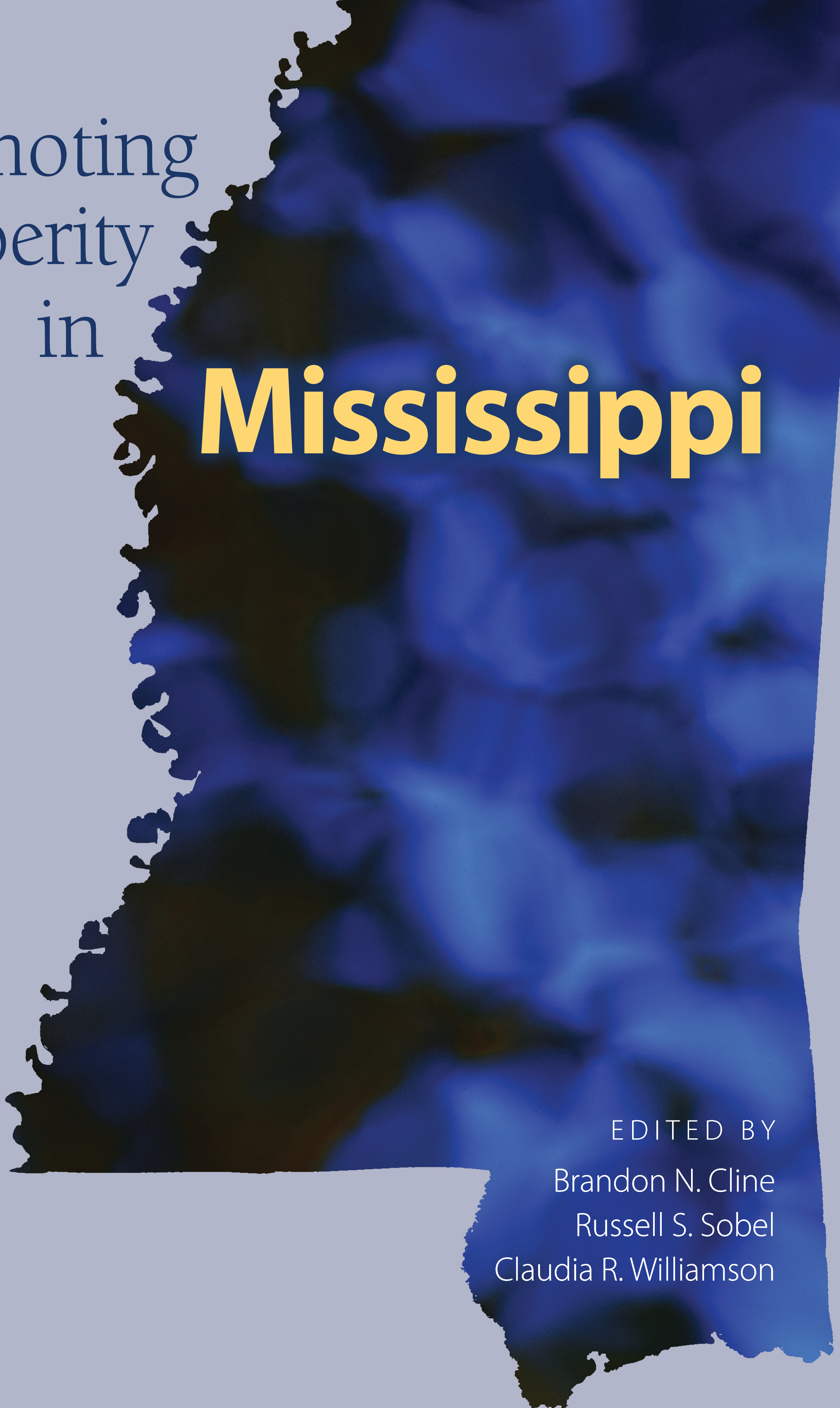
Promoting Prosperity in Mississippi



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Preface

What creates prosperity? Why are some states rich and others poor? Why does Mississippi consistently rank as one of the poorest states in the nation? Can anything be done to move Mississippi 'out of last place'? These questions are often raised by our students and fellow Mississippians. This book addresses each of these questions by identifying areas in which Mississippi can improve its economic conditions.

In this book, we identify key areas for Mississippi economic policy reform. Twenty-one scholars, ten of which are from or work in Mississippi, have contributed original policy research. All twenty chapters were written specifically for Mississippi with a shared goal to promote prosperity in the state. While some of the chapters contain complex policy reforms, we have made every effort to present the concepts and ideas in a way that is understandable to the average citizen, the person who can benefit the most from this information.

The first three chapters of the text summarize the basic economic principles necessary to achieve economic prosperity. These three chapters present the principles behind the reforms proposed in the subsequent seventeen chapters. Each chapter was written independently and offers unique insight into different areas of state policy reform. While the topics covered range from tax reform, education reform, healthcare, corporate welfare, occupational licensing and business regulatory reform to criminal justice reform, and natural disaster recovery efforts, there is a clear unifying framework underlying the conclusions reached in each chapter. The theme throughout is that economic growth is best achieved through free market policies, policies which are based on limited government, lower regulations, lower taxes, minimal infringement on contracting and labor markets, secure private property rights, low subsidies, and privatization. Policy based on these principles allows Mississippians to have more rights and more choices in their lives.

We hope that readers come away with a better understanding of capitalism's true potential to generate the long-run economic growth necessary to make Mississippi more prosperous, as well as ideas for policy reforms that could accomplish it in our lifetimes. This book illustrates that if Mississippi embraces economic freedom, the state will experience more entrepreneurship, increased business and capital formation, higher labor productivity and wages, and overall economic growth. Our main goal is to provide the scholarly, academic research that can inform state policy decisions and open a much needed dialogue on growth-oriented policy reform in Mississippi.

We focus on long-run policy improvements. Thus, the analysis is not an assessment of any particular administration or political party. Instead, this book can be thought of as a blueprint of possible economic reform proposals that use scientific evidence as a guiding principle. We emphasize that our unifying framework, which shapes the conclusions drawn in each chapter, is based on economic science, not politics. All authors address their respective topics by relying on academic research. Topics and policy conclusions were not based on any particular political agenda, political party, or political expediency. Instead, the authors relied on cold, hard facts and data with references to published academic literature to develop policy reform suggestions specific for Mississippi. In fact, many reforms suggested may not be politically possible.

The inspiration for this book came from *Unleashing Capitalism*, a series of books using economic logic to improve state policy in West Virginia, South Carolina, and Tennessee. We owe thanks to more people

than we could possibly list. We are indebted to our colleagues and the Finance and Economics advisory board at Mississippi State University who helped review chapters and provide invaluable feedback. We thank Ken and Randy Kendrick, Earnest W. and Mary Ann Deavenport, and the Pure Water Foundation for the funding necessary to embark on a project of this magnitude. We also thank our friends and family for their support, and for putting up with the long working hours that went into conducting this research. Most importantly, we would like to thank the staff and supporters of the Institute for Market Studies at Mississippi State University for publishing this book. Without their support, this book would not have been possible.

Let's start promoting prosperity in Mississippi!

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PART 1

Introduction: The Role of Government and Economic Growth

1

The Case for Growth

Russell S. Sobel and J. Brandon Bolen

1

The Case for Growth

Russell S. Sobel and J. Brandon Bolen

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

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

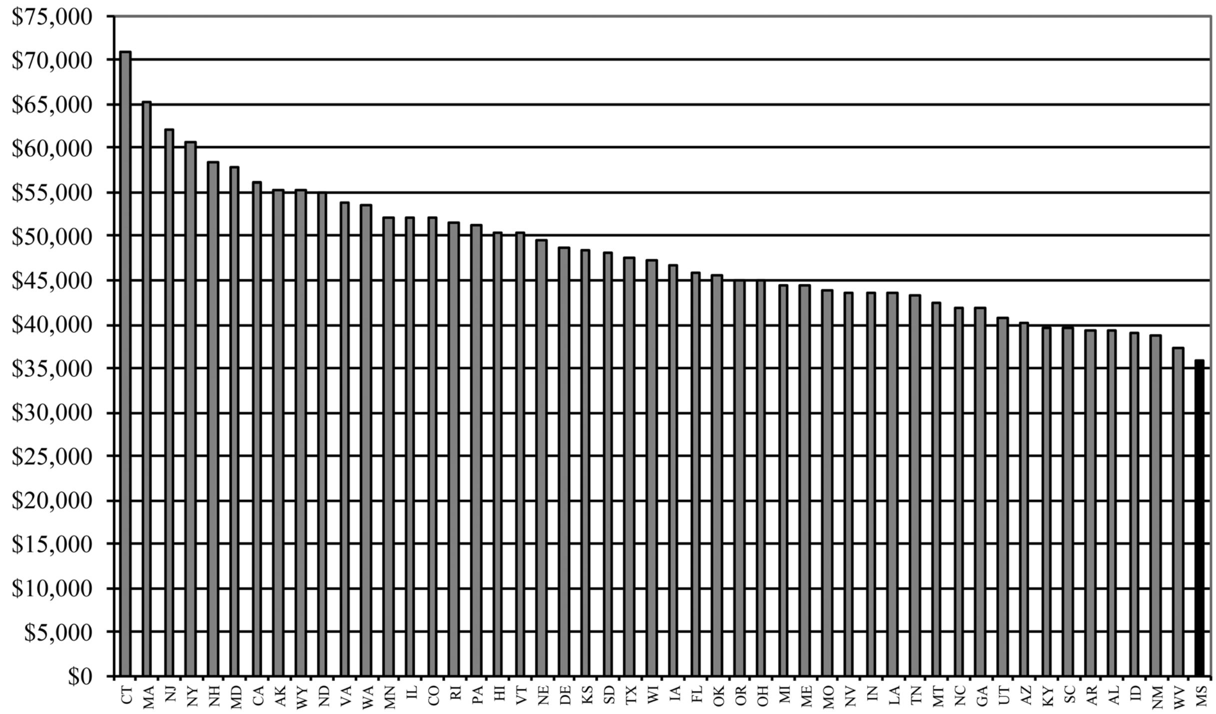
The Have's and the Have Not's

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

With a 2016 per capita personal income of only $35,936, Mississippi ranked 50th, making it the poorest U.S. state. Average income in Mississippi is about 72.5 percent of the U.S. average of $49,571. What this implies is that the average person in the United States as a whole has roughly 38 percent higher income than the average Mississippian. This disparity isn't just with states in the North or West. Two of Mississippi's neighboring states (Arkansas and Alabama) have 10 percent higher per capita personal incomes, and the others (Louisiana and Tennessee) have 20 percent higher per capita personal incomes.

1 This chapter is based on Sobel and Daniels (2007), Sobel and Leguizamon (2009), and Sobel, Clark, and Leguizamon (2012).

Figure 1.1: Average Income by State, 2016



Source: Bureau of Economic Analysis (2017). Per capita income data is in 2016 dollars.

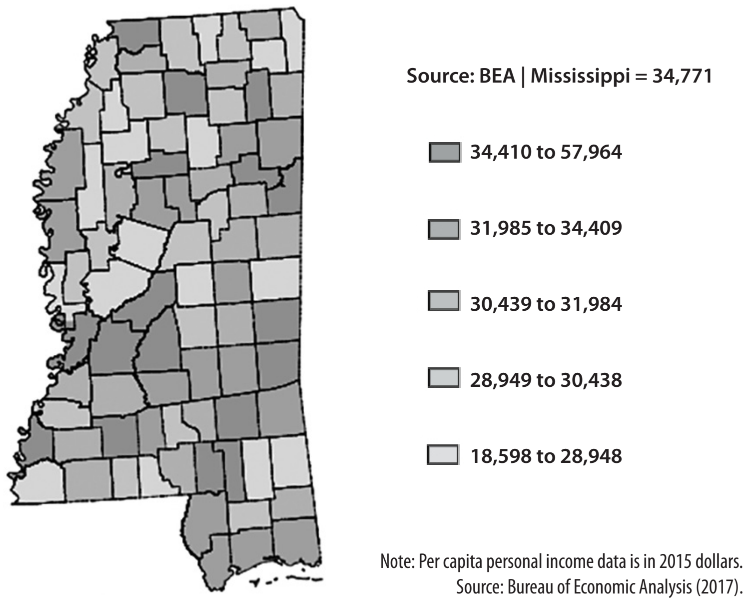
Prosperity does indeed cease at the Mississippi border. The border counties in each of Mississippi's neighbors have higher per capita personal incomes than their Mississippi counterparts. The differential at the Tennessee border is perhaps the most striking. At the county level per capita income is, on average, $6,184 higher in the five Tennessee counties that border Mississippi than in the six Mississippi counties that border Tennessee. A similar income disparity of $5,261 exists when examining the border county differential with Louisiana. There are many other measures of personal, family, and household income and in some, like median household income, the differentials are even greater (the border county median household income differential with Tennessee is $6,934). A similar, but smaller, disparity exists along the Arkansas and Alabama borders.

Figure 1.2 (next page) shows per capita personal income by county in Mississippi. Per capita personal income ranges from $18,598 in Issaquena County (the 3rd poorest county in the United States in 2015), to $57,964 in Madison County (the only county in Mississippi with a per capita income higher than the national average). There is a noticeable clustering of low income counties in the northwestern region of the state bordering the Mississippi River commonly referred to by Mississippians as "the Delta." As a region historically dependent on agriculture, the Delta has experienced high poverty rates, dwindling populations, and a loss of employment opportunities in recent decades.

Do the low per capita income levels of the Delta explain why Mississippi has experienced the lowest average per capita income in the country each year since 1930? In short, the answer is no. The average per capita income in the Mississippi Delta is $32,800, which is significantly lower than the average of $35,200 elsewhere in the state. While a difference of $2,400 is worth noting, Mississippi would still rank last in the country in per capita personal income if the counties of the Delta were excluded.

Mississippi has a hard-working labor force, a bounty of natural resources, wonderful recreation opportunities, major transportation rivers, and other significant advantages. From a purely economic perspective, there is no reason Mississippi should be so low in the national income rankings. So why does the average Mississippian earn significantly less than the average citizen in other states? One fundamental problem is that despite its many advantages, Mississippi has been unable to get its economic policies right. Getting these policies right is the key to increasing prosperity.

