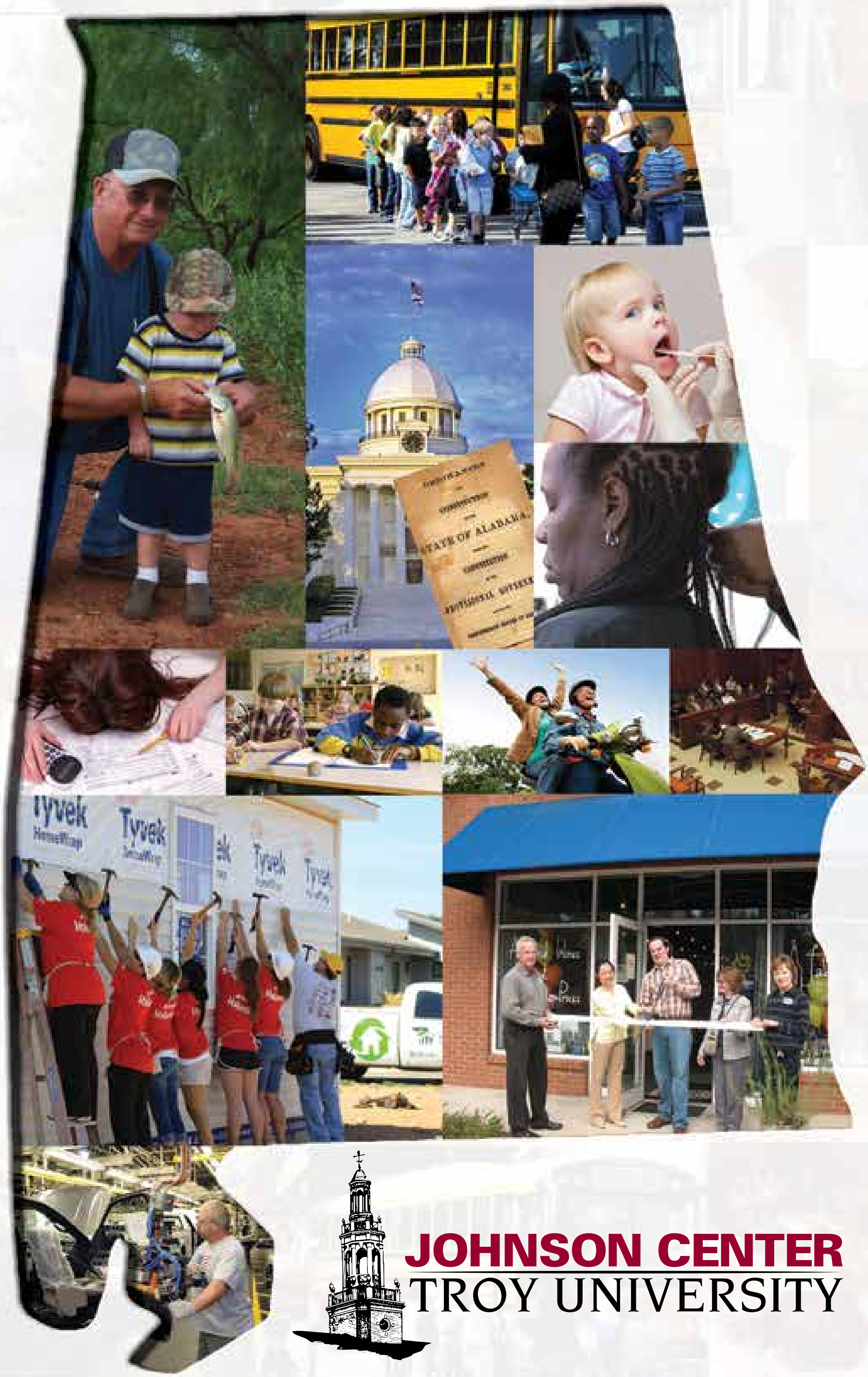
IMPROVING LIVES IN ALABAMA

A Vision for Economic Freedom and Prosperity



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A Vision for Economic Freedom and Prosperity

Edited by

Daniel Sutter

About the Johnson Center

The Manuel H. Johnson Center for Political Economy at Troy University provides a dynamic and rigorous education program focused on the moral imperatives of free markets and individual liberty, as well as relevant policy research on national and local issues. Founded in 2010, the Johnson Center has rapidly grown from an idea into a vibrant hub of teaching, scholarship, and rigorous public debate. The Johnson Center has established itself as a leading and reliable contributor to public policy in Alabama and across the nation.

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Improving Lives in Alabama:
Introduction

Daniel Sutter

We all want Alabamians to lead wealthier, healthier and happier lives. But how do we achieve these goals? Properly balancing the roles of the private and public sectors holds the key. The Manuel H. Johnson Center for Political Economy was founded at Troy University in 2010 to support research and teaching about how economic freedom generates prosperity and happiness. We have compiled this volume to offer a variety of ways to improve life in Alabama.

Eighteenth Century Scottish professor Adam Smith, widely regarded as the founder of the economics discipline, titled his most famous book *An Inquiry into the Nature and Causes of the Wealth of Nations*. This indicates that economists have been thinking, studying and writing about wealth and growth since the founding of our discipline. And the accumulated evidence overwhelmingly demonstrates that economic freedom leads to prosperity and happiness. A market economy is the dizzying array of voluntary interactions which emerge when property rights are secure. In a market economy people are free to earn a living as they choose, start a business if they wish, purchase the goods and services they desire, and save and invest for retirement or benefit their children and grandchildren. People also are free to form clubs, foundations, churches, and civic groups to pursue other goals. The prosperity generated by the market is not limited to monetary riches, but includes all aspects of human well-being and flourishing, including life expectation, infant mortality, educational attainment, environmental quality, and happiness. Markets deliver people materially better lives *and* the satisfaction of having earned their well-being through their own efforts.

This book offers a mix of concrete steps for the near term and long run targets. Some of the concrete suggestions, like reducing the number of jobs requiring occupational licensing (Chapter 9) or privatizing school services (Chapter 5), could be implemented immediately. More often the focus is on the direction Alabama must move to reap the full benefits of economic freedom. Too often the energy and focus required to accomplish the day-to-day tasks of government (as well as business or personal life) prevents us from assessing whether we are on path to achieve our long term goals. Dealing with this year's budget, repairing the roads, or educating students, leaves policymakers with too little time to consider the long term. *Improving Lives*, as the volume's subtitle suggests, offers a vision for a freer, wealthier, and happier Alabama.

The vision for public policy offered here draws on specific views about how both the private and public sectors operate. The first three chapters thus detail these views, starting in Chapter 1 with a discussion by G. P. Manish and Malavika Nair on the nature of the market economy as well as indexes developed to measure how closely a nation approaches the ideal of economic freedom. The chapter also reviews the enormous evidence on how economic freedom yields prosperity and growth. Drawing a line between the private and public sectors also requires a theory of the operation of the public sector. George Crowley provides this in Chapter 2, reviewing the theory of public choice. Chapter 2 also lays out the role of and need for constitutional rules to constrain democratic governments. Many people subscribe to an essentially romantic or idealized view of democracy in which perfectly informed citizens can precisely control politicians. Public choice views politicians as pursuing their own interests and only imperfectly controlled by citizens through elections. Constraints on democracy, as exemplified by Alabama's constitutional balanced budget provision, allow citizens to better control politicians. Alabama's tax system, analyzed by Jim Couch, Douglas Barrett, David Black, and Keith Malone in Chapter 3, reflects the public choice and constitutional economics approaches. Our system features several constitutional constraints on the state's power to tax, including maximum tax rates for income and property taxes and the earmarking of most tax dollars to specific purposes, like the Education Trust Fund. Alabama's tax system takes a toll on economic activity, with its heaviest burden imposed on lower income families, and costs the state economy far more than just the dollars raised to fund government.

The next seven chapters of the book turn to specific policy issues, beginning with spending programs and moving on to legal and regulatory issues. The first two chapters look at public primary and secondary (K-12) education. In addition to being the largest budget item, education also significantly affects Alabamians' opportunity to lead productive and flourishing lives. Trillions of dollars and numerous rounds of reform across the nation over the last thirty years have failed to improve educational outcomes noticeably. John Merrifield and Jesse Ortiz explain why in Chapter 4, and argue that real improvement requires competition and a diverse range of schooling options to serve the many different learning styles of Alabama's children. While Merrifield and Ortiz argue that money alone will not solve the problems of our public schools, many of the dollars we appropriate to education never reach the classroom. As Daniel Smith and Robin Aguiar-Hicks observe in Chapter 5, Alabama spends $1.4 billion on non-teaching related items like food service, maintenance and transportation. School districts across the state could likely save over $100 million by contracting for these services with private companies, which have better incentives to control costs and provide better service. Rapidly escalating expenditures on Medicaid, the state medical care program for low income (and other) Alabamians, have squeezed other components of the state budget. Scott Beaulier describes in Chapter 6 the likelihood of even greater Medicaid expenditures in the future, and how changes in the Federal funding formula could break the state budget. Fortunately, options for reform exist, and have been tested in other states. Perhaps the most important reform would be to alter the underlying Federal cost sharing structure for Alabama Medicaid. Chapter 7 by Eileen Norcross considers the pension system for Alabama teachers and state employees, the Employees Retirement System and Teachers Retirement System (ERS/TRS). Pension benefits are legally guaranteed for current retirees and employees, and yet ERS/TRS is underfunded, meaning that it lacks assets sufficient to pay off all of the promised benefits. And the underfunding problem may be far worse than the state reports, due to excessively optimistic assumptions by ERS/TRS concerning the rate of return on its assets. Should the state retirement systems ever be unable to meet their obligations, Alabama taxpayers will be called upon to step up and make good these promises.

Chapter 8 by George Crowley turns to Alabama's aggressive use of tax breaks and development incentives to lure major manufacturing employers to Alabama. Case studies reveal that four of five of the most prominent development deals have succeeded as advertised, bringing thousands of manufacturing jobs to the state. But the important question is whether this success has come at a too high of a cost, both directly to taxpayers, and indirectly in economic opportunities not realized. And while Alabama aggressively courts major manufacturers in pursuit of jobs, other state policies cost us jobs. Daniel Smith focuses in Chapter 9 on the license restrictions Alabama imposes on over 140 occupations, or a quarter of the state labor market. Occupational licensing too often imposes unnecessary educational and training requirements on practitioners, making both consumers and Alabamians blocked from pursuing a career of their choosing worse off. John Dove examines the legal environment for business in Alabama in Chapter 10. Specifically, Alabama's tort law may be deterring as much investment in our state as tax breaks manage to attract. The chapter recommends that Alabama end its partisan election of judges and abandon its doctrine of joint-and-several liability.

The final two chapters explore the broader societal and cultural context of the market economy. People who have not studied economics often believe that economics is merely about dollars, profits, and material things. But economics is really about human values, namely the things which people are willing to work and save for. Economic freedom often focuses on institutions, property, and the legal framework, and yet the market order both supports and is supported by the larger culture. Adam Lowther in Chapter 11 focuses on the victim narrative, the world view where individuals see themselves as victims of forces beyond their control, and seek security from the government. Art Carden considers in Chapter 12 the importance of dignity accorded to commerce and wealth creators as a factor in the emergence of the market economy and modern prosperity. Culture affects whether market institutions emerge, and if so, whether they can be sustained. Doubters of a link between institutions and culture should consider Dr. Lowther's examination of how the victim narrative is affecting the U.S. military and foreign policy.

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Economic Freedom and Prosperity in Alabama

G. P. Manish and Malavika Nair

Economic Freedom and Prosperity in Alabama

G. P. Manish and Malavika Nair

Summary Points

- Economic freedom allows citizens to use their time, talents and property to their benefit through voluntary exchange, with knowledge that their property is protected from theft or government confiscation.
- Under economic freedom, prices and profit and loss in the market emerge, providing signals to allow entrepreneurs to direct resources to uses valued by consumers, resulting in prosperity and economic growth
- The Economic Freedom of the World and Economic Freedom of North American indexes measure the extent to which nations and the U.S. states respectively approach the ideal of free markets. The indexes help convincingly establish the link between economic freedom and prosperity, as well as health, income equality, and overall well-being.
- Alabama's low state and local tax burden and labor market policies contribute favorably to the state's economic freedom scores. But a high level of Federal spending and poor scores on other areas of business regulation lower Alabama's economic freedom.

1. Introduction

One of the most enduring questions facing economists is why some countries are rich and others are poor. What applies across countries also applies within countries. While the United States consistently ranks as one of the wealthiest countries in the world, there exists a wide variation in income and standards of living across the states. In the year 2010, for instance, Connecticut was the richest state in America with a personal per capita income of $55,427, a figure significantly higher than that of the poorest state, Mississippi, which had a corresponding figure of $30,841.[1]

What explains these wide variations in income per capita across states and countries? More importantly, if we can explain what causes economic growth, are there particular policies that can be pursued to promote economic growth? In this chapter, we make the case that policies that promote economic freedom are the ones that bring about more growth. This is because economic freedom fosters an environment conducive to competition, productive entrepreneurship and capital accumulation, which in turn cause economic growth. We then evaluate Alabama's freedom and growth performance over the last two decades.

Economic prosperity and growth translate not just into higher standards of material well-being, but also better life expectancy, health, literacy and leisure. We value material well-being not just because we value money, but because having a bigger income allows us to enjoy more of the things that money can buy. This means more people or previously poor people are able to afford things like better healthcare, education for their children, vacations or more time to spend with family and so on as a result of economic growth.

Section 2 of this chapter lays out the process of economic growth and the role that entrepreneurship, private property and capital accumulation play in it. It also shows how certain policies like lower taxes, less burdensome regulation and a well-functioning legal environment are crucial elements of economic freedom for their ability to foster entrepreneurship. Section 3 provides evidence from cross-country data in the Economic Freedom of the World Index to show that the positive relationship between freedom and growth is robust and holds across countries. Section 4 then presents Alabama's case.

2. The causes of economic growth

Economists must understand the process of economic growth in order to recommend policies to promote economic growth. It is no coincidence that the policies of economic freedom are highly correlated with various measures of human well-being across the world. More economic freedom means better institutions or rules of the economic game. This encourages productive entrepreneuership that in turn grows the economic pie.

Economic growth implies a bigger and improved consumption basket of goods and services for everyone, which translates into higher livings standards that can be measured by rising levels of GDP per capita. For growth to occur, entrepreneurs need to accumulate more capital, invest in better technology and produce the goods and services that consumers desire in a more productive manner. Thus, policies that promote entrepreneurship like secure private property rights, lower taxes and less burdensome regulation also promote economic growth. This section briefly lays this process as well as the crucial role played by businesses, entrepreneurs and economic freedom.

i. Capital Accumulation and Technology

Economists often use the imaginary example of a man stranded on an island to portray some fundamental economic truths. Consider Robinson Crusoe, the English sea voyager in Daniel Defoe's famous 18th Century novel, who finds himself ship wrecked on a deserted island with no food or any other consumer goods. Shorn of any other resources, Robinson must rely solely upon his own labor to sustain himself.

Given his pressing need for food, Robinson decides that wading into the nearby ocean and trying to catch fish with his bare hands offers the quickest way to obtain something to eat. After having persevered at this for ten hours, he obtains a catch of ten fish at the rate of one fish per hour worked. Dissatisfied with his low productivity, Robinson thinks of a more efficient way of utilizing his labor in the production of fish. He realizes that he could potentially obtain a much bigger catch of fish per hour worked by fishing with the aid of a raft and a net. Having a raft would allow him to strike out into deeper waters, where fish are far more abundant and possessing a net would allow him to catch them with ease.

Constructing these capital goods, i.e., the raft and net, however, will take him time, say thirty hours, or three ten hour working days. To survive while producing the raft and net he needs to save, i.e., not consume some of the fish that he currently has. In other words, Robinson needs to save and invest his only resource, his labor, to produce the capital goods that will make him a more productive fisherman. He would, indeed, need to do the same, not only to enjoy more fish, but also to produce other consumer goods like meat or a house. For the former, he would need to construct a bow and some arrows to enable him to kill his prey, whereas for the latter he would need to construct an axe to be able to chop wood.

Thus, the production and accumulation of capital goods allow Robinson's economy to grow, i.e., for him to enjoy an ever-growing basket of the goods and services that he desires. Also essential is constantly improving technology, or the knowledge of how to produce various goods and services. To ensure that he continues to be more productive and therefore also more prosperous, Robinson needs to know how to produce a variety of goods and services and the most efficient way of producing any good or service.[2]

Thus, a Robinson who knows how to build a raft and a net, a set of bow and arrows and an axe and who saves enough to produce these capital goods will be wealthier and able to enjoy more fish, consume meat and will no longer have to sleep out in the open, at the mercy of the forces of nature. On the other hand, a Robinson who does not possess such advanced technology, i.e., who does not know how to produce these capital goods or one who does not save and invest in their production will be significantly poorer. He will be a much less productive fisherman and will not have the luxury of eating meat or enjoying the shelter of a home.

What applies to an economy of one individual also applies with equal force for an economy of millions. The developed countries of today enjoy high levels of productivity and a vast array of goods and services as a result of the past accumulation of capital goods and technology. Individuals in these economies enjoy a vast stock of capital goods produced over past generations along with the knowledge of a rich menu of various production processes. Poorer, less developed economies are, on the other hand, characterized by a relatively small consumption basket and rudimentary capital goods and technology.

Entrepreneurship and Private Property

A crucial difference between Crusoe's one-man economy and our modern world is that we are constantly engaged in trading with one another. While Crusoe was forced to produce all the goods he desired by himself, participants in a modern economy are engaged in a highly specialized division of labor. In such an economy, people are not self-sufficient in the production of the consumer goods; they do not produce these goods for themselves and their own families. Instead, they rely on others to produce the consumer goods that they need. More specifically, they rely on *entrepreneurs* to produce these goods and services.

In a complex market-based economy, the all-important decisions of what to produce, how to produce and how much to produce are made by private entrepreneurs. How do entrepreneurs make these decisions? They do so guided by what the father of economics, Adam Smith, famously termed the "invisible hand" of the price system.[3] Those entrepreneurs who undertake projects and reap profits as a result are the ones who remain in business and continue to make these important production decisions. On the other hand, those entrepreneurs who incur sustained losses are forced to abandon their ventures and exit the market and no longer serve consumers' wants.

The profit and loss system not only decides who becomes and remains an entrepreneur, but also ensures allocation of scarce resources based on the preferences of consumers. When entrepreneur A earns a profit, it implies that consumers are willing to pay more for the product than the entrepreneur paid for the resources utilized to produce it. The entrepreneur's cost of production reflects the opportunity cost of using the resource, i.e., the amount that other entrepreneurs competing for the resource were willing to pay to utilize it in the production of other products. Thus, the fact that consumers were willing to pay more for A's product than his total cost of production implies that A has succeeded in bidding away these resources from alternate lines of utilization into the production of a commodity more highly valued by consumers.

On the other hand, entrepreneurs who fail to produce goods and services in line with the preferences of consumers earn losses. The amount that consumers are willing to pay for these products is less than their cost of production, indicating that the resources used up in producing the products would be better utilized in the production of other commodities. Hence the price system guides entrepreneurs in a way that consumer wants are being fulfilled as well as society's scarce resources are being utilized most efficiently.[4]

Market prices and the associated profits and losses also guide entrepreneurial activity in the realms of capital accumulation and technological improvement. Economic growth requires accumulation of capital and investment in research and development (activities far removed from consumption) in ways that ultimately conform to the preferences of consumers. Since all capital goods and technology are ultimately geared towards the production of consumer goods, entrepreneurs must be keen forecasters and use strong judgment while making decision regarding capital. Here again, the profit and loss system allows entrepreneurs to produce precisely those capital goods and invest in exactly those technologies that will result in consumer goods that are most highly valued by the consumers.[5]

A well-functioning price system is therefore the key to directing entrepreneurial activities and ensuring sustained economic growth. For a well-functioning price system, however, secure private property rights are vital. Without secure private property there can be no exchange of goods and services and therefore no price formation. In a world without private property rights in the ownership of resources and consumer goods, these goods can no longer be traded. Without markets for these goods there would be no prices of either resources or consumer goods established, thereby making the calculation of profits and losses impossible. As Austrian economists F.A. Hayek (Hayek 1935a; 1935b)) and Ludwig von Mises (Mises 1920) pointed out, without profits and losses the allocation of resources in line with consumer preferences becomes impossible.

In fact, highly centrally planned economies like the erstwhile Soviet Union and India were characterized by poverty and underdevelopment in the face of a substantial accumulation of capital and the employment of state of the art technology in certain areas of the economy. A dearth of the consumer goods amongst the broad masses and the production of consumer goods of poor quality existed side by side with imposing steel mills and hydroelectric projects.[6]

The lack of a coherent and meaningful price system explains this anomaly of poor economic growth in the face of sizeable capital accumulation. Both these economies were characterized by highly insecure private property rights in the ownership of goods, with widespread and numerous controls and regulations placed on private economic activity. As a result, prices in these economies neither reflected the valuations that consumers placed on products nor the actual state of resource scarcities. Resource allocation undertaken on the basis of these prices did not ensure an allocation in line with consumer preferences, but instead reflected the whims and fancies of the planners.

In other words, where there is no private property or property rights are insecure, entrepreneurs cannot exercise control over resources. Hence they are unable to undertake production of consumer or capital goods in a way that not only maximizes profit but also fulfills consumer wants and allocates scarce resources efficiently.

Policies that promote entrepreneurship

Policies that promote private property rights also promote entrepreneurship and economic growth. Secure private property rights allow several pathways of control over resources. The most obvious pathway is personal choice or freedom. Individuals who lack the freedom to make choices about how to spend or invest their income are worse off than they would be with that freedom. An inability to make personal choices regarding one's own property hampers economic growth. However, economic freedom extends well past personal freedom and civil liberties. Entrepreneurs need the freedom to trade with other entrepreneurs and employ resources (capital and labor) as they wish. This implies that the aforementioned system of prices, profit, and loss must be allowed to guide entrepreneurs. Any policy hampering the smooth functioning of this system (such as price controls, taxes or bailouts) and its coordinative function in the market will also hamper entrepreneurship and economic growth.

Another crucial element of economic freedom is the ability for new businesses to freely enter an industry and compete with existing businesses. Entrepreneurs must be able to start new businesses without having to deal with unnecessarily burdensome regulations. Heavy start-up costs imply that on the margin some entrepreneurs are shut out of the market and hence consumers are made worse off. Government granted legal privileges also impair the freedom to enter certain markets. Privileges reduce the amount of competition in the market place and create an incentive for incumbent firms to lobby politicians for additional favors.[7] Business lobbying impoverishes society by channeling scarce resources away from satisfying consumer wants and into unproductive uses, like lobbying itself. In this case, the economic pie does not grow, rather it is merely being re-distributed and a few gain at the expense of many.

Finally, a well-functioning legal system that enforces property rights is very important. Entrepreneurs, businesses and investors need to know that they and their property are secure against theft, violence or fraud. An unbiased, and low cost mechanism for dispute resolution and restitution allows entrepreneurs to undertake projects and risks without worrying about unfairly losing the fruits of their labor. In countries with corrupt and poorly enforced legal systems, uncertainty regarding the ability to keep one's own property leads to poor incentives to start new businesses. Entrepreneurs can only rely on family networks to resolve disputes allowing business activity only within family or clan boundaries and leaving possible gains from trade unrealized.

3. Economic Freedom of the World

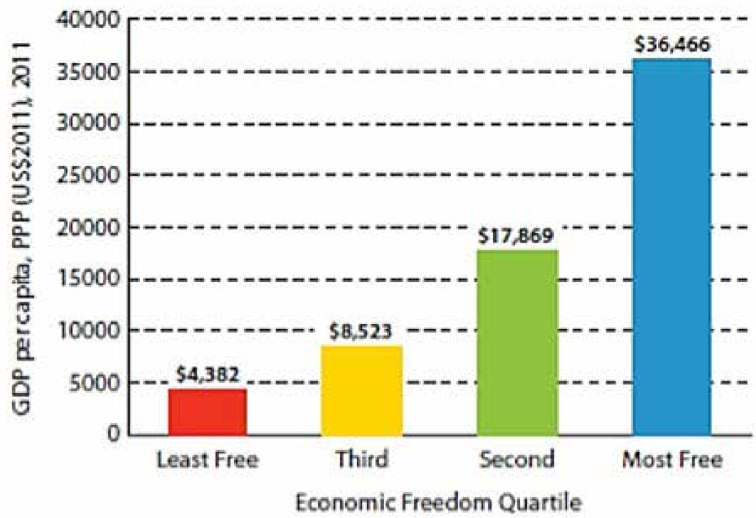
Does economic freedom really provide a formula for growth in Alabama? The evidence overwhelmingly says yes, and it is instructive to start with the cross-country data. We therefore start by showing correlations between Economic Freedom of the World index (EFW, Gwartney, Lawson and Hall 2013) and different measures of prosperity and well-being like GDP per capita and life expectancy. The results are unequivocal, economic freedom across the world does indeed correlate highly with measures of well-being.

The EFW index measures economic freedom for 153 countries through 5 sub-categories of freedom important for entrepreneurs and markets. The categories are: 1) The Size of Government; 2) Legal System and Property Rights; 3) Sound Money; 4) Freedom to Trade Internationally; 5) Regulation. The size of government variable takes into account the levels of taxes and government expenditure, plus the extent of government owned enterprises. Higher taxes, more government spending and large government sectors imply lower economic freedom (Gwartney, Lawson and Hall 2013, p. 3-7).

The legal system and property rights category measures the fairness and reliability of the police and court system. A better functioning legal system supports the contracts needed by entrepreneurs and businesses to produce goods and services and capture gains from trade. The sound money component measures money growth and inflation in a country. Low inflation and stable monetary growth provide a foundation for a smoothly functioning economy. Hence, sound money provides a foundation for translates into more economic freedom in a country.

The freedom to trade internationally component measures the extent of tariffs, capital controls and other barriers hampering free trade across countries. Lower tariffs and capital controls increase economic freedom since entrepreneurs are able to source products and sell goods to whichever market values them most highly. Finally, the regulation component captures the extent of regulations which increase start-up costs and compliance costs for businesses as well as the extent of labor market and credit market regulations. Less regulation reduces the costs of starting or growing a business and hence translate into more economic freedom.

Figure 1.1



Source: Gwartney, Lawson and Hall 2013, p. 21.

Figure 1.1 shows the relationship between economic freedom in 2011 and GDP per capita adjusted for purchasing power parity in 2011 across nations. Countries are ranked for economic freedom and then divided into quartiles to aid visual depiction. The relationship between the two is strong and obvious. Countries like Hong Kong, Singapore, United States and Switzerland that rank in the highest quartile for economic freedom also rank in the highest category for GDP per capita. Countries like Zimbabwe, Chad and Nepal rank in the lowest quartile for economic freedom as well as the lowest category for GDP per capita. Some countries in the middle catergories include Belgium, Portugal, Brazil, Morocco and India.

Nations with more economic freedom are clearly more prosperious, but critics might argue that economic freedom only benefits the wealthy of a country at the expense of the poor. The strong, positive correlation of GDP per capita with economic freedom does not automatically imply that economic freedom also benefits the poor in the same way. The status of the poorest people in a nation may not be captured accurately by country averages. **Figure 1.2** shows the relationship between economic freedom and the income level of the poorest 10% of people in each country in 2011. The benefits of economic freedom run deep: the more economic freedom in a country, the richer its poorest members will be. Economic freedom and competition make consumer goods abundant and cheap and benefit all members of a society.

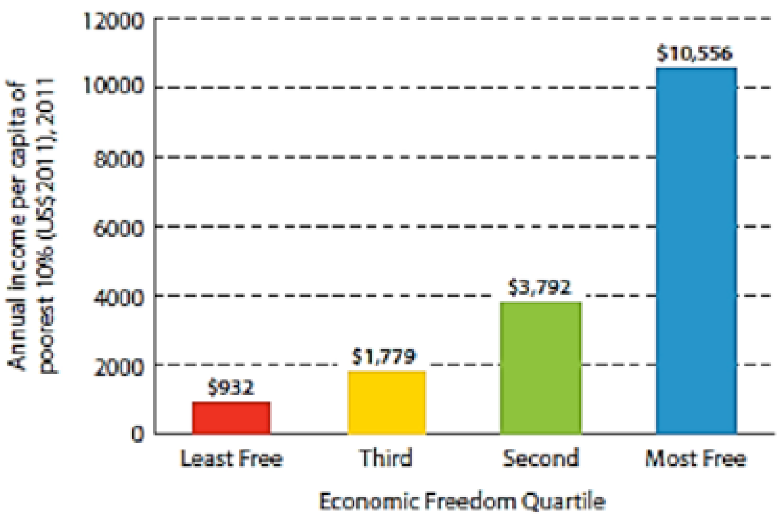
Figure 1.3 shows the relationship between economic freedom and life expectancy at birth for all countries in 2011. Once again, there is a positive relationship. More economic freedom translates into higher life expectancy for all countries, although the relationship is not as dramatic as the one between freedom and income. This is explained by the fact that poor countries around the world have benefited from the huge advances in medicine during the twentieth century through exports and humanitarian efforts aimed at making vaccinations and antibiotics available to the masses.

Now that we have shown there is indeed a strong relationship across countries between economic freedom and economic growth, we now turn to this question specific to Alabama. While certain federal level policy variables will no longer be relevant, namely sound money and the freedom to trade internationally; others like regulation, size of government and legal environment will still play into the level of economic freedom within the state.

4. Economic Freedom and Growth in Alabama

In the globalized and economically integrated world of today, Alabama must compete not only with other states in America, but also with nations all over the world to attract the entrepreneurship and the investment that drives economic growth. Instituting policies that secure private property rights and promote economic freedom are vital to ensure success in this competitive endeavor, for they provide both the incentive

Figure 1.2



Source: Gwartney, Lawson and Hall 2013, p. 22

for entrepreneurial investment as well as the system of profits and losses to ensure that these investments ultimately satisfy the preferences of consumers.

Over the past two decades, Alabama's economic performance has been rather poor. Indeed, Alabama consistently ranks in the bottom ten states in per capita personal income (PCPI). When analyzing these rankings for the twenty year period between 1991 and 2010, one finds that Alabama was ranked 39th in 1991 with a per capita income of $16,337 and at 42nd in 2010 with a per capita income of $33,710. The state's highest annual ranking during these years was 39th, achieved in 1991, 1995 and 1997, and its lowest rank was 46th in 2001. In fact, for some years between 2001 and 2010 Alabama was ranked worse than 42, often finding itself in the 43rd and 44th positions.[8]

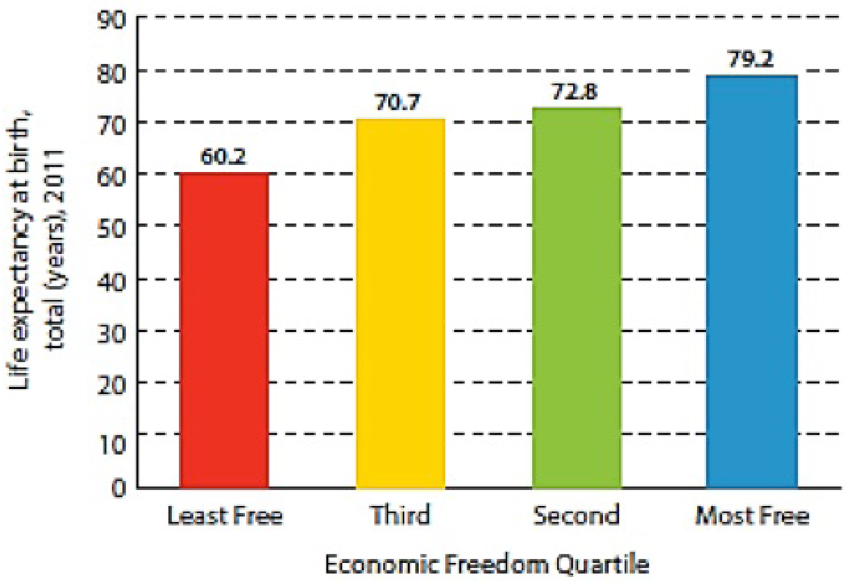
In keeping with this low ranking, Alabama witnessed relatively low growth of real PCPI during the two decades between 1990 and 2010. During the 1990s, for instance, real PCPI in Alabama grew at a modest 1.6 per cent, whereas this rate fell significantly to 1.1 per cent during the following decade. As a result of this poor growth performance Alabama's PCPI as a percentage of US PCPI grew only by a little more than 3 per cent over these twenty years, from 81 per cent to 84.40 percent. In sharp contrast, during this same period Louisiana's PCPI as a percentage of US PCPI grew from 78 per cent to 93 per cent. Thus, unlike its neighbor, Alabama did not significantly outperform the other states and catch up with the rest of the country during this period.[9]

How does economic freedom help explain Alabama's underwhelming income and growth performance? It turns out that despite being a "red state," Alabama has a relatively low level of economic freedom relative to other states. Thus, consider the most recent *Economic Freedom of North America (EFNA)* report (Bueno, Ashby and Mcmahon 2012), an annual publication of the Fraser Institute. The report features two indices that rate the economic freedom of the various states on a ten point scale. The first of these is an all-government index that captures the impact of restrictions on economic freedom by all levels of government (federal, state and local/municipal), whereas the second is a subnational index that only captures the impact of restrictions at the state and local levels. These indices are both composed of ten sub-components that focus on various government imposed restrictions to economic freedom in three broad areas, namely, the size of government (area 1), takings and discriminatory taxation (area 2) and labor market freedom (area 3) (Bueno, Ashby and Mcmahon 2012, p. 6-11).

As in the case of the rankings of per capita income, Alabama consistently finds itself in the bottom ten states in the area of economic freedom when the all-government index (federal, state and local) is considered. Indeed, when the scores of all the states are compared, Alabama's average rank during the 1990s is 39th, with this figure falling slightly to 40th during the following decade. The state's rank remains persistently low and also relatively stable throughout the period, with the highest ranking during these two decades being the 36th achieved in 1995 and 1996, whereas the lowest rank was a 42nd recorded in 2000.[10] The state does, however, perform significantly better in relation to other states when the subnational index is considered. For in this case Alabama's rank in 1990 was 3rd; a rank that fell to 19th in 2000 before rising to 9th by the end of that decade in 2010.

Table 1.1 below depicts Alabama's rank relative to other states in the three key areas of the EFNA index. As seen below, the rankings for all these three areas are provided both for the all-government as well as the subnational indices. Several important points are worth noting: first, Alabama performs poorly in area 1, or the size of government. Moreover, it does so in both indices, i.e., regardless of whether one counts the size of the federal government's footprint in Alabama's economy or not. The state does, however, perform much better in area 2, i.e., in the area of state taxation, an area that takes both direct as well as indirect taxes into account. And finally, Alabama performs remarkably and consistently well in the area of labor market freedom at the

Figure 1.3



Source: Gwartney, Lawson and Hall 2013, p. 23

subnational level, thereby indicating that labor market policies at the state and local levels are relatively free and unrestrictive.

Let us now turn to another economic freedom index to analyze Alabama's performance on this front relative to other states. *The Freedom in the 50 States* index published by the Mercatus Center (Ruger and Sorens 2013)[12] scores and ranks states in over 200 policy variables that fall into three broad categories of freedom, namely, fiscal, regulatory and personal freedom. Unlike the EFNA index, the Mercatus Index does not have an all government index that includes the impact of the policies of the Federal government on economic freedom along with those of the state and local governments. Instead, it only considers the actions of the state and local governments in its calculations of a state's economic freedom score.

Alabama, as in the case of the subnational EFNA index, performs relatively well in the overall Mercatus Index, coming in at a rank of 18th in the latest rankings released in 2013. Its performance does, however, vary greatly across the three broad sub-categories included in the index. Thus, whereas it performs very well in the area of fiscal freedom, with a rank of 5th, it performs relatively poorly in the areas of regulatory and personal freedoms, with ranks of 38th and 43rd respectively.

In order to better understand Alabama's performance in the various areas of economic freedom, let us begin by focusing on an area in which it does poorly throughout the period between 1990 and 2010, namely, the size of government. Its average ranking in this area in the all-government freedom index of the EFNA stood at 43rd during the 1990s and 45th during the 2000s, and throughout the latter decade Alabama consistently remained in the bottom five states in this category. In fact, in 2010 Alabama's total government (federal, state and local) expenditure as a percentage of its gross domestic product (GDP) stood well above the national average, with 33 percent of the state's GDP being expended by the various levels of government as compared to the national average of 25.9 percent. Indeed, Alabama does very poorly when compared to other states on this front, with an average rank of 46 for the years between 2000 and 2010.[13]

The relatively large role played by government expenditure in the Alabama economy is also reflected in the figures for the proportion of the state's workforce employed by government at all levels (federal, state and local). During the period between 2001 and 2010, Alabama's average rank in this area was 39, and the proportion of Alabamans employed by the various levels of government stood at 19.8 percent in 2010, above the national average of 17.2 percent. In fact, if the proportion of Alabama's workforce employed in the government sector corresponded to the national average, the state would have seen approximately 56,000 workers released and available to work in the private sector in the year 2010 alone.[14] Moreover, the numbers are similar if only the state and local levels of government are considered. Here too, Alabama employs a greater proportion of its workforce in government employment than the national average. For instance, in 2010 Alabama employed 16.8 percent of its workforce in state and local governments, whereas the national average for this year stood at 14.8 percent.[15]

The significant role played by both government expenditure and government employment in Alabama's economy act as a drag on the economic growth of the state. The relatively large share of the workforce employed in government employment implies that fewer resources are available for employment in the private sector for capital accumulation and technological growth. Entrepreneurs now have less to work with, whereas governments at all levels have more. Governments, however, are notoriously inefficient producers of goods and services. Bureaucrats, due to a lack of incentives, are not known either for their level of customer service or for their desire to be more efficient. Moreover, government expenditure is not guided by any system of profit and loss, implying that there is really no way to verify whether it does serve consumer preferences or it does not.[16]

Another area of concern for Alabama in relation to economic freedom is that of business regulation, as indicated by the lowly rank of 38th recorded in this are in the Freedom in the 50 States index published by the Mercatus Center (Ruger and Sorens 2013, p. 43).[17] To a large extent, this low ranking is due to the state's especially poor legal liability system. Citing a survey of business owners and managers conducted by the U.S. Chamber of Commerce, Ruger and Sorens note that Alabama has a particularly unfavorable lawsuit climate facing businesses, where they are especially vulnerable to be the victims of tort abuse. In fact, Alabama ranks 47th among American states in the area of freedom from tort abuse in 2011, a rank that has remained virtually unchanged over the last decade (Ruger and Sorens 2013, p. 29).

Needless to say, the heightened threat of being potential victims of lawsuits greatly increases the potential cost of doing business in Alabama. It also makes businesses that operate in Alabama relatively less competitive, since the increased risks and costs associated with it are often passed on to the consumers in the form of higher prices. Thus, a reform of the tort law system in Alabama is essential in order to attract more entrepreneurs and therefore for greater economic growth.

Over and above this poor performance in the area of business regulation, Alabama performs even more poorly in the area of personal freedom, with a ranking of 43rd in the nation. The state performs exceedingly poorly in the areas of the incarceration rate for victimless crimes, the regulation of alcohol distribution and the taxation of alcohol sales and in its policies with respect to medical and recreational marijuana use, with its rank in the three areas standing at 39th, 46th and 50th respectively (Sorens and Ruger 2013, p.50-61). Such repressive policies in the realm of personal freedoms could have a significant negative impact on the state's ability to attract young, motivated and skilled workers.

As indicated by table one above, Alabama does perform well on some components of economic freedom. For example, at 7.6 percent of personal income, Alabama has one of the lowest tax burdens in the nation, ranking 5th among the fifty states in this area in 2011 (Ruger and Sorens 2013, p. 15). The state also scores very highly in the areas of labor market freedom and health insurance regulation, ranking 2nd and 4th in these areas respectively as of 2011 (Ruger and Sorens 2013, p. 35, 33); the latter a result of fewer state-level mandates than the national average and the absence of any price controls. Moreover, Alabama ranks 9th in the important area of property rights protection in 2011 thanks to flexible, decentralized zoning rules and comprehensive eminent domain reform (Ruger and Sorens 2013, p. 31).

Table 1.1: Ranks for Alabama in the Three Component Areas (EFNA Index) [11]

AREA	1990	2000	2010
Area 1 (All Government)	48	44	45
Area 1 (Subnational)	21	47	39
Area 2 (All Government)	11	14	17
Area 2 (Subnational)	6	14	12
Area 3 (All Government)	38	38	44
Area 3 (Subnational)	7	5	5

The greater economic freedom brought forth as a result of these lighter regulations bodes well for economic growth in Alabama in the long run as proven by the fact that the state has received an A+ grade for overall business friendliness in a nationwide survey of small business owners conducted by the website Thumbtack.com in association with the Kauffman Foundation in 2013. Alabama rates highly in various areas of business and entrepreneurial freedom, scoring a grade of A+ in the category of ease of hiring, A for the ease of starting a business, A+ in regulations and A+ in zoning.[18]

Conclusion

In this chapter we have argued that Alabama has not benefited from economic growth over the last two decades because it has failed to implement policies that promote economic freedom. The size of government spending, low personal freedom, heavy regulatory burden and a weak legal system have prevented the state from reaping the benefits of more entrepreneurship and competition. This helps explain why Alabama consistently ranks poorly when compared to other states in the nation in terms of personal income per capita.

We also argued that it is no coincidence that more economic freedom leads to more economic growth. There are strong a priori reasons for this, more economic freedom fosters an environment that encourages the right kind of entrepreneurship through competitive market forces as well as capital accumulation that increases productivity. The more entrepreneurs are engaged in trying to earn profits by having to compete with other entrepreneurs in a fair level playing field, the more consumers are served as the supply and variety of goods becomes more abundant and cheaper. On the other hand, when government plays a large part in this process of resource allocation, scarce resources are channeled away from serving consumers and squandered trying to win favors by lobbying politicians and restricting competition. In order to reap more benefits of this virtuous market process that benefits both entrepreneurs and consumers simultaneously while efficiently making use of society's resources, the state of Alabama needs to make a move towards policies that promote economic freedom.

Notes

1. Indeed, the personal per capita income of the District of Columbia was even higher than that of Connecticut and stood at a figure of $71,220.
2. For more on the relationship between capital accumulation and economic growth see Rothbard (2009 [1962] p. 47 – 70, 517 – 527), Mises (1998 [1949] p. 479 – 520) and Hayek (2008).
3. For Adam Smith's three references to the "invisible hand" see Smith (1976 [1776]).
4. See Mises (1952) and Kirzner (1973) for more on how profits and losses guide entrepreneurial decision making and the allocation of resources on the market.
5. See Kirzner (1971) for a brief and lucid exposition on the relationship between entrepreneurship and economic growth and development.
6. For more on economic development under central planning in the erstwhile Soviet Union see Nutter (1962) and Boettke (1990). India's economic performance during its socialist era is dealt with in Bhagwati and Desai (1970) and Manish (2011; 2013).
7. As noted by Baumol (1990) and Boettke and Coyne (2009), in an environment with widespread government intervention, a significant portion of a nation's entrepreneurial energy is diverted into unproductive channels like rent-seeking.
8. Per Capita personal income figures are nominal and are from the U.S. Chamber of Commerce, Bureau of Economic Analysis (March 2013 release). The rankings of American states have been calculated using these figures by the Bureau of Business and Economic Research, University of New Mexico. Spreadsheet containing both the per capita income figures as well the rankings based on them available online at http://bber.unm.edu/econ/us-pci.htm.
9. Growth rates of real PCPI were calculated by the authors using the nominal PCPI figures from the Bureau of Economic Analysis and Consumer Price Index (CPI) numbers from the Bureau of Labor Statistics. The PCPI figures for Alabama and Louisiana as a percentage of US PCPI are from the Bureau of Economic Analysis.
10. Rankings calculated by the authors from data provided in the dataset for researchers accompanying Bueno, Ashby and Mcmahon (2012) and available online at freetheworld.com.
11. The rankings in all the three areas were calculated by the authors using the data provided in in the dataset for researchers accompanying Bueno, Ashby and Mcmahon (2012) and available online at freetheworld.com.
12. Available online at http://freedominthe50states.org/.
13. Figures available in dataset for researchers accompanying Bueno, Ashby and McMahon (2012). Available online at freetheworld.com. Rankings calculated by the authors using this data.
14. The figure of 56,000 was calculated by the authors using the figure of 1.872 million for Alabama's workforce in 2010 (this figure, obtained from the Bureau of Labor Statistics is the figure for only December 2010 but has been used as an approximation for the figure for 2010 as a whole.
15. Figures available in dataset for researchers accompanying Bueno, Ashby and McMahon (2012). Available online at freetheworld.com.
16. For more on the perverse incentives facing bureaucrats see Niskanen (1971). The classic work on the implications of the lack of a profit and loss system on bureaucratic efficiency is Mises (1944).
17. Available online at http://freedominthe50states.org/.
18. Available online at http://www.thumbtack.com/survey#2012/states.

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Improving Lives in Alabama
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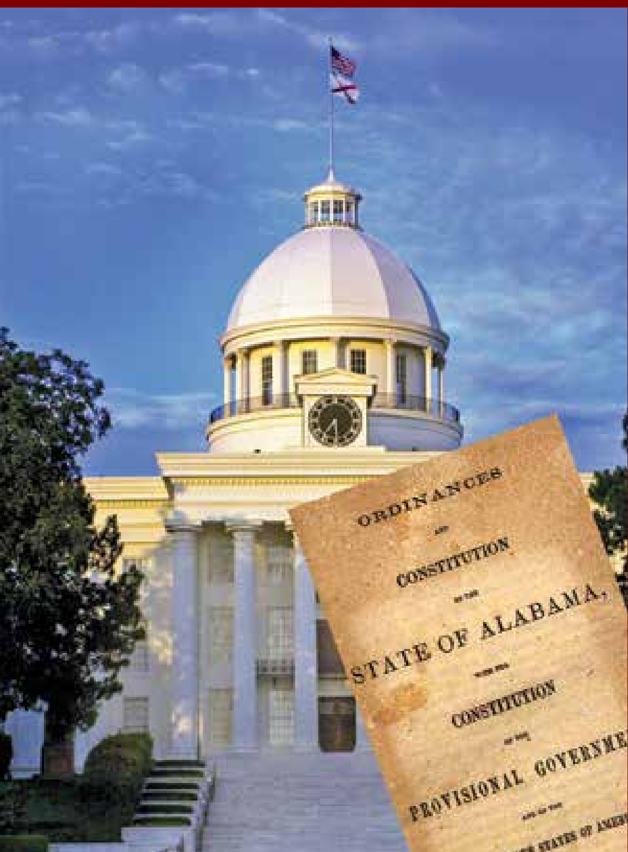
2

The Need for Constitutional Constraints on Government



George R. Crowley

The Need for Constitutional Constraints on Government

George R. Crowley

Summary Points

- Public choice theory demonstrates that the incentives facing elected representatives, voters, and bureaucrats in representative democracy lead to excessive spending. Constitutional limits on government are needed to prevent excessive spending.
- Alabama is home to the world's longest written and most amended constitution. Alabamians should consider a complete overhaul of the document to retain only features essential to limiting government.
- Fiscal decentralization enhances the tailoring of local government services to local conditions. Alabama should move to constitutional home rule for local communities, and avoid requiring state-wide decisions on purely local policy matters.
- Alabama should adopt a tax and expenditure limitation on state spending. Spending growth should be strictly limited, perhaps to the rate of inflation plus population growth.
- A gubernatorial line item veto has been proven effective in limiting excessive spending. Alabama's line item veto should be strengthened by requiring a two-thirds majority in the state legislature for an override.

Introduction

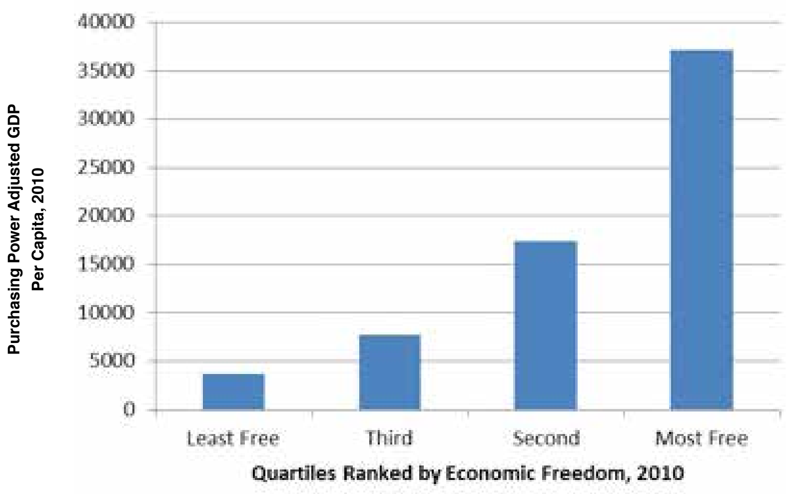
Societies with the highest incomes and strongest rates of economic growth rely primarily on private-decision making instead of government intervention. Nevertheless, public choice economics offers compelling arguments as to why the self-interested politicians, bureaucrats, voters, and special interest groups will make choices in representative democracy leading to a government much larger than that preferred by the average citizen. Thus, this chapter discusses the primary mechanism through which citizens can curtail the excessive growth of government: constitutional rules to constrain taxing and spending power. Several specific constraints—including fiscal decentralization and home rule, tax and expenditure limits, and a separation of powers—will be discussed, and Alabama's specific case will be evaluated. Notably, Alabama is home to the longest written constitution in the world, but as will become clear a lengthy document does not imply a stringent set of rules. Constitutional reform will be a crucial step towards freeing the invisible hand in Alabama.

Smaller Government, Greater Prosperity

Economists have studied the link between institutions and economic prosperity since Adam Smith first inquired about the causes of the wealth of nations.[1] Fundamentally, societies must determine how scarce resources should be allocated amongst competing ends. Historically, nations have taken one of two approaches: central planning orchestrated by the government, or decentralized, private, market-based decision-making. Recent advances in the study of economic institutions have led to a tremendous amount of additional research in this area and improved our understanding of the role a society's reliance on the market plays in economic growth: nations which embrace market institutions have stronger economies and higher living standards. The relationship between markets and prosperity is so strong that even in differences in policies across the U.S. states significantly affect prosperity and growth.

One popular measure of the degree to which a nation relies on markets rather than government for decision-making is the Economic Freedom of the World index (Gwartney, Lawson, and Hall 2013). The index ranks 140 countries using five distinct measures of institutions: the size of government, protection of property rights, soundness of the money supply, openness of international trade, and the level of regulation. Countries are given a score ranging from 1 to 10, with 10 indicating the most economically free. The index provides an easy-to-use method for

Figure 2.1: Economic Freedom and Prosperity



Source: Heston, Summers, and Aten (2012) and Gwartney, Lawson, and Hall (2013)

comparing institutions across countries: those countries with high levels of economic freedom provide the best circumstances for markets to allocate resources while the lowest-scoring countries are typically home to excessively large governments which expropriate private property and place crippling restrictions on private transactions.

The linkage between economic freedom and welfare is striking. **Figure 2.1** shows average per capita gross domestic product (GDP) (a standard measure of living standards) across nations grouped into quartiles according to their economic freedom scores as reported in Gwartney, Lawson, and Hall (2013). GDP per capita is roughly ten times higher on average in the countries with the most economic freedom than in the least free countries. The disparity in living standards reflects the damage caused by excessively intrusive government and poor legal institutions. What's more, per capita GDP in the freest countries is still more than double that in countries in the second quartile, indicating limits on government are important even amongst relatively free nations. The results are clear: limited government and a reliance on market institutions lead to higher incomes and a more prosperous society.

While it may be unsurprising that the relationship between economic freedom and prosperity is clear across nations with wildly different governments, it is perhaps less obvious that as strong a link would be observable across the U.S. states. Bueno, Ashby and McMahon (2012) compile data on the states and present an index of economic freedom simliar to that described above. States are rated in three major areas: size of government, taxation, and regulation, again scored on a scale of 1-10, with 10 indicating the highest level of economic freedom. **Figure 2.2** illustrates the relationship between economic freedom in the 48 contiguous U.S. states and personal income per capita. As with the international data, the relationship is clear: freeer states (those with smaller, less intrusive governments) are characterized by higher incomes. In fact, states with the highest levels of economic freedom have 25% higher per capita incomes—nearly $10,000 a year—than those states with the lowest levels of freedom. Even though the states are organized under a single, relatively-free national government, cross-state variations in institutions clearly affect economic wellbeing.

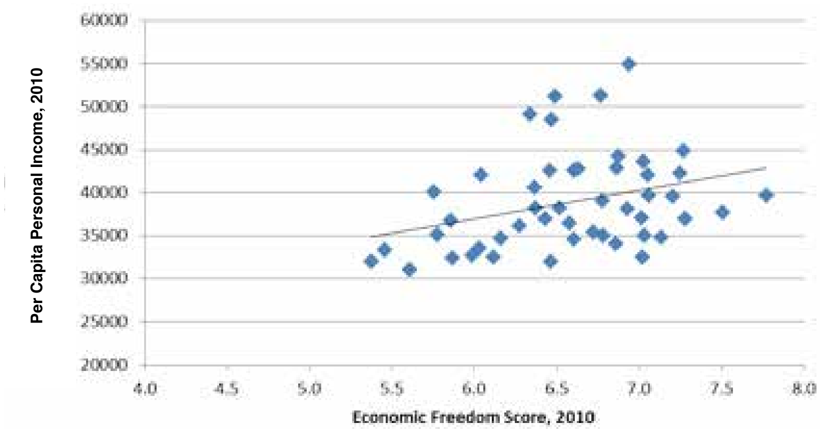
Delving deeper at the state level, the data also show a negative relationship between the size of government and economic growth. In particular, the size of a state's government relative to the level of income in the state (in other words, how heavily the state relies on government rather than private decision-making) has an adverse effect on the economy. **Figure 2.3** shows the long-run relationship between the size of state government and personal income over the last several decades (for the 48 contiguous states). The negative slope of the trend line indicates that states which featured larger governments (as a percentage of income) in 1979 exhibited lower per capita income three decades later. On average, the states with the largest governments in 1979 (where state spending made up roughly 11% of personal income) had per capita incomes roughly $6,000 lower than those states with the smallest governments (with spending making up only about 5% of income).

While **Figure 2.3** provides a snapshot of a specific time period, **Figure 2.4** examines the relationship between the growth of per capita income and the change in the size of government. In other words, **Figure 2.4** considers the relationship between economic growth and the change in government spending relative to the state's economy. The growth of government is measured here as the percentage change in state spending as a percentage of income. For example, if state spending grew from 6% of state income in 1992 to 8% in 2010, this would be 25% growth in state government in **Figure 2.4.** Once again, we observe a clearly negative relationship: states with fast growing governments exhibit lower rates of economic growth.

The evidence above leads to a straightforward conclusion: excessively large government has harmful effects on economic growth. This is not to say, however, that any government is detrimental to an economy. The components of economic freedom include protection of property rights and a court system, both of which governments supply. Therefore, economists have observed a hill-shaped relationship between the size of the public sector and economic wellbeing.[2] A government which is too small and weak will be unable to provide the essential ingredients for economic growth: fundamental functions like protection of property, enforcement of contracts, and defense. The hill is steep in this region, as an increase in government creates the conditions for market exchange and wealth creation. Further expansion of government allows provision of services like infrastructure and education which likely improve market conditions, though not to the same extent as the fundamental functions. Beyond some point, however, additional growth of government becomes excessive and infringes on the private sector's ability to allocate resources efficiently.

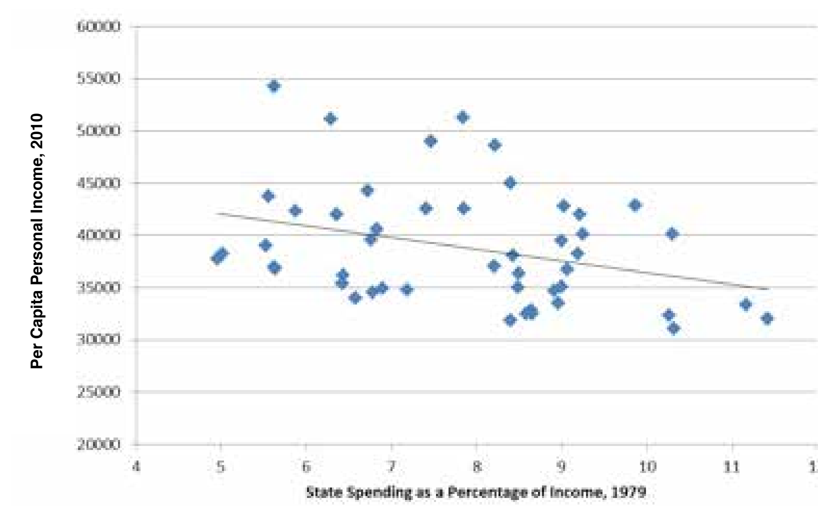
Economists have shown that excessively large government harms economic growth in several ways. First and foremost, a larger government entails a heavier burden of taxation. Taxes inevitably alter the choices made by buyers and sellers and therefore cause resources to be allocated differently. Consequently, high taxes not only necessarily reduce economic freedom, they negatively affect growth (Poulson and Kaplan 2008) and entrepreneurship (Garrett and Wall 2006). Further, a larger public sector is more susceptible to influence from competing special interests lobbying politicians for various forms of assistance, such as subsidies or protection from competition.[3] While these interventions are themselves inefficient, the effect is worsened as firms begin to devote resources to lobbying rather than other, more productive endeavors.[4] In short, the more a society relies on the public sector to allocate resources rather than the market, the more resources will be used unproductively

Figure 2.2: Economic Freedom and Per Capita Income Across the U.S. States



Source: Bureau of Economic Analysis (2013) and Bueno, Ashby, and McMahon (2013)

Figure 2.3: Per Capita Income (2010) vs. Size of State Government (1979)



Source: U.S. Census Bureau (1980) and Bureau of Economic Analysis (2013)

Figure 2.4: Growth in Per Capita Personal Income vs. Growth in State Spending (1992-2010)

Source: U.S. Census Bureau (2013) and Bureau of Economic Analysis (2013)

as government officials make decisions based on political considerations instead of market signals. The end result is lower incomes and weaker economic growth.

The Growth of Government and Need for Constitutional Rules

The evidence above, as well as more than 200 years of economic research starting with Adam Smith (1776) provides a clear picture of the role of government in the economy. Markets work when governments provide clear and well-secured property rights, stable legal institutions, and fundamental public goods such as national defense. Beyond these basic functions, however, excessively large government burdens the economy and weakens prospects for growth and human flourishing. The central issue then becomes one of creating a government strong enough to secure rights and encourage market activity while simultaneously limiting its ability to grow excessively large. This is the role of a constitution.

An often-heard response to claims of government inefficiency in democracy is that people just need to elect the "better" politicians, or simply become "more involved" in the political process. Public choice economics, a branch which applies the basic tenants of economics to the political sphere, provides compelling reasons why democratic political decision making is necessarily prone to problems leading to inefficient policies.[5] These "government failures" result in a government with a size and scope far greater than that preferred by the average citizen. In other words, fundamental deficiencies within the public sector and democratic process demonstrate that electing the "right" people or getting average citizens more involved will be insufficient. While the public choice view of politicians may appear cynical to many today, similar views can be traced as far back as our nation's founding with Madison famously writing in 1788, "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary."

Public choice's major contribution applies "methodological individualism" to politics, which simply acknowledges that when it comes to actual decision-making, there is no one entity called "the government." Instead, political action is carried out by individual politicians, bureaucrats, and voters—in a word, people—each acting in their own self-interest and facing their own incentives. Systematic application of individual incentives readily explains the bias towards excessive spending found in representative democracies.

For example, self-interested politicians will want to get (re)elected, and will therefore act to win the most votes at the least possible cost. Importantly, this is as true for "benevolent" politicians as it is for "selfish" ones: a benevolent politician must still get elected in order to execute policy for the common good. This results in a bias towards special interest groups made up of a large number of voters. Politicians can earn a relatively large number of votes from large groups by supporting a single issue or set of issues. On the other hand, attempting to gather a similar number of votes by catering to the individual whims of an unorganized group of voters is exceedingly high cost. Further exacerbating the issue is the general lack of knowledge across individual voters, a phenomenon economists refer to as "rational ignorance." Self-interested voters will view voting as a means to an end: his or her vote matters because it helps one's favored candidate win. This means the value of information to voters arises from ensuring that one votes for the truly preferred candidate. Because the probability of casting a deciding vote is almost zero (after all, how many elections are ever decided by a single vote?), the value of becoming informed is almost zero. Meanwhile, the costs of becoming informed about political issues are relatively high, so voters choose to remain uninformed about candidates and policy. On the other hand, members of an interest group find it within their self-interest to be informed (at least about the issue they care the most about). The end result of this interaction between politicians seeking to maximize votes and rationally ignorant voters is a bias towards policy which concentrates benefits and disperses costs.

A simple example will help illustrate this concept. A proposed tariff on imported sugar will increase profits for domestic sugar farmers at the cost of increased sugar prices for all consumers across the nation. Economic theory shows that the tariff will impose total costs (in terms of higher prices and inefficiency) greater than the benefits generated. Nevertheless, these costs will be *dispersed* across all consumers of sugar. Even if the tariff cost the nation $3 billion annually, this would amount to roughly $10 per person, spread across countless transactions involving sugar each year. Individual voters will likely be rationally ignorant of the tariff in the first place, but even if they were fully informed it is unlikely any one (let alone the entire group, collectively) would find the possibility of avoiding the relatively small individual cost imposed by the tariff to be worth incurring the considerable costs of becoming politically active and attempting to change the policy. On the other hand, the workers and firms in the U.S. sugar industry benefit significantly from the tariff, and have a strong incentive to be informed about the policy. Domestic sugar producers will lobby Congress, make campaign contributions, and vote against opponents. Since sugar consumers represent a silent majority, the end result is policy which leads to spending in excess of that demanded by the average citizen.

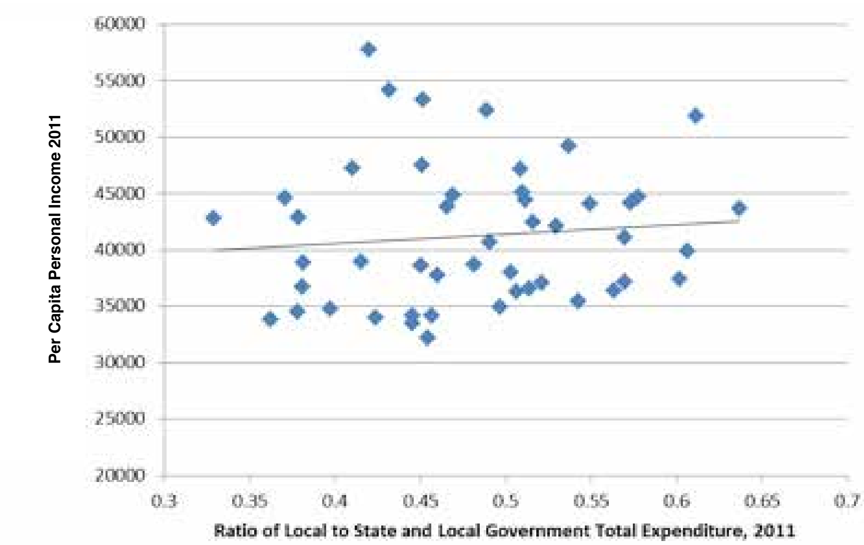
Additional imperfections in the electoral process contribute further to excessively large government. While elections theoretically hold politicians accountable to voters, these elections occur infrequently, in most cases in cycles of 2, 4, or 6 years. Except in extreme cases such as recall elections, voters have no way of "disciplining" incumbent politicians during the period between elections. While more frequent elections could potentially address this issue, such a system would likely encourage politicians to favor even more short-sighted policies aimed at providing constituents with immediately-felt benefits (with long-run costs) in advance of the next election. Term limits can prevent a "bad" elected official from remaining in office, but remove the threat of being "voted out" during the last term, reducing accountability to voters.[6] Further, bureaucrats actually carry out the majority of government policy, and bureaucrats are either appointed by elected representatives or civil service employees and not directly accountable to voters. Self-interested bureaucrats will want to see the power and responsibilities (and thus budget) assigned to their bureau maximized, further biasing policy towards increased spending.[7] Finally, within the legislature itself, proposed legislation will be biased towards those policies which provide large benefits to local jurisdictions (at the expense of taxpayers nationwide) as representatives engage in so-called "logrolling" or vote-trading whereby they secure concentrated benefits for their constituents.

Given the inherent bias towards excessive growth of government, and the inability of the electoral mechanism alone to remedy it, citizens must impose additional constraints on elected officials.[8] Constitutional economics spins out of the public choice tradition and essentially asks what types of rules will best channel the self-interest of political actors into actions which serve societal welfare. Brennan and Buchanan (1977, 1978, 1980) begin from the premise of government as "Leviathan" seeking to maximize its size and scope, and reach the conclusion that society must impose constraints in the form of strict constitutional rules and/or competition amongst governments (a byproduct of fiscal decentralization) in order to prevent it from becoming excessively large.

Fiscal Decentralization: A Key to Constraining Government

Fiscal decentralization (or fiscal federalism as it is often called) refers to the organization of government into different levels, with each providing specific types of services. As a nation, the United States features multiple levels of government (a federal government and 50 states) with each state then made up of multiple levels as well (counties, cities, and specialized jurisdictions such as school districts). Economics provides a rationale for the devolution of services to lower levels of government: it both enhances efficiency and provides a constraint on the growth of government. Alabama would benefit from increased decentralization of its government.

