ONWARD Wisconsin

Unleashing Capitalism with Common Sense Public Policy

Adam Hoffer
Russell Sobel
Scott Niederjohn
Nabamita Dutta

ONWARD Wisconsin

Unleashing Capitalism with Common Sense Public Policy

*The editors would like to thank the Menard Family for their generosity in making this work possible.

Cover and book design by Jeremy Munns © 2023

Back Cover and Credit page design by Kali Ysquierdo © 2023

Printed and bound in the United States by Lulu.com

MENARD FAMILY INITIATIVE | UWL

Preface

How can we create the best Wisconsin for our friends, family, and children? This is the question that drove my work as an economist at the University of Wisconsin-La Crosse for more than a decade. This book summarizes the answers from years of empirical research.

We need to lay a foundation for long-run economic success. To do so, this book identifies key areas for Wisconsin economic policy reform. Ten scholars, half of whom live or work in Wisconsin, contributed original policy research to this book.

Each chapter was written specifically for Wisconsin, with a shared goal to promote prosperity in the state. While some of the chapters will undoubtedly contain complex policy reforms, we make every effort to present the concepts and ideas in a way that is understandable to any Wisconsin citizen who is interested in making Wisconsin thrive. My hope with this book is that that readers come away with a better understanding of capitalism's true potential to generate the long-run economic growth necessary to make Wisconsin more prosperous.

This book illustrates that if Wisconsin embraces economic freedom, the state will experience more entrepreneurship, higher income levels, and better living standards for all Wisconsin citizens regardless of their socio-economic status. 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 Wisconsin.

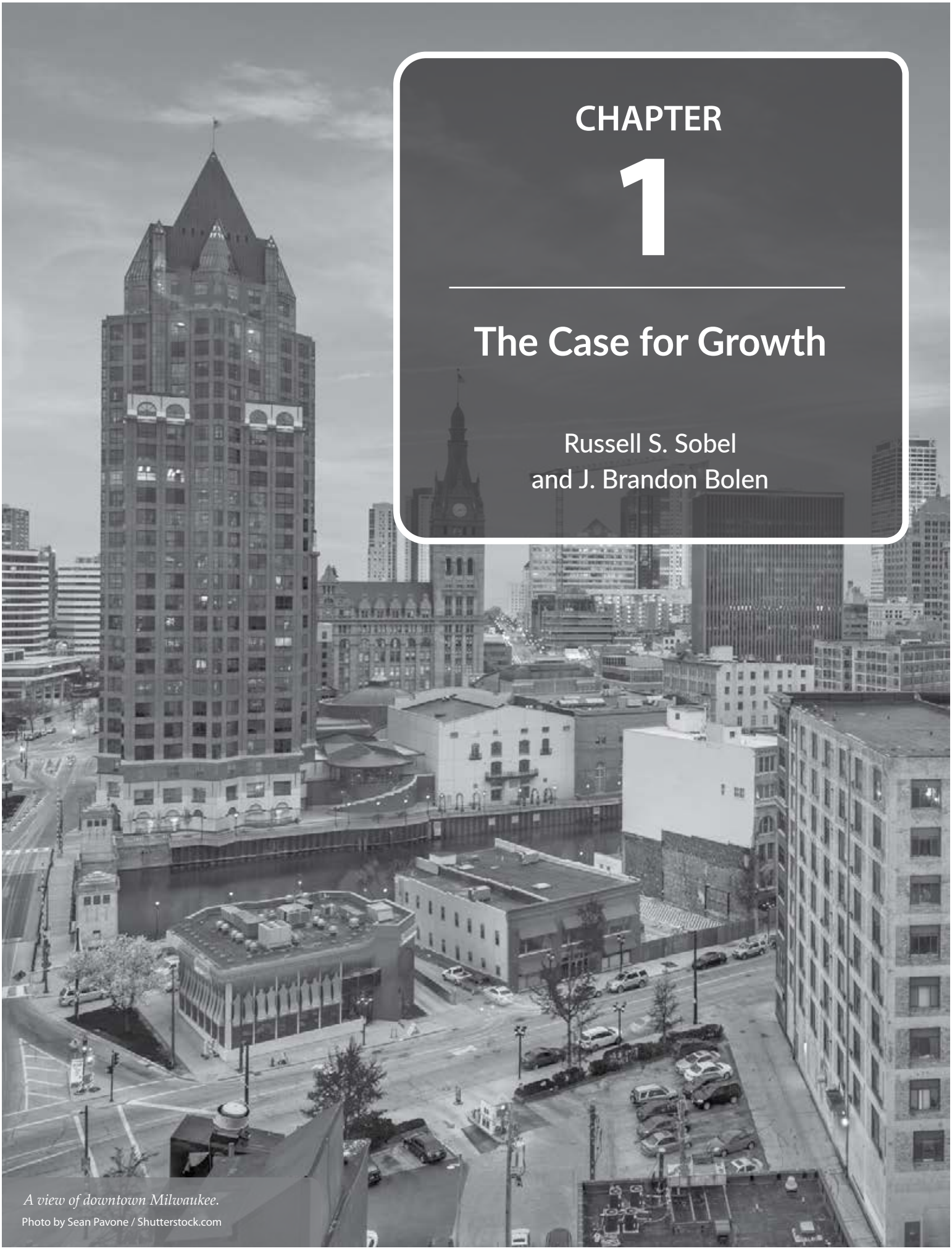
We focus on long-run policy improvements. Thus, the analysis is not an assessment of any administration or political party. Instead, this book can be thought of as a blueprint of possible economic reform proposals that use scientific evidence as a guiding principle. We emphasize that our unifying framework, 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 are not based on a political agenda, political party, or political expediency. Instead, the authors rely on cold, hard facts and data with references to published academic literature to develop policy reform suggestions specific for Wisconsin, even if those reforms do not seem politically possible under our current political regime.

The inspiration for this book comes from Unleashing Capitalism, a series of books that use economics to improve state policy in West Virginia, South Carolina, Tennessee, and Mississippi.

On Wisconsin!

—ADAM J. HOFFER, PH.D.

Table of Contents



CHAPTER

1

The Case for Growth

Russell S. Sobel
and J. Brandon Bolen

A view of downtown Milwaukee.
Photo by Sean Pavone / Shutterstock.com

1 The Case for Growth

Wisconsin needs policy founded on a vision of a better future for its children and grandchildren. If done correctly, policy reform has the potential to dramatically increase the well-being of Wisconsinites within a generation. Within a few generations the state could even be at the top of the national income rankings. 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, Wisconsin needs to adopt policies that have been shown to increase growth in other states and to abandon policies that have decreased economic growth in Wisconsin and in other states.

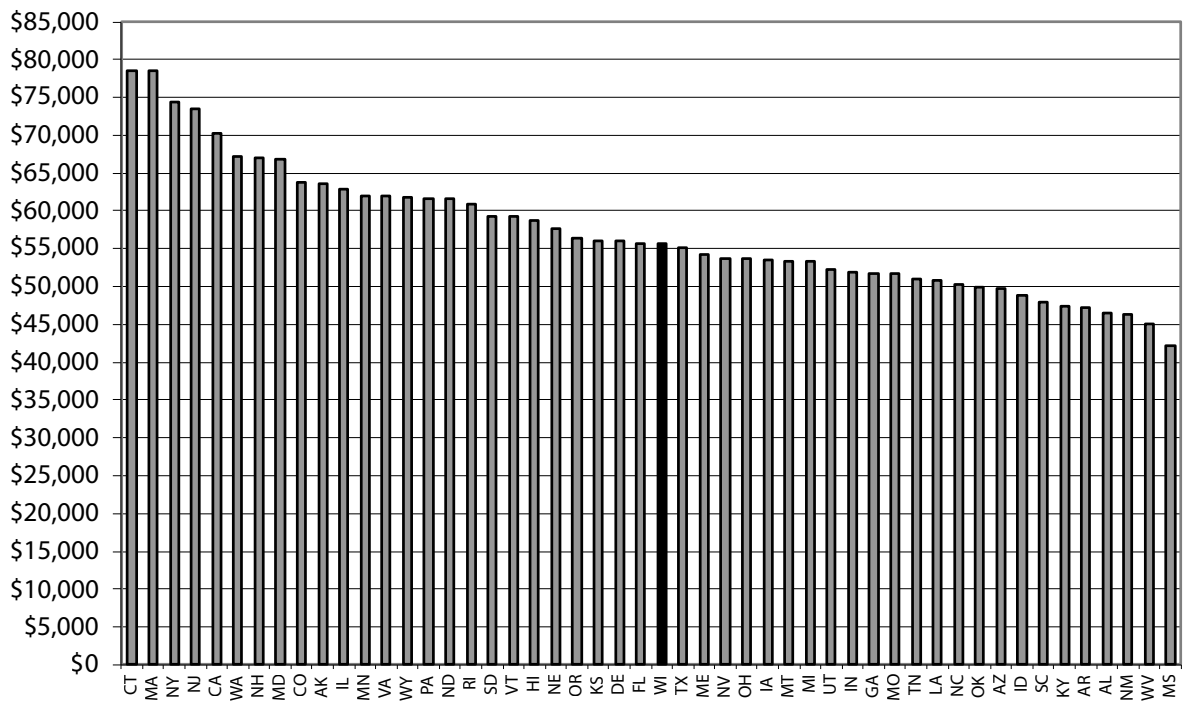
To begin our quest to understand which policies promote, and which hinder, economic growth, this introductory chapter outlines the main arguments for why economic growth should be considered one of the most important policy priorities in the Badger State.[1]

The Haves And The Have-Nots

How wide are the differences in standards of living across states? How does average income in Wisconsin compare with average income in other states? Figure 1.1 shows the most recent data available on per capita personal income for all 50 states.

With a 2020 per capita personal income of $55,593, Wisconsin ranked 26th among the 50 states. This places the average Wisconsinite's income almost in the middle of the pack among citizens across the United States. The average income in Wisconsin is about 93 percent of the national average of $59,510. Two of Wisconsin's neighboring states—

Figure 1.1 **Average Income by State, 2020**



Note: *Per capita personal income data are in 2020 dollars.* Source: BEA (n.d.).

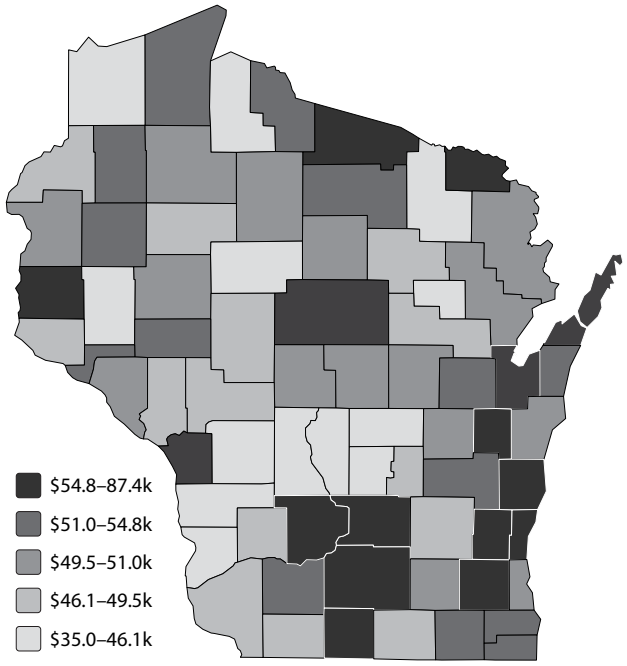
Illinois and Minnesota—have average income levels quite a bit higher (12 to 13 percent higher) than Wisconsin's.

Wisconsin has a hardworking labor force, a bounty of natural resources, wonderful recreation opportunities, major waterway transportation by rivers and the Great Lakes, and other significant advantages. From a purely economic perspective, there is no reason Wisconsin should not rank much higher in the national income rankings. So, what keeps the average Wisconsinite from being able to achieve a level of income as high as those of citizens in states like Connecticut, Washington, New Hampshire, Maryland, and Colorado? One fundamental problem is that, despite its many advantages, Wisconsin has been unable to get its economic policies right. Getting these policies right is the key to increasing prosperity.

It is often telling to examine how incomes differ between one state's border counties and the adjacent counties in neighboring states. These are the places where differences can be mostly attributed to differing state policies rather than to other factors. Three of Wisconsin's neighboring states have counties that are more prosperous than the Wisconsin counties they border. The differential at the Iowa border is the largest. At the county level, per capita income in 2020 is, on average, $6,339 higher in the Iowa counties that border Wisconsin than in the Wisconsin counties that border Iowa. A similar border-county income disparity of $5,855 exists between Illinois and Wisconsin. A similar, but smaller, disparity of $4,859 exists between Minnesota and Wisconsin border counties. Only the border counties in Michigan are poorer (by $2,283 per capita) than their counterparts in Wisconsin.

Figure 1.2 shows per capita personal income by county in Wisconsin. Per capita personal income ranges from roughly $35,000 in Menominee and Shawano Counties to just over $87,000 in Ozaukee County. This is a fairly large disparity among counties within a single state. In fact, Ozaukee County ranks well when compared to all counties in the United States in terms of having low poverty and high per capita income, and it clearly benefits from being near the major metropolitan area of Milwaukee. As one moves away from that area toward the northwest, county prosperity levels tend to decline.

Figure 1.2 Wisconsin Per Capita Income by County, 2020



Source: BEA (n.d.).

Note: *Per capita personal income data are in 2020 dollars.*

Can Wisconsin Become A High-Income State?

Often citizens in states like Wisconsin, who have average or below-average income levels compared to citizens of other states, assume that there are underlying factors, perhaps geographical, historical, or even climate-related, that simply make it impossible for their state to achieve a higher spot in the national income rankings. Thus, it is worthwhile to examine Wisconsin's historical performance in the income rankings.

While Wisconsin ranked 26th in per capita personal income in 2020, the path by which it got there is interesting. Figure 1.3 shows the entire history of Wisconsin's rank. In 1929, the first year that data began

to be collected, Wisconsin ranked 19th richest among the then 48 states. It briefly achieved this rank again in the 1990s. Wisconsin's current rank of 26th is obviously low compared to its historical performance. The overall history looks like a long-term downward trend with a few periods of more rapid growth that improved the Badger State's rank, but only temporarily.

Thus, Wisconsin's history is one of average prosperity but also of falling further behind other states through time. The following chapters will discuss the policies that may (or may not) have contributed to this pattern, but the underlying direct explanation is easy to uncover: differing rates of economic growth.

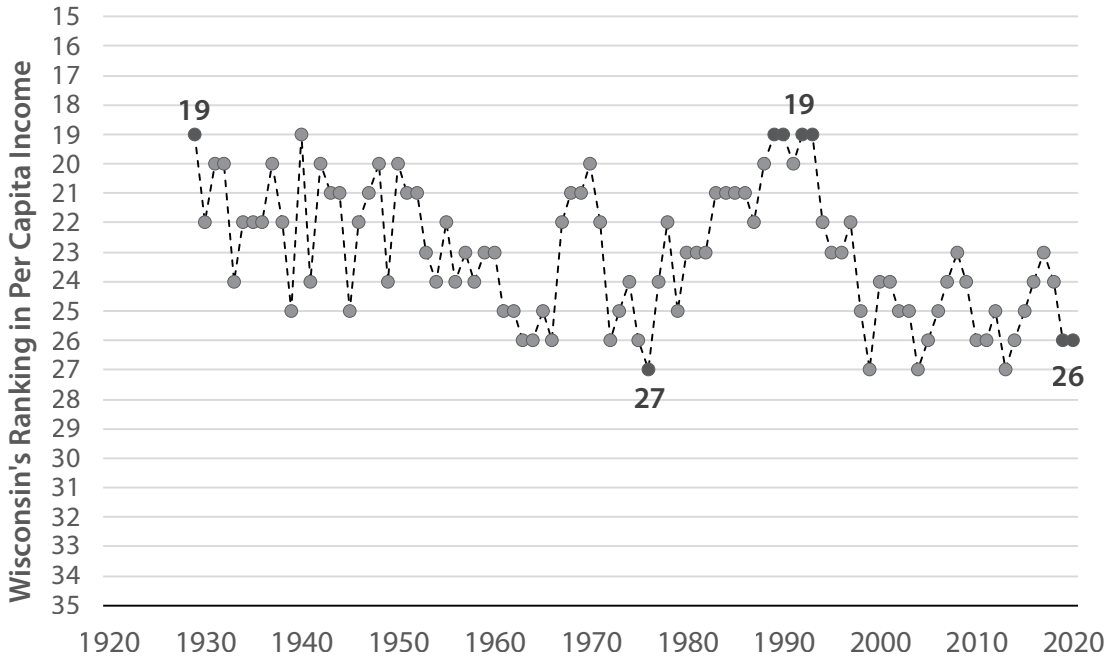
Just One Percentage Point: Will Our Children Be Better Off?

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 have been able to sustain higher rates of economic growth over longer periods of time. Places that suffer low or declining rates of growth are the ones that fall behind.

Figure 1.4 shows Wisconsin's average growth rate of per capita personal income for three periods of time: 1961–1980, 1981–2000, and 2001–2020. This is the "real" growth rate, or the growth rate after adjusting for inflation.

During the 1961–1980 period, Wisconsin's average real rate of economic growth was 2.4 percent. The next two decades brought lower growth rates to Wisconsin—growth averaged 1.7 percent during the 1981–2000 period. The most recent two decades, the period from 2001 to 2020, witnessed growth slowing even further, to 1.1 percent on average: the seventh slowest economic growth rate among all states during this period. As we will discuss later, however, this final period was not one of uniformly slow growth. While growth averaged only 0.6 percent during 2001–2013,

Figure 1.3 **Wisconsin's Historical Income Ranking**



Note: *This is Wisconsin's ranking among states in real per capita personal income. Note that the ranking is out of 48 states and the District of Columbia before 1950. In 1950 the government began including Alaska and Hawaii in the data, even though these territories did not achieve statehood until 1959.* Source: BEA (n.d).

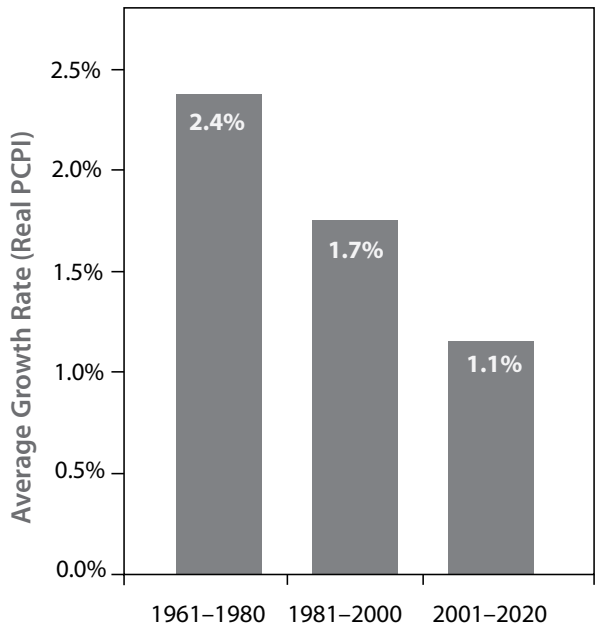
during 2014–2020 it increased substantially, to 2.1 percent—almost back to the higher growth rates experienced in the 1960s and 1970s.

While some might think that the difference between 1.1, 1.7, and 2.4 percent seems small, nothing could be further from the truth. Over long periods of time, even small differences in growth add up to significant differences. This is the topic to which we now turn our attention.

Figure 1.5 shows the history of income growth in Wisconsin, adjusted for inflation, along with several alternative future projections. One projection simply takes Wisconsin's recent rate of real per capita economic growth over the 2001–2020 period, 1.1 percent, and forecasts it into the future. The other two projections show what the future would hold if Wisconsin's growth over the next few decades were increased back to the 1981–2000 rate of 1.7 percent or to the 1961–1980 rate of 2.4 percent. These real growth rates are not unrealistic. Both are actual growth rates previously experienced in Wisconsin.

The last year of historical data shown in figure 1.5 is 2020, a year in which the average income in Wisconsin was $55,593. Let us consider the simple question of what the

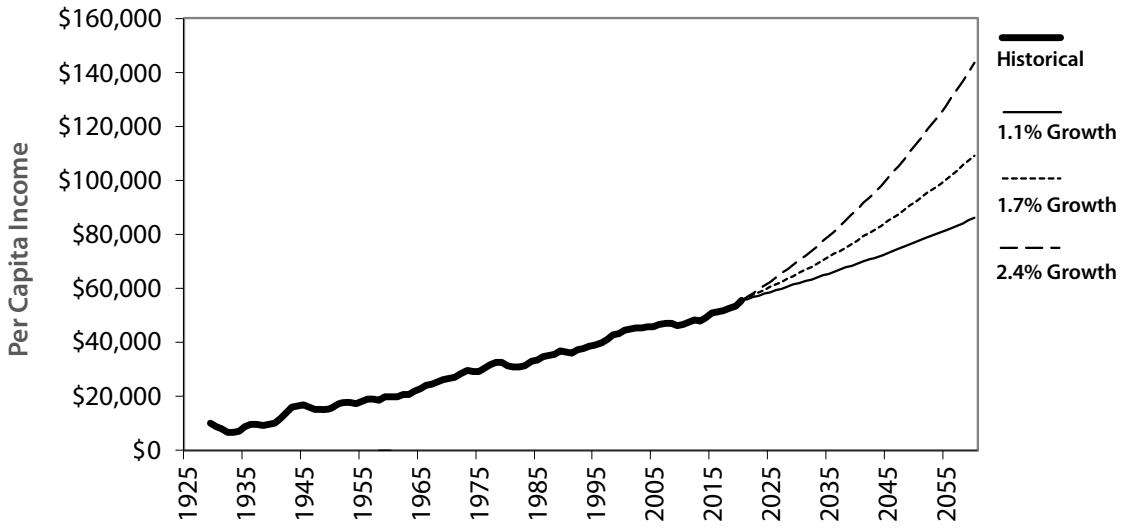
Figure 1.4 **Wisconsin's Rate of Growth**



Sources: BEA (n.d.); BLS (n.d.).

Note: *PCPI = per capita personal income. This figure depicts real growth rates, meaning PCPI is adjusted for inflation using CPI data from the Bureau of Labor Statistics.*

Figure 1.5 **Wisconsin Per Capita Income, Historical and Projected**



Note: *Per capita income is adjusted for inflation to constant 2020 dollars.* Sources: BEA (n.d.); BLS (n.d.).

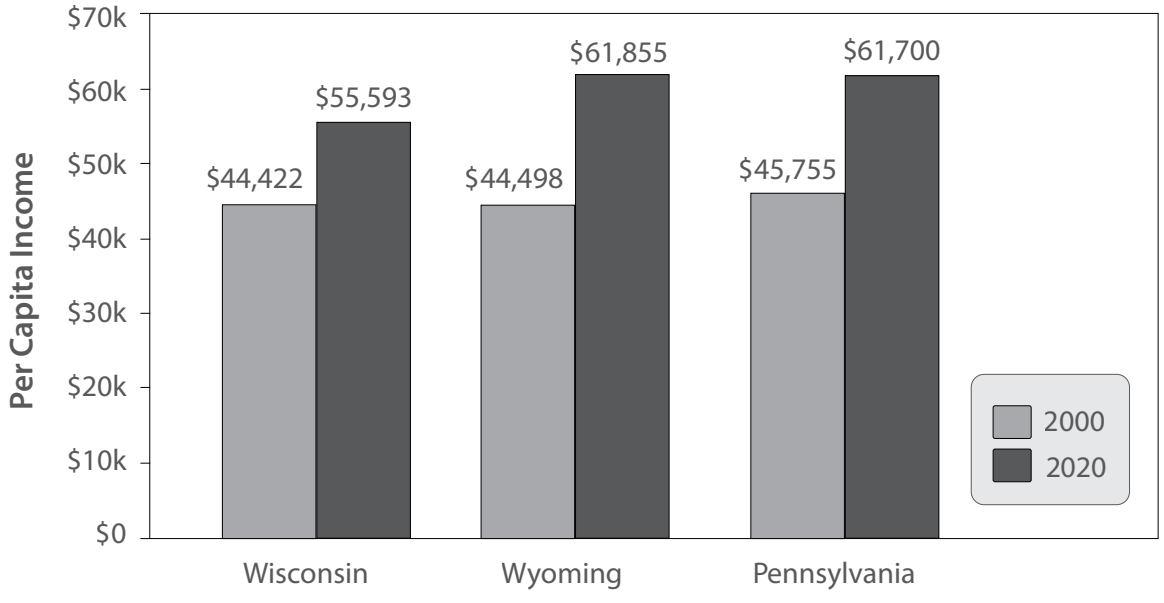
average income will be in one generation, or 20 years into the future, in 2040.[2] At a growth rate of 1.1 percent, average income in Wisconsin will be $69,190 in 2040. What if instead growth could be increased to 1.7 or even 2.4 percent? Under these alternative scenarios, average income in 2040 would instead be $77,882 or $89,335, respectively. Thus, going from a 1.1 percent to a 2.4 percent rate of economic growth results in a difference of almost $20,145 in average income one generation into the future! Also, remember that we are considering average income *per person*. The average family size in Wisconsin is 2.39 persons (from 2020 Census data), so the impact of this difference on the average family is roughly 2.4 times this amount—or a substantial $48,347 difference in family income under the two alternative scenarios 20 years into the future. This comparison should make obvious the importance of faster economic growth to the well-being of future Wisconsin families.

What if we look even further into the future? What about two generations? By 2060, the last forecast period shown in figure 1.5, the differences grow even larger. Average income in 2060 would be $86,113 at a growth rate of 1.1 percent, but it would be $109,108 at 1.7 percent or a whopping $143,555 at 2.4 percent. Make no mistake about it: over two generations, a 1 percentage point increase in Wisconsin's rate of growth means a difference of almost $57,500 in per capita income.

Perhaps a better way of looking at the data is to calculate the year in the future when average income in Wisconsin hits $80,000. To put this income level in perspective, it is approximately the current average income level in Connecticut and Massachusetts. At Wisconsin's recent 1.1 percent growth rate, average income in Wisconsin will hit $80,000 in the year 2054. At a 1.7 percent rate of economic growth, this date will instead be 2042—that is, 12 years earlier. At a 2.4 percent rate of economic growth, this date becomes 2036—or 18 years earlier. Increasing economic growth moves forward the date at which the average Wisconsinite will have an income level of $80,000 by almost an entire generation.

Rather than relying entirely on future projections, it is also useful to consider a

Figure 1.6 **State Growth Comparisons**



Note: *Per capita income is adjusted for inflation to constant 2020 dollars.*

Source: BEA (n.d.).

few specific historical income comparisons. Consider the cases of Wisconsin and two states that 20 years ago, in 2000, were very similar to it in terms of income: Wyoming and Pennsylvania. Figure 1.6 presents these data. In 2000, the average income in Wisconsin was $44,422, while Wyoming and Pennsylvania had average incomes of $44,498 and $45,755, respectively. Pennsylvania, Wyoming, and Wisconsin ranked 17th, 20th, and 21st, respectively, in per capita personal income among the states in 2000.

Over the next 20-year period, Wyoming was able to sustain a 1.6 percent rate of growth and Pennsylvania a 1.4 percent rate, both higher than Wisconsin's 1.1 percent rate. After 20 years, less than one generation, Wisconsin's 2020 average per-person income of $55,593 is about $6,262 less than the average income in Wyoming and $6,107 less than the average income in Pennsylvania. The result is that, while Wisconsin fell to 26th in the national income ranking, Wyoming has risen to 14th and Pennsylvania to 15th during the same period.

It seems almost unbelievable that such small differences in growth can produce such large differences in per capita income 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 to 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:

Rule of 70

$$\text{Number of years it takes income to double} = \frac{70}{\text{Annual rate of economic growth}}$$

Thus, a state that sustains a 1.1 percent growth rate, as Wisconsin did over the past two decades, doubles its living standards every 64 years, approximately (70 ÷ 1.1). A state that sustains a growth rate of 1.7 percent sees its living standards double every 41 years, approximately, and a state that sustains a growth rate of 2.4 percent doubles its living standards in only 29 years.

As these numbers clearly illustrate, small differences in the rate of economic growth produce big differences in standards of living when the growth rate differences are sustained over long periods of time. As the experiences of other states illustrate, large leaps in the income rankings are possible. Within a 15-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 by 10 places, from 30th to 20th; and Montana moved up 11 places, from 47th to 36th. All of these states did this the same way—by sustaining high rates of economic growth.

From Rags to Riches: It Can Be Done

Because economic growth rates vary considerably more across countries than across 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 60 years ago, Argentina was almost as rich as many European nations, while Hong Kong was relatively poor. Because of their differing policy climates, Hong Kong was able to grow into one of the richest areas in the world while Argentina fell 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. As in the case of Argentina, Wisconsin's abundance of natural resources by itself cannot guarantee rapid economic growth.

Figure 1.7 shows the levels of per capita income in 1960 and 2014 for Hong Kong and four countries: the United States, Venezuela, Argentina, and Japan.[4] In 1960, though the United States was the richest of the group with a per capita income of almost $15,000, Venezuela was not far behind, with a per capita income of $10,600. Japan and Hong Kong, on the other hand, were relatively

poor. Their average citizens' incomes were only 25 percent of the average in the United States (roughly $4,900 and $3,800, respectively).

These economies followed vastly different paths over the next 42 years. Growth rates were most rapid in Hong Kong and Japan (both roughly 4.5 percent), while growth was virtually nonexistent in Argentina (0.8 percent) and Venezuela (0.7 percent). Over the same period, US per capita income growth averaged 2.5 percent.

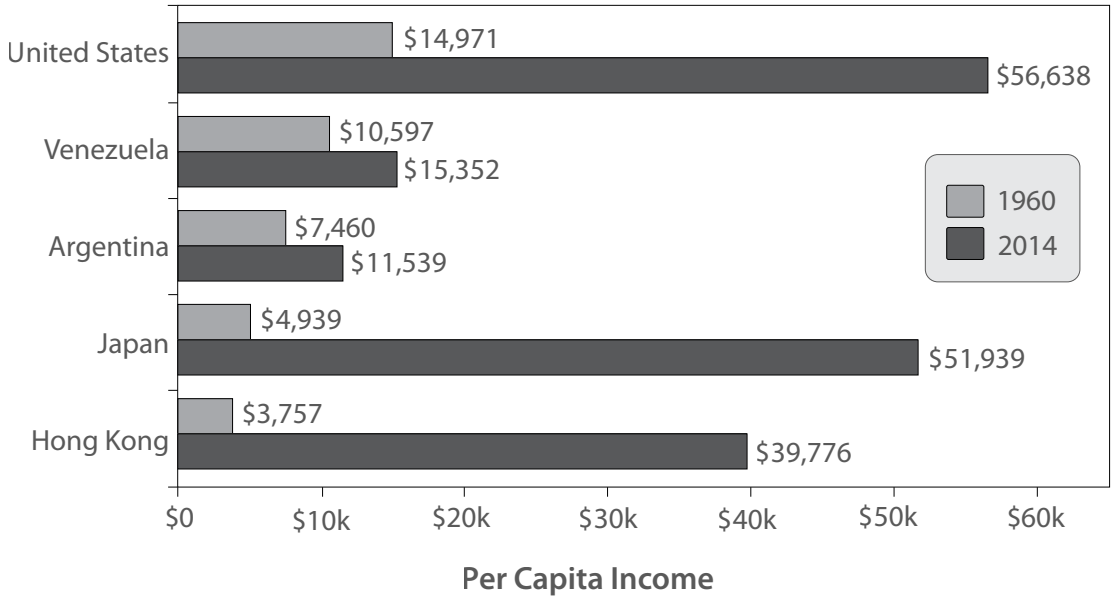
Fast-forward two generations. By 2014, Hong Kong was wealthier than most European countries, and Japan was not far behind the United States in terms of per capita income. Both are true "rags to riches" stories. In contrast, the average Argentine citizen is only $4,000 richer than his or her grandparents, and the average Venezuelan citizen is only $5,000 richer. Today the average citizen in Argentina or Venezuela has only a fraction of the income that average citizens in the other three countries have.

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 people 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. Economic growth may increase our income and standard of living, but how does it affect these other measures of personal well-being? By focusing on growth, can we achieve other goals as well? Let us look at the evidence.

People want to lead long, healthy lives, and this requires access to quality health care. Figure 1.8 shows how two important measures of health and longevity differ between groups of the highest-income and lowest-income states. Without exception, high-income states see citizens live longer, healthier lives. The average high-income state ranks 5th out of 50 in terms of the life

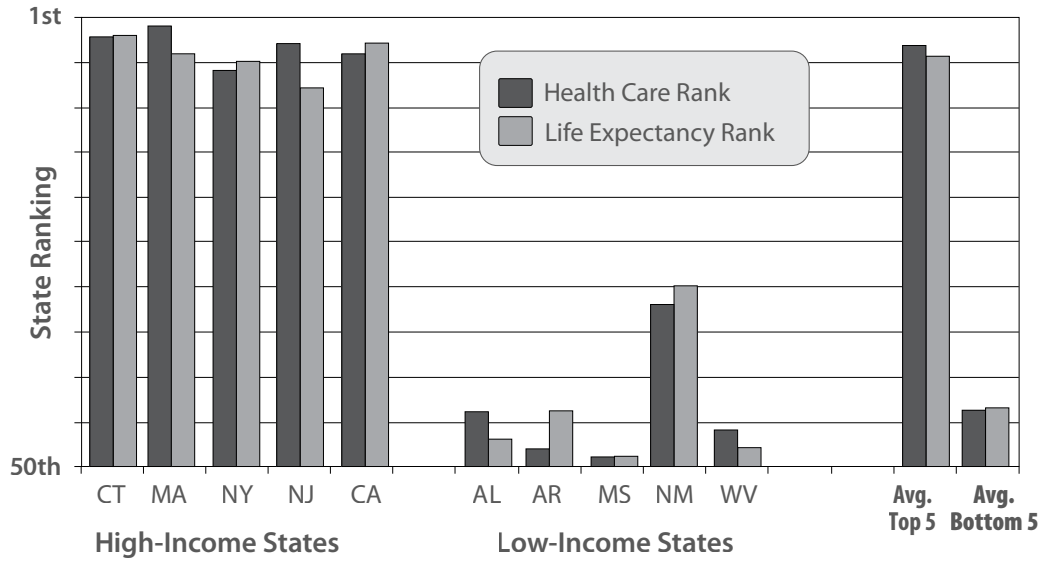
Figure 1.7 **International Growth Comparisons**



Sources: Summers and Heston (1994); World Bank (n.d.).

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

Figure 1.8 **Health Indicators by Income Level**



Sources: "Health Care Rankings," U.S. News and World Report, accessed April 13, 2022, https://www.usnews.com/news/best-states/rankings/health-care; Measure of America (n.d.).

expectancy of its citizens. The average low-income state ranks only 45th. In terms of health care quality, the picture is the same: Richer states do better while poorer states, such as Wisconsin, do worse. The average high-income state ranks 4th in terms of health care quality. The average low-income state ranks 45th.

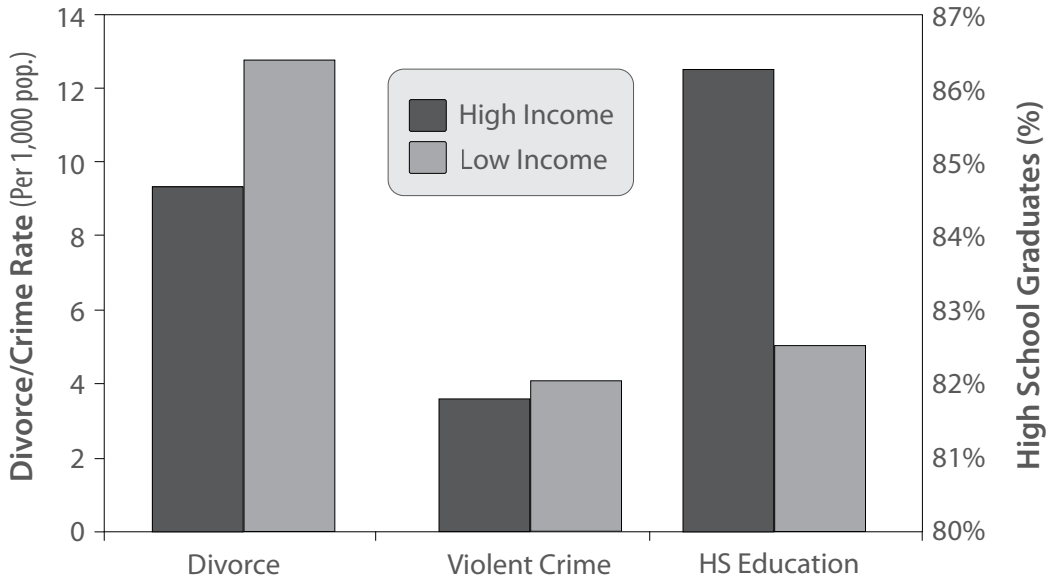
This difference is not limited to physical health; it also appears in measures of mental health. People in lower-income states suffer from the highest rates of mental illness: almost 20.2 percent in the lower-income states compared with only 17.2 percent in the richer states (SAMHSA 2012). This difference is likely due to the lower levels of stress at home and in the workplace that higher income brings.

In addition to valuing our own health, we care about the well-being of our families and children. All parents want their kids to grow up in stable families, live in safe neighborhoods, and receive a good education. Do higher income levels lead to these outcomes as well? Figure 1.9 presents the evidence. Families living in the five states with the highest average incomes experience lower divorce rates than families in the five lowest-income states (9.4 versus 12.8 on average). Richer families have fewer money problems destroying their marriages and more money to spend on family vacations and leisure activities. Furthermore, higher incomes lead to safer neighborhoods. For instance, the five highest-income states have lower rates of violent crime than the five lowest-income states (3.6 versus 4.1 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 (86.3 percent versus 82.5 percent). Higher-income states have more children graduating from college as well (not shown in figure 1.9). 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.

The evidence is overwhelming. Economic growth not only makes us materially richer,

Figure 1.9 **Divorce, Crime, and Education**



Sources: Measure of America (n.d.); "American Community Survey (ACS)," US Census Bureau, accessed April 13, 2022, https://www.census.gov/programs-surveys/acs/

but also helps to accomplish our other goals as well. The objective of growth is really about creating a future for Wisconsin 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 o f life within a generation or two. If Wisconsin continues to grow at the rate it has during the past two decades, Wisconsinites will remain below average on the national economic ladder.

In contrast, a better and richer Wisconsin is possible to achieve within our lifetimes. An increase in Wisconsin's rate of real per capita economic growth back to the 1.7 or 2.4 percent levels sustained in the past would vastly increase family incomes and put Wisconsin on the path to be one of the richest states 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 Wisconsin will automatically result in reductions in crime, fewer health problems, and increases in educational attainment. These social ills are a result of poverty, not a cause of it, and focusing on policies that target those areas to produce economic growth is simply putting the cart in front of the horse.

But can policy reform increase growth by a meaningful amount? Evidence from the experience both of other states and of countries around the globe suggests that 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?

Notes

[1] This chapter is based on Sobel and Daniels (2007); Sobel and Leguizamon (2009); Sobel, Clark, and Leguizamon (2012); and Sobel and Bolen (2018).

[2] All dollar values for future years are given in 2020 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. In other words, we are using a real—inflation-adjusted—growth rate.

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

[4] The data in figure 1.7 rely on a historical comparison because 2014 is the last year for which the World Bank was able to report reliable GDP per capita data for Venezuela, and as of 2020 Hong Kong's economic independence from the People's Republic of China has effectively ceased.

References

BEA (Bureau of Economic Analysis). n.d. *Personal Income by State*. Washington, DC: US Department of Commerce. Accessed April 13, 2022. https://www.bea.gov/data/income-saving/personal-income-by-state.

BLS (Bureau of Labor Statistics). n.d. "Consumer Price Index." Washington, DC: US Department of Labor. Accessed April 13, 2022. https://www.bls.gov/cpi/.

Measure of America. n.d. *Human Development Index*. Brooklyn, NY: Social Science Research Council. Accessed April 13, 2022. http://www.measureofamerica.org/.

SAMHSA (Substance Abuse and Mental Health Services Administration). 2012. *National Survey on Drug Use and Health Report*. Washington, DC: US Department of Health and Human Services. https://www.samhsa.gov/data/report/results-2012-national-survey-drug-use-and-health-summary-national-findings

Sobel, Russell S., and J. Brandon Bolen. 2018. "The Case for Growth." In *Promoting Prosperity in Mississippi*, edited by Brandon N. Cline, Russell S. Sobel, and Claudia R. Williamson, 3–14. Mississippi State: Mississippi State University Institute for Market Studies.

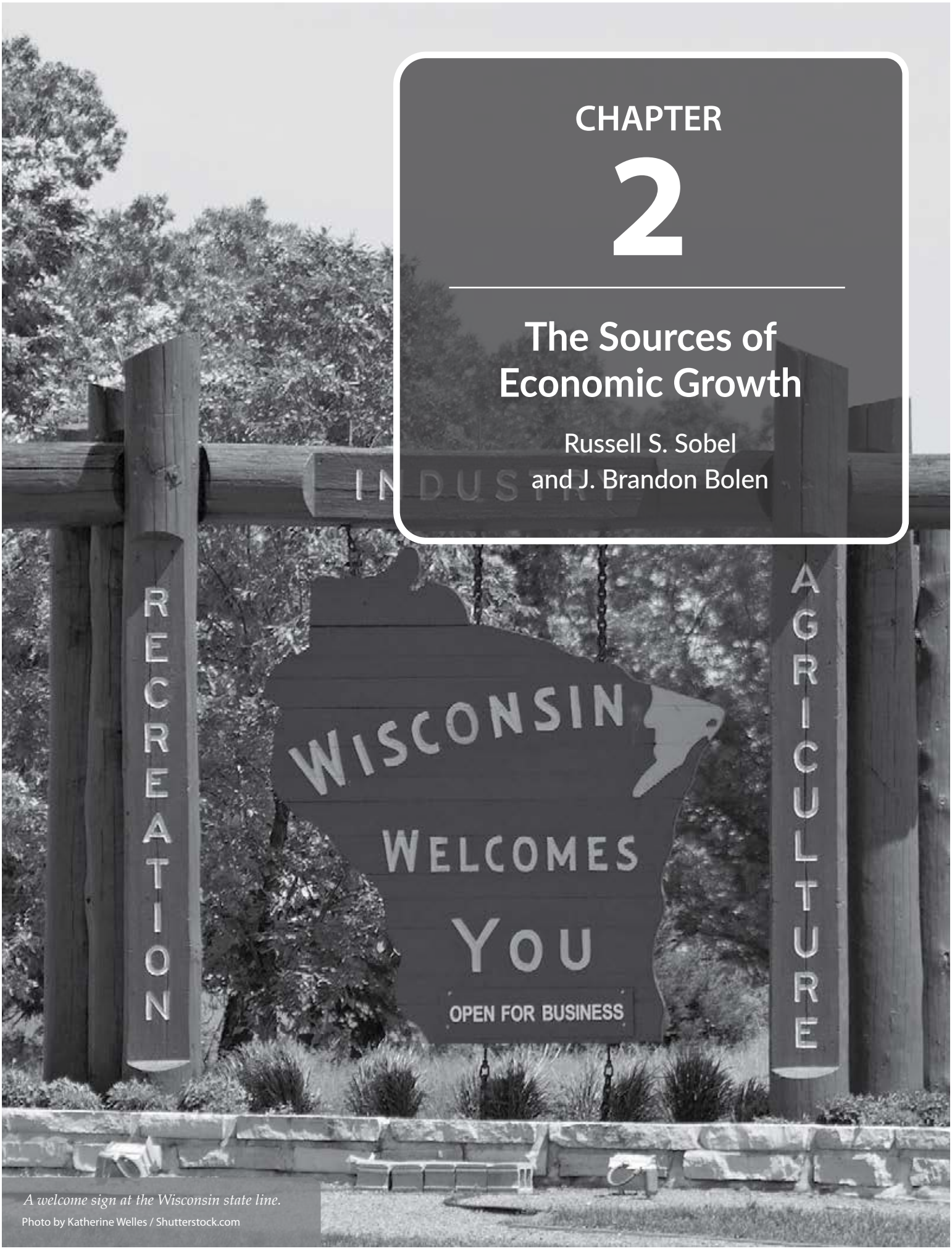
Sobel, Russell S., J. R. Clark, and Susane J. Leguizamon. 2012. "The Case for Growth." In *Freedom and Prosperity in Tennessee*, edited by J. R. Clark, 1–16. Chattanooga, TN: Scott L. Probasco Jr. Chair of Free Enterprise.

Sobel, Russell S., and Susane J. Daniels. 2007. "The Case for Growth." In *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It*, edited by Russell S. Sobel, 1–12. Morgantown, WV: Center for Economic Growth, Public Policy Foundation of West Virginia.

Sobel, Russell S., and Susane J. Leguizamon. 2009. "The Case for Growth." In *Unleashing Capitalism: A Prescription for Economic Prosperity in South Carolina*, edited by Peter T. Calcagno, 7–20. Columbia, SC: South Carolina Policy Council.

Summers, Robert, and Alan Heston. 1994. *The Penn World Tables (Mark 5.6)*. Cambridge, MA: National Bureau of Economic Research.

World Bank. 2022. "World Development Indicators." World Bank. Last modified September 23, 2022. http://data.worldbank.org/data-catalog/world-development-indicators.



CHAPTER

2

The Sources of Economic Growth

Russell S. Sobel
and J. Brandon Bolen

A welcome sign at the Wisconsin state line.
Photo by Katherine Welles / Shutterstock.com

2 The Sources of Economic Growth

The previous chapter made the case for why increasing the rate of economic growth in Wisconsin should be considered one of the state's top policy priorities. However, policy reform to promote growth should be based on evidence of what has worked and what has not worked in Wisconsin and other areas. Chapter 1 presented evidence that economic growth is faster in states such as Wyoming, Pennsylvania, Vermont, North Dakota, South Dakota, and Montana, as well as in Hong Kong and Japan. How can this success be replicated in Wisconsin? Can we uncover which policies tend to promote prosperity? These are the questions we address in this chapter.[1]

As this chapter will show, 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. Economist Dwight Lee writes,

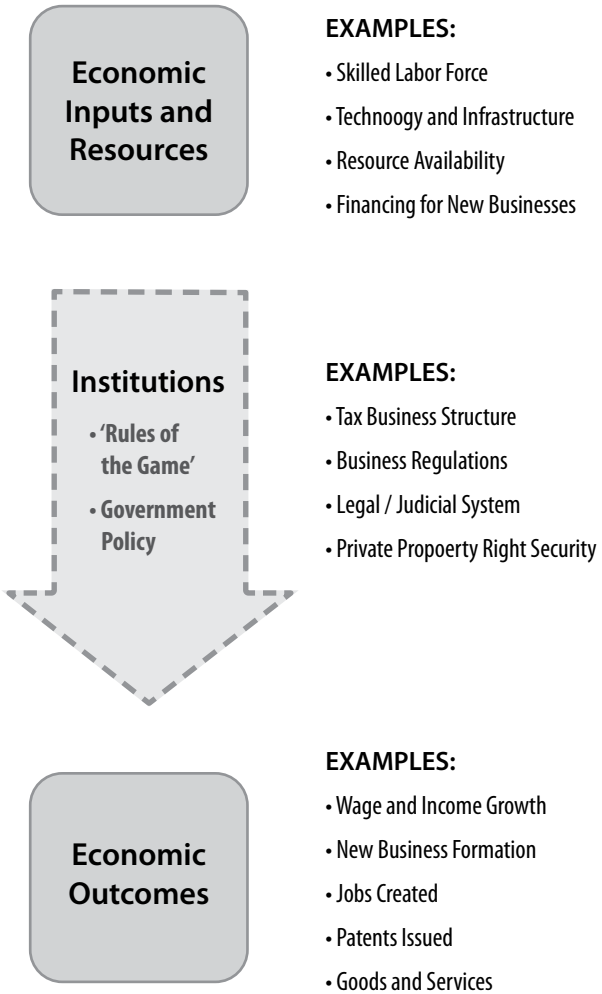
> No matter how fertile the seeds of entrepreneurship, they wither without the proper economic soil. In order for entrepreneurship to germinate, take root, and yield the fruit of economic progress it has to be nourished by the right mixture of freedom and accountability, a mixture that can only be provided 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 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, and new businesses). This concept is illustrated in figure 2.1. As the large arrow in the middle of the figure shows, the economic outcomes generated from any specific set of economic inputs depend on the institutions—the political and economic "rules of the game"—under which an economy operates. The important point is that some rules of the game are better than others at producing prosperity.

Figure 2.1 Inputs, Institutions, and Outcomes



Source: Hall and Sobel (2006)

Several analogies will help to clarify this point. 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 duration of the game, the time given on the shot clock, the rules about fouling, and the three-point line rule. Examples of the measurable outcomes are the score, the winning team, the number of fouls, and so forth. 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 about 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. If the point value of longer shots decreased, fewer players would attempt them.[2]

The basketball example might sound hypothetical, but when Clemson University economists Robert McCormick and Robert Tollison (1984) studied an actual rule change, they found that game play did indeed change. Adding an additional referee to a basketball game was expected to result in more fouls being called, a slower-paced game, and less scoring. When these rule changes were introduced in the Atlantic Coast Conference, however, they had precisely the opposite effect: 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 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 when they are not looking. The play and outcomes of a game of Monopoly would be significantly different under these different institutional rules because 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 players devoting more resources to trying to protect their property cards from being stolen (and putting 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 "institution" is 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 of the process. Too many government policy makers 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 because of 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 Wisconsin economy operates, the state can change economic outcomes for the better. When institutions are weak, even places with abundant natural resources or other inputs have difficulty becoming prosperous.

