Economic freedom isn’t simply about money. It’s about the value of liberty and individual freedom – the very principles of American free enterprise.

In 2008, the state of South Carolina ranked 45th in per capita income, making it the 6th poorest state in the country. How did that happen? A century’s worth of unfavorable business policies out of Columbia. Unleashing Capitalism is an expert prescription for the systemic problems that keep South Carolina poor. It is a road map to prosperity through policy reforms that will put economic power back in the hands of the people.

Editor: Peter T. Calcagno
Associate Editors: Joshua C. Hall and Russell S. Sobel
Presumably the original intent of imposing a tax rate schedule with graduated marginal tax rates was to make the income tax progressive. However, what progressivity exists in the state's income tax structure is due to the zero tax on the first $2,630 of income, and because of the graduated marginal tax rates. However, since the marginal tax rate increases over such small steps in income, as shown in Figure 5.5, most of the progressivity occurs at lower income levels, not higher levels of income. At higher income levels, the average tax rate hardly increases at all. This nature of the current tax is directly contradictory to the goal of progressivity. So although on the surface it appears that the tax satisfies the vertical equity condition, it really does this only at the lower income levels reducing the wealth of these lowest income taxpayers, not the intended consequence.

Figure 5.5 also shows what the average tax rates are for various incomes and taxes under the current tax system in South Carolina. In the right columns it also shows what the taxes and average tax rates would be if the 1959 tax tables were indexed for inflation. The figure clearly shows that the 1959 indexed tax rate structure is more uniformly progressive, especially at higher levels of incomes. It keeps tax rates extremely low for the lowest income individuals in the state.

Figure 5.5 also shows that the current tax system charges all income groups more in taxes than an indexed rate schedule. The only exception is the $5,000 income earner in the table. As South Carolina income taxes continue to climb while the tax brackets remain stagnant, the state becomes a relatively high-tax state. This has a negative impact on
Unleashing Capitalism:  
A Prescription for Economic Prosperity in South Carolina

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The South Carolina Policy Council Education Foundation was established in 1986 as a nonpartisan, tax-exempt public policy research and education foundation. Its mission is to educate members and all South Carolinians about state and local public policy based on the traditional South Carolina values of individual liberty and responsibility, free enterprise and limited government.

Cover concept by Ron Huey and Mike Martin.

Printed in the United States of America.
Such a significant reduction in taxes on industrial property would obviously lead to a serious improvement in the state's competitiveness. In general, a tax rate of around 1 percent might be sufficient to attract more industry. Working to reduce the various taxes applied to industry would seriously improve the state's competitiveness. For example, Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate that is still lower than the national average. A reduction in industrial property taxes would help South Carolina to become more competitive with other states in the South, and perhaps even the country, if it can reduce its rate to around 1 percent. This would be a significant reduction from the current rate of 3.73 percent.

South Carolina's effective tax rate is almost 2.5 times greater than Georgia's tax, and almost 4 times greater than North Carolina's. This puts South Carolina at a disadvantage in attracting industry. In Figure 5.8 we present the effective property tax rates for Southeastern states, for comparison. The ranks given for the states are out of all 50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million. In Figure 5.8 we present the effective property tax rates for Southeastern states, for comparison. The ranks given for the states are out of all 50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million. The data is calculated based on the property tax rates and property values for the largest city in each state.

Transporting machinery and equipment into the state is expensive, and the costs of transport are often included in the purchase price of the machinery. However, if the machinery is actually used in the state to produce something, it is worth the cost of transport. This is because the machinery is an investment that will generate income for the state in the future. This is why it is important to consider the effective tax rate on industrial property when deciding which state to choose for a new business. The effective tax rate is calculated by taking into account the property tax rate, the state income tax rate, and the state sales tax rate. The effective tax rate is a measure of the total tax burden on industrial property. It is calculated by taking the property tax rate, multiplying it by the state income tax rate, and then dividing the result by the state sales tax rate. The effective tax rate is a useful measure of the total tax burden on industrial property because it takes into account all of the taxes that are applied to industrial property.
PREFACE

I have spent many years as a professor of economics, working to impart the principles of economics to my students, and researching in the area of political decision making. I have wanted an opportunity to take that knowledge and provide it to a new audience outside the typical academic setting. After years of engaging in countless discussions with my colleagues, members of the business community, and the people at the South Carolina Policy Council, I realized we were all asking the same question: how do we improve the economic conditions in South Carolina? When the Policy Council asked me to put together a bold plan to strengthen the free market in our state, I suggested we write this book. We believe it provides a comprehensive approach to generating economic prosperity in South Carolina.

The inspiration for this book came from *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It*. The same principles and economic arguments developed in that book apply to South Carolina. We approached many of the same experts who collaborated on the first book, and some new ones, mostly economists. While some of these chapters contain some complex policy reforms, we have made every effort to present the concepts and ideas in a way that is understandable to the average citizen, the person who can benefit the most from this information. The three introductory chapters provide the background in basic economic principles that will make it easier to understand how the policy reforms offered in the other nine chapters are critical to the prosperity of our state economy.

At first glance South Carolina appears to be a small government pro-market state, with a small regulatory environment, taxes competitive with the national average, and business-friendly practices. However, if South Carolinians take a closer look they will realize that they have one of the highest income tax rates in the country, and the highest effective property tax rate on machinery and equipment in the United States. Average income in South Carolina is about 80 percent of the U.S. average. South Carolina has hard-working individuals, natural resources, major ports, major metropolitan areas, and many other noteworthy advantages. From a purely economic perspective, there is no reason South Carolina should be near the bottom of the national income ranking.

Things have been better and worse. In 1979 South Carolina ranked 49th in per capita income, but by 1988 South Carolina rose from 49th to 38th, an impressive increase of 11 spots in just 9 years. Unfortunately these gains have slipped away since the mid-1990s, and in less then twenty years we have returned to nearly the bottom ranking at 45th.

Each chapter in this book was written independently, and addresses different areas of state policy reform. While the authors address a wide array of issues, from tax policy to economic development and regulatory reform, a common theme exists in the conclusions we draw regarding the current problem areas of our state policy. All of the authors agree that *Unleashing Capitalism* will make our state policies more consistent with a free market economy, or ‘economic freedom,’ which is the best way to improve the overall prosperity of South Carolina. If we take the steps outlined in these chapters, South Carolina will experience an increase in capital formation, higher labor productivity and wages, and reduced levels of resources devoted to wasteful political lobbying and rent seeking.
We hope that readers will gain a better understanding of capitalism and its true potential to generate the long-run economic growth that will make South Carolina more prosperous, as well as ideas for policy reforms that could bring this to fruition within our lifetimes. Our primary goal is to provide the scholarly research that can inform state policy decisions, and we hope to open a dialogue on policy reform that can generate growth and prosperity in South Carolina.

We owe thanks to more people than we could possibly list. We are indebted to Russell Sobel whose original vision paved the way for us to conduct this research analysis in South Carolina. We thank our colleagues, starting with our advisory board from across the state that helped to review these chapters and provide their expert knowledge of South Carolina. The authors who worked hard to meet the demands of the project, and Joshua Hall for his excellent organizational and editing support. We thank our friends and family for their support, and for putting up with the long working hours that went into conducting this research. Finally, we would like to thank the staff and members of the South Carolina Policy Council for publishing this book. Without their support, this project would not have been possible.

Peter T. Calcagno, Ph.D.
Associate Professor of Economics
Director, Initiative for Public Choice & Market Process
College of Charleston
CHAPTER 1

THE CASE FOR GROWTH

by Russell S. Sobel and Susane J. Leguizamon
over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in million in fixtures). Notice that South Carolina's effective tax rate on industrial property is various taxes applied to industry would seriously improve the state's competitiveness.

Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate has the highest tax in the country on industrial property, it should be no surprise that it has serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina one of the lowest per capita incomes and economic growth rates in the country.

Although it is probably not critical that South Carolina set its tax rate to the lowest in one of the lowest per capita incomes and economic growth rates in the country, it should definitely make it at least competitive for the Southeast. Since South Carolina

<table>
<thead>
<tr>
<th>State</th>
<th>Rank</th>
<th>Tax</th>
<th>Average Tax Rate</th>
</tr>
</thead>
<tbody>
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<tr>
<td>Virginia</td>
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<tr>
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<td>35</td>
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<td>Georgia</td>
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<td>4</td>
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<tr>
<td>South Carolina</td>
<td>1</td>
<td>$1,864,900</td>
<td>3.73%</td>
</tr>
</tbody>
</table>

* Taxes measured in the states' largest city only.

Source: National Association of Manufacturers (2009)

This chapter is based on Sobel and Sobel (2009).
1

THE CASE FOR GROWTH

Russell S. Sobel and Susane J. Leguizamon

South Carolina needs policy founded in a vision of a better future for its children and grandchildren. If done correctly, policy reform has the potential to drastically increase the well-being of South Carolinians within a generation. Within two generations the state could be at the top of the national income rankings, rather than the bottom. This progress requires policy reform undertaken with the explicit objective of increasing the rate of economic growth and sustaining it over the long term. This reform must be based on science, not politics. That is, South Carolina needs to adopt policies that have been proven to increase growth in other states, and to abandon policies that have decreased economic growth in South Carolina and in other states.

To begin our quest to understand which policies promote, and which hinder, economic growth this introductory chapter outlines the main arguments for why economic growth should be considered as one of the most important policy priorities in the Palmetto State.1

If South Carolina can get its policies in shape prior to the beginning of the recovery from the current national economic downturn, it will be in a strong competitive position to attract the new businesses coming to life as the economy recovers.

THE HAVE’S AND THE HAVE NOT’S

How wide are the differences in standards of living across states? How does average income in South Carolina compare with that of other states? Figure 1.1 (on the following page) shows the most recent data available on per capita personal income for all fifty U.S. states.

With a 2008 per capita personal income of only $31,884, South Carolina ranked 45th, making it the sixth poorest U.S. state. The only states with lower per capita personal incomes are Kentucky, Arkansas, West Virginia, Utah, and Mississippi.

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1 This chapter is based on Sobel and Daniels (2007).
Figure 1.1: Average Income by State, 2008

Note: All per capita personal income data in Chapters 1 and 2 are adjusted for inflation to constant 2008 dollars using the Consumer Price Index. Source: Bureau of Economic Analysis (2009).

Average income in South Carolina is about 80 percent of the U.S. average of $39,751. South Carolina has a hard-working labor force, a bounty of natural resources, excellent ports, major metropolitan areas, wonderful recreation opportunities, and other significant advantages. From a purely economic perspective, there is no reason South Carolina should be near the bottom of the national income ranking.

Why does the average South Carolinian earn so much less than the average citizen in other states? One fundamental problem is that despite its many advantages, South Carolina has been unable to get its economic policies right. Getting these policies right is the key to increasing prosperity.

HAS SOUTH CAROLINA ALWAYS RANKED AT THE BOTTOM?

While South Carolina ranked 45th in per capita personal income in 2008, the path by which it got there is interesting. Figure 1.2 shows the entire history of South Carolina’s ranking.
Figure 1.2: South Carolina’s Historical Income Ranking

Note: This is South Carolina’s ranking among U.S. states in real per capita personal income. Note that the ranking is out of 48 states prior to 1950. In 1950 the government began including Alaska and Hawaii in the data, even though they did not achieve statehood until 1959. Source: Bureau of Economic Analysis (2009).

In 1929, the first year the data began being collected, South Carolina ranked as the poorest state among the then 48 states. For the majority of the early history shown in this graph South Carolina hovered near the bottom of the rankings. In 1979, South Carolina ranked 49th with only Mississippi having lower per capita income.

In the 1980s, however, things dramatically changed. Between 1979 and 1988 South Carolina rose from 49th to 38th in the rankings, an impressive movement of 11 spots upward in 9 years. Unfortunately, these gains have slipped away since the mid-1990s, and from 1997 to 2008 South Carolina fell from 38th to 45th.

Had South Carolina been able to maintain its upward trend that happened in the 1980s, jumping 11 places every nine years, in 2008 instead of ranking 45th in the nation, South Carolina would have ranked as the 14th richest state. While we will discuss the policies that may (or may not) have contributed to this pattern in the next chapter, the underlying direct explanation is easy to uncover—the differing rates of economic growth during these periods.

Figure 1.3 (on the following page) shows South Carolina’s average growth rate of per capita personal income for the decades of the 1980s, 1990s, and 2000s (through 2008). This is the ‘real’ growth rate, or the growth rate after adjusting for inflation.
Figure 1.3: South Carolina’s Declining Rate of Growth

![Bar chart showing the average growth rate (Real PCPI) for South Carolina from 1980s to 2000s.](chart)


During the 1980s, South Carolina’s 2.2 percent average real rate of economic growth—the 15th highest rate of growth among U.S. states at that time—is what propelled the state upward so rapidly in the income rankings during that decade. During the 1980s, South Carolina experienced 6 consecutive years of rapid growth, each of over 2.2 percent, with some years above 3 percent.

Unfortunately, economic growth in South Carolina slowed after the 1980s, falling to 1.5 percent in the 1990s, and to less than 1 percent so far in the 2000s. Rather than being one of the fastest growing states, South Carolina’s recent growth of 0.8 percent makes it the 12th slowest growing state during the 2000s.

While some might think that these differences seem trivial, say between 1.5 and 2.2 percent growth, nothing could be further from the truth. Even small differences in growth, over long periods of time, add up to significant differences. This is the topic to which we now turn our attention.

### JUST ONE PERCENTAGE POINT: WILL OUR CHILDREN BE BETTER OFF?

Large changes in wealth and prosperity cannot be generated overnight. Places that are prosperous today went through stages of development. What prosperous areas have in
common is that they were able to sustain higher rates of economic growth over longer periods of time. Let us consider a few examples.

Figure 1.4 shows the history of income growth in South Carolina, adjusted for inflation, along with several alternative future projections. One projection simply takes South Carolina’s historical rate of real per capita economic growth over the last 20 years, 1.2 percent, and forecasts it into the future. The other two projections show what the future would hold if South Carolina’s growth rate could be increased to 1.7 percent and 2.2 percent respectively. These real growth rates are not unrealistic. Both are actual growth rates experienced in other U.S. states over the last two decades.

Figure 1.4: Which Future for South Carolina?

![Figure 1.4: Which Future for South Carolina?](image)

Note: Per capita income is adjusted for inflation to constant 2008 dollars.

The last year of historical data shown in the figure is 2008, a year in which the average income in South Carolina was $31,884. Let us consider the simple question of what the average income will be in one generation, or twenty years into the future, in 2028. At the historical growth rate of 1.2 percent, average income in South Carolina would be $40,475 in 2028. What if instead growth could be increased to 1.7 or even 2.2 percent? Under these alternative scenarios, average income in 2028 would instead be $44,668 and $49,271 respectively. Thus, a one percentage point higher rate of economic growth results in a difference of almost $8,800 one generation into the future. Also remember that we are

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3 All dollar values for future years are given in today’s dollars—or ‘real dollars’—that have already been adjusted to take out the impact of inflation on the purchasing power of money in the future because we are using a real, inflation adjusted, growth rate.
considering average income per person. The average family size in South Carolina is 3.02 persons, so the impact of this difference on the average family is three times this amount—or a substantial $26,564 difference in family income under the two alternative scenarios 20 years into the future.

What if we look even farther into the future? What about two generations? By 2048 the differences grow even larger. Instead of average income being $51,380 in 2048 at a growth rate of 1.2 percent, it would be $62,576 at 1.7 percent, or a whopping $76,139 at 2.2 percent. Make no mistake about it, over two generations a one percentage point increase in economic growth rate of 1.2 percent, it would be $62,576 at 1.7 percent, or a whopping $76,139 at 2.2 percent. What if we look even farther into the future? What about two generations? By 2048 the differences grow even larger. Instead of average income being $51,380 in 2048 at a growth rate of 1.2 percent, it would be $62,576 at 1.7 percent, or a whopping $76,139 at 2.2 percent. Make no mistake about it, over two generations a one percentage point increase in economic growth rate of 1.2 percent, it would be $62,576 at 1.7 percent, or a whopping $76,139 at 2.2 percent. Perhaps a better way of looking at the data is to ask, at what date in the future will average income in South Carolina hit $50,000? To put this figure in perspective, it is approximately the current average income levels in Wyoming and New Jersey. At South Carolina’s historical 1.2 percent rate of growth it will hit $50,000 in the year 2046. At a 1.7 percent rate of economic growth, this date would instead be 2035—or eleven years earlier. At a 2.2 percent rate of growth it becomes 2029—or seventeen years earlier. Increasing economic growth by just one percentage point moves the date at which the average South Carolinian will have an income level of $50,000 forward by almost an entire generation.

Rather than relying entirely on future projections, it is also useful to consider a few specific historical income comparisons. Consider the cases of South Carolina and two states that twenty years ago, in 1988, were virtually identical to it in terms of income, Oklahoma and South Dakota. Figure 1.5 presents this data. In 1988 the average income in South Carolina was $25,341, while Oklahoma and South Dakota had average incomes of $25,872 and $24,964 respectively. South Carolina ranked 38th in per capita income that year, with Oklahoma one spot ahead of South Carolina (37th) and South Dakota one spot behind (39th).

**Figure 1.5: State Growth Comparisons**

![Bar chart showing average per capita income in 1988 and 2008 for South Carolina, Oklahoma, and South Dakota.]

Note: Per capita income is adjusted for inflation to 2008 constant dollars.
Over the next twenty year period, South Carolina was able to sustain a 1.2 percent rate of growth, Oklahoma 1.8 percent and South Dakota 2.1 percent. After twenty years, or one generation, South Carolina’s 2008 average income of $31,884 is about $5,000 less than the average income in these other two states ($36,899 and $37,375 respectively). The result is that while South Carolina has fallen to 45th in the national income rankings, Oklahoma has risen to 28th and South Dakota to 26th.

It almost seems unbelievable that such small differences in growth can produce such large differences through time, but they can. A well-known financial formula called ‘The Rule of 70’ helps us to understand the importance of time and economic growth rates in generating prosperity. According to this rule, an area’s standard of living will double every X years, where X equals 70 divided by the rate of economic growth:

\[ \text{The Rule of 70:} \quad \text{Years it takes for income to double} = \frac{70}{\text{Annual rate of economic growth}} \]

So, a state that sustains a 1.2 percent growth rate, as has South Carolina, doubles its living standards roughly every 58 years (70 divided by 1.2). A state that sustains an economic growth rate of 1.7 percent sees its living standards double approximately every 41 years, and a state that sustains a growth rate of 2.2 percent doubles its income in only 32 years.

As these numbers clearly illustrate, small differences in the rate of economic growth produce big differences in standards of living when they are sustained over long periods of time. The principle at work here is the same one responsible for the ‘miracle’ of compound interest. South Carolina currently ranks 45th in average income. If all states continue their current growth rates, 20 years into the future, South Carolina will have fallen to 48th. If instead South Carolina could increase growth to just 1.7 percent, its ranking in twenty years would be 34th. If South Carolina could manage to grow at 2.2 percent, it would rank 23rd in the nation within one generation. If that 2.2 percent could be sustained for forty years, South Carolina would rank as the 13th richest state in the nation in 2048.

As the experiences of other states illustrate, these large leaps in the income rankings are possible. Between 1988 and 2008, Wyoming moved up 31 places from 35th to 4th, North Dakota jumped 28 places from 48th to 20th, Louisiana rose 16 places from 46th to 30th, South Dakota improved 13 places from 39th to 26th, and Texas moved up 10 places from 33rd to 23rd. All of them did this the same way—by sustaining high rates of economic growth.

**FROM RAGS TO RICHES: IT CAN BE DONE**

Because economic growth rates vary considerably more across countries than across U.S. states, some international comparisons of long-run growth are even more impressive. An often cited example is the comparison between Hong Kong and Argentina. Approximately fifty years ago, Argentina was almost as rich as many European nations, while Hong Kong was relatively poor. Due to their differing policy climates, today Hong Kong is one of the richest countries in the world while Argentina has fallen behind. This example is often

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4 Alternatively this is sometimes referred to as the ‘Rule of 72’ which produces similar results, but is divisible by more whole numbers making it easier to use in simple calculations.
pointed to as proof of how little a country’s natural resources matter for growth. Hong Kong, after all, is essentially a rock island in the ocean. Argentina, in contrast, has a wealth of natural resources. Like Argentina, South Carolina’s abundance of natural resources by itself cannot guarantee a fast rate of economic growth.

Figure 1.6 shows the levels of per capita income in 1960 and 2002 for five countries: the United States, Venezuela, Argentina, Japan, and Hong Kong. In 1960, while the United States was the richest of the group with a per capita income of almost $15,000, Venezuela was not far behind at $10,600. Japan and Hong Kong, on the other hand, were relatively poor. Their average citizens had only 25 percent as much income as the average citizen in the United States (per capita incomes of roughly $5,000 and $3,750 respectively).

Figure 1.6: International Growth Comparisons

![Chart showing per capita income growth for five countries: United States, Venezuela, Argentina, Japan, and Hong Kong.]

Note: Per capita income is adjusted for inflation to 2005 constant U.S. dollars. Sources: Heston and Summers (1994) and World Bank (2004).

These countries followed very different paths over the next forty-two years. Growth rates were most rapid in Hong Kong (5.3%) and Japan (4.1%), while growth was virtually non-existent in Argentina (0.5%), and was actually negative in Venezuela (-0.3%). Over the same period U.S. per capita income growth averaged somewhere in the middle of these other countries (1.9%).

Fast forward two generations. By 2002, Hong Kong was nearly as rich as the United States (and wealthier than most European countries), and Japan was not far behind. Both are true ‘rags to riches’ stories. In contrast, the average citizen in Argentina is only $2,000 richer than his or her grandparents and the average citizen in Venezuela is almost $1,000 poorer.
ECONOMIC GROWTH AND HUMAN WELL-BEING

At this point, some readers might be questioning whether income is really a good measure of personal well-being. While increasing income certainly helps everyone afford more of the things they want, there is more to life than material possessions. We also care about our families, our health, and our overall safety. While growth may increase our income and standard of living, how does it affect these other measures of personal well-being? By focusing on growth can we also achieve other goals as well? Let us look at the evidence.

People want to lead long healthy lives and this requires access to quality healthcare. Figure 1.7 shows how two important measures of health and longevity differ between groups of the highest income and lowest income states. Without exception, citizens in high income states live longer, healthier lives. Because South Carolina is one of the lowest income states, it is also one of the least healthy. It ranks near the bottom of the U.S. health rankings, at 46th. Citizens in lower income states also have shorter lives. The average high income state (in the top 10) ranks 19th out of 50 in terms of the life expectancy of its citizens. The average low income state (in the bottom 10) ranks only 35th. In terms of health care quality, the picture is the same. Richer states do better, while poorer states like South Carolina do worse. The average high-income state ranks 19th in terms of health care quality. The average low-income state ranks 35th.

Figure 1.7: Health Indicators by Income Level

Sources: Morgan and Morgan (2009) and U.S. Census Bureau (2005). Note Mississippi ranks 50th and thus has no bar height.

This difference is not limited only to physical health; it also appears in measures of mental health. People in lower income states suffer from the highest rates of mental illness (almost 13 percent in the lower income states compared with only 9 percent in the richer
states). This difference is likely due to the lower levels of stress at home and in the workplace that higher income brings.

In addition to our own health, we also care about the well-being of our families and children. All parents want their kids to have stable families, live in safe neighborhoods, and receive a good education. Does having higher income levels lead to these as well? Figure 1.8 presents the evidence. Families living in the five states with the highest incomes experience lower divorce rates than families in the five lowest income states (2.8 versus 4.8 on average). Richer families have fewer money problems destroying their marriages and more money to spend on family vacations and leisure activities. Furthermore, higher income leads to safer neighborhoods. For instance, states with higher incomes have lower rates of violent crime (3.4 versus 4.8 on average).

Our children benefit from economic growth not only in terms of safety and stability but also in the area of education. Children growing up in high income states are far more likely to graduate from high school. The five highest income states have higher percentages of the population graduating from high school than all five of the lowest income states. Higher income states have more children graduating from college as well (33.6 percent versus 19.6 percent college educated population, not shown in figure). Not only does more education increase a child’s future earning potential, enhancing the state’s prospects for growth in the future, but people with higher levels of education report higher levels of job satisfaction and overall happiness in their lives.

**Figure 1.8: Divorce, Crime, and Education**


The evidence is overwhelming. Economic growth not only makes us materially richer; it helps to accomplish our other goals as well. The objective of growth is really about creating a future for South Carolina where families are not only wealthier, but also happier, healthier, safer, and better educated.
CHAPTER 1: THE CASE FOR GROWTH

CONCLUSION

This introductory chapter has explained how even small differences in economic growth rates can produce substantial differences in the quality of life within a generation or two. If South Carolina refuses to undertake policy reform, and continues its current trend, in twenty years the state will have fallen to 48th in per capita personal income, and South Carolinians will remain at the bottom of the economic ladder.

In contrast, a better and richer South Carolina is possible to achieve within our lifetimes. A one-half of a percentage point increase in the rate of real per capita economic growth, from 1.2 percent to 1.7 percent, would result in a ranking of 34th twenty years into the future, and a one percentage point increase in growth to 2.2 percent would result in South Carolina becoming the 23rd richest state in the nation within one generation. More importantly, this growth does not have to come at the expense of other things people value—to the contrary, these other areas are also enhanced by economic growth.

But can policy reform actually increase growth by a meaningful amount? One of the best examples is the country of Ireland. Ireland’s free market reforms have been so successful that many refer to it as the ‘Irish Miracle’. Ireland’s policy reform in the late 1980s and early 1990s enabled its economic growth rate to rise from 2.3 percent to 7.9 percent. The country saw its unemployment rate fall from 17 percent to 4 percent. Ireland’s future is brighter than ever and the benefit of these reforms took less than a decade to unfold. In the next chapter we turn to the next important question: Which policies are most conducive to creating and sustaining long-term economic growth in a state?
REFERENCES


CHAPTER 2

THE SOURCES OF ECONOMIC GROWTH

by Russell S. Sobel and Joshua C. Hall
over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in the figure because it is the lowest-tax state.)

Such a significant reduction in taxes on industrial property would obviously lead to a reduction in tax revenues on industrial property, at least initially. However, the overall effect of lower taxes on the state's fiscal situation is likely to be positive.

Although it is probably not critical that South Carolina set its tax rate to the lowest in the nation, it should be no surprise that it has one of the highest tax rates in the country. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has a serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina has the highest tax rate in the country on industrial property, it should be no surprise that it has a serious disadvantage, in terms of its ability to attract and keep industry.

Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate that is still significant when compared to the taxes paid in other states. Although the rate may not be critical, it is important to note that the rate is still significantly higher than the rates in other states.

Working to reduce the rate to around 1 percent might be sufficient to attract more industry. The state of Virginia has a rate of 0.48 percent, which is the lowest in the nation. This rate is significantly lower than the rates in other states, and it is likely that the state benefits from this lower rate.

The table below shows the state rank, net tax, and effective tax rate for manufacturing property tax in the country. In Figure 5.8, we present the effective property tax rank for the states. The ranks given for the states are out of all 50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million.

<table>
<thead>
<tr>
<th>State</th>
<th>Rank (of 50)</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delaware</td>
<td>50</td>
<td>$238,840</td>
<td>0.48%</td>
</tr>
<tr>
<td>Kentucky</td>
<td>47</td>
<td>$327,100</td>
<td>0.65%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>37</td>
<td>$491,071</td>
<td>0.98%</td>
</tr>
<tr>
<td>Florida</td>
<td>24</td>
<td>$677,683</td>
<td>1.36%</td>
</tr>
<tr>
<td>Georgia</td>
<td>20</td>
<td>$760,381</td>
<td>1.52%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>17</td>
<td>$834,000</td>
<td>1.67%</td>
</tr>
<tr>
<td>Texas</td>
<td>6</td>
<td>$1,264,358</td>
<td>2.07%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>10</td>
<td>$1,033,544</td>
<td>2.53%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>4</td>
<td>$1,291,050</td>
<td>2.58%</td>
</tr>
</tbody>
</table>

The previous chapter made the case for why increasing the rate of economic growth in South Carolina is a priority. In this chapter, we focus on the relationship between economic inputs, institutions, and outcomes. As we will soon see, there is one thing that all successful economic outcomes have in common: they are based on wealth. Economic growth is a result of economic inputs, and the combination of institutions and outcomes are the result of institutional action. We address in this chapter the question of which policies promote economic growth.

Table 5.5 shows that the current tax system charges all income groups more in the state of South Carolina. In the right columns, it also shows what the taxes and average tax rates would be if the 1959 tax tables were indexed for inflation. The table clearly shows that the 1959 indexed tax rate structure is more uniformly progressive, with lower average tax rates than an indexed rate schedule. The only exception is the $5,000 income earner in the 1959 tax tables, which pays an average tax rate of 2.90 percent. The current tax system charges this group an average tax rate of 2.51 percent.

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Table 5.5: Tax System Charges All Income Groups More in the State of South Carolina

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<tr>
<th>Taxable Income</th>
<th>Amount</th>
<th>Average Tax Rate</th>
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</thead>
<tbody>
<tr>
<td>$5,000</td>
<td>$377</td>
<td>2.90%</td>
</tr>
<tr>
<td>$20,000</td>
<td>$954</td>
<td>2.51%</td>
</tr>
<tr>
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The previous chapter made the case for why increasing the rate of economic growth in South Carolina should be considered one of the top policy priorities. However, policy reform to promote growth should be based on evidence of what has worked, and what has not worked in South Carolina and other areas. Evidence was presented in the previous chapter that economic growth is faster in states like Texas, South Dakota, Wyoming, and Louisiana; and in countries like Hong Kong, Japan, and recently Ireland. How can this be replicated in South Carolina? Can we uncover which policies tend to promote prosperity? These are the questions we address in this chapter.1

As we will soon see, there is one thing that high-income and fast-growth places generally have in common: they have unleashed capitalism and backed it up with sound political and legal systems that firmly protect property rights and prohibit fraud, theft, and coercion. By doing so, they have created a level playing field for prosperity to take root. As economist Dwight Lee writes:

No matter how fertile the seeds of entrepreneurship, they wither without the proper economic soil. In order for entrepreneurship to germinate, take root, and yield the fruit of economic progress it has to be nourished by the right mixture of freedom and accountability, a mixture that can only be provided by a free market economy. (1991, 20)

THE PROCESS OF ECONOMIC GROWTH

To understand economic growth and the best way for government policy to promote it, we must first delve deeper into the relationship between economic inputs, institutions, and outcomes.

An economy is a process by which economic inputs and resources, such as skilled labor, capital, and funding for new businesses, are converted into economic outcomes (e.g.,

1 This chapter is based on Sobel and Hall (2007).
wage growth, job creation, or new businesses). This concept is illustrated in Figure 2.1. As the large arrow in the middle of the figure shows, the economic outcomes generated from any specific set of economic inputs depend on the ‘institutions’—the political and economic ‘rules of the game’—under which an economy operates. The important point is that some rules of the game are better than others at producing prosperity.

Figure 2.1: Inputs, Institutions and Outcomes

- **Economic Inputs and Resources**
  - Examples:
    - Skilled Labor Force
    - Technology & Infrastructure
    - Resource Availability
    - Financing for New Businesses

- **Rules of the Game (Govt. Policy)**
  - Examples:
    - Tax System Structure
    - Business Regulations
    - Legal/Judicial System
    - Private Property Right Security

- **Economic Outcomes**
  - Examples:
    - Wage and Income Growth
    - New Business Formation
    - Jobs Created
    - Patents Issued
    - Goods and Services


Several analogies will help to clarify. First, let us consider a basketball game. The players, the court, and the basketballs are all inputs into the process. The ‘institutions’ in this context are the rules under which the game is played. Some examples of these rules are the time length of the game, the length given on the shot clock, the rules on fouling, and the...
three-point line rule. Examples of the measurable outcomes are the score, the winning team, the number of fouls, etc. The important point is that the outcomes will be influenced by which rules of the game are chosen. The reason for this is that the rules of the game affect the choices and behavior of the people playing the game. If, for example, the rule that shots made from behind the three point line were changed so that these were now worth only one and a half points, we would expect players to respond to this rule change in a predictable manner. As the point value of those longer shots decreased, fewer players would attempt them.\footnote{This change in the rules would also alter the incentives in the selection of players, or investments in resources for an economy. Coaches would now have a much weaker preference for players who could make longer shots.}

While a basketball example might sound hypothetical, Clemson University economists Robert McCormick and Robert Tollison (1984) found that while adding an additional referee to a basketball game was expected to result in more fouls being called, a slower-paced game, and less scoring, when these rule changes were actually introduced in ACC basketball they had precisely the opposite effect. The result was fewer fouls, a faster pace, and more scoring. The explanation? Knowing that fouls were more likely to be called by referees, players changed their behavior and committed fewer of them.

To take another example, consider for a moment the board game ‘Monopoly.’ The ‘institutions’ in this analogy are again the rules under which the game is played. Imagine if a new rule were created making it legitimate to steal the property cards of other players if they were not looking. The play and outcomes from a game of ‘Monopoly’ would be significantly different under these different institutional rules, as players would alter their behavior in response to them. Not only would this rule change increase the rate of theft among players, it would also result in fewer properties being purchased, less investment (houses or hotels) on the properties, and more resources being devoted to trying to protect their property cards from being stolen (and more effort into trying to steal the property of other players).

As a final analogy, consider the process of baking cakes. In this context, the ingredients are the inputs, the ‘institutions’ are the oven, and the outcomes are the delicious cakes that result at the end. The main point is obvious—if the oven is not working, simply putting more ingredients (inputs) into the oven does not result in more cakes coming out the other end. Too many government policies at every level of government fail to realize this, and keep pouring money into programs that attempt to increase the inputs into the economy when the real problem is that the oven is broken due to failed economic policies. An economy cannot spend its way out of problems that are caused by weak institutions. Rather institutions must be improved, and this, and only this, will result in investments in inputs paying dividends at the other end of the process.

This model makes it clear that by improving institutions, or the rules of the game under which the South Carolina economy operates, it can change economic outcomes for the better. When institutions are weak, even places with abundant natural resources or other inputs have difficulty becoming prosperous. South Carolina, and the countries of Argentina and Venezuela, fit into this category of resource-rich areas that have not been able to sustain economic growth (as was noted in the previous chapter).

The important point is that our daily economic lives are played out under a set of rules that are to a large extent determined by government-enacted laws and policies. These political and legal ‘institutions’ as economists call them, are what create the incentive structures within the state economy. Prosperity requires that South Carolina get the rules right.
ADAM SMITH’S QUESTION:
WHY ARE SOME PLACES RICH AND OTHERS POOR?

Adam Smith, the ‘father of economics,’ published the first book addressing the set of
topics we now consider ‘economics’ in 1776. In his book, titled An Inquiry into the Nature
and Causes of the Wealth of Nations, Adam Smith (1998 [1776]) attempted to answer a single
question: Why are some nations rich and others poor? Economic science has come a long way
in 200 years, and volumes of published research now clearly provide the answer to the
question Adam Smith posed long ago. The answer is fundamentally the same one arrived at
by Adam Smith.

In a nutshell, he found that countries become prosperous when they have good
institutions that create favorable rules of the game—rules that encourage the creation of
wealth. Smith further concluded that the institutional structure that best promotes prosperity
is an economic system of capitalism backed up by sound political and legal institutions.
According to Smith, an economy becomes prosperous when they use unregulated private
markets to the greatest extent possible, with the government playing the important but limited
role of protecting liberty, property, and enforcing contracts. More than 200 years of published
scientific evidence now supports Smith’s conclusion.

Capitalism is not a political position or platform, it is an economic system—a set of
institutions or rules that define the ‘economic game.’ Capitalism’s institutions produce
prosperity better than the alternative of government control, not only in terms of financial
wealth, but in terms of other measures of quality of life. Adopting institutions (‘rules of the
game’) consistent with the economic system of capitalism has the potential to generate
outcomes that better accomplish the common goals of all political parties: prosperity, wealth,
health, family, security, etc.

THE RISE AND DECLINE OF ECONOMIC FREEDOM
IN SOUTH CAROLINA

While most people tend to think of capitalism and socialism as alternative and discrete
forms of economic organization, in reality government policies tend to lie somewhere on a
continuum between these two extremes. What differs on this continuum is the degree to
which the government uses its power to enact command and control policies that intervene
into the private sector. Some countries, like North Korea, have governments that use a
command and control approach to organizing nearly the entire economy. These countries lie
at the extreme socialist end of the capitalist-socialist spectrum. Other countries, such as
China, are nominally socialist but rely considerably more on the private sector in organizing
their economies. Some countries have moved from one end of the continuum to the other, like
the former Soviet Republics of Estonia and Latvia, and Slovenia (formerly part of socialist
Yugoslavia), who all adopted radical reforms that moved them toward capitalism.

On the other hand, most market-based economies have a much larger degree of
government intervention and control than is envisioned under pure capitalism. Within the last
decade, a significant advance in our understanding of this continuum was the publication of
the Economic Freedom of the World index created by economists James Gwartney (a former
Chief Economist of the Joint Economic Committee of Congress) and Robert Lawson. They derive an index measure for each country that places them on a spectrum from zero to ten, in which ten represents the greatest degree of ‘economic freedom’, i.e., reliance on capitalism, and zero represents the greatest degree of ‘economic repression’, i.e., reliance on government control of the economy. In their most recent ranking, the United States scores 8.0 out of 10, ranking the United States as the eighth most capitalist, or free market, economy in the world. The United States is actually tied for eighth place with Australia. The countries ranking the most capitalist in the world are Hong Kong, Singapore, New Zealand, and Switzerland.

Because state and local policies vary within the United States, Amela Karabegovic and Fred McMahon created an index of the Economic Freedom of North America, which ranks U.S. states and Canadian provinces by the degree of free market orientation within each state or province. Among U.S. states, South Carolina ranked 25th in the most recent index, for year 2005 data. As recently as the late 1980s, however, South Carolina was in the top 10 of this index. Figure 2.2 shows how South Carolina’s economic freedom rank has changed.

**Figure 2.2: South Carolina’s Economic Freedom Rank**

![Graph showing South Carolina's Economic Freedom Rank from 1980 to 2010. The rank ranges from 25th to 9th over the years.](image)

Source: Karabegovic and McMahon (2008).

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4 Online at http://www.freetheworld.com. The most recent edition is the 2008 report (Karabegovic and McMahon 2008) which includes annual rankings through 2005. Rankings here have been recalculated among only the U.S. states (i.e., excluding the Canadian provinces).
During the 1980s, South Carolina rose from 25th to 9th in the economic freedom ranking among U.S. states. In 1989 South Carolina’s policies ranked among the top 10 most free market in the country. Since that time, and particularly since 1997, economic freedom has been on the decline in South Carolina, falling back to where it began in the early 1980s.

Does the ‘market-friendliness’ of South Carolina’s policies help to explain its recent economic performance? Recall that Figure 1.2 from Chapter 1 showed South Carolina’s per capita income ranking from 1929 forward, and that there was a large improvement in South Carolina’s ranking in the 1980s followed by a subsequent decline. Figure 2.3 shows the remarkable correlation between South Carolina’s economic freedom and per capita income rankings. Here, South Carolina’s per capita income ranking is measured on the left y-axis, while its economic freedom ranking is on the right y-axis. Also shown in the figure in boxes at the top are the average growth rates during these three periods.

**Figure 2.3: Economic Freedom vs. Prosperity in South Carolina**

![Graph showing economic freedom vs. prosperity in South Carolina]


During the 1980s when South Carolina’s economic freedom was improving, growth was rapid (3.0%), and the state rose 10 spots in the per capita income rankings. During the 1990s, economic freedom began receding and South Carolina’s growth began to slow (1.5%). Beginning around 2000, South Carolina’s economic freedom began dropping significantly, and it fell 6 places in the per capita income rankings due to its below average growth (0.8%).

The point should be obvious, for South Carolina to improve economic growth it must again move toward policies that embrace capitalism and free markets. If South Carolina
continues its current policy trend, the state’s economic ranking is likely to suffer, and within a decade South Carolina will be at the very bottom of the national economic rankings with states such as West Virginia and Mississippi. With all of South Carolina’s advantages over these states, it is almost unbelievable that the Palmetto State could be in such company. Yet, as the earlier oven analogy demonstrated, when policies are bad, economic outcomes suffer despite having good inputs into the process.

Returning to Ireland’s growth ‘miracle’ discussed in the previous chapter, we find an example of a country enacting significant pro-market reforms and gaining prosperity as a result. Ireland jumped from a score of 6.3 (out of 10) in 1985 to a score of 8.2 by 1995 in the international economic freedom index, leading Ireland to become the fifth most free market economy in the world. As a result, Ireland’s growth skyrocketed, unemployment fell, and prosperity flourished.

To help illustrate how much less South Carolina relies on capitalism than some of the other U.S. states, it is worthwhile to examine one of the major components of the economic freedom index, government spending as a share of the state economy, shown in Figure 2.4.

**Figure 2.4: Government Control of the Economy**

![Graph showing government control of the economy across U.S. states.]

Source: Karabegovic and McMahon (2008).

How much government spends relative to the total size of a state’s economy is a good measure of the extent to which government controls the allocation of economic resources in a state. Government spending is, of course, only one component of the overall economic freedom index, which also includes measures of government regulations, relative tax rates, and threats to private property.

Looking at spending alone, relative to the other U.S. states, South Carolina has the tenth largest government share of state economic activity. Combined, all federal, state, and
local government spending in South Carolina amounts to 40.5 percent of the state economy. For comparison, in the most free market state, Delaware, government controls only 20.5 percent of the economy, leaving roughly 80 percent to the private sector. At the other extreme, in the least capitalist state, West Virginia, government spending is the highest in the nation, taking up 51.3 percent of the state economy, and leaving less than half of the state economy’s resources to the private sector.

Figure 2.5 shows the data for state and local government spending alone (that is, excluding federal government spending which is included in Figure 2.4). When considering state and local government spending, South Carolina has the 11th largest government sector in the United States at 17.8 percent of the state economy.

**Figure 2.5: State & Local Government Control of the Economy**

![Figure 2.5: State & Local Government Control of the Economy](image)

Source: Karabegovic and McMahon (2008).

South Carolina’s government size is one of the factors that led to the trends in economic freedom shown earlier. From 1982 to 1988 total government spending fell by 5 percent of the economy, while it has risen 10 percent since 1989. State and local spending combined fell by almost 2 percent of the economy during the 1982 to 1988 period, while it rose by 6 percent since 1989. International studies across OECD countries suggest that a nation’s economic growth rate falls by 1 percentage point for every 10 percentage point increase in government as a share of the economy. This interestingly, is roughly the amount by which South Carolina’s economic growth rate has fallen as its government sector expanded by 10 percent of the state economy since 1989. The slowdown in economic growth is not entirely explained by the increase in government spending, as other indicators in the

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^5 See Gwartney, Stroup, Sobel, and Macpherson (2009), page 622.


**DID HURRICANE HUGO PLAY A ROLE?**

Astute readers may notice that South Carolina’s first downward trend began around 1989, the year in which Hurricane Hugo hit South Carolina, causing roughly $6 billion in damage to the state, and resulting in 24 of South Carolina’s 46 counties being declared disaster areas. At the time Hurricane Hugo was the costliest hurricane in U.S. history, although it has now been surpassed by four other hurricanes, including Hurricanes Andrew and Katrina.

With regard to economic prosperity, evidence from states like South Carolina, as well as Florida and North Carolina who also suffer from regular hurricane strikes, suggests that a state recovers fairly quickly. South Carolina’s ranking in per capita income, for example, had returned to its 1988 level by the mid-1990s. Louisiana, after falling to 50th in per capita income after Hurricane Katrina struck, has already rebounded and is now ranked higher than it was prior to the storm in per capita income, although conditions there may be different from the post-Hugo situation as there was a much larger permanent outflow of low-income population from Louisiana due to the storm.

While economic activity was eventually restored, the lasting negative impact of Hurricane Hugo is likely found mostly in its impact on economic freedom—especially the size of government—in South Carolina. Higgs (1987) notes that throughout the history of the United States, individual ‘crisis’ events are often met with supposedly temporary increases in government spending or programs that often persist forever. One need only think of the many new federal programs enacted after the September 11th terrorist attacks as an example of this process. Therefore, events such as Hurricane Hugo often lead to permanent ‘ratchets’ upward in government spending, regulations, and other market interventions (such as price controls and regulations).

In addition, research by Leeson and Sobel (2008) shows that the massive inflows of federal FEMA spending that accompany hurricanes tend to result in increases in state government corruption, bureaucracy, and increases in special interest group influence in state government in a manner similar to what unfolds accompanying large inflows of foreign aid to poorer countries in the world. After Hurricane Hugo, FEMA rapidly injected over $387 million of federal spending into South Carolina. For comparison, this would be roughly 0.6 percent of the state economy at the time, 5.6 percent of South Carolina state government spending that year, or $112 per person in the state.

South Carolina’s economic freedom has shown a mostly downward trend since Hurricane Hugo, and if this storm is to be blamed for anything, it would be its lasting deterioration of the economic freedoms South Carolinians enjoyed prior to the storm’s landfall in Charleston on the night of September 21, 1989.

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6 These 10 index components measure a variety of factors including government spending, taxes, regulations, and the security of property rights.

SOUTH CAROLINA’S OTHER ECONOMIC POLICY RANKINGS

Not only does South Carolina’s economic freedom ranking show the need for policy reform, but nearly every other national index of business climate agrees. Below are South Carolina’s most recent rankings in all of the major national indices of business climate related issues.8

South Carolina’s Business Climate Rankings:

7th Small Business & Entrepreneurship Council’s Small Business Survival Index (2008)  
11th Small Business & Entrepreneurship Council’s Small Business Tax Index (2009)  
25th Tax Foundation’s State Business Tax Climate Index (2009)  
25th Fraser Institute’s Economic Freedom of North America (2005)  
27th Directorship Magazine’s Boardroom Guide to the Best States for Business (2009)  
37th CNBC’s America’s Top States for Business (2009)  
40th Corporation for Enterprise Development’s (CFED) Development Capacity Index (2007)  
41st Progressive Policy Institute’s (PPI) New Economy Index (2002)  
42nd Beacon Hill Institute’s State Competitiveness Report (2007)  
42nd Milken Institute’s National State Technology & Science Index (2008)  
43rd Institute for Legal Reform (ILR) / Harris State Liability Systems Ranking Study (2008)  
45th Milken Institute’s Cost of Doing Business Index (2007)

Beside the two small business rankings from the Small Business & Entrepreneurship Council, South Carolina generally ranks in the 30s or 40s in most others. These indices are to one extent or another measuring the same thing; South Carolina’s lack of reliance on capitalism.

Even South Carolina’s individual income tax is among the worse in the nation, with a six bracket tax code that is virtually identical to what it was in 1959 when median family income was $3,821 and the top, 7 percent, tax bracket began at $10,000. At that time the median family was in the second lowest, or 3 percent, tax bracket. Because of a failure to update the brackets properly through time for inflation South Carolina’s top 7 percent tax bracket started at $13,350 in 2008, meaning the vast majority of families have now been artificially moved into the highest tax bracket because of inflation. For comparison, the 2007 median family income in South Carolina was $52,913. Had the 1959 tax brackets been properly updated for inflation, the top 7 percent bracket would not begin until an income level of $73,987 in 2008, and the median family would be in the third lowest, or 4 percent, tax bracket. This would be more similar to other states like North Carolina whose 7.75 percent top rate begins at $60,000 or West Virginia whose 6.5 percent top rate also begins at $60,000.

Essentially, South Carolina now has an individual income tax system that is almost a flat rate system in which virtually all taxpayers in the state are in one bracket. The difference is that the other states with flat rate systems have significantly lower rates, with Illinois at 3 percent, Pennsylvania at 3.07 percent, Indiana at 3.4 percent, Michigan at 4.35 percent,  

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Colorado at 4.63 percent, and Massachusetts at 5.3 percent. Thus, South Carolina imposes a marginal income tax rate on its median family almost twice as high as these other states.

In addition to South Carolina’s uncompetitive individual income tax rates, the effective property tax rate on industrial property in the state is the highest in the nation. A study by the Minnesota Center for Public Finance Research that appears in the 2009 Competitiveness Redbook published by the National Association of Manufacturers provides a ranking of the tax burden on a representative manufacturing business with $25 million of property consisting of $12.5 million in machinery and equipment, $10 million in inventories, and $2.5 million in fixtures. South Carolina ranks first, with an annual property tax bill of $1,864,900 which amounts to a 3.73 percent effective tax rate. For comparison, in the most free market state, Delaware, this same business’s property tax bill would be $238,840 (an effective rate of 0.478 percent, the lowest in the nation). Thus, the annual property tax bill for an identical manufacturing business in Delaware is about 13 percent of the tax bill they face in South Carolina.

Perhaps more importantly, the property taxes levied on this business would be $760,381 in Georgia, and $491,071 in North Carolina. With effective tax rates of 1.521 percent and 0.982 percent respectively, the property tax this representative firm would face in South Carolina’s neighboring states is only a fraction of what it is in South Carolina (41 percent for Georgia and 26 percent for North Carolina). The high property tax rates South Carolina imposes on equipment and machinery result in less capital investment and reduced prosperity for all South Carolinians.

We will return specifically to the issue of South Carolina’s taxes, and potential areas for reform, in Chapters 4 and 5.

**South Carolina Has Low Economic Freedom Relative to Its Neighboring States**

South Carolina’s lack of economic freedom, especially relative to its neighboring states, is drawing business out of the state. While South Carolina ranked 25th in economic freedom in 2005, Georgia and North Carolina both ranked in the top 5—in fact, they were tied for third with Colorado. Only Texas and Delaware ranked higher in economic freedom than South Carolina’s two neighboring states.

Georgia and North Carolina also both ranked in the top 10 of CNBC’s America’s Top States for Business, while South Carolina ranked 37th. In fact, South Carolina ranks lower than both of its neighboring states in 9 out of the 12 business climate rankings presented earlier in this chapter. Because business location decisions are most flexible across neighboring state lines, this is problematic for South Carolina. It also increases the importance of making policy reforms in the Palmetto State an immediate priority.

Because of their better business climates, Georgia and North Carolina have created a more vibrant entrepreneurial environment. Measures of entrepreneurial activity, including venture capital investments per capita, patents per capita, establishment birth rates for large firms, and the growth rate of sole proprietorships, show South Carolina lagging behind its neighboring states.\(^9\)

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\(^9\) See Figure 2.7 for the actual numbers.
One of the places where this difference is visible is in the recent relative performance of the ports of Charleston and Savannah, located only about 100 miles apart.\(^\text{10}\) While container traffic at the other largest U.S. ports remained relatively constant between 2006 and 2007, Savannah’s traffic increased by almost 21 percent, allowing it to become the fourth largest port in the nation almost out of nowhere. It has been the fastest growing port in the United States since 2000; and in 2007, Savannah handled more than 2.6 million 20-foot equivalent units (TEUs) and is now home to new distribution centers for retailers like Ikea and Target.

South Carolina’s weak competitive position has meant that during this same period, Charleston’s port has seen dwindling traffic. In 2005, Charleston handled 12.6 million metric tons of containerized freight including lumber, electronics and pharmaceutical products, making it the fourth largest port in the United States. By 2006, traffic had fallen by 9 percent, and then declined by another 7 percent in 2007. As a result, Charleston fell to eighth place among U.S. ports in terms of container tonnage—even behind Norfolk, Virginia. Things could get even worse in the coming years, if Maersk Line stops using the Charleston port when its contract expires in 2010.

**WHAT IS CAPITALISM? THE CONCEPT OF ECONOMIC FREEDOM**

While everyone has a general idea of what economists mean by the term ‘capitalism’ it is important that we now define it more precisely. Fundamentally, capitalism is an economic system founded on the private ownership of the productive assets within an economy. These include land, labor (including your person), and all other tangible property (e.g., cars, houses, factories, etc.) and intangible property (e.g., radio waves, intellectual property, etc.). Individuals are free to make decisions regarding the use of their property, with the sole constraint that they do not infringe upon the property rights of others.

The freedom of action given to private owners under a system of capitalism is why the index that ranks states and countries is called the ‘economic freedom’ index. Economic freedom is synonymous with capitalism. More specifically, the key ingredients of economic freedom and capitalism are:

- personal choice and accountability for damages to others,
- voluntary exchange, with unregulated prices negotiated by buyers and sellers,
- freedom to become an entrepreneur and compete with existing businesses, and
- protection of persons and property from physical aggression, theft, lawsuits, or confiscation by others, including the government.

The concept of capitalism is deeply rooted in the notions of individual liberty and freedom that underlie our country’s founding and are reflected in the Declaration of Independence and U.S. Constitution. Economic freedoms are based in the same philosophies that support political and civil liberties (like the freedom of speech and the freedom to elect representatives). Individuals have a right to decide how they will use their assets and talents. On the other hand, they do not have a right to the time, talents, and resources of others.

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\(^{10}\) Data and information for this section are from Johnson (2008) and Roth (2008).
Because private property rights, and their protection, are critical to economic progress, it is worthwhile to be more specific about private property rights.\textsuperscript{11} Private property rights entail three economic aspects: (1) control rights – the right to do with your property as you wish, even to exclude others from using it, so long as you do not use your property to infringe on the property rights of someone else; (2) cash flow rights – the right to the income earned from the property or its use (i.e. being the ‘residual claimant,’ which is also critical for enabling the property to be used as collateral for loans); and, (3) transferability rights – the right to sell or divest of your property under the terms and conditions you see fit.

A government policy that weakens any one of these components of property rights weakens property rights in general. Taxes, for example, restrict the cash flow rights associated with property and so weaken private property rights on that dimension.\textsuperscript{12} Regulations, on the other hand, restrict how owners may use their property, infringing on control rights, and weakening private property rights on that dimension. Outright takings, or other forms of outright expropriation, by removing the property from an owner’s possession (such as eminent domain or shoreline property takings, especially when allowing the state to remove the property from an owner’s possession and transfer it to another private owner) actually weaken property rights on all of the dimensions considered above, making property a ‘contingent right’ (contingent on the state’s arbitrary will) rather than an ‘absolute right’ guaranteed and protected by law.

In order to nurture capitalism, government must do some things but refrain from doing others. Governments promote capitalism by establishing a legal structure that provides for the even-handed enforcement of contracts and the protection of individuals and their property from aggressors seeking to use violence, coercion, and fraud to seize things that do not belong to them. However, governments must refrain from actions that weaken private property rights or interfere with personal choice, voluntary exchange, and the freedom of individuals and businesses to compete. When these government actions are substituted for personal choice, economic freedom is reduced. When government protects people and their property, enforces contracts in an unbiased manner, and provides a limited set of ‘public goods’ like roads, flood control, and other major public works projects, but leaves the rest to the private market, they support the institutions of capitalism.

\textsuperscript{11} Note that the appropriate definition of property rights are those of protective rights—that is, rights that provide individuals with a shield against others who would invade or take what does not belong to them. Because these are nonaggression or ‘negative’ rights, all citizens can simultaneously possess them. In the popular media some people argue that individuals have invasive rights or what some call ‘positive rights’ to things like food, housing, medical services, or a minimal income level. The existence of positive rights require the forceful redistribution of wealth, which implies that some individuals have the right to use force to invade and seize the labor and possessions of others, and such invasive rights are in conflict with economic freedom. If you can ask “at whose expense” at the end of a statement about a claim of someone’s right, it is not—and can not be—a real right. Real rights, such as the right to your life or free speech, do not impose further obligations on others (other than to avoid from violating your right). The right to property does not mean you have a right to take the property of others, nor is it a guarantee you will own property—rather it is a right that protects legitimately acquired property against the aggression from others who would take it.

\textsuperscript{12} In addition, because the value of a property asset is determined by the present discounted value of the net income from the property’s ownership, taxes often directly impact the current market value of property to the owners. Insecure cash flows due to taxes also inhibit long-term contracting and lending.
CAPITALISM, DEMOCRACY, AND CONSTITUTIONAL CONSTRAINTS

It is also important to distinguish between economic freedom and democracy. Unless both parties to a private exchange agree, the transaction will not occur. On the other hand, majority-rule voting is the basis for democracy. When private mutual agreement forms the basis for economic activity, there will be a strong tendency for resources to be used in ways that increase their value, creating income and wealth. The agreement of buyer and seller to an exchange provides strong evidence that the transaction increases the well-being of both. In contrast, there is no such tendency under majority rule. The political process generates both winners and losers and there is no assurance that the gains of the winners will exceed the cost imposed on the losers. In fact, there are good reasons to believe that in many cases policies will be adopted for the purpose of generating benefits for smaller and more politically powerful interest groups—even when those policies impose much greater costs on the general public. Elected officials must cater to the special interest groups who provide votes and support for their political candidacy—they have to if they want to keep getting reelected.

The reason why the political allocation of resources is problematic is that when the government is heavily involved in activities that provide favors to some at the expense of others, people will be encouraged to divert resources away from productive private-sector activities and toward lobbying, campaign contributions, and other forms of political favor-seeking. We end up with more lobbyists and lawyers, and fewer engineers and architects. Predictably, the shift of resources away from production and toward plunder will generate economic inefficiency. We will return to this idea in more detail in Chapter 3.

Unconstrained majority-rule democracy is not the political system that is most complementary with capitalism—limited and constitutionally constrained government is. Constitutional restraints, structural procedures designed to promote agreement and reduce the ability of interest groups to exploit consumers and taxpayers, and competition among governmental units (federalism and decentralization) can help restrain the impulses of the majority and promote economic freedom.

As Supreme Court Justice Robert Jackson emphasized in West Virginia State of Education vs. Barnette (1943, 638), “one’s right to life, liberty, and property, to free speech, a free press, freedom of worship and assembly, and other fundamental rights may not be submitted to vote; they depend on the outcome of no elections.” The fundamental principle is that there needs to be safeguards preventing democratic governments from enacting policies that infringe on the property rights of citizens, just like the rules preventing it from infringing on the rights to free speech and worship. When property rights are secure so that owners can use their property in the ways they see fit without the fear of the property being seized, overly regulated, or taxed, the foundation for unleashing capitalism is created.

WHAT CAPITALISM IS NOT: BEING BUSINESS FRIENDLY DOES NOT MEAN GIVING AWAY FAVORS

Before moving on, one additional point needs clarifying. There is a difference between what economists call capitalism and what some might consider ‘business-friendly policies.’ When government gives subsidies or tax breaks to specific firms or industries that
lobby but not to others, this is at odds with the institutions, or rules of the game, consistent with capitalism.

When it becomes more profitable for companies and industries to invest time and resources into lobbying the political process for favors, or into initiating lawsuits against others, we end up with more of these types of destructive activities, and less productive activity. Firms begin competing over obtaining government tax breaks rather than with each other in the marketplace. They spend time lobbying rather than producing.

