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What America's Decline in Economic Freedom Means for Entrepreneurship and Prosperity

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Executive Summary

Donald J. Boudreaux, Editor

There is ongoing interest both inside and outside the United States regarding the nation's tepid and abnormally slow recovery from the pronounced contractions in 2008. A number of scholars have explained components of the slow recovery but almost no analysis exists that provides a larger understanding for the country's dismal economic performance. The collected essays in *What America's Decline in Economic Freedom Means for Entrepreneurship and Prosperity* provide just such a framework, which allows readers to both understand the nature of the problem facing the United States and equally as important the path to recovery and prosperity.

The first essay, by Liya Palagashvili, sets the stage for prosperity by explaining the fundamental, central role played by entrepreneurs in a prosperous economy. Admittedly, this is not that controversial. Most people and even economists recognize the pivotal, even essential role played by entrepreneurs, innovators, and business people more generally in directing investment, creativity, and human effort. Simply put, modern economies require entrepreneurs for prosperity.

Russell Sobel's essay provides a critical link that is too often ignored or misunderstood, which is the relationship between economic freedom and entrepreneurship. Entrepreneurship does not exist or occur in a vacuum and Sobel's work demonstrates the importance of economic institutions such as the rule of law, taxes, and regulations in promoting (or potentially discouraging) entrepreneurship. Sobel finds that, not only does economic freedom increase the *quantity* of entrepreneurial activity, it also dramatically increases the *quality*—that is, the productivity—of entrepreneurial activity.

The combination of the essays by Palagashvili and Sobel form the basis for the question answered by Robert Lawson regarding the state of economic freedom in the United States. The index published in *Economic Freedom of the World* is an empirical measurement of economic institutions across 152 countries. Generally speaking, economic freedom has improved since 1970, the first year for which comprehensive data is available. Professor Lawson notes, however, that there has been a slight decline since 2000 in the average level of economic freedom amongst the members of the Organisation for Economic Co-operation and Development (OECD), which encompasses the 34 most industrialized countries in the world.

More importantly for the purposes of this paper, Lawson focuses on the performance of the United States. Readers might be surprised to learn that the United States is today (2012) only the ninth economically freest nation among the OECD countries. New Zealand is the freest, with Canada second. Equally as troubling is the decline in the United States' performance over time. The US has fallen from third place overall in 1980 to twelfth place in the latest rankings. Simply put, the findings from Lawson's analysis of the United States' declining performance in economic freedom combined with the findings from Palagashvili and Sobel's essays more than plausibly explains the nation's sluggish recovery.

The final two essays in the series explore in more detail two of the main reasons for the decline in the economic freedom in the United States: (1) rule of law, and (2) regulations. Roger Meiners and Andrew Morriss first examine the rule of law in the United States including its meaning, importance, and recent changes. The authors pay due attention to the relationship between the rule of law, entrepreneurship, and business startups. Meiners and Morriss demonstrate how the rule of law has been eroded in the United States—an erosion that accelerated over the last decade or so—through a series of legal and other interventions by government. While painting no rosy picture of the current health of the rule of law in the United States, these scholars explain how the rule of law might be better protected and therefore improved through more jurisdictional competition.

The final chapter, by Wayne Crews, probes the legal, political, and economic details of government regulation in the United States. Data are presented showing the massive growth of bureaucratic intervention. Consistent with Meiners's and Morriss's argument, Crews demonstrates that today's long and sweeping regulatory reach is evidence of a breakdown of America's constitutional order—a weakening of the rule of law. Crews also documents the enormous economic burden of regulation. He estimates that regulation costs the average US household US$14,976 annually, or nearly one quarter of its before-tax income.

In summary, the information and arguments presented here demonstrate unmistakably that the growth of government stymies entrepreneurship and threatens prosperity—a demonstration that, it is hoped, will help inspire efforts not just to slow, but to reverse, this growth and return to prosperity.

What America's Decline
in Economic Freedom Means for Entrepreneurship and Prosperity

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1. Entrepreneurship, Institutions, and Economic Prosperity

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1. Introduction

Entrepreneurs are agents of change who constantly create new environments that breed further opportunities for progress and development. We often think of the big names in the field such as Andrew Carnegie and John D. Rockefeller as the drivers of the economy. Carnegie was the industrialist responsible for the mass expansion of the American steel industry and Rockefeller revolutionized the petroleum industry in the 19th century. Though both of these entrepreneurs have substantially improved our economic well-being, they were only able to achieve their successes because of an existing entrepreneurial environment that allowed them to create and reap the benefits of their enterprises and build upon already existing innovations of previous entrepreneurs. Rockefeller, for example, achieved his successes by relying on the newly constructed railroad infrastructure, which was largely made possible by other entrepreneurs and innovators. And, while Matthew Boulton's and James Watts's steam engine played a key role in sparking the industrial revolution and the development of the modern world, it was only because of an already existing steam engine that allowed Watts to experiment with adjustments and create this new one. Many of these big name innovators whom we readily associate with economic progress and growth can often make us overlook a more important factor: the gist of economic growth comes not from a handful of grand innovators, but from a thriving environment of small, medium, and large-sized businesses in a competitive, entrepreneurial atmosphere where these entrepreneurs are constantly altering the environment and giving rise to further entrepreneurial opportunities and innovations. This competitive striving is the essence of entrepreneurship. And this is the aspect of entrepreneurship I will be linking to long-run economic progress.

In the last few decades, there has been a renewed interest in entrepreneurship as the driver of economic growth. This renewed interest stands in contrast to post-1950s mainstream or neoclassical economic theories regarding the importance of capital, labor, and technology for economic development and prosperity. These models first emphasized that the accumulation of capital generates economic growth—and the accumulation of capital was only possible through savings and investment. Soon after, economists began analyzing the relationship between capital, labor, and technology as inputs into a growth production function. These models led economists to conclude that nations were poor because people there did not save enough, or that people in these nations did not use technology efficiently. While these statements highlight important patterns in developing countries, they also pose questions: Why are these people not saving? Why do people in poor countries use technology less efficiently than do people in rich countries? Why in certain countries do workers not invest in their own development while workers in other countries do regularly make such investments? The neoclassical growth-theory models made no effort to explain why these factors differ from country to country. Scholars using these models therefore failed to analyze the *incentives* that encourage growth-enhancing, as well as growth-destroying, behaviors. Fortunately, growth theories now situate entrepreneurship as an indispensable component of economic growth.

Entrepreneurship refers to the ability to discover profit opportunities—whether they are from market innovations or for arbitrage opportunities across time and place. The entrepreneur is one who is alert to perceived opportunities and motivated by the gain of profit (Kirzner, 1973). Entrepreneurship is omnipresent and the specific entrepreneurial act depends on the different profit opportunities in any given context. In general, entrepreneurs are thought of as the business owners, creators of ideas, and innovators in an economy. An important follow-up question is, then: what influences people to invent, innovate, or open new businesses—or rather, what influences entrepreneurial activities to flourish?

This chapter aims to present an understanding of entrepreneurship and how it relates to economic growth. In doing so, it also focuses on the mechanisms by which entrepreneurship is encouraged and impeded. This chapter does so by analyzing the institutional environment within which entrepreneurial activity takes place. The overall theoretical perspective in this literature is that entrepreneurship is fundamental for economic growth and long-run prosperity, and institutions that protect property rights and provide favorable business environments encourage greater entrepreneurship and innovation. Thus, the first link will provide an analysis of how entrepreneurship influences economic growth. This link includes a discussion of the importance of small business activities, innovations, inventions, market opportunities, and the overall mechanisms of a market process.

The second link is an analysis of how institutions influence entrepreneurship. Institutions are the "rules of the game", which include such things as legal rules, property rights, constitutions, political structures, and norms and customs. The institutions of a particular country dictate how costly or beneficial certain decisions are to the individuals who make them—including decisions to open a business or to invent a product or production process. Factors like the legal costs of entering a market describe the regulatory environment and thus are part of the "institutions" of a particular country. In addition to providing the theoretical links between entrepreneurship and growth, and then between institutions and entrepreneurship, this chapter also surveys empirical work in this area. This work analyzes the extent of entrepreneurial activity across countries and overtime; it seeks to illustrate the causal relationship between these variables.

2. Theoretical perspectives on entrepreneurship

2.1. Entrepreneurship and growth

Within the literature on economics and entrepreneurship, there are two main notions of the entrepreneur. On one hand, Kirzner (1973) describes the entrepreneur as one who drives the market toward efficient outcomes by exploiting profit opportunities. These profit opportunities arise because there exists some knowledge that is previously unknown, and the entrepreneur is alert to this knowledge and can act upon it (Kirzner, 1973: 35; 1979: 139). For example, someone who lives in a small town and witnesses an influx of immigrants might now "see" profit in opening an international deli there. Or, as college enrollments are increasing in a particular college town, someone might "see" profit in a new enterprise that renovates homes and turns them into rental units. In these examples, the entrepreneur becomes the "driver" of the market process by redirecting resources from lower-valued to higher-valued uses. This process of market exchange itself generates important feedback regarding valuable projects and encourages entrepreneurship. The profits that entrepreneurs earn (and losses that they suffer) generate information—signals—that promote further efforts to more efficiently allocate resources and production—that is, to better satisfy human wants. In the case of the international deli owner, if he would have opened the business in a town with no immigrants he likely would have witnessed little demand for his deli items. As a result, he would have earned negative profits (losses). These losses would signal him, and others, that resources channeled into this particular species of production in this particular town do not satisfy enough consumer desires. These signals would then lead him to close down the deli. The shuttering of the deli, far from being a regrettable outcome for society, would free up resources to be used in other ways—ways that will hopefully better satisfy the people in the town.

But in a world where the deli owner correctly predicts or perceives the consumer demand coming from the new immigrant population, the deli will now yield profits for the entrepreneur. These profits "signal" to the entrepreneur, and provide the incentive, to continue operating. These profits also encourage him and other entrepreneurs to continue to be alert for new opportunities for production and innovation. In essence, the Kirznerian entrepreneur discovers an opportunity that allows him to make better use of existing resources and information to better serve human wants.

It is important here to briefly mention why economists care so much about production. The reason production is in the analytical forefront is that individuals produce ultimately in order to satisfy human wants—that is, to consume. Entrepreneurial profit comes precisely from the fact that individuals are interested in buying products or services that entrepreneurs sell. If an entrepreneur, for example, produces 4-foot-long nails, he will be unable to sell that product because people do not desire it. Production of this particular output would yield losses. Market forces would drive this particular enterprise out of business. Merely producing a large quantity of *anything* does not lead to "economic prosperity". Production is important only to the extent that it serves human wants—and the entrepreneurial market process leads to prosperity because it constantly generates the adjustments and innovations that direct resources into uses that better serve people's wants.

The second main notion of entrepreneurship comes Joseph Schumpeter (1942 [1950]) who describes the entrepreneur as a creative and bold innovator in a constant process of replacing old technologies with new technologies. Schumpeter emphasized the entrepreneur as a "disruptive" agent in society engaging in creative destruction. Creative destruction is the process introduced by the entrepreneur whereby new products or services or production techniques render old products or services or supply techniques obsolete (Schumpeter, 1950: 81–86). The most common example of creative destruction is the automobile, which led to the disappearance of the horse and buggy. But consider also how personal computers destroyed many mainframe computer companies, or how DVDs ended the production and sale of VCRs. Examples are practically endless. In Schumpeter's view, the entrepreneur is an innovator for whom profits are the incentive to come up with new technologies and inventions; the entrepreneur thereby becomes the engine of economic growth. The entrepreneur discovers new information and new combinations of capital and resources and introduces these into the market place. By doing so, this "daring" entrepreneur disrupts the current state of production in the economy and brings forth this new idea that fundamentally alters economic production.

Schumpeter gives an example of the textile industry that produces only with "hand labor" where the role of the entrepreneur is to notice and act upon the possibility of using power looms for production and forever altering this industry (Schumpeter, 1934 [2008]: 129–130). The introduction of assembly lines is another example of Schumpeterian entrepreneurship because it fundamentally changed the nature of production in ways that greatly increased industrial productivity. Entrepreneurs are, in essence, creating and then offering the insights that lead to new goods or services, or to new processes and combinations for producing already existing goods and services, or new methods in the organization of an industry. Schumpeter's entrepreneur is a constant catalyst for disrupting the current economic conditions and generating economic growth.

Economists often discuss the tension between the two notions of entrepreneurship: the Kirznerian entrepreneur is an "equilibrating" force in society while the Schumpeterian entrepreneur is "disequilibrating". For the purposes of this chapter, this tension is unimportant because both roles of the entrepreneur improve society's material standard of living and, hence, each is crucial to long-run economic prosperity.[1]

There are, of course, real distinctions between these two roles. For example, Kirzner's entrepreneur does not fundamentally change the nature of production or an industry; instead, this entrepreneur makes better use of already existing information and resources in society. In contrast, Schumpeter's entrepreneur disrupts the current nature of production and of the industry by introducing new innovations and production processes. Yet in both Kirzner and Schumpeter's

1. Boudreaux (1994) argues that Schumpeter's entrepreneur and Kirzner's entrepreneur have complementary roles and both, in a broader sense, act in equilibrating ways.

account, entrepreneurs are motivated by profits—profits provide the incentive for the Kirznerian entrepreneur to channel resources to their most highly valued uses and profits are what encourage the Schumpeterian entrepreneur to innovate. While these two entrepreneurial roles are distinct from each other, it is the interaction between them that drives much of the economic process of development. In other words, the combined role of *both* the Kirznerian and the Schumpeterian entrepreneur provides the theoretical link between entrepreneurship and long-run economic prosperity and growth.

In Kirzner's notion of entrepreneurship, the important mechanism is that entrepreneurs drive the market toward efficient use of existing resources. This corresponds to the movement of a point *inside* of what economists call the production possibilities frontier (PPF) to a point *on* the PPF. At any given point, the total output that a society can produce depends on the resources available and available technology. As entrepreneurs engage in the process of discovery and arbitrage, they reallocate resources to push the economy toward the maximum potential level of output. In essence, as the entrepreneur discovers previously unexploited opportunities, he channels resources to their most highly valued uses and, thus, ensures that each resource contributes as much as it can to the well-being of society. In contrast, an economy operating at any point inside of the PPF is not making full and best use of its resources. When such inefficiency exists (as it always does, to some degree, in reality), "entrepreneurs rearrange given resources to push the economy closer to the PPF. In general, arbitrage ensures a tendency toward a given PPF" (Boettke and Coyne, 2009: 158). It is through these adjustments that Kirzner's entrepreneur increases economic productivity and, hence, creates widespread wealth. Says Kirzner: "the entrepreneur is to be seen as responding to opportunities rather then creating them; as capturing profit opportunities rather then generating them … Without entrepreneurship, without alertness to the new possibility, the long-term benefits may remain untapped" (1973: 74). The vital role of Kirzner's entrepreneur is to drive the market process toward greater efficiency in production.

Schumpeter's entrepreneur, again, is different. He is an innovator whose initial actions disrupt rather than smooth out economic activities. For example, the entrepreneur who introduces power looms both raises the productivity of some textile-industry workers by allowing each worker to produce more output per hour *and*, by allowing textile mills to operate with fewer workers, releases labor that can be used to produce other goods and services. As Schumpeter explains, "[a] worker with such a loom is now in a position to produce six times as much as a hand-worker in a day" (Schumpeter, 1934: 130). This means that entrepreneurs enhance growth by innovating in ways that shift the PPF outward. Society can use fewer resources and produce more of the same things in the industry where the innovation occurred. But this is not the end of the story. When machines are introduced in one industry and production is now more efficient there, resources are thus freed up to produce other outputs that would otherwise be too costly to produce.

In the 19th century, a majority of Americans worked in farming to feed the entire country. With technological breakthroughs in agricultural productivity in the 20th century, fewer than 2% of Americans now work in farming to feed a nation that has more than four times the population it had in 1900. Increasing productivity in agriculture allows people to use fewer workers and other resources to produce more output (food), which frees up labor to go into satisfying other consumer demands. When the majority of the population is no longer needed to just keep us alive by producing food, workers move into other areas to produce the likes of cellphones, computers, cars, and contact lenses. Through these market innovations, the entrepreneur acts as a powerful force in moving the economy forward and making societies wealthier. In doing so, the entrepreneur also destroys old products and generates new ones—what is called "creative destruction" (Schumpeter, 1950). It is through this mechanism that Schumpeterian entrepreneurship leads to economic growth and prosperity.

Randy Holcombe (2008) discusses yet another aspect of entrepreneurship. Inspired by Kirzner's research, he points out that entrepreneurially driven adjustments to the economy actually create additional profit opportunities. New profit opportunities arise, or are more likely to be noticed, as entrepreneurs encounter the discoveries of previous entrepreneurs. This process repeats itself as new entrepreneurs build on the ideas and actions of these previous entrepreneurs. The result is a continual growth in entrepreneurial opportunities and activity. Holcombe explains: "When entrepreneurs take advantage of profit opportunities, they create new entrepreneurial opportunities that others can act upon. Entrepreneurship creates an environment that makes more entrepreneurship possible" (2008: 61). In this case, when the entrepreneur seizes profit opportunities, he creates new profit opportunities for other entrepreneurs to act on. It is important to understand this process because the entire notion of the Kirznerian entrepreneur rests on this idea that entrepreneurs are seizing previously unnoticed profit opportunities.

But from where do these profit opportunities come? They come from an entrepreneurial environment—an environment where entrepreneurs are constantly seizing profit opportunities. Entrepreneurs then are also constantly changing the economic environment and giving rise to new profit opportunities. This on-going activity creates new market opportunities and generates the possibility for greater specialization. Opportunities for greater specialization are vital because these entrepreneurial insights create new niches, which generate innovations and lead to greater economic growth. In summary, an entrepreneurial environment allows for various profit opportunities to arise, encouraging the entrepreneur not only to act upon them but also, without intending to do so, to create yet newer opportunities for profitable entrepreneurial activity.

Holcombe's mechanism for economic growth rests on Adam Smith's observation that the division of labor and the growth that it engenders are limited by the extent of the market. As Smith explains: "When the market is very small, no person can have any encouragement to dedicate himself entirely to one employment" (Smith, 1776: 27). But, as markets grow, this growth encourages greater specialization which, in turn, promotes more innovation. The more immediate source of this greater innovation is greater specialization. As tasks become more specialized, people become both more alert to the possibility of mechanizing tasks as well as more knowledgeable about how to carry out this mechanization.

For example, someone working in retail will probably not be able to discover potential profit opportunities in the way that internal-combustion engines are currently manufactured. But someone with training in mechanical engineering or experience in that area of work *is* more likely to find unexploited profit opportunities. Such opportunities can include finding a way to manufacture the engine more efficiently or finding lower-cost sources of inputs. These profit opportunities arise in part from differences in *knowledge* among people: the retail agent does not have the same knowledge as the mechanical engineer so practically he cannot spot available profit opportunities in the existing process used to produce internal-combustion engines. But the retail agent may have greater knowledge about where and how to sell the internal-combustion engine. Different knowledge in a particular area of work creates opportunities to notice things that would be difficult to notice without detailed knowledge of that area. This entrepreneurial activity increases the extent of the market and allows for new market opportunities and greater specialization in the niches.

It is this entrepreneurial process that drives economic growth. Efforts to foster such a process should not focus on particular businesses, corporations, or people. Instead, such efforts should strive to create an environment that allows for entrepreneurial activity of all kinds to thrive. Such an environment, of course, would reliably reward successful entrepreneurs with profits and punish unsuccessful ones with losses. As Holcombe explains:

> With few opportunities, there is little incentive to devote any resources toward seeking them out. In an environment of economic change, new opportunities will continually be presenting themselves. When entrepreneurs take advantage of some opportunities, the economic environment changes, creating additional opportunities. Thus, entrepreneurship leads to more entrepreneurship. (2008: 65)

In the literature about entrepreneurship and growth, the tendency is to assume that "entrepreneurial activity" refers specifically to the activities of large firms. The reason is that large firms have historically been viewed as the most important sources of jobs and innovation. However, the mechanisms described in this paper apply both to small, medium, and large-sized firms. In fact, Acs, Carlsson, and Karlsson (1999) argue that *small* firms have an advantage over large firms at generating more innovative products, but that many large firms have an advantage specifically in *process* innovation.[2] This reality might be explained by the fact that diseconomies of scale perhaps characterize innovative activities—diseconomies specifically caused by the "inherent bureaucratization process which inhibits both innovative activity and the speed at which innovations move through the corporate system towards the market" (Links and Rees, 1990: 25). Others suggest that the company organization and culture in smaller businesses are more conducive to employee participation during the product innovation processes. The larger the company, the more difficult it is to maintain this creative type of environment. Furthermore, Acs, Carlsson, and Karlsson explain that:

> new industries are characterized by a high rate of product innovation, carried out mostly by small firms. As entry rates decline over time, so does the rate of product innovation. The firms remaining in the industry devote an

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2. "Process innovation" refers to a new and improved production or delivery method. This may include changes in technique or equipment used to produce the product. This is in contrast to product innovation, which refers to a new good or service or improvements in that good or service. Yet another type of innovation is organizational innovation, which leads to new business practices or a new workplace organization.

> increasing share of their R&D efforts to process innovation, in which large firms may have an advantage due to their ability to spread costs over a large output. (1999: 29)

For example, many large companies today—such as Google—purchase innovative products from small enterprises and specialize in giving a wider pool of customers access to the product. In other words, innovative products are generally created by smaller start-ups, but Google and other large firms end up purchasing rights to produce these products from their creators and then building production and distribution arrangements that effectively get these products into consumers' hands. Acs, Carlsson, and Karlsson conclude that "a dynamic economy requires a high level of innovation activity, which in turn requires vigorous entry of new firms, most of which are necessarily small" (1999: 33) . The complementary roles of small, medium, and large-sized businesses illustrate the importance not only of "large corporations" for economic growth, but of a dynamic entrepreneurial environment that includes firms of different sizes to discover new products, generate improvements, and, in the end, raise living standards.

This notion of entrepreneur-driven economic growth differs from the standard neoclassical explanations of growth. Those models emphasize physical and human capital inputs as central inputs into the production process. In line with this emphasis, economists have cited savings as key to growth because it allows for capital accumulation. Accordingly, these models then discuss technological knowledge as another factor of economic growth. All of these factors are seen as "inputs" into a production process. The importance of an entrepreneurial environment is that it can attract these inputs and lead to greater investment and spur growth. But the main emphasis ought to be, not on production-function inputs, but instead on the *institutions* that best encourage the flourishing of entrepreneurial activity.

2.2. Institutions and entrepreneurship

While the above analysis explored the link between entrepreneurship and economic growth, not all forms of entrepreneurship are growth enhancing. Because the entrepreneur is motivated by personal profit opportunities, the institutions governing a society have a big influence on the extent to which entrepreneurial activities lead to innovation and productive outcomes. Institutions as the "rules of game" facilitate economic, social, and political interactions and can alter the incentives and payoffs to engage in growth-enhancing entrepreneurial behavior.

Depending on the rules, the institutions create incentives for particular actions and may dissuade individuals from taking other actions. As individuals respond to incentives by evaluating the costs and benefits of various activities, they are always in a sense influenced by institutions. If in a particular society individuals are not able to reap the benefits of their invention, we would not expect this society to be a technological hub. In other societies, if it is particularly costly to open up new businesses, many potential entrepreneurs will be dissuaded from becoming *actual* entrepreneurs. The rules of the game determine the relative payoffs to different entrepreneurial activities and these rules change over time and among states and countries. Where people find it profitable to engage in activities such as arbitrage and innovation, entrepreneurship flourishes. Thus, depending on the institutions, entrepreneurial activity can either encourage or impede economic growth.

Baumol (1990) was one of the first to make this distinction between various forms of entrepreneurship encouraging or impeding economic growth. He identified three forms of entrepreneurship: productive, unproductive, and destructive. Productive entrepreneurship involves the introduction of new goods into the marketplace, the introduction of new methods of production, the opening of new markets, the discovery or creation of new sources of supplies of raw materials and intermediate goods, or the implementation of new organizational or managerial strategies (Baumol, 1990). The discussion above of entrepreneurship and growth was confined to "productive" entrepreneurship. Unproductive entrepreneurial activities, in contrast, include rent-seeking and other redistributive efforts.

An example of such unproductive entrepreneurship is a business owner spending resources to lobby legislators for subsidies or other favors. These efforts and expenditures diminish long-run economic growth, both directly and by creating additional opportunities for such unproductive entrepreneurship. Coyne, Dove, and Sobel (2010) describe how unproductive entrepreneurial activities breed more unproductive opportunities by creating unproductive niches for profit, altering for the worse the pattern of incentives in that society, and creating unproductive social capital and networks. Through these mechanisms, unproductive entrepreneurship breeds more unproductive opportunities for entrepreneurs to exploit, which further minimizes and crowds out productive activity and growth. Destructive entrepreneurship is similar to unproductive entrepreneurship, but also destroys existing resources or existing productive capacity as the entrepreneur attempts to increase his own wealth. For example, violent conflict and theft are examples of destructive entrepreneurship because these acts destroy existing societal resources in an attempt to redistribute wealth. Institutions can thus shape the relative payoffs to partaking in productive, unproductive, or destructive entrepreneurial activities. When there is relatively greater benefit to engaging in unproductive activities, entrepreneurs spend more resources on rent seeking and lobbying and other redistributive—as opposed to productive—efforts. Only when institutions generate incentives to induce *productive* entrepreneurship will entrepreneurs contribute to growth. In order words, the link between entrepreneurship and economic growth is only *activated* with certain institutions.

One of the most important institutional structures identified with allowing productive entrepreneurship to flourish is the institution of secure private property rights. When there is poor protection of property rights, it is less profitable to engage in business ventures because entrepreneurs might not be able to keep enough of their profits, or they might perceive that their capital investments will be seized, stolen, or destroyed (Boettke and Coyne, 2003; 2009). Acs, Carlsson, and Karlsson explain that the protection of property rights is vital for entrepreneurs also because they "need to rely on the security of their residual claims for the returns from the organizations they have created … [and] entrepreneurs must raise capital, bear risks, and enter new markets. Such activities require transactional trust over a long-term horizon, and this is strengthened by stable property rights that are effectively enforced" (2013: 22).

The structure of a tax system is also important. If the tax system punishes market success, entrepreneurs will divert their resources into other, more profitable ventures outside the market, such as lobbying legislators for favors. If the "rules of the game" are such that lobbying efforts yield more reward than inventing a new product or exploiting arbitrage opportunities, entrepreneurial activities will be unproductive and destructive, thereby stymieing economic development or even causing economic decline. Thus, various institutional arrangements—including aspects of legal rules, property rights, and structures—alter the balance of incentives among various forms of entrepreneurship, and can thereby influence or impede economic growth. Moreover, one of the most important institutional structures for encouraging market entrepreneurial activity is to allow for competition among firms. Kirzner discusses how competition in the market exists as long as there are no arbitrary barriers to entry (1973: 97; 1985: 130, 142). Without barriers to entry, the competition among firms for profits generates entrepreneurial activity leading to the creation of new products and services and lower-cost methods of producing goods and services. Thus, barriers to entry into a market are barriers to exercising entrepreneurship: such barriers impede the competitive process and the incentives entrepreneurs face in exploiting potential profit opportunities.

Thus, productive entrepreneurship is a consequence of the institutional setting. Boettke and Coyne (2009) also explain:

> Only under a certain institutional environment will entrepreneurs have an incentive to discover new resources, substitutes for existing resources or trading partners to obtain resources … only in certain institutional contexts will entrepreneurs have an incentive to discover new technological knowledge such as new production processes or new organization structures. (Boettke and Coyne 2009, 158).

It is important to emphasize the role of institutions because entrepreneurs are in some sense omnipresent: they exist across cultures and over time and they will always employ their creativity in search for personal gain (Baumol, 2002; Koppl, 2007). Boettke and Coyne explain: "An African tribesman, a European peasant, or an American farmer are all acting entrepreneurially when they pursue opportunities to better their personal circumstances through beneficial exchange and interaction. It is a human trait to be alert to those things that are in our interest to be alert to" (2009: 137–138) . Differences in entrepreneurship in a society should then be attributed to differences in institutions and not purely to differences in the inherent entrepreneurial spirit of a person or a culture. Individuals respond to perceived costs and benefits, and not all societies have environments that reward the invention of new goods or the discovery of a low-cost way of producing a product. In any given population, the institutional environment shapes and constrains the opportunities and incentives to entrepreneurship.

In a broader light, an institutional environment favorable to entrepreneurship includes more than laws and formal institutions, but encompasses norms, attitudes, and informal institutions. McCloskey (2010) provides a rich account of how the ethics and language surrounding the role of the entrepreneur changed in Northwest Europe during the 18th century (she calls this "the Bourgeois Revaluation"), and how this change was vital for sparking economic growth and the modern world. She ties her work with Kirzner's, explaining: "A new rhetorical environment in the eighteenth century encouraged entrepreneurs. As a result over the next two centuries the production possibility curve leapt out by a factor of one hundred" (2011: 53). McCloskey does acknowledge the role of formal institutions governing entrepreneurship, but argues that entrepreneurial discovery and creativity also depends on other factors, such as the virtues of courage and hope, and a context of entrepreneurial dignity. McCloskey is employing the Kirznerian entrepreneur in her work and arguing that this sort of entrepreneurial discovery and innovation in the late 18th century came from "releasing of the West from ancient constraints on the dignity and liberty of the bourgeoisie, producing an intellectual and engineering explosion of ideas" (2011: 49). This mechanism also ties to Holcombe's (2008) argument above: once breeding ideas were set free, they created more and more opportunities for entrepreneurial activities and Kirznerian alertness. McCloskey explains: "The idea of the steam engine had babies with the idea of rails and the idea of wrought iron, and the result was the railroads. The new generation of ideas—in view of the continuing breeding of ideas going on in the background—created by their very routinization still more Kirznerian opportunities" (2011: 50).

McCloskey's work is showing that the change in rhetoric and ethics encouraged individuals to enter commercial life. Ethics, attitudes, and norms are an aspect of the institutional environment—called the "informal institutions"—and thus, when the institutional environment becomes more favorable to the entrepreneurial environment, there would be increase in entrepreneurial activity. Martin summarizes this connection between the Kirznerian entrepreneur and McCloskey's work; he argues:

> The application [of Kirzner's work] to McCloskey's case is entirely straightforward: the Bourgeois Revaluation can be interpreted as an ecological shift in entrepreneurial alertness … Innovative discoveries—those that create rather than dissipate sheer profit—require not only formal private property rights and free prices, but a social environment characterized by Bourgeois Dignity and Liberty. (2012: 760)

In explaining the history of the modern world, McCloskey attributes this Bourgeois Revaluation as a significant cause of the take-off in economic growth. Thus, in addition to the formal institutions discussed in this section, the attitudes, norms, and informal institutions in a society also have a significant impact on economic growth. Many of the findings discussed in the next section reveal this connection between institutions, entrepreneurship, and economic growth.

3. Empirical findings

There are multiple ways in which scholars attempt to measure entrepreneurial activity. First, there are framework conditions of entrepreneurship. These include such things as the ease and cost of doing business and "favorableness" of regulatory environments. These measures equate "entrepreneurship" with conditions that allow entrepreneurial activity to flourish. Second, there are output indicators, such as those that track the creation of new firms or that use registries to create an index of the prevalence of high-growth firms. These indicators include measures of the number of firms, the sizes of different firms, or growth of new enterprises. Third, there are attitude and cultural traits that gauge citizens' opinions and behavior toward entrepreneurship—traits that can be discovered and quantified by survey questions. For example: "Do people in this particular society want to start new businesses? Do people in the society believe that the entrepreneur has an important role to play? Are entrepreneurs praised? How likely are individuals to start a new business?" Measures of these attitudes are distilled from population surveys with the aim of attempting to capture the attitudes of a population toward entrepreneurship or trying to understand the extent of the "entrepreneurial spirit" of the people.

Within the entrepreneurship literature, there is no consistent agreement on which of these three measures best captures and quantifies the notion of entrepreneurship. Ideally, a measure of entrepreneurship should include all three components (framework, attitude/culture, and output). To review the empirical findings, I address a handful of studies that use each of these measures of entrepreneurship. One of the most expansive studies done on the framework measures of entrepreneurship is the index published in *Economic Freedom of the World* (EFW; Gwartney, Lawson, and Hall, 2014). This index has five components as part of economic freedom: Area 1. Size of Government; Area 2. Legal System and Property Rights; Area 3. Sound Money; Area 4. Freedom to Trade Internationally; and Area 5. Regulation. For purposes of measuring an entrepreneurial environment, Area 5. Regulation and Area 2. Legal System and Property Rights are the most important. The regulation component includes credit market regulations, labor market regulations, and business regulations. All of these are vital for understanding an entrepreneurial environment because each influences the incentives to engage in entrepreneurial activity. Is it costly to start a business? Am I even allowed to start a business? Will my business face unduly high labor costs? Can I fire bad or redundant workers? These components are key for allowing entrepreneurship to flourish. Where regulations make it difficult to start and operate businesses, entrepreneurs will have a hard time bringing their new ideas and innovations to fruition. Promising entrepreneurs who face onerous regulations might opt out of doing business or may decide to take their ideas to countries with a more favorable business climates.

Legal System and Property Rights, Area 2 of the EFW index, plays one of the most important roles in the measure of an entrepreneurial environment. This component includes such things as protection of property rights, legal enforcement of contracts, business costs of crime, reliability of the police, and impartial courts, among others. This component, in addition to measuring the security of property rights, also in essence measures the degree to which each country is governed by the rule of law. Well-established legal rules, a rule of law, and protection of business owner's property rights help ensure that entrepreneurs are safe from both private and public predation. An individual who has an idea to start a business might not invest in the business if he believes that his government can easily shut him down or that police will not protect his building from looters. This component is also important for encouraging capital flows, which help entrepreneurs to expand their businesses, ideas, and innovations. If people outside the country perceive it to be unstable, then they will not invest in that particular country. Property rights and the rule of law thus play a key role in attracting capital. The authors explain this linkage: "When individuals and business lack confidence that contracts will be enforced and the fruits of their productive efforts protected, their incentives to engage in productive activity is eroded" (Gwartney, Lawson, and Hall, 2014: 5).

The EFW index is produced annually, ranking today 152 countries. The general findings are consistent from year to year, though specifics regarding each particular country change. The most consistent finding is that the most economically free countries tend to have the highest incomes while the least economically free countries have the lowest incomes (mostly countries in sub-Saharan Africa). The findings from year to year in the EFW index are also consistent regarding Area 2. Legal System and Property Rights. Each year, the study finds that countries that have good legal rules and protection of property rights are always the high-income countries—and countries that rank the lowest in this particular component are the poorest countries in the world.

Take, for example, the rankings from the 2014 report. The top five countries ranked highest in protection of property rights and legal systems are Finland, New Zealand, Norway, and Singapore, and Switzerland (Gwartney, Lawson and Hall, 2014). These countries are industrial countries in the sample with the highest income. The five countries ranked worst in protection of property rights and legal systems are Venezuela, Haiti, Democratic Republic of the Congo, Central African Republic, and Togo. The countries in this latter group all are in the lowest-income category in the sample. Furthermore, not only is strong protection of property rights correlated with high incomes, but it is also correlated with rapid economic growth (Gwartney, Lawson and Hall, 2014: 21). Hall and Lawson (2014) also find that, almost without exception, countries with higher and improving economic freedom scores tend to grow more rapidly. In fact, a one-point decline in the economic freedom rating is associated with a reduction in the long-term growth of GDP of between 1.0 and 1.5 percentage points annually (Gwartney, Holcombe, and Lawson, 2006).

The findings in *Economic Freedom of the World* on the importance of property rights for entrepreneurship and also for economic prosperity are in line with the overall literature on this topic. In general, entrepreneurial opportunities and activities differ significantly across societies and these differences stem chiefly from differences in property rights protection and the rule of law (Boettke and Subrick, 2002; Scully, 1988; Gwartney, Holcombe, and Lawson, 1998, 1999; Johnson, McMillan, and Woodruff, 2000) are also among those who argue that there is little incentive for entrepreneurs to invest without strong protection of property rights, even if capital is abundant and available. The key finding in this line of literature is that property rights are essential for a thriving entrepreneurial environment.

The second component of the EFW index that theoretically should be important for economic growth is Area 5. Regulation. However, there is not as strong a correlation between regulation and economic prosperity as there is with property rights and economic prosperity (Gwartney, Lawson, and Hall, 2014). Many high-income and high-growth countries ranked extremely low in the regulation component (meaning they had unfavorable business, labor, or credit market regulations) and many low-income countries ranked highly in the regulation component. Take, for example, the top five highest ranked in freedom from regulation: Hong Kong, Fiji, Bahamas, New Zealand, and Qatar. While Hong Kong and New Zealand are high-income countries, the other three countries in this group are middle-to-low income. Other high-income countries like Australia, Germany, France, the United States, and the United Kingdom rank at about the global average on regulatory burdens, and also rank alongside countries like Uganda and Rwanda in this component. This fact could indicate that, without protection of strong property rights, having a favorable business climate free from burdensome regulation is not sufficient to foster vibrant entrepreneurship. This reality might explain why relatively poor countries such as the Bahamas rank very poorly in protection of property rights and legal rules but rank highly on the regulation measure. If the actual institutions of property rights are not present, it might not matter very much if regulations are burdensome or not. Another way to explain this phenomenon is that the benefits of property rights on economic growth almost always outweigh the costs of burdensome regulation, so countries with strong property rights and burdensome regulations can still experience high levels of income and wealth.

