POLICY WATCH

BB&T CENTER FOR ECONOMIC AND COMMUNITY DEVELOPMENT

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INDIVIDUAL ACTION, PUBLIC POLICY AND ECONOMIC GROWTH

A Foundation in Economic Freedom, by the Editor

A foundation for economic prosperity must be grounded in sound principles, principles individuals can objectively measure, benchmark and adhere to without considerable sacrifice. At a minimum, applying the principles must be simple to guide individuals through conflict and internal debate. I submit that such a foundation rests in the four cornerstones of economic freedom: 1) private ownership of resources or property, 2) personal choice, 3) voluntary exchange, and 4) free entry into markets or competition.

In this first issue of *Policy Watch,* I would like to begin with a focus on what happens when the fourth cornerstone, competition, begins to break down. In the United States, for example in South Carolina, this fourth principle is broken down through considerable action. To explain, allow me to focus on two cases of competition: 1) competition in the market for goods and services and 2) competition in the political arena. Let us assume that personal choice is most freely and widely exercised in the first case, whereas this personal choice is limited in the second case. We will now focus on the second case and consider the act of lobbying government officials for special favors that transfer benefits, or economic rent, to a special interest group. The classical economist David Ricardo defined "rent" as a return in excess of opportunity cost, or a return above what would be required for an owner to put a resource into production. Lobbying government for special favors then is referred to in economics as "rent-seeking." Examples of rent-seeking outcomes include subsidies for particular industries, regulations that exclude certain groups in society from a particular benefit, or enlarged benefit payments to certain demographic groups.

> Let individual innovations and entrepreneurship in the marketplace flourish. Minimize distortions in the tax code.

So now, in our example, we are

ABOUT *POLICY WATCH*

Policy Watch is a new publication from the BB&T Center for Economic and Community Development, housed in Coastal Carolina University's E. Craig Wall Sr. College of Business Administration. *Policy Watch* will focus on issues of economic policy and targets an audience seeking relevant, concise information grounded in sound economic theory.

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using the political process to advance our interests in the marketplace. Since this lobbying activity succeeds in excluding certain groups, it impedes competition in the marketplace. According to our foundation principles, less competition is less economic freedom. This constrains personal choice and voluntary exchange, which is inconsistent with personal and economic freedoms and hence inconsistent with economic prosperity in the overall society.

Let us consider a general example of a policy that induces rent-seeking behavior, the case of overly burdensome, selective taxes. For our purposes, "overly burdensome" may be objectively defined in reference to tax rates for alternative economic activities or for similar activities in competing jurisdictions.

Selective taxes increase the likelihood of rent-seeking behavior or lobbying, what the economist William Baumol refers to as unproductive entrepreneurship. Economists Russell Sobel and Thomas Garrett estimate the economic cost of such behavior to be between 3.8 percent and 5.4 percent of a state's total tax revenue, implying an additional cost of $473 to $672 million in South Carolina in the 2008-2009 fiscal year, as noted in the recently published book, *Unleashing Capitalism in South Carolina,* edited by Peter Calcagno with Josh Hall and Russell Sobel. There are still other costs, including compliance, enforcement, administrative and behavioral costs. In a separate study published in 2008, Sobel finds that South Carolina has a higher incidence of unproductive entrepreneurship relative to productive entrepreneurship, ranking it 33rd out of the 50 states in terms of net productive entrepreneurship.

Steven Arsenault and Douglas Walker recommend several reforms for South Carolina in particular. Three of these reforms address the following: 1) income tax brackets are not indexed to inflation, 2) the exemption of all Social Security income and up to $10,000 of pension income for those ages 65 and older, and 3) the high effective manufacturing property tax rate.

Consider the income tax brackets. Since the brackets are not indexed to inflation, $13,350 of annual income in 2009 puts an individual in the highest tax bracket, 7 percent, in South Carolina. If indexed to inflation, only income in excess of $73,200 would be taxed at this rate. In neighboring North Carolina, only income over $60,000 is taxed at the top rate, 7.75 percent.

The exemption of all Social Security income and up to $10,000 of pension income for those ages 65 and older is another policy that benefits a particular group disproportionately. This policy benefits retirees at the expense of younger generations, and does not support a competitive workforce for South Carolina.

Finally, South Carolina's effective manufacturing tax rate is the highest in the United States, two and a half times that of Georgia and four times that of North Carolina. This does not help a state with one of the lowest per capita income levels and lowest economic growth rates in the country.

Reducing the effective manufacturing property tax rate would reduce the incentive to seek/offer special tax rebates to attract new industry. This would make South Carolina more attractive for industry and reduce the costs associated with rent-seeking behavior.

Economic freedom supports an efficient approach to economic prosperity. Let individual innovations and entrepreneurship in the marketplace flourish. Minimize distortions in the tax code.

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