Tennessee 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 Tennesseans 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, Tennessee needs to adopt policies that have been proven to increase growth in other states, and to abandon policies that have decreased economic growth in Tennessee 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 Volunteer State.\(^1\)

If Tennessee can get its policies in shape prior to 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 Tennessee 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 2010 per capita personal income of only $34,955, Tennessee ranked 37\(^{th}\), making it the fourteenth poorest U.S. state. Three of Tennessee’s neighboring states (Virginia, Missouri, and North Carolina) have higher per capita personal incomes. Prosperity does indeed cease at the border. At the county level, average income is $2,361 higher in Virginia’s bordering counties and $731 higher in North Carolina’s bordering counties.

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\(^1\) This chapter is based on Sobel and Daniels (2007) and Sobel and Leguizamon (2009).
Average income in Tennessee is about 87.5 percent of the U.S. average of $39,945. Tennessee has a hard-working labor force, a bounty of natural resources, major metropolitan areas, wonderful recreation opportunities, major transportation rivers, and other significant advantages. From a purely economic perspective, there is no reason Tennessee should be so low in the national income rankings.

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

Has Tennessee Always Ranked Near the Bottom?

While Tennessee ranked 37th in per capita personal income in 2010, the path by which it got there is interesting. Figure 1.2 shows the entire history of Tennessee’s ranking.
In 1929, the first year the data began being collected, Tennessee ranked as the 42\textsuperscript{nd} poorest state among the then 48 states. For the majority of the early history shown in this graph Tennessee hovered in the mid to lower 40s in the rankings. By 1981, Tennessee ranked 44\textsuperscript{th}, two spots poorer than it did in 1929.

In the 1980s, however, things changed dramatically. Between 1982 and 1995 Tennessee rose from 44\textsuperscript{th} to 31\textsuperscript{st} in the rankings, an impressive movement of 13 spots upward in 13 years. Unfortunately these gains slipped away beginning in the mid-1990s, and from 1996 to 2008 Tennessee fell from 31\textsuperscript{st} to 40\textsuperscript{th}. Tennessee rose only slightly to 37\textsuperscript{th} by 2010.

Had Tennessee been able to maintain its upward trend that began in the 1980s, jumping 13 places every 13 years, in 2010 instead of ranking 37\textsuperscript{th} in the nation, Tennessee would have ranked as the 16\textsuperscript{th} 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 Tennessee’s average growth rate of per capita personal income for three periods of time: 1972 to 1981, 1982 to 1995, and 1996 to 2010. This is the ‘real’ growth rate, or the growth rate after adjusting for inflation.
During the 1982 to 1995 period, Tennessee’s 2.4 percent average real rate of economic growth—the 4th 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 that period, Tennessee experienced 9 years of rapid growth, each of 2.3 percent or higher, with some years above 4 percent. This was a significantly higher growth rate than the 1.7 percent Tennessee had achieved earlier in the 1972 to 1981 period.

Unfortunately, economic growth in Tennessee slowed after the mid-1990s, falling to 0.9 percent between 1996 and 2010. Rather than being one of the fastest growing states, Tennessee’s recent growth of 0.9 percent makes it the 10th slowest growing state during the 1996 to 2010 period. Even excluding the recent recession years, average growth from 1996 to 2008 was only 1.2 percent, the 6th worst (slowest) rate of growth among the 50 U.S. states.

While some might think the difference between 1.7 and 2.4 percent seems small, 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 Tennessee, adjusted for inflation, along with several alternative future projections. One projection simply takes Tennessee’s recent rate of real per capita economic growth over the 1996 to 2008 period (prior to the recession), 1.2 percent, and forecasts it into the future. The other two projections show what the future would hold if Tennessee’s growth were increased back to the 1972-81 rate of 1.7 percent or the 1982-95 rate of 2.4 percent. These real growth rates are not unrealistic. Both are actual growth rates experienced in other U.S. states over the last decade.

Figure 1.4: Which Future for Tennessee?

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

Note: Per capita income is adjusted for inflation to constant 2010 dollars.

The last year of historical data shown in the figure is 2010, a year in which the average income in Tennessee was $34,955. Let us consider the simple question of what the average income will be in one generation, or twenty years into the future, in 2030. At the historical growth rate of 1.2 percent, average income in Tennessee would be $44,373 in 2030.² What if instead growth could be increased to 1.7 or even 2.4 percent? Under these alternative scenarios, average income in 2030 would instead be $48,970 and $56,171 respectively. Thus, going from a 1.2 percent to a 2.4 percent rate of economic growth results in a difference of almost $11,800 in average income one generation out into the future. Also remember that we are considering average income per person. The average family size in Tennessee is 2.99 persons (from 2010 Census data), so the impact of this difference on the

² 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.
average family is roughly three times this amount—or a substantial $35,275 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 2050 the differences grow even larger. Instead of average income being $56,329 in 2050 at a growth rate of 1.2 percent, it would be $68,604 at 1.7 percent, or a whopping $90,263 at 2.4 percent. Make no mistake about it, over two generations a 1.2 percentage point increase in Tennessee’s rate of growth means a difference of almost $34,000 in per capita income.

