10-1-1998

Employment Research, Vol. 5, No. 2, Fall 1998

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Citation

W.E. Upjohn Institute. 1998. Employment Research 5(2). [https://doi.org/10.17848/1075-8445.5\(2\)](https://doi.org/10.17848/1075-8445.5(2))

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UPJOHN INSTITUTE

Employment Research

FALL 1998

Industrial Incentives
Competition among American
States and Cities

Three Systems of Workers'
Compensation

New Books

Vol. 5, No. 2

Employment Research is published twice a year by the W.E. Upjohn Institute for Employment Research, a nonprofit research organization devoted to finding and promoting solutions to employment-related problems at the national, state, and local level. The Institute is an activity of the W.E. Upjohn Unemployment Trustee Corporation, which was established in 1932 to administer a fund set aside by Dr. W.E. Upjohn, founder of the Upjohn Company, to conduct research on the causes and effects of unemployment and seek measures for the alleviation of the hardships suffered by the unemployed.

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Randall W. Eberts
Executive Director

Peter S. Fisher and Alan H. Peters

Industrial Incentives Competition among American States and Cities

In recent years, there has been much "revisionist" research on the effects of economic development programs at the state and local level. There is now substantial evidence that economic development programs can help local economies by reducing unemployment and increasing earnings. Some, such as Bartik (in his book *Who Benefits from State and Local Economic Development Policies?*), have gone beyond this to argue that such local policies may benefit the nation if the incentives are concentrated in low-growth or high-unemployment regions, because the benefits of jobs created there will exceed the benefits lost by not creating jobs in low-unemployment areas.

Are the economic development incentives offered by states and cities significantly higher in high-unemployment places? This article summarizes the results of a study, sponsored by the Upjohn Institute, that uses new data to examine the spatial pattern of incentive offers.

In our research, we measured competition among places based on the dollar value of a locality's standing incentive offer to industrial firms expanding or locating in that locality. The standing offer included the whole range of competitive incentives over which state

or local governments have some direct control: income tax investment and jobs credits, property tax abatements, sales tax exemptions, grants, loans, loan guarantees, and firm-specific job-training and infrastructure subsidies. Because incentives may be embedded in tax codes, and because the value of incentives to a firm must be measured net of income tax effects, we also modeled the federal corporate income tax, each state's and city's corporate income and net worth taxes, the major state and local sales taxes paid by business, and local property taxes.

We used the hypothetical firm method to measure the value of competitive incentives. We constructed financial statements for 16 hypothetical firms, representing the characteristics of a typical large and small firm in each of eight fast-growing manufacturing industries. The model then measured the net returns on a new plant investment, after all taxes and incentives. The new plant is located in one of 24 states, the 24 that account for the most manufacturing employment in the United States (combined, they represent 86% of the total), and in one of 112 cities, randomly selected from within these 24 states.

(continued on p. 3)

From the Executive Director

The Institute over the years has forged lasting and productive associations with scholars and practitioners from many organizations and in many parts of the country. For 15 years starting in 1962, the Institute maintained an office in Washington, D.C., from which prominent policy experts such as Sar Levitan, Saul Blaustein, Herbert Striner, and Irving Siegel led the Institute staff on important projects related to federal employment policy.

Times have changed. We have seen a major shift in the locus of policy making, with state and local governments assuming much more responsibility for social programs and with private foundations promoting social initiatives. We have also witnessed a revolution in information technology, particularly e-mail and Internet access to information. Both changes have drastically reduced the necessity of locating in the Washington area in order to be a prominent player in analyzing and evaluating policy and in informing the policy debate.

Currently, our research affiliations extend from Japan to Hungary and from Canada to Australia. For instance, we recently co-sponsored a conference with the Canadian International Labor Network (CILN), which brought together 20 prominent economists from six European countries, Japan, Australia, Canada, and the United States and was organized by Peter Kuhn of McMaster University. These scholars provided in-depth country comparisons of worker displacement and the extent of their unemployment spells and earnings losses, marking the first time that researchers have been able to use micro-level data across this many countries to address job displacement, which is currently a major concern to many European and Asian countries. This research will appear as an Institute publication.