The finding on the regulation component in the EFW Report is slightly different than other studies in this literature. Djanjov, La Porta, Lopez-de-Silanes, and Shleifer (2002) find that countries with heavier regulation tend to be more corrupt and have larger unofficial economies. This study concludes that stricter regulation is not associated with higher-quality production or better pollution or health outcomes. Instead, countries that heavily regulate their businesses and do not allow for a flourishing entrepreneurial environment also have extremely high levels of corruption—and these countries are, unsurprisingly, mostly in sub-Saharan Africa.

The *Doing Business* index (World Bank Group, 2014) is another attempt to measure the entrepreneurial environment by analyzing indicators of regulation. These two main indicators are (1) complexity and cost of regulatory process and (2) strength of legal institutions. Complexity and cost of regulatory process includes such things as costs of starting a business (number of procedures, payments, minimum capital requirements), paying taxes, and dealing with construction permits. The strength of legal institutions includes things such as enforcement of contracts, labor market regulation, and protection of minority investors. This index is updated annually and covers 189 economies. Klapper, Love, and Randall (2014) use this index and find that better business regulatory environments are associated positively with economic growth.[3] The *Doing Business* (2014) report summarizes the main findings of the index of the costs of doing business with the recent economic-growth literature, reporting that studies overwhelming find that better business environments are vital for economic growth. The report also concludes that one important implication of the findings is that "fostering an efficient regulatory environment for the financial and private sector can contribute to economic growth by aiding the efficient exit of insolvent firms during economic slowdowns and encouraging a speedier recovery in the formation of new firms during economic expansions (World Bank Group 2014: 103). In another study,

3. The study includes 109 countries over the period from 2002 to 2012.

Jovanovic and Jovanovic (2014) investigate how business regulation (as measured by the *Doing Business* indicators mentioned above) affects the flow of foreign direct investment in 28 Eastern European and Central Asian countries. The study finds a positive relationship between freedom from burdensome regulation and foreign indirect investment. Their study shows that a reduction in the cost of starting a business is positively associated with increases in foreign direct investment flows. One of the main conclusions to be drawn from the study by Jovanovic and Jovanovic (2014) is that "governments may be able to attract foreign direct investment by creating a more efficient and more business-friendly regulatory environment" (World Bank Group, 2014: 104). Overall, these findings indicate that burdensome regulations have a negative impact on such things as economic growth and foreign direct investment.

As mentioned, firm creation is also one of the measures used to capture the concept of entrepreneurship. In measuring entrepreneurship through output conditions such as number of firms, the relationship between entrepreneurship and economic growth is still positive. Klapper, Love, and Randall (2014) find that country-specific GDP growth is associated with higher new firm registration, even after controlling for global macroeconomics shocks. Other studies analyze the relationship between the "framework" conditions (regulations) and output conditions. They find that reforms that simplify business registration lead to more firms being created (Branstetter, Lima, Taylor, and Venâncio, 2014; Bruhn, 2011; Monteiro and Assuncao, 2012). In another in-depth study, Bripi (2013) focuses on differences among provinces in Italy. Bripi analyzes differences in local regulatory burden and firm creation and finds a negative relationship between the time and cost of regulatory-compliance procedures and the rate of creation of small firms. The study controls for many important variables, including measures of financial development and efficiency of bankruptcy procedures—yet still concludes that bureaucratic time delays due to inefficient regulatory procedures reduce the entry rate in industries that should have "naturally" high entry rates relative to low-entry sectors. Overall, Bripi's study draws significant distinction between heavily regulated southern provinces and lightly regulated northern provinces to demonstrate how regulations are a significant obstacle to entrepreneurship and economic performance in the southern regions.

Along these lines, Desai, Gompers, and Lerner (2003) find that better protection of property rights and less government corruption (they call this "greater fairness") increase firm entry rates, reduce firm exit rates, and lower the average size of the firm. This important paper analyzes 33 European studies. Their definitions of "entrepreneurial activity" is the combination of entry and exit rates, the average firm size, and a weighted-average of a firm age. The authors conclude that "[g]reater fairness and stronger protection of property rights are critically important in encouraging both the emergence and the growth of new enterprises, particularly in emerging markets" (Desai, Gompers, and Lerner, 2003: 31). Likewise, Scarpetta, Hemmings, Tressel, and Woo (2002) find that regulations have a significant impact upon entrepreneurial outcomes. This study concludes that business entry rates are significantly lower with stricter administrative regulations and stricter sector-specific market regulations. Similarly, using World Bank measures, Klapper, Laeven, and Rajan (2006) find that higher costs of business entry significantly reduce the fraction of new firms in a country. This is in contrast to an earlier study relying on the same World Bank measures but in this case finding that entry barriers do not robustly affect entrepreneurship (van Stel, Wennekers, Thurik, Reynolds, and de Wit, 2003). In other studies, Ovaska and Sobel (2005) and Bjørnskov and Foss (2008) also do not find strong evidence of regulation's impact on entrepreneurial activity. They use the EFW index reporting the regulation component, which is consistent with my preceding discussion of this component. However, when employing the same data and making a few minor adjustments, Freytag and Thurik (2007) show that the degree of regulation does indeed significantly weaken entrepreneurial activity.

In a recent study, Dreher and Gassebner (2013) measure entrepreneurship using survey data in an attempt to capture "entrepreneurial culture/attitude/spirit". The survey comes from the *Global Entrepreneurship Monitor* (Amoros and Bosma, 2014) and measures individuals between 18 and 64 years old who have taken some action toward creating new businesses in the past year. Their study includes 43 different countries and 93 observations in total. The authors find that firm regulation discourages entrepreneurship and worsens overall economic performance. Also using the measures of entrepreneurship from the *Global Entrepreneurship Monitor*, van Stel, Carree, and Thurik (2005) find that entrepreneurial activity does have a positive impact on economic growth, but this result only holds true for relatively rich countries. In poorer countries, entrepreneurship seems to have a negative impact on growth. They explain this finding in two ways: this finding might indicate (1) that there are not enough larger companies present in these poor countries to complement the activities of small-scale entrepreneurs; or (2) that entrepreneurs in these poorer countries have lower human-capital levels compared to entrepreneurs to high-income industrial countries. Yet another explanation for this finding could be that, because poorer countries lack strong protection of property rights, entrepreneurial activity does not translate into economic growth there.

Recall that strong protection of property rights are important to help ensure that entrepreneurs are safe from both private and public predation, and that in an environment where property rights are not well protected, individuals will not make long-term business investments. Further, strong protection of property rights are important for encouraging capital flows and helping entrepreneurs to expand their businesses, which is necessary for economic growth. Thus, when individuals are surveyed about their "entrepreneurial activity/spirit" with the backdrop of a bad institutional environment, this does not necessarily translate into business and job creation or what we may typically think of as thriving entrepreneurial and innovative activities present in developed countries. Individuals in the developing world who attempt to start businesses have to deal with corrupt local and national governments, with burdensome and arbitrary regulations, and with uncertain environment about whether they can keep their profits. It is no surprise that in this type of institutional environment measures of entrepreneurial spirit or attitude or activity would not result in economic growth.

Furthermore, in other studies, Acs and Audretsch (1988) specifically find the strong impact of entrepreneurship on innovation and Blanchflower (2000) and Parker (2009) find the relationship between a strong entrepreneurial environment and subsequent job creation. Other studies have followed along these lines in measuring entrepreneurship, innovation, job creation, and economic growth. Van Praag and Versloot (2007) review and summarize this literature and conclude that differences in entrepreneurship account for varying levels of wealth and prosperity across nations—with greater entrepreneurial activity associated with greater economic growth and prosperity.

Some scholars have investigated also the relationship specifically between *small* business firms and growth. Thurik (1996) studied European economies and found that a rise in the share of small firms in certain economies and a high share of "smallness" in a specific industry creates additional output in the entire economy. Follow-up studies were done by Carree and Thurik (1998, 1999) and in both found similar results, namely, that small business enterprises are uniquely associated with economic growth. Similarly, Acs and Audretsch (1990) and Audretsch (1995) find that small businesses play an important role specifically in innovative activities. Acs (1992) reviews the empirical literature of small-business activity in the 1970s and 1980s; he summarizes the findings on the importance of small firms for (1) an entrepreneurial environment (2) routes of innovation (3) industry dynamics and (4) job generation. On this last component, Audretsch and Thurik (2000) found that an increase in the rate of entrepreneurship (as measured by the number of business owners as a percentage of the labor force) led to lower levels of unemployment in 23 OECD countries during the period from 1984 to 1994.

Overall, while there are different ways to measure entrepreneurship, the findings in the empirical literature generally illustrate that entrepreneurship is linked to economic growth and innovation. A number of studies also find that institutions or "conditions" such as property rights and regulatory environments have an impact upon entrepreneurial activity. In a recent historical, comprehensive overview of the evolution of entrepreneurship, Landes, Mokyr, and Baumol (2012) document how entrepreneurship and innovation have been principal causes of technological progress, rising living standards, productivity, and economic growth. More importantly, the authors show that favorable institutions facilitate those productive entrepreneurial actions that were crucial to the rise of the modern world.

4. Current state of entrepreneurship

So far this chapter has presented theoretical considerations and empirical findings on how a thriving entrepreneurial environment is vital for the long-run health of an economy. Yet it is also important to evaluate the current state of entrepreneurship to gauge either the hopes or perils of growth in the United States and other Western countries. This section will present a variety of reports that rely on different measures of entrepreneurship.

According to the measures of the framework conditions of entrepreneurship, the business climate in the United States is slowly deteriorating. The 2014 EFW index reports that the United States has seen a decline in its average economic freedom scores from 8.65 in 2000 (when it ranked second) to 7.81 in 2012 (rank 14th).[4] In Area 2. Legal Systems and Property Rights, there has been a significant decline in rating, falling from 9.23 in 2000 to 7.02 in 2012. Specifically, Component 2C. Protection of Property Rights fell from a high rating of 9.10 in 2000 to 6.95 in 2012. This trend poses a long-term problem: if the conditions that foster entrepreneurial activity are eroding, what will become of economic prosperity for future Americans? The United States seems to be one of the only countries in the West

4. Scores range from 0 to 10; 10 is the best possible score a country can receive.

with such a large decline in property rights. The United Kingdom has seen only a slight decline in protection of property rights since 2000 and Canada has actually improved, moving from a score of 7.98 in 2000 to 8.39 in 2012.

The United States' rating for Area 5. Regulation is also declining, though more slowly than the decline in property-rights protection. The 2014 edition of the regional report, *Economic Freedom of North America*, says: "The expanded use of regulation in the United States has resulted in sharp rating reductions for components such as independence of the judiciary, impartiality of the courts, and regulatory favoritism. To a large degree, the United States has experienced a significant move away from rule of law" (Stansel, Torra, and McMahon, 2014: 51). The most significant feature of the lower rating for regulation is found in Sub-component 5Cii. Bureaucracy costs for business, for which the United States had a rate of 8.15 in 2000, falling to a low of 2.59 in 2012. This reality means that it has become increasingly more difficult for entrepreneurs in the United States either to start companies or to continue running their companies without significant administrative and bureaucratic obstacles. But this trend is not novel to the United States. Canada, the United Kingdom, Germany, France, and other Western democracies have all similarly dropped in their ratings for bureaucracy-costs measures.

In general, the EFW index seems to reflect the current reality that the United States is becoming a more highly regulated, more politicized, and more heavily policed state. Moreover, the growing regulatory burden on businesses all across the Western world poses a major problem by impeding an entrepreneurial business climate. Overall, when entrepreneurship is measured in terms of the framework conditions by the *Economic Freedom of the World*, serious concerns arise about the current and future state of entrepreneurship in the United States and the Western world.

According, however, to the 2014 *Doing Business* index, the United States seems still to be performing moderately well—ranking 7th worldwide in a sample of 189 economies (World Bank Group, 2014). The *Doing Business* index includes components of the ease of starting a business, registering property, paying taxes, dealing with construction permits, and a host of others. In the component, Ease of starting a business, the United States ranks 46th, which is on par with average rank of 45 held by OECD high-income economies. Canada, in this same measure, ranks 2nd for the ease of starting a business, while the United Kingdom is ranked 44th. The United States ranks relatively poorly here because it requires on average six procedures and 5.6 days, and costs 1.2% of income per capita to start a business in the United States. In the business-taxes component of this index, the United States ranks 47th, which is slightly above the average rank of 53 for OECD high-income economies. The United States' low ranking stems mainly from the fact that it is very costly to file, prepare, and pay taxes as a business in the United States—totaling about 43.8% of business profits (World Bank Group, 2014). While the *Doing Business* index does show a somewhat favorable state of entrepreneurship in the United States, the trajectory of the costliness of starting a business and paying taxes again raises concerns for a favorable business environment in the future.

When the current state of entrepreneurship is measured with output variables, the results are mixed. According to the *State of Entrepreneurship Report* (Kauffman Foundation, 2014), the rate of new business creation in the United States has been flat or falling in the last two decades. The report explains, "the per-capita entrepreneurship rate has been steadily declining, meaning that even as the population expanded and the overall number of new businesses formed each year held steady or grew, the pace slowed, failing to keep up with population growth" (Kauffman Foundation, 2014: 7). The overall conclusion of the *State of Entrepreneurship Report* is that a decreasing business-creation environment indicates that the state of entrepreneurship in the United States is slowly declining.

Similarly, Decker, Haltiwanger, Jarmin, and Miranda (2014) conclude that the pace of business dynamism has declined over recent decades and that there has been a falling trend in the pace of job creation. An important aspect of the declining trends is a marked decline in the firm startup rate, which they note naturally leads to a reduction in the number of young firms operating in the economy. The authors suggest this declining rate of business creation and subsequent fall in the number of young firms contributed disproportionately to the overall fall in employment growth from 2006 to 2009.

The *Global Entrepreneurship Monitor* (GEM) report provides a different story: this report finds that the current trend of entrepreneurship in the United States is positive and that we should be optimistic about entrepreneurial prospects in the United States (Amoros and Bosma, 2014). GEM conducted a survey in 2013 of 5,698 working-age adults and found high and stable new business-startup rates for the third consecutive year. GEM finds that nearly 13% of the US working-age population was in the process of starting or running a business—which is the highest entrepreneurship rate reported among the 25 developed economies in their sample. GEM's indicators include societal attitudes toward entrepreneurship, surveys asking about the participation of entrepreneurs in multiple phases of the entrepreneurship process, and profiles of the entrepreneurs. GEM relies on an important measure called "total early-stage entrepreneurial activity" (TEA), which includes what they refer to as "nascent entrepreneurs". These are entrepreneurs who are in the process of starting businesses or are currently owners of new business.[5] The United States has the highest percentage of its adult population in the process of starting a business (9.2%), compared to the average level (4.4%) of nascent entrepreneurial activity in other wealthy countries in North America, Europe, and Asia.

Lastly, another way to gauge the current state of entrepreneurship is to analyze attitudes and opinions toward entrepreneurs and the activities involved in starting businesses. *Eurobarometer* is a survey of European Union countries designed to measure the level of interest in starting businesses and the public's attitudes toward entrepreneurs. In the 2012 report of *Eurobarometer*, a majority (58%) of EU respondents said they would prefer to work as an employee rather than attempt to start their own business (European Commission, 2012). A large majority of EU respondents think it is difficult to start one's own business due to a lack of available financial support (79%); and that it is difficult to start one's own business due to the complexities of the administrative process (72%). These perceptions and attitudes have been relatively stable in the last ten years.[6] When asked their opinions of entrepreneurs in general, 87% of EU respondents agree that entrepreneurs are important job creators. This finding might seem to indicate that the Europeans have a positive outlook on entrepreneurs, but at the same time a majority of Europeans (over 50%) also believe that entrepreneurs take advantage of other people's work and that they think only about their own narrow monetary interests.[7] This somewhat negative portrayal of entrepreneurs perhaps helps to explain the current tepid state of entrepreneurship in the European Union. Surveys such as the *Eurobarometer* are deemed important because they provide important insights into each country's climate of opinion and its entrepreneurial culture. However, in terms of properly assessing the current actual state of entrepreneurship, these surveys are not helpful because they tell us little about actual entrepreneurial

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5. The exact definition of "nascent entrepreneurship" is those individuals, between the ages of 18 and 64 years, who have taken some action toward creating a new business in the past year.
6. According to the 2003 *Eurobarometer*, 50% of the population in 2002 answered that they would prefer to be an employee rather than to start a business. And, in 2002 76% of EU respondents think it is difficult to start one's own business due to a lack of available financial support and 69% said that it is difficult to start one's own business due to the complexities of the administrative process.
7. The survey also covered the US population, where only 30% answered that entrepreneurs take advantage of other people's work and think only about their own narrow monetary interests.

activity. Furthermore, when taking into consideration how institutions can influence entrepreneurship, these factors merely reflect the "consequence" of an entrepreneurial environment. Perhaps if the administrative costs to starting a business were lower, more Europeans would be open to the idea.

Finally, according to the 2013 *Global Entrepreneurship and Development Index* (GEDI), the United States ranks highest in entrepreneurship across the world, and has remained at this position for a number of years (Acs, Szerb, and Autio, 2013). The GEDI report is unique in that it attempts to capture many measures of entrepreneurship—including the framework conditions of entrepreneurship, output measures, and attitude measures—in one index. The GEDI measures entrepreneurship on three indicators: Entrepreneurial Attitudes, Abilities, and Aspirations.

Measures of Attitudes include things such as market size, a country's general riskiness for business, cultural attitudes toward entrepreneurs, and population's use of the Internet. The Abilities index includes measurements of the business regulatory environment, the political influence of powerful business groups, and the level of formal education of entrepreneurs. The Aspiration index includes a measure of high-growth businesses, the availability of risk finance, and a measure of a country's new product potentials. The report ranks 120 countries annually and provides a measure of the "efficient use of entrepreneurial resources". The United States ranks highest among all countries and scored highest in the measure of efficient use of entrepreneurial resources. Australia and Sweden came in 2nd and 3rd, respectively. The United Kingdom ranked 9th in the index.[8] The conclusion of this study is that in the United States there seems to be, in general, optimism in terms of a growing entrepreneurial environment.

Overall, the evidence on the state of entrepreneurship in the United States (and partly in Canada and the West) is mixed. Measures of entrepreneurship that attempt to capture the current levels of entrepreneurial activity and attitudes do clearly demonstrate that entrepreneurship is at an all-time high in the United States. And yet the framework conditions used to analyze the "institutions" necessary for entrepreneurial activity seem to indicate that favorable institutions are slowly declining. So when entrepreneurship is measured by these framework conditions, it seems to indicate that the state of entrepreneurship in the United States and in Europe is low. One way to reconcile the tensions between the various measures of the current state of entrepreneurship is to realize that the framework conditions are better

8. Canada cannot be compared here because its measure and rank are absent from this index.

indicators of the *future* state of entrepreneurship than of current activities of firms. When property rights or the regulatory environment get worse, it takes some time before individuals and businesses alter their behaviors. The framework-conditions measures of entrepreneurial activity might actually serve as trend predicators for the future state of entrepreneurship in the United States and the West. As the institutions—the "rules of the game"—are now making it more costly to engage in productive entrepreneurship relative to unproductive entrepreneurial behavior, what should we expect about the future profit opportunities and patterns of entrepreneurs?

5. Conclusion

Productive entrepreneurial activity is a fundamental force for long-run prosperity and economic growth. People living in the United States and much of the developed world today experience significantly higher standards of living because entrepreneurs constantly introduce and improve market products—not only items such as personal computers and cell phones, but new medicines, better clothing, and other technologies that improve ordinary people's daily lives. Not only are new and improved products entering the market, but they are also becoming more affordable due to entrepreneurial innovations in production processes.

The most important force powering economic growth is not a handful of grand innovators and "big names" but, rather, a constant and thriving entrepreneurial environment that consists of different-sized firms each exploiting various profit opportunities and thereby breeding innovations and opportunities for further entrepreneurial activities. But this type of productive entrepreneurship also depends on the institutions and incentive structures that govern it. New technological improvements are sparked in areas where entrepreneurs are able to reap the benefits of their innovations, and new businesses arise in areas where start-up costs are lower while general business activity thrives in areas where property rights of individuals and businesses are well protected. It is no surprise that differences in institutional arrangements governing entrepreneurial behavior explain differences in global income levels and economic growth. In parts of the world where important institutional structures such as the strong protection of property rights are lacking, there is also an absence of entrepreneurial insights and innovations. Such places suffer also a slower rate of business creation and lower levels of income. Though entrepreneurship exists in all environments, institutions will dictate how it manifests itself. It is thus of fundamental importance to understand how different institutions and policies affect the incentives of entrepreneurs and entrepreneurial activity.

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2. Economic Freedom and Entrepreneurship

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1. Introduction

Entrepreneurship is a primary driving force behind economic growth and prosperity. A large share of the differences in national economic growth rates across countries is explained simply by differing levels of entrepreneurial activity. Reynolds, Hay, and, Camp (1999) find that one-third of the difference in economic growth rates across countries is explained by differing levels of entrepreneurship, while Zacharakis, Bygrave, and Sheperd (2000) find that differing levels of entrepreneurial activity explain approximately one half of the differences in economic growth among countries.

The actions of entrepreneurs create not only wealth and jobs, but also new goods and services that improve the well-being of consumers. During the past century alone, medical innovations have resulted in life expectancy increasing by approximately 30 years in the United States,[1] and those years are spent in more comfort because of entrepreneurs such as Willis Carrier who invented modern air conditioning, and Italian immigrant Candido Jacuzzi who developed the first hydrotherapy pump for bathtubs to help his son who suffered from juvenile rheumatoid arthritis.

Economists have long recognized the important role that entrepreneurs play in advancing society. Schumpeter (1942) described how entrepreneurs search for new combinations of resources, guided by the profit and loss system, and unleash

1. Life expectancy at birth was 78.7 in 2010 and 47.3 in 1900 (United States Centers for Disease Control and Prevention, 2014: table 19).

a process of "creative destruction" in which new goods and services replace old ones. Kirzner (1997) argued that the entrepreneurial discovery process is vital to the effectiveness of markets.

As is discussed at length elsewhere in this book, there is a clear and robust link between the level of economic freedom across countries (and states) and their levels of economic performance. Simply stated, better institutions that are consistent with more economic freedom result in higher levels of income and faster economic growth. However, entrepreneurship is a main *reason* higher levels of economic freedom promote growth. More economic freedom results in higher prosperity precisely because it results in higher levels of entrepreneurial activity (Sobel, 2008a; Kreft and Sobel, 2005; Sobel, Clark, and Lee, 2007; Hall and Sobel, 2008; Hall, Sobel, and Crowley, 2010).

More specifically, better economic institutions tend to more productively allocate the entrepreneurial talent within a society (Sobel, 2008a, Baumol, 1990, 1993, 2002). Every state and nation has large numbers of people who are innovative and entrepreneurial. However, the proportion of those individuals who choose to actually pursue a life as a for-profit market entrepreneur is influenced by the existing institutions. These individuals have many options, including using their talents to generate income for themselves in the political and legal arenas. Thus, differences in measured rates of *private-sector* entrepreneurship are 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 countries with institutions providing secure property rights, a non-corrupt and independent judicial system, contract enforcement, and effective limits on government's ability to transfer wealth through taxation and regulation, creative individuals are more likely to engage in productive market entrepreneurship—activities that create wealth (for example, deliver innovative products such as the smart phone). In areas without strong institutions, these same individuals are instead more likely to attempt to manipulate the political or legal process to capture transfers of existing wealth through unproductive political and legal entrepreneurship—activities that destroy wealth (for example, lobbying and unjustifiable lawsuits). This reallocation of effort occurs because the institutional structure largely determines the relative personal and financial rewards that accrue to investing entrepreneurial energies into productive market activities compared to investing those same energies instead into unproductive political and legal activities.

This chapter discusses this relationship between institutions consistent with economic freedom and entrepreneurship. I begin by providing a more detailed discussion of the underlying ideas and literature summarized above, then continue to explore data on institutions and entrepreneurship rates both internationally and across US states.

2. Understanding market entrepreneurship and its role in prosperity

For over three centuries, economists have attempted to understand and define the concept of an "entrepreneur" and the role such people play in economic progress. In the 1700s, Richard Cantillion identified the willingness to bear the personal financial risk of a business venture as the defining characteristic of an entrepreneur (Sobel, 2008b). In the mid-1800s, John Stuart Mill used the term to refer to a person who assumes both the risk and management of a business, providing a clearer distinction than Cantillon between an entrepreneur and other business owners (such as shareholders of a corporation) who assume financial risk, but do not actively participate in the day-to-day operations of the firm (Sobel, 2008b).

Schumpeter ([1911] 1934, 1942) stressed the role of the entrepreneur as an innovator who finds new combinations of resources and creates new goods and services. He termed this process "creative destruction" because the introduction of new products and production processes often leads to the obsolescence of others, such as when the car replaced the horse and buggy. Because new products displace old industries this process is disruptive, and often leads to calls to restrict or prohibit the new products. The opposition to new "big box" stores, and calls to ban them so they do not displace "mom and pop" stores is one example. However, to Schumpeter this process of creative destruction is the source of true economic progress. Societies that can and do tolerate this recycling of labor and capital from older and less productive industries to new ones are the ones that prosper and grow. According to McCloskey (2010), innovation and creative destruction increase when societal attitudes become more favorable.

Kirzner (1973, 1997) viewed entrepreneurship as an equilibrating force in which entrepreneurs discover previously unnoticed profit opportunities and act on them, bringing markets toward equilibria. Holcombe (1998) ties the ideas of Kirzner and Schumpeter together by noting that Schumpeterian innovation results in a host of new profit opportunities in related complementary areas (such as producing tires or accessories for the automobile once it is invented).

Wealth creation is fundamentally about channeling limited resources into the production of those goods and services with the highest value in the marketplace. According to Hayek (2002 [1968]), the pattern of resource use that yields the highest value, however, is something that must be discovered within the marketplace through competition, and entrepreneurial trial and error. 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 at chasing this ever-moving target through the continuous process of entrepreneurship and discovery.

Sifting through these many combinations is a difficult task because the number of possible combinations of society's resources is almost limitless. Two quick illustrations will help to clarify the vastness of these opportunities. First, consider the typical automobile license plate. Many have three letters, a space, and three numbers. There is a formula for calculating the total number of "combinations"—the total number of possible different license plates—that could be created using these three letters and three numbers. The number is more than you might think: 17,576,000. Second, let us consider the number of possible ways to arrange a deck of cards. Even with only 52 cards, there is a mind-blowing number of ways to arrange them—the answer is a 68 digit number: 80,658,175,170,943,878,571,660,636,856, 403,766,975,289,505,440,883,277,824,000,000,000,000.

With this many ways to rearrange a deck of 52 cards, the astonishing implication is that 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 the Earth did nothing but shuffle cards 24 hours a day their entire life, and even unrealistically assuming they could shuffle the deck 1,000 times per second, we would have not even come close to making it through a fraction of the number of total possible arrangements of the deck throughout all of human history.

Now, returning to the economy, we clearly have more than just three letters and numbers, or 52 cards, with which to work. Instead, we have millions, or even billions, 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 practically infinite (Romer, 2008).

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

Countries with higher levels of economic freedom promote entrepreneurship by increasing the rate of experimentation—entrepreneurial trial and error. In countries in which everyone is allowed to try out their unique and crazy ideas for new products, there is a greater rate of business failure but, because of the higher level of experimentation, the odds of stumbling onto the one-in-a-million new venture like Microsoft or Apple are higher. *Table 2.1* shows the data for OECD countries on the relationship between economic freedom and the rates of entrepreneurial activity and business failures from Sobel, Clark, and Lee (2007). Those countries with higher levels of economic freedom have statistically significant higher mean levels of both entrepreneurship and business failures (at the 5% level of statistical significance).[2]

Table 2.1. Economic freedom, entrepreneurial activity, and business failure

Economic freedom	Total Entrepreneurial Activity Index	Business failures per 10,000 firms
Top half of sample (half with the most economic freedom)	7.51	116.70
Bottom half of sample (half with the least economic freedom)	6.74	67.58

Source: Sobel, Clark, and Lee (2007).

As the data show, higher economic freedom is associated both with higher rates of new business formation, and more business failures—a truly robust engine of creative destruction. 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

2. The total entrepreneurial activity index is a measure of the proportion of the population engaged in entrepreneurial activities, so this increase is roughly equivalent to an increase of 1 percentage point of the population engaged in entrepreneurial activities.

incentives facing public officials are very different than those 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. The same is not true for public officials in charge of handing out tax incentives or low-interest loans. They may have other concerns beyond creating wealth. For example, officials may be concerned about *where* a new business is located in order to maximize political support among voters. But there is no reason to think that this decision corresponds with the most economically advantageous one.

From society's perspective, the profits earned by entrepreneurs (and assessed by investors) 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 those same resources. For example, an entrepreneur who takes the resources necessary to produce a fleece blanket that sold for $50 and instead turns them into a pullover that sells for $60 has earned a $10 profit. Since the prices of the resources used by entrepreneurs reflect the opportunity cost of their employment in other uses, the $10 profit generated by the entrepreneur reflects the amount by which he/she has increased the value of those resources. By increasing the value created by our limited resources, entrepreneurs increase overall wealth in a society.

No one individual, or group of individuals, could be in charge of this entrepreneurial discovery process. There is nobody, not even those seemingly in the best position to know, who can predict which business opportunities are the most viable in advance. For example, Ken Olson, president, chairman, and founder of Digital Equipment Corporation, who was at the forefront of computer technology in 1977, stated: "There is no reason anyone would want a computer in their home". Today his remark sounds funny because we all have computers in our homes (indeed, now even in our pockets and purses!), but at the time even those in the infant computer industry did not see this coming. An even better example might be the story of Fred Smith, the founder of Federal Express Corporation. He actually wrote the business plan for FedEx as his senior project for his strategic management class at Yale. While we all know in retrospect that FedEx was a successful business idea, Smith's professor at Yale, one of the leading experts on business strategy, wrote on his paper in red ink: "The concept is interesting and well-formed, but in order to earn better than a C the idea must be feasible". The point? Even smart professors, business leaders, and government officials cannot possibly pre-evaluate business ideas and identify those that will be most successful and those that will fail. A thriving economy is created when individual entrepreneurs have the freedom to try new ideas, risking their own assets, or the assets of their private investors, and the profit-and-loss system is used to decide their fate. To quote Nobel laureate W. Arthur Lewis: "[c]ollective judgment of new ideas is so often wrong that it is arguable that progress depends on individuals being free to back their own judgment despite collective disapproval … To give a monopoly of decision to a government committee would seem to have the disadvantage of both worlds" (1955: 172).

Far too often governments attempt to adopt the wrong policies to promote entrepreneurship—such as state-run venture capital funds, government-funded or subsidized business incubators, economic development authorities, or new employees within the education system aimed at expanding entrepreneurship education within schools and colleges. Unfortunately, these policies expand the government sector, thereby resulting in a decline in the economic freedom score of the country (or state).[3] To encourage entrepreneurship, policy should instead focus on reducing the burdens on entrepreneurial start-ups and tolerating business failures—precisely those policies consistent with economic freedom. *Figure 2.1* shows the relationship between the level of entrepreneurial activity in OECD countries and their level of economic freedom from Sobel, Clark, and Lee (2007). As is clearly visible in the figure, those countries with higher levels of economic freedom and smaller governments are those that have the highest rates of entrepreneurial activity.

Often overlooked is the importance of the rule of law for promoting a robust entrepreneurial climate. The "rule of law" refers to governance by predictable rules that are not dependent on the whims of currently elected politicians. When undertaking the construction of a skyscraper, for example, long-term contracts that govern financing and liability are critically important. This type of entrepreneurship therefore depends on the ability to undertake long-term contracting in an environment within which future disputes can be predictably settled under the previously agreed upon rules. Attempting to plan in a society in which rules are constantly changing is not easy, and it frustrates the ability of entrepreneurs to promote productive economic change.

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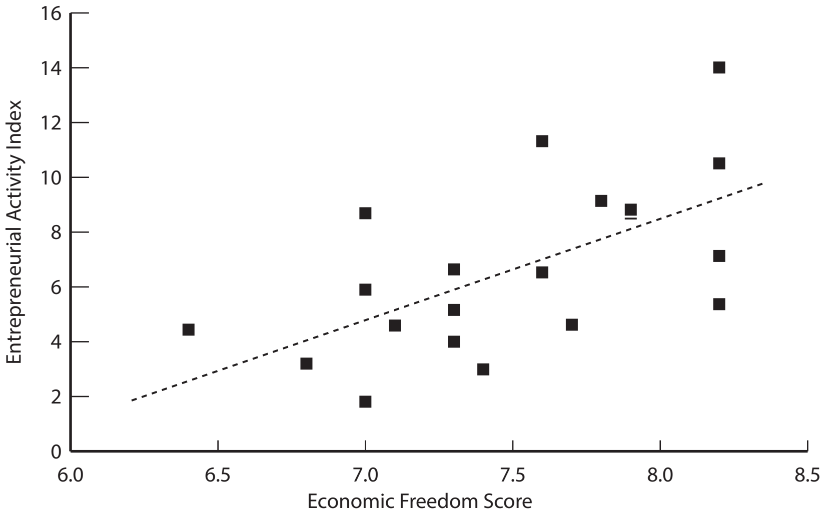
3. See Landes, Mokyr, and Baumol, 2010 for examples.

Figure 2.1. Economic freedom and entrepreneurial activity in OECD countries, 2002



Source: Sobel, Clark, and Lee, 2007.

Because entrepreneurs frequently create new products that require new interpretations of existing statutory and common law (or the creation of new law), it is the *predictability* of the dynamic application of the law into new areas that matters most in attracting entrepreneurs to an area and supporting innovation within an economy, a point first recognized by Dove and Sobel (forthcoming). Innovations like the internet create a need for applications of law into the digital arena, while innovations like the automobile require new applications of precedent from existing laws that applied to horses and buggies. Similarly, medical innovations in cloning and stem cells create a need for entirely new areas of law to be developed. Therefore, what matters most to an entrepreneur is the *predictability* with which a jurisdiction's laws will be applied into these new areas. For entrepreneurs to be willing to make large up-front investments in research, development, and manufacturing facilities, they need to be fairly certain how the existing laws in the geographic area in which they locate will be applied and interpreted into the new areas related to the innovative good or service produced by the entrepreneur.

The wide variation in how states and countries are applying existing laws to driverless automobiles is one such example. Despite the fact that cars have had cruise control for decades, and that airplanes use auto-pilot, and that the liability issues are clearly settled in those cases, many jurisdictions insist on treating driverless cars as a completely different and entirely new area of law and, hence, subjecting them to unnecessary legal uncertainty. Jurisdictions with good dynamic application of the rule of law, such as Nevada, allow for a straightforward application of existing law in those other areas to driverless cars and create a more certain legal environment within which entrepreneurship can take place and flourish.

As a second example, consider the recent innovations in the process of hydraulic fracking in shale formations to extract oil and gas. Some US state governments, such as Pennsylvania's, explained that all existing drilling laws applied to this new technology and simply passed a few new paragraphs of law to clarify how it applied. Other state governments, such as West Virginia's, treated the new technology like an entirely new industry, putting it on hold and going through a long negotiated process of outlining an entirely new set of rules and taxes to be applied. As a result, the shale industry boomed early in Pennsylvania, while it was slow and reluctant to develop in West Virginia.

One of Adam Smith's insights in his famous 1776 book, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, is that specialization and the division of labor (key sources of productivity, wage, and income growth) are limited by the size or "extent" of the market. When consumer markets are larger in size, smaller specialized stores can survive that could not survive in a smaller marketplace. A small town population, for example, may be able to support two general purpose pet stores, each carrying a broad line of products. In a large city, however, a dozen or more pet stores can flourish, with a greater extent of specialization. One store, for example, might specialize in snakes and other reptiles, while another specializes in birds. Increasing the size of the markets to which entrepreneurs' goods and services sell increases wealth by allowing them to specialize more narrowly in areas where they do best. One primary way government policies can therefore promote more specialization and wealth creation is by having policies that enable entrepreneurs to sell and compete in larger national and global marketplaces and, hence, expand their customer base. To compete in these markets businesses ought not be hampered by unreasonable taxes and government regulations that raise the cost of doing business. In addition, policies consistent with free trade—those that make importing and exporting easy and without unnecessary costs and regulations—also enable entrepreneurs to produce more wealth through greater specialization.