Perhaps a better way of looking at the data is to ask, at what date in the future will average income in Tennessee hit $50,000? To put this figure in perspective, it is approximately the current average income level in Massachusetts, New Jersey, and Maryland. At Tennessee’s historical 1.2 percent rate of growth it will hit $50,000 in the year 2041. At a 1.7 percent rate of economic growth, this date would instead be 2032—or nine years earlier. At a 2.4 percent rate of growth it becomes 2026—or fifteen years earlier. Increasing economic growth by just 1.2 percentage points moves the date at which the average Tennessean 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 Tennessee and two states that fifteen years ago, in 1995, were virtually identical to it in terms of income, Vermont and Wyoming. Figure 1.5 presents this data. In 1995 the average income in Tennessee was $30,532, while Vermont and Wyoming had average incomes of $30,129 and $30,559 respectively. Tennessee ranked 31st in per capita income that year, with Wyoming one spot ahead of Tennessee (30th) and Vermont two spots behind (33rd).

Figure 1.5: State Growth Comparisons

Note: Per capita income is adjusted for inflation to 2010 constant dollars.
Over the next twenty year period, Tennessee was able to sustain a 0.9 percent rate of growth, Vermont 1.9 percent and Wyoming 2.7 percent. After fifteen years, less than one generation, Tennessee’s 2010 average income of $34,955 is about $5,150 less than the average income in Vermont and $9,900 less than average income in Wyoming. The result is that while Tennessee has fallen to 37th in the national income rankings, Vermont has risen to 19th and Wyoming has risen to 6th.

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:

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

So, a state that sustains a 1.2 percent growth rate, as Tennessee was recently prior to the recession, doubles its living standards roughly every 58 years (70 ÷ 1.2). A state that sustains a growth rate of 1.7 percent sees its living standards double approximately every 41 years, and a state that sustains a growth rate of 2.4 percent doubles its income in only 29 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. Tennessee currently ranks 37th in average income. If all states continue their current growth rates, 20 years into the future, Tennessee will have fallen to 42nd. If instead Tennessee could increase growth to just 1.7 percent, its ranking in twenty years would be 29th. If Tennessee could manage to grow again at 2.4 percent, it would rank 16th in the nation within one generation. If that 2.4 percent could be sustained for forty years, Tennessee would rank as the 8th richest state in the nation in 2050.

As the experiences of other states illustrate, these large leaps in the income rankings are possible. Between 1995 and 2010, North Dakota moved up 31 places from 42nd to 11th, Wyoming jumped 24 places from 30th to 6th, South Dakota rose 16 places from 38th to 22nd, Vermont improved 14 places from 33rd to 19th, and Montana moved up 12 places from 47th to 35th. 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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3 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, Tennessee’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).

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.
CHAPTER 1: THE CASE FOR GROWTH

CHATTANOOGA VERSUS CHARLOTTE: A TALE OF TWO CITIES

Returning closer to home, let’s take a more detailed look at the comparison between Tennessee and North Carolina. Because of their similar histories, the cities of Chattanooga, Tennessee and Charlotte, North Carolina are interesting to consider. In 1890, Chattanooga’s population was roughly three times bigger than Charlotte’s (29,100 versus 11,557). By 1950 both cities had approximately the same average incomes, educational levels, and populations. In 1950, Chattanooga’s population of 131,041 was almost identical to Charlotte’s population of 134,042. Both cities were in states with significant rural populations, and both relied heavily on industries which have dwindled (for Charlotte this was textiles and tobacco). Over the subsequent six decades, however, Charlotte has grown into a crowning jewel of the South, with a population more than four times the size of Chattanooga (731,424 versus 167,674 in 2010). Similarly, in 1950, Memphis was three times bigger than Charlotte, while today Charlotte is now 13 percent bigger.

Virtually all of Charlotte’s new jobs and businesses were in industries that could have located anywhere. Charlotte’s numerous new bank headquarters are an example. Nine Fortune 500 companies now have their corporate headquarters located in the Charlotte metro area. There was no special geographic reason, such as a specific natural resource or even a sea port, giving Charlotte an advantage over Chattanooga in its ability to attract and nurture these businesses. The question of interest is why these two seemingly similar cities diverged so drastically. As we have seen, over such a long period of time, even small differences in growth rates can produce large differences in income. What made it possible for Charlotte to sustain a higher rate of growth over such a long period of time? The answer is simply that North Carolina had a set of policies in place that were more conducive to economic growth.