Allan Hunt, Assistant Director of the Institute, has finished a project in Australia with the Victorian Workcover Authority. Dr. Hunt led a team of researchers to evaluate the performance and structure of Victoria's workers' compensation system and to provide recommendations for improving the system. This work is mentioned in his article in this issue of the newsletter.

Closer to home, we have had the privilege over the last six months of working with one of the nation's leading urbanologists, David Rusk. Author of the widely acclaimed book *Cities without Suburbs*, Mr. Rusk has worked with many communities to address issues of housing, neighborhoods, schools, urban redevelopment and revitalization, and urban sprawl. He is currently working in the Kalamazoo area and has been based at the Institute while conducting his research. Institute staff have worked closely with Mr. Rusk, collecting data and analyzing local trends and conducting in-depth studies of the performance of Michigan school districts and the feasibility of tax-base sharing arrangements among local cities and townships.

The Institute also keeps abreast of recent research through our annual Dissertation Award. Each year we receive many excellent dissertations, and the selection committee is always challenged to choose the top three. As described in the column to the right, this year's award went to Steven Haider of the University of Michigan for his work on income inequality. Our congratulations to him and to the two runners-up.

Given the extensive involvement of the Institute with various agencies and organizations, it is safe to say that our location in the country's heartland has not impeded our ability to carry out our mission.

Randall W. Eberts

1998 Dissertation Award Winners

The W.E. Upjohn Institute is pleased to announce the winner of its fourth annual Dissertation Award: Steven J. Haider, of the University of Michigan, for "Econometric Studies of Long-Run Earnings Inequality." Haider's dissertation advisor was Gary Solon.

Two honorable mentions were also chosen: Kanika Kapur of Northwestern University for "Labor Market Implications of Employer-Provided Health Insurance," and Paul A. Smith of the University of Wisconsin-Madison for "The Impact of the 1981 Welfare Reforms on Female-Headed Households." Kapur's advisor was Bruce D. Meyer, and Smith's was Robert Haveman.

Haider's dissertation comprises three studies. First he examines the relationship among annual earnings inequality, lifetime earnings inequality, and earnings stability. Then he examines the long-run earnings inequality at the family level, where he finds that the increasing earnings inequality for husbands was responsible for 75 percent of the gross increase in family earnings inequality. Haider also develops an estimation technique, used in other portions of his work, that is applicable to a broad class of incomplete data problems.

Kapur addresses the gap between policy and research in the areas of medical insurance portability and job mobility, small firms and the small-group health insurance market, and the impact of recent state-level health insurance legislation. Smith uses two approaches to analyze the effects of changes in welfare-program benefit formulas and eligibility rules on the economic well-being of, and the choices made by, low-income individuals.

Winners of the Dissertation Award receive a cash prize of \$2,000. Each honorable mention receives a \$500 prize.

The deadline for submission for the 1999 award is July 7, 1999. Any individual whose dissertation has been accepted during the 12-month period of July 1, 1998, to June 30, 1999, is eligible for the 1999 prize.

Industrial Incentives*(Continued from p. 1)***Is There Significant Variation in Returns across Locations?**

Is there sufficient variation in returns on investment across states and cities that tax and incentive differences could affect location decisions? If incentives have little effect on profitability at different sites, there is little reason to worry about their effects on redistributing employment.

We found large differences between the returns available at the "best" locations and returns available at the "worst" locations, considering state and local tax systems and tax incentives (but not other incentives). Even when we ignored variation within states by focusing on a representative city in each state, we found effective state/local tax rates on new investment that ranged, for

example, from 1.7% to 10.2% for a small but profitable manufacturer of soaps and toiletries, and from 4.1% to 23.8% for a large but low-profit automobile manufacturer. These are the extreme cases; for the typical sector, the highest-tax state placed a tax burden on manufacturers that was about three times as large as that in the lowest-tax state.

Another way of examining the magnitude of incentives is to measure the difference between the best and the worst standing offers among our sample of cities and then to convert this difference to an hourly wage equivalent. For some firms, the results were startling. For the large drug firm, the difference between the best and worst sites translated into an average hourly wage difference of \$1.82. For most firms modeled, the equivalent hourly wage difference between the best and worst sites was between \$0.65 and \$0.95 per hour. Moreover, the spreads between

cities at, for example, the 80th and 20th percentiles or the 75th and 25th percentiles remained large. Thus, it seems reasonable to conclude that, at least at the extremes, taxes and incentives are potentially large enough to influence location decisions.