In addition, by arbitrarily making some industries more (or less) profitable than others, private sector economic activity is distorted in those sectors relative to other sectors. For growth, market-determined returns (profit rates) and market prices should guide these investments, not government taxes and subsidies. Capitalism is about a fair and level playing field for everyone. This does mean lower overall levels of taxes and regulations—ones that are applied equally to everyone.

Business subsidies may visibly create jobs, but the unseen cost is that the tax revenue or other resources necessary to fund these subsidies generally destroy more jobs than are created. They result in a net reduction in economic activity. The problem, politically, is that these losses are not as visible. When every taxpayer in South Carolina has to pay, say, $1 more in taxes to fund some multi-million dollar subsidy, this reduced spending spread out all over the state ends up causing job losses at businesses all over the state. Government subsidy programs can, thus, transfer jobs around the state, but on net the overall impact is negative.

When business interests capture government’s power things can go just as bad for capitalism as when government power is held in the hands of less business-friendly groups. For example, when companies can get government to use the power of eminent domain to take property from others, or use lobbying or connections to get special tax favors, subsidies, or exemptions for their business, this policy climate is not conducive to capitalism either.

Economic progress, growth, and development are not about having business take over government policy making. Unconstrained democracy is a threat to capitalism regardless of who is in power. Progress is not about turning policy over to a specific industry; instead it is about being competitive across the board to attract many new types of businesses in different locations. It is about an environment in which small rural entrepreneurs can compete and thrive in the global marketplace that is now becoming more connected to them through the Internet. It is about creating more high-paying jobs across the board.

South Carolina has a bad record when it comes to granting these special favors, including those offered to BMW, Michelin, and (unsuccessfully) Cabela’s. All firms in South Carolina should have a good business climate, without having to devote time, effort, and resources toward political lobbying and favor seeking to get it. Many of these firms—including small entrepreneurs—simply do not have the political power to even begin to negotiate a better business climate like large companies. These same resources devoted toward offering these special favors to big businesses would be better spent doing across the board tax reductions on South Carolina’s entrepreneurs, individuals, and all businesses. The issue of selective tax incentives is taken up in more detail in Chapter 7.
Institutions and Growth: A Closer Look at the Evidence

Nobel Prize winning economists F.A. Hayek, Douglass North, and Milton Friedman won their Nobel awards for contributions to our understanding of why (and how) capitalism creates such remarkable prosperity. The reason why so many economists are in agreement on this issue is because the evidence is so clear. Let us take a closer look at the evidence on the relationship between capitalism and prosperity.

First, let us compare states’ reliance on capitalism, the Economic Freedom of North America index, and state per capita income. This is shown in Figure 2.6. The trend line shown in the figure clearly has a positive slope. Thus, the states whose citizens have the highest average incomes are the states that rely most heavily on capitalism. The poorest states are those that rely most on government.

Figure 2.6: Reliance on Capitalism and Prosperity

![Graph showing the relationship between economic freedom score and per capita personal income.](image)

Sources: Karabegovic and McMahon (2008) and Bureau of Economic Analysis (2009).

How does the economic freedom index correlate with other measures of economic activity? Figure 2.7 shows, for the top 5 and bottom 5 ranking states in the economic freedom index, seven measures of economic prosperity and entrepreneurial activity. In addition, the table shows the averages for these two groups of states on these important indicators of prosperity, as well as the difference between the averages for these two groupings of states. For comparison, South Carolina’s data on these measures is shown at the bottom of the table.
The states listed in the top of the table, those with the best institutions, are uniformly more prosperous than the states with the worst economic institutions. The differences in economic outcomes are striking. Looking at the averages given in the bottom of the table, average per capita personal income is $5,618 higher, and the poverty rate is 3.1 percentage points lower, on average, in those states with the best economic institutions. Examining the measures of entrepreneurial activity, a similar pattern emerges—states with the most economic freedom have higher rates of entrepreneurial activity. Relative to the states with the least economic freedom, those with the most have venture capital investment $123.16 higher per capita, a rate of patents 21.2 higher per 100,000 residents, a growth rate of sole proprietorships 1.4 percentage points higher, an establishment birth rate almost 2 percent higher, and a birth rate of large establishments 2.4 percentage points higher.

Because South Carolina ranks in the middle of the pack on economic freedom, the measures of entrepreneurship and prosperity for South Carolina generally fall in between the values for the top and bottom states. Of most interest, however, is probably how South Carolina compares to its neighboring states of Georgia and North Carolina (both listed among the top 5 states in Figure 2.7). As was mentioned earlier in this chapter, South Carolina lags behind its neighboring states on measures of entrepreneurial activity and prosperity.

Figure 2.7: Capitalism’s Economic Record

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rank (among U.S. states)</td>
<td>Per Capita Personal Income (2008)</td>
<td>Poverty Rate (2007)</td>
</tr>
<tr>
<td>Top 5 States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Delaware</td>
<td>8.5 1</td>
<td>$40,852 10.3%</td>
<td>$60.97 52.6 5.5% 13.1% 14.2%</td>
</tr>
<tr>
<td>Texas</td>
<td>7.8 2</td>
<td>$38,575 16.3%</td>
<td>$113.29 25.9 3.3% 12.8% 12.0%</td>
</tr>
<tr>
<td>Colorado</td>
<td>7.6 3 (tie)</td>
<td>$42,377 11.5%</td>
<td>$333.22 37.1 4.6% 14.2% 13.0%</td>
</tr>
<tr>
<td>Georgia</td>
<td>7.6 3 (tie)</td>
<td>$33,975 14.3%</td>
<td>$103.63 14.6 4.0% 13.5% 11.7%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>7.6 3 (tie)</td>
<td>$34,439 14.3%</td>
<td>$82.57 19.5 3.5% 11.7% 10.3%</td>
</tr>
<tr>
<td>Bottom 5 States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Montana</td>
<td>6.0 46 (tie)</td>
<td>$34,256 14.1%</td>
<td>$14.30 12.6 1.9% 12.0% 10.7%</td>
</tr>
<tr>
<td>New Mexico</td>
<td>6.0 46 (tie)</td>
<td>$32,091 17.9%</td>
<td>$10.08 16.3 2.7% 12.1% 10.8%</td>
</tr>
<tr>
<td>Maine</td>
<td>5.8 48 (tie)</td>
<td>$35,381 12.2%</td>
<td>$34.96 9.3 3.0% 11.2% 9.5%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>5.8 48 (tie)</td>
<td>$29,569 20.7%</td>
<td>$18.53 5.6 3.4% 11.1% 9.7%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>5.3 50</td>
<td>$30,831 17.1%</td>
<td>$0.00 0.0 2.8% 9.5% 8.6%</td>
</tr>
<tr>
<td>Average - Top 5 States</td>
<td></td>
<td>$38,044 13.3%</td>
<td>$138.74 29.9 4.2% 13.1% 12.2%</td>
</tr>
<tr>
<td>Average - Bottom 5 States</td>
<td></td>
<td>$32,426 16.4%</td>
<td>$15.57 8.8 2.8% 11.2% 9.9%</td>
</tr>
<tr>
<td>Difference (Top minus Bottom)</td>
<td></td>
<td>$5,618 -3.1%</td>
<td>$123.16 21.2 1.4% 1.9% 2.4%</td>
</tr>
</tbody>
</table>

For Comparison:

<table>
<thead>
<tr>
<th>State</th>
<th>Rank (among U.S. states)</th>
<th>Per Capita Personal Income (2008)</th>
<th>Poverty Rate (2007)</th>
<th>Venture Capital Investment Per Capita</th>
<th>Patents Per 100,000 Pop.</th>
<th>Sole Proprietorship Growth Rate</th>
<th>Establishment Birth Rate (all firms)</th>
<th>Establishment Birth Rate (large firms only)</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Carolina</td>
<td>6.8 25</td>
<td>$31,884 15.1%</td>
<td>$22.98 13.2 2.4% 11.8% 9.7%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
EVIDENCE FROM ACROSS THE WORLD

While state comparisons are probably the most valuable for South Carolina policy reform, it is worthwhile to spend a moment looking at some additional evidence on the relationship between reliance on capitalism, or economic freedom, and prosperity from around the world. This is meaningful because as mentioned earlier, there are much larger differences between countries than between U.S. states. The majority of countries in the world indeed rely less heavily on capitalism than does South Carolina, but their fate can help us understand what is in store for the state if policy keeps moving in the wrong direction.

Figure 2.8 shows the average income level within four different groupings of countries in the Economic Freedom of the World index. Countries are divided into these groups based on their scores, and again higher numbers mean a heavier reliance on capitalism, rather than political planning, to organize their economies. The pattern in Figure 2.8 is clear and is the same pattern we saw across the U.S. states above. A heavier reliance on capitalism makes countries more prosperous.

Figure 2.9 shows a similar graph for the relationship between reliance on capitalism and income growth rates over the 1990-2003 period for countries of the world. Those relying least on capitalism are not only poorer to begin with (looking at average income levels), but they are also becoming worse off through time. As their negative growth rates show, average income is actually falling through time in these countries. At the opposite end of the spectrum are countries that rely heavily on capitalism and have both high incomes and high growth rates as a result.

Figure 2.8: Capitalism and Income (International Data)

In summary, the international evidence bears out the same conclusions as the evidence from U.S. states. Those areas embracing capitalism are richer and grow faster, and those areas that do not are poorer and grow slower.

**THE GAP BETWEEN RICH AND POOR**

This chapter has presented evidence that areas relying on capitalism—the protection of private property through limited political and sound legal institutions—are more prosperous. The data we have presented here on average per capita income supports this conclusion. Some readers, however, might worry that while reliance on capitalism causes average income to rise, it may cause the distribution of income among people to change in an undesirable direction. After all, opponents of capitalism in the popular media quote statistics about how the rich are getting richer and the poor are getting poorer. Would a heavier reliance on capitalism make this happen in South Carolina?

First, it is important to differentiate between income disparities *within* a state changing and income disparities *across* states changing. For example, states (and countries) relying more heavily on capitalism have both higher levels of income and faster income growth, while states (and countries) relying less heavily on capitalism have both lower levels of income and slower economic growth. So it is true that through time, the relatively richer citizens of places like Delaware keep getting richer faster than the relatively poorer citizens of places like South Carolina. As Chapter 1 demonstrated, through time, even small differences
in growth rates can cause large differences in prosperity. However, this is the result of some areas getting policy to work properly. States that adopt good policies not only make their citizens richer, but those citizens keep getting even wealthier through time. States adopting bad policies make their citizens poorer and also cause them to experience slower growth, leaving them behind the progress of others. In other words, it is differences in the reliance on capitalism that explain the growing disparities across states.

While the growing disparities across states are caused by policy differences in whether states embrace capitalism, the impact of a greater reliance on capitalism within a given state is a different story altogether. While certainly under capitalism some earn more than others, the alternative to this, the political allocation of wealth, is actually much more uneven. The benefits of government spending and transfers are much more highly concentrated among the politically powerful than are the benefits of private economic activity. The larger the government control of the economy, the more concentrated and uneven is income growth.

Let us look at the evidence. Consider the comparison of West Virginia—the state ranking 50th in the index of economic freedom—versus Delaware—the state ranking 1st. It is worth noting that these two states also rank 50th and 1st respectively in one of the alternative measures of state reliance on capitalism presented earlier in this chapter—the Institute for Legal Reform’s State Liability Systems Ranking of state legal systems. While the economic freedom index is certainly the closest measure to what economists mean by capitalism, because the most fundamental underpinning for capitalism is secure property rights (which are to a great degree determined by precedent through the state’s court decisions) the Institute for Legal Reform’s ranking of state legal systems provides another measure.

There is no question that both studies are in agreement as to these two states comprising the two extremes: Delaware is the best example of capitalism in the United States and West Virginia is the best example of the lack of free markets. From the government spending data presented earlier, in West Virginia government spending exceeds 50 percent of the economy, while in Delaware it is only 20 percent. Let us compare how income growth varies across the income distribution in Delaware and West Virginia.

Figure 2.10 shows data on how the growth of income has differed among income classes in West Virginia over the last two decades. Income growth has been very uneven in West Virginia. The poorest 20 percent of West Virginians experienced income growth of approximately 11 percent, in total, over the past two decades. Moving to the right, higher income groups saw income rise even faster. The richest 20 percent of West Virginians experienced a 63 percent increase in income over this period, a growth rate almost six times as large as for the lowest 20 percent.

Now, let us consider income growth in Delaware. As we have seen, Delaware’s government size, relative to its economy, is less than half as large as West Virginia, and it has one of the most favorable business climates in the United States, with very low labor and business regulations and a highly-rated legal system. As Figure 2.11 shows, income growth in Delaware has been much more even.

The income growth for the poorest 20 percent of Delaware’s population was almost 30 percent, a rate similar to all other income groups, including the richest 20 percent. Over the past two decades, those with the lowest incomes in Delaware have seen their incomes grow

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by almost three times as much as those with the lowest incomes in West Virginia. Capitalism, as Delaware illustrates, is a rising tide that lifts all boats.

**Figure 2.10: West Virginia Income Growth**

![Graph showing income growth in West Virginia by income quintile.](image)

**Figure 2.11: Delaware Income Growth**

![Graph showing income growth in Delaware by income quintile.](image)

In the economies with the most reliance on capitalism and the smallest government sectors, income growth is much more rapid—not just overall—but also for those with the lowest incomes. Places where legislatures and political parties control the distribution of wealth and economic activity end up with the most favoritism and smallest gains for those with low incomes. This is because those with lower incomes do not have the political power to compete with special interest groups for government spending, contracts, regulations, and handouts.

Contrary to what many commentators would have you believe, the evidence clearly supports the view that income distributions in economies with more government control tend to be less equal. Nobel Laureate Milton Friedman perhaps put it best in episode five of his 1980 documentary *Free to Choose* when he said: “A society that puts equality before freedom will end up with neither. A society that puts freedom before equality will end up with a great measure of both.”

**COULD OTHER THINGS ACCOUNT FOR THESE DIFFERENCES IN PROSPERITY?**

Up to this point we have relied on presentations of simple correlations to establish the linkage between good institutions and prosperity. Some readers might wonder if these relationships hold up to closer inquiry after controlling for other factors that might account for observed differences. This is the realm of academic journal publications, and for our intended audience, the details behind this analysis would be uninteresting.

Rather than attempting to present these more detailed results here, we instead point the reader to the following published articles on this subject contained in the accompanying footnote to this sentence. All of these articles are published in academic journals, in which authors submit papers that are reviewed anonymously by other scholars from across the globe in a scientific manner. Papers generally go through revisions and must pass a high level of scrutiny. These studies confirm the conclusions we have shown in this chapter, namely that economic freedom promotes prosperity.

It is worth noting that this literature does provide evidence rejecting some popularly held notions of what other factors might explain these differences in prosperity. Areas rich in natural resources, for example, do not necessarily grow faster than those areas with none. The previously mentioned case of Hong Kong (a rock island in the ocean) and how it has grown rapidly versus resource-rich countries with slow or negative growth, such as Venezuela and

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14 The positive relationship between economic freedom and growth has been shown to be robust in a large number of studies. Gerald Scully (1988), for example, finds that politically open countries that respect private property rights, subscribe to the rule of law, and use markets instead of government to allocate resources, grow three times faster than countries that do not. Harvard economist Robert Barro (1996) finds a positive relationship between economic freedom and growth. Gwartney, Lawson, and Holcombe (1999) take into account demographics, changes in education and physical capital and find that economic freedom is still a significant determinant of economic growth. John Dawson (1998) finds that economic freedom positively affects growth and it does so by directly affecting the productivity of capital and labor and indirectly through its influence on the environment for investment. This is consistent with Hall and Jones’s (1999) finding that policies consistent with economic freedom improve labor productivity. A very nice overview of the findings of this literature can be found in Berggren (2003) and a list of the dozens of studies on economic freedom can be found at www.freetheworld.com.
Constitutionally limited political institutions and sound legal institutions—are more prosperous. We began with a review of the economic evidence on the sources of prosperity and growth. Beginning with Adam Smith, over 200 years of evidence suggests that reliance on capitalism is the best route to achieve increases in living standards. States and countries relying more heavily on capitalism not only have higher income levels and faster average income growth, but also faster and more even growth across the income distribution.

One key component in reforming policy in a manner conducive to growth is to ensure the security of private ownership rights. This implies protection of persons and property from unreasonable aggression, theft, lawsuits, or confiscation by others, including the government. This is why having a weak legal system is devastating to the underpinnings of a free market economy. Too often these violations of private property sneak in under the guise of regulations that require costly actions on the part of property owners, or restrict their ability to use their property as they see fit.

In addition to the legal foundations necessary for capitalism, governments must also refrain from attempting to control the state’s economy by spending citizens’ incomes for them through high taxes and government expenditures. Large rates of government employment, ownership of land and of productive assets, and high government spending, beyond some basic functions, reflect the government attempting to drive the economy rather than leaving this to the private sector. There is no getting around the fact that the private and government sector shares in the state economy add up to 100 percent. The goal should be to increase the share controlled through the private sector and diminish the share controlled through the public sector. The evidence clearly shows that prosperity follows as a result.
REFERENCES


### CASES CITED

Figure 5.8: Industrial Property Taxes in Southeastern states*, 2007

<table>
<thead>
<tr>
<th>State</th>
<th>Rank</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
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</thead>
<tbody>
<tr>
<td>Delaware</td>
<td>50</td>
<td>$238,840</td>
<td>0.48%</td>
</tr>
<tr>
<td>Virginia</td>
<td>49</td>
<td>$241,498</td>
<td>0.48%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>35</td>
<td>$491,071</td>
<td>0.65%</td>
</tr>
<tr>
<td>Alabama</td>
<td>35</td>
<td>$533,776</td>
<td>0.98%</td>
</tr>
<tr>
<td>Florida</td>
<td>24</td>
<td>$677,683</td>
<td>1.11%</td>
</tr>
<tr>
<td>Georgia</td>
<td>20</td>
<td>$760,381</td>
<td>1.57%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>17</td>
<td>$783,407</td>
<td>1.57%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>14</td>
<td>$833,234</td>
<td>1.67%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>10</td>
<td>$1,033,544</td>
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</tr>
<tr>
<td>Texas</td>
<td>6</td>
<td>$1,264,358</td>
<td>2.53%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>4</td>
<td>$1,291,050</td>
<td>2.58%</td>
</tr>
</tbody>
</table>

* Taxes measured in the states' largest city only.
CHAPTER 3

WHY CAPITALISM WORKS

by Russell S. Sobel and Peter T. Leeson
the reasons why and how capitalism works

the reason why, for policy making, good intentions

over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in million in fixtures). Notice that South Carolina's effective tax rate on industrial property is

industry moves into the state. Furthermore, if the official tax rates are lowered, then the state

revenue may in fact increase once the growth rate in the state begins to pick up and more

Such a significant reduction in taxes on industrial property would obviously lead to a

various taxes applied to industry would seriously improve the state's competitiveness.

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than

one of the lowest per capita incomes and economic growth rates in the country.

Although it is probably not critical that South Carolina set its tax rate to the lowest in

has the highest tax in the country on industrial property, it should be no surprise that it has

serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina

UNLEASHING CAPITALISM
3
WHY CAPITALISM WORKS

Russell S. Sobel and Peter T. Leeson

The previous chapter showed that increased reliance on capitalism has allowed other states and countries to become more prosperous. To promote capitalism in South Carolina, its political and legal institutions must do two things: (1) strongly protect private property rights and enforce contracts; and (2) refrain from adopting policies or undertaking actions that infringe on voluntary actions and contracting in the private sector.

Unfortunately, governments often enact policies that interfere with capitalism without fully understanding the economic consequences. While policy makers in South Carolina and other states are indeed smart and reasonable people, most do not have formal training in advanced economics. To ensure that the true economic consequences of policies are better understood, elected officials and citizens must become more knowledgeable about a few basic principles of economics. We hope this book will help to accomplish that goal. For readers wanting to learn more, we suggest the easy-to-read book, Common Sense Economics: What Everyone Should Know about Wealth and Prosperity, by James D. Gwartney, Richard L. Stroup, and Dwight R. Lee.¹ With better knowledge of fundamental economics and the basic structures that operate within an economy—the reasons why and how capitalism works—policy makers can make better state policy decisions.

In this chapter we discuss these basic economic principles, including the concepts of wealth creation and entrepreneurship.² In addition, we examine the concept of ‘unintended consequences’—or secondary effects—the reason why, for policy making, good intentions simply are not enough to guarantee good outcomes.

¹ We also suggest the equally easy-to-read classic, Free to Choose by Nobel Laureate Milton Friedman and his wife, Rose Friedman.
² This chapter is based on Sobel and Leeson (2007).


**VOLUNTARY EXCHANGE, WEALTH CREATION, AND VALUE ADDED**

While we tend to think of our wealth in dollars, true wealth has nothing to do with paper money itself. Total wealth in a society is not a fixed pie waiting to be divided among us. Wealth, instead, is constantly being created by each of us; the ‘economic pie’ grows each day. Wealth is created through both production and exchange. An example will help to illustrate.

Suppose that two neighbors trade a bushel of hay for a load of wood. Both are now better off; after all, they were only willing to trade with each other because each wanted what the other person had more than what they traded away. Both have become wealthier in every sense of the word even though no new money has been printed, nor existing money passed around.

On an everyday basis, money only represents wealth to people because it measures the quantity of these trades—or purchases—we can undertake when we exchange money that we earn from producing at our jobs for the goods and services produced by others. A man on a deserted island with $1 million is very poor indeed without anything to purchase with the money. On the other hand, a man deserted on an island with no money, but a group of other people, will be much wealthier because of his ability to produce and exchange with others—even in the absence of paper money on the island.

Taking the example further, suppose a group of island castaways decided that half of them should dig holes and the other half should fill them in. After a full-day’s work, they would have nothing to show for this effort; nothing was produced. Holes were dug and filled again. No wealth was created, even though people worked very hard.

Wealth would be created if instead half the tribe collected coconuts and the other half fished. Now they would have dinner. Suppose one castaway invents a new tool that increases the number of fish she can catch. This invention would further increase wealth; there is more food at the dinner table. In fact, the new tool might increase productivity so much that only half as many castaways are needed fishing, and the extra castaways are free to labor at a new task such as building a shelter, further increasing wealth. As these examples illustrate, there is a close link between prosperity, or ‘wealth,’ and the quantity, quality, and value (or usefulness) of the output produced. Prosperous places—those with high levels of income and wealth—become that way by producing large quantities of valuable goods and services.

One difference between this castaway analogy and our daily economic lives, however, is that we might anticipate the castaways sharing the fruits of their labor, for example, splitting the fish caught that day. In a large and advanced economy it no longer works this way. Instead, each of us gets paid in dollars, or money income, for what we produce at our jobs. We then go to stores and exchange that money for the goods and services produced by others at their jobs.

The amount of income we earn is determined by both the prices people are willing to pay us for what we are producing and how many units of it we can produce. For individuals, states, and nations, income is determined by the value of output. A worker with a backhoe will be more productive than a worker with a shovel and will earn more as a result. An entrepreneur producing apple pies will be more prosperous than one producing mud pies because people place a higher value on apple pies (and thus are willing to pay more for them).

This logic leads to one obvious, and simple, litmus test that can be used to decide if a suggested new policy or law is good, or bad, for the South Carolina economy—does it...
increase, or decrease, the net amount or value of output (of goods and services) produced in the state. Regulations, such as those adopted in some European nations for example, which restrict the workweek to 35 hours, clearly result in reduced output and reduced standards of living as a result. For a tax-funded government program, this principle must be applied by looking at the net change in output—that is, one must properly account for the reduced output caused by the taxes or other resources necessary to fund the policy.

One of Adam Smith’s insights in his previously mentioned 1776 book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, is that labor productivity, the main determinant of wage rates, is increased through specialization and the division of labor. When labor is divided into specific tasks, like workers in an assembly-line, they can produce more as a group than could have been produced individually. The same holds true when individuals specialize across different occupations and industries.

However, according to Smith, our ability to specialize, thereby increasing our productivity and enhancing our wages, depends on the size or ‘extent’ of the market to which we sell. When consumer markets are larger in size, smaller specialized stores can survive that could not have survived in a smaller marketplace. Cheraw’s population, for example, might be able to support one or two general purpose pet stores, each carrying a broad line of products. In a place like Greenville, however, a dozen or more stores can flourish, with a greater extent of specialization, one store, for example, might specialize in snakes and other reptiles, while another specializes in birds. Increasing the size of the markets to which South Carolina’s goods and services sell could increase wealth by allowing South Carolinians to specialize more specifically in areas where they do best.

Population growth in metropolitan areas would be one way of increasing market size. But another way to increase market size is to enact policy reform that better enables the businesses in South Carolina to sell and compete in larger national and global marketplaces and expand their customer base. To compete in these markets South Carolina businesses need to be on a level playing field with their competitors. South Carolina’s taxes and regulations are a competitive disadvantage to firms located in the state. The higher prices South Carolina businesses must charge for their products greatly limits the markets in which they can compete. If these tax and regulatory costs could be reduced through policy reform, firms could offer more competitive pricing, increasing their market shares and the extent of their markets. This would allow both the businesses themselves, and their workers, to become more specialized and earn higher incomes as a result.

In addition to specialization and the division of labor, capital investment also increases labor productivity. Higher levels of education (more ‘human capital’) and better machinery, buildings, and tools to work with (more ‘physical capital’) can help our citizens produce more output and generate more income. Recent capital investments in sawmills provide a good example of this. An experienced operator of a newer optimizing edger earns $13 per hour compared to the $10 per hour wage rate a worker previously earned manually edging boards. Operators of new stacking systems earn $12 per hour compared to the $9 per hour wage rate workers previously earned manually staking lumber. Similarly, workers running newer optimizing trimmers earn $14 per hour compared with the previous wage of $8 per hour for workers doing manual trimming. With this new capital equipment workers are more productive and earn higher wages as a result.
For those familiar with the logging industry, a worker operating a ‘feller buncher,’ a huge machine with claws and a round built-in saw that the worker drives, can harvest roughly two and a half times as much timber in the same amount of time as a worker with a chainsaw. As a result, the wage rate he earns is roughly two to three times higher as well. This capital equipment allows the worker to be more productive and thus to earn more income.

But new factories, better machinery, and equipment are expensive. They require large investments in assets and property (a feller buncher, for example, can cost a half-million dollars or more). In South Carolina, taxes (such as property taxes on capital equipment), regulations, and lawsuits decrease the return from capital investment and thereby lower the inflow of capital into the state. As we discussed in Chapter 2, South Carolina has the highest property taxes in the nation on a representative manufacturing facility’s equipment and machinery. This results in South Carolina’s workers being less productive—and earning less as a result.

The income a state produces from its output depends not only on how much is produced (which can be expanded through specialization, division of labor, and capital investment), but also on the price per unit, or value, of the goods and services produced. A timber stand containing mostly River Birch trees will produce less income than one with a higher proportion of more valuable Live Oak trees. Income can be increased not only by increasing labor productivity, but also by raising the value per unit—or ‘value added’—of South Carolina labor.

However, the answer to the question of which specific uses of South Carolina’s resources create the most value, and thus income, is not obvious. In fact, the answer is so complex that it is not something any one person or group of people knows, not even a group of expert economic planners. It is an answer that must be discovered by individuals in the private sector through the decentralized process of entrepreneurship, a process of private trial and error. This is the topic of our next section.

Before moving on, however, let us complete our discussion of the process of wealth creation started above. As we pointed out, in a real-world economy things work a bit differently than in the castaway example because we must first earn income by producing goods and services. Only then do we use that income to acquire the goods and services produced by others. The ability to turn our income into prosperity and wealth through exchange is the second important part of this process.

As consumers, we turn income into wealth through the acquisition of goods and services like food, clothing, shelter, and recreation. In our shopping, we search out and negotiate with potential sellers from around the globe. We spend time and effort on this search because maximizing the value we get from our limited budgets makes us wealthier. Finding a product we want to buy at a lower price increases our wealth because we now have more money to spend on other things.

This is the reason why restrictions on the ability of citizens to freely engage in trade with people from other geographic areas through tariffs, quotas, taxes, and other restrictions, destroy wealth. Individuals cannot generate as much value and happiness from their limited incomes. Not only are there fewer options to select among, but also the taxes and regulations make things more costly for us to purchase, reducing our ability to stretch our budgets and

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Amount</th>
<th>Average Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$290</td>
<td>2.5%</td>
</tr>
<tr>
<td>$20,000</td>
<td>$954</td>
<td>4.77%</td>
</tr>
<tr>
<td>$75,000</td>
<td>$4,804</td>
<td>6.70%</td>
</tr>
<tr>
<td>$100,000</td>
<td>$7,607</td>
<td>7.60%</td>
</tr>
</tbody>
</table>

Figure 5.5 also shows that the current tax system charges all income groups more in taxes than the optimal tax system just described. Some income groups—such as those who are just starting a career—are hit especially hard. It keeps tax rates extremely low for the lowest income groups, causing the number of very low-income taxpayers to increase. This is one reason to avoid adopting policies that interfere with, or restrict Internet purchases.
turn our income into wealth.\(^3\) This is one reason to avoid adopting policies that interfere with, tax, or restrict Internet purchases.

As this section has discussed, our well-being is the result of both production and exchange. Becoming more prosperous can be accomplished by increasing the amount of wealth created in the state through: (1) increasing in the quantity, quality, and value of goods and services the state’s citizens produce, and (2) increasing the number and value of the voluntary exchanges the state’s citizens make, both with other South Carolinians and with people from around the world.

Policy reform that lowers taxes and regulations can help achieve these goals because it results in: (1) increased specialization of labor and increased capital investment—increasing labor productivity and wages; (2) increased ability of residents and businesses to buy and sell with individuals from across the state, nation, and globe; and (3) more private sector entrepreneurship that allows the decentralized decisions of workers and business owners—rather than government planning—to help search out and identify the ever-changing bundle of goods and services that creates the most value and income for South Carolina.

### Entrepreneurship and Discovery

Of the many potential things South Carolina could produce with its resources, it should set its sights on those having the highest value in the marketplace. However, this target is an ever-shifting one, with new opportunities arising and others dwindling every day. One important reason the economic system of capitalism is especially good at generating prosperity is because it does a good job at chasing this ever-moving target through the continuous process of entrepreneurship and discovery.

Sifting through these many combinations is a difficult task because the number of possible combinations of society’s resources is almost limitless. Two quick illustrations will help to clarify the vastness of these opportunities. First, think for a moment about the typical automobile license plate. Many have three letters, a space, and three numbers. There is a formula for calculating the total number of ‘combinations’—the total number of possible different license plates—that could be created using these three letters and three numbers. The answer is more than you might think: 17,576,000. Second, let us consider the number of possible ways to arrange a deck of cards. Even with only 52 cards, there is a mind-blowing number of possible ways to arrange them—the answer is a 68 digit number: 

\[80,658,175,170,943,878,571,660,636,856,403,766,975,289,505,440,883,277,824,000,000,000,000\]

With this many ways to rearrange a deck of 52 cards, the astonishing implication is that each and every time you shuffle a deck of cards you are most likely making a new ordering of cards that has never been seen before, and is likely never to be seen again. In fact, even if every human that has ever lived on the Earth did nothing but shuffle cards 24 hours a day their entire life, and even unrealistically assuming they could shuffle the deck 1,000 times per

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\(^3\) If the benefits from the spending undertaken with the tax revenue, or from the regulation, are things we value highly enough, the tradeoff might be worth it. Of course, if this were the case, we would expect citizens to voluntarily contribute to the cause, or privately regulate the activity, being considered. But when the value created by government policy is lower than our losses from the resulting higher prices and more limited availability of goods and services, society’s well-being is reduced.
second, we would have not even come close to making it through a fraction of the number of total possible arrangements of the deck throughout all of human history.\textsuperscript{4}

Now, returning to the economy, we clearly have more than just three letters and numbers, or 52 cards, with which to work. Instead, we have thousands of different resources that could be combined into final products. With this many inputs to work with, the number of possible different final product combinations that could be produced is almost infinite.

Entrepreneurship is important because it is the competitive behavior of entrepreneurs that drives this search for new possible combinations of resources that create more value. A vibrant entrepreneurial climate is one that maximizes the number of new combinations attempted. Some of these new combinations will be more valuable than existing combinations and some will not. In a market economy, it is the profit and loss system that is used to sort through these new resource combinations discovered by entrepreneurs, discarding bad ideas through losses and rewarding good ones through profits. A growing, vibrant economy depends not only on entrepreneurs discovering, evaluating, and exploiting opportunities to create new goods and services, but also on the speed at which ideas are labeled as successes or failures by the profit and loss system.

From an economic standpoint then, business failure has a positive side; it gets rid of bad ideas, freeing up resources to be used in other endeavors. In our example, where half of the castaways were digging holes and the other half filling them in, business failure would be equivalent to the half that were filling in the holes going out of business and losing their jobs. A capitalist economic system causes this failure and then replaces it with a profitable business that installs underground piping in the holes to provide running water.

A vibrant economy will have both a large number of new business start-ups and a large number of business failures. Minimizing business failures should not be a goal of public policy. Instead the goal should be to maximize the number of new combinations attempted, which also implies having a lot of failures. In an economy where all entrepreneurs—even those with crazy and marginal ideas—can try them out in the marketplace, there will be a lot of business failures. The benefit is that it increases the odds that we will stumble on that one-in-a-million new major innovation, or the next fortune 500 company. Business failures are a natural result of the uncertainty involved in knowing whether a new idea will meet the ‘market test.’ From an economic perspective, it is better to try 100 new ideas and have 60 fail, than to only try 50 and have 30 fail. By doing so, we end up with 20 additional new businesses.

Noted economist Joseph Schumpeter (1934 [1911]) stressed the role of the entrepreneur as an innovator who carries out new combinations of resources to create products that did not previously exist. The result of these new combinations is entirely new industries that open considerable opportunities for economic advancement. In Schumpeter’s view, the entrepreneur is a disruptive force in an economy because the introduction of these new combinations leads to the obsolescence of others, a process he termed ‘creative destruction.’

The introduction of the compact disc, and the corresponding disappearance of the vinyl record, is just one of many examples of this process. Cars, electricity, aircraft, and personal computers are others. Each significantly advanced our way of life; but in the process of doing so, other industries died or shrunk considerably. Economists today accept

\textsuperscript{4} For an insightful and more thorough demonstration of the process of computing combinations for a deck of cards see http://www.worsleyschool.net/science/files/deck/ofcards.html.
Schumpeter’s insight that this process of creative destruction is an essential part of economic progress and prosperity and that capitalism is uniquely suited to foster it.

A point worth clarifying is that it is much better to have a decentralized profit and loss system sorting through these new combinations, than a government approval board or decision-making process. The reason is that the incentives facing public officials can be very different than the incentives facing venture capitalists and entrepreneurs. While each venture capitalist and entrepreneur brings different motivations to the table, ultimately their success or failure is determined by whether their idea generates wealth. This is the ‘market test’ we alluded to earlier. The same is not true for public officials in charge of handing out tax incentives or low-interest loans. They may have other concerns beyond creating wealth. For example, officials may be concerned about where a new business is located in order to maximize political support among voters. But there is no reason to think that this decision corresponds with the most economically advantageous one.

In addition, there is no individual, or group of individuals, that could be in charge of this discovery process. There is nobody, not even those seemingly in the best position to know, who can predict which business opportunities are the most viable in advance. For example, Ken Olson, president, chairman and founder of Digital Equipment Corporation, who was at the forefront of computer technology in 1977, stated: “There is no reason anyone would want a computer in their home.” Today his remark sounds funny because we all have computers in our homes, but at the time even those in the infant computer industry did not see this coming. An even better example might be the story of Fred Smith, the founder of Federal Express Corporation. He actually wrote the business plan for FedEx as his senior project for his strategic management class at Yale. While we all know in retrospect that FedEx was a successful business idea, Smith’s professor at Yale, one of the leading experts on business strategy, wrote on his paper in red ink: “The concept is interesting and well-formed, but in order to earn better than a C the idea must be feasible.”

The point? Even smart professors, business leaders, and government officials cannot possibly pre-evaluate business ideas and identify those that will be most successful and those that will fail. A thriving economy is created when individual entrepreneurs have the freedom to try new ideas, risking their own assets, or the assets of their private investors, and the profit and loss system is used to decide their fate. While some policy makers may think hydrogen fuel is the future of the state economy, the truth is that South Carolina’s future is yet to be discovered, and when it is, it will likely be in something that is not yet invented or known at the present time. In the end, it is South Carolina’s citizens that must discover the future for the state, not the state political process.

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5 It is important to recognize that from society’s perspective the profits earned by entrepreneurs represent gains to society as a whole. Because entrepreneurs must bid resources away from alternative uses, production costs reflect the value of those resources to society in their alternative uses. Thus, profit is only earned when an entrepreneur takes a set of resources and produces something worth more to consumers than the other goods that could have been produced with those resources. A loss happens when an entrepreneur produces something that consumers do not value as highly as the other goods that could have been produced with those same resources. For example, an entrepreneur who takes the resources necessary to produce a fleece blanket sold for $50 and instead turns them into a pullover that sells for $60 has earned a $10 profit. Since the price of the resources used by entrepreneurs reflect the opportunity cost of their employment in other uses, the $10 profit generated by the entrepreneur reflects the amount by which they have increased the value of those resources. By increasing the value created by our limited resources, entrepreneurs increase overall wealth in a society.
In addition, many good ideas die because entrepreneurs simply cannot put together the initial level of resources necessary to comply with the many rules, regulations, and permissions necessary to open a business in South Carolina. We will never know if one of these could have been another FedEx. If we want a thriving economy, South Carolina must find ways to make it easier and less costly for entrepreneurs to try to test their ideas in the marketplace.

To promote entrepreneurship, government often attempts to enact new programs, such as state-run venture capital funds, government-funded or subsidized business incubators, economic development authorities, or even to create new positions within the education system aimed at expanding entrepreneurship education within schools and colleges. Unfortunately, these policies grow the government sector, and shrink the private sector. The simple fact is that the public and private sectors sum to 100 percent of the economy, and expansion of government spending means reductions in private spending, and of the resources available within the private sector. One wonders, for example, whether the hundreds of millions of tax dollars spent to build the Innovista building in Columbia would have created more jobs and opportunities had this money simply been left in the private sector’s hands. Opponents of this project claim that so far it probably has created fewer jobs than even the Hardee’s Restaurant that used to occupy the land on which it was built.  

Entrepreneurship is the means by which we discover ways to increase the value created by the state’s labor, physical, and natural resources (or economic inputs, in the framework of Figure 2.1 in Chapter 2). Successful entrepreneurship expands the overall economic pie and allows us to generate more wealth and prosperity. To encourage growth, policy reform must reduce the burdens on entrepreneurial start-ups and learn to tolerate business failures.

**Adam Smith (again): The Invisible Hand Principle**

Under capitalism there is no captain of the ship, no central economic planning authority making the decisions for the economy as a whole. How, in the absence of this central economic planning, can an economy thrive? Adam Smith’s most important insight was the concept of ‘the invisible hand’ of the marketplace which provides the answer to this fundamental question.

Smith’s insight was that the incentives under capitalism are arranged in such a way that even though we all pursue different goals and objectives to advance our own economic interests, we are in turn faced with strong incentives to pursue those actions that also create the most wealth for society as a whole. An example will help to illustrate Adam Smith’s invisible hand principle in action.

Suppose the price of maple lumber increases because of higher consumer demand for maple furniture. This single price change will change the incentives faced by decision makers throughout the economy, likely resulting in changes in which properties are harvested, the percent of maple sent to sawmills versus other uses, the incentive of non-furniture makers to substitute away from maple, etc. The ‘signals’ sent by these market prices are what enable our workers and businesses to identify changes in which goods and services create the most value.

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6 See South Carolina Policy Council (2009).
Price signals not only tell us when new opportunities are arising; they also help us to find out when what we are doing is no longer as highly valued, or when the resources we are using have found an alternative use in which they create even more value.

Nobel Laureate F.A. Hayek (1945) stressed that unregulated prices are a necessary ingredient for a functioning capitalism-based economy. The information contained in prices about buyer preferences, relative scarcity, and the cost of production is essential to good business decision making. However, these all-important prices are often missing in the government sector.

For policy, taxes should be viewed as prices people pay for the goods and services they receive from government. If a private firm provided roads, water, and sewers, it would extend service to any new development willing to pay a price high enough to cover the firm’s costs of reaching and servicing the area. When government runs these services, however, the prices it charges are often out of line with true costs. This can result in development not being undertaken when and where it should be; or being undertaken when and where it should not. Policies should be designed to avoid interfering with market prices; and when possible, we should also attempt to set taxes and user fees for government provided goods and services at levels more analogous to market prices. Additionally, consumer choice mechanisms can often be introduced into government provided goods and services, such as with school voucher (i.e., parental choice) programs—as long as the money follows their choice—to help infuse more of a profit and loss system into government provision.

**Spontaneous Order: A Thriving Economy is a Result of Human Action, Not Human Design**

Nobel Laureate F.A. Hayek (1967) contributed to our understanding of economic progress by realizing that much of the economy is the ‘result of human action but not human design.’ What Hayek had in mind with this distinction was that many institutions are not consciously designed. Rather, they are the result of the efforts of many individuals, each pursuing their own ends, whose activities create order through time. The English language is one example, as is the common law and a successful economic system. No one person or group of people can sit down and create these things by human design.

Hayek called these outcomes ‘spontaneous orders.’ Another example of spontaneous order is the marketplace itself—the nexus of interpersonal relationships based on producing, buying, and selling goods and services. When there are large gains to be had, Hayek pointed out, these relationships spontaneously arise without any central economic planning.

Hayek’s concept can be illustrated with an example. Suppose a college in South Carolina added a new dormitory on campus that was separated from the classroom buildings by several acres of undeveloped land. The college could hire someone to plan and pave the sidewalks in advance so that students could walk to campus. Alternatively, students could be allowed to have one semester in which they tracked through the woods on their own, creating their own pathways. The college could then retrospectively pave these pathways. The deeper and wider a pathway is, the wider the sidewalk is made. Many of the road systems in the
United States are the result of this process in which trailblazer’s paths were then used by wagons, and eventually the larger ones paved to become major highways.7

The important difference is that when a system is allowed to arise naturally it will be much more likely to satisfy the true desires of those involved and create the most value. One university in Ohio that pre-planned its sidewalks has subsequently had to install benches and holly shrubs to discourage people walking ‘in the wrong places’ and making trails in the grass. Students simply were not using the ‘planned’ sidewalks. Spontaneous orders work better with human nature and help to accomplish our specific goals in the most efficient manner. The ‘unplanned’ sidewalks simply go where people need them the most.

While we have explored Smith and Hayek’s reasons why an economy organized as a ‘ship without a captain’ is best, let us now turn to the reasons why having a strong captain in control can prevent prosperity.

GOOD INTENTIONS ARE NOT ENOUGH:
THE PREVALENCE OF UNINTENDED CONSEQUENCES

As we mentioned in the introduction to this chapter, what often happens is that new policies restricting capitalism are enacted because they ‘sound like good ideas.’ Unfortunately, these policies frequently have unintended consequences that work against the very goals they were intended to achieve.

The minimum wage is a good case in point. While many people are in favor of the minimum wage law, they support it because they think it helps low income families. The published scientific evidence, however, rejects this view and instead concludes that the minimum wage actually makes the intended beneficiaries worse off.8 So, for the same reason—the goal of helping those in need—economists are generally opposed to minimum wage legislation. This position can only be reached by examining all of the other indirect changes that happen as a result of a minimum wage, such as less worker training, fewer employee benefits, and most importantly fewer jobs and higher unemployment for low-skilled workers.

Again, it is important to remember that economics is a science, not a political position. We care little about the publicly stated intent or goal of the policy, and rather evaluate policy based on published research that examines real-world evidence. Good intentions are not enough to guarantee good outcomes. A few more examples will help to illustrate this important point.

The employment provisions of the Americans with Disabilities Act (ADA) were passed with the intention of lowering barriers to employment for disabled persons. The legislation prohibits discrimination based on disability status and further requires employers to make reasonable accommodations for employees with disabilities. Has the ADA lived up to its stated intent? Has it expanded employment among the disabled?

7 A more in-depth illustration of this idea for interested readers is given in the famous “I, Pencil” essay by Leonard Read, available at the Foundation for Economic Education’s website http://www.fee.org/pdf/books/I,%20Pencil%202006.pdf.
8 For evidence, see some of the studies compiled by the Joint Economic Committee of Congress, available at http://www.house.gov/jec/cost-gov/regs/minimum/case.htm
Thomas DeLeire, a public policy professor at the University of Chicago, wrote his Ph.D. dissertation on the employment effects of the ADA legislation when he was in graduate school at Stanford University. His research shows that the ADA has actually harmed the employment opportunities for disabled Americans.\(^9\) By increasing the cost of hiring disabled workers and making it harder to fire them, this legislation has resulted in a reduction in employment among disabled individuals. Prior to the ADA, 60 out of every 100 disabled men were able to find jobs. After the ADA went into effect, however, employment fell to less than 50 per 100 disabled men. After adjusting for other factors, DeLeire concludes that 80 percent of this decline was caused by the bad incentives created by the ADA. While the entire purpose of this legislation was to increase the employment opportunities for the disabled, the data simply do not support this view. Instead, the ADA seems to have made it more difficult and costly for employers to hire disabled workers, resulting in reduced job opportunities for disabled people. If the goal is to expand employment opportunities for disabled Americans, the research suggests that the ADA is not the answer.

Environmental policy often has the most devastating examples of unintended consequences. Under the Endangered Species Act, for example, large areas around the nesting grounds of the red-cockaded woodpecker can be declared ‘protected habitats,’ which then imposes stringent restrictions on the surrounding property owners (a ‘loss of control rights’ in the terminology introduced in Chapter 2). When the Federal Fish and Wildlife Service put Boiling Springs Lakes, North Carolina on notice that active nests were beginning to form near the town, it unleashed a frenzy of action on the part of the residents, but not of the type you might expect (Associated Press 2006). Foreseeing the potential future restrictions on their property use, landowners swarmed the city hall to apply for lot-clearing permits. After removing the trees, the land would no longer be in danger of being declared an environmentally protected habitat because no future nests could form on the property.

Similar incidents have occurred throughout the range of this bird, and the total habitable nesting area for this species in the United States has fallen dramatically as a result of the poor incentive structure created by the law. The red-cockaded woodpecker has lost a significant portion of its habitat, moving it closer to extinction because of the unintended consequences of the Endangered Species Act.

As these examples illustrate, policy designed with even the best intentions can create unintended consequences that work against the original goal of the policy. The concept of unintended consequences vividly illustrates why having an economic ‘captain’ can often produce more harm for an economy than not having one.

One additional problem with government regulations is that there is no natural profit and loss-type system to weed out bad policies through time. In the end, some policies just do not live up to their stated goals, or do so but only at too high of a cost. In 2003, for example, West Virginia imposed a maximum eight hour operating restriction on taxi drivers.\(^{10}\) This law was intended to reduce driver fatigue and accident rates among taxi cabs. Policy makers, however, overlooked the unintended consequences resulting from changing the incentives faced by cab drivers. With fewer hours to drive in a day, cab drivers started driving at faster speeds and took fewer breaks. Not only did the law result in a significant reduction in the number of cabs operating in the state, which led to more driving while intoxicated incidents, but it exacerbated the very problem it was designed to reduce. Even though there are fewer


\(^{10}\) See Corey and Curott (2007) for a longer description of this law and its consequences in West Virginia.
cabs on the road due to the law, the total number of accidents committed by cab drivers has increased in West Virginia since the regulation has been passed. Despite this information being widely-known, state policy makers in West Virginia do not ‘have the time to get the law off the books’ due to having to deal with too many other, more pressing, current issues. Simply put, government lawmakers just do not have the time to go back and look into the effectiveness of all laws from the past, nor the time to introduce the legislation to repeal them.

This highlights the need for one important reform that should be applied to each and every new state program and regulation—a ‘sunset’ provision. Sunset provisions are statements put into the law as it is created that cause the law to ‘expire’ naturally at some point in the future unless certain conditions are met. This can be done with a simple phrase such as: “If this regulation can not prove, with data, that it is accomplishing its stated goal within five years, it shall expire.” Some lawmakers may even desire to insert the words “meeting its stated goal at a reasonable cost” to not only ensure the policy is accomplishing its goal, but also in a cost effective manner.

**VOTE EARLY, VOTE OFTEN: BAD PEOPLE OR BAD INCENTIVES?**

Economists are of the opinion that government agencies tend to be less efficient than private firms. But the reason has nothing to do with ‘bad politicians’ or the particular people involved in the government sector. Getting more out of government is not a matter of getting ‘better people’ in government. Government workers are smart, caring, and devoted to their causes. The problem is that the reward structure—the rules of the game—within their jobs does not provide the right incentives to encourage the best outcomes. Nobel Laureate James Buchanan, with coauthor Gordon Tullock, published a seminal book on this subject called the *Calculus of Consent* (1962). As they pointed out, in government there is no invisible hand. An example will help to illustrate.

Most people know that government budgets are often given as fixed amounts for each fiscal year. At the end of the year, any remaining money in the budget is usually taken back and if money remains the next year’s funding is likely be reduced because the agency did not need all of the money it was allocated. To avoid this outcome, government agencies are notorious for spending their remaining budgets rapidly at the end of each fiscal year. The point is that even a person who was very careful and frugal with their money at home, or would be at a job in a private corporation, would begin to behave differently under this different set of rules that are present in the government sector. In government, the problem is not the people; it is the incentives they face.

**THE NIRVANA FALLACY**

The ‘nirvana fallacy’ is the logical error of comparing actual things with unrealistic, idealized alternatives.\(^{11}\) For instance, some might see a problem in the current health care system and propose that because of this failure, we should have a government-run health care system, based on the logic that this ideal government-run system would overcome all of the

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CHAPTER 3: WHY CAPITALISM WORKS

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problems. This tendency to idealize the outcomes of future government policies and programs is a persistent bias in policy making.

In reality, both market and government sector provisions have their limitations—neither is perfect, and there will be particular problems under either alternative. To help overcome this fallacy, there is one simple reminder, or test, that should be remembered when considering new government policies or programs. This is simply asking the question of which current government agency do you want running or administering the program. For example, the idealized attractiveness of a government-run health care system is more realistically viewed by imagining the nation’s health care system being run by FEMA, the Department of Defense, the Internal Revenue Service, or a state agency such as the Department of Motor Vehicles, Department of Education, or the Department of Social Services.

Only through careful thought about real-world alternatives, by comparing the likely true limitations of both the private and public sectors, can good judgments about policy be made. To be a productive force in an economy, government must do some things (like protect people and their property, enforce contracts in an unbiased manner, and provide a limited set of ‘public goods’) but refrain from doing others.

WEALTH CREATION VERSUS WEALTH DESTRUCTION: TRADE AND TRANSFERS

As was noted earlier, when Jeff buys corn from Mary for $20, wealth is created. But when the government taxes Jeff $20 and gives it to Mary, this does not create wealth—no corn is produced. When governments do too much of this type of redistribution among individuals, there arises a fierce competition to become a recipient of government funding—another Mary. When business firms in the state think about trying to become more profitable, they too often think about how to secure more government subsidies, favors, or tax breaks. Instead, their efforts should be devoted to doing a better job at whatever it is they produce.

In stressing the role of entrepreneurship in an economy, New York University economist William Baumol notes that entrepreneurial individuals have a choice to devote their labor efforts toward either private-sector wealth creation, or toward securing wealth redistribution through the political and legal processes (e.g., lobbying and lawsuits).12 This decision is influenced by the corresponding rates of return—or profit rates—of these alternative activities. Capitalist institutions, or institutions providing for secure property rights, a fair and balanced judicial system, contract enforcement, and effective limits on government’s ability to transfer wealth through taxation and regulation, reduce the profitability of unproductive political and legal entrepreneurship. Under this incentive structure, creative individuals are more likely to engage in the creation of new wealth through productive market entrepreneurship.

In areas with weaker capitalist institutions, like South Carolina, these same individuals are instead more likely to engage in attempts to manipulate the political or legal process to capture transfers of existing wealth through unproductive political and legal

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12 Spending effort and resources to secure wealth through political redistribution is what economists call ‘rent seeking.’ See, for instance, Tullock (1967) and Tollison (1982).
entrepreneurship—activities that destroy overall wealth. This reallocation of effort occurs because the institutional structure largely determines the relative personal and financial rewards to investing entrepreneurial energies into productive market activities versus investing those same energies instead into unproductive political and legal activities. For example, a steel entrepreneur might react to competition by trying either to find a better way of producing steel (productive entrepreneurship), or by lobbying for subsidies, tariff protection, or filing legal anti-trust actions (unproductive entrepreneurship).

To understand this distinction better, it is useful to consider the difference between positive-sum, zero-sum, and negative-sum economic activities. Activities are positive sum when net gains are created to society. Private market activities are positive sum because both parties gain in voluntary transactions. When you purchase a pizza, you value the pizza more than the money you pay for it, while the pizzeria values the money it receives from you more than it did the pizza. Government actions that transfer wealth, regulate, subsidize, or protect industries from competition are instead zero sum activities. One party’s gain (e.g., the subsidy) is offset exactly by another party’s loss (e.g., the taxes). However, because the zero-sum transfer requires an investment of resources in lobbying to secure, their overall impact on the economy is negative. Magnifying this is the fact that others will devote resources to political lobbying on the ‘defensive side’ of transfers to protect their wealth from being seized. The resources devoted toward securing (and fighting against) zero-sum political transfers have a cost; we have more lobbyists and thus fewer scientists and engineers.

Unproductive entrepreneurship is unproductive because it uses up resources in the process of capturing zero-sum transfers and these resources have alternative, productive uses. Baumol’s theory is founded in the idea that entrepreneurs exploit profit opportunities not only within private markets but also within the political and legal arenas. Thus, differences in measured rates of private sector entrepreneurship are partially due to the different directions entrepreneurial energies are channeled by prevailing economic and political institutions, through the rewards and incentive structures they create for entrepreneurial individuals.

In places like South Carolina, where the state government’s large influence over spending encourages individuals to fight over obtaining state government funds, it encourages a high level of unproductive entrepreneurship. As a result, South Carolina has less productive private-sector entrepreneurship.

How much unproductive entrepreneurship is there in South Carolina? While it is hard to derive an exact number, some data can help to illustrate. In 2009, for example, 377 registered lobbyists represented 534 companies and organizations in South Carolina. In addition, South Carolina was home to 8,961 resident and active lawyers. Campaign contributions to candidates running for office in the 2008 South Carolina elections amounted to almost $50.9 million, or $26.43 per vote cast in the election. Policy reform that reduces the profitability of initiating lawsuits and lobbying government can create more wealth and prosperity as entrepreneurial efforts are re-channeled into productive uses.

13 South Carolina State Ethics Commission (list is available online at http://www.sc.gov/LobbyingActivity/LobbyistsWithPrincipalsReport.aspx).
15 Data for federal offices ($20.8 million) is from www.opensecrets.org and data for state offices ($30.1 million) is from www.followthemoney.org. Voter turnout data (1,927,153 votes were cast in the 2008 general elections) is from the Nonprofit Voter Engagement Network, www.nonprofitvote.org.
Studies that examine the relationship between measures of productive private sector entrepreneurial activity and a state’s economic freedom index (measuring institutional quality) have found highly significant results. Higher economic freedom produces higher venture capital investments per capita, a higher rate of patents per capita, a faster rate of sole proprietorship growth, and a higher establishment birth rate (both overall and among large firms) as was seen in Figure 2.7. Capitalism promotes productive entrepreneurial efforts.

But this same research also suggests that states with the worst freedom scores have the worst records on lobbying activity and lawsuit abuse—the unproductive types of entrepreneurship. In the ranking of ‘net entrepreneurial productivity’ in which productive entrepreneurship is measured relative to unproductive political and legal entrepreneurship, South Carolina ranks 33rd. It has both lower levels of private, productive entrepreneurial activity and higher levels of unproductive activity than fast-growth states with better scores on economic freedom such as Georgia, North Carolina, Delaware, Nevada, and Texas. South Carolina has the 19th highest rate of unproductive entrepreneurial activity among states, while only the 29th highest rate of productive entrepreneurship. The relationship between having strongly capitalist institutions (as measured by economic freedom) and the index of net entrepreneurial productivity across states is shown in Figure 3.1.

Figure 3.1: Institutional Quality and Entrepreneurial Productivity

![Graph showing the relationship between Economic Freedom Score and Net Entrepreneurial Productivity Index](image)


The data in Figure 3.1 suggest that capitalism and limited government promote prosperity not only because they promote productive activities, but also because they

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16 See, for example, Sobel (2008).
17 As a more detailed comparison with its neighbors, while South Carolina ranks 33rd in the index of net entrepreneurial productivity, North Carolina ranks 15th and Georgia ranks 18th. For reference, South Carolina ranks 25th in economic freedom while Georgia and North Carolina are tied (with Colorado) at 3rd.
discourage unproductive, wealth-destroying activities. While the later chapters of this book are devoted to specific policy reforms for South Carolina, Figure 3.2 gives a general list of state policy reforms that increase net entrepreneurial productivity, thereby generating wealth.

Figure 3.2: Reforms That Increase the Reward to Productive Entrepreneurship Relative to Unproductive Entrepreneurship

- Reduce or eliminate state personal and corporate income taxes
- Eliminate legal minimum and maximum price and wage laws
- Reduce occupational licensing restrictions
- Place constitutional limits on eminent domain and environmental property takings
- Reduce government ownership of productive resources (e.g., land holdings)
- Make broad reductions in government employment, spending, and levels of taxation
- Strive for broadly applied, simplified tax codes that reduce the ability of groups to lobby for specific exemptions, credits, and rate reductions
- Reduce the returns to lobbying by eliminating forms of pork-barrel legislation that use state money to fund local pet projects, and by eliminating business subsidies
- Increase the use of market-based reforms such as medical savings accounts, school vouchers or school choice programs, privatized retirement funds, privatized government services (ambulance, water, garbage)

Source: Based on Sobel (2008).

CONCLUSION

Chapter 1 made the case for why increasing economic growth should be an important policy goal in South Carolina. Chapter 2 presented evidence that areas relying more heavily on capitalism are wealthier. This chapter examined the underlying reasons why capitalism promotes prosperity.

Capitalism makes people wealthier because it results in higher labor productivity, increased specialization, expansion of markets, increased capital investment, expanded opportunities to trade with others, more entrepreneurial discovery, and a channeling of entrepreneurial efforts toward productive activities. It helps put resources to their most productive uses, generating higher incomes in the process.

Despite the overwhelming evidence in favor of increased reliance on capitalism, South Carolina has been reluctant to embrace this ideal in policy. This might be surprising when viewed from the outside as South Carolina is a state who has recently had a two-term free market leaning governor, and a Republican controlled legislature. However, when we examine all U.S. states, there is very little correlation between political party control of the legislature (or other measures of party affiliation) and economic freedom scores. Figure 3.3 shows a scatter plot of each state’s economic freedom score, and the percentage of the state
legislature that was Republican in the same year as the data used to construct the economic freedom score (2005).

