Unleashing Capitalism:
Why Prosperity Stops at the West Virginia Border
and How to Fix It

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PREFACE

As an economist at West Virginia University, I am often asked what could be done to improve our state’s economy. This book is the answer to that question.

Twenty-five scholars, mostly economists, from across the nation contributed their expertise to this volume. All fourteen chapters are original scholarly research done specifically for West Virginia. We have made every effort possible to make this book readable by the average citizen, although some of the policy reforms are more complex by their very nature. The four introductory chapters provide the background in basic economic principles necessary to understand why the reforms proposed in the final ten chapters are critical to the health of our state economy.

On the cover and chapter title pages are photographs of the economic activity that lies just on the other side of our state border. While these are visually striking, the data is even more convincing. The average citizen in West Virginia’s 28 border counties is $2,147 poorer than the average citizen in the 34 counties on the other side of our border. The difference is largest for Virginia, but even Kentucky’s border counties are $2,365 richer. Most of these counties have virtually identical demographics and geography as their counterparts in West Virginia. The explanation for the difference in prosperity is that these areas simply have better state policies.

While West Virginia’s average income has ranked 48th or 49th for the last two decades, we have not always been at the bottom of the national economic ladder. In 1934, for example, West Virginia ranked 30th. The figure below shows West Virginia’s ranking throughout the entire history for which average income data are available. As the figure clearly illustrates, our current situation is the result of long-term, sustained problems in our state policies.

![Graph showing West Virginia's economic ranking](image)

Source: Bureau of Economic Analysis (2006), see reference list at end of Chapter 1 for full citation.

The chapters in this book were each written independently, and tackle different areas of state policy reform. While the authors address a broad spectrum of issues, from tax policy to legal and regulatory reform, there is clearly a common theme in the conclusions they reach regarding the current problem areas of our state policy. The authors unanimously agree that
making our state policy climate more consistent with free-market capitalism, or ‘economic freedom,’ is the best way to improve the economic well-being of our state. By doing so, West Virginia will experience increased capital formation, higher labor productivity and wages, and reduced levels of resources devoted to wasteful political and legal plunder.

Our authors have based their research on science, not politics. The issues addressed in this book were not chosen based on whether they align with the positions of any particular political party or even whether the reform is politically feasible. Instead, we simply asked our authors to develop ideas for policy reform in West Virginia, and to back up their analysis with cold, hard facts and references to the published academic literature. We have attempted to frame our discussion around West Virginia’s long-term policy climate. Thus, this book should not be viewed as an assessment of any particular administration, candidate, or political party. Rather, it should be viewed as an assessment of possible economic reform proposals using standard scientific methods and statistical data analyses.

We hope that readers will come away with a better understanding of capitalism’s true potential to generate the long-run economic growth necessary to make West Virginia more prosperous, as well as ideas for policy reforms that could accomplish it in our lifetimes. Our main goal is to provide the scholarly, academic research that can inform state policy decisions and open a much needed dialogue on growth-oriented policy reform in West Virginia.

We owe thanks to more people than we could possibly list. We are indebted to the dozens of West Virginia citizens and business owners who took the time to let us conduct interviews and provided us with valuable information. We thank our friends and family for their support, and for putting up with the long working hours that went into conducting this research. Most importantly, we would like to thank Ken and Randy Kendrick for providing the financial support necessary to fund such a major research project. Without their support this book would not have been possible.

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CHAPTER 1

THE CASE FOR GROWTH
by Russell S. Sobel and Susane J. Daniels

West Virginia needs policy founded in a vision of a better future for our children and grandchildren. If done correctly, policy reform has the potential to drastically increase the well-being of our citizens within a generation. Within two generations our 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 in our state and sustaining it over the long term. This reform must be based on science, not politics. We need to adopt policies that are proven to increase growth in other states, and abandon current policies that are proven to have decreased economic growth in our state and others.

This book is written for the layman. It contains the latest research on which policies best promote state economic growth by scholars from across the nation. In compiling this book we hope to provide a guide to which policy reforms will increase economic growth in West Virginia. It is important to note at the outset that the ideas contained in this book are not political. We did not pick issues based on which reforms would be easiest to ‘sell politically’ or are currently being proposed (or opposed) by the major political parties in our state legislature. We simply asked our economic and legal scholars to examine West Virginia’s current policies and to identify reforms that would best promote growth in our state based on their examination of the data and knowledge of the latest research.

To begin our quest for growth, this introductory chapter outlines the main arguments for why economic growth should be considered as one of our most important policy priorities in the Mountain State.

THE HAVE’S AND THE HAVE NOT’S

How wide are the differences in standards of living across states? How does average income in West Virginia 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 2005 per capita personal income of only $26,029, West Virginia ranked 48th, making us the third poorest state. We moved up one spot this year from our long-held ranking of 49th thanks to Louisiana’s single-year plummet in per capita income from $28,000 to
$24,582 due to Hurricane Katrina, which sadly made Louisiana the poorest state in the nation in 2005. Mississippi is the only other state poorer than West Virginia.

**Figure 1.1 Average Income by State, 2005**

Note: All per capita personal income data in Chapters 1 and 2 are adjusted for inflation to constant 2005 dollars using the Consumer Price Index. Source: Bureau of Economic Analysis (2006).

Average income in West Virginia is about 75 percent of the U.S. average of $34,495. West Virginia has a hard-working labor force, a bounty of natural resources, low crime, a location central to the East Coast population, wonderful recreation opportunities, and other significant advantages. From a purely economic perspective, there is no reason we should be at the bottom of the national income ranking.

Why does the average West Virginian earn so much less than the average citizen in other states? One fundamental problem is that despite our many advantages, we have been unable to get our economic policies right. As the photographs on the cover of this book vividly illustrate, job creation virtually stops at our state line. The only difference between locating jobs on one side of the Ohio River versus the other are the state policies businesses must comply with. Getting these policies right is the key to increasing our prosperity.

**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’s consider a few examples.
Figure 1.2 shows the history of income growth in West Virginia, adjusted for inflation, along with several alternative future projections. One projection simply takes our historical rate of real per capita economic growth over the last 20 years, 1.4 percent, and forecasts it into the future. This is the ‘real’ growth rate, or the growth rate after adjusting for inflation. The other two projections show what the future would hold if our growth rate could be increased to 1.9 percent and 2.4 percent respectively. These real growth rates are not unrealistic. Both are actual growth rates experienced in other U.S. states over the last two decades.

The last year of historical data shown in the figure is 2005, a year in which the average income in West Virginia was $26,029. Let’s consider the simple question of what the average income will be in one generation, or twenty years into the future, in 2025. At our historical growth rate of 1.4 percent, average income in West Virginia will be $34,375 in 2025. But what if we could increase growth to 1.9 or even 2.4 percent? Under these alternative scenarios, average income in 2025 would instead be $37,926 and $41,827 respectively. Thus, a one percentage point higher rate of economic growth results in a difference of more than $7,000 just one generation into the future. Remember also that this is average income per person. The average family size in West Virginia is 2.9 persons, so the impact of this difference on the average family is almost three times this amount.

What if we consider even further into the future? What about two generations? By 2045 the differences grow even larger. Instead of average income being $45,392 in 2045 at a growth rate of 1.4 percent, it would be $55,262 at 1.9 percent, or a whopping $67,213 at 2.4 percent.

Note: Per capita income is adjusted for inflation to constant 2005 dollars.

1 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.
percent. Make no mistake about it, in two generations a one percentage point increase in our rate of economic growth means a difference of more than $20,000 in our citizens’ average income.

Perhaps a better way of looking at the data is to ask, at what date in the future will average income in West Virginia hit $40,000, or even $50,000? To put these figures in perspective, they are about the current average income levels in Maryland and Connecticut respectively.

At our historical 1.4 percent rate of growth we will hit $40,000 in the year 2036 and $50,000 in 2052. At a 1.9 percent rate of economic growth, we would instead hit an average income level of $40,000 in 2028 and $50,000 in 2040. At a 2.4 percent rate of growth we hit $40,000 in 2024 and $50,000 in 2033. Increasing economic growth by just one percentage point moves the date at which we hit an average income level of $50,000 forward by almost twenty years, or 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 West Virginia and two states that in 1965 were virtually identical to us in terms of income, Georgia and North Carolina. Figure 1.3 presents this data. In 1965 the average income in West Virginia was $13,361, while Georgia and North Carolina had average incomes of $13,900 and $13,194 respectively. Georgia ranked 41st in average income, one spot ahead of West Virginia, while North Carolina ranked three spots below West Virginia at 45th. Over this period in which West Virginia was able to sustain a 1.4 percent rate of growth, Georgia sustained a rate of growth of 2.0 percent and North Carolina 2.2 percent. After forty years, or two generations, West Virginia’s 2005 average income of $26,029 is about $5,000 less than the average income in Georgia and North Carolina ($31,191 and $31,029 respectively). The result is that while we have fallen to 48th in the national income rankings, Georgia has risen to 33rd and North Carolina to 35th.

Figure 1.3: State Growth Comparisons

Note: Per capita income is adjusted for inflation to 2005 constant dollars.
As an even longer-term comparison, in 1934 West Virginia was ranked 30th in the national income rankings, and had a slightly higher average income ($4,547) than did Texas ($4,270), who was ranked 32nd. After seventy years, the difference in the two states’ growth rates has created a wide disparity in average income. Today, West Virginia’s income lags a full $6,000 behind Texas ($26,029 versus $32,604), and Texas now ranks 27th in average income. Remarkably, this difference was created by Texas having an economic growth rate only 0.4 percentage points higher than West Virginia’s over the period.

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 years, where \( X = \frac{70}{	ext{rate of economic growth}} \).

The Rule of 70:

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

So, a state that sustains a 1.4 percent growth rate, as we have done in West Virginia, doubles its living standards every 50 years (70 divided by 1.4). A state that sustains an economic growth rate of 1.9 percent sees its living standards double every 37 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. West Virginia currently ranks 48th in average income. If all states continue their current growth rates, 20 years into the future, West Virginia will have moved up one spot in the rankings to 47th. If instead we could increase our growth to just 1.9 percent, our ranking in twenty years would be 35th. If we could manage to grow at 2.4 percent, we would rank 17th in the nation within one generation.

As the experiences of other states illustrate, these large leaps in the income rankings are possible. Between 1965 and 2005, Virginia moved up 22 places from 29th to 7th, New Hampshire jumped 19 places from 25th to 6th, Minnesota and Wyoming rose 14 places each (from 23rd to 9th and 24th to 10th respectively), South Dakota jumped 13 places from 29th to 16th, Colorado moved up 12 places from 20th to 8th, and North Carolina rose 10 places from 45th to 35th. All of them did this by sustaining rapid rates of economic growth over this forty year period.

**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

2 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.
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 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, West Virginia’s abundance of natural resources by itself cannot guarantee a fast rate of economic growth.

Figure 1.4 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 wasn’t 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 wasn’t far behind. Both
countries are true ‘rags to riches’ stories. 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.

**CHARLESTON, W.V. VERSUS CHARLOTTE, N.C.: A TALE OF TWO CITIES**

Returning closer to home, let’s take a more detailed look at the comparison between West Virginia and North Carolina. Because of their similar histories, the cities of Charleston, West Virginia and Charlotte, North Carolina are interesting to compare. In 1920 both cities had approximately the same average incomes, educational levels, and populations. Charleston’s population of 39,608 was just slightly below Charlotte’s population of 46,338. 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 eight decades, however, Charlotte has grown into a crowning jewel of the South, with a population ten times the size of Charleston (53,421 versus 540,828).

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 Charlotte. There was no special geographic reason, such as a specific natural resource or even a sea port, giving Charlotte an advantage over Charleston 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 and need, 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’s look at the evidence.

People want to lead long healthy lives and this requires access to quality healthcare. Figure 1.5 (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. Because West Virginia is one of the lowest income states, it is also one of the least healthy. We rank near the bottom of the U.S. health rankings, at 43rd. Citizens in lower income states also have shorter lives. The average high income state ranks 16th out of 50 in terms of the life expectancy of its citizens. The average low income state ranks only 45th. In terms of health care quality, the picture is the same.
Richer states do better, while poorer states like West Virginia do worse. The average high-income state ranks 10th in terms of health care quality. The average low-income state ranks 45th.

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 larger 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 1.6 presents the evidence. Families living in states with higher incomes experience lower divorce rates than families in low 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). While West Virginia has always had a low crime rate relative to other low income states, our crime rate could fall even lower if our income grows.

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. All five high income states have higher percentages of the population graduating from high school than all five lower 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, further 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 1.6: Divorce, Crime, and Education

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


Finally, West Virginians often complain about their children leaving the state in order to find employment opportunities. Keeping our children close to home, so that we may share their lives, certainly has enormous value. Economic growth has the potential for creating hundreds or thousands of high-paying skilled jobs—jobs that will help to ensure our children stay in our state after finishing school, rather than seeking employment in other states that have better employment opportunities.

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 West Virginia 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 we refuse to undertake policy reform, and continue our current trend, in twenty years West Virginia will have only moved up one spot, to 47th, in average income and our children will remain at the bottom of the economic ladder.

In contrast, a better and richer West Virginia is possible to achieve within our lifetimes. A one-half of a percentage point increase in our rate of real per capita economic growth, from 1.4 percent to 1.9 percent, would result in our ranking rising to 35th twenty years
into the future, and a one percentage point increase in growth to 2.4 percent would result in West Virginia becoming the 17th richest state in the nation within one generation. And, importantly, this growth does not have to come at the expense of other things we value—to the contrary, these other areas are also enhanced by economic growth.

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

REFERENCES


CHAPTER 2

THE SOURCES OF ECONOMIC GROWTH

by Russell S. Sobel and Joshua C. Hall

East End near East Liverpool, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 80.53° W & Latitude 40.63° N).
The previous chapter made the case for why increasing the rate of economic growth in West Virginia should be considered one of our top policy priorities. However, policy reform to promote growth should be based on evidence of what has, and what has not, worked for other places. Evidence was presented in the previous chapter that economic growth is faster in states like Colorado, New Hampshire, South Dakota, Virginia, Georgia, North Carolina, and Delaware; and in countries like Hong Kong, Japan, and recently Ireland. How can we replicate this in West Virginia? Can we uncover which policies tend to promote prosperity? These are the questions we address in this chapter.

As we will soon see, there is one thing that high-income and fast-growth places 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., wage growth, job creation, or new businesses). This is illustrated in Figure 2.1 (following page). 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

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Several analogies will help to clarify. First, let’s consider a basketball game. The players, the court, and the basketballs are all inputs into the process. The ‘institutions’ in this context are the rules under which the game is played. Some examples of these rules are the time length of the game, the length given on the shot clock, the rules on fouling, and the three-point line rule. Examples of the measurable outcomes are the score, the winning team, the number of fouls, etc. The important point is that the outcomes will be influenced by which
rules of the game we choose. 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.1

While a basketball example might sound hypothetical, 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).

This model makes it clear that by improving institutions, or the rules of the game under which the West Virginia economy operates, we can change our economic outcomes for the better. When institutions are weak, even places with abundant natural resources or other inputs have difficulty becoming prosperous. West Virginia, and the countries of Argentina and Venezuela, fit into this category of resource-rich areas that haven’t been able to sustain economic growth.

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 we get the rules right in West Virginia.

**ADAM SMITH’S QUESTION:**
**WHY ARE SOME PLACES RICH AND OTHERS POOR?**

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

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1 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.
In a nutshell, he found that countries become prosperous when they have good institutions that create favorable rules of the game—rules that encourage the creation of wealth. Smith further concluded that the institutional structure that best promotes prosperity is an economic system of capitalism backed up by sound political and legal institutions. According to Smith, an economy becomes prosperous when they use unregulated private markets to the greatest extent possible, with the government playing the important but limited role of protecting liberty, property, and enforcing contracts. More than 200 years of published scientific evidence now supports Smith’s conclusion.

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

Unfortunately, West Virginia has failed to embrace these ideas despite the overwhelming evidence of their effectiveness. In the annual study that ranks countries and states according to the extent to which they embrace capitalism, or free-market policies, West Virginia consistently ranks 50th among the U.S. states. In other words, West Virginia relies on capitalism the least of all 50 U.S. states to organize its economy. This is why economists find it amusing when editorial writers blame capitalism for West Virginia’s poor economic performance. This myth is something we tackle head on in Chapter 4. But for now, the important point is that if avoiding capitalism was better than embracing it, we should be the richest state in the nation instead of one of the poorest.

WEST VIRGINIA:
THE LEAST FREE-MARKET ECONOMY IN AMERICA

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, Latvia, and Slovenia, 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 control and intervention than is envisioned under pure capitalism. Within the last decade, a significant advance in our understanding of this continuum was the publication of the Economic Freedom of the World index created by economists James Gwartney (a former
Chief Economist of the Joint Economic Committee of Congress) and Robert Lawson. They derive a single index measure for each country that places them on a spectrum from zero to ten, in which ten represents the greatest degree of ‘economic freedom’, i.e., reliance on capitalism, and zero represents the greatest degree of ‘economic repression’, i.e., reliance on government control of the economy. In their most recent ranking, the United States scores 8.2 out of 10, ranking the United States as the third most capitalist, or free-market, economy in the world. The United States is actually in a three-way tie for third place with New Zealand and Switzerland (both also with scores of 8.2). The two countries ranking higher than the United States are Singapore (8.5) and Hong Kong (8.7).

Because state and local policies vary within the United States, Amela Karabegovic and Fred McMahon created an index of the Economic Freedom of North America, which ranks U.S. states and Canadian provinces by the degree of free-market orientation within each state or province. Among U.S. states, West Virginia ranks dead last at 50th. West Virginia is the only U.S. state that even ranks below some of the Canadian provinces when they are included in the ranking. This abysmal ranking means that in West Virginia government intervenes into our economy to a greater extent than any other state in the nation. Many resource allocation decisions left to the private sector in other states are made by the government in West Virginia.

To help illustrate how much less we rely on capitalism than other 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 2.2.

![Figure 2.2: Government Control of the Economy](source: Karabegovic and McMahon (2006)).
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, West Virginia has the second largest government share of state economic activity—or, alternatively, the second lowest share for the private sector. In the overall economic freedom index, our poor performance in other areas of government intervention is what pulls us down to the 50th position in the ‘reliance on capitalism’ ranking.

In West Virginia, 52 percent of all spending in the state is controlled by the government sector; leaving only the remaining 48 percent for the private sector. For comparison, in the most free market state, Delaware, government controls only 20 percent of the economy, leaving 80 percent to the private sector. Similar conclusions could be drawn from examining other measures of government size in West Virginia. We are also among the highest in terms of the share of the labor force employed by government and the percent of land owned by government. Once regulations and other forms of government control are included, far less than half of our state economy is in the hands of the private sector.

Even some of the countries formerly part of the Soviet Union, like Estonia, Latvia, and Slovenia have more capitalist-based policy environments than West Virginia. Estonia, for example, has an economic freedom score of 7.8, ranking it the 12th most free-market economy in the world. While the United States overall score is 8.2, West Virginia’s state score is approximately 25 percent lower than the U.S. average, which converts to a value of approximately 6.2. Using this methodology, West Virginia is significantly less free market than Estonia, below Latvia, and approximately tied with Slovenia. Keep in mind that these are countries whose policies were at the North Korea end of the capitalist-socialist spectrum less than two decades ago. In fact, they were able to move from pure socialism to a higher capitalism score than West Virginia within two years of undertaking reform.

According to a study published by the Federal Reserve Bank of Dallas, the citizens of the most free-market U.S. state, Delaware, gain $3,882 in annual income, while the citizens of West Virginia lose on average almost $5,294 relative to the national average based on differences in the free-market orientation of their state policies. West Virginia’s population is too poor to afford this massive loss of per capita income caused by our state government’s infringements on private property through lawsuit abuse, government regulations, restrictions, and taxes. According to the Federal Reserve Bank of Dallas’s estimates, if we had Delaware’s policies in West Virginia, each West Virginian could be almost $10,000 richer. Critics who worry about the costs of undertaking policy reform don’t understand the human and social costs of not undertaking it.

Returning to Ireland’s growth ‘miracle’ discussed in the previous chapter, we find another example of a country enacting significant pro-market reforms and gaining prosperity.

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4 The data in Figure 2.2 include all federal, state, and local government spending. Given West Virginia’s better than average ability to secure federal pork barrel spending, it is worthwhile to also examine the data once federal spending is excluded. Even when excluding the federal government, state and local government control of the economy in West Virginia amounts to almost one-fourth of our state economy, again the second highest level of government control in the nation. For comparison, Delaware’s state and local share is 10 percent.

5 Cox and Alm (2002).
as a result. Ireland jumped from a score of 6.3 (out of 10) in 1985 to a score of 8.2 by 1995 in the economic freedom index, leading Ireland to become the fifth most free-market economy in the world. As a result, Ireland’s growth skyrocketed, unemployment fell, and prosperity flourished.

Fortune 500 firms butt-up against our state borders; Marathon Oil (formerly Ashland Oil) is just over our border in Kentucky, and NewPage Corporation (formerly Westvaco, the West Virginia Pulp and Paper Company) lies exactly on the other side of our border in Luke, Maryland. MeadWestvaco also has a plant across our border in Covington, Virginia. We have placed pictures of the striking differences between the two sides of our state line on the chapter title pages and front cover of this book. The location decisions of these companies certainly weren’t made because of workforce or financing issues. These factors would be identical had they located just feet away on West Virginia’s side of the border. What explains their location decision, of course, is that our state is simply a more costly place in which to locate.

Our ‘Open for Business’ signs at the state border are misleading. Not only does our 50th ranking in the economic freedom index suggest the opposite, but uniformly every other national index of business climate agrees. We rank 47th in the Tax Foundation’s State Business Tax Climate Index, 41st in the Milken Institute’s Cost-of-Doing Business Index, 47th in the Beacon Hill Institute’s State Competitiveness Report, 46th in the Milken Institute’s State Technology and Science Index, 50th in the Progressive Policy Institute’s New Economy Index, 50th in the Institute for Legal Reform’s State Liability Systems Ranking, and as the number one ‘Judicial Hellhole’ in the American Tort Reform Foundation’s annual survey. All of these indices are to one extent or another measuring the same thing: West Virginia’s lack of reliance on capitalism. Our state is a hostile environment for capital investment and business development. Our signs may say ‘Open for Business,’ but our policies don’t.

The average citizen in West Virginia would be much better off today if we were still a part of our former state, Virginia—the 10th most free-market economy in the nation. As in the case of Delaware, if we had Virginia’s policies we’d be significantly wealthier. The divergent rates of economic growth in Bluefield, West Virginia and Bluefield, Virginia (right across the border) are obvious to anyone who has been there, and they result from differences in state policies. As Bray Cary, CEO of West Virginia Media Holdings and host of the state-wide television show “Decision Makers” once jokingly remarked, a good start to policy reform in West Virginia might be to just get copies of Virginia’s state laws and do a quick find-and-replace to insert the word ‘West’ before ‘Virginia.’

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**Business Perspective:**

“I think the B&O [Business and Occupation] tax prevents a lot of companies from coming to West Virginia. It taxes companies on sales revenue rather than on profit. So you get taxed on the amount that you sell, whether you make a profit or loss.”—Don Gallion, President and CEO of FCX Systems, Inc.

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Because of West Virginia’s decades-old unwillingness to embrace capitalism we have turned ourselves into one of the poorest states in the nation. As Adam Smith would have predicted, our well-being is consequently lower than other states as a result of our bad institutions. We are the state within the U.S. whose policies are the closest to the socialist policies of the former Soviet Union, and we shine as an example of why that form of economic organization does not produce prosperity. The good news is that the path to prosperity is well established—adopt capitalist institutions that allow individual initiative to flourish.

West Virginia has demonstrated some willingness to undertake reforms promoting capitalism over the past five years. These include the recent small reductions to business tax rates, limits on eminent domain abuse, privatization of workers compensation, and caps on non-economic damages awarded in medical malpractice lawsuits. While these reforms are certainly encouraging, there is much more that needs to be done.

WHAT IS CAPITALISM? THE CONCEPT OF ECONOMIC FREEDOM

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

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 would imply that some individuals
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 don't 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 weaken property rights on all of the dimensions considered above, making property a ‘contingent right’ (contingent on the state’s arbitrary will) rather than an ‘absolute right’ guaranteed and protected by law.

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

**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 have the right to use force to invade and seize the labor and possessions of others, 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 isn’t a 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 doesn’t 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.
winners and losers and there is no assurance that the gains of the winners will exceed the cost imposed on the losers. In fact, there are good reasons to believe that in many cases policies will be adopted for the purpose of generating benefits for smaller and more politically powerful interest groups—even when those policies impose much greater costs on the general public. Elected officials must cater to the special interest groups who provide votes and support for their political candidacy—they have to if they want to keep getting reelected. We explore this in more detail in Chapter 14.

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 ISN’T: BEING BUSINESS FRIENDLY DOESN’T 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 industry groups that lobby them but not to others, this is at odds with the policy structure, 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—but it means ones that are applied equally to everyone.

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 other private owners, 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 isn’t about having business take over government policy making. Unconstrained democracy is a threat to capitalism regardless of who is in power. Progress it isn’t about turning policy over to a specific industry; it’s about being competitive across the board to attract things like new bank headquarters to Charleston, a major investment in a coal liquefaction facility, or a furniture manufacturing facility. It’s 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’s about creating more high-paying jobs across the board.

Businesses that compete nationally or globally are currently at a cost disadvantage if they locate in West Virginia. Occasionally we attract something like the Toyota facility in Buffalo, West Virginia, but this only happened because of an intense political negotiation in which Toyota’s property taxes were lowered significantly, and some regulations were eased, in exchange for the firm locating in our state (Ward, 1996). All firms in our state should have a good business climate, like the one afforded to Toyota, without having to devote time, effort, and resources toward political lobbying and favor seeking to get it. Many of the firms in our state—including our small entrepreneurs—simply don’t have the political power to even begin to negotiate a better business climate like Toyota did.

When state policies result in a higher cost of doing business, like they do in West Virginia, one of the few types of development that flourishes is retail development in the form of new ‘big box stores’ and retail chains. They can survive because they mainly compete against other local businesses that are also subject to the same higher costs and regulations. While the jobs created by this retail development aren’t bad, they certainly aren’t the types of new jobs in engineering, accounting, banking, architecture, or entrepreneurship that lead to true income growth and prosperity in a state. Growth in these types of jobs requires a business climate that is broadly pro-capitalism—it requires we move up in these business climate and economic freedom rankings.

**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’s take a closer look at the evidence on the relationship between capitalism and prosperity.
First, let’s consider the measure of states’ reliance on capitalism, the *Economic Freedom of North America* index, and how closely related it is with states’ levels of per capita income. The data shown in Figure 2.3 above are the 50 states plotted with their level of reliance on capitalism on the horizontal axis, and their level of per capita income on the vertical axis. 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.

CHAPTER 2: THE SOURCES OF ECONOMIC GROWTH

While the economic freedom index is certainly the closest measure to what economists mean by capitalism, it is worth considering some alternative measures. We mentioned quite a few other indices of business and legal climate earlier in this chapter. Because the most fundamental underpinning for capitalism is secure property rights, which are to a great degree determined by a state’s court decisions, the Institute for Legal Reform’s ranking of state legal systems provides a good alternative measure of capitalism.

Figure 2.4 shows the same relationship as Figure 2.3, but this time for the index of legal system quality and average income. The data again show a positive relationship. States whose legal systems better protect the property rights of individuals are richer. States whose legal systems do a worse job of protecting individuals’ property rights are poorer.

As a final comparison, Table 2.5 shows the economic records of the handful of states that make the top ten list in both of these rankings versus the handful of states who make the bottom ten list in both rankings. The bottom rows of the table show the averages across these two groups of states on important indicators of prosperity, including not only per capita personal income, but also the poverty and unemployment rates.

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**Figure 2.5: Capitalism’s Economic Record**

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<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Both Top 10s</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Delaware</td>
<td>1</td>
<td>8.6</td>
<td>74.9</td>
<td>$37,084</td>
</tr>
<tr>
<td>Colorado (tie)</td>
<td>2</td>
<td>7.7</td>
<td>8</td>
<td>$37,459</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>7</td>
<td>7.5</td>
<td>6</td>
<td>$37,835</td>
</tr>
<tr>
<td>North Carolina</td>
<td>2 (tie)</td>
<td>7.7</td>
<td>10</td>
<td>$31,029</td>
</tr>
<tr>
<td><strong>Both Bottom 10s</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Mexico</td>
<td>48</td>
<td>5.7</td>
<td>40</td>
<td>$27,912</td>
</tr>
<tr>
<td>Mississippi</td>
<td>47</td>
<td>5.8</td>
<td>48</td>
<td>$24,925</td>
</tr>
<tr>
<td>West Virginia</td>
<td>50</td>
<td>5.3</td>
<td>50</td>
<td>$26,029</td>
</tr>
<tr>
<td><strong>Average Value: Top States</strong></td>
<td>7.9</td>
<td>67.9</td>
<td>$35,852</td>
<td>9.7%</td>
</tr>
<tr>
<td><strong>Average Value: Bottom States</strong></td>
<td>5.6</td>
<td>43.7</td>
<td>$26,289</td>
<td>17.4%</td>
</tr>
<tr>
<td><strong>Difference (Top minus Bottom)</strong></td>
<td></td>
<td></td>
<td>$9,563</td>
<td>-7.7%</td>
</tr>
</tbody>
</table>


The states listed in the top of the table are ranked in the top ten of both the *Economic Freedom of North America* ranking and the Institute for Legal Reform’s *Ranking of State Liability Systems*. The four states in this mutual top ten group (Delaware, Colorado, New Hampshire, and North Carolina) are uniformly more prosperous than the three states in the mutual bottom ten group (New Mexico, Mississippi, and West Virginia). Average per capita personal income is $9,563 higher in the top states, interestingly a difference right on target with the estimates mentioned earlier in the study by the Federal Reserve Bank of Dallas. Those states who rely more heavily on capitalism—private sector coordination rather than government spending and control, and who have the supporting legal institutions that protect
private property—have poverty rates 7.7 percentage points lower, and unemployment rates 1.4 percentage points lower than those that rely more heavily on government planning.\(^{15}\)

**EVIDENCE FROM ACROSS THE WORLD**

While state comparisons are probably the most valuable for West Virginia 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 West Virginia, but their fate can help us understand what is in store for our state if policy keeps moving in the wrong direction.

![Figure 2.6: Capitalism and Income (International Data)](image)

Figure 2.6 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

\(^{15}\) Some of the gap in average unemployment rates can be explained by Mississippi’s higher than average unemployment rate that remains elevated due to lingering effects of Hurricane Katrina. Without including Mississippi in the average, however, the differential in the unemployment rates remains fairly large at 0.7%.
political planning, to organize their economies. The pattern in Figure 2.6 is clear and is the same pattern we saw across the U.S. states above. A heavier reliance on capitalism makes people more prosperous.

Figure 2.7 shows a similar graph for the relationship between reliance on capitalism and income growth rates over the 1990-2003 period for countries of the world. Those relying least on capitalism are not only poorer to begin with (looking at average income levels), but they are also becoming worse off through time. As their negative growth rates show, average income is actually falling through time in these countries. At the opposite end of the spectrum are countries that rely heavily on capitalism and have both high incomes and high growth rates as a result.

**Figure 2.7: Capitalism and Growth (International Data)**

![Graph showing the relationship between economic freedom and income growth rates for different quartiles of economic freedom.](image)


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 West Virginia?

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 West Virginia. 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’s look at the evidence. Consider again the comparison of West Virginia—the state ranking 50th in both the index of economic freedom and the alternative measure of legal system quality—versus Delaware—the state ranking 1st in both indices. 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. As we have seen, in West Virginia government spending controls more than half of all income, while in Delaware it is only 20 percent. Let’s compare how income growth varies across the income distribution in Delaware and West Virginia.

Figure 2.8 shows data on how the growth of income has differed among income classes in West Virginia over the last two decades. As you can see in the figure, 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’s consider income growth Delaware. As we have seen, Delaware’s government size, relative to its economy, is less than half as large as West Virginia, and it has one of the most favorable business climates in the United States, with very low labor and

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business regulations and a highly-rated legal system. As Figure 2.9 shows, income growth in Delaware has been much more even.

**Figure 2.8: West Virginia Income Growth**

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


**Figure 2.9: Delaware Income Growth**

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

The income growth for the poorest 20 percent of the state’s population was 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 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 don’t have the political power to compete with special interest groups for government spending, contracts, regulations, and handouts.

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

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

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

Rather than attempting to present these more detailed results here, we instead point the reader to the following published articles on this subject contained in the accompanying footnote to this sentence. All of these articles are published in scientific journals, in which authors submit papers that are reviewed anonymously by other scholars from across the globe. 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.

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17 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.
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 Argentina, are good examples. Our example in Chapter 1 comparing Charlotte and Charleston also demonstrated that Charlotte’s growth wasn’t because it had a significant natural advantage, it just had better policy. Geographic climate variation, or just plain luck, does not explain the differences observed across countries or regions or states either. When we see pictures of our state line, or the borders between countries—like the two sides of the former Berlin Wall separating wealthy West Germany from relatively poor 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 200 years of evidence suggests that reliance on capitalism is the best route to achieve increases in living standards. States and countries relying more heavily on capitalism not only have higher income levels and faster average income growth, but also faster and more even growth across the income distribution.

The 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, 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**

Why Capitalism Works
by Russell S. Sobel and Peter T. Leeson

East Liverpool, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 80.58° W & Latitude 40.61° N).
The previous chapter showed that increased reliance on capitalism has allowed other states and countries to become more prosperous. To promote capitalism in West Virginia, our 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 understanding their economic consequences. While policy makers in West Virginia and other states are indeed smart and reasonable people, most do not have formal training in advanced economics, nor do they solicit advice from a council of economic advisors. To ensure the true economic consequences of policy are better understood, our elected officials and citizens must become more knowledgeable about a few basic principles of economics. We hope this book will help to accomplish that goal. For readers wanting to learn more, we suggest the easy-to-read book, Common Sense Economics: What Everyone Should Know about Wealth and Prosperity, by James D. Gwartney, Richard L. Stroup, and Dwight R. Lee.\(^1\) With better knowledge of fundamental economics and the basic structures that operate within an economy—the reasons why and how capitalism works—policy makers can make better state policy decisions.

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

**Voluntary Exchange, Wealth Creation, and Value Added**

While we tend to think of our wealth in dollars, true wealth has nothing to do with paper money itself. Total wealth in a society is not a fixed pie waiting to be divided among us.

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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.
Wealth, instead, is constantly being created by us all; 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 has existing money been 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 the castaways 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 laborers can now begin a new task such as building a shelter for the group, 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 we produce. 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).

One of Adam Smith’s insights in his previously mentioned book, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1998 [1776]), 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. Morgantown’s population, for example, might be able to support two or three general purpose pet stores, each carrying a broad line of products. In a place like Pittsburgh, however, a dozen or more stores can flourish, with a greater extent of specialization, one store, for example, specializing in snakes and other reptiles, while another specializes in birds. Increasing the size of the markets to which West Virginia’s goods and services sell would increase our wealth by allowing our citizens to specialize more specifically in the areas in which they do best.

Having one or two of our larger cities grow into larger metropolitan areas would be one way of increasing our markets. But another way to increase our markets is to enact policy reform that better enables the businesses in our state to compete in larger national and global marketplaces. To compete in these markets West Virginia businesses need to be on a level playing field with their competitors. West Virginia’s high taxes and regulations are a major competitive disadvantage to firms located in our state. The higher prices West Virginia 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, our 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.

In addition to specialization and the division of labor, capital investment also increases labor productivity. Higher levels of education (more ‘human capital’) and better machinery, buildings, and tools to work with (more ‘physical capital’) can help our citizens produce more output and generate more income. Recent capital investments in sawmills provide a good example of this. An experienced operator of a newer optimizing edger earns $13 per hour compared to the $10 per hour wage rate a worker previously earned manually edging boards. Operators of new stacking systems earn $12 per hour compared to the $9 per hour wage rate workers previously earned manually staking lumber. Similarly, workers running newer optimizing trimmers earn $14 per hour compared with the previous wage of $8 per hour for workers doing manual trimming. With this new capital equipment workers are more productive and earn higher wages as a result.

For those familiar with the logging industry, a worker operating a ‘feller buncher,’ a huge machine with claws and a round built-in saw that the worker drives (pictured), can harvest roughly two and a half times as much timber in the same amount of time as a worker with a chainsaw. As a result, the wage rate he earns is roughly two to three times higher as well. But new factories, better machinery, and equipment are expensive. They require large investments in assets and property (the feller buncher, for example, costs almost a half-million dollars). In West Virginia, threats to the control rights,
cash flow rights, and transferability rights of private property from lawsuits, regulations, and especially high business-property taxes hamper this investment.

The income we get from our output depends not only on how much we can produce (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 we produce. A timber stand containing mostly poplar trees will produce less income than one with a higher proportion of more valuable black cherry trees. With rising oil prices, West Virginia companies are now exploring whether turning coal into liquid fuel might generate higher market value than supplying it as solid coal. Some believe that a similar opportunity might exist in making furniture in West Virginia rather than selling our wood as raw lumber. Income can be increased not only by increasing labor productivity, but also by raising the value per unit—or ‘value added’—of West Virginia labor.

But the answer to the question of which specific uses of our 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’s 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. For example, finding something 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 why we should 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 our state through: (1) increasing in the quantity, quality, and value of goods and services our state’s citizens produce, and (2) increasing the number and value of the

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2 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.
voluntary exchanges our citizens make, both with other West Virginians 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 our residents and businesses to buy and sell with individuals from across the state, nation, and globe; and (3) more private sector entrepreneurship that allows the decentralized decisions of workers and business owners—rather than government planning—to help search out and identify the ever-changing bundle of goods and services that creates the most value and income for our state.

ENTREPRENEURSHIP AND DISCOVERY

Of the many potential things we could produce with our resources in West Virginia, we should set our 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. As an illustration, 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.\(^3\) Now, returning to the economy, we have more than just three letters and numbers to work with. 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 failures or successes by the profit and loss system.

\(^3\) Although, West Virginia further limits the number of combinations because the first digit of the standard license plate indicates the month in which the plate expires each year. With only 12 possibilities for the first digit, the number of possible combinations is reduced by more than half, to a still greater than adequate number of 8,112,000. However, this does provide a good illustration of why restrictions on trade and resource use greatly diminish economic productivity—because they limit the inputs and drastically reduce the number of combinations.
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. Our goal should instead be to maximize the number of new combinations attempted, which also implies having a lot of failures. 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 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

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4 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.
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 didn’t 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.

As director of the WVU Entrepreneurship Center, one of us personally witnessed many good ideas die because the entrepreneur simply could not put together the initial level of resources necessary to comply with the many rules, regulations, and permissions necessary to open a business in West Virginia. We will never know if one of these could have been another FedEx. But for a thriving economy we must find ways to make it easier and less costly for entrepreneurs to try to test their ideas in the marketplace.

Entrepreneurship is the means by which we discover ways to increase the value created by our 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 rules of the game 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, 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 those goods and services creating the most value and communicate to them to invest more heavily in these goods’ production. 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.

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 were 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 attempt to set taxes and user fees for government provided goods and services at levels more analogous to market prices.

**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 West Virginia 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
CHAPTER 3: WHY CAPITALISM WORKS

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.\(^5\)

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 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 AREN’T ENOUGH: UNINTENDED CONSEQUENCES

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

The minimum wage provides a good example. 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.\(^6\) 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. Chapter 10 takes a closer look at this issue.

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?

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\(^6\) 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](http://www.house.gov/jec/cost-gov/regs/minimum/case.htm)
Thomas DeLeire, a public policy professor at the University of Chicago, wrote his Ph.D. dissertation on the employment effects of the ADA legislation when he was in graduate school at Stanford University. His research shows that the ADA has actually *harmed* the employment opportunities for disabled Americans. 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. When the Federal Fish and Wildlife Service put Boiling Springs Lakes, North Carolina on notice that active nests were beginning to form near the town, it unleashed a frenzy of action on the part of the residents, but not of the type you might expect (Associated Press 2006). Foreseeing the potential future restrictions on their property use, landowners swarmed the city hall to apply for lot-clearing permits. After removing the trees, the land would no longer be in danger of being declared an environmentally protected habitat because no future nests could form on the property.

Similar incidents have occurred throughout the range of this bird, and the total habitable nesting area for this species in the United States has fallen dramatically as a result of the poor incentive structure created by the law. The red-cockaded woodpecker has lost a significant portion of its habitat, moving it closer to extinction because of the unintended consequences created by the Endangered Species Act. If instead we paid people $500 for finding a red-cockaded woodpecker nest on their property, rather than taking the property’s use from them, owners would not have the perverse incentive to destroy the bird’s potential nesting grounds.

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.

**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 isn’t a matter of getting ‘better people’ in government. Government workers are smart, caring, and devoted to their causes.

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The problem is that the reward structure, the rules of the game, within their jobs does not get the incentives right to encourage the best outcomes. Nobel Laureate James Buchanan, with coauthor Gordon Tullock, published a seminal book on this subject called the *Calculus of Consent* (1962). As they pointed out, in government there is no invisible hand. An example will help to illustrate.

Most people know that government budgets are often given as fixed amounts for each fiscal year. At the end of the year, any remaining money in the budget is usually taken back and if money remains the next year’s funding is likely be reduced because the unit 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 isn’t the people; it’s the incentives they face.

**WEALTH CREATION VERSUS WEALTH DESTRUCTION:**
**TRADE AND TRANSFERS**

When Jeff buys corn from Mary for $20, wealth is created. But when the government taxes Jeff $20 and gives it to Mary it does not create wealth. In this second case, 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 our 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 weak capitalist institutions, like West Virginia, 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

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8 Spending effort and resources to secure wealth through political redistribution is what economists call ‘rent-seeking.’ See, for instance, Tullock (1967) and Tollison (1982).
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 car, you value the car more than the money you pay for it and the car dealer values the money he receives more than the car he sells you. 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 lobbying firms and fewer DVD manufacturers.

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

In places like West Virginia, where the legal structure is poor and lawsuits are unusually profitable for lawyers and their clients, and where state government’s large influence over spending encourages individuals to fight over obtaining state government funds, we encourage a high level of unproductive entrepreneurship. As a result, we have less productive private-sector entrepreneurship.

How much unproductive entrepreneurship is there in West Virginia? While it is hard to derive an exact number, some data can help to illustrate. In 2006, for example, 369 registered lobbyists represented 480 companies and organizations in West Virginia. In addition, our state was home to 4,497 resident and active lawyers. Campaign contributions to candidates running for office in the 2004 West Virginia elections amounted to almost $27.5 million, or $35.70 per vote. Policy reform that reduces the profitability of initiating lawsuits and lobbying government can create more wealth and prosperity for our state 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

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11 Data for federal offices (amounting to $4.36 million) is from www.opensecrets.org and data for state and local offices (amounting to $23.12 million) is from www.followthemoney.org. Voter turnout data (769,645 votes were cast in the 2004 general elections) is from the West Virginia Secretary of State’s office, http://www.wvsos.com/elections/history/turnout/voterturnoutstats.htm.
quality) have found highly significant results.\footnote{See, for example, Sobel (2006).} 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). Capitalism promotes productive entrepreneurial efforts.