Figure 1.2: Mississippi Per Capita Income by County, 2015



Note: Per capita personal income data is in 2015 dollars.
Source: Bureau of Economic Analysis (2017).

Just One Percentage Point: Will Our Children Be Better Off?

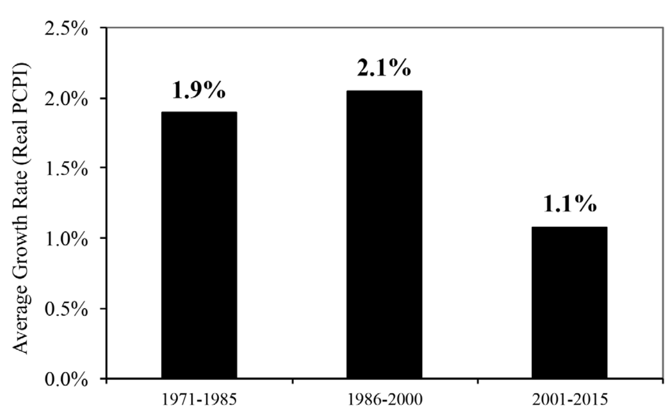
Large changes in wealth and prosperity cannot be generated overnight. Places that are prosperous today went through stages of development. What prosperous areas have in common is that they were able to sustain higher rates of economic growth over longer periods of time.

Figure 1.3 shows Mississippi's average growth rate of per capita personal income for three periods of time: 1971 to 1985, 1986 to 2000, and 2001 to 2015. This is the 'real' growth rate, or the growth rate after adjusting for inflation.

During the 1986 to 2000 period, Mississippi's average real rate of economic growth was 2.1 percent, which was the 14th highest rate of growth among U.S. states at that time. During that period, Mississippi experienced 9 years of rapid growth above two percent and 5 years above three percent. This was a slightly higher growth rate than the 1.9 percent Mississippi had achieved earlier in the 1971 to 1985 period.

Had Mississippi been able to sustain this rate of growth, faster than the average of other states, Mississippi would have soon climbed up the national income rankings. Unfortunately, economic growth in Mississippi slowed after the mid-1990s, falling to 1.1 percent between 2001 and 2015. While growth slowed in many states due to the economic down-

Figure 1.3: Mississippi's Declining Rate of Growth



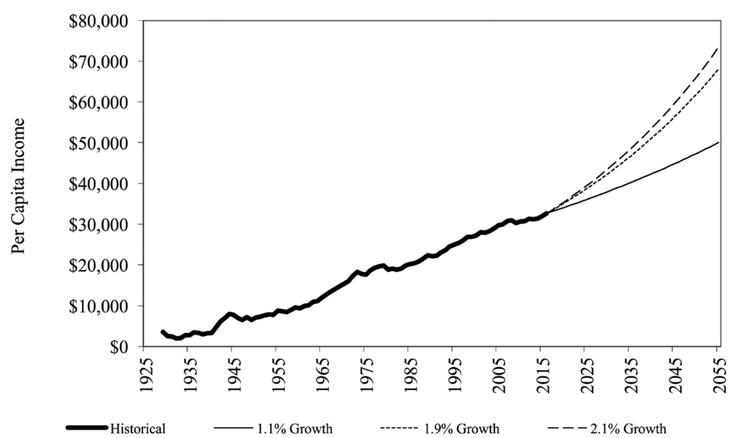
Source: Bureau of Economic Analysis (2017), Bureau of Labor Statistics (2017). Note: All per capita personal income data in Chapters 1 and 2 are adjusted for inflation to constant 2010 dollars using the Consumer Price Index unless otherwise noted.

turn during the period, Mississippi's growth rate decreased even relative to other states falling from the 14th highest growth rate among U.S. states to the 23rd highest growth rate. Even excluding the recent recession years, average growth from 1996 to 2008 was only 1.7 percent, a significant decrease from the growth of the previous period. Thus, the recession is not the reason for the slowdown in Mississippi's growth.

While some might think the difference between 1.1, 1.9, and 2.1 percent seems small, nothing could be further from the truth. Even small differences in growth, over long periods of time, add up to significant differences. This is the topic to which we now turn our attention.

Figure 1.4 shows the history of income growth in Mississippi, adjusted for inflation, along with several alternative future projections. One projection simply takes Mississippi's recent rate of real per capita economic growth over the 2001 to 2015 period, 1.1 percent, and forecasts it into the future. The other two projections show what the future would hold if Mississippi's growth were increased back to the 1971-85 rate of 1.9 percent or the 1986-2000 rate of 2.1 percent. These real growth rates are not unrealistic. Both were actual growth rates experienced in other U.S. states from 2001-2015, and previously experienced in Mississippi itself.

Figure 1.4: Which Future for Mississippi?



Note: Per capita income is adjusted for inflation to constant 2010 dollars. Sources: Bureau of Economic Analysis (2017), Bureau of Labor Statistics (2017)

The last year of historical data shown in the figure is 2016, a year in which the average income in Mississippi was $32,649. Let us consider the simple question of what the average income will be in one generation, or twenty years into the future, in 2036. At the historical growth rate of 1.1 percent, average income in Mississippi would be $40,635 in 2036.[2] What if instead growth could be increased to 1.9 or even 2.1 percent? Under these alternative scenarios, average income in 2036 would instead be $47,573 and $49,475 respectively. Thus, going from a 1.1 percent to a 2.1 percent rate of economic growth results in a difference of almost $8,841 in average income one generation out into the future. Also, remember that we are considering average income *per person*. The average family size in Mississippi is 2.58 persons (from 2010 Census data), so the impact of this difference on the average family is roughly 2.5 times this amount–or a substantial $22,810 difference in family income under the two alternative scenarios 20 years into the future.

What if we look even farther into the future? What about two generations? By 2056, just one year beyond the forecast period shown in Figure 1.4, the differences grow even larger. Instead of average income being $50,573 in 2056 at a growth rate of 1.1 percent, it would be $69,317 at 1.9 percent, or a whopping $74,973 at 2.1 percent. Make no mistake about it, over two generations a one percentage point increase in Mississippi's rate of growth means a difference of almost $25,000 in per capita income.

Perhaps a better way of looking at the data is to ask, at what date in the future will average income in Mississippi hit $50,000? To put this figure in perspective, it is approximately the current average income

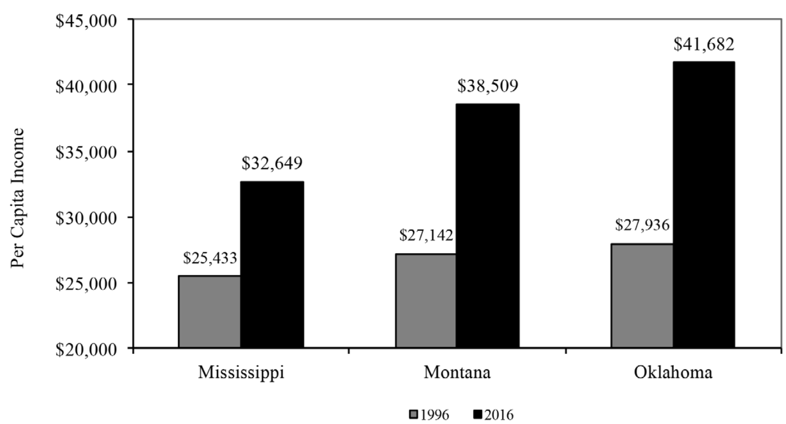
2 All dollar values for future years are given in today's dollars—or 'real dollars'—that have already been adjusted to take out the impact of inflation on the purchasing power of money in the future because we are using a real, inflation adjusted, growth rate.

level in Alaska, North Dakota, and Wyoming. At Mississippi's historical 1.1 percent rate of growth it will hit $50,000 in the year 2055. At a 1.9 percent rate of economic growth, this date would instead be 2039—or sixteen years earlier. At a 2.1 percent rate of growth it becomes 2037—or eighteen years earlier. Increasing economic growth by just one percentage point moves the date at which the average Mississippian will have an income level of $50,000 forward by almost an entire generation.

Rather than relying entirely on future projections, it is also useful to consider a few specific historical income comparisons. Consider the cases of Mississippi and two states that twenty years ago, in 1996, were very similar to it in terms of income, Montana and Oklahoma. Figure 1.5 presents this data. In 1996, the average income in Mississippi was $25,433, while Montana and Oklahoma had average incomes of $27,142 and $27,936 respectively. Montana ranked two spots ahead of Mississippi (48th) and Oklahoma five spots ahead (45th).

Over the next twenty-year period, Mississippi was able to sustain a 1.3 percent rate of growth, Montana 1.9 percent and Oklahoma 2.1 percent. After twenty years, less than one generation, Mississippi's 2016 average income of $32,649 is about $5,860 less than the average income in Montana and $9,033 less than average income in Oklahoma. The result is that while Mississippi has remained 50th in the national income rankings, Montana has risen to 38th and Oklahoma has risen to 28th.

Figure 1.5: State Growth Comparisons



Note: Per capita income is adjusted for inflation to 2010 constant dollars. Source: Bureau of Economic Analysis (2017)

It almost seems unbelievable that such small differences in growth can produce such large differences through time, but they can. A well-known financial formula called 'The Rule of 70' helps us to understand the importance of time and economic growth rates in generating prosperity.[3] According to this rule, an area's standard of living will double every *X* years, where X equals 70 divided by the rate of economic growth:

$$\textbf{\textit{The Rule of 70:}} \quad \textit{Years it takes for income to double} = \frac{70}{\textit{Annual rate of economic growth}}$$

So, a state that sustains a 1.3 percent growth rate, as Mississippi did over the last two decades, doubles its living standards roughly every 54 years (70 ÷ 1.3). A state that sustains a growth rate of 1.9 percent sees its living standards double approximately every 37 years, and a state that sustains a growth rate of 2.1 percent doubles its income in only 33 years.

As these numbers clearly illustrate, small differences in the rate of economic growth produce big differences in standards of living when they are sustained over long periods of time. The principle at work here is the same one responsible for the 'miracle' of compound interest. Mississippi currently ranks 50th

3 Alternatively, this is sometimes referred to as the 'Rule of 72' which produces similar results, but is divisible by more whole numbers making it easier to use in simple calculations.

in average income. If all states continue their current (2001-2015) real per capita growth rates, 20 years into the future Mississippi will have climbed two spots to rank 48th. If instead Mississippi could increase growth back to just 1.9 percent, its ranking in twenty years would be 32nd. If Mississippi could manage to grow again at 2.1 percent, it would rank 29th in the nation within one generation. If that 2.1 percent could be sustained for forty years, Mississippi would rank as the 20th richest state in the nation in 2056.

As the experiences of other states illustrate, these large leaps in the income rankings are possible. Within a fifteen-year period, North Dakota moved up 32 places from 42nd to 10th, Wyoming jumped 23 places from 31st to 8th, South Dakota rose 18 places from 37th to 19th, Vermont improved 10 places from 30th to 20th, and Montana moved up 11 places from 47th to 36th. All of them did this the same way—by sustaining high rates of economic growth over the 15-year 1995 to 2010 period.

From Rags to Riches: It Can Be Done

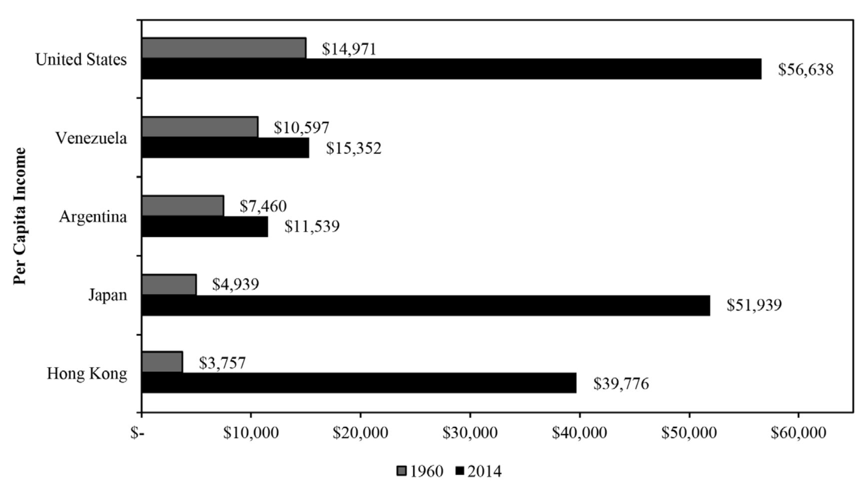
Because economic growth rates vary considerably more across countries than across U.S. states, some international comparisons of long-run growth are even more impressive. An often cited example is the comparison between Hong Kong and Argentina. Approximately fifty years ago, Argentina was almost as rich as many European nations, while Hong Kong was relatively poor. Due to their differing policy climates, today Hong Kong is one of the richest countries in the world while Argentina has fallen behind. This example is often pointed to as proof of how little a country's natural resources matter for growth. Hong Kong, after all, is essentially a rock island in the ocean. Argentina, in contrast, has a wealth of natural resources. Like Argentina, Mississippi's abundance of natural resources by itself cannot guarantee a fast rate of economic growth.

Figure 1.6 shows the levels of per capita income in 1960 and 2014 for five countries: the United States, Venezuela, Argentina, Japan, and Hong Kong. In 1960, while the United States was the richest of the group with a per capita income of almost $15,000, Venezuela was not far behind at $10,600. Japan and Hong Kong, on the other hand, were relatively poor. Their average citizens had only 25 percent as much income as the average citizen in the United States (per capita incomes of roughly $5,000 and $3,750 respectively).

These countries followed very different paths over the next forty-two years. Growth rates were most rapid in Hong Kong (4.5%) and Japan (4.5%), while growth was virtually non-existent in Argentina (0.8%) and Venezuela (0.7%). Over the same period U.S. per capita income growth averaged somewhere in the middle of these other countries (2.5%).