Another reason policies consistent with free trade promote entrepreneurship is that they subject domestic firms to greater foreign competition. This greater competition forces domestic firms to try harder to innovate and reduce costs so as to be competitive on a global scale. Areas that restrict free trade end up with domestic firms that cannot compete effectively on a global level due to higher costs and less innovative products. Free trade also better allows domestic firms to use low cost inputs into their production process. Sugar tariffs in the United States, for example, raise the cost of sugar, so domestic candy makers and soft drink makers use high fructose corn syrup as a cheaper alternative. By changing the input mix of domestic firms, these firms do not innovate in the same areas as their global competitors and often have inferior products. These are two additional reasons economic freedom, through free trade, promotes a healthier entrepreneurial sector. Ironically while many governments enact restrictions on free trade with the intention of expanding domestic industry, the empirical evidence shows that higher tariff rates result in fewer new entrepreneurial ventures. Estimates from Sobel, Clark, and Lee (2007) find that among OECD countries, each 1-percentage point increase in the average tariff rate in a country is associated with seven fewer new entrepreneurial ventures per 1,000 people in the population.

The impact of regulation on entrepreneurship also merits discussion. Regulatory climates with numerous and burdensome regulations have three harmful effects on the entrepreneurial climate. First, they limit the number of experiments happening. With a higher hurdle and steeper costs of going into business, fewer new combinations of resources are attempted—fewer new startups are created—lessening the odds of finding those rare true success stories. Even at an early age, experimentation with selling and business is important for developing an interest in entrepreneurship for individuals. Lemonade stands and bake sales, for example, were historically typically activities children undertook to learn about entrepreneurship. Cities across the United States have taken serious measures to shut down precisely these types of activities due to health and regulatory concerns. Without the required (and expensive) business permits, and food and drug regulations and product labeling satisfied, police have shut down children's lemonade stands in states from Georgia to Iowa. With fewer children experimenting, fewer adult entrepreneurs are spawned.

In addition to limiting experimentation, regulations function as a fixed cost, distorting the size of firms and the viability of small entrepreneurial firms. As a simple example, consider that installing a handicapped ramp is equally expensive for a small restaurant and a larger one. For smaller firms, the compliance cost of regulations therefore is more burdensome as a share of their budget. With the multitude of regulations that must be satisfied, large firms with tax and legal departments have the advantage because they have the resources and knowledgeable staff to comply, while small firms—especially startups—do not. Calcagno and Sobel (2014) find that as regulatory levels grow, it disproportionately affects smaller firms (those with fewer than 5 employees). Thus areas with more regulatory burdens end up with fewer new small firms in the marketplace; an engine of economic growth and prosperity is stalled.

The third and final reason why heavy regulation hurts entrepreneurship is that it forces firm owners and employees to devote a larger share of their time toward regulatory compliance and away from the internal activities of the business, such as product development and customer relations. With the recent significant increases in banking regulation in the United States, for example, senior bank employees now have to spend more time complying with regulations and regulators, and, hence, have less time left to spend on the internal operation of the real business functions of the bank [see Allison (2013)]. Thus, higher regulations lead to increased time spent on compliance by firm owners and employees, leaving less effort to be put into business development and expansion.

This section has outlined the economic understanding of for-profit market entrepreneurship, and considered how policies consistent with economic freedom are both necessary and beneficial in promoting entrepreneurial innovation. Low levels of government spending leave more resources available for entrepreneurs in the private sector, low taxes on business owners and capital allow higher returns to entrepreneurial ventures and capital formation, reasonable regulations lessen the burden on entrepreneurial trial and error, a strong rule of law enables the long-term contracting necessary to undertake and finance entrepreneurial ventures, and free trade allows for greater specialization and higher incomes.

3. Understanding the entrepreneur—an agent of change

Until this point, we have restricted our discussion to only one half of the equation—entrepreneurship within the private, for-profit, sector. While historical definitions of entrepreneurship rest on the role of the entrepreneur in creating and managing a for-profit business in the market sector, the modern economics literature offers a broader understanding of the activities of entrepreneurial individuals.

Every society has a large number of *potential* entrepreneurs—creative individuals. However, not all of them choose to employ their talents to open new businesses in the marketplace. Like all other individuals they allocate their talents to where they each receive the highest return. There are many alternative activities an entrepreneurial individual may choose to pursue.

At a fundamental level, entrepreneurial individuals can choose to devote their labor efforts toward either private-sector wealth creation, or securing wealth redistribution through the political and legal processes (for example, lobbying and lawsuits), as has been stressed recently by Baumol (1990, 1993, 2002) and Sobel (2008a). This decision is influenced by the corresponding rates of return—or profit rates—of these alternative activities. Institutions providing for secure property rights, a fair and balanced judicial system, contract enforcement, and effective limits on government's ability to transfer wealth through taxation and regulation, reduce the profitability of unproductive political and legal entrepreneurship. Under this incentive structure, creative individuals are more likely to engage in the creation of new wealth through productive market entrepreneurship.

In areas with little economic freedom, these same individuals are instead more likely to attempt 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 rather than investing those same energies instead into unproductive political and legal activities. For example, a steel entrepreneur might react to competition by trying either to find a better way of producing steel (productive entrepreneurship) or by lobbying for subsidies or tariff protection, or filing anti-trust actions (unproductive entrepreneurship).

To understand this distinction better, 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 what you otherwise would have bought with the money you pay for it, while the pizzeria values the money it receives from you more than it did the pizza. Government actions that transfer wealth, regulate, subsidize, or protect industries from competition are not positive sum. One party's gain (for example, the subsidy) is offset by another party's loss (for example, the taxes). However, because securing the transfer requires an investment of resources in, say, lobbying, the overall impact on the economy is negative (Tullock, 1967). Magnifying this reality is the fact that others will devote resources to political lobbying on the "defensive side" of transfers to protect their wealth from being seized (Wenders, 1987). 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 valuable resources in the process of capturing zero-sum transfers. 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.

While this idea has mostly captured attention in the literature since Baumol's (1990) exposition, and he is often credited with the origin of the idea, the basic idea in reality dates back to the works of Bastiat and Hayek. In his 1850 pamphlet, Bastiat noted:

> Man can only derive life and enjoyment from a perpetual search and appropriation; that is, from a perpetual application of his faculties to objects, or from labor. This is the origin of property.
>
> But also he may live and enjoy, by seizing and appropriating the productions of the faculties of his fellow men. This is the origin of plunder.
>
> Now, labor being in itself a pain, and man being naturally inclined to avoid pain, it follows, and history proves it, that wherever plunder is less burdensome than labor, it prevails; and neither religion nor morality can, in this case, prevent it from prevailing. (Bastiat, 1850 [2007]: 5)

Similarly, according to Hayek:

> Having seen what I have of the world, it appears to me that the proportion of people who are prepared to try out new possibilities that promise to improve their situation—as long as others do not prevent them from doing so—is more or less the same everywhere. It seems to me that the much-lamented lack of entrepreneurial spirit in many young countries is not an unchangeable attribute of individuals, but the consequence of limitations placed on individuals by the prevailing point of view. For precisely this reason, the effect would be fatal if, in such countries, the collective will of the majority were to control the efforts of individuals, rather than that public power limits itself to protecting the individual from the pressure of society—and only the institution of private property, and all the liberal institutions of the rule of law associated with it, can bring about the latter. (Hayek, [1968] 2002: 19).

As is clear, both of these authors make the same point—in societies governed by bad rules, creative people devote their time and talents in ways to generate income for themselves outside of the market sector—through political and legal plunder. Thus, a more complete understanding of the role of economic freedom in promoting *productive* entrepreneurship and prosperity requires a broader definition of entrepreneurship than simply applying the idea to for-profit activities in a business within the marketplace. In reality, entrepreneurial individuals are agents of change—individuals who come up with new ways of doing things and implement them. These activities are not limited to the for-profit marketplace business sector.

For example, there are "academic entrepreneurs" who come up with new programs and implement them within the educational system, "social entrepreneurs" who come up with new non-profit foundations, "military entrepreneurs" who come up with new battlefield strategies, "sports entrepreneurs" who come up with new ways to play their sport, "political entrepreneurs" who come up with new ways of manipulating the political system for gain, and "legal entrepreneurs" who come up with new ways of litigating cases.

As one simple case in point, American football had been played for decades prior to anyone attempting a forward pass. In the 1876 game between Yale and Princeton, Yale's Walter Camp threw forward to a teammate as he was being tackled, resulting in a touchdown. Despite protests by the opposing team, the referee actually tossed a coin to make his decision and allowed the touchdown to stand. Walter Camp is an entrepreneur, albeit not in the for-profit market sector creating a business.

Another example is the case of the gerrymandering of political districts. A brainchild of Massachusetts Governor Elbridge Gerry, it was the first time political district boundaries were significantly manipulated to alter the outcomes of elections. The first use of the filibuster in the US Senate in the 1830s is another example of political entrepreneurship. While these are examples of people within the political sector thinking creatively to get ahead, the more appropriate examples are of private individuals finding new ways to redistribute wealth to themselves through the political process. Holcombe (1999) discusses one such example. In the late 1800s, the union veterans of the US Civil War were able to become the first group to receive large-scale selective transfers through the federal government. Once they opened the door, it made it easier for other groups to seek selective transfer funding that benefitted their narrow groups, paving the way for the modern American welfare state.

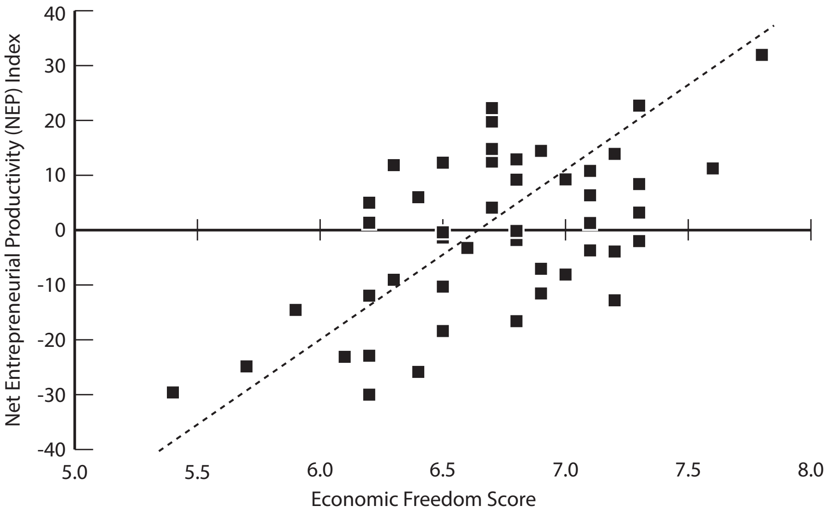
In the legal arena, creative attorneys frequently come up with new ways of litigating cases. One such example is the case of medical monitoring damages in the state of West Virginia. When the environmental spillover effects from a business's activities result in physical injury to non-consenting third parties, courts have long allowed damages to be awarded to the injured parties, including damages for monitoring of their medical condition. However, in all cases the person filing the claim was required to show that actual physical injury was present. In 1999, the plaintiff's attorney litigating the case of *Bower v. Westinghouse* [206 W.Va. 133, 522 S.E.2d 424 (1999)] was able to argue creatively that individuals who showed no physical injury should be given damage awards for future medical monitoring *in case* they started developing problems (Leddy and Yanni, 2009). The legal brilliance of the precedent is that it provides lump-sum payments to large classes of uninjured parties living near a business even when there is no evidence of actual physical harm, with no restriction that the money actually be spent on the medical monitoring. Now jokingly known as the "Ford F-150 rule" because large groups of individuals have spent their checks on new pickup trucks, the creative thinking of one attorney has opened the door to many new lawsuits representing class actions of uninjured parties to seek transfers through the legal process from surrounding business entities.

Back to the bigger picture. What is important in a society is the proportion of entrepreneurial individuals who spend their time and talent creating wealth through engaging in productive, wealth-creating market entrepreneurship, rather than trying to secure wealth through unproductive, wealth-destroying political and legal plunder. Higher levels of economic freedom increase the returns to productive market entrepreneurship and lower the returns to unproductive political and legal entrepreneurship. Areas with higher economic freedom, therefore, will have not only higher rates of measured market entrepreneurship, but also lower levels of unproductive political and legal entrepreneurship.

While measures of unproductive entrepreneurship across countries are not available, it is possible to estimate them across the U.S. states. Sobel (2008a) shows that states with higher economic freedom scores both have more productive private sector entrepreneurship *and* less unproductive entrepreneurship. He constructs an index of "net entrepreneurial productivity" that grows with the proportion of entrepreneurial talent allocated to the private sector, and falls with increasing political activity or lawsuit abuse.[4] *Figure 2.2* shows the clear, and strong, relationship between the economic freedom scores of US states and their levels of net

4. The index is basically the difference in the state's ranking relative to other states on measures of productive entrepreneurship minus its ranking on measures of unproductive entrepreneurship.

Figure 2.2. Economic freedom and the productivity of entrepreneurship, 2001



Source: Sobel, 2008a.

entrepreneurial productivity. Higher levels of economic freedom therefore not only promote the good types of entrepreneurship, but also lower the destructive types of entrepreneurship.

4. Economic freedom, the productivity of capital, and crony capitalism

Human and physical capital, when employed productively by entrepreneurs, are engines of wealth creation. Human capital refers to the education and talents of individuals, while physical capital refers to man-made resources such as machines that go into the production of other goods and services. The ability of capital to generate wealth depends on how productively it is allocated by entrepreneurs.

Gwartney, Holcombe and Lawson (2006) postulated that countries with higher levels of economic freedom—specifically, those countries that rely chiefly on the market to allocate investment into physical capital, should be able to generate a higher level of productivity and wealth for any given level of investment. They test their hypothesis and indeed find that the contribution of investment in physical capital to economic growth is higher in countries with more economic freedom.

Expanding on that idea, Hall, Sobel, and Crowley (2010) apply the same concept to human capital. Considering the contrast between productive and unproductive entrepreneurship, they postulate that the returns to investments in human capital (for example, schooling) should be higher in countries with more economic freedom. Not only do they confirm this hypothesis, they actually find that in countries with very low levels of economic freedom the returns to schooling are negative—implying that higher levels of education destroy wealth. This finding suggests that, in these societies, as people become better educated, they simply use these talents to manipulate the political and legal systems for wealth transfers. They become more effective rent seekers.

Economic freedom improves the productivity of both human and physical capital in a society. Therefore, with any given level of entrepreneurial effort or level of investment in physical capital, societies with more economic freedom generate more wealth and economic growth from those investments.

A closely related issue is "crony capitalism" and the use of selective incentive policies by governments. There is a difference between what economists call capitalism and what some might consider "business-friendly" policies. When government gives subsidies or tax breaks to specific firms or industries that lobby but not to others, this practice is at odds with the institutions, or rules of the game, consistent with capitalism and economic freedom. When it becomes more profitable for companies and industries to invest time and resources into lobbying the political process for favors, or into initiating unjustified lawsuits, we end up with more of these types of destructive activities, and less productive activity. Firms compete in the government decision-making process for tax breaks rather than in the marketplace for consumers' patronage. They spend time lobbying rather than producing.

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

Business subsidies may visibly create jobs, but the unseen cost is that the tax revenue or other resources necessary to fund these subsidies generally destroy more jobs than are created. They result in a *net* reduction in economic activity. The problem, politically, is that these losses are not as visible. When every taxpayer has to pay, say, $1 more in taxes to fund some multi-million-dollar subsidy, the resulting reduction in consumer spending is spread out over the entire economy, causing job losses in multitudes of other businesses, and a reduction in consumer well-being. But because each individual loss is small, these losses go unnoticed. Government subsidy programs can, thus, create jobs in the relatively few favored industries, but only by destroying jobs in numerous unfavored industries. And because the favored industries will generally be less efficient than are the unfavored ones, the overall economic impact is negative. When business interests capture government's power, things can go just as bad for capitalism as when government power is held in the hands of groups less friendly to business. For example, when companies persuade government to use the power of eminent domain to take property from others, or use lobbying or connections to get special tax favors, subsidies, or exemptions for their business, this policy climate is not conducive to capitalism either.

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

Government officials often cite the necessity to offer these credits to entice firms to locate in particular jurisdictions. However, the main reason such incentives are necessary is the high taxes that already exist in these areas on these types of firms and the appropriate solution is to lower the taxes that prevent the jurisdiction from being competitive in the first place. These incentives would not be necessary if the tax structure were less burdensome.[5]

When governments give favors to some businesses (or groups) but not others, it unfairly distorts the competitive market process as unsubsidized firms must now compete with the politically favored, subsidized firms for employees, resources, land, and consumers. All firms should have a good business climate, without having to devote time, effort, and resources toward political lobbying and favor seeking to get it. Unlike the large companies who receive selective incentives from governments, many businesses—including small entrepreneurs—simply do not have the political power even to begin negotiating a better business climate. The resources devoted toward offering these special favors to big businesses would be better spent making across-the-board, broad-based tax reductions that apply to

5. Recently in Illinois, for example, when the corporate income tax was raised across the board, subsidies had to be given to specific high-profile firms to get them to stay in the state.

all entrepreneurs and businesses. But when governments engage in this type of activity it promotes an environment of favor seeking and fosters a higher level of unproductive entrepreneurship. Society is not only poorer because of the resources withdrawn from the productive sector as each group spends time and effort to get a political favor, but also because it necessitates that other groups now spend time and talent to get similar favorable treatment. This is why broad-based policies that are fair and equally applied to all outperform environments where policies are selectively applied.

In the United States, the federal government's response to the 2008 financial crisis and recession included an unprecedented increase in the number of government subsidies, grants, and contracts given directly to *specific* private businesses. For example, in October 2008 the Troubled Asset Relief Program (TARP) authorized $700 billion in expenditures to purchase assets and equity from more than a dozen financial institutions. Also in late 2008, the Federal Reserve's "Maiden Lane Transactions" set up limited-liability companies with nearly $100 billion to aid JPMorgan Chase, Bear Stearns, and AIG. In early 2009, the American Recovery and Reinvestment Act (ARRA) began spending over $840 billion, which included many tax benefits, contracts, grants, and loans, and entitlements, going to thousands of specific private companies.

As a result of this major increase in government involvement, companies have rushed to make sure their interests are being heard in the political process that allocates these government favors. According to the Center for Responsive Politics, total expenditures on lobbying the federal government rose by over 20% from 2007 to 2010 (after adjusting for inflation) to more than $3.5 billion. Lobbying by the finance, insurance, and real-estate sector alone has been over $450 million per year since 2008, and the industry is now represented by approximately 2,500 individually registered federal lobbyists. In addition to increasing its lobbying activities, the finance, insurance, and real-estate sector has also increased political donations given directly to federal political campaigns. These donations are made largely through PAC contributions, rising from $287 million during the 2006 election cycle to $503 million during the 2008 election cycle and $319 million during the 2010 election cycle. Some of the industrial sectors to which ARRA money is specifically targeted, such as energy, have seen the biggest increases in lobbying activity, with a 66% increase in federal lobbying expenditures between 2007 and 2010. The industry now spends over $450 million annually on lobbying and is represented by over 2,200 registered federal lobbyists. Similarly, the energy sector has increased its donations to federal political campaigns, raising them from $51 million during the 2006 election cycle to $81 million during the 2008 election cycle, and $76 million during the 2010 election cycle.

Political connections or, more precisely, government grants, contracts, and bailouts, are becoming increasingly important in determining which firms succeed and which fail. These policies followed in the United States over the past decade have resulted in a significant decline in the economic freedom score of the United States. This reduced economic freedom has fostered an environment in which businesses invest significantly more resources in lobbying—unproductive entrepreneurship. The result is that fewer resources are devoted to productive entrepreneurial endeavors such as research and development efforts to generate new products and innovations.

5. Foreign aid and dead capital—the importance of property rights

Private property rights that are well defined and enforced are an important component of economic freedom. In the least developed countries, the lack of these rights is a significant factor limiting entrepreneurship. Financing for new entrepreneurial ventures is critical. In most societies, individual entrepreneurs can mortgage their assets, such as homes or cars, using them as collateral to secure loans to provide equity for their new businesses. But in many countries with low levels of economic freedom, property rights are informal at best. Without proper titles, deeds, and identification systems, individuals may own assets such as a home, but be unable to collateralize them to take out loans. This lack of collateralization holding back the ability of entrepreneurs in such countries has been a major research area of Hernando de Soto (2000, 2006). While some people in the United States actually complain about the large number of businesses offering auto-title loans, they instead should feel extremely lucky this opportunity exists so easily. According to de Soto (2006), in Tanzania, for example, pledging moveable property such as a car as collateral for a loan takes 297 days on the mainland, while on the semiautonomous part of Tanzania known as Zanzibar, such pledges do not exist. This lack of the ability to collateralize assets is a major hurdle to entrepreneurial financing.

In efforts to help ailing, less-developed economies, the developed world has given billions in foreign aid to governments. Not only do such government-to-government transfers (as the late economist Peter Bauer called them) not solve the fundamental problems with the institutions in these countries, they often prop up corrupt political leaders, leading to few incentives for internal economic reform. Even worse, according to Coyne, Sobel, and Dove (2010) foreign aid results in aid recipients investing resources in establishing networks and relationships that maximize the amount of aid received. Once these networks are in place, they can have the counterproductive effect of making change toward liberal market and political institutions that much more difficult given the rent-seeking nature nurtured by the foreign aid. Large inflows of foreign aid, just like large amounts of government spending in any area, lead to business firms learning effectively how to compete for government favors, rather than learning how to compete in the marketplace. Thus, foreign aid often promotes the harmful types of unproductive entrepreneurship in these countries and builds human capital in favor seeking.

Creating an environment within which individual entrepreneurs generate wealth has been difficult for less-developed countries. But the solution is not foreign aid that promotes government favor seeking by individuals. The solution is reforms that promote economic freedom through greater use of private ownership rights—secure and defined property rights that allow for collateralization. The rise of the internet and private microlending to small entrepreneurs in less-developed countries, through organizations such as Kiva.org, has shown significant potential. But until significant reforms to promote economic freedom are undertaken, the wealth generating creativity of billions of entrepreneurial individuals in these less-developed countries remains harnessed and underused. The vast majority of measured entrepreneurship in such countries simply reflects "necessity-driven" entrepreneurship in which individuals must grow their own food, make their own clothes, and undertake household production because of the lack of private-sector job opportunities.

6. Updated evidence on economic freedom and entrepreneurship rates

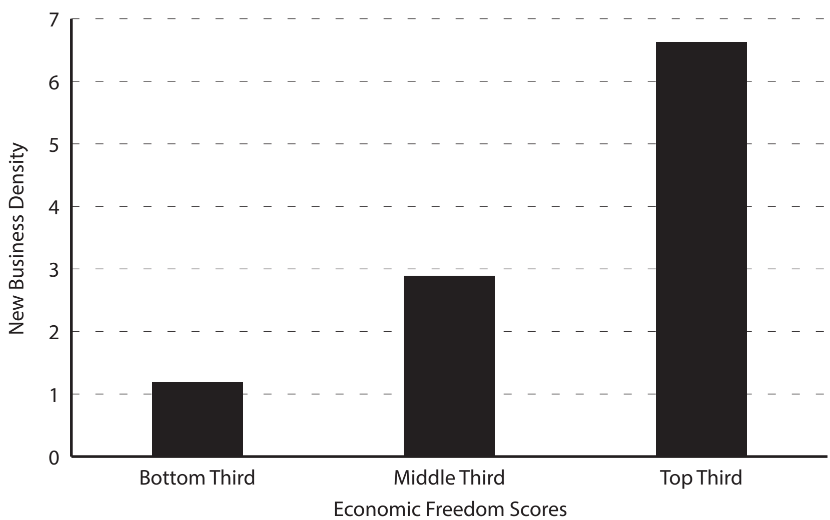
Using the most recent economic freedom ratings and most recent data on entrepreneurship rates, this section presents new evidence on the relationship between economic freedom and rates of entrepreneurial activity both across countries and across US states.

The most recent scores for economic freedom around the world were obtained for each country available from *Economic Freedom of the World* (EFW) (Gwartney, Lawson, and Hall, 2014). These data were matched with cross-country data on entrepreneurship rates from a joint effort of the World Bank and the Kauffman

Foundation (World Bank Group, 2013). According to the World Bank, the data collection was completed in June 2013 directly from 139 countries based on company registrations of new firms. Data are provided on new business entry density, defined as the number of newly registered corporations (private companies with limited liability) per 1,000 working-age people (aged 15–64). Once the matching was complete, there were 105 countries for which data were available on both variables. This is a significantly larger number of countries than has been examined in previous literature, which looked at OECD countries only.

How large are the differences in entrepreneurship rates by levels of economic freedom in 2014? To answer this question, the countries were then ranked by their level of economic freedom, and averages were computed for the data divided into three groupings. That is, the countries were broken down into the third having the highest EFW scores, the third in the middle, and the third having the lowest EFW scores (making for 35 countries in each grouping). *Figure 2.3* shows the differences in entrepreneurship rates across these groupings.

Figure 2.3. Entrepreneurship rates of countries grouped by lowest, middle, and highest scores for economic freedom, 2014



Sources: Gwartney, Lawson, and Hall, 2014; World Bank Group, 2013.

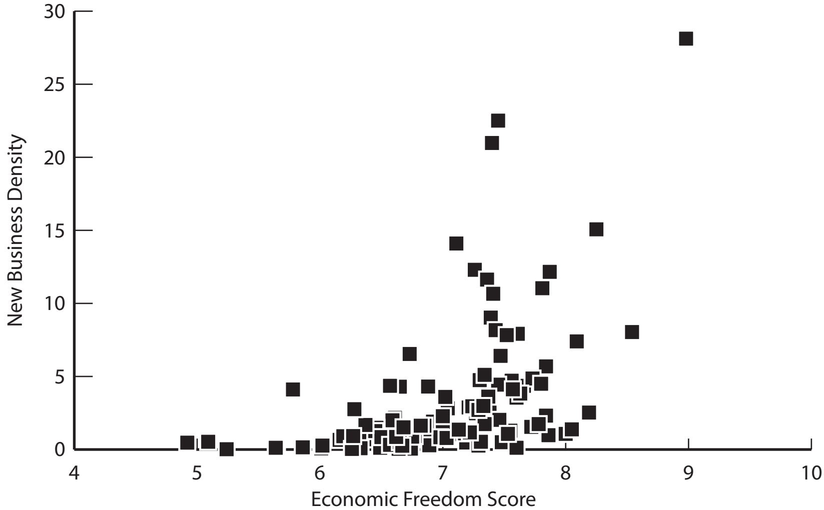
As can be seen in figure 2.3, the impact of economic freedom on entrepreneurship rates is strong. The third of the countries with the lowest economic freedom scores had just slightly more than one new private entrepreneurial venture per 1,000 people (the actual value is 1.19) in 2014. Countries in the middle third achieved almost three new ventures per 1,000 people (the actual value is 2.89). But the third of the countries with the highest economic freedom scores achieved a rate of new venture formation of more than six per 1,000 people (the actual value is 6.63). In essence, each move to a higher third doubles the number of new entrepreneurial ventures.

As one might imagine, the extremes of the ratings were glaring. For example, the three countries in the overlapping dataset with the highest economic freedom scores (Hong Kong, Singapore, and New Zealand) averaged 17.1 new ventures per 1,000 people, while the three countries in the overlapping dataset with the lowest economic freedom scores (Democratic Republic of the Congo, Algeria, and Argentina) managed only 0.249 new ventures per 1,000 people (or alternatively stated, approximately one new venture per 4,000 people).

To further illustrate the data, *figure 2.4a* shows all 105 countries plotted with their associated levels of new business formation (per 1,000 people) and economic freedom scores. A simple linear regression using these data produces a coefficient of 3.33, with an associated *t*-value of 5.62 (significant at the 1% level) with an R-squared of 0.23. What this means is that each one-unit increase in a country's economic freedom score produces roughly a 3.33-unit increase in new business ventures per 1,000 people. Eyeing the data reveals that a non-linear estimation would be more appropriate and would result in a higher R-squared, although such an estimation would require excessive complexity for this chapter. Fortunately, the reality and significance of the non-linear relationship can be seen clearly in the figure. Basically, entrepreneurship rates are flat under an EFW score of about 7.0. Below that level, a country's institutions simply are not supportive of the entrepreneurial process. So moving from a very low score of 5.5 to another low score below 7.0 such as 6.5 would have little effect in promoting entrepreneurship due to the generally weak institutions. Once a country's institutions get above an EFW score of 7.0, however, increases in economic freedom result in increased entrepreneurship rates. While the EFW index tries to present the issue of socialism to capitalism on a spectrum, the result here indicates that countries with an EFW score below 7.0 simply fail to have an economy that features private entrepreneurship of any meaningful magnitude.

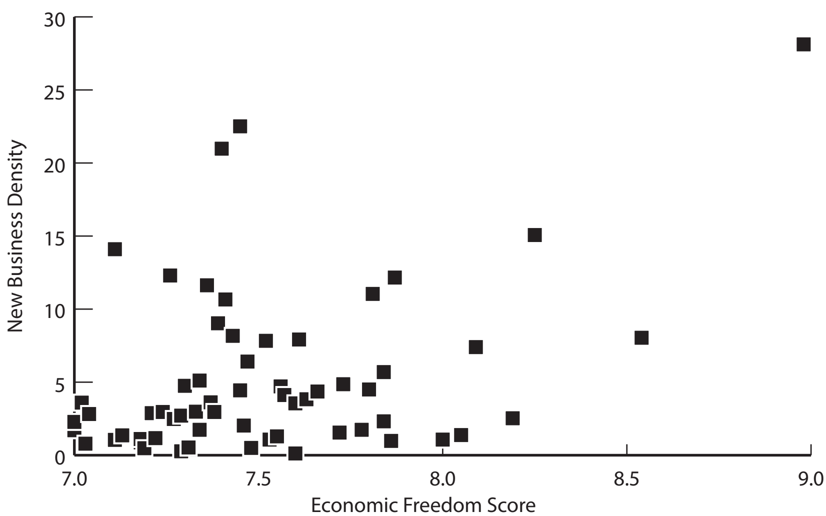
The relationship among those countries above an EFW score of 7.0 shows a much more linear relationship, as is shown in *figure 2.4b*. Countries among this group clearly improve their rates of entrepreneurship as they increase their economic freedom, even if only modestly.

Figure 2.4a. Entrepreneurship rates and economic freedom for 105 countries, 2014



Sources: Gwartney, Lawson, and Hall, 2014; World Bank Group, 2013.

Figure 2.4b. Entrepreneurship rates and economic freedom for countries with an EFW score of 7.0 and above, 2014



Sources: Gwartney, Lawson, and Hall, 2014; World Bank Group, 2013.

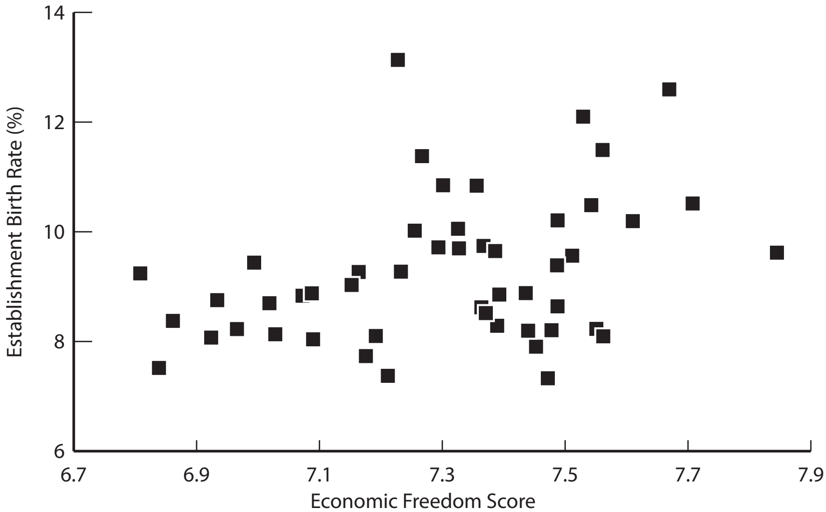
As mentioned earlier, the United States' level of economic freedom has fallen in recent years, from a peak of 8.65 in 2000 to 7.74 in the most recent report (using the chain-linked index). Using the above results as a guide, this 0.91-unit decline in economic freedom in the United States will result in a 3.03-unit decline in entrepreneurial ventures per 1,000 people among the working-age population. Using 2014 data, this implies that, for each of the preceding ten years, approximately 740,000 fewer new business ventures were launched in the United States than would have been launched had economic freedom not fallen in the 21st century from its level in 2000. Again, had the relationship been estimated using a non-linear model, this impact would have been even larger (approaching 1,000,000 fewer new ventures annually).

We move now to the US state level. The most recent economic freedom levels of the US states are obtained from Stansel and McMahon (2013). Data on establishment birth rates for the US states are obtained from the US Small Business Administration, Office of Advocacy (2014). *Figure 2.5* shows the relationship across all US states. Again, as in the case of countries shown before, the data show a clear positive relationship between economic freedom and productive entrepreneurship. States with higher economic freedom scores have higher rates of new ventures being formed. A simple linear regression produces a coefficient of 1.957 (with a statistically significant *t*-ratio of 2.63). This finding implies that for every one-unit increase in a US state's economic freedom score, the birth rate of new establishments goes up by almost two percentage points. Using the average state, that converts into approximately 2,600 new establishment births annually in the state for every one-unit increase in economic freedom.

Again, comparisons of the top three and bottom three states are striking. The three states with the highest economic freedom scores (Delaware, Texas, and Nevada) have an average establishment birth rate of 10.9% per year, while the three states with the lowest economic freedom scores (Mississippi, West Virginia, and New Mexico) have an average establishment birth rate of 8.4% per year, meaning they have establishment birth rates 2.5 percentage points lower each year than states with higher levels of economic freedom (or approximately 3,300 fewer new firms for the average state).

This section has shown that, using the most recent data available, the positive relationship between economic freedom and the rates of productive entrepreneurship remains strong and robust. Both countries and states with higher levels of economic freedom have higher rates of new venture creation—that is, productive entrepreneurship.

Figure 2.5. Establishment birth rates and economic freedom in US states, 2013



Sources: Stansel and McMahon, 2013; US Small Business Administration, Office of Advocacy, 2014.

7. Conclusion

It has long been established in the literature that areas with higher economic freedom are both more prosperous and have faster rates of economic growth. The important point made in this chapter is that an important medium through which economic freedom produces growth is productive entrepreneurship. That is, economic freedom produces growth because economic freedom promotes entrepreneurship, and this additional entrepreneurship produces economic prosperity.

This chapter discussed the relationship between economic freedom and prosperity through its impact on entrepreneurship. It also reviewed the existing literature on the topic, and provided updated empirical evidence on the relationship, which remains robust even in the post-great recession world.

From the discussion, it is clear that all component areas of economic freedom play an important role in fostering entrepreneurial activity. This chapter has outlined the specific ways in which the rule of law, regulation, government spending and taxation, and free trade affect the productivity of entrepreneurship. Even more important, however, is the fact that the overall level of economic freedom alters the balance between the rewards for productive and unproductive entrepreneurship. In short, more freedom generates more productive entrepreneurship and less unproductive entrepreneurship.

Entrepreneurship is a key source of economic growth and prosperity. A thriving entrepreneurial sector is enabled by good policies and institutions. The empirical evidence from both previous literature and the updated data presented here is robust and consistent—areas with higher economic freedom have greater levels of productive entrepreneurial activity.

Many states and nations have significantly misguided policies (such as government run venture capital firms, business development centers, and incubators) that are ostensibly intended to promote entrepreneurship but in the end only grow the size and scope of government. Such policies lower economic freedom and actually harm entrepreneurship. To promote and foster entrepreneurial activity requires policies and institutions that enhance economic freedom.

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3. Economic Freedom in the United States and Other Countries

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1. Introduction

For over two decades, scholars have been working to measure the degree to which a nation has implemented a certain set of policies that Adam Smith called a "System of Natural Liberty"; Marx called "Capitalism"; some call "laissez faire"; and we shall call "economic freedom". Economic freedom is present when individuals are permitted to choose for themselves and engage in voluntary transactions as long as they do not harm the person or property of others. Individuals have a right to their own time, talents, and resources, but they do not have a right to take things from others or demand that others provide things for them. The use of violence, theft, fraud, and physical invasions are not permissible in an economically free society, but otherwise, individuals are free to choose, trade, and cooperate with others, and compete as they see fit. When government agents, such as police officers or judges, work to protect people from private predators, government acts in support of economic freedom. On the other hand, government agents, such as tax collectors and regulators, often violate the economic freedom of individuals by preventing them from trading as they see fit. When governments plan at the collective level the economic decisions of people, they violate their economic freedom. In summary, the

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Major elements of this chapter were drawn, with permission, from Chapter 1: Economic Freedom of the World in 2012, in Gwartney, Lawson, and Hall, 2014: 1–23.

cornerstones of economic freedom are (1) personal choice, (2) voluntary exchange coordinated by markets, (3) freedom to enter and compete in markets, and (4) protection of persons and their property from aggression by others.