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 Wisconsin 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 this book, titled *An Inquiry into the Nature and Causes of the Wealth of Nations*, *Smith* ([1776] 1998) attempted to answer a single question: Why are some nations rich and others poor? Economic science has come a long way in 250 years, and volumes of published research now clearly provide the answer to the question Smith posed long ago. The answer is the same one he arrived at.

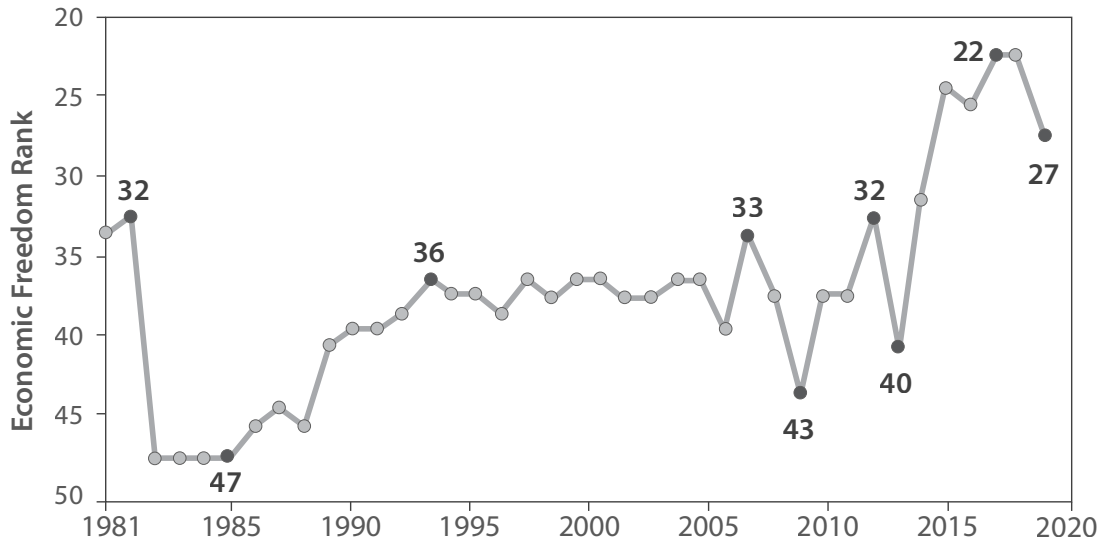
In a nutshell, Smith found that countries become prosperous when they have good institutions that create favorable rules of the game—rules that encourage the creation of wealth. He further concluded that the institutional structure that best promotes prosperity is an economic system of capitalism backed up by sound political and legal institutions. According to Smith, an economy becomes prosperous when it uses unregulated private markets to the greatest extent possible and when the government plays the important but limited role of protecting liberty and property and enforcing contracts. Almost 250 years of published scientific evidence now support 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, security, and so forth.

The Rise and Decline of Economic Freedom in Wisconsin

While most people think of capitalism and socialism as alternative and discrete forms of economic organization, in reality government policies tend to lie somewhere on a continuum between these two extremes. What differs on this continuum is the degree to which the government uses its power to enact command-and-control policies that intervene in the private sector. Some countries, such as North Korea and Cuba, have governments that adopt 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

Figure 2.2 **Wisconsin's Economic Freedom Rank**



Source: Stansel, Torra, and McMahon (2021).

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 Georgia, Estonia, and Latvia, all of which adopted radical reforms that moved them toward capitalism and away from their former Soviet socialist systems.

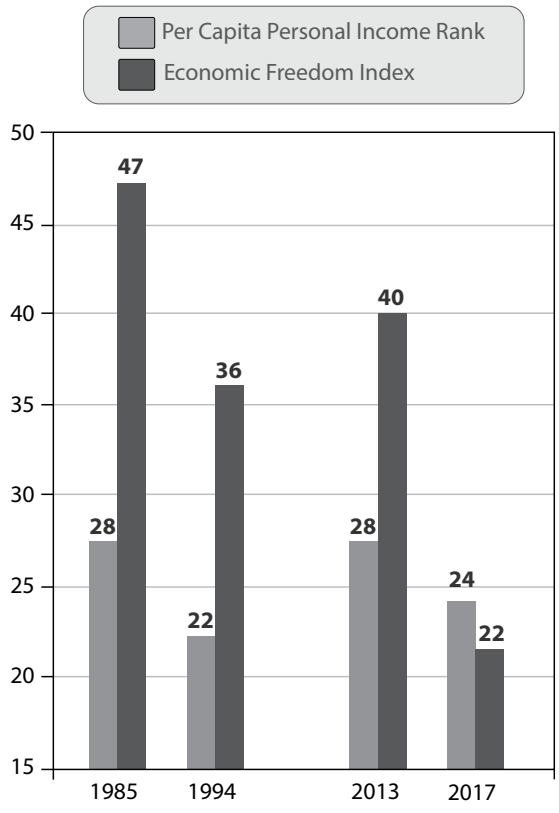
On the other hand, most market-based economies have a much larger degree of government intervention and control than is envisioned under pure capitalism. Within the past two decades, a significant advance in our understanding of this continuum has accompanied the publication of the *Economic Freedom of the World* index, created by economists James Gwartney (a former chief economist of the Joint Economic Committee of Congress) and Robert Lawson.[3] Gwartney and Lawson derive an index measure for each country, placing it on a scale from 0 to 10, where 10 represents the greatest degree of "economic freedom"—that is, reliance on capitalism—and 0 represents the greatest degree of "economic repression"—that is, reliance on government control of the economy. In the most recent index, the United States scores 8.24 out of 10 and ranks as the sixth most capitalist, or free-market, economy in the world. Other countries ranking among the most capitalist in the world are New Zealand, Switzerland, Ireland, and Australia.

Because state and local policies vary within the United States, Dean Stansel, José Torra, and Fred McMahon have created an index called *Economic Freedom of North America* that ranks each state (and also the Mexican states and Canadian provinces) by their degree of free-market orientation.[4] Wisconsin ranked 27th out of 50 in the most recent index. Figure 2.2 shows how Wisconsin's economic freedom rank has changed over time.

After an initial large decline in Wisconsin's economic freedom ranking in the early 1980s, Wisconsin stayed ranked near the bottom of the index (47th) for most of the remainder of the 1980s. There was a noticeable improvement in Wisconsin's economic freedom ranking in the late 1980s and early 1990s, from 47th to 36th by 1994. The second major improvement occurred in the 2013–2017 period, when Wisconsin rose 18 places in the rankings, to 22nd. Since that time, Wisconsin's economic freedom ranking has declined back to 27th among the states.

Does the "market-friendliness" of Wisconsin's policies help to explain its economic performance? Is there evidence from the past two times Wisconsin increased its economic freedom that prosperity increased as a result? Figure 2.3 shows how Wisconsin's placement in the national income rankings changed during the two prior periods in which it changed its policies to become more economically free. (Remember that the rank of 1st represents "most economically free" and "highest per capita income" while the rank of 50th represents "least economically free" and "lowest per capita income." Thus, somewhat unusually for a bar chart, shorter bars are better than longer ones in figure 2.3.)

Figure 2.3 **Economic Freedom vs. Prosperity in Wisconsin**



Sources: Stansel, Torra, and McMahon (2021); Bureau of Economic Analysis (n.d.).

The upper pairs of bars show that between 1985 and 1994, when Wisconsin's economic freedom rank improved from 47th (fourth worst among the states) to 36th, this 11-place increase in the state's rank was accompanied by a 6-place increase in Wisconsin's national per capita income rank, from 28th to 22nd. The lower pairs of bars show that again, between 2013 and 2017, as Wisconsin's economic freedom rank improved from 40th to 22nd, its per capita income rank again improved, from 28th to 24th. What figure 2.3 makes abundantly clear is that the two times Wisconsin has undertaken steps to increase its economic freedom, the prosperity of Wisconsinites relative to citizens of other states has increased as well.

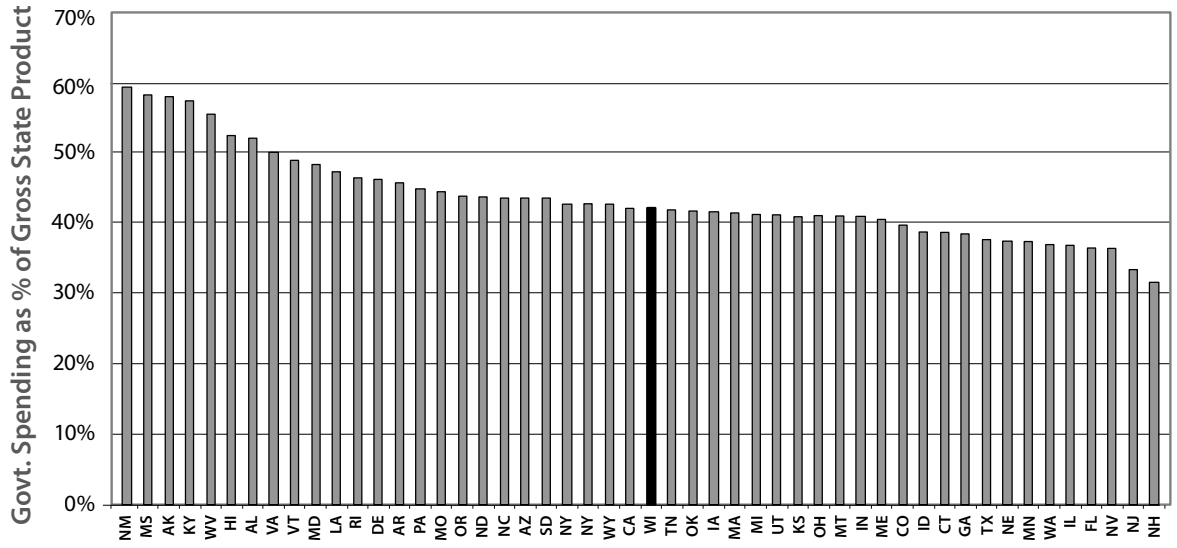
The point should be obvious: for Wisconsin to improve economic growth, it must again move toward policies that embrace capitalism and free markets. If Wisconsin continues along the downward trend that began in the past few years, the state's economic rank is likely to suffer, and Wisconsin will stagnate again in the national economic rankings.

One of the major components of the economic freedom index is government spending as a share of the state economy, shown in figure 2.4. How much the government spends relative to the total size of a state's economy is a good measure of the extent to which the 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 other states, Wisconsin has the 25th largest government share of state economic activity. Combined, all federal, state, and local government spending in Wisconsin amounts to 42 percent of the state economy, leaving the remaining 58 percent of the state's economic resources available to the private sector. For comparison, in the most economically free state, New Hampshire, the 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 considering state and local spending alone, as shown in figure 2.5, Wisconsin remains in the 25th place. 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.

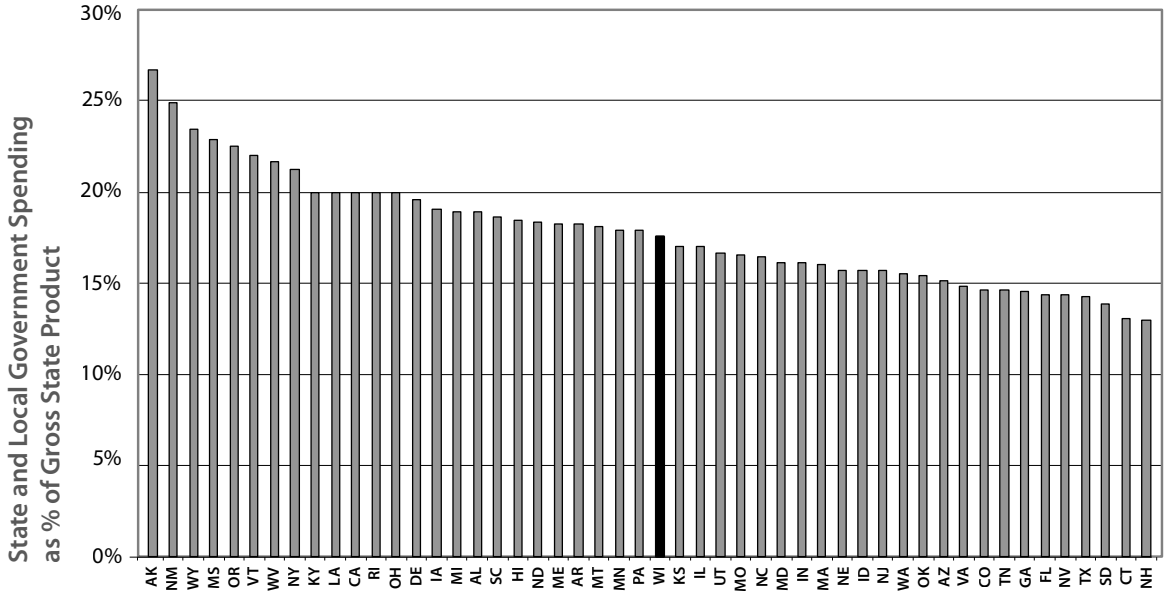
Figure 2.4 **Government Control of the Economy, 2019**



Source: Stansel, Torra, and McMahon (2021).

Note: *Government spending includes federal, state, and local government spending.*

Figure 2.5 State and Local Government Control of the Economy



Source: Stansel, Torra, and McMahon (2021)

International studies across countries in the Organisation for Economic Co-operation and Development (OECD) suggest that a nation's economic growth rate falls by 1 percentage point for every 10-percentage-point increase in government as a share of the economy (Gwartney et al. 2022, 582). This, interestingly, is precisely the difference in the size of government between Wisconsin and the most economically free state, New Hampshire. In other words, citizens of New Hampshire can expect to experience an economic growth rate in their per capita income, every year, 1 percentage point higher than that of Wisconsin citizens. If one recalls the importance of these differences in growth rates from chapter 1, it should be clear why the per capita income in New Hampshire is $11,504 higher than it is in Wisconsin.

Wisconsin's Other Economic Policy Rankings

Not only does Wisconsin's economic freedom rank (27th in 2021) show the need for policy reform, but many other national indices of state business climates agree:

21st CNBC's "America's Top States for Business" (2021)

25th Milken Institute's "State Technology and Science Index" (2020)

13th Institute for Legal Reform's "State Legal Climate Ranking" (2019)

21st Forbes's "Best States for Business" (2019)

33rd Information Technology & Innovation Foundation's "State New Economy Index" (2020)

27th Tax Foundation's "State Business Tax Climate Index" (2022)

28th Small Business & Entrepreneurship Council's "Small Business Policy Index" (2019)

35th Small Business & Entrepreneurship Council's "Small Business Tax Index" (2019)

Wisconsin generally ranks average or slightly below average in the national business climate rankings. Its best ranking

(13th) regards the quality of the legal system in the state, and it is worth noting that as recently as 2017, Wisconsin ranked 20th in that index as well. These indices are to one extent or another measuring the same thing; Wisconsin's middle-of-the-road economic performance is mirrored by its middle-of-the-road record on embracing capitalism.

Wisconsin's worst rankings generally regard its tax structure and reflect the state's high tax rates for corporate income, unemployment insurance, and property. The taxes most in need of reform in Wisconsin to increase economic growth are the taxes that fall on capital investment (such as property taxes on machinery and equipment). 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, Wisconsin's taxes on capital investment limit the economic growth prospects of the Badger State.

Like a three-legged stool, a state's tax system, legal system, and regulatory code must all be well designed to support economic growth. We have briefly discussed Wisconsin's legal and tax codes, but 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 of regulation is reflected in the expenditures of the regulated business rather than appearing as a category of government spending. Moreover, many regulations have hidden costs in the form of higher prices consumers pay as a result of the regulation. Lastly, many regulations are local, so there is variation even within a state.

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.

What Is Capitalism? The Concept of Economic Freedom

While most people have 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 one's ownership of their own labor efforts, land, and all other tangible property (cars, houses, factories, etc.) and intangible property (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 on the property rights of others.

The freedom of action given to private owners under a system of capitalism is why the indices that rank states and countries have "economic freedom" in their titles. 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, and confiscation by others, including by the government.

The concept of capitalism is deeply rooted in the notions of individual liberty and freedom that underlie the country's founding and are reflected in the Declaration of Independence and the United States Constitution. Economic freedoms are based in the same philosophies that support political and civil liberties (liberties such as 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 what they entail.[5] Private property rights have several components: (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 your property or from its use (i.e., the right to be 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 yourself of your property under the terms and conditions you see fit.

A government policy that weakens any one of these components of property rights weakens property rights in general. Taxes, for example, restrict the cash flow rights associated with property and so weaken private property rights on that dimension.[6] 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 and other forms of expropriation (such as eminent domain, especially when the government transfers property from one private owner to another), by removing property from an owner's possession, actually weaken property rights on all the dimensions considered above. They make property a "contingent right"—that is, a right contingent on the state's arbitrary will—rather than an "absolute right" guaranteed and protected by law.

In order to nurture capitalism, the government must do some things but refrain from doing others. Governments promote capitalism by establishing a legal structure that provides for the evenhanded enforcement of contracts and the protection of individuals and their property from aggressors seeking to use violence, coercion, and fraud to seize property that does 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 a government protects people and their property, enforces contracts in an unbiased manner, and provides a limited set of "public goods" such as roads, flood control, and other major public works projects but leaves the remaining activities to the private market, it supports the institutions of capitalism.

Capitalism, Democracy, and Constitutional Constraints

It is also important to distinguish between economic freedom and democracy. Unless both parties to a private exchange agree to the exchange, 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 are adopted for the purpose of generating benefits for small and 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 that 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 from productive private-sector activities and devote them to 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 to capitalism—limited and constitutionally constrained government is. Constitutional restraints, structural procedures designed to promote agreement and reduce the ability of interest groups to exploit consumers and taxpayers, and competition among governmental units (federalism and decentralization) can help restrain the impulses of the majority and promote economic freedom.

As Supreme Court Justice Robert Jackson emphasized in *West Virginia State of Education v. Barnette*, "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."[7] The fundamental principle is that there need to be safeguards preventing democratic governments from enacting policies that infringe on the property rights of citizens, just like the rules preventing them from infringing on the rights to free speech and freedom of worship. When property rights are secure so that owners can use their property in the ways they see fit without fear of the property being seized, overly regulated, or exorbitantly or unfairly taxed, the foundation for economic freedom, prosperity, and growth has been created.

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

Before moving on, one additional point needs clarification. There is a difference between what economists call capitalism and what some might consider "business-friendly" policies. When a 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 increasingly 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 to obtain government tax breaks rather than competing 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, governments distort private-sector economic activity in those sectors relative to other sectors. To promote 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 revenues or other resources necessary to fund these subsidies generally destroy more jobs than they create. They result in a *net* reduction in economic activity. The problem, politically, is that these losses are not as visible. When every taxpayer in Wisconsin has to pay, say, $1 more in taxes to fund some multimillion-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 may be negative.

When business interests capture the government's power, things can go just as badly for capitalism as when government power is held in the hands of less business-friendly groups. For example, when companies can get the 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 businesses, 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 creating 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.

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

When governments give favors to some businesses but not others, this is unfair to the competitive market process because unsubsidized firms must then compete with the politically favored, subsidized firms for employees, resources, land, and consumers. All firms in Wisconsin 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 Wisconsin's businesses—including small entrepreneurs—simply do not have the political power to even begin to negotiate a better business climate like the one available to the large companies that do receive incentives. The resources devoted toward offering these special favors to big businesses would be better spent providing across-the-board, broad-based tax reductions that apply to all Wisconsin'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 awards for contributions to the understanding of why (and how) capitalism creates such remarkable prosperity. The reason why so many economists agree on this issue is that the evidence is so clear. Let us take a closer look at evidence about the relationship between capitalism and prosperity.

How does the *Economic Freedom of North America* index correlate with other measures of economic activity? Table 2.1 shows seven measures of economic prosperity and entrepreneurial activity for the top five and bottom five states in the economic freedom index. To provide a picture uncomplicated by the recent national recession and pandemic, the data are from before that period. The table shows the averages for these two groups of states on these important indicators of prosperity as well as the difference between these averages.

The states listed at 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 for the states with the best economic institutions, and the average poverty rate is 3.1 percentage points lower. Examining the measures of entrepreneurial activity, a similar pattern emerges in that 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, 21.2 more patents 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 percent higher. This strong relationship between economic freedom and rates of entrepreneurship has been well documented at both the state and national levels (Kreft and Sobel 2005; Sobel, Clark, and Lee 2007).

Table 2.1	Capitalism's Economic Record								
State	Economic Freedom Index (2005)		Economic Performance Measures		Measures of Entrepreneurial Activity (annual averages)				
	Score	Rank Among U.S. States	Per Capita Personal Income 2008	Poverty Rate 2007	Venture Capital Investment Per Capita	Patents per 100,000 population	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%**

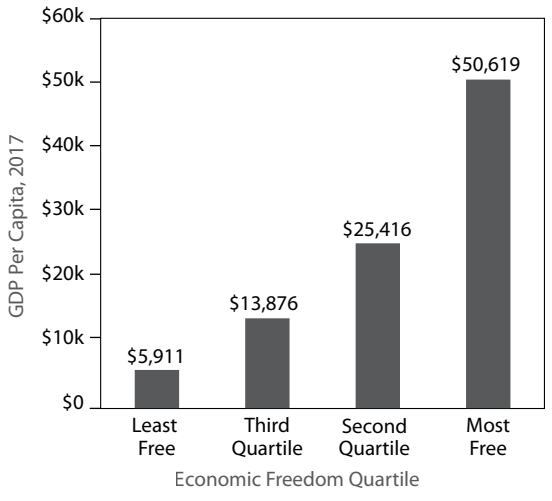
Sources: Sobel and Hall (2009)

Evidence From Across The World

Though state comparisons are probably the most valuable data for Wisconsin policy reform, it is worthwhile to spend a moment looking at some additional evidence about 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 the states. The majority of countries in the world indeed rely less heavily on capitalism than does Wisconsin, but their fate can help us understand what is in store for the state if policy keeps moving in the wrong direction.

Figure 2.6 shows the average income level within four different groupings of countries in the *Economic Freedom of the*

Figure 2.6 Capitalism and Income (International Data)

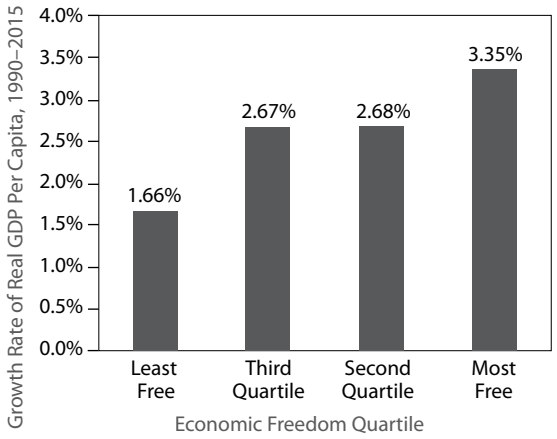


Source: Gwartney et al. (2021)

World index. Countries are divided into these groups on the basis of their scores, which reflect the reliance on capitalism, rather than political planning, to organize their economies. The pattern in figure 2.6 is clear. A heavier reliance on capitalism makes countries more prosperous.

Figure 2.7 shows a similar graph for the relationship between reliance on capitalism and income growth rates over the 1990–2015 period for countries of the world. The countries relying least on capitalism are not only poorer to begin with (looking at average income levels), but they are also becoming worse off through time. As their negative growth rates show, average income is actually falling through time in these countries. At the opposite end of the spectrum are countries that rely heavily on capitalism and have both high incomes and high growth rates as a result. In summary, the international evidence bears out the same conclusions as the evidence from the states. Areas that have embraced capitalism are richer and are growing faster, and areas that have not are poorer and are growing more slowly.

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



Source: Gwartney, Lawson, and Hall (2017)

Could Other Things Account For These Differences In Prosperity?

Up to this point we have relied on presentations of simple correlations to establish the link between good institutions and prosperity. Some readers might wonder whether these relationships hold up under closer inquiry—that is, if we control for other factors that might account for observed differences. This is the realm of academic journal publications, and many have been published on this subject, and clearly conclude that the relationship between economic freedom and prosperity is robust. For readers interested in these more detailed results and papers, the endnote attached to this sentence contains more detail.[8] All of these articles are published in academic journals, to which authors submit papers that are then reviewed anonymously in a scientific manner by other scholars around the globe. Papers generally go through revisions and must hold up under 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 about what other factors might explain these differences in prosperity. Areas rich in natural resources, for example, do not necessarily grow faster than areas with none. Recall the case of Hong Kong, a rock island in the ocean, which has grown rapidly while resource-rich countries such as Venezuela and Argentina exhibit slow or negative growth. Neither does geographical climate variation, or just plain luck, explain the differences observed across countries or regions or states. When we see stark differences across the borders between countries—like the two sides of the former Berlin Wall, which separated wealthy, capitalist West Germany from relatively poor, socialist East Germany—it becomes clear that institutional differences, differences in the rules of the economic game, are the true source of differences in prosperity.

Conclusion

This chapter has presented evidence that areas relying on capitalism, with 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 about the sources of prosperity and growth. Beginning with Adam Smith, approximately 250 years of evidence suggest that relying on capitalism is the best way to achieve increases in living standards. States and countries that rely more heavily on capitalism not only have higher income levels and faster average income growth but also have faster and more even growth across the income distribution.

One key component of reforming policy in a manner conducive to growth is to ensure the security of private ownership rights. This entails the protection of persons and property from unreasonable aggression, theft, lawsuits, or confiscation by others, including the government. A weak legal system is devastating to the underpinnings of a free-market economy. All too often, violations of private property occur 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 establishing the legal foundations necessary for capitalism, governments must 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 and ownership of land and productive assets, as well as high government spending beyond what's necessary to fulfill 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 public-sector shares in the state economy add up to 100 percent. The goal should be to increase the share controlled by the private sector and diminish the share controlled by the public sector. The evidence clearly shows that prosperity follows as a result.

Notes

[1] This chapter is based on Sobel and Hall (2007); Sobel and Hall (2009); Sobel, Clark, and Hall (2012); and Sobel and Bolen (2018).

[2] This change in the rules would also alter the incentives influencing the selection of players—that is, the investments in resources for the economy. Coaches would have a much weaker preference for players who can make longer shots.

[3] This index is available online at http://www.freetheworld.com. The most recent edition is the 2021 report (Gwartney et al. 2021).

[4] Both the country (*Economic Freedom of the World*) and state (*Economic Freedom of North America*) economic freedom indices are available online at http://www.freetheworld.com. The most recent edition is the 2021 report (Stansel, Torra, and McMahon 2021). Ranks reported in this chapter are calculated among only the 50 U.S. states (i.e., excluding Canadian provinces and Mexican states).

[5] Note that the appropriate definition of property rights identifies them as protective rights—that is, rights that provide an individual 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 minimum income. The existence of positive rights requires 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. Such invasive rights are in conflict with economic freedom. If you can ask "at whose expense" after someone claims a right to something, it is not—and cannot be—a real right. Real rights, such as the right to your life or the right to free speech, do not impose further obligations on others (other than to avoid 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 that you will own property. Rather, it is a right that protects legitimately acquired property against the aggression of others who would take it.

[6] 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 because of taxes also inhibit long-term contracting and lending.

[7] 319 U.S. 624, 638 (1943).

[8] Scully (1988), finds that politically open countries that respect private property rights, subscribe to the rule of law, and use markets instead of the 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) account for demographics, changes in education, and physical capital and find that economic freedom is still a significant determinant of economic growth. Dawson (1998) finds that economic freedom positively affects growth and that it does so directly by 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. Berggren (2003) provides a summary of findings from the literature. More recently, Hall and Lawson (2014) and Lawson, Murphy, and Powell (2020) have provided the most detailed reviews of the literature that employ the country-level measures from the *Economic Freedom of the World* report, while Stansel and Tuszynski (2018) provide a similar review of the literature employing the subnational data for states and provinces in the United States, Canada, and Mexico from the *Economic Freedom of North America* report.

References

Barro, Robert J. 1996. "Democracy and Growth." *Journal of Economic Growth* 1 (1): 1–27.

Berggren, Niclas. 2003. "The Benefits of Economic Freedom: A Survey." *Independent Review* 8 (2): 193–211.

BEA (Bureau of Economic Analysis). n.d. *Personal Income by State*. Washington, DC: US Department of Commerce. Accessed April 13, 2022. https://www.bea.gov/data/income-saving/personal-income-by-state.

Dawson, John. 1998. "Institutions, Investment, and Growth: New Cross-Country and Panel Data Evidence." *Economic Inquiry* 36 (4): 603–19.

Gwartney, James D., Robert A. Lawson, and Joshua C. Hall. 2017. *Economic Freedom of the World: 2017 Annual Report*. Vancouver: Fraser Institute.

Gwartney, James D., Robert A. Lawson, Joshua C. Hall, and Ryan H. Murphy. 2021. *Economic Freedom of the World: 2021 Annual Report*. Vancouver: Fraser Institute.

Gwartney, James D., Robert A. Lawson, and Randall G. Holcombe. 1999. "Economic Freedom and the Environment for Economic Growth." *Journal of Institutional and Theoretical Economics* 155 (4): 1–21.

Gwartney, James D., Richard L. Stroup, Russell S. Sobel, and David A. Macpherson. 2022. *Economics: Private and Public Choice*. 17th ed. Boston: Cengage Learning.

Hall, Joshua C., and Robert A. Lawson. 2014. "Economic Freedom of the World: An Accounting of the Literature." *Contemporary Economic Policy* 32 (1): 1–19.

Hall, Joshua C., and Russell S. Sobel. 2006. "Public Policy and Entrepreneurship." Technical Report 06-0717, Center for Applied Economics, Kansas City.

Hall, Robert E., and Charles I. Jones. 1999. "Why Do Some Countries Produce So Much More Output per Worker Than Others?" *Quarterly Journal of Economics* 114 (1): 83–116.

Kreft, Steven F., and Russell S. Sobel. 2005. "Public Policy, Entrepreneurship, and Economic Freedom." *Cato Journal* 25 (3): 595–616.

Lawson, Robert A., Ryan Murphy, and Benjamin Powell. 2020. "The Determinants of Economic Freedom: A Survey." *Contemporary Economic Policy* 38 (4): 622–42.

Lee, Dwight R. 1991. "The Seeds of Entrepreneurship." Journal of Private Enterprise 7 (1): 20–35.

McCormick, Robert E., and Robert D. Tollison. 1984. "Crime on the Court." *Journal of Political Economy* 92 (2): 223–35.

Scully, Gerald. 1988. "The Institutional Framework and Economic Development." *Journal of Political Economy* 96 (3): 652–62.

Smith, Adam. (1776) 1998. *An Inquiry into the Nature and Causes of the Wealth of Nations*. Washington, DC: Regnery.

Sobel, Russell S., and J. Brandon Bolen. 2018. "The Sources of Economic Growth." In *Promoting Prosperity in Mississippi*, edited by Brandon N. Cline, Russell S. Sobel, and Claudia R. Williamson, 15–34. Mississippi State: Mississippi State University Institute for Market Studies.

Sobel, Russell S., J. R. Clark, and Joshua C. Hall. 2012. "The Sources of Economic Growth." In *Freedom and Prosperity in Tennessee*, edited by J. R. Clark, 17–46. Chattanooga, TN: Scott L. Probasco Jr. Chair of Free Enterprise.

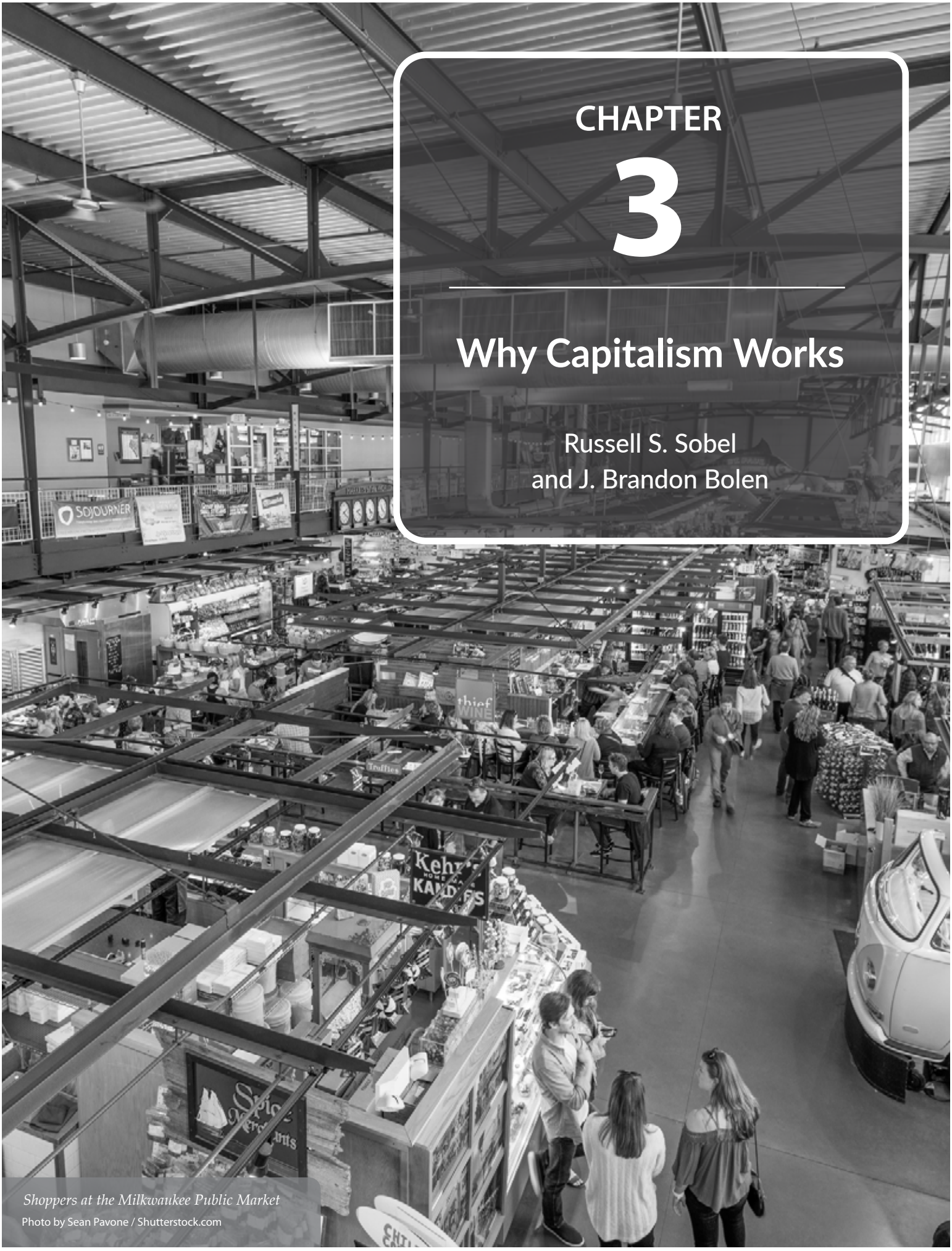
Sobel, Russell S., J. R. Clark, and Dwight R. Lee. 2007. "Freedom, Barriers to Entry, Entrepreneurship, and Economic Progress." *Review of Austrian Economics* 20 (4): 221–36.

Sobel, Russell S., and Joshua C. Hall. 2007. "The Sources of Economic Growth." In *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It*, edited by Russell S. Sobel, 13–36. Morgantown, WV: Center for Economic Growth, Public Policy Foundation of West Virginia.

———. 2009. "The Sources of Economic Growth." In *Unleashing Capitalism: A Prescription for Economic Prosperity in South Carolina*, edited by Peter T. Calcagno, 21–48. Columbia, SC: South Carolina Policy Council.

Stansel, Dean, José Torra, and Fred McMahon. 2021. *Economic Freedom of North America: 2021 Annual Report*. Vancouver: Fraser Institute.

Stansel, Dean, and Meg P. Tuszynski. 2018. "Sub-national Economic Freedom: A Review and Analysis of the Literature." *Journal of Regional Analysis and Policy* 48 (1): 61–71.



Shoppers at the Milkwaukee Public Market
Photo by Sean Pavone / Shutterstock.com

CHAPTER

3

Why Capitalism Works

Russell S. Sobel
and J. Brandon Bolen

3 Why Capitalism Works

Chapter 2 showed that increased reliance on capitalism has allowed states and countries to become more prosperous. To promote capitalism in Wisconsin, the state's 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 Wisconsin 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 who want to learn more, we suggest the easy-to-read book *Common Sense Economics: What Everyone Should Know about Wealth and Prosperity*, by James Gwartney (former chief economist of the Joint Economic Committee of the US Congress) and his coauthors (Gwartney et al. 2016).[1] With better knowledge of the fundamentals of 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 constantly being created by each of us; the "economic pie" grows each day.

Wealth is created through both production and exchange. An example will help to illustrate: Suppose two neighbors trade with each other, exchanging a bushel of hay and a load of wood. Both are now better off—after all, they were willing to trade with each other only because they each wanted what the other person had more than what they themselves traded away. Both have become wealthier in every sense of the word even though no new money was printed, nor was existing money passed around.

On an everyday basis, money represents wealth to us only because it measures the quantity of the 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 deserted on an 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 with a group of other people, will be much wealthier because of his ability to produce and exchange with others—despite the absence of paper money on the island. Production and exchange, not money, are the true sources of wealth.

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

Wealth would have been created if instead half the tribe had collected coconuts and the other half had fished. Then they would have dinner. Suppose one castaway invents a new tool that increases the number of fish she can catch. This invention will further increase wealth; there will be more food at the dinner table. In fact, the new tool

might increase productivity so much that only half as many castaways are needed for 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 over the course of the day. A large and advanced economy 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 use that money to buy the goods and services produced by others at their jobs.

The amount of income we earn is determined by two factors: 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 whether a suggested policy or law is good or bad for the Wisconsin 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, that restrict the workweek to 35 hours clearly result in reduced output and thus in reduced standards of living. The California legislature is currently considering a similar law to restrict the workweek to four days (32 hours). The net effect of such a law—because it reduces output—would be to make Californians poorer, despite the rhetoric of the politicians proposing the law, who state the opposite.

For a tax-funded government program, this principle must be applied by looking at the *net* change in output from both the tax and the spending. That is, one must account for the reduced output caused by the additional taxes necessary to fund the policy. Often politicians present government programs as a "free lunch," quoting the jobs created or the benefits of the spending while ignoring the reduced output caused by the taxes necessary to fund the program.

One of Adam Smith's insights in *An Inquiry into the Nature and Causes of the Wealth of Nations* ([1776] 1998) is that labor productivity, the main determinant of wage rates, is increased through specialization and the division of labor. When laborers focus on specific tasks, as in the case of workers in an assembly line, they can produce more as a group than they all would have produced working 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, smaller and more specialized stores can survive that could not in a smaller marketplace. Rhinelander's population, for example, is able to support two general-purpose pet stores, each carrying a broad line of products. In a place like Milwaukee, however, a dozen or more stores can flourish, and they have a greater degree of specialization: some focus on saltwater fish while others focus on birds and reptiles. Increasing the size of the markets to which Wisconsin's goods and services sell could increase wealth by allowing Wisconsinites to specialize more specifically in the areas where they are most productive.

Population growth in metropolitan areas is one way market sizes increase. But another way to increase market size is to enact policy reforms that enable the businesses in Wisconsin to sell and compete in larger

national and global marketplaces and to expand their customer bases. To compete in these markets, Wisconsin businesses need to be on a level playing field with their competitors. Wisconsin's taxes and regulations are a competitive disadvantage to firms located in the state. The higher prices Wisconsin businesses must charge for their products greatly limit 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, as a result, earn higher incomes.

In addition to specialization and the division of labor, capital investment also increases labor productivity. Higher levels of education (more "human capital") and better machinery, buildings, and tools to work with (more "physical capital") can help our citizens produce more output and generate more income. Recent capital investments in 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 than in the past. With this new capital equipment workers are more productive, and they earn higher wages as a result.

But new factories, better machinery, and additional equipment are expensive. They require large investments in assets and property. In Wisconsin, 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 a result, Wisconsin's workers are less productive—and earn less as well.

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 Wisconsin labor.

Which specific uses of Wisconsin's resources create the most value and thus income? The answer 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. The next section of this chapter will delve into this topic.

Before moving on, however, let us complete the discussion about the process of wealth creation. As we pointed out, in a real-world economy, things work a bit differently than in the example about the castaways: we must earn income by producing goods and services before we can 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 such as food, clothing, shelter, and recreation. When we shop, we search out goods and services 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. If we can find a good or service we wish to buy at a lower price, this increases our wealth because we now have more money to spend on other things.

This is the reason why restrictions such as tariffs, quotas, and taxes that limit citizens' ability to freely engage in trade with people from other geographical areas destroy wealth. When restrictions are in place, individuals cannot generate as much value and happiness from their limited incomes. Not only are there fewer options for us 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. We can become more prosperous by increasing the amount of wealth created in the state by (1) increasing 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 Wisconsinites 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 Wisconsin.

Entrepreneurship and Discovery

Of the many potential things Wisconsin 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 that it does a good job of chasing this ever-moving target through the continuous process of entrepreneurship and discovery.

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

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

Since there are 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 who has ever lived on earth has done nothing but shuffle cards 24 hours a day for their entire lives, and even assuming (unrealistically) that 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.

Now, returning to the economy, we clearly have more than just three letters and three 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 and more valuable combinations of resources. A vibrant entrepreneurial climate is one that maximizes the number of new combinations attempted. Some will be more valuable than existing combinations and some will not. In a market economy, it is the profit and loss system that sorts 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 with which ideas are labeled 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 for other endeavors. In our deserted island example where half of the castaways were digging holes and the other half were 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 the failed business with a profitable business that creates value, perhaps one 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 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 in the marketplace, there will be a lot of failures. The benefit is that this 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 of them fail than to try only 50 and have 30 of them fail. By trying 100 ideas, we end up with 20 additional new businesses, even though we have more failures.

Noted economist Joseph Schumpeter ([1911] 1934) 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 is entirely new industries that open considerable opportunities for economic advancement. In Schumpeter's view, the entrepreneur is a disruptive force in an economy because the introduction of these new combinations leads to the obsolescence of others, a process he termed "creative destruction."

The introduction of the automobile and the corresponding disappearance of the horse and buggy is just one of many examples of this process. Electricity, aircraft, digital music, and personal computers are others. Each invention significantly improved our quality of life, but in the process, other industries died or shrank considerably. Economists today accept Schumpeter's insight that 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 from 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.[4] This is the "market test" we alluded to earlier. The same is not true of 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 influencing *where* a new business is located in order to maximize political support among voters. But there is no reason to think that the decision that satisfies these concerns corresponds with the most economically advantageous decision.

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, the president, chairman, and founder of Digital Equipment Corporation, was at the forefront of computer technology in 1977 when he 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 at the forefront of 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. Smith actually wrote the business plan for FedEx as his senior project for his strategic management class at Yale. We all know in retrospect that FedEx was a successful business idea, but 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 evaluate business ideas in advance and identify which will succeed and which 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 their fate is decided by the profit and loss system. While some policy makers may think that a particular industry is the future of the state economy, the truth is that Wisconsin's future is yet to be discovered, and when it is discovered, it will likely be something that is not yet invented or currently known. In the end, it is Wisconsin's *citizens* who must discover the future for the state, not the state political process.

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

To promote entrepreneurship, governments often attempt to enact new programs, such as state-run venture capital funds, government-funded or subsidized business incubators, and 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 expand 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 in the resources available within the private sector. One wonders, for example, whether the millions of tax dollars Wisconsin spent on incentives for Mercury Marine, Kohl's Department Stores, Quad/Graphics, and Bucyrus International would have created more jobs and opportunities had this money simply been left in the private sector's hands.[5]

Entrepreneurship is the means by which we discover ways to increase the value created by the state's labor resources, physical resources, 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 faced with strong incentives to pursue the 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 affecting which properties are harvested, the percentage of maple wood sent to sawmills versus put to other uses, the number of non–furniture makers who substitute a different material for maple, and so on. The "signals" sent by these market prices are what enable 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 purposes, 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 to reach and serve the area. When the government provides these services, however, the prices it charges are often not in 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 be. 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 programs (i.e., parental choice programs)—as long as the money follows the consumers' choices—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

Hayek (1967) also 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; others are 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 Wisconsin adds a new dormitory on campus that is 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 can walk to campus. Alternatively, students could be allowed one semester in which they trek 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 would be made. Many of the road systems in the United States are the result of this process, in which trailblazers' paths were used by wagons and eventually the larger ones were paved to become major highways.[6]

The important point 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 preplanned its sidewalks has subsequently had to install benches and holly shrubs to discourage people from 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's and Hayek's reasons why an economy organized as a "ship without a captain" is best, let us now turn to the reasons why having a strong captain in control can prevent prosperity.

Good Intentions Are Not Enough: the Prevalence of Unintended Consequences

As we mentioned in the introduction to this chapter, what often happens is that new policies restricting capitalism are often enacted because they simply seem upon quick consideration to sound like good ideas to elected politicians. 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. Many of the people who are in favor of minimum wage laws support them because they think such laws help low-income families. The published scientific evidence, however, generally rejects this view and instead concludes that minimum wages actually make the intended beneficiaries worse off.[7] So for the same reason—the goal of helping those in need—most economists are opposed to minimum wage legislation. This position can be reached only by examining all 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. Economists care little about the publicly stated intent or goal of a policy. Rather, they evaluate the policy on the basis of 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 on the basis of 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 PhD 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 diminished employment opportunities for disabled Americans by increasing the cost of hiring disabled workers and making it harder to fire them (DeLeire 1997, 2000). Before 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.

The entire purpose of the ADA was to increase employment opportunities for the disabled, but the data simply do not support the view that the law achieved this outcome. 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 provides 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," a designation that imposes

stringent restrictions on surrounding property owners (a loss of "control rights," to use the terminology introduced in chapter 2). When the US Fish and Wildlife Service put Boiling Springs Lakes, North Carolina, on notice that active nests were beginning to form near the town, the news unleashed a frenzy of action on the part of residents, but not of the type you might expect.[8] Foreseeing the potential future restrictions on their property use, landowners swarmed the city hall to apply for lot-clearing permits. After the trees were removed, 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 the red-cockaded woodpecker, 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 Endangered Species Act. The bird has lost a significant portion of its habitat, moving it closer to extinction, because of the unintended consequences of the Endangered Species Act.

Lastly, many jurisdictions have banned plastic grocery bags to protect the environment. However, reusable grocery bags tend to gather harmful bacteria, such as *E. coli*, with repeated use. A study published by the University of Pennsylvania found that emergency-room visits and deaths related to these bacteria have risen by 25 percent in areas that ban plastic bags (Klick and Wright 2012). Once you consider the harmful secondary effects on human health, these regulations are seen to be significantly less beneficial than they might first appear.

As these examples illustrate, even policy designed with 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 over time. In the end, some policies just do not live up to their stated goals, or they do so but at too high of a cost. West Virginia, for example, imposed a maximum eight-hour operating restriction on taxi drivers (see Corey and Curott 2007). The law was intended to reduce driver fatigue and accidents involving taxis. Policy makers, however, overlooked the unintended consequences resulting from changing the incentives cab drivers faced. With fewer hours to drive in a day, cab drivers started driving faster and taking 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 incidents of driving while intoxicated, but it exacerbated the very problem it was designed to reduce: Even though there are *fewer* cabs on the road owing to the law, the total number of accidents committed by cab drivers has *increased* in West Virginia since the regulation was passed. Although this information is widely known, state policy makers in West Virginia are so tied up with more pressing current issues that they simply do not take the time and effort to reconsider and repeal the law. Simply put, government lawmakers just do not have the time to look into the effectiveness of all laws from the past, nor to introduce legislation to repeal them.

This highlights the need for states to review and sunset old regulations. Quite simply, if a regulation adopted in Wisconsin cannot prove, with data, that it is accomplishing its stated goal in a cost-effective manner within some explicit period of time, it should be repealed. Regulations, and other policies, should have to fight to stay in place on the basis of 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 Buchanan and Tullock point out, in government there is no invisible hand.

An example will help to illustrate. Government agencies' budgets are often disbursed as fixed amounts for each fiscal year. At the end of the year any remaining money in the budget is usually taken back, and if money remains, the next year's funding is likely to be reduced because the agency did not need all 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 is very careful and frugal with money at home (and would act the same way in a job for 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.[9] For instance, some might see problems in the current health care system and propose that, because of these failures, we should have a government-run health care system, based on the logic that this ideal government-run system would overcome all the existing 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 methods of provision have their limitations—neither is perfect, and there will be particular problems under either alternative. To help overcome this fallacy, there is one simple reminder, or test, that policy makers and regular citizens alike should remember when they consider new government policies or programs. That is to simply ask yourself 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 quickly diminished to a more realistic viewpoint 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, the Department of Education, or the Department of Social Services.

Only through careful thought about real-world alternatives, by comparing the likely limitations of both the private and the public sectors, can policy makers make good judgments about policy. To be a productive force in an economy, a government must do some things—such as protecting people and their property, enforcing contracts in an unbiased manner, and providing a limited set of "public goods"—but, equally importantly, it must refrain from doing others.

Wealth Creation Vs. Wealth Destruction: Trade and Transfers

When Jeff voluntarily 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—to be another Mary. When businesses think about trying to become more profitable, all too often they think about how to secure more government subsidies, favors, or tax breaks. Instead, their efforts should be devoted to doing a better job producing whatever it is they produce.

Stressing the role of entrepreneurship in an economy, New York University economist William Baumol (1990) notes that entrepreneurial individuals have a choice to devote their labor efforts either toward private-sector wealth creation or toward securing wealth redistribution through the political and legal processes (e.g., lobbying and lawsuits).[10] Their decision is influenced

by the corresponding rates of return—or profit rates—of these alternative activities. Capitalist institutions, or institutions that provide secure property rights, a fair and balanced judicial system, contract enforcement, and effective limits on the government's ability to transfer wealth through taxation and regulation, reduce the profitability of unproductive political and legal entrepreneurship. Under this incentive structure, creative individuals are more likely to engage in the creation of new wealth through productive market entrepreneurship.