But this same research also suggests that states with the worst freedom scores have the worst records on lobbying activity and lawsuit abuse—the unproductive types of entrepreneurship. In the ranking of ‘net entrepreneurial productivity’ in which productive entrepreneurship is measured relative to unproductive political and legal entrepreneurship, West Virginia ranks 49th. We have both low levels of private entrepreneurial activity and poor scores on legal quality and lobbying activity per capita. The relationship between having strongly capitalist institutions (as measured by economic freedom) and the index of net entrepreneurial productivity across states is shown in Figure 3.1.

Figure 3.1: Institutional Quality and Entrepreneurial Productivity

![Graph of Institutional Quality and Entrepreneurial Productivity](image)


The data in Figure 3.1 suggest that capitalism and limited government promote prosperity not only because they promote productive activities, but also because they discourage unproductive, wealth-destroying activities. While Part II of this book is devoted to specific policy reforms for West Virginia, Figure 3.2 (following page) 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

- Reducing or eliminating state personal and corporate income taxes
- Reducing or eliminating state turnover or business and occupation taxes
- Workers compensation reform (privatization, damage caps, rule enforcement)
- Medical malpractice reform (privatization, damage caps, rule enforcement)
- Judicial reform (eliminating partisan elections for state courts, liability limits)
- Eliminating state minimum and maximum price and wage limits and restrictions
- Reducing occupational licensing restrictions (and enacting right-to-work laws)
- Constitutional limits on eminent domain and environmental property takings
- Reducing government ownership of productive resources (e.g., land holdings)
- Broad reductions in government employment, expenditures, and levels of taxation
- 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 state ‘budget digests’ and other forms of pork-barrel legislation that use state money to fund local pet projects
- Increased use of market-based reforms such as medical savings accounts, school vouchers, and privatized retirement funds


CONCLUSION

Chapter 1 made the case for why increasing economic growth should be an important policy goal in West Virginia. 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 income in the process.

Despite the overwhelming evidence in favor of increased reliance on capitalism, West Virginia has been reluctant to embrace this ideal in policy. Surprisingly, this is not an issue of political ideology being different in West Virginia. When we examine all U.S. states, those states whose citizens vote most heavily Democratic are just as likely to embrace capitalism and economic freedom as states that vote heavily Republican. Figure 3.3 shows this relationship using data from the 2004 presidential election, along with each state’s economic freedom score.
The trend line in the figure is virtually flat. There is no obvious relationship between Republican vote share 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. 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 legislature that is Republican.

If our political orientation doesn’t explain our reluctance to adopt more capitalism-friendly policies, what does? In casual conversations with some West Virginians we found that our state’s unique historical experience with coal mining is commonly cited. The famous song lyric, “I owe my soul to the company store,” from “Sixteen Tons,” typifies the reaction of some West Virginians toward capitalism.

How founded in reality are these myths of capitalism from our coal-mining past? That is the issue we will explore in the next chapter. By addressing some of these myths, perhaps the social resistance to pro-capitalism policy reform can be overcome in West Virginia. We will then turn to Part II of the book, which contains chapters that give specific suggestions for policy reform that can create a brighter economic future for West Virginia.
REFERENCES


CHAPTER 4

The Cultural Opposition to Capitalism: Mythbusting through Our Past

by Claudia R. Williamson

Salt Run near of Brilliant, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 80.64° W & Latitude 40.25° N).
Capitalism is sometimes perceived negatively by the general population in West Virginia. This anti-capitalist mentality has no doubt been responsible for some of West Virginia’s current policies. Because popular attitudes play a significant role in shaping the economic policies that legislators pursue, attitudes toward capitalism grounded in reality rather than folklore are crucial to achieving the much-needed reforms this book considers.

After discussions with many individual West Virginians, it became clear that this anti-capitalist mentality is mostly rooted in stories from our state’s historical experiences with industry, specifically in coal mining. What role did capitalism play in our past? This chapter examines the evidence. To do this, I draw on the work of noted economic historian, Price V. Fishback from his book, *Soft Coal, Hard Choices: The Economic Welfare of Bituminous Coal Miners, 1890-1930*. By looking at the historical data uncovered in Fishback’s research it becomes possible to separate the rhetoric from the reality of capitalism’s role in West Virginia’s coal mining history.

**The Origins of West Virginia’s Anti-Capitalist Mentality**

Visitors to West Virginia do not have to visit very long before they hear firsthand accounts of the state’s unique history. However, this history has become muddled with urban legends and deciphering fact from fiction has become quite a challenge. Growing up in West Virginia, I was often told of the horrific and unbearable conditions that coal miners faced over the state’s history. The stories usually involved numerous accounts of how the conditions of the mines were unsafe, the miners were not fairly compensated, and miners were continually exploited by the owners of the mines. The most popular stories of exploitation surround examples of
miners and their families living in over-priced, yet run-down company housing and having to shop at the company store where prices were heavily inflated.

Understanding the reality of these claims will allow West Virginians to identify with their heritage, but also be free from a history and cultural inheritance that has stifled future economic progress. Fishback’s *Soft Coal* provides a historical analysis of the life of a typical coal miner during 1890 to 1930. He incorporates economic theory and techniques in conjunction with actual data from company records to debunk many of the myths surrounding this industry. The topics he covers include the distinctive labor market for coal miners, the effects of safety regulation, a comparison of wages within and across different industries, and the supposed exploitation of miners by the mining owners. I present a detailed overview and summary of Fishback’s academic research into these issues.

**MYTH #1: COAL MINERS HAD NO VOICE**

Fishback explains that miners had two options for bettering their working conditions: voice or exit. Voice refers to the ability of miners to bargain (either individually or collectively as a union) with their employers. Exit refers to the ability of miners to leave one job for another. Previous studies of the causes of improved working conditions and pay for miners focus only on the voice option and generally ignore the exit option. Because of this omission, many have assumed that unions were responsible, and necessary, for improved working conditions.

In reality, the ability of miners to switch between employers was the major driving force behind improved benefits and working conditions. The coal mining industry was a competitive labor market where miners would travel to work in the coal fields due to their isolated locations. If a miner was unsatisfied with his job, there was always the option to migrate to another coal field or even switch to another industry. This option was a powerful force compelling companies to offer competitive wages and attractive employment packages.

Although miners could seek employment elsewhere if conditions were not satisfactory, some readers may be skeptical about how well this potential check on mine owners’ behavior operated in practice. One sign that miners were capable of exercising their right to exit was the existence of a high turnover rate in mining. Figure 4.1 shows the turnover and stable force rates for West Virginia in 1921.

The U.S Coal Commission’s turnover rate is calculated as total employment separations as a percent of the average yearly number of workers on payroll. For example, a company with 10 regular employees who had 30 different people hold those 10 jobs during the year, would have a turnover rate of 200 percent because there would be 20 separations relative to the average workforce of 10. The final column in the figure shows the stable force rate, calculated as the percentage of workers who remained with the same employer for the entire year. These data allow us to gain insight into the true degree of mobility of miners.

With turnover rates over 100 percent, the average mine had twice as many workers cycle through employment as there were jobs in a given year. For comparison, the turnover rate for 160 firms in other industries during 1913-1914 averaged 115 percent, lower than the turnover rates in coal mining. A high turnover rate suggests that miners could move at a relatively low cost in order to seize an opportunity for a higher valued employment package.

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1 Material covered in this section is largely based on Chapter 1, 2, and 3 of Fishback (1992).
elsewhere. The stable work force rate shows that less than half of the average mining company’s workers remained on payroll for an entire year or more. The turnover and labor force stability rates presented here suggest a high degree of mobility among miners, and reflect a high degree of competition among employers for the services of miners.

Figure 4.1: Turnover Rates and Stable Work Force Rates in 1921

<table>
<thead>
<tr>
<th>Area</th>
<th>Turnover Rate</th>
<th>Stable Force</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonunion West Virginia, Virginia, and Kentucky(^a)</td>
<td>211.3</td>
<td>31.0</td>
</tr>
<tr>
<td>Mixed West Virginia(^b)</td>
<td>148.0</td>
<td>46.0</td>
</tr>
<tr>
<td>Union West Virginia(^c)</td>
<td>133.0</td>
<td>44.5</td>
</tr>
</tbody>
</table>

Notes: \(^a\)Southern Appalachian, Northeastern Kentucky, Virginia, Logan, Kenova-Thacker, Pocahontas, and Tug River districts; \(^b\)Winding Gulf and New River districts; and \(^c\)Panhandle, Fairmont, Kanawha and Coal River districts. Source: U.S. Coal Commission (1925b).

Similar evidence is presented by Corbin (1981). He examined records from the Stevens Coal Company Acme fields located in Kanawha County, West Virginia and found that only twelve out of fifty-eight men that worked at the mine in 1904 were still employed there sixteen months later, even though total employment had increased. This suggests that miners in this region had a high degree of mobility. Another study conducted by the U.S. Children’s Bureau in Raleigh County, West Virginia found that almost sixty percent of families interviewed had lived in their community three years or less.

The implication of this high degree of worker mobility is that potential employers were in competition with each other for the services of West Virginia miners. This competition could take many forms. To attract workers away from other companies, employers could offer higher wages, improved safety, better working conditions, or more fringe benefits, for example. Other differences across jobs included opportunities for overtime work, the likelihood of layoffs, and future advancement opportunities within the company. Working conditions included the spaciousness, temperature, wetness, workplace independence, and the level of safety. The attributes offered within the ‘company town’ itself (housing, shopping, etc.) were also important to workers. Since many employers owned the town, they could exercise direct control over housing, education, sanitation, and shopping.

A well-established result in economics is that in competitive labor markets like this one, the value of total employment packages tends to equalize across employers. That is, some employers might offer higher money wages than others, but they will tend to have other job benefits that are lower. On the other hand, employers offering more benefits pay for these through lower money wages. Some workers prefer having higher wages and worse working conditions, while others are willing to earn less money to receive higher non-monetary benefits. The composition of employment packages was different, reflecting the different tastes and preferences of the miners, but the value of each tended to equalize across mines.

If an employer, for example, were to charge a higher price to workers for rental housing, this cost must be offset with an increase in some other attribute of the employment
package (like increased wages or safety) to remain competitive with other potential employers. If not, a miner would find it in his best economic interest to migrate to the coal mine with a higher valued employment package. Because of this exit option, miners were much more powerful negotiators with their employers than is generally believed.

Although miners did have the choice of exit, migration was not without some cost. Miners would sometimes become attached to a certain coal community or find it difficult to move their families to another town. The other option to voice their dissatisfactions was to band together as a union. With unionization, miners faced a tradeoff. They could demand higher wages through the threat of strikes, but these wage increases came at a substantial cost to some subsets of miners. First, the higher labor costs might result in a mine becoming less competitive and going out of business, eliminating all of the jobs. Second, if the mine remained in business, the resulting higher prices necessary to cover the higher wages would result in the mine not being able to sell as much coal in the marketplace, in turn reducing the number of workers needed. Lastly, at the higher wages, companies simply did not hire as many workers. They conserved on their use of labor as the price of labor went up.

Thus, unions typically traded higher wages, or increases in the value of the overall employment package, for fewer miners being employed. Unions could increase the compensation of some miners, but not all of them. The benefits they created for certain miners were paid for by unemployment of others. This increased the unemployment rate of miners in unionized areas and they were forced to seek employment elsewhere, likely a lower-paying job. There is no general consensus on the overall impact of unionization of the coal industry on economic welfare. While certain union members may have gained, the overall effect on the industry may have been a decrease in welfare.

This section has compared the roles of voice (unionization) and exit (mobility/capitalism) in improving the welfare of coal miners. It is clear that capitalism, the system under which firms must compete with one another for the services of miners, was a force for progress in our history, not a force of oppression. Capitalism relies on the idea that each of us owns our own labor, and can change jobs when and where we see fit without permission from government agencies or threats of coercion from our employers. Under capitalism, workers and firms must bargain voluntarily.

The role of government in supporting capitalism is to strongly enforce property rights and laws against coercion and fraud. This allows the competition created by capitalism to produce better working conditions and higher wages. The reforms suggested in this book result in more potential employment opportunities for current workers in West Virginia. With more employment opportunities, and more exit options for workers, this same force can help to promote prosperity today.

**MYTH #2: MORE SAFETY REGULATION, PLEASE**

Coal miners performed a dangerous job. They faced higher safety risks than workers in most other industries. Before 1930, three to four men were killed per 1,000 workers each year. Accident rates varied across states, but were higher in West Virginia than any other state east of the Mississippi River. Why would anyone choose to be a coal miner given these

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2 Material covered in this section is largely based on Chapter 7 of Fishback (1992).
conditions? It’s quite simple; the job paid well. Coal miners received higher hourly earnings than workers in other industries precisely because of the danger involved. If a specific job or company was considered more dangerous, miners would be less likely to accept these jobs. Therefore, miners required higher wages to work under these conditions.

The fatal accident count stayed relatively constant in the U.S. before 1930. However, this is somewhat deceiving. In 1910, the U.S. Bureau of Mines was created with a focus on mainly large-scale accidents, defined as gas and dust explosions and other accidents killing more than five men. State mining legislation was also mainly concerned with these types of accidents. This resulted in a decline in large-scale accidents, but an increase in small-scale accidents, which received less publicity but accounted for more deaths overall.

Figure 4.2 below shows data on fatal accident rates in coal mining. The fatal accident rates shown in the figure are the number of accidents per 10 million man hours worked. The data show that small-scale accidents (such as roof falls, hauling accidents, small explosions, and electrocutions) accounted for the vast majority, or 84 percent (17.6 ÷ 20.9), of fatal accidents. Large-scale accidents accounted for only the remaining 16 percent.

**Figure 4.2: Average Fatal Accident Rates for Major Coal Mining States: 1903-1930**

<table>
<thead>
<tr>
<th>State</th>
<th>Total</th>
<th>Small Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>26.1</td>
<td>19.4</td>
</tr>
<tr>
<td>Arkansas</td>
<td>26.8</td>
<td>25.5</td>
</tr>
<tr>
<td>Colorado</td>
<td>38.4</td>
<td>29.5</td>
</tr>
<tr>
<td>Illinois</td>
<td>16.8</td>
<td>14.4</td>
</tr>
<tr>
<td>Indiana</td>
<td>17.9</td>
<td>16.4</td>
</tr>
<tr>
<td>Iowa</td>
<td>13.1</td>
<td>13.1</td>
</tr>
<tr>
<td>Kansas</td>
<td>16.8</td>
<td>16.1</td>
</tr>
<tr>
<td>Kentucky</td>
<td>16.0</td>
<td>14.1</td>
</tr>
<tr>
<td>Maryland</td>
<td>11.9</td>
<td>11.4</td>
</tr>
<tr>
<td>Michigan</td>
<td>11.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Missouri</td>
<td>10.6</td>
<td>10.4</td>
</tr>
<tr>
<td>Montana</td>
<td>23.5</td>
<td>22.1</td>
</tr>
<tr>
<td>New Mexico</td>
<td>47.1</td>
<td>26.6</td>
</tr>
<tr>
<td>Ohio</td>
<td>21.0</td>
<td>19.8</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>43.9</td>
<td>24.2</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>16.1</td>
<td>14.0</td>
</tr>
<tr>
<td>Tennessee</td>
<td>17.0</td>
<td>14.2</td>
</tr>
<tr>
<td>Texas</td>
<td>5.1</td>
<td>5.1</td>
</tr>
<tr>
<td>Utah</td>
<td>49.4</td>
<td>34.3</td>
</tr>
<tr>
<td>Virginia</td>
<td>22.2</td>
<td>21.4</td>
</tr>
<tr>
<td>Washington</td>
<td>32.9</td>
<td>25.0</td>
</tr>
<tr>
<td><strong>West Virginia</strong></td>
<td><strong>28.6</strong></td>
<td><strong>23.5</strong></td>
</tr>
<tr>
<td>Wyoming</td>
<td>37.4</td>
<td>27.9</td>
</tr>
<tr>
<td>United States</td>
<td>20.9</td>
<td>17.6</td>
</tr>
</tbody>
</table>

Note: Rates calculated by dividing the number of accidents by the number of ten million man-hours worked. Source: Fishback (1992), Chapter 7.
Most small-scale accidents occurred in a miner’s room due to a roof fall or a misfired explosive and were the result of the choices made by the miners themselves about the individual safety precautions they took on their jobs. Miners were paid by the amount of coal they could dig out and were given a significant amount of independence to decide the best way to achieve this. Thus, miners faced a direct tradeoff between income and safety and were left free to decide how much safety prevention to undertake.  

Though incorrect, it is common to see ‘greedy’ mine operators as the reason that mines could be quite dangerous. Often times, both miners and operators chose to ignore safety decisions in order to increase productivity, because it meant more income for both the mine owner and the miners themselves. Nevertheless, due to the dangerous work conditions in coal mining, government decided to regulate the industry with safety legislation. However, the effects of this legislation were mostly disappointing (Graebner 1976).

The creation of the U.S. Bureau of Mines, the federal agency of safety regulation, was intended to reduce mine accidents. However, this was not achieved because after only three years the Bureau had shifted its focus from mine safety to promotion of the western metal mines (Graebner 1976). The Bureau, a noncompulsory agency, mainly served as an informational agency, testing better mine safety techniques and providing safety standards to the mines. The enforcement of any legislation was a responsibility of each state. Nearly all states had adopted their own form of safety regulation, with West Virginia ranking among the most lenient. Enforcement of safety legislation was often difficult and imposed significant costs on the mines. States were often pressured by the mine operators to avoid regulations that would put local mines at a disadvantage compared to other states.

The myth that in order for miners to have more safety government intervention was necessary is simply not supported by actual data. In fact, in some instances regulation may have actually increased accident rates. To pinpoint the effects of safety legislation, Fishback measures the results of mine safety legislation on accident rates. His analysis uses data from twenty three coal mining states from 1903 to 1930. Most of the laws concerning coal mining safety could be considered failures. Laws concerning licensing of foremen, state miners, and requirements for training were the most disappointing. The only laws that actually reduced coal mining accidents were those that restricted riding in coal cars and required permission to use explosives. Most of the others laws either formalized existing practices or were not enforced. With the passage of workers’ compensations laws, accidents actually increased. Under this new system, employers had an incentive to pay workers compensation instead of paying the extra costs of accident prevention.

Mandated safety regulations often create unintended consequences that work against the original intent of the legislation. Even when these regulations are effective, the improved safety conditions result in lower money wages for workers. Are workers really better off being safer but making less income? Under capitalism, workers and employers are allowed to individually negotiate these tradeoffs, rather than having government adopt ‘one size fits all’ regulations. Government regulations limit the ability of employers and employees to use their local knowledge to arrive at the arrangements that best apply to their specific cases.

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3 Operators of the mine were only partly responsible for undertaking safety measures in public areas of the mine. In these areas, it was both the miner’s and the operator’s responsibilities to see that correct safety measures were followed.
CHAPTER 4: THE CULTURAL OPPOSITION TO CAPITALISM

MYTH #3: COAL MINERS OWED THEIR SOULS TO THE COMPANY STORE

The final myth to be busted is one that is the most commonly exaggerated and misunderstood. The company store is painted as an evil villain in common folklore. It is said that coal operators often used the company store as another way to exploit workers. They allegedly did this by charging higher prices, issuing pay only in store scrip, and keeping miners in debt. Fishback debunks this myth by explaining the limits on the store monopoly, why the company issued scrip, and how company stores priced their goods.

Many argue that company stores acted as monopolies because of a lack of competition due to the isolated locations of mines. Even if some stores began to face competition from other stores, it is said that many miners were forced to use the company store by threats of dismissal and issuance of scrip for pay. However, the company store was part of the employment package that coal operators offered in a competitive labor market. Miners considered the overall value of this package when deciding about employment. Thus, even if mine owners could maintain a local store monopoly, they still faced limits due to competition from other mining towns. If owners chose to charge higher prices at the company store, miners had to be compensated with an increase in wages or lower housing rents in order to competitively price the value of the employment package they offered miners. If they did not, miners would seek employment in mining towns that offered higher valued packages. This limited the company store’s ability to exploit miners, especially in non-union towns.

The issuance of scrip is the most frequently misunderstood practice of the company store. It is argued that companies undertook this practice as another means of exploiting the miner by forcing him to shop at the store. David Corbin recalls the common view of the company store in southern West Virginia:

If a coal miner survived a month of work in the mines, he was paid not in U.S. currency but in metals and paper (called coal scrip), which was printed by the coal company. Because only the company that printed the coal scrip honored it, or would redeem it, the coal miner had to purchase all his goods-his food, clothing, and tools- from the company store. Hence, the miner paid monopolistic prices for his goods. (1981, 10)

This suggests that miners were paid almost entirely in scrip. In reality, however, scrip was used as an advance on wages for the following pay period. The majority of the time miners were paid in cash, either monthly or biweekly. The Immigration Commission (1911) often cited scrip as an opportunity for miners to receive credit. They also stated that extending credit was actually an unusual practice for company stores because of the high worker turnover rates. By extending credit the company took on the risk that the miner would leave town to take another job before repaying their debt. The Commission also found that after deductions for rent, fuel, doctors, and store purchases, miners received between 30 to 80 percent of their income in cash on payday. In West Virginia, store deductions accounted for 30 to 50 percent of mines’ payroll. These wide ranges in percentages suggest that miners were

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4 Material in this section is largely based on Chapter 8 of Fishback (1992).
not being forced to purchase goods at the company store by the issuance of scrip or any other coercive means.

Did company stores charge monopoly prices as David Corbin’s quote claims? We have discussed the competitive pressures facing mining companies, but to what extent did these pressures prevent monopoly pricing in company stores in reality? In December 1922, the U.S. Coal Commission collected data on company store prices and nearby independent stores. Figure 4.3 shows price comparisons between coal company stores and independent stores in nearby cities. The final column shows the percentage by which prices at coal company stores were higher (+), or lower (-), than stores in nearby cities.

Figure 4.3: Price Comparisons of Stores in Coal Areas with Stores in Manufacturing Areas in Nearby Cities, December 1922

<table>
<thead>
<tr>
<th>Coal District</th>
<th>Nearby City</th>
<th>Price Differential %</th>
</tr>
</thead>
<tbody>
<tr>
<td>New River District, WV</td>
<td>Charleston, WV</td>
<td>11.8</td>
</tr>
<tr>
<td>Kanawha District, WV</td>
<td>Charleston, WV</td>
<td>4.9</td>
</tr>
<tr>
<td>Alabama District</td>
<td>Birmingham, AL</td>
<td>0.0</td>
</tr>
<tr>
<td>Connellsville Region, PA</td>
<td>Uniontown and Connellsville, PA</td>
<td>-0.5</td>
</tr>
<tr>
<td>Westmoreland District, PA</td>
<td>Greensburg, PA</td>
<td>5.4</td>
</tr>
<tr>
<td>Barnesboro Region, PA</td>
<td>Pittsburgh, PA</td>
<td>-5.0</td>
</tr>
<tr>
<td>Belmont County, OH</td>
<td>Zanesville, OH and Wheeling, WV</td>
<td>-2.2</td>
</tr>
<tr>
<td>Central &amp; Southern Illinois</td>
<td>Springfield, IL</td>
<td>-2.0</td>
</tr>
<tr>
<td>Southern Ohio</td>
<td>Zanesville, OH and Wheeling, WV</td>
<td>-1.0</td>
</tr>
<tr>
<td>Windbar District, PA</td>
<td>Pittsburgh, PA</td>
<td>-1.8</td>
</tr>
</tbody>
</table>

Source: U.S. Coal Commission (1925a).

In six out of the ten cases, company stores in mining towns actually charged lower prices than independent stores in nearby cities. This clearly rejects the claim that miners were exploited by the company store where their employer held monopoly power. A study conducted by the Immigration Commission in 1908 found identical results, with company stores generally having equal or lower prices than independent stores. The study also found that stores located in more isolated mining towns charged higher prices. This, however, does not automatically imply exploitation by the company store. Due to these mines’ remote locations, transportation costs to and from them were higher. It is therefore reasonable to expect that the prices of goods transported to remote mines would be higher. This explains why the New River District has the highest price differential percentage. Furthermore, there is some evidence that concludes that in the more isolated mining towns, wages were higher to offset the higher prices.

The evidence suggests that miners did not “owe their souls to the company store”. Company stores had limited power due to the competitive labor market. Miners considered the overall value of the employment package, so higher store prices had to be offset by increases in some other aspects of the package. Scrip was not used as a means of forcing miners to shop at the company store. Scrip was often an opportunity for miners to receive an
advancement of their paycheck, not a practice to keep miners in debt to the company. When the miners did shop at the company store, they purchased goods that were similarly priced, if not cheaper, than in independently-owned stores in nearby cities.

In an era when workers in rural areas had limited access to banks, local housing, and stores, mining companies provided these for their workers. Mining companies did not have to offer these amenities; rather they did so as a means to compete for workers against other employers. The more employment options available to workers, the more competition there is for their services. The expanded employment opportunities the reforms in this book would create for West Virginians today would help to increase this beneficial competition.

CONCLUDING REMARKS

This chapter addressed the cultural opposition to capitalism in West Virginia that seems to be founded in popular myths about our state’s coal mining history. This mentality has made citizens reluctant to adopt market-oriented reforms in our state, and in doing so, has made it more difficult to make West Virginians better off. Other myths exist from our history blaming capitalism for the state’s ills, such as folklore from the timber industry. Rather than blindly accepting these stories, we encourage readers to examine the evidence in these historical cases.

Hopefully, by understanding the reality of West Virginia’s experiences with capitalism, it is possible to undo a part of this wealth-retarding culture. Throughout our history capitalism has served as a force for improving wages and living standards. Armed with better knowledge about the economic relationship between coal mine owners and miners, and the potentially significant impact that cultural attitudes can have on economic policy, we can move toward creating a culture in West Virginia that is conducive to UNLEASHING CAPITALISM for the benefit of the citizens of the state.
REFERENCES


CHAPTER 5

WHEN IT COMES TO TAXES: FOCUS ON BEING COMPETITIVE

by Justin M. Ross and Joshua C. Hall

Wellsville, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 80.65° W & Latitude 40.60° N).
WHEN IT COMES TO TAXES: FOCUS ON BEING COMPETITIVE

Justin M. Ross and Joshua C. Hall

A common misperception is that the burden of taxes on an economy is simply equal to the tax revenue generated. In reality, taxes cost society much more than is generated in revenue. The additional costs come in many forms, including administrative costs, enforcement costs, compliance costs, ‘excess burdens,’ and costs associated with resources spent by individuals and groups to avoid the tax, both before the tax is implemented (lobbying) and afterwards (evasion). High taxes are extremely costly to a state’s economy. Countless studies find that higher taxes lead to significant reductions in economic growth. The purpose of this chapter is to explain the true costs of taxation, review the empirical literature on taxation and economic growth, and to examine West Virginia’s overall tax burden relative to other states.

WHY TAXES COST MORE THAN THEY TAKE

Just because a tax is levied on one specific group of individuals does not mean they will be the ones who bear the eventual burden of the tax. This concept is known in the economics literature as ‘tax shifting.’ A tax imposed on business assets, for example, might lead to higher prices for consumers, shifting some of the burden forward. Similarly a tax imposed directly on consumers of a product will lead to reduced demand, shifting some of the burden backward onto the companies producing the good or service that is taxed.\(^1\)

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

According to the U.S. Census Bureau, state and local governments around the nation took in more than $1 trillion in combined tax revenue during fiscal year 2003-04.\(^2\) Figure 5.1

\(^1\) For additional information on where the actual burdens of different taxes fall, see Pechman (1985) and Fullerton and Rogers (1993).

\(^2\) Available at http://www.census.gov/govs/www/estimate04.html.
summarizes the sources of tax revenue for West Virginia in 2003-04. Combined state and local government tax revenue in West Virginia was almost $5 billion, with $3.75 billion levied at the state level.

**Figure 5.1: West Virginia 2003-04 Tax Revenue by Source**

<table>
<thead>
<tr>
<th>Tax Revenue</th>
<th>State</th>
<th>Local</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenue</td>
<td>$3,749,013,000</td>
<td>$1,218,492,000</td>
<td>$4,967,505,000</td>
</tr>
<tr>
<td>Property</td>
<td>3,370,000</td>
<td>975,664,000</td>
<td>979,034,000</td>
</tr>
<tr>
<td>Sales and gross receipts</td>
<td>2,093,253,000</td>
<td>56,795,000</td>
<td>2,150,048,000</td>
</tr>
<tr>
<td>General sales</td>
<td>1,021,365,000</td>
<td>n/a</td>
<td>1,021,365,000</td>
</tr>
<tr>
<td>Selective sales</td>
<td>1,071,888,000</td>
<td>56,795,000</td>
<td>1,128,683,000</td>
</tr>
<tr>
<td>Motor fuel</td>
<td>309,274,000</td>
<td>n/a</td>
<td>309,274,000</td>
</tr>
<tr>
<td>Alcoholic beverage</td>
<td>8,624,000</td>
<td>3,038,000</td>
<td>11,662,000</td>
</tr>
<tr>
<td>Tobacco products</td>
<td>107,609,000</td>
<td>n/a</td>
<td>107,609,000</td>
</tr>
<tr>
<td>Public utilities</td>
<td>188,412,000</td>
<td>34,609,000</td>
<td>223,021,000</td>
</tr>
<tr>
<td>Other</td>
<td>457,969,000</td>
<td>19,148,000</td>
<td>477,117,000</td>
</tr>
<tr>
<td>Individual income</td>
<td>1,068,212,000</td>
<td>n/a</td>
<td>1,068,212,000</td>
</tr>
<tr>
<td>Corporate income</td>
<td>181,515,000</td>
<td>n/a</td>
<td>181,515,000</td>
</tr>
<tr>
<td>Motor vehicle license</td>
<td>83,663,000</td>
<td>216,000</td>
<td>83,879,000</td>
</tr>
<tr>
<td>Other taxes</td>
<td>319,000,000</td>
<td>185,817,000</td>
<td>504,817,000</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau (2007).

What these revenue numbers exclude, however, are the many distortions in economic activity, and in the behavior of individuals, that occur in response to these taxes. Figure 5.2 helps to illustrate these costs. The direct cost of taxation is the obvious accounting cost–individuals who pay the tax will have less money to spend on other goods and services. The tax revenue generated does measure this reduction in private economic spending resulting from the tax. But there are other significant costs.

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

To illustrate, suppose the legislature is considering a proposal to levy a new tax on unhealthy fast food. Further suppose that Burger King estimates this new tax will cost the company $2 million. At this point, Burger King would be willing to spend up to $2 million to prevent the imposition of the tax. They may hire lobbyists, make campaign contributions, attempt to secure media attention, or attempt to fight the legality of the tax in court. Once the tax is imposed, they will continue to devote resources toward attempting to get the tax repealed, the rate lowered, or to secure an exemption from the tax. Resources spent in this manner are wasteful for precisely the reasons discussed in Chapter 3—they are taken away from other productive activities (investments in capital equipment, buildings, or hiring more workers, for example). In the terminology of Chapter 3, this is ‘unproductive entrepreneurship.’ It is important to note that these costs are present even if the tax is not enacted by the legislature. Simply the threat of imposing a new tax creates these costs.
To see the magnitude of these exemptions in practice, one only needs to skim the 47th Biennial Report of West Virginia Tax Laws that is littered with exemptions to specific taxes. Sobel and Garrett (2002) estimate the level of rent seeking in to be somewhere between 3.8 to 5.4 percent of the state’s total tax revenue, implying an additional indirect cost of $200 to $300 million in wasted resources in West Virginia devoted to altering policy. To reduce these costs, many economists advocate broad-based uniform taxes rather than allowing rates and exemptions to vary across different goods and services (Holcombe 2001). Without the ability to individually reduce their own tax rate, any one particular industry is less likely to expend effort to lobby for changes. A tax that targets one specific industry, such as West Virginia’s soft drink tax, tends to generate larger indirect rent-seeking costs.

**Figure 5.2: The Cost of Taxation***

<table>
<thead>
<tr>
<th>Indirect Cost:</th>
<th>Direct Cost:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lobbying and Rent-Seeking Cost ($0.038-$0.054)</td>
<td>Tax Revenue Collected</td>
</tr>
<tr>
<td><strong>Political Process</strong></td>
<td><strong>Action: Tax Levied</strong></td>
</tr>
<tr>
<td><strong>Effect: Prices Change</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Indirect Costs:</strong></td>
<td><strong>Indirect Costs:</strong></td>
</tr>
<tr>
<td>Behavioral Changes ($0.32-$0.52)</td>
<td>Compliance Cost ($0.22)</td>
</tr>
<tr>
<td>Enforcement Cost ($0.019)</td>
<td>Administrative Cost ($0.0061)</td>
</tr>
</tbody>
</table>

Notes: *Cost per dollar of tax revenue in parentheses. Based on studies of federal tax revenue, except in the case of rent seeking, which is based on the average of all state governments. Sources: (1) Based on author calculations from estimates of state capital rent seeking in Sobel and Garrett (2002); (2) Feldstein’s (1999) estimate of the excess burden from the federal income tax; (3) Moody, Warcholik, and Hodge (2005); (4) Payne (1993).

Furthermore, unlike private markets in which you must pay prices for the things you purchase, with government it is often possible to receive the benefits of government programs while making others pay. Thus there will be additional lobbying and rent-seeking costs associated with the fight over which programs will be funded, or who will obtain the benefits, when the revenue is spent. For example, the American Association of Retired Persons was among the groups that successfully lobbied for the passage of a one-time three percent

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3 This report is available at http://www.state.wv.us/taxrev/47thtaxlaws.pdf.
increase in benefits for public retirees in 2006.\textsuperscript{4} To secure this funding they had to compete against other groups who also wanted additional government funding. The existence of this opportunity for rent seeking, and a tax system that allows for frequent amendments, winds up allocating state resources to those with the most political power, and not necessarily to welfare enhancing programs or to those most in need (Holcombe 2001).

Returning to Figure 5.2, the tax itself will cause additional indirect costs, highlighted in the lower right box in the figure. The first of these costs, the behavioral changes, is associated with distortions in the behavior of producers and consumers in response to the tax. To economists these costs are known as the ‘deadweight cost’ or ‘excess burden’ of taxation. Whenever a tax is imposed, individuals will substitute away from the activity that is taxed to other activities that are now comparatively cheaper. As an illustrative example, suppose West Virginia imposes a new $100 tax on each candy bar sold in the state. Further assume this would drive the price so high that candy bar sales would fall to zero. The tax would collect no revenue, but it clearly would still have a cost to society. Consumers who like to eat candy bars are now worse off because they aren’t consuming them, and the producers of candy bars are worse off as well due to the lower number of candy bars sold.

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

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

The final indirect costs in Figure 5.2 are the compliance, enforcement, and administrative costs. Every tax must be administered and enforced by a taxing authority, and there will be costs associated with these activities. These are the least expensive indirect costs as a share of tax revenue, generally amounting to less than three percent (Payne, 2003). Compliance costs, however, are considerable at 22.2 cents per dollar of tax revenue (Moody, Warcholik, and Hodge 2005). This cost includes the hours of book keeping, the time spent filling out tax forms, the hiring of accountants to deal with tax law changes, and so on.

All told, these costs add up to between $0.60 and $0.82 for every $1.00 of tax revenue raised. In other words, one dollar of taxes costs the West Virginia economy somewhere between $1.60 and $1.82. This has significant implications for cost/benefit analysis of government projects funded through taxation. A project with benefits of $150 million that requires $125 million in taxes to fund is not efficient to undertake once these additional costs of taxation are considered.

While total state and local tax revenue in West Virginia amounts to around $5 billion, the true cost of these taxes on the West Virginia economy is in the range of $8 to $9 billion.

\textsuperscript{4} HB 4846, The West Virginia Association of Retired School Employees’ summer 2006 newsletter available at http://wvarse.org/ WVARSE\%20Summer\%202006\%20PDF.pdf
WEST VIRGINIA’S TAX BURDEN: A COMPARISON

In 2005, West Virginia’s total state taxes per capita were the 15th highest in the nation at $2,367 according to the U.S. Census. This was slightly lower than Maryland’s $2,410 but significantly above our other neighboring states by an average of $225.

This is not the best measure of tax burden though, because some states are simply richer than others. Thus a more appropriate measure of tax burden is tax revenue as a percent of state income. Using this measure, West Virginia’s tax burden is much higher. According to calculations by the Federation of Tax Administrators, West Virginia’s total state and local tax burden as a percent of income is the fourth highest in the nation.5 As a percent of income, Virginia has the lowest tax burden of our neighboring states, ranking 42nd.

Figure 5.3 shows West Virginia’s taxes as a share of personal income compared to the overall U.S. average. The first set of columns show the comparison for state taxes only, while the final set of columns show combined state and local taxes. A positive number in the ‘difference’ column means West Virginia’s taxes are higher than the U.S. average.

Figure 5.3: Taxes as a Percent of Personal Income: West Virginia versus the U.S. Average, 2004

<table>
<thead>
<tr>
<th>State Only</th>
<th>State Only</th>
<th>State Only</th>
<th>State Only</th>
<th>State Only</th>
<th>State Only</th>
<th>State Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenue</td>
<td>8.02</td>
<td>6.08</td>
<td>1.94</td>
<td>10.63</td>
<td>10.41</td>
<td>0.22</td>
</tr>
<tr>
<td>Property</td>
<td>0.01</td>
<td>0.11</td>
<td>-0.10</td>
<td>2.09</td>
<td>3.28</td>
<td>-1.18</td>
</tr>
<tr>
<td>Sales and gross receipts</td>
<td>4.48</td>
<td>3.02</td>
<td>1.46</td>
<td>2.41</td>
<td>1.19</td>
<td>1.22</td>
</tr>
<tr>
<td>General sales</td>
<td>2.18</td>
<td>2.04</td>
<td>0.15</td>
<td>2.18</td>
<td>2.52</td>
<td>-0.34</td>
</tr>
<tr>
<td>Selective sales</td>
<td>2.29</td>
<td>0.98</td>
<td>1.31</td>
<td>0.66</td>
<td>0.36</td>
<td>0.30</td>
</tr>
<tr>
<td>Motor fuel</td>
<td>0.66</td>
<td>0.35</td>
<td>0.31</td>
<td>0.02</td>
<td>0.05</td>
<td>-0.03</td>
</tr>
<tr>
<td>Alcoholic beverage</td>
<td>0.23</td>
<td>0.13</td>
<td>0.10</td>
<td>0.23</td>
<td>0.13</td>
<td>0.10</td>
</tr>
<tr>
<td>Tobacco products</td>
<td>0.40</td>
<td>0.11</td>
<td>0.29</td>
<td>0.40</td>
<td>0.22</td>
<td>0.26</td>
</tr>
<tr>
<td>Public utilities</td>
<td>0.98</td>
<td>0.35</td>
<td>0.63</td>
<td>1.02</td>
<td>0.43</td>
<td>0.59</td>
</tr>
<tr>
<td>Other</td>
<td>2.28</td>
<td>2.02</td>
<td>0.26</td>
<td>2.28</td>
<td>2.22</td>
<td>0.07</td>
</tr>
<tr>
<td>Individual income</td>
<td>0.39</td>
<td>0.31</td>
<td>0.08</td>
<td>0.39</td>
<td>0.35</td>
<td>0.04</td>
</tr>
<tr>
<td>Corporate income</td>
<td>0.18</td>
<td>0.18</td>
<td>0.00</td>
<td>0.18</td>
<td>0.19</td>
<td>-0.01</td>
</tr>
<tr>
<td>Motor vehicle license</td>
<td>0.68</td>
<td>0.44</td>
<td>0.24</td>
<td>1.08</td>
<td>0.66</td>
<td>0.42</td>
</tr>
</tbody>
</table>


Total state taxes as a percent of personal income in West Virginia are just over eight percent, almost a full two percent higher than the U.S. average. This difference is sizable—West Virginia’s state taxes are a full one-third higher than in the average state. When examining individual state tax sources, only two fall below the U.S. average, state property taxes and state alcoholic beverage taxes. Taxes on both individual and corporate income, two of the more important for growth, are higher in West Virginia than the U.S. average.

5 http://www.taxadmin.org/FTA/rate/04stl_pi.html.
When local taxes are included, the picture remains mostly unchanged, with the exception that because many other states have local option sales taxes, West Virginia’s state and local sales tax burden is below the U.S. average. In addition, because of West Virginia’s relatively low local residential property taxes we fall further below the U.S. average on relative property taxation. Nonetheless, the conclusion remains that relative to other states West Virginia has a high tax burden.

LIVING ON THE EDGE

Earlier we discussed how the behavioral costs of taxation become larger when it is easier for people to avoid the tax. According to the U.S. Census, 54.3 percent of the state’s 2005 population lives in counties bordering other states. This is up from the 1990 and 1980 Census when the share in border counties was 53.3 and 52.2 percent, respectively.

While total population has declined over the last few decades, it has declined the fastest in counties that do not border other states. In addition, only two of West Virginia’s nine Metropolitan Statistical Areas (MSA’s) are entirely contained within the border of our state. The implication is that the indirect costs of taxation are quite large in West Virginia because the majority of the state’s consumers, producers, and workers can easily cross the border to escape our high taxes.

While we have seen that West Virginia’s tax burden is higher than the U.S. average, let’s take a closer look at how West Virginia compares to our neighboring states. Figure 5.4 shows total taxes as a percent of personal income for West Virginia and our neighbors. The left half of the table includes only state taxes, while the right half includes both state and local taxes.

<table>
<thead>
<tr>
<th>State Only</th>
<th>State and Local</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Kentucky</td>
<td></td>
</tr>
<tr>
<td>% of Income</td>
<td>Difference from WV</td>
</tr>
<tr>
<td>7.49%</td>
<td>-0.52%</td>
</tr>
<tr>
<td>Maryland</td>
<td></td>
</tr>
<tr>
<td>% of Income</td>
<td>Difference from WV</td>
</tr>
<tr>
<td>5.59%</td>
<td>-2.43%</td>
</tr>
<tr>
<td>Ohio</td>
<td></td>
</tr>
<tr>
<td>% of Income</td>
<td>Difference from WV</td>
</tr>
<tr>
<td>6.30%</td>
<td>-1.72%</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td></td>
</tr>
<tr>
<td>% of Income</td>
<td>Difference from WV</td>
</tr>
<tr>
<td>6.14%</td>
<td>-1.88%</td>
</tr>
<tr>
<td>Virginia</td>
<td></td>
</tr>
<tr>
<td>% of Income</td>
<td>Difference from WV</td>
</tr>
<tr>
<td>5.26%</td>
<td>-2.76%</td>
</tr>
<tr>
<td>West Virginia</td>
<td></td>
</tr>
<tr>
<td>% of Income</td>
<td>Difference from WV</td>
</tr>
<tr>
<td>8.02%</td>
<td>-1.86%</td>
</tr>
</tbody>
</table>


The purpose of MSA’s are to identify areas of high economic and social interaction, where component counties must have either 25 percent of employed residents commuting to the central county or at least 25 percent of the employment filled by a resident of the central county (Hammond 2003).
When only state taxes are considered, West Virginia’s tax burden is higher than all of our neighboring states. Virginia and Maryland both have substantially lower taxes as a percent of personal income. On average, our neighboring states have tax burdens that are 1.86 lower as a percent of income. When both state and local taxes are considered, West Virginia’s tax burden is, on average, 0.46 above surrounding states. The combined state and local tax burden in West Virginia remains higher than all of our neighbors except Ohio.