This chapter will first discuss how economic freedom is measured as a practical matter by the index published in the annual editions of *Economic Freedom of the World*. Second, the chapter will review the actual economic freedom scores for selected nations, with particular emphasis on OECD nations. Finally, recent trends in economic freedom among those countries will be discussed. The case of the United States, which has seen a fairly dramatic decline in economic freedom since 2000, will be a major focus of this final section.

2. Measuring economic freedom

The index published in *Economic Freedom of the World* (EFW) (Gwartney, Lawson, and Hall, 2014) is designed to measure the extent to which the institutions and policies of a nation are consistent with the conception of economic freedom described above. Put another way, the EFW measure is an effort to identify how closely the institutions and policies of a country correspond with a limited government ideal, where the government protects property rights and arranges for the provision of a limited set of "public goods" such as national defense and access to money of sound value, but little beyond these core functions.

In order to receive a high EFW rating, a country must provide secure protection of privately owned property, even-handed enforcement of contracts, and a stable monetary environment. It also must keep taxes low, refrain from creating barriers to both domestic and international trade, and rely more fully on markets rather than government spending and regulation to allocate goods and resources. In many ways, a country's EFW summary rating is a measure of how closely its institutions and policies compare with the idealized structure implied by standard textbook analysis of microeconomics.

Limited government designed to protect the rights of minorities and promote political action based on agreement can be an effective way to protect economic freedom, but elections and simple majoritarian democracy are not enough. Democracy must be buttressed with constraints on the power of the executive, constitutional protection of individual rights, decentralization of government action, and rule of law. If they are not, the result will be political instability and the trampling of economic freedom. This is a vitally important point that has largely been ignored by political leaders, the media, and modern intellectuals. Failure to recognize this point will almost surely lead to disappointment in the results of majoritarian democracy, as well as loss of both political and economic freedom.

The EFW index now covers 152 countries with data available for approximately 100 countries back to 1980. This data set facilitates the ability of scholars to analyze the impact of both cross-country differences in economic freedom and changes in that freedom across a time frame of more than three decades. The EFW measure will also help scholars examine the contribution of economic institutions more thoroughly and disentangle it more completely from political, climatic, locational, cultural, and historical factors as determinants of growth and development.

The construction of the index published in *Economic Freedom of the World* is based on three important methodological principles. First, objective components are always preferred to those that involve surveys or value judgments. Given the multidimensional nature of economic freedom and the importance of legal and regulatory elements, it is sometimes necessary to use data based on surveys, expert panels, and generic case studies. To the fullest extent possible, however, the index uses objective components. Second, the data used to construct the index ratings are from external sources such as the International Monetary Fund, World Bank, and World Economic Forum that provide data for a large number of countries. Data provided directly from a source within a country are rarely used. Importantly, the value judgments of the authors or others in the Economic Freedom Network are never used to alter the raw data or the rating of any country. Third, transparency is present throughout. The report provides information about the data sources, the methodology used to transform raw data into component ratings, and how the component ratings are used to construct both the area and summary ratings.

Table 3.1 gives the structure of the EFW index. The index measures the degree of economic freedom present in five major areas: [1] Size of Government; [2] Legal System and Security of Property Rights; [3] Sound Money; [4] Freedom to Trade Internationally; [5] Regulation. Within the five major areas, there are 24 components in the index. Many of those components are themselves made up of several sub-components. In total, the index comprises 42 distinct variables. Each component and sub-component is placed on a scale from 0 to 10 that reflects the distribution of the underlying data. When sub-components are present, the sub-component ratings are averaged to derive the component rating. The component ratings within each area are then averaged to derive ratings for each of the five areas. In turn, the five area ratings are averaged to derive the summary rating for each country. Following is an overview of the five areas of the EFW index.

Table 3.1. Areas, Components, and Sub-components of the EFW index

1. Size of Government

A. Government consumption
B. Transfers and subsidies
C. Government enterprises and investment
D. Top marginal tax rate
- *(i) Top marginal income tax rate*
- *(ii) Top marginal income and payroll tax rate*

2. Legal System and Property Rights

A. Judicial independence
B. Impartial courts
C. Protection of property rights
D. Military interference in rule of law and politics
E. Integrity of the legal system
F. Legal enforcement of contracts
G. Regulatory restrictions on the sale of real property
H. Reliability of police
I. Business costs of crime

3. Sound Money

A. Money growth
B. Standard deviation of inflation
C. Inflation: most recent year
D. Freedom to own foreign currency bank accounts

4. Freedom to Trade Internationally

A. Tariffs
- *(i) Revenue from trade taxes (% of trade sector)*
- *(ii) Mean tariff rate*
- *(iii) Standard deviation of tariff rates*

B. Regulatory trade barriers
- *(i) Non-tariff trade barriers*
- *(ii) Compliance costs of importing and exporting*

C. Black-market exchange rates
D. Controls of the movement of capital and people
- *(i) Foreign ownership/investment restrictions*
- *(ii) Capital controls*
- *(iii) Freedom of foreigners to visit*

5. Regulation

A. Credit market regulations
- *(i) Ownership of banks*
- *(ii) Private sector credit*
- *(iii) Interest rate controls/negative real interest rates*

B. Labor market regulations
- *(i) Hiring regulations and minimum wage*
- *(ii) Hiring and firing regulations*
- *(iii) Centralized collective bargaining*
- *(iv) Hours regulations*
- *(v) Mandated cost of worker dismissal*
- *(vi) Conscription*

Area 1. Size of government

The four components of Area 1 indicate the extent to which countries rely on the political process to allocate resources and goods and services. When government spending increases relative to spending by individuals, households, and businesses, government decision-making is substituted for personal choice and economic freedom is reduced. The first two components address this issue. Government consumption as a share of total consumption (1A) and transfers and subsidies as a share of GDP (1B) are indicators of the size of government. When government consumption is a larger share of the total, political choice is substituted for personal choice. Similarly, when governments tax some people in order to provide transfers to others, they reduce the freedom of individuals to keep what they earn.

The third component (1C) in this area measures the extent to which countries use private investment and enterprises rather than government investment and firms to direct resources. Governments and state-owned enterprises play by rules that are different from those to which private enterprises are subject. They are not dependent on consumers for their revenue or on investors for capital. They often operate in protected markets. Thus, economic freedom is reduced as government enterprises produce a larger share of total output.

The fourth component (1D) is based on (1Di) the top marginal income tax rate and (1Dii) the top marginal income and payroll tax rate and the income threshold at which these rates begin to apply. These two sub-components are averaged to calculate the top marginal tax rate (1D). High marginal tax rates that apply at relatively low income levels are also indicative of reliance upon government. Such rates deny individuals the fruits of their labor. Thus, countries with high marginal tax rates and low income thresholds are rated lower.

Taken together, the four components of Area 1 measure the degree to which a country relies on personal choice and markets rather than government budgets and political decision-making. Therefore, countries with low levels of government spending as a share of the total, a smaller government enterprise sector, and lower marginal tax rates earn the highest ratings in this area.

Area 2. Legal system and property rights

Protection of persons and their rightfully acquired property is a central element of economic freedom and a civil society. Indeed, it is the most important function of government. Area 2 focuses on this issue. The key ingredients of a legal system consistent with economic freedom are rule of law, security of property rights, an independent and unbiased judiciary, and impartial and effective enforcement of the law. The nine components in this area are indicators of how effectively the protective functions of government are performed. These components are from three primary sources: the *International Country Risk Guide* (PRS Group), the *Global Competitiveness Report* (World Economic Forum), and the World Bank's *Doing Business* project.

Security of property rights, protected by the rule of law, provides the foundation for both economic freedom and the efficient operation of markets. Freedom to exchange, for example, is meaningless if individuals do not have secure rights to property, including the fruits of their labor. When individuals and businesses lack confidence that contracts will be enforced and the fruits of their productive efforts protected, their incentive to engage in productive activity is eroded. Perhaps more than any other area, this area is essential for the efficient allocation of resources. Countries with major deficiencies in this area are unlikely to prosper regardless of their policies in the other four areas.

Area 3. Sound money

Money oils the wheels of exchange. An absence of sound money undermines gains from trade. As Milton Friedman informed us long ago, inflation is a monetary phenomenon, caused by too much money chasing too few goods. High rates of monetary growth invariably lead to inflation. Similarly, when the rate of inflation increases, it also tends to become more volatile. High and volatile rates of inflation distort relative prices, alter the fundamental terms of long-term contracts, and make it virtually impossible for individuals and businesses to plan sensibly for the future. Sound money is essential to protect property rights and, thus, economic freedom. Inflation erodes the value of property held in monetary instruments. When governments finance their expenditures by creating money, in effect, they are expropriating the property and violating the economic freedom of their citizens.

The important thing is that individuals have access to sound money: who provides it makes little difference. Thus, in addition to data on a country's rate of inflation and its government's monetary policy, it is important to consider how difficult it is to use alternative, more credible, currencies. If bankers can offer saving and checking accounts in other currencies or if citizens can open foreign bank accounts, then access to sound money is increased and economic freedom expanded.

There are four components to the EFW index in Area 3. All of them are objective and relatively easy to obtain and all have been included in the earlier editions of the index. The first three are designed to measure the consistency of monetary policy (or institutions) with long-term price stability. Component 3D is designed to measure the ease with which other currencies can be used via domestic and foreign bank accounts. In order to earn a high rating in this area, a country must follow policies and adopt institutions that lead to low (and stable) rates of inflation and avoid regulations that limit the ability to use alternative currencies.

Area 4. Freedom to trade internationally

In our modern world of high technology and low costs for communication and transportation, freedom of exchange across national boundaries is a key ingredient of economic freedom. Many goods and services are now either produced abroad or contain resources supplied from abroad. Voluntary exchange is a positive-sum activity: both trading partners gain and the pursuit of the gain provides the motivation for the exchange. Thus, freedom to trade internationally also contributes substantially to our modern living standards.

At the urging of protectionist critics and special-interest groups, virtually all countries adopt trade restrictions of various types. Tariffs and quotas are obvious examples of roadblocks that limit international trade. Because they reduce the convertibility of currencies, controls on the exchange rate also hinder international trade. The volume of trade is also reduced if the passage of goods through customs is onerous and time consuming. Sometimes these delays are the result of administrative inefficiency while in other instances they reflect the actions of corrupt officials seeking to extract bribes. In both cases, economic freedom is reduced.

The components in this area are designed to measure a wide variety of restraints that affect international exchange: tariffs, quotas, hidden administrative restraints, and controls on exchange rates and capital. In order to get a high rating in this area, a country must have low tariffs, easy clearance and efficient administration of customs, a freely convertible currency, and few controls on the movement of physical and human capital.

Area 5. Regulation

When regulations restrict entry into markets and interfere with the freedom to engage in voluntary exchange, they reduce economic freedom. The fifth area of the index focuses on regulatory restraints that limit the freedom of exchange in credit, labor, and product markets. The first component (5A) reflects conditions in the domestic credit market. One sub-component provides evidence on the extent to which the banking industry is privately owned. The final two sub-components indicate the extent to which credit is supplied to the private sector and whether controls on interest rates interfere with the market in credit. Countries that use a private banking system to allocate credit to private parties and refrain from controlling interest rates receive higher ratings for this regulatory component.

Many types of labor-market regulations infringe on the economic freedom of employees and employers. Among the more prominent are minimum wages, dismissal regulations, centralized wage setting, extension of union contracts to nonparticipating parties, and conscription. The labor-market component (5B) is designed to measure the extent to which these restraints upon economic freedom are present. In order to earn high marks in the component rating regulation of the labor market, a country must allow market forces to determine wages and establish the conditions of hiring and firing, and refrain from the use of conscription.

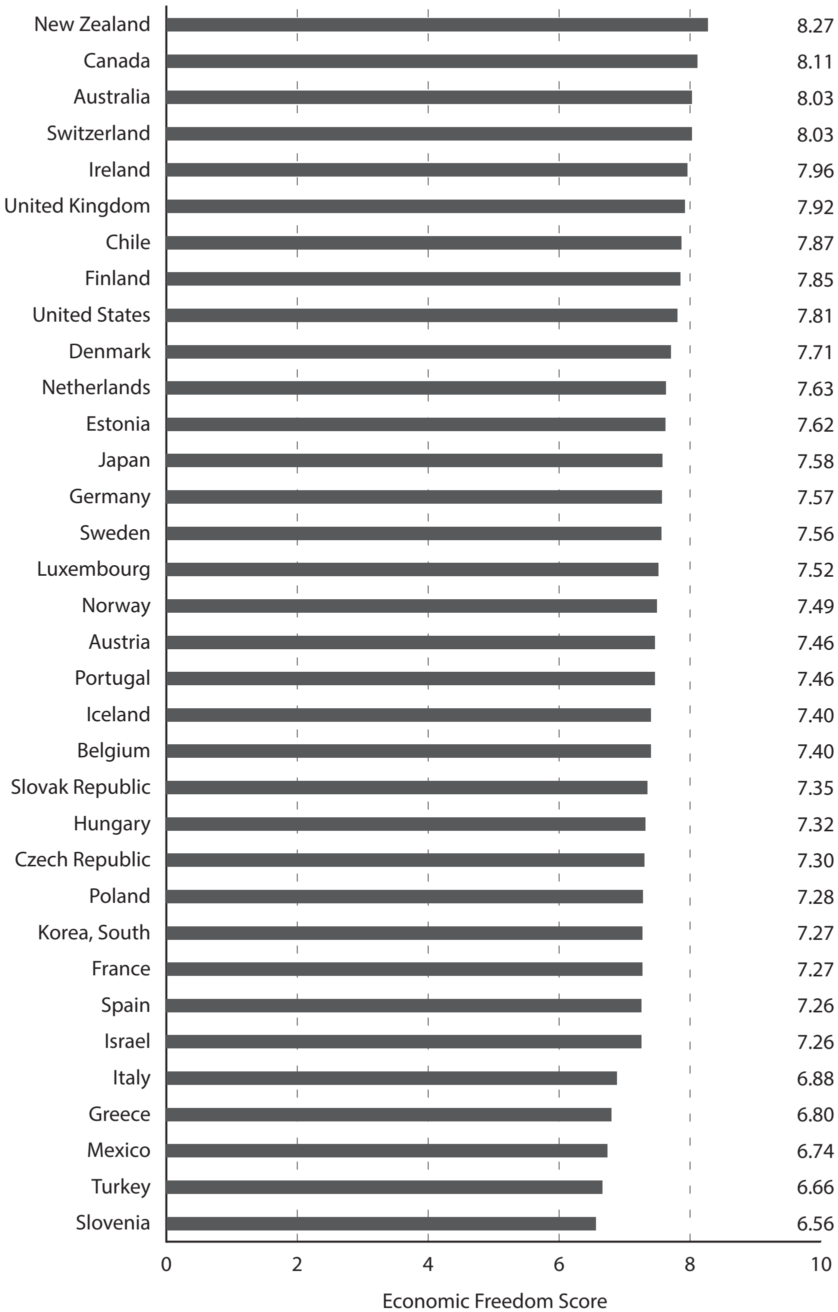
Like the regulation of credit and labor markets, the regulation of business activities (component 5C) inhibits economic freedom. The sub-components of 5C are designed to identify the extent to which regulations and bureaucratic procedures restrain entry and reduce competition. In order to score high in this portion of the index, countries must allow markets to determine prices and refrain from regulatory activities that retard entry into business and increase the cost of producing products. They also must refrain from "playing favorites", that is, from using their power to extract financial payments and reward some businesses at the expense of others.

3. Economic freedom of the OECD nations

Figure 3.1 presents the summary economic freedom ratings for 2012, sorted from highest to lowest, for the 34 *current* members of the Organisation for Economic Co-operation and Development (OECD).[1] The OECD began in 1960 with 18 European counties plus Canada and the United States. Very quickly, advanced non-European countries like Australia, New Zealand, and Japan were added. In recent years, the OECD has expanded membership to several middle-income European economies in southern and eastern Europe as well as to Mexico and Chile. It should be noted that several important nations with high income and a high degree of

1. Throughout this chapter, the chain-linked version of the EFW index is used. Please consult Gwartney, Lawson, and Hall, 2014 for details. The Appendix (p. 83) provides chain-linked EFW scores for all the OECD nations from 1970 to 2012.

Figure 3.1. Summary ratings on EFW index, OECD nations, 2012



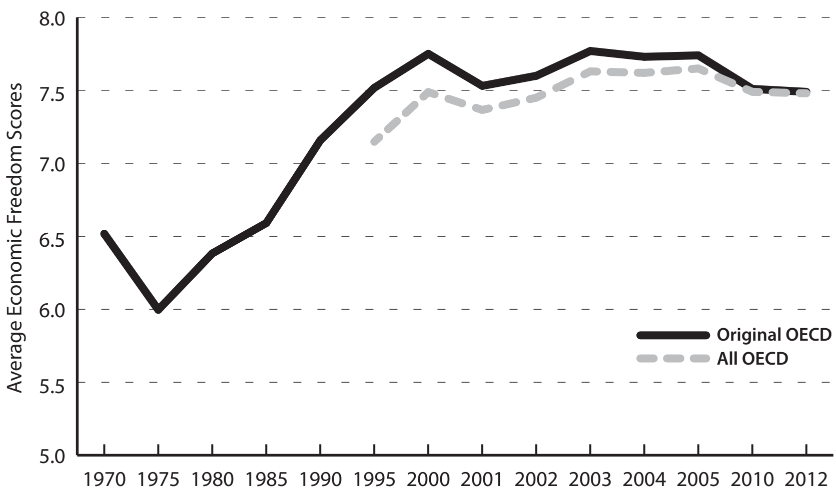
Source: Gwartney, Lawson, and Hall, 2014. Scores are from the chain-linked version of the EFW index.

economic freedom, such as Hong Kong and Singapore, are not members of the OECD; nor are large economic powers such as the so-called BRICs (Brazil, Russia, India, China) included. Nevertheless, using OECD membership is a fairly objective way to select for countries that are highly economically developed or show significant promise.

In general, OECD nations enjoy relatively high levels of economic freedom. At present, New Zealand has the highest economic freedom score (8.27) and Slovenia the lowest (6.56). Only Greece, Mexico, Turkey, and Slovenia are below the world average of 6.84. Unsurprisingly, there is less variation among the OECD nations than among the world as a whole. The standard deviation of scores in the OECD is half (0.42) that of the world (0.90).

The EFW index is calculated back to 1970 as the availability of data allows. *Figure 3.2* shows the average EFW ratings for the original 20 OECD members since 1970 and for all 34 members since 1995.[2] Two worthwhile ideas can be seen in figure 3.2. First, the average level of economic freedom has increased over the long run. This is true whether looking only at the original OECD members or all members. Second, while the average of the newer OECD members was once lower than the

Figure 3.2. Average ratings on the EFW index, OECD Nations, 1970–2012



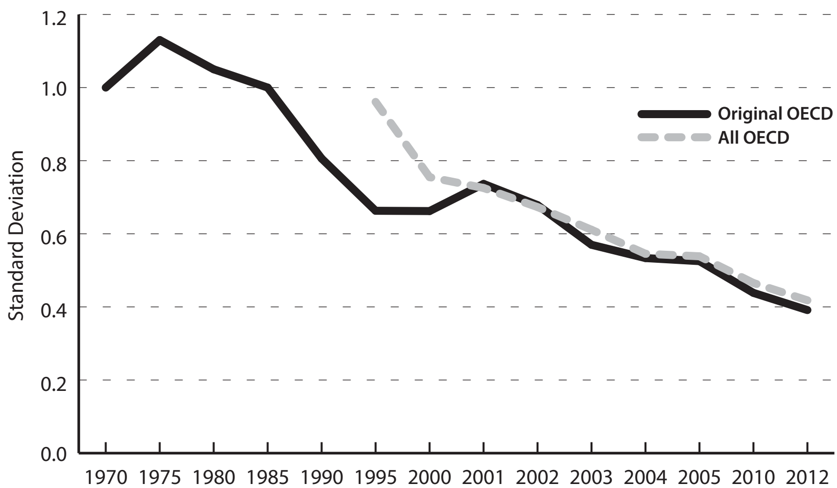
Source: Gwartney, Lawson, and Hall, 2014. Scores are from the chain-linked version of the EFW index.

2. The original OECD members all have data starting in 1970. 1995 is the first year in which data are available for all 34 countries.

original members' average, by 2012 there was essentially no difference in average economic freedom between the two groups. This is suggestive of convergence of economic freedom among the member states.

Figure 3.3 shows the standard deviation of EFW scores for the 20 original OECD members since 1970 and for all 34 current members since 1995. Here we see clear evidence of convergence among OECD nations. Among the original OECD members, the standard deviation began with a value of around one unit in 1970 but had fallen to 0.40 units by 2012. And, similar to the pattern seen in figure 3.2, although there was more variation initially when the new members were added, there is no long any difference in the variation of economic freedom when the original membership is compared with the expanded membership of the OECD.

Figure 3.3. Standard deviation of scores on the EFW index, OECD Nations, 1970–2012



Source: Gwartney, Lawson, and Hall, 2014. Based on the chain-linked version of the EFW index.

These patterns may surprise many observers who think economic freedom has to have been decreasing during this period. One needs to remember the intellectual environment of the postwar era continuing through the 1960s and 1970s however. Most of the high-income nations of the world were instituting their modern expansive welfare states during this period, and quite a few of them were dallying with outright centralized economic planning. Inflation, and in some cases such as Israel, borderline hyperinflation, was endemic in the 1970s and national wage and price controls were instituted even in the relatively economically free

United States. The intellectual climate matched the real world. Economists at the very top of the profession were advocating nationalization of industries and massive industrial planning (Thurow, 1980) and liberal (using the term in the correct sense) economists like Milton Friedman were considered fringe curiosities if not laughing stocks.

Consider how much the political and intellectual environment has changed since 1980. Privatization and deregulation of transportation, communications, and (on some margins) financial markets has taken hold. Marginal tax rates are down in almost all nations. Conscription is a dying policy in Europe in the post-Cold War era. Inflation of any significant degree is unheard of in the OECD and for that matter the entire world save for a couple exceptions like Zimbabwe and Venezuela. Tariffs are way down thanks to GATT negotiations and the creation of the WTO, and many nations have at least partially privatized their pension systems. The last few decades have even been called "The Age of Milton Friedman" (Shleifer, 2009).

Intellectually, there has been a resurgence of acceptability for the concept of economic freedom to the point where opponents have invented a new sneer-term, "neo-liberal", to describe the move toward more economic freedom since 1980 (Boas and Gans-Morse, 2009). While there is no one of Milton Friedman's stature living today (Klein, 2013), it is fair to say that there are vastly more adherents of economic freedom in the economics profession today than 30 or 40 years ago.

With all this said, there has been a modest reversal of the trend toward economic freedom since 2000 when the EFW index peaked for OECD nations. The average rating for the original OECD nations has fallen by 0.26 points since 2000, even while the overall average remained relatively constant (indicating offsetting improvements in economic freedom among the newer additions). Although the trend begins earlier, the financial crisis that began in earnest in 2008 has unleashed more regulations, nationalizations, bailouts, and economic stimulus in almost all these nations. It is hard to say if the gains to economic freedom won during the 1980s and 1990s will be entirely erased by this new trend.

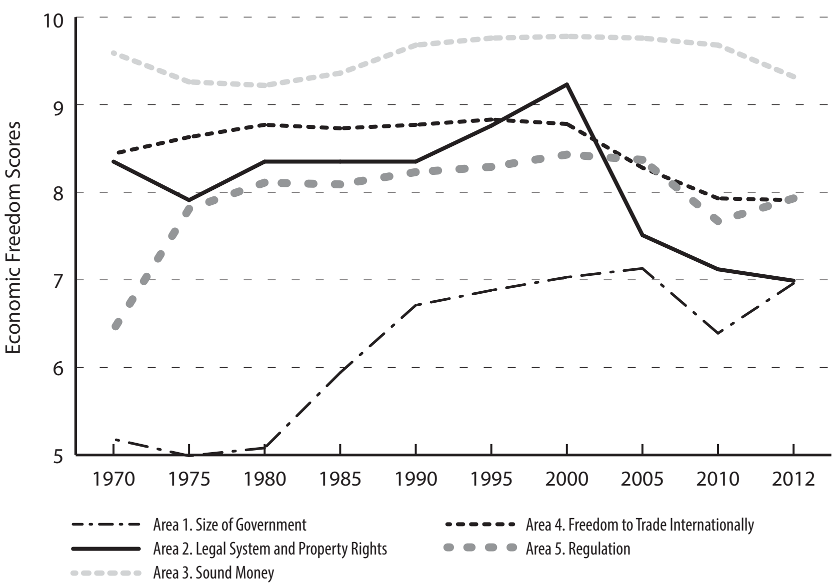
4. The declining economic freedom in the United States

Nowhere has the reversal in the economic freedom trend been more evident than in the United States. Throughout the period from 1970 to 2000, the United States ranked as the world's freest OECD nation (generally third freest economy overall behind Hong Kong and Singapore). The chain-linked summary rating of the United States in 2000 was 8.65. By 2005, the US rating had slipped to 8.20. The slide has continued. The 7.81 chain-linked rating of the United States in 2012 was more 0.8 units lower than the 2000 rating. Thus, the decline in economic freedom in the United States has been more than three times greater than the average decline in the OECD.

The 0.8 point decline in the summary rating between 2000 and 2012 on the 10-point scale of the index may not sound like much, but scholarly work on this topic indicates that a one-point decline in the EFW rating is associated with a reduction in the long-term growth of GDP of between 1.0 and 1.5 percentage points annually (Gwartney, Holcombe, and Lawson, 2006). This implies that, unless policies undermining economic freedom are reversed, the future annual growth of the US economy will be only about half its historic average of 3%.

What accounts for the US decline? While the US ratings and rankings have fallen in all five areas of the EFW index, the reductions have been largest in the Legal System and Protection of Property Rights (Area 2), Freedom to Trade Internationally (Area 4), and Regulation (Area 5). The plunge in Area 2 has been particularly alarming. In 2000, 9.23 was the Area 2 rating for the United States but by 2012 the area rating had plummeted to 6.99 (*figure 3.4*). While it is difficult to pinpoint the precise reason for the decline in Area 2, the increased use of eminent domain to transfer property to powerful political interests, the ramifications of

Figure 3.4. Ratings for Areas 1–5 of the EFW index, United States, 1970–2012



Source: Gwartney, Lawson, and Hall, 2014. Scores are from the chain-linked version of the EFW index.

the wars on terrorism and drugs, and the violation of the property rights of bondholders in the auto-bailout case have weakened the US tradition of rule of law. We believe these factors have contributed to the sharp decline in the legal system area.

Expanded use of regulation has also been an important contributing factor to the rating reductions of the United States. During the past decade, non-tariff trade barriers, restrictions on foreign investment, and business regulation have all grown extensively. The expanded use of regulation in the United States has resulted in sharp rating reductions for components such as independence of the judiciary, impartiality of the courts, and regulatory favoritism. To a large degree, the United States has experienced a significant move away from rule of law and toward a highly regulated, politicized, and heavily policed state.

Figure 3.5 reports the ratings for seven of the nine components in Area 2. Legal System and Property Rights.[3] All seven indicators, which come from three underlying sources, show declining values for the United States.[4] The magnitudes of some of the declines are truly remarkable. The measures for Judicial Independence (2A) and Impartial Courts (2B) have respectively fallen to values of 6.7 and 5.9 in 2012 from 8.0 and 9.0 in 2000. Could the expanded use of secret Foreign Intelligence Surveillance Courts (FISA Courts), where government requests are rubber stamped nearly 100% of the time be responsible for this? Is the interference of the executive branch of the federal government in the bankruptcy proceedings of GM and Chrysler responsible for this?

Component 2C (Property Rights) has fallen to 7.0 from 9.1. Could the Supreme Court's notorious *Kelo v. City of New London* decision in 2005 making it easier to condemn private property and transfer that property to politically connected private interests be the cause? Could the expanded us of civil asset forfeiture, in which the government can take your property without any proof of guilt, in prosecuting the war on drugs be responsible for this? Could increasing environmental, safety, and health rules and new acts like Sarbanes-Oxley, Dodd-Frank, and the Affordable Care Act be seen as a threat to property rights?

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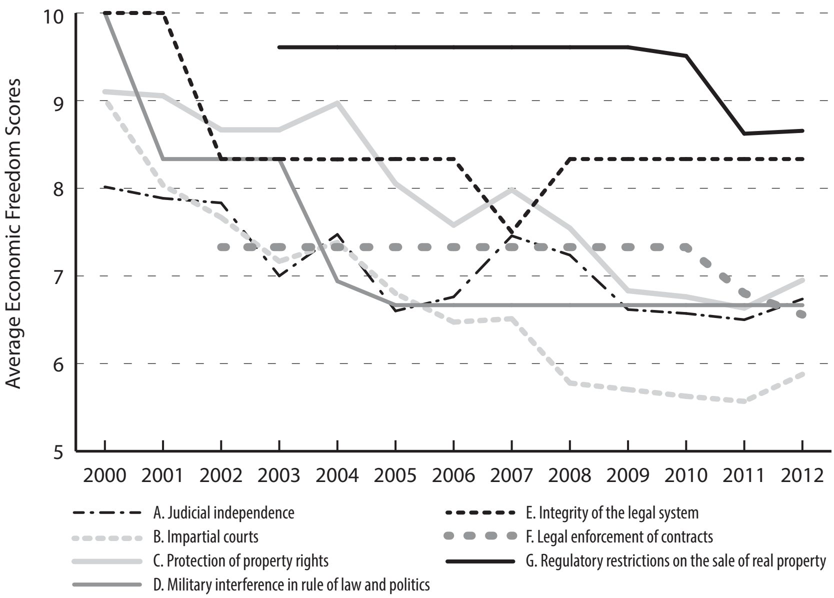
3. Components 2H (Reliability of Police) and 2I (Business Costs of Crime) are omitted from figure 3.5 because they have been included in the EFW index only since 2005. Both of these components have exhibited declines as well.

4. Components 2A, 2B, and 2C are from the World Economic Forum's *Global Competitiveness Report*; 2D and 2E are from the PRS Group's *International Country Risk Guide*; 2F and 2G are from the World Bank's *Doing Business* project. For details about sources, see Appendix: Explanatory Notes and Data Sources, pp. 231–243 in Gwartney, Lawson, and Hall, 2014.

Figure 3.5. Ratings for Components 2A–2G of Area 2. Legal System and Property Rights of the EFW index, United States, 2000–2012



Source: Gwartney, Lawson, and Hall, 2014. Scores are from the chain-linked version of the EFW index.

Component 2D (Military Interference in the Political Process) has fallen to 6.7 from 10. Could the growth of political power of the military and military contractors (for example, Hallibuton) be driving this? Or could the fact that local police officers now sport armored cars, assault rifles, and body armor and look more like soldiers at war than cops keeping the peace (Balko, 2013) be a factor? Could the nationalization of airport security by TSA agents be responsible?

The answer to all these questions is likely to be "yes". We will never know which of these various factors figure most prominently in the construction of these ratings. However, whatever the underlying causes, when multiple indicators from different sources each using very different methods arrive at the same conclusion, we should take the results very seriously. It is clear in the data that property rights and the rule of law are under attack in the United States.

5. Conclusions

The economic freedom of the world's most developed nations has changed a lot over the last 40 years. The post-war expansions of government power—reductions in economic freedom—were apparent in many countries such that by 1970 and

1975, when EFW data become available, many OECD countries had low scores for economic freedom. The effects of the Reagan and Thatcher political revolutions and the intellectual rebirth of classically liberal ideas led to increases in economic freedom and convergence among OECD nations. The so-called Washington Consensus of lower taxes, lower trade barriers, privatization, and deregulation is quite evident in the data in the EFW index. The last decade on the other hand has not been as kind to the cause of economic freedom.

Only time will tell if the recent reversal in the economic freedom trend is permanent or not. Most worrisome perhaps is that the United States appears to have clearly lost its high-ground status as the most economically free nation in the OECD. It is not at all clear which OECD nation, if any, will take up the mantle to champion an economically free future.

Appendix

Chain-linked EFW scores for all OECD nations, 1970–2012.

	1970	1975	1980	1985	1990	1995	2000	2005	2006	2007	2008	2009	2010	2011	2012
Australia	6.96	6.07	6.86	7.17	7.57	7.98	8.07	8.24	8.28	8.32	8.21	8.10	8.07	8.05	8.03
Austria*	6.08	5.93	6.33	6.34	6.98	7.16	7.55	7.84	7.81	7.79	7.68	7.62	7.60	7.58	7.46
Belgium*	7.44	6.80	7.06	7.03	7.35	7.43	7.89	7.53	7.50	7.54	7.46	7.42	7.52	7.48	7.40
Canada*	7.91	7.12	7.68	7.78	8.09	8.11	8.36	8.34	8.31	8.29	8.25	8.14	8.17	8.05	8.11
Chile	3.96	3.62	5.38	5.83	6.78	7.53	7.41	7.92	7.93	8.05	7.98	7.92	7.98	7.90	7.87
Czech Republic						5.84	6.53	6.92	6.91	7.14	7.17	7.09	7.13	7.17	7.30
Denmark*	6.84	6.24	6.39	6.53	7.26	7.73	7.92	7.94	7.96	7.97	7.87	7.74	7.94	7.83	7.71
Estonia						6.08	7.61	7.97	7.95	7.94	7.74	7.72	7.80	7.77	7.62
Finland	6.82	6.16	6.65	6.92	7.24	7.50	7.73	7.97	7.87	7.91	7.81	7.79	7.91	7.99	7.85
France*	6.63	5.93	6.09	5.99	7.07	7.02	7.31	7.38	7.38	7.58	7.49	7.47	7.49	7.45	7.27
Germany*	7.44	6.85	7.16	7.25	7.65	7.63	7.67	7.76	7.70	7.61	7.53	7.57	7.58	7.69	7.57
Greece*	6.33	5.86	5.76	5.14	5.99	6.44	6.91	7.31	7.27	7.33	6.92	6.79	6.88	6.77	6.80
Hungary			3.94	4.67	5.04	6.19	6.56	7.23	7.13	7.14	7.18	7.19	7.32	7.61	7.32
Iceland*	6.13	4.40	5.25	5.53	6.95	7.69	8.04	8.09	7.96	7.84	7.15	7.02	7.05	7.33	7.40
Ireland*	6.79	5.97	6.47	6.54	7.13	8.29	8.20	8.41	8.26	8.20	7.82	7.67	7.78	7.82	7.96
Israel	4.58	3.87	3.48	4.03	4.66	6.04	6.77	7.37	7.25	7.26	7.22	7.13	7.31	7.27	7.26
Italy*	5.98	5.17	5.37	5.57	6.60	6.66	7.36	7.33	7.23	6.85	6.76	6.72	6.79	6.81	6.88
Japan	6.78	6.38	6.88	7.05	7.58	7.50	7.90	7.79	7.75	7.74	7.65	7.50	7.58	7.48	7.58
Korea, South	5.39	5.26	5.49	5.54	6.31	6.67	6.79	7.26	7.44	7.47	7.26	7.18	7.28	7.30	7.27
Luxembourg*	7.47	7.62	7.51	7.82	7.79	7.93	8.02	7.72	7.70	7.76	7.77	7.66	7.65	7.61	7.52
Mexico	6.45	5.76	5.13	4.61	6.13	6.43	6.44	6.82	6.86	6.78	6.71	6.60	6.69	6.63	6.74
Netherlands*	7.04	6.55	7.23	7.28	7.60	7.95	8.21	7.92	7.84	7.84	7.78	7.63	7.64	7.76	7.63
New Zealand	6.32	5.69	6.35	6.21	7.82	8.84	8.52	8.56	8.26	8.50	8.41	8.36	8.37	8.51	8.27
Norway*	5.93	5.58	5.79	6.46	7.13	7.56	7.27	7.69	7.54	7.69	7.59	7.46	7.49	7.52	7.49
Poland				3.46	3.55	5.37	6.34	6.89	6.99	6.94	6.99	7.13	7.11	7.18	7.28
Portugal*	5.89	3.73	5.53	5.37	6.25	7.46	7.55	7.43	7.49	7.46	7.36	7.18	7.16	7.43	7.46
Slovak Republic						5.55	6.20	7.64	7.54	7.55	7.59	7.49	7.43	7.47	7.35
Slovenia						5.15	6.72	6.95	7.02	7.02	7.08	7.04	6.58	6.58	6.56
Spain*	6.41	5.85	6.10	6.08	6.57	7.25	7.54	7.60	7.55	7.52	7.44	7.22	7.32	7.50	7.26
Sweden*	5.51	5.35	5.68	6.47	7.11	7.28	7.62	7.58	7.53	7.52	7.49	7.53	7.73	7.67	7.56
Switzerland*	7.45	7.46	7.99	8.15	8.15	8.19	8.63	8.19	8.17	8.20	8.02	8.05	8.13	8.12	8.03
Turkey*	3.49	3.87	3.77	4.85	5.06	5.89	5.81	6.09	6.20	6.33	6.61	6.52	6.54	6.69	6.66
United Kingdom*	5.98	5.92	6.57	7.53	8.08	8.20	8.50	8.38	8.25	8.15	8.08	7.95	7.94	7.97	7.92
United States*	7.60	7.73	7.92	8.11	8.35	8.50	8.65	8.21	8.13	8.21	7.99	7.71	7.75	7.74	7.81

Note: * = original member of Organisation for Economic Co-operation and Development (OECD).
Source: Gwartney, Lawson, and Hall, 2014.