Fast forward two generations. By 2014, Hong Kong was wealthier than

Figure 1.6: International Growth Comparisons



Note: Per capita income is adjusted for inflation to 2005 constant U.S. dollars. Sources: Summers and Heston (1994) and World Bank (2017).

most European countries, and Japan was not far behind the United States. Both are true 'rags to riches' stories. In contrast, the average citizen in Argentina is only $4,000 richer than his or her grandparents and the average citizen in Venezuela is only $5,000 richer. Today the average citizen in Argentina or Venezuela has only a fraction of the income that citizens in the other three countries have.

Meridian versus Charlotte: A Tale of Two Cities

Returning closer to home, let's take a more detailed look at the long run trends in Mississippi relative to other states. Because of their similar histories, Mississippi and North Carolina are interesting to compare. In the late 1800s, the cities of Meridian, Mississippi and Jackson, Mississippi were almost identical in terms of average income, educational levels, and populations to the city of Charlotte, North Carolina. Jackson, actually had about an 80 percent higher population than Charlotte prior to the Civil War, but even by 1870 the populations were roughly identical (4,234 versus 4,473). Similarly, in 1890 the population of Meridian, Mississippi was roughly equal to the population of Charlotte, North Carolina (10,624 versus 11,557). Like Meridian and Jackson, Charlotte was in a state with a significant rural population, and also relied heavily on industries which dwindled through time (for Charlotte this was textiles and tobacco). Even as recently as the 1950s Jackson's population remained about three-fourths the size of Charlotte, with similar demographic factors (134,042 versus 98,271). Over the subsequent decades, however, Charlotte has grown into a crowning jewel of the South, with a population more than 4 times larger than Jackson and 17 times larger than Meridian (731,424 versus 173,514 and 41,148 in 2010).

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

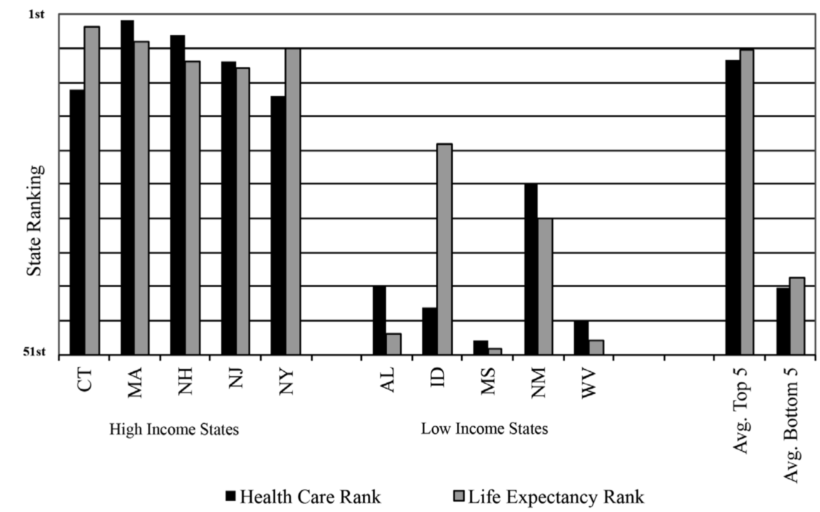
Economic Growth and Human Well-being

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

People want to lead long healthy lives, and this requires access to quality healthcare. Figure 1.7 (on the following page) shows how two important measures of health and longevity differ between groups of the highest income and lowest income states. Without exception, citizens in high income states live longer, healthier lives. The average high income state ranks 6th out of 50 in terms of the life expectancy of its citizens. The average low income state ranks only 40th. In terms of health care quality, the picture is the same. Richer states do better, while poorer states like Mississippi do worse. The average high-income state ranks 8th in terms of health care quality. The average low-income state ranks 41st. Because Mississippi is a lower income state, it is also one of the less healthy placing 49th in the U.S. health rankings, and 50th in life expectancy.

This difference is not limited only to physical health; it also appears in measures of mental health. People in lower income states suffer from the highest rates of mental illness (almost 20.2 percent in the lower income states compared with only 17.2 percent in the richer states)[4]. This difference is likely due to the lower levels of stress at home and in the workplace that higher income brings.

Figure 1.7: Health Indicators by Income Level

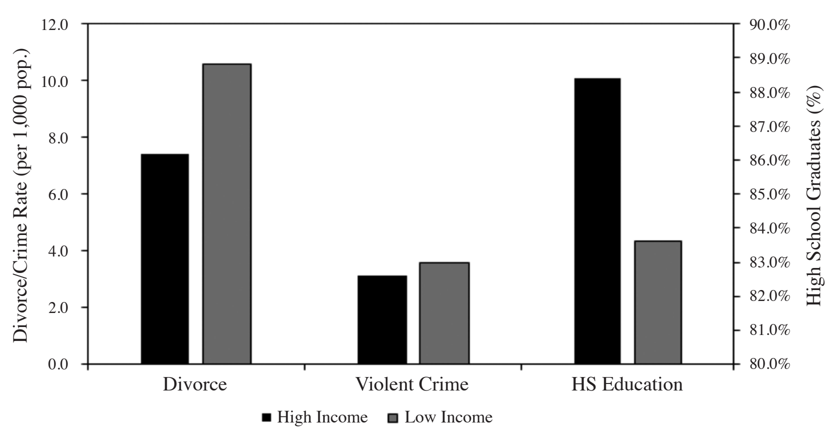


Sources: U.S. News and World Report (2017), Measure of America (2017).

In addition to our own health, we also care about the well-being of our families and children. All parents want their kids to have stable families, live in safe neighborhoods, and receive a good education. Does having higher income levels lead to these as well? Figure 1.8 presents the evidence. Families living in the five states with the highest incomes experience lower divorce rates than families in the five lowest income states (7.4 versus 10.6 on average). Richer families have fewer money problems destroying their marriages and more money to spend on family vacations and leisure activities. Furthermore, higher income leads to safer neighborhoods. For instance, states with higher incomes have lower rates of violent crime (3.1 versus 3.6 on average).

Our children benefit from economic growth not only in terms of safety and stability but also in the area of education. Children growing up in high income states are far more likely to graduate from high school. The five highest income states have higher percentages of the population graduating from high school on average than the five lowest income states. Higher income states have more children graduating from college as well (35.1 percent versus 23 percent college educated population, not shown in figure). Not only does more education increase a child's future earning potential, enhancing the state's prospects for growth in the future, but people with higher levels of education report higher levels of job satisfaction and overall happiness in their lives.

Figure 1.8: Divorce, Crime, and Education



Sources: Measures of America (2017) and Center for Disease Control and Prevention (2017).

4 Substance Abuse and Mental Health Services Administration (2012)

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

Conclusion

This introductory chapter has explained how even small differences in economic growth rates can produce substantial differences in the quality of life within a generation or two. If Mississippi refuses to undertake policy reform, and continues its current trend, Mississippians will remain at the bottom of the national economic ladder.

In contrast, a better and richer Mississippi is possible to achieve within our lifetimes. An increase in Mississippi's rate of real per capita economic growth, back to the 1.9 percent level sustained from 1971 to 1985, would result in a ranking of 32nd twenty years into the future. An increase back to the 2.1 percent level sustained from 1986 to 2000 would result in Mississippi becoming the 29th richest state in the nation within one generation, and the 20th richest state in the nation within two generations.

More importantly, this growth does not have to come at the expense of other things people value—to the contrary, these other areas are also enhanced by economic growth. Reducing crime, improving health outcomes, and increasing education are frequently discussed policy agenda items, but improvements in these areas are a symptom of growth, not a cause. Policy reform that increases economic growth and prosperity in Mississippi will *automatically* result in reductions in crime and health problems, and increases in educational attainment. These social ills are a result of poverty, not a cause of it, and focusing on policies targeted in those areas to produce economic growth is simply putting the cart in front of the horse.

But can policy reform actually increase growth by a meaningful amount? Evidence from both the experience of U.S. states and countries around the globe suggests the answer is yes. In the next chapter we turn to the next important question: Which policies are most conducive to creating and sustaining long-term economic growth in a state?

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2

The Sources of Economic Growth

Russell S. Sobel and J. Brandon Bolen

2

The Sources of Economic Growth

Russell S. Sobel and J. Brandon Bolen

The previous chapter made the case for why increasing the rate of economic growth in Mississippi should be considered one of the top policy priorities. However, policy reform to promote growth should be based on evidence of what has worked, and what has not worked in Mississippi and other areas. Evidence was presented in the previous chapter that economic growth is faster in states like Vermont, Oklahoma, North Dakota, South Dakota, and Montana; and in countries like Hong Kong and Japan. How can this be replicated in Mississippi? Can we uncover which policies tend to promote prosperity? These are the questions we address in this chapter.[1]

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

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

The Process of Economic Growth

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

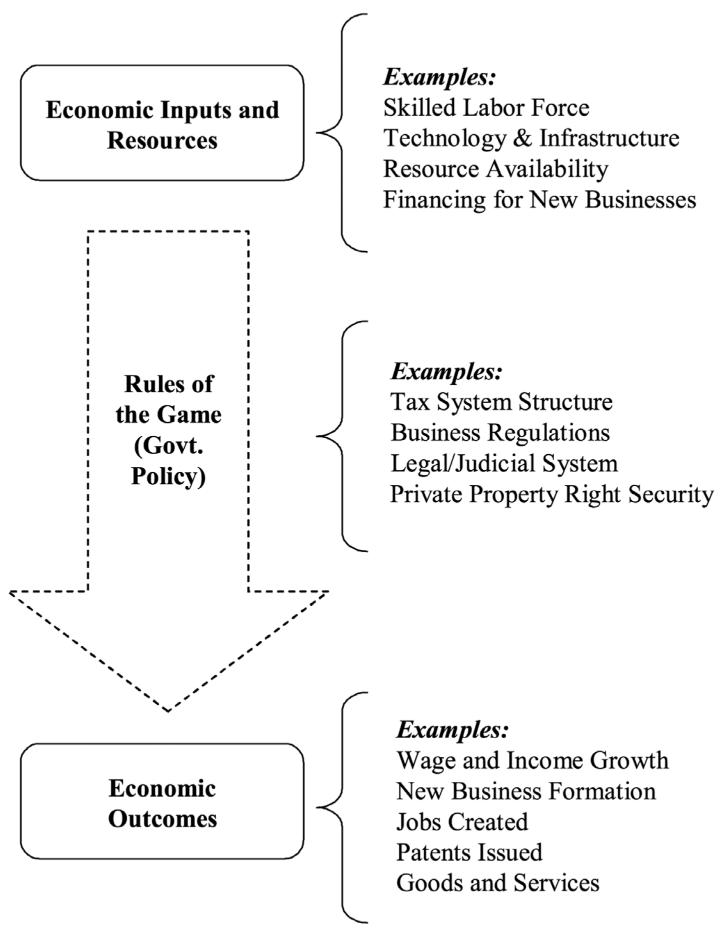
An economy is a *process* by which economic inputs and resources, such as skilled labor, capital, and funding for new businesses, are converted into economic outcomes (e.g., wage growth, job creation, or

1 This chapter is based on Sobel and Hall (2007a), Sobel and Hall (2009), and Sobel, Clark, and Hall (2012).

new businesses). This concept is illustrated in Figure 2.1. As the large arrow in the middle of the figure shows, the economic outcomes generated from any specific set of economic inputs depend on the 'institutions'—the political and economic 'rules of the game'—under which an economy operates. The important point is that some rules of the game are better than others at producing prosperity.

Several analogies will help to clarify. First, let us consider a basketball game. The players, the court, and the basketballs are all inputs into the process. The 'institutions' in this context are the rules under which the game is played. Some examples of these rules are the time length of the game, the length given on the shot clock, the rules on fouling, and the three-point line rule. Examples of the measurable outcomes are the score, the winning team, the number of fouls, etc. The important point is that the outcomes will be influenced by which rules of the game are chosen. The reason for this is that the rules of the game affect the choices and behavior of the people playing the game. If, for example, the rule that shots made from behind the three point line were changed so that these were now worth only one and a half points, we would expect players to respond to this rule change in a predictable manner. As the point value of those longer shots decreased, fewer players would attempt them.[2]

Figure 2.1: Inputs, Institutions and Outcomes



Source: Hall and Sobel (2006).

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

To take another example, consider for a moment the board game "Monopoly." The 'institutions' in this analogy are again the rules under which the game is played. Imagine if a new rule were created making it legitimate to steal the property cards of other players if they were not looking. The play and

2 This change in the rules would also alter the incentives in the selection of players, or investments in resources for an economy. Coaches would now have a much weaker preference for players who could make longer shots.

outcomes from a game of "Monopoly" would be significantly different under these different institutional rules, as players would alter their behavior in response to them. Not only would this rule change increase the rate of theft among players, it would also result in fewer properties being purchased, less investment (houses or hotels) on the properties, and more resources being devoted to trying to protect their property cards from being stolen (and more effort into trying to steal the property of other players).

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

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

The important point is that our daily economic lives are played out under a set of rules that are to a large extent determined by government-enacted laws and policies. These political and legal 'institutions' as economists call them, are what create the incentive structures within the state economy. Prosperity requires that Mississippi get the rules right.

Adam Smith's Question: Why Are Some Places Rich and Others Poor?

Adam Smith, the 'father of economics,' published the first book addressing the set of topics we now consider 'economics' in 1776. In his book, titled *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith (1998 [1776]) attempted to answer a single question: Why are some nations rich and others poor? Economic science has come a long way in 230 years, and volumes of published research now clearly provide the answer to the question Adam Smith posed long ago. The answer is fundamentally the same one arrived at by Adam Smith.

In a nutshell, he found that countries become prosperous when they have good institutions that create favorable rules of the game–rules that encourage the creation of wealth. Smith further concluded that the institutional structure that best promotes prosperity is an economic system of capitalism backed up by sound political and legal institutions. According to Smith, an economy becomes prosperous when they use unregulated private markets to the greatest extent possible, with the government playing the important but limited role of protecting liberty, property, and enforcing contracts. Over 230 years of published scientific evidence now supports Smith's conclusion.