In areas with weaker capitalist institutions, like Wisconsin, 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 either by trying to find a better way of producing steel (productive entrepreneurship) or by lobbying for subsidies or tariff protection or filing legal antitrust 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 values the pizza. Government actions that transfer wealth or 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 securing the zero-sum transfer requires an investment of resources in lobbying, its 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 on 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 Wisconsin, the state government's large influence over spending encourages individuals to fight over obtaining state government funds, encouraging a high level of unproductive entrepreneurship. As a result, Wisconsin has less productive private-sector entrepreneurship.

How much unproductive entrepreneurship is there in Wisconsin? While it is hard to derive an exact number, some data can help to illustrate. In 2022, for example, 706 registered lobbyists represented 808 companies and organizations in Wisconsin.[11] In addition, Wisconsin was home to 15,488 resident and active lawyers (American Bar Association 2021). Campaign contributions to candidates running for office in 2019 and 2020 Wisconsin statewide elections, and equivalently spending by these candidates, amounted to over $70.5 million, or $21.38 per vote cast in the election.[12] Policy reform that reduces the profitability of initiating lawsuits and lobbying the government can create more wealth and

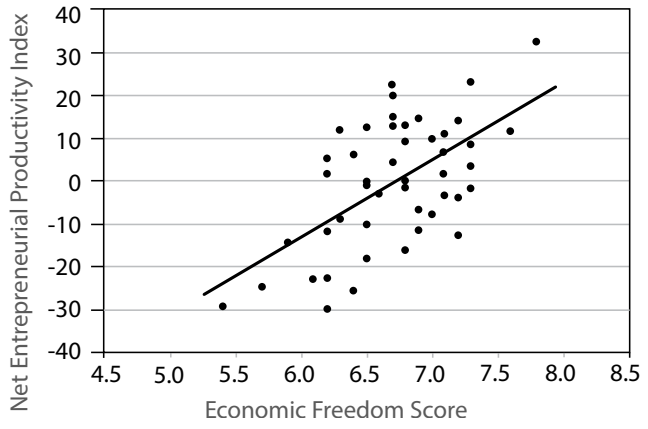
prosperity as entrepreneurial efforts are rechanneled into productive uses.

Studies that examine the relationship between measures of productive private-sector entrepreneurial activity and a state's economic freedom index (measuring institutional quality) have found highly significant results (see, e.g., Sobel 2008). Greater 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 shown in table 2.1. 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, Wisconsin ranks 36th. 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. While Wisconsin had only the 25th highest rate of productive entrepreneurship among the states, it had the 7th highest rate of unproductive entrepreneurial activity. Simply put, in Wisconsin being an unproductive entrepreneur is easier and more profitable than being a productive one. 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.

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 policy reforms specifically for Wisconsin, the following general list of state policy reforms (based on Sobel 2008) provides ideas about how to increase net entrepreneurial productivity, thereby generating wealth:

Figure 3.1 **Institutional Quality and Entrepreneurial Productivity**



Source: Sobel (2008).

- 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, and privatized government services (ambulance, water, garbage, etc.).

Conclusion

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

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

Despite the overwhelming evidence in favor of increased reliance on capitalism, Wisconsin has been reluctant to embrace this ideal in policy. This might be surprising when viewed from the outside, because Wisconsin is a state that has had a few recent Republican governors 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 (see Sobel and Leeson 2007).

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 Wisconsin's state policies consistent with economic freedom, growth, and prosperity.

Notes

[1] We also suggest the equally easy-to-read classic Free to Choose (1980), 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); and Sobel and Bolen (2018).

[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 under consideration or to privately regulate the relevant activity. 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.

[4] It is important to recognize that, from society's perspective, the profits earned by entrepreneurs represent gains to society as a whole. Because entrepreneurs must bid resources away from alternative uses, production costs reflect the value of those resources to society in their alternative uses. Thus, profit is earned only 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 the 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 reflects the opportunity cost of these resources' employment in other uses, the $10 profit generated by this entrepreneur reflects the amount by which the entrepreneur has increased the value of these resources. By increasing the value created by our limited resources, entrepreneurs increase overall wealth in a society.

[5] It is estimated that Wisconsin spends at least $1.53 billion per year on tax incentive programs. For a list, see Wisconsin's page in the New York Times' United States of Subsidies series, http://www.nytimes.com/interactive/2012/12/01/us/government-incentives.html#WI.

[6] A more in-depth illustration of this idea can be found in the famous I, Pencil essay by Leonard Read (1958), available at the Foundation for Economic Education's website, https://fee.org/resources/i-pencil/.

[7] For evidence, see some of the studies compiled and reviewed by the National Bureau of Economic Research, available in Neumark and Shirley (2022).

[8] Associated Press, "Rare Woodpecker Sends a Town Running for Its Chain Saws," *New York Times*, September 24, 2006.

[9] For a more detailed discussion and original sources, see Wikipedia, s.v. "Nirvana fallacy," http://en.wikipedia.org/wiki/Nirvana_fallacy.

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

[11] Wisconsin Ethics Commission website, accessed November 14, 2022, https://lobbying.wi.gov/Home/Welcome.

[12] Data for federal offices ($27.3 million) are from OpenSecrets, accessed November 8, 2022, www.opensecrets.org; data for state offices ($43.2 million) are from FollowTheMoney.org, accessed November 8, 2022, www.followthemoney.org. Voter turnout data (3,297,524 votes were cast in the 2020 general election) are from the Wisconsin Elections Commission, "November 3, 2020 Election Data Report," February 3, 2021, https://www.wispolitics.com/wp-content/uploads/2021/01/D.-November-2020-Election-Data-Report-Updated.pdf.

References

American Bar Association. 2021. *Profile of the Legal Profession*, 2021. Chicago: American Bar Association, July 2021. https://www.americanbar.org/content/dam/aba/administrative/news/2021/0721/polp.pdf.

Baumol, William J. 1990. "Entrepreneurship: Productive, Unproductive and Destructive." *Journal of Political Economy* 98 (5): 893–921.

Buchanan, James M., and Gordon Tullock. 1962. *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.

Corey, Joab N., and Nicholas A. Curott. 2007. "Lower Business Regulation: Costs and Unintended Consequences." In *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It*, edited by Russell S. Sobel, 131–43. Morgantown, WV: Center for Economic Growth, Public Policy Foundation of West Virginia.

DeLeire, Thomas. 1997. "The Wage and Employment Effects of the Americans with Disabilities Act." PhD diss., Stanford University.

———. 2000. "The Unintended Consequences of the Americans with Disabilities Act." *Regulation* 23 (1): 21–24.

Friedman, Milton, and Rose Friedman. 1980. *Free to Choose: A Personal Statement*. New York: Harcourt Brace Jovanovich.

Gwartney, James, Richard L. Stroup, Dwight R. Lee, Tawni H. Ferrarini, and Joseph P. Calhoun. 2016. Common Sense Economics: *What Everyone Should Know about Wealth and Prosperity*. New York: St. Martin's Press.

Hayek, F. A. 1945. "The Use of Knowledge in Society." *American Economic Review* 35 (4): 519–30.

———. 1967. *Studies in Philosophy, Politics, and Economics*. Chicago: University of Chicago Press.

Klick, Jonathan, and Joshua D. Wright. 2012. "Grocery Bag Bans and Foodborne Illness." Research Paper No. 13-2, University of Pennsylvania Law School, Institute for Law & Economics. https://ssrn.com/abstract=2196481.

Neumark, David, and Peter Shirley. 2022. "Myth or Measurement: What Does the New Minimum Wage Research Say about Minimum Wages and Job Loss in the United States?" Working Paper 28388, National Bureau of Economic Research, Cambridge, MA, revised March 2022. https://www.nber.org/papers/w28388

Read, Leonard E. 1958. *I, Pencil: My Family Tree as Told to Leonard E. Read*. Irvington-on-Hudson, NY: Foundation for Economic Education.

Schumpeter, Joseph A. (1911) 1934. *The Theory of Economic Development*. Cambridge, MA: Harvard University Press.

Smith, Adam. (1776) 1998. *An Inquiry into the Nature and Causes of the Wealth of Nations*. Washington, DC: Regnery.

Sobel, Russell S. 2008. "Testing Baumol: Institutional Quality and the Productivity of Entrepreneurship." *Journal of Business Venturing* 23 (6): 641–55.

Sobel, Russell S., and J. Brandon Bolen. 2018. "Why Capitalism Works." In *Promoting Prosperity in Mississippi*, edited by Brandon N. Cline, Russell S. Sobel, and Claudia R. Williamson, 35–51. Mississippi

State: Mississippi State University Institute for Market Studies.

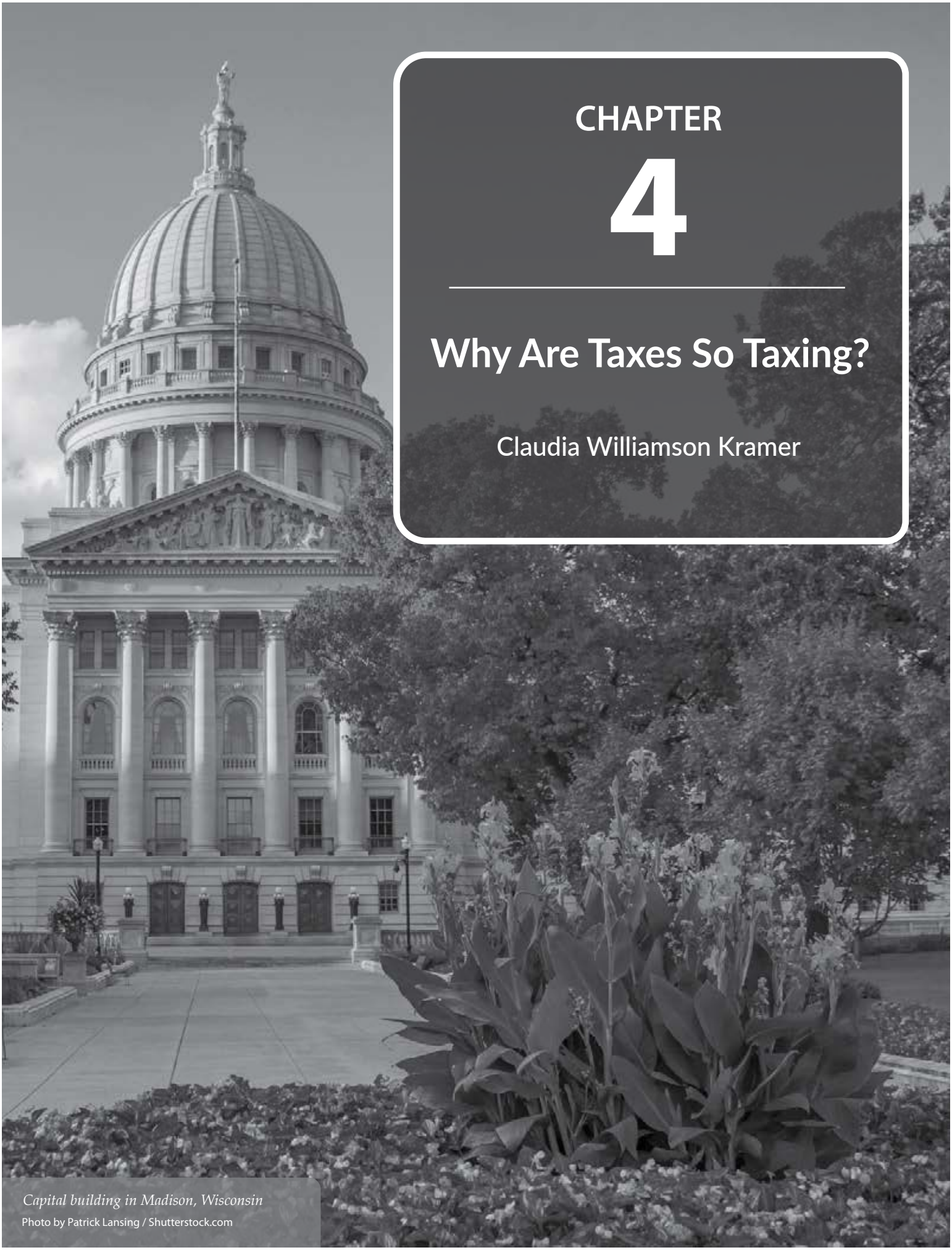
Sobel, Russell S., J. R. Clark, and Peter T. Leeson. 2012. "Why Capitalism Works." *In Freedom and Prosperity in Tennessee*, edited by J. R. Clark, 47–68. Chattanooga, TN: Scott L. Probasco Jr. Chair of Free Enterprise.

Sobel, Russell S., and Peter T. Leeson. 2007. "Why Capitalism Works." In *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It*, edited by Russell S. Sobel, 37–54. Morgantown, WV: Center for Economic Growth, Public Policy Foundation of West Virginia.

———. 2009. "Why Capitalism Works." In *Unleashing Capitalism: A Prescription for Economic Prosperity in South Carolina*, edited by Peter T. Calcagno, 49–70. Columbia, SC: South Carolina Policy Council.

Tollison, Robert D. 1982. "Rent Seeking: A Survey." *Kyklos* 35 (4): 575–602.

Tullock, Gordon. 1967. "The Welfare Cost of Tariffs, Monopolies, and Theft." *Western Economic Journal* 5 (3): 224–32.



CHAPTER

4

Why Are Taxes So Taxing?

Claudia Williamson Kramer

Capital building in Madison, Wisconsin
Photo by Patrick Lansing / Shutterstock.com

4 Why Are Taxes So Taxing?

High taxes are tremendously costly to a state's economy. Countless studies find that higher taxes significantly lower economic growth and reduce standards of living. This is partly due to the fact that the burden of taxes on an economy goes beyond the dollar amount of taxes collected. Indeed, taxes cost an economy much more than the revenue they generate. These additional costs come in many forms, including enforcement costs, administrative costs, compliance costs, and market inefficiencies. Often overlooked are the resource costs associated with trying to avoid taxes. Individuals, groups, and businesses spend time, effort, and dollars trying to minimize or avoid paying taxes. The costs start before a tax is implemented (lobbying) and continue after it is in place (avoidance).

This chapter explains the true costs of taxation, reviews the empirical literature on taxation and growth, and examines Wisconsin's overall tax burden relative to those of other states.[1]

Why Taxes Are So Costly

When a tax is levied on one specific group of individuals, such as consumers, this does not mean that they will bear the actual burden of the tax. In economics, this concept is known as *tax shifting*. A tax imposed on businesses, for example, can lead to higher prices for consumers. These higher prices will make consumers bear more of the burden of the tax, even though the tax is collected through businesses. Similarly, a tax imposed directly on consumers of a specific product will reduce demand for that product, shifting some of the tax burden back onto the businesses that produce the taxed product.[2]

We often say that "businesses" or "groups" pay taxes, but one thing is definite: all tax burdens fall on *individuals*. Only individuals bear tax burdens because all groups or entities, including businesses, are made up of individuals. A "business" does not bear the tax burden; instead, the burden falls across the owners, suppliers, employees, and customers of the taxed businesses.

Table 4.1 Wisconsin 2018–2019 Tax Revenue by Source

	State		Local		Total	
Tax Revenue	$20,039,033,000		$10,604,049,000		$30,643,082,000	
Property	$99,934,000	0.50%	$10,604,049,000	91.58%	$9,810,748,000	32.02%
Sales and gross receipts	$8,446,278,000	42.15%	$599,018,000	5.65%	$9,045,296,000	29.52%
General sales	$5,695,550,000	28.42%	$465,241,000	4.39%	$6,160,791,000	20.10%
Selective sales	$2,750,728,000	13.73%	$133,777,000	1.26%	$2,884,505,000	9.41%
Motor fuel	$1,065,158,000	5.32%	n/a	0.00%	$1,065,158,000	3.48%
Alcoholic beverage	$62,124,000	0.31%	n/a	0.00%	$62,124,000	0.20%
Tobacco products	$599,794,000	2.99%	n/a	0.00%	$599,794,000	1.96%
Public utilities	$363,507,000	1.81%	n/a	0.00%	$363,507,000	1.19%
Other	$660,145,000	3.29%	$133,777,000	1.26%	$793,922,000	2.59%
Individual income	$8,759,680,000	43.71%	n/a	0.00%	$8,759,680,000	28.59%
Corporate income	$1,364,796,000	6.81%	n/a	0.00%	$1,364,796,000	4.45%
Motor vehicle license	$525,370,000	2.62%	$33,304,000	0.31%	$558,674,000	1.82%
Other taxes	$842,975,000	4.21%	$260,913,000	2.46%	$1,103,888,000	3.60%

Sources: US Census Bureau (2019).

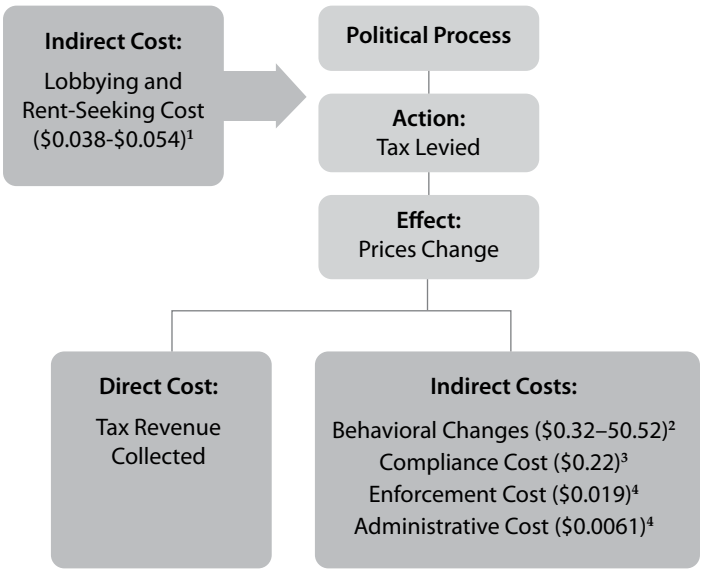
In 2018–2019 fiscal year, state and local governments around the country collected over $1.85 trillion in combined tax revenue.[3] Table 4.1 illustrates that Wisconsin's combined state and local government tax revenue amounted to more than $30.6 billion, $20.0 billion of which was levied at the state level. Almost 44 percent of the state tax revenue was generated from the individual income tax, 42 percent from the sales tax, and almost 7 percent from corporate income tax. Local governments' main revenue source was property taxes (92 percent). Combined, state and local tax revenue was 32 percent property tax, 30 percent sales tax, 29 percent individual income tax, and 4 percent corporate income tax.

Although these revenue numbers are large, they exclude the many distortions in economic activity and individual behavior that occur because of taxes. Figure 4.1 highlights these additional costs. The direct cost of taxation is the observable accounting cost—individuals who pay a tax have less money to spend elsewhere. The actual tax revenue collected measures only this reduction in private economic spending. There are, however, other significant indirect costs.

The first hidden cost stems from the political process. The indirect costs of lobbying and rent-seeking (expending resources to capture "rent", i.e., economic wealth or privilege) reflect the resources devoted by individuals attempting to alter tax policy in their favor. Individuals and special interest groups use the political process to fight against the imposition of new taxes, to resist increases in tax rates, and to reduce or repeal specific taxes. They spend substantial time and money in the process.

To help illustrate this point, let's suppose that the legislature is considering a new tax on unhealthy fast food. McDonald's calculates that this new tax will cost the company $2 million. Clearly, it makes sense that McDonald's would be willing to spend up to $2 million to fight this tax. To do so, McDonald's might hire lobbyists, make campaign contributions, attract media attention, or fight the legality of the tax in court. Even if the tax is imposed, McDonald's will find it beneficial to continue to devote resources toward repealing the tax, reducing it, or securing an exemption. Resources spent in this manner are wasteful from wealth creating perspective. As discussed in chapter 3, resources used for lobbying are resources that are taken

Figure 4.1 **The Cost of Taxation**



Sources:

[1] Author calculations from estimates of state capital rent-seeking in Sobel and Garrett (2002).
[2] Feldstein's (1999) estimate of the excess burden from the federal income tax.
[3] Moody, Warcholik, and Hodge (2005).
[4] Payne (1993).

Note: Amounts in parentheses are costs per dollar of tax revenue. The data are based on studies of federal tax revenue, except in the case of rent-seeking, the amount for which is based on the average for all state governments.

away from productive activities such as investing in new capital, hiring additional workers, and providing on-the-job training. Using the terminology from chapter 3, this is "unproductive entrepreneurship." It is critical to realize that these hidden costs are present even if the tax is ultimately not imposed. Merely the threat of imposing new taxes creates these indirect costs.

To see the magnitude of tax policy lobbying, one need only peruse the Wisconsin Department of Revenue's website, which is littered with numerous exemptions to specific taxes.[4] Using Sobel and Garrett's (2002) estimated state-level costs of rent-seeking—between 3.8 and 5.4 percent of tax revenue—we can approximate the indirect costs of lobbying. In the 2018–2019 period alone, Wisconsin incurred indirect costs of $1.16 to $1.65 billion in wasted resources devoted to altering policy. To reduce such costs, many economists advocate using broad-based *uniform* taxes instead of making rates and exemptions vary across individuals, businesses, and markets (Holcombe 2001). With uniform taxes, one particular group or industry is unable to reduce its individual tax bill; hence, groups and industries are less likely to expend resources lobbying for tax policy changes. In contrast, a tax that explicitly targets one industry, such as Wisconsin's $0.126 per cigarette tax or the vape tax[5] of $0.05 per milliliter,[6] promotes larger indirect rent-seeking costs.

Moreover, unlike with private markets in which you must pay for a good or service to receive benefit from it, with government it is possible to receive benefits from government programs while making *others* pay for them. As a result, there will be additional lobbying costs associated with fighting over which programs will be funded from government expenditures. For example, the semiconductor manufacturer Foxconn successfully lobbied state lawmakers for $2.8 billion in incentives to locate in Racine County. In order to secure this funding, Foxconn had to compete with other groups that also wanted to receive government funding. The mere existence of the opportunity to rent-seek and alter tax codes pushes government resources to those with the most political power, not to those in need. Thus, the political process results in government-funded programs that are not always welfare-enhancing or well-targeted to help those in need (Holcombe 2001).

So far, I have covered the direct costs of taxation and the indirect lobbying costs associated with the political process. Unfortunately, I am not done. The tax itself creates other indirect costs, as shown in figure 4.1. These include behavioral changes, compliance costs, enforcement costs, and administrative costs.

First, behavioral changes are the distortions created when producers and consumers respond to the tax. Economists refer to these costs as "deadweight loss" or the "excess burden" of taxation—a strange way of saying that taxes cause markets to be inefficient. When an activity is taxed, individuals will tend to forgo the taxed activity and substitute other activities that are now relatively cheaper. The resulting inefficiencies can be quite significant, ranging from 32 to 52 percent of tax revenue.[7]

For example, let's assume that Wisconsin imposes a new $100 tax on each candy bar sold in the state, and this results in candy bar sales falling to zero. No tax revenue is collected, but this tax is clearly costly to the state. The producers of candy bars and the consumers who like eating them are now worse off. This tax creates a wedge between producers and consumers who otherwise would be selling and buying candy bars at a price satisfactory to both sides. When these transactions do not take place because of higher prices due to taxes, there is an economic loss to society. The forgone transactions result in unseen market inefficiencies.

Candy bar fanatics may find ways around the tax. Instead of forgoing the purchase of candy bars, these fanatics may change where they make their purchases or even where they live. Wisconsinites living on the Minnesota border will simply drive across the state line to purchase candy bars; real Snickers addicts may move to another state. These reactions to taxes must be included in the costs of taxation. The easier

it is for consumers to buy substitute goods, move, or shop in other states, the larger these indirect costs will be.

Businesses also have an incentive to change their behavior because of taxes. When a tax reduces the profitability of one particular use of a business's resources, this means that other uses have become *more profitable by comparison*. The business will react accordingly, producing in areas that are not subject to the tax. In the candy bar example, Wisconsin candy makers will shift from making candy bars to making other tasty treats such as fudge, pralines, or caramels. This shift, however, will further increase the behavioral costs of taxation. Like consumers, firms can also move to other states that impose lower taxes. Again, the easier it is for businesses to alter their behavior in response to a tax, the larger indirect costs will be.

The final indirect costs are the compliance, enforcement, and administrative costs. Taxes must be administered and enforced by a taxing authority, and this results in additional costs. Ironically, these are typically the least expensive indirect costs, absorbing approximately 3 percent of tax revenue (Payne 1993). Compliance costs, including time spent bookkeeping, filling out tax forms, hiring accountants to deal with changes in tax laws, and more, are considerably higher—about 22 percent of tax revenue (Moody et al. 2005).

Collectively, these indirect costs add up to $0.60 to $0.82 for every $1.00 of tax revenue collected. In other words, one tax dollar costs the Wisconsin economy between $1.60 and $1.82. These estimates have significant implications when policy makers weigh the costs and benefits of undertaking government-funded projects. For example, a project with estimated benefits of $150 million that requires $125 million in taxes may appear to be a worthy undertaking. Once the additional indirect taxation costs are taken into consideration, however, it becomes clear that this project is not an efficient investment.

The true cost to the Wisconsin economy of collecting $30.6 billion in taxes is an additional $18.4 to $25.1 billion.

Wisconsin's Tax Burden in Context

In 2019, Wisconsin's total tax bill averaged about $5,261 per person. This was slightly below the average across all states, which was approximately $5,665 per person. Wisconsin's per capita tax bill is $1,474 lower than Minnesota's, $1,021 lower than Illinois's, and $125 lower than Iowa's. However, Wisconsin's per capita taxes are higher than those of Michigan ($4,463).[8]

This is not the best measure of Wisconsin's tax burden, however, because some states are wealthier than others. Instead of measuring tax rates or taxes per person, a more appropriate measure of the tax burden is tax revenue as a percentage of state personal income. Individuals and businesses may pay a lower tax dollar amount in Wisconsin, but they also receive less income. In order to take this into account, we calculate taxes as a share of personal income.

According to the Tax Policy Center, Wisconsin's total tax burden ranks 27th compared to other states'. Wisconsin's total tax burden is comparable to that of the average state, but its tax burden is lower than those of three out of four surrounding states: Minnesota, Illinois, and Iowa. Only Michigan has a lower tax burden.[9]

Table 4.2 shows Wisconsin's taxes as a share of personal income relative to the overall US average. The first set of columns shows state taxes only, while the second set shows state and local taxes combined. A positive number in the difference column indicates that Wisconsin's taxes are higher than the US average.

According to this measure, Wisconsin's state tax burden is 6.47 percent of income—a difference of 0.63 percentage points, which is higher than the US average. This is a sizeable difference. Wisconsin's state taxes are more than 10 percent higher than those of the average state. As for tax revenue sources, only five fall below the US average: state property taxes, selective sales taxes, alcoholic beverage taxes, other sales taxes, and other taxes. The corporate income tax, important for economic growth, is higher in Wisconsin than the US average.

When local taxes are included, the results change quite a bit. Wisconsin's total tax

Table 4.2	Taxes as a Percentage of Personal Income: Wisconsin vs. the US Average, 2019					
	State Only			State and Local		
	WI	US Avg.	Difference	WI	US Avg.	Difference
Tax Revenue	6.47%	5.83%	0.63%	9.89%	10.03%	-0.14%
Property	0.03%	0.10%	-0.07%	3.17%	3.11%	0.05%
Sales and gross receipts	2.73%	2.71%	0.01%	2.92%	3.45%	-0.54%
General sales	1.84%	1.80%	0.04%	1.99%	2.34%	-0.35%
Selective sales	0.89%	0.91%	-0.02%	0.93%	1.11%	-0.18%
Motor fuel	0.34%	0.27%	0.07%	0.34%	0.28%	0.06%
Alcoholic beverage	0.02%	0.04%	-0.02%	0.02%	0.04%	-0.02%
Tobacco products	0.19%	0.10%	0.09%	0.19%	0.10%	0.09%
Public utilities	0.12%	0.06%	0.05%	0.12%	0.15%	-0.03%
Other	0.21%	0.44%	-0.22%	0.26%	0.54%	-0.28%
Individual income	2.83%	2.21%	0.61%	2.83%	2.41%	0.41%
Corporate income	0.44%	0.31%	0.13%	0.44%	0.35%	0.09%
Motor vehicle license	0.17%	0.15%	0.02%	0.18%	0.16%	0.02%
Other taxes	0.27%	0.35%	-0.07%	0.36%	0.53%	-0.17%
Sources: US Census Bureau (2019); Bureau of Economic Analysis (2019).						

burden is 9.89 percent of income, which is 0.14 percentage points lower than the US average. This reduction in the difference results from Wisconsin's relatively low sales tax. Many other states impose local sales taxes at higher rates than Wisconsin does. Individual income and corporate income total tax burdens remain higher compared to those of other states.

Run For The Border

Earlier I described how, the more the behavioral costs of taxation increase, the easier it becomes for individuals and businesses to avoid the tax. According to the US Census, 18.6 percent of Wisconsin's population lives in counties bordering other states.

Wisconsin is a medium-size state (65,498 square miles) and it borders four other states. Madison, the state's capital and second-largest urban center, is located west of Milwaukee, the largest metropolitan area in the state. From the Madison area, where over 15 percent of the population lives, one can get to Illinois in under an hour's drive (about 60 miles), to Iowa in about two hours (about 110 miles), or to Minnesota in a little more than two hours (about 140 miles). In addition, the 35 percent of the state's population that resides in the Milwaukee–Racine–Waukesha combined statistical area (CSA) can cross the border into Illinois in less than 40 minutes (about 40 miles). Furthermore, three of Wisconsin's CSAs cross into other states: Chicago–Naperville, Minneapolis–St. Paul, and Marinette–Iron Mountain.[10] This implies that the indirect costs of taxation can be quite large in Wisconsin, since the majority of the state's consumers, producers, and workers can easily cross the border to escape higher taxes.

We have seen that Wisconsin's total tax burden is similar to that of the average state, but let's examine more closely how Wisconsin compares to its neighboring states. Table 4.3 lists taxes as a percentage of personal income for Wisconsin, Illinois, Iowa, Michigan, and Minnesota.

When only state taxes are included in the comparison, Wisconsin's tax burden is higher than those of two of its four neighboring states: Illinois and Michigan. Iowa has the same tax burden, and Minnesota has a dramatically higher tax burden, over 2 percentage points higher than Wisconsin's. When both state and local taxes are included, Wisconsin's tax burden is lower than those of all surrounding states except Michigan. On average, Wisconsin's tax burden is 0.51 percentage points lower than those of neighboring states.

Table 4.4 summarizes individual income, corporate income, and sales tax rates, comparing Wisconsin and surrounding states. Wisconsin does not have a strict tax advantage in individual income tax rates or corporate tax rates. Wisconsin's top marginal income tax rate is lower than those of Minnesota and Iowa; however, both Illinois and Michigan have lower flat income tax rates.

Wisconsin has the lowest sales tax compared to its neighbors, even considering local sales tax options. This suggests that Wisconsin is more competitive in sales tax rates, implying that residents in bordering states, particularly Illinois, have an incentive to shop in Wisconsin.[11]

Wisconsin has a lower flat corporate income tax rate (7.9 percent) than two neighboring states, Minnesota and Illinois. Wisconsin's corporate income tax rate is higher than Michigan's flat rate of 6 percent. Iowa starts taxing corporate income at a lower rate than Wisconsin (5.5 percent compared to 7.9 percent), but Iowa has a higher top marginal rate of 9.8 percent. Looking only at corporate income tax rates can give the impression that Wisconsin does not tax businesses too heavily; however, as shown in the next chapter, Wisconsin uses additional business taxes that are costly to the state's economy.

Table 4.3 Taxes as a Percentage of Personal Income: Wisconsin vs. Neighboring States, 2019

	State Only		State and Local	
	Tax Burden % of Income	Difference from WI	Tax Burden % of Income	Difference from WI
Illinois	5.71%	-0.76%	10.69%	0.80%
Iowa	6.47%	0.00%	10.40%	0.51%
Michigan	6.16%	-0.31%	9.07%	-0.82%
Minnesota	8.49%	2.03%	11.45%	1.56%
Wisconsin	6.47%		9.89%	
Average	0.24%		0.51%	

Sources: US Census Bureau (2019); Bureau of Economic Analysis (2019).

Taxation and Economic Growth: the Empirical Evidence

A considerable amount of economic research has been devoted to understanding the association between taxes and economic growth. In general, these studies conclude that while some level of government can support capitalism and, in the process, generate growth and prosperity,

Table 4.4 Comparison of 2022 State Tax Rates

	Individual Income		Corporate Income		Sales	
	Tax Rates	Brackets	Tax Rates	Brackets	Tax Rate	Food Exempt
Illinois	4.95	1	9.50	1	6.25	no; 1.0 rate
Iowa	0.33 to 8.53	9	5.50 to 9.80	3	6.0	yes
Michigan	4.25	1	6.00	1	6.0	yes
Minnesota	5.35 to 9.85	4	9.80	1	6.875	yes
Wisconsin	3.54 to 7.65	4	7.90-	1	5.0	yes

Sources: "Tax Rates/Surveys Tax Rates," Federation of Tax Administrators, accessed November 7, 2022, https://www.taxadmin.org/current-tax-rates.

governments almost always expand well beyond the optimal level (Higgs 1987). This expansion in government increases the tax burden on citizens. Even worse, it gets in the way of human flourishing.

Focusing on taxes specifically, a large literature shows a strong negative association between taxes and economic growth. Mullen and Williams (1994) find that higher marginal income tax rates hurt economic growth. Helms (1985) finds that taxation to fund transfer payments significantly retards economic growth. Bartik (1992) concludes that state and local taxes have a consistently negative effect on state and city economic growth.

A study by Holcombe and Lacombe (2004) provides strong evidence of the cross-border effect of taxes. Through a comparison of counties sharing a state border, the authors control for geographic similarities such as climate, workforce, and proximity to markets, thus leaving only differences in state policy. Not surprisingly, Holcombe and Lacombe find that states that raised their income tax rates faster than their neighbors did had slower economic growth, leading to an average decline in per capita income of 3.4 percent.

Becsi (1996) examines how state and local taxes affect state economic growth. He finds a significant negative relationship between state marginal tax rates and state growth from 1961 to 1992. More recently, Poulson and Kaplan (2008) find that higher marginal tax rates have a negative impact on economic growth and that states that rely more on an income tax instead of alternative taxes to generate revenue experience lower growth.

Plaut and Pluta (1983) find that high taxes have a negative effect on employment. Interestingly, they find a positive relationship between property taxes and industrial growth. They hypothesize that firms prefer locally dominated tax systems to state-dominated tax systems (like Wisconsin's) because the benefits related to the high local property taxes are likely to accrue locally.[12] Conversely, firms may avoid states where most taxes are levied at the state level, since the link between taxes paid and benefits received (from the firm's perspective) is less direct. (The link between business taxes and location decisions is explored in chapter 5.)

Taxes not only affect where businesses locate, they also affect where people locate. If taxes are too high relative to the benefits received from government spending, people will move. Cebula (1974) finds that migrants tend to move to areas with low property tax levels. Conway, Smith, and Houtenville (2001) look at migration by elderly Americans and find that elderly migration is motivated by low personal income taxes and estate taxes. Cebula (2009) has updated his earlier work to examine the 2000–2005 period. He finds similar results: namely, that individuals during this period "voted with their feet" and were more likely to move to areas with lower tax burdens.

Conclusion

The purpose of this chapter is to explain the true burden of taxation on the Wisconsin economy and to explore how Wisconsin's taxes compare to those of its neighbors and the United States as a whole. According to reliable estimates, each dollar of tax revenue costs the Wisconsin economy somewhere between $1.60 and $1.82. In addition, several measures of tax burden indicate that Wisconsin places itself at a competitive disadvantage relative to other states in attracting businesses and households.

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

Notes

[1] This chapter is based on Ross and Hall (2007); Ross, Hall, and Calcagno (2009); Hall and Hoffer (2012); and Cline and Williamson (2018).

[2] For additional information on where the actual burdens of different taxes fall, see Pechman (1985) and Fullerton and Rogers (1993).

[3] US Census Bureau, "Annual Survey of State and Local Government Finances," last modified September 21, 2022, https://www.census.gov/programs-surveys/gov-finances.html.

[4] See the State of Wisconsin Department of Revenue home page, https://www.revenue.wi.gov/Pages/home.aspx; and "Tax Incentives for Business," State of Wisconsin Department of Revenue, https://www.revenue.wi.gov/Pages/Businesses/Incentives.aspx.

[5] "Cigarette Tax," State of Wisconsin Department of Revenue, November 4, 2022, https://www.revenue.wi.gov/Pages/FAQS/ise-cigar.aspx#cig4.

[6] "Vapor Products Tax," State of Wisconsin Department of Revenue, December 21, 2021, https://www.revenue.wi.gov/Pages/FAQS/ise-vape.aspx.

[7] Behavioral costs are estimated to range from $0.32 to $0.52 on the basis of Feldstein's (1999) estimate of the excess burden from the federal income tax

[8] "State and Local Tax Revenue, Per Capita," Tax Policy Center, August 25, 2022, http://www.taxpolicycenter.org/statistics/state-and-local-tax-revenue-capita.

[9] "State and Local Tax Revenue as a Percentage of Personal Income," Tax Policy Center, August 25, 2022, http://www.taxpolicycenter.org/statistics/state-and-local-tax-revenue-percentage-personal-income.

[10] "Wisconsin—Core Based Statistical Areas (CBSAs) and Counties," US Department of Commerce Economics and Statistics Administration, US Census Bureau, accessed November 8, 2022, https://www2.census.gov/geo/maps/metroarea/stcbsa_pg/Feb2013/cbsa2013_WI.pdf.

[11] Janelle Fritts, "State and Local Sales Tax Rates, Midyear 2022," Tax Foundation, July 19, 2022, https://taxfoundation.org/publications/state-and-local-sales-tax-rates/.

[12] As shown in table 4.1, over 65 percent of Wisconsin's total tax revenue is generated at the state level. This is significantly higher than the US average of 58 percent, indicating that Wisconsin is at a competitive disadvantage.

References

Bartik, Timothy J. 1992. "The Effects of State and Local Taxes on Economic Development: A Review of Recent Research." *Economic Development Quarterly* 6 (1): 102–11.

Becsi, Zsolt. 1996. "Do State and Local Taxes Affect Relative State Growth?" *Economic Review* 81 (2): 18–36.

Bureau of Economic Analysis. 2019. *Gross Domestic Product by State and Personal Income by State*. Washington, DC: Bureau of Economic Analysis. https://www.bea.gov/data/gdp/gdp-state.

Cebula, Richard J. 1974. "Local Government Policies and Migration: An Analysis for SMSAs in the United States, 1965–1970." *Public Choice* 19 (l): 85–93.

———. 2009. "Migration and the Tiebout-Tullock Hypothesis Revisited." American Journal of Economics and Sociology 68 (2): 541–51.

Cline, Brandon N., and Claudia R. Williamson. 2018. "Why Are Taxes So Taxing?" In *Promoting Prosperity in Mississippi*, edited by Brandon N. Cline, Russell S. Sobel, and Claudia R. Williamson, 57–65. Starkville, MS: Institute for Market Studies.

Conway, Karen Smith, and Andrew J. Houtenville. 2001. "Elderly Migration and State Fiscal Policy: Evidence from the 1990 Census Migration Flows." *National Tax Journal* 54 (1): 103–23.

Feldstein, Martin. 1999. "Tax Avoidance and the Deadweight Loss of the Income Tax." *Review of Economics and Statistics* 81 (4): 674–80.

Fullerton, Don, and Diane Lim Rogers. 1993. *Who Bears the Lifetime Tax Burden?* Washington: Brookings Institution.

Hall, Joshua C., and Adam J. Hoffer. 2012. "When It Comes to Taxes in Tennessee: Focus on Competitive Advantage." In *Freedom and Prosperity in Tennessee*, edited by J. R. Clark, 69–86. Chattanooga, TN: Scott L. Probasco Jr. Chair of Free Enterprise.

Helms, L. Jay. 1985. "The Effect of State and Local Taxes on Economic Growth: A Time Series–Cross Section Approach." *Review of Economics and Statistics* 67 (4): 574–82.

Higgs, Robert. 1987. *Crisis and Leviathan: Critical Episodes in the Growth of American Government*. New York: Oxford University Press.

Holcombe, Randall G. 2001. "Public Choice and Public Finance." In *The Elgar Companion to Public Choice*, edited by William F. Shughart II and Laura Razzolini, 396–421. Cheltenham, UK: Edward Elgar.

Holcombe, Randall G., and Donald J. Lacombe. 2004. "The Effect of State Income Taxation on Per Capita Income Growth." *Public Finance Review* 32 (3): 292–312.

Moody, J. Scott, Wendy P. Warcholik, and Scott A. Hodge. 2005. "The Rising Cost of Complying with the Federal Income Tax." Special Report SSP No. 138, Tax Foundation, Washington, DC.

Mullen, John K., and Martin Williams. 1994. "Marginal Tax Rates and State Economic Growth." *Regional Science and Urban Economics* 24 (6): 687–705.

Payne, James L. 1993. *Costly Returns: The Burdens of the U.S. Tax System*. San Francisco: ICS.

Pechman, Joseph A. 1985. *Who Paid the Taxes: 1966–1985?* Washington, DC: Brookings Institution.

Plaut, Thomas R., and Joseph E. Pluta. 1983. "Business Climate, Taxes and Expenditures, and State Industrial Growth in the United States." *Southern Economic Journal* 50 (1): 99–119.

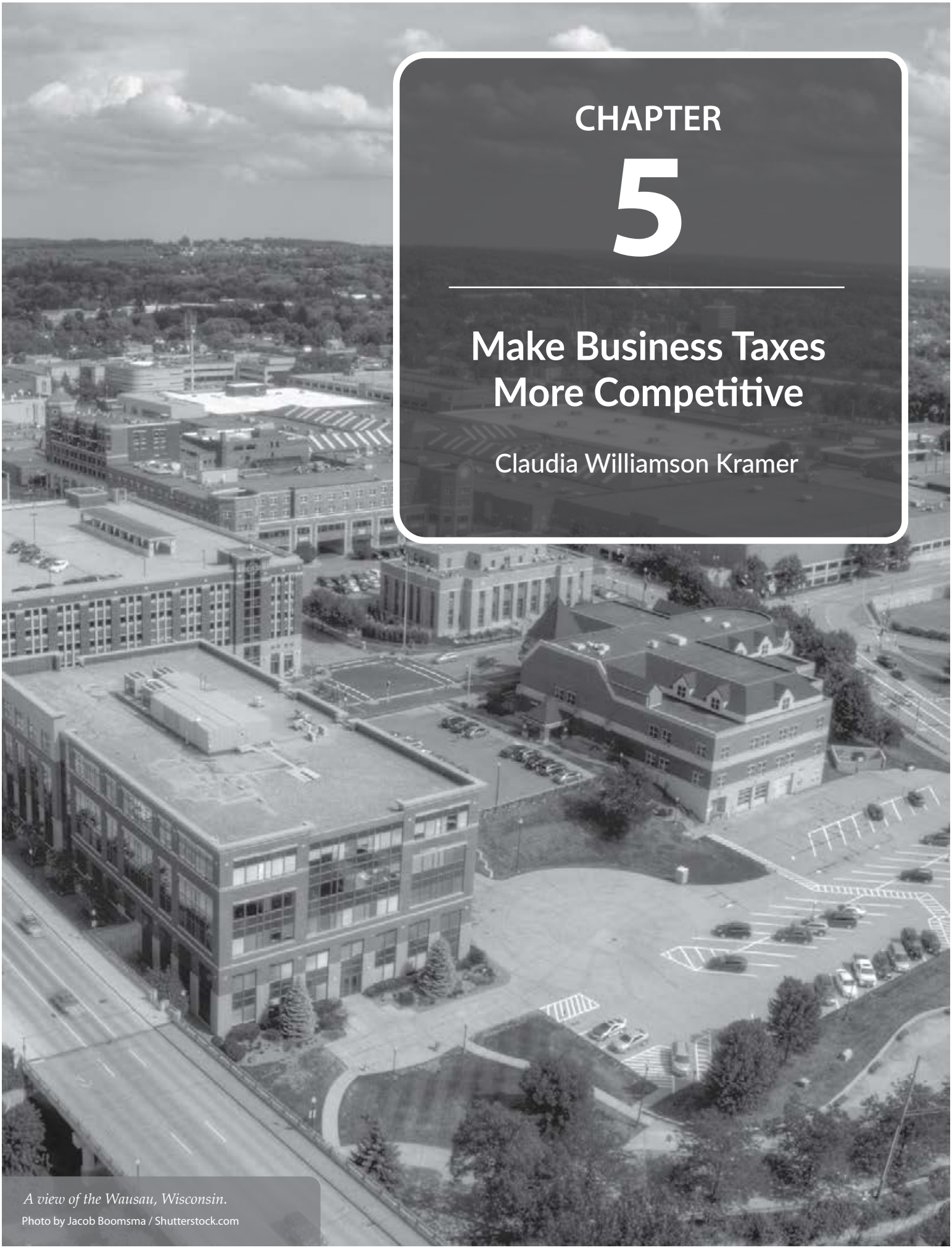
Poulson, Barry W., and Jules Gordon Kaplan. 2008. "State Income Taxes and Economic Growth." *Cato Journal* 28 (1): 53–71.

Ross, Justin M., and Joshua C. Hall. 2007. "When It Comes to Taxes: Focus on Being Competitive." In *Unleashing Capitalism: Why Prosperity Stops at the West Virginia Border and How to Fix It*, edited by Russell S. Sobel, 69–79. Morgantown, WV: Center for Economic Growth, Public Policy Foundation of West Virginia.

Ross, Justin M., Joshua C. Hall, and Peter T. Calcagno. 2009. "When It Comes to Taxes in South Carolina: Focus on Remaining Competitive." In *Unleashing Capitalism: A Prescription for Economic Prosperity in South Carolina*, edited by Peter T. Calcagno, 73–85. Columbia, SC: South Carolina Policy Council.

Sobel, Russell S., and Thomas A. Garrett. 2002. "On the Measurement of Rent Seeking and Its Social Opportunity Cost." *Public Choice* 112 (1–2): 115–36.

US Census Bureau. 2019. *State and Local Government Finances: 2018–19*. Washington, DC: US Census Bureau. https://www.census.gov/programs-surveys/gov-finances.html.



CHAPTER

5

Make Business Taxes More Competitive

Claudia Williamson Kramer

A view of the Wausau, Wisconsin.
Photo by Jacob Boomsma / Shutterstock.com

5 Make Business Taxes More Competitive

State and local taxes represent a significant cost for corporations.[1] Location and employment decisions for companies are influenced by the relative tax burdens of different states (Helms 1985; Gupta and Hoffman 2003; Bartik 1985; Papke and Papke 1986). To become more competitive at attracting newcomers, Wisconsin recently passed income tax relief, retroactive to January 1, 2021. A special concern was the second-highest individual income tax rate of 6.27 percent, which covered a broad swath of Wisconsin taxpayers. That 6.27 percent rate was lowered to 5.3 percent. Before the change, Wisconsin's *second* highest rate was above the top marginal income tax rates in 31 states (23 had lower top rates than Wisconsin and eight levy no income tax at all).[2]

Although this is a move in the right direction that should encourage individuals to live in the state, Wisconsin's tax system needs additional improvements to attract new companies and promote in-state business expansion. For example, the legislature recently proposed eliminating Wisconsin's tangible personal property tax, which would reduce businesses compliance burdens and diminish tax distortions that discourage certain business investments. This repeal was vetoed by Gov. Tony Evers, however.

Recall from chapter 4 that the most pro-growth tax systems are characterized by broad-based, low-rate taxes. Unfortunately, Wisconsin's tax system embodies an inequitable allocation of the tax burden by varying tax rates across industries, using industry-specific taxes, and providing tax credits to certain companies, an issue that was more thoroughly explored in chapter 4. In this chapter, I outline Wisconsin's business tax burden and explore several tax reforms that can make Wisconsin's tax law more attractive for business growth.

Specifically, to unleash capitalism, Wisconsin should consider (1) reducing business tax rates and applying them equally to all firms; (2) reducing business property tax rates, including commercial, industrial, and apartment tax rates; (3) eliminating tangible property tax; and (4) eliminating business tax credits.

Business Tax Burden

Tax competition is an unpleasant reality for state revenue and budget officials, but it provides an effective restraint on state and local taxes. When a state imposes higher taxes than neighboring states, businesses will cross borders. It is also worth remembering that although businesses collect taxes, the true burden of business taxes will always fall on individual consumers, business owners, suppliers, and others.

Table 5.1 illustrates the fiscal constraints placed on businesses operating in Wisconsin during fiscal year 2018-2019. The first column of the table reports the total effective business tax rate as a percentage of private-sector gross state product (GSP). Private-sector GSP captures all goods and services created in Wisconsin by businesses. This measure reflects the tax burden on companies operating in the private sector, the sector that drives entrepreneurship, job growth, and economic opportunity. Wisconsin's effective business tax rate is 4.0 percent, lower than those of three neighboring states and 0.5 percentage points lower than the national average. But Michigan's total effective business tax rate is 0.7 percentage points lower than Wisconsin's. Compared to Michigan, Wisconsin saddles firms with a tax burden more than 17 percent higher simply for locating in Wisconsin.

The second column paints a similar picture. These statistics show that it costs Wisconsin business owners, on average, $4,800 per employee to cover state and local taxes. This is $1,000 less per employee than Iowa's comparable figure and $800 less than Minnesota's. Illinois's per-employee tax burden is the same as Wisconsin's, while Michigan's is lower by $700 per employee.