**Figure 5.5: Comparison of 2006 State Tax Rates**

<table>
<thead>
<tr>
<th>State</th>
<th>Individual Income</th>
<th>Corporate Income</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tax Rates Brackets</td>
<td>Tax Rates Brackets</td>
<td>Rate</td>
</tr>
<tr>
<td>West Virginia</td>
<td>3.0 - 6.5 5</td>
<td>9.0* 1</td>
<td>6.0</td>
</tr>
<tr>
<td>Kentucky</td>
<td>2.0 - 6.0 6</td>
<td>4.0 - 7.0 3</td>
<td>6.0</td>
</tr>
<tr>
<td>Maryland</td>
<td>2.0 - 4.75 4</td>
<td>7.0 1</td>
<td>5.0</td>
</tr>
<tr>
<td>Ohio</td>
<td>0.712 - 7.185 8</td>
<td>5.1 - 8.5 2</td>
<td>6.0</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>3.07 1</td>
<td>9.99 1</td>
<td>6.0</td>
</tr>
<tr>
<td>Virginia</td>
<td>2.0 - 5.75 4</td>
<td>6.0 1</td>
<td>4.0</td>
</tr>
</tbody>
</table>


Finally, Figure 5.5 demonstrates that West Virginia does not have a tax rate advantage over any of its neighbors in the three most visible taxes: individual income, corporate income, and general sales taxes. West Virginia has a lower tax rate than one state in both the corporate and the individual income tax, but a different state in each. While Pennsylvania has a higher corporate income tax, it has a low flat income tax. Similarly, West Virginia is tied for the highest state sales tax rate, and is the only one that does not exempt food from taxation.

**TAX DIFFERENTIALS WITHIN WEST VIRGINIA**

Let’s now take a closer look at the tax burden in West Virginia by examining total state and local tax burdens at the county level. Figure 5.6 (following page) shows the 2002 tax quotient for each county in West Virginia. The tax quotient is calculated as the amount of the county’s revenue generated through state and local taxation relative to the same measure for all counties in the nation. A tax quotient greater than one, for example, would imply that the county has an above average tax burden relative to other counties in the United States and is likely at a competitive disadvantage in terms of business and household location decisions.
Figure 5.6: Comparative 2002 Tax Burden by County Tax Quotient

\[ TQ_i = \left( \frac{TB_i}{TB_N} \right) \]

Notes: \( TB_i \) represents share of total county government revenue that comes from state transfers and county tax revenue. \( TB_N \) represents this same calculation for all U.S. counties. Each county’s tax quotient \( (TQ_i) \) is then determined by dividing the county’s tax burden by the nation’s tax burden \( (TQ_i = TB_i ÷ TB_N) \). Source: Authors’ calculations from U.S. Census Bureau (2007).

Only 13 of West Virginia’s 55 counties have a tax quotient below one, showing a lower than U.S. average tax burden. The average county in West Virginia has a tax quotient of 1.109, with the largest being Doddridge County with 1.419 and Grant County being the lowest at 0.489. While there are many differences between these counties, it is nonetheless useful to compare these two counties to see if there are any other dramatic differences that may be partially attributable to the difference in tax burden.

Grant is a larger county in terms of population with more than 11,000 residents in 2005, whereas Doddridge has just 64 percent of that population with approximately 7,500. However, Grant has three times as many business establishments, as well as an employment level more than 3.5 times larger than Doddridge. Across all West Virginia counties, there is indeed a clear negative relationship between the tax quotient and both employment and establishments. A one-percent increase in the county’s tax quotient is associated with a -0.17 percent decline in that county’s reported number of business establishments and a -0.14 percent decline in employment.
TAXATION AND ECONOMIC GROWTH: THE EMPIRICAL EVIDENCE

Over the past thirty years a considerable amount of economic research has been undertaken in an effort to understand the relationship between taxes and economic growth. While some minimal level of government is necessary to support the institutions of capitalism, governments generally grow way beyond this optimal level. This is an issue explored in more detail in Chapter 14.

In a study for the Joint Economic Committee of the U.S. Congress, Richard Vedder and Lowell Gallaway (1998) examine the relationship between the size of government and economic growth. They found that the amount of state and local spending that maximized economic growth to be 11.42 percent of Gross Domestic Product. In 2004, West Virginia state and local spending was nearly 25 percent of Gross State Product, suggesting that West Virginia state and local government far exceeds the size necessary to maximize economic growth.7

Looking specifically at taxes, there is a large literature showing a strong negative relationship between taxes and economic growth. Mullen and Williams (1994) find that higher marginal income tax rates hurt economic growth. Jay Helms (1985) finds that taxation used to fund transfer payments significantly retards economic growth. Bartik (1992) provides an excellent summary of the research on state and local taxes and economic growth and concludes that state and local taxes have a consistently negative effect on state and city economic growth. In terms of business location decisions, it is not surprising that he finds tax decisions play a much larger role in studies that look across suburban jurisdictions than across states. Taxes are one part of the package that determines business location, including climate, local amenities, workforce quality, and public infrastructure. Once firms decide on a region, however, taxes can play a much larger role in their location choice, as the pictures of West Virginia’s state border throughout this book illustrate.

A recent study by Holcombe and Lacombe (2004) provides strong evidence of the cross-border effect of taxes. By comparing counties located across state border from one another, Holcombe and Lacombe are able to effectively control for geographic similarities such as climate, workforce, and proximity to markets leaving only differences in state policy. Looking at the 30-year period from 1960 to 1990, they find that states raising their income tax rates faster than their neighbors had slower economic growth, leading to an average decline in per capita income of 3.4 percent.

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

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7 Vedder and Gallaway (1998) looked at state and local spending over time, and thus used Gross Domestic Product. Looking at West Virginia, it is appropriate to use Gross State Product (GSP). GSP in 2004 according to the Bureau of Economic Analysis (2007) was $49,903,000,000 and state and local government expenditures were $12,201,294,000 according to the Census Bureau (2007). For a more recent look at the size of government and growth, see Taylor and Brown (2006).
Writing for the Federal Reserve Bank of Atlanta, Becsi (1996) examines how state and local taxes affect relative state economic growth. He finds a significant negative relationship between relative state marginal tax rates and relative state growth from 1961 to 1992. The effect of differences in marginal tax rates across states helps to explain not only short-run differences in growth across states, but also the persistence of growth differentials among states over time.

Taxes not only impact where businesses locate, but also where people locate. If taxes get too high relative to the benefits received from government spending from government’s activities, people will move elsewhere. An early paper on this was by Cebula (1974) who found that migrants tended to move to areas with low property tax levels. Cebula’s work has been replicated by many others such as Niskanen (1992). Conway, Smith and Houtenville (2001) look at migration by elderly Americans and find that elderly migration is motivated in part by low personal income taxes and estate taxes.

CONCLUSION

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

According to the best economic estimates, each dollar of tax revenue really costs the West Virginia economy somewhere between $1.60 and $1.82. In addition, almost every measure of tax burden indicates that West Virginia puts itself at a competitive disadvantage in attracting businesses and households when compared to other states.

Empirical studies have a long history of consistently finding that state taxation hinders development and economic growth by constraining the forces of capitalism. To promote economic growth, West Virginia must find ways to significantly lower its overall tax burden. The next chapter will explore several specific tax reforms that can help to accomplish this goal.

REFERENCES


CHAPTER 6

THREE SPECIFIC TAX REFORMS FOR INCREASING GROWTH

by Robin C. Capehart and Pavel A. Yakovlev

Martins Ferry, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 80.72° W & Latitude 40.10° N).
The task of increasing economic growth in West Virginia is about increasing the overall level of economic activity in our state. Higher economic growth creates new jobs and increases wages, leading to higher standards of living. Simply put, higher economic growth is the source of greater future prosperity. Economic growth occurs when businesses increase investment and hire more workers in order to expand their operations. An expansion of in-state businesses and an attraction of out-of-state businesses would bring more capital investment, jobs, and overall economic prosperity to West Virginia. A pro-growth tax policy would encourage in-state businesses to expand their operations and entice more companies to do business in West Virginia.

While there are many other factors beside taxes that affect business location decisions, taxation is an important element in this decision making process and, unlike other factors, it is determined by state policy makers. Hence, state tax policy can have a direct and significant impact on the level of economic activity and growth in that state. A quantitative analysis of state business locations during 1981-2000 performed in this chapter reveals that states with a better tax climate have a higher occurrence of companies listed on NYSE, AMEX, and NASDAQ doing business in these states. This statistically significant relationship is illustrated in Figure 6.1 (following page), which shows that a positive relationship exists between the number of companies located in each state and the state’s tax system score.\(^2\)

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1 Other factors affecting business location decisions may include quality of life, skilled labor, infrastructure, crime, state economic performance, and proximity to markets or factor inputs that add up to the overall cost of doing business.

2 Tax climate scores are taken from the *Economic Freedom of North America* that reports the extent of the restrictions on economic freedom imposed by governments in North America. Economic freedom is rated on a scale from 0 to 10 with higher values indicating higher levels of economic freedom. The evidence presented in the *Economic Freedom of North America* report also indicates that economic freedom fosters prosperity and economic growth.
Figure 6.1: Business Location and State Discriminatory Taxation

Notes: State takings and discriminatory taxation scores come from *Economic Freedom of North America: 2006 Annual Report*, while company location data come from COMPUSTAT industrial database that contains companies listed on NYSE, AMEX, and NASDAQ. Our sample contains 48 state averages for the period 1981-2000 (California and New York were dropped as outliers).

We also find that states with lower top marginal income tax rates (i.e., higher tax climate scores) have more companies listed on the NYSE, AMEX, and NASDAQ. This statistically significant relationship is illustrated in Figure 6.2, which shows that a positive relationship exists between the number of these companies located in each state and that state’s top marginal income tax rates score. In other words, the lower the top marginal income tax rate in a state, the more companies choose to locate there. It is clear from Figures 6.1 and 6.2 that West Virginia is at the bottom of the pack in terms of both business vitality and tax system ratings.

The evidence depicted in Figures 6.1 and 6.2 suggests that state taxes play an important role in business location decisions. Studies by Feldstein, Hines, and Hubbard (1995), Desai and Dharmapala (2006), Desai (2005), and Bartik (1985) confirm that taxes matter in attracting more businesses and economic activity. Simply put, having more businesses equals greater economic activity and higher economic growth. This evidence inspires the forthcoming discussion of the specific tax policy recommendations aimed at creating better business tax climate in West Virginia in order to promote economic growth.
THREE SPECIFIC TAX REFORMS FOR INCREASING GROWTH

Figure 6.2: Business Location and State Top Income Tax Rates

Notes: State takings and discriminatory taxation scores come from Economic Freedom of North America: 2006 Annual Report, while company location data come from COMPSTAT industrial database that contains companies listed on NYSE, AMEX, and NASDAQ. Our sample contains 48 state averages for the period 1981-2000 (California and New York were dropped as outliers).

THREE PRO-GROWTH TAX PROPOSALS FOR WEST VIRGINIA

Government can promote economic growth by pursuing policies that do not create excessive burdens on the ability of entrepreneurs to make investments and create jobs. Taxes affect human and physical capital investment decisions that are fundamental to economic growth. In a recent study, Gordon and Lee (2005) find that lower corporate tax rates can substantially boost economic growth. A high corporate tax rate decreases economic growth because it reduces the incentive to take risks, accumulate capital, and engage in entrepreneurial activity.

The most pro-growth tax systems, according to the Tax Foundation, are characterized by broad-based, low-rate taxes. The value added tax (VAT), for example, is more consistent with this broad-based and economically neutral tax philosophy than are state corporate income taxes and business franchise taxes, especially in an economy characterized by service rather than manufacturing industries.

Unfortunately, the tax system that has evolved in West Virginia places a heavy burden on capital investment through the business franchise tax and the personal property tax levied on inventory, machinery, and equipment. West Virginia’s tax regime also creates an excessive burden on taxpayers through a high-rate profits tax on corporations and an inequitable allocation of the tax burden through the use of tax credits and a number of industry-specific taxes. The overall effect has been a tax system that is not conducive to economic growth and job creation. According to the Tax Foundation’s 2007 State Business Tax Climate Index, West Virginia ranks 34th nationally, which places West Virginia above its regional
competitors such as Kentucky and Ohio, but below Maryland, Pennsylvania, and Virginia.\(^3\) Fortunately, West Virginia ranks better (26\(^{th}\)) on the corporate tax component of the index; but it could do better by lowering corporation net income and business franchise tax rates.\(^4\)

Ideally, the state would be much better off with a substantially redesigned business tax system that is less likely to distort and discourage economic activity. Consequently, we propose the following three specific changes to the tax system in West Virginia that are consistent with the pro-growth objective:

1. Repeal the business franchise tax and personal property tax on inventory, machinery, and equipment, and if necessary replace them with a broad-based value added tax similar to the ‘business enterprise tax’ in New Hampshire.

2. Replace the high-rate profits tax on corporations with a low-rate profits tax on all businesses.

3. Repeal the future use of all business tax credits.

We shall now look at each of these proposals separately and provide the economic reasoning for these pro-growth tax reform recommendations.

**REPLACING THE ‘JOB KILLER’ TAXES**

In January 1999, the Center for Business and Economic Research at Marshall University submitted a report detailing the economic effects of the proposals put forth by the Commission on Fair Taxation. While the proposals were numerous, the two recommendations that had the most positive potential impact on West Virginia’s economy were (1) the elimination of the personal property tax on inventory, machinery, and equipment and (2) the elimination of the business franchise tax.

The reason that the repeal of these two taxes has such a beneficial influence is that each heavily taxes capital investment and, thus, removing that burden helps the economy to grow and create jobs. Thus, in regard to West Virginia’s tax system as a whole, the personal property tax on inventory, machinery, and equipment and the business franchise tax are truly ‘job killers.’ Similarly, the expert on state tax systems and director of Federal Funds Information for States, Marcia Howard, argues that since companies must pay property taxes whether they make profit or not they might be more harmful to small start-up companies than income-based business taxes.\(^5\) If the goal of real tax reform is to increase economic growth, repealing the personal property tax on business assets and the business franchise tax are essential.

A closer look at these two taxes reveals their detrimental impact. The business franchise tax (BFT) is levied on a business’s capital as measured by its net worth. No matter how a business is formed, this value represents the same thing: the amount of money a

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\(^3\) The Tax Foundation’s *State Business Tax Climate Index* measures the competitiveness of state business taxes by assessing five major components of each state’s tax system: the corporate tax, individual income tax, sales tax, unemployment insurance tax, and property tax. It is available at: http://www.taxfoundation.org/publications/show/78.html.

\(^4\) In November 2006 the top corporate income tax rate was reduced from 9 percent to 8.75 percent.

business has available to invest and reinvest in order to grow and increase labor productivity. Although it is West Virginia’s 6th largest revenue source, the BFT is clearly an anti-growth, anti-capital-formation tax especially for small firms. Furthermore, the relatively high rate decreases West Virginia’s competitive position and the BFT creates extensive enforcement problems due to the ability of taxpayers to manipulate the tax base to avoid the tax.

Like the BFT, the personal property tax on inventory, machinery, and equipment is a tax on capital investment. Most states have recognized the adverse economic impact of taxes on business assets and have repealed them in total or in part. In West Virginia, the personal property tax falls predominantly on inventory, machinery, equipment, and vehicles, creating a competitive disadvantage for businesses located in West Virginia. Therefore, the personal property tax has a very strong negative effect on growth and prosperity.

The tax on inventories discourages investment in retail and wholesale operations. It discriminates against in-state businesses that carry large inventories relative to sales, and weighs in favor of firms that have little or no stock. Out-of-state mail order and Internet sellers are also favored since they do not pay the tax on their inventories.

The personal property tax on machinery and equipment discourages capital investment—the primary determinant of labor productivity and wages. This investment is critical to prosperity. The tax also places West Virginia businesses at a competitive disadvantage in competing with firms from other states and nations. For example, let’s assume that a company buys a piece of machinery for $100,000. For the purposes of this example, let’s also assume that we depreciate the machinery $10,000 per year for 10 years. Theoretically, the amount of the machine that we use each year is $10,000. Yet, we pay taxes on $100,000 in value the first year; $90,000 the second year; $80,000 the third year; and so on despite the fact that the economic consumption is only $10,000. After 10 years, we’ve paid taxes on a total value of $550,000 for a $100,000 piece of machinery. More importantly, if a company wants to buy a new piece of machinery in the 7th year and the new machinery costs $150,000, the company’s taxes will jump from a tax base of $30,000 to $150,000. This means the company’s taxes will be five times higher than they would be if it keeps using the old equipment. This tax discourages businesses from buying new equipment, meaning workers will be less productive and the company will be at a competitive disadvantage.

While affirming the destructive effects of the business franchise tax and the personal property tax on business assets, policy makers constantly warned of the need for replacement revenues. In 2005, municipalities and counties received $25 million and $88 million, respectively, from the tax on personal property. Moreover, our schools received over $229 million from the personal property tax. In total, state and local governments collected over $344 million, or nearly one-third of all property taxes, from the tax on personal property.

In 1999, the Commission on Fair Taxation offered a plan that would eliminate the two major job killing taxes while maintaining revenue. In short, the plan called for replacing this revenue with broad-based business taxes, the redistribution of most of the current school levy to local governments, and a ‘hold harmless fund’ that used other state revenues such as severance taxes. This approach achieved four objectives: (1) eliminated the job killer taxes; (2) resulted in no increase in property taxes; (3) ensured state and local governments were funded at the same level; and (4) eliminated the need for local governments to raise taxes.

As the other chapters in this book clearly show, West Virginia’s prosperity would be greatly increased by actually making substantial cuts in overall taxes, rather than only considering revenue neutral tax reform. While reducing overall tax levels is critical, even
revenue neutral reform can increase growth if it lessens the excessive burdens of our high-rate, narrow-based taxes on capital investment. In fact, substantial reductions in job killer taxes, even if done in a revenue neutral manner, could potentially increase growth by more than if the legislature was only willing to make minor reductions in overall taxes (Myles 2000).

To achieve revenue neutrality, the Commission on Fair Taxation recommended replacing the business franchise and personal property taxes with a value added tax (VAT). The VAT is a tax on value added, which is the difference between the revenue received from the sales of goods or services and the cost of what is purchased as inputs. The proponents of a VAT argue that such a tax is revenue stable, economically neutral, simple to compute and administer, broad based, and does not unnecessarily discriminate between different types of economic activities. Currently, more than a hundred countries use some version of a value added tax, while only two U.S. states, Michigan and New Hampshire, have a value added tax. While the United States lacks a national VAT, Canada has both a national and a sub-national VAT. Therefore, despite the conventional wisdom that a VAT is an instrument only for a national government, it can be implemented at the state or even local level.

While the main recommendation of this chapter is that West Virginia’s business franchise tax and personal property tax on inventory, machinery, and equipment must both be reduced or eliminated, if this must be done in a revenue neutral fashion, we recommend replacing the lost revenue with a broad-based VAT similar to New Hampshire’s rather than Michigan’s VAT. Michigan has a consumption-type VAT and New Hampshire has an income-type VAT. Consumption-type VAT differs from income-type VAT with respect to the tax base. The key difference between the two is the tax treatment of capital investment. By excluding capital expenditures from its base, a consumption-type VAT taxes consumption but not investment, while an income-type VAT taxes both consumption and investment. Thus, an income-type VAT does not favor consumption over investment or vice versa.

Both types of VAT, however, are levied on the production, or origin, side rather than the sales, or destination, side of business transactions. This makes these sub-national VATs fundamentally different from state and local retail sales taxes. Therefore, argues Ebel (1999), a sub-national VAT is a complement to, rather than a substitute for, a state retail sales tax. In their review of Michigan’s and New Hampshire’s experiences with a VAT, Tosun and Yakovlev (2004) point out that New Hampshire’s VAT, unlike in Michigan’s, is used as a complement rather than as a substitute for a profits-based tax. It appears that New Hampshire’s VAT has not yet been prone to the weaknesses that Michigan SBT exhibited such as the erosion of its base through numerous exemptions, deductions, and credits. Thus, we believe a proposed West Virginia VAT could coexist with a new broad-based business profits tax in order to achieve revenue neutrality.

In 1999, the Commission on Fair Taxation proposed adopting a ‘single business tax,’ a tax conceptually similar to Michigan’s VAT, to replace West Virginia’s corporation net income tax and business franchise tax. As originally proposed, the single business tax was supposed to be applicable to a broad range of businesses, eliminating the problems with pass-

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6 See a policy report by Tosun and Yakovlev (2004) at the Bureau of Business and Economics Research, West Virginia University for a review of recent state experience with VAT in the United States. This report has also analyzed the possibility of adopting county-level VAT for Broward County, Florida.

7 For a review of the U.S. and international experiences with VAT see Tosun and Yakovlev (2004), Schenk and Oldman (2006), and Schenk (1989).
through entities such as partnerships and limited liability corporations (LLCs) that avoid paying the corporation net income tax. However, this proposal did not pass.

The 2006 Tax Modernization Project Team\(^8\) also reviewed the possibility of replacing the corporation net income tax and the business franchise tax with some form of VAT, but it did not recommend proceeding with it before all the implications of such proposal were carefully examined. Since Michigan recently repealed its VAT because of apparent dissatisfaction with the tax that was partially due to numerous exemptions that eventually significantly eroded its tax base, the 2006 Tax Modernization Project Team raised a concern that since West Virginia and New Hampshire would be unique among the U.S. states in their usage of a VAT it could make West Virginia’s tax system unfamiliar to nation-wide businesses and thus hinder their willingness to locate here. Similarly, Tosun and Yakovlev (2004) point out that the lack of experience with VAT in most U.S. states can make its implementation costly both in terms of a transitional period and the major administrative changes that it would require.

However, as long as the adoption of a VAT in West Virginia resulted in the complete elimination of our job killer taxes (the business franchise tax and the personal property tax on inventory, machinery, and equipment) we believe that a thorough cost-benefit analysis would show net gains to the West Virginia economy, especially in the long run.

**TAXING BUSINESS INCOME FAIRLY**

**THE GROWTH OF PASS-THROUGH ENTITIES**

Business owners operate over 70 percent of all businesses as sole proprietorships, but as a type of business organization, sole proprietorships generate only 5 percent of the business revenue nationwide. For the most part, these are small businesses with few employees and relatively modest levels of gross receipts. The vast majority of sales revenue is generated by other types of business organizations such as C and S corporations, and LLCs. The way in which business taxes treat those corporations has significant implications for revenue adequacy, efficiency, and equity (the three main principles of a sound tax policy).

Historically, larger businesses have used the C corporation as a form of business that, in general, protects owner-shareholders from liability. Other businesses less concerned about liability and more interested in tax benefits organize as partnerships. This includes most organizations of highly compensated professionals such as lawyers, accountants, and engineers. Businesses seeking the liability protection of a C corporation and the tax benefits of a partnership organize as S corporations. The primary concern with S corporations is that small businesses in particular must incur the time and expense of meeting the state law requirements of a C corporation.

In recent years, an increasing number of businesses are organizing as limited liability companies (LLCs) that are now authorized under law in all states. Limited liability companies are easier to form than S corporations and enjoy the liability protection of a corporation and the pass-through tax benefits of a partnership. In 2000, the number of new businesses

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\(^8\) Tax Modernization Project Team consisted of representatives from the State Department of Tax and Revenue, Marshall University, and West Virginia University, among others.
organizing as LLCs increased nearly 22 percent over the previous year compared to a mere 2.2 percent increase for corporations (including S corporations). Nearly 60 percent of all non-proprietorship businesses organized as an LLC. Clearly, the limited liability company and several variations have become the predominant form of organization for new businesses.

**PROBLEMS WITH THE CORPORATION NET INCOME TAX**

The sole business tax on profits in West Virginia is the corporation net income tax (CNIT) that is now levied at a top rate of 8.75 percent. The CNIT is a relatively simple tax due to its linkage with federal income tax on corporations. However, there are a number of problems with the CNIT.

First, the CNIT discriminates against business income generated by corporations. Businesses organized as a pass-through entity may generate considerable amounts of income, yet escape the net profits tax despite the fact that theoretically it is using the same amount of government services. A discriminatory tax structure disrupts economic growth by causing capital and labor to flow to certain areas for tax purposes, rather than economic purposes.

Second, West Virginia’s top tax rate of 8.75 percent is one of the highest in the nation and only one border state, Pennsylvania, has a higher rate. As a result, some corporations have been shifting income into jurisdictions with a lower tax rate, which severely damages West Virginia’s competitive position. In November 2006, the top rate was lowered from 9 to 8.75 percent, moving West Virginia down from the 7th to the 14th highest corporate income tax rate. While this is a welcomed improvement, West Virginia still has a much higher rate than the bordering states of Kentucky, Maryland, and Virginia.

Third, the number of entities organized as corporations has declined while there has been rapid growth in the formation of pass-through entities such as limited liability companies and partnerships. Consequently, the tax base for the corporation net income tax has narrowed significantly.

Fourth, the corporation net income tax is an unstable source of revenue. Over the last 15 years, the revenue yield from the tax has fluctuated as much as 30 percent from the prior year’s collections. The Business Tax Subgroup of the West Virginia Tax Modernization Project (2006) noted during that 15 year period, corporation net income tax collections were lower than the previous year over one-half the time while more than one-third of the time collections declined more than 10 percent from the prior year. A study by Stark (2002)

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9 See Figure 5.5 in Chapter 5 for a comparison of the corporation net income tax rates for West Virginia and neighboring states.
10 West Virginia Department of Tax and Revenue (2006), page 130.
11 For estimates of the stability of different taxes over the business cycle see Holcombe and Sobel (1997), Sobel (1996), Sobel and Holcombe (1996), and Sobel and Wagner (2003). All find the corporation net income tax to be the most unstable revenue source.
concluded that state taxation of corporate income has evolved over time toward something quite different than a tax on corporate income.

Fifth, the corporation net income tax results in the double taxation of corporate income. When a corporation earns a profit, the income is either distributed to shareholders in dividends or is kept as retained earnings by the corporation. The dividends paid to shareholders are taxed again for a second time by the individual income tax. Retained earnings, on the other hand, increase the book value of the corporation resulting in an appreciation of the company’s stock by the full value of the retained earnings. This increase in the stock price is then again taxed under the individual income tax as a capital gain to the shareholder when the stock is sold. Thus all corporate profits are taxed twice, once by the corporation net income tax and then again under the individual income tax. In comparison, the profits of all other businesses organized as pass-through entities are taxed only once under the individual income tax.12 This double taxation is the primary reason for the explosion of pass-through forms of business organization.

Additional studies reveal that state corporate income tax revenue has undergone a steady decline or erosion for a number of reasons including increased usage of tax shelters or advanced tax planning by corporations, proliferation of business tax incentives, and increasing reliance on pass-through entities such as S corporations and limited liability companies (LLCs).13 A study by Fox and Luna (2005) concluded that an increase in the LLCs and S corporations is responsible for significant declines in state corporate income tax revenue. Another study by Fisher (2002) suggested that a substantial increase in state reliance on tax incentives for manufacturing firms during the 1990s can be linked to declining state corporate income tax revenue.

**A New Business Profits Tax**

Theoretically, all business income should be taxed the same. Elimination of the corporation net income tax would achieve this goal, as then all business income would be taxed only once under the individual income tax. On the other hand, replacing the corporation net income tax with an equal tax on all business income would still result in business income being taxed at a higher rate than other forms of income (such as wage and salary income), but it would eliminate the distortions created by the differential tax treatment of corporations.

Like the current corporation net income tax, businesses would start with the business income reported for federal income tax purposes either on their Form 1120 (C corporations), 1120S (S corporations), Form 1065 (partnerships and limited liability companies and Form 1040 (Schedule C, sole proprietorships; Schedule E, rental real estate and royalties; and Schedule F for farming). In order to determine state taxable income, the federal taxable income would be adjusted using the increasing and decreasing modifications currently applicable under the corporation net income tax. The major advantage of extending this tax to all forms of business organization is that because of the broader tax base, a much lower tax rate, as low as 2 percent, could produce revenue neutrality. In a similar proposal on November 29, 2006, Michigan Governor, Jennifer Granholm proposed a new state business

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12 The economic principle of tax neutrality suggests that all income should be taxed only once, and at the same rate. For this reason economists generally suggest either a complete elimination of the corporation net income tax or creating exemptions in the individual income tax for dividend income and capital gains.

13 See Cornia, Edmiston, Sjoquist, and Wallace (2005), Brunori and Cordes (2005), and Fisher (2002).
tax that would replace Michigan’s single business tax (SBT) estimated to bring more revenue at lower tax rate due to its broad base.  

**The Fallacies of Tax Credits**

West Virginia is fond of creating selective tax incentives in an attempt to centrally plan and control the state’s economy. As Chapter 3 discussed, these selective tax incentives are extremely harmful to economic prosperity. In addition to encouraging substantial lobbying and rent-seeking activity as industries attempt to persuade the legislature to give a selective tax credit to their industry, these selective incentives create distortions in economic activity by favoring some industries at the expense of others.

Because market prices and the profit and loss system already automatically encourage resources to flow to the industries that create the highest profits, wages, and income for a state’s citizens, these incentives by definition cause resources to flow into less productive uses that generate less income and reduce prosperity. Politicians often enact these incentives in an attempt to encourage investments in a particular industry they believe is worthwhile. But as the discussion of ‘wrong predictions’ in Chapter 3 illustrated, there is simply no way that even the smartest individuals in the world can correctly guess which industries or businesses will be profitable in the future.

Friedrich Hayek, winner of the 1974 Nobel Prize in economics, argued that the true knowledge necessary to make wise resource allocation decisions exists only in local and decentralized forms. In other words, no one person or group of people can possibly acquire all local and private knowledge required to centrally plan an economy as governments attempt to do with selective tax incentives. Hayek (1945) concludes that an efficient allocation of resources can only be accomplished through reliance on the unregulated system of market prices (and the resulting profits and losses) that exist in a true free-market capitalist economy.

In accordance with Hayek’s argument, the most efficient taxes are the ones that cause the least distortions in the free-market price mechanism (and therefore the least impact the decentralized decisions and behavior of private decision makers). This is why low, uniform, broad-based taxes are the most conducive to economic growth and prosperity as they interfere least with the ability of the private economy to search out those industries and businesses that generate the most income for an economy’s citizens.

Like many states, West Virginia has enacted a host of tax credits in an attempt to attract or retain business investment. In all, West Virginia offers 19 different types of tax credits, each designed to encourage a particular type of economic activity. Supporters of tax credits feel that they are necessary to attract new businesses and encourage the expansion of existing industries. In reality the only reason we have to give these selective incentives to get businesses to locate in West Virginia is because our current tax rates are much higher than other states. States with low-rate, broad-based taxes simply do not have to give these incentives to be competitive in attracting businesses. More importantly, low-rate, broad-based taxes do not distort relative market prices, and profit rates, across industries so investment flows correctly into the industries that create the highest income for a state’s residents.

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In addition to the economic distortions tax incentives create, economic studies that have examined the economic benefits of tax credits have concluded that they have not produced the intended effect of expanding economic activity and overall job production (see Chapter 8). In a 1996 study, released by the West Virginia Department of Tax and Revenue, for example, Mark Muchow, current Deputy Secretary of Revenue, examined the costs and benefits of the ‘super tax credit’ program as it applied to job creation in the coal industry. He concluded that while the financial benefits received from the tax credits may have contributed to an increase in the industry’s competitive position the program failed to produce jobs and that “equity, efficiency and fairness all suffered.” The study noted the fact that while coal production increased 30 percent during the 8 year period, coal employment decreased 30 percent. Moreover, Muchow added that the awarding of super tax credits to the coal industry probably eroded public confidence in the overall fairness of the tax system.

Recent tax reform studies in West Virginia have recommended the elimination of some or all of West Virginia’s tax credits. Likewise, we propose the elimination of all tax credits in conjunction with the implementation of a low-rate, broad-based tax structure for businesses in West Virginia. The increased revenue from the elimination of these selective tax credits can be used to help finance the broader tax rate reductions so essential to economic growth. We return to the issue of tax credits in Chapter 8, which is devoted entirely to a more detailed analysis of their use, efficiency, and legality.

**CONCLUSION**

In this chapter, we discuss the importance of taxes in business location decisions and economic growth. A review of economic literature and our own empirical analysis indicates that taxes do matter in determining business location decisions. However, it is not only the level of taxes but also the way taxes are collected that matters. Taxes that are too complex, riddled with exemptions, credits, and preferential treatments distort and discourage economic activity leading to slower economic growth.

Clearly, a substantial reform of West Virginia taxes is well warranted as confirmed in the Tax Modernization Project by West Virginia Department of Tax and Revenue. Our three specific reform proposals recommend (1) eliminating all tax credits; (2) eliminating the business franchise tax and personal property tax on inventory, machinery, and equipment (and replacing them if necessary for revenue with a broad-based value added tax similar to the business enterprise tax in New Hampshire); and (3) replacing the high-rate profits tax on corporations with a low-rate broad-based profits tax on all businesses. We believe that a careful calibration of tax rates and bases for these tax reform proposals can make West Virginia’s tax system more conducive to economic growth and prosperity.

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15 See, for example, Enrich (1996), Lynch (1996), Enrich (1998), LeRoy, Lack, and Walter (2007). In addition, authors have concluded that the Commerce Clause will likely serve as the basis for nationwide legal challenges to state tax credits (Enrich 2006a, 2006b).

16 The 1999 Governor’s Commission on Fair Taxation called for the elimination of all tax credits while the 2006 Report of the Tax Modernization Project proposed the elimination of six specific credits and further study of all other tax credits.
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CHAPTER 7

MAKE PROPERTY RIGHTS MORE SECURE: LIMIT EMINENT DOMAIN

by Edward J. López, Carrie B. Kerekes, George D. Johnson

Chapter 2 emphasized that market capitalism is the institutional structure that best promotes economic growth and prosperity. Economic policies help set the rules of the game, and the living standards of future West Virginians depend heavily on today’s policymakers choosing good rules. This is especially important in the area of property rights. Yet under current West Virginia policies, property rights are highly vulnerable to infringement by government control in the form of excessive taxation, regulation, and takings for centrally planned economic development.

This chapter examines the important role of private property rights in a market system and the process by which secure property rights promote economic growth. We will first argue that long-term growth and prosperity are the benefits of secure property rights. We will then contrast pro-growth property policies with those policies that currently prevail in West Virginia. High taxes, excessive regulation, and loosely limited eminent domain powers are all tools of central planning and government control of the economy. Under these policies property rights are insecure, which distorts incentives for making good resource use decisions, discourages using assets as collateral for beneficial investments, and forfeits the dynamic benefits that emerge out of capitalism.

Finally, this chapter will suggest reforms. Taxes, regulation, and takings through eminent domain decrease the security of property rights; therefore, these government infringements should be limited. Enacting policies that cut taxes, eliminate excessive regulation, and place meaningful restrictions on the eminent domain powers are necessary steps in UNLEASHING CAPITALISM in West Virginia to promote long-term economic growth and rising living standards in our state.

PRIVATE PROPERTY: THE FOUNDATION OF MARKET CAPITALISM

The notion of private property can seem fairly straightforward, especially for people living in a mostly capitalist society such as the United States. One reason for its familiarity to us is that
private property is a bedrock principle of market capitalism. Think of a growing economy as an award-winning Broadway show. Private property is like the stage crew, constantly working behind the scenes to make sure the show runs smoothly. Private property, while perhaps underappreciated, is vital to ensuring that the economy will grow and prosperity will rise over time.

That said, it is useful to ask, what exactly is ‘private property?’ In other words, what does it mean for a person to claim that he or she ‘owns’ a resource? Scholars have grappled with this question since the days of antiquity, and the law has evolved so that ownership of a valuable resource—such as a piece of land—means that the owner is entitled to certain rights over that resource and that other people do not share in those rights. For example, an owner usually has the right to physically possess the owned property. Also, private property rights generally entitle the owner to use the property in any way the owner sees fit. Owners also have the right to alienate (i.e., sell, divest, or transfer) their property to new owners, and to exclude non-owners from any or all of the above rights at their discretion. As was discussed in Chapter 2, well defined and enforced private property rights entail three economic aspects; owners have control rights, cash flow rights, and transferability rights.

Other definitions of property can be conceptualized by considering different combinations of the rights to possess, use, alienate, and exclude. Hernando de Soto, in his celebrated book, *The Other Path*, defines private property as a combination of rights “which confer on their holders inalienable and exclusive entitlement to them” (1989, 159). In general, we move away from private property when one or more of these rights are attenuated. For example, excessively high taxes (examined in Chapters 5 and 6) decrease rights to cash flow from property. Excessive zoning and other regulations (examined in Chapter 9) decrease control and transferability rights by interfering with the ability of owners to make decisions regarding the use of their property. Finally, posing the greatest threat, strong eminent domain powers (examined in this chapter) undermine the entire bundle of private property rights.

### The Benefits of Well-Defined and Enforced Private Property Rights

Well-defined and enforced private property rights are the cornerstone of a capitalist economy. The positive economic effects of private property are widespread. Secure property rights promote specialization and exchange, provide incentives for conservation and preservation of resources, and promote technological innovation, entrepreneurship, capital accumulation, and investment. In essence, secure property rights underlie economic growth.

Even though a system of private property allows individuals to make their own resource use decisions, based on their own personal goals, under a system of capitalism the price system encourages owners to discover and make exactly those decisions that create the

1 Possession is not always a right with private property. For example, ownership of common stock in a corporation does not entitle the owner to take possession of the company’s physical assets such as office furniture, computer servers, etc.

2 The positive relationship between secure property rights and capital formation, investment, and economic growth has been well documented in the economics literature (Boettke 1994; Besley 1995; Knack and Keefer 1995; Mauro 1995; Acemoglu, Johnson, and Robinson 2001; Acemoglu, Johnson, and Robinson 2002, Kerekes and Williamson 2006).
most net benefits for society. This is Adam Smith’s ‘invisible hand principle’ discussed in Chapter 3. According to Adam Smith’s famous book, *The Wealth of Nations* (1998 [1776]), private property is the cornerstone of growth and prosperity because private property best supports the division of labor and free exchange that are the keys to market capitalism. Similarly, Hernando de Soto in *The Mystery of Capital*, explains the process by which secure, well-defined property rights promote economic development (de Soto 2000). He discusses several of the beneficial aspects of a system of secure property rights including their ability to help realize the economic potential of assets, integrate dispersed information into one system, make individuals accountable and assets fungible, network individuals, and protect transactions (de Soto 2000).³

Because the transfer between individuals of private property underpins exchange, private property rights also support a system of market prices that serve as signals to owners about the most profitable uses of resources. Through prices, people are able to discover the knowledge that puts a piece of property to its best use. This process of entrepreneurial discovery, and its importance in creating economic growth was discussed in Chapter 3. Prices also establish a system of profits and losses which provide incentives and enable individuals to make wise economic decisions (Mises 1920 [1935]). Hence, property rights are pivotal to a capitalism-based economy because of their ability to transmit a large amount of information through market prices (Hayek 1945; Hayek 1960).

Information transmission is one of the most desirable aspects of a capitalist system because it allows the best use of resources which promotes economic growth. No central planner can harness all the information necessary to make production decisions to manage an economy. However, a free-market system founded on private property rights naturally supports a decentralized process of production and exchange that leads to efficient use of resources and economic growth.⁴

Through profits and losses, property rights provide individuals with incentives to make sound economic decisions. For instance, producers of goods and services that are in high demand will realize economic profits. However, when consumer demand falls, producers will face economic losses that encourage resources to flow elsewhere. In this manner, profits and losses give producers the incentive to provide goods and services that are most highly valued by consumers while finding low cost methods of production. These incentives are in place only if owners have control, cash flow, and transferability rights. Entrepreneurship and technological innovation are also motivated by economic profits as realized through the price system, which depends on well-defined and enforced private property rights.

In addition, property rights provide incentives for the preservation of property and the conservation of resources. Individuals are more likely to care for their property when they are fully responsible for their actions and are able to reap the gains from an increase in property value. Likewise, secure property rights provide incentives to conserve for the future and to protect natural resources. When property rights are transferable, the preservation of natural resources increases the value of an individual’s land. The Sierra Club, for example, has a long history of purchasing land specifically for conservation and preservation, much of which they

³ For further analysis of property rights institutions and their historical evolution, see also Demsetz (1967), North and Thomas (1973), North (1981), Rosenberg and Birdzell (1986), and North and Weingast (1989).

⁴ Douglass North (1990) shows that property rights facilitate the process of production and exchange by reducing transactions costs. He argues that this reduction in transactions costs leads to increased capital formation and economic growth.
donate to governments as state and national parks. Those who sell to the Sierra Club are motivated by price. And price is how the Sierra Club communicates knowledge of the land’s conservation value. Producers also conserve resources by using as few inputs as possible, in order to minimize costs and increase profits.

Private property rights are critically important for sustained long-run economic growth because they increase the incentive for owners to make long-term capital investments. Secure property rights not only enable owners to use their property as collateral to secure loans to finance capital investment in land, buildings, machinery, or equipment, but also ensure the owner will be able to realize the gains from his or her investment. When the future return associated with a current capital investment has a chance of being expropriated, the incentive to make these capital investments simply isn’t as strong. The incentives for making long-term capital investments are paramount for long-term growth. Hernando de Soto states:

Capital is the force that raises the productivity of labor and creates the wealth of nations. It is the lifeblood of the capitalist system, the foundation of progress, and the one thing the poor countries of the world cannot seem to produce for themselves. (2000, 5)

Secure property rights enable assets to be used as collateral to obtain credit and generate additional capital. Capital investment and accumulation stimulate production and increase labor productivity. As labor productivity increases, wages increase. And rising wages are followed by increased prosperity and rising living standards. In order for West Virginia to experience growth and prosperity, more capital investment is essential. This can be achieved by making property rights more secure so as to increase the incentive to invest in capital.