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 (on the following page) 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. The average high income state ranks 6th out of 50 in terms of the life expectancy of its citizens. The average low income state ranks only 35th. In terms of health care quality, the picture is the same. Richer states do better, while poorer states like Tennessee do worse. The average high-income state ranks 6th in terms of health care quality. The average low-income state ranks 41st. Because Tennessee is a lower income state, it is also one of the less healthy placing 38th in the U.S. health rankings, and 46th in life expectancy.
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**

![Graph showing Divorce, Crime, and Education rates in High and Low Income States.](image)


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 Tennessee where families are not only wealthier, but also happier, healthier, safer, and better educated.

**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 Tennessee refuses to undertake policy reform, and continues its current trend, in twenty years the state will have fallen to 42nd in per capita personal income, and Tennesseans will remain at the bottom of the economic ladder.

In contrast, a better and richer Tennessee is possible to achieve within our lifetimes. An increase in Tennessee’s rate of real per capita economic growth, back to the 1.7 percent level sustained from 1972 to 1981, would result in a ranking of 29th twenty years into the future. An increase back to the 2.4 percent level sustained from 1982 to 1995 would result in Tennessee becoming the 16th richest state in the nation within one generation, and the 8th richest state in the nation within two generations.

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.
Reducing crime and increasing human capital through education are policy agenda items of the Tennessee Chamber of Commerce & Industry in their recent 10 for TN proposals. But improvements in these areas are a symptom of growth, not a cause. Policy reform that increases economic growth and prosperity in Tennessee will *automatically* result in reductions in crime and increases in educational attainment. These social ills are a result of poverty, not a cause of it, and focusing on policies targeted in those areas to produce economic growth is simply putting the cart in front of the horse.

But can policy reform actually increase growth by a meaningful amount? Evidence from both the experience of U.S. states and countries around the globe suggests the answer is yes. 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?

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REFERENCES


The previous chapter made the case for why increasing the rate of economic growth in Tennessee 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 Tennessee and other areas. Evidence was presented in the previous chapter that economic growth is faster in states like Vermont, Wyoming, North Dakota, South Dakota, and Montana; and in countries like Hong Kong and Japan. How can this be replicated in Tennessee? 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 (2007a) and Sobel and Hall (2009).
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**

![Diagram showing inputs, institutions, and outcomes]

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

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

**Economic Outcomes**
- 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 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.²

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 Tennessee 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. Tennessee, 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 Tennessee get the rules right.

² 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.
**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 230 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. Over 230 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 TENNESSEE**

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 two decades, 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 placing it on a scale of zero to ten, where 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 the most recent index, the United States scores 7.6 out of 10, ranking it the tenth most capitalist, or free-market, economy in the world. The United States has fallen five spots in the past two years however, and now ranks below Canada. The countries ranking as 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, that ranks U.S. states and Canadian provinces by the degree of free-market orientation within each state or province. Among U.S. states, Tennessee ranked 19th in the most recent index, for year 2009 data. In 1995, however, Tennessee was ranked 7th in this index. Figure 2.2 shows how Tennessee’s economic freedom rank has changed.

Figure 2.2: Tennessee’s Economic Freedom Rank


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4 Online at http://www.freetheworld.com. The most recent edition is the 2011 report (Ashby, Bueno, and McMahon 2011) which includes annual rankings through 2009. Rankings reported in this chapter have been recalculated among only the U.S. states (i.e., excluding the Canadian provinces).
From 1981 to 1995, Tennessee rose from 26\textsuperscript{th} to 7\textsuperscript{th} in the economic freedom ranking among U.S. states. Since that time, and particularly since 2005, economic freedom has been on the decline in Tennessee, falling back to near where it began in the early 1980s.

Does the ‘market-friendliness’ of Tennessee’s policies help to explain its recent economic performance? Recall that Figure 1.2 from Chapter 1 showed Tennessee’s per capita income ranking from 1929 forward, and that there was a large improvement in Tennessee’s ranking in the 1980s followed by a subsequent decline. Figure 2.3 shows the remarkable correlation between Tennessee’s economic freedom and per capita income rankings. Here, Tennessee’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 two periods.

Figure 2.3: Economic Freedom vs. Prosperity in Tennessee


Between 1982 and 1995 when Tennessee’s economic freedom was improving, growth was rapid (2.4\%), and the state rose 13 spots in the per capita income rankings. Beginning in 1995, economic freedom began falling and Tennessee’s growth slowed substantially (0.9\%). From 2005 to 2008, Tennessee’s economic freedom dropped significantly, and it fell 4 places in the per capita income rankings in only 4 years. A recent, but slight, improvement in economic freedom from 2008 to 2009 resulted in the per capita income ranking rising three spots in three years.
The point should be obvious, for Tennessee to improve economic growth it must again move toward policies that embrace capitalism and free markets. If Tennessee continues its downward trend that began in the mid-1990s, the state’s economic ranking is likely to suffer, and within two decades Tennessee will be at the very bottom of the national economic rankings with states such as West Virginia and Mississippi. With all of Tennessee’s advantages over these states, it is almost unbelievable that the Volunteer 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.