Figure 2.5: Fiscal Decentralization and Per Capita Income



Source: U.S. Census Bureau (2013) and Bureau of Economic Analysis (2013)

Given our federal system of multiple levels of government, a fundamental question is raised: what types of services should be provided at each level of government? The basic guiding principle follows from the economic concept of spillovers (or externalities) and stipulates that a service should be provided at the level of government which encompasses all of the costs and benefits. For example, we provide military defense at the federal level because the nation as a whole stands to benefit from that service. At the other end of the spectrum, garbage collection services primarily benefit only those residents in a local community and can be best provided by local governments. If each individual city, county, or even state attempted to provide for its own military defense, the result would likely be costly and inefficient. Similarly, if the federal government attempted to coordinate garbage collection for every community in America, it is difficult to imagine a result short of disastrous. Local policies are better designed at the local government level, where they can be tailored to conditions and characteristics unique to the community. Higher levels of government will simply lack the local knowledge necessary to efficiently provide such services.

In addition to efficiency concerns, decentralization of decision-making and service provision allows for variation in policymaking. While a state government would need to impose a one-size-fits all policy applicable to all residents, local governments, each providing services only to their own residents, would be able to choose a level of service best suited to its own needs. When services are provided at the county or city level, residents are able to "vote with their feet" and choose the community which provides the services (and charges the taxes) they most prefer. Charles Tiebout (1956) famously formalized this concept and showed that given a low enough cost of mobility, residents would be able to choose the community which best met its needs.

The Brennan and Buchanan (1977, 1978, 1980) "Leviathan" model follows from this logic. When governments are decentralized, the resulting lower-level jurisdictions have the incentive to attract residents, who in turn pay attention to things like tax rates when choosing a place to live or work. The greater the degree of this decentralization, the more options from which residents will have to choose, and the greater the competitive pressures facing governments will be. In the alternative, when a state government (or worse-yet a national government) centralizes all decision-making, residents have no recourse; they cannot (at least without substantial cost) "vote with their feet" and choose an alternative community. The result in such cases is unconstrained government, free to grow to a larger-than-optimal size. The idea that federalism would lead to competition amongst governments, which in turn would have a beneficial constraining effect was recognized by the Founding Fathers, with Madison writing in Federalist No. 51, "The different governments will control each other; at the same time that each will be controlled by itself."

This analysis is not unlike the distinction between two marketplaces: one characterized by fierce competition amongst rival firms, the other dominated by a single monopoly. Just as consumers benefit from competition amongst firms, citizens benefit from competition amongst local governments, a natural byproduct of fiscal decentralization. Therefore, we would expect states with more decentralized governments to outperform more centralized states. **Figure 2.5** shows that this is in fact the case. The figure displays the clearly positive relationship between per capita income and the level of fiscal decentralization, defined here as the ratio of local government expenditure to total state and local government expenditure, for the 48 contiguous U.S. states. Alabama ranked 27th in fiscal decentralization in 2010, with a rating of 0.496.

Unfortunately, the structure of Alabama's constitution fails to provide adequate fiscal decentralization. In fact, it concentrates power at the state level, and deprives local county governments

Table 2.1

Comparing U.S. State Constituions, 2013

	Year Ratified	Length (Words)		Year Ratified	Number of Amendments
Longest			**Most Often**		
Alabama	1901	376,006	Alabama	1901	880
Texas	1876	86,936	California	1879	527
Oklahoma	1907	81,666	South Carolina	1896	498
Louisiana	1975	69,876	Texas	1876	474
Missouri	1945	69,394	Oregon	1859	253
Shortest			**Least Often**		
Vermont	1793	8,565	Rhode Island	1986	12
Iowa	1857	11,089	Illinois	1971	12
Rhode Island	1986	11,407	Alaska 1	959	29
Indiana	1851	11,476	Connecticut	1965	30
Minnesota	1858	11,734	North Carolina	1971	31

Source: Council of State Governments (2013)

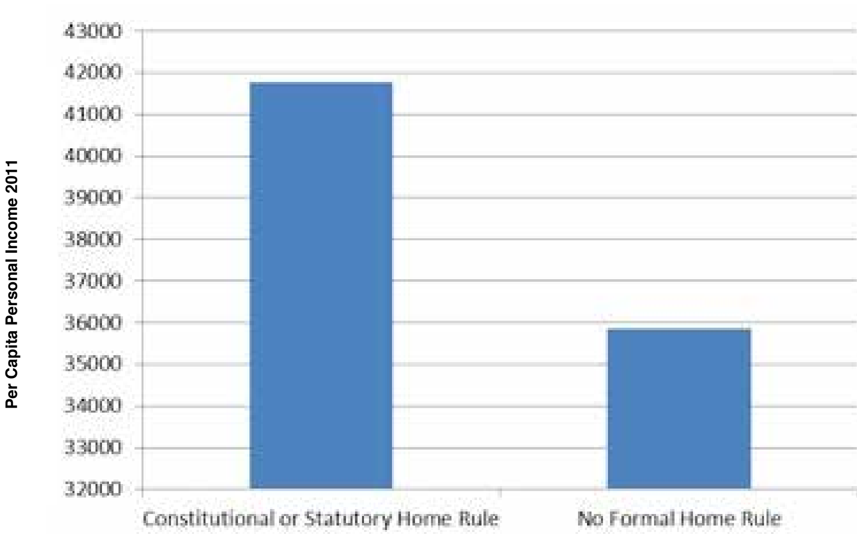
of any autonomy, requiring constitutional amendments each time a local government seeks authority to carry out even the most basic of actions. A look at the specificity and limited scope of the amendments to the state's fundamental law cannot be overstated. Amendment 482, for example, states the following: "The Limestone county commission is hereby authorized with or without charge to provide for the disposal of dead farm animals, and the excavating of human graves," while Amendment 756 states, "In Shelby County, the Legislature, by local law, may provide for the enforcement of traffic laws on private roads in private gated communities in the county." Other purely local issues codified in the state's constitution include mosquito control in Mobile County (Amendment 351), the salary paid to the Judge of Probate of Winston County (Amendment 877), and rules governing Bingo in Greene County (Amendment 743).

Alabama is home to not only the longest state constitution, but in fact the longest written constitution in the world (see Table 1). Its 376,006 words make it more than four times the length of the next longest U.S. state constitution, and more than 80 times longer than the Constitution of the United States. Much of that length comes from the (as of January 1, 2013) 880 amendments (far more than any other state) which have been added over the last 111 years, most of which pertain to very specific issues affecting only a single county. Importantly, the age of Alabama's constitution is irrelevant here: Vermont's constitution dates back to the 18th century while Rhode Island's is less than 30 years old, yet both are much shorter and feature far fewer amendments.

While each of these examples (and the countless more not included here) deals with issues important to the residents of the affected county, all must be passed by the state legislature and many go on the ballot for a statewide vote. In other words, voters statewide (or at least their elected representatives) have a say in determining the ability of individual counties to provide fairly basic services to their residents. Alabama's constitution deprives county commissions of all autonomy and in fact requires amendment each time a county wishes to provide a new service, be it hiring someone to dispose of dead farm animals or policing the roads of a new community, even if that service will likely have zero impact on the rest of the state. This approach is clearly contrary to the traditional spillover-based theories of federalism.

In effect, Alabama's constitution actually empowers, rather than constrains, the central state government by requiring counties to get the OK from elected officials in Montgomery (and in some cases voters statewide) before acting. Proponents of this type of arrangement claim that this prevents a hodgepodge of laws or regulations across counties and prevents local governments from imposing cumbersome rules and regulations on their residents. While this may be true to some extent, the alternative is a system wherein the state must impose one-size-fits-all policy across all counties, or spend precious time during the legislative session debating issues which pertain to only small portions of the population. In the event these amendments must go on the statewide ballot, voters from across the state get a say in the goings-on in counties in which they may never reside, or even visit. This approach exacerbates the already prevalent rational ignorance issue, as voters are far less likely to be informed about issues which do not directly affect them, making these statewide votes on local issues subject to inefficiency due to mistakes or even random voting.

Figure 2.6: Home Rule and Per Capita Income



Source: Maddex (2006) and Bureau of Economic Analysis (2013)

Most U.S. state constitutions do not place so much power over day-to-day operations of local officials in the hands of their central government. Many in fact go a step further in the opposite direction and explicitly grant home rule—the ability to act autonomously in the passing of laws which affect residents and operations in their jurisdiction—to local governments. As **Figure 2.6** shows, states with formal home rule are characterized by noticeably higher per capita personal income. To the extent greater fiscal decentralization serves to constrain state government and improve the welfare of all citizens, Alabama would be wise to grant greater autonomy to its local jurisdictions by implementing fundamental constitutional reform.

The beneficial effects of constitutional reform in Alabama go beyond the fiscal impacts, however, and include increases in efficiency. Local residents are in the best position to determine what types of services are needed, and local governments are in the best position to effectively provide them at the lowest cost. Likewise, state legislators should be more concerned with truly statewide issues, and rationally ignorant voters, many of whom already find the ballot each November lengthy and incomprehensible, should not be burdened with deciding issues completely irrelevant to their lives. Finally, the elimination of Alabama's current way of handling purely local issues via constitutional amendment would lead to a drastic reduction in the size and complexity of its fundamental law, and provide a greater degree of stability since it would eliminate the routine addition of multiple amendments each election cycle. As it stands now, Alabama's constitution is already far too long and far too complex, and is unfortunately designed to only get longer and more complex.

The Importance of Constitutional Limits

The incentives facing political actors lead to a systematic bias in favor of government growth and excessive spending. While occasionally citizens elect politicians who favor "smaller government," this alone is unlikely to counteract the strong momentum propelling government growth. Constitutional economics provides insight into the types of rules, beyond the electoral mechanism, which help mitigate the issues leading to the spending bias in government. These constitutional constraints are not unlike rules in any game or sport: they serve to prevent players (in this case politicians and bureaucrats) from taking advantage of the system. Fiscal decentralization plays an important role in limiting the size and scope of government, but additional constraints limiting elected officials' discretionary power over fiscal issues are necessary as well.

States have experimented with a variety of constitutional rules designed to limit the growth of government, such as balanced budget requirements. Perhaps the most direct approach to constraining government spending is the use of a tax and expenditure limit (TEL). TELs are based on the idea that unconstrained government growth will be excessive, and therefore cap the annual growth of government at some more desirable level. As of 2010, 30 states operate under some type of TEL (Waisanen 2010). While Alabama's constitution features a notoriously strict balanced budget requirement (which actually stipulates any government official who violates the requirement is subject to fine or imprisonment) and a large portion of Alabama's tax code (including the state's income tax rate and deductions) is codified in the constitution, Alabama is one of the states without a statewide TEL. Alabama does have strict limits on the growth of certain types of local taxation, notably property tax rates, but no formal expenditure limits apply to the state government.

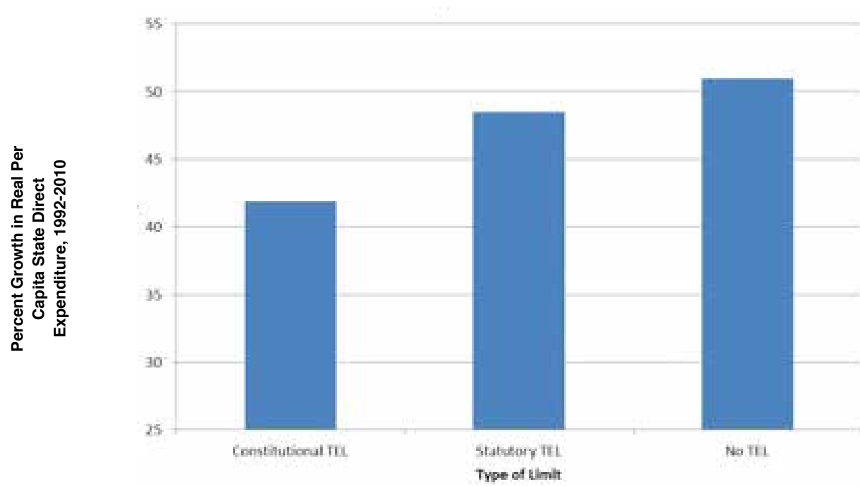
Limitations vary across states, both in terms of what exactly is limited (tax revenues or expenditures or both), on what the actual limit is based, and procedures for waiving the TEL. One key characteristic that has been identified as important in the economics literature is whether the TEL is codified in a state's constitution or simply by legislation. That rationale behind this is that constitutional amendment is typically far more difficult than legislative action, and thus a constitutional TEL will serve as a stricter constraint. As of 2010, 17 states feature a constitutional

TEL while the remaining 13 have statutory limits.

Figure 2.7 compares the average rate of government spending growth in states based on the type of TEL in use. In short, TELs are effective at slowing the growth of government spending. Over the time period 1992-2010, states with constitutional TELs experienced the lowest growth rate of roughly 42%, while governments in states with a statutory TEL grew at a rate of about 48%. Unsurprisingly, the fastest government growth (about 51%) occurred in states with no TEL. In other words, a constitutional TEL, on average, reduced spending by roughly 9%.

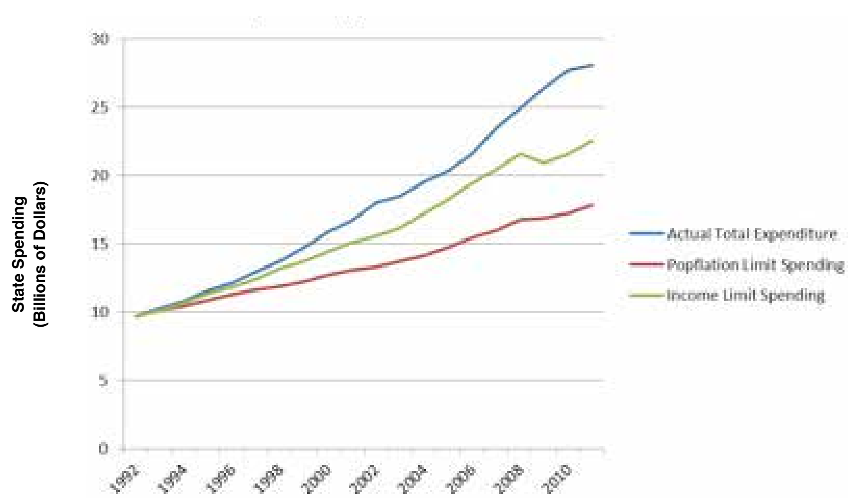
The key component of any TEL is the actual limit, and specifically on what that limit is based. Across the states, various limits are used. Some TELs restrict the growth of government to some measure of economic growth (such as personal income). Others are based on measures of expected revenue growth, or even arbitrary growth rates (such as Oklahoma's 12%). One particularly restrictive, and thus popular, TEL is the so-called "popflation" limit which restricts the growth rate of government to the percentage increase in a state's population plus the inflation rate. By requiring government spending grow only at the rate of population growth plus inflation, these TELs are designed to keep real per capita spending constant. In other words, the only increases in government spending allowed under a popflation TEL are those in response to an increase in population or increase in the inflation rate, in a sense prohibiting any true expansion in the size of government. Colorado's TEL (considered the strictest in the country until its recent suspension) is based on this model.

Figure 2.7: The Effect of Tax Expenditure Limits



Source: U.S. Census Bureau (2013) and Waisanen (2010)

Figure 2.8: State Spending Growth in Alabama



TELs have serious effects on the rate of government growth over time. **Figure 2.8** graphs state spending in Alabama over the last 20 years, 1992-2011. In addition to actual total (nominal) expenditure, two estimated levels are displayed showing the hypothetical levels of government spending had Alabama adopted a TEL in 1992. Over the past two decades, state total expenditure has increased from roughly $10 billion to $28 billion in nominal terms. Starting from the same 1992 level of spending, had total state expenditure growth followed the growth rate of personal income, spending would have been considerably lower by 2011 (roughly $22 billion). A popflation TEL would have had an even more constraining effect, limiting the growth rate of spending so much that spending in 2011 would have only reached roughly $18 billion.

These data show how powerful a truly strict expenditure limit (such as a popflation limit) can be. Since states employ progressive tax systems, tax revenues increase rapidly during economic booms. The spending bias inherent to government means politicians and bureaucrats are quick to spend these additional tax revenues, resulting in government expansion. Even under a TEL based on personal income growth, "allowed" expenditure growth would accelerate during economic booms as incomes rose. In theory, the constraint should bind the other way (note above the sharp drop in "Income Limit Spending" during the Great Recession) when incomes fall during recessions, but cutting spending programs during a recession is oftentimes politically unfeasible as citizens become invested in (and bureaucrats entrenched in) the programs. Adopting a strict TEL based on some "exogenous" growth rate such as popflation is the easiest way to insure government does not grow excessively large during economic booms.

A final look at **Figure 2.8** makes this point clearer. Had a popflation limit been imposed in 1992, state total expenditure would have been roughly 36% lower today. Cutting 36% of state total expenditure at once would be politically suicidal for any politician, making it an impossible task. The same result, however, could have been achieved simply by limiting the *growth* of spending beginning in 1992, a much more reasonable goal.

Residents of U.S. states would be richer today had state governments' growth been limited to a popflation rate. **Figure 2.9** plots per capita income in 2011 against an "index of excess spending" calculated by taking total state expenditure in 1992 and adjusting it by the state population growth and national inflation rates between 1992 and 2011, and then dividing it into the actual level of state expenditure in 2011. The result creates a ratio of spending in excess of the amount that would have taken place had a popflation limit been observed over the past two decades: states with a ratio greater than 1 have witnessed their government grow faster than the rates of population growth and inflation. **Figure 2.9** displays a clearly negative relationship between per capita income and the level of excess spending. Alabama's excess spending ratio over this time period was 1.25.

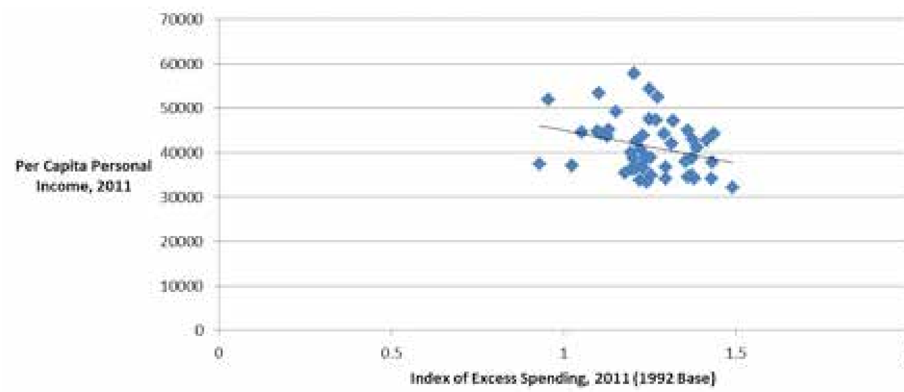
In addition to strict fiscal rules such as TELs, constitutions must make sure to provide for a separation of powers whereby no one branch of government is able to dominate the policymaking process. This is not a new idea: our Founding Fathers designed our federal constitution with this in mind, with James Madison writing in Federalist No. 51 that, "Ambition must be made to counteract ambition." Government structured with features such as a bicameral legislature with each chamber comprised of representative elected from different districts is clearly illustrative of this idea. In theory, representatives from different districts will have difficulty gathering the consent necessary to pass legislation favoring a specific geographical area, especially when such legislation must pass both houses (Buchanan and Tullock 1962).

One area where Alabama could strengthen its separation of powers is in its gubernatorial veto. Like our federal government, legislation in Alabama which passes in both houses goes before the Governor and is subject to his or her veto. Unlike a Presidential veto, however, in Alabama the Governor's veto power is fairly weak: while a Presidential veto requires a 2/3 majority to override, Alabama's constitution requires only a simple majority of the members of the legislature vote to override a veto (Maddex 2006). This essentially means that in theory a veto can be overridden with the same number of votes used to pass the legislation in the first place, effectively nullifying it as a real constraint.[9] This clearly weakens the power of the executive relative to the legislature, and a stronger veto power would create a greater balance. On the other hand, the Governor of Alabama does retain a line item veto, which has been shown to be an effective tool at reducing spending (Krol 2007).

Conclusion

While economics provides clear evidence that limited government and a reliance on market institutions drive prosperity and growth, public choice theory shows that representative democracy tends to spend more than desired by the average citizen. Brennan and Buchanan (1977, 1978, 1980) show that two possible constraints on government can prevent it from growing excessively: competition between governments and

Figure 2.9: Spending Growth in Excess of Popflation and State Personal Income



Source: Bureau of Economic Analysis (2013) and U.S. Census Bureau (2013).

strict constitutional constraints. Alabama has serious room for improvement in both of these areas. The following reforms could help free the invisible hand in Alabama:

- *Greater fiscal decentralization.* Alabama's constitution deprives local communities, such as counties, from carrying out even the most basic of functions without state approval. The result is a constitution with nearly 900 amendments, the vast majority of which pertain to only one locality, as well as a greater degree of concentrated power in Montgomery. Alabama must revisit the basic design of its constitution to address this fundamental problem and restore a sensible devolution of power.

- *Simplification of the constitution.* Alabama is home to the world's longest written constitution, which is routinely amended multiple times each election cycle. The end result is a bloated, confusing document and a strong degree of uncertainty surrounding the state's fundamental law. Alabamians should consider a complete overhaul of the document to retain only essential features to limit government, drawing on our federal constitution as a guide.

- *Adopt a statewide constitutional expenditure limit.* Governments grow, essentially by definition. TELs based on rates such as popflation are key to keeping the growth of government to a reasonable rate. While it may be easy for a politician to pay lip service to the idea of shrinking the size of government, political reality makes this untenable. A more pragmatic solution is to institute a hard cap on future growth of state expenditures.

- *Strengthen the separation of powers.* Alabama's executive branch is weakened by the relative ease with which the legislature can override its veto power. The line item veto could be given more significant power by requiring a supermajority to override it. A stronger executive should better balance statewide interests against the more localized interests of the members of the legislature.

Notes

1. Adam Smith is credited as the founder of economics as a discipline and his most influential work, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) is often cited as one of the first and most important books analyzing the relationship between the role of government and economic growth.
2. See Vedder and Gallaway (1998) for a more complete discussion of this relationship.
3. Gordon Tullock (1967) is credited with providing the first economic analysis of this phenomenon, which has come to be known as 'rent seeking.'
4. See Baumol (1990) for a discussion of how government intervention in response to rent-seeking leads to a shifting of entrepreneurship from productive into unproductive (from society's point of view) avenues.
5. Public choice as a branch of economics begins with Buchanan and Tullock (1962). Mueller (2003) provides a survey of advances made in the field over the last 40 plus years. A recent contribution by Caplan (2007) expands on the traditional view of public choice.
6. See Besley and Case (1995) for empirical evidence of this effect.
7. The seminal analysis of bureaucracy is due to Niskanen (1971).
8. Brennan and Buchanan (1985) offer a clear statement on the need for constitutional rules.
9. Technically, Alabama's constitution states that legislation is passed by a simple majority vote of a quorum (defined as a majority of the elected members), while a veto can only be overridden with a simple majority vote of all elected representatives. This means that the requirement to override a veto is, albeit weakly, stricter than the initial passage of legislation.

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Improving Lives in Alabama
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3

Taxing Alabama: How the State Generates Revenue and the Impact on Residents

Jim F. Couch, J. Douglas Barrett, David Black, and Keith D. Malone

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Summary Points

- Alabama collected over $8.3 billion in revenue from 47 different taxes in 2012. The individual income tax and sales tax were the largest sources of revenue.

- The state's tax system includes several safeguards against the tendency of politicians to tax excessively, with limits on income and property tax rates included in the state constitution. Alabama also earmarks a larger portion of its tax revenue for specific purposes like education than any other state.

- Reliance on the income tax results in considerable variance in tax collections over the business cycle. Consequently the state suffers repeated instances of painful spending cuts after state lawmakers engage in unsustainable spending when the economy booms.

- Alabama's current tax system places a relatively heavy burden on the state's poorest residents. Reliance on the sales tax and the form of the income tax account for the burden placed on low income families.

- Alabama has numerous options for tax reform. One promising reform alternative involves replacing the sales tax with an increase in the property tax. This reform plan yields gains in terms of both economic growth and reducing the tax system's impact on the poor.

Introduction

Indisputably, the most vital function of any tax system is generating revenue to fund government spending programs. Generating adequate funding at the state and local level is particularly essential because, unlike the federal government, state and local governments typically operate under constitutionally required balanced budget mandates. The significant and largely inflexible expenditure commitments of state and local governments to education, police and public safety, prisons, Medicaid, and public health exacerbate the need for adequate funding. Additional constraints are added, when compared with the federal tax system, as State and local jurisdictions face further complications due to smaller populations, narrower economic bases, and competition to attract new industry and jobs to the area. The competition is both interstate and intrastate, and often takes the form of low overall tax burdens.

Alabama does not escape any of the above pitfalls of a tax system. Specifically, Alabama faces a balanced budget mandate and an expanding demand for government services. These facts, coupled with a constrained tax base and an economy with irregular but recurrent economic contractions, yield periodic but serious budget crisis from time to time. Such a budget crisis manifests itself when planned spending exceeds revenue collections and the state is forced to cut spending via a proration process.[1] The rapid increase of tax revenues during an economic expansion contributes to the existence of a crisis as lawmakers often increase spending during these periods. Such spending levels become unsustainable when tax collections decline during a recession. Should spending be restrained in some manner[2] during the expansion, later reductions in tax revenue occurring during inevitable economic downturns would not result in such severe spending cuts and could perhaps be avoided all together depending on the severity of the recession and the management of available funds during expansions.

Additionally, Alabama is of particular interest because it is not a typical U.S. state in other respects. For example, Malone et. al. (2011) note that state policy makers are not only subject to a mandatory balanced budget, but to balance the budget under the duress of earmarked tax receipts. During 2012, as reported by the State of Alabama Comprehensive Annual Financial Report (2013), Alabama earmarked 87.3% of total tax revenue, with more than 64% earmarked for education.

Alabama's tax earmarks are very specific, sometimes with as much as 90-100% of net collections flowing into specific subsections of the budget from certain tax revenue sources. For

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example, the Utility Gross receipts tax is earmarked at 100%. Different taxes in Alabama are designated for the Alabama Education Trust Fund, the General Fund, and numerous other subsections of the budget. Education receives the largest benefit from earmarking with more than 93% of total net collections of income and sales taxes (the state's largest revenue generators), flowing directly into the Education Trust Fund. Alabama earmarks taxes to a greater degree than any other state.[3] Such an extraordinary degree of earmarking leaves state officials with a very limited ability to transfer receipts between budget subsections to achieve the required budget balance should a budgetary crisis arise.

Government finance in Alabama is also unique in many other ways. According to the U.S. Department of Education, Alabama's K-12 public schools are on average much more dependent on state funding than schools in other states. In fact, the state is responsible for almost sixty percent (60%) of all primary and secondary educational expenditures while the average percentage of funding from states is 49.7%. Local governments in Alabama contribute 25.5% to K-12 education, far less than the U.S. average of 40.8%.[4] It is little surprise that such a high dependence on state funds for education will result in a significant amount of tax revenue being earmarked for educational purposes. For example, approximately eighty-two percent (82%) of sales tax revenue flows into the Education Trust Fund, while only four percent (4%) is available for the General Fund.[5] Income, property, and numerous other taxes are also primarily earmarked to education.

In addition to the distinctive qualities described above, numerous constitutional provisions on Alabama's tax system control maximum rates for some taxes, force the earmarking of tax revenues, divide the budget into numerous independent funds, and prescribe the method for changing tax rates and other characteristics. Such qualities and constitutional provisions yield an Alabama tax system with some very unique features. Five distinguishing characteristics are:

- The distribution of Alabama's state and local tax burden is among the most regressive in the United States.
- Alabama has relatively low state and local taxes compared with regional states and the U.S. average. This is true even after adjusting for the fact that Alabama is among the poorest states.
- Income taxes, even though are levied at a low income threshold, are lower than in most states.
- Property taxes in Alabama are lower than any other state.
- Sales taxes in Alabama are above the national average.

These characteristics and various fiscal crises since 2000 have led to persistent calls for tax reform in Alabama. Prior to tax reform, a thorough understanding of the existing tax system and its impact on Alabama tax payers is necessary. The purpose of this chapter is to provide such an understanding. The next section provides a history of the creation of Alabama's tax system, and discusses recent fiscal concerns. Section Three examines the impact of the tax system on the Alabama economy and residents. Section Four surveys some possible reform alternatives. The final section concludes.

2 Creation of Alabama's Tax System and Current Tax Revenue

How did Alabama's tax system get to where it is today? It is safe to say that Alabama did not begin with the complex revenue generation structure that currently exists, and which collected approximately $8.3 billion during 2012. This amount of tax revenue was generated from levying forty-seven taxes[6], ranging from individual and corporate income taxes to various severance taxes to excise taxes on gasoline and financial institutions. Some of these taxes collect several billion dollars per year while other taxes collect much smaller amounts. Traditionally, the individual income tax is the largest revenue generator, collecting in excess of $3 billion in 2012, while "Miscellaneous Tags" is the representative for the perennial lowest collection category, totaling just over $238,000 during the same year.

Examination of *A Legislator's Guide to Alabama Taxes* (LGT) (2013) reveals that the original levying provisions were not as complex and the individual tax categories were much fewer in number when the state first began levying taxes in 1935. Since this time however, Alabama's tax system has evolved, seemingly continuously to the system that we have today. The LGT also reveals that taxing provisions for five different taxes were included in the Constitution of Alabama of 1901; however, the state did not begin to impose these tax provisions until fiscal problems began to mount during the Great Depression. Since this time, Alabama has amassed a tax system including more than seventy different taxes, licenses and fees. Currently, sixteen taxes and fees have some sort of constitutional authority/provision while sixty are levied by statutory authority.

Between 1901 and 1935, Alabama enforced various fees contained in the Constitution of Alabama of 1901 to raise revenue while the taxing provisions largely remained idle. A review of the LGT indicates that only a nominal tax on gasoline was levied during this time frame. Fees levied include, among many others: marriage license fees, motor vehicle registration, health statistics fees and numerous other "inspection" fees. Not until the mounting economic horrors of the Great Depression did Alabama begin to enact its taxing authority provisions outlined by the state constitution.

As detailed by Harvey (1989), local school systems across the country experienced prolonged funding crises during the Depression. Alabama did not escape these school funding issues, and with many local school systems facing bankruptcy, the state began funding the majority of public school expenditures.[7] Increased educational funding responsibilities and other Depression Era fiscal pressures led Alabama to begin implementation of the first phase of the tax system in 1935. This phase involved the application of numerous minor taxes[8] and two major taxes, individual and corporate income taxes property taxes. The second phase, instigated in 1939, added a general sales tax and additional "other" small taxes to the revenue system. In addition to these two initial phases, the Alabama tax system has experienced numerous revisions and additions to the tax base. Many of the original taxes have undergone numerous revisions of the tax base, tax rates, and adding exemptions and exclusions. New taxes like Motor Fuels, Utility Gross Receipts and Cellular Telecommunications taxes have been added.

To better understand the prevailing tax structure in Alabama, the remaining part of this section provides an overview of four major tax system components and analyzes recent trends. Three of the four – the income tax, sales tax, and property tax were introduced above. The fourth classification refers to a catchall, "other taxes," which accounts for all other tax revenue. These "other taxes" each contribute to the total state revenues in a minor capacity; therefore, the review of these taxes will be limited to only those that historically generate a minimum of $200 million in revenue. Detailed information regarding current total state finances and earmarking taxes in Alabama is also provided. Unless otherwise noted, all of the data contained in the remainder of this section has been gathered from various editions of the following; the State of Alabama Department of Revenue *Annual Report* (2004 – 2013), *A Legislators Guide to Alabama's Taxes* (2005, 2011 and 2013), and the *State of Alabama Comprehensive Annual Financial Report* (2004 – 2013). All information for tax receipts is located in **Figures 3.1 – 3.4**.

Figure 3.1 depicts contributions by tax source for 2012. **Figures 3.2 – 3.4** provide historical tax collection data.[9] We begin by examining Alabama's income tax.

2.1 Income Taxes

The 25th amendment to the Constitution of Alabama of 1901, ratified in August 1933, authorized the state legislature to levy and collect income taxes on individuals and corporations in Alabama. As discussed above, Alabama began collecting these taxes in 1935. The 1933 amendment set the maximum tax rate at five percent (5%) for individuals and three percent (3%) for corporate income. Since the initial implementation of these taxes, each tax has been subjected to numerous alterations to further define or redefine exemptions, exclusions and deductions. However, maximum tax rates are included in the original constitutional levying provisions, and thus, a constitutional amendment is necessary to increase the maximum tax rates. Today, the maximum rate for individuals remains at 5%, while the tax on corporate income has been amended on two occasions and is now 6.5%.[10] Alabama follows most states in levying corporate income taxes on net income collected from operations within the state, requiring residents to pay tax on their entire taxable income, and making non-residents pay taxes on any income earned in Alabama.

Income taxes represent the single largest revenue generator for the state, collecting approximately $3.4 billion during 2012. The breakdown between individual and corporate income tax collections is $3.017 billion and $0.379 billion respectively. Total income tax collections represent just over thirty-nine percent (39%) of total tax collections for the year. As expected, both personal and corporate income taxes are somewhat cyclical and vary with the health of the state economy. Since fiscal year 1994, personal (individual) income tax revenue has experienced periods of growth and decline.

Sixteen out of nineteen years saw growth in personal income tax revenue, with the largest annual increase being 28% in the 2005 fiscal year. Growth in income tax collections continued, at a decreasing rate, through 2008. However, the impacts of the "Great Recession"[11] began to catch up with Alabama, as personal income tax collections declined by 12% in 2009 and by an additional 16% during 2010. In total, income tax collections fell during 2009 and 2010 by $920 million. Such a significant reduction in tax collections puts additional pressure on a state such as Alabama with the characteristics described earlier. Personal income tax collections began to rebound in 2011;

Figure 3.1: Alabama Tax Revenue, 2012

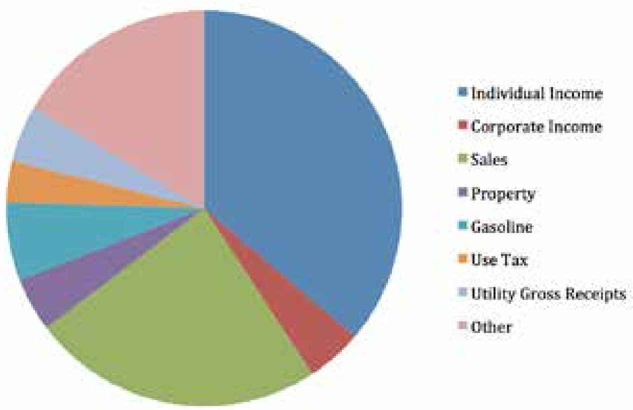
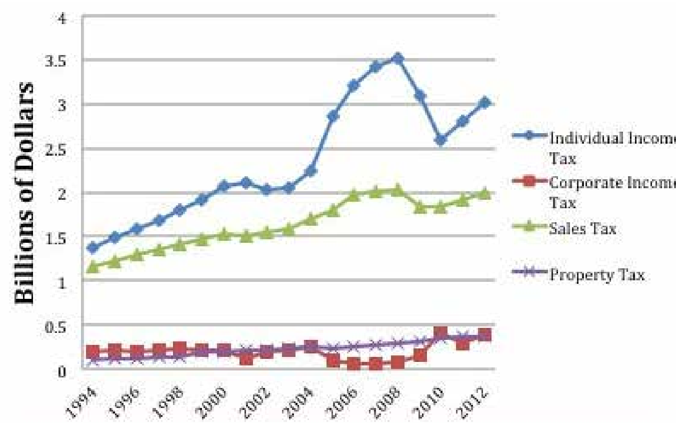


Figure 3.2: Major Taxes Collected in Alabama



however, growth of nearly 8% during 2011 and 2012 has not been enough to return collections to pre-recession levels.

Corporate income tax collections are much less significant as part of total state revenue than personal income tax collections. Several contributing factors help account for the relatively low level of corporate income tax revenue. The chief factor is simply the low tax rate. Alabama has one of the lowest corporate income tax rates in the nation. During 2012, the corporate income tax generated just over $379 million. The largest amount of corporate income tax revenue collected during the review period, shown in **Figure 3.2**, is $411 million, which was collected in 2010.

During the period from 1994 through 2012, collections for corporate income taxes showed more up and down movement than the personal income tax above. Corporate income tax collections increased during thirteen years while declining in six. Four of the six reductions in collections were all greater than 29%, declining by 43.8%, 65.5%, 39.6% and 29.4% during 2003, 2005, 2006, and 2011 respectively. These reductions in revenue were balanced by various small and moderate increases in revenue, as well as, two large increases of 123% in 2009 and 150% in 2010. The timings of these large increases coincide with the periods of decreasing personal income tax collections. While corporate income tax collections in 2009 begin to return to pre-2005 levels, it is unclear why corporate income tax collections grew by such a large amount during 2010. A review of *A Legislators Guide to Alabama's Taxes* does not indicate a change in the tax law that would explain the generation of an additional $247 million in tax revenue when typical collections prior to 2010 average only $168.3 million. One possible explanation would be the use of separate reporting to shift profits from a higher tax state to Alabama and its low tax on corporate income. Studies suggest companies engage in profit shifting to minimize their tax liability,[12] and this might have been especially tantalizing for corporations during recessions.

2.2 Sales Taxes

Alabama began levying sales taxes by statutory authority in 1939 as part of the second stage of implementing the tax system we know today. During this time, the state adopted a tax on general sales tax of two percent (2%) and a sales tax on automobile purchases of one half of one percent (0.5%). Given the statutory nature of these taxes, sales tax rate changes do not require constitutional amendment, and therefore are much easier to modify than income and various other taxes. In fact, the Alabama Legislature has altered the sales tax structure in some form or fashion on more than forty occasions since the initial implementation in 1939. This compared with the income tax, discussed in the previous section, which has only been amended four times since 1933.

The general sales tax was imposed on all taxable goods sold to the public or corporations and on the proceeds from operating places for amusement or entertainment. At the time, as part of the effort to increase public school funding, a portion of the proceeds from this tax was distributed (earmarked) to the Special Education Trust Fund. Currently, sales taxes are still earmarked for education, with more than 80% of net collections from this tax flowing into the Education Trust Fund annually. Since 1939, rates, exemptions, and other aspects of the law have been amended approximately forty times, and the current rate is 4% on general sales and 2% for automobiles. Local jurisdictions also impose sales taxes on top of the 4% figure levied by the state.[13]

The sales tax represents the second largest source of tax revenue for the state. In 2012, sales tax revenue was just under $2 billion, accounting for 24% of total tax revenue. Sales tax revenues also fluctuate with the state economy, with most years experiencing growth at varying rates. Until 2007, sales tax collections had increased considerably since collecting only $1.15 billion during 1994. However, growth began to slow during the recession, with growth of only 2.5% during 2007 and a paltry 0.26% during 2008. During the following year (2009), effects of the recession seemed to hit full force and collections decreased by nearly $200 million, or almost 10%. This represents the largest movement for any given year in this review and the only decrease in collections. Sales tax collections began to recover during 2010 with a minor increase of less than 1% and collections have continued to increase in 2011 and 2012, but have not yet recovered to pre-recession levels. Historical information on sales tax collections is also found in **Figure 3.2**.

2.3 Property Taxes

State property taxes are imposed on real estate, personal property and improvements to real property, and are regularly involved in debates about Alabama's current tax system. As mentioned previously, the initial stage of levying taxes in Alabama during 1935 involved the addition of a property tax. Similar to income taxes, the maximum property tax rate was set by constitutional provision and any change to this maximum requires a constitutional amendment. Additionally, the state imposed the maximum rate in 1935 and earmarked 100% of the tax revenue. At that time, 46.16% of property tax revenue was designated for education while 38.46% was designated for the general fund and the remaining 15.38% set aside for needy confederate veterans and their widows. Since initial implementation, exemptions, exclusions and earmarks (obviously, in 2013, the state has no need for an earmark pertaining to needy confederate veterans and their widows) have been revised; however, the maximum rate remains at the 1935 constitutionally controlled maximum level.

The 1935 maximum rate for state property tax is 6.5 mills of "assessed" value. A mill is defined as 1/1000 of a dollar or 1/10 of one cent. This definition makes a levy of 6.5 mills equal to $0.0065 or 0.65% of $1. However, the effective tax rate is even lower as the tax only applies to the "assessed" value of the property. Assessed value is defined as the percentage of the properties' market value that is subject to the tax. For example, an assessment ratio of 10% would indicate that the tax rate applies to ten ($10) out of each one hundred ($100) of market value. The effective tax rate, therefore, will vary depending on the assessment ratio. In this example, the effective tax rate falls to 0.065% of $1.

Furthermore, Alabama categorizes property into four general classes. Each class is subject to the 6.5 mill rate; however each class has a distinct assessment ratio. As with the tax rate itself, the state constitution prescribes definitions of property classes and assessment ratios for each class. Any desired changes to the classes, assessment ratios, or tax rates require a constitutional amendment. The classes and assessment ratios (AR) are defined as:

- Class I – tangible property of electricity, gas and other utilities (AR = 30%)
- Class II – tangible property not otherwise classified (AR = 20%)
- Class III – tangible agricultural, residential, and forest property (AR = 10%)
- Class IV – private passenger automobiles and trucks devoted to personal use. (AR = 15%)

Each class then has an effective tax rate of 0.195%, 0.13%, 0.065%, and 0.0975% respectively.

In addition to the constitutionally defined assessment ratios, numerous exemptions decrease the effective assessed value of property taxes and reduce revenue. The *homestead exemption* and the *current use rule* are important explanations of why Alabama collects less property tax revenue than projected based on market values, assessment ratios, and the 6.5 mil rate. The homestead exemption excludes property owned by people over age 65, the blind, and people who retired due to total and permanent disability from the state property tax. In addition, it provides a $4,000 exclusion in assessed property values for owners under age 65 on property up to 160 acres. The current use rule classifies property based on its existing state of use according to the four classifications outlined above. This rule allows some forest and agricultural properties operated as part of a for-profit business to be taxed at a lower assessment ratio than other businesses operating in the state. This decreases property tax liability for some areas within the state.[14]

Considering these factors and the low tax rate, it is understandable that Alabama is widely known to have one of the lowest effective property tax rates in the country. As shown in the 2006 Public Affairs Research Council of Alabama (PARCA) report, Alabama has the lowest property tax burden of any state; more than sixty percent (60%) lower than the national average. Furthermore, a 2004 report from the Tax Foundation, utilizing property 2002 tax data collected by the Bureau of the Census, reveals that state and local governments in Alabama collect $329 in property tax revenue per capita compared with the U.S. average per capita is $971. This tells us that the tax could be tripled and per capita property tax revenue would rank only slightly above the national average. Such a move however, would change Alabama's placement in per capita property tax revenue collected from 50th to 17th. Furthermore, if only the state level property taxes are considered, in 2012, the Alabama Department of Revenue reveals that per capita property tax collections total only $75.77. As a result, the property tax is relatively inconsequential at the state level and revenue generated from income, sales, gasoline and motor fuel, and utility gross receipts taxes all exceed revenue collected from property taxes.

Specifically, as shown in **Figure 3.2**, state property tax collections totaled only $0.365 billion during 2012, or 4.4% of total state tax revenue. Much like the taxes discussed previously, property tax revenue has increased in most years, with the only decrease in collections occurring during 2005 (a decrease of approximately 10.5%). Although collections have grown at a much slower rate since 2010, property tax collections have generally grown at a rate larger than 5% with the largest increase, of 36%, occurring in 1999.

2.4 Other Taxes

The final set of taxes we discuss is a catchall category referred to as "other taxes." While many of these taxes have a small individual impact, together they provide a sizeable portion of revenue, accounting for almost $2.6 billion (or 30.9% of total tax revenue for Alabama) during 2012. Some items included in the "other taxes" category are cellular telecommunications tax receipts, corporate shares tax receipts, receipts from financial institutions, excise taxes, motor vehicle title fees, rental or leasing tax receipts and numerous license fees. Of the forty some odd taxes, other than income, sales and property taxes, three additional taxes identified in **Figure 3.1** – gasoline and motor fuels, use, and utility gross receipts – account for $1.19 billion or just more than 45% of revenue generated by "other taxes". The gasoline and motor fuel tax produced revenue of $0.531 billion while the utility gross receipts tax collected $0.382 billion and the use tax generated $0.283 billion in revenue during 2012. As show in **Figure 3.3**, collection levels of these taxes also varied within the historical period included in this review of Alabama's tax system. All other taxes levied by Alabama each generated less than $200 million both historically and during 2012, with most generating less than $100 million per year.

Gasoline and motor fuels taxes are excise taxes on the sale, consumption, distribution, storage, or withdrawal from storage of gasoline and/or motor fuel. Alabama places a total tax of $0.16 per gallon on gasoline and $0.17 per gallon on motor fuel.[15] The utility gross receipts tax is a privilege tax imposed on every utility furnishing services in Alabama. Electricity, domestic water, and natural gas are taxed at four percent (4%) of the monthly gross if the gross does not exceed $40,000. These services are taxed on a graduated scale for a monthly gross between $40,000 and $60,000. Any amount larger than $60,000 is taxed at the maximum rate on the scale, $2,200 plus 2% of the excess over $60,000.

Telegraph and telephone services also fall within this category and are taxed at 6.7% of gross sales if under $60,000 or $4,020 plus 3.7% of the excess over $60,000. Finally, use taxes behave essentially like the sales taxes previously discussed. A use tax is levied, in the form of an excise tax, on the use, storage, or other consumption of tangible personal property and/or machinery in Alabama when such property is used in the performance of a contract. Alabama charges a 4% tax on tangible personal property, a 1.5% tax on machinery, and a 2% tax on automobiles.

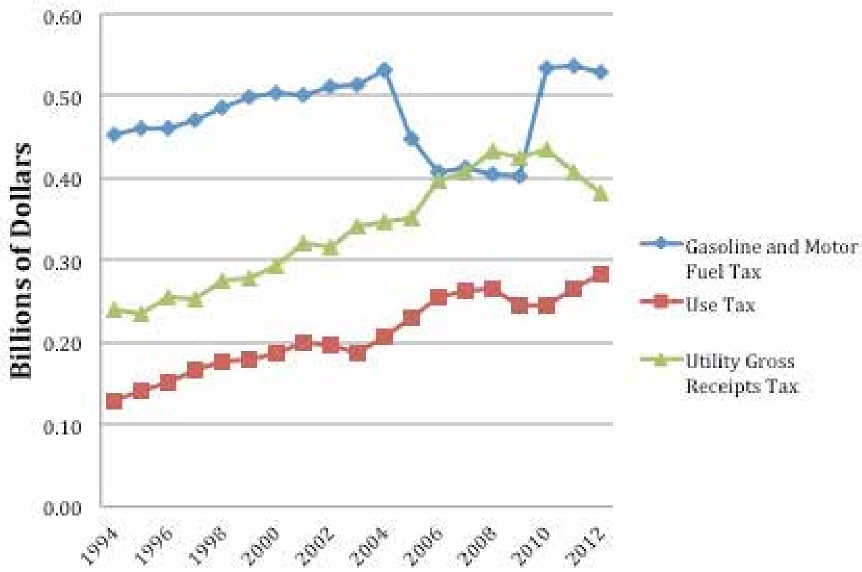
Now that each major tax source has been discussed, we next detail the specific earmarking of each of the taxes.

2.5 Earmarking

Earmarked taxes they must be used for specific purposes rather than being available in the General Fund. The purported reason for earmarking is to disallow capricious spending at the discretion of politicians. Reports from both the National Conference of State Legislatures (2008)[16] and the Public Affairs Research Council of Alabama (2006) conclude that Alabama earmarks tax revenue to a greater degree than any other state. Like most states, Alabama earmarks gasoline and motor fuel taxes for highway programs. However, Alabama earmarks all revenue collected from income taxes for the education trust fund and teachers' salaries. The majority of sales tax revenue is also earmarked for general education purposes. Unlike the income tax, all of the revenues from other taxes are not earmarked at the 100% rate, but many are earmarked at quite high rates. Other "lesser" taxes, not included in this analysis, are earmarked at varying rates.

In summary, Alabama has significant earmarking of major tax sources, a large number of taxes that are earmarked, and a dearth of exceptions in which taxes are earmarked art a lower rate. One would expect that total tax collections in Alabama will be earmarked at a rate approaching 100% of amount recorded for income and fuel taxes revealed above. Data from the

FIGURE 3.3: OTHER TAXES COLLECTED IN ALABAMA



National Council of State Legislatures (NCSL) (2008) indicates that total tax collections in Alabama are earmarked at 84%, while PARCA reports a slightly higher amount of 87.5%. Regardless of which number is the most accurate, earmarking in Alabama is twenty percent (20%) higher than in the next closest state, and well above the US average of 24% - see **Figure 3.4**. This means that Alabama earmarks tax revenue at a rate more than three times higher than the national average.

Such a high degree of earmarking conjoined with the balanced budget mandate leave the Governor and legislature limited authority regarding state financial decisions. Such a limited authority could lead to a fiscal crisis when economic contractions occur and collections begin to decline. Total taxes and the impacts of earmarking are summarized below.

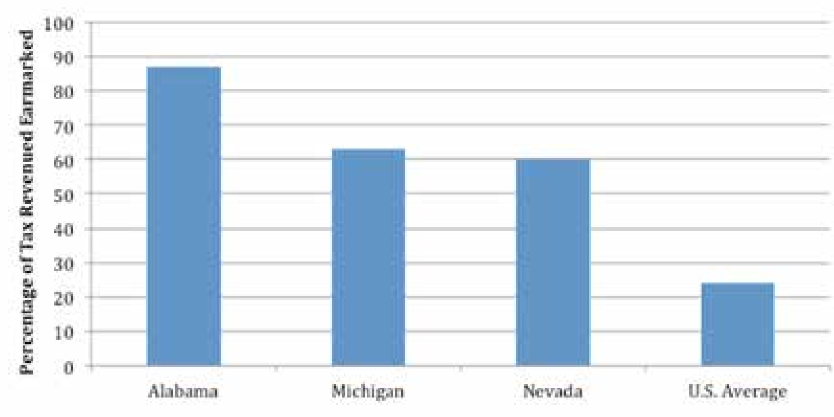
2.6 Total Taxes

During 2012, Alabama's tax system collected more than $8.3 billion in revenue. This overview focused on six of the more than forty state taxes levied, which produced over $6 billion (83.4% of Alabama's total tax receipts in 2012). Over the nineteen year period examined in this chapter, total tax collections follow the up and down movements of the individual taxes. Total tax collections increase in fifteen out of the nineteen years. Examination of **Figure 3.5** supporting evidence that tax collections vary based on the state of the economy. Tax collections increase during expansionary phases of the economy– 1994-2000, 2003-2008 and 2011–2012 in our historical review period. Oppositely, tax collections decreased during and after the recession of 2001 (2001–2002) and the "Great Recession" of 2009–2010. Even though tax collections began to expand again in 2011, total collections during 2012 were still more than $300 million below the prerecession level. Historical total tax collections are located in **Figure 3.5.**

The sensitivity of total tax collections to economic conditions creates the potential for budgetary crises when revenues fall during recessions. **Figure 3.6** provides further evidence regarding the variability of tax collections during the business cycle by examining the period between 2003 and 2012. Specifically we examine the expansionary period of 2003 – 2008 and the contractionary period of the "Great Recession." Collections for five of the six taxes examined grew by more than 20% during 2003 – 2008; only the Gasoline and Motor Fuels tax experienced a decline. Conversely, tax collections behaved much differently during and after the recession. Property and use taxes continued to increase but at a smaller rate than previously. Individual income and utility gross receipts taxes declined significantly while sales taxes only decreased slightly. The gasoline and motor fuel tax rebound during this phase, increasing by more than twenty percent (20%).

Variability in collections of different taxes indicates that the types of taxes levied can contribute to the periodic budget crises and proration discussed in the introduction. The "Great Recession" provides an example of this process; Alabama is heavily dependent on the income tax and **Figure 3.6** depicts that income taxes possess the largest amount of variability during the period examined. Further examination reveals that individual income tax collections decreased by $0.921 billion in 2009 and 2010. Even though some tax collections increased during the period, the large degree of variability in individual income tax collections and smaller decreases in collection of other taxes yielded a decrease in total taxes of $1.175 billion during the period. Such a precipitous decline in tax revenue led to proration of both the general fund and the education trust fund during

Figure 3.4: The Use of Earmarking by States



2009 and 2010. Such fluctuations in state finances, increasing demand for services, and the impact of Alabama's taxes on residents (examined in the subsequent section), have resulted in calls for tax reform in Alabama.

3. Impacts of Alabama's Tax System on Residents

The tax system created by the Constitution of Alabama inevitably modified several aspects of the state's economy. Some of the effects were expected or planned, while others were unintended or unforeseen. Effects of a tax system on the economy can be broadly classified into *equity, efficiency, revenue adequacy* and *economic stability*. In brief, equity refers to fairness in the distribution of tax burdens relative to income or wealth. Efficiency encompasses influences and actions that affect economic behavior and the allocation of resources in the taxing jurisdiction. Compliance costs are an aspect of the efficiency effects of taxes. Revenue adequacy refers to the ability of a tax system to consistently generate sufficient revenues to support the expenditure programs to which the government is committed. Stability refers to the macroeconomic and cyclical effects of taxes.

Revenue adequacy and stability are obviously important characteristics of any tax system, but tend to be ignored during economic expansions when tax revenue is growing. On the other hand, these become sensitive topics when economic conditions begin to deteriorate or when demand for state services rises faster than tax revenue. Lack of available revenue to fund basic services like education, law enforcement, and highways will negatively impact residents. The adequacy of state revenues is even more significant for Alabama's K-12 education system because of its dependence on state level funding.

Alabama's tax system is sensitive to economic downturns which resulted in inadequate revenue and proration during 2009 and 2010. During this time, the cyclical effects of taxes impaired revenue adequacy and resulted in negative impacts for residents.

Figure 3.5: Total Taxes Collected in Alabama

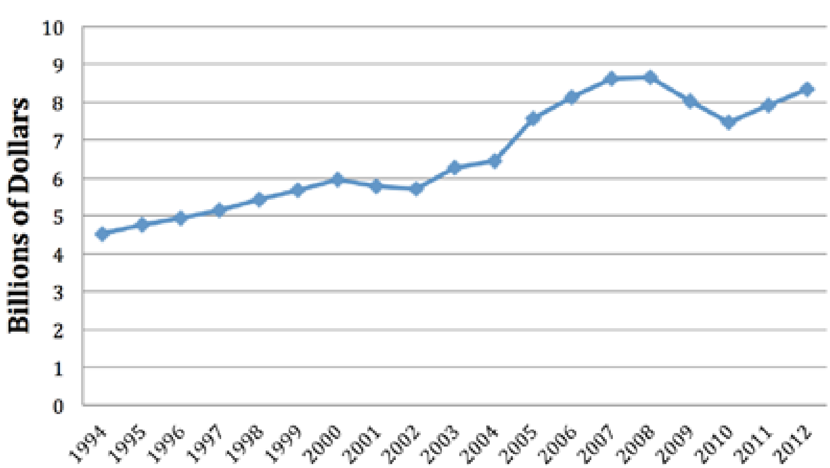
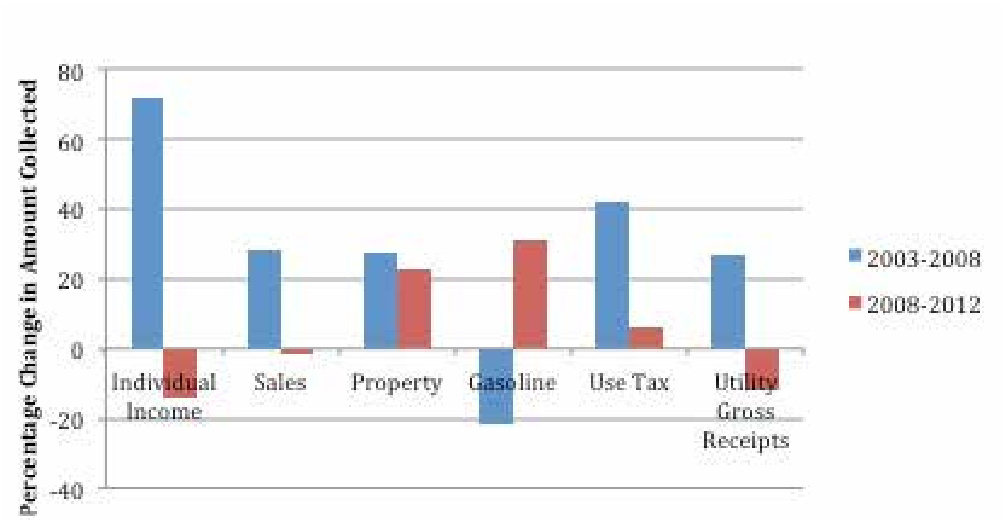


Figure 3.6: Variability of Alabama Tax Revenues



In summary, inadequate revenue results in negative impacts on residents and this impact is amplified during economic downturns. Both topics should be considered by policy makers in discussion of tax reform.

While revenue adequacy and stability are straightforward topics, the same cannot be said for equity and efficiency. There is a lack of general agreement regarding meaning of these concepts, especially when residents or politicians engage in a debate over them. The majority of this section is devoted examining how economists study these often perplexing concepts. However, before turning to equity and efficiency, it is important to note one additional aspect of the tax system that is of concern to residents within any taxing jurisdiction – *the revenue maximizing Leviathan.*

Brennan and Buchanan (1977, 1980) discuss the revenue-maximizing Leviathan aspect of taxation, and raise concern based on constitutional limitations and political incentives. A constitution imposes constraints on a government to tax, and these constraints are (usually implicitly) based on some intended balance of the various tax system effect characteristics listed previously in this section. However, once the tax structure has been established the citizenry has no additional rights (beyond those in the constitution) regarding taxation. The fear then surrounds the possibility of politician-bureaucrats then attempting to maximize tax revenue for the purposes of furthering their own personal agendas.

The consequences of such a Leviathan could be deleterious. Gifford and Kenney (1984) discuss the temptation to move to socialism for the quick revenue rewards without regard for ethical concerns, especially if the decision-maker faces short-term foreign or domestic threats. Niskanen's (1971) "budget-maximizing bureaucrat" seeks to maximize quantity of services provided (in exchange for an increasing budget level) rather than providing a level at which marginal revenue and marginal cost is equal. In general, public decision-makers are faced with a plethora of incentives to spend more and a paucity to curtail said spending. In any event, one's concern over the Leviathan model likely will depend on his view of government – as a benevolent provider of public goods, or an out-of-control instrument of wealth redistribution.

To some degree the Leviathan issue is beyond the scope of this chapter; however, we can comment on the issue given the constitutional nature of Alabama's tax system as discussed earlier in the chapter. As discussed in Section 2, Alabama currently levies the constitutional maximum rate for income and property taxes. While the maximum property tax has remained constant, the maximum rates on individual and corporate income both have been raised in an effort to capture additional revenue. Additionally, politicians are believed to have an inclination toward furthering their own agenda and as mentioned above, they may do so via maximizing revenue. However, the linkage between personal gain and the Leviathan may be more indirect. Specifically, public officials sometimes engage in unnecessary spending to bring gifts to their districts in an effort to secure votes in future elections. Continuous and/or increasing spending will eventually compel raising additional tax revenue to maintain a balanced budget. Alabama, like most all states, is no stranger to such tactics. While the exact degree to which Alabama follows the Leviathan model is unclear, such activity does have an impact on residents and Alabamians must be concerned about such activity.

The remainder of this section describes how economists study equity and efficiency as well as reporting how Alabama's tax system affects residents in these two categories. Equity is examined first.

3.1 Equity in Alabama's Tax System.

A controversial topic in almost all discussions of the tax system and/or tax reform involves the issue of who bears the burden of taxation. This issue is categorized as the equity aspect of the tax system. More generally, equity is a fairness principle that examines how the cost of government is divided among the citizens. As one might presume, no choice of distributing the tax burden will please everyone; however, Slemrod (1993) distinguishes three possible approaches to the distribution of the tax burden. Specifically, these approaches are the benefit principle, the utilitarian principle and the ability to pay principle.

The benefit principle holds that tax burden should be distributed based on the benefits citizens receive from the government. The principle is the most market-oriented in nature and essentially considers taxes and fees as analogous to prices for goods and services provided by the government (i.e. public goods). If structured correctly, a tax system constructed on the benefit principle results in a level of government spending on public goods that is directly related to what users are collectively willing to pay.[17] Measuring the exact benefits each individual receives from government services like national defense or police presence in a city makes application of the benefit principle difficult. On the other hand, the benefit principle works very well when the public good can be directly related to use and Alabama levies a number of use taxes and fees, while not a major source of revenue, are structured based on this principle. One example of such a tax would be the gasoline tax discussed in the previous section. The gasoline tax is added to the price of fuel at the pump and a driver's tax burden increases with the number of miles driven.

The next method of assessing the burden of taxation is the utilitarian principle. This principle is on the opposite end of the spectrum from the benefit principle. Strict adherence to the benefit principle would prohibit income redistribution via welfare programs whereas the utilitarian principle assigns tax burdens specifically to maximize social welfare. Slemrod (1993) further notes that applying a tax system of this nature would yield total after tax income that is equally distributed among everyone. This type of tax system, most certainly, is not supported from the market perspective as it would have significant negative side effects. Most notably, this type of tax system obliterates the incentive to participate in the economy—resulting in a declining standard of living for everyone.

The third and final principle noted by Slemrod (1993) is ability to pay, which assigns tax burden based on the ability to withstand the burden. The general viewpoint is that individuals with higher incomes are better able to withstand the burden of paying taxes since they have a higher capacity to earn income. This principle is also based on the idea that paying taxes involves less "pain" as an individual's income increases. While this idea of diminishing pain is impossible to prove, many state, federal and even international tax systems are structured based on this principle.

Further complicating the ability to pay issue, economists divide this principle into two components—horizontal and vertical. Horizontal Equity (HE) focuses on the equal tax treatment of those with equal incomes. Specifically, individuals who earn equal incomes should pay equal taxes. Musgrave (1990) suggests that such a principle is uncontroversial, and numerous attempts have been made to provide a meaningful measure of HE. Oppositely, Kaplow (2000) suggests that HE is a fallacious principle lacking intrinsic value. He argues that the concept of HE is only a "rough proxy" for social welfare problems that could potentially arise due to the lack of HE. Kaplow appropriately notes that the tax code can be used to discriminate and/or punish political adversaries; however, he also notes that the various measures of HE that have been developed do not seem to be related to the potential problems.

In general, HE assumes that people with identical pretax income are equal and should be treated as such. A problem arises as this is not necessarily true; such an assumption ignores the fact that different people with identical income may have different life experiences. Kaplow (2000) offers an example using medical expense deductions. Two individuals with identical pre-tax income and each pay a different amount tax. This result suggests a violation of HE; however, each individual experienced a different degree of illness during the year. Different illness levels indicates different circumstances which yield varying levels of medical expense deductions so HE may or may not be violated.[18] He concludes by suggesting,

> *"there is in fact no good argument for viewing HE as an independent evaluative principle and that pursuing HE is in conflict with the very core of welfare economics, the Pareto principle."* (Kaplow, 2000 p. 22)

Given Kaplow's suggestion and lack of meaningful ways to measure HE, this aspect of Alabama's tax system will not be considered.

On the other hand, vertical equity (VE) is based on the ability to pay principle of taxation, which asserts that individuals with a greater ability to pay taxes should pay more. VE examines the redistributive effect of state and local tax systems. In other words, VE measures how a tax system alters the distribution of income. The concept is much more understood than that of HE and numerous measures have been developed to quantify exactly how tax systems alter the income distribution. Therefore, VE constitutes the central focus surrounding the equity impacts of Alabama's tax system. [19]

From a VE perspective tax systems are typically classified as progressive, regressive or proportional.[20] A tax system is deemed progressive (regressive) if the average tax rate rises (falls) as income increases. On the other hand, in a proportional tax system tax rates do not vary with income. Thusly, a progressive tax system reduces income inequality, a regressive tax system increases inequality, and the proportional tax system leaves the income distribution unaltered. The purpose of this section is to measure how the Alabama tax system currently affects residents. To this end, this section measures and classifies the equity impacts of Alabama's current tax system. It is not intended to address what the equity impacts *should be*.

On balance federal taxes are known to be progressive, due to both the graduated rate structure of and amount of revenue raised via the individual income tax. In contrast, many state and local tax systems are believed to be regressive. Data from the Institute on Taxation and Economic Policy (ITEP) (2003) indicate that average tax rates generally decline with income in most, if not all states. Different taxes impact residents differently. For example, state income taxes are generally perceived to be progressive (like the federal income tax), while state sales and property taxes are regressive. The effect of the total tax system depends on the degree of progressivity or regressivity of each of the individual taxes and the proportion of overall revenue accounted for by each.

ITEP data[21] indicate that Alabama's tax system is regressive, but provide no exact measure of the degree of regressivity. Fortunately, Formby, Kim, and Malone (2013) estimate the exact degree of regressivity present in Alabama's tax system. Formby et. al. employ two of the leading Gini-based measures[22] of VE and find that Alabama's tax system is indeed regressive and to a significant degree when compared to other states. Their findings, constructed utilizing 2002 data from ITEP, reveal that all state and local tax systems in the United States are regressive, and Alabama ranks as the 7th or 9th most regressive state depending on the index used.[23] Thus, Alabama's tax system widens the gap between the rich and the poor. Furthermore, comparing Alabama to the average degree of tax regression across all states, the tax system regressivity index is more than 30% or 43% higher in Alabama, again depending on the index used.

An interesting (and less than appealing) characteristic is pointed out by Levitis and Johnson (2006). The authors find that in 2002, residents of Alabama reach the threshold for paying income taxes faster than residents of any other state in the nation. This threshold of $4,600 prevailed through 2005, and required a two-parent family of four to begin paying income taxes at a level of income which was seventy-five percent below the 2005 poverty line. This issue was addressed in April 2006 with the passage of HB 292. This bill, signed by Governor Bob Riley and taking effect in January 2007, was designed to mitigate the effects of income taxes on low income residents of Alabama. HB 292 increased the standard deduction for married couples who earn less than $20,000 per year from $4,000 to $7,500. The change in standard deduction is gradually phased out between $20,000 and $30,000, with married couples who make more than $30,000 receiving no benefit from HB 292. Single and single-parent households in the income brackets above also enjoy a new higher standard deduction with identical phase-outs. The new law also increased the dependent exemption from $300 to $1,000 for those households earning less than $20,000 per year and from $300 to $500 if the taxpayer earns between $20,000 and $100,000. The dependent exemption remained the same for all other income brackets.