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4. Special Interests, Competition, and the Rule of Law

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Consider one day's headlines on legal topics drawn from the *Wall Street Journal*:

1. *FDA Nears Rule Shift on Food Ingredients* concerns a regulation 17 years in the making that concerns "ingredients used to thicken, preserve and flavor foods" (Tracy, 2014: A3). Self-declared "public interest" groups have sued, contending that the agency's notion of ingredients not subject to FDA regulation because "generally recognized as safe" is unsound. "The public deserves" that the FDA provide more "regulatory scrutiny over food additives".

2. *EU Official Decries Google Pressure* details a four-year probe by the European Union "competition commissioner" into Google's "manipulation" of search results (Fairless, 2014: B1). The commissioner explains that European politicians are concerned that European companies cannot keep pace with Google and, to add to the burdens of the antitrust officers, they have been "unearthing" Google's use of differential tax rates in different jurisdictions.

3. *OSHA Takes Aim at Dollar Tree* notes that the retail discount chain has been subject to $866,000 in fines during the past year, including $262,500 in fines for violations at one store in Watauga, Texas (Berzon and Ziobro, 2014: B2). The agency head explained that across the country each "store has some serious hazards". Hazards included boxes stacked too high and blocked electrical panels. No injuries have been reported but workers could have been injured.

4. *Board Backs Access to a Pricey Drug* explains that the Arkansas Drug Utilization Review Board recommended the state's Medicaid program end a legal battle by allowing use of a costly drug (more than $300,000 a year) called *Kalydeco* that treats cystic fibrosis (Walker, 2014: B2). Federal law requires drug makers to provide at least a 23.1% discount to Medicaid beneficiaries.

5. *Disabled-Access Lawsuits Surge* reports thousands of suits being filed against small businesses in the past year for violations of federal disability law that mandates accessibility requirements (Loten, 2014b: B4). For example, a thousand-square-foot hotdog eatery in Miami was cited for 30 violations. Lawsuits have risen sharply as "testers" are now used to look for violations as the basis of suit. Under federal law, defendants may be required to implement physical modifications and, while plaintiffs cannot sue for damages, the defendant pays legal expenses of both sides.

6. *Accessibility Claims Expected over Websites* is a companion article predicting a new crop of suits contending that websites, including apps, lack adequate access for persons with disabilities (Loten, 2014a: B4). The Department of Justice settled an accessibility suit with H&R Block and, in doing so, provided a "road map" for disability claims against websites that lack proper captions, text alternatives, and audio descriptions. Potentially hundreds of thousands of website and app providers could be at risk.

7. *Trial Turns to "Secrecy" at UBS* reports on the day's court proceedings in a Justice Department suit against a Swiss national who worked in Switzerland partly for American clients (Grossman, 2014b: C3). He was accused of abetting US income tax evasion by the use of, naturally, Swiss bank accounts.[1]

8. *Mortgage Rules Move Closer to Final Form* discusses the three-year process to finalize "long-delayed mortgage-market standards" as the Federal Reserve and five other regulatory agencies exercise powers expanded by the Dodd-Frank law of 2010 (Zibel and Ackerman, 2014: C3). The new rules will, regulators assure, prevent "a repeat of the 2008 financial crisis".

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1. Three weeks later the jury took less than an hour to acquit the defendant (Grossman, 2014a: C1).

Other articles in the *Wall Street Journal* that day noted other legal matters, but the preceding articles illustrate the domination of legal matters by regulations aimed at exerting public control over private behavior (Gershman, 2014: A6). These regulatory efforts are allegedly focused on preventing bad consequences of private actors' behavior. None are aimed at increasing the production of wealth by facilitating the creation of businesses or making it cheaper to conduct transactions. The best-case scenario for such regulations is that they will cost less to implement than the costs of the harms they avoid. Today this is how many people conceive of the role of law—to reduce or prevent bad consequences.

But there is another, and more important, role for the law: to facilitate the creation of wealth by making it easier and cheaper for people to engage in economic activity by organizing entities and conducting transactions. For example, when a government sets out clear default rules to govern the internal affairs of a business entity, it makes it less costly for investors to form such entities. That in turn expands commerce and increases wealth. Similarly, by establishing laws that facilitate contracting, the state can lower the cost of creating a contract.

Those were the concerns of much of the legal system until the Progressive Era began the expansion of the regulatory state and the crowding out of wealth-increasing laws by focusing on loss-avoiding regulatory activity. Similar efforts are key to justification of much legislation today. They create opportunities for special interests to use the legal system to gain unfair advantages over the public.

How to get "good law" puzzles legal scholars. Most academics (and probably most people) believe that we know it when we see it but why some jurisdictions have legal regimes that are generally regarded as supportive of personal and economic freedom, and others do not, is not clear. The larger puzzle is beyond our scope; here we discuss some features consistent with an economically productive rule of law and some reasons that defects arise in legal regimes.

The growth of the regulatory state

The primary beneficiaries of a focus on loss-avoiding regulatory activities are lawyers, bureaucrats, special interests in the private sector, and politicians. Those groups are the ones that know best how to manipulate the political agenda that receives broad support. These interests frame efforts to benefit themselves as public-spirited regulations. The news stories above can be recast as: protecting the public from poisons in food, protecting completion from a predatory monopolist, protecting employees from unsafe working conditions, allowing those afflicted with terrible diseases to have access to over-priced drugs, providing disabled persons the dignity of access to restaurants and other services that non-disabled persons enjoy, ensuring that all taxpayers pay their fair share, and preventing rapacious bankers from visiting another financial catastrophe on the nation. How one frames an issue counts for a great deal.

The role of lawyers

"Too many lawyers" is a common claim, yet the market for legal services shows signs of both oversupply of lawyers and undersupply of the services (Koppel, 2014: B3). Signs suggest the market for legal services is being disrupted by new businesses that provide services using technology, systems engineering, and business methods (Susskind, 2008, 2013). Lawyers can play crucial roles as "transaction cost engineers" or they can gum up transactions with efforts to block competition. Rather than attack the legal profession as a whole, as some have, we focus on legislatures' responsibility for this state of affairs. There is no doubt that it is also a result of action by bureaucracies, but solving the problem starts at the legislature.

By way of full disclosure, it should be noted that we work for state universities and, in previous careers, worked for regulatory agencies—that makes us bureaucrats. And we are both lawyers. Like our colleagues now and those in other government agencies, we are hired help. We follow and enforce rules and budgets set by legislators. We have some discretion but have no doubt that if we charge off in some non-sanctioned direction to achieve what we think would be greater glory, our employers would quickly rein us in.

Bureaucrats are not unconstrained free agents who invent rules and spend public money without oversight. Indeed, on the occasions when they attempt to do so, legislatures take action. For example, disgraced, former Illinois Governor Rod Blagojevich was impeached not only for his efforts to trade an appointment to the US Senate and other official acts for favors and contributions, but also for efforts to create a regulatory program and spend state money without legislative approval (Illinois House of Representatives).

It is important to focus on legislatures. While bureaucrats have some degrees of freedom, agencies exist because they are delegated authority to act by legislators, who often then disclaim responsibility for the costs of the resulting regulations. The key point is that, while bureaucrats may push the mission of their agency and will plead for bigger budgets and more authority, agencies' actions ultimately require legislative and administrative consent.

Legislators and special interests

After the election in 2014, when the Republicans recaptured control of the US Senate, there was discussion in media that the election results would produce change in many areas of federal regulation. However, as the next chapter documents, regardless of how dramatic election outcomes may appear to be, the regulatory state has grown continuously for decades. There are fits and starts, but the regulatory state never shrinks. This is not because the bureaucrats are out of control but because Congress and the President have not seen fit to roll back the regulatory state, occasional election rhetoric aside. Nor is it because it is impossible, as the rare successful deregulatory initiatives demonstrate (Stansel and McMahon, 2013: table 2.1b). In the 1970s, the commercial aviation, trains, trucking, telecommunications, and natural gas industries all were significantly (but not entirely) deregulated under the Carter and Reagan administrations. But in most areas of the economy and in our personal lives, legislative intervention generally expands, often eroding freedom and the rule of law.

Public Choice, a field largely invented by Nobel laureate James Buchanan and his colleague Gordon Tullock, is often called politics without romance (Buchanan and Tullock, 1962). Applying economic logic to the political arena allows the rose-colored political glasses to come off. We then see the political process more clearly by focusing on the incentives of participants in politics. Just as companies peddle products by advertising the benefits and ignoring the shortcomings, politicians sell themselves and their ideas in a highly competitive arena for votes and, then, political power.

The essence of Public Choice can be summarized briefly. Running for office requires garnering positive publicity, financial support, and votes. Issues must be framed in a way palatable to a potential majority of voters. Yet voters are rationally ignorant about most political issues: information is costly, there are hundreds of issues, and to become knowledgeable about all would take an immense amount of time, so voters focus on a few issues they care about, whether financial, such as support for teachers' unions, or non-financial, such as abortion. Even voters well informed about a specific issue generally know little about the nuances of candidates' views, even if the candidate has been in office and has an extensive record.

The sugar subsidy is often used in teaching principles of economics to illustrate economic damages when government subsidizes a domestic industry (Wohlgenant, 2014). Students are irritated to learn of the seeming foolishness and may ask why Congress allows this to go on, decade after decade. The answer is concentrated benefits and dispersed cost. Each American household chips in about $10 a year to sweeten the pot for domestic sugar producers. It is hard for an individual voter to get excited about a few bucks when other political policies mean so much more. Few of us know how our representatives vote on most issues—unless we are recipients of the benefits (and such measures are frequently buried in complex legislation). Congressional representatives from the few southern states where sugar cane is grown, and the few northern states where sugar beets are grown, pay close attention to this issue because sugar growers care a lot as they reap the benefits.

Sugar-grower representatives ensure continued support for sugar subsidies by trading votes in Congress ("logrolling") for, say, urban mass transit support that benefits this or that city but is of no value to sugar beet farmers in North Dakota who chip in for the transit subsidy. More is involved than just handing over money to sugar growers. Subsidies and regulations have complex results. For example, Chicago used to be a major candy-making center. No more. Pricey US sugar drove many candy makers out of the country (Lyderson, 2006). The sugar subsidy is surely not responsible for industrial decline in the Midwest, as a single nick in an economy matters little. However, make that a thousand nicks and the total damage is immense.

Politicians routinely claim they will not support legislation for special interests. But, if true, they are unlikely get to Congress or the state legislature, are ineffective if they get there, and generally do not last long in politics. It tends to be a winning strategy to rail against special interests but support the causes not branded as special interests that matter to your constituents.

Federal regulation of industry began on a large scale with regulation of the railroads. Mid-western farmers claimed that prices to carry grain to eastern markets were too high. Agricultural interests thought they had won a victory with the creation of the Interstate Commerce Commission (ICC). However, contrary to the expectations of agrarian interests, the agency was soon dominated by the industry it was presumed to control (Kolko, 1965). Farmers did not dominate the ICC, experienced railroad people did. An economist, viewing the same episode, documented that the railroads wanted the ICC as a way to have government protection for cartelization of the industry (Hilton, 1966). This is referred to as regulatory capture. Whether an industry originally seeks regulation or not, it has strong incentives to gain a strong position in the details of the regulation. Capture is possible because the public remains rationally ignorant of the intricate details of regulatory schemes.

Other times, moral crusades have political impact. Alcohol was illegal in the United States during Prohibition (thereby greatly benefiting Canadian alcohol vendors and Bahamian rum runners). Some alcohol vendors learned to benefit from the controls. Bruce Yandle first explained this in a landmark article that noted that bootleggers profit from the prohibition of the legal sale of alcohol and want restrictions to continue (Yandle, 1983; Smith and Yandle, 2014).

In more recent times, the moral and health crusade against tobacco products has produced numerous regulations on such products over the past 50 years. Seeing the threat, the industry played an active role in crafting regulations that have allowed the major cigarette makers to continue profitable existences in the face of less competition (Yandle, Rotondi, Morriss, and Dorchak, 2008). Politicians can play both sides of the issue—talking tough to the delight of those who wish tobacco to be prohibited while catering to the interests of the tobacco makers.

Legislators need not even engage in actual regulation; even the *threat* of regulation can benefit them. That is, legislators can credibly threaten to impose costly regulations on an industry. They gain the virtue of appearing to protect voters from misbegotten deeds of rapacious business practices, while bringing business interests running in the form of contributions. Professor Fred McChesney explains this as "Money for Nothing" (McChesney, 1997). While this may be seen as near extortion—contribute enough and we call off the regulatory dogs—it is legal and bolsters campaign coffers.

Of course, legislative interventions are necessary to control some problems. Few question the need for national defense, a judiciary, basic principles of tort, property, and commercial law, and other sensible roles for governments. There is an important role for the law in facilitating private transactions. For example, the Uniform Commercial Code, a version of a statute enacted in whole or in part by every US jurisdiction, draws upon long-established mercantile practice to facilitate commerce by providing sensible default rules to govern many aspects of business transactions (Mentschikoff, 1950; Kamp, 2001). Doing so enables businesses to spend less on drafting agreements, making the cost of transactions lower.

Similarly, states provide default rules to solve internal governance problems for business entities such as partnerships, corporations, and LLCs. These laws enable people to create business entities at lower cost, facilitating commerce. Tort law principles govern interactions between strangers where one party causes harm to another. Property law specifies the parameters of ownership and provides mechanisms through which ownership of assets can be verified cheaply, facilitating trading those interests. But we have gone far beyond the provision of ordinary public services expected of a government. Today we face a bewildering array of laws and attendant regulations that are incredibly complex. Regardless of the rationales for passage of the kinds of statutes that lead to the types of headlines noted at the start of this chapter, their existence means that it is ever more difficult to start and manage a business.

The challenge for governments is to find a balance between creating laws and regulations that facilitate the creation of wealth and protect persons and property from harm and laws that impose costs on one group to benefit another and reduce net wealth. Regulation can impede economic growth rather than facilitating it. For example, Google and Amazon have run up against regulatory barriers in the development of commercial drones. They have moved work to Australia, citing less severe regulatory environment there (Stewart, 2014). How then to get things done in the United States? Google "has hired a lobbyist firm to influence policy-makers to clear the path forward" (Neal, 2014). In the meantime, a Chinese firm has become the leader in the drone market (Nicas and Murphy, 2014: B3). When more roadblocks for new business developments exist in the United States than in China, something is amiss.

Historical roots

Regulatory states with broad powers do not appear overnight in functioning democracies—they evolve over time. In the United States, the seeds planted in the Progressive Era, which began with railroad regulation, bore fruit during the Great Depression, when the Roosevelt Administration and Congress turned to government to solve additional problems. The federal government enacted regulatory measures in the belief that increased regulatory control could lead to prosperity by reducing the bad effects of the Depression.

For example, the National Industrial Recovery Act (NIRA), passed in 1933, created the National Recovery Administration (NRA). The NRA's job was to establish codes for every industry under which markets would be divided among firms that agreed, with government oversight, to have "fair competition". In practice, that meant government-approved prices and wages and restrictions on the means by which firms could compete. In short, it established government-sanctioned cartels to organize every major industry in the United States. "Unscientific" price-cutting competition would be set aside in favor of a closely regulated industrial structure. The NRA quickly issued thousands of regulations, many of which were actually written by the affected industries themselves. This was a dramatic change in the role of the legal system, which had previously focused on facilitating voluntary transactions except when they were agreements in restraint of trade.[2]

Another New Deal regulation further illustrates how far such controls could go, as they still do today. The Agricultural Adjustment Act (AAA) of 1933 imposed detailed controls on agriculture, along similar lines to the NIRA's approach to manufacturing. Although held unconstitutional in part by the Supreme Court in 1936, Congress passed a new version that was almost as far reaching as the first version (*United States v. Butler*). This second version was challenged as well. The facts of this case are worth examining to illustrate the key difference between transaction-facilitating law and loss-avoidance laws.

Roscoe Filburn was born to a farm family in Ohio and made his living on his 95 acres, selling milk and eggs (Chen, 2009). Filburn also planted wheat, some of which he sold, some of which his family ate, and much of which was fed to his livestock. Under the terms of the second (1938) version of AAA, Filburn was told he could plant just 11.1 acres in wheat. Instead, he planted 23 acres and harvested 239 bushels of wheat more than his share of the federal quota. When agents of the United States Department of Agriculture discovered the extra acreage, Filburn was ordered to pay a penalty of $117.11, 49¢ for each extra bushel grown without authorization. The Supreme Court upheld the controls on planting limits and the fines imposed on lawbreakers (*Wickard v. Filburn*). Although Filburn argued that, because the wheat he grew was consumed on his own farm, it had not been sold in commerce, the Court found that "consumption of homegrown wheat" affected interstate commerce since his homegrown wheat substituted for wheat he would have bought in the market had he not grown his own: "That [Filburn's] contribution to the demand for wheat may be trivial by itself is not enough to remove him from the scope of federal regulation". Mr. Filburn alone does not matter, but let many farmers act similarly and there would be an impact on the wheat market. The Court found this sufficient to justify regulation of Filburn's private wheat patch grown for his own consumption.

In practice, *Filburn* means that Congress can regulate commerce down to the smallest level. The Commerce Clause says Congress may regulate only commerce

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2. The Supreme Court struck down the NRA codes in 1935 as beyond the constitutional power of the federal government to regulate interstate commerce, which had been the asserted basis for the NIRA (Schechter, 1935).

that is interstate, but because the actions of individual actors within a state can, in the aggregate, affect interstate commerce, regulatory powers over business are nearly unlimited. In the decades that have passed since *Filburn*, Congress has not been shy about imposing detailed national regulations on business. The Supreme Court cited *Filburn* as part of the justification for the federal ban on medical marijuana, even if grown for personal use (*Gonzales v. Raich*). As these regulations are layered upon one another, the result has been increasing legal complexity, which is itself an important cost.

Legal complexity

Some legal matters are unavoidably complex. Later we will review some complex areas of law that provide competitive benefits, where the complexity is required by the nature of the issues addressed. However, regulatory regimes are often complex for non-productive reasons, which deters economic activity. This complexity can be by design, to reduce competition by raising the cost of attempting to compete. Professor Peter Shuck argues that complexity is costly, is increasing, and does not result in greater justice (Schuck, 1992). Shuck's framework is useful for thinking about the structural legal problem we face in a system of ever-increasing rules. He argues that complexity has four dimensions: density, technicality, differentiation, and indeterminacy or uncertainty.

Dense rules

Dense rules are numerous and cover in detail certain kinds of behavior and transactions. Specific terminology is important and permission is often required from authorities. Schuck gives the example of pension law. Any one who has looked into the Employee Retirement Income Security Act of 1974 (ERISA) realizes that you either become an expert in the field or are a danger to yourself and others. Dense rules reduce transactions by raising the level of investment necessary to determine whether a transaction is permitted.

Technical rules

Technical rules require expertise to understand and use, so ordinary citizens (that is, anyone but an expert) rarely can comprehend them. The Internal Revenue Code is a prime example: interpreting the tax code requires special expertise and knowledge of a bewildering array of regulations, revenue rulings, and other material in addition to the statutory language. (The Code is also dense as it runs to

18,000 pages.) Technical rules impede economic activity by raising the cost of complying with them when engaged in economic transactions. On the margin, there will be fewer such transactions as a result.

Differentiated rules

Differentiated rules occur when an area is subject to multiple sources of legal constraints. Schuck illustrates the issue in the case of product safety—there are multiple federal and state laws, standards issued by private organizations, and provisions of tort and contract law. The same is true of some areas of property law—there are overlapping federal, state, and local rules that apply to particular properties on everything from historic preservation (generally trying to prevent changes to buildings) to disability access (generally requiring changes to make buildings more accessible). Adding differentiation to a regulatory effort can make the rules more accurate, but it can also raise the cost of engaging in economic activity, as actors must determine, for each transaction, which rules apply (Morriss and Dudley, 2006).

Uncertain (or indeterminate) rules

Uncertain (or indeterminate) rules are flexible rules and institutions that can be difficult to define and are often determined in practice by the facts of the particular matter at hand. In torts, the "reasonable person" standard governs in negligence. What is "reasonable" depends on the circumstances, making predictable application of the rule in advance difficult. This can be true for administratively issued regulations as well—efforts to distinguish "abusive" tax shelters from legitimate tax avoidance raise the same type of questions.

The complexity problem is especially salient when Congress or a state legislature grants authority to a bureaucracy to regulate an issue. The bureau responds with dense and technical regulations. Despite all the detail, agencies retain significant discretion in deciding which rules will be enforced, when they will be enforced, and against whom they will be enforced. That is, the rules are, despite their density, still uncertain and differentiated in terms of who will run afoul of them.

Prior to the New Deal, Schuck notes, most matters among private parties were largely governed by private law. Since then, an explosion of legislation has greatly expanded administrative rules to cover many aspects of business and people's conduct of their private lives. Administrators and judges, interpreting statutes and regulations, frequently have significant discretion in applying these rules. That results in uncertainty. This in turn means people face greater costs in conducting transactions and organizing their lives.

Are we, short of a wholesale legal revolution, doomed to live in a world of ever expanding and intrusive law? Schuck's categorization of the current legal regime is instructive and illustrates much that is wrong. However, not all legal complexity need be wasteful or held in suspicion. As we develop next, complex legal regimes appear to be necessary for the functioning of certain markets and are, therefore, beneficial. Why they arise in some places and not others deserves attention.

Competition in law

In the same way that competition among market actors lowers costs and prices, increases variety, and improves quality, so too does legal competition among jurisdictions. Just as jurisdictions compete to attract economic activity to their territories, they can use their legal systems to enhance their competitive positions. Competition among jurisdictions within a country, where subnational jurisdictions can compete, as in Canada and the United States, and across countries provides incentives for legislators to constrain their natural desire to exploit their power to impose more legal controls that serve to make them and their positions more valuable.

The result of competition is seen in the Fraser Institute's *Economic Freedom of the World* (Gwartney, Lawson, and Hall, 2014). More wealth is created in countries with less wealth-destroying, transaction-inhibiting law. Even within countries, legal competition provides benefits. Residents of Saskatchewan enjoy more freedom than do residents of Quebec, just as residents of Florida enjoy more freedom than do residents of New York. National governments sometimes allow competition within their borders. For example, in Canada and the United States, provincial and state governments, and cities within those jurisdictions, have the ability to differentiate themselves in taxes and regulation. Personal income-tax rates in Alberta are capped at 10% while they rise to 21% in Nova Scotia (Canada Revenue Agency, 2014). In New York, an average of 12.6% of personal income goes to state and local taxes while it is 7.5% in Texas (Tax Foundation, 2014). Alberta has greater labor-market freedom than does Prince Edward Island; North Carolina has greater labor-market freedom than does New Mexico (Stansel and McMahon, 2013).

Subnational governments can make themselves more attractive to residents and businesses. Firms do not leave California for Texas in search of better scenery or weather: it is sometimes to take advantage of a less burdensome tax and regulatory environment. How a state can make itself attractive for business opportunities is illustrated by the case of Delaware as the most favored location for firm incorporation. Designing legislation in response to business can be catering to special interests. However, Delaware's story is one of responding to substantive business reasons, not because there has been a "race to the bottom" to get away with looting shareholders or lining the pockets of legislators.

Corporate law

At one time New Jersey was the dominant state for incorporation, which is a matter of state, not federal, law (Yablon, 2007). But New Jersey damaged its reputation for consistent, reliable law by making major changes in its corporate law in 1913 that restricted businesses ability to organize as their owners saw fit. Delaware responded by adopting the pre-1913 New Jersey law and accepting as binding prior New Jersey precedent interpreting it. Delaware effectively promised that it would respect the interests of the users of corporate law and not make the law a matter of political whim. Delaware located the interpretation of its corporate law in the Court of Chancery, where there were no juries, and soon developed a reputation for appointing only particularly knowledgeable judges to that court. Not only did this promote legal stability, but it ensured that the law could adapt to meet future needs. As firms moved their state of incorporation (which does not require a firm to have a physical presence in the chosen state) to Delaware, the state began to benefit from having the best corporate law. Thousands of firms pay annual registration fees and Delaware attorneys and corporate services companies earn fees representing the firms that select Delaware as their corporate home.

Because Delaware offers high-quality law in the corporate area, the state earns significant revenue that accounts for about 25% to 30% of the state budget (Bainbridge, 2014; Wayne, 2012). In effect, this fiscal dependence serves as a "bond" for Delaware's continued adherence to its side of the bargain. If Delaware began to behave badly by changing the law in foolish ways, companies could easily change their state of incorporation. That this would dramatically reduce state revenues gives Delaware's legislators and judges an incentive to ensure that they are not perceived to have reneged on the bargain. By contrast, revenues from corporate fees make up a tiny fraction of the California state budget, giving that state's legislators and courts little reason to care if the owners of California businesses find the state's laws governing business organizations unhelpful. Not surprisingly, more Fortune

500 companies are incorporated in Delaware than in any other state. Analyses of stock-price changes following the move of a corporation's domicile to Delaware generally find that the price of the stock increases after the move—a sign that investors approve of the governance solutions provided by Delaware law. The fact that other states can offer to provide quality law and legal services in that area disciplines the legislature in Delaware from reneging and attempting to extract revenue from firms.

Similarly, as limited liability companies (LLCs) have become popular, states competed to be attractive places for registration of this organizational form of business. Although LLCs were first given legal status in the United States by legislation in Wyoming in 1977, the form quickly spread to other states, which developed market niches that lured LLC owners to use their states. Nevada has emerged as a significant state for LLC organization. The Nevada LLC statute emphasizes flexibility, low fees, and provides specialized courts to handle disputes related to LLCs. Having gained a reputation for good law in this area, Nevada has little incentive to debase the law as its LLCs can migrate their legal home elsewhere and other states know that to compete for more business registrations they must offer quality business law and courts.

International competition for financial services

We generally think of regulation as stifling competition, but competition among regulatory regimes can produce higher quality regulation that is attractive to business interests. A few decades ago the market for international debt securities was less than a trillion dollars. Today it is tens of trillions as money moves globally to seek the best opportunity. Tariffs and other trade restrictions have generally been reduced through GATT and WTO agreements, which also spurred investment in other nations. Governments that resist free trade and integration into the global economy deny better lives for their citizens, North Korea being the sickly poster boy for a lack of economic openness.

As the number of countries expands (the UN began with 51 members and now has 193), the number of competitors for capital has increased. Government leaders do not always want investment for the betterment of the populace. Leaders may intend to expropriate wealth, or decide to do so once it appears, but investors understand this reality and make choices based on evaluation of risks. Invest in Switzerland and the chance of government expropriation (either directly or through inflation) is low; invest in the Central African Republic or Venezuela and the chance of expropriation is high. Improve the investment climate, as China and Chile have done over the last 30 years, and more cash flows in to create jobs and wealth. How to get government leaders to behave and not steal is the great unknown in economic development but, in general, competition for capital has meant gradual improvements in economic freedom around the world. People, like capital, migrate to where there are opportunities.

Countries have different comparative advantages. Remote places with small populations are unlikely to be competitive locations to build cars, but they can become attractive locales to produce goods that do not require a large labor pool, such as financial services. Since World War II, a number of small jurisdictions with few alternatives learned how to develop regulatory and legal regimes that would lure international financial services business.

For example, the Netherlands Antilles, a Dutch colony in the Caribbean near Venezuela, was one of the first to create a legal regime specifically designed to attract international investment. By the 1970s, it had a role as the jurisdiction that facilitated US companies tapping into the growing "Eurodollar" market of US dollars outside the United States, enabling these firms to reduce their capital costs significantly. How did a tiny Dutch territory become the preferred location for issuing US corporate bonds?

It was the result of a combination of an entrepreneur, notary Anton Smeets, and some historical accidents that created an opportunity that Smeets was clever enough to seize (Morriss, 2010). When oil was discovered in Venezuela in the early twentieth century, the Anglo-Dutch refiner Royal Dutch/Shell was eager to exploit the oil field but reluctant build an expensive refinery operation in unstable Venezuela. Close to the Venezuelan coast, the islands of Curacao and Aruba offered excellent natural harbors and the stability of Dutch law. Oil companies like Royal Dutch/Shell built their refineries on those islands and brought crude oil from Venezuelan fields to the islands. This arrangement necessitated the development of a professional workforce of accountants, lawyers, and notaries (an important profession in civil law systems such as the Netherlands') to help administer the refining companies and the other firms that grew up around them. When German armies massed on the Dutch border early in World War II, the Dutch multinationals wanted to safeguard their international assets from the Nazis. If the companies remained headquartered in the Netherlands, the Germans would acquire ownership by making Dutch shareholders an offer they could not refuse, giving the Nazis title to extensive assets around the world in neutral countries. (The Germans did indeed manage to acquire, at a substantial discount, many Dutch businesses after the invasion.)

Under Dutch law, the legal "seat" of the corporations (the civil law equivalent of the state of incorporation under US law) could be cheaply and quickly relocated to other parts of the Kingdom of the Netherlands. Anton Smeets proposed to manage the legal affairs of companies that chose to relocate their legal seats to Curacao and many Dutch multinationals accepted. Smeets formed a firm to do so, CITCO, which continues to be a global leader in the corporate services market. As a result, a vibrant business in managing the legal affairs of Dutch companies developed on the island during the war years.

After the war, many multinationals returned to the Netherlands, but the infrastructure remained in place. Smeets and others persuaded the Curacao government, which had substantial autonomy in tax and business law under the post-war Dutch constitution, to adopt a "ring-fenced" tax regime, allowing businesses registered in the jurisdiction but not actually operating there to pay just 10% of the normal corporate tax rate. This gave such firms an effective tax rate of 2.4% to 3.0% percent, well below the level of taxation in most of the developed world. When the United States and the Netherlands extended the post-war tax treaty covering the European portion of the Kingdom to cover the former colonies now made into formally equal constituent parts of the Kingdom, US firms that created subsidiaries in the Antilles were exempted from the 30% tax on payments to foreign persons or entities that applied to many payments by Americans to foreigners.

Over time, a large market in Eurodollars grew, particularly in London. As deposits in foreign banks, Eurodollar deposits were unregulated by the United States government. As foreign currency deposits, they were exempt from a great deal of local banking regulation in many countries, particularly the United Kingdom. Thus a huge pool of Eurodollars available for investment grew as the United States spent billions on the Marshall Plan and on defense activities in Europe and elsewhere. Countries that feared US sanctions on their financial assets, including the Soviet Union, also sought to keep their dollar assets outside US financial institutions.

When US interest rates rose in the 1960s as a result of the Johnson administration's increase in federal spending to simultaneously fund the Vietnam War and the "Great Society" social programs, the United States imposed restrictions on using US capital markets to fund international business (Boise and Morriss, 2009). The combination of money free from those restrictions and the lower interest rates available in the Eurodollar market was attractive to US companies seeking funds. By the 1970s, virtually every major US corporation had a finance subsidiary in the Netherlands Antilles to gain access to the Eurodollar market. As a result, Curacao was the largest Caribbean offshore center.

The Curacao story has an unhappy ending (for Curacao). As the use of Curacao entities grew, US law enforcement agencies began to worry that these entities were being used to conceal ownership of assets. Someone could form a Curacao entity, issue bearer shares as the means of ownership, purchase US real estate, then sell the bearer shares to someone else. Since there was no registry of share ownership, not only did the use of the Curacao entity make the ownership of the US property anonymous but the transfers could be done without reporting and so without alerting US authorities that taxes might be owed. The IRS also became concerned that Americans were using this same device to create entities that they paid money to (creating an expense against their US income) and which was then taxed only at the 2.4% to 3% Curacao rate under the treaty, but returned to the US investor. Again, bearer shares would enable an American to illegally evade taxes using this method. After unsuccessfully attempting to negotiate limits to the treaty's use, the Reagan Administration cancelled the tax treaty with the Antilles in 1984. To prevent this from harming US firms' access to the Eurodollar market, the United States simultaneously ended the need for structures like those provided by the Antilles by restructuring the 30% tax on bond payments to foreigners to eliminate the need for an intermediate entity.

During this same period, other jurisdictions developed their own niches in financial services. In the Western Hemisphere, Bermuda developed as the global center for insurance companies and reinsurance companies; the Cayman Islands created banking and trusts laws that drew business; the Bahamas developed an extensive offshore banking business. In Asia, Hong Kong and Singapore developed roles as financial centers. In Europe, Guernsey, Jersey, the Isle of Man, Luxembourg, Lichtenstein, Gibraltar, Malta, Switzerland, Andorra, and others developed financial sectors. Like Delaware, these are small jurisdictions with few natural resources and small labor forces.

But it was not just these jurisdictions that became providers of law for organizing financial transactions. London and New York became the major centers, offering their own specialized legal regimes. For example, it was the United Kingdom's restraint in regulating Eurodollar transactions—and the belief of financial institutions that such restraint would continue—that made London the center of the Eurodollar market in the 1950s and 1960s. This is remarkable as it occurred even as Britain heavily regulated and taxed domestic financial transactions, imposing both exchange controls on transactions in sterling, and punishingly high marginal tax rates on individuals' and firms' domestic income. In New York, the bond market grew based in part on New York state law governing bonds, with the crucial feature being a relentless focus on the language of the offering documents and an unwillingness to go beyond it in most circumstances. This history of government restraint in this area gave investors certainty in how they would be treated in the future.

Of course, any country can produce laws that look good on paper; committing to following the laws so that investors have confidence is a critical piece in developing as a financial center. Here the same dynamic is at play as in the comparison of Delaware and California given earlier. If a large country were to renege on the quality of its financial rules, it would suffer damage that would have minimal impact on government revenue. If a small country such as Luxembourg were to do so, the damage would be severe. This "bonding" effect means that smaller jurisdictions can do a better job of credibly committing to maintaining a stable corporate law regime. Further, given the importance of the financial industry to their economies, the legislatures in smaller jurisdictions are much more likely to pay attention to needed changes in the law that are responsive to changes in technology and business organizations. While, as we will see, some corrupt countries become involved in financial services, they do not become major players and often have short lives in that market. More honest regimes attract business over the longer term; Luxembourg is stable and honest (Transparency International, 2013).

Building a jurisdiction on law

In the 1950s, the Cayman Islands were three small, mosquito-ridden, islands with few sources of income—fishing, thatch rope making, and a small amount of tourism (small because of a lack of infrastructure and the mosquitos). The government supplemented meager income by issuing postage stamps for collectors. Today the Cayman Islands are no larger physically (although no longer mosquito-ridden) but their economy is far more robust as a result of financial services (high-end tourism has increased largely due to the financial services business) (Freyer and Morriss 2013). How did these three small islands go from relative poverty in 1960 to pass Britain in GDP per capita by 1980? As with the Netherlands Antilles, a key component was the development of a legal regime that attracted international business.

As Britain shed many of its colonies in the 1950s and 1960s, the Cayman Islands opted to remain affiliated with Britain. Beginning with the 1960 Companies

Law, based on English corporate law, Cayman made a concerted effort to enter the competition for international financial business. Over the 1960s, it added additional statutes creating or clarifying just how various business entities (banks) and relationships (trusts) could be established. Cayman used its lack of direct taxation (although Cayman had plenty of indirect taxes) to attract business, since this allowed entities organized in the Caymans to pay only fixed licensing fees rather than the hefty direct taxes being applied in most developed economies. This made Cayman a neutral location for multinational investment pools, keeping the cost of organizing such efforts low.

When the Bahamas became independent in 1973, investor concern over the post-independence government's efforts at "Bahamianization" of the financial sector workforce led a number of foreign banking investors to shift operations to Cayman. It had modeled its banking statute on the Bahamas' and had licensed banks doing business in the Bahamas in Cayman. Thus, like Delaware's success in persuading companies incorporated in New Jersey to relocate when New Jersey attempted to renege on the regulatory bargain it had made with firms, Cayman was able to capitalize on the Bahamas' misstep.

Beginning in the 1970s, Cayman also began to develop a sophisticated regulatory system that enhanced that jurisdiction's reputation and reduced the cost of doing business there. Although sophisticated financial professionals use Caymanian entities, Cayman opted not to mimic the retail-investor-oriented type of regulation in the United States but instead to focus on preventing risks to the jurisdiction's reputation. It did this by relying heavily on a system built around licensed professionals, whose interests were to preserve the future stream of income possible from their licenses. This encouraged these professionals to report any problematic behavior by businesses to the regulators but allowed the regulators to have a lighter touch and to impose fewer costs on regulated entities than regulators in many other jurisdictions.