Economists have also recognized that private property is fundamental to guaranteeing equality and liberty in accord with the values of our society. In the words of Thomas Jefferson, which are engraved in the ceiling of the West Virginia Supreme Court: “The true foundation of republican government is the equal right of every citizen in his person and property and in their management.” The policies of a government should reflect these values, and secure rights to private property achieve it. Economist Murray Rothbard (1978) advocates what is known as the ‘nonaggression axiom’: that no man may invade, or expropriate, the property of another individual. An important implication of this view is that private property confers upon an individual the right to free exchange in the absence of government intervention. In fact, government expropriation of private property violates the ‘natural right’ theory of property in which an individual employs his own means to attain his rightfully chosen ends. Private property is the institution that secures the fruits of one’s labor, which enables individuals to produce goods and services for exchange to sustain life and to increase wealth.

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5 The quoted passage is from an 1816 letter to Samuel Kercheval (Lipscomb and Bergh 1903, vol.15, p.36). The Court's web site features a description of the Court chambers that includes a photo in which the inscription is visible. Online at: http://www.state.wv.us/wvsca/kidspage/courtroom.htm (Cited January 16, 2007).
6 The concept of property as the primary natural right was stressed by English philosopher John Locke in his famous 1690 book, the Second Treatise on Government. Ayn Rand (1964, 94) goes so far as to say that “without property rights, no other rights are possible”. Rand illustrates that the right to life includes the right to sustain life and this necessitates the property right to the product of one’s own effort.
GOVERNMENT THREATS TO THE SECURITY OF PRIVATE PROPERTY

Excessive taxation, regulation, and strong eminent domain powers make property rights less secure, increasing owner uncertainty. Greater uncertainty decreases the willingness to undertake capital investment and accumulation thereby reducing the productivity of labor and depressing wages. Greater uncertainty also curtails transactions transferring property to new owners who discover more valuable uses. Ultimately, economic growth stagnates. When government undermines private property rights, the economy suffers and this thwarts prosperity for West Virginia’s future.

Government intervention through taxation and regulation hinder capital investment and create a hostile business environment. Taxes weaken property rights by restricting the cash flow rights associated with property. By reducing profits, taxes reduce the incentive of individuals to increase skills and abilities so as to better produce goods and services. Regulations (including price and wage controls) restrict control rights, interfere with how individuals use their property, and increase the cost of doing business. As was discussed in Chapter 2, West Virginia ranks 50th in the Economic Freedom of North America Index,$^7$ 47th in the Tax Foundation’s State Business Tax Climate Index,$^8$ and 41st in the Milken Institute’s Cost-of-Doing Business Index.$^9$ In addition to taxation and regulation, perhaps the greatest threat to private property is the eminent domain powers of government. When the government intervenes with strong eminent domain powers, private property rights are weakened and the economy forfeits the dynamic benefits of market capitalism.

Prior to our discussion of the uses of eminent domain, it is important to understand that under capitalism there is a clear channel through which property currently owned by one individual can be purchased by a new owner. Potential buyers can simply negotiate a purchase price with a current property owner, as happens routinely in residential and commercial real estate transaction. Because the new owner must pay a price agreeable to the buyer there is a strong incentive to only transfer property when it increases the value and wealth created by the property. The value the current owner receives from the property will determine the price at which they are willing to sell. If the new use is more valuable than the current use, the potential buyer will be in a position to offer the current owner a higher price for the property than the price at which the current owner is willing to sell, and a transaction will occur. Thus, whenever the new use of the property creates more value than the current use, a mutually beneficial exchange can and will occur in the private marketplace. Importantly, the fact that the potential buyer had to negotiate a mutually agreeable price with the current owner ensures that the potential buyer must pay the true cost of taking the property’s use value away from the current owner.

However, when government is willing to use its power of eminent domain to transfer private property from one individual to another, the potential buyer now has the ability to use government power to take the property from the current owner at a price lower than the current owner was willing to accept in private negotiation. After all, if the price wasn’t lower when the property was taken through eminent domain, the potential buyer would have simply purchased the property in the private marketplace from the current owner. Using eminent domain to take property from an owner is simply a way for the potential buyer to acquire

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some of the property’s current value without having to compensate or pay the current owner. This is problematic for several reasons, but most importantly it: (1) diminishes the incentive for current owners to make capital investments that increase the value of their property, (2) results in substantial resources being devoted to lobbying in attempts to get the government to use eminent domain powers to transfer property, and resources being devoted by current owners to defend their property against being seized (‘unproductive entrepreneurship’ in the terminology of Chapter 3), and (3) no longer assures that the transfer of ownership rights will result in more value and wealth created because the potential buyer does not have to leverage his or her future income stream (which reflects the value of the property’s new use to society) to compensate the current owner for their lost value (which reflects the value of the property’s current use to society).

**EMINENT DOMAIN ABUSE**

The rest of this chapter will focus on the problems associated with strong eminent domain powers and how to curtail these powers to achieve a more secure system of property rights. Eminent domain is direct expropriation of property by government and is an infringement on the rights normally defined by private property. Governments do not have unlimited power to use eminent domain; the Fifth Amendment to the United States Constitution states “nor shall private property be taken for public use, without just compensation.” Thus, takings must be for the public use, and governments must at least pay some compensation to property owners.

Traditionally, ‘public use’ has only encompassed property takings for government provision of infrastructure, like railroads and highways, and to erect government buildings such as public schools and courthouses. However, the term ‘public use’ has evolved over the past century to mean ‘public purpose,’ and today state and local governments frequently use eminent domain to benefit private parties when they entail some ‘public purpose’ such as enhancing the tax base or creating job growth. In effect, the current interpretation allows property to be taken from individual A and transferred to individual B, so long as individual B can claim the transfer also achieves one of these public purposes. Interpreted in this manner, eminent domain has become permissible for purposes such as taking private property for redevelopment or to increase tax revenues.

In 2005, the U.S. Supreme Court handed down the notorious *Kelo v. City of New London* decision. In this well-known case, the city condemned the homes of numerous Connecticut residents near Fort Trumbull State Park. This property was taken by eminent domain for the purpose of redevelopment. Specifically, the city’s redevelopment plan included a privately owned hotel and shopping center, as well as research, office, and retail space to accompany a new facility constructed by the pharmaceutical company Pfizer. The Court sided with the city, and the implication of this decision is that it is legal to use eminent domain to transfer private property from one set of individuals to another, not for public use, but for private benefit.

It is important to understand the *Kelo* decision as part of a long political and legal history that has slowly eroded property rights. In late nineteenth century takings cases, the Supreme Court began to put greater focus on whether condemnation procedures were fair and

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10 U.S. Const. amend V.
democratic, and put less emphasis on whether individual property rights were being infringed. In a real sense, the Court began to create ways for elected bodies to legally take property, so long as doing so was intended to promote the public purpose. As Justice Stevens writes for the *Kelo* majority, “when this Court began applying the [public use test of the] Fifth Amendment to the States at the close of the 19th century, it embraced the broader and more natural interpretation of public use as ‘public purpose’.”

In other early cases, the Court ruled that takings for infrastructure such as roads, utilities, and common carriers satisfied the public use clause. Most people now think of these as ‘traditional’ uses for eminent domain, which usually do not involve more than incidental transfer of property from one private party to another.

Only later did the Court begin to recognize transfers between private parties for the purpose of economic development. Among the first of several reinterpretations of the public use clause occurred in 1954 in the landmark Supreme Court decision of *Berman v. Parker*. The Court upheld the District of Columbia’s plan to raze entire struggling neighborhoods, then transfer parts of the land to private parties and begin anew. Later, in *Hawaii Housing v. Midkiff* (1984), the Court allowed the state to redistribute properties from a small number of landowners to a large group of tenants in order to avert the “social and economic evils of a land oligopoly.” Standing alongside these as another landmark takings case, the Michigan Supreme Court, in *Poletown Neighborhood Council v. Detroit* (1981), allowed Detroit to condemn a residential neighborhood to be transferred to General Motors. The Court reasoned reducing unemployment and “revitaliz[ing] the economic base of the community” served the public purpose. This decision was later reversed in *County of Wayne v. Hathcock* (2004).

The common thread running through these cases, and *Kelo*, is an ever-expanding definition of ‘public use.’ In *Berman* and *Midkiff*, the Court determined that the ideals of urban renewal and economic competition serve the public purpose. This was essentially the same meaning brought before the *Kelo* Court. As the Stevens opinion states: “Promoting economic development is a traditional and long accepted function of government. There is, moreover, no principled way of distinguishing economic development from the other public purposes that we have recognized.” In this light, it is understandable why some legal observers saw *Kelo* as a straightforward affirmation of precedent (SCOTUSblog 2005).

But *Kelo* did more than ‘merely’ uphold precedent and leave eminent domain powers intact. In fact, the 2005 decision politicized eminent domain in two important ways. First, under *Kelo* governments are not required to show that the expected economic benefits of a taking are realistic. What’s important is that the government crafts an ‘integrated’ or ‘comprehensive’ development plan (i.e., one that is not designed to benefit ‘identifiable individuals’) through a process that is open, fair and democratic. As the Stevens opinion puts it, we should not “second-guess the City’s considered judgments about the efficacy of its development plan.” In other words, the Court leaves it up to majorities of city councils and legislatures to say what is in the public interest. Second, the Court reminds readers that “nothing in our opinion precludes any State from placing further restrictions on its exercise of takings power.” The Court leaves enforcement of individual rights to the federal system of

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governments. In short, economic development takings are valid if they are filtered through a democratic process, and the enactment of constraints on eminent domain takings are up to state legislatures, governors, and their courts.

The West Virginia Supreme Court has not been a sufficient brake on *Kelo* style transfers. The most egregious abuses of eminent domain have occurred in Charleston and Wheeling. In Charleston, the state’s top eminent domain abuser is the Charleston Urban Renewal Authority (CURA). Since the 1960s, CURA has seized 523 properties for 47 projects, 28 of which were private projects (Berliner 2006). In the mid 1990s, CURA again condemned property in downtown Charleston to sell to private developers. This time the property owner fought back. The Courtland Company, which operated a commercial parking lot on this property, challenged the taking on the argument that the property itself was not blighted. However, this property was located within a redevelopment area that CURA had declared blighted. In *CURA v. Courtland* (1998), the West Virginia Supreme Court ruled in favor of CURA, and this precedent stands today in West Virginia.

In Wheeling, the legislature designated the downtown area as a National Heritage Area in October 2000 when it passed the Wheeling National Heritage Act (WNHAA).\(^{16}\) This act created the Wheeling National Heritage Area Corporation (WNHAC) to manage and redevelop the area.\(^ {17}\) In 2002, The WHNAC proposed to convert 90 percent of downtown Wheeling into a ‘Victorian-themed outlet mall.’ This plan would have condemned properties and transferred them from their present owners to private retail businesses chosen by City officials (Berliner 2003). Fortunately, the West Virginia Supreme Court ruled the financing of the plan unconstitutional in May 2003.\(^ {18}\)

In addition to these examples, a case involving a family farm and Snowshoe Mountain provides another illustration of eminent domain abuse in West Virginia. For eight generations, the Sharp family has owned a farm in Pocahontas County, near Slatyfork, WV (Nabors 2006). This area is also home to Snowshoe Mountain ski resort. Due to expansion, Snowshoe claims it needs the Sharp farm to build a larger sewage treatment facility. Although Governor Joe Manchin has offered Snowshoe nearby public land for $1 on which to build a treatment plant, Snowshoe and local government remain focused on seizing the Sharp Farm, citing higher project costs (HuntingtonNews.net 2006).

If West Virginia is going to achieve pro-growth policies, we need to take it into our own hands to impose meaningful restraints on eminent domain abuse. Property owners need the security to ensure their property improvements will be protected, not condemned from beneath them and handed off to another private owner. Otherwise, fewer property improvements and investments will take place, and economic growth will be slowed. In order to truly serve the public purpose, West Virginia needs to enact its own restrictions on the use of eminent domain takings to better protect the property rights of our citizens.


THE KELO BACKLASH

The *Kelo* decision struck a moral chord with the American people, who awoke to the threat that any home could now be taken much more easily. Suddenly redevelopment agencies throughout the country captured the attention of the media, politicians, and citizen groups. As Figure 7.1 shows, major newspaper coverage of eminent domain issues increased nearly fivefold in the year following *Kelo*. Opinion polls showed that the American public at large was strongly opposed to the ruling, disagreeing with the Court by over 90 percent in several online polls. In a nationwide poll, 68 percent of registered voters supported legislative restraints on eminent domain. Dozens of grassroots organizations sprung up, and individuals whose properties were condemned told their stories on web sites and blogs.

Figure 7.1: Major Newspaper Coverage of Eminent Domain

![Bar chart showing major newspaper coverage of eminent domain issues before and after *Kelo*.](chart.png)

People were quick to deploy their opinions into the political sphere, gathering signatures, writing elected officials, and funding pro-property rights groups. By November 2006, voters would decide on ballot initiatives in 12 states, and approve measures in nine. State legislators turned quickly into the wind as well. Bills were passed in 30 states and enacted in 28 of those. West Virginia is among these 28. But like in many other states, the changes to eminent domain law did not go far enough to meaningfully protect property rights.

As researchers have shown, several of these state laws are riddled with loopholes that local governments can ‘drive bulldozers through’ (Sandefur 2006; Lopez and Totah 2007). Most of these laws begin with language that implies they will ban the kinds of takings that incited the *Kelo* backlash. But according to recent economics research (Campbell and Lopez

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19 Poll results from various web sites including msnbc.com, cnn.com, chronicle.augusta.com, haptonroads.com, and bradentont.com. See Economist (2005) and Andres (2005) for the 90% and 68% results, respectively.

20 Governors vetoed bills in Arizona, Iowa, and New Mexico. The Iowa state legislature overrode the veto.
2007), almost half the enacted changes were diluted by broadly defined exemptions for blight or urban renewal, and vague definitions of public health and safety. The state of Vermont provides a good for example. The first section of their new statute reads as follows:

Notwithstanding any other provision of law, no governmental or private entity may take private property through the use of eminent domain if the taking is primarily for purposes of economic development, unless the property is taken pursuant to chapter 85 of Title 24 (urban renewal).

There are at least two inviting loopholes in this seemingly simple language. First, the word “primarily” leaves a variety of scenarios open to Kelo-style transfers. The condemning government might need only tack on a traditional public purpose (e.g., a public park) to a redevelopment plan to get around this restriction. Other states created a similar loophole with less subtlety, like Missouri’s new law which bans takings that are “solely for economic development.” With the courts interpreting public use so broadly, any government official with a modicum of creativity could tweak the development plan to pass the test. Supreme Court Justice Antonin Scalia has said that in “practically every case” only a “stupid staff” would fail to muster such a rationale.

Only a minority of the states’ new eminent domain laws have actual bite when it comes to restricting eminent domain. The majority are all bark, and no bite. Sadly, West Virginia’s statutory response is something of a poster child for reforms that have little bite.

A CRITIQUE OF WEST VIRGINIA’S RESPONSE

The West Virginia Legislature wasted no time in responding to the Kelo decision. On January 11, 2006, the first day of its session, the House of Delegates introduced two bills that would limit eminent domain. A week later, two more bills were introduced. The Senate, while slower to respond, also introduced two bills within the first few weeks of the 2006 session.

Only House Bill 4048 passed and eventually became law. Compared to the bill that was originally introduced, the final bill as enacted represents a much weaker limitation on eminent domain abuse. The original HB 4048 lists a baker’s dozen “public uses for which private property may be taken or damaged,” and limits eminent domain powers as follows:

(n) Notwithstanding any other provision of law, eminent domain may not be used to condemn property for:
(1) Private retail, office, commercial, industrial or residential development, or for enhancement of tax revenue; or
(2) To purchase property for a purpose that results in a transfer in fee of the property to a person, nongovernmental entity, corporation or other business entity to fulfill the purpose of the use of eminent domain.

21 Vermont General Assembly, S.246, April 14, 2006, Sec. 1. 12 V.S.A. § 1040.
The proposed bill then gives a right of first purchase opportunity to property owners whose property is taken but not used for the stated public purpose.

In contrast, the bill as enacted contains neither of the above provisions. After passing the House 97-0 on January 19, 2006, HB 4048 was sent to the Senate where the bill was filtered through three separate committees and heavily amended. On March 9, the bill passed the Senate by a 34-0 vote. In its final version, the bill is nearly three times longer than its introduced version and takes a dramatic shift in how eminent domain powers are limited. Rather than prohibiting takings for private purposes as in its original version, the enacted version allows takings so long as the property is blighted and the condemning authority has followed an approved redevelopment plan—making the new law remarkably similar to the *Kelo* majority opinion, and essentially nullifying the restrictions set forth in the legislation as it was originally proposed. The ‘public uses’ for taking private property are left intact. Missing are the provisions that ban takings for private transfers and give property owners right of first repurchase.24 The Governor signed HB 4048 on April 5, 2006, and it was enrolled into the Code of West Virginia on April 17, 2006.

Like so many of the other states’ new laws, West Virginia’s restrictions on eminent domain offer numerous exemptions and loopholes. Blight is a common exemption that severely weakens eminent domain restrictions. This is especially true where ‘blight’ is broadly defined. For example, while the new law does take steps to protect non-blighted properties located in blighted areas, the statutory definitions of blight are so all-encompassing as to effectively nullify these protections. From the Code of West Virginia, as amended in 2006 by HB 4048:

(c) “Blighted area” means an area, other than a slum area, which by reason of the predominance of defective or inadequate street layout, faulty lot layout in relation to size, adequacy, accessibility or usefulness, insanitary or unsafe conditions, deterioration of site improvement, diversity of ownership, tax or special assessment delinquency exceeding the fair value of the land, defective or unusual conditions of title, improper subdivision or obsolete platting, or the existence of conditions which endanger life or property by fire and other causes, or any combination of such factors, substantially impairs or arrests the sound growth of the community, retards the provision of housing accommodations or constitutes an economic or social liability and is a menace to the public health, safety, morals, or welfare in its present condition and use.

(d) “Blighted property” means a tract or parcel of land that, by reason of abandonment, dilapidation, deterioration, age or obsolescence, inadequate provisions for ventilation, light, air or sanitation, high density of population and overcrowding, deterioration of site or other improvements, or the existence of conditions that endanger life or property by fire or other causes, or any

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combination of such factors, is detrimental to the public health, safety or welfare.\textsuperscript{25}

A government or agency that wants to condemn a property for economic development can surely meet at least one of the listed criteria. It strains credulity to imagine otherwise. Such an expansive definition fails to pass Scalia’s “stupid staff” test. Unfortunately, West Virginia’s new law does little if anything to enact stronger protections than offered by the \textit{Kelo} Court, leaving property owners in West Virginia as vulnerable and uncertain as any in the country.

**THE NEED FOR MARKET-BASED REFORM**

Under \textit{Kelo} the Supreme Court has said it will give broad deference to state and local governments to determine what is defined as ‘public use,’ leaving property rights extremely poorly secured in West Virginia. The Court has instead politicized the protection of property rights, and it is now up to West Virginia to place our own boundaries on the use of eminent domain. People across the state and country overwhelmingly support stronger property rights than \textit{Kelo} affords. If we do nothing, our institutions will remain at odds with policies that are proven to increase economic growth, which is the only way to build a better standard of living for West Virginians. As discussed in Chapter 2, pro-growth policies are underpinned by well-defined and enforced private ownership rights. Fundamental are private property rights to land, one of our most important and valuable assets. Enacting meaningful restrictions on eminent domain would reduce government control of land-use decisions.

There are important and needed ways for West Virginia to reform its policies to instill greater security of private property rights. First, the state legislature can revisit the relevant section of the Code of West Virginia, and instill a more straightforward set of restrictions on eminent domain powers. By far the best solution would be to enact a categorical ban on takings for economic development purposes. This would eliminate a significant tool of government central planning, leaving the market process freer to generate long-term growth and prosperity. South Dakota is a very good example for West Virginia to follow. Their new eminent domain law, which was enacted just weeks prior to West Virginia’s, reads in its entirety:

Section 1. No county, municipality, or housing and redevelopment commission, as provided for in chapter 11-7, may acquire private property by use of eminent domain: (1) For transfer to any private person, nongovernmental entity, or other public-private business entity; or (2) Primarily for enhancement of tax revenue.

Section 2. No county, municipality, or housing and redevelopment commission, as provided for in chapter 11-7, may transfer any fee interest in property acquired by the use or threat of eminent domain within seven years of acquisition to any private person, nongovernmental entity, or public-private

\textsuperscript{25} Code of West Virginia, 1931, Chapter 16, Article 18, Section 16-8-3 as amended by H.B. 4048, March 11, 2006.
business entity without first offering to sell such fee interest back to the person who originally owned the property, or such person's heirs or assigns, at current fair market value, whether the property has been improved or has remained unimproved during the interval, or at the original transfer value, whichever is less.26

Notice the conspicuously absent list of exemptions and loopholes. Such a law would be a strong signal to property owners that their investments and improvements in property would be secure from eminent domain abuse. Similarly New Mexico’s legislature passed the following bill, which reads in its entirety:

The state or a local public body shall not condemn private property if the taking is to promote private or commercial development and title to the property is transferred to another private entity within five years following condemnation of the property.27

Unfortunately, New Mexico Governor Bill Richardson vetoed the bill, and New Mexico property owners are still vulnerable to *Kelo*-style takings. Governor Richardson apparently heard the calls of critics who argued that a categorical ban would preclude traditionally accepted uses for eminent domain. In fact, this was the stated reason for Governor Richardson’s veto. Rather than throwing out the baby with the bathwater, these critics advocate specific procedural and economic restrictions such as: requiring governments to pay greater than fair market value; imposing waiting periods for transferring condemned property to private parties; more advance notice to property owners; and a more open and inclusive process of planning economic development. In an extensive new study, legal scholar Ilya Somin analyzes the details of such proposals and concludes:

Unfortunately, these approaches, while not wholly without merit, are unlikely to be as effective as a categorical ban. In some situations, they may even make the situation worse than it would be in their absence (2006, 30).

Short of an outright ban, policymakers can still achieve meaningful restrictions on eminent domain for economic development. For starters, the legislature can codify narrower definitions of ‘public use’ and ‘blight.’ Following the language of preeminent nineteenth century legal scholar Thomas M. Cooley, for example, the Reason Foundation suggests enacting the following definition for public use.

The term “public use” shall only mean the possession, occupation, and enjoyment of the land by the general public, or by public agencies; or the use of land for the creation or functioning of public utilities or common carriers such as a railroad, utility, or tollroad; the acquisition of property to cure a concrete harmful effect of the current use of the land, including the removal of

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public nuisances, structures that are beyond repair or that are unfit for human habitation or use, and the acquisition of abandoned property. The public benefits of economic development, including an increase in tax base, tax revenues, employment, general economic health, shall not constitute a public use. (2007, 1)

Similar definitions for ‘public use’ have been enacted in Arizona, Colorado, Florida, Georgia, Indiana, Iowa, Kentucky, and Minnesota. Georgia has also enacted a narrower definition of ‘blight’ than its previous law. Going further, Florida has banned eminent domain takings even for eliminating blight.

But again, an outright ban on takings for economic development, without exemptions or loopholes, would be the best and strongest signal to property owners that their investments and improvements in property would be secure from eminent domain. A proposed amendment to the West Virginia State Constitution was introduced on January 23, 2007. If ratified, section nine, article three would include the following:

(b) Notwithstanding any other provision of law, the State of West Virginia, or any of its departments, divisions, agencies, commissions, corporations, boards, authorities, or other entities, or any municipality or county, or any agency, corporation, district, board, or other entity organized by or under the control of any municipality or county in the state and vested by law to any extent whatsoever with the power of eminent domain, may not condemn property for the purposes of private retail, office, commercial, industrial, or residential development; or primarily for enhancement of tax revenue; or for transfer to a person, nongovernmental entity, public-private partnership, corporation, or other business entity. Nothing in this amendment shall limit the exercise of eminent domain by or for the benefit of public utilities or other entities engaged in the generation, transmission, or distribution of telephone, gas, petroleum products, electricity, water, sewer, or other utility products; or services by or for the benefit of any airport authority for airport-related activities. Nothing in this amendment shall be interpreted to prohibit the state or a municipal or county governing body from exercising the power of eminent domain for the purpose of constructing, maintaining, or operating streets, roads or railroads.

(c) Property condemned pursuant to the power of eminent domain in this state, if not ever used for the purpose or purposes for which it was condemned, that is subsequently determined to be sold, shall be first offered for sale to the person or persons from whom the property was condemned, or his or her known or ascertainable heirs or assigns, at the price which was paid for the property, less such amount, if any, as the person or persons from whom the property was condemned shall show by good and sufficient documentation to be the amount of income and transaction taxes, if any, actually paid in connection therewith, and if the offer shall not be accepted within ninety days
from the date it is made, the property may be sold to any other person, but only at public sale after legal notice is given.²⁸

The proposed amendment would enact a categorical ban on takings for private transfer and economic development purposes. This amendment reserves the use of eminent domain for ‘traditional’ uses. In addition, it also includes a clause giving property owners the right of first repurchase. The proposed constitutional amendment places a more permanent restriction on the use of eminent domain than mere legislation. In contrast to legislation with loopholes and exemptions, this amendment could not be changed easily by future legislatures, and thus places the bounds of eminent domain use in the hands of voters. An amendment limiting eminent domain would greatly increase the security of private property rights in West Virginia; therefore, policy makers should push through such an amendment.

A parallel line of reform can be pursued by local governments, which should pass resolutions upholding the importance of securing rights to private property and barring the use of eminent domain takings for economic development purposes.

Finally, the West Virginia Supreme Court of Appeals should overturn its ruling in Charleston Urban Renewal Authority v. The Courtland Co. (1998). Within the past two years, high courts in Michigan and Ohio have overturned their previous rulings to impose a narrower scope for economic development takings. By doing the same, the West Virginia high court can achieve an improved environment for property rights.

Leaving our statutes and precedents as they currently exist, with broad powers given to condemning authorities through accommodating exemptions and loopholes, does effectively nothing to curtail eminent domain abuse in West Virginia.

CONCLUSION

This chapter has examined the importance of secure and well-defined property rights in a market system. We have shown that private property is vital to ensure future economic growth and prosperity in West Virginia. As presented in this chapter, private property rights entitle the owner to: 1) use the property as the owner sees fit, 2) alienate (i.e., sell) their property to new owners, and 3) exclude non-owners from the above rights. As discussed in Chapter 2, when private property rights are well defined and enforced, owners have control, cash flow, and transferability rights.

The benefits of secure property rights include the promotion of specialization and exchange, incentives for conservation and preservation of resources, technological innovation, entrepreneurship, capital accumulation, and investment. Private property leads to an efficient allocation of resources by supporting exchange and a system of prices that convey information. Private property is necessary for economic growth and to achieve prosperity. Government infringement through taxation, regulation, and strong eminent domain powers make private property rights less secure in West Virginia. These policies distort incentives, discourage the use of assets as collateral, and forfeit the benefits of capitalism.

The remainder of this chapter discussed the problems associated with strong eminent domain powers and how to limit these powers for a more secure system of property rights. To restrict eminent domain for economic development, the West Virginia state legislature could codify narrow definitions for ‘public use’ and ‘blight.’ Alternatively, to best restrict eminent domain abuse and to restore a pro-growth property rights environment in the state, the state legislature should enact a categorical ban on takings for economic development purposes. When government intervention is curtailed and private property rights are made more secure, the foundations for **UNLEASHING CAPITALISM** will be present in West Virginia. Economic growth and prosperity for all West Virginians will be the result.

**REFERENCES**


**CASES CITED**

QUIT PLAYING FAVORITES: WHY BUSINESS SUBSIDIES HURT OUR ECONOMY

by Michael J. Hicks and William F. Shughart II

West Virginia, like many other states, uses targeted tax incentives in an attempt to stimulate economic growth. Targeted tax incentives (tax abatements, infrastructure financing or, in some cases, outright grants of public funds) are fiscal tools designed to entice a private firm to a new location, to support an existing business’s expansion plans, or to prevent a company from relocating to another city or state. In West Virginia these programs have ranged from tax credits for the aerospace industry, to subsidies for hydroelectric power generation, to direct aid for individual retailers. Despite the wide variety of incentives offered, there is little evidence that these efforts have generated benefits worth their true economic costs.

While a broad, low-rate tax structure is conducive to economic growth (see Chapters 5 and 6), selective tax incentives are a different story altogether. They are tools of central economic planning that distort relative prices and profit rates, and destroy wealth by encouraging firms to shift resources into obtaining these preferential government favors.

This chapter’s purpose is to help the reader better understand the role targeted tax incentives may play in state and local economic development. We begin by discussing the efficacy of selective tax incentives, with special attention to the political factors that explain their popularity. We then provide a summary of the findings of scholarly research addressing the actual impacts of targeted tax incentives on employment, incomes and economic growth.

That discussion is followed by a section detailing West Virginia’s specific experiences with incentives. Based on the available evidence, we end by concluding that the state’s prosperity would be enhanced by abandoning its selective incentive program (and dissolving the economic development agencies that offer them) in favor of broad-based tax cuts and other pro-growth initiatives that benefit business in general rather than a few politically favored companies. *UNLEASHING CAPITALISM* requires West Virginia to replace ‘business-friendly’ with ‘market-friendly’ policies.
THE EFFICACY OF TAX INCENTIVES

Despite the evidence (summarized below) suggesting that targeted tax incentives rarely produce benefits that exceed their economic costs, public officials nationwide nevertheless engage in an ongoing arms race to sway business location choices by offering inducements such as temporary relief from sales, property or corporate income taxes, upgrades to local infrastructure, and subsidies for worker training programs. Such sweeteners, frequently financed by issuing bonds, typically are justified by studies conducted by consulting firms purporting to show that large numbers of new jobs will be created as a result. These ex ante forecasts typically sum estimates of the numbers of workers employed by the company receiving the subsidy and by suppliers that will be enticed to locate nearby. An employment or income ‘multiplier’ is then applied to the job total as a way of estimating the indirect economic impact induced by additional spending on housing and at local retail establishments.

These so-called economic impact studies often are seriously flawed, however. As a result, they grossly overstate the employment and income gains associated with a new or expanded plant. A common error is to count all of the people employed at the subsidized facility as a net addition to the local workforce and to count the total wages paid there as a net addition to local income. But most of the people filling these new jobs will have been employed beforehand at firms in the immediately adjacent area. For example, 90 percent of the workers employed at the Nissan facility in Canton, Mississippi, which opened in 2001, lived and worked in the five-county area surrounding the plant (Peavy 2007). Only 10 percent of the jobs at Nissan were filled by people who either were unemployed before the plant opened or moved to Madison County, Mississippi from more distant locations, including out of state, and only that 10 percent of the Nissan workforce properly is counted among the holders of new jobs created by the plant. Moreover, only the difference between the wages paid at Nissan and the wages earned previously represents a net addition to local income for the 90 percent of the workers that merely changed jobs. Recognizing that the bulk of the hires at a new or expanded plant will be drawn from the ranks of the already-employed local labor force leads to the conclusion that the net increases in jobs and income usually will be much smaller than the gross increase.

Even so, and often subject to little or no accountability, companies receiving generous public subsidies rarely meet the job creation or hourly wage targets promised in return. They often pull up stakes and move their operations elsewhere when the subsidies run out. Relocation in search of bigger incentives is a tactic especially popular among ‘call centers’ and high-tech companies that employ few specialized physical assets and, thus, can easily abandon one site in favor of another (LeRoy 2005).

Even in the rare case where selective incentives actually attract people from other states or cities to the local workforce, additional public services will be needed to accommodate them. If the new company on the block has been granted relief from state and local taxes to the point where the company’s tax bill does not cover these additional costs, the higher tax bill will fall on other existing businesses, perhaps destroying as many or more jobs as supposedly were created by the subsidy in the first place.

Selective tax incentives produce other unintended consequences. In addition to encouraging substantial lobbying and rent-seeking activity as companies attempt to persuade
the legislature to give a selective tax credit to them, these selective incentives create
distortions in economic activity by favoring some industries at the expense of others.

Given serious doubts about the efficacy of tax incentives, why are they so popular? The answer is that businesses looking to expand their plants or to move to new locations have
strong incentives to lobby for tax breaks and other subsidies that add to owners’ profits and, moreover, encouraging a bidding war between two or more state or local governments promises to increase the value of the incentives they can extract from any one of them. Politicians interested in re-election, in turn, have strong incentives to respond to private firms’ self-serving subsidy demands in order to take credit for enticing a high-profile company to town or to avoid blame for the jobs that would be lost if an existing employer moved to another location. The politicians will be supported on the tax-incentive issue by other groups having immediate financial stakes in the process, including local real estate developers, investment bankers (who float public bond issues and arrange financing for the incoming firm), and economic development officials whose livelihoods depend on success in chasing after ornaments to add to the local or state economy.

The special interests of subsidy-seeking private firms dominate the political process because voter-taxpayers are only weakly motivated to become informed about the costs of tax incentive programs and to organize in opposition to them. They see the jobs ‘created’ at a new plant; they do not see the jobs that are lost elsewhere in the economy as a result of the higher tax burden imposed on other businesses and as a result of the economic resources reallocated from productive activities toward lobbying government to obtain these favors. Nor can they readily see the higher future tax bill they themselves will be required to pay in order to amortize and service the public debt issued to finance the subsidies diverted into the pockets of the owners of politically influential private companies.

WHAT ARE THE ECONOMIC IMPACTS OF
TARGETED TAX INCENTIVES?

Not surprisingly, economists have devoted considerable attention to analyzing the effects of taxes and targeted tax incentives. The most extensive review of the literature exploring the links between fiscal policy and economic growth is contained in a 1997 article, which compiles the results of more than 90 such studies conducted in the United States (Wasylenko 1997). Many of the studies reviewed by Wasylenko, and many of those published since, attempt to determine whether interstate differences in tax policy help to explain cross-state differences in income growth, wages and industrial composition. Other contributions to this literature ask whether public spending on infrastructure is growth-enhancing. Much of this research will be discussed elsewhere in this volume. However, some of the studies reviewed by Wasylenko, plus several more recent papers, specifically investigate the impact of targeted tax policies on economic growth. These studies inform the debate over targeted tax incentives and we summarize them here. By targeted tax incentives we mean those which are focused on a particular industry, geographical region or, in some cases, an individual firm.

\[1 \text{ Tax policy can influence industrial composition by causing productive resources, including labor, to move from tax-disfavored to tax-favored sectors of the economy.} \]
Two important empirical questions are at the heart of the debate over targeted tax incentives. The first is whether or not tax incentives actually influence firms’ location choices. The second, and perhaps more important question, is whether, in combination with firms’ location decisions, tax incentives actually lead to improved local economic performance.

We begin by noting that businesses do, in fact, seem to be responsive to state and local economic development incentives. A review by Timothy Bartik (2002) concludes that the majority of scholars who have studied the issue find some evidence of firms’ location decisions being influenced by incentives. More recent research on Maryland’s Job Creation Tax Credits links employment growth to the availability of incentives, but characterizes the response as both mild and sector-specific (Sohn and Knapp 2002). One of us (Hicks 2007a) finds that tax incentives promoted entry by large retailers in California.

However, this evidence is not necessarily a cause for celebrating the usefulness of incentives as a policy tool. All of the aforementioned studies, which find business location decisions to be favorably influenced by targeted tax incentives, also conclude that the benefits to the communities that offered them were less than their costs.

Figure 8.1 summarizes the results of the existing literature on targeted tax incentives, including some finding evidence that incentives had no impact or even a negative impact on the economic performance measure(s) studied by the author. The studies range from national studies of state-level incentives, to state-level evaluations of incentives targeted at a particular industry, to a very few quasi-experimental studies of the impact of tax incentives on individual firms.

Ambrosius (1989) conducted a nationwide study of economic development incentives in a time-series model of the United States. She found that such incentives did not explain economic outcomes at the state level. Trogan (1999) built on Ambrosius’s work, examining the growth rates of U.S. states as functions of the availability of fiscal incentives and a number of other variables unrelated to state policy initiatives. He found that favorable tax treatment for manufacturing in general, including loan programs, led to higher levels of employment, but were quite costly. He also found, however, that firm-specific targeted incentives actually reduced state per capita incomes.

Notable recent studies include Gabe and Kraybill (2002), who evaluate firm-level tax incentives on a sample of more than 350 Ohio firms. The authors asked not only whether incentives contributed to job growth, but also whether recipient firms overstated expected employment gains. Gabe and Kraybill found no evidence that the incentives promoted employment growth (and some weak evidence that they actually reduced it). Firms receiving Ohio’s tax incentives also overstated the number of employees they expected to add to their payrolls to a greater extent than non-recipient firms. Similarly, in a study of Maryland, Sohn and Knapp (2002) evaluated the impact of tax incentives on employment at the firm level and reported weak sector-specific positive impacts that were quite small. Perhaps the most influential of the studies we reviewed found few local or regional impacts associated with the entry or expansion of more than 100 new large firms during the 1980s (Fox and Murray 2004).
**Figure 8.1: Empirical Studies of Large Firm Impacts and Tax Incentive Efficacy**

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

LaFaive and Hicks (2005) examined all of Michigan’s targeted incentives for manufacturing and wholesaling firms, from 1995 to 2004, under the Michigan Economic Growth Authority (MEGA) grant program. The authors found no programmatic impact either on overall economic performance or on employment in the targeted manufacturing and wholesaling sectors. On the other hand, LaFaive and Hicks did find that the incentives increased construction employment modestly in the affected counties, but did so at a very high cost: the impact was roughly one new construction job per $125,000 of annual MEGA spending.

In Figure 8.1’s final entry, (Hicks 2007b) studied California’s oft-criticized incentives to Wal-Mart. Using a panel of California counties from 1990 to 2004, he finds that the tax incentives increased the probability of Wal-Mart opening new stores, but that Wal-Mart’s entry was not associated with overall increases in county-level employment.

The literature summarized above, which comprises all of the peer-reviewed academic research of which we are aware, examines the local impact of targeted tax incentives from a purely empirical point of view. Other studies (not assessed in detail here) find that the location decisions of firms may be influenced by the offer of a local tax incentive. However, as with those we have cited, all of them concur forcefully with the conclusion that targeted tax incentives do not provide local economic benefits outweighing their economic costs. What, then, has been West Virginia’s experience with targeted tax incentives?

**Tax Incentives in West Virginia**

West Virginia has a long history of offering tax incentives for specific firms and industries. The generally poor performance of the state’s economy provides abundant anecdotal evidence that these incentives have not been effective in stimulating economic development. These shortcomings were widely recognized and the State Department of Tax and Revenue performed a self-study of tax incentives in 2002 at the request of then-Governor Bob Wise.

The 2002 study identified 22 existing targeted tax credits. After comparing the values and types of incentives offered by West Virginia with those of other states, the Department of

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2 It should also lead policymakers to question the multipliers so commonly applied or assumed in economic impact studies. In West Virginia, for instance, it is not uncommon for economic development officials to claim multiplier effects as high as seven for new firm entry.

3 Nor have they been effective in equally poor Mississippi. Mississippi has had an incentive program in place since the 1930s—the first such program in the nation. Originally known as Balance Agriculture with Industry (BAWI), the program was intended to promote diversification of the state’s economy by enticing manufacturing firms to relocate to Mississippi from high-wage northern states. See Cobb (1993) for an in-depth analysis of BAWI’s few modest success stories as well as its many failures.
Tax and Revenue made detailed recommendations. Among these were recommendations to eliminate 11 programs, revamp three and leave eight unchanged. The study further recommended the introduction of two new incentives. The study’s authors did not address the question of whether the tax incentives actually contributed to improved economic performance; their only concern was whether or not the incentives achieved the goals set out in pertinent authorizing legislation, such as the number of claimant firms and gross job creation by recipients of the incentives.

Among the programs targeted for termination were tax incentives for the aerospace sector and security tax credits for convenience stores. Neither of these incentives had ever been taken advantage of: in the three years of its existence, the aerospace sector credit had not been claimed; nor, after four years of availability, had the convenience store security credit. A coal-loading facility tax credit was among the eight incentives the Department of Tax and Revenue recommended be continued. In the decade prior to the study, roughly $500,000 in such credits had been claimed every year. This level of use led the study’s authors to conclude that the incentive has been effective.

Three incentive programs were also found to have been successful (again by the criteria of use and claimed effectiveness, not actual economic performance), but to warrant modification. These were the Business Investment and Jobs Expansion Credit (‘Supercredit’), the Industrial Expansion and Revitalization Credit and the Research and Development Projects Credit (R&D), all of which provide tax relief for qualifying firms. The modifications recommended for each of these programs were designed to reduce administrative costs, to make the tax credits available to more types of businesses (especially small firms), and to reduce the complexity of the application process.

Of these programs, the Supercredit incentive is the largest, but the most complicated. Indeed, given that it required claimants to complete and file a 16-page form, the study’s authors called Supercredit the most complex tax incentive in the nation. However, the program also has been popular. Credits as high as $60 million were claimed in some of the program’s early years, according to the Department of Tax and Revenue, which deemed it have been successful insofar as the participating firms reported that they had used the credits to add more than 9,000 workers to their payrolls.\(^4\) Roughly $206 million in Industrial Expansion and Revitalization credits and $16.8 million in Research and Development Projects credits were claimed over the decade preceding the Department of Tax and Revenue’s self-study.

Two new tax incentives were proposed. The first exempted items purchased for use in qualifying R&D projects from state sales and use taxes, while the second exempted venture capital firms from the business franchise tax.

Virtually all of the Department of Tax and Revenue’s recommendations subsequently were approved by the state legislature. Sunsets for five of the 11 programs recommended for termination were scheduled; six others were shut down. The reforms designed to streamline the application process and to expand participation in the state’s three largest incentive programs, the previously mentioned Supercredit and the Industrial Expansion and Revitalization and Research and Development Projects credits, were adopted. These three credits, along with two of the programs the 2002 self-study recommended be continued

\(^4\) Interestingly, however, the total amount of Supercredit claimed by the program’s participants has exceeded their collective tax liability in some years. In 1997, for example, participating firms claimed over $43 million in credits, but owed taxes that should have warranted only $2.6 million in Supercredit benefits.
without modification, account for approximately 85 percent of the selective incentives the state grants each year, which totaled about $70 million in 2003, according to the Department of Tax and Revenue. The business franchise tax exemption for venture capital firms accounts for perhaps another 10 percent; less than $1 million in incentives typically is claimed annually under the eight other programs that remain active in West Virginia.

