVERYONE AGREES THAT CITIES CREATE WEALTH

If you were left to read only geographers, planners, and urban economists, you would come away with the perception that cities are at the heart of explaining economic growth and wealth creation. Not everyone agrees. Over the past decade, economics has seen a dramatic revival of the attempt to unravel the mysteries of economic growth, a question that was first addressed by Adam Smith in his 1776 book, *The Wealth of Nations*. Smith found that "little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice". Yet the quest to reveal the secrets of growth continues.

In his book, *The Wealth and Poverty of Nations* (1998), David Landes argues that the West has prospered through work and innovation in an open society. Robert Putnam, in *Making Democracy Work* (1994), tells us that prosperity comes from regions that enjoy effective government with a legacy of civic engagement. In *Power and Prosperity* (2000), the late Mancur Olson emphasizes the power of free markets, the protection of property rights, and the irrationality of governments' subsidizing losing firms and industries and localities.

Melvyn Krauss, in *How Nations Grow Rich* (1997), reminds us of the benefits of free trade and that much of the prosperity and wealth of the past half-century is due to specialization and the opening up of global markets. (I once heard Milton Friedman say there is a free lunch and it comes from the benefits of free trade.)

Nobel Laureate Douglass North talks about the importance of institutions in the creation of wealth. Harvard economist Robert Barro concludes (1997) that, after all is said and done, the determinants of economic growth are education, lower fertility rates, lower government consumption, the rule of law, low inflation, along with more innovation and the diffusion of technology. This last point is key. It is widely accepted that innovation, not factor endowments, is at the heart of wealth creation. Innovation is no longer an external or exogenous factor in economic growth but an endogenous factor, which isn't subject to diminishing returns.[6]

6 Endogenous growth theory distinguishes between physical and human capital. The latter is embodied in the labour force. And, unlike physical capital, the accumulation of human capital isn't subject to diminishing returns. This is because human capital formation is a "social activity", involving groups of people in a way that has no counterpart in the accumulation of physical capital. And this human activity has external or spillover effects. On this both new urban thinkers and traditional growth theorists can agree. But the former attach most of the credit to the actual environment of cities, while the latter emphasize the role of capitalism.

The curious fact in all these books, and in many others, is that none mentions the role of cities in the creation of wealth. Just because most growth happens in cities, we should not confuse cause and effect. Correlation is not causation.

What's missing in the writing by new urban thinkers is a role for entrepreneurs, risk takers, and incentives. This is not to suggest that cities should be a free-for-all environment of unregulated markets, but one can't help thinking that central planning is never far from the surface of much that is written about how modern cities should operate.

# CONCLUSIONS AND RECOMMENDATIONS

What are we to make of all the attention given to cities as drivers of economic wealth and prosperity? What makes cities rich — or countries, for that matter — isn't easy to define. If it were, most of our problems would be solved. And it isn't simply a matter of giving cities greater economic and political powers. I believe the necessary powers are already in place.

Let me conclude with the following observations as to what I think cities can do to enhance growth:

1. Skilled workers are key to a successful city, but encouraging and attracting entrepreneurs and businesses should be at the centre of any policy to create wealth. In order to attract both, cities have to be good at getting the basics right. That means good schools, good roads, safe streets, and reasonable municipal taxes. Once these things are in order, the art galleries and high-tech jobs will follow.

2. Get the smart people, but don't micromanage: that means letting them figure what sectors or industries to work in. Encouraging certain clusters or sectors over others won't work. When the Berlin Wall fell, urban planners hoped to attract big company headquarters to that city. The strategy failed. Inexplicably, Berlin became a haven for artists, web designers, and software writers, with few government incentives. Cities are complex creatures with their own cycles of growth, decay, and sometimes re-growth.

3. Macro policy isn't dead: boosting productivity is the key to increasing economic wealth. Getting fiscal and monetary policy right swamps anything we can do to micromanage wealth creation at the municipal or city level.

4. Price public services correctly: anyone caught in rush hour traffic in Toronto knows the situation is intolerable. But gridlock isn't simply a question of more or even better public transit, but of pricing externalities properly. London was able to cut its traffic problem almost overnight by charging drivers closer to the real cost of using roads. On the same theme, we need fewer subsidies and more user fees. Here, I agree with Glenn Murray, who, when mayor of Winnipeg, wanted to rely less on property taxes and more on user fees, but not with his suggestion to revive Winnipeg's economy by spending money on the arts to attract hip workers to that city.

5. Eliminate unnecessary regulations: unnecessary and irrational zoning laws do more harm than most suppose. One study, by Harvard economist Edward Glaeser (1998), has shown that almost half the cost of housing in New York is directly related to regulation. It would be interesting to see what the comparable costs in Canada's major cities are.

It should be clear to anyone living in Canada that our big cities need fixing. But the best urban policy is to deliver municipal services efficiently without the distraction of attracting specific clusters, creating global city-states, or attempting to attract knowledge workers without establishing an environment where businesses want to invest and expand. On this point, I like to quote Glaeser (1998): "A city which wishes to prosper should focus on pricing externalities correctly, protecting property rights and ensuring that human capital can be developed within its borders".

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**Conferences**

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