Cayman also invested in creating sophisticated statutes and regulations that facilitated particular transactions, such as creating captive insurance companies and investment funds. Caymanian legislators acted much like Delaware's legislators, regularly suspending partisan hostilities to pass legislation needed to enhance the competitiveness of the financial sector and being careful to keep fees at a level that would not—as legislators regularly put it—"kill the goose that laid the golden eggs".

Another key advantage for Cayman has been its continued affiliation with the United Kingdom. Not only has Britain provided considerable technical support over the years, but Cayman's British affiliation means that its court of final appeal is the Privy Council in Britain. This access to one of the world's highest quality courts gives investors confidence that the rule of law is likely to be respected. Similarly, the regular practice of bringing in visiting judges from the Commonwealth to hear sensitive cases has provided further assurances of judicial independence.

Of course, Cayman's regulatory efforts are far from perfect. The government has made plenty of missteps and the Islands face challenges today. What is remarkable is the degree to which Cayman has avoided wrecking its financial sector while growing to be the fifth largest financial center in the world economy. This success is due to a remarkable record of value-added regulation, in which the Islands have competed for business by enhancing the rule of law and by crafting regulations that promote transactions rather than impede them.

The competitive market for law

The existence of Cayman as a competitor in this market for law has been important for the United States. As Professors Erin O'Hara and Larry Ribstein noted in their seminal book *The Law Market*: "Parties, in effect, can shop for law, just as they do for other goods. Nations and states must take this 'law market' into account when they create new laws" (O'Hara and Ribstein, 2009: 3). Failure to do so, the case in many jurisdictions, means that capital and people are likely to flee to better opportunities, generating greater wealth for residents of jurisdictions that provide better institutions for markets.

Consider captive insurance, a structure by which a business creates its own insurance company to cover its own risks. Why create your own insurance company? Many non-profit hospitals use captive insurers to handle their medical malpractice and other insurance needs. Because a hospital has a better ability than do non-captive insurers to assess the adequacy of its own procedures and staff quality to prevent malpractice from occurring, it is in a better position than a third-party insurer to assess its real risks. In short, a captive owner has an incentive to manage risks to itself that is lacking in market transactions where the cost of accurate disclosure of risks may be higher premiums and the value of safety measures is captured across many firms that participate through the insurance provider. Many industries make use of captive insurance, including trucking and manufacturers with warranties to fund.

Cayman and Bermuda were early leaders in the captive market, but Colorado passed the first US captive statute in 1972 (Morriss and Estes, 2014: 5). Few other states followed until the market had developed offshore. Nine more states adopted captive statutes by 1992 and more quickly followed as the number of domestic captive insurance companies doubled between 1992 and 2000. The captive market grew, in part, because jurisdictions competing for business innovated regularly. For example, Guernsey created a new form of captive, the protected cell company, which was swiftly copied by US and other offshore jurisdictions. Protected cell companies essentially allow "siloing" insurance reserves in what might be thought of as different virtual companies within a single entity, increasing the ability to customize strategies for particular risks. Between 1999 and 2005, 15 US jurisdictions implemented protected cell company legislation.

The most successful US jurisdictions, Vermont and Hawaii, have amended their statutes more than 30 times; in Hawaii's case, there have been an average of 1.36 substantive amendments per year. This suggests an impressive level of legislative attention to a highly specialized body of law, which appears to be a key factor in success in the market. Morriss and Estes (2014) found a 0.491 positive correlation between the number of material amendments per year and the number of captive insurance companies registered. A comparison of the relative success of US jurisdictions suggests that those that reinvest a portion of the revenue from their captive license fees into promoting the jurisdiction have done better than those that do not.

Bad actors (eventually) lose in the competitive law market

The role of law in promoting economic growth in the Caymans contrasts with the sad experience of Antigua's efforts to establish a financial center without investing in developing the necessary legal infrastructure. Like the Caymans, it had limited economic opportunities beyond tourism, fishing, and agriculture. It too sought to become a center for financial activities. Unfortunately for Antigua, rather than entice a group of Oxbridge law graduates with practical experience in London, the government decided to work with American Allen Stanford and his Stanford International Bank. Stanford invested heavily in local politicians. He became a major donor to the ruling political party, set up a newspaper to promote his allies, and spent heavily on promoting Caribbean activities such as cricket tournaments that bought him influence and goodwill. He was able to capture the Antigua financial regulatory agency, even serving on its board himself at one point—a staggering conflict of interest for the owner of the largest regulated entity. By 2008, the bank claimed $8 billion in assets, mostly invested in its certificates of deposit.

A private investment analyst, Alex Dalmady found the claims of consistent, high returns suspicious, and in 2009 wrote a widely distributed report suggesting the investments were part of a fraud scheme. Investors could believe his report or not. At the same time, the top Antiguan financial regulator rejected Dalmady's analysis and announced that he believed Stanford's operations were legitimate, saying: "I have never in my eight years here seen a letter from a customer of the bank complaining they had not been paid", and that: "We are not turning a blind eye, but at the same time we cannot allow the blogosphere and press articles to distract us. We have to make sure that when you have a good client that we have never found wanting, we have to stay the course" (Ishmael, 2009).

Later, some of Stanford's employees sued Stanford in the United States for employment discrimination and alleged that he was running a Ponzi scheme. This came to the attention of the US Securities and Exchange Commission (SEC) and the agency launched an investigation that ultimately led to Stanford's indictment on charges of conspiracy, wire and mail fraud, obstruction of the SEC investigation, and conspiracy to launder money based on his activities in the United States. Stanford was ultimately convicted of federal criminal charges and sentenced to 110 years in prison. Antigua was not a credible jurisdiction for financial services. Credulous investors who wanted to believe Stanford's claims of above-market rates of return were taken in.

The key lesson from Antigua's experience is the need for market-assisting legal measures. Allowing a regulated financial entity to dominate a government regulator prevents the development of market-facilitating regulation and instead facilitates fraud.

Basic rules of law, not minute regulation

At the start of this chapter we noted several articles about law that happened to appear in the *Wall Street Journal* on one day. While we have focused on regulatory competition in the financial services and business organization areas, let us return to those examples and contrast the regulatory regimes we are now under compared to what might exist under a stable legal regime not imposing needless complexities.

FDA Nears Rule Shift on Food Ingredients

The first story concerned new FDA regulations for food additives that have been many years in the making. Congress gave the FDA immense powers to regulate food. The result is that industry spends billions a year meeting detailed food regulations that, besides increasing food costs, tend to push toward uniformity. For those who decry the standardization of our diet, part of it can be explained by the need for producers to follow dense federal rules, whether they make sense or not. A side impact of these rules, as is true with many, is that it becomes ever more difficult for a mom-and-pop start up to enter the food product industry. All producers are subject to the same requirements to prove compliance with detailed regulations. Little firms are at a significant disadvantage. Finally, if a company poisons its customers by putting some bad ingredient in its product, it will be sued in tort. Companies have strong aversion to such litigation and the bad publicity it brings.

EU Official Decries Google Pressure

The next story concerned the EU's complaining that Google "manipulates" search results. If you are old enough, you will recall the same shrieking that went on in Europe, and in the United States, about 20 years ago, due to Microsoft's Internet Explorer's domination of the search-engine market. Just as Google now must spend millions on high-priced lawyers and lobbyists, Microsoft similarly spent huge sums defending itself in a case involving a service it invented and gave away. "Unfair monopoly!" cried the critics. The antitrust suits in the United States, an area of law that is highly uncertain, gradually withered away. Does anyone think Internet Explorer is a monopoly today? Competitors were free to offer alternatives, as they did. Similarly, others can offer services to compete with Google.

Simplistic notions about competition are used to justify attacks on the very firms that drive innovation and higher standards of living. Joseph Schumpeter wrote about the unsettled manner in which competition progresses in a free market. He called it the process of "creative destruction" (Schumpeter, 1942: 83). Innovators enter the market. Many fail but, of those who succeed, existing interests fear the threat. Uber and other software-based firms are roiling the staid, monopolized taxi market.

OSHA Takes Aim at Dollar Tree

In the third example, Dollar Tree stores were required to pay a fine to the Occupational Safety and Health Administration (OSHA) for numerous safety violations. Boxes in the storerooms were piled too high. Some boxes were in front of electrical panels. Why were the boxes piled high? Largely because the holiday inventory had come in; retail sales go way up during the holidays, so the stores need more merchandise. That aside, who is to say that the rule saying boxes cannot be piled more than the federally mandated inches high is the optimal height? Even if a little lower, boxes could still fall. If piled three inches higher, the added risk is miniscule. Even OSHA noted there had been no injuries, but you cannot be too careful! Yes you can. Safety is costly. Companies are supposed to comply with dense OSHA regulations that control nearly every aspect of physical operations. Are the rules beneficial? The stores owners know that if they endanger their customers or employees, lawyers will be happy to represent them in litigation for the damage caused by negligent acts. No retailer wants such problems. OSHA's inability to compare the costs and benefits of its regulatory efforts prevent the agency from such considerations and, on the margin, are likely to expand the regulatory regime past the point at which the regulations add value.

Board Backs Access to a Pricey Drug

The next story concerned a costly drug being approved for use in treating cystic fibrosis under Medicaid in Arkansas. The poor are provided access to certain medical benefits under Medicaid. Drug companies are required to sell their products at significant discounts under such government coverage. When drug companies sell their products in different markets at different prices, there are complaints about price discrimination, but that is exactly what federal law requires when selling to recipients of certain government benefits. The drug companies face what Schuck calls uncertain law, as state and federal rules can be in conflict.

Disabled-Access Lawsuits Surge

Fifth among the stories was one concerning the rise of disability access suits to places of public accommodation such as restaurants. Small hot dog parlors must retrofit to meet federal standards for wheelchair and other disability access. The one mentioned in Miami had 30 violations. No one would disagree with the idea of granting respect to persons with disabilities but, if every business must comply with costly regulations, small businesses tend to be at a disadvantage relative to the cookie-cutter corporate chains that have standard designs that comply with all regulations. Quaint little hot dog shops will go by the wayside. In many instances, no disabled person has complained; rather "testers" go looking for violations of uncertain and dense federal rules and then bring suit.

Accessibility Claims Expected over Websites

Similarly, the sixth story concerned federal standards for website access by the disabled. Websites must provide alternative text, audio, and other alternatives for various disabled users. H&R Block was picked on to make an example. No doubt this large company can afford to hire web designers to add the needed features but that will not be the case with many smaller web designers or small firms with sites. Forcing all web-based vendors to meet costly design standards will limit innovation and competition.

Trial Turns to "Secrecy" at UBS

The next article concerned the SEC's prosecution of a Swiss banker for following Swiss law but not following US law when dealing with American clients. The jury would not convict. This relates to the discussion of financial services in this chapter. Companies operating in the Cayman Islands and other such jurisdictions are often branded by politicians and US regulators as bad actors akin to Allen Stanford in Antigua. Some in the United States government would love to force all jurisdictions to adopt rules identical to those adopted in the United States so that it could have a monopoly over legal rules. The rules in Switzerland and other financial centers are technical but, unlike the uncertain regulatory regime in the United States, the financial centers focus on rules needed to protect the interests of multiple parties in highly complex transactions. The financial centers know investors will flee if they exhibit legal uncertainty.

Mortgage Rules Move Closer to Final Form

Finally, the last story concerned the nearly complete new mortgage-industry rules soon to be adopted in the United States. The regulators claim that these rules will prevent a repeat of the 2008 financial meltdown in the United States that largely originated in the mortgage industry. What is not discussed is that the mortgage mess did not occur in Canada or the European Union; it was an American special. The subprime meltdown has multiple causes but among them are what Schuck would call differentiated and uncertain regulatory requirements to expand the pool of people eligible for mortgages to include those lacking proper credit in pursuit of political points for expanding home ownership, lax regulation by the regulatory agencies charged with banking oversight, and an extended period of artificially low interest rates caused by central bankers actions (Taylor, 2009; Norberg, 2009).

Using the law to build, not destroy, economic growth

These examples illustrate an important distinction among the types of law, a distinction that is too often neglected in today's debates over regulation. Law and legal institutions can serve two quite different functions. First, law can provide a means of reducing the cost of engaging in wealth-creation. Trade, creation of business entities, facilitation of investment—all of these are cheaper and easier to do within a well-developed framework of laws. By providing "off the rack" default solutions, which may well be complex, the legal system can cut transactions costs. Contract law is a good example of this. By providing regulatory regimes that make transactions more trustworthy, the legal system can encourage wealth-enhancing transactions. The development of corporate governance law in Delaware and captive insurance law in various jurisdictions are examples of this. These laws avoid the problems of regulatory capture because they are framed as generally applicable laws, which economic actors can opt out of by either writing their own contract provisions to substitute for the defaults or opting to use a different jurisdiction for a transaction.

Unfortunately, law can also impose costs greater than the benefits they produce. Even well-meaning efforts to address market and social ills tend to fall into this category because of the public choice issues. Those with the most to gain from involvement with the legislature and regulators are most likely to influence the regulatory process. Growing complexity, in the forms discussed by Schuck (1992), increases the likelihood of bad outcomes because it both raises the costs imposed and makes concealing special interest easier.

Improving the performance of our economies requires more attention to promoting wealth-increasing legal developments while restraining those that destroy wealth. One means of doing so is by enhancing competition among jurisdictions. As we saw in the examples above, these are powerful forces that can promote value-added legal institutions. That the Cayman Islands developed from a quiet backwater into a modern financial center, Vermont developed a captive insurance industry, the Netherlands Antilles found a (temporary) opportunity in facilitating US corporate finance, and Delaware has become the market leader in corporate law are examples of the power of competition to transform even small jurisdictions into powerhouses. To gain the benefits of such competition, care must be taken to avoid the fate of Antigua. Avoiding regulatory capture by fraudsters requires understanding and investment in sound institutions.

Foreign Account Tax Compliance Act

As we have focused on financial regulation, we close by considering the Foreign Account Tax Compliance Act (FATCA), passed by the US Congress in 2010 as part of its post-financial-crisis efforts at economic stimulus. Copycat statutes followed elsewhere, including "son of FATCA" in the United Kingdom and "mini-FATCA" in France. These statutes impose complex costly requirements for information exchange between financial institutions and governments. The Banking Federation and Institute of International Bankers estimate that the top 30 non-US banks will spend $7.5 billion on compliance with FATCA alone. These compliance costs add nothing to the global stock of wealth—they are simply additional costs of doing business internationally. On the margin (and for some distance from the margin, if the $7.5 billion estimate is correct), the FATCA requirements will reduce the volume of international financial dealings. That will in turn reduce economic growth by reducing trade.

Let us propose an alternative way to view the role of law. There are many countries where a meaningful rule of law is absent or inadequate. Jurisdictions that provide sophisticated legal environments for structuring business transactions are, in effect, exporting the rule of law to those countries that lack it. For example, considerable investment into China flows through Hong Kong's financial sector and the British Virgin Islands. They offer tested legal entities and structures for conducting international business. Similarly, a study of the role of the island of Jersey in the UK economy found that investment through Jersey produced £2.3 billion in annual tax revenues and supported 180,000 British jobs (Capital Economics, 2013).

Why are these jurisdictions used? Hong Kong and Jersey have excellent courts; the British Virgin Islands has a well-developed legal regime for the governance of offshore corporations (IBCs). These advantages give investors confidence that their legal advisers' predictions of how possible disputes will be handled are accurate. They also provide assurance that unanticipated disputes will be handled fairly. As noted earlier, these advantages come in part from the use of smaller jurisdictions that are both specialists and can be relied upon.

In contrast to legal structures that add value, laws such as FATCA and its progeny add needless or low-value complexity and reduce growth. These laws create barriers to investment. They divert resources from the budgets of developing countries into administrative efforts that create costly compliance mechanisms with minimal benefit. Creating a regulatory framework under the guise of consumer or investor protection that is intended to deter the free movement of funds harms the rich and the poor

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5. One Nation, Ungovernable? Confronting the Modern Regulatory State

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1. Introduction

> *Is not your indignation roused at this absolute, imperious style? For what did you open the veins of your citizens and expend their treasure? For what did you throw off the yoke of Britain and call yourselves independent? Was it from a disposition fond of change, or to procure new masters?*
>
> —New York Governor George Clinton, appealing to the public as "Cato" on October 11, 1787, in opposition to Alexander Hamilton's and the Federalists' vision of national government (Ford, 1892).

When policy makers neglect federal regulation, they ignore arguably the greatest element of governmental influence in the United States' economy and perhaps in society itself. One cannot prove it, but it would be no great surprise to find the regulatory enterprise to constitute a greater bulk than federal spending. As a policy concern, regulation merits attention like that paid to the $18 trillion national debt. This essay provides a road map for focusing attention on regulation.

In the early 21st century, those wishing to address regulation find themselves constrained: after a century of progressivism and policy dominance by intellectuals supportive of larger government, there remains little mobilized constituency for limited government. Republicans are at peace with the welfare state, a federal role in education, antitrust regulation, non-declaration of wars, and even with not

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enforcing the congressional "power of the purse", out of fear of blame for shutting down the federal government. The executive branch steers and makes law, despite the Constitution's assignment of that role to Congress in Article 1, Section 8: "All legislative powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives". Once executive power expands, noted University of Chicago political scientist William Howell, "[t]he president doesn't give back that which was given to him before … What you see over the long arc of history is … a dramatic expansion of presidential power and authority" (Kuhnhenn, 2015).[1]

The modern ethos of extending regulatory agency and executive branch power became epitomized in President Barack Obama's February 2013 *State of the Union Address*. Capping weeks of the White House's touting of a "pen and phone" strategy (Rucker, 2014) to further expand federal economic, environmental, and social regulation and intervention (White House, Office of the Press Secretary, 2014), the president promised that, "[i]f Congress won't act soon … I will. I will direct my cabinet to come up with executive actions we can take, now and in the future" (Marks, 2013).

Should the new 114th Congress object to such aspirations, it faces "the year of the veto" (Sink and Wong, 2015; see also Korte, 2015). The president followed through on a veto of the Keystone XL pipeline (White House, Office of the Press Secretary, 2015) in contrast to America's one-time ethos of rapid, driven infrastructure growth (Gordon, 2004). Alas, no resurgence of constitutional order and federal government restraint appears in the offing; politicians and even courts no longer possess the vocabulary for it. Nonetheless, the goal of this paper is to inspire advocates of limited government by showing how policy makers could use the limited tools at their disposal to create a body of information that can make such reform possible in more favorable circumstances.

Part 2 points to some economic and social consequences of the unrestrained modern government, and takes a moment to recognize (or perhaps lament) that, while the Constitution is not coming to the rescue, we are not without options. Part 3, in light of Congress' over-delegation of power to federal agencies, briefly reviews the formal oversight procedures that ostensibly exist for the thousands of regulations issuing annually. Part 4 shows that central oversight of regulation sports

1. William G. Howell is co-author of the book, *Thinking about the Presidency: The Primacy of Power* (Howell, 2013).

theoretical inconsistencies and gaps and argues it has not worked, but posits why, just possibly, it could. Part 5 presents the data demonstrating that federal regulatory review has fallen short and is far from comprehensive. Part 6 covers some of what is (imperfectly) known about regulatory burdens and volume to help inform efforts to liberalize. Finally, Part 7—given the reality that code or administrative agency law is here to stay for the time being—offers disclosure-based "low-hanging-fruit" reform proposals, while remaining cognizant of central review's shortcomings. The aim of these proposals is (1) to help legitimize Congress' case for regulatory liberalization and enable a revival of some semblance of constitutional order; and (2) to facilitate future liberty-minded executive branches' deployment of the "pen and phone" in *defense* of liberty. An alternate take on "Energy in the Executive" (Hamilton, 1788) would be a welcome contrast to its malevolent usage in undermining the institution of limited government and destabilizing core values of classical liberal society.

2. Regulatory overreach?

> *I think that is really where the thrill comes from. And it is a thrill; it's a high … I was born to regulate. I don't know why, but that's very true. So long as I am regulating, I'm happy .*
>
> —OSHA safety standards program director Marthe Kent in 2001 (quoted in Olson, 2001).

Seemingly, no corner of life escapes the modern state's purview, and much emanates not from an elected Congress but from the president and from unelected bureau personnel. Concern over executive branch ambition ranges across the policy spectrum—from a House Republican lawsuit against President Obama's unilateral actions (Walsh and Bash, 2014) to Georgetown law professor Jonathan Turley's 2014 House Judiciary Committee testimony that "[w]e are in the midst of a constitutional crisis with sweeping implications for our system of government" (Turley, 2014).

One doesn't have to dig to find exasperation. Home Depot co-founder Bernie Marcus told *Investor's Business Daily* that:

> Having built a small business into a big one, I can tell you that today the impediments that the government imposes are impossible to deal with. Home Depot would never have succeeded if we'd tried to start it today. Every day you see rules and regulations from a group of Washington bureaucrats who know nothing about running a business. And I mean every day. It's become stifling. (Merline, 2011)

What sorts of impediments? Here's a short list of recent ones:

- the Department of Health and Human Services and the Internal Revenue Service are transforming America's traditional medical system via the Patient Protection and Affordable Care Act;
- financial regulations such as the Sarbanes-Oxley and Dodd-Frank laws foster the very "too big to fail" entities cited as the reason to intervene in the first place, create instability, and damage the poor's access to banking services;
- communications regulation such as the aggressive "net neutrality" rules of the Federal Communications Commission (FCC) (US FCC, 2015) threatens free speech and network infrastructure investment even though the rationales for establishing an FCC no longer exist (Cox and Crews, 2005);
- energy regulation and green extremism disrupt access to land and resources, aggravating energy poverty and even food shortages (Action Aid and Competitive Enterprise Institute, 2011);
- the homeland security culture has wrought a cabinet department, invasive airport security, general surveillance, and an as yet incalculable impact on civil liberties;
- antitrust agencies disrupt competition (in the name of protecting it) despite the modern technological era's rapid pace of "creative destruction" compared to the "smokestack monopoly" era that allegedly justified antitrust regulation;
- the Department of Justice's "Operation Chokepoint" threatens to harass small entities out of business in pursuit of federal control over a financial industry segment—without congressional approval or even the normal public comment process (Murray, 2014b).

Such examples scale down to the Consumer Product Safety Commission's proposed window blinds regulation to FDA's regulation of a serving size of breath mints (US CPSC, 2013; US FDA, 2014; see also Istook, 2014, 2015).

What is the impact of all this? Those doing the regulating see no problem. Previewing his 2014 *State of the Union Address*, President Obama said: "2014 was the fastest year for job growth since the 1990s. Unemployment fell faster than any year since 1984" (cited in Davis, 2015).

Others continue seeing things differently. Referring to the economy and well-being, Obama asserted in his 2015 *State of the Union Address* that "tonight, we turn the page" (White House, Office of the Press Secretary, 2015a). But growth emerging from a painfully low baseline is hardly turning over a new leaf. Unemployment is "down" because statistics omit those who have given up the job hunt. Job growth that did occur has been attributed to an end to unemployment benefits (Brennan, 2015). An astounding 92 million Americans are not working (CBS/Associated Press, 2014), positioning labor-force participation at a 36 year low, with nearly 12 million having dropped out during the Obama administration (Meyer, 2014). Data point to high debt per capita, and to the highest part-time and temporary-job creation rates in contrast to full-time career positions (for example, see US Census Bureau, 2014). A popular blog laments the "slow death of American entrepreneurship" (Casselman, 2014). Headlines tell painful tales, like that of January 2015 in *Investor's Business Daily* (2015) reporting on businesses dying faster than they're being created, a circumstance the *Washington Post* had noted in 2014 (Ingraham, 2014). Likewise a Brookings study (Hathaway and Litan, 2014) on small business formation noted declining rates, as did a *Wall Street Journal* report on reduced business ownership rates among the young (Simon and Barr, 2015). One recruiter described to the *Wall Street Journal* how regulations undermine employment (Moore, 2013), while others point to an inverse correlation between regulation and innovation (Kritikos, 2014). And industry anecdotes parallel the general statistics: in food service, regulations are driving restaurants out of business and even sending them abroad (Little, 2013).

One can recognize that small business may not be, as is often claimed, the "backbone" of the entire economy—rather, new businesses appear to be (Dearie and Geduldig, 2013). Yet, regulations are a hidden tax for them and their larger brethren; obscured in prices for most of us, if you are a businessperson, you have found them. It is an awakening mirroring the college graduate encountering his first docked paycheck, wondering, "Who's this guy FICA?"

Congress blames overreach and its consequences on the president and agencies, but Congress both actively delegated that power and permitted its seizure with inaction. The over-delegation phenomenon of unelected and unaccountable agency personnel doing the lawmaking was detailed in David Schoenbrod's *Power without Responsibility* (1993). In *Is Administrative Law Unlawful?* Philip Hamburger sees the modern administration state as a reemergence of the absolute power practiced by pre-modern kings (2014a).[2] In *Imprimis*, Hamburger describes the return of monarchical prerogative—the very condition our Constitution was drafted to eliminate:

> the United States Constitution expressly bars the delegation of legislative power. This may sound odd, given that the opposite is so commonly asserted by scholars and so routinely accepted by the courts … The Constitution's very first substantive words are, "All legislative Powers herein granted shall be vested in a Congress of the United States". The word "all" was not placed there by accident. (2014b: 5)

The Supreme Court, for its part, has struck down rules in some cases: for example, *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000) invalidated FDA tobacco regulation as exceeding the agency's authority under FDCA to regulate products without manufacturer claims of therapeutic benefit. The Court has remanded some cases for further proceedings: *Massachusetts v. EPA*, 549 U.S. 497 (2007) and *Whitman v. Am. Trucking Associations*, 531 U.S. 457 (2001). The Court however tends to defer to agencies' "expertise" (May, 2010). Justice Clarence Thomas described the roots of this deference:

> Many decisions of this Court invoke agency expertise as a justification for deference. This argument has its root in the support for administrative agencies that developed during the Progressive Era in this country. The Era was marked by a move from the individualism that had long characterized American society to the concept of a society organized for collective action. (*Perez v. Mortgage Bankers Association*, 2015: 19, note 6)[3]

The combination of the progressive victory, inertia, and a ratchet effect that expands government power without ever unwinding (Higgs, 1987) implies that resurgence in constitutional order is not in the offing. For all intents and purposes,

2. Prof. Hamburger expanded on themes of administrative law in series of blog posts at the *The Volokh Conspiracy*. Posts begin here: <http://www.washingtonpost.com/news/volokh-conspiracy/wp/2014/07/14/prof-philip-hamburger-columbia-guest-blogging-on-his-is-administrative-law-unlawful/>.
3. Thomas referenced *Woodrow Wilson and the Progressive Era 1910–1917*, p. 1 (Link, 1954).

code law has won, and is here to stay for the time being. Such constraints appear to prevent us from doing much about regulation until such time as reinstating congressional accountability to voters for everything the bureaucracy does is achieved (Crews, 2013). The traditional approach to addressing such concerns presumes that limited government can be saved in Washington by means of the ballot box. But congressional action on regulatory reform measures that secures a presidential signature is improbable to say the least in the current environment.

Congress enabled this bureaucratic and presidential hubris, and only Congress can fully reverse "regulation without representation" (Schoenbrod and Taylor, 2003: 84). States are increasingly aware that the Constitution's Article V affords them an opportunity to amend the founding document to reduce the federal leviathan and reestablish accountability for the regulatory bureaucracy (Leef, 2014). We shall be optimistic and shall look at the limited good administrative oversight can do, with an eye toward using its failures to create a body of information that can build a foundation and case for future liberalization and re-establishment of democratic accountability.

There is no silver bullet. As William A. Niskanen made clear in *Market Liberalism*: "More promising than any identifiable change in the regulatory process would be a revival of the constitutional doctrines limiting restraints on interstate commerce, restrictions on private contracts, the uncompensated taking of property rights, and the undue delegation of policy decisions to regulatory agencies" (1992: 114). So our process reforms are not enough; yet to build momentum in the current environment, the regulatory state must endure at minimum disclosure, transparency and accountability demanded of taxing and spending.

We have gotten "what the Constitution says" off our chest and can next confront the regulated nation we live in and address constraints that prevent our traditional tools from doing much about it. But this is not a pessimistic survey: the final section highlighting incremental reforms addressing regulatory overreach is meant to create ammunition to help in restoration of constitutional order.

3. What formal constraints apply to the administrative and regulatory state?

Legislatures rarely control spending, let alone the tentacles of the regulatory enterprises they endorsed over decades through both design and apathy. As lawmaking untethered from the legislature and was delegated to unelected, unaccountable bureaucracies, economic, environmental, and social interventions escalate. In terms of output level, there were 72 laws passed by Congress and signed by the president in 2013 (US GPO, 1995–2014); meanwhile agencies, implementing laws passed earlier and by earlier Congresses, issued 3,659 rules and regulations—a multiple of 51 rules for every law.

On those occasions when Congress gets traction on regulatory liberalization and is able to mobilize for reform, the inspiration is often smaller business burdens and job concerns. Since 1980, the Regulatory Flexibility Act has directed federal agencies to assess their rules' effects on small businesses and describe regulatory actions under development "that may have a significant economic impact on a substantial number of small entities" (US GPO, 2009: 64,131–32). It has (imperfectly) recognized the importance of vitality in small business and the need to scale federal actions to the size of those expected to comply, and occasional attempts to update it occur but have not been implemented. Another mobilization-driven regulatory reform was the Unfunded Mandates Reform Act of 1995 (P.L. 104-4), driven largely by governors mobilized against Washington's rules for which compliance was disrupting states' own budgetary priorities (Dilger and Beth, 2014). So popular was the Senate version of the legislation it was dubbed "S. 1"

The 1996 Congressional Review Act (CRA) requires agencies to submit reports to Congress on their major—roughly $100 million—rules. Maintained in a Government Accountability Office database available on line, these reports allow one to more readily observe which of thousands of final rules issued each year are major and which agencies are producing the rules (US GAO, various).

The CRA gives Congress a window of 60 legislative days in which to review a major rule and, if desired, pass a "resolution of disapproval" rejecting the rule. The CRA, in spirit, is one of the more important recent affirmations of the separation of powers. But despite the issuance of thousands of rules since passage, including many dozens of major ones, only one rule has been rejected: a Labor Department rule on workplace repetitive-motion injuries in early 2001.

Such concerns were recognized early, and upgrades to CRA to require an affirmative approval of major agency regulations before they are effective are required. Congress did not do this with Republican control of both Houses and the presidency, and now Obama promises a veto should they pass such legislation. Meanwhile the CRA itself is further undermined now, given that final rules are no longer properly submitted to the Government Accountability Office and to Congress as required under the law (Copeland, 2014). That is an indispensable step since Congress needs the reports to introduce a formal disapproval resolution.

The Constitution has not come to the rescue, and alas, nor has Congress, so for the moment, we are largely "stuck" with the executive branch review of regulations. The basis of the modern regulatory process is the post-New-Deal Administrative Procedure Act (APA) of 1946 (P.L. 79-404), which set up the process of public advance notice of rule-makings and provided the opportunity for the public to provide input and comment before a final rule is published in the *Federal Register* subject to a 30-day period before it becomes effective. The *Federal Register* is the daily depository of all these proposed and final federal rules and regulations, such as the 3,659 rules of 2013. While the APA established formal rule-making processes with quasi-judicial proceedings for significant regulations, these are rarely used. Instead, APA's "informal rule making" procedure of notice and comment ("Section 553" rule making) is most common (Carey, 2014: 2). But there is wiggle room even for that. As noted in a 2014 survey from the Congressional Research Service, "[t]he APA specifically authorizes any federal agency to dispense with its requirements for notice and comment if the agency for good cause finds that the use of traditional procedures would be 'impracticable, unnecessary, or contrary to the public interest' " (Carey, 2014: 2).

During the late 1970s and early 1980s, concern over regulations' economic impacts bred inquiries and reforms meant to reinvigorate the economy while stemming that era's inflationary pressures (Hopkins, 1976). The mood was for rethinking government regulations, in contrast to today's compulsion to expand them. Alongside cost concerns, agency tendencies to overstate or selectively express benefits was recognized. Prominent regulatory liberalizations began in the 1970s, and included certain trucking, rail, and airline deregulatory moves, partial financial services reforms, relaxed antitrust enforcement, and paperwork reduction (Firey, 2011). The regulatory review story began with President Nixon, was elaborated extensively by President Ford, and embraced more fully by President Carter. This involved the White House Office of Management and Budget (OMB) acting as central reviewer of important agency regulations. A significant advance was the Reagan Administration's formalization of more activist central regulatory review at the Office of Information and Regulatory Affairs (OIRA) within OMB.

Created by the Paperwork Reduction Act of 1980, OIRA first concentrated on reducing the private sector's federal paperwork burdens. Later, OIRA's authority was expanded by President Reagan's February 17, 1981 Executive Order 12291 to encompass (theoretically) a larger portion of the regulatory process by requiring that any new major executive agency regulation's benefits outweigh costs where not prohibited by statute (independent agencies were exempt), and to review agencies rules and analyses. Earlier administrations' regulatory review efforts such as those conducted by the Council on Wage and Price Stability, the Council of Economic Advisers and the interagency Regulatory Analysis Review Group, lacked extensive enforcement powers (DeMuth, 1980). These earlier bodies could seek regulatory cost analysis if not statutorily prohibited, but could not enforce net-benefit requirements; agencies could still reject reviewers' counsel and appeals to the president were possible, but rare (DeMuth, 1980). Net benefit analysis has insurmountable problems of its own in this writer's view (Crews, 2013a: 11 ("The Costs of Benefits"); Crews, July 2013b), but the *intent* was significant in the prevailing context of consciously addressing regulation. The early and mid-1980s saw declining costs and flows of regulation, particularly economic regulation in contrast to social and environmental (Hopkins, 1992).

Over the years, OIRA review—and that at the first President Bush's Council on Competitiveness tasked to screen regulations (Bloomberg Business, 1991)—faced political opposition, narrow scope of authority (Bolton, Potter and Thrower, 2014) and limited resources (Dudley, 2011). On September 30, 1993, President Bill Clinton's replacement of Reagan's E.O. 12291 with his own E.O. 12866 (Regulatory Planning and Review) reduced OIRA's authority. President Clinton's approach retained the central regulatory review structure but "reaffirm[ed] the primacy of Federal agencies in the regulatory decision-making process" (US GPO, 2009), weakening the "central" in central review. The new order also changed the Reagan criterion that benefits "outweigh" costs to a weaker stipulation that benefits "justify" costs. But the order did retain requirements for agencies to assess costs and benefits of "significant" proposed and final actions, conduct cost-benefit analysis of "economically significant" ($100 million plus), and to assess "reasonably feasible alternatives", and for OIRA to review those. As with E.O. 12291, independent agencies remained exempt.

President Obama's own January 18, 2011 E.O. 13565 on review and reform (Improving Regulation and Regulatory Review) carried on the Clinton order and articulated a pledge to address unwarranted regulation (US GPO, 2011a). The president achieved a few billion dollars in savings, even wisecracking in the 2013 *State of the Union Address* about a rule that had categorized spilled milk as an "oil" (White House, 2012). Suffice it to say that such trivialities are not the source of the regulatory excess and economic stagnation that concern many; the few billion dollars cut via executive order have been swamped by rules otherwise issued and legacy regulation.

Independent agencies, while they are subject to APA notice-and-comment are not subject to enforceable regulatory review. Still President Obama addressed them in his July 11, 2011 E.O. 13579 (Regulation and Independent Regulatory Agencies) with a call to fall into line on disclosure (US GPO, 2011a). A president cannot change congressional directives with respect to independent agencies, but can use the pen-and-phone bully pulpit, if not to restrain agencies, to *discourage their excesses*.

In all, four of President Obama's executive orders address over-regulation and rollbacks and the role of central reviewers at OIRA.[4] Yet, expansion of government into economic, social, and environmental realms has been the administration's emphasis, not review-generated cutbacks. Quite the contrary: the situation today is that expansions in which many agencies engage are supported and encouraged by the administration, such as President Obama's call on the FCC November 10, 2014 "to take up the strongest possible rules to protect net neutrality" (White House, 2014).

So, despite Obama's executive orders ostensibly shining a light on regulatory excess, walking the executive order walk likely awaits a different executive. Formal executive branch regulatory review processes cannot work when the executive's philosophy is that government, not private individuals and interactions, should dominate finance, health care, energy policy, manufacturing, and other spheres of human action. Barack Obama's repeated pledges to go around Congress attest to this while every instance from net neutrality to rules on the sizes of breath-mint servings to school lunch mandates underscores a federal government disinclined to leave the public alone. Like the original E.O. 12291, the *potential* for executive orders to boost oversight and review is high when the motivation exists. But the limits have undermined the review process.

4. The limits of central regulatory review

> *Nobody could fly an airplane commercially on any route without specific permission from the Civil Aeronautics Board, and price competition, cutting prices, was illegal.*
>
> —Alfred Kahn (cited in CNN, 2010).

The central review we just described does not work well enough.