In 2002, the legislature dramatically altered the mechanisms for incentivizing businesses to relocate to the state. Near the end of the legislative session, a West Virginia Economic Development Grant Committee was created, with authority to distribute roughly $250 million in lottery-revenue-backed bonds to finance a one-time economic development effort. The legislation required the governor to appoint a commission to review proposals submitted by any entity. Several hundred proposals were considered and 47 specific grants ultimately were made to applicants ranging from city and county governments to individual firms. The largest grant, to Ohio County, provided $35 million for the purpose of establishing a business-and-technology park to be occupied primarily by a Cabela’s sporting goods store. The smallest grant the committee approved ($100,000) was for the purchase of a rail spur by Putman County for conversion to a hiking trail.5

The process did not escape criticism and, following a decision by the state Supreme Court that the bill authorizing the Economic Development Grant Committee represented an unconstitutional delegation of legislative power, a special session of the legislature was called to rewrite the original law. The statutory language was amended so as to comply with the Court’s ruling; by the end of 2006, more than half of the 47 grants approved by the committee had been funded.

Today, West Virginia offers economic development incentives under 14 active programs. A schedule for funding the remaining grants approved by the governor’s Economic Development Committee is in place. In the next section, we ask two questions: how have the grants been distributed geographically and, what is perhaps more important, what has been their economic impact?

THE DISTRIBUTION AND IMPACTS OF WEST VIRGINIA’S ECONOMIC DEVELOPMENT GRANTS

The geographic distribution of West Virginia’s economic development grants is highly skewed. About 85 percent of the 47 grant proposals approved by the governor’s committee went to projects in just five counties. More than half (29) of the state’s 55 counties received no grants, and per capita spending in the counties ranged from zero to just over $1,200 per citizen.

In an effort to determine whether regional variation in economic performance may have influenced the grant-approval process, we performed statistical tests (not reported here) that related the amount of grant monies received by a county to the county’s pre-grant rate of economic growth (controlling for population). We found no statistically significant correlation between the two variables: counties exhibiting slower rates of growth were no more likely to be recipients of economic development grants than their counterparts that were

5 Other projects financed by these grants include funding for academic and research facilities at West Virginia University and Marshall University and the construction of a new high school in Jefferson County.
growing faster prior to the program’s implementation. It thus appears that the grants were not targeted at counties in greatest need of economic development assistance. This is neither approbation nor censure of the process, simply an observation. It simply suggests that the regional disparities in grant funding cannot be explained by cross-county differences in economic growth rates.\(^6\)

Be that as it may, the most salient question raised by West Virginia’s grant program is whether it has had observable effects on economic development outcomes. It is too early, as of this writing, to conduct the careful economic and statistical analysis necessary to fully evaluate the impact of the grants. Such a study would control for the timing of each grant, holding constant other factors, such as baseline economic conditions and unrelated economic development policies, which determine a county’s rate of growth independent of the grant process. However, one specific grant approved by the governor’s committee does provide fertile ground for a preliminary analysis of the program’s effectiveness.

As mentioned above, the economic development grant to Ohio County was used to finance the construction of a retail mall designed for occupancy by a new Cabela’s outdoor sporting goods store. In addition to the $35 million grant awarded to the county, public funds were made available for infrastructure improvements at the site, including highway off-ramp construction. A number of other incentives were provided to the retailer. The total value of the subsidies to Cabela’s has been estimated to be as high as $120 million (see Hicks 2007b).

Our attempt to assess the impact of the spending on the local Ohio County economy is guided in part by a forthcoming study of all existing Cabela’s retail stores over the period from 1998 through 2003 (Hicks 2007b). The study finds no persistent employment impacts on the counties in which the outlets were located. Although the Cabela’s in Ohio County was not included in the analysis, since it had not yet been built, it is nevertheless possible to apply the methods of the forthcoming study to shed some light on the impact of the rather sizeable incentives provided to the retailer to locate in West Virginia.

The announcement in 2003 that a new Cabela’s was coming to Ohio County augured the creation of 1,200 jobs (West Virginia Development Office 2003). The retailer opened its doors in August of 2004. Two years later, Ohio County’s economy showed little evidence that the promise had been fulfilled (see Figure 8.2 on the following page). From August 2004 to August 2006, 700 workers were added to the county’s employment rolls.\(^7\) This addition to the local workforce translates into an employment growth rate that is identical to the West Virginia state average over the same time period (roughly 1.68 percent per year). Similarly, Ohio County’s unemployment rate rose by 0.5 percent from August 2004 to August 2006, compared with an increase of 0.6 percent for the state as a whole.

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\(^6\) A more complete ‘public choice’ analysis of the grant-approval process would include political variables, such as whether a county was represented on the Economic Development Grant Committee or by members of key legislative committees having oversight responsibilities with respect to the grant program.

\(^7\) This evidence is consistent with Peavy (2007), who finds that the net increase in employment in the five-county area surrounding Mississippi’s Nissan plant has been far less than the number of workers actually employed at the new facility. He calls this a ‘displaced worker effect.’
Thus, in employment terms, the economic performance of Ohio County has not differed markedly from the state average following the Economic Development Grant Committee’s $35 million investment in Cabela’s. Despite being among the largest of the committee’s grants, the initial evidence suggests that the incentives offered to the retailer have not delivered the promised benefits. To be fair, it is possible that job growth in Ohio County, though modest and essentially identical to that of the state as a whole, would have been slower in the absence of the incentive package. It is simply too early to perform the careful economic study necessary to assess the effectiveness of this and other economic development grants. However, even if the grant to Ohio County was shown to be responsible for all of the net job creation there (and this would be very unlikely given the many other factors that contribute to economic growth), then the efficacy of the public’s investment would still be questionable. The cost per job for the roughly 700 people added to payrolls in Ohio County ranges from just under $50,000 to more than $170,000.

**SUMMARY AND POLICY RECOMMENDATIONS**

Targeted tax incentives are a frequently used economic development policy tool. Given that they are widely offered, it is difficult to fault private firms either for asking or accepting
subsidies from state and local governments. After all, depending on the structure of the incentives made available in any particular case, the owners of subsidy-recipient firms stand to profit through a lowering of their tax bills or by shifting some of the costs of building and operating their businesses to other taxpayers. The politicians and economic development officials who grant selective incentives benefit in turn by being able to take credit for luring trophy companies to an area, supposedly bringing all of the blessings of more robust growth: new jobs, higher incomes, more tax revenue and a better quality of life.

There is, however, little evidence that targeted tax incentives produce benefits that exceed their economic costs. Even on the occasions when scholars have found selective incentives influenced business location choices, the cost per net job created has turned out to be extraordinarily high.

The fact of the matter is that selective incentives benefit the firms receiving them at the expense of existing firms, who lose some of their employees to higher paying jobs and who face higher tax bills to help finance the subsidies granted to the favored newcomer. Targeted tax incentives are a ‘business-friendly’ public policy—friendly to the firms receiving what amounts to corporate welfare—but they are not ‘market-friendly.’

When governments offer selective tax incentives and economic development grants firms are encouraged to reallocate their resources away from production and into securing them, and to lobby for the extension of these programs to other firms and industries. In the terminology of Chapter 3, these policies increase the reward to ‘unproductive entrepreneurship’ and lower prosperity as a result. They are tools of central economic planning, in which the political process is substituted for the market process in driving resource allocation decisions. Politicians often enact these incentives in an attempt to encourage investment in a particular industry they believe to be worthwhile. But as the discussion of ‘wrong predictions’ in Chapter 3 illustrated, there is simply no way central planners can predict which industries or businesses will be profitable in the future.

Instead, these opportunities must be discovered within the marketplace, through the decentralized decisions of entrepreneurs and the private investors who are always eager and willing to fund profitable new ventures. These private sector decision makers are forced by the harsh realities of a competitive marketplace to consider the true costs and benefits of additional investment in a particular business or industry. Selective tax incentives and economic development grants result in a misallocation of resources and a lower economic return from capital investment in West Virginia. They result in distortions to market prices, and to the profit and loss signals they generate.

It is not a function of government to create jobs. Paraphrasing Paul Johnson (1991, 142 & 156), government’s function is to facilitate the creation of wealth in the private sector by providing the basic infrastructure that underpins capitalism—the enforcement of contracts and property rights, and a limited set of public goods—while leaving the rest to individual initiative. Because the state is a poor substitute for private investors, it should restrict itself to these limited tasks rather than trying to single out a few industrial or retail champions for special treatment. West Virginia’s economic development can best be fostered by eliminating these programs and adopting market-friendly policies, such as broad-based tax and regulatory relief that provide advantages to every business in the state, and reduce the need to use these incentives to attract businesses in the first place. If policymakers resist succumbing to the false promises of targeted tax incentives, they will succeed in UNLEASHING CAPITALISM. West Virginia’s economy will grow and prosper as a result.
REFERENCES


LOWER BUSINESS REGULATION: COSTS AND UNINTENDED CONSEQUENCES

Joab N. Corey and Nicholas A. Curott

From the standpoint of promoting economic growth and prosperity, West Virginia not only taxes and spends too much, it also regulates too much. Businesses and entrepreneurs in our state are burdened by numerous, costly regulations that are generally unnecessary and too intrusive. Even when enforced with civility and the kindest of intentions, too much red tape ensnares the lives of business owners in West Virginia. In order to generate prosperity the regulatory burden must be lifted and replaced with an environment that encourages innovation and success. This chapter examines how West Virginia’s regulatory environment has exacerbated many of the problems these regulations are meant to solve and shows how these barriers to prosperity can be removed.

THE ‘LAW OF UNINTENDED CONSEQUENCES’

Business regulations are imposed for reasons such as protecting the health of consumers, preserving a clean environment, and ensuring the safety of workers. Because these regulations are intended to promote ends that most people value, the goals of regulation are typically desirable. However, because regulations change the incentives faced by private sector decision makers, these well-intentioned regulations also generate many ‘unseen’ and often unpredictable changes in behavior that can result in outcomes that are not desirable. In the framework of Chapter 2, regulations change ‘the rules of the game’ under which private-sector decisions are made. While the economic concept of ‘unintended consequences’ was first introduced in Chapter 3, with an example of how the Americans with Disabilities Act has unintentionally harmed the employment prospects of the disabled, let’s now consider some more detailed examples.

Currently, airline passengers traveling with a child less than 24 months of age may elect to simply hold the child in their lap to avoid having to purchase an additional seat for the child. Under the current system parents are allowed to make the decision as to whether the benefits of the child having a separate seat are worth the additional cost. At the federal level,
Congress has repeatedly considered legislation that would outlaw lap-held infants on airplanes and would require parents to purchase separate seats for these children. The goal of this regulation is certainly desirable—the intent is to prevent injuries and deaths among these children. According to a report by the Federal Aviation Administration, nine children under the age of two have died in plane crashes since 1978, and three of these deaths might have been prevented if this law were in place (Federal Aviation Administration 1995).

The economic approach requires us, however, to consider what other changes might arise from the legislation altering the behavior of parents. Quite obviously, one impact of this legislation would be to increase the cost of air travel for parents with small children. A mother flying to Disney World with her infant son, for example, would find the cost of air travel has doubled. How will parents respond? Predictably, as the cost of one mode of transportation rises, parents will substitute to others. Rather than flying to Disney World, some parents will now choose to drive. Because the likelihood of a serious accident per mile traveled in an automobile is 30 times higher than for air travel, some of these same children will be injured or killed on the roadways in route to their destination. Studies conducted both by the FAA, and independent academic scholars, have uniformly concluded that the net effect would be to substantially increase the number of children injured or killed each year.\footnote{See Federal Aviation Administration (1995), Stout (1999), and Newman, Johnston, and Grossman (2003).} Quite simply, more children would be hurt on the roadways than would be saved on airplanes.\footnote{Similarly because of travelers’ fears of flying after the September 11th terrorist attacks, they drove instead, and in the three months following the attacks an additional 1,000 people or more died in car accidents (than would have otherwise occurred)—a number much larger than would have died in the air.}

Thus, as it turns out, this regulation intended to protect the well-being of young children, on net, would actually harm them. The lesson to be drawn from this example is simple: well-meaning attempts to improve outcomes through regulation more often than not end up causing more harm than good. Economists call this phenomenon the ‘Law of Unintended Consequences’. It states that government regulations often result in outcomes that are different from what is intended, undermining the very goals the regulations are meant to achieve, because of ‘secondary effects’ or unintended consequences.

In fact, economic estimates suggest that the vast majority of regulations create such large unintended consequences that they should be repealed. Here are additional examples:

- Viscusi (1984) finds evidence that the mandated introduction of child-resistant safety caps on medicine bottles has increased the incidence of analgesic poisonings among children as more people have responded by leaving the bottles out in plain view, or open to avoid having to deal with the cap. On net, an additional 3,500 children have been poisoned as a result of this law than would have been poisoned without it.

- Federal fuel-efficiency mandates (‘CAFE standards’) force auto makers to significantly reduce the size and weight of vehicles. As a result, there are more highway deaths (about 3,000 more per year) and serious nonfatal injuries (about 15,000 more per year) than would otherwise occur because these lighter cars do not offer as much protection for occupants. All told, CAFE standards have killed more than 50,000 people since their enactment (Crandall and Graham 1989).
Over concerns that some antidepressant medications led to suicidal thinking, in 2004 the Food and Drug Administration mandated suicide warnings on the labels of selective ‘serotonin reuptake inhibitors’ (SSRIs, which include Prozac, Paxil, and Zoloft). Because of the warning label, prescriptions of these drugs fell by 20 percent. More individuals suffering from depression went untreated, and the net effect may have been an increase in suicides, particularly among teenagers suffering from depression (Childs 2007).

In addition to the cases listed above, there is also evidence that laws requiring bicyclists to wear helmets actually result in higher injury rates among cyclists, and that scares about mercury in vaccines have lead to increased disease rates as parents have been less willing to vaccinate children.

While the greatest drawback to regulations is that they are often counterproductive due to these detrimental unintended consequences, another disadvantage is that they are burdensome to the economy. This is especially true of business regulations that can greatly increase the costs of starting or running a business, thereby reducing business activity and employment growth. In addition, regulations are also costly because of the time, money, and effort that people spend lobbying both for and against them, and trying to find loopholes around them. Funds that otherwise would have been put to productive use generating wealth are instead transferred to the political process in the hopes of changing the regulations. Such action, a result of regulation, deprives the economy of its full wealth-generating capacity.

For all of these reasons, a government insistent upon imposing a large number of business regulations will create a poor business climate, and West Virginia is a prime example. Excessive business regulation has played a significant role in the creation of a business environment that is not conducive to economic growth. As mentioned in Chapter 2, West Virginia ranks poorly in multiple indices that measure an economy’s reliance on market capitalism, including ranking dead last in the Fraser Institute’s ‘Economic Freedom Index.’ Looking specifically at business climate, the Forbes Best States for Business (Badenhausen 2006) ranking looks at the state’s business costs, labor, economic climate, growth prospects, quality of life, and regulatory environment in determining the quality of the business climate relative to other states. For 2006, West Virginia ranked 49th, edging out only post-Katrina Louisiana. West Virginia’s regulatory environment subcomponent ranked 47th, a crucial factor in keeping West Virginia near the bottom of the overall list. Conversely, the state that tops the 2006 Forbes rankings, Virginia, also ranked first in regulatory environment.

West Virginia’s poor regulatory environment has contributed significantly to the state’s low level of economic growth. Using the Forbes rankings on the regulatory climate across states, Figure 9.1 (following page) shows the impact high regulations have on the level of entrepreneurial activity in a state. When comparing the ten states with the lowest business regulations (the ten highest scores) to the ten states with the highest business regulations (the ten lowest scores), both the growth rate of self employment and the establishment birth rate are clearly reduced by the presence of these burdensome regulations. If regulations produced measurable benefits, one might try to justify these economic costs as worthwhile. However, as we have shown, because of secondary effects it is unclear that these regulations produce the offsetting benefits necessary to justify their existence.

3 In fact, the suicide rate among those less than 19 years of age rose for the first time in more than a decade (by more than 18 percent).
The next few sections of this chapter will focus on specific regulations in West Virginia, many of which were gathered from personal interviews with West Virginia business owners. Simply listing all of West Virginia’s business regulations would fill volumes, so these examples are offered as a representative sample of the ways in which unnecessary regulations unintentionally harm businesses and consumers in West Virginia.

**THE CASE OF C&H TAXI**

C&H Taxi is a Charleston-based cab company that operates as a leasing service. The company leases cars to drivers who work as independent contractors servicing the public’s transportation needs.\(^4\) The company’s profit depends on the number of leases, while the cab drivers’ profit depends on the number of people they transport and the length of the trips. In 2003, the state legislature amended its rule on common carriers, which effectively reduced the amount of consecutive hours a driver was allowed to operate a vehicle without a break period to eight consecutive hours.\(^5\) The change was made with the best of intentions—to reduce accidents by mandating shorter driving periods. But as we have illustrated in the case of

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\(^4\) This section based on Corey (2007) personal interview.

similar regulations, such rules are both economically costly to businesses and often result in outcomes opposite of what was intended.

Prior to 2003, C&H Taxi used to lease cabs for a 24-hour period, during which drivers would spend a portion of that time driving around the city of Charleston and responding to people’s calls relayed through a dispatcher. Drivers themselves could decide when to rest and when to drive. In response to this law, C&H Taxi had to change its lease policy and now only offers an eleven hour leasing period. In the four years prior to the passage of this regulation, the company averaged 11,895 leases per year, but in the 4 years since this law went into effect, C&H Taxi has averaged only 9,858 leases annually, a yearly reduction of over 2,000 leases.

Thus, due to this regulation, there are over 2,000 fewer cabs servicing the city of Charleston each year. Not only does this reduce the profits of C&H Taxi, but it also hurts the livelihood of cab drivers, as this regulation has caused them to work fewer hours or quit driving cabs altogether. Consumers in Charleston are worse off as fewer cabs means longer periods spent waiting for taxi service. This can cause people to become frustrated with the company and further hurt the cab industry as well as the income of cab drivers. Indeed, this is shown in the data as the number of leases issued by C&H has decreased every year since the inception of this regulation. Less income also means less tax revenue.

In short, nobody wins—C&H Taxi, cab drivers, the local economy, and the general public of Charleston all lose as a result of this regulation. While many businesses respond to regulation by adjusting on other margins to minimize the regulation’s impact, C&H Taxi’s options are also limited by different regulations. One might think, for example, that C&H Taxi could change their lease rates or their meter rates in order to stimulate more business; however, government regulates these rates as well.

Has the regulation been effective? The purpose was to reduce the consecutive driving time performed by taxi drivers and other chauffeurs in order to improve the safety of the drivers. The idea was that by reducing consecutive driving time, drivers would be less fatigued and, as a result, there would be fewer traffic accidents. While many believe that improved traffic safety would be worth the expense of damaging the transportation industry, safer and more alert drivers was not the outcome this regulation generated. By instituting this rule it changed the incentives faced by both leasing companies, such as C&H Taxi, and the drivers themselves.

With a twenty-four hour lease period, the driver could take breaks and rest more frequently while still generating a satisfactory return on their lease investment. With the new reduced driving time, a driver has the incentive to drive consecutively for nearly the entire period in order to maximize their income in the limited window now available. As a result, drivers now report feeling more fatigued when on the road than prior to the law because they take fewer breaks.

The data supports this as well. Even though there are fewer cabs on the road due to the reduced number of leases, the total number of accidents committed by cab drivers has increased since the regulation has been passed. In the four-year period prior to regulation, C&H Taxi had a total of 33 accidents where the cab driver was considered to be at fault—that averages out to just over eight accidents a year. However, in the four years after the regulation was passed, C&H Taxi had a total of 45 at-fault accidents, or just over eleven accidents per year. The regulation has exacerbated the very problem it was designed to reduce.
THE CASE OF BOSTON BEANERY

Although it can be easy to see the negative impacts of a specific regulation like the one that affects C&H Taxi, even the most seemingly inconsequential regulations can have a detrimental effect on the performance of a business. The Boston Beanery Restaurant and Tavern, a food-service franchise, has experienced the burden of living with these seemingly minor, yet costly, regulations. The Boston Beanery originated in Morgantown, West Virginia in 1983, but has since branched out to have locations in other states including Kentucky, Pennsylvania, and Virginia.

As a franchise with several locations, it is important that the company keep each restaurant identical to one another to minimize costs and build a brand name. This is a critical part of any franchising endeavor. A customer needs to be able to enter a Boston Beanery restaurant in West Virginia and find the same atmosphere, food and drink items, and customer service that he or she would find in a Boston Beanery restaurant in other states. However, the different state regulations make the act of keeping all locations identical impossible to do.

This is certainly the case when it comes to comparing liquor regulations that exist in West Virginia and other states. For example, in West Virginia it is illegal to put up a neon Budweiser sign in the window of a restaurant, but this is perfectly legal in all of the other states in which the Boston Beanery has located. An even more obtrusive problem is that all states have different regulations on the times and limits of drink specials. Regulations such as these destroy the homogeneity of the individual locations that the franchise strives to create.

These regulations have a monetary cost in addition to the adverse effect of destroying the identical nature of the various locations. Due to the differences in the regulatory environment of the restaurants, the Boston Beanery headquarters must tailor its operations so that it fits each location. Instead of having just one menu or training manual for all of the different restaurants (usually an advantage of operating a franchise), the Boston Beanery has to spend time and money tailoring the menus and training manuals so that they coincide with the operation procedure designed to fit the specific regulations of the state. Regulations seemingly as trivial as not being able to hang a neon Budweiser sign outside of a restaurant, once piled on, become a major hassle and burden on business owners and can have a negative impact on business performance with little or no offsetting benefit.

THE CASE OF VIDEO LOTTERY PROMOTION

Examples of seemingly inconsequential business regulations that impose higher costs and lower profits, without a real identifiable benefit to the public, do not end with taxis or the restaurant industry. In 2001, West Virginia passed the Limited Video Lottery Act which legalized the use of certain types of slot machines at bars and clubs located away from family-friendly settings. However, there are many requirements with regard to licensing and operating these machines that make this a very costly endeavor. The number of machines that an establishment may have is limited. Bars are only allowed to have five machines on premises, while fraternal clubs are allowed ten. Acquisition of additional machines above this

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6 This section based on Seman (2007) personal interview.
legal limit could result in a felony conviction, punishable by fines and jail time for the owner. Thus, the manager of a bar who deems it in the best interest of his establishment, and its patrons, to install a sixth machine is prohibited from doing so by law.

This is clearly a case of central planning and the political process being substituted for letting markets decide how many of these machines are located in such locations. In addition, with the proliferation of devoted video lottery establishments, one would be hard pressed to argue that these machine limits have resulted in reductions in gambling activity—they merely move customers from some establishments to others. In fact, a more accurate description of the true intent behind the passage of these restrictions might be that they were championed by some businesses in an attempt to restrict the competition faced from other businesses.

Examples of detrimental regulations in this industry do not end with machine limits. On November 1, 2005 a policy came into effect that prohibits the advertisement of video lottery machines. The operators of the locations that have invested in these machines are not allowed to engage in any promotional activities to advertise the fact that they have these machines. Even worse, establishments with these machines who had business names containing words that advertised or promoted gambling were forced to change their name in order to comply with this regulation. Failure to comply with this regulation would result in the revocation of the owners’ license to have and operate video lottery machines. The owners may also suffer civil penalties which can be imposed for each day in which this regulation is violated. The cost to a business of changing its name is not limited to the amount of money spent changing the letters on the front of the building. Also lost is the time and money spent turning that name into a recognizable entity. All past investment in creating name-brand recognition (advertising, promotion, etc.) is eliminated once the name is changed; this is yet another cost of regulation. It also gave a significant advantage to those firms whose names already complied with the statute as they maintained their brand-name recognition.

Perhaps more egregious than the costs of these regulations is the apparent lack of benefit. Enforcing a policy that prevents the advertisement of gambling machines does nothing more than increase the cost incurred by gamblers to find gambling machines. If gamblers enjoy the legal act of gambling, then preventing them from doing is a cost, not a benefit. Why should the legal act of gambling be different from all other legal goods and services? The fact that the state forbids the advertisement of gambling seems hypocritical given the barrage of advertisements for the state lottery that exist on billboards, radio, and television. After all, the lottery is simply a gamble with an extremely high payoff and an extremely low probability of winning.

THE CASE OF ENVIRONMENTAL REGULATION

Environmental regulation in West Virginia provides additional examples of well-intentioned policies that have undesirable consequences. For example, in 2004, Senate Bill 163 was enacted with the intent of protecting and conserving water resources by requiring businesses to report their water usage to the West Virginia Department of Energy and Power (WVDEP). This bill provides the foundation for possible future legislation that would establish a comprehensive water management plan for the state.

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Unfortunately, the establishment of additional new requirements for reporting, monitoring and managing water usage has resulted in undesirable outcomes. First of all, these regulations have added further expenses and compliance costs to the already over encumbered business environment in West Virginia. They have also imposed disproportionate burdens on small, rural, and water-intensive businesses. Furthermore, these proposals threaten the ‘riparian rights’ of property owners, which allow them to use water from a river or stream adjacent to their property. Although they are intended to benefit citizens, water use regulations will only hamper prosperity by impeding the state’s ability to retain and attract businesses and to generate new employment opportunities.

Another example is the WVDEP Division of Air Quality (DAQ) minor source air permitting rule.9 As this case demonstrates, sometimes it is the method by which a regulation is administered that can adversely affect the business environment. In West Virginia, many businesses must obtain a WVDEP-DAQ air pollution permit in an effort to comply with both state and federal environmental regulations before they begin to build and operate their business. This usually results in a company having to wait anywhere from 90 to 120 days before they begin construction. In other states, a company can acquire the necessary environmental permits during the construction and operation of their business, so there is less time lost as a result of satisfying environmental regulations. The inefficient method in which the West Virginia government administers the compliance of this environmental regulation puts the state at a disadvantage when competing for business. Most people looking to open and operate a company would be more willing to work in a state that allows them to start immediately, rather than a state that requires a three to four-month waiting period while his or her air pollution permit application works its way through the approval process. West Virginia would have a more attractive business climate if it adopted the more efficient process of regulation compliance used by other states. Clean air and a safe environment are obviously important, but there are less costly ways to achieve this objective.

**THE CUMULATIVE BURDEN OF REGULATION**

In the final analysis, the problem that West Virginia must confront is not the unintended side effects or the costs imposed by any one regulation, but rather the cumulative burden of all these regulations put together. Regulation in West Virginia has gotten to the point of micromanaging individual behavior. The decisions of business owners and entrepreneurs are substituted for decisions made by political central planning. Virtually every field of human endeavor, from construction to manufacturing, from banking to medicine, from food to transportation, is suffocated under a mountain of rules and regulations.

The cumulative cost of all this regulation is staggering. Some of the costs are easily observed, such as the loss in revenue for C&H Taxi, the loss in income for the cab drivers, and the cost of changing menus, operation procedures, or even the name of the business in order to comply with the state’s regulations. In addition, as we have seen, there are other costs that are not easily observed. The resources (in the form of time and money) that management at C&H Taxi spends trying to legislate against harmful regulations are resources that are not spent improving their fleet of taxi cabs or putting a global positioning system (GPS) in the cabs.

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in order to more efficiently serve the public. Similarly, the time the Boston Beanery spends trying to adapt their locations to the states regulations is time not spent on inventing new palate-pleasing recipes or opening another location. The owner of the establishment that carries the video gambling machines is reported to spend as much as $75,000 on the machines, only part of which involves the acquisition of the machines while the rest of the money is spent obtaining the appropriate licensing necessary to operate the machines.

The cumulative effects, both seen and unseen, of all these regulations add up to a significant disincentive to engage in productive activity and a gross waste of human effort. In the words of one business owner who wished to remain anonymous, “The real problem with regulation is that it wastes the energy of our best and brightest entrepreneurs and business owners, who must expend significant time, effort, and resources in unproductive endeavors to figure out these rules and ensure compliance. They are converted into government employees who must spend their time overseeing, interpreting, and enforcing regulations when they could be engaging in productive activities within their company that instead generate wealth.” In fact, the desire of some of our interviewees to remain anonymous highlights yet another problem in that those business owners who best know how to fix our regulatory code are often afraid to speak out for fear of retaliation by public officials imposing additional regulations to punish their criticism.

**POLICY RECOMMENDATIONS**

West Virginia should follow the example of other states that have recognized the need to eliminate burdensome regulations and have implemented regulatory reform. Of critical importance is the fact that just because a regulation was passed with good intentions does not mean it will produce good outcomes. Keeping in line with the reforms in states like New York, West Virginia should begin the process with a temporary moratorium on the adoption of new regulations, and all current regulations should be forced to prove their effectiveness using real pre- and post-implementation data. An explicit and rigorous set of standards should be drafted to determine which existing regulations are desirable, and new regulations should have to pass a stringent adoption process.

Toward this end, one tool that has been adopted by several other states that may help ensure greater efficiency in West Virginia’s regulatory system is a required cost-benefit analysis. Recently, states such as New York, Colorado, Florida, and California have adopted requirements that regulations be subjected to a cost-benefit analysis prior to becoming law.\(^\text{10}\) Cost-benefit analysis tries to determine whether a policy or project is worthwhile by estimating and quantifying the dollar value of its costs and benefits, and then seeing whether the benefits outweigh the costs. The cost effectiveness of different regulations varies greatly, so the state government could promote a more effective use of resources by explicitly considering the costs and benefits of current and proposed regulations. This could be implemented through a law or executive order requiring agencies to periodically review the cost effectiveness of existing regulations and to prepare a System Impact Analysis that includes a cost-benefit analysis any time the revision or adoption of a new regulation is under

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\(^{10}\) For an example of how other states have been using cost-benefit analysis standards for regulation and how West Virginia might go about implementing it, see the manual prepared by the New York Governor’s Office for Regulatory Reform (1996).
consideration. Critically, these studies must be required to consider the secondary impacts or unintended consequences created.

Introducing the use of cost-benefit analysis can help eliminate inefficient regulations and make the government regulatory process less burdensome on the state’s economy. However, analysis and review requirements alone will not automatically lead to more efficient regulation. They must be coupled with effective oversight mechanisms to make sure that agencies comply with the rules and actually reduce inefficient regulations. In addition, efforts to improve regulation are not likely to be successful without detailed guidelines and strict statutory language. A transparent and well-designed review process is not a panacea, but it can help insure a more efficient regulatory environment.

In addition to requiring a cost-benefit analysis of all existing regulations, and the future requirement of proposed regulations to pass this test, sunset provisions on all regulations should be included if they fail to produce a follow-up demonstration of true effectiveness within five years after implementation. By including sunset provisions conditional on proof of effectiveness, we can ensure that the citizens of West Virginia truly benefit, and are not harmed, by new regulations. In fact, proving to our citizens that a new regulation has lived up to the desired outcome seems to be an obvious improvement. The citizens of West Virginia deserve this proof. With this information, citizens will also be better able to hold elected officials accountable for the policies they enact.

CONCLUSION

The examples mentioned in this chapter highlight how regulations often have a very real and detrimental impact without creating the intended outcome. C&H Taxi, the Boston Beanery Restaurant and Tavern, and video lottery establishments across the state show how a poorly thought out or even seemingly inconsequential regulation can reduce a company’s profits and make for an unfriendly business climate. For this reason, states with an overall poor score in the Forbes Best States for Business rankings of 2006 often have a poor score in the section on regulatory environment, and West Virginia is no exception. Regulations can and do hurt businesses in a variety of ways and often do not achieve the desired result for which they are enacted. The imposition of a cost-benefit analysis that forces regulatory agencies to analyze the effects of a regulation coupled with thoughtful considerations of how the regulations might alter peoples’ behavior may go a long way in improving West Virginia’s regulatory environment.

The companies cited in this chapter have all been hurt by state regulations, but they are at least still in business. The real cost of an excessive regulatory climate would be best illustrated by those companies who have gone out of business, have left the state, or who never got off the ground. Sadly, their stories will never be heard.

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CHAPTER 10

REDUCE LABOR RESTRICTIONS: FROM SCHOOL CHOICE TO RIGHT TO WORK

by Nathan J. Ashby and Mark T. Gillis

Near Rockland, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 81.64° W & Latitude 39.28° N).
According to public opinion polls, the economy, wages, job growth, and employment are among the top concerns of Americans. From teenagers working at fast-food restaurants to coal miners, everyone would like to earn higher wages and have better employment opportunities. While we all desire these common goals, we often have different ideas on how to achieve them with policy. These issues are, however, fundamentally economic questions. Fortunately, both economic theory and evidence agree on a few clear answers.

We begin this chapter by first presenting the basic economic concepts behind wage and employment determination. With these tools it will become easier to see why some labor-market policies are better than others at promoting job and wage growth. We continue by addressing several diverse areas of policy reform that can achieve these goals in West Virginia. The policy reforms in this chapter cover a broad range of issues related to labor markets including Right-to-Work legislation, occupational licensing, minimum wages, prevailing wage laws, and school vouchers.

**The Inexorable Truth about Wages**

Why do workers earn so much more on average today than they did 50 years ago? Why does a logger operating a feller buncher earn more than a logger operating a chainsaw? The answer is one simple word: productivity. Simply put, productivity refers to the quantity of goods and services that an individual is capable of producing with his skills and tools (or ‘human capital’ and ‘physical capital,’ respectively). The fact that wages are driven by productivity is indisputable. All economists agree that this is as unquestionable as the Earth rotating around the sun, or as gravity pulling a dropped rock towards the earth.

Figures 10.1 and 10.2 (following page) illustrate this by tracing the movement of real per capita income growth, unemployment, and productivity growth for the United States from 1951 to 2005. As the figures demonstrate, there is nothing subtle about the importance of productivity in determining income growth and employment. When productivity increases,
real income per capita grows. When productivity growth is low, for instance during the late 1970s and early 1980s, unemployment rates are higher.¹

**Figure 10.1: Productivity and Real Income Growth**

![Figure 10.1: Productivity and Real Income Growth](image)


**Figure 10.2: Productivity and Unemployment**

![Figure 10.2: Productivity and Unemployment](image)


¹ The correlation between productivity growth and income growth (Figure 10.1) is 0.412. The correlation between productivity growth lagged one year and the unemployment rate (Figure 10.2) is -0.411.
Consider, for example, how the U.S. economy changed during the 1980s. In the early 1980s, productivity growth was dwindling, declining at a rate of -0.77 percent in 1982. In that same year, real income per capita declined at a rate of -0.08 percent and unemployment reached nearly 10 percent. Over the next four years, productivity growth improved significantly, growing at an average rate of 2.85 percent per year. Accordingly, during this period real income per capita grew at an average rate of 3.31 percent and the unemployment rate fell to under 7 percent by the end of 1986.

If average income growth was plotted with other things that people consider responsible for determining wages, such as minimum wages or unions, there would be no observable relationship. Income and employment come from the fact that workers provide others with goods or services they value. Consequently, the more goods and services that a worker can provide, the higher his or her value to others, and correspondingly the higher will be the worker’s income. Unsurprisingly, being able to provide more goods and services is exactly what is meant by the term ‘increasing labor productivity.’

There are volumes of scientific studies proving the link between labor productivity and wages. That same evidence shows that it is both the physical capital (tools and machinery) and human capital (skills, abilities, and education) that workers have at their disposal which determines their productivity. Consider the impact of physical capital. When a doctor receives an X-ray machine, he can diagnose and treat more patients. If a secretary replaces his typewriter with a computer, he can produce more reports faster and of higher quality. When a logger is given a feller buncher, he can harvest more trees in a day. Human capital has similar implications. When a doctor learns a new procedure, he can better and faster serve his patients. If a secretary takes a typing class, he can produce reports faster. When a logger learns how to operate his machinery better, he can supply more lumber.

Logical reasoning and, more importantly, historical evidence establish that there is an unquestionable relationship between productivity, wages, and employment. Thus, any policy designed with the intention of increasing incomes, wages, and employment must be consistent with increasing productivity. Policies that restrict wages or limit the entry of workers and entrepreneurs into industries actually reduce overall labor productivity and are thus detrimental to wages as a result. States such as West Virginia, Mississippi, Michigan, and Ohio have not prospered in recent decades because of the heavy influence of various labor market restrictions and constraints. By comparison, states with less constrained labor markets such as Texas, Delaware, New Hampshire, and North Carolina exhibited stronger economic growth.

The remainder of this chapter is devoted to discussing in more detail the policies and regulations that restrict labor markets in West Virginia and to provide policy solutions to improve labor market conditions in the state. The policies and regulations analyzed here should not be considered an exhaustive list. Instead, they are intended to exemplify the economic thinking behind how labor regulations and policies in general should be examined when attempting to predict the likely economic consequences.
TRYING TO DEFY THE LAWS OF NATURE

“The well-intentioned desire of Congress to help the poor apparently will not be restrained by the rules and principles of the free market that otherwise do restrain American businesses and workers. Apparently, Congress can change the rules that would otherwise affect the affairs of mankind. So, Mr. Speaker, I have asked my staff to draft a measure I call the Obesity Reduction and Health Promotion Act. Since Congress will apparently not be restrained by the laws and principles that naturally exist, I propose that the force of gravity, by the force of Congress, be reduced by 10 percent. Mr. Speaker, that will result in immediate weight loss for every American.” – Representative Bill Sali (Idaho Statesman 2007).

This comment, made recently by Idaho congressman Bill Sali on the floor of Congress, may seem nonsensical. It is impossible to change the force of gravity or any of the laws that govern nature with legislation, a fact to which any scientist would agree. However, for an economist, ignoring the laws that govern markets is just as irrational. From Representative Sali’s point of view, and coincidentally an economist’s point of view, ignoring the fact that labor regulations will induce businesses to use less labor is the equivalent of ignoring the laws of nature. Business regulations are costly, and when something costs more, less of it is utilized.

Imagine that you lived in a town where every time you wanted to purchase a good or service you were responsible for ensuring that what you are purchasing conforms to hundreds of regulations. Every time you wanted to buy something, you would have to devote significant time and resources to checking the regulations. As a result, you would undeniably purchase fewer products, if for no other reason than you would not have the time. Suppose that, additionally, in neighboring towns you could buy the same goods and services without having to worry about those regulations. You would prefer to shop in these neighboring towns because the cost of purchasing these items would be lower. Essentially, this is the atmosphere that businesses locating or considering locating in West Virginia face. Businesses, though, are the shoppers for labor in this analogy. Business firms purchase the labor services of workers; as such, the more regulations firms have to address, the more costs they must incur and, therefore, the less labor that they will ultimately hire. Less labor hired means less competition and correspondingly lower wages in the long run. Moreover, when neighboring states have fewer and less costly labor regulations, businesses will prefer to ‘shop’ for their workers in those states instead of West Virginia.

Labor regulations are particularly interesting because most individuals work in environments much safer than the minimum safety level required by law, and at jobs that pay significantly more than the minimum wage required by law. Most businesses also offer benefits that exceed what is required by law. Why is this? The economic explanation for why employers pay more, offer better benefits, or good working conditions is simple—they are interested in making profits, but must compete with other potential employers to hire workers. In competing for workers and retaining those workers they have, firms must ensure that they are satisfied. Competition among employers for labor is the quickest path to higher wages and better working environments.
While policies that foster greater reliance on free-market competition improve labor conditions, government policies that straddle employers with costly rules, regulations, mandates, and restrictions regarding employment practices generally do not. The Americans with Disabilities Act (ADA) example discussed in Chapter 3 is a good illustration. While the goal was to expand employment opportunities for the disabled, the data clearly show that it has caused a significant drop in the employment rate among disabled Americans as it has made hiring a disabled worker more expensive to an employer.

Does greater reliance on market competition and less reliance on government policy and regulation promote employment and wage growth? One of the subcategories of the overall score in the *Economic Freedom of North America* index is ‘labor market freedom,’ measuring the extent to which states refrain from passing legislation that restricts employment practices. Figure 10.3 presents this index of labor market freedom along with unemployment and personal income growth across states averaged over the period 1981 to 2003. The states are shown compiled into groups of 10 when ranked from the most free to the least free. Of particular interest is that states with the most labor market freedom had the highest rates of income growth and the lowest unemployment rates. Those states that had the least amount of labor market freedom (including West Virginia, which ranked 50th on average over the period) had slower rates of income growth and high unemployment rates on average. Simply put, despite the good intentions behind our current rules and regulations in labor markets, they unfortunately result in a poorer workforce and a more unemployed West Virginia.

**Figure 10.3: Average Labor Market Freedom, Income Growth, and Unemployment (1981-2003)**

<table>
<thead>
<tr>
<th>Rates</th>
<th>Most Free</th>
<th></th>
<th></th>
<th></th>
<th>Least Free</th>
</tr>
</thead>
</table>

OCCUPATIONAL LICENSING: A WOLF IN SHEEP’S CLOTHING

Wages are determined by labor productivity. Thus, to increase wages we need a more productive West Virginia workforce. A worker can increase his productivity in many ways, by becoming more skilled at his craft, becoming better trained, having access to better machinery, or having access to better technology, among many other possibilities. The bottom line is that a worker who is more productive is better off because he earns more income. At the same time, this increased productivity benefits others in society because the worker now produces more goods and services that other people value. In other words, higher productivity benefits both the West Virginia worker and the West Virginia consumer. A more productive doctor benefits more patients. A more productive teacher benefits more students. A more productive logger creates more lumber for others to use.

Contrast this with the social impact of government policies that attempt to limit entry or competition in different occupations to increase wages. The significant difference here is that whereas higher wages through higher productivity benefit all of society, higher wages through restricting markets actually hurt the rest of society. Laborers who can get government policy enacted that restricts competition from others of the same or similar occupation can charge a higher price for their services. States that require licensing for plumbers, for example, have fewer plumbers, and they charge more for their services. By restricting entry into the medical profession, the American Medical Association (AMA) effectively allows doctors an opportunity to charge more for their services. Higher prices are not the only way in which the rest of society is worse off when competition is restricted. With fewer workers, there will be fewer goods and services produced. Thus society is harmed through both higher prices and fewer goods and services.

A common misconception about public policy is the belief that businesses are always averse to being regulated. There are some types of regulations—those that restrict competition in an industry—that can greatly increase the prices businesses can charge to consumers. Businesses often push for these types of new regulations. The particular types of regulations they often seek, however, are those that give them an unfair advantage over their competition or restrict entry into their industry to weaken price competition. As Chapter 2 indicated, one of the key ingredients of economic freedom and capitalism is the freedom to become an entrepreneur and compete with existing businesses. Using regulation to restrict others of similar occupation from competing for customers distinctly contradicts this component.

One such example of labor using regulation to restrict those of similar work from entering a market is through occupational licensing. Occupational licensing requires that for a given occupation, an individual must have a state granted license to practice his craft. You are probably well aware that doctors require a license to practice medicine and that lawyers must pass state bar exams, but the realm of occupational licensing far exceeds these common occupations. Currently, West Virginia has 86 occupations that are illegal to perform without a state occupational license. Included in those 86 are many occupations you might suspect, such as dentists, pharmacists, physicians, and lawyers. However, you probably will be surprised to learn that, in West Virginia, you need a license to be a funeral director, vendor at a sporting event, plumber, manicurist or pedicurist, or even a parking valet. There are separate

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2 For a more scientific overview of these issues, see Kleiner (2000).
3 This does not even include certifications or registrations, which are generally viewed as more lenient forms of licensing. Information on occupational licensing is from America’s Career InfoNet (2007).
licenses for becoming a barber and a hairdresser, each requiring at least 2,000 hours of approved school training in the field. There are even separate licenses required for barbers and barber instructors. Adams, Jackson, and Ekelund (2002) estimate that in the market for cosmetology alone, occupational licensing regulations generate $1.7 billion in profits for cosmetologists through restricting competition and impose $111 million of deadweight costs on society each year in the United States.