To help illustrate how Tennessee relies on capitalism less 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

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, Tennessee has the 21st largest government share of state economic activity. Combined, all federal, state, and local government spending in Tennessee amounts to 42.2 percent of the state economy. For comparison, in the most free market state, Delaware, government controls only 25.6 percent of the economy, leaving roughly 75 percent to the private sector. At the other extreme, in the state ranking 50th in economic freedom (the least capitalist state), West Virginia, government
spending is among the highest in the nation, taking up 51.9 percent of the state economy, and leaving less than half of the state’s economic resources available to the private sector. In both New Mexico and Mississippi, government spending exceeds 56 percent of the economy.

Changes in Tennessee’s government size as a share of its economy is one of the key factors that led to the trends in economic freedom shown earlier. Figure 2.5 shows Tennessee’s ranking in the size of government component of the economic freedom index. Here lower rankings (implying smaller government control) are better, and higher rankings (implying more government control) are worse, as the size of government enters negatively into the computation of the overall economic freedom index.

Figure 2.5: Tennessee’s Government Size Rankings

During the 1980s and early-1990s, total (all) government spending fell by roughly 4 percent of the state’s economy, while it has risen by 12 percent of the state’s economy since. This expansion in the size of government has lead to Tennessee’s ranking in government-sector control of the economy worsening by 17 places. While Tennessee currently has the 21st largest government sector among U.S. states, back in 1993 Tennessee had the 13th smallest government sector (ranked 38th). Excluding federal spending doesn’t change the pattern. While Tennessee used to have the 3rd smallest state and local (S&L) government control (ranked 48th), it has worsened 9 spots in the rankings since that time considering state and local spending alone. Tennessee’s government spending as a share of the economy was higher in 2009, either including or excluding federal spending, than it had been in the entire history.
of the state. Recent reductions from 2010 to 2011 in the state’s budget are a move in the right
direction, and Tennessee needs to maintain this trend to stimulate economic growth.

The pattern shown by the data is obvious. During the period prior to 1995, Tennessee’s
government was shrinking as a share of the economy, and economic growth was
rapid. Since that time Tennessee’s government sector has grown substantially and as a result
Tennessee’s rate of economic growth has fallen dramatically. 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 Tennessee’s economic growth rate has fallen as
its government sector expanded by 12 percent of the state economy since the mid-1990s. The
slowdown in economic growth is not entirely explained by the increase in government
spending, as other indicators in the economic freedom index show downward trends as well.
While Tennessee’s scores for 8 of the 10 index components rose from 1981 to 1995, since
that time Tennessee’s scores for 7 of the 10 index components have fallen.

**TENNESSEE’S OTHER ECONOMIC POLICY RANKINGS**

Not only does Tennessee’s economic freedom ranking show the need for policy reforms that
embrace capitalism, but nearly every other national index of business climate agrees.
Tennessee’s most recent rankings in all of the major national indices of state business
climates are presented below.

**Tennessee’s Business Climate Rankings:**

- 25th Small Business & Entrepreneurship Council’s *Small Business Survival Index* (2011)
- 17th Small Business & Entrepreneurship Council’s *Small Business Tax Index* (2011)
- 27th Tax Foundation’s *State Business Tax Climate Index* (2011)
- 19th Fraser Institute’s *Economic Freedom of North America* (2011)
- 18th CNBC’s *America’s Top States for Business* (2011)
- 44th Corporation for Enterprise Development’s (CFED) *Development Capacity Index* (2007)
- 41st Progressive Policy Institute’s (PPI) *New Economy Index* (2010)
- 44th Beacon Hill Institute’s *State Competitiveness Report* (2010)
- 41st Milken Institute’s *National State Technology & Science Index* (2010)
- 19th Institute for Legal Reform (ILR) / Harris *State Liability Systems Ranking Study* (2010)
- 22nd Pacific Research Institute’s *U.S. Tort Liability Index* (2010)
- 9th Milken Institute’s *Cost of Doing Business Index* (2007, inverted to make 1=best)
- 21st Forbes *Best States for Business* (2011)

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5 See Gwartney, Stroup, Sobel, and Macpherson (2009), page 622.
6 These 10 index components measure a variety of factors including government spending, taxes, regulations,
and the security of property rights.
7 These rankings can be found on line at the following websites, http://www.milkeninstitute.org (two),
With the exception of the *Cost of Doing Business Index*, Tennessee generally ranks in the 20s to mid-40s in the national business climate rankings. These indices are to one extent or another measuring the same thing; Tennessee’s lack of reliance on capitalism.

The one area of Tennessee’s business climate that has shown significant improvement in recent years is the legal system rankings. Due to Tennessee’s tort and medical malpractice reforms, in the ILR/Harris ranking for example, Tennessee has improved 10 spots in the ranking. This is in jeopardy however if the proposal to move to elected judges in Tennessee becomes law. Studies clearly show that states with elected judges, especially if they are elected in partisan elections, have worse legal systems than those states with an appointment mechanism for selecting judges. Tennessee's recent expansion in charter schools, and restrictions on collective bargaining for teachers, are also movements in the right direction.