Rent seeking

For one thing, it is not quite accurate, as OMB has proclaimed, that "businesses generally are not in favor of regulation" (US OMB, 1997). Business not only generally favors regulation, but often sought regulation in the first place (Stigler, 1971), so the premise of OIRA regulatory reviews may be suspect terrain at the

4. These are all available on OMB's webpage, *Regulatory Matters*, <https://www.whitehouse.gov/omb/inforeg_regmatters>.

very outset. Taxes obviously transfer wealth and affect profits, but regulations do likewise: pollution controls, accounting requirements, privacy mandates, and the like do not affect every firm equally. They create artificial entry barriers and hobble competition; they benefit some producers while punishing others. This aggravates cronyism and fosters attempts at regulatory capture. Consumers enjoying falling prices and growing output were not up on their hind legs demanding the Interstate Commerce Commission, or the state regulation of utilities (Geddes, 1992), or the antitrust laws, or regulation of Uber: these were and are sought by political elites and producers protecting profits and eliminating competition. And what were once small businesses, when they get big, may look more favorably upon rent-seeking and score-settling (Tollison, 1982).

Regulation benefits regulatory advocates and pressure groups and, obviously, the regulator. Thus, regulations have a constituency that favors command-and-control rules over market processes, quite distinct from the social welfare rationales that dominate the rhetoric of the entire policy realm and central review. This creates legislation and rules for "review" that should not exist in the first place.

Also important: just as *economic* regulatory agencies are captured by special interests, much of what is considered *social* or *health and safety* or environmental regulation may be bad for consumers as well (Crandall, 1992). Even when regulation "works", the overall or societal benefits can be outweighed by costs; also the social calculus approach to net benefits can ignore wealth transfers, regulatory takings, and due process.

Executive review presumably recognizes institutionally that agencies and departments do not benefit from *curtailing* operations, from *not* regulating. Conversely, they gain immensely—in budget allocation, staffing, and political and career status—the more extensive the regulatory empires they oversee. Turf-building assures agencies will sometimes not care all that much about anything more than cosmetic cost-benefit concerns, enough to create the appearance of a need to regulate (mints, blinds, menus, energy choices). However, unlike private actors, bureaus suffer no repercussions when their interventions prove scientifically, socially, or economically wasteful and harmful. Output for bureaus is not directly measurable but must be inferred from the level of activity, creating a slippage in the ability to closely monitor agency effectiveness (Niskanen, 1971). Unlike profit-making firms, unaccountable bureaus can disregard minimizing the costs of their "product" (regulations) since others (private sector entities and their customers) bear the impact of their actions.

The executive branch regulatory review regime now in place was intended to be a step toward regulating regulation. However, if one presumes rent seekers capture the regulatory process, then it is no leap to suspect they also captured or capture the regulatory review process. There may be rent-seeking and rent-avoidance motivations at play. The more cynical view is that presidents established regulatory review for the purpose of monitoring their appointees to make certain that promises of public or private goods made to "essentials" and "influentials" are satisfied and are delivered with lower cost burdens (Bueno de Mesquita, Smith, Siverson and Morrow, 2003). This may be correct.

Regulatory dark matter

Even if APA notice and comment were to excel, and the OIRA review of rules to be well functioning, it provides only a partially adequate safeguard since the already incomplete discipline of rule making—which provides OIRA the matter to review in the first place—down plays agency guidance documents ("non-legislative" rules), memoranda, notices, and bulletins with legal effect (Crews, 2014c). These and other "non-rules" can be ways of avoiding not just the constitutional law-making process, but may skirt the publication notice-and-comment requirements of the Administrative Procedure Act and federal Office of Management and Budget (OMB) review (Mercatus Institute, 2014).

Guidance documents are a way of getting around central control, since the APA's requirement of publishing a notice of proposed rule making does not apply "to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice", in addition to the "good cause" exemption for legislative rules noted earlier (P.L. 79-404: §553). Like agency notice-and-comment rules, sometimes guidance is upheld by courts, sometimes not, when it does more than merely interpret (Whisner, 2013). Notable examples of guidance include Environmental Protection Agency's Clean Water Act jurisdictional guidance on "Waters of the United States" (US EPA, 2014), the Federal Trade Commission's guidance on disclosure of paid search engine results (Oreskovic, 2013), and President Obama's waivers of elements of the Patient Protection and Affordable Care Act. But something must be done. No one has made a systematic study of the total quantity of agency guidance but it may be that guidance document volume dwarfs that of rule making (Raso, 2010), which is not surprising when no one can even say with authority how many agencies exist (Whisner, 2013: 386). Raso quotes a 1992 *Duke Law Journal* article: "Federal Aviation Administration rules are two inches thick while corresponding guidance totals forty feet; similarly, IRS rules consume a foot of space while supporting guidance documents total over twenty feet" (Strauss, 1992: 1463, 1469). It is hard to argue against the proposition that "the body of guidance documents (or nonlegislative rules) is growing, both in volume and in importance" (Whisner, 2013: 394).

There are even more ways agencies regulate. "Sub rosa" regulation has been an issue for decades. In *Regulation and the Reagan Era*, Robert A Rogowski was clear:

> Regulatory bureaucracies are able to accomplish their goals outside the realm of formal rule making … An impressive underground regulatory infrastructure thrives on investigations, inquiries, threatened legal actions, and negotiated settlements … Many of the most questionable regulatory actions are imposed in this way, most of which escape the scrutiny of the public, Congress, and even the regulatory watchdogs in the executive branch. (1989: 209–210)

Reform is extremely difficult: one must appreciate that attempts to force more of this informal regulatory dark matter into the notice and comment stream might induce agencies to become even more creative in skirting review, such as with informal provision of information regarding agency expectations (Shapiro, 2014), doubtless at times of the variety: "Nice business you got there, shame if something were to happen to it". New constraints could lead to other unforeseen measures by agencies to escape oversight, the effectiveness of which could depend "significantly on how easy it is for OIRA to detect avoidance, and for OIRA, the courts, and others to respond" (Mendelson and Wiener, 2014: Abstract). Agencies can also raise the costs of presidential review of what they do, "self-insulating" their decisions with "variations in policy making form, cost-benefit analysis quality, timing strategies, and institutional coalition-building" (Nou 2013: 1,756).

But on the other hand …

Data we shall cover next in part 5 support those skeptical of central review's effectiveness and bear out that just a small part of regulatory output is reviewed and that escaping scrutiny is, if not easy, not difficult either. It will seem obvious that the review process has not been driven by public-interest theory and that it has not fared well. An as yet unarticulated theory of rent seeking, the reality that independent agency rules are not reviewed, and that it is easy to escape review are enough to explain the botched process we shall see in Part 5.

Yet there might be something salvageable in a "public interest" theory of regulatory review. Here, I will note that officials of limited-government persuasion have headed OIRA, many of them well-acquainted with the special-interest theory of regulation. There are grave problems with central review; perhaps the institution can be changed so that the "public interest" is better served; additionally, as discussed in part 7, we might influence the kind of information agencies create until such time as reforms instituting congressional accountability ripen.

Tough centralized review of regulations has been argued as a way to empower consumers and citizens, relative to the rent-seeking and capture that typically prevails. Without central regulatory review, costs of influencing laws are high since policy formation is dispersed among numerous agencies and lawmakers. Producer groups whose members are often more concentrated (crony types, not infrequently), hold a relative advantage in securing favorable policy since lower organizational costs enable them to prevail at the expense of those less favorably positioned. For scattered consumers, the cost of political organization are higher and tendencies to free-ride on the efforts of others can dominate even when ire is raised, derailing the ability to push back on over-regulation or to even recognize it.[5] Regulation therefore grows over time because it costs consumers more to organize and prevent having a dollar taken away than it costs for them to simply accept the loss. Consumers become the put-upon "suppliers" in the equation of "demanders and suppliers of wealth transfers" (McCormick and Tollson, 1982).

Centralized regulatory review may come to the "rescue" by helping level the playing field for the usual losers in the rent-seeking game. Theoretically again, centralization of review in one spot can increase the "rate of return" to lobbying for dispersed groups (like consumers) relative to that of concentrated interests because they need influence only one entity rather than many (Miller, Shughart, and Tollison 1984). Meanwhile, expected benefits for concentrated groups are likely to be little influenced or even reduced (since they would have taken most of the pie anyway without central review). If that holds, "commissions (i.e., the reviewing entities) that are responsible for regulating several industries are less likely to be captured by a single industry, and thus are more likely to be responsive to the diverse interests of consumers and consumer advocates" (Mueller, 1989: 245).

But central review mechanisms can block neither legislators nor presidents who act to circumvent such oversight. To the extent Congress passes onerous laws,

5. The seminal discussion on free-riding and group behavior is Olson, 1965.

requires unnecessarily rapid statutory deadlines for new regulations, prohibits cost analysis of rules, creates loopholes that prevent or enable avoidance of review, or frontally acts to benefit special interests, aggressive regulatory review remains improbable. In many ways, we need to become better at measuring the unmeasured. So let us look where central review stands now.

5. What the government's numbers say about central review of regulation

In June 2014, the White House Office of Management and Budget (OMB) released the *2014 Draft Report to Congress on the Benefits and Costs of Federal Regulations* (US OMB OIRA, 2014a). These annual reports show the results of OMB's reviews of a subset of the thousands of proposed and final rules issued annually. But notices, guidance documents, memoranda and bulletins get no scrutiny here, and rarely anywhere else.

When they draw attention to these reports at all, administrations stress "net-benefits" of the regulatory enterprise as a whole (Sunstein, 2012). So, in the new report, the administration says that in its fiscal year 2013 (October 1, 2012–September 30, 2013), executive agency major rules generated benefits of up to $81.4 billion annually, while costing only $2.4 billion to $3.0 billion annually in 2010 dollars (US OMB OIRA, 2014a: 20–21, table 1-4). For the decade 2003 to 2013, costs were pegged at between $68.5 billion and $101.8 billion, in 2010 dollars (US OMB OIRA, 2014a: 9–11, table 1-1).

Today's official narrative maintains that this OMB-reviewed subset of major or "economically significant" executive branch rules (those anticipated to have a $100 million economic impact) account for the bulk of regulatory costs. The OMB holds that: "[T]he benefits and costs of major rules, which have the largest economic effects, account for the majority of the total benefits and costs of all rules *subject to OMB review*" (US OMB OIRA, 2014a: 22, emphasis added). But OMB's break-downs incorporate benefits and costs of only the few "major" executive agency rules that agencies or OMB have expressed in quantitative, monetary terms.

Only seven rules in the *2014 Draft* had both cost *and* benefit analysis performed, out of 54 executive agency major rules that OMB reviewed. OMB listed another 11 rules with dollar costs assigned, without accompanying benefit estimates (US OMB OIRA, 2014a: 26–28, table 1-6(b)). There were a few hundred non-quantified "significant" rules OMB looked at, and hundreds more it did not review (indeed over 3,500 rules and regulations are finalized each calendar year).

The "subject to OMB review" clause in the quotation above is a critical qualifier. Plenty gets left out, like "non-major" rule impacts, as well as the aforementioned guidance documents, memoranda, and other notices. Ominously, independent agencies' thousands of rules get no OMB review, not even the many rules stemming from high-impact laws like the Dodd–Frank Wall Street Reform and Consumer Protection Act. Indeed, the non-reviewed character of most rules small and large, such as controversial independent agency rules like the Federal Communications Commission's on-going net neutrality proposals to impose utility-style regulation on the internet detract from the annual report's authority as a comprehensive survey of the compliance burdens and economic impact.

In instances like the independent Consumer Financial Protection Bureau created by Dodd-Frank, the concern goes well beyond lack of regulatory review (Murray, 2014: a, c): there exists a fundamental lack of accountability, either executive or legislative or judicial, since the President cannot remove the director, and since Congress does not fund the self-financing agency. Congress lacks even the necessary "power of the purse" to ensure even an appearance of accountability to voters (Murray, 2014: a, c).

Thirty other major rules implemented transfer programs (US OMB OIRA, 2014a: 28–29, table 1-7(a)); such "budget rules" are officially considered transfers rather than regulations. Paying little regard to these may be appropriate in a limited government context, but not as the federal government dominates ever more such economic and social activities as retirement and medical insurance.

Over the years, some 10% of all rules have been reviewed whether or not costs and benefits enter into the picture. In the *2014 Draft Benefits and Costs* report, OMB tells us that: "From fiscal year 2004 through FY 2013, Federal agencies published 37,022 final rules in the Federal Register. OMB reviewed 3,040 of these final rules under Executive Orders 12866 and 13563" (US OMB OIRA, 2014a: 8). As noted, for FY 2013, OMB reviewed 54 major rules and a few hundred significant ones, 18 of which had a cost estimate. For context, 3,659 rules were finalized by over 60 federal departments, agencies, and commissions during the calendar year.

OMB's once-common recognition that costs "could easily be a factor of ten or more larger than the sum of the costs … reported" (US OMB, 2002: 37), was a more helpful stance, since, as *table 5.1* shows, of several thousand agency rules issued, and the several hundred reviewed annually by OMB, only a handful of executive agency rules (and no independent agency rules) feature cost analysis alone, let alone the cost-benefit analysis that could justify common administration claims of net benefits for the entire regulatory enterprise.

Table 5.1. The "funnel of gov"—on the depth of regulatory cost review, 2001–present

	Major Exec. Agency Rules Reviewed by OMB			*Federal Register*	Costed rules as % of total final* rule flow
	Both costs and benefits	Rules with costs only	Grand total, rules with costs	Final rules	
2001	14	13	27	4,132	0.65%
2002	3	0	3	4,167	0.07%
2003	6	4	10	4,148	0.24%
2004	11	7	18	4,101	0.44%
2005	13	2	15	3,943	0.38%
2006	7	1	8	3,718	0.22%
2007	12	4	16	3,995	0.40%
2008	13	6	19	3,830	0.50%
2009	16	12	28	3,503	0.80%
2010	18	8	26	3,573	0.73%
2011	13	6	19	3807	0.50%
2012	14	9	23	3708	0.62%
2013	7	11	18	3659	0.49%
Total	**147**	**83**	**230**	**50,284**	**0.46%**

Source: compiled by W. Crews from US Office of Management and Budget, various fiscal years' editions of *Report to Congress on the Costs and Benefits of Federal Regulations*, <http://www.whitehouse.gov/omb/inforeg_regpol_reports_congress>.

Note *: final rules published in the *Federal Register* are presented by calendar year; other data by fiscal year. Final rules data are available in the Appendix of various years' editions of *Ten Thousand Commandments*, available at <www.tenthousandcommandments.com>.

As a percentage of the annual flow of final rules in the *Federal Register,* the proportion of rules designated "major" with cost analysis averaged around 36% over the decade; but the proportion of *all* rules with any cost analysis at all has averaged just 0.46%. The percentage of all rules with a cost assessment has never reached 1% in OMB reports (the highest was .8% in 2009). Benefits, which the federal government declares justifies the modern regulatory state, fare even worse.

6. Beyond the OMB annual reports—a more complete picture of the regulatory enterprise

If you make 10,000 regulations you destroy all respect for the law.

—Winston Churchill

The partial picture given by the OMB's annual *Report to Congress* may be rounded out somewhat by examining pages of rules, numbers of them, and costs of regulations where such information is available. This section reviews some of what we think we know about regulatory costs. Alas, the *known* is outweighed by the *unknown*. Policy makers could use such information to make the case for greater disclosure and accountability—and liberalization.

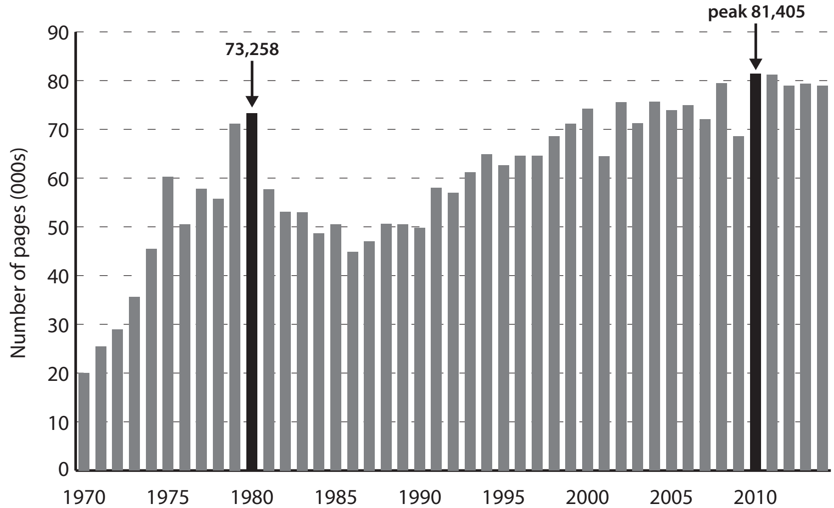
Thousands of rules, thousands of pages of regulations

While an utterly imperfect gauge, the number of pages in the *Federal Register* is probably the most frequently cited measure of regulation's scope, which unintentionally highlights the abysmal condition of regulatory oversight and measurement. At the end of 2014, the page count stood at 78,978, the fifth-highest level in the *Register*'s history (*figure 5.1*; Crews, 2014a). Both 2010 (81,405 pages) and 2011 (81,247 pages) were all-time record years. The 79,435 count in 2008 under George W. Bush holds the third-highest title. In keeping with the modern "pen-and-phone" ethos, of six all-time-high *Federal Register* page counts, five have occurred during the Obama administration.

Note the interim 1980 peak of 73,252 pages of regulations, which held the "record" until 2000. This essay is not the venue for an extended discussion but, despite concerns some might have with a public-interest theory of regulatory central review, one could make the case that the then-just-initiated E.O. 12291 process contributed to the initial decline during the 1980s. If it did, agencies eventually found a way to compensate and resume regulatory output, as well as engage in strategic avoidance of OIRA review and "regulatory dark matter".

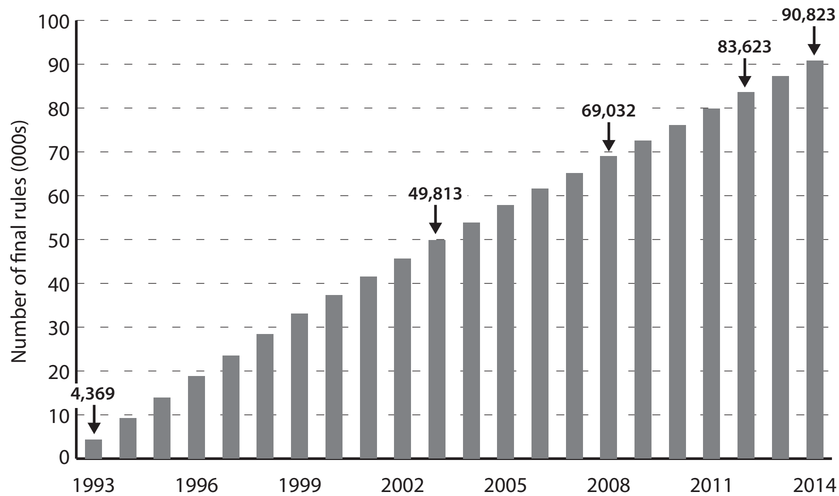
Among those thousands of pages were 3,541 final rules and regulations in 2014 (Crews, 2014a). Mirroring *Federal Register* pages, this count peaked at 7,745 in 1980 (Crews, 2014d: 62), when Reagan's E.O. 12291 was issued, then declined during that decade. Since 1993, when Clinton's E.O. 12866 was issued, rules have never dipped below 3,500 annually and often exceeded 4,000, especially during the 1990s. Over the past 20 years, 90,823 rules have been finalized (*figure 5.2*). These counts do not include guidance, bulletins, executive orders, memoranda, and the like, which have assumed greater prominence but are not reflected in ordinary rule counts.

Figure 5.1. Number of pages in the Federal Register, 1970–2014



Source: National Archives and Records Administration, Office of the Federal Register (various).

Figure 5.2. Cumulative count of final rules published in the Federal Register, 1993–2014

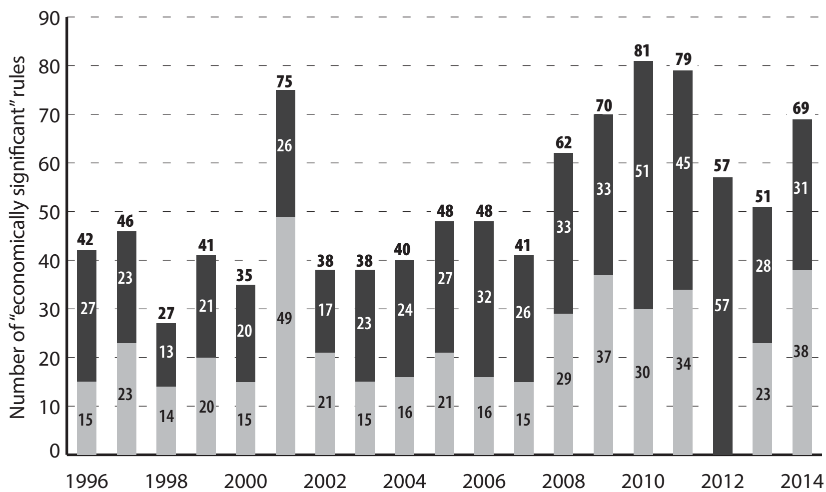


Source: National Archives and Records Administration, Office of the Federal Register (various).

This chapter has stressed accountability, noting that much law comes from agencies rather than elected lawmakers: while agencies issued 3,541 rules in 2014, Congress passed 129 laws that were signed by the president (Crews, 2015). While the rules are not substantively related to the current year's laws since they represent ongoing implementation of typically far earlier legislation, this ratio amounts to 27 rules for every law in terms of flow. Another 2,375 proposed rules were issued in 2014 and are under consideration by agencies.

Of the more than 3,000 rules issued each year, the subset known as "economically significant" is noteworthy. These rules, anticipated to have economic effects of $100 million or more annually, have begun to increase in recent years. *Figure 5.3* shows that the annual totals are down substantially from the 2010 peak of 81, but did jump to 69 from 51 last year. Nonetheless, besides 2001, the flow of completed economically significant rules from 2008 forward is notably higher than during the late 1990s and first few years of the 2000s.

Figure 5.3. Completed "economically significant" rules issued annually, 1996–2014



Source: Compiled from *The Regulatory Plan and Unified Agenda of Federal Regulatory and Deregulatory Actions* (US OMB OIRA, various). No Spring 2012 edition appeared.

The paperwork and compliance drag

> *I would say that seven years ago, I would spend 20 to 25% of my time as CEO of a small company dealing with regulatory issues … I spend no less than 50 or 60 percent of my time today dealing with regulatory issues. It's unbelievable.*
>
> —Banking CEO Mike Menzies on regulatory compliance (cited in Smith, 2012).

According to the 2014 federal *Information Collection Budget*, it took 9.453 billion hours in 2013 to complete the paperwork requirements from 22 executive departments and six independent agencies subject to the survey; that is up from 7.4 billion in 2000 (US OMB OIRA, 2014b). Most of that is Treasury (tax compliance) but new financial and health regulations are changing the landscape. It is hard to visualize 9.5 billion hours, but an 80-year human lifespan is 29,200 days. In hours, that is 700,800 hours. Looked at that way, 9.5 billion hours of paperwork is the equivalent of *13,488 full human lifetimes*. This is paperwork only, not other directives, mandates, or restrictions involved in actually carrying out regulation.

Unsurprisingly, but ominously, the job market for "compliance officers" is booming while other Americans cannot find work. The *Wall Street Journal* pointed to $162,000 to $232,000 salaries for large (particularly financial) firms' compliance officers and rising employment in the category overall compared to the actual productive economy—all driven by complicated new laws, regulations, and fines (Millman and Rubenfeld, 2014).

Smaller firms do suffer more from regulatory compliance costs generally. According to a major study by the National Association of Manufacturers (NAM), per-employee regulatory costs for firms of fewer than 50 workers can be 29% greater than those for larger firms—$11,724 for smaller firms compared to $9,083 for larger ones (Crain and Crain, 2014: 2).

A placeholder for the annual dollar cost of the regulatory state

We went a couple of hundred years without anyone bothering to reckon the total cost of federal regulation in the United States. Today, cost estimates of the regulatory enterprise range from the few billion the Office of Management and Budget bothers to proclaim (recall from part 5 that OMB has presented costs for 157 rules since 2000), through the $2.028 trillion annually the National Association of Manufacturers (NAM) estimated in 2014 (Crain and Crain, 2014: 1), and onward into the stratosphere according to an academic estimate of dozens of trillions in lost GDP annually (Dawson and Seater, 2013).

For a bit of bracketing and context, a 1995 report from the General Accounting Office (today called the Government Accountability Office) put 1994 regulatory costs at $647 billion in 1995 dollars (US GAO, 1995), which would be around $990 billion in 2013 dollars even assuming no new regulation in 20 years. Earlier governmental reckonings before and after the turn of the century from the OMB and the Small Business Administration (SBA), with various levels of critique and venom, have also noted annual costs in the hundreds of billions, some well in excess of $1 trillion converted into today's dollars. See *table 5.2* for these, as well as the NAM's just noted modeling of 2012 total annual regulatory costs in the economy of $2.028 trillion (in 2014 dollars).

These surveys tend to convey regulatory costs using the following categories: 1. economic regulatory costs (e.g., price-and-entry restrictions and transfer costs like price supports that shift money from one pocket to another); 2. workplace regulatory costs; 3. environmental regulatory costs; 4. paperwork costs.

Among these, the latest comprehensive federal government assessment of the entire federal regulatory enterprise that one might regard as "official" was prepared in September 2010 for the Small Business Administration (Crain and Crain, 2010). Modeling techniques have changed over time as the SBA presented several versions over the past decade and a half, with the most recent falling into criticism to which the authors responded directly (Crews, 2014d: 82, fn 20). Policy makers have a responsibility to disclose regulatory costs, uncertainties notwithstanding. The reality is no "objectively identifiable magnitudes" are available and costs in a fundamental sense are unmeasurable to third parties (Buchanan, 1969). But no blank checks for regulators should be permitted and, until congressional accountability is established for all regulations, the effort needs to be made. Meanwhile other developments—including recent major financial, health, and environmental policies—indicate regulatory costs not captured by most assessments to date. Other long-known costs, such as indirect costs and the effects of lost innovation or productivity, are difficult to assess and can produce underestimates of the total regulatory burden, which works to the advantage of the regulator.

For convenient annual cataloging of what we can reckon about regulatory costs, rather than employing a sophisticated model, I compile an informal baseline less than the NAM estimate using largely government data such as turn-of-the-century aggregate OMB and Governmental Accountability Office estimates, the annual updates from the *Report to Congress* and the annual *Information Collection*

Table 5.2. Estimates of the Cost of Regulation in the late 20th and early 21st centuries

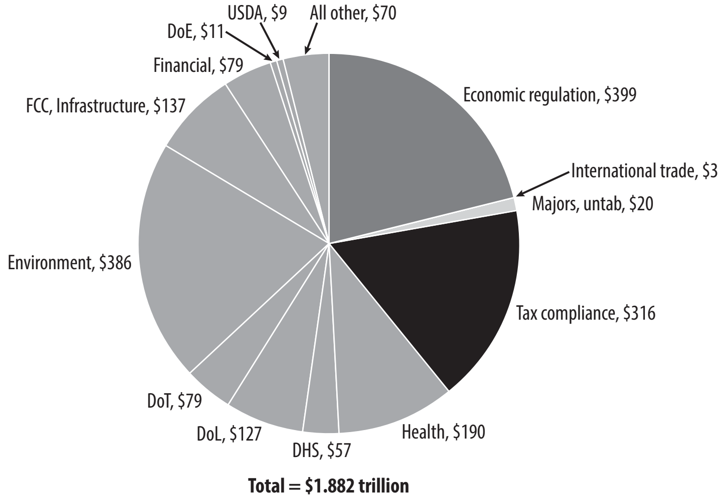
	Hopkins 1992 ($1991)	GAO 1995 ($1995)	Hopkins 1995 ($1995)	SBA 2001 ($2001)	OMB 2002 ($2001)	SBA 2005 ($2004)	SBA 2010 ($2009)	NAM 2014 ($2012)
Environmental	115		168	197	203	221	281	330
Other Social	36		55		30			
Transportation					22			
Labor					22			
Economic Regulation						591	1,236	1,448
Efficiency	73		80		150			
Transfers	130		147		337			
Efficiency—Domestic				101				
Transfers—Domestic				202				
Efficiency—Int'l Trade				44				
Transfers—Int'l Trade				88				
Workplace and Homeland Security				82		106	75	92
Paperwork/Process/ Info Collection (tax compliance)	189		218	129	190	195	160	159
Totals	**543**	**647**	**668**	**843**	**954**	**1,113**	**1,752**	**2,029**
Totals ($2013)		**992.498**	**1,024.712**	**1,109.39**	**1,255.46**			

Notes: [1] GAO = Government Accountability Office; SBA = Small Business Administration; NAM = National Association of Manufacturers. [2] Some figures are here adjusted to 2013 by the change in the consumer price index between 2001 and 2013 (1.316), and between 1995 and 2013, derived from US DoL BLS, 2014b: Table 24. Historical Consumer Price Index for All Urban Consumers - (CPI-U), U.S. city average, All items.

Sources: Crain (N.V.) and Crain (W.M.), 2010; Crain (W.M.) and Crain (N.V.), 2014; Crain (W.M.), 2005; Crain (W.M.), and Hopkins, 2001; Hopkins, 1992, 1995; US GAO, 1995; US OMB, 2002: 15,037–15,038.

Budget (which tabulates paperwork hours), and independent agency rule costs, supplemented with the few private-industry and sector analyses that exist. I reckon a placeholder of $1.882 trillion (*figure 5.4*), as compiled in more detail elsewhere in the working paper, *Tip of the Costberg: On the Invalidity of All Cost of Regulation Estimates and the Need to Compile Them Anyway* (Crews, 2014e).

Figure 5.4. Annual cost of federal regulation and intervention ($billions), 2015 placeholder



Source: Crews, 2014e.

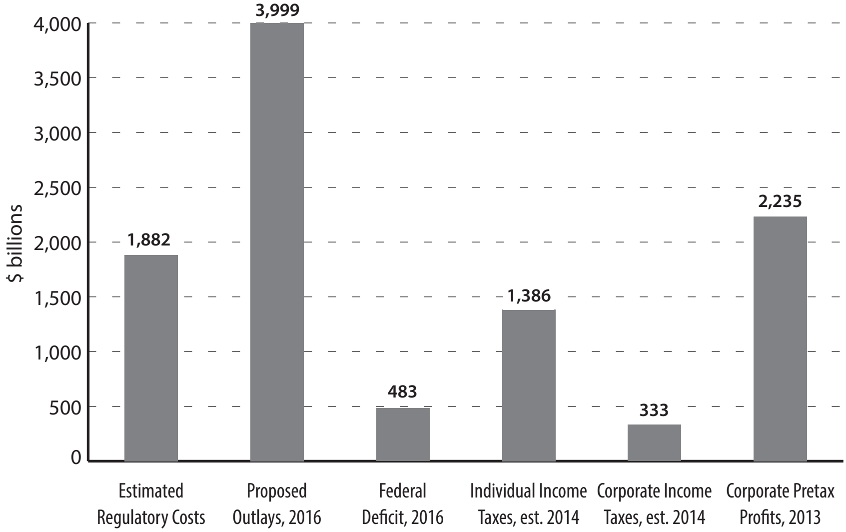
Each element of regulatory costs demands a dissertation unto itself for those affected but the largest components portrayed are legacy economic regulation, environmental regulation, and paperwork burdens. In the modern United States—after Dodd-Frank and the Affordable Care Act—the health services and financial components can be expected to expand. In any event, our figure of $1.88 trillion omits much: most regulations' costs are never tabulated and some entire classes of government intervention—such as antitrust, government manipulation of money, credit, and interest rates, and restricted access to resources— are ignored by officialdom. (Crews, 2014e: Unfathomed, Unmeasured Omissions).

Regulatory costs compared to federal spending, the deficit and taxes

How might we put regulatory costs in perspective? We probably cannot, since costs are not truly measurable, but here goes. The Commerce Department's Bureau of Economic Analysis in December 2014 estimated a 2014 GDP of $17.6 trillion (US DoC BEA, 2014b). The regulatory cost placeholder of $1.88 trillion is equivalent to around 11% of that.

Let's look at regulation in comparison to the size of the federal government itself. In FY 2014, the US federal government posted a deficit of $482 billion on $3.504 trillion in total spending outlays. *Figure 5.5* shows outlays, regulation, and the deficit at one glance. One could envision regulations as a form of off-budget spending in the sense that they represent costs of federal requirements the

Figure 5.5. Estimated regulatory costs compared to everything else ($ billions)



Note: Federal deficit and outlay numbers are by fiscal year; regulatory costs by calendar year.
Sources: Crews, 2014e; corporate 2013 pretax profits (domestic and international) from US DoC BEA, 2014a; estimated 2014 tax figures from US OMB, 2015; 2014 outlays and deficit from CBO, 2015: table 1-2: CBO's baseline budget projections (p. 13).

population is compelled to bear. For that perspective we seek, note that our placeholder for estimated regulatory costs approaching $2 trillion is equivalent to more than half the 2014 level of fiscal budget outlays ($3.5 trillion), and nearly four times the $482 billion deficit.

Regulatory costs also easily exceed the cost of individual income taxes and vastly outstrip revenue from corporate taxes. As figure 5.5 also shows, regulatory costs now tower over the estimated 2014 individual income-tax revenues of $1.386 trillion. Corporate income taxes, estimated at $333 billion in 2014, are dwarfed by regulatory costs.[6] Regulatory costs also rival the level of pre-tax corporate profits, which were $2.235 trillion in 2013 (US DoC BEA, 2014a).

Furthermore, while not shown in the chart, US regulatory costs surpass the 2013 GDPs of both our neighbors: Canada's stood at $1.827 trillion, and Mexico's at $1.261 trillion according to the World Bank (2014). As it happens, there are only nine countries whose GDP exceeds the cost of regulation in the United States. If

6. Individual income-tax receipts had fallen substantially during the economic downturn and are rising again at the moment (US OMB, 2015). Corporate tax receipts had declined by half during the recent downturn.

US regulatory costs of $1.88 trillion were a "country", it would be the world's tenth largest economy, between India and the Russian Federation. The implication is that less or smarter regulation could enable a far healthier economy.

Regulation's impact on families

When a business pays taxes, part of those costs get passed along to consumers in prices, or indirectly in lost output and generally diminished wealth. Like the taxes they are required to pay, businesses will pass some regulatory costs on to consumers. Regulatory costs will be borne by businesses of various types, households, lower-level governments, and so forth in direct pass-downs and in broader indirect economic drag. The "incidence" for households, or how much of the American family household budget is "absorbed" by regulatory costs is impossible to say. Businesses bear the brunt (apparently 50% or more, varying by kind of entity) yet, as noted in the study for the National Association of Manufacturers on regulatory costs:

> It is worth emphasizing that all regulatory costs are—and can only be—borne by individuals, as consumers, as workers, as stockholders, as owners or as taxpayers. In other words, the distinction between "business" and "individuals" focuses on the compliance responsibility, fully recognizing that ultimately all costs must fall on individuals. (Crain and Crain, 2014: 46)

Regulatory costs propagate through an economy, but the ultimate economic unit remains the individual. Just for perspective, were we to assume full pass-through of all such costs to consumers, we can look at the "share" of each household's regulatory costs and compare it with total annual expenditures as compiled by the Bureau of Labor Statistics (BLS) (US DoL BLS, 2014a).[7] The comparison is just a useful way of reflecting on the magnitude of regulatory costs. For America's 125.67 million households, or "consumer units" in BLS parlance, the average 2013 income was $63,784. *Figure 5.6* breaks down household expenditures of $51,100 by category. Note that the highest category is housing at $17,148 annually; the second-highest category is transportation at $9,004.

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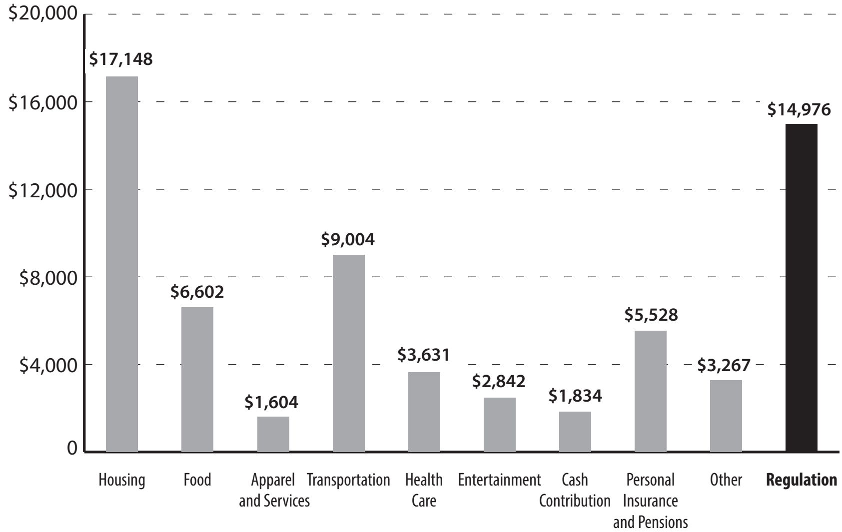
7. For the Bureau of Labor Statistics (BLS), "[c]onsumer units include families, single persons living alone or sharing a household with others but who are financially independent, or two or more persons living together who share expenses." For each "unit", average annual expenditures were $51,442 according to the BLS. The BLS also provided additional information on these figures (via e-mail from Vera Crain, February 22, 2013) and in US DoL BLS, 2012, 2013.