The inclusion of non-tax incentives very often did little to change the majority of cities in the top 20 or bottom 20. In most cases, cities that were highly competitive after taxes and tax incentives were also highly competitive after the inclusion of non-tax incentives. Overall, non-tax incentives did not ameliorate, but actually accentuated, the tax differentials between the best and worst cities.

Three tentative conclusions emerge: 1) the differences in investment returns across states and cities due to tax and incentive differences are quite substantial, and it is certainly plausible that these differences are large enough to influence

Figure 1 Rate of Return on New Plant Investment in the 25 Cities with Highest Return after Incentives: Multi-state Instruments Manufacturer, \$180 Million Plant

location choices; 2) the magnitude of incentives, relative to returns after taxes but without incentives, is substantial; and 3) incentive competition per se is not producing convergence across sites; if anything, it is increasing inter-site differences.

Are Returns Higher in High-Unemployment Cities?

We focus here on the results for the sample of 112 cities, using actual local tax rates and incentive programs as well as state taxes and incentives. Almost all of the correlations between unemployment and taxes or incentives are of modest size. There is a consistently negative relationship between unemployment and returns after basic taxes (without any incentives); the highest-unemployment places have the highest tax burdens. There is a consistently positive relationship between unemployment and tax incentives: the highest-unemployment places offer the largest state and local tax incentives. This result is dominated by local property-tax abatements and by enterprise-zone (EZ) incentives; we deliberately allowed the largest incentives available in a city (which would be enterprise-zone incentives in the 40% of our cities with such zones) to represent the city as a whole. Considering non-tax incentives, there is no clear pattern of providing inducements to shift jobs either towards or away from high-unemployment places.

Figure 1 illustrates the lack of any consistent pattern by focusing on a firm that was typical in terms of the correlation of taxes and incentives with unemployment—the instruments manufacturer building a \$180 million plant. We show only the top 25 cities (those with the highest return for this plant after taking into account all taxes and incentives) ordered by unemployment rate. For each city, the graph shows the rate of return after basic taxes and how this rate of return is improved through the provision of enterprise zone incentives and other (tax and non-tax) incentives. Some cities that ranked poorly after basic taxes improved their position dramatically through non-enterprise zone incentives; others did so

through enterprise zone credits. Some cities, including some with relatively low unemployment, were very competitive without incentives and enhanced their position further through incentives. But incentives are not primarily compensating for high basic taxes.

While incentives do modestly favor places with higher unemployment, these incentives only offset the tendency of basic state taxes on business to be higher in high-unemployment states. The end result is a spatial pattern of returns on new investment that is essentially random: there is no discernible tendency for returns to be more attractive in high-unemployment or in low-unemployment places. It appears that, after at least a decade and a half of intense competition for investment and jobs and the widespread adoption of pro-development tax policies and development programs, states and cities have produced a system of taxes and incentives that provides no clear inducement for firms to invest in higher-unemployment places. It is true that in the absence of that competition the pattern of returns might well favor the least distressed places. However, this is difficult to say for certain, because some of the “perversity” we observed in state taxes may itself be the result of competitive pressures that produced changes in the underlying tax codes of certain states. Some incentives are embedded in what we modeled as the “basic” tax system.

Conclusions: The National Benefits of Competitive Economic Development Policy

These results are consistent with the following arguments (though they certainly cannot be taken as proof):

1) State and local tax reductions and development incentives are adopted for a variety of reasons, high unemployment perhaps being one, but slow growth and simple imitation of others being more important reasons.

2) Even where economic distress, as measured by high unemployment, may have provided the original political impetus to cut business taxes or adopt incentives, these measures are likely to

persist even if state economic performance improves.

To the extent that tax and incentive competition results in a redistribution of jobs, our research lends little support to the argument that this redistribution has beneficial effects for the nation as a whole (by shifting jobs from places with low unemployment to places with high unemployment). Neither can we say that it is clearly harmful (i.e., by providing inducements to redistribute jobs in the opposite direction). Of course, one can only speculate what the spatial pattern of returns on investment in 1992 would have looked like had states and cities never undertaken to influence their economic fortunes by offering inducements to industry in competition with one another. Only if this pattern would have been distinctly counterproductive (with higher returns in lower-unemployment places) could one conclude that competition has been beneficial, by nullifying such effects.