Alabama's tax system places a relatively heavy burden on low-income state residents, violating the ability to pay principle. While people disagree with respect to the desirable degree of progressivity in a tax system, there is general if not universal acceptance by economists, policy makers and residents alike that a regressive tax system is not desirable. Alabama and all other states fail when using this measuring stick for the success of a tax system.

Another VE question of interest is how do major taxes in Alabama contribute to or mitigate the total regressivity of the tax system. While little is known about the equity impact of some smaller taxes, generally economists believe that state sales and property taxes are regressive, while state income taxes have some degree of progressivity. The ITEP data do not allow all six taxes from the previous section to be examined; however, Malone (2006) decomposes the equity effects of Alabama's tax system to determine the equity impact of income, property and sales taxes.

Malone (2006) reports that as expected, sales taxes are regressive in all states, including Alabama. Alabama ranks twentieth in terms of sales tax regressivity, which is slightly above the U.S. average. Property taxes are also generally regressive[24] across the nation; however, property taxes in Alabama are only slightly regressive, with Alabama ranking fortieth in terms of property tax regressivity. This is better than the U.S. average for property tax regressivity. Income taxes also follow the norm and are typically progressive. Alabama, on the other hand, does not follow the norm and total income taxes are regressive. Four other states[25] also utilize regressive income taxes, but Alabama's income tax is the most regressive of all state income tax systems in the nation. Breaking the income tax down into personal and corporate components reveals that corporate income taxes are slightly progressive in Alabama while personal income taxes are again regressive.

The results presented above are based on data from 2002. How does the passage of HB 292 in 2006 affect the regressivity of Alabama's tax system? Incorporating changes to the income tax threshold and dependent deductions into the ITEP data set yields promising results. Re-estimating the equity indexes reveals that HB 292 reduced total regressivity between 3.3% and 3.7%, depending on which index is considered. In the regressivity ranking of all states, Alabama remains at 9th place in one index and drops to 9th place in the other. The reform did not have any impact on the decomposition coefficients for sales, property and corporate income taxes as the reform only applied to individual income taxes. HB 292 did however result in an improvement in personal income tax regressivity. Unfortunately, personal income taxes remain regressive; however, regressivity of this tax decreased by 28.6% as a result of this tax reform. This movement moves Alabama's regressivity ranking on personal income taxes from 1st to 5th.

Alabama's tax system and major components are all regressive. HB 292 helped reduce some of the regressivity present; however, Alabama's tax system continues to place a heavy burden on the state's poorest residents. If a tax system's impact is measured based on the ability to pay principle, then Alabama's tax system has a significant impact on residents, especially those residents at the lower end of the income distribution. Having investigated the effects of Alabama's tax system with respect to equity, we turn to a discussion of the impacts on efficiency.

3.2 Efficiency of Alabama's Tax System

A 2008 report from the Tax Foundation26 offers a quote from noted economist Henry George:

> *"As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be impoverished and their power of producing wealth destroyed by taxation, which, if levied in any other way, could be borne with ease."*
> (Tax Foundation, 2008 p. 1)

Mr. George made this comment relating to how taxation influences economic activity. Taxes undoubtedly have some type of impact on market participants. Essentially, tax rates are one determinant of how people choose to spend and save money. An increase in tax rates discourages the activity being taxed. From the sales tax perspective, sales taxes effectively increase the price of goods and services and the money available to consumers for spending and saving necessarily decreases. As the amount of funds available declines, so do the number of purchases as consumers must make choices regarding how to spend their money. From an income tax perspective, a higher tax on overtime hours discourages employees from working overtime while taxing non-resident investment income discourages investment from outside the state. For a more concrete example, consider the employment impact of Alabama's sales tax.

As described previously, Alabama collected approximately \$1.991 billion in sales taxes during 2012. Utilizing employment multipliers from the Bureau of Economic Analysis (BEA), we can estimate the employment impact from levying a sales tax of 4% at the state level. The BEA reports that the Retail Trade sector supports a total 22.52 private sector jobs in the Alabama economy per \$1million of output.[27] Since sales taxes increase the effective price and reduce sales, the sales tax will have a negative employment effect. Therefore, \$1.991 billion in sales tax reduces private employment in Alabama by 44,857.9 jobs. It is true that all taxes will create some type of burden and that the tax revenue will be used to create jobs in the public sector. However, Mr. George's comment raises the question of identifying an alternate method of taxation that does not create such a large burden on the private sector.

Efficiency encompasses influences and actions that affect economic behavior in the taxing jurisdiction. The effects of behavioral responses are revealed as changes to consumer expenditures, income, employment, production, government expenditures and tax revenues in the taxing region. Such distortions of activity create a burden in excess of tax revenue and economists commonly refer to this as the deadweight loss or excess burden of taxation. Deadweight loss refers to the value that would be present in the economy if not for the tax. For example, sales taxes result in reduced sales for the item that is taxed; customers who do not purchase the item because of the tax lose any benefit they would receive from purchasing the item.

Almost every conceivable tax imposes some type of excess burden on the economy. Avoiding an excess burden altogether is not a realistic option, so instead economists examine how to structure the tax system to minimize the excess burden of raising a required amount of revenue for government. Recalling Mr. George's comment, how do we raise revenue without "distressing" the economy and causing significant harm to future economic growth? Just as different taxes have different equity effects as discussed above, different taxes impose diverse levels of excess burdens because different consumers and producers in the region will all respond to the tax in a slightly different manner. Furthermore, the tax rate also affects the excess burden of the tax as well as the level of tax revenue collected.

For example, let us consider three hypothetical taxes: small, medium and high. A "small" tax will generate low levels of revenue but also generate a minor amount of excess burden, since the small rate will result in limited alterations to behavior. Suppose that the "small" rate does not generate enough revenue to pay for current services, so a "high" tax rate is imposed. A high tax rate will have a significant impact on economic decisions in the region and will typically also yield only a low level of revenue because of the substantial excess burden. An extreme example of these two cases would be to tax income at 0% and at 100%. Obviously a 0% tax rate will generate $0 tax revenue and have an excess burden equal to zero; however, it is also commonly assumed[28] that a 100% rate would also generate $0 tax revenue as such a tax rate would reduce the benefit from working to zero – implying an excess burden of 100%. On the other hand, a "medium" tax rate will generate more revenue that the "small" tax because of the higher rate, and more revenue than the "high" tax because a "medium" tax results in a lower level of excess burden.

Measuring the level of excess burden present in taxes suffers from a number of practical difficulties centering on the fact that residents and firms within the taxing region each will have a somewhat unique response to each tax and tax rate – making the supply and demand interactions difficult to estimate. To this end, numerous advanced statistical models have been developed to attempt to measure the excess burden of taxes. However, more is known about excess burden at the federal level, and research by Ballard, Shoven and Whalley (1985) estimates the excess burden of federal taxation to be between 17 cents and 56 cents per dollar. This means that each dollar of revenue raised results in an additional reduction in economic activity of $0.17 to $0.56. A more recent study by Conover (2010) places the average excess burden of all federal taxes at $0.44.

Unfortunately, not much is known about tax system efficiency and excess burden at the state level. If we apply the most recent estimate of the excess tax burden of federal taxes to Alabama's 2012 tax revenue of $8.3 billion, Alabama's tax system generated an excess burden of $3.65 billion, i.e., Alabama's current tax system reduces economic activity by $3.65 billion. By definition, an efficient or optimal tax system is one that minimizes the excess burden while achieving the previously discussed objectives of equity, revenue adequacy, and economic stability. Based on this definition and the level of excess burden estimated above, can Alabama's tax system be classified as efficient? In general, intuition suggests that Alabama's broad base, low rate approach would yield a relatively efficient tax system. However, the question remains, can Alabama's current mix of taxes be altered such that the result is increased economic activity, indicating an increase in efficiency?

Without a sophisticated econometric model built specifically for Alabama, it is impossible to answer this question with any certainty. Conversely, estimating the changes to economic activity due to the reform of various major taxes would allow an evaluation of the efficiency present in the current tax system. For example, if some tax reform package is instituted and the result is increased tax revenue and increased economic activity, then one can conclude that the current tax system is not efficient. Also, if the same reform plan reduces revenue and economic activity then the existing tax structure is more efficient than the one including tax reforms.

We now examine recent tax reform debates in Alabama and around the nation. Part of the analysis will focus on the efficiency impacts of various tax reforms packages for Alabama to determine the relative efficiency of Alabama's current tax system. Equity impacts of the reforms will also be considered.

4. Tax Reform in Alabama

Across the country, many state and local governments have experienced budget crises since 2000. These problems were due in large part to unsustainable spending during periods of economic boom. These problems were particularly acute following the period 2007–2009. A number of explanations have been offered to explain these revenue shortages. David Brunori (2001) cites obsolete state tax systems, growth in e-commerce, an increasingly global economy, and the rising number of state funded projects as reasons for the widespread funding shortages during and after the recession prior to his article. No doubt, tax structures that are slow or unresponsive to changing economic conditions or expanding state and local expenditures are a primary factor associated with recent revenue crises.

For example, many state tax systems across the United States were developed over fifty years ago and were structured to meet prevailing revenue needs under the economic conditions that prevailed at that time. Alabama is included in this group of states. Recall that Alabama's tax system is governed in large part by the Constitution of Alabama of 1901 with constitutional amendments required to change many aspects of the revenue system. From this perspective, it seems intuitive that the contribution of outdated tax systems to deteriorating fiscal conditions results from tax structures constructed primarily for agricultural- and manufacturing-based economies. It should not be surprising to find that these outmoded tax structures fail to generate added revenue in an information-based global economy in which services are increasingly important.

Problems of growing expenditures, mounting deficits, and overall regressivity[29] of state tax systems led to calls for tax reform in many states. Since 2000, residents in more than twenty-five states have experienced some alteration to their current tax and/or spending structure. In several other states, changes to the tax structure have been proposed but defeated in popular votes or withdrawn by elected officials due to lack of support. Alabama's recent revenue pattern was addressed in Section 2, and Alabama provides us with recent examples of both successful and unsuccessful attempts of tax reform (see Side Bar: Tax Reform in Alabama).

As these debates continue, a general understanding of the consequences of tax reform is essential. The effects of tax reform will differ based on the purpose of the reform. Brunori (2001), George R. Zodrow (1999), John E. Petersen and Dennis R. Strochota (1991) and others have outlined the effects of tax reform based on the following characteristics: *equity, efficiency, revenue adequacy, stability,* and *accountability*. As discussed previously, Brennan and Buchanan (1977, 1980) consider a sixth characteristic: the *revenue-maximizing Leviathan*. These various works suggest that tax changes seeking simultaneous modification of all aspects of taxation in a single reform package are not generally politically viable. In practice, specific reform proposals are usually limited to altering one or two of the above characteristics of a tax system. Governor Riley might argue that pursuing even two types of reforms in the same plan is not worthwhile. In any event, most tax reform debates are centered on alterations to the tax structure that will enhance equity, efficiency or, in the Leviathan case, increase tax revenue. As previously discussed, in the political milieu, equity can be an ambiguous or nebulous concept depending upon what is being debated or proposed. However, specific tax reform plans that are designed to improve equity are generally intended to benefit low-income recipients compared with those with above average or higher incomes. This is accomplished by shifting part of the tax burden away from low income earning individuals to higher income recipients or families.

Tax reform plans promoting efficiency can be analyzed in static or dynamic terms. Improving static efficiency involves the excess burden of taxes for a given level of revenue. In contrast, dynamic efficiency focuses on a tax structure that promotes economic growth and enhances the average standard of living across time. Thus, dynamic efficiency involves simultaneously choosing the level and structure of taxes as well as the size of public projects and programs. From this perspective, the most efficient tax system minimizes the adverse effect of taxes while maximizing the net benefits of publicly provided goods and programs. Assuming such goods are normal (as they most certainly are), a broader tax base is likely to be of value to state and local governments. This is the case because such a tax base can lead to enhanced tax revenues, as economic growth creates larger average incomes and raises the standard of living.

4.1 Alternative Reforms of Alabama's Tax System

The above discussion of equity and efficiency, the characteristics of Alabama's current tax structure and a concern over the revenue maximizing leviathan, suggests the study of revenue neutral tax reform, which can be summarized as follows:

- *Revenue neutral reforms* – this type of reform holds aggregate tax revenue constant while altering the distribution of the tax burden.

More simply, this type of reform alters the method by which tax revenue is raised. Revenue neutral reforms can be targeted to improve the tax system in terms of equity, efficiency, or both, while keeping tax receipts unchanged. In fact, altering how tax revenue is generated will almost certainly alter equity,[30] and in all likelihood, efficiency as well.[31]

Given the number of taxes Alabama currently imposes and others not currently used the possibilities for reform almost endless. In an effort to gain insight into how Alabama's current tax system impacts the economy and residents of the state, two reform alternatives will be examined and the efficiency and equity impacts will be discussed. Furthermore, any potential impact on revenue adequacy will be discussed. Specifically, we will examine two revenue neutral tax reform alternatives. Selected reform alternatives are presented in **Table 3.1**.

Efficiency effects of alternative reforms are analyzed using a state computable general equilibrium model that permits an assessment of both the immediate and long run effects of the reform. The Alabama specific regional model was calibrated by Regional Econometric Models Inc. (REMI).[32] The specific changes for a given reform are entered into the REMI model and the model forecasts changes to employment, production, gross state product and several other variables. To assess the equity effects of the tax reforms we use ITEP Distribution Tables and equity measures discussed in the previous section, and apply procedures analogous to those used by Formby, Smith and Thistle (1992) to determine the effects of the reforms on the distribution of tax burdens and after-tax income distributions.

4.2 Tax Reform Results

Table 3.1 details two potential revenue neutral tax reform plans. The first reform considered, RN-1, replaces the state sales tax on all goods with an increase in the Alabama personal income

Sidebar: Tax Reform in Alabama

Pleas for tax reform in Alabama began even before implementation of the current revenue system in the 1930s. Prior to the continuing system that we know today Alabama utilized a biannual revenue bill which levied taxes and other fees on an ad hoc basis. In fact, an article from *The Birmingham News* (March 31, 2008) indicates that the state's leaders have been ignoring calls for tax reform since early in the previous century. In 1918, concerns over funding levels for public health programs, the prison system, and social welfare in general along with a reform-minded governor, Charles Henderson, resulted in a study of Alabama by the Russell Sage Foundation. The final report recommended tax reform, though the recommendations were largely ignored.

Even during development of the current system in the 1930's, the Brookings Institute made recommendations regarding state and local government efficiency and the tax system. Again legislators charged ahead, paying no heed to the tax structure suggestions from Brookings. Since development of the current tax system, numerous Constitutional amendments have revised rates, exemptions, etc. Appeals for tax reform have remained prevalent, with most reform discussion surrounding the issue of equity. Other major tax reform studies include the Legislature's Interim Committee on Revenue in 1947 and the Blue-Ribbon Tax Commission in 1990. Although the Legislature deliberated over the results from the 1990 Commission, no action was taken as a result of either the 1947 or 1990 reform endeavors.

Calls for a more progressive tax structure continued in 2000 with a study from Arise Citizens' Policy Project – a state-based group devoted to improving lives of the state's poor. More recently, Hamill (2002) published a tax reform article regarding tax policy and Judeo-Christian ethics. In 2003, following the recession of 2000 – 2001, Governor Riley proposed a tax reform and spending accountability package intended to improve the fairness of the tax system, and boost revenue by $1 billion. Both aspects of the bill became topics of impassioned debate across the state. Alabama legislators agreed after deliberation to put the plan to a statewide vote. In September 2003, Alabama voters overwhelmingly rejected the tax restructuring plan. Given the discussion of excess burden outlined in this chapter, it is likely beneficial for the economy that this plan was rejected. In fact, at the time economic projections of the reform in Alabama revealed large reductions in economic activity.

Alabama passed a more modest equity based reform proposal in 2006, after budgets improved in an expansionary phase of the business cycle. This reform plan, as discussed in Section 3.1, reduced income tax rates on low income families, thus providing a modest reduction in regressivity. Today, with the 2006 reform as a recent success, Alabama has numerous options for future tax reform.

tax. The second reform, RN-2, replaces the sales tax with an increase in the property tax to recapture the revenue. These two alternatives allow an assessment of the efficiency and equity effects of Alabama's three major taxes. Efficiency results are presented in **Table 3.2** and **Table 3.3. Table 3.2** details projected changes in variables while **Table 3.3** reflects percent changes in the variables. Equity results are presented in **Table 3.4**.

Utilizing historical tax data, reform RN-1 necessitates increasing Alabama's state personal income tax rate to 8.19%. From an efficiency standpoint, the REMI model displays positive effects as measured by each key economic variable. Employment expands by a total of 127,500 (5.01%) and GRP increases by $7.63 billion (3.86%). Real disposable personal income rises by $11.55 billion (6.02%). On a per capita basis, real disposable personal income increases by $2,150 (5.39%). Furthermore, such a change in taxes is expected to result in approximately 50,000 people moving into the state which is an increase of slightly more than one percent.

All of these results are forecasted to occur during the initial year of implementation. From an efficiency perspective, these results indicate that Alabama's current tax system is less than optimal and shifting away from sales taxes and generating the revenue from increased income tax rates reduces the excess burden of the current tax system. Continued economic expansion in Alabama over the time horizon of the model demonstrates further effects of a reduced excess burden.[33] Although designed to be revenue neutral, the increase in economic activity under RN-1 will generate additional tax revenue. For example, the increase of $11.55 billion in real disposable personal income suggests that economic growth induced by the reform would generate an additional $0.946 billion in income tax revenue at the new income tax rate. An increase of this amount would represent an increase in total tax collections of 10.19%. This additional revenue, in accordance with the balanced budget mandate, would then be used to supplement funding for current state services.

Economic gains of this nature imply that Henry George's theory is correct. In this case, the sales tax "destroys" a significant amount of wealth as signaled by the large economic gains associated with RN-1. Such an outcome associated with an increase in the income tax may come as a surprise some tax policy analysts who advocate lowering and/or abolishing state income taxes to spur economic growth. Typical reasons for the argument include: state income taxes stunt economic growth; higher state income tax rates drive people (especially the more affluent) to migrate to states with lower income tax rates; and higher state income tax rats encourage businesses to incorporate in or move to states with lower state income tax rates.[34] While Stewart (2013) and Tannenwald et. al. (2011) argue against the migration effect argument, McBride (2012) summarizes twenty-six articles on this issue and twenty-three of these studies indicate a negative relationship between the income tax rate and economic growth.

Results for tax reform in Alabama, presented here, are seemingly incongruous with the negative relationship between income tax rates and economic growth. Gale and Samwick (2014) present different results when studying long-term economic growth as related to a decrease in the income tax. They conclude that decreasing the income tax rate may have "small to negative" effects on overall long-term economic growth and the structure of the tax reform is imperative to the end results. This seems to be the case in our tax reform plans for Alabama. According to the REMI model, any negative side effects associated with increasing the income tax rate are more than offset by the complete removal of the sales tax[35]. Even if income taxes are more disruptive to efficiency than sales taxes, this result would still possible when we compare the relative changes in the tax rates. RN-1 requires a 63.8% increase in the current income tax rate while the sales tax rate decreases by 100%.

Table 3.4 reflects the equity impacts of reform RN-1. The table reveals that this reform reduces total tax system regressivity. Specifically, Alabama's tax system regressivity is reduced by an average of 61.9%[36] when RN-1 is applied. The tax system is still not progressive; however such a large reduction in regressivity drastically changes regressivity rankings with Alabama now ranking in the top ten least regressive states in the nation. **Table 3.1** reveals that Alabama would now rank 44th or 45th in terms of total tax system regressivity. Decomposing the total regressivity reveals that personal income tax regressivity increases by 208.3% while sales tax regressivity drops to zero (a decrease of 100%). However, even with the increase in personal income tax regressivity, sales taxes in the current system are much more regressive than personal income taxes; thereby the elimination of sales tax regressivity more than outweighs the increase in income tax regressivity.

Examination of **Tables 3.2, 3.3** and **3.4** reveals that simulation RN-2 also shows positive gains in efficiency and equity. RN-2 replaces the sales tax by increasing the property tax. Revenue neutrality requires that the property tax be increased by 108.38%. Forecasted gains for this simulation exceed those discussed with RN-1. Total employment increases by 132,000 (5.19%) while GRP and real disposable personal income expand

Table 3.1: Revenue Neutral Reforms for Alabama's Current Tax System

1. Replace the sales tax on all goods with an increase in the Alabama income tax. (RN-1)
2. Replace the sales tax on all goods with an increase in the Alabama property tax. (RN-2)

Table 3.2: Efficiency Results of Tax Reform

Simulation ID	Total Emp (Thous)	GSP (Billion $)	Disp Pers Inc (Billion $)	Disp Pers Inc Per Cap (Thous $)	Population (Thous)
RN-1	127.5	7.63	11.55	2.15	49.88
RN-2	132	7.92	11.99	2.24	51.7

Table 3.3: Efficiency Results of Tax Reform - Percent Change

Simulation ID	Total Emp (Thous)	GSP (Billion $)	Disp Pers Inc (Billion $)	Disp Pers Inc Per Cap (Thous $)	Population (Thous)
RN-1	5.01%	3.86%	6.02%	5.39%	1.03%
RN-2	5.19%	4.01%	6.25%	5.61%	1.07%

by $7.92 billion (4.01%) and $11.99 billion (6.25%) respectively. Real disposable personal income per capita rises by $2,240 (5.61%) and population increases by 51,700 (1.07%). Based on the REMI estimations, it seems that property taxes result in less excess burden than do sales or income taxes and this simulation again predicts economic growth over the model's time horizon. Economic growth will again result in increased tax revenue from personal income taxes. Gains in personal income tax collections are smaller for this simulation due to the income tax remaining at 5%. Thus, income taxes are projected to increase by approximately $0.599 billion (6.45%).

Equity outcomes are also larger for this simulation than RN-1. Again, Alabama's tax system continues to be regressive; however, RN-2 removes approximately 70% of the current tax system's regressivity. Alabama would then rank in the top five least regressive in each index, with a ranking of 47th or 48th depending on which index is used. Decomposition of tax system regressivity reveals, as in the previous simulation, sales tax regressivity drops to zero and property tax regressivity increases by 320%. Comparing RN-1 and RN-2, we note that total regressivity decreases by a larger amount under RN-2 even though property tax regressivity is increases by a larger amount in RN-2 than income tax regressivity increased in RN-1. This is because income tax regressivity is 240% larger than property tax regressivity as measured under the current tax law.

5. Conclusion

This chapter analyzes the origins of Alabama's current tax system and the tax system's impacts on residents and the economy of the state. We have determined that much of Alabama's current tax structure was developed within the *Constitution of Alabama* of 1901 and many of the state's taxes are meticulously governed by constitutional constraints. Furthermore, Alabama's current tax system is one of the ten most regressive tax systems in the United States, which places a heavy burden on low income residents in the state. Testing the efficiency of the current tax system using the REMI model also indicates that Alabama's current mix of tax base and tax rates is not the optimal tax system. In other words, it is possible to alter the method in which Alabama raises revenue and the current tax rates and generate economic growth benefiting all Alabamians.

Given equity and efficiency conditions and the periods of budget crisis experienced by the state since 2000, we examined two tax reform plans to determine how the state could alter the tax system and improve equity and efficiency. Both reform alternatives generate significant changes to equity and efficiency and provide some additional revenue for the state as it faces an ever increasing demand for services. The models used in this analysis suggest that the state economy is very sensitive to changes to the sales tax rate, in which decreasing the sales tax spurs economic growth. Changing the sales tax rate also has a significant impact on equity, moving the state from the top ten

Table 3.4: Equity Effects of Tax Reform

Simulation ID	State Regression Ranking*	% Change State Tax Registration	% Change: Contributions of Tax Sources to Tax induced Rises in Inequality: Sales Taxes	Property Taxes	Income Taxes
Current	9/7	--	--	--	--
RN-1	44/45	-61.90%	-100%	0%	208.30%
RN-2	47/48	-69.35%	-100%	320%	0%

** Ranking differs depending on which measure of regressivity is used.*

"most" regressive to the top ten "least" regressive in each of the reform alternatives.

Although each reform plan generates positive gains for state residents, the issue of tax revenue variability must also be considered. The first reform plan relies heavily on the income tax which has been shown to have significant variability in collections between economic expansion and recessions while the sales tax exhibits less variability. Should this reform alternative be adopted, the state would need to engage in substantial tax and spending planning to avoid potentially sizeable budget crises in the future. The second reform alternative presented here relies more heavily on the property taxes, which are less variable than sales taxes. This reform plan would not require the level of planning needed to maintain a balanced budget as in the first reform plan.

The results are clear. Alabama's current tax system is not optimal in terms of equity or efficiency. In addition to the issues discussed in this chapter, there are a number of additional concerns that Alabama should address as part of tax reform. Many of these additional concerns are related to the revenue maximizing Leviathan discussed earlier. Some related questions include what, if anything should be done about earmarking or the constitutionally controlled maximum tax rates. Reducing earmarking would allow legislators more freedom when a budget crisis arises, but also increase the potential for shifting tax revenue toward their own 'pet' projects. Likewise, constitutional restrictions on maximum tax rates prevent the government from taxing more than is allowed by the constitution without approval from the voters.

Still another deliberation stems from our tax reform plans which eliminate the sales tax – in the case that such a plan be undertaken, should a constitutional amendment be added to prohibit future lawmakers from re-establishing the sales tax to collect additional revenue? One's concern over these questions will depend on his demand for services provided by the state versus his view of what the government should or should not do. From the perspective of "freeing the invisible hand," we recommend retaining constitutionally controlled maximum tax rates to mitigate the Leviathan effect. This should be expanded to include a prohibition of state sales taxes if a reform plan similar to those described in this chapter were to be implemented. Lastly, the earmarking issue is somewhat more arduous. A delicate balancing act is preferred here – one that reduces earmarking to allow more flexibility during a state budget crisis; however, not so much that legislators' can create budget crises in addition to those which occur naturally.

Notes

1. Proration is an occurrence that is related to the balanced budget mandate. When state revenues are not enough to cover "planned" budgetary expenditures, the planned spending must be reduced (prorated) so that the required balance is achieved. The process if further complicated when the state constitution limits which parts of the budget can or cannot be prorated. For example, in the event that Alabama's education budget is prorated, legislators are prohibited from prorating teacher salaries.
2. There are numerous options for limiting spending increases by lawmakers during periods of expanding tax revenue. Some examples include: a) taxpayer refunds as done by then Governor Reagan in California, b) excess revenues could be deposited into a rainy day fund – a possibility that Alabama already employs for education, or c) spent on short term projects that do not require sustained spending.
3. This is as noted by the National Conference of State Legislatures (NCSL). Specifically, a 2008 report from the NCSL found that Alabama earmarked 84% of each tax dollar collected during 2007. The next highest earmarking state is Michigan with 63% while the average for forty-nine reporting states is only 24%. It should be noted that New Jersey did not participate in the survey.
4. Statistics on education funding can be found at nces.ed.gov/quicktables/
5. Earmarking for sales and other taxes is reported in *A Legislator's Guide to Alabama Taxes*.
6. This is the number of state taxes that generated revenue in 2012, as reported by the Alabama Department of Revenue 2012 Annual Report (2013).
7. Recall that Alabama remains responsible for the majority of education expenditures at approximately 60%.
8. Examples of minor taxes include Deed Recorded Tax, Motor Carrier Mileage Tax, and cigarette, inheritance and financial institution excise taxes, among others.
9. Please note that all historical tax collection data is as reported by the Alabama Department of Revenue for the given year and has not been adjusted for inflation.
10. The maximum tax rate for corporate income was raised to 5% in 1963 and then to 6.5% in 2001.
11. According to the Center on Budget and Policy Priorities (CBPP), and many other sources, the recession from December 2007 through June 2009 has been called the "Great Recession." The CBPP publication, "Chart Book: The Legacy of the Great Recession," notes that this recession was the longest and most severe recession since the Great Depression.
12. Brunori (1998) observes that separate reporting allows businesses operating in multiple states to shift profits from high tax to low tax states. In fact, if properly utilized, this method of tax planning can completely eliminate a corporation's tax liability in a given state.
13. Information from the Alabama Department of Revenue indicates that the average general sales tax rate (excluding farm machinery and automobiles), across all jurisdictions in Alabama, is 8.36%, with 4% going to the state and an average of 4.36% going to local governments.
14. For example, Hamill (2002) points out that the U.S. Forest Service has estimated that approximately seventy-one percent (71%) of Alabama is covered by forest property. This suggests that classifying such property under a business valuation for those agricultural and forest properties that are operated for profit, would certainly increase state property tax revenue. An exact amount of increased collections is impossible to determine as not all of these properties in the state would be reclassified.
15. The gasoline tax is a subset of the overall motor fuels tax which is reported separately from other motor fuels. Other fuels included in the more general motor fuel classification include diesel fuel, tractor fuel, gas oil, kerosene, and jet fuel. The motor fuels tax also includes a tax on motor carriers operating on Alabama highways.
16. Ibid #1.
17. Therefore, taxes levied on the basis of the benefit principle do not suffer from the revenue maximizing Leviathan problem.
18. Therein lies Kaplow's problem, are these two individuals really equal based on the arbirtrary selection of adjusted gross income and medical expense deductions. Kaplow would argue that the answer is assuredly no.
19. See also, Musgrave and Thin (1948), Suits (1977), Kakwani (1977), Reynolds and Smolensky (1977), Blarkorby and Dolandson (1984), Kiefer (1985) Bishop, Formby and Zheng (1998), and Lambert (2001) among many others.
20. Pigou (1929) was the first to formalize the concept of tax progressivity (regressivity) and suggested two possible methods of measurement.
21. As found in the 2003 ITEP publication, Who Pays? *A Distributional Analysis of the Tax Systems in All 50 States*.
22. Specifically, Formby *et. al* (2013) employ the Reynolds-Smolensky index (1977) and the Kakwani index (1977). See their paper or Lambert (2001) for the exact explanation and derivation of each index along with similarities between the measures.
23. The rankings will differ because tax rates differ across states and tax rates are treated differently by each index.
24. Malone (2006) reports that property taxes are slightly progressive in Hawaii and North Dakota. Property taxes in all other states are regressive.
25. Illinois, Indiana, Michigan and Pennsylvania also have regressive income taxes.
26. See "Why Taxes Matter" from the Tax Foundation, 2008.

27. Here we utilize the Retail Trade sector for simplicity. It is assumed that most taxable sales can be classified in this manner. In fact, examination of retail trade sales from the Census Bureau indicates that approximately 88% of taxable sales would be classified as retail trade.
28. This assumption is commonly assumed in economics discussion of income taxes following the theory of the Laffer Curve. For an example, see http://www.laffercenter.com/the-laffer-center-2/the-laffer-curve/.
29. Research contained in Joel Slemrod (1994) provides evidence detailing recent increases in federal, state and local tax regressivity.
30. For a discussion of distributionally neutral taxes, see Formby, Medema and Smith (1995). Formby et al. show that neutrality in terms of shares of the overall tax burden will not be neutral in terms of the relative distribution of income. Conversely, neutrality in terms of shares of the after-tax distribution of income will not be neutral in terms of shares of the overall tax burden.
31. Equity and efficiency are characterized by economists as opposite sides of the same coin and improving equity is typically thought to come at the expense of efficiency and vice versa. Therefore, it is important to study both aspects of tax reform to get a clearer picture of the full impact of the tax reform. However, study of both is also important to determine if both can be improved at the same time to ascertain if, as summarized from the George quote – the current mix of taxes overburdens our economic "horse."
32. The REMI model is essentially a circular flow model from basic models that is constructed using two fundamental underpinnings; households maximize welfare and firms maximize profits. See Treyz (1997) and Treyz et al. (1992) for a description of the history and development of the REMI model. These works also detail the major components and equations used in the forecasting process.
33. The REMI model will forecast results over a thirty year time horizon. Each simulation results in continued economic growth in the years following the implementation of the tax reform. Such additional growth is outside the scope of this chapter and has been omitted from the current discussion.
34. See Reed (2008), Bania et. Al (2007) and Tomljanovich (2004) for examples.
35. These results do not necessarily come as a surprise – recall from the characteristics of Alabama's tax system that sales taxes are above the national average and income taxes are below. It should also be noted that economic forecasting using the REMI model concur with research concluding that income taxes being detrimental to economic growth. REMI forecasts of Governor Riley's Tax and Accountability plan in 2004 signaled significant negative economic side effects associated with the plan. The forecasts even predicted significant out migration from the state - opposite of results from Stewart (2013) and Tannenwald et. al. (2011).
36. Recall from section 3.1 that there are two major methods of measuring regressivity and each treat tax rates differently. The different treatment of tax rates yields varying reductions in regressivity when tax rates change. Here, for simplicity, we average the reductions from each major index and present a single number.

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4

Reinventing the Alabama K-12 School System to Engage More Children in Productive Learning

John Merrifield and
Jesse Ortiz

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Summary Points

- Alabama's public schools continue to poorly educate our children. The cost of the public schools burdens the state economy, while their poor performance threatens the quality workforce needed for growth and leaves thousands of Alabamians ill-equipped to lead happy and productive lives.
- A failure to engage students in their learning is the proximate cause of poor learning performance and contributes to Alabama's scandalously high dropout rate.
- Public school proponents offer an unending series of reforms focused on smaller class sizes. Larger schools, more spending, and increased control by lawmakers and educational bureaucrats. This failed game plan will never remedy the fundamental problems of Alabama's schools.
- Alabama needs a system offering students and parents a diverse range of genuine educational options based on learning styles and subject matter, in short, competition in education.

The Alabama K-12 public school system, like elsewhere in the United States, is chronically low performing. Our nation's best public school systems are still pretty bad because all fifty of the U.S. school systems implicitly make numerous heroic assumptions, such as one size fits all, incentives don't matter, and schooling is the one sector that can perform at high levels with price control. The key chronic low performance symptoms include higher than necessary K-12 costs, low student achievement levels, and a work-force that is ill prepared for 21st century jobs. Predominant recent approaches to school system improvement – higher standards, teacher micro-management, more stringent teacher qualification requirements, promises to improve political-administrative accountability based on test scores, and large per-pupil spending hikes - have been costly, but have done little to improve Alabama's student attainment levels. Despite decades of national and state education reform frenzy, the Alabama K-12 school system still contains multiple systematic flaws that undermine student engagement and doom efforts to significantly improve student achievement levels. An utterly deplorable fact is that the roots[1] of the low performance problem described in stark terms by the 1983 non-partisan National Commission on Excellence in Education's Nation at Risk report[2] have survived three decades of frenzied activity, nationwide. That is, additional authoritative groups, including the 1994 U.S. congress (Democrat majority in both chambers at the time) and another national commission have periodically re-affirmed, to this day,[3] the 1983 commission's sense of immense risk and great urgency:

> *"The educational foundations of our society are presently being eroded by a rising tide of mediocrity that threatens our very future as a nation and a people. If an unfriendly foreign power had attempted to impose on America the mediocre educational performance that exists today, we might well have viewed it as an act of war."*

Because of the persistence of the low-performing system (a very inefficient schooling strategy), far too many Alabama K-12 students remain confused, overwhelmed, or bored, which has produced underachievement, high dropout rates, and a workforce that lacks the fundamental skills to compete with other leading states. The result is that Alabama, along with every other state, has failed to receive an adequate return on its huge investment (ROI) in a K-12 system. The inefficiency and the chronic low performance of Alabama's system of traditional public schools (TPS) is not limited to low income, urban school districts. Certainly, the problems are at their worst in urban schools attended by the poor. But the basic problems of dismal performance and falling productivity[4] are system-wide problems with scattered exceptions widely described as someone(s) succeeding against incredible odds.[5] The agents of those isolated success stories typically cannot sustain, much less replicate, the basis for their shining examples of high performing schools, and even occasionally, entire school districts.

Alabama needs a relentlessly improving menu of schooling options, public and private, as diverse as Alabama's schoolchildren. Since the individual schools on such a menu will be specialized, not comprehensive, no school can serve all children. Parents will compare schools of choice to find the best match for each of their children. Naturally, transportation challenges may prevent first best selections for large families of diverse children, and it remains to be seen just how specialized the alternatives to TPS will be. Second best choices may turn out to be much better for many children than the assigned TPS, and perhaps in many cases, not too far below the effectiveness, for many children, than the first best school that was too far away, or had unaffordable additional costs.

The prevailing large comprehensive schools approach to address the challenges created by student diversity (student talents, achievement levels, interests, and learning styles) is an increasingly expensive schooling strategy that has left many children unprepared for employment or citizenship. The needed student-teacher connections—engagement in learning – necessary to address the problems associated with learning issue diversity in the class room, and the within school diversity in how children learn and what subject themes secure engagement in learning, will continue to be unacceptably scarce until it is possible to decide a child's school through expanded school choice from an appropriately diverse menu of instructional approaches. A sufficiently diverse menu of schooling options requires a substantial financial leveling of the playing field – funding equity—between the different actual and potential schooling options, public and private.

There are several available policy options that would create the school choice conditions that would address the problems associated with the diversity of student learning determinants. Those policy options include properly structured universal tuition vouchers, education savings accounts, corporate and individual tuition tax credit options, and legislation allowing the creation of an independent, market-driven (price-decontrolled, profit allowed) charter school system. The restriction-laden U.S. and international examples of school choice expansion only hint at what is possible with universal approaches that provide funding equity between publicly- and privately-provided schooling options. Alabama needs to do more than just copy an existing school choice expansion policy. Even smaller steps than the small, existing private school choice programs such as an open enrollment within the public schools and more magnet schools are options that can be good first steps, and eventually become part of a larger scale, overall school system transformation.

We proceed with a more detailed assessment of Alabama's recent struggles to significantly improve its school system outcomes. We follow that description of the persistent low performance problem with a discussion of recent decades of futility applying politically correct, conventional wisdom to the low performance problem. After we identify what we believe are the unaddressed 'roots of the problem', we describe the essential drivers of a dynamic (relentlessly improving, appropriately diverse menu of policy options capable of adequately addressing those roots.

Plummeting Productivity

School system outcomes including high school completion, college and employment readiness, and scores on national assessments have remained largely stagnant despite large increases in inflation-adjusted K-12 spending since at least 1990. The National Assessment of Education Progress (NAEP) exams are more reliable than state assessment data,[6] though Alabama's assessments are closer to the rigor of the NAEP tests than most states. A Fordham Foundation assessment of the state tests gave Alabama's 2010 mathematics assessment a B+. It 8/10 of Fordham's criteria,[7] and the English language and arts standards received a B. Even with less rigor than the NAEP test, Alabama's state assessments still show 20-30% of its students fail to meet academic standards.

NAEP data shows that while Alabama's 4th grade reading levels are comparable with the national average, the 4th grade math and science levels are below the national average, and 8th grade students performed well below the 'Nation at Risk'[8] [=unacceptably low] national average on mathematics, science and reading (see **Tables 4.1** and **Table 4.2**).

Table 4.1: 2013 and 2000 NAEP Math Assessment Scores

2013 NAEP 8th Grade Math Assessment Scores

State	All Students	White	Black
National Average	284/272	293/283	263/243
Alabama	269/264	280/275	250/240
Louisiana	273/259	285/275	259/239
Mississippi	271/254	285/268	255/237
Massachusetts	301/279	307/284	277/258

While the scores on the NAEP have shown some improvements since 2000, Alabama still ranks among the worst states overall. Far too many students are still scoring "below basic" on the NAEP (**Table 4.2**); a term indicating "non-mastery of fundamental skills."[9] Alabama's 8th grade NAEP math score was 269; 15 below the national average.

Far too many Alabama high school graduates are unprepared for college. **Table 4.3** reports the college-ready share of high school graduates (based on the American College Testing [ACT] exam scores for 2008-2012). Since the ACT is a college entrance exam, those results reflect the skills and knowledge of the majority of Alabama's best students. Roughly 76% of the Alabama's 2013 graduating class took the ACT. **Table 4.3** shows the percent of Alabama's 2013 graduating class that were considered college ready by the ACT.

The results show that while Alabama students score slightly above the national average on the English portion of the exam, they are well behind in the other subjects. **Table 4.4** show Alabama's ACT historical benchmarks. Alabama's 2012 graduating class actually scored worse on the ACT in English and Math than their 2008 predecessors.

Even more worrisome than Alabama's poor performance on the NAEP and ACT exams is its scandalous dropout rate. It is one of the highest in the country. Between 2002 and 2012, roughly 30% of Alabama's high school students failed to graduate in their allotted four years.

Alabama's 2012 Adjusted Cohort Graduation Rates (ACGR) - the percent of students that successfully complete high school in four years with a regular high school diploma - was only 72% (**Table 4.5**). The gap between white and black students, as well as students characterized as limited English proficiency, is especially wide.

Unwise Conventional Wisdom on How to Improve Schools

The large share of Alabama K-12 students that still perform below basic is a key reason why an end to the policy practice of "more-of-the-same-harder (Merrifield, 2001)" or the Hess (2010) version, "the same thing over and over" – recycling policy change with a track record of costly disappointment – is long overdue. Alabama is not getting nearly enough for its massive investment in K-12 schooling. Far too many Alabama adults lack the basic skills[13] they need to realize the high earnings available in the modern economy. Paraphrasing a former Assistant Secretary of Education's assessment of state rankings, the best schools are at the top of the cellar stairs. The Hess' book about the need for systemic transformation notes that the problem persists at the district level: "acclaimed districts are impressive only relative to their peers."[14]

Despite years of reform frenzy – justified by the persistently dismal outcomes of the current K-12 system – the roots of the low performance problem remain largely intact. We create an almost impossible teaching task when we assign children to classrooms, often in huge schools, on the basis of just their age and address; no attempt to sort them (or allow self-sorting via choice) according to subject-specific abilities, or specific thematic factors that can influence student engagement. The single salary schedule for teachers, which bases pay on just general credentials and experience, creates shortages of some types of teachers and stifles innovation and pursuit of excellence. Teachers with no tangible incentive to succeed, or to avoid failure, are supposed to succeed in exceptionally diverse classrooms with politically-correct, 'teacher-proof,' weak and boring textbooks and curricula; one size fits all materials chosen for them. Because of the learning issue diversity thrust upon teachers, many students are not developing even in classrooms of hard-working, competent teachers. That learning issue diversity, and resulting mismatches

Table 4.2: Below Basic Scores

Alabama NAEP Below Basic Scores

Year	Math	Reading	Science
2013	40%	32%	--
2011	40%	33%	47%
2009	42%	34%	49%
2005	47%	37%	---
2000	47%	---	---

Source: National Center for Education Statistics[10]

Table 4.3: ACT Scores

2013 ACT Results: Percent of Students Considered College Ready[11]

Subject	Alabama Average	National Average
English	66	64
Algebra	31	44
Reading	41	44
Biology	30	36
Meeting All Four	20	26

Table 4.4: Percent of Alabama Students Meeting ACT College Readiness Benchmarks

Percent of Alabama Students Meeting ACT Benchmarks

Year	Number of Students Tested	English	Mathematics	Reading	Science	% Students Meeting all 4 Benchmarks
2008	35,590	68%	30%	48%	21%	16%
2009	35,809	67%	29%	47%	21%	16%
2010	36,624	66%	31%	47%	23%	18%
2011	37,800	65%	32%	48%	22%	18%
2012	39,565	65%	33%	48%	23%	18%

Source: ACT

Table 4.5: Graduation Rates

2011-12 Adjusted Cohort Graduation Rates[12]

States	Total	White Students	Black Students	Limited English Proficiency
United States	79%	84%	67%	57%
Alabama	72%	78%	63%	36%
New Mexico	63%	73%	60%	56%
Arkansas	81%	84%	73%	76%
Texas	86%	92%	81%	77%

between lesson content and pace and student interests and abilities lead to parental disappointment and complaint that makes many teachers dread parental interaction.

Parents are largely powerless to achieve desired changes, except incompletely, at best, as political activists. That arduous process forces frustrating and debilitating compromise with other parents trying to solve different problems for their children. The obstacles to engagement undermine the co-production process that is unique to the education industry. Co-production means that the customers (students) must assist in the production of the service or product. In a typical business-customer transaction, customers are largely or entirely passive recipients; for example in the production of a legal document by a lawyer, or a haircut by barber. The desired student intellectual growth occurs only with the active co-operation of the clients, the students.

The importance of engagement to student outcomes is obvious and extensively documented.[15] The motivation to learn, which is a key part of being engaged in school, is a proven key element of the learning process at all age levels.[16] Engaged students learn more quickly, retain information longer, and are less likely to get in trouble or dropout.[17] Yet, numerous studies have found that a large proportion of U.S. K-12 students are not engaged in their coursework[18]; something that has been shown to intensify with age.[19] The failure of past education reform efforts to address the engagement imperative was documented by a 2005 survey,[20] and again, more recently, in 2013, with a national survey of over 600,000 5th through 12th grade students. The extent of student disengagement is frightening (**Table 4.6**). Over 55% of students were considered disengaged, with 17% considered actively disengaged, meaning that they felt negative about their schools and will likely spread that negativity.

Disengagement has a drastic impact on student success. The Gallup poll estimated that a one percentage point increase in a school's average student engagement score is associated with a 6 point increase in reading achievement and an 8 point increase in math achievement. Comparing those figures with math achievement levels increases for Alabama over the past decade, shows that those gains can be considered massive. A key finding of the study is that students who agreed that their schools were committed to building their strengths and had a teacher who made them feel excited about the future were almost 30 times as likely to be engaged learners as their peers who agreed with neither statement.[21] The high rates of disengagement typically don't include the most disengaged children of all, dropouts.[22]

Table 4.6: Student Engagement 5th – 12th Grade – U.S.

Percentage	Level of Engagement
55%	Engaged
28%	Not Engaged
17%	Actively Disengaged

Too much subject interest and learning style diversity in TPS classrooms

While students living within public school attendance zones are often homogeneous in terms of socio-economic status and ethnic makeup, there are large differences in student subject-matter interests[23], learning styles, and career goals.[24] Therefore, it is easy to see how course material may be too difficult, uninteresting, or confusing to some students who have trouble learning via the prevailing pedagogy. Harvard professor Paul Peterson noted that, "the general consensus is that it doesn't work having all these kids [students with vast educational differences] together. For teachers, the challenges can be [unnecessarily] enormous."[25] An especially telling example of politics run-amok is increased "mainstreaming" of special needs children. "The percentage of special needs children who spend more than 80% of their time in a regular classroom jumped from 17% to 35% from 1995 to 2005."[26] And, *"in making the mainstreaming decision, school[s] cannot, at least not officially, consider the well-being of the other students at the school."* [27]

Large disparities in student intellect within individual classrooms force many teachers to lower their standards so that the majority of their students can advance. The result is that many students under-achieve or drop out because of boredom.[28] Such "watering down" practices appear to be especially rampant in inner city schools.[29] Programs for gifted and talented children are increasingly rare, and often exist in name only. The diversity in student interest, knowledge attainment levels, and learning styles within attendance zones create an impossible teaching task; namely, to find a uniform process to address diverse instructional needs. Better teacher training can do little to make teachers better at being everything to everyone. There are no "best practices" for student groups that are highly diverse in terms of learning determinants.

Counter-Productive Structures of the Current Traditional Public School System

TPS are riddled with rules and practices that impede learning. For example, attendance zones mean that schools have to offer something for everyone (uniformly comprehensive) in every zoned school. An analogy of how attendance zones keep schools from providing the instruction that matches each child's needs is that of a restaurant that *must* cater to all of the diverse tastes within its jurisdiction.[30] Such a restaurant would have a poorly executed, huge menu to attempt to serve a cliental with vast differences in tastes. Or, it would lack specialized menu choices, for example cuisine items with narrow country/ethnic appeal, choosing rather to provide food options that the vast majority of their captive clientele will accept. Lack of specialization precludes the preferred meal of most diners. Similarly, the attendance zone of a traditional public school (TPS) precludes addressing the instructional needs of students with widely different interests and learning styles. Teachers simply *cannot* connect with many of their students.[31] The educational mismatches and high level of disengagement found in public schools also causes teachers and school officials to come into conflict with parents and each other.[32] The especially low performance of urban public school systems is evidence that learning style and subject interest diversity is an especially large problem in large urban district schools where the interests, learning styles, and student intellect are especially diverse.

Our typically large, 'comprehensively uniform' TPS (including "shopping mall high schools"[33]) are a failed attempt to address student diversity. They don't achieve the needed grouping by ability, by subject, and mega-schools typically fail to create a sense of community and a distinct purpose and identity needed to engage some students in their academic pursuits.[34] Also, because they lack a coherent mission, "comprehensively uniform"[35] mega-schools are hard to manage,[36] and highly vulnerable to waste[37], corruption[38], and fraud.[39] The ability of the typical U.S. private school to provide a sense of community and purpose has been found to be a major reason why the majority of their students surpass their public school counterparts on state and national examinations each year.[40] And private schools have lower achievement gaps between minority and white students,[41] and have a higher percentage of college-bound students.[42] A 1993 Harvard study found that classroom composition was even more of a determining factor for increased student test scores than the sense of community small schools tend to achieve.[43] The effects of classroom composition are larger after the 5th grade, when students, rather than teachers, set the pace for academic achievement.[44]

Grouping students by age instead of by their ability to perform in each subject area, further compounds the challenges caused by attendance zones. Students have natural tendencies to perform better on certain subjects than others. So, the current process of grouping students by age instead of by their subject-specific abilities is part of the reason for too much subject interest and learning style diversity in TPS classrooms. It's another reason that students at higher achievement levels are prone to lose interest in same-age classrooms,[45] while students at lower achievement levels may feel overwhelmed.[46] Age is not a key determinant of the proper level and pace of instruction.[47] Asserting that a students' current grade level equivalents should be based on their age, is similar to having the shoe or clothing industry assign all students of a certain age the same clothing or shoe size.[48] Yet, TPS provide identical instruction based on students' age. Grouping students *by specific subject* interest and ability instead of by age would greatly enhance student engagement and academic achievement.[49] Grouping children by subject specific ability is very different from the much-maligned 'tracking' of students according to assumed general ability. Tracking assumes that children are uniformly, high-, low-, or average-ability, while the reality is that the vast majority have subject strengths and weaknesses.

Our over-challenged teachers are also insufficiently incentivized

The teaching profession is hindered by the lack of incentives inherent in the TPSS. The inability of teachers to choose an instructional approach that exploits strengths that can be very specific can be boring or stressful, and prevent them from increasing their earnings. Indeed, as noted previously, there are few, if any, tangible rewards for outstanding performance. That persistent factor, alongside the single salary schedule, discourages high achievers from entering the teaching profession in the first place,[50] and causes many of those who enter it anyway, to quickly exit. That is especially true of teachers with skills that are useful outside of teaching; for example the math and science skills that are in chronic short supply in schools.[51] Subject-specific teacher shortages force administrators to use out of field teaching, which feeds teacher burnout and student disengagement. The terms 'uniform' and 'single' arise from basing salaries only on experience and educational attainment levels; something known to push out higher ability teachers.[52] And, neither a teacher's years of experience, nor their level of education, have been found to be strong indicators of student performance.[53]

Uniform pay schedules also create equity, and talent distribution problems.[54] For example, more experienced teachers are more common in suburban school districts, where base salary rates are higher, and job stress is lower. Meanwhile, inner city schools with a more urgent need for the best available teachers have traditionally had higher than average teacher turnover rates.[55]

The accountability crisis

Accountability can come from two main sources: accountability to government officials (top-down accountability), and bottom-up accountability to clients.[56] TPS suffer from total reliance on inherently weak and poorly informed top-down accountability to public officials. The bottom-up accountability that is inherent in the private sector requires empowerment of parents and students to choose schools that best match their goals, subject matter interests, or specific pedagogical styles that help those students learn best. Top-down accountability focuses attention on the specifics of the official accountability measures like state assessments. That has produced 'teaching to the tests,' a teaching practice that has greatly narrowed curricula to tested items and to lessons aimed at standardized test preparation.[57] For example, there is greater emphasis on math and reading test questions, and much less coverage of untested subjects like history and social studies.[58] Teaching to tests and dumping large chunks of the curriculum is not conducive to engaging children in well-rounded, productive learning. And because of the disengagement factors we've discussed, the extra time on tested subjects has produced only modest measurable gains, while creating even greater dissonance in the neglected critical areas at the core of the justification for public schooling; for example, social cohesion through an understanding and commitment to American values and governance traditions.

More intense testing to increase top-down accountability has not improved the U.S. K-12 system. The Clinton Administration's Goals 2000 Education Act of 1994, and the Bush Administration's No Child Left Behind (NCLB) Act of 2001, aimed to address the *Nation at Risk*[59] alarms with much improved top-down accountability through a mass focus on standardized testing. NCLB, reinforced by new state laws, implores schools to meet certain standards (i.e. have a certain percentage of students achieve proficient or above on state assessments). Yet, educators typically face few, if any, major repercussions when they fail to meet their objectives. That is something that is evident from the many low performing Alabama TPS schools that remain open year after year.[60] The Alabama Association of School Boards lists on its website 72 TPS schools that have been in the lowest 6% of schools for three out of the past six years.[61]

Since bottom-up accountability to families is inherently comprehensive, though subjective (informed by accessible data and personal observation), it can transform the current, largely stagnant and resistant-to-change K-12 system into one that creates student-teacher-content connections infused with relentless improvement. Without the informed and motivated scrutiny of parents, there is little fiscal motivation to remove ineffective educators, improve services, or reduce costs. Government oversight (top-down accountability) that monitors performance, including threats of processes that could eventually end with personnel actions and/or a school's closure, has failed to produce the type of continuous improvement necessary to turn around low-performing school systems and schools that work for no one.[62] Families moving money by voting with their feet is what bottom-up accountability means. That's the fundamental basis of a school choice system. That meaningfully pressures schools to continuously improve without the more difficult and less effective alternative of political or administrative actions that typically must [awkwardly] apply to everyone.[63]

Teacher micro-management and de-professionalization / teacher-proof curricula.

Growing frustration with low performance and difficulty creating appropriate incentives has led to teacher bashing, and lacking appropriate incentives, a perverse determination to force teachers to be more successful. In school districts across the country, regulations and oversight by state and local officials drastically limit the autonomy teachers have in preparing their own lessons. In many states, teachers must follow a timetable and strict guidelines and for what, when, and in some cases how they should teach. Such drastic measures allow for little discretion to adapt unique teaching abilities to their particular mix of students. That, and demoralization of teachers, inevitably stifles engagement and innovation in the classroom. Teachers often can do little more than follow a structured outline of what they must teach, and then they are scolded when their students fail to succeed at high rates.

Teacher resistance to micro-management and discomfort with imposed practices—specifying *how* they should do their jobs—further undermines teacher commitment to engage their students in learning. The insulting and demoralizing micro-management process also contributes to teacher burnout.[64] The inability to control the design and delivery of content underutilizes the unique strengths of each school's staff.

Lack of school autonomy

Public school principals typically lack key management powers.[65] They usually control only a small part of their school's overall budget. Principals frequently lack the authority to make personnel decisions, and typically lack the ability to financially reward top performing teachers.[66] A 2001 Public Agenda survey of 853 public school superintendents and 909 public school principals found that 92% of superintendents and 89% of principals said that it would either be somewhat helpful or be very helpful to provide them with much more autonomy in running their schools and then hold them accountable for results.[67] A large majority (69%) of superintendents said school boards interfere with their jobs, and 81% said bureaucracy and politics are the main reasons superintendents leave their jobs. Furthermore, 71% and 67% of superintendents and principals, respectively, wanted more authority to remove ineffective teachers, and 76% and 67%, respectively, wanted the ability to reward outstanding teachers. The fact that top-down accountability has continued to increase since that survey is further evidence of the dire need to address the inherent weaknesses of political micro-management with a large increase in students' school choice options.

Past Reform Attempts Didn't Address the Issues Described Above

The education establishment throughout the U.S. has been in reform mode for at least a century.[68] It became frenzied, but still ineffective, with the 1957 Sputnik 'scare' and even more so after the release of the seminal first Nation at Risk report (1983).[69] But the predominant reform efforts, including increased funding, smaller classes, plus at least symbolically increased top-down accountability with higher standards left the system's key barriers to engagement intact.[70] Some reform efforts made them worse. We know that the mega-school approach that provides customization and specialized instruction within giant, "shopping mall" schools is a failed strategy that fosters fraud and creates school management problems that go beyond the persistent inability to fully engage the majority in high value learning.

More Money Syndrome

State governments across the country have long held low spending levels as the culprit to the low student achievement levels on standardized tests and large gaps between various social economic groups. Yet, almost every state in the U.S. spends more money per student than every country in the world.[71] Alabama's 2012 average K-12 expenditure per-pupil was $8,562, which ranked 40th in the U.S. in 2013[72] (**Table 4.7**). Alabama's low spending compared to other U.S. states will lead some to suggest that increased expenditures per-pupil is the answer to increase student achievement levels. Yet, that conclusion doesn't match up with the higher output per dollar that states such as Texas and Florida have been able to achieve (based on national assessment scores, dropout rates, etc), not to mention other OECD countries. Alabama actually spent at similar or slightly higher per-pupil levels than Germany, France, Korea, and Finland; countries far outperformed the U.S. as a whole on prominent international tests like PISA[73] (**Table 4.8**). Overall, the U.S. ranked 39th out of the 62 countries on the PISA in 2012, and Alabama was low-performing compared to other U.S. states.

A particularly shocking case that demonstrated the system's typically ineffective use of additional resources arose from a 1985 Kansas City, Missouri desegregation-driven reform effort. A 1985 court decision ordered the Missouri Legislature to spend over two billion dollars to improve facilities and desegregate the Kansas City School District. Per-pupil spending quickly rose to roughly twice the national average. The ensuing spending spree lowered the student-teacher ratios below 13:1 - the lowest in any major school district at the time. By the end of the twelve-year spending spree, student test scores had not risen, achievement gaps between minorities and whites had not fallen, and integration had failed to occur.[75] Families continued to flee the low-performing Kansas City schools despite their lavish budgets and impressive facilities. Under-motivated, out-of-field, and burned out teachers were still commonplace at the end of the twelve year period following the passage of the desegregation mandate. Educators still lacked the autonomy to best decide how to do their jobs, and lack proper direct accountability to students and parents. The additional money did not eliminate any of the debilitating practices described above.

Smaller Class Sizes

Despite its poor track record[76] and high cost, class size reduction has been a key funding priority for many states including Alabama. The average U.S. class size fell steadily from 22.6 in the 1970s to 16.2 in 2002.[77] That coincided with a sharp drop in academic performance throughout the country. Would anyone dare speculate that class size reduction prevented an even larger drop in performance? We would regard such speculation as credible. Also, at the same time, school size rose with the pressure to produce comprehensive (include everything) schools, even though public schools were widely known to be mostly too big.[78]

No doubt, for some children studying certain subjects, a class size reduction would be worth the cost, but an untargeted, across-the-board reduction in class size is worse than foolish. On a level playing field of diverse schooling options, school entrepreneurs would continually experiment with class size to determine the specific circumstance in which smaller classes yield enough improvement in educational experiences and outcomes to justify the cost.

Higher Standards and Increased Top-Down Accountability

In addition to spending more money, in part for class size reductions, increased top-down accountability was widely seen as an essential reform.[79] Before we make our recommendations for moving forward, we want to deal directly with the fundamental pros and cons of the latest round (NCLB + Obama-Duncan) of frenzied federal response to the previous round of reform failure. Note, first, that the increased attention to school policy at the federal and state levels implicitly presumes that political arenas in which individuals have less voice can do what the smaller, local political arenas could not. "It is not clear how the problems of the local political arena can be solved by moving authority and control up to an even larger political arena." [80]

The current Federal Race to the Top policy yielded some school system improvements, but most federal and state efforts, including NCLB, have amounted to a more-of-the-same-harder version of the failed 'Goals 2000' Act (a 1994 law whose preambles amount to 'Nation at Risk' III).[81] We welcome NCLB's public school choice provisions, and the NCLB-generated data. It brings attention to the system's failure to move forward much since the 1983 *Nation at Risk* declaration. We deplore the NCLB premise that our low-performing system's key deficiencies are unclear definitions of success, unqualified educators, and insufficient pressure[82] to excel. There is no evidence that higher standards lead to improved performance.[83]

Solution: A Diverse, Dynamic Menu of Schooling Options

We need to address student diversity through specialized schools of choice, not through "internal choice"[84] within mega-

Table: 4.7: K-12 Expenditures by State

2012 K-12 Expenditures Per-Pupil By State

State	Total Spending
National Average	$10,608
New York	$19,552
Georgia	$9,247
Alabama	$8,562
Florida	$8,372
Texas	$8,261
Utah	$6,206

Source: U.S. Census Bureau

Table 4.8: 2012 OECD PISA Scores

2012 OECD PISA Scores By Country

Country	Mathematics	Reading	Science
China	613	570	580
Korea	554	536	538
Germany	514	508	524
France	495	505	499
USA	481	498	497

Source: OECD PISA [74]

schools. Widespread access to a menu of schooling options as diverse as the engagement factors and learning styles of our children will address and probably largely eliminate the disengagement problems of the current system. Though large urban areas appear most in need of specialization, and best able to support it, recent, major improvements in technology[85] can provide many benefits of specialization even to rural Alabama.

Increased Engagement through Better Matching of Students and Educators

Another benefit of increased school choice arises from "peer effects."[86] Choice among diverse schooling options will mean that school peers have similar subject interests or learning styles, a characteristic that has shown to improve learning rates and material retention.[87] Experience with magnet schools (specialized, district-run public schools)—a school integration strategy based the lure specialized curricula—hints at the potential gains from systems with specialized schools of choice available to everyone, rather than a hard-to-secure exception sometimes available through magnet schools or chartered public schools.[88]

Schools with a focused mission attract the educators with specific talent and passion for that school's instructional approaches. The proper matching process between educator talent and passion and student interest and aptitude that we describe below can also lessen the friction between parents and teachers; something found to be a major cause of costly teacher burnout.[89]

Fiscal Benefits

Specialization by schools, rather than costly specialization within large schools, will mean more manageable schools and less corruption.[90] Competition will drive efficiency gains, while specialization can also save money by eliminating duplication of services. For example, the matching of specialized instructional approaches to the students that will benefit the most from them eliminates the need to maintain similar non-core subjects at several schools.

Smaller Schools

Studies show that there are many benefits to smaller schools.[91] As specialization takes place, schools focusing on different pedagogical approaches and specific themes such as sports,[92] law, health, or engineering are likely to emerge. Students that do not currently fit in the current public school system can find a niche school that works with their natural talents and abilities, rather than against their weaknesses.

Smaller schools enhance the community feel of schools by enabling teachers, school administrators, and parents to play a greater, more personal role in the education of their students.[93] Smaller schools would mean a rise in the number of schools, which would offset some of the transportation cost implications of matching children interest/ability to school mission.[94] The net transportation cost effects of school specialization and residential choice are unknown. Certainly, transportation challenges could deter some large families from enrolling each child in their best existing school choice, though second and third best *choices* will still be, by definition, preferred to the assigned public school.

Appropriate Specialization Requires Choice and Market-Set Prices

Basic Rationale

Attendance zones – assigning children to schools through home address – mandates unspecialized neighborhood schools ("comprehensive uniformity"[95]).[96] Because exclusivity over a zone forces each TPS to at least appear to consider every major instructional preference the zone might contain, an attendance zone precludes noteworthy specialization. You can't assign children to specialized schools because that would aggravate existing disengagement problems, while likely creating a political outcry that would quickly end the policy. So, implementation and exploitation of the needed diverse menu of schooling options requires school choice. And meaningful universal choice requires funding equity which we define to mean much-reduced financial discrimination against those opting out of the assigned school. That means that the subsidy available to a particular child cannot depend upon whether their teachers are school district employees. Achievement of the best possible mix of schooling options, and the need for incentives for relentless improvement, also require low formal barriers to new schooling approaches. Accountability exists through closure of schools that lose funding when they fail to be 'choiceworthy' to enough families. That would eventually include every change-resistant TPS. The appropriate choice policies (do not favor TPS) – that focus on maximizing the academic development of children, regardless of how they advance - could yield gradual privatization of K-12 schooling.[97]

An example will help convey how specialization would improve engagement, and why specialized schooling options cannot have attendance zones. New Zealand, which has public school choice, has a school that teaches math and basic statistics through computation of sports statistics like batting averages and field goal percentages. That school teaches English through sports stories and by having children write imaginary sports articles. That approach generates excitement and engagement among children that are sports nuts. Since it has the opposite effect on children that are not sports nuts, such schooling options cannot have attendance zones. All such specialized theme or specialized pedagogy schools must compete to be chosen.