Figure 5.6. US household expense budget of $51,100 compared to regulatory costs



Sources: Bureau of Labor Statistics, 2014a; calculations by author. Proxy for "households" here is BLS depiction of 125,670,000 "Consumer units"; that comprises "families, single persons living alone or sharing a household with others but who are financially independent, or two or more persons living together who share expenses".

To reflect upon magnitudes: if one were to imagine allocating annual regulatory costs directly to individuals and assume full pass-through of costs to them, US households "pay" $14,976 annually in hidden regulatory tax ($1.882 trillion in regulation ÷ 125.67 million "consumer units"), "equivalent" to 23% of average income before taxes. That figure is higher than every annual household budgetary expenditure item except housing. The implication is that regulation has large societal wealth impacts. More is "spent", so to speak, on embedded or hidden regulation in society than on health care, food, transportation, entertainment, apparel and services, and savings. Societal regulatory costs amount to 29% of the typical household's expenditure budget.

7. A reform agenda—when the pen and phone advance liberty

If you ever get annoyed, look at me, I'm self-employed; I love to work at nothin' all day.
—Bachman-Turner Overdrive, *Takin' Care of Business*.

To the extent ill-founded, overlapping, and unclear regulations (and tax policy) dominate, businesses cannot plan, hiring becomes an insupportable risk (businesses will not hire if they know they cannot fire thanks to labor law) and citizens suffer. In the competitive marketplace, it takes a lot of bad ideas to generate a winner; over-regulation and its close ally *uncertainty* cut down on breakthroughs, slowing growth. A vanguard study on the uncertainty created by regulations and fiscal, trade, and debt policy estimated $261 billion in such costs just since 2011 (McNabb, 2013).

Moreover, policy makers and regulators fail to recognize that, while businesses want to "create jobs" as a matter of good citizenship, that goodwill does not change the reality that jobs are a cost, a *liability*. The modern environment makes business more risk averse (Casselman, 2013). One British businessman addressing French employment regulations observed: "[W]hen I am 100 percent utterly and completely certain that it is an absolute certainty that it is an absolute necessity that I need to recruit a new employee, I go to bed, sleep well and hope that the feeling has gone away by the morning" (Richardson, 2013).

If businesses are "punished" for hiring or cannot predict regulations coming their way, it is little wonder that they do not expand. We have already noted consequences, such as business startups hitting a record low (Reuters, 2012). Like poverty, unemployment does not have causes; both are the default state of mankind; only *wealth* has causes (noted in Crews, 2011a). The threat of regulation can induce companies to behave in reactive ways, distorting markets and creating economic inefficiency, compounding stagnation. Perhaps most ominous is that over half of existing firms would not do it again given today's anti-business climate of uncertainty (Gehrke, 2012). Wynn Resorts CEO Steve Wynn called Washington "the greatest wet blanket to business, and progress and job creation in my lifetime. And I can prove it and I could spend the next 3 hours giving you examples of all of us in this market place that are frightened to death about all the new regulations, our healthcare costs escalate, regulations coming from left and right" (Seeking Alpha$^{\alpha}$, 2011).

People like Wynn and our British businessman are hardly alone. *The Atlantic* conducted a Silicon Valley poll finding government to be a key innovation barrier (Gillespie, 2014), while Gallup polling found record numbers pointing a finger at big government (Jones, 2013). Regulatory liberalization that reduces uncertainty that increases the returns to risk-taking is the yet-to-be-deployed stimulus package. The problem, at this moment, is that Congress will have a tough time with a liberalization agenda in the "year of the veto".

The president has already promised to veto the Regulatory Accountability Act (EOoP OMB, 2015), the 114th Congress' signature regulatory reform bill that passed the second week of the new session in January 2015. The Regulatory Accountability Act of 2015 (H.R. 185) would codify some provisions contained in the executive orders we have discussed so far, making them enforceable, as well as allow formal semi-judicial proceedings for major rules and address guidance documents.

Similarly, the prior 113th Congress' passage of the ALERRT Act of 2014 (Achieving Less Excess in Regulation and Requiring Transparency, H.R. 2804), which also would in part codify existing executive orders, was met with presidential disregard (elements of this disclosure-oriented legislation will be described later). In both the 112th and 113th Congresses, the House passed the REINS Act (Regulations from the Executive in Need of Scrutiny, H.E. 367) to require an expedited congressional vote on all major or significant rules before they are effective (Adler, 2013). Note that this would change the presumption we saw in the Congressional Accountability Act. That act's "resolution of disapproval" would become a positive affirmation—a major advance in accountability for regulations. REINS has been reintroduced in the 114th Congress (Office of Sen. Rand Paul, 2015), but the president promised to veto it in the prior session.

Congress needs to broaden the REINS objection to any controversial rule, whether or not tied to a cost estimate that deems it a major rule. Furthermore, in the era of regulatory dark matter, the requirement for congressional approval should extend further to guidance documents and other agency decrees. At the moment, the point is moot since an Obama veto is assured, but the debate needs to occur.

Another important congressional reform in the "wish list" category would include changing statutory language that induces some agencies to disregard economic concerns in evaluating their regulations (Manheim, 2009). Ultimately, only Congress can compare questionable rules to the benefits that could be gained if the compliance costs went elsewhere. Therefore, Congress should also explore allocating regulatory cost authority among agencies in a "regulatory budget", while distinguishing between categories like economic, health/safety, and environmental regulations (Crews, 1998). A "budget" would create incentives promoting other supervisory mechanisms like central review, cost analysis, and sunsets, and inspire agencies to "compete" with one another in terms of lives they save or some other regulatory benefit rather than think within their own box.

Unfortunately, all the legislative accountability reforms just covered are unlikely to become law. Perhaps the most promising option for bipartisan, cross-branch, and bicameral cooperation is a "regulatory improvement commission" contained in the Regulatory Improvement Act of 2013 (Stemberg, 2013). This body, like the military base closure and realignment commission, would initiate review of the entire existing regulatory apparatus as distinct from the one-by-one appraisal that characterizes OMB review. The commission would select a bundle of rules for rollback with expedited congressional vote.

Certainly, today's policy climate is quite different from the 1990s, when Republicans proposed outright elimination of agencies like the Department of Energy (CEI, 1994). While major actions may not happen in the 114th Congress, it may be possible to develop "veto-override-proof" steps that lay important groundwork for a more favorable future reform environment. Congress can at least begin making regulatory realities more apparent, even in the current atmosphere that precludes fundamental reforms.

Meanwhile, as the next presidential elections approach, policy scholars may ponder what the executive's "pen and phone" can do to reduce rather than increase government influence in the economy. We knew from our Constitution's framers and we know now from the modern "pen and phone" era that, for better or worse, an energetic executive's hands are far from tied. Alexander Hamilton sought a king (Syrett, 1965) but settled for vigorously defending "Energy in the Executive". And to be sure, an "energetic" liberalization attitude prevailed in the executive branch during past presidencies and resulted in the creation of the executive branch review and oversight process itself. Given that such "pen and phone" power exists, it is time it be used to reduce government's scope and expand the private sphere (especially if Congress codifies the reforms).

Executive orders can expand governmental power as President Harry Truman's failed attempt to seize control of America's steel mills (*Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579, 1952) and Franklin Delano Roosevelt's confiscation of gold emphatically confirm (Traynor, 2013). These, too, were "pen and phone" executive orders; likewise, minus the phone, the Emancipation Proclamation to free slaves in the rebellious states. The optimistic spirit of the following recommendations holds that areas of bipartisan agreement between the executive and legislative branches in divided government can be found. We know from reforms in the 1990s that some Democrats are not going to go to the mat for maintaining a regulatory state that harms their constituents. If we do not succeed in directly reducing regulation in the next couple of years, some recommendations below will produce information about the state of regulation that can help enable reform in a more favorable future climate.

Enforce, strengthen and codify existing executive orders on regulation

In part 3, we covered the series of executive orders over recent decades meant to address the flow of regulation. For starters, Congress should insist that existing executive orders on cost analysis and review—to limit government—should be strictly applied, strengthened, and ultimately codified (as would be done via the aforementioned House-passed ALERRT Act) and further, extended to independent agency rules, guidance documents, and other agency proclamations.

Implement a regulatory moratorium

It is lost to the mists but upon entering office President Obama's chief of staff announced a regulatory freeze as part of a first 100 days initiative (Associated Press, 2009). The march of rule making was not appreciably reduced, but no permanent reduction followed a 90-day moratorium implemented by President George H.W. Bush either, who had directed agencies to look for rules to waive. Each generated just a few billions in savings (Sunstein, 2011). Moreover, many rules implement statutory requirements and are exempt from executive waiver, although recently with respect to the Patient Protection and Affordable Care Act, waivers applied via bulletin, memo, and press release by the Internal Revenue Service (Graham and Broughel, 2014). With the Bush moratorium, agencies were being asked to describe what they did badly—a task at odds with self-interest and bureaucratic turf building. Furthermore, Bush's three-month campaign was considerably shorter than needed to examine the fruits generated by an intense, thorough audit.

Obama's unilateral waivers notwithstanding, getting regulations off the books requires the same laborious public notice and comment procedures of a new rule. "Going back and reviewing stuff is as hard as drafting regulations", said Linda Fisher, who oversaw EPA pesticide regulation during the Bush effort (quoted in Davis, 1992). Still, a new effort should build upon the best of the Bush and Obama moratoria, and lawfully freeze regulation for a lengthier, more thorough audit, publish reports on the data generated, seek public comment on which rules should go, and so forth. Creativity will produce useful information to support more substantive reforms—such as stipulating that, for every new rule, one within or outside the agency should be eliminated. This latter would amount to a status quo "regulatory budget" or freeze for the duration of the review.

Boost resources at the Office of Information and Regulatory Affairs and increase free-market law and economics staff at agencies

More money and staff could enhance OIRA's executive order review function, or that of some subsequent body (see Dudley, 2011 on expanding OIRA resources). Where political circumstances prevent that, the administration and Congress might shift personnel and funds to concentrate on key agencies (or some subset).

However, since OIRA already grants special attention to major rules, and since a handful of agencies usually account for most major rules, OIRA already concentrates its resources for the most part, so this is a limited, even naïve, option. Additional analytical help can and does come from employees borrowed from federal agencies and departments. A moratorium could help the process of regrouping.

Alternatively, economists and divisions at agencies whose job is benefit-and-cost assessment and preparation of Regulatory Impact Analyses (RIAs) could be moved out of less active agencies. The president or OIRA chief or Congress could give these economists "Bureau of No" marching orders, to look for reasons *not* to regulate, to challenge conventional RIAs that somehow always find net benefits rather than net costs, and to underscore the role of competitive discipline and other factors that "regulate" economic efficiency and health and safety apart from Washington bureaus. Agency economists, deployed where objectively more useful in blocking the ceaseless regulatory flow, could provide greater assurance that more complete analyses were being carried out even without changes at OIRA.

It must be emphasized that *it is not enough for economists reviewing agency output to focus on Regulatory Impact Analyses*. Only a few get prepared. The flow, the rising costs, and the limited scrutiny to which even major rules are subject indicates that the ignored costs of "minor" rules may actually be very large. Recall from table 5.1 that non-major rules and independent agency rules make up the regulatory bulk. Still a rough 80/20 rule should apply such that, while costs can be masked behind the number of rules, a relative handful account for the bulk of impending regulatory burdens. Economists can get better at concentrating efforts on that few if there is presidential encouragement, and bipartisan support, of their role and acknowledgement of their importance.

Systematize review, sun-setting, revision and repeal of regulations

Short of the moratorium advocated above, and in keeping with the spirit of executive orders and retrospective reviews that agencies allegedly conduct already (details at *Federal Register*, no date), more aggressive periodic rule review by OMB and agencies would be valuable. Congress occasionally considers regulatory sunsetting; the president too could, in pen-and-phone fashion, require agency-generated regulatory requirements to expire or sunset within a given period of time unless they are re-proposed with public notice and comment.

This task requires an executive who agrees with the observation that regulations sometimes go too far, who recognizes that allowing even good rules to mount inappropriately is counterproductive (Mandel and Carew, 2013). While sunsets or rule phase-outs may be disregarded without legislative backup, formal reporting on deadlines and extensions and non-extensions, and disclosing ratios of what gets contained and what gets discarded helps quantify whether streamlining or supervision really happens. If the answer turns out to be no, we have automatically generated the record capable of prompting Congress to do so. Here are a few criteria by which agencies should routinely evaluate outstanding rules:

- Which rules can be eliminated or relaxed without becoming bogged down in scientific disputes over risk assessment? Which rules are just silly? Which are paternalistic?

- Are the data that regulated entities are required to report being used at all?

- Does the rule create unfavorable health costs (such as health costs of advertising restrictions on some needed drug)?

Such questions can help isolate burdensome or counterproductive rules. The president has already encouraged retrospective review with E.O. 13563's call for agencies to develop and execute plans to "periodically review its existing significant regulations to determine whether any such regulations should be modified, streamlined, expanded, or repealed so as to make the agency's regulatory program more effective or less burdensome".

OMB *Reports to Congress* do make several worthwhile recommendations for regulatory improvement, including:

> [F]acilitating public participation and fostering transparency by using plain language; making objective, evidence-based assessment of costs and benefits an integral part of the regulatory decision-making process; using retrospective review to inform decisions about specific rules and, more broadly, about the appropriate interpretation of impact analyses that feature incomplete quantification; and, finally, aligning agency priorities across all levels of internal hierarchy. (US OMB OIRA, 2013: 5)

These are useful steps. However, besides reviewing the limited implementation of certain parts of E.O. 13563, including "regulatory look back, reducing paperwork burdens, simplifying government communications, and promoting long-run economic growth and job creation via international regulatory cooperation" (US OMB OIRA, 2013: 5), little about aggressively reducing existing regulation appears in OMB reports. Agency RIAs and the entire executive branch review process should reflect a higher burden of proof regarding rules' value. Where agency analyses under the various executive orders appear not to justify a rule, OMB should be more forthright about saying so, and it should challenge non-major rules as well.

OMB could recommend modifications to entire regulatory programs based on plain common sense, regardless of executive orders. OMB might note costs of presumably beneficial regulations, and compare those benefits to superior advantages available elsewhere (hiring policemen or firemen, dividing or painting highways). In other words, OMB has the experience and know-how to create a benefit "yardstick" to objectively critique high-cost, low-benefit rules (which can help inform the "Transparency Report Card" we will cover shortly). The president can continue pressing agencies about rule reductions, and demand that they rank regulations and show that their least effective rules are superior to another agency's rules. Findings should be published.

Again, the president's leadership role can legitimize the task of eliminating rules, of rolling government back from the places it should not be.

Reduce dollar thresholds that trigger Regulatory Impact Analyses

Non-major rule costs get disregarded since analysis is not required. Review is accordingly non-existent and burdens unheeded. The Federal Communications Commission's open internet ("net neutrality") order was not regarded as significant, only a "prophylactic" rule, for example (Federal Communications Commission, 2011), despite huge industry-altering effects.

During the Carter-era regulatory review programs, when the $100-million major-rule threshold originated, there were a "suspiciously large number of regulations … projected to cost $90–95 million" (DeMuth, 1980: 21). Rules may have exceeded the threshold but were ignored or understated just enough by agencies to evade scrutiny. Along with reinstating moratoria, devising criteria for a periodic review and stressing review driven by executive order, the president (or of course Congress) may also reduce the flow of rules that escape analysis simply by lowering the threshold at which written Regulatory Impact Analyses are asked to be prepared.

The current $100-million threshold translates into written analysis for a handful of rules. More rules would be brought within that umbrella simply by lowering the bar to $50 million or $25 million. Doing so will not automatically improve how RIA tallies of costs and (especially) benefits are performed. In fact, if net-benefit analysis rather than cost-analysis persists, RIA exploitation for dubious net benefits will continue. Further, some agencies may strategically adapt behavior to the likelihood of review and present major rules larger than truly intended in order to negotiate and give the appearance of compromise (DeMuth, 1980: 21), but expanding their sphere of influence.

Such behaviors can be confronted: President Reagan's E.O. 12291 permitted the Director of OMB to order rules to be treated as major even when at first blush they do not appear to be, thereby activating the RIA requirement. Far fewer rules should escape cost analysis and subsequent reconsideration and review.

Scrutinize all agency decrees that affect the public, not just "rules"

To what extent do agency guidance documents get review? With tens of thousands of agency proclamations annually, it does not suffice for executive agency "significant" or "major" rules to receive OMB review. Nor is it enough any longer to include independent agencies. Regulatory dark matter is gaining ground on the readily observable.

Today, "undocumented regulation" like presidential and agency memos, guidance documents, bulletins, and press releases may enact policy directly or indirectly (Crews, 2014c) or even by veiled threat (Brito, 2014). Interpretations may be articulated by agencies, and regulated parties pressured to comply without an actual formal regulation or understanding of costs. The EPA Clean Water Act jurisdictional guidance on "Waters of the United States" is a prominent example we noted earlier. To address this loophole, former OIRA director John Graham and James Broughel propose options such as reinstating a George W. Bush requirement to prepare analysis for significant guidance documents, explicitly labeling guidance documents as nonbinding, and requiring notice and comment for significant guidance documents (Graham and Broughel, 2014).

As a July 2012 report by the US House of Representatives Committee on Oversight and Government Reform expressed it:

> Guidance documents, while not legally binding or technically enforceable, are supposed to be issued only to clarify regulations already on the books. However … they are increasingly used to effect policy changes, and they

> often are as effective as regulations in changing behavior due to the weight agencies and the courts give them. Accordingly, job creators feel forced to comply. (2011: 7)

Policy making ought not to have descended to this level. All potentially significant decrees by agencies need scrutiny, not just "rules". It is the case that agencies will attempt to strategically adapt to the new scrutiny (Shapiro, 2014) but a highly engaged executive, and Congress, can draw attention to and definitively address quasi- or semi-regulatory activity.

Require publication of rules in the Unified Agenda of Federal Regulations

There are rules, and then there are rules. Agencies are supposed to alert the public to their priorities in the semi-annual Regulatory Plan and Unified Agenda of Federal Regulatory and Deregulatory Actions (the "Agenda"). It normally appears in the *Federal Register* each fall and, minus the Regulatory Plan, each spring. The Agenda is intended to give researchers a sense of the flow in the regulatory pipeline as it details rules recently completed, plus those anticipated within the upcoming 12 months by federal departments, agencies, and commissions. But, there is a whopper of a disclaimer, as the *Federal Register* noted: "The Regulatory Plan and the Unified Agenda do not create a legal obligation on agencies to adhere to schedules in this publication or to confine their regulatory activities to those regulations that appear within it" (NARA OFR, 2009: 64,133). An executive order, and legislation, should command that agencies *do* confine their regulatory activities to those appearing in the Agenda.

Tally federal regulations that accumulate as businesses sectors grow

The observation that there is no free lunch may hold particularly for the small businessperson. The "Small Business Anthem", heard on the radio program, the *Small Business Advocate® Show* (SmallBusinessAdvocate.com), goes in part:

> Even though you make payroll every Friday,
> You don't have a guaranteed paycheck.
> You're a small business owner, and you eat what you kill.

For perspective on the small-business regulatory climate, the list in *table 5.3* shows basic, non-sector-specific laws and regulations that affect small businesses as they

Table 5.3. Federal Workplace Regulation Affecting Growing Businesses

1 employee

- Fair Labor Standards Act (overtime, minimum wage [27% min. wage increase since 1990]).
- Social Security matching and deposits.
- Medicare, Federal Insurance Contributions Act (FICA).
- Military Selective Service Act (allowing 90 days leave for reservists, rehiring of discharged veterans).
- Equal Pay Act (no sex discrimination in wages).
- Immigration Reform Act (eligibility that must be documented).
- Federal Unemployment Tax Act (unemployment compensation).
- Employee Retirement Income Security Act (standards for pension and benefit plans).
- Occupational Safety and Health Act.
- Polygraph Protection Act.

4 employees—all the above, plus:

- Immigration Reform Act (no discrimination with regard to national origin, citizenship, or intention to obtain citizenship).

15 employees—all the above, plus:

- Civil Rights Act Title VII (no discrimination with regard to race, color, national origin, religion, or sex; pregnancy-related protections; record keeping).
- Americans with Disabilities Act (no discrimination, reasonable accommodations).

20 employees—all the above, plus:

- Age Discrimination Act (no discrimination on the basis of age against those 40 and older).
- Older Worker Benefit Protection Act (benefits for older workers to be commensurate with younger workers).
- Consolidation Omnibus Budget Reconciliation Act (COBRA) (continuation of medical benefits for up to 18 months upon termination).

25 employees—all the above, plus:

- Health Maintenance Organization Act (HMO option required).
- Veterans' Reemployment Act (reemployment for persons returning from active, reserve, or National Guard duty).

50 employees—all the above, plus:

- Family and Medical Leave Act (12 weeks unpaid leave or care for newborn or ill family member).

100 employees—all the above, plus:

- Worker Adjustment and Retraining Notification (WARN) Act (60-day written notice of plant closing)—Civil Rights Act (annual EEO-1 form).

grow. This list, however, assumes non-union, non-government contractor firms with interstate operations and a basic employee benefits package. Only general workforce-related regulation is included: omitted are categories such as environmental and consumer product safety regulations and regulations applying to specific types of businesses, such as mining, farming, trucking, or financial firms. For those enterprises, numerous other laws and regulations would apply (For one industry-specific roundup, see National Automobile Dealers Association, 2014).

By executive order or statute, the federal government must build upon this by revealing how federal regulations now accumulate *in specific sectors*. This will give some idea of impacts in particular industries and economic subdivisions, which can help guide reforms and liberalization.

Compile an Annual Regulatory Transparency Report Card

Measure what is measurable, and make measurable what is not so.

—Frequently attributed to Galileo but, alas, probably not his.

Improving annual public disclosure for regulatory output and trends is one realm in which the president can unambiguously undertake initiatives on his own without statutory regulatory reform or congressionally stipulated transparency reporting. An annual Regulatory Transparency Report Card detailing agency regulatory output in digest form, incorporating the current year's data plus historical tables could be encapsulated and published as a chapter in the Federal Budget, the *Economic Report of the President*, the OMB *Benefits and Costs* report, or some other format. Before 1994, information such as numbers of proposed and final rules, and major and minor rules was collected and published in the appendix, Annual Report on Executive Order 12291, in the annual *Regulatory Program of the United States Government* (US OMB, 1992). This report identified what actions the OMB took on proposed and final rules it reviewed per that order, and the preceding 10 years' data, with information on specific regulations that were sent back to agencies for reconsideration. The *Regulatory Program* ceased when the Clinton administration's E.O. 12866 replaced E.O. 12291 with the aforementioned reaffirmation of agency primacy.

Significant but valuable *non-cost* information should also be published. Agencies and the OMB could assemble quantitative and non-quantitative data into charts and historical tables, enabling cross-agency comparisons. Presenting ratios of rules with, *and without*, benefit calculations helps reveal whether or not the regulatory enterprise can be deemed as doing the good it claims. Table 5.1 above showing the "Funnel of Gov" in part aims at this conceptualization.

Table 5.4 gives a sample of what should be officially summarized and published annually by program, agency and grand total, and with historical tables (Crews, 2011b).

Some elements shown here were incorporated H.R. 2804, the ALERRT Act (Achieving Less Excess in Regulation and Requiring Transparency), which, as noted, passed the House in 2014 (but not the Senate) and, before that, into S. 3572, the Restoring Tax and Regulatory Certainty to Small Businesses Act introduced by Sen. Olympia Snowe (R-Maine) in the 112th Congress, but never passed.

Regular highlight reporting accompanied by the affirmation of a presidential cheerleader would reaffirm the importance of disclosure and, in the process, expose to what extent Congress itself causes regulatory excess. Congress delegated

Table 5.4: Annual Regulatory Transparency Report Card: Recommended Official Summary Data by Program, Agency & Grand Total (with Five-Year Historical Tables)

- Tallies of economically significant, major, and non-major rules by department, agency, and commission.
- Numbers and percentages of rules affecting small business.
- Depictions of sectoral regulatory accumulation.
- Numbers and percentages of regulations that contain numerical cost estimates.
- Tallies of existing cost estimates, including subtotals by agency and grand total.
- Numbers and percentages lacking cost estimates, with explanations for absence of cost estimates.
- Federal Register analysis, including numbers of pages and proposed and final rule breakdowns by agency.
- Number of major rules reported on by the GAO in its database of reports on regulations.
- Rankings of most active executive and independent rule-making agencies.
- Identification of rules that are deregulatory rather than regulatory.
- Allegedly "non-regulatory" rules that affect internal agency procedures alone (important as federal government expansion into new realms of activity displaces the private sector).
- Number of rules new to the Unified Agenda; number that are carry-overs from previous years.
- Numbers and percentages of rules facing statutory or judicial deadlines that limit executive branch options to address them.
- Rules for which weighing costs and benefits is statutorily prohibited.
- Percentages of rules reviewed by the OMB and action taken (echoing figure 5.1 above).

too much power to agencies, and Congress imposed the statutory deadlines that can undermine regulatory analysis. Disclosure will help shift the narrative back to congressional accountability for what agencies do, which is a proper stance.

Designate multiple classes of major rules in transparency reporting

Above, we advocated lowering cost thresholds for regulatory review. For decades, regulations have been loosely divided into those that are major or economically significant (over $100 million in annual impacts) and those that are not. But this gives only a rough idea of minimum costs. For example, given the definition an economically significant rule, we can infer that the 200 major rules in the 2014 year-end *Unified Agenda*, when fully implemented someday, will have economic impacts of around $20 billion annually (100 million times 200 rules), minus any rules among that 200 that reduce costs (Crews, 2014b).

A Regulatory Transparency Report like that described above should obviously include the number of economically significant (or major) rules but this designation should be expanded to disclose more than a minimum level of costs. OMB could develop guidelines recommending that agencies separate economically significant rules into categories representing increasing costs and present them in the Regulatory Transparency Report. Here is one suggested breakdown:

- Category 1: > $100 million, <$500 million
- Category 2: > $500 million, < $1 billion
- Category 3: > $1 billion
- Category 4: > $5 billion
- Category 5: >$10 billion

This itemization is merely one option for presenting numbers within each category, and was incorporated in the Restoring Tax and Regulatory Certainty to Small Businesses Act (S. 3572) and the ALERRT Act (H.R. 2804), but the executive branch could facilitate such reporting on its own. For example, some cost estimates of the EPA New Source Performance Standards rule figure about $738 million annually (US EPA, 2001). Appreciating when EPA is imposing "Category 2" rules and the like would be more helpful shorthand than knowing about economic significance. This could be especially useful as Congress explores formal hearing requirements for mega rules, such as the House passed in January 2015 as part of the Regulatory Accountability Act.

Report separately on economic, health and safety, and environmental regulations

While economic regulation had lost favor in the 1980s compared to environmental or health and safety rules, there has been a resurgence of it in banking, energy, telecommunications, and other realms. Alas, these are often the domain of independent agencies not subject to central OMB review. This is ironic since the origins of executive branch regulatory review were driven in part by the recognition that economic regulation worked against the public interest. Such views were sustained by OMB's one-time willingness to adopt the premise that some economic regulation "produces negligible benefits" (US OMB, 1997).

Indeed, whether the proposition is "fine tuning" of the macro economy, or direct government management of an specific industry's output and prices (such as agricultural quotas or electricity generation prices) or entry into an industry (such as trucking), coercive economic interference lacks legitimacy. The reality of governmental failure and acknowledgement of cronyism in economic concerns is more evolved now, as is (among some) an appreciation of the impossibility of central economic planning and calculation (von Mises, 1920). Economic regulations can no longer be presumed rooted in the public interest; the more defensible default assumption is that they serve the regulated and their captured bureaus.

However today, an engaged executive's and even Congress' ability to address economic regulation as opposed to health and safety rules is undermined by that lack of oversight of independent agency rules that increasingly govern. In presenting itself as authoritative on aggregate regulatory net benefits, the annual *Report to Congress* conceals more than it reveals in this regard.

Since the role of health and safety regulation differ so from economic regulation, separate presentation—in the *Report to Congress*, in any Regulatory Transparency Report or elsewhere—are important from the standpoint of comparing the relative merits of regulations. Conceptual differences render meaningless any comparison of, for example, purported economic benefits from an energy regulation with lives saved by a safety regulation, so such categories of costs should be presented and analyzed separately and congressional accountability for outcomes established.

With executive buy-in, to the extent that analyses such as the OMB *Report to Congress* and other investigations help in delegitimizing economic regulation, such realms can be freed from government purview altogether (a utopian thought, as aggressions as recent as net neutrality clearly attest). But, with that new rationality we would leave Congress and OMB with the "lesser" task of documenting and controlling costs of environmental, health, and safety regulations. Then, where health and safety rules reveal that they too are based upon private interest or are detrimental to the public, a motivated executive can urge their rollback as well. Isolating categories for analysis is a first step toward enabling this greater oversight.

Improve assessments of "transfer" costs

Paralleling the distinction between "economic" and "social" regulation, process rulings like leasing requirements for federal lands and revenue collection standards and service-oriented administrative paperwork—such as that for business loans, passports and obtaining government benefits already appear separately in OMB reports, and in some cases the federal *Information Collection Budget* (US OMB OIRA, 2014b).

Certain of these administrative costs represent not regulation as such, but "services" secured from government by the public. But that does not make it appropriate to fail in actively disclosing and questioning them, or in anticipating their entailing future costs or having displacement or deadweight effects. Similarly, it is important not to lump service-related paperwork in the same category with the tax compliance burden and other involuntary, non-service-related process costs such as workplace reporting requirements. All these are hardly minimal and should be tallied and reduced where possible.

OMB has begun recognizing that these transfers "may impose real costs on society", may "cause people to change behavior", and result in "deadweight losses"; OMB expressed that it "will consider incorporating any such (cost-benefit) estimates into future Reports" (US OMB, 2013: 22). More needs to be done to analyze the costs of these transfers and their impacts on individual rights and economic growth.

As more of the economy—such as health care—succumbs to federal supervision, there is less inclination for subsequent generations of Americans to recognize what government does as regulation or interference; it just "is". This becomes more of a concern as quasi-regulation grows; addressing it all is an increasingly important task of the executive branch and Congress.

Acknowledge and minimize indirect costs of regulations

In its *Report to Congress*, OMB allows that "many regulations affect economic growth indirectly through their effects on intermediate factors" (US OMB, 2013: 48), but is non-committal on whether the net effects are positive or negative. If indirect costs of regulation are too difficult for policy makers themselves to compute, then government cannot credibly argue that compliance is feasible or fair or affordable.

Compliance-focused regulatory cost estimates may inadvertently or purposely omit indirect costs. That uncertainty requires that indirect costs be guarded against and minimized, since some have argued that indirect costs of regulation could even exceed the magnitude of direct costs (Laffer and Bord, 1992: 18), and since OMB itself occasionally has acknowledged that regulatory costs could be many times the amount it presents annually attaching to major rules (US OMB OIRA, 2002: 37).

Fairness and accountability in government require acknowledging indirect costs. Without addressing indirect effects, officials will systematically underestimate and downplay regulatory impacts and over-regulate. Taxing and spending are substitutes for regulation, and if regulation is perceived as an artificially cheap alternative means of achieving governmental ends, policy makers will exploit it and it will increase. Allowing regulators to disregard entire categories of indirect costs (such as bans or disapprovals of pipelines or antitrust regulation or product bans) could inspire more regulations of that very type. Imagine acknowledging only direct costs of regulations—such as the engineering costs of controlling an emission—while ignoring outright input or product bans as indirect costs. Under such scenarios, many regulations could be expected to feature bans or disapprovals so that regulators could appear to avoid imposing high regulatory costs.

Recognizing and in a level-headed manner incorporating indirect cost into the analysis presents serious challenges but, if the executive branch and Congress emphasize cost over net-benefit assessments, manpower and resources are freed for a wider assessment of indirect regulatory costs.

Dealing with indirect costs, and all costs for that matter, will ultimately require congressional approval of final agency rules, because complete cost assessments and quantification are impossible for third parties who are mere mortals (Buchanan, 1969: 42–43), no matter which government agency they work for. This points to an important principle: the aim of annual regulatory accounting cannot be not solely accuracy, but to make Congress more accountable to voters for regulatory impacts, and to induce agencies to minimize indirect costs by ensuring that they "compete" before Congress for the "right" to regulate. Even imperfect recognition of the magnitude of indirect costs can provide a basis for allocating scarce resources in loose correspondence with where a (perhaps one day) more accountable Congress believes benefits to lie. The presidential pen and phone can raise the profile of this important concern.

Formalize "do not regulate" reporting and offices

Some have called for an independent congressional office of regulatory analysis resembling the Congressional Budget Office (US HR CGRO, 1998). This would go beyond more resources for OIRA or agency economics. There are scenarios in which the independent office could be a good idea, such as if the entity were formally chartered with an anti-regulatory "bias" to offset the pro-regulatory bias prevailing in the entire rest of the federal government, including its independent agencies. Some formal entity could highlight the desirability of market-oriented alternatives over command options for every regulation, and continually present the case for eliminating existing rules and create plans for elimination of regulatory agencies themselves. A much stronger version of OIRA or a body that replaces it, in conjunction with agency law and economics personnel of laissez-faire persuasion, could bolster this "Bureau of No" role.

Conclusion

> *Joyfully to the breeze royal Odysseus spread his sail, and with his rudder skillfully he steered.*
>
> —Homer, *The Odyssey* (trans. G.R. Palmer).

The modern conceit is that untethered regulation and rule making always work. They do not; overreach by bureaucracy and the administrative state may not only impede economic efficiency but also undermine health, safety, and environmental progress. Healthy government requires recognizing downsides to coercive intervention; it requires vigilant legislative and executive institutions and mindsets that seek reasons *not* to add yet another rule or decree to the existing tens of thousands. Meanwhile the public has a right to know the ways federal agencies have harmed and harm that which they oversee, and how those negatives may propagate beyond the agency throughout the economy and society.

Despite semi-formal central review of economic, environmental, and health and safety regulations and their accompanying paperwork since the late 1970s and the 1980s, a significant and escalating regulatory burden is apparent:

- costs of regulation and realms subject to regulation have grown, while benefits remain ambiguous;
- entire sectors of society experience regulation from independent agencies that get little scrutiny;
- *Federal Register* page counts occupy record heights;

- economically significant and major rules reviewed annually have increased notably over the past decade;
- regulatory dark matter outside the normal notice and comment procedure lacks adequate scrutiny.

It is no longer enough just to cut federal spending and balance the budget. This essay has stressed the need to offset the march of bureaucracy and regulation and proposed ideas for doing that, even though the current reality assures us that the Constitution is not coming to the rescue in the near term. There is much about which to be optimistic; the ideas that created the American experiment in the first place remain "discovered", available in the public domain. One might say, there will always be an America—somewhere. To keep it here, we need merely the rocks off of America's economic lawn. Given today's economy, there should be bipartisan momentum for economic and regulatory reform, some animated new constituency for limited government.

The regulatory process, therefore, itself needs more regulation. The executive and legislative branches may not agree on congressional reassertion of its authority with respect to making of law and regulation. While it would be preferable that Congress engage by implementing the Regulatory Improvement Act, the REINS Act, and other measures that directly limit agency authority, those face veto threat and must await a change in the presidency. Still, many recommendations presented here can be implemented by executive action, by the same pen and phone now used to expand the state. However it happens, the new normal needs to be one that ensures that, if an expensive or burdensome regulation is enacted, elected representatives are on record for or against, and accountable to voters.

The federal regulatory enterprise increasingly affects many, and changes are likely one way or another. With conventional options to restore liberties and elevate the rule of law exhausted or ignored, the states themselves may address the federal government's expansion by taking rightful powers back from Congress and the executive branch. The Constitution's Article V does provide for the states to call a convention to amend the Constitution and restore balance of power, and several states are pursuing that option (Brown, 2014). One proposal with respect to over-regulation specifically is the "Regulation Freedom Amendment" that would empower two thirds of the states to force Congress to propose said amendment. The amendment would stipulate that, in any given instance, a quarter of the members of either the House or the Senate could require Congress to vote on a significant federal regulation, very much like the REINS Act legislation would do (Buhler, 2013). Such as step can be avoided by reconsidering the regulatory state via recommendations presented here. The modern statesman's primary task is to double GDP, rather than to double spending or regulatory burdens, no matter the political party.

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