The irony of occupational licensing is that those seeking occupational licensing almost always argue that it is in the ‘public interest’ to ensure that only qualified individuals be allowed to perform a certain occupation. In his famous book *Capitalism and Freedom*, Nobel laureate Milton Friedman writes:

> In the arguments that seek to persuade legislatures to enact such licensure provisions, the justification is always said to be the necessity of protecting the public interest. However, the pressure on the legislature to license an occupation rarely comes from the members of the public who have been mulcted or in other ways abused by members of the occupation. On the contrary, the pressure invariably comes from members of the occupation itself. Of course, they are more aware than others of how much they exploit the customer and so perhaps they can lay claim to expert knowledge. (1982 [1962], 140)

While the importance of licensing as a tool for signaling quality and preventing social problems (such as an illegitimate doctor spreading disease) is supported by some economists, it is near impossible to explain how most of the many occupations that require licensing serve the public interest. It is relatively easy to simply ask around for a reference for a good barber. Even though they are licensed, very few people go to a new barber without a recommendation from a friend. And when was the last time you heard someone really care enough to ask whether or not a hotel or restaurant valet has an occupational license?

The social costs created by occupational licensing, through higher prices and reduced quantities of goods and services are an issue that should not be ignored. Figure 10.4 (following page) illustrates the relationship between the cost of living and the number of occupations requiring licenses by states. This figure supports the theory that states with more occupations requiring licenses have a higher cost of living resulting from the higher prices charged by laborers in restricted markets. Clearly, reducing some of the unnecessary licensing

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4 Friedman (1962 [1982]) would certainly not be amongst these economists though, as argues that even medicine should not require a license to practice. Friedman argues that without government regulation, the free market would provide private certifications in these occupations (and would do so more efficiently than can government). Examples of private certifications include Underwriters Laboratories, Inc. (UL), Consumer Reports, displaying a particular college degree or association certification, or even the use of brand names.

5 Gross (1986) argues that there is no evidence that occupational licensing serves any public interest that would justify the costs associated with the reduction in economic freedom and capitalism. Additionally, Gross argues that there is no improvement in occupational quality with increased licensing. Maurizi (1974) presents evidence that licensing boards often use their power to prolong periods of higher incomes through excess demand for the services of the occupation in question, suggesting that occupational licensing does not serve the public interest.

6 It is important to note that there are many variables that impact cost-of-living differences across states. The effect of occupational licensing is likely small when considering these other effects, but significant nonetheless.
and allowing the market to guide consumers and entrepreneurs could improve the outcomes in West Virginia’s labor markets.

**Figure 10.4: Occupational Licensing and Cost of Living by State**

![Graph showing the relationship between occupational licensing and cost of living by state.](image)

Sources: America’s Career InfoNet (2007) and Berry, Fording, and Hanson (2003).

**RIGHT-TO-WORK LAWS: HIGHER EMPLOYMENT, FASTER GROWTH**

The previous section illustrated how restricting competition in labor markets can hurt the economic well-being of a state. As you may suspect, occupational licensing is not the lone way of restricting labor market competition. Perhaps the most common form of using regulation to restrict labor markets comes from unions. Just as occupational licenses can impede new laborers from entering certain fields, unions can restrict the supply of labor garnering a higher than market wage for their members.

Upfront, it is important to acknowledge that the problems economists associate with unions are not necessarily a result of the union itself. Personal choice is an important part of economic freedom and capitalism and as Friedman (1990 [1980]) acknowledges, the right to voluntarily organize is a personal choice. The problem created by unions is often that they compose perhaps the largest and most influential special interest group in the United States. As such, it is of significant interest to politicians to cater to them. Political catering to any special interest group can be destructive for an economy (see Chapters 2 and 3). Just as occupational licensing creates benefits for a small, specific group of individuals at the expense of consumers and the rest of society, so to do the gains that unions obtain through the political process. As Friedman acknowledges, “[t]he gains that strong unions win for their members are primarily at the expense of other workers” (1990 [1980], 233).
Under capitalism workers should be allowed to voluntarily form and join unions. However, in many states unions have used the political process to require other employees to join the union to work, and to require a company to hire only union labor. In addition, unions have sometimes resorted to the use of outright violent force against other employees and managers. These violate the key components of economic freedom and capitalism. States can overcome these restrictions and ensure voluntary choice and competition for their workers by adopting Right-to-Work laws. Right-to-Work laws legally prevent unions from requiring membership to be a condition of employment, either before or after being hired at a union shop. Effectively, Right-to-Work laws allow more labor competition, which is important for attracting new business to a state. Currently, 22 states have Right-to-Work laws.

Regardless of one’s opinion or political ideology, if growth and prosperity are the true concerns for West Virginia, then evidence must be used as a guide. In a 1998 survey of the evidence on Right-to-Work laws, economist William Moore concludes that Right-to-Work laws have a positive and significant effect on state industrial growth. Economist Morgan Reynolds (1998) ranks Right-to-Work laws as a 9 out of 10 in terms of their potential in reducing the ability of unions to capture state legislatures. In summary, the evidence suggests that states with Right-to-Work laws tend to have higher rates of income growth and lower rates of unemployment. Figures 10.5 and 10.6 reveal these differences.

Figure 10.5: Unemployment Rates and Right-to-Work Legislation

![Unemployment Rates Graph]


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8 In another study Dinlersoz and Hernandez-Murillo (2002) argue that Idaho experienced acceleration in manufacturing growth as a result of passing a Right-to-Work law in 1986.
Figure 10.5 shows that, on average, states with Right-to-Work laws have an unemployment rate 0.5 percent less than states without Right-to-Work laws. A difference of 0.5 percent may not sound like much, but in West Virginia it means more than 9,000 more jobs. Furthermore, as Figure 10.6 shows, throughout the 1980s, 1990s, and 2000s, states with Right-to-Work laws have experienced higher growth in real per capita personal income.

**Figure 10.6: Real Income Growth Rates in Right-to-Work and Non-Right-to-Work States**


One of the arguments often made by opponents of Right-to-Work laws is that states without them have higher average incomes. As Figure 10.7 indicates, this is true. However, this ignores the fact that these states (mostly southern) started out much poorer than the rest of the nation prior to these laws being enacted. In addition, because states with Right-to-Work laws are growing more rapidly than those without Right-to-Work laws, income in these states will eventually surpass non-Right-to-Work states.10

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9 Oklahoma, the most recent state to adopt a Right-to-Work law, has only had the law in effect since 2003. Excluding Oklahoma minimally changes the results. In 2003, average unemployment would be 4.98 percent and 5.49 percent for Right-to-Work and non-Right-to-Work states respectively.

10 The numbers in Figure 10.6 vary depending on how the three recent states to adopt Right-to-Work laws are counted (Idaho, Texas, and Oklahoma). In the figure they are counted based on the date of adoption. So for 1980, Idaho, Texas, and Oklahoma are counted as non-Right-to-Work states, for 1990, Texas and Oklahoma are counted as non-Right-to-Work states and Idaho is counted as a Right-to-Work state, and for 2003 and 2005, all are counted as Right-to-Work states. Altering these classifications does not alter the trends of the numbers.
Figure 10.7: Average Real per Capita Income in Right-to-Work and Non-Right-to-Work States

<table>
<thead>
<tr>
<th>State Type</th>
<th>1980</th>
<th>1990</th>
<th>2003</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-to-Work States</td>
<td>$21,203</td>
<td>$25,216</td>
<td>$29,889</td>
<td>$31,001</td>
</tr>
<tr>
<td>Non-Right-to-Work States</td>
<td>$24,185</td>
<td>$29,239</td>
<td>$34,057</td>
<td>$35,084</td>
</tr>
<tr>
<td>Difference</td>
<td>14.06%</td>
<td>15.95%</td>
<td>13.95%</td>
<td>13.17%</td>
</tr>
</tbody>
</table>


By giving workers the ‘Right to Work,’ the economy of West Virginia could be vastly improved. Perhaps in this case more than any other, change is very politically costly as a legislator might jeopardize his campaign funding or votes from unions by supporting a Right-to-Work law. However, with union membership declining rapidly throughout the United States, a growing number of states are finding it much less politically costly to enact Right-to-Work laws because unions comprise a smaller and smaller share of voters through time, and control less of the funding for political candidates. If the goal is growth and prosperity for West Virginia, the issue of Right to Work must be addressed.

THE HIGH COSTS OF THE MINIMUM WAGE

Advocates of the minimum wage claim it is an effective policy to help low-skilled workers earn higher incomes. Unfortunately, they are wrong. Even more unfortunate is that the minimum wage causes the most harm precisely to those workers the law is intended to help.

Most people really do understand the negative impacts caused by having a minimum wage. After all, if higher wages could simply be legislated, why not set the minimum wage at $1,000 per hour. Virtually everyone could identify the harm that would cause. Setting the minimum wage for college professors at that level, for example, would predictably cause economic consequences including increased prices (tuition) for students, lower fringe benefits for faculty members to offset the higher wage costs, and would result in colleges hiring fewer professors and having larger class sizes. While the few professors who retained their jobs would earn more, in total it would clearly result in harm to both students and many other college professors who would lose their jobs.

Simply put, higher minimum wages result in businesses hiring fewer low-skilled workers. Economists’ best estimates suggest that for every 10 percent increase in the minimum wage, low-skilled employment falls by 3 percent. In other words, if we were to begin with a $5.15 minimum wage and increase it to roughly $5.67, three out of every one hundred low skilled workers would lose their jobs. For each additional 50 cents, three more jobs per one hundred would be eliminated. Urban inner-city youth are particularly hard hit, and the unemployment rate among that group has hovered around 25 percent due to the

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minimum wage lowering their employment opportunities. These workers are worse off not only because they can no longer find gainful employment, but also because they lose the years of on-the-job experience and training that lead to higher future wages.

It is important to note, however, that this estimate is for an increase in the federal minimum wage, which applies in all states. When states enact a minimum wage higher than the federal wage, the employment losses are likely to be much, much larger as businesses will simply relocate their operations to other states (or just not open in the state with the now higher wages). In addition, firms in that state are at a competitive disadvantage in pricing their goods and services when competing against firms from other states, resulting in further reductions in business activity and employment.

Some might argue that these employment losses are worth the cost because the minimum wage does benefit those workers who retain their jobs at the higher legislated wage. Unfortunately, the data suggest that these people are not the low-income people the policy is intended to help. Generally, the least skilled workers are the ones whose employment is most jeopardized by a higher minimum wage. In addition, nationally, only 16 percent of minimum wage workers are heads of families in poverty. In fact, about 40 percent are members of a family in top half of income distribution. Just over 60 percent are employed part time, and more than 35 percent are teenagers.

As Johan Norberg (2003) states in his recent book *In Defense of Global Capitalism*, for these low-skilled workers the choice is not between a low paying job and higher paying job; the choice is between a low paying job and either no job at all or an even less attractive job in the underground economy. Economic theory and decades of evidence demonstrate that the minimum wage is ineffective in achieving the poverty-reducing objectives of its supporters.

While hundreds of published articles find a negative impact of the minimum wage on employment, one article in the mid-1990s gained publicity because it was the first study to not find a negative impact of a minimum wage increase. This study is often cited by minimum wage proponents. In that study, David Card and Alan Krueger (1994) found that a higher minimum wage did not reduce employment in the fast food industry in New Jersey and eastern Pennsylvania. However, what most people who cite this study do not know is that dozens of follow-up studies have completely and uniformly discredited the results of the Card and Krueger study. David Neumark and William Wascher (2000), for example, obtained the actual payroll data from these firms (rather than relying on simple phone surveys), and this more accurate data from the same companies showed exactly what economic theory would predict—the higher minimum wage did indeed reduce employment and hours worked. Other studies have pointed to other major problems with their data (see Burkhauser, Couch, and Wittenburg 2000a, 2000b; Couch and Wittenburg 2000). For interested readers, Neumark and Wascher (2006) provided an extensive review of research on the impact of the minimum wage on employment.

Most economists agree that the minimum wage is one of the worst policies for reducing poverty. Figure 10.8 demonstrates that the states with high relative minimum wages (measured as relative to average annual income) actually end up with high poverty rates. States such as West Virginia and Mississippi, which have considerably constraining minimum wage policies, have some of the highest poverty rates. In contrast, the state with the least

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12 Nathan Ashby (2007) recently demonstrated that states with lower minimum wages as a percentage of per capita income have higher migration inflows because of the job opportunities created in these areas.
constraining minimum wage (relative to the average wage level), Delaware, has experienced phenomenal economic growth in recent decades and has the fifth lowest poverty rate in the nation. The fact is that states such as Delaware and New Jersey have minimum wages which are well below the market wage for most occupations, and thus have poverty rates that are among the lowest in the country. Higher minimum wages simply cost some workers their jobs, and thus lead to lower income and poverty.

**Figure 10.8: Minimum Wages and Poverty Rates**

![Graph showing the relationship between minimum wages and poverty rates from 1981 to 2003.](image)


The problems caused by the minimum wage are not necessarily the fault of a given state’s policymakers. Indeed, many states have accepted the federal minimum wage of $5.15 per hour for some time now. Such a minimum wage will have little impact on statewide opportunities in a state such as New York or California where the market wage is much higher than this wage. However, in a state such as West Virginia or Mississippi where the state income per capita is much lower than other states, this creates a significant constraint on employers and greatly reduces the incentive to move employment operations to these states.

When measured relative to average labor costs, between 1981 and 2003, West Virginia had the second-most restrictive minimum wage in the United States, ahead of only Mississippi. A more relevant comparison would be to compare West Virginia to its neighboring states in terms of minimum wage competitiveness. Virginia ranked 15th in the nation during this period followed by Maryland (16th), Ohio (23rd), Pennsylvania (28th), and Kentucky (40th). West Virginia faces a huge competitive disadvantage in this respect.

Making matters worse, West Virginia recently passed House Bill 4023 which will further increase our minimum wage to $5.85 in June of 2007 and $7.15 in June of 2008. Because of the disastrous economic consequences such a high minimum wage would create, many exemptions were given in West Virginia’s new minimum wage increase. The new minimum wage will only apply to employers with six or more employees and at least $500,000 annual gross income, and it does not apply to any business involved in interstate
commerce (Terry 2006). Therefore, the new legislation might not be as damaging as it appears on the surface. Had it not contained these exemptions, the unemployment created could have reached well into the double digits. What could be more damaging is federal legislation that would increase the federal minimum wage to $7.15. If prosperity is the goal, West Virginia’s delegation should lobby for statewide exemptions similar to those that U.S. House Speaker Nancy Pelosi is requesting for the island of American Samoa (Hurt 2007).

**PREVAILING WAGE RATES: PREVAILING WHERE?**

Although many people have never heard of them, ‘prevailing wage laws’ have been around since the Great Depression. Prevailing wage laws in West Virginia require that “all workmen employed by or on behalf of a public authority be paid the prevailing hourly rate of wages while engaged in the construction of public improvements” (West Virginia Division of Labor 2007a). This description obviously leads one to wonder why prevailing wage laws are necessary. If the wage was actually prevailing, there would be no need for the law. If the wages were prevailing, the market would dictate that workers earn these wages anyway.

Why, then, do prevailing wage laws exist? Much like occupational licensing and organized unions, prevailing wage laws are a way of blocking out competition and earning a higher wage through the political process and not through the market. Prevailing wage rates are actually determined by a survey done by the Commissioner of the West Virginia Department of Labor each year, and not by the market. Powerful special interests benefit significantly from prevailing wages set higher than the market rates, and as such, are often catered to as well.

Several studies have shown that, across the nation, prevailing wage rates do not correspond to the actual prevailing market wage rate. In Oregon, a study determined that rates required by prevailing wage laws were 25 percent higher than prevailing market rates on average. Furthermore, a report from the General Accounting Office, which is the auditing agency for the United States Congress, suggested that 57 percent of prevailing wage rates had been set at union wage rates without even actually having a true wage survey of the community done (Public Service Research Foundation 2001).

Consider some of the prevailing wages required by law in Kanawha County, West Virginia for 2007.13 A ‘painter’ requires a basic hourly rate of $21.43. A ‘bricklayer’ requires a basic hourly rate of $25.34. An ‘elevator mechanic’ requires a basic hourly rate of $34.83. Consider what the income would be for individuals working 40 hours a week for 50 weeks a year at these positions. Wage rates of $21.43, $25.34, and $34.83 correspond to incomes of $42,860 (Painter), $50,680 (Bricklayer), and $69,660 (Elevator Mechanic). More significantly, these rates only represent the basic hourly rates. There are additional fringe benefit requirements equal to about half of these basic hourly wage rates. There are over 45 other job classifications that have similar prevailing basic hourly rates (West Virginia Division of Labor 2007b).

Prevailing wage laws impede labor competition and drive up the costs of public projects, creating a larger tax burden for everyone. Considering there is no economic justification for them, prevailing wage laws appear to serve little purpose but to further the

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13 Each county in West Virginia has different prevailing wage rates.
interests of well-organized small subsets of workers at the expense of other workers and the general public of West Virginia. In order to improve our labor markets, West Virginia should follow the lead of other states that have repealed such laws or put state-wide bans on local prevailing wage laws.

**IMPROVING HUMAN CAPITAL THROUGH SCHOOL CHOICE**

A quality education greatly increases the productive capacity of an individual, thereby resulting in higher wages. However, most would agree that the primary and secondary education system in the United States has not performed satisfactorily. Students in U.S. public schools, who were once far ahead of students from other countries, have fallen seriously behind, jeopardizing our competitive position in the global economy. So what has gone wrong in our schools? Why has quality not risen as rapidly as it has in many other developed countries in the world? The answer is that in these other countries, including most of Europe, parents and students can choose which school they want to attend, creating serious competitive pressures between schools for students.

In *Capitalism and Freedom*, Milton Friedman points out that public education in the United States is a near perfect case of a monopoly. Like with any other monopoly, absent are the pressures and incentives to perform well and satisfy consumers—here parents and students. Unlike most goods, including college educations, students and their parents have had very little choice when it comes to the K-12 education of their children. If a child has a bad educational experience at a given school, it is very difficult for her to go elsewhere without moving; therefore schools face little to no competition. Schools usually receive funds regardless of performance. In fact, schools often receive more funds as a result of poor performance; yet evidence has demonstrated that increasing the funds of public schools rarely improves the quality of educational attainment on standardized exams. Rather, this monopoly situation creates perverse incentives that make it nearly impossible to reward the good teachers, and to fire the bad ones. Innovation is stifled, and parents have little control.

As a solution to this problem, Friedman proposed a voucher program where all children are given the money to attend school, but can make their own choice of where to go. One source of debate is whether these vouchers should be restricted to only public schools or whether students could use the vouchers also to attend private schools. Given that the average private school tuition is half of the average cost of educating a student at an American public school, this is an important consideration as all but the most exclusive private schools would be affordable to families with a voucher.14

Charter schools and vouchers are arguably the most common forms of school choice. Compared to voucher programs, charter school programs do not create the same entrepreneurial incentives, or at least not as strongly. Charter schools are publicly funded, but privately run. They operate under a written contract that details how the school will be

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14 For example, public K-12 per pupil expenditures in Monongalia County for 2004-05 were $8,091. For comparison, currently the three major private schools in the area have much lower annual tuition and fees. Annual tuition and fees are: Morgantown Learning Academy ($5,250 + fees = approximately $6,000), St. Francis Central Catholic School ($2,628 if Catholic, $4,572 if not), Trinity Christian School ($5,000 for K-5th, $6,200 for 6-8th grade, $6,300 for 9-12th grade). However, public K-12 per pupil expenditure data excludes debt service and capital improvements, so the differential is even greater if all costs were included.
organized and managed, and what students will be taught. While students from public schools in the area may transfer to the charter school, the charter school program does not directly create competition between the other schools. Voucher programs on the other hand, put all schools into competition with one another.

There are currently about 4,000 charter schools serving over one million students across the United States. With regard to vouchers, the states of Florida, Maine, Ohio (Cleveland only), Vermont, Utah, Wisconsin (Milwaukee only) and the District of Columbia are currently providing government funded vouchers for students.

The evidence on the effectiveness of voucher and charter school programs is clear—they increase the quality of education and lead to higher wages for those students in the future (and even result in a higher rate of entrepreneurship among graduating students, see Sobel and King, forthcoming). The positive impacts have been identified by Hoxby (1994; 2003a; 2003b; 2004) and Rouse (1998) when analyzing vouchers in Milwaukee, and Greene (2001) when analyzing the effects of Florida’s voucher program. In addition, Metcalf (1999) reports that students who participated in the Cleveland voucher program had significantly higher test scores than public school students in language and science. Interestingly, Hoxby points out that almost immediately after introducing vouchers, the existing public schools showed quick and massive improvements in measures of educational attainment and quality. Measures of educational quality in these public schools rose more in the first few years after the implementation of vouchers than they had over the entire previous thirty years.

Recently, Utah has been considering enacting the first entirely statewide voucher system. This would make Utah the state with the most ‘free market’ education system in the country. A recent report by the Andrew Coulson of the Cato Institute (2006) estimates an index measuring how market oriented the K-12 education systems are in the U.S. states. Currently, no U.S. state scores particularly well in this index, but it should be noted that West Virginia ranks near the bottom.

A voucher system in West Virginia would allow parents more choice in educating their children, and put competition to work to improve our schools. Everybody knows that monopolies are bad for consumers—they result in higher prices, and lower quality and customer satisfaction—and K-12 education is no exception. Local public schools should not have monopolies over students in their geographic area any more than we should give that same power to universities or to fast-food restaurants. Market competition can improve the quality of education. Better educational outcomes will mean higher worker productivity and higher wages for our children as a result. A better, and more competitive, K-12 education system is a clear route to prosperity in West Virginia.

PROMISE Scholarship: An Investment in Human Capital?

In 2002, West Virginia introduced the PROMISE (Providing Real Opportunities for Maximizing In-state Student Excellence) scholarship program with the intention of increasing investment in higher education.\footnote{The stated purpose of PROMISE is that it “is a merit-based scholarship program designed to keep qualified students in West Virginia by making college affordable.”} Initially, the program was designed to grant full tuition to an in-state public institution or equivalent dollar scholarship to an in-state private institution for
high school seniors graduating with a 3.0 grade point average and a score of 21 on the ACT or 1000 on the SAT. Although some of the details have changed since its inception, the basics of the program remain. At first, you might think that this program appears to be consistent with increasing living standards for West Virginians. Undeniably, investment in education is a significant and important way of investing in human capital and increasing worker productivity. However, as this book has repeatedly stressed, good intentions do not necessarily guarantee good results.

In order to make a real difference for the economic prosperity of West Virginia, PROMISE would have to actually affect two important details. First, it would have to encourage more students to go to college than before; otherwise this scholarship is simply transferring income amongst West Virginians. Second, and more importantly, it would have to encourage students to remain in West Virginia after graduation; otherwise this scholarship is actually subsidizing the growth of other states. As you may suspect, preliminary survey evidence in West Virginia, and evidence from similar programs in other states, suggests that PROMISE does not, and will not, stack up.

In a recent survey of the first graduating class of PROMISE scholars, 97 percent of those students said that they would have attended college anyway, while 71 percent said they would have attended college in West Virginia. Perhaps most importantly, 82 percent of respondents said that the PROMISE scholarship had no effect on their decision to remain in West Virginia after graduation. Finally, only 50 percent of the graduates responding said they planned to remain in West Virginia after graduation (Gorczyca-Ryan 2007). Again, it is entirely possible that a large portion of this 50 percent planned on remaining regardless of the PROMISE scholarship.

Exactly what does PROMISE do then? To answer this, it is important to consider who benefits most. The correlation between parents’ income and children’s academic achievement is very well established in the economic literature—parents with higher incomes tend to have more academically successful children, who are thus more likely to meet the eligibility criteria. While the reason for this relationship may be debatable, the result is not. Thus, the students most likely receiving the PROMISE scholarship are students who have parents with higher incomes. The fact that 97 percent of PROMISE graduates would have attended college anyway supports this. What then is PROMISE actually investing in? Students from families with high incomes no longer have to pay for college, which saves them around $15,000 per year. Essentially, this is a $15,000 annual refund for these upper-income families. PROMISE also costs the citizens of West Virginia about $40 million a year to provide.

While PROMISE may be well intentioned in trying to increase investment in human capital, the first step that must be taken to improve the labor situation in West Virginia is to get the policy environment correct. Without a policy environment that encourages worker productivity and competition, the jobs that college graduates want will not be in West Virginia. Investment in human capital for the state will continue to subsidize the growth of West Virginia’s neighbors. In the meantime, subsidizing higher education is highly unnecessary because most of the benefits go directly to the individuals attending college anyways. As Milton Friedman describes,

If higher education improves the economic productivity of individuals, they can capture that improvement through higher earnings, so they have a private incentive to get the training. . . It is against the social interest to change their
private interest by subsidizing schooling. The extra students—those who will only go to college if it is subsidized—are precisely the ones who judge that the benefits they receive are less than the costs. Otherwise they would be willing to pay the costs themselves. (1982 [1962], 179)

West Virginia’s economy would currently be best served by the elimination of PROMISE. At the very least, changing PROMISE to a ‘means-tested’ program, so that eligibility is restricted only to those with low incomes, would be a significant improvement.

**CONCLUSION**

This chapter has shown that in order to grow and prosper, West Virginia needs labor policy founded with the intention of increasing worker productivity and promoting competition in labor markets. Wage growth and better employment opportunities for all West Virginians can only be sustained by productivity growth. The key to fostering growth and prosperity in West Virginia is to promote policies that encourage capital investment.

Regulations are often enacted with the intent of protecting workers. However, these regulations often burden the very workers they were enacted to benefit. As we have shown, regulations lead to reduced wages and higher unemployment. Businesses avoid locating in states with burdensome labor regulations and high labor costs. More business activity means more competition for labor, promoting prosperity for workers in West Virginia. As Nobel Prize winning economist Milton Friedman puts it, “Competition for his services—that is the worker’s real protection” (1990 [1980], 246).

Government-imposed minimum wages, despite their popularity, actually harm the very workers they are intended to help through reductions in employment and other job opportunities. Many economies (such as Hong Kong, Japan, South Korea, and Taiwan) began their economic transition with wage levels much lower than the wages in the already-developed world. As the firms in these countries increased labor productivity, the wages in these countries naturally increased as well. This process of economic development is the only true route to higher wages and income. Recent federal minimum wage legislation passed by the U.S. Congress will impact much of the country adversely. Economic evidence shows that lower-income states such as West Virginia will be harmed the most.

Finally, the education system in West Virginia can be greatly improved by increasing competition among primary and secondary schools through enacting vouchers and school choice programs to end the current monopoly that strangles our K-12 education system. We also recommend eliminating the PROMISE scholarship (or at least restricting eligibility to only those with low income).

A better and more efficient educational system, and a more competitive labor-market, will create the necessary environment to make West Virginia a desirable location for tomorrow’s promising business. Because labor is our most important and valuable resource, *UNLEASHING CAPITALISM* within our educational system and labor markets can result in massive and immediate increases in the standard of living for all West Virginians.

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16 Johan Norberg (2004) suggests that the path of development in these countries is not anomalous; a similar path has been traveled by all prosperous economies whether it be recently or the distant past.
REFERENCES


CHAPTER 11

QUIT PUNISHING THE WORKING POOR: REDUCE WORK DISINCENTIVES IN THE WELFARE SYSTEM

by Anthony C. Gregory and J. Sebastian Leguizamon

Middleport, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 82.05° W & Latitude 38.99° N).
In broad terms, West Virginia’s sluggish long-term economic growth is due to a wide range of policies that inhibit the ability of our state economy to allocate resources to their most productive uses. Undoubtedly, West Virginia’s most valuable resources are the hard-working, dedicated men and women who make up our workforce. When policies infringe on the productive use of our labor resources, the consequences can be devastating because high wages and incomes are the result of labor being employed productively (see Chapters 3 and 10). As we will see in this chapter, West Virginia’s current welfare system unintentionally retards prosperity by interfering with the incentives faced by individuals when they make employment decisions.

The welfare system in West Virginia is intended to help low-income citizens. As this book has repeatedly stressed, however, just because a program is designed with good intentions does not guarantee that it will produce good outcomes. Ideally, the welfare system is designed to provide temporary relief for those persons who are either between jobs or are injured, until they can return to gainful employment, and to supplement the incomes of residents who are currently employed but do not earn enough to sustain a basic standard of living.

Academic studies evaluating the effectiveness of welfare programs measure success in terms of the number of able-bodied recipients who eventually return to gainful employment, or who increase their own wage income to a level sufficient to move them up and out of the welfare system. At the other end of the spectrum, programs are considered to be ineffective when they create significant long-term welfare dependency among the able-bodied population. In this chapter we use these criteria to examine the effectiveness of West Virginia’s welfare system.

We will examine a variety of programs including Temporary Assistance to Needy Families (TANF, which is known as WV Works), Medicaid, Food Stamps, the Earned Income Tax Credit, Supplemental Security Income (SSI), and disability benefits.
This chapter will first illustrate the importance of high employment and labor force participation rates for a state’s economy. We then turn to an analysis of the effective (‘implicit’) tax rates faced by individuals receiving public assistance. Our calculations suggest that the structure of welfare benefits is such as to face the lowest income West Virginians with effective tax rates two to three times higher than the tax rates faced by even the richest Americans. No one single program is the culprit; instead this is the result of the failure of policy makers to explicitly consider the combined benefit reduction rates of these many welfare programs as they work in conjunction with one another. We then turn our attention to an analysis of similar problems in the structure of disability benefits. Finally, we conclude with policy recommendations that would correct these problems to create a more productive (and wealthy) labor force in West Virginia.

WEST VIRGINIA’S WILLINGNESS TO WORK

In recent years, West Virginia’s unemployment rate has been close to the national average, which typically indicates a healthy economy. Yet, residents’ income levels and wage growth have continued to lag behind that of other states. The reason for this apparent contradiction is that the unemployment rate is a misleading measure as it fails to provide a complete picture of labor market conditions due to the very way it is defined.

The unemployment rate is calculated as the number of persons who are unemployed as a percent of the active labor force (Bureau of Labor Statistics 2006). In turn, the labor force is defined as the total number of persons who are either employed or unemployed. The omitted category is those individuals who are not in the labor force, for example students and retirees. Figure 11.1 illustrates the relationship among these different categories.

Figure 11.1: Population, Labor Force, Employment, and Unemployment in West Virginia (2004)

Civilian Non-institutional Population
(aged 16 years and older)

= 1,452,000

Not in the labor force
= 657,000

Employed
= 753,000

Unemployed
= 42,000

Labor Force
= 795,000

Note: Box sizes not to scale, for illustration purposes only. Source: Bureau of Labor Statistics (2004).
The labor force is calculated as the number employed (753,000) plus the number unemployed (42,000), or 795,000 persons. The unemployment rate is then calculated as the number unemployed (42,000) divided by the labor force (795,000), or 5.3 percent.

\[
\text{Unemployment Rate} = \frac{\text{Number Unemployed}}{\text{Labor Force}} = \frac{42,000}{795,000} = 5.3\%
\]

Not everyone who is really ‘unemployed,’ however, is actually counted as unemployed by the Bureau of Labor Statistics. To be counted as unemployed a person must be actively seeking employment. Stay-at-home spouses, for example, who are not currently trying to find employment, are not counted as unemployed because they are not actively seeking outside employment. More importantly, if an unemployed worker decides to quit looking for work, they will no longer be counted as unemployed—even if they still desire to work and would take a job if one was offered to them. Instead these individuals are counted as ‘not in the labor force’ for the purposes of calculating the unemployment rate. While a low unemployment rate can potentially indicate a healthy economy, it suffers from the problem of excluding those persons who are eligible to work, yet choose not to actively seek employment opportunities.

Economists have long been aware of this problem with the measurement of the unemployment rate and this is why sudden drops in the unemployment rate during a recession do not necessarily point to an economic recovery. The drop instead could simply be caused by many unemployed job seekers simply deciding to quit looking for work. To overcome these problems, most economists prefer to examine the ‘labor force participation rate’ in conjunction with the unemployment rate. The labor force participation rate is calculated as the percentage of the civilian non-institutional, working-age population (16 years of age and older) who are in the labor force (meaning they are either employed, or unemployed and are actively seeking work). West Virginia’s labor force participation rate is equal to the labor force (795,000) divided by the relevant population (1,452,000), or 54.7 percent.

\[
\text{Labor Force Participation Rate} = \frac{\text{Labor Force}}{\text{Population}} = \frac{795,000}{1,452,000} = 54.7\%
\]

West Virginia’s labor force participation rate of 54.7 percent implies that just over half of all able-bodied, working-age persons actually participate in West Virginia’s labor force. West Virginia’s labor force participation rate ranks below every other state, and is even a distant 5 percentage points below the 49th ranked state, Louisiana (Bureau of Labor Statistics 2004). This ranking is not the result of a high elderly population, nor a large percent of young people attending school. When the labor force participation rate is calculated excluding these two groups (that is, using only individuals aged 25 to 64) West Virginia ranks a distant 50th at 67.7 percent, more than 6 percentage points below 49th ranked Tennessee.

This low labor force participation rate puts West Virginia’s economy at a distinct disadvantage in generating high standards of living and economic growth. As Figure 11.2 (on the following page) shows, across states there is a clear positive relationship between average income levels and labor force participation rates. Figure 11.3 (also on the following page) shows that not only do states with higher labor force participation rates have higher average levels of income, but also faster income growth.
Figure 11.2: Labor Force Participation and Per Capita Income


Figure 11.3: Labor Force Participation and Annual Income Growth

The choice of so many working-age West Virginians not to participate in the labor force reduces our potential economic output and thus adversely affects the well being of all state residents. Having a large number of able persons not in the labor market quite simply represents a huge unused productive resource. Merely closing our five percentage point labor force participation rate gap with 49th-ranked Louisiana would introduce an additional 72,600 workers into West Virginia’s economy. Even using conservative estimates, this would increase the size of our state’s economy by almost $1.1 billion.

In the long-run, a relatively low percentage of the population not participating in the labor force impedes overall economic growth; fewer workers translates into fewer productive jobs, less wealth creation, and lower overall income.

**LIVING BELOW THE LINE IN WEST VIRGINIA**

Why might relatively fewer West Virginians be pursuing employment compared to other states? While West Virginia’s relatively higher median age could indicate a greater number of early retirees, other ‘old-age’ states such as Maine, Montana, and Florida, have much higher labor force participation rates. In addition, as we already mentioned, even among only those aged 25 to 64, we have by far the lowest labor force participation rate in the nation, and much lower than our neighboring states. While West Virginia’s labor force participation rate among 25 to 64 year olds is 67.7, Ohio’s is 79.1, Pennsylvania’s is 79.7, Virginia’s is 80.0, Kentucky’s is 81.4. Thus, on average, our neighboring states have about a 13 percentage point higher labor force participation rate among 25 to 64 year olds. Alternatively stated, out of every 100 West Virginians in this age group, 13 fewer work than among the same age group in our neighboring states.1

One possible explanation is that the benefits of employment for low-income residents may barely, or in some cases clearly do not, outweigh the benefits of relying on federal and state aid. West Virginia ranks near the top among states in terms of public aid recipients and number of residents below the poverty line.2 In 2003, 6.4 percent of residents were receiving public assistance, trailing only the District of Columbia, and 17.4 percent of the population was living below the federal poverty line, the third highest level among U.S. states (U.S. Census Bureau 2003).

Government public aid programs are usually meant to sustain individuals and encourage them to move upwards and out of poverty. When these programs provide individuals with a strong disincentive to find employment and leave public assistance, however, they end up creating more poverty—not less.

Figure 11.4 (following page) illustrates how poverty levels have actually increased on average between 1980 and 2003 in the highest public aid states, including West Virginia (with the exception of the District of Columbia, which typically experiences large variations, and Kentucky). On the other hand, in the lowest public aid states, poverty levels are on average now relatively lower (with the exception of Colorado).

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1 The rural nature of our state might be responsible for the low labor force participation as it presents transportation barriers to employment, yet other predominantly rural states do not suffer from such low labor participation rates and a similar data analysis shows that we are far below other rural states.

2 ‘Public aid recipients’ refers to the percentage of TANF and SSI recipients as of December 2003.
Government aid programs come in a variety of shapes, sizes, and benefits. Public aid, as defined in Figure 11.4, refers to Supplementary Security Income (SSI), an income supplement program for aged, blind, and disabled persons who have little income, and Temporary Assistance to Needy Families (TANF) (Social Security Administration 2006). TANF came into existence during the welfare reforms of the mid-1990s and gives states wide-ranging flexibility with federal funds to mold their own assistance programs (Department of Health and Human Services 2006); West Virginia’s program is referred to as WV Works. States have a fair amount of discretion in determining the recipients and services provided with TANF funds, given that they remain within broad federal guidelines.

There is no denying that some public assistance programs can provide meaningful, even essential, benefits to those in need. However, these programs are supposed to help the people they assist, not trap them in the welfare system. But frequently the design of these programs is such that they actually create strong disincentives for recipients to earn income by finding employment. When this is the case, it has devastating economic consequences.

The reason welfare programs create these disincentives is because, for obvious reasons, the benefits a recipient receives are reduced as they earn income. For example, suppose that a person who earns no income from employment receives $10,000 in benefits, while a person who earns $6,000 receives $5,000 in benefits. A person who decides to accept this job will have total spendable income of $11,000; only $1,000 more than if they didn’t work at all. Given that taking the job also has additional costs such as transportation, child care, and clothing (among others), it is unlikely this person would choose to work.
To measure these disincentive effects, economists calculate what is known as the ‘implicit’ tax rate. The logic of this calculation is simple; if a regular worker received a $6,000 annual raise, and the worker’s net pay (reflecting spendable income) went up by only $1,000 as a result, the worker must have lost $5,000 of the $6,000 raise in taxes on that additional income. The tax rate would be calculated as $5,000 ÷ $6,000, or 83.3 percent.

The implicit marginal tax rate faced by a welfare recipient is calculated in a similar manner. Continuing our earlier example, the aid recipient only has an additional $1,000 of spendable income when he or she earns $6,000 more in wage income. The person gets to ‘keep’ only one-sixth of this additional income, implying an implicit tax rate of five-sixths or 83.3 percent. Mathematically:

\[
\text{Implicit Marginal Tax Rate: } = 1 - \frac{\text{Change in Spendable Income}}{\text{Change in Earned Income from Employment}}
\]

To consider one last hypothetical example, suppose that when the recipient earns $6,000 in income from employment, benefits are reduced from $10,000 to $3,000 (rather than to $5,000 as before). Now, by holding employment, the individual would have spendable income of only $9,000; the $6,000 of earned income plus the $3,000 in benefits. When compared to the $10,000 in spendable income (all transfer benefits) received when the person doesn’t work at all, he or she actually has less spendable income when holding employment. Because in this case spendable income actually falls as income is earned from employment, the implicit tax rate must be greater than 100 percent. Indeed it is—according to the formula above, the person’s implicit tax rate would be 117 percent. Thus, an implicit tax rate greater than 100 percent corresponds to a situation in which earning additional income from employment actually reduces the aid recipient’s spendable income.

While most aid programs are careful to consider how rapidly benefits are reduced as aid recipients earn income, to avoid imposing these high implicit tax rates, the problem is that aid recipients often qualify for many different programs, all of which have different and varying benefit-reduction rates. The combined implicit tax rates on these many different programs, when taken together, are what must be considered when examining the work disincentives created by the structure of the welfare system in West Virginia. In addition, as a person begins earning income from employment, not only are benefits reduced, but the person must also now pay both federal and state income and employment taxes on that income. This also needs to be added into the calculations to arrive at the final implicit marginal tax rate.

While the idea behind how these implicit tax rates are calculated is fairly simple, actually making the calculations is not. It requires taking a specific representative person, say a single mother with two children, and then going through the specific requirements for each and every program for which she qualifies. In addition, sample state and federal income tax forms must be completed to account for any additional taxes, deductions, and credits. This process is then repeated for different levels of income. At each level of income, the mother’s total benefits are added to her income, her taxes subtracted, to find her spendable income. Only then is possible to calculate the implicit tax rates she faces.

To illustrate these employment disincentives in West Virginia, we have undertaken these calculations for a single mother with two children living in our state. Depending on her income, this mother is eligible for one or more of the following programs: TANF, Medicaid, Food Stamps, and the Earned Income Tax Credit. In each of the four programs, benefits are
reduced and/or eliminated as earned income rises. Also depending on her income, she will be subject to Social Security taxes, as well as federal and state income taxes. The results of these calculations are shown in Figure 11.5

**Figure 11.5: The Effect of Transfer Benefits and Taxes on the Incentive of a West Virginia Mother of Two to Earn Income**

<table>
<thead>
<tr>
<th>Annual Gross Wage</th>
<th>Transfer Benefits*</th>
<th>Income &amp; Employment Taxes b</th>
<th>Spendable Income</th>
<th>Implicit Marginal Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$11,026</td>
<td>$0</td>
<td>$11,026</td>
<td></td>
</tr>
<tr>
<td>$2,000</td>
<td>$10,012</td>
<td>$324</td>
<td>$11,688</td>
<td>66.9%</td>
</tr>
<tr>
<td>$4,000</td>
<td>$6,986</td>
<td>$648</td>
<td>$10,338</td>
<td>167.5%</td>
</tr>
<tr>
<td>$6,000</td>
<td>$5,986</td>
<td>$972</td>
<td>$11,014</td>
<td>66.2%</td>
</tr>
<tr>
<td>$8,000</td>
<td>$5,694</td>
<td>$1,319</td>
<td>$12,376</td>
<td>31.9%</td>
</tr>
<tr>
<td>$10,000</td>
<td>$5,906</td>
<td>$2,043</td>
<td>$13,864</td>
<td>25.6%</td>
</tr>
<tr>
<td>$12,000</td>
<td>$5,832</td>
<td>$2,547</td>
<td>$15,286</td>
<td>28.9%</td>
</tr>
<tr>
<td>$14,000</td>
<td>$5,220</td>
<td>$3,051</td>
<td>$16,170</td>
<td>55.8%</td>
</tr>
<tr>
<td>$16,000</td>
<td>$4,376</td>
<td>$3,555</td>
<td>$16,822</td>
<td>67.4%</td>
</tr>
<tr>
<td>$18,000</td>
<td>$3,859</td>
<td>$4,059</td>
<td>$17,801</td>
<td>51.1%</td>
</tr>
<tr>
<td>$20,000</td>
<td>$3,436</td>
<td>$4,563</td>
<td>$18,874</td>
<td>46.4%</td>
</tr>
</tbody>
</table>


If this single mother does not hold employment, and thus earns zero income, she will have $11,026 in spendable income, all of which is welfare (‘transfer’) benefits. When she decides to begin working, the first $2,000 she earns in gross income increases her spendable income by only $662, equating to a marginal tax rate of nearly 67 percent. As the mother reaches a level where some benefits are completely removed, at $4,000 of earned income for instance, marginal tax rates exceed 150 percent causing overall spendable income to actually fall as she earns additional wage income. At a gross earned income level of $6,000 the mother actually has less spendable income than if she didn’t work at all ($11,014 versus $11,026). Up to $8,000, total spendable income is little changed from that at zero earned income. Finally, suppose that this mother gets offered a full-time job earning $20,000. Even with a full-time job, this single mother has only $7,848 in additional spendable income. Again, taking into account the costs of holding employment, such as transportation and child care, it is unlikely that this mother would choose to work.