The last three columns highlight that Wisconsin relies more on business tax revenue at both the state and local levels relative to Michigan. Local businesses in Wisconsin

Table 5.1	Business Tax Burden, 2018–2019				
	Business Tax Burden		Business Share of Total Taxes		
	Total Effective Business Tax Rate (% of private-sector GSP)	Business Taxes ($ per employee)	Business taxes (% state taxes)	Business taxes (% local taxes)	Business taxes (% total state and local taxes)
Illinois	4.6%	$4,800	36.0%	54.4%	44.5%
Iowa	4.6%	$5,800	36.8%	58.2%	44.7%
Michigan	3.3%	$4,100	33.0%	40.3%	35.2%
Minnesota	4.3%	$5,600	34.7%	46.3%	37.5%
Wisconsin	4.0%	$4,800	34.6%	46.9%	38.9%
United States	**4.5%**	**$6,500**	**38.5%**	**52.2%**	**44.0%**

Source: Ernst & Young (2020)

contribute almost 47 percent of the local tax revenue, which is less than the national average of about 52 percent. Combined, over 38 percent of total tax revenue in Wisconsin is generated from businesses, which is a higher percentage than two other states in the region. Specifically, business taxes represent 35 percent of total tax revenue in Michigan and 37.5 percent in Minnesota. Nationally, six additional states rely less on business taxation than Wisconsin. On average, business bears 44 percent of the tax burden across the country.

Wisconsin places a lower tax burden on its businesses compared to most surrounding states and compared to the average state. However, 11 states, including Michigan, Ohio, and Indiana, tax businesses at a lower rate, which suggests that Wisconsin could be more competitive at attracting entrepreneurs and business development. Ten states, including Michigan, Minnesota, and Ohio, rely on local business taxes less than Wisconsin does. This suggests that Wisconsin may discourage small business development and entrepreneurship relative to other states. As a result, business-minded individuals may never open that new coffee shop, clothing boutique, or hair salon. This results in less employment in the state and a reduced responsiveness to the products and services demanded by Wisconsinites. These unseen costs—the businesses not opened and the jobs left uncreated—are more examples of the indirect costs of taxation discussed in chapter 4.

State Business Tax Rankings

The Tax Foundation's *State Business Tax Climate Index* provides an indicator of which states' tax systems are the most hospitable to business and economic growth. States with more competitive tax systems score well (represented by a higher score) in the index because they are best suited to generate economic growth.

According to the Tax Foundation's *2022 State Business Tax Climate Index*, Wisconsin ranks 27th nationally in terms of its overall tax system.[3] This is down one spot from its 2020 rank. This aggregate ranking indicates that Wisconsin is doing well by limiting tax burdens in some respects, but there is still room for improvement. In fact, there are 26 other states that should be more attractive to companies making a location decision, including Michigan (with a rank of 12) and nearby Indiana (with a rank of 9). The overall ranking, however, masks significant differences across the diverse types of taxes businesses pay.

As shown in table 5.2, Wisconsin's overall rank places it above all neighboring states except Michigan, which ranks 12th. Michigan's relatively low tax burden is driven by its low (i.e., good) ranks regarding individual income tax, sales tax, and unemployment insurance tax. Minnesota, on the other hand, comes in 45th, mainly because of high corporate and individual income taxes. Illinois ranks 36th overall but has a higher individual income tax rank than

Table 5.2	2022 State Business Tax Climate Index					
	Overall Rank	Corporate Tax Rank	Individual Income Tax Rank	Sales Tax Rank	Property Tax Rank	Unemployment Insurance Tax Rank
Illinois	36	42	13	39	48	40
Iowa	38	38	38	15	39	34
Michigan	12	20	12	10	21	7
Minnesota	45	45	43	29	32	30
Wisconsin	27	31	37	7	16	28

Source: Cammenga and Walczak (2021).

Wisconsin. Iowa ranks 36th overall owing to high corporate and property taxes, and it ranks worse than Wisconsin on all tax measures.

With the exception of Michigan, Wisconsin outranks its neighbors in the corporate tax category, and it ranks 31st nationally. Even though Wisconsin taxes corporations less than neighboring Illinois, Iowa, and Minnesota, it has higher business taxes than 30 other states. Corporate tax rates matter for economic growth, capital accumulation, and entrepreneurship (Lee and Gordon 2005). Wisconsin's corporate taxes partially explain why the state's per capita GDP lags the national average. [4]

Corporate income tax rates, though important, are only part of the total tax burden on corporations. Wisconsin manages to tax businesses in other ways that can discourage business expansion and deter new businesses from locating in the state. Sales taxes, property taxes, and unemployment insurance taxes add significantly to the overall business tax burden. Businesses may pay sales tax on their inputs, for example. Property taxes can be levied on the value of a business's land, office building, machinery, equipment, fixtures, and inventories. Unemployment insurance taxes create additional burdens as a company grows.

Sales and property taxes are Wisconsin's two best categories compared to its neighbors. However, there is still room for improvement that could positively affect employment growth and small business start-ups (see Mark, McGuire, and Papke 2000; Bartik 1989). For example, Wisconsin recently missed out on an opportunity to improve the business property tax burden when it failed to repeal taxes on tangible property. To boost business development and job growth, Wisconsin should consider reducing corporate and individual income taxes, eliminating business tangible property taxes, and reducing the unemployment insurance tax burden.

What Are Businesses Paying?

It's becoming clear that Wisconsin can improve its business tax climate. To further explore Wisconsin's business tax burden, table 5.3 breaks down fiscal year 2018-2019 state and local business taxes into seven categories: property, sales, excise (including public utilities and insurance), corporate income, unemployment insurance, pass-through income, and license and other taxes.

Wisconsin collects 39 percent of its business tax revenue from taxing property, making property taxes the category with the largest share of Wisconsin's business tax burden. This share is higher than the national average for property taxes and higher than property taxes' share of Michigan's and Minnesota's business tax burdens. It is almost 10 percentage points higher than the 30 percent share of business taxes that property taxes represent in Minnesota, which means that firms in Wisconsin pay over 30 percent more in their share of business property taxes. Compared to firms in Delaware, the state with the lowest share of property taxes, Wisconsin firms pay over

Table 5.3	Share of State and Local Business Taxes, 2018–2019						
	Property	Sales	Excise	Corporate Income	Unemployment Insurance	Pass-through Income	License and Other Taxes
Illinois	47.3%	15.4%	14.5%	8.4%	5.1%	4.4%	4.9%
Iowa	40.0%	22.7%	11.0%	6.9%	5.3%	7.5%	6.5%
Michigan	38.4%	21.9%	11.7%	7.1%	7.5%	6.2%	7.1%
Minnesota	29.9%	20.8%	16.4%	11.9%	5.1%	8.5%	7.3%
Wisconsin	39.0%	20.7%	10.1%	11.1%	5.0%	6.4%	7.7%
US Average	**37.9%**	**21.3%**	**12.2%**	**9.3%**	**4.3%**	**6.5%**	**8.5%**

Note: The "excise" category includes public utilities and insurance.

Source: Ernst & Young (2020).

230 percent more in the share of business property taxes simply to operate in the state!

Wisconsin's corporate income, unemployment insurance, and license tax burdens are higher than the national average, but its sales, excise, and pass-through income tax burdens are slightly lower than the national average. Corporate income, however, represents a larger share of business taxes in Wisconsin than in all neighboring states except Minnesota. This suggests that tax rates can be deceiving, because the tax burden can still be high even if the frequently quoted corporate income tax rate appears low.

Business Property Taxes

In order to boost employment and economic growth, Wisconsin policy makers should consider reducing business property taxes. But which ones? To help identify business property tax burdens, the Lincoln Institute of Land Policy and the Minnesota Center for Fiscal Excellence published a report, *50-State Property Tax Comparison Study*, detailing business property tax burdens.

On the basis of this study, table 5.4 separates business property taxes into three categories: commercial property, industrial property, and apartment buildings. Each category specifies the state's tax rank out of all 50 states (a higher rank indicates a lower burden), the state's tax rate, and an approximate tax bill for a hypothetical property.

Wisconsin taxes all three categories of business property at a rate that exceeds the national average. Only 10 states,

Table 5.4	Business Property Taxes, 2019								
	Commercial Property			Industrial Property			Apartment Property		
	Tax Rate	Tax Rank	Tax Bill	Tax Rate	Tax Rank	Tax Bill	Tax Rate	Tax Rank	Tax Bill
Illinois	3.51%	49	$42,173	1.98%	44	$39,566	1.42%	25	$8,913
Iowa	3.02%	47	$36,252	1.80%	38	$35,934	2.77%	47	$17,466
Michigan	3.77%	51	$45,267	2.22%	46	$44,434	3.74%	51	$23,570
Minnesota	2.77%	42	$33,219	1.67%	33	$33,399	1.65%	31	$10,420
Wisconsin	2.58%	40	$30,994	1.42%	29	$28.406	2.58%	44	$16,240
US Average	**1.92%**		**$23,052**	**1.40%**		**$27,898**	**1.65%**		**$10,375**

Note: Values are calculated using the largest city in each state. To approximate the tax bill for commercial and industrial property, land and buildings are valued at $1 million. For the apartment property tax bill, the apartment is valued at $600,000.

Source: Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence (2020).

including all four neighboring states, tax commercial property (office buildings and hotels, for example) at a higher rate than Wisconsin does. This means that 40 states tax commercial property at much lower rates. For example, say Hilton operates a Hampton Inn located in Wisconsin with an estimated value of $2 million: this hotel will cost Hilton about $61,988 in property taxes per year. The same $2 million Hampton Inn located in Cheyenne, Wyoming, will cost Hilton only $16,462 in property taxes. Wisconsin businesses pay almost four times the amount of taxes on commercial property as businesses located in other states, such as Wyoming or Washington.

The story is still worse for apartment-building owners. The last three columns of table 5.4 highlight Wisconsin's tax burden on apartment property. Wisconsin once again taxes property at a rate higher than the national average—in fact, its rate is 8th highest in the country, and higher than the rates in two out of four of its neighboring states. For an apartment building valued at $600,000, a Wisconsin owner pays more than $16,000 in taxes. Compare this to an apartment owner in Illinois, who pays around $9,000. Wisconsin has several college towns with lots of apartment rentals. Their owners pay a substantially higher rate for owning an apartment building in Madison or La Crosse, for example, than they would were the building in Champaign, Illinois. In fact, they pay 80 percent more in taxes than Illinois apartment owners do. On average, this tax is passed through to lower-income families and college students.

Wisconsin does better when it comes to industrial property taxes levied on manufacturing property such as machinery and equipment, inventories, and fixtures. Wisconsin ranks 29th with an industrial property tax rate near the national average of 1.40 percent. All surrounding states tax manufacturing operations at higher rates. However, more than 20 states, including Tennessee, Washington, Wyoming, and New York, tax industrial property at much lower rates. For example, a manufacturing firm valued at $10 million pays about $284,000 in industrial taxes in Wisconsin, but this same manufacturing plant operating in New York pays instead only $115,910 in industrial taxes.

To further illustrate, let's look at the Volkswagen assembly plant located in Chattanooga, Tennessee (my home city). The market value of the Volkswagen Chattanooga Assembly Plant is roughly $1 billion.[5] Tennessee taxes industrial property at 1.008 percent;[6] thus, Volkswagen should have paid about $1 million in industrial property taxes for the plant in 2021. However, if this same car plant were located in Wisconsin, Volkswagen's tax bill would increase by over 40 percent! In other words, Volkswagen would pay over $400,000 *more* in taxes simply for being located in Wisconsin.

It should be noted that, although this example illustrates how taxing Wisconsin's industrial taxes are to companies, Tennessee gave Volkswagen over $800 million in subsidies to locate in Chattanooga.[7] This clearly demonstrates that state politicians are aware of their state's uncompetitive tax environment, which is why they find it necessary to give subsidies and preferential tax treatment to encourage growth and development. This topic is further discussed in chapter 2.

What drives Wisconsin's high business property taxes? Wisconsin taxes land, buildings, machinery, and equipment at higher rates than most states do, to the detriment of manufacturing, distribution, and research and development (R&D) facilities. Since property taxes can place a large burden on business, they can have a significant effect on firms' location decisions. Bartik (1989) provides strong evidence that property taxes have a negative impact on business start-ups. Because property taxes are paid regardless of profit, they have the strongest negative effect on the establishment of small businesses, since many new businesses are not profitable in their first few years. Bartik estimates that a 10 percent cut in business property tax rates would increase business activity by 1 to 5 percent. He further estimates that a 10 percent decrease would increase the number of new plants opening by 1 to 2 percent. Mark, McGuire, and Papke (2000) estimate that a tax decrease on business property of 1 percentage point would increase annual employment growth by 2.44 percentage points.

What do these estimates imply for Wisconsin property tax rates and business development? Using the numbers in table 5.4, if Wisconsin were to lower its commercial property taxes to the national average—that is, institute a 25 percent reduction in its commercial property tax—Wisconsin's business activity could increase by 2.5 to 12.5 percent, new plant establishments could grow by between 2.5 and 5 percent, and annual employment growth could increase by 2.27 percentage points per year!

Collectively, this tells us that high property tax systems like Wisconsin's will deter new start-ups, decrease employment, and lower overall business activity. States that keep statewide property taxes low can position themselves better to attract business investment. Localities competing for business can put themselves at a greater competitive advantage by keeping personal property taxes low. Wisconsin should consider reducing property taxes to boost business and job growth.

Location, Location, Location

So far, I've examined data representing different aspects of business tax rates and tax burdens. By most comparisons, Wisconsin's business tax climate is worse than average. However, these data do not tell business owners what they really want to know before they choose where to locate: How much will my company pay in taxes?

Comparing states' business tax revenue as a percentage of total taxes or comparing business tax rates can be misleading. Many business taxes are collected in one state but paid by companies in other states. Thus, tax collections do not accurately portray the relative tax burden that real-world businesses incur in each state. In addition, different types of businesses receive tax incentives, such as new job tax credits, new investment tax credits, sales tax exemptions, and property tax abatements. Not all businesses enjoy such incentives, however. As a result, tax burdens not only vary across states, they also vary across industries and vary by the age of the firm: older firms typically face higher tax rates.

The Tax Foundation published a study, *Location Matters 2021*, to directly tackle these issues (Walczak et al. 2021). This study used eight model firms—a corporate headquarters, an R&D facility, a technology center, a data center, a shared services center, a capital-intensive manufacturer, a labor-intensive manufacturer, and a distribution center—and calculated each firm's tax bill in each state. The study accounted for all business taxes: corporate income taxes, property taxes, sales taxes, unemployment insurance taxes, capital stock taxes, inventory taxes, and gross receipts taxes. Additionally, the researchers calculated 2021 tax rates for new and mature firms eligible for various tax incentives. In this report, a lower rank represents a lower tax burden.

Table 5.5 reports the tax cost of doing business in each of the eight industries for mature and new firms for Wisconsin and its neighboring states. Wisconsin's tax rates vary tremendously across industry and age of firm. For example, Wisconsin places a lower tax burden on new capital and labor-intensive manufacturing firms and mature labor-intensive firms, ranking in the top 10 states for all three categories. The good ranking is due, in large part, to new manufacturing firms qualifying for several substantial tax incentives, including property tax abatements, investment credits, and jobs credits. Mature firms receive property tax abatements and other tax credits.

Minnesota taxes new and mature capital-intensive firms less than Wisconsin does. Other surrounding states tax new capital and labor-intensive firms more than Wisconsin does. Iowa taxes mature capital-intensive manufacturing firms less than Wisconsin does.

Compared with neighboring states, Wisconsin places less of a tax burden on both new and mature corporate headquarters, R&D headquarters, and technology centers. However, Wisconsin's corporate headquarters tax burden is one of the highest in the country: it ranks 39th for mature firms and 32nd for new firms. Corporate headquarters rank worst in Wisconsin because of a combination of high corporate income, high unemployment insurance, and high property taxes.

Table 5.5 Total Effective Tax Costs of Doing Business, 2021

	Capital-Intensive Manufacturing				Labor-Intensive Manufacturing				Corporate Headquarters				R&D Headquarters			
	Mature Firm	Rank	New Firm	Rank	Mature Firm	Rank	New Firm	Rank	Mature Firm	Rank	New Firm	Rank	Mature Firm	Rank	New Firm	Rank
Illinois	16.9%	38	7.1%	11	16.0%	44	13.4%	32	21.8%	43	20.4%	37	16.4%	47	14.7%	28
Iowa	8.2%	12	11.1%	19	11.6%	30	17.3%	42	26.7%	49	27.6%	48	13.7%	35	17.8%	37
Michigan	11.3%	21	12.7%	28	8.8%	16	10.1%	21	22.1%	45	25.6%	47	16.0%	46	25.4%	48
Minnesota	6.7%	6	8.2%	9	9.5%	21	13.2%	31	25.7%	48	28.1%	49	15.4%	42	20.4%	42
Wisconsin	10.2%	17	8.8%	10	8.0%	10	7.0%	9	19.4%	39	18.8%	32	11.9%	24	13.9%	25
	Distribution Warehouse				**Shared Services Center**				**Data Center**				**Technology Center**			
	Mature Firm	Rank	New Firm	Rank	Mature Firm	Rank	New Firm	Rank	Mature Firm	Rank	New Firm	Rank	Mature Firm	Rank	New Firm	Rank
Illinois	26.7%	16	27.7%	19	22.0%	24	15.9%	7	16.7%	46	9.6%	15	19.3%	50	21.1%	38
Iowa	62.8%	48	70.9%	48	35.2%	46	45.3%	47	7.9%	19	17.2%	27	16.7%	45	25.6%	47
Michigan	50.3%	44	62.4%	44	28.1%	37	39.4%	42	5.0%	9	21.0%	31	16.0%	43	27.4%	50
Minnesota	54.9%	45	57.6%	41	33.9%	45	44.0%	46	8.7%	22	4.2%	3	15.5%	42	24.7%	46
Wisconsin	37.4%	30	42.0%	30	21.5%	21	18.3%	10	8.6%	21	32.2%	36	10.6%	16	14.3%	18

Source: Walczak et al. (2021).

A near-average tax burden is faced by new R&D firms (for which Wisconsin ranks 25th) and mature R&D firms (for which Wisconsin ranks 24th). Technology centers in Wisconsin face a comparatively lower tax burden relative to other states; Wisconsin ranks 16th for mature firms and 18th for new firms.

Distribution warehouses are heavily taxed; the rate is 37.4 percent for mature warehouses and 42 percent for new warehouses. These rates rank Wisconsin 30th for both older and new warehouse centers. Although this rank is higher than most states in the country, Illinois is the only neighboring state that offers a lower tax burden for warehouses. Wisconsin comes in with slightly-below-average tax costs for mature shared service centers and data centers. Comparing neighboring states, only Michigan taxes mature data centers less than Wisconsin does. New shared services centers are taxed at 18.3 percent in Wisconsin, which ranks 10th in the nation in this category. However, Illinois does even better, ranking 7th with a 15.9 percent tax rate. New data centers in Wisconsin are heavily taxed, at 32.2 percent, with a tax burden rank of 36. Neighboring Minnesota ranks 3rd in the country with a tax rate of only 4.2 percent.

One thing to remember is that the total effective tax rate includes tax incentives that states provide to specific industries and firms. Illinois, for example, offers one of the more generous withholding tax credits in the nation. Iowa also offers generous investment and job creation tax incentives to new firms. In Minnesota, data centers and capital-intensive manufacturers receive generous property tax abatements, and equipment is not included in the property tax base.

I am not advocating that Wisconsin pursue more tax incentives in order to rank more favorably. Wisconsin already provides generous tax incentives, including property tax abatements, investment credits, and job creation tax credits. These credits reduce the tax burdens for many manufacturing firms, but they shift the burden to firms in other industries. As chapter 2 showed, this tax strategy not only increases the cost of taxation significantly, it also distorts market activity.

Conclusion and Policy Suggestions

In order to attract more job creation and business development, Wisconsin should simplify its tax system, implementing broad-based, uniformly low tax rates and reducing the administrative and enforcement costs. Recall from chapter 4 that an efficient tax system is one that relies on low rates and uniform application of taxes—the opposite of providing tax incentives for different types of firms and for newer operations rather than older ones. In order to attract businesses to locate in Wisconsin and promote prosperity, policy makers need to reduce all tax rates, not only for new firms for a specified amount of time but for all firms in any industry.

A good starting point is to reduce taxes on corporate and R&D headquarters and distribution warehouses. This reduction of business taxes will foster entrepreneurship, encourage business expansion, and give new businesses a reason to consider moving to Wisconsin.

Policy makers often generate tax credit deals under the umbrella of job creation and economic development. If Wisconsin officials need to offer such incentive packages to attract new companies, this tells us that prior lawmakers created an unfavorable business tax climate that is deterring market activity. Tax credits only provide shelter from a bad business climate. Economic development and job creation tax credits complicate the tax system, narrow the tax base, drive up tax rates for companies that do not qualify, distort the free market, and often fail to achieve economic growth (see Peters and Fisher 2004; Fox and Murray 2004). Indeed, many existing business owners and executives have reason to object to the generous tax incentives enjoyed by some of their direct competitors, and even firms looking to relocate to Wisconsin may have cause to be wary of the rates that will ultimately come into force once economic development incentives are no longer available. A far more effective approach is the systematic improvement of the state's business tax climate for the long term.

In sum, in order to increase business growth and unleash capitalism, Wisconsin should (1) lower business tax rates and apply taxes equally to all firms, (2) reduce business property tax rates, including commercial, industrial, and apartment tax rates; (3) eliminate tangible property tax; and (4) eliminate business tax credits.

Notes

[1] This chapter is based on Cline and Williamson (2018).

[2] Katherine Loughead, "Wisconsin Legislature Considering Several Pro-growth Tax Reforms," June 29, 2021, https://taxfoundation.org/wisconsin-state-budget-tax/.

[3] A rank of 1 is best; 50 is worst. The index shows tax systems as of July 1, 2021 (the beginning of fiscal year 2022).

[4] "Per Capita Real Gross Domestic Product (GDP) of the United States in 2021, by State," Statista, November 2, 2022, https://www.statista.com/statistics/248063/per-capita-us-real-gross-domestic-product-gdp-by-state/.

[5] Brian Lawson, "Volkswagen's New $1 Billion Plant Up and Running in Chattanooga," *AL.com*, May 25, 2011, https://www.al.com/breaking/2011/05/volkswagens_new_1_billion_plan.html.

[6] See Hall and Hoffer (2012) for a thorough analysis of Tennessee's tax system.

[7] See Mike Pare and Dave Flessner, "Volkswagen Won Most Subsidies in Tennessee, but Were They All Necessary?," *The Tennessean*, September 16, 2017, https://www.tennessean.com/story/news/investigations/2017/09/17/volkswagen-chattanooga-subsidies-tennessee-but-were-they-all-necessary/622157001/.

References

Bartik, Timothy J. 1985. "Business Location Decisions in the United States: Estimates of the Effects of Unionization, Taxes, and Other Characteristics of States." *Journal of Business and Economics Statistics* 3 (1): 14–28.

———. 1989. "Small Business Start-Ups in the United States: Estimates of the Effects of Characteristics of States." *Southern Economic Journal* 55 (4): 1004–18.

Cammenga, Janelle, and Jared Walczak. 2021. 2022 *State Business Tax Climate Index*. Washington, DC: Tax Foundation. https://files.taxfoundation.org/20220104110127/2022-State-Business-Tax-Climate-Index3.pdf.

Cline, Brandon N., and Claudia R. Williamson. 2018. "Make Business Taxes Competitive." In *Promoting Prosperity in Mississippi*, edited by Brandon N. Cline, Russell S. Sobel, and Claudia R. Williamson, 69–77. Starkville, MS: Institute for Market Studies.

Ernst & Young LLP. 2020. *Total State and Local Business Taxes for FY19*. Ernst & Young, November 9, 2020. https://www.ey.com/en_us/tax/total-state-and-local-business-taxes-for-fy19#:~:text=Businesses%20paid%20more%20than,state%20and%20local%20tax%20revenue.

Fox, William F., and Matthew N. Murray. 2004. "Do Economic Effects Justify the Use of Fiscal Incentives?" *Southern Economic Journal* 71 (1): 78–92.

Gupta, Sanja, and Mary Ann Hoffman. 2003. "The Effect of State Income Tax Apportionment and Tax Incentives on New Capital Expenditures." Supplement, *Journal of the American Taxation Association* 25 (s-1): 1–25.

Hall, Joshua C., and Adam J. Hoffer. 2012. "When It Comes to Taxes in Tennessee: Focus on Competitive Advantage." In *Freedom and Prosperity in Tennessee*, edited by J. R. Clark, 69–86. Chattanooga, TN: Scott L. Probasco Jr. Chair of Free Enterprise.

Helms, L. Jay. 1985. "The Effect of State and Local Taxes on Economic Growth: A Time Series–Cross Section Approach." *Review of Economics and Statistics* 67 (4): 574–82.

Lee, Young, and Roger H. Gordon. 2005. "Tax Structure and Economic Growth." *Journal of Public Economics* 89 (5–6): 1027–43.

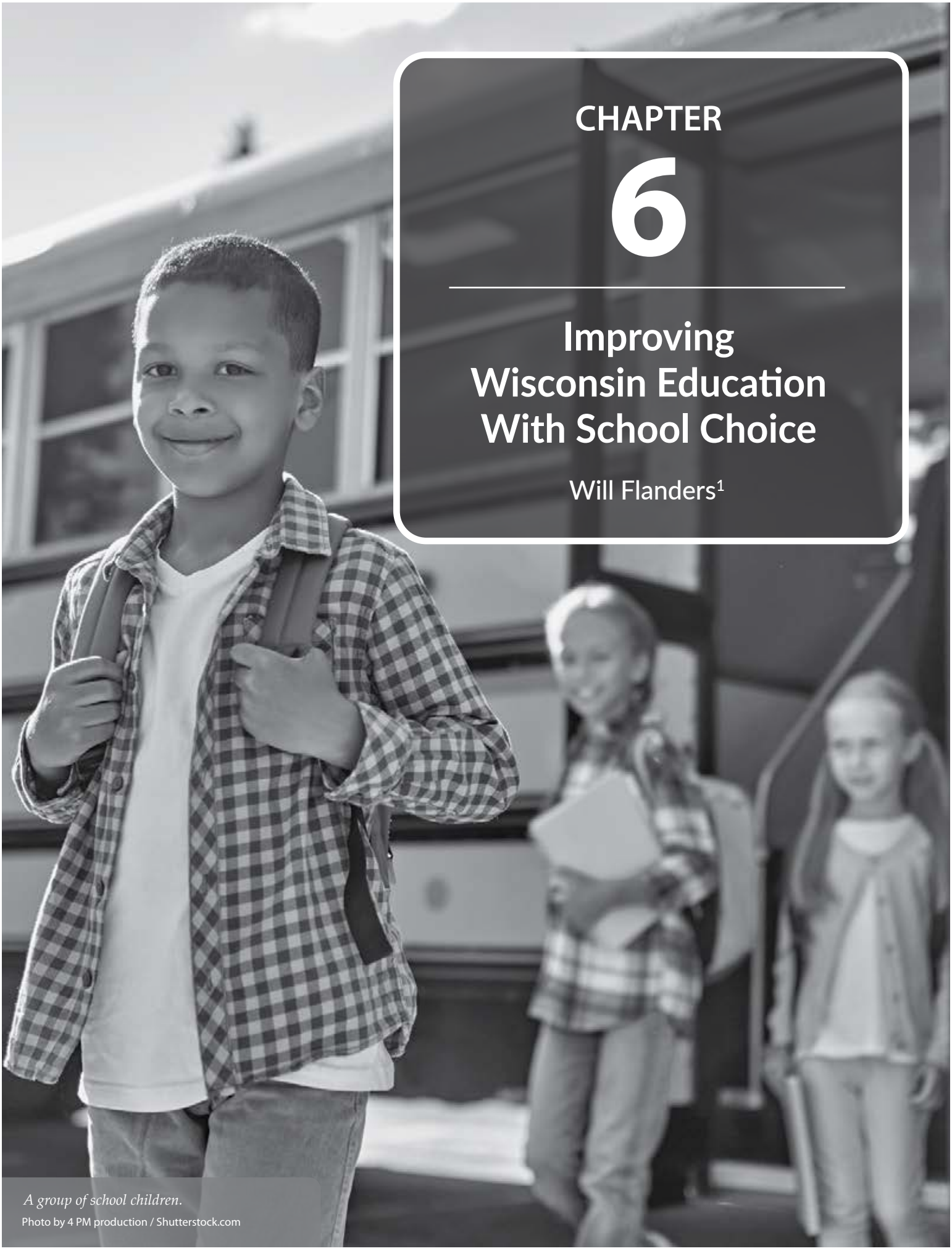
Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence. 2020. *50-State Property Tax Comparison Study*. Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence. June 2020. https://www.lincolninst.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2019_full.pdf

Mark, Stephen T., Therese J. McGuire, and Leslie E. Papke. 2000. "The Influence of Taxes on Employment and Population Growth: Evidence from the Washington, D.C. Metropolitan Area." *National Tax Journal* 53 (1): 105–23.

Papke, James A., and Leslie E. Papke. 1986. "Measuring Differential State-Local Tax Liabilities and Their Implications for Business Investment Location." National Tax Journal 39 (3): 357–66.

Peters, Alan, and Peter Fisher. 2004. "The Failure of Economic Development Incentives." *Journal of the American Planning Association* 70 (1): 27-37.

Walczak, Jared, Katherine Loughead, Ulrik Boesen, and Janelle Cammenga. 2021. *Location Matters 2021: The State Tax Costs of Doing Business*. Washington, DC: Tax Foundation. https://taxfoundation.org/publications/location-matters/.



CHAPTER

6

Improving Wisconsin Education With School Choice

Will Flanders[1]

A group of school children.

Photo by 4 PM production / Shutterstock.com

6 Improving Wisconsin Education With School Choice

The Academic Foundations of School Choice

The modern story of school choice begins with Nobel Prize–winning economist Milton Friedman, one of the most important proponents of free market economics writ large in the past century. In 1955, Friedman wrote an article titled "The Role of Government in Education," where he first posited the notion that there is little reason that government subsidization of education needs to occur in schools that are run by the government:

> Given, as at present, that parents can send their children to government schools without special payment, very few can or will send them to other schools unless they too are subsidized. Parochial schools are at a disadvantage in not getting any of the public funds devoted to education; but they have the compensating advantage of being run by institutions that are willing to subsidize them and can raise funds to do so, whereas there are few other sources of subsidies for schools. Let the subsidy be made available to parents regardless of where they send their children—provided only that it be to schools that satisfy specified minimum standards—and a wide variety of schools will spring up to meet the demand.

Friedman believed that the introduction of competition into the educational system would work as it does across other free markets. Because schools facing competition would have to compete for students, they would be more incentivized to work to meet the needs of families. If a school failed in this regard, it would be subject to the same sort of market pressures that drive any other business to close its doors. To put it simply, market forces would work to improve the educational marketplace over time and would ensure that every child could attend a school that better suited to meet his or her needs.

Throughout the 1980s, recognition that America's system of public education was on shaky ground increased. In order to address widespread consternation about the state of American public education, President Reagan's secretary of education, T. H. Bell, put together the National Commission on Excellence in Education to present a clear-eyed view of the state of education in America. The commission's report, "A Nation at Risk," was one of the most influential calls for a change to the status quo in the history of American education.

Among the key findings of the report was the revelation that teachers came far too often from the bottom quartile of college students. Moreover, the focus of educator preparatory programs on the art of teaching rather than the core subject material left new teachers underprepared to impart knowledge to students. What was needed was a renewed focus on curriculum standards and a revolution in the composition of the teaching workforce.

Chubb and Moe (1990), two political scientists associated with the Brookings Institute, recognized the problems put forth in "A Nation at Risk" but prescribed a somewhat different solution. In a 10-year study of more than 500 schools, they argue that the excessive layers of bureaucracy present in most public schools impede their ability to meet the needs of students. They recommend a far more limited role for government in public education as a kind of minimal gatekeeper for quality in a system where parents are provided with a scholarship to take to the school of their choice.

All of these ideas had percolated in academia over the course of decades but had yet to find a venue to be tried outside the proverbial ivory tower. The next step in the history of school choice happened in Wisconsin, where a unique bipartisan coalition coalesced around the concept of school vouchers. From this beginning in Wisconsin, private school choice has expanded greatly around the nation. Though the form that

school choice programs take and participation levels vary greatly, today 26 states offer some private school choice program (American Federation for Children 2023).

Of course, the concept of "school choice" encompasses arrangements beyond vouchers to attend private education. These options can include charter schools, open-enrollment programs, and home schooling. These options will also be discussed throughout this chapter.

History of Private School Choice in Wisconsin

Milwaukee

In the late 1980s, there was increasing dissatisfaction with the quality of education being offered by public schools in Milwaukee. Of particular concern were the struggles of African American students, who were seemingly being left behind in a school district resistant to change. Among the fiercest advocates for an alternative was Howard Fuller, a civil rights activist and MPS Superintendent who saw improving education in the Black community as the only path toward true freedom.

Fuller's early approach to addressing the plight of African American students involved the creation of a school district within Milwaukee that was centered in the region where most African Americans lived.[2] Fuller saw this as a means to ensure that the concerns of these families would not be ignored, as he perceived them to be by the broader school board. However, this approach proved politically untenable. Partially as an alternative to this idea, Governor Tommy Thompson began pushing the notion of creating a school voucher program for Milwaukee (Witte and Wolf, n.d.).

In an important moment of bipartisanship, Democratic legislators such as Polly Williams cooperated with Republican Governor Thompson to get the Milwaukee Parental Choice Program (MPCP) signed into law. The legislation was not without its flaws, but through court cases and legislative change, the program began to better fulfill its original vision.

For example, religious schools were not allowed to participate in the initial program. In 1995, legislation was passed to allow religious schools to participate. This change was challenged in court in *Jackson v. Benson*, with the argument that allowing religious schools to participate represented governmental establishment of a religion, as prohibited by the First Amendment to the US Constitution. It took several years for the question to make it to the Wisconsin Supreme Court. In a landmark decision that had implications for school choice around the nation, the court ruled that the inclusion of religious schools in the voucher program is constitutional.[3]

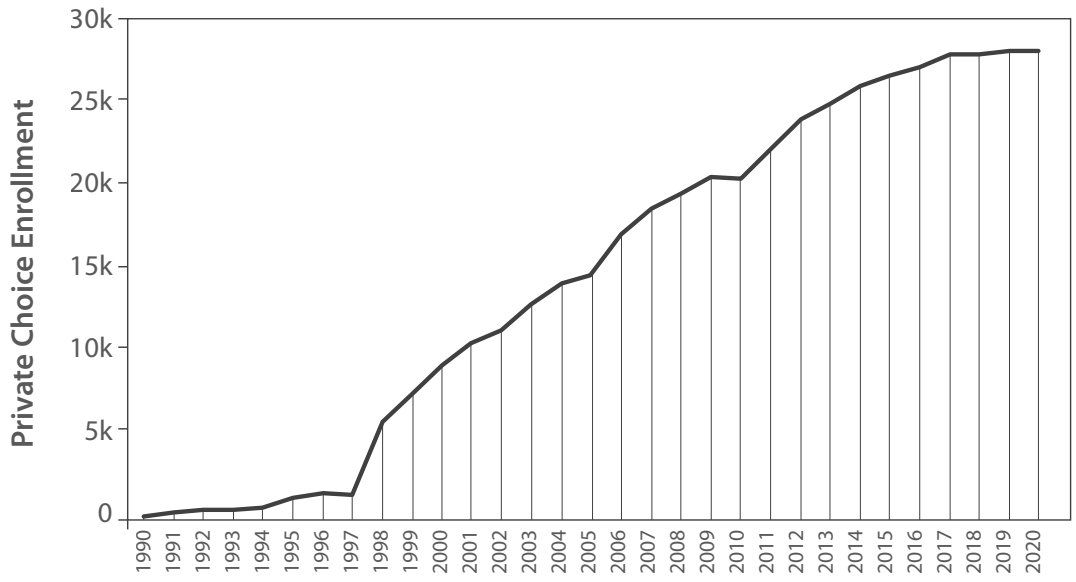
This decision, along with later moves to lift enrollment caps on the program[4] and increase income limits, led to rapid growth in the MPCP. Figure 6.1 charts the enrollment growth of the program between 1990 and 2020. From humble beginnings with just 300 students, the program has grown to serve more than 27,000 Milwaukee students in 2021. Concurrently with the decision on the constitutionality of religious school participation, the program saw the steepest increases in enrollment between 1997 and 1998.

Though enrollment growth has leveled off to some extent, it is important to highlight that the rate of growth is an impressive feat in and of itself in recent years. Since the onset of the COVID-19 pandemic, enrollment in Milwaukee public schools has declined by more than 5 percent while enrollment in the MPCP has grown slightly.[5]

The rest of Wisconsin

In recent years, efforts began to expand school choice to other areas of Wisconsin. In 2011, the Racine Parental Choice Program (RPCP) was created. As of the 2020/21 school year, the RPCP enrolls more than 3,500 students. In 2013, students statewide gained access to private school choice through the creation of the Wisconsin Parental Choice Program (WPCP). The WPCP is the most rapidly growing parental choice program in the state, having increased from serving just under 3,000 students in

Figure 6.1 MPCP Enrollment Growth, 1990–2020



Source: Kava (2007).

the 2016/17 school year to more than 11,500 students in 2021.

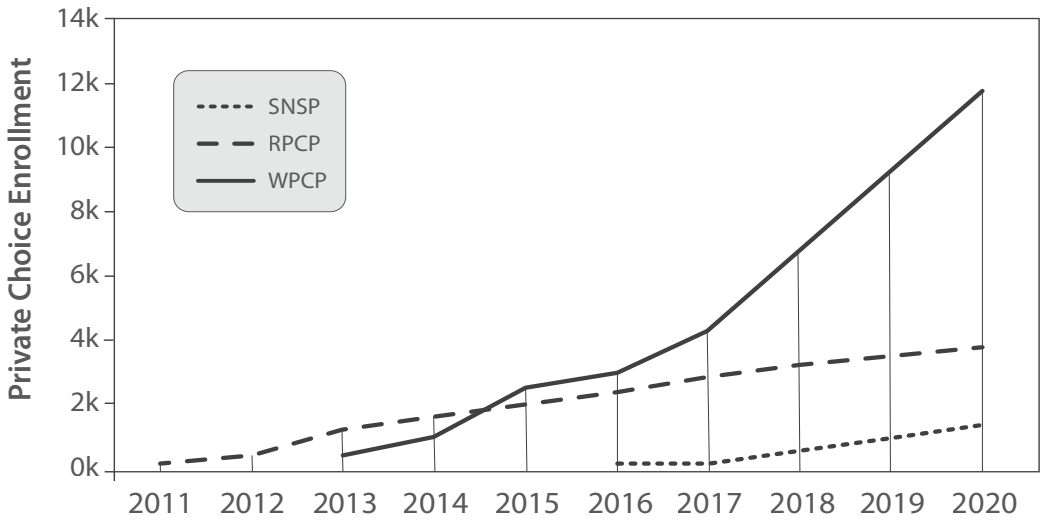
There are important differences between each of these programs in terms of eligibility. While the MPCP and RPCP have income limits of 300 percent of the federal poverty limit, the WPCP has an income limit of 220 percent. This creates an uncomfortable situation in which a child who lives in the city of Milwaukee is eligible for choice, but another child whose family has the exact same income and lives a mile away is not eligible because the family lives outside the Milwaukee city limits.

Another key difference between the programs is in the number of students who are eligible to participate on an annual basis. In Milwaukee and Racine, there is no cap on enrollment—as many students as want to attend a choice school can do so as long as there are sufficient seats to be filled. In other areas of the state, however, there is a cap on the number of seats based on the enrollment of the school district. When the WPCP began in 2015/16, only 1 percent of the total enrollment of a district could enroll in choice. Potential enrollment in each district goes up by 1 percent per year until it reaches 10 percent, at which point the enrollment caps are set to be eliminated.[6]

A final school choice program in the state important to discuss is the Special Needs Scholarship Program (SNSP). The SNSP provides a more substantial voucher to families to choose schools for the education of students with identified disabilities. Before the creation of the SNSP in 2016, voucher schools would receive the standard voucher amount for a student with a disability who wished to attend a private choice school. This would often make it challenging for the school to meet these students' needs. Students in the SNSP receive $12,977 per pupil, plus the potential for reimbursement to schools for costs above this amount.

Figure 6.2 depicts enrollment growth for each of the state's programs outside Milwaukee. As can be clearly seen, growth in the WPCP has been extensive despite enrollment caps on the program. Even during the school years interrupted by COVID-19, when enrollment in many public schools suffered, the program continued growing rapidly. Both the RPCP and the SNSP have enjoyed consistent growth as well.

Figure 6.2 WPCP, RPCP, and SNSP Enrollment over Time



Source: Pugh (2021).

Evidence of the Benefits of School Choice

Over the past three decades, a substantial body of research has been built on the benefits of school choice, both in Wisconsin and around the nation. On the whole, these findings support the notion first put forth by Milton Friedman that competition in the education marketplace can work to improve student outcomes. This section will be subdivided into several parts focused on each area of research.

In this section, I will make use of two kinds of research that warrant defining—randomized control trial (RCT) studies and observational studies. RCT studies are viewed as the "gold standard" in academic research. Much like medical trials for new drugs, RCT studies include a treatment group and a control group; experimental subjects are randomly assigned to one group or the other. RCT studies are generally preferable to observational studies because they work to overcome the problem of selection bias that is pervasive in research. In the context of school choice, this can be seen, for example, when a parent who seeks out an alternative educational option for a child also uses other means to help the child do better in school.

Another aspect of school choice worthy of explanation is the large role played by scholars at the University of Arkansas via the School Choice Demonstration Project (SCDP). In 2006, the Wisconsin Legislature wanted to conduct a comprehensive analysis of the performance outcomes of the MPCP. The legislature required the Wisconsin Department of Public Instruction to share information on the program with the SCDP. Over the next 15 years, the SCDP conducted extensive research on the MPCP. This research will serve as a source of much of the information I discuss subsequently.

Because the MPCP no longer had an enrollment cap by the time the SCDP began its research, there were not regular lotteries to determine which students did or did not get into a school. Consequently, most of the analyses by SCDP fall within the observational realm rather than qualifying as RCT studies. That said, the researchers took great pains to match students participating in the MPCP with similar students who were attending public schools so that the information collected would be comparable.

Improved test scores

The national evidence for the relationship between improved student test scores and school choice is somewhat mixed, though it tends to be positive. RCT studies have found that school choice is correlated with positive impacts on student test performance in the District of Columbia, New York, and Charlotte, North Carolina, among other places (Forster 2016).

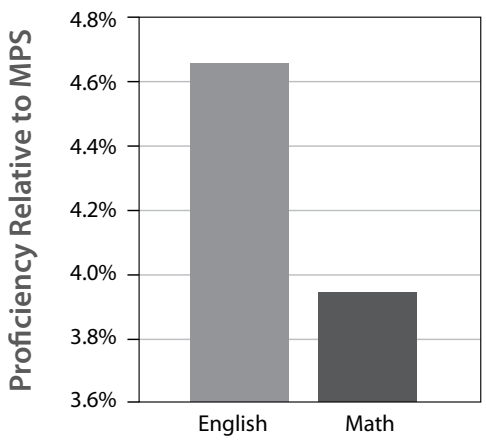
The SCDP found that students in the MPCP were often behind their peers academically in the early years of schooling but made gains by 8th and 10th grade on state standardized tests. This finding holds for both reading and science tests. Test scores for MPCP students were lower in math in some grades (Jacob and Wolf 2012).

More recently, in a series of studies (Flanders 2017, 2022) called "Apples to Apples," I evaluated the proficiency rates in MPCP schools relative to Milwaukee public schools via observational analyses. Controlling for a number of characteristics of students, including poverty, race, and English-language-learner status. These studies endeavor to put schools on a level playing field. In each year, I have found higher levels of proficiency in MPCP schools relative to Milwaukee public schools both in math and in English and language arts. Figure 6.3 depicts the results in Milwaukee for the 2022 edition of the "Apples to Apples" study in math and English.

On average, MPCP students had proficiency rates that were 4.65 percent higher in English and language arts and 3.95 percent higher in math. These differences were both statistically significant and substantively significant.

It is important to highlight that not every study has found results supporting the benefits of school choice. Indeed, two RCT studies of the Louisiana school choice program (Mills and Wolf 2016; Abdulkadiroglu et al. 2016) found that participating students did worse than their public-school peers. DeAngelis, Burk and Wolf (2018) offer one possible explanation for findings such as these, making the argument that heavy regulation of school choice programs has a chilling effect on the sort of schools that want to participate. When programs are heavily regulated, only schools that are desperate for enrollment may choose to participate. This means that many high-quality schools may not. That said, researchers are somewhat in the realm of speculation when they attempt to explain away these results, and an honest look at the data suggests that school choice, in and of itself, is not a magic elixir for improving student test performance.

Figure 6.3 Proficiency at Milwaukee Private Choice Schools Compared to Public Schools, 2019



Source: Flanders (2019).

College enrollment and graduation rates

Graduation from high school and graduation from college represent important milestones in the economic success of individuals. According to recent data from the Bureau of Labor Statistics, an individual with a high school diploma earns, on average, $154 more per week than a high school dropout.[7] An individual with a college degree earns, on average, $502 more per week than an individual with just a high school diploma. Even more so than individual test scores, school choice programs can represent a sea change to the extent that they help participants achieve these milestones.

Wolf et al. (2013) examined the impact of the District of Columbia's Opportunity Scholarship Program on high school

graduation rates in an RCT. As part of the SCDP, Cowen et al. (2012) tracked the rate of high school graduation among MPCP students and the matched sample of public-school students. In a statistical model, they found that the MPCP was related to an increase of about 4 percentage points in the likelihood of high school graduation.

With respect to college graduation, for years the evidence was more limited. This is likely because of the challenge of following students once they leave the K–12 environment. However, in recent years, this has begun to change. Chingos et al. (2019) examined effectiveness on three programs, including the MPCP. In their examination of the Florida Tax Credit Scholarship program—a program that provides funding for students to attend private schools via donations—they found that students who used the scholarship were more likely to attend college and remain in college than students in public schools. For the DC Opportunity Scholarship Program, they found no effect on college attendance or persistence.

The results for Milwaukee were more positive. MPCP students were 5 percentage points more likely than similar students in public schools to enroll in college. These students were 38 percent more likely to graduate from college than students in the public-school sample.

Character and civics

The concepts of character and civics are somewhat more nebulous and subjective than some of the other areas of school choice benefits that I have examined so far. Even though these concepts are more challenging to define and measure, they may be even more important to many families as they evaluate schools for their children.

Much of the research on character and school choice comes from the MPCP. Fleming, Mitchell, and MacNally (2014) compared the responses of students in the MPCP with those of public-school students on three domains: political tolerance, civic outcomes, and volunteerism. They found statistically significant advantages for private choice students on questions of tolerance as well as a higher likelihood that these students said they would vote in the future. They also found that MPCP students were more likely to have volunteered and to say that volunteering was important, though they did not find differences in the likelihood that students said they would volunteer as an adult.

Another approach to evaluating the role schools play in character development is to compare the life outcomes of choice participants with those of others. DeAngelis and Wolf (2020) examined the criminal records of individuals who participated in the MPCP in Milwaukee. They found that MPCP students were 53 percent less likely to have been convicted of a drug crime, 86 percent less likely to have been convicted of a property crime, and 38 percent less likely to have been involved in a paternity lawsuit.

The market effects of private school choice

With several decades of school choice under our belts, do we observe the sort of market conditions that Milton Friedman hypothesized should develop? There are a number of ways to answer this question. Several studies have examined the impact of private school choice programs on public schools, testing the notion that competition owing to choice should lead public schools to work toward improvement.

The vast majority of research in this area has found this to be the case. Of 26 studies that have investigated this topic, 24 have found a positive effect on public-school performance, 1 found a neutral effect, and 1 found a negative effect (in Florida). These effects tend to increase when the percentage of students in a district who are eligible for the private school choice program increases—likely because this further increases the district's risk of losing students.

A related question is whether families behave as do consumers of other services when it comes to educational choice. Flanders, DeAngelis and Johnson (2017) used enrollment data to see whether families were making decisions that could be tied to objective measures of school quality, such as test scores. They found that schools in the MPCP that had higher scores on the

state exam were growing more quickly than schools that had lower test scores. Their study also found that lower-performing choice schools were more likely to close or to leave the program than public schools with similar performance levels.

This helps to make the case that school turnover in private school choice programs is not necessarily a bad thing. Instead, it represents a feature of a functional market, in which alternatives that are not meeting the needs of consumers are replaced by better options.

The economic impact of private school choice

In general, the literature on the long-term benefits of education suggests that education is one of the most prominent factors in predicting an individual's lifetime earnings.

In the review of evidence above, I highlight a number of areas where Wisconsin's school choice program offers benefits that are related to these factors. DeAngelis and Flanders (2017) attempted to quantify these benefits across a number of different areas where school choice was shown to offer better outcomes. These included the economic benefits of high school graduation and the benefits of reduced commission of crimes by school choice graduates. It is estimated that, over the next 20 years, school choice will provide an economic benefit to the state of Wisconsin of nearly $500 million. This research has since been replicated for Mississippi and Tennessee and can be used as an effective counterargument to claims that school choice represents a cost to taxpayers.

Myths About Private School Choice

Private school choice represents a destabilizing force in what, for more than a century, was a government monopoly on control of public education. Because of this, many entrenched interests seek to undermine private school choice with both legitimate and illegitimate critiques. In this section, I will cover some of the major ones that routinely get brought up and explore their applicability to Wisconsin's school choice programs.