It will take market-determined price and profit change to get schooling entrepreneurs to create and sustain a menu of schooling options that appropriately addresses the diversity of the student population. So, for example, suppose a sports themed school receives more applications than it has space. With a constraint that schooling be 'free' (zero tuition; government funds cover 100% of the cost), the popularity of the school will yield a shortage (wait list). And there is little or no monetary incentive to eliminate the shortage by shifting resources from other types of schooling. But if schools have permission to seek a tuition levy on top of whatever public funds arrive with each student, the school can react to its popularity by raising its tuition rate to the level necessary to balance the number of applicants against the number of openings. Such tuition add-ons would provide the wherewithal to expand the school, or build another, and establish the price level needed to balance supply and demand.[98] The tuition hike—a needed signal of true cost—will also appropriately discourage the families with the lowest degree of preference for the sports theme over other available schooling options. *Initially*, the tuition increase also discourages families with the least ability to pay the tuition. But in due time, the expansion of supply—increased competition—will drive tuition rates down to the level actually required to deliver that instructional approach. A lower level still above zero means schools are not willing to provide enough of the sports theme instructional approach for just the government funds supporting each child. Means tested scholarships will be available to low income families that can make the case that specialized options with a tuition levy—like a sports-themed school—will greatly assist their child's academic development. Education historian Diane Ravitch's examples of haphazard "boutique" school creation illustrate the importance of price signals to the school design/formation process.[99]

The existing ban on charging tuition on top of government funding prevents deployment of innovative instructional approaches that initially cost more than the per-pupil subsidy level, which is especially sad since the tuition levy may be wholly or partially temporary, but absolutely necessary to get the innovation into production; that is, for it to ever exist. Once in existence, competition and experience can quickly bring the cost down to where the government subsidy covers the full cost, or nearly so. That was the effect of the Chile's voucher program and the Florida McKay Special Needs voucher program. In both places, permission to add-on came after the voucher program was in operation. Permission to add-on greatly raised school and student participation in the programs. After some market adjustment, most private schools charged tuition, but nearly all of the tuition levies are very modest. A ban on tuition add-ons creates standard, horrific price control problems: shortages, waste, stifled innovation, and declining product quality,[100] which exactly describes our nation's school systems. All of the prominent federal (NCLB, Goals 2000, etc.) and state-level school system reform proposals implicitly assumed that price control is okay for the education industry; that somehow, forty centuries worth of awful price control outcomes[101] do not apply to the production of schooling.

Since we are not legal scholars, we cannot assure that allowing TPS or chartered public schools to charge tuition will survive a constitutional challenge. A typical state constitution requirement that the state provide free schooling does not necessarily preclude the provision of alternatives that, in some instances cost more than what the state's taxpayers are willing to provide for everyone. Certainly, it seems that it will be appropriate, and likely legally necessary, to *have some free options available to everyone, but not necessarily just free options*. Low income families have been found to be willing and able to supplement subsidies with private funds when it yields schooling that will work much better for their child.[102]

The equity argument against price decontrol (argument for 'free' only) offers further proof of the dangers of unchallenged assumptions. Certainly, allowing tuition levies can severely impact low income families. But third parties can address those affordability/access issues on a case-by-case, academic talent (scholarship) or financial need basis. Mandating free-only schooling options does not generally benefit lower income families since this merely eliminates schooling options that are not feasible for just the per pupil government funding. And mandating free-only, subsidized schooling short-circuits the product development process that transforms initially costly services into widely affordable options.

Real School Choice Facilitates Broader Bottom-up Accountability

Current laws promise to hold schools accountable for low test scores,[103] but the actual consequences for low performance have been minimal.[104] And the promised top-down accountability for low scores is not nearly enough. We need incentives for large, broad-based, continuous improvement in student performance. The current system of top-down accountability produces stifling controls over teachers, endless standardized tests, and a curriculum narrowed to the test items and test-taking skills. Schools have no tangible incentive to pursue additional improvements after meeting their narrowly assigned objectives. So, schools deemed successful often become complacent and end difficult efforts to make further gains.[105] An inappropriately narrow focus and complacency are major, inherent flaws of systems wherein providers [educators] are not directly dependent on payments from their clients (parents); instead being paid, judged, and directed by elected officials and their appointed administrators. Only through bottom-up accountability that can only result from well-informed, high stakes consumer/parent choice will educators maintain an appropriately broad focus beyond a few tested subjects and fully address the interests of their students/parent customers, while also working to attract new ones. Meaningful school choice fosters direct accountability to parent/student clients, which provides educators the necessary strong incentives to focus on the full schooling experience, not a narrow experience defined by tested items.

Integration Benefits of School Choice

Specialization and school choice can also enhance educationally beneficial, and legally mandated, ethnic and racial diversity. There is no basis to expect a strong correlation between skin color or ethnicity and interest in specific pedagogical approaches or subject themes; unless the subject themes relate specifically to such backgrounds. Therefore, sorting of children into schools and classrooms according to *their abilities in particular subjects* (≠ 'tracking') and or their pedagogical preferences, should provide an ethnic/racial mix in each school that reflects the population of the surrounding area.

Research has yet to draw a clear distinction between school choice policy options that reduce the racial and socio-economic diversity of schools, and which options increase it. The studies that contradict claims that academic issues are parents' top concern may be the result of minimal, readily observable differences between 'comprehensively uniform'[106] attendance-zoned schools. Quite often the only readily apparent difference between nearby TPSs is student body composition, which parents may see as a sign of possible beneficial peer effects. Since virtually all of the available data arise from such circumstances, - the effects of possibly more important differences between nearby schools (specialized approaches, curriculum, pedagogy, teacher training, and textbooks) as choice-making criteria[107] are largely unavailable to study - can make it appear that many parents may have racist motives for their school choices. When parents can send their children to a school that focuses on a highly valued specific subject theme or learning style, they are much more likely to voluntarily integrate their children with other children with the same interests regardless of race or ethnicity. That's the lesson of popular magnet schools – widely over-subscribed – and public school choice policies aimed at integration progress, such as in Cambridge, Massachusetts.

Benefits of Rivalry and Genuine Competition

Existing, modest school choice programs have injected some useful school rivalry into the existing system, but not yet the full-blown competition that is a proven agent of efficiency and relentless improvement in most markets. Parental choice from a dynamic, appropriately diverse menu of schooling options will inject the needed genuine competition. If schools must vie for a share of an education market, each school has to attain a choice-worthiness level that will cover their school's expenses, probably by specializing in instructional approaches that exploit the strengths of its staff.[108] Schools would have to value performance over credentials, and thus would less readily accept mediocre products of weak teacher training programs[109] that have often been described as trivial programs with non-trivial negative consequences.

Since an engaging specialty area is worthless without high quality instruction, schools of choice have to compete for the most effective teachers. The resulting competition would yield higher incomes for master teachers of the most valued specialty areas. And the rivalry for top teachers would also cause teaching to become a more desirable profession for the most able students. Many schools would no longer insist that every aspiring teacher go through the hoops and hurdles of teacher certification that have repeatedly been shown to have little correlation with student performance.[110] Teachers, including esteemed professionals seeking a pre-retirement second career in teaching could be hired and retained, based on subject mastery and their ability to successfully communicate their knowledge to students.[111] Competitive pressures would also increase the probability of dismissal of the teachers lacking a valued teaching strength, or without the ability to readily acquire one with additional training.

Competitive pressures could force schools and school systems to seriously reconsider convenient, but counter-productive practices like attendance areas, grouping by age, one-size-fits-all, politically correct curricula and textbooks, and teacher salary schedules that fail to recognize differences in competence or subject fields. On a modest basis, such re-assessments were outcomes of the restriction-laden Milwaukee Voucher Program. Some Milwaukee school administrators asked district officials for more autonomy in running their schools once faced with competition from choice schools.[112]

Economic Development Magnet

Families and businesses move to places that offer private school choice without a huge tuition bill on top of school taxes. A survey of families leaving inner city Baltimore for better suburban schools found that nearly half would have remained in the inner city had there been a significant tuition voucher program, or widely available charter schooling options.[113] The privately-funded Edgewood (San Antonio, Texas) tuition voucher program attracted significant immigration and business development; so much that in several years of rapid growth in voucher use, school district enrollments also grew.[114] In these times of fiscal stress and shrinking labor force participation, a school choice-based economic stimulus policy needs much more attention. It may be the necessary catalyst for the extra political support needed to enact transformative school choice policies.[115]

Policy Options to Facilitate Appropriate School Choice Outcomes

Widespread engagement in learning requires a diverse menu of schooling options that, in turn, requires meaningful school choice, which requires light regulation,[116] a level playing field, and market-determined prices to signal the scarcity of each schooling option. Of the many school choice policy options that could create the necessary conditions of a high performing school system,115 we review five policy approaches with a chance of being adopted in Alabama in the near future, plus a sixth that would be a good first step towards one of the other five.

1. Education savings accounts (ESA); a universal version of what Arizona provides to help eligible families opt out of assigned, failed TPSs; about 20% of Arizona schoolchildren. The state makes an annual deposit that is available to pay tuition or purchase supplies and courses from any approved schooling provider.

2. Course choice[118] – like as ESA; the state pays for courses from non-TPS providers.

3. A universal tuition tax credit, going significantly beyond the Alabama Accountability Act - can foster the specialized schooling options that would raise the effectiveness of our educators, and engage significantly more children in academics.

4. Universal eligibility for a tuition voucher that can be phased in gradually, or first tested and fine-tuned in the state's lowest performing urban school systems.

5. Forty-three states, including the District of Columbia (but not Alabama) have laws that allow the creation of chartered public schools, but many severely limit charter use. Alabama needs a strong charter law, as defined below, to foster the specialized schooling options that will greatly expand engagement in learning by Alabama K-12 students.

6. Open enrollment among traditional public schools (TPS), including magnet schools.

Education savings accounts, Course choice, Tuition Tax Credits, and Tuition vouchers

Each of those is a possible way to achieve bottom-up accountability, a much more level playing field between public and private schooling options (funding equity), critical price signals, entrepreneurial initiative, and the other critical conditions described above. Adam Smith's *Wealth of Nations* (1776) proposed tuition vouchers as an alternative to the current TPS public finance monopoly. Milton Friedman's 1955 essay,[119] and his chapter in *Capitalism and Freedom*,[120] injected tuition vouchers into contemporary policy debates. Friedman proposed universal tuition vouchers to harness entrepreneurial initiative driven by market-generated price signals, arguing that the outcome would be much preferred to the widely-lamented achievement deficits of our current, virtually closed system, due mainly to the public school system's public funding monopoly. Tuition tax credits, course choice programs, and education savings accounts can also level the playing field between public and private providers of instruction, while adding flexibility to buy schooling from multiple providers and reducing the potential for debilitating regulation of private schooling options.

1. Education Savings Accounts (ESA)

When an eligible student opts out of public schools, parents receive an annual state-financed deposit in an account they can access via debit card for approved schooling purchases. All else equal (for example, eligibility and annual funding amount), the important advantage of an ESA over the more conventional tuition voucher is the ESA flexibility to divide the state-provided funding among multiple providers – for example, course selection from different providers – and the flexibility to spend less now, to spend more in the future, with ESA balance carryover from one year to the next.

Legislation creating universal education services accounts (ESA), combined with competitive pressures, would provide producers of low cost instructional approaches (e.g. cyber schools) an incentive to offer parents some of the subsidy amount as a deposit in an ESA that would fund other educational expenses such as purchasing text books, transportation costs, tutoring services, or whatever the state approves. Likewise, ESAs motivate parents to find the least expensive schools appropriate to the unique attributes of their children. Currently no state offers such ESAs to all families.[121] Alabama should lead the way.

2. Course choice

The government can opt to pay per child, per course, rather than just on the long-standing all-or-nothing per child basis. Like an ESA, per course funding facilitates blended learning, but with less flexibility than choice that includes privately-provided options that may include services that are not as courses; for example, therapy for special needs children. Utah provides course choice limited to public schools, including on-line options.

3. Tuition Tax Credits

Tuition tax credits have the same flexibility advantages of ESAs, with the advantage that courts are likely to rule that ESAs are state money while tuition tax credits, especially non-refundable credits, are generally not seen by the courts as state money. State money is more vulnerable to debilitating regulation of schooling practices. Non-refundable tuition credits escape the 'state money' designation by being limited to each taxpayer's designated tax liability (like state income tax), which, except for the wealthiest taxpayers, is well below a private school tuition for even one child. Thus, for most families, especially those with multiple school-age children, non-refundable tuition tax credits would not defray private school tuition costs very much. Refundable credits, which can exceed the designated tax liability, can solve that problem, but at the risk of the regulation that could come with 'state money' being paid to taxpayers with a credit amount larger than their designated tax liability. For example, if there is a refundable tuition tax credit of $5000 per child, eligible taxpayers will get a check (state money) for the difference between the $5000 per child, and the amount of state income tax they would otherwise owe.

4. Tuition Vouchers

The existing, narrowly targeted, restriction-laden U.S. voucher programs do not remotely resemble the Friedman vision of a level playing field between public and private options, which he believed would lead to gradual full privatization. The existing voucher programs target certain groups of children (special needs, low-income, from failing schools, etc.), certain types of schools (i.e. private, secular, not for profit schools, etc.), and/or allow only a fraction of the total student population to participate. And the dollar value of the voucher is rarely much over half of per pupil TPS funding, often much less than half. Studies of those limited versions of tuition voucher programs have created a lot of misleading, implicit generalizations about potential larger scale, less restricted voucher programs.[122] As Rick Hess noted through his pick-axe and bulldozer metaphor, only the 'pick-axe' variety has been implemented anywhere. Only pick-axe vouchers have generated effects to study. "Bulldozer" voucher programs have not existed to study. That's critically important because the un-researched 'bulldozer' effects seem likely to be significantly different from the pick-axe effects seen so far.[123]

Like Hess, Milton Friedman carefully differentiated between universal and restriction-laden targeted tuition vouchers, calling the latter "charity voucher" programs;[124] much smaller than the transformational "education" voucher programs that he envisioned. Larger voucher programs exist in Chile, the

Netherlands, and Sweden, but tight regulation by the central government limits entrepreneurial initiative and the needed subject area and/or pedagogical specialization. For example, Sweden specifies a national curriculum that all schools must teach. Since the national curriculum consumes 95% of the school year, Sweden has only pedagogical choice. That is, Sweden's school system (public + private, combined) teaches the prescribed national curriculum in a wide variety of ways.

The evidence accumulated from voucher program studies indicates that even small doses of school choice boost school system performance. Multiple studies found that each of thirteen U.S. voucher programs had positive effects on parental and student satisfaction and student achievement levels on standardized tests.[125] The Friedman Foundation website lists over 24 different studies written by public and non-profit based organizations that attributed positive effects to the various U.S. voucher and tax-credit programs.[126] None of those studies found there to be any negative impacts on choice schools or the TPSs. That is true, despite the often large restrictions imposed on those programs.[127] To avoid too much of a detour from our recommendations, we provide further discussion of evidence in an online Appendix.[128]

Tax Credit – Low-Income Voucher Combinations

Several states, including Alabama, allow a tax credit when businesses or individuals donate to "scholarship" organizations that fund vouchers for low income families.[129] Such organizations are non-profit and are responsible for distributing the donated money to children on a random or need basis. That combination of means-tested vouchers funded by tax credits for businesses, and tax credits for families that spend their own money on private schooling, is an alternative to the aforementioned direct subsidy and charter school approaches to the needed diverse menu of schooling options. Compared to those options, a tax credit – low income voucher combination has the disadvantage of likely yielding much less per pupil funding for private school users than that received by TPS users. Private schools' financial disadvantage is likely magnified if the tax credit is 'non-refundable;' that is, if the credit amount is capped at the tax liability targeted by the credit, typically state income tax. But, as noted above, a key advantage of the non-refundable credit approach is that courts may construe vouchers, ESAs, and refundable credits to be expenditure of state money, a legal obstacle to choice programs in many states, and a political issue in that some taxpayers will object to subsidy use at, for example, non-secular schools. As we will briefly argue below, the Alabama constitution does not appear to pose major obstacles to any of the approaches described above. Avoidance of price control effects is a major advantage of all tax credit approaches.

A "Strong" Charter Law

Alabama does not currently authorize chartered public schools (CPS), and the weak charter law proposals that recent Alabama legislatures have considered would not detectably change the Alabama school system. The charter laws that exist in California, Minnesota, Arizona, and Washington, DC provide a model for a good place to start on this route to a better school system.[130] Those states exempt CPS from many of the rules that apply to traditional public schools (TPS), provide charter school per pupil funding levels comparable to the level for TPS, and provide multiple sources of the needed charter. The typical weaker charter laws provide little or no regulatory relief, fund charters at much lower levels than TPS, and allow few, if any, alternatives to school districts as charter authorizers. After matching the strongest existing charter laws, the next step would be to improve upon them by avoiding the price control created by all of the existing charter laws, by allowing shared financing of tuition, and by allowing school charter/mission-based selective admissions.

Open Enrollment – End Attendance Areas

While open enrollment curbs the attendance area barrier to specialization, it does not provide the price signals to inform and motivate it, or the incentives to drive the politically difficult resource re-allocation process. Still, with the 'comprehensive uniformity' starting point of the current system, initial specialization decisions are likely to result in the establishment of magnet schools that would mostly be wildly popular. The open enrollment mandated by the federal NCLB Act for students in failing schools is a useful first step to build familiarity and with widespread public sector specialization, and thereby gradually increase the political feasibility of policy approaches that could produce a high performing system, and sustain it through disruptive changes.[131] The weak response to the NCLB public school choice mandate argues that choice among existing schools will not be that helpful to the choosers, or do much to motivate school system change, including specialization. Therefore, increased provision of magnet/charter schools may be the only way to develop much specialization from the current school district governance process. A recent Center for Reinventing Public Education provided useful tips for improving outcomes of public school choice.[132]

To achieve the needed dynamic, diverse menu of schooling options, Alabama's school choice program must provide a portable per pupil funding level comparable to the per pupil funding of TPS, maintain low formal entry barriers for education entrepreneurs that might start new schools, place no permanent caps on the number of students that can opt out of their assigned TPS, and avoid price control effects by letting schools accept vouchers as partial payment. Implementation of such a policy would provide Alabama with the world's most competitive system and system-transforming policies. It would provide parents and students with a dynamic, diverse set of schooling options not yet available anywhere in the U.S.

Pilot Program for a Universal School Choice Program

A pilot program approach is a reasonable, yet risky way to launch and develop support for a statewide program. To attract enough entrepreneurs into the market, the state should enact the pilot as a permanent program contingent on the absence of serious problems. It's a risky approach, because in addition to the costly delay in bringing the benefits of genuine choice to the entire state, there is a chance that something set-up as a pilot will provide a distorted view of a full-scale permanent program. The uncertainty inherent in even the best-conceived pilot approach may stifle the investment needed to produce the lion's share of the benefits. A temporary, privately funded voucher program for residents of the Edgewood District of San Antonio, Texas provides an indication of what could happen. The program was successful in its early years at attracting new businesses into the area and fostering public school improvement. But since the program was scheduled to end within ten years of startup, the only major investment was a new school created by the one of the key funders of the voucher program. Participants found better choices for themselves among the existing schools, but there was no major diversification in the menu of schooling options.[132]

That said, political realities may dictate a pilot program approach. A rapidly growing large metro area with a large low income population and a history of frustration with previous school reform efforts is an ideal place to start a pilot program. The history of frustration will minimize resistance to the pilot, and the large population will maximize the potential for specialization, while also maximizing access to the choices thru public transportation.

If politically feasible, phased multi-region or statewide implementation is a better approach. It avoids the temporariness problem, while providing time for adjustment132 and abandonment, if necessary. Elements to possibly phase in include geographic areas, student age eligibility, the value of the voucher, and existing self-pay users of private schools. The key factor to have in place right away is permission to accept the voucher as partial payment; always avoid price control. Price signals are essential to orchestrate the adjustment process, and the chance to add-on eliminates the potential for debilitating, quality-undermining shortages. Choice supporters must exhort philanthropists to fund add-ons for low income families to curb protests about unequal opportunity that could undermine the political support for the program during the critical transition period.

Supply Side

To optimize the effects of a school choice program, new policies must help potential education entrepreneurs – often educators with little familiarity with the business aspects of setting up and operating an independent school – develop their ideas and seek financing. So, we recommend that the state create a program to train educators in the business aspects of running a school, including familiarity with the relevant regulations. To support education entrepreneurship, at least one Alabama university should offer training designed specifically for them. Arizona State University used a USDOE grant to set up such a program.

Accountability: Bottom-Up, not Top-Down

Schools of choice must have the necessary freedoms to enact their own specialized curriculums, hire teachers they deem best fit their schools, and buy the textbooks they prefer. Full disclosure of academic policies and outcomes will allow parents to hold them accountable. In the rare cases where there is not yet enough competition to close low-performing schools, a provision for state intervention may be needed. For enhanced school transparency, we recommend the publication of annual student assessments of schools of choice. A website that contains lists schools of choice, their ratings, their accreditation status, and a listing of teachers and school officials will help parents and students make good choices.

Mandatory standardized testing is a delicate issue. While some well-chosen tests would enhance transparency of schools of choice, it would be unwise to use test scores as a criterion for permission to enroll subsidized students. Such a requirement will amount to the kind of regulation that often undermines choice and innovation, as has happened in Sweden, New Zealand, Chile, and the Netherlands. And as is now the case with public schools, formal high stakes testing would cause some private schools to fixate on specific test content, invest school time in test prep, and consequently take time away from other important curriculum areas.133

Alabama Accountability Act (AAA)

Year one of the AAA[136] saw 719 students leave their assigned TPS. Most of them went to another school within the same school district. Only 18 transferred to another district, and only 52 switched to a private school. The AAA program yields large fiscal cost savings for each tax credit user; at least 20%[137] of the per-pupil costs for each tax credit user, which during the 2011-12 academic year amounted to $1680 per student. And based on evidence from U.S. school choice programs (see online Appendix) we can also expect academic gains.

The AAA is a strong framework for building stronger school choice programs. The flexibility inherent in the AAA allows school districts room to become competitive with private schools. The tax credit of up to $3500 per student is a large fraction of private school cost; close to 100% for some parochial schools. The ability for businesses to donate to the scholarship fund to enable families who are unable to attend schools that costs more than the $3500 is also valuable. But the program should be improved in several areas.

1. Increase the number of students eligible to participate in the tax credit program

The AAA covers only 14% of all public schools. Universal eligibility should be rapidly phased in. The resulting huge increase in the market would create incentives for education entrepreneurs to increase or expand their services.

It is a huge mistake to assume that only students attending persistently failing schools or schools performing in the bottom 10% of the state's math/reading assessments are in need of additional options to improve their education options. Because of student diversity and resulting mismatches with the one-size-fits-all approaches, even schools deemed successful contain a large number of students that would benefit from moving to a school with teachers and programs that fit them better than their assigned school.

Summary and Concluding Remarks

To engage the majority in productive learning, and provide every child with a high minimum level of opportunity to pursue happy and productive lives, Alabama needs to move forward with reforms to yield the much-needed, dynamic, diverse menu of schooling options. Choice and competition must be brought into K-12 education, and particularly the segment of the market currently dominated by public schools. There is no proven alternative to achieve significantly improved schooling outcomes. Decades of futility pursuing ostensible fixes that do not address the current system's fundamental flaws—reasons that school systems around the U.S. persistently fail to engage enough children in learning – have proven that. Policymakers have clung to, indeed further eroded, a de facto, failed business model for K-12 schooling that is contrary to much of what we know about business, economics, human nature, and how children learn. Current schooling practices do not reflect effective planning in any meaningful sense. Current schooling policies and practices are a multi-level (federal, state, district) collection of traditions and rules that demand compliance regardless of their sum total effect on student learning.

There are several policy options for moving forward with a real plan – ones aligned with what we know about human nature and how/why children learn—and considerable flexibility with each of the main options. The policy options are not mutually exclusive. For example, providing ESAs, tuition vouchers, or tuition tax credits does not preclude adopting a strong charter law. We strongly recommend at least the latter (CPS yield higher rates of return on public funds[138]); an Alabama charter law to include at least the key provisions of the strongest existing charter laws,[139] preferably plus price de-control and permission to exclude mission-incompatible children.

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5

School Service Privatization in Alabama

Daniel J. Smith and
Robin P.K. Aguiar-Hicks

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Summary Points

- Alabama school districts spent almost $1.4 billion–nearly $2,000 per pupil–on food, operation and maintenance, and transportation services over the 2010-11 school year. This represents nearly 20 percent of Alabama education budget.
- Even modest cost reductions achieved through privatizing of food, operations and maintenance, and transportation services could potentially result in millions of dollars of savings for Alabama school districts.
- Less than one-fifth of Alabama school districts contract out for operations & maintenance, food, or transportation services. Public school districts in the state lag significantly behind other states in privatizing these auxiliary school services. School districts in other states, like Michigan, that have privatized auxiliary school services to a greater extent, have realized higher quality service, substantial savings, and even higher salaries for teachers.
- Providing auxiliary services in-house provides an avenue for the growth of public-sector unions. Public agencies are susceptible to pressures from politicians or employee groups to hire additional workers, even if those workers are unnecessary.
- The significant benefits of privatization available to Alabama school districts detailed in this study are potentially available to other government agencies at the state and local level in Alabama, ranging from refuge collection to golf courses.

1. Introduction

The challenges of the current economic climate have forced school districts across Alabama and the nation to scrutinize their budgets for cost savings which would not adversely affect educational quality. While Alabama school districts should be commended for their cost-cutting creativity, traditional measures like hiring and salary freezes have reached their limits of effectiveness. Districts have begun to consider and even resort to cuts that will likely impact the classroom, such as reducing library budgets, staff, books, teaching tools, and other classroom supplies.[1]

Fortunately many school districts across the nation have discovered a way to improve their budgets without skimping in the classroom; contracting out for auxiliary school functions like food, operation and maintenance, and transportation services. Contracting out for auxiliary services does not adversely affect educational quality, and creates cost savings which can be funneled back into the classroom. Private contractors disciplined by the competitive forces of the market can decrease the costs of these auxiliary services through specialization and economies of scale, while preserving, and often even enhancing, quality.

Superintendents and business managers in school districts are specialists in education, not managing transportation schedules, dietary guidelines, and routine maintenance work. In addition to saving money, contracting for auxiliary services would allow superintendents and business managers to focus on their core mission of educating Alabama's students. Asking school district administrators to supervise these auxiliary tasks is like asking a math instructor who doesn't know a punt from a pass to coach the football team. Firms specializing in auxiliary services to school districts are more flexible, entrepreneurial, and subject to competition, oftentimes fostering better service at a lower price.

While school districts across the country are benefiting from contracting out for auxiliary school services, Alabama school districts have largely left this potential source of savings untapped. Less than one-fifth of Alabama school districts contract out for food, operation and maintenance, and transportation services. Alabama's students stand to lose ground to other states in terms of educational quality if our school districts do not consider all viable opportunities to put more money back into the classroom.

Section 2 provides an overview of privatization and a review of the theoretical and empirical evidence on the benefits of privatization. Section 3 reviews the evidence on auxiliary school service privatization across the nation and the growth of successful privatization of auxiliary school services in Michigan School Districts. Section 4 presents the results from a survey the authors conducted of Alabama school districts on their privatization of auxiliary services. Section 5 concludes.

2. Privatization

Privatization is the process of transitioning from the government provision of a good or service to the private provision of that good or service. Privatization allows private companies to submit bids to enter into a contract to provide a good or service for a specified timeframe.[2] Essentially, privatization means that a designated good or service will be purchased on the competitive market rather than being provided by government.

Privatization can take many forms and occur at many different levels of government. For example, it can range from the privatization of large programs such as social security in Chile or the contracting out of astronaut taxis by NASA to private companies, to privatizing rest areas and welcome centers at the state level, all the way to the privatization of emergency medical services, garbage collection, and golf courses at the city level.[3] Privatization also includes the process of a government agency contracting out for specific auxiliary services historically provided in-house. For instance, municipal golf courses can contract out to private companies for lawn maintenance, janitorial services, or golf cart maintenance and repair.

Many private firms themselves contract out auxiliary services to dedicated providers.[4] For instance, most physicians and lawyers do not directly employ someone or own their own lawn equipment to mow their lawn. Instead, they contract with a lawn care company to provide the personnel, equipment, and management necessary to maintain their lawns. Even individuals routinely contract out services such as oil changes and roofing to private companies that specialize in the provision of that good or service.

Just as private firms and individuals contract out for services that they lack expertise in, government agencies can contract out to private providers for auxiliary services. For example, a public school can use private contractors for non-educational functions such as food, operation and maintenance, and transportation services, with no worry of compromising their core public mission of education. Rather than a government agency providing a good or service outside of their core capabilities and mission, that agency can contract out with private providers with expertise. Contracting out to expert contractors for auxiliary services offers the potential for both cost savings and quality enhancements. Note that contracting for auxiliary services does not imply the privatization of public schools.

Section 2.1 details the potential benefits of privatization. Section 2.2 provides a review of the evidence on privatization in practice.

2.1 *The Benefits of Privatization*

Determining the proper size and scope of government is a critical question for citizens, because a government which exceeds its proper protective and productive functions impedes economic growth.[5] Once citizens determine that government should provide a good or service, we have a common interest in ensuring the costs are no higher than necessary to provide the good or service of desired quality. This is especially true when government provides goods and services that could be provided by the private sector.

Private sector companies face the competitive forces of the market, and consequently are far more cost efficient and innovative than public bureaucracies in providing goods and services. Alabama's state agencies should plan to purchase goods and services from specialized private providers whenever possible. As economist Paul Rubin argues:

> *When a competitive open market exists, this usually offers the most powerful method of controlling costs. If a product is made internally, then the firm must spend substantial managerial resources monitoring costs and efficiencies. In the market, on the other hand, simple shopping or seeking bids can easily and cheaply control costs. The best way to control costs is through the market.*[6]

Government agencies should particularly contract out to private firms for auxiliary goods and services. Businesses frequently contract out to other firms for the provision of goods and services that fall outside their core mission.[7] This can include everything from advertising campaigns, logistics, and the procurement of raw materials all the way to cleaning services, lawn maintenance, and window cleaning. Due to the substantial benefits from specialization, businesses find it profitable to contract for or purchase many goods and services in order to better focus on what really matters, namely the good or service they sell in the market. Contracting for auxiliary goods and services saves businesses on payroll costs, equipment and maintenance, and especially management's time. Government agencies can take advantage of these benefits by contracting out to private companies for auxiliary services.

Our economy features many firms which provide janitorial, lawn care, payroll and other auxiliary services. Because of economies of scale and their greater knowledge, specialized firms can provide these goods and services at a lower cost. Businesses and government agencies can take advantage of this competition in contracting out. Firms and government agencies can specify in the contract the terms of the provision, the expected quality, the length of the contract, employee background checks, and other necessary details in order to ensure that the firm is receiving the goods and services on the terms required. If the contractor does not perform satisfactorily, the firm or government agency can terminate the deal and open the contract for bidding again.

Specialization allows school administrators to select the best service providers, allowing school administrators to focus more exclusively on educating students, which is ultimately what they really have unique talents, experience, and passions for. Specialization allows contractors to develop their talent as they repeatedly engage in their craft. For example, a private contractor who specializes in food management for several school districts acquires a lot of best practices and cost reduction strategies in food inventory, preparation, and delivery. Specialization also provides the economies of scale to employ more efficient technology and methods of organization and production. While it would be difficult for a small school district to hire a lawyer to keep up-to-date on dietary guidelines and food preparation regulations, a firm specializing in food management might find it cost effective to do so, resulting in better dietary awareness and regulatory compliance. Finally a food management company is likely to have adequately trained personnel to fill-in for sick or vacationing employees, back up equipment available, and other resources to meet unexpected contingencies.

Privatization allows government entities to focus more of their time and public money on accomplishing their specified public missions. By trying to provide goods and services that can be readily provided by the private sector, government agencies often stray from their core mission and get entangled in often inefficient bureaucracies.[8] For instance, when a good or service is provided publicly rather than privately, there is far more incentive for shirking.[9] Providing auxiliary services in-house also provides the avenue for the growth of public-sector unions.[10] A good example of this is the higher frequency of strikes by public employees.[11] Public firms often face pressure from politicians or employee groups to make additional but ultimately unnecessary hires, or delay implementation new labor-saving technology.[12] James Bennett and Manuel Johnson found in a review of the research that public colleges, public trash collection, and public hospitals all employed many more workers than their private-sector counterparts.[13]

Cost and quality advantages can be particularly large when it comes to the privatization of auxiliary functions. The economist Andrei Shleifer, summarizing the empirical evidence on privatization, concludes that when it comes to government provision of goods and services, "…the conditions under which government ownership is superior…are very limited."[14]

Finally, but importantly, school district administrators likely entered the profession because of a passion for and experience in education. Allowing administrators to focus on what they are best and most passionate about: educating youth.

2.2 *A Brief Overview of the Empirical Evidence on Privatization in the United States*

The U.S. has witnessed many successful privatization experiments for a range of goods and services from trash collection and golf courses to emergency medical services. The evidence demonstrates that privatization typically delivers promised benefits, especially when it comes to services that theoretically and empirical have no market failures.[15]

Private producers, across a broad array of different services including fire protection and garbage collection, can provide a similar quality service at a similar, and oftentimes lower, cost than government providers.[16] Manuel Johnson and James Bennett argue that the evidence on the benefits of privatization "…is both overwhelming and irrefutable."[17]

A study on school transportation in Indiana by Robert McGuire and Norman Van Cott found that private companies were 12% cheaper on average than districts who ran in-house bus service.[18] Looking at garbage collection in Fairfax County, VA, James Bennett and Manuel Johnson found that private garbage companies in Fairfax County, Virginia, offered twice weekly pickup for a lower cost than the once-weekly county service.[19]

Emergency Medical Service privatization has reduced response times, improved reliability, and lowered cost.[20] Privatization of state-run liquor stores has resulted in significant savings with no adverse impact on social outcomes.[21] Highways

Figure 5.1: The Cost of Auxiliary Services

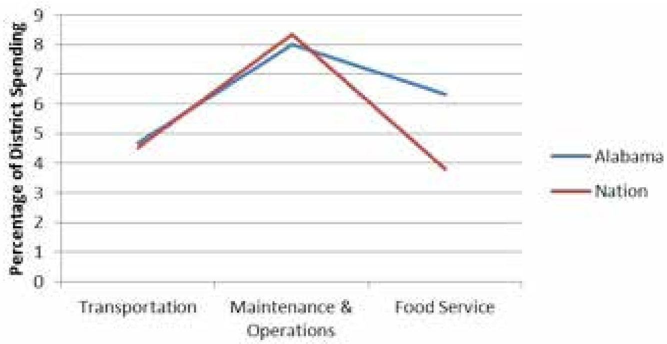
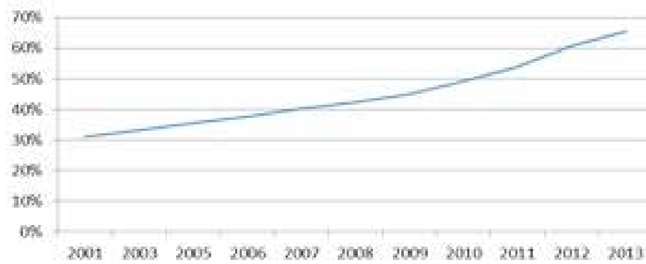


Figure 5.2: Percentage of Michigan School Districts Contracting Food, Operations or Maintenance, or Transportation



have been successfully privatized.[22] Highway rest stops have been privatized, saving taxpayer money and improving services.[23] Social services, including foster care have been successfully contracted out to private agencies.[24] Privatization of education itself has shown promising results in improving educational outcomes while drastically reducing costs.[25]

3 Auxiliary School Service Privatization

K-12 public education is one area of potential privatization where contracting out for auxiliary services offers substantial benefits, both in terms of savings and quality. Cash-strapped administrators across the country can free up time and money by putting the provision of these services up for bid. School district administrators likely entered the profession because they have passion and experience in educating youth. Allowing those administrators to focus exclusively on what they are best and most passionate about doing results in better service.

Auxiliary school services compose a substantial share of public school district expenditures. As **Figure 5.1** illustrates, nationally transportation, maintenance and operations, and food services account for more than one out of every six dollars spent by school districts; these represent federal, state, and local tax dollars directed to education which fail to make it into the classroom.[26] As the figure further illustrates, costs for these services in Alabama track the national averages pretty closely with the exception of food services, which are over 60% higher in Alabama (6.4% vs. 3.8% nationally).[27]

Any available savings in the provision of these auxiliary services can help school districts better achieve their purpose of educating youth. Alabama school districts in total spent nearly $1.4 billion on these three services, or about $2,000 per pupil.[28] These monies spent on auxiliary services represent substantial areas of potential savings for cash-strapped school districts. Spending more than necessary on auxiliary services makes Alabama less competitive with other states.

In the 2011-2012 School Year, over 58% of Alabama students took advantage of free or reduced cost meals, helping explain why Alabama school districts spend over 6% of their budget on food services. [29] There are many potential cost-saving benefits that outsourcing food services can offer. If food services were to be contracted out, we could see a decline in the average cost of food per student. This is turn would translate to higher savings. These savings can be substantial for both rural and non-rural school districts. While there are also additional benefits that could come from outsourcing, such as better food quality and better food selection, the primary motive for contracting food services remains the potential savings benefits.

In a 2007 study, the Mackinac Center for Public Policy found that nation-wide, 13.2% of traditional public school districts contracted out for food management services. A 2008 national survey conducted by American School and University, found that 17.7% of school districts across the nation contract out for maintenance and operations services.[30] An estimated 30% of school districts across the nation contract out for transportation services.[31]

Michigan has been one of the leading states for privatization of auxiliary school services. The Mackinac Center for Public Policy has closely tracked contracting by Michigan public school districts for over a decade, allowing an analysis of its adoption and changes in reported cost and quality. As **Figure 5.2** shows, the percentage of districts contracting for food, transportation, or janitorial services has more than doubled in the last decade from 31% in 2001 to 65.5% in 2013, resulting in millions of dollars of reported savings and improved service.[32]

Figure 5.3: Percentage of Michigan School Districts Contracting by Category

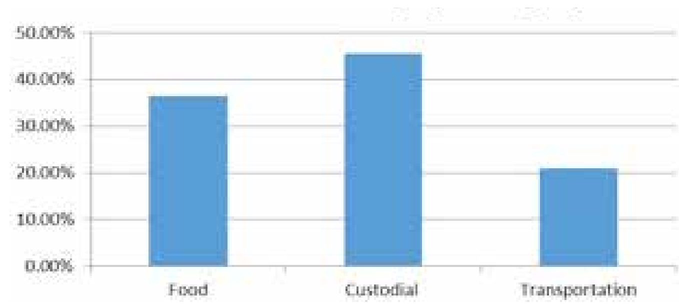


Figure 5.3 displays the percentage of Michigan districts contracting for each category as of 2013; custodial privatization was the most prevalent, followed by food services, and transportation. Many Michigan school districts contract out multiple auxiliary functions.

Michigan school districts have consistently reported being very pleased with the results of contracting auxiliary services. As **Figure 5.4** shows, over 92% of districts which contracted out reported being satisfied in 2013, while less than 4% reported being dissatisfied with their service provider. [33]

The satisfaction Michigan school districts express with their contracting experience may be enhanced by the millions of dollars of savings. In the 2012 Mackinac Center survey, school districts new to contracting, despite the transition costs, expected to save at least $12.8 million.[34] In fact, in 2012, 85% of new contracting school districts in Michigan reported net savings from privatization.[35] For instance, Flushing Community Schools contracted out their food service management and realized a savings of $50,000 per year.[36] Gaylord Community Schools saved $100,000 the first year contracting out their custodial services and expected to save around $1 million the next three years.[37] Hastings School District realized 16.9% savings on custodial services, providing the district an extra $118,480 per year to put back into classrooms.[38] No new contracting districts in their 2012 survey reported losses from privatization, and many of the districts that reported no savings in the first year were expecting savings in the long run.[39]

A 2007 Mackinac Center study (co-authored by Dr. Daniel J. Smith) analyzed the savings by school district size. Districts of all sizes in Michigan realized savings from contracting for food, transportation, and janitorial services, with small districts (under 999 pupils) reporting the largest savings. [40] For instance, Gwinn Area Community schools, a district with roughly 1,500 students, saved $123 per student by contracting out for custodial services.[41]

Savings from privatizing auxiliary services can be funneled back into classroom budgets by school districts. Coldwater Community Schools, a larger Michigan district with over 10,000 students, saved $104 per student by contracting out for custodial services and used it to purchase new technology for the classroom.[42] In addition, the Mackinac Center found that Michigan school districts that privatized food, custodial, or transportation services paid higher teacher salaries.[43]

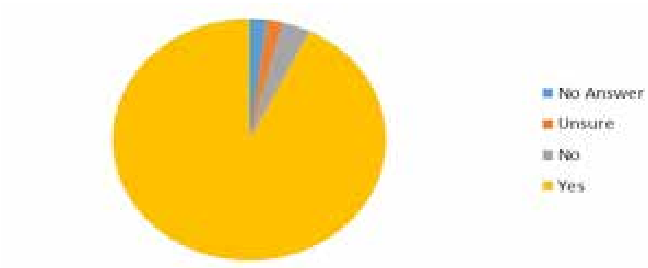
4 Auxiliary School Service Privatization in Alabama Public School Districts

The Johnson Center at Troy University and the Alabama Policy Institute surveyed Alabama Public School Districts to determine the current extent of contracting out for auxiliary services. In addition, districts were asked about their reasons for initiating contracting out and their satisfaction with contracted services. The survey was conducted between March of 2012 and May of 2014.

All 134 Alabama school districts were contacted, 65 of which were city school districts, 67 of which were county school districts, and two of which were non-traditional schools, as listed in **Appendix 5.1**. Initial contact was via email, with several follow up phone calls, and an Alabama Public Records Act request sent via mail on May 20th, 2012. Despite multiple contact attempts and official public records requests, thirteen school districts did not respond. All school districts that reported contracting for food, operations and maintenance, and food services were contacted multiple times by email and phone prior to the release of this study, beginning May 21st, 2014, in order to verify their contracting status. However, there were still a few districts that could not be reached to verify their initial responses.

Following the Mackinac Center's methodology, districts were classified as contracting out if at least one of the three major functions–food, operations and maintenance, and transportation–was contracted out, to some extent, to a private company. Often exploratory contracts will be issued as workers retire, helping a district ease into the contracting process, and we made sure to capture these districts in our survey. We also note, separately, Alabama school districts that contract out for functions outside these primary areas, such as lawn service.

Figure 5.4: Satisfaction with Contracting in Michigan School Districts



Alabama lags significantly behind the nation in privatizing auxiliary services. Only 16% of Alabama school districts (19 of 121 responding districts) contract out, to some degree, food, operations and maintenance, or transportation services. Three districts contracted out for two of these services (Alexander City, Anniston City, and Florence City). Of the Alabama school districts contracting out food, operations and maintenance, and transportation services, 85% (17 school districts) were city school districts, one was a county district (St. Clair County), and one is a non-traditional school district (Alabama Youth Services). These districts ranged in size from 400 students (Alabama Youth Services) to 5,400 (Gadsden City Schools), with an average student population of 2,900.[44]

A total of four Alabama school districts (3% of the 121 responding school districts) reported contracting out for either all or part of their school food services or food management (**Figure 5.5**). This meager total constitutes a slight expansion of food service contracting since the Mackinac Center's 2006-2007 national survey, which found that only one school district contracted out for food service.[45]

Figure 5.5

Districts Contracting for Food Services

Alabama Youth Services

Alexander City

Anniston City

Selma City

A total of five school districts (4% of the 121 responding school districts) in Alabama contracted out for some form of transportation services (**Figure 5.6**). If Alabama School Districts experienced the 12% saving rate that the economist Robert McGuire and Norman Van Cott found for school districts in Indiana achieved contracting out for transportation services, it would amount to savings of over $40 million.[46]

Figure 5.6

Districts Contracting for Transportation Services

Anniston City

Florence City

Gadsden City

Jacksonville City

Tarrant City

The most prevalent area of contracting out in Alabama is operations, custodial, and maintenance services. Most of the districts in **Figure 5.7** only partially outsource these services (e.g., maintenance but not custodial) but several have completely outsourced these services. Thirteen Alabama school districts (nearly 11% of the 121 responding school districts) contracted out for some form of custodial and operations services.

Figure 5.7

Districts Contracting for Maintenance & Operations Services

Alexander City

Andalusia City

Brewton City

Dothan City

Eufaula City

Florence City

Haleyville City

Lanett City

Leeds City

Saraland City

St. Clair County

Thomasville City

Tuscumbia City

Fifty one districts (42%) reported contracting out some other auxiliary services, the most popular being lawn care (37 districts) and substitute teachers (eight districts). Other auxiliary services that Alabama school districts reported contracting out for included floor care, special education transportation, bus maintenance, therapy services (occupational & speech), printing services, and non-staff coaches.

Many contracting school districts elected not to respond to the questions regarding savings and satisfaction. Four of the five districts (80%) responding to the question on savings from contracting reported savings (**Figure 5.8**). However, the one district that did not report savings still reported being satisfied with the overall contracting experience (the district indicated that they contracted out for the expertise of the contractor and that the expenses were approximately the same). All thirteen of the contracting districts who responded to the question regarding satisfaction reported being satisfied with the contracting experience (**Figure 5.8**).

5 Conclusion

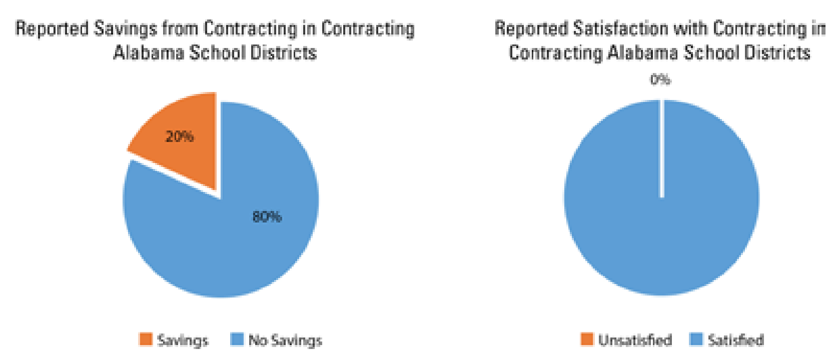
Contracting out for auxiliary services offers an underutilized source of savings for government entities struggling with budget cuts. Even without the pressure of budget cuts, government agencies have a responsibility to explore cost reduction strategies to economize on taxpayers' money. Privatization offers numerous opportunities for savings in Alabama, ranging from golf courses to rest stops. Alabama's K-12 public school districts can benefit from the specialization and economies of scale offered by private contractors for food, operations & maintenance, transportation, and other auxiliary services.

Unfortunately, Alabama public school districts lag behind the nation in contracting out for these auxiliary school services. However, this is also means that contracting out for auxiliary services represents an underutilized avenue for savings for Alabama's school districts. Privatization can redirect public money earmarked for education back into the classroom to bolster academic programs and offset recent budget cuts. Contracting can also allow administrators to focus their time and energy more towards educating Alabama youth.

While some Alabama school districts have already forged ahead with competitive contracting and are actively realizing savings and oftentimes superior performance, the majority are behind the curve and failing to take advantage of opportunities that could save Alabama taxpayers millions of dollars. These savings can be reinvested in Alabama's youth by bolstering academic programs and by providing classroom materials. As cash-strapped school districts already know, every dollar counts during these financially difficult times.

Many school districts across the country have already demonstrated how to successfully contract out auxiliary services. Consequently many resources exist for any district looking to consider contracting. While written specifically for Michigan's legal environment, a *School Privatization Primer* by Michael LaFaive offers many lessons and 'rules of thumbs' of the privatization process that would be relevant for Alabama school districts.[47]

Figure 5.8



Appendix 5.1: Alabama school districts

Albertville City
Alexander City
Andalusia City
Anniston City
Arab City
Athens City
Attalla City
Auburn City
Autauga County
Baldwin County
Barbour County
Bessemer City
Bibb County
Birmingham City
Blount County
Boaz City
Brewton City
Bullock County
Butler County
Calhoun County
Chambers County
Cherokee County
Chilton County
Choctaw County
Clarke County
Clay County
Cleburne County
Coffee County
Colbert County
Conecuh County
Coosa County
Covington County
Crenshaw County
Cullman City
Cullman County
Dale County
Daleville City
Dallas County
Decatur City
Dekalb County
Demopolis City
Dothan City
Elba City
Elmore County
Enterprise City
Escambia County
Etowah County
Eufaula City
Fairfield City
Fayette County
Florence City
Fort Payne City
Franklin County
Gadsden City
Geneva City
Geneva County
Greene County
Guntersville City
Hale County
Haleyville City
Hartselle City
Henry County
Homewood City
Hoover City
Houston County
Huntsville City
Jackson County
Jacksonville City
Jasper City
Jefferson County
Lamar County
Lanett City
Lauderdale County
Lawrence County
Lee County
Leeds City
Limestone County
Linden City
Lowndes County
Macon County
Madison City
Madison County
Marengo County
Marion County
Marshall County
Midfield City
Mobile County
Monroe County
Montgomery County
Morgan County
Mountain Brook City
Muscle Shoals City
Oneonta City
Opelika City
Opp City
Oxford City
Ozark City
Pell City
Perry County
Phenix City
Pickens County
Piedmont City
Pike County
Randolph County
Roanoke City
Russell County
Russellville City
Saraland City
Scottsboro City
Selma City
Sheffield City
Shelby County
St Clair County
Sumter County
Sylacauga City
Talladega City
Talladega County
Tallapoosa County
Tallassee City
Tarrant City
Thomasville City
Troy City
Trussville City
Tuscaloosa City
Tuscaloosa County
Tuscumbia City
Vestavia Hills City
Walker County
Washington County
Wilcox County
Winfield City
Winston County

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6

Medicaid in Alabama: Innovative Reforms for the Future

Scott A. Beaulier

Medicaid in Alabama: Innovative Reforms for the Future

Scott A. Beaulier

Summary Points

- Alabama Medicaid, the state health care program primarily for poor Alabamians and their children, now accounts for over 40% of General fund expenditures. Both the number of enrollees and total spending have increase dramatically since 2000.
- Projected spending growth, even if Alabama never embraces the expansion encouraged by the Patient Protection and Affordable Care Act, will further strain the state budget. And changes in the Federal funding formula could wreak havoc with the state budget at any time.
- Alabama needs sensible and sustainable reforms, already tested in other states, to bring Medicaid spending under control and improve the quality of care for beneficiaries.
- The most promising reforms include changing Federal funding for Alabama Medicaid to a block grant system and greater reliance on alternatives to traditional nursing homes when patient circumstances permit.

Introduction

With serious fiscal challenges at the federal level and most states facing budget cuts and layoffs, the federal system of health insurance for low-income individuals and families, known as Medicaid, cannot be maintained in its current form. Between fiscal years (FY) 2000 and 2010, total Medicaid expenditures in Alabama increased at a rate of 6.7% per year, with combined state and federal total expenditures rising from $2.85 billion to $4.75 billion.[1]

Alabama's Medicaid expenditures cannot keep increasing at the rates experienced over the last decade. Unfortunately, though, federal policy is headed in the wrong direction: The Patient Protection and Affordable Care Act of 2010 (PPACA), upheld by the Supreme Court of the United States in late June 2012, means more rapid expenditure increases in Medicaid in the near future .

Rather than embrace PPACA, Alabama has held the line and appears intent on rejecting the Medicaid expansion. Our state, nonetheless, needs sensible market-based reforms to Alabama Medicaid. Alabama's political leadership perceives any changes to Medicaid as being politically costly and seems more willing to find ways to continue funding a system in need of innovative reforms.

Without these reforms, Alabama's taxpayers will be directly responsible for more of the state's Medicaid expenditures in the future. And not only will Alabamians face potentially higher state taxes, they will also be liable for higher federal taxes or increased federal indebtedness. To advance meaningful reform, lawmakers must first acknowledge that a major problem exists and then move forward with changes to improve individual care and realize significant budgetary savings in both the long- and short-term.

This chapter offers recommendations for Medicaid reforms to improve Alabama's Medicaid system. The reforms, which have been pioneered in states like Rhode Island, seek to improve care and outcomes for all Medicaid stakeholders while emphasizing individual accountability and responsibility currently missing in Alabama's system.

Alabama's Current Medicaid System

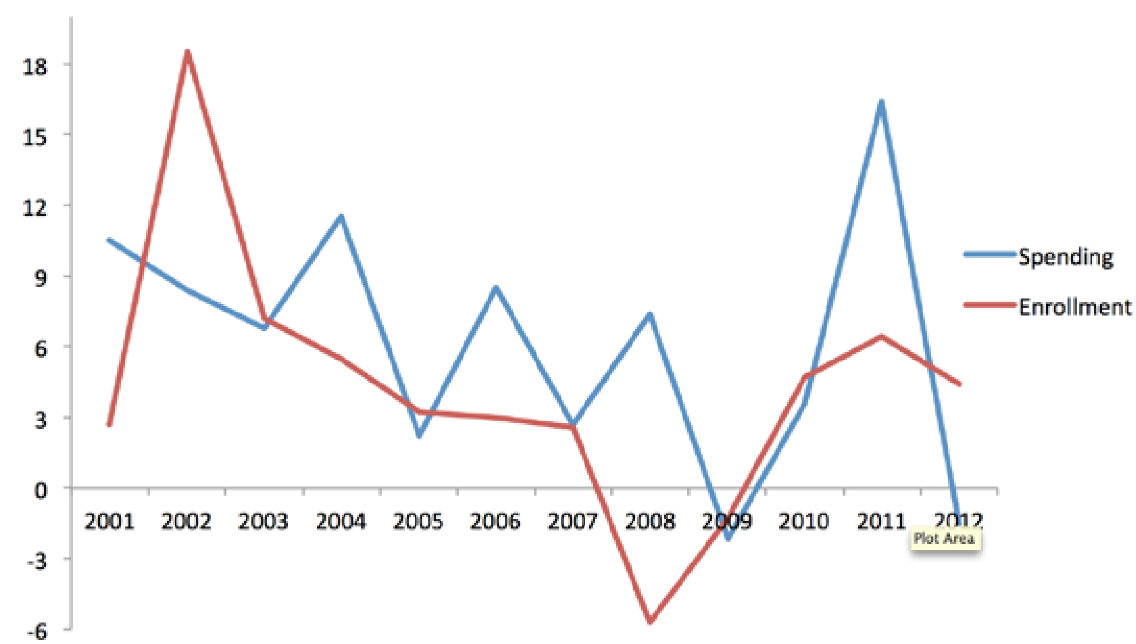
Title XIX of the Social Security Act authorized the establishment of Medicaid in 1965. The program provides health care coverage primarily to the poor and their children, but also covers some elderly people, the disabled, and some uninsured working adults. Medicaid is a joint state and federal program, with enrollees supported through complex federal and state funding formulas. While the federal government plays a crucial role in supporting Medicaid programs across the states, each state administers its own program within federal guidelines.

Alabama began to develop its Medicaid program in 1967, and officially implemented it in 1970.[2] On January 1, 1970, there were 253,991 Alabamians eligible for Medicaid benefits; the Department of Pensions and Security monitored eligibility and enrollment.[3] In the program's early years coverage included inpatient and outpatient care, laboratory and radiology services, pharmaceuticals, optometric care, and home health care.

Because Medicaid is a federal program, Alabama officials must abide by federal eligibility criteria and are constrained in how they administer their program. Over the past 40 years, Medicaid coverage has expanded to include individuals with higher incomes, the disabled, pregnant women, those who are poor and elderly, and a number of other groups. As coverage guidelines have expanded along with population growth, total Medicaid enrollment in Alabama has increased by 41%,[4] from 676,938 persons in FY 2000 to 954,793 in FY 2009.[5]

As enrollment has grown and health care costs have risen, Medicaid expenditures in Alabama and across the nation have exploded, as **Figure 6.1** reveals. Some of this spending growth is an inevitable consequence of increased coverage and the increase in health care costs, but the design of the system suggests that a good portion of this cost growth has been unnecessary. The standard framework for state Medicaid programs is to pay all of a member's health-related expenses. The Medicaid participant has no real incentive to "shop around" to economize on costs of care, while practitioners have incentives to drive up costs by recommending expensive tests, additional follow-ups, etc. Currently, only Arkansas and New Mexico require co-payments for Medicaid members. Other states, such as Arizona and California, have sought to introduce minor co-payments, but the administrative costs of co-payment programs were substantial

FIGURE 6.1: PERCENT CHANGE IN ALABAMA'S TOTAL MEDICAID SPENDING AND ENROLLEMENT, FY 2000-2012



Source: *Alabama Medicaid Agency Annual Reports* relative to the revenue gained. And the introduction of co-payments in California proved politically unpopular.[6] Although revenue from nominal co-payments should not be expected to cover all administrative costs, unforeseen savings are likely to the extent that co-pays result in fewer medical procedures. In many cases, states wanting to introduce or raise co-pays have been blocked by the federal agency that administers Medicaid, the Center for Medicare and Medicaid Services (CMS). In February 2012, for example, CMS rejected California's request to introduce co-pays ranging from $3 for prescriptions to $100 for inpatient hospital stay because they were "neither temporary nor targeted at a specific population."[7]

Medicaid in Alabama covers a number of different groups. Infants born to Medicaid-eligible pregnant women are guaranteed benefits. Children under the age of six are covered as long as their family income is no more than 133% of the federal poverty level, which in 2012 was $30,657 for a family of four. Children ages 6-18 are covered if family income is up to 100% of the federal poverty level, which is $23,050 for a family of four. Supplemental Security Income (SSI) recipients deemed eligible by the Social Security Administration are covered as well as some low-income Medicare beneficiaries and many institutionalized individuals in need of long-term care. Low-income families are covered as long as their income is 11.5% or less of the federal poverty line.[8]

The federal government and state of Alabama share in Medicaid funding through what is known as a matching grant system. A matching grant system is one where states must provide dollars to "match" federal money provided under the program. The federal match for state Medicaid expenditures is determined through the Federal Medical Assistance Percentage (FMAP) and based each state's per-capita income; FMAPs across states range between 50% and 83%. Alabama's per-capita income for 2011 was $34,650 per person, which makes it the 8th poorest state in the United States. Compared to the U.S. average of 14.3%, Alabama had 17.5% of persons—805,000 people—living below the federal poverty level of $22,050 for a family of four in 2009 (our most recent census year).[9] Alabama's FMAP of 68.53% for FY 2013, which is the 10th highest among states.[10]

Discussions of Medicaid policy often refer to the "Medicaid multiplier," or the match of federal dollars for each dollar a state spends. Alabama's multiplier for FY 2013 based on our current FMAP is 2.18, meaning that for every $1 in state spending, the federal government contributed $2.18.

A state's FMAP changes over time, and a reduction in a state's FMAP means that fewer federal dollars are matched per state dollar. Consequently a state must appropriate additional funds from its own revenues to maintain a given level of spending. Over the last 10 years Alabama's FMAP has averaged 71.1%, but has declined significantly over the last four years due to expiration of the American Recovery and Reinvestment Act of 2009. Thanks to ARRA, Alabama's FMAP rate increased to 77.5% for FY2009 and FY2010. Alabama has been racing towards a fiscal cliff when it comes to Medicaid funding in recent years. A $184 million shortfall in funding in 2012 was covered by a transfer from the Alabama Trust Fund, which required a referendum vote.[11]

This is just the most recent example of over-spending and failure to reform. In 2010, Alabama Medicaid was approximately $200 million short in funding, and federal stimulus money was needed to close the gap.[12] Rather than cut or reform Medicaid, Alabama has relied on these band aids, and thus continues to face potential fiscal crisis from any downward adjustment of the state's FMAP.[13]

The true problem is Alabama's ever-increasing liability for Medicaid. The federal government's open-ended match of state expenditures provides all states an incentive to expand Medicaid in ultimately unsustainable and inefficient ways. As a result, Medicaid spending, both in total and as a share of the federal budget, has been rising. According to the Congressional Budget Office, Medicaid's share of U.S. gross domestic product (GDP) will rise from 1.9% in 2010 to 4.5% in 2050.[14] Rather than force politicians to reconsider the Medicaid model or make entitlement programs more austere, the financial crisis of 2008 and the continuing weak economic recovery have instead resulted in an expansion in Medicaid in the short-run and massive projected Medicaid expenditures in the future.[15]

States and individual providers have little incentive to control costs or rein in Medicaid services. In fact, they face the opposite set of incentives: more spending means more federal money. States therefore have strong incentives to expand eligibility, provide additional services, and grab more federal Medicaid dollars. One recent example of eligibility expansions that have helped to grow state Medicaid programs has been the eligibility expansions for family planning services, one of the optional areas of coverage for state programs. Twenty-nine states, including Alabama, have obtained federal approval for Medicaid to cover family planning benefits, including contraceptive services, sexually transmitted disease tests, pap tests, and other services. Some states providing family planning benefits—Iowa and Wisconsin, for example—offer coverage for families with incomes up to 300% of the poverty level. These states have poverty rates significantly below national averages and respectable per-capita incomes; yet, they face strong incentives to provide coverage to even more people because of the prospect of receiving more federal money.

Politicians fine the opportunity to expand healthcare coverage for many of their constituents at federal expense irresistable. Equally challenging is the harsh political backlash anticipated with any cuts in coverage or reduction of services.

Lawmakers, Medicaid administrators, and health professionals in Alabama face the same incentives as other states. Medicaid is the largest budget item in the state's General Fund budget, and second in overall state spending only to education. Direct Medicaid expenses accounted for 36.4% of all General Fund expenditures in FY 2012.[16]

Most of Alabama's Medicaid costs are incurred through services for the disabled, blind, and aged: in FY 2010, nearly 65% of all benefit payments in were made to members of these groups. Payments to pregnant women and low-income children, Sixth Omnibus Budget Reconciliation Act (SOBRA) payments, accounted for another 20% of the caseload. Because aged, blind, and disabled enrollees tend to require more specialized treatments and longer-term care, the costs of treating them will rise as more of them enter Medicaid.

In addition to demographic trends and incentives facing any particular state, which both point towards higher levels of Medicaid spending in the future, the PPACA will provide significant upward pressure on Medicaid expenditures as well. Under the new law, states will be incentivized to expand the income threshold for Medicaid to 133% of the federal poverty level for childless adults. According to the Kaiser Family Foundation, the expansion in coverage promised under PPACA will result in $470 million in new state spending during the 2014-2019 period and $10.3 billion in federal outlays to Alabama; under the "enhanced outreach scenario," expenditures will rise to $693 million for Alabama and $11.4 billion for federal expenditures to Alabama.[17]

The nature of the up-front federal funding will make PPACA expansions too enticing for most states to refuse. The federal government will pay all costs for newly eligible Medicaid enrollees initially, and these contributions will be scaled back slowly over time. By 2020, the effective FMAP of 100% for new enrollees will be no more than 90%, *and the federal government has the authority to radically reduce the FMAP rates going forward.* While many politicians will be enticed by the initial "free" federal money, uncertainty about the future FMAP rates and the difficulty of paying for these new enrollees makes the deal anything but "free" for the states.

Upon passage of the PPACA, researchers at The Heritage Foundation estimate the following for Alabama:

> 168,000 (16.4% more) new enrollees will be added immediately.[18] Additional research by the Kaufmann Family Fund suggests that, between 2014 and 2019, somewhere between 351,000 and 456,000 new members will be added in Alabama, and the state will face an addition cost somewhere between $470 million and $693 million between 2014 and 2019 alone.[19] Assuming the federal program gets phased out as we move farther out into the future and assuming demographic trends continue, these costs will rise sharply after 2019.

Options for Medicaid Reform

The Alabama Legislature and Governor Bentley have hard choices when it comes to Medicaid. Any reduction in the state's federal matching rate threatens a fiscal crisis. Maintaining funding at current levels and expanding coverage to more people will be impossible, given Alabama's limited budget dollars. Reform will be a necessity. Fortunately, state lawmakers will not have to reinvent the wheel when it comes to Medicaid reform. Many states have introduced innovative reforms over the past decade under a waiver system established by the federal government. Given the weaknesses of the current system, several reforms offer the potential to benefit taxpayers and recipients. If Alabama lawmakers decide to get serious about Medicaid reform, one state they should look to for guidance is Rhode Island.

A. *Block Grants*

Rhode Island received approval for a waiver that effectively created a five-year block grant for its Medicaid program. In contrast with matching grants, a block grant involves the federal government transferring a set amount of money to a state. A block grant offers two advantages relative to a matching grant: first, federal dollars do not automatically increase as state spending rises, reducing the incentive to spend more; and second, states get to keep any savings from controlling costs and waste in their Medicaid program. Rhode Island was guaranteed $12 billion of federal grants (in five annual payments), and state expenditures are still at comparable levels to those under the old matching grant system. Instead of dealing with the aforementioned FMAP incentives, Rhode Island receives a known, fixed amount of federal funding through 2013, which does not increase or decrease with the number of enrollees or level of costs, or otherwise promote inefficiencies in health care.

Rhode Island's Global Medicaid Waiver of 2008 sought to control state Medicaid expenditures for the long-term and asked the CMS for greater flexibility over their program. Many skeptics expected service cuts and co-payment increases under Rhode Island's block grant system, but these have not materialized and the state has saved more than $2 billion in the program's first four years. These savings came from innovative Medicaid approaches in the state and the elimination of the FMAP incentive to drive up state expenditures in return for more federal funds. The case of Rhode Island demonstrates that a simple change to funding formulas may result in drastic differences in outcomes.

Thanks to the flexibility provided under Rhode Island's Medicaid block grant, several new initiatives for cost containment and market-based incentives have been or are in the process of being introduced. Competitive contracting and performance-based compensation, for example, are now being considered in Rhode Island.[20] The notion that Medicaid enrollees have the right to receive treatment from "any willing provider" is being waived in favor of a more responsible-user model, which requires doctors and hospitals to competitively bid for Medicaid dollars instead of being granted payments simply by being federally approved.[21] The state is developing Health Savings Accounts (HSAs) to encourage wellness and prevention. The waiver process as a whole in Rhode Island has also been simplified, resulting in a more streamlined and less bureaucratic process for changing premiums and other program details, which has also proven more effective in controlling administrative costs.[22]

With block grant funding, many innovative program changes are imaginable, such as those embraced in Rhode Island. A limit on total federal dollars available increases the potential to reduce provider reimbursement rates for hospitals, nursing homes, physicians, and pharmacies. Should reimbursement rates decline, managed care programs may become more attractive, and a shift to managed care should be seriously considered.

B. *End Program Expansions and Cap Optional Benefits*

Current law mandates that states must provide a certain set of health benefits to their Medicaid enrollees, but states retain discretion over offering many optional services. Coverage for optional populations and benefits has significantly contributed to escalating Medicaid costs in Alabama and elsewhere. For FY 2009, 20% of Alabama residents received at least one service from Medicaid, slightly more than the national average of 15%.[23]

Levels of enrollment, however, do not tell the whole story because the quality of coverage varies greatly across states. For example, Medicaid in Alabama has very strict requirements when it comes to providing coverage to low-income parents; for example, parents making more than a few thousand dollars lose eligibility. Alabama is much more in line with national trends when it comes to insuring disabled individuals, pregnant women, and children.