Figure 3.3: Economic Freedom and Political Affiliation

The trend line in the figure is virtually flat. It does have a slightly upward slope, but it is statistically insignificant. Quite simply, there is no statistically significant link between Republican control and reliance on capitalism in state policy. In fact, the states with the highest percentages on both ends of the spectrum have virtually indistinguishable scores on economic freedom. Across states, both Democrats and Republicans are equally likely to enact policy that embraces capitalism. The reason is because capitalism helps both parties to accomplish goals of common importance. This nonpartisan relationship also holds up for other measures of state political affiliation, including the percentage of the state population voting for the Republican presidential candidate.

We now turn to the second part of the book, which contains chapters that give specific suggestions for policy reform that can create a brighter economic future for South Carolina.
REFERENCES


South Carolina's effective tax rate on industrial property is 1.52 percent. This is significantly lower than the rates in other Southeastern states. For example, Kentucky's rate is 4.88 percent, Louisiana's is 3.73 percent, and West Virginia's is 3.73 percent. Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate that is almost 4 times greater than South Carolina's. This puts South Carolina at a significant disadvantage compared to its Southeastern neighbors.

Such a significant reduction in taxes on industrial property would obviously lead to a competitive advantage for South Carolina in attracting new industry. Furthermore, if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more industry moves into the state. Working to reduce the tax burden on industrial property is a key strategy for South Carolina to become more competitive in the Southeastern region.

In Figure 5.8 we present the effective property tax rates data for Southeastern states, for comparison. The ranks given for the states are out of all manufacturing property tax in the country. In Figure 5.8 we present the effective property tax rates data for Southeastern states, for comparison. The ranks given for the states are out of all manufacturing property tax in the country.
CHAPTER 5: SPECIFIC TAX REFORMS

It is apparent that South Carolina is at a serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina has one of the lowest per capita incomes and economic growth rates in the country, a significant reduction in taxes on industrial property would obviously lead to a serious disadvantage. In order to attract and keep industry, South Carolina must set its tax rate at around 1 percent, which might be sufficient to attract more industry. Working to reduce the various taxes applied to industry would seriously improve the state's competitiveness.

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than Georgia's rate, and almost 4 times greater than North Carolina's. This puts South Carolina at a disadvantage, especially at higher levels of incomes.

Although it is probably not critical that South Carolina set its tax rate to the lowest in the United States, the state could still benefit from reducing its tax rate. A reduction in taxes would make South Carolina more attractive to industry, which would help to improve the state's competitiveness.

In Figure 5.8 we present the effective property tax rates for industrial property in Southeastern states, 2007. Notice that South Carolina's effective tax rate is almost 2.5 times greater than Delaware's, the lowest-tax state. Delaware's effective tax rate is over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in the figure because it is the lowest-tax state.)

The table below lists the effective property tax rates for industrial property in various states, along with their corresponding tax rates and net taxes.

<table>
<thead>
<tr>
<th>State Rank (of 50)</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delaware 50</td>
<td>$238,840</td>
<td>0.48%</td>
</tr>
<tr>
<td>Virginia 49</td>
<td>$241,498</td>
<td>0.48%</td>
</tr>
<tr>
<td>Kentucky 47</td>
<td>$327,100</td>
<td>0.65%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>$334,999</td>
<td>0.98%</td>
</tr>
<tr>
<td>Alabama 35</td>
<td>$533,776</td>
<td>1.11%</td>
</tr>
<tr>
<td>Florida 24</td>
<td>$677,683</td>
<td>1.36%</td>
</tr>
<tr>
<td>Georgia 20</td>
<td>$760,381</td>
<td>1.52%</td>
</tr>
<tr>
<td>Louisiana 17</td>
<td>$783,407</td>
<td>1.67%</td>
</tr>
<tr>
<td>Mississippi 4</td>
<td>$833,234</td>
<td>1.67%</td>
</tr>
<tr>
<td>West Virginia 14</td>
<td>$833,234</td>
<td>1.67%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>$1,255,255</td>
<td>2.07%</td>
</tr>
<tr>
<td>Texas 6</td>
<td>$1,264,358</td>
<td>2.53%</td>
</tr>
<tr>
<td>Missouri 12</td>
<td>$1,303,755</td>
<td>2.63%</td>
</tr>
<tr>
<td>Michigan 11</td>
<td>$1,328,313</td>
<td>2.51%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Amount</th>
<th>Average Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$290</td>
<td>2.90%</td>
</tr>
<tr>
<td>$15,000</td>
<td>$377</td>
<td>2.51%</td>
</tr>
<tr>
<td>$50,000</td>
<td>$2,784</td>
<td>5.51%</td>
</tr>
<tr>
<td>$100,000</td>
<td>$6,352</td>
<td>6.10%</td>
</tr>
<tr>
<td>$200,000</td>
<td>$13,554</td>
<td>6.41%</td>
</tr>
</tbody>
</table>

Presumably the original intent of imposing a tax rate schedule with graduated tax brackets was to make the income tax progressivé. However, what progressivity exists in the state's income tax structure is due to the zero tax on the first $2,630 of income. When the current tax is broken down into its components, what is apparent is that it produces a very flat average tax rate. The marginal tax rates were to make the income tax progressivé. However, what progressivity occurs at such small steps in income is not higher levels of income. At higher income levels, the horizontal equity condition, it really does this only at the lower income levels reducing the overall tax burden. It keeps tax rates extremely low for the lowest income earners and reduces the progressivity at higher levels of incomes. It keeps tax rates extremely low for the lowest income earners and reduces the progressivity at higher levels of incomes.
CHAPTER 4
WHEN IT COMES TO TAXES IN SOUTH CAROLINA: FOCUS ON REMAINING COMPETITIVE

by Justin M. Ross, Joshua C. Hall and Peter T. Calcagno
over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in million ($12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5 million in fixtures). Notice that South Carolina's effective tax rate on industrial property is at around 1 percent might be sufficient to attract more industry. Working to reduce the various taxes applied to industry would seriously improve the state's competitiveness.

Although it is probably not critical that South Carolina set its tax rate to the lowest in the country, it should definitely make it at least competitive for the Southeast. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate almost 4 times greater than North Carolina's. This puts South Carolina at a competitive disadvantage in the Southeast. Furthermore, if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more industry moves into the state. Figure 5.8: Industrial Property Taxes in Southeastern states, 2007

<table>
<thead>
<tr>
<th>State</th>
<th>Rank (of 50)</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virginia</td>
<td>49</td>
<td>$241,498</td>
<td>0.48%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>27</td>
<td>$533,776</td>
<td>0.65%</td>
</tr>
<tr>
<td>Alabama</td>
<td>35</td>
<td>$760,381</td>
<td>0.98%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>17</td>
<td>$1,264,358</td>
<td>1.36%</td>
</tr>
<tr>
<td>Texas</td>
<td>6</td>
<td>$783,407</td>
<td>1.57%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>4</td>
<td>$1,291,050</td>
<td>2.07%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>1</td>
<td>$1,695,358</td>
<td>2.53%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>14</td>
<td>$833,234</td>
<td>3.73%</td>
</tr>
</tbody>
</table>

Source: National Association of Manufacturers (2009)

Table 5.5 also shows what the average tax rates are for various incomes and taxes. A common misperception is that the burden of taxes on an economy is simply equal to the true costs of taxation, where the actual burdens of different taxes fall, see Pechman (1985) and where the actual burdens of different taxes fall, see Pechman (1985) and HY. COUNTLESS STUDIES FIND THAT HIGHER TAXES LEAD TO SIGNIFICANT REDUCTIONS IN ECONOMIC GROWTH. (lobbying) and afterwards (evasion). High taxes are extremely costly to a state’s economy. The additional costs come in many forms, including: administrative costs, enforcement costs, compliance costs, ‘excess burdens,’ and costs associated with resources revenue. The extra 2\% to the goal of progressivity. So although on the surface it appears that the tax satisfies the vertical equity condition, it really does this only at the lower income levels reducing the marginal tax rates was to make the income tax progressive. However, what progressivity occurs at
A common misperception is that the burden of taxes on an economy is simply equal to the tax revenue generated. In reality, taxes cost society much more than is generated in revenue. The additional costs come in many forms, including: administrative costs, enforcement costs, compliance costs, ‘excess burdens,’ and costs associated with resources spent by individuals and groups to avoid the tax, both before the tax is implemented (lobbying) and afterwards (evasion). High taxes are extremely costly to a state’s economy. Countless studies find that higher taxes lead to significant reductions in economic growth. The purpose of this chapter is to explain the true costs of taxation, review the empirical literature on taxation and economic growth, and to examine South Carolina’s overall tax burden relative to other states.¹

**WHY TAXES COST MORE THAN THEY TAKE**

Just because a tax is levied on one specific group of individuals does not mean they will be the ones who bear the eventual burden of the tax. This concept is known in the economics literature as ‘tax shifting.’ A tax imposed on business assets, for example, might lead to higher prices for consumers, shifting some of the burden forward to consumers. Similarly, a tax imposed directly on consumers of a product will lead to reduced demand, shifting some of the burden backward onto the companies producing the good or service that is taxed.²

One thing is certain, however, and that is: all taxes are borne by *individuals*. A ‘business’ cannot bear taxes. Instead, business taxes fall on the owners, employees, suppliers, or customers of the business.

¹ This chapter is based on Ross and Hall (2007).
² For additional information on where the actual burdens of different taxes fall, see Pechman (1985) and Fullerton and Rogers (1993).
According to the U.S. Census Bureau, state and local governments around the nation
took in more than $1 trillion in combined tax revenue during fiscal year 2005-06. Figure 4.1
summarizes the sources of tax revenue for South Carolina in 2005-06. Combined state and
local government tax revenue in South Carolina was over $12 billion, with $7.75 billion
levied at the state level.

Figure 4.1: South Carolina 2005-06 Tax Revenue by Source

<table>
<thead>
<tr>
<th>Tax Revenue</th>
<th>State</th>
<th>Local</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>$9,808,000</td>
<td>$3,950,238,000</td>
<td>$3,960,046,000</td>
</tr>
<tr>
<td>Sales and gross receipts</td>
<td>$4,200,121,000</td>
<td>$286,839,000</td>
<td>$4,486,960,000</td>
</tr>
<tr>
<td>General sales</td>
<td>$3,186,306,000</td>
<td>$95,908,000</td>
<td>$3,282,214,000</td>
</tr>
<tr>
<td>Selective sales</td>
<td>$1,013,815,000</td>
<td>$190,931,000</td>
<td>$1,204,746,000</td>
</tr>
<tr>
<td>Motor fuel</td>
<td>$511,834,000</td>
<td>n/a</td>
<td>$511,834,000</td>
</tr>
<tr>
<td>Alcoholic beverage</td>
<td>$143,034,000</td>
<td>$186,000</td>
<td>$143,220,000</td>
</tr>
<tr>
<td>Tobacco products</td>
<td>$32,056,000</td>
<td>n/a</td>
<td>$32,056,000</td>
</tr>
<tr>
<td>Public utilities</td>
<td>$44,173,000</td>
<td>$71,663,000</td>
<td>$115,836,000</td>
</tr>
<tr>
<td>Other</td>
<td>$282,718,000</td>
<td>$119,082,000</td>
<td>$401,800,000</td>
</tr>
<tr>
<td>Individual income</td>
<td>$2,727,251,000</td>
<td>n/a</td>
<td>$2,727,251,000</td>
</tr>
<tr>
<td>Corporate income</td>
<td>$296,753,000</td>
<td>n/a</td>
<td>$296,753,000</td>
</tr>
<tr>
<td>Motor vehicle license</td>
<td>$156,077,000</td>
<td>$21,604,000</td>
<td>$177,681,000</td>
</tr>
<tr>
<td>Other taxes</td>
<td>$369,787,000</td>
<td>$425,674,000</td>
<td>$795,461,000</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau (2009).

What these revenue numbers exclude, however, are the many distortions in economic
activity, and in the behavior of individuals, that occur in response to these taxes. Figure 4.2
helps to illustrate these costs. The direct cost of taxation is the obvious accounting cost—
individuals who pay the tax will have less money to spend on other goods and services. The
tax revenue generated does measure this reduction in private economic spending resulting
from the tax. However, there are other significant costs.

The first hidden cost of taxation comes from the political process itself. The indirect
costs of lobbying and rent seeking (upper left box) reflect the resources devoted by
individuals attempting to alter tax policy decisions within the political process. Interest
groups will devote substantial time and effort into fighting against the imposition of a tax, or
an increase in tax rates, as well as to secure reductions in tax rates, or their repeal.

To illustrate, suppose the legislature is considering a proposal to levy a new tax on
unhealthy fast food. Further suppose that Hardee’s estimates this new tax will cost the
company $2 million. At this point, Hardee’s would be willing to spend up to $2 million to
prevent the imposition of the tax. They may hire lobbyists, make campaign contributions,
attempt to secure media attention, or attempt to fight the legality of the tax in court. Once the

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Footnote: Available at http://www.census.gov/govs/www/estimate06.html.
tax is imposed, they will continue to devote resources toward attempting to get the tax
repealed, the rate lowered, or to secure an exemption from the tax. Resources spent in this
manner are wasteful for precisely the reasons discussed in Chapter 3—they are taken away
from other productive activities (which includes investments in capital equipment, buildings,
or hiring more workers). In the terminology of Chapter 3, this is ‘unproductive
entrepreneurship.’ It is important to note that these costs are present even if the tax is not
enacted by the legislature. Simply the threat of imposing a new tax creates these costs.

To see the magnitude of these exemptions in practice, one only needs to skim the
Sales & Use Tax Exemptions Fiscal Year 2008-2009 which outlines the exemptions to
specific taxes. Sobel and Garrett (2002) estimate the level of rent seeking to be somewhere
between 3.8 to 5.4 percent of the state’s total tax revenue, implying an additional indirect cost
of $473 to $672 million in wasted resources in South Carolina devoted to altering policy. To
reduce these costs, many economists advocate broad-based uniform taxes rather than allowing
rates and exemptions to vary across different goods and services (Holcombe 2001). Without
the ability to individually reduce their own tax rate, any one particular industry is less likely
to expend effort to lobby for changes. A tax that targets one specific industry, such as South
Carolina’s beer tax, tends to generate larger indirect rent-seeking costs.

Figure 4.2: The Cost of Taxation*

4 This report is available at http://www.bcb.sc.gov/BCB/bea/exemptions.pdf.
Furthermore, unlike private markets in which you must pay prices for the things you purchase, with government it is often possible to receive the benefits of government programs while making others pay. Thus, there will be additional lobbying and rent-seeking costs associated with the fight over which programs will be funded, or who will obtain the benefits, when the revenue is spent. For example, the American Association of Retired Persons was among the groups that successfully lobbied for the funding of a one-time $2.9 million for seniors to receive home and community based services such as home delivered meals in 2009.\footnote{Legislative update March 17, 2009 vol. 26, no. 09 http://www.scestatehouse.gov/reports/hupdate/lu2609.htm\#e3 AARP South Carolina News} To secure this funding they had to compete against other groups who also wanted additional government funding. The existence of this opportunity for rent seeking, and a tax system that allows for frequent amendments, winds up allocating state resources to those with the most political power, and not necessarily to welfare enhancing programs or to those most in need (Holcombe 2001).

Returning to Figure 4.2, the tax itself will cause additional indirect costs, highlighted in the lower right box in the figure. The first of these costs, the behavioral changes, is associated with distortions in the behavior of producers and consumers in response to the tax. To economists these costs are known as the ‘deadweight cost’ or ‘excess burden’ of taxation. Whenever a tax is imposed, individuals will substitute away from the activity that is taxed to other activities that are now comparatively cheaper. As an illustrative example, suppose South Carolina imposes a new $100 tax on each candy bar sold in the state. Further assume this would drive the price so high that candy bar sales would fall to zero. The tax would collect no revenue, but it clearly would still have a cost to society. Consumers who like to eat candy bars are now worse off because they are not consuming them, and the producers of candy bars are worse off as well due to the lower number of candy bars sold.

Consumers may also change where they make their purchases to avoid the tax, or if possible, where they live. South Carolinians living on the Georgia border might now drive to Georgia to buy candy bars, or chocolate lovers might even decide to move to another state. These are all costs of taxation that must be considered, and the easier it is for consumers to find substitute goods, move, or shop across the border the larger are these indirect costs.

It is important not to forget that business firms will also have an incentive to change their behavior in response to taxes. When a tax reduces the profitability of any one use of a business’s resources, it means that other uses become more profitable by comparison, and the firm will make adjustments as a result, further increasing the behavioral costs of the tax. Like the consumer, firms can also move to areas that impose lower taxes. Again, the easier it is for firms to change their behavior in response to a tax, the larger will be the indirect behavioral costs of taxation.

The other indirect costs in Figure 4.2 are the compliance, enforcement, and administrative costs. Every tax must be administered and enforced by a taxing authority, and there will be costs associated with these activities. These are the least expensive indirect costs as a share of tax revenue, generally amounting to less than three percent (Payne 2003). Compliance costs, however, are considerable at 22.2 cents per dollar of tax revenue (Moody, Warcholik, and Hodge 2005). This cost includes the hours of book keeping, the time spent filling out tax forms, the hiring of accountants to address changes in tax laws, etc.
All told, these costs add up to between $0.60 and $0.82 for every $1.00 of tax revenue raised. In other words, one dollar of taxes costs the South Carolina economy somewhere between $1.60 and $1.82. This has significant implications for cost/benefit analysis of government projects funded through taxation. A project with benefits of $150 million that requires $125 million in taxes to fund is not efficient to undertake once these additional costs of taxation are considered.

While total state and local tax revenue in South Carolina amounts to around $12 billion, the true cost of these taxes on the South Carolina economy is in the range of $19 to $22 billion.

**SOUTH CAROLINA’s TAX BURDEN: A COMPARISON**

In 2006, South Carolina’s total state taxes per capita were the 47th highest in the nation at $2874 according to the U.S. Census. This was lower than Georgia’s $3321 and North Carolina’s $3384.

This is not the best measure of tax burden though, because some states are simply richer than others. Thus, a more appropriate measure of tax burden is tax revenue as a percent of state income. Using this measure, South Carolina’s tax burden is higher. According to calculations by the Federation of Tax Administrators, South Carolina’s total state and local tax burden as a percent of income is the 44th highest in the nation. As a percent of income, South Carolina has the lowest tax burden of our neighboring states.

Figure 4.3 shows South Carolina’s taxes as a share of personal income compared to the overall U.S. average. The first set of columns show the comparison for state taxes only, while the final set of columns show combined state and local taxes. A positive number in the ‘difference’ column means South Carolina’s taxes are higher than the U.S. average.

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6 http://www.taxadmin.org/FTA/rate/06stl_pi.html.
Figure 4.3: Taxes as a Percent of Personal Income: South Carolina versus the U.S. Average, 2006

<table>
<thead>
<tr>
<th></th>
<th>State Only</th>
<th></th>
<th>State and Local</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenue</td>
<td>5.97</td>
<td>6.48 -0.50</td>
<td>9.58</td>
<td>10.89 -1.31</td>
</tr>
<tr>
<td>Property</td>
<td>0.01</td>
<td>0.11 -0.10</td>
<td>3.05</td>
<td>3.27 -0.22</td>
</tr>
<tr>
<td>Sales and gross receipts</td>
<td>3.23</td>
<td>3.03 0.20</td>
<td>3.45</td>
<td>3.75 -0.30</td>
</tr>
<tr>
<td>General sales</td>
<td>2.45</td>
<td>2.07 0.39</td>
<td>2.53</td>
<td>2.57 -0.04</td>
</tr>
<tr>
<td>Selective sales</td>
<td>0.78</td>
<td>0.97 -0.19</td>
<td>0.93</td>
<td>1.18 -0.26</td>
</tr>
<tr>
<td>Motor fuel</td>
<td>0.39</td>
<td>0.33 0.07</td>
<td>0.39</td>
<td>0.34 0.06</td>
</tr>
<tr>
<td>Alcoholic beverage</td>
<td>0.11</td>
<td>0.04 0.07</td>
<td>0.11</td>
<td>0.05 0.06</td>
</tr>
<tr>
<td>Tobacco products</td>
<td>0.02</td>
<td>0.13 -0.11</td>
<td>0.02</td>
<td>0.14 -0.11</td>
</tr>
<tr>
<td>Public utilities</td>
<td>0.03</td>
<td>0.10 -0.07</td>
<td>0.09</td>
<td>0.22 -0.13</td>
</tr>
<tr>
<td>Other</td>
<td>0.22</td>
<td>0.36 -0.14</td>
<td>0.31</td>
<td>0.45 -0.14</td>
</tr>
<tr>
<td>Individual income</td>
<td>2.10</td>
<td>2.24 -0.14</td>
<td>2.10</td>
<td>2.45 -0.35</td>
</tr>
<tr>
<td>Corporate income</td>
<td>0.23</td>
<td>0.43 -0.20</td>
<td>0.23</td>
<td>0.48 -0.25</td>
</tr>
<tr>
<td>Motor vehicle license</td>
<td>0.12</td>
<td>0.17 -0.05</td>
<td>0.14</td>
<td>0.19 -0.05</td>
</tr>
<tr>
<td>Other taxes</td>
<td>0.28</td>
<td>0.49 -0.20</td>
<td>0.61</td>
<td>0.75 -0.13</td>
</tr>
</tbody>
</table>

Sources: U.S. Census Bureau (2009) and Bureau of Economic Analysis (2008).

Total state taxes as a percent of personal income in South Carolina are approximately nine and a half percent, just less than one and a half percent lower than the U.S. average. This difference is relatively small—South Carolina’s state taxes are just under the average state. When examining individual state tax sources, nine out of the thirteen categories fall below the U.S. average, most notably state property taxes, state income taxes, and state corporate taxes. However, these differences are less than half a percent from the U.S. average.

When local taxes are included, the picture remains mostly unchanged, with the exception that because many other states have local option sales taxes, South Carolina’s state and local sales tax burden is below the U.S. average. In addition, because of South Carolina’s relatively low local residential property taxes we fall further below the U.S. average on relative property taxation. Nonetheless, the conclusion remains that relative to other states South Carolina is just under or at the U.S. average. South Carolina tax policy needs to continue to focus on remaining a relatively low tax state.

LIVING ON THE EDGE

Earlier we discussed how the behavioral costs of taxation become larger when it is easier for people to avoid the tax. According to the U.S. Census, 40.9 percent of the state’s 2008 population lived in counties bordering other states. This is up from the 2000 and 1990 Census when the share in border counties was 40.8 and 40.4 percent, respectively. South Carolina’s total population has increased over the last decade nearly twelve percent, but it has grown even faster in border counties.

In addition, two of South Carolina’s Metropolitan Statistical Areas (MSA’s), which are defined in part by the magnitude of mobility within the area, spill directly across the
The purpose of MSA’s are to identify areas of high economic and social interaction, where component counties must have either 25 percent of employed residents commuting to the central county or at least 25 percent of the employment filled by a resident of the central county (Hammond 2003).

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### Table: Comparison of 2006 State Tax Rates

<table>
<thead>
<tr>
<th>Individual Income</th>
<th>Corporate Income</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TAX RATES</strong></td>
<td><strong>TAX RATES</strong></td>
<td><strong>TAX RATE</strong></td>
</tr>
<tr>
<td>Georgia</td>
<td>1.0-6.0</td>
<td>4*</td>
</tr>
<tr>
<td>North Carolina</td>
<td>6.0-7.75</td>
<td>4.25*</td>
</tr>
<tr>
<td>South Carolina</td>
<td>.0-.7.0</td>
<td>6.0</td>
</tr>
<tr>
<td><strong>BRACKETS</strong></td>
<td><strong>BRACKETS</strong></td>
<td><strong>FOOD EXEMPT</strong></td>
</tr>
<tr>
<td>6</td>
<td>6</td>
<td>Yes</td>
</tr>
<tr>
<td>3</td>
<td>6,9</td>
<td>Yes</td>
</tr>
<tr>
<td>6</td>
<td>5</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Notes: * Georgia and North Carolina food sales are subject to local sales taxes. Source: Federation of Administrators at http://www.taxadmin.org/fta/rate/tax_stru.html.
Finally, Figure 4.5 demonstrates that South Carolina has a higher or the same tax rates over its neighbors in two of the three most visible taxes: individual income, corporate income, and general sales taxes. South Carolina has a lower state corporate tax rate than both of its neighboring states, but the individual income tax and sales tax are higher than both. South Carolina has the highest state sales tax rate at least two percent higher than neighboring Georgia and North Carolina.

**TAX DIFFERENTIALS WITHIN SOUTH CAROLINA**

Let us now take a closer look at the tax burden in South Carolina by examining local tax burdens by county. Figure 4.6 shows the tax quotient for each county in South Carolina from the most recent Census of government finances, which was in 2002. The tax quotient is calculated as the amount of the county’s revenue generated through county and local taxation relative to the same measure for all counties in the nation. A tax quotient greater than one, for example, would imply that the county has an above average reliance on tax collections relative to other counties in the United States and is likely at a competitive disadvantage in terms of business and household location decisions.

Figure 4.6: Comparative 2002 Tax Burden by County Tax Quotient

---

8 In South Carolina, municipal governments are fiscally more important than county governments. The figure above aggregates municipal taxes up to the county level. Thus there may be areas within a county that have a tax quotient above or below the county average. However, for the purpose of examining how tax differential vary geographically within South Carolina, as well as their impact on employment and number of business establishments, the county level is an appropriate unit.
A tax quotient below one, which would indicate a tax burden lower than the U.S. average, is found in 19 of the 46 counties in South Carolina. Nonshaded counties are those with tax quotients of 0.5 or lower (0.5<). The average county in South Carolina has a tax quotient of 1.12, with the largest being Bamberg County with 2.90 and Marlboro County being the lowest at 0.05. Across all South Carolina counties, there is a negative relationship between the tax quotients and both 2002 employment and Census reported business establishments. A one-percent increase in the county’s tax quotient is associated with a -0.07 percent decline in that county’s reported number of business establishments and a -0.02 percent decline in employment.

**TAXATION AND ECONOMIC GROWTH: THE EMPIRICAL EVIDENCE**

Over the past thirty years a considerable amount of economic research has been undertaken in an effort to understand the relationship between taxes and economic growth. While some minimal level of government is necessary to support the institutions of capitalism, governments generally grow way beyond this optimal level. This is an issue explored in more detail in Chapter 12.

In a study for the Joint Economic Committee of the U.S. Congress, Richard Vedder and Lowell Gallaway (1998) examine the relationship between the size of government and economic growth. They found that the amount of state and local spending that maximized economic growth to be 11.42 percent of Gross Domestic Product. In 2007, South Carolina state and local spending was 12.15 percent of State Gross Domestic Product, suggesting that South Carolina state and local government exceeds the size necessary to maximize economic growth.\(^9\) In terms of percentage points, that may not seem like a lot of difference, but it represents over a billion dollars in state and local spending in South Carolina. However, state and local spending has increased by 41 percent between the years 1997-2007 (adjusted for inflation), while overall State Gross Domestic Product grew at only 24 percent. Thus, state and local government grew at nearly double the rate of growth over roughly the last decade.

Looking specifically at taxes, there is a large literature showing a strong negative relationship between taxes and economic growth. Mullen and Williams (1994) find that higher marginal income tax rates hurt economic growth. Jay Helms (1985) finds that taxation used to fund transfer payments significantly retards economic growth. Bartik (1992) provides an excellent summary of the research on state and local taxes and economic growth and concludes that state and local taxes have a consistently negative effect on state and city economic growth. In terms of business location decisions, it is not surprising that he finds tax decisions play a much larger role in studies that look across suburban jurisdictions than across

\(^9\) Vedder and Gallaway (1998) looked at state and local spending over time, and thus used Gross Domestic Product (GDP). Looking at South Carolina, it is appropriate to use State Gross Domestic Product what used to be referred to as Gross State Product (GSP). State GDP in 2007 according to the Bureau of Economic Analysis (2009) was $151,703,000,000 and state and local government expenditures were $18,410,000,000. For a more recent look at the size of government and growth, see Taylor and Brown (2006).
states. Taxes are one part of the package that determines business location, including climate, local amenities, workforce quality, and public infrastructure. Once firms decide on a region, however, taxes can play a much larger role in their location choice.

A recent study by Holcombe and Lacombe (2004) provides strong evidence of the cross-border effect of taxes. By comparing counties located across state border from one another, Holcombe and Lacombe are able to effectively control for geographic similarities such as climate, workforce, and proximity to markets leaving only differences in state policy. Looking at the 30-year period from 1960 to 1990, they find that states raising their income tax rates faster than their neighbors had slower economic growth, leading to an average decline in per capita income of 3.4 percent. Reed (2008) also looks at the relationship between taxation and income growth at the state level from 1970-1999 using several different methodological approaches. He finds ‘robust’ evidence that taxes used to fund general fund expenditures are negatively related to growth.

Plaut and Pluta (1983) find that high taxes have a negative effect on employment growth. Interestingly they find a positive relationship between property taxes and industrial growth. They hypothesize that firms prefer locally-dominated tax systems to state-dominated tax systems that are more prevalent in the South because the benefits related to the high local property taxes are likely to accrue locally. Conversely, firms may avoid states where most taxes are levied at the state level because there is not as clear of a link between taxes paid and benefits received from the firm’s perspective.

Writing for the Federal Reserve Bank of Atlanta, Becsi (1996) examines how state and local taxes affect relative state economic growth. He finds a significant negative relationship between relative state marginal tax rates and relative state growth from 1961 to 1992. The effect of differences in marginal tax rates across states helps to explain not only short-run differences in growth across states, but also the persistence of growth differentials among states over time.

More recently, Poulson and Kaplan (2008, 67) also look at the effect of taxes on state economic growth. They find the following:

The analysis reveals that higher marginal tax rates had a negative impact on economic growth in the states.

... The analysis underscores the negative impact of income taxes on economic growth in the states. Most states introduced an income tax and came to rely on the income tax as the primary source of revenue. Jurisdictions that imposed an income tax to generate a given level of revenue experienced lower rates of economic growth relative to jurisdictions that relied on alternative taxes to generate the same revenue.

Taxes not only impact where businesses locate, but also where people locate. If taxes get too high relative to the benefits received from government spending from government’s activities, people will move elsewhere. An early paper on this was by Cebula (1974) who found that migrants tended to move to areas with low property tax levels. Cebula’s work has

---

10 In 2006, 62.4 percent of South Carolina’s state and local tax revenue came from state taxes. This places the state right near the median of all states (62.2 percent). So South Carolina has a comparative advantage in this area over North Carolina (68.6 percent) in this respect but is nowhere near Georgia (54.9 percent).
been replicated by many others such as Niskanen (1992). Conway, Smith and Houtenville (2001) look at migration by elderly Americans and find that elderly migration is motivated in part by low personal income taxes and estate taxes. Cebula (2009) updated his earlier work to look specifically at the 2000-2005 period and he finds similar results, namely that individuals during this period ‘voted with their feet’ and were more likely to move to areas with lower tax burdens.

CONCLUSION

The aim of this chapter has been to clarify the true costs of taxation on the South Carolina economy, and to explore how South Carolina’s taxes compare to its neighbors and the nation.

According to the best economic estimates, each dollar of tax revenue really costs the South Carolina economy somewhere between $1.60 and $1.82. Currently using these measures of tax burden South Carolina puts itself at a slight competitive advantage in attracting businesses and households when compared to other states. The important point is to maintain this competitive advantage. However, this does not mean there is not room for reform to increase the productivity of South Carolina. As was discussed in Chapter 2, the top state income tax rates are higher than Georgia and slightly lower then North Carolina, but there are six tax brackets with an income of just over $13 thousand dollars placing you in the top bracket for single or joint filing. The median household income in South Carolina for 2007 was $43,508 effectively placing over fifty percent of the population in the highest tax bracket. In North Carolina a single filer must earn at least $60,000 and $100,000 for a joint return to enter the top bracket of 7.75 percent. In addition, our state and local governments are growing faster than overall state growth.

Empirical studies have a long history of consistently finding that state taxation hinders development and economic growth by constraining the forces of capitalism. To promote economic growth, South Carolina must find ways to keep its overall tax burden low. The next chapter will explore several specific tax reforms that can help to accomplish this goal.
CHAPTER 5: SPECIFIC TAX REFORMS

Notice that South Carolina's effective tax rate on industrial property is 119.

Although it is probably not critical that South Carolina set its tax rate to the lowest in

Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than

Such a significant reduction in taxes on industrial property would obviously lead to a

various taxes applied to industry would seriously improve the state's competitiveness.

Furthermore, if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more


Hammond, George W. 2003. What's in a Name?


the figure because it is the lowest-tax state.)

over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in

million ($12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5

industry moves into the state. Furthermore, if the official tax rates are lowered, then the state

revenue may in fact increase once the growth rate in the state begins to pick up and more

Such a significant reduction in taxes on industrial property would obviously lead to a

various taxes applied to industry would seriously improve the state's competitiveness.

at around 1 percent might be sufficient to attract more industry. Working to reduce the

The 'net tax' and 'effective tax rate' are calculated based on property valued at $25

50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25

manufacturing property tax in the country. In Figure 5.8 we present the effective property tax

* Taxes measured in the states' largest city only.

Source: National Association of Manufacturers (2009)
CHAPTER 5

SPECIFIC TAX REFORMS TO INCREASE GROWTH IN SOUTH CAROLINA

by Douglass M. Walker and Steven J. Arsenault
over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in million in fixtures). Notice that South Carolina's effective tax rate on industrial property is million ($12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5 million ($238,840 in revenue may in fact increase once the growth rate in the state begins to pick up and more Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate seriously disadvantage, in terms of its ability to attract and keep industry. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has Importantly, South Carolina's effective tax rate is almost 2.5 times greater than 50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million. In Figure 5.8 we present the effective property tax reduction in tax revenues on industrial property, at least initially. However, the overall such a significant reduction in taxes on industrial property would obviously lead to a various taxes applied to industry would seriously improve the state's competitiveness.

Table 5.1: States with the highest industrial property tax

<table>
<thead>
<tr>
<th>State</th>
<th>Tax Rate (2009)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Texas</td>
<td>0.48%</td>
<td>$1,264,358</td>
</tr>
<tr>
<td>Mississippi</td>
<td>0.65%</td>
<td>$1,291,050</td>
</tr>
<tr>
<td>Louisiana</td>
<td>0.98%</td>
<td>$783,407</td>
</tr>
<tr>
<td>West Virginia</td>
<td>1.11%</td>
<td>$833,234</td>
</tr>
<tr>
<td>Alabama</td>
<td>1.11%</td>
<td>$533,776</td>
</tr>
<tr>
<td>Florida</td>
<td>1.36%</td>
<td>$677,683</td>
</tr>
<tr>
<td>Georgia</td>
<td>1.52%</td>
<td>$760,381</td>
</tr>
<tr>
<td>North Carolina</td>
<td>1.57%</td>
<td>$241,498</td>
</tr>
<tr>
<td>California</td>
<td>2.53%</td>
<td>$1,264,358</td>
</tr>
<tr>
<td>Delaware</td>
<td>3.73%</td>
<td>$238,840</td>
</tr>
</tbody>
</table>

* Taxes measured in the states' largest city only.

Source: National Association of Manufacturers (2009)

Figure 5.5 also shows that the current tax system charges all income groups more in the 1959 indexed tax rate structure is more uniformly progressive, especially at higher levels of incomes. It keeps tax rates extremely low for the lowest income figure clearly shows that the 1959 tax tables would be if the 1959 tax tables were indexed for inflation. The vertical equity condition, it really does this only at the lower income levels reducing the to the goal of progressivity. So although on the surface it appears that the tax satisfies the term, eventually citizens will have to pay off their debtors through higher taxes in the future, about 4.4 million for the foreseeable future. The current federal government debt of $11 trillion amounts to each $1 trillion that we add to this amount, each system of raising state revenues. Thanks to the explosion in federal government spending that...
5

SPECIFIC TAX REFORMS TO INCREASE ECONOMIC GROWTH IN SOUTH CAROLINA

Douglas M. Walker and Steven J. Arsenault

The time is ripe for undertaking changes to transform and simplify the South Carolina system of raising state revenues. Thanks to the explosion in federal government spending that began in late 2008, we can expect to see federal budget deficits in excess of $1 trillion per year for the foreseeable future. The current federal government debt of $11 trillion amounts to $36,000 per person in the United States. For each $1 trillion that we add to this amount, each citizen’s burden increases by another $3,300. Aside from the federal debt, South Carolinians are responsible for their own state’s debt, which in 2007 was about $15 billion. The state has about 4.4 million people, so state debt amounts to approximately $3,400 per South Carolinian. Although these alarming levels of government debt can be financed in the short-term, eventually citizens will have to pay off their debtors through higher taxes in the future, or decreases in government spending. Or, most likely, both.

In this chapter we examine some reforms to the South Carolina tax system that could help increase economic growth in the state. Although these reforms alone cannot solve our state’s fiscal crisis, they can help reduce the fiscal stress and set the stage for longer-term economic growth and tax revenue enhancement.

Given that the citizens of South Carolina are certain to see a significant increase in their future federal tax obligations, the state should act now to simplify its tax system, reduce the administrative and enforcement costs associated with the current tax system, and otherwise work to reduce the tax burden on the citizens of South Carolina. Such changes now will increase the attractiveness of the state for individuals and businesses. The changes we examine in this chapter can be implemented in a way that is tax-neutral, i.e., in a way that keeps the overall amount of tax revenue the same as current levels.

As the previous chapter demonstrates, South Carolina’s tax system is typical of other states in the U.S. in terms of the types of taxes imposed at the state level. Furthermore, our state is somewhat competitive with its neighboring states. However, there are numerous ways the tax system in the Palmetto State could be modified to produce revenue with fewer

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1 Source: U.S. Census Bureau (2009).
distortions and lower tax collection and compliance costs. Perhaps more importantly, these changes would also make the state a more attractive place to live and for business to locate, both of which would increase South Carolina’s rate of economic growth. In this chapter we expand on Chapter 4 and discuss three specific types of tax reform which should be undertaken. We begin with a discussion of some statistics on state income, government revenues, and state debt.

**SOUTH CAROLINA FINANCIAL STATISTICS**

In considering whether tax reform is needed in South Carolina, and what specific reforms would be best, it is useful to put the South Carolina tax situation in the context of the state’s levels of per capita income, government revenue, and public debt. Economists define economic growth as an increase in per capita income (state income divided by population). The effect of inflation (changing prices) is typically removed from the per capita income measure so that it is measuring the actual purchasing power of income, undistorted by the effects of rising prices. A primary goal of any proposed tax system changes in South Carolina should be to encourage economic development through capital and business investment. This, in turn will increase employment, and these changes together will increase economic growth and South Carolinians’ standard of living. In turn, tax revenues can increase if incomes are rising.

Let us examine per capita income data on South Carolina, relative to other states and the United States in general. Unfortunately, South Carolina currently ranks quite low among the states. Data from the U.S. Bureau of Economic Analysis indicates that South Carolina has one of the lowest levels of per capita income in the United States. Figure 5.1 (on the next page) shows that in 2005 the state’s per capita income was $28,285, which ranked 43rd in the country, and is far below the U.S. average of $34,471. Although per capita income rose slightly to $29,515 in 2006, South Carolina’s rank actually fell to 45th in the country. The rate of income growth was 4.3 percent, which ranked 37th lowest in the country. These data are a good indication of the overall picture of South Carolina income relative to the rest of the United States. Clearly, our state is far behind other states in terms of economic development.

It is worth noting that neither of South Carolina’s neighbors are in this list of lowest-income states. As discussed earlier in Chapter 2, this difference in per capita incomes between South Carolina, Georgia and North Carolina may be partially due to the relatively low level of economic freedom in our state. Relatively high taxes are also largely to blame for this difference. In Figure 5.2 we present a closer look at per capita income, along with the overall levels of state government spending, tax revenues, and debt. It is interesting to compare the figures from South Carolina to its neighbors Georgia and North Carolina.
Figure 5.1 States with the lowest per capita income, 2005-2006

<table>
<thead>
<tr>
<th>Per capita personal income (dollars)</th>
<th>Rank in U.S.</th>
<th>% of U.S. avg.</th>
<th>% change, 2005-2006</th>
<th>Rank of % change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>U.S.</strong></td>
<td>34,471</td>
<td>36,276</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Louisiana</td>
<td>24,664</td>
<td>30,952</td>
<td>50</td>
<td>41</td>
</tr>
<tr>
<td>Montana</td>
<td>29,015</td>
<td>30,688</td>
<td>41</td>
<td>42</td>
</tr>
<tr>
<td>Idaho</td>
<td>28,478</td>
<td>29,952</td>
<td>42</td>
<td>43</td>
</tr>
<tr>
<td>New Mexico</td>
<td>27,889</td>
<td>29,673</td>
<td>45</td>
<td>44</td>
</tr>
<tr>
<td>South Carolina</td>
<td>28,285</td>
<td>29,515</td>
<td>43</td>
<td>45</td>
</tr>
<tr>
<td>Kentucky</td>
<td>28,272</td>
<td>29,352</td>
<td>44</td>
<td>46</td>
</tr>
<tr>
<td>Utah</td>
<td>27,321</td>
<td>29,108</td>
<td>46</td>
<td>47</td>
</tr>
<tr>
<td>Arkansas</td>
<td>26,681</td>
<td>27,935</td>
<td>47</td>
<td>48</td>
</tr>
<tr>
<td>West Virginia</td>
<td>26,419</td>
<td>27,897</td>
<td>48</td>
<td>49</td>
</tr>
<tr>
<td>Mississippi</td>
<td>25,051</td>
<td>26,535</td>
<td>49</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: U.S. Bureau of Economic Analysis.

Figure 5.2 State government revenues, spending, and debt, 2007

<table>
<thead>
<tr>
<th></th>
<th>Georgia</th>
<th>North Carolina</th>
<th>South Carolina</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>9.52 million</td>
<td>9.04 million</td>
<td>4.40 million</td>
</tr>
<tr>
<td>State govt. revenue</td>
<td>$45.0 billion</td>
<td>$51.8 billion</td>
<td>$27.5 billion</td>
</tr>
<tr>
<td>State govt. revenue per capita</td>
<td>$4,727</td>
<td>$5,730</td>
<td><strong>$6,250</strong></td>
</tr>
<tr>
<td>State govt. spending</td>
<td>$41.8 billion</td>
<td>$44.0 billion</td>
<td>$24.8 billion</td>
</tr>
<tr>
<td>State govt. spending per capita</td>
<td>$4,391</td>
<td>$4,867</td>
<td><strong>$5,636</strong></td>
</tr>
<tr>
<td>State govt. spending as a % of revenue</td>
<td>93%</td>
<td>85%</td>
<td>90%</td>
</tr>
<tr>
<td>State govt. debt</td>
<td>$11.4 billion</td>
<td>$19.0 billion</td>
<td>$15.0 billion</td>
</tr>
<tr>
<td>State govt. debt per capita</td>
<td>$1,197</td>
<td>$2,102</td>
<td><strong>$3,409</strong></td>
</tr>
<tr>
<td>State govt. debt as a % of revenue</td>
<td>25%</td>
<td>37%</td>
<td><strong>55%</strong></td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau

Several numbers are worth highlighting in Figure 5.2. Notice that government revenue and spending per capita are both larger in South Carolina than in Georgia and North Carolina. This indicates that, generally, the South Carolina government plays a larger role in the state economy, compared to its neighboring states. Yet, as shown in Figure 5.1, South Carolina
ranks much lower in terms of state per capita income. These data support the argument in Chapter 2 that less government intervention tends to generate more economic growth.

Another issue that becomes clear from the data in Figure 5.2 is that the levels of government debt per capita and debt as a percentage of state revenue are significantly larger in South Carolina than in the neighboring states. Since the government sector in South Carolina is relatively large, one can argue that the level of economic growth has been stifled, relative to its neighbors with somewhat smaller government sectors.

In this chapter we are not addressing how to cut government spending, but such budgetary changes are needed if South Carolina is truly interested in increasing its level of economic growth. In the following section we focus more specifically on the types of taxes which generate the state’s revenue. We then discuss some specific changes to the state’s tax structure which will help increase the rate of economic growth in the Palmetto State.

**SOUTH CAROLINA’S CURRENT TAX STRUCTURE**

South Carolina funds state and local government operations through a mixture of sales and use taxes, property taxes, and individual and corporate income taxes. As shown in the previous chapter (Figure 4.1), South Carolina raises its revenue from a variety of sources, but the overwhelming majority of revenues come from property taxes (31%), general and selective sales taxes (25% and 10%, respectively), and individual income taxes (22%). These revenue sources are typical of other states, and it will take a strong political will to fundamentally change the system. Before discussing specific changes that can help increase economic growth in South Carolina, it is worth examining in more detail the different taxes used by the government.

Historically, the state’s tax system has undergone a slow transformation. From its beginning until the early 1900s, South Carolina relied almost entirely on real and personal property taxes to fund its revenue needs. An income tax was first adopted in 1921, with the goal of funding state government in order to make property taxation available exclusively to local governments. The elimination of property taxes as a funding source for the state government was completed in the early 1940s.

**SALES AND USE TAXES**

Sales and use taxes are imposed at both the state and local government level. At the state level, most retail sales of tangible goods are subject to sales tax at a rate of 6 percent. Out-of-state purchases are subject to a use tax at the sales tax rate with a credit given for sales taxes paid to other states on the goods purchased. Sales taxes are efficiently collected by retail businesses at the time of sale, while use taxes on out-of-state purchases are reported by the taxpayer on his or her state income tax form, making enforcement of use taxes significantly more difficult.

At the local level, counties may adopt an additional local option sales tax on retail sales of tangible goods at a rate of 1 percent. The local option sales tax must be approved by a county-wide referendum, and at least 71 percent of the revenue must be used to reduce local real estate taxes. Counties may also impose additional retail sales taxes at a rate of 1-2 percent to fund capital projects, transportation and schools.
As in most other states, South Carolina’s sales and use taxes are subject to numerous exemptions. For example, prescription drugs, newspapers, Bibles, and textbooks are all entirely exempt. Since late 2007, sales of most unprepared food items are exempt from state sales tax (but not from the local sales taxes). Other interesting exemptions from the sales and use taxes include sweetgrass baskets made by local artists from locally grown sweetgrass; gold, silver or platinum bullion; vacation time-sharing plans; 70 percent of the gross proceeds of the rental or lease of portable toilets; and 50 percent of the gross proceeds of the sale of a modular home. South Carolina also provides a 1 percent reduction in the state sales and use tax for senior citizens age 85 and older. Purchases by businesses and agricultural operations for resale, for use in production, or for further processing are likewise exempt. Unlike other states, however, the maximum sales tax on motor vehicles, motorcycles, boats, and airplanes is $300. The effect of this sales tax cap is that the same sales tax is due from the purchase of a $6,000 used car as from a $90,000 luxury car or a $250,000 yacht.

Like a number of other states, South Carolina also offers an annual sales tax holiday during the first weekend in August on a long list of specified items. The list of exempt items for the sales tax holiday includes school supplies (such as pencils, lunchboxes, notebooks and book bags), school related supplies (such as computers, printers and computer software), and items that bear no specific connection to schools (such as clothing, clothing accessories, sheets, bath towels and wash clothes, pillows and pillow cases).

**Local Property Taxes**

Real and personal property is taxed based on a percentage of market value. The rates range from 4 percent to 10 ½ percent, depending on the classification of the property. Owner-occupied housing and noncommercial farm land are assessed at a 4 percent rate, while rental and commercial properties, commercial farms and personal vehicles are assessed at 6 percent. Transportation companies are subject to a 9 ½ percent rate, and manufacturing, utilities and personal property other than personal vehicles are assessed at 10 ½ percent.²

Local property taxes are also subject to numerous exemptions and exceptions. For example, farm and forest property, including golf courses, is assessed at use value rather than market value, which generally results in substantial tax savings. A homestead exemption exempts the first $50,000 of market value of an owner-occupied residence from local property taxes for owners over 65 years old. Since 2008, the entire market value of all owner-occupied residences is exempt from property taxes for education operations.

Moreover, businesses that establish new manufacturing plants may negotiate with individual counties to pay a fee in lieu of property taxes. Qualification requirements are based on the amount of money invested and the number of jobs created by the project, ranging from an $85 million minimum investment with no jobs requirement to a $20 million minimum investment that creates 400 jobs. The effect in some cases is to lower the assessment ratio for these facilities from 10 ½ percent to 6 percent. These agreements typically cover a twenty year period and can include protection against future tax increases (see Chapter 7).

² Unlike other states, in South Carolina, the rates for each classification of property are specified in the state Constitution. The definition of the properties within each category is left to the General Assembly. S.C. Constitution, Art. X, §§ 1 and 2.
STATE INDIVIDUAL INCOME TAX

South Carolina’s current state income tax structure dates back to 1959. At that time, the state individual income tax rates ranged from 2 1/2 percent to a maximum of 7 percent, with tax brackets increasing for every $2,000 of taxable income. Thus, the income level required to reach the top marginal rate of 7 percent was $10,000. However, at that time, the median family income in South Carolina was $3,821, placing the average taxpayer in the second lowest bracket at a marginal tax rate of 3 percent. The brackets were not changed until 1981, when the South Carolina legislature indexed the brackets for inflation. The indexing for inflation was short-lived, however, and was repealed in 1986. In 1995, the state again adopted an inflation index for its individual income tax brackets. However, the adjustment was limited to one-half of the Consumer Price Index (CPI) up to a maximum of 4 percent per year. Thus, while the brackets are indexed for inflation, the rate of adjustment is not adequate to keep up with actual increases in taxpayer income levels. Bills are currently pending in both the House and Senate that would change the inflation adjustment to the full CPI amount, but it is unclear whether or not they will be enacted into law.

Gross income for state tax purposes is the same as the federal definition, subject to various increases and decreases. Some of these adjustments establish significant tax exemptions. For individuals, the taxpayer’s federal gross income is decreased by social security income, as well as retirement income up to $3,000 for taxpayers under age 65 and $10,000 for taxpayers age 65 and older. Individuals age 65 and older are also entitled to a $15,000 tax deduction against any South Carolina taxable income, reduced by any deduction already allowed for retirement income.

Now that we have provided a general overview of how tax revenues are generated in South Carolina, we move on to explain some of the general principles of taxation that economists focus on when designing and evaluating tax policy. It is with these principles in mind that we suggest in the following section ways to improve South Carolina tax policy.

PRINCIPLES OF TAX THEORY

If we wish to reform the South Carolina tax system to be more efficient, raise more revenues at lower costs, improve fairness, and generate economic growth then we must consider some of the basic principles of taxation from economics. Here we give a brief review of some of these principles. Further details can be found in any public finance text, such as Gruber (2007).

The first set of economic principles on taxation address ‘ability to pay.’ Most economists, voters, and politicians would probably agree that those who are more able to pay taxes should have a higher tax burden than individuals with a lower ability to pay. Furthermore, individuals should be treated fairly or equally, with respect to ability to pay and taxes.

The principle of ‘horizontal equity’ states that individuals with the same income should be expected to pay the same amount in income taxes. This principle falls under equal treatment under the law, and few people would disagree with the principle. It is also fairly straightforward. However, since ‘taxable income’ can vary across individuals with the same gross income, one could still argue that adjustments used to arrive at taxable income could be
unfair. At this point our concern is setting tax rates relative to income, and this issue in particular is clear. Individuals who have the same taxable income should pay the same taxes.

It follows, then, that individuals with higher incomes should probably be expected to pay higher taxes than individuals with lower incomes. Millionaires should pay more in taxes than the homeless. It should be noted, if the same income tax rate is applied to all individuals, the rich will pay more in taxes than the poor. For instance, if a tax rate of 15 percent is applied to all income, then a person with $10,000 income will pay $1,500 in taxes, while a person with income of $50,000 will pay $7,500. Yet, the concept of ‘vertical equity,’ in most interpretations, means that higher income individuals should pay a higher percentage of their incomes in taxes. This principle is typically done by setting marginal tax rates so that they increase as income increases. This is the case with the federal tax code, which has tax brackets with rates from 10 percent up to 35 percent, at the highest levels of income. A tax system is called ‘progressive’ if the average tax rate increases as income increases. Many economists and most voters and politicians probably agree that a progressive tax system is fair, since higher income individuals have a greater ability to pay taxes.

The ‘benefit principle’ says that individuals who benefit from government policies or programs should bear a large portion, if not all, of the costs of providing the services. Obviously, this principle does not conform with wealth redistribution programs like social security, government unemployment benefits, or other welfare payments. The best example of the benefit principle applied to taxes might be the tax on gasoline. The gas tax revenue is used to build and maintain roads. Since drivers of cars and trucks are the users of the roads, the tax on gas forces the beneficiaries of government roads to pay for the costs of providing the roads. Of course, many taxes are not based on the benefit principle. One example is people without children usually have to pay local property taxes to support education, even though their family will not receive any direct benefits from the taxes they pay.

The remaining tax principles that economists usually consider in evaluating tax policy relate to ‘economic efficiency.’ Economists are concerned with overcoming the problem of scarcity to the extent possible. This means we must make choices with how to use our limited resources in order to make ourselves as well off as possible. In the case of tax policy, this means that we want to raise tax revenue at the least possible cost to taxpayers, the government, and society. There are three important concepts that relate to this goal of cost minimization: ‘deadweight losses,’ ‘excess burden,’ and ‘rent seeking.’ These issues were raised in the previous chapter, and we briefly reintroduce them here.

One problem with taxes, especially those placed on specific items like gasoline, cigarettes, or luxury cars, is that they distort behavior. That is, since the tax typically increases the price of the product to the consumer, fewer mutually beneficial voluntary transactions take place in the market for the taxed product. Since the number of transactions is reduced, the total benefits that the consumers and producers receive from the transactions in that market are reduced. In particular, producers lose the profit they would have made on the additional sales they would have made in the absence of the tax. Consumers lose the benefits they would have received because they typically value products at greater than the market price they actually have to pay for them. In this way, society’s wealth is reduced. This effect also slows the rate of economic growth, as some individuals are now less wealthy as a result.

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3 There is both a state and federal tax on gasoline. The federal tax is 18.3 cents per gallon. The state tax in South Carolina is 16 cents per gallon. With a total tax of 34.3 cents per gallon, South Carolina’s gas tax is relatively low compared to the national average.
of the tax. It is important to emphasize that the costs we are referring to here are not the taxes themselves; taxes represent simply a transfer of wealth, not a net loss of it. But a deadweight loss is a loss of wealth, an inefficiency due to the tax changing people’s consumption behavior.\footnote{Consumers may in fact simply buy something else rather than the taxed item. But this will be their next best option, in the absence of the tax. Thus, they are losing some benefits relative to the non-tax situation since they do not consume their first choice.}

Another aspect of the deadweight loss issue is broad-based taxation. Theory suggests that taxes should be applied generally, to all products, rather than selectively on particular products. This is because with a general sales tax, for example, all products are taxed equally and the tax does not change relative prices. So the tax does not affect people’s consumption decisions. However, taxes on specific items make those items relatively more expensive, causing fewer transactions in those markets, and creating deadweight loss. In order to minimize these problems, tax exemptions, such as those noted earlier for textbooks, mobile homes, vacation time-shares, etc., should be eliminated. If sales transactions or income is to be taxed, the best policy is to tax it all at the same rate.

Excess burden relates to the cost of complying with tax laws. In the case of sales taxes, gasoline taxes, and other specific taxes, the excess burden may be relatively low. Since sellers already have computerized systems (generally) tracking their sales transactions, it is fairly low cost to add an additional sales tax change, track the taxes collected, and remit the taxes to the state government. The income tax, on the other hand, is extremely complicated. The federal tax code is outlined in over 10,000 pages mind-numbing law/tax jargon. It is questionable whether any individual human understands and could apply all of the rules in the tax code. As a result, many individuals buy tax software, or hire accountants or tax lawyers. The use of scarce resources simply to comply with arbitrary, overly complicated tax rules is a waste of resources, considering that the income tax revenue could be raised through a much simpler framework which would have much lower compliance costs. It has been estimated that in 2006 alone, the federal tax code wasted 6 billion hours of time and more than $265 billion for compliance.\footnote{Source: Tax Foundation (2006).} The federal tax code is much more complicated than the South Carolina code, but they are similar animals. Indeed, the South Carolina income tax computation begins with federal taxable income. Many of our proposed changes outlined in the remainder of this chapter address this issue of the excess burden from tax compliance.

Finally, rent seeking is a big concern relevant to the current tax system in South Carolina. Rent seeking refers to individuals or interest groups using scarce resources in an effort to secure transfers of wealth from the government (i.e., taxpayers). In other words, rent seeking occurs when interest groups spend money on lobbyists, give bribes to politicians, or otherwise attempt to influence legislation in order to benefit themselves. Such activities reduce the overall level of wealth in South Carolina because rent seeking devotes scarce resources to unproductive entrepreneurship to use the language of Chapter 3 (lobbying), rather than the production of goods or services for the market economy. For example, the U.S. car industry has spent millions lobbying Congress in order to restrict the importing of foreign-produced cars. These expenditures of time and effort to influence politicians means they have fewer resources with which they can produce cars. In the context of tax laws in South Carolina, there are tax exemptions for all sorts of products; these are typically the result of lobbying by some interest group in the past. The way to reduce rent seeking is to have simple
tax rules that are applied uniformly, and are set within an infrastructure of fairness and resistance to manipulation by politicians and interest groups.

**TAX CHANGES FOR SOUTH CAROLINA**

Considering the current tax structure in South Carolina in light of the tax theory principles discussed above, let us now discuss some general changes that could simplify the South Carolina tax system and do so in a way that would also lower costs to the citizenry. These changes are just one step in the overall proposal in this book to improving how government functions and increase economic growth for South Carolina. A primary goal is to make government work *smarter*. This means streamlining the tax system, making the law simple to follow and difficult to manipulate by special interests and short-sighted politicians. In time, these changes can encourage economic growth.

**OVERHAUL THE INCOME TAX**

Several problems with the South Carolina income tax have been mentioned earlier in this book (see Chapter 3 and 4). Further problems arise in light of the tax principles discussed above. An overhaul of the income tax should focus on simplifying it and making it transparent, enlarging the tax brackets, and reducing the compliance costs and rent seeking associated with tax legislation.

**INDEXING FOR INFLATION**

Perhaps the most obvious suggestion, and one of the simplest to implement, is that the income tax brackets should be accurately indexed for inflation. Although the legislature has done this during specific periods, they currently do not. While indexing was reintroduced in 1995, it was at only half the rate of CPI growth up to a maximum of 4 percent per year. The effect of this is to push taxpayers into higher tax brackets much quicker than their pay raises otherwise would. This leads to a ‘hidden’ or ‘built in’ tax increase. This failure to adequately index the tax brackets for inflation is a politically easier way to raise tax revenues than simply telling people openly, ‘we want to raise your taxes.’ However, it suggests that politicians are not being honest with taxpayers.