Tennessee’s lack of a state income tax on wage income is one of the state’s main advantages over most other states. Numerous studies have shown that states without income taxes on wage income grow significantly faster, and are more prosperous, than states with income taxes on wage income, and the most convincing of these studies use border county comparisons across state lines. Tennessee’s limited income tax only taxes interest and dividend income, at a rate of 6 percent, and allows for a $1,250 exemption per filer, as well as generous (and recently increased) exemptions for those aged 65 and over with taxable income less than $26,200 (single) or $37,000 (married). It accounts for only a very small fraction of state tax revenue, but it does provide some revenue for local governments in Tennessee who get 2.25 of the 6 percent tax. The 6 percent rate is in line with Tennessee’s eight neighboring states (whose rates range from 5 to 7.75 percent). As a foundation for future prosperity, Tennessee should reject proposals that call for imposing a state income tax on wage income.

Tennessee’s corporate income tax of 6.5 percent is also in line with the eight neighboring states whose top rates range from 5 to 6.9 percent. Tennessee’s state sales tax rate is 7 percent. Neighboring state Mississippi also levies a 7 percent state sales tax rate, and two of Tennessee’s other neighbors, Kentucky and Arkansas levy state sales tax rates of 6 percent, only 1 percentage point lower than Tennessee. Georgia and Alabama have the lowest state sales tax rates of Tennessee’s neighbors at 4 percent. Tennessee allows local option sales taxes, and the average local sales tax rate in Tennessee is 2.44 percent. This compares favorably to Alabama’s local sales tax average of 4.03 percent, Missouri’s average of 3.24 percent, and Georgia’s average of 2.95 percent. There are no local sales taxes in neighboring states Kentucky and Mississippi. At neither the state or local level alone do Tennessee’s sales tax rates seem out of line with surrounding states, however, when one combines the two rates, Tennessee does rank the highest in the nation at a combined rate of 9.44 percent.

While this high ranking on the sales tax has been a statistic cited in the press during debates about lowering the sales tax on food in Tennessee, it is important to remember both that states without income taxes on wage income (like Tennessee) generally have higher sales tax rates to generate additional revenue, and that if it were not for the high local sales taxes, the state’s 7 percent rate alone would only rank Tennessee as tied for the 19th highest combined sales tax rate in the nation (tied with Indiana, Mississippi, New Jersey, and Rhode Island). Like many other states, Tennessee does levy a lower sales tax rate on food. Despite the popular argument that reducing the sales tax rate on food helps the poorest citizens, it is important to remember that all purchases with federal food stamps are exempt by federal law.

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9 Tax rates cited are as of January 1, 2011; source: http://www.taxfoundation.org.
from state sales taxes in all states. Recent proposals to lower the current 5.5 percent rate on food down to 5 percent over three years really do little to help those most in need whose food stamp purchases are not subject to the tax anyway. The bigger danger is that proposals to lower Tennessee’s sales taxes would be tied to increases in other taxes that are more damaging to economic growth than is the sales tax. The more important point, however, is from the standpoint of promoting economic growth, if some taxes are to be reduced there are much more important taxes to cut than the sales tax.

The taxes most in need of reform in Tennessee to increase economic growth are the taxes that fall on capital investment (such as property taxes on machinery, equipment, intangibles, and inventories), and the taxes on inheritance and gifts that reduce the incentives to accumulate wealth and pass that wealth on to future generations, especially through the transfer of family businesses. As we will discuss in the next chapter, capital investment—expenditures on things like machinery and equipment that increase the productivity of labor—is a key driver of economic growth. Unfortunately, Tennessee levies some of the highest taxes in the nation on capital investment, a big factor limiting the economic growth prospects of the Volunteer State.

As an example, Tennessee’s effective property tax rate on industrial property is among 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. Tennessee ranks tenth, with an annual property tax bill of $1,033,544 which amounts to a 2.067 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 one-fourth of the tax bill they face in Tennessee.

Perhaps more importantly, the property taxes levied on this business in six of Tennessee’s eight neighboring states are significantly lower; $241,498 in Virginia, $327,100 in Kentucky, $491,071 in North Carolina, $553,776 in Alabama, $686,550 in Arkansas, and $760,381 in Georgia. By choosing to locate right across the state border, this representative manufacturing firm’s tax bill would be between 25 and 77 percent lower. Only Mississippi and Missouri have higher effective property taxes at $1,291,050 and $1,111,255 respectively. The high property tax rates Tennessee imposes on equipment and machinery result in less capital investment and reduced prosperity for all Tennesseans.