Costs

Perhaps the most commonly heard point in opposition to school choice is that it takes money away from public schools. There are two key arguments to oppose this notion, one based on the concept of free markets and another based on the reality of spending levels.

On the first point, one of the virtues of a market system is that markets work to identify quality. A consumer who is dissatisfied with the produce selection at grocery store A may choose instead to buy produce at grocery store B. This loss of revenue sends a signal to grocery store A that its managers might want to consider improving their produce selection and quality lest they lose more customers. I have already discussed the evidence that private school choice works to improve the quality of both choice schools *and* public schools, but choice opponents seem to believe that public schools should be exempt from these market forces.

The second point is that private school choice actually represents savings to Wisconsin taxpayers and leaves public school districts with more money per remaining student. Currently in Wisconsin, students enrolled in private school choice receive $8,300 in grades kindergarten through 8 and $8,946 in grades 9 through 12. As of the 2019–2021 biennial budget, the minimum funding for a public school district in the state is $10,000 per student—meaning more is spent on a student in a public school even in the lowest-spending district (DPI 2020). This means that, in the aggregate, choice students represent savings when all revenue is considered.

In addition, school districts are allowed to make up the revenue reduction that they receive when a student chooses to attend a choice school. If districts do this—by raising local property taxes—they actually end up with more money per remaining student than they had before the student left for choice (Flanders 2019). Of course, one might argue that a system whereby all the tax dollars follow the student to the student's new school would be more rational.

While the current system is arguably not a good funding system, the reality is that it invalidates any arguments about an additional public cost for choice students.

The one key exception to this is in the city of Milwaukee, where the so-called Funding Flaw did not allow Milwaukee public schools to count choice students in their enrollment (Ford 2012). This means that the MPCP currently does represent an additional cost to local Milwaukee taxpayers. That said, policy makers have recognized the existence of this flaw, and it is gradually being phased out, to be fully eliminated by 2025 (Pugh 2021).

"Creaming" the best kids

A second common complaint is that any performance advantage of the state's choice programs is simply due to these schools only selecting (or "creaming") the best students. In reality, this sort of process is not possible under state law. Choice-participating schools must take all applicants. If an excessive number of students apply to a particular school, a lottery must be held for admission. The only exceptions to this rule are for the siblings of students already attending the school or for students who attended a different private school in the program during the previous year.[8]

Others point to a lower rate of students with disabilities in choice programs as evidence of creaming. Indeed, it is likely that disability rates are lower in the choice program than in traditional public schools. Private schools may simply not have the means to adequately meet the needs of particular disabled students, notably those with severe disabilities. However, the degree of difference between private choice and public schools on this question is likely exaggerated by existing data.

As part of the SCDP, Wolf, Witte, and Fleming (2012) attempted to identify a more accurate count of the number of students with disabilities participating in school choice. They found that because choice schools lack federal financial incentives to identify students as disabled, reported rates of disability are far lower than they might be if the same students attended traditional public schools. They estimate that between 8 and 14 percent of students in the MPCP have some form of disability, compared to approximately 19 percent in Milwaukee public schools. While this gap is still meaningful, the rate found by Wolf, Witte, and Fleming (2012) is nonetheless far higher than the 1.6 percent of choice students reported to have a disability by the Department of Public Instruction at the time.

The creation of the SNSP may have worked to further close this gap, but new research with student-level data would be needed to make this determination.

Private choice schools are unaccountable

Private schools are often seen as "unaccountable" since they are not subject to the regulation as public schools. In reality, however, voucher schools arguably face the same level of accountability as traditional schools from the source with the greatest interest in their performance: parents and families. As discussed earlier, families gravitate toward the schools that meet their needs best; those that do not perform well tend to shut down over time. This is less the case in traditional public education because public schools effectively have a captive base of consumers in the students who are zoned for the school.

Beyond parental accountability, participating schools in Wisconsin are subject to a level of accountability that has previously caused the school choice program here to be called the most regulated program in the nation (Stuit and Doan 2013). Choice programs in Wisconsin face a laundry list of regulations that include financial audits, a requirement to maintain accreditation, and a requirement that a school submit a proposed budget before opening. Failure to comply with these—and other—requirements can result in the removal of a school from the program (Flanders, DeAngelis, and Johnson 2017). Indeed, the argument that the programs are overregulated holds far more water than claims that they are not regulated sufficiently.

Other Forms of School Choice

Charter schools

Charter schools are public schools whose operation is contracted to actors outside the school district. Charter schools in Wisconsin were first authorized by the legislature in 1993, and the first school opened in Stevens Point in 1994. In 1995, the legislature removed a cap on the number of charter schools and their expansion began in earnest (Eagleburger 2009).

Wisconsin offers three types of charter schools that differ on the basis of whom they are authorized by: independent charters, non-instrumentality charters, and instrumentality charters.

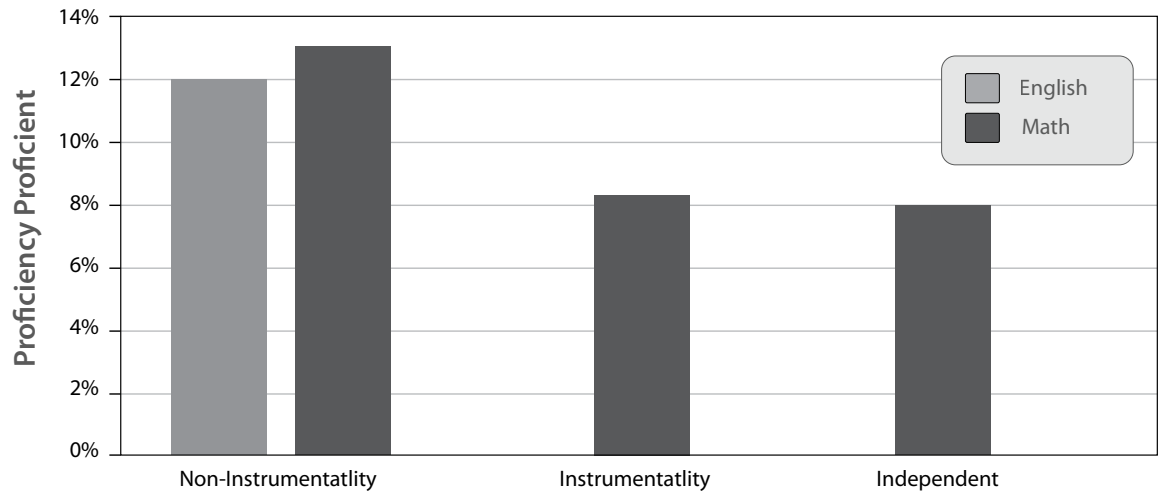
Independent charter schools can be authorized by a number of institutions according to state law. The institutions that currently authorize such schools are University of Wisconsin System schools, the Office of Educational Opportunity, and the City of Milwaukee. As of 2020, 9,126 students are enrolled in independent charters throughout the state (Kava 2021a).

Non-instrumentality charter schools are authorized by the school district but are afforded a degree of independence from school district mandates. For instance, these schools differ in terms of the curriculum being taught and have generally not had a unionized teaching workforce. Instrumentality charters, on the other hand, have often been referred to as "charters in name only." They are subject to many of the same regulations as traditional public schools and have unionized teachers. It is difficult to tease out which charters are instrumentalities and which are non-instrumentalities without delving into the individual school contracts. But statewide, about 35,077 students attend these two types of charters.

Charter schools routinely outperform traditional public schools in academics. Figure 6.4 shows proficiency rates in the city of Milwaukee, where a large share of charter schools in the state are located, between charter and traditional public schools (Flanders 2022).

All three types of charters showed a performance advantage in at least one of the two subjects. The performance advantage of non-instrumentality charters across both math and English was the largest observed in any of the school choice sectors considered in this chapter. In these schools, students performed more than 12 percent better in English and more than 13 percent better in math than students in traditional public schools on average. Students of both instrumentality charters and independent charters showed approximately 8 percent

Figure 6.4 **Proficiency Advantage for Milwaukee Charter Schools, 2019**



Note: *Only statistically significant differences are shown.*

higher proficiency in math, while no significant differences were observed in their proficiency in English. (In previous iterations of this report, an advantage in English was found for independent charters.)

Similar to private school choice programs, charter schools are funded at a lower level than traditional public schools. For the 2020/21 school year, independent charters received $9,165 per pupil (Kava 2021a). District charters make their own contracts with the district, but most are set on the basis of the independent charter amount. Given the performance advantage seen above, this leads to a greater "bang for the buck" for taxpayers from charter schools relative to other public schools. DeAngelis (2020) found that independent charter schools were 29 percent more cost effective than traditional public schools in Wisconsin. Flanders (2017) found that a higher degree of independence from the district for charters led to higher levels of cost effectiveness.

Open enrollment

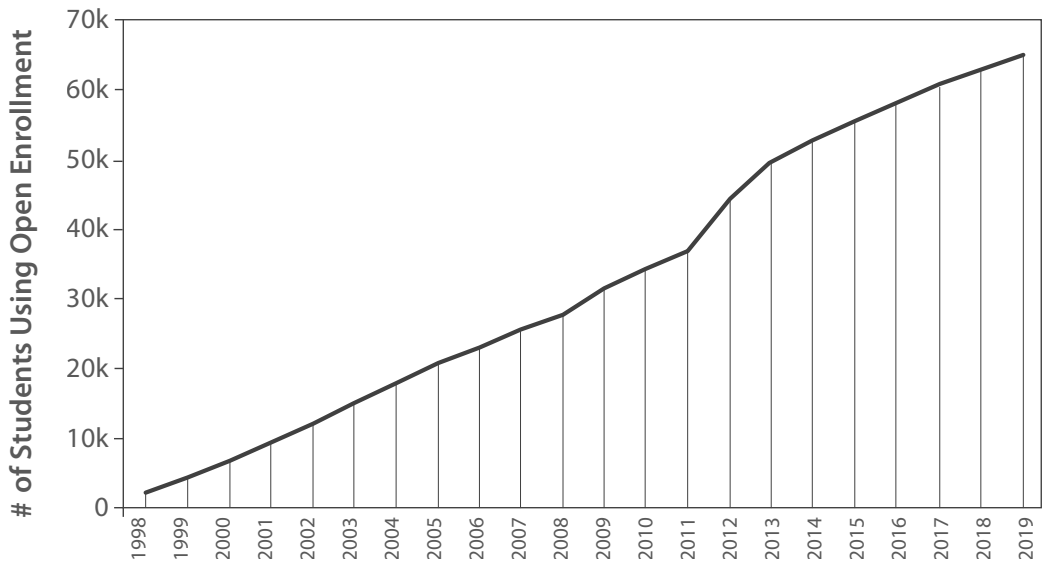
Open enrollment allows public-school students to move from one district to another so long as the desired district has space available. The program began in the 1998/99 school year with 2,464 participants. Since that time, it has grown to become the largest school choice program in the state, with more than 65,000 participants by the 2020/21 school year (Kava 2021a). Figure 11.5 charts this growth over time.

Flanders and Holmberg (2021) conducted a broad analysis of the state's open enrollment programs to evaluate what drove families to particular school districts. Similar to what has been found regarding the drivers of enrollment in private school choice, the analysis found that the net "winners" in open enrollment are districts that have higher proficiency rates. Students also leave lower-income districts to enroll into districts with higher incomes on average.

Tuition tax credit

Beginning in 2014 under Governor Scott Walker, a tax credit for tuition expenses on private education has been available to all Wisconsin families. In recognition of the reality that paying for private school is a challenge even for those above the income limits for the state's school choice programs, the credit allows families to deduct up to $4,000 for grades K–8 and $12,000 for grades 9–12 from their state income tax. According to a 2019 analysis, 33,900 families took advantage of the credit for savings of more

Figure 6.5 **Open Enrollment Growth, 1998–2019**



than $5,000 on average.[9]

Future of School Choice in Wisconsin

Though Wisconsin has come further down the road of educational choice than many other states, much work is still needed to fully realize Friedman's vision. Here, I describe five key areas for further reform that will ensure that educational choice in Wisconsin continues to flourish in the coming decades.

1) Remove income limits

Friedman's vision was for universal school choice—available to families of all income levels. While some might find the notion of providing a subsidy to families of means to be a bit distasteful, recall that the original vision for school choice is for money that is already being spent enabling a child to attend public school to be spent enabling that child to attend a private school instead—so there would not be an additional cost.

Currently in Wisconsin, all school choice programs have income limits. As mentioned earlier, even greater unfairness is created by having different income limits depending on which school choice program a child is eligible for. At minimum, policy makers should work to equalize income limits across the programs, with the ultimate goal of removing such limits entirely.

2) Move toward student-centered funding

Another key issue involves the variations in funding that exist between private school choice, charter schools, and traditional public schools. As noted earlier, even the lowest-funded public school district in the state currently receives more funding per student than any choice or charter school. Policy makers should work to equalize funding across schools so that individual students receive the same amount of funding whether they attend school at their zoned local school or at the parochial school across the street.

Flanders (2021a) provided a road map for moving to a more student-centered funding model. The high level of dependence on property taxes in Wisconsin, which are constitutionally required to be spent within the school district, makes a full realization of student-centered funding a challenge. However, an incremental step along the path toward student-centered funding would be to mandate that public, charter, open enrollment, and private schools within the boundaries of a local school district receive equal levels of funding.

3) Remove institutional barriers to choice

DeAngelis, Burke and Wolf (2018) find that heavy regulation of school voucher programs decreases the extent to which high-quality schools participate in them. This makes intuitive sense: when the requirements for a school to participate in a choice program are too onerous, only the schools that are the most desperate for students will agree to abide by them. The authors also find that heavy regulation of choice programs leads to a homogenization of the types of learning offered by private schools, effectively reducing the educational variety that is a key feature of such programs (DeAngelis and Burke 2017).

Unfortunately, Wisconsin often finds itself among the ranks of the states with the most heavily regulated programs (Stuit and Doan 2013). From short enrollment windows that are difficult for parents to meet to the need to collect paperwork from students' families to prove they are low-income enough to participate, private schools take on a lot of bureaucratic headaches when they begin to accept students from the state's parental choice programs.

There are, admittedly, positive aspects to the current regulatory environment. When policy makers can provide a laundry list of regulations that choice schools are subject to, this can offer an effective counter to the argument routinely made by school choice opponents that the state's programs are "unaccountable."[10] That said, as we look to make school options more accessible to families statewide, the need to encourage participation by high-quality schools likely outweighs the benefits of the talking points

here.

4) Improve the environment for charter schools

While Wisconsin allows several types of authorizers for charter schools, only a handful of these government entities actually choose to authorize. For example, out of 421 school districts, only 48 percent of districts contract with instrumentality and non-instrumentality charter schools. Similarly, all University of Wisconsin campuses and technical colleges have the authority to authorize, but only three actually do.

The state needs to be thoughtful about identifying governmental entities to authorize, it needs to attract national high-quality charter schools, and it needs to encourage local leaders to open more charter schools. Models to consider include Arizona State University preparatory academies, Purdue University's Purdue Polytechnic High School, and Central Michigan University Center for Charter Schools. These models are successful because they maximize resources and provide a pipeline of educational options. The state must play a role in these partnerships because the politics of charter schools continues to dominate institutions of higher education and local school districts.

5) Move toward education savings accounts

While Wisconsin has long been a leader in offering educational choice, an important limitation on choice is the availability of high-quality local options for students to move to. Particularly in rural areas of the state, students may lack such options. In such situations, a type of school choice that allows students to supplement classes that are available online with some distance learning options, or even take classes in a fully virtual environment, can be particularly useful. Education savings accounts (ESAs) provide one means of achieving this.

ESAs cut out the school as the middleman in accessing school choice. Instead, funds are provided directly to parents for use on approved education expenses. Besides supplemental classes for rural students, these could include access to tutoring services, the purchase of needed classroom supplies, or transportation. Because voucher schools in Wisconsin are already funded less than their public-school peers, a move toward funding equity must occur before the move toward ESAs—because polling shows that private schools would be likely to reduce seats if the current voucher amount were able to be split between multiple providers. That said, ESAs must be part of the long-term vision for school choice in the state.

Conclusions

The future success of Wisconsin, and the United States at large, depends on creating a workforce that is ready for the high-demand jobs of the future. These jobs may be less dependent on a college degree than the jobs of the past, but they are likely to be even more dependent on the development of highly specialized skills. The traditional, "one-size-fits-all" model of the public education monopoly is ill equipped to prepare students for this world. To meet the demands of the future, Wisconsin must continue to embrace educational choice that matches students to their passions and to the needs of employers.

Wisconsin already has a head start in the race to craft such a future. From humble beginnings in the early 1990s, the Milwaukee Parental Choice Program has grown to serve as a model for what can be accomplished when a bipartisan coalition of education reformers is willing to think outside the box. In the wake of this accomplishment, other important reforms such as open enrollment, charter schools, and statewide private school choice have been enacted. Yet, both in Milwaukee and around the state, work needs to be done to ensure that all students, regardless of where they call home, have access to the educational environment that will work best for them.

Notes

[1] Research director, Wisconsin Institute for Law & Liberty. The views expressed in this chapter are my own.

[2] Rogers Worthington, "Black School District Urged in Milwaukee," *Chicago Tribune*, September 3, 1987, https://www.chicagotribune.com/news/ct-xpm-1987-09-03-8703070111-story.html.

[3] Judith S. Lohman, "Wisconsin Supreme Court School Voucher Decision," OLR Research Report, October 10, 2003, https://www.cga.ct.gov/PS98/rpt%5Colr%5Chtm/98-R-0821.htm.

[4] "History: School Choice in Wisconsin," School Choice Wisconsin, accessed November 9, 2022, https://schoolchoicewi.org/school-choice-history-timeline/.

[5] WISEdash Public Portal, "Enrollment Trends," Wisconsin Department of Public Instruction, accessed November 9, 2022, https://wisedash.dpi.wi.gov/Dashboard/dashboard/20060.

[6] "Wisconsin Parental Choice Program," School Choice Wisconsin, accessed November 9, 2022, https://schoolchoicewi.org/wisconsin-parental-choice-program/.

[7] "Learn More, Earn More: Education Leads to Higher Wages, Lower Unemployment," US Bureau of Labor Statistics, May 2020, https://www.bls.gov/careeroutlook/2020/data-on-display/education-pays.htm.

[8] Wis. Stat. § 19.23(3a).

[9] "K–12 Private School Tuition Deduction," EdChoice, accessed November 11, 2022, https://www.edchoice.org/school-choice/programs/wisconsin-k-12-private-school-tuition-deduction/.

[10] Jon Erpenbach, "Taxpayers Bear the Costs of Unaccountable Choice Programs," website of Jon Erpenbach, Wisconsin State Senator—District 27, accessed November 9, 2022, https://legis.wisconsin.gov/senate/27/erpenbach/news/columns/taxpayers-bear-the-costs-of-unaccountable-choice-programs/.

References

Abdulkadiroglu, Atila. Parag A. Pathak & Christopher R.Walters. 2016. "Free to Choose: Can School Choice Reduce Student Achievement?" NBER Working Paper. https://www.nber.org/papers/w21839

American Federation for Children. 2023. School Choice Programs Near You." Website, March 10, 2023. https://www.federationforchildren.org/state-programs/

Chingos, Matthew M., Daniel Kuehn, Tomas Monarrez, Patrick J. Wolf, John F. Witte, and Brian Kisida. 2019. "The Effects of Means-Tested Private School Choice Programs on College Enrollment and Graduation." Research Report, Urban Institute, Washington, DC, July 2019. https://www.urban.org/research/publication/effects-means-tested-private-school-choice-programs-college-enrollment-and-graduation.

Cowen, Joshua M., David Fleming, John Witte, Patrick Wolf and Brian Kisida. "Student Attainment and the Milwaukee Parental Choice Program: Final Follow-up Analysis." University of Arkansas Department of Education Reform, February 1, 2012. https://scholarworks.uark.edu/scdp/76/

DeAngelis, Corey A. 2020. "The Cost-Effectiveness of Public and Private Schools of Choice in Wisconsin." *Journal of School Choice* 15 (2): 225–47.

DeAngelis, Corey A., and Lindsey M. Burke. 2017. "Does Regulation Induce Homogenization? An Analysis of Three Voucher Programs in the United States." EDRE Working Paper 2017-14, University of Arkansas Department of Education Reform, September 5, 2017. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3038201.

DeAngelis, Corey A., Lindsey M. Burke, and Patrick J. Wolf. 2018. "The Effect of Regulations on Private School Choice Program Participation: Experimental Evidence from Florida." EDRE Working Paper 2018-18, University of Arkansas Department of Education Reform, October 22, 2018. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3273428.

DeAngelis, Corey A., and Patrick Wolf. 2020. "Private School Choice and Character: More Evidence from Milwaukee." *Journal of Private Enterprise* 35 (3): 13-48

DPI (Department of Public Instruction). 2020. "DPI Releases Fall Student Count and Revenue Limit Information." News release, DPI-NR 2020-67, October 15, 2020. https://dpi.wi.gov/news/releases/2020/dpi-releases-fall-student-count-and-revenue-limit-information.

Eagleburger, Scott. 2009. "Statutory Report Series: Legislative Report on Charter Schools 2013–14." Wisconsin Department of Public Instruction.

Flanders, Will. 2017. "Bang for the Buck: Autonomy and Charter School Efficiency in Milwaukee." *Journal of School Choice* 11 (2): 282–97.

Flanders, Will. 2019. *Truth in Spending: An Analysis of K–12 Public School Spending in Wisconsin*. Report, Wisconsin Institute for Law & Liberty, March 2019. https://will-law.org/wp-content/uploads/2020/12/will-truth_in_spending_web.pdf.

Flanders, Will. 2021a. *Fund Every Kid: Reforming Wisconsin's School Funding Formula*. Milwaukee: Wisconsin Institute for Law & Liberty, July 2021. https://will-law.org/wp-content/uploads/2021/07/FundEveryKidv101.pdf.

Flanders, Will. 2022. "Apples to Apples IV." Wisconsin Institute for Law & Liberty Policy Report, March 2022. https://will-law.org/wp content/uploads/2022/05/ApplestoApplesII.pdf

Flanders, Will, Corey A. DeAngelis, and Morgan Johnson. 2017. "Accountability in Action: The Impact of Fiscal Accountability and Parental Choice on the Milwaukee Parental Choice Program." School Choice Wisconsin and Wisconsin Institute for Law & Liberty, August 2017. https://schoolchoicewi.org/wp-content/uploads/2021/06/Accountability-Report.pdf.

Flanders, Will, and Jessica Holmberg. 2021. "Public School Choice in Wisconsin: A Work in Progress." Milwaukee: Wisconsin Institute for Law & Liberty, January 2021. https://will-law.org/wp-content/uploads/2021/01/publicschoolchoicev7.pdf.

Fleming, David J., William Mitchell, and Michael McNally. 2014. "Can Markets Make Citizens? School Vouchers, Political Tolerance, and Civic Engagement." *Journal of School Choice* 8 (2): 213–36. https://doi.org/10.1080/15582159.2014.905397.

Ford, Michael. 2013. "Understanding School Finance in Wisconsin: A Primer." Milwaukee: Badger Institute. https://www.badgerinstitute.org/wp-content/uploads/2022/08/schoolfinanceprimerfinalpdf.pdf

Friedman, Milton. 1955. "The Role of Government in Education." http://la.utexas.edu/users/hcleaver/330T/350kPEEFriedmanRoleOfGovttable.pdf.

Jacob, Anna M., and Patrick J. Wolf. 2012. Milwaukee Longitudinal School Choice Evaluation: Annual School Testing Summary Report, 2010–11. Report #32, School Choice Demonstration Project, Fayetteville, AR, February 2012. https://cpb-us-e1.wpmucdn.com/wordpressua.uark.edu/dist/9/544/files/2018/10/report-32-milwuakee-longitudinal-school-choice-evaluation-annual-school-testing-summary-report-2010-11-2auz99h.pdf.

Kava, Russ. 2007. "Milwaukee Parental Choice Program." Informational Paper 29. Madison, WI: Wisconsin Legislative Fiscal Bureau, January 2007. https://docs.legis.wisconsin.gov/misc/lfb/informational_papers/january_2007/0029_milwaukee_parental_choice_program_informational_paper_29.pdf.

Kava, Russ. 2021a. "Charter Schools." Informational Paper 30. Madison, WI: Wisconsin Legislative Fiscal Bureau, January 2021. https://docs.legis.wisconsin.gov/misc/lfb/informational_papers/january_2021/0030_charter_schools_informational_paper_30.pdf.

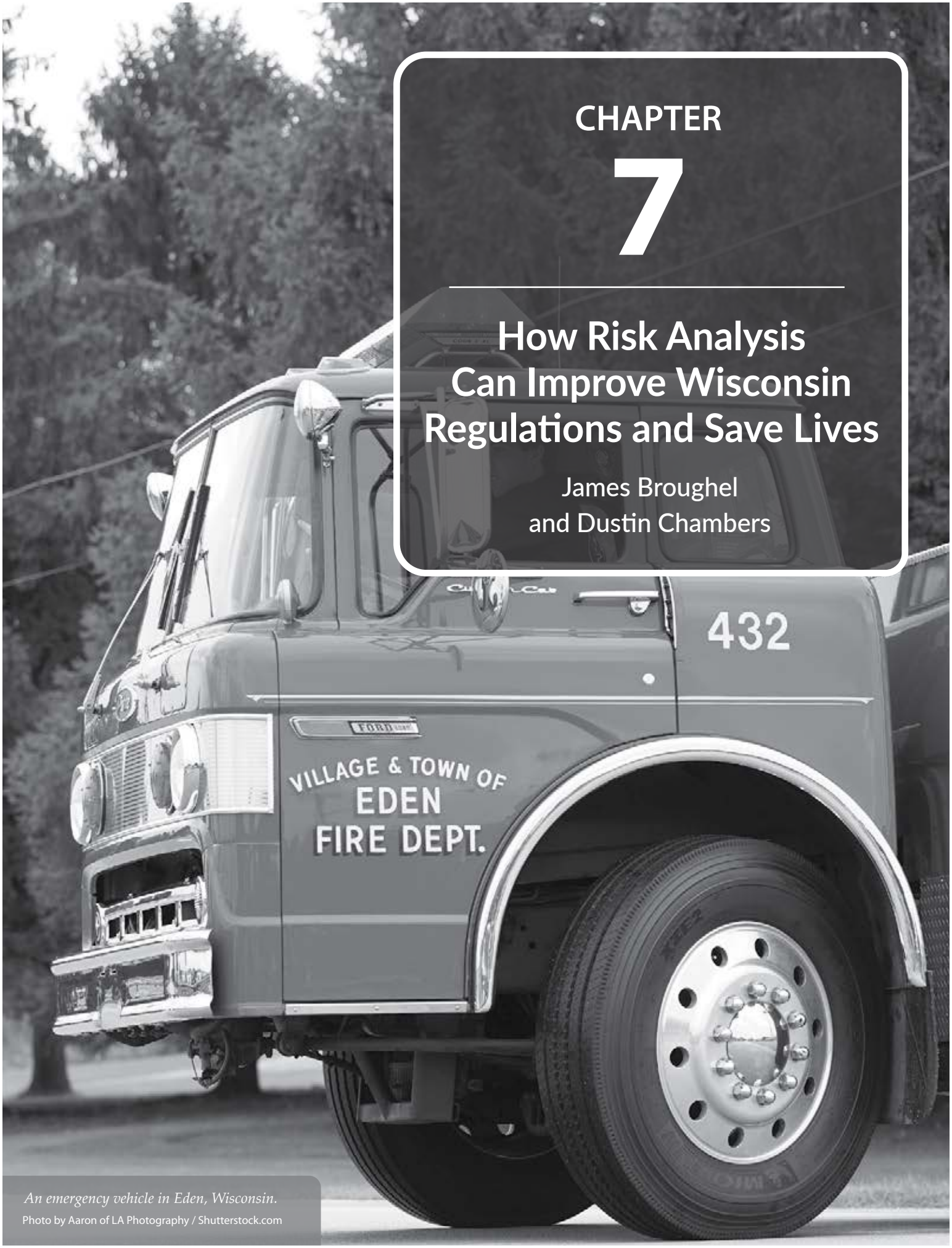
Kava, Russ. 2021b. "Open Enrollment Program." Informational Paper 29. Madison, WI: Wisconsin Legislative Fiscal Bureau, January 2021. https://docs.legis.wisconsin.gov/misc/lfb/informational_papers/january_2021/0029_open_enrollment_program_informational_paper_29.pdf.

Pugh, Christa. "Private School Choice and Special Needs Scholarship Programs." Informational Paper 28. Madison, WI: Wisconsin Legislative Fiscal Bureau, January 2021. https://docs.legis.wisconsin.gov/misc/lfb/informational_papers/january_2021/0028_private_school_choice_and_special_needs_scholarship_programs_informational_paper_28.pdf

Stuit, David, and Sy Doan. 2013. *School Choice Regulations: Red Tape or Red Herring?* Thomas B. Fordham Institute, January 2013. https://fordhaminstitute.org/national/research/school-choice-regulations-red-tape-or-red-herring.

Witte, John F., and Patrick J. Wolf. n.d. "The Wisconsin Role in the School Choice Movement." Tommy @ 30 Project. Accessed November 9, 2022. https://urbanmilwaukee.com/wp-content/uploads/2017/05/The-Wisconsin-Role-in-the-School-Choice-Movement.pdf.

Wolf, Patrick J., John Witte F., and David J. Fleming. 2012. "When Rights, Incentives, and Institutions All Clash: The Case of School Vouchers and Special Education in Milwaukee." Education Reform Faculty and Graduate Student Publications.



CHAPTER

7

How Risk Analysis Can Improve Wisconsin Regulations and Save Lives

James Broughel
and Dustin Chambers

An emergency vehicle in Eden, Wisconsin.
Photo by Aaron of LA Photography / Shutterstock.com

7 How Risk Analysis Can Improve Wisconsin Regulations and Save Lives

Each morning when we wake up, we face a plethora of risks in the day ahead. These may include the risk of getting into a car accident on the way to work, the risk of catching COVID-19 from our coworkers, and the risk of contracting heart disease from eating poorly or not exercising. Although risks are usually thought to be associated with harms (which is primarily how they will be discussed in the context of this chapter), some risks can be beneficial. When we buy a lottery ticket there is a risk we might win. There is a risk of meeting our future spouse when we walk into a nightclub, a risk of landing our dream job after we submit an employment application.

The reason policy makers care about risks is that a responsibility of public policy is to prevent harms of various kinds. However, no harm will occur with certainty. There may be only a small chance of an asteroid hitting the earth, but the results would be catastrophic. By contrast, there is a high probability that a citizen will experience a mosquito bite this year; however, the harm from this event is minuscule. How should policy makers react to such a divergence in risks?

What these events have in common is they combine an outcome with an associated probability. For example, there might be a 1 percent chance of developing cancer from walking onto a radioactive waste site with no protective equipment. Or there could be a one-in-a-million chance of being hit by lighting during a thunderstorm. In each case, the overall level of risk depends both on the likelihood some event will occur (the probability) and on the consequences of the event itself. These consequences can be very significant, as with death, or they can be trivial, as with the mosquito bite.

Policy makers should be deliberate when assessing risks for the simple reason that there are opportunity costs to using public funds. Spending money to mitigate the risk of children drowning in swimming pools means fewer resources are available to devote to fire prevention. The result is that the overall level of risk may be higher than it could be, given the current allotment of public resources. In other words, optimizing the government's risk mitigation strategy (and allocating the current level of funding accordingly) could lead to a reduction in the risk faced by the community with no additional funds spent. However, without careful analysis, it is usually not obvious how resources should be spent, which is why risk analysis is critical to the efficient implementation of risk policy.

In determining how much risk to take on, a person must consider a number of factors, including but not limited to the specific *target* risk being addressed. For example, let's say someone is concerned about the risk of dying in a car accident. One could reduce risk substantially by sitting at home all day rather than driving to work. A salesperson who spends most of the day on the telephone might be able to perform this job from almost anywhere, so the option to telework might be available, making this risk-reduction strategy more palatable. On the other hand, a plumber doesn't have this luxury. In choosing the stay home, the plumber forgoes a considerable amount of income. As we will see, forgoing income results in elevated *substitute* risks of various kinds.

Risks that increase when another risk falls are called "countervailing risks," and in some cases these can even be large enough to offset the risk that is directly being reduced by policy (the "target risk"). By choosing to stay home rather than drive to work, the plumber described above has reduced the chance of dying in a car accident. But by forgoing income, the plumber might have to cut back on a monthly gym membership or make cheaper and less healthful eating choices. These behavioral changes could increase risks associated with poor health.

Even the example of the teleworking salesperson presents tradeoffs, since social isolation might increase the risk of depression. Some people might opt to drive to work in spite of having the option to telework, simply because they prefer to chat

with coworkers in the coffee room or to see their colleagues face to face in meetings. For both the salesperson and the plumber, staying at home is not costless, including in terms of accepting countervailing risks.

Public policy makers have it even harder because they must make decisions about risk for an entire community. The state of Wisconsin has annual expenditures of roughly $60 billion (Urban Institute 2022). Some of these funds are spent to reduce residents' risks. Spending on police departments reduces the risk that certain crimes will occur, such as robberies or vandalism. Spending on hospitals reduces the risk of a child dying after accidentally drinking poisonous chemicals. Spending on free or subsidized school lunches reduces the risk of malnutrition. And so on. Since public funds are not unlimited, public policy makers must make tough decisions and set priorities about which risks to mitigate.

Directing spending toward the largest risks is not necessarily an optimal strategy either. There is a 100 percent chance that every person on this planet will die at some point. Consequently, this risk presents us with a very high-impact outcome (death) and a high likelihood of it occurring (100 percent). But that does not mean that all of our resources should be spent on the development of antiaging drugs or artificial hearts and brains. After all, such drugs and technologies might not be very effective, so we might not get a high return on investment. Relatedly, if we only have a limited amount to spend on risk reduction, we might save more lives by directing scarce resources toward other purposes. For example, spending a few million dollars on additional traffic lights might save more lives than devoting the same resources toward antiaging research that has little chance of working.

Another important concept policy makers should consider is what economists call "diminishing marginal returns." Even if traffic lights are very effective at preventing deaths, it wouldn't make sense to have them at every street corner. At some point we don't want more traffic lights. The cost of lights becomes prohibitively expensive because the lights slow down the flow of traffic and increase travel times, which causes other problems. At some point, even high-payoff risk reduction efforts start producing lower returns, so it makes sense to spend on other priorities—perhaps higher-visibility crosswalks.

This is where risk analysis comes in. Risk analysis is a tool that analysts can use to assess the magnitude of risks for the purposes of making the kinds of comparisons just described. The purpose of this chapter is to explain to policy makers what risk analysis is and how it can be used to inform policy in Wisconsin, and also to walk through how that analysis is produced, including how to avoid some common pitfalls. We will focus primarily on mortality risks—that is, the risk of death—since these risks tend to be the largest and most significant risks that individuals and policy makers are concerned with. However, it is worth noting that the principles described in this chapter can be applied to other risks as well.

We begin our chapter with a review of the literature on "mortality risk analysis," explaining how the analysis of mortality risks has gained acceptance over time. This acceptance, however, has come primarily from the academic community, because most governments around the world still do a poor job analyzing risks. We therefore proceed with some step-by-step instructions that policy makers can follow in order to assess risks.

An important tool for deciding how to deal with risks is "cost-effectiveness analysis," which is used to evaluate how much it costs to achieve a particular change in outcomes. For example, an analyst might estimate the cost-per-life-saved of various policy alternatives and then see which one saves the most lives for the least cost. In order to perform cost-effectiveness analysis prudently, one needs to estimate the opportunity costs of funds that are to be devoted to implementing a regulation or other policy. These opportunity costs include how funds might be used to reduce risks in the absence of the policy. Calculating opportunity cost sounds hard to do, but

there are sound conceptual ways to do it. With such information in hand, regulators and other policy makers can make more effective decisions that save both money and lives.

Our chapter concludes by examining several recent Wisconsin regulations for which regulators have produced an economic impact analysis. We demonstrate how key values from this kind of analysis can be used to determine whether a regulation actually increases or reduces mortality risks. Fortunately, a cost estimate is often all that is needed to make a preliminary assessment of a regulation's impact on mortality risk. Since Wisconsin regulators don't appear to be considering these outcomes at present, there is an opportunity for tools like risk analysis to be incorporated into the Wisconsin policy making process. Moreover, the analysis recommended in this chapter is fairly easy to conduct, so the state could perform this kind of analysis on a modest budget, so long as analysts are adequately trained.

All told, there are many opportunities available to Wisconsin policy makers (as well as to policy makers in other states) to make their regulatory system more evidence-based and rational from a risk perspective. This chapter offers an accessible explanation of how to do it.

Risk-Risk Tradeoffs

The academic literature on the mortality costs of policy expenditures chiefly traces back to the scholarship of Aaron Wildavsky, a political scientist at the University of California, Berkeley, who famously coined the phrase "richer is safer" (1981). Wildavsky's argument was that wealth is the primary means by which society combats risk. With fewer resources, fewer risks can be addressed and with more resources, more risks can be addressed. Hence, richer is safer. This theoretical argument has been borne out in the data as well. At the individual level, richer individuals tend to live longer (Chetty et al. 2016). The finding extends to the national level: richer countries overcome many of the risks that plague developing countries, such as malaria (Pritchett and Summers 1996).[1]

Since having more resources means one is able to combat more risks, it is easy to see how this logic also applies in reverse when resources are taken from people. That is to say, when individuals' incomes are lowered, they have fewer resources to devote to risk reduction, and hence they are likely to see some risks increase in their lives. A classic example involves job loss. If a person is living on the margins and barely making rent, losing a job might compel a move to a worse neighborhood with more crime and lower-performing schools, which in turn might result in short-run dangers while also having long-lasting impacts on the person's children. It is easy to see why low-income families are more susceptible to the kinds of risk increases that accompany a decline in income (Thomas 2019).

The association between income and health contributes to what economists call "risk-risk tradeoffs," or the idea that when one risk is reduced, another risk might be increased at the same time (Graham and Wiener 1995). For example, taking a Tylenol might reduce the risk of a headache while simultaneously increasing the risk of a stomachache. In the context of income and health, spending money to reduce risks through public programs can increase risk as citizens are taxed to pay for the risk mitigation measures.

Risk-risk tradeoffs are commonplace. One recent study that analyzed Germany's policy of phasing out its nuclear power plants found that reducing the risk of a Fukushima-style meltdown by closing nuclear power plants resulted in increased coal-fired power plant emissions, thereby raising risks associated with air pollution (Jarvis, Deschenes, and Jha 2019). Here we see an example of a countervailing risk (air pollution) increasing in lockstep with the reduction of a target risk (nuclear power plant meltdown). It is also possible for "coincident risk" reductions to occur, whereby a risk falls in tandem with target risk reductions. For example, exercising frequently at the gym might reduce the risk of a heart attack and the risk of a stroke at the same time.

Many risk-risk tradeoffs are unique to the circumstances involved with a particular public policy action. For example, not every policy is going to lead to more coal-fired power plant emissions, as was the case with the German nuclear policy. However, there are some risk-risk tradeoffs that are more general, such as those related to income losses. All public policies cost resources to varying extents, and consuming resources for one purpose means those resources can't be utilized for other purposes. The corresponding loss of private income owing to the taxing and spending of resources to support public policies increases some private risks, since reducing household incomes limits individuals' ability to mitigate risks using their own resources.

Cost-Effectiveness Analysis and Mortality Risk Analysis

In the early 1990s, economists and risk analysts began estimating the extent of the income-safety relationship using real-world data. One such scholar was a decision scientist named Ralph Keeney. Relying on the correlation between income and mortality, Keeney published a paper that argued that when a $5 million cost is spread across American society, this will likely produce one additional death due to the income-loss effect (Keeney 1990). This $5 million number is known as the "value of an induced death," or VOID.

Keeney's paper was fairly primitive and suffered from some statistical problems, which were quickly pointed out by critics (Sinsheimer 1991). As a result, future studies improved on Keeney's model by better controlling for variables that might correlate with income and also have an influence on mortality, thereby leading to improved estimates of the effect that a loss of income has on mortality.

One recent study we wrote (Broughel and Chambers 2022) found that for every $38.6 million in lost income among Americans, one death can be expected. Newer studies like ours do not completely overcome the statistical problems identified by Keeney's critics, but they do a much better job. Moreover, a separate line of research relying on theoretical models (rather than correlations in data) has also been developed to explain the income-mortality relationship. These models yield somewhat higher VOID estimates and are also useful. For example, a recent study by one of us and a coauthor (Broughel and Viscusi 2021) estimated that the VOID was closer to $108.6 million. Thus, it is reasonable to conclude that the average VOID for the United States lies somewhere between these two recent estimates, perhaps near the midpoint of these values (if one gives each estimate equal weight), which is $73.6 million. For the purposes of this chapter, we will use a VOID of $75 million.

An interesting use of the VOID concept is that it can be paired with cost-effectiveness analysis to determine whether a policy increases or reduces mortality on balance. As noted earlier, cost-effectiveness analysis estimates the cost per unit of the result desired. If the policy goal is to save lives, a cost-effectiveness analysis will estimate the cost to save one life. Therefore, a policy that costs $100 million and saves 100 lives would have a cost effectiveness of $1 million per life saved. This kind of information can be used to determine which policy among several saves the most lives for a given level of spending. For example, if one policy has a cost effectiveness of $10,000 per life saved and another a cost effectiveness of $1 million per life saved, spending on the first policy is often better because devoting a given amount of resources toward it saves more lives. (In this case $1 million could save 100 lives with the first policy but just one life with the second.)

Former Office of Management and Budget analyst John Morrall published an article in 1986 highlighting how a suite of lifesaving regulations from the federal government ranged in their cost effectiveness from $100,000 to $72 billion (1984 dollars) per life saved. Another cost-effectiveness study from the 1990s suggested that if the US federal government reallocated existing resources more efficiently, it could save 60,000 additional lives per year without spending any additional money (Tengs and Graham 1996). These examples highlight how cost-effectiveness analysis can be a

powerful tool to make policy more beneficial to the public.

The cost effectiveness of a policy or regulation can also be combined with the VOID to ascertain whether, on balance, a policy is risk reducing or risk increasing. For example, if the VOID is $75 million and a regulation costs $75 million per life saved, then the risk benefits exactly offset the risk costs from income losses. In other words, in this simple case, for every dollar spent addressing target risks, countervailing risks increase to exactly offset the risk benefits. Therefore, the policy's overall impact on risk is neutral. In this way, the VOID value acts as a kind of cost-effectiveness cutoff whereby when a regulation or other policy's cost effectiveness exceeds the VOID value, the regulation can be expected to increase, rather than decrease, mortality risk.[2]

Limitations Of Cost-Effectiveness Analysis

Cost-effectiveness analysis is an incredibly valuable tool. However, it does have some shortcomings that are worth noting. To understand these limitations, it helps to compare cost-effectiveness analysis to an alternative policy analysis tool known as cost-benefit analysis. Whereas a cost-effectiveness analysis for a lifesaving policy would count up how many lives are saved by a policy or regulation, a cost-benefit analysis would try to assign a dollar value to the expected lives saved. For example, if a regulation saves 10 expected lives and a life is valued at $500,000, then the benefits from the regulation would be worth $5 million.

By assigning dollar values to benefits—even those, like human lives, that aren't traded in markets—analysts can consider more of the benefits a regulation produces, whereas cost-effectiveness analysis typically considers only a single benefit. This is not so controversial with a benefit like saving lives, but in other cases, people may not agree that a particular policy goal is a good idea. For instance, some policy makers might think building more public parks is a good idea while others might think we have too many public parks as it is. In this case, the goal is not agreed upon, so it's easy to see why finding the most cost-effective ways to build public parks may not be very useful.

Decisions about which goals should be prioritized depend on value judgments, and it should not be the job of analysts to make these kinds of value judgments. That said, once a particular goal is identified—for example, through legislation—analysts can proceed with that information and identify the cheapest ways to achieve the goals already decided upon.

There are also some problems with the way cost-effectiveness analysis has historically been implemented, though these problems are sometimes easy to address. First, the costs estimated are often accounting expenditures, not economic costs. To see the difference, consider a simple regulation that forces $1 million to be spent on compliance by businesses. An accounting analysis would value the costs at $1 million because that is what is spent. But the true economic cost to society likely differs from $1 million. Had there been no regulation, some of the funds spent on compliance might have been invested and might have grown in value (a concept known as the opportunity cost of capital). Other funds might have gone toward consumption or even been wasted. The true economic cost of the regulation likely differs from the $1 million accounting cost.

A related issue with cost-effectiveness analysis is that health-related benefits are usually discounted in cost-effectiveness analysis.[3] In other words, a life saved or another health-related benefit is treated as less valuable the further it is in the future. This is a problem because the rate at which health-related benefits are discounted is basically arbitrary (or "normative," because it depends on a value judgment).

Also problematic is that discounting health-related benefits converts health benefits into a measure of lifetime welfare. (The idea behind discounting is that lifetime welfare is lower when the health benefits arrive later than when they arrive sooner.) This is problematic because welfare in economics is measured on an ordinal scale (see Broughel and Baxter 2022)—that is, a scale that involves rankings

but not intensities. This is a problem for cost-effectiveness analysis because cost-effectiveness values become difficult to interpret when they involve rankings. To make the issue more concrete, imagine that an analysis of major league baseball teams finds that for each $50 million in total player payroll, a team can expect to move up one place in their end-of-season ranking. This statistic doesn't offer much general guidance about how much to spend on player personnel, because the value of going from 11th place to 10th place is probably not as valuable as going from 2nd place to 1st place. In the latter scenario, spending $50 million might be worthwhile to become a championship contender; in former scenario, the team will simply be less mediocre. The relative positions are hard to compare.

When the outcome analysts are interested in is welfare, the problem becomes even harder than this baseball example illustrates, because we don't know where we are starting from on the scale. Whether to spend $1 million to move up five notches on a welfare scale is pretty abstract—not much guidance for practical policy use. The simplest way around this issue is to evaluate cost effectiveness in units of outcomes (e.g., actual lives saved) as opposed to units of welfare (e.g., discounted lives saved).

In the sections that follow, we will outline a process for conducting a cost-effectiveness analysis that overcomes the problems with both discounting and measuring opportunity costs appropriately. The discounting problem is fairly easy to address—we can simply measure cost effectiveness in terms of lives saved rather than in terms of welfare. The problem with opportunity cost analysis is slightly trickier, but it is not impossible to correct.

Mortality Risk Analysis: Step By Step

This section provides a more detailed explanation of the procedure a state like Wisconsin can use to conduct proper mortality risk analysis. As the name implies, mortality risk analysis aims to predict whether policies (on balance) are expected to increase or reduce mortality. It compares a regulation or other policy's target risk reductions with the countervailing risk increases stemming from lost household income. Such analysis can be produced by regulatory agencies, centralized analytical offices in the government, independent economists in the private sector, or academic experts.

Step 1: Evaluate whether the policy is lifesaving

The first step in a mortality risk analysis is to determine if the goals of a particular policy under review are related to health or safety risks. Many policies do not target health or safety hazards. For example, a financial services or insurance regulation might reduce the risk of fraud but not the risk of death. This is not necessarily a drawback, because reducing mortality is not the purpose of such regulations. Nonetheless, in addition to having these other benefits, such regulations will affect mortality risk through their impact on household income, and this is pertinent information that may prove useful to policy makers.

If a policy does not save any expected lives but imposes positive costs on the community, it can be expected to increase mortality risk. In such a case, the cost-per-life-saved ratio is infinite since there are zero lives saved in the denominator of the ratio. Since the cost-per-life saved exceeds the VOID level, this signals that the policy increases mortality risk.

It is also possible for a policy to save the community money by reducing costs—for example, costs on businesses. Such policies will impose negative costs and therefore tend to reduce mortality risk when there are no other direct health effects to target risks.

Step 2: If the policy is lifesaving, estimate how many lives it will save

If a policy is intended to save lives, the next step is to estimate the number of lives it will save. This requires that analysts understand the magnitude of the risk involved and how (as well as why) the policy is expected to reduce the risk. For example, if a regulation is targeting a hazardous waste site, the regulatory agency should try to

ascertain how many individuals die from this hazard annually and how many of these deaths the regulator believes its regulation can prevent if it conducts a cleanup.

The timeline over which lives are saved is also important and should be determined. Despite the fact that discounting lives can be problematic for the reasons described above, the timing of lives saved still matters because of the time value of money. Saving lives often saves money or boosts economic output (for example, because individuals work and earn incomes), and it is preferable to accrue these benefits earlier because they can be invested and earn positive returns.

Step 3: Calculate the accounting costs of the regulation over time

Once an analyst ascertains how many lives a policy is expected to save, it's time to estimate the accounting cost of the regulation. Accounting costs are the actual public and private financial expenditures (or savings) caused by the policy. For example, if a regulation forces businesses to spend a million dollars on capital expenditures, this would be considered a part of the accounting costs of the regulation. Similarly, if a regulation causes a business to forgo revenues—or close altogether—this would be an additional accounting cost on top of any spending on compliance. Analysts should also tally the expected accounting costs borne by the government to administer and enforce a given regulation. The timing of these expenditures should also be calculated.

As noted, some policies save money; money saved can be counted as negative costs (or cost savings). For example, a new government regulation might streamline or repeal previously existing inefficient regulations, resulting in a lower compliance burden on individuals and businesses. Additionally, saving lives also generates benefits. Additional production or earnings stemming from saved lives can be conceptualized as cost savings and should be deducted from the total gross cost of the regulation.