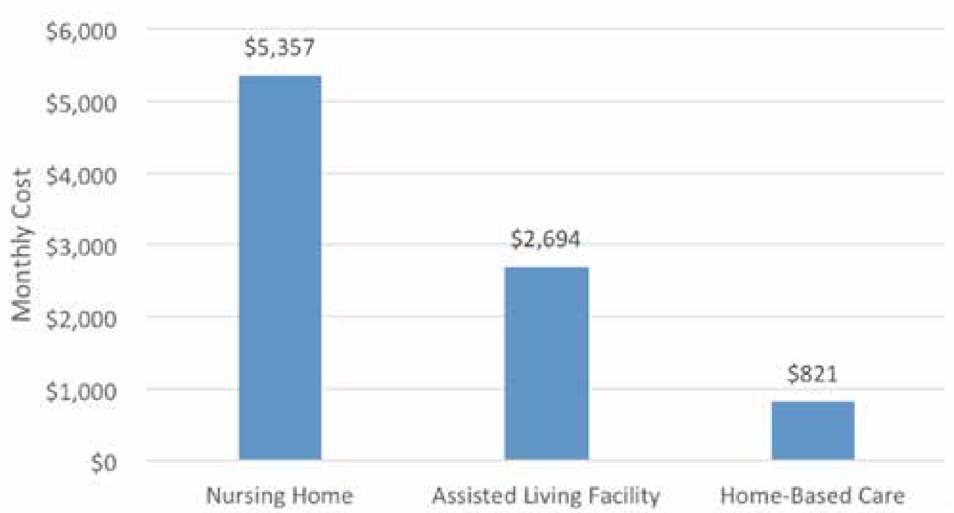
Transportation service, e.g., special vans for wheelchair-dependent Medicaid members, is an optional service which Alabama's program currently covers. Inpatient care for Medicaid patients over age 65 in institutions for mental disease and organ transplants are two other optional services that Alabama covers, but physical therapy and private nursing services are two programs Alabama currently does not cover.

Long-term Care

As stated earlier, Alabama has a disproportionately large share of aged, blind, and disabled Medicaid beneficiaries. These beneficiaries are typically dependent on long-term care, one of the largest line item expenses for Medicaid both nationally and in Alabama. For FY 2010, in fact, long-term care accounted for 29.8% of all Medicaid expenditures in Alabama. Alabama's population is older than the national average, with more than 650,000 people age 65 or older.[24] As the elderly population grows because of demographic trends, long-term care medical costs will rise as well.

Nursing facility care drives most of Alabama's expenditures for long-term care. Alabama currently spends over 60% of long-term care dollars on nursing facilities, twice the national average and a share exceeded by only three states (Michigan, Rhode Island, and Vermont). Our current management of long-term

Figure 6.2: Cost of Care Alternatives



care suffers from serious inefficiencies. Many economists and public health experts have found that community health and home health programs for long-term care provide satisfactory care at much lower costs. In New Mexico, for example, most long-term care has been shifted to a home health model; people tend to prefer this living arrangement, and it produces tremendous savings over nursing facility alternatives.

Alabama Medicaid's coverage of assisted living services is also obsolete. Assisted living offers enrollees a superior quality of life and taxpayers substantial savings in comparison with traditional nursing home care. Yet Alabama Medicaid seriously limits the number of people who are granted assisted living benefits, leaving more than 10,000 Medicaid nursing home enrollees on waiting lists.[25] Alabama's Medicaid program spent $902 million on nursing home care in 2011, and the average cost of care per person is $64,284.[26] The more than 9,000 people receiving assisted living care cost Alabama Medicaid a little more than $11,000 per person.[27]

At present, Alabama's Medicaid program does not extend beyond this very small group of assisted living patients. While the state does cover home-based care options under the Elderly and Disabled Waiver, more Medicaid recipients use nursing homes than the services offered through this waiver. Not only does Medicaid coverage of assisted living facilities and home-based care create better options for individuals, both are significantly less expensive than nursing homes. In the short run, measures to increase assisted living coverage may add to Alabama's Medicaid expenditures, depending on their utilization. Adding 1,000 assisted living patients to the 1,000 already covered in nursing homes, for example, could drive up the total cost in the short term unless additional policies were put in place to regulate the number of available beds. Over time, however, shifting to assisted living and phasing out nursing home care for all but the most extreme cases would be consistent with best practices in other states.

Figure 6.2 displays the monthly cost to Alabama Medicaid of nursing home, assisted living facility, and home-based care, and thus the potential for savings.[28 29 30] Medicaid covers nearly three quarters of Alabama's 23,000 nursing home patients.[31] Every person placed in an assisted living facility instead of a nursing home, could save the state more than $2,660 per month. Some patients will need the extensive care provided by nursing homes, but other states have a significantly higher share of Medicaid enrollees in assisted living facilities than Alabama, suggesting the potential for our state to save money. Alabama could realize savings of $29 million per year by bringing its ratio of Medicaid nursing home and assisted living facility patients in line with that of Mississippi.[32] Allowing these individuals to receive the care they need in their own homes could save $49 million per year.[33] The savings provided by Medicaid coverage of assisted living facilities and increased utilization of home-based care could be invested in other areas, bettering the quality, quantity, and distribution of Medicaid benefits. Again, any savings may, in the short-term, be offset by any increased utilization of the newly covered service.[34]

Interest groups like the Alabama Nursing Home Association, up-front cost concerns of legislators about switching to more assisted living, and a general reluctance to change have all contributed to Alabama's excessive reliance on nursing home care. The Home and Community Based Waiver of 2012 is a step in the right direction for cost containment and quality of life for those needing nursing home care. A more rapid shift to provide at-home services or assisted living facilities as alternatives to nursing home care should be one of the main priorities of the Alabama Medicaid Agency, state legislators, and Governor Bentley.[35] Alabama should combine the waiver for assisted living facilities with a continuum of care. Alabama Medicaid should also evaluate the health and economic circumstances facing each enrollee to ensure that they receive in-home assistance, assisted living facilities, or nursing home care to meet their needs in the most cost-effective manner.

Non-Emergency Transportation

The Alabama Medicaid Agency provides non-emergency transportation to eligible beneficiaries needing assistance getting to dental appointments, doctor offices, medical facilities, etc. Medicaid beneficiaries receive "reasonable" compensation for their non-emergency transportation expenses. In addition to transportation, the program also covers lodging when patients must stay over in advance of a hospital or doctor visit.

While Medicaid's non-emergency transportation coverage serves a laudable goal—helping the poor get to medical providers—the program distorts individual behaviors, encourages abuse, and results in overall inefficiencies. In many cases, cheap transportation options to a hospital or doctor exist—public buses around Birmingham, for example, cost less than $5 to ride in most cases. Under current reimbursement policies, however, recipients get reimbursed for private automobile transportation to and from the hospital or even more expensive taxi service.

The current program that leads people to think they have "free" unlimited non-emergency transportation, encouraging excessive expenses. This optional benefit could be reformed to provide eligible enrollees a certain amount of cash or credits per year to use on transportation. These credits could be carried into future years, and once they are exhausted, some co-payment from the beneficiary could be implemented. Alabama Medicaid's transportation benefit rests on well-meaning idea of ensuring that beneficiaries can get to their health care providers, it has been abused and seems out of line with other benefits the State provides to the poor. Alabama subsidizes food for poor Alabamians, but the State does not fully subsidize travel to grocery stores in the same manner it subsidizes travel to and from health care providers.

C. *Matching Service to Need*

Two common stereotypes of Medicaid beneficiaries is that they use emergency rooms for services that could be handled by a doctor or an outpatient clinic, and they use outpatient clinics excessively because there are no explicit monetary costs for them to do so. When Medicaid fails to match up enrollees with the appropriate, low-cost providers, overall expenditures rise and valuable, life-saving surgeries that could have been provided in emergency rooms are reallocated to people in less desperate need of these procedures.

Routine procedures and surgeries can be provided far more effectively and at a far lower cost by outpatient clinics and private practice doctors. Our current Medicaid system, however, favors hospitals over doctor's offices. State administrators set rates for Medicaid reimbursement, and these rates are generally lower than rates paid by the private sector. The low, complicated fee schedule results in a number of undesirable consequences that include the following:

- Lower supply of doctors servicing Medicaid patients because of the low fees;
- Uncertainty for beneficiaries about whether or not a particular doctor takes Medicaid;
- Tremendous administrative and accounting costs for offices and clinics managing Medicaid reimbursement complexities; and
- Treating Medicaid beneficiaries as second-class citizens in a traditional doctor's office.

Combined, these effects lead beneficiaries towards emergency rooms and away from doctor's offices: Why waste time shopping for a doctor who takes Medicaid when the ER will take you for "free"? And, the complex Medicaid reimbursement process and low fee schedule for Alabama doctors leaves many saying to themselves, "Why bother with Medicaid patients when the administrative costs are enormous and the reimbursement rates are far lower than those for private sector patients?"

The solution here is not necessarily to raise reimbursement rates for doctors, but, rather, to make the entire process less complex and to discourage emergency care use when private physicians are the more appropriate channel for medical needs. If Medicaid enrollees were expected to be more responsive to the incentives created by a fair system—a system with co-pays and market-based principles—everyone in the system would stand to benefit. Doctors would be more willing to schedule Medicaid patients; wait times for all patients would decline, and those most in need of emergency care would receive care more quickly. Reform not only promises benefits to non-Medicaid members, it also promises significant benefits to Medicaid enrollees themselves.

D. *Health Savings Accounts*

Several states have introduced reforms that encourage responsible habits and preventive health for enrollees. In West Virginia, a Medicaid redesign in 2007 asked enrollees to sign a pledge to take medications regularly, keep appointments, and avoid unnecessary emergency room visits. In return for making these promises, enrollees in the redesigned program were guaranteed a better set of benefits than those in the basic plan. In Texas, Health Opportunity Accounts (HOAs) have been proposed by legislators, and these accounts provide enrollees with health benefit funds that can be used toward non-Medicaid covered expenses if enrollees complete health programs, such as smoking cessation or weight loss plans.[36]

E. *Direct Purchase of Private Health Insurance*

Many of Alabama's Medicaid enrollees are eligible for private health insurance, but they choose not to pursue private alternatives because Medicaid's benefits are more generous. Reformers could look at adopting a plan that helps support the premiums for eligible enrollees. By shifting enrollees to private health insurance, taxpayers would be guaranteed that benefits were more in line with those being provided by typical private sector employees. Enrollees would also be held more accountable: decisions about when to visit health care providers would involve more cost-benefit analysis by the individuals, which is what the typical person on private health insurance does when deciding about whether or not to visit a provider.

Conclusion

Medicaid in Alabama leaves much to be desired for beneficiaries, care providers, and taxpayers. Alabama's system is not in step with many of the innovative changes being introduced across the country, and some of the more sensible things about our Medicaid program—low eligibility thresholds for poor adults, for example—are at risk of being adjusted by PPACA. Rather than continuing to be a program that reacts to budgetary shocks, Medicaid in Alabama has the potential to become a proactive, innovative leader when it comes to "best practices" for Medicaid reform around the nation.

Alabama needs to initiate reforms such as block grants, a waiver for assisted living facilities, and programs focused on healthy incentives. Medicaid is in need of a major overhaul, which should include market-based reforms. The status quo is not viable in the long-term, and taxpayers have grown weary of footing an increasingly expensive bill for Medicaid benefits that are far more generous than the benefits they enjoy in private health insurance plans. Lawmakers should seize this opportunity to reform and lead Alabama in the direction many other states are taking with Medicaid reform.

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32. At present, the annual total cost of care for 900 residents is $57.85 million (900 * $5,357 * 12). Reducing this cost to $2,694 per month would reduce the annual cost per resident to $32,328, for a savings of $31,956 per resident per year, or $28.7 million per year for 900 residents ($31,956 * 900).
33. By reducing the monthly cost per resident to $821, the state would save $54,432 per year per resident, or approximately $49 million per year for 900 residents.
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Pension Reform in Alabama: A Case for Economic Accounting

Eileen Norcross

Pension Reform in Alabama: A Case for Economic Accounting

Eileen Norcross

Summary Points

- Alabama's three major pension plans face a gap between plan assets and plan liabilities of $59 billion, or four times larger than the state's estimate. Without significant policy changes, the state could run out of pension assets to pay retirees by 2023 requiring tax increases, service and benefit reductions.
- The goal of any pension system is to provide a retirement to employees based on a formula-determined amount. Yet the defined benefit model presents the opportunity for short-sighted public officials to manipulate and defer costs through the use of actuarial techniques.
- Alabama's history of investing 10 percent of pension plan assets to attract and support Alabama-based businesses has weakened the plan's funding status. Alabama-specific investments have underperformed in recent years, highlighting the risk of using pension assets for secondary policy goals such as subsidizing economic development.
- Alabama should close the current defined benefit plan and establish a funding strategy to pay benefits earned by employees to date. A new defined contribution plan should be established for all employees.

The funding shortfall in state and local pension systems is a problem of national as well as local significance for governments, public employees, and taxpayers.

State and local governments must confront large—and as of yet only partially recognized—unfunded liabilities that will require an increasing amount of revenue to sustain. A combination of flawed accounting, poor market returns, and erratic funding policies has contributed to falling funding levels across plans, and obscured a total funding shortfall of over $4 trillion nationally.[1] By one estimate, Illinois, Connecticut, and New Jersey are projected to run out of assets to pay retiree benefits by 2020.[2]

Alabama's three pensions systems are under similar strain. By one estimate, the state may run out of pension assets by 2023.[3]

When valued based on the certainty of payment, Alabama will have to increase its contributions from $1.6 billion to $3.4 billion annually, or $819 per household, to fully fund the system.[4] Given the magnitude of pension liabilities relative to revenues, the question of whether chronically underfunded governments will seek a federal bailout of their pension systems is a subject that has garnered congressional attention.[5]

The implications of pension underfunding affect both public employees and taxpayers. More than 8 million Americans receive retirement benefits from a state or local pension plan. An additional 19 million public employees anticipate that the benefits they are currently earning will be available when they retire. With 222 state-operated plans and a further 3,196 municipal pension plans, these systems vary in terms of management, benefit size, and fiduciary policies, yet all face the same funding challenge rooted in misleading accounting.[6]

Without accounting, benefit, and funding reforms, taxpayers and citizens will be asked to shoulder a growing financial burden in the coming decade. The trade-off between fully funding pensions and providing city services is a growing dilemma for municipalities. Former New York City mayor Michael Bloomberg recently warned of the mounting budgetary trouble presented by employee benefits. Since 2002, New York City's pension costs have increased by 500 percent.[7] The pension systems of Chicago and Los Angeles are quickly swamping general funds.[8] In 2012 Springfield, the capital city of Illinois spent 20 percent of its budget on pensions, as the city simultaneously reduced services.[9] Even more alarming, rising pension costs are at least partially responsible for the bankruptcy filings of Central Falls, Rhode Island; Detroit, Michigan; and four California cities: Vallejo, Stockton, San Bernardino, and—most recently—Hot Desert Springs.[10]

Along with many other state and local policymakers, Alabama legislators recognize that pension reform is necessary to the long-term stability of the state's budget and economy. In May 2012 Alabama Governor Robert J. Bentley signed Act 377 (Senate Bill 388), reforming the Retirement System of Alabama (RSA) by decreasing employees' annual contribution and increasing the minimum retirement age. The act also made small changes in how benefits are calculated.[11] The law mainly applies to those hired after January 1, 2013. Therefore, the near-term effects on the system's underfunding are modest and are estimated to save $162 million a year over the next 30 years, for a total savings of $5 billion. In practical terms, new employees' take-home pay will increase, and their future benefits will decrease.

Such stopgap measures are not nearly enough to plug the funding shortfall facing the RSA. According to the system's actuarial reports, Alabama's three main pension systems, the Employees Retirement System (ERS), the Teachers Retirement System (TRS) and the Judicial Retirement Fund (JRF), report total assets of $28 billion and total liabilities of $42 billion for a funding gap of $14 billion, and an average funding ratio of 62 percent. This puts Alabama well below ideal level of 100 percent funding that would ensure the plan has enough assets on hand to meet its obligations to employees.[12]

Government estimates of pension plan liabilities have been widely criticized by economists for erroneously linking the value of plan liabilities to the performance of plan assets. According to economic theory, plan liabilities have an intrinsic value that is independent of the investment performance of the assets held by the fund.

This principle informs what "discount rate" plan sponsors should select when calculating the present value of liabilities. This is a calculation that is fundamental to the health of the plan since it determines how much money the sponsor should contribute today to ensure promised benefits are funded when an employee retires. Currently, Alabama values its pension liabilities—and calculates the amount needed to fund benefits—based on an 8 percent expected annual return on plan assets.

However, public-sector pension benefits are protected under state law. They represent a default-free promise to pay employees a benefit over their retired years. In terms of value and risk, public pensions are akin to government debt. When valued on this "risk-free" or fair-market basis, Alabama's pensions are in very poor shape and represent a massive debt for the state.

On a fair-market basis the total unfunded liability for the ERS, TRS, and JFR increases to $59 billion and the average funded ratio drops to 32 percent. The size of Alabama's unfunded pension liability is 37 times larger the state's debt, which totaled $1.59 billion in 2012. With a gross domestic product of $183 billion in 2012, Alabama's unfunded pension liability represents one-third of the state economy. This puts the Retirement System of Alabama (RSA) on critical footing. Absent further policy changes, the plan will run out of assets to pay retirees in less than a decade, draining a significant amount of resources from the state's budget and economy.

The actuarial approach of linking the value of plan liabilities to the expected performance of plan assets produces several behaviors that have undermined the stability of public-sector pensions. Contribution levels are affected. By undervaluing the liability, the amount calculated to fully fund the plan is underestimated. Even when the sponsor makes the full annual contribution, it is contributing too little.

Another behavior arising from muddling the values of assets and liabilities is that plan managers have an incentive to take on more investment risk in order to keep liabilities and contributions low as well as to generate excess returns to fund benefits. But shifting plan assets into higher-risk investments introduces even more funding volatility. If the assets underperform, then the plan's funding gap increases. The RSA's investment strategy mirrors the national trend. US public plans have moved away from bonds and into higher-risk equities over the last three decades.[13]

Lastly, by failing to accurately value plan liabilities, policymakers have little incentive to make the kinds of changes necessary to ensure employees are more likely to be paid the accrued benefits that they have earned.

The structure of the defined benefit plan makes it susceptible to mismanagement in the public sector. Budgetary and actuarial manipulation, opportunistic accounting practices, interest-group bargaining, and the short-term thinking of politicians render it less than ideal as a vehicle for ensuring a secure retirement for public employees.

Fortunately, there are reforms legislators and state leaders can undertake today to stabilize the current defined benefit system and improve retirement options for employees. Firstly, an accurate accounting of Alabama's defined benefit plan should alert lawmakers to the trade-offs necessary to funding benefits that have been accrued. To ensure the liability does not grow even larger, Alabama should close the current defined benefit plans and establish a defined contribution plan for employees. This will not only shift the financial risk of plan underfunding away from taxpayers, but it will also benefit Alabama employees by ensuring that they have ownership over the annual contributions made to their retirements, enhanced career flexibility, and control over their retirement savings. A DC plan can be designed to reflect the risk tolerance of public-sector employees by seeking income security for retirees and offering the option for the annuitization of savings.

This chapter provides a fair-market analysis of Alabama's three pension plans. First, the structure and policies affecting plan benefits are outlined. This is followed by a discussion of the key accounting assumptions that affect the valuation of plan liabilities, notably "the discount rate" guidance used in public-sector accounting that effectively obscures the true value of liabilities and creates unrecognized funding gaps.

A fair-market valuation of the ERS, TRS, and JRF allows for a fuller assessment of the RSA's investment strategy. This section considers various approaches taken to investing plan assets. Particular attention is given to Alabama's dual-purpose investment philosophy that dedicates up to 10 percent of the plan's pension assets with the goal of producing economic benefits for the state. Economically targeted investments (ETIs) have played a an ongoing role in state pension investments over the last 30 years, producing mixed results for plan funding. In the case of Alabama, "in-state" investments—while generating some economic activity—have in recent years performed poorly for the pension fund, creating funding gaps.

This chapter concludes with several recommendations for how Alabama can improve funding in its defined benefit plans and undertake structural reforms to meet the RSA's stated goals of "Strength, Stability and Security" for Alabama retirees and taxpayers.

The History and Structure of Alabama's Retirement System

The state of Alabama operates three pension plans on behalf of state and local employees. The Teachers' Retirement System, the Employees' Retirement System, and the Judicial Retirement Fund are commonly managed as part of the Retirement System of Alabama.

The TRS provides benefits to state-supported educational institutions. It is a cost-sharing, multiple-employer plan. Participating employers include 13 public universities, 31 post-secondary institutions, 133 city and county boards of education, and 32 state agencies.

The ERS is a multiple-employer plan and provides pension benefits for state employees, state police, and employees of municipalities and quasi-public organizations, where these governments elect to participate in the system. ERS participants include 290 cities, 65 county governments, and 518 other public entities (e.g., public works authorities, housing authorities, commissions, and libraries).

The JRF is a cost-sharing, multiple employer plan providing pension benefits to judges and justices. In 2012 there were 67 participating employers.[14]

A total of 114,050 retirees and 221,735 employees are covered by an RSA pension. **Table 7.1** shows the number of retired and active participants in each plan according to occupation.

Alabama's pension benefits

The RSA offers employees a defined benefit pension plan in retirement. A defined benefit plan provides participants with fixed monthly payments over their retired years, determined by a formula based on each employee's years of service, and a measure of final average salary (e.g., an average of the highest five years), multiplied by a percentage of salary. The employee and employer make regular contributions to plan. These contributions are invested in a mix of domestic and international equities, fixed income, and alternatives, which fund the benefit payments. Regardless of the performance of the plan's assets, the employer promises to pay the amount determined by the pension formula to the retiree. In a defined benefit plan, the employer bears the investment risk and reward. In a public-sector plan, taxpayers ultimately bear the investment risk.

The defined benefit model is in contrast to the defined contribution plan in which the final amount of retirement benefits is unknown, but is determined by the annual contributions set aside and the performance of those savings when invested. In a defined contribution plan, investment risk is borne by the employee.

Table 7.1: Retired and Active Members of the Retirement System of Alabama

Plan and Date of inception	Teachers' Retirement System (1939)	Employees' Retirement System (1945)	Judicial Retirement Fund (1973)	Total
Retirees and beneficiaries currently receiving benefits				
General	78,370	20,618	347	99,335
State Police	—	839	—	839
Local Employees	—	19,519	—	19,519
Deferred Retirement Option (DROP)	4,436	2,121	—	6,557
Terminated employees entitled to but not yet receiving benefits				
General	18,568	3,197	45	21,810
State Police	-	16	—	16
Local Employees	—	7,341	-,	7,341
Active Employees				
General	133,791	29,548	337	163,676
State Police	—	777	—	777
Local Employees	—	53,844	—	53,844
Totals	**235,165**	**137,820**	**729**	**373,714**

Source: Retirement Systems of Alabama Comprehensive Annual Financial Report for FY 2013, p. 25 (http://www.rsa-al.gov/uploads/files/2013_CAFR.pdf).

Given the growing funding gap in RSA's plans, in 2012, the state modified benefits for new hires. Tier 1 members—or those employees hired before January 1, 2013—will contribute more to their plans, but maintain a higher benefit multiplier and thus more generous retirement payouts. Tier II employees will contribute less of their salary to the pension plan, increasing their take-home pay. However, newer hires are subject to lower benefit multipliers and higher retirement ages, effectively decreasing the size of their retiree benefits.

Unfortunately, these reforms are insufficient to close the funding gap. Government accounting standards (and actuarial methods) fail to fully capture the value and funding status of public-sector plans. On an economic-accounting basis, funding shortfalls in public pensions are far greater than current government accounting methods recognize.

1. The Accounting Error that Compromises the Funding of US Public-Sector Pension Plans

A defined benefit pension plan is fully funded if plan assets are equal to plan liabilities. A funding gap emerges in the plan when liabilities exceed assets. The plan's funding ratio is the portion of the liability that is covered by assets. It is calculated by dividing plan assets by plan liabilities. **Table 7.2** shows these basic measures for the RSA. Columns 1 through 4 report the unfunded liability and funding gap under government accounting conventions in the RSA's actuarial reports.

On an actuarial basis, the RSA's three main plans hold $28 billion in assets and $41 billion in liabilities for a funding gap of $14 billion. Plan assets cover only 65 percent of plan liabilities, leaving 35 percent of the plan unfunded.

Table 7.2: Key Features of ERS and TRS

	ERS	ERS State Police	ERS Other law enforcement	TRS
Vesting				
Tier I (pre- July 30, 1979)	25 years of creditable service, or Age 60 with 10 years of credited service	Age 52 with 10 years of creditable service	Age 60 with 10 years of creditable service	25 years of creditable service, or Age 60 with 10 years of creditable service
Tier II (post-July 30, 1979)	Age 62 with 10 years creditable service	Age 56 with 10 years of creditable service	Age 56 with 10 years of creditable service	Age 62 with 10 years of creditable service
Final Average Salary				
Tier I	Highest five of last 10 years	Highest five of last 10 years	Highest five of last 10 years	Highest five of last 10 years
Tier II	Highest three of the last 10 years	Highest three of the last 10 years	Highest three of the last 10 years	Highest three of the last 10 years
Service Multiplier (applied to years of creditable service)				
Tier I	2.0125% of Final Average Salary	2.875% of Average Final Salary	2.0125% of Final Average Salary	2.0125% of Final Average Salary
Tier II Benefits capped at 80% of Final Average Salary	1.65% of Final Average Salary	2.375% of Average Final Salary	1.65% of Final Average Salary	1.65% of Final Average Salary
Employee Contributions				
Tier I (effective October 1, 2012)	7.5%	10%	8.5%	7.5%
Tier II (effective for those hired after January 1, 2013)	6%	10%	7%	6%
Disability Retirement allowance formula (Percent of Final Average Salary multiplied by years of creditable service)	Granted to a member with 10 or more years creditable service who becomes permanently incapacitated before reaching retirement			
Tier I	2.0125% of FAS * years of creditable service.	2.875% of FAS * years of creditable service	2.0125% of FAS * years of creditable service.	2.0125% of FAS * years of creditable service.
Tier II (capped at 80% of members' FAS)	1.65% of FAS * years creditable service	2.375% of FAS * years of creditable service	1.65% of FAS * years creditable service	1.65% of FAS * years creditable service

Source: *Retirement Systems of Alabama Comprehensive Annual Financial Report for FY 2013, pp. 80–82 and 94–99 (http://www.rsa-al.gov/uploads/files/2013_CAFR.pdf).*

However, these measures are based on an accounting flaw, embedded in all US public-sector pension plans, that miscalculates plan liabilities by linking their value to the expected performance of plan assets.

Comparing the performance of a pension system's assets and liabilities first requires transforming the liability into its present value. The pension liability is a formula-determined benefit that is promised to the employee in the future. It is funded by contributions and the interest earned (the time value of money) on those contributions over the working life of the employee. Determining the present value of pension liabilities requires "backing out" the interest earned over that future period, a calculation known as "discounting the liability," or reverse compound interest. Discounting requires selecting a rate of interest to transform the future value into a present value. The subject of how to select this interest rate is the source of much controversy in US public-sector accounting, but it is a straightforward matter for economists.

Economic theory holds that the value of a liability—a stream of future cash flows—Is independent of the value of the assets used to finance that liability.[15] The present value of a liability should be calculated based on the risk and timing of the payments of that liability. Government pension plans, protected by state law and constitutions, offer workers a guaranteed payment, certain to be paid over a specific period of time. The discount rate selected should reflect the legal protections and timing of benefit payments. Alabama law protects accrued benefits for vested employees who are eligible to retire.[16] A vested employee's earned benefits are akin to a government debt. If Alabama law implies a "default-free" promise to pay vested workers earned pension benefits, an appropriate match to value the liability is the *notional* yield on a 15-year Treasury bond.[17] Fifteen years represents the median or average duration of a plan with a mix of active and retired members. Current Treasury yields are at historic lows. As of September 2013, when the last actuarial valuation of the RSA was performed, the yield on a notional 15-year Treasury bond was 3.12 percent. Mathematically, lowering the discount rate increases the liability's present value, and thus the contributions necessary to fund the plan.

To date, the approach of US public-sector plans is informed by Government Accounting Standards Board (GASB) 25 guidance that suggests that plan actuaries select a discount rate to value plan liabilities based on the expected return on pension fund assets.[18] Alabama assumes an annual return of 8 percent on plan investments and uses this to calculate the present value of the plan's liabilities. According to economic theory, the expected performance of the plan's assets is completely unrelated to the *value* of the plan's benefits. This distinction between the value of assets and the value of liabilities is vital to the health of the plan because regardless of the performance of the plan's assets, the liability must be paid over a specific period of time. Under current GASB accounting, "There is a mismatch between the plan's legal requirement to pay benefits and its probability of being able to do so."[19] That is, the liability must be paid even if the assets do not generate an 8 percent annual return. This, "contingent liability," the risk that the assets do not return as expected, is unrecognized in GASB accounting.

By way of analogy, government accounting guidance implies that the value of a home mortgage can be calculated based on the expected performance of the mortgage-holder's 401(K) plan. In effect, GASB 25 suggests it is possible for mortgage-holders to pay only a fraction of their monthly mortgage by assuming high returns in their investments, believing this will still result in the mortgage being fully paid off on schedule.

The practical result of the approach suggested by GASB 25 is shown in columns 5–7 of **Table 7.3**. On a fair-market basis—that is, when the liability is valued on a default-free basis—Alabama's unfunded pension liability is $59 billion and the funded ratio is 32 percent.

One implication of applying GASB 25 for several decades to calculate liabilities and contributions is that in spite of Alabama's good track record of making the full actuarial contribution to the plan, this contribution is calculated based on high-risk asset returns, and is thus too little to fully fund the system. Unfortunately, good funding discipline cannot undo the effects of distorted accounting. Alabama runs the serious risk of moving to a PAYGO system over the next several years, presenting lawmakers with the possibility of needing to raise taxes to fund retiree benefits in the near future.

Effective in June 2013, public pensions will report their liabilities based on a new GASB rule, known as GASB 67. An attempt to reach a compromise between the actuarial and economic approaches, GASB 67 allows plans to use the expected return on assets to value the funded portion of the liability. The unfunded portion is to be valued based on a lower-risk, high-quality municipal bond yield. The change only applies for reporting, and not contribution purposes. While plans with deep funding gaps will show greater pension shortfalls in their financial reports under GASB 67, it will not affect funding decisions. Further, the new rule continues to undervalue a portion of

Table 7.3: FY 2013 Schedule of Funding Progress: Actuarial vs. Market Valuation ($000)

	Total Assets (a)	Total Liabilities (b)	Unfunded Liability (b–a)	Funded Ratio (a/b)	Fair Market Value Liability (c)	Fair Market Value Unfunded Liability (c–a)	Fair Market Value Funded Ratio(d)
ERS	$9,116,551	$13,884,995	$4,768,443	66%	$27,781,679	$18,665,128	33%
TRS	$18,786,008	$28,251,367	$9.465,359	66%	$56,526,518	$37,740,510	33%
JRF	$234,300	$380,469	$146,170	62%	$761,259	$526,960	32%
Total	$28,136,858	$42,516,831	$14,379,972	65%	$85,069,457	$59,932,598	31%

Author's Calculations based on plan actuarial valuation reports. Retirement Systems of Alabama Comprehensive Annual Financial Report for FY 2013 (http://www.rsa-al.gov/uploads/files/2013_CAFR.pdf).

the liability—the portion backed by assets—and will persist in producing artificially inflated funding levels.[20]

II. The Implication of Fair-Market Valuation of Liabilities for Plan Asset Investments

Perhaps the most distortionary effect of valuing plan liabilities based on expected asset returns is that plan sponsors believe that a risky portfolio "helps pay for the plan" by lowering plan expenses and contributions on the books. But there is a real risk that if the assets do not realize the expected return, the plan will be left with a funding gap. Recent recessionary periods show the consequences of chasing risky investments to fund public pensions. Over the last decade, public-sector plan fiduciaries have taken on more investment risk to make up for market losses, in a stark contrast to how pensions were funded in an earlier period. The shift helps to explain why traditionally safe pensions are now a highly volatile experience for employees, governments and taxpayers.

In the 1950 and 1960s, pension plans were primarily invested in low-risk bonds, which more closely match the risk characteristics of the liability. Effectively, pension funds' heavy investments in bonds helped to neutralize the effects of flawed governmental pension accounting.

Beginning in the 1970s, both private and public pension plans began to move away from legal lists in selecting pension plan investments in favor of a "prudent person" standard which requires the plan fiduciary to act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity" would act, "when selecting investments.[21]

Public pension portfolios have changed significantly in the last 30 years. US public plans have taken on greater levels of investment risk than private plans.[22] **Figure 7.1** shows the trend away from fixed income and toward equities between 1984 and 2011 in US public-sector pension plans.

Between 1984 and 1995, public plans portfolios held on average 38 percent of assets in equities, 5 percent in alternative investments, and 50 percent in fixed income (i.e., bonds). In the period leading up to the Great Recession, 2001–2007, this mix changed sharply with funds holding 60 percent of assets in equity, 10 percent in alternatives, and 29 percent in fixed income. The exposure to higher-risk investments resulted in a $1 trillion loss between October 2007 and October 2008.[23]

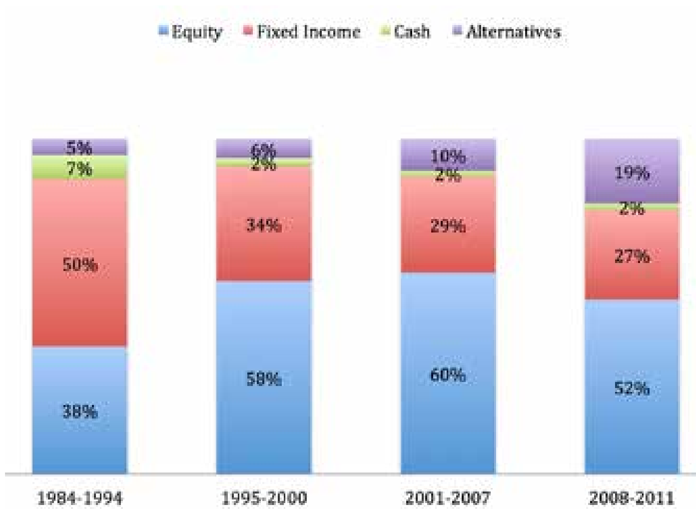
Remarkably, these steep losses have not changed the general approach of many public-sector fund fiduciaries. The desire to make up for losses may account for another dramatic shift in plan investments, including a larger exposure to alternatives. Between 2008 and 2011, public plans, on average, have invested 52 percent of their assets in equities, 19 percent in alternatives, and 27 percent in bonds.

Alabama's pension investment strategy mirrors the national trend. **Figures 7.2** and **7.3** show the asset composition of the ERS and TRS over the last decade. Between 2001 and 2011 the RSA shifted the proportion of fixed income from of an average of 41 percent holdings to 26 percent, and increased investments in equities from an average of 44 percent to 60 percent.[24]

Linking liability valuation to asset performance leads plan fiduciaries to believe that greater levels of investment risk will lower plan contributions and improve funding levels.[25] It is often expressed as the idea that the plan must "get" a "required rate of return," to ensure the plan is funded.[26] This can be seen in the RSA's Quarterly Economic Report (March 19, 2013), which points to Fed policy as "putting the defined benefit plan in a checkmate type situation."[27] Low yield on 10-year Treasuries (2 percent) "puts an extra level of burden on the equity side. If rates go lower from here, it simply makes the long-term checkmate problem that much worse. This is perhaps the biggest issue facing defined benefit pension plans in the current area given the very low level of risk-free interest rates."[28]

The problem with this line of thinking is that plans do not "get" the return they assume they will achieve, but a "highly random and uncertain draw from an increasingly wide distribution of possible returns."[29] More investment risk introduces greater volatility and a greater than 50 percent chance that assets will underperform, leaving the plan with a funding

Figure 7.1: US Public Pension Funds, Asset Investment Composition, by Decade, 1984–2011

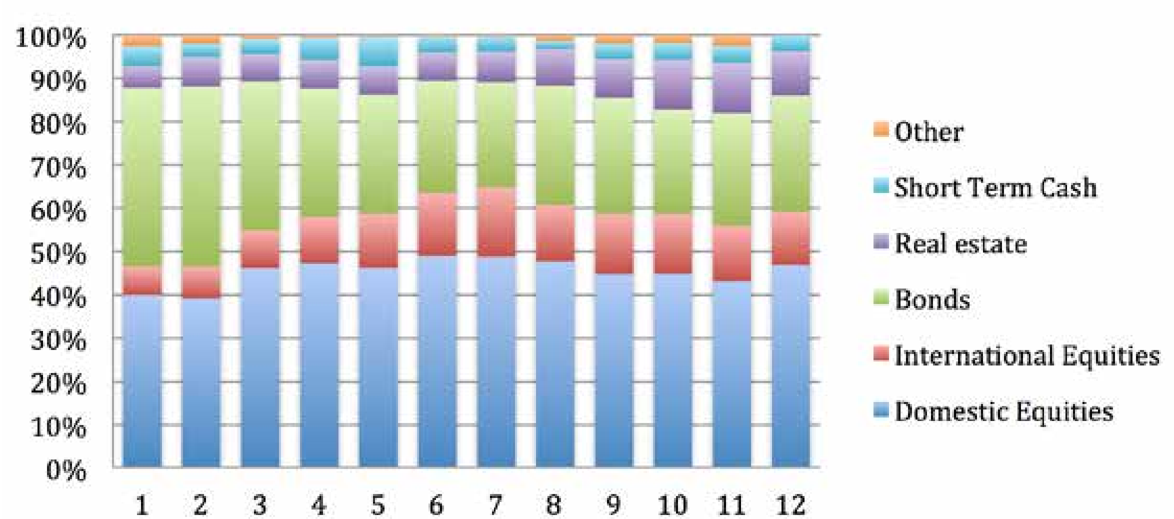


Source*: Pensions & Investments, Databook, 2012.*

gap. Related to that is the fact that the expected return on the portfolio doesn't change the amount that's needed to fund the system each year. Paying for a defined benefit pension plan simply requires that an accurately calculated contribution—one that amortizes the cost of future benefits over a period of years—be made to the plan.[30] How the liability is financed doesn't change the payments that are required to fully fund the plan.

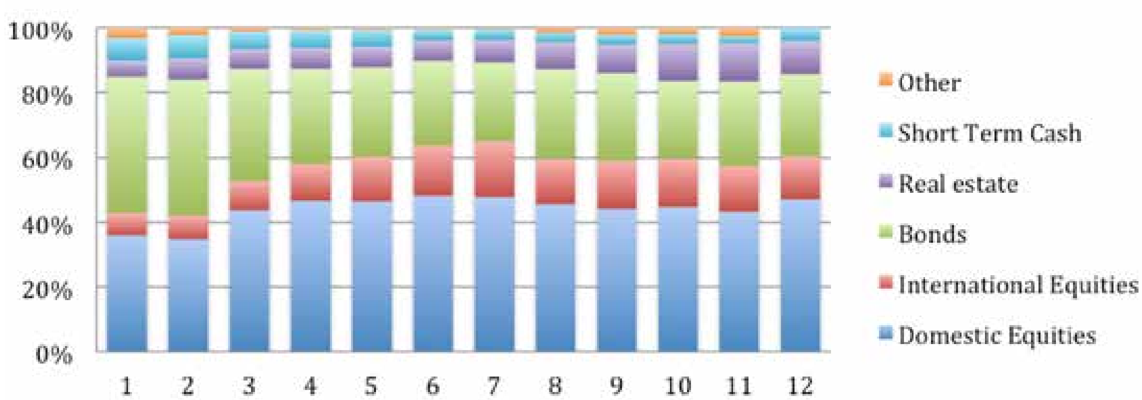
RSA investments are governed by the Boards of Control of the ERS and TRS consisting of eight ex-officio members, sixteen elected members, and two appointees. The board invests under a prudent person standard and under legal limits that cap how much of the portfolio can be dedicated to particular asset classes.[31]

Figure 7.2: Employee's Retirement System of Alabama Asset Investment, 2001–2012



Source: Author's Calculations based on The Center for Retirement Research at Boston College, Public Plans Database, http://crr.bc.edu/data/public-plans-database/.

Figure 7.3: Teachers' Retirement System of Alabama Asset Investments, 2001–2012



Source: Author's Calculations based on The Center for Retirement Research at Boston College, Public Plans Database, http://crr.bc.edu/data/public-plans-database/.

The RSA's investment strategy is driven by the vision of Dr. David Bronner, CEO of the RSA. When he assumed the role in 1973 the plan was deeply underfunded. To improve funding of the pension plan, Bronner believed he needed to improve Alabama's economy. Based on this insight a "dual-purpose" investment strategy was devised to use pension plan assets to lure business to the state: "the stronger I can make the state of Alabama, the stronger I can make the pension fund."[32]

Under his direction, the pension investment strategy has three stated goals: (a) asset management and benefit provision, (b) the use of direct investments to facilitate industry recruitment and expansion, and (c) the promotion of tourism, a goal for which the RSA spends $54 million a year for TV, print, and billboard ads.[33] Ten percent of the RSA's portfolio is invested in attracting and supporting Alabama-based businesses. Pension funds have been used to back as many as 50 businesses, including a Wal-Mart distribution center and the headquarters of RayCom Media. Bronner's most high-profile economic-development project was launched in 1993: a $180 million investment in a dozen golf courses, known as the Robert Trent Jones Trail.

Using pension fund contributions to make ETIs raises the question of whether it is a responsible strategy. Should pension contributions be used for reasons other than ensuring the plan is fully funded? Is the plan subsidizing pet projects that would not survive otherwise, in exchange for lower returns on the pension fund? ETIs became widespread in public pension plans in the late 1980s.[34] Today, state pension plans hold three times as many "in-state investments" at 9.7 percent of their portfolios as do other institutional investors.[35] ETIs can be evaluated based two criteria: (a) do they deliver competitive returns for the pension plan and (b) do they produce other benefits such as local economic growth.

Brown, Pollet, and Weisbenner find that ETIs generate excess returns for a sample of 20 plans—where those investments consist of smaller stocks that represent a primary industry for the state.[36] A subsequent study by Holberg and Rauh examines the performance of specific classes of assets, and finds that pension funds' in-state investments underperform and reduce pension plan resources by $1.2 billion annually.[37]

These studies only assess ETI's investment performance. The second question is whether ETIs—even if they underperform as investments—provide other benefits such as increased jobs, income, or tax revenues for the state that would have not otherwise occurred. Two RSA-commissioned reports make the case that the RSA's use of pension funds to promote state economic growth has been a boon to the state. The $5.6 billion invested between 1990 and 2011 in Alabama-alternatives such as golf courses and business loans, is claimed to have generated $1.1 billion in tax revenues, $28 billion in gross state product by $28 billion, and 282,000 jobs.[38]

The RSA-commissioned reports are based on a common defense of ETIs by governments. The plan fiduciary might be able to accept a lower investment return in the pension fund if the investments produce economic gains for the state.[39] These "secondary benefits" are argued to also help plan beneficiaries indirectly by ensuring there will be enough tax revenues available to make up for any losses that might result from a less-than-competitive return on such investments for the fund itself.[40]

However, this logic covers up a real fiscal hazard of gambling with pension contributions. If the state's economic activity is correlated with the performance of in-state stocks, the pension plan will suffer should the investments fail—at precisely the worst moment—when tax revenues and economic activity

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Figure 7.4: Detailed RSA Investment Returns

Investment Returns / **2012**

For the period ended September 30, 2012 (Percent)

	1-YEAR	3-YEARS	5-YEARS	10-YEARS
TOTAL DOMESTIC EQUITY				
TRS	28.27	12.95	1.26	8.45
ERS	28.08	12.88	1.23	8.46
JRF	30.36	13.57	1.55	8.47
TOTAL INTERNATIONAL EQUITY				
TRS	14.99	2.76	-4.22	8.97
ERS	15.05	2.78	-4.17	8.98
JRF	14.88	3.07	-3.39	n/a
TOTAL FIXED INCOME AND ALTERNATIVES				
TRS	10.11	8.02	1.40	4.51
ERS	10.16	8.17	0.48	4.12
JRF	5.53	6.64	5.91	5.62
TOTAL RSA RETURNS				
TRS	18.30	9.30	0.35	6.46
ERS	18.01	9.37	-0.04	6.22
JRF	19.01	9.80	2.60	6.84
BENCHMARKS				
S&P 500	30.20	13.20	1.05	8.01
DJIA	26.52	14.45	2.17	8.59
MIDCAP 400	28.54	14.33	3.83	10.77
SMALLCAP 600	33.35	15.14	3.29	10.74
MSCI EAFE	13.75	2.12	-5.24	8.20
CITIGROUP BIG	5.12	6.04	6.69	5.46
BARCLAYS	5.16	6.19	6.53	5.33

dip.[41] Put another way, a Texas pension plan may not want to overweight its holdings in oil stock. And in fact, it may want to go short on such positions, hedging the plan's pension liability against a failure in a prominent sector of the state economy. The fiduciary would want to ensure the fund does not lose value at the same time the state is experiencing fiscal and economic pressure. Investment losses lead to funding gaps. "Concessionary returns" translate into the potential for future tax hikes to pay for unfunded pension liabilities.

Dr. Bronner acknowledged this risk in 2012. The TRS's asset performance was trailing that of other states, a factor he attributed to the Alabama-specific investments.[42] This highlights the danger of investing assets for reasons other than funding plan benefits. The RSA may claim economic benefits were generated by using pension funds to invest in Alabama over a twenty-year period, but it has also exposed the pension to more risk and the chance that if these investments fail, so will the tax revenues they generate, making it more difficult to fund the system, shifting the funding burden for past public service to future generations.[43]

Of related concern is how the RSA showcases its Alabama-centric investment returns in its annual reports—emphasizing the "golf-course strategy" with glossy marketing and selective financial reporting that combines returns on fixed income and "alternatives" obscuring the performance of the Alabama-specific investments.[44] On a combined basis, fixed income and alternatives returned 10 percent on a one-year basis and 4.5 percent on a ten-year basis for both the TRS and the ERS (see **Table 7.3**). The graphic below is taken from the RSA's 2012 Annual Report. Twelve pages are dedicating to promoting golf courses and resorts but no information is provided in this report on the specific performance of Alabama-based investments, many of which are classified as "alternatives," for the plan.[45]

To know the performance of fixed income versus alternative investments, the RSA's Quarterly Economic Updates give a slightly more detailed breakdown.[46] **Table 7.4** shows the rates of return for the TRS and ERS over the period in specific asset classes. Alternatives performed significantly worse than fixed income over a one-year, three-year, and five-year period for both systems. However, even this breakdown does not provide enough detail to assess the performance of Alabama-based investments, since these are distributed in different categories including alternatives, private placements, and fixed income, according to other sources.[47]

Table 7.3: Returns on Fixed Income and Alternatives in TRS and ERS

Period Ending January 2013	FY To Date	1-Year [50]	3-Year	5-Year	10-year
TRS Fixed Income	1.0	9.8	9.93	3.85	6.57
TRS Alternatives	0.1	7.78	2.27	-4.84	n/a
ERS Fixed Income	1.02	9.9	10.1	3.69	6.49
ERS Alternatives	0.05	8.01	2.9	-6.37	n/a

Source: RSA Quarterly Economic Update, March 19, 2013, Macroeconomic Commentary.

The RSA's approach to pension plan investments, as well as its approach to financial reporting, flows from the fiction that plan liabilities can be lowered and funding improved by risky investments, that chase a "required" 8 percent annual return. The pressure to pursue risk in public-sector pensions is a direct result of muddling the value of liabilities with the expected performance of plan assets. But if liabilities should be valued like bonds, then how should the fiduciary invest the assets? A risk-free discount rate to value plan liabilities does not imply that the fund should invest exclusively in US Treasuries, and in fact there may be a role for riskier investments, such as equities.[48] This kind of investment approach can only work if economic accounting is put into effect. The liability must be valued according to the risk and timing of benefit payments. And the asset investments must hedge against the risk that the liability will change in value due to wage increases or inflation and interest rate fluctuations, a concept developed in the next section.

V. Investing assets to fund employee benefits

Current government accounting implies that if public-sector plans embrace more investment risk they can achieve better funding levels. However, the plans may achieve the expected returns, and they may not. A 10 percent decline in the market translates into a 10 percent increase the plan's funding gap. Risky asset portfolios do not "help to pay for the plan" by lowering pension expenses and contributions. This can only happen if returns are equal or greater to the discount rate. If they fall short, the plan will require higher rather than lower contributions.[49]

The role of the pension plan fiduciary should be to ensure the plan is fully funded for employees and that the burden of funding the plan is not shifted to future generations. The fiduciary must hedge against the risk that the liability may change in value due to wage increases, or fluctuations in real interest rates and inflation. The portfolio that hedges against these risks is called a Liability Matching Asset Portfolio (LMAP).[50]

In addition, the fiduciary may hold a second portfolio consisting of risky assets, called a Risky Asset Portfolio (RAP). The size of the RAP depends on the investor's tolerance for risk. This risk is rewarded with an expectation, but not a guarantee, of returns greater than the risk-free rate. RAP investments do not give sponsors a pass to "anguish over the best new asset class to add to their portfolio—from venture capital, hedge funds, alternatives and infrastructure to exotic betas."[51] Instead, RAP should represent the market capitalization-weighted portfolio of all risky assets.[52]

Pennacchi and Madhi test what an ideal portfolio for a public-sector pension plan might consist of if the liabilities are properly valued on a default-free basis, and if the assets are invested to hedge against the risk that the liability will change in value due to wage increases, or interest rate/inflation fluctuations.[53]

If the pension fund's liabilities are nominal and no COLAs are provided a "risk-minimizing allocation" would consist of a 9 percent short position in equities, a 160 percent allocation to fixed income, a 24 percent allocation to private equity and a 27 percent short position in hedge funds. This implies the fund should borrow via short positions in other categories to increase investment in US fixed income securities.

Today, Alabama invests its pension plan assets in the belief that greater risk will produce lower funding levels. But risk taken with the pension assets translates directly into funding risk. As with all public-sector pension plans, liabilities are mismeasured and assets are invested heavily in high-risk categories because the ledger is muddled, creating dramatic "funding disequilibrium." The only way to resolve this disequilibrium this is through an economic accounting that values the liabilities as though they are intended by law to be paid; and that invest the assets with a view to minimizing the risks that the liability may change in value, as wages, or interest rates and inflation change.

The RSA fiduciaries worry that low yields on Treasury bonds will prevent the system from achieving a "required rate of return." And disappointing returns on Alabama-specific investments may be leading the system to mask their true financial performance in reports. This points to the flawed logic at work in public pension accounting, which encourages fiduciaries to pursue high returns in order to lower funding levels, as well as the danger of using the pension fund to pursue other policy aims. These behaviors underscore the importance of economic accounting, of the liability, and also of changing the fund's asset investment strategy by shifting to a Liability-Matching Portfolio, though given the size of the funding gap, this alone will not be sufficient to save the system. A combination of increased contributions and benefit reductions will be required to make up for years of insufficient contributions.

VI. Stabilizing and Securing Employee Retirement in Alabama

The defined benefit pension is essentially an annuity,[54] in which the employer promises to pay a predetermined amount to the employee over the employee's retired years.

The employer's responsibility is to accurately calculate the amount needed to fund the payments and to make the contributions necessary to ensure benefits are paid in full. However, public-sector accounting guidance and changed investment practices, coupled with politicians' incentive to push spending obligations to the future, has shown that governments are poorly suited to investing, managing, and operating retirement systems for employees. In addition, technical accounting techniques and assumptions leave employees at an informational disadvantage about the true funding status of their retirement benefits.

These two features of defined benefit plans—the incentive of politicians to obscure costs and underfund the system coupled with the informational disadvantage of employees—points to a classic "Principal-Agent problem" in public-sector pension systems.[55] Studies indicate that in some cases, governments may adopt actuarial assumptions to reduce annual payments, or obscure the true size of unfunded pension obligations.[56] Accounting sleights-of-hand in defined benefit plans allow governments to avoid full funding since, much like payment on a long-term debt, contributions can be deferred: "when a budget deficit occurs, it is likely governments will rely on pension contributions to solve budget problems."[57] Even if governments are legally bound to make the full contribution each year, accounting techniques without any basis in economic theory or financial practice can be employed to alter the value of the liability and adjust the annual payment to suit the sponsor, effectively suppressing part of the obligation and pushing payment into the future.[58]

This is not true of the defined contribution plan, where the sponsor must make the full contribution to the employee's retirement account each year. The employer's contribution to a defined contribution account is guaranteed, the investment performance and final amount available in retirement is not. The shifting of investment risk from the government (more accurately, the taxpayer), to the employee in a defined contribution plan is likely a reason why some advocacy groups, including unions, resist the move away from the defined benefit model, where risk can be shifted to taxpayers. But it also indicates a concern that employees or employers may contribute too little to individual retirement savings, investments may perform poorly, or individuals may make uninformed financial decisions, through risky investment or tapping into retirement savings and putting their retirement income at risk. To this end, a new retirement system should be structured to offer workers the best elements of both plan designs with a focus on income security rather than wealth maximization.

Firstly, Alabama public workers should be offered control over their own retirement savings and discretion over how their savings are structured. To that end, the state should close the defined benefit system and devise a funding strategy to honor the benefits earned to date. A new defined contribution plan should be established for all workers.[59] In addition to ensuring that the state makes annual contributions to employees' retirement accounts, the DC plan has several other features that make it an attractive retirement option for workers. Employees are fully vested in their contributions. Employee ownership over retirement contributions permits both investment and career flexibility in that the DC plan allows the employee to change jobs without losing retirement benefits.

A DC plan's investment strategy can be designed to reflect the risk tolerance of individuals within the public-sector workforce. Specifically, the DC plan may include the option to invest in a life-cycle fund, which automatically adjusts to more conservative investments as the employee approaches retirement. The DC plan may also give employees the option to partially annuitize their retirement savings. Automatic enrollment and a robust contribution level set for employers would help to ensure that employees are setting aside sufficient savings for retirement.[60]

It has been noted that a retirement system's goal should focus on income security as opposed to wealth maximization.[61] To meet the goals of "Safety, Security and Stability" in retirement for Alabama employees, the management and financial stewardship of a newly established retirement system should be shifted out of the government. Such a change does not preclude allowing employees a variety of options in how to structure their retirement savings—which should reflect the risk tolerance of individuals—instead, transitioning out of a government-managed DB plan eliminates the perverse incentives, political gaming, and flawed accounting that has undermined the certainty of a public-sector pension for retirees.

Recommendations

There are several principles Alabama should follow to improve the funding of the current DB system while ensuring workers have more options and ownership over their retirement savings.

1. Fair-Market Valuation. only an economic accounting of the liability can provide a true picture of plan funding status and indicate the amount of contribution necessary to fully fund the system. Alabama should value the plan liability based on the likelihood of benefits being paid under Alabama state law. The discount rate chosen should match the risk and timing of plan payments, such as the yield on US Treasury bonds.

2. Close the Defined Benefit plan to new hires. New hires should be shifted to a defined contribution plan—an option that should be extended to current workers. Each day the system remains open, Alabama's liability for public-sector workers increases. As managed to date, the DB plan presents an active risk to taxpayers and an uncertain future for employees. Employee contributions have been invested for purposes other than ensuring full funding. Ancillary economic benefits do not justify state speculation with employee contributions. The new Defined Contribution plan can incorporate design elements of the DB plan including automatic enrollment, investment in life-cycle funds, and the option for partial or full annuitization.

3. Develop a strategy to fund earned benefits that have been earned to date. Given the size of the funding gap, increased contributions will be necessary, as will be possible changes to benefit formulas.

4. Change the asset investment strategy in the Closed Defined Benefit plan. The asset investment strategy should hedge the risks present in the liability. This means adopting a portfolio that matches investments with the risk of the liability changing due to wage changes or interest rate/inflation fluctuations. High-risk investments do not make up for losses with certainty. They come with the risk of funding gaps. The volatility of investments affects the volatility of funding.

5. Improve disclosure. Current reporting on the Alabama pension system does little to clarify the true performance of the plan for employees. Alabama's annual pension reports market golf tourism to a distracting degree. The reports' emphasis on tourism reveals a skewed fiduciary philosophy that views pension contributions as a source of lending for pet projects and state economic investments. Pension reports should clearly indicate funding status and investment performance for employees and the public.

Conclusion

Alabama's pension system is deeply underfunded for reasons that extend to all state and local pension plans in the United States. The valuing of liabilities based on expected asset returns results in unrecognized funding gaps, due to insufficient contributions and risky investment policies. In addition this accounting mishap encourages plan fiduciaries to embrace greater investment risk to make up for losses. The RSA has increased its exposure to high-risk investments over the decade. In addition it has used plan contributions to attract business to Alabama. The secondary economic benefits of such economically targeted investments have come at the price of poor investment performance for the pension fund. Effectively, Alabama has subsidized economic development with employee pension contributions, and passed on the risk of higher taxes and lower benefits to Alabama residents. The only way for Alabama to fix its pension funds is to close the current DB system, fully account for plan liabilities, and uncover how much will be required to pay for benefits earned to date. The state of Alabama should establish a Defined Contribution plan for employees, eliminating the risk of political manipulation of retiree benefits, and ensuring younger workers have more control over their retirement savings.

Notes

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2. Joshua D. Rauh, "Are State Public Pensions Sustainable? Why the Federal Government Should Worry about State Pension Liabilities," May 15, 2010, available at SSRN: http://ssrn.com/abstract=1596679 or http://dx.doi.org/10.2139/ssrn.1596679. This estimate presumes pension plans earn an assumed rate of return of 8 percent annually on pension investments.
3. ibid, p. 3 and p. 26
4. Joshua D. Rauh and Robert Novy-Marx, "The Revenue Demands of Public Employee Pension Promises," September 16, 2012, available at SSRN: http://ssrn.com/abstract=1973668 or http://dx.doi.org/10.2139/ssrn.1973668. P. 3 and p. 48.
5. See "State and Municipal Debt: The Coming Crisis?," testimony to the House Committee on Government and Oversight Reform, February 9, 2011 (http://mercatus.org/sites/default/files/Norcross-2-9-11_Testimony.pdf); "State and Municipal Debt: Tough Choices Ahead," testimony, April 14, 2011 (http://oversight.house.gov/hearing/state-and-municipal-debt-tough-choices-ahead/).
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8. Steven Malanga, "Bailouts of Cities? Advocates for Cash-Strapped Municipalities Want Washington to Clean Up Their Mess," City Journal, Autumn 2013, http://www.city-journal.org/2013/23_4_snd-bailouts.html.
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10. Rick Lyman and Mary Williams Walsh, "Police Salaries and Pensions Push California City to the Brink," New York Times, December 27, 2013, http://www.nytimes.com/2013/12/28/us/police-salaries-and-pensions-push-california-city-to-brink.html?_r=0.
11. http://www.ncsl.org/issues-research/labor/highlights-pension-reform-2012.aspx.
12. Richard Dreyfuss, "Fixing the Public Sector Pension Problem: The (True Path to Long-Term Reform)," Civic Report No. 74, February 2013, CSLL at Manhattan Institute.
13. The investment behavior of US public plans may be compared to US private plans and public and private plans in Canada and Europe where liability discount rates are not selected based on expected asset returns. Andonov, Bauer, and Cremers find that between 1993 and 2010, US public-sector defined benefit plans "uniquely increased allocations to riskier investments to maintain high discount rates, thereby camouflaging the degree of underfunding." See Aleksander Andonov, Rob Bauer and Martijn Cremers, "Pension Fund Asset Allocation and Liability Discount Rates: Camouflage and Reckless Risk Taking by U.S. Public Plans?" (May 1, 2013), available at SSRN: http://ssrn.com/abstract=2070054 or http://dx.doi.org/10.2139/ssrn.2070054.
14. Retirement Systems of Alabama Comprehensive Annual Financial Report for FY 2013, p. 24, http://www.rsa-al.gov/uploads/files/2013_CAFR.pdf.
15. This new multiplier to calculate benefit payments also applies to firefighters
16. Prior to October 1, 2011 Tier I members contributed ERS members contributed 5% of salary. Full-time police officers, firefighters and correctional officers contributed 6% of salary. These employee contribution levels were raised on October 1, 2011 to 7.25% for ERS members and 8.25% for police, firefighters and correctional officers. These are the rates that apply to all Alabama Tier I employees or those hired before January 1, 2013
17. The valuation of pension liabilities flows from the Modigliani-Miller Theorem, which holds that the liability—a stream of future financial payments—is independent in value from the assets used to finance or pay for that liability. See F. Modigliani and M. Miller, "Corporate Income Taxes and the Cost of Capital: A Correction," *American Economic Review* 53, no. 3 (1963): 433–43. For a layman's summary, see Anne P. Villamil, "Modigliani-Miller Theorem," *The New Palgrave Dictionary of Economics*, 2nd ed., 2008, http://www.econ.uiuc.edu/~avillami/coursefiles/PalgraveRev_ModiglianiMiller_Villamil.pdf. Further discussion of this central principle of corporate finance can be found in several recent contributions including M. Barton Waring, *Pension Finance: Putting the Risks and Costs of Defined Benefit Plans Back under Your Control* (Hoboken, NJ: Wiley, 2012); Robert Novy-Marx and Joshua Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (Fall 2009): 191–210; Frank Russek, "The Underfunding of State and Local Pension Plans," *Economic and Budget Issue* Brief, Congressional Budget Office, May 4, 2011.
18. Alabama Constitution, Article 1, § 22, http://ballotpedia.org/wiki/index.php/Article_I,_Alabama_Constitution#Section_22.
19. Ronald J. Ryan and Frank J. Fabozzi, "Rethinking Pension Liabilities and Asset Allocation," *Journal of Portfolio Management* 28, no. 4 (Summer 2002); and Mercer LLC, "Mercer Pension Discount Yield Curve and Index Rates in the U.S.," 2010, http://www.mercer.com/articles/1213490. Note that this is a notional bond yield. There are no 15-year Treasury bonds. This duration is selected since it matches the timing of payments and the mid-point of the stream of future cash flows. Alternatively, one may select the actual yield on 10- or 20-year Treasury bonds.
20. GASB, "Financial Reporting for Pension Plans: An Amendment of GASB Statement No. 25," Statement No. 67 of the Government

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21. Andrew G. Biggs and Kent A. Smetters, "Understanding the Argument for Market Valuation of Public Pension Liabilities," AEI, May 2013, p. 5.

22. Andrew G. Biggs, "Proposed GASB Rules Show Why Only Market Valuation Fully Captures Public Pension Liabilities," *Financial Analysts Journal* 67, no. 2 (2011), http://www.aei.org/files/2011/02/01/BiggsFinancialAnalysisJournal.pdf.

23. This rule is derived from the common law of trusts. This is an objective standard based upon how a person with experience and knowledge of a certain area would act in a given situation. If a fiduciary lacks the expertise for a certain area then the fiduciary must obtain expert help. 29 U.S.C. § 1104 (a)(1)(B).

24. Pensions & Investments, Databook 2012.

25. Deborah J. Lucas and Stephen P. Zeldes, "How Should Public Plans Invest?," *American Economic Review*, 2009 vol. 99 no. 2. P. 537–532, citing Alicia Munnell et al. (2008).

26. Author's Calculations based on The Center for Retirement Research at Boston College, Public Plans Database, http://crr.bc.edu/data/public-plans-database/.

27. Ibid., Andonov, Bauer, and Cremers (2013), p. 3.

28. M. Barton Waring, *Pension Finance: Putting the Risks and Cost of Defined Benefit Plans Back under Your Control*, Wiley Finance, 2012, p. 214.

29. RSA Quarterly Economic Update, March 19, 2013, pp. 23–24.

30. Ibid., p. 24.

31. Waring, 41.

32. Waring writes, "high realized returns are not under our power to require or demand." P. 216.

33. Investments may not exceed the following maximum levels: domestic fixed income (50%), international fixed income (10%), domestic equity (65%), and international equity (25%), with no more than 5% held in any individual stock, real estate (15%), alternative investments (10%) and short-term investments (10%). Comprehensive Annual Finance Report for the Retirement Systems of Alabama, FY 2012, http://www.rsaal.gov/About%20RSA/Pubs%20and%20forms/RSA%20Pubs/CAFR/2012%20CAFR.pdf.

34. "Alabama's Ace Investments: Out-of-the-ordinary investments pay off for Alabama's retirement system." By Jenny Price, *The Council of State Governments*, State News, April 2005.

35. 2009-2011 Economic Impact of RSA on Alabama, Commissioned by the Retirement System of Alabama, May 2012, Center for Business and Economic Research, Culverhouse College of Commerce and Business Administration, the University of Alabama, p. 2. http://www.rsa-al.gov/About%20RSA/News/RSAimpact200911_Final%20Report.pdf

36. A 1989 report commissioned by New York Governor Mario Cuomo entitled, "Our Money's Worth," made the case that public pensions should not invest to maximize returns, but rather to "optimize" them by choosing projects with secondary benefits to society such as affordable housing, job creation, and economic development. The Administration later stressed that the plan should not necessarily accept "concessionary returns" to meet these larger social or economic objectives and that it is possible to eat your cake and have it too by choosing socially or economically beneficial investments that also earn a competitive rate of return for the pension fund. See M. Wayne Marr, John R. Nofsinger, and John L. Trimble, "Economically Targeted Investments and Social Investments: Investment Management and Pension Fund Performance, *Manuscript for the Research Foundation, Institute for Chartered Financial Analysis*, April 1995.

37. Jeffrey R. Brown, Joshua Pollet, and Scott J. Weisbenner, "The Investment Behavior of State Pension Plans," *NBER*, September 2009.