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

The Rise and Decline of Economic Freedom in Mississippi

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

On the other hand, most market-based economies have a much larger degree of government intervention and control than is envisioned under pure capitalism. Within the last two decades, a significant advance in our understanding of this continuum was the publication of the *Economic Freedom of the World* index created by economists James Gwartney (a former Chief Economist of the Joint Economic Committee of Congress) and Robert Lawson.[3] They derive an index measure for each country placing it on a scale of zero to ten, where ten represents the greatest degree of 'economic freedom', i.e., reliance on capitalism, and zero represents the greatest degree of 'economic repression', i.e., reliance on government control of the economy. In the most recent index, the United States scores 7.75 out of 10, ranking it the sixteenth most capitalist, or free-market, economy in the world. However, the United States has fallen eight spots since 2008, and now ranks below Canada. The countries ranking as the most capitalist in the world are Hong Kong, Singapore, New Zealand, and Switzerland.

Because state and local policies vary within the United States, Dean Stansel, José Torra, and Fred McMahon create an index of the *Economic Freedom of North America*, ranking U.S. states and Canadian provinces by the degree of free-market orientation within each state or province.[4] Among U.S. states, Mississippi ranked 40th in the most recent index, for year 2014 data. In 1995, however, Mississippi was ranked 25th in this index. Figure 2.2 shows how Mississippi's economic freedom rank has changed.

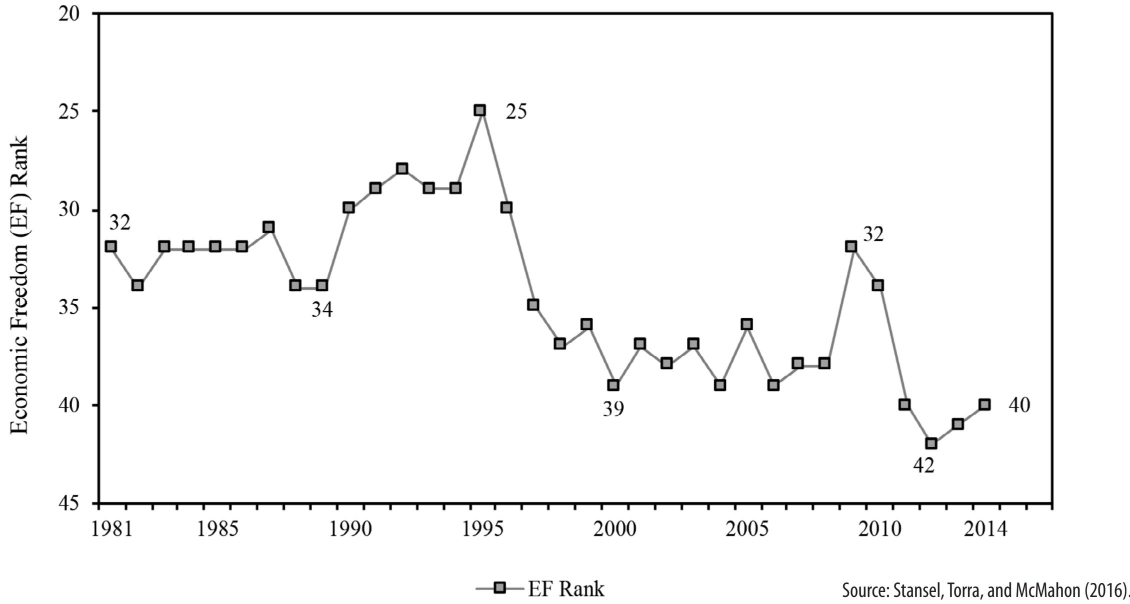
From 1989 to 1995, Mississippi's economic freedom ranking improved nine places, from 34th to 25th among U.S. states. Since that time, particularly in the late 1990s, economic freedom has been on the decline in Mississippi, falling in recent years to its lowest rank recorded (42nd).

Does the 'market-friendliness' of Mississippi's policies help to explain its recent economic performance? Recall that Figure 1.3 from Chapter 1 showed Mississippi's per capita income growth over the last few decades, and that there was a slight improvement in Mississippi's growth from 1986-2000, followed by a subsequent large decline in economic growth. Figure 2.3 shows the remarkable correlation between Mississippi's economic freedom and 3-year moving average per capita income growth. Here, Mississippi's 3-year moving average per capita income growth is measured on the left *y*-axis, while its economic freedom ranking is on the right *y*-axis.

3 Online at: http://www.freetheworld.com. The most recent edition is the 2016 report (Gwartney, Lawson, and Hall 2016).

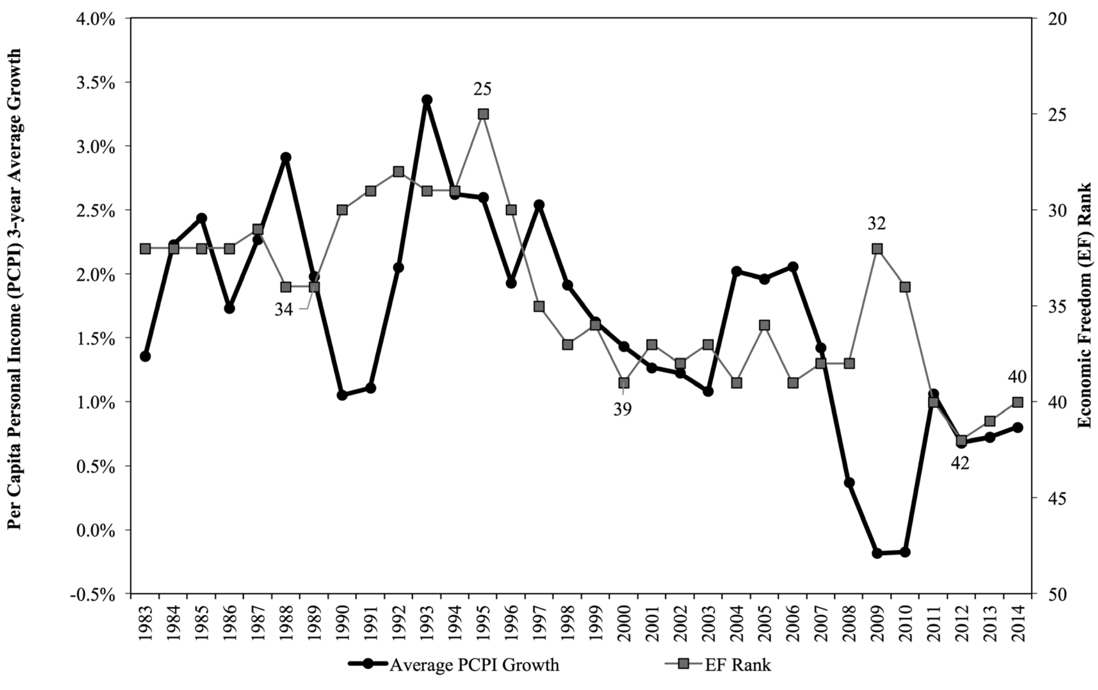
4 Online at https://www.fraserinstitute.org/studies/economic-freedom. The most recent edition is the 2016 report (Stansel, Torra, and McMahon 2016) which includes annual rankings through 2014. Rankings reported in this chapter have been recalculated among only U.S. states (i.e., excluding Canadian provinces and Mexican states).

Figure 2.2: Mississippi's Economic Freedom Rank



Source: Stansel, Torra, and McMahon (2016).

Figure 2.3: Economic Freedom vs. Prosperity in Mississippi



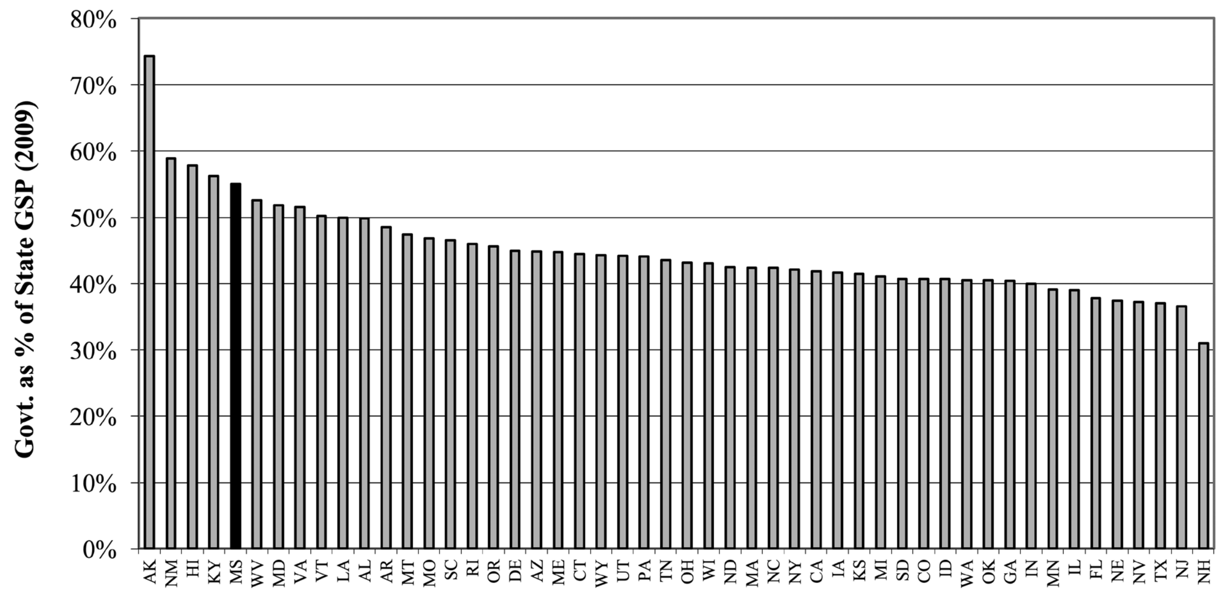
Source: Stansel, Torra, McMahon (2016) and Bureau of Economic Analysis (2017).

First, it is worth noting that the graph includes two recessionary periods that impacted growth in Mississippi (and all states) independent of state economic policies. These two downturns are visible in the figure, the first in 1990-91 and the second in 2007-09. Abstracting from these two national events, one can clearly see the close relation between economic freedom and economic growth, especially in the period between the two recessions, and since the recent recession. Perhaps the most important correlation occurs from the mid-1990s to the mid-2000s when as Mississippi's economic freedom declined from 25th in 1995 to 39th by 2000, growth in Mississippi fell by almost two percentage points.

The point should be obvious, for Mississippi to improve economic growth it must again move toward policies that embrace capitalism and free markets. If Mississippi continues its downward trend that began in the early to mid-1990s, the state's economic ranking is likely to suffer, and Mississippi will remain at the very bottom of the national economic rankings.

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

Figure 2.4: Government Control of the Economy



Source: Stansel, Torra, McMahon (2016).

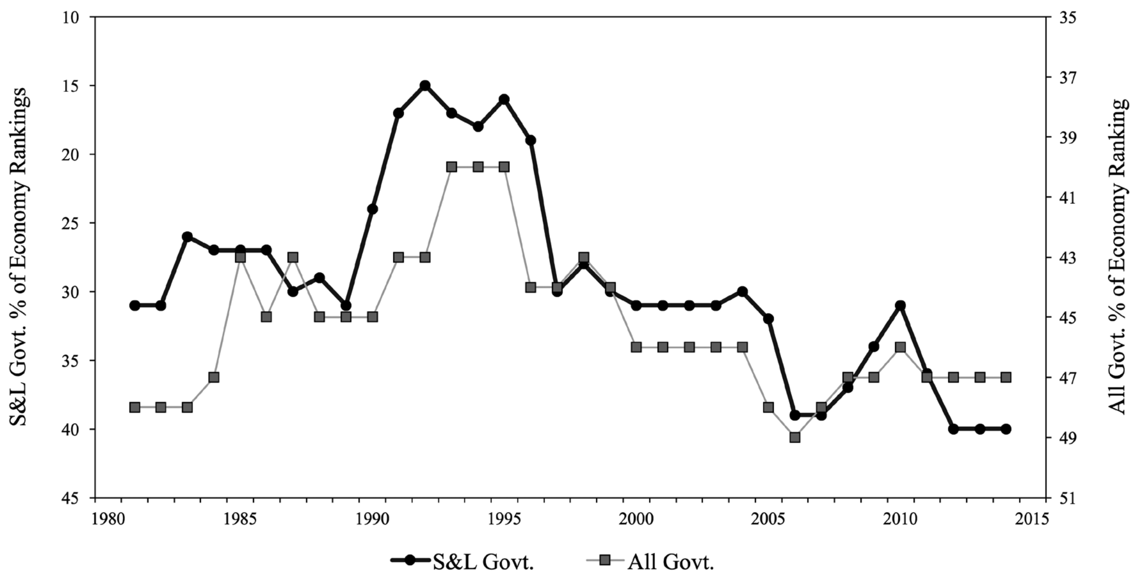
How much government spends relative to the total size of a state's economy is a good measure of the extent to which government controls the allocation of economic resources in a state. Government spending is, of course, only one component of the overall economic freedom index, which also includes measures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

Looking at spending alone, relative to the other U.S. states, Mississippi has the 5th largest government share of state economic activity. Combined, all federal, state, and local government spending in Mississippi amounts to 55 percent of the state economy leaving less than half of the state's economic resources available to the private sector. For comparison, in the most free market state, New Hampshire, government controls only 31 percent of the economy, leaving roughly 69 percent to the private sector.

While the above data include federal spending, if one computes the ranking based on state and local spending alone, Mississippi fares even worse–moving up to 4th highest share of government across states. In other words, the issue of too much government control and spending relative to other states is a state and local spending issue, not a federal one.

Changes in Mississippi's government size as a share of its economy is one of the key factors that led to the trends in economic freedom shown earlier. Figure 2.5 shows Mississippi's ranking in the size of government component of the economic freedom index. Here lower numbered rankings (implying smaller government control) are better, and higher numbered rankings (implying more government control) are worse, as the size of government enters negatively into the computation of the overall economic freedom index. The axes in the figure have been reversed accordingly so that a decline in the size of government (and thus an improvement in economic freedom) is represented by the data lines moving upward.

Figure 2.5: Mississippi's Government Size Rankings



Source: Stansel, Torra, McMahon (2016).