To illustrate, consider the current income tax tables for single individuals in South Carolina. Figure 5.3 illustrates the marginal tax rates applied to different income levels. In Figure 5.3 we present the South Carolina income tax table for a single individual. A curious aspect of the table is that each tax bracket is $2,630 ‘wide.’ There is no theoretical reason the brackets should be equally wide or be of the width they are in South Carolina. The brackets have ended up this way because they were occasionally indexed to inflation. They are based on their 1959 values – $2,000 each bracket. The tax rates have changed slightly (the 2.5% lowest rate was reduced to 0%), but otherwise, the tax brackets have changed very little since their introduction in 1959.
Figure 5.3 South Carolina income tax rates, 2007

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Marginal Tax Rate</th>
<th>Tax Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $2,630</td>
<td>0%</td>
<td>$0</td>
</tr>
<tr>
<td>$2,630 - $5,260</td>
<td>3%</td>
<td>3% of amount over $2,630</td>
</tr>
<tr>
<td>$5,260 - $7,890</td>
<td>4%</td>
<td>$79 + 4% of amt. over $5,260</td>
</tr>
<tr>
<td>$7,890 - $10,520</td>
<td>5%</td>
<td>$184 + 5% of amt. over $7,890</td>
</tr>
<tr>
<td>$10,520 - $13,150</td>
<td>6%</td>
<td>$316 + 6% of amt. over $10,520</td>
</tr>
<tr>
<td>$13,150 and above</td>
<td>7%</td>
<td>$474 + 7% of amt. over $13,150</td>
</tr>
</tbody>
</table>

Since the tax brackets have not been indexed consistently, it means that virtually everyone is paying higher taxes than they would have been had the brackets been correctly indexed for inflation. This represents a ‘hidden tax.’ Had the 1959 South Carolina income tax table been consistently indexed by inflation, it would look like the rate scheme pictured in Figure 5.4. As Figure 5.4 demonstrates, the current highest marginal tax rate of 7 percent would be applied to incomes of over $73,200, not the current $13,150. This tax schedule reflects a more reasonable tax structure, as found in other states that attempt to have a progressive rate structure.

Figure 5.4 South Carolina income tax rates: 1959 and 2009

(adjustment)*

<table>
<thead>
<tr>
<th>Tax Brackets, 1959</th>
<th>Marginal Tax Rates, 1959</th>
<th>Taxable Brackets in 2009 if 1959 Brackets Indexed by CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $2,000</td>
<td>2.5%</td>
<td>$0 - $14,640</td>
</tr>
<tr>
<td>$2,000 - $4,000</td>
<td>3%</td>
<td>$14,640 - $29,280</td>
</tr>
<tr>
<td>$4,000 - $6,000</td>
<td>4%</td>
<td>$29,280 - $43,920</td>
</tr>
<tr>
<td>$6,000 - $8,000</td>
<td>5%</td>
<td>$43,920 - $58,560</td>
</tr>
<tr>
<td>$8,000 - $10,000</td>
<td>6%</td>
<td>$58,560 - $73,200</td>
</tr>
<tr>
<td>$10,000 and above</td>
<td>7%</td>
<td>$73,200 and above</td>
</tr>
</tbody>
</table>

* The Bureau of Labor Statistics reported the CPI in 1959 was 29.1. For the first half of 2009, it was 213.1. Prices are thus 7.32 times higher now than in 1959.

The current median income in South Carolina is around $43,500, as reported in Chapter 4. Suppose exemptions and deductions reduce this amount so that the median taxable income is $30,000. This amount is close to the 2006 per capita income reported for South Carolina in Figure 5.1. Then if the income tax brackets for South Carolina had been indexed

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6 The source of the 1959 marginal income tax table is the South Carolina Policy Council (2006).
for inflation, the median person’s income has increased relative to inflation, causing the person to move from the second lowest tax bracket (3%, with a 1959 median income of $3,821) to the 4 percent bracket in 2009. Yet, currently, since the tax brackets have not been adjusted for inflation, the 2009 median income earner falls deep into the highest tax bracket of 7 percent.

Presumably the original intent of imposing a tax rate schedule with graduated marginal tax rates was to make the income tax progressive. However, what progressivity exists in the state’s income tax structure is due to the zero tax on the first $2,630 of income, and because of the graduated marginal tax rates. However, since the marginal tax rate increases over such small steps in income, as shown in Figure 5.5, most of the progressivity occurs at lower income levels, not higher levels of income. At higher income levels, the average tax rate hardly increases at all. This nature of the current tax is directly contradictory to the goal of progressivity. So although on the surface it appears that the tax satisfies the vertical equity condition, it really does this only at the lower income levels reducing the wealth of these lowest income taxpayers, not the intended consequence.

### Figure 5.5 South Carolina income tax: Current tax rates compared to inflation-indexed rates, 2009

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Current Income Tax Rates/Brackets</th>
<th>Income Tax Rates/Brackets if 1959 Tax Schedule was Inflation Adjusted to 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tax Amount</td>
<td>Average Tax Rate</td>
</tr>
<tr>
<td>$5,000</td>
<td>$71</td>
<td>1.42%</td>
</tr>
<tr>
<td>$10,000</td>
<td>$290</td>
<td>2.90%</td>
</tr>
<tr>
<td>$15,000</td>
<td>$604</td>
<td>4.03%</td>
</tr>
<tr>
<td>$20,000</td>
<td>$954</td>
<td>4.77%</td>
</tr>
<tr>
<td>$30,000</td>
<td>$1,654</td>
<td>5.51%</td>
</tr>
<tr>
<td>$50,000</td>
<td>$3,054</td>
<td>6.10%</td>
</tr>
<tr>
<td>$75,000</td>
<td>$4,804</td>
<td>6.41%</td>
</tr>
<tr>
<td>$100,000</td>
<td>$6,554</td>
<td>6.56%</td>
</tr>
<tr>
<td>$150,000</td>
<td>$10,054</td>
<td>6.70%</td>
</tr>
<tr>
<td>$200,000</td>
<td>$13,554</td>
<td>6.77%</td>
</tr>
</tbody>
</table>

Figure 5.5 also shows what the average tax rates are for various incomes and taxes under the current tax system in South Carolina. In the right columns it also shows what the taxes and average tax rates would be if the 1959 tax tables were indexed for inflation. The figure clearly shows that the 1959 indexed tax rate structure is more uniformly progressive, especially at higher levels of incomes. It keeps tax rates extremely low for the lowest income individuals in the state.
Figure 5.5 also shows that the current tax system charges all income groups more in taxes than an indexed rate schedule. The only exception is the $5,000 income earner in the table. As South Carolina income taxes continue to climb while the tax brackets remain stagnant, the state becomes a relatively high-tax state. This has a negative impact on businesses and individuals who are considering moving to South Carolina, reducing economic potential.

**LOWERING INCOME TAX RATES**

In addition to indexing the tax brackets, legislators should also reduce income tax rates. South Carolina has one of the highest marginal tax rate schedules in the country. This is problematic for future economic growth in the state because high marginal tax rates stifle economic growth.

Consider just the states in the Southeast. As Figure 5.6 shows, South Carolina has one of the highest marginal tax rates in the Southeast. When one considers that the only state with a higher rate, North Carolina, actually has a much higher income threshold to reach the highest bracket, South Carolina effectively has the highest personal income taxes in the Southeast. Alabama and Georgia have similarly high tax rates. Although their highest tax rate is lower than South Carolina’s, so too is the income required to get into their top tax bracket.\(^7\)

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**Figure 5.6 Income tax rates in Southeastern states, 2009**

<table>
<thead>
<tr>
<th>State</th>
<th>Highest Marginal Income Tax Rate</th>
<th>Income at which Top Tax Rate Applies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Florida, Tennessee*, Texas</td>
<td>0</td>
<td>n/a</td>
</tr>
<tr>
<td>Alabama</td>
<td>5%</td>
<td>$3,000</td>
</tr>
<tr>
<td>Mississippi</td>
<td>5%</td>
<td>$10,000</td>
</tr>
<tr>
<td>Virginia</td>
<td>5.75%</td>
<td>$17,000</td>
</tr>
<tr>
<td>Kentucky</td>
<td>6%</td>
<td>$75,000</td>
</tr>
<tr>
<td>Georgia</td>
<td>6%</td>
<td>$7,000</td>
</tr>
<tr>
<td>Louisiana</td>
<td>6%</td>
<td>$50,000</td>
</tr>
<tr>
<td>Arkansas</td>
<td>7%</td>
<td>$31,700</td>
</tr>
<tr>
<td><strong>South Carolina</strong>**</td>
<td><strong>7%</strong></td>
<td><strong>$13,350</strong></td>
</tr>
<tr>
<td>North Carolina</td>
<td>7.75%</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

South Carolina legislators should carefully consider how to improve economic growth in the state. One way of doing this is to bring the state more in line with higher-growth and more competitive state economies. We could attract more workers with lower tax rates and by

\(^7\) Which state effectively has the highest income tax depends on deductions, exemptions, and other state-specific tax laws.
making tax compliance less costly. These changes are important because taxes distort behavior. When we tax labor and income at relatively high rates, it creates a disincentive to working. It also increases the incentive for individuals to find ways to avoid taxes. Tax avoidance may include legal options, such as hiring accountants and lawyers to find loopholes in the tax code. But some individuals may resort to tax evasion – illegal ways of reducing their tax burdens. Such incentives would be reduced if the tax rates were lowered in South Carolina.

Would lowering tax rates result in less tax revenue for the state? Possibly in the short run. However, the main benefit from lowering taxes is that it will encourage more work, entrepreneurship, and income-earning. This is fundamentally important to increasing the rate of economic growth and moving South Carolina up the states’ per capita income rankings. This will be followed by an increase in tax receipts.

**Flat-Rate Income Tax**

Those states in which the highest tax bracket starts at very low income levels – i.e., Alabama, Mississippi, Virginia, Georgia, and South Carolina – effectively have a flat-rate income tax. This is because the income threshold to enter the highest income tax bracket is so low. Other states have gone ahead and implemented a flat-rate income tax, as shown in Figure 5.6. A further simplification of the South Carolina income tax would be to enact a flat-rate income tax, rather than keeping the current tax structure of six income brackets.

In order to ensure a progressive income tax, the flat tax should include an exemption on extremely low levels of income. For example, the state could exempt the first $10,000 or $15,000 of income. Then impose a 3.0 percent or 3.5 percent tax on all federally taxable income in excess of that level. A flat rate tax of around 3.5 percent would put South Carolina in a position that is competitive with all the states that currently have flat-rate income taxes. These are shown in Figure 5.7. Public finance economists could provide an analysis of South Carolina government revenues and determine an approximate rate that would be revenue-neutral. If a flat tax was implemented, the income exemption would need to be annually indexed for inflation.

**Figure 5.7 States with a flat-rate income tax, 2009**

<table>
<thead>
<tr>
<th>State</th>
<th>Flat Income Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colorado</td>
<td>4.63%</td>
</tr>
<tr>
<td>Illinois</td>
<td>3.0%</td>
</tr>
<tr>
<td>Indiana</td>
<td>3.4%</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>5.3%</td>
</tr>
<tr>
<td>Michigan</td>
<td>4.35%</td>
</tr>
<tr>
<td>Utah</td>
<td>5.0%</td>
</tr>
</tbody>
</table>
COMPREHENSIVE SALES TAX

A more comprehensive tax reform to address the complexity and unfairness of the current tax system in South Carolina would be to eliminate the income tax altogether, as well as other state taxes and replace them all with a broad-based sales tax. A sales tax-only strategy would require a rate much higher than the current 6 percent sales tax in South Carolina. Several states have no state income taxes (Alaska, Florida, Nevada, Texas, South Dakota, and Wyoming). However, no state has yet replaced its entire tax system with only a sales tax. The only way this tax would be politically and economically feasible is if the elimination of all other taxes is legislated at the time the new sales tax is implemented. Otherwise, citizens are likely to see the higher sales tax imposed in addition to other taxes currently in place.

The benefit of a sales-tax-only reform is that this option drastically reduces enforcement costs by government, as well as compliance costs by taxpayers. Currently, consumers bear no real burden in complying with sales taxes. The administrative burdens on sellers who collect the tax and remit it to government are minimal. This reform would not add any additional burdens on either consumers or producers. In addition, a sales tax would eliminate lobbying efforts on the part of special interest groups. However, it would be critical that the sales tax legislation be very strict in disallowing any exemptions once the legislation is passed. Otherwise, the lobbying and special interest-based exemptions would lead to the same types of problems that exist in the current tax system. This means that the current sales tax exemptions mentioned earlier would be eliminated.

In terms of the incentive effects of this proposal, the sales tax is preferable to an income tax. This is because income taxes discourage work and entrepreneurship. If South Carolina eliminates the income tax altogether, there is no disincentive to productivity. A consumption tax (i.e., sales tax) does not discourage work. It also ensures that individuals who consume more pay more in taxes. Thus, the tax retains a progressive structure since higher-income individuals generally consume more than those with lower incomes.

If legislators would like to exclude the poorest South Carolinians from taxes altogether, they can include an exemption for the first, say, $15,000 of consumption spending. This could be done via rebate checks that would be sent to all state residents effectively reimbursing for their sales tax burdens on the first $15,000 of spending each year. If the tax rate was, say, 20 percent, then each person would receive a check for $3,000 at the beginning of the year to cover the sales tax on their first $15,000 of consumption spending for the year.

The overall goal in overhauling the South Carolina income tax should be to simplify it, lower the tax rates, and ensure that whatever tax brackets exist are indexed for inflation. In the next section we expand on some ways in which the tax system could be simplified, whatever income tax rate reforms may be implemented.

SIMPLIFY THE TAX SYSTEM

As the above discussion shows, both the South Carolina income tax system and the state’s tax system as a whole are extremely complex. The hodge-podge of sales, income and

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8 A popular recent explanation of a sales tax on a national scale can be found in Boortz and Linder (2006). This plan is commonly known as the FairTax. In addition to the federal plan HR25, South Carolina currently has a proposal in the state legislature House Bill 3992. For more information see http://scfairtax.org/.
property taxes creates a confusing and burdensome tax system for citizens and businesses alike. Simplifying the tax rules in the state would be a very positive step toward reducing both compliance costs ("excess burden") and rent seeking (i.e., lobbying to get the tax code modified out of self-interest) and increasing entrepreneurship and economic growth.

Some of the measures that can be taken to simplify the state’s tax system are highlighted in the income tax section above. Indexing the income tax for inflation, lowering the income tax rates, and, in particular, considering the adoption of a flat-rate income tax or a sales-tax-only system would significantly simplify the tax system.

Assuming that the current tax system is to be retained in something resembling its current form, tax simplification should focus on eliminating exemptions and tax loopholes. As discussed earlier, both the sales tax and the income tax are subject to numerous exemptions and exclusions that appear to have resulted from purely political decision-making. It is hard to justify, on an economic development basis, such exemptions as the sales tax exemptions for vacation time shares, rental or lease of portable toilets or sales of modular homes. While the $300 cap on the maximum sales tax due on the purchase of motor vehicles, boats and airplanes is no doubt politically popular, the effect of the cap is to make the sales tax significantly more regressive.\(^9\) It makes little sense from a tax policy perspective to exempt a significant portion of the purchase of luxury items such as expensive automobiles and boats from the sales tax.

The same is true of the exemptions under the income tax as well. In particular, the exemption of all social security income and, for taxpayers age 65 and older, up to $10,000 in pension income would appear to be politically-motivated tax provisions. Drawing retirees to the state through these types of exemptions unnecessarily complicates the state’s income tax law and does little to increase the competitiveness of South Carolina’s workforce. Furthermore, it transfers retirees’ tax burdens to younger generations. If the state wishes to reduce the tax burden on citizens, it should treat all citizens equally. If taxes are too high, then a reduction in government spending should be considered.

Finally, the sales annual tax holidays should be reconsidered. Because these sales tax holidays apply only to specific goods, they create a significant burden on businesses, which must keep track of which goods qualify for the sales tax holiday and which do not. Moreover, the particular goods selected as qualifying for the sales tax holiday are arbitrary and often based on political decisions rather than policy decisions about what tax relief taxpayers actually need. While sales tax holidays are often sold to the public as assisting low-income consumers, their effects are substantially more beneficial to higher-income taxpayers who have more disposable income to spend. Finally, while politically popular, sales tax holidays have no significant effect on economic growth or consumer purchases. At best, their effect is to shift the timing of purchases, causing consumers to purchase goods that they would otherwise have purchased anyway, at a tax cost to the state.

**Lower the Manufacturing Property Tax**

In the section above on income tax reforms, it was explained that high tax rates tend to discourage whatever activity is being taxed. In the case of income taxes, they discourage working, entrepreneurship, and investment. This decrease in productive activity is because any gains that are received from these activities are taxed by the government. The goal of this

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\(^9\) A regressive tax is one that takes a smaller percentage of one’s income as income increases.
chapter is to suggest reforms that will enable the state to continue raising revenue, but in smarter ways that will encourage increased work, investment, entrepreneurship, and ultimately, long-term economic growth.

Perhaps one of the easiest and most important changes that the legislature could enact would be to significantly lower the manufacturing property tax. According to a recent report by the Minnesota Center for Public Finance Research, South Carolina has the highest manufacturing property tax in the country. In Figure 5.8 we present the effective property tax rates data for Southeastern states, for comparison. The ranks given for the states are out of all 50 states. The ‘net tax’ and ‘effective tax rate’ are calculated based on property valued at $25 million ($12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5 million in fixtures). Notice that South Carolina’s effective tax rate on industrial property is over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in the figure because it is the lowest-tax state.)

**Figure 5.8 Industrial Property Taxes in Southeastern states*, 2007**

<table>
<thead>
<tr>
<th>State</th>
<th>Rank (of 50)</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Carolina</td>
<td>1</td>
<td>$1,864,900</td>
<td>3.73%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>4</td>
<td>$1,291,050</td>
<td>2.58%</td>
</tr>
<tr>
<td>Texas</td>
<td>6</td>
<td>$1,264,358</td>
<td>2.53%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>10</td>
<td>$1,033,544</td>
<td>2.07%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>14</td>
<td>$833,234</td>
<td>1.67%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>17</td>
<td>$783,407</td>
<td>1.57%</td>
</tr>
<tr>
<td>Georgia</td>
<td>20</td>
<td>$760,381</td>
<td>1.52%</td>
</tr>
<tr>
<td>Florida</td>
<td>24</td>
<td>$677,683</td>
<td>1.36%</td>
</tr>
<tr>
<td>Alabama</td>
<td>35</td>
<td>$533,776</td>
<td>1.11%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>37</td>
<td>$491,071</td>
<td>0.98%</td>
</tr>
<tr>
<td>Kentucky</td>
<td>47</td>
<td>$327,100</td>
<td>0.65%</td>
</tr>
<tr>
<td>Virginia</td>
<td>49</td>
<td>$241,498</td>
<td>0.48%</td>
</tr>
<tr>
<td>Delaware</td>
<td>50</td>
<td>$238,840</td>
<td>0.48%</td>
</tr>
</tbody>
</table>

*Source: National Association of Manufacturers (2009)*  
* Taxes measured in the states’ largest city only.

Importantly, South Carolina’s effective tax rate is almost 2.5 times greater than Georgia’s tax, and almost 4 times greater than North Carolina’s. This puts South Carolina at a serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has one of the lowest per capita incomes and economic growth rates in the country.

Although it is probably not critical that South Carolina set its tax rate to the lowest in the country, it should definitely make it at least competitive for the Southeast. Since

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10 This issue was recently discussed in the Greenville News “Manufacturing Tax Raises Recruitment Concerns July 18, 2009
Georgia’s rate is effectively 1.52 percent and North Carolina’s is just under 1 percent, a rate at around 1 percent might be sufficient to attract more industry. Working to reduce the various taxes applied to industry would seriously improve the state’s competitiveness.

Such a significant reduction in taxes on industrial property would obviously lead to a reduction in tax revenues on industrial property, at least initially. However, the overall revenue may in fact increase once the growth rate in the state begins to pick up and more industry moves into the state. Furthermore, if the official tax rates are lowered, then the state will no longer need to offer special tax rebates to attract new factories. This would be consistent with the goal of reducing rent seeking, discussed earlier.

The rate of property tax on industrial property in South Carolina is set in the Constitution, a Constitutional amendment would be necessary to change it. In South Carolina, an amendment to the Constitution must be approved by two-thirds of the members of the House of Representatives and two-thirds of the Senate, followed by approval by a majority of electors in a statewide referendum in a general election. Thus, changing the rate of such taxes is a major undertaking with significant political consequences.

Finally, with any changes that the legislature makes to simplify and reduce taxes in South Carolina, there need to be safeguards against further manipulation. If South Carolina can build a reputation as being market friendly to employers and workers, and a reputation for having simple, stable tax laws, it will make it easier and more attractive for new companies to locate here and for existing ones to expand and stay here. These polices help to unleash capitalism in South Carolina and the effects of this growth will surely offset the lower tax rates.

CONCLUSION

South Carolina ranks as one of the poorest states in the nation. Yet, the state has abundant natural resources, a talented workforce, and opportunities for improvement. Unfortunately antiquated and uncompetitive tax laws are holding the state’s growth rate down.

In this chapter, three tax reforms have been suggested that would be a key step in helping South Carolina to attract new industries and keep existing ones. A reduction in industrial property taxes is critical, as South Carolina currently has the highest tax on industrial equipment in the nation. Obviously, this makes South Carolina very uncompetitive in attracting new industry. To offset the high taxes, firms and industries must lobby the state government for tax breaks. A significant and permanent reduction in these taxes would send a clear signal that South Carolina wants to grow. If the tax is made simple and transparent, firms would not need to waste their time or money lobbying state politicians. South Carolina would be an easy choice for new industry.

Second, it would be worthwhile for the legislature to focus on simplifying the entire tax system. Get rid of antiquated parts of the law and simplify those that remain. Eliminate loopholes and exemptions that were introduced as political favors to certain groups. Treat all taxpayers and income the same. If income and sales are going to be taxed, then apply the taxes equally to everyone. There is no economic justification for giving some South Carolinians special treatment at the expense of other citizens. When the tax code is simplified, fewer resources will need to be devoted to complying with tax laws. This would produce real savings for the people of South Carolina.
Finally, the income tax system in South Carolina needs to be overhauled. We have offered a number of proposals. At the very least, the income tax brackets should be indexed for inflation using the CPI. This adjustment should be done every year so that taxpayers are not pushed into higher tax brackets merely because of inflation. There is no excuse for politicians to impose the ‘hidden inflation tax’ that they create by not indexing tax brackets.

If the government does not want to index the tax brackets, then it should simplify the system and simply impose a flat-rate income tax. A modest income exemption could be included so that the income tax is progressive. The tax rate should be set at a rate that is competitively low with nearby states and with other states that have a flat tax. A flat rate income tax of 3.5 percent would be competitive.

A more comprehensive reform would be to eliminate all state taxes, including property taxes and fees, and instead implement a sales tax as the single mechanism to raise revenue for the state government. The necessary sales tax rate would have to be determined through an economic and statistical analysis. The sales tax should not be manipulated, however, until the elimination of all other taxes is certain. This would greatly simplify the South Carolina tax code, and put the state at the cutting edge of tax policy. Citizens would save millions of dollars and hours of time each year if they did not have to deal with the income tax. The sales tax would impose little additional burden on retailers in the state and would still raise the revenue needed by government.

In politics it is often very difficult to change the status quo. However, sometimes the status quo is antiquated and needs an overhaul. This clearly is the case with South Carolina taxes. Because of its tax system, our state has become one of the least competitive states, and we continue to be one of the lowest income states in the nation. Until politicians have the courage to make policy changes that improve economic well-being, and voters demand them to, South Carolinans should not expect our low economic ranking to change.
REFERENCES


over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in the figure because it is the lowest-tax state.) Notice that South Carolina's effective tax rate on industrial property is almost 2.5 times greater than Georgia's rate and almost 4 times greater than North Carolina's. This puts South Carolina at a disadvantage for attracting industry. Importantly, South Carolina's effective tax rate is almost 2.5 times greater than the national average for industrial property tax. 

Such a significant reduction in taxes on industrial property would obviously lead to a reduction in tax revenues on industrial property, at least initially. However, the overall benefit to the state would be realized. Working to reduce the overall burden of taxes on industry moves into the state. Furthermore, if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more industry moves into the state. 

Although it is probably not critical that South Carolina set its tax rate to the lowest in the country, it should be no surprise that it has one of the lowest per capita incomes and economic growth rates in the country. As can be seen in Table 5.6, the state has the highest tax in the country on industrial property. The list of the 50 states in order of taxes on industrial property is not given in the text, but the table shows that South Carolina has the highest tax in the country on industrial property, with Delaware being the lowest-tax state. 

Table 5.6: Effective Industrial Property Tax Rates, 2007

<table>
<thead>
<tr>
<th>State</th>
<th>Rank</th>
<th>Net Tax</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Delaware</td>
<td>50</td>
<td>$238,840</td>
<td>0.48%</td>
</tr>
<tr>
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</table>

Figure 5.6: Effective Industrial Property Tax Rates, 2007

* Taxes measured in the states' largest city only.
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Cluster Theory: A New Prescription for Old Style Government Planning?

by Frank Hefner
CHAPTER 5: SPECIFIC TAX REFORMS

...the figure because it is the lowest-tax state.

Furthermore, if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more industrial growth occurs. Such a significant reduction in taxes on industrial property would obviously lead to an increase in the number of industries setting up shop in the state.

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than Georgia's tax, and almost 4 times greater than North Carolina's. This puts South Carolina at a serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has the lowest growth rate. The state's lack of competitiveness is due to the high tax rates on industrial property, which make it less attractive to industries looking for low-cost locations.

The ranks given for the states are out of all 50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million ($12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5 million in fixtures). Notice that South Carolina's effective tax rate on industrial property is almost 2.5 times greater than Georgia's rate, and just under 1 percent, a rate the country, it should definitely make it at least competitive for the Southeast. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has the lowest growth rate. The state's lack of competitiveness is due to the high tax rates on industrial property, which make it less attractive to industries looking for low-cost locations.

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*Taxes measured in the states' largest city only.
6

CLUSTER THEORY: A NEW PRESCRIPTION FOR OLD STYLE GOVERNMENT PLANNING?

Frank Hefner

INTRODUCTION

As noted in Chapter 2, Adam Smith’s, An Inquiry into the Nature and Causes of the Wealth of Nations, is considered the birth of modern economics. It is clear from the title that Smith was interested in analyzing the creation of wealth and prosperity in nations. His analysis led him to the ‘invisible hand’ of the market rather than the ‘visible foot’ of government actions. He did recognize a role for government, but that role was very limited and restricted to providing the framework for individuals to act within the market.

Since Adam Smith, economists have always been concerned with economic growth. Besides analyzing the mechanisms to allocate scarce resources, economists have also provided theories of growth. In much of the modern literature in what is now called growth theory, mathematical models have been developed to explain how economies grow. The goal in these models is to find an optimal solution given a set of constraints. In this mathematical mix one finds what is called a policy variable, i.e., an economic variable that can be manipulated by some economic planner. In fact the very concept of modeling growth for many decades consisted of finding the right knob to turn, so to speak, on the economic mechanism. This implies that a planner or a policy maker can and should make decisions regarding what variables to manipulate and by how much.

Models to explain economic growth and development were primarily developed post World War II. Before World War II, government intervention in the economy to promote growth was not considered much, while after World War II the very concept of economic growth implied government action. Since then the accepted notion is that growth theory means government action. The prevailing thinking in the literature is that an economy, particularly a country, without guidance from a planner would not grow or develop in an adequate manner. The impediments keeping the economy from growing on its own are called ‘market failures.’ These failures provide the theoretical justification for government intervention and planning. On the other hand, some economists have pointed out that we cannot ignore government failures in economic development.¹

¹ Krueger (1990) for example.
Economic development in practice and in recent theory has come to refer to growth in regions; such as states, counties and municipalities. Reviewing the literature, both the academic and applied, one cannot help but conclude that there is a strong sense that the notion of economic development implies that there is something wrong with the region that must be corrected by, once again, government intervention or the guidance of a planner. There is also a bias that left on their own, individuals and businesses will not find profitable activities and thus generate economic wealth or growth. When considering regions, the theory of economic growth and development seems to imply that the region has some structural flaws so that industry would either not develop internally or migrate to the region; or if industry does develop or re-locate to the region, it will be the wrong kind of industry. This belief of course implies that there is some theory by which economic planners or government leaders can decide what is the right industry. Following this train of thought leads to what is called industry targeting. Industry targeting ultimately means that the government will pick winners by deciding which industries or sectors of the economy to target. Targeting eventually implies providing special treatment by the economic planner to the desired industries or firms.

A number of various strategies and models have been provided by economists that are used in economic development. In the final analysis, many of these models, mathematical and statistical, are basically descriptive models. For example, economic impact models are often used in regional economic analysis to evaluate the impact of a change in the economic landscape of a state or community. The modeling technique is an input-output model, developed by Leontief who received the Nobel Prize for his work in modeling. The underlying principle of input-output modeling is an accurate accounting of the inputs that are used by industry. These inputs are termed backward linkages or the supply chain. The output side of the accounting framework identifies the distribution of output across industrial sectors. For example, in order to produce tires a firm may need rubber, labor, electricity, various chemicals and so on. These are the inputs. The tires are then sold to automobile companies and consumers. These markets are the forward linkages. Leontief figured out how to calculate the total change in demand from all industrial sectors for a given change in consumer demand (final use). The model provides much useful information. At the regional level, input-output modeling provides economists the tools to analyze events such as the impact of a plant closing in a county. These models are however, static in nature; in effect they provide snapshot pictures of the economy at a point in time. Whether they can be used as a prescription for development is another issue entirely. In fact, much of the literature and analysis in regional development is more descriptive than prescriptive. Dangerous misapplications of theory occur when these descriptive models are used by policy makers to both predict and prescribe.\(^2\)

Cluster analysis developed and promoted by Michael Porter, a professor at Harvard, has recently become the accepted tool in current economic development theory and practice. Harvard University houses the Institute for Strategy and Competiveness (ISC), which has become a cluster analysis think tank. In 2002, the ISC conducted studies of all 50 states, the results of which were presented at the National Governors Association Winter Meeting 2002 in Washington, D.C. The South Carolina study was prepared for then Governor Jim Hodges. Porter visited South Carolina in December 2003 where he unveiled what was perceived to be a new economic development strategy for the state. The Council on Competitiveness

\(^2\) In the heyday of economic planning, input-output models were used by central governments for planning purposes.
(renamed New Carolina) was launched to activate his cluster strategy. Many states have similar councils of competitiveness. As a result of widespread acceptance of Porter’s cluster analysis, cluster initiatives have developed everywhere. The Competitiveness Institute lists over 450 cluster initiatives on their website and note that their member base consists of over 1,700 practitioners from more than 98 countries. Cluster analysis and the resulting market intervention policies are clearly worldwide. Many international economic organizations – Organization for Economic Co-operation and Development, the World Bank, International Monetary Fund, United Nations Industrial Development Organization and United Nations Conference on Trade and Development – are engaged in sponsoring research and the development of cluster policies throughout the world. Under the label of cluster analysis, policy makers have actively encouraged the establishment of a wide range of initiatives: science parks, business incubators, (eco-) industrial parks, industrial districts, targeted recruitment, enterprise zones, foreign trade zones, and centers of expertise.

As a result of such widespread acceptance, Michael Porter and Cluster Analysis have become brand names. Also with such widespread acceptance, it becomes difficult to critically evaluate cluster theory. Cluster analysis is now the standard for modeling economic development, both at the national and regional levels. After his presentation to South Carolina in 2003, “Porter was hailed as nothing less than a savior, a hero – the ‘guru’ of economic development.” However there is value in questioning whether the emperor is wearing any clothes. Bergman and Feser (1999) question whether cluster analysis is but a passing fad, or as they say, “the latest craze in a field prone to embrace miracle solutions only until a more fashionable idea emerges.” They further note that, “If one thing is clear, it is that Porter’s eloquent and convincing account of economic interdependence, geography, and competitiveness is short on specifics.” Despite its popularity, Martin and Sunley (2003, 5) caution that within a policy context: “the cluster concept should carry a public health warning.” The caution that a public health warning should be issued when cluster analysis is conducted is warranted and puts us squarely among the group of skeptics, characterized by Norton (2000) thusly, “To skeptics, cluster theory sometimes looks like a vehicle for state and local government officials in search of a targeting rationale.” In the final analysis, South Carolina, like many state and regional governments, in the course of promoting clusters end up targeting the ‘hot industries’ of the moment. In the last decade the hot industries have included biotech, information technology, creative media and nanotech. As Motoyama (2008, 7) notes, this happens partly because politicians and policy makers seek what are viewed as “sexy high-tech sectors.” Cluster analysis has a certain elegance about it. The cluster methodology is blessed with a Harvard cachet. The Harvard connection provides some sense of validation. In addition, the method itself looks impressive and has the appearance of scientific backing. Indeed one of the reasons cluster analysis is so appealing to policy makers and politicians is exactly that impressive analytics and presentations can be developed to justify inherently political proposals.

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3 TCI is a non-profit, non-governmental organization. Many of the cluster initiatives are basically private in nature. However, the cluster methodology, as we will discuss later, has an implied public policy direction. http://www.competitiveness.org/
5 Woodward (2005, 3).
6 Bergman and Feser (1999), web book with no pagination.
private-public effort. This label masks the essential role of government in the clustering strategies – in effect “It is a way of promoting government intervention, while feigning to be non-interventionist.”

From a practical point, economists, analysts, policy makers – indeed, anyone interested in analyzing clusters using Porter’s methodology – may ask: How do you find clusters? Porter has provided a methodology, however policy makers have an agenda and thus are prone to find clusters where they are needed to justify and support that agenda. Political action was clearly the goal of the 2002 report Porter conducted for South Carolina where he wrote: “The aim of our project, and of this short document, is to increase awareness of the specific regional conditions to inform political action at the state level.”

State and local governments across the country are conducting cluster analyses, thereby creating a herd effect. As a result, confronted with numerous uncertainties and ambiguities in the cluster concept, Martin and Sunley (2003, 25) claim that policy makers following the herd “tend to be drawn to promoting similar varieties of ‘high-technology, knowledge-based’ clusters.” Further, faced with the ambiguity and complexity of the cluster theory, “many public authorities resort to using the same set of cluster consultancy companies (flying ‘cluster-makers’) who are commissioned, often at considerable public expense, to rapidly produce a cluster decomposition.”

Finally, cluster promotion in South Carolina and other states through government action has avoided considering the obvious: action by government is not costless. In the process of attempting to pick the winners, government policy often creates losers. In the targeting game, we must ask who decides which industries are the winners and which ones become the losers? The winners in the targeting game are those firms that receive public support either through tax breaks or subsidies that are not available to other firms in the state or to other firms desiring to locate to the state. Who are the losers? In some cases existing firms end up paying the taxes for the incentives that government offers their competition. In all cases, existing firms pay for the subsidies offered. Where tax incentives are used instead of direct subsidies, tax burden is shifted.

The widespread development of what is called the ‘New Economy’ has exposed structural weaknesses in various states, such as poor education. South Carolina is no exception. Public officials are desperately trying to find ways to keep their states competitive in this new arena of economic activity. Unfortunately, many of the actions taken by state governments are unproven in their ultimate effect or are in the form of tax incentives that have not been shown to increase the competitiveness of companies that receive them.

This chapter will discuss a number of issues and critiques related to economic development that rely on government use of cluster theory focusing particularly on the potential misuses of these models by policy makers. Facilitation, for example, has become a buzzword used by many cluster initiatives and ends up being another justification for government intervention. Given that economic development models are often used to justify state or local government offering firms incentives and subsidies, this chapter will overlap the next one which deals primarily with the effectiveness of targeted incentives.

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9 Ibid., 242.
10 Ibid, 236.
**CHAPTER 6: CLUSTER THEORY**

### WHAT IS A CLUSTER?

A cluster is simply a grouping. Industry clusters, according to Porter (2001, 7) are “geographic concentrations of interconnected companies, specialized suppliers, service providers, firms in related industries, and associated institutions.” The traditional economic geography literature has always used economic models to analyze how industries interact with each other. The economist Alfred Marshall in 1890 referred to the grouping of related industries as an industrial district. In that time period similar industries along with their support industries were located in geographic proximity. The economic benefits of this organization became known as agglomeration effects. Proximity reduced transportation and other production costs. Thus, there is a long history of cluster type analysis in economics, long before the term cluster. Consequently, there are a number of papers that criticize Porter as not being very original. As Desrochers and Sautet (2004, 237) note, that “despite all of the hype, in practice clusters do not constitute a radical break from past practices.” What Porter effectively did was re-package these theories into a model that had more pizzazz, thus more effectively marketing the approach. Or as several authors have noted, this is a case of old wine in new bottles.

A number of schematics exist to explain clusters. Figure 6.1 provides a simple view of an industry cluster, presented below.

**Figure 6.1: Cluster Schematic**

![Cluster Schematic](image)

*Industry Cluster: Interdependent firms and institutions*

*Source: Bergmann and Feser (1999)*

From Figure 6.1 one can see that the major concept is interconnectedness. Indeed, “membership within the group is an important element of each member firm’s individual competitiveness.”(Bergman and Feser, 1999) In traditional economic development models, input-output models were used to measure the various linkages among firms in a region. As note previously, backward linkages referred to the supply chain going into the production process while forward linkages referred to the markets supported by the production process. In Figure 6.1 the backward linkages are labeled trading sectors. This sector represents all of...
the inputs into the industry. What makes this schematic representation different from the traditional input-output approach is the addition of other factors that affect the industry, labeled supporting sectors and related sectors. In addition, the chart identifies institutional features that affect an industry not found in traditional input-output analysis. Although in practice most clusters are also defined by geographic proximity that is not a theoretical necessity. Indeed, geographical boundaries for many clusters are constructed in many forms: states, combination of states, corridors, and so on.

In his report to the National Governor’s Association, Porter conducted a cluster analysis of South Carolina. Figure 6.2 lists the industry clusters that were found and analyzed in the Porter report.

Figure 6.2: Clusters Identified in Porter Study of South Carolina, 2002

<table>
<thead>
<tr>
<th>Textile</th>
<th>Medical Devices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Services</td>
<td>Construction Materials</td>
</tr>
<tr>
<td>Hospitality and Tourism</td>
<td>Building Fixtures, Equipment and Services</td>
</tr>
<tr>
<td>Heavy Construction Services</td>
<td>Publishing and Printing</td>
</tr>
<tr>
<td>Automotive</td>
<td>Lighting and Electrical Equipment</td>
</tr>
<tr>
<td>Apparel</td>
<td>Communications Equipment</td>
</tr>
<tr>
<td>Chemical Products</td>
<td>Heavy Machinery</td>
</tr>
<tr>
<td>Financial Services</td>
<td>Pharmaceuticals</td>
</tr>
<tr>
<td>Production Technology</td>
<td>Information Technology</td>
</tr>
<tr>
<td>Power Generation</td>
<td>Prefabricated Enclosures</td>
</tr>
<tr>
<td>Distribution Services</td>
<td>Analytical Instruments</td>
</tr>
<tr>
<td>Motor Driven Products</td>
<td>Leather Products and Sporting Goods</td>
</tr>
<tr>
<td>Education and Knowledge Creation</td>
<td>Aerospace Vehicles and Defense</td>
</tr>
<tr>
<td>Processed Food</td>
<td>Agricultural Products</td>
</tr>
<tr>
<td>Transportation and Logistics</td>
<td>Aerospace Engines</td>
</tr>
<tr>
<td>Metal Manufacturing</td>
<td>Power Transmission and Distribution</td>
</tr>
<tr>
<td>Plastics</td>
<td>Jewelry and Precious Metals</td>
</tr>
<tr>
<td>Furniture</td>
<td>Tobacco</td>
</tr>
<tr>
<td>Forest Products</td>
<td>Fishing and Fishing Products</td>
</tr>
<tr>
<td>Entertainment</td>
<td>Oil and Gas</td>
</tr>
<tr>
<td></td>
<td>Footwear</td>
</tr>
</tbody>
</table>

Note: The clusters were ranked by employment. In 2002 textiles had the largest amount of employment and footwear manufacturing had the least.

The most obvious observation to be made is that this table covers practically all industries operating in South Carolina. From this perspective, the claim could be made that every industry, business, or firm is in some kind of cluster. Clearly from a theoretical and empirical perspective, all industries and businesses in South Carolina are connected to other businesses and industries in some form. Since clusters are everywhere, policy makers end up favoring certain clusters, or finding clusters to justify favorable political treatment.

Although cluster analysis is continually marketed as a break from traditional industrial targeting, Porter (2002, 12) makes the following claim based on his analysis of employment in these clusters:
The employment by cluster gives a more detailed profile of the activities in the state economy contributing to overall prosperity. They can be used to test whether policies targeted at specific, for example so-called high tech, industries have a chance of creating a material impact on overall living conditions in the state. (emphasis added)

Employment by sector actually ends up being the measure Porter uses for much of his analysis. The technical term is location quotients, or LQ’s. These are the result of dividing two ratios. For example, if 20 percent of South Carolina’s workforce is engaged in textiles, while only 10 percent of the U.S. workforce is in textiles, then the LQ for textiles is 2. In effect, this is a ratio of concentrations. Any number larger than one indicates that the region has a higher concentration than the nation. LQ’s are used to identify what are called traded clusters; which means that firms in these clusters are more likely to export their goods and services from the state. Since clusters are everywhere (as was shown in Figure 6.2), Porter uses this technique to identify cluster strengths. The clusters depicted in Figure 6.3 are the clusters which have an LQ greater than 1. These form what is often called South Carolina’s export base. But what does that really tell us about the growth potential of a particular industrial category?

**Figure 6.3: Porter’s Cluster Analysis for South Carolina**
Figure 6.3 is an example of the kind of impressive looking and perhaps confusing schematics that cluster analysis can provide. In Figure 6.3, Porter uses employment growth rates to identify the dynamic clusters in the state. The vertical axis represents the percentage of national employment for a particular cluster. For example, in 1999, 16.7 percent of all textile employment in the United States was in South Carolina textiles, while South Carolina’s average share of national employment was 1.41 percent. The horizontal axis depicts the percentage change in the share of national employment. For example, the share of employment in Chemical Products grew between 1990 and 1999 about 50 percent, while the share of employment in Textiles dropped by 12.4 percent. Porter (2002, 24) in his analysis states: “The upper right-hand quadrant contains the region’s strongest, most dynamic clusters, where the state has both a stronger than proportional share of national cluster employment and is adding share.” A cluster is considered dynamic by Porter’s analysis simply because it is more concentrated in South Carolina than other clusters in the state and is adding share faster than the other clusters. Effectively what Porter is saying in his analysis using Figure 6.3 is the following: In 1990 the furniture sector in South Carolina employed 2 percent of the U.S. employment in furniture. By 1999, the furniture sector in the state represented about 3 percent of total U.S. furniture workers, which represents a 50 percent increase in share. Does this statistic necessarily imply that the furniture industry is growing? Does this fact necessarily mean that South Carolina is better off because of this change? Employment in this sector in South Carolina could have been stagnant while the industry declined nationally and Porter’s analysis would have characterized the furniture cluster as being dynamic. These kinds of statements fundamentally do not provide much information. The methodology is also an old technique. As Woodward and Guimarães (2009) note, while Porter cluster analysis is new, the tools end up looking more like the traditional industrial targeting models of the past.\footnote{I have to admit that as a regional economist I have done my share of location quotient analysis and comparative location quotient analysis ("shift-share"). However, I never viewed this technique as a method to explain growth. It is a very descriptive technique and does provide information, a "snap shot" picture of the economy.} However, Porter’s analysis does provide quick and what appear to be impressive graphics.

Porter’s emphasis in his writing is on competitiveness. Indeed his classic book is entitled Competitive Advantage of Nations. To illustrate this, he designed his now famous diamond.
Chapter 6: Cluster Theory

Figure 6.4: Porter’s Diamond: The Complete System

The diamond is supposed to represent how an economy, firm, or cluster can create a competitive advantage. Competitive advantage is traced to the four major corners of the diamond: 1) firm strategy, the nature of structure and rivalry in the country, which includes attitudes toward competition, market institutions, the degree of local competition, and other cultural and historical factors affecting how firms do business with each other, their workers, and the government; 2) factor conditions, such as labor and natural resources; 3) demand conditions or the nature of local demand (consumers who demand sophisticated consumer electronics motivate firms to innovate in that field, for example); and 4) the presence of related and supporting industries (linkages in the input-output framework), which stimulates cooperation, and successful competitors, which stimulates rivalry (rivalry encourages firms to innovate).

To keep the schematic simple, all of the interconnected lines that Porter includes are not shown. In Porter’s presentation, every block is connected to each other in order to show the nature of interconnectivity. The diamond reproduced in Figure 6.4 is a complete view. Most of Porter’s work and indeed most analysts who refer to Porter’s work use the diamond minus government and chance. According to Porter, as a rule competitive advantage is the outcome of the interaction of these blocks in this diamond. What Porter has provided in this diamond model is a listing of the interactions of almost every possible factor related to a business and the business environment. This model has been presented as a break from what Porter views as the more traditional model of economic development which was driven by government directed policy decisions and incentives. With respect to the role of government, Porter sends mixed signals. He acknowledges that “most clusters form independently of government and sometimes in spite of it.”

Porter (2000, 26).
build on established and emerging clusters, at the same time he notes that government should avoid the temptation to create entirely new ones because “there should be some seeds of a cluster that have passed a market test before cluster development efforts are justified.” From a market perspective, if a cluster or firm has already passed a market test it would not need government involvement. As a result, in practice, government involvement comes into play when firms in the cluster have not passed a market test and thus require preferential treatment in the form of subsidies, tax incentives, or government loans.

However, many cluster analysts argue that the four factors in Porter’s diamond can be influenced in a pro-active way by government. Regardless of the origins or the modeling approach, in practical policy the cluster approach effectively argues for a role for government to act as a catalyst. Although Porter claims that all clusters matter in practice, policy makers want to know which clusters really matter; i.e., which clusters should be targeted. Woodward (2005) claims that policy makers in South Carolina believed that Porter’s analysis presented in 2003 was designed to specifically identify clusters to target for economic development. Besides the government block, Porter’s diamond includes the role of chance in economic development. Again, this is another factor that is not often discussed by cluster analysts. By chance, we mean all of the unpredicted elements surrounding business. This can range from unexpected innovation and entrepreneurship to shifts in economic conditions worldwide. Entrepreneurship is too complex to be planned or predicted. As was explained in Chapter 3, entrepreneurship is also the heart of a dynamic, growing economy.

Porter’s analysis falls short on explaining how clusters start from scratch. The carpet cluster in Dalton, Georgia, is an example of what might be called an accidental development. Krugman (1991) traces the development of the carpet industry here to one Catherine Evans, who in 1895, by chance, made a tufted bedspread as a wedding gift. Eventually she figured out how to make tufted products more efficiently and thus emerged the business that became the carpet capital of the world. There is nothing in the cluster analysis that would allow a researcher to predict this chance event created by an entrepreneurial spirit. However, once the industry is developed, a cluster analyst by looking backwards can explain how it all happened.

One aspect of the widespread adoption of cluster strategy is that all states and regions end up using the same analysis to compete with each other. This is especially relevant for cluster creation. If the analysis indicates a state is competitive only by tax incentives, then the only way to become more competitive is to offer more tax incentives.

In practice, using cluster analysis, government has become intimately involved in promoting selective clusters to target for development. Indeed, the very process of most legislative activity has involved targeting, i.e., selecting specific clusters or industries to promote, which implies to the exclusion of others.

Academic economists have long criticized government directed development programs arguing that the government decision-makers are ill equipped to pick industries. Another reason offered is that there are too few potential industries compared to the large number of communities offering incentives. This targeting creates a potential bidding war. Two examples are provided in the next chapter. The film industry where states attempt to provide competitive advantage by offering larger cash subsidies and the escalating public expenditures per job created in the automobile industry. While the effectiveness of such policies is being debated, concerned citizens and elected officials face huge pressures to ‘do

\[ ^{15} \text{Ibid, 26.} \]
something’ to promote economic development, especially during periods of economic downturns. Unfortunately, doing something implies either tax incentives or subsidies. In addition, “the ability to attend ribbon-cutting ceremonies and ‘take credit’ for businesses moving into their districts has powerful political appeal for elected leaders.”

A review of the listed clusters in South Carolina, Alabama, Virginia, Georgia and North Carolina is presented in Figure 6.5. All four states are chasing a competitive advantage in several common sectors such as automotive, aerospace/aviation, and some form of life sciences. In the aerospace/aviation cluster South Carolina is also competing with Oregon, Connecticut, Florida, Washington, Kansas, and New Mexico, to name a few. Each state in its clustering efforts is attempting to develop a competitive advantage over the other states. This begs the question, how uniquely competitive can a state be compared to other states following the same strategies? If voters in South Carolina are not careful, eventually the major difference in terms of policy will end up being the size of incentive packages offered.

Figure 6.5: Clusters Identified for Targeting or Development

<table>
<thead>
<tr>
<th>South Carolina ¹</th>
<th>Alabama ²</th>
<th>North Carolina ³</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statewide Clusters:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aerospace</td>
<td>Automotive</td>
<td>Aerospace, Aviation, and Military Defense</td>
</tr>
<tr>
<td>Agribusiness</td>
<td>Automotive</td>
<td>Automotive, Truck, and Heavy Equipment</td>
</tr>
<tr>
<td>Apparel</td>
<td>Chemicals</td>
<td>Biotechnology, Pharmaceuticals, and Life Sciences</td>
</tr>
<tr>
<td><strong>Automotive</strong></td>
<td>Distribution/Warehousing</td>
<td>Business and Financial Services</td>
</tr>
<tr>
<td>Distribution Services</td>
<td>Food Processing</td>
<td>Chemicals, Plastics, and Rubber</td>
</tr>
<tr>
<td>Nuclear</td>
<td>Forest Products</td>
<td>Green Energy</td>
</tr>
<tr>
<td>Recycling</td>
<td>Life Sciences</td>
<td>Information and Communications Technology</td>
</tr>
<tr>
<td>Textiles</td>
<td>Primary Metals</td>
<td>Textiles, Apparel, and Textile Machinery</td>
</tr>
<tr>
<td>Tourism</td>
<td>Rubber and Plastics</td>
<td></td>
</tr>
<tr>
<td><strong>Upstate Clusters:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Aviation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Composites</td>
<td>Aerospace</td>
<td>Advanced Communications</td>
</tr>
<tr>
<td>Engineering &amp; Construction</td>
<td>Automotive</td>
<td>Advanced Manufacturing</td>
</tr>
<tr>
<td>Medical Devices</td>
<td>Plastics and Advanced Materials</td>
<td>Aerospace</td>
</tr>
<tr>
<td><strong>Midlands Clusters:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advanced Manufacturing</td>
<td>Corporate Headquarters</td>
<td>Bioscience</td>
</tr>
<tr>
<td>Health Care</td>
<td>Energy</td>
<td>Energy</td>
</tr>
<tr>
<td>Hydrogen/Fuel Cells</td>
<td>Food Processing</td>
<td>Logistics</td>
</tr>
<tr>
<td>Insurance Services</td>
<td>Life Sciences</td>
<td></td>
</tr>
<tr>
<td><strong>Lowcountry Cluster:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advanced Security</td>
<td>Technology</td>
<td></td>
</tr>
<tr>
<td>Aerospace/Aviation</td>
<td>Modeling and Simulation</td>
<td></td>
</tr>
<tr>
<td><strong>Automotive</strong></td>
<td>Wood Products</td>
<td></td>
</tr>
<tr>
<td><strong>Biosciences</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Creative Industries</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Italics indicate the common clusters being pursued by more than one state
¹ http://www.newcarolina.org.
² http://www.amazingalabama.com. Alabama specifically refers to these at their ‘key industry targets.’
³ http://www.nccommerce.com. These are not specifically listed as clusters on their web site, however, this is list of NC industry sectors that have ‘capitalized on’ NC strategic advantages. In the individual reports, several of these sectors are identified as clusters.
⁴ http://www.yesvirginia.org. These are Virginia’s targeted business sectors.
⁵ http://www.gaworkready.org/pages/view/overview-of-work-ready-regions. The state refers to the clusters as ‘Work Ready Regions’ as part of their job training strategy.

16 Goetz, et. al. (2009, 2).
In a dynamic, free market economy, firms grow and die. Current cluster theory does not address this dynamic, entrepreneurial phenomenon. Indeed, we are tempted to ask if the current view is once a cluster, always a cluster. Economic landscapes are littered with decaying clusters – consider Detroit and the auto making cluster and Silicon Valley in the aftermath of the dot com bubble. In a dynamic economy it must be recognized that clusters not only grow and prosper, but also decline and die.

In the next section, specific targeting policies are presented. There is no particular reason to single out these industries nor do we have a bias for or against them. The real question that must be asked is what particular bias was contained in the political process in choosing these industries. In a sense one could justifiably claim that the political process in South Carolina by its very nature involves choice. However, does this necessarily imply that some industries get rewarded with a preferential status and thus get tax breaks or subsidies and others do not? In the context of trying to develop a state’s economy, the free market strategy is clear: create conditions for all industry, firms, and individuals to succeed. In other words, do not single out a particular cluster or industry in legislation – yet that is what South Carolina legislation has done. For example, the Enterprise Zone Act of 1995 specifically provides tax incentives to qualified tire manufacturers in the state. The obvious question that must be asked is ‘Why tires? Why not plastics? Why not boats?’ The film industry cluster has received unusual preferential treatment and will be discussed in the next chapter. The example presented here is what will be referred to as the ‘Cabela’s Incentive.’

EXTRAORDINARY RETAIL

The extraordinary retail legislation highlights many of the problems of targeting for economic development. A number of questions should have been raised and answered before the legislation to target a specific firm or industry was enacted. What happens if a company wants to locate in South Carolina and does not belong to a favored cluster or a targeted industry? Does the general assembly convene to pass new legislation in favor of the next lobbyist? What about firms that currently exist in South Carolina that are profitable, employ a small number of people, and pay the normal taxes. In terms of economic development would such a company not be an asset to the community in which it is located? However, in

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17 S.C. Code of Laws, SECTION 12-10-45. Designation of census tract by tire manufacturer as enterprise zone; certification of tire manufacturer. [SC ST SEC 12-10-45] A tire manufacturer that has over one billion dollars in capital investment in this State, and employs over five thousand workers in this State may, after certification by the council, designate up to two census tracts, but not to exceed four hundred acres per site, in any area of the State as an enterprise zone provided that a capital investment of at least one hundred million dollars be made over a five-year period at each site. The tire manufacturer's capital investment must be based upon the gross cost of assets in South Carolina as shown on the manufacturer's property tax and fee-in-lieu of property tax filings. The council will certify the manufacturer if it determines that the available incentives are appropriate for the new project, the total benefits of the new project exceed the costs to the public, and the qualifying business otherwise fulfills the requirements of this chapter.
South Carolina’s current approach to using clusters and other targeting tools in economic development with government support, this standard may not be adequate in the policy maker’s view. In 2006 South Carolina’s general assembly passed legislation providing tax incentives normally reserved for manufacturing to apply to ‘extraordinary retail’ establishments. These establishments are defined in the following manner:

An extraordinary retail establishment is a single store located in South Carolina within two miles of an interstate highway or in a county with at least three and one-half million visitors a year, and it must be a destination retail establishment which attracts at least two million visitors a year with at least thirty-five percent of those visitors traveling at least fifty miles to the establishment. The extraordinary retail establishment must have a capital investment of at least twenty-five million dollars including land, buildings and site preparation costs, and one or more hotels must be built to service the establishment within three years of occupancy.18

The idea of this incentive was to target specific large retailers to induce them to locate to the state. The tourism angle presumably was combined with the definition since it was hoped that customers would travel more than fifty miles to shop at the new establishment. Notice, this tourism concept does not necessarily bring in additional spending to the state, unless the establishment is located near a border and North Carolinians and Georgians travel to shop there. The case that made the news was the large outdoor outfitters, Cabela’s, attempt to locate a new establishment in the Charleston area. The issue that quickly surfaced was the effect Cabela’s would have on local outdoor outfitters, particularly the numerous fishing tackle shops in the area. To the extent that Cabela’s displaced shopping at existing stores, there would be no net change in total sales in the region. In addition, the existing stores could lose sales while Cabela’s received a variety of tax incentives. The potential of increased sales due to customers traveling more than 50 miles to shop at the proposed facility would add little to total sales in the state if these travelers are South Carolinians living more than the required distance. In order to have an incremental impact on tourism related sales, Cabela’s would have to draw tourists from out-of-state who came specifically to shop at the outfitter. The efficacy of these types of incentives will be discussed in more detail in the next chapter. It must be noted here that research shows that employment did not increase in those counties where a new Cabela’s located in other parts of the country. Hicks (2007) concludes from his analysis of 9 establishments in 9 different counties: “… from a public policy standpoint there is nothing to recommend regional polices to attract or dissuade the location of retail firms.”19 He discovered that any employment effects from the opening of a new Cabela’s disappeared within three months. From a public policy standpoint South Carolinians must wonder what kind of research was conducted by policy makers to justify the extension of targeted tax incentives to this type of firm. Furthermore, what does such a strategy imply for existing firms? One is tempted to facetiously suggest that the recommendation for the local firms is to have a cluster analyst conduct a study that defines their combined businesses as an ‘outdoor retail cluster’ in order to 1) seek an incentive package designed specifically for them or failing that, 2) at least block potential competitors from receiving a more favorable government

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19 Hicks (2007, 121).
sponsored business environment. To the extent that this recommendation is followed, it generates the type of unproductive entrepreneurship discussed earlier in this book, which will only hamper growth in South Carolina.

**Organic Clusters vs. Planned Clusters**

Martin, Mayer and Mayneris (2008) ask a very important question: “Is policy intervention required?” In their article, Natural Clusters: Why Policies Promoting Agglomeration are Unnecessary, they conclude the following: “…. the starting point of cluster-policy advocates is right – clusters do bring economic benefits – but their conclusion is not.” When firms make location decisions they already take into account the benefits of being in a cluster. Their research in France indicates that costly public interventions in the market to promote clusters are not warranted. There is general agreement among economists that it is difficult or nearly impossible for public policy to intentionally create clusters where they do not already exist. Research Triangle Park in North Carolina is frequently cited as an example of an instance in which public policy set out to change a region’s economic base, but failures are far more common. It must be pointed out that in 1957, the civic, business, and political leaders of North Carolina decided that the Research Triangle should be undertaken as a private effort with collaboration of the three flagship universities in the state rather than a state/government sponsored effort. There is a lengthy list of places that set out to create the next Silicon Valley and to date have failed. “The tantalizing paradox of clustering is that it implies that the location of economic activity is not preordained and that, therefore, public policy (and other factors) can make a difference. Yet, at the same time it is virtually impossible to say what it takes to successfully create a new industry cluster in a particular place.” The belief that policy makers have sufficient knowledge to make such decisions is what economist F.A. Hayek (1988) called a “fatal conceit.”