38. Ibid.

39. Yael V. Hochberg and Joshua D. Rauh, "Local Overweighting and Underperformance: Evidence from Limited Partner Private Equity Investments," NBER, October 2012.

40. The Economics of Retirement System of Alabama's Investments on the State Economy and the RSA, presented by M. Keivan Deravi, Auburn University, Montgomery, 2012 http://www.rsa-al.gov/About%20RSA/News/Deravi%20PowerPoint%205-2012.pdf.

41. The philosophy of "concessionary returns" was expressed by Dr. Bronner in a recent interview: "There's not one investment that I can think of in Alabama that you couldn't make more money in other places. . . . But if you don't invest in Alabama, Alabama will never change. It will never improve. It will never do anything." David White, "Teachers' Retirement System Returns over Many Periods Trail Those of Many Other Pension Funds, Study Shows," Birmingham News, May 31, 2012.

42. In 1994 the Clinton administration Department of Labor endorsed this idea and attempted to alter ERISA guidance governing private-sector plans, arguing that an ETI that produced "collateral benefits" for employees in the form of an improved economy, but did not necessarily earn a competitive return for the fund, could be defended. http://www.plansponsor.com/MagazineArticle.aspx?Id=6442462106.

43. Jeffrey R. Brown, Joshua Pollet, and Scott J. Weisbenner, "The Investment Behavior of State Plans," September 2009, p. 3 and p. 14.

44. Dr. Bronner told TRS board members, "The retirement systems doesn't do well compared to other states because of the Alabama investments." David White, "Teachers' Retirement System Returns over Many Periods Trail Those of Many Other Pension Funds, Study Shows," *Birmingham News*, May 31, 2012.

45. Highly publicized failures—http://alreporter.com/component/k2/item/29-dr-bronnor's-experiment-goes-wrong-for-alabama.html.

46. The Retirement Systems of Alabama, 2012 Annual Report, "The RSA: On the Championship Course," p. 24 (http://www.rsa-al.gov/About%20RSA/Pubs%20and%20forms/RSA%20Pubs/Annual%20Report/Annual%20Report%202012.pdf).

47. Ibid.

48. RSA Quarterly Economic Update, March 19, 2013. Macroeconomic Commentary pp. 5–14.

49. The Alabama-based investments are not classified clearly for financial reporting purposes. They are often referred to as "alternative investments" in media reports and RSA promotional materials. RSA financial and investment reports do not break down nor discuss the Alabama-specific investments' performance, nor do they define the "alternatives" category more precisely. Alabama investments may also be included in fixed income and private placements. The RSA's website lists several "alternative real estate investments," including the Robert Trent Jones golf trail, PCH Hotels, RSA real estate web site, the Colony at the Grand, National Village, Community Newspaper Holdings, Raycom and iPic Theaters. While Addy and Ijaz (2008) indicate that Alabama-based investments are also included in private placements. See "Economic Impacts of RSA-Owned Investments on Alabama" Center for Business and Economic Research, Culverhouse College at the University of Alabama, for the Retirement Systems of Alabama, December 2008, p. 1 (bonds).

50. One-year and five-year returns on alternatives appear skewed by the volatile performance of TRS and ERS Alternative "Preferred Stock," which returned 48.46 percent and 39 percent, respectively. On a five-year basis, returns were negative, with a return of -24.67 and -19.97.

51. RSA Quarterly Economic Update, Macroeconomic Commentary, March 19, 2013, pp. 23–24.

52. Ibid. Waring.

53. This approach is developed by M. Barton Waring in Pension Finance (2012), see pp. 135–80.

54. Waring, 146.

55. Ibid.

56. George Pennacchi and Mahdi Rastad, "Portfolio Allocation for Public Pension Funds," *Journal of Pension Economics and Finance* 10, no. 2 (April 2011), 221–45. The authors note that previous research suggests pension funds invest in equities to hedge against wage uncertainty. See Fisher Black, "Should You Use Stocks to Hedge Your Pension Liability?," *Financial Analysts Journal* 45, no. 1 (January/February 1989), 10–12. Mirko Cardinale, "Cointegration and the Relationship between Pension Liabilities and Asset Prices (Watson Wyatt Technical Paper Series No. 2003-TR-06, 2003); Deborah Lucas and Stephen Zeldes, "How Should Public Pension Plans Invest?," *American Economic Review* 99, no. 2 (2009): 527–32. This research is based on a positive correlation between equities and wages. Pennacchi and Rastad test this and find a negative correlation between growth in US state and local wages and US equities. They find that as the period grows longer, the negative correlation increases. Thus, Pennachi and Rastad conclude that since the typical duration of a pension plan's liabilities is 15 years, stocks may not be the best hedge against wage risk.

57. An annuity can be thought of as "longevity insurance" that protects individuals against the risk of outliving their resources due to a long life, bad investments, or careless savings. For a discussion see G. A. "Sandy" Mackenzie, "The Role of Private Sector Annuities Markets in an Individual Accounts Reform of a Public Pension Plans," IMF Working Paper, Fiscal Affairs Department, September 2002, p. 13.

58. The Principal-Agent problem describes a situation when one party (the principal, in this case pension holders and taxpayers) employs an agent (government) to perform a transaction or make decisions on its behalf. A conflict may arise if the agent has asymmetric information and the principal cannot be sure the agent is acting in its best interests.

59. Odd J. Stalebrink, "Public Pension Funds and Assumed Rates of Return: An Empirical Examination of Defined Benefit Pension Plans," *American Review of Public Administration*, vol 44, No. 1 (2014) pp. 92-111: 5. "Studies have shown that the adopted investment return assumptions may be partly driven by political opportunism. More specifically, the evidence suggests that governments and retirement systems, under certain conditions, adopt actuarial assumptions for purposes of reducing the annual required contributions to a pension plan and/or for the purposes of obscuring the magnitude of the unfunded pension liability."

60. J. Peng, "Public Pension Funds and Operating Budgets: A Tale of Three States," *Public Budgeting and Finance* 24, no. 2: 59–73.

61. These techniques are not limited to the selection of the discount rate, but also include asset smoothing and the use of amortization schedules to reduce annual payments.

62. A model to follow for transition from the defined benefit plan to a defined contribution plan is the state of Michigan, which transitioned its state employees to a DC plan in 1997, saving $167 million in annual pension costs and between $2.3 billion and $4.3 billion in unfunded liabilities. See Richard Dreyfuss, "Estimated Savings from Michigan's 1997 State Employees Pension Plan Reform," Mackinac Center for Public Policy, June 23, 2011, http://www.mackinac.org/15284.

63. See "Social Security, Pensions and Retirement Security," Andrew Biggs, Testimony before the Senate Committee on Finance, Subcomittee on Social Security, December 18, 2013 (http://www.finance.senate.gov/imo/media/doc/Biggs%20--%20Senate%20Finance%20Testimony%20on%20Social%20Security%20and%20Pensions%20--%20Dec%2019%202013.pdf) and remarks of Jeffrey Brown in "Public Pension Reform: Addressing Pressing Fiscal Realities from a Long-Term Perspective," by Thomas L. Gais and Paul Yablonski, TIAFF-CREF Institute, pp. 15–16.

64. Ibid.

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8

Tax Incentives Job Creation and the Unseen: Is Alabama Giving Away the Store to Attract New Industry

George R. Crowley, Ph.D.

Tax Incentives Job Creation and the Unseen: Is Alabama Giving Away the Store to Attract New Industry

George R. Crowley,Ph.D.

Summary Points

- Alabama has a long history of aggressive use of tax incentive packages for industrial recruitment. The state's various tax incentive deals with manufacturing firms have likely reached into the billions of taxpayer dollars.

- Alabama is not alone in this campaign, as many states are similarly aggressive in offering tax deals to large, high-profile corporations. Despite the popularity of using tax incentives for industrial recruitment, there is little scholarly evidence of their effectiveness, and the potential exists for the incentives to crowd out investment by firms lacking the political clout to receive a deal.

- This chapter analyzes five recent, high-profile tax deals between the state of Alabama and Mercedes-Benz, Honda, Hyundai, National Alabama Corporation, and ThyssenKrupp. Evidence suggests most of these deals have a strong impact on the manufacturing sector where they are located, but surrounding areas do not appear to benefit. Tax revenue data show a modest increase in the growth rate of property tax revenues in these counties relative to the state as a whole.

- Although the majority of manufacturing plants created through tax incentives have created thousands of jobs for Alabamians, the jobs have come at a significant cost, both in taxpayer dollars and potentially lost opportunities.

- Alabama should establish itself as competitive without the use of selective incentives by maintaining its low tax rates and simplifying its tax code, and get policymakers out of the business of picking winners to receive tax benefits. At a minimum, the development process should be revamped to improve oversight, transparency, and accountability.

1. Introduction

The past several decades have seen an explosion of competition between state governments for large-scale investment projects by high-profile companies. A recent report by the New York Times estimates that state and local governments spend (or give up in terms of abated taxes) roughly $80 billion per year on incentive packages for companies.[1] Alabama has been particularly aggressive in recruitment of business. The state already boasts some of the lowest tax rates in the country, and has over the last several years offered a series of massive tax incentive packages to encourage businesses to invest in the state. Alabama's dedication to industrial recruitment has directly led to investment by a number of multinational manufacturing businesses, with each hiring thousands of Alabamians.

The variety of tax incentives available in Alabama is extensive, and any attempt to simply list all of them quickly becomes unwieldy. The Alabama Department of Revenue "Summary of Alabama Taxes and Tax Incentives" report from June 2009 lists incentives to which businesses may be entitled by meeting certain qualifications including abatements and exemptions to the business privilege tax, sales and use tax, property tax, and corporate income tax.[2] The Economic Development Partnership of Alabama adds the capital investment tax credit and industrial grant program to the list of major incentives in Alabama.[3] *Business Facilities* lists several additional incentives available in the state, including possible abatement of local taxes (in addition to state taxes), programs designed to provide infrastructure, training programs, and special loans designed to attract business (2012)[4]. Alabama has also designated 28 so-called depressed economies Enterprise Zones (25 counties and three cities); businesses choosing to locate or expand in these areas may qualify for additional tax and non-tax incentive packages (Economic Development Partnership of Alabama 2012b)[5]. In addition to all of these programs, the Alabama Department of Commerce offers "to develop an incentives package uniquely designed" for specific businesses. [6]

Examples of successful industrial recruitment in Alabama date back to the state's 1993 agreement with Mercedes-Benz. The state offered a lucrative $253 million incentive package to win the company's first American manufacturing plant. [7] This deal, which was controversial at the time because of its size, has since been viewed as an important step towards establishing Alabama as a state where industry was welcomed.[8] Since then, Alabama has struck similar incentive deals for large-scale investments by Honda, Hyundai, and Boeing. The practice shows no signs of stopping, with announcement in July 2012 of a $158 million package for Airbus's first American manufacturing plant.[9] In November 2012 Alabamians voted to further expand the use of economic incentives. [10] In addition, two bills passed by the State Legislature in 2012 (HB 160 and HB 159) expanded the Governor's discretionary power to create tax incentive packages.[11]

Alabama's use of tax breaks to attract high-profile business to the state, while successful, has also generated controversy. In 2012, the Alabama Education Association (AEA) filed a lawsuit against Governor Bentley attempting to block a number of tax incentives over concerns the adverse effects on revenue sources could potentially harm funding for education.[12] The suit was eventually dismissed, but the AEA's concerns merit serious consideration for a state faced with significant budget issues. Further criticisms center on the lack of transparency in the process of issuing the incentive packages.[13]

The numerous deals for industrial recruitment have rarely been subject to retrospective review to evaluate if promised benefits have materialized. Alabama does not provide any official report of the cost of business tax incentives.[14] A 2012 study by the PEW Center on the States reported Alabama (along with 25 other states) had no formal criteria for evaluating the effectiveness of tax incentives.[15] The creation of thousands of jobs through the location of large-scale manufacturing facilities in the state is undisputed but it is far less clear that the incentive packages in terms of costs and benefits to taxpayers. While the benefits of a deal—the employees hired, the capital invested—are visible, the costs—the outcomes absent government intervention—are often "unseen" and consequently easily overlooked. Are these firms simply drawing workers from other businesses? Further, is it possible that these high-profile investments have crowded out other entrepreneurs who lack the clout to receive a large tax deal? This chapter seeks to answer these questions through a comprehensive analysis of several high-profile deals between Alabama and private companies.

The following section summarizes some of the key findings of the academic literature on tax incentives and industrial recruitment. Section 3 provides background on manufacturing in Alabama, while Section 4 provides comprehensive case studies of six recent high-profile tax deals made by Alabama. The policy implications of this report are discussed in Section 4, while the final section offers concluding remarks.

2. Tax Incentives and Job Creation: Theory and Evidence

A motivation for tax incentives exists in what is known as economic base theory. While the simple economic base model has been repeatedly modified in attempts to make it more realistic since its inception, its general themes remain a crucial component of regional impact analysis. [16] According to this model, certain industries such as manufacturing are "basic" and depend on factors external to the local economy. In other words, these basic industries export most, if not all, of their products to other states, regions, or countries. For example, the Airbus plant will sell the aircraft produced there exclusively to companies located outside of Mobile County and Alabama. According to base theory, these industries are important because by exporting their products, they import money and capital which then support the non-basic industries in the area that depend on the local economy, such as restaurants, convenience stores, and suppliers. In fact, according the model, basic employment has a "multiplier effect" in that each basic job supports multiple non-basic jobs. Thus, basic industries drive growth in the economic base model and its more complicated variants.

The implications of base theory as a model for economic development are straightforward. In theory, states or regions should seek to strengthen their basic industries to drive growth of the economy as a whole. It is unsurprising, then, that states engage in contentious bidding wars with one another through the use of tax incentives whenever a high-profile company announces plans to build a new manufacturing facility. After all, if the economic base model is accurate, each of those manufacturing jobs will lead to several additional jobs in local businesses, hence the claims of indirect jobs due to the plants. Alabama's major tax deals accord well with the guidance of base theory, as all have been for large-scale manufacturing facilities.

Despite the intuitive nature and widespread acceptance among policymakers for the use of tax incentives in industrial recruitment, this sort of governmental intervention is not without criticism. By definition, the process is unfair because certain firms are given advantages not available to other firms. In a survey of the literature aimed at informing policy in developing countries, Zee, Stotsky, and Ley questioned the usefulness of tax incentives for businesses. Specifically, they pointed to the various costs associated with a regime of tax incentives: distortionary effects caused by giving incentives to one firm and not another, forgone revenue (by design), administrative costs, and costs associated with rent-seeking as firms attempt to secure favorable tax deals.

Further, previously-invested firms may be unable to compete with newly subsidized ones, leading to no improvement in employment rates as old firms are merely replaced by new ones.[17] Alabama's own history provides insight into this phenomenon of competing firms threatened by selective incentives. Following the Mercedes-Benz deal, steel firm Trico secured its own incentive package under an expanded version of the incentive law. Rival incumbent firm Gulf States Steel, finding itself at a competitive disadvantage, attempted to block the incentive package through a lawsuit, which was ultimately withdrawn.[18]

In these kinds of interventions, the visible effects (capital investment, jobs created, etc.) are often trumpeted while the potential alternative uses for taxpayer money and other resources devoted to creating the incentive are overlooked.[19] Nineteenth century French theorist and political economist Frédéric Bastiat referred to this as the "unseen," and offered his now-famous parable of the broken window to illustrates the point: if a shopkeeper's window is broken by a child and must be replaced, this creates work for the glazier, and may at first be seen as having a positive impact on the local economy. This line of thinking overlooks that the shopkeeper has fewer resources to spend on some completely different activity. The broken window does not create any economic activity, but simply redirected the shopkeeper's purchases.

Following Bastiat's logic, Alabama's incentive deals beg the question of whether the workers would have been employed in other jobs without these incentives. The evidence suggests in at least some cases, yes. A 2002 study by Faulk on Georgia's use of employment tax credits indicates 72.4 to 76.5 percent of the jobs created by firms participating in the program would have been created in the absence of the program, meaning taxpayers paid over $3 million for jobs that would have been created without the state's intervention.[20] Of course it is also possible that the taxpayer money spent to lure industry could have been used instead for an even more inefficient project, or simply to grow the size of government. While economists differentiate themselves from practitioners in other disciplines in part due to their understanding of these opportunity costs, "the unseen" is by definition impossible to measure and thus left out of the impact analysis used to justify intervention.

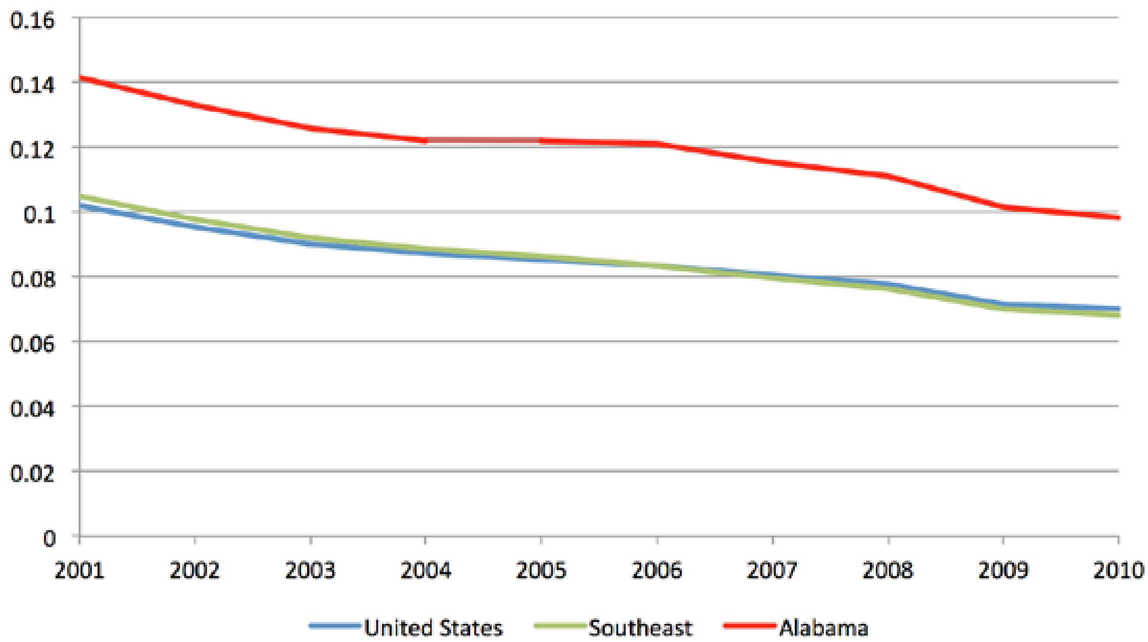
In fact, it may be the case that if those resources are employed only because of government intervention in the form of incentives, then their use is not economically efficient. In other words, if a firm can only locate a new manufacturing plant in the state with massive subsidization, it is likely the case that the project is not an efficient use of resources. Had the location been viable, the firm would have located there on its own. Thus, for truly efficient projects, tax incentives are likely subsiding activities that would have occurred anyway. In these cases, tax abatements represent a pure cost to the state in the form of lost revenue. Tennessee's former governor has indicated that his state's multi-million dollar incentive packages used to secure Nissan and GM-Saturn plants were probably too large since the firms were likely to locate in the state anyway, and South Carolina used incentives to secure a BMW facility already attracted to the state's skilled labor.[21]

A common response to this line of thinking is the claim that states must engage in industrial recruitment in order to stay competitive. In other words, even if Alabama were to represent an efficient and profitable opportunity for a firm absent any incentive deal, the firm may choose to locate in another state which was willing to offer a lucrative tax package. This would seem to be the case prior to Alabama's adoption of tax incentives as a tool for industrial recruitment, with firms locating in neighboring states despite Alabama's low tax rates. For example, one of the reasons Tennessee landed the Saturn automotive plant in Spring Hill in 1985 was because the state agreed to provide $20 to $30 million in training for workers, plus another $50 million for the Saturn Parkway and other roads.[22]

While Alabama today is certainly aggressive in its use of tax incentives for industrial recruitment, it is hardly alone amongst the states; Alabama was amongst multiple suitors for each of the major recruitments discussed in the following section. In public finance literature, commentators describe this competition as a "race to the bottom" with all states attempting to offer increasingly attractive deals to attract investment, theoretically resulting in a shortage of tax revenue needed to fund other government services. For example, according to The New York Times, Kansas cut its education budget by $104 million after offering a $36 million incentive package to recruit AMC Entertainment, a company which had been located in neighboring Missouri. Not to be outdone, Missouri used an incentive package to recruit Applebee's headquarters from Kansas.[23] Concerns about tax incentives' potential to reduce funds available for other government services have been voiced in Alabama as well, as the aforementioned Alabama Education Association (AEA) lawsuit against Governor Bentley illustrates.[24]

In *The Wealth of Nations*, Adam Smith listed four principles for judging any tax system: the system must raise appropriate revenues, be equitable, be easily administered at low cost, and ensure accountability. [25] George Washington University public policy professor David Brunori argues that company-specific tax

Figure 8.1: Ratio of Manufacturing Employment to Total Employment, 2001-2010



Source: Bureau of Economic Analysis

deals violate all of these criteria since they fail to collect enough revenue (since the taxes are abated, at least in the short run), are by definition not equitable, add to an already complicated tax code, and are notoriously difficult to monitor. Citing Alabama's deal with Mercedes-Benz specifically, he claims that it is difficult to see how the company will ever generate enough activity to allow the state to recoup the $253 million in incentives.[26]

Empirical studies of the effectiveness of tax incentives show incentives policymakers overestimate the role incentives play in attracting new firms. In a survey of the literature, Wasylenko concludes state tax incentives have little effect on firm location decisions and that, "States appear to overestimate the degree to which taxes affect economic outcomes," suggesting that while a state's business tax climate is clearly important, policymakers may have less power to encourage investment than they might think.[27] In another survey of the literature, Peters and Fisher echo this sentiment noting that despite their popularity, the majority of the scholarly evidence shows minor at best benefits of tax incentives targeted towards specific firms. The authors warn of policymakers who "believe that they can influence the course of their state or local economies through incentives and subsidies to a degree far beyond anything supported by even the most optimistic evidence" and call for alternative methods of economic development including infrastructure improvements and worker education.[28] This argument of the policymaker's lack of knowledge necessary to improve upon market outcomes dates back to Hayek.[29] To its credit along these lines, Alabama has made substantial investments in workforce development programs in recent years. According to the Governor's Office for Workforce Development, more than $8.3 million was approved in FY 2011 and another $9.6 million in FY 2012 for community colleges to offer dual enrollment in career technical programs, career coaching, equipment purchases, parolee transition programs, and training systems for robotics, welding, injection molding, and other careers.[30]

Wasylenko summarizes several studies of the effects of taxation on economic development. He advocates against the use of any "Band-Aid approach," stating that if tax laws need to be frequently changed to attract business to a state, it is likely indicative of some fundamental problem with the tax system as a whole. Broader tax reform is preferred, as it does not attempt to pick winners and losers.[31]

Evidence of the effects of broader tax policy (such as overall tax rates or credits available to all businesses rather than specific firms) on employment is more positive. In a study of Georgia's Jobs Tax Credit, Faulk finds evidence that this broader type of tax incentive leads to modest increases in employment. The Georgia program differs from the types of deals discussed in this report in that it is a broad policy which all firms meeting certain qualifications may benefit from, and not a set of special tax breaks given to any one specific firm.[32] In a study of the Washington D.C. metro area, Mark, McGuire, and Papke show that higher sales and personal property tax rates are linked to

Table 8.1: Ranking the Size of State Manufacturing Sectors (By Employment), 2013

Top Ten States					Bottom Ten States				
Rank	State	Total Employment	Manufacturing Employment	Percentage Manufacturing	Rank	State	Total Employment	Manufacturing Employment	Percentage Manufacturing
1	Indiana	3,682,999	506,683	13.76	41	Colorado	3,351,702	148,904	4.44
2	Wisconsin	3,530,389	474,374	13.44	42	New York	11,555,389	490,939	4.25
3	Iowa	2,018,830	221,508	10.97	43	Alaska	461,935	16,783	3.63
4	Michigan	5,309,084	581,113	10.95	44	Montana	638,747	22,619	3.54
5	Ohio	6,663,005	691,317	10.38	45	Florida	10,556,082	358,105	3.39
6	Alabama	2,542,368	258,953	10.19	46	Maryland	3,474,596	116,000	3.34
7	Arkansas	1,577,678	157,444	9.98	47	New Mexico	1,079,067	35,431	3.28
8	Kentucky	2,413,942	236,098	9.78	48	Wyoming	395,312	11,512	2.91
9	South Carolina	2,498,641	233,565	9.35	49	Nevada	1,559,621	45,331	2.91
10	Mississippi	1,535,589	141,999	9.25	50	Hawaii	875,837	18,012	2.06

Source: Bureau of Economic Analysis

lower employment growth.[33] As noted above, Alabama has made strides in this area and already boasts some of the lowest income and sales taxes in the country.

Terry Buss notes that tax incentives are typically politically popular, largely because they are typically implemented outside of the budget process, unbeknownst to voters. Indeed, in Alabama the projects are secret before they are officially unveiled, and even carry code names such as "Project Rosewood" and "Project Bingo," which were used for the Mercedes-Benz and Honda deals respectively. Further, states rarely evaluate tax incentive programs once they have been implemented, so even bad policy is left unnoticed. Buss advocates a number of policy prescriptions including requiring formal cost-benefit before and periodic evaluations after a tax incentive has been granted, including sunset provisions which terminate incentive deals without reauthorization, requiring legally binding performance contracts, concentrating incentives on other industries and not just manufacturing, and ensuring that incentive deals do not harm competitors or neighboring economies.[34] However, as states find themselves attempting to remain competitive with one another, these reforms become problematic if implemented by one state alone. To some extent, Alabama has required specific firm performance in the form of tying incentives to quotas on job creation, as evidenced by a number of the agreements described below.

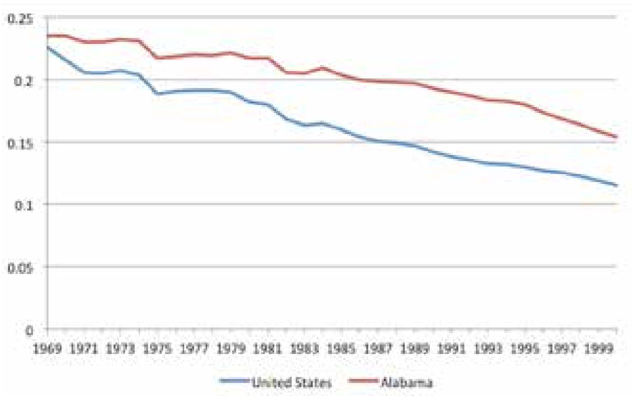
3. Manufacturing in Alabama

Before delving into the specific details of some of Alabama's most prominent tax incentive deals, it is useful to discuss overall trends in the manufacturing sector both within the state and the country as a whole. This overview will shed light on the overall strength of manufacturing in the state (relative to the country as a whole) and will also provide at least suggestive evidence of effectiveness of Alabama's industrial recruitment efforts. Chart 1 shows the ratio of manufacturing employment to total employment over the past decade for Alabama, the Southeast, and the United States as a whole. While the ratio is declining for each area, Alabama has maintained a noticeably higher ratio of its employment in manufacturing.

Table 8.1 provides more recent data (2013) on the ratio of manufacturing employment to total state employment. Alabama remains home to a relatively strong manufacturing sector (in terms of employment), ranking 6th amongst the states with just over 10% of all state employment in manufacturing. This exceeds both the national average of roughly 7%, as well as the ratios in nearby states such as Mississippi and South Carolina. Alabama's dependence on manufacturing is also nearly 5 times that of the states with the smallest manufacturing sectors.

The decline in manufacturing in both Alabama and the nation depicted in **Figure 8.1** above is not a new phenomenon, nor is the relatively large size of Alabama's manufacturing sector. **Figure 8.2** shows the same ratio of manufacturing employment to total employment for Alabama and the United States from 1969-2000. These historical data also point to Alabama's continued dedication to manufacturing. While roughly 23% of workers in both the United States and Alabama were employed in manufacturing sectors at the beginning of the sample in 1969, manufacturing's share of total employment in the U.S. fell to just over 11% by 2000, the ratio in Alabama remained at roughly 15%. In sum, while employment in the manufacturing sector has been on the decline across the nation, Alabama has retained a relatively large share of its employment in manufacturing, even predating the use of industrial recruitment incentives.

Figure 8.2: Ratio of Manufacturing Employment to Total Employment, 1969-2000



Source: Bureau of Economic Analysis

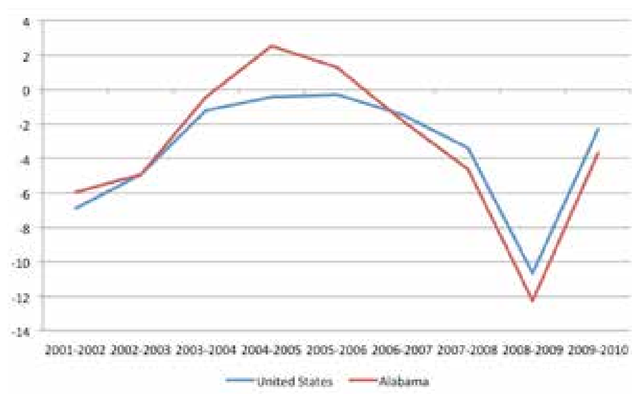
While declines in manufacturing for both Alabama and the country as a whole are apparent, the rate at which the sectors are shrinking is important. **Figure 8.3** shows the annual growth rates for manufacturing employment in the United States and Alabama from 1969-2000. Early in the sample, Alabama experienced less severe declines in the manufacturing sector than the United States as a whole, but from roughly 1972-1984 the rate of growth in the sector mirrored the national growth rate almost exactly. From the mid-eighties through the early nineties, however, Alabama experienced growth in the sector in spite of national declines. This trend was reversed in the late-nineties, with United States growth outpacing state growth.

Figure 8.3: Annual Percentage Growth Rate in Total Manufacturing Employment, 1969-2000

Source: Bureau of Economic Analysis

More recently, Alabama's manufacturing sector growth has outpaced the national rate. **Chart 8.4** presents annual growth rates for 2001-2010. From 2003-2006, Alabama experienced modest positive growth in manufacturing employment, while the US as a whole continued to experience declines. High profile agreements with Hyundai and Honda were reached in the years preceding this above-national-average growth. From 2006-2010, however, changes in manufacturing in Alabama again mirrored the national average.

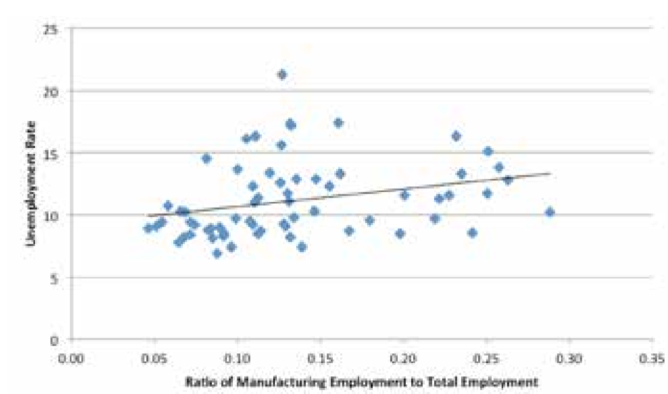
Figure 8.4: Annual Percentage Growth Rate in Total Manufacturing Employment, 2001-2010



Source: Bureau of Economic Analysis

For Alabama, the claim that focusing on manufacturing is essential to prosperity appears dubious. **Figure 8.5** plots the 2010 unemployment rate against the ratio of manufacturing to total employment for each county in the state. Only a slight positive correlation is observed, suggesting that a higher dependence on manufacturing is associated with a higher unemployment rate.

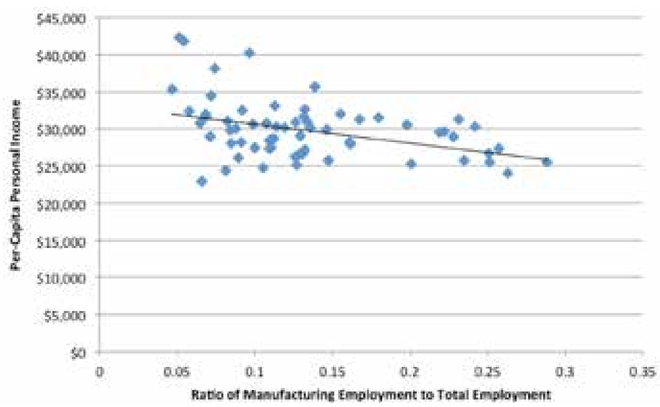
Figure 8.5: Correlation between Ratio of Manufacturing Employment to Total Employment and Unemployment Rate: 2010



Source: Bureau of Economic Analysis

An alternative claim for a focus on manufacturing is that it provides high paying jobs. **Figure 8.6** plots the same ratio against 2010 per-capita personal income for the counties and shows a slightly *negative* relationship between the two.

Figure 8.6: Correlation between Ratio of Manufacturing Employment to Total Employment and Per-Capita Income (2010)



Source: Bureau of Economic Analysis

As a matter of policy, Alabama has clearly devoted considerable resources to the recruitment of firms promising to invest in large-scale facilities with the intention of strengthening its already well-established manufacturing sector. These general historical statistics suggest that these programs may have contributed to the continued above-average size of the manufacturing sector in the state, though they also provide evidence that Alabama's dependence on manufacturing has always been high relative to the national average. The following section provides a more detailed discussion of some high profile incentive packages within the state.

4. Tax Packages in Alabama

Alabama has a long history of using tax incentives to attract high-profile businesses to the state. This section analyzes the effect on local employment of five recent tax deals: Mercedes-Benz (1993), Honda (1999 & 2002), Hyundai (2002), National Alabama Corporation (2007), and ThyssenKrupp (2007). Each of these packages was designed to recruit a high-profile manufacturing company with no previous connection to the state. The specific incentives included in each package are detailed, as reported in primary sources (i.e. the original agreements or memorandums of understanding between Alabama and the corporation), media reports, Alabama state agencies, and the corporations' own press releases. Data on employment, earnings, and other economic variables are from the Bureau of Economic Analysis[35] and the Alabama Department of Industrial Relations.[36]

Mercedes-Benz, Tuscaloosa County, 1993

Widely considered the deal which put Alabama on the map in terms of manufacturing (with the automotive industry in particular), the state's 1993 recruitment of Mercedes-Benz's first American manufacturing facility was a monumental event in its development policy. The initial agreement called for Mercedes-Benz to make a $300 million investment, eventually employing 1,500 workers. The deal proved that Alabama could attract high-profile multinational firms, and suggested that the aggressive use of tax incentives was an effective tool in recruiting a targeted company. The deal is widely viewed as a success, as the plant has been in continual operation since 1997, and currently employs some 3,000 workers.[37] Its success has been cited as the reason why other foreign car manufacturers would choose to make Alabama their American home in the future.

The Mercedes-Benz incentive package visibly served as the blueprint for subsequent tax deals. The package included a variety of tax breaks, promises to provide services, and direct payments for things such as construction costs. The state Alabama agreed to waive or reimburse all fees (where it is legal to do so) and provide assistance with securing the necessary permits and licenses, ensure that Mercedes-Benz has minimal franchise tax liability, and receives all tax exemptions and credits to which it is legally entitled. These incentives include ten-year abatements of state and local non-educational real and personal property taxes and sales taxes, plus abatements of any deed or mortgage taxes. The training facility located at the project site is exempt from real estate property taxes as well.

Alabama offered other non-tax incentives including provision of necessary environmental impact analyses, economic impact studies, and indemnified Mercedes-Benz for any penalties related to violations of environmental laws at the site. The state also secured the land for the plant and conveyed it to the company at essentially no cost. The agreement included a promises to maintain a fleet of Mercedes-Benz vehicles and that the University of Alabama will provide German language classes, and an offer to rename a nearby highway the "Mercedes-Benz Autobahn."

The state was largely responsible for paying for the construction of the facility. The agreement called for Alabama to pay for preparation of the site, at an estimated cost of $12.4 million. The government was also responsible for providing and improving infrastructure, including roads estimated at $50 million, water and sewer services, rail lines, access to other utilities, zoning, space at the Port of Mobile, and construction of a $600,000 fire station nearby. Finally, Alabama and the Tuscaloosa County Industrial Development Authority paid $42.6 million and $11 million respectively (financed from bonds) towards construction of the plant.

The state agreed to pay for the construction of a training facility, and $5 million per year for its operation. Additional start-up training costs, including airfare, hotels, and per diems for executives coming from as far away as Germany, and a temporary training facility were also provided. In all, the agreement called for the state to pay between $60 and $90 million for training services.

The estimated total cost to taxpayers of the Mercedes-Benz incentive package, including the tax abatements, was at least $253 million.[38] Since the original agreement in 1993, several expansions at the Mercedes-Benz facility have been subsidized by additional tax incentives and subsidies including $119 million in 2000 and $11 million in further abated property taxes in 2009.[39]

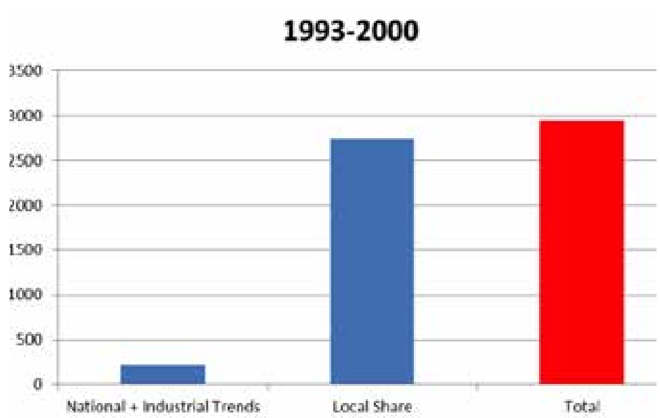
For the initial agreement of 1,500 workers, taxpayers paid $170,000 per directly-created job over the lifetime of the tax breaks, with the average manufacturing job in Tuscaloosa County earning $43,000 per year in 1997, the year the plant began production.[40] Given the average individual income tax rate in Alabama of just under 5% (the highest marginal rate of 5% is placed on all income over $3,000) these jobs generated just over $2,000 each in state income tax revenue that year.

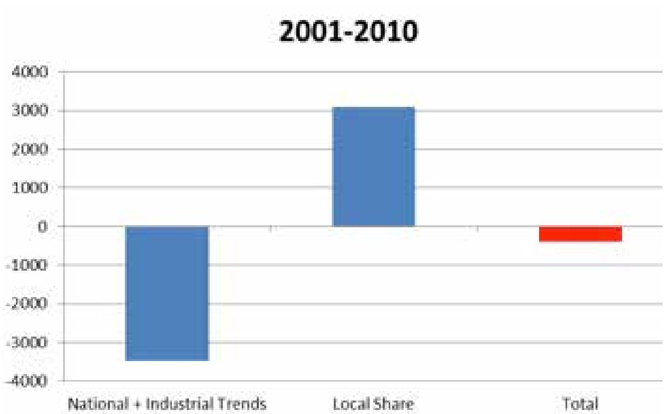
The Mercedes-Benz U.S. official website touts an annual economic impact of $1.5 billion, roughly 3,000 employees, and claims responsibility for more than 22,000 direct and indirect jobs in the region.[41] A 2002 report in the *Savannah Morning News* on the impact of the Mercedes-Benz facility on the town of Vance (where the plant is located) found that much of this return accrued outside of the immediate vicinity of the plant; after an initial period of excitement following the beginning of construction, little to no benefits were felt there. The majority of workers at the plant commute from nearby (and much larger) Tuscaloosa, where Mercedes-Benz workers represent only a small percentage of the population.[42]

Because, as noted above, employment in the manufacturing sector is on the decline nationwide, simply looking at the gain or loss of manufacturing jobs across the country as the result of a large manufacturer starting a business in a particular region may be misleading. To differentiate regional changes in employment from those that are the result of a national trend, shift-share analysis can be used.[43] While it lacks a strong foundation in economic theory, the shift-share approach is a useful back-of-the-envelope accounting tool for approaching how changes in employment in a given region compare to the averages for the nation as well as the industry itself. In other words, it attempts to separate out the portion of a change in employment in a region that is due to national trends (both overall as swell as within the industry) from the portion that is due to factors unique to the region. The shift-share technique breaks down a change in local employment in a given industry into several components: changes due to overall national economic growth (the "national" component), changes due to national trends within each industry (the "industrial mix" component), and changes that are due to factors unique to the local economy (the "competitive shift" or "local share" component).[44] This approach provides a simple, intuitive look at how a local industry is performing relative to national averages. A positive local share component indicates the local economy is relatively specialized in an industry, and is outpacing the sector's nationwide performance. Importantly, however, shift-share analysis does not speak to any causes or explanations for that growth or relative specialization, and only serves to identify local industries which are performing better (or worse) than would be expected based on national averages.

The Mercedes-Benz deal has almost certainly increased manufacturing employment in Tuscaloosa County, which increased by 3,000 jobs or 30% between 1993 and 2000. This is remarkable given that manufacturing employment grew by only 2% nationwide over the same time period, and that employment in Alabama in the sector fell by 7%. From 2001-2010, manufacturing shrank by about 3% in the county, with a loss of nearly 400 jobs.[45] Again, however, this relatively small loss is noteworthy given that the manufacturing sector shrank nearly 30% nationwide during the same decade. As **Figure 8.7** shows, the summary of the shift-share decomposition for the manufacturing industry confirms that the local characteristics of the county accounted for nearly all (2,700) of the jobs created from 1993-2000 and significantly offset the losses associated with the overall national decline in manufacturing from 2001-2010.

Figure 8.7: Changes in Manufacturing Employment in Tuscaloosa County





From a tax revenue perspective, results are mixed **(Figure 8.8)**. Data from the Alabama Department of Revenue's annual report show that over the past decade (2001-2010) property tax revenue growth in Tuscaloosa county, which averaged 7.3% annually, was higher than in the state as a whole (5.4% average annually). The difference in sales tax revenue growth is less significant, with Tuscaloosa County averaging growth of 3.2% annually, while the state averaged 2.2% annual growth from 1997-2010. Evidence of a significant increase in investment in the county is lacking. From 1997-2010, Tuscaloosa County experienced an average annual growth rate of 6.4% in the taxable assessed value of property in the county, while Alabama as a whole saw average annual growth of 6.1%. In the years following the deal (1997-2001) income tax revenue in the county grew at an average rate of 3.4 % annually, identical to growth in the state as a whole over the same time period.

Honda, Talladega County, 1999 & 2002

Alabama's continued efforts to recruit foreign auto manufacturers resulted in a May 1999 agreement with Honda chose Alabama as the site of its first American production facility, with plans to invest $300 million and employ 1,500 workers. When compared to the Mercedes-Benz incentive package, the initial Honda agreement was relatively small at only an estimated $158 million, but was subsequently followed by a second agreement in 2002, which was itself subsequently amended in 2008 with additional incentives.[46] As with the Mercedes-Benz package, the Honda deal includes a waiver of fees and licenses, and assistance in securing all available tax credits and exemptions. The state also promised to provide access to nontaxable bonds, produce the necessary environmental and economic impact reports, and assist in securing other sources of credit.

The tax incentives are similar as well, with Honda receiving abatements of all real and personal property taxes designated for non-educational purposes, as well as taxes related to deeds and mortgages. The state also exempts the facility from real estate property taxation, and also purchased the land for the project. The agreement required Alabama to provide some $20.5 million in site preparation, as well as infrastructure improvements including roads, water/sewer, fire protection, rail, and other utilities. The agreement also required the state to pay $10 million for construction of a training facility, and $30 million for start-up training.[47]

In 2002 when Honda announced intentions to expand production by 2,000 employees through $425 million in additional investment, Alabama once again offered a variety of incentives. All previous abatements were renewed in the 2002 agreement, with the state also promising an additional $9.5 million for site preparation and $1 million for improvements in the area's water supply. Finally, an additional $45 million for training was included in the 2002 agreement. According to Good Jobs First, the total value of these incentives and abatements can be estimated at $90 million. The agreement was modified once again in 2008 to allow for an additional $600,000 payment by the state for road projects, $4 million for additional water services, and an additional $1 million for training.

Today, Honda claims 4,000 employees and a total investment in Alabama of $2 billion on its official website.[48] Manufacturing employment declined in Talladega County between 2001 (a year between the two agreements discussed here) and 2010 by nearly 8%, which is substantially less than the overall contraction of the national manufacturing sector of nearly 30% (see **Figure 8.9**). The positive local share suggests factors unique to the local economy (including the Honda deal) helped mitigate what would have otherwise been a large loss of manufacturing jobs.

Figure 8.8: Growth in Tax Revenue in Tuscaloosa County (Annual Growth Rate, 2003-2010)

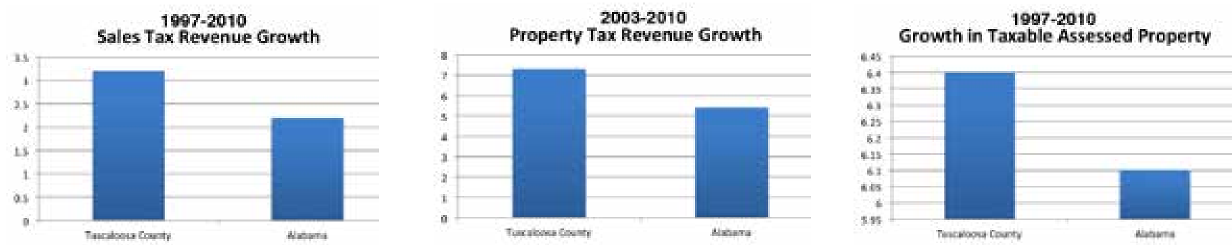
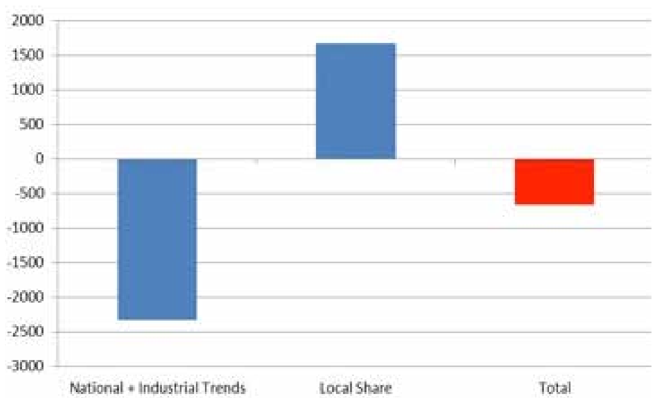


Figure 8.9: Changes in Manufacturing Employment in Talladega County (2001-2010)



Alabama Department of Revenue data shows total property tax revenues in Talladega County grew on average by 6.6% annually from 2003-2010 compared to average annual growth of 5.4% in the state as a whole (**Figure 8.10**). State sales tax revenues collected in the county grew on average 4.3% annually over the same time period, compared to average annual growth of 4% across the state. One significant observable difference is that in the years following the Honda deal (2003-2010) the assessed value of property in Talladega County grew at an average of roughly 8% annually compared to average annual growth of only 5.2% across the state. This may indicate significant increases in investment within the county, though the lack of a similarly large difference in property tax revenue growth is likely due to the various tax abatements in place.

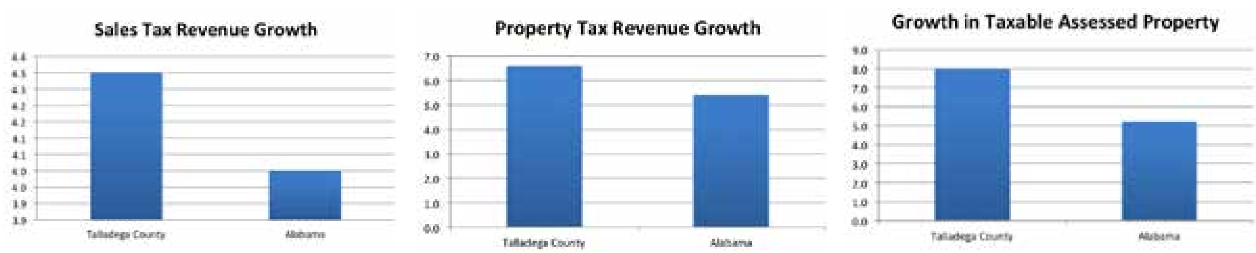
Hyundai, Montgomery County, 2002

The most recent high-profile automotive manufacturer drawn to the state through industrial recruitment was Hyundai, with an April 2002 agreement to invest $1 billion in a manufacturing facility. By this time, nearly a decade after the Mercedes-Benz deal, a standard set of incentives designed to attract automotive manufactures had been established, and the Hyundai package looked very similar to those that had come before it.

Alabama once again abated state and local non-educational property taxes, sales taxes, and mortgages taxes for the maximum period allowed by law (at the time) of ten years. In addition to these abatements, the state provided assistance with securing permits, minimized business privilege tax liability, and ensured receipt of all exemptions and credits, including the capital investment credit. In a slight twist on the incentive structure, Hyundai's business license tax liability can be reduced by the amount of taxes paid by qualifying suppliers locating in the state, a clear attempt to get Hyundai to do its own industrial recruitment for Alabama. The Hyundai agreement also contains explicit language preventing harm to the company should tax incentive laws change (the company is allowed to renegotiate).

Once again, Alabama secured land for the site and conveyed it to the company at essentially no charge. The state provided for an economic impact report, but the agreement allowed Hyundai to comment and suggest revisions. Enterprise and foreign trade zones, each with their own set of tax incentives, were expanded to include the Hyundai facility, and the agreement explicitly states that the company is under no obligation to hire Alabamians. The state also paid for site preparation, which amounted to $12.5 million, with any charges above that amount paid by the company. The 'standard' infrastructure improvements must be made by Alabama as well.

Figure 8.10: Growth in Tax Revenue in Talladega County (Annual Growth Rate, 2003-2010)



The Hyundai agreement includes specific provisions of penalties (in the form of refunded payments) should certain hiring thresholds not be met. Non-tax incentives included a $7 million training facility and $54.8 million in operating funds, residency waivers for employees and their families for use at state universities, visa assistance, temporary living quarters, $10 million dollars of advertising provided by the RSA, and a requirement that the state pay for the groundbreaking ceremony. All told, the incentives and abatements total roughly $252 million.

The official Hyundai Motor Manufacturing Alabama (HMMA) website notes that their Montgomery facility had 3,700 employees as of 2011, with an annual payroll of $223 million. The same web page also notes that an economic impact study conducted by Auburn economics professor M. Keivan Deravi found that HMMA and its suppliers generated 2% of the state's GDP.[50] The data in **Figure 8.11** support these claims: from 2002-2010, employment in Montgomery County's manufacturing sector increased by nearly 12% while the manufacturing sector shrank by 22% in both Alabama and the rest of the U.S.

Figure 8.11: Changes in Manufacturing Employment in Montgomery County (2002-2010)

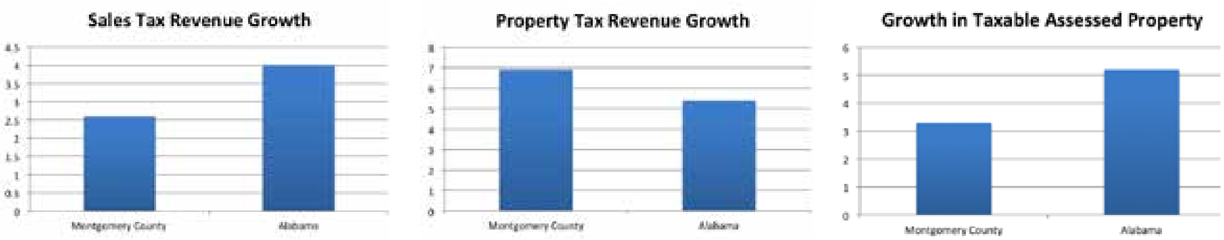
Tax data shows that in the years following the tax deal (2003-2010), average annual property tax revenue growth in Montgomery County outpaced the state as a whole at 6.9% compared to 5.4% (**Figure 8.12**). Sales tax revenue data shows average annual growth of revenues in the county of only 2.6% compared to 4% statewide. Taxable assessed value of property in the county grew at an average rate of 3.3% from 2003-2010 in Montgomery County, compared to growth of 5.2% in Alabama as a whole. In the years prior to the tax incentive (1997-2001), however, average growth in assessed property value in the county was roughly 3% annually compared to 7.5% statewide. In other words, while statewide growth in property value slowed significantly between the pre and post incentive years, the rate of annual growth in assessed value of property in Montgomery County remained constant.

National Alabama Corporation, Colbert County 2009

The National Alabama Corporation, a subsidiary of a Canadian rail car manufacturer, entered into an agreement with the state of Alabama in July 2007 to build a manufacturing facility in Colbert County, with the intention of eventually having as many as 1,800 employees. According to the agreement, the state provided incentives to National Alabama including provision of all the necessary environmental impact analyses, economic impact report, as well as a promise to help the company obtain "the full benefit of all statutory tax incentives for which the Company is legally eligible." Specific incentives provided by the state include abatement of the non-educational portion of state and local real and personal property taxes (for a period of ten years) and sales taxes levied on certain types of construction or manufacturing equipment. The estimated value of these abatements (as stated in the report) totals roughly $11 million. The agreement also stipulates that the new facility would qualify for special income tax credits and not be subjected to taxation on inventory. The state also agreed to introduce 'special tax legislation' designed to extend tax credits on behalf of National Alabama at a later date.

In addition to these tax abatements and incentives, Alabama agreed to pay National Alabama $20 million ($1 million per

Figure 8.12: Growth in Tax Revenue in Montgomery County (Annual Growth Rate, 2003-2010)



year over twenty years) for partial reimbursement of its costs related to improvements required to make the project site suitable for plant construction. The agreement also includes several conditions related to the possibility of Colbert County being included in the Gulf Opportunity Zone. When this did not happen, a portion of the agreement requiring the state to pay National Alabama an additional $53 million and Colbert County to pay $25 million came into effect. Of this, Alabama was required to pay $13.25 million and Colbert County $2 million upon commencement of construction of the facility. In sum, cash payments owed by the state and local governments to National Alabama totaled about $35 million.

According to the agreement, the remainder of these payments by the state and county ($28 and $23 million respectively) come due once the facility employs certain numbers of workers, up to the projected maximum of 1,800. An additional $10 million is to be made available for training. Other non-cash incentives paid for by the state include the land for the facility (estimated to be worth $10 million), provision of infrastructure (including roads, water, and sewage treatment), training services, and the establishment of a welding school at Northwest Shoals Community College. The plant was also funded in part by a $350 million loan from the Retirement Systems of Alabama (RSA), Alabama's state pension fund.[51]

The National Alabama plant has failed to live up to expectations. While the agreement was never supposed to produce immediate results (and as of this writing only five years have passed), the sheer magnitude of the failure makes an analysis possible. By 2010, the company was in such financial distress that the RSA stepped in to take complete control of the facility, reportedly paying another $275 million. Months later, the plant employed only 120 workers.[52] At that point, the promised cash incentives already owed by state and local governments amounted to about $300,000 per job created, compared to the total wages per manufacturing job in Colbert County of $47,835.[53] Adding the value of the non-cash incentives related to construction of the facility makes the cost-per-job ratio even worse.

By October 2010, government officials were no longer making the agreed-upon $1 million per year incentive payments.[54] Eventually, National Steel Car's (the parent company of the Alabama plant) CEO was indicted on securities fraud charges related to the RSA's investment in the plant, which were ultimately dismissed after he agreed to pay RSA $21 million in damages.[55] In 2012, the facility was leased to another company, Navistar; as of March 2014, Navistar employed 250 workers at the plant.[56] Navistar, in turn, subleased a portion of the facility to FreightCar America, which recently announced plans to expand its operation and add an additional 150-200 workers to its own existing 500 employees at the site.[57]

ThyssenKrupp, Mobile County, 2007

Alabama engaged in a fierce competition with Louisiana to secure ThyssenKrupp's (TK) first American steel manufacturing plant, a total investment estimated at the time to be nearly $4 billion. The memorandum of understanding between TK and Alabama, dated May 14, 2007, is over 100 pages long, indicative of the largest incentive package offered by the state to date. The TK deal was fundamentally more aggressive than those that have come before it, with a special piece of legislation dubbed the "Mega-Project Tax Incentive" allowing for an expansion of a number of incentives and abatements.

The state agreed to either pay for or reimburse a variety of fees related to necessary permits, and also offered 'preparatory real estate due diligence' in the form of relocating or otherwise mitigating any cemeteries, historic properties, natural resources, or protected species and habitats on the project site. TK was not to be held responsible for any damage done to any sensitive areas on the property.

The list of tax incentives promised to TK is extensive. Upon request, Alabama is required to help the company minimize its income tax liabilities, and in particular ensure that TK receives all tax credits to which it is entitled. Non-educational ad valorem real and personal property taxes, sales taxes, and deed/mortgage taxes, are abated for the length of the project. Additionally, the "Mega-Project Tax Incentive" was enacted, which exempts TK from property taxes for 20 years (compared to the ten-year abatement offered in the past), utility taxes from ten years, and extends the income tax capital credit from 20 years to 30 years. The total value of these abatements is estimated to be $350 million.[58] The agreement also stipulates that Alabama and Mobile County are responsible for making a $314 million cash grant to TK.

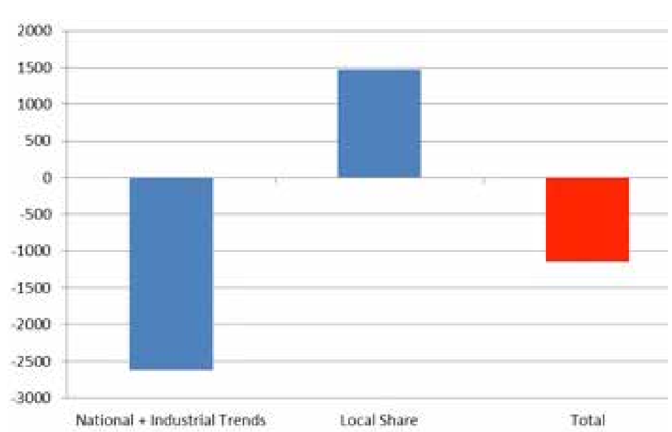
Additional non-tax incentives include the state agreeing to purchase all rights to the land for the facility (estimated at $45 million) and to purchase $100 million worth of title insurance. The state also agreed to remove any noise restrictions, and to purchase and convey to TK a neighboring property which would be adversely affected by the construction. Alabama was also required to make substantial infrastructure improvements, including rail, roads, and utilities. Incentives related to the training of employees include $31 million in reimbursement to TK, construction of a $12 million training center and five years of $5 million in annual operating funds for it, provision of a temporary training space until the permanent facility is completed, and creation of a "Steel Manufacturing Technology Program" at the center, in cooperation with the Alabama College System.

In sum, estimates of the incentive package's total cost to taxpayers surpass $800 million. The extended (by way of the "Mega-Project" legislation) state income tax capital credit is not included in this figure, and has been estimated to be worth as much as $3.7 billion over the 30-year period.[59] Provisions in the agreement, however, stipulate that TK is only entitled to the entire package if it employs 2,000 workers by the two-year anniversary of the project's commencement. The agreement also requires periodic updates from TK to the state regarding the number of its employees. In 2011, the incentive package was expanded to include an additional estimated $600 million in tax abatements, bringing the total value of the package (not including the potential from the income tax capital credit extension) to over $1 billion. The expansion of the incentive package was in response to a similar expansion in TK's investment, to $5 billion (Amy 2011).[60]

According to the TK Steel USA official website, the facility in Mobile County currently employs 1,800 workers, with continued plans to expand to the promised 2,700.[61] According to the Alabama Department of Industrial Relations, in 2011 wages paid per manufacturing job in Mobile County were roughly $58,000.[62] At the current 1,800 workers, the incentive package breaks down to roughly $555,555 per directly-created job. At full capacity of 2,700 employees, that number falls, but remains high at $370,000 per job. An impact study issued shortly after the signing of the agreement estimated some additional 4,300 indirect jobs.[63] Using this alternative number brings the per-job cost of the project down to $142,857, still almost three years' worth of worker wages. Finally, in late 2012 TK announced its intention to sell the Mobile facility.[64] The sale was completed in late 2013, with international firms ArcelorMittal and Nippon Steel jointly purchasing the plant for $1.55 billion. [65]

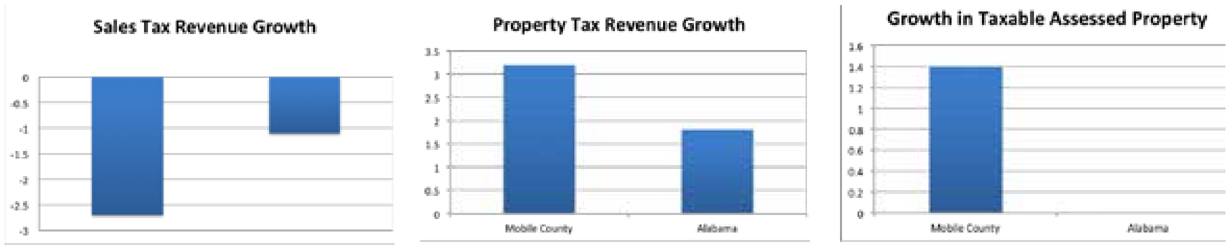
The employment data in Mobile County show a relatively strong manufacturing sector, especially given the extreme downturn in the sector nationally over the period in question (2007-2010). Since the agreement was signed, Mobile County's manufacturing employment fell by almost 7%, much less than the decline of more than 15% across the country as a whole. Indeed, total employment across all sectors has of course fallen nationally during the recent recession. The data in **Figure 8.13** reflect this, with Mobile County's local share indicating almost 1,500 jobs added due to features unique to the local economy, relatively close to the 1,800 workers employed at TK.

FIGURE 8.13: CHANGES IN MANUFACTURING EMPLOYMENT IN MOBILE COUNTY (2007-2010)



In the years following the incentive deal (2008-2010) property tax revenues in Mobile County have grown at an average annual rate of 3.2% compared to the statewide average annual growth rate over that same period of 1.8% (**Figure 8.14**). Sales tax revenues, however, have decreased in the county at an average rate of 2.7% compared to a decrease of 1.1% annually statewide. The assessed value of property in Mobile County has grown at an average rate of 1.4% from 2008-2010, compared to virtually no growth statewide over that same period. This may indicate an above-average increase in investment in the county since for the years prior to the incentive package (1997-2006) the average annual rate of growth in property values for Mobile County and

Figure 8.14: Growth in Tax Revenue in Mobile County (Annual Growth Rate, 2008-2010)



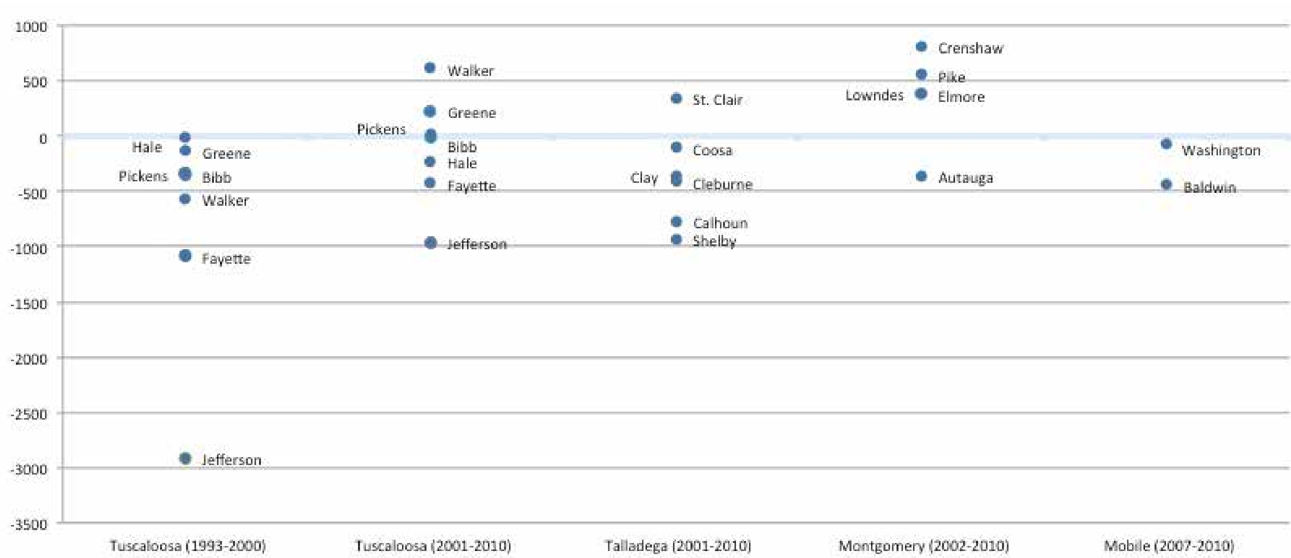
Alabama as a whole were quite similar to one another (8.4% and 7.9% respectively).

While the above data suggests relatively strong manufacturing sectors in many of the areas where Alabama's tax incentive deals have been implemented, evidence from surrounding areas is less conclusive. **Figure 8.15** presents data on the local share component for manufacturing in the counties surrounding the areas discussed above. With a few exceptions, manufacturing sectors in these counties have a negative local share, indicating they preform worse than national and industry trends would predict. The Mercedes deal in Tuscaloosa County appears to have had no measurable spillover effect on manufacturing in surrounding counties, which averaged a loss of 18% of manufacturing jobs from 1993-2000, and another 17% from 2001-2010. Most striking is that in the years immediately following the Mercedes-Benz deal (1993-2000), manufacturing in neighboring counties contracted at a rate faster than the sector's decline in the U.S. as a whole, indicating a local disadvantage. Turning to the Honda deal in Talladega County, in all but one neighboring county the manufacturing sector shrank at a rate faster than the national average, indicating a local disadvantage.