This article describes research published in the Upjohn Institute book of the same title. Drs. Fisher and Peters are professors of urban planning at the University of Iowa.

The Institute is interested in publishing books in these areas:

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H. Allan Hunt

Three Systems of Workers' Compensation

Introduction

Only three countries in the world maintain sub-national workers' compensation systems: Australia, Canada, and the United States. Three models are used to organize the insurance responsibilities for making the payments to injured or ill workers: private market, exclusive public insurer, and mixed (although the three models do not correspond exactly with the three countries). All 10 Canadian provinces, 6 U.S. states, and 3 jurisdictions in Australia use the exclusive public insurer approach; the remaining 44 U.S. states and 4 jurisdictions in Australia use a predominately private market approach; and 3 Australian states use a mixed approach, in which the public fund bears the underwriting risk, but private firms collect and disburse the money.

We will look at each of the three models, one from each country.¹ Studying different jurisdictions, even though from different nations, follows the tradition of using the "laboratory of the states" to inform policy decisions. We will describe the essential features of each system and then review system performance.

British Columbia

British Columbia has an exclusive public fund (monopoly) that collects the insurance assessment from employers and pays the specified benefits to workers. Virtually all employers are required to purchase coverage from the Workers' Compensation Board of British Columbia (WCB). Premiums are determined by the WCB annually for some 70 classes of employer and are designed to ensure that, in the aggregate, all future benefits arising from injuries and illnesses in the current year can be paid from the funds collected in that year. The WCB also attempts to see

that employers are treated equitably in their relative cost of assessment. Experience-rating provides that assessment rates can vary by one-third (either up or down) from the class average. The British Columbia fund is fully forward funded (unlike many others), and 35–40 percent of annual income is currently derived from investment earnings on reserves held against future obligations.

Michigan

Michigan has a fairly pure private system, which is noteworthy for a large segment (about 50%) of self-insurance. This self-insured sector includes the huge firms of the auto industry and an extensive "group self-insurance" program for smaller employers. Michigan is also noted for its very early, and successful, deregulation of insurance rate-making in 1983 (the second jurisdiction in the United States to do so). Insurance prices are set by individual insurers based on market considerations, with no interference from the state. With the sale of its state accident fund in 1994, Michigan demonstrated that it did not wish to foster the competition of public firms with private firms; Michigan put its faith completely in the market.

Victoria

Victoria has a workers' compensation system that is unique to Australia, characterized by public underwriting (risk-bearing) but private marketing, premium collection, and claims administration. The impetus for this system came from widespread dissatisfaction with the private system before 1985 and strong revulsion to the excesses of a monopoly public system from 1985 to 1992. This "third way" puts

a special burden on the administrator and regulator, the Victorian WorkCover Authority (VWA), to provide appropriate incentives for all participants in the workers' compensation system. The VWA bears the risk and holds the money. Some 14 private "agents" market the insurance, collect the premiums, and make the benefit payments. Another unique Australian invention is the "employer excess." In Victoria, the employer is directly responsible for making the first 10 days of income maintenance payments, as well as the first \$317 of medical expenses. This is thought to increase employer incentives for prevention, to raise the likelihood of prompt payment of income maintenance benefits, and to reduce system administrative costs.

Benefit Differences and Similarities

So, we have three quite different administrative and regulatory systems designed to accomplish basically the same tasks. Before looking at overall system performance, we should note some significant differences in benefits among the three systems. The first difference is in the waiting period before wage replacement benefits commence. In British Columbia, the public fund pays from the first day of lost wages. In Michigan, the insurer begins paying after 7 days have passed. In Victoria, the employer is responsible for paying the first 10 days of lost wages directly. These differences have significant implications for the number of claims that are compensable and, hence, that the administrative entity has to deal with. They also have implications for any attempt to compare the performance of these three systems.