Glável (2008) notes that clusters enhance the productivity of individuals and firms only if they are formed naturally from the free market. The most famous example of a high technology cluster is Silicon Valley, “where, without any government planning, the world’s first semiconductor cluster began in the 1950s.” The spectacular success of Silicon Valley has encouraged economic planners to try to replicate the ingredients that produced that success. “To this end, states are investing in their universities, encouraging technology transfer from universities to industry, trying to stimulate investment by ‘angels’ and venture capitalists, and subsidizing high technology businesses through cash grants, tax credits, and tax exemptions. While Silicon Valley was fathered by entrepreneurship, states are now trying to artificially create clusters through government policy, thereby prompting the question of whether a government bureaucrat can succeed where an entrepreneur has not.” South Carolina is no exception.

Since clustering is important to economic growth and development and to firm profitability, free market economic theory argues they will develop spontaneously.

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“Clustering is the result of entrepreneurial activity and is driven by the production of valued goods to seize profits.” This will occur naturally (organically) in a market based economy. South Carolina policy makers do not need to engage in modeling to determine what clusters they should try to attract. Viable clusters will form naturally.

**CONCLUSION**

Cluster analysis in most cases is a descriptive tool that provides interesting anecdotal history for how some regions have developed. Economic geographers, who after all developed the modeling and tools associated with cluster analysis, and perhaps feeling left out with all of the accolades thrown to Porter, ask if the theory is not really new or different, why is it so popular in practice? Motoyama (2008) provides three reasons. Cluster analysis provides: 1) an easy explanation; 2) a clear direction; and 3) a political justification. However the method provides almost no guidance on how to actually develop a successful cluster. Porter points to the Napa wine region as a primary example of an innovative cluster, while he refers to Silicon Valley as one of the most famous examples. Neither one was planned or created by a policy maker. Once the cluster has naturally (organically) developed it is interesting and useful to investigate it. There is value in taking snapshots of the economy. Analyzing the interconnectedness of businesses to each other, to educational institutions, natural geography and so forth provides useful information. For example, it is useful to analyze the role of backward and forward linkages in industrial location decisions in order to answer the question whether firms actually consider these linkages. However such descriptions do not necessarily imply that South Carolina policy makers should intervene in the process. Indeed, there is nothing in Porter’s work that indicates how a government planner would go about developing a cluster from scratch. Further, cluster analysis in too many cases has become a justification for questionable government intervention. To the extent that cluster initiatives become organizations that promote and advertise communities using private resources, community boosterism or cheerleaders for the local economy, they certainly serve a useful purpose. The objection arises when cluster initiatives go beyond and become advocates for specialized government treatment in the form of subsidies and preferential taxes.

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27 Woodward and Guimarães (2009).
29 See for example Hefner and Guimarães (1994).
REFERENCES


Chapter 6: Cluster Theory


CHAPTER 5: SPECIFIC TAX REFORMS

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...million in fixtures). Notice that South Carolina's effective tax rate on industrial property is...

...if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more...

...Such a significant reduction in taxes on industrial property would obviously lead to a...

...Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate...

...has the highest tax in the country on industrial property, it should be no surprise that it has...

...serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina...

...Importantly, South Carolina's effective tax rate is almost 2.5 times greater than...

...50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25...

...Figure 5.8: Industrial Property Taxes in Southeastern states*, 2007

...Tennessee 10 $1,033,544

...Texas 6 $1,264,358

...Mississippi 4 $1,291,050

...South Carolina

...State Rank (of 50) Net Tax Effective Tax Rate

...South Carolina

...Figure 5.5: South Carolina income tax: Current tax rates compared to...

...Schedule was Inflation Adjusted to...

...Figure 5.5 also shows that the current tax system charges all income groups more in...

...taxes and average tax rates would be if the 1959 tax tables were indexed for inflation. The...

...under the current tax system in South Carolina. In the right columns it also shows what the...

...wealth of these lowest income taxpayers, not the intended consequence.

...to the goal of progressivity. So although on the surface it appears that the tax satisfies the...

...average tax rate hardly increases at all. This nature of the current tax is directly contradictory...

...occurs at increases over such small steps in income, as shown in Figure 5.5, most of the progressivity...

...exists in the state's income tax structure is due to the zero tax on the first $2,630 of income,...

...marginal tax rates was to make the income tax progressive. However, what progressivity...

...TAX INCENTIVES: COSTLY, INEFFICIENT AND DISTORTIONARY
CHAPTER 7
SOUTH CAROLINA’S
TAX INCENTIVES: COSTLY, INEFFICIENT AND DISTORTIONARY

by Peter T. Calcagno and Frank Hefner
over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in the rankings as the lowest-tax state.)

Working to reduce the tax burden on industrial property is not without its challenges. For example, South Carolina's effective tax rate is almost 2.5 times greater than Delaware's, and the state's rate is significantly higher than that of other Southeastern states. As shown in Figure 5.8, South Carolina's effective tax rate on industrial property is 3.73%.

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than Delaware's, which has one of the lowest per capita incomes and economic growth rates in the country. Since South Carolina has one of the highest tax rates in the country, it detracts from the state's ability to attract and retain industry. This is especially true for industries that are sensitive to tax rates, such as those in the manufacturing sector.

The tax rate on industrial property in South Carolina is significant, with the state ranking 14th highest out of 50 states for its effective tax rate. As shown in the table below, South Carolina's tax rate is higher than that of many other Southeastern states, including Kentucky, West Virginia, and North Carolina.

<table>
<thead>
<tr>
<th>State</th>
<th>Rank</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Carolina</td>
<td>14</td>
<td>$833,234</td>
<td>3.73%</td>
</tr>
<tr>
<td>Kentucky</td>
<td>47</td>
<td>$327,100</td>
<td>1.11%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>14</td>
<td>$833,234</td>
<td>1.57%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>20</td>
<td>$760,381</td>
<td>2.58%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>10</td>
<td>$1,033,544</td>
<td>2.53%</td>
</tr>
<tr>
<td>Texas</td>
<td>6</td>
<td>$1,264,358</td>
<td>3.73%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>4</td>
<td>$1,291,050</td>
<td>5.06%</td>
</tr>
<tr>
<td>Virginia</td>
<td>49</td>
<td>$241,498</td>
<td>0.48%</td>
</tr>
</tbody>
</table>
| Source: National Association of Manufacturers (2009)

These findings are consistent with the literature on tax policy and economic development. Studies have shown that high taxes can be a major disincentive for businesses to locate in a state, leading to a decrease in economic growth. In particular, targeted tax incentives, such as tax credits and subsidies, are often used to attract businesses to a state. However, these policies can create distortions in the economy that can have negative effects on economic growth.

For example, targeted tax incentives may create distortions in the economy by altering relative prices and profits. In addition, they may create the type of deadweight cost (see Chapter 3) that destines economic growth and selective tax incentives are often used to support these policies. These preferential government favors are often justified as a means of supporting economic growth, but studies have shown that they can have negative effects on economic growth.

The evidence suggests that South Carolina's tax policy is not maximizing economic growth. Instead, it is likely that the state is losing out on potential economic growth due to high taxes. This is especially true for industries that are sensitive to tax rates, such as those in the manufacturing sector. The state's high tax rate on industrial property is a significant disincentive for businesses to locate in South Carolina.

The state's high tax rate on industrial property is one of the reasons why it is ranked 14th highest out of 50 states. As shown in the table above, South Carolina's tax rate is significantly higher than that of other Southeastern states, including Kentucky, West Virginia, and North Carolina.

In conclusion, South Carolina's high tax rate on industrial property is a significant disincentive for businesses to locate in the state. This is especially true for industries that are sensitive to tax rates, such as those in the manufacturing sector. The state's high tax rate is likely to negatively impact economic growth and reduce the state's ability to attract and retain industry.
The government of South Carolina uses industry targeting or targeted tax incentives in an attempt to create jobs and stimulate economic growth. Targeted tax incentives, which include: job development and retraining tax credits, tax abatements, infrastructure financing or, in some cases, outright grants and loans of public funds, are fiscal tools designed to attract a private firm to a new location, help support or expand an existing business, or to prevent a company from relocating to another city or state. In South Carolina these programs range from tax credits for locating or expanding corporate headquarters, to subsidies for the motion picture industry. While these policies are common among state governments, the efficacy of these policies has been called into question over and over again by many scholars and policy makers.

As noted in Chapter 3, a low-rate tax structure that is broad based is conducive to economic growth, selective tax incentives are quite a different matter. They are tools of central economic planning and much like tax policy in general often create distortions that affect relative prices and profits. In addition, they may create the type of deadweight cost (see Chapter 4) that destroys wealth by encouraging firms to shift resources into areas that receive these preferential government favors.

The purpose of this chapter is to provide the reader with a better understanding of the role targeted tax incentives may play in state and local economic development. We begin by discussing the distortions that these policies create drawing upon the literature on taxes (public finance). From there we examine the efficacy of targeted tax incentives, focusing specifically on the political factors that explain their popularity. We then present a summary of the findings of scholarly research addressing the impacts targeted tax incentives have on the areas of employment, income and growth.

Then we detail some of the specific cases of South Carolina’s experiences with incentives. We end by concluding that the evidence suggests that South Carolina’s prosperity would be enhanced by abandoning its industry targeting approach (and dissolving the economic development agencies that offer them) in favor of broad-based tax cuts and other
pro-growth initiatives that benefit business in general rather than a few favored companies or industries. We maintain that South Carolina would be better off by promoting ‘market-friendly’ policies that provide a beneficial business climate for all firms and not a ‘business-friendly’ policy for a few firms.

SELECTIVE INCENTIVES CREATE DISTORTIONS IN MARKETS

Recall from Chapter 4 that when taxes are imposed on consumers or businesses the tax burden can be shifted back to businesses, or on to consumers, respectively. For example, a recent Kansas City Federal Reserve Report finds that from 1992-2005 a one percent increase in the state corporate tax rate decreases the wages of employees by .52 percent.\(^1\) Further, remember that the taxation process creates indirect costs and behavioral changes that can result in ‘deadweight cost’ or ‘excess burden’ of taxation. Similarly, when state governments, such as South Carolina offer businesses tax credits or subsidies it can create an ‘excess burden’ or an inefficiency that creates a ‘wedge’ between the price consumers pay and the price businesses receive. This type of ‘wedge’ creates a distortion in the market by redirecting resources into a specific industry. For instance, a business interested in locating to South Carolina may request or be offered a tax credit in return for locating to the state. This negotiation process is similar to the lobbying efforts noted in earlier chapters – efforts that create additional indirect costs that can offset the benefits of the tax credit or subsidy.

The process of receiving the tax credit lowers the cost for the specific business for which the credit applies. This encourages greater production of this product by this business than would otherwise occur in South Carolina if directed purely by free market forces. In addition, the benefits of the tax credit may be shifted from the targeted businesses to existing businesses, employees, or consumers, which again can distort the behavior of consumers, or production of other business. The same analysis applies if specific firms are offered subsidies.\(^2\) While these types of selective or targeted incentives seem to benefit businesses and consumers, they instead create distortions that require us to ask how else these resources would have been allocated in South Carolina if the tax credit or subsidy had not been offered to these specific businesses in the first place.

As was discussed in Chapter 5, South Carolina has embedded in its constitution property tax assessment ratios which discriminate among various classes of properties. In order to rectify the high assessment on industrial property in the state, and attract the manufacturing sector, a fee-in-lieu of tax (FILOT) law was passed in 1987. This incentive is a discretionary incentive and the fee is a negotiated rate with state or county officials. Between 1987 and 2000, 320 FILOT agreements were negotiated.\(^3\) The original FILOT applied to relatively large new plants with a minimum required investment of $85 million. Since then the threshold has been progressively reduced, from $45 million in the early 1990s to $5 million in 1995 to $1 million in 1999 for select counties. To qualify for the FILOT with a $1 million investment, the new industry must locate or expand in a county that has an average annual unemployment rate of at least twice the state average during each of the last two

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\(^1\) Felix (2009)

\(^2\) While both tax credits and subsidies create distortions in the allocation of resources for consumers and businesses, they are different. A tax credit is offset against taxable income and reduces a business’s tax burden while a subsidy is a direct payment by the government to the business.

\(^3\) Woodward, Miley, and Ulbrich (2000).
completed calendar years. The law has a number of other provisions. One does not need to 
examine the details in order to observe that this incentive is clearly a second best solution to 
the property tax provision in the constitution. As a second best solution it has a number of 
unsatisfactory results: not every new industry qualifies, the fee is a negotiated fee which 
means it is unpredictable and subject to being tainted by political preferences, existing 
industries continue to pay their taxes based on the mandated assessment ratios; thus, shifting 
the burden of taxes from new firms to existing firms.

**THE EFFICACY OF TAX INCENTIVES**

Economists and policy makers have argued that competition among states to entice 
companies through selective incentives provides no net gain to the U.S. economy. “From the 
states' point of view each may appear better off competing for particular businesses, but the 
overall economy ends up with less of both private and public goods than if such competition 
was prohibited.” So what effects do these policies have on a state's economic growth?

Several of the Federal Reserve District Banks have published articles investigating the 
role of tax incentives on state economic growth. The evidence in these studies suggests that 
state governments should eliminate, abolish or refine tax incentives policy and thereby 
remove the competition that is occurring between states for investment.

The subject of state governments targeting industries through financial incentives 
raises important questions regarding economic growth and development, which requires us to 
examine whether the economic benefits of these policies are worth the economic costs. 
Whether or not state development incentives lead to real job creation and economic growth 
has been the subject of much debate among economic scholars. There is a breadth of 
economics literature that has examined a variety of programs across the United States at both 
the state and local level. These studies suggest that economists have long doubted the efficacy 
of using state inducements to attract mobile firms. Economists have found the evidence 
associated with the issue of tax and other development incentives generating economic 
growth unconvincing.

Selective incentives include direct economic incentives as well as tax abatements, and 
are broken down by the National Association of State Development Agencies into several 
categories: industry grants, loan guarantees, industrial development bonds and guarantees, 
umprella bonds, general obligation bonds, customized industrial training, state funded venture 
capital corporations, privately sponsored development credit corporations, and other financing 
programs.

Ultimately all of these selective incentives have one major goal, which is to create 
jobs in the state. Gabe and Kraybill (1998) in a study that examines which firms in Ohio

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oweight these costs. Bartik (1994) argues that development incentives provide the greatest benefit to high 
unemployment areas. However, he notes that state governments often attract firms to areas that have low 
unemployment, limiting the benefits that a state may receive from these types of incentives. Calcagno and 
Thompson (2004) find that selective incentives merely reallocate resources rather than generate real economic 
growth.

5 Articles from regional Federal Reserve Bank publications include: Mauey and Spiegel (1995), Burstein and 

6 Esinger (1989)

7 Buss (1999a, 1999b, 2001)
receive selective incentives find that the number of new jobs promised by the targeted business is the major factor in deciding who receives the incentive. Examining over 2000 programs across all states Saiz (2001) finds no evidence of overall growth in state gross domestic product or employment levels as a result of using financial incentives and finds negative impacts in certain industries. In more recent studies, the evidence continues to suggest that these policies are not effective in generating jobs or economic growth and development. The effects across Kentucky counties were analyzed in a 2008 report of state government incentives to attract businesses. The authors examined the actual incentives claimed by these businesses and found that there were weak positive effects associated with tax incentives, but only in border counties and found no evidence of spillover effects in adjacent counties. The authors argue that since Kentucky’s incentive packages are similar to most states, their findings can be applied to other states.\footnote{Hoyt et al. (2008)} Figure 7.1, provides a summary of the literature, which has consistently found that selective incentives have little effect anywhere in the United States. Similarly Peters and Fisher (2004, p 35), using a meta-analysis, of the most commonly cited reviews of this literature arrive at the same conclusion. They conclude that “the most fundamental problem is that many public officials appear to believe that they can influence the course of their state or local economies through incentives and subsidies to a degree far beyond anything supported by even the most optimistic evidence.”\footnote{Peters and Fisher (2004). A meta-analysis is where the results of various papers on a topic are examined and summarized using a variety of statistical techniques to test whether the overall findings are statistically significant.}
**Figure 7.1: Empirical Studies of Tax Incentive Efficacy**

<table>
<thead>
<tr>
<th>Study</th>
<th>Region/Time</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ambrosius (1989)</td>
<td>National study of development incentives, 1969–1985</td>
<td>No evidence of incentive impact on manufacturing value-added or unemployment, thus suggesting that tax incentives were ineffective.</td>
</tr>
<tr>
<td>Trogan (1999)</td>
<td>National study of state economic growth and development programs, 1979–1995</td>
<td>General fiscal policy found to be mildly effective, while targeted incentives reduced economic performance (as measured by per capita income).</td>
</tr>
<tr>
<td>Edmiston (2004)</td>
<td>Panel study of large firm entrance in Georgia, 1984–1998</td>
<td>Employment impact of large firms is less than gross job creation (by about 70%), and thus tax incentives are unlikely to be efficacious.</td>
</tr>
<tr>
<td>Hicks (2004)</td>
<td>Panel study of gaming casinos in 15 counties (matched to 15 non-gambling counties)</td>
<td>No employment or income impacts associated with the opening of a large gambling facility. There is significant employment adjustment across industries.</td>
</tr>
<tr>
<td>LaFaive and Hicks (2005)</td>
<td>Panel study of Michigan’s MEGA tax incentives, 1995–2004</td>
<td>Tax incentives had no impact on targeted industries (wholesale and manufacturing), but did lead to a transient increase in construction employment at the cost of roughly $125,000 per job.</td>
</tr>
<tr>
<td>Hicks (2007a)</td>
<td>Panel study of California’s EDA grants to Wal-Mart in the 1990s</td>
<td>The receipt of a grant did increase the likelihood that Wal-Mart would locate within a county (about $1.2 million generated a 1% increase in the probability a county would receive a new Wal-Mart), but this had no effect on retail employment overall.</td>
</tr>
<tr>
<td>Hicks (2007b)</td>
<td>Panel study of entry by large retailer (Cabela’s)</td>
<td>No permanent employment increase across a quasi-experimental panel of all Cabela’s stores from 1998 to 2003.</td>
</tr>
</tbody>
</table>

Source: Hicks and Shughart (2007).
Buss (1999a, 2001) claims that the research that state development agencies conduct has little economic value and that state governments should not meddle with private location decisions. According to Poole et al. (1999), the actual impact of development strategies is often unknown because these economic developers lack the necessary skills to identify the appropriate method and have limited data for analysis. The tool most often used by economic development agencies is the economic impact study.

These economic impact studies often contain serious flaws. As a result, they may overstate the employment and economic gains associated with a new or expanded plant. Several issues should be noted here, first there is no one accepted methodology for counting jobs and income. While new jobs may be created by the targeted firm there is likely to be a re-shuffling of the local labor force in an effort to fill the new jobs. In 2001, Nissan opened a facility in Canton, Mississippi, where 90 percent of the workers employed lived and worked in the five counties surrounding the plant (Peavy 2007). Thus, only 10 percent of the jobs at the new Nissan plant were taken by individuals who either were previously unemployed prior to opening the plant or moved to Madison County, Mississippi, from more distant locations, including out of state (Hicks and Shughart 2007). It is not known from the impact study whether the jobs that workers leave are filled, remain vacant, or are eliminated when they move to the new job openings. Further, the benefit of these jobs to the state can be mitigated depending on whether labor migrates from out of state to fill these positions. Finally, the benefits of new jobs are subject to overstatement and double counting when indirect or ripple effects are evaluated. The indirect effects attempt to measure the economic benefits the new jobs create throughout the economy. This concept will be explained in more detail in the case study below.

Often firms that receive these selective incentives are subject to little or no accountability and rarely create the number of jobs or the hourly wage rates they promise. These firms will often move their operations elsewhere when the tax incentives or subsidies cease to exist. In particular, ‘call centers’ and high-tech companies that employ few specialized physical assets will relocate because they can easily abandon one site in favor of another in search of a larger more attractive incentive package (LeRoy 2005).

When these selective incentives attract individuals from other states or cities to the local labor force, additional public services may be needed to accommodate them. If the new company in the area has been granted relief from state and local taxes, and the tax revenue generated from the new firm does not cover these additional costs, the increased government spending will fall on other existing businesses. This tax shifting may destroy as many jobs as the incentives given to the new firm are intended to create.

If the efficacy associated with these types of policies is in serious doubt it begs the question, why they are so popular with state governments? The answer goes back to Chapters 3 and 4 and the discussion of businesses employing resources to lobby for tax breaks and other subsidies that add to owners’ profits. This lobbying often creates a bidding war between two or more state and or local governments that can increase the value of the incentives the firm can extract from these government entities.

Numerous studies point out that there are clear political benefits for using selective financial incentives.10 “Governors, mayors, legislators, and council members justify these public investments on the grounds that private-sector decisions to invest in a community

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result in jobs, income, and tax revenues that are essential to the economic and social well-being of a community or state” (Poole et al. 1999, 1). Hinkley et al. (2000) claim that both legislators and the public are not provided with enough information from economic development agencies about the economic incentives offered and call for an increase in audits of these agencies. While several authors do concede that targeting has a political component to it, they fail to recognize that targeting industries may well be an inefficient allocation of resources.\(^{(1)}\)

Industries seeking preferential treatment dominate the political process because voter-taxpayers have very little incentive to be well informed about the costs associated with these tax incentive programs and to create any means of organized opposition. The jobs ‘created’ at a new plant are easily visible to the state or local community; they will not see the jobs that are lost elsewhere in the economy due to the higher tax burdens imposed on other businesses and consumers. Nor do they see the scarce resources being allocated away from productive ventures that could produce real output and growth being spent instead on lobbying government officials to obtain these favors. In addition, taxpayers may be unable to see that their future tax bills will be higher in order to amortize and service the public debt issued to finance the subsidies diverted toward the owners of politically influential private companies (Hicks and Shughart 2007).

**WHAT ARE THE ECONOMIC IMPACTS OF TARGETED TAX INCENTIVES?**

Although tax incentives have long been endorsed as the highway to prosperity, with promises of attracting businesses, providing jobs and enriching the state, most public finance experts consider them bad policy. It has already been discussed how tax incentives that target specific companies create inequities, complications and inefficiencies. Further, they shrink the tax base, thus shifting the burden of taxes and reducing tax revenue available for the basic functions of state government. Finally, there’s little evidence that targeted incentives bring growth in the form of good paying jobs, as demonstrated in the previous figure. Figure 7.2 reports the average cost per job to attract automobile factories to the various states that offered incentives to attract foreign car companies.

Figure 7.2: U.S. Auto Plant Investments*

<table>
<thead>
<tr>
<th>Company</th>
<th>State</th>
<th>Announcement Date</th>
<th>Initial Employment Estimate</th>
<th>Announced State and Local Incentives (Millions)</th>
<th>Real Incentives‡ (2001 Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hyundai</td>
<td>Alabama</td>
<td>2002</td>
<td>2,000</td>
<td>$118</td>
<td>$118†</td>
</tr>
<tr>
<td>Toyota</td>
<td>Alabama</td>
<td>2001</td>
<td>350</td>
<td>$29</td>
<td>$29</td>
</tr>
<tr>
<td>Nissan</td>
<td>Mississippi</td>
<td>2000</td>
<td>4,000</td>
<td>$295</td>
<td>$299</td>
</tr>
<tr>
<td>Honda</td>
<td>Alabama</td>
<td>1999</td>
<td>1,500</td>
<td>$158</td>
<td>$165</td>
</tr>
<tr>
<td>GM</td>
<td>Michigan</td>
<td>1998</td>
<td>700</td>
<td>$107</td>
<td>$114</td>
</tr>
<tr>
<td>Mercedes</td>
<td>Alabama</td>
<td>1994</td>
<td>1,500</td>
<td>$253</td>
<td>$289</td>
</tr>
<tr>
<td>BMW</td>
<td>South Carolina</td>
<td>1992</td>
<td>1,900</td>
<td>$130</td>
<td>$155</td>
</tr>
<tr>
<td>Toyota</td>
<td>Kentucky</td>
<td>1986</td>
<td>3,000</td>
<td>$147</td>
<td>$214</td>
</tr>
</tbody>
</table>

*Inflation adjustments are made using GDP deflator series.
‡Includes only primary real incentive, not additional ongoing incentives.
†2002 dollars assumed equal to 2001 dollars.
Source: Division of Research; University of South Carolina, 2002. Economic Impact of BMW

In particular, the figure shows that cost per job ranges from a low of $59,000 to a high of $192,730, interestingly enough the high and low both occur in Alabama. South Carolina is in the middle of this group with expenditures just over $81,000. As explained above, given the difficulties in accounting for new jobs and income using economic impact studies, and the general conclusion from the economic literature that selective incentives have been shown to produce few if any benefits, it is not clear whether these firms are generating enough economic benefit to cover the high costs per job.

To further examine the issue, Figure 7.3 presents the total economic incentives provided by the South Carolina state government from 1994-2007. Over this 14 year period state spending for incentives has increased from over $32 million in 1994 to over $250 million in 2007 almost an 8 fold increase. Most notably in 1999 and 2000 spending increased by large percentage changes, more than doubling the spending from each of the previous years, 101 and 118 percent, respectively. While no statistically significant correlation appears to exist between spending on economic incentives and employment, it is interesting to note that in the years following these large increases in spending the percentage change in employment is negative. Thus, while spending in South Carolina on economic incentives increased substantially over a 13-year period, employment and personal income did not. Despite the assurances of policy makers that incentives would create jobs and higher income levels, neither has kept pace with the spending.
Figure 7.3: South Carolina Spending on Incentives Compared with Employment and Income Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Economic Incentives</th>
<th>% Change in Total Economic Incentives</th>
<th>% Change in Employment</th>
<th>% Change in Personal Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994-1995</td>
<td>$32,262,687</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1995-1996</td>
<td>$32,915,625</td>
<td>2.0%</td>
<td>1.8%</td>
<td>4.9%</td>
</tr>
<tr>
<td>1996-1997</td>
<td>$33,483,632</td>
<td>1.7%</td>
<td>2.2%</td>
<td>4.6%</td>
</tr>
<tr>
<td>1997-1998</td>
<td>$35,215,256</td>
<td>5.2%</td>
<td>3.7%</td>
<td>5.6%</td>
</tr>
<tr>
<td>1998-1999</td>
<td>$34,889,757</td>
<td>-0.9%</td>
<td>3.0%</td>
<td>4.1%</td>
</tr>
<tr>
<td>1999-2000</td>
<td>$70,340,202</td>
<td>101.6%</td>
<td>2.4%</td>
<td>5.9%</td>
</tr>
<tr>
<td>2000-2001</td>
<td>$153,727,118</td>
<td>118.5%</td>
<td>-0.9%</td>
<td>2.3%</td>
</tr>
<tr>
<td>2001-2002</td>
<td>$151,836,661</td>
<td>-1.2%</td>
<td>-2.3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>2002-2003</td>
<td>$152,138,291</td>
<td>0.2%</td>
<td>0.9%</td>
<td>2.0%</td>
</tr>
<tr>
<td>2003-2004</td>
<td>$175,649,647</td>
<td>15.4%</td>
<td>0.2%</td>
<td>4.6%</td>
</tr>
<tr>
<td>2004-2005</td>
<td>$182,636,009</td>
<td>4.0%</td>
<td>2.1%</td>
<td>4.5%</td>
</tr>
<tr>
<td>2005-2006</td>
<td>$185,439,957</td>
<td>1.5%</td>
<td>2.1%</td>
<td>6.2%</td>
</tr>
<tr>
<td>2006-2007</td>
<td>$254,610,950</td>
<td>37.3%</td>
<td>2.4%</td>
<td>3.5%</td>
</tr>
</tbody>
</table>

Source: South Carolina Board of Economic Advisors

Efficacy of Tax Incentives for the Film Industry: A Case Study

The film industry is very aggressive in seeking incentives from state governments and states seem eager to offer these incentives. As was mentioned in Chapter 6 on clusters, no particular bias exists for or against this industry. The real question that should be asked is what is so special about the film industry (or film cluster) that warrants special types of incentives. Then further, why not provide similar incentives to other industries?

What makes the film industry special? The industry has a number of desirable features: creative, entertaining, environmentally clean, and so on. The answer perhaps was best summarized in a Federal Reserve Bank of Minneapolis publication: “Call it a movie trailer for economic development: A film production company comes to town with its director and stars, spends a lot of money on lodging and food, hires locals as crew and extras. Residents run into their favorite stars at the local coffee shop, and the location is seen by millions of viewers on the big screen - a great boost for tourism.”\(^{12}\) In an effort to capture this economic development, almost every state in the country has a film office. More importantly, almost every state offers a very favorable incentive package to the film industry. Figure 7.4 presents the selective incentives that several states offer to the film industry. Indeed, if each state is attempting to create a ‘competitive advantage’ in the film industry and the tool is tax incentives, then there should be no surprise that each state ‘ups the ante’ each time another state raises the stakes. Since so many states are competing with each other for a limited number of films, these type subsidies encourage a ‘race-to-the-bottom’ as each state raises the

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\(^{12}\) Cobb, Kathy, “Roll the credits and the tax incentives,” *Fedgazette*, (Federal Reserve Bank of Minneapolis) Sept. 2006
ante in their generosity. As one New York producer noted about Connecticut’s increase in their subsidies: “The good news is that Connecticut could spur the New York credit higher.”

---

Figure 7.4: Incentives for Film Industry – Selected States

<table>
<thead>
<tr>
<th>State</th>
<th>Description of Incentive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Exemptions on sales, use, and lodging taxes</td>
</tr>
<tr>
<td></td>
<td>Income tax credit equal to 25%</td>
</tr>
<tr>
<td></td>
<td>35% payroll expenses rebate for salaries paid to Alabama residents when expenses are</td>
</tr>
<tr>
<td></td>
<td>between $500,000 and $10 million</td>
</tr>
<tr>
<td></td>
<td>A 25–35% credit or rebate for sound production</td>
</tr>
<tr>
<td></td>
<td>The maximum amount of rebates is capped at $5 million for 2009, $7.5 million for 2010,</td>
</tr>
<tr>
<td></td>
<td>and $10 million for 2011.</td>
</tr>
<tr>
<td>Florida</td>
<td>Films, TV Commercials, and Music Videos of $625,000 or more are eligible for a 15-22%</td>
</tr>
<tr>
<td></td>
<td>cash rebate</td>
</tr>
<tr>
<td></td>
<td>Multiple Commercials and Music Videos with $500,000 or more in qualified expenditures</td>
</tr>
<tr>
<td></td>
<td>are eligible for a 15-20% cash rebate</td>
</tr>
<tr>
<td></td>
<td>Indie Films or Documentaries with qualified expenditures between $100,000 and $625,000</td>
</tr>
<tr>
<td></td>
<td>are eligible for a 15-17% cash rebate</td>
</tr>
<tr>
<td></td>
<td>Digital Media projects of $300,000 or more are qualified for a 10% cash rebate</td>
</tr>
<tr>
<td></td>
<td>All qualified productions are eligible for a sales tax exemption</td>
</tr>
<tr>
<td>Georgia</td>
<td>30% tax credit</td>
</tr>
<tr>
<td></td>
<td>An across the board flat tax credit of 20% based on a minimum investment of $500,000.</td>
</tr>
<tr>
<td></td>
<td>An additional 10% Georgia Entertainment Promotion can be added by including an animated</td>
</tr>
<tr>
<td></td>
<td>Georgia logo on approved projects.</td>
</tr>
<tr>
<td></td>
<td>8% sales tax exemption</td>
</tr>
<tr>
<td>Kentucky</td>
<td>Refundable sales tax incentive</td>
</tr>
<tr>
<td></td>
<td>Refundable income tax credit up to 20% of expenditures over $500,000.</td>
</tr>
<tr>
<td></td>
<td>Commercials can apply for the income tax credit, if they have expenditures over $200,000</td>
</tr>
<tr>
<td></td>
<td>Documentaries and Broadway productions are eligible if they have expenditures over $500,000</td>
</tr>
<tr>
<td>Maryland</td>
<td>25% rebate on in-state costs on a minimum of $500,000.</td>
</tr>
<tr>
<td></td>
<td>Exemptions from state sales tax on qualified items.</td>
</tr>
<tr>
<td>Mississippi</td>
<td>20% rebate on spending in Mississippi</td>
</tr>
<tr>
<td></td>
<td>25% rebate on salaries that are subject to Mississippi Income Tax withholding up to $1</td>
</tr>
<tr>
<td></td>
<td>million.</td>
</tr>
<tr>
<td></td>
<td>20% rebate on salaries not subject to Mississippi Income Tax withholding up to $1</td>
</tr>
<tr>
<td></td>
<td>million.</td>
</tr>
<tr>
<td></td>
<td>Exemption from the state's 7% sales tax on some items and a reduction on others.</td>
</tr>
<tr>
<td>North Carolina</td>
<td>25% tax credit on a minimum of $250,000 of in-state spending</td>
</tr>
<tr>
<td>South Carolina</td>
<td>20% cash rebate for in-state employee wages</td>
</tr>
<tr>
<td></td>
<td>10% cash rebate for out-of-state employee wages (up to $3,500)</td>
</tr>
<tr>
<td></td>
<td>20% cash rebate for salaries of out-of-state performing artists, including stunt</td>
</tr>
<tr>
<td></td>
<td>performers.</td>
</tr>
<tr>
<td></td>
<td>30% cash rebate for in-state supplies (if $1,000,000 spent)</td>
</tr>
<tr>
<td></td>
<td>Sales and accommodations tax exemptions if film budget is over $250,000</td>
</tr>
<tr>
<td>Virginia</td>
<td>Through the Governor's Motion Picture Opportunity Fund a cash rebate can be attained at</td>
</tr>
<tr>
<td></td>
<td>the discretion of the governor.</td>
</tr>
<tr>
<td></td>
<td>State sales tax and use exemptions and state and local lodging tax exemptions.</td>
</tr>
<tr>
<td></td>
<td>State owned property provided free</td>
</tr>
<tr>
<td></td>
<td>Free rental of a 350,000 square feet office building in Richmond.</td>
</tr>
</tbody>
</table>

Source: Web pages of State Film Offices
In order to justify the incentives, a number of quantitative studies have been performed. These studies use regional economic impact models in order to estimate the so-called multiplier effect. The multiplier effect calculates the additional impacts in a local economy caused by an increase in local direct spending. For example, the money spent on food in the local restaurants by the film crew would be a direct expenditure. The salary paid to the employees in the restaurant as a result of these meals is termed an indirect expenditure. When the restaurant employees spend their salary in the local economy on food, gasoline, clothing, and so on, they exert an induced impact. The multiplier attempts to measure the total of all of these impacts. The multiplier effects are often termed ‘ripple effects,’ invoking an image of a rock tossed into a pond generating ripples across the water. A number of computer models are available which allow researchers to localize economic impacts. One of the most widely used software models is IMPLAN, (Impact Analysis for Planning). IMPLAN calculates three kinds of multipliers:

1. Output: This measures the total economic activity that takes place within the economy.
2. Income: This is commonly referred to as personal income and includes employee compensation and proprietor’s income.
3. Jobs: Total jobs measured as full time equivalents.

In 2008, a study conducted by Hefner examined the economic impact of nine film and television productions made in South Carolina in the years 2006 and 2007. The data were provided by the South Carolina Film Commission. South Carolina, like many other states, pays cash to film producers. In fact, the South Carolina Film Commission advertises on its web site that South Carolina Pays Cash. At the time these films were being made, South Carolina was paying a 20 percent ‘rebate’ on wages and a 30 percent ‘ rebate’ on qualified spending. Slightly more than $8 million was paid to South Carolina residents by these nine productions (film and television). Salary rebates totaling $8.4 million were given to support the $8 million in direct local salary. In terms of direct salary, this means that the state government gave the film industry $1 in rebates to generate $0.95 in increased salary to South Carolina residents. The films spent $14,407,563 in South Carolina for supplies and services provided by local firms. These productions received $7,385,342 in rebates for supplies. In effect, the state of South Carolina paid about a 50 percent subsidy for the in-state spending.

In order to provide the most favorable treatment possible to justify these subsidies, a multiplier analysis was also conducted. Total expenditures (salary, supplies and services) in South Carolina were $22,546,211. Using IMPLAN, the total economic impact within the state was estimated to be $38,815,045. Total cash subsidies paid amounted to $15,815,028. Total economic impact includes goods such as lumber for set design, services, such as lodging and car leasing, and income, such as salary to extras. Of this total economic impact, labor income

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14 IMPLAN was initially developed by the U.S. Department of Agriculture Forestry Service and is now maintained and marketed by a private firm (Minnesota IMPLAN Group, Inc.).

15 Employee compensation includes wages and salaries as well as benefits such as health and life insurance, retirement and non-cash compensation. IMPLAN refers to this category as labor income.

16 http://www.scommerce.com/docdirectory/ResearchFolder/Film%20Cost%20Benefit%20Analysis%202008%20by%20Frank%20Hefner,%20College%20of%20Charleston.pdf

17 http://www.scfilmoffice.com

18 The rebates were applied to salary paid to non-South Carolina residents. In addition, rebates were also applied to spending on supplies that were purchased outside the state.

19 Total economic impact is not the same thing as state income. The total impact includes all purchases, direct and ripple, and all employee compensation, direct and ripple.
amounted to $14,534,908. However, the most relevant measure and perhaps the best metric in these cases is to compare tax dollars spent to tax dollars received. This calculation is both the most difficult estimation and the one that has the most profound public finance implications. More importantly it ensures an apples to apples comparison, which is not always the case with multiplier effects. The South Carolina Tax Impact/Total Rebate is $0.19. This means that for each tax dollar given in rebates, the return to the general revenue fund from these expenditures is only $0.19.

Thus after the film rebate, the services that the film industry produces generates less in tax revenue than the tax dollars spent to attract the film industry. This creates a net loss to the general revenue fund of $0.81 for each tax dollar spent. Thus, the tax subsidies as they were structured at the time of Hefner’s 2008 study generated a net loss to the general revenue fund. This has profound implications during budgetary hard times as has been experienced by the state in the recent recession. Given that this money is being taxed away from the private sector, it should be spent on what capitalism considers the legitimate functions of limited government (e.g. property rights enforcement, infrastructure development, education), and not to favor a particular industry. When government spends taxpayer dollars to subsidize a targeted industry the relative tax burden to individuals and businesses will increase. As noted in Chapter 2, taxing money away from one area of the private sector only to give it to another segment of the private sector is not capitalism. This policy merely redistributes wealth and will not lead to greater economic growth. Further, when the subsidy generates a drain on the government’s budget, core government services taxpayers expect to receive may be cut.

The conclusion that subsidies to the film ‘cluster’ are a net loss to state revenues has also been confirmed in multiple states. The Rhode Island Department of Revenue estimated that the state of Rhode Island gets back $0.28 for every dollar it provides to production companies.20 The Connecticut Department of Economic and Community Development, after analyzing 13 projects between July 1, 2006, and Sept. 30, 2007, determined that the state received $0.08 in tax revenue for every dollar spent.21 In Michigan, the State Senate Fiscal Agency reports that in 2008 the anticipated cost to the state was $127 million which was estimated to generate only $10 million in tax receipts. In Wisconsin before their incentive bill was proposed, their Department of Revenue determined that the state would likely see a net loss in revenue.22 Louisiana’s chief economist in 2005 estimated that the state revenue gains from the total economic activity of film production would be about 16 percent - 18 percent of state tax credit costs.23

There are multiple studies that demonstrate that the kinds of incentives given to the film industry are a drain on the general revenues of the states pursuing this industry. This leads many researchers to ask the very relevant question of whether the states that give such generous subsidies to the film industry could have better spent those funds in other ways that would have produced stronger and more sustainable economies. To answer this question requires an understanding of the most relevant concept economics has to offer: opportunity cost. The concept of opportunity cost examines what is the highest valued alternative that is foregone when one activity is chosen over another. Markusen (2007) observes that

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21 Christopherson and Rightor. (Forthcoming 2010).
23 Albrecht (2005).
opportunity costs are rarely considered in the incentives game. Kruger (1990) in her aptly titled paper, “Government Failures in Development,” reminds us that action by government is not a costless activity. This simple but important point should cause South Carolinians to seriously consider whether these types of policies are the best use of the states’ scarce resources. Could these tax dollars be better spent on what capitalism regards as the legitimate functions of government? More importantly we should be asking how market forces would have allocated these resources within the private sector had they not been taxed away in the first place.

**SUMMARY AND POLICY RECOMMENDATIONS**

It is not the proper function of government to decide which businesses should receive favor, nor do they have the unique ability to identify which of these businesses will succeed. This is the role of the private sector and the profit and loss system.

Given the vast literature on the ineffectiveness of incentives, one may ask why policy makers persist in asking for legislation to provide more incentives. The literature also argues that there clearly is a political benefit to offering these incentives even if there is not an economic one for the state. Calcagno and Hefner (2007) find that offering incentives can increase a state’s corporate tax revenue, which might provide political motivation. Whether or not tax revenues increase, providing selective incentives gives the appearance that legislatures and policy makers are doing something concrete to generate economic development and solve the problems of the state. In addition, Buss (2001) notes that politicians face little risk from offering these types of incentives. If the firm fails they can blame it on economic conditions, and if it is successful they can take all the credit. Public choice economics argues that politicians are often short-sighted in their policy judgments, not looking beyond the next election cycle (see Chapter 12).

South Carolina offers a wide variety of selective tax incentives that create distortions in the economy and limit the ability of the private sector to generate economic growth. These incentives simply create unnecessary competition between states increasing the incentives offered for little benefit. South Carolina needs to reform its property tax laws so they can stop using it as an excuse to offer these incentives. A lower tax rate for business and property across the board will do more to generate economic growth in South Carolina than any selective incentive.
REFERENCES


Cobb, Kathy. 2006 Roll the Credits… and the Tax Incentives, Fedgazette, Minneapolis, MN: Federal Reserve Bank of Minneapolis, September.


the figure because it is the lowest-tax state. Over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in million in fixtures). Notice that South Carolina’s effective tax rate on industrial property is almost 2.5 times greater than that of Kentucky. Although it is probably not critical that South Carolina set its tax rate to the lowest in one of the lowest per capita incomes and economic growth rates in the country. It should definitely make it at least competitive for the Southeast. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has a serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina offers in a State Economic Development Program. Review of Regional Studies 28 (3): 1-14.


The Economic Impact of BMW on South Carolina. 2002. Division of Research, University of South Carolina.
over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in $12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5 million in current assets.)

Such a significant reduction in taxes on industrial property would obviously lead to a reduction in tax revenues on industrial property, at least initially. However, the overall revenue may in fact increase once the growth rate in the state begins to pick up and more industry moves into the state. Furthermore, if the official tax rates are lowered, then the state would have the highest tax in the country on industrial property, it should be no surprise that it has the lowest per capita incomes and economic growth rates in the country.

Although it is probably not critical that South Carolina set its tax rate to the lowest in the country, it should definitely make it at least competitive for the Southeast. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has the lowest per capita incomes and economic growth rates in the country. In Figure 5.5 we present the effective property tax rates data for Southeastern states, for comparison. The ranks given for the states are out of all 50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million ($12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5 million in current assets).

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than Delaware's. The average tax rate for South Carolina is 3.73% compared to Delaware's 0.48%.

Figure 5.8: Industrial Property Taxes in Southeastern states*, 2007

<table>
<thead>
<tr>
<th>State</th>
<th>Rank</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delaware</td>
<td>1</td>
<td>$238,840</td>
<td>0.48%</td>
</tr>
<tr>
<td>Virginia</td>
<td>49</td>
<td>$241,498</td>
<td>0.65%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>37</td>
<td>$491,071</td>
<td>0.98%</td>
</tr>
<tr>
<td>Alabama</td>
<td>35</td>
<td>$533,776</td>
<td>1.11%</td>
</tr>
<tr>
<td>Georgia</td>
<td>20</td>
<td>$760,381</td>
<td>1.52%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>14</td>
<td>$833,234</td>
<td>1.57%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>10</td>
<td>$1,033,544</td>
<td>1.67%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>4</td>
<td>$1,291,050</td>
<td>2.07%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>1</td>
<td>$1,864,900</td>
<td>2.53%</td>
</tr>
<tr>
<td>Florida</td>
<td>24</td>
<td>$677,683</td>
<td>3.05%</td>
</tr>
<tr>
<td>Georgia</td>
<td>20</td>
<td>$760,381</td>
<td>3.05%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>14</td>
<td>$833,234</td>
<td>3.12%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>10</td>
<td>$1,033,544</td>
<td>3.12%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>4</td>
<td>$1,291,050</td>
<td>3.39%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>1</td>
<td>$1,864,900</td>
<td>3.73%</td>
</tr>
</tbody>
</table>

* Taxes measured in the states' largest city only.

Source: National Association of Manufacturers (2009)
CHAPTER 8

REGULATORY REFORM PRINCIPLES
FOR SOUTH CAROLINA

by Douglas M. Walker
CHAPTER 5: SPECIFIC TAX REFORMS

Notice that South Carolina's effective tax rate on industrial property is over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in the table below). Although it is probably not critical that South Carolina set its tax rate to the lowest in the 50 states, the serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has one of the lowest per capita incomes and economic growth rates in the country.

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate at around 1 percent might be sufficient to attract more industry. Working to reduce the reduction in tax revenues on industrial property, at least initially. However, the overall various taxes applied to industry would seriously improve the state's competitiveness.

<table>
<thead>
<tr>
<th>State</th>
<th>Rank</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virginia</td>
<td>49</td>
<td>$241,498</td>
<td>0.48%</td>
</tr>
<tr>
<td>Kentucky</td>
<td>47</td>
<td>$327,100</td>
<td>0.65%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>37</td>
<td>$491,071</td>
<td>0.98%</td>
</tr>
<tr>
<td>North Dakota</td>
<td>36</td>
<td>$1,033,544</td>
<td>1.11%</td>
</tr>
<tr>
<td>Oregon</td>
<td>35</td>
<td>$1,264,358</td>
<td>1.57%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>3</td>
<td>$1,864,900</td>
<td>2.53%</td>
</tr>
<tr>
<td>Montana</td>
<td>34</td>
<td>$1,955,061</td>
<td>2.58%</td>
</tr>
<tr>
<td>Washington</td>
<td>33</td>
<td>$3,010,525</td>
<td>3.26%</td>
</tr>
<tr>
<td>Texas</td>
<td>6</td>
<td>$1,264,358</td>
<td>0.62%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>14</td>
<td>$833,234</td>
<td>1.04%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>10</td>
<td>$1,033,544</td>
<td>1.42%</td>
</tr>
<tr>
<td>South Dakota</td>
<td>9</td>
<td>$1,398,886</td>
<td>1.80%</td>
</tr>
</tbody>
</table>

Source: National Association of Manufacturers (2009)

*Taxes measured in the states' largest city only.*
8

REGULATORY REFORM PRINCIPLES FOR SOUTH CAROLINA

Douglas M. Walker

Many citizens are unaware of the extent to which the federal and state government intervenes in our daily lives. Indeed, government affects almost everything we do, either directly or indirectly. Government taxes almost all monetary transactions, it licenses workers in a wide variety of industries, it regulates technical aspects of many types of consumer products, and government even controls individuals’ behavior on private property. Seldom do voters consider the aggregate monetary and non-monetary costs of government regulation. Voters can be pardoned; however, since if they made an effort at comprehensive awareness of government regulation, they would have time for little else. Even if they did have a vast knowledge of the regulatory environment, there is little they could do to change it.

South Carolina is one of the poorest states in the nation. The state’s failure to keep pace with other states is due to many causes, but the size and scope of government in the economy is a primary cause. The other chapters in this book illustrate this fact. One aspect of the state government that needs comprehensive reform is the regulatory environment. This chapter describes some general principles and examples for regulatory reform which would promote a free market, economic growth, and individual freedom in South Carolina.1

South Carolina does rank well in some general surveys, such as Forbes’ ‘America’s Best States to Live.’ South Carolina ranks 26th. Some more specific examples of business environment rankings are discussed in Chapter 2. For example, South Carolina does rather well in the Small Business & Entrepreneurship Council’s rankings.2 In the 2009 business tax index, South Carolina ranks 11th in the country, meaning the state has the 11th best business tax system in the United States. South Carolina ranked 7th in the 2009 Small Business Survival Index.

South Carolina ranks particularly well in ‘regulatory environment’ for business—getting Forbes’ 3rd rank of all 50 states for 2008. Yet the state ranks 29th overall in the ‘Best States for Business’ (Badenhausen 2008), falling 6 spots in the ranking since the previous year. Both of South Carolina’s neighbors score better, with North Carolina ranked 3rd and

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1 The approach of this chapter follows closely that of Corey and Curott’s (2007) examination of regulatory reform in West Virginia.
2 Source: Small Business & Entrepreneurship Council (http://www.sbecouncil.org/).
Georgia ranked 5th. Figure 8.1 illustrates the 2007 and 2008 ‘Best States for Business’ rankings for South Carolina and its two immediate neighbors. All three states rank in the nation’s top 5 states for ‘regulatory environment.’ However, this criteria is the only one for which South Carolina is ranked in the top five. The other criteria are ‘business costs,’ ‘labor,’ ‘economic climate,’ ‘growth prospects,’ and ‘quality of life.’ One reason South Carolina ranks so highly is that the politicians offer large incentives to companies to locate in South Carolina. Indeed, the Forbes study methodology indicates that ‘incentives’ are a major component of the ‘regulatory environment’ category. Yes, South Carolina may indeed be aggressive in offering targeted tax breaks for companies who locate in the state (see Chapter 7). Nonetheless many of the other criteria for business success are lacking in South Carolina, as the state’s rankings for ‘business cost,’ ‘labor,’ and ‘economic climate’ reflect. One of the major components of ‘business cost’ is taxes. So although the state may offer incentives to attract businesses, these incentives are offset by relatively high taxes, as discussed in Chapter 5. These incentives would be unnecessary if taxes in the state were already low and regulations were already business-friendly.

Perhaps more importantly, most jobs in the United States and in South Carolina are created by small businesses. The state does little to attract small, independently-owned companies. It does little to encourage its citizens to open businesses. Instead, the focus of state incentives appears to be heavily leaning toward attracting big businesses. Such a strategy may make news headlines and may, in fact, create lots of jobs, but if state regulations stifle entrepreneurship and people’s willingness to open small businesses, incentives for large companies will only offset losses in small business employment.

The state should seek a regulatory system that treats all businesses equal and encourages all sizes of companies to open in South Carolina. This can be done by having a consistent and simple regulatory environment that minimizes compliance and enforcement costs.

Figure 8.1 Forbes’ “Best States for Business” Rankings for South Carolina, Georgia, and North Carolina

<table>
<thead>
<tr>
<th>State</th>
<th>Business Cost</th>
<th>Labor</th>
<th>Regulatory Environment</th>
<th>Economic Climate</th>
<th>Growth Prospects</th>
<th>Quality of Life</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>23</td>
<td>6</td>
<td>5</td>
<td>10</td>
<td>6</td>
<td>31</td>
<td>15</td>
</tr>
<tr>
<td>North Carolina</td>
<td>4</td>
<td>14</td>
<td>2</td>
<td>21</td>
<td>11</td>
<td>34</td>
<td>4</td>
</tr>
<tr>
<td>South Carolina</td>
<td>27</td>
<td>33</td>
<td>3</td>
<td>41</td>
<td>20</td>
<td>43</td>
<td>29</td>
</tr>
</tbody>
</table>

Figure 5.5: South Carolina income tax: Current tax rates compared to inflation-indexed rates, 2009

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Current Rates</th>
<th>Inflation-Indexed Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000</td>
<td>$10.05</td>
<td>$10.10</td>
</tr>
<tr>
<td>$5,000</td>
<td>$71.00</td>
<td>$71.10</td>
</tr>
</tbody>
</table>

3 The Forbes article (Badenhausen 2008) explains the criteria on which the indexes are based. I quote directly from the article: “Business cost” is based on cost of labor, energy, and taxes. “Labor” measures education attainment, net migration and projected population growth. “Regulatory environment” measures regulatory and tort climate, incentives, transportation and bond ratings. “Economic climate” measures job, income and gross state product growth, unemployment, and the presence of “big” companies. “Growth prospects” measures projected job, income and gross state product growth, business openings/closings, and venture capital investments. Finally, “quality of life” measures schools, health, crime, poverty rates and the cost of living.
Overall, South Carolina ranks lower than both neighboring states in all metrics, and are in the middle of the pack compared to all the states. ‘Regulatory environment’ is the highest ranked criterion for South Carolina, but South Carolina is still relatively unattractive to prospective businesses who may be considering a move to the Southeast. South Carolina policy makers should revise and simplify our regulatory environment to be more competitive with our neighbors. These regulatory reforms would help foster the creation of new businesses, attract businesses from out-of-state, and reduce unnecessary government intervention into private markets. All of these would enhance economic growth in South Carolina.

**PRINCIPLES FOR REGULATION REFORM**

Too often politicians focus on passing well-intentioned legislation that, in the near-term, seems to be well informed and beneficial. Indeed, it would be surprising if any legislation was passed if lawmakers did not believe that someone would benefit from it. Yet, the effects of legislation and regulation are not limited to their intended effects. Often regulations will have unintended consequences that, in many cases, will be worse than the original problems they are designed to alleviate.

Every act of government has unintended consequences. Many of these cannot be foreseen by lawmakers or the voters who support them. Yet, these secondary consequences are just as important as the intended effects of regulation, even if they are not immediately visible. In the classic book, *Economics in One Lesson*, Henry Hazlitt (1946, 5) explains that:

> The whole of economics can be reduced to a single lesson, and that lesson can be reduced to a single sentence. *The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups.*

Hazlitt’s ‘lesson’ is worth keeping in mind as we examine some principles by which South Carolina’s regulatory framework could be improved upon. The goal of such changes would be to improve the economic climate in the state, to encourage more entrepreneurial and business activities, more employment, and a higher standard of living for the citizens in the state. The regulatory institutions set-up by government can play a key role in this.

Here we describe a general strategy for reviewing all of the state-level regulations in South Carolina. The recommendations start with general evaluation strategies and moves to more specific ones. One very general criterion by which regulations can be evaluated is whether they are ‘useful.’ That is, have they ever been cited in legal disputes? If not, then perhaps the regulation is not needed on the books and should be eliminated. For example, recently the South Carolina governor mentioned that there is a regulation that prohibits a circus lasting 48 hours in one place during any particular year.\(^4\) Is this regulation useful? Has it been relevant in recent history for settling disputes among citizens? For those regulations that are deemed relevant and useful, they could be subjected to more stringent evaluative criteria.

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\(^4\) See Governor’s Office (2008) for a list of odd regulations in South Carolina.
COST-BENEFIT TEST FOR NEW AND EXISTING REGULATIONS

One way to help improve the regulatory environment of South Carolina is to ensure a regular review of existing regulations. The effects of the regulation should be carefully estimated. The evaluation should focus, as Hazlitt suggests, on both the short- and long-run effects of policies. Equally important, the regulatory impact should attempt to evaluate the impacts on everyone affected, not just the intended beneficiaries.

One way of undertaking an analysis of the net benefits of regulation would be to have a legislative committee group the regulations into categories by their importance. For the most important regulations – those that impact large numbers of businesses and citizens, a more comprehensive cost-benefit analysis could be undertaken. In these cases, the studies could be so detailed as to include monetary estimates. However, doubts have been raised as to the value of such studies (e.g., Richardson 2001), and whether such studies can even be performed accurately (e.g., Walker 2007). Still, such analysis would represent valuable information that legislators could then use to decide whether continuation of the regulations is warranted.

For those regulations that are deemed to be ‘minor’ – i.e., those that probably do not have a widespread impact – a more general evaluation process could be undertaken. For example, the evaluative committee could recommend that any regulation that puts burdens on a particular industry but not others, or legislation that provides benefits to one group of people at the expense of others, could be repealed because such regulation does not treat people equally under the law. Otherwise, some judgment should be made as to whether the regulation serves a socially-valuable service, or if it only benefits one group at the expense of others.

In some cases, either major or minor regulation may be judged to be problematic or obviously misguided (see Chapter 12). For example, in 2008 a law was passed to exempt hair shampooers from the 1,500 hour training requirement that applies to cosmetologists (Governor’s Office, 2008). The original law was politically motivated to restrict competition in the hairstyling industry. There is no good economic reason for such legislation. After all, individuals are not required to have hours of training to wash their own hair; why should the government require training to wash someone else’s hair simply because they are getting paid? Laws such as a restriction on who can wash hair or apply cosmetics could be immediately repealed. There is no economic reason for South Carolina legislators to get involved to such an extent in private market transactions.  

What is being suggested here is not that every single regulation be the subject of an intense cost-benefit analysis, but rather, that each South Carolina regulation be periodically reviewed to determine whether the benefits of the regulation – to all South Carolinians – outweigh the costs of the regulation to all South Carolinians. Those that cannot pass this simple test, either with empirical evidence or through the use of common sense and a few basic economic principles of regulation, should be repealed.

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5 Later I will discuss “sunset provisions” which cause the regulation to automatically expire at the end of some pre-determined time period, unless the legislature acts to renew the legislation.
**Unintended Consequences**

Government at any level should not intervene simply because there is a potential that some government action could improve a situation. Indeed, there are many situations where the use of government, i.e., force or coercion, could be used to improve the situation for at least some of those involved. However, this ability of government to use force does not mean that such actions are the appropriate function of government.

A major consideration that is relevant to the cost-benefit analysis discussed above is that of unintended consequences. Although some regulation may have a positive intent, the effects of the policy may not be limited to those intended impacts. Indeed, Hazlitt’s book mentioned above is largely dedicated to explaining the secondary, unintended consequences of the federal government. State regulations, too, will always have unintended consequences that must be considered along with the intended effects of the policy.

As a simple example, consider the hair washing regulation cited above. (More substantive regulations will be considered in a later section.) The intent is probably to help ensure that customers seeking a haircut or hairstyling services receive those services by individuals who are property trained. Yet, one unintended consequence of this regulation was to significantly raise the cost to consumers. This increased cost is because the law effectively requires licensed cosmetologists to wash hair. The training required to be a cosmetologist is expensive in both money and time spent. These high costs of training will be passed on to the consumers of the product. It will cause customers to pay more money, and fewer people will choose to have their hair washed with their haircuts. If instead hair salons were free to hire whomever they choose to wash hair, the prices for such services would be lower. Although the politicians may have intended to help the consumers with the legislation, it undoubtedly makes them worse off. After all, how much could the consumer possibly benefit if the person who washes their hair is required by law to have 1,500 hours of training relative to the cost and effort to acquire the hours of training?