When additional work results in flat or falling income, the incentives to move beyond public assistance are undoubtedly weak. It is important to note that nowhere are we saying that aid recipients are lazy—instead we are saying that the personal reward to work is so low that very few recipients chose to hold employment. Rather than penalizing the working poor, such as this single mother of two, for increasing work-related earnings, the welfare system must reward individuals for pursuing employment opportunities. Given our findings above it is, unfortunately, not surprising that our current combination of stagnant poverty and high percentage of public aid assistance is associated with the nation’s worst labor force participation rate.
Do these disincentives translate into a lower desire to work for West Virginia aid recipients? In 2004, only 11.7 percent of adult TANF recipients met the minimum work participation standards by averaging at least 30 hours per week in work-related activities during a month. While West Virginia still met the minimum federal work participation requirements according to TANF, we ranked 49th among the U.S. states. Moreover, ranking as the second highest rate in the nation, 75.2 percent of adult TANF recipients in our state averaged zero hours in work-related activities in 2004, as shown in Figure 11.6 (U.S. Department of Health and Human Services 2004).

This leads us to conclude that while WV Works has succeeded in reducing the number of TANF recipients since its enactment in 1997, the program is not producing clear results in terms of encouraging labor force reentry by recipients.

3 Work-related activities include unsubsidized employment, training and education, and job-search activities.
4 Furthermore, it is unclear whether former recipients are now officially in the labor force or merely had their benefits removed after the sixty-month maximum reliance period. Such low work-related activity participation by current TANF recipients does not suggest that a large number of former recipients are likely now in the workforce. A 2001 study of former TANF recipients in the U.S. found that while 71 percent were employed sometime during the next year upon leaving the program, only 37 percent held a job for the full year after leaving (Acs, Loprest, Roberts 2001).
UNABLE OR UNWILLING TO WORK?

Disability insurance is yet another welfare program that can create poor incentives for previously injured, but able-bodied, West Virginians to rejoin the labor force. With an economic history of relatively dangerous occupations—coal mining, forestry, and heavy industry—it might come as no surprise that West Virginia leads the nation in the percentage of residents receiving federal disability payments (SSA 2005). What comes as a surprise, and raises strong concern, is how much of a lead we actually have.

According to the Social Security Administration, nearly 4.4 percent of West Virginia’s total population received federal disability benefits in 2005. The next highest state, Kentucky, had a 3.8 percent disability benefit rate. Do disability benefits also create strong disincentives to work? Consider the strong negative correlation between the percent of the population receiving federal disability benefits in 2005 and labor force participation, as shown in Figure 11.7. While more disabled persons should be negatively correlated with labor force participation, West Virginia’s high level of disability, and its subsequent effect on labor force participation, is dramatically out of line with other U.S. states.

Figure 11.7: Labor Force Participation Rate versus Percent of Population Receiving Federal Disability Benefits

Sources: U.S. Census Bureau and Social Security Administration (2005).
According to Hammond (2006), while

it is likely that states with high concentrations of risky industries will naturally have higher shares of residents receiving disability income...the relatively high share of residents receiving disability payments in the state may also be due in part to rent seeking behavior on the part of some West Virginia residents.

‘Rent seeking,’ a topic first discussed in Chapter 3, here refers to the practice of otherwise healthy, ineligible recipients wrongfully receiving disability benefits through a flawed eligibility determination process. While these disability benefits are federally administered, states can play a large role in the determination of recipients. The current poor condition of West Virginia’s judicial system might be allowing this behavior, and reforms to our legal and judicial systems that could help reduce frivolous disability claims are discussed in the next two chapters of this book.

An improved screening process for disability applicants could also aid in reducing the number of non-disabled person receiving benefits. For instance, one proposal by economists Benitez-Silva, Buchinsky, and Rust (2004) involves an alternative screening mechanism which relies on an applicant’s health data and screening to produce a ‘disability probability.’ By granting benefits only to those with the highest probability of disability, this type of improved eligibility process could reduce the awarding of benefits to non-disabled applicants from 29 percent to 18 percent, while also lowering the wrongful denying of benefits to truly disabled applicants by approximately 14 percentage points. Revamping the eligibility determination process would likely lead to lower costs, better targeting of benefits to those who rightfully need them most, and a reduced reliance on benefits by other individuals.

Aside from the potential of a too liberal disability determination process, the actual level of disability benefits in West Virginia also likely acts as a disincentive to pursue employment. In terms of the value of disability benefits per recipient, West Virginia’s 2005 monthly average of $984.80 ranks as the fifth-highest among all states (SSA 2005). A study by David Autor and Mark Duggan (2002) concluded that “the generosity of disability benefits leads to reduced participation in the labor force.” Autor and Duggan continue by noting that “the disability benefits formula is progressive but not indexed to regional wage levels, [therefore] workers in low wage states face significantly higher earnings replacement rates than workers in high wage states.” The earnings replacement rate refers to the ratio of disability income to prior wage earnings. In a low-wage, low cost-of-living state such as West Virginia, these high monthly benefits can act as a strong deterrent to seeking employment and lead instead to attempts to qualify for disability payments.

Disability recipients in West Virginia receive, on average, $11,800 per year in benefit income.5 For many of these individuals, if they worked, taxes would quickly reduce earned income well below the benefits one can receive from disability. Clearly, the disability program creates another disincentive to pursue employment for some potential members of the West Virginia workforce.

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5 Average monthly disability-benefit data from the U.S. Social Security Administration (2005).
QUIT PUNISHING AND BEGIN REWARDING

West Virginia has the lowest percentage of working age individuals participating in the labor force, while remaining high in terms of poverty and the proportions of public assistance and transfer payment recipients. Several characteristics of the state may contribute to these rankings, yet one cannot deny the enormous disincentive effects of West Virginia’s current public aid programs illustrated here.

In this chapter, we have demonstrated how a typical welfare recipient faces extremely high implicit marginal tax rates as earned income from employment rises. Moreover, other transfer programs, such as disability, may lead work-eligible individuals to pursue government assistance due to the generosity of benefits and a flawed qualification process. Whether current aid recipients stay at or below the poverty line due to increasing income penalties or able individuals elect to receive government payments instead of an earned wage, these conditions adversely affect the health of West Virginia’s economy. As evidenced by a stagnant poverty level and income gap between our state and the rest of the nation, these redistribution programs have had limited success in terms of growing productive human capital and raising our standard of living.

We strongly believe that accelerated policy reform can empower low-income individuals to move out of poverty and into employment. Specifically, reform needs to pay specific attention to the implicit tax rates that the working poor face as their earned income from employment increases, and benefits are subsequently reduced. As we have shown, tax rates can jump to extremely high levels, two to three times as high as the tax rates faced by even the richest Americans.

West Virginia needs to utilize the flexibility in TANF funds given by the federal government to reform the payment structure within our welfare system. Public aid that motivates and gives incentives for employment is badly needed, as evidenced by poverty rates today above those of twenty-five years ago and an exceedingly high number of TANF recipients not working. As a start, the state should require and enable greater work-related activity by recipients; with over 75 percent of adult recipients not participating in work-related activities even a small improvement would be beneficial. Moreover, West Virginia’s nation-leading disability benefit rate must be reduced through a stricter and simpler determination process that addresses wrongful disability claims via the judicial system.

Without continued reform, we risk the possibility of some individuals merely maintaining their low economic status, with little hope of upward socioeconomic mobility for them, or their children. Our state’s economic future depends on encouraging able individuals to look for better opportunities; opportunities that can be found in the job market rather than in a monthly government check. The barriers, discouraging obstacles, and disincentives to the full benefits of employment must be reduced. Rewarding working individuals with what they rightly deserve, while directing effective benefits only to those in need, are the first steps towards making the most out of West Virginia’s most valuable resource—our labor.
REFERENCES


CHAPTER 12

REDUCE THE COST OF CIVIL LITIGATION AND DEPOLITICIZE THE COURTS

by Michael J. Hicks

Kyger Creek Power Plant near Addison, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 82.11° W & Latitude 38.93° N).
The structure and excesses of West Virginia’s civil litigation system impose considerable cost on the state’s economy, and is responsible for dampened productivity growth and wages. The cost to the state’s citizenry is high, and concern over the state’s judicial system is widely appreciated outside the state. In several indices and reports, into the distant past, West Virginia has consistently ranked at the bottom of effective civil litigation systems. The result is that firms outside the state avoid relocating into West Virginia, dampening investment. Further, firms within the state, especially those with a nexus in other locations, divert investment to other areas to avoid the state’s civil litigation system. It is through this transmission mechanism that productivity growth has been stifled, and wages kept stagnant.

In this chapter, I review the state of West Virginia’s civil litigation system and place it, and the debate regarding civil litigation, into a national context. I then review existing studies that explicitly link civil litigation systems to economic performance. This is followed by the results of a national empirical study. I describe the approach and findings, and conclude with a summary and policy recommendations. Chapter 13 will continue the discussion of our legal system, focusing specifically on reform proposals for West Virginia.

BACKGROUND

Excessive tort and civil litigation costs rank high among the complaints of a wide variety of groups across the country. In West Virginia, concern about the impact of the civil litigation system on the economy is illustrated by complaints about the Broadnax decision and a recent special legislative session called specifically to deal with medical malpractice insurance.

At the national level, the most egregious tort cases provide compelling evidence of a runaway system (e.g. $80,000 for a spilled cup of coffee at McDonald’s, or $500,000 for a broken toe in New York). The billing practices for legal services (e.g., the high hourly rate) does little to generate trust in the system’s efficacy. These concerns typically manifest themselves in efforts to modify public policy to reduce civil litigation—primarily tort costs.
In contrast, consumer, legal, labor, civil rights, and environmental groups argue that
civil litigation is an important constitutional protection. They oppose greater restrictions on
civil litigation on the grounds that access to the courts remains a difficult proposition for
many citizens and that safeguards for individuals are a hallmark of our civil society.

Such arguments suggest that there is not a broad agreement that our legal system has
resulted in an optimal amount of litigation or that the system is achieving the goals of equity
and efficiency. However, these groups also share several concerns. Business groups rightly
are worried about the impact of litigation costs on commerce. Consumer and environmental
groups are concerned that high legal and litigation costs prevent many citizen from gaining
access to the courts. Proponents of easier court access point to high lawyer fees (33 percent
contingency fees for example) and administrative ‘log jams’ at state courts as chief
hindrances to gaining reasonable civil litigation.

The direct costs of civil litigation are easily defined—lawyers and expert witness fees,
the opportunity cost of management (time spend preparing for litigation), and direct payments
to plaintiffs. Secondary costs include more expensive contracting procedures and other
defenses against future litigation, as well as reduced capital investment due to litigation-
induced uncertainty regarding future profits. This latter issue potentially reduces productivity
and economic growth. Thus, the very real concerns expressed by both groups offer potential
policy adjustments. This current investigation confines its discussion to the findings regarding
tort reform and impacts on productivity growth.

ISSUES IN TORT REFORM AND CIVIL LITIGATION COSTS

The majority of legal costs borne both privately and publicly are not the result of civil
litigation. In comparison, criminal litigation is very expensive, both for the public and the
accused. Further, legal expenses for routine business creation, expansion, contracting and
other activities dominate the non-criminal proceedings. Where businesses undertake legal
expenditures in support of basic business activities, legal costs are simply part of the inputs to
production. The real concern is that, at the margin, a distortionary level of legal activities
results from our civil litigation system.

The most enduring issue is the partisan election of state judges in West Virginia. State
supreme court justices are appointed by the governor in 29 states, while popular elections are
used in the other 21 states.1 Among states using popular elections, only eight (including West
Virginia) rely on partisan elections in which the candidates run as a member of a political
party (e.g., Democrat or Republican). The remaining 13 states use non-partisan elections in
which candidates are not officially affiliated with a political party and run on name alone.2

Thus a persistent issue in the academic literature is whether it is better to have judges
that are appointed or elected. Among the many arguments put forth by those in favor of
appointing judges is that elections bring a higher degree of politics into court rulings and

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1 In some states the governor can only appoint from a slate of candidates put forth by a nominating commission,
however, the governor generally appoints some or all of the members of this nominating committee. For this
reason, the literature generally does not make a distinction between these two alternatives.

2 The states using partisan elections are Alabama, Illinois, Louisiana, Michigan, Pennsylvania, Ohio, Texas, and
West Virginia. Note that while party affiliations do not appear on the ballot in Ohio, candidates are nominated
for the court by a party and thus are considered to be running in a partisan election.
thereby undermine confidence in the judiciary. The research on this topic is so large and extensive that interested readers should refer to Link (2004) and Hanssen (2004) for more comprehensive reviews of this literature. The main conclusion from this research, however, is that states using elections do worse in measures of legal system quality.

There is not only evidence that legal outcomes differ depending on whether judges are appointed or elected, but also depending on whether partisan or nonpartisan elections are used. Hanssen (2000) finds, for example, that partisan elected judges side less frequently with challengers to a regulatory status quo, and Hall and Brace (1996) find that partisan elected judges dissent less frequently on politically controversial issues. Sobel and Hall (2007) find that states with elected state supreme court justices have lower overall legal system quality, and that legal quality suffers even worse when they are elected on a partisan basis.³

The extremely politicized nature of partisan elections was witnessed in the 2004 state supreme court election in West Virginia. It was the most ‘expensive’ judicial election in the nation in 2004, with the Democratic incumbent spending $376,000 to the opponents $540,000. In addition, this spending was dwarfed by the spending on political advertisements and publicity by other groups in the state. One pro-incumbent group spent more than $1 million by itself, while the largest anti-incumbent group spent $2.5 million.

Figure 12.1, from Sobel and Hall (2007), shows the average rankings and scores from the Institute for Legal Reform’s State Liability Systems Ranking for states grouped according to the method of selecting state supreme court judges.

<table>
<thead>
<tr>
<th>Type of System</th>
<th>Average Ranking</th>
<th>Average Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appointed</td>
<td>21.1</td>
<td>61.0</td>
</tr>
<tr>
<td>Elected</td>
<td>31.5</td>
<td>53.5</td>
</tr>
<tr>
<td>Partisan</td>
<td>39.9</td>
<td>47.9</td>
</tr>
<tr>
<td>Nonpartisan</td>
<td>26.4</td>
<td>56.9</td>
</tr>
</tbody>
</table>


In this index, the average ranking of the states appointing judges is 21st, while the average ranking for states using partisan elections is 40th (in the scoring system, the average quality score differs by a sizeable 13 points). States using nonpartisan elections still tend to score worse than states appointing judges; however the difference is not nearly as large. This data suggests that doing away with partisan supreme court elections in West Virginia would improve the quality of our state’s legal system. By moving to nonpartisan elections (or gubernatorial appointment) our legal system could be improved.

Too often, the mechanics of tort reform dominate discussions regarding state-level civil litigation. This is useful, but understates the potential impact, since effects on individual businesses (especially corporations) are not limited to individual state reforms, but are influenced by litigation in other states. Research into the impact of court politics on litigation

³ Their study also finds that legal outcomes (and quality scores) differ depending on which political party controls the state supreme court, particularly in areas such as eminent domain, workers compensation, and medical malpractice.
outcomes found that tort awards were typically ‘exported’ to out-of-state firms (Helland and Tabarrok 2002). These authors found that tort awards against out-of-state firms were 42 percent higher in states where judges were subject to partisan elections.4

The authors disentangled the effects of anti-business politics (using an index of ratings of statewide elected officials) and the impact of partisan elections. They found across all states that elect judges that roughly two thirds of the higher awards were due to out-of-state defendants, while the remainder of the award differential was due to the anti-business voting record of statewide elected officials (reflecting a general anti-business environment in the state). These authors are simply arguing that the process of elections impacts the outcomes of the size and frequency of awards against out-of-state defendants.

These findings suggest that tort reform in the state where a firm’s goods are sold may be more important for some industries than tort reform in their home state. A paper published by the National Bureau of Economic Research found that liability reform has the greatest impact on industries whose goods or services are both produced and consumed in the same state (Campbell, Kessler and Shepherd 1995). These findings also suggest that broad tort reform is more important in influencing business action than is a simple effort to limit damages. The problem was probably best summarized by retired West Virginia Supreme Court Judge Richard Neely (1988, 4):

As long as I am allowed to redistribute wealth from out-of-state companies to injured in-state plaintiffs, I shall continue to do so. Not only is my sleep enhanced when I give someone else’s money away, but so is my job security, because the in-state plaintiffs, their families, and their friends will reelect me.

Later I discuss the impact of reforming tort laws, but clearly the evidence presented above suggests that there are indeed inter-state differentials that meaningfully impact firm costs. Also, reform in one state may affect firms in other states.

There have been periods in which the tort reform movement has swept the nation. Post World War II, the 1970s and 1980s saw two significant waves of legislative activity. The first of these primarily addressed medical malpractice insurance and came in response to physician and hospital claims that excessive damages were increasing their insurance rates, and leading to higher medical costs. Today, this is a familiar story. Evidence regarding the factual basis for claims made in the 1970s is mixed. As with today’s malpractice debate, it seems likely insurance rates were rising, but the prime cause may not have been increased malpractice claims. A 1988 study found that rapid declines in real interest rates in the 1970s forced insurers to raise premiums to compensate for poorly performing stocks and other securities (Abraham 1988). Since the claims of rapid insurance rate increases are accompanied by declining asset performance nationally, it is equally likely that the same effect is occurring today. This is even more likely because of eased regulatory restrictions that permit more flexible financial asset integration in the finance and insurance industries.

The second wave of tort reform occurred in the 1980s and resulted in considerable state-level changes across the country. The most visible changes essentially comprised: punitive damage reform, caps on damages and attorney contingency fees, and reform of the

4 This 42 percent increase is the tort award differential conditioned on the probability of winning in these states. This means that both the award and probability of plaintiffs winning were higher in the out-of-state cases. The combination of these two factors meant that the average award differential was higher.
collateral source rule (limiting awards when the plaintiff was partially liable). These issues surrounded the most spectacular cases used to lobby for tort reform. More technical issues, such as how payments were distributed over time, over whether parties that were only partially liable may be required to pay the full amount when the responsible party was unable, and the relative level of negligence also figured prominently in reform efforts of the 1980s.

In West Virginia, current tort and civil litigation policy reform efforts include changes in the collateral source rule and rules pertaining to relative negligence. Damage caps and uniform standards for punitive damages are also concerns of the Chamber of Commerce and other lobbying groups. More broadly, the issue of tort exportation (also known as venue fairness) and the issue of judicial selection are issues taken up by West Virginia’s Chamber.

Litigation costs involve both public and private expenditures. Direct public costs include expenditures associated with establishing and operating courts. Direct private costs involve attorney and litigation fees (later I will measure litigation costs as the value of legal services provided in each state). Indirect costs affect both public and private entities, just as incentive effects influence behavior. It is the incentive effect that generates indirect costs. Examples of indirect costs include re-directing investment (the ‘Delaware effect’), over investment in legal services, or a decision not to introduce a product due to liability concerns.

It is worth noting that damage awards, which firms view as a cost, are socially optimal when they reflect true damages. They provide the incentive for firms to make appropriate decisions involving the tradeoff between production cost and product safety. The problem, however, is there is no ‘invisible hand’ leading the legal system to award optimal damage amounts. The leading researcher in this field, Harvard’s Steven Shavell (1999) argues “...we can have no confidence that the actual amount of litigation activity tends toward the socially desirable.” When litigation goes overboard, as is often the result of the incentive structure faced by attorneys and their clients seeking ever-higher damage awards, efficiency is reduced.

Less attention is paid to issues of civil litigation costs arising from legal complexity, case overload and electronic management of cases. Analysis of electronic case management, record keeping and caseload impacts on court efficiency are part of the research agenda of the Federal Justice Center and Rand Corporation (McKenna, Hooper, and Clark 2000). These concerns more often arise in the context of comprehensive reform, not in marginal adjustments to the existing civil litigation system. These issues matter because such reforms are likely to generate the highest level of consensus, as well as the fastest cost reduction.

The issue of costs and tort reform involve many issues and must be evaluated at the state level. It is not my intention to fully review the issues affecting tort reform and civil litigation costs, but merely to present the issue as preface to testing the hypothesis that legal costs are affecting productivity growth. Chapter 13 addresses these West Virginia specific legal reform issues in more detail.

**Existing Research on Tort Reform and the Economy**

Given the intense debate regarding tort reform, it is not surprising that very different research findings regarding the impact of tort reform and civil litigation co-exist. In addition to the numerous politically-motivated policy briefings, there is a considerable body of scientific and legal analysis by academic scholars. Within this academic literature, there are three broad research areas. The first is the political science analysis of civil litigation trends and impacts.
This literature exists for a number of states and the federal government, and is typically characterized by institutional analysis of problems associated with tort reform and civil litigation. These studies outline the growing number of civil cases and typically estimate the direct average cost per case. Studies of this nature include DeFrank and Hammock (1990), Lewis and Becerra (1995) and Perryman (2002).

A stock argument in these cases is that the number of civil cases is rising, a factual trend across the nation. In each of these cited studies, estimates of cost savings related to tort reform are provided based on the average cost per case estimate. This method is suspect because of the existence of fixed costs in litigation. For example, the existence of a judicial system is costly—even if no cases are tried. At the margin a small reduction in caseloads may not generate cost savings anywhere near the average cost per case. This is also a problem for businesses that retain lawyers, thus incurring fixed costs, simply in anticipation of litigation. Despite these criticisms, political science researchers seem to universally argue for policy adjustments related to tort rules, selection of the judiciary, case management, and venue fairness. There are few studies that reject specifics of tort reform, and none which I could find which rejected reform broadly.

The second collection of research emanates from the legal community. These studies are typically studies of counties or cities, or specific rules within a jurisdiction. They do much for informing specific policy options, but are notably inconsistent in their treatment of broad reform issues. One interesting article determined that within tort cases the gender of the defendant’s attorney more strongly affected outcome that did any of 22 other variables, with the exception of an admission of liability by the defendant, the month of the verdict, or the fact that the case had already been tried (Merritt and Barry 1999). This study strongly suggests that fairness of judicial outcomes (or statistical bias in the model) is present. These studies are particularly important in identifying inconsistencies in legal doctrine across jurisdictions; they are much less useful in evaluating the relative effects. (For example a conclusion of the Merritt and Barry study was that tort costs are low—a subjective and empirically unevaluated finding.)

Legal research also offers insights into the settlement process, but less than is offered by experimental economics, which includes specific issues like uncertainty and informational issues that mask findings of the small data samples available in empirical studies of settlements (Wittman, Friedman, Crevier, and Braskin 1997; Babcock and Pogarsky 1999).

The third realm of research involves the impact of civil litigation and tort on productivity and growth. These studies differ from the other quantitative models by attempting to either link changes in tort related legislation to economic (or political) factors, or explain differing growth rates by differences in civil litigation rules and institutions.

There are two peer reviewed economic studies that specifically address economic growth and litigation. The best known of these papers was published by the National Bureau of Economic Research (Campbell, Kessler, and Shepherd 1995). This NBER research examined all U.S. states from 1969 to 1990, categorizing 14 legal reforms as either increasing or decreasing the size of tort judgments. These were primarily general tort related changes (6 of the 14 were medical malpractice only). This method built on the authors’ existing research on medical malpractice and tort. From this information, the authors added publicly available data on the timing of legislation and economic growth to an econometric model. The technique employed to statistically model these effects accounts for two endemic problems that typify the legal and political science studies cited earlier: reverse causation and trend.
First, it is possible that during slow growth years legislation restricting torts are passed as part of an economic stimulus plan. This would bias the results towards finding a negative relationship between looser tort rules and economic growth. Also, it is possible that states with loose tort rules suffer from a political climate that generally reduces economic activity. In lobbyist vernacular—a business climate of litigation and regulation may slow growth independently of simple tort rules. This is the reverse-causation problem that so often leads to poor inference of statistical evidence and which has been circumvented by these authors.\(^5\)

The second major problem is the existence of a persistent trend in total number of tort cases. Economic (and legal) theory suggests that as the number of transactions rises, so too will the number of transactions related litigation. Since both the number of transactions and the number of court cases have risen over time, simple statistical analysis which does not account for this trend will lead to strong positive, but spurious correlation. The authors have avoided this problem as well.\(^6\)

After correcting for these types of statistical error, the authors present a very robust set of conclusions. First, liability reducing tort reform is associated with greater productivity and higher employment in various industries, while liability increasing reforms are associated with lower output per worker and less employment. Second, as predicted, the impact of tort reform is most pronounced in industries where consumption and production occur in the same state. Third, the impact on short term growth rates is less pronounced than on their trends, which suggests longer-run impacts of reforms.

These findings are among the strongest evidence that differing levels of tort liability rules affect state economic performance. Despite the strength of this NBER study, the authors are cautionary. They point out that the problem of reverse causation may not be entirely corrected, a conclusion I believe is fairly unlikely. Second, they suggest that the ‘Delaware effect’ may be occurring. The ‘Delaware effect’ describes a situation where productive capital avoids high tort areas, migrating to areas with more restrictive liability rules. This would explain some of the growth and growth rate differentials the authors found. This does not refute their conclusions, but it does suggest more growth related analysis is warranted.

The second study examined the Austrian economy and legal system from 1960 through 1995 (Clemenz and Gugler 2000). This study employed data on economic growth rates and the number of civil cases filed in Austrian courts. These authors found strong empirical evidence that a long-run relationship between the level of economic activity and the number of civil cases. This means that over time the proportion of civil cases to the size of the Austrian economy is nearly constant. This hypothesized relationship is important because it suggests that increases in the amount of litigation are associated with a greater number of transactions in an economy, not necessarily a litigation explosion. This is consistent both with the NBER study findings. The second finding in this study is that growth in civil litigation is counter-cyclical to the economy. More clearly, short-run growth in the economy is associated with less litigation, while a downturn sees an increase in civil litigation. This finding is

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\(^5\) The authors use an instrumental variable technique in a simultaneous equations model to circumvent the reverse causation problem known as ‘reverse causality.’

\(^6\) Trending variables may suffer from the problem of non-stationarity, a statistical issue that suggests the inverse of the autoregressive component will contain an eigenvector which contains a characteristic root outside the unit-circle (>1, or <\(-1\)). These variables are said to not have a unit-root (the square root of the autoregressive parameter contains numbers greater than 1, or less than \(-1\) (and i, the imaginary number necessary for calculating the square root of a negative number). In essence, variables that trend, but are not really related, will appear to be strongly correlated.
interesting because it is consistent with the hypothesis that during harder times individuals and firms litigate more. This is essentially an activity that redistributes income during recessions. This is consistent with economic arguments from Adam Smith (1998 [1776]) and others who have provided evidence that redistributive economic activities are harmful to economic growth (Murphy, Shleifer and Vishny 1995).

The Austrian study is helpful in establishing the business cycle impacts and the transactions/litigation trend determined in the NBER study. The study’s inherent limitation is that there are no easily comparable legal systems for inter-regional analysis. This means that specific tort reforms cannot be evaluated relative to other states. Combined with the empirical findings of the NBER, these limitations suggest expanded analysis of the impact of civil litigation on the economy is warranted.

A MODEL OF LITIGATION COSTS AND ECONOMIC GROWTH

Economists model growth using a technique known as a production function, which accounts for the inputs to the production process: people, knowledge, and machinery. A typical production function model suggests that the level of regional economic activity is a function of human and physical capital. See equation 1, where $Y$ is output, $K$ is physical capital, $N$ is labor, and $H$ is human capital.

$$Y = f(K, N, H) \quad \text{(Equation 1)}$$

The model I employ is a typical regional production function where growth is explained as a direct function of physical and human capital, along with measures of the cost of civil litigation and an error term. The model also corrects for the impact of cross-border relationships across that influence growth rates. In this type of growth model, this spatial component is especially important, since regions grew at different rates during the period I analyzed and may have cross-border impacts. I also correct the model for statistical errors that are potentially generated by observing variables over a long time period. Data for all 50 states and the District of Colombia was used from 1978 through 1998. These are available from the Bureau of Economic Analysis. A more technical description is available in Hicks (2002). The state economy is measured by Gross State Product (GSP).

I performed two tests on these data. The first test was an evaluation of the existence of trends in both the costs of legal services and the size of the economy. This is similar to the question asked in the previously mentioned research on Austria, except that here the cost of legal services is used, not the number of tort cases. Here I only examine West Virginia.

The first test clearly demonstrates that, in West Virginia, there is a long-run relationship between the size of the economy and the costs of legal services. This was expected, and suggests that part of the anecdotal observed explosion in litigation is related simply to the size of the state’s economy. However, the nature of the long-run relationship

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7 This model is a type known as an augmented neoclassical production function. The traditional neoclassical production function suggests that output is a function of capital and labor, $Y = f(K, L)$. This model occasionally includes several measures of capital, except when the level of analysis is at the state or national level. The augmentation of the model is primarily the inclusion of human capital components (e.g., years of education).

8 The model used a correction for spatial autocorrelation and for persistence effects (autocorrelation), as well as the potential for divergence between regions to generate a variance that is not constant over time.

9 A ‘Johansen-Juselius cointegration test’—significant at the 5 percent level.
suggests that there is not a linear (or proportional) relationship between these variables. This suggests that part of the increase in legal services is explained directly by the size of the economy (GSP), but that the increase is occurring at an accelerating rate. See Figure 12.2.

Figure 12.2, GSP and Legal Services Expenditures in West Virginia

Indeed, in 1978 West Virginia’s spending on legal services as a percent of state GSP ranked 44th, but by 1998 rose to the 12th highest in the nation. This is all the more shocking because legal services cluster in several areas such as Washington, D.C., New York, Chicago, and Los Angeles due to the high levels of finance, government, and other industries where legal services play an important role. West Virginia has no such cluster, and so it would be unlikely our state would ever approach the top 10 states in terms of the proportion of GSP composed of legal services. Yet it does. Indeed, there are many reasons why legal services should represent a relatively small proportion of our GSP, and none, albeit structural problems that would suggest it should be near or above average.

It is clear that over the past twenty years spending on legal services in West Virginia has risen in both absolute terms, and relative to other states. Notably there are many states where the absolute size of legal service rose more quickly, but that is largely due to a more rapidly growing economy. These findings generally support the conclusions in the Austrian study, but do not yet answer the central question—whether or not legal costs are inhibiting economic growth. To answer that question, I employ a standard economic growth model.

The growth model estimates the cost of legal services on the overall economy in each state. The model was estimated to evaluate the annual impact of changes in per capita legal services on growth in each state’s output per person. Overall, the model performed as expected in terms of the relative impacts of human and physical capital. In this respect, the model was consistent with others of its type.
The findings regarding the impact of growth in legal services were surprisingly strong. Across the board, per capita increases in the cost of legal services reduced the rate of economic growth. Since legal costs in West Virginia have risen (after adjusting for inflation) by 148 percent since 1978, the resulting reduction in growth ranges from between 1.13 percent and 4.52 percent. This translates into annual losses in growth of between 0.056 percent and 0.226 percent per year over each of the past twenty years. The impact of this is to reduce the level of personal income for the average West Virginian in 2000 by $425 to as much as $990 from what it would have been without this massive growth in legal costs. This represents a remarkable negative impact resulting from litigation costs, and is entirely consistent with the impacts assessed by the NBER study in 1995 on individual industries most heavily impacted by tort rules (those where production and consumption occurred in the same state). The closeness of these findings using a different time period, and asking different questions suggests that the actual impact near the range of growth impacts mentioned above.

Even at the most modest levels, legal services impacts on growth are negative, robust to alternative models, supported by the highest quality existing research, and their impact is significant.

**SUMMARY AND POLICY RECOMMENDATIONS**

This much is clear: the impact of litigation costs on economic growth and personal income is both negative and significant in West Virginia. Existing research supports the contention that, at the margin, economic growth is negatively affected by the costs of civil litigation.

The source of rapidly rising civil litigation costs in the state is not clear. I have not evaluated the impact of damages, specific tort rules, or different types of litigation as the primary culprit in increasing costs. For example is it large damage awards, consumer tort, or business-to-business torts that are the most compelling problem?

It seems highly likely though, that for West Virginia, the costs of the legal system act as a comparative disadvantage, reducing the level of economic activity, leading to stagnant wage growth and relatively lower levels of income. The civil litigation system in West Virginia has the effect of imposing a tax on each citizen of perhaps more than $1,000 annually—with no resulting government expenditure. It is merely lost prosperity.

The very clear implication is that to recover this lost prosperity deep changes in our civil litigation system are necessary, and are among the most immediate of our public policy concerns. The next chapter explores specific reforms to West Virginia’s legal system that can help to fix our problems and thereby promote prosperity and economic growth.

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10 In addition, because legal services are counted as part of GSP, these estimates are inherently too low. The reason is that because for every dollar spent on in-state civil litigation, my model includes that one dollar received by legal firms as employee compensation.
REFERENCES


CHAPTER 13

LEGAL REFORM: SPECIFIC
CHANGES TO PROMOTE
ECONOMIC GROWTH

by Kristen M. Leddy and Matthew T. Yanni

Mapleshade near Gallipolis, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 82.17° W & Latitude 38.82° N).
With respect to attracting and retaining business in West Virginia, one pressing legal issue is tort reform. Tort reform is designed to reduce the amount of tort litigation, and it usually involves legislation restricting tort remedies or imposing caps on damage awards. According to the 2006 State Liability Systems Ranking Study (Institute for Legal Reform 2006), West Virginia ranks as the nation’s worst state with respect to its legal liability system.\footnote{Online at: www.instituteforlegalreform.com/}

In this chapter, we explore the role of the liability system in West Virginia and how its structure affects the state’s business climate. In the West Virginia Chamber 2007 Policy Recommendations (West Virginia Chamber of Commerce 2006),\footnote{Online at: www.wvchamber.com/} and Judicial Hellholes 2006 (American Tort Reform Association 2006),\footnote{Online at: www.atra.org/} the West Virginia Chamber of Commerce and the American Tort Reform Association have recommended various civil justice reforms aimed at improving the legal liability system in West Virginia. In several cases, these groups’ recommendations overlap. We will analyze their proposals for reform based on their validity and constitutionality. This will serve as a starting point for an examination of legal reform in West Virginia.

The father of economics, Adam Smith, stated in The Wealth of Nations (1937 [1776]) that one of the few roles of government is to establish a fair and independent judiciary, specifically with the goals of contract enforcement and the resolution of disputes. A system conducive to accountability creates incentives for citizens to respect the property of others—a fundamental basis for long-term economic growth.

In this chapter, we begin by defining the role of the state in protecting citizens through a sound legal system with specific emphasis on civil liability. We discuss the negative consequences of the state’s current legal system. Then, we lay the groundwork for three specific legal liability reforms: joint and several liability, medical malpractice liability, and venue shopping. These reforms receive significant attention because they are fair, likely to

\footnote{Online at: www.instituteforlegalreform.com/}
have a positive impact on the state’s legal system, and relatively easy to implement. We briefly discuss two further avenues of legal reform; however, these lack the great potential of the other reforms covered in more detail. Finally, we conclude that West Virginia’s business climate could be significantly improved by the proposed legal liability reforms.

**The State’s Legal Role**

In order to promote economic growth, the state should ensure that each person can fully pursue their own self-interest without infringing upon the ability of all others to do the same. With respect to a legal system that can enforce this doctrine, the state should provide a system whereby grievances between parties can be decided in a fair and efficient manner. Boettke and Subrick (2003) show that legal systems with these characteristics promote economic growth and development.

The fairest method of resolution requires that one who injures another, or the ‘tortfeasor,’ must pay the exact value of the damage that he or she has caused. Reasonable people may differ in determining the exact value of the damage a tortfeasor has caused. For this reason, a jury composed of the injured party’s peers is presented with the facts of the case and then asked to render a decision about the party’s fault and its legal liability. Ideally, a jury carefully weighs the facts of the case, determines the tortfeasor’s degree of liability, and then presents the injured party with an award equal to the value of the damage caused by the tortfeasor.

The key here is the equitable settling of grievances. If it is just for the injured party to be fully compensated to the value of her injuries, then it is only just that the injuring party be responsible for only those injuries he caused. In some cases, West Virginia fosters injustice by requiring tortfeasors to pay sums greater than their contribution to the injury. Public sentiment and the resulting legislation have placed the interests of the injured party above all else.

West Virginia’s liability system is designed to ensure that injured parties are compensated at least to the extent of their injuries. However, the existing legislation often ensures that business and insurance pay compensation above and beyond the dollar value of the injury. West Virginia lags behind all other states with respect to providing a fair and efficient system of injury compensation based on the Institute for Legal Reform’s (2006) 2006 State Liability Systems Ranking Study. In the next section we explain the economic burden placed on West Virginia by its legal liability system.

**Consequences of the Current Legal System**

West Virginia’s low ranking with respect to its legal liability system is a result of legislation designed first to provide that victims are compensated to the full value of their injuries and second, to punish and deter businesses for grossly negligent or intentionally damaging

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4 See e.g. *Kizer v. Harper* (2001), at fn 26: “This Court is not unmindful of the fact that Appellant, who was charged with only 1% fault, is being held liable for the full verdict under principles of joint and several liability. Despite the seeming inequity of this result, we cannot, without turning the tort law of this state ‘on its head,’ reach a contrary result. *Miller v. Monongahela Power Co.*, 184 W.Va. at 671, 403 S.E.2d at 414.”
actions. Although some may believe that this is exactly the correct policy for West Virginia to pursue, unfair transfers of wealth distort the market system and the incentives businesses face. Fortunately, some simple legal reforms have been shown to remedy the situation. Adopting these reforms would lead to a more fair judicial system and greater prosperity for our state.

LEGAL LIABILITY REFORM IN WEST VIRGINIA

We base our recommendations for legal liability reform upon the notion of fairness, a positive impact on the state’s business climate, and the constitutionality of implementing the reform in West Virginia. The three legal reforms considered in the following sections include: 1) eliminating the doctrine of joint and several liability in all civil tort claims, 2) extending reform efforts in the area of medical malpractice liability, and 3) ending venue shopping in products liability and class action lawsuits.

JOINT AND SEVERAL LIABILITY

‘Joint and several liability’ is a hybrid of ‘joint liability’ and ‘several liability,’ in which each defendant in a tort lawsuit can be held responsible for the full amount of damages awarded in a case. This holds even when a defendant is found responsible for only a small percentage of the damage. Take a hypothetical case with two joint tortfeasors, in which the jury finds that one party holds a certain percentage of the liability, with the rest held by the other. Under pure joint and several liability, either defendant could be held responsible for the full amount of the judgment. This is sometimes referred to as the ‘deep pockets’ rule. The National Association of Mutual Insurance Companies (2006) argues, in Joint and Several Liability Reform States, that pure joint and several liability has turned lawsuits into searches to find the most financially lucrative defendants.

When a financially wealthy individual or company may be joined as a defendant, a plaintiff has a greater chance of recovering damages than when the defendants are financially insolvent. Proponents of joint and several liability, on the other hand, argue that it protects victims from being undercompensated if one of the defendants cannot pay its share of proportionate liability. A joint tortfeasor who may have paid more than its fair share of a judgment would have a right of contribution against a defendant who fails to pay its proportionate share. According to White and Williams (2006), this often leads to inequitable results and procedural battles between defendants to enforce their contribution rights, particularly where one defendant remains ‘holding the bag.’

Joint and several liability unfairly requires that injured parties be compensated by parties not entirely liable for their injuries in the event one party cannot pay its proportionate share.

5 Although it is possible to modify the West Virginia Constitution, proposing reforms that are currently unconstitutional would change the nature of this project from a practical to a theoretical one. If our goal is to help the state grow economically, we should concentrate on those reforms that may be implemented with relative ease. We made this determination with respect to West Virginia’s legal structure, not necessarily with respect to political opposition or support.

6 Joint liability refers to liability shared by two or more parties, while several (or proportionate) liability refers to liability where parties are liable only for their respective obligations.

7 E.g. Haynes v. City of Nitro (1977). The right of contribution is the defendant’s ability to pursue another defendant who fails to pay her proportionate share.
share of an award. The social interest requires that tortfeasors be required to pay only that damage they have caused. Under the doctrine of joint and several liability, they can be required to pay for damages caused by another party. Despite the social reasons to compensate injured parties, it is both unfair and inefficient to force individuals or businesses to pay for damages they have not caused.

Currently in West Virginia, the law states that joint and several liability always applies except where a defendant is found 30 percent or less at fault. That defendant's liability shall be several and not joint, and that defendant will only be liable for the damages attributable to him or her.\textsuperscript{8} There are, however, some exceptions. Joint and several liability still applies to those who commit intentional torts; any party who acts in concert with another as part of a common plan or design resulting in harm; negligent or willful unlawful emission, disposal or spillage of toxic or hazardous substance; or manufacture or sale of a defective product.\textsuperscript{9} Also, on motion, a court can order reallocation of any uncollectible amount among the other parties, though defendants less than 10 percent at fault will not be subject to reallocation.\textsuperscript{10} In cases involving medical professional liability, West Virginia has adopted several liability.\textsuperscript{11} Under several liability, the defendant is responsible only for the value of damages he caused.

Courts in neighboring states are split in their decisions on the application of joint and several liability. Ohio applies modified joint and several liability, in which joint and several liability only applies to economic losses if the defendant is more than 50 percent liable for unintentional torts or any percentage liable for an intentional tort.\textsuperscript{12} Tennessee has eliminated joint and several liability.\textsuperscript{13} In June 2002, the Pennsylvania Legislature passed the Fair Share Act, which applied several liability unless a defendant's proportionate negligence was greater than 60 percent, with some exceptions.\textsuperscript{14} However, in September 2006, the Supreme Court of Pennsylvania affirmed a decision which made the Fair Share Act unconstitutional, returning Pennsylvania to pure joint and several liability.\textsuperscript{15} Maryland and Virginia apply pure joint and several liability as long as the injury to the plaintiff is indivisible.\textsuperscript{16} Fortunately, according to the American Tort Reform Association’s (2005) \textit{Joint and Several Liability Rule Reform}, and Lenckus and Wray (2004), states which apply pure joint and several liability are in the minority because about two-thirds have either abolished joint and several liability or restrict its application to defendants that are at least 50 percent liable for a plaintiff's injury.