Similar results are found for the areas surrounding Mobile County. The Hyundai deal in Montgomery County seems to have had the most positive spillover effects, with neighboring economies exhibiting mixed results ranging from manufacturing employment tripling in Crenshaw County to a decrease of 40% in Autauga. The employment surge in Crenshaw County was directly related to the Hyundai deal: SMART Alabama, a major supplier to the Hyundai facility, constructed a large-scale plant of its own in 2003-2004, now employing some 700 workers.[66]

As the data in **Figure 8.15** represents only the local share of employment changes, the largely negative findings indicate local disadvantages in manufacturing. Possible explanations for the relatively weak performance of manufacturing in neighboring areas include that these surrounding counties have a comparative disadvantage in manufacturing, or that they have a higher concentration of poorly-performing industries within their manufacturing sector relative to the 'typical' distribution (which may further speak to the importance of industrial recruitment in the area). Alternatively, these results may provide evidence that the boon to the areas targeted by recruitment efforts adversely affected manufacturing in surrounding areas.

Figure 8.15: Local Share of Changes in Manufacturing Employment in Neighboring Counties



5. Policy Implications

The use of tax incentives to attract high-profile, large-scale manufacturing facilities to Alabama has been pervasive, and recent events suggest it is unlikely to stop in the future. The evidence provided here and elsewhere suggests these tax deals have, in most cases, led to the creation of thousands of manufacturing jobs for Alabamians, and depending on the assumed multiplier effect, many additional indirect jobs as well. These jobs come at a substantial cost to taxpayers, however, with the value of the direct subsidies, tax abatements, and other incentives used likely reaching into the billions of dollars. There is also evidence that even if the local economy which receives the project benefits from it, neighboring economies are not similarly affected. And, in the case of National Alabama, there is no guarantee that a large investment by a corporation will yield any benefits to the community.

From a tax revenue perspective, these incentive deals have an ambiguous effect on the state's pocketbook. First and foremost, the state is (by definition) not collecting many of the taxes that would normally be paid by these corporations due to the various abatements in place. Even in cases where the agreements had explicit ending dates (such as the Mercedes incentive package) additional tax abatements have been negotiated at a later date, effectively extending the length of time the company is exempt from paying certain taxes. Data on property tax collections in the counties examined here seem to indicate a modest increase in the annual growth rate of revenues relative to the state as a whole. On the other hand, while the rate of growth in assessed property values is higher than state average in many of these counties, the various abatements in place mean that property tax revenues do not grow at the same rate.

Ideally, Alabama would be able to be competitive without the use of billions of taxpayer dollars to lure corporations. To do this, policymakers should take steps to simplify Alabama's tax structure and keep rates as low as possible. The sheer number of tax incentives, credits, and exemptions make navigating the tax code an arduous process. The fact that Alabama routinely includes provisions in its formal agreements which stipulate it must help firms locate all tax credits to which they might be entitled suggests companies already have a difficult time making sense of Alabama's tax code. Simplification will help Alabama remain attractive to business, and curb the need for tax incentives in the first place.

Simplification of the tax code will also help get Alabama policymakers out of the practice of picking winners and losers amongst businesses. While it is easy to point to the thousands of jobs created by a company awarded a tax incentive package, the "unseen" potential investment that never occurs because other firms are not able to win the same tax breaks should also be considered. Alabamians must not forget that a project which is only profitable after government intervention is likely not the most efficient use of resources. A tax code based on low rates and simple, broad rules will assure all firms are on a level playing field. If the use of incentives is to continue, Alabama must also consider the impact of such incentives on neighboring economies and potential state-based competitors.

Given their political popularity, Alabama's use of targeted incentives for industrial recruitment will likely continue and expand. A number of steps can be taken to help mitigate the adverse effects of the policy. If incentives are going to be used, Alabama should ensure provisions are in place to protect taxpayers from potential failures. A number of the incentive deals discussed here include certain punishment provisions should a company fail to hire a requisite number of employees. While these are steps in the right direction, further oversight is needed. As Buss suggests, sunset provisions requiring the periodic reauthorization of tax breaks, instead of the broad 10-20 year commitments currently used, would ensure businesses continue to make wise decisions lest they lose their government funding.[67] And in the event a firm fails, the state must be prepared to cut its losses and not fall into the trap of continuing to invest taxpayer money in a lost cause.

Transparency needs to be applied to the policymakers' side as well. The current practice of secret meetings and deals with codenames allows the government to spend taxpayer money without voters' knowledge. Without accountability, the process is too susceptible to rent seeking and special interest politics. While some degree of secrecy is likely required during the negotiation process due to the existing competition between state governments, full disclosure once an agreement has been reached should be the rule.

Finally, the exclusive focus on manufacturing firms is detrimental to Alabama. As noted above, there is no evidence that a focus on manufacturing improves employment or income prospects for Alabamians. Manufacturing's share of total employment has been on the decline in the U.S. and the state for at least the last two decades, and specializing in a declining

Sidebar: The State Economic Development Arms Race, By Daniel Sutter

Alabama is not the only state offering tax breaks and development incentives to businesses, so the question we face in the near term is, Should Alabama unilaterally stop using economic development incentives? This raises different issues from the larger question of politically managed economic development. Four arguments together suggest that sitting on the sidelines will cost less than expected.

1. *Natural Cost Advantages*. Businesses will in the absence of any development incentives locate where their costs of operation are lowest. Evidence that incentive packages have a relatively small effect on firm location decisions suggests the magnitude of operating cost differences. Alabama will not lose out on all business location decisions by unilaterally halting development incentives. Furthermore, businesses with higher costs of operating in Alabama than elsewhere attracted through incentive packages will often be in danger of failing without future incentives. Economic development successes can create a fragile state economy.

2. *The Winner's Curse*. The competition between states for businesses resembles pro sports teams' bidding for free agents. Teams decide how much to bid for a free agent based on several factors, notably the player's expected contribution on the field. The team willing to pay the most will often have overestimated a free agent's expected contribution. The team that believes a free agent's performance will not diminish over the term of a lengthy contract will tend to outbid other teams. This phenomenon, known as the "Winner's Curse," extends to economics, business, and also incentive deals for businesses. Alabama and other states will all occasionally overestimate the value of companies to the local economy. Winner's Curse suggests that Alabama will often "win" when we overvalue and possibly overpay for a company, and we will avoid instances of buyer's remorse by sitting out.

3. *Fewer Alabamians than Expected Will Benefit*. Manufacturing companies bringing thousands of jobs to our state will benefit all Alabamians, right? Yet economics suggests that far fewer Alabamians will benefit than one might imagine. Only a portion of the stockholders of the company will be Alabamians, and many persons working at the plant will come from out of state. The new economic activity and the influx of new residents will create generally only very local benefits, and we will have to look carefully to find them. Local businesses, for instance, may not necessarily benefit. Yes, a retail store or restaurant may well enjoy extra business due to new residents, but then end up paying more in rent for their site. Renters in the community will face higher rents for apartments, and streets will have more traffic. The most certain beneficiaries will be the owners of commercial and residential real estate. Local economic activity typically drives up property values. A thriving and dynamic local economy will typically boost property values, and we do not wish to discount this dynamic. Yet using tax dollars to boost the value of some citizens' property is not a legitimate purpose of limited government.

4. *No Deals, or the Best Deal for All?* A refusal to make special deals for individual businesses does not prevent us from improving Alabama's business climate. The business taxes typically waived in an incentive package, for instance, can be repealed. Alabama could combine a comprehensive business tax and regulatory overhaul with abolition of state incentive packages. Such reforms would offer our best deal to all businesses while halting additional benefits like training facilities built at taxpayer expense. Such a "best deal for all" approach may keep Alabama competitive in attracting businesses. The great political challenge Alabama (or any state) would face in foreswearing tailored deals is remorse when losing out to another state. A "best deal for all" approach might make these inevitable moments more palatable to voters and politicians.

industry is a dubious proposition. The decline of manufacturing in the U.S. is indicative of market forces and the process of creative destruction attempting to move resources from inefficient to efficient uses. At present, Alabama is using taxpayer money to prevent market forces from moving resources towards other industries. Manufacturing firms are also highly sought-after by rival states, and pursuit of them leads Alabama to promise a much more aggressive package of subsidies and incentives than other firms might require.

6. Conclusion

Alabama has a long history of using aggressive tax abatements and subsidies to attract high-profile manufacturing firms to the state. Indeed, Alabama has a long record of success in this area, from Mercedes-Benz in 1993 to Airbus in 2012. The success is not without cost, however, as the value of the various incentive packages likely reaches into the billions of taxpayer dollars.

The "seen" effects are clear. With rare exceptions, these firms have invested large amounts of capital, employed thousands of Alabamians, and exported billions of dollars' worth of goods. Depending on the multiplier assumed, the impact extends into many additional indirect jobs. However, policymakers and taxpayers must be wary of "giving away the store" to any large-scale manufacturing firm that is interested in locating in the state. Evidence presented here suggests the economic impacts in terms of employment are limited to the immediate vicinity of the investment, with neighboring economies performing significantly worse than those receiving the incentives discussed above. The process is also highly secretive, largely kept out of the view of voters, and ultimately relies on the government's ability to pick winners and losers.

Ultimately, the more Alabama can rely on its low taxes, and a more simplified tax code to attract business and less on the discretion of policymakers to handout taxpayer money, the better off the state will be. If the use of incentives is here to stay, however, the process could be drastically improved by greater transparency (by all parties), greater accountability, ensuring existing firms are not harmed, and a decreased focus on solely manufacturing.

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42. Savannah Morning News, *Ten Years after Mercedes, Alabama Town Still Pans for Gold* (2002), http://savannahnow.com/stories/100902/LOCSWEET.shtml.

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44. Specifically, for employment in a given industry the basic shift-share technique would decompose the total change in employment in that industry (TC_i) such that $IM_i=NG_i+TC_i+CS_i$ where NG_i is the national growth component (beginning state employment in the industry * national growth rate of total employment) , IM_i is the industry mix component (beginning state employment in the industry * the difference in national growth rates of employment in that industry and total employment) and CS_i, the competitive-shift or local share component (beginning state employment in the industry * the difference in state and national growth rates of employment in the industry).

45. Due to changes in the Bureau of Economic Analysis classification of industries between 2000 and 2001, an overall analysis since the signing of the incentive package in 1993 until today is not possible as jobs classified as manufacturing are not necessarily the same across samples.

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50. Hyundai America, *Hyundai Motor Manufacturing Alabama and Suppliers Generate Total Impact of $3.8 Billion to Alabama's Economy and More Than 34,000 Full-time Equivalent Jobs Statewide in 2010*, http://hyundaiamerica.us/hyundai-motor-manufacturing-alabama-and-suppliers-generate-total-impact-of-3-8-billion-to-alabamas-economy-and-more-than-34000-full-time-equivalent-jobs-statewide-in-2010/ (last visited July 20, 2012).

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9

Reforming Occupational Licensing in Alabama

Daniel J. Smith

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Summary Points

- Occupational licensing undermines consumer sovereignty and restricts occupational freedom in Alabama. Professional groups use the goal of protecting consumers from unqualified practitioners as cover to restrict access into the profession and artificially raise wages.
- Alabama currently licenses over 140 different occupations, affecting over 1/4th of the state's workforce.
- The costs of occupational licensing fall disproportionately on low-income and minority Alabamians.
- Policy-makers can better protect consumer interest and economic growth in Alabama by transitioning from occupation licensing to occupational certification.

1. Introduction

Occupational licensing is the exclusive and compulsory government certification and registry of the qualified practitioners in a specific industry. To enter the profession, potential practitioners must meet requirements specified by a board of active industry practitioners. These requirements can range from simply registering with the state board, all the way to examinations, or even hundreds of hours of classroom or practical experience. These requirements also often include an assortment of substantial application, licensing, licensing renewal, background investigation, change of address, and examination fees.

The intended purpose of occupational licensing is to ensure quality and reputability in specified professions by restricting unqualified or unscrupulous personnel from practicing. This protection helps foster consumer confidence in the profession, especially for complex goods and services for which consumers have difficulty accurately gauging quality and reliability. The providers of complex services typically have more information than consumers and thus could conceivably exploit the ignorance of consumers. For example, a conniving auto mechanic may take advantage of a poorly informed customer by recommending the purchase of unnecessary services. Similarly, unscrupulous physicians, with their superior medical knowledge, could diagnose patients with nonexistent diseases in order to charge them for additional treatments and visits. Additionally, with consumers having little knowledge of a complex good or service, providers may enter into the field on falsified credentials, providing fraudulent goods and services to unknowing consumers.

Economists refer to this problem as the asymmetric information problem.[1] Governmental licensing, most often carried out at the state level, addresses this potential asymmetric information problem by giving practicing professionals the ability to regulate and monitor their colleagues. Consumer complaints can be reviewed by other professionals, and practitioners found to engage in crooked practices could be censured, suspended, or even barred from practicing. With licensing in place to prevent unqualified or unethical practitioners from entering a field, consumers can have a high level of trust in the active industry practitioners.

However, occupational licensing does not always work like this in practice. Industry groups can lobby for occupational licensing under the pretense of advancing the public interest, and then use licensing to artificially and unnecessarily restrict entry into the profession in order to increase industry wages.

Occupational licensing requirements, including training, fees, and exams, can be used to unnecessarily restrict access to the profession, especially for low-income or minority groups, decreasing economic mobility and occupational choice. Rather than an assurance of quality care and professionalism, occupational licensing can allow practitioners to fleece consumers, prevent competition, and restrict labor freedom.

Most occupational licensing is carried out at the state level, leaving each state to decide what occupations to license, as well as the extent of the licensing requirements. Many states have experienced a surge in occupational licensing in recent years.[2] In the 1950s only one in twenty U.S. workers needed a license to work, compared with about one in three today.[3] Occupations that traditionally required no licensure, such as florists, and home entertainment installers, are beginning to require licensure across the U.S.

Alabama currently licenses over 140 different occupations.[4] While the total number of licensed occupations appears small, this represents a substantial portion of the total Alabamian workforce. Over a fourth of Alabama's workforce requires express permission from an industry board in order to practice in their chosen occupation.[5] The expansion of occupational licensing suggest that Alabama policymakers should examine licensing's potentially significant costs, which include reduced labor mobility for professionals, higher cost of service, and decreased access to goods and services for low-income consumers. These costs should be carefully weighed against the perceived benefits of occupational licensing. In particular, Alabama policymakers should carefully monitor the expansion of occupational licensing requirements as well as the growth of occupational licensing to new industries, in particular industries with no evidential need for licensure. Furthermore, Alabama policymakers can examine alternatives to occupational licensure, such as voluntary certification, which offer an assurance of quality to consumers without enabling industry professionals to unfairly restrict entry into the profession.

Carefully monitoring the scope and power of licensed occupations, and especially transitioning to certification will substantially improve labor freedom and mobility in Alabama, especially for low-income and minority groups. Certification would also make it substantially easier to attract out-of-state professionals to Alabama. Consumers would benefit from generally lower prices as well as a wider range of quality and price options to better suit their particular circumstances and needs. Certification would particularly expand the access of low-income Alabamians to services they desire.

2 The Theoretical Case for Occupational Licensing

The justification for government-sponsored occupational licensing laws rests on the potential for practitioners to exploit the ignorance of consumers. When quality is costly to discern, consumers may not have the ability or necessary information to gauge the quality of a good or service, leading to a situation where the practitioner in the field has more information than the average consumer about the good or service they are offering, a situation referred to as information asymmetry.

Information asymmetries emerge whenever practitioners hold information that their average consumer cannot cost-effectively obtain.[6] Through education, training, and experience, practitioners in complex fields often acquire information about their goods and services that is not readily available to their average consumer, creating the potential for practitioners to exploit their consumer's relative ignorance. If a practitioner's average consumer is not in a situation to gauge either the qualifications of the practitioner or the quality of a service or good, especially even after the service was allegedly performed, the potential for two types of abuse emerges. First, unqualified practitioners can deceive consumers with falsified, substandard, or even non-existent qualifications, leading to the potential for low-quality or even harmful goods, services, or treatments.[7] Second, qualified practitioners, from their position of expertise, can recommend costly product upgrades, services, or treatments that are unnecessary.[8]

A classic example of a market with asymmetric information leading to the first problem, that of low-quality goods or services, is the lemon problem in used car markets.[9] Sellers of used cars often have more complete information on the condition of a car than potential customers. While some aspects, such as the condition of the interior and exterior, may be readily visible to potential customers, the condition of the motor and other components are difficult for the average consumer to accurately assess. Without a way to evaluate the true quality of used car, consumers would be unwilling to purchase used cars at the high-quality price, instead only offering the low-quality price, leading sellers of high-quality vehicles to drop out of the used car market.

An example of a market with asymmetric information leading to the second problem, that of a practitioner recommending costly services that are unnecessary or charging for services that aren't actually performed, is the market for car repairs. Car mechanics, including regular service-providers such as oil-change companies, often have more knowledge than the average consumer on the mechanical condition of an car, as well as the costs of parts and labor. This puts consumers potentially at risk for being sold services and repairs that are unnecessary, or even services, such as transmission flushes, that may not even be performed.

Occupational licensing is one of the most common solutions implemented by federal, state, and local governments to protect consumers in markets with information asymmetries.[10] By ensuring the credentials and professional practice of practitioners, occupational licensing offers assurance for consumers against potential abuse. Occupational licensing is often implemented through the creation of a board of practitioners that is granted the task of regulating entry into the field through the imposition of registration and education requirements, testing, and professional standards. In order to operate within licensed occupations, all practitioners must be properly licensed through the board of practitioners by meeting all the standards set forth by the board. The board monitors practitioners for false credentials or unscrupulous practice, with the threat of fees, license suspension, or even license revocation for violators.

3 Occupational Licensing in Practice

By restricting entry to the profession, the licensing requirements set forth by a board of practitioners can be used to artificially inflate industry wages. Rather than solving the potential asymmetric information problem, occupational licensing can enable industry professionals to more systematically exploit any existing information asymmetries. Consumers who do not have the information or experience to accurately assess practitioner qualification and product or service quality, will also not have the necessary information and experience to judge whether a government-sanctioned board of practitioners is mandating licensing requirements that are necessary and proper to ensuring quality service or actually operating to reduce competition and raise industry wages. Ill-equipped lawmakers and voters often do not have the information to judge whether licensing requirements mandated by occupational licensing are intended to promote the public interest and protect consumers, or to restrict entry into the profession and benefit industry practitioners.

Many empirical studies have found that many professions have successfully used occupational licensing legislation to artificially inflate wages without a discernible increase in quality for consumers.[11] Even more troubling, poor quality practitioners who may be able to meet the entry requirements may still be able to secure a license to practice. Licensing boards can often restrict private forms of professional evaluation that could more effectively regulate industry practitioners. For example, state medical boards often make it very difficult to compare the records of healthcare professionals.[12] Additionally, despite being one of the most powerful industry boards, state medical boards have notoriously been unable, or unwilling, to discipline doctors who have clinical privileging actions against them.[13] Because of this, studies find that even in the medical profession, a profession where the potential asymmetric information problem is likely the greatest, occupational licensing tends not to increase quality in practice.[14]

While overall quality may very well increase in some professions, the quality increases likely exceed a cost-benefit analysis. This means that the cost of a new mandated quality increase may exceed the benefits of that quality improvement to consumers. In other words, with asymmetric information, the profession may require quality improvements that operate to restrict entry into the profession and raise industry wages, but are nonessential to consumer safety.

Particularly disconcerting, the costs of occupational licensing fall disproportionately on low-income households and minorities.[15] This occurs for three reasons. First, when occupational licensing is expanded to more and more professions, low-income households are denied the occupational choice to enter into what should be low-startup cost professions. The increased costs of filing paperwork, fees, and burdensome education requirements with dubious impact on professional quality, all increase the costs of entering the licensed profession. Relatively, those people entering a profession from a lower-income bracket will find these burdens more inhibitive than those entering a profession with higher-income. Minority groups, such as females and blacks, can especially be hurt by licensing laws.[16] For example, Alabama extending occupational licensing to barbers, natural hair stylists, and eyebrow threaders in 2013 will likely deny access to what would otherwise be a low-skill and low-startup-cost occupation that poses no serious health threats to the population. It is difficult to envision any type of an asymmetric information problem when it comes to getting haircuts; barbers that provide bad haircuts will lose customers and go out of business. Yet, every state in the nation now licenses barbershops.[17]

The second reason the costs of occupational licensing fall disproportionately on the poor are that those industries with financial resources and political connections are more likely to become occupationally licensed in the first place.[18] Thus, most of the artificial wage inflation brought about through occupational licensing occurs in industries already comfortably receiving higher incomes. In addition, the fees and exam costs associated with licensing requirements are likely passed on to consumers in the form of higher prices. As a portion of their budget, low-income consumers can expect to face higher costs for the services they need when those services have occupational licensing.

The third reason occupational licensing falls disproportionately on low-income and minority groups is that occupational licensing laws prevent low-income households from trading off quality for price when it comes to licensed occupations, instead forcing consumers to purchase exclusively from the highest quality providers at an inflated price, or, to do without that service. This third effect is known as the 'Cadillac effect.' With restricted supply and inflated wages spawned by the unrealistically high requirements to enter the profession, low-income households are faced with the dilemma of scrounging around for the money to buy Cadillac-quality service, go without, or to do it themselves. Sidney Carroll and Robert Gaston found that electrical occupational licensing actually resulted in more accidental deaths from electrocution. This was because the restricted supply of electricians, and thus higher cost of employing electricians, forced many low-income households to attempt to do the electrical wiring themselves.[19] In a separate study by the same authors, they found that there were higher rates of rabies in domestic animals where veterinary occupational licensing was in effect, presumably because the higher costs of Cadillac-quality veterinary care forced low-income pet owners to go without veterinary services.[20] Similar effects have been found in occupationally licensed plumbers and real estate brokers. Even more troubling, these results have also been found to hold in occupationally licensed medical fields such as medical doctors, dental care, optometrists, and pharmacists.[21]

Across the country, active practitioners are seeking to artificially inflate their profession's wages by restricting entry through occupational licensing. Petitions for occupational licensing are typically brought by active practitioners in the field with the stated purpose of protecting consumers from unqualified practitioners. Yet, occupational licensing in practice tends to be used by industry professionals to undermine consumer sovereignty and restrict occupational choice for millions of Americans, especially low-income and minority Americans. Even professions that have dubious claims for the need for occupational licensing, such as fortune-tellers, reptile catchers, florists, and sheep dealers, are being licensed across the nation.[22]

4 Occupational Licensing in Alabama

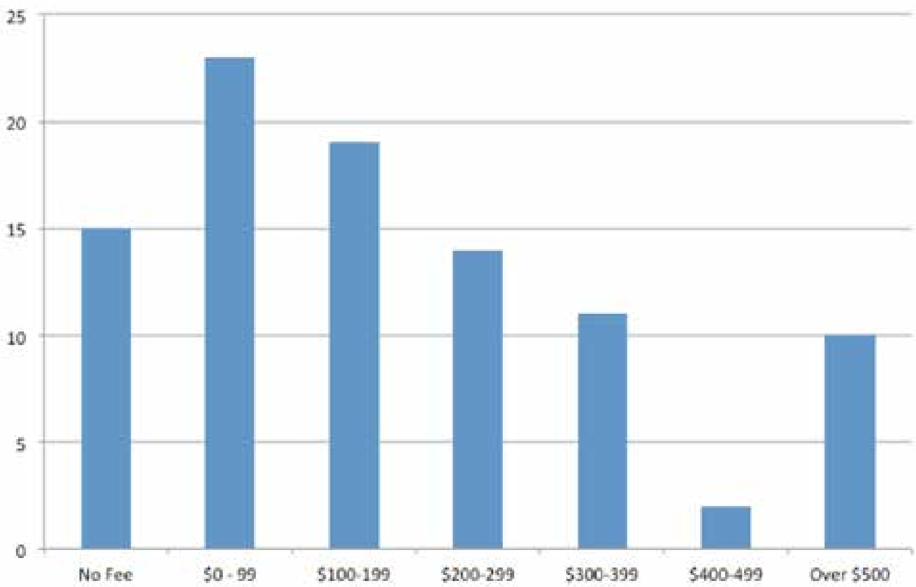
Using the Alabama Department of Labor 2013 Licensed Occupation Guide (LOG) and the Alabama Department of Revenue Occupational Licenses, Alabama has over 140 different categories of licensed occupations and internships. **Figure 9.1** lists all the licensed occupations in Alabama. The newest profession added is barbers, who were incorporated under the Alabama Board of Cosmetology in 2013. Barbers have operated for about 30 years without any licensing in Alabama.[23]

In order to receive a license to practice in their field within in the state of Alabama, members of these licensed industries must pay for licensing applications, fees, exams, inspections, training, and in a few cases, background checks. These initial fees are substantial, especially for someone just entering the profession. Using the 2013 fees listed in the LOG, and the current total active practitioners in each licensed occupation, the total initial fees paid in Alabama are estimated to be over $81.6 *million*. This is a conservative estimate for several reasons. This figure excludes fees paid by non-resident practitioners as well as inactive practitioners, which can be quite substantial for the Alabama economy. For instance, Alabama has 1,805 non-resident licensed architects. When submitting bids, out-of-state architects likely factor in the licensing fee costs into higher cost estimates for Alabamians. This estimate also excludes separate site incorporation or inspection fees and surety bond requirements. For example, in addition to their $250 application fee and $200 renewal fee, veterinarians must also pay a $150 new premise inspection fee and a $150 annual premise renewal fee. Massage Therapists, in addition to their $100 initial license fee, $25 application fee, and their $100 biannual renewal fees, must also pay $100 establishment fees and then $50 biennial establishment renewal fees. It also excludes the Alabama Controlled Substance Certificate fee, which ranges from $150 for a medical doctor to $35 for a veterinarian.[24] These initial costs also exclude the cost of initial classroom education or training which are substantial in some cases. Cosmetologists (including manicurists and estheticians) in Alabama require 1,200 credit hours or 3,000 hours of training to receive their license. Barbers, now managed by the cosmetology board, require only slightly less; 1,000 hours in barbering school or 2,000 hours under the immediate supervision of a licensed barber. In Alabama, commercial interior designers, are required to have 48 semester hours of interior design education and have a combined six years of education and practical experience.[25] Additionally, some fees, such as the fees for Alabama's over 15,000 law enforcement personal are not included because they vary drastically across the state and are not readily

Figure 9.1: Licensed Occupations in Alabama (2013)

Accountant, Certified Public • Mastectomy Fitter • Aircraft Flight Instructor • Mine Electrician • Aircraft Mechanic • Mine Fireboss • Aircraft Pilot • Mine Foreman - Surface Mine • Anesthesiology Assistant • Mine Foreman - Underground Mine • Architect • Motor Vehicle Dealers - Used • Athletic Trainer • Motor Vehicle Rebuilders • Auctioneer • Motor Vehicle Reconditioners • Auctioneer Apprentice • Motor Vehicle Wholesalers • Audiologist • Natural Hair Stylist • Automotive Dismantler • Motor Vehicle Dealer - New • Barber • Nurse Anesthetist • Bar Pilot • Nurse, Clinical Specialist • Chiropractor • Nurse, Licensed Practical • Cosmetologist • Nurse, Midwife • Cosmetologist Apprentice • Nurse, Practitioner • Cosmetology Instructor • Nurse, Registered • Counselor • Nursing Home Administrator • Counselor, School • Occupational Therapist • Court Reporting • Occupational Therapist Assistant • Dental Hygienist • Onsite Wastewater Treatment Operator • Dentist • Optometrist • Dietician • Pedorthist, Prosthetists, and Orthotists • Doctor of Medicine • Pedorthist, Prosthetists, and Orthotists Licensed Assistant • Electrical Contractor • Orthotics Supplier • Electrical Journeyman • Pest Control Operator - Ornamental & Turf • Elevator Contractor • Pest Control Operator - Household • Limited Elevator Contractor • Pest Control Operator - Wood Destruction • Elevator Mechanic • Pest Control Operator - Structural Fumigation • Limited Elevator Mechanic • Pharmacist • Elevator Inspector • Pharmacy Technician • Embalmer • Physical Therapist • Embalmer Apprentice • Physical Therapy Assistants • Emergency Medical Technician • Physician Assistant • Engineer, Professional • Plumber and Gas Fitter Journeyman • Estheticians • Plumber and Gas Fitter Master • Eyebrow Threader • Plumber and Gas Fitter Apprentice • Fire Fighter • Podiatrist • Forester • Polygraph Examiner • Funeral Director • Polygraph Examiner Internship License • Funeral Director Apprentice • Psychological Technician • General Contractor • Psychologist • General Contractor - Subcontractor • Real Estate Appraiser Trainee • Geologist • Real Estate Appraiser Certified General Real Property • Harbor Pilot • Real Estate Appraiser State Registered Real Property • Hearing Instrument Dealer • Real Estate Appraiser Licensed Real Property • Hearing Instrument Fitter • Real Estate Appraiser Certified Residential Real Property • Hearing Instrument Dealer Apprentice • Real Estate Broker • Heating and Air Conditioning Contractor • Real Estate Salesperson • Heating and Air Conditioning Contractor-Refrigeration • Respiratory Therapy • Home Builder • Restricted Agent (Securities) • Home Medical Equipment Service Provider • Sale of Checks • Insurance Sales Agent • School Bus Driver • Interior Designer • Securities Broker/Dealer Investment Advisor • Securities Broker/Dealer Agent • Investment Advisor Representative • Security Alarm Installer • Landscape Architect • Shampoo Assistant • Landscape Occupations • Sign Language Interpreter and Transliterator • Law Enforcement Personnel • Social Worker • Lawyer - Regular Members • Soil Classifier, Professional • Lawyer - Special Membership • Speech Pathologist • Liquefied Petroleum Gas Dealer - A, B • Surveyors - Engineer Intern • Liquefied Petroleum Gas Dealer - B-1, C-2, F, F-1 • Surveyors - Professional • Liquefied Petroleum Gas Dealer - D • Surveyors - Land Surveryor Intern • Liquefied Petroleum Gas Dealer - C, C-1, E • Surveyors - Land Surveryor Professional • Manicurist • Teacher, Classroom • Manufactured Housing Installer • Tree Surgeon • Manufactured Housing Salesperson • Veterinarian • Marriage and Family Therapist • Veterinarian Technician • Marriage and Family Therapist Associate • Water Transportation Personnel • Massage Therapist • Water Treatment Op-

Figure 9.2: Distribution of Total Initial Costs for Licensed Practitioners in Alabama (2013)



reported. Finally, the number of active practitioners for twenty-six licensed occupations was unavailable, including the newly licensed barbers, eyebrow threaders, and natural hair stylists.

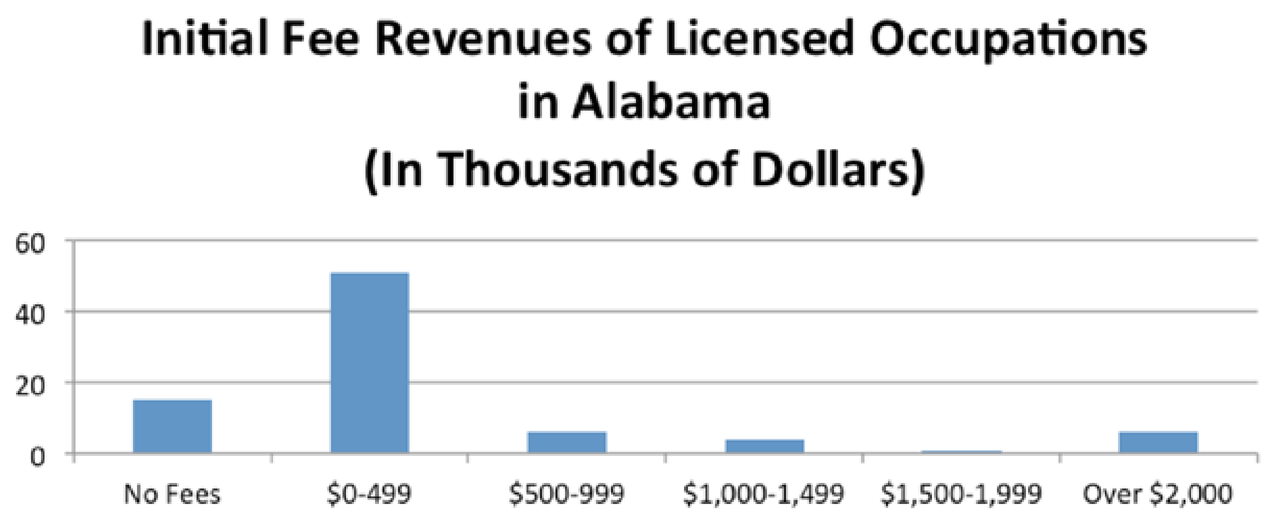
Figure 9.2 provides a distribution of the licensed professions in Alabama ranked according to their initial entry costs. Architects have the highest entry costs, being required to pay $1,630. Pharmacists and certified public accountants come in second ($950), followed by psychologists ($800), home medical equipment providers ($750), psychological technicians ($730), and counselors ($710). **Figure 9.3** shows the frequency distribution of the estimated total revenue brought in through initial startup fees by each licensed profession. Lawyers, registered nurses, certified public accountants, pharmacists, securities brokers and dealer agents, and medical doctors initial licensing entry fees brought in more than an estimated $5 million each. Classroom teachers initial fees came to an estimated total of $3.78 million, and cosmetologists brought in an estimated $2.84 million. The estimated total entry costs for Alabama social workers was an astounding $2.14 million.

In addition to initial licensing and examination fees, practitioners in licensed occupations in Alabama also must pay an estimated $30.84 *million* in annual licensing renewal fees. For example, podiatrists pay the highest annual fees ($400), followed by home medical equipment providers ($325), and medical doctors, lawyers, chiropractors, and marriage and family therapists ($300). Veterinarians pay a $200 renewal fee and a $150 annual premise renewal fee. Massage therapists pay $100 biannually to renew their license and an additional $50 biannually to renew their establishment (compare this to emergency medical technicians who pay a simple $10 renewal fee annually). In total, medical doctors, lawyers, registered nurses, home builders, general contractors, classroom teachers, cosmetologists, real estate brokers, and insurance sales agents across Alabama pay more than $1 million each in annual licensing fees. These figures exclude additional fees such as those required by some occupations such as for address changes (court reporting requires $25 for a change of information), late fees (dieticians are charged $125), inactivity fees (veterinarians are charged $100), or surety bond requirements. It also doesn't include the cost of ongoing education requirements (psychologist pay $50 annually for continuing education).

These entry costs represent a substantial burden for those seeking to enter into a licensed profession in Alabama, especially if they involve training or education programs that oftentimes require student debt or on-going fees. For high-skilled services, these costs are likely passed onto consumers. For low-skilled services, these entry costs represent steep barriers for access to the profession.

The Institute for Justice, in their 2012 *License to Work* national study, ranked Alabama as being the 24th most extensively and onerously licensed state, having the 38th most burdensome licensing laws, and having licensed 47 of the 102 moderate-income occupations they studied.[26] Part of the reason for Alabama's showing in these rankings is that Alabama regulates several professions that aren't widely licensed in other states. For example, Alabama has licensing requirements for auctioneers, locksmiths, hair shampoo assistants, massage therapists, and tree surgeons. Funeral Directors (not embalmers, who are licensed separately) are licensed in Alabama, requiring that they served as an apprentice (which itself involves annual licensing fees)

FIGURE 9.3: TOTAL INITIAL STARTUP REVENUE BY LICENSED PROFESSION



for two years, become certified through the Moratory School, and pass an exam. After that, the entry costs are only $50 and an annual renewal fee of $50. Tree surgeons in Alabama must submit a written statement of their training and experience, pass an examination that costs $75, receive a Professional Services Permit, and pay an annual licensing permit fee of $175.

Not only does occupational licensing impose significant hurdles to those seeking to enter into licensed occupations, and harm Alabama consumers, it also raises the costs for professionals to move to Alabama. Reciprocity requirements and hurdles needlessly restrict and prolong professionals licensed in other states from coming to Alabama to meet consumer needs. For instance, a licensed practitioner from another state coming to Alabama – either temporarily or permanently – must often get re-licensed. This process may involve meeting new requirements, needlessly repeating requirements, or paying additional fees, unnecessarily delaying and raising the cost of out-of-state practitioners practicing in Alabama despite being licensed in another state. This is particularly troublesome, and deterring, for professionals interested in moving with spouses to military bases or for other jobs in Alabama. Even more troubling, these reciprocity hurdles can be particularly harmful during natural disasters, when professionals registered in nearby states are needed to quickly come to affected Alabama communities for response and recovery as well as debris removal and rebuilding.

5 Reforming Occupational Licensing in Alabama

Given the strong tendency for licensed occupations to undermine consumer sovereignty and to restrict occupational choice, without increasing quality along dimensions relevant to consumers, Alabama legislators should consider reforming occupational licensing. Reforming occupational licensing would promote economic growth, job growth and substantially reduce unnecessary fees and training requirements.

There are potentially two ways for Alabama legislators to reform occupational licensing. The first would be a complete transition away from occupational licensing towards voluntary certification. This would offer the most relief from unnecessary labor restrictions, providing Alabama job growth while allowing voluntary certification to ensure consumer safety and quality. The second path offers a more gradual and experimental approach, which takes into account the extreme political difficulty of removing privileges from entrenched special industry groups. Alabama legislators could reform the existing occupational licensing system to reduce the potential for industry abuse, bringing licensure requirements and licensed occupations back in line with those of other states to ensure Alabama's competitiveness. Alabama legislators could also sharply restrict the spread of occupational licensing to new industries. This section explores both of these options separately.

5.1 *Alternatives to Occupational Licensing: Voluntary Certification*

Competitive markets offer many alternatives to occupational licensing that operate to ensure consumer safety and quality, without undermining occupational choice and consumer sovereignty. Institutional mechanisms emerge in markets to reduce the potential for exploitation on the basis of asymmetric information.[27] Rather than asymmetric information being a problem that the market cannot handle, asymmetric information is a profit opportunity for alert entrepreneurs that see the need for a market for assurance.[28] Such mechanisms include advertising, contracting, liability clauses, insurance, brand names, chain stores, leasing, warranties and guarantees, reputation, pre-purchase inspections or second opinions, performance or maintenance history reports, and consumer reviews. [29] Modern technology, with the ability for consumers to rate their post-transaction satisfaction or dissatisfaction with a good or service provider, further enhances the ability for consumers to avoid practitioners that exploit information asymmetries, and punish those good or service providers that do exploit information asymmetries with unfavorable reviews. Additionally, the internet provides consumers with readily available, and fairly accurate, information on how to better discern the quality of goods and services as well as a forum to seek second-opinions.[30] Additionally, the legal system and even investigative reporting can play a large role in ensuring consumer safety and quality.

In addition to the above-mentioned institutional mechanisms that have emerged in markets to help protect consumers in markets with information asymmetries, there will also be a profit opportunity for third-party certifiers to provide voluntary assurances of practitioner quality. Where there is consumer demand for certification, due to information asymmetries, private certification agencies will have the market incentive to provide independent certification of industry practitioners. Certifiers would be able to set requirements that industry practitioners could elect to meet for certification, seek certification through an alternative agency, or remain uncertified and rely on other forms of ensuring consumer quality and safety such as guarantees and reputation. Voluntary certification has many benefits for both consumers and workers over occupational licensing.

Consumers are better served by voluntary certification for three reasons. First, third-party certifiers earn profits only by ensuring consumers a consistent, and clearly defined, level of quality. The opportunity for alternative certifiers to enter the market and compete for consumers by offering better certification helps ensure the honesty of certifiers. For example, private certification agencies, such as the Institute for Highway Safety and Consumer Laboratories, already exist and operate effectively for many professional occupations.[31] In addition, consumers can employ or demand the alternative institutional mechanisms detailed above to ensure quality as well, such as guarantees and reputation, offering another form of competition. Independent third-party certifiers also are under far more pressure to remain objective when evaluating potential unscrupulous or questionable behavior and to quickly revoke the certification of practitioners who violate the certification requirements. Private certification agencies are also liable to civil action if they fraudulently certified practitioners.

The second reason consumers benefit from voluntary certification is that consumers are given the sovereignty to determine the level of price and quality that best meets their need. Voluntary certification avoids the Cadillac effect by allowing consumers a wide-range of choices depending upon their economic circumstances and quality preferences.[32] When buying goods online at stores like Amazon, buyers have the ability to choose which level of price and quality they are comfortable with by examining the prices offered and the customer (and expert) reviews. Certification would allow similar institutions to work for other goods and services because certification agencies that attempted to require unnecessary or costly requirements, especially costs that are passed on to consumers, would lose out to more honest certification agencies.

The third way in which consumers benefit from voluntary certification is that consumers get the discretion to decide which industries are plagued by information asymmetries enough to warrant the cost of certification. For instance, it is unlikely that most consumers would demand, if given the choice, certification for industries such as auctioneers, hair shampooers, locksmiths, massage therapists, and barbers. If consumers did demand it, they would be willing to pay for it, creating the incentives for a private certification agency to emerge.

Voluntary certification also helps protect workers. While occupational licensing boards hold a government-granted monopoly, independent certifiers cannot restrict entry into the profession. This provides an avenue for especially entry-level and low-income workers to enter a field, gain experience, and build a reputation with customers that will know they have to rely on alternative mechanisms, such as advertising, guarantees, reputation, and family and friend networks, for ensuring quality and safety. Additionally, voluntary certification will help eliminate unnecessary demands on practitioners such as fees and other requirements that do not impact consumer safety and quality.

Voluntary certification would also not impede the ability of legislators to continue to maintain, and monitor, certain bonding and insurance requirements for designated occupations. However, private certification agencies would likely monitor this to some extent, and the burden of inquiring (and verifying) practitioners about bonding and insurance would fall on consumers. Asking for and verifying the existence and validity of bonding and insurance for practitioners does not suffer from the information asymmetry problem described earlier.

5.2 *Occupational Licensing Reform*

There is a second option for reforming occupational licensing laws. A more gradual reform of occupational licensing would be more politically viable given that special interest groups would likely adamantly protect their existing occupational licensing privileges. While a complete reform to voluntary certification offers the most benefits to Alabama consumers and workers, gradual reforms could still provide some benefits. Such gradual reforms could include limiting the extension of occupational licensing to new occupations, removing occupational licensing for those occupations that few other states require licensing for, and by ensuring that occupational licensing requirements in Alabama are competitive with other states.

As occupational licensing spreads to more and more fields, it is increasingly being mandated in occupations that have no discernable need for occupational licensing, allowing industry groups with no evident justification for occupational licensing to enjoy the privileges of restricting entry into the profession. Occupational licensing can only be justified if a measurable information asymmetry is found to exist and if existing private mechanisms such as reputation, private certification, and guarantees are found to be insufficient. It is difficult to find any information asymmetries when it comes to auctioneers, shampooers, and barbers, for example. Further, it is difficult to see why money-back guarantees, reputation, and the legal system would be insufficient to address any information asymmetries in these fields if they did exist.

To limit the potential for abuse, Alabama lawmakers should consider strictly restricting the expansion of occupational licensing to new industries, and should remove occupational licensing in fields with no demonstrable need for occupational licensing. Alabama policy-makers should also look at the licensing laws of other states to examine Alabama's competitiveness in terms of licensing requirements. If the cost or time requirements of licensing are higher than the average of other states for each occupation, Alabama politicians should consider lowering the licensing requirements to prevent industry abuse.

State politicians should also consider reducing the cost of relocating to Alabama for practitioners licensed in other states. While this chapter addresses the costs of active practitioners in Alabama, substantial fees and licensing requirements are necessary even for practitioners coming to Alabama that were previously licensed in other states.[33] This is particularly troublesome for Alabama, uniquely situated in both Hurricane Alley and Tornado Alley. In times of natural disaster, occupational licensing laws become particularly harmful, both in the immediate response and in the debris removal and rebuilding phases. Immediately, doctors, nurses, and other medical professionals, licensed in nearby states, are oftentimes prohibited by occupational laws from coming to assist. In the debris and rebuilding stages, when construction workers, electricians, and plumbers are desperately needed, occupational licensing laws inhibit licensed out-of-state workers from coming and assisting in the clean-up and rebuilding.

6 Conclusion

Occupational licensing, while promoted as a means to protect consumer interests, in practice, tends only to empower professional groups to undermine consumer sovereignty and occupational freedom. Low-income and minority groups are hit the hardest, both as consumers and as potential entrants into a licensed profession. By raising the cost and requirements to enter a profession, a professional group can restrict entry and thus artificially inflate wages.

Turning to private certification rather than compulsory licensing would protect consumer sovereignty and occupational freedom in Alabama. This would help Alabama retain and attract new professionals and better protect consumers.

Notes

1 There is some disagreement in the economics profession as to whether asymmetric information is, in fact, a market failure that government is capable of correcting. For example, see: Pennington, Mark (2011). *Robust Political Economy: Classical Liberalism and the Future of Public Policy*. Northampton, MA: Edward Elgar.

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Alabama's Department of Revenue list of Individuals/Entities Requiring Permits/Certificates was also included in this study, where applicable, available online: http://revenue.alabama.gov/licenses/pdf/Occupations_Entities.pdf.

5 The total number of Alabamians in licensed occupations was taken from the Alabama Department of Labor *2013 Licensed Occupation Guid*e (http://www2.dir.state.al.us/WorkforceDev/LOG/LOG.pdf) and the relevant licensing boards or licensees lists for those occupations that did not have the information contained in the LOG. Licensed occupations in Alabama that did not report the number of professionals in their field and thus are excluded include: Automotive Dismantler, Barbers, Elevator Contractors, Limited Elevator Contractor, Elevator Mechanics, Limited Elevator Mechanics, Eyebrow Threaders, General Contractor – Subcontractor, Motor Vehicle Rebuilders, Motor Vehicle Reconditioners, Motor Vehicle Wholesalers, Motor Vehicle Dealer – New, Natural Hair Stylist, Pedorthist, Prosthetists, and Orthotists Licensed Assistants, Polygraphy Examiner Internship, Real Estate Appraiser Trainee, Real Estate Appraiser State Registered Real Property, Real Estate Appraiser Licensed Real Property, Real Estate Appraiser Certified Residential Real Property, Sale of Checks, Surveyors – Engineer Intern, Surveyors – Land Surveyor Intern, and Water Transportation Personnel. Aircraft Flight Operators were also excluded because the LOG reported number includes Northwest Florida licensees. The data for Alabama's Civilian Workforce (employed and unemployed) was taken from the Alabama Labor Market News (http://www2.dir.state.al.us/Newsletter/LMI%20newsletter.pdf) for December 2013 (seasonally adjusted).

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Improving Lives in Alabama
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10

Legal Reform in Alabama: Recommendations and Implications

John A. Dove

Legal Reform in Alabama: Recommendations and Implications

John A. Dove

Summary Points

- The rule of law and an impartial judiciary is critical for commerce.
- Alabama's tort system is rated as one of the worst in the nation, despite recent reforms.
- Alabama should change its system of judicial selection. Partisan election of judges has been shown to significantly compromise independence and leads to biased treatment of out of state defendants.
- Alabama is one of only a handful of states which still impose joint and several liability, a rule demonstrated to impose significant risks on businesses and reduce productivity and growth.

All business activity requires risk taking within the face of an uncertain future. However, through the protection and enforcement of contract and property rights these risks and uncertainty can be greatly reduced. In order to accomplish this it requires a legal system that recognizes these rights and their applicability to all parties, as well as an independent judicial branch to ensure that this is carried out.

Unfortunately, Alabama's legal system has been plagued by perceptions of onerous tort abuse and a biased judicial branch for years. This situation has led some to recognize various counties and parts of the state as being susceptible to large-scale lawsuit abuse as well as judges (who are elected along partisan lines) that are considered to be plaintiff friendly rather than adhering to the rule of law (American Tort Reform Foundation, Various Years). A dysfunctional legal system can have long-term negative effects on economic growth and development within the state. A number of organizations have noted that these perceptions have translated into stifled business growth and entrepreneurial activity throughout Alabama. For instance, a 2012 Harris Poll found that 70% of corporate lawyers said that a state's tort and litigation environment heavily influenced decisions on where to locate and do business (Institute for Legal Reform 2012).

Recognition of the problems of Alabama's tort system and its detrimental effects on business and entrepreneurial activity led the state legislature in 2011 to enact a number of reforms to correct these problems and stimulate business activity and job growth. Although these reforms have generally been received positively, other important reforms are needed that could help improve the rule of law and judicial impartiality and with it also stimulate economic and business activity even more.

Alabama should alter its method of apportioning fault in civil trials and change its method of judicial selection. Research in law and economics clearly shows that resolving these two problems should increase job growth, worker productivity, wages, and business research and development. These reforms will also increase predictability, impartiality, and independence within the judicial branch of government, helping to ensure that the rule of law functions well. Therefore, these reforms, along with those recently enacted by the state legislature, would help increase long run growth and well-being throughout the state.

Introduction

The rule of law is integral to the development of any society and to a vibrant and growing economy. Its importance can be found from what the rule of law creates: stability and predictability. Ultimately, to achieve this result, the rule of law must contain three major characteristics: (1) Laws must be prospective and not retrospective, (2) Laws must be known and certain, and (3) All laws must apply equally to similarly situated individuals without exception.[1]

When these three conditions are met, the rule of law will promote economic growth, progress, and development, as well as justice and fairness. This is because the rule of law ultimately creates a delimited sphere within which each of us may operate, free from the interference of anyone else, and clearly demarcates permissible and impermissible behavior. The rule of law helps reduce the uncertainty that exists in an uncertain world and allows individuals to better plan and to make decisions within that uncertain world. Overall, it leads to greater investment in the economy in the form of human and monetary capital, as it grants greater economic freedom to all individuals. Therefore, through these channels it will, over time, increase entrepreneurial and business activity, which leads to greater economic growth and well-being.

Given this, it is important to try and quantify the rule of law and legal quality across states. One such study, conducted by the U.S. Chamber of Commerce's Institute for Legal Reform in conjunction with the Harris Poll, has attempted to do so on an annual basis.[2] Specifically, the study surveys over 1,000 legal experts within companies with at least $100 million in annual revenues. These experts indicate their knowledge of a state's legal system and then provide scores for each state along a set of ten different subcomponents based on a score of 0 (low) to 5 (high). From this, each state is given an overall score and rank, with the score ranging between 0 (low) and 100 (high). Thus, the higher the number a state receives, the "better" the quality of its legal institutions. This index was compiled for every year from 2002 through 2008, and then every other year thereafter.

For each subcategory every respondent is asked to score the state(s) that he or she is familiar with based on whether or not the state identified is doing an "excellent job at creating a fair and reasonable litigation environment" or whether the state identified is doing "a failing job at creating a fair and reasonable environment" within each subcomponent (Institute for Legal Reform 2012). **Table 10.1** provides a full, list of each of these subcomponents.

From this index, it is possible to observe the impact that greater legal quality can have within a state. This can be found in **Figures 10.1** through **10.4**, which compare overall legal quality to four important economic variables including economic freedom, per capita income, unemployment rates, and the net average firm growth rate for all states, which is a good measure of overall entrepreneurial activity within the state.[3]

Table 10.1: State Liability System Ranking Sub-Categories

Categories	
Category I	Overall Treatment of Tort and Contract Litigation
Category II	Having and Enforcing Meaningful Venue Requirements
Category III	Treatment of Class Action Suts and Mass Consolidation Suits
Category IV	Damages
Category V	Timeliness of Summary Judgment or Dismissal
Category VI	Discovery
Category VII	Scientific and Technical Evidence
Category VIII	Judges' Impartiality
Category IX	Judges' Competence
Category X	Juries' Fairness

Figure 10.1: Correlation Between Overall Legal Quality and Economic Freedom Score 2002-2010

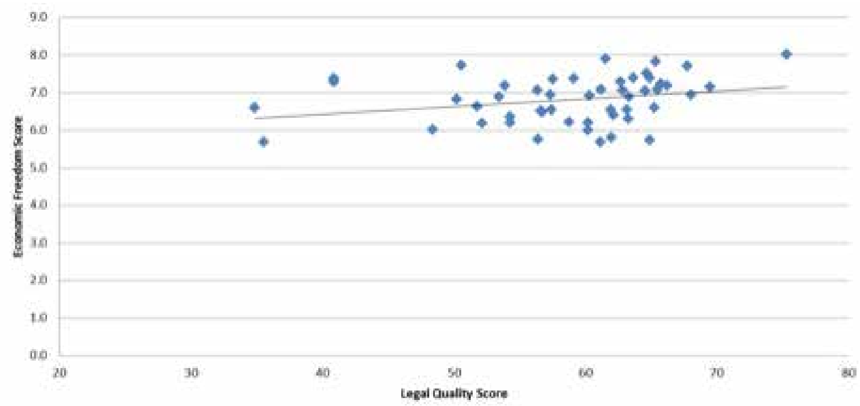


Figure 10.2: Correlation Between Overall Legal Quality and Per Capita Gross State Product 2002-2012

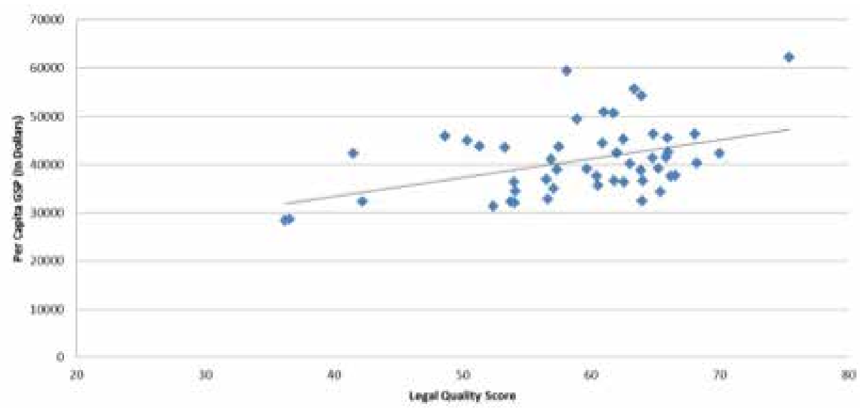


Figure 10.3: Correlation Between Overall Legal Quality and Unemployment Rate 2002-2012

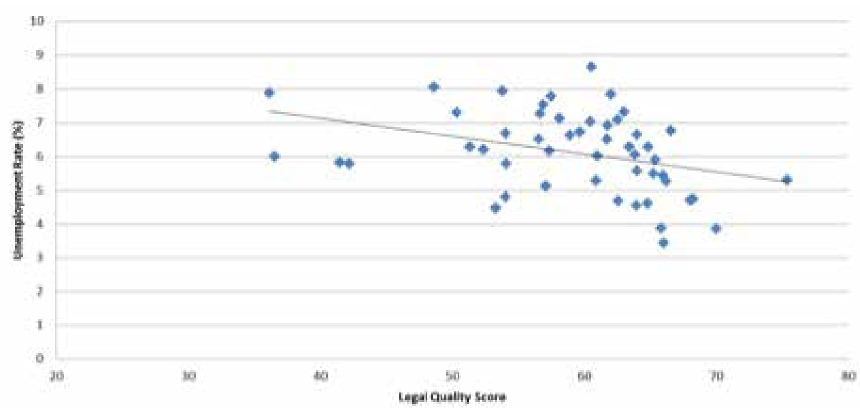
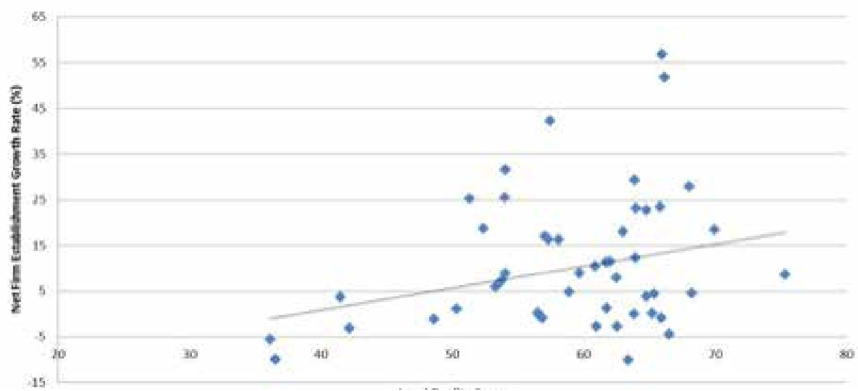


Figure 10.1 shows the relationship between each state's average legal quality score and each state's average economic freedom score between 2002 and 2010, the most recent year for which economic freedom scores are available. As noted, there is a direct link between the rule of law and economic freedom, as greater predictability and reduced future uncertainty allows more individuals to capitalize on the gains from trade and economic activity broadly. **Figure 10.1** shows a clear positive relationship between these two variables. In other words, as a state's legal quality increases, so does economic freedom.

Further, **figures 10.2** and **10.3** also indicate how greater legal quality increases economic activity as measured by both per capita state product (GSP) and state unemployment rates. As shown, per capita GSP is much higher and unemployment rates are much lower for those states that have greater legal quality. Finally, there is a clear positive correlation between legal quality and net firm establishment growth shown in **Figure 10.4**.[4]

Numerous academic studies also support the proposition that a better tort system is linked to greater economic growth overall. For example, Campbell, Kessler, and Shepherd (1998) analyzed how much firm productivity is impacted by liability reform, finding that for every decrease in the overall level of liability, firm productivity grew by 2% every year (over the years 1972 to 1990). This suggests an increase in worker productivity of roughly $1,050 per year per worker (and would also translate into higher wages for employees). Other studies have found that research and development severely lags in high liability-risk states and also that unemployment is higher in those jurisdictions, as well (Kimmel 2001). This happens because entrepreneurs in high liability-risk states are much less likely to create and innovate, and, also to put new products on the market. This is especially true for products

Figure 10.4: Correlation Between Overall Legal Quality and Net Firm Establishment Growth Rate 2002-2012



and innovations that have never faced legal issues before simply due to the fact that they never previously existed and thus makes it much more difficult to manage any potential future legal risk that might be associated with the product.

Overall then, as each of these figures and the academic literature clearly indicates, there is a strong, positive relationship between legal quality and economic growth and prosperity. Healthy legal institutions foster greater long-run stability within an economy. In other words, as suggested above, individuals are better able to plan for and invest in the future, as the future business and economic climate within a state becomes much more predictable and foreseeable. When this is possible there is more entrepreneurial activity, which tends to reduce overall unemployment and simultaneously increase wages and individual incomes.

Although it is clear from the above how important legal quality within a state is, unfortunately Alabama's legal system has consistently been rated as one of the poorest in the country. The overall impact is profound, as shown in **Table 10.2**. This table shows the average legal quality score, per capita income, unemployment rate, economic freedom score, and average net firm growth between 2002 and 2012 for the top five states on the Institute for Legal Reform's legal quality index compared to Alabama. As can be seen, the difference in economic outcomes between the top five states and Alabama is quite stark.

Specifically, the average legal quality score of the top five states was 27.30 points higher than Alabama. Further, the top five states had an average per capita income that was almost $15,000 higher than Alabama. The top five states also had an average unemployment rate that was almost 1% lower than Alabama. Finally, the average net firm growth rate was 11.74% for the top five states and -3.10% for Alabama.

It is possible to understand the magnitude of these differences by comparing Alabama to the OLS regression results obtained. This would suggest that had Alabama had a legal quality score equal to the average score of the top five states over the period, the per capita income would have been roughly $10,700 higher, unemployment rates would have been 1.43 percentage points lower, economic freedom scores would have been 0.54 points higher, and net firm establishment growth would have been 13.10%. Obviously this is a substantial and significant difference for every metric analyzed.

The contrast between Alabama's legal environment compared to all other states can also be seen in **Figure 10.5**, which shows the average score that Alabama has received for every subcomponent category of the legal index compared to the average score for all states.

Table 10.2

List of States by Overall Legal Quality Ranking, Average Per Capita Income, Unemployment, and Economic Freedom 2002-2012

	Average Legal Quality Score	Per capita Income	Average Unemployment	Average Economic Freedom Score	Average Firm Establishment Growth Rate
TopFive States					
Delaware	75.39	62128	5.31	8.01	8.63%
Virginia	68.04	46245	4.72	7.70	28.00%
Minessota	65.94	45523	5.45	6.60	-0.83%
Nebraska	70.01	42318	3.86	7.15	18.41%
Iowa	68.23	40210	4.75	6.95	4.55%
Alabama	**42.22**	**32296**	**5.78**	**7.29**	**-3.10%**
OLSRegressionEstimates Independent Variable = Average Legal Quality Score		$392	0.05%	0.02	0.40%

As can be seen Alabama scores well below the national average in every category, and is even an outlier in some of those subcategories. The overall effect that this has is borne out with the poorer economic and business environment that this has created within the state. This is also observed through a large body of anecdotal evidence as well.

For instance, numerous counties and portions of the state have been cited as having overly onerous tort awards and a biased judiciary due to extremely large awards given to in-state plaintiffs and what is perceived as an extremely close relationship between plaintiffs' lawyers and a number of judges around the state (American Tort Reform Foundation, Various Years). As a case in point, the two largest verdicts awarded in the U.S. in both 2003 and 2004 happened here in Alabama (American Tort Reform Association 2005).

Responding to these and other perceived abuses of the tort system, a number of reforms were signed into law in 2011. These changes affected the statute of limitations, or the length of time, for which someone might be liable for damages. The reforms also strengthened venue requirements in order to cut down on forum shopping, or trying to move a lawsuit to a plaintiff friendly location. Further, the state also increased the standards for the use of expert witness testimony, reduced the interest that would accrue while a verdict was on appeal, and also reduced the liability that a manufacturer could face regarding defective products.

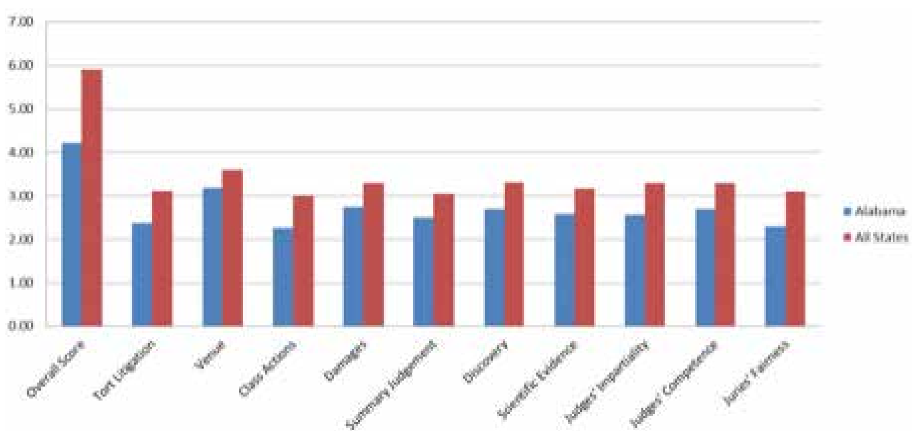
Although these changes are a significant positive step toward stemming tort abuse, Alabama could benefit from further reform. The remainder of this chapter focuses on two issues in particular. The first is the method of selecting judges in the state, while the second is the rule applied to apportion fault between parties in a lawsuit. As will be discussed, the incentives for judges created by partisan elections set up the potential for biased rulings in favor of in-state plaintiffs, decreasing impartiality and undermining economic growth. Further, Alabama's method of apportioning fault among multiple defendants has serious negative unintended consequences and significantly curtails business activity and entrepreneurship. Thus, reforming these two areas of Alabama's legal system, along with those previous reforms implemented, may lead to greater long-run growth and prosperity within the state.

II The Rule of Law and Legal Independence

An independent judiciary is generally considered the cornerstone of the rule of law. Ultimately, an independent judiciary is relatively insulated from other branches of government -- the executive and legislative branches, and also from external private influences that may bias decision making and judicial outcomes. Independence substantially increase the likelihood that the judicial branch will rule on the basis of the law, rather than private or political interests.

Within the federal government, this independence is most evident through the life tenure of judges. The method of appointment - executive nomination with the approval of the Senate – also increases independence. Federal judges are much more insulated from and protected against changing political circumstances or changes that may occur within public opinion.

Figure 10.5[5]: Difference for Each Subcomponent to the Harris Index for the State of Alabama Relative to All Other States



However, this situation is vastly different within the states. Each state is able to determine how judges within its jurisdiction are selected. These forms of judicial selection include partisan elections, non-partisan elections, gubernatorial appointment, merit plans, and legislative election. The first three methods of selection are by far the most popular within each state. Merit plans are generally methods whereby a governor may appoint judges from a list compiled by a nominating commission, and which in some states may also require the approval of the state legislature. **Figure 10.6** provides a list of each type of selection for state Supreme Court justices and the number of states that employ each.[6]

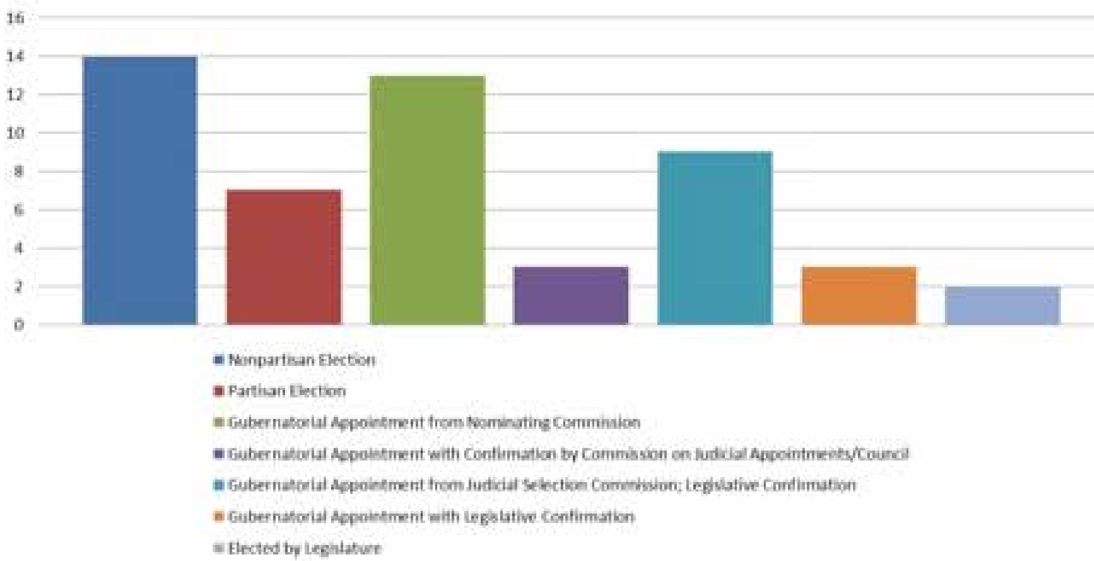
Most important to consider within this context are the incentives created by each method of selection, and how this impacts judicial impartiality, the rule of law, and judicial rulings. Under partisan elections, judges must earn their seats by gaining enough support from citizens through the ballot box. Thus, judges share many similarities with other popularly elected leaders, including many of the same incentives. Most importantly, partisan election requires that judges seek support from the general electorate and raise money to finance successful election campaigns. However, these incentives have several unintended consequences. The unintended consequences of seeking constituent support are best illustrated in the following quote:

> *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 . . . It should be obvious that the in-state local plaintiff, his witnesses, and his friends, can all vote for the judge, while the out-of-state defendant can't even be relied upon to send a campaign donation.*
>
> *Richard Neely –*
> *Former Chief Justice of the West Virginia Supreme Court*

Like Alabama, West Virginia also elects its judges along partisan lines. As can be seen, when judges are elected, in many ways they are responsible to the citizens and constituents that will fund their campaigns and actually vote for them during the election. Thus, in many cases, electing judges may actually bias decisions toward outcomes that, although they may disproportionately benefit constituents, may undermine the rule of law, and ultimately economic growth and development.