Step 4: Determine the opportunity cost of the regulation and its cost effectiveness

The expenditures calculated in step 3 represent accounting costs, not economic opportunity costs. To understand why, consider a manager at a company who must devote more time to compliance because of a new regulation. A regulatory analyst might calculate the cost of the regulation as the additional time the manager spends on compliance multiplied by the manager's salary. However, the new compliance activities also displace other productive activities, such as developing new product lines. With or without the regulation, the manager's salary is likely to be the same, but the manager's productive output will likely fall with the regulation in place. Consequently, multiplying a manager's hourly wage by required compliance time results in a measure of accounting cost but not of economic opportunity cost. To determine the latter, we need to estimate the value of the productive activities that never occurred because of the regulation.

The opportunity cost of expenditures—what is forgone when the regulation is enacted—is not the value of the expenditures themselves, in this case the manager's salary, but rather the value associated with the manager's activities in a setting where the regulation was never enacted. In theory this value could be positive, negative, or zero. For instance, if in the absence of the regulation the manager would have been playing video games on the job, then the opportunity cost of the manager's time could be zero. On the other hand, if the manager would have been rolling out software enhancements to boost employees' productivity, then the opportunity cost is probably quite high.

Identifying the opportunity cost can be tricky, but essentially it involves considering what the most likely use of resources would be in the absence of a policy and identifying a rate of return associated with that use of resources. This may sound hard, but it is no different from what businesses do routinely when they identify a weighted average cost of capital or a minimum required rate of return (a hurdle rate) for projects.

Government analysts should adopt similar methodologies to establish a reasonable opportunity cost rate that projects need to overcome to be deemed worthwhile.

At this point, accounting expenditure flows should be divided into resources that would have been consumed in absence of the regulation and those that would have been invested. The investment flows can be discounted at the rate of return associated with those investments, and this information can be compiled to generate a cost-per-life-saved estimate. Note that the opportunity cost discount rate serves a different purpose from a discount rate intended to discount health or other social benefits because they occur in the future.

Step 5. Compare the cost effectiveness of the policy to the VOID

Suppose that a policy saves lives at the cost of $50 million in present value terms for each life saved. Furthermore, suppose that the VOID is $75 million. In this case the policy reduces mortality risk, at least initially, because the direct cost of saving a life ($50 million) is less than the cost at which policies unintentionally take an additional life ($75 million). If policy makers decide to scale up this policy by tripling spending to a total of $150 million, then we would expect it to save three lives ($150 million divided by $50 million per life saved). However, since the cost of this program reduces household incomes by $150 million, we can also expect the loss of two lives ($150 million divided by $75 million per induced death). On net, this policy can be expected to save one life.

By contrast, if a policy has a cost effectiveness with a present value that exceeds the VOID (e.g., if the policy costs $100 million per life saved), then the policy increases mortality risk in the near term. In this case, the expected deaths resulting from lower household income exceed the expected lives saved directly by the policy.

These risk calculations, however, are just the beginning of the story, because the two inputs in a cost-effectiveness analysis—cost and the outcome variable estimate—are not evolving over time in the same way. Displaced investments are growing at the rate of return associated with the opportunity cost of capital, while the lives saved may be a fixed amount, may be an amount that is ongoing (e.g., five lives saved each year), or may be growing over time.

Step 6: Produce a table of outcomes, tracking the policy's impact over time on real resources and risk

A very simple equation for calculating the opportunity cost of capital is f × ROI, where f is the fraction of the return on an investment that is reinvested each period and ROI is the rate of return on the investment. For example, if f is 0.75 and ROI is 10 percent, then f × ROI will be 7.5 percent. We believe a reasonable hurdle rate for projects is in the range of 5 to 7 percent since it is likely that most of the marginal return displaced for compliance purposes is invested, and because market rates are often estimated to be in the range of 7 to 10 percent annually on marginal investments.[4]

Table 7.1 shows a hypothetical regulation that saves 35 lives five years after being enacted (with no additional lives saved thereafter). The economic costs have a present value of $250 million. Meanwhile, the VOID in this example is assumed to equal $75 million in the current year.

In the first period, the regulation has an economic cost of $250 million (labeled in table 7.1 as the "total cost"). The VOID in period 1 is $75 million, so this regulation increases risk in the initial period because it imposes positive costs immediately but no lives are saved until year 5. Thus, for the first five years after the regulation goes into effect, overall risk is increased since the cost effectiveness (i.e., the cost to save a life) of the regulation exceeds the VOID during that timeframe.

The economic costs are changing over time, however, because of the opportunity cost of capital. To understand what is happening, the total costs accrued must be broken down into units of real resources (in other words, they must be divided between forgone consumption and forgone investment). Because *f* is assumed to be 0.7 here, $175 million of the $250 million in initial economic costs would have been

Table 7.1 The Mortality Costs of a Hypothetical Regulation

Year	Total Lives Saved	Total Cost (millions)	Forgone Consumption (millions)	Investment Value (millions)	Cumulative Forgone Consumption (millions)	Cost per Life Saved (millions)	VOID (millions)	Cumulative Expected Deaths from Lost Income	Net Lives Saved	Risk Increasing?
0	0	$250	$75	$175	$75	$∞	$75	3	−3	yes
1	0	$318	$56	$187	$131	$∞	$76	4	−4	yes
5	35	$643	$74	$245	$398	$18	$80	8	27	no
10	35	$1,195	$103	$344	$851	$34	$85	14	21	no
25	35	$4,578	$285	$950	$3,628	$131	$102	45	−10	yes
50	35	$26,087	$1,546	$5,155	$22,912	$802	$140	201	−166	yes

Note: $f = 0.7$, ROI = 10%, VOID = $75 million, $p = 1.25\%$. Source: Authors' calculations.

invested in the absence of the regulation and $75 million would have been consumed in the initial period.

The value of the capital investment grows at a rate of $f \times$ ROI each year going forward. So, for example, by year 5, the capital investment "fund" that has been lost because of the regulation will have grown to be worth $245 million. In the first year after implementation, the value of forgone investment is $187 million ($175 × 1.07). This investment fund would have generated consumption worth $56 million in the first period ($187 × 0.3). The value of this displaced consumption stream also grows at a rate of $f \times$ ROI going forward. For example, the consumption stream the capital fund would have generated would have grown to an annual value of $74 million by year 5, and the cumulative consumption forgone over the first five years of the regulation being in place would equal $398 million.

What is called total cost in table 7.1 is equal to the total consumption stream lost up until that point in time plus the value of investment capital at that point in time (as if it were to be cashed in and all the proceeds consumed in that period). This total cost can also be used to estimate the expected deaths a regulation has indirectly generated up until that point in time.

In year 0, there are three expected deaths ($250 million divided by a $75 million VOID). The VOID is assumed to grow at the rate of productivity, here assumed to be 1.25 percent annually. Once the regulation saves 35 lives in year 5, the regulation becomes risk reducing because the total cost per life saved is less than the VOID at that time. By year 25, however, this situation reverses, since in year 22 the expected deaths imposed by the regulation overtake the number of expected lives saved, and thus the regulation cumulatively increases mortality risk from that point forward.[5] Such reversals could be grounds for building sunset provisions into regulations so that they expire before their more detrimental impacts take hold.

Step 7: Report information to decision makers

The example above highlights how the effects of a regulation on mortality risk can differ depending on the time period being analyzed. Many regulations initially increase risk since compliance expenditures are often made up front while benefits are realized with a lag. This situation often reverses once some of the benefits accrue. However, the situation can then reverse again (as in the example above), because money can be reinvested (with compound returns) while lives cannot. Thus, a critical question for policy makers is not just *whether* a policy increases risk but *when* it does so.

Ultimately, it's a value judgment whether policies are worth implementing when they increase mortality risk at various points in time. Such value judgments depend on a variety of factors, including the number of lives a policy saves, whose life specifically is

saved (e.g., how old they are), and the overall costs. That said, some value judgments are easier to make than others. If a regulation aims to reduce risk but increases risk across all time periods, it is hard to see what the justification could be for that regulation. But without a formal mortality risk analysis, the likelihood that policy makers will identify such counterproductive regulations is low.

Case Study: Wisconsin Regulations

In this section, we consider several actual Wisconsin regulations to demonstrate how mortality analysis can be used in a real-world context. Wisconsin already has a law in place that requires state regulatory agencies to produce budgetary and economic analysis for new regulations. Specifically, agencies fill out a standardized form, known as a "Fiscal Estimate & Economic Impact Analysis," when they enact new regulations. This is a form from the Wisconsin Department of Administration (2016),[6] and there is a similar template for analyzing existing rules (Wisconsin Department of Administration 2012). It is worth noting that there is no mention of risk issues in either of these templates.

Unfortunately, there is no publicly available central repository for these economic impact statements in Wisconsin, making them difficult to collect and analyze. Creating such a repository would be beneficial both for transparency purposes and for the purposes of research. Given this shortcoming, we relied on internet searches to identify a few examples of agencies using these forms. We found two regulations from the Department of Natural Resources, which we will examine in this section.

We chose these rules primarily because (1) they are relatively recent; (2) they could in theory be risk-related, given their relation to environmental programs (although the agency does not calculate lives saved in either instance); and (3) one regulation imposes net costs, according to the agency, while the other is cost saving. Thus, they offer useful examples to demonstrate the kind of information a properly conducted risk assessment can uncover. However, we caution readers that these regulations should not be construed as representative of all regulations in Wisconsin. We merely offer them as examples.

Example 1: Hazardous Waste Disposal

Our first example is a Wisconsin Department of Natural Resources (DNR) regulation, finalized in 2019, related to disposal of hazardous waste (Wisconsin Department of Natural Resources 2019). The primary aim of the regulation was for the state to stay in compliance with the US Environmental Protection Agency's Resource Conservation and Recovery Act requirements, which were updated in the years leading up to this regulatory action. According to the Wisconsin DNR, the regulation will increase compliance costs for regulated entities by between $334,785 and $617,785 per year while at the same time saving regulated entities approximately $840,533 to $2,146,805 per year. Thus, even if one assumes a worst-case scenario for both compliance costs ($617,785) and savings ($840,533), this regulation is predicted to generate net cost savings.

The Wisconsin DNR makes no claims that this regulation will save lives. Rather, the DNR notes that many aspects of the regulation are related to "paperwork reductions" and "relaxations of regulations," though there appear to be several "new information collection burdens." This helps explain why the regulation is cost saving, because it is most likely a deregulatory action.

In many respects, the analysis of this regulation can end here. The cost analysis demonstrates that the regulation is cost saving, thereby reducing some mortality risks through the household-income channel. There are no other apparent mortality benefits or costs; thus, this regulation is likely to reduce mortality risk overall, assuming that the agency's calculations are correct.

It may be worth digging a little deeper into the DNR's calculations, however, in order to better ascertain the magnitude and timing of these risk reductions. There are several issues worth noting about the DNR's calculations. First, the agency has calculated both costs and cost savings, and these

estimates are presented transparently. This represents a best practice.

However, the DNR's estimates, as stated, are not suitable for use in a cost-effectiveness analysis without some adjustment. First of all, the dollar year these numbers are reported in is not stated in the economic analysis. The regulation is from 2019, so presumably these estimates are reported in 2019 dollars, but it would be helpful if this were stated explicitly by the agency.[7] Second, the costs are presented in annualized form: that is, these are estimates of ongoing costs averaged on a per-year basis. Far more useful for our purposes is the present value of costs, which better reflects the total cost of the rule. (Much as a monthly mortgage payment provides an incomplete picture of the total amount of money owed on a mortgage, an annualized value of cost does not fully capture the total cost of a rule.)

An additional problem with reporting annualized values is that they conceal the fact that costs are often growing at some rate over time, owing to the opportunity cost of capital. An annualized value, because it is an average, appears to flatten out costs. This can be misleading because it can give the false impression that benefits exceed the costs, though this may not be the case if costs are growing over time and benefits are not (or vice versa).

For simplicity's sake, we will use the midpoint between $334,785 and $617,785 in annual costs, which is $476,285. In table 7.2 we compare this DNR regulation to another regulation that imposes costs in 2021. To make the two regulations comparable, we present costs in inflation-adjusted 2021 dollars. According to the consumer price index, this is $494,961. If we assume that the opportunity cost of capital rate is 7 percent, then the present value of this stream of annualized costs (assuming the annualized cost continues in perpetuity) is $7.1 million in 2021 dollars.

When we do similar calculations for costs savings, we get an estimate of $22.2 million in cost savings expressed as a prevent value (in 2021 dollars), for a net improvement of $15.1 million in reduced costs. This is roughly two-fifths of our estimate of the VOID. Therefore, this regulation initially produces indirect benefits worth two-fifths of a saved life. This regulation can be expected to save more lives in the future as cost savings compound over time. The first life saved would be expected to occur in 2025 if the 2019 VOID is $75 million and is growing at 1.25 percent annually.[8] See table 7.2.

Example 2: Stormwater Discharge Permits

Our second example is another Wisconsin DNR regulation. This one is from 2021 and is related to stormwater discharge permits (Wisconsin Department of Natural Resources 2021). Like the previous regulation, this rule is also intended to bring the state of Wisconsin's regulatory regime in line with federal regulations. However, in this case the regulation is anticipated to impose net costs. According to the agency, the regulation will generate total costs of $2,778,900 per year. Additionally, it will generate savings of $1,118,400 annually, for a net compliance cost burden of $1,660,500. As with the previous regulation, the DNR does not claim that this regulation will save any lives. Thus, this regulation can be expected to increase mortality risk on balance since its cost effectiveness (which is infinite in this case) exceeds the VOID.

We assume that the DNR's estimates are expressed in 2021 dollars, since this was the year the rule was finalized and no other information is available. The annualized cost has a present value of $23.7 million at a 7 percent discount rate. Since we are evaluating the regulation in 2021, there is no need to adjust this value for inflation. $23.7 million is about one-third of our estimate of the VOID, and this initial value would be expected to grow over time. One could produce a cost-effectiveness table similar to what is presented in table 7.2 to track this growth. We forgo doing that here for simplicity's sake.

Discussion

There are several takeaways worth noting after reviewing the regulatory analyses performed for the two DNR example

Table 7.2 The Mortality Cost of the Wisconsin DNR's 2019 Hazardous Waste Disposal Regulation

Year	Total Lives Saved (target risk)	Total Cost (millions)	Forgone Consumption (millions)	Investment Value (millions)	Cumulative Forgone Consumption (millions)	Cost per Life Saved	VOID (millions)	Cumulative Expected Deaths from Lost Income	Net Lives Saved	Risk Increasing?
2019	0	–$15	–$5	–$11	–$5	–$∞	$75	0	0	no
2020	0	–$19	–$3	–$11	–$8	–$∞	$76	0	0	no
2024	0	–$39	–$4	–$15	–$24	–$∞	$80	0	0	no
2029	0	–$72	–$6	–$21	–$51	–$∞	$85	–1	1	no
2044	0	–$275	–$17	–$57	–$218	–$∞	$102	–3	3	no
2069	0	–$1,684	–$93	–$309	–$1,375	–$∞	$140	–12	12	no

Sources: Wisconsin Department of Natural Resources (2019); authors' calculations.

Note: $f = 0.7$, ROI = 10%, VOID = $75 million, $p = 1.25\%$.

regulations in the previous section. First, the DNR deserves credit for calculating both the costs and the cost savings associated with its regulations. This is clearly a best practice, and thus avoids a common practice of many federal agencies of intermingling financial costs and savings with nonpecuniary benefits and costs, which often aren't directly comparable.

However, the DNR's analyses may be unintentionally misleading because they present costs in annualized rather than present-value form. Although regulatory costs can be expressed in both annualized and present-value form, present values are more useful since these better reflect total costs and make cost-effectiveness analysis easier to produce.

These two examples are also interesting because the risk reduction benefits of the deregulatory action offset some of the risk-increasing costs of the regulatory action. At first glance, the costs of stormwater permit regulation exceed the cost savings generated by the hazardous waste regulation. However, it is important to note that a cost borne in 2019 is not the same as an equivalent cost borne in 2021. A dollar in compliance is more costly to society in 2019 than in 2021 owing to the opportunity cost of capital, and this difference must be accounted for in order to make an accurate comparison between the two regulations.

Taking a step back, Wisconsin's rulemaking process is notable because it involves the production of economic analysis (Broughel and Hoffer 2021), which the examples above show can include useful information that is easily converted into a format usable for cost-effectiveness and mortality analysis. This implies that risk analysis could be incorporated into the existing rule evaluation process in Wisconsin without much difficulty.

Cost-effectiveness analysis requires in its most basic form just two inputs: the accounting costs of the policy in question and an estimate of the primary benefit achieved by the policy. A cost-effectiveness estimate based on these inputs could be required as a standard part of regulatory analysis. That said, to ensure that analysis is useful, Wisconsin may also need to invest in personnel capable of performing rigorous analysis. Most of what seems to constitute economic analysis for regulations in the state seems to be little more than a form that is filled out by agencies according to a short, standard template. If Wisconsin is under-investing in analysts qualified to produce economic analysis, analysis will necessarily be of low quality. That said, owing to the relatively simple nature of cost-effectiveness analysis, a small investment may be all that is needed to start performing some basic, but useful, risk analysis.

Conclusion and Policy Recommendations

The analysis of risks is important both in our daily lives as individuals and at a collective level when governments set policy. Wisconsin policy makers should consider requiring risk analysis like that outlined in this chapter. It may be fairly easy to incorporate risk analysis into existing regulatory analysis (or to add it as an additional requirement), thereby improving the objectiveness and transparency of Wisconsin regulations' impacts. If such analysis is conducted properly and used in decision making, it could save lives and reduce costs simultaneously.

To produce a risk analysis, policy makers could use a simple checklist that follows the steps outlined in this chapter. We have included an example of such a template in the appendix. Moreover, interested parties in Wisconsin need not wait until government officials adopt this kind of analysis before they use it to inform policy. Academic economists, industry trade associations, advocacy groups of various kinds, and even private citizens could perform such analysis themselves with the appropriate training. Indeed, as this chapter has shown, it is fairly easy to produce a mortality risk analysis by drawing on information from agencies' existing economic analysis or by supplementing those reports with data from other sources, such as academic studies.[9]

As one analysis recently put it, "On paper, Wisconsin's process for reviewing new and existing rules appears to be quite thorough, especially relative to some other states" (Broughel and Hoffer 2021). However, risk analysis is a glaring omission from a system that otherwise appears to be tailored for producing evidence-based regulations. We see abundant opportunities for improving the regulatory system in Wisconsin by creating a more robust role for the economic analysis of risks.

APPENDIX: Risk Analysis Template For State Regulations

1. Is the regulation lifesaving?
2. If yes, how many lives will the regulation save?
3. What compliance expenditures are likely to result from this regulation (including forgone expenditures because of lower income or revenues, as well as government expenditures)?
4. What cost savings are likely to result from the regulation?
5. What is the opportunity cost of the regulation? In other words, what fraction of foregone expenditures would have been consumed vs. invested, and what rate of return would have been earned on the foregone investments?
6. On the basis of the regulation's opportunity cost, what is the present value of the regulation's costs (net of cost savings)? Clearly state the dollar-year and year in which the cost is evaluated (e.g., a cost borne in 2019 expressed in 2021 dollars).
7. Calculate the cost effectiveness of the regulation (i.e., the present value of costs net of cost savings per life expected to be saved).
8. Based on the relevant value of an induced death, is the regulation expected to increase risk in present-value terms?
9. Will the regulation increase risk in the future? If so, when?
10. Provide a table detailing how the regulation will affect real resources (e.g., consumption and investment), as well as risk, over several decades.

Notes

[1] An important caveat here involves so-called deaths of despair. These tend to be deaths related to drug overdoses, suicide, and alcoholism, which are contributing to life expectancies falling among some groups in high-income countries, in particular in the United States. See Case and Deaton (2020).

[2] When a policy is said to cost $75 million per life saved, this does not imply that $75 million will actually be spent. For example, a regulation that costs $7.5 billion in order to save 100 lives has a cost effectiveness of $75 million per life saved. The same cost effectiveness applies if one spends $750,000 in order to save an expected one-hundredth of a life. In fact, many regulations have high cost-effectiveness values not because they cost a lot of money but because they don't produce much in the way of benefits.

[3] Opportunity cost and discounting are related because health benefits are sometimes discounted on the basis of an argument that capital has an opportunity cost in that it can be invested. This line of argumentation confuses two concepts: the rate of return on capital and the rate of time preference of society.

[4] Arguably, public project hurdle rates should include risk and irreversibility premiums as well. On the marginal rate of return to private investment, see Broughel and Baxter (2022). See also Harberger and Jenkins (2015).

[5] Note that a cumulative change in risk and a marginal change in risk can occur in different periods. For example, a regulation might increase risk for a few years before all the mortality benefits from previous years are offset.

[6] Wisconsin has a cost-benefit analysis template as well, but it appears to be for procurement purposes only. See Wisconsin Department of Administration (2019).

[7] Notably, the estimated compliance costs did not change from 2017 (when the rule was first proposed) to 2019 (when the rule was finalized). See Wisconsin Department of Natural Resources (2017).

[8] The expected life is saved in 2025 owing to rounding. In actuality, the predicted total cost savings would exceed the VOID in 2031.

[9] For a similar example of a risk analysis that applies this methodology, see Broughel and Baxter (2022).

References

Broughel, James, and Andrew Baxter. 2022. "A Mortality Risk Analysis for OSHA's COVID-19 Emergency Regulations." *Journal of Risk and Financial Management* 15(10): 481-501.

Broughel, James, and Dustin Chambers. 2022. "Federal Regulation and Mortality in the 50 States." *Risk Analysis* 42 (3): 592–613.

Broughel, James, and Andrew Hoffer. 2021. *Wisconsin Regulation in Focus*. Wisconsin Institute for Law & Liberty, Menard Family Initiative.

Broughel, James, and W. Kip Viscusi. 2021. "The Mortality Cost of Expenditures." *Contemporary Economic Policy* 39 (1): 156–67.

Case, Anne, and Angus Deaton. 2020. *Deaths of Despair and the Future of Capitalism*. New Jersey: Princeton University Press.

Chetty, Raj, Michael Stepner, Sarah Abraham, Shelby Lin, Benjamin Scuderi, Nicholas Turner, Augustin Bergeron, and David Cutler. 2016. "The Association between Income and Life Expectancy in the United States, 2001–2014." *Journal of the American Medical Association* 315 (16): 1750–66.

Graham, John D., and Jonathan Baert Wiener, eds. 1995. Risk vs. Risk: *Tradeoffs in Protecting Health and the Environment. Cambridge*, MA: Harvard University Press.

Harberger, Arnold C., and Glenn P. Jenkins. 2015. "Musings on the Social Discount Rate." *Journal of Benefit-Cost Analysis* 6 (1): 6–32.

Jarvis, Stephen, Olivier Deschenes, and Akshaya Jha. 2019. "The Private and External Costs of Germany's Nuclear Phase-Out." Working Paper 26598, National Bureau of Economic Research, Cambridge, MA.

Keeney, R. L. 1990. "Mortality Risks Induced by Economic Expenditures." *Risk Analysis* 10 (1): 147–59.

Morrall, John F., III. 1986. "A Review of the Record." *Regulation* 1986: 25–34.

Pritchett, Lant, and Lawrence H. Summers. 1996. "Wealthier Is Healthier." *Journal of Human Resources* 31 (4): 841–68.

Sinsheimer, Peter. 1991. "The Risks of Economic Modeling before Establishing the Causal Inference." *Risk Analysis* 11 (2): 187–88.

Tengs, Tammy O., and John D Graham. 1996. *The Opportunity Costs of Haphazard Social Investments in Life-Saving, in Risks, Costs, and Lives Saved: Getting Better Results from Regulation*. Oxford University Press and AEI Press.

Thomas, Diana W. 2019. "Regressive Effects of Regulation." *Public Choice* 180:1–10.

Urban Institute. 2022. *State Fiscal Briefs: Wisconsin*. Urban Institute. November 2021. https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-fiscal-briefs/wisconsin.

Wildavsky, Aaron. 1981. "Richer Is Safer." *Financial Analysts Journal* 37 (2): 19–22.

Wisconsin Department of Administration. 2012. DOA-2050 (C04/2012).

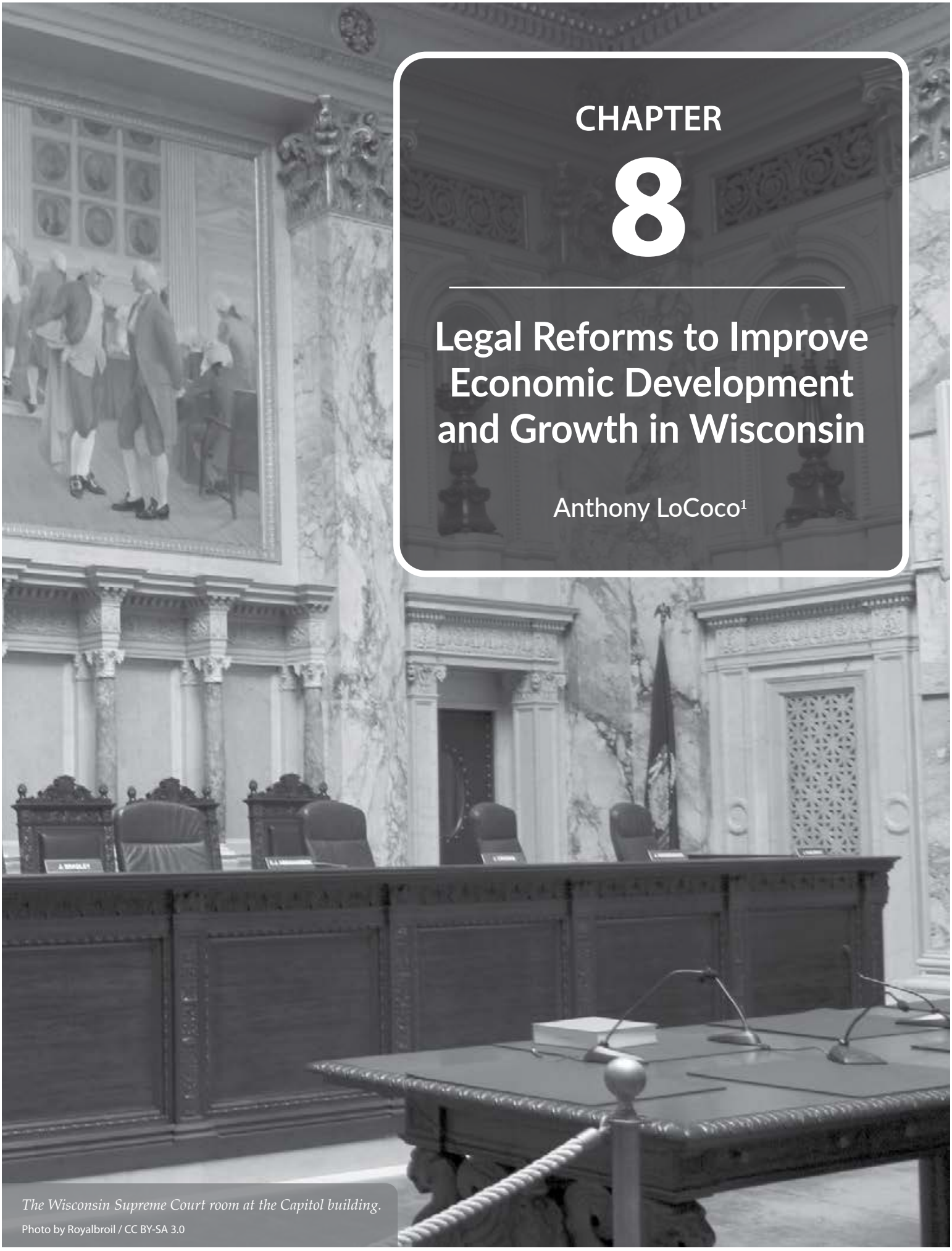
Wisconsin Department of Administration. 2016. DOA-2049 (R09/2016).

Wisconsin Department of Administration. 2019. Justification of State of Wisconsin. DOA-3821a (R04/2019).

Wisconsin Department of Natural Resources. 2017. Chapter NR 600 Series Draft Rule Fiscal Estimate & Economic Impact Analysis.

Wisconsin Department of Natural Resources. 2019. Fiscal Estimate & Economic Impact Analysis Chapter. NR 600 Series WA-06-17.

Wisconsin Department of Natural Resources. 2021. Storm Water Discharge Permits, Fiscal Estimate & Economic Impact Analysis.



CHAPTER

8

Legal Reforms to Improve Economic Development and Growth in Wisconsin

Anthony LoCoco[1]

The Wisconsin Supreme Court room at the Capitol building.

8 Legal Reforms to Improve Economic Development and Growth in Wisconsin

The topic of legal reform is a broad one that would normally include numerous proposals applicable to civil litigation and other legal dealings between private parties. But when one is considering reforms that will support economic growth, it is critical to examine interactions with government in particular. Whether government policies make it easier for individuals to undertake entrepreneurial initiatives or instead make it costlier or more difficult for businesses to operate and satisfy consumer demands can make a big difference in the economic trajectory of a state.

The reforms proposed in this chapter thus focus on four steps that Wisconsin legislators can take now in order to ensure a more favorable climate for business activity. First, the legislature should reinvigorate statutory constraints on agency authority by amending 2011 Wisconsin Act 21 to require that agencies possess explicit and specific authority in state law before engaging in regulatory activity. Second, together with Wisconsin voters, the legislature should amend the state constitution to provide constitutional protection for economic freedom. Third, to reduce the financial burden of litigation against the government, the legislature should modify Wisconsin's Equal Access to Justice Act, allowing for fee-shifting in a greater variety of circumstances. Finally, to reduce the uncertainty that litigation against government produces resulting from long stretches of time before judicial opinions are rendered, it is time to expand and redistrict the Wisconsin Court of Appeals.

Together, these changes will make Wisconsin a better place to start and run a business. This, in turn, will spur growth and development in our state.

Reinvigorate Statutory Constraints on Agency Authority

For the past decade a battle has been fought in Wisconsin regarding the proper scope of agency authority. For the most part, those favoring limited governmental power have experienced enormous success in achieving a state of affairs in which agency discretion is cabined, better protecting the economic freedom of Wisconsin citizens. A catalyst for this revolution was 2011 Wisconsin Act 21, a law that (among other things) ordered that "no agency may implement or enforce any standard, requirement, or threshold, including as a term or condition of any license issued by the agency, unless that standard, requirement, or threshold is explicitly required or explicitly permitted by statute or by a rule that has been promulgated in accordance with this subchapter."[2] In other words, the law directs courts to "narrowly construe imprecise delegations of power to administrative agencies,"[3] such that if an agency wants to act, it needs to be able to point to clear statutory or regulatory language authorizing it to do so.

Act 21 supports economic growth by reining in overregulation of small businesses by regulatory agencies too quick to find authority where it does not exist.[4] In light of a recent study concluding that "on a per-capita basis, Wisconsin is the most regulated state in the Great Lakes region" (Broughel and Hoffer 2021, 6), this type of deregulation is welcome relief for the Badger State. Unfortunately, in 2021 the Supreme Court of Wisconsin gutted Act 21 in a pair of decisions, both with the same title: *Clean Wisconsin v. Wisconsin Department of Natural Resources*.[5] These decisions, involving environmental regulations by the Department of Natural Resources, restored to agencies the ability to rely on vague and broadly worded delegations of power to support regulatory actions not clearly authorized by statute. The legislature should now step in and overrule the *Clean Wisconsin* cases by clarifying the proper application of Act 21.

The modern rollback of the administrative state in Wisconsin

The decade between 2010 and 2020 represented a transformation of administrative law in Wisconsin. One major success occurred in *Tetra Tech v. Wisconsin Department of Revenue*, in which the Wisconsin Supreme Court ended its long-standing "practice of deferring to administrative agencies' conclusions of law."[6] In other words, an agency is no longer afforded a special advantage in cases against the individuals it regulates—the ability to "authoritatively [tell] the court how to interpret and apply the law that will decide its case."[7]

But there were also legislative victories. As noted, in 2011 the legislature and Governor Scott Walker enacted 2011 Wisconsin Act 21. This law reformed several aspects of the rulemaking process. For example, it required agencies to obtain gubernatorial approval before engaging in rulemaking.[8] When the superintendent of public instruction and the Department of Public Instruction tried to skirt this requirement, the Wisconsin Supreme Court ordered compliance, another significant win.[9]

But one of Act 21's most powerful provisions was the one mentioned above, *Wisconsin Statutes* section 227.10(2m), which requires agencies to identify explicit authorization in a statute or rule before engaging in certain regulatory activity.[10] This protection was bolstered by additional provisions, sections 227.11(2)(a)1.–2., which related to rulemaking, a specific type of agency action. Those additional safeguards provided that certain types of broad provisions, such as those "containing a statement or declaration of legislative intent, purpose, findings, or policy" and those "describing the agency's general powers or duties," do not confer rulemaking authority "beyond the rule-making authority that is explicitly conferred on the agency by the legislature."[11]

A good illustration of this safeguard in action occurred in a COVID-19-era case, *Wisconsin Legislature v. Palm*. That lawsuit involved a challenge to an order by the secretary-designee of the Department of Health Services "to all people within Wisconsin to remain in their homes, not to travel and to close all businesses" deemed by the secretary-designee to be nonessential.[12] The secretary-designee relied for her authority on such broadly worded statutes as *Wisconsin Statutes* section 252.02(6), providing that the Department of Health Services "may authorize and implement all emergency measures necessary to control communicable diseases."[13]

In part citing *Wisconsin Statutes* section 227.10(2m), the court concluded that the challenged order was not authorized by statute, declaring that the court would not "expansively read statutes with imprecise terminology that purport to delegate lawmaking authority to an administrative agency."[14] The court acknowledged that in the past "court decisions permitted Wisconsin administrative agency powers to be implied" but explained that Act 21 "significantly altered our administrative law jurisprudence."[15]

Palm was a high-profile example of the promise of Act 21. Unfortunately, just one year later, the court reversed course and severely limited the scope of the same law.

The Clean Wisconsin decisions

Act 21's demise occurred in the context of two environmental law cases involving the regulation of high-capacity groundwater wells[16] and concentrated animal feeding operations (CAFOs).[17] In both cases, the general question was whether the Department of Natural Resources could rely on broad statutory authority to engage in particular regulatory actions.[18] For example, in the case involving CAFOs, the department argued that it had authority to require a dairy farm to conduct off-site groundwater monitoring, and it based this authority on vague and expansive statutory provisions such as *Wisconsin Statutes* section 283.31(3), which merely authorized the department to require the pollutant discharges of such farms to "meet" "groundwater protection standards."[19]

Under the logic of *Palm*, Act 21's explicit authority requirement should have worked to prohibit the Department of Natural

Resources from finding the power to impose an off-site groundwater monitoring requirement in statutes that did not even mention it. And indeed, *Palm*'s author, Justice Roggensack, wrote separately to say exactly that.[20] But the majority in each *Clean Wisconsin* case disagreed on the application of Act 21, drawing a distinction between "explicit" authority, which is mandated by Act 21, and "specific" authority, which the court concluded was not:

> Explicit authority and broad authority are different concepts but not mutually exclusive ones. An explicit phrase can be broad or specific; broad authority can be either explicit or implicit. . . . Section 227.10(2m) targets, in a general sense, only the distinction between explicit and implicit agency authority. . . . Accordingly, for purposes of § 227.10(2m), if the legislature clearly expresses in a statute's text that an agency can undertake certain actions, the breadth of the resulting authority will not defeat the legislature's clear expression.[21]

The court similarly waved away, as concerning rulemaking alone rather than agency action outside the context of rulemaking, the separate provisions of Act 21 specifically excluding general policy and purpose statements as a font of authority.[22]

The *Clean Wisconsin* decisions will allow Wisconsin agencies to claw back a substantial amount of agency authority, contrary to the manifest purpose of the legislature. This will mean increased administrative burdens for Wisconsin businesses. Because agencies will be relying on vague provisions for their authority, these businesses will also have to contend with a comparative lack of notice regarding the scope of agency power.

The legislature should update Act 21

The good news is that updating Act 21 is not overly complicated. The statute should be amended to require that an agency identify explicit *and* specific authority that supports its actions: broad statements by the legislature do not suffice. If there are concerns about hampering the legislature's authority to delegate relatively broad authority, then a provision could be added requiring a clear statement from the legislature that a broad delegation is intended. Finally, portions of the sections of Act 21 that apply to rulemaking authority alone can be expanded to apply beyond that context. For example, purpose statements should never independently confer authority to state agencies.

These changes will restore Act 21's sweep and appropriately cabin agency authority to only those grants expressly given to agencies by the legislature. This will produce a much more predictable, navigable, and fair regulatory environment for Wisconsin businesses.

Strengthen Constitutional Protection of Economic Freedom

Unlike in select areas such as free speech, religious liberty, or the right to keep and bear arms, the state and federal constitutions impose only modest restraints on the ability of state governments to regulate businesses. Even where constitutional rights are applicable in the economic sphere—such as in the area of equal protection—courts generally apply very lenient review of government action.[23] The end result is a freer hand for state agencies—or the legislature—to impose costly and burdensome regulations on Wisconsin businesses.

To improve this situation, Wisconsin should amend its state constitution to better protect economic freedom—specifically, "the right to earn a living in any lawful occupation without unnecessary government interference"[24]—subjecting all state laws or regulations burdening this right to heightened judicial review.

Rational basis review of economic claims

Before discussing the benefits of constitutional protection of economic freedom, it is useful to examine the standard that currently applies to most state infringements of economic rights in Wisconsin.

Unlike the federal government, which is limited in its action to only those powers specifically enumerated in the federal Constitution, individual states possess broad authority, as separate sovereignties,[25] to enact "regulations designed to promote the public convenience or the general prosperity, as well as regulations designed to promote the public health, the public morals, or the public safety."[26] This is sometimes referred to as the "police power."[27]

Although the police power is broad, it is "of course subject to constitutional restrictions."[28] The problem in the area of economic regulation is that there are relatively few constitutional restrictions on the Wisconsin Legislature's authority to act. Take the Equal Protection Clause, which "embodies a general rule that States must treat like cases alike but may treat unlike cases accordingly."[29] If a law categorizes Wisconsinites on certain bases such as race or national origin, courts will typically apply a very strict level of review and require the law to be "narrowly tailored 'to serve a compelling state interest.'"[30] This high standard properly cabins the legislature's ability to enact race-based legislation.

On the other hand, in the case of economic regulation, where no trigger like race or some explicit fundamental right exists, courts will instead assess state classification under what is called "rational basis" review.[31] Instead of a "compelling" interest, the state need only be in pursuit of a "legitimate" one.[32] Instead of a tight fit between the effect of the law and the goal it is pursuing (i.e., narrow tailoring), there need only be a "rational" relationship.[33] Laws will virtually always meet this test. The upshot is that successfully challenging business regulations on constitutional grounds will be difficult, even where those regulations are clearly in need of amendment or invalidation because of their unfair or economically unsound basis.

Requiring stricter judicial review of economic freedom claims

What can be done? The two main avenues for constitutional relief would be (1) to obtain a state court decision recognizing heightened protection of economic rights or (2) to amend the state constitution and add such protection directly.

The first avenue was tried, unsuccessfully, in the 2018 case *Porter v. State*. That case involved a challenge to laws that barred Wisconsinites from owning or operating both cemeteries and funeral homes simultaneously.[34] The purpose of such a bizarre law becomes clearer when the legislative history is examined, which indicates that the statute was requested, sponsored, and drafted by the Wisconsin Funeral Directors and Embalmers Association—evidence of an attempt to limit competition from cemetery owners.[35] The challengers of the law, a cemetery and one of its principal owners,[36] argued for heightened scrutiny based on the fact that the Wisconsin Constitution protects "liberty" as an inherent right.[37] Specifically, in perhaps its most majestically phrased provision, the state constitution declares, "All people are born equally free and independent, and have certain inherent rights; among these are life, liberty and the pursuit of happiness; to secure these rights, governments are instituted, deriving their just powers from the consent of the governed."[38] In the petitioners' view, this liberty had to include economic liberty—"the right to earn a living in any lawful occupation without unnecessary government interference."[39] Unfortunately, a majority of the court essentially rejected this claim out of hand with little discussion and ultimately upheld the law under typical rational basis review.[40]

Porter thus suggests that constitutional amendment is the more feasible approach. There is a temptation to automatically dismiss the possibility of amendment because of an inchoate apprehension that such a process would be exceedingly difficult or even impossible to complete. But, unlike at the federal level, amendment of the Wisconsin Constitution—which would bind state government—is straightforward enough to have been completed more than 100 times since statehood (Wisconsin Legislative Reference Bureau, 2021/22, 484n).[41] To take effect, a suggested amendment must obtain a majority vote of

two successive state legislatures and then approval in a statewide referendum.[42] With the right proposal, this task is achievable.

There are a number of different approaches to extending constitutional protection to economic freedom. One option would be to codify an approach like the one requested by the *Porter* challengers. Laws and regulations impairing or substantially impairing "the right to earn a living in [a] lawful occupation" would have to meet an intermediate level of scrutiny: government must show a "real and substantial connection," not just any rational relationship, to a legitimate government purpose.[43]

Other formulations are available. The Goldwater Institute, for example, has drafted a "Right to Earn a Living Act," a statutory solution that limits specified regulations and restrictions "to those demonstrably necessary and carefully tailored to fulfill legitimate public health, safety, or welfare objectives" (Bolick 2016, 7). That suggests a more limited scope of available purposes and an even tighter fit between the law and its purpose.

The applications of such a constitutional economic freedom provision are numerous. For example, such a right could serve as a potent weapon against unreasonable occupational licensing requirements preventing Wisconsinites from engaging in particular professions without the expenditure of significant resources (see Bolick 2016).

A reasonable debate can be had on how best to calibrate this constitutional safeguard to ensure that the state has a sufficiently free hand to pursue proper objectives, especially in the areas of health and safety. But the bottom line is that such a provision would generally give Wisconsin citizens and businesses a legal basis to challenge unjust laws and regulations that survive only because the applicable bar is currently so low. Were such a right in place, for example, the result in *Porter* could well have been different, allowing the cemetery owner to expand his business and increase competition.[44]

Multiply Fee-Shifting Opportunities

The preceding discussion has focused on leveling the playing field between private litigants and government by restraining agency discretion and providing citizens with a new constitutional right to protect their economic freedom. But none of this may matter if litigants do not have the resources to legally challenge government actions. Even when an individual or business is ultimately successful in litigation against a government agency, the expense of a multiyear court battle can be substantial.

One simple improvement that can be made in this area is to increase opportunities in which successful litigants can recover attorney fees against the government. This will provide private litigants who are confident in their positions with some reassurance that they will not be left destitute at the finish line of a dispute. But this is not simply about making Wisconsinites whole—frequent losses can also incentivize government entities to compromise more often and engage in protracted litigation only when it is truly necessary and justifiable.

Under the so-called American rule, "parties to litigation typically are responsible for their own attorney fees," regardless of who wins.[45] This rule holds true against the government.[46] The legislature, however, is free to change the rule in specified contexts.[47] The Wisconsin Legislature has done so in the Wisconsin Equal Access to Justice Act (WEAJA).[48]

In a nutshell, the WEAJA provides attorney fees to individuals and certain businesses if they prevail in particular types of litigation against the government—exactly the remedy advocated here. But there are four significant limitations on the award of fees that could be modified or eliminated to broaden the WEAJA's scope and effectiveness.

First, the WEAJA applies by its terms only to actions *by* state agencies and those arising from "contested cases,"[49] particular types of administrative proceedings "generally [involving] two or more clearly identified adverse parties, as well as some type of fact-finding by an agency decision maker."[50] This leaves without relief litigants

in a variety of cases who may have to *initiate* certain litigation against state agencies—perhaps to have a rule declared illegal or to restrain certain agency action. Amending the WEAJA to apply to actions by *or against* state agencies would solve this problem.

Second, attorney fees are not permitted if the state agency was "substantially justified in taking its position."[51] But "substantially justified" means merely having a "reasonable basis in law and fact."[52] That is not much of a bar, and it should be raised. For example, the requirement of a "strong" basis in law and fact would provide better protection and discourage government entities from taking fliers in court where citizen interests are concerned.

Third, the WEAJA attempts to determine who can "afford" to pay for an attorney by limiting its application to individuals who make less than $150,000 per year in adjusted gross income (each year over a three-year period), businesses that employ 25 or fewer full-time employees or that have gross annual sales of less than $5,000,000, and nonprofits that employ 25 or fewer employees.[53] But where a litigant ultimately prevails against the government and the government's position was *not even substantially justified*, an injustice has been done and that litigant is entitled to some form of relief. Further, reimbursement of the private party should not be the sole goal; the government should be penalized for its error. These cost-saving categories need not be eliminated entirely, but they should be expanded (or fees awarded on a reduced basis to those who fall outside them).

Fourth, the WEAJA applies only to state agencies, not to the state itself. This loophole should be remedied.[54]

There are other possibilities available for reforming the WEAJA. For example, the legislature could reexamine the current attorney fee rate cap of $150 per hour[55] or consider whether a modified version of the WEAJA would be appropriate at the local government level. But basic changes like those discussed in this section would make litigation against the government more feasible for Wisconsinites.

Expand and Redistrict the Wisconsin Court of Appeals

The final reform recommended here focuses on reducing legal uncertainty, which has a clear negative impact on economic growth. "For example, firms may delay investment and hiring during periods of high uncertainty. Households may exercise precautionary reductions in spending by increasing their saving rates in anticipation of possible changes in incomes or wealth. Financing costs may also rise if risk premiums embedded in interest rates increase" (Jackson, Kliesen, and Owyang 2019, 1). Yet uncertainty is a fixture of our legal system; as the philosopher Jeremy Bentham (1843) once put it in an 1808 letter to James Mackintosh, the "power of the lawyer is in the uncertainty of the law."

Litigation, in particular, can present unpredictable costs and outcomes to individuals and companies, discouraging risk-taking, expansion, and innovation. A package of legal reforms designed to support economic growth, therefore, should include proposals that eliminate uncertainty where possible. One option that offers significant upside in this regard in exchange for a relatively modest investment is expanding and redistricting the Wisconsin Court of Appeals to shorten the time litigants must await final decisions. This fix is especially important in the context of government litigation, because government entities often have virtually unlimited resources and therefore can be in a much better position to "wait out" a private litigant who may not have the luxury of time on his or her side.

Background on Wisconsin's court system

Generally speaking, Wisconsin's judiciary is composed of three levels of review: trial-level courts called "circuit courts" in Wisconsin's 72 counties, staffed by approximately 250 judges; an intermediate-level court of appeals, composed of 16 judges, that hears appeals from the circuit courts; and a seven-justice supreme court that primarily (though not exclusively) provides a second level of appellate review, sitting in judgment of decisions by the court of appeals.[56]

The bulk of litigation in Wisconsin occurs in the circuit courts. It is usually only after that litigation concludes that the court of appeals or the supreme court (or both) may review a circuit court's decision.[57] This appellate review is critical to ensure that the lower court reached the right decision for the right reasons. But although both the court of appeals and the supreme court hear such appeals, these courts serve different purposes. The court of appeals' chief role is to correct errors in the decisions of circuit courts.[58] Litigants are correspondingly entitled to bring their cases to the court of appeals for review,[59] resulting in a significant caseload for that court: 2,156 filings in 2021 alone (Wisconsin Court System 2021, 2). In contrast, the Wisconsin Supreme Court's chief role is "that of law defining and law development."[60] It need not accept for review cases brought before it,[61] and in practice accepts only a fraction: in the 2020/21 term, it granted 52 petitions out of 651 received.[62]

Thus, for most individuals and businesses, the court of appeals represents both the only opportunity to correct a circuit court error and the end of the litigation process. Put differently, and in the context of the earlier discussion, a decision from the court of appeals is where litigation uncertainty largely terminates.

Time to obtain an opinion from the court of appeals

Unfortunately, obtaining a decision from the Wisconsin Court of Appeals, at present, requires a significant time investment. In 2021, *on average*, 369 days elapsed from the initiation of an appeal to the decision (Wisconsin Court System 2021, 3). But although waiting more than a year for a decision is problematic enough, this general figure masks even longer intervals. For example, in 2021 the wait increased to 490 days on average for a three-judge opinion and to a whopping 534 days on average for a per curiam opinion—that is, one authored "by the court" rather than by a named judge (Wisconsin Court System 2021).

The length of time to obtain a decision also varies by area of the state. The court of appeals is divided into four districts corresponding very roughly to Milwaukee County (District I), southeastern Wisconsin (District II), the northern half of Wisconsin (District III), and central and southwestern Wisconsin (District IV).[63] To select just one instance, in District II, the time period to obtain a decision for a per curiam opinion in 2021 was 617 days—almost two years (Wisconsin Court System 2021, 3).

On the whole, moreover, this picture appears to be worsening. As figure 8.1 shows, even while total filings in the court of appeals have fallen over the past 20 years, the average time to obtain an opinion has increased dramatically.