A small reform, on par with Ohio’s system, would require West Virginia to further restrict its application of joint and several liability to defendants with proportionate negligence of 50 percent or more. At best, West Virginia should enact a state law which extends several liability from cases involving medical professional liability to all civil cases, in which each defendant will only be liable for its proportionate share of the plaintiff's loss. Proportionate liability will alleviate the threat of holding businesses accountable for substantial judgments not incurred by their actions.

\textsuperscript{9} Id.
\textsuperscript{10} Id.
\textsuperscript{13} McIntyre v. Balentine (1992).
\textsuperscript{14} 42 Pa. C.S.A. §7102 (2005).
\textsuperscript{15} DeWeese v. Cortes (2006).
**MEDICAL MALPRACTICE LIABILITY**

In 2003, West Virginia enacted HB2122, reforming its liability system with respect to the responsibilities of medical professionals (Sensabaugh and Grinberg 2004). Reducing state medical malpractice from joint and several liability to pure several liability, in 2005, was also an important victory for both patients and medical staff. By limiting medical malpractice liability to pure several liability, West Virginia has provided for patient care and helped to attract and retain high quality doctors and their staffs.

Despite recent successes, there are still important reforms outstanding to decrease the burden medical malpractice places on the state and its medical providers. We propose to limit expert medical testimony to that of established professionals in the same field as the defendant in medical malpractice cases. This helps to curtail the use of medical experts in trials that do not have expert knowledge of pertinent issues at hand, and are not sufficiently familiar with standard procedures in that field. We further propose the creation of a statute of limitations for medical malpractice liability and the implementation of pre-trial screening or arbitration. These actions help to ensure that lawsuits are taken to court in a timely manner and are legitimate. This reduces the burden placed on both the state court system and the medical professionals named as tortfeasors.

**VENUE SHOPPING**

We recommend the imposition of meaningful venue requirements to help eliminate venue shopping and ‘jackpot justice’ in West Virginia, as well as reduce the state’s burden in providing a location for these trials to be held. In 2003, it seemed that West Virginia was well on its way to accomplishing just that. In that year, West Virginia amended the state’s venue statute to restrict access to the state courts for non-residents unless (i) a substantial part of the acts or omissions giving rise to the claim occurred in the state or (ii) the plaintiff could not obtain jurisdiction against a defendant where the claim arose. Furthermore, each plaintiff had to independently establish that the venue was proper. This law was passed to prevent abuse of the state’s courts by nonresidents who viewed West Virginia as a ‘magnet jurisdiction.’ These are plaintiff-friendly jurisdictions with generous juries, particularly for asbestosis cases, where nonresidents could take advantage of liberal consolidation laws. This, according to Goodwin Procter LLP’s (2006) *Products Liability and Mass Torts Alert*, placed pressure on defendants to settle out of court and limited the court’s ability to deal with the merits of individual claims.

Unfortunately, this significant legislative reform measure was declared unconstitutional by the State Supreme Court in *Morris v. Crown Equipment Co.* (2006). In this case, the Supreme Court of Appeals held that a plaintiff cannot be denied the right to bring a products liability lawsuit in this state against both a West Virginia corporation and an out-of-state corporation merely because the plaintiff is the resident of another state.

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18 *Id.*
The decision in \textit{Morris} is likely to limit the effectiveness of venue reform in West Virginia. In his dissenting opinion, Justice Maynard declared that this decision eviscerated a statutory safeguard against the abuse of West Virginia courts. Nonresident plaintiffs will be able to avoid the strictures of the venue statute and bring products liability and mass torts cases into state courts, without any showing of acts or omissions in the state, so long as each plaintiff can allege a colorable claim against a West Virginia defendant.\footnote{See supra at note 18.} In December 2006, the United States Supreme Court declined to hear an appeal of this case (Dickerson 2006). Effectively, the U.S. Supreme Court left this matter to the states in a classic federalist stance. This means that if West Virginia desires further change, it will have to come from the state legislature. One avenue of reform may redress the state’s lackadaisical class action certification rule.

**OTHER POTENTIAL AVENUES OF REFORM**

In this section, we cover some additional reforms that do not merit a full and thorough treatment but still deserve attention. We address the contentious issue of punitive damages, specifically with reference to their theoretical unfairness, despite the small part they play in the state’s award system. We also discuss the problems with medical monitoring, and explain why the status quo is nonsensical and harmful to the West Virginia economy.

**LIMITING PUNITIVE DAMAGES**

According to the Institute for Legal Reform’s (2006) 2006 \textit{U.S. Chamber of Commerce State Liability Systems Ranking Study}, punitive damages reform tops the list of the most important issues for state policymakers who care about economic development to focus on to improve the litigation environment. Punitive damages are damages awarded to a plaintiff, in addition to compensatory damages, when the defendant is found to have acted with recklessness, malice or deceit. These damages are intended to punish and deter blameworthy conduct.

Fortunately, punitive damages constitute a very small part of the tort system. They are awarded in less than 4 percent of all tort injury verdicts. Nonetheless, controversy surrounds them because they bear no relation to compensation (News Batch 2006). The determination of punitive damages is left to the jury. Significantly, juries often have little guidance and wide latitude in how to assess damages, and courts are reluctant to interfere with the province of the jury even when an award is excessive (Torrance 2001).

West Virginia imposes no statutory limits on punitive damages awards. The standard for determining whether to award punitive damages is a preponderance of the evidence. This level of proof is required in most civil cases, and it means that the finder of fact in a case must find only that the facts are more probably one way than another. Eleven other states employ this standard. Thirty-one states require a higher level of proof, clear and convincing evidence; two other states mostly prohibit punitive damages; and five states prohibit punitive damages altogether (Torrance 2001).

Despite its low level of proof and the lack of statutory limits, reforming punitive damages in West Virginia may not be the most pressing tort reform issue for the state to
address in improving its business climate. Fortunately, according to Nugent (2003), West Virginia “is not known for the frequency or severity of punitive damages assessed by its juries.” Thus, punitive damage reform seems more like a high profile but low impact legal measure.

**MEDICAL MONITORING DAMAGES**

According to Peterson (2007): “A medical monitoring claim seeks to recover the anticipated costs of long-term diagnostic testing necessary to detect latent diseases that could develop as a result of tortious exposure to toxic substances in the environment. Medical monitoring has long been part of recoverable damages when there is present physical injury.” After a controversial decision in 1999, however, plaintiffs in West Virginia courts can bring a claim for medical monitoring damages if wrongfully exposed to an injurious or toxic substance absent present physical injury. This decision also authorizes the award of lump sums to plaintiffs.

To permit medical monitoring damages for plaintiffs who lack present physical injury creates a number of potential problems, including the fact that a plaintiff does not have to prove that he or she suffered an actual physical injury, much less that the defendant caused it. Also, there is astronomical and unpredictable liability for defendants, widespread and serious abuse by plaintiffs (who may be awarded a lump sum where there’s no guarantee the money will be spent on medical monitoring), and a legal system clogged with unreliable and trivial claims (Schwartz and Behrens 2001). The status quo of medical monitoring is ripe for legislative change. Barrett and Brookshire (2004) suggest requiring actual injury for monitoring or eliminating the alternative of lump sum awards, as well as overturning the Supreme Court of Appeals decision altogether.

**CONCLUSION**

We conclude that West Virginia is in need of meaningful legal liability reform to promote a healthy business climate and the long-term economic growth that it generates. This chapter outlined the major avenues for meaningful legal liability reform in West Virginia, covering the issues of joint and several liability, medical malpractice liability, and venue requirements with suggestions for their improvement. We believe that legal liability reform has great potential to increase prosperity in West Virginia, and is a necessary step in the process of UNLEASHING CAPITALISM.

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22 *Id.*
23 *Id.*
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CHAPTER 14
REDUCE, DECENTRALIZE, AND CONSTITUTIONALLY CONSTRAIN GOVERNMENT
by Daniel S. Sutter and Rex J. Pjesky

Marathon Oil (formerly Ashland Oil) located near Catlettsburg, Kentucky on the West Virginia border. Photo source: NASA World Wind (Longitude 82.59° W & Latitude 38.37° N).
An economy can rely on either the private or public sector to make resource allocation decisions. The economic system of capitalism is founded on the principle that these decisions, to the greatest extent possible, should be left to the private sector. The size of a state’s total expenditures, or its total tax burden, is a rough measure of the extent to which decisions over the use of resources are taken away from private individuals and transferred to the public sector. The previous chapters of this book have illustrated that West Virginia, to a much greater extent than other states, uses government to make these decisions, and have outlined specific reforms that can increase prosperity by transferring these decisions back to the private sector.

To understand why resource allocation decisions made within public sector are generally less beneficial for a state’s economy requires an understanding of the process by which these decisions are made. Public sector resource allocation decisions are the result of a complex process influenced by voters, elected officials, government employees, and special interest groups. The field of economics devoted to studying these interactions is known as ‘public choice theory.’ Economist James Buchanan won the 1986 Nobel Prize in Economics for his leadership and contributions in the early development of this field. We begin this chapter with a brief review of the literature to show why, unless constitutionally constrained, government tends to grow beyond the size that is best for prosperity.

We continue by presenting evidence on the relationship between government size and economic growth. The data clearly show that an excessively large government sector, like that which is present in West Virginia, slows economic growth. We next examine two ways to counter the excessive spending bias within West Virginia’s political system: 1) fiscal decentralization that shifts taxes and spending as much as possible to local governments, and 2) the imposition of constitutional tax and expenditure limits on state government.
THE IMPERFECTIONS OF POLITICS THAT LEAD TO EXCESSIVE GOVERNMENT SPENDING

Public choice economists have studied representative democracy extensively over the past fifty years and have concluded that political decision making suffers from a number of serious problems when compared to decision making in the private market. The incentives within democratic politics simply create a tendency for government to spend too much—more than the average citizen wants, and more than would be economically efficient (Matsusaka 1995). While it was noted in Chapter 3 that government employees and the managers of government agencies often face perverse incentives leading them to spend wastefully, there is much more to the story. Here we outline three additional problems plaguing resource allocation decisions made within the government sector.

The first problem in political-decision making is that elected officials possess considerable power to shape the outcomes of government decisions through control of the voting agenda (Romer and Rosenthal 1978). For example, suppose that voters truly desire a three percent increase in the school budget. A ballot question that poses only two options to voters: increasing spending by five percent if approved or leaving spending at current levels if it fails, would likely be approved by voters even though it far exceeds their desired level of spending. As another example, within legislatures the order in which bills and amendments are voted on can influence which pass and which fail.

In this regard, politics is a lot like the NCAA basketball tournament: match ups matter. If you could control the parings of the teams, it could go a long way toward getting your favorite team to the championship. You could ensure your favorite team plays the opponents they are most likely to match up well against, while trying to get the teams defeated who are likely to pose a major threat for your favorite team. A similar dynamic prevails in politics.

Legislators in positions of power can limit which bills their colleagues get to vote on or whether amendments can be offered during floor debate. Legislative leaders can assign a bill they oppose to a hostile committee to ensure that the bill dies. Legislators can manipulate the ballot propositions citizens get to vote in elections. School boards can choose the highest tax rate they can get citizens to approve, and not let voters vote on taxes for individual spending items. This process of ‘agenda setting’ explains why the majority party in Congress or a state legislature has so much power. Control of the agenda and the order of voting allow politicians to influence which outcomes are eventually selected.

Our democracy is a representative, not direct, democracy and this creates a second problem: the control of political representatives. A legislator may not faithfully represent his or her constituency on each issue, and the ability of voters to punish their elected officials is weak. Incumbents have a significant advantage in elections, and as we will soon see, voters have little incentive to really become informed about the behavior of their elected officials.

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2 This is one reason why 24 states have some form of voter initiative by which voters, through obtaining signatures, can put statutes and/or amendments directly on the ballot. These initiatives are most effective when the signature requirement is low (less than 5 percent). West Virginia, however, does not have the voter initiative, so in West Virginia legislation cannot be directly proposed by citizens. For more information on voter initiatives see Matsusaka (1995).
Additionally, elections are held at most once every two years. Consequently all of the votes, committee work, bills sponsored, and hearings held over the two-year period (or longer) must be reduced to a single up or down vote. Political candidates each represent a bundle of platforms and positions, and voters simply cannot adjust on all margins.

Also, because political representation is geographic, elected officials have a strong incentive to push 'pork' programs that transfer benefits to their district at the expense of other districts (Weingast, Shepsle, and Johnsen 1981). When elected officials can shift the tax costs onto taxpayers in other districts, even voters desire to expand government spending in their district beyond what would be efficient. The reason why this is a major problem, of course, is that this same phenomenon is simultaneously occurring for all legislative districts, through legislative vote trading (logrolling) and ‘pork barrel’ legislation.

In the marketplace, our choices have direct and personal consequences. If you choose to buy more soft drinks, you are the one who must bear the cost of the purchase. There is a link between payment and consumption. Politics affords us the opportunity to buy more soft drinks and push the cost off on other taxpayers, leading to larger than efficient spending. Economic theory concludes that governments are overly inclined to enact policies that benefit concentrated interest groups at the expense of the general public because of the disconnect between payment and consumption that government provides.

The third problem in political-decision making arises because any particular voter is highly unlikely to affect the outcome of an election. The probability of being the decisive voter is so low for many national elections, say less than 0.00006, that many have commented on how an individual is more likely to be in an auto accident on the way to vote than to be the decisive voter in the election. Again, while our choices in the marketplace have direct and personal consequences, our choices in the political voting process do not.

The low probability that any one voter will decide the outcome of an election has several negative consequences. First, voters have only a weak incentive to actually turn out to vote in the first place—a concept known in the academic literature as ‘rational abstention.’ Many voters are simply not willing to bear the cost of taking time away from work or family to vote when the probability that their vote will change the outcome is so small. This economic concept helps to explain why voter turnout rates are low (turnout rates have hovered around 50 percent for the last century or so).

Second, this low probability reduces the incentive for people to become informed about politics—they simply will not incur the time-intensive process of learning about current political issues and candidates when their vote is unlikely to matter. This concept is known as ‘rational ignorance,’ and it explains why so few people can actually name their elected representatives. Finally an emerging body of literature suggests that this low probability encourages voters to vote ‘expressively’—to express ideological preferences or vote to make a personal statement without regard to the actual economic consequences of the policy.

These pathologies of politics outlined above combine to create an inherent bias toward excessive spending within a democratic government. Agenda control creates the ability for elected officials to pursue policies benefiting themselves or interest groups, and infrequent elections are a weak device to prevent such manipulation. Politicians will find that voting for

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1 See Mueller (2003) for a discussion of this probability and the related literature. Also, a recent summary of the factors influencing voter turnout may be found in Aldrich (1993).
3 Buchanan and Wagner (1977) offer an excellent dissection of democratic politics’ pro-spending bias.
increased spending brings votes, particularly when the taxes can be shifted to other geographic areas. Managers of public agencies and government workers will generally favor increased spending regardless of the true demand for the services of the agency because it leads to higher salaries, larger staffs, greater prestige from controlling a larger budget, and additional resources to pursue their mission (Niskanen 1971). Elected officials benefit from increased spending because they can take credit when government addresses a problem, like hiring more police officers to fight crime, building more prisons, or raising teacher salaries.

While the interest groups that benefit from these programs fight hard for their enactment, the corresponding higher taxes and reduced disposable income are widely dispersed over the general public so no single interest group champions the fight against these new spending programs. Given the weak connection between political participation and outcomes, only those with a lot at stake get involved. For example, if the state widens a local road in Parkersburg, the residents of that community benefit, but all 1.9 million West Virginians pay slightly higher taxes. While economic decisions should be made by weighing the total benefits and total cost, Parkersburg’s residents will weigh the full benefits against only their tiny share of the tax cost. They will be in favor of the new road even if it is not in the economic interest of the state as a whole. Parkersburg residents who stand to gain the concentrated benefits of this project will lobby and push hard for the project to be funded, while the taxpayers of West Virginia—each bearing only a tiny fraction of the cost—will not find it in their interest to lobby against the project.

There are about 26,000 full-time public school teachers in West Virginia, each with a large vested interest in education policy and funding. Thus it is not surprising that school teachers, not parent-taxpayers, play the major role when the legislature considers school issues. Beneficiaries contact their legislators, form interest groups and make campaign contributions, and representatives continually receive requests for more spending. Elected representatives gain votes by supporting interest groups, and do not face the offsetting lost votes from the millions of taxpayers who bear the costs because the taxpayers are largely, and rationally, ignorant about the policies.

**EXCESSIVE GOVERNMENT AND ECONOMIC GROWTH**

Because of the reasons outlined above, unconstrained democracy leads to excessive government size. Evidence of excessive government can be seen in the relationship between government spending and economic growth. Economists Richard Vedder and Lowell Gallaway (1998) review the evidence at the state, federal, and international level and find a stable, hill-shaped relationship between average citizen income and the size of government. Initially, a small government sector expands prosperity as it provides the framework a market economy requires: secure property rights, enforcement of contracts, and protection of life and property against invaders. As a government expands past these core functions, however, the expansion of government reduces growth for several reasons.

First, as government increasingly makes decisions over the allocation of resources it results in a less efficient use of these resources, producing lower income and wages for

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6 For a discussion of how these forces over time results in elected representatives themselves favoring more spending see Payne (1991).

7 The classic treatment of why democracies through time lead to economic stagnation is Olson (1982).
citizens. Unlike the private sector where resources allocations are based on profit and loss considerations, geographically-based politics often dominates in political decision making and thus political resource decisions do not always result in the best allocation of resources for the state as a whole. Second, government must impose taxes to fund this additional spending. Taxes distort choices in the market, and the cost to the economy of this distortion exceeds the dollars collected for government to spend (see Chapter 5).

Typically, government taxes income, real property, corporate profits, and investment income; therefore, as government expands, increased taxes reduce the incentive to work, save, invest, and start new businesses. Third, when government controls a higher percent of an economy’s spending it encourages interest groups to devote more resources to lobbying the political process rather than to private sector wealth creation. Chapter 3 presented the economic theory behind why this lobbying is socially unproductive based on Gordon Tullock’s (1967) theory of ‘rent seeking’ and William Baumol’s (1990) theory of ‘unproductive entrepreneurship.’

Figure 14.1: The Size of State Government versus Average Income

![Graph showing the relationship between state government spending as percent of state income and average income.](image)


Statistical research in economics proves that excessively large government slows economic growth. Chapter 2 presented detailed empirical evidence on this issue, and here we only briefly present some additional evidence. Figure 14.1 begins by looking at the long-run relationship between government size and the economy by comparing state per capita
personal income in 2004 with state spending as a percentage of personal income in 1977.\textsuperscript{8} States with larger governments in 1977 had lower incomes a quarter of a century later, as indicated by the negative slope to the trend line plotted through the scatter plot. The trend line indicates that having government spending at 12 percent of income instead of 5 percent in 1977 resulted in a reduction in 2004 average citizen income of approximately $5,000.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure14.2.png}
\caption{Growth in Per Capita Income vs. Growth in State Spending}
\end{figure}

Sources: U.S. Census Bureau (2006), Bureau of Economic Analysis (2006), and authors’ calculations.

While Figure 14.1 compares the levels of income and government, Figure 14.2 considers the relationship between the growth rates of income and government spending. The figure plots the cumulative growth in real (inflation-adjusted) per capita personal income between 1990 and 2004 for the contiguous 48 United States against the cumulative growth in state spending as a percentage of income over the same period. Note that these are not the average annual growth rates, but are instead the percentage by which the 2004 value exceeds the value for 1990. The trend line clearly shows a negative relationship—states with faster growing government sectors have lower economic growth rates as a result.\textsuperscript{9}

Spending is not the only means by which government controls resource allocation decisions. Other means include regulations, price controls, and mandates. Thus state spending

\textsuperscript{8} Economists use prior values (like the 1977 value used here) to avoid the criticism that the causation between the variables runs in the other direction (e.g., lower income resulting in more government).

\textsuperscript{9} Vedder and Gallaway (1998, 1999) provide further evidence on the growth consequences of excessive spending.
may provide an incomplete picture of the true extent of government size. The best overall measure of government’s economic control is the ‘Economic Freedom Index’ employed throughout this book. We would refer readers to the detailed data analysis in Chapter 2 to confirm that these negative relationships between the size of government and prosperity hold even stronger once these other areas of government intervention are considered. As has been repeatedly noted, West Virginia scores 50th in this index of reliance on capitalism. In fact, West Virginia’s score of 5.1 is indeed almost a full point lower than the next two lowest states. Of all 50 U.S. states, West Virginia has the largest government sector and government intervention, and the prosperity of West Virginia’s citizens suffers dramatically as a result of this excessive government spending and control of the state economy.

**DECENTRALIZATION: INCREASED RELIANCE ON LOCAL GOVERNMENT AS A PATH TO PROSPERITY**

While the overall size of government matters, so too does which level of government undertakes the spending. The structure of government in the United States features multiple levels of government: the Federal government, the fifty state governments, county and city governments, and independent local governmental units like school and water districts. This structure is known as a system of ‘fiscal federalism.’ States vary considerably in terms of their degree of decentralization. West Virginia’s government sector is highly centralized with the state government controlling a much larger share of total state and local government spending than in other states. This section shows why West Virginia would benefit from decentralizing both taxes and spending to give greater control to local governments.

In economic theory there is a well defined criterion for deciding which level of government should be responsible for carrying out a specific duty or spending program (see, for example, Inman and Rubinfeld 1997). The general principle is that spending and taxes should be decentralized to the lowest geographic level of government possible that still incorporates the main beneficiaries of the program. Parks, bike paths, or local roads that primarily benefit local residents should be provided by local governments, and funded by local taxes. Major state highways, on the other hand, benefit most of the state’s residents and are better funded at the state level. Interstate highways, or national defense, for similar reasons are better funded at the national level.

An appropriately designed system of fiscal federalism benefits society in several ways. Most importantly, local communities can accommodate people’s differing preferences for government goods and services. Some individuals, for example, might prefer more spending on parks, while others would prefer to instead devote these resources to education. Where a state might adopt a one-size-fits-all approach, local communities can choose a combination of spending on parks, police, and schools that reflects the preferences of their residents. Decentralization also reduces conflict among communities. If residents of Huntington want a first-rate municipal park system, they will have to pay for it themselves and cannot push some of the cost onto residents of Charleston or Morgantown by using state tax dollars.

Decentralization offers an additional advantage to citizens: they can choose to move to the community that provides the combination of government services and taxes most closely matching their tastes and preferences. Charles Tiebout (1956) called this process ‘voting with
your feet,’ and it both lets citizens choose local government services and reveals which goods and services people (as opposed to interest groups) truly value. For example, one community might devote fewer resources to reducing class sizes in schools, and instead spend the money on reducing crime or providing public parks, while another does the opposite. The location decisions of individuals give local governments feedback on how well they are satisfying citizens. Localities that don’t satisfy their residents will see a falling population and tax base, while those localities doing a better job will see an inflow of people and tax revenue.

The greater citizen responsiveness of local, as compared with state or federal, government is another advantage of decentralization. Albert Hirschman (1970) explains how voice and exit are the two means people have to control organizations, including governments. ‘Voice’ is participating in decision making by voting or attending city council, school board or stockholders meetings, while ‘exit’ is leaving the organization (moving out of a jurisdiction), reducing a government’s tax base or a company’s customer base. Both exit and voice operate more effectively at the local level. Political action by any one individual is more likely to be decisive in a small community, making voice more effective, and exit is more effective because moving to a different school district within a town (or a different town within the urban area) is much more easily accomplished than moving to another state (or country).

One way to understand why local governments are likely to be more efficient is simply that they are in greater competition with one another. Like with the provision of all other goods and services, increased competition produces more desirable outcomes for consumers. Because competitive pressures between governments are weaker as one moves up the ladder, higher level governments simply become less responsive to their consumers because they have more monopoly power. Simply compare how bad the U.S. federal government would have to become before you would be willing to move out of the country to how bad your city government would have to become before you would be willing to move outside the city limits (or to another city).

For all of these reasons states with more decentralized government sectors outperform more centralized states. Figure 14.3 considers the relationship between real per capita personal income in 2004 and fiscal decentralization for the contiguous 48 United States. Decentralization in Figure 14.3 is measured by the ratio of spending by all local governments in the state to the total amount of state plus local government spending. Local government accounts for only 38 percent of total spending in West Virginia (making West Virginia the 2nd most centralized state). In contrast, local spending comprises up to 65 percent of total state and local spending in the most decentralized states. The trend line in Figure 14.3 shows that citizens of more decentralized states had about 10 percent higher average incomes than citizens of the most centralized states like West Virginia.
Figure 14.3: Decentralization of Government and Prosperity

The Need for Constitutional Limits on State Spending

At the local government level, governments are constrained by the ability of citizens to easily move out of the jurisdiction. Because it is more costly to escape a bad state government than a bad local government, mobility is not as effective in creating competitive pressures between state governments. The problem becomes even worse at the federal level. In the absence of these competitive constraints on government, constitutional rules and provisions can be used as an alternative method to limit the power of state and national governments. In other words, constitutions are a substitute for mobility in constraining government. This is why imposing constitutional constraints on national governments is more important than imposing constitutional constraints on state governments, which in turn is more important than imposing constitutional constraints on local governments.10

One frequently imposed constraint on state government is a tax or expenditure limit law (TEL). As of 2005, thirty states had passed some form of tax or expenditure limit law, although West Virginia was not one of them. The limitations take a variety of forms. Several states limit the rate of spending growth to the rate of growth in per capita personal income. Others limit appropriations to some percentage of projected state revenue. Missouri limits

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revenue to 5.64 percent of the previous year’s state personal income and requires voter approval for any tax hike over 1 percent of state revenues.

The most important difference across state provisions is whether the limit is part of the constitution or merely a legislative statute. A constitutional limitation is a much more effective constraint, because state legislators can always rescind or modify a statutory limitation. Seventeen states have a constitutional TEL, while thirteen have a statutory TEL.

As Figure 14.4 shows, only constitutional TELs are effective at slowing the growth of state government. This figure shows the growth in state government expenditures as a percentage of state income between 1990 and 2004 for three groups of states; those with a constitutional TEL, those with only a statutory TEL, and states with no TEL. While states with a constitutional TEL had expenditure growth significantly lower than states with no TEL, states with a statutory TEL actually had higher expenditure growth than states with no TEL. Clearly statutory TELs are not an effective means to limit expenditure growth.

One type of expenditure limit restricts the annual growth rate of state expenditures to the percent increase in state population plus the rate of inflation. The sum of these two values is frequently called the rate of ‘popflation.’ In a nutshell, a ‘popflation’ limit on expenditure

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Figure 14.4: Growth of Government under Constitutional and Statutory TELs

Sources: U.S. Census Bureau (2006) and authors' calculations.

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growth keeps a state’s real per capita spending constant through time. Spending can increase to accommodate population growth and inflation, but any higher level of spending must be specially approved by either voters or a supermajority (such as two-thirds or three-quarters instead of a simple majority) in the state legislature. If state tax revenues grow by more than popflation in a given year, the excess revenues cannot be spent by the legislature and must instead either be deposited into a rainy-day fund or refunded to taxpayers. Several states have recently considered a population plus inflation spending limit under the name of a ‘Taxpayer’s Bill of Rights’ or TABOR. Alaska has had such a limit since the early 1980s.

Figure 14.5: Spending in Excess of TABOR Limit and Prosperity

![Figure 14.5: Spending in Excess of TABOR Limit and Prosperity](image.png)

Sources: U.S. Census Bureau (2006) and authors' calculations.

Figure 14.5 considers the potential benefits of a TABOR popflation rule for each state’s economy. We calculated what spending would have been in 2004 for each state if a binding population plus inflation limit had been in place since 1990, regardless of whether the state actually had such a rule or not. We then present actual spending as a ratio to this predicted level. A ratio of 1, for example, means that state spending was at the level it would have been under a TABOR popflation rule, while a ratio of 2 means that actual spending was double what it would have been with a popflation limit in effect. West Virginia, which has no TEL of any kind, did poorly in limiting expenditures, with an excess spending ratio of 1.76, the third highest among the U.S. states. By contrast, Alaska, which has had a binding popflation rule since the 1980s, had the lowest excess spending ratio in the country, at 0.99. As the negatively sloped line in Figure 14.5 shows, states in which spending grew much
faster than popflation were less prosperous in 2004, and the consequence of excessive spending is dramatic. The trend line shows that an excess TABOR spending ratio of 2 is associated with about a 25 percent reduction in the average income of a state’s citizens when compared to an excess TABOR spending ratio of 1.

**ARE LOW-INCOME STATES DIFFERENT?**

The evidence we have presented using data from all 50 U.S. states suggests that cutting government size and growth leads to greater prosperity. But some readers may wonder whether this remains true specifically among low-income states. Perhaps low-income states are different, and so the policies that work for other states may not work for West Virginia. In this section we explicitly address this concern.

Figure 14.6 shows the ten states with the lowest average incomes in the 1990 Census. The table reports for each state the cumulative growth in real per capita personal income between 1990 and 2004, along with several measures of government size, scope, and centralization discussed in this chapter.

**Figure 14.6: West Virginia versus Other Low-Income States**

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>23.4%</td>
<td>6.8</td>
<td>42.0%</td>
<td>1.8</td>
</tr>
<tr>
<td>Kentucky</td>
<td>21.2%</td>
<td>6.8</td>
<td>41.0%</td>
<td>1.6</td>
</tr>
<tr>
<td>Louisiana</td>
<td>23.5%</td>
<td>7.1</td>
<td>50.1%</td>
<td>1.4</td>
</tr>
<tr>
<td>Mississippi</td>
<td>26.6%</td>
<td>6.8</td>
<td>48.2%</td>
<td>2.0</td>
</tr>
<tr>
<td>Montana</td>
<td>24.0%</td>
<td>6.3</td>
<td>42.9%</td>
<td>1.5</td>
</tr>
<tr>
<td>New Mexico</td>
<td>23.7%</td>
<td>6.0</td>
<td>44.7%</td>
<td>1.6</td>
</tr>
<tr>
<td>North Dakota</td>
<td>25.9%</td>
<td>7.0</td>
<td>43.2%</td>
<td>1.4</td>
</tr>
<tr>
<td>South Dakota</td>
<td>34.1%</td>
<td>7.9</td>
<td>47.8%</td>
<td>1.3</td>
</tr>
<tr>
<td>Utah</td>
<td>21.5%</td>
<td>7.3</td>
<td>45.1%</td>
<td>1.5</td>
</tr>
<tr>
<td>West Virginia</td>
<td><strong>19.2%</strong></td>
<td><strong>5.1</strong></td>
<td><strong>37.6%</strong></td>
<td><strong>1.8</strong></td>
</tr>
</tbody>
</table>

Sources: U.S. Census Bureau (2006), Karabegovic and McMahon (2006), and authors’ calculations.

Among low-income states, West Virginia had the slowest income growth during this period. Why did West Virginia lag behind these other low-income states? West Virginia’s government size and centralization are major culprits, as the data shows. Columns 3 through 5 show three measures of government size: the Economic Freedom Index for each state, local government spending as a percentage of state and local government spending, and spending in excess of a hypothetical TABOR limit for each state. West Virginia is not only the least
economically free among the group, but it also was the most centralized, and was among the highest in expenditure growth exceeding popflation.

The fastest growing low-income state was South Dakota, with cumulative 34 percent growth in real average income. Why was South Dakota more successful in generating income growth among these low-income states? South Dakota not only has the highest economic freedom score among these states, but it also lead the group with the least spending growth beyond the popflation rule, and was third in decentralization with local governments accounting for almost half of combined state and local spending.

If West Virginia had experienced South Dakota’s growth rate since 1990, the average citizen in West Virginia would have been $3,000 richer in 2004, or $12,000 for a family of four. Even when restricting our analysis to only low-income states, it remains clear that a large, centralized, and fast-growing government sector harms the welfare of a state’s citizens. South Dakota has relied on capitalism and decentralization more than West Virginia, and has experienced more robust growth as a result. As these data clearly show, even among low-income states, excessive state government spending hurts prosperity.

CONCLUSION: UNLEASHING CAPITALISM BY LIMITING WEST VIRGINIA STATE GOVERNMENT

As this chapter has shown, representative democracy contains an inherent bias to spend too much, and a large, bloated government is a major burden on the West Virginia economy. The pathologies of politics indicate that excessive spending is not an accident but is rather the result of perverse incentives within the political process. Only a change in the structure of government can effectively counter the pro-spending bias of politics. Based on both the published economic literature and our analysis, we can recommend two important policy changes for West Virginia: (1) decentralize spending to local governments, and (2) enact a constitutional tax or expenditure limit law.

First, West Virginia should decentralize spending to county and particularly local governments as much as is possible using the rule that expenditures (and the taxes to fund them) should be pushed down to the lowest level of government that comprises the main beneficiaries of each program. West Virginia is currently one of the most centralized states in the country, and this centralization harms prosperity by replacing competitive local governments with a monopolistic state government.

Second, West Virginia should enact a constitutional tax or expenditure limit law (TEL) that requires a supermajority in both houses of the state legislature to raise taxes or increase spending. We believe that constitutionally restricting state expenditure growth to the rate of population growth plus inflation (or ‘popflation’) through a ‘Taxpayer’s Bill of Rights’ (or TABOR), with excess tax revenues refunded to citizens, offers the most attractive option. Annual rebates of excess tax revenues to taxpayers would provide West Virginians with a tangible reminder of the benefits of limiting government expenditure growth.

UNLEASHING CAPITALISM requires reducing the size and role of government in the West Virginia economy. While this should involve some immediate spending cuts, it is worth noting that smaller government can be accomplished successfully over a longer time horizon. By limiting future expenditure growth, major reductions in government can occur with the passage of time. Government in West Virginia is 76 percent larger today than it
would have been had expenditure growth been held to population plus inflation over the past fifteen years. Limiting spending growth for the next decade can go a long way toward harnessing runaway government expenditure growth in West Virginia and increasing the prosperity of all West Virginians.

REFERENCES


SUMMARY OF CHAPTER CONCLUSIONS

Near Addison, Ohio on the West Virginia border. Photo source: NASA World Wind (Longitude 82.12° W & Latitude 38.92° N).
SUMMARY OF CHAPTER CONCLUSIONS

PART I — INTRODUCTION: THE ROLE OF GOVERNMENT IN ECONOMIC GROWTH

CHAPTER 1 THE CASE FOR GROWTH
by Russell S. Sobel and Susane J. Daniels
• Small differences in economic growth rates can produce substantial differences in the quality of life within a generation or two
• A better and richer West Virginia is possible to achieve within our lifetimes
• This growth does not have to come at the expense of other things we value—to the contrary, these other areas are also enhanced by economic growth

CHAPTER 2 THE SOURCES OF ECONOMIC GROWTH
by Russell S. Sobel and Joshua C. Hall
• States relying more heavily on capitalism have higher income levels, faster average income growth, and more even growth across the income distribution
• The key component in reforming policy is to ensure the security of private ownership
• Government must refrain from attempting to control the state’s economy through regulation and spending citizens’ incomes for them through high taxation
• The goal should be to increase the share of our state economy controlled through the private sector and diminish the share controlled through the public sector

CHAPTER 3 WHY CAPITALISM WORKS
by Russell S. Sobel and Peter T. Leeson
• Specialization, division of labor, and capital investment all increase labor productivity and prosperity
• Capitalism embodies a process in which entrepreneurs continuously discover new and more valuable uses for our resources, generating higher income in the process
• Government central planning and economic control often create unintended consequences—the problem is not bad people in government, but bad incentives
• To begin UNLEASHING CAPITALISM, policy reform must increase the reward to productive (market) entrepreneurship and decrease the reward to unproductive (political and legal) ‘entrepreneurship’

CHAPTER 4 THE CULTURAL OPPOSITION TO CAPITALISM:
MYTHBUSTING THROUGH OUR PAST
by Claudia R. Williamson
• Capitalism played an important and productive role in West Virginia’s past—it was a source of prosperity, not of exploitation
• By understanding the reality of West Virginia’s experiences with capitalism, it is possible to undo a part of the wealth-retarding culture that is based in myths and stories from our past
PART II — SPECIFIC POLICY REFORMS FOR INCREASING ECONOMIC GROWTH

CHAPTER 5 WHEN IT COMES TO TAXES: FOCUS ON BEING COMPETITIVE
by Justin M. Ross and Joshua C. Hall

- Taxes are more costly than most people realize ($1.60 to $1.82 per $1 of revenue)
- High tax counties and states tend to grow slower and have less business activity and employment
- Almost every measure of tax burden indicates that West Virginia is at a competitive disadvantage in attracting businesses and households compared to other states
- High taxes on business capital investment are West Virginia’s biggest problem

CHAPTER 6 THREE SPECIFIC TAX REFORMS FOR INCREASING GROWTH
by Robin C. Capehart and Pavel A. Yakovlev

- Eliminate the business franchise tax and personal property tax on inventory, machinery and equipment—perhaps replacing them with a broad-based value added tax similar to the Business Enterprise Tax in New Hampshire
- Replace the high-rate profits tax on corporations with a low-rate profits tax on all businesses
- Repeal the future use of all business tax credits that distort market prices and profit rates in favor of broad-based, low-rate taxes

CHAPTER 7 MAKE PROPERTY RIGHTS MORE SECURE: LIMIT EMINENT DOMAIN
by Edward J. López, Carrie B. Kerekes, George D. Johnson

- Secure property rights are the cornerstone of capitalism
- Excessive taxation, regulation, and use of eminent domain makes property rights less secure, and thereby harms prosperity
- The West Virginia Supreme Court of Appeals should overturn its 1998 ruling in Charleston Urban Renewal Authority vs. Courtland, which upheld the taking of non-blighted private property to promote the city's economic development plan
- The U.S. Supreme Court’s 2005 Kelo v. City of New London decision opens the door to significant eminent domain abuse for private redevelopment
- H.B. 4048 was passed in 2006, but it isn’t strong enough—the state legislature should revisit the relevant section of the Code of West Virginia, and instill a more straightforward set of restrictions on eminent domain powers; numerous exemptions and loopholes must be eliminated

CHAPTER 8 QUIT PLAYING FAVORITES: WHY BUSINESS SUBSIDIES HURT OUR ECONOMY
by Michael J. Hicks and William F. Shughart II

- West Virginia offers economic development incentives under 14 active programs
- Companies receiving generous public subsidies rarely meet the job creation or hourly wage targets promised in return
- There is little evidence that targeted tax incentives produce economic benefits that exceed the costs
- West Virginia’s prosperity would be enhanced by abandoning its selective incentive program and dissolving the economic development agencies that offer them
- West Virginia’s economic development can best be fostered by adopting broad-based tax and regulatory relief, rather than selective tax incentives and subsidies
CHAPTER 9  LOWER BUSINESS REGULATION: COSTS AND UNINTENDED CONSEQUENCES
by Joab N. Corey and Nicholas A. Currott

- Forbes 2006 Best States for Business ranks West Virginia 47th in regulatory environment
- Regulations are costly because they result in businesses spending resources in efforts to comply with the regulations, avoid or find loopholes in the regulations, and lobby against the regulations
- Regulations often cause unintended consequences—counterproductive effects that were not anticipated—‘good intentions are not enough’ to justify policy
- A review of the cost effectiveness of our state business regulations should be undertaken, and new regulations should be subject to cost-benefit analysis before becoming law (and include sunset provisions based on proof of effectiveness)

CHAPTER 10  REDUCE LABOR RESTRICTIONS: FROM SCHOOL CHOICE TO RIGHT TO WORK
by Nathan J. Ashby and Mark T. Gillis

- Eliminate unnecessary and competition-reducing occupational licensing laws to foster entrepreneurship and reduce the cost of living
- Enact a Right-to-Work law
- Eliminate the state minimum wage and seek exemption from the federal minimum wage
- Repeal prevailing wage laws
- Eliminate or ‘means-test’ the PROMISE scholarship
- Improve K-12 education through greater use of school choice programs, vouchers, and charter schools

CHAPTER 11  QUIT PUNISHING THE WORKING POOR:
REDUCE WORK DISINCENTIVES IN THE WELFARE SYSTEM
by Anthony C. Gregory and J. Sebastian Leguizamon

- West Virginia has one of the lowest percentages of aid recipients holding employment
- These well-intended government programs, when combined, too often face individuals with an incentive to remain on public assistance and out of the active labor market
- West Virginia needs to utilize the flexibility in TANF funds to restructure the system of transfer benefits
- Policy reform must recognize the interactions among programs and be done in a manner that lowers the overall ‘implicit tax rates’ on earned income

CHAPTER 12  REDUCE THE COST OF CIVIL LITIGATION AND DEPOLITICIZE THE COURTS
by Michael J. Hicks

- Economic growth is significantly harmed by our high tort and civil litigation costs
- Broad based reform in civil litigation is necessary
- Do away with partisan election of judges in favor of either appointment or non-partisan elections
CHAPTER 13  LEGAL REFORM: SPECIFIC CHANGES TO PROMOTE ECONOMIC GROWTH
by Kristen M. Leddy and Matthew T. Yanni

• Modify the doctrine of joint and several liability to either eliminate it in all civil tort cases, or at least restrict its application to defendants with proportionate negligence of 50 percent or more
• Continue medical malpractice liability reform by limiting the scope of expert medical testimony and creating a statute of limitations
• Revisit legislative efforts to prevent abuse of the state’s courts by nonresidents seeking plaintiff-friendly venues
• Consider the limitation or elimination of punitive and medical monitoring damage awards

CHAPTER 14  REDUCE, DECENTRALIZE, AND CONSTITUTIONALLY CONSTRAIN GOVERNMENT
by Daniel S. Sutter and Rex J. Pjesky

• The incentives within democratic politics create a strong tendency for government to spend and grow excessively—beyond the levels best for economic growth
• We must limit government size, and especially growth, to increase prosperity
• Overall spending can be reduced and made more effective by decentralizing spending to local governments
• Enact a constitutional tax or expenditure limit law (TEL) requiring a supermajority in each house of the state legislature to raise taxes or enact major new spending programs
• Constitutionally limit state spending growth to the rate of population plus the rate of inflation, with excess revenues refunded to citizens each year via a ‘Taxpayers Bill of Rights’ (TABOR)
ABOUT THE PUBLIC POLICY FOUNDATION OF WEST VIRGINIA

The Public Policy Foundation of West Virginia is a nonprofit research and educational organization that conducts scholarly research and analysis of public policy in West Virginia. The Foundation’s mission is to advance sound policies based on the principles of free enterprise, individual liberty, and limited government.

The Foundation shall pursue its mission by conducting timely research on important issues and communicating the findings to government officials, elected leaders, the media, business leaders, community organizations, and individual citizens.

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