Up until around 1995, by either measure Mississippi was moving in the right direction, with government spending and control of the economy falling, and Mississippi's rank relative to other states improving. As we saw in the prior graphics, this reduction in government size as a share of the economy during that period resulted in improved economic freedom and faster economic growth in the state. Since the mid-1990s, however, government spending has risen significantly as a share of the Mississippi economy, from around 45 percent to an average of 54 percent from 2000 to 2014. The expansion in the size of government peaked in 2006 at 71 percent following Hurricane Katrina and the infusion of federal funds following the disaster. Even when 2006 is omitted from the calculation, total government spending still averaged 53 percent, a significant increase from previous decades.

Excluding federal spending, Mississippi's state and local (S&L) spending as a percentage of the total economy has also risen from an average of 17 percent in the early-1980s to an average of 24 percent from 2009 to 2014. Mississippi, which once had the 15th *best* ranking in its state and local size of government indicator now has the 10th *worst* ranking.

The pattern shown by the data is obvious. During the period prior to 1995, Mississippi's government was shrinking as a share of the economy, and economic growth was rapid. Since that time Mississippi's government sector has grown substantially and as a result Mississippi's rate of economic growth has fallen dramatically. International studies across OECD countries suggest that a nation's economic growth rate falls by 1 percentage point for every 10 percentage point increase in government spending as a share of the economy.[5] This interestingly, is roughly the amount by which Mississippi's economic growth rate has fallen as its government sector expanded by 9 percent of the state economy since the mid-1990s.

Mississippi's Other Economic Policy Rankings

Not only does Mississippi's economic freedom ranking show the need for policy reform, but nearly every other national index of business climate agrees. Mississippi's most recent rankings in the major national indices of state business climates are presented below.

Mississippi's Business Climate Rankings:[6]

40th Fraser Institute's *Economic Freedom of North America* (2016)

47th CNBC's *America's Top States for Business* (2016)

50th Beacon Hill Institute's *State Competitiveness Report* (2015)

46th Milken Institute's *National State Technology & Science Index* (2016)

43rd Institute for Legal Reform (ILR) / Harris *State Liability Systems Ranking Study* (2015)

48th Forbes *Best States for Business* (2016)

50th Information Technology & Innovation Foundation's *State New Economy Index* (2014)

28th Tax Foundation's *State Business Tax Climate Index* (2017)

Mississippi generally ranks below average, and mostly near the bottom in the national business climate rankings. The poor ranking is not just in the economic freedom index. These indices are to one extent or another measuring the same thing; Mississippi's lack of reliance on capitalism.

Because business firms and citizens alike can easily locate across a state border to avoid policies, but still take advantage of similar regional, geographic, transportation, or weather advantages, having worse policies than your neighboring states can be a big disadvantage in economic development. Unfortunately, Mississippi is in this situation. Of the eight business climate rankings presented, Tennessee beats Mississippi in all eight. Alabama and Arkansas outrank Mississippi in six of the eight rankings each, and Louisiana is higher ranked in five of the eight. Of Mississippi's neighbors, Tennessee is definitely the 'one to beat' in that it ranks in the top 20 in five of the eight business climate rankings presented.

The one area of Mississippi's business climate that has shown some improvement in recent years is the legal system ranking, although much more is needed in this area. Since the inception of the ranking in 2002, Mississippi has risen from 50th to 43rd. Most of the improvement has occurred during the 2012 to 2015 period when Mississippi jumped from 48th to 43rd. This is in jeopardy however if the proposal to move to partisan election of judges in Mississippi becomes law.[7] Studies clearly show that states with elected judges, especially if they are elected in partisan elections, have worse legal systems than those states with an appointment mechanism for selecting judges.[8] Nonetheless, there is a substantial need of liability and tort reform in Mississippi. The Institute for Legal Reform estimates such reforms, alone, could boost employment in the state by 1.07 to 2.89 percent.[9]

5 See Gwartney, Stroup, Sobel, and Macpherson (2018), page 588.

6 These rankings can be found on line at the following websites, http://www.freetheworld.com, http://www.cnbc.com, http://www.beaconhill.org, http://www.milkeninstitute.org, http://www.instituteforlegalreform.com, http://www.forbes.com, http://www.taxfoundation.org, and http://www.itif.org/.

7 See Gates (2017) regarding House Bill 496.

8 See Sobel and Hall (2007b), Hall and Sobel (2008), and Hall and Sobel (2009).

9 See http://www.instituteforlegalreform.com/states/mississippi.

The taxes most in need of reform in Mississippi to increase economic growth are the taxes that fall on capital investment (such as property taxes on machinery, equipment, intangibles, and inventories). As we will discuss in the next chapter, capital investment—expenditures on things like machinery and equipment that increase the productivity of labor—is a key driver of economic growth. Unfortunately, Mississippi levies some of the highest taxes in the nation on capital investment, a big factor limiting the economic growth prospects of the Magnolia State.

As an example, Mississippi's effective property tax rate on industrial property is among the highest in the nation. A study by the Minnesota Center for Public Finance Research that appears in the *2009 Competitiveness Redbook* published by the National Association of Manufacturers provides a ranking of the tax burden on a representative manufacturing business with $25 million of property consisting of $12.5 million in machinery and equipment, $10 million in inventories, and $2.5 million in fixtures. Mississippi has the fourth highest tax burden in the country with an annual property tax bill of $1,291,050, which amounts to a 2.582 percent effective tax rate. For comparison, in the lowest tax state, Delaware, this same business's property tax bill would be $238,840 (an effective rate of 0.478 percent). Thus, the annual property tax bill for an identical manufacturing business in Delaware is less than one-fifth of the tax bill they face in Mississippi.

In 2016, Mississippi adopted a reform that will help as long as it is upheld, a graduate phase-out of its capital stock tax that begins in 2018 and will be fully implemented by 2028. Along with the reductions in corporate and individual income taxes that are scheduled to begin phasing in at that time, this should improve some of Mississippi's poor tax climate rankings and improve growth.

Like a three legged stool, a state's tax system, legal system, and regulatory code must all be well designed to support economic growth. While we have briefly discussed Mississippi's legal and tax codes, reforms to the state's regulatory structure also warrant discussion. The true burdens of regulation on a state's business climate are often very hard to quantify and measure. Most of the cost is reflected in the expenditures of the business rather than as a category of government spending, and in addition many of the regulations have hidden costs through the higher prices to consumers that result. Lastly, many regulations are local, so there is variance even within a state. However, while the true burden of regulations are often hard to quantify, relative measures of regulatory are available. For example, Mississippi ranks 30th in the Forbes index subcomponent on regulatory climate.

One significant problem with regulations—in all states—is that there is no natural "profit and loss" mechanism that serves to indicate which regulations, once in place, are performing well and which are not. Identifying which current regulations are ineffective or fail to create benefits that exceed economic costs is difficult, and getting these regulations repealed through the political process is often even more of a challenge. One obvious area for improvement in Mississippi has to do with its lack of a sunset provision. While sunset provisions—those that force regulations to be reconsidered and fight to stay in place—have been shown to result in significantly improved state regulatory climates, Mississippi's sunset provisions were terminated over three decades ago.[10]

The most comprehensive study of state rulemaking, "52 Experiments with Regulatory Review: The Political and Economic Inputs into State Rulemakings," was conducted in 2010 by Jason Schwartz from the New York University School of Law's Institute for Policy Integrity. Schwartz gives Mississippi a "D" in its regulatory review system. Schwartz (2010, pp. 371) noting that "Mississippi offers no centralized, substantive review of agency regulation… and its periodic review is both standard-less and unrealized…"

10 See note (i) in table 3.27, Summary of Sunset Legislation, in Council of State Governments (2010), and also Baugus and Bose (2015).

Promising bills have, however, been proposed in the Mississippi Legislature that could improve Mississippi's regulatory process by requiring agency review and sunsetting of rules that aren't reviewed within five years.[11] Clearly there is room for improvement in Mississippi's system of regulatory review. What is needed is a meaningful requirement for an independent, non-governmental, body to undertake a serious and transparent review of state rules, and a process that would require all regulations to sunset if they cannot justify renewal after a certain period of time in place.

What is Capitalism? The Concept of Economic Freedom

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

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

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

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

Because private property rights, and their protection, are critical to economic progress, it is worthwhile to be more specific about private property rights.[12] Private property rights entail three economic aspects: (1) control rights – the right to do with your property as you wish, even to exclude others from using it, so long as you do not use your property to infringe on the property rights of someone else; (2) cash flow rights – the right to the income earned from the property or its use (i.e. being the 'residual claimant,' which is also critical for enabling the property to be used as collateral for loans); and, (3) transferability rights – the right to sell or divest of your property under the terms and conditions you see fit.

11 See Wilson (2017) and Sanders (2017). In particular, under H.B. 1265, state rules that aren't reviewed in five years by the state agencies that made them would sunset; while H.B. 1112 would require a thorough and regular review of state agencies.

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

A government policy that weakens any one of these components of property rights weakens property rights in general. Taxes, for example, restrict the cash flow rights associated with property and so weaken private property rights on that dimension.[13] Regulations, on the other hand, restrict how owners may use their property, infringing on control rights, and weakening private property rights on that dimension. Outright takings, or other forms of outright expropriation, by removing the property from an owner's possession (such as eminent domain, especially when allowing the state to remove the property from an owner's possession and transfer it to another private owner) actually weaken property rights on all of the dimensions considered above, making property a 'contingent right' (contingent on the state's arbitrary will) rather than an 'absolute right' guaranteed and protected by law.

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

Capitalism, Democracy, and Constitutional Constraints

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

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

Unconstrained majority-rule democracy is not the political system that is most complementary with capitalism—limited and constitutionally constrained government is. Constitutional restraints, structural procedures designed to promote agreement and reduce the ability of interest groups to exploit consumers

13 In addition, because the value of a property asset is determined by the present discounted value of the net income from the property's ownership, taxes often directly impact the current market value of property to the owners. Insecure cash flows due to taxes also inhibit long-term contracting and lending.

and taxpayers, and competition among governmental units (federalism and decentralization) can help restrain the impulses of the majority and promote economic freedom.

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

What Capitalism Is Not: Being Business Friendly Does Not Mean Giving Away Favors

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

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

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

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

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

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

Mississippi has a bad record when it comes to granting these special favors, including millions of dollars in incentives given to Hattiesburg's Stion Corporation , Canton's Nissan plant, West Point's Yokohama Tire plant, Senatobia's Twin Creeks solar panel company, Hinds County's Continental Tire plant, and Columbus' KiOR facility. These incentives are not only extremely costly, often costing up to $200,000 per job created, and sometimes ineffective as these firms close or relocate prior to fulfilling their job creation promises, but more importantly, they simply create the wrong policy climate—one that encourages all firms to try to invest in seeking favors from Mississippi's state government.

As a case in point, in 2010, Mississippi spent $27.7 million in a loan to build a facility in Senatobia, Mississippi for Twin Creeks, a solar panel company who pledged to create 500 jobs but never employed more than 25 employees before going out of business. In an effort to recover taxpayers' money, the state settled with the company for the rights to possible royalties worth up to $10 million and the rights to Twin Creeks' future shares of lawsuits and antitrust claims. Additionally, as of June 2017, Mississippi is suing the KiOR plant in Columbus, another failed business, for $77 million accusing the company of fraud. However, it is not only these failed and fraudulent cases of misallocated taxpayer dollars that create poor incentives for businesses, but any case where political favors choose economic winners rather than the private market.[14]

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

When governments give favors to some businesses but not others, it is unfair to the competitive market process as unsubsidized Mississippi firms must now compete with the politically-favored, subsidized firms for employees, resources, land, and consumers. All firms in Mississippi should have a good business climate, without having to devote time, effort, and resources toward political lobbying and favor seeking to get it. Many of Mississippi's businesses—including small entrepreneurs—simply do not have the political power to even begin to negotiate a better business climate like these large companies. The resources devoted toward offering these special favors to big businesses would be better spent doing across the board, broad-based tax reductions that apply to all of Mississippi's entrepreneurs and businesses.

Institutions and Growth: A Closer Look at the Evidence

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

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

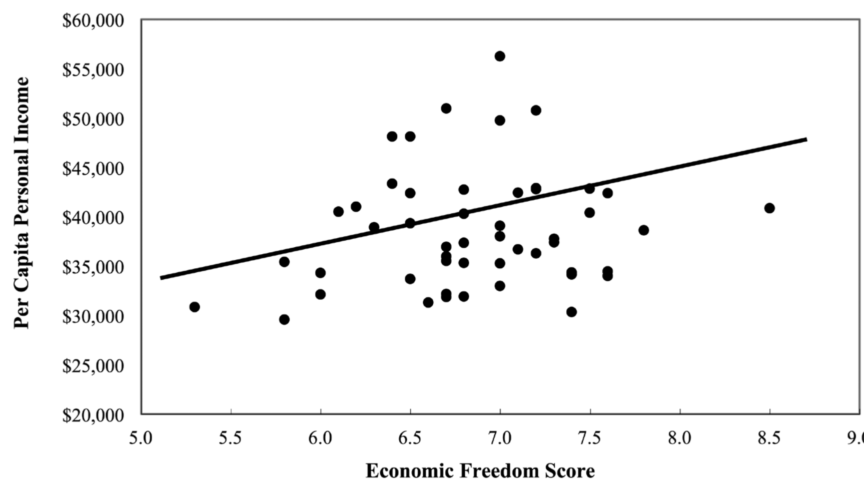
How does the economic freedom index correlate with other measures of economic activity? Figure 2.7 shows, for the top 5 and bottom 5 ranking states in the economic freedom index, seven measures of economic prosperity and entrepreneurial activity. To provide a picture uncomplicated by the recent national

14 See Wright (2013) and Amy (2017).

recession, this data is from prior to the recession. The table shows the averages for these two groups of states on these important indicators of prosperity, as well as the difference between the averages for these two groupings of states.

The states listed in the top of the table, those with the best institutions, are uniformly more prosperous than the states with the worst economic institutions. The differences in economic outcomes are striking. Looking at the averages given near the bottom of the table, average per capita personal income is $5,618 higher, and the poverty rate is 3.1 percentage points lower, on

Figure 2.6: Reliance on Capitalism and Prosperity



Sources: Sobel and Hall (2009).