Wage replacement levels for injured workers also differ and are set by statute. Michigan specifies that injured workers shall receive 80 percent of their pre-injury net wage (net of taxes), subject to a maximum at 90% of the state average weekly wage (\$533/week in 1997).² British Columbia provides 75 percent wage replacement against the net wage, again subject to a maximum (\$580/week in 1997). Benefits are free of federal and

state income taxes in both British Columbia and Michigan. Victoria replaces 95 percent of the workers' pre-injury base wage (not including overtime or premium pay), subject to a maximum of 100% of average weekly earnings (\$505/week in 1997); this drops to 60 percent at 26 weeks unless the worker is totally incapacitated or is found to have a "serious injury." Benefits are taxable in Victoria; it is also common practice for the employer to "top-up" the compensation benefit to 100% of the pre-injury weekly earnings in a collective agreement.

Finally, permanent disability award criteria vary. Victoria is just implementing (as of 30 September 1998) a new system of impairment rating, based on the American Medical Association's *Guides to the Evaluation of Impairment*, 4th Edition. This system will use medical practitioners, independent medical examiners, and medical review panels to rate the impairment of each worker, replacing the serious injury system, which proved to be too difficult to control. British Columbia uses a sophisticated system of interdisciplinary disability evaluation that includes medical doctors, vocational rehabilitation practitioners, and expert claims personnel. The disability pension awarded to a worker is the higher of the estimated medical impairment level or the estimated lifetime earnings losses. Michigan in theory pays wage-loss benefits for life. However, a system of compromise and release settlements ("redemptions") has evolved that serves to "cash out" the worker's claim in exchange for the employer's release from further liability. This system is run by the lawyers, who tend to think of it as a rather sophisticated disability rating system that responds to the many nuances of individual worker situations, injuries,

etc. Critics tend to think of it as a "crap shoot" where the financial results bear little correlation to the disabilities.

Workers' Compensation Performance

It is extraordinarily difficult to make comparisons across jurisdictions because of statutory differences and variations in local practice. Most comparisons are actually more misleading than informative. However, comparisons on the broadest aggregates may be meaningful.

First, the difference in the number of injuries (claims per 100 workers) is vast. British Columbia has more than twice as many compensable claims as Michigan or Victoria (Table 1), but this primarily reflects the differences in the waiting periods for wage-loss benefits. On the other hand, aggregate benefits paid per worker in 1997 are quite similar. Since aggregate benefits per worker reflects both the number of workers who receive payments and the average payment received, it is a better index of the actual burden of workers' compensation payments on the economy.³ Basically, Victorian workers are receiving lump-sum payments for specific injuries, pain and suffering benefits, and common law settlements that bring them above the North American standard. Michigan workers receive lump-sum settlements that capitalize their future wage-loss, whereas British Columbia workers receive periodic income maintenance payments.

Table 1 also reports the average employers' cost of workers' compensation insurance. Michigan is the lowest (1.72 percent of payroll), followed by Victoria and then British Columbia. Of course, these results do not control for industry structure or a host of other differences between the three jurisdictions.

What this quick analysis seems to show is that comparisons between different workers' compensation systems are not simple. Moreover, the systems' differing structures are not the reason for the differences in performance. Rather, each system is an organic whole that has its own internal logic, which is why it is not possible to just lift features from one system that seems to work and insert them in another system that doesn't work. What is needed, rather, is good, aggressive management and attention to system indicators. This is one social policy area where the "continuous improvement" model makes more sense than "best practice." Through the continuous improvement path, we can all attain more efficient and equitable workers' compensation systems.

Notes

1. These are jurisdictions where the Institute has done work and with which we are quite familiar. The references cited below provide more detail on these three workers' compensation jurisdictions.

2. All monetary units are in U.S. dollars, based on average currency conversion rates for 1997.

3. Ignoring the privately borne costs. In Michigan, injured workers bear the first 7 days of wage-loss costs, while in Victoria, the employer bears the first 10 days of wage-loss costs. These costs are included in the British Columbia figures.

Suggestions for further reading

Duncan S. Ballantyne, and Lawrence Shiman, *Revisiting Workers' Compensation in Michigan*, Administrative Inventory, Workers Compensation Research Institute, Cambridge, MA, October 1997.

H. Allan Hunt, Peter S. Barth, Terrance J. Bogyo, Alan Clayton, Robert W. Klein, and Ralph W. McGinn, *Victorian Workers' Compensation System: Review and Analysis, Volume I*, Victorian WorkCover Authority, Melbourne, Australia, August 1997.