Another illustrative example is minimum wage laws. Although these are very popular among politicians – both democrats and republicans – and among the public, they arguably have some serious negative economic effects. Effective July 24, 2009, the federal minimum wage became $7.25. This law means it is illegal for individuals to hire workers for less than that rate. It also makes it illegal for workers to take a job for less than this amount. On the surface, such a law would seem to help individuals who are stuck in low paying jobs. After all, why should someone who works hard not be able to afford the basic necessities of life? The problem is that the minimum wage makes it more likely that employers will switch from hiring humans (labor) to using machinery (capital), where possible. A good example of this switch from labor to capital can be seen at some airports. In the Atlanta airport, for example, trashcans have been replaced with cans that include electric compactors. This reduces the number of workers that will be needed to collect the garbage. At the Charleston airport, many of the parking booths are now automated. This is just as convenient for customers, but some workers had to find other jobs.

To be clear, this is not an argument against automation, since those workers who are laid off can eventually find a different job. However, the South Carolina examples demonstrate that if the cost of labor is artificially pushed up, employers are more likely to search for less expensive alternatives. Since the higher wage also makes it more attractive for potential workers to find a job, increases in the minimum wage are likely to be followed by
more job applications being submitted. If the employers have more applicants than they have jobs available at the current wage rate (say, the minimum wage), then they must make a decision about who to hire and whose applications to discard. Which applicants are most likely to be offered a job? Those with the most education, skills, and experience will likely get the first job offers. Yet, the purpose of the minimum wage law is to help those with the least education, skills, and experience. So although the minimum wage law is well-intentioned, its actual effect may be to harm those individuals it most seeks to help.

Rent control laws are similar in this regard. Although they are designed and intended to help relatively poor people, rent control laws create artificial shortages of apartments. Since landlords have more tenant applications than apartments, they can pick and choose who to rent the apartments to. When it comes to a choice between a rich and poor tenant, most landlords are going to choose the richer ones. Why not be assured that the rent will get paid? In many cases, landlords often require minimum incomes to qualify to rent. So the rent control law, which is aimed at helping poor people to afford their rent, can often leave them without a home.

The rent control and minimum wage examples are typical economic textbook examples of the unintended consequences of well-meant legislation. Such unintended effects could with careful analysis be predicted prior to enacting new regulations.

Economists have studied regulations in a variety of industries. Such research often exposes unintended consequences of regulations. In many cases, the very people who are supposed to be protected by the regulation end up being harmed. Take, for example, regulations that prevent optometrists from advertising their services. This was the focus of a landmark regulation study (Benham, 1972). Many people believe that advertising increases the price of goods and services since advertising is, in fact, a cost incurred by producers. They can simply pass these costs on to consumers. Yet, Benham found that eyeglass prices were significantly lower in states which allowed optometry advertising. In short, more competition among producers more than offset the costs of advertising, and resulted in benefits to consumers in states that allowed advertising.

This raises the question of when is regulation, in general, going to improve society’s welfare.

**Taking Sides: Consumers or Producers?**

Although not all government regulations impact consumers’ or producers’ behavior, we are concerned here mainly with regulations that do intervene in free market transactions – interactions between willing buyers and sellers. Despite the fact that markets naturally develop to help both consumers and producers serve their own interests, market transactions are, by their nature mutually beneficial. If that were not the case, then the two parties would not willingly transact with each other. This means that producers must create and sell things that the consumers are willing to pay for. Indeed, most production activity is geared toward satisfying consumers. But there are some activities undertaken by the supply side of the market that are unproductive, in the sense that they attempt merely to generate transfers of wealth to benefit them. Such transfers are commonly at the expense of consumers, as a group.

Government regulations are often the result of the rent-seeking behavior, examples of which have been discussed elsewhere in this volume. For example, the regulation requiring

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6 For a more general study on optometry regulation see Haas-Wilson (1986).
hair washers to have 1,500 hours of training was almost certainly the result of the cosmetology industry lobbying government for regulation. Auto manufacturers may favor regulations that specify construction standards, labor practices, environmental regulations, etc. Although this will raise the cost of production, existing firms may be hopeful that the imposition of such costly government regulations will create barriers to entry from new firms. Thus, although their own costs may increase, the existing firms can also charge higher prices when their competition is restricted (see Chapters 3 and 12).

These examples raise an important ‘general rule’ for government to follow in its creation and re-examination of regulation. Resources are scarce and must be allocated to their highest valued uses. The entire study of economics is geared toward addressing the problem of scarcity. In other words, since humans’ desires are greater than the limited resources available to satisfy them, people must make choices. Economists study how choices are made in an effort to best satisfy people’s desires given their limited resources.\(^7\)

We should clearly acknowledge that some level of government regulation can be beneficial to society. For example, we may all agree that some level of workplace safety regulations, or at least a legal burden to provide a safe workplace, is useful. And other regulations that spell-out legal recourse can help the wheels of commerce keep spinning. Socially useful production activities should not be over-regulated. However, business interests may often find that it is easier or less costly to lobby government for favors – through regulations or outright wealth transfers – than focus on lowering costs of production or otherwise improving the competitiveness of their firm or industry. ‘Rent-seeking behavior’ has been addressed elsewhere in this volume, and the discussion below is limited to those types of activities on the part of producers.

If we consider for a moment our overall economic interests from a ‘social’ perspective, it is clear that as a society – whether defined as a small group of friends, the people of a state, or the entire world’s population – we have an interest in abundance. Abundance is the inverse to scarcity. An abundance of everything (money, goods, services, clean air, good health, etc.) would mean that scarcity does not exist. Then humans would not need to make choices, such as, how to spend $100 of income. If everyone had unlimited money to buy unlimited goods and services, no one would need to be concerned with making choices among different products.\(^8\)

It is helpful to dissect the market for goods and services into its two basic components: consumers and producers. (In economic analysis, these refer to the demand curve and supply curve, respectively.) Let us consider whether the self-interest of the two sides of the market is consistent with the interests of society. Recall from above that ‘society’ has an interest in abundance – more goods and services are better than less.

Now consider consumers. They have limited budgets and generally are seeking to get the most goods and services in order to overcome their scarcity problem. In this sense, consumers share the concerns of society overall; their interests are consistent with each other. Now consider producers. What is their interest? If I am a hair stylist, then it is in my best

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\(^{7}\) Scarcity applies not only to money, goods, and services. It also applies to time, for example. We all have limited time each day, but we may have many more tasks than we can expect to complete each day. Scarcity also applies to things like information good health and clean air. These things – “goods” as economists call them – are all scarce.

\(^{8}\) Of course, even in this case there is scarcity. A very rich person can buy any consumer good, but there is not unlimited time to consume it all. So choices must still be made. Although this cannot be ignored, this point is not critical to the main argument.
interest that hair stylist services be scarcer. That is, it is to my benefit if there are few, if any, other hair stylists practicing near me. As a producer my interest is in having scarcity for the good or service that I supply. If I have no competition, then I am able to charge higher prices for my services than I otherwise might. In addition to higher prices, if I have little or no competition, then there is less pressure on me to offer high quality products. Clearly, then, the interests of producers are inconsistent with the interests of society. Consider, in addition, the fact that producers like higher prices for their products as opposed to lower prices. This is in direct conflict with the interests of consumers in particular and society overall. Higher prices mean that the people in society will have lower purchasing power, given income, and will therefore have lower standards of living.

To summarize, consumers in particular and society in general have an interest in lower prices and abundance of the goods and services offered in markets. Producers, on the other hand, have an interest in higher prices and scarcity for the goods and services that they offer for sale. If we were to make a general rule for government regulation, and whether it should come down on the side of helping consumers or producers, then which is better? It should be clear that government will be acting in the interests of society if its regulations generally favor consumers, and not producers.

This general rule might seem clear enough, but it is not always. Consider yet again the regulation requiring 1,500 hours of training to wash hair. The justification for enacting this regulation was most likely ‘the protection of consumers.’ After all, the hair washer is using chemicals that could conceivably cause harm if they are used improperly. This is where common sense and economic analysis are helpful. First, it is arguable whether there is any real danger to consumers from using shampoo in a commercial setting. But more importantly, the policy proposal should be judged not only for its intended effect but also the secondary consequences, as discussed earlier. The policy that requires training for hair stylists effectively restricts the supply of that service. The result is increased scarcity of hair styling services and higher prices. This is detrimental to consumers and society overall, but beneficial to the producers in that industry. Therefore, policies such as licensing requirements for particular jobs, serve to restrict the supply in that industry. The result is higher prices, and quite possibly, lower quality services for consumers. This lower quality may result because with less competition in the market, sellers may not worry as much about being better than the competition.

To be clear, I am not suggesting that all industries focus on lobbying for government favor. However, any regulatory reform that can prevent special treatment for individual firms or industries will generally result in a better, more competitive business environment. This, in turn, will raise the standard of living for residents of South Carolina.

Caveat Emptor

The above discussion is not to say that government should always implement policies to help consumers. Indeed, it would be advisable to not intervene in consumers decisions as much as possible. Policy makers should leave it up to the individual consumer to decide what to purchase from the array of goods and services available in the free market. The consumer is responsible for collecting information on the products they wish to consume. Sellers, for their part, are expected to provide honest information on the products. For most products that one would find at a grocery store or department store, these simple rules of thumb would be
sufficient. For medicines, as an example, one might argue that some sort of information clearinghouse or government agency (such as the FDA) could be warranted. Yet, it is probably rare that the idea of individual liberty is considered when government regulation is being passed.

Caveat emptor, ‘Let the buyer beware’ is a good rule for supporting individual freedom. Businesses who hope to do well will have to convince the public that their products are high quality. Consumers can gain information from their own experience, or the experience of others, through resources such as Consumer Reports or Underwriters Laboratories. The policy recommendation is not to eliminate all regulation regarding consumer transactions, but rather, that politicians in South Carolina and at every level of government give some credit to individuals for being able to make informed consumption decisions on their own. Government does not have to intervene in every transaction.

**Bailouts for Failing Industries?**

Above it was argued that consumers should be left on their own to make decisions about what goods and services to consume. Economists give them the benefit of the doubt that they will tend to consume goods and services that they expect will benefit them. At the same time, producers should be left to their own devices, when it comes to the market test.

As Hazlitt eloquently explains in his chapters on prices and profits (Chapters 15 and 21, respectively), the market provides an extremely efficient way of allocating scarce resources among potential producers of goods and services. Only those firms that can earn a consistent profit will be able to survive in the long run. Profitable firms produce goods and services that consumers want, at a price they are willing to pay. For this to happen, the producer must be able to produce the product for a cost of production below the selling price. The more competitors on the supply side of the market, of course, the lower the market price. This competitive pressure provides incentives for producers to come up with ways to economize – to keep quality high but cost of production. Some producers will not survive. Indeed, most small businesses do not survive their first year. But the willingness of entrepreneurs to take risks is critical for the economy to work.

Markets work best when the signals of profit and loss are allowed to work. That is, ‘profit’ is a signal that the firm is doing something right. (Firms can make changes to increase their rate of profit, but if they are making a profit, it means that their production is socially valuable.) Similarly, a firm that consistently has a negative profit – or losses – is wasting scarce resources. A firm that has continual losses signals that the willingness of consumers to buy the firms’ products is lower than the cost of production. It is in society’s interest that such firms go out of business. This frees up the scarce input resources being used by the firm (labor, capital, natural resources, and entrepreneurship) for use by other firms and industries. As unfortunate as it may be for the affected individuals, some firms going out of business is a necessary part of a functioning market economy.

This point raises an issue related to South Carolina regulation. In particular, state regulations should do nothing to ensure a particular firm’s or industry’s survival. State government should never use taxpayers’ money to support failing industries. Subsidies to

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9 Underwriters Laboratories® is a private and independent organization that conducts product safety certification tests and has been writing standards for safety for over a century.

such industries, as an example, cost both taxpayers and consumers, only to benefit industries that are already using scarce resources wastefully.

Based on these principles, the recent federal government bailouts of the auto industry are misguided. Similarly, policies that use taxpayer money to encourage the purchase of products produced only in South Carolina are wasteful. We will examine an example of this type of policy in more detail below.

The overall point of this analysis is that government should not side with consumers or producers in their market transactions. Consumers should be responsible for their own behavior, and producers should be required to survive the market profit test. Government involvement through regulation that intervenes in transactions wastes taxpayer money and impedes the important functions of markets. Such interventions should be avoided in South Carolina. If our state could develop a reputation in the United States for being a market-friendly state, it would attract more industry, which would enhance economic growth, as discussed earlier in this book.

**Sunset Provisions**

Along with the other general principles for regulatory reform discussed thus far, all new legislation should include ‘sunset provisions,’ or dates upon which the legislation automatically becomes void. Such a provision serves several valuable purposes.

First, an automatic sunset provision inserted into every regulation would ensure that the state government would have to review regulations periodically. For example, if the standard sunset provision was five years, then a regulation would automatically become void five years after its passage, unless legislators specifically renew the regulation. This provision may encourage politicians to review legislation prior to renewing it. For those regulations that are not addressed, they would be automatically eliminated which will keep the regulatory code shorter than it might otherwise be.

A second benefit of sunset provisions is that they would create the potential for new debate prior to regulations being renewed. Again this helps to ensure that whatever regulations exist continue to be current and relevant. Information over the past consequences of the legislation could enter into the debate and, in the long term, this strategy may lead policy makers in South Carolina to more thoroughly evaluate regulations before enacting them.

Each state has meaningless laws, and South Carolina is no exception. For example, many South Carolinians are familiar with rumored laws that, for example, it is legal to beat your wife on the courthouse steps on Sundays, and adult males are by law required to bring a rifle to church on Sundays in order to ward off an Indian attack.10

These laws sound silly, but there are some other laws that have very recently been enforced and are the subjects of current legal battles. For example, recently in Mount Pleasant, South Carolina, authorities decided to enforce the state’s gambling laws. Police raided and arrested about 20 participants in a home poker game in April 2006. There is now a legal battle in the state over the antiquated gambling laws, which can be interpreted to ban board games. The legal battle has been ongoing for a couple of years, with a statewide legal

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10 For a list of these types of laws in South Carolina, see www.dumblaws.com. The listing does not provide the actual statutes, in many cases.
battle over gambling looming. The law in question reads (South Carolina Regulatory Code section 16-19-40, unlawful games and betting):

If any person shall play at any tavern, inn, store for the retailing of spirituous liquors or in any house used as a place of gaming, barn, kitchen, stable or other outhouse, street, highway, open wood, race field or open place at (a) any game with cards or dice, (b) any gaming table, commonly called A, B, C, or E, O, or any gaming table known or distinguished by any other letters or by any figures, (c) any roly-poly table, (d) rouge et noir, (e) any faro bank (f) any other table or bank of the same or the like kind under any denomination whatsoever or (g) any machine or device licensed pursuant to Section 12-21-2720 and used for gambling purposes, except the games of billiards, bowls, backgammon, chess, draughts, or whist when there is no betting on any such game of billiards, bowls, backgammon, chess, draughts, or whist or shall bet on the sides or hands of such as do game, upon being convicted thereof, before any magistrate, shall be imprisoned for a period of not over thirty days or fined not over one hundred dollars, and every person so keeping such tavern, inn, retail store, public place, or house used as a place for gaming or such other house shall, upon being convicted thereof, upon indictment, be imprisoned for a period not exceeding twelve months and forfeit a sum not exceeding two thousand dollars, for each and every offense.11

Note first that the regulation is written in a way that is very difficult for an average person to read. Also note that it specifies the ‘outhouse’ as a place gambling should not occur. The law is outdated, and should be revisited. More importantly, the law violates the principle of mutually beneficial exchange. Why should government ban such games? If the government of South Carolina wishes to ban gambling, then the state lottery should be illegal. The most serious problem with this type of law, however, is that it is selectively enforced, as it was in Mount Pleasant. Charities often hold ‘casino nights’ or bingo games, and the police do not enforce the gambling law. There are countless private poker games that occur in South Carolina without police enforcement. Why enforce the gambling law in Mount Pleasant, when there are much more pressing issues the police could address? The regulation should be updated to at least the 20th century.

Several principles have been outlined in this chapter, which could help inform regulatory reviews in South Carolina. These principles also apply when politicians are drafting new regulations.

First, legislators should consider all of the costs and benefits of their regulations, both in the long and short term, and the impacts on all groups, not just beneficiaries. All policy proposals should consider any unintended consequences that may be predictable. All levels of government can provide examples of laws which have unintended negative consequences.

Second, it is not necessary for government to choose sides between consumers and producers. In most cases, free markets efficiently allocate scarce resources, and government intervention is unnecessary and even causes decreases in overall wealth. However, if the government is going to pass regulations and such regulations are going to side with either consumers or producers, consumers should be supported as their interests are consistent with

those of society. Consumers like abundance, while suppliers like scarcity of the products they produce. The supply side of the market does not need government support, since what industries survive and fail are already regulated by markets.

This is not to say that we do not need government. Indeed, as recent scandals have shown, some government oversight of the market is necessary. It is government’s job to enforce contracts, to punish fraudulent behavior, and to penalize those who violate others’ property rights. When government fails in these basic functions it is partially because the focus of government is spread across too many different functions. Many regulations represent distractions from the core role of government.

**EXAMPLES OF WASTEFUL AND INEFFICIENT REGULATIONS IN SOUTH CAROLINA**

South Carolina has several regulations that would, under the principles outlined above, either be eliminated or largely revised. What follows are but a few examples of these wasteful regulations. The underlying goal in recommending that legislators evaluate policies on their potential to create a net benefit, is so they allow individuals to keep their freedoms and accept the consequences of their decisions, and that what regulations are kept are periodically reviewed, is that regulations should become less burdensome to individuals who are participating in markets in South Carolina.

Adam Smith explained, when individuals are free to act in their self-interest, their pursuits are usually consistent with the best interests of society. There are, of course, some exceptions to this view, but free market competition requires that the best policy is to design government institutions and regulations that allow the incentives of decentralized decision makers dictate what is produced and consumed in society. When one reads some of the South Carolina regulations it becomes clear that the state government has gone astray from the basic principles of government. These examples are only representative of some much larger and more pervasive regulatory reforms that are needed in the state.

**PROFESSIONAL LICENSING REQUIREMENTS**

In May 2008, the governor’s office reported that it had signed a law to repeal the 1,500 hour training requirement for hair washers. This is the type of action that should be taken on a whole array of regulations in South Carolina that protect producers and impose unnecessary costs on consumers.

There is no economic or legal justification for the State of South Carolina to regulate or license, in any way, the training required of cosmetologists, hair stylists, or hair washers. If a business owner is incompetent in his/her practice, the consumers will stop using their services and the firm will go out of business. The free market through profits and losses constantly regulates the hair care services industry. What such regulations tend to do, not only in cosmetology/beauty industries, but also for any variety of professions, is to artificially restrict the number of practitioners. This unambiguously results in a lower quantity of services offered and higher prices. The supposed benefits to consumers that result from such regulations, such as higher quality, are questionable.
This provides just one example where the legislature and governor of South Carolina moved toward the type of regulatory reform that can improve economic well-being. Policy makers could go further, however, and eliminate the 1,500 hour training requirement for cosmetologists. Many industries license practitioners, including lawyers and medical doctors. It is fine if these industries would like to have their own professional organizations to specify requirements for membership. It is not necessary that the state government require that every individual practicing in the state be a member of such organization. Consumers can choose for themselves.

Like many other areas of government regulation, economists have even studied the cosmetology profession and regulations governing it. For example, Adams, Jackson, and Ekelund (2002, 273) study the cosmetology industry, and find that regulatory requirements for practicing have resulted in an increase in overall prices, and a reduction in the quantity of such services produced and consumed in the United States. In particularly, every state (as of their study) required a state examination, including written and practical sections (Adams et al., 262). The average number of hours of school training was 1,607. Oregon actually required 2,300 hours of training! In each state there was an application fee. All of these things restrict the quantity of cosmetology services and raise the prices because supply is artificially limited. Perhaps more importantly, Adams et al. (2002) conclude that the regulations cause enormous deadweight losses and rent transfers due to the regulations in the United States — around $1.8 billion total, per year. That is an astonishing cost for what might seem to be relatively minor regulations on a relatively minor industry.

The State of South Carolina also regulates who can practice massage in the state. Individuals who wish to practice massage therapy upon completion of formal training must pay fees to the state to obtain a license. One of the licensing requirements is that the individual:

completes a massage therapy program of five hundred hours of supervised study at an approved massage/bodywork school. Approved schools are those found by the Department to have met the minimum qualifications as set forth by the Commission on Higher Education for such programs… (South Carolina Code Ch. 77-100(b))

This case is the same as the previous one. Consumers can evaluate the qualifications of massage therapists on their own. State government officials have no specialized knowledge in this area, and the licensing requirement is an obvious attempt by individuals in the massage industry to restrict the supply of massage therapists. If consumers want massage therapists with lots of training, they can simply ask the provider what training they have had. It is beyond the necessary role of government to license this industry. As in the above case, simply because there is government licensing does nothing to ensure that consumers receive a higher-quality service.12

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12 Earlier I discussed research on regulations on optometry advertising. Title 40 of the South Carolina Code addresses optometry. The law only requires truth in advertising; there is no ban on advertising prices or services. But like other professions, the state controls the regulatory framework for the profession. See http://www.scstatehouse.gov/code/t40c037.htm for more information.
MANUFACTURED HOUSING BOARD

Chapter 79 of The South Carolina Code of Regulations outlines the “Uniform Standards Code for Manufactured Housing Act.” The regulation runs a full 20 pages (printed in very small font), with the first two pages being dedicated to defining words such as ‘approved,’ ‘habitable room,’ ‘repair,’ and ‘structure.’ Section 2 lists the eight different types of licenses that must be issued by the South Carolina Manufactured Housing Board. Anyone who engages “in any business regulated by the Act” must have one of these licenses that include:

- Manufactured Home Manufacturer
- Manufactured Home Retail Dealer
- Manufactured Home Retail Salesperson
- Manufactured Home Retail Multi-Lot Salesperson
- Manufactured Home Show Permit/Temporary
- Manufactured Home Installer
- Manufactured Home Repairer
- Manufactured Home Contractor

Of course, the applicant must pay a fee to the state and provide a list of information and qualifications to the board. The Manufacturing Housing Board notes that if it receives a bad check from any licensee, and it is not made good within ten days, this is “considered prima facie evidence of untrustworthiness or incompetency in such a manner as to endanger the interest of the public” (79-5). Why is bouncing a check in this context a danger to the ‘public interest’ any more than if I bounce a check to Wal-Mart? Laws already exist to protect individuals for cases of failure to pay in fulfillment of a contract. This additional regulation is unnecessary and inefficient. The regulations go on to explain what each license allows its holder to do, with respect to the trailer business. These regulations were written to benefit the manufactured housing industry. As noted elsewhere in this book, policy makers rarely have the specialized knowledge in this or other aspects of resource allocation to know whether regulating this industry will provide a net benefit to South Carolinians.

The point here is that even for such a small industry like mobile homes, the state finds it necessary to involve itself in every aspect of this industry. There is no reason a private trade association could not serve exactly the same purpose that the government regulations serve. Indeed, there is no compelling reason to have government involved in any way in this industry.

As with hair washers and massage therapists, the license for working with any aspect of the trailer business requires proof of training and written examinations on various aspects of the duties. As in the case of most professions and businesses, the state has no special expertise in the industry. Yet, it licenses those people in the industry, charging each individual substantial fees (at least $100 for a two-year license). While advocates of these regulations might argue that it helps ensure that only trained professionals work in the industry, the market is arguably much more effective at regulating the industry. Consumers’ can ask for recommendations from prior customers, for example. They can demand legally binding
warranties from the manufacturers, repairmen, etc., prior to entering into transactions with them.\(^{13}\)

The mobile home industry itself can have its own trade organization. The organization could adopt the same regulations that the state currently requires. The point is that the government need not make compliance to these regulations a legal requirement. If the ‘protections for consumers’ are deemed important by the consumer, they will patronize only those trailer sellers who have the particular training/license.

The fact that the state licenses people in this industry is another example where an industry is engaging in unproductive entrepreneurship to benefit through regulation at the expense of consumers. These regulations effectively restrict the supply of mobile homes and thereby increase the prices consumers will have to pay. Although supporters of the regulations could argue that they are designed to protect consumers, the regulations fail a cost-benefit test. There is no evidence that regulations help consumers, yet they are very costly.

These regulations, and others like them, should be reviewed and perhaps repealed. As with the above example, the Manufactured Housing Board regulations fail when compared to the general principles outlined earlier in the chapter. The only likely benefits of these regulations is that it helps restrict the supply side of the market and keeps prices higher for those who might wish to enter the industry.

‘Sustainable Agriculture’ in South Carolina

The South Carolina Department of Agriculture has its ‘Palmettovore’ and ‘Certified SC Grown’ programs, which were recently the focus of a South Carolina Policy Council article (2009).\(^{14}\) The program is geared toward encouraging individuals to purchase and consume only agricultural products grown and processed in South Carolina.

This program uses taxpayers’ money to promote the consumption of products produced within South Carolina. The goal of the program, of course, is to encourage people to ‘live locally.’ By supporting producers who live around you, they can support other local businesses, and this should help the local economy. At the same time, if agricultural products, seafood, etc., are purchased from local or in-state vendors, the environmental impact will be smaller since transportation costs would arguably be lower over shorter distances. Proponents also argue that the produce or seafood will be fresher since it has to travel a shorter distance.

It may, of course, be true that foods that are produced locally or are shipped shorter distances will taste better or will have less of a negative environmental impact than products brought in from further distances. Indeed, many restaurants in Charleston, South Carolina for example, actively promote the fact that they use local seafood and other ingredients. Many consumers value this, for many of the reasons that the Palmettovore promotion explains. Simply because the program might have some of the merits proponents claim does not mean that the program is an appropriate function of government and a worthwhile use of taxpayer money.

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\(^{13}\) Angie’s List is one example of an independent private market solution to provide customers with information about quality and reliability of services. Customers provide reviews online of service providers for 250 different services.

In effect, the ‘Palmettovore’ and ‘Certified SC Grown’ programs require that taxpayers’ money be taken and used to produce promotional material for these programs that benefit South Carolina producers. If the SC Grown proponents are correct – if locally grown products are better tasting, have less of a negative environmental impact, or are otherwise better than ‘non-local’ products, then it would not be necessary for the government to promote them. Here again, free markets serve precisely this function. The program is a veiled attempt at producing benefits for the agriculture industry in South Carolina at the expense of taxpayers. If local producers wish to advertise their quality and encourage people to buy their products, this should be done at their own expense, not at the expense of taxpayers.

One argument proponents may give in response to this is that sometimes foreign producers receive government subsidies to export their products. The 19th century French economist and statesman Frederic Bastiat addressed this issue in his famous sophism, ‘The Petition of the Candle-makers.’ Bastiat shows how producers often lobby government to protect producers in an industry, at the expense of taxpayers and consumers. Bastiat uses a similar argument as the ‘Grown in SC’ proponents to show how fallacious these arguments can be. In his story, the candle-makers are lobbying government to outlaw the free use of sunlight. Since sunlight is free, it represents vigorous competition to the candle-making industry. Since there is such a low-cost option to candles, the candle-making industry argues that it is unfair and asks that all windows be covered. In addition, support of the candle-makers business will mean they will have more money to spend on other local businesses. This type of protectionist argument to ‘buy SC grown’ whether used to restrict foreign trade or trade from other states limits growth and trade to South Carolina.

Consumers already have the incentives to buy the best quality, lowest price products. If South Carolina products are really better tasting, and they are more environmentally friendly, then consumers should already be willing to buy them. If foreign producers, or producers from other states, are able to supply products of similar quality at lower prices, then consumers will favor the ‘foreign’ products.’ South Carolina farmers and fishermen are free to promote locally grown products at their own expense and not have government tax consumers to advertise buying local products. If local farmers or fishermen cannot compete, then productive resources are better used in other industries.

This argument comes down to comparative advantage, specialization, and the benefits from trade. Almost all parties benefit when we specialize in areas for which we have a comparative advantage in production. Yes, specialization based on comparative advantage does mean that jobs will be lost in certain industries, but such labor is then freed-up to be employed in other industries. South Carolina regulations should encourage specialization and trade, not restrict it.

While it may be true that South Carolina agricultural products and seafood are better quality and taste better, it should be left up to the producers to market their products to consumers. It is fine if they wish to fund programs like ‘Palmettovore’ or ‘Certified SC Grown’ these may be effective programs, but these programs should be paid for by the farmers and fishermen who expect to benefit from them. These ‘buy local’ programs are an inappropriate and wasteful use of taxpayers’ money.
REGULATORY REFORM AND ECONOMIC GROWTH

One of the problems that plagues the regulatory environment in South Carolina (as well as other states, and the federal level), is that voters and politicians naturally want government to act when it appears government could do something to improve a situation or help one group of people. For example, government often intervenes in mutually beneficial, voluntary transactions. Yet, the United States was founded on principles of individual economic freedom, where individuals have the right to use their property as they please, so long as they are not harming other people.

When it comes to economic activity, to which many regulations apply, the government is interfering with voluntary transactions. So we need not necessarily defer to a cost-benefit analysis of a particular regulation. Let us first consider the principle of individual liberty. In free markets, individuals can produce and consume whatever goods they wish to, so long as they are not intentionally harming others. In cases where some harm occurs due to negligence or fraud the legal system exists to deal with these situations. In minor cases when consumers are not happy with the products they have purchased, they are free to ‘vote with their dollars.’ This market test regulates who stays in business and who does not.

A larger point to be made here is that these types of regulations will severely restrict entrepreneurial activities in the state. If individuals who recognize profit opportunities must work through tomes of regulations before acting, many people with good ideas will not bother.

There are numerous international examples that can illustrate this point. For example, Doing Business ranks countries based on their regulatory environment and reforms to encourage economic development. Types of changes include the protection of property rights and streamlining of bureaucratic hurdles to opening businesses. Just as countries around the globe that make it easier for individuals to trade and engage in businesses will see increased economic development, the same is true for individual states in our country. Although South Carolina is relatively poor for the United States, it could potentially improve its rankings if it would do more to promote economic activity. In general, this means reducing the cost of doing business in the state – minimizing the cost of complying with regulations.

Since special interests in a particular industry have lobbied government to create numerous regulations, it significantly raises the costs to newcomers to the industry. South Carolina must reverse this trend. Removing state regulations would encourage new people to enter business. This creates more competition for other sellers, resulting in higher quality products, more products, and lower prices for consumers.

What about protecting the consumers? Producers who sell shoddy products or whose negligence harms consumers will be held responsible in the court system. Products that are low quality or otherwise disliked by consumers will not survive the consumers’ voting with their dollars. Regulations do little to preclude poor quality or incompetent services. These problems are best addressed through legal action on the part of victims. However, South Carolina and most other states have, over a long period of time, crowded the law books with regulations with the stated purpose of protecting consumers, but with the actual effect of protecting suppliers already in the industry from new potential competition.

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15 See [www.doingbusiness.org](http://www.doingbusiness.org) for information.
CONCLUSION

South Carolina does have a market-friendly regulatory system, compared to many other states. Still there is room for improvement. Legislators should revisit existing regulations and check whether the regulations are actually serving the general public or some special interest group. Those that do not serve the public interest should be eliminated.

Private organizations can and do exist to provide useful information to concerned citizens and to policy makers in helping to guide South Carolina in the direction of a more market-friendly business environment.16

Lawmakers, for their part, should review regulations periodically and evaluate them for costs and benefits. Eliminate those regulations whose costs outweigh their benefits; eliminate those regulations that merely serve a particular interest group. For all new regulations, put sunset provisions so that the regulations in the state do not continue to grow as new regulations are stacked atop old ones. Minimize the state’s regulatory code so that citizens can understand it. If South Carolina citizens can convince their policy makers to engage in regulatory reform in a significant way, South Carolina can gain a reputation in the nation for being a low-regulation, market-friendly state. This will encourage the creation of new businesses and the growth of new ones. This will help stem our relatively high unemployment rate, and will help increase our rate of economic growth. With significant changes, South Carolina could finally move from the bottom of the state economic rankings.

16 The South Carolina Policy Council has done an admirable job of watching state legislation and publicizing unnecessary or anti-market regulations.
REFERENCES


The effective tax rate on industrial property is over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in the figure because it is the lowest-tax state.)

Notice that South Carolina's effective tax rate on industrial property is $12.5 million ($12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5 million in fixtures). The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million ($200,000 in manufacturing property tax in the country). In Figure 5.8 we present the effective property tax revenue may in fact increase once the growth rate in the state begins to pick up and more revenue may in fact increase once the growth rate in the state begins to pick up and more...

Although it is probably not critical that South Carolina set its tax rate to the lowest in the country, it should definitely make it at least competitive for the Southeast. Since one of the lowest per capita incomes and economic growth rates in the country.

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate that puts South Carolina at a serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has...
CHAPTER 9

WORKFORCE DEVELOPMENT REQUIRES EDUCATIONAL REFORM

by L. Brooke Conaway
CHAPTER 5: SPECIFIC TAX REFORMS

The figure clearly shows that the 1959 indexed tax rate structure is more uniformly progressive, and because of the graduated marginal tax rates. However, since the marginal tax rate exists in the state's income tax structure is due to the zero tax on the first $2,630 of income, the vertical equity condition, it really does this only at the lower income levels reducing the average tax rate hardly increases at all. This nature of the current tax is directly contradictory and because of the graduated marginal tax rates was to make the income tax progressive. However, what progressivity among the most important building blocks of the economy almost doubled from that of the bottom ten states in the nation.

The current tax brackets remain the same as the previous year. The only exception is the $5,000 income earner in the $25,000 to $50,000 bracket. This is due to the $5,000 income earner in the $25,000 to $50,000 bracket.

The table. As South Carolina income taxes continue to climb while the tax brackets remain the same as the previous year. The only exception is the $5,000 income earner in the $25,000 to $50,000 bracket.

Inflation-indexed rates, 2009

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$200,000</td>
<td>$13,554</td>
</tr>
<tr>
<td>$150,000</td>
<td>$12,054</td>
</tr>
<tr>
<td>$100,000</td>
<td>$6,554</td>
</tr>
<tr>
<td>$75,000</td>
<td>$4,804</td>
</tr>
<tr>
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<td>$3,054</td>
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<td>$30,000</td>
<td>$1,654</td>
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<tr>
<td>$10,000</td>
<td>$208</td>
</tr>
<tr>
<td>$5,000</td>
<td>$104</td>
</tr>
</tbody>
</table>

The rates data for Southeastern states, for comparison. The ranks given for the states are out of all 50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million in fixtures. Notice that South Carolina's effective tax rate on industrial property is over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in the table.)

Furthermore, if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more industry moves into the state. Such a significant reduction in taxes on industrial property would obviously lead to a serious improvement in the state's competitiveness.

Table 5.8: Industrial Property Taxes in Southeastern states*, 2007

<table>
<thead>
<tr>
<th>State</th>
<th>Rank (50)</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Louisiana</td>
<td>17</td>
<td>$783,407</td>
<td>0.48%</td>
</tr>
<tr>
<td>Texas</td>
<td>6</td>
<td>$1,264,358</td>
<td>0.76%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>4</td>
<td>$1,291,050</td>
<td>0.98%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>10</td>
<td>$1,033,544</td>
<td>1.11%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>1</td>
<td>$1,864,900</td>
<td>1.36%</td>
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<td>South Carolina</td>
<td>1</td>
<td>$1,864,900</td>
<td>1.36%</td>
</tr>
</tbody>
</table>

This puts South Carolina at a disadvantage compared to other Southeastern states. Therefore, it should definitely make it at least competitive with the Southeast. Since it has one of the lowest per capita incomes and economic growth rates in the country, it should definitely make it at least competitive with the Southeast.
9

WORKFORCE DEVELOPMENT REQUIRES EDUCATIONAL REFORM

L. Brooke Conaway

CURRENT ECONOMIC STATE AND EDUCATIONAL OUTPUT IN SOUTH CAROLINA

The current state of South Carolina’s economy seems bleak as it continues to rank in the bottom ten states in the nation in both measures of per capita income and per capita gross state product. It also remains in the top ten states with the highest unemployment rate and the largest portion of population below the poverty level. The unemployment rate in 2009 has almost doubled from that of 2008, which pushed South Carolina from having the fifth largest unemployment rate to having the fourth largest rate in the nation. While the unemployment rate is rising for all areas as the United States weathered the recent recession, it is more important than ever to make sure that shrinking state and federal budgets are spent efficiently to ensure economic growth for the future.

Among the most important building blocks for future economic growth is educational reform. An important part of South Carolina’s future lies in the hands of its students, and it is vital that they be adequately prepared to be diverse in the type of labor they can offer and be flexible as the needs of the economy change. It is well known by economists that investment in human capital is a major component of economic well-being, yet current investments in South Carolina’s education system do not appear to be paying off (Sobel and King 2008). Students seem to be unprepared for many types of labor, suggesting some defect in the educational system that is failing to prepare them to be adaptive in their future endeavors.

Many individuals in South Carolina are ill-prepared to face changing economic conditions and lack the necessary skills to successfully adapt. Rather than acquire additional education or training, business and labor are lobbying governments to keep failing industries afloat. Better educated workers are more likely to be able to switch industries to keep up with the ever changing demand for labor as efficiency dictates labor’s best use. For instance, imagine if we had kept the railroad industry as the main source of transportation and transit with the massive public funding that we are currently spending on the automotive industry? If the railroad workers had not been able to adjust when the industry began to decline, our economy would be much worse as a result. Unfortunately, it seems that South Carolina’s and the U.S. workforce as a whole now attempts to remain in declining industries for the sake of keeping those particular jobs at the expense of economic growth, new jobs, and new skills.

In addition to propagating the inefficient use of the labor force, it seems that those without the resources to seek a better future are stuck in a cycle of poor educational investment. The current economic system in South Carolina unofficially dictates the types of students that are able to attend private schools because generally parents with higher incomes are the only ones able to afford private school tuition. This system tends to leave many less fortunate children behind in public schools to continue the cycle of receiving a lower quality education, which will assuredly lead to fewer skills and options for the future. This is certainly not to say that all public schools offer a low quality education or that public schools are filled with only the underprivileged. It is merely an observation that parents must pay if they want more choices for their children’s education and that those who are unable to pay may suffer the consequences of fewer educational options.

Figure 9.1: South Carolina and National Average ACT Scores over Time

![Graph showing ACT scores over time]

Figure 9.2: South Carolina Average SAT Scores over Time

![Graph showing SAT scores over time]
Seniors and juniors declining college entrance exam scores are perhaps demonstrative of workers in South Carolina being unprepared for the labor market changes that often occur with growth. Average SAT and ACT scores for public school students show that South Carolina is at the bottom of the pile when it comes to preparing students for college. As shown in Figures 9.1 and 9.2 on previous page, ACT scores have shown little improvement in past years. More recently math and verbal SAT scores have been falling since 2005. South Carolina’s SAT and ACT scores have been consistently in the bottom five worst state averages for at least the last fifteen years.

South Carolina students showed a slight improvement (less than half a point) in the ACT score since 2004, yet there has been a downturn as of this year. While, SAT scores are now almost back down to their levels at the beginning of the decade. The most recent ACT report also notes that only 58 percent of graduating students are ready for the course rigor of college English, 42 percent are ready for college reading, 35 percent are ready for college math and only 20 percent are ready for college science. Most shocking is that a mere 18 percent of South Carolina public schools managed to meet federal standards of adequate academic yearly progress, established by the No Child Left Behind Act, for the 2008 school year.

Examining both economic and educational output data, it seems as though South Carolina is generating relatively undesirable outcomes with its current education policies. Investment in education over the last several years has failed to generate favorable increases in educational output, which in turn has failed to help improve the state of the economy as a whole. In order to turn the current situation around, South Carolinians must look at what is being done right and what is being done wrong when it comes to state policy on education. The following sections will discuss South Carolina’s educational spending over the last several years, why the current educational policies are not working, and possible policy reforms that will breed better results. The last section of the chapter contains concluding remarks about the effects better educational investment will have on South Carolina’s economy.

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PUBLIC INVESTMENT IN EDUCATION FOR SOUTH CAROLINA

South Carolinians must examine how their students are being educated and where taxpayer money is being spent to understand why this lack of preparation for the labor force continues. Over the last several years, real spending per child in South Carolina has increased from $8336 in 2002 to $11,480 in 2008. The growth rate of spending per child has increased from a modest 0.8 percent per year from 2002 to 2004, to much larger growth rates of 6 percent and 7 percent in 2005 and 2006, respectively. In fact, spending has grown by almost 20 percent from 2006 to 2008.  

Compared to the neighboring states of North Carolina and Georgia, these are large increases in spending over the last few years. North Carolina’s expenditures per student have been consistently lower compared to South Carolina’s spending per student, and Georgia’s has been only slightly higher with an ever shrinking gap. In 2006 North Carolina spent less per child than South Carolina did in 2002, yet students were producing higher test scores. In addition, South Carolina saw declining SAT and ACT scores around the same time these heavy spending increases occurred (shown in Figures 9.1 and 9.2).

The composition of educational spending in each state is divided into operating, total capital and non K-12 categories of expenditures. Operating expenditures include money spent on instruction and pupil support. Over the last 10 years, both Georgia and North Carolina spent at least 3-7 percent more on this type of spending than South Carolina. Within the category of instruction and pupil support, both states also spent 3-4 percent more directly on the classroom instruction. Previous research has shown that it is the quality of spending, not the quantity, that generates better educational output. Research by Hanushek (2005a) reported that more spending does not translate into better educational output, but improving the quality of spending does increase educational output. Education funds should be allocated to those inputs that generate the most output per dollar, and the data suggests that North Carolina and Georgia have figured out what those inputs are, while South Carolina is being left behind.

Has any good come from the additional spending in terms of educational output or in building human capital in South Carolina’s public school system? As noted above, Figures 9.1 and 9.2 shows that ACT and SAT scores have declined since spending has increased. How about the performance of students in lower grade levels for students who are not on the brink of graduation? Using reading and math proficiency exams over grades 1-12 to measure educational output, the data suggests the research is true. Not a single grade in South Carolina schools has shown consistent improvement from 2003-2007, and most have had either continually smaller increases in improvement or decreases in improvement during this time frame.

Compared to Georgia and North Carolina, South Carolina’s reading and math scores are 30-60 percent lower for the percentage of students in each grade who are proficient. So, it seems that North Carolina and Georgia are spending less and getting more, while it is the
other way around for South Carolina.\textsuperscript{12} These comparisons show why educational productivity per dollar spent is so important, especially in the face of shrinking state budgets. They also show that it is possible to spend fewer tax dollars on education and obtain more from educational investments.

**Incentive Problems in Traditional Public Schools**

How did all this additional spending generate such poor educational rankings in South Carolina? In order to answer this question of how South Carolina is spending more and achieving less it is imperative to understand the incentive problems traditional public schools face, especially with little geographic competition. If the incentive problems are not addressed, South Carolinians will continue to see more public funds spent with little educational improvement. Of course public schools have in mind the goal of educational quality for their students, but they are also interested in budget maximization.

Public schools that do not use the budget allotted to them typically lose some funding; therefore, it may be in a public school’s best interest to find ways to spend all of their budget. This incentive problem is one of many that helps discourage quality spending on education. Rather than choosing to spend money on inputs that generate better educational output from students, the budget may be spent on materials for those who lobby the most for additional funds. For example, a technology-earmarked budget might be spent on new technology that provides little marginal benefit over the old technology.

As an anecdotal example of this type of spending, for many years our family-owned computer business sold computers to the local public schools in return for budgetary funds earmarked for technology spending. New computers were purchased every year that were only marginally better than the computers purchased the previous school year; however, if these funds were not spent they would not be re-allocated the next school year. Old computers were cycled down as protocol allowed to other government projects with smaller budgets such as after-school and in-school suspension programs; however, many times these year-old computers were hauled away to older, little-used government buildings and were sold as government surplus by the pallet for next to nothing.

Even though these year-old computers were equally as functional as the newly purchased computers for school labs, the budget was exhausted simply to retain the same or better budgetary allocations for the next fiscal year. Is it true that tax dollars spent in such a way really improve the quality of education received by public school students? Since we see other states, such as North Carolina, spending less money on education and producing better output, one can argue that North Carolina is spending its taxpayers’ money more efficiently to increase the quality of public school education.

Another incentive problem that could explain these poor outcomes is the ‘principal-agent problem.’ The principal-agent problem is merely a misalignment of incentives between the principal (i.e. parent of a public school child) and the agents acting on the principal’s behalf (i.e. teachers and administrators in the public school system). The parents wish is to have their children receive the best education possible, yet there is little that can be done to

\textsuperscript{12} Note: Georgia’s spending is higher, but has declined over the years nearly to South Carolina’s level. North Carolina’s has shown small increases in spending, yet has been consistently lower than South Carolina. Information from “Spending, Revenue and Taxes,” School Data Direct tables for Georgia, North Carolina and South Carolina, Available at: \url{http://www.schooldatadirect.org/}. 
ensure the agent has the same alignment of incentives to result in those same objectives. This problem is likely to be worse the fewer school choices available to parents and students. This does not mean that public school administrators and teachers do not care about the well being of the children with whom they are entrusted to educate.

Quite the contrary, many teachers and public school officials go into the profession because they want to help provide a nurturing and educational environment for students. Why then might the educational system remain in its current state and generate misaligned incentives between parents and schools? The answer may lie, in part, in the final destination of the tax dollars spent per pupil. According to the National Center for Educational Statistics (NCES), only 49 cents of every dollar spent goes to actual instruction expenditures. The rest seems to go to fund the bureaucracy that keeps this educational system in place.13

School budgets are determined by district administrators and are typically earmarked so that when the money gets to the school how it will be spent has already been pre-determined. This type of budgeting prevents each school from deciding where the money would best be spent and forces those actually working with students to resort to other measures to try and increase quality. Many times teachers spend their own money to make sure students are given a better education. One recent nationwide survey showed that nearly half of the teachers that responded spent $500 or more per year out-of-pocket, and some as much as $3500 per year.14

Because the public education system is very convoluted, parents are likely to be unsure of who to hold responsible for declining public educational quality and what to do to change it. Parents do not typically interact with district level and higher-up school authorities, but rather see teachers and school staff on a regular basis. It may be easy for the parent to blame the teacher rather than the administrator simply because of proximity. The administrators working outside of the school itself are far removed from the day-to-day interaction with students, yet it is they who decide where most of the public funds are spent. Teachers might find it difficult to be held responsible for the results of inefficiencies in spending when they have very little discretion in how these funds are spent.

It is also the administrators who tend to receive the higher salaries rather than the teachers and staff who offer a more direct impact on student education. The larger the administrator’s salary, the greater is the incentive to ensure their job security. Any blame for poor school performance can easily be pushed by the administrator to the school itself in order to avoid losing public favor and employment. So, the teachers who are in need of the greatest incentive to generate the highest educational quality receive the most blame and lower pay. As discussed earlier, we can see that there is a big difference between South Carolina and its neighboring states, Georgia and North Carolina, when it comes to the composition of expenditures. South Carolina has consistently spent less on instruction and pupil support and has seen a decline in educational output per dollar spent.15 For instance, NCES graduation rates in 2004 for South Carolina were less than either Georgia or North Carolina, see Figure 9.3.

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15 Georgia, North Carolina and South Carolina spending distribution information found under Spending, Revenue and Taxes, School Data Direct tables, Available at: [http://www.schooldatadirect.org/](http://www.schooldatadirect.org/)
Figure 9.3 Expenditures per Student and Graduation Rates

<table>
<thead>
<tr>
<th>State</th>
<th>Expenditure per Student</th>
<th>Number of districts</th>
<th>Enrollment</th>
<th>Graduation Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>$7,423</td>
<td>180</td>
<td>1,522,424</td>
<td>61.2</td>
</tr>
<tr>
<td>North Carolina</td>
<td>$6,960</td>
<td>117</td>
<td>1,325,707</td>
<td>71.4</td>
</tr>
<tr>
<td>South Carolina</td>
<td>$7,137</td>
<td>85</td>
<td>696,376</td>
<td>60.6</td>
</tr>
</tbody>
</table>


One can imagine that being blamed for spending inefficiencies would dishearten even the most genuinely motivated teachers and provide a disincentive to improve educational quality. Personal goodwill and out-of-pocket spending must be relied upon in many situations in order for public school teachers to go above and beyond their job duties and provide a higher quality education. Some teachers are quite content to provide this goodwill and extra work because charitable acts provide them pleasure. Unfortunately, many individuals are not prone to be this benevolent without the proper incentives, and many teachers are not able to afford these additional expenses to help their students receive a better education.

School principals are the only link between administrators and teachers, and school boards have discretion in the direction of funds spending; therefore, it is likely very difficult for school principals to act as managers and create successful incentive programs to generate better educational quality and to make sure funds are spent where that particular school needs them the most. Relying on the goodwill of others and on a far-removed administration to efficiently earmark school budgets is not a safe bet when it comes to educating children in South Carolina. This issue will be discussed in more detail in Chapter 10.

**CURRENT SOUTH CAROLINA SCHOOL CHOICE PROGRAM**

What is South Carolina currently doing to help improve this bleak educational outlook? It is obvious that the South Carolina Department of Education realizes the importance of parental choice and competition among schools when it comes to education; however, the current program offers choices among only a few publically funded options. South Carolina parents currently have a choice among single-gender, Montessori, charter, middle-college and international-baccalaureate programs, as well as programs with special emphasis on the arts and environmental and outdoor education.\(^{16}\)

While there are benefits to offering such choices, it seems that the program has entirely missed the point of school choice. Rather than allow parents to dictate what type of school programs are offered the way a private industry would, it allows parents to choose from programs dictated by the public school system. The point of school choice is to allow schools to compete for students the way private firms compete for customers.

As the program stands, parents may choose to send their children to schools in different districts based on their preferences; however, if a school lacks enrollment because parents and students are not impressed with the educational product offered, it is unlikely to

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shut down due to a lack of efficiency or customers. This program misses the point that the
incentive to offer superior educational quality is most effective when the school must serve
the desires of its customers or shut down.

These products were not dictated by market demand, but rather dictated by what
school officials thought parents might want. For example, it may be that one district has many
parents who prefer a Montessori Method of instruction and another district where most
parents prefer special emphasis on environmental education. The current system guesses at
what parents want in and across districts and does not provide a method to respond to changes
in preferences over time. It is unlikely that school officials are able to know what types of
educational programs parents might want or know when parental preferences change.

Previous educational reform has attempted to mimic the private incentive arrangement
by offering bonuses for schools that get the highest test scores. Teacher bonuses awarded in
this manner have created a system of ‘teaching to the test.’¹⁷ This program gives teachers the
incentive to make sure students do well on the exams, so they begin to teach students how to
do well on these exams rather than teaching the students to apply the information they have
learned to various situations. This method of instruction may be part of the problem causing
South Carolina students, among others, to be ill-prepared for work in a variety of businesses.

Given South Carolina’s current situation, it is clear that the programs and types of
spending meant to solve these problems are not effective. It is obvious that change is needed
in both how tax money is spent and what kinds of incentive programs are used. Without
spending more tax dollars on bureaucratic task forces to determine the most efficient way to
spend education funds and what options to offer parents, how can we change the educational
system in South Carolina so that its citizens receive higher educational output per dollars spent?

POSSIBLE SOLUTIONS

The answer is more competition. Currently educational output per dollar spent is too
low compared to similar states and this output has declined over time. The change in school
policy that would help increase educational output per dollar spent is to promote more
competition and effectively set up incentive structures that will generate increased quality.
There are various methods that could be utilized to promote competition.

Charter schools are one way to help spark competitive forces. Charter schools help
promote competition by allowing the public school more autonomy and freedom from general
public school regulations, as long as they continue to generate successful results from
students. The charter for the school is renewable on average every 5 years.¹⁸ Compared to
North Carolina and Georgia, South Carolina’s charter schools program is small. North
Carolina and Georgia both have more charter schools than South Carolina. Georgia and North
Carolina currently have 71 and 98 charter school programs, respectively. With each state
having over 30,000 charter school students, whereas in South Carolina there are only 31

cda.lesc.edu/education/secondary/Courses/ED318/Resources/Readings/Teaching%20to%20the%20Test.pdf.
schools and a little over 5,400 students. Promoting charter schools would provide parents with more options and provide schools with more autonomy in spending their budgets.

Vouchers and tax credits for education are another method of promoting competition. A voucher program would give funding directly to parents rather than schools and allow parents to choose which schools their children attend. Parents may choose public or private schools and have all or part of the tuition paid for through educational funding. Tax credits could come in a variety of forms. Some tax credit programs are tuition tax credit programs, where parents receive a credit against their state (and sometimes local) taxes for tuition payments at eligible private schools. Another way the tax code can be employed to expand parental choice in South Carolina is through a scholarship tax credit program, where individuals can make donations to scholarship-granting organizations that provide scholarships to individuals attending non-public schools.

South Carolina and North Carolina currently do not have school voucher programs, but Georgia began its first voucher-like program in 2007 allowing children with special needs and disabilities to earn scholarships to private schools. Georgia also enacted an education scholarship tax credit in 2008 that allows parents and businesses to reduce their tax liability through donations to private school scholarship granting organizations. A great deal of competition would be generated if vouchers and tax credits were employed to give as many families real school choice.

If each child has a voucher or a tax-credit funded scholarship that pays the cost of tuition, parents will choose the school that provides the best education. Private schools, in an effort to make a profit, will try to out-perform each other in an attempt to attract these additional dollars. The dollars will go to the schools that provide the best education and administrators will have an incentive to continue to provide a high level of service in an attempt to generate operating revenue.

Inter-district choice is another way that may generate more competition in the provision of education. Inter-district choice involves loosening restrictions on which public school students may attend based on their home addresses. One county in Georgia has recently decided to crack down on the practice of parents faking an address in a county other than where they reside just to get into the schools in other counties or districts. Why should we limit parents to one or two choices when they may prefer a school in another district, despite the driving distance, because that school outperforms the school(s) in their own district? Liberalization of these policies would allow parents to send their children to whichever public school they choose, which would promote more competition for those students among schools in the area.

Liberalizing the regulation of homeschooling and the use of magnet schools are also other methods that could be useful in reaping some of the benefits of competition. Less regulation would allow parents more options, and magnet schools would provide options among specially-themed schools to give students a chance to study in a specific area of interest. As seen in Figure 9.4 Georgia and North Carolina currently have far more magnet

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21 David Casas and Tim Callahan (2009)
22 Vouchers could come in the form of scholarships for students or tax credits for parents.
23 For a provocative take on how public schools could be privatized, see Vedder (2000).
24 Andrew Castillo (2009).
schools than South Carolina. Any of these avenues could be taken advantage of to get South Carolina on the right track to getting more output per dollar in education.

Figure 9.4 Magnet Schools in South Carolina and Neighboring States

<table>
<thead>
<tr>
<th>State</th>
<th>Elementary School</th>
<th>Middle School</th>
<th>High School</th>
</tr>
</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>35</td>
<td>13</td>
<td>24</td>
</tr>
<tr>
<td>North Carolina</td>
<td>99</td>
<td>34</td>
<td>19</td>
</tr>
<tr>
<td>South Carolina</td>
<td>14</td>
<td>8</td>
<td>9</td>
</tr>
</tbody>
</table>


**THE EFFECTS OF SCHOOL POLICY REFORM ON GROWTH AND DEVELOPMENT**

What could changes in school policies mean for South Carolina’s economic future? Educational policy reform to increase the level of competition among schools could offer not only short-term, but also long-term benefits for South Carolina’s economy. For instance, Sobel and King (2008) showed that those counties in South Carolina with fewer schools to choose from have fewer self-employed individuals. The importance of having young, self-employed individuals lies in the statistic showing that small businesses provide the most significant amount of job creation; therefore, more small businesses and self-employment would greatly help alleviate the growing unemployment rate in South Carolina and generate economic growth.

Larson (2009) provides further analysis on this subject by examining the poorest counties in South Carolina and noting that there are no private schools in these counties available for parents to choose from if they are not satisfied with the public school system. His results showed that even without parents contributing any income towards the education of their children, the sheer availability of private schools and voucher or tax credit programs would increase the number of jobs substantially in these counties. The most conservative estimates from Larson’s study generate hundreds of new jobs through small businesses in these rural counties. Larson notes that not only will more school choice create more jobs and boost South Carolina’s economy, but the existence of private schools will also increase the quality of education and performance of students in public schools.

What Larson (2009) argues is that public school educational quality and student performance benefit from the existence of private schools in an effort to remain competitive. Thus, when faced with competition from private schools, public schools will take measures to increase educational quality and therefore student performance. This idea that public schools will improve as a result of facing competition from private schools has been looked at by many authors. There is a divide in the literature as to the effect private schools have on public school student performance. Authors, such as Hoxby (1994) Couch et al. (1993) and Dee (1998), find that public schools show immediate improvement as a result of the competitive pressures from private schools.

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26 Small Business Administration, definitions of small businesses, Available at: [http://www.sba.gov/advo/research/dyn_st05.pdf](http://www.sba.gov/advo/research/dyn_st05.pdf).
Others, such as Sander (1999), Arum (1996), Bayer and McMillan (2005), and Simon and Lovrich (1996), have found that there is no effect on public schools possibly in part because private schools may gain the high ability students from public schools, but public schools take measures to counteract the decrease in mean student ability. Jepsen (2002) studied this divide in opinion with a comprehensive review and attributed the differences in results to the data set, empirical approach and how the degree of private school competition and public school achievement were measured.

One problem that has not been addressed by previous studies is the likelihood that public schools will take some time to improve when faced with additional competitive pressures from private schools. In a study by Conaway (2009), data from counties in California are used to show that public schools do begin to show improved student performance when there are private schools that start to gain more students; however, the increase in student performance does not show up until many years after the public schools begin to feel the pressure of competition. Even eventual improvement in public schools would be preferable and beneficial for the economy in the long run compared to the current situation.

Hanushek’s (2005b) research showed that improving teacher quality, student outcomes and overall school quality can have major impacts on local economies. He noted that improved student outcomes and teacher quality translate directly into increased individual earnings and direct benefits for local and aggregated economies. In addition, the speed with which improvement is made is also related to the speed with which the local economy improves. So, policies that generate quick and positive student performance will lead directly to substantial benefits in economic growth and development.

In short, promoting competition and giving parents more school choices in a way that is responsive to their preferences will eventually translate into greater economic growth. It is well known that investment in human capital is highly important for economic growth, but as Hanushek (2008) notes that it is the quality of that spending not the quantity that matters. Tax dollars should be chasing the most useful and productive educational inputs if we want to see a more flexible and capable labor force in South Carolina.

Simply spending more money on public education is not the solution to increased quality, better outcomes and economic growth. Spending more tax dollars on bureaucratic teams in order to determine how best to get increases in educational quality per dollar spent is not the most effective way to generate long-term economic expansion. The most effective way to take advantage of more efficient educational investment is to implement policies that increase school competition across the entire state. South Carolina has a chance to take advantage of the well-known fact that markets and competition lead to increased human capital, entrepreneurship and economic prosperity.
REFERENCES


the figure because it is the lowest-tax state. Over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in million in fixtures). Notice that South Carolina's effective tax rate on industrial property is 50 states. The 'net tax' and 'effective tax rate' are calculated based on property valued at $25 million ($12.5 million in machinery and equipment, $12.5 million in inventories, and $2.5 million).