Figure 2.7: Capitalism's Economic Record

	Economic Freedom Index (2005)		Economic Performance Measures		Measures of Entrepreneurial Activity (annual averages)				
State	Score	Rank (among U.S. states)	Per Capita Personal Income (2008)	Poverty Rate (2007)	Venture Capital Investment Per Capita	Patents Per Capita (per 100,000 pop.)	Sole Proprietorship Growth Rate	Establishment Birth Rate (all firms)	Establishment Birth Rate (large firms only)
Top 5 States									
Delaware	8.5	1	$40,852	10.3%	$60.97	52.6	5.5%	13.1%	14.2%
Texas	7.8	2	$38,575	16.3%	$113.29	25.9	3.3%	12.8%	12.0%
Colorado	7.6	3 (tie)	$42,377	11.5%	$333.22	37.1	4.6%	14.2%	13.0%
Georgia	7.6	3 (tie)	$33,975	14.3%	$103.63	14.6	4.0%	13.5%	11.7%
North Carolina	7.6	3 (tie)	$34,439	14.3%	$82.57	19.5	3.5%	11.7%	10.3%
Bottom 5 States									
Montana	6.0	46 (tie)	$34,256	14.1%	$14.30	12.6	1.9%	12.0%	10.7%
New Mexico	6.0	46 (tie)	$32,091	17.9%	$10.08	16.3	2.7%	12.1%	10.8%
Maine	5.8	48 (tie)	$35,381	12.2%	$34.96	9.3	3.0%	11.2%	9.5%
Mississippi	5.8	48 (tie)	$29,569	20.7%	$18.53	5.6	3.4%	11.1%	9.7%
West Virginia	5.3	50	$30,831	17.1%	$0.00	0.0	2.8%	9.5%	8.6%
Average - Top 5 States			$38,044	13.3%	$138.74	29.9	4.2%	13.1%	12.2%
Average - Bottom 5 States			$32,426	16.4%	$15.57	8.8	2.8%	11.2%	9.9%
Difference (Top minus Bottom)			$5,618	-3.1%	$123.16	21.2	1.4%	1.9%	2.4%

Source: Sobel and Hall (2009).

average, in those states with the best economic institutions. Examining the measures of entrepreneurial activity, a similar pattern emerges–states with the most economic freedom have higher rates of entrepreneurial activity. Relative to the states with the least economic freedom, those with the most have venture capital investment $123.16 higher per capita, a rate of patents 21.2 higher per 100,000 residents, a growth rate of sole proprietorships 1.4 percentage points higher, an establishment birth rate almost 2 percent higher, and a birth rate of large establishments 2.4 percentage points higher. This strong relationship between economic freedom and rates of entrepreneurship has been well documented at both the state and national levels.[15]

Because Mississippi ranks in the bottom of the pack on economic freedom and business climate measures, the measures of entrepreneurship and prosperity for Mississippi also suffer like in other states near the bottom. Relative to other states, Mississippi's level of venture capital investment, patents, and large firm births fall well below average.

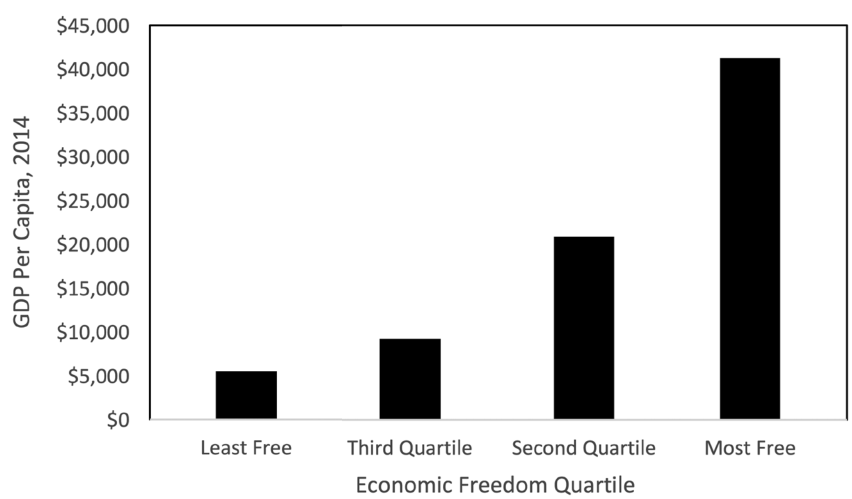
Evidence from Across the World

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

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

Figure 2.9 shows a similar graph for the relationship between reliance on capitalism and income growth rates over the 1990-2014 period for countries of the world. Those relying least on capitalism are not only poorer to begin with (looking at average income levels), but they are also becoming worse off through time. As their negative growth rates show, average income is actually falling through time in these countries.

Figure 2.8: Capitalism and Income (International Data)



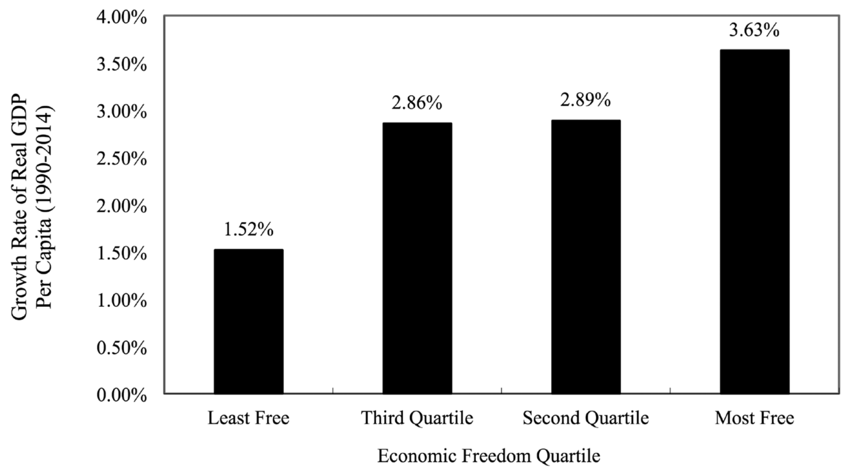
Source: Gwartney, Lawson, Hall (2016).

15 See Kreft and Sobel (2005) and Sobel, Clark and Lee (2007).

At the opposite end of the spectrum are countries that rely heavily on capitalism and have both high incomes and high growth rates as a result.

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

Figure 2.9: Capitalism and Growth (International Data)



Source: Gwartney, Lawson, Hall (2016).

Could Other Things Account for These Differences in Prosperity?

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

Rather than attempting to present these more detailed results here, we instead point the reader to the following published articles on this subject contained in the accompanying footnote to this sentence.[16] All of these articles are published in academic journals, in which authors submit papers that are reviewed anonymously by other scholars from across the globe in a scientific manner. Papers generally go through revisions and must pass a high level of scrutiny. These studies confirm the conclusions we have shown in this chapter, namely that economic freedom promotes prosperity.

It is worth noting that this literature does provide evidence rejecting some popularly held notions of what other factors might explain these differences in prosperity. Areas rich in natural resources, for example, do not necessarily grow faster than those areas with none. The previously mentioned case of Hong Kong (a rock island in the ocean) and how it has grown rapidly versus resource-rich countries with slow or negative growth, such as Venezuela and Argentina, are good examples. Geographic climate variation, or just plain luck, does not explain the differences observed across countries or regions or states either. When we see the borders between countries—like the two sides of the former Berlin Wall separating wealthy, capitalist West Germany from relatively poor, socialist East Germany—it is clear that institutional differences, differences in the rules of the economic game, are the true source of differences in prosperity.

16 The positive relationship between economic freedom and growth has been shown to be robust in a large number of studies. Gerald Scully (1988), for example, finds that politically open countries that respect private property rights, subscribe to the rule of law, and use markets instead of government to allocate resources, grow three times faster than countries that do not. Harvard economist Robert Barro (1996) finds a positive relationship between economic freedom and growth. Gwartney, Lawson, and Holcombe (1999) take into account demographics, changes in education and physical capital and find that economic freedom is still a significant determinant of economic growth. John Dawson (1998) finds that economic freedom positively affects growth and it does so by directly affecting the productivity of capital and labor and indirectly through its influence on the environment for investment. This is consistent with Hall and Jones's (1999) finding that policies consistent with economic freedom improve labor productivity. A very nice overview of the findings of this literature can be found in Berggren (2003) and, more recently, Hall and Lawson (2014).

Conclusion

This chapter has presented evidence that areas relying on capitalism—the protection of private property through constitutionally limited political institutions and sound legal institutions—are more prosperous. We began with a review of the economic evidence on the sources of prosperity and growth. Beginning with Adam Smith, over 230 years of evidence suggests that reliance on capitalism is the best route to achieve increases in living standards. States and countries relying more heavily on capitalism not only have higher income levels and faster average income growth, but also faster and more even growth across the income distribution.

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

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

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3

Why Capitalism Works

Russell S. Sobel and J. Brandon Bolen

3

Why Capitalism Works

Russell S. Sobel and J. Brandon Bolen

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

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

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

Voluntary Exchange, Wealth Creation, and Value Added

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

1 We also suggest the equally easy-to-read classic, *Free to Choose* by Nobel Laureate Milton Friedman and his wife, Rose Friedman.

2 This chapter is based on Sobel and Leeson (2007), Sobel and Leeson (2009), Sobel, Clark, and Leeson (2012).

stantly being created by each of us; the 'economic pie' grows each day. Wealth is created through both production and exchange. An example will help to illustrate.

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

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

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

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

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

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

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

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

However, according to Smith, our ability to specialize, thereby increasing our productivity and enhancing our wages, depends on the size or 'extent' of the market to which we sell. When consumer markets are larger in size, smaller specialized stores can survive that could not have survived in a smaller marketplace. Oxford's population, for example, is able to support two general purpose pet stores, each carrying a broad line of products. In a place like Jackson, however, a dozen or more such stores can flourish, with a greater extent of specialization, some focusing on saltwater fish, while others may focus on birds and other reptiles. Increasing the size of the markets to which Mississippi's goods and services sell could increase wealth by allowing Mississippians to specialize more specifically in areas where they do best.

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

In addition to specialization and the division of labor, capital investment also increases labor productivity. Higher levels of education (more 'human capital') and better machinery, buildings, and tools to work with (more 'physical capital') can help our citizens produce more output and generate more income. Recent capital investments in the auto industry provide a good example of this. Modern robotics and automation allow workers to position, spin, and move the parts they are assembling much more easily and quickly. With this new capital equipment workers are more productive and earn higher wages as a result.

But new factories, better machinery, and equipment are expensive. They require large investments in assets and property. In Mississippi, taxes (such as property taxes on capital equipment), regulations, and lawsuits decrease the return from capital investment and thereby lower the inflow of capital into the state. As we discussed in Chapter 2, Mississippi has among the highest property taxes in the nation on a representative manufacturing facility's equipment and machinery. This results in Mississippi's workers being less productive—and earning less as a result.

The income a state produces from its output depends not only on *how much* is produced (which can be expanded through specialization, division of labor, and capital investment), but also on the price per unit, or *value*, of the goods and services produced. A company trying to sell mud pies will generate less income than one producing apple pies. Income can be increased not only by increasing labor productivity, but also by raising the value per unit—or 'value added'—of Mississippi labor.

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

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

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

This is the reason why restrictions on the ability of citizens to freely engage in trade with people from other geographic areas through tariffs, quotas, taxes, and other restrictions, destroy wealth. Individuals cannot generate as much value and happiness from their limited incomes. Not only are there fewer options to select among, but also the taxes and regulations make things more costly for us to purchase, reducing our ability to stretch our budgets and turn our income into wealth.[3] This is one reason to avoid adopting policies that interfere with, tax, or restrict Internet purchases.

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

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

Entrepreneurship and Discovery

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

Sifting through these many combinations is a difficult task because the number of possible combinations of society's resources is almost limitless. Two quick illustrations will help to clarify the vastness of these opportunities. First, think for a moment about the typical automobile license plate. Many have three letters, a space, and three numbers. There is a formula for calculating the total number of 'combinations'–the total number of possible different license plates–that could be created using these three letters and three numbers. The answer is more than you might think: 17,576,000. Second, let us consider the number

3 If the benefits from the spending undertaken with the tax revenue, or from the regulation, are things we value highly enough, the tradeoff might be worth it. Of course, if this were the case, we would expect citizens to voluntarily contribute to the cause, or privately regulate the activity, being considered. But when the value created by government policy is lower than our losses from the resulting higher prices and more limited availability of goods and services, society's well-being is reduced.

of possible ways to arrange a deck of cards. Even with only 52 cards, there is a mind-blowing number of possible ways to arrange them—the answer is a 68 digit number:

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

With this many ways to rearrange a deck of 52 cards, the astonishing implication is that each and every time you shuffle a deck of cards you are most likely making a new ordering of cards that has never been seen before, and is likely never to be seen again. In fact, even if every human that has ever lived on the Earth did nothing but shuffle cards 24 hours a day their entire life, and even unrealistically assuming they could shuffle the deck 1,000 times per second, we would have not even come close to making it through a fraction of the number of total possible arrangements of the deck throughout all of human history.[4]

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

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

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

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

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

4 For an insightful and more through demonstration of the process of computing combinations for a deck of cards see http://www.worsleyschool.net/science/files/deck/ofcards.html.

because the introduction of these new combinations leads to the obsolescence of others, a process he termed 'creative destruction'.

The introduction of the compact disc, and the corresponding disappearance of the vinyl record, is just one of many examples of this process. Cars, electricity, aircraft, and personal computers are others. Each significantly advanced our way of life; but in the process of doing so, other industries died or shrunk considerably. Economists today accept Schumpeter's insight that this process of creative destruction is an essential part of economic progress and prosperity and that capitalism is uniquely suited to foster it.

A point worth clarifying is that it is much better to have a decentralized profit and loss system sorting through these new combinations, than a government approval board or decision-making process. The reason is that the incentives facing public officials can be very different than the incentives facing venture capitalists and entrepreneurs. While each venture capitalist and entrepreneur brings different motivations to the table, ultimately their success or failure is determined by whether their idea generates wealth.[5] This is the 'market test' we alluded to earlier. The same is not true for public officials in charge of handing out tax incentives or low-interest loans. They may have other concerns beyond creating wealth. For example, officials may be concerned about *where* a new business is located in order to maximize political support among voters. But there is no reason to think that this decision corresponds with the most economically advantageous one.