Academic studies have also highlighted the impact of the election of judges on judicial outcomes. One of the most important of those studies was Tabarrok and Helland (1999), which looked at total damage awards from tort cases in partisan elected states versus other states. Their findings definitively showed that in partisan elected states, damage awards against out-of-state business defendants were on average almost $940,000, while in other states the awards on average were roughly only $275,000. They also found that by moving a case which involved an out-of-state defendant from a non-partisan to a partisan elected state raised the expected award received almost 40%, which translated into an average award of just over $360,000 higher.

Figure 10.6: Method of Judicial Selection by State



Judges elected along partisan lines seek to direct benefits to their in-state constituents at the expense of out-of-state defendants. While unfairly high tort awards in Alabama may raise business' costs, these costs will be spread among all the company's customers and stockholders, only indirectly affecting the judge's constituents.

In order to better see how much judicial selection type may impact legal quality, perceptions of judicial independence, and judicial competence, I have put together a table to categorize each state by the method of selection they employ and how they score on each of those measures from the State Liability System survey. This comparison demonstrates which type of judicial selection method leads to a higher overall legal quality. The results can be found in **Figure 10.7**.

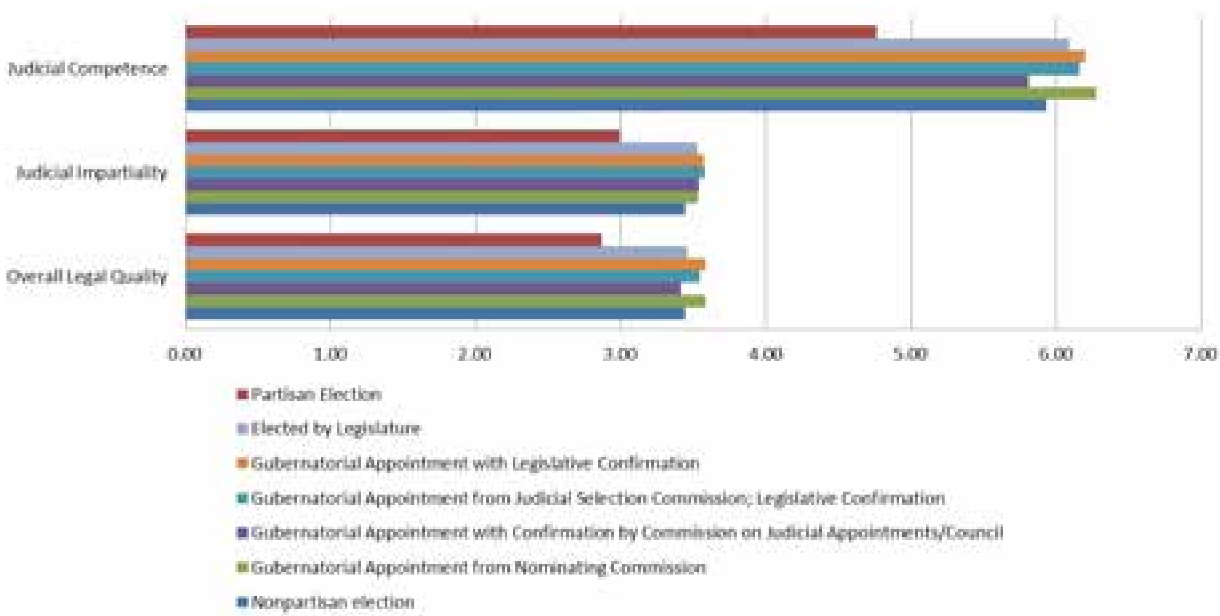
These results clearly show that legal systems in states that elect judges along partisan lines score much lower than those in states employing any other method of selection. In fact, the method of selection which resulted in the highest quality legal systems was gubernatorial appointment from a nominating commission.

The two remaining components of the State Liability System survey in **Figure 10.7** illustrate exactly how judicial selection hurts Alabama's judiciary. The first is the component measuring the perceived impartiality of the judicial branch in each state. This column also shows that judiciaries in states that elect their judges along partisan lines are perceived to be the least impartial relative to all other methods of selection. Further, the method of selection that appears to lead to the greatest perception of judicial independence is, again, gubernatorial appointment from a nominating commission.

The final component is the perceived competency of judges. Again, states with partisan elections are considered to have the least competent judges relative to all other methods of selection. Gubernatorial appointment from a judicial selection commission and legislative confirmation (which is another type of merit plan system) is considered to produce the most competent judges. These findings have also been verified within the academic literature by Sobel and Hall (2007). Their study formally tested how each method of selection affected legal quality and found that states using merit systems had the highest legal quality, states with nonpartisan elections were in the middle, and states using partisan elections had the lowest legal quality.

Overall, as all of the above anecdotal, theoretical, and empirical evidence seems to suggest partisan judicial elections lead to relatively poorer quality legal institutions and undermine the rule of law. This is most evident when contrasted with the selection of federal judges, which is a careful process of executive nomination with legislative consent, and also with lifetime appointments. As a consequence, the federal judiciary is one of the most insulated and independent legal bodies.

Figure 10.7: Legal Quality and Judicial Selection Type



Although the federal method of selection may be undesirable, the evidence overwhelmingly suggests that Alabama's current system of partisan election is deeply flawed and in need of reform. The reform that would have the most significant impact, and which has worked extremely well in other states that have shifted away from partisan elections, is to move to some form of judicial appointment, possibly with retention elections through a merit system. Such a system better insulates judges from both citizens who would be constituents and the possibility that the legislative or executive branch may unduly attempt to influence the judiciary.

III The Purpose of Tort Law and Issues with the Tort System in Alabama

As noted, while the purpose of the criminal law is to punish and deter wrongdoing, the purpose of torts is to provide compensation of injuries resulting from civil wrongs. A properly designed tort law promotes economic growth and progress and adequately compensates wronged or injured parties. Yet the design of a rule that will neither stifle economic growth and progress nor fail to adequately compensate injured parties is challenging. An important part of the challenge is a rule to apportion fault and shares of an award among multiple defendants.

Here, Alabama generally uses a rule of joint and several liability to apportion fault. However, Alabama is only one of 8 states that still adhere to a rule of pure joint and several liability; most states have either eliminated or modified the rule. While joint and several liability has some advantages, the evidence shows that the rule reduces economic growth and often produces unequitable results.

The intent of joint and several liability is to allocate liability among defendants based on the overall percentage of each individual defendant's negligence, (for example, when one defendant caused 60% of the damage to a plaintiff and another defendant caused 40%). However, under joint and several liability a number of complications can arise. For example, if one or more defendants are "judgment proof," meaning insolvent and unable to pay the damages awarded, then under the rule a plaintiff may collect all damages from any single defendant regardless of that defendant's percentage of fault. Thus, from the example above, if the plaintiff who caused 60% of the damage is unable to pay, then the party responsible for only 40% of the damage will be responsible for paying the full 100%.

One of the largest secondary effects arising from a rule of joint and several liability is its impact on business relations and activity. Boyd and Ingberman (1997) studied the economic impact that joint and several liability has on business relationships. They found that in states that had a rule of joint and several liability, relatively wealthier businesses were much less likely to contract and do business with relatively less wealthy businesses (since in the event that both parties were sued for some damage, the clear incentive is to force 100% of the payment from the wealthier firm). Overall, this has the effect of reducing economic transactions and business activities, and also makes it more difficult to capitalize on economies of scale and minimize production costs, meaning consumer products as a result are relatively more expensive. These authors further found that for those states which have adopted a system of proportional liability this situation was far less prevalent. This may, at least partially, explain why Alabama is home to only one Fortune 500 company.

The impact of shifting away from pure joint and several liability on economic activity can be profound. For instance, Kimmel (2001) found that shifting away from such a liability rule increased employment in the manufacturing sector by 1.5%, in the construction sector 1.4%, in the wholesale trade sector 0.8%, and in automobile repair by 1%. Overall, her findings suggest that shifting away from pure joint and several liability could decrease a state's unemployment rate by 1%.

Overall, this research indicates that some other method of appropriating liability may be efficiency-enhancing and thus lead to increased well-being and economic activity. Several options are available, all of which have been adopted by a vast majority of states in some form or another. One alternative is pure several liability, which would limit a defendant's liability to the actual percentage of damage caused, a rule in place in sixteen states. Another option would be to simply modify the existing rule, and prohibit joint liability for any defendant that is found to be below a given percentage at fault (for five states that threshold is below 51%, while for five states it is below 60%). A third solution may be to completely prohibit joint liability except for economic damages.

Research demonstrates that adoption of any of these alternative rules would increase economic activity, job growth, and productivity, while still providing the necessary security to promote sound and safe business practices and allow for the potential recovery of damages by plaintiffs injured through the negligence of others.

IV Conclusion

Although the importance of the rule of law and property rights protection and enforcement is a known ingredient for economic growth and prosperity, for some time Alabama has been an underperforming state along a number of different metrics regarding its overall legal quality. This has translated into lagging economic activity compared to most other states. This chapter has analyzed some of the challenges that the state faces and has offered several long-term recommendations that could help to improve the overall economic climate within the state through legal and judicial reform. Although these changes would take time to implement and ultimately to impact the economy, their long-lasting effects could be an extremely beneficial and long overdue change in the state.

Notes

1. This definition of the rule of law is loosely based on Fuller (1969). Further, none of the following analysis considers any issues regarding criminal law. Thus, there is no analysis as to whether the legal system is "tough" or "soft" on crime, or what could be done to change the criminal code. Here, torts is an area of the law that deals with civil as opposed to criminal wrongs. Whereas the purpose of the criminal law is typically to punish and deter wrongdoing, the purpose of torts is to provide compensation resulting from civil wrongs.
2. I employ this index as it has been used by a number of academic studies to measure legal quality (Sobel and Hall 2007; Sorens and Ruger 2009, 2011, 2013). Further, the only other similar measure compiled was the Tort Liability Index which, unfortunately, was only published in 2006, 2008, and 2010 (McQuillan and Abramyan 2006, 2008, 2010). Even by that measure, Alabama still scores relatively poorly, ranking 40th in 2006 and 2008 and 25th in 2010. Using this dataset nets very similar results to those provided throughout the paper. Therefore, I opt to use the Institute for Legal Reform's study as it allows for analysis over a much longer timeframe and provides more up to date information.
3. The information for economic freedom comes from the annual Freedom of North America Report conducted by the Frasier Institution (www.freetheworld.com). Per capita gross state product comes from the Bureau of Economic Analysis (www.bea.gov). Data for unemployment rates and establishment growth rates come from the Bureau of Labor Statistics (www.bls.gov).
4. It is also possible to determine whether there is a statistically significant relationship that exists between each of these indicators. This can be accomplished by using a statistical technique known as ordinary least squares (OLS). The results indicate that a one point increase in a state's legal quality score increases per capita income by $392, and is significant at the 1% level. Further, a one point increase in a state's legal quality decreases unemployment by .05%, and is significant at the 5% level. A one point increase in a state's legal quality score increases economic freedom by 0.02 points and is statistically significant at the 10% level. Finally, a one point increase in a state's legal quality score also increases net firm growth rates by 0.4 percentage points and is significant at the 5% level.
5. The overall score is scaled down by a factor of 10 in order to fit the graph.
6. This information was obtained from The American Judicature Society (www.ajs.org).

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11

Cultural Renewal: How to Make America Great Again

Adam B. Lowther

Cultural Renewal: How to Make America Great Again

Adam B. Lowther

Summary Points

- The primary characteristics of the great American narrative—individual liberty, personal responsibility, respect for private property, and the desire to "avoid entangling alliances"—have long served as the glue that binds the nation together.
- A new ethic of entitlement, dependence, collective responsibility, and a desire to export democracy through a variety of means—to include force—is replacing that narrative.
- The turn from the great American narrative toward the victim narrative has had negative consequences for economic policy, both in Alabama and the nation. The rise of the victim narrative affects all aspects of government activity, including military and foreign affairs.
- Meeting the long-term challenges in economic and foreign affairs facing Alabama and the United States will require a rejection of the worldview that has led to the current condition.

Introduction

Historian Paul Johnson opens *A History of the American People* with, "The creation of the United States of America is the greatest of all human adventures. No other national story holds such tremendous lessons, for the American people themselves and for the rest of mankind."[1]

While many Americans may see Johnson's words as an example of a mythical "American exceptionalism," early Americans often viewed the nation in biblical terms. The United States of America was seen as the "new Jerusalem," the "light of the world," and "a shining city upon a hill."[2] America was the earthly embodiment of mankind's greatest hope for a fallen creation. Through hard work, self-sacrifice, and rugged independence, Americans sought to overcome both the natural world and mankind's sinful nature.

An ethos developed during the nation's early history that was composed of two parts. On the one hand, it was full of hope and optimism, believing that individuals could achieve great success in a country where government did not restrict opportunity. On the other hand, Americans saw the world beyond the nation's borders as prone to strife and warfare.

Thus, when the Founding Fathers spoke of "civil religion," natural abundance, and manifest destiny, they were giving birth to what may be called the great American narrative, which has endured for more than two centuries.[3] Individual liberty,[4] personal responsibility, respect for private property, and the desire to "avoid entangling alliances," the primary characteristics of the great American narrative, have long served as the glue that binds together a nation of disparate economic, social, and religious interests. Today, this narrative is under attack as never before.[5]

A new ethic of entitlement, dependence, collective responsibility, and a desire to export democracy through a variety of means—to include force—is replacing the great American narrative. This new narrative, known as the victim narrative, is—like its predecessor—manifested in both domestic and foreign affairs. The great American narrative and the victim narrative represent opposing worldviews that cannot coexist.

Today, Americans are turning to government en masse, leaving domestic affairs to interest groups competing for the most government benefits. In foreign affairs, neoconservatives and neoliberal institutionalists—the "liberal" school of thought's right- and left-wing variants—are vying for supremacy within a Beltway intelligentsia that cannot decide whether kinetic or nonkinetic means are the best way to export or impose American democracy.

The influence of international relations liberalism is now pervasive in what has long been a bastion of realist thought: the military. When Navy Captain Wayne Porter and Marine Colonel Mark Mykleby, influential officers on the Joint Staff under former Chairman Admiral Michael Mullen, authored *A National Strategic Narrative*, it was clear that even the military was losing its attachment to the great American narrative's domestic and foreign affairs characteristics.[6] Porter and Mykleby exemplify the pervasive influence of the victim narrative within the military. As is argued in the remainder of this chapter, it is time to reject the victim narrative and once again embrace the great American narrative and its central characteristics.

Rejecting the Victim Narrative

At its core, the victim narrative rejects the very notion that every American and every nation is the master of their own destiny and responsible for their own success or failure. The belief in rugged individualism and self-reliance, at the individual and national levels, has given way to a focus on real or perceived grievances at home and abroad. Capitalism, classism, racism, sexism, or another "ism" is to blame for the failings of Americans and nations.[7] Personal choices are conspicuously absent from any explanation of success or failure.[8] Like the serpent in the Garden of Eden, the victim narrative promises to right past wrongs (at home and abroad) and free Americans from the chains that bind them. This seductive story does not discriminate based on age, gender, race, or religion. It seeks to influence every American. In rejecting Benjamin Franklin's admonition, "They who can give up essential liberty to obtain a little temporary safety deserve neither liberty nor safety,"[9] the victim narrative offers security at the cost of liberty.

The victim narrative is not new. Plato warned of its appeal in *The Republic*, and the Framers of the Constitution sought to create an "Empire of Liberty," preventing the ascension of the victim narrative by creating a limited republic—not a democracy.[10] The checks and balances found in the Constitution were specifically designed to restrain the power of the national government's three branches in domestic and international affairs. The Constitution's limitations, the amendment process, and the separate powers of the states were thought sufficient to protect the people from the rise of Plato's democratically elected despot, similar to what de Tocqueville called "soft despotism."[11]

In the slow turn from American exceptionalism and the great American narrative toward the victim narrative, domestic and foreign affairs have suffered greatly. Today, the United States is again at a crossroads. With the national debt surpassing the nation's gross domestic product, many advocates of liberty are wondering if the nation is beyond salvation. At a time when the American people are deeply concerned about the nation's economic future and are weary of the Long War, proponents of the victim narrative are lobbying for dramatic expansions in the government's role in domestic and foreign affairs.

In domestic affairs, there is a call for greater involvement in the lives of Americans.[12] Government's role in providing food, shelter, clothing, education, health care, and retirement must all grow. If left to their own devices—free to succeed or fail on their own—too many Americans are expected to make the wrong choices or suffer at the hands of the "ists" (capitalists, racists, sexists, etc.). Thus, the benevolent hand of government and its selfless bureaucracy are needed to act on behalf of rugged individualism's erstwhile victims. Only then will the nation achieve John Kenneth Galbraith's "good society."[13]

Government's creep into every aspect of what was once considered private exemplifies the concrete influence of the victim narrative. In his influential work The Road to Serfdom, Nobel Laureate F. A. Hayek wrote, "When the course of civilization takes an unexpected turn—when, instead of the continuous progress which we have come to expect, we find ourselves threatened by evils associated by us with past ages of barbarism—we naturally blame anything but ourselves."[14] It is the natural inclination to look beyond the mirror for a culprit. This enables the victim narrative to persist.

Foreign affairs have fared little better. The history of American interaction in the world over the past 20 years is the history of realism's decline and liberalism's ascension. It was a period marked by a decided turn from a guarded view of activity in the world to a preference for a United States that acts as "global cop" and maker of world order.

Henry Kissinger describes the conflict between realism and idealism, saying:

> *Such controversy on foreign affairs as takes place is divided between an attitude of missionary rectitude on one side and a sense that the accumulation of power is self-implementing on the other. The debate focuses on an abstract issue: whether values or interest, idealism or realism, should guide American foreign affairs.*[15]

Over the past two decades, liberalism has carried the day. In much the same way as the victim narrative has shaped domestic affairs, its tenets have shaped and are shaping the American approach to foreign affairs.

A dramatic shift in the nation's approach to the world began after the Soviet Union's demise. This single event emboldened advocates of Immanuel Kant's "perpetual peace" and encouraged them to take the offensive against an all-too-pessimistic political realism.[16]

Kantians challenged the tenets of Thucydides, Machiavelli, Morgenthau, Waltz, Mearsheimer, and American foreign affairs decision makers by positing a future that is ahistorical and forgetful of the Cold War's lessons.[17] What E. H. Carr described as utopianism, Enlightenment liberalism, and Wilsonian idealism modern international relations calls neoliberal institutionalism, neoconservatism, and neoliberal internationalism.[18] While differences within the liberal school of thought exist, each of these variants rejects the central tenets of realism.[19]

Hans Morgenthau described the debate between realists and liberals in saying:

> *One [liberalism] believes that a rational and moral political order, derived from universally valid abstract principles, can be achieved here and now. It assumes the essential goodness and infinite malleability of human nature, and blames the failure of the social order to measure up to the rational standards on lack of knowledge and understanding, obsolescent social institutions, or the depravity of certain isolated individuals or groups.*[20]

In rejecting human nature as irreparably flawed, liberalism is inextricably linked to the victim narrative.

Realism, according to Morgenthau, is grounded in a set of objective laws that are rooted in what is best understood as the Judeo–Christian understanding of human nature. Interests, defined in terms of power, are the main signpost that guides realism but are influenced by American values. These interests are not eternal but evolve with the state over time, and while political action has moral significance, universal moral principles are often difficult to apply directly to the actions of the state. This is because realism separates a state's aspirations from universal moral laws.

Thus, it should come as no surprise that realism often separates foreign affairs from morality, focusing on national interests.[21] Undeniably skeptical of grand schemes to refashion human civilization, realism proposes a more constrained role for government that focuses on a limited role in defending the nation's vital interests.

The present challenge to the American narrative and the accompanying liberal/realist debate is not new. American exceptionalism, as epitomized in the great American narrative versus the victim narrative, and liberalism versus realism, has long influenced the course of American history.

Near the end of his second term, George Washington published "The Address of General Washington to the People of the United States on His Declining of the Presidency of the United States" in the American Daily Advertiser on September 19, 1796.[22] In what is better known as his "Farewell Address," President Washington advised the young nation that it was, in fact, set apart and laid out a realist approach to foreign affairs.

Even as the United States has grown into a global superpower, Washington's wisdom remains as relevant today as it was in 1796. It serves as a useful framework for a reinvigorated great American narrative that is premised on an acceptance of American exceptionalism and a realist approach to foreign affairs.

The Great American Narrative in Domestic Affairs

When George Washington wrote his "Farewell Address," the Constitution had been the nation's foundational document for less than a decade. Even during that brief period, President Washington saw divergent visions of a culturally, ethnically, and religiously homogeneous people begin to break down national unity. Urging the prevention of such disunity comprises over half of the "Farewell Address." In encouraging a common sense of heritage and patriotism, Washington wrote:

> *Citizens by birth or choice of a common country, that country has a right to concentrate your affections. The name of American, which belongs to you in your national capacity, must always exalt the just pride of patriotism more than the appellation derived from local discriminations. With slight shades of differences, you have the same religion, manners, habits, and political principles. You have in common cause fought and triumphed together. The independence and liberty you possess are the work of joint councils and joint efforts—of common dangers, sufferings, and success.*[23]

Washington's words were prophetic, and he would go on to expand on this theme in an effort to prevent the differences in habits and interests from tearing the nation apart as they ultimately did.

While the United States has grown in economic and military strength over the past two centuries, it is again at a point where there is reason for concern. With dramatic changes in the country's demographic composition, vitriolic and partisan politics, dramatic growth in government, and serious economic challenges, the common bonds that held the nation together are fraying.

In an increasingly competitive global economic and security environment, the United States will cease to be the world's leading power unless there is a renewal of the great American narrative. To that end, three reforms are required.

From Democracy to Liberty.

In a rare challenge to the reigning political orthodoxy, economist Randall Holcombe laments the rise of a more democratic system of government in the United States, writing, "By 1980 democracy had completely replaced liberty as the fundamental principle of American government. Liberty remained as something valued by Americans and something worth protecting but only to the extent that it met with the approval of the majority."[24]

His cause for concern is based upon the loss of individual liberty that has accompanied the democratization of almost every aspect of American life. Where education, health care, charity, retirement, and many additional aspects of life were once the sole purview of the individual, they are now governed by a plurality of voters. Accompanying the rise of democracy has been a dramatic decline in private property rights and the economic freedom of Americans,[25] and as more of American life comes before the voter, a plurality is demanding more from government at the expense of a declining number of taxpayers.

Greater government spending is responsible for higher taxes, greater government borrowing, greater regulation of everyday life, and a diminution of the very liberty that the Framers of the Constitution sought to protect.[26] According to the most recent data, federal, state, and local spending equals 40 percent of the gross domestic product—a post–World War II high.[27] With approximately two-thirds of government spending consisting of some form of popularly supported transfer-payment program, the United States is well on its way to becoming the democracy that the Framers sought to prevent and that Plato warned against.

Although many Americans envision a solution to the nation's current woes that would "throw the bums out," blaming elected officials for creating popular programs and waging popular wars is shortsighted and places blame where it does not belong. Instead of looking to government, Americans must once again embrace the characteristics of the great American narrative and that sense of rugged individualism, personal responsibility, and private charity that was instrumental in building a remote European outpost into a global superpower.

As Nobel Laureate Milton Friedman once wrote, "The world runs on individuals pursuing their separate interests. The great achievements of civilization have not come from government bureaus."[28] Only when Americans look to themselves instead of the ballot box to find solutions will we find a cure for the nation's domestic and foreign ills.

From Entitlement to Entrepreneurship.

After more than two centuries, President Washington's words remain as prescient as ever. He admonished Americans, "As a very important source of strength and security, cherish public credit. One method of preserving it is to use it as sparingly as possible."[29] John Adams, in his first address to Congress, offered similar advice, saying, "The consequences arising from the continual accumulation of public debts in other countries ought to admonish us to be careful to prevent their growth in our own."[30]

With a national debt that is now greater than the gross domestic product and certain to climb significantly higher, it is clear that neither Republicans nor Democrats have heeded Washington's warning. As the victim narrative has gained influence, an ever-increasing number of Americans demand that government provide more from a declining number of taxpayers.

On one hand, 51 percent of Americans paid no federal income taxes in 2010.[31] On the other hand, 52.6 percent of Americans receive "significant income" from the government.[32] Thus, it should come as no surprise that American households are now receiving more in government assistance than they pay in taxes.[33] This is at a time when "the wealthy" are paying a significantly larger percentage of their income in federal income taxes than the wealthy in any other country in the Organization for Economic Co-operation and Development (OECD).

In other words, fewer Americans are contributing to the public good, while more Americans are placing demands on it. The entitlement mentality that is now so pervasive has created an entire industry of special-interest groups that seek ways to pilfer the public coffers. Whether it is corporate welfare, farm subsidies, student grants and loans, or entitlement programs for the elderly and poor, federal, state, and local budgets have become the troughs at which far too many Americans feed. As Randall Holcombe notes:

> *When government is small and the scope of its activities is limited, there is little incentive for special interests to try to use the government to advance their interests rather than to rely on their own productive activities in the market. When the government is large and when its limits are less sharply defined, there are potentially large gains to be had if government policies can be steered in a particular way.*[34]

Where Americans once expected to work for many years before enjoying the fruits of their labor, many now believe they are entitled to the comforts they have yet to earn. This state of affairs cannot last for long. The United States will soon find itself in a position where it is unable to borrow the resources needed to sustain entitlement programs at home and wage endless wars abroad to help the world's downtrodden.

Noticeably absent in the discussion of current fiscal challenges facing the United States has been any discussion of priorities at the national level. The wisdom of the Constitution may provide some guidance in this regard. The Preamble stipulates that our government was established to "provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity."

Note that it does not say "provide for the general Welfare…." It does explicitly say "provide for the common Defence." It's time to get our priorities straight.

Absent a renaissance of the entrepreneurial spirit and a rejection of the victim narrative's entitlement mentality, the United States will find itself in a steady state of economic and military decline. As history suggests, a nation's military might follows its economic strength. Europe is already facing a time when the welfare state has driven many European economies to the brink and left its militaries impotent.[35] Nations are cutting their military expenditures so drastically (to maintain the welfare state) that they cannot project power beyond their borders.[36] These enfeebled countries possess neither a robust economy nor a military capable of defending their national interests. Absent significant reform, the United States is likely to find itself in a similar position in the future.

During his first inaugural address, Thomas Jefferson said, "a wise and frugal government, which shall leave men free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned—this is the sum of good government."[37] He was correct, and today's scholarly evidence supports Jefferson's thesis.[38] Without a significant cultural shift away from the victim narrative's entitlement mentality, the United States will not recover its recently lost fiscal and military power.

From Secularism to Civil Religion.

Over the past two centuries, the United States has evolved from a frontier society of Anglo-farmers into a diverse country. However, ethnic, religious, and cultural diversity has not diminished the value of the timeless virtues that made this nation great.

In his "Farewell Address," Washington placed one virtue above all others, saying, "Of all the dispositions and habits which lead to political prosperity, religion and morality are indispensable supports. In vain would that man claim the tribute of patriotism who should labor to subvert these great pillars of human happiness, these firmest props of the duties of men and citizens." Washington went on to add, "Let it simply be asked where is the security for property, for reputation, for life, if the sense of religious obligation desert the oaths, which are the instruments of investigation in courts of justice?"[39]

For Washington, religion was the basis of morality, which served as the foundation upon which a free people were able to control human passion and govern themselves. De Tocqueville described the role of religion in the United States in writing:

> *Religion in America takes no direct part in the government of society, but it must be regarded as the first of their political institutions; for if it does not impart a taste for freedom, it facilitates the use of it. Indeed, it is in this same point of view that the inhabitants look upon religious belief. I do not know whether all Americans have a sincere faith in their religion—for who can search the human heart?—but I am certain that they hold it to be indispensable to the maintenance of republican government.*[40]

Both Washington and de Tocqueville understood the power of religion to constrain human nature. This view—that religion is an indispensable check on the passions of the people—was seen as the glue that held society together and enabled a free people to govern themselves.

Today, the ongoing effort to supplant a Judeo–Christian civil religion with the victim narrative's aggressive secular humanism is responsible for exacerbating many of the social ills it purports to solve. By substituting an all-powerful government for a belief in the Creator, advocates of the victim narrative have systematically undermined the positive societal characteristics that played a prominent role in the nation's success during its first century and a half.

By replacing fathers with welfare checks, government has destroyed the nuclear family for millions of American children. As a result, these children are less likely to lead healthy, happy, productive, and successful lives.[41] In fact, no other variable can better predict the probability that a child will grow up in poverty than whether the child's mother is married.[42] Thus, American society is in free fall and turning increasingly to government to solve social ills that government is largely responsible for making far worse.

Similarly, the demise of a civil religion has left American foreign affairs without its compass. Rather than viewing the United States as a shining "city upon a hill"—a beacon of liberty for the world to emulate—as John Winthrop (1630), John F. Kennedy (1961), and Ronald Reagan (1976) all once called it, today's international relations liberals seek an activist foreign policy that rejects the Judeo–Christian worldview for a secular worldview, one where omnipotence is present in the exercise of American power. It is a macro-level example of the micro-level deterioration of American society.

What, then, is the solution in foreign affairs?

Realism: A Pragmatic Approach to Foreign Affairs

While Porter and Mykleby's *A National Strategic Narrative* has many flaws, they and the National Security Strategy are correct in suggesting that a growing American economy is central to successfully defending the nation's vital interests. However, both documents clearly articulate elements of the victim narrative, and they advocate policies that will not stimulate the economic growth they claim to support. It is only in rejecting this worldview and the welfare state that comes with it that the United States can begin to recover lost ground.

Commentators in the economic press have gone to great lengths to elaborate on the specific details of the reforms required to move America in a positive direction, but with the domestic sea change that would occur, the nation should also experience a cultural shift—a return to personal responsibility and self-reliance. Such a shift could also impact an American approach to foreign affairs similarly, reducing the nation's penchant for activism abroad. In advocating such an approach, three overarching elements will play an important role.

From Adventurism to Constraint.

Sebastian Rosato and John Schuessler suggest that a realist approach to foreign affairs begins by making three assumptions: First, the international system is anarchic. Second, states cannot know the present or future intentions of others. Third, interstate war is unpredictable and often has devastating consequences.[43] Because of these conditions, a realist approach to foreign affairs accepts the limits of American power—kinetic and nonkinetic—and seeks to focus on defending the nation's enduring vital interests. Should these be harmed, it would cause great damage to the economic and physical security of the nation.

This precludes moral crusading. In a recent dismantling of neoconservative historical revisionism, Christopher J. Fettweis writes, "What the Founding Fathers actually believed, and what they recommended to their successors, was that the United States should be restrained in its actions, not isolated from the rest of the world."[44]

William C. Martel suggests the United States follow a policy of "restrainment," which he describes as a "foreign policy designed to counteract the forces that undermine international peace and security, while calling for the United States to exercise greater self-restraint and work collaboratively toward this goal."[45] Although restrainment is designed to be a 21st-century version of containment—designed to deter modern challenges to international order—Martell's strategy is less about constraining American activism and more about internationalizing such efforts.

Instead, prudence should become the "supreme virtue in politics," as Hans Morgenthau once suggested.[46] A foreign policy of prudence would require that the United States constrain its desire to act as moral agent in a world that is decidedly imperfect. While adopting former Secretary of State Cordell Hull's maxim, "He may be a son-of-a-bitch, but he's our son-of-a-bitch," may be unappealing, a dispassionate approach to focusing American foreign affairs on the defense of the nation's vital interests is a prudent policy.[47] In keeping with an approach governed by constraint, the United States would be wise to heed George Kennan's advice: "The best way for a larger country to help smaller ones is surely by the power of example."[48]

From Offense to Defense.

For the United States, the 20th century marked a decided shift from nonintervention to the offensive use of military power. In some instances, such as the defeat of Nazi Germany and imperial Japan, the exercise of American strength was necessary, but in many instances, it did little to protect the nation's vital interests. Too often in the post–World War II period, American policymakers were susceptible to using military power simply because it was there. As Madeleine Albright once asked then-Chairman of the Joint Chiefs of Staff General Colin Powell, "What's the point of having this superb military that you're always talking about if we can't use it?"[49]

Instead, the nation could benefit from a grand strategy with the five elements proposed by Clark Murdock and Kevin Kallmyer: First, it should be balanced, aligning competing interests. Second, it should be prudent, employing American power conservatively and cautiously. Third, it should be principled; rejecting American values wholesale is untenable. Fourth, it should be purposive, guided by a clear strategic vision. Fifth, it should be sustainable, enduring across Republican and Democrat Administrations.[50]

While attributes three and four (principled and purposive) are the most problematic for realists, American adventurism could be constrained if the United States were to develop a clear and widely accepted understanding of its enduring national interests. In constructing a more rigorous framework of national interest and grand strategy, it might prove more difficult for a President to employ American power for ill-conceived or arbitrary purposes. Such an approach would leave the Department of Defense more representative of its name.

From Permanent Presence to Permanent Interests.

When Thomas Paine wrote Common Sense, he warned, "As Europe is our market for trade, we ought to form no partial connection with any part of it. It is the true interest of America to steer clear of European contentions."[51] Thomas Jefferson shared a similar view, advocating "free commerce with all nations, political connection with none, and little or no diplomatic establishment."[52]

While some may scoff at such an approach today, both Paine and Jefferson understood that the success of the United States was premised on its trading relations, not its political alliances and ties. In advocating and conducting foreign affairs that were largely noninterventionist, they sought to protect American trade from the arbitrary whims of nations in competition with one another. This objective is no less valid today than it was in the 18th century, despite America's rise to superpower status. In fact, with the U.S. the world's largest manufacturer, the intent of Paine and Jefferson may be more prescient today than it was more than two centuries ago.[53]

Focusing on the nation's commercial interests calls for the United States to play a lesser role in supporting or thwarting the machinations of other states and their leaders, be they democratic or authoritarian. This is not to say that the United States should idly watch as the world descends into chaos. Rather, it is a call for a more focused approach to foreign affairs that never loses sight of what has long mattered most to the country. What made the American role in the Cold War so important was that Soviet Communism was a fundamental threat to American commercial interests. This was because the Soviet Union sought to overthrow the economic system upon which American prosperity was based.

Today, however, neither al-Qaeda nor China nor any other potential threat has the means to bring about grave economic harm to the United States—absent a nuclear exchange. Without such a threat to the United States' vital interests, less is more when it comes to what has become a permanent American military presence in an estimated 70 percent of countries around the globe. After all, if everything matters, nothing matters.

Conclusion

With the United States facing long-term challenges in economic and foreign affairs that are certain to prove difficult to solve, it is finally time to reject the worldview that led to the nation's current condition. The timeless wisdom of the Founders offers 21st-century Americans the intellectual framework for a renaissance of individual and national rejuvenation. To be successful, however, rejecting the victim narrative at home and abroad is crucial.

Yes, the world is inherently unfair because human nature is deeply flawed, but to suggest that an all-powerful government can right domestic and international wrongs is the height of hubris. All too often, those who advocate such policies are judged by their intentions rather than by the effects of their actions. If such were the case, it would be all too clear that the welfare state is an abject failure and that an American foreign policy more narrowly focused on the defense of vital interests is best for a nation that may soon fall from its lofty perch.

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Improving Lives in Alabama
A Vision for Economic Freedom and Prosperity

JOHNSON CENTER
TROY UNIVERSITY

12

Economic Possibilities for our Grandchildren: Unleashing the Invisible Hand in Alabama

Art Carden

Economic Possibilities for our Grandchildren: Unleashing the Invisible Hand in Alabama[1]

Art Carden

Summary Points

- Economic institutions and a culture that dignifies honor and innovation provide the foundation for growth, prosperity and improving lives in Alabama. With the proper institutions in place – secure property rights, a dependable legal system, political stability, honest government, and open & competitive markets – growth ensues as people search for new and better ways to do things.
- Alabama's policy makers have erected barriers to this natural progress through occupational licensing, immigration restrictions, and blocking innovative businesses. At the same time, policy makers waste resources in pursuit of government-led economic development plans like sports stadiums, theme parks, and the Alabama Cruise Terminal.
- A culture and civil society which dignifies commerce and innovation provides a foundation for the institutions to support prosperity and growth. Alabama's civil society – churches, clubs, and charitable organizations – can contribute to a culture conducive to growth and flourishing.

Introduction

The *Improving Lives in Alabama* project has considered several weighty and controversial issues. Daniel Smith summarized the research on occupational licensing and showed that it works to the detriment of the least of these among us. George Crowley discussed the opportunity cost of industrial subsidies and explained why Alabamians are not better off because of corporate welfare. John Merrifield and Jesse A. Ortiz, Jr. explored the research on educational choice and argued that expanding opportunities for families to choose how to educate their children would lead to better outcomes. Eileen Norcross explored Alabama's position in the looming discussion over the future of public pensions, and criticism her article elicited notwithstanding many economists agree that public pension liabilities are seriously understated. The chapters in this volume fill in details about specific policy proposals that can improve lives in Alabama. This chapter takes a bird's-eye view of Alabama's economic future. If we preserve liberty and dignity for innovators, entrepreneurs, and average, everyday people, the economic possibilities for our grandchildren are practically unlimited.

Most of what follows will not be very new in spite of the fact that a large part of my job as a professor is to tell or to hear some new thing. We will explore the foundations of economic growth in terms of textbook treatments and classic contributions. To improve lives in Alabama, we should focus our attention on the social, political, and cultural institutions that support and shape production. Observers make a mistake when they focus on distribution per se. Nobel Laureate Robert Lucas (2004) summarizes this nicely in one of my favorite quotes:

> *Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution. In this very minute, a child is being born to an American family and another child, equally valued by God, is being born to a family in India. The resources of all kinds that will be at the disposal of this new American will be on the order of 15 times the resources available to his Indian brother. This seems to us a terrible wrong, justifying direct corrective action, and perhaps some actions of this kind can and should be taken. But of the vast increase in the well-being of hundreds of millions of people that has occurred in the 200-year course of the industrial revolution to date, virtually none of it can be attributed to the direct redistribution of resources from rich to poor. The potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production.*

What unleashes the "apparently limitless potential of increasing production"? We can think about economic growth in the context of an insight from Adam Smith, the man widely considered to be the father of economics. In a 1755 essay that prefigured some of the themes of his *Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith wrote:

> *Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.*[2]

"The natural course of things" is a process by which people search for new and better ways to do things. A large body of research suggests that this is the case: when people have the economic freedom that comes with "peace, easy taxes, and a tolerable administration of justice" and when innovation and production are embraced, societies are "carr[ied]…to the highest degree of opulence."[3] Economic freedom and a culture that embraces innovation can carry us higher still and to ever-broader economic possibilities for our grandchildren.

II. Institutions and Economic Growth

Research into why some places are very rich while other places are very poor suggests a way forward for Alabama. These insights appear in textbook treatments familiar to introductory economics students. Cowen and Tabarrok (2013: 125-129) explain five (literal) textbook conditions we might call the "ultimate causes" of economic growth. They are secure property rights, a dependable legal system, political stability, honest government, and open and competitive markets. These are foundational because a society's rules—its institutions—help determine whether societies succeed or stagnate.[4]

According to Gwartney et al. (2010:46-52), property rights are important because they encourage wise stewardship, productive use of resources, activities that create value for others, and the development and conservation of natural resources. When property rights are secure, people have incentives to invest and innovate because they will enjoy the fruits of their labor. When property rights are insecure, people have weaker incentives to produce and trade.

A dependable legal system is important because it helps shape people's expectations. Ours is "a nation of laws, not of men," and the fact that the law is supposed to be no respecter of persons means that property rights are more secure and legal outcomes are less arbitrary than they would otherwise be. When the same abstract legal principles apply to everyone, people face less uncertainty and, therefore, they have better incentives to invest. This is one area in which Alabama has considerable room for improvement, as John Dove's contribution to this volume points out. The Mercatus Center's Freedom in the 50 States report notes that "Alabama's court system ranks as one of the worst in the country" according to survey data from the Chamber of Commerce that is used in compiling the report; however, this still represents marked improvement since 2001 (Ruger and Sorens 2013).

Fortunately, Alabamians do not have to worry about the kind of political instability that plagues many societies around the world. Corruption is a bigger and more relevant problem. Cowen and Tabarrok note that "honest government" is important because corruption can be "like a heavy tax" on businesses. In some countries, for example, police officers and government officials regularly solicit bribes in order to discharge their legal duties or to be persuaded not to abuse their regulatory powers. Tragically, there are far too many examples of the same in Alabama. Yet while fighting corruptions is undoubtedly important, perhaps a more valuable task in the long run is rolling back the government interventions creating opportunities for corruption in the first place.

Open and competitive markets are essential to growth because they help direct resources into the right hands. Open and competitive markets ensure that resources are used wisely in that a competitive market in equilibrium is one in which goods are produced by those who have the lowest costs of production, goods go to those who value them most highly, and all mutually-beneficial trades are made.[5] Open and competitive markets also encourage people to innovate: to build cheaper mousetraps, better mousetraps, or whole new ways of catching mice that others may have never considered. While regulatory obstacles have gotten in the way of firms like Uber, a Birmingham-area startup called Shipt has the potential to change the way Alabamians shop.[6] When we give others the gift of liberty, we also give ourselves the gift of prosperity.

III. Embracing Open and Competitive Markets

Alabama policy makers can make genuine progress unleashing the invisible hand as public policy limits access to many Alabama markets. Granted, Alabama is not alone in limiting access to these markets, but just because other states are doing the same thing does not mean it is good public policy. Alabama policy makers can improve lives in Alabama by abandoning occupational licensing rules, repealing "price gouging" laws, and eliminating the hoops that technology innovators must jump through to do business in Alabama.

Occupational Licensing

In his first contribution to this volume, Daniel Smith considered occupational licensing. Asymmetric information problems—specifically, sellers know more about the goods they are offering than buyers—mean that buyers might find themselves cheated by unscrupulous sellers. When quality is difficult to measure, markets might not emerge at all. Hence, regulation might be necessary to protect consumers and to ensure that a market exists.[7] These information problems create an opportunity for firms and organizations that can provide certification services. Examples include the Underwriters' Laboratory and the Good Housekeeping Seal of Approval. Certification solves the information problem without distorting output or without distorting the political incentives.[8]

Licensing, however, can be a barrier to entry that reduces output and raises prices. This makes us worse off as a society because we have fewer athletic trainers, tree trimmers, massage therapists, locksmiths, and so on than we would have without licensing. Licensing also reduces innovation, and it benefits the wealthy (who can pay for quality) at the expense of the poor (who cannot) (Kleiner 2006: 43). Members of the licensed occupations also spend time, energy, and money protecting their privileged positions through lobbying. As Tullock (1968) argued in a seminal article on the economics of politics, this lobbying is pure social waste. The relevant institutional problem, therefore, is to identify ways to prevent special interests from using regulation to restrict access to the market.

These restrictions make it harder for people to climb the economic ladder. Americans extol the virtues of hard work, innovation, and entrepreneurship, but these virtues are punished by laws requiring that people obtain government licenses to practice their chosen trades. Alabama can open access to the economic order, reduce unemployment, and generate economic growth by removing restrictions on entry into occupations that currently require a government license.

Price Gouging Laws Close Markets

Natural disasters have the capacity to turn people's lives upside down. Governments actually make problems worse by prosecuting "price gougers," those who raise prices for food, water, gasoline, generators, building supplies, and other goods and services in the wake of disasters. These rules restrict market forces that are perhaps most necessary during times of extreme chaos. Prices send signals to people telling them that they need to conserve resources that are suddenly scarcer and more valuable than they were before the storm: think twice about driving, for example, or try to get the whole family into one single hotel room. When governments control prices, they create shortages and actually hinder recovery efforts by unintentionally encouraging people to waste precious resources and discouraging people from outside the disaster-stricken area who would have otherwise been motivated to bring supplies into the area because of higher prices.[9]

Immigration and the Labor Market

Policy makers should work to make the labor market more open and more competitive. In 2011, Alabama passed an immigration law that attracted criticism from commentators and economists. The law targeted undocumented immigrants because they are allegedly a drain on state resources and because they allegedly take the jobs of Alabama workers, but as economists continue to point out, immigrants do not merely raise the supply of labor. They also raise labor demand because they too want goods and services that natives produce. Caplan (2012) points out that immigrants' effects on natives' earnings are either very small or positive. Furthermore, decades of experience with a growing labor force suggests that immigrants do not displace natives in the labor market. The large-scale entry of women into the workforce in the 1960s and 1970s did not cause massive unemployment for men. Immigration also has not caused large-scale displacement of American workers.

Immigration restrictions burden more than the immigrants. They also burden employers, whether they employ immigrants or not, and they create risks for Americans who have been cleared to work in the United States legally. Alabama immigration law will cost Alabamians as Alabama businesses spend more time complying with burdensome regulations and less time focusing on their core business. In short, Alabama companies like Dreamland and Jim & Nick's will be spending more time filling out paperwork and less time cooking barbecue or expanding their operations. Alabama's immigration law makes it costlier to do business in the state and diverts businesses' attention from their core business of serving customers toward the distraction of regulatory compliance. There are legitimate concerns that undocumented immigrants in Alabama may be a net drag on state welfare resources, but it is hardly clear that the proposed "cure" is better than the disease.[10]

Embracing Innovation and Disruptive Business Models: From Uber to Tesla

In Summer 2014, Birmingham officials were trying to figure out what to do about possible entry from ride-sharing app service Uber. As with occupational licensing, there is at least a plausible argument for why regulation might be warranted (consumer protection with asymmetric information), but Uber, Lyft, and other firms solve information problems with their rating systems. They ultimately settled on regulations that did not technically bar UberX's ride-sharing service but created a complex set of bars to clear and hoops to jump through that made the company's low-price business model impractical in the city. Birmingham leaders missed an opportunity to demonstrate their openness to innovation. The same scene was repeated in Tuscaloosa in the Fall, when city leaders again warned Uber that UberX drivers would essentially be regulated like taxicabs. They ultimately threatened to arrest Uber drivers. These endeavors send a bad message to innovators about whether Alabama is or isn't receptive to innovation. I wonder: how many companies like Shipt aren't being started because of regulatory barriers? How much additional innovation are we missing out on because regulation blocks transportation innovation?

In a policy study for the Mercatus Center at George Mason University, economists Stewart Dompe and Adam C. Smith discuss cab drivers' complaints against platform providers like Uber and Lyft. They note that the regulatory complaints being filed by incumbent taxi drivers in cities like "Chicago, Houston, Seattle, and Boston" represent "spending scarce resources on contesting wealth instead of creating it" (Dompe and Smith 2014:1). The debate about the safety of ride-sharing operations often overlooks the fact that firms have valuable brand names that they have incentives to protect. With respect to taxi regulation, Dompe and Smith (2014:2) note that "(t)he rationale for regulating taxicabs is to protect consumers, yet the regulation's main result is to keep prices high and actively discourage services to lower-income customers."

As Tullock (1968) and Krueger (1974) pointed out and as a large body of scholarship continues to verify, resources are consumed in zero-sum battles over the distribution of government favors like subsidies and special tax breaks. Resources are also consumed as people spend more time, money, and energy complying with increasingly-complex taxes. Government action encourages what Baumol (1990) called "unproductive entrepreneurship" as people look for ways not to create new value, but to curry favor with the government.

The Uber controversy is an example showing that there is really nothing new under the regulatory sun. In the early twentieth century, cities like Los Angeles cracked down on private jitney services (Eckert and Hilton 1972). The market for livery services in most cities is very heavily regulated. These artificial supply restrictions raise prices and encourage people to drive when they would otherwise a driver. By lowering the price of hiring someone to take care of the driving, ride-sharing services would, I expect, reduce distracted or drunk driving. While it is too early to tell from systematic study, some evidence is gathering that ride-sharing firms like Uber and Lyft reduce DUI arrests (Badger 2014).

State and local policymakers have an opportunity to avoid the same mistake with respect to direct sales of Tesla's electric cars. Some states (like Michigan) have passed laws and made rules effectively banning direct-to-consumer sales and mandating that people buy cars through dealerships. This introduces unnecessary costs, makes car-buying more expensive, helps keep depreciated, environmentally-unfriendly cars on the road longer, and restricts residents' access to innovative new products.

By obstructing companies that are trying to do new and innovative things, state and local officials are effectively saying "disruptive innovators need not apply" and protecting special interests. Instead, Alabama leaders should work to capitalize on other states' mistakes. Instead of blocking companies like Uber, Lyft, Airbnb, Tesla, and others, Alabama's leaders should be eliminating the barriers preventing people from bringing innovative new products and technologies into the state—or developing them here.

Opening the Market for Banking Services: Institutional Change in Alabama

An example from Alabama's history illustrates. The CEO of First Alabama Bank described Birmingham in the 1960s as "feudal" (Gamble 1987: 27).[11] For many years, banks were not allowed to operate branches across county lines, or in some cases even across city lines. Nor were many banks allowed to hold portfolios that included banks in different regions. This made the banking sector extremely inefficient as banks did not provide customers with the levels of service demanded and were limited to carrying portfolios of highly geographically concentrated loans. While banks were able to diversify by holding deposits of state funds and by holding US Treasury securities, Alabama's financial system—and therefore, the state's economy—was not as dynamic as it could have been.

That changed when Central Bank of Alabama, under the leadership of Harry Brock (for whom the Brock School of Business at Samford University is named) worked to change the law throughout the 1960s and 1970s, first to allow bank holding companies and then eventually to allow statewide branch banking. This made banking in Alabama more competitive, ultimately benefiting customers across the state. While Mr. Brock and others were ultimately successful, they had to expend considerable resources simply securing permission to compete with other banks as opposed to actually competing and providing better services to Alabamians. The institutional change led to greater productivity, but Alabamians would have enjoyed greater wealth without the restrictions in the first place.[12] In part, this would have happened because the banking sector would have been more competitive, but it also would have happened because the political entrepreneurs who were able to change Alabama banking would have spent less time and energy trying to get permission to offer banking services and more time and energy actually offering banking services. As in medieval Europe and as in many countries with dysfunctional institutions around the world today, Alabama regulators were careful to make life difficult for innovators who wanted to upset the status quo.

IV. White Elephants: Stadiums, Convention Centers, and Amusement Parks

I was born in Alabama but grew up near Columbus, Ohio. The first time I ever voted, I voted *for* a subsidy that would have built a hockey arena and a soccer stadium. Fortunately, the measure was defeated. As I learned more about economics I came to understand the error of my ways. Resources are scarce, they have alternative uses, and it is hardly clear even in theory that stadiums, convention centers, and large public works are wise uses of resources. The empirical literature suggests that at best stadiums are an economic wash for a metropolitan area (Coates and Humphreys 2008).

Stadium and Convention Center deals are deceptively attractive for voters and politicians. We're told that if we build a stadium or a new convention center, then we will get an increase in tourism and, therefore, an increase in economic activity. It's a story for which I fell the first time I voted, but the evidence suggests governments should no more build stadiums than they should build pizza places or subsidize Big Box retailers. Bad development policy does not require bad intentions, only a combination of bad ideas and bad incentives.

Stadium and convention center proponents base their arguments on projections of large economic impacts that, as Sanders (2014) shows, do not materialize. Sanders offers a comprehensive survey of convention center debates, how they fail to meet consultants' rosy projections, why the projections are so rosy in the first place, and why coalitions of downtown property owners succeed in getting convention centers built and expanded. This leaves states and cities on the hook for stadiums and convention centers that must be paid for but that are not generating enough revenue to cover both their costs of operation and their debt service. Stadiums are not net generators of new economic activity; rather, they are redistributors of existing economic activity (Coates and Humphreys 2008)—and expensive ones at that.

Stadium proponents argue that a new stadium will generate tourist revenue as people visit town for a Big Event, but the evidence shows that even Big Events are not growth creators. Baade and Matheson (2001) use data from 1973-1997 to estimate the effect of the MLB All-Star game on local economies. They actually find a negative relationship between employment growth and hosting the All-Star game, and using data on California cities they find that the All-Star Game is actually associated with a reduction in taxable sales. Calling MLB's impact estimates "a wild pitch" rather than "a home run," they summarize their results (p. 322):

> *"Instead of an expected gain of around 1,000 jobs in the year a city hosts an All-Star Game, employment numbers in host cities have actually fallen more than 8,000 jobs below what would have been expected even without the promised $60 million All-Star boost.*
>
> *"In analyzing the impact of All-Star Games in San Diego, Oakland, and Anaheim, an examination of taxable sales data reveals that taxable sales in host cities have not only failed to increase during All-Star Games, but have on average fallen nearly $30 million below what would have normally been expected in these host cities."*

Furthermore, Baade et al. (2008:194) argue that "New stadiums, arenas, and franchises, as well as mega-events, appear to be as likely to reduce taxable sales as increase them."

Why don't stadiums and convention centers produce game-changing economic growth? As Baade et al. (2008) and Coates and Humphreys (2008) explain, stadiums simply alter patterns of economic activity but not necessarily the total amount. First, sports and stadium events compete for entertainment dollars within the city. The money spent by fans at and around the stadium is not being spent elsewhere. A Big Game at a domed stadium in downtown Birmingham would cannibalize economic activity that would otherwise take place in other parts of the city. Second, big events create traffic and congestion, crowding out activities by other people. When we lived in Memphis, we were once unable to get a table at a restaurant that was filled with people who were in town for the Liberty Bowl. The very visible spending they were doing at a Memphis restaurant was crowding out spending we would have done.

Finally, sports might reallocate activity across time. People might not make more trips to visit Birmingham. Instead, they simply change their travel plans in order to be there for (or in order to avoid) the Big Game. Two examples illustrate. In Summer 2013, I planned a trip to Atlanta in order to avoid higher hotel prices on the night of a Braves home game. In 2014, economist Edward J. Lopez spoke at Samford. Snow and ice prevented Dr. Lopez's originally scheduled visit in January. As Dr. Lopez did his undergraduate work at Texas A&M and as I did mine at the University of Alabama, we decided to schedule his visit during the week of the Alabama-Texas A&M game in Tuscaloosa. Sports, in this case, did not affect whether Dr. Lopez visited but when Dr. Lopez visited. There is nothing wrong with stadiums, arenas, and convention centers, and officials should do nothing to stop anyone who wishes to build a stadium, an arena, or a convention center with their own money. Officials should not, however, commit government funds to such endeavors.

Governments have a less-than-stellar track record when it comes to picking winning projects. We can learn an important development lesson from the VisionLand amusement park failure in the early 2000s. VisionLand was the brainchild of the now-imprisoned Larry Langford, and it was built by a coalition of Birmingham-area communities using bonds on which they defaulted very quickly. After changing hands a few times, the park finally ended up in private hands for a fraction of the amount borrowed to build the park. Rosy projections about the economic impact of VisionLand failed to materialize, and the project ended up being an expensive boondoggle that underscores the importance of keeping large decisions removed from politics. On January 11, 1996, *The Bond Buyer* carried the headline "Alabama Cities Hope Theme Parks Will Be a Godsend" and quoted local Birmingham-area leaders who were optimistic about VisionLand's potential for increasing tourism. Five and a half years later, on June 6, 2001, *The Bond Buyer* carried the headline "Alabama Theme Park Depletes Reserve Fund, Defaults on Bonds" (Sigo 2001:35).

The Alabama Cruise Terminal in Mobile provides another example of a public investment that failed to create economic development. The Cruise Terminal was built in the 2000s to attract a cruise ship. Carnival Cruise Lines stopped operating from the port in 2011, leaving local officials "shocked, saddled with cruise terminal debt."[13] Specifically, they were left with $20 million in debt and $1.8 million in annual payments.[14]

The failures of VisionLand and the Alabama Cruise Terminal as well as the results of the research on stadiums and convention centers suggest that some policy changes might be appropriate. Specifically, Alabama legislators should not use state money for local development projects. While a stadium, amusement park, or Hall of Fame promises to be a catalyst for spending from out-of-state visitors, but most of the spending comes from state residents. Taxing residents of Huntsville to build a Hall of Fame in Birmingham redistributes resources and makes little economic sense. It might make political sense in that it might be part of a log-roll in which one legislator trades support for a pork project to another legislator in anticipation of a *quid pro quo*.

At the local level, VisionLand and the Alabama Cruise Terminal show the dangers of using government to promote "economic development" beyond what could reasonably be considered the provision of local public goods like quality schools and law enforcement. Constitutional provisions prohibiting government from giving special breaks to firms or building edifices to encourage economic development would make it more costly for special interests to seek privileges. While the proponents might devise new ways to justify these projects through approved channels (e.g., making a museum, Hall of Fame, or stadium part of an approved school), raising the cost of wasting resources will result in fewer wasted resources.

We get wasteful policies in part because they provide concentrated benefits to special interests while spreading the costs among a large population. We also get these policies because they are popular among even those who actually stand to lose from them. Caplan (2007) calls this "rational irrationality." Many people hold irrational beliefs about economics; for instance, they claim to want prosperity but support policies that impoverish them. People do not update their beliefs because doing so is costly (it requires economics training, for example) and the benefits are very small. For an individual voter, taking the time and energy to understand an issue like international trade is very costly, but that voter's actions are unlikely to influence public policy. Therefore, people go on indulging the systematic biases on economic issues Caplan documents.

Voters' incentives to remain uninformed or irrational combined with politicians' incentives to focus on their own short-run gains even at long-run expense to their constituents provides a rationale for limiting political involvement in economic development. While voters have turned down initiatives aimed at building larger convention facilities and stadiums in the past, Birmingham residents have been told that they will get a stadium whether they like it or not. Policymakers should explore state, county, and city-level provisions that would make it more difficult for governments to "encourage" economic development by picking winners and losers.

V. Thinking about Work and Charity in the 21st Century

Public policy is only one element of a prosperous, flourishing society, and there is only so much we can accomplish by telling people with power what they should and should not do. There is more to a robust civil society than the political and commercial sectors; there is a valuable social and cultural sector comprised of clubs, organizations, churches, and other groups. Organizations in this sector help define the cultural constraints that influence political and commercial action, and the way we think about work is an important cultural constraint.[15]

McCloskey (2010, forthcoming) traces what she calls "The Great Enrichment" of the West to the development of a culture that prized innovation and dignified commerce.[16] She attributes our prosperity today to liberty that allowed people to buy, sell, and trade without government interference and a culture that esteemed them for doing so. This was evident in the way we used language. McCloskey notes that "innovation" and "novelty," for example, were feared, not celebrated, and the terms were not complimentary. To be "honest," as with Shakespeare's "honest, honest Iago" in *Othello* meant not "keeping one's promises" or letting one's yes be yes and one's no be no. It meant being a noble and aristocratic person with high social standing. A rhetorical change came when we started to identify it with truth-telling and is today manifested in phrases like "honest work."

Put simply, coming up with new ideas and testing them in the market came to be seen as a dignified and honorable thing to do. Dealing extensively with literary and documentary sources, McCloskey (forthcoming) argues that a combination of "reformations, revolts, and reading increased the dignity of ordinary Europeans" and made them rich during the eighteenth and nineteenth centuries. Imitating these new ideas helped to propel the Asian Tigers forward in the middle of the twentieth century and China and India forward toward the end of the century.

Changes in how we think about work created the fertile soil out of which the Great Enrichment grew. For the better part of history, people disdained productive work. Work was something to be done by women and slaves. This started to change in the medieval monasteries. Sunshine (2014:26) describes the change:

> *St. Benedict of Nursia, whose rules for monastic life were the foundation for nearly all Western monasticism, mandated that his monks take a vow of poverty and at the same time be engaged in work—understood primarily in agricultural terms as production of goods. There were two reasons for this: first, in the ancient world, work was seen as demeaning, and thus having the monks work promoted humility; second, Benedict recognized that God gave Adam work to do in the Garden before the Fall, and so work was good no matter what society thought of it.*

Over time, work became honest, meaning honorable. Whelchel (2012) seeks to reclaim this tradition. He argues that people need to fulfill the Bible's cultural mandate and suggests that Christians seek to "reweave Shalom" (pp. 91ff)— usher in the peace of God—by "restor(ing) the Biblical doctrine of work" (p. 106) and recovering the "cultural mandate" to "fill the Earth and subdue it" (p. 95). In a state that is overwhelmingly Christian, a renewed dignity for work and a blurring of the lines between the sacred and the secular can be an important source of innovation and prosperity going forward.[17]

Churches, clubs, and civic organizations can take important steps toward encouraging a culture of innovation and production by recognizing that working as a banker, barista, or business owner and moving resources from low-value to high-value uses is a ministry just like volunteering in a soup kitchen or as a missionary. These organizations can also think differently about how we try to help those who are less fortunate than we are. Corbett and Fikkert (2009) and Lupton (2011) explain how well-meaning but poorly-executed charitable endeavors can actually make things worse for the people we are trying to help. This is the case both domestically and globally, and Corbett and

Fikkert and Lupton make the case that churches and charitable organizations should rethink the way they try to help people. Alabamians, as residents of a state where there are great needs but also great hearts overflowing with generosity, would be wise to consider these lessons carefully.

VI. Conclusion

Alabama's economic history has seen more success than failure. Even the moral (and economic) abominations of slavery and Jim Crow were insufficient to prevent Alabama's development as a very wealthy region by historical and global standards. There is room for improvement. State leaders wasted valuable human capital by protecting slavery in the early 19th century and by protecting institutionalized racism in the early 20th. These were visible manifestations of policies that made us poorer. More seductive (and less abominable) but still wasteful policies include industrial policies and development projects that throw good money after bad and laws that interfere with the working of prices.

We cannot plan prosperity. The best thing a government can do is nurture the institutional soil out of which prosperity grows by protecting private property rights, by refraining from enacting policies that limit access to the marketplace, and by refusing to give away taxpayer money to special interests in the name of "economic development." Adam Smith was right over two centuries ago: when people enjoy peace, easy taxes, and a tolerable administration of justice, they prosper.

Notes

1. "Economic Possibilities for our Grandchildren" is also the title of a 1930 essay by John Maynard Keynes. This essay was completed in part with the assistance of a Summer Research Grant from Samford University in Summer 2013. Research assistance from Hamilton Spivey was supported by a generous grant from the Charles G. Koch Charitable Foundation.
2. Smith is quoted by Dugald Stewart, who is in turn quoted in Edwin Cannan's preface to Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations*, available here: http://www.econlib.org/library/Smith/smWN0.html. Last accessed January 3, 2014.
3. See Stansel and McMahon (2013) and Hall and Lawson (2014) for summaries of this literature. In a similar volume exploring public policy in Tennessee, Sobel, Clark and Leguizamon (2012), Sobel, Clark, and Hall (2012), and Sobel, Clark, and Leeson (2012) discuss how and why economic freedom leads to growth. Many well-researched volumes have tried to explain why The West grew rich while The Rest did not. These include Clark (2007), North and Thomas (1973), North (1981), Rosenberg and Birdzell (1986), McCloskey (2006, 2010, Forthcoming), North, Wallis, and Weingast (2009), Mokyr (2009), Acemoglu and Robinson (2012), Deaton (2013), and many others.
4. This is a key insight in the research agenda of 1993 Nobel Laureate Douglass C. North. See expecially North (1981, 1990, and 2005) as well as North, Wallis, and Weingast (2009).
5. See chapter 4 of Cowen and Tabarrok (2013) for an easy and accessible discussion of competitive equilibrium.
6. While reviewing the penultimate version of this chapter, the author bought a one-year "MemberShipt" for grocery delivery.
7. See Law and Kim (2005) for an empirical analysis of this during the Progressive Era.
8. See Friedman (1962 [2002]: 137-160) for a classic discussion of occupational licensing.
9. Giberson (2011) discusses the negative effects of "Price Gouging" laws.
10. Recent and comprehensive literature on the economics immigration can be found in the Winter 2012 issue of the *Cato Journal* and a series of papers prepared by the Free Market Institute at Texas Tech University that will appear in a book published by Oxford University Press.
11. Information in this paragraph and the next is also drawn from a personal conversation with Mr. Brock in 2013.
12. See Gamble (1987) for a history of Central Bank and for more information on changes in the way banks were regulated.
13. Murtaugh (2011).
14. Dugan (2013).
15. See Leighton and Lopez (2013) and Rodrik (2014) for discussions of the relationship between ideas and institutional change.
16. The information in this paragraph is drawn from a collaborative project between McCloskey and Carden that in turn relies on McCloskey (forthcoming, particularly chapter 16).
17. This topic is far too broad to treat completely here. I refer the reader to Whelchel (2012), Richards (2010), Schneider (2002), and Carden (2014).

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