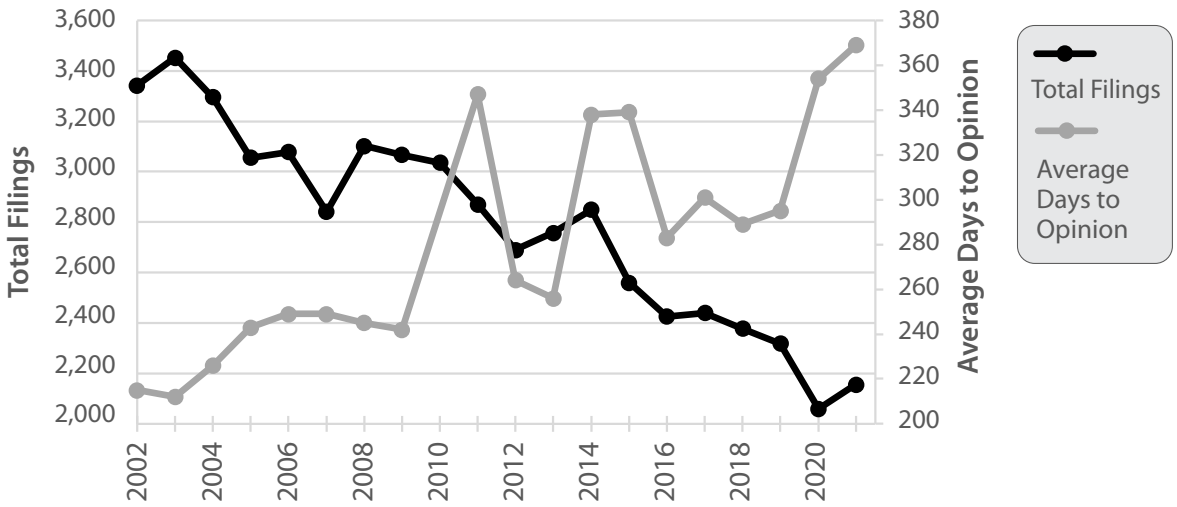
Depending on the subject matter of the dispute—whether to grant a permit, the allocation of intellectual property, the requirements of a contract—this sort of delay can negatively affect individuals, businesses, or even entire communities for months or years. This is hardly an ideal environment for economic growth. Further, as noted above, in litigation against the government the burden imposed by lengthy proceedings is not always distributed evenly; the government will often have the benefit of essentially unlimited resources on its side whereas a private litigant—a business, perhaps—may view immediate resolution as an urgent necessity. The private party may be forced to settle or capitulate entirely if faced with the prospect of more than a year of waiting for a decision.

The solution: Expand and redistrict

What can be done to reduce the time it takes to obtain an opinion at the court of appeals? There are numerous measures available, but two good places to start are to expand and redistrict the court.

When the court of appeals was instituted in 1977, the legislature assigned it 12 judges: three for each district.[64] From 1985 to 1994, four additional judges were added, one at a time, until the court reached its current configuration: four judges each in District I and District II, three judges in District III, and five judges in District IV.[65] But despite this initial, relatively regular expansion, no new judges have been added to the court

Figure 8.1 **Total Filings vs. Average Days to Obtain an Opinion**



Source: "Court of Appeals Statistics," Wisconsin Court System, https://www.wicourts.gov/other/appeals/statistical.jsp.

Note: This graph was produced using the Wisconsin Court of Appeals' own statistics. Those statistics should be consulted for additional details on methodology. Missing from the data is information on average days to decision in 2010.

since 1994, almost three decades ago. It is long since time to revisit this issue: it stands to reason that more judges will mean lighter caseloads per judge, which should result in quicker decision times. More carefully assigning caseload among the judges by redistricting will boost this effect.

Redistricting and expansion at the court of appeals could proceed as follows. First, conduct a full county-by-county audit of the decision-making process at the court. Assess how many days it took to resolve individual cases over a chosen period of time, sorted by county; rank the counties according to how much appellate work they are producing on average; then evenly group the counties into new, contiguous geographical districts to better distribute the court's caseload: wait time should not be a function of where a litigant lives. Notably, the Wisconsin Constitution allows the number of districts to be increased beyond the current four,[66] and this should be done if it will allow a more even distribution of labor and better tracking of decision times at the court.

Second, decide how many days should ideally elapse from initiation of an appeal to a decision at the court of appeals. For example, the current length of 534 days for a per curiam opinion creates an unnecessary amount of cost and uncertainty. Then, using data already on file and referenced in part above, assign the number of judges needed to reach this goal to each district. For example, in 2021 District I experienced 573 filings, or 143 average filings per judge, and averaged 420 days from the filing of the notice of appeal to a decision (Wisconsin Court System 2021, 1, 3). Thus a rough estimate is that, to reduce the time to a decision to 365 days, there should have been only 124 filings per judge, requiring 4.6 judges—the addition of a single judge. Assessing the data at a more granular level (for example, looking at the time to a decision for each type of opinion, such as three-judge, one-judge, and per curiam) will allow even closer estimates.

Third, do not neglect the funding of additional court staff. Staff attorneys, for example, play an integral role in the decision-making process, and their work should be factored into all calculations.

The end result of this process will be a more responsive court of appeals designed

for the Wisconsin of today, not the Wisconsin of 1994. The investment of a modest amount of money for new positions will represent enormous savings to Wisconsinites in terms of reduced litigation time—and uncertainty—in the thousands of matters heard at the Wisconsin Court of Appeals each year.

Summary Of Policy Recommendations

- Reinvigorate statutory constraints on agency authority.
- Strengthen constitutional protection of economic freedom.
- Multiply fee-shifting opportunities.
- Expand and redistrict the Wisconsin Court of Appeals.

Conclusion

Considered jointly, the recommendations outlined in this chapter would go a long way toward providing Wisconsinites with the confidence they need vis-à-vis their government to pursue success in the economic sphere, leading to growth and prosperity in the state. The first two proposals will cabin agency activity and provide workers with statutory and constitutional remedies when the government goes too far. The third and fourth proposals will put Wisconsinites in a better position to shoulder the burdens of litigation against the government when such litigation becomes necessary. These few modifications to Wisconsin's organic and statutory laws can help produce a new economic renaissance in the Badger State.

Notes

[1] Chief Legal Counsel & Director of Oversight, Institute for Reforming Government. The views expressed in this chapter are my own. Disclosure: my previous employer, the Wisconsin Institute for Law & Liberty, was involved with many of the matters discussed herein, such as the *Tetra Tech* and *Porter* cases.

[2] 2011 Wis. Act 21, § 1r.

[3] Wisconsin Legislature v. Palm, 2020 WI 42, ¶ 52, 391 Wis. 2d 497, 942 N.W.2d 900.

[4] For more information on the negative impact of federal regulations on the Wisconsin economy, see Chambers and O'Reilly (2021).

[5] See Clean Wisconsin, Inc. v. Wisconsin Department of Natural Resources (*Clean Wisconsin I*), 2021 WI 71, 398 Wis. 2d 386, 961 N.W.2d 346; Clean Wisconsin, Inc. v. Wisconsin Department of Natural Resources (*Clean Wisconsin II*), 2021 WI 72, 398 Wis. 2d 433, 961 N.W.2d 611.

[6] Tetra Tech EC, Inc. v. Wisconsin Department of Revenue, 2018 WI 75, ¶ 3, 382 Wis. 2d 496, 914 N.W.2d 21.

[7] Tetra Tech at ¶ 69 (plurality opinion).

[8] 2011 Wis. Act 21, § 4.

[9] Koschkee v. Taylor, 2019 WI 76, 387 Wis. 2d 552, 929 N.W.2d 600.

[10] 2011 Wis. Act 21, § 1r.

[11] Wis. Stat. § 227.11(2)(a)1.–2. Wis. Stat. § 227.11(2)(a)3. provides an analogous safeguard with respect to statutory standards, requirements, and thresholds.

[12] Wisconsin Legislature v. Palm, 2020 WI 42, ¶ 1, 391 Wis. 2d 497, 942 N.W.2d 900.

[13] *Palm* at ¶ 45 and note 15 (quoting Wis. Stat. § 252.02(6)).

[14] Palm at ¶ 55.

[15] Palm at ¶ 51.

[16] Clean Wisconsin, Inc. v. Wisconsin Department of Natural Resources (*Clean Wisconsin II*), 2021 WI 72, 398 Wis. 2d 433, 961 N.W.2d 611.

[17] Clean Wisconsin, Inc. v. Wisconsin Department of Natural Resources (*Clean Wisconsin I*), 2021 WI 71, 398 Wis. 2d 386, 961 N.W.2d 346.

[18] See *Clean Wisconsin II* at ¶¶ 1–2; *Clean Wisconsin I* at ¶¶ 1–2.

[19] See *Clean Wisconsin I* at ¶¶ 3, 9, 27, 39 (quoting Wis. Stat. § 283.31(3)).

[20] *Clean Wisconsin I* at ¶¶ 70–71 (Justice Roggensack, dissenting).

[21] *Clean Wisconsin II* at ¶¶ 23–24; see also *Clean Wisconsin I* at ¶¶ 24–25.

[22] *Clean Wisconsin II* at ¶ 30; see also Clean Wisconsin I at ¶ 75 n.12 (Justice Roggensack, dissenting).

[23] See, e.g., Williamson v. Lee Optical of Oklahoma Inc., 348 U.S. 483 (1955).

[24] Porter v. State, 2018 WI 79, ¶ 64, 382 Wis. 2d 697, 913 N.W.2d 842 (Justices R. G. Bradley and Kelly, dissenting).

[25] See, e.g., Lands' End, Inc. v. City of Dodgeville, 2016 WI 64, ¶ 128, 370 Wis. 2d 500, 881 N.W.2d 702 (Justice Ziegler, concurring) (citing Nebbia v. New York, 291 U.S. 502, 524 (1934)).

[26] *Lands' End* at ¶ 129 (quoting Chicago,

Burlington and Quincy Railway Co. v. Illinois, 200 U.S. 561, 592 (1906)).

[27] *Lands' End* at ¶¶ 128–29.

[28] *Lands' End* at ¶ 130.

[29] Vacco v. Quill, 521 U.S. 793, 799 (1997).

[30] *In re Mental Commitment of Mary F.-R.*, 2013 WI 92, ¶ 35, 351 Wis. 2d 273, 839 N.W.2d 581 (quoting City of Cleburne v. Cleburne Living Center, 473 U.S. 432, 440 (1985)).

[31] See *In re Mental Commitment of Mary F.-R.*

[32] See *In re Mental Commitment of Mary F.-R.* (quoting *Cleburne* at 440).

[33] See *In re Mental Commitment of Mary F.-R.* (quoting Cleburne at 440).

[34] Porter v. State, 2018 WI 79, ¶ 2, 382 Wis. 2d 697, 913 N.W.2d 842.

[35] *Porter* at ¶ 55 (Justices R. G. Bradley and Kelly, dissenting).

[36] *Porter* at ¶ 2 and note 2 (majority opinion).

[37] See *Porter* at ¶¶ 60–61 (Justices R. G. Bradley and Kelly, dissenting).

[38] Wis. Const. art. I, § 1.

[39] *Porter* at ¶ 64 (Justices R. G. Bradley and Kelly, dissenting).

[40] See *Porter* at ¶¶ 31–35, 51. The challengers sought what amounted to an intermediate level of scrutiny and did not ask for the highest level of review: strict scrutiny. See *Porter* at ¶ 58; *Porter* at ¶ 75 (Justices R. G. Bradley and Kelly, dissenting). The two dissenting justices noted that claim therefore remains available in a future case.

[41] See *Porter*.

[42] Wis. Const. art. XII, § 1.

[43] *Porter* at ¶ 24.

[44] See *Porter* at ¶ 96 (Justices R. G. Bradley and Kelly, dissenting).

[45] Estate of Kriefall v. Sizzler USA Franchise, 2012 WI 70, ¶ 72, 342 Wis. 2d 29, 816 N.W.2d 853.

[46] See, e.g., Martineau v. State Conservation Commission, 54 Wis. 2d 76, 79, 194 N.W.2d 664 (1972).

[47] See *Martineau* at 79–80.

[48] Wis. Stat. § 814.245.

[49] See Wis. Stat. § 814.245(3).

[50] Collins v. Policano, 231 Wis. 2d 420, 427, 605 N.W.2d 260 (Ct. App. 1999); see Wis. Stat. § 227.01(3).

[51] Wis. Stat. § 814.245(3).

[52] Wis. Stat. § 814.245(2)(e).

[53] Wis. Stat. § 814.245(2)(b)–(c), (3), (8).

[54] Wis. Stat. § 814.245(3); State v. Detert-Moriarty, 2017 WI App 2, ¶¶ 1–2, 373 Wis. 2d 227, 890 N.W.2d 588.

[55] Wis. Stat. § 814.245(5)(a)2.

[56] See, e.g., "Court System Overview," Wisconsin Court System, https://www.wicourts.gov/courts/overview/overview.htm.

[57] Wis. Stat. §§ 808.03, 808.10 (2019/20).

[58] See Cook v. Cook, 208 Wis. 2d 166, 188, 560 N.W.2d 246 (1997).

[59] Wis. Stat. § 808.03(1).

[60] *Cook* at 189.

[61] Wis. Stat. § 809.62(1r)

[62] "Wisconsin Supreme Court Annual Statistical Report 2020–2021 Term," Wisconsin Court System, p. 2, https://

www.wicourts.gov/sc/DisplayDocument.pdf?content=pdf&seqNo=439770.

[63] "Court of Appeals: Wisconsin's Intermediate Appellate Court, Overview," Wisconsin Court System, https://www.wicourts.gov/courts/appeals/index.htm.

[64] Wis. Stat. § 752.03 (1977/78).

[65] See 1985 Wis. Act 29, § 2342z (thirteen); 1989 Wis. Act 63, § 2 (fourteen); 1991 Wis. Act 71, § 2 (fifteen); 1993 Wis. Act 16, § 3566 (sixteen).

[66] Wis. Const. art. VII, § 5(1).

References

Bentham, Jeremy. 1843. *Memoirs and Correspondence*. Vol. 10 of *The Works of Jeremy Bentham*, edited by John Bowring. Edinburgh: William Tait, 1838–1843.

Bolick, Clint. 2016. "Right to Earn a Living Act," Goldwater Institute.

Broughel, James, and Adam Hoffer. 2021. *Wisconsin Regulation in Focus*. Wisconsin Institute for Law & Liberty and Menard Family Initiative, November 2021.

Chambers, Dustin, and Colin O'Reilly. 2021. "The Regressive Effects of Regulations in Wisconsin." Policy Brief, Mercatus Center at George Mason University, Arlington, VA, March 2021.

Jackson, Laura E., Kevin L. Kliesen, and Michael T. Owyang. 2019. "A Bad Moon Rising? Uncertainty Shocks and Economic Outcomes." Economic Synopses, Federal Reserve Bank of St. Louis, March 1, 2019.

Wisconsin Court System. 2021. *Court of Appeals Annual Report, 2021*. https://www.wicourts.gov/ca/DisplayDocument.pdf?content=pdf&seqNo=522182.

Wisconsin Legislative Reference Bureau. 2021/22. *Wisconsin Blue Book*.

Cases Cited

Chicago, Burlington and Quincy Railway Co. v. Illinois, 200 U.S. 561 (1906).

City of Cleburne v. Cleburne Living Center, 473 U.S. 432 (1985).

Clean Wisconsin, Inc. v. Wisconsin Department of Natural Resources (Clean Wisconsin I), 2021 WI 71, 398 Wis. 2d 386, 961 N.W.2d 346.

Clean Wisconsin, Inc. v. Wisconsin Department of Natural Resources (Clean Wisconsin II), 2021 WI 72, 398 Wis. 2d 433, 961 N.W.2d 611.

Collins v. Policano, 231 Wis. 2d 420, 605 N.W.2d 260 (Ct. App. 1999).

Cook v. Cook, 208 Wis. 2d 166, 560 N.W.2d 246 (1997).

Estate of Kriefall v. Sizzler USA Franchise, 2012 WI 70, 342 Wis. 2d 29, 816 N.W.2d 853.

In re Mental Commitment of Mary F.-R., 2013 WI 92, 351 Wis. 2d 273, 839 N.W.2d 581.

Koschkee v. Taylor, 2019 WI 76, 387 Wis. 2d 552, 929 N.W.2d 600.

Lands' End, Inc. v. City of Dodgeville, 2016 WI 64, 370 Wis. 2d 500, 881 N.W.2d 702.

Martineau v. State Conservation Commission, 54 Wis. 2d 76, 194 N.W.2d 664 (1972).

Nebbia v. New York, 291 U.S. 502 (1934).

Porter v. State, 2018 WI 79, 382 Wis. 2d 697, 913 N.W.2d 842.

State v. Detert-Moriarty, 2017 WI App 2, 373 Wis. 2d 227, 890 N.W.2d 588.

Tetra Tech EC, Inc. v. Wisconsin Department of Revenue, 2018 WI 75, 382 Wis. 2d 496, 914 N.W.2d 21.

Vacco v. Quill, 521 U.S. 793 (1997).

Williamson v. Lee Optical of Oklahoma Inc., 348 U.S. 483 (1955).

Wisconsin Legislature v. Palm, 2020 WI 42, 391 Wis. 2d 497, 942 N.W.2d 900.

CHAPTER

9

A Road Map for Market-Based Health Care Reform in Wisconsin

Daniel Sem and Scott Niederjohn

A doctor cares for a patient.

Photo by Rapeepat Pornsipak / Shutterstock.com

9 A Road Map for Market-Based Health Care Reform in Wisconsin

The challenge of improving health care has gained attention across the United States. Proposals advanced in Wisconsin and elsewhere seek to reduce health care costs, maintain quality, and increase accessibility. This chapter will examine the economics of health care, considering both demand and supply in the market. Wisconsin currently does not have an efficiently functioning market for health care. We consider the reasons for this given the constraints and loopholes present in the state, along with the tradeoffs that all health care public policies must face. Finally, we advance a set of principles that should be followed in any health care reforms considered by Wisconsin policy makers.

1. The demand for health care has distinctive features that make it different from ordinary consumer demand for goods and services.
2. The supply of health care faces many obstacles to the efficient provision of service to patients.
3. The demand and supply of health care do not meet in a well-functioning open market, unlike the demand and supply for many other goods and services.
4. The exclusive use of insurance to pay for health care distorts market forces and gives decision-making power to third parties.
5. Therefore, reform should concentrate on ensuring that there is a properly functioning market, and improving incentive structures to promote health care access and affordability while maintaining quality.

The Economics of Health Care

The economist Thomas Sowell (1993) stated, "The first lesson of economics is scarcity: there is never enough of anything to satisfy all that want it. The first lesson of politics is to disregard the first lesson of economics." To be sure, health care has its peculiarities in both demand and supply. Although analysts commonly refer to a health care "market," we will show that the beneficial effects of true markets are often absent where health care is concerned. Forces such as third-party payers, pricing problems, counterproductive regulation, and a lack of productivity from technology complicate the picture. An underlying problem is the conflation of the terms "health care" and "insurance" by politicians. Quality health care can be obtained with or without insurance. Further, complete reliance on insurance in its current form removes or distorts typically useful market forces, leading to increased cost.

Politicians may talk about "free" health care for everyone, but a serious consideration of health care must begin with a realistic analysis of the relevant economic principles. We find these to be the most important:

The demand for health care

As the Thomas Sowell quotation indicates, the fundamental problem that all economics systems must grapple with is scarcity. Health care is not at all immune to the tradeoffs and economic choices that must be made under such conditions of scarcity. Resources for the production of health care—the people, hospitals, prescription drugs, clinics, and technology—have valuable uses in other sectors. What's more, people desire more health care than can be provided with existing resources, no matter the funding system employed. As a result, we have to make choices about how, and to whom, health care is to be delivered.

Most goods and services produced in the Wisconsin economy come from the private sector, and most people prefer it that way. Few of us would want our cheese, motorcycles, or professional sports to be produced by the government. But when it comes to health care, people often think differently. To many, the allocation of medical care on the basis of price seems unethical. As a result, many nations with market economies (Canada, the United Kingdom, and nearly all the nations of Western Europe) have chosen socialized arrangements for medical care to some degree.

While the systems in these countries differ in particular ways, most hospitals are operated by the government and paid for with taxes. Commonly, tax revenues do not keep pace with the quantity of health care that people demand when it is provided for them at no direct cost. Frequently the result is shortages. To deal with the shortages, governments develop rules and policies to allocate health-care services. The consequence is that patients sometimes must wait in line for important medical procedures, or that certain procedures or drugs are not covered. In Canada, a recent survey[1] revealed that the total waiting time between referral by a general practitioner and treatment by a specialist averaged to 25.6 weeks. Of that time, the wait from referral to consultation with the specialist was 11.1 weeks. The waiting time between specialist consultation and treatment was 14.1 weeks. The wait times measured for 2020 were all higher than in 2019. They differed substantially across the provinces.

Shortages and other problems in the health-care sector arise from the workings of demand and supply—but not always in the same way as in other sectors. One seemingly important difference in demand is the idea that health care is a necessity. To be sure, there are not good substitutes for medical care. When health care prices increase, the quantity demanded falls very little. For example, when prices increase for the latest cancer treatment or the newest diagnostic device, people still seek the treatment. They are made even more willing because they often do not bear all of the out-of-pocket costs. The economic term for a good or service that sees little change in quantity demanded when price goes up is "inelastic," and health care demand is decidedly inelastic.

How important is this characteristic of health care? Its status as a necessity might seem to set health care apart in a special category. However, its necessity does not explain why health care should be different. It is understandable to pay a high price for a cancer drug ($170,000 in some cases), but what if the efficacy of the drug is questionable and data suggests it may extend life at most 10 weeks? This is the case for many new and expensive cancer drugs.[2] This clearly presents a moral and ethical dilemma, but does it not include elements of market considerations—and isn't it more logical that the patient rather than a remote third party should make these decisions?

Health care is by no means the only necessity about which consumers make choices. Food and housing are necessities, too, but most Americans don't turn to others to manage their purchase of food and housing. They don't ask their employers to buy their groceries or pay their rent. Instead, they decide what sort of food they wish to eat and what sort of housing they wish to have. Their food and housing choices may be supported by nutrition programs or housing subsidies, but consumers do not expect massive government intervention into these markets.

In addition to being inelastic, the demand for health care is highly dependent on income. As incomes rise, people demand more health care—and the effect is not small. Per capita income in the United States amounted to about $63,416 in 2020. That level of per capita income alone explains a good portion of why Americans now demand more and better health care. Economists call goods with a positive response to income "normal goods" and health care is a prime example of such a good.

The expressed demand for health care in the United States is boosted by payment methods. American consumers of health care depend heavily on third-party payers. Most families have health insurance paid for, at least in part, by an employer. As a result, they do not feel the "bite," in direct costs, of the health care they consume. As Milton Friedman once wrote, "Nobody spends somebody else's money as wisely as he spends his own."[3] Vernon Smith, the 2002 Nobel Laureate in Economics, describes it this way:[4]

> A is the customer. B is the service provider. B informs A what A should buy from B, and a third entity, C, pays for it from a common pool of funds. Stated this way, the problem has no

known economic solution because there is no equilibrium. There is no automatic balance between willingness to pay by the consumer and willingness to accept by the producer that constrains and limits the choices of each.

For good reasons, consumers of health care do not shop around for medical care as they do for other goods and services. Of course, in an emergency situation, a patient will not and cannot be expected to "shop." But most health care is not delivered in an emergency situation. Instead, health services involve repeated interactions between physicians and patients.

Although these relationships are highly personal, neither the patient nor the physician decides what service or therapy can be provided and paid for. Rather, the third-party insurer does, in that the physician follows and is constrained rules imposed by a third-party. Furthermore, because of the personal nature of the relationship between patient and doctor, patients do not quickly or easily change providers.

The disinclination to shop is reinforced by the payment system. From the patient's perspective, why spend time shopping for a low price when somebody else is paying the bill? From the physician's perspective, why antagonize others in the system by encouraging out-of-network shopping (which the industry refers to as "leakage")? The point is not that more shopping would solve all of health care's economic problems, but that important forces that make other markets work are absent in health care—with little or nothing to take their place. Consumers might prefer a more efficient market in health care that also empowers them, but such a market cannot directly be observed, given the way health care is paid for today via insurance-based reimbursement.

Health insurance itself has a special status in the United States. In 2019, it is estimated that 92.6 percent of Wisconsin residents had health insurance for the entire year.[5] And 60.5 percent of state residents had health insurance through insurance programs offered by their employers. The insurance is part of their compensation packages. It is a form of compensation not subject to federal income tax or Social Security tax. This special tax status makes group health insurance an attractive option for employers and employees, even as it discourages well-functioning markets in health care.

It hasn't always been this way. Before World War II, health insurance was an individual responsibility and health care costs were much lower. During the war, although workers were in short supply, federal wage and price controls prevented companies from offering increased wages to attract workers. But employers could offer prospective employees "fringe benefits." One such inducement was health insurance, thanks to a War Labor Board decision to exempt pension and insurance contributions from wage and price controls.

In 1943, the Internal Revenue Service ruled that such benefits were not to be considered taxable income. This ruling was built into the tax code in 1954, converting a temporary wartime expedient into a durable part of the nation's laws. The U.S. is unusual in having this arrangement. Japan is the only other developed nation to rely on system of employer provided health insurance coverage. This coupling of health insurance with employment has been cited as a potential barrier to business creation as workers experience an "entrepreneurship lock," staying in their current jobs to keep health benefits for their families (Fairlie, et al, 2011).

Two additional factors influence demand for health care:

- First, our population is aging, and older people demand more health care than younger people. By 2030, over 20 percent of the population (about 70 million U.S. citizens) will be 65 years old or older, and about 8.5 million will be older than 85. People older than 85 are in fact the fastest-growing age group in the United States. Individuals in this age group consume a great deal of health care. They are the ones most likely to be disabled, to use multiple medications, and to need comprehensive long-term care.

- Second, physicians themselves influence demand. Most physicians are compensated on a fee-for-service basis. This provides an incentive for them to offer more services, especially when they know that the services they provide will generate little or no out-of-pocket expense to their patients. The threat of malpractice suits is also relevant. It provides an incentive for physicians to practice what's called "defensive medicine." Failure to test for a potentially serious condition could create malpractice liability, while ordering low-value tests would have no downside for the physician (and would generating additional revenue). In the face of such incentives, it is not surprising that physicians may order expensive tests even when they know the tests have little value medically.

The supply of health care

Like the demand for health care, the supply of health care has some distinct influences that affect the provision of services. One such influence is the supply of physicians. Medical education ordinarily requires four years of undergraduate college work, four years of medical school, a residency, and perhaps three more years of training in a medial specialization. It is an expensive undertaking in both financial and opportunity costs.

The supply of primary care physicians, informally known as "family doctors," is a particular challenge. In a properly functioning market, arguably most health care would be provided by primary care physicians. These providers can offer more time and coordinate with specialists when necessary. However, primary care is not emphasized in today's reimbursement-driven fee-for service model. Driven by insurance, the system is distorted to favor care delivery from more profitable specialty units. Though troublesome, this may not be permanent. A recent Bloomberg article noted how outside the scope of the large providers, this trend in relative importance of physician roles may be reversing.[6]

In most sectors of the economy, supply is increased through gains in productivity. Unfortunately, the health care sector has not experienced the productivity gains that are widespread elsewhere in the economy. Health care is part of a broader service sector, including teaching, acting, and waiting tables. And, like other parts of the service sector, it lags behind the overall economy in measured productivity. While today's farmers can grow 20 times the corn of a 1900 farmer because of productivity advances like tractors and pesticides, a brain surgeon today certainly cannot treat 20 times the patients she did in 1900.

Another supply problem is that technology in health care works differently than it does elsewhere. In other sectors, when a technological breakthrough brings new products, the initial price tends to be high. Mobile phones and large-screen televisions, for example, appeared in stores initially as relatively expensive products. In most sectors, however, market forces soon take over and work to reduce prices. High early prices attract additional producers. Competition increases. Production techniques improve. Supply increases and prices come down.

In health care, new technologies often take years to develop, and they are subject to numerous regulations. Their demand may be influenced more by whether they will be covered by insurance than by their medical value. Like other new products, they come onto the market initially at a high price. But we don't typically see market pressures bringing prices quickly down in health care. Why not? The explanation has to do with the nature of health care when stakes are high. Consumers facing serious medical problems demand prompt access to the latest technology—the latest robot-assisted surgery, the least invasive treatment for a herniated disk, or the newest cancer treatment.

Consider the recent and dramatic increase in cost of the EpiPen, an auto-injector that treats allergic reaction episodes. Per unit, its price abruptly increased several hundred percent. Competition could have easily forced price stabilization, if not for regulatory barriers that make it too time-

consuming and costly to introduce a competing product of equal quality and efficacy.[7]

Although competition can stabilize prices, understandably patients and their physicians do not want to wait around for new producers to enter the market, increase competition, increase supply, and reduce prices. Of course, this preference is easier for patients to satisfy when someone else is paying for the treatment in question.

Lack of a functioning market

Taken separately, supply of and demand for health care in the United States have their own distinctive problems. But a more fundamental problem is that, because payments for services are made by a third party (that is, insurance), the demand and supply of health care do not meet in a well-functioning open market, unlike many other goods and services. These other sectors have shown that markets do not have to function perfectly to deliver large gains to consumers. Problems such as small numbers of producers and historically poor customer service give way when open competition is possible. But health care suffers from being provided outside the context of a vibrant free-market system. Health care policies that shift costs heavily to third-parties have eroded the incentive for consumers and providers to economize. In the introduction to her 1997 book *Market Driven Health Care*, Regina Herzlinger writes:

> Is the health care sector different from the other sectors of the economy? Are there no lessons at all to be learned from the manufacturing and service industries that turned themselves inside out to give the United States back its number-one competitiveness ranking? Do world-class firms like McDonalds that specialize in quick, courteous, consistent, low-cost service really have nothing that the health care sector can emulate? Is there really no role in the health care sector for brilliant entrepreneurs and technologies, like those who created the consumer-responsive Home Depot and the technology leader Microsoft?

Years after the publication of Herzlingler's book, little has changed. Policy discussion tends to focus on how to pay for health care's increasing costs rather than how to control those costs while achieving high quality. In a vibrant market consumers do not have to settle for high costs and indifferent producers. Consumers weigh the price of a good or service against its quality. If the quality isn't provided at the right price, they walk away. Producers pay close attention to these decisions. They innovate to provide consumers with the quality they want at the price they are willing to pay. Providers who are successful remain in business and expand, while providers who are not successful are driven out.

An additional obstacle to vibrant markets in health care is the lack of price transparency. In most cases patients undertake a treatment with little idea of how much it costs. In the case of emergency care, until recently there were surprise bills after the fact, averaging $750-$2,600 per episode.[8] And, given the prevalence of third-party payers, consumers have little incentive to find out prices when the make the "purchase decision" to seek care. However, this issue cannot be completely blamed on lazy health care consumers. They find it difficult to compare prices—and the price matters little if insurance is covering the procedure. With prices not easily observable, they can vary greatly across location, insurance status, and other factors. A joint replacement can be twice as expensive in one location but the actual price can be very difficult to observe.[9] Recent federal requirements have added pricing transparency and have reduced surprises, but problems still persist.[10]

Would open markets with price transparency work in health care? The case of Lasik eye surgery suggests they could. While not generally covered by insurance, this market has been characterized by innovation, increases in quality, falling prices and even marketing to attract customers based on outcomes and prices. Another example of price transparency is the Surgery Center of Oklahoma[11] where the prices of procedures are clearly observable on an easy to navigate website.

Health Care Tradeoffs

Thomas Sowell (1987), once again, provides guidance as we consider the options to improve health care funding and delivery in Wisconsin and the nation. While Sowell was referring to all economic choices when he said, "There are no solutions, only tradeoffs", perhaps no sector better illustrates this economic law better than health care.

According to economist Arnold Kling (2006), the tradeoffs in health care revolve around three primary goals:

- affordability
- access
- insulation from risk

Kling explains that because of scarcity, any system can only achieve two of these three. Kling's "pick any two" framework is sometimes referred to as the "heath care trilemma." Here we examine the three goals, including a consideration of quality metrics, and conclude with our recommendations. We believe that reforms should maximize affordability and access while maintaining high quality with measurable positive outcomes. These reforms must involve a greater reliance on market forces. The current opaque and rigid reimbursement-driven world of insurance, we argue, should at least be supplemented and potentially be replaced by market-driven reforms.

Issues of access

As documented earlier, employers provide most of the health-care coverage in Wisconsin. The 2019 Wisconsin Family Health Survey reports that 92.6 percent of Wisconsinites were covered by health insurance for at least part of the year. The report further estimates that 270,000 Wisconsin residents were insured for only part of the year and 275,000 had no health insurance coverage at all during the year. Among Wisconsin adults aged 65 and older, 95 percent have Medicare coverage and 4 percent have Medicaid coverage. Compared with Whites, 93.7 percent of whom had health insurance for the entire past year, Blacks stood at 81.2 percent coverage and Hispanics at 87.1 percent. Residents living in non-poor households averaged 95.8 percent health insurance coverage last year, while the figure was 86.6 percent for poor households and 87.6 percent for near-poor households.

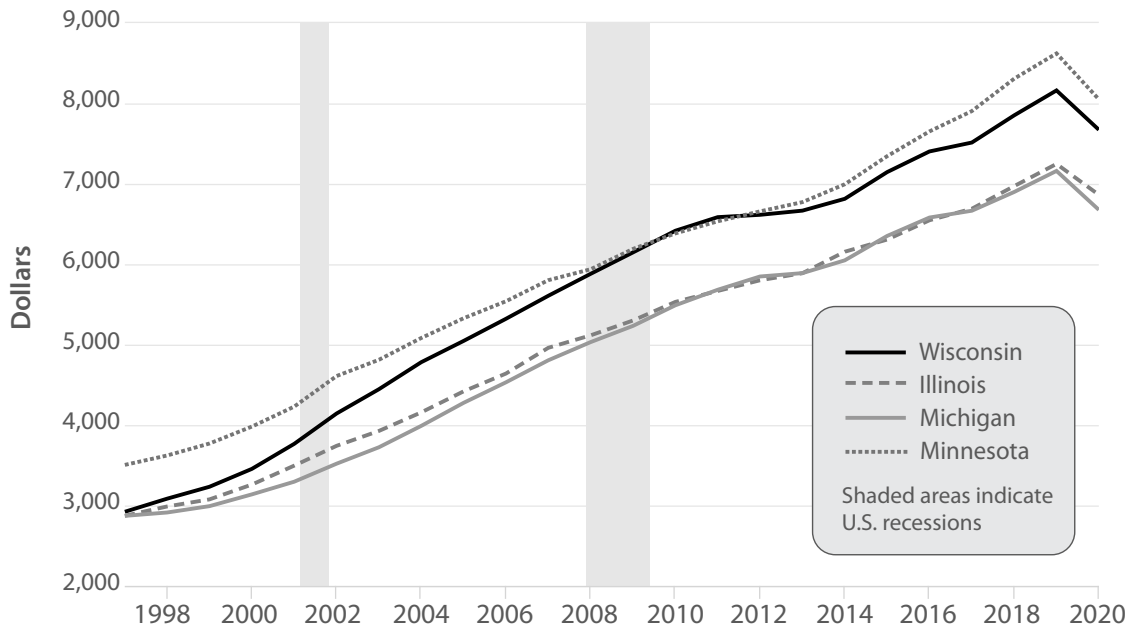
Directly or indirectly, states pick up much of the cost for the uninsured. Uninsured individuals receive health care at state-subsidized clinics and hospital emergency rooms. States also bear most of the treatment costs of chronic illness among the uninsured. Moreover, having large numbers of people without good health care hurts the state's labor force. It erodes human capital and hampers Wisconsin's productivity.

Issues of affordability

The United States leads the developed world in health care spending per capita. The Centers for Medicare and Medicaid Services (CMS) estimates that the U.S. spent more than $12,500 per person on health care services in 2020.[12] Total health care spending in the U.S. consumes nearly 18 percent of Gross Domestic Product (GDP). In contrast, national health expenditure data collected by the Organisation for Economic Cooperation and Development (OECD)[13] reveals that the United Kingdom spent less than $6,000 per person and Canada closer to $7,000.

Figure 9.1 shows per capita personal health-care spending in Wisconsin and other Midwest states from 1997 to 2020.[14] While each of these states spends less, per capita, than the national average, the total is still near $8,000 of total health care spending per person in 2020. High health care spending would be easier to accept if it led to superior health. However, standard measures of health outcomes do not show significant advantages for higher-spending states within the U.S. or for the U.S. relative to the world.[15] This raises the possibility that the U.S. could achieve current levels of health with lower spending, greatly increasing affordability. However, this is only a possibility until reforms are implemented to improve the efficiency of health care delivery.

Figure 9.1 **Per Capita Health Care Spending in the Midwest**



Source: US Bureau of Economic Analysis, "Per Capita Personal Consumption Expenditures: Services: Healthcare for Wisconsin [WIPCEPCHLTHCARE]," retrieved from FRED, Federal Reserve Bank of St. Louis, February 9, 2022, https://fred.stlouisfed.org/series/WIPCEPCHLTHCARE.

Mitigating risk

Consumers want health care to be affordable, but they also want the ability to mitigate risk. That, of course, is the purpose of insurance. We think of insurance as protecting us financially against rare but expensive losses. Insurance protects us against "insurable risks," commonly defined as having these characteristics:

- Potential, rather than already realized
- Significant and important in size and scope
- Well-defined and out of the policyholders' complete control
- Reasonably independent from other losses
- Not so large as to be beyond the ability of an insurer to pay

Defined in this way, individuals' health care risks are insurable. Thus it is not surprising that health insurance came into its own in the last century as a way of pooling individual risks.

In some ways, health insurance is not that different from other forms of insurance. Auto insurance is purchased to pool the risk with other drivers of an accident that leads to very large bills. Homeowner's insurance works in a similar way. A large pool and efficient administration can keep the costs low. Everyone pays a premium and escapes the risk of individual disaster. However, unlike group health insurance, we do not ask our auto and home insurance companies to pay for our routine expenses.

Consider this question: Should auto insurance should cover the cost of replacing windshield wiper blades? Most consumers would answer "no," recognizing that it's better to handle routine replacement themselves. Adding an insurance company to the mix would only increase costs. Yet even as consumers do not expect insurance to pay for wiper blades, they do generally expect that health insurance should cover every health care cost—including some that small.

One way to make health insurance more affordable is have consumers handle small costs while keeping insurance in place for the larger, less predictable expenditures. This is exactly the purpose of high deductible health insurance plans. These plans provide lower monthly premiums in exchange for larger out of pocket costs. High deductible plans appear unusual to those who are accustomed to the idea that health insurance should cover "everything." Yet, covering small medical costs out of pocket was common in the U.S. years ago—and covering small auto costs out of pocket instead of using insurance is routinely accepted today.

Is health care, defined as the ability to adequately take care of our physical and mental needs, a right? Many would answer yes. Still, one should not confuse insurance with health care. Many Wisconsinites likely view the two terms as synonyms. They are used to treating their health insurance provider as a third-party payer for their health care needs. Whether one thinks health care is a right or not, it is a separate issue when we consider whether universal health care insurance should be provided by the government. The government in Singapore provides public health care in the form of citizen-owned Health Savings Accounts (HSAs), and the consumers purchase their own health care in a private market using these. Thus, they are still using market forces, even though the government feels all citizens should get support for health care costs.

Insurance is simply one of many ways of paying for health care—a peculiar way that generates perverse incentives, and disempowers patient-consumers. It does not just shift the cost of paying, but in a system where prices and market incentives are blunted, it also increases the overall costs of the health care system. Incentives for high costs are spread throughout the system. Consider what happens when a disproportionate share of unhealthy individuals join an insurance plan. This can occur because individuals with greater health care needs, when given the opportunity, are more likely to purchase health insurance. They also may opt for richer benefits than individuals with fewer health care needs. In such a case, known as "adverse selection," the insurance plan faces huge claims and must charge high premiums to remain solvent. These high premiums make the insurance even less attractive for relatively healthy people. Their exit makes matters worse and works against the large pools that make insurance more effective.

Any insurance policy or even the entire system can be affected by adverse selection. All of this occurs in a system of insurance that may lead patients to demand, and providers to supply, more health care than is medically useful.

Which two to choose?

Our current health insurance market structure (1) promotes access and (2) mitigates risk. Affordability suffers, as predicted by the Kling trilemma that says we may have only two of the three desirable characteristics. Alternatively, the Canadian and British systems (1) emphasize affordability and (2) mitigate the risk faced by individuals from medical expenses. These two characteristics come from universal health care achieved through a single payer government program. Still, the third characteristic, access, is reduced or compromised. These systems lead to a rationing of care[16] through price controls, spending caps, and queuing. The wait times to see a specialist, for example, can be significant (as documented earlier). Furthermore, while they decrease direct cost to patient-consumers, the overall cost of health care is still relatively high and increasing faster than inflation (albeit not as high as in the U.S.), and paid for in other ways such as taxation.

A Common-Sense Reform Idea For Wisconsin: Direct Primary Care

Direct Primary Care (DPC) is a model that gives patients 24/7 access to their doctor, unheard of in the reimbursement-driven world of insurance. This market-based approach is actually being implemented in Wisconsin. Under DPC, health care is received directly from physicians, without the intervention of insurance and without the bureaucracy found in the current

medical system. DPC focuses on the patient-physician interaction, delivering up-to-date medical treatment but with the personal touch that was common in medicine many years ago.

Physicians prefer this model because it provides them with more time with patients. While the average patient load in a traditional practice is 2,000, with DPC a physician may manage 345 patients on average. Each patient receives more attention and the physician has a less harried environment for practice.

DPC models can be affordable, too: they cost about $70 per month on average. DPC patients can call or text their doctors 24/7, and get more in-person time and care than is normally the case. For less than the cost of a single emergency visit ($1,500 in Wisconsin), the patient gets a personal physician. Routine follow-up lab tests, prescriptions, and even imaging are provided, typically for a nominal extra cost. This is more affordable, accessible and better care for over 90 percent of common medical problems. Advocates believe that DPC is better for the doctor and better for the patient. Direct Primary Care is just one possible model but it illustrates a common-sense path forward to reform for Wisconsin. While the details of new models are not certain, their potential comes from the ability to avoid the opaque reimbursement-driven system that has led to unrelenting increases in health care costs in the U.S.

Policymakers cannot centrally specify just how new models of health care should work. However, by supporting open markets, price transparency and related reforms, they can open the field to new possibilities preferred over the current system by patients and practitioners alike.

Principles for Further Reform

We advise that the best mix for Wisconsin is a health care system that emphasizes affordability and access while maintaining quality. To increase the effectiveness of Wisconsin's health care system, we believe that government policies concerning health care should incorporate the following principles:

- Consumers should have significant leeway to choose among providers and services. This could be facilitated by ready access to their medical records and flexible usage of HSAs (see below).
- Insurance should be of the high-deductible variety to insulate individuals and families from catastrophic expenses. Both the demand and the supply sides of the market would function more efficiently if insurance merely performed its risk-reduction role rather than functioning as a third-party payer called upon to cover almost all health care expenses.
- Consumers should be able to choose the insurance they want, and insurance should not be tethered to employment. If there is federal or state-sponsored insurance, there should also be private options available, with tiers of coverage to choose from.
- Policy makers should consider measures to bolster tax-advantaged HSAs that could be used more flexibly—for instance, to pay for routine medical expenses through new compensation models. One such promising model, DPC, replaces fee-for-service with a membership fee, resulting in beneficial effects for patients and providers.
- Medicare and Medicaid dollars spent in the state should also be provided via vouchers that may be used to purchase DPC, among other alternatives.
- Widespread price transparency would allow consumers to make informed decisions about their health care. Health care navigators or advocates, who have a health care and fiduciary duty only to the patient-consumer (rather than to an insurance company), could help consumers navigate the insurance and care options.

Conclusion

Patient-consumers should be empowered to seek care in a functioning market with upfront transparent pricing. We believe that a high level of quality, accessibility and affordability would be the result. Insurance should not be used as the sole mechanism

for obtaining health care. Patient-consumers, no matter their wealth status, should also have access to health care by other delivery channels.

This will only be possible in Wisconsin if consumers have options outside of the traditional bounds and constraints of insurance-driven markets that are not really markets at all. The following elements are necessary:

- Consumer options to choose quality high deductible plans (whether private or public)
- Protected access to direct primary care providers (physicians, nurse practitioners, etc.)
- Freedom to spend Medicare and Medicaid dollars on new models such as direct primary case outside the world of insurance
- More flexible usage of HSAs for purchasing health care

All of this must be done with an eye to making sure affordable health care access is provided to all, including especially those who currently struggle financially. Many of these patients receive inadequate care, perhaps because of unfavorable social determinants of health. This recommended approach is all about providing the value-based care that the health care industry says it wants, but in a more flexible way that empowers consumers.

Notes

[1] Moir, Mackenzie and Barua, Bacchus. "Waiting Your Turn: Wait Times for Health care in Canada" Fraser Institute, 2021. https://www.fraserinstitute.org/studies/waiting-your-turn-wait-times-for-health-care-in-canada-2021

[2] https://arstechnica.com/science/2017/02/most-new-high-priced-cancer-drugs-dont-even-extend-life-for-10-weeks/

[3] Quoted by Cogan, John F., Hubbard, Glenn, R. and Kessler, Daniel P. "Healthy, Wealthy and Wise" *The Wall Street Journal* May 4, 2006.

[4] Vernon L. Smith, "Trust the Customer!," *Wall Street Journal*, March 8, 2006, A20.

[5] Wisconsin Family Health Survey, 2019: https://www.dhs.wisconsin.gov/publications/p45369a-19.pdf

[6] Angelica Peebles, "Medicine's Worst-Paying Specialty Is Luring Billions from Wall Street," Bloomberg, February 10, 2022, https://www.bloomberg.com/news/features/2022-02-10/primary-care-health-investors-bet-billions-on-medicine-s-worst-paying-specialty.

[7] https://www.govinfo.gov/content/pkg/CHRG-114shrg22221/html/CHRG-114shrg22221.htm and https://thehill.com/blogs/pundits-blog/health care/292438-competition-is-the-cure-for-epipens-price-hike

[9] Nisha Kurani et al., "Price Transparency and Variation in U.S. Health Services," *Health System Tracker*, January 13, 2021, https://www.healthsystemtracker.org/brief/price-transparency-and-variation-in-u-s-health-services.

[10] Dave Muoio, "CMS Sent Out Warnings to Hospitals Failing at Price Transparency. Some Still Aren't Sure Where They Land," May 10, 2021, *Fierce Healthcare*, https://www.fiercehealthcare.com/hospitals/cms-sent-out-its-first-wave-warnings-to-hospitals-noncompliant-its-new-price-transparency.

[12] Centers for Medicare and Medicaid Services, "NHE Fact Sheet," last modified February 17, 2023, https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/NHE-Fact-Sheet.

[13] Matthew McGough et al., "How Does Health Spending in the U.S. Compare to Other Countries?," *Health System Tracker*, February 9, 2023, https://www.healthsystemtracker.org/chart-collection/health-spending-u-s-compare-countries-2/.

[14] U.S. Bureau of Economic Analysis, Per Capita Personal Consumption Expenditures: Services: Health care for Wisconsin [WIPCEPCHLTHCARE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WIPCEPCHLTHCARE, February 9, 2022.

[15] Max Roser, Esteban Ortiz-Ospina, and Hannah Ritchie, "Life Expectancy," *Our World in Data*, 2013, https://ourworldindata.org/life-expectancy; Shameek Rakshit et al., "How Does U.S. Life Expectancy Compare to Other Countries?," *Health System Tracker*, December 6, 2022, https://www.healthsystemtracker.org/chart-collection/u-s-life-expectancy-compare-countries/.

References

Fairlie, Robert W., Kapur, Kanika, Gates, Susan M. Rand Corporation research brief: 2011. https://www.rand.org/pubs/research_briefs/RB9579.html

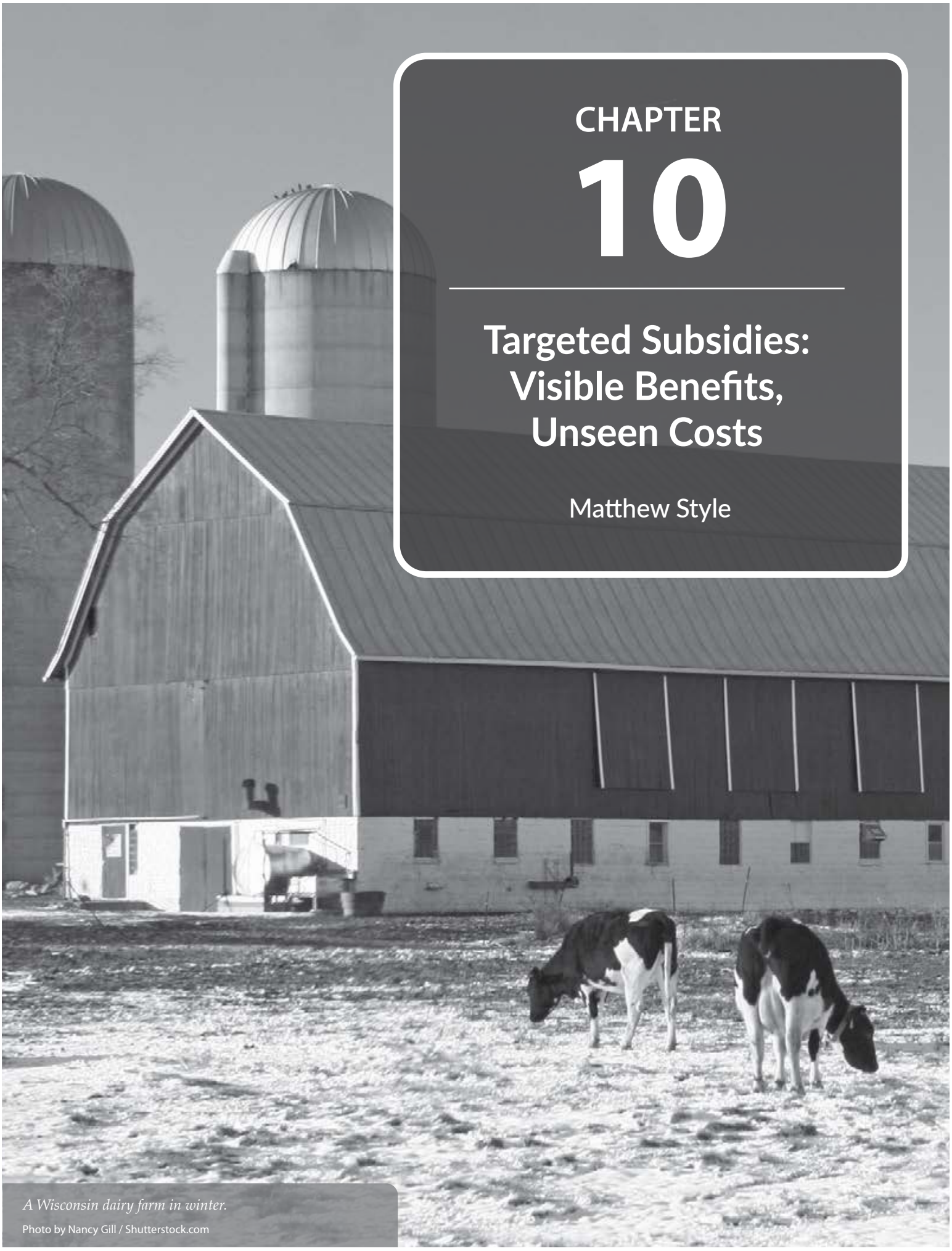
Goldhill, David. 2013. *Catastrophic Care: Why Everything We Think We Know about Health Care Is Wrong*. New York: Vintage.