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

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

5 It is important to recognize that from society's perspective the profits earned by entrepreneurs represent gains to society as a whole. Because entrepreneurs must bid resources away from alternative uses, production costs reflect the value of those resources to society in their alternative uses. Thus, profit is only earned when an entrepreneur takes a set of resources and produces something worth more to consumers than the other goods that could have been produced with those resources. A loss happens when an entrepreneur produces something that consumers do not value as highly as the other goods that could have been produced with those same resources. For example, an entrepreneur who takes the resources necessary to produce a fleece blanket sold for $50 and instead turns them into a pullover that sells for $60 has earned a $10 profit. Since the price of the resources used by entrepreneurs reflect the opportunity cost of their employment in other uses, the $10 profit generated by the entrepreneur reflects the amount by which they have increased the value of those resources. By increasing the value created by our limited resources, entrepreneurs increase overall wealth in a society.

In addition, many good ideas die because entrepreneurs simply can not put together the initial level of resources necessary to comply with the many rules, regulations, and permissions necessary to open a business in Mississippi. We will never know if one of these could have been another FedEx. If we want a thriving economy, Mississippi must find ways to make it easier and less costly for entrepreneurs to try to test their ideas in the marketplace.

To promote entrepreneurship, government often attempts to enact new programs, such as state-run venture capital funds, government-funded or subsidized business incubators, economic development authorities, or even to create new positions within the education system aimed at expanding entrepreneurship education within schools and colleges. Unfortunately, these policies grow the government sector, and *shrink* the private sector. The simple fact is that the public and private sectors sum to 100 percent of the economy, and expansion of government spending means reductions in private spending, and of the resources available within the private sector. One wonders, for example, whether the hundreds of millions of tax dollars spent on incentives for Continental Tire, Nissan, Stion Corporation, Toyota, KiOR, and Yokohama Tire would have created more jobs and opportunities had this money simply been left in the private sector's hands.

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

Adam Smith (again): The Invisible Hand Principle

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

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

Suppose the price of maple lumber increases because of higher consumer demand for maple furniture. This single price change will change the incentives faced by decision makers throughout the economy, likely resulting in changes in which properties are harvested, the percent of maple sent to sawmills versus other uses, the incentive of non-furniture makers to substitute away from maple, etc. The 'signals' sent by these market prices are what enable our workers and businesses to identify changes in which goods and services create the most value. Price signals not only tell us when new opportunities are arising; they also help us to find out when what we are doing is no longer as highly valued, or when the resources we are using have found an alternative use in which they create even more value.

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

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

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

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

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

Hayek's concept can be illustrated with an example. Suppose a college in Mississippi added a new dormitory on campus that was separated from the classroom buildings by several acres of undeveloped land. The college could hire someone to plan and pave the sidewalks in advance so that students could walk to campus. Alternatively, students could be allowed to have one semester in which they tracked through the woods on their own, creating their own pathways. The college could then retrospectively pave these pathways. The deeper and wider a pathway is, the wider the sidewalk is made. Many of the road systems in the United States are the result of this process in which trailblazer's paths were then used by wagons, and eventually the larger ones paved to become major highways.[6]

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

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

6 A more in-depth illustration of this idea for interested readers is given in the famous "I, Pencil" essay by Leonard Read, available at the Foundation for Economic Education's website http://www.fee.org/pdf/books/I,%20Pencil%202006.pdf.

Good Intentions Are Not Enough: The Prevalence of Unintended Consequences

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

The minimum wage is a good case in point. While many people are in favor of the minimum wage law, they support it because they think it helps low income families. The published scientific evidence, however, rejects this view and instead concludes that the minimum wage actually makes the intended beneficiaries worse off.[7] So, for the same reason—the goal of helping those in need—economists are generally opposed to minimum wage legislation. This position can only be reached by examining all of the other indirect changes that happen as a result of a minimum wage, such as less worker training, fewer employee benefits, and most importantly fewer jobs and higher unemployment for low-skilled workers.

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

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

Thomas DeLeire, a public policy professor at the University of Chicago, wrote his Ph.D. dissertation on the employment effects of the ADA legislation when he was in graduate school at Stanford University. His research shows that the ADA has actually *harmed* the employment opportunities for disabled Americans.[8] By increasing the cost of hiring disabled workers and making it harder to fire them, this legislation has resulted in a reduction in employment among disabled individuals. Prior to the ADA, 60 out of every 100 disabled men were able to find jobs. After the ADA went into effect, however, employment fell to less than 50 per 100 disabled men. After adjusting for other factors, DeLeire concludes that 80 percent of this decline was caused by the bad incentives created by the ADA. While the entire purpose of this legislation was to increase the employment opportunities for the disabled, the data simply do not support this view. Instead, the ADA seems to have made it more difficult and costly for employers to hire disabled workers, resulting in reduced job opportunities for disabled people. If the goal is to expand employment opportunities for disabled Americans, the research suggests that the ADA is not the answer.

Environmental policy often has the most devastating examples of unintended consequences. Under the Endangered Species Act, for example, large areas around the nesting grounds of the red-cockaded woodpecker can be declared 'protected habitats,' which then imposes stringent restrictions on the surrounding property owners (a 'loss of control rights' in the terminology introduced in Chapter 2). When the Federal Fish and Wildlife Service put Boiling Springs Lakes, North Carolina on notice that active nests were beginning to form near the town, it unleashed a frenzy of action on the part of the residents, but not of the type you might expect (Associated Press 2006). Foreseeing the potential future restrictions on their property use, landowners swarmed the city hall to apply for lot-clearing permits. After removing the trees,

7 For evidence, see some of the studies complied by the Joint Economic Committee of Congress, available at http://www.house.gov/jec/cost-gov/regs/minimum/case.htm

8 See DeLeire (1997, 2000).

the land would no longer be in danger of being declared an environmentally protected habitat because no future nests could form on the property.

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

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

One additional problem with government regulations mentioned in Chapter 2 is that there is no profit and loss-type system to eliminate bad policies throughout time. In the end, some policies just do not live up to their stated goals, or do so but at too high of a cost. West Virginia, for example, imposed a maximum eight hour operating restriction on taxi drivers.[9] The law was intended to reduce driver fatigue and accidents involving taxis. Policy makers, however, overlooked the unintended consequences resulting from changing the incentives faced by cab drivers. With fewer hours to drive in a day, cab drivers started driving at faster speeds and took fewer breaks. Not only did the law result in a significant reduction in the number of cabs operating in the state, which led to more driving while intoxicated incidents, but it exacerbated the very problem it was designed to reduce. Even though there are *fewer* cabs on the road due to the law, the total number of accidents committed by cab drivers has *increased* in West Virginia since the regulation has been passed. Despite this information being widely-known, state policy makers in West Virginia do not 'have the time to get the law off the books' due to having to deal with too many other, more pressing, current issues. Simply put, government lawmakers just do not have the time to go back and look into the effectiveness of all laws from the past, nor the time to introduce the legislation to repeal them.

This highlights the need for Mississippi to reform its regulatory review process along the lines of the discussion in Chapter 2. Quite simply if a regulation adopted in Mississippi cannot prove, with data, that it is accomplishing its stated goal in a cost effective manner within some period of time, say five years, it should be repealed. Regulations, and other policies, should have to fight to stay in place based on scientific evidence regarding the costs and benefits they create.

Vote Early, Vote Often: Bad People or Bad Incentives?

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

Most people know that government budgets are often given as fixed amounts for each fiscal year. At the end of the year, any remaining money in the budget is usually taken back and if money remains the

9 See Corey and Curott (2007) for a longer description of this law and its consequences in West Virginia.

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

The Nirvana Fallacy

The 'nirvana fallacy' is the logical error of comparing actual things with unrealistic, idealized alternatives.[10] For instance, some might see a problem in the current health care system and propose that because of this failure, we should have a government-run health care system, based on the logic that this ideal government-run system would overcome all of the problems. This tendency to idealize the outcomes of future government policies and programs is a persistent bias in policy making.

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

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

Wealth Creation versus Wealth Destruction: Trade and Transfers

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

In stressing the role of entrepreneurship in an economy, New York University economist William Baumol notes that entrepreneurial individuals have a choice to devote their labor efforts toward either private-sector wealth creation, or toward securing wealth redistribution through the political and legal processes (e.g., lobbying and lawsuits).[11] This decision is influenced by the corresponding rates of return—or profit rates—of these alternative activities. Capitalist institutions, or institutions providing for secure property rights, a fair and balanced judicial system, contract enforcement, and effective limits on government's ability to transfer wealth through taxation and regulation, reduce the profitability of unpro-

10 For a more detailed discussion, and source for this definition, see http://en.wikipedia.org/wiki/Nirvana_fallacy.

11 Spending effort and resources to secure wealth through political redistribution is what economists call 'rent-seeking.' See, for instance, Tullock (1967) and Tollison (1982).

ductive political and legal entrepreneurship. Under this incentive structure, creative individuals are more likely to engage in the creation of new wealth through productive market entrepreneurship.

In areas with weaker capitalist institutions, like Mississippi, these same individuals are instead more likely to engage in attempts to manipulate the political or legal process to capture transfers of existing wealth through unproductive political and legal entrepreneurship–activities that destroy overall wealth. This reallocation of effort occurs because the institutional structure largely determines the relative personal and financial rewards to investing entrepreneurial energies into productive market activities versus investing those same energies instead into unproductive political and legal activities. For example, a steel entrepreneur might react to competition by trying either to find a better way of producing steel (productive entrepreneurship), or by lobbying for subsidies, tariff protection, or filing legal anti-trust actions (unproductive entrepreneurship).

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

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

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

How much unproductive entrepreneurship is there in Mississippi? While it is hard to derive an exact number, some data can help to illustrate. In 2016, for example, 445 registered lobbyists represented 1,172 companies and organizations in Mississippi.[12] In addition, Mississippi was home to 7,059 resident and active lawyers.[13] Campaign contributions to candidates running for office in 2015 and 2016 Mississippi statewide elections amounted to over $62.6 million, or $32.48 per vote cast in the election.[14] Policy reform that reduces the profitability of initiating lawsuits and lobbying government can create more wealth and prosperity as entrepreneurial efforts are re-channeled into productive uses.

12 Mississippi Secretary of State (available at http://www.sos.ms.gov/elec/portal/msel/page/search/portal.aspx).

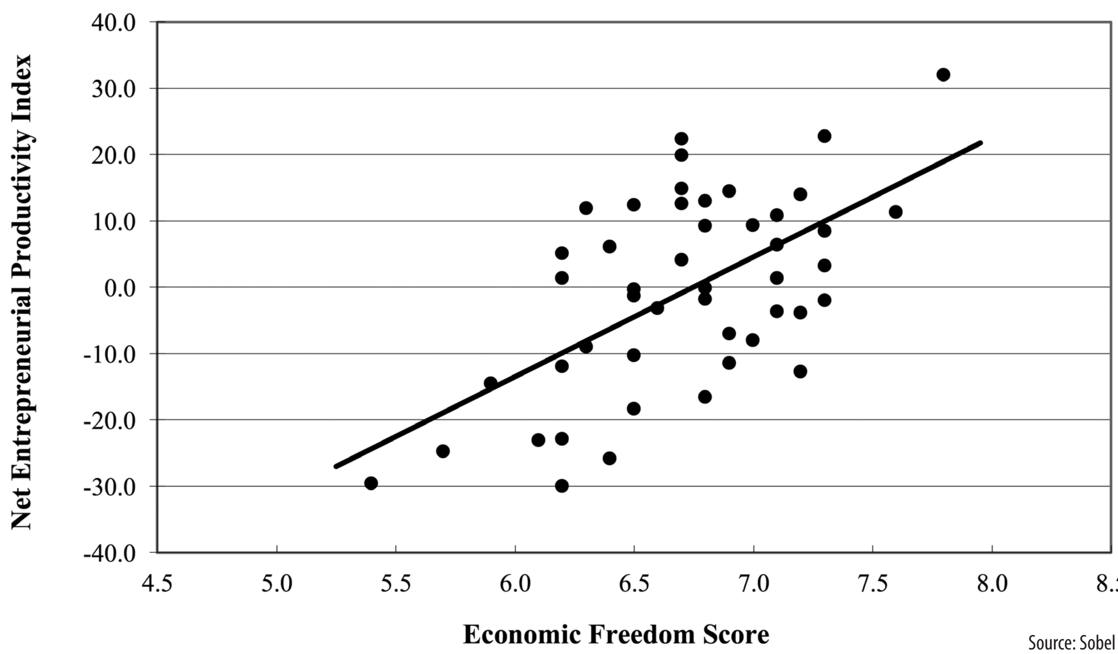
13 American Bar Association's *National Lawyer Population by State*, 2017 (available at https://www.americanbar.org/content/dam/aba/administrative/market_research/National%20Lawyer%20Population%20by%20State%202017.authcheckdam.pdf).

14 Data for federal offices ($11.4 million) is from www.opensecrets.org and data for state offices ($45.7 million) is from www.followthemoney.org. Voter turnout data (1,209,357 votes were cast in the 2016 general election and 718,180 in the 2015 statewide election) is from the Mississippi Secretary of State, http://www.sos.ms.gov/Elections-Voting/Pages/2016-General-Election.aspx.

Studies that examine the relationship between measures of productive private sector entrepreneurial activity and a state's economic freedom index (measuring institutional quality) have found highly significant results.[15] Higher economic freedom produces higher venture capital investments per capita, a higher rate of patents per capita, a faster rate of sole proprietorship growth, and a higher establishment birth rate (both overall and among large firms) as was seen in Figure 2.7. Capitalism promotes productive entrepreneurial efforts.