Although it is probably not critical that South Carolina set its tax rate to the lowest in 1850 states, for comparison. The ranks given for the states are out of all 1850 states. Furthermore, if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more business moves into the state. Additionally, if tax rates are lowered, then the state may realize the advantage of the anticipated growth in the state. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has a serious disadvantage, in terms of its ability to attract and keep industry.

the figure because it is the lowest-tax state.) Revenue may in fact increase once the growth rate in the state begins to pick up and more industry. Working to reduce the property tax in the country, it should definitely make it at least competitive for the Southeast. Since South Carolina has a relatively small industrial base and a high tax rate, it is at a serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina is the only state in the Southeast that needs weighted student funding, it would have an even greater advantage if it lowered its tax rate to attract more businesses and create more jobs.

### Table 5.3: Average Tax Rates for Various Incomes and Taxes

<table>
<thead>
<tr>
<th>State Rank (of 50)</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 $1,864,900</td>
<td>0.48%</td>
<td></td>
</tr>
<tr>
<td>24 $677,683</td>
<td>0.98%</td>
<td></td>
</tr>
<tr>
<td>25 $677,683</td>
<td>1.11%</td>
<td></td>
</tr>
<tr>
<td>29 $677,683</td>
<td>1.36%</td>
<td></td>
</tr>
<tr>
<td>31 $677,683</td>
<td>2.07%</td>
<td></td>
</tr>
<tr>
<td>37 $491,071</td>
<td>0.65%</td>
<td></td>
</tr>
<tr>
<td>41 $334,406</td>
<td>0.82%</td>
<td></td>
</tr>
<tr>
<td>48 $241,498</td>
<td>0.98%</td>
<td></td>
</tr>
<tr>
<td>49 $241,498</td>
<td>0.48%</td>
<td></td>
</tr>
<tr>
<td>50 $241,498</td>
<td>0.48%</td>
<td></td>
</tr>
</tbody>
</table>

Statutory maximum income tax rate: 50%.

Presumably the original intent of imposing a tax rate schedule with graduated taxes was to make the income tax progressive. However, what progressivity taxes and average tax rates would be if the 1959 tax tables were indexed for inflation. The figure clearly shows that the 1959 indexed tax rate structure is more uniformly progressive, as average tax rates hardly increase at all. This nature of the current tax is directly contradictory to the original intent of the tax reform. It is no secret that jumpstarting South Carolina's economy, among other things, is an issue of concern for most people in the state. The state's ability to attract and keep industry is critical to economic growth. Therefore, the state should work to reduce its tax rate to make it more competitive for business and industry. The table above shows the average tax rates for various incomes and taxes as provided by the National Association of Manufacturers in 2009.
10
PUTTING CHILDREN FIRST: WEIGHTED STUDENT FUNDING IN SOUTH CAROLINA

Jameson Taylor

It is no secret that jumpstarting South Carolina’s economy, among-the-worst-in-the-nation, requires reforming the state’s among-the-worst-in-the nation school system. In fact, fixing both requires essentially the same solutions: expanding individual liberty, streamlining government, and encouraging innovation and creativity. As far as education policy is concerned, one idea in particular promises to bring about – and has brought about – these reforms in numerous school districts across the country. This policy is weighted student funding.

Weighted student funding (WSF) is a student-centered mechanism of school funding in which funding is assigned to individual students, rather than via inflexible categorical programs. Under WSF, funding follows each child, ideally being distributed directly to the school the child attends. Such funding varies for each student as based on different needs or weights correlated to disabilities, socio-economic status, academic achievement, and other indicators. More specifically, WSF provides flexible funding that encourages schools to take responsibility for using resources as efficiently as possible to provide each student with the services that are best for them. Thus WSF is much more than a method of funding education, it is a means of creating a culture of high expectations, accountability and transparency in the public school system.

HOW EDUCATION IS CURRENTLY FUNDED

In order to better understand how WSF would work in South Carolina, it is necessary to look at how schools are currently funded. First, we want to provide readers with a brief reminder of why South Carolina so desperately needs weighted student funding. There is no disputing that South Carolina’s educational system is among the worst in the United States.¹ Consider the following:

• 82 percent of schools in South Carolina failed to meet federal ‘adequate yearly progress’ (AYP) standards for 2008.

• South Carolina has 11 of the nation’s 25 worst public schools.

¹See Coulson, Andrew, Achievement in Context, South Carolina Policy Council (February 2005); available at: http://www.scpolicycouncil.com/images/pdf/225.pdf. Observes Coulson: “Of particular concern in this era of global competition is the finding that, as South Carolina’s students are falling to the bottom of the national heap, so, too, is the United States falling to the bottom of the international heap” (2).
• South Carolina has the 4th worst high school completion rate – 56 percent – in the country.

• The state’s SAT scores are the worst in the Southeast and among the worst in the United States, ahead of only the District of Columbia, Hawaii and Maine.

For years South Carolinians have heard that increasing education spending is the best means of improving the state’s public school system. State government, General Assembly, etc. have done that, with the result that the state’s per pupil spending is the third-highest in the Southeast (cf. Figure 10.1). Moreover, during the 1990s South Carolina ranked 9th in terms of how fast it increased K-12 expenditures and continues to rank near the top in terms of the proportion of revenue it devotes to education.²

Figure 10.1 Southeastern Per Pupil Spending 2007 U.S. Census Data

![Figure 10.1 Per Pupil Spending](image)

Clearly, more money is not the answer. Moving forward, the real challenge is for the state to better use the already significant resources it devotes to public education. Weighted student funding allows for this efficient use of resources.

South Carolina’s public school funding is essentially derived from three sources: the federal government, the state and local communities. For fiscal year 2009-2010 (FY09-2010),

per pupil allocations are projected to reach an average of $11,242.\textsuperscript{3} This amount consists of averages of $5,792 in local dollars; $4,153 in state funds; and $1,296 in federal funds. For our purposes, the source of these funds is less important than what can be done with each pot of money. Federal and state allocations, in particular, are controlled by specific programmatic mandates that govern what are called ‘categorical funds.’ Federal funding, for instance, is subject to Title I (of the Elementary and Secondary Education Act) guidelines and other requirements (e.g., Reading First or the Mathematics and Science Partnership Program). Nearly half of state funding is restricted to certain initiatives, such as reading programs, class size reduction, or summer school.

Categorical funds are funds to which strings are attached. In order to obtain the money, schools or districts may need to create a special program or, launch a new school altogether. In their groundbreaking report on WSF in South Carolina, Bryan Hassel and Marguerite Roza (2007) delineate some of the ways categorical funding handicaps student achievement and innovation:

Because the funds arrive to school districts in so many different pots, each with its own restrictions on how it can be used, district services are at times fragmented with multiple programs/services for each type of student. The fragmentation of the funding restricts districts from making decisions about how best to meet the needs of its students and instead forces districts to separate resources according to their categorical source.

Consider a few examples of how this system may thwart district efforts to achieve worthy goals:

**CREATING AN INNOVATIVE NEW SCHOOL**

Currently districts cannot combine all of their funds to offer a comprehensive, innovative school designed around the unique needs of its students, despite the fact that the state has several categorical allocations intended specifically to help districts fund different school models. Rather, if a district that wants to use funds to finance a new school model with a comprehensive approach, the district might attempt to cobble together some combination of the state’s 25 separate categorical allocations earmarked for alternative schools, such as: junior scholars, youth in government, homework centers, and others as a way to fund the school. However, some of these allocations are intended only for math and science schools, or schools for arts and humanities, or ‘lab schools,’ or for SAT improvement. Some of the funds are earmarked only for operating costs; others can be applied only for personnel. Other funds are intended only for special services (like character education or alcohol abuse services). As a result of all these restrictions, creating a new innovative school means piecing funds together into a patchwork quilt that may or may not have any coherence.\textsuperscript{4}

\textsuperscript{3} As adjusted for ‘regional cost differences,’ The Education Week Research Center reports that South Carolina’s adjusted per-pupil expenditure is $8,339. The national (adjusted) average is $8,973.

\textsuperscript{4} As discussed in Chapter 3, F.A. Hayek (1945) explained that individuals have specific knowledge of time, place and circumstances that others cannot always possess. The knowledge necessary to run an entire economy cannot be known by only a few individuals, which is why central planning cannot work. Hall (2006) explains how this insight applies to the education system, and why decisions are best made at the school rather than district level.
Chapter 5: Specific Tax Reforms

Several different allocations exist for a district interested in creating a program to close achievement gaps and better serve low-performing students. Again, all come with their own restrictions which, in combination, make it difficult or impossible to use them well. Some specify that funds must be used for Reading Recovery (a specific reading program); others focus on class size reduction in the primary years; others are for schools to provide summer assistance to students. While each set of restrictions may have its own logic, districts may find it difficult to meet their own students’ specific needs. For example, consider a district with many students who are employed in tourism over the summer. For these locales, restricting funds for use on summer assistance makes little sense. The district would probably achieve better results with these students by using the funds for a Saturday program during the school year.

Building Teacher Knowledge and Skills

South Carolina has 15 different programs designed to fund professional development or enhance teacher quality. Each has its own restrictions, requirements, and specific purpose, making it difficult or impossible for a district to combine the funds into one coherent professional development initiative that truly raises the level of teaching capability.5

As indicated above, federal funds are often restricted by categorical funding requirements. Although federal funding accounts for approximately 12 percent of per pupil funding in South Carolina, there is little state lawmakers can do about lifting these stipulations. The good news here is that local funding, which makes up about 52 percent (up from 48 percent for 2008), of per pupil funding is not subject to state categorical mandates. That being said, the sales tax/property tax swap (Act 388) passed in 2006 ceded to the state control over education dollars formerly derived from local property taxes.6 Moreover, state mandates exercise a great deal of influence over how districts can spend their education funds – for instance, funding unique programs or increasing teacher salaries. Again, the source of each school’s funding is less important than what can be done with each pot of money. For this reason, we will focus our attention on those categorical restrictions that hamper state funding.

State Funding

The state’s share of public school financing is primarily controlled by the 1977 Education Finance Act and the 1984 Education Improvement Act. The former distributes education dollars proportionately as based on each district’s tax base (referred to as the index of taxing ability) and accounts for roughly 65 percent of General Fund K-12 education expenditures. As indicated in Hassel and Roza’s report for the South Carolina Policy Council (2007) on weighed student funding, 45 percent of state education funding is restricted by categorical programs. In fact, according to Education Week, South Carolina ranked fifth in the nation with at least 74 different categorical funding programs it requires. Hassel and Roza delineate some of the ways in which categorical funding hampers schools:

5Hassel and Roza, 8-9.
6This legislation can be found at: http://www.scstatehouse.gov/cgi-bin/web_bh10.exe?bill1=4449&session=116.
INHIBITS SPENDING COHERENCE

Each distinct state allocation (or ‘categorical’) is intended to serve a specific group of students or further some specific program. As a result, regulations often require separate accounting, place limits on what can be purchased with funds, and prescribe in detail what services are to be provided and how. The effect is to prohibit commingling of funds across categories, making it difficult to pull funds from different line items to design an intentional, coherent program. The result in many cases is the layering of programs on top of one another over time, making it difficult to align the use of funds with district and school strategies and priorities or evaluate how well different programs are working.

IMPOSES BURDENSOME ACCOUNTING AND FUND MANAGEMENT

Funds from each source need to be accounted for separately. As a result, districts or schools may have hundreds of different funding sources to manage. These cumbersome requirements often necessitate the oversight of a program manager to take on administrative tasks, diverting funds from educational activities.

CREATES UNPREDICTABILITY

With resources tied to the creation of a myriad of programs, each with its own complex formula for allocation, districts have a difficult time predicting from year to year what resources will be at their disposal.

FORCES A ONE-SIZE-FITS-ALL APPROACH

Districts and schools differ in their needs and in their capacities to solve the problems they face. Categoricals that come with prescriptions for use limit districts and schools from using funds in ways that school officials think are the most efficient and effective.7

In short, categorical funding is inefficient, reduces the amount of money available for instructional services, and is difficult to track and manage. Moreover, such restrictions encourage a top-down approach to school funding that centralizes control in the hands of legislators, instead of freeing up schools or districts to fund the programs they think will work best for their students.

A second problem with the way schools are funded in South Carolina is that funding goes to districts, instead of schools themselves. This is partially attributable to the dependence on categorical funding, which creates logistical and accounting burdens for individual schools. It is also a reflection of a bureaucratic administrative culture in South Carolina’s school districts and legislature that stifles leadership and innovation.

The result is that schools are not free to spend education dollars on targeted programs that would be most beneficial to their students. WSF experts Hassel and Roza argue:

Because the funds arrive to school districts in so many different pots, each with its own restrictions on how it can be used, district services are at times fragmented with multiple programs/services for each type of student. The fragmentation of the funding restricts districts

7Hassel and Roza, 2, 5.
from making decisions about how best to meet the needs of its students and instead forces
districts to separate resources according to their categorical source.\(^8\)

As indicated above, weighted student funding allocates education dollars to each child
based on his specific needs. What this means, in practice, is that each school receives a
specific amount of funding to educate each child. The thinking here is that education funding
should be centered on schools rather than districts because schools are the locus of each
student’s education. Thus while districts can provide some administrative support, most
decisions about how education funds are spent should be made at the school level.
Understanding why this should be the case requires evaluating school funding procedures in
light of the goals such funding seeks to accomplish.

**A NEW WAY OF LOOKING AT SCHOOL FUNDING**

In order to discern the best means for funding public education in South Carolina, the
focus needs to be on what measures determine success. School funding experts generally
agree that a successful school funding strategy is one sustained by the following three values:

- Efficiency
- Equity
- Accountability

Weighted student funding would greatly improve the funding of South Carolina’s
school system because WSF can be shown to be the best available strategy within the current
framework for achieving the values articulated above. These values provide an objective
standard for determining which funding policies should be implemented. A WSF system that
does not meet these criteria would be a failure. Likewise, the current means of funding public
schools in South Carolina is a failure precisely because it is inefficient, inequitable and
hinders accountability.

**EFFICIENCY**

The primary measure of success in the public school system is student achievement.
For this reason, the federal No Child Left Behind (NCLB) Act ties education funding to
adequate yearly progress (AYP) goals. In turn, districts and schools are given annual report
cards that record and track their performance in meeting these goals.

With regard to school funding in particular, the most relevant question is how to use
funds efficiently to enhance student performance. School administrators typically assume
increasing instructional time is the best means of improving student achievement. As asserted
by the Education Oversight Committee, “greater investment in the classroom and in direct

\(^8\)Ibid., 8.
instruction will improve the academic performance of students.\textsuperscript{9} In turn, allocating more money to instructional time often requires reducing administrative costs.

One of the primary strengths of WSF is that it simplifies the debate regarding the efficient use of education funds by directly tying instructional funding to specific students. As recommended by the Oversight Committee, under a WSF model, 85 percent of funds generated by each student would go to instruction and instructional support services for that student. The important point here is not that WSF mandates an increase in instructional time (it does not), but that such funding makes it easier to correlate student funding with student achievement.

Moreover, by simply shifting funding to where it belongs – to each student and his school – reductions in administrative time and costs are realized almost automatically. Consider the following benefits realized by school districts in other states that have adopted WSF:

- **Hartford, Connecticut.** In three years, the Hartford Public School District increased instructional funding by more than 40 percent by correspondingly reducing central office administrative expenses.

- **Baltimore, Maryland.** In two years, Baltimore City Schools succeeded in reallocating 80 percent of district operating costs to individual schools, increasing school funding by more than $88 million.\textsuperscript{10}

As things stand, South Carolina’s current system of funding public schools is extremely inefficient. The pioneering WSF report issued by the Thomas B. Fordham Institute (2006) discusses this problem in detail. “Policies at the district, state, and federal level all contribute to the problem,” observes the report. “Many of the assumptions and political deals built into those policies deny, ignore, or even compound those problems. These public policies are so flawed and so consistently fail to solve problems that the entire financing system needs to be modernized if the core problems of inequity and antiquity are to be solved.”\textsuperscript{11}

One inefficiency mentioned by the Fordham Institute report entails districts using minimum staffing requirements to provide funding to schools. The solution, used by many of the districts that have implemented WSF, is to give principals discretion over hiring and staffing decisions. The idea here is that funding should be allocated on a \textit{per student} basis, rather than a \textit{per teacher} basis. More generally, WSF is thus grounded in the insight that educational resources, or inputs, should correspond as closely as possible to specific outcomes – in this case, the academic success of particular students.


EQUITY

One of the primary drivers behind the WSF movement – and with bipartisan supporters as varied as former U.S. Secretary of Education William J. Bennett to Clinton Chief of Staff John Podesta, it can fairly be called such – is the desire for equitable funding. Education funding varies widely from district to district in South Carolina. Consider that for FY08-2009 only one of the school districts (Allendale County Schools) located in one of the state’s five poorest counties also ranked among the top five in terms of highest per pupil allocations. At the same time, Dillon County, the third poorest in the state, was home to three of the bottom five districts in terms of per pupil spending. As Figures 10.2 and 10.3 below indicate, projected education funding for FY09-2010 produced similar results.

Figure 10.2: Per Pupil Funding Five Poorest Counties in South Carolina (FY09-2010)

<table>
<thead>
<tr>
<th>County</th>
<th>% in poverty</th>
<th>Total funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allendale</td>
<td>36.8%</td>
<td>$13,053</td>
</tr>
<tr>
<td>Williamsburg</td>
<td>36.3%</td>
<td>$11,367</td>
</tr>
<tr>
<td>Dillon</td>
<td>27.7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dillon 1=$9,333</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dillon 2=$8,243</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dillon 3=$7,865</td>
</tr>
<tr>
<td>Bamberg</td>
<td>27.4%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bamberg 1=$10,889</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bamberg 2=$12,471</td>
</tr>
<tr>
<td>Lee</td>
<td>26.2%</td>
<td>$12,196</td>
</tr>
<tr>
<td>South Carolina</td>
<td>15.1%</td>
<td>$11,242</td>
</tr>
</tbody>
</table>

12 For FY09-2010, none of the poorest counties are among the top five in terms of total spending. This is because budget cuts slightly reduced the state share of Education Financing Act funding.
Figure 10.3: Per Pupil Funding Five Wealthiest Counties in South Carolina (FY09-2010)

<table>
<thead>
<tr>
<th>County</th>
<th>% in poverty</th>
<th>Total funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beaufort</td>
<td>10.4%</td>
<td>$15,240</td>
</tr>
<tr>
<td>Berkeley</td>
<td>10.6%</td>
<td>$10,733</td>
</tr>
<tr>
<td>Dorchester</td>
<td>10.7%</td>
<td></td>
</tr>
<tr>
<td>Lexington</td>
<td>10.9%</td>
<td></td>
</tr>
<tr>
<td>York</td>
<td>12.1%</td>
<td></td>
</tr>
<tr>
<td>Lexington</td>
<td></td>
<td>Lexington 2=$8,830</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Lexington 4=$12,423</td>
</tr>
<tr>
<td>York</td>
<td></td>
<td>York 1=$9,557</td>
</tr>
<tr>
<td></td>
<td></td>
<td>York 2=$11,870</td>
</tr>
<tr>
<td></td>
<td></td>
<td>York 3=$11,232</td>
</tr>
<tr>
<td></td>
<td></td>
<td>York 4=$10,840</td>
</tr>
</tbody>
</table>

No doubt, these inequities should be addressed. Again, WSF offers a solution. The promise behind WSF is that education dollars follow the child and that children with special needs are funded in a manner that directly serves their needs. WSF in this regard functions like a market economy, which focuses on how to best serve its consumers. Under WSF, the district within which a child resides is irrelevant. All things being equal, low-income children, no matter where they live, are funded equally. It is difficult to imagine a fairer allocation formula.

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13Funding capital construction costs would continue to be an issue in that WSF is dedicated to operational costs. One option for reform here would be to dedicate lottery funding to helping poorer districts build and renovate schools.
According to the WSF model, each student receives an equal amount of base funding. This funding is then supplemented according to various weights. Handicapped students who require additional attention, for instance, would be matched with additional funding. Such funding would not be tied to a new program a school might not be able to afford, but would come in the form of additional dollars that could be used to hire additional teachers or bring in specialists to help each child. The *Fund the Child* report explains how this weighting system works:

Under WSF, the per-student amount varies with the characteristics of the child. Students with added educational needs receive extra funding based on the costs of meeting those needs. The amount attached to each student is calculated by taking a base amount and adding money determined by a series of ‘weights’ assigned to various categories of students. These weights could take the form of dollar amounts: an extra $500 for a student in one category, $1,000 for a student in another. Or they could be expressed in proportional terms, with students in a high-need category generating, say, 1.4 or 1.5 times the base level of funding. Either way, the concept is the same: students with higher levels of need receive more ‘weight’ in the funding system. … Most districts that have implemented weighted student funding assign higher weights for: students from low-income families; English language learners; students with disabilities (including different weights for different types of disabilities); and students with previously low test scores.\(^\text{14}\)

Of course, questions regarding equitable funding do not disappear under WSF, but become part of the debate regarding the value of each weight assigned to various student needs. The benefit, however, is that the WSF formula forces policy makers to assign specific monetary values to specific needs, thus making it easier to determine whether this additional spending is having a measurable impact on student performance. These weights can then be re-assessed periodically based on the impact on student performance.

Another benefit for South Carolina, in particular, is that the shift to WSF would depoliticize the entire debate regarding equitable funding for rich districts versus poor districts or urban districts versus rural ones. In doing so, WSF would force policy makers to address the only inequities that matter: differences in students’ abilities and circumstances that might otherwise prevent them from obtaining the resources they need to be academically successful.

**Accountability**

Accountability is the new buzz word among education officials these days. As noted earlier, NCLB requires each school be assigned a report card as a means of holding schools more accountable. Teachers are held accountable for improving test scores and exceeding AYP standards. Principals are accountable for improving overall school performance while administering funds as efficiently as possible. The flip side of accountability, however, is responsibility. If we are truly to hold schools accountable for the performance of each student, we need to give schools and districts the funding flexibility to create learning strategies appropriate for each student. In particular, principals need to be given more flexibility over staffing and budgetary decisions. Currently, in South Carolina such decisions are made at the district level. As observed by the Fordham Institute: “Almost no dollars as such reach

\(^{14}\text{Fund the Child, 21-22.}\)
individual schools; the district pays nearly all the bills. School budgets are developed at the central office, and decisions on hiring, services, and teacher allocation are made there.\textsuperscript{15}

As we shall explain below, the state government can loosen its control over education by employing several strategies to help districts and schools work together to implement a WSF formula that provides for more accountability and transparency. Here, the only point we wish to make is that categorical funding is one of the key obstacles to making education funding more transparent. This is primarily because regulations regarding categorical funding require complex accounting procedures that make it next to impossible to track how money is being distributed and used. Observes the Fund the Child report:

District allocation practices are so murky and complex that it is difficult to determine how much money is spent at any individual school. Even school boards and district administrators may have little idea how much money their schools have. ... Even now, most schools receive resources that are tracked at the district level, and not within school budgets.\textsuperscript{16}

Again, we can look at how WSF has worked in other states to illustrate how WSF would improve accountability and transparency in South Carolina:

- \textit{San Francisco, California.} Schools in San Francisco tie weighted student funding to instructional line-items in the budget, which are then correlated with specific academic goals.

- \textit{Houston, Texas.} School-level budgets in Houston show the weights and funding for each subcategory of student and also include academic achievement data.

- \textit{Hawaii.} In Hawaii, the only system to have implemented WSF on a statewide basis, district officials are able to provide formal input each year as the state gradually transitions to a comprehensive WSF funding formula.\textsuperscript{17}

Overall, WSF would eliminate or reduce many of the principal-agent problems that exist in the current public school system (see Chapter 9).

\section*{How WSF Would Work in South Carolina}

Implementing weighted student funding should be relatively easy in South Carolina insofar as the state already uses a limited WSF approach to fund public education. As provided for by the 1977 Education Finance Act (EFA) the state allocates a minimum base dollar amount per pupil, which encompasses the spending for the defined minimum educational program to an average student. For FY09-2010, the base student state spending is projected to be $2,334 assuming enrollment of 691,816. EFA funds, however, differ according to each district’s tax base, with poorer districts receiving more money.

\textsuperscript{15}Ibid., 19.  
\textsuperscript{16}Ibid., 20.  
\textsuperscript{17}Snell, 140-141.
In addition to base student spending, the EFA also provides for additional funding calculated according to various weights adjusted for grade level, disability and other factors. Kindergartners, for instance, are weighted at 1.3 times the base while vocational students are weighted at 1.29 the base. Thus, as observed by Hassel and Roza (2007), EFA can be thought of as a weighted student funding model – except in one crucial aspect, “weighted funds follow children to districts, but not necessarily to schools.”¹⁸ Moreover, current EFA funding only accounts for slightly more than half of total state funding – or about a quarter of overall funding. Remaining state funds are subject to categorical requirements specified by the Education Improvement Act (EIA), restricted state grants, and lottery funds.¹⁹

Still, as Hassel and Roza argue, the EFA can serve as the basis of shifting the majority of state education funding to a weighted student system. They explain how this reform could be implemented:

- Expanding the Education Finance Act’s weighting system to include additional groups of students not currently weighted, namely low-income and gifted students;
- Converting categorical funds intended to serve a specific student type into new or existing weights in EFA;
- Converting other categorical funds into per pupil funds within the basic EFA allocation;
- Distributing funds (including those for public charter schools) on the basis of each child’s new weighted amounts.²⁰

Hassel and Roza identify three types of categorical programs, concluding that only funds dedicated to services not directly related to K-12 education (i.e., unusual transportation needs) should remain categorical. Funds devoted to serving particular student populations should be converted to weights while funds tied to other priorities (Hassel and Roza mention science education) should be added to the base pupil allocation. Under this model, only 8 percent of current categorical funding would remain as such (see Figure 10.4).

¹⁸Hassel and Roza, 7.
¹⁹Hassel and Roza report that EIA funding is controlled by 44 categoricals; restricted General Funds, 26 categoricals; and Lottery funds, 4 categoricals (7).
²⁰Ibid., 9.
Figure 10.4
Demonstration of How Categorical Funds Could Convert to Per Pupil Funds

In light of the questions regarding equity raised above, it is important to emphasize that Hassel and Roza’s model merely converts the state’s existing categoricals into weights and so does not change “priorities with regard to the student groups it wants to serve.” In other words, under the WSF reform what are now only implied weights would simply be converted into transparent, actual weights. For this reason, debates over how to fund WSF or over how much each district should contribute are beside the point. Federal and district allocations would remain the same, with the most essential change being to fund individual students, rather than categorical programs. Hassel and Roza explain:

It is worth noting how much would not change as a result of this shift in approach to funding. … Since the new weights are based on how much South Carolina currently spends to meet the needs of different groups of students, the amount of funding dedicated to these groups would not change. The amount of state funding received by most individual districts would not change markedly, with the exception of a drop in funding for some districts that are now

\(^{21}\)Ibid., 10.
particularly successful at winning competitive grants or obtaining reimbursement for spending on state-funded programs. Overall, the state’s funding priorities would remain the same.\textsuperscript{22}

But simply transitioning to a weighted funding formula is not enough. The next – and politically more difficult – step is to distribute these funds to schools, rather than districts.\textsuperscript{23} We shall examine this and other challenges in the next section.

**IMPLEMENTING WSF: QUESTIONS & POSSIBILITIES**

Perhaps the most striking aspect of the WSF reform in South Carolina is that the policy has yet to be enacted. By all accounts, nearly every key stakeholder – from the governor to members of the General Assembly to the Education Department – believes WSF should be implemented in South Carolina. Yet a consensus has not been reached regarding the details of the funding plan, with legislation (H 3724) that would have enacted WSF dying in committee during the 2009 session. In particular, questions remain regarding the following four issues: 1) Which categories of funds should be reallocated via the WSF formula?; 2) What weights should be assigned to different subgroups of students?; 3) Would districts or schools administer WSF distributions?; 4) How would WSF affect funding?

*Which Categoricals Does the State Need?*

As indicated above, Hassel and Roza argue that only 8 percent of state funding should remain as categorical funding. They mention, in particular, unusual transportation costs as a category that could be retained. Other advocates of WSF have suggested treating food service or pilot programs as categorical distributions. In the experience of districts that have adopted WSF, however, the trend has been to shift as many categoricals as possible to the WSF formula.

In Hawaii, for instance, the gradual transition to a WSF mechanism has been accompanied by an annual assessment during which school officials provide input on whether the reform is on track. Year after year, the key stakeholders have concluded that WSF is working and that additional categorical funds should be converted into discretionary spending. In the course of this review process, Hawaii has developed specific benchmarks that must be met for a categorically funded program to be reallocated to the WSF distribution. Similar guidelines for South Carolina would entail requiring that:

1. The funding in question must be provided to all schools;
2. The funding must be provided to all schools at a particular level (i.e., all middle schools);
3. The funding must be able to be distributed equitably by the WSF formula;
4. The reallocation must actually provide for greater funding flexibility for schools.\textsuperscript{24}

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\textsuperscript{22}Ibid., 12.

\textsuperscript{23}Hassel and Roza acknowledge, “The system proposed here would ensure state money follows children, but only to the district level” (14).

\textsuperscript{24}As adapted from Snell, 141.
Currently, transportation and food service are two of the categoricals that remain under district control in Hawaii. Likewise, economies of scale may encourage similar policies in other locales. Still, even as regards to such functions traditionally provided by school districts, schools can be given the option to purchase these services from the district or to hire another provider. In short, practically any service actually provided by a school for its students can be accounted for under a comprehensive WSF system. Accordingly, there are very few categoricals that cannot be eliminated or, at least, reevaluated so as to provide for more flexible funding. Thus even in the face of pressure from lobbyists and others to preserve certain categoricals, advocates of WSF should try to reallocate as many of the state’s 74 categoricals as possible to the WSF formula. A realistic goal, as Hassel and Roza suggest, would be to reduce categoricals to less than 10 percent of per pupil expenditures.

**WHAT WEIGHTS SHOULD BE ASSIGNED?**

A second question that has stymied WSF reform in South Carolina pertains to the different weights given to subgroups of students. Hassel and Roza resolve this question by specifically correlating the weights to current funding levels. These are their recommendations:

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23Cotton Lindsay touches upon such questions in his report on scholarship tax credits. See Lindsay, Cotton, *Fiscal Impact of the 2005 Universal Scholarship Tax Credit Proposal*, South Carolina Policy Council (March 2005).

24Hassel and Roza caution: “Each categorical program has numerous and varying special interests that are likely to try and protect specific pots of money. … In some cases, the state legislators responsible for a particular allocation could be its biggest defenders” (16).
As Hassel and Roza’s work shows, the best strategy would be to retain, to the extent possible, the current funding levels the state already has in place. Undoubtedly, some lawmakers will want to use the WSF process as a vehicle for increasing funding for certain groups or programs. Such considerations, though, are not essential to the WSF reform.

**SHOULD DISTRICTS OR SCHOOLS CONTROL FUNDING?**

A third concern voiced about WSF regards the extent to which districts or schools should oversee WSF distributions. The key here is patience. Ideally, the WSF reform empowers individual schools to use education dollars to create individually tailored instruction plans for each student. This model, however, may not work for every school – or, at least, not without allowing for a transitional period during which principals and other school-level administrators receive additional management and budgetary training.
During the 2008 hearings on WSF before the South Carolina House, the Department of Education specifically indicated it did not want student-based funds going to individual schools. “The existing district-based funding method should be ‘preserved,’” asserted Sandy Smith, department deputy superintendent for policy and legislation, “even if the total money allocated is based on a stricter per-student formula.”

The education department’s opposition to expanding local control over education dollars is also shared by district administrators who may fear, not only a loss of control, but also the loss of their jobs. As noted elsewhere in this book, public officials always have the incentive to expand their budgets and their control. By reducing reliance on categorical funding, WSF will eliminate the need for certain district administrative positions. This is to be expected as more funds are allocated to instruction.

Weighted student funding, however, is not just about eliminating needless administrative burdens. The most important element of WSF is that it enables individual schools to be creative and innovative in how they serve their students. To use a free market term, WSF encourages schools to be entrepreneurial in using their resources as wisely as possible to produce the best possible outcomes.

Thus the Fund the Child report makes it clear that if WSF is the mechanism for improving school funding, the success of the WSF reform lies in the hands of the individual schools receiving this funding. “Simply stated, for WSF to be effective, principals must be given authority over a significant portion of the overall funding pool.”

Toward this end, WSF should be complemented by reforms that encourage principals to be more than administrators, but to be leaders. Accordingly, the state should also look at providing training and mentoring opportunities for principals. No doubt, some principals fear the changes WSF will bring. But a recent study by the American Institutes for Research finds that teachers and administrators want greater autonomy over spending decisions and so support WSF by wide margins. Likewise, even the National Education Association acknowledges “WSF shows promise,” especially as a means of addressing funding inequities. The reality is that principals and teachers are already being held accountable for school performance. Giving school leaders responsibility over funding programs they know will work for their students is essential to helping them meet these expectations.

Although state and district administrators are still reluctant to relinquish control over funding to individual schools, recent budget cuts have encouraged these groups to increasingly call for flexible funding, which would mean reducing categorical funding restrictions. During the 2009 session, at least 50 of South Carolina’s 85 school districts passed a resolution declaring that:

Local funding decisions must be made to support the unique qualities and challenges presented by each student, classroom and school; and

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28 Fund the Child, 35.
30 Fund the Child, 30.
Under current state law, school districts have limited flexibility in the expenditure of most funds disbursed through the State Department of Education, which impedes our ability to focus dwindling resources in the classroom.\(^\text{31}\)

This resolution was also supported by the South Carolina School Boards Association (SCSBA), whose president, Gerald Cook, stated that current funding mechanisms hinder innovation and accountability. Said Cook:

Freedom to innovate, coupled with accountability, is an approach worth considering for all public schools. Yet now, while charter schools are free to pursue initiatives that they consider promising — and while public officials across the state, including the Governor, applaud that freedom — local schools, governed by local boards, continue to be constrained by a host of legislative mandates that prevent them from using money in the ways that make the most sense for their communities. Their hands are tied. … Many of the state’s mandates — teacher training, summer school, character education, career counselors, school nurses and assessments, among many other functions — are not just good but necessary to support the school’s mission. We want those things for all our children. But how much sense does it make to fund them if it means removing a teacher from a classroom?\(^\text{32}\)

Thus, it would seem that resistance to school-level funding is eroding. In addition, Hassel and Roza recommend several strategies that could be used to facilitate the gradual transition from a district-centric funding model to a student-centered approach:

**Require that funds be spent on schools according to how much student revenue they generate**

South Carolina should require that money generated by a student via the new weighted funding system be spent proportionately on that child’s school in one of two ways. Funds could be spent directly; for example, by paying salary and benefits of teachers working at the school. Or funds could be spent indirectly on shared or centrally provided services that tangibly benefit the school in an equitable fashion; for example, by paying for specialist instructors who serve multiple schools. Even costs for reasonable leadership and district operations could be accounted for in per pupil terms to each school to achieve full transparency.

**Require transparent reporting of how funds are spent at the school level**

In addition to continuing to follow and use the existing SC financial accounting requirements, each district should be required to report publicly (a) the amount of funding ‘generated’ by each of its schools, based on their student populations; and (b) the amount of resources devoted to each school by student type. In addition, the state should make available school-level expenditure reports through the use of InSite\(^\text{33}\) and make it possible for citizens to ‘query’ the online financial information system to obtain additional information.
Chapter 10: Putting Children First

Encourage Responsible Moves Toward School-Based Funding Control

One strategy would be to place schools into tiers of increasing financial independence, based on schools’ demonstrated capacity to handle budget control. All schools could immediately be empowered to develop draft budgets linked to their annual school improvement plans, submitting these for approval to their local school boards. Schools could apply to the local school board for greater levels of school-level financial independence after demonstrating their capacity to carry out the responsibility. State oversight, and an appeals process to the state board of education, would ensure that districts grant financial independence to schools that deserve it.\(^{34}\)

 Needless to say, institutional resistance to WSF can be overcome. Currently, WSF is being used in 15 major school districts across the country, including New York City, Houston, San Francisco, Baltimore and the entire state of Hawaii. If decentralizing school funding can work in these places, there is no reason it cannot be successful in South Carolina.\(^{35}\)

How Would WSF Affect State Funding?

Unfortunately, questions related to funding WSF are perhaps most responsible for thus far preventing the passage of this reform in South Carolina. This is ironic given that, as discussed above, WSF would not alter current funding priorities. Total state spending on education would remain the same under the WSF model, as would the proportion of local contributions. Still, it should come as no surprise that education officials stuck in the mindset of assuming that more money translates into higher student achievement have sought to expand the WSF weights to insure that every dollar – and more – will be spent on initiatives they support. The best strategy for countering such tactics is to make any WSF reform revenue neutral. In itself, shifting to a WSF model does not require increasing or decreasing overall education funding. Thus debates over such funding should not be used as an excuse to sidetrack WSF.

Another obstacle impeding WSF reform concerns South Carolina’s longstanding debate over equitable funding. On average, the state provides 70 percent of the total base cost of EFA funding, with districts responsible for the remainder.\(^{36}\) District contributions, however, vary greatly, ranging from $1,733 for Dillon 2 to $12,157 for Beaufort.

South Carolina arguably does a fair job of allocating state and federal dollars to its poorest districts. There are some exceptions, such as Dillon District 2, but it is noteworthy that counties like Allendale and Lee are among the top five in terms of state funding. Likewise, among the state’s poorest districts, total per pupil funding usually approximates, if not exceeds, the state average. This is to say that the EFA, if not a complete success, has certainly helped close the funding gap between the state’s wealthiest and poorest districts.

\(^{34}\)Hassel and Roza, 4, 15.
\(^{35}\)The American Institutes for Research report mentioned above provides useful insights on how two very diverse localities – San Francisco and Oakland – obtained “buy in” from key stakeholders at the district, school and parental level.
\(^{36}\)Recent budget cuts have somewhat reduced the state contribution for FY09-2010.
Indeed, if the experience of other districts across the country holds true, schools in every district in the state will benefit from WSF. Again, this is because WSF is not based on geography, but focuses dollars on helping those students who most need it, regardless of where they live. In so doing, WSF results in a more equitable distribution of education funds for schools even within the same district. For example, prior to implementing WSF in the Cincinnati Public School District less than half of schools were funded within 10 percent of the district average, with a per pupil disparity of $6,000 between the highest and lowest funded schools. After passing a robust WSF reform, these inequities were minimized as every school received the weighted average necessary to fund its unique student population. “On average, schools gained or lost $266 per-pupil – 4.2 percent of the average school budget,” observes the Fund the Child report. “The largest gain was $730,881 – a 16.8 percent increase in that school’s original budget. The largest loss was $595,316 – a 16.4 percent decrease in that school’s original budget.”

By distributing education dollars in a manner more consistent with the free market, WSF will result in lower education costs for all taxpayers. Most important, WSF shifts the emphasis of education funding away from inputs, such as district-level funding, to results – namely student achievement. In turn, WSF brings accountability and transparency to public school funding, helping insure education dollars are being used as efficiently as possible.

\[\text{Fund the Child, 10, 47.}\]

\[\text{Accordingly, weights should not be tied to income per se, but to student performance. Hassel and Roza wonder if weighting low performance will provide a perverse incentive for underperforming schools (17). WSF reforms in Baltimore, however, seemed to have overcome this obstacle by weighting both low performance and high performance, with the former pot of money gradually being reduced in favor of the latter. The result is that persistently underperforming schools are gradually given less fiscal independence.}\]
CONCLUSION

We began this chapter by indicating that one of the keys to unleashing capitalism in South Carolina is reforming the public school system. Capitalism properly refers to much more than an economic system. As practiced in the United States, the culture of capitalism is one that puts individuals first in the sense that it prizes individual liberty and personal responsibility. Perhaps the most important benefit of WSF is that it brings these values to life in the public school system. First, WSF empowers local administrators to look for innovative ways to serve their students. As such, it brings to the fore educational leaders, rather than just educational managers. Second, WSF encourages entrepreneurial thinking among teachers and other staff members, who are free to develop new strategies aimed at helping students learn. In addition, there is some evidence that WSF could even foster an entrepreneurial spirit among students themselves.  

Apart from the benefits it brings to individual schools, WSF is also important as a counter to the centralizing and bureaucratic forces that have plagued, not just our state’s schools, but our state’s economy. These forces claim the government can do things better than the free market, thereby suggesting the average citizen cannot really be trusted – whether it be to run a business or to decide upon the best use of education dollars. By contrast, weighted student funding uses those values – liberty, responsibility and innovation – consistent with a free market economy to empower local schools to create the conditions necessary for student achievement. In doing so, WSF refocuses questions about education funding away from debates regarding administrative categories and back toward its primary goal: helping individual students succeed.

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39See Larson, Sven, How School Choice Can Create Jobs for South Carolina, South Carolina Policy Council (October 2009).
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Hassel, Bryan and Marguerite Roza. 2007. Funding the Child: Getting Results in South Carolina through Weighted Student Funding. Columbia, South Carolina: South Carolina Policy Council with the Thomas B. Fordham Foundation.


CHAPTER 11
INCREASING THE WORK INCENTIVES OF THE WORKING POOR:
A WELFARE ANALYSIS

by J. Sebastian Leguizamon and Anthony C. Gregory
UNLEASHING CAPITALISM

CHAPTER 5: SPECIFIC TAX REFORMS

Over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in million in fixtures). Notice that South Carolina's effective tax rate on industrial property is the lowest-tax state.)

Although it is probably not critical that South Carolina set its tax rate to the lowest in the country, it should definitely make it at least competitive for the Southeast. Since one of the lowest per capita incomes and economic growth rates in the country, it should be no surprise that it has the highest tax in the country on industrial property, at least initially. However, the overall reduction in tax revenues on industrial property, at least initially. However, the overall reduction in tax revenues on industrial property, at least initially. However, the overall reduction in tax revenues on industrial property, at least initially. However, the overall reduction in tax revenues on industrial property, at least initially. However, the overall reduction in tax revenues on industrial property, at least initially.

Table 5.8: Industrial Property Taxes in Southeastern states*, 2007

<table>
<thead>
<tr>
<th>State</th>
<th>Rank</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Carolina</td>
<td>1</td>
<td>$1,864,900</td>
<td>3.73%</td>
</tr>
<tr>
<td>Georgia</td>
<td>2</td>
<td>$760,381</td>
<td>0.48%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>3</td>
<td>$783,407</td>
<td>0.65%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>4</td>
<td>$833,234</td>
<td>0.98%</td>
</tr>
</tbody>
</table>

* Taxes measured in the states' largest city only.
Source: National Association of Manufacturers (2009)

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than Georgia's tax, and almost 4 times greater than North Carolina's. This puts South Carolina at a serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has...
11

INCREASING THE WORK INCENTIVES OF THE WORKING POOR: A WELFARE ANALYSIS

J. Sebastian Leguizamon and Anthony C. Gregory

As it has been mentioned before in this book, economic growth is the result of a process by which economic inputs are converted into economic outcomes. Economic growth can be achieved by either increasing the inputs to production or making the inputs more productive. However, increasing the level of capital investment alone is not sufficient to promote sustained growth. For instance, an economy’s investment in new and better machines becomes useless when it lacks the necessary workers to operate them. Thus, it is important to have willing individuals capable of fully exploiting the benefits of capital investment. However, we often observe able-bodied adults not willing to participate in the labor force, leaving unrealized productivity gains on the table.

Why do so many individuals opt out of the labor force? Although some individuals are pursuing unpaid productive endeavors, many are not. It is these individuals whose behavior affects the possibility for economic growth. As pointed out earlier, institutions play an important role in economic growth. Institutional structures that provide incentives conducive to economic growth, including incentives to participate in the labor force, are heavily influenced by public policy. Consequently, it is imperative to adopt economic policies that align worker’s incentives with an environment conducive to economic growth.

Currently, a relatively low number of able South Carolinians participate in the state’s labor force. While some not participating are students, stay-at-home spouses, or retirees enjoying a well-earned respite from work, a significant number are relying on state and federal aid instead of employment. Most troublesome, this is largely due to the state’s current design of aid programs. If South Carolina can right its public aid programs, the state will be well on its way to achieving its full economic potential.

ON THE OUTSIDE OF THE EQUATION

The unemployment rate is often cited as a primary measure of economic health, and typically portrayed as a snapshot of how efficiently a labor market is matching willing workers with the economy’s need for productive labor resources. The rate is calculated as the
number of unemployed workers expressed as a percentage of the total labor force, which is defined as the sum of employed and unemployed persons. While some individuals elect not to work, others might be willing to work but have given up searching for employment; in both instances, these individuals are not counted as members of the labor force. Figure 11.1 below illustrates the composition of the civilian non-institutional population, as defined by the Bureau of Labor Statistics (BLS).

Figure 11.1: Population, Labor Force, Employment, and Unemployment in South Carolina (2007)

Civilian Non-Institutional Population (Aged 16 years and older) = 3,367,233

Labor Force = 2,125,073

Not in the Labor Force = 1,242,160

Employed = 2,006,178

Unemployed = 118,895


Although its calculation is simple and straightforward, the unemployment rate fails to provide a complete view of the labor market. South Carolina’s rate of unemployment was 11.8 percent in July 2009, the sixth highest in the nation (Bureau of Labor Statistics, 2009). This is undoubtedly burdensome to the health of the state’s economy. This phenomenon, however, is mostly due to the 2008 recession created by the financial meltdown, and is likely a temporary figure. This chapter is focused on the long-run economic conditions faced by the South Carolinians, and going back to 2007 figures provides a better insight to the regular economic environment of the state. In 2007, and more in line with previous unemployment trends, the unemployment rate was approximately 5.6 percent.

\[
\text{Unemployment Rate} = \frac{\text{Number Unemployed}}{\text{Labor Force}} = \frac{118,895}{2,125,073} = 5.6\%
\]

However, a person is classified as ‘unemployed’ only if he or she is actively seeking employment. For example, full-time students, stay-at-home spouses, and early retirees who choose not to look for remunerated work are rightly not classified as unemployed. But what about those workers who grow tired of searching for work and decide to stop? Such persons could contribute to a company’s production of goods and services, but are not counted as members of the labor force and, consequently, are not captured in the unemployment rate.
In order to receive a more complete assessment of the health of the labor market, economists many times calculate the labor force participation rate in addition to the unemployment rate. The labor force participation rate is a measure of the number of able-bodied persons who are employed or actively looking for work in an economy. Therefore, subtracting the labor force participation rate from 1 provides a measure of potential workers who are not in the labor force. While we have seen that there are a variety of reasons why someone would voluntarily take themselves out of the workforce, this calculation also provides a view of the relative number of persons who are willing to work but have grown discouraged or found alternative sources of income outside of employment. By capturing those persons who are willing to work but are currently outside of the labor force, this calculation provides a deeper assessment of the growth potential of an economy. In 2007, out of the 3,367,233 individuals in South Carolina’s civilian non-institutional population, 63.1 percent were either working or searching for employment.

\[
\text{Labor Force Participation Rate} = \frac{\text{Labor Force}}{\text{Civilian Population}} = \frac{2,125,073}{3,367,233} = 63.1\%
\]

Economic growth, and therefore income growth, is reliant upon able-bodied, working-age citizens applying their knowledge, skills, and abilities to productive means. South Carolina’s labor force participation rate suggests that more than one third of the state’s citizens age 16 and over have found a reason to stop participating in activities that could potentially enhance the state’s economic growth. Some may have chosen to retire or are simply unable to work; yet within that 37 percent are many working-age individuals who could contribute to the Palmetto State’s economy, but are not doing so currently. When potential workers’ abilities are not being applied in a productive fashion due to misguided public policies, the potential for economic and earnings growth is inhibited.

Figure 11.2 below plots per capita income levels and labor participation rates for all 50 states and the District of Columbia in 2007. As the graph shows, high per capita income levels are normally associated with high labor force participation rates. Therefore, while a low unemployment rate could potentially indicate a healthy economy, it must be accompanied by a high labor participation rate for this to be true. An unemployment rate that is artificially low due to able-bodied workers literally taking themselves ‘out of the equation’ signals underutilized resources and is a harbinger of relatively slow economic growth.
Figure 11.2: Labor Force Participation and Per Capita Income (2007)

In 2007, South Carolina’s labor force participation rate of 63.1 percent ranked 44th among U.S. states and was nearly three percentage points below the national average. Even though labor force participation rates may be influenced by the number of individuals who decide to pursue full-time higher education, South Carolina’s ranking does not improve when labor force participation is calculated for individuals between 25 and 64 years of age. Using this age group, South Carolina’s labor force participation ranking remains at the 44th spot, just above Arizona and Louisiana.

According to the Bureau of Economic Analysis (BEA), the state’s per capita income in 2007 was $31,103, more than $5,000 below the national average. However, 2007 was not an anomaly; South Carolina’s labor force participation rate and per capita income levels have trailed surrounding states and the nation for many years. Can this sustained gap be explained? Although most states, on average, have experienced annual declines in their labor force participation during the past decade, Figure 11.3 also shows that states with the lowest average declines experienced higher income growth during the same time. Figure 11.3 shows that not only do states with higher labor force participation rates tend to have higher levels of income, but states whose public policies do not discourage labor force participation also have faster annual income growth. In this context, it can be observed why South Carolina’s economic growth has lagged behind most of the U.S. states.
Figure 11.3: Average Annual Income Growth Rate vs. Average Annual Growth of Labor Force Participation (1997-2007)


As the preceding graphs have shown, public policy that discourages individuals from joining the labor force impairs the standard of living of all residents by reducing South Carolina’s potential economic output. If South Carolina were to raise its labor force participation rate to the national average (66 percent), that would introduce an additional 97,300 workers into its economy. This participation could potentially increase the size of the state’s economy by $3 billion or more. In short, fewer South Carolinians participating in the workforce leads to less overall wealth creation and lower income levels.

OFFERING A REASON TO WORK

As mentioned above, South Carolina’s labor force participation rate ranks near the bottom being the 44th lowest in the nation. Discouraged workers can negatively impact the income potential of all South Carolina residents in both the present and future. Even if we include only individuals aged between 25 and 64, South Carolina’s labor force participation still ranks among the lowest ten states. While well above West Virginia (68.7 percent), Mississippi (73.0 percent), and Kentucky (73.6 percent), South Carolina’s 76.1 percent participation rate among those between ages 25 and 64 still lags behind the nation’s 78.0 percent, as well as Georgia and North Carolina (its neighboring states with 78.9 and 78.2 percent respectively). Moreover, when compared to those states with the highest labor force
participation rates (Nebraska, Minnesota, Iowa, North and South Dakota) South Carolina’s labor force participation rate is, on average, 10.1 percentage points lower. Thus, out of 100 individuals between the ages of 25 and 64, these states have on average 10 more individuals than South Carolina participating in the labor force.

However, might there be another reason than discouragement for working-age South Carolinians to choose not to seek employment? People desire to work for a variety of reasons; for a sense of purpose, to fulfill a passion, and due to the need and want to earn a wage that allows a decent standard of living. These reasons and many more act as incentives for individuals to seek employment.

For some individuals the benefits from working might be overshadowed by the benefits offered by state and federal assistance. Government aid programs are intended to help sustain individuals for a short period of time, until they can move upwards and out of poverty. Figure 11.4 illustrates, however, that there is no clear relationship between government assistance and the reduction of poverty. The chart depicts the percentage of individuals below the poverty line in 1980 and 2007. Clearly, the states that had the most people receiving public aid did not see the largest reduction in poverty.

Among the states with the highest percentage of government assistance, California and Rhode Island both grew the number of people living below the poverty line between 1980 and 2007. In contrast, Idaho, Utah, and New Hampshire all reduced their poverty rates in 2007, even though they were among the states with the lowest percentage of people receiving public assistance. South Carolina, positioned somewhere in the middle, has managed to decrease the overall number of people living in poverty since 1980. Nonetheless, if the benefits that come from employment barely outweigh what can be received by relying on government assistance, the incentive to join the labor force can be greatly diminished.

Figure 11.4: Does Public Aid Take Us Out of Poverty?

Source: U.S. Census Bureau (2009)
As defined in the figure above, public aid comes in several different forms. The federal welfare reforms of 1996 saw Temporary Assistance to Needy Families (TANF) replace what was known as Aid to Families with Dependent Children (AFDC), giving states a wide-ranging flexibility to design their assistance programs with federal funds (Department of Health and Human Services 2006). While there are some general rules, each state has discretion over the time limits and the amount of funds provided to each family. South Carolina’s TANF program is called ‘Family Independence’ (FI). Under FI, case managers work with eligible families in order to develop strategies to achieve sufficiency within 24 months (South Carolina Department of Social Services 2009). Other programs include Supplementary Security Income (SSI), which is an income assistance program intended for aged, blind, and disabled persons (Social Security Administration 2006), as well as the Supplemental Nutrition Assistance Program (SNAP) (previously known as Food Stamps), Women and Infant Care (WIC), Earned Income Tax Credits (EITC), and other subsidies such as public housing or rent assistance.

For the most part, these programs are meant to provide individuals with the temporary financial support necessary to sustain basic needs until the individuals can support themselves. Yet, the design of these programs may produce the unintended consequence of actually trapping people inside the welfare system. Government assistance that proves nearly as attractive as employment and, most importantly, penalizes those who seek meaningful jobs or increases in work activities to earn additional income, can have dire effects on an economy.

How could an assistance program penalize individuals who decide to work? Few would argue that assistance should not decrease as a person earns incrementally more income from working more hours or taking a pay increase. However, a person’s choice to remain on public assistance or to seek greater work hours depends heavily on how much of the earned income he or she actually brings home as disposable income. As earned income rises and individuals qualify for fewer assistance programs, the reduction in benefits can create situations whereby individuals only reap a small portion of their efforts to find and hold a job.

This disincentive to earn income can manifest itself through high implicit marginal tax rates. In the calculation below, we see that the implicit marginal tax rate represents the tax rate on a change in disposable income that is funded by a change in earned income. For example, if a welfare recipient’s earned income from work rises by $5,000, and her benefits are reduced by $4,000, she only realizes an additional $1,000 in disposable income. This translates into an enormous implicit marginal tax rate of 80 percent.

\[
\text{Implicit Marginal Tax Rate} = 1 - \frac{\text{Change in Disposable Income}}{\text{Change in Earned Income from Employment}}
\]

A typical public aid recipient can participate in several aid programs concurrently. While each program considers how quickly benefits are reduced as earned income rises, a problem arises when these reductions are aggregated across aid programs. Therefore, the combined implicit tax rate from all programs, rather than each program individually, strongly shapes the incentive – or disincentive – to work. Moreover, employed individuals are faced with paying federal and state income taxes and employment taxes, in addition to experiencing a reduction in aid benefits.

The disincentives to employment that we have been describing are easily illustrated in South Carolina. In Figure 11.5 on the next page, we have constructed a schedule of total
earnings, taxes, and benefits, and the resulting disposable income an individual would experience given a varying level of weekly work hours and pay in 2007. In this case, we have profiled a single mother with two children, whose benefits include TANF (FI), Food Stamps, EITC, WIC, and housing assistance. Implicit tax rates on additional earned income are calculated in the far right-hand column.

**Figure 11.5: The Effect of Transfer Benefits, Taxes, and Work Related Expenses on the Incentive of a South Carolina Mother of Two**

<table>
<thead>
<tr>
<th>Weekly Hours</th>
<th>Yearly Earnings</th>
<th>Total Taxes</th>
<th>Total Benefits</th>
<th>Child Care Expenses*</th>
<th>Medicaid / SCHIP (# enr.)</th>
<th>Disposable Income</th>
<th>Implicit Marginal Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 Hours</td>
<td>$0</td>
<td>$0</td>
<td>$13,008</td>
<td>$0</td>
<td>3</td>
<td>$13,008</td>
<td>23.09%</td>
</tr>
<tr>
<td>20 Hours</td>
<td>$5,352</td>
<td>$408</td>
<td>$12,180</td>
<td>$0</td>
<td>3</td>
<td>$17,124</td>
<td>37.84%</td>
</tr>
<tr>
<td>25 Hours</td>
<td>$6,684</td>
<td>$504</td>
<td>$11,772</td>
<td>$0</td>
<td>3</td>
<td>$17,552</td>
<td>63.39%</td>
</tr>
<tr>
<td>30 Hours</td>
<td>$8,028</td>
<td>$612</td>
<td>$11,028</td>
<td>$0</td>
<td>3</td>
<td>$18,444</td>
<td>69.64%</td>
</tr>
<tr>
<td>35 Hours</td>
<td>$9,372</td>
<td>$708</td>
<td>$10,908</td>
<td>$720</td>
<td>3</td>
<td>$18,852</td>
<td>72.42%</td>
</tr>
<tr>
<td>40 Hours</td>
<td>$10,704</td>
<td>$816</td>
<td>$16,716</td>
<td>$720</td>
<td>2</td>
<td>$19,884</td>
<td>25.52%</td>
</tr>
<tr>
<td>40 Hours @ $6.00</td>
<td>$12,468</td>
<td>$732</td>
<td>$16,620</td>
<td>$1,000</td>
<td>2</td>
<td>$20,376</td>
<td>72.11%</td>
</tr>
<tr>
<td>40 Hours @ $6.50</td>
<td>$13,512</td>
<td>$660</td>
<td>$16,056</td>
<td>$1,000</td>
<td>2</td>
<td>$20,928</td>
<td>71.13%</td>
</tr>
<tr>
<td>40 Hours @ $7.00</td>
<td>$14,028</td>
<td>$612</td>
<td>$9,780</td>
<td>$1,000</td>
<td>2</td>
<td>$21,216</td>
<td>44.19%</td>
</tr>
<tr>
<td>40 Hours @ $7.25</td>
<td>$15,072</td>
<td>$540</td>
<td>$9,072</td>
<td>$1,000</td>
<td>2</td>
<td>$21,624</td>
<td>64.44%</td>
</tr>
<tr>
<td>40 Hours @ $7.50</td>
<td>$15,588</td>
<td>$504</td>
<td>$8,676</td>
<td>$1,000</td>
<td>2</td>
<td>$21,780</td>
<td>69.77%</td>
</tr>
<tr>
<td>40 Hours @ $7.75</td>
<td>$16,116</td>
<td>$456</td>
<td>$8,400</td>
<td>$2,184</td>
<td>2</td>
<td>$21,876</td>
<td>81.82%</td>
</tr>
<tr>
<td>40 Hours @ $8.00</td>
<td>$16,632</td>
<td>$432</td>
<td>$8,016</td>
<td>$2,184</td>
<td>2</td>
<td>$22,032</td>
<td>69.77%</td>
</tr>
<tr>
<td>40 Hours @ $8.25</td>
<td>$17,148</td>
<td>$384</td>
<td>$7,620</td>
<td>$2,184</td>
<td>2</td>
<td>$22,200</td>
<td>67.44%</td>
</tr>
<tr>
<td>40 Hours @ $8.50</td>
<td>$17,676</td>
<td>$348</td>
<td>$7,236</td>
<td>$2,184</td>
<td>2</td>
<td>$22,380</td>
<td>65.91%</td>
</tr>
<tr>
<td>40 Hours @ $8.75</td>
<td>$18,192</td>
<td>$312</td>
<td>$6,852</td>
<td>$2,184</td>
<td>2</td>
<td>$22,548</td>
<td>64.44%</td>
</tr>
<tr>
<td>40 Hours @ $9.00</td>
<td>$18,708</td>
<td>$276</td>
<td>$6,456</td>
<td>$2,184</td>
<td>2</td>
<td>$22,704</td>
<td>69.77%</td>
</tr>
</tbody>
</table>

a) Minimum wage as of early 2007 was $5.15 an hour. This has been changing as a result of the Fair Labor Standards Act (FLSA). Total benefit calculations are based on benefit rules for 2005 (latest available), and may be subject to more current revisions. South Carolina also requires a minimum of 30 hours of work related activities in order to be eligible for welfare. Some of the work related activities include education and training. There are people that receive benefits even though they work zero hours, due to the fact that they may be looking for work. The top of the table analyzes changes to the number of hours when mothers work at the state’s minimum wage. Once they have reached the full-time benchmark, the table analyzes changes in wages. The table goes up to 40 hours per week at $9.00 dollars per hour. At this point, the person has come out of poverty, according to the Federal Poverty Line for 2007 ($17,600 for a family of three).

b) Child care expenses are those for which the family is responsible, after accounting for child care subsidies. The table assumes no child support since in many occasions this depends on court rulings. Monthly child care costs were calculated using data from the National Association of Child Care Resource & Referral Agencies (http://www.naccrra.org). Additionally, monthly house rent/mortgage was tabulated using weighted averages from the American Community Survey (2006 and 2007). Finally, all other calculations, including state and federal taxes, were obtained using tabulating tools from the beta version of the Low Income Family Project by the Urban Institute. The implicit marginal tax rates were calculated by the authors given the values obtained in all other tabulations.