Like a three legged stool, a state’s tax system, legal system, and regulatory code must all be well designed to support economic growth. While we have discussed Tennessee’s legal and tax codes, reforms to the state’s regulatory structure also warrant discussion. Regulatory reform is also a policy priority of the Tennessee Chamber of Commerce & Industry in its recent 10 for TN proposals. In national rankings of regulatory climate, Tennessee doesn’t do too poorly, raking 6th best in the country in the Forbes index subcomponent on regulatory climate, and 12th when ranking states by their expenditures on regulatory enforcement. However, what matters most is Tennessee’s rank relative to its neighboring states, and three of Tennessee’s neighbors rank in first, second, and third place in the Forbes regulatory ranking, while two others rank seventh and ninth. In addition, these indices also give state’s

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higher rankings for having Right-to-Work laws, so part of Tennessee’s high ranking is simply due to this one policy. The true regulatory climate that impacts small and large businesses would rank much lower on the list if this one labor-related policy was excluded.

One significant problem with regulations—in all states—is that there is no natural “profit and loss” mechanism that serves to indicate which regulations, once in place, are performing well and which are not. Identifying which current regulations are ineffective or fail to create benefits that exceed economic costs is difficult, and getting these regulations repealed through the political process is often even more of a challenge. One obvious area for improvement in Tennessee has to do with its sunset provision. While sunset provisions—those that force regulations to be reconsidered and fight to stay in place—have been shown to result in significantly improved state regulatory climates, Tennessee’s sunset provision, adopted in 1982, that all newly enacted rules sunset after one year is often circumvented by the state legislature. According to Hahn (2000, pp. 882-3), in Tennessee “the legislature routinely votes to eliminate the expiration date of the sunset provision, defeating its original purpose.” Hahn notes that in one year the legislature only allowed 7 rules adopted in the previous year to expire, and all seven were minor issues or rules.

A more recent study in 2010 by Jason Schwartz from the New York University School of Law’s Institute for Policy Integrity, gives Tennessee a “D” in its regulatory review system. Schwartz (2010, pp. 371) notes that “Tennessee has not aggressively used its power to sunset rules. In the 1990s, the legislature voted to extend nearly all rules beyond the expiration date of the sunset provision.” He continues, that from “2005 through 2010, only one rule has not been extended by the annual legislation on sunsetting rules.” Schwartz notes that until recently the House and Senate Government Operations Committees have been “plagued by squabbling or indifference... and have had trouble scheduling joint meetings to review rules.”

While Tennessee has granted its legislative review committees substantial power, and has recently amended their authority in 2009, Schwartz remains skeptical of Tennessee’s process of regulatory review. Schwartz concludes “Tennessee’s structure is not reasonable... Reviewing rules by forcing them to expire after one year is not the most straightforward or efficient approach to regulatory review. The system also only gives the legislature the binary choice of letting a rule expire or not, instead of helping to calibrate regulations... (h)istorically review has been inconsistent and not transparent. There is no effective periodic review, inter-agency coordination, or protection against agency inaction. Analytical requirements are extremely weak, though at least the regulatory flexibility analysis looks at the consequences of creating small business exemptions.”

Clearly there is room for improvement in Tennessee’s system of regulatory review. Perhaps a longer sunset window, but with a more meaningful requirement for an independent, non-governmental, body to undertake serious and transparent cost-benefit and efficiency analysis, with public input, and considering amendments and changes to regulations, would help to improve Tennessee’s regulatory code.
TENNESSEE HAS LOW ECONOMIC FREEDOM RELATIVE TO ITS NEIGHBORING STATES

As we have alluded to in the discussions of Tennessee’s regulatory ranking and taxes on capital investment, what matters most is not Tennessee’s absolute rankings in national policy indices, but rather Tennessee’s rank relative to its neighboring states. Because business firms and citizens alike can easily locate across a state border to avoid policies, but take advantage of other regional, geographic, transportation, or weather advantages, having “good” policies sometimes simply is not enough when you have neighbors with “great” policies. Unfortunately, Tennessee is in this situation. At least three of Tennessee’s neighbors are among the very top in the nation when it comes to business and economic policy. Sometimes having good neighbors is a disadvantage.

Of the thirteen business climate rankings presented earlier, Tennessee ranks in the top 10 in only one of them. Virginia, on the other hand, is in the top 10 nationally in seven of the thirteen rankings, and in the top 15 in ten of the rankings. Similarly, North Carolina ranks in the top 10 in four of the rankings, and Georgia in two. When comparing Tennessee to its neighboring states only, Virginia beats Tennessee in eleven of the thirteen rankings, North Carolina and Missouri beat Tennessee in nine of the thirteen rankings, and Georgia beats Tennessee in eight of the thirteen rankings. The only neighbors that Tennessee outranks on a majority of the business climate rankings are Arkansas, Kentucky and Mississippi. In the critical economic freedom ranking, both North Carolina and Georgia are among the top 10 most economically free states in the nation, while Tennessee ranks 19th.

Ranking Tennessee only versus its neighbors on an index by index basis, Tennessee ranks sixth or worse out of these nine states in 5 of the business climate rankings. Thus, while Tennessee’s mid-level absolute national rankings in many of the indices may seem adequate, with such competitive neighbors, adequate simply isn’t good enough when you are competing with those states for new businesses and residents.