Herzlinger, Regina E. 1997. *Market-Driven Health Care*. Reading, MA: Addison-Wesley.

Kling, Arnold. 2006. *Crisis of Abundance: Rethinking How We Pay for Healthcare.* Washington, DC: Cato Institute.

Sowell, Thomas. 1987. *A Conflict of Visions*. New York: W. Morrow.

Sowell, Thomas. 1993. *Is Reality Optional? And Other Essays*. Stanford, CA: Hoover Institution Press.



CHAPTER

10

Targeted Subsidies: Visible Benefits, Unseen Costs

Matthew Style

A Wisconsin dairy farm in winter.

Photo by Nancy Gill / Shutterstock.com

10 Targeted Subsidies: Visible Benefits, Unseen Costs

A win for Wisconsin! That was the message in 2017 as the state found itself in the headlines of every national news outlet. The stories accompanying these headlines announced plans for a new manufacturing facility in the eastern part of the state. Foxconn, the world's largest consumer electronics contract manufacturer, was on track to spend $10 billion on a factory that would create 13,000 manufacturing jobs. It was great news for a state that had lost thousands of manufacturing jobs in recent decades.

Factories in the United States now require fewer workers as they did several decades ago. The transition has seen manufacturing jobs move overseas or be replaced by automation. From January 1980 to August 2022, US manufacturing employment decreased from 19.82 million workers to 12.85 million. This decrease of almost 7 million jobs amounts to 35 percent across a span of 42 years. In the 21st century alone, Wisconsin has experienced a loss of 123,000 jobs, or 20.6 percent of its January 2000 manufacturing workforce according to industry employment data from the Bureau of Labor Statistics.

In step with the steady advance of computer technologies, the United States and the rest of the world have pivoted toward a digital and automated economy. This marks a sharp departure from the physical and labor-intensive work of the past. This change has been good for the US and world economies, introducing increased productivity, new products, and new professions that were unthinkable years ago. Evidence of productivity gains is visible in the US industrial production index, an economic indicator created by the Federal Reserve to measure the real output of industrial production. Even with 7 million fewer manufacturing workers, this production index is much higher today than it was in 1980.[1]

The changing economy entails an uncomfortable tradeoff, however. Greater productivity—using less in resources to produce more items—often requires a smaller number of workers Human labor is unlike any other factor of production in that its use is tied directly to human well-being. Humans have needs and aspirations, families, and communities, which is what makes the loss of employment so difficult to handle. In contrast, we do not empathize with aluminum that must be put to another use when its productivity changes.

The Boeing 787 Dreamliner provides an example. Its carbon fiber hull makes the plane much more lightweight and fuel efficient—therefore much cheaper to operate compared to previous generations of planes constructed from aluminum. We celebrate this great success of technological innovation without worrying about the aluminum whose "job" was being replaced by carbon fiber. We won't find sheets of aluminum out picketing. Instead, they will be employed in making cans, appliances, baseball bats, and other valuable products. Thus the reallocation of aluminum feels quite different from unemployment and job search by manufacturing workers who are our friends and neighbors. However, just like the pieces of aluminum, people need to find other uses for their skills and talents.

Even as there are significant gains owing to innovation, there will be some costs. The economist Joseph Schumpeter coined the term "creative destruction" to describe the loss of value experienced by existing assets when a new innovation takes hold. Schumpeter saw the process as beneficial overall but with huge costs for legacy technologies. A nascent auto industry threatened the legacy horse-and-buggy industry in the early twentieth century; however, today—in the long run—the auto industry is to thank for a lot of the growth the US has seen in the past century. The midwestern states have certainly seen creative destruction, with disruption of existing industries and losses of manufacturing jobs leading to the nickname "The Rust Belt."

Even with midwestern manufacturing production at a high, declines in manufacturing jobs present a challenge for the Rust Belt: How do you provide jobs for thousands of people who find themselves unemployed? The problem is acute in the Midwest, with its large historical emphasis on manufacturing. Often the unemployed were very good at their manufacturing jobs, but now they find their skills less valued. The loss of manufacturing jobs also puts stress on other businesses—those that once provided for these workers.

Economic reasoning classifies manufacturing as part of the tradable sector of industries, meaning industries that generate value in their home market but compete outside it. When a factory employs thousands of workers, value is being generated in one specific location, but the output goes to markets outside that area while the revenues flow back in. Workers spend their paychecks at local restaurants, hospitals, retailers, grocery stores, and the like, contributing to the local economy by bringing in "outside money." The locality that depends on making automobile parts is competing against manufacturers from other states and countries to serve far-flung communities. Manufacturers face outside competition—suggesting the image of Michigan versus Alabama or even Michigan versus Mexico City. Those that lose the competition face a loss of jobs to another area. This is different from the situation in the nontradable sectors (such as restaurants, hospitals, and retail), which must always compete in their local area for business. For better or for worse, a clinic in Eau Claire, Wisconsin, is not competing against one in Miami. If one clinic fails in Eau Claire, the patients and medical workers move to another clinic nearby. People who live in Eau Claire will still need to see a doctor.

This reasoning suggests that, in tradable sectors, the local economy would gain if someone stepped in to protect jobs (or to bring in replacement jobs should a facility go out of business). The whole area might benefit as its industries in tradable sectors generate more value. In turn, all other local services and industries should benefit. This is the primary rationale for applying protection and subsidies to aid local businesses.

How can this strategy be bad? The answer lies in the contrast between visible benefits and unseen costs. For Wisconsin, the news that Foxconn would deliver high-tech manufacturing jobs sounded great. According to the *New York Times*, Foxconn would invest $10 billion in its new facility and create 13,000 jobs (analysts estimated that an additional 22,000 jobs would be created indirectly).[2] Less prominently mentioned was the $2.85 billion in estimated tax breaks that Foxconn would receive over a 15-year period. And hardly mentioned at all was the politically driven competition among states to provide incentives, a process dubbed a "race to the bottom." These races can be quite harmful.

While targeted subsidies appear at the surface level to be a logical approach to drive job growth to your locality opposed to another, there are many hidden issues lurking in the details. This is why Frédéric Bastiat wrote his famous 1845 satirical essay, "The Petition of the Candlemakers," urging that the French government ban sunlight. While candlemakers would get visible benefits from the cutoff of sunlight, the additional money spent on candles would not be available elsewhere in the economy: an unseen cost. If a candlemaker were to gain an extra $10 in business from a new customer by "banning sunlight", this $10 would be lost to producers in other industries. Bastiat's lesson can be applied to the Foxconn situation: Foxconn would hire many people in Wisconsin (a visible benefit), but the taxes to pay for subsidies would be an unseen cost.

Note that the inefficiency of targeted subsidies does not mean that their proponents are ill-intentioned or evil. Good people can make bad mistakes. Often policy failures occur because there are unintended consequences lurking in the background that spoil the whole situation, consequences that many people fail to see beforehand because these people do not understand the incentives at work. In part to understand incentives, economists often talk about institutions, or "the rules of the game." As

we will see, in the case of targeted subsidies the rules of the game can lead to unhelpful political competition among states.

A Piece of the Pie: Subsidy Competition

To make governance more accountable, the framers of the Constitution deliberately allowed for productive competition between states. In 1932, Supreme Court Justice Louis Brandeis called the states "laboratories of democracy." Under this conception of federalism, states can individually innovate and experiment with different forms of governance. If a state chooses the correct solution to a problem, citizens will locally benefit from the experiment and other states are free to imitate the successful state. The innovative state may also be rewarded through an increased tax base, as both people and enterprises migrate to the more favorable jurisdiction. The other benefit of "laboratories of democracy" federalism is that poor policy choices are isolated to the experimenting state. Mobility across states thus becomes a choice mechanism, as presented by Charles Tiebout (1956), who argued that people would "vote with their feet" by relocating to a jurisdiction that better serves them.

Tiebout's theory has been the subject of direct tests in recent years. Banzhaf and Walsh (2008) find that migration happens between neighborhoods as a response to air pollution levels, as people move from areas of increasing air pollution to areas with lower pollution levels. Looking at migration patterns in Canada, Ferguson et al. (2007) find that economic opportunities and amenities are equally important drivers of urban migration, while economic performance is the leading factor that encourages people to move to more rural areas. Sasser (2010) finds that labor market conditions, per capita incomes, and housing affordability are all important to migration decisions. Sasser also shows that housing affordability is starting to gain more influence, while historically the biggest pull factor has been per capita income. Arif et al. (2020) find that cities with greater degrees of economic freedom generate a positive inflow of migrants from less-free cities.

The tendency of labor, capital, and knowledge to coalesce in a given area, generating efficiencies, is known as *agglomeration*. The mechanism of agglomeration has been used as an explanation for why cities are important and why they may specialize in different industries. The idea of agglomeration was first proposed in the 1800s by British economist Alfred Marshall. Economists who have expanded on the idea include Krugman (1991), Ellison and Glaeser (1997, 1999), Audretsch and Feldman (1996), and many more. Agglomeration made the Midwest famous for manufacturing and agriculture owing to historical and geographical advantages. Silicon Valley emerged as a hub for tech start-ups because of the entrepreneurial climate and the proximity to high-quality academic institutions such as Stanford University and the University of California at Berkeley. The locations of these clusters, once established, have been persistent.

If Wisconsin wants to see long-term growth, it needs to become a competitive environment where successful businesses, talented workers, and future entrepreneurs want to locate. This pressure toward long-run economic growth is universal and not confined to Wisconsin. Because of the great pressure to create this environment now, states may compete to provide targeted economic incentives to attract business. If workers and businesses often coalesce through agglomeration in thriving areas, targeted subsidies at first glance appear to become a necessary investment by states to get into the game. The whole process imposes pressure on politicians: they need to deliver on economic promises to show that they are expanding the local economy. Companies, for their part, would be foolish to pass up profitable subsidy opportunities.

Milwaukee was an early-stage competitor for Amazon's "second headquarters" (HQ2). Imagine what would have happened if Milwaukee had been the ultimate winner instead of Arlington, Virginia. Restaurants, real estate professionals, entertainment venues, and a host of opportunities would

have come to Milwaukee to accommodate an army of new high-skilled, high-income workers. Is it any wonder that states compete with each other by using targeted subsidies to entice businesses? And is it surprising that states with desirable employers try to keep these employers by using subsidies? The result of this reasoning is that many layers of government try to attract business in what has been called "smokestack chasing," a term that dates back to a time when smokestacks were symbols of prosperity rather than symbols of pollution.

Frederiksson et al. (2004) argue that states may use a variety of tools to attract businesses such as targeted tax cuts, infrastructure improvements, and simultaneous relaxation of environmental standards. Quantitatively, they found a near one-for-one escalation in tax rate battles. When a neighboring state lowered its tax rate by 10 percent, the competing state would follow suit with its own change of, on average, 9.3 percent. When a neighboring state increased spending on infrastructure by 10 percent, the competing state would respond with a 12.0 percent increase locally. Jensen, Malesky, and Walsh (2015) find that cities with elected mayors are more likely to provide larger development incentives with more relaxed oversight than cities that have an appointed city manager. Thus, their research shows a connection between elections and subsidy programs.

The research cited here shows that states use plenty of incentives to target and attract businesses. The academic literature also reveals the race that occurs among states. But do these targeted subsidy programs actually work to retain or attract new businesses? Many researchers find little or no effectiveness.

Are states truly "laboratories of democracy," as Justice Brandeis suggested? A growing number of studies have measured the impact of different states' subsidy programs. Most recently, Bundrick and Yuan (2019) found little evidence that Arkansas's Quick Action Closing Fund, used to help secure deals to attract business, has been able to increase incomes and lower rates of poverty over the long term in Arkansas counties. Studying Ohio, Gabe and Kraybill (2002) found little effect on employment growth among establishments that received development incentives to expand facilities between 1993 and 1995. They also found that the employment effect may be negative and that firms that received such benefits may have overstated their expansion's employment impact.

Jensen (2017) finds little evidence that incentive programs have increased the number of jobs in Kansas. In a survey of businesses, many stated that they would have stayed in Kansas absent the incentive program. This finding is consistent with that of Bartik (2018), who finds that, across 30 studies, incentive programs influenced the choice of location for somewhere between 2 and 25 percent of firms. That is, a strong majority of firms were going to pick the same location regardless of incentives. Patrick (2016) finds that capital-related subsidies encourage firms to substitute away from labor toward being more capital intensive, thus decreasing labor's role. Other studies find similar results:

- Button (2019) finds no impact from movie subsidies on growth in the number of feature films or in employment, wages, and establishments in the film industry or related industries.
- Fox and Murray (2004) find no significant effects from economic development incentives across a panel of large firms.
- Hicks (2003) does not find a significant increase in employment or income in counties that acquire a gaming facility.
- Hicks (2007) does not find lasting employment increases for counties following the entrance of a Cabela's retail outlet.

In light of these results, why do these policies persist? One explanation is perverse political incentives. Sobel, Wagner, and Calcagno (2022) argue that economic development incentives generate political benefits. They find that larger incentive programs are associated with larger campaign contributions from interested sectors as well as with higher margins of

victory for incumbents. This explanation is known as rent-seeking, or playing the political system to make money without a genuine economic contribution. There is an extensive literature on *rent-seeking*, including studies by Jensen and Malesky (2018), Coyne and Moberg (2014), and Mitchell, Sutter, and Eastman (2018).

Additional Costs

Gordon Tullock (1967) introduced the idea that rent-seeking as a zero-sum game and potentially a negative-sum game. To provide context to why this theory is powerful, we will have to make a quick diversion to a sports analogy. Within economics, a zero-sum game is any competition that creates a winner and a loser, much like a sports game. The Packers after beating the Vikings earn one win and the Vikings earn one loss, offsetting one another in the standings. Someone is gaining and someone is losing proportionately, this is zero-sum. Now imagine if the Packers ended up gaining one statistical win and the Vikings earn two statistical losses at the same time, this is what we would call negative-sum games. This is because the Vikings are losing more (by an order of magnitude) than what the Packers are gaining. Therefore, as a whole (impartial to either side) we would say that more is being lost than gained, therefore becoming a negative-sum game. War is another example of a negative-sum game. Because of war, lives and property are being destroyed for both the "winners" and "losers". While one party will earn their objective at the expense of the other when they sue for peace, both parties will not be able to escape these other losses. These additional costs of war turn it into a negative-sum game.

Now that we have that context, time to divert back to the original point. Rent-seeking is often defined as the competition for scarce economic resources, typically "economic rents". Economic rents could be the profits that candlemakers see after banning sunlight or economic rents could be the limited subsidy money that companies see with targeted benefits. Typically, government intervention into the market can create opportunities for rent-seeking as these privileged opportunities come with some exclusive benefit that is worth capturing.

While Tullock was analyzing quantity restrictions and tariffs to support local manufacturers exposed to international trade, he came up with a colorful example, he pointed out the nature of theft. At first glance, the robbed homeowner loses what the thief gains—a zero-sum game. Items transferred hands but nothing was created nor destroyed – or so it seems. But theft involves an even greater inefficiency because a thief invests resources to steal and a homeowner invests resources to protect property against the thief. These investments could dwarf the actual losses involved in a theft.

To put Tullock's theory into perspective of targeted incentives, if a company is deciding between remaining in Wisconsin or relocating to Minnesota, the overall effect of the choice across the two states is zero-sum. If Minnesota gains 1,000 jobs and Wisconsin loses them, the total number of jobs society as a whole possesses remains unchanged: no jobs were created or destroyed. The jobs merely changed hands—a transfer. Just like Bastiat's illustration of a candlemaker, earning $10 at the expense of another industry by banning the sun.

What makes Tullock's frame of analysis powerful is the costs of seeking and defending the jobs. These extra costs turn the game into a negative-sum game, a game in which society as a whole loses resources, like war. Let's say both Wisconsin and Minnesota offer incentive packages to the company considering relocation. They might also expend time and resources lobbying the company. These resources come with an opportunity cost—and they are deployed not to create a new job, product, or capital good but instead to maintain or capture something already created. Therefore, they are wasted. In Tullock's example, both the thief and the homeowner are wasting resources to control a good. In a world without burglary, these resources would be freed to create something new. In this world without burglary, they would spend their money on a vacation instead of a home-security system.

The waste of resources consumed in attempts to attract and maintain industries isn't the only detriment of incentive programs. Bartik (2019) argues that subsidy competition may also harm the job market. At a variety of levels, governments have trouble sitting out this competition. LaFaive and Hicks (2005) find that Michigan's MEGA tax incentives had little effect on its targets but had spillover effects on the construction industry. In the market for passenger aircraft, both the US and the European Union feel they have no choice but to protect their own manufacturers. As a result, the US provides subsidies to Boeing and the EU counters with subsidies to Airbus. Another international case is China's over-capacity in steel, aluminum, fisheries, and other tradable industries. The adverse effects on other countries[3] lead to defensive subsidies to mitigate the risk of losing those jobs and industries. Even so, subsidies are often ineffective at saving jobs, as evidenced by Alcoa's multiple aluminum subsidies coupled with a shrinking workforce in upstate New York.[4]

Taking Stock: Wisconsin's Specialties and Subsidies?

The state of Wisconsin is home to many great enterprises whose products and services are used around the globe. Areas of strength include agriculture, manufacturing, and management of corporations. According to GDP data from the Bureau of Economic Analysis, Wisconsin is often a median state in terms of GDP per capita, falling somewhere between 20th and 30th among the states over the past decade. GDP per capita is often viewed as a measure of economic success because it takes the overall value of goods and services produced within an area and divides it by population. The per-person result incorporates a basic control for population size. Judging by this statistic, Wisconsin is in the middle of the pack.

To become better than average, Wisconsin needs to produce higher-value goods and services. This means maintaining current high-value industries and growing new ones. This is the goal of just about every development program, whether it is instituted by a US state, the federal government, or a foreign government. The strategy amounts to promoting exports while attracting investment from near and far.

To highlight the relative strengths of Wisconsin industries, Figure 10.1 shows the specializations of various Wisconsin industries. The measure employed is referred to as the GDP quotient or GDP balance. (Similar concepts in regional development are referred to as location quotients and shift-share analysis.) The goal is to provide an account of the industries that have a larger impact on a particular state compared to the nationally average state.

$$\text{GDP Balance} = \frac{\text{Industry's Share of Local GDP}}{\text{Average of Industry's Share in All Localities}}$$

If GDP Balance > 1 → Specialized

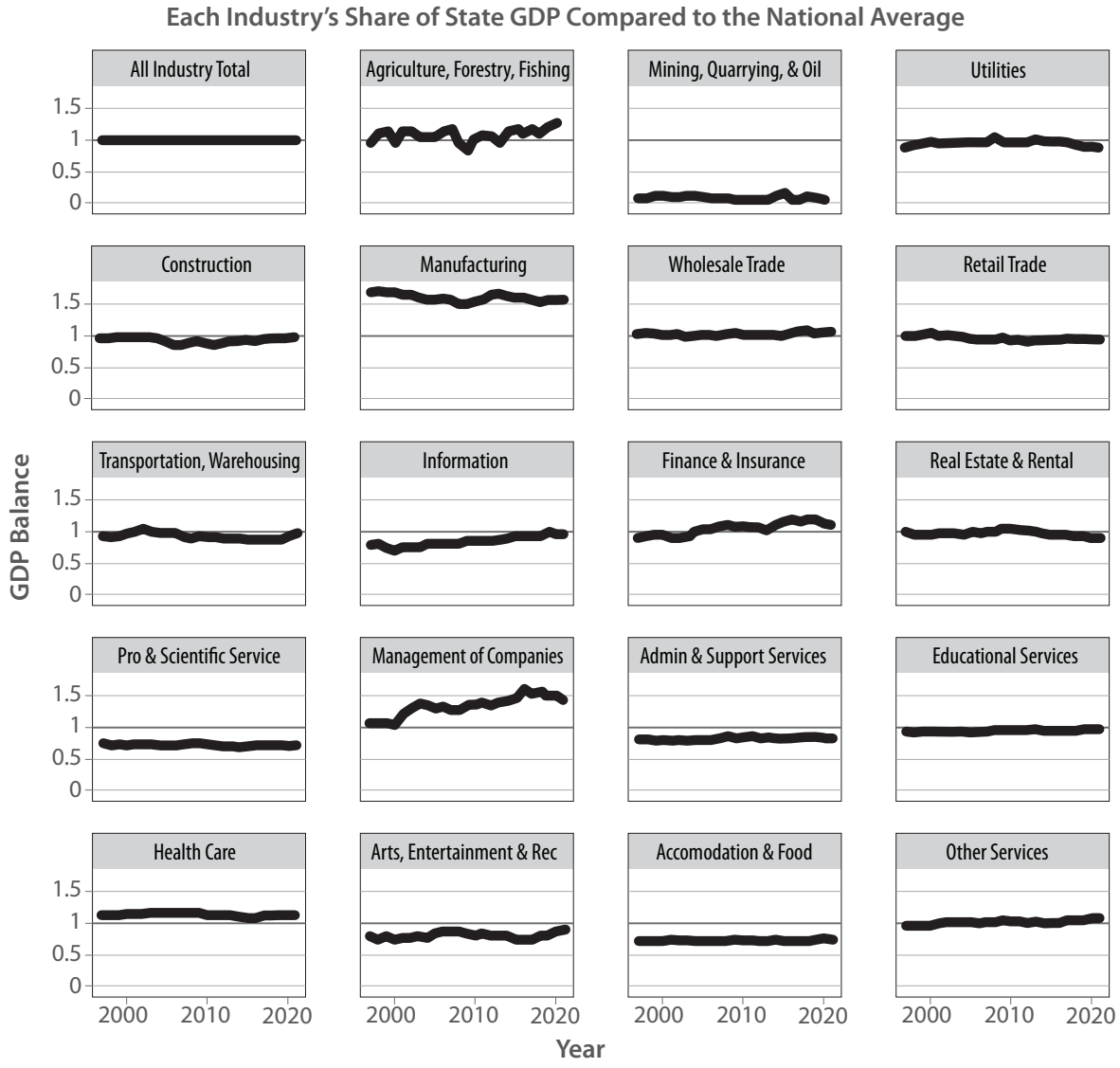
If GDP Balance = 1 → Average

If GDP Balance < 1 → Not Specialized

This measure can highlight which industries make up a larger share of local GDP than what is typical. This helps analysts find areas with disproportionately high or low concentrations of an industry compared to the industry's average across the board. These measures do not indicate superior production capabilities, but they do show how the state economy tilts more toward industries and sectors.

A quick example from outside Wisconsin will use two extremes to explain the usefulness of this measure. North Dakota is home to vast fields of agriculture and, within the past 10 years, to a booming oil drilling sector. For 2021, North Dakota's GDP balance for agriculture was 4.43, and the corresponding figure for oil drilling was 6.32. These figures, well above 1.00, show how these sectors' contributions are four to six times larger to the local economy than to the economy of the average state. As recently as 2010, the figure for oil drilling was hovering

Figure 10.1 **Wisconsin Specialization Levels by Industry**



Source: Author's calculations based on data from the Bureau of Economic Analysis.

around 1. The change since then illustrates the dramatic oil boom that is still in progress.

While natural resources constitute a major part of North Dakota's economy, it should come as no surprise that the GDP balances of information (0.59) and finance (0.65) are much lower. Taken together, all these figures show a growing comparative advantage of oil on top of the state's historical agricultural advantage—and a much lower share of the state's economy for information and finance.

In sharp contrast, New York showed a GDP balance of 0.09 for agriculture and 0.01 for mining and drilling. New York's big advantages showed up in information (2.38) and finance (2.57). While New York has quite a bit of farmland, agriculture's contribution to the state economy is dwarfed by the contributions of other sectors. Both New York and North Dakota face their own challenges, and GDP balance illustrates that there are large differences between the two states. North Dakota in particular has seen prosperity due to oil, bringing its per capita income into rough parity with New York's. Still, if the state experiences an increasing population, it will have to find industries that can scale and generate higher-valued tradable goods to maintain high per capita income.

Turning to Wisconsin, we can use GDP balance to see where jobs and economic activity are originating. This will highlight success stories, growth opportunities, and vulnerabilities.

Wisconsin's recent subsidies

Over the past several decades Wisconsin has become strongly identified with agriculture and manufacturing, as well as with its role as the home of many large national corporations founded within the state. In this respect Wisconsin is often quite sensitive to the tradable sector. International trade barriers can present challenges to agriculture, generate labor substitution in manufacturing, and disrupt the business models of Wisconsin-based corporations.

In Figure 10.1, we see about 25 years' worth of GDP data broken up by large industry categories. The horizontal line within the graph shows us the average GDP contribution for all states. Any dot above that line means that the share of Wisconsin's GDP coming from that industry is higher than the national average. Wisconsin standouts are agriculture, manufacturing, and management of companies, while information and financial services have been close to average.

One clear pattern in Figure 10.1. Manufacturing and the management of corporations have nearly one-and-a-half times the importance to the Wisconsin economy as they have to the economy of the average state. Therefore, supporting these two industries has become a significant focus within the state of Wisconsin. In a globalized economy these two industries are gems eagerly sought by other localities, near and far. Wisconsin has responded with large subsidies, as measured by the Subsidy Tracker tool compiled by Good Jobs First (see Table 10.1).

As shown in Table 10.1, the clear trend is that Wisconsin has given support to create new facilities or headquarters for many of the state's largest employers. The Foxconn deal was one of the largest ever recorded by the Subsidy Tracker. Many of the corporations on the list in Table 10.1 have received tens of millions of dollars in tax-refundable credits from the state, and much of this funding has come from the Wisconsin Economic Development Corporation (WEDC). Dozens of other companies that are not on the list also received WEDC funds. Typically the subsidies were granted in exchange for the creation of jobs or a certain level of promised capital investment. While many corporations have been able to stay within the Badger State, these deals have certainly come with costs.

Table 10.1 **Wisconsin's Largest Subsidies**

Company	Industry	Subsidy Value (millions)	Year	Subsidy Details
Foxconn	manufacturing	$2,850	2017	tax credit to build new facility
Mercury Marine	manufacturing	$123	2009	tax credit and local loan to keep the company in state
Kohl's	retail / management of companies	$62.5	2012	tax credits and TIF* for corporate headquarters
Green Bay Packaging Inc.	manufacturing	$60	2018	tax credits to build new paper mill
Komatsu	manufacturing / management of companies	$59.5	2018	tax credits to build new headquarters
Northwestern Mutual	financial services / management of companies	$50.5	2013	tax credits to build new headquarters
Quad/Graphics	printing/manufacturing	$46	2011	tax credits for job creation
Oshkosh Corporation	manufacturing	$35	2011	tax credits to build new facility

Note: **TIF = tax increment financing district.* Source: Subsidy Tracker database, accessed March 15, 2023, Good Jobs First.

Bad incentives create bad outcomes

Subsidies can be used either to attract new business that has not operated within the state or to maintain an existing in-state enterprise. When a government at any level issues subsidies, it ties a public interest to the well-being of the subsidized industry. Any relevant business decision becomes more political in nature. When governments engage in targeted incentives, they take on a role similar to that of a shareholder. In Wisconsin, the past decade has shown perverse outcomes of inserting the state into corporate decisions through various targeted subsidies. Foxconn is the biggest example—but it is certainly not the only one.

As noted at the beginning of this chapter, the Foxconn deal in 2017 sounded like a great idea: a new multibillion-dollar production facility with thousands of new manufacturing jobs. The cost would be targeted tax credits for the company—just one company. It sounded like a tax cut, and the public may view targeted tax credits as generally the same as a tax cut for all. The deal even included a planned highway expansion to accommodate the expected new traffic.

The deal had many supporters, but it also received its fair share of criticism. While it appeared to be a good deal, ultimately there was a catch: the unseen costs of applying such a large subsidy. One voice in this debate was a study conducted by Mitchell et al. (2019), who estimated that if Foxconn were to build its original LCD screen plant as planned, the "economic losses [would be] in the range of $5.7 billion to $34.3 billion" over the 2018–2032 time period. The study pointed to substantial costs in the form of higher tax rates to pay for the subsidy. By contrast, there would have been lower taxes if the plant had existed in a nonsubsidy environment. The idea was that if Foxconn had not been offered a tax break, the state would have been increasing its tax base, decreasing the tax burden on other sources of tax revenue.

Although Foxconn had promised to bring 13,000 jobs to Wisconsin (with estimates of tens of thousands of additional jobs in stimulated economic growth), analysts had raised many public finance questions about the effects of such a deal. The biggest gamble was whether the subsidies were decisive in getting Foxconn to locate in Wisconsin. In the best-case scenario, which assumed that the funds were indeed decisive, there would be some positive effects from bringing in the new plant. The worst-case scenario, considered likely by many analysts, was that the subsidies did not have a real effect on the plant's location. Wisconsin would then stand to lose through the opportunity cost of higher taxes for everyone else to pay for a plant that would have been built regardless. In this case, Wisconsin would be like a business that offers a discount to attract a customer who was going to shop at the business anyway.

After its initial announcement, Foxconn scaled down its plans because of changing macroeconomic conditions. Then in 2021, facing COVID-19 and emerging supply chain problems, Foxconn further reduced its planned capital investment (initially $10 billion) to $672 million. At the same time, it decreased its jobs commitment from 13,000 to 1,454.[5] Though Wisconsin will reduce its subsidy expenditure through clawbacks and other performance benchmarks, there will be long-lasting effects of the "unseen." The state was able to negotiate a reduction in the benefits package, lowering it from $2.85 billion to $80 million. Still, some of the damage had already been done. The *Financial Times* reported that the Village of Mount Pleasant had spent over $181 million buying up land for the facility, often using eminent domain. Additionally, Mount Pleasant and Racine County had issued more than $310 million in debt to fund land acquisition and infrastructure improvement projects.[6]

The Foxconn case demonstrates a glaring issue in government planning: in high-stakes games, miscalculations can be disastrous. No one at Foxconn could have predicted how the trade war with China or the COVID-19 pandemic would dramatically shift supply chains between the United States and East Asia. Neither could anyone in Madison, Racine, or Mount Pleasant have foreseen this. Because the state, county, and village governments became involved in Foxconn's

location choices, members of the public acquired a stake in the well-being of this business transaction. As a result, some people lost their houses for a field. Overexpanded highways and other capital such as land sat underutilized. Many different investment choices at all levels of government were made on the basis of something that did not happen. The worst-case scenario for the original plan appeared to be an estimated loss of $34 billion in GDP over 14 years—and it now appears that the entire investment may have been for nothing.

Maintaining Wisconsin's best: Fending off other states

While the Foxconn deal is the most prominent example of targeted subsidies going awry, there are certainly smaller ones that have yielded mixed results as well. Many Wisconsin-based corporations have utilized funding sources from WEDC to receive some level of support, exchanging job pledges for economic support through tax credits or the establishment of a TIF (tax increment financing district). Nor is this strategy unique to Wisconsin. An out-of-state example is the New York Power Authority's ReCharge NY program, which provides discounted power to firms and organizations that pledge to retain or bring in a certain number of jobs to New York.

While some protections exist such as funds getting clawed back in Wisconsin if a company does not meet its job creation pledge, this does not mean that the funds used on the jobs were efficiently allocated. These programs can still impose costs due to subsidies on the jobs created, even if these deals do live up to their job pledges. Take the example of the state of New York, where they offered Alcoa one of the largest subsidy packages in the recorded history of the Subsidy Tracker. The New York Power Authority provided $5.6 billion in discounted power over 30 years to aid the ailing smelter to save jobs. However, it is estimated that this package would cost $148,000 per job or $4.4 million per job over the 30-year deal.[7] In this case, even when working as intended, this deal carries significant costs. While claw backs can help prevent underperformance, it cannot structurally fix a problematic deal if too much money is offered per job.

It is often very hard to future-proof many of these deals as a variety of economic factors can change needs in the future. The national retailer Kohl's decided to stay in Wisconsin after considering relocation to another state. Kohl's remained in Milwaukee after receiving $62.5 million in tax credits and other forms of assistance to create 3,000 jobs and build a new headquarters. Kohl's ended up abandoning the plan to construct a new headquarters a year later; the company decided to acquire nearby buildings to renovate instead.[8] While it is unclear what happened to the final number of jobs created, this change of plans and conditions were certainly unexpected when this deal was originally constructed.

Another controversial development story in Wisconsin is the case of Mercury Marine, a prominent outboard motor manufacturer in Fond du Lac. Mercury Marine received assistance after policy makers learned that the company was considering closing the Fond du Lac plant to consolidate jobs in Stillwater, Oklahoma. After negotiating a $70 million offer from the state and $53 million from Fond du Lac, Mercury Marine announced its decision to stay in Wisconsin and to add 400 jobs there—the Stillwater plant, meanwhile, would be closing down. Oklahoma had offered a competing incentive package, including money to help Mercury Marine relocate entirely to Stillwater, creating a bidding war between the two states.[9] This became another example of two states bidding against one another just to reshuffle jobs.

As these examples illustrate, states may play tug-of-war to retain a company out of fear that they will lose jobs to another state. Knowing the incentives of politicians, it is easy to understand why they would step in to protect their constituents. This raises the risk that companies will be motivated to play localities off against one another. The result may distort natural market decisions, diverting companies from the best overall locations.

Ultimately, if we want to unleash capitalism in Wisconsin, we need to find ways to phase out selective development incentives in favor of uniformly lower tax rates. Many of these development incentives come with significant costs that we have seen in research evaluations. To attract new businesses, states may be giving up useful tax revenue to a firm that would locate in the state anyway. Also, if a state's subsidies *are* decisive, the state might be accidentally encouraging and supporting a bad investment using public funds. Desperate attempts to keep jobs in state are bad public policy and a high-stakes game.

Policy Paths Forward

There are many possibilities for reform, but they all face the obstacles of political feasibility and coordination costs. It is difficult for any one state to "go first" in cutting back targeted subsidies.

The easiest and simplest advice would be to embrace the free market to make Wisconsin a competitive and innovative state. This is in keeping with the policy proposals in the other chapters of this book. Simply put, if you make Wisconsin a place that workers and firms will want to call home, that is all the incentive that you need to attract more. Instead of targeting a specific firm with tax abatements, the goal would be to provide all businesses with a tax environment that is competitive overall. Instead of providing specific payroll incentives to make training costs cheaper, the goal would be to provide all firms with an educational, training, and workforce environment that is better overall. This would involve investing in educational policies and workforce training programs geared toward today's labor market.

While many conventional development policies have been plagued by unseen costs and little effectiveness, there are three policy alternatives can help promote realistic change. The first would be reforming TIFs in Wisconsin's current environment. The second would be improving the business environment—finding ways to provide workers with avenues to acquire useful skills and helping entrepreneurs start and expand businesses. This strategy would enable the in-state workforce to attract employers without having to entice them with money. The overall goal would be to create a state where firms want to operate because of market considerations. Finally, we have the first policy alternative which has become an increasingly popular proposal, the creation of an interstate compact to curtail the subsidies "race to the bottom." A properly structured agreement could reduce the pressure on states to engage in desperate measures to prevent other states from poaching business establishments from one another – a problem that Wisconsin has faced with Mercury Marine, Kohl's, and others contemplating moves to other states.

Wisconsin's current environment

Wisconsin state law prohibits localities from offering property tax abatements, sales tax incentives, and payroll tax incentives. Many of these functions are handled by state-based agencies. This alone makes the environment for subsidy reform a little less complex for the Badger State, because many of the state's localities are already reined in. However, the one tool that Wisconsin, out of "necessity," has employed at the local level is the use of tax increment financing districts. TIFs are a tool that allows a locality to use projected future property tax revenues as a source of up-front financing for development projects. For example, when a new business expansion is expected to raise property values in the future, the locality can use future tax revenues to finance the development project.

A few studies have examined the complete impact of TIFs and routes for reform. Dye and Merriman (2000) find that property value growth in Chicago was slower after the adoption of TIFs, suggesting that TIFs can be a barrier to growth for cities. Other studies examining Illinois find adverse effects of TIFs. Byrne (2010) shows how industrial-based districts in Chicago saw employment growth while retail-based districts saw a decline in employment. He argues that TIFs may still be useful in relieving blighted areas to redevelop into new housing and commercial units. Weber

(2003) finds that TIFs in Illinois depleted property tax revenue for schools over the life of the district and that school revenue had to be made up by increased state educational aid. While TIFs have some benefits, they are not free from negative side effects and we should reexamine how they are used.

Despite a growing research literature that has shown the unseen costs of TIFs and similar programs, conventional wisdom still seems to view these policies as productive. This means that Wisconsin faces a great deal of competitive pressure from other states. Eliminating incentives entirely, while preferable in an ideal world, would certainly be a tough sell politically. A small but helpful first step would be to make sure that oversight mechanisms exist over WEDC programs and related activities by local governments.

Good jobs and good competition

The large sums of money provided by targeted incentives are certainly attractive to their potential recipients. All things being equal, firms will tend to take the state up on its offer to at least accept what is seen as free money to help their bottom-line. Such policies necessarily involve the state in picking firms for favored treatment. However, state efforts to improve human capital generally can help businesses in a non preferential way. Firms always face workforce development costs and may be receptive to state efforts to lure them through education and other workforce development programs accessible to all.

A consistent recommendation in both Porter (1996) and Bartik (2019) has been to encourage training programs to give firms access to a good labor market. Both authors argue that localities should focus on job training programs and infrastructure investments that can be used by all rather than ones that favor certain firms. Have well-studied tax cuts for all, not just one firm. The presence of a positive environment may also indirectly encourage a cluster to form without conscious direction from government. This agglomeration argument has inherent appeal. Employers want to be located near a good source of potential employees. Another benefit of educating and training an up-to-date workforce is that workers will not be held back by investments in old technologies and industries and thus will be better able to ride the wave of creative destruction. If there are good institutional and infrastructural foundations within an economy, then the natural business dynamics of agglomeration will attract more interest from similar firms.

An old constitutional tool

Momentum has built in recent years toward an interstate compact to curtail the race to provide subsidies. Now that many states are already discussing provisions, perhaps such an arrangement is feasible. Currently the US Constitution allows states to cooperate with one another on a variety of compacts. One example of an interstate compact is the agreement among states to honor a valid driver's license from many other states, enabling one state's license holders to legally drive on a different state's roads. Additionally, within the Driver License Compact, states share data on traffic violations. The good news is that there is a political appetite among states for an agreement that would limit targeted subsidies.

One of the many proposals for an interstate compact on subsidies is offered in Farren and Mitchell (2020). The proposed compact would include common rules and an enforcement mechanism, definition of what a target subsidy is and is not, transparency and evaluation measures, and a dispute-resolution mechanism that enables states to bring up and settle grievances. The goal is a relatively comprehensive agreement to reduce potential cheating by states. If such a compact is successfully adopted, it could potentially decrease the arms-race mentality among states.

An interstate compact on targeted subsidies amounts to an old remedy within the Constitution. It could be an effective solution to prevent the "race to the bottom" behavior exhibited by many states which would not only help Wisconsin but the other states in the union.. An interstate compact would help Wisconsin in two ways: First,

Wisconsin would have to focus only on its own business environment and would no longer need to remain constantly vigilant to guard against another state trying to poach one of Wisconsin's large employers. Second, a properly defined and enforced compact would leave businesses free to seek their comparative advantage. In such an environment, those that do find value in moving to Wisconsin will not be siphoned away by some state that happens to bid more. Nor will Wisconsin be tempted to overbid for a company already planning to come without the incentive. The task of structuring a suitable compact will not be easy, but it will be full of reward for participating states.

Notes

[1] The Board of Governors of the Federal Reserve System calculates an index of industrial production in the United States. Industrial production has more than doubled since January 1980: August 2022 was 116 points higher on the index. Release: 6.17 Industrial Production and Capacity Utilization

[2] Nelson D. Schwartz and Vindu Goel, "Foxconn Says It Plans to Build Factory in Wisconsin, Adding 3,000 Jobs," *New York Times*, July 27, 2017, https://www.nytimes.com/2017/07/26/business/foxconn-factory-wisconsin-jobs.html.

[3] "2021 Report to Congress on China's WTO Compliance," Office of the United States Trade Representative, February 2022.

[4] Brian Mann and David Sommerstein, "Alcoa Slashes Nearly 500 Jobs in Massena, Move Called 'Devastating' for St. Lawrence County," *North Country Public Radio*, November 3, 2015, https://www.northcountrypublicradio.org/news/story/29984/20151102/alcoa-slashes-nearly-500-jobs-in-massena-moved-called-devastating-for-st-lawrence-county.

[5] David Shepardson and Karen Pierog, "Foxconn Mostly Abandons $10 Billion Wisconsin Project Touted by Trump," *Reuters*, April 20, 2021, https://www.reuters.com/business/foxconn-sharply-scales-back-wisconsin-investment-2021-04-20/.

[6] Steff Chavez, "Foxconn in Wisconsin: Tech Mega-Deal Faces Reality Check," *Financial Times*, October 5, 2022, https://www.ft.com/content/7b9b10f0-7b55-4c53-a6fe-5d76833851ba.

[7] Williams, D., and J. Heaney. 2007. "Alcoa cuts deal for low-cost hydropower Proposed deal with Massena company called 'exceptionally lavish'". *The Buffalo News*. December 21, 2007, https://buffalonews.com/news/alcoa-cuts-deal-for-low-cost-hydropower-proposed-deal-with-massena-company-called-exceptionally-lavish/article_bce0890e-5b0b-5cbd-a295-2f65d48690a3.html

[8] Tom Daykin, "Kohl's Drops Plans for New Headquarters Building," *Milwaukee Journal Sentinel*, November 21, 2013, https://archive.jsonline.com/business/kohls-drops-plans-for-new-headquarters-building-b99147627z1-232836511.html/.

[9] Rick Barrett, "Mercury Deal Could Cost State $70 Million," *Milwaukee Journal Sentinel*, November 6, 2009, https://archive.jsonline.com/business/69343837.html/.

References

Arif, Imran, Adam Hoffer, Dean Stansel, and Donald Lacombe. 2020. "Economic Freedom and Migration: A Metro Area–Level Analysis." *Southern Economic Journal* 87:170–90.

Audretsch, David B., and Maryann P. Feldman. 1996. "R&D Spillovers and the Geography of Innovation and Production." *American Economic Review* 86 (3): 630–40.

Banzhaf, H. Spencer, and Randall P. Walsh. 2008. "Do People Vote with Their Feet? An Empirical Test of Tiebout." *American Economic Review* 98 (3): 843–63.

Bartik, Timothy J. 2018. "'But For' Percentages for Economic Development Incentives: What Percentage Estimates Are Plausible Based on the Research Literature?" Upjohn Institute Working Paper 18-289, W.E. Upjohn Institute for Employment Research, Kalamazoo, MI.

Bartik, Timothy J. 2019. *Making Sense of Incentives: Taming Business Incentives to Promote Prosperity*. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.

Bundrick, Jacob, and Weici Yuan. 2019. "Do Targeted Business Subsidies Improve Income and Reduce Poverty? A Synthetic Control Approach." *Economic Development Quarterly* 33 (4): 351–75.

Button, Patrick. 2019. "Do Tax Incentives Affect Business Location and Economic Development? Evidence from State Film Incentives." *Regional Science and Urban Economics* 77:315–39.

Byrne, P. F. 2010. "Does Tax Increment Financing Deliver on Its Promise of Jobs? The Impact of Tax Increment Financing on Municipal Employment Growth." *Economic Development Quarterly* 24 (1): 13–22.

Coyne, Christopher, and Lotta Moberg. 2014. "The Political Economy of State-Provided Targeted Benefits." *Review of Austrian Economics* 28 (3): 337–56.

Dye, Richard F., and David F. Merriman. 2000. "The Effects of Tax Increment Financing on Economic Development." *Journal of Urban Economics* 47 (2): 306–28.

Ellison, Glenn, and Edward Glaeser. 1997. "Geographic Concentration in U.S. Manufacturing Industries: A Dartboard Approach." *Journal of Political Economy* 105 (5): 889–927.

———. 1999. "The Geographic Concentration of Industry: Does Natural Advantage Explain Agglomeration?" *American Economic Review* 89 (2): 311–16.

Farren, Michael D., and Matthew D. Mitchell. 2020. "An Interstate Compact to End the Economic Development Subsidy Arms Race." Mercatus Research, Mercatus Center at George Mason University, Arlington, VA.

Ferguson, Mark, Kamar Ali, M. Rose Olfert, and Mark Partridge. 2007. "Voting with Their Feet: Jobs versus Amenities." *Growth and Change* 38 (1): 77–110.

Fox, William F., and Matthew Murray. 2004. "Do Economic Effects Justify the Use of Fiscal Incentives?" *Southern Economic Journal* 71 (1): 78–92.

Fredriksson, Per G., John A. List, and Daniel L. Millimet. 2004. "Chasing the smokestack: strategic policymaking with multiple instruments." *Regional Science and Urban Economics* 34 (4): 387-410.

Gabe, Todd M., and David S. Kraybill. 2002. "The Effect of State Economic Development Incentives on Employment Growth of Establishments." *Journal of Regional Science* 42 (4): 703–30.

Hicks, Michael J. 2003. "A Quasi-experimental Estimate of the Impact of Casino Gambling on the Regional Economy." *Proceedings of the 93rd Annual Meeting of the National Tax Association*. N.p.: National Tax Association.

Hicks, Michael J. 2007. "A Quasi-experimental Test of Large Retail Stores' Impacts on Regional Labor Markets: The Case of Cabela's Retail Outlets." *Journal of Regional Analysis and Policy* 37 (2): 116-122.

Jensen, Nathan M. 2017. "Job Creation and Firm-Specific Location Incentives." *Journal of Public Policy* 37 (1): 85–112.

Jensen, Nathan M., and Edmund J. Malesky. 2018. Incentives to Pander: *How Politicians Use Corporate Welfare for Political Gain*. Cambridge: Cambridge University Press.

Jensen, Nathan M., Edmund J. Malesky, and Matthew Walsh. 2015. "Competing for Global Capital or Local Voters? The Politics of Business Location Incentives." *Public Choice* 164 (3–4): 331–56.

Krugman, Paul. 1991. *Geography and Trade*. Cambridge, MA: MIT Press.

LaFaive, Michael D., and Michael J. Hicks. 2005. "MEGA: A Retrospective Assessment." A Mackinac Center Report, Mackinac Center for Public Policy, Midland, MI.

Mitchell, Matthew D., Michael D. Farren, Jeremy Horpedahl, and Olivia Gonzalez. 2019. "The Economics of a Targeted Economic Development Subsidy." Mercatus Research, Mercatus Center at George Mason University, Arlington, VA.

Mitchell, Matthew D., Daniel Sutter, and Scott T. Eastman. 2018. "The Political Economy of Targeted Economic Development Incentives." *Review of Regional Studies* 48 (1): 1–9.

Patrick, Carlianne. 2016. "Jobless Capital? The Role of Capital Subsidies." *Regional Science and Urban Economics* 60:169–79.

Porter, Michael E. 1996. "Competitive Advantage, Agglomeration Economies, and Regional Policy." *International Regional Science Review* 19 (1–2): 85–90.

Sasser, Alicia C. 2010. "Voting with Their Feet: Relative Economic Conditions and State Migration Patterns." *Regional Science and Urban Economics* 40 (2–3): 122–35.

Sobel, Russell S., Gary A. Wagner, and Peter T. Calcagno. 2022. "The Political Economy of State Economic Development Incentives: A Case of Rent Extraction." *Economics & Politics* (Awaiting Publication).

Tiebout, Charles M. 1956. "A Pure Theory of Local Expenditures." *Journal of Political Economy* 64 (5): 416–24.

Tullock, Gordon. 1967. "The Welfare Cost of Tariffs, Monopolies, and Theft." *Western Economic Journal* 5 (3): 224–32.

Weber, Rachel. 2003. "Equity and Entrepreneurialism: The Impact of Tax Increment Financing on School Finance." *Urban Affairs Review* 38 (5): 619–44.

ONWARD Wisconsin

Unleashing Capitalism with Common Sense Public Policy

How can we create a more prosperous future for Wisconsin? This edited volume was assembled to answer that question by engaging a team of economic scholars and experts who have each provided ideas for policy reforms that can accomplish that goal.

Our authors have based their research on published academic literature, not on politics. The issues addressed in this book were not chosen based on whether they align with the positions of any particular political party or administration. While the authors address a broad spectrum of issues, from tax policy to legal and regulatory reform, there is a common theme in the conclusions they reach regarding the current problem areas of Wisconsin's state policy.

Based upon over 200 years of research it is clear that higher levels of economic freedom can achieve higher rates of long-term economic growth, and these authors conclude that making Wisconsin's state policy climate more consistent with economic freedom will result in increased capital formation, higher labor productivity and wages, and faster long-run economic growth.

We hope that readers will come away with a better understanding of Wisconsin's economic issues and possible ways to reform policy to improve prosperity in the Badger state.

MENARD FAMILY INITIATIVE | UWE