H. Allan Hunt, Peter S. Barth, and Michael J. Leahy, *The Workers' Compensation System of British Columbia: Still in Transition*, Workers' Compensation Board of British Columbia, Richmond, British Columbia, March 1996.

Dr. Hunt is Assistant Executive Director of the Upjohn Institute.

Table 1 Workers Compensation Comparison, 1997

Measure	British Columbia	Michigan	Victoria*
Wage loss claims/100 workers	4.1	1.5	1.5
Benefit payments/worker	\$284.27	\$278.93	\$335.56
Employer cost/\$100 payroll	\$2.23	\$1.72	\$1.80

*Victoria data are for 1997-98 fiscal year. Note: Dollar values in U.S. \$.

New Books from the Upjohn Institute

Industrial Incentives

Competition Among American States and Cities

Peter S. Fisher and Alan H. Peters,
University of Iowa

This book provides clear and concise information on what is often an emotionally charged subject—

economic development incentives. The authors' extensive research reveals tax and incentive policies across the 24 most industrialized states in the U.S.A. and a

sample of 112 cities from within those states.

"[Fisher and Peters'] research is the first rigorous study that provides us with significant information about the average magnitude of economic development incentives in the United States, how these incentives vary across different types of firms, and which states and cities offer the biggest incentives. It is painstakingly careful and fairminded. No serious discussion of federal, state, or local policy toward incentives should take place without taking account of their findings.

"Economic development researchers should consider this book a basic reference tool. Economic developers who want to know what the competition is doing should also find this book to be essential reading."
Timothy J. Bartik, W.E. Upjohn Institute

307 pp. \$29 cloth ISBN 0-88099-184-4
\$19 paper ISBN 0-88099-183-6 / 1998.

Growth in Disability Benefits Explanations and Policy Implications

Kalman Rupp
Social Security Administration
David C. Stapleton, *The Lewin Group*,
Editors

This collection of original papers reveals why caseloads of the nation's two largest income entitlement programs for disability—Social Security Disability Income (SSDI) and Supplemental Security Income (SSI)—have soared. Using the Social Security Administration's own data, the authors are able to point to factors that are contributing to the programs'

growth, including program design, changing demographics, the labor market, and the interaction with other programs in the nation's social safety net.

Contributors include **Kalman Rupp, David C. Stapleton, Kevin A. Coleman, Kimberly A. Dietrich, Gina A. Livermore, Aaron Yelowitz, Charles G. Scott, Mary C. Daly, L. Scott Muller, Peter M. Wheeler, John Bound, Sherrie Kossoudji, Gema Ricart-Moes, Andrea Zeuschner, Gilbert Fisher, Melinda Upp, Larry Masanari, Celeste Hemingson, Charles Jones, Stanford G. Ross, Andrew I. Batavia, Howard H. Goldman, Jane L. Ross, Carolyn L. Weaver, Susan M. Daniels, Jane West, Richard V. Burkhauser, Patricia M. Owens, and Craig Thornton.**

436 pp. \$33 cloth ISBN 0-88099-188-7
\$23 paper ISBN 0-88099-187-9 / 1998.

Topics in Unemployment Insurance Financing

Wayne Vroman, *Urban Institute*

When—or if—the next recession hits, some states may find that their unemployment insurance (UI) trust fund balances will fall short of what's needed to pay for growing numbers of UI claims. The reason, says Wayne Vroman, is that the economic boom of

the 1990s has given states the confidence to enact new financing schemes that allow a serious reduction in the size of UI trust fund balances.

Vroman warns that, because of recent financing practices, "States are more at risk for insolvency in the late 1990s than they were in 1990. A repetition of widespread and large-scale borrowing of the past is a distinct possibility."

He bases this statement on an empirical study that examines historical levels of states' UI trust fund balances between recessions and the specific methods used to finance trust fund balances. These methods include traditional means of financing, tax-base indexing, state reserve funds, and "flexible" financing such as solvency taxes and legislative response mechanisms. In addition, he addresses the tradeoffs of financing UI debt by either borrowing from the U.S. Treasury or issuing state bonds.

160 pp. \$24 cloth ISBN 0-88099-194-1
\$14 paper ISBN 0-88099-193-3 / 1998.

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