Because business location decisions are most flexible across neighboring state lines, this is problematic for Tennessee. It also increases the importance of making policy reforms in the Volunteer 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 Tennessee lagging behind its neighboring states.11

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.).

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11 See Figure 2.7 for the actual numbers.
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.

Because private property rights, and their protection, are critical to economic progress, it is worthwhile to be more specific about private property rights. 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. 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, especially when allowing the state to remove the property from an owner’s possession and transfer it to another private owner) actually weakens property rights.

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.

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.
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.

**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 re-elected.

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 Tennessee 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.
Tennessee has a bad record when it comes to granting these special favors, including millions of dollars in incentives given to Union City’s Goodyear Tire & Rubber plant, Madison’s Peterbilt Motors Company, Nashville’s Dell Computer plant, Spring Hill’s General Motors plant, Amazon.com’s facilities in Chattanooga and Cleveland, Chattanooga’s Volkswagen auto assembly plant, and numerous film and television incentives. These incentives are not only extremely costly, often costing up to $200,000 per job created, and sometimes ineffective as these firms close or relocate prior to fulfilling their job creation promises, but more importantly they simply create the wrong policy climate—one that encourages all firms to try to invest in seeking favors from Tennessee’s state government.

Government officials often cite the necessity to offer these credits to entice firms to locate in the state. However, the only reason the incentives are necessary is due to the high taxes on these types of firms in Tennessee to begin with, such as the property taxes discussed earlier. The problem is the underlying tax structure, and the solution is to lower the high taxes that prevent Tennessee from being competitive in the first place. These incentives would not be necessary if Tennessee had a more competitive tax structure.

When governments give favors to some businesses but not others, it is unfair to the competitive market process as unsubsidized Tennessee firms must now compete with the politically-favored, subsidized firms for employees, resources, land, and consumers. All firms in Tennessee 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 Tennessee’s businesses—including small entrepreneurs—simply do not have the political power to even begin to negotiate a better business climate like these large companies. The resources devoted toward offering these special favors to big businesses would be better spent doing across the board, broad-based tax reductions that apply to all of Tennessee’s entrepreneurs and businesses.

**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 on the following page. 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

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. To provide a picture uncomplicated by the recent national recession, this data is from prior to the recession. 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, Tennessee’s data on these measures is shown at the bottom of the table.
### Figure 2.7: Capitalism’s Economic Record

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<td>Delaware</td>
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<td>North Carolina</td>
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<tr>
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<td>West Virginia</td>
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<td><strong>Average - Top 5 States</strong></td>
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<td>$138.74 29.9 4.2% 13.1% 12.2%</td>
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<tr>
<td><strong>Average - Bottom 5 States</strong></td>
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</tr>
<tr>
<td><strong>Difference (Top minus Bottom)</strong></td>
<td>$5,618 -3.1%</td>
<td>$123.16 21.2 1.4% 1.9% 2.4%</td>
<td></td>
</tr>
<tr>
<td><strong>For Comparison</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tennessee</td>
<td>7.4</td>
<td>$34,330 15.8%</td>
<td>$44.37 12.9 4.0% 11.1% 10.1%</td>
</tr>
</tbody>
</table>

Sources: Bureau of Economic Analysis (2009), Karabegovic and McMahon (2008), U.S. Census Bureau (2009), and Sobel (2008).

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 near 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 Tennessee ranks in the middle of the pack on economic freedom and business climate measures, the measures of entrepreneurship and prosperity for Tennessee generally fall in between the values for the top and bottom states. Of most interest, however, is probably how Tennessee 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, Tennessee lags behind its neighboring states on measures of entrepreneurial activity and prosperity.
While state comparisons are probably the most valuable for Tennessee 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 Tennessee, 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.

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 Tennessee?

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 Tennessee. 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 roughly 25 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 about 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.

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.\(^{15}\) 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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\(^{15}\) 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.
Argentina, are good examples. Geographic climate variation, or just plain luck, does not explain the differences observed across countries or regions or states either. When we see the borders between countries—like the two sides of the former Berlin Wall separating wealthy, capitalist West Germany from relatively poor, socialist East Germany—it is clear that institutional differences, differences in the rules of the economic game, are the true source of differences in prosperity.

CONCLUSION

This chapter has presented evidence that areas relying on capitalism—the protection of private property through 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 230 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**

The previous chapter showed that increased reliance on capitalism has allowed other states and countries to become more prosperous. To promote capitalism in Tennessee, 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 Tennessee 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 chapter 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.

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\(^1\) 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) and Sobel and Leeson (2009).
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 Tennessee 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. Cookeville’s population, for example, is able to support two general purpose pet stores, each carrying a broad line of products. In a place like Memphis, 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 Tennessee’s goods and services sell could increase wealth by allowing Tennesseans 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 Tennessee to sell and compete in larger national and global marketplaces and expand their customer base. To compete in these markets Tennessee businesses need to be on a level playing field with their competitors. Tennessee’s taxes and regulations are a competitive disadvantage to firms located in the state. The higher prices Tennessee 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 the auto industry provide a good example of this. Modern robotics and automation allow workers to position, spin, and move the parts they are assembling much more easily and quickly. With this new capital equipment workers are more productive and earn higher wages as a result.