Benefits include EITC, TANF, Food Stamps, WIC, House Subsidies.

Without employment, and thus no earned income, this single mother of two receives $13,008 in total aid. Let us say that she finds a part-time job for 25 hours per week; she now earns $6,684 from this job and receives $11,772 in benefits for a total disposable income of $17,952 after taxes. By pursuing part-time employment, this woman increased her total spendable income by $4,944, while her earned income increased by $6,684. Therefore, the
implicit marginal tax rate she faced when deciding whether or not to accept this part time job was around 26 percent;\(^1\) most economists agree that this is within the realm of not discouraging employment.

Due to her good performance, her boss asks if she would be interested in working another 5 to 10 hours per week. Taking on an additional 5 hours, for a total of 30 hours of work per week, leads to an increase in this woman’s earned income of $1,344, but her total disposable income only rises by $492. In this decision, the woman faces an implicit tax rate of 63 percent. Employment taxes are part of the reason, albeit small, as they rise by $96. However, the primary reason for the high marginal tax rate comes from a steep falloff in benefits; working an additional 5 hours causes this single mother’s benefits to drop by $744. For this reason, this woman now has a significant incentive to reject her boss’s offer of additional work and income. This ‘disincentive’ would be strengthened further if this single mother must also seek additional childcare or added transportation costs due to the extra hours.

If this mother of two decided to go from being fully dependant on public welfare (working 0 hours a week) to being a full-time worker (40 hours a week at $5.15 per hour), her disposable income would rise from $13,008 to $19,884. This amounts to an increase of $6,876, only 64.2 percent of her total earned wages ($10,704), translating into an implicit marginal tax rate of 35.8 percent.\(^2\) This rate is comparable to the marginal income tax rate faced by the top 5 percent of the wealthiest Americans.

The example above is repeated throughout the table in Figure 11.5. Normally, we think of accepting additional hours at work, transitioning from part-time to full-time, or pay increases as milestones in a person’s career. Yet, when these achievements are combined with stair-step public aid reductions, it becomes apparent why the structure of public assistance programs could trap an individual in poverty by incentivizing them to remain on public aid and, thus, out of the workforce.

Further evidence that the current structure of public aid in South Carolina poses a disincentive to work is shown in Figure 11.6 below. The change in work participation rates of TANF recipients are plotted by state from 2002 to 2006. Georgia showed the largest increase, with the work participation rates of TANF recipients rising by nearly 60 percentage points. On the other hand, Massachusetts experienced the largest decrease, with a drop of nearly 50 percentage points. While not witnessing a relatively large decrease, South Carolina’s work participation rates dropped by nearly 5 percentage points. The fact that a smaller share of TANF recipients in South Carolina were working in 2006 versus 2002 illustrates that the disincentives described above have changed very little, at best, or have possibly worsened.

Even though Georgia’s impressive increase in labor force participation of TANF families is partly due to an initial 8.2 percent participation rate in 2002, work participation of TANF families in Georgia in 2007 was 15.4 percentage points higher than that in South Carolina. Evidently, there are several lessons that can be learned from the neighboring state.

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\(^1\) This implicit marginal tax rate represents the case in which a welfare recipient goes from 0 to 20 hours of work. This example is not included on the table, which only shows implicit marginal tax rates based on 5-hour increments.

\(^2\) This implicit marginal tax rate is calculated as we change from 0 to 40 hours of work. This provides a different scenario from that presented in the table, where the implicit marginal tax rate is calculated as we increase working hours from 35 to 40.
Referring to TANF exclusively, Georgia appears to have stricter eligibility criteria. For instance, a typical poor Georgian family of three may not receive benefits for more than 48 months over its lifetime. In contrast, South Carolina’s time limit is currently as high as 60 months, which allows recipients to stay on the rolls for longer periods of time. Additionally, the asset limit determination is more rigid in Georgia. In order to qualify for TANF in Georgia, a family must not have assets exceeding $1,000. In South Carolina, however, this limit is $1,500 higher than Georgia’s asset limit. While this may seem small, this difference allows more families to qualify for benefits under South Carolina’s FI program than under the Georgian counterpart. As a result of the loose eligibility rules, it is not surprising to see more South Carolina families depend on TANF rather than earnings from work, relative to Georgia.

**Figure 11.6: Percentage Change in Work Participation Rates of Families Receiving TANF between 2002 and 2006**

Source: U.S. Department of Health and Human Services (2009) (Note: This graph measures the difference between the work participation rates between 2002 and 2006).

**DISABILITY OR DISINCENTIVE?**

Disability insurance claims may yet be another aid program that can create disincentives to work. Rejoining the labor force may seem very unattractive to previously injured South Carolinians that continue receiving disability benefits once those injuries have been overcome. Under federal law, social security disability benefits must be discontinued if the individual is no longer disabled or when he/she returns to work. However, disability eligibility is not restricted to physical impairments. Emotionally disabled workers may also be eligible for benefits if found incapable of doing a job that is available to the worker.
While physical disability is relatively easy to assess, emotional health tests are subject to psychological scrutiny, which can be a target of ‘rent seeking’ behavior. In this context, otherwise healthy, ineligible recipients may wrongfully receive disability benefits through a flawed eligibility determination process. Improving screening processes for disability applicants could aid in reducing the number of non-disabled persons receiving benefits.

The Social Security Administration (SSA) reported that in 2007 approximately 3.2 percent of South Carolinians received social security disability benefits. Although South Carolina is not the state with the highest percentage of the population receiving disability payments, it scores 0.7 percentage points above the national average (2.5 percent). As Figure 11.7 shows, there is a strong negative correlation between the percent of the population receiving federal disability benefits and labor force participation in 2007. In other words, low ratios of disability receipts are usually associated with higher levels of labor participation. Conversely, it is possible that defective screening processes keep able-bodied workers out of the labor force, raising the percentage of South Carolina’s population receiving federal disability benefits.

Figure 11.7: Share of Population with Federal Disability Benefits and Labor Force Participation Rate (2007)

Source: U.S. Census Bureau and Social Security Administration (2009)

Economists Benitez-Silva, Buchinsky, and Rust (2004) found that, between 1992 and 1996, an average of 22 percent of applicants awarded disability benefits were not truly disabled and 58 percent of legitimately disabled applicants were denied benefits. They propose an alternative mechanism relying on the applicant’s health data and screening to produce a ‘disability probability.’ Benefits then would be granted to applicants with the
The highest probability of being disabled. This in turn could improve the eligibility process by reducing the awarding of benefits to non-disabled applicants by nearly 11 percentage points, while also lowering wrongful denials to truly disabled individuals by approximately 14 percentage points. Improved screening processes will likely lead to cost reductions and better targeting of benefits to those who rightfully need them the most.

Aside from loose eligibility screening processes, high levels of disability benefits will likely act as a disincentive to pursue employment. As stated by David Autor and Mark Duggan (2002), “the generosity of disability benefits leads to reduced participation in the labor force.” They also note that even though benefits are progressive, they are not indexed to the wage levels in the region, suggesting that workers in states with low wages face significantly higher earnings replacement rates, compared to workers in other states. This replacement rate refers to the ratio of disability income to prior wages. Thus, workers in states with low wages and high levels of average monthly disability benefits such as South Carolina ($1,002 per recipient), have an incentive to attempt to qualify for disability instead of seeking employment.

**Proposing a Better Way Forward**

South Carolina’s labor force participation rate is the 6th lowest in the United States. In terms of poverty and the share of the population relying upon public assistance, South Carolina ranks somewhere in the middle with plenty of room for improvement. Although economic growth is determined by many different factors, this chapter has illustrated how some of the existing welfare policies are affecting the incentive structure in South Carolina by suppressing participation in the labor force, which is an important determinant of economic progress.

We demonstrate how a single mother of two, recipient of several forms of public assistance, may be subject to high implicit marginal tax rates as she seeks self-reliance through employment. Rather than encouraging greater work-related activities, the existing design of assistance programs may cause long-term public aid to appear as the best option. Additionally, other transfer programs such as disability benefits, may lead work-eligible individuals to pursue government assistance due to flawed screening processes and generous benefit levels.

South Carolina’s problems are not isolated, nor are they as deep as some other states’. Employment disincentives created by high levels of transfer benefits potentially affect all states. South Carolina must necessarily adjust some of its welfare policies in order to keep its citizens from falling into a trap created by perverse incentives, and instead keep raising the standard of living of its residents by pursuing growth-oriented policies.

As evidenced in this chapter, we believe that welfare policy reform in South Carolina can empower low-income individuals to move out of poverty and into self-reliance through employment. Reforms need to focus heavily on addressing the high implicit tax rates that the working poor face as their earned income increases and benefit levels are reduced. Here, the focus should primarily address the lack of coordination among the different welfare programs in benefit reduction. As shown, tax rates for these individuals may reach levels as high as 72 percent, more than two times the level of marginal income tax rates faced by the richest families in the United States.
South Carolina policy makers should take advantage of the flexibility given by the federal government in controlling the funds awarded by the Temporary Aid for Needy Families program in order to design a welfare system with incentives focused on employment. Public assistance that motivates individuals to come out of poverty, replacing welfare income for work earnings, will boost South Carolina’s economic growth and move the state upwards in economic rankings.

Without reform, South Carolina may face the possibility of never reaching the economic growth that neighboring states enjoy. South Carolina’s incentives mechanism must be based on the principle that allowing individuals to keep the majority of work-related income they earn provides additional benefits that cannot be found in a monthly government check. Until then, many potential workers will have reason to think twice before joining the labor force, and the Palmetto State’s economy will continue to suffer because of it.
REFERENCES


CHAPTER 12

CONSTITUTIONALLY CONSTRAIN GOVERNMENT TO UNLEASH CAPITALISM

by Daniel S. Sutter and Andres Bello
over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in industry moves into the state. Furthermore, if the official tax rates are lowered, then the state revenue may in fact increase once the growth rate in the state begins to pick up and more such a significant reduction in taxes on industrial property would obviously lead to a

at around 1 percent might be sufficient to attract more industry. Working to reduce the Georgia's rate is effectively 1.52 percent and North Carolina's is just under 1 percent, a rate since South Carolina has the highest tax in the country on industrial property, it should be no surprise that it has serious disadvantage, in terms of its ability to attract and keep industry. Since South Carolina is one of the lowest per capita incomes and economic growth rates in the country.

Importantly, South Carolina's effective tax rate is almost 2.5 times greater than

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<th>State Rank (of 50)</th>
<th>Net Tax</th>
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</thead>
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<tr>
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<tr>
<td>50</td>
<td>$0</td>
<td>1.09%</td>
</tr>
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* Taxes measured in the states' largest city only.

Source: National Association of Manufacturers (2009)
12

CONSTITUTIONALLY CONSTRAIN GOVERNMENT TO UNLEASH CAPITALISM

Daniel Sutter and Andres Bello

INTRODUCTION

Society can either rely on private or public sector decision-making to allocate resources. The chapters of this book have described the benefits of capitalism, or private sector decision-making. This chapter addresses the most direct way government can direct resources, by taxing and spending. Economists have documented the benefits of limiting the size and scope of government, and we begin by reviewing the evidence on how large government slows growth. Despite the cost of large government, public choice analysis reveals that the interactions of self-interested politicians, bureaucrats, citizens, and interest groups result in excessive spending, or more spending than desired by the average citizen. We examine three ways to counter the spending bias of representative democracy and benefit South Carolina: fiscal decentralization and competition between local governments; separation of powers; and tax and expenditure limits. Along the way we specifically examine the performance of South Carolina. South Carolina scores about average overall on the economic freedom index of institutional quality, but South Carolina’s poor record on government spending substantially lowers its ranking. South Carolina ranks below the national average on several measures of entrepreneurship, the mechanism through which economic freedom translates into growth. Reducing the size of state and local government will be important in unleashing capitalism in South Carolina.

MARKET INSTITUTIONS AND ECONOMIC PROSPERITY

Adam Smith, the founder of economics, was an early proponent of the role of institutions in generating wealth for nations. The last several decades have witnessed an explosion of research examining the link between institutions, and specifically the institutions of the market economy, to economic growth, both across nations and within nations. Humans
have an inherent tendency to improve the quality of their lives, and the institutions of a market economy harness this self-interest in service of others through the profit incentive.

Much of the recent research on institutions and economic performance employs an index of economic freedom for more than 140 countries worldwide compiled by the Fraser Institute (Gwartney and Lawson 2008). The international economic freedom index measures the quality of institutions based on five component areas: the size of government, the legal system and protection of property rights, the quality of the money supply, freedom to engage in international trade, and economic regulation (e.g., of credit and labor markets). The index is a score from 0 to 10, with 10 representing a high level of economic freedom. The index allows comparisons between countries, or a way to classify countries as having more or less economic freedom. A market economy requires a legal infrastructure protecting property rights and the freedom to trade. Internationally, many weak or predatory governments fail to supply the basic framework for market exchange, with terrible consequences for human well-being, as illustrated by Figure 12.1. The figure reports Gross Domestic Product (GDP) per capita, a measure of the standard of living across nations, averaged across quintiles of countries as ranked by their economic freedom score, as reported by Gwartney and Lawson (2008). GDP per capita is nearly ten times higher in the top 25 percent of countries as ranked by economic freedom than in the bottom 25 percent of countries. These differences in standard of living did not occur over night, and can reflect the cumulative impact over decades of an environment hospitable to a market economy. The difference between the top and bottom quartiles of nations reflects the effect of the lack of protection of property and the rule of law. But GDP per capita is still more than double in the freest 25 percent of countries than in the second 25 percent, so even among nations where the rule of law is reasonably well established, limiting government spending and regulation is critical for growth and a high standard of living. Economic freedom does not merely lead to the pursuit of a narrow measure of the standard of living, or produce growth for some at the expense of poverty for others. Norton and Gwartney (2008) show that economic freedom reduces extreme poverty and improves a nation’s score on the United Nations’ Human Poverty Index.

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1 Economists have extensively investigated the relationship between economic freedom and prosperity. For a discussion of some of the findings of these studies, see Gwartney, Holcombe and Lawson (2004) and Lawson (2007).
Figure 12.1: Economic Freedom and Prosperity

Source: Gwartney and Lawson (2008)

The record also shows that a large state government slows economic growth. The impact of state and local government on economic performance is surprising, given that all U.S. states share the same basic legal framework (the rule of law, an independent judiciary), and that federal government spending, taxation and regulation are consistent across the states. Yet differences in economic freedom across states affect prosperity.
Figure 12.2: Per Capita Income (2008) vs. Size of State Government (1977)

![Graph showing relationship between state spending as a percent of income (1977) and per capita personal income (2008). The graph includes a fitted line indicating a negative relationship. Source: U.S. Census and Bureau of Economic Analysis]

Figure 12.2 illustrates the long run relationship between government size and the economy. The figure plots state per capita personal income (PCPI) in 2008 against state spending as a percentage of personal income in 1977. This allows us to see the impact of large state government in 1977 on standards of living three decades later. States with larger governments in 1977 had lower incomes 30 years later, as indicated by the negative slope to the trend line plotted through the scatter plot. The fitted line indicates that a large state government in 1977, about 12 percent of income versus 5 percent, reduced PCPI in 2008 by about $5,000.
Figure 12.3: Growth in Per Capita Income vs. Growth in State Spending As a Percentage of Personal Income

![Graph showing the relationship between growth in per capita income and growth in state spending as a percentage of personal income.](image)

Source: U.S. Census, Bureau of Economic Analysis and author’s calculations

Figure 12.3 considers the relationship between state spending growth and economic growth. The figure plots the growth in real PCPI between 1992 and 2006 for the contiguous United States against the growth in state spending as a percentage of income over the same period. The trend line shows a negative relationship between fast growing governments and economic growth.²

Regulations and mandates can substitute for government spending, so spending may paint an incomplete portrait of government allocation of resources. For example, government could protect coastal barrier islands by purchasing private lands at fair market value, which

² Vedder and Gallaway (1997, 1998) provide further evidence on the consequences for growth of excessive spending and references to other recent econometric studies.
would involve a substantial expenditure, or simply prohibit owners from developing their property. Regulation affects the use of private property as surely as if the state government had purchased the lands. Thus the evidence on state economic freedom and growth discussed in Chapter 2 is relevant to our topic. Lower economic freedom, even at the subnational level, reduces income and slows growth.

Figure 12.4: Economic Freedom: South Carolina and Its Neighbors

<table>
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<tr>
<th>State</th>
<th>Overall Index</th>
<th>Size of Government</th>
<th>Takings and Discriminatory Taxation</th>
<th>Labor Market</th>
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<td>6.0 (T-40th)</td>
<td>6.7 (T-34th)</td>
<td>8.4 (T-1st)</td>
</tr>
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<td>North Carolina</td>
<td>7.6 (T-3rd)</td>
<td>7.5 (T-14th)</td>
<td>7.5 (T-11th)</td>
<td>7.3 (9th)</td>
</tr>
<tr>
<td>Georgia</td>
<td>7.6 (T-3rd)</td>
<td>7.7 (12th)</td>
<td>7.5 (T-11th)</td>
<td>7.4 (T-10th)</td>
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<tr>
<td>U.S. Average</td>
<td>6.9</td>
<td>6.9</td>
<td>7.0</td>
<td>6.8</td>
</tr>
</tbody>
</table>

Source: Karabegovic and McMahon (2008).

Figure 12.4 displays the 2008 annual all government economic freedom scores (from 2005) of South Carolina, North Carolina and Georgia.\(^3\) South Carolina’s overall score of 6.8 ranks tied for 25\(^{th}\) nationally and is just below the national average of 6.9. But both Georgia and North Carolina score 7.6 and tie for 3\(^{rd}\) nationally, ranking higher than South Carolina. Figure 12.4 also reports the score and national rank of all three states on each of the three components of state and local economic freedom: the size of government, takings and discriminatory taxation, and labor market regulation. South Carolina has a mixed institutional environment. On the one hand, South Carolina’s score of 8.4 in labor market regulation ties it for the top spot nationally. However, the state ranks 40\(^{th}\) in the size of government area with a score of 6.0, and 34\(^{th}\) with a score of 6.7 on takings and discriminatory taxation. South Carolina thus has a problem with the size of government and high tax rates. The state’s taxing and spending problem is exacerbated because North Carolina and Georgia rank among the top 15 states nationally in each of these areas.

The importance of limiting the size of government for economic prosperity cannot be overstated. Economists Richard Vedder and Lowell Gallaway (1998) conclude based on evidence at the state, federal, and international level that a stable, hill-shaped relationship between income and the size of the public sector.\(^4\)

As government grows from a very low level, the growth provides police, courts and national defense which sustain the framework the market economy requires: stable property rights, enforcement of contracts, and protection from foreign invaders and marauders. Government provided infrastructure and services like roads and highways, schools, and fire protection also increase the productivity of the economy. Yet as government expands past these core functions, however, the expansion of government reduces growth and income begins to fall.\(^5\) Government growth hurts the economy in three ways. First, government

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\(^3\) The full indices are contained in Karabegovic and McMahon (2008) and available on-line at www.freetheworld.com/efna.html.

\(^4\) Vedder and Gallaway (1998) call this the “Armey curve” in honor of economist and former Congressman Richard Armey, who hypothesized the existence of such a relationship.

\(^5\) Olson (1982) examines democratic rent seeking and economic stagnation.
increasingly makes resource allocation decisions, and these decisions are made for political reasons, not profit or loss considerations. Second, government must tax to fund spending. Taxes distort choices in the market, and the cost to the economy of this distortion exceeds the dollars collected for government to spend. Higher taxes reduce economic freedom, entrepreneurship (Garrett and Wall 2006), and growth (Poulson and Kaplan 2008). Marginal tax rates, the tax people pay if they earn an extra $1,000 or if a business earns an extra $1 million in profit, determine how much taxes reduce economic activity. The disruptive effect of taxes increases more than proportionally with the tax rate, so that the distortion from a 20 percent income tax rate is more than double that from a 10 percent. Vedder and Gallaway (1999) contend based on the available evidence that the cost of taxes may be 40 cents or more per dollar of revenue raised. Third, interest groups use resources to lobby politicians for increased spending, what Gordon Tullock (1967) labeled ‘rent seeking.’ Resources spent trying to secure favors from government cannot be used to produce things of value like cars, clothes, homes, and computers, making society poorer.

**ENTREPRENEURSHIP: TURNING ECONOMIC FREEDOM INTO PROSPERITY**

Economists have made considerable progress over the past several years establishing entrepreneurship as the link between economic freedom and prosperity. This is not surprising as previously economists like Joseph Schumpeter, Ludwig von Mises, and Israel Kirzner argued that the entrepreneur is the agent of creative destruction and progress in the market economy. The entrepreneur is the source of ideas for new or improved products, new uses for existing products, and new forms of economic organization. Entrepreneurship requires a free market, because we cannot know what new ideas will be discovered, or from where these ideas will come. Recent research documents how economic freedom increases entrepreneurship, using a variety of different measures of entrepreneurial activity, including the number of sole proprietorships, net business formation, patents, and venture capital.\(^6\) Taxes and regulations like minimum wages particularly (which affect economic freedom) negatively impact entrepreneurship.

**Figure 12.5: Economic Freedom and Entrepreneurship**

<table>
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<tr>
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<tbody>
<tr>
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<tr>
<td>Least Free</td>
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</tbody>
</table>


Figure 12.5 illustrates the impact of economic freedom on two measures of entrepreneurship, sole proprietorships as reported by Garrett and Wall (2006), and an index of productive entrepreneurship constructed by Sobel (2008). The Figure compares the mean levels of entrepreneurship in the five states with the highest economic freedom scores and five states with the lowest economic freedom scores (plus ties in each case).

South Carolina faces an entrepreneurship deficit. The state ranked tied for last with Mississippi in sole proprietorships in 1990 and ahead of only West Virginia in 2000 (Garrett and Wall 2008), and tied for 29th in Sobel’s (2008) index of productive entrepreneurship. The entrepreneurship deficit must be closed for South Carolina to capture the full benefits of the market economy.

Can South Carolina take direct steps to generate entrepreneurship? Would-be entrepreneurs will point out that they could start new businesses if they could obtain access to venture capital or other types of subsidies. State development policies were examined in detail in Chapter 7, and have an indistinguished record. Development incentives often disadvantage new and small businesses, which lack the political clout to obtain such favors, and face higher taxes to pay for the programs. Kreft and Sobel (2005) specifically examine the relationship between venture capital and entrepreneurship across states and found that entrepreneurship attracts venture capital, while an increase in venture capital does not increase entrepreneurship. Kreft and Sobel (2005, 603) observe, “entrepreneurial activity must be the focus of development efforts and venture funding will automatically, and naturally flow into the area to support this activity.” Entrepreneurship requires ideas and alertness for new profit opportunities, tasks for which state governments have no comparative advantage.

Politicalization of the economy affects entrepreneurship in a second way beyond simply disrupting productive, wealth-generating activities. The human drive for self-improvement does not disappear as opportunities to pursue profit in the market are blocked. Instead, as William Baumol (1990) has argued, and as examined in Chapter 2, politicization of the economy shifts entrepreneurship to socially unproductive forms like litigation or the pursuit of government subsidies and favors. The same creativity, alertness and intelligence which generate new wealth for the economy under good institutions become a drain on the productive economy. We see political entrepreneurship at work when companies exploit state development incentives, and in the successful efforts of banks and automakers to obtain government bailouts.

**THE IMPERFECTIONS OF POLITICS AND EXCESSIVE GOVERNMENT SPENDING**

The economic analysis of institutions and growth demonstrates what government must do to facilitate growth: maintain secure property rights, provide an efficient court system, and supply important public goods like national defense or infrastructure. Then government must avoid politicizing the economy, by taxing, spending, and regulating too much. South Carolina particularly must control government spending and addressing its entrepreneurship deficit. It might seem that in order to unleash capitalism, South Carolina voters need to work to elect politicians who will reduce spending.

Yet direct political action, paradoxically, is unlikely to attain this goal. To understand why, we must consider insights from the application of economic analysis to the political
process, or public choice economics. The vision of democracy emerging from public choice scholarship contrasts sharply with the high school civics class. Political decision making suffers from a number of serious problems in comparison with market decision making and these problems lead government to spend too much, that is, more than the average citizen would like government to spend. Representative government results in a budget which is not merely larger than fiscal conservatives’ desire, but larger than the majority of voters prefer. Democratic politics fails to deliver a government of the size we desire.\footnote{The classic public choice analysis of democracy is Buchanan and Tullock (1962). Mueller (2003) provides a recent synthesis and overview, while Mitchell and Simmons (1994) provide a very readable treatment. For an analysis of the differences in the pathologies of politics at the level of the individual citizen, see Caplan (2007).}

The first element of politics leading to excessive spending is the considerable power to shape government decisions possessed by political agenda setters. Politics is like sports in that match ups matter. Some teams match up very well against some opponents but very poorly against others. If you could set the matchups in a playoff tournament, you could create a bracket to help your favorite team. You could go a long way toward getting your favorite team to the championship merely by setting the matchups, even without blatantly cheating in your team’s favor (e.g., making their opponents play short handed). A similar dynamic prevails in politics. Legislators can limit what bills their colleagues get to vote on, or if their colleagues can offer amendments during floor debate. Legislative leaders can assign a bill they oppose to a hostile committee to ensure that the bill dies; agenda setting explains why the majority party in Congress or a state legislature has so much power. Politicians and bureaucrats can also manipulate the ballot propositions and tax measures which citizens get to vote on in elections. Voting and elections never pin down one outcome, allowing politicians to influence the eventual outcome. Given that politicians can benefit from spending money (providing benefits to grateful constituents or bureaucrats), they will take advantage of agenda power to increase government spending.

We live in a representative and not a direct democracy, and this creates a second problem, the control of politicians. A legislator can pursue his or her interests at constituents’ expense on some issues because voters have only relatively weak means to control politicians. Reelection is the main incentive citizens have to control their representatives; other types of political action like sending letters or making phone calls and working for (or contributing to) a candidate eventually affect reelection prospects. Yet we elect legislators once every two or four years. Consequently all the votes, committee work, bills sponsored and hearings held over two (or four) years by an incumbent legislator must be combined into one vote for or against, and turning out the incumbent may mean electing a weak opponent. Citizens might have one or two issues which matter most to them, and vote for or against their legislator based on their position on these issues. Beyond one’s vote, the citizen has no further leverage to reward or punish any other actions by their representative. By contrast, firms can have their employees work for a salary, or on commission, or pay bonuses based on profit or team performance, offer promotions and raises, and terminate employment relatively quickly for unacceptable performance. One election every two years is a poor control, leaving legislators comparatively broad discretion to pursue policies that either they or special interest groups prefer at the expense of constituents.

The third problem of politics is a lack of decisiveness for individual action, that is, individuals can not directly decide political outcomes. In the market, our choices or actions decide what happens to us, largely if not totally. For example, if you choose to buy soft drinks

10.48%

1.56%
and not bottled water at the grocery store, you will come home with soft drinks. We can decide what career to pursue, or if we want to start a business, even though we cannot guarantee ourselves success. In politics you can vote, volunteer, or contribute money to your favorite candidate or cause, yet still end up with the other outcome. In politics, our actions rarely determine outcomes: your vote only actually decides a tie election, and elections almost never end in ties. The weak correlation between action and outcomes gives people little reason to participate in politics – why take time off work to go stand in line if your vote is unlikely to matter? This also reduces the incentive for people to become informed about politics – candidates in elections, ballot propositions, and bills under consideration. The lack of incentive to follow politics is known as rational ignorance. The lack of decisiveness also lowers the cost of voting to make a statement without regard to the actual consequences of a policy. Thus people might vote to increase the minimum wage to show that they care about the working poor, even though a higher minimum wage increases unemployment for low wage workers.\(^8\)

Together the problems of politics create a bias toward excessive spending in representative democracy through the ‘law’ of concentrated benefits and dispersed costs.\(^9\) Agenda control creates the ability for politicians to pursue policies benefitting themselves or interest groups, and infrequent elections are a weak device to prevent such manipulation. Bureaucrats and government employees will favor increased spending which leads to higher salaries, larger staffs, greater prestige from controlling a larger budget, and additional resources to pursue their mission, and will support representatives who deliver larger budgets.\(^10\) Politicians can take credit for government spending to address a problem, like say hiring more police officers to fight crime, building more prisons, or raising teacher salaries. Because of the weak connection between participation and outcomes in politics, only people with a lot at stake tend to follow the issue and get involved. Generally these are the beneficiaries of government spending, as the costs of government spending - higher taxes and reduced disposable income for families - are widely dispersed, and rarely result in press conferences or photo opportunities. For example, there are about 70,000 full-time public school (K-12) teachers in South Carolina, and about 1.77 million households in the state. If the state government appropriated funds to give each teacher a $5,000 per year raise, the cost per household would be about $200 per year. Two hundred dollars is not a trivial sum, but the average teacher has much more at stake than the average taxpayer. So it is not surprising that teachers and not taxpayers rally at the state capitol when the legislature considers school funding. Powerful teachers unions will lobby and make campaign contributions to support legislators’ votes to increase spending on public schools.\(^11\) Politicians will find that voting for increased spending brings them benefits.

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\(^8\) Brennan and Lomasky (1993) call this type of voting “expressive voting” and analyze such incentives in democracy. See also Caplan (2007) on how the lack of decisiveness can have far-ranging effects on voters’ political world views.

\(^9\) Buchanan and Wagner (1977) offer an excellent dissection of democratic politics’ pro-spending bias.

\(^10\) Niskanen (1971) analyzes the pro-spending bias of government bureaucracy.

\(^11\) For a discussion of how these forces over time affect representatives and generate a “Culture of Spending,” see Payne (1991).
THE NEED FOR CONSTITUTIONAL LIMITS ON STATE SPENDING

Direct political action will not fix the problem of excessive government spending. Occasionally citizens may elect some politicians supporting small government who will stem the tide. But pleas for greater political participation do not repeal the law of concentrated benefits and dispersed costs. That political action might occasionally reduce government spending, or more often only the growth of government, does not invalidate the proposition that representative government usually spends more than the average citizen prefers. The spending bias is like home field advantage in football. Home teams win a disproportionate share of games, and when two equally matched teams play, the home team often wins. Home field advantage is not absolute, and home teams do lose, even sometimes to an inferior opponent. Similarly the spending bias in politics leads government to normally but not always spend excessively. Thus the federal government ran a budget surplus in the late 1990s, but has run deficits 36 of 40 years since 1969.

The playing field of representative government tilts in the favor of higher spending and taxes. To resolve this dilemma, we must look for insights from constitutional economics, which studies the choice of rules for limiting government. Constitutional economics focuses on limitations beyond normal democratic politics (e.g. elections) which might combat the pathologies of politics.\(^{12}\) Sports leagues make rule changes during the off-season to maintain competitive balance. Similarly when citizens realize that the rules of representative democracy favor concentrated benefits and excessive spending, the rules need to be changed.

A variety of constitutional constraints on fiscal policy have been adopted in different states. The evidence shows that constitutional constraints have limited state government, at least on the margin (Krol 2007). A relevant constraint given South Carolina’s problem of excessive spending are tax and expenditure limits (TELs). As of 2005, thirty states had passed some type of TEL, most since the ‘tax revolt’ of the 1970s. The limitations take a variety of forms. Several states limit the rate of spending growth to the rate of growth in per capita personal income. Others limit appropriations to some percentage of projected state revenue. The most important difference across state provisions is whether the limit is part of the state constitution or merely a legislative statute. A constitutional limitation is a more effective constraint, because if state legislators want to increase spending to win reelection, they can always rescind a statutory limitation. A total of 17 states, including South Carolina, have a constitutional TEL, while thirteen states have only a statutory TEL. Not all constitutional TELs are created equal, and as we will discuss shortly, South Carolina’s limit suffers from two flaws which limit its effectiveness.

Constitutional TELs have slowed the growth of state government.\(^{13}\) To illustrate this, Figure 12.6 shows growth in state government expenditures as a percentage of state income between 1992 and 2006 for three groups of states, those with a constitutional TEL, those with only a statutory TEL, and states with no restriction. State government spending grew 8.8 percent in states with a constitutional TEL, 9.8 percent in states with a statutory TEL, and 9.9 percent in states with no TEL. Thus a constitutional limit reduced spending growth by 10 percent compared with a statutory TEL or no limitation.

\(^{12}\) The best statement of the need for constitutional rules limiting government is Brennan and Buchanan (1985). Lee and McKenzie (1987) and Racheter and Wagner (1999) also provide good treatments.

\(^{13}\) See Holcombe (1999) and Vedder and Gallaway (1999) for additional analysis and an evaluation of the evidence.
A form of expenditure receiving attention in recent years limits the annual growth of state expenditures to the percentage increase in population plus the inflation rate. A population rate plus inflation, or ‘popflation,’ limit on expenditure growth keeps real per capita spending constant. Thus spending can automatically increase to accommodate population growth and inflation, but an increase in spending above this level requires special approval, either by voters or a super majority (a two thirds instead of the simple majority in South Carolina) in the state legislature. If state tax revenues grow by more than popflation in a year, the excess revenues cannot be spent by lawmakers but must instead be either deposited in a rainy day fund or refunded to taxpayers. Several states have recently considered a popflation spending limit under the name of a Taxpayer’s Bill of Rights or TABOR; Alaska has had such a limit since the early 1980s.

A strict expenditure limit addresses the problem of state and local government spending booms during economic expansions. State tax systems are on net progressive, and thus tax revenues increase, often very rapidly, when the economy is strong even without an increase in tax rates. If unconstrained, politicians will spend this money to increase reelection prospects.
Figure 12.7: State Spending Growth in South Carolina

Figure 12.7 reflects this problem in South Carolina, showing the growth to total state expenditures over 1992-2007. The figure graphs both actual spending and the popflation in the state. Over the period state spending grew about 40 percent more than the popflation value, and most of this excess spending occurred between 1997 and 2002. Such spending sprees result in two problems. First, the new spending is often for pork barrel projects of questionable value. After all, state and local government were already supplying important services like roads, police, courts, and prisons before the boom. Flush coffers allow politicians to fund wasteful projects that nonetheless win votes due to the law of concentrated benefits. In South Carolina, areas of state spending which increased the most proportionally over 1997-2002 included highways, welfare and government administration. Limiting the pork barrel spending spree will result in a better use of resources. Second, when the economy eventually goes into recession and tax revenues fall, states face a budget crisis, made worse by the spending boom. States often engage in unsustainable spending, hiring new employees and beginning new programs requiring funding even when revenues fall. The fiscal crises that states confront with each recession are due primarily to excess spending booms, not inadequate revenue to fund core government services (Stansel and Mitchell 2008). Politicians often then manipulate a budget crisis to their advantage, exploiting agenda setting power to threaten to cut vital services instead of the new pork barrel spending if tax increases are not approved. For instance, states which faced worse fiscal crises during the 1990-91 recession were more likely to raise taxes, and then recovered from the recession more slowly (Poterba 1994). The tax hikes diminish economic freedom and set the stage for another cycle of excess spending when the economy recovers. A strict expenditure limit can help end this spending spree, budget crisis cycle once and for all.

Limiting the growth of government spending during a boom is likely to be easier politically than cutting existing programs. Before new spending is approved, no one knows exactly who will benefit from the new programs – who will be hired for new jobs, what

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14 Mitchell and Simmons (1994) label this the Washington Monument strategy after the Federal government’s closing of national parks during the government shutdown in 1995. Similarly school boards will threaten to cut bus service or athletics or even close schools before the end of the year in advance of a school millage election instead of laying off administrators.
companies will get contracts – is not yet known. Consequently we do not have individuals who face the loss of their jobs or reduction in income as when spending is reduced. Over time the effect of avoiding excessive spending can be extensive. Spending in South Carolina was 40 percent greater in 2007 than it would have been if held to the population level since 1992 (see Figure 12.7). Cutting state government spending by 30 percent now would likely be a Herculean task, but the same effect could have been achieved merely by limiting spending since 1992.

Figure 12.7 considers the potential benefits of limiting excess spending during booms. For each state, we take state and local spending in 1992 and adjust for state population growth and national inflation between 1992 and 2006. We then divided actual state spending in 2006 by the population limited level, creating a ratio of excess spending over the period. A ratio of 1, for example, means that state spending was at the level it would have been under a population rule while a ratio of 2 means that actual spending was double the population limit level. Figure 12.8 then graphs the scatterplot of state income against our index of excess spending. States indulging in spending sprees were poorer in 2006. And the consequence of excessive spending is dramatic. The trend line shows that an excess spending ratio of 2 compared to 1 is associated with about 25 percent lower PCPI in 2006.

**Figure 12.8: Spending Growth in Excess of Population and State Income**

South Carolina currently has a constitutional TEL in place, and yet has experienced reasonably fast growth in state spending. The state’s excess spending ratio for 1992-2006 was 1.41, exceeding the average across states of 1.36. South Carolina’s expenditure limitation suffers from two weaknesses (Poulson 2005). First, the limit in the state’s TEL is relatively high, at over 9 percent of state income, so although TELs cap annual expenditure growth, the cap in South Carolina is too high. Second, the South Carolina limitation requires that excess revenues either be placed in a rainy day fund or can be used to attract federal matching funds. Rainy day funds are problematic as a limit on government; Wagner and Sobel (2006) show that these funds can be used by legislators to circumvent spending limits. A preferable limit would return revenues in excess of a much stricter limit to taxpayers each year.
DECENTRALIZATION AND SEPARATION OF POWERS

Most of the time people debate whether government should provide a service, but which level of government should undertake a task is also an important question. The U.S. features multiple levels of government, with the Federal government, the fifty state governments, county and city governments, and independent governmental units like school and water districts. Government in South Carolina is currently relatively centralized, and the state could benefit from decentralizing its government.

A guiding principle for assigning functions to different levels of government is to match the geographic scope of the benefits of government goods and services with political jurisdictions. A strong military defends an entire country, so defense is naturally a national government function, while parks and street repairs primarily benefit local residents and thus are an appropriate municipal government function. A well-designed system of fiscal federalism benefits society in several ways, perhaps most importantly by accommodating people’s differing preferences for government goods and services. Where state government might adopt a one-size-fits-all approach, local communities can choose a combination of spending on parks, police, schools and other services that reflects the preferences of their residents. When cities make these decisions, local residents can choose to spend more on the services they desire.

Of course, the problems of politics might lead to a bias toward excessive spending by local governments, but when local government provides services, citizens now have an additional mechanism to limit spending: they can ‘vote with their feet’ and leave a community which spends too much. Charles Tiebout (1956) proposed that mobility across communities lets citizens choose local government services in a manner analogous to the market place. If people move to communities with low crime rates and excellent parks, this lets politicians know that people value these government services, as opposed to say smaller class sizes in public schools.

Local government should be more responsive to citizen preferences. Albert Hirschman (1970) explains how political participation, or ‘voice,’ and voting with one’s feet, or ‘exit,’ interact in controlling organizations, including government. Both exit and voice operate more effectively at the local level than at the state level. Political action by any one individual is more likely to be decisive in a small community, making voice more effective. In addition, exit is more effective because moving to the next town is less disruptive than moving to another state.
For all of these reasons states with more decentralized governments should outperform more centralized states. Figure 12.9 considers the relationship between real per capita personal income in 2006 and fiscal decentralization for the contiguous United States. Decentralization in Figure 12.9 is measured by the ratio of spending by all local governments in the state to the total amount of state plus local government spending for 2006 (but the ratio is stable from year to year). Local government accounts for only 45 percent of total spending in South Carolina, which ranks 37th nationally, compared with an average across states of 55 percent, and local government accounts for about 65 percent of total state and local spending in the most decentralized states. The fitted line in Figure 12.9 shows that more decentralized states had about 10 percent higher PCPI in 2006 than the most centralized states. In addition, the state legislature in South Carolina has the authority to influence spending by county and municipal governments (Articles VII, VIII), so the state has less decentralization than the local spending share indicates.

The separation of powers provides a means of making government more representative. A bicameral legislature, for example, elects representatives and senators from different districts. The differing districts divide up the constituency differently, and thus the views of representatives from a South Carolina county likely differ from the county’s senator. Requiring approval of legislation by both houses increases the amount of support needed to pass a bill into law (Buchanan and Tullock 1962). The law of concentrated benefits warns that minorities can secure passage of spending measures. South Carolina could take further advantage of the separation of powers by strengthening its executive branch. South Carolina has a long tradition of legislative domination of the executive branch, originating in the state’s first constitutions following independence, when Americans were highly suspicious of executive power as embodied by King George III (Tyer and Young, n.d.). South Carolina, for example, was one of the last states to adopt an executive budget in the 1990s. The governor...
does have a line-item veto power, which has proven to be a useful tool in restraining state
spending (Krol 2007). Further strengthening of the executive branch will serve to expand the
support necessary for spending, and should help combat the spending bias of democracy.

A factor which strengthens legislative dominance is the direct election of a number of
executive branch offices. The statewide offices filled by election in South Carolina include
secretary of state, attorney general, education superintendent, comptroller general, and
agriculture commissioner. By contrast, the President is the only elected executive officer of
the federal government, with other cabinet positions filled through appointment. A savvy
governor will consider some of the political forces affecting the outcome of election contests
in making appointments to these positions, so similar persons are often appointed to these
positions. Independent election of these positions, however, certainly weakens the executive
branch relative to the legislature, and limits a governor’s ability to form coherent policy
initiatives. Elected attorneys general or secretaries of state will sometimes have different
coalitions of supporters, and could be from a different party. Governors are already held
accountable for policy through elections, so greater use of appointment for executive branch
positions does not make government less democratic.

The judiciary represents the third branch of government in the separation of powers.
And the judiciary plays a particularly important role in constitutional government as enforcer
of the constitutional contract (Brennan and Buchanan 1985). A constitution serves to limit
government, but government will naturally try to evade the constitutional limitations on its
powers. Although judicial review was not explicitly included in the U.S. Constitution, judicial
review of legislative and executive acts is implicit in the design of constitutional government
(Wagner 1993). And judicial review by the Supreme Court served to limit the growth of
government during the early 20th Century under the doctrine of substantive due process
(Siegan 1980). South Carolina’s constitution serves to make the judiciary subordinate branch
of the legislature, as the General Assembly has the authority to appoint judges, and for terms
of six to ten years as opposed to lifetime appointments (Article V). The selection of judges for
state courts thus helps cement the legislative dominance in South Carolina. Election of
judges, particularly on a partisan basis, however, does not seem to be an imprisonment over
appointed judges (Sobel and Hall 2007).

**CONCLUSION: LIMITING GOVERNMENT TO UNLEASH CAPITALISM**

Representative democracy is prone to spend too much, and a large, bloated
government burdens the economy. The nature of representative democracy leads to excessive
spending as a rule and not an accident. South Carolina particularly suffers from a problem of
large government: although the state ranks slightly above average on overall economic
freedom, its size of government score is one of the lowest. South Carolina’s tax and spend
ways stand in contrast to its neighbors, Georgia and North Carolina.

Only a change in the structure of government can effectively counter the pro-spending
bias of politics. We can recommend three changes for South Carolina to more effectively
limit government spending:

- **Greater fiscal decentralization.** South Carolina ranks in the bottom third of states in
  fiscal decentralization. Decentralization will allow competition between local
governments to better serve citizens. South Carolina’s 46 counties could sustain
vigorous competition, and residents would never have to move too far to ‘vote with their feet.’

- **Strengthen the separation of powers.** South Carolina is one of the most legislatively dominated states in the country. The executive branch can be strengthened by moving to gubernatorial appointment in place of elections for executive branch positions, while allowing gubernatorial appointment and legislative confirmation of judges would strengthen the judiciary. Stronger executive and judicial branches should better balance statewide interests against the more local interest of legislators.

- **Pass a revamped constitutional expenditure limit.** South Carolina’s current limit has too high of a ceiling on expenditures. We believe that a population plus inflation or ‘popflation’ limit represents a more appropriate ceiling given the bias for excessive spending in democratic politics and the role of spending growth in fueling periodic fiscal crises. And excess revenues should be refunded to citizens annually to prevent legislators from evading the constraint. In addition, rebating excess revenues to taxpayers each year would provide state residents a tangible reminder of the value of limiting government.

South Carolina has a reasonably strong base of economic freedom, but the state is burdened by the legislature’s tax and spend ways. Cutting spending immediately would be desirable, but the power over time of limiting the growth of state spending should not be underestimated. State government in South Carolina was 40 percent larger in 2007 than it would have been had expenditure growth been held to population plus inflation over the previous fifteen years. Limiting spending growth to popflation for the next decade or two would bring spending in South Carolina in line with other states. Public choice theory suggests that spending will be easier to prevent than to cut.
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the figure because it is the lowest-tax state.)

Delaware is listed in over 7.8 times higher than the most industry-friendly state, Delaware. (Delaware is listed in revenue may in fact increase once the growth rate in the state begins to pick up and more reduction in tax revenues on industrial property, at least initially. However, the overall such a significant reduction in taxes on industrial property would obviously lead to a working to reduce the at around 1 percent might be sufficient to attract more industry. Working to reduce the

Although it is probably not critical that South Carolina set its tax rate to the lowest in the country, it should definitely make it at least competitive for the Southeast. Since one of the lowest per capita incomes and economic growth rates in the country.

importantly, South Carolina's effective tax rate is almost 2.5 times greater than Georgia's tax, and almost 4 times greater than North Carolina's. This puts South Carolina at a Figure 5.8: Industrial Property Taxes in Southeastern states*, 2007

Source: National Association of Manufacturers (2009)

<table>
<thead>
<tr>
<th>State</th>
<th>Rank</th>
<th>Net Tax</th>
<th>Effective Tax Rate</th>
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<tbody>
<tr>
<td>Virginia</td>
<td>49</td>
<td>$241,498</td>
<td>0.48%</td>
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<tr>
<td>Texas</td>
<td>6</td>
<td>$1,264,358</td>
<td>2.53%</td>
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<tr>
<td>South Carolina</td>
<td></td>
<td>$1,864,900</td>
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<tr>
<td>Delaware</td>
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<td>West Virginia</td>
<td>14</td>
<td>$833,234</td>
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<td>4</td>
<td>$1,291,050</td>
<td>1.11%</td>
</tr>
<tr>
<td>Alabama</td>
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ABOUT THE SOUTH CAROLINA POLICY COUNCIL

The South Carolina Policy Council is an independent non-profit, non-partisan public policy research organization in Columbia, SC. The SC Policy Council was founded in 1986 as a private, member-based organization to promote the principles of limited government, free enterprise, individual liberty and responsibility. For more than two decades the Policy Council has provided credible research, innovative ideas and in-depth analysis of public policy ideas. The SC Policy Council brings together state and national experts to provide information on a wide-range of issues, including tax and budget policy, government accountability, health care and education reform. South Carolina Policy Council staff members work with civic, community and business leaders, as well as state and local policy makers, to develop innovative reforms to empower individuals and generate economic prosperity for all South Carolina’s citizens.

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Founded in the fall of 2008 the Initiative for Public Choice & Market Process advances the understanding of the economic, political and moral foundations of a free market economy. The Initiative for Public Choice & Market Process supports the growth and development of teaching and research at the College of Charleston School of Business and Economics while engaging students and the Charleston business community.

ABOUT THE AUTHORS

EDITOR:

Peter T. Calcagno, Ph.D., is an Associate Professor of Economics at the College of Charleston. He is the founding Director of the Initiative for Public Choice & Market Process. Dr. Calcagno is member of the Editorial Board of B-Quest Business Journal and is an adjunct scholar at the Ludwig von Mises Institute. He has won awards for his teaching and is the author of more than 20 articles and book chapters. His areas of research are public choice economics and political economy.
ASSOCIATE EDITORS:

Joshua C. Hall, Ph.D., is an Assistant Professor of Economics at Beloit College in Beloit, Wisconsin. Formerly an economist for the Joint Economic Committee of the U.S. Congress, he authored over fifty journal articles, policy reports, and book reviews since earning his doctorate in economics from West Virginia University in 2007.

Russell S. Sobel, Ph.D., is Professor of Economics and James Clark Coffman Distinguished Chair in Entrepreneurial Studies in the College of Business and Economics at West Virginia University. He has published over 150 books and articles, including a nationally best-selling Principles of Economics textbook. Dr. Sobel was the founding Director of the West Virginia University Entrepreneurship Center and served in that role until 2006. His research has been the subject of articles in the New York Times, Wall Street Journal, Washington Post, and The Economist Magazine, as well as appearances on CNBC, CSPAN, and the CBS Evening News. He has received numerous awards for both his teaching and research. Dr. Sobel also teaches regular courses in economics for U.S. Congressional Staff and West Virginia K-12 school teachers. Dr. Sobel serves as Senior Economist and Director of the Center for Economic Growth for The Public Policy Foundation of West Virginia.

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Arnold Hite, Ph.D., is a Professor of Economics at Charleston Southern University. His research interests are in the areas of Industrial Organization, International Trade, and Environmental Economy. Dr. Hite earned his doctorate in economics from Texas A&M and has been at Charleston Southern University since 1990.

William Sandberg, Ph.D., is an Associate Professor of Management at the University of South Carolina. Bill Sandberg joined the USC faculty in 1986 to teach strategic management and entrepreneurship. In recent years he has taught only entrepreneurship, including “consulting projects” courses and one on commercializing R&D innovations. He earned his Ph.D. in Business Administration from the University of Georgia in 1984, majoring in management policy with a minor in organizational behavior and concentrated study in industrial organization economics. He also holds two degrees in finance from Northwestern University. Prior to joining the USC faculty, he was an assistant professor at the University of Houston. His research has focused on strategic aspects of entrepreneurship, beginning with his dissertation (New Venture Performance: The Role of Industry, Strategy, and the Entrepreneur, Lexington Books, 1986) and continuing with studies of firms’ and managers’ opportunity recognition and of the impact of “disruptive technology” on established industries. Bill’s research has been published in the Academy of Management Journal, Academy of Management Review, Strategic Management Journal, Entrepreneurship Theory and Practice, Journal of Business Venturing and elsewhere. He also is interested in countries’ transitions from communism to freer
societies with market economies, and in this pursuit has visited Russia and two Eastern European countries.

**Timothy Terrell**, Ph.D., is an Associate Professor of Economics at Wofford College in Spartanburg, South Carolina, where he has taught since 2000. Dr. Terrell obtained his Ph.D. in economics from Auburn University in 1998, following an M.A. in economics from Clemson University. He has written on environmental regulation, economic policy, and the ethics of markets in journals like the *Quarterly Journal of Austrian Economics*, the *Journal of Markets and Morality*, and the *Duke Environmental Law Policy Forum*. Dr. Terrell has also written dozens of op-eds and edited or contributed to several books. He is an adjunct scholar with the Ludwig von Mises Institute, where he serves on the editorial staff of the *Quarterly Journal of Austrian Economics*, and has lectured on ethics and economic policy at four universities in Europe. Dr. Terrell also maintains an economic consultancy and is a partner in a Spartanburg-area real estate investment firm. He lives near Greenville with his three children.

**William Woolsey**, Ph.D., is an Associate Professor of Economics at The Citadel. He earned his doctorate in economics from George Mason University.

**Bruce Yandle**, Ph.D., is Alumni Distinguished Professor of Economics Emeritus, Clemson University, and Dean Emeritus of Clemson University’s College of Business and Behavioral Science where he has been a faculty member in Economics since 1969. While at Clemson, he taught in graduate programs in France, Italy, Germany and the Czech Republic. He is currently Distinguished Adjunct Professor of Economics with George Mason University’s Mercatus Center and lectures regularly on Capitol Hill. He is a Senior Fellow with PERC in Bozeman, MT, and Senior Fellow with Clemson’s Thurmond Institute. Bruce has served in Washington on two occasions. He was a White House senior economist during the Ford and Carter administrations. He served as Executive Director of the Federal Trade Commission during the Reagan Administration. He has served as president of the Association of Private Enterprise Education, as Chairman of the S.C. State Board of Economic Advisors, and as Chairman of the Spartanburg Methodist College board of trustees. He received his A.B. in economics from Mercer University and his MBA and PhD, both in economics, from Georgia State University. He is author of 16 books and writes a quarterly newsletter on the economy, which is posted on the Strom Thurmond Institute web site.

**Other Contributing Authors:**

**Steven J. Aresenault**, L.L.M., J.D., is an Associate Professor in the Department of Accounting and Legal Studies at the College of Charleston. He holds an L.L.M. in Taxation from the University of Florida College of Law and a J.D. from the University of South Carolina School of Law. He has published numerous articles on taxation, estate planning, employee benefits, tax planning and related areas. In addition to
taxation, his current research interests include bankruptcy and antitrust law in the People’s Republic of China and the effects of financial statement disclosure requirements on the legal and accounting professions.

**Andres Bello** is a student and Research Assistant in the Ph.D. program in Business Administration Finance at the University of Texas Pan-American.

**Brooke Conway**, Ph.D., is a recent graduate of Clemson University with a doctorate in Applied Economics. Her primary interests include Industrial Organization, Public Choice, and Education, and her dissertation was written under Robert D. Tollison and Michael T. Maloney in the fields of Public Choice and Education. Her dissertation included essays concerning the causes of interest group formation within a state and whether more interest group activity translates into reduced economic development. Her essay on education used data from California counties to show that public schools improve as a result of competition from private schools, yet the effect is lagged by several years. She obtained her first faculty position at Georgia Southern University where she is currently an Instructor of Economics.

**Anthony C. Gregory** is a graduate of West Virginia University with masters’ degrees in Economics and Business Administration. He was a research assistant in the Bureau of Business & Economic Research at West Virginia University for one and a half years, and is currently working in the corporate headquarters of *Southwest Airlines*.

**Frank Hefner**, Ph.D., is a Professor of Economics and director of the Office of Economic Analysis at the College of Charleston. He received his B.A. Degree in Economics from Rutgers College and his M.A. and Ph.D. Degrees from the University of Kansas. He taught at Washburn University in Topeka while he was a research assistant in the Institute for Policy and Social Research at the University of Kansas and at the University of South Carolina where he served as a research economist in the Division of Research. His research interests include regional economic development and forecasting. He is a past president of the Southern Regional Science Association.

**Peter T. Leeson**, Ph.D., is Visiting Professor of Economics at the Becker Center on Chicago Price Theory at the University of Chicago and BB&T Professor for the Study of Capitalism at George Mason University. Formerly, he was a Visiting Fellow in Political Economy and Government at Harvard University and the F.A. Hayek Fellow at the London School of Economics. Professor Leeson is the author of more than 80 articles in journals and books.

**J. Sebastian Leguizamon** is a Ph.D. candidate in the Department of Economics at West Virginia University. He served as a research assistant in the Bureau of Business & Economic Research at West Virginia University for two and a half years and is now finishing his dissertation on the efficiency of state and local government spending, applied to specific forms of expenditure.
Susane J. Leguizamon is a Ph.D. candidate in the Department of Economics at West Virginia University. Her current research analyzes expenditure mimicking behavior by national governments as well as envy in the housing market.

Justin M. Ross, Ph.D., is an Assistant Professor of Public Finance at Indiana University in the Bloomington School of Public & Environmental Affairs. He earned his B.S. in Business Economics from Wright State University and his Ph.D. in economics from West Virginia University.

Daniel S. Sutter, Ph.D., is an Associate Professor of Economics in the Department of Economics and Finance at the University of Texas - Pan American. His areas of specialization include public choice and constitutional economics. He earned his doctorate in economics from George Mason University.

Jameson Taylor, Ph.D., is Director of Research for the South Carolina Policy Council, where he is responsible for supervising and conducting policy research. Dr. Taylor’s current work is focused on restructuring and constitutional reform while his wider interests include constitutional law, bioethics and personalism. Taylor is a contributing author to Taylor's Encyclopedia of Government Officials and his work has appeared in a variety of magazines and journals, including Citizen, Clements' International Report, Faith & Reason, and The Review of Metaphysics. He has also taught philosophy at Christendom College and holds distinction as a three-time Earhart Fellow, a Publius Fellow with the Claremont Institute, and an E. A. Morris Fellow. Dr. Taylor holds an A.B. in government from Bowdoin College and a Ph.D. in politics from the University of Dallas, where he wrote his dissertation on Karol Wojtyla’s The Acting Person.

Douglas M. Walker, Ph.D., is an Associate Professor of Economics at the College of Charleston. Previously he taught at Georgia College, Louisiana State University, and Auburn University. He received his Ph.D. in economics from Auburn in 1998. Walker’s teaching interests are in international and public economics. His research has focused on the economic and social effects of legalized gambling, and has been published in journals such as International Gambling Studies, Journal of Gambling Studies, Public Choice, Public Finance Review, and Review of Regional Studies. His book, The Economics of Casino Gambling, was published by Springer in 2007, and was published in Chinese translation in 2008.
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