But this same research also suggests that states with the worst economic freedom scores have the worst records on lobbying activity and lawsuit abuse—the unproductive types of entrepreneurship. In the ranking of 'net entrepreneurial productivity' where productive entrepreneurship is measured relative to unproductive political and legal entrepreneurship, Mississippi ranks 38th. It has both lower levels of private, productive entrepreneurial activity and higher levels of unproductive activity than fast-growth states with better scores on economic freedom. Mississippi has the 15th highest rate of unproductive entrepreneurial activity among states, while having the 15th *worst* rate of productive entrepreneurship. The relationship between having strongly capitalist institutions (as measured by economic freedom) and the index of net entrepreneurial productivity across states is shown in Figure 3.1.

Figure 3.1: Institutional Quality and Entrepreneurial Productivity



Source: Sobel (2008).

The data in Figure 3.1 suggest that capitalism and limited government promote prosperity not only because they promote productive activities, but also because they discourage unproductive, wealth-destroying activities. While the later chapters of this book are devoted to specific policy reforms for Mississippi, Figure 3.2 gives a general list of state policy reforms that increase net entrepreneurial productivity, thereby generating wealth.

15 See, for example, Sobel (2008).

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

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

Source: Based on Sobel (2008).

Conclusion

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

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

Despite the overwhelming evidence in favor of increased reliance on capitalism, Mississippi has been reluctant to embrace this ideal in policy. This might be surprising when viewed from the outside as Mississippi is a state who has a Republican governor, and a Republican controlled legislature. However, prior research has shown very little correlation between political party control of the legislature (or other measures of party affiliation) and economic freedom scores.[16]

With the general principles that should guide state policy reform now outlined in detail, the remaining chapters of this book will turn to specific reforms to Mississippi's state policies consistent with economic freedom, growth, and prosperity.

16 See Sobel and Leeson (2007).

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Summary of Chapter Conclusions

PART 1. Introduction: The Role of Government and Economic Growth

Chapter 1: The Case for Growth—Russell S. Sobel, The Citadel, and J. Brandon Bolen, Mississippi State University

- Mississippi is the poorest state in the United States in terms of per capita income. Mississippi underperforms economically relative to all of its bordering states.
- Focusing on policies that generate economic growth is the most viable pathway to alleviating Mississippi's weak economic condition.
- Very small changes in economic growth rates may yield vast positive changes in the quality of life for Mississippi residents within as little time as one to two generations.
- Focusing on economic growth does not mean that other important policy goals such as improving health and education and reducing crime are neglected.

Chapter 2: The Sources of Economic Growth—Russell S. Sobel, The Citadel, and J. Brandon Bolen, Mississippi State University

- The economic activity of a state necessarily occurs within that area's institutional context, including the legal, regulatory, and tax environments, as well as the degree of private property rights. The quality of these institutions affects the output of economic activity.
- Capitalism is an economic system based on the private ownership of productive assets within an economy.
- Abundant evidence demonstrates that areas with institutions that allow capitalism to thrive experience much higher levels of prosperity relative to areas that do not rely upon capitalism.

Chapter 3: Why Capitalism Works—Russell S. Sobel, The Citadel, and J. Brandon Bolen, Mississippi State University

- The prosperity of an area is determined by the total quantity of production and quality of goods and services that individuals value. This prosperity is influenced by factors such as the degree of specialization of labor, capital investment, and entrepreneurship.
- Capitalism is an economic system that generates prosperity because its decentralized nature supports the specialization of labor, capital investment, and entrepreneurship.
- Government policies, even when well-intentioned, often create harmful unintended consequences. This is often due to the more centralized nature of government decisions.

PART 2: Promoting Prosperity One Issue at a Time

Chapter 4: Why are Taxes so Taxing? —Brandon N. Cline and Claudia R. Williamson, Mississippi State University

- High taxes can be extremely costly. In addition to the cost of the tax itself, taxes create indirect costs including enforcement costs, administrative costs, and costs incurred from distortions of the market economy.
- Mississippi has a higher tax burden compared to its bordering states. This may negatively affect the location decisions of businesses and individuals, causing them to leave the state.
- Empirical evidence demonstrates that high tax rates significantly damper rates of economic growth.

Chapter 5: Make Business Taxes More Competitive—Brandon N. Cline and Claudia R. Williamson, Mississippi State University

- State and local taxes represent a significant cost for businesses. These tax costs affect the location decisions of businesses and deter them from operating in Mississippi.
- In addition to corporate income taxes, there are a myriad of other taxes businesses pay, such as property taxes and inventory taxes. Some taxes such as the inventory tax and intangible property tax do not exist in the majority of other U.S. states.
- To generate more prosperity within the state, Mississippi should consider reducing its tax burden upon businesses.

Chapter 6: "Selective Incentives," Crony Capitalism and Economic Development— Thomas A. Garrett, University of Mississippi, and William F. Shughart II, Utah State University

- This chapter evaluates the costs and benefits of targeted tax incentives designed to lure new private business enterprises to Mississippi.
- Our analysis demonstrates that Mississippi is poorer, not richer, by funding incentive programs.
- Reasons that incentive packages fail include no new employment since many individuals hired were previously employed, the additional tax cost to accommodate the new population growth, and resources allocated to funding the subsidies could have been spent on better schools, roads, or used to finance a reduction in tax rates for all.
- The funds now being spent to benefit a handful of private business owners could be used to finance broad-based reductions in tax rates and lightening the regulatory burden on all Mississippians.

Chapter 7: Incentive-Based Compensation and Economic Growth— Brandon N. Cline and Claudia R. Williamson, Mississippi State University

- Incentive based compensation is a payment method where an individual's pay is in some way tied to their performance. Economic literatures studying incentive based pay for executives show that use of incentive based pay improves company performance and by extension state economies.
- Empirical data shows that firms in Mississippi use incentive-based compensation less than similar firms in other states.
- Mississippi can help improve its economic position by restructuring parts of its tax code to allow for greater use of incentive based executive compensation.

Chapter 8: Mississippi Shadow Economies: A Symptom of Over-Regulated Markets and Measure of Missed Opportunities—Travis Wiseman, Mississippi State University

- This chapter discusses Mississippi's regulatory environment and the state's cumbersome habit of maintaining outdated and burdensome regulation, far longer than other states.
- Several sensible and low-cost reforms are introduced that can help curtail unwanted shadow economic activity, and promote prosperity in Mississippi.
- A case study of one industry that Mississippi over-regulates – the brewing industry – is discussed.

Chapter 9: Occupational Licensing in Mississippi—Daniel J. Smith, Troy University

- Occupational licensing, the regulation of individual entry to a profession, enables industry practitioners to restrict entry to their profession and raise prices on consumers.
- The effects of occupational licensing fall heaviest on low-income residents who must pay higher prices or resort to lower-quality home-production or black market provision.
- Mississippi has at least 118 different occupational categories with licensing, representing nearly 20 percent of Mississippi's labor force.
- The total estimated initial licensing costs in Mississippi exceed \$48 million and the estimated annual renewal costs add up to over \$13.5 million.
- Mississippi policymakers can promote prosperity in Mississippi by removing unnecessary and overtly burdensome licensing laws.

Chapter 10: Prosperity Districts: A Ladder Out of Last Place—Trey Goff, Out of Last Place Alliance

- Prosperity districts are geographically self-contained areas that reduce or eliminate unnecessary government restrictions on business activity, including regulation, taxation, and private subsidization
- Prosperity districts can be a unique and promising solution to the state's economic woes by allowing specific areas to be exempt from unproductive policies.
- Prosperity districts allow experimentation to determine which policies work best.
- Real world examples of the potential success of prosperity districts can be seen in the closely related concept of special economic zones, which have seen tremendous economic growth and development in places such as Singapore.

Chapter 11: Promoting Prosperity in Mississippi through Investing in Communities—Ken B. Cyree, University of Mississippi, and Jon Maynard, Oxford Economic Development Foundation

- We investigate the impact of investing in community livability and the relation to the change in total employment to promote prosperity in Mississippi.
- We document the decline in Mississippi employment, on average, from 2007-2016, and especially the decline in manufacturing employment.
- Our analysis shows that increased employment is significantly related to better school rankings, higher changes in wages, and higher changes in per capita retail sales. New business creation is not statistically related to employment.
- Our results suggest that in order to promote prosperity in Mississippi, we should invest in quality of life for the community.

Chapter 12: Local Governments Run Amok? A Guide for State Officials Considering Local Preemption—Michael D. Farren, George Mason University, and Adam A. Millsap, Florida State University

- Local governments sometimes implement regulations and ordinances that stifle economic growth.
- Preemption is a legal doctrine asserting that state law takes precedence over local law. In some cases it should be used by state governments to overrule local governments.
- State officials should consider preemption when local rules violate the principles of generality or free exchange. Such policies often involve barriers to entry, price controls, or business practice mandates.
- Violations of generality and free exchange harm economic growth because they inhibit economic activity and the efficient allocation of resources. Conversely, preempting such policies promotes economic growth.

Chapter 13: School Choice: How To Unleash the Market in Education—Brett Kittredge, Empower Mississippi

- The United States has fallen behind other countries in K-12 education. One study found that American students ranked 38th out of 71 countries when tested in math, reading, and science.
- A government monopoly has existed in our delivery of education in the United States. Students are assigned to a school based on their zip code and the year they were born.
- Because students are assigned to a school based on a district line, real estate prices naturally rise in neighborhoods within a desirable school district. This has the effect of pricing out many families and forcing them to live in areas with less desirable schools.
- To improve quality, our education system should be student centered and market based. Parents should have options available to craft a custom education for their child based on their specific learning needs.
- The legislature can adopt a market based education through a universal school choice program that has broad eligibility, autonomy for all schools, and level funding across the various educational sectors.

Chapter 14: Medicaid: A Government Monopoly That Hurts the Poor—Jameson Taylor, MS Center for Public Policy

- State health care policy revolves around Medicaid, which is a government-subsidized insurance program consuming one-third of Mississippi's budget.
- Health outcomes for Medicaid insurance patients are very poor; patients with no insurance at all fare better.
- Medicaid's number one problem, like that of many American insurance plans, is that it incentivizes the over utilization of health care while insulating recipients from the financial consequences of poor lifestyle choices.

- Medicaid is crowding out the development of innovative products and policy ideas.
- Reforms aimed at unleashing the power of health care pricing including large HSAs, direct surgical care, and comparative shopping incentives can begin to disrupt Medicaid's monopoly.

Chapter 15: Tipping the Scales: Curbing Mississippi's Obesity Problem— Raymond J. March, San Jose State University

- Widespread obesity has serious health and financial consequences in Mississippi.
- Government policy, although well intended, is associated with increased levels of obesity especially for lower-income households.
- State-led efforts to reduce obesity are costly and unlikely to succeed because they fail to address the underlying causes of why less healthy food options are consumed.
- Private and local solutions are more effective in promoting health and reducing obesity.
- The most effective way to combat widespread obesity is the market, not the government.

Chapter 16: Criminal Justice Reform in Mississippi—Trey Goff, Out of Last Place Alliance

- Despite decreasing rates of both violent and property crime since 1996, Mississippi incarceration rates have steadily increased.
- Mississippi has an incarceration rate that is among the highest in the world, most due to incarcerating non-violent crimes.
- The economic drain from this level of mass incarceration is extremely detrimental for the state economy in terms of both the cost of maintaining incarceration and the negative effects of incarceration upon individuals in the labor market.
- Reevaluating and restructuring the criminal justice system in Mississippi to reduce incarceration rates would be an extremely effective tool to increase the economic strength and wellbeing of the state.

Chapter 17: Property Takings: Eminent Domain and Civil Asset Forfeiture— Carrie B. Kerekes, Florida Gulf Coast University

- Secure private property rights provide incentives for individuals to undertake investments and make capital improvements to their property and businesses. To promote prosperity, Mississippi policy makers should continue to improve laws and policies to restrict property takings.
- Following reforms passed in 2011 to protect against development takings, property owners in Mississippi are reasonably protected from eminent domain takings.
- Citizens are significantly less protected in the case of civil asset forfeiture. Civil asset forfeiture laws in Mississippi provide incentives for law enforcement agencies to seize private property.

Chapter 18: The Small-Dollar Loan Landscape in Mississippi: Products, Regulations, Examples, and Research Findings on Interest Rate Caps—Thomas (Tom) William Miller, Jr., Mississippi State University

- The best fuel for economic growth and prosperity is free market prices, including interest rates.
- Despite the goal of improving consumer welfare, interest rate caps often harm the very people legislatures intend to help—especially users of small-dollar loan products.
- Despite their well-known harmful effects on consumers, laws continue to fetter consumer credit markets with interest rate caps.
- Setting good rules governing how legitimate businesses provide access to consumer credit is important for everyone living in Mississippi.
- The Mississippi legislature can greatly help consumers by eliminating, or greatly raising, interest rate caps in all small-dollar loan markets.

Chapter 19: Natural Disasters and Prosperity in Mississippi—Daniel Sutter, Troy University

- Extreme weather poses a severe financial risk for a state economy. Mississippi is particularly exposed to the threat of damage from natural disasters.
- Free market practices often perform better at meeting the challenges posed by natural disasters rather than government policies. Removal of harmful policies such as occupational licensing and building codes during disaster may better allow the market to speed disaster recovery.
- Some government policies such as flood and wind insurance may exacerbate exposure to natural disasters. Other policies slow recovery time by creating uncertainty after the occurrence of a natural disaster.

Chapter 20: Learning from Disasters in Mississippi—Stefanie Haeffele and Virgil Henry Storr, George Mason University

- This chapter examines disaster recovery in Mississippi and how policies that foster entrepreneurship might help spur disaster recovery going forward.
- Entrepreneurs can spur disaster recovery by providing needed goods and services, restoring disrupted social networks, and acting as focal points around which other residents can coordinate their recovery efforts.
- To promote prosperity in Mississippi, officials should develop policies that ensure that entrepreneurs have the space to act in the wake of disaster.

About the Institute for Market Studies at Mississippi State University

The Institute for Market Studies (IMS) at Mississippi State University, created in 2015, is a nonprofit research and educational organization conducting scholarly research and providing educational opportunities to advance the study of free enterprise.

The IMS's mission is to support the study of markets and provide a deeper understanding regarding the role of markets in creating widely shared prosperity. This includes advancing sound policies based on the principles of free enterprise, individual liberty, and limited government. The IMS pursues its mission by bringing together leading scholars to conduct timely research on current economic and financial issues.

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