But new factories, better machinery, and equipment are expensive. They require large investments in assets and property. In Tennessee, 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, Tennessee has among the highest property taxes in the nation on a representative manufacturing facility’s equipment and machinery. This results in Tennessee’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 company trying to sell mud pies will generate less income than one producing apple pies. Income can be increased not only by increasing labor productivity, but also by raising the value per unit—or ‘value added’—of Tennessee labor.

However, the answer to the question of which specific uses of Tennessee’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 turn our income into wealth. 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 Tennesseans 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

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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.
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 Tennessee.

ENTREPRENEURSHIP AND DISCOVERY

Of the many potential things Tennessee 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:

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

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 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.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.

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.
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 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

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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.
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 solar power is the future of the state economy, the truth is that Tennessee’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 Tennessee’s citizens that must discover the future for the state, not the state political process.

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 Tennessee. We will never know if one of these could have been another FedEx. If we want a thriving economy, Tennessee 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 on incentives for Goodyear Tire & Rubber, Peterbilt Motors Company, Dell Computer, General Motors, Amazon.com, and Volkswagen would have created more jobs and opportunities had this money simply been left in the private sector’s hands.

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. 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 Tennessee 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.6

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.

6 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.
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. 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?

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. 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

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7 For evidence, see some of the studies complied by the Joint Economic Committee of Congress, available at http://www.house.gov/jec/cost-gov/regs/minimum/case.htm
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 mentioned in Chapter 2 is that there is no profit and loss-type system to eliminate bad policies through time. In the end, some policies just do not live up to their stated goals, or do so but at too high of a cost. West Virginia, for example, imposed a maximum eight hour operating restriction on taxi drivers. The law was intended to reduce driver fatigue and accidents involving taxis. 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 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 Tennessee to reform its regulatory review process along the lines of the discussion in Chapter 2. Quite simply if a regulation adopted in Tennessee cannot prove, with data, that it is accomplishing its stated goal in a cost effective manner within some period of time, say five years, it should be repealed. Regulations, and other policies, should have to fight to stay in place based on scientific evidence regarding the costs and benefits they create.

**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*.

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9 See Corey and Curott (2007) for a longer description of this law and its consequences in West Virginia.
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. 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 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 provision have their limitations—neither is perfect, and there will be particular problems under either alternative. To help overcoming 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). 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 Tennessee, 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 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

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11 Spending effort and resources to secure wealth through political redistribution is what economists call ‘rent-seeking.’ See, for instance, Tullock (1967) and Tollison (1982).
entrepreneurial energies are channeled by prevailing economic and political institutions, through the rewards and incentive structures they create for entrepreneurial individuals.

In places like Tennessee, 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, Tennessee has less productive private-sector entrepreneurship.

How much unproductive entrepreneurship is there in Tennessee? While it is hard to derive an exact number, some data can help to illustrate. In 2011, for example, 1,572 registered lobbyists represented 733 companies and organizations in Tennessee. In addition, Tennessee was home to 16,630 resident and active lawyers. Campaign contributions to candidates running for office in the 2010 Tennessee elections amounted to over $75.3 million, or $47.04 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.

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 economic freedom scores have the worst records on lobbying activity and lawsuit abuse—the unproductive types of entrepreneurship. In the ranking of ‘net entrepreneurial productivity’ where productive entrepreneurship is measured relative to unproductive political and legal entrepreneurship, Tennessee ranks 32nd. 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. Tennessee has the 25th highest rate of unproductive entrepreneurial activity among states, while only the 30th 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.

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12 Tennessee Ethics Commission (list is available online at https://apps.tn.gov/ilobbysearch-app/search.htm).
14 Data for federal offices ($22.8 million) is from www.opensecrets.org and data for state offices ($52.5 million) is from www.followthemoney.org. Voter turnout data (1,601,549 votes were cast in the 2010 general election) is from the United States Elections Project, http://elections.gmu.edu/Turnout_2010G.html.
15 See, for example, Sobel (2008).
16 As a more detailed comparison with its neighbors, while Tennessee ranks 32nd in the index of net entrepreneurial productivity, North Carolina ranks 15th and Georgia ranks 18th. For reference, Tennessee ranks 19th in economic freedom while Georgia ranks 5th and North Carolina ranks 9th.
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 discourage unproductive, wealth-destroying activities. While the later chapters of this book are devoted to specific policy reforms for Tennessee, 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 Tennessee. 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, Tennessee has been reluctant to embrace this ideal in policy. This might be surprising when viewed from the outside as Tennessee is a state who has a Republican 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).

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.